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SEVEN COMMON NOTIONS ABOUT EQUALIZATION

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INTRODUCTION

Canada's equalization program dates back to 1957. What started out as a modest transfer has since expanded to a much more comprehensive mechanism, which aims to smooth out differences in provinces' ability to generate revenues with which to fund their spending initiatives.

There is no shortage of strong opinions on the value and efficacy of equalization. Some observers consider it to be a fundamental element of Canada's social fabric. Others view it as a yoke that does more damage to the Canadian polity than it does good.

The difficulty in reconciling these diverse views lies in the fact that while equalization is intuitive on a superficial level, the details of how it works are complex. It has been said that only a very small handful of Canadians have a solid understanding of the mechanism of equalization, how the program works and the interplay between its various determinants.

At the same time, equalization attracts sporadic, but often intense, media scrutiny and public policy analyses, usually coinciding with adjustments made to the program. In the interests of brevity and readability, however, some of those analyses have either over-simplified the program or misinterpreted it, meaning that not all of the current notions about equalization are necessarily accurate.

This paper does not provide an in-depth examination of how equalization works. That information is available from a number of other sources.(1) Rather, it looks closely at a few of the more common claims made about (or against) the program to explore the extent to which, and under what conditions, they might be true.

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(1) Notably, the Department of Finance has a concise description of the program on its Web site, at http://www.fin.gc.ca/access/medbriefe.html.

"RICH" PROVINCES PAY EQUALIZATION TO "POOR" PROVINCES

This is one of the most common beliefs about the equalization program. Newspaper articles, and even some policy research papers, about equalization sometimes speak in terms of "rich" (or "have") provinces – usually Alberta and Ontario – relinquishing their own tax revenues and transferring them to "poor" ("have-not") provinces.(2)(3)

This impression has been given momentum by the Ontario government's recent campaign suggesting that the province contributes $23 billion more to confederation each year than it receives in return. This claim (the soundness of which is not addressed here) has reinforced the perception that, if Ontario is funding programs such as equalization, the province's own-source revenues must be suffering as a result. This impression is further amplified by arguments that contrast provincial deficits in Ontario with budgetary surpluses at the federal level.

The fact of the matter is that equalization is a federal transfer program funded entirely by taxes and other revenues accruing to the Government of Canada. The federal government then transfers some of that revenue to "have-not" provinces. Tax revenues in "have" provinces are unaffected by the equalization program.(4) Provinces do not contribute to the program directly, nor can they "opt out" of equalization any more than they can "opt out" of national defence or foreign policy.

Federal tax rates are the same across Canada. All else being equal, an individual earning $50,000 in Alberta pays the exact same federal tax as someone earning that salary in New Brunswick.(5) In that sense, the "burden" of financing equalization does not vary across Canada.

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(2) For example, in the 17 February 2005 edition of *The Economist*, equalization was referred to as a program whereby "richer provinces hand over some of their revenues to poorer ones."

(3) These terms are commonly used in discussions of equalization. "Have," or "rich," provinces are those that do not qualify for equalization because they exceed a national standard for provincial revenue-generating ability. "Have-not" provinces do qualify for the transfer and, in that sense, are sometimes called "poor."

(4) However, some argue that since the federal government levies taxes to finance equalization, and since the federal and provincial governments tax many of the same bases – incomes, for example – the federal government may occupy an undue share of the tax "room," thus limiting provinces' ability to generate revenues.

(5) The sole exception to this is Quebec, where provincial taxes are higher and federal taxes lower. This is because in the 1960s, Quebec received a transfer of tax points to compensate the province for having opted out of certain federal transfer programs.

Where the difference lies, then, is in the variation in wealth and population across the country. At the risk of oversimplifying the case, the fact that Ontario has a larger number, and a higher proportion, of high-income earners means that that province generates more revenue for the federal government than, say, Prince Edward Island. Because Ontario contributes more to federal revenues than other provinces, it would be accurate to suggest that it contributes more to equalization than other provinces, in the same way as it contributes more to national defence or to any other federal expenditure.

Of course, the benefits of equalization, by definition, do not accrue to "have" provinces. In that sense, it would also be accurate to suggest that those in "have" provinces pay more taxes to the federal government than is transferred back. However, residents of "have" provinces do not personally contribute more to equalization than residents of "have-not" provinces. Neither do provincial governments pay into the program.

