PRB 04-50E

Library of Parliament | Bibliothèque du Parlement

EQUALIZATION: WAITING FOR THE PERFECT FORMULA

Philippe Le Goff
Economics Division

25 January 2005

PARLIAMENTARY INFORMATION AND RESEARCH SERVICE
SERVICE D'INFORMATION ET DE RECHERCHE PARLEMENTAIRES

TABLE OF CONTENTS

Page

CANADA

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

EQUALIZATION: WAITING FOR THE PERFECT FORMULA

The Equalization program, which is entrenched in the *Constitution Act*, is considered by some as the “cement” of Confederation. Its primary objective is to enable all provincial governments to provide comparable public services at comparable levels of taxation. In short, the idea is to correct horizontal imbalances (between provinces), which result inevitably from the fact that certain provinces are richer than others and their governments can thus generate larger revenues at relatively lower levels of taxation. Under the Equalization program, the federal government grants the less prosperous provinces an unconditional transfer representing the difference between their fiscal (revenue-raising) capacity and the average (standard) fiscal capacity of five “average-income” provinces.(1) This is called the representative tax system (RTS).

The Equalization program has been the subject of extensive analysis, study and criticism over the years.(2) While there is unanimous support for the idea, the present formula is described by its harshest critics as complex, opaque and, especially, punitive for the beneficiary provincial governments whose fiscal capacity increases at an above-“average” rate. The recent disagreement between the federal government and Newfoundland and Labrador over oil royalties shows the extent to which support for the existing formula and piecemeal changes over the years is not unanimous.

BILL C-24

On 23 November 2004, the federal Minister of Finance introduced Bill C-24 to implement the new Equalization and territorial formula financing (TFF) framework, which had been announced at the meeting of First Ministers on 26 October 2004. The federal government emphasized that the framework meets the demands of the provinces and territories, which have long been seeking stable and predictable funding.

---

(1) British Columbia, Saskatchewan, Manitoba, Ontario and Quebec.

(2) See the Selected Bibliography at the end of this paper.

Bill C-24 amends the *Federal-Provincial Fiscal Arrangements Act* to authorize the Minister of Finance to make Equalization payments to the provinces for the fiscal years beginning after 31 March 2004, and to change the manner in which those payments will be calculated. It also authorizes the Minister to pay grants to the territories, under a new legislative regime, for the fiscal years between 1 April 2001 and 31 March 2005, and to make TFF payments for subsequent fiscal years. Finally, the bill also makes consequential amendments to that act and to other acts.

The new framework represents a fundamental change in the present formula for calculating Equalization and TFF payments. Bill C-24 states the exact amounts that will be transferred to the provinces over the coming years in respect of Equalization payments. Changes in fiscal capacity, which vary with economic circumstances, will form the basis of the allocation of equalization payments among the provinces for the 2005-2006 fiscal year, but not for subsequent years. Starting in the 2006-2007 fiscal year, Equalization payments will be indexed by the same factor (3.5%) for all provinces, regardless of the relative change in their respective fiscal capacities.

EXPERT PANEL REVIEWING EQUALIZATION PROGRAM

To rally consensus on some choice of formula, the federal government has appointed an expert panel to conduct a public review of Equalization and TFF.

The panel will first examine the annual allocation of Equalization and TFF payments among provinces and territories. It will study the RTS approach used in Equalization and the current Gross Expenditure Base approach used in TFF, including the treatment of various territorial, provincial and local revenue sources, such as natural resources. It will also examine alternative approaches to measuring fiscal capacity based on macroeconomic variables and, if appropriate, indicators of expenditure needs. In addition, the panel will look at the mechanisms for making annual changes to the allocation, which reflect changes in the relative economic circumstances of the provinces and territories, while ensuring that payments are stable and predictable, to assist them in sound financial planning.

Second, the panel will review aggregate measures of the evolution of fiscal disparities among provinces and the evolution of the costs of providing services in the territories. The measures will provide governments and citizens with information to help guide future federal decisions on the evaluation, at fixed intervals, of the overall level of Equalization and TFF.

ALTERNATIVES TO THE REPRESENTATIVE TAX SYSTEM

The economic literature includes not only studies on the characteristics of the representative tax system, in particular whether it should be based on a two-, five- or ten-province standard, or should include non-renewable natural resources, or even consider setting a floor or ceiling for the amounts granted under the program; it also offers many suggestions for replacing the present Equalization program. An overview of the three main approaches is provided below.

A. Comprehensive Formula Approach

Proponents of the comprehensive formula,(3) which has the attraction of apparent simplicity, contend that it would make the program more comprehensible and transparent and would help to attenuate or eliminate certain negative effects of the present formula. There are a number of variations on this single-variable approach, which is designed to serve as an indicator of a province's fiscal capacity. One of four main variables, to which a range of statistical transformations can be applied, is generally used:

- personal income;
- net provincial revenue at factor cost;
- provincial product at market price;
- gross provincial product (expenditures).

Without going into detail, these four variables measure revenue flows, but generally do not take changes in wealth into consideration. Based on the latest evaluations of the various comprehensive formulas proposed in the economic literature, they are not very effective at solving the problems associated with the present formula. Moreover, they must be adjusted – sometimes elaborately – in order to correct certain distortions or simply to meet the fundamental objectives of the Equalization program.

---

(3) Also called "macro" formula, it is designed to simplify calculations by using a single macroeconomic variable to determine a province's fiscal capacity and Equalization entitlement.

B. Expenditure Needs Approach

One of the most frequent criticisms of the Equalization program is that it focuses on provinces' fiscal capacity (potential revenue) without taking into account their expenditure needs. However, levelling the "net fiscal benefits"(4) of two persons with the same income living in two different regions – the objective sought through the Equalization program in the name of equity – requires that the provinces' expenditure needs be considered as well as their fiscal capacity.

