

Equalization
Moving Forward under the *New Framework*

**A submission
to the**

**Expert Panel on Equalization and
Territorial Formula Financing**

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July 6, 2005

1 Introduction

In October 2004, the federal government announced a *New Framework* for Equalization and Territorial Formula Financing (TFF). The key elements of the new Equalization framework include setting a \$10 billion floor on aggregate Equalization for 2004/05 and increasing Equalization to \$10.9 billion for 2005/06. Recipient provinces' shares of the global amount have been fixed for these two years and individual floor provisions were introduced for Saskatchewan and British Columbia. For the period beyond 2005/06, the federal government established a 10 year funding track, fixing the annual rate of growth in aggregate Equalization at 3.5%. Missing from the *New Framework* is a description of the mechanism that will be used to allocate the Equalization "pot" to recipient provinces after 2005/06. Indeed, the Expert Panel on Equalization and TTF was set up to provide advice on this very issue. As outlined in *Key Issues for the Review of Equalization and Territorial Formula Financing*, hereinafter referred to as the Issues paper, the Expert Panel is expected to provide advice on:¹

- an allocation mechanism for Equalization that is evidence-based and formula driven,
- mechanisms to ensure stability and predictability of payments,
- evidence-based aggregate measures of fiscal disparities to assist in the future re-evaluations of the level of federal support for Equalization, and
- whether to have an independent body to provide advice on the allocation of Equalization.

This paper represents a summary of my views on the core questions before the Panel and on how to move forward with Equalization in Canada. I begin with an examination of our approach to Equalization in the past and under the current arrangements. Although the current situation is transitional, it represents an unprecedented departure from the principles that have guided Equalization for over twenty-five years. For this reason it is important to understand what these interim arrangements accomplish and what they do not. This section shows that Equalization Past, while not ideal, was responsive to relative fiscal disparities and consistent with the constitutional principle underlying Equalization

¹ See *Key Issues for the Review of Equalization and Territorial Formula Financing (2005)* (<http://www.eqttf-pfft.ca/english/issuespaper0.asp>).

(when measured against the five province standard). In contrast, the current arrangements are not responsive, fail to use a clear standard, and are unfair. The result is an approach that is more like a system of discretionary grants than Equalization.

With these lessons in mind, I examine the four core issues that are before the Expert Panel using the Equalization objectives listed in the Issues paper as evaluation criteria. My recommendation is to continue to use the Representative Tax System approach to measure relative fiscal disparities and to allocate Equalization to recipient provinces using an “all provinces, all revenues in” standard. My choice reflects my weighting scheme with relatively large weights assigned to responsiveness, fairness and transparency. While my analysis and recommendations are informative, perhaps the paper’s more important contribution is to show that the process of making recommendations also requires making judgements about the relative importance of different objectives. I make clear the weighting scheme that guided my choices. When the Expert Panel makes its recommendations and when the federal government decides on Equalization for the future, they should do the same.

2 A Bargain Struck

A natural starting place is to contemplate the purpose of Equalization as defined by section 36 of the *Constitution Act*. Under section 36, the federal government is committed to making Equalization payments so as to ensure provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. In its efforts to provide advice on the questions summarized in the Issues paper, the Expert Panel will be confronted with the broader questions of how best to interpret and implement the constitutional principle of Equalization. There are other objectives or considerations relating to Equalization such as stability of payments, responsiveness, and fairness, although the relative importance of these various considerations has changed over time. The compromise among the competing objectives inherent in Equalization in the 1980s and 90s reflects a distinct weighting scheme for these objectives. The current Equalization arrangements reflect a

different compromise. The bargains struck in the past and present are worth reviewing if we are to understand the implications of future alternatives.

2.1 Equalization Past

Although Equalization in Canada has a long history, the basic approach has not changed much in the past 20 years. Before the introduction of the *New Framework* the federal government used the Representative Tax System (RTS) approach and a five province standard in its attempt to achieve the goal of ensuring reasonably comparable levels of public services at reasonably comparable levels of taxation.² Equalization payments were distributed to provinces based on their net revenue deficiency relative to the standard. The formula was responsive to changes in a province's fiscal capacity, increasing (decreasing) a recipient's entitlement when its net deficiency increased (decreased).

Several features are worth noting. The scheme operated on a gross basis meaning that provinces with below-standard fiscal capacity received Equalization but provinces with above-standard capacity were not equalized down. The RTS approach equalized fiscal disparities only with respect to provincial own-source revenues. Provincial entitlements were subject to a floor provision in part to smooth out (but not eliminate) year to year variability in payments due to fluctuations in standard bases or national average tax rates. Aggregate Equalization, determined as the sum of entitlements paid to recipient provinces, was subject to a ceiling provision, ensuring that the growth in total payments did not exceed the rate of growth in GDP. Finally, the workings of Equalization were affected by the generic solution, which applied when more than 70% of a tax base was located in a single province. In this situation, only 70% rather than 100% of those revenues would be subject to Equalization.

