

**Provincial Fiscal Equalization and Territorial
Formula Financing:**

**Expert Review Panel Consultation at the C. D.
Howe Institute, June 10, 2005
Rapporteur's Comments**

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SUMMARY AND DISCUSSION

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By Jack M. Mintz

On June 10, 2005, forty-one consultation participants gathered to discuss Canada's Provincial Fiscal Equalization and Territorial Formula Financing (TFF) programs. I will review four issues that were discussed during the day: (i) what objective is sought via the Equalization and TFF programs, (ii) what appropriate measure is needed to achieve the objectives being sought, (iii) what design issues need to be addressed and (iv) what process should be developed in designing the two programs.

1. Objectives

Discussions appropriately began with a debate over the objectives being sought for designing the Equalization program. Should Equalization be used to achieve greater horizontal equity whereby Canadians, with similar resources, would have the same incomes including the value of government services no matter where they live? If so, why not replace the Equalization program with transfers to individuals who can then determine through the political process the allocation of resources between public and private goods and services? Or is the objective of Equalization program to ensure that comparable public services are provided at reasonable tax rates across Canada's region, requiring allotments to governments?

In general, most participants agreed that the primary objective of the Equalization program and TFF funding is the second objective, consistent with the Constitution Act of 1982, to ensure comparable services at reasonable tax rates. Therefore, the provision of funds directly to provincial governments that are unable to accomplish this objective is the primary focus of the Equalization program.

2. *Measuring Fiscal Needs or Capacities*

Given the objective of Equalization and TFF funding, the participants discussed two possible approaches to measuring the entitlement – one based on expenditure needs (similar to an approach used in Australia) and the other based on fiscal capacity (revenues as in the current Canadian approach).

In general, participants agreed that an approach that includes some element of expenditure needs would be appropriate in principle. In particular, the cost of providing public goods and services can vary across the country, especially due to differences in age distributions and wage rates. The cost of living is especially high in the North, and indeed expenditure plays an important role in setting TFF payments. However, the Australian approach to equalization was rejected by most on practical grounds. It was felt that attempting to measure representative per capita expenditure needs would require an assumption that all provinces and territories should be providing the identical goods and services, which is inconsistent with provincial autonomy and a much more decentralized government in Canada compared to Australia. Further, it would be highly complex to implement the expenditure approach and would affect provincial expenditure decisions that influence how much money would be received.

Much more consensus was achieved with respect to basing the Equalization and TFF programs on fiscal capacity. However, a difficult set of issues rested with defining fiscal capacity.

The typical assumption is that provincial revenues on a per capita basis would be used to measure fiscal capacity. A bigger set of issues might be raised, however, as to how such revenues should be measured. For example, should revenues be summed up and measured relative to provincial income? Or should revenues be measured according to the current approach under the Representative Tax System by measuring each tax base and rate. I will return to this subject below but here I will raise some of the trickier issues.

The first question is what is the appropriate measure of fiscal capacity. One approach would be to take provincial gross domestic product as a measure of income and fiscal capacity as some tax rate multiplied by the income measure, producing revenues that fund public goods and services in the province. This measure of fiscal capacity is the basis for the “macro” approach. A second approach is to measure fiscal capacity by defining some notional tax base that would be multiplied by a standard tax rate. The Representative Tax System, using the existing tax bases for income, sales and other taxes, is effectively

based on this system. A third approach would be quite different – it would be based on measuring the cash flow used to finance public goods and services. Cash flow is different from income because it recognizes financial transactions as part of the resources used to spend on goods and services besides revenues received: revenues can be used to pay for public goods and services or to invest in assets or pay down debt and provinces can borrow money or sell assets to spend on goods and services.

Regardless of the approach, several difficulties remain. The most problematic is the treatment of resource revenues received by the provinces. Considerable divergence in fiscal capacities arises from differences in resources wealth owned by the provinces, which is not fully reflected in income measures. Some resource revenues, like hydro, are not included in the formula since the resource is owned by a provincial Crown Corporation. Further, non-renewable resources (oil, gas and mining deposits) result in provinces receiving one-time “capital” revenues because the presumed income is equivalent to selling off an asset once the resource is extracted. Neither the macro-approach nor Representative Tax System easily deals with natural resources, which has plagued negotiations over the Equalization system since the oil price shocks of the 1970s.

An intriguing proposal to only claw-back 20 percent of the resource royalties under the existing Representative Tax System was subject to considerable debate with no consensus reached. The rationale for only a 20 percent claw-back is based on a concept that if the resources were privatized, the provinces would only be collecting revenues equal to 20 percent of the resource royalties. The approach would also be politically convenient in that no one province would lose equalization payments although the federal government would have to pay more.

The aforementioned hypothetical argument was criticized by some delegates as being too ad hoc. First, the provinces tax resources more highly than other forms of income – in the case of provincial ownership of resources, the actual revenues they receive add to their fiscal capacity, not some hypothetical amount. Second, the approach fails to recognize that the capital nature of non-renewable resource revenues and discourages provinces from following a fiscally-prudent policy. The cash flow metric of fiscal capacity would create better incentives for provinces to manage their fiscal finances over time.

The issues raised were not resolved by a consensus. More time was needed to be spent on the question of royalties and how they relate to fiscal capacity. The cash flow approach was only briefly discussed.

