

**SUPPLEMENTAL SUBMISSION TO THE EXPERT PANEL
ON EQUALIZATION**

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PURPOSE OF THE SUPPLEMENTAL SUBMISSION

In my submission to the Expert Panel in July 2005 and earlier to the Commons Finance Sub-Committee on Fiscal Imbalance, I presented a scenario under which rising energy prices would create exceptional fiscal imbalances. These imbalances could:

- Impair the economic growth of Canada as a whole
- Threaten our nation's ability to maintain its most valued social programs, and
- Weaken the case for national unity.

I attach as Appendix A, the Synopsis of my original submission to the Panel. It was hoped that this could by now be dismissed as an unnecessarily alarmist position as oil prices settled back below \$40 a barrel and natural gas prices retreated to average prices of the past decade. However, if anything, the scenario I painted was too pale and the threats are emerging as more vivid. Few analysts are predicting such a retreat in prices, while some are predicting an average price for oil of \$70 a barrel or more next year and, more importantly from a provincial revenue perspective, a natural gas price of \$13 per BTU (Jeff Rubin, Globe and Mail, Dec. 19, 2005). Whether in 2006 or a subsequent year, whether resulting from a sudden spike in energy prices or through more gradual processes, the impacts of the unequal distribution of natural resources and its effect on fiscal capacity disparities must be dealt with by Canada

Growing disparities in the per capita fiscal capacities of the provinces will mean that Canada will be forced to choose from among three broad policy options:

- A greatly increased role for the federal government in the provision of social programs, and the attendant intrusion into areas of constitutional jurisdiction of the provinces – perhaps through painful and protracted negotiations with and through the Council of the Federation and replete with the potential for hostilities and fodder for separatists;
- A much stronger equalization effort; or
- The gradual but steady erosion of the social programs provided by provinces and of the relative equality of benefits of Canadian citizenship across the country, arising from the need to maintain a degree of tax competitiveness to avoid suffer stagnation and decline as the unequal fiscal benefits of doing business in energy producing provinces draws financial and other industries to the West.

These choices are not mutually exclusive and a combination could be expected. The last option is what will occur if there is inaction on the part of the federal government.

The purpose of this Submission is to add to the analysis I provided earlier and to urge the Panel to make the most of its opportunity to impact federal government policy, both strictly within the primary mandate and extended within the amount of latitude that was given to it in its terms of reference.

THE PROBLEM

The situation facing Canada is that high energy prices are providing a bonanza of growth and prosperity in the West and, to a lesser degree, on the East Coast. This would be all to the good, except for the fact that the same forces are having negative consequences for the majority of Canadians living in other provinces. The motivation to raise this concern is not envy for the prosperity of Albertans and others, but to strengthen Canada as a whole and to defend the interests and prospects of those others who suffer negative consequences from high energy prices. The objective of Canadian policy should be to sustain the growing prosperity in the West while reducing or removing the negative impacts on the rest of Canada.

“Dutch Disease”? - Interest rates, the Canadian dollar plus tax differentials: High energy prices have impacts on interest rates and the value of the Canadian dollar that dampen economic activity in the major population centres in the heartland of Central Canada. This dampening is exacerbated by tax rate differentials between provinces. The net result already appears to be a slowing of economic growth in Canada as a whole. The economies of Central Canadian provinces could be stagnant or in recession should the tax differentials increase substantially.

What is the evidence? Despite a booming economy in the West and very strong growth in the value of energy exports, Canadian real economic growth in 2006 is projected to fall to the middle of the pack in the G7, from a leading position in recent years (recent OECD projections). It has been estimated that “since August (of 2004) Canada has lost about 100,000 manufacturing jobs, with Ontario being the hardest hit” (Globe and Mail, December 16, 2005, quoting Mr. Jason Myers, senior vice president and chief economist for the Canadian Manufacturers and Exporters).

