

# **Atlantic Policy Forum on Equalization**

## **Summary Report**

**Atlantic Provinces Economic Council (APEC)**

**July 14, 2005**

Canada's Equalization program must be formula driven in order to allow it to appropriately respond in full to the widely divergent fiscal resources of Canadian provinces, and as such it cannot be governed by a fixed amount. Therefore the program should return to one based on the provision of the absolute dollar amounts required to equalize individual provinces' fiscal positions, rather than be limited to the allocation of a predetermined amount of money. The Equalization program should retain the Representative Tax System as a measure of fiscal capacity and not utilize macro indicators. It should not sacrifice adequacy and responsiveness for the sake of simplicity and stability. These were the key conclusions of an APEC Policy Forum held in Halifax on June 14, 2005. While they had many different views on the complexities of the Equalization program, all participants recognised the critical importance this program plays in supporting the provision of public services in the Atlantic provinces and emphasized the need for the federal government to adhere to the principles of Equalization as expressed in the Canadian Constitution (see Appendix A). Other significant highlights of the discussion included:

- All revenue sources should be included in the Equalization formula on an equal basis (i.e., comprehensive revenue coverage). In particular, natural resource revenues, including both offshore and onshore oil and gas revenues, should be fully included in the Equalization formula as variations in fiscal capacity are due in large part to provincial variations in natural resource revenues. Participants did not believe that the Equalization formula acted as a significant disincentive to develop offshore resources.
- Some participants expressed concerns that multiple standards within the Equalization program risked undermining the basic principle as expressed in the Constitution. However, there was a general consensus that the recent Atlantic

- Accords should be regarded as a separate issue from Equalization as they should be seen more as addressing the Constitutional commitment to support economic development, rather than the commitment to equalize provincial fiscal capacities.
- Expenditure needs should not be incorporated into the Equalization program without detailed study of the issues. Provincial variations in population structure might be better addressed through adjustments to the Canada Health Transfer and the Canada Social Transfer to reflect such demographic differences.
  - Some of the concerns relating to measurement of property taxes and natural resources and the stability or predictability of payments could be addressed by adopting changes that have been previously discussed by federal and provincial financial officials, and by aggregating tax bases.
  - Most participants believed that the Equalization program would benefit from a permanent independent advisory body. As a Constitutional responsibility the Equalization program has an overarching role in Canada and therefore requires a special reporting arrangement to the citizens of Canada. At present there is confusion over its role, and decisions on allocations have become highly politicized. While acknowledging that the program is fundamentally a federal responsibility the participants regard the creation of a permanent independent commission as a positive step to provide impartial advice on its operation while improving public knowledge of its functioning.

The Atlantic Provinces Economic Council (APEC) views the work on Equalization by the *Expert Panel on Equalization and the Territorial Financing Formula* to be of extreme importance to the Atlantic provinces. APEC convened a Policy Forum to elicit advice from knowledgeable persons in the region that would be submitted to the Panel and that would be used to promote broader understanding of the program and the changes that are being considered. The Forum consisted of leading academics in the region and was observed by senior Finance officials from the four Atlantic provinces (see Appendix B). It was held in Halifax on June 14, 2005.

### **Background**

At present there is no Equalization formula in legislation. The payments being made for 2005-06 are legislated, fixed amounts totalling \$10.9 billion, as agreed to at the First Ministers' meetings last Fall. The new legislation requires that the overall equalization pool and individual provincial entitlements expand at 3.5% per annum from the 2005-06 level.

The Expert Panel has been appointed by the federal government to make recommendations on a formula to provide for new allocations of Equalization among recipient provinces for 2006-07 and future years. Its mandate is restricted to considerations associated with allocations, not with the total payout. It is also to advise on whether a permanent Commission (or some other body) be instituted to carry on this work on a permanent basis and to advise on possible indicators of fiscal disparities that can be used to evaluate the overall funding level of the program in the future.

The Panel is also examining the treatment of natural resource revenues in the Equalization formula; whether to rely exclusively on the Representative Tax System (RTS) to determine entitlements or to move, in whole or in part, towards a macro formula; and various issues relating to expenditure needs, user fees, property taxes and the stability and predictability of the Equalization program.

