

**Report on the
Expert Panel on Equalization and Territorial Formula Financing
Workshop**

Minto Place Suite Hotel
Ottawa, Ontario
June 3, 2005

In attendance from Panel:

Al O'Brien, Chair
Fred Gorbet, Member
Robert Lacroix, Member
Elizabeth Parr-Johnston, Member
Mike Percy, Member

The Secretariat of the Expert Panel

Academic Participants:

Serge Coulombe, Moderator
Bev Dahlby
Jean-Yves Duclos
Jim Feehan
Paul Hobson
Michael Smart
Tracy Snoddon
François Vaillancourt
Sam Wilson

Report prepared by Bev Dahlby

Summary of the Discussions

There was a consensus among the academic economists who attended the meeting that the Representative Tax System (RTS) should be retained as the basis for the current equalization formula, although with significant modifications. Concerns were expressed about the practical and conceptual problems in implementing a needs component in the equalization formula, which would take into account variations in demographic and cost factors across provinces. There was no support for a macro formula because using a single macro variable, such as per capita gross provincial product or personal income per capita, would not adequately reflect provincial tax practices and their fiscal capacities. While expressing support for an RTS system, the participants generally felt that the current formula needs major revisions. There was a strong desire to return, as soon as possible to a formula-based system capable of committing the provinces and federal government to a set of relatively stable rules regarding equalization payments.

It was pointed out that there has been a long history of special treatment of resource revenues in the equalization program and that a number of committee reports and task forces have recommended that only 20 to 50 percent of resource revenues be included in the equalization formula. The arguments for partial inclusion of resource revenues include the need to provide provinces with appropriate incentives to develop and price the natural resources that are under their control, a desire to reduce the volatility in equalization payments, and a need to make the equalization program “affordable” because it is financed by federal taxes and the federal tax base does not closely correspond to the resource revenue base that gives rise to equalization entitlements. The partial inclusion of resource revenues means that full equalization of fiscal capacity across provinces is not possible, leading to differences in the net fiscal benefits received by individuals in different provinces. There was no consensus as to what constitutes acceptable differentials in provincial services and taxes.

It was also pointed out that there is a wide variation in the degree of equalization in other federations around the world, ranging from a very strong commitment to uniformity in taxes and services in Germany and to the total absence of a formal equalization program in the United States. The variations in the extent of fiscal equalization among federations reflect their political and social cohesion. In this sense, the level of equalization is ultimately a “political” question that a federation must resolve based on its shared values and economic circumstances. With regard to the actual level of equalization in Canada, it was pointed out that the equalizing effects of other programs such as Canada Health Transfer (CHT) should be taken into account in assessing the total level of equalization.

A more detailed summary of the discussion around the three main equalization themes is presented below.

Theme 1: Principle based Allocation

The Representative Tax System

The aim of the equalization program is to allow provinces to provide reasonably comparable public services at reasonably comparable levels of taxation, and not about redistributing income among individuals. Therefore a system that transfers funds to the provinces based on their fiscal capacities is appropriate. There was a consensus that the Representative Tax System (RTS) is the right approach for determining the allocation of equalization, although it needs major adjustments.

It was noted that RTS may be the only way of achieving the goals for equalization as set out in the constitution in sections 36(1) and 36(2) and that one of the most important attributes of RTS is that it tries to reflect the actual tax practices of the provinces. RTS is also an appropriate basis for equalization in Canada because the provincial governments have significant tax powers. In contrast; RTS is less important in Australia, where need is explicitly used to determine equalization, because the Australian states' tax powers are much more limited.

Concerns were expressed that the RTS formula may affect provinces' fiscal decisions as they may attempt to "game" the system to their advantage, although the evidence on the magnitude of these "incentive effects" is inconclusive.

There was no consensus as to whether the current five province standard or a ten province standard should be the basis for equalization because this issue is intimately connected to the treatment of non-renewable resource revenues in the formula. (The discussion on this issue is contained in a following section.)

