ACHIEVING A NATIONAL PURPOSE:
Putting Equalization Back on Track

Expert Panel on Equalization and Territorial Formula Financing

May 2006

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May 2006

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, Ontario

Dear Minister,

Members of the Expert Panel on Equalization and Territorial Formula Financing have spent the past year reviewing a host of issues related to Canada's Equalization program, listening to the views of provinces, experts and interested Canadians, and exploring alternative approaches.

We are pleased to provide our Panel's final report and recommendations.

We would like to thank all those who participated in this important review process. While there are widely divergent views on how specific components of the Equalization program should be addressed, with few exceptions, we heard strong support for the program. Most want to see the Equalization program fixed, not abandoned.

We hope that this report will add to Canadians' understanding of the purpose of Equalization and the objectives it is intended to achieve. We hope it will provide a strong foundation for open, informed and constructive discussions among the provinces, the federal government and interested Canadians. Most importantly, we hope our recommendations will help put Equalization back on track and secure a solid foundation for one of Canada's essential cornerstones.

Yours sincerely,

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University of Alberta

Fred Gorbet
Principal, Strategy Solutions

Robert Lacroix
Founding member, Centre for Interuniversity Research and Analysis on Organization (CIRANO)

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EXECUTIVE SUMMARY

Achieving a national purpose

Canadians have long been committed to the principle that, as part of a vast and diverse federation, people across the country should have access to reasonably comparable public services, and they should pay for those services with reasonably comparable tax levels.

In practical terms, it means that if people live in Newfoundland and Labrador or British Columbia, Montréal or Medicine Hat, their children should have reasonably similar opportunities to get a good education. They should have access to reasonably comparable health care, social services, and justice systems. And people in one part of the country shouldn't pay substantially higher taxes to support those services compared with their fellow Canadians in other parts of the country.

This important national purpose is at the heart of Canada's federation. It is enshrined in Canada's Constitution and it provides the basis for the federal government program called Equalization. Under the Equalization program, the federal government provides financial support to provinces that are less wealthy and less able than other provinces to provide public services without charging unacceptably high levels of taxes.

In many ways, Equalization reflects a distinctly Canadian commitment to fairness. It has been described as the glue that holds our federation together.

Equalization reflects a distinctly Canadian commitment to fairness. It has been described as the glue that holds our federation together.

In recent years, however, questions have been raised about whether the glue is as strong as it was in the past, whether it's being spread too thinly or too thickly in some provinces, and whether the Equalization program is, in fact, achieving the national purpose it was intended to fulfill.

On top of those questions, it's fair to say that the program may be simple in theory and principle, but that's where the simplicity ends. The saying 'the devil is in the details' certainly rings true for Equalization. In spite of the fact that the federal government will spend well over $11 billion on Equalization in 2006–07, Equalization has been largely ignored by the vast majority of Canadians and it is understood by only a select few academics, experts, and finance officials across the country.

Questions about Equalization demand answers. They demand a thorough review of Canada's Equalization program—how it is designed and implemented and how it might be improved. Furthermore, Canadians deserve to know that their tax dollars are being used effectively to achieve an essential national purpose.

In March 2005, the Expert Panel was established by the federal Minister of Finance to address key questions about the future of Canada's Equalization program. Based on extensive consultations with provinces, experts, and academics, reviews of a wide range of options and ideas, and a thorough technical analysis, the Panel has prepared a comprehensive package of recommendations designed to put Equalization back on track.

Equalization has largely been ignored by the vast majority of Canadians and it is understood by only a select few academics, experts, and finance officials across the country.

Assessing Equalization

Starting with the basics

Canada's Equalization program has been in place since the mid 1950s. While many changes have been made throughout the program's history, the basic approach involves assessing the fiscal capacity of provinces to deliver public services. Those provinces that have less ability to pay for reasonably comparable levels of public services receive Equalization payments, while others with a higher fiscal capacity do not.

Canada's approach to Equalization may be unique, but it's important to understand that most countries with a combination of federal and regional governments provide some form of redistribution of funding to ensure that common objectives are met.

Getting the facts right

The federal government pays for Equalization through general taxes paid by all Canadian taxpayers.

While some have talked about money being transferred from one province to another, in fact, all the money for Equalization comes from Canadian taxpayers across the country and is shared among the less wealthy provinces. Equalization is paid by the federal government to provincial governments and does not include any sharing of provincial revenues among provincial governments.

There are no strings attached to Equalization funding.

The federal government doesn't tell provinces how to spend Equalization funding – there are no conditions placed on how funds should be used or what, if any, standards should be achieved. Provinces make decisions on behalf of their residents and they are accountable to their electors for the services they provide.

Equalization is designed to be a permanent program.

Unlike most other federal government programs, Equalization is enshrined in Canada's Constitution. How the program is designed and how much money it involves can be and is changed on a periodic basis. But without a change in Canada's Constitution, the program will remain an essential component of Canada's federation. As long as the program is designed to bring the fiscal capacity of less wealthy provinces up to a certain standard, unless all provinces have the same fiscal capacity, some will receive Equalization payments and some won't.

Equalization doesn't level the playing field among all provinces.

Equalization brings less wealthy provinces up to a common standard, but it doesn't bring wealthier provinces like Alberta and Ontario down to the standard.

Resource revenues in one province are not shared with other provinces.

Most people the Panel heard from want to see the Equalization program improved, not abandoned.

Provinces keep all the money they raise from resources and all their other tax bases. No provincial government funds go to support Equalization. Although some provinces talk about having their resource revenues "clawed-back," the only impact from Equalization is that provinces get less Equalization funding if their own revenues increase. That's the way Equalization is supposed to work.

Equalization is designed to address fiscal disparities among provinces.

Provincial premiers have raised concerns about a fiscal imbalance between provincial and federal governments. The issue relates to whether or not the responsibilities of provinces and the federal government are matched with their respective abilities to pay. While Equalization does provide financial support from the federal government to receiving provinces, it is not designed or intended to address the broader issue of fiscal imbalance between the provinces and the federal government.

Identifying the key issues

As a result of its consultations and discussions, the Panel learned that:

- ***Most want to see the Equalization program improved, not abandoned.***

  While fundamental questions have been raised about the purpose and effectiveness of Equalization, most believe that Equalization meets an important national purpose and it is an essential component of Canada's intergovernmental fiscal arrangements. Furthermore, information reviewed by the Panel and included in this report suggests that Equalization has been effective in reducing the financial gap between wealthy and less wealthy provinces. For provinces that receive Equalization payments, it's an important source of funds that helps them to achieve the objective of providing reasonably comparable public services at reasonably comparable levels of taxation.

- ***Equalization should be put back on track through a principle-based, formula-driven approach.***

If there was one consistent message the Panel heard, it was a call to return to a principle-based formula-driven approach.

The Panel consistently heard concerns about what many saw as an increasingly ad hoc approach to Equalization. Before 2004, Equalization was based on a formula that determined both the overall amount of money to be provided for Equalization and the allocation to individual provinces. The formula was complex and was not without its share of problems. However, the New Framework introduced by the federal government in 2004 has been consistently criticized by provinces and academics. On top of that, many questioned the impact of separate Offshore Accords with Newfoundland and Labrador and Nova Scotia on the Equalization program. The result is a call to put Equalization back on track and return to a new, less complex, formula.

- ***The treatment of resource revenues is the most complex and controversial aspect of Equalization.***

Different provinces, experts, and analysts have different ideas as to how the Equalization program can and should be improved. By far, the most contentious issue involves how resource revenues should be treated in the formula. The Panel heard strongly held and diametrically opposing views ranging from excluding resource revenues entirely to including them completely. Given the importance of resources to the economies of some provinces and the impact of high prices for oil and gas in particular, this issue has direct bearing not only on the Equalization program but on the potential for resource revenues to increase disparities among provinces.

Putting Equalization back on track

The Panel's goal was to put Equalization back on track – to develop a sound and effective program and establish a firm and sustainable foundation for the future.

There is no perfect solution for Equalization in Canada. Given the dynamics and diversity of Canada's federation, perfection will undoubtedly continue to elude all of us.

Nonetheless, the Panel's goal was to put Equalization back on track—to develop a sound and effective program and establish a firm and sustainable foundation for the future.

The starting point is a clear set of principles, and the result is a balanced package of recommendations addressing a wide range of options and ideas. The key question for the Panel was: *Will this result in a better Equalization program for all Canadians*? In the Panel's view, the answer is yes.

The Panel's Recommendations

Starting with principles

1. ***A clear set of principles should be adopted to guide future development of the Equalization program in Canada.***

Returning to a rules-based, formula-driven approach

2. ***A renewed Equalization formula should be developed and used to determine both the size of the Equalization pool and the allocation to individual provinces.***
3. ***A 10-province standard should be adopted.***
4. ***Equalization should continue to focus on fiscal capacity rather than assessing expenditure needs in individual provinces.***
5. ***Equalization should be the primary vehicle for equalizing fiscal capacity among provinces.***

Improving the Equalization formula

6. ***The Representative Tax System (RTS) approach for assessing fiscal capacity of provinces should be retained.***
7. ***Steps should be taken to simplify the Representative Tax System (RTS).***
8. ***A new measure for residential property taxes should be implemented based on market value assessment for residential property.***
9. ***User fees should not be included in Equalization.***

Striking a balance on the treatment of resource revenues

10. ***In principle, natural resource revenues should provide a net fiscal benefit to provinces that own them.***

11. ***Fifty percent of provincial resource revenues should be included in determining the overall size of the Equalization pool.***

12. ***Actual resource revenues should be used as the measure of fiscal capacity in the Equalization formula.***

13. ***All resource revenues should be treated in the same way.***

14. ***A cap should be implemented to ensure that, as a result of Equalization, no receiving province ends up with a fiscal capacity higher than that of the lowest non-receiving province.***

Improving predictability and stability

15. ***The current approach for determining Equalization entitlements and payments should be replaced with a one estimate, one entitlement, one payment approach.***

16. ***Three-year moving averages combined with the use of two-year lagged data should be used to smooth out the impact of year-over-year changes.***

Assessing Equalization

17. ***The federal government should track and report publicly on measures of fiscal disparities across provinces.***

Improving governance and transparency

18. ***A more rigorous process should be put in place to improve transparency, communications, and governance. This is preferable to setting up a permanent independent commission to oversee Equalization.***

Assessing the impact

The Panel's recommendations result in similar fiscal capacities for all receiving provinces after Equalization.

The Panel understands that the best ideas can sound good in principle, but what people really want to know is: What's the bottom line? Will the Panel's recommendations have an impact on whether or not a province qualifies for Equalization, how much it would receive, and how that compares with what it currently receives?

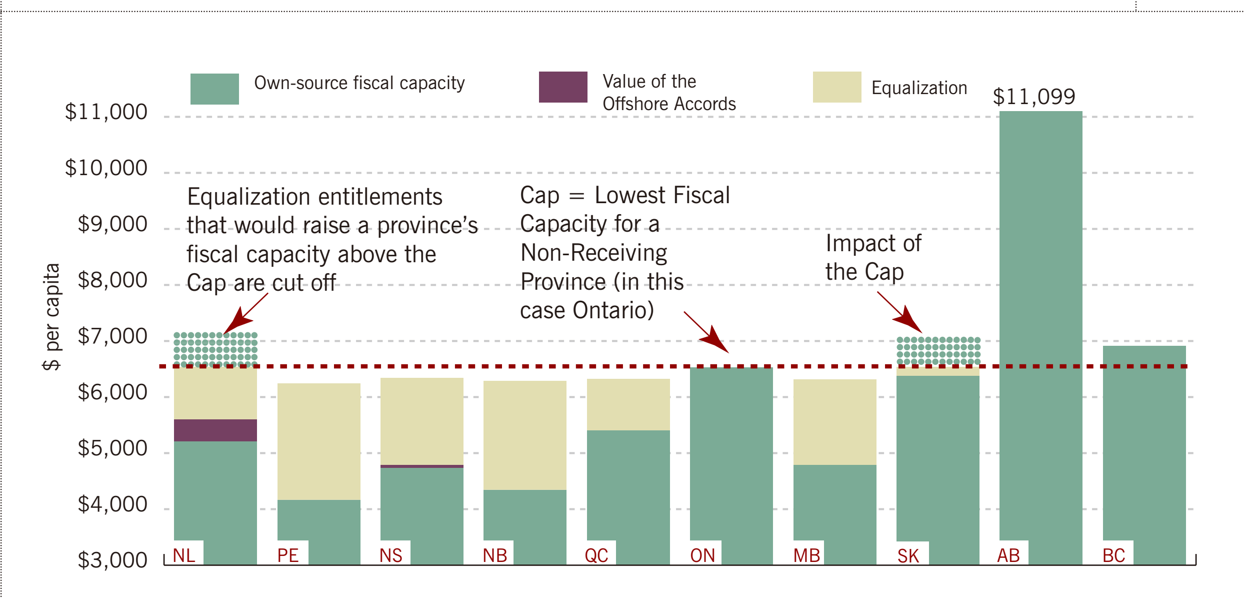
The Panel has done a thorough technical analysis to provide a snapshot of the combined financial impact of its recommendations. It's important to keep in mind that it's just that, a snapshot. Actual numbers and allocations can and will vary depending on circumstances at the time.

The Panel's projections show what the allocation to the various provinces would be in 2007–08, the first year that our recommendations could be implemented. Two comparisons are shown: one with the amounts announced for 2006–07 by the federal Minister of Finance in November 2005, and one with a base case that reflects a formula-driven approach similar to what was in place before 2004.

The analysis shows that:

- Consistent with the purpose of Equalization, the Panel's recommendations result in similar fiscal capacities among all receiving provinces after Equalization.

Provincial Fiscal Capacity Before and After Equalization (using the Panel's formula) for 2007–08



- The total cost of the Equalization program proposed by the Panel is more than the current program. That's primarily because of the move to a 10-province standard and because the latest data reflect higher oil and gas prices.
- In the Panel's view, using a formula-to-formula comparison gives the most accurate picture of the potential impact of their recommendations. In this case, because of its higher fiscal capacity, British Columbia would not be eligible for Equalization under the Panel's recommended formula and would be entitled to only a small amount of funding under the previous formula. Newfoundland and Labrador would receive less under the Panel's approach, primarily because of the Panel's recommendation that no receiving province should have a higher fiscal capacity after Equalization than the lowest non-receiving province. This cap affects Newfoundland and Labrador's entitlement to Equalization because its fiscal capacity is greater than Ontario's.
- If you compare each province's allocation under the Panel's recommendations to the amounts announced under the New Framework in 2006–07, two receiving provinces receive less while the others receive more. This is primarily because of the return to a formula-driven approach which puts all provinces on a similar footing.

Provincial Fiscal Capacity Before and After Equalization for 2007–08[1]

$ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Fiscal Capacity (using the Panel's formula)										
Before Equalization	5,601	4,167	4,784	4,346	5,406	6,534	4,785	6,377	11,099	6,913
Equalization	933	2,079	1,560	1,945	917	0	1,528	157	0	0
After Equalization	**6,534**	**6,246**	**6,344**	**6,291**	**6,322**	**6,534**	**6,313**	**6,534**	**11,099**	**6,913**

[1] Table shows the before Equalization fiscal capacity of provinces using a 100 percent inclusion rate for resource revenues and includes payments provided through the Offshore Accords. Equalization entitlements are shown net of the fiscal capacity cap.

Formula-to-Formula Comparison for 2007–08

$ million / $ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
Panel's Recommendations											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	**12,563**
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
Base Case Scenario											
Total Entitlements	587	282	1,363	1,417	6,273	0	1,720	0	0	35	**11,676**
Per Capita Entitlements	1,136	2,047	1,454	1,885	830	0	1,468	0	0	8	
Changes											
Total Entitlements	***-105***	***4***	***99***	***45***	***653***	***0***	***69***	***156***	***0***	***-35***	***887***
Per Capita Entitlements	***-203***	***31***	***105***	***60***	***86***	***0***	***59***	***157***	***0***	***-8***	

Note: Totals may not add due to rounding.

Benefits of the Panel's recommendations

- Equalization is returned to a principle-based, formula-driven approach with a solid foundation for the future.
- Moving to a 10-province standard is a principled approach that reflects the true nature of Canada's federation and the real diversity among the provinces.
- Although Equalization will never be a simple program, the Panel's recommendations result in a considerably simpler and more transparent approach and should make the basics of Equalization more easily understood by Canadians.
- While the approach is not as certain as the New Framework, particularly for the federal government, the use of moving averages provides greater stability and at the same time accommodates the wishes of the provinces to return to a formula-driven approach.

- Taken together, the package of recommendations provides a balanced approach that carefully weighs the pros and cons of different options and combines them into a solid Equalization formula for the future.
- Instead of an all-or-nothing approach to the treatment of resource revenues, the Panel's recommendations balance the various options and provide a reasonable solution, a workable solution that provides the best outcomes in terms of its overall impact on provinces.
- The Panel's recommendations for a rigorous review and reporting process should result in a more open and transparent Equalization program.

We hope our recommendations will help focus the debate and achieve the objective of putting Equalization back on track.

Concluding comments

The Panel appreciates very much the extensive cooperation, ideas, and insight provided by the provinces and by leading experts and academics across Canada.

Throughout the process, we were struck by how little is known about Canada's Equalization program and the many misconceptions about what it is and is not designed to achieve. We also listened carefully over the past few months while the purpose of Equalization was questioned and serious concerns were raised about its future viability in Canada.

As Panel members, we hope our report will shed more light on this important Canadian program. And we hope our recommendations will help focus the debate and achieve the objective of putting Equalization back on track.

ACHIEVING A NATIONAL PURPOSE: *Putting Equalization Back on Track*

EXAMINING EQUALIZATION

Completing a comprehensive review

In March 2005, the federal Minister of Finance announced the beginning of a comprehensive review of Canada's Equalization program and Territorial Formula Financing (TFF). The review fulfilled an agreement among First Ministers in October 2004.

An Expert Panel was established to review a broad range of issues, consult with provinces and territories, seek the advice of various academics and experts, look at comparable fiscal arrangements in other countries, and listen to the views of interested Canadians.

The Panel's mandate involved the most comprehensive review of the Equalization program in more than two decades.