The Governor of the Bank of Canada has commented on the resilience of the Canadian economy as it adjusted to the higher value of the Canadian dollar over the past few years. This performance has been commendable, but can it be sustained? The manufacturing economy of Central Canada is being propped up by direct government investments and interest-free loans. In recent months another series of body blows to the manufacturers and other segments of the economy in Central Canada have been delivered. These include a continuation of the rise in the Canadian dollar, higher interest rates and much higher energy costs. Though these are not yet a knock-out punch, can the economies of New Brunswick, Quebec, Ontario and Manitoba continue to withstand these blows? In particular, as manufacturing declined the economy of Ontario relied more on the financial industries. If they begin to move, there will be little doubt that Central Canada will be facing serious economic difficulties. Will the economies in the provinces of Central Canada be flattened by “Dutch Disease” combined with growing tax competition from the West? Will they take a significant period of time before they once again rise to match or lead Canadian economic growth as a whole?

One hesitates to describe the situation using the phrase “Dutch Disease”. This was used to describe the loss of competitiveness of segments of the Dutch economy when resource revenues from North Sea oil and gas caused the Dutch guilder to rise. In Canada’s case, the disease may prove to be much more virulent and may affect far more aspects of the national well-being. This is because the benefits, especially those pertaining to public

sector revenue, are concentrated in a few provinces having roughly one-quarter of the Canadian population, with relatively less available to the national government to be used to ameliorate the effects on other parts of the economy.

Of course, the situation isn't all negative for other parts of Canada. The resource boom is providing strong revenue growth in federal corporate income taxes and other federal government revenues. The rise in the Canadian dollar dampens inflationary pressure and allows latitude for lower interest rates, which could benefit all parts of Canada. The wealth and economic activity in the West creates some demand for goods produced in other parts of Canada. The necessity in all this is that the positives must be used appropriately to offset the negative impacts in parts of the Canadian economy, without cutting off the growth in the energy sector.

Fiscal Imbalances: The intergovernmental fiscal situation in Canada places too great a burden on the increasingly unequal capacities of the provinces. The provinces with the lowest tax rates do not need more revenue to sustain their social programs. Other provinces cannot raise revenues needed to sustain social programs while maintaining a competitive fiscal environment. Indeed, their competitive position could slip badly. Alberta is in a position in which its surpluses would allow it to take a personal and corporate tax holiday, perhaps extended over decades. Added to the absence of provincial sales taxes, this would create a large tax haven in the midst of the federation - a situation unlike any other in leading industrial countries.

The vertical fiscal imbalance: Those provinces with relatively little opportunity to raise natural resource revenues will not be able to tap into other sources of revenues, such as raising corporate and personal income taxes, without further damaging their competitive position against energy-producing provinces. It would be economically (and politically) self-destructive to pursue such a path. This has implications both for the so-called "vertical" fiscal imbalance as well as for the "horizontal" fiscal imbalance. The political and economic exigencies preclude most provinces from using their primary powers of taxation to the extent that might be necessary. This lays bare the fallacy of the federal position that provinces have the same scope for raising taxes as does the federal government, because both orders of government have access to most of the primary sources of taxation. **Access to tax room is an illusion when it is constrained by an overwhelming need to maintain a competitive tax environment. The provinces, in total, have less capacity than the federal government because they must draw from unequal tax bases and this capacity is further constrained with growing disparities among the provinces.** The effect is to have tax rates in less affluent provinces that provide revenues insufficient to maintain the quality of social programs for which Canadians as a whole are prepared to pay. With their large responsibilities for delivering social programs, this creates the "vertical fiscal imbalance" which is acknowledged by virtually all governments but, only tacitly and tentatively by the current federal government, through increases in federal transfer and other programs.

This policy is defensible only if one believes that it is justifiable to reduce the cost of public programs by creating a situation in which the citizens of the poorest provinces have fewer and less costly (that is, lesser quality) programs than those available in affluent provinces. Such a policy is in complete contradiction to the Equalization provisions of the Canadian Constitution and could be subject to challenge in the courts.

The evidence is clear that funding for social programs has been choked off over the past decade and more. I have chosen to portray this as the unintended consequence of reliance on the unequal tax bases of the provinces, though undoubtedly there would be a minority in Canada who would be quite prepared to see our social programs wither away, even at a cost of greatly increased inequality. As the previous submission documented, expenditure on public programs (all orders of government combined) as measured against GDP has dropped by 7.6 percentage points or by 22% since 1992 and is now near the lowest amongst the G7. This once again has been confirmed, almost in bravado fashion, in the November 2005 federal Economic Update. As the United States continues to spend, unless Japan reduces its relative spending on public programs, Canada is likely to be at the bottom of the pack in 2006/07. A nation cannot have quality universal health care, world class public post-secondary institutions and other social and community benefits if it is not prepared to pay for them. Emerging problems in these programs are most apparent in Ontario, Quebec and other provinces which do not have access to energy resource revenues. The debate in Canada with respect to private health care should be whether provinces such as Alberta need to have it, and whether Quebec and other provinces can or cannot avoid it, given resources available to them. This leads into the discussion on “horizontal fiscal imbalance”.