EQUALIZATION IS A SUBSIDY TO "POOR" PROVINCES

Equalization is frequently described, particularly in the media, as a subsidy paid by rich provinces to poor provinces. The issue of whether or not rich provinces "pay" poor provinces has been addressed above. However, the description of equalization as a "subsidy" requires some attention.

Whether or not equalization constitutes a subsidy is unclear. The purpose of the program is to provide transfers to poor provinces in order that Canadians have access to reasonably comparable levels of provincial government services at reasonably comparable levels of provincial taxation, regardless of where in the country they live. This is considered necessary by many because rich provinces can generate revenues more easily than poor provinces: a 1% increase in income taxes, for example, will generate more revenue and, more importantly, more revenue per person in Ontario than it will in Nova Scotia. Equalization is designed to compensate for this gap, to some degree.

The economic definition of a "subsidy" is a payment made by a government to producers or consumers to offset the cost of production. In a sense, then, equalization does loosely fit this description, inasmuch as it permits provincial governments to "produce" services more cheaply, i.e., at lower levels of taxation.

However, when one considers the economic impacts typically associated with subsidies, it is less certain whether that term can be accurately applied to equalization payments. In the private sector, subsidies are considered to be market-distorting. It is generally assumed that in the absence of government intervention, private companies compete with one another on more or less equal (or at least "fair") terms. Subsidies are damaging because, the argument goes, they fundamentally alter these competitive pressures by favouring one company, or one industry, over another.

Does this describe equalization? Some say it does. Others disagree, maintaining that public- and private-sector transfers are not so easily comparable. For example, it is argued that equalization payments do not create an advantage for poorer provinces as much as they partially offset an advantage in wealthier ones. Unlike private-sector activity, there is no level playing field across the provinces in the absence of federal government intervention. The distribution of natural resources across the country is the clearest example of this fact.(6)

Furthermore, the purpose of equalization is not to allow some provinces to "produce" government services more cheaply than others. Canada's social programs are such that each provincial government is, in a sense, intended to provide a reasonably homogeneous set of services to the same customer: Canadians. In a sense, then, each is required to provide more or less the same services (i.e., incur the same costs), but without access to the same revenue streams. This makes it difficult to directly compare private- and public-sector transfers.

One final point further muddies the waters, making it unclear whether equalization constitutes a subsidy: that is, whether or not provinces compete with one another. In the sense of "competitive federalism," provinces do have the freedom to explore best policy practices which could create conditions that lure individuals and businesses from other parts of the country. However, provinces do *not* have the profit- (or revenue-) maximization goals that presuppose private-sector competition; all governments share a common goal of maximizing the welfare of their citizens. Policies may seek to generate growth and prosperity, but their primary objective is usually to create prosperity at home, not explicitly to lure it away from elsewhere (although they may have that effect).

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(6) This, of course begs the question: just because resources are distributed unevenly across Canada, is the federal government compelled to intervene? That issue speaks to another criticism of equalization, discussed below: that equalization clouds economic signals within Canada.

EQUALIZATION INHIBITS ECONOMICALLY EFFICIENT MIGRATION

The issue of whether or not equalization constitutes a subsidy touches on another frequent criticism of the program: that it distorts market signals in Canada. Specifically, it is argued that by helping poor provinces finance the cost of providing services at a given tax rate, equalization entices people to remain in those provinces and to resist the pull of economic opportunity elsewhere in Canada.

It is difficult to amass evidence to support or refute this claim. A cursory examination of interprovincial migration statistics provides superficial evidence for the contrary view: provinces that receive equalization payments tend to be those that experience a net outflow of migrants, suggesting that economic advancement remains a powerful motive to relocate. Moreover, migration statistics show that residents of Prince Edward Island and Newfoundland and Labrador – traditionally the largest per capita recipients of equalization – are nevertheless among the most likely of all Canadians to move to another province.(7)

However, it would be misleading to suggest that this information provides conclusive evidence that equalization does not affect labour mobility. After all, no information exists on what migration rates would be in the *absence* of equalization.

Even so, it seems reasonable to assume that, as with other federal transfers that have a regional dimension – Employment Insurance, for example – equalization does, to some degree, limit labour movements. Consider the case of Newfoundland and Labrador. Equalization payments comprised an estimated 20% of provincial government revenues in that province in 2004-2005 (down from 25% the year before). The hypothetical withdrawal of those revenues would significantly affect the level of services or taxation rates in what is already one of Canada's most heavily taxed provinces. The resulting economic impact would very likely encourage some provincial out-migration. In that sense, one could argue that equalization does, in fact, inhibit labour mobility, to at least a limited degree.