While resource revenues raised some very difficult issues for equalization, other issues were discussed, some of them also very briefly.

- The question of property taxation raises issues related to economic rents, due to agglomeration of people moving to preferred locations. In theory, the benefits of living in large urban areas will be capitalized in real estate prices, therefore providing a larger tax base for provinces and municipalities levying property taxes based on market value or some proxy close to its value. Therefore, it seems that property values would be appropriate to include as a wealth measure of fiscal capacity, which would be unrelated to income.
- User fees or benefit-related taxes would be included as revenue subject to equalization if they are viewed as an alternative to general taxation powers. However, one could make a case that fees are a payment for benefits received by the user so that the cost of public services, net of user fees, should be subject to equalization. The topic was only briefly discussed and the participants did not express a view on the subject. Yet, it raises an important issue. For example, as discussed above, resource royalties and stumpage fees can be viewed as user fees paid by companies for the right to extract minerals or cut down trees owned by provincial governments. One approach would be to exclude them entirely from the Equalization formula. The other approach is to fully include them, because government may use royalties or taxes to raise revenues that add to their fiscal capacity to provide public services, which seems more reasonable to me.
- In general, there seemed to be consensus that the 10-province standard is more appropriate than a 5-province standard for determining the allocation. The use of the 5-province standard was to reduce the cost of the program. One specific point worth considering is to consider limiting payments to some ratio, such as 80 percent of the 10-province standard, rather than achieving a similar fiscal result by excluding some provinces from determining the national standard. This approach would have the benefit of reducing clawbacks that have incentive effects on provincial decisions.

- The time period chosen to determine the equalization allocation need not be set to one year only; a fixed-ratio provincial allocation is possible over several years. During this period, the system operates as a revenue-sharing approach with amounts only varying by the total quantum allocated. A longer period smoothes out fluctuations in payments compared to a year by year approach. However, the longer the period chosen, the greater might be the revisions needed at the beginning of a new period if a secular trends in growth rates means that a province should be getting a significantly different share.

3. *Design Issues*

The design of the Equalization program should be based on a reasonable set of criteria, including the following:

Redistributive objectives: Consistent with the intent of the program, the allocation should be fair in assisting provinces to provide comparable public services at reasonable cost to provincial taxpayers.

Efficiency: The mechanism should be such that it distorts at least as possible decisions to allocate resources to achieve the highest net benefits possible.

Transparency: The system should be transparent so that voters are able to understand how the program operates.

Predictability and Stability: The allocation provided should improve the stability of revenues received by provinces and also be predictable for planning purposes.

Several criticisms were made of the Representative Tax System. First, in designing a program that redistributes wealth, 100 percent tax-back rates that reduce the incentives for provinces to develop their economies surely makes little sense. Specifically, recipient provinces whose economy grows would see an expanding per capita tax base and would lose Equalization entitlements, perhaps compromising their budgets. A social program should balance redistributive objectives with the efficiency cost of distorting decisions and it seems unlikely that 100 percent is an optimal clawback rate. Second, the existing

Representative Tax System is too complex and, as a result, undermines transparency. Third, while the recent program reduced fluctuations in revenues faced by provinces, its payments were not predictable because they were subject to multiple adjustments, including during the budget year.

Although there was no consensus, some participants were attracted to a simpler approach for equalization such as the macro-approach. Under the macro-approach, as discussed in detail by one of the speakers, the allocation would be based on the difference between per capita national and provincial tax base multiplied by two factors: the provincial population and a tax rate expressed as a ratio total tax revenues in all provinces to a total tax base. Possibly the tax base would be simply private and public gross income (such as GDP), which is less subject to policy determination. One could adjust the formula for needs by weighting people differently. One could even choose to reduce the 100 percent clawback rate by only allowing for a proportion of the difference in per capita tax bases to be used for determining the Equalization payment.

One issue that is increasingly unclear is whether the total equalization payment paid to all provinces is no longer reflective of the degree to which inequality in fiscal capacities now exist. Evidence has shown that fiscal capacities among the provinces have been moving towards to the national average (leaving aside Alberta).

Further, by fixing the aggregate amount as recently done, provinces will be squabbling over the allocation shares – more given to one province leads to less allocated to the other. This could lead to quite difficult negotiations based on a zero-sum game for provinces when the allocation shares are determined independent of a fixed aggregate payment. Allowing negotiations to affect the total quantity (based on a principled approach) would create a better atmosphere for negotiations.

4. Process

The use of a permanent advisory committee raises a host of governance issues. Who would appoint the body? What would be its role? What information would be made available to the committee that would be independent of the governments? Delegates were somewhat lukewarm about creating a separate body unless it was purely a technical body to advise governments or inform the public. Such a body could be a useful forum for addressing difficult questions that could be politically problematic for elected officials to take on in public.

Some reference was made to the Canada Pension Plan as a model because CPP is a joint federal-provincial program of whose legislation cannot be changed without the approval of the federal government and at least two-thirds of the provinces representing two-thirds of the population. Given the federal government pays for the cost of operating the Equalization program, it would seem that the rules would continue to be subject to federal Ministerial responsibility. A CPP model with provincial control would imply a much different funding approach, which would require contributions from the provinces to a trust fund, which would result in direct payments made by one province to others as in Germany.