

**RESPONSES TO THE KEY QUESTIONS ON EQUALIZATION  
RAISED BY THE EXPERT PANEL ON EQUALIZATION**

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## **INTRODUCTORY COMMENTS**

Equalization has been called the “cornerstone” of the Canadian federation. It is enshrined in the constitution:

**“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.”**

Equalization really moves to the heart of citizenship rights in Canada where we take the position that we all have the right to reasonably comparable services in all provinces at reasonably comparable tax burdens. Equalization is the means of assuring residents in less affluent provinces can receive similar services to those in more affluent provinces without paying unduly higher taxes.

Regrettably since the early 1980's the commitment to equalization has been reduced through measures such as the lower five province standard and subsequent narrowing of revenue coverage especially evident with user fees. As well, in renewal discussions since 1982, the federal government has resisted movement on the key issue of the standard and been slow to address measurement issues such as the property tax base, which would tend to increase payments and quick to take action where entitlements would be reduced. Each renewal was dominated by a concerted federal effort to ensure that program entitlements would fall well within unilaterally imposed program ceilings, which were the federal measure of affordability. The ceilings were lowered with each renewal.

Arguably corrective action should have been taken on the standard and revenue coverage issues on a planned basis. Such adjustments would also recognize the increasing health cost pressures and the provincial responsibility for social programs.

Such improvements would have fit well within earlier ceilings on the program, which were the federal government's definition of affordability at the time. Currently the program represents 0.8% of GDP, a major decline from the 1.3% that prevailed in the early 1980's. While a changing GDP share is a normal outcome when disparities are seen to be narrowing, much of the diminution is attributable to federal reduction measures.

Looking forward, the fixed 3.5% “growth track” outlined by the federal government could impede progress on needed improvements and reduce further the equalization share of GDP. The “growth track” is actually less than projected nominal GDP growth and the former ceilings on the program

**For convenience, the questions raised by the Expert Panel are reproduced before each response.**

### **KEY QUESTIONS ON EQUALIZATION**

#### **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?*

#### **Response**

**The best measure of fiscal disparities among provinces is the Representative Tax System (RTS).** The RTS measures the various tax bases in use by the provinces and assesses the relative revenue raising capacity of each province under each tax base and simply sums the results into comprehensive provincial assessments.

This system provides the strongest evidence tested information possible (strengthened over the years by rigorous debate and analysis by officials of areas of contention and possible improvement). The RTS system has incorporated improvements over the years, with all such improvements having been subjected to full scrutiny among officials.

The current measuring stick is deficient in two major areas, standard and revenue coverage:

#### **THE STANDARD**

The five province standard was imposed in 1982, as a federal cost-saving measure. This effectively excludes Alberta's oil and gas capacity from equalization calculations. In 1982, this was justified as excluding two roughly equal "outliers" from the calculations Alberta and Atlantic Canada. While the populations were equal in 1982, today, Alberta's population is about 30% higher than Atlantic Canada's. That growing divergence means there is simply no sound basis for continuing use of the five province standard.

**The standard for equalization should be restored to the all-province national average standard.** Lower standards not only weaken the

commitment to equalization but also introduce distortions as economic activity or tax bases move across the country.

## **COMPREHENSIVE REVENUE COVERAGE**

**Comprehensive revenue coverage is essential to comprehensive assessments of capacity to raise revenues.** Unfortunately, the present system does not have reasonably comprehensive revenue coverage.

Perhaps the major issue here is user fees. Some argue that these are simply charges for service and should therefore be excluded from equalization. However, many of these fees result from government decisions to substitute user charges for direct taxes to produce lower direct taxes for taxpayers. The substitution of one revenue source say sewer and water charges for another say property taxes in no way results in an improvement in revenue capacity of less well off provinces, yet the current system reduces equalization in such circumstances, contributing to a lowering of well being in all receiving provinces. It may be noted that the reduction for receiving provinces occurs even if the substitution for traditional taxes occurs only in more affluent provinces. Equalization should be neutral regarding provincial revenue policy. The distortions inherent in the partial exclusion of user fees should be addressed.