The ceiling and floor provisions, the generic solution and the use of a five province standard reflect program considerations that are distinct from the constitutional principle.

² The five province standard has been in place since 1982.

The Issues paper lists the following objectives for Equalization: adequacy, fairness, stability, predictability, transparency/accountability/governance, responsiveness, and sound incentives. Equalization, as it as operated during this period, reflected a particular compromise among these competing objectives.

The adequacy objective (and constitutional principle) is defined as ensuring provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Whether an Equalization system is adequate therefore depends on how one defines “reasonably comparable”. Taking the RTS and standard as given, Equalization Past satisfied the adequacy principle by ensuring that recipient provinces had sufficient revenues to achieve the fiscal capacity given by the five province standard. In years where the ceiling and floor provisions were in effect, discrepancies in post-equalization fiscal capacity relative to the standard arose. As a consequence, adequacy was not fully achieved in these years.

The objectives of stability and predictability were addressed by including ceiling and floor provisions. These objectives were accommodated at the expense of responsiveness and adequacy. Incentive effects, believed to be most problematic when a disproportionately large share of a tax base was located in a single recipient province, were mitigated by the adoption of the generic solution. The decision to replace the ten province standard with the five province standard in 1982 was, in part, motivated by the federal government’s concern over financing the program. In particular, by removing Alberta and its sizeable and growing natural resource revenues, the federal government avoided having to finance a much larger Equalization program. Although not explicitly included in the Issues paper’s list of objectives, affordability has nevertheless played an important role in Equalization.

The fairness objective has a number of dimensions. Inclusion of all revenues in the RTS formula satisfied the notion of fair treatment of different revenues sources. However, the exclusion of some provinces from the standard seemed at odds with the notion of fairness since the revenues of these provinces were not subject to Equalization. The extent to

which Equalization Past satisfied the fairness objective depends on your point of view about the appropriateness of a five province standard versus a ten province standard or some other alternative. For instance, the use of the five province standard and a gross scheme resulted in recipient provinces being equalized to the same per capita fiscal capacity but this was less than 100% of the national average. Whether or not this is fair depends on what you consider to be the appropriate standard.

Overall, Equalization Past can be characterized as assigning a relatively large weight to adequacy, defined as the five province standard. The objectives of responsiveness, predictability and stability received some weight. Incentives received a small weight with the limited application of the generic solution. The use of a formula-driven approach satisfied the objectives of transparency and accountability. Deviations from the general formula resulting from the floor and ceiling provisions were also consistent with the transparency objective since the rules were known and applied indiscriminately to all recipient provinces.

2.2 Equalization Present

The current Equalization arrangements have been put in place by the federal government for 2004/05 and 2005/06. Some elements are transitional. For example, the fixed shares for recipient provinces for the two year period are transitional in the sense that the government intends to adopt a new allocation formula for 2006/07. Other elements, such as the fixed annual growth rate of 3.5% for aggregate Equalization, are more permanent. Since Equalization Present is a combination of transitional and permanent features, it is useful to think about how this arrangement satisfies the principle of reasonably comparable levels of services at reasonably comparable levels of taxation as well as the other program objectives.

The Equalization arrangements for 2004/05 and 2005/06 represent a significant departure from Equalization Past in terms of the implicit weighting of the various program objectives. By fixing recipients' shares, the *New Framework* assigns a zero weight to the

objectives of responsiveness and fairness. The individual floor provisions for some recipients (but not all) also violate the fairness objective. Current relative fiscal deficiencies no longer play a role in the determination of a province's Equalization payment. This situation is certainly at odds with the RTS approach to determining how much Equalization was needed and who needed it. It is not clear what kind of incentive effects are resolved and what new ones created by the adoption of fixed shares and a fixed pot.

Under the current arrangements, each recipient is equalized to a level above the five province standard. Thus, the interim arrangements satisfy the adequacy principle if sufficient revenues are defined as that needed to achieve the five province standard. However, there is substantial variation in the extent to which each recipient is raised above this standard. For example, for 2004/05, Saskatchewan had a per capita fiscal capacity of about 109.5% of the five province standard after Equalization while BC and Quebec achieved about 101%.³ Multiple standards raise difficult questions about how to define or assess adequacy. Does satisfying adequacy mean achieving a *minimum* standard or achieving *the* standard? In either case, the question of what benchmark to use remains.