Assessing a province's expenditure needs is as great a methodological challenge as evaluating its fiscal capacity, in view of the many complex factors that influence the cost of delivering government services to the public. Socio-demographic characteristics (the age pyramid, relative poverty, geographic dispersion), input cost (construction costs, transportation costs), environmental factors, technical and economic factors (infrastructure, capacity and expertise of the public and private sectors) and financial situation (level of indebtedness) must all be considered. The development of a representative expenditure system, even if it were based in part on objective criteria, would also be influenced by many subjective decisions that would not guarantee a consensus among the provinces, or even simplicity or transparency in the approach.

C. Capital Flows Approach

The less familiar capital flows approach is based on the principle that the sum of all provincial governments' capital movements (capital inflows less outflows) is subject to Equalization. Capital inflows include, in particular, direct and indirect taxes and non-tax revenues (e.g., natural resource royalties, asset sales, loans and investment income). Capital outflows include the purchase of financial assets, debt repayments (changes in the financial asset balance), debt service and program expenditures. Thus, unlike the present representative tax system, the capital flows approach takes into account the financial transactions associated with changes in the value of assets and liabilities.

The capital flows approach is considered by its proponents to provide a better measure of the provinces' fiscal capacity. It also makes it possible to "neutralize" the effect of the Equalization program on the provinces' economic and fiscal policies. If financial transactions were included in calculating Equalization payments, the provinces would be more inclined to pay down their debt and invest rather than spend on new programs. The provinces

(4) This means the difference between the quality of public services offered to a person with a given set of characteristics, particularly in terms of overall income, and that person's tax burden.

would still be able to fund their programs, even while paying down their debt, because the amounts allocated to the debt would be partly offset by an increase in Equalization payments. This approach might also offer a solution to the controversial issue of non-renewable natural resources, since it recognizes that certain revenues are non-recurring. However, royalties on non-renewable natural resources would have to be invested, not immediately spent to fund existing or new programs.[5]

It remains to be determined whether this approach is simpler and more transparent than the present formula, and whether the federal and provincial governments are prepared to accept it. The C.D. Howe Institute, which supports this approach, emphasizes the need to provide for a transitional period before adopting it completely, since it would fundamentally change the way provincial governments manage their public finances.

CONCLUSION: POLITICAL DECISIONS AND ECONOMIC CONSTRAINTS

There is probably no perfect Equalization formula or approach; each has its advantages and disadvantages, given current constraints. Consequently, whether the federal and provincial governments are in favour of a particular formula or recommendation advanced by the expert panel will depend on the benefits they stand to derive from it. Lengthy negotiations will no doubt be necessary for all provinces to agree on a new approach; and in view of the diverse positions held, the outcome may, with a few changes, still be the status quo. On the other hand, failing a quick consensus among the parties, the expert panel's recommendations may lead to an in-depth review of all federal transfers and once again raise the question of fiscal imbalance.

On this point, it should be noted that some political commentators have proposed merging the Canada Health Transfer and Canada Social Transfer with the Equalization program to create a general per capita "supertransfer." Under that approach, each province would receive a different per capita amount based on its total fiscal capacity or expenditure needs, thus making it possible to even out any horizontal or vertical fiscal imbalance.[6] Apart from the obvious constitutional and political constraints, it is probably unrealistic to believe that a system can be

---

(5) Only the proceeds from those investments could be spent without the province being penalized with respect to Equalization.

(6) Fiscal imbalance is horizontal where it exists between provinces, and vertical where it exists between the federal government and the provinces.

created that would achieve absolute tax fairness among the citizens of all provinces, without significantly restricting the provinces' freedom of action with respect to their economic and tax policies. Moreover, any evaluation of the provinces' fiscal capacity and expenditure needs will always be based on subjective criteria.

That said, whatever formula is used, the Equalization amounts received by the provinces ultimately depend on the federal government's ability to pay. Federal revenues depend on economic circumstances, a fact that prevents the federal government from being over-generous in the long term without running the risk of incurring budget deficits. This fact is, unfortunately, inconsistent with the greater, more stable and more predictable funding the provinces are seeking.

Lastly, it should be noted that the expert panel responsible for reviewing Equalization and TFF is scheduled to report to the federal government by the end of 2005. The government is committed to putting new arrangements in place for the allocation of Equalization and TFF by 1 April 2006.

SELECTED BIBLIOGRAPHY

Boadway, Robin. "Revisiting Equalization Again: RTS vs. Macro Approaches." Working Paper 2002(2). Institute of Intergovernmental Relations, Queen's University, Kingston, 2002.

Hobson, Paul A. R. "What Do We Already Know About the Appropriate Design for a Fiscal Equalization Program in Canada and How Well Are We Doing?" Working Paper 2002(6). Institute of Intergovernmental Relations, Queen's University, Kingston, 2002.

Holden, Michael, and Stephen Laurent. *Equalization*. TIPS-109E. Parliamentary Information and Research Service, Library of Parliament, Ottawa, June 2004.

MacNevin, Alex S. "The Canadian Federal-Provincial Equalization Regime: An Assessment." Tax Paper 109. Canadian Tax Foundation, Toronto, 2004.

Smart, Michael. "Redistribution, Risk, and Incentives in Equalization: A Comparison of RTS and Macro Approaches." Working Paper 2002(1). Institute of Intergovernmental Relations, Queen's University, Kingston, 2002.

Mintz, Jack M., and Finn Poschmann. "Follow the Cash: Changing Equalization to Promote Sound Budgeting and Prosperity." Backgrounder 85. C.D. Howe Institute, Toronto, October 2004.