

26 May 2005

René St-Jacques
Secretary
Expert Panel on the Equalization and
Territorial Formula Financing
14th Floor, 291 Laurier Ave West
Ottawa, ON K1A 0G5

Re: Written advice on the core questions in the terms of reference

Dear René,

Attached is my written advice on the core questions in the terms of reference as they relate to the Expert Panel's mandate.

To summarize my views, I believe that a properly functioning equalization program would have the following characteristics:

- A formula-driven program without federal floors or ceilings
- A formula based on a Representative Tax System
- A formula that moves in the longer-term towards equalizing less than 100 percent of the difference between the Equalization Standard and a provinces own Fiscal Capacity
- A formula that excludes all non-renewable resource revenues
- A formula that does not include "expenditure needs"
- Only royalty revenues from offshore exploration should be excluded from the formula.
- A formula that uses three-year moving average to smooth out large fluctuations
- A program that operates without a permanent advisory commission

Having said all that, it is obvious that moving from the present day program (which has none of the above characteristics save the last one) to such a program would require a thoughtful transition plan over a period of at least five years.

I trust these written comments fulfill my commitment as outlined in your Letter of Agreement dated May 25, 2005. I am available at my regular billing rate to discuss this further.

Best regards,

Kenneth J. Boessenkool
VP Business Development

On October 24, 2004 the Prime Minister announced a *New Framework* for the equalization program. This *New Framework* was a serious break with the past. Prior to the *New Framework* the program was (for the most part):

- Formula driven in terms of the total dollars (the exception being recent floors on total payments) and in terms of the allocation across provinces.
- Driven by a representative tax system formula that equalized all provinces up to a single standard based on five provinces (the exception being the Offshore Accords and arguably the “generic solution” for some resource revenues in some provinces)

Under the *New Framework*, the equalization program:

- Has an entirely arbitrary determination of the total dollars (\$10 billion in 2004-05 and rising to \$10.9 billion in 2005-06 and growing at 3.5% thereafter) and in terms of the allocation across provinces (fixed shares as determined by First Ministers in October 2004)
- Driven by the whim of the Federal government in consultation with provinces.

The Federal Government recognized that the current situation is, in the long term, untenable and created an Expert Panel on Equalization and Territorial Formula Financing to, among other things, provide advice to the Government of Canada on “[t]he allocation among provinces of the annual Equalization allotment set in legislation...”¹

This paper provides written advice on the Key Questions on Equalization from the core questions in the terms of reference as they relate to the Expert Panel’s mandate, including:²

Linking Overall Funding Levels to trends in Provincial Fiscal Disparities

- a) *What indicators of fiscal disparities would be relevant to evaluating funding levels for Equalization?*

Allocating Equalization among provinces

- a) *Are multiple standards of Equalization among provinces reasonable and sustainable over the long term? If so, what principles or evidence should determine how they vary among provinces?*
- b) *Is the exclusion of some natural resource revenues and user fees from Equalization consistent with “reasonably comparable treatment” of receiving governments?*

¹ Expert Panel on Equalization and Territorial Formula Financing Terms of Reference (as released at the October 24, 2004 First Minister’s Meeting)

² Expert Panel on Equalization and Territorial Formula Financing, [Key Issues for the Review of Equalization and Territorial Financing](#) (31 March 2005), as summarized in a letter to the author dated April 27 from Al O’Brien, Chair, Expert Panel on Equalization and Territorial Formula Financing.

- c) *Should Equalization incorporate expenditure need measures?*
- d) *How can the measurement of revenue capacity from natural resources and property tax revenues be improved under Equalization?*
- e) *Could aggregate (e.g. macro approaches) measures of revenue capacity provide a better alternative to current methods? Should the Representative Tax System (RTS) be retained in whole or in part? Could one combine both RTS and macro measures?*

Improving the Stability and Predictability of Payments

- a) *Should Equalization payments be made more stable and predictable?*
- b) *What is the best way of doing so without undue effects on other desirable program objectives?*

Transparency, Accountability and Governance

- a) *Would a permanent advisory commission (or other mechanisms) on matters of allocation and disparity trends significantly improve transparency and accountability to Canadians? Is it needed?*

This paper will consider each of these topics in turn.

To preview the conclusions, the paper concludes that a properly functioning equalization program would have the following characteristics:

- A formula-driven program without federal floors or ceilings
- A formula based on a Representative Tax System
- A formula that moves in the longer-term towards equalizing less than 100 percent of the difference between the Equalization Standard and a provinces own Fiscal Capacity
- A formula that excludes all non-renewable resource revenues
- A formula that does not include “expenditure needs”
- Only royalty revenues from offshore exploration should be excluded from the formula.
- A formula that uses three-year moving average to smooth out large fluctuations
- A program that operates without a permanent advisory commission

The paper also concludes that moving from the present day program (which has none of the above characteristics save the last one) to such a program would require a thoughtful transition plan over a period of at least five years.

A. Linking Overall Funding Levels to trends in Provincial Fiscal Disparities

Q1. What indicators of fiscal disparities would be relevant to evaluating funding levels for Equalization?

There are (at least) two broad ways to rationalize an equalization program within a federal state. The first, the “Federal Approach” is a political-economy argument based on the nature of federalism and the rights of citizenship within a federation. The second, the “Net Fiscal Benefit” approach is an efficiency argument based on reducing the incentives for inefficient migration. The first two sections below provide a brief review of these two approaches (of which this paper finds only the former convincing).

The third section below briefly looks at some of the “incentive issues” that are raised by the current equalization program. It finds that the equalization program creates a number of perverse incentives for provincial governments – particularly in the area of efficient taxation.

A concluding section draws out recommendations.

A Federal Approach to Intergovernmental Transfers³

Any system of intergovernmental transfers must satisfy the underlying principles of federalism. Tom Courchene approvingly quotes the 1939 Report of the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Report), which supports two fundamental or overarching principles underpinning intergovernmental grants in federal states.⁴ Courchene calls these two principles the “federal rationale” and the “citizenship rationale”; both also find their expression in Canada’s Constitution.

The Federal Rationale

Courchene defines the federal rationale as follows: “the second order of government must have revenues sufficient to exercise the powers assigned to it under the Constitution.”⁵ In the words of the Rowell-Sirois Report, transfers must ensure every province a real and not illusory autonomy by guaranteeing to it, free from conditions or control, the revenues necessary to perform those functions which relate closely to its social and cultural development.⁶ This rationale is, broadly speaking, consistent with the wording of section 36(2) of the *Constitution Act, 1982*.⁷

³ This analysis liberally borrows from Kenneth J. Boessenkool, *Clearly Canadian: Improving Equity and Accountability with an Overarching Equalization Program* CD Howe Institute Commentary 114 (Toronto: CD Howe Institute) pp. 3-6.

⁴ Thomas .J. Courchene, *Renegotiating Equalization: National Polity, Federal State, International Economy*, C.D. Howe Institute Commentary 113 (Toronto:C.D. Howe Institute, September 1998). See also Canada, Royal Commission on Dominion-Provincial Relations, *Report* (Rowell-Sirois Report) Ottawa: King’s Printer, 1939).