It is also difficult to see how multiple standards satisfy fairness, defined in the Issues paper as “reasonably comparable treatment of all jurisdictions”. The mechanism or rationale (other than discretionary choice by the federal government) for deciding which province would be equalized to a higher level and why also fails to satisfy the principle of transparency and accountability. The current arrangements are consistent with stability and predictability objectives. Recipient provinces get a fixed share of a larger pot. This is both stable and predictable from the perspectives of the federal and provincial governments.

There has been a significant re-weighting of key objectives in the move from Equalization Past to Equalization Present. Responsiveness, fairness and transparency are

³ Interestingly, as a result of this interim arrangement, Saskatchewan had the second highest per capita fiscal capacity in the country in 2004/05.

much less important in the current arrangements while stability and predictability now play a bigger role. Adequacy is more difficult to assess under Equalization Present and the impact on incentives is uncertain.

One might argue that the interim system with its fixed shares, multiple standards and selective floors is so far removed from the principle of equalizing based on relative fiscal deficiencies that it is not Equalization at all. While it is recognized that the interim arrangements are transitional, it is important to keep in mind the features of the current arrangements that are fundamentally at odds with the underlying principle of Equalization.

3 Moving Forward: Equalization Future

The main question of interest is what weight will the different objectives for Equalization receive in the future? The Expert Panel is expected to provide advice on four key issues: an allocation mechanism, stability and predictability mechanisms, evidence-based measures of fiscal disparities for re-evaluations of the funding support for Equalization, and on the desirability of an independent advising body. This section considers these questions in the context of the key objectives for Equalization. However, before turning to this, I discuss a critical element in the *New Framework* that is *not* part of the Expert Panel's mandate but is already an important component of Equalization Future, namely the fixed funding track. Although the Panel has been tasked with providing advice on evidence that could be used to assess whether the fixed funding track is adequate, the annual rate of funding growth itself is outside the purview of the Panel and apparently not up for discussion. But this policy choice has important implications for the bargain that will be Equalization Future. For this reason, I address this issue first.

3.1 Fixed Funding Track and the Adequacy of Funding Growth for Equalization

As noted in the Issues paper, the fixed funding track defines the extent to which revenue and fiscal need disparities will be equalized and is separate from the decision as to how to

allocate Equalization to recipient provinces. There are some important issues arising from the federal government's choice of how to determine the aggregate funding for Equalization. These include issues relating to affordability, commitment, and stability.

The rationale for the choice of a 3.5% annual growth rate is not obvious. The federal government has argued that this rate is consistent with long-term historical growth trends for Equalization, but this estimate seems low.⁴ This historical average masks substantial year to year variations in the growth of annual payments, ranging from a low of -14% to a high of about 15%. Affordability, stability and predictability from the perspective of the federal government's finances are possible motivations for the fixed funding track.

Affordability is a relative concept. When an individual thinks about whether they can afford a certain commodity this year they think not only about the price of this item and how it has changed but also about how their income has changed. From a government's perspective, whether an increase in aggregate Equalization is affordable depends on how revenues have changed relative to expenditure commitments. Fixing the annual rate of growth in Equalization in absolute terms (i.e. at 3.5% per year) is at odds with the notion of affordability. Aggregate Equalization is stable and predictable but this need not translate into stable and predictable entitlements for individual recipients. Depending on the allocation mechanism, the fixed funding track may be a factor contributing to instability and unpredictability for the provinces. In this sense, adopting the fixed funding track essentially shifts risk away from the federal government and onto the provinces.

The decision to adopt an annual escalator for growth is reminiscent of the switch from open-ended matching grants for health and post-secondary education to block grants with the introduction of Established Programs Financing, EPF, in 1977. Provinces received an equal per capita grant that was to grow over time using a GDP-based escalator. Over the years the escalator was frequently reduced. The per capita grant was eventually frozen, then eliminated, and then replaced by the Canada Health and Social Transfer in 1996.

⁴ Over the period from 1980/81 to 2003/04 the average annual rate of growth in aggregate Equalization was about 4.2%.

Freezing per capita grants results in very stable and predictable payments to the provinces but is not necessarily desirable or consistent with the objectives of the program. Indeed, the formula-driven approach to Equalization Past was frequently applauded as the mechanism that made Equalization relatively immune to discretionary and ad hoc changes by the federal government.

Experience suggests that there is nothing special about an Equalization escalator that would make it immune from the discretionary tinkering that characterized EPF.⁵ So not only is a fixed growth rate of 3.5% inconsistent with an affordability objective, it is also a number to which the federal government may find it difficult to commit. This is an additional source of instability and unpredictability for the recipient provinces.