The horizontal fiscal imbalance: By the time the Panel presents its report to the federal government, the extent of the emerging fiscal imbalance may be more clear. It is expected that efforts will be made, as in the past, to delay and downplay the surpluses arising from resource revenue windfalls. However, without one-time charges and special fund transactions, it is likely that the Alberta surplus will easily exceed \$10 billion in 2005/06. There are some predictions that its surplus could rise above \$19 billion in 2006/07 (Patrick Brethour, Globe and Mail, December 19, 2005). Even the provincial revenues available at current oil and natural gas prices could be sufficient to allow Alberta to eliminate personal and corporate income taxes. Saskatchewan, British Columbia and Newfoundland and Labrador will also be flush with cash – the later particularly so because of the new provisions of the Atlantic Accord and related equalization arrangements for that province. Meanwhile, revenue growth in other provinces will stagnate as their economies grow slowly.

The result of all this will be extreme pressure on public services provided in Central Canada. Added to this is slower growth in the private sector. The impacts are already apparent, but they will become even more critical in the years ahead. Unless the horizontal (and vertical) fiscal imbalance is addressed, the economies of Central Canadian provinces will be in serious difficulty. As described by Jeff Rubin, CIBC World Markets chief economist, “People and capital will vote with their feet” and “will flee the enfeebled economies of Ontario and Quebec” (Globe and Mail, December 19, 2005). Revenues will be stagnant with the result that social programs will be unsustainable and the infrastructure (roads and public transportation, water and sanitation, crime control, etc.) required to maintain a vibrant economy will not be adequately supported. The federal programs in child care, post-secondary education support, urban transportation, etc. will be too stretched to make a significant difference. Furthermore, these federal programs funnel as many (and sometimes more) dollars per capita to Alberta and other revenue rich provinces as they do to less affluent provinces, allowing further reductions in taxes in those provinces and increasing their competitive advantage. The special equalization provisions favouring Newfoundland and Labrador, Saskatchewan and British Columbia were completely at odds with emerging needs.

National Unity: The emerging situation could feed separatist sympathies. Emerging trends include:

- The economy of Quebec lagging Canada's as a whole over an extended period
- The loss of quality in social programs, with federal "intrusions" being portrayed as both a resented and inadequate response to this concern
- Economic policy which does not appear to be optimal for Quebec, and
- Intergovernmental fiscal arrangements which leave little or nothing in the way of a positive balance in favour of Quebec

It is difficult to see that there are significant economic or fiscal advantages for Quebec from union with Canada under the current arrangements. Perhaps this is only to be expected given globalization. As posited in a March 2000 paper entitled "The Role of Intergovernmental Fiscal Relations in Maintaining an Effective State in Canada" by Richard Bird and Francois Vaillancourt, "Quebec ... may not be one of the big winners from continental integration, but at the same time the process means that it also has less to gain from remaining part of Canada". However, they also go on to suggest that arrangements for an improved economic and social union could be developed. Rather than simply relying on traditional bonds from a shared history, at a minimum, Canada's intergovernmental fiscal relations should evolve to address the fiscal imbalances. This evolution should ensure that there are fiscal benefits for Quebec that offset or compensate for any negative consequences of national monetary and other federal government policies which must respond to the energy-induced growth of the West.

FICTION, FOLKLORE AND RED-HERRINGS

The dimensions of the problems developing in Canada as a result of fiscal imbalances require renewed vision and greater effort. What is not helpful is some of the fiction, folklore and red-herrings being dropped on the Panel in some submissions. A few examples might be instructive.