⁵ Courchene, *Renegotiating Equalization*, p. 11.

⁶ Rowell-Sirois Report, p. 80.

⁷ Which reads as follows:

36. (1) *Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of 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.*

The federal rationale and section 36(2) find expression in Canada's equalization program. Equalization is not concerned with the *level* of revenues that all provinces have access to, but with *differences* among provinces in their ability to extract revenue from their tax bases.

The Citizenship Rationale

As Canada's official mechanism for interprovincial redistribution, equalization is at the core of what is often referred to as the "principle of fiscal equality". Namely that other than through the formal equalization program, federal government spending programs should be governed by the principle of equal treatment of provinces. Federal spending directed to individuals should not depend on province of residence.⁸

This principle of equal treatment is closely linked with the citizenship rationale, which Courchene defines as follows:

Citizens, wherever they may live, ought to have access to certain basic economic and social rights — rights that ought to attend citizenship, as it were. Since some of these basic rights fall under provincial jurisdiction, it is imperative that the provinces have adequate funds to provide them.⁹

In other words, provinces should have an adequate revenue base from which to fund services that provide for the basic economic and social rights of Canadian citizens.

While the federal rationale (and the equalization program) is concerned with differences among provinces in their ability to extract revenue, the citizenship rationale is concerned with levels of revenues. Since equalization gives all provinces access to these revenues, federal transfers based on the citizenship rationale should, like citizenship itself, be provided to all Canadians equally.

Two mechanisms provide the bulk of the revenues by which provinces fund programs in their jurisdictions that relate to the citizenship rationale.

First, the provinces and the federal government share tax bases. Both Ottawa and the provinces can levy personal and corporate income taxes, as well as retail-based consumption taxes. The second mechanism is equal per capita federal-provincial transfers, for example the CHT and the CST, federal transfers to provincial governments that are directed toward provincial health, postsecondary education, and welfare programs.

These two transfers are not primarily redistributive; rather, they respond to the gap between *aggregate* provincial revenues and *aggregate* provincial expenditures.

(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.*

⁸ Group of 22, *Making Canada Work Better* (Toronto, May 1996), p. 6. Courchene refers to this as "fiscal neutrality — this is the proposition that, apart from equalization, federal programs should treat similarly situated individuals equally, regardless of place of residence." Thomas J. Courchene, *ACCESS: A Convention on the Canadian Economic and Social Systems* (Toronto: Ontario Ministry of Intergovernmental Affairs, 1996), p. 8.

⁹ Courchene, *ACCESS*, p. 6.

Following the citizenship rationale for intergovernmental transfers, the CST and the CHST should treat Canadians equally regardless of their place of residence. Each province should receive the same amount per capita.

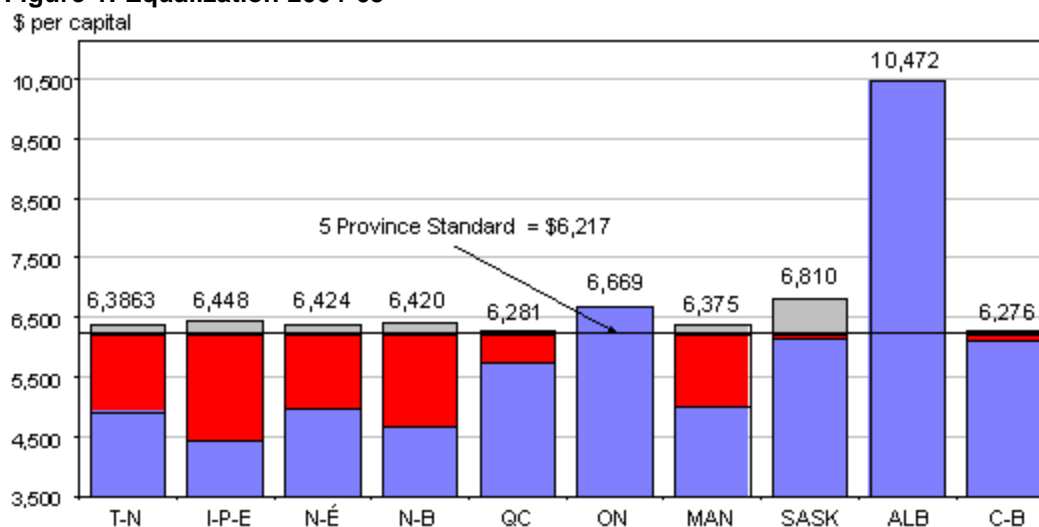
Why This Matters

This analysis suggests that the rationale for equalization is quite different from the rationale for transfers such as the CST and CHT. Equalization is a program that should address disparities *between provinces* (horizontal equity) while the latter programs deal with disparities *between the two levels of government* (vertical equity).

Recent changes to equalization, culminating in the *New Framework*, suggest that Ottawa has confused these two rationales. Equalization is increasingly being looked at as a mechanism to address both vertical and horizontal equity. By instituting ceilings and floors in equalization, the federal government is increasingly looking to equalization to address the disparity between the two levels of government.

The first irony of this confusion is that at the same time as Equalization is being called to the task of addressing vertical equity, the CST and CHT have seen significant increases. These increases should have reduced the need to also increase the total spending on Equalization. The second irony is that it has become increasingly obvious that by setting these various floors and ceiling it is becoming increasingly difficult for Equalization to address vertical equity (see Figure 1¹⁰).

Figure 1: Equalization 2004-05



So in terms of the question above, the funding level of equalization (i.e. the level of spending by Ottawa) should be driven by an appropriate formula that addresses horizontal equity. What that formula should be is discussed at length below.

¹⁰ Expert Panel, *Key Issues* p. 18.

The “Net Fiscal Benefit” Approach to Intergovernmental Transfers¹¹

Net Fiscal Benefits Defined

Much of the literature on reducing horizontal imbalances is based on the idea of “comprehensive income,” which is defined as the sum of earnings, w , and net fiscal benefits, *NFBs*. An NFB is defined as the difference between the benefits received from government expenditures and the taxes paid. Equilibrium requires that individuals migrate across regions until their comprehensive incomes are the same (net of migration costs).