Aggregate Equalization, as determined by many reasonable formula-based alternatives, will match exactly the exogenous funding available only in the most fortuitous of circumstances. Whether a surplus or deficit arises depends of course on the allocation mechanism adopted. For example, a funding surplus is a likely scenario if the old RTS system and the same five province standard continued with little modification.

Alternatively, suppose the allocation formula is based on the RTS approach but with a ten province standard and all revenues included. It is undoubtedly the case that the unconstrained sum of Equalization entitlements owing to recipient provinces based on this standard would be well in excess of what would be allowed given a rate of growth in Equalization of 3.5% per year. How will the funding surplus or deficiency be handled?

The choice of allocation mechanism might be unintentionally influenced by how the mechanism interacts with the fixed funding track. Consideration of all Equalization objectives, for example, might lead the Panel to recommend an allocation mechanism that

⁵ There is empirical evidence to support the hypothesis that the allocation of grants is influenced by the political motivations of the federal or central level of government. Case (2001) looks at block grants in Albania and finds some support for the influence of politics on the distribution of grants. Johansson (2003) looks at formula-based grants in Sweden arguing that while the level of grants is more difficult to change for purely discretionary reasons, formula or rule changes achieve the same effect. She finds that even in this case politics plays a role in allocating grants. Mixon and Hobson (2001) and Borck and Owings (2003) also find some support for the influence of politics.

when combined with the fixed funding track results in a persistent deficiency. This could be interpreted by voters and provincial governments as persistent under-funding of Equalization and, politically, this might be unattractive to the federal government. On the other hand, an allocation mechanism that produces a persistent surplus to be shared with recipient provinces or “saved “ by the federal government may have more appeal. The role of the various objectives including those implicit objectives of affordability and political expediency in determining the choice of allocation mechanism should be made clear.

It is important to keep the issues relating to the fixed funding track in mind when considering the questions before the Expert Panel.

3.2 *The Allocation Mechanism*

To recommend an allocation mechanism, the Panel must first consider a series of broader questions including: what principle should guide how Equalization is allocated; under what circumstances should a province receive Equalization; will one province get a bigger per capita grant than another and, if so, how much bigger should the grant be? In addition to these questions, there are a number of more pointed questions that need to be addressed if the Panel is to provide advice on an evidence-based and formula-driven approach to the allocation of Equalization.

What principle should guide who gets Equalization and how much?

There is broad agreement in the economics literature as to what an ideal Equalization system might look like.⁶ Such a scheme requires Equalization to be funded on a net basis and to equalize disparities in both revenues and needs. Applying this to the Canadian context, the standard would include all ten provinces, all revenue sources and expenditure needs. This ideal system is consistent with the constitutional principle of providing sufficient revenues to ensure reasonably comparable levels of public services at reasonably comparable levels of taxation.

⁶ See Boadway (2004) for a full description of the ideal benchmark system.

Equalization Past used a variant of the ideal (with some bells and whistles) and a RTS system to answer the allocation question. Relative fiscal disparities with respect to revenues were used to decide who got Equalization. Absent ceilings and floor provisions, Equalization fulfilled its goal of adequacy by ensuring recipient provinces were equalized to the five province standard. The current system with fixed shares and a fixed pot is fundamentally at odds with using relative fiscal disparities as the basis for Equalization and, for this reason, should be discarded as a template upon which to base Equalization Future.

To be consistent with the constitutional principle of Equalization, the allocation principle should be based on relative fiscal disparities.

Should disparities in both revenue and needs be included?

In theory they should be but most would argue that we lack sufficient data and expertise to effectively include needs. Proposals such as expanding the RTS approach to include needs have not been met with much enthusiasm. The concerns raised are arguably complex and controversial but this stems partly from a lack of experience in dealing with such issues. Certainly the questions of what to measure and how to measure it generate more debate and less agreement for a Representative Expenditures System (RES) as compared to the RTS. For these reasons, we might have to accept that the inclusion of needs is not feasible at this time. And if needs are excluded, we will be unable to implement the ideal system of Equalization.

Net or Gross Scheme

The ideal system calls for a net scheme but historically Canada has operated its Equalization system on a gross basis. A net scheme requires provinces with fiscal capacities above the relevant standard to contribute revenues directly. Under a gross scheme, the federal government finances payments from general revenues and above-standard provinces are not explicitly equalized down. While a net scheme is preferred under the ideal system, past experience suggests that a proposal for a net scheme is unlikely to receive much support from participating provinces.

Should the RTS approach be used to measure revenue disparities?