### **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?*

### **Response**

**Multiple standards of equalization** over time are inherently unsustainable and unreasonable. They also **threaten the credibility of the program and its capacity to meet the commitment in the Constitution.** Multiple standards distort the calculation of entitlements and undermine the principle of the fair treatment of provinces in the distribution of fiscal resources. They also erode support for the program as provinces not participating in special arrangements and provinces perceiving themselves as contributors of the program no longer feel fairly treated.

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

## **Response**

### **NATURAL RESOURCE REVENUES**

**The exclusion of natural resource revenues and user fees from equalization is inconsistent with the objective of assuring “reasonably comparable treatment”.**

Natural resource revenue has the most uneven distribution among provinces and the disparities have grown over time. For example from 1986 to 2004, natural resource revenue as a percentage of total revenue increased from 23% to 33% in Alberta, 4% to 13% in British Columbia and 7% to 12% in Saskatchewan. With the exception of Newfoundland, all other provinces generate less than 2% of their revenue from natural resources. On a per capita basis, the majority of natural resource endowments are found in the west with Alberta (\$2,543) Saskatchewan (\$1,082) and British Columbia (\$956) raising the most in 2004-05, with the rest raising under \$100.

The magnitude of these provincial revenues and the fact they are continuing to grow as a share of resource rich provinces budgets demands that they be included in equalization calculations in order to assure effective equalization. The Alberta share is equivalent to the entire sales tax and consumption tax revenues in receiving provinces. In the absence of these revenues, to maintain similar public services, Alberta would be levying sales and consumption taxes more on a par with other provinces and these provincial revenues would be equalized.

Fundamentally, these resource revenues are used to provide public services. They serve as substitutes for other direct taxes on a province's citizens. It would be doubly unfair to exclude these resource revenues from equalization since the reduced reliance on traditional taxes (mainly but not only by resource rich provinces) already reduces equalization.

It should also be noted that exclusion of natural resource revenues would redistribute the equalization pie significantly from less affluent provinces without natural resource revenues to those with natural resource revenues. This result would depart further from “reasonably comparable treatment”.

### **USER FEES**

**Comprehensive revenue coverage provides the best basis for assuring “reasonably comparable treatment”.** Departures from comprehensive revenue coverage weaken the basis for comparisons among provinces. Basic local

government user fees serve as substitutes for broader property tax application. The reduced property taxes serve to reduce equalization while the exclusion of half the user fee revenue compounds the reduction.

The key question that should be asked is whether the service is a public service. If the service is a public service then equalization should treat the choice of revenue raising means to fund that service in a neutral manner. It should not discriminate against local authorities choice of relative reliance on property taxes or user charges. Comprehensive revenue coverage including user fees would eliminate any such discrimination. The measurement of fiscal capacity should be policy neutral and reflect how and what provinces actually tax.

*c) Should Equalization incorporate expenditure need measures?*

### **Response**

**The current Equalization system incorporates what is perhaps the best measure of expenditure need: that is population served.** Using population served as the proxy for need maintains focus on the constitutional commitment “to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

The current system implicitly assumes overall costs of services Canada-wide are roughly equal and in equalizing revenues leaves the mix and choice of services up to local decisions.

There are considerable conceptual and practical difficulties to the identification and development of other measures of expenditure need. Some have argued that greater weight be placed on elderly populations, as their health care costs are higher. Others say greater weight be placed on younger people, as that’s where the needed early intervention investments promote longer-term health savings and also note the greater need for educational investment. Some may argue new Canadians entail greater needs, while others may point to First Canadians. Some suggest costs per capita costs of public services are actually lower in smaller provinces with lower average wages while others argue the economies of scale in larger jurisdictions result in lower per capita public service costs. Some argue highways per capita are a good measure of need whereas others argue miles of highway would be a better measure. Still others might wish to use some variants of passenger or freight weighted miles.

