



## **Atlantic Roundtable on Equalization**

**July 20, 2005  
Moncton, NB**

### **A Report from the Atlantic Provinces Economic Council**

On July 20, 2005, the Atlantic Provinces Economic Council (APEC) hosted an Atlantic roundtable on behalf of the Expert Panel on Equalization and Territorial Formula Financing in Moncton, New Brunswick. The Expert Panel has been asked to provide advice to the federal Minister of Finance on Canada's equalization program, on topics such as the relative merits of the Representative Tax System (RTS) versus macro measures; the appropriateness of incorporating expenditure need; the treatment of revenue arising from natural resources, property taxes and user fees; mechanisms to ensure stability and predictability of payments; appropriate measures of fiscal disparities; and the need for a permanent independent advisory body.

The roundtable provided an opportunity for a cross section of regional leaders to share their views on the equalization program and proposals for reform. The meeting was moderated by Aldéa Landry, President and CEO, Landal Inc. and former Chair, APEC Board of Governors.

Professors Paul Hobson (Acadia University) and Wade Locke (Memorial University) launched the session by providing an overview of their perspectives regarding the role of equalization and the various proposals for reform. Professor Hobson argued that efficiency and horizontal equity are two key principles that should underpin any equalization program, and that the Canadian equalization program is enshrined in Section 36(2) of the Constitution Act, 1982 in order to fulfill these two principles.

Professor Hobson indicated that a key parameter for the equalization program is responsiveness, with a formula-based program without an arbitrary ceiling as the best way to ensure this. Responsiveness overrides any concerns about predictability, which he pointed out could be addressed through other means (such as a moving average provision). He argued that a formula-based program is also inherently transparent, although recent unilateral decisions by the federal government suggest the need for a permanent advisory body. He further postulated that a program most consistent with the principles of equalization would be one that uses the Representative Tax System (RTS) and equalizes to a single standard. In his view, arguments in favour of expenditure needs, based on the experience of other jurisdictions such as Australia, should be treated with caution because of the very different structures of these federal states.

Professor Locke identified the treatment of natural resources as a huge issue for the equalization program, as resource revenues, notably from oil and gas, are a significant contributor to fiscal disparities. He favours a formula based approach under a ten-province standard (no ceiling), with full inclusion of natural resource revenues if they are used to benefit residents just like any other revenue source. He also argued in favour of the RTS as being most consistent with the principles stated in Section 36(2) of the Constitution. He pointed out that some changes are warranted in the treatment of revenue sources such as sales tax, where different average provincial tax rates apply to different segments of the base. In this case, it may be appropriate to split the sales tax base into HST and GST components. On the topic of expenditure needs, while he acknowledged that the principle is attractive, he argued that in practice it would be difficult to implement and requires more research. He also rejected suggestions of shifting from the current gross system (where equalization transfers are made to provinces with positive entitlements) to a net system (where the federal treasury would receive a reverse flow of equalization transfers from (richer) provinces with negative entitlements) as politically unfeasible.

The moderator then opened the floor for discussion.

Delegates addressed the essential role of the equalization program as a tool to strengthen the Canadian federation and provide support for the provision of services in have-not provinces. Most agreed that responsiveness, rather than predictability should be the overriding criterion.

One delegate felt that equalization should be broadened to include consideration of the provincial benefits of other federal activities such as having the national capital in Ontario or spending on military bases. However, others pointed out that the objectives of equalization, ensuring that all provinces can provide reasonably comparable public services at reasonably comparable levels of taxation, should not be confused with objectives of (regional) economic development. The principles of economic development and equalization are stated in separate but related sections of the Constitution Act, with economic development covered in Section 36(1).

Specific comments on the equalization program focused on several key issues.

### **A. The Level of Equalization**

There was strong support for a formula driven program. Participants expressed concern about the current limits on the program and rejected the concept of a fixed and arbitrary ceiling in the design of a new formula. Participants emphasized that the Panel must address this in its report to the Minister, even though it was not explicitly asked to comment on this issue.

Responsiveness was identified as the most important criteria. Although equalization entitlements can and have been scaled back during times of federal budget constraints, it was pointed out that this has negatively affected the adequacy of the program. One participant warned that under these limitations, the equalization program could be subject to a Constitutional challenge.

Some participants rejected federal concerns regarding affordability. One delegate suggested that if provinces were fully equalized to a ten-province standard, then the need for other

forms of federal support (such as politically motivated economic development initiatives) would be correspondingly diminished.

Many identified a net (as opposed to gross) system as the ideal to be pursued, but recognized that in the current political climate, this option could be seen as excessive, and unlikely to gain support. One delegate thought that the concept of a net program was rejected too quickly and proposed that full equalization could be achieved by integrating the Canada Health Transfer / Canada Social Transfer (CHT/CST) into the equalization program, and extracting negative entitlements from have provinces on this broader base. Others expressed doubts about whether larger provinces would be receptive to this.