The basic answer is yes. The RTS approach is appealing as it equalizes revenues based on actual tax rates and bases chosen by provinces. Payments adjust with changes in a province's relative fiscal disparity in terms of revenues, consistent with the objective of responsiveness. The system is not fully responsive since changes in needs disparities have no corresponding impact on a province's Equalization entitlement. The RTS system does not ensure full consistency with the adequacy objective as defined by the ideal system and RTS Equalization need not result in stable or predictable payments. Fairness is sacrificed to the extent that provinces with higher needs are not be recognized. By excluding expenditure needs, we perhaps avoid expenditure-related incentive problems. However, incentive issues with respect to provincial tax decisions are still a possibility. Conceptually, the workings of such a system are straightforward and transparent, satisfying the program objective of transparency/accountability/governance.

While not perfect, Canada has a lot of experience and expertise with respect to the RTS system. We should work on resolving outstanding RTS issues, especially those associated with property taxation, user fees and natural resources rather than whole scale replacement of something that is conceptually appealing and reasonably well-functioning.

What standard should be adopted?

The choice of standard reflects in some sense how to make operational the "reasonably comparable" principle. But the choice of standard will be influenced by and will have implications for other program objectives like fairness, stability and affordability. Given the choice of a gross system with revenue Equalization only, the ideal benchmark will not be achieved. Thus, the adequacy objective as measured against the ideal benchmark will not be satisfied. As a second best, adequacy can be defined relative to the benchmark implicit in the chosen standard.

Consider Equalization Past and Present. In the past, the RTS approach and a five province standard were adopted for Equalization. As long as recipient provinces had post-equalization fiscal capacities equal to the five province standard, Equalization was adequate relative to that benchmark. When ceiling and floor provisions came into effect, variations in recipients' post-equalization fiscal capacities would occur. The extent to which the adequacy objective was not satisfied (i.e. all recipients achieve the five province standard) could be evaluated by looking at the magnitude of the deviation from the five province standard.

Under Equalization Present, every recipient province is effectively equalized to a different standard. As discussed above, it is unclear how to assess adequacy when multiple standards are used. If the current arrangements are interpreted as adopting a five province *minimum* standard then adequacy is satisfied; alternatively, if the five province standard is *the* standard but various floor provisions and ad hoc adjustments (like fixing shares) have resulted in deviations from the standard, then the adequacy objective is not fulfilled. In this case, the degree to which adequacy is not satisfied could be measured as above by the extent of the deviation from the five province standard.

Once chosen, adequacy can be assessed relative to the standard but the choice of standard is ultimately governed by other considerations. For example, the decision to replace the ten province standard in place prior to 1982 with the five province standard represented a trade-off between fairness and affordability. Many would argue that a ten province standard is a fair approach as it treats all provinces in the same way. Since provinces are treated differently in the five province standard, the five province standard is not equitable. Moreover, deviations from the five province standard were permitted if payments to individual provinces fell dramatically or if the growth in aggregate Equalization was substantial. Thus, fairness and stability were re-weighted whenever the floor and ceiling provisions came into effect. In the case of the current arrangements, other considerations, like stability and predictability of aggregate payments and ensuring payments to recipient provinces do not decline, dominate all other objectives.

Given our experiences with Equalization Past and Present, what standard should be adopted for the future? First, given the choice of a gross system and a RTS approach that includes all revenue sources, adequacy with respect to the ideal is unattainable and therefore the choice of standard must be determined by other considerations such as fairness, affordability, stability and predictability. If fairness is most heavily weighted, the natural choice is a ten province standard. A large weight assigned to the objective of affordability when choosing a standard is problematic. Affordability is a relative concept that changes from year to year. A seven province standard might have been affordable last year but this year only a five province standard is manageable; in other words, the definition of “reasonably comparable” changes from year to year. This option seems unworkable.

The choice of standard should be guided by principles consistent with Equalization objectives and should be able to stand the passage of time. Fairness is a reasonable principle to govern the choice of standard. Affordability can be handled by other mechanisms (i.e. something like the fixed funding track).

Should Resource Revenues Be Included?

If were not for the fact that some revenue sources, especially natural resources, are very unevenly distributed across provinces, most concerns about the RTS system and the choice of standard would be more easily resolved. The questions of whether to run the system on a gross or net basis and whether to include needs would, however, remain.

With a relatively even distribution of tax bases, the “all provinces, all revenues in” standard is the natural choice from the perspective of fairness. Full equalization would be achieved at least from the revenue standpoint and the adequacy goal (relative to this standard) would be satisfied. All revenues and provinces would be treated in a similar way by the RTS formula, reinforcing the fair and equitable treatment of all provinces. Equalization would be responsive to changes in relative fiscal disparities and the principle and determination of Equalization would be transparent. Stability and predictability of recipients’ entitlements would not, however, be guaranteed and

distortions to provincial tax decisions are possible. In this scenario, concerns about affordability would be less of an issue in this world.

