Advice to the Expert Panel on Equalization

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The current equalization program, with its RTS approach, is an excellent program that should be maintained with appropriate adjustments to various aspects of the formula and calculations. These would include a move to a ten-province standard, inclusion of an expenditure/needs-based equalization after sufficient and extensive research, modifications to the sales tax base and the business income revenue base, full inclusion of natural resources in the formula, removal of the ceiling that was in place when the formula worked to allocate entitlements and removal of the fixed annual pot of equalization monies introduced in 2004, which implies a return to a formula-determined amount for equalization in each year.

Question: What indicators of fiscal disparities would be relevant to evaluating funding levels for Equalization?

The current RTS system, with appropriate modifications, should be used to measure relative fiscal capacity. In this context relative fiscal capacity can be measured in terms of the ability of a province to raise revenue per capita from its revenue bases using relevant national average tax rates relative to the revenue per capita that could be raised by the national average standard (i.e., all ten provinces).

The two modifications that would, in my opinion, be required to improve the equity and efficiency characteristics of the Equalization program are:

a) *Split the Equalization base for General and Miscellaneous Sales Taxes into two distinct bases. One for those provinces that impose Harmonized Sales Taxes (HST) and a separate base for those provinces that maintain their own General Retail Sales Taxes (RST).*

   Rationale: My understanding of how bases have been constructed is to remove strategic behavior on the part of provincial governments. In this context, the decision to exclude some portion of a base for economic development or other strategic reasons should not enable the provincial to simultaneously lower the size of its equalization base. If this strategic behaviour were allowed, provincial governments could, for example, use selective tax cuts, implicitly funded by equalization, to attract businesses from other provinces without bearing the financial consequences of their actions.

   A tangible illustration of this problem could have been Newfoundland and Labrador's EDGE program, where new firms establishing within the province were given a tax holiday from provincial corporation income taxes. If these exempted firms were also excluded from the equalization base for Business Income Revenue, then the province would have an incentive to offer the tax holiday to attract the businesses. In effect, they would be losing nothing by the tax holiday because they were not receiving any tax from the firm when it was located in another province. However, if a company is exempted from provincial corporation income taxes because it establishes operations in that province, the province's equalization base increases and its equalization entitlement falls correspondingly. Consequently, provinces bear the cost of their strategic behavior. In other words, the current equalization system is, for the most part, set up so that a province cannot increase its equalization entitlements by behaving strategically.

While this principle ought to be maintained within the equalization formula, it does not support the proposition that there should only be one sales tax base. In fact, two separate sales tax bases are required because once a province participates in the HST, it loses its discretion to tax or not business inputs, but private sector purchases of business inputs expands the equalization base of a province. Hence, a situation exists where a province gains no revenue from private sector purchases of businesses inputs and the workings of the equalization formula reduce that province's equalization entitlement as if it fiscal capacity had been enhanced.

This problem becomes especially pronounced for provinces that have a large share of their economic activity composed of exported natural resources. For natural resource projects that export their final product, the final sale is exempt from provincial HST. However, resource companies are entitled to claim an input tax credit for taxes paid on business inputs such as machinery, equipment, goods and services. In effect, the provincial government receives no net tax revenue from these operations after allowing for input tax credits. Consequently, their fiscal position in terms of the sales tax base is unaltered. Yet, some portion of the purchases of inputs by these resource companies does enhance the equalization base. In other words, the purchase of inputs by the resource companies expands the sales tax base under the current system even though the provincial treasury fiscal position remains unaltered.

This inequity and potential inefficiency can be easily rectified by having two separate sales taxes – one for provinces participating in the HST and the other for those that do not.

b) *Decompose the Business Income Revenue equalization base into two distinct bases – one for private sector corporation income and the other for profits of government business enterprises.*

<u>Rationale:</u> Currently, for the purpose of calculating equalization entitlements from this base, the national average tax rate is applied to the sum of private corporation profits in each province and the remitted profits of government business enterprises, such as provincial hydro crown corporations. From the Second Estimate/Legislated Final Calculation: 2004-05, the national average tax

rate for this base was 9.88%. Using Quebec as an illustration, one observes that Quebec had $34.3 billion of private sector income eligible for taxation under this base and was allocated a $36.4 billion in corporate profits for the purpose of equalization calculations. From this level of private sector profits, the provincial treasury would have been able to raise approximately $3.1 billion given its corporation income tax rate. As well, given the equalization formula, it would have had the opportunity to raise $3.6 billion, which reflects the fact that its tax rate is lower than the national average. Consequently, Quebec's equalization loss on this part of the base would have been greater than the revenue it collected on this portion of the base. This is appropriate and fair given the idea behind equalization.