In the fiction category, as I noted in my previous submission, the assertions that Equalization has contributed to regional disparities are totally unsupported. Indeed, the evidence clearly shows a narrowing of regional economic disparities, as measured by per capita GDP and incomes, during periods when the Equalization effort was strongest. Levelling the playing field creates opportunities for personal and business development which would otherwise be denied when the playing field is too uneven. Canada risks a slowdown in much of the country and growing disparities such as prevailed until the implementation of Equalization and joint federal/provincial funding of other social programs in the 1950s and 1960s, unless efforts are made to ameliorate growing imbalances in tax rates and services in the various regions.

Folklore is raised with respect to the history of inclusion of natural resources in Equalization calculations. It is posited by some commentators that the inclusion of natural resource revenues was delayed in order to assist the growth of the oil and gas industry in Western Canada. In fact, except for the embryonic first five years of the program, when only three sources of provincial revenues were equalized, oil and gas and other natural resource revenues have been included in the formula. Oil and gas revenues were brought into the formula in 1962 with the result that Alberta soon no longer

received equalization payments. There were many years in which Alberta would have been eligible to receive payments, except for the inclusion of natural resource revenues. There is also a fabrication that full inclusion of natural resources was rejected in consideration of a number of factors, when in fact, keeping the cost of the program down was the only important consideration in developing arrangements for less-than-full inclusion. Similarly, folklore maintains the erroneous assumption that full inclusion of natural resources would cause volatility in the Program. In fact, because the tendency is for Central Canadian and Western Canadian economies to move in opposite cycles with changes in resource prices, full inclusion, such as with a ten-province standard, provides for a more stable program. As I noted elsewhere, it has been the delays in calculating needed responsiveness of payments which has been the cause of unnecessary instability in the program.

More recently, red-herrings are brought forward to defend less-than-full inclusion of natural resources. In this category are arguments that exploitation of natural resources requires exceptional outlays on the part of provinces and that gains in incomes arising from resource wealth are “capitalized” into higher prices.

The red-herring of the “exceptional outlays” theory is supported by folklore, with a statement from decades ago by a single politician. Undoubtedly, there are some provincial outlays associated with support for industries, whether for primary, secondary or final outputs. Because no comprehensive study across industries has been done, there is not a shred of evidence appearing that oil and gas developments require exceptional provincial outlays relative to other industries of similar size, except perhaps to the extent that frontier regions require new infrastructure, which will be utilized for decades to come. It is difficult to imagine that off-shore resources require exceptional outlays relative to expenditures required for the establishment and on-going support of other major industries. Furthermore, the federal government provided much of the initial public expenditure with respect to the developments in the Eastern Offshore region. In the West, the oil and gas industry provides the product transportation infrastructure through pipelines, in marked contrast to the manufacturing industries in Central Canada and elsewhere. The cost of environmental studies are also cited. Without comparative studies, it is difficult to determine whether environmental studies concerning new transportation or electrical transmission routes in highly populated areas are more or less costly than those environmental studies related to developments in remote areas. Perhaps the environmental studies carried on in municipalities across the nation with respect to hog barns are higher in total than the cost of environmental studies on a natural gas pipeline. Arguably, agriculture consistently requires the largest provincial/local outlays over the long term relative to economic production, with heavy manufacturing perhaps a close second. In all of this, one thing clear is that we do not know the relative costs of supporting different types of industries. The second, is that it would be patently unfair to include one type of expenditure (with respect to exploitation of oil and gas) in calculations of equalization without examining and including all other similar expenditures with respect to other industries.

Capitalization appears to be another case of a concept which perhaps needs further exploration, but cannot be factored into current calculations without such examination. Certainly, with growing revenues and personal incomes, more qualified teachers and the best medical practitioners will cost more than spent in provinces in which such resources are not affordable. And people will spend more on their housing and other amenities. However, if there is a “capitalization” effect, should it be considered in the calculations?

And if so, how strong is it relative to other cost and need factors which then should also be considered? Once again we simply don't have any answers at the present time. If Edmonton has remained a relatively low-cost city, while Vancouver has become amongst the highest cost, does that destroy the capitalization argument, or does it simply suggest that there are other more important factors at play, such as the wealth of immigrants to the region? Is it more important to build in this "capitalization" cost factor than to build in the need factors related to providing services to aboriginal people in Winnipeg and other Prairie cities and elsewhere? It is unhelpful to drag one red-herring of unknown dimensions across the path of those developing an equalization formula, without providing the scent of other more important fish to fry.