The question that remains, then, is whether or not this is economically inefficient. On this point, economists' and policy analysts' opinions differ widely. On one hand, many argue that equalization *is* economically inefficient because residents of poorer provinces, through

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(7) Residents of Saskatchewan, situated next door to Canada's strongest economy, are the most mobile group of Canadians.

equalization, have access to services that would otherwise necessitate significantly higher tax rates. Accordingly, they are more inclined to stay where they are instead of moving to where economic opportunities are greater.

Those who hold the opposing view do not argue against the value or purpose of labour migration. Rather, they maintain that migration should occur for *economic* reasons, not because of differing provincial fiscal capacities. Economically efficient migration is that which responds to market conditions, allowing labour resources to be distributed across the country according to where the need is greatest. Moving from Nova Scotia to Alberta because of better job opportunities or higher wages is an acceptable motive for economists. Moving to take advantage of more generous social programs or more liberal tax regimes (or both) is not. In this sense, lucrative tax incentives and generous spending programs are no less economically distortionary than production subsidies. Advocates of this view hold that equalization *prevents* economically efficient migration.

Others, however, have argued that, far from inhibiting interprovincial migration, equalization may, in fact, *encourage* it. Equalization improves the ability of poor provinces to provide high-quality services in areas such as health and education. In the absence of these programs, "have-not" provinces would produce a lower-quality workforce that would be less able to respond to market forces. A shortage of skilled trades workers in Alberta, for example, would be less likely to be filled by surplus workers from New Brunswick if training programs in that province were not up to the standards of other provinces.

EQUALIZATION DISCOURAGES ECONOMIC DEVELOPMENT

Another argument against equalization is that it prevents provincial governments from bearing the full costs, or receiving the full benefits, of their economic development decisions. In this way, it minimizes economic development incentives and does not penalize provinces for implementing poor policies.

To understand this argument requires a brief detour to explain how equalization payments are determined. Equalization is designed as a top-up to provinces with weak tax bases and relatively poor resource endowments. If a province falls below the national standard for provincial revenue-generating ability, then it receives as much equalization as necessary for it to reach the standard.

As a simplified example, suppose that, on average, provinces were capable of generating \$6,000 in revenues per person, provided they all had identical tax rates. A province that was capable of generating only \$5,000 per person would then be entitled to equalization payments totalling \$1,000 per person. Equalization has been criticized on the grounds that this payment provides a cushion to equalization-receiving provinces. If a province were to implement a poorly designed policy that saw its tax base erode – say, to \$4,500 per person – its overall revenues would not change, because this loss would be offset by an identical \$500-per-person increase in equalization payments. The opposite is also true: a policy that promoted economic development and saw provincial tax-generating capabilities rise to \$5,500 per person would be negated by a \$500-per-person decrease in equalization payments.

That equalization discourages economic development is perhaps the most common criticism of the program. The best example of this is the issue of oil and gas development in the Atlantic offshore. Indeed, the federal government's recently signed offshore revenue agreements with Nova Scotia and Newfoundland and Labrador speak directly to this point.

Prior to the development of the Atlantic offshore, it was recognized that the resource royalties that would result from that development would affect equalization payments in Nova Scotia and Newfoundland and Labrador. Because of the way equalization was structured, every dollar in new resource royalties would be offset by a dollar less in equalization payments. Many, including the provinces themselves, argued that this "clawback" was a powerful disincentive to develop the resource.

The evidence of public policy decisions in this area suggests that this view held currency amongst decision-makers. In the mid- to late 1980s, the federal government negotiated offshore accords with the two provinces that included limitations on the clawback. A second arrangement, one that applied to other provinces as well, was reached in 1994. New, more generous deals were reached with Nova Scotia and Newfoundland and Labrador in early 2005.