In addition, Quebec had $2 billion in adjusted profits of government business enterprises and an allocation of $2.2 billion for the purposes of equalization calculations. While the government has $2 billion in revenue to spend on goods and services, the current equalization system reduces its entitlements by $0.22 billion, leaving them net revenue, after equalization, of $1.8 billion.

Implicitly, the current approach assumes that 10% of the base is collected by provincial governments who tax at the national average tax rate and their entitlements are reduced correspondingly. If governments tax below the national average tax rate, then their equalization loss exceeds their revenue and if they tax above the national average tax rate, then the equalization loss falls short of the revenue. And, this is the way it should work to avoid strategic behaviour on the part of governments. However, there is something fundamentally wrong with this type of calculation when it is applied to profits from government business enterprises. Provincial governments have access to 100% of the remitted profits, but the equalization calculation implicitly assumes that it only has access to 10%. This is unfair since not all provinces have the same ability to generate profits from government business enterprises.

To overcome this problem and to improve the equity associated with the allocation mechanism under the RTS, it would be a simple matter of treating private sector profits and government business enterprise profits as separate bases.

Question: Are multiple standards of Equalization among provinces reasonable and sustainable over the long term? If so, what principles or evidence should be determined how they vary among provinces?

In principle the answer is no. The current "gross" system really should be a "net" system so that every province has the same net per capita fiscal capacity to provide goods and services to its constituents. The net system would be completely equalizing and require less resources than the gross system. However, the "gross" system can be thought of as a compromise that we have made to ensure that all provinces accept and support the equalization program. As such, it helps ensure cohesion that would otherwise be severely strained by any attempt to move to a "net" system at this time. Moreover, while it would be technically possible to mimic a "net" system with the current system of intergovernmental grants through reducing the entitlements of Ontario and Alberta under the CST and the CHT by the amount of the negative entitlement implied by the equalization formula, this would probably be less acceptable from political or cohesion perspective than straight adoption of the "net" system. Provinces receiving lower transfers for health care could legitimately point to the equalization system as the culprit, which, in turn, would reduce support for this very value program.

Another issue that comes under this question is that of the equalization ceiling and the fixed annual allocation of equalization funds currently in place. The equalization ceiling ran counter to the goal of equalization, which effectively ensured that multiple standards would be exacerbated. Likewise, the current fixed aggregate allocation should not be allowed to continue. The formula should be allowed to determine the absolute entitlement for each province. With a fixed annual allocation, it allows for multiple standards of equalization and tends to exaggerate this situation as provinces move into or out of the formula.

To further illustrate possible concerns with the fixed pool of equalization funds, Tables 1 to 3 have been attached at the end of this document. Table 1 illustrates that as long as the identity and number of equalization-receiving provinces is not altered in switching from one standard to another standard the allocation of equalization funds to each province are identical under the constrained five-province standard, the constrained ten-province standard or the implicit standard now being suggested by federal finance. However, Table 2 illustrates that in going from a constrained five-province standard to a constrained ten-province standard to federal finance's implicit standard, the relative allocation of equalization funds is significantly affected. In fact, provinces that have been arguing for a ten-province standard can be worse off in the presence of a constrained with either the ten-province standard or the implicit standard than with the five-province standard. Finally, Table 3 illustrates that the five-province and the ten-province standard mimic the implicit standard if the constrained is sufficiently binding. It also illustrates that constraint itself determines which provinces receive funding. While the most deficient provinces will be funded in the presence of the constraint, some province such as Saskatchewan, British Columbia and Ontario would be excluded from the equalization program, even though they would have qualified to receive equalization in this example under the ten-province standard.

Question: Is the exclusion of some natural resource revenues and user fees from Equalization consistent with "reasonably comparable treatment" of receiving governments?

To the extent that natural resource revenues are used in such a way that they bestow net fiscal benefits to residents of a province, they should not be excluded from the formula. That being said, I think it is important to realize that the New Atlantic Accord does not affect how offshore oil and gas are treated by the equalization formula. Equalization entitlements are reduced dollar-for-dollar with incremental offshore revenue as it would in the absence of the Accord. Rather, the Accord is a bilateral agreement between the federal government and the governments of Newfoundland and Labrador and Nova Scotia. It is best to assess the legitimacy of this type of agreement in terms of Section 36.1 of the constitution, in that it facilitates the ability of these provincial governments to enhance economic development within their provincial boundaries. In other words, the Atlantic Accord should be thought of as an economic development tool and not as part of the equalization program.