Output is maximized when marginal products are equalized across provinces (w_j equals w_i). However, if for some reason NFBs in one province exceed those in another province (NFB_j exceeds NFB_i), individuals will be induced to migrate to take advantage of this fact. The result is that individuals in the high-NFB province will accept lower market incomes than in those in a low-NFB province (so that w_i exceeds w_j). This *fiscally induced* migration is, therefore, inefficient. The federal government can eliminate this inefficiency by transferring funds to the low-NFB region so that marginal products are again equalized. According to the advocates of this methodology, equalizing provincial revenues can offset these differential NFBs.¹²

Some Conceptual and Practical Problems with the NFB Approach

Several conceptual difficulties weaken this approach. First, it assumes no relationship between NFBs and marginal products. Yet surely a positive correlation exists between these two – even if it is not perfect – in which case NFBs are (partial) signals that people *should* migrate.¹³

Second, it ignores capitalization, which equalization of revenues alone cannot capture. Capitalization often cited as the primary reason the United States has no equivalent to Canada’s equalization program despite wide variations in fiscal capacities across states. The predominant US view is that differences in fiscal capacities across states are capitalized in wages and other prices such as property values.¹⁴

According to this argument, differences in fiscal capacity between, say, New York and Mississippi are offset by the higher cost of delivering services in the former. While New York has a richer tax base, it must provide its public services at local costs. On the other hand, although Mississippi has a weaker revenue base, its government enjoys a lower wage and cost environment in which to provide services. If the differences in fiscal capacity are fully capitalized, redistributing money from New York to Mississippi would distort the economic adjustment

¹¹ This analysis liberally borrows from Boessenkool, *Clearly Canadian*, Appendix C p. 21.

¹² See Robin W. Boadway and Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada* (Toronto: Canadian Tax Foundation, 1993).

¹³ I thank Bill Robson for pointing me in this direction. The next three points are from Thomas J. Courchene, *Renegotiating Equalization: National Polity, Federal State, International Economy*, C.D. Howe Institute Commentary 113 (Toronto: C.D. Howe Institute, September 1998).

¹⁴ See for example Wallace Oates, *Fiscal Federalism*. (New York: Harcourt, Brace, Jovanovich, 1972)

process and be inefficient. Capitalization means, according to Wallace Oates, that equalization is a matter of taste rather than of principle.¹⁵

Third, differences in comprehensive income between *individuals* motivate fiscally induced migration, so transfers to *provinces* offer no guarantee that these inducements will disappear.

Finally, the approach overlooks the sometimes significant costs of mobility. Adding to the conceptual difficulties are empirical findings that any efficiency gains from a redistributive program may be overtaken by the cost of raising the revenues to pay for the program.¹⁶

Assuming these difficulties could be overcome and that the relationship between NFBs and marginal products is not perfect, an equalization program could increase efficiency and reduce fiscally induced migration. However, if, in addition, other federal programs provided large regional NFBs, migration decisions would still be inefficient.¹⁷ The trouble is that in Canada there are a number of other programs that provide large Net Fiscal Benefits, and many of these programs provide them to individuals rather than to provinces. The primary example is the regionally determined benefits and the various “developmental uses” programs in the Employment Insurance Program. Other examples include the various shared cost programs and the fact that the CST and CHT are not provided on a strictly “equal per capita basis.” As Boessenkool points out, these transfers are strongly biased in favour of equalization receiving provinces.¹⁸

Why This Matters

Both conceptual and practical problems mean that the NFB approach is seriously flawed as a way to justify the size of equalization payments. This paper therefore concludes that the justification for the size of equalization payments must be found in the “federal rationale” as it finds expression in the Constitution.

Incentive Issues¹⁹

Taxing Incentives

For at least 30 years, economists studying equalization have built economic models showing that equalization creates incentives for less-developed provinces to raise their taxes. By manipulating their own tax rates, in theory, poorer

¹⁵ Ibid. Courchene provides another example. He points out that the European Union originally contemplated equalizing its member nations up to only 65 percent in the late 1970s and omitted the idea altogether in the 1990s. Thomas Courchene. *Social Canada in the Millennium: Reform Imperatives and Restructuring Principles*. (Toronto: C.D. Howe Institute. 1994) p. 108.

¹⁶ William G. Watson, “An Estimate of the Welfare Gain from Fiscal Equalization,” *Canadian Journal of Economics* 19 (1986): 298–308.

¹⁷ See S.L. Winer and D. Gauthier, *Internal Migration and Fiscal Structure: An Econometric Study of the Determinants of Interprovincial Migration in Canada* (Ottawa: Economic Council of Canada, 1982), chap. 2; and Kathleen M. Day and Stanley L. Winer, “Internal Migration and Public Policy: An Introduction to the Issues and a Review of Empirical Research on Canada,” in Allan Maslove, ed., *Issues in the Taxation of Individuals* (Toronto: University of Toronto Press, 1994).

¹⁸ Boessenkool, *Clearly Canadian*, see esp. Table 1.

¹⁹ This section borrows heavily and liberally from Kenneth J. Boessenkool, *Taxing Incentives: How Equalization Distorts Tax Policy in Recipient Provinces*, AIMS Equalization Paper #3 (Halifax: Atlantic Institute for Market Studies, June 2002)

provinces can affect the size of their equalization payment and get partially compensated for the debilitating effects of those higher taxes.

These conclusions flow from an emerging consensus that the equalization program produces perverse incentives for recipient provinces.

Courchene and Beavis²⁰ used a theoretical model to suggest that recipient provinces could manipulate the equalization formula to increase their equalization entitlements. Other economists have extended or provided a variant of this theoretical analysis, each suggesting that the equalization formula provides the opportunity for recipient provinces to manipulate their tax policy in inefficient ways.²¹

Specifically, Michael Smart and Bev Dahlby show that the equalization program contains incentives that result in recipient provinces underestimating the cost to their economies of raising tax rates. Recipient provinces, the theory argues, have an incentive to levy higher tax rates than they otherwise would. Further, this theoretical work suggests that there is an incentive for recipient provinces to rely more heavily on relatively weak tax bases and less heavily on relatively strong tax bases.

Despite fairly strong theoretical support for the notion that the equalization formula produces perverse incentives, little empirical work shows the existence and strength of these incentives.

A paper by Boessenkool²² is a notable exception. That paper provides a summary of the perverse incentives identified by previous theoretical work. It then provides some empirical support for these contentions. Using tax-base and tax-rate data from the calculation of equalization payments, Boessenkool concludes:

- First, as a result of the equalization program, recipient provinces levy tax rates in excess of what they otherwise would. Support for this notion comes from comparing tax rates in recipient provinces to those in comparable non-recipient provinces.
- Second, recipient provinces levy higher than average tax rates on relatively weak tax bases, and lower than average tax rates on relatively strong tax bases.

²⁰ Thomas Courchene, and David A. Beavis. 1973. "Federal-provincial tax equalization: an evaluation." *Canadian Journal of Economics* 6, 483–502.

²¹ See for example Richard Bird and Enid Slack. 1990. "Equalization: the representative tax system revisited." *Canadian Tax Journal* 38, 913–27; Michel Boucher and Jean-Luc Migué. 2002. "Federal Grants under the Discipline of Global Forces." In Paul Boothe (ed.), *Equalization: Helping Hand or Welfare Trap?* Halifax: Atlantic Institute for Market Studies; Thomas Courchene. 1994. *Social Canada in the Millennium: Reform Imperatives and Restructuring Principles*. Toronto: C.D. Howe Institute; Bev Dahlby. 2002. "The Incentive Effects of Fiscal Equalization Grants: With Special Reference to the GNWT's Formula Financing Grant." In Paul Boothe (ed.), *Equalization: Helping Hand or Welfare Trap?* Halifax: Atlantic Institute for Market Studies; Bev Dahlby and L. Sam Wilson. 1994. "Fiscal capacity, tax effort, and optimal equalization grants." *Canadian Journal of Economics* 27, 657–72; Michael Smart. 1998. "Taxation and deadweight loss in a system of intergovernmental transfers." *Canadian Journal of Economics* 31, 189–206; and Dan Usher. 1995. *The Uneasy Case for Equalization Payments*. Vancouver: The Fraser Institute.