Macro Formulas

There was no support for a macro formula because using a single macro variable, such as per capita gross provincial product or personal income per capita, to determine equalization entitlements would not adequately reflect the tax practices and the fiscal capacities of the provinces. It was also pointed out that provinces might still have adverse incentives, with regard to tax rates and economic development policies, under a macro formula.

A Needs Component

There were concerns about the conceptual and practical problems in implementing a needs component in the equalization formula, which would take into account the variations in demographic and cost factors across provinces. There are problems in defining needs, as opposed to actual expenditures on programs, and variations in expenditures across provinces may reflect differences in preferences and priorities rather than "need". Cost differentials are problematic. With some indicators of need and using average provincial wages and salaries as an index of cost, Ontario might qualify for equalization. It was also felt that a needs formula could become very complicated as more and more factors might be added to reflect specific needs in each

province. There was also concern that a needs component in the equalization formula would create many more opportunities for provinces to adopt fiscal and regulatory policies that would increase their equalization entitlements.

However, it was acknowledged that the Territorial Funding Formula has to be based on needs because the territories have relatively little capacity to raise tax revenues. The Australian approach to equalization, where need is a major component of the equalization formula, might work for the territories, but not for the provinces, because the Canadian provinces have much greater tax powers than the Australian states or the Canadian territorial governments. There was some support for incorporating the higher cost of providing services in Northern Canada in the Territorial Funding Formula.

Other Issues

The problems of measuring particular tax bases under the RTS formula were discussed. The use of federal personal income tax by province was suggested as an alternative to the current stratified provincial income tax base approach because it would be much simpler and would yield very similar entitlements. The problems with measuring the property tax base were briefly discussed, without any conclusive results.

There was discussion of whether the RTS formula should be used to calculate total equalization or to allocate a fixed amount of equalization that is determined by some other means. Some viewed a split between the allocation of entitlements and the level of equalization as a basic inconsistency. Others thought that it is appropriate to use RTS to determine the allocation of entitlements and to use some other factors, such as affordability for the federal government, to determine the total amount of equalization. With regard to the allocation of the gap between the RTS level of funding and the amount available for equalization, it was suggested that an equal per capita allocation was appropriate.

The possibility of using a hybrid RTS-macro approach was discussed. It was noted that personal income is implicitly used as the base for some taxes. A simplified RTS using only five or six bases and a proxy for the remaining bases that are not measured very well in the current system was also suggested.

There was no support for a system with multiple standards for equalization, even though under the current system every province is equalized to a different standard because the separate “deals” create different standards.

It was generally agreed that we need to get a formula that works and is durable. Both the provinces and the federal government have to commit to a formula. The problem is to design a fiscal arrangements system that has credibility with provinces and the federal government. Having a formula based system such as RTS is more likely to produce commitment and stability than a number-based negotiated system, such as the Canada Health Transfer.

Finally, it was pointed out that other federal transfer programs, such as the Canada Health Transfer and the sharing of federal gasoline excise tax revenues also help to equalize the fiscal capacities of the provinces.

Theme 2: Factoring in Natural Resources

Natural resources revenues are an important reason for equalization because they are not equally distributed across the provinces, leading to large variations in fiscal capacity. However, for most of the history of the equalization program, natural resources have been treated differently than other sources of revenue. Since 1958, natural resources were treated the same as all other revenues in only seven years and for the first five years, they were not considered at all. Continuing to treat natural resource revenues differently from other sources of provincial tax revenue would be consistent with past practices.