Let's turn now to whether user fees should be excluded or not from the revenue bases considered in determining equalization entitlements. One could argue that user fees do not impart a net fiscal benefit to user to the extent that they are simply benefit taxes for publicly-provided private goods. However, if revenues earned on these items are profit generating, then the excess revenue adds to provincial revenues that can be used to finance other goods and services or lower other taxes and this will create a net fiscal benefit that requires equalization. On the other hand, user fees for public provided goods that are unrelated to the intensity of usage of that good, such as hunting licenses, bestow a net fiscal benefit on the user and simply represent another revenue source to the provincial treasury that ought to be equalized. Since more of the services for which user charges are pure or quasi public goods and it would be difficult or impossible to distinguish profit from revenue in publicly-provided private goods, the revenues generate by user fees on these services ought to be included in the equalization base.

Question: Should Equalization incorporate expenditure need measures?

Based on Section 36.2 of the constitution, there ought to be expenditure need measures incorporated into the equalization formula. We are trying to ensure that reasonably comparable **services** are provided at reasonably comparable levels of taxation. By equalizing revenues only, we are equalizing expenditure levels, which will may or may not generate comparable services levels when need-based factors differ across provinces.

Incorporating expenditure elements can be quite complex and can have undesired and unanticipated redistribution impacts. For example, the following types of questions will have to be addressed: should there be one pool of equalization funds for revenue equalization and one for expenditure equalization; how do we distinguish between differences in provincial spending based on provincial discretion versus legitimate need; what variables should be included; what weight should be attached to each variable and how are these weights to be determined; etc. These redistributions may reduce the support for the equalization program and before we do that, this issues needs to be studied extensively.

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

For natural resources, we need to develop bases that proxy the potential economic rent that is embodied in the resource. For different resources this may require more refinement of how specific equalization bases are defined. This might include, for example, mining taxes.

For local property taxes, it seems that market value assessment per dwelling unit would be a reasonable candidate. Most local governments use this as a basis for taxation and it fits with the RTS framework.

Question: 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 RTS is best approach for allocating equalization in Canada. Based upon the principles embodied in Section 36, a macro formula would be inappropriate. A macro formula may proxy a province's fiscal capacity in some circumstances and some points in time, but not in others. For example, a personal income measure would not pick up the implication for fiscal capacity from the progressivity of the income tax system and the variations in income distribution across provinces. Moreover, RTS mimics how provinces actually behave in terms of their revenue-raising behaviours.

As well, some people have suggested that a macro formula would be simple to understand and make the program more transparent. This is to some degree a superficial illusion because of the complexities that underlie the variables that go into the macro formula – such as GDP or personal income. Most people would have a general idea of what GDP is, but no idea of the assumptions that go into determining it. The fact that they do not understand the intricacies of the statistic does not make it less useful. In this context, the basic idea underlying the equalization formula is straight-forward and simple — provinces below some standard per capita fiscal capacity are equalized up to that standard. So long as there enough independent experts around who can verify the calculations, there is no need for the general public to have a detailed understanding of how these standards and bases are calculated.

Question: Should Equalization payments be made more stable and predictable?

No. Equalization should respond to the relative economic circumstances of provincial governments — increasing in bad years and decreasing in more prosperous years. The correction of horizontal inequities is a key function of the equalization program and, as such, there is no need to ensure stability or predictability. The closer we go to stability and predictability, the further we move from equalization and the nearer we move to simple revenue sharing. While this may be fine in some other context, it is not equalization.

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

Making it more stable and predictable will eliminate its key function, which is to respond to variations in economic activity between provinces and how they change over time.

Question: 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?

Yes, an independent advisory body would be appropriate. It could facilitate public debate and consultation so that all stakeholders can have an opportunity to present their views to an objective group of professionals.

Table 1: Illustration of how the fixed equalization pot gets allocated per capita allocation factors – No change in identity or number of equalization-receiving provinces