Considerable research and evaluation would be required to create expenditure need measures with a possibility of becoming generally acceptable.

d) *How can the measurement of revenue capacity from natural resources and property tax revenues be improved under Equalization?*

### **Response**

**Measurement of natural resource revenue capacity can be improved by moving to the all province national average standard with full resource revenue inclusion.** In itself this would have resolved many of the tax back difficulties inherent in the Five Province standard and a ten-province tax rate). The federal provincial technical committees on equalization should address the special situations that arise regarding problematic tax-back rates, as it has through the Generic solution for provinces with a dominant share of a tax base. There is no question that natural resource revenues are the most inequitably distributed, that they are used to fund public services and that they serve to keep other taxes in better endowed provinces down.

**On property taxes, there appears to be a broadening consensus on the fuller adoption of market value assessment as the basis for measuring taxation capacity.**

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?*

### **Response**

**The RTS system and its continuous improvement over time provides the best focus on the revenue raising capacities and practices of provinces which in turn goes to the heart of equalization.** Some simplification of the 33 revenue bases may be possible. However that is a task that would require great care and caution.

Macro approaches as reviewed over the years generally failed the tests of better reflecting the revenue raising capacities of the provinces.

### **Improving the Stability and Predictability of Payments**

a) *Should Equalization payments be made more stable and predictable?*

### **Response**

**For equalization to meet its key objectives as outlined in the Constitution, it must be responsive to differences in revenue raising capacities among provinces.** Of necessity this has imposed some challenges on the stability and predictability fronts. While stability and predictability are also valued, these

should not be viewed somehow as substitutes for adequacy. And if adequacy requires an unanticipated adjustment in a province's payments, the adjustment must be made on a timely basis or the most fundamental program objective will be short-changed.

The commitment to balanced budgets has increased the sensitivity of provinces to negative changes in equalization. Prevailing federal measures help cushion both the economics and cash flow impacts of negative adjustments. However, the movement to full accrual accounting generally backs out these cushioning measures.

It may also be noted that other measures than equalization have left provinces more exposed to instability and unpredictability. These include the termination of the Canada Assistance Plan, which provided federal sharing in social assistance costs which rise in times of economic weakness and erosion of the Revenue Guarantee Program, which protected provinces against year over year drops in revenue.

*b) What is the best way of doing so without undue effects on other desirable program objectives?*

## **Response**

**The last program renewal incorporated significant stability and predictability into program entitlements by implementing a three-year moving average basis into entitlement calculations.** Perhaps allowing that system to work would be an improvement.

In addition, the ten province standard with full revenue coverage would be more comprehensive, less dependent on the on the economic fortunes of Ontario, and reflect better the fiscal capacities of all provinces and all revenue sources, thereby balancing out all the positives and all the negatives in all jurisdictions. This system is appreciably less volatile than the five province system.

It may be noted that Manitoba established a Fiscal Stabilization Fund as a way of dealing with the instability of equalization, with positive surprises being deposited to this special fund and the money in the fund used to cushion negative surprises.

**Encouraging cooperative work among federal and provincial officials on an equalization forecasting committee could make a significant contribution to better forecasting.** Their work should include a review of key underlying revenue growth factors and assumptions and an effort to use updated information. Currently equalization estimates are often based on outdated information on revenue yields, economic performance and key pricing and growth components.

## **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?*

### **Response**

The main shortcoming of the federal provincial finance review and analysis of equalization is the lack of a federal “champion” for the program. This is a marked contrast from virtually all other federal programs, which have their own departmental champions. While proponents of other programs can be assured at least that their interests were defended and presented, the same is not the case for equalization. During some transfer discussions, it appeared more that transfers were the residual balancing item to secure federal budgetary targets and the inability to secure targeted “savings” in direct federal areas was often accompanied by more stringent measures on transfers..

In general the federal provincial finance process does provide a means to address measurement issues, disparity issues, trend issues, etc. However this group’s efforts have been severely circumscribed by the federal affordability constraint. As a result, no substantial work on the standard for example has taken place in the last two decades.

It would be helpful to broaden the scope of work of these federal provincial finance groups to include more work on items of interest to provinces. Possibly a joint chairing approach rather than having all sessions only at the call of the federal chair would be helpful as well.

**Introduction of yet another permanent body to provide advice and recommendations on equalization issues could complicate the current process and potentially reduce its effectiveness.**