

Summary of the meeting in Montréal, June 8th 2005.

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The following overall conclusions can be drawn from the discussions reported below:

- 1) Equalization must be looked at in the more general context of the sharing of fiscal resources and of all federal transfer programs;
- 2) A closed envelope for Equalization was criticized for various reasons .The main ones were that this created a zero-sum game with winners and losers and that it was no longer an equalization program, with total payments not varying when appropriate. In defence of this approach , it was noted that this allowed separating allocating and setting the amount;
- 3) The Equalization formula should not take into account needs or costs differences but other programs perhaps should (health care);
- 4) The Representative Tax System (RTS) approach was preferable to other approaches such as the use of macro indicators to allocate equalization but its implementation needed to be well thought out;
- 5) Natural resource revenues were a difficult subject, but most participants agreed on a 100% inclusion of natural resource revenues in Equalization ;
- 6) Revenue stabilization was important in Equalization reform but not central:
- 7) A permanent body should be created to generate information (data, studies) about Equalization but not to set the amounts paid out.

Before turning to the items discussed in some detail, one should note that several participants stated that it was difficult to analyse Equalization only. This transfer interacted with other transfers and programmes, and federal government intervention in several economic sectors complicated analyses. Analysts had difficulties “seeing the whole picture” because issues were complex and they did not have all the data and information needed. Many participants felt that several aspects of federal provincial sharing of responsibilities and resources needed to be re-examined, not only Equalization. One example of this is the link between economic development and equalization. It was

argued that provincial governments did not have the proper incentives to pursue growth policies and get themselves out of poverty. While regional development initiatives and equalization are distinct issues, one dealing with redistribution, the other with growth, equalization while not promoting growth actively should not hinder it passively.

Closed or open envelope?

The group was not keen on the closed envelope proposals, for several distinct reasons.

- First, with such a system, provinces could only gain or lose equalization entitlements at other provinces' expense/gain. This would favour bilateral and ad hoc agreements (such as the Atlantic Accords), creating transfers favouring certain provinces, and going against the principles of Equalization.
- The pre October 2004 system was that disparities were measured first and then payments were made. Post October 2004, total payments are first defined, and then each province's share is calculated. This may stabilize federal payments and make provincial amounts more predictable but less stable in terms of financial needs.
- A fixed envelope was undesirable because it did not permit total equalization payments to decrease when disparities were reduced.

It was put to the group that pre October 2004, the federal government adjusted the equalization computations in part to achieve a total outlay target anyway. A fixed envelope makes this explicit.

Should the formula take into account needs or costs?

It was generally, though not unanimously, agreed that measures of needs and costs should not be included in the computation of Equalization entitlements since:

- incorporating needs and costs in Equalization payments might because of moral hazard have provinces “create” additional spending needs;
- introducing needs and costs would only complicate matters further, making it impossible for an informed citizen to understand.

Some participants agreed that it would be more appropriate to incorporate measures of cost and needs, such as poverty, into other transfers, particularly the social or health transfers. Another proposed to include measures of fiscal capacity in the social and health transfers. Such changes may be more easily done for the social transfer as the current 10 year agreement for health funding is based on the principle of per capita grants.

There was a debate on the measurement of needs and costs. One participant noted that if prices were taken into account the relative disparity between the rich and the poor would surely diminish, as the purchasing power of a dollar is much higher in real terms in less developed areas (particularly for real estate, capital expenditures, and wages). Another participant noted that the disparities were indeed real, particularly if you measured levels of and access to education, the number of children, levels of pollution, and other types of human capital accumulation.

Representative Tax System or macro approach?

There was a general agreement on using the RTS for calculating Equalization entitlements since:

- RTS was the closest measure to the second part of the constitutional requirement of “reasonably comparable levels of public services at reasonably comparable levels of taxation”.
- using macroeconomic indicators might not solve any problems as the federal-provincial debates would only shift to different grounds. Another area of concern was the underground economy, which would not be measured by a macro type approach.

Overall, participants expressed the desire for the Equalization formula to use “encompassing” measures of fiscal capacity. The Equalization calculation should use exhaustive measures of provincial fiscal capacity to better align Equalization computations to actual provincial government finances. Participants noted that although in some cases bases were defined and taxed differently, whenever bases were comparable they should automatically be included in Equalization computations. One participant noted that both macro and RTS approach involved aggregating data using respectively prices and tax rates and thus were therefore not conceptually that different. But that taxation rates were more easily manipulated by governments than macroeconomic market prices. Hence a valid question is: could provinces react strategically to the presence of Equalization payments by setting lower or higher tax rates?

Natural Resources:

A consensus emerged that natural resources should be included at 100% in equalization, which was consistent with equal treatment of all provinces. It was mentioned several times that the Atlantic Accords went against the spirit of Equalization. Participants acknowledged there were, however, several important issues to be considered. It was suggested that the inclusion of petroleum would generate substantially higher total Equalization payments for the federal government. It was not clear how the federal government could afford these extra payments if it did not have access itself to this tax base. According to some, this was the key in deciding whether petroleum should be included at 100% in the calculation of Equalization.

Participants discussed whether there should be a distinction between renewable and non-renewable resources and whether natural resource revenues should be considered on a cash-flow basis or whether they should also include revenue capitalisation which included economic rents.

Finally, it was noted that the Canadian federation was somewhat unique in the industrialized world (thus neglecting Nigeria and Sudan): besides Russia, no other country has such an uneven distribution of natural resources. Russia, though, already has a system of bilateral accords.

Revenue stabilization?

While fluctuations in equalization entitlements are normal and very much in the spirit of equalization, most participants acknowledged that the current Equalization system contained uncertainty. The 42 month and 7 round process of entitlement calculations was one major source of uncertainty. Shocks caused by quinquennial census information on population and changes in Ontario's economy were also of concern. It was agreed that revenue stabilization or smoothing should be an objective in an improved Equalization formula. Provincial governments need some type of certainty if they are to plan their finances properly, although the level of revenue guarantee should not be 100% of initially projected entitlements. Several participants highlighted that revenue smoothing may impose costs of a different kind if smoothed equalization adjustment payments turn out to be anti-cyclical. If for example 80% of projected entitlements were paid up front and the balance paid two or three years later, payments could arrive at the wrong time in the business cycle. Extra payments due to a local recession would come too late.

Necessity of having a permanent body for Equalization :

It was agreed by almost all the participants that it was appropriate to set up a permanent body dealing with Equalization. A majority of participants thought this body's mandate should consist of information gathering and analysis. This body would liaise with provincial treasuries and Ministries of Finance, deal with technical issues and ensure data quality. It would be free to publish papers and simulation analyses. One important function of this body would be in communications: disseminating information on Equalization, namely its purpose and computation, to the general public. Indeed, on several occasions it was noted that the general public does not understand the objective or

the functioning of the Equalization transfer. It would probably need to examine how the equalization formula interacted with other transfer payments. Very few participants wanted that body to calculate payments to provinces. It was noted that the benefits of a small technically oriented group were substantial, easily identifiable, and available at relatively little cost, while the benefits of a large and costly body susceptible to political pressure were probably marginal. All participants stressed the importance of such a body's independence.