	NL	PEI	NS	NB	QU	ON	MN	SK	AB	BC	Total
1. Notional per capita, own-source yield	$4,914	$4,436	$4,977	$4,655	$5,729	$6,669	$5,001	$6,155	$10,472	$6,114	
2. Provincial population (000)	517	138	937	751	7,538	12,379	1,169	995	3,198	4,192	
3. Population in five-province standard (000)	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	
4. Population in receiving provinces for five-province standard (000)	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	
5. Population in ten-province standard (000)	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	
6. Population in receiving provinces for ten-province standard (000)	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	
7. Notional total own-source yield ($ Million)	$2,542	$612	$4,663	$3,497	$43,188	$82,558	$5,848	$6,126	$33,489	$25,631	
8. Five-province per capita standard	$6,217	$6,217	$6,217	$6,217	$6,217	$6,217	$6,217	$6,217	$6,217	$6,217	
9. Ten-province per capita standard	$6,543	$6,543	$6,543	$6,543	$6,543	$6,543	$6,543	$6,543	$6,543	$6,543	
10. Implicit per standard for $10 B constrained equalization pool	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	
11. Provincial Entitlement: five-province standard ($ Million)	$674	$246	$1,162	$1,174	$3,678	$0	$1,422	$62	$0	$434	**$8,852**
12. Entitlement share: five-province standard	7.6%	2.8%	13.1%	13.3%	41.5%	0.0%	16.1%	0.7%	0.0%	4.9%	
13. Share of population receiving equalization under five-province standard	3.2%	0.8%	5.8%	4.6%	46.4%	0.0%	7.2%	6.1%	0.0%	25.8%	
14. Provincial Entitlement: ten-province standard ($ Million)	$843	$290	$1,467	$1,419	$6,130	$0	$1,803	$385	$0	$1,798	**$14,134**
15. Entitlement share: ten-province standard	6.0%	2.1%	10.4%	10.0%	43.4%	0.0%	12.8%	2.7%	0.0%	12.7%	
16. Share of population receiving equalization under ten-province standard	3.2%	0.8%	5.8%	4.6%	46.4%	0.0%	7.2%	6.1%	0.0%	25.8%	
17. Provincial Entitlement: using implicit standard for $10 B pool ($ Million)	$711	$255	$1,229	$1,227	$4,211	$0	$1,505	$132	$0	$730	**$10,000**
18. Constrained provincial entitlement: five-province standard ($ Million)	$711	$255	$1,229	$1,227	$4,211	$0	$1,505	$132	$0	$730	**$10,000**
19. Constrained provincial entitlement: ten-province standard ($ Million)	$711	$255	$1,229	$1,227	$4,211	$0	$1,505	$132	$0	$730	**$10,000**

1. *Data for rows 1 through 9 and row 11 were taken directly from Provincial Fiscal Equalization Second Estimate/Legislated Final Calculation: 2004-2005, Federal-Provincial Relations Division, Department of Finance, Government of Canada.*
2. *Row 10 was calculated as sum of $10 billion plus notional own-source yield for equalization-receiving provinces (all provinces but ON and AB in this case) divided the sum of the population in the corresponding provinces.*
3. *Row 12 calculated as row 11/sum of row 11.*
4. *Row 13 calculated for receiving provinces only as province's population divided by the sum of population in equalization receiving provinces under the five-province standard.*
5. *Row 14 is calculated as the difference between row 9 and row 1 multiplied by row 2 if positive and zero otherwise.*
6. *Row 15 calculated as row 14/sum of row 14.*
7. *Row 16 calculated for receiving provinces only as province's population divided by the sum of population in equalization receiving provinces under the ten-province standard.*
8. *Row17 is calculated as the difference between row 10 and row 1 multiplied by row 2 if positive and zero otherwise.*
9. *Row 18 uses population shares for the receiving provinces to top up the $8.85 billion in equalization entitlements that would occur with the unconstrained operation of the equalization formula under the five-province standard to the assumed $10 billion fixed pot available for equalization.*
10. *Row 19 uses population shares for the receiving provinces to reduce the $14.12 billion in equalization entitlements that would occur with the unconstrained operation of the equalization formula under the ten-province standard to the assumed $10 billion fixed pot available for equalization.*

Table 2: Illustration of how the fixed equalization pot gets allocated per capita allocation factors – With change in identity and number of equalization-receiving provinces in switching from five-province to ten-province standard