Specifically, the Expert Panel was asked to provide advice to the Government of Canada on:[1]

- The allocation among the provinces of the annual Equalization allotment set in legislation is to be evidence-based and derived from a formula, including consideration of:
    - The current Representative Tax System (RTS) approach
    - The treatment of various provincial and local revenue sources, such as natural resources, property taxes, and user fees
    - Other approaches to measuring fiscal capacity based on macroeconomic variables
    - Indicators of expenditure needs, if appropriate
- The allocation among territories of the annual TFF allotment set in legislation, as well as specific dimensions of the TFF program
- Mechanisms that would ensure that payments to provinces and territories are stable and predictable, to assist in sound financial planning
- Evidence-based measures of changes in fiscal disparities among provinces and the costs of providing services in the North, to provide information to governments and citizens and assist in future re-evaluations of the overall level of federal support for Equalization and TFF
- Whether to have, on a permanent basis, an independent body to provide ongoing advice to the Government of Canada on the allocation of Equalization and TFF as well as to conduct periodic reviews of provincial disparities and the costs of providing services in the North
- How to address difficult or challenging issues that could be involved in implementing the approach recommended by the Expert Panel

[1] Further information on the Expert Panel's mandate, consultation process, and submissions received as part of the review are available on the Expert Panel website at www.eqtff-pfft.ca.

Consulting across the country

The Panel's consultation process began with the development of a Key Issues Paper outlining important facts and background information about Equalization and TFF and identifying issues and questions to focus the discussions.[2]

Submissions to the Panel were sought through a dedicated website, as well as through direct invitations to all provinces and territories and a group of academics with expertise in federal-provincial fiscal arrangements in general and Equalization in particular.

The Panel sought advice and ideas from a wide range of people and organizations including provinces, academics, and interested Canadians.

Meetings were held with representatives of all provinces. For some provinces, Panel members met with premiers and finance ministers at their request, while for other provinces, meetings were held primarily with officials. Extensive discussions were held on particular issues of concern to several provinces and, throughout the consultation process, Panel members participated in conversations, e-mails, and informal discussions.

Four regional roundtables were held with the aim of providing additional opportunities for academics, government officials, business representatives, and other interested individuals to meet with the Panel and present their views. Roundtables were held in:

- Montréal, hosted by the Centre for Interuniversity Research and Analysis on Organization (CIRANO)
- Toronto, hosted by the C. D. Howe Institute
- Calgary, hosted by the Canada West Foundation
- Moncton, hosted by the Atlantic Provinces Economic Council

An academic workshop was also held, bringing a group of academics together to address key elements of the Panel's mandate and to provide their advice.

Summaries of the roundtable discussions and the academic workshop are available on the Panel's website. In addition, over 40 submissions were received, most of which are available on the Panel's website.

In addition to these consultations, Panel members reviewed extensive research, looked at models currently in place in other countries, and considered a wide range of options both in principle and by a thorough technical analysis. By the

[2] The Expert Panel's Issues Paper is available on its website.

time this report was completed, the Panel had met with more than 180 people from the public, private, and academic sectors, many of them more than once. A list of those who participated in the consultation process is included in Annex 1.

The result is a thorough and comprehensive review of Canada's Equalization program, a sound analysis of the implications of different options and ideas, and a clear understanding of the various positions and ideas put forward by the federal government, provincial governments, and interested individuals.

Reporting to Canadians

The Panel was asked to report to the federal Minister of Finance and the Government of Canada. At the same time, the Panel hopes that its report and recommendations will be of interest to Canadians from coast to coast to coast.

Early on, the Panel realized that the issues and approaches involved in Equalization and TFF are fundamentally different. While both start with a common purpose, they are vastly different in terms of how they are designed, what they measure, how they operate, and how significant they are in comparison to the revenues provinces and territories can raise. For that reason, the Panel has chosen to produce two separate reports – this report focused on Equalization and a second report dedicated specifically to TFF and the unique challenges of Canada's territories.

We urge Canadians to read both reports for a number of reasons. First, Equalization and TFF may be federal programs, but Canadians pay for them through their tax dollars and they benefit from them in terms of the services they receive, especially in less wealthy provinces and territories. Second, while the programs are complex, it's important for Canadians to have at least a basic understanding of what Equalization is intended to do, how it works, and how it benefits our entire country. More detailed information and analysis intended for more specialized and technical audiences are available in the annexes to this report.

Canadians deserve better information, clearer information, about these vitally important programs and their role in Canada's federation. With that objective in mind, our report begins with the basics about Equalization as we know it today.

"Clearly, Canadians want every province and all its citizens to have an equal opportunity to prosper. Adequate and equitable fiscal arrangements make that possible. History shows they work. Therefore we must move forward by strengthening these programs to the benefit of all Canadians."

- Honourable Greg Selinger Minister of Finance Manitoba and Ronald H. Neumann[3]

[3] Selinger G. and Neumann, R. (2005). Strengthening Intergovernmental Fiscal Arrangements in Canada in H. Lazar (ed.). *Canadian Fiscal Arrangements: What Works, What Might Work Better,* p. 246.

ACHIEVING A NATIONAL PURPOSE: *Putting Equalization Back on Track*

EQUALIZATION 101

Rightly or wrongly, Equalization has a reputation of being largely incomprehensible to the vast majority of people. In fact, the Panel heard that university professors shy away from explaining it in economics classes because it's just too complex.

At the risk of baffling the majority of people reading this report, it's essential to begin with the basics of Equalization – what it's intended to achieve, how it has changed over time, and how the program operates, without unnecessarily exposing the "devils" lurking in the details. It's also important, given the questions and misconceptions surrounding recent discussions about Equalization, to get the facts straight so that Canadians can judge for themselves.

"Canada's Equalization has a reputation as too arcane and complex to be understood by mere mortals. This reputation is largely undeserved. At the level of principle, the program is entirely straightforward. ... Of course, the devil remains in the details."

- Michael Smart[4]

The essence of Equalization

The purpose of Canada's Equalization program stems from a basic commitment to fairness and equity. In a diverse federation like Canada, Equalization has a specific purpose: to ensure that across the country, people have access to reasonably comparable public services at reasonably comparable levels of taxation.

Unlike most other federal funding programs, Equalization is unique in that its purpose is specifically included in Canada's Constitution. While the details of how the program operates can and do change over time, the fundamental commitment remains. Without a change in Canada's Constitution, Equalization will remain an essential component of Canada's federation.

"A society which strongly favours universal medical coverage must surely also be committed to universal quality education. Investment in essential public services is an investment in economic well-being and Canada cannot afford to stint in developing a productive society and workforce. Equalization is the underpinning of this objective."

- Donald G. Dennison[5]

Canada certainly is not alone in providing a mechanism for redistributing federal revenues and addressing disparities among provinces or states. In fact, many countries that are federations involving a central government and several regional governments have equalization systems similar to ours. That includes countries like Germany, Switzerland, Australia, India, Pakistan, and South Africa. The United Kingdom also has an equalization approach that takes into account the special fiscal needs of Scotland, Wales, and Northern Ireland. While they vary in approach, all have a similar objective—to allow regional governments to provide more comparable public services than otherwise would be the case.

[4] Smart, M. (July 2005). *Some notes on Equalization Reform*. Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 1.

[5] Dennison, D.G. (July 2005). Brief to the Expert Panel on Equalization and Territorial Formula Financing, p. 1.

"Equalization is too important a component of Canadian federal democracy to leave in the hands of a select group of fiscal high priests. And now, probably more than at any time in our history, we need to understand this critical institution."

- Gregory P. Marchildon[6]

To understand the basics of Equalization in Canada, it's important to keep some key points in mind:

- Equalization is funded entirely by the federal government using taxes paid by Canadians all across the country.
- The basic approach is to assess the financial capability of provinces (defined for Equalization purposes as fiscal capacity) to deliver public services. Those provinces that have less ability to pay for reasonably comparable levels of public services receive Equalization payments while others do not.
- The Equalization payments a province receives from the federal government are unconditional; they have no strings attached. Provinces have complete discretion as to how they use the funds to provide public services to their residents.
- Equalization does not take the different expenditure needs of provinces into account. The formula that was developed over the years measures a province's fiscal capacity to deliver public services, but does not take into account a range of factors (except for the size of a province's population) that would affect the volume or costs of public services in different provinces.
- Equalization is only designed to raise provinces up to a common standard. Provinces with fiscal capacities above the common standard do not see any reductions as a result of Equalization.
- Equalization is designed to fill the gap between a province's own fiscal capacity and a common standard across the country. It was not designed as a permanent entitlement. As a province's wealth increases, the principle is that it should receive less money in Equalization payments and none whatsoever if its fiscal capacity is above the common standard. As a result, the amount provinces have received has moved up and down. Since the program was initiated, three provinces (British Columbia, Alberta, and Saskatchewan) have actually moved in and out of the Equalization program.

[6] Marchildon, G.P. (Fall 2005). *Understanding Equalization: Is it Possible*? Canadian Public Administration, vol. 48, no. 3, p. 420.

Tracing the history

Several books and articles have been written tracing the history of Equalization and changes in fiscal arrangements throughout Canada's history. For the purposes of this report, we'll only highlight the origins of the program and some of the major changes that have taken place leading up to the present day.

Equalization's roots can be traced back to the Rowell-Sirois Royal Commission Report in 1940. Following Canada's Great Depression, when three prairie provinces were virtually bankrupt, the Commission recommended that the federal government set up a program to provide grants to provinces based on their fiscal needs. The Second World War pre-empted action on the Royal Commission recommendations but, in the 1950s, the federal government turned its attention to the issue once again.

The roots of Canada's Equalization program date back to the 1940s. The first formula-driven approach was established in 1957.

The first formula-driven Equalization program was established in 1957. Under that program, provinces received a grant from the federal government if their per capita revenue from personal income tax, corporate income tax, and inheritance taxes was less than what the two richest provinces of the day (Ontario and British Columbia) could raise at the same tax rates. The program was to be reviewed every five years.

Between 1962 and 1967, the program was changed to include half of natural resource revenues as the fourth tax base in the formula. The standard of the two richest provinces was also changed to a 10-province or national average standard.

Several key changes took place over the next twenty years. The number of different types of revenues included in the formula grew from the original three to 29. This resulted in a more comprehensive approach with more detailed measures but also added to the complexity of the program. Also, during that time, substantial increases in oil prices drove up the revenues of oil-producing provinces, especially Alberta. With a 10-province standard in place, the impact on Equalization was to drive up the national average and the costs to the federal government of providing Equalization grants to receiving provinces. Consequently, many of the adjustments made to the program were focused primarily on reducing the overall impact of provincial natural resource revenues and containing costs for the federal government.

Successive changes to Equalization have added layers of complexity to the program.

In 1982, a number of significant changes were made. First and foremost, Equalization became part of Canada's Constitution. Second, the standard was changed. Instead of a national average or 10-province standard, a five-province standard was introduced based on the average of Québec, Ontario, Manitoba, Saskatchewan, and British Columbia. This new standard excluded the highs and the lows in fiscal capacity of the provinces (taking out oil-rich Alberta and the less-wealthy Atlantic provinces) and focused instead on the middle range of provinces. This reduced the costs to the federal government of including 100 percent of resource revenues in the Equalization formula.

From 1982 to 2004, the program remained largely the same in its basic approach. But the formula became increasingly complex through a series of technical adjustments discussed by federal and provincial officials or added at the discretion of the federal government. New tax bases were added (particularly in relation to resource revenues), ceilings and floors on the total amount of Equalization were added, and adjustments were made in how provinces' revenues were estimated and payments were made.

In the mid 1980s, the federal government entered into specific agreements with both Newfoundland and Labrador and Nova Scotia in relation to their offshore resources. These agreements (*Canada-Nova Scotia Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing* [1982] and *Canada-Newfoundland and Labrador Agreement on Offshore Oil and Gas Resource Management and Revenue Sharing* [1985]) provided for time-limited, partial compensation for any reductions in Equalization payments to these two provinces as a result of increasing revenues from offshore developments. In effect, the Accords meant that the two provinces would receive separate offsetting payments from the federal government if increasing revenues from offshore developments led to decreases in their Equalization payments.

In February 2005, new Offshore Accords (*Arrangement between the Government of Canada and the Government of Newfoundland and Labrador on Offshore Revenues, 2005* and *Arrangement between the Government of Canada and the Government of Nova Scotia on Offshore Revenues, 2005*) were signed with the two provinces. Those Accords extend protection to 2012 and provide full compensation for any reductions in Equalization payments as a result of increased revenues from offshore developments. Generally speaking, in order to qualify for the full offset payments (made outside of the Equalization program) and a potential extension to 2020, the two provinces would have to continue to qualify for Equalization and continue to have a higher-than-average per capita net debt burden. Both provinces received guaranteed advance payments of a part of the benefits they were expected to receive over the first eight-year term of the 2005 Accords.

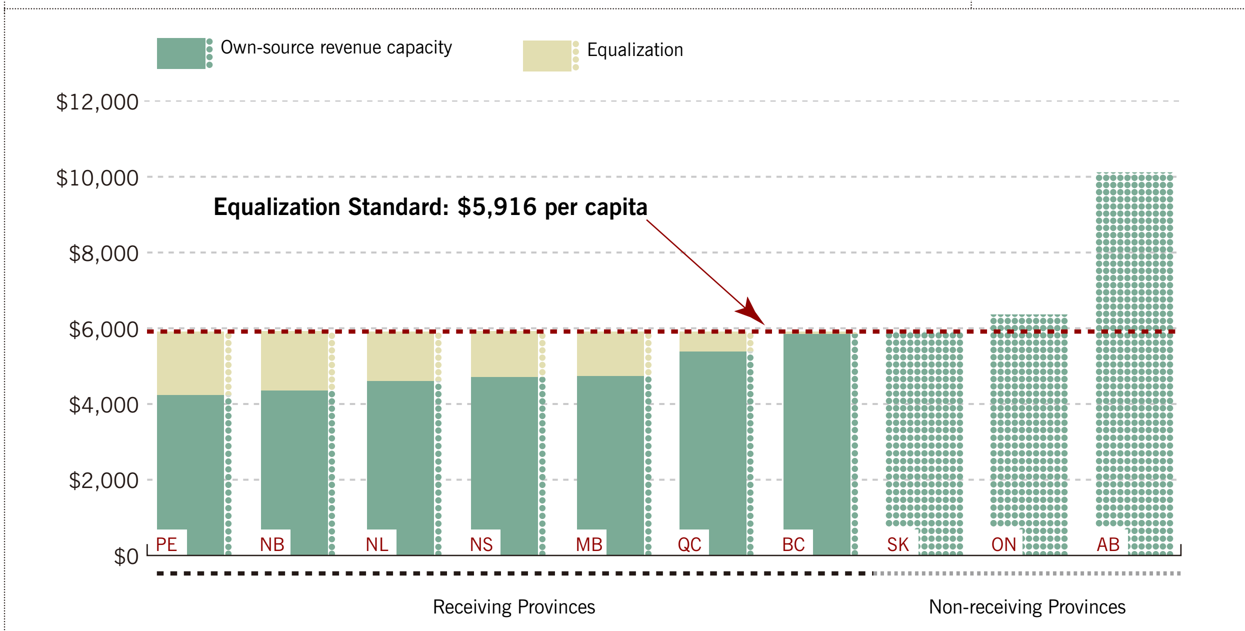
The impact of these Accords on the Equalization program is controversial. Both Newfoundland and Labrador and Nova Scotia contend that the Accords have nothing to do with Equalization and are intended to support economic development and debt reduction in the two provinces. On the other hand, others have argued that these so-called “side deals” have broken the fundamental, underlying nature of the Equalization program and opened the door to calls for similar deals with other provinces.

Equalization: Then and Now

For the purposes of this report, it’s important to look at how the Equalization program worked before and after major changes were made in 2004.

Before 2004, Equalization payments were driven by a complex but consistent formula. The formula determined both the overall amount the Equalization program would pay out to receiving provinces and the amount each province would receive.

FIGURE 1 – How Equalization has Worked
Per Capita Fiscal Capacity and Equalization Entitlements for 2003–04



Source: Finance Canada

The formula measured the per capita fiscal capacity of provinces using the Representative Tax System (RTS). The RTS measures the amount of money provinces could raise from 33 different tax bases if they taxed those bases at national average tax rates. A province's fiscal capacity on each of the 33 bases was then summed up and compared to a five-province average standard. If the formula determined that a province's overall fiscal capacity across all of the tax bases combined was below the standard, that province received an Equalization grant to bring it up to the common standard.

With the formula still in place, Equalization payments had started to decline from their highest peak of $10.9 billion in 2000–01 to an expected level of $8.9 billion in 2004–05. This was due to the combined impact of a slow-down in Ontario's economy and tax reductions in several provinces.

At the same time, the financial position of the federal government had improved dramatically and resulted not only in balanced budgets but also unanticipated surpluses. A number of federal transfer programs had been reduced by a substantial amount in the mid 1990s and provincial pressures were mounting to increase Equalization as well as other transfers, particularly in the case of health care.

The New Framework, introduced in October 2004, fundamentally changed how Equalization works.

In response, a New Framework for both Equalization and TFF was announced at a First Ministers' Meeting in October 2004. Under the New Framework:

- The formula is no longer used to determine the overall amount of funding to be allocated for Equalization and TFF. Instead, a fixed pool of funds was set in legislation.
- The pool of funds to be available for Equalization was set at a minimum of $10 billion for 2004–05, effectively stopping the decline in Equalization payments.
- Each province was guaranteed that its Equalization entitlements would not be lower than the amount announced for 2004–05 and included in the 2004 federal budget.
- A guaranteed growth rate of 3.5 percent per year was set in legislation, ensuring that the overall pool of funds available for Equalization would continue to increase over 10 years.
- Fixed shares for receiving provinces were set out in advance for the first two years of the New Framework, replacing the normal operation of the Equalization formula with a negotiated allocation.