The Panel is to report back to the federal government by the end of 2005 so that necessary legislative changes can be put into effect for the 2006-07 fiscal year.

The key points from the discussions at the APEC Policy Forum are as follows.

### **1. Allocating a Fixed Amount**

The participants emphasized that moving the program from a formula-determined one to a mechanism which allocates shares of a fixed amount of funds is a fundamental change to the system of Equalization in Canada. Such a move has significant design implications for a new formula, as changes in entitlements for different provinces will have potentially large indirect effects on other provinces' entitlements. For most of its history the previous formula determined entitlements in absolute amounts with no cap.

The Forum participants unanimously recommended that the fixed amount concept be set aside in favour of a return to absolute measures with no cap.

The federal commitment to a fixed amount stems from the Premiers' call for the total equalization payout to be returned to \$10.9 billion, its level in 2000-01, having fallen to less than \$8.9 billion by 2004-05. Equalization receiving provinces have called for enhancements to the program for a number of years – including a national average standard – and were also concerned that improved federal support for health care through the Canada Health Transfer was strictly on a per capita basis and would be largely, if not entirely, offset by the reduced level of equalization they were receiving.

Many recipient provinces view this “top up” as a temporary measure and continue to call on the federal government to raise the Equalization standard from one based on five provinces to one based on ten provinces to better meet the Constitutional commitment, which would raise the entitlements to an amount in excess of \$14 billion per year. The new commitment of \$10.9 billion, to expand at 3.5%, is clearly deficient by that comparison.

Participants at the Policy Forum noted that allocations of a fixed amount can result in serious problems of instability of entitlements for individual provinces. Further, under a fixed pot of \$10.9 billion, a move from a five to a ten province standard can result in substantial reductions in entitlements for some recipient provinces (e.g., the Atlantic provinces). It was emphasized that the recommendations for changes to the Equalization program under a fixed allocation would be very different from those made under a program with absolute entitlements.

The Forum participants noted that the diverse situations of each province across Canada means that the formula should be free to appropriately respond in full to each province's measured fiscal deficiency, without regard for the total payout. Participants emphasized that the program partly functions as an insurance policy and that provinces' entitlements must be able to respond to their changing circumstances.

It was noted that the Canadian public sector provides an extremely high level of political and taxing autonomy to its provinces, by comparison with virtually all other federal states. This has resulted in large differences in fiscal capacities between provinces. Differences in natural resource endowments accentuate these variations in fiscal capacity. The size and volatility of natural resource revenues for individual provinces can also make year to year swings in fiscal situations a major factor. By comparison, the Australian model of Equalization is based on redistribution of a large amount of revenue to all states to provide equal fiscal capacities, and given their lack of revenue autonomy this is accomplished using broad measures of allocation.

## **2. Should the Equalization Program move away from the Representative Tax System (RTS) to one based on Macro measures?**

Forum participants were unanimous in their belief that macro measures would not serve the program well, and that the RTS in principle must be adhered to as a measure of fiscal capacity.

Concepts such as Gross Domestic Product (GDP) and personal income are national accounts based and were never developed to measure interprovincial differences in fiscal capacities. Furthermore the RTS is a reflection of the actual tax bases of provinces; GDP does not reflect the ability to tax.

It was also pointed out that the personal income tax is a progressive tax and would not be reflected in macro measures.

While macro measures might give the appearance of simplicity it was noted that these measures are in fact extremely complex. It was felt that accuracy and responsiveness were more important factors than simplicity.

The argument that the RTS has significant disincentive effects was also discussed in this context. It was the view of the Forum that these are exaggerated and that

aggregation of bases, use of lagged data or a move to a ten province standard resolves many of these problems.

It was also noted that a move to macro formulae would by its nature provide a huge fiscal advantage to resource dependent provinces such as Saskatchewan and British Columbia who presently receive Equalization, while the Atlantic provinces would lose out.

### **3. Should there be Multiple Standards?**

The Forum participants had divided opinions on this question, especially in the general context of the recent Offshore Accords. Some participants expressed concern that the Accords have degraded the principle of Equalization, while others argued that the Accords do not affect the principle of Equalization or the allocation formula but rather represent a federal government regional development program as mandated by Section 36(1) of the Constitution. It was the opinion of some participants that special rules for special circumstances are part of the Canadian democratic process. It was noted by Forum participants that Equalization is not the only program that redistributes wealth around the country. Other examples are the Canada Health Transfer and the new gasoline tax transfer. Participants emphasized that there is always room for equalization outside the Equalization formula itself.