²² Boessenkool, *Taxing Incentives*.

What Does This Mean?

The conclusion that Equalization causes distortions in provincial tax rates has serious implications for program design. Clearly the program should be designed in such a way as to mitigate these incentives as much as is reasonable.

Boessenkool provides three tentative suggestions ranging from modest to radical.

First, he points to Courchene²³ who suggests that one way of dealing with equalization's perverse incentives is to move away from fully equalizing all tax bases. Courchene proposes that equalization should be converted into a version of a negative income tax for provinces. He recommends equalizing only 70 percent of the difference between the standard and a province's own fiscal capacity. The advantage of this idea is that it leaves the current program design intact, but dulls the perverse incentives by up to 30 percent.

A more comprehensive proposal, suggested by Boothe²⁴ would be to move away from the 33 tax bases currently used in equalization and instead equalize poorer provinces based on a single, macroeconomic standard. Boothe proposes equalizing provinces using differences in personal income. While this proposal would undoubtedly create its own set of perverse incentives (e.g., dulling the incentive to maximize personal income within a recipient province), it would eliminate the direct link between equalization entitlements and a province's tax rates.

Finally, a radical proposal would be to consider phasing out equalization transfers altogether. It is notable that the United States does not have an equalization program. Yet Coulombe²⁵ finds that, compared to Canadian provinces, U.S. states show a greater degree of economic convergence in incomes and employment. The U.S. approach is based on the idea that differences in fiscal capacity are capitalized in other prices (housing, wages). To the extent that differences in fiscal capacity are capitalized, there is a reduced need for federal transfers to account for these differences. Worse, to the extent that capitalization occurs, equalization payments will merely serve to dampen the natural economic adjustment that would otherwise take place.

How might we address capitalization while still paying homage to the constitutional imperative to make equalization payments? Rather than equalize provinces based on fiscal capacities, Ottawa might consider that its responsibility under Section 36(2) could be met by providing equal per capita transfers (like the CHST) to ensure that all provinces have a similar base of income from which to fund core programs.

Given the discussion in the previous two sections, the first of these suggestions appears most palatable in the current context.

²³ Social Canada in the Millenium.

²⁴ Paul Boothe. 1998. *Finding a Balance: Renewing Canadian Fiscal Federalism*. C.D. Howe Institute Benefactors Lecture. Toronto: C.D. Howe Institute; and Paul Boothe. 2002. "Modest but Meaningful Change: Reforming Equalization." In Paul Boothe (ed.), *Equalization: Helping Hand or Welfare Trap?* Halifax: Atlantic Institute for Market Studies.

²⁵ Serge Coulombe. 1999. *Economic Growth and Provincial Disparity: A New View of an Old Canadian Problem*. C.D. Howe Institute Commentary 122. Toronto: C.D. Howe Institute.

Conclusion: Indicators of Fiscal Disparities

The above rather round-a-bout discussion points to three conclusions:

- Equalization should be concerned with horizontal, not vertical imbalances.
- Equalization should “ensure that provincial governments have *sufficient revenues* to provide reasonably comparable levels of public services at reasonably *comparable levels of taxation*.”
- Equalization should be designed to mitigate perverse incentives.

These three conclusions lead to three practical recommendations for the Equalization program:

- Equalization should be a formula-driven program without federal floors or ceilings
- The Equalization formula should be based on a Representative Tax System
- The equalization formula should move, in the longer-term, towards equalizing less than 100 percent of the difference between the Equalization Standard and a province’s own Fiscal Capacity

B. Allocating Equalization among provinces

Q1. Are multiple standards of Equalization among provinces reasonable and sustainable over the long term? If so, what principles or evidence should determine how they vary among provinces?

The discussion above (and the discussion on non-renewable resources below) suggests that the answer to the first question is “No”. The multiple standards currently existing in equalization are a direct result of:

- The attempt to use equalization to address vertical, as well as horizontal, imbalances.
- The improper treatment of non-renewable resources.

Q2. Is the exclusion of some natural resource revenues and user fees from Equalization consistent with “reasonably comparable treatment” of receiving governments?

This paper takes the view that non-renewable resources should not be included in the 33 tax bases for equalization, and that removing them is consistent with “reasonably comparable treatment” of receiving (and non-receiving) governments. The case is made below, which draws heavily and liberally from Boessenkool.²⁶

The Problem

The View from Ottawa

In a seminal book, *Social Canada in the Millennium*, Courchene notes that Ottawa’s approach to nonrenewable resources has been to “downplay the role of resource revenues in the equalization formula.”²⁷ The federal government has

²⁶ Boessenkool, *Taking off the Shackles*, pp. 3-11.

²⁷ Courchene, *Social Canada in the Millennium*, p. 302.

done so because volatile oil and gas prices have produced large swings in the cost of the equalization program.

A look through the history of equalization from 1957 through the 1980s demonstrates that to escape the implications of rising oil prices for the total cost of the program, Ottawa made many changes — from fully equalizing natural resources across all provinces to excluding them from the formula altogether.²⁸

During the early 1970s, for example, Alberta was part of the equalization standard. Large increases in the price of oil, mostly located in Alberta, raised equalization entitlements significantly. Even Ontario, the country's second richest province, fell below the standard; it would have become eligible for payments for the first time had Ottawa not changed the standard. Without the removal of Alberta from the standard, the cost of the program would have exceeded the federal government's ability to finance it.

Today, with oil prices testing historic highs, the estimates of adding Alberta to the equalization standard in 2000/01 are significant.

Shifts in natural resource prices have another perverse impact on the workings of equalization. Even if it is Alberta's oil and gas revenues that are raising entitlements, it is Ontario that bears the brunt of the higher costs because, as the largest province, it contributes the most to Ottawa's general revenues (out of which equalization is funded).

In summary, the problem with natural resources from Ottawa's point of view is that swings in the prices of these resources, particularly oil and gas, produce commensurate swings in the cost of the program.

The View from the Recipient Provinces

At the core of the problem from the recipients' point of view is the concept of *taxback*. When developers discover and exploit nonrenewable resources in a province that receives equalization payments and the government of that province taxes the proceeds, these revenue increases are taxed back via a reduction in equalization payments. Recipient provinces therefore face a perverse incentive to prefer continued reliance on equalization revenues over the greater self-sufficiency that would come from the full development of their nonrenewable resources.

Equalization taxes back rising provincial own-source revenues in two ways: changes in the provincial tax base, and changes in the provincial tax rate.