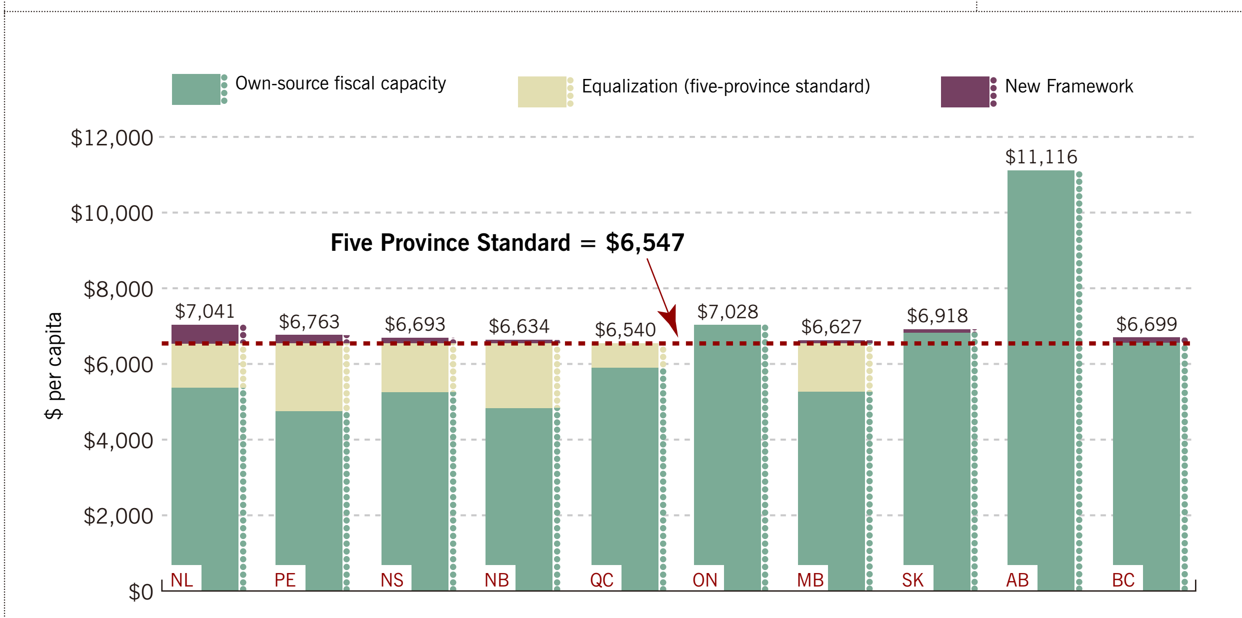
- The allocation in the New Framework was legislated on an interim basis pending the outcomes of the Panel's work and the development of a new allocation method.
- On November 8, 2005, the federal government announced that the same approach would be extended to determine Equalization entitlements for 2006–07.

There are some important implications of this New Framework.

The interim allocation does not have a common standard to which all provinces are compared and raised. Instead, the standard varies for individual provinces depending on their former shares (over the last three years) of total Equalization funding, regardless of changes in their relative fiscal capacity. As a result, some receiving provinces receive more and others less than they would have if the previous Equalization formula had been applied.

- As Figure 2 shows, in 2005–06, with the exception of Québec, the per capita fiscal capacities of the receiving provinces were higher under the New Framework than they would have been under the former five-province standard.

FIGURE 2 — Fiscal Capacity and Equalization under the New Framework (2005–06)



Source: Finance Canada

- The New Framework results in Newfoundland and Labrador having a higher fiscal capacity after Equalization than Ontario (even without the Offshore Accords being taken into account).
- Because the total Equalization pool is fixed in advance, changes in one province's fiscal capacity, up or down, will have a direct impact on the amounts other provinces receive.
- The New Framework guarantees a known and growing amount of funds for Equalization. In this way, it improves stability and predictability, particularly for the federal government. On the other hand, the shares each province receives under the New Framework are not necessarily any more stable or predictable than they were in the past.

Assessing Equalization

In the past year, serious questions have been raised about the purpose of Equalization, whether that purpose is being achieved, and how the impact of Equalization can or should be measured. In view of that, it's important to address several key questions.

What purpose is Equalization intended to serve?

Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

- Section 36(2)
The Constitution Act, 1982

As noted earlier, the Equalization program is enshrined in Section 36(2) of Canada's Constitution. The section specifically identifies the purpose of ensuring reasonably comparable levels of public services at reasonably comparable levels of taxation.

The section in the Constitution specifically related to Equalization is preceded by Section 36(1) which outlines commitments on behalf of both the federal and provincial governments.

While both sections outline commitments to fairness in opportunities and public services across the country, it's not clear whether, or to what extent, the sections are linked. Some have suggested that the two sections both apply to Equalization and complement one another. Others have said the effectiveness of Equalization should be measured by its impact on creating equal opportunities, reducing disparities among provinces, promoting economic development, or ensuring a certain quality of public programs. That implies that Equalization is intended to serve the specific purposes outlined in Section 36(1). Still others have suggested that Equalization has hampered economic development in receiving provinces by encouraging dependency on payments from the federal government.

Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to

a. promoting equal opportunities for the well-being of Canadians;

b. furthering economic development to reduce disparity in opportunities; and

c. providing essential public services of reasonable quality to all Canadians.

- Section 36(1)
The Constitution Act, 1982

The Panel's view is that the purpose of Equalization is a broad national purpose outlined simply and clearly in Section 36(2). It is not intended as an economic development tool nor is it designed to ensure that common standards in quality or outcomes in public services are achieved. Instead, its focus is on making sure all provinces have the fiscal capacity to deliver reasonably comparable education, health care, social services, roads, and transportation services to their residents at reasonably comparable levels of taxation – period.

Furthermore, Equalization is uniquely designed to reflect the Canadian reality where provinces have considerable autonomy and responsibility for the vast majority of public services including education, health, and social services. It is not designed to interfere in that autonomy or to influence policy decisions made by provincial governments. It simply enables less wealthy provinces to deliver reasonably comparable public services to their residents. Provinces are accountable to their residents for the decisions they make and the services they deliver, while the federal government is accountable for determining how much money it will provide to the Equalization program and how that money will be allocated among the provinces.

Equalization is uniquely designed to reflect the Canadian reality where provinces have considerable autonomy and responsibility for the vast majority of public services.

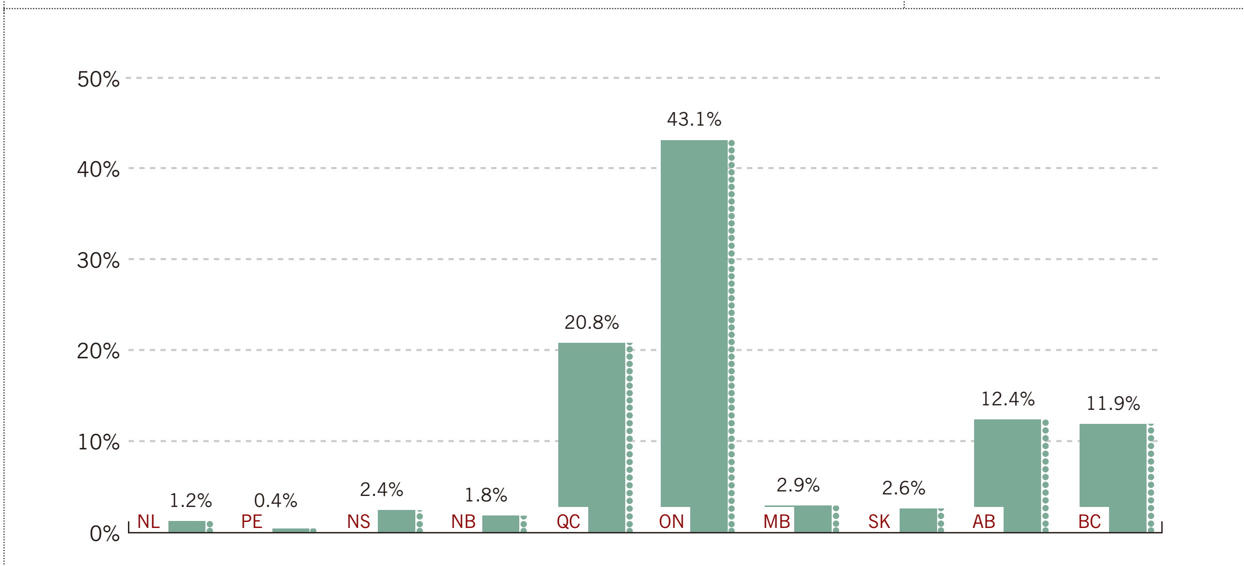
Who pays for Equalization?

As noted earlier, Equalization is paid for by the federal government with taxes raised from Canadian taxpayers across the country. Because Ontario has the largest population in the country and higher-than-average incomes, Ontario taxpayers generate about 43 percent of federal revenues. Correspondingly, as Figure 3 shows, they "pay" for about 43 percent of the

Equalization is paid for by the federal government with taxes raised from Canadian taxpayers across the country.

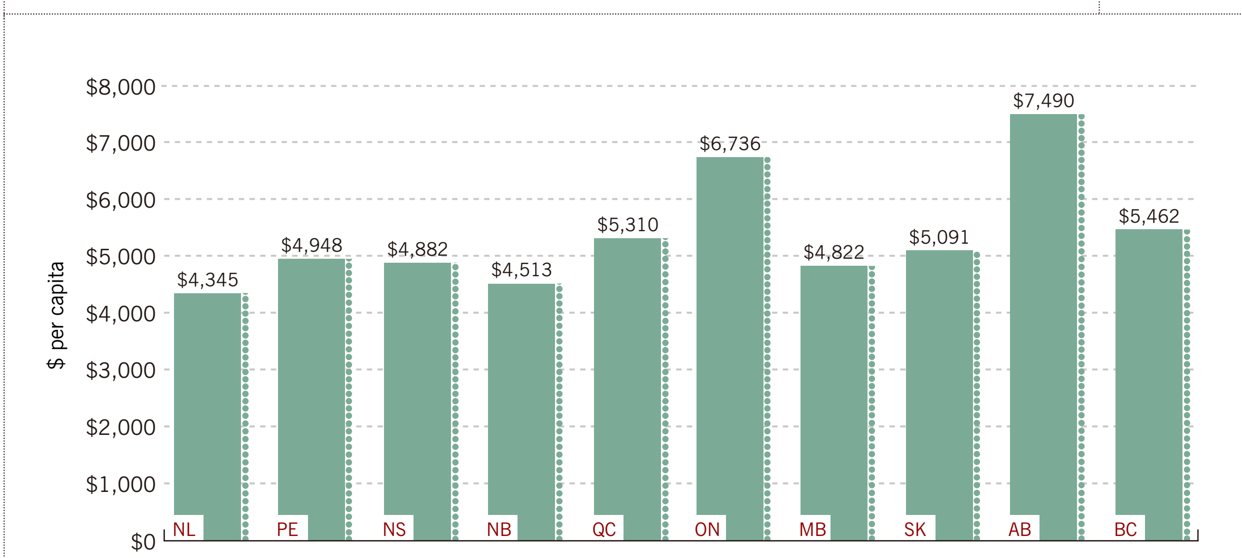
costs of the Equalization program compared with just under 21 percent coming from Québec taxpayers. As Figure 4 shows, on a per capita basis, Alberta taxpayers contribute the highest amount to total federal revenues, followed by taxpayers in Ontario and British Columbia.

FIGURE 3 – Percentage of Federal Revenues Collected in each Province (2003)



Source: Statistics Canada: Provincial Economic Accounts

FIGURE 4 – Per Capita Revenues Collected in each Province by the Federal Government (2003)



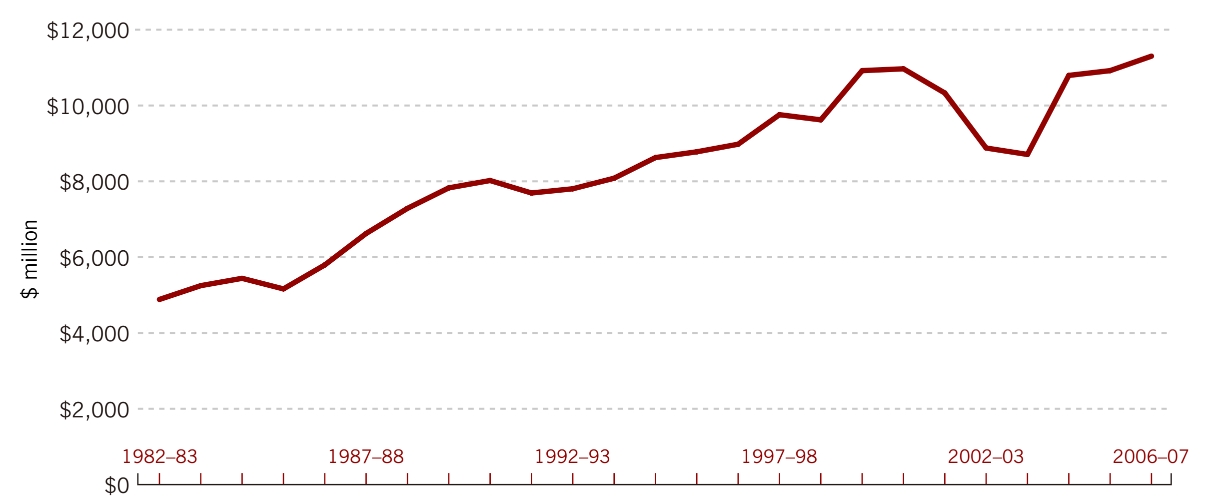
Source: Statistics Canada: Provincial Economic Accounts

How big a program is Equalization for the federal government?

Information in the following tables suggests that Equalization is a relatively small program in comparison with all other spending by the federal government.

Total federal government spending on the Equalization program has grown from just under $4 billion in the early 1980s to about $11 billion in 2005–06 (see Figure 5). The October 2004 New Framework established a new base for Equalization at almost its highest level since the program was introduced. Unlike the past, where Equalization fluctuated up and down in response to changing circumstances, the New Framework also established an automatic rate of annual growth in overall spending on Equalization.

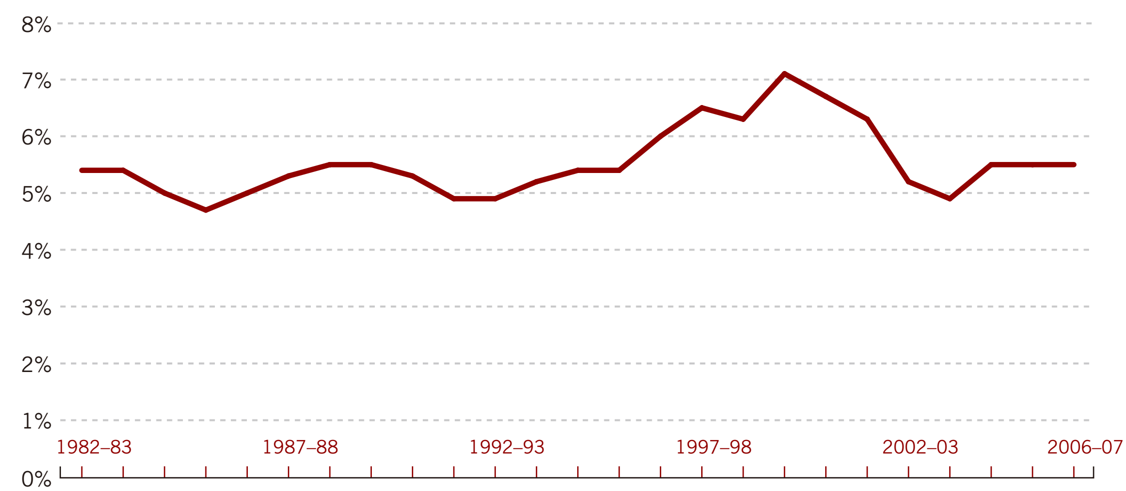
FIGURE 5 – Total Equalization Entitlements (1982–83 to 2006–07)



Source: Finance Canada

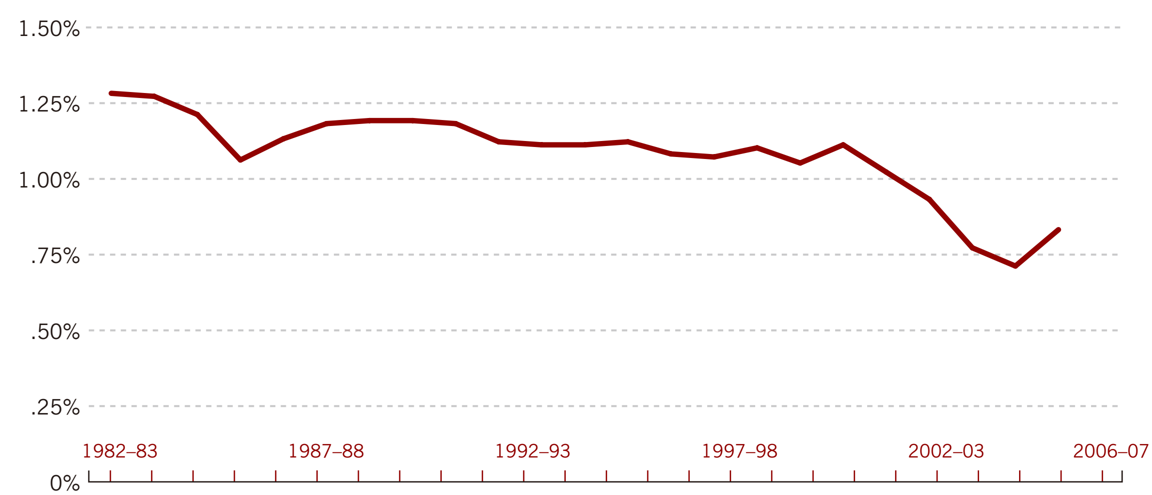
As a proportion of total federal government spending, Equalization has ranged from a low of 4.7 percent in 1985–86 to a high of 7.1 percent in 1999–2000. For the current fiscal year (2006–07), Equalization makes up 5.5 percent of the federal government's total spending (see Figure 6). As Figure 7 shows, Equalization has declined to less than 1 percent of Gross Domestic Product (GDP) by 2005–06. In terms of overall transfers from the federal government to provinces, Equalization currently makes up just over a quarter (26 percent) of all transfers.

FIGURE 6 – Equalization Entitlements as a Percentage of Federal Expenditures (1982–83 to 2006–07)



Source: Finance Canada, Public Accounts and Federal Budget documents

FIGURE 7 – Equalization as a Percentage of Gross Domestic Product (GDP) (1982–83 to 2005–06)

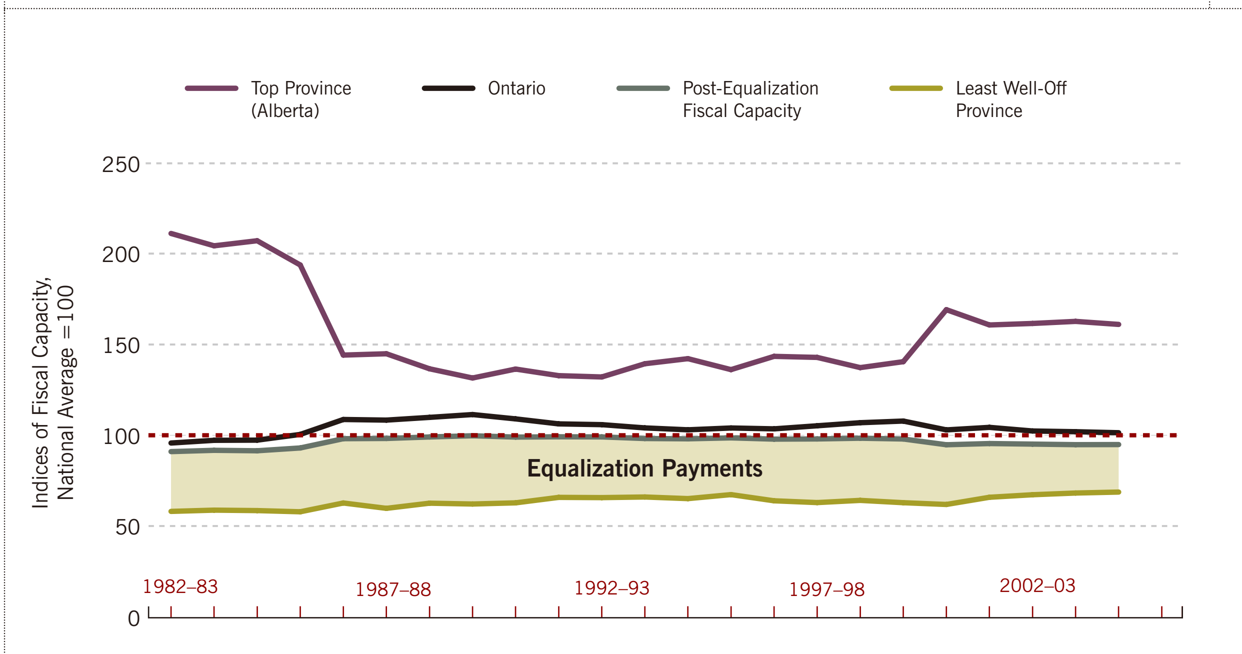


Source: Finance Canada, Statistics Canada: National Accounts

Does Equalization help reduce fiscal disparities among provinces?