	NL	PEI	NS	NB	QU	ON	MN	SK	AB	BC	Total
1. Notional per capita, own-source yield	$4,914	$4,436	$4,977	$4,655	$5,729	$6,400	$5,001	$6,155	$10,472	$6,114	
2. Provincial population (000)	517	138	937	751	7,538	12,379	1,169	995	3,198	4,192	
3. Population in five-province standard (000)	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	
4. Population in receiving provinces for five-province standard (000)	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	
5. Population in ten-province standard (000)	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	
6. Population in receiving provinces for ten-province standard (000)	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	16,238	
7. Notional total own-source yield ($ Million)	$2,542	$612	$4,663	$3,497	$43,188	$79,225	$5,848	$6,126	$33,489	$25,631	
8. Five-province per capita standard	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	
9. Ten-province per capita standard	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	
10. Implicit per standard for $10 B constrained equalization pool	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	$6,288	
11. Provincial Entitlement: five-province standard ($ Million)	$609	$228	$1,043	$1,079	$2,721	$0	$1,274	$0	$0	$0	**$6,955**
12. Entitlement share: five-province standard	8.8%	3.3%	15.0%	15.5%	39.1%	0.0%	18.3%	0.0%	0.0%	0.0%	
13. Share of population receiving equalization under five-province standard	4.7%	1.2%	8.5%	6.8%	68.2%	0.0%	10.6%	0.0%	0.0%	0.0%	
14. Provincial Entitlement: ten-province standard ($ Million)	$788	$276	$1,369	$1,340	$5,340	$468	$1,680	$281	$0	$1,358	**$12,901**
15. Entitlement share: ten-province standard	6.1%	2.1%	10.6%	10.4%	41.4%	3.6%	13.0%	2.2%	0.0%	10.5%	
16. Share of population receiving equalization under ten-province standard	3.2%	0.8%	5.8%	4.6%	46.4%	0.0%	7.2%	6.1%	0.0%	25.8%	
17. Provincial Entitlement: using implicit standard for $10 B pool ($ Million)	$711	$255	$1,229	$1,227	$4,211	$0	$1,505	$132	$0	$730	**$10,000**
18. Constrained provincial entitlement: five-province standard ($ Million)	$751	$266	$1,302	$1,286	$4,799	$0	$1,596	$0	$0	$0	**$10,000**
19. Constrained provincial entitlement: ten-province standard ($ Million)	$696	$251	$1,202	$1,206	$3,994	$468	$1,471	$103	$0	$610	**$10,000**

1. All information and calculations identical to table 1 except that Ontario's fiscal capacity has been reduced to $6,400 per capita. This results in Saskatchewan and British Columbia being over the five-province standard, but along with Ontario are below the ten-province standard and qualify for equalization under this broader standard.

Table 3: Illustration of how the fixed equalization pot gets allocated per capita allocation factors – With change in identity and number of equalization-receiving provinces in switching from five-province to ten-province standard and $5 billion pool

	NL	PEI	NS	NB	QU	ON	MN	SK	AB	BC	Total
1. Notional per capita, own-source yield	$4,914	$4,436	$4,977	$4,655	$5,729	$6,400	$5,001	$6,155	$10,472	$6,114	
2. Provincial population (000)	517	138	937	751	7,538	12,379	1,169	995	3,198	4,192	
3. Population in five-province standard (000)	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	26,274	
4. Population in receiving provinces for five-province standard (000)	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	
5. Population in ten-province standard (000)	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	31,815	
6. Population in receiving provinces for ten-province standard (000)	28,617	28,617	28,617	28,617	28,617	28,617	28,617	28,617	28,617	28,617	
7. Adjusted population in receiving provinces for ten-province standard (000)	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	11,051	
8. Notional total own-source yield ($ Million)	$2,542	$612	$4,663	$3,497	$43,188	$79,225	$5,848	$6,126	$33,489	$25,631	
9. Five-province per capita standard	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	$6,090	
10. Implicit per standard for $5 B constrained equalization pool	$5,914	$5,914	$5,914	$5,914	$5,914	$5,914	$5,914	$5,914	$5,914	$5,914	
11. Ten-province per capita standard	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	$6,438	
12. Provincial Entitlement: five-province standard ($ Million)	$609	$228	$1,043	$1,079	$2,721	$0	$1,274	$0	$0	$0	**$6,955**
13. Share of population receiving equalization under five-province standard	4.7%	1.2%	8.5%	6.8%	68.2%	0.0%	10.6%	0.0%	0.0%	0.0%	
14. Provincial Entitlement: ten-province standard ($ Million)	$788	$276	$1,369	$1,340	$5,340	$468	$1,680	$281	$0	$1,358	**$12,901**
15. Adjusted share of population receiving equalization under ten-province standard	4.7%	1.2%	8.5%	6.8%	68.2%	0.0%	10.6%	0.0%	0.0%	0.0%	
16. Provincial Entitlement: using implicit standard for $5 B pool ($ Million)	$517	$204	$878	$946	$1,388	$0	$1,067	$0	$0	$0	**$5,000**
17. Constrained provincial entitlement: five-province standard ($ Million)	$517	$204	$878	$946	$1,388	$0	$1,067	$0	$0	$0	**$5,000**
18. Constrained provincial entitlement: ten-province standard ($ Million)	$517	$204	$878	$946	$1,388	$0	$1,067	$0	$0	$0	**$5,000**

1. Identical to Table 2 but the equalization pool has been reduced from $10 billion to $5 billion