Natural resources in Canada are, however, markedly uneven in their distribution. With Equalization Past, the standard included all revenues sources for the five provinces. Revenues from the excluded provinces, including the very large resource revenues accruing to Alberta, were excluded. The move from the ten to the five province standard meant the federal government could avoid having to equalize these sizeable revenues and made Equalization more affordable. However, it is the unevenness in the distribution of any tax base that gives rise to revenue disparities and the need for Equalization. In other words, the “reasonably comparable” principle provides a strong rationale for equalizing these revenues disparities whether or not they are associated with natural resources. Fairness, defined in terms of similar treatment of all provinces and all revenue sources, also argues in favour of the full equalization of these revenues.

Three main problems arise then with strict adherence to an “all provinces, all revenues in” standard. Operating as a gross scheme, the federal financing requirements increase dramatically and the issue of affordability becomes a serious concern. Compounding this is the fact that the ownership of natural resources is assigned to the provinces in the Constitution. To fully equalize natural resource revenues potentially creates a violation of provincial Constitutional rights.⁷ Finally, unlike many other tax bases, provinces have much more discretion with respect to development of natural resources and associated tax bases. When this is the case, adverse incentive effects associated with Equalization potentially come into play.

Affordability issues can be handled in a number of ways. Consistent with the notion of affordability as a relative concept, a GDP-based ceiling like that used in Equalization Past could be adopted. Alternatively, the extent to which recipient provinces are equalized to the standard can be determined at the discretion of the federal government. The fixed

⁷ Boadway (2005) provides a comprehensive and compelling discussion of the key issues relating to natural resources and Equalization.

funding track adopted as part of the *New Framework* is a variant of this approach. As argued above, the setting of the fixed funding track to an number rather than to some indicator linked to growth in revenues or growth in the overall economy is only weakly linked to affordability and open to manipulation for reasons unrelated to affordability.

The argument that equalizing natural resource revenues is fundamentally different than equalizing other revenues is unconvincing. The federal government equalizes income tax revenues and these revenues are also “owned” by provincial governments. The final argument against full inclusion depends on the adverse incentive effects for developing natural resources. While these negative incentive effects are predicted by theory, the extent to which they are operating in practice is less certain. In part, this reflects the fact that while there appears to be substantial anecdotal evidence of negative incentive effects, rigorous empirical evidence on this subject is quite limited and far from conclusive.⁸

The absence of compelling arguments and evidence on incentive effects and natural resource ownership issues strengthens the argument in favour of using the fairness and adequacy principles to guide the treatment of natural resources. On this basis, all provinces and all revenues sources should be included in the standard.

Equalization Past attempted to mitigate adverse incentive effects by adopting the generic solution - a compromise between full inclusion and incentive effects. The generic solution applied to any province with 70% or more of any tax base not just those relating to natural resources. As such, the generic solution was equitable in its application in that it applied to any tax base that satisfied the rule. The generic solution could be continued as part of Equalization Future. Whether the 70% rule should be revisited depends, in part,

⁸ Dahlby and Warren (2003) find some evidence that the Australian Equalization system affects the choice of tax rates in a manner consistent with theory while the results in Cavlovic and Day (2003) do not support the hypothesis that the negative incentive effects associated with Equalization in Canada have hindered the adoption of growth-enhancing provincial government policies. Snoddon (2003) examines the differential incentive effects for tax choices caused by the switch to the five province standard in 1982. While some results are consistent with the differential changes in incentive effects, the results are not conclusive.

on whether incentive effects are considered to be more or less problematic with the move an “all provinces, all revenues” standard in conjunction with the fixed funding track.

How to allocate funding surpluses or shortages?

The above discussion argues in favour of an allocation mechanism using the RTS approach with all provinces and all revenues included. In an unconstrained environment, the sum of entitlements to recipient provinces determines aggregate Equalization. However, under the *New Framework*, aggregate funding is determined according to the fixed funding track that is already in place. With an “all provinces, all revenues in” standard, these funds will not be sufficient. How will the shortfall be allocated?

The two obvious ways are to determine Equalization entitlements as a percentage of the standard (i.e. 85% or 95%) such that the aggregate funding constraint is satisfied. This percentage would vary from year to year but each recipient would achieve the same post-equalization fiscal capacity. Adequacy, defined as revenues sufficient to meet the standard, would not be fully satisfied. The degree to which Equalization falls short of the adequacy goal could be measured as the difference between 100% of the standard and the actual percentage achieved (i.e. 85%). Alternatively, the entitlement for each recipient province can be reduced on an equal per capita basis until the aggregate funding constraint is satisfied. This approach benefits the provinces with the lowest revenue capacity relative to first option.