The base taxback occurs whenever the value of a province's base increases. If corporate income rises in Newfoundland, its equalization entitlement falls because its capacity to raise corporate income tax (CIT) has increased. How much equalization falls depends on the tax rate on corporate income. If the provincial tax rate equals the national average rate, then its equalization payment falls by the amount by which its provincial revenues rise (a 100 percent taxback). If the provincial tax rate is half of the national average rate, the taxback is 200 percent,

²⁸ See Appendix B in Boessenkool, *Taking off the Shackles*, pp. 26-29

and if the provincial rate is double the national average rate, the taxback is 50 percent.²⁹

The rate taxback is less straightforward. Equalization entitlements in all but a few instances do not move much in response to changes in provincial tax rates. If a tax base is available to all or most provinces, then the use of a national average tax rate means that changes in a particular province's rate has a small impact on the amount of equalization it receives.

Those "few instances" are critical, however. Changes in provincial tax rates can have a large impact on equalization entitlements if a province has a substantial portion of the country's *total* base for that revenue source. In the extreme, if a recipient province has 100 percent of a particular base, changes to its tax rate result in a one-for-one change in the national average tax rate, and every dollar that the province raises in revenue is taxed back dollar for dollar by the equalization formula.

Clearly, recipient provinces face little incentive to levy taxes on their nonrenewable resources when the equalization formula effectively taxes back all or much of the gains. In fact, these circumstances give provinces an incentive to rely on federal equalization, rather than revenue from nonrenewable resources. The result is that provinces become shackled to equalization revenues, rather than moving toward greater independence through the development of lucrative natural resources.

The Context

From the above analysis come two criteria by which to evaluate any treatment of non-renewable resources. First, it must protect the total cost of the program from the price swings of natural resources, particularly oil and gas. Second, it must minimize the incentives of recipient provinces to rely on equalization payments over revenues from natural resources, primarily by reducing or eliminating the taxback on those revenues.

The sections below turn now to the broad question of the principles and guidelines for the treatment of nonrenewable resource revenues within equalization. They begin with a brief look at the Constitution, asking what basis it provides for equalizing non-renewable resource revenues. They then turn to the economics of that equalization.

The Constitutional Dilemma

The Canadian Constitution arguably speaks with a forked tongue on the subject of nonrenewable resources within equalization. Section 36, which contains the equalization clause, supports their inclusion in the formula, while Sections 92 and 125, which reference the ownership of nonrenewable resources, argue against their inclusion. Further muddling the case is the fact that some of the resource development in question — oil and gas off the shores of Nova Scotia and Newfoundland — is not easily classified as a *provincial* natural resource.

²⁹ This is yet another example of the perverse incentives noted above – recipient provinces are encouraged to set their tax rates above national average rates.

The Equalization Clause

The Canadian Constitution contains an explicit paragraph on equalization, Section 36(2). It requires the federal government to redistribute enough revenue so that all provinces can offer “reasonably comparable” services at “reasonably comparable” levels of taxation.

The presence of nonrenewable resources within a province — in particular, the ability to collect royalties from those resources — means that it can provide services at a lower level of taxation than other provinces. Alberta, for example, has oil and gas revenues exceeding those available to other provinces. This endowment allows it to provide services to its population by taxing other sources of revenue at a comparatively lower rate than other provinces and relying on revenues from the nonrenewable resources to make up the difference.

Since the equalization clause requires that comparable services be provided at comparable levels of taxation, the presence of these nonrenewable resources in Alberta should be taken into account in calculating equalization entitlements for provinces without a similar endowment. On this view, equalization revenues should flow to provinces without resource endowments so that they can provide reasonably comparable services at tax rates on nonresource-based revenue sources that are comparable to the tax rates on those sources in endowed provinces.³⁰

Provincial Ownership of Nonrenewable Resources

Other sections of the Constitution put the ownership of, and legislative power over, nonrenewable resources exclusively with the provinces. Section 92A, in particular, restricts the right to make laws regarding nonrenewable resources to the provinces.³¹ Clause 4 of the same section grants to the provinces the power of direct taxation of natural resources to the provinces.³² Section 125 strengthens this provision by stipulating that lands belonging to a province (which include nonrenewable resources) are not to be taxed.³³

³⁰ See Usher, *The Uneasy Case*, esp. pp 67ff.

³¹ *In each province, the legislature may exclusively make laws in relation to*
(a) *exploration for non-renewable resources in the province;*
(b) *development, conservation and management of non-renewable resources and forestry resources in the province, including laws in relation to the rate of primary production therefrom.*

The older Section 109 says much the same thing:

All Lands, Mines, Minerals, and Royalties belonging to the several Provinces of Canada, Nova Scotia, and New Brunswick at the Union, and all Sums then due or payable for such Lands, Mines, Minerals, or Royalties, shall belong to the several Provinces of Ontario, Quebec, Nova Scotia, and New Brunswick in which the same are situate or arise, subject to any Trusts existing in respect thereof, and to any Interest other than that of the Province in the same.

³² Specifically, it states:

In each province, the legislature may make laws in relation to the raising of money by any mode or system of taxation in respect of

(a) *nonrenewable resources and forestry resources in the province and the primary production therefrom.*

³³ The section says

No lands or property belonging to Canada or any Province shall be liable to Taxation.

The Constitution, Usher concludes³⁴ gives the provinces ownership of the tree (Section 92A(1)) as well as entitlement to its fruit (Sections 92A(4) and 125). Ottawa therefore has questionable jurisdiction over redistributing these resources across the country through equalization.

Thus, the Constitution appears to contradict itself on the issue of nonrenewable resources. The equalization clause favours the redistribution of revenue from them, while the exclusive right to their ownership and taxation argues against such redistribution.

Offshore Oil and Gas

Further confusing matters is the fact that much of the current pressure to reform the equalization program's treatment of natural resources is largely the result of the discovery of offshore oil and gas off the coasts of Newfoundland and Nova Scotia. There is a broad legal consensus that these offshore resources do not belong to the coastal provinces but to Ottawa. Despite this legal interpretation, the federal government has granted these provinces *de facto* rights over these resources by allowing Newfoundland and Nova Scotia to tax them and by including them in the equalization formula. Ottawa calls these items *shared revenues* to indicate its legal ownership, even if *de facto* it has handed over that ownership to the provinces.

The Economic Case

Fortunately, the economic case is clearer. The argument is in two strands. The first is that nonrenewable resource royalties are incorrectly thought of as income. Rather, they should be treated as capital assets. Second, as a result of the capitalization of resource rents in things such as wages and other prices, the benefits of nonrenewable resource endowments would be accounted for in any equalization formula even if it did not specifically include these resources.

Royalties as a Capital Asset

Resource revenues differ from revenues from other sources inasmuch as the underlying tax base is nonrenewable. Royalties from nonrenewable resources are not properly revenues. They are the transfer of a stock of wealth from one form to another, without generation of any increase in wealth. In accounting terms, one can think of income and sales taxes as streams of income for the taxing jurisdiction, while the exploitation of nonrenewable resources is more appropriately thought of as the sale of a capital asset.

