

*Nine Theses on Equalization*

*A Submission to the Expert Panel  
On Equalization and Territorial Financing*

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- 1) **Equalization is targeted to have-not governments, not to have-not provinces.**
  - a) Equalization is meant to ensure that all Canadians are provided with reasonably comparable levels of public services, at reasonably comparable levels of taxation. It is not meant to ensure that all Canadians enjoy equal benefits from the private sector, or that every provincial economy operates at the same capacity.
  - b) Thus, it makes sense to tie entitlements to measures of provincial government access to resources (like tax bases) than to tie entitlements to indicators of private sector access to resources (like GPI). On this ground, it seems that an RTS approach is more consistent with received principles than is a Macro approach.
- 2) **Equalization dollars buy health care, education and social services.**
  - a) Just as all Canadians expect to have equal access to federally provided services, such as the federal justice system and the services of the Canadian Armed Forces, they expect equal access to publicly provided services that fall under provincial jurisdiction. Primary among these provincial services are health care, education and social services.
- 3) **All tax bases are created equal, but some tax bases are more equally distributed than others.**
  - a) Special treatment of particular revenue sources (for example, natural resources) is inadvisable. In the case of revenue sources available to only a few provinces, preferential treatment of revenue sources favours some recipient provinces over others. In the case of revenue source available to all provinces, preferential treatment of revenues sources encourages distortions in provincial tax mix.
  - b) Particularly troubling is the idea that natural resources ought to receive preferential treatment, because inequality of access to natural resource revenue is a major source of difference in provincial revenue raising capacities. Failure to account for these differences limits the ability of Equalization to meet its constitutional commitments.
- 4) **An RTS approach is consistent with an efficiency-enhancing role of equalization.**
  - a) Differences in fiscal capacity among provinces imply that some governments can provide the same level of public services at lower taxes (or more services for the same level of taxes). The existence of such advantages may weigh on the minds of families when deciding on their provinces of residences and cause fiscally induced migration. This migration is commonly held to be efficiency destroying. The motivations for movement are based on the actual, real world, observed levels of fiscal differences among provinces. An RTS approach, which is based on actual tax-setting behaviour, partially counteracts these real motivations for inefficient migration.
  - b) By contrast, a Macro approach would provide increased real income (via increased access to public services) to regions in inverse proportion to their overall economic performance. Migration from economically weak regions to stronger regions in response to differences in private sector incomes, which is commonly held to be efficiency enhancing, would be reduced.

- 5) **The ten province standard is most consistent with the principles of equalization.**
  - a) The current five-province standard has worked in the last number of years to dampen total payments made under Equalization. Excluding Alberta's very large fiscal capacity has resulted in lower payments to all recipient provinces than a ten-province standard (all other rules held fixed) would have. Thus, the overall equalizing effect of Equalization has been attenuated.
  - b) One would expect a potential migrant to make location decisions by comparing overall well-being in the province of origin to the most favourable province of destination. By lowering the overall level of entitlement, the five-province standard has exacerbated the gap in fiscal capacity between recipient provinces and the fiscally strongest province (Alberta). This could have served only to encourage inefficient, fiscally induced migration.
- 6) **Arguments based on the incentives of provincial governments do not form a basis upon which to judge RTS versus Macro.**
  - a) The received incentive arguments against RTS equalization is that provinces have no incentive to take actions, including lowering tax rates, that might improve their tax bases because an increase in their tax bases result in lower equalization payments. If one replaces the words "tax base" by the words "provincial net income" (or any other macro indicator), the same argument applies.
- 7) **Equalization should be responsive, not stable.**
  - a) Provincial government revenues vary with economic conditions in a province and equalization entitlements should respond to resulting changes in provincial government revenues. In other words, Equalization should be able to perform an important insurance function. Given Canada has a common currency and regionally diverse types of economic activities the insurance role is critically important since it acts as substitute for flexible exchange rates as an avenue of economic adjustment.
- 8) **Formulas are better than petty politics.**
  - a) Side deals are very dangerous, and often appear to be made for reasons of political expediency. Moreover, it is difficult to assess if a collection of side deals accord with a set of well-articulated principles. In short, side deals are not transparent.
  - b) The current RTS formula is not opaque. Its basic operations can be explained simply to any interested parties. The number of tax bases inside the overall formula makes the algebra (or the spreadsheet) more ominous, but does not add to the inherent complexity of the system.
- 9) **A cap on total entitlements invites political bickering.**
  - a) A cap on total equalization entitlements creates a zero-sum game. Whenever the federal and provincial governments enter discussions involving the formula, any proposed changes in the formula which benefit some provinces necessarily results in losses for other provinces. This is divisive. Also, the zero-sum environment creates divisions and bickering under normal operating conditions. If a change in economic conditions in one province results in a higher entitlement, other provinces must experience a reduction in entitlements even if conditions they face are unchanged.