Since the 1980s, there have been significant fiscal disparities among the most and the least well-off provinces. As Figure 8 shows, Equalization has helped to narrow the gap. Without Equalization payments, the fiscal capacity of the least well-off province was between 58 and 68 percent of the national average. With Equalization payments, the fiscal capacity of that province was raised to between 91 and almost 100 percent of the national average.

FIGURE 8 – Contribution of Equalization to Reducing Inter-Provincial Disparities (1982–83 to 2004–05)



Source: Finance Canada

How important are Equalization payments to the provinces that receive them?

Equalization allocations to individual provinces have changed over time. Ontario has never qualified for Equalization and Alberta has not received Equalization payments since the early 1960s. Saskatchewan and British Columbia have seen substantial year-to-year variations in Equalization payments. Most other receiving provinces have consistently relied on Equalization for significant amounts of money.

TABLE 1 – Equalization Entitlements (1993–94 to 2006–07)

	$ millions										
YEAR	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
1993–94	900	175	889	835	3,878	0	901	486	0	0	**8,063**
1994–95	958	192	1,065	927	3,965	0	1,085	413	0	0	**8,607**
1995–96	932	192	1,137	876	4,307	0	1,051	264	0	0	**8,759**
1996–97	1,030	208	1,182	1,019	4,169	0	1,126	224	0	0	**8,959**
1997–98	1,093	238	1,302	1,112	4,745	0	1,053	196	0	0	**9,738**
1998–99	1,068	238	1,221	1,112	4,394	0	1,092	477	0	0	**9,602**
1999–00	1,169	255	1,290	1,183	5,280	0	1,219	379	0	125	**10,900**
2000–01	1,112	269	1,404	1,260	5,380	0	1,314	208	0	0	**10,948**
2001–02	1,055	256	1,315	1,202	4,679	0	1,362	200	0	240	**10,310**
2002–03	875	235	1,122	1,143	4,004	0	1,303	106	0	71	**8,859**
2003–04	766	232	1,130	1,142	3,764	0	1,336	0	0	320	**8,690**
2004–05	762	277	1,313	1,326	4,155	0	1,607	652	0	682	**10,774**
2005–06	861	277	1,344	1,348	4,798	0	1,601	82	0	590	**10,900**
2006–07*	687	280	1,379	1,432	5,354	0	1,690	0	0	459	**11,282**

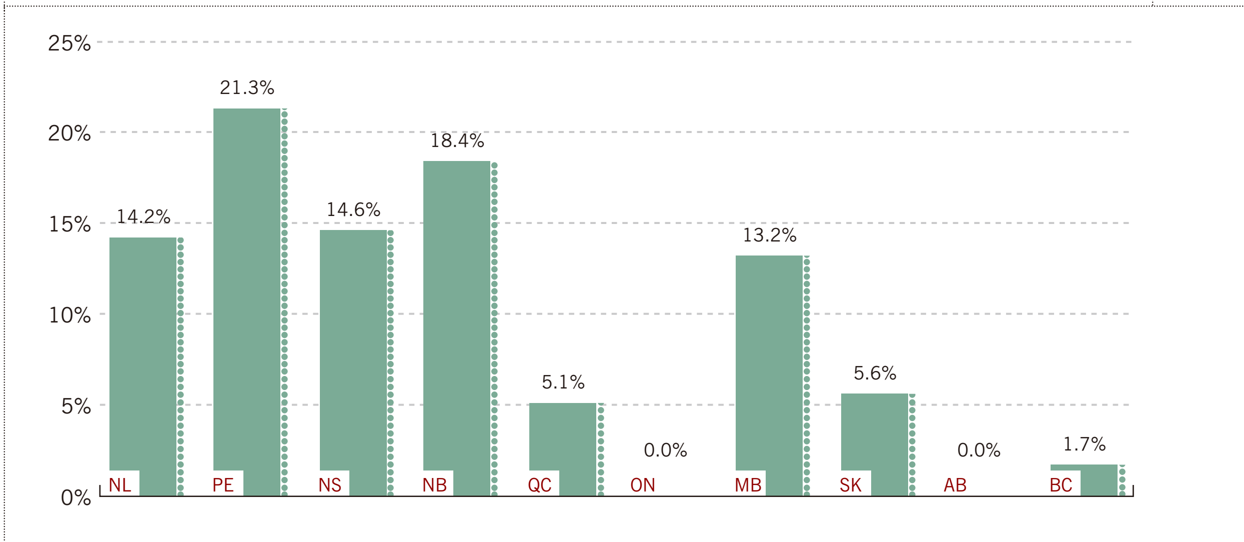
* As announced by the federal Minister of Finance in November 2005

Note: Totals may not add due to rounding.

Source: Finance Canada

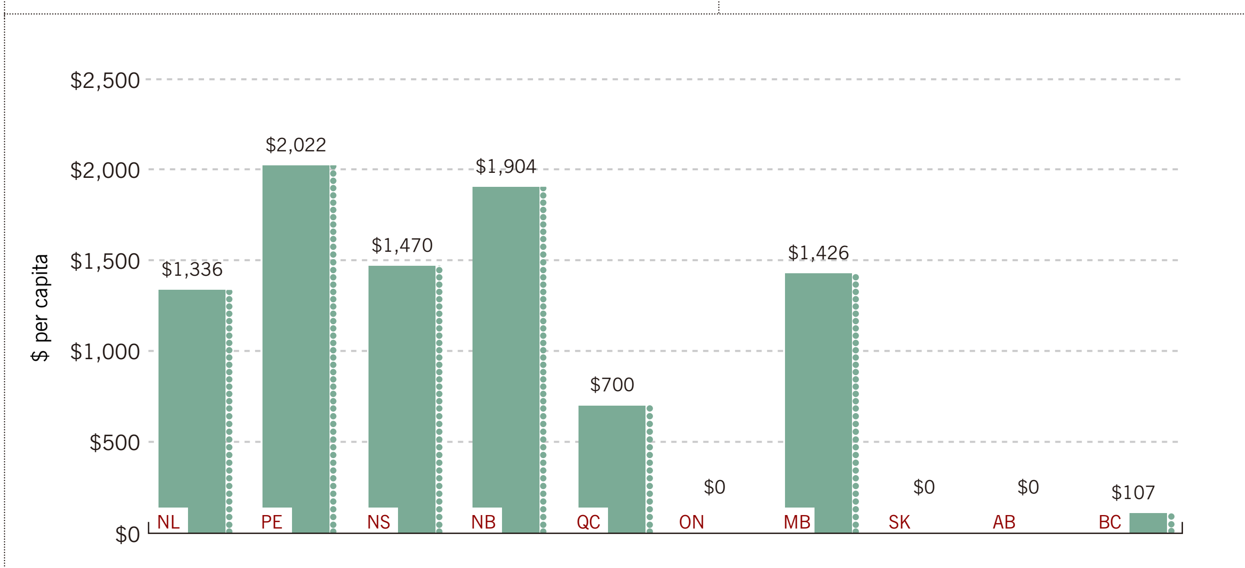
Equalization payments clearly are an important source of revenue for receiving provinces. The impact varies across the receiving provinces. In 2004–05, for example, Equalization made up just over five percent of provincial and local revenues in Québec, while the proportion was over 21 percent in Prince Edward Island (see Figure 9). On a per resident basis, in 2006–07 Equalization payments are expected to range from $107 per person in British Columbia to $700 per person in Québec and over $2,000 per person in Prince Edward Island (see Figure 10).

FIGURE 9 – Equalization as a Percentage of Provincial and Local Government Revenues (2004–05)



Source: Finance Canada, Statistics Canada: Financial Management System

FIGURE 10 – Equalization Entitlements Per Capita (2006–07)



Source: Finance Canada

"The Equalization Program contributes ... 22.1% of revenues in New Brunswick, in 2005–06. To put into context what this means to New Brunswick, equalization funding represents nearly 75% of total spending in the Department of Health and Wellness; it exceeds the province's $1.2 billion budget for education and postsecondary education; and it exceeds the amount of revenues that the province derives from personal and corporate income taxes and capital taxes combined."

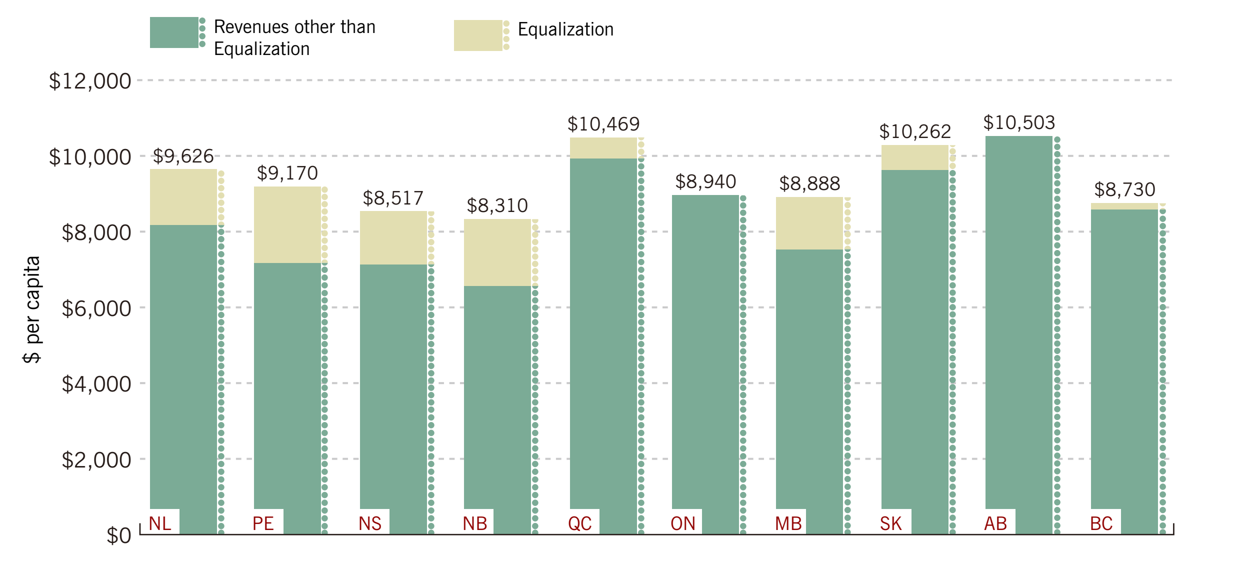
- Hon. Jeannot Volpé
  Minister of Finance,
  New Brunswick [7]

Does Equalization help provinces provide reasonably comparable services?

Because of the nature of Canada's federation and the substantial amount of provincial autonomy, there are few consistent and comparable measures of public services across the country. Furthermore, it's important to remember that Equalization is only intended to bring receiving provinces' fiscal capacity up to a certain standard. Beyond that, provinces can decide to tax more or incur debt to pay for services to their residents. As noted earlier, provinces can choose the nature and level of public services they will provide along with how those services are funded.

We know, however, that provincial program spending (the amount of money provinces spend on delivering public services) ranges from a high of $10,503 per person in Alberta to a low of $8,310 per person in New Brunswick (for 2004–05), a range of slightly more than $2,000 per person. This is a much smaller range than the differences in fiscal capacities among the provinces. Without Equalization payments, the gap in fiscal capacity between the lowest province (Prince Edward Island) and highest (Alberta) was over $6,000 per person.

FIGURE 11 — Provincial and Local Government Program Expenditures Per Capita by Sources of Finance (2004–05)



Source: Finance Canada, Statistics Canada: Financial Management System

[7] Volpé, J. (July 2005). Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 5.

This suggests that Equalization is closing a large part of the gap among provinces and going a long way to achieving its goal of “reasonable” comparability.

As Figure 11 shows, in all provinces the majority of the costs of public services are paid for by their own sources of revenues other than Equalization payments. However, in several of the receiving provinces, the absence of Equalization payments would make it difficult for them to deliver reasonably comparable public services to their residents.

ACHIEVING A NATIONAL PURPOSE: *Putting Equalization Back on Track*

IDENTIFYING THE ISSUES

Throughout its consultations, Panel members listened to a wide range of opinions and ideas about Equalization and how it should be changed for the future.

While it's difficult to summarize the wide range of opinions and suggestions, the following provides highlights of the key themes and issues identified through the process. Copies of submissions and summaries of roundtable discussions are available on the Panel's website.

Most want to see the program put back on track, not abandoned.

Improve the Equalization program, don't abandon it

While there continues to be strong support for the purpose and principles underlying Equalization, some commentators and analysts have called the program into question, with comments ranging from the lack of performance measures to assess its effectiveness to concerns that it is counterproductive, reduces Canada's productivity, creates "welfare provinces," and establishes a permanent sense of entitlement to Equalization. These are growing concerns and important questions to address. At the same time, all provinces, whether they receive Equalization payments or not, continue to be strong supporters of the program, as are most academics and experts. Most want to see the program put back on track, not abandoned.

"The notion of 'sharing' has virtues, but fiscal arrangements should not maintain poorer provinces in a state of splendid dependence."

- Bruce Winchester[8]

Return to a principle-based, formula-driven approach

The Panel consistently heard concerns about what many saw as an increasingly ad hoc approach to Equalization. People pointed in particular to the introduction of the New Framework and the "side deals" with Newfoundland and Labrador and Nova Scotia. There may be concerns with the details of the formula but the majority of people preferred a return to a formula-driven approach to provide greater stability and credibility for the program. The majority also supported maintaining the current RTS for assessing fiscal capacity rather than moving to macroeconomic indicators like Gross Domestic Product (GDP). Although there was support for simplification, accuracy, and fixing problem areas, most suggested that the basic RTS approach works well and should not be replaced.

"Formulas are better than petty politics."

- Dr. Craig Brett and Dr. Frank Strain[9]

8 Winchester, B. (2005). Submission to the Expert Panel on Equalization and Territorial Formula Financing from the Atlantic Institute for Market Studies, p. 4.

9 Brett, C. & Strain, F. (June 2005). *Nine Theses on Equalization*. Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 2.

"... the announcement of a new framework for equalization instead of providing the intended stability and predictability for the provinces, seems to have opened up a Pandora's box and unleashed long pent up regional tensions."

- France St-Hilaire[10]

Replace the concept of a fixed pool included in the New Framework

The vast majority of provinces, academics, and experts did not support the New Framework, particularly the concept of a fixed pool with a fixed annual rate of increase. They preferred a return to a formula to set the overall size of the pool even though this could result in greater year-over-year uncertainty about the size of the total pool. Receiving provinces, in particular, were concerned that the fixed pool shifted more risks to provinces and introduced new dynamics among the provinces sharing in a single, fixed pot. Concerns were also raised that the 3.5 percent rate for annual increases in the Equalization program was an arbitrary amount that doesn't necessarily reflect changes in fiscal disparities among the provinces.

"The recent move to replace a formula-driven process by establishing an arbitrary, though escalating, 'pot' is an understandable but unworthy decision."

- Donald G. Dennison[11]

Introduce a 10-province standard

The majority of provinces and many academics supported a 10-province standard. They argued that, while the five-province standard introduced in the mid 1980s reduced the federal government's overall costs, a 10-province standard is consistent with the principles of Equalization and should be established as the target. Ontario objects to the 10-province standard because it increases the overall costs of the Equalization program, which increases the burden on Ontario taxpayers who pay a substantial proportion of all federal taxes.

"Returning to a 10-province standard would more accurately measure provincial fiscal capacities and better achieve the Constitutional commitment of the federal government."

- Honourable Greg Selinger
Minister of Finance,
Manitoba[12]

Find a better way of dealing with resource revenues

When we say "find a better way," that's not to suggest that there was agreement on what that "better way" would be. In fact, of all the issues involved in Equalization, the treatment of resource revenues is the most controversial. Opinions ranged from 100 percent inclusion of resource revenues in the formula to complete exclusion. In the words of Thomas Courchene, treatment of resource revenues is "a theoretical and empirical minefield," an issue that "one copes with rather than solves."[13] From an

[10] St-Hilaire, F. (May 2005). *Fiscal Gaps and Imbalances: The New Fundamentals of Canadian Federalism*, p. 2.
[11] Dennison, D.G. Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 3.
[12] Selinger, G. (July 2005). Presentation to the Expert Panel on Equalization and Territorial Formula Financing, p. 7.
[13] Courchene, T. Quoted by James Feehan in *Canadian Fiscal Arrangements*, by Harvey Lazar (ed.), p. 185.

academic perspective, concerns were expressed about the current RTS approach to measuring resource revenues, the increasing complexity this causes, and the challenges involved in getting accurate data. Alternative suggestions included developing new measures of economic rent, introducing macro measures as a proxy for resource revenues, or measuring only actual revenues collected and used by provinces to support public services.

Addressing provincial expenditure needs in Equalization may add too much complexity

"... unlike with revenue equalization, the notion of comparable levels of public services is inherently very difficult to measure."

- Robin Boadway[14]

To date, the Equalization program has focused only on measures of fiscal capacity with no attempts to measure or assess variations in expenditure needs across the provinces. Most provinces support this direction and are concerned that addressing needs would add further complexity to an already complex program. It also could result in indirect intrusions by the federal government into decisions that are the responsibility of provinces. Others said that needs should be taken into account in targeted transfers to provinces such as the Canada Health Transfer or the Canada Social Transfer, but not for general purpose transfers such as Equalization payments. On the other hand, some provinces and experts argued that there are real differences in needs that are not adequately captured in the Equalization program. They suggested that the idea of assessing needs deserved further study.