There is no doubt that the current structure of the equalization program means that any improvement in economic conditions and fiscal capacity will be offset by forgone equalization payments. Thus, while equalization may not eliminate economic development incentives altogether, it does reduce those incentives. The cost of inactivity on the economic development front is greatly diminished – particularly in cases such as offshore energy, which is a relatively low-employment industry and where royalties are the primary benefit to the province. However, this situation does not completely remove governments' incentives to build their economies. Other potential benefits – job creation, higher wages, higher standards of living, reduced uptake of social services, etc. – remain. There is also the improved morale that comes from being more self-sufficient. In the case of the Atlantic offshore, even if every dollar in energy royalties were to be clawed back by lower equalization payments, there would still be benefits to proceeding with the project. Why a province would actively choose to forgo economic development merely to hold onto equalization payments is unclear.

NOVA SCOTIA AND NEWFOUNDLAND AND LABRADOR WERE TREATED UNFAIRLY BY EQUALIZATION

Prior to the 2005 federal offshore agreements with the two offshore energy-producing Atlantic provinces, governments in both provinces had argued that they were unfairly penalized by equalization. Although agreements had been reached to lower the equalization clawback (discussed above), both Nova Scotia and Newfoundland and Labrador maintained that it was unfair that a wealthy province like Alberta was "allowed" to keep all of its oil and gas revenues, while the relatively poor Atlantic provinces were forced to relinquish most of theirs via forgone equalization payments.

While this viewpoint enjoyed some popular support as an economic development policy, it ran counter to the fundamental purpose of equalization. In a sense, the "unfairness" of the clawback represented nothing more than equalization doing exactly what it was intended to do – to compensate provinces for their relative inability to generate own-source revenues. As provinces became wealthier, their fiscal capacities would grow, and their need for equalization payments to make up the difference relative to other provinces would fall. To suggest that provinces were being penalized for their economic development efforts ignored the benefits they had received through equalization up to that point. In that regard, it has been argued that the provinces wanted to have their cake and eat it, too.

At the same time, however, while the clawback may in fact be no more than equalization operating according to design, it is difficult to ignore the fact that it yields some peculiar-looking results. Every dollar in oil and gas royalties levied by Alberta makes its way to provincial government coffers, making it the richest province in Canada. By contrast, most royalty revenues in two of Canada's poorest provinces were clawed back, until very recently, by the federal government.

SASKATCHEWAN HAS BEEN TREATED UNFAIRLY BY EQUALIZATION

The idea that Saskatchewan has received unfair treatment has gained momentum in the light of the recent offshore agreements between the federal government and the provinces of Nova Scotia and Newfoundland and Labrador. Indeed, most equalization-receiving provinces have voiced objections over those agreements because they themselves have been subject to a similar clawback in revenues from other non-renewable resources. However, of these provinces, Saskatchewan has by far the most grounds for complaint.

Saskatchewan has typically been a recipient of small equalization payments; its wealth in minerals, oil and gas has not been quite enough to compensate for its relative poverty in most other provincial revenue sources. For example, personal disposable incomes in Saskatchewan are only four-fifths the level in neighbouring Manitoba; yet in 2003, Manitoba received over $1,100 per person in equalization payments, while Saskatchewan received $123 per person. If non-renewable resources were to be removed from the equalization formula, Saskatchewan's entitlements would more than double.(8) More in-depth studies have demonstrated that in some cases, the clawback for Saskatchewan's energy resources is over 100%.(9)

In other words, Saskatchewan has been subject to a considerable equalization clawback for decades – a clawback similar to the one for which Nova Scotia and Newfoundland and Labrador received compensation in 2005. The province has argued that, over the past 10 years, natural resource revenue clawbacks have cost it $4 billion in government revenues. Accordingly, Saskatchewan argues that if the two Atlantic provinces are entitled to an exemption from equalization for their energy resources, it should be treated no differently.

On one hand, this position is no more defensible than that of Nova Scotia and Newfoundland and Labrador. Equalization is intended to compensate for differences in revenue-

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(8) Based on the author's calculations using the first estimate of 2004-2005 equalization entitlements.

(9) T. Courchene, "Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues," *Choices*, Vol. 10, No. 2, Institute for Research on Public Policy, Montréal, March 2004.

generating ability precisely because provinces have different fiscal strengths. Some are endowed with energy resources. Others have large forestry industries. Others have high personal incomes. As *overall* revenue-generating ability increases, the need for equalization falls and payments are designed to decrease accordingly. Given the principle of equalization, therefore, Saskatchewan has no grievance.