This argument holds only for *nonrenewable* resources. If a resource is renewable, its exploitation is less clearly treated as a sale of a capital asset. Consider the difference between oil or gas extraction and forestry. The former resources are nonrenewable — their extraction today means they cannot be extracted tomorrow. In contrast, harvest from the forestry today does not preclude harvest sometime down the road if an adequate reforestation program is in place. Within the accounting classification, forestry revenues fall somewhere between annual

³⁴ Usher, *The Uneasy Case*, pp. 75-76.

income and the sale of a nonrenewable resource. In fact, an adequate reforestation program results in annual revenues reflecting the long-term sustainability of that resource.

Treating resource extraction as a sale of a capital asset means that the full amount of revenue derived from that activity should not be included as current provincial revenues. The better argument is for partial inclusion. Further, the closer the resource is to a nonrenewable resource, the smaller the portion that should be included.

Treating nonrenewable resource revenues as sales of capital assets is more than an arcane theoretical construct. The Alberta Heritage Savings Trust fund was at least partly motivated by the desire to spread the proceeds from the sale of oil over a number of generations of Albertans. Accordingly, a portion of the revenue from this sale was set aside so its benefits could be spread over a long period of time. Alaska has done a similar thing with the Alaska Providence Fund, which set aside portions of royalty revenues out of which state residents are paid an annual stipend (which can be thought of as the resulting stream of revenue).

Ottawa should not, therefore, view Newfoundland's and Nova Scotia's revenues resulting from the discovery and exploitation of oil and gas as current income for these provinces but as the proceeds from sale of a capital asset whose benefits should be spread over a much longer period of time. A period (admittedly arbitrary) of 25 or 50 years would imply an appropriate taxback in the order of 2 to 4 percent. Fully taxing back the revenues from these sources effectively strips away a capital asset from the provincial government without giving it the benefit of its use for the long-term benefit of its citizens.

Capitalization

The second strand of the economic argument is that the rents from the extraction of natural resources are effectively capitalized in other prices in the wider economy, a second-order effect that is reflected in growing provincial non-resource revenues, such as income and sales taxes, which reduce equalization entitlements.

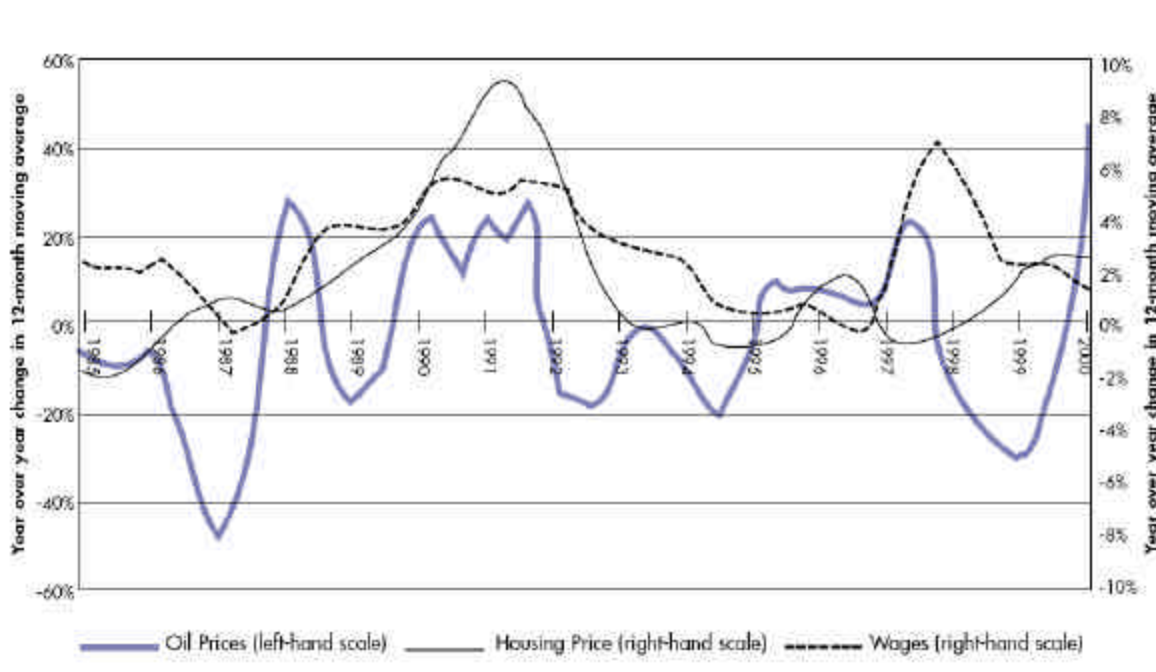
This capitalization argument is the primary reason the United States has no equivalent to Canada's equalization program despite wide variations in fiscal capacities across states. The predominant US view is that differences in fiscal capacities across states are capitalized in wages and other prices such as property values.

Canadians may not wish to go as far as the US model in assuming full capitalization (the equalization clause in our Constitution suggests that we do not). The case for capitalization of nonrenewable resource rents is stronger, however, than the case for complete capitalization of fiscal capacities across provinces. The discovery of nonrenewable resources within a province is a sure-fire way of boosting consumer prices, wages and property values. And since personal income taxes, property taxes, and sales taxes are part of the equalization program,

explicitly including nonrenewable resources is unnecessary. Indeed, doing so amounts to double counting.

This view receives empirical support from the experience in Alberta over the past few decades. Oil prices have been a key driver of both wages and housing prices there. (Although oil prices are much more volatile than either wages or housing prices, any sustained movement in the former has a noticeable impact on the latter in Alberta — see Chart 1). This impact has become gradually muted over the past two decades, as oil has become a much less significant driver of the Alberta economy over that period.

Chart 1: Capitalization of Oil Prices in Wages and Housing Price, Alberta, 1985-2000



In brief, movements in the prices of other tax bases reflect the additional fiscal capacity that results from the discovery and exploitation of nonrenewable resources. And since these other tax bases are included in the equalization formula, natural resource revenues do not need to be.

Summary of Economic Case

The first strand of the economic argument says that only a small portion of nonrenewable resource revenues (say, 2 to 4 percent) should be treated as annual revenue. The second strand is that the capitalization of resource rents in other prices, such as wages and housing prices, takes at least partial account of the rents arising from the discovery and exploitation of nonrenewable resources.

When we put these two strands together, we can argue that the small portion of the resource revenues that might legitimately be included in equalization may well be accounted for by the capitalization of resource rents in other prices. An

equalization program that excluded nonrenewable resources altogether could, therefore, adequately reflect the additional fiscal capacity that comes from the discovery and exploitation of natural resources.

Conclusion: Exclusion of Non-Renewable Resources

The above discussion points to three conclusions:

- The treatment of non-renewable resources in equalization have been problematic from both the federal and provincial point of view.
- The Constitution (where the primary argument for Equalization comes from) is unclear on the proper treatment of non-renewable resources.
- There is a strong economic argument for excluding non-renewable resources from Equalization.

These three conclusions lead to a practical recommendation for the Equalization program:

- The Equalization formula should exclude all non-renewable resource revenues

Q3. Should Equalization incorporate expenditure need measures?