Various studies and reports have argued that only 20 to 50 percent of resource revenues should be included in the equalization formula. A number of arguments were put forward for including only a portion of resource revenues:

- the need to give provinces an incentive to develop resources in an efficient manner and not to under price them. Historically, provinces have been under-priced resources to create jobs, leading to uneconomic development of some resources and excessive environmental damage. It was argued that Quebec's hydro-electricity resource might be as valuable as Alberta's oil, but it is underpricing it, resulting in excessive pressures for development and causing environmental problems. It was noted, however, that Hydro-Quebec dividends are included entirely in the equalization formula.
- the practical issue of "affordability". Equalization is financed by federal taxes and the federal tax base does not include the provincial royalties that gives rise to equalization entitlements. In other words, if oil and gas revenue in Alberta were fully included, Ontario residents would be heavily taxed to pay for equalization to the other provinces that do not have oil and gas resources.
- variations in the "quality" of the natural resources. These give rise to differences in the economic rents that the resources generate, and these quality differences are not fully captured by the current system. (For example, the average oil field in Saskatchewan does not generate the same economic rent as the average oil field in Alberta.) Differences in the quality of resources have created pressures to define the resource bases very narrowly, giving rise to the tax back problem.
- the fact that resource royalties are source-based taxes and that resource revenues are volatile because of fluctuations in world prices.
- provincial ownership of natural resources. This implies different treatment from other revenue bases because "the crown cannot tax the crown".

Not with standing these arguments for special treatment of resource revenues, at least one participant argued that, for efficiency and neutrality purposes, all revenue sources should be treated in the same manner for equity reasons and that a 70 percent inclusion rate should apply to all revenue sources.

There were several proposals for modifying the treatment of non-renewable resource revenues:

- provincial expenditures on resource development, associated infrastructure, and the environmental cost of resource extraction should be deducted from the resource revenues that are included in the equalization program.
- measuring resource revenues on a cash flow basis, by deducting private sector current and capital expenditures on resource projects from their gross revenue stream, in order to more accurately measure the economic rents that they generate.
- excluding for equalization purposes, natural resource revenues that are invested in a Heritage Fund until they are used to finance provincial spending
- including 20 to 25 percent of resource royalties from various sources in a single “pot” to be equalized, instead of trying to calculate separate equalization entitlements for different types of resource revenues. This would move the system toward a revenue sharing approach.

Theme 3: Evidence Relevant to the Adequacy of Equalization

There is a wide variation in the degree of fiscal equalization in federations around the world. In Germany, there is a strong commitment to equality of living conditions, resulting in a complex revenue-sharing scheme among the different orders of government. In Australia, the commitment to equality is also strong and “needs” are a major factor in distributing Commonwealth grants to the state governments. In Switzerland, there are equalizing fiscal transfers, but large variations in fiscal capacities exist. In the United States, there is no formal fiscal equalization program. These variations in the degree of fiscal equalization reflect the political and social cohesion of the federations. In this sense, the equalization standard is ultimately a “political” question that a federation must resolve based on its shared values and economic circumstances. To some extent, this reflects different judgments concerning how much citizens are expected to adjust to differences in subnational governments’ fiscal capacities by moving or by accepting lower services and/or higher taxes.

It was pointed out that different countries use different approaches to determining the total amount of equalization. Some use a certain number of federal tax points. The Australians use the sales tax revenue and Germany uses a share of VAT revenues

It was argued that we cannot bring every province up to Alberta’s level. This means that we have to accept the reality that Alberta’s capacity is higher than the rest of the country, and people in nine of the 10 provinces will have lower level of services than in Alberta. This is the reality unless Canadians are willing to spend substantially more on equalization. Currently, the service disparities are not excessive because Alberta’s per capita expenditures are not substantially greater than in the rest of the country.

It was claimed that provinces with large debts have reduced fiscal capacity, but it was also argued that a province should not be rewarded for running up its debt.

It was argued that CHT funds should also be allocated according to the equalization formula, but this would mean that Alberta and Ontario would not receive funding for health care. As a result, the federal government's ability to impose the regulations in the Canada Health Act in those provinces would be compromised. However, a figure was used to demonstrate that the current CHT allocation, which is linked to an equalized income tax point transfer, also helps to equalize the fiscal capacities of the provinces.