However, when viewed in light of the 2005 federal offshore agreements with Nova Scotia and Newfoundland and Labrador, Saskatchewan's claims are on more solid ground. Saskatchewan residents may justifiably ask why two provinces are entitled to special treatment for their non-renewable energy resources when others, with similar resources, are not.

EQUALIZATION IS AN ECONOMIC DEVELOPMENT TOOL

A common misconception of equalization is that its goal is to promote regional economic development, putting it in the same category as government subsidies, grants, loan guarantees and the operations of regional development offices such as the Atlantic Canada Opportunities Agency.

This argument is based upon the observation of long-term growth patterns in equalization payments since, for example, the early 1980s. The idea is that since the Atlantic provinces (the usual objects of this accusation) continue to receive equalization after decades of the "handout," and in fact now receive more than they did 20 years ago, then the program must not be working.

This assigns an objective to equalization that it was never intended to meet. The goal of the program is to boost the fiscal capacities of poorer provinces to ensure that Canadians receive a reasonably homogeneous level of provincial government services without some provinces having to pay a far greater cost (in terms of taxation intensity) than others. There is no economic development component to the program. There was never intended to be.

At the same time, however, equalization does indirectly affect provincial economic welfare. Since equalization is an unconditional grant, provinces could use the money for new economic development initiatives rather than to fund public services. In addition, as mentioned above, removing equalization would cause a dramatic reduction in the level and quality of government services that provinces could afford. This would require either deficit financing or fiscal retrenchment of such a magnitude that economic activity would be significantly affected.

Given this view of equalization as a failed regional development program, and the somewhat incongruous view of equalization as an inhibitor of economic development (discussed above), it is worth considering the economic record of Canada's equalization-receiving provinces. Data on provincial per capita Gross Domestic Product (GDP) show that the gap between rich and poor provinces in Canada is closing. Over the 20 years from 1983 to 2003, the economies of the five easternmost provinces – all recipients of equalization – grew faster than the national average. Manitoba and Saskatchewan saw their relative wealth fall slightly, although in the case of Saskatchewan, this was because the oil boom in the early 1980s inflated Saskatchewan's GDP figures in 1983.

So if per capita provincial economic activity has, for the most part, converged over the past 20 years (whether because of, in spite of, or independent of, equalization), why then have equalization payments risen over that period? There are two contributing explanations.

The first is inflation. Although equalization payments doubled in nominal terms from 1981-1982 to 2003-2004, rising prices accounted for much of this growth. After taking inflation into account, equalization payments grew much more modestly over most of that period and fell sharply over the past few years. However, even after accounting for inflation, real equalization payments still rose, albeit more modestly, through the 1990s.

This brings us to the second explanation for equalization's rise: Ontario. Ontario is by far the largest province in terms of population and economic output. As such, when equalization payments are calculated, Ontario carries great weight in the formula. Through much of the 1990s, growth in the Ontario economy outpaced growth in the Canadian economy as a whole.(10) As a result, provincial revenue-generating capacity in Ontario grew faster than in other provinces, making those provinces which received the transfer seem poorer by comparison. At the same time, the population of Ontario was also growing faster than the national average, meaning that Ontario's weight in the formula was increasing still further.

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(10) Although per capita economic growth in Quebec and the Atlantic provinces outpaced growth in Ontario from 1983 to 2003 as a whole, this was not the case through most of the 1990s.

CONCLUSION

Equalization has been frequently criticized as opaque, difficult to understand and, according to some, rife with perverse economic incentives. Since the details of the program are so complex, the sometimes limited public understanding of how it works has led to a number of assumptions about equalization. Not all of these are accurate, as this paper has indicated.

The program's complexity has also made well-informed debate on the merits and drawbacks of the present equalization mechanism difficult. This challenge has been exacerbated by a number of recent changes related to the program: modifications in the 2004 federal budget; extra funds added to the transfer in October 2004; and the Atlantic accords negotiated in January 2005. Each of these further complicates the issue.

One solution to this problem might be to alter the structure of the present equalization system. While the notion of equalization as a principle is generally popular, this attachment does not necessarily extend to the existing mechanism itself. Indeed, there is no shortage of opinions on how equalization could be altered to improve the transparency and efficiency of the program. Some of these alternative approaches are discussed in another Library of Parliament publication,[11] although the existence of a "perfect formula" remains in question.

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(11) Philippe Le Goff, *Equalization: Waiting for the Perfect Formula*, PRB 04-50E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, January 2005.

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