Participants were in general agreement that the Offshore Accords should be viewed as a separate issue from Equalization, though it was noted that in view of these “side deals” the need for special rules for natural resources in the formula, and especially the 70/30 rule have become questionable. Special provisions such as the 70/30 generic solution and the floor provision impinge on other provinces’ entitlements and are unnecessary now that they are essentially accommodated through these other arrangements outside of the program itself.

In terms of the recent Offshore Accords, some participants were forthright in their support for asymmetry in the Equalization program while others strongly opposed this as a movement away from the Constitutional commitment to equalizing fiscal capacities. Most felt that the Accords were more in line with the goals of Section 36(1) of the Constitution and should be viewed as separate from Section 36(2).

From the perspective of the Equalization formula itself the discussants at the Forum emphasized that the program should be bound by the principles in the Constitution. The Forum participants emphasized that the words used in Section 36(2) are very important (see Appendix A).

### **4. Inclusion of Natural Resource Revenues**

The treatment of natural resource revenues includes onshore and offshore oil and gas, as well as mining taxes and forestry. The Forum emphasized that the large degree of provincial autonomy over their revenues means that interprovincial differences in

natural resource revenues have a major effect on relative fiscal capacities. They cannot be ignored. The implications of removing natural resource revenues from the equation for provinces without natural resources, such as Prince Edward Island, are enormous. Participants again stressed the principles of Section 36(2) in the Constitution.

The Forum participants also noted that there are complex measurement problems associated with resources, but they should be based on economic rents. One participant suggested that it was reasonable to exclude natural resource revenues when they were withheld from public spending through investment in an arm's length Heritage Fund and to include them when they become available for public spending. This was seen as impractical by other Forum discussants, who also questioned if this would not lead to potential manipulation.

Participants discussed the alleged disincentive effects of the RTS with respect to natural resources, noting that some economists have advocated reducing the natural resource inclusion to 25%. The Forum generally agreed that those studies did not recognise the political reality that provincial politicians want economic development and employment and do not engage in steps to reduce development for the sake of winning extra equalization.

The Forum participants noted that the Offshore Accords do not impact on the size or distribution of Equalization directly. It was also pointed out that the Accords only impact two provinces while restrictions on the inclusion or exclusion of natural resources – which has been called for in light of the offshore deals -- impact all receiving provinces. Excluding these revenues would ignore the large differences in fiscal capacity related to these revenues. The Forum participants expressed support for the inclusion of 100% of natural resource revenues.

## **5. Adjustments for Expenditure Needs**

On balance, Forum participants were not supportive of introducing expenditure need into the Equalization formula without further major study.

It was recognised that expenditure needs criteria are an inherent part of the Australian system of Equalization. However, while the principle of considering expenditure needs is valid it raises major measurement problems. The Forum participants also worried over whether the introduction of expenditure needs would take away from provincial autonomy by allowing increased federal discretion over services to be equalized.

Participants discussed the implications of the aging populations as an aspect of fiscal need that might require correction: Perhaps additional weight should be applied to provinces with a large percentage of their population over 65 years. Some participants expressed concern over the complexity that would arise: Would we also need to look at miles of roads, amount of snowfall, numbers of immigrants, etc? Also, in a

situation where we are discussing allocation criteria, how would this impact on the Atlantic provinces? Participants felt on balance that the use of expenditure need in the Equalization formula could potentially reduce entitlements for the Atlantic region.

It was also noted that age weighting federal transfers for social factors would probably be better accomplished through the federal Canada Health Transfer and the Canada Social Transfer. Professor Robin Boadway has proposed dividing these transfers into three, an education component weighted by population of school age, a health component weighted by the elderly and a social assistance component weighted by social assistance needs.