POLICY OPTIONS

Improving the Equalization Formula: In my previous submission to the Expert Panel, I presented 14 conclusions with respect to the equalization formula (together with five recommendations concerning the potential establishment of a permanent advisory commission. There is no need to go back through the analysis leading to these recommendations, as it is available in the first submission. Nothing provided to the Commission, at least in the material available on the Commission's internet site, would lead to different conclusions.

Of these recommendations, this supplemental paper emphasizes point 4 – **“Overcoming the negative consequences of fiscal capacity disparities arising from natural resource revenues is now and is likely to remain as the central challenge which must be addressed by the Program through the foreseeable future.”**

This must be the central mission of the Panel's work, given the unfolding circumstances as outlined in this supplemental paper. The fact that resource revenues are "exported", that is, paid by others outside of the producing province(s), means that GDP or income-based formulae do not work to adequately address this issue. Furthermore, it would be a totally unsatisfactory outcome if the Panel tried to ignore or soft-pedal the issue and bought into the package of fiction, folklore and red-herrings in order to justify its position.

However, the work of the Panel is constrained by the level of the Equalization commitment in the federal plan. The current commitment is just above 0.8% of GDP as compared with a level over 1.3% in the 1980's. This is a paltry equalization commitment compared to efforts in Germany, Australia and elsewhere and the commitment will fall further under the federal plan unless nominal GDP growth falls below 3% annually. While real GDP growth of 1% annually, combined with 2% GDP inflation is a possible scenario, it is one that would signal great under-performance from the Canadian economy. The Panel is urged to provide guidance on this issue of adequacy with respect to the equalization commitment of the federal government.

It is recognized that full equity in relative fiscal capacity, as provided in Australia, is not achievable, and may not even be desirable. However, there must be consideration given to the amount which is required for the maintenance of programs in Central Canada, without allowing those provinces' tax rates to become so uncompetitive that business and individuals stampede to Calgary. The Constitutional provision that the federal government must make equalization payments such that provinces can provide

reasonably comparable public services at reasonably comparable levels of taxation cannot be ignored.

In the current circumstances, the Panel's primary focus must be to include full recognition of resource revenues in the distribution formula.

Other Policy Options: Traditional equalization will not be sufficient to address the issues raised in the scenario presented in this supplemental submission. Therefore a number of related policy options are presented for consideration by the Panel. It is hoped that the Panel will use its latitude to reflect on such options as these in its final report.

Combining federal transfer payments: The Australian example might be appropriate for Canada. In Australia, transfer payments are not broken into "equalization" and "other". All Australian states receive transfers under the formula established by the Australian Grants Commission. All Canadian provinces also receive transfer payments from the federal government but only some receive equalization. It would be desirable to abolish the classification of provinces into equalization-recipients and non-recipients, by combining the equalization, CHT, CST and other transfers into one package under which all provinces would be recipients. This would also allow for greater flexibility in directing the transfers to the provinces based more on relative need and could include directing greater support to Central Canadian provinces (primarily PEI, New Brunswick, Quebec, Ontario and Manitoba) now and until such time as resource revenue imbalances are less severe.

Redistributing reliance on certain tax bases: As noted in this submission, there is too great a reliance by provinces on unequally distributed tax bases. The Constitution provides the rationale for royalties and other revenues deriving directly from natural resources to be provincial revenues. However, there are shared fields of taxation which should be adjusted to lessen disparities in fiscal capacity and the reliance on equalization. The most obvious of these is the corporate income tax. **The corporate income tax should become a federal tax.** The mechanism for achieving this may require negotiation, but not constitutional change. The current federal government believes that there should be a reduction in the CIT. This policy position could be modified such that there is a reduction in or elimination of **provincial** CIT, with compensation to provinces provided from the federal government in the form of cash transfers or the transfer of some other less inequitably distributed tax source (eg. the GST or other consumption taxes). The current opposition party has a proposal to reduce the federal GST. This could allow scope for negotiation with the provinces to utilise some of the GST room, while reducing reliance on more inequitably distributed taxes. Thus both major parties have a plans that could be worked with to achieve lesser provincial reliance on inequitable tax bases and thus reduce the reliance on equalization payments.