Delegates recognized that equalization program could be subject to considerable strain over the next two decades as the rapid growth of oil and gas revenues will disproportionately benefit provinces such as Alberta. Under these circumstances and a ten province standard, it is conceivable that even wealthy provinces such as Ontario could become eligible for equalization. However, it was pointed out that the principle of inclusion, whereby all provinces are eligible depending on their fiscal circumstances, is an essential feature of the Canadian program. On a practical level, it was noted that Ontario, because of its large size, would never move far (below) from a ten-province standard.

## **B. The Standard for Equalization**

There was general support in favour of a ten-province standard, including full inclusion of natural resources, as the system most compatible with the principles of equalization enshrined in the Constitution. It was also emphasized that there should be a single standard to which provinces are equalized.

One observer questioned whether the differences between a five-province standard and a ten-province standard would be significant, especially when the total amount of equalization is fixed. But others stated that under a fixed amount of equalization, moving the standard up or down could have huge implications for individual provinces depending upon how the allocation is made.

## **C. Expenditure Need**

While participants indicated their receptiveness to including measures of expenditure needs in the equalization formula, most recognized it would be very difficult to implement. Complications arise around topics such as the measurement of the value of public services. How does one, for example, measure the benefit associated with road or infrastructure spending? Concerns were expressed that this could act as a disincentive to provinces to offer or efficiently deliver public services. There was general agreement that this topic requires a significant level of research effort before policy makers will be in a position to review alternatives.

Delegates did point out that a clear case can be made for incorporating expenditure needs in areas that are easier to measure. For example, demographic differences clearly boost health and education costs and measures to reflect this could be incorporated in the CHT or CST rather than relying exclusively on equal per capita transfers. However, one observer questioned the value of incorporating expenditure needs in these programs, arguing that program expenditures reflect policy choices of provincial governments and that higher wage costs in some provinces would offset greater needs in other provinces.

#### **D. Representative Tax System (RTS) versus Macro Measures**

There was strong endorsement of the RTS as the most appropriate measure of fiscal capacity in line with the stated principles of equalization and the need for a responsive system. It was noted that while arguments in favour of macro measures are often premised on their effectiveness at measuring individuals' ability to pay, these measures are largely designed to redress vertical income imbalances rather than equalize provincial capacity to provide comparable services.

In addition, macro measures are subject to a host of data measurement challenges. However one observer suggested that the data issues relating to the RTS can be just as problematic. Moreover, it was pointed out that the RTS can hardly be defined as responsive when it takes several years before equalization payments are finalized.

#### **E. Natural Resources**

There was a general agreement that resource revenues from all sources, including onshore and offshore oil and gas, mineral and forestry resources and hydro electricity, should be fully included, to the extent that they are being used as any other revenue source to provide services, lower taxes or reduce debt service costs. Most participants saw no legitimate argument for excluding natural resources apart from possible affordability concerns and one delegate argued that this could be addressed by including natural resources and then scaling back all entitlements to meet an imposed budget constraint. Excluding natural resources favours certain provinces which undermines the principles of full inclusion and equal treatment.

One participant argued that natural resource revenues should be excluded from the equalization formula on grounds that these represent a run down of capital assets. Provinces might be deterred from exploiting resources if 100% of these revenues are taxed back, pointing to a possible disincentive effect. Other participants responded that the capital asset argument was spurious and emphasized that there was no empirical evidence to support the disincentive argument.

Measurement problems for natural resources were not identified as a key challenge except in the case of imputed hydro rents and oil leases. Some participants indicated that the equalization formula should also include "imputed" resource revenues from provincial hydro corporations (such as in Quebec and Manitoba).

## **F. Property Taxes**

Property taxes are a difficult issue even though most assessments are now based on market values. The issues have been examined extensively in the past but without consensus. There are different views as to whether market values reflect ability to pay (i.e., fiscal capacity) or whether they simply reflect scarcity value. If higher market values reflect higher amenities or quality of life, then in the opinion of one delegate, they should be equalized.

It was noted that the compromise discussed at the last equalization renewal (whereby market values would be used for 50% of the base, and modified for unique price circumstances in British Columbia) seems to have broad acceptance among the provinces.

## **F. A Permanent Advisory Commission**

There was considerable agreement on the benefits of having an independent advisory body. It could reduce some of the politics and perceptions of bias in the current program. An independent commission would help overcome the natural bias of officials who necessarily seek to protect their own (provincial) interests.

However, it was stressed that such a body should not have executive powers as this would undermine the democratic accountability of elected officials. One delegate felt that an advisory committee was a better concept than a commission.

Even under a formula-based program, an advisory body could help address technical issues by supporting research on topics such as expenditure needs, and providing a mechanism for on-going review and public consultation. An independent body could also improve transparency and accountability through regular reporting on the functioning of the program.

Several participants proposed that members of such a commission should include appointments by both federal and provincial governments.

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