The fairness principle requires that recipient provinces be treated in a similar manner. Option one is consistent with this principle.

3.3 Mechanism for Stability and Predictability of Payments

Under the fixed funding track, Equalization in aggregate will likely be more stable and predictable than was the case given Equalization Past. The stability and predictability implications for individual recipients are, however, less clear.

Our experience with Equalization Past shows that relative fiscal disparities can change substantially from one year to the next as a result of idiosyncratic and asymmetric shocks across provinces. Absent floor and ceiling provisions, the RTS system responded to these changes by increasing entitlements when a recipient's position relative to the standard declined and decreasing payments when fiscal positions improved relative to the standard. Aggregate Equalization adjusted as required. When the ceiling came into effect payments were adjusted downward. Floor provisions were used more frequently than was the case for the ceiling. These provisions protected a qualifying province whose entitlements would otherwise fall dramatically but had no adverse effects on other recipients.

Under the proposed allocation mechanism and the fixed funding track, an improvement or a worsening of any one recipient's fiscal position relative to the standard will directly affect the Equalization entitlements of other recipients even if their fiscal positions relative to the standard are unchanged. In this respect, the fixed funding track in conjunction with the RTA approach adds instability and unpredictability into the system. This problem will only be made worse if a mechanism is put into place to limit year over year reductions in Equalization payments for a qualifying province.

Consider the case of a "fortunate" recipient whose fiscal situation improves significantly in a particular year and who, as a result, would receive a smaller Equalization payment in the absence of any special provisions. Under the fixed funding track with no floor provisions, the reduction in the payment to the "fortunate" recipient eases the aggregate funding constraint for other recipients. By introducing a floor provision, aggregate requirements will be higher and x will be readjusted for all recipients. So not only does the "fortunate" province get some additional own source revenues from its improved fiscal position, it gets to keep more Equalization than would otherwise be the case. This happens at the expense of other recipient provinces. In effect, floor provisions penalize other recipients for the improvement in the "fortunate" recipient's fiscal position.

For these reasons, floor provisions to promote stability are not recommended if they are to be funded from the fixed Equalization pot. If stability is assigned a large weight and floor provisions deemed essential, then they should be financed outside of the fixed funding track. In this way, the perverse impacts on other recipients can be avoided.

The fixed funding track may be changed at the discretion of the federal government. This is another source of instability and unpredictability in the system. This issue is not easily resolved but the creation of an independent advisory board could help. This issue is discussed below in section 3.5.

3.4 Evidence-based Aggregate Measures of Fiscal Disparities

The adoption of an allocation mechanism based on the RTS and a ten province standard provides a natural way for measuring fiscal disparities. Suppose the method of reconciling aggregate Equalization entitlements with the fixed funds available is to lower the percentage of the national average to which recipient provinces are equalized to something less than 100%. Then a natural way to measure the adequacy of the fixed funding track is to examine the gap between 100% and the $x\%$ of the national standard actually achieved. A downward trend in x is a clear signal that there are growing disparities that are not being satisfactorily addressed by the Equalization funds available under the fixed funding track.

3.5 Independent Advisory Body

In the past, Equalization entitlements to recipient provinces were largely formula- driven and aggregate Equalization was determined as the sum of these individual entitlements. Differences between the amounts determined by the formula and the amounts actually paid out occurred from time to time when floor and ceiling provisions came into effect. Ex ante, these provisions applied indiscriminately to all recipients.

The need for an independent advisory board as a vehicle for public reporting and accountability is not great given a rules-based, formula-driven approach. Such a body may have served a useful role as a source of independent research and input into the renewal discussions that occurred every five years. And an advisory group would have been able to offer valuable input on how best to handle issues like the volatility of payments, data revisions, and floor and ceiling adjustments.

Relative to Equalization Past, there will be a greater role for an independent advisory group in the future. The most obvious issue is the fixed funding track tying the annual rate of growth in Equalization funding to 3.5%. I have outlined several problems created by this approach. It is more difficult for the federal government to remain committed to a number as opposed to a formula. Discretionary changes are easier to justify when the fixed growth rate is not linked to any relative measure of affordability. In the absence of independent and timely evidence to the contrary, it may be difficult to evaluate the federal government's actions with respect to the fixed funding level. By collecting and publicly reporting data on Equalization, indicators of fiscal disparities and how they have changed over time, and other measures like the growth in federal government revenues relative to GDP growth, the incidence of discretionary and ad hoc tinkering with the fixed funding level or other elements of Equalization can potentially be reduced. At the very least, the rationale for such changes may become more transparent.