Canada's equalization program is based on *revenue* differences among provinces, but does not take into consideration differences on the *expenditure* side of provincial budgets. Thus, equalization implicitly assumes that the cost of "providing reasonably comparable public services" is identical across the country. This has led to a call to include "need" within the equalization program.

The first difficulty with the proposal to account for expenditure differences is deciding what is meant by "need." Defining need in terms of *cost* is quite different from defining it in terms of *demand*. If the equalization program were to incorporate the former definition, then it would have to account for the fact that average wages, rents, and capital costs are much higher in Toronto, Calgary, and Vancouver than in Halifax, Saskatoon, and Fredericton. As Shah shows, defining "need" in terms of costs and incorporating it into equalization would, in fact, require a *reduction* in transfers to the Atlantic provinces and Quebec.³⁵

If need is defined according to demand, on the other hand, then incorporating differences in need into equalization would mean accounting for, among other things, differential rates of unemployment and income levels. For the most part, this would mean additional compensation for "have-not" provinces.

The trouble with this is that although the current equalization program uses a revenue approach, it still implicitly accounts for a number of demand factors. If employment or income falls in a particular region or province, this affects its tax base relative to the national average, triggering larger equalization payments.³⁶

³⁵ Anwar Shah, "Fiscal Need and Equalization," *Canadian Public Policy* 22(2): 99–115.

³⁶ This is particularly the case for the five provinces that do not form part of the standard, since a reduction in their bases does not affect the denominator of the equalization formula.

In addition, there exist a number of programs outside of equalization that account for need, such as the Employment Insurance program and, arguably, the many shared cost programs between Ottawa and the provinces.³⁷

The second difficulty with the proposal to account for expenditure needs is the potential threat that it poses to the principle that equalization transfers should remain unconditional. This principle flows from the fact that equalization is meant to deal with horizontal equity – the problem of a relative shortage of revenues compared to other provinces for the delivery of a common basket of services.

If, for example, the current equalization program incorporated need, provinces would not necessarily spend the additional money they received on programs that were related to the factor that increased their entitlement. This fact would lead to pressure on Ottawa to impose conditions on the portions of equalization payments that respond to the need variables.³⁸ (This is true whether need is defined as cost or as demand.) Succumbing to this pressure would lead to heavily conditional or shared-cost programs, which, respectively, increase federal interference in provincial jurisdictions and allow provincial leveraging of Ottawa's budget.

Conclusion: Expenditure Need

The discussion above leads to a practical recommendation for the Equalization program:

- The Equalization formula should not incorporate “expenditure needs.”

Q4. How can the measurement of revenue capacity from natural resources and property tax revenues be improved under Equalization?

The response to Q2 above deals with the treatment of natural resources. However, there is one additional point that should be made.

Treatment of Natural Resources

The Atlantic Accords lump together all revenues from offshore development – i.e. they include corporate income tax as well as resource revenues. The gist of the response to Q2 suggests that the two revenue sources within equalization that deal with offshore revenues should be altered in such a way that corporate income tax (and other non-royalty revenues) from offshore activities should be included with other provincial corporate income tax revenues, and royalties should be excluded from the equalization formula.

This means that the Atlantic Accords should be unpacked, and the various revenue sources treated as provincial “own source” revenues. This is consistent with the argument, made above, that the federal government has *de facto* transferred the authority to tax these activities to the provinces.

³⁷ See Boessenkool, *Clearly Canadian*, Appendix A for some (dated) examples of shared cost programs of this type.

³⁸ As Courchene shows, the incorporation of “need” into the Australian system of equalization has put increasing pressure on the Commonwealth government to abandon untied grants to the states in favor of tied grants. See Thomas J. Courchene, “Subnational Budgetary and Stabilization Policies in Canada and Australia,” in J. Poterba and J. von Hagen, eds., *Fiscal Institutions and Fiscal Performance* (Chicago: University of Chicago Press, 1997).

Treatment of Property Tax Revenues

The author of this paper has done little prior work on the treatment of property tax revenues within equalization. Having said that, this paper offers the following for consideration.

1. Some of the arguments made in favor of removing non-renewable resource revenues can be applied to the treatment of property taxes, namely:
 - Property is a capital asset, and revenues from the taxation of this capital asset are arguably not income in the same way that revenue from an income tax is.
 - Changes in property values are arguably reflected in higher wages and other prices, which are included in equalization.
2. However, property taxes are different from non-renewable resource revenues in the following ways:
 - There is no claim to provincial ownership of property in the same way as there is a (constitutional) claim to ownership of non-renewable resources.
 - You can calculate a present value of the revenue to a property by determining the value of the property based on its potential to generate rental income (which may be the theoretically appropriate – though practically difficult – tax base for determining revenue capacity).
 - Property taxes can reasonably be viewed as a user fee for municipal services. This argument can be set against the “capital asset” argument above.

Given these points, there appears to be a good argument for keeping property tax revenues in the Equalization calculation, and for the tax base to be something approximating the revenue potential of the property. Having said that, revenue potential would be a very difficult thing to measure in practice, so no strong overall conclusion exists.

Conclusion: Measurement of Revenue Capacity

The discussion above leads to a practical recommendation for the Equalization program:

- Only royalty revenues from offshore exploration should be excluded from the formula.

Q5. Could aggregate (e.g. macro approaches) measures of revenue capacity provide a better alternative to current methods? Should the Representative Tax System (RTS) be retained in whole or in part? Could one combine both RTS and macro measures?

The use of a macro approach has a number of attractions – it (potentially) simplifies the equalization formula, it (potentially) makes the program easier to understand, it (potentially) can provide a much more stable determination of payments over time, and it (potentially) offers a way to avoid the problems with natural resources noted above.

However, a macro formula also brings with it a number of important disadvantages which outweigh the advantages above. First, it disentangles the operation of the program from the essential argument for its existence – as described in section 36 of the Constitution – by uncoupling the program from any measure of provincial revenues. If the goal of the program is to equalize provincial revenues (or, in the words of section 36, “*to ensure that provincial governments have sufficient revenues...*”) then the program should have some operational foundation in the measurement of those revenues.

Second, in practice, the use of a macro formula results in essentially arbitrary underpinnings for the total size of the program. While the RTS system can (and, as this paper argues, should) determine both the distribution and the overall size of payments, a macro formula requires arbitrariness in (a) the choice of an indicator, and (b) the percentage to which provinces are equalized.

Most of these points can be illustrated by looking at a particular macro approach. In a C.D. Howe Benefactor’s Lecture, Paul Boothe³⁹ laid out a self-described “radical proposal for reform” of equalization. While the full scope of the proposal is beyond what is required here, of relevance is Boothe’s scheme to redistribute revenues across provinces based on a “macro” formula.⁴⁰ Rather than comparing provincial fiscal capacities using the representative tax system, this formula would redistribute money based on differences in a macroeconomic measurement across provinces.

After considering a number of macro variables, including personal income and smoothed gross domestic product (GDP), Boothe opts for a five-year moving average of an adjusted measure of personal income.⁴¹ Boothe chooses this measure because it most closely resembles the current distribution of payments – an indication that the measure itself has less rationale than the RTS system on which its choice was essentially based.