## **6. Property Taxes, User Fees and Complexity in Measurement**

Equalization of property taxes in the present formula is a very large component of the entitlements. Some participants had been involved in a roundtable discussion on property taxes with Federal and Provincial Finance officials in 2003 as part of the 2004 Equalization renewal. At that time it was generally felt that movement to assessed property values and away from simulated base measurements would result in improvements. The April 2004 renewal did introduce these changes to a degree although they have been overridden by the 2004 new Equalization framework and consequently never put into effect. The Forum recommends that the move to assessed property values be made.

The issue of the inclusion of user fees was regarded more as a technical matter by the Forum and one participant suggested that it might be linked to the inclusion of expenditure need factors.

In terms of reducing the complexity of measurement of natural resource bases it was pointed out that much of the complexity was the result of the significantly different economic rents being generated from different types of natural resource reserves. However a fine division of these products leads into problems with respect to tax back and potential disincentives. Some compromise can be achieved by aggregating bases.

## **7. Stability and Predictability**

The Forum was concerned that stability, predictability and simplicity are potentially in opposition to the fundamental principles of the program. Adequacy is much more important: The program must respond to changes in the fiscal circumstances of each province. Modifications to lessen volatility of payments through averaging were included in the 2004 renewal and should be revived. Data shocks, particularly associated with Census have always been a problem.

Forum participants repeated the point that the program is a form of insurance to provinces who fall into hard times fiscally and that it must be able to respond to these needs. It is a way of sharing risks.

## **8. Permanent Independent Commission**

Forum participants emphasized that the Equalization program has a special status in the Canadian Constitution and as such the creation of a permanent body or commission was important. Equally important, a rules based impartial process should serve smaller, less politically powerful provinces better than a purely politically driven process.

Participants recognise that it is very difficult for the public to be engaged in discussions on Equalization at a technical level given its complexity. Yet an informed public is important to sustaining a program that shifts large sums of taxpayers' money about the country. The program is unique in that it is part of the Canadian Constitution and the formula must serve the public interest as described in the Constitution. Participants noted that there is general confusion over the goals of the program in the public eye, particularly between the goals of economic development and fiscal disparities. These are listed separately in Sections 36(1) and 36(2) respectively of the Constitution. The role of Equalization is clearly separate from economic development. The Constitutional status of the Equalization program is critically important and establishes not only a fundamental feature of Canadian citizenship but also an explicit goal which any allocation mechanism must take into account.

Forum participants hold strong views on the need for a separate body to report to the Canadian citizens on the functioning of this program whose objectives are clearly stated in Section 36(2). In recent years the Equalization program has changed from a formula based system to one often shaped by political deal making and federal unilateralism. Participants at the Forum generally felt that a separate body could help depoliticize the program and inform Canadians of developments which threaten the notion of Canadian citizenship implied by the Constitution. Unlike many other parts of the Constitution, the Equalization clause is unlikely to be enforced through the Courts, as it is non justiciable. An independent body could help Canadian citizens ensure Canadian governments actually comply with this clause.

Nonetheless, Forum discussants were also conscious of the fact that someone has to appoint the members of the Commission and the ultimate legislation has to be federal. It was recognised that political input would still need to occur.

While some participants expressed fears that a Commission would negate the involvement of elected officials, others regarded the creation of a permanent body as a significant measure to help improve informed debate of the issues. It could also provide independent advise on the operation of the formula and the RTS.

**Appendix A: Canada’s Constitutional Commitment to Equalization and Economic Development (The Constitution Act, 1982)**

*Section 36(1) Without altering the legislative authority of Parliament or the provincial legislatures, or the rights of any of them with respect to their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to*

- A) promoting equal opportunities for the well being of Canadians*
- B) furthering economic development to reduce disparity in opportunities, and*
- C) providing essential public services of reasonable quality to all Canadians.*

*Section 36(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

**Appendix B: Participants in the APEC Policy Forum on Equalization**

Elizabeth Beale, President and CEO, APEC  
David Chaundy, Senior Economist, APEC  
John Palmer, Consultant  
Marilyn Gerriets, Saint-Francis Xavier University  
Paul Hobson, Acadia University  
Wade Locke, Memorial University  
Lars Osberg, Dalhousie University  
Jennifer Smith, Dalhousie University  
Frank Strain, Mount Allison University  
Michael Temelini, Memorial University  
Weiqiu Yu, University of New Brunswick

There were also observers from the four provincial finance departments and the Atlantic Canada Opportunities Agency.