If Equalization is based on the principle of equalizing fiscal disparities and is implemented using an RTS approach and an "all provinces, all revenues in" standard, then changes in aggregate funding should be linked in some way to evidence on the extent to which the fixed funding track is adequate (defined relative to this standard). For example, the percentage of the national average to which recipients are equalized relative to the 100% benchmark is one such indicator. The development of evidence-based measures by an independent advisory group can help guide future discussions regarding the required level of funding.

Finally, there are several aspects with respect to Equalization Future that are at present undecided. The allocation mechanism is uncertain. Mechanisms to deal with stability and predictability might be adopted even though they are likely to have undesirable consequences if funded from the fixed Equalization pot. The choice of how best to deal with Equalization shortages or surpluses is up in the air. The more discretionary are the arrangements adopted in the future and the less connected these arrangements are to a principle-based approach, the greater the pressures from various groups to adjust the system. In this situation, an advisory group might help to improve accountability and alleviate the inevitable pressures from interest groups. However, while the need for an independent advisory group is even greater in this context, there are no guarantees that discretionary tinkering and political manipulation will not occur.

4 Final Remarks

The Expert Panel on Equalization and TTF was set up to provide the federal government with advice on several important issues relating to how Equalization should operate in the future. The main issues to be considered include the allocation mechanism for Equalization, possible mechanisms to address stability and predictability concerns, different measures of fiscal disparities, and the value of an independent advisory board. The fixed funding track, introduced as part of the federal government's *New Framework* and an important element of Equalization in the future, is *not* part of the Expert Panel's mandate. At the outset, it is important to recognize that decisions on how best to move forward with Equalization must be consistent with the underlying constitutional principle of ensuring that provinces have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. As is the case with most policy choices, there are other objectives, like stability of payments, responsiveness, and fairness and these must also be taken into consideration.

Our choice for Equalization in the Future reflects a decision on how to balance these different objectives. To highlight the tradeoffs that must be confronted, the paper reviews the federal government's approach to Equalization in the past and present, focusing on

the weighting scheme for the various Equalization objectives implicit in each. There has been a significant re-weighting of key objectives in the move from Equalization Past to Equalization Present. Responsiveness, fairness and transparency are assigned small weights in the current arrangements. The objectives of stability and predictability are dominant. The constitutional principle (or adequacy) is more difficult to assess under Equalization Present and the incentives effects are uncertain.

By fixing shares and introducing multiple standards and selective floors, the current arrangements are at odds with the fundamental principle of Equalization based on relative fiscal disparities. The current system is not Equalization but rather a system of discretionary grants to a particular set of provinces. This may seem like harsh criticism for what amounts to a transitional arrangement. The lesson is, however, important. Equalization Present is part of a transition from the past to the future. If we want a program in the future that is consistent with the underlying principle of Equalization and is not just a discretionary grant program, the current arrangements should not be used as our template.

As part of its job, the Expert Panel needs to make clear the tradeoffs inherent in all of its recommendations. To help in this respect, I consider each of the main issues before the Panel and use my preferred weighting scheme to make my own recommendations. The value of this approach is not so much in the recommendation itself (although this is useful) but is in detailing the process that must be undertaken to justify a particular course of action.

The constitutional principle for Equalization provides the foundation for my own recommendations. Drawing on a principle-based approach, I assign a relatively large weight to responsiveness and fairness. Given this, my preference is to continue to use the RTS approach to measure relative fiscal disparities and to allocate Equalization to recipient provinces. I recognize that the system will likely be operated on a gross basis, will include revenues only, and will therefore not achieve full Equalization. My choice of standard is an “all provinces, all revenues in” standard and is primarily guided by the

fairness principle. This rules-based approach is also appealing in that it is a transparent mechanism for allocating Equalization. The RTS approach combined with the fixed funding track determines the allocation of entitlements and also gives rise to an obvious and natural way to assess the adequacy of the overall funding of Equalization. In this approach, the standard and the allocation mechanism are based on the Equalization objectives. Affordability does not influence these choices but is accommodated by integrating the RTS with the fixed funding available.

This approach does not ensure stability and predictability of payments. Indeed, promoting stability given the fixed funding constraint is unfair to other recipients and makes the system less responsive. If stability is considered important, it should be funded outside of the aggregate Equalization envelope. As part of my recommendations I have outlined several issues with the fixed funding track. While not part of the Expert Panel's mandate, the fixed funding track affects how Equalization in the future will function. These effects should be fully addressed in the Expert Panel's recommendations to the federal Minister of Finance.

Finally, the idea of an independent advisory board is a good one. Accountability and transparency can be improved with an independent advisory board. Discretionary and ad hoc changes, a significant possibility given the fixed funding track, can potentially be minimized. And finally, such a group could serve a valuable research function.

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