Boothe’s macro formula has a second degree of arbitrariness. In the specific case, Boothe’s formula would equalize up to 32 percent of adjusted personal income. This arbitrary number would be subject to federal gaming in the future as Ottawa would be tempted to use the equalization program to offset the impacts of changes to other programs by moving the target percentage up or down. And provinces would have a large incentive to continually push this number up. Of course, that is precisely what provinces have done in recent years by pushing Ottawa to set various “floors” under equalization – something this paper argues has undermined the essential nature of the program.

³⁹ Paul Boothe. 1998. *Finding a Balance: Renewing Canadian Fiscal Federalism*. Benefactors Lecture, 1998. Toronto: C.D. Howe Institute.

⁴⁰ Boothe advocates combining the provincial impact of a number of major federal transfers (equalization, the Canada Health and Social Transfer, and the regional components of unemployment insurance). He then proposes increasing the fiscal capacity of all provinces (via a transfer of tax points) up to the amount of the weakest province. The remaining differences in fiscal capacity would then be equalized by the use of an interprovincial revenue-sharing scheme driven by the macro formula described in the text.

⁴¹ He subtracts federal direct taxes, the GST, provincial-local transfers to persons, and changes to farm inventories, all items outside the normal sources of revenue for provinces. He also uses a five-year average to enhance stability.

In terms of the treatment of natural resources, Booth notes that, “an important characteristic of [adjusted personal income] is that it does not explicitly include natural resource revenue” and as such is not susceptible to swings in the price or exploitation of nonrenewable resources.⁴²

Further, Boothe finds that his macro proxy for fiscal capacity would enable the use of an all-province standard. The macro formula would minimize the impact in recipient provinces of taxing provincial resources since the taxback would occur only when adjusted personal income rose as a consequence. Thus, any taxback would likely operate with a slight lag and not in direct proportion to provincial revenues from nonrenewable resources.

In summary, the use of a macro formula holds out the potential to address some of the challenges facing equalization. However, it has at least two serious flaws – it decouples the program from its essential rationale and it requires a large, and dangerous, degree of arbitrariness. Further, this paper provides a number of ways in which to address some of the advantages contained in the macro approach.

Conclusion: Macro Approach

The discussion above leads to the conclusion that a macro approach is not warranted and that (as concluded above) the RTS is the appropriate basis for the equalization program.

C. Improving the Stability and Predictability of Payments

Q1. Should Equalization payments be made more stable and predictable?

In a word, yes. Equalization entitlements have fluctuated fairly widely during the 1980s and 1990s. The average annual change in equalization entitlements during those two decades was more than \$75 in Newfoundland and New Brunswick, around \$60 in Manitoba and Saskatchewan, and \$30 in Quebec.⁴³

These kinds of fluctuations make fiscal planning more difficult for provinces, and can also mean substantial fiscal shifts in the cost to the federal government.

Q2. What is the best way of doing so without undue effects on other desirable program objectives?

The federal government (in the *New Framework* in particular) has addressed these challenges by setting floors on the overall size of the equalization pie, and by also freezing individual entitlements. As argued above (A. Q1), these changes undermine the very essence of the program itself.

This suggests that a better way to smooth out fluctuations (which over time *should* occur to reflect underlying changes in fiscal capacity) is to use some sort of moving average for the calculation of equalization entitlements. This obviously adds to the complexity of the program, but it should allow Equalization to meet the two goals of greater stability and also ensure that the program continues to reflect relative fiscal capacities.

⁴² Boothe, *Finding a Balance*, p. 49.

⁴³ Boessenkool, *Clearly Canadian* p. 14.

Conclusion: Stability and Predictability

The discussion above leads to a practical recommendation for the Equalization program:

- The Equalization program should use a three-year moving average for provincial entitlements to smooth out large fluctuations

D. Transparency, Accountability and Governance

Q1. Would a permanent advisory commission (or other mechanisms) on matters of allocation and disparity trends significantly improve transparency and accountability to Canadians? Is it needed?

The equalization program operated for lengthy periods of time by working according to a formula that was periodically reviewed by both the standing 5 year renewal process and various ad-hoc parliamentary and extra-parliamentary examinations. Only in recent years, with the program becoming increasingly *ad hoc* has the need apparently arisen for an outside commission to assist in the determination of the parameters of the program.

There are at least three reasons why this commission should not be made permanent:

- A program that functions according to a set formula should not need an ongoing commission to determine the parameters of the program – indeed such a panel might result in more “tinkering” with the program than is helpful over the long term. The danger is that this would work contrary to the goal of stability of the program over time. This would dilute, not improve, transparency.
- Such a commission would remove some accountability from the Minister of Finance for the operation of the program. A commission would dilute accountability from the Department of Finance and the Minister who should be ultimately accountable for the operation of Equalization.
- Related, but on the other side of the coin, such a panel could never completely remove all accountability from the Minister of Finance. At the end of the day, substantial changes would need to come from the Minister, not from an external commission. Therefore, unless such a commission was made entirely independent of government (not a good idea for the two reasons above), it would exist in a sort of policy “no-person’s-land”. Over time it would either get too influential, or become powerless.

Conclusion: Advisory Commission

The discussion above leads to a practical recommendation for the Equalization program:

- A program that operates without a permanent advisory commission

Summing Up

This paper argues that a properly functioning equalization program would have the following characteristics:

- A formula-driven program without federal floors or ceilings
- A formula based on a Representative Tax System
- A formula that moves in the longer-term towards equalizing less than 100 percent of the difference between the Equalization Standard and a provinces own Fiscal Capacity
- A formula that excludes all non-renewable resource revenues
- A formula that does not include “expenditure needs”
- Only royalty revenues from offshore exploration should be excluded from the formula.
- A formula that uses three-year moving average to smooth out large fluctuations
- A program that operates without a permanent advisory commission

A final point: Moving to a program of this nature will undoubtedly result in fairly large adjustments to payments to some provinces, and perhaps even overall payments from Ottawa. (Though Boessenkool estimates the shift in overall payments in his, admittedly dated, paper to be very small.⁴⁴) Quebec and Saskatchewan in particular would face fairly significant shifts in their total entitlement.⁴⁵

These adjustments to provincial (and overall) payments suggest that a shift to a program as outlined above should be phased in. There are two possible ways to do this:

1. Phase the new program in over 5 years. This can be done by calculating the value of the program under the new system as well as the current allotment. In the first year, use 1/5 of the new and 4/5 of the current allotment to calculate provincial entitlements. In the second year use 2/5 of the new and 3/5 of the current allotment, and so on.
2. Guarantee that no province will receive less than it is receiving now in nominal terms. Over time, with growth in the economy, payments under the proposed program should grow in nominal terms to the level each province is receiving now.

This paper is indifferent as to which of these transition mechanisms is preferable.

⁴⁴ Boessenkool, *Taking off the Shackles*, Table 1.

⁴⁵ *Ibid.*