It should be noted that tax shifts may occur haphazardly without conscious public policy initiative. If Alberta eliminates its CIT, others will need to reduce or eliminate their corporate income tax to maintain a competitive environment. While provinces may be reluctant to give up all or part of their CIT, they may, on reflection, believe that a negotiated settlement on this issue would be a valuable pre-emptive strike against a situation which has the potential to severely damage their competitive position with respect to head office and other corporate activities.

A co-ordinated approach to taxation field adjustments between the federal and provincial governments is the best way forward.

Interest rates and monetary policy: The Bank of Canada needs to consider the nation as a whole. However, the needs of different regions will be different during this period of high energy prices. The Bank should tilt toward relatively lower interest rates and a relatively lower Canadian dollar in order to soften the blows being suffered by the economy outside of the resource producing regions.

Building alternative energy sources: Canada should undertake a major investment in providing secure and cost-effective alternative energy sources. This could include jump-starting construction of more hydro, wind and nuclear facilities, as well as proceeding with development of the national power grid. It would perhaps be to the benefit of both Alberta and the rest of Canada if the Province of Alberta were to maintain tax rates and dedicate a significant portion of its surplus funds to providing long-term funding for these projects. The payoff to Alberta would come both from a strengthened Canada and the returns from its investments being available when natural gas production and energy revenues begin to decline.

Increasing the equalization effort: In 2000, the federal government promised to remove the ceiling on equalization permanently. However, a ceiling has now been re-imposed at an even lower level relative to GDP. It should be noted that soaring oil and gas prices have provided a significant boost to federal government revenues through the corporate income tax. Given the exceptional circumstances related to both the horizontal and the vertical fiscal imbalance in Canada, the Panel should take any latitude available to it to urge a more appropriate equalization commitment from the federal government.

Though these other policy options may appear to be beyond the limited mandate of the Panel, it would be useful for the Panel to consider such matters and to reflect on how they can be brought together with decisions on equalization. Coherent and comprehensive public policy is necessary to address fiscal imbalance in Canada. Equalization decisions should not be made in isolation from other intergovernmental fiscal arrangements.

ANNEX A

July Submission to the Expert Panel on Equalization

Synopsis

The Expert Panel on Equalization has been created at a difficult time for Canada. Growing disparities in the fiscal capacities of provinces due to soaring energy prices are creating a major challenge for intergovernmental fiscal relations. Left uncorrected, the growing disparities are likely to dampen the economic and social prospects of Central Canada and the nation as a whole.

Alberta and other resource rich provinces will have the capacity to maintain programs while cutting taxes. Health, education and other social programs are in greater part financed through the unequal provincial tax bases. Provinces without revenues from natural resources will not be able to increase taxes to maintain programs should their economies slow, while maintaining a competitive environment with the provinces that enjoy energy revenues. Quality of social programs, to be maintained on a national scale, will require a stronger equalization effort. Businesses and individuals may make decisions to move based not on economic fundamentals, but rather on the basis of the availability of better services and lower tax rates. The differing prospects of individual provinces also may place our fragile federation in further jeopardy.

The limited mandate of the Expert Panel, focussing on allocation of a fixed sum, rather than on the adequacy of the Equalization Program, cannot be expected to address this problem adequately. Nevertheless, its recommendations can have an impact. In this paper there is discussion and nineteen points are drawn as conclusions on some of the key issues identified by the Panel.

The paper concludes that benchmarking of the fiscal capacities of provinces against the top province, the national average and each other, is necessary to gauge the adequacy of the Equalization Program. This basic degree of transparency and accountability is necessary for the nation to have an appropriate debate on the status of the equalization effort.

The paper gives reasons why the representative tax system should be used to calculate fiscal capacities, rather than using a macro approach. A macro approach appears to offer simplicity but adds complications and concerns about accuracy.

A further conclusion of great importance in the current circumstances is that all provincial revenues, and all natural resource revenues in particular, must be included in the calculation of Equalization. The inclusion of user fees should also be broadened to include income-tested user fees that provide a growing portion of the financing for health and education services.

With respect to the issue of a permanent commission, this paper concludes that, unless it operates with a broad mandate and has the confidence of both federal and provincial governments, it would be more likely to detract from transparency and accountability than to aid in management of the Program.