Provide more stability and predictability

While receiving provinces are primarily concerned with the adequacy of Equalization, they also expressed concerns particularly with the predictability of Equalization payments. Because of the use of several estimates and adjustments, some receiving provinces have experienced substantial drops in the amount of Equalization they receive as a result of changes in data. These shocks can occur up to three and a half years after their original entitlement was determined. In terms of stability, provinces suggest that Equalization should respond to changes in their fiscal capacity over time, but they prefer to have smoothing or "averaging" mechanisms in place so there aren't dramatic changes on a year-to-year basis.

[14] Boadway, R. (June 2005). *Evaluating the Equalization Program – Notes for the Expert Panel*, Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 21.

Improve the current process rather than introducing a permanent independent body

The Panel was specifically asked to consider whether an independent body should be set up to provide ongoing advice to the Government of Canada on Equalization and TFF and to conduct periodic reviews. The majority of provinces indicated there was no need for such a body. While there is room for improvement in the current intergovernmental process, most preferred that process to an arms-length body similar to the one currently in place in Australia. Those who supported an independent body saw it as an opportunity to prevent political deal-making, to address issues in a more open and transparent way, and to undertake ongoing research on key issues related to Equalization.

"While most observers, myself included, consider this program an important part of the glue that binds Canadians to one another, there are dangers in having the negotiations that surround the program turn into a bargaining bazaar that is too remote from its original public purpose and the related constitutional provisions that help to give the program its legitimacy."

- Harvey Lazar[15]

Improve transparency, awareness, and understanding of Equalization

As noted earlier in this report, few Canadians and only a smattering of finance officials and academics understand the inner workings of the Equalization program. Furthermore, there is very little public education or focus on Equalization at either the federal or provincial levels—until and unless there are problems. This raises concerns that what gets ignored can diminish in value and importance to Canadians, particularly if federal-provincial negotiations take place exclusively behind closed doors and all they hear are problems with the program or squabbles between governments.

[15] Lazar, H. (2005). *Canadian Fiscal Arrangements: What Works, What Might Work Better*. p. 29.

PUTTING EQUALIZATION BACK ON TRACK

PUTTING EQUALIZATION BACK ON TRACK

There is no perfect solution for Equalization in Canada. That's the reality the Panel faced.

Given the dynamics of Canada's federation and the strong differences among the financial situations and preferences of individual provinces, not to mention the expectations of the federal government, perfection will undoubtedly continue to elude all of us.

Nonetheless, the Panel has pursued the goal of developing a sound and effective Equalization program for Canada. To achieve that goal, we reviewed all of the various issues and options in detail, not only in principle, in theory or in concept, but from a thorough technical perspective. This level of technical analysis proved to be time consuming but essential. Often we have found ideas that, while promising in principle, have consequences for provinces and for the Equalization program as a whole that are simply not acceptable.

The Panel has pursued the goal of developing a sound and effective Equalization program for Canada. To achieve that goal, we reviewed all of the various issues and options in detail, not only in principle, in theory or in concept, but from a thorough technical perspective.

What follows, then, is a balanced package of recommendations designed to put Canada's Equalization program back on track and to establish a solid and sustainable foundation for the future.

Recommendations

Starting with principles

In developing recommendations for the future of Canada's Equalization program, the Panel has been guided by a set of principles, some of which have been in place for some time and others which are new.

> **1. A CLEAR SET OF PRINCIPLES SHOULD BE ADOPTED TO GUIDE FUTURE DEVELOPMENT OF THE EQUALIZATION PROGRAM IN CANADA.**

Consistency with Canada's Constitution
The design and implementation of the Equalization program should be consistent with and support the national purpose outlined in section 36(2) of Canada's Constitution.

Fairness
Canada's Equalization program should provide equitable and consistent treatment for all provinces. The "rules of the game" should be embodied in an Equalization formula that applies equally to all provinces.

Adequacy and responsiveness
The Equalization program should provide sufficient revenues to receiving provinces to allow them to meet the goal of providing reasonably comparable public services at reasonably comparable levels of taxation. The program also should be robust enough to respond to changes in provinces' financial situations and to preclude the need for separate agreements with individual provinces.

Policy neutrality and sound incentives
The Equalization program should respect the autonomy of provinces in making decisions on behalf of their residents. It should have sound incentives and not cause provinces to make decisions that they would not make if the Equalization program were not in place.

Equity among receiving and non-receiving provinces
While the objective of Equalization is to increase the fiscal capacity of less wealthy provinces, it should not bestow benefits on receiving provinces that put them in a stronger financial position than provinces that do not receive Equalization payments.

Simplicity
Equalization, by its very nature, will remain a complex program. However, expectations for accuracy and comprehensiveness should not be used to add excessive complexity to the program.

Transparency
Steps should be taken to improve awareness and understanding of the program and to clarify how decisions are made and how the program operates.

Predictability and stability
Although Equalization should be responsive to changes in provinces' financial circumstances, it should be designed to avoid unnecessary shocks and to provide reasonable stability and predictability for both the provinces and the federal government.

Affordability
The Equalization program must be affordable and sustainable over time. The federal government is responsible for determining how much it will spend to achieve the goals of the Equalization program.

Accountability
Given that Equalization is a federal program paid for by Canadian taxpayers, the federal government should be accountable for the overall operation of the program and the allocation to individual provinces. Provinces are accountable to their residents in terms of how Equalization funds are used.

Returning to a rules-based, formula-driven approach

If there was one consistent message the Panel heard throughout its consultations, it was the need to return to a rules-based, formula-driven approach. Rightly or wrongly, provinces and many academics perceive that the former rigour of the Equalization program has been replaced by more ad hoc, one-off decisions with individual provinces and on individual issues.

Therefore, the Panel recommends that:

2. A RENEWED EQUALIZATION FORMULA SHOULD BE DEVELOPED AND USED TO DETERMINE BOTH THE SIZE OF THE EQUALIZATION POOL AND THE ALLOCATION TO INDIVIDUAL PROVINCES.

The Panel understands that the New Framework introduced by the federal government in October 2004 has some distinct advantages, particularly because it provides certainty about how much will be allocated to the Equalization program on an annual basis. However, there are serious concerns with the approach. Provinces argue that it increases stability and predictability for the federal government but not for the receiving provinces. Their shares of the fixed pot could go up or down based on factors completely outside their own province's control, particularly if there are changes in the economic situation of other receiving provinces.

There also is a sense that the concept of a fixed pool runs counter to the fundamental nature of Equalization—that it is intended to respond to changes in fiscal capacity of the provinces, rather than acting as a fixed entitlement over time. Establishing a fixed pool with a growth track divorces the Equalization program from the actual financial situation in provinces and the overall need for Equalization over time.

3. A 10-PROVINCE STANDARD SHOULD BE ADOPTED.

The vast majority of provinces and many academics recommend adoption of a 10-province standard. The Panel agrees.

"At first glance, the move to a fixed pool of equalization funds under the 2004 New Framework appears likely to improve stability. But this view rests on a fundamental misconception: the goal should be stability in receiving provinces' net revenues and not in Equalization transfers themselves. The goal should therefore be transfers that are highly responsive to changes in a receiving province's own fiscal capacity, not to extraneous events."

- Michael Smart[16]

"If the federal government first establishes its financial commitment [to Equalization] and then determines a means of allocating this funding among provinces, we limit the possibilities to determine a fair allocation and create a beggar-thy-neighbour mentality among provinces."

- Government of Saskatchewan[17]

[16] Smart, M. (July 2005). *Some Notes on Equalization Reform*. Submission to the Expert Panel on Equalization and Territorial Formula Financing. p. 7.

[17] Government of Saskatchewan (March 2005). Submission to the Standing Senate Committee on National Finance, Senate of Canada, p. 5.

Over the years, a variety of different standards have been used in the Equalization program (see Annex 2 for more information). Some experts and academics suggest that the choice of a standard is ultimately a political choice reflecting Canadians' values and the extent to which they want to see disparities among provinces addressed through a program like Equalization.

On the other hand, others argue that a 10-province standard is a "natural" standard that reflects the reality of the financial circumstances of all 10 provinces, not just the middle five. The five-province standard, in place before the New Framework, was introduced for a single, but important, purpose—to decrease the federal government's overall costs for Equalization at a time when Alberta's fiscal capacity was increasing dramatically because of high oil prices. While it makes sense from a financial perspective, it is not a principle-based approach and it does not adequately capture the reality of the diversity and disparity among the various provinces.

The Panel recommends that a 10-province standard should be adopted.

"The government believes that a national-average standard would more accurately reflect the level of fiscal disparities throughout the country and is more consistent with the intent of the constitutional commitment."

- Honourable Jeannot Volpé
Minister of Finance,
New Brunswick[18]

We acknowledge that this may increase the overall costs of the Equalization program. If the costs of a full 10-province standard (combined with other adjustments to the formula recommended by the Panel) exceed what the federal government is prepared to spend on Equalization in any given year, it should explicitly scale back the entitlements to receiving provinces on an equal per capita basis. As outlined later in this report, the federal government should outline the parameters for determining the affordability of the Equalization program as part of a number of steps to improve the transparency and governance of the program.

4. EQUALIZATION SHOULD CONTINUE TO FOCUS ON FISCAL CAPACITY RATHER THAN ASSESSING EXPENDITURE NEEDS IN INDIVIDUAL PROVINCES.

To date, the way of determining whether or not provinces receive Equalization funding has focused exclusively on determining fiscal capacity. That is to say, do provinces have the capacity to raise enough money through their own sources of funds to provide reasonably comparable public services?

[18] Volpé, J. (July 2005). Presentation to the Expert Panel on Equalization and Territorial Formula Financing, p. 6.

Assessing expenditure needs would require comparable approaches across the provinces to measure disparities, not only in the volume of services provided but also in a number of factors that affect the costs of delivering services (e.g., composition of the population, health and education status, dispersion of the population, wage rates, etc.).

The Panel examined the approach taken in Australia, for example, where an independent commission systematically gathers comprehensive and detailed information on a whole range of variables related to actual expenditure programs in the different states. Comprehensive information is tracked over time for each of the states and for the country as a whole. For each program reviewed, national average standards are determined and grants to individual states are based on program expenditure standards as well as fiscal capacity standards.

There is one critical difference, however. Canada is a much more decentralized federation where provinces have jurisdiction over key areas like health and education. Different provinces have different priorities in terms of what services they provide and how they provide them. Provincial governments make political decisions about the menu of public services they will provide to meet the needs of their residents, and they are accountable to their residents for those decisions. It's a complex and diverse approach, but it reflects the reality of our country and it has served us well.

Moving to a needs-based approach would require common information bases and common ways of measuring standards for programs across 10 very disparate and autonomous provinces. It would also involve a much more prominent role by the federal government in measuring and tracking information on areas that are beyond its jurisdiction. While some provinces believe the idea of addressing needs has merit, all acknowledge that this would add considerable complexity to what is already a very complicated program.

While some provinces believe the idea of addressing needs has merit, all acknowledge that this would add considerable complexity to what is already a very complicated program.

On balance then, the Panel recommends that needs not be assessed as part of the Equalization program. If the Government of Canada feels that there are disparities in particular public services that should be addressed, and the provinces agree, it should do so through targeted programs such as the Canada Health Transfer, the Canada Social Transfer, or national infrastructure programs—but not through Equalization.

Additional information on issues related to expenditure needs is included in Annex 3.

5. EQUALIZATION SHOULD BE THE PRIMARY VEHICLE FOR EQUALIZING FISCAL CAPACITY AMONG PROVINCES.

As if the Equalization program isn't complicated enough on its own, other federal transfer programs, particularly the Canada Health Transfer and the Canada Social Transfer, also include an equalizing component. These programs provide federal funding to provinces through a combination of per capita cash payments and tax points. The result is that wealthier provinces like Ontario and Alberta receive lower cash payments than other provinces. There is a designated component (called Associated Equalization) that provides payments to provinces to equalize tax points as part of the Canada Health Transfer and the Canada Social Transfer.

Furthermore, under these transfers, if a province's fiscal capacity increases to a point where it is no longer eligible for Equalization, that province actually receives more in per capita cash transfers through the Canada Health Transfer and the Canada Social Transfer to compensate for the fact that it no longer receives Equalization funding for its share of the tax point transfer.

The result is confusing at best and adds yet another layer of complexity to the process. It amounts to "back door" equalization and is an ongoing source of irritation both on technical grounds and in principle. It is beyond the Panel's mandate to recommend a specific solution; however, the Panel encourages the federal government and the provinces to address this issue so that Equalization is the primary vehicle for equalizing fiscal capacity across provinces.

"... there is a useful principle that can guide our approach—put as much as possible of the explicit inter-provincial redistribution into one program: Equalization. Canadians will support a transparent formula to help less well-off provinces provide reasonably comparable public services. Building unequal treatment into program after program not only hurts the economy but also fuels inter-regional grievances."

- William Robson[19]

Improving the Equalization formula

Within the context of the overall framework outlined above (a formula-driven approach based on a 10-province standard, measuring fiscal capacity but not expenditure needs) several important changes should be made to the actual formula for Equalization.

6. THE REPRESENTATIVE TAX SYSTEM (RTS) APPROACH FOR ASSESSING FISCAL CAPACITY OF PROVINCES SHOULD BE RETAINED.

Throughout its consultations, the Panel consistently heard that the RTS approach should be retained. The key strength of the RTS approach is that

[19] Robson, W. (January/February 2006). *Of Money, Power and Politics: Time to Straighten Out a Federal-Provincial Mess*, in The Howe Report, quoted by permission.

it provides a more accurate measure of a province's fiscal capacity, it reflects provinces' actual tax practices, and it is more in keeping with the Constitutional commitment to "reasonably comparable" levels of taxation.

One of the concerns with the RTS approach is its complexity. So-called "macro" measures have the advantage of being broader based, less detailed, and easier to measure. They focus solely on an overall indicator, such as Gross Domestic Product or personal income, as a measure of fiscal capacity. Essentially, a macro approach equates a province's fiscal capacity with its taxpayers' ability to pay taxes.

"For all its flaws and complexity, basing equalization entitlements on some measures of the tax bases that the provinces actually utilize is the preferred approach because it is based, however imperfectly, on what the provinces actually tax."

- Bev Dahlby[20]

On the other hand, critics of macro measures suggest that they are a proxy rather than an accurate measure of a province's fiscal capacity, that they do not reflect the provinces' actual tax practices, and that they assume that every dollar of income is equally available to be taxed, regardless of its source.

Based on its review of the alternatives, the Panel recommends that the RTS approach should be retained on an overall basis.

7. STEPS SHOULD BE TAKEN TO SIMPLIFY THE REPRESENTATIVE TAX SYSTEM (RTS).

While there is strong support for maintaining the RTS approach, the Panel also heard consistent suggestions for simplifying what has become an increasingly complex series of tax bases.

The Panel's recommendations simplify the formula and reduce the number of tax bases from 33 to five.

When Equalization was first introduced in 1957, only three tax bases were included. Today, the number of tax bases has grown to 33. This growth in complexity raises a number of concerns. Adding complexity may not improve accuracy or reliability. It may increase the potential of creating incentives or disincentives that affect decisions by provincial governments. It certainly makes the program less transparent and more difficult to understand. As a result, there is less scrutiny of the program and more potential for special deals and ad hoc practices. Finally, continuing to add more and more tax bases to reflect changes in industries like oil and gas is likely not sustainable.

For these reasons, the Panel recommends that steps should be taken to simplify the approach.

In order to choose which tax bases could be consolidated into a more simplified approach, the Panel considered:

- Tax bases that are either small or involve only modest disparities among provinces.

[20] Dahlby, B. (July 2005). *Review of the Canadian Equalization and Territorial Funding System*. Submission to the Expert Panel on Equalization and Territorial Financing, p. 20.

"While not perfect, Canada has a lot of experience and expertise with respect to the RTS system. We should work on resolving outstanding RTS issues ... rather than whole-scale replacement of something that is conceptually appealing and reasonably well-functioning."

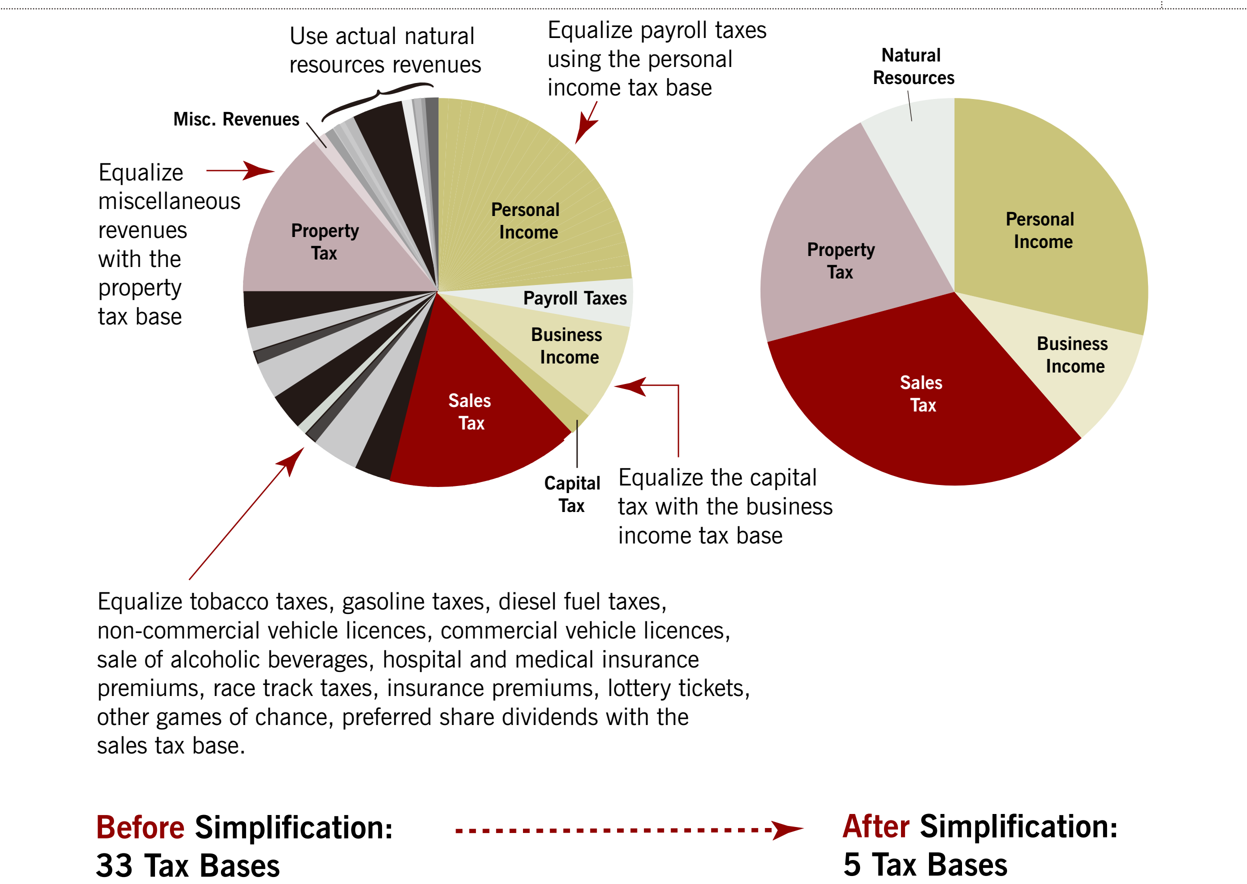
- Tracy Snodden[21]

- Tax bases where the tax practices among the provinces vary significantly, making it difficult for the RTS to arrive at a meaningful "representative practice" (e.g., payroll taxes, hospital and medical insurance premiums).
- Tax bases where there is no obvious way of measuring disparities (e.g., miscellaneous revenues base).

The result is the simplified approach shown in Figure 12. This approach uses four tax bases for all non-resource revenues: personal income tax, business income tax, property tax, and sales tax. All revenues (other than resource revenues) would be folded into these four bases. As explained later in this report, the Panel also recommends replacing the current 14 RTS resource tax bases with a single measure (actual resource revenues).

Further information on how the RTS system should be simplified is included in Annex 4.

FIGURE 12 – Representative Tax System (RTS) Simplification



[21] Snodden, T. (2005). *Equalization: Moving Forward Under the New Framework*. Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 13.

8. A NEW MEASURE FOR RESIDENTIAL PROPERTY TAXES SHOULD BE IMPLEMENTED BASED ON MARKET VALUE ASSESSMENT FOR RESIDENTIAL PROPERTY.

Property tax revenues make up the second largest source of revenues included in the Equalization formula. The measurement of a province's fiscal capacity to raise property taxes has been one of the most controversial issues in the Equalization program.

The disagreements begin with fundamental questions about the nature of property taxes—whether they are a tax on wealth, a tax on the income of people who own the property, or not a tax at all but rather a user fee to cover the cost of services received in a municipality. These basic issues are complicated by the fact that there are large variations in property taxes across the country and the rate of tax varies substantially within provinces, with property tax rates generally being lower in areas where average market values are higher.

In spite of the controversies and measurement problems, provincial property taxes were first included in the Equalization formula in 1967 and municipal property taxes were phased-in starting in 1973–74. Three types of property taxes were included: residential, commercial-industrial, and farm. The property tax base was measured on the basis of a multiconcept approach taking into account a mix of indicators and proxy measures including capital stock measures, provincial GDP, disposable income, agricultural land values, urbanization, and demographic changes. Most notable in this base was the absence of the very measure which, arguably, provincial and local governments actually tax, the assessed market values of property.

By the later 1990s, all provincial and local governments had adopted a market value approach for assessing the value of residential property. As a result, Finance Canada began extensive work on a new approach for measuring the property tax base in the Equalization program. This "stratified market value" approach groups together all municipalities that have similar property values into the same "tax bracket." It then assumes that all municipalities in that bracket are able to levy a similar average tax rate. The approach was extensively tested and discussed with the provinces.

Agreement had been reached with most provinces to implement this new approach on a phased-in basis, starting in 2004. However, with the introduction of the New Framework, changes to the property tax base were never implemented in legislation.

The Panel reviewed the various options and approaches for addressing concerns with the proposed stratified market value approach. Discussions were held with British Columbia and Québec officials to review their concerns and the particular circumstances in British Columbia.

The Panel's view is that the stratified market value approach has distinct advantages and should be implemented fully and consistently across all provinces. Its primary advantage is that it reflects the actual taxing practices of provinces and municipalities and, with stratification, it takes into account variations in market value of residential property in different municipalities across the country. In effect, for the purposes of Equalization, the fact that housing prices in cities like Vancouver or Toronto are higher than they are in Sudbury, Laval, or St. John's does not really matter because they are grouped together in different brackets. The stratified approach also takes into account the substantial variations in property tax rates across provinces and within a particular province.

The primary advantage is that it reflects the actual taxing practices of provinces and municipalities and, with stratification, it takes into account variations in market value of residential property in different municipalities across the country.

The Panel considered the issue of the special adjustment for British Columbia that was part of the 2004 Renewal. The Panel's understanding is that the incorporation of this adjustment was a compromise position aimed at mitigating the impacts of moving away from the multiconcept approach. Given that the inclusion of this adjustment would not have a material impact on British Columbia's Equalization entitlement under the Panel's package of recommendations, the Panel believes it is neither necessary nor appropriate to include this special adjustment.

The Panel also examined the current commercial-industrial and farm tax bases. These two tax bases currently make up about 44 percent of the total property tax base. A multiconcept approach is used to measure provinces' fiscal capacity for both of these tax bases. While there are some concerns with the current approach, developing a better conceptual framework for measuring the farm and commercial-industrial property tax bases would require considerable work and the development of extensive data to ensure comparability across provinces. For that reason, the Panel does not recommend any changes at this time.

Additional information about property taxes is included in Annex 5.

9. USER FEES SHOULD NOT BE INCLUDED IN EQUALIZATION.

User fees are another controversial aspect of Equalization. Across Canada, provincial and municipal governments collect a broad range of user fees totaling more than $21 billion a year. User fees are charges paid for goods and services provided by the public sector. They cover water, sewer and garbage charges, permits and licences, fees for the use of skating rinks and recreational facilities, rents for low-income housing, parking fees, and a host of other miscellaneous charges.

Currently, half of the $21 billion in user fees charged by provinces and municipalities is included in Equalization. The broad range of fees charged by postsecondary institutions, health and social services organizations has not been considered part of the government universe for Equalization purposes and these fees are not included in the Equalization formula.

To assess whether or not user fees should be included, the Panel considered two key questions:

- What is the conceptual rationale for including or excluding user fees?
- How would user fees be measured in an Equalization formula?

Currently, some user fees are included in Equalization while others are not. Receiving provinces generally support including user fee revenues in Equalization.

In answer to the first question, the Panel heard diametrically opposing views.

On the one hand, receiving provinces generally support including user fee revenues in Equalization. In their view, these fees are no different from other types of taxes. They are important sources of revenues that help offset the costs of providing public services. As a matter of policy, some provinces choose to charge lower fees for certain services while others opt to have higher fees but lower overall taxes. They argue that the Equalization program should not interfere with decisions made by provinces and, therefore, user fees should be included just like all other sources of revenues available to provinces. Including user fees also provides a direct benefit to receiving provinces. All receiving provinces would be entitled to more Equalization funding if user fees were included.

On the other hand, most academics who study these issues contend that user fees should not be included, except for the portion that represents a profit to provinces and could be used to pay for other public services.

To understand their arguments, it's helpful to go back to the fundamentals of the Equalization program and what it is intended to achieve. The intent of the Equalization formula is to address disparities in the fiscal capacity of provinces, disparities that affect their ability to deliver reasonably comparable public services to their residents. That's why regular taxes, including sales taxes, are equalized.

Most academics suggest user fees that merely cover all or part of the costs of providing specific services should not be included in Equalization because they do not generate additional fiscal capacity for provinces or create disparities in the fiscal capacity of provinces.

Sales taxes are a good example. Buyers are required to pay sales tax when they purchase taxable goods and services. The buyer gets nothing directly in return from the government for paying the tax on the purchase. The sales tax is simply a source of revenue for the government to use to pay for a wide range of public services such as health care and education. A province with a weak sales tax base has less fiscal capacity than other provinces and less ability to use revenues from sales taxes to provide services that are reasonably comparable to those in other provinces. In this case, Equalization would help to fill the gap.

User fees, though, are a different story. A user fee is essentially a payment for a good or service provided by the government. In return for the fee, people get a direct benefit—they get to skate at the local rink, they're able to park, or they get their marriage registered. Since the fee is intended to offset the government's cost of providing the service, the government is not left with additional money (additional fiscal capacity) that could be used to help them pay for health care or education.

Most academics suggest user fees that merely cover all or part of the costs of providing specific services should not be included in Equalization because they do not generate additional fiscal capacity for provinces or create disparities in the fiscal capacity of provinces.

On the other hand, some user fees go well beyond covering governments' costs of providing the service. They generate profits that the government can and does use to provide other public services. These fees should be included in Equalization. A good example is alcohol sales. Provinces generate profits from the sale of alcohol. These profits are used by provinces to help support other public services. A province that has more profit from the sale of alcohol is in a better financial position to provide its citizens with public services than a province that makes less profit. Such profits from user fees should be included in Equalization.

There's another important difference between taxes and user fees. Taxes such as income tax or sales tax are clearly defined. But in the case of user fees, there are few limits on what a province could choose to call a public service. Each province could have its own definition. It could choose to include a wide range of services, call them public services, and charge user fees for those services. If all of those user fees were included in Equalization, it would significantly increase the size of the program. In the Panel's view, this is not consistent with the intention of Section 36(2) of the Constitution.

In the Panel's view, user fees are different from other taxes. Unless they are intended to raise a profit, they do not generate disparities in fiscal capacity among provinces that need to be equalized.

The second question relates to how disparities in user fees could be measured. The current approach for full and partial cost recovery of user fees is arbitrary and has no conceptual basis. It essentially includes 50 percent of user fees in the formula and uses a province's overall fiscal capacity (excluding resource capacity) to determine entitlements. The choice of this arbitrary approach may reflect the fact that determining an appropriate way of measuring disparities in user fees is no simple task.

Under an RTS, a tax base or several separate tax bases would have to be constructed, reflecting the practices of provinces and municipalities and intended to measure disparities in fiscal capacity resulting from user fees. The tax base or bases would assess how much revenue each province could raise if it levied a national average user fee for the thousands of activities for which they currently levy user fees. Developing this type of tax base would add tremendous complexity to the formula. Moreover, the results would be difficult to interpret.

The Panel recommends that user fees that do not generate profits not be included in the Equalization formula.

Clearly, this is a difficult issue given the very different views involved. However, in the Panel's view, user fees are different from other taxes. Unless they are intended to raise a profit, they do not generate disparities in fiscal capacity among provinces that need to be equalized. Moreover, the challenge of developing appropriate measures and the additional complexity this would add are significant problems to overcome.

Therefore, the Panel recommends that user fees that do not generate profits not be included in the Equalization formula. Profits generated from the sale of alcohol, lottery tickets, and vehicle registrations should continue to be equalized.

Additional background on issues related to user fees is included in Annex 6.

Striking a balance on the treatment of resource revenues

No issue in the entire Equalization program is more contentious than how to deal with resource revenues. Through its consultations, the Panel heard strongly held and diametrically opposing views from both provinces and academics. Some argue that 100 percent of resource revenues should be included in Equalization while others say resource revenues should be excluded completely.

No issue in the entire Equalization program is more contentious than how to deal with resource revenues.

The issue is more than just one of principle. Natural resource revenues are a very significant source of disparities in fiscal capacity among the provinces. There are also very different impacts on provinces depending on whether, and to what extent, natural resources are included in the Equalization formula.

In general terms, receiving provinces with significant natural resources but lower than average revenues from other tax bases (e.g., Saskatchewan and British Columbia) receive substantially higher benefits if resource revenues are excluded from Equalization or included only on a limited basis. Receiving provinces with little or no resource revenues (e.g., New Brunswick and Prince Edward Island) benefit the most if 100 percent of resource revenues are included because it means the total pool of Equalization and the allocations they receive are higher. In the case of non-receiving provinces with no resources (i.e., Ontario), if resource revenues are included, combined with a 10-province standard, then its taxpayers, already hit by higher oil and gas prices, are asked to pay even more to assist receiving provinces. The greater the percentage of resource revenues included in Equalization, the greater the burden could be on Ontario taxpayers.

It's clearly a Canadian conundrum.

The Panel has reviewed the various ideas and options and attempted to strike the right balance with the following package of recommendations.

Additional information on the treatment of resource revenues in Equalization is included in Annex 7.

The starting point for the Panel's recommendations is ownership. Under Canada's Constitution, provinces own their natural resources. As owners, they should receive a net fiscal benefit from those resources. The workings of the Equalization program should not compromise this fundamental principle.

10. IN PRINCIPLE, NATURAL RESOURCE REVENUES SHOULD PROVIDE A NET FISCAL BENEFIT TO PROVINCES THAT OWN THEM.

The starting point for the Panel's recommendations is ownership. Under Canada's Constitution, provinces own their natural resources. As owners, they should receive a net fiscal benefit from those resources. The workings of the Equalization program should not compromise this fundamental principle.

Several provinces voiced concerns about having their resource revenues clawed back as a result of Equalization. In the Panel's view, it's not completely accurate to talk about provinces facing a claw-back if they receive less Equalization than they otherwise would have if they see substantial increases in resource revenues. That's precisely how Equalization is intended to work. On the other hand, provinces that see increases in their resource revenues almost completely offset by decreases in Equalization payments can argue, and rightly so, that the result is they're no better off in the end than if they had no resource revenues at all.

The Panel believes that provinces should receive benefits from the development of their natural resources. Nothing in the Equalization program should provide a disincentive for maximizing the potential of resource developments. At the same time, Equalization is not and should not be considered a permanent entitlement. Provinces with natural resources are in a good position to develop their economies and reduce, if not completely eliminate, their need for Equalization. This should be pursued as a stronger objective than retaining their eligibility for Equalization.

11. FIFTY PERCENT OF PROVINCIAL RESOURCE REVENUES SHOULD BE INCLUDED IN DETERMINING THE OVERALL SIZE OF THE EQUALIZATION POOL.

The Panel heard strong arguments for and against including resource revenues in the Equalization formula. The arguments generally fall into three categories:

- **Include 100 percent of resource revenues**

Several provinces and experts suggest that all provincial resource revenues should be included in the Equalization formula since these revenues are a major source of income for the provinces and a cause of significant fiscal disparities across the country. Resource revenues are an important component of a province's fiscal capacity. They help provinces pay for the costs of providing public services. And, as we're seeing now with high prices for oil and gas, they result in stronger economies for provinces lucky enough to have natural resources within their boundaries. They are also a significant source of fiscal disparities among provinces.

- **Exclude resource revenues entirely**

Starting from the principle of provincial ownership, some have recommended that resource revenues be completely excluded from the Equalization formula. In many cases, the arguments relate primarily to the exclusion of non-renewable resource revenues on the basis that these resources are capital assets which can only be used once. They are not a permanent source of revenues for provinces.

"The current program fails to acknowledge the ownership of natural resources rests with individual provinces under the Constitution. Saskatchewan's rights of ownership extend to the financial rewards for those resources, to be used for the benefit of its citizens. Equalization transfers most of those benefits to other parts of Canada and to the federal government."

- Government of Saskatchewan[22]

[22] Government of Saskatchewan (June 2005). *Equalization Reform: A Fair Deal for Saskatchewan*. Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 1.

- **Include a portion of resource revenues**

This middle position reflects the view that both extremes are untenable in the Canadian context. A portion of resource revenues should be included because of the fact that resource revenues do contribute substantially to a province's fiscal capacity. On the other hand, because resources are owned by provinces and there are other factors to consider, less than the full amount of resource revenues should be included.

"A provincial government under the Constitution has 'vastly greater control over the natural resources it owns than it does over the natural resources it doesn't own .... A province can with respect to natural resources it owns: (a) decide whether to develop them, (b) decide by whom, when and how they're going to be developed, (c) determine the degree of processing that's to take place within the province, (d) dispose of them upon conditions that they only be used in a certain way, or in a certain place, or by certain people, (e) determine the price at which they or the products resulting from their processing will be sold.'"

- Mervin Leitch
Former Attorney
General,
Alberta [23]

The Panel assessed the arguments in support of full inclusion of resource revenues put forward by a number of provinces and experts and does not believe that this solution is appropriate for a number of reasons.

First and foremost is the fact that, constitutionally, provinces own natural resources within their boundaries. As owners, the provinces determine when and under what conditions a particular natural resource will be developed. This is very different from other sources of revenues that are owned privately and simply taxed by a provincial government.

Second, provinces that benefit from natural resources face considerable uncertainty due to large swings in prices (for oil and gas in particular), wide variations in costs of production, uncertainty over the potential volume of production, and significant changes in profitability. On top of that, there are public costs involved in providing the necessary infrastructure to develop natural resources as well as in monitoring and regulating environmental impacts. Provinces with resource revenues reap not only the benefits but also must pay the costs for development, regulation, and management of their natural resource sectors.

Third, based on the principle of policy neutrality, the Equalization program should not provide incentives or disincentives for provinces to develop natural resources or adjust their royalty programs. If receiving provinces with resource revenues are allowed to "keep" more of those revenues without seeing them offset by corresponding reductions in Equalization, there is a greater likelihood that they will fully develop their resources and tax them appropriately.

The Panel does not, however, support the view that the ownership argument naturally leads to the conclusion that 100 percent of resource revenues should be excluded from Equalization. That approach would appeal to receiving provinces with natural resource revenues, as it would allow them

[23] Leitch, M. (November 1971). The Constitutional Position of Natural Resources, reprinted in J.P. Meekison (ed.), *Canadian Federalism: Myth or Reality?*, pp. 170–178.

to receive all the benefits from their own resource developments plus full access to Equalization. However, receiving provinces without resource revenues would see a substantial drop in the overall size of the Equalization program and the amount they receive. Economics aside, this doesn't meet the fairness test for all Canadians.

"A portion of resource revenues—greater than zero but significantly less than 100%—must be included in Equalization. There is no magic figure..."

- Royal Commission on the Economic Union and Development Prospects for Canada[25]

We also do not accept the argument advanced by those who favour full exclusion that there is a fundamental difference between renewable and non-renewable resource revenues. In fact, there is good evidence to suggest that "non-renewable" energy sources such as oil and gas are, in fact, more durable and long-lasting than some resources that have been considered "renewable", particularly Canada's fishing stock and lumber resources.

The Panel's conclusion is that some, but not all, resource revenues should be included in the Equalization formula. The question then becomes: what proportion of resource revenues should be included?

In the absence of what the Royal Commission (1985) terms a "magic figure", the Panel has used economic and Constitutional arguments combined with best judgements to propose what we believe is a balanced solution.

Looking at the literature, arguments are made for an inclusion rate that is somewhere between 20 percent at the low end and 70 percent at the high end. Several academics suggest that the lower end, in the 20 to 30 percent range, should be the target. Support for a lower inclusion rate dates back to a 1982 Economic Council of Canada report.[24] Others suggest that 30 percent of resource revenues should be excluded (roughly the rate of federal taxes), while the remaining 70 percent would be subject to Equalization. The 70 percent inclusion rate is also favoured by some because it mirrors the generic solution already in place in cases where the vast majority of a particular tax base is included in one province.

Our best judgement indicates that a 50 percent inclusion rate combines the merits of the various arguments and provides the most reasonable results for all receiving provinces, particularly when this is combined with the entire package of changes proposed by the Panel.

The Panel has considered all these arguments and, most importantly, assessed the impact of various scenarios on all receiving provinces. Our best judgement indicates that a 50 percent inclusion rate combines the merits of the various arguments and provides the most reasonable results for all receiving provinces, particularly when this is combined with the entire package of changes proposed by the Panel.

[24] Economic Council of Canada (1982). *Financing Confederation: Today and Tomorrow*.
[25] Quoted by Feehan in *Canadian Fiscal Arrangements: What Works, What Might Work Better*, p. 197.

12. ACTUAL RESOURCE REVENUES SHOULD BE USED AS THE MEASURE OF FISCAL CAPACITY IN THE EQUALIZATION FORMULA.

If a portion of resource revenues should be included in Equalization, how should those resource revenues be measured?

The RTS approach is used for all the major tax bases included in the Equalization formula, and for the most part, it works well, particularly if the Panel's recommendations for simplifying the approach are adopted. But in the case of resource revenues, it has become increasingly complex with 14 separate tax bases. Suggestions are that the current approach likely will become even more complex in future in order to capture the dynamics of a changing industry and taxation environment. There are also serious measurement problems with the RTS approach when it is applied to resource revenues.

The Panel considered a number of different alternatives for replacing the current RTS approach, including the use of actual revenues, introducing an aggregate resource GDP tax base, or developing a new measure of economic rent.

There are serious measurement problems with the RTS approach when it is applied to resource revenues.

Keeping in mind that the Equalization program is intended to reflect what provinces actually do, a good case can be made for replacing an overly complex and somewhat inaccurate RTS approach with actual revenues. Under this approach, instead of estimating what provinces could or might raise through royalties using elaborate but inaccurate calculations, Equalization would be based on the revenues provinces actually receive.

A second option, creating a resource GDP tax base, would aggregate the value of production in all resource sectors in a province to create a new tax base. Initial work done for the Panel suggests that there may be merit in pursuing this option in the longer term, but considerable work and analysis would be required.

A third option is to develop a new measure of economic rent. Economic rent is the difference between the selling price of a good or service and the cost of producing it, including a normal return on the investment involved. In the case of resources like oil and gas, there's a difference between the price of oil and gas set on international markets and the cost of producing it. Because provinces own the resources, they are also in a position to capture some of that gap, the economic rent, through royalties paid by companies developing the resources and by the sale of Crown leases.

The challenge becomes how to develop a measure that accurately reflects the potential economic rent a province could receive from the exploitation of natural resources. The Panel believes that an economic rent measure would be exceedingly complex and based on many hypothetical assumptions.

Based on these assessments, the Panel believes that the use of actual revenues is preferable to the current RTS approach or to a new measure of economic rent.

One potential downside to the use of actual revenues in the formula is the possible incentive for provinces to manipulate their royalty rates in order to maximize how much they could receive under Equalization. A 50 percent inclusion rate, combined with a number of smoothing mechanisms outlined in subsequent recommendations, will help to minimize this possibility.

An issue that has arisen with respect to oil and gas revenues is whether all revenue received should be counted for Equalization purposes, or whether revenue dedicated to savings vehicles such as Heritage Funds should be excluded on the grounds that it is not being used to provide public services. The Panel considered this issue and concluded that it is difficult to sustain these distinctions in a market environment where provinces are able to borrow on capital markets. Not counting resource revenues that are "saved" could provide incentives for provinces to save resource revenue and borrow against this asset to fund current expenditures. For this reason, the Panel recommends that all oil and gas revenue received by provinces should count as resource revenues for the purposes of Equalization.

"... provinces are rational and intelligent revenue maximizers. This means that the actual revenues collected should serve as the tax base for purposes of the formula."

- Thomas Courchene[26]

13. ALL RESOURCE REVENUES SHOULD BE TREATED IN THE SAME WAY.

The Panel sees no reason to distinguish between different types of resource revenues. Therefore, the treatment of all resource revenues should be the same whether those revenues arise from oil and gas, onshore or offshore resources, forestry, potash, other minerals, or hydroelectricity.

The measurement of fiscal capacity related to hydroelectricity deserves special mention. In most cases, provinces with substantial hydroelectricity resources have chosen to develop and distribute those resources through Crown corporations. For the most part, provinces have also chosen to provide electricity to their residents at low prices rather than charge full prices. Instead of capturing economic rent and generating government revenues, they give their residents the direct benefit of lower-priced electricity.

[26] Courchene, T. (July 2005). *Resource Revenues and Equalization*. Submission to the Expert Panel on Equalization and Territorial Formula Financing, p. 41.

Under the current RTS approach, a portion of provincial revenues from hydroelectricity is counted in one tax base (the water rentals base), while a portion of the profits of Crown corporations paid to provincial governments is considered in the same way as profits of private corporations. Some have suggested that this approach underestimates the revenue-generating capacity of provinces in cases where they charge less than the full economic value of the electricity.

The Panel considered a number of options for the treatment of hydroelectricity in the Equalization formula. Consistent with its position that all resource revenues should be treated in the same way, the current water power rentals base should be folded into a single resource revenue base and measured by actual revenues. In addition, the Panel recommends that the remittances from Crown corporations involved in resource extraction and development, including hydroelectricity Crown corporations, should be included as part of a province's resource revenues and not as business income.

14. A CAP SHOULD BE IMPLEMENTED TO ENSURE THAT, AS A RESULT OF EQUALIZATION, NO RECEIVING PROVINCE ENDS UP WITH A FISCAL CAPACITY HIGHER THAN THAT OF THE LOWEST NON-RECEIVING PROVINCE.

Consistent with the Panel's principles, Equalization should provide equity among provinces. However, it should not result in less wealthy provinces having a greater fiscal capacity than provinces that do not receive Equalization.

The Panel's recommendations for including 50 percent of resource revenues in the Equalization formula will benefit receiving provinces with resource revenues. However, in some scenarios, a receiving province like British Columbia, Newfoundland and Labrador, or Saskatchewan could end up with a higher fiscal capacity after Equalization than a non-receiving province like Ontario. That runs counter to a fundamental principle of equity that should underlie any changes to the Equalization program.

Consistent with the Panel's principles, Equalization should provide equity among provinces. However, it should not result in less wealthy provinces having a greater fiscal capacity than provinces that do not receive Equalization.

Consequently, the Panel recommends that a fiscal capacity cap be implemented. To determine a province's post-Equalization fiscal capacity and whether or not it is entitled to Equalization, the Panel's view is that 100 percent of a province's resource revenues should be included in calculating a province's fiscal capacity for the purposes of the cap. If a province's resulting fiscal capacity is higher than that of the lowest non-receiving province, then its entitlement to Equalization would be capped. While some might suggest that less than 100 percent of resource revenues should be included in the cap for a variety of reasons, in the absence of reliable and comparable information, the Panel's view is that including 100 percent of resource revenues in determining a province's fiscal capacity for purposes of calculating the cap is appropriate.

The Panel understands that implementation of its recommended cap is complicated by the existence of separate Offshore Accords for Newfoundland and Labrador and Nova Scotia. In the case of Nova Scotia, its fiscal capacity continues to be lower than the lowest non-receiving province, so the cap does not apply. But in the case of Newfoundland and Labrador, the combination of resource developments in the province along with the Panel's proposed revisions to the Equalization formula mean that Newfoundland and Labrador's fiscal capacity (including own-source revenues, payments from Offshore Accords and Equalization) is expected to be higher than the lowest non-receiving province.

In the Panel's view, this contradicts a fundamental principle. It is not within the Panel's mandate to suggest that the Offshore Accords should be changed. However, we believe that the principle should be upheld. If Newfoundland and Labrador's fiscal capacity after Equalization is higher than the lowest non-receiving province, the cap should apply regardless of the Offshore Accords and the province should not receive Equalization payments that put them above the cap. The Panel understands that, under their 2005 Accord, Newfoundland and Labrador is protected from losses in Equalization payments. It's up to the federal government to determine how this should be resolved. In the Panel's view, the principles of Equalization should not be compromised nor should the Equalization program be adjusted to accommodate the Offshore Accords.

Further details on how this fiscal capacity cap is calculated are contained in Annex 10.

Improving predictability and stability

The Panel's mandate specifically calls for recommendations on how to improve the predictability and stability of the Equalization program.

In practice, there is little certainty around a receiving province's entitlement for Equalization.

Through its consultations, the Panel heard two types of concerns about volatility in Equalization. The first concern is with predictability and the fact that continual adjustments to the data and the resulting "data shocks" months after the year's payments have been made make it difficult if not impossible to predict what actual Equalization payments will be.

Under the current system, entitlements for Equalization in a given year are re-estimated a number of times over four years until final data are available for the year in question. In practice, this means that there is little certainty around a receiving province's entitlement for Equalization. Seven different estimates are used, and then a final calculation is made. This can extend the process for up to 30 months after the initial entitlement is determined. Examples of prominent shocks that have taken place in the recent past include: unanticipated economic developments in certain provinces that have an impact on the overall Equalization pool, and revisions in key Statistics Canada data (e.g., changes in population estimates as a result of new Census figures).

The second concern is with stability in Equalization entitlements on a year-over-year basis. While the provinces suggest that the Equalization program should be responsive to changing economic circumstances, that objective needs to be balanced against the impact significant year-over-year changes in Equalization entitlements can have on individual provinces.

To address these concerns, the Panel recommends the following:

15. THE CURRENT APPROACH FOR DETERMINING EQUALIZATION ENTITLEMENTS AND PAYMENTS SHOULD BE REPLACED WITH A ONE ESTIMATE, ONE ENTITLEMENT, ONE PAYMENT APPROACH.

16. THREE-YEAR MOVING AVERAGES COMBINED WITH THE USE OF TWO-YEAR LAGGED DATA SHOULD BE USED TO SMOOTH OUT THE IMPACT OF YEAR-OVER-YEAR CHANGES.

The Panel understands the importance of basing Equalization entitlements and payments on accurate and complete data. However, accuracy is being achieved at the cost of considerable uncertainty for provinces.

Provinces would know with certainty what their entitlement and payment would be for the year based on a single estimate of their fiscal capacity.

The combined effect of both these recommendations would be a significant simplification of the payment system and a vast improvement in the stability of Equalization entitlements. In effect, it means that provinces would know with certainty what their entitlement and payment would be for the year based on a single estimate of their fiscal capacity.

Using a three-year moving average will ensure that changes in data are accommodated on a continuing basis. The Panel recommends that data used in the three-year moving average be weighted on a 50–25–25 basis. This gives the highest weight to the most recent year and makes the formula more responsive to changes in provinces' financial circumstances. The use of two-year lagged data will help improve the accuracy of the data used to determine Equalization entitlements.

In practice, this approach means that, for the year 2007–08 for example, payments would be made based on a moving average of data from 2005–06, 2004–05, and 2003–04, with weights of 50, 25, and 25 percent, respectively.

This approach, combined with the use of a 10-province standard, will also smooth out year-over-year changes in the Equalization program caused by economic changes in specific provinces. For receiving provinces, the use of moving averages means that, if a province experiences a sharp increase in its fiscal capacity, for example, a moving average would prevent the province from experiencing a similarly sharp decline in its entitlement for Equalization. The reverse would also be true; if a province experiences a sharp decline in fiscal capacity, it would take a couple of years before it would see a corresponding increase in Equalization funding.

Additional information on the Panel's recommendations for improving predictability and stability is included in Annex 8.

Assessing Equalization

The Panel's mandate specifically asks for advice on "evidence-based measures of the evolution of fiscal disparities among provinces". Those measures should help address the key question: does Equalization reduce financial disparities among provinces such that provincial governments are able to provide reasonably comparable services at reasonably comparable levels of taxes?

In terms of evidence-based measures for the Equalization program, the Panel recommends that:

17. THE FEDERAL GOVERNMENT SHOULD TRACK AND REPORT PUBLICLY ON MEASURES OF FISCAL DISPARITIES ACROSS PROVINCES.

Measures for Equalization should be limited to broad-based indicators of fiscal disparities pre- and post-Equalization. Such measures are consistent with the Panel's view of the purpose of the Equalization program and with the respective accountabilities of the federal and provincial governments in our federal system.

The Panel considered a range of possible evidence-based measures for assessing the impact of Equalization over time.

While some may prefer more comprehensive measures and reporting, the Panel believes that measures for Equalization should be limited to broad-based indicators of fiscal disparities pre- and post-Equalization. Such measures are consistent with the Panel's view of the purpose of the Equalization program and with the respective accountabilities of the federal and provincial governments in our federal system.

Specifically, the Panel recommends that the federal government should collect and report annually to Parliament on several key indicators including:

- Per capita fiscal capacity of provinces, pre- and post-Equalization, on an annual and multi-year basis.

- Equalization payments to receiving provinces as a proportion of provincial revenues and program expenditures.
- Equalization payments as a proportion of national GDP, federal revenues, and federal spending.
- Other measures of trends in fiscal disparities including changes in tax effort, fiscal capacity, and program spending among provinces.

The Panel understands the desire by some to see more information about outcomes across the various provinces. However, as noted above, we believe that responsibility lies with the provinces.

Additional information about evidence-based measures of disparities is included in Annex 9.

Improving governance and transparency

Since its inception, Equalization has been the responsibility of the federal government. Changes to the design and implementation of the program have been made through a series of intergovernmental consultations and processes, primarily between finance officials, held behind closed doors and rarely involving public scrutiny.

The majority of provinces reject the idea of replacing the intergovernmental process with an independent, arms-length agency.

That's not to suggest that the process hasn't worked reasonably well. In fact, the majority of provinces reject the idea of replacing the intergovernmental process with an independent, arms-length agency. The fact that the process has worked reasonably well to date and is viewed as a model in other parts of the world is largely a testament to the dedication and hard work of finance officials in the federal government and in provincial governments across the country.

That being said, there is room for improvement, particularly with respect to the transparency of the process.

The Panel recommends that the following steps should be taken to achieve that objective.

18. A MORE RIGOROUS PROCESS SHOULD BE PUT IN PLACE TO IMPROVE TRANSPARENCY, COMMUNICATIONS, AND GOVERNANCE. THIS IS PREFERABLE TO SETTING UP A PERMANENT INDEPENDENT COMMISSION TO OVERSEE EQUALIZATION.

The Panel was asked to assess whether the federal government should establish a permanent, independent body to provide ongoing advice on Equalization and conduct periodic reviews of provincial disparities. The majority of those consulted supported strengthening and improving the current process rather than establishing an independent body.

The majority of those consulted supported strengthening and improving the current process rather than establishing an independent body.

Those who support an independent body point to concerns with the lack of transparency of the process and the overall lack of understanding about the Equalization program. The fact that decisions are negotiated and made behind closed doors undermines the credibility of the program. They point to examples such as Australia where an arms-length, independent commission is responsible for all aspects of the equalization program. Furthermore, they suggest that an independent body would be better able to provide public education about Equalization, engage in research and independent assessments, and add credibility to the program.

On the other hand, most provinces indicated that an arms-length body is not needed if improvements can be made to the current process and if the Equalization program is returned to a principle-based, formula-driven approach. Their concerns centre more on reducing ad hoc decisions, improving transparency in decision-making, and ensuring that the federal government is more responsive to their specific concerns. They also contend that accountability for the program must continue to reside with the federal government rather than being transferred to a body that is not directly accountable to Canadians.

The Panel firmly believes that a more rigorous, expanded, and transparent process is the best fit for Canada's federation.

The Panel also heard that, while independent agencies offer a professional and credible view, they also are prone to incentives for increasing complexity and expanding their mandate as permanent employees with a single focus on Equalization. Agencies would see countless opportunities for seeking more information, testing more ideas, and proposing more layers of solutions. The typical oversight role of citizens and the media is also diminished, as people are less willing to question experts than politicians.

The Panel firmly believes that a more rigorous, expanded, and transparent process is the best fit for Canada's federation.

The federal government should report annually to Parliament on key measures related to Equalization.

To improve the process, the Panel recommends that:

- The federal government should report annually to Parliament on key measures related to Equalization in combination with the Canada Health Transfer, the Canada Social Transfer, and any other general purpose transfers provided to some or all of the provinces. Annual reports on Equalization should also refer to major changes made in the program, issues raised by the provinces and territories, and how those issues were addressed.

Steps should be taken to implement a more constructive process for ongoing discussions among provincial and federal government representatives.

- Five-year reviews of the Equalization program should be retained. Well in advance of each five-year renewal, the federal government should issue a public discussion paper outlining key issues and options for changes to Equalization. The discussion paper would serve as the basis for a Parliamentary review process in which provinces, academics, and interested parties would be able to express their views before the next renewal.
- Any material changes to the Equalization program, particularly funding changes (e.g., any scaling back of the overall amount allocated by the federal government to the Equalization program), made within the five-year renewal period should be the subject of a public discussion paper. Periodic public reviews should also be launched to focus attention on particular issues, objectives, or aspects of Equalization.
- Finance Canada should make an up-to-date and user-friendly simulation model of the Equalization program available on its website, along with the associated databases. This would take some of the mystique out of the program, improve understanding, and improve predictability for provinces.
- Ongoing academic research related to Equalization should be encouraged through a number of existing mechanisms and research agencies, along with combined support from federal and provincial governments. Research reports should be reviewed through the intergovernmental process.

The Panel also recommends that steps be taken to implement a more constructive process for ongoing discussions among provincial and federal government representatives. Clearly, the federal government is responsible for the Equalization program. However, Equalization has a substantial impact on provinces, particularly those that receive Equalization. The Panel heard concerns that the current process does not provide the kind of forum that's needed for a forthright and constructive discussion of various ideas and options. The result is frustration and a lack of trust between federal and provincial governments. In the Panel's view, these concerns can be addressed through more open and constructive discussions, including discussions by Finance Ministers at their regular meetings.

ACHIEVING A NATIONAL PURPOSE: *Putting Equalization Back on Track*

ASSESSING THE IMPACT

ASSESSING THE IMPACT

The Panel understands that the best ideas can sound good in principle and in theory, but what people want to know is the bottom line. What is the combined impact of the Panel's recommendations on whether or not a province qualifies for Equalization, how much it would receive, and how that compares with what it currently receives?

The Panel has done a thorough and complete technical analysis to address these critical questions. At the outset, however, it's important to keep a number of key points in mind.

The Panel has done a thorough and complete technical analysis of its package of recommendations based on the latest available information.

First, the Panel has focused its assessment on what its recommended new formula would provide both in terms of an overall price tag for the Equalization program and the allocation to individual provinces for 2007–08. Consistent with the Panel's recommendations, the results are based on the most recent data from February 2006 and a three-year moving average including 2003–04 (weighted 25 percent), 2004–05 (weighted 25 percent) and 2005–06 (weighted 50 percent).

Second, the Panel's calculations are intended as illustrations of the combined impact of its recommendations. They are a snapshot in time based on current information. The actual cost of the Equalization program and the allocation to individual provinces can and will vary depending on actual information available closer to the time when decisions are made for 2007–08.

Third, the impact of the Panel's recommended approach is compared to both Equalization entitlements that were announced in November 2005 under the New Framework for 2006–07 and to a formula-driven base case. As noted earlier in this report, interim allocations under the New Framework were based on an agreement reached with the provinces rather than on a formula-based approach. The result is that some provinces actually received more in Equalization funding than they would have if a consistent formula had been used.

The provinces have unanimously asked for a return to a formula-based approach.

The provinces have unanimously asked for a return to a formula-based approach. For purposes of comparison, the Panel has also compared the impact of its recommendations with a base case reflecting the impact of the formula developed as part of the 2004 Renewal, just before the New Framework was announced. Two modifications were made. A weighted moving average was applied (as in the case of the Panel's recommended approach) and a pool of $11.7 billion (the legislated amount for 2007–08) was used. Without this adjustment to an $11.7 billion total, the pool of Equalization funds to be allocated under the pre-2004 formula would have been much smaller.

In the Panel's view, this is a "more pure" comparison, since it compares the impact of two formula-driven approaches (one before the New Framework and one including all of the Panel's recommendations).

Finally, Annex 10 provides more detailed analysis of the impact of the Panel's recommendations.

With those comments in mind, these are the highlights of the financial impacts of the Panel's recommendations.

Consistent with the purpose of Equalization, the Panel's recommended approach results in comparable fiscal capacities among all receiving provinces.

- Table 2 compares the fiscal capacity of provinces before and after the Panel's recommended Equalization formula is applied. It shows that, while there are significant disparities in fiscal capacity of provinces before Equalization, the Panel's formula results in very similar fiscal capacities among receiving provinces.
- The Panel's formula does not result in equal fiscal capacities for receiving provinces after Equalization primarily because of the partial inclusion of resource revenues.
- Table 2 also shows the impact of imposing a cap on the amount of Equalization funding provided to some receiving provinces. Consistent with the principle of equity, the Panel recommends that no receiving provinces should end up with a fiscal capacity greater than that of the lowest non-receiving province. In this case, Ontario's fiscal capacity becomes the cap for all receiving provinces. The cap affects both Newfoundland and Labrador and Saskatchewan.

TABLE 2 — Provincial Fiscal Capacity Before and After Equalization for 2007–08[27]

$ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Fiscal Capacity (using the Panel's formula)										
Before Equalization	5,601	4,167	4,784	4,346	5,406	6,534	4,785	6,377	11,099	6,913
Equalization	933	2,079	1,560	1,945	917	0	1,528	157	0	0
After Equalization	**6,534**	**6,246**	**6,344**	**6,291**	**6,322**	**6,534**	**6,313**	**6,534**	**11,099**	**6,913**

[27] Table 2 shows the before Equalization fiscal capacity of provinces using a 100 percent inclusion rate for resource revenues and includes payments provided through the Offshore Accords. Equalization entitlements are shown net of the fiscal capacity cap.

The total amount to be allocated under Equalization is higher and most receiving provinces would receive more than they would under the previous formula.

- As Tables 3 and 4 show, the total cost of the Equalization program would increase from $11.3 billion in 2006–07 to about $12.6 billion in 2007–08 as a result of the Panel's recommendations. Under the New Framework and the fixed increase of 3.5 percent per year, the total cost of the Equalization program would increase to $11.7 billion by 2007–08. Therefore, the increase resulting from the Panel's recommendations is about $900 million. This increase is primarily the result of moving to a 10-province standard (which includes high oil and gas prices). If 100 percent of resource revenues had been included along with a 10-province standard, the total cost would have been $16 billion.
- In 2007-08, all receiving provinces except British Columbia and Newfoundland and Labrador would receive more Equalization under the Panel's recommendations.

TABLE 3 – Formula-to-Formula Comparison for 2007–08

$ million / $ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
Panel's Recommendations											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	**12,563**
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
New Framework											
Total Entitlements	587	282	1,363	1,417	6,273	0	1,720	0	0	35	**11,676**
Per Capita Entitlements	1,136	2,047	1,454	1,885	830	0	1,468	0	0	8	
Changes											
Total Entitlements	***-105***	***4***	***99***	***45***	***653***	***0***	***69***	***156***	***0***	***-35***	***887***
Per Capita Entitlements	***-203***	***31***	***105***	***60***	***86***	***0***	***59***	***157***	***0***	***-8***	

Note: Totals may not add due to rounding.

- The Panel's assessment shows that British Columbia would not be entitled to Equalization under the Panel's recommended formula because it has a higher fiscal capacity. Using the most recent data, under the previous Equalization formula, British Columbia would have been entitled to only a small amount of Equalization funds, substantially less than it received under the New Framework.
- In the case of Newfoundland and Labrador, the reduction in Equalization entitlements reflects the impact of the Panel's recommended cap. Under both the Panel's recommended formula and the modified 2004 Renewal formula, Newfoundland and Labrador has a higher fiscal capacity than Ontario, the lowest non-receiving province.
- In the case of Québec, additional entitlements under the Panel's recommendations reflect the fact that Québec did not benefit as much from the New Framework as other receiving provinces. They also reflect the impact of moving to a 10-province standard and changing the measurement of property taxes and resource revenues.

TABLE 4 – Comparison of the Panel's Recommendations for 2007–08 with Announced Entitlements for 2006–07

$ million / $ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
Panel's Recommendations											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	**12,563**
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
Announced Entitlements for 2006–07											
Total Entitlements	687	280	1,379	1,432	5,354	0	1,690	0	0	459	**11,282**
Per Capita Entitlements	1,328	2,030	1,472	1,905	710	0	1,446	0	0	109	
Changes											
Total Entitlements	***-204***	***7***	***82***	***30***	***1,571***	***0***	***99***	***156***	***0***	***-459***	***1,281***
Per Capita Entitlements	***-395***	***49***	***88***	***40***	***207***	***0***	***82***	***157***	***0***	***-109***	

Note: Totals may not add due to rounding.

Benefits of the Panel's recommendations

- Equalization is returned to a principle-based, formula-driven approach with a solid foundation for the future.
- Moving to a 10-province standard is a principled approach that reflects the true nature of Canada's federation and the real diversity among provinces.
- Although Equalization will never be a simple program, the Panel's recommendations result in a considerably simpler and more transparent approach and should make the basics of Equalization more understandable to Canadians.
- While the approach is not as certain as the New Framework, particularly for the federal government, the use of moving averages provides greater stability and, at the same time, accommodates the wishes of the provinces to return to a formula-driven approach.
- Taken together, the package of recommendations provides a balanced approach that carefully weighs the pros and cons of different options and combines them into a solid Equalization formula for the future.
- Instead of an all-or-nothing approach to the treatment of resource revenues, the Panel's recommendations balance the various options and provide a reasonable solution, a workable solution that provides the best outcomes in terms of its overall impact on provinces.
- The Panel's recommendations for a rigorous review and reporting process should result in a more open and transparent Equalization program.

CONCLUDING COMMENTS

CONCLUDING COMMENTS

In the past year, members of the Panel have reviewed all aspects of the Equalization program, listened to the views of provinces and experts, explored a wide range of options, and developed what we believe is a balanced approach for the future.

During the year, we have also seen growing interest in Canada's Equalization program starting with fundamental questions about the purpose and effectiveness of Equalization and fueled by provincial concerns about fiscal imbalances, both among provinces and between the provinces and the federal government.

While many of these concerns extend beyond the Panel's mandate, we cannot end this report without commenting on a number of issues important to Canada's future.

First, fiscal arrangements in Canada are being reduced to debates about who pays and who gets. The Panel understands the financial challenges faced by many provinces across the country and their concerns about their financial capacity compared with that of the federal government. But this kind of "cheque-book" federalism puts all the emphasis on money and the interests of individual provinces while any sense of a higher purpose is lost. This issue is not helped by what many have seen as a growing lack of trust between the federal government and the provinces.

Related to this concern, some have suggested that Canadians no longer support the concept of sharing across the country as strongly as they did in the past. In fact, one participant in the Panel's consultations suggested that while the underlying concept of Equalization received unanimous support when it was included in Canada's Constitution, he's not sure the same would be the case today. Fundamental questions about the very nature of Equalization and whether it is achieving its intended objective have caused some to suggest that the program should be scrapped entirely. In the Panel's view, both the provinces and the federal government need to tackle these questions head on. This is an important Canadian program which for too long has not received the attention or interest it deserves. In the view of the Panel, the more decentralized Canada becomes, the more important Equalization is to the future of Canada.

This is an important Canadian program which for too long has not received the attention or interest it deserves. In the view of the Panel, the more decentralized Canada becomes, the more important Equalization is to the future of Canada.

The Panel also has concerns about the potential for growing economic disparities in the country as a result of continuing high oil and gas prices. Our recommendations provide a balanced solution. But if oil and gas prices in particular, stay high over the longer term, disparities among provinces with and without resources will increase and become a source of growing friction. The potential of this issue to undermine the future of Equalization is high, particularly as provinces seek special deals similar to the Newfoundland and Labrador and Nova Scotia Offshore Accords.

It's up to the federal government and the provinces to address these issues over the longer term and determine how they will, together, deal with the potential for growing disparities across our nation.

In many respects, these issues go to the heart of our federation and are beyond the ability of an unconditional, formula-driven program like Equalization to resolve. It's up to the federal government and the provinces to address these issues over the longer term and determine how they will, together, deal with the potential for growing disparities across our nation.

Finally, the Panel was struck by how little is known about the Equalization program and how few people across the country are interested in it, even though it involves billions of taxpayers' dollars. Canadians deserve to know more about the Equalization program, particularly the purpose it achieves and the benefits it provides to people across the country.

In closing, we hope our recommendations will help put Equalization back on track. More importantly, we hope our recommendations will put Equalization on a solid foundation for the future. And we hope our report will bring greater focus and understanding to an important Canadian program.

ACHIEVING A NATIONAL PURPOSE: *Putting Equalization Back on Track*

ANNEXES

Annex 1: List of Canadians Consulted

(Submissions were received from those in italics)

Roundtable and Academic Workshop Participants

Anstey, Reg, Newfoundland and Labrador
Aubry, Jean-Pierre, Québec
Beach, Charles, Ontario
Beaulne, Pierre, Québec
Bellchamber, Nigel, Ontario
Bird, Richard, Ontario
Boadway, Robin, Ontario
Boessenkool, Kenneth, Alberta
Boyer, Marcel, Québec
Brett, Craig, New Brunswick
Butler, Michael, British Columbia
Castonguay, Claude, Québec
Charest, Caroline, Québec
Chaundy, David, Nova Scotia
Coulombe, Serge, Ontario
Courchene, Thomas, Ontario
Dahlby, Bev, Alberta
Davies, Bryan, Ontario
Davies, James, Ontario
deClercy, Christine, Saskatchewan
Dempsey, Stephen, Nova Scotia
Desjardins, Pierre-Marcel, New Brunswick
Duclos, Jean-Yves, Québec
Dunn, Christopher, Newfoundland and Labrador
Emery, J.C. Herb, Alberta
Feehan, James, Newfoundland and Labrador
Finn, Jean-Guy, New Brunswick
Fortin, Pierre, Québec
Gagné, Robert, Québec
Gannon, Patrick J., Manitoba
Gauthier, Isabelle, Québec
Gibbins, Roger, Alberta
Gilchrist, Donald, Saskatchewan
Godbout, Luc, Québec
Gross-Stein, Janice, Ontario
Grubel, Herb, British Columbia
Hale, Geoffrey, Alberta
Hirsh, Todd, Alberta
Hobson, Paul, Nova Scotia
Holle, Peter, Manitoba
Kitchen, Harry, Ontario
Kneebone, Ronald, Alberta
Landry, Aldéa, New Brunswick, P.C.
Lazar, Harvey, British Columbia
Locke, Wade, Newfoundland and Labrador
MacLauchlan, Wade, Prince Edward Island
Marchildon, Gregory, Saskatchewan
Marshall, Jim, Saskatchewan
Martin, Laurent, Québec
McGuire, Francis, New Brunswick
Mintz, Jack, Ontario
Montmarquette, Claude, Québec
Neumann, Ronald H., Manitoba
Orr, Dale, Ontario
Plourde, André, Alberta
Poole, Claurelle, Ontario
Poschmann, Finn, Ontario
Rault, Stéphanie, Québec
Reuber, Grant L., Ontario
Richards, John, British Columbia
Robson, William, Ontario
Rousseau, Jean-Marc, Québec
Sayers, Anthony, Alberta
Scarth, William, Ontario
Smart, Michael, Ontario
Smith, Jennifer, Nova Scotia
Snoddon, Tracy, Ontario
St-Hilaire, France, Québec
Strain, Frank, New Brunswick
Tapp, Stephen, Ontario
Thibault, Charles, Québec
Tompkins, Gary, Saskatchewan
Tupper, Allan, British Columbia
Usher, Dan, Ontario
Vaillancourt, François, Québec
Vardy, David, Newfoundland and Labrador
Watson, William, Québec
Wilson, Sam, Alberta
Wilson, Thomas, Ontario
Winchester, Bruce, Ontario
Wingender, Philipe, Québec
Young, Robert, Ontario

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Government Representatives (some of whom participated in the roundtables)

The Honourable Michel Audet, Minister of Finance, Government of Québec
The Honourable Lorne Calvert, Premier, Government of Saskatchewan
The Honourable Peter G. Christie, Minister of Finance, Government of Nova Scotia
The Honourable John Hamm, former Premier, Government of Nova Scotia
The Honourable Shirley McClellan, Deputy Premier and Minister of Finance, Government of Alberta
The Honourable Mitchell Murphy, Minister of Finance, Government of Prince Edward Island
The Honourable Gregory F. Selinger, Minister of Finance, Government of Manitoba
The Honourable Loyola Sullivan, Minister of Finance, Government of Newfoundland and Labrador
The Honourable Harry Van Mulligen, Minister of Government Relations, Government of Saskatchewan
The Honourable Jeannot Volpé, Minister of Finance, Government of New Brunswick

Andersen, Colin, Deputy Minister and Secretary of Treasury Board, Government of Ontario
Anderson, Barbara, Assistant Deputy Minister, Department of Finance, Government of Canada
Bennett, Ian, Deputy Minister of Finance, Government of Canada
Boothe, Paul, former Associate Deputy Minister of Finance, Government of Canada
Boschmann, Ewald, Deputy Minister of Finance, Government of Manitoba
Brady, Erin, Government of Saskatchewan
Burns, Nigel, Government of Prince Edward Island
Butt, Christopher, Government of Newfoundland and Labrador
Callanan, Laus, Government of Newfoundland and Labrador
Campbell, Krista, Government of Canada
Campbell, Glenn, Government of Canada
Cody, Elizabeth, Assistant Deputy Minister, Department of Finance, Government of Nova Scotia
Constantine, Robert, Assistant Deputy Minister, Department of Finance, Government of Newfoundland and Labrador
Curtis, Garry, Government of British Columbia
Déry, Patrick, Government of Québec
Ewing, Patrick, Government of British Columbia
Godbout, Gilles, Government of Québec
Gouchie, Jamie, Government of New Brunswick
Guérard, Martin, Government of Québec
Guillot, Audrey, Government of Ontario
Harnish, Vicki, Deputy Minister of Finance, Government of Nova Scotia
Hartmann, Erich, Government of Ontario
Horsman, Nancy, Government of Canada
Houde, Jean, Deputy Minister of Finance, Government of Québec
Jelley, Paul R., Deputy Minister of Finance, Government of Prince Edward Island
Johnson, Christine, Government of British Columbia
Johnson, Eric, Government of Sakatchewan
Johnson, Stephen, Government of Ontario

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Keenan, Sean, Government of Canada
Kieley, Peter, Government of New Brunswick
Knight, Barbara, Deputy Minister of Intergovernmental Affairs, Government of Newfoundland and Labrador
Lévesque, Louis, Associate Deputy Minister of Finance, Government of Canada
Macdonald, Neil, Government of Nova Scotia
MacGregor, Mary, Government of Alberta
Mallory, John, Deputy Minister of Finance, Government of New Brunswick
Manning, Brian, Deputy Minister of Finance, Government of Alberta
McAllister, James, Government of Ontario
McFadyen, Craig, Government of Ontario
McGregor, Kirk, Assistant Deputy Minister, Department of Finance, Government of Saskatchewan
McInnes, Robert, Government of Saskatchewan
McInnis-Leek, Nancy, Government of Nova Scotia
McQuarrie, Sarah, Government of Ontario
Mentzelopoulos, Athana, Deputy Minister of Intergovernmental Relations, Government of British Columbia
Mercier, Jérome, Government of Canada
Milinchuk, Sharon, Government of Saskatchewan
Minty, Tyler, Government of Canada
Morehen, Tony, Government of Alberta
Mullaly, Bill, Government of Newfoundland and Labrador
Paddon, Terry, Deputy Minister of Finance, Government of Newfoundland and Labrador
Paquet, Alain, Government of Québec
Paul, Nick, Deputy Secretary to Treasury Board, Government of British Columbia
Perreault, René, Government of Manitoba
Sample, Robert, Government of Canada
Saunders, Alistair, Government of Nova Scotia
Savoie, Jocelyn, Government of Québec
Séguin, Jean, Government of Québec
Sidey, Ian, Government of Ontario
Smith, Grant, Government of British Columbia
Sparkes, Adam, Assistant Deputy Minister, Department of Natural Resources, Government of Newfoundland and Labrador
Staples, Andrew, Government of Canada
Styles, Ronald, Deputy Minister of Finance, Government of Saskatchewan
Sweeting, Tom, Government of Ontario
Troke, Daniel, Government of Nova Scotia
Turgeon, Bernard, Assistant Deputy Minister, Department of Finance, Government of Québec
Vermaeten, Arndt, Government of Canada

Veikle, Glen, Associate Deputy Minister of Industry and Resources, Government of Saskatchewan
Vrooman, Tamara, Deputy Minister of Finance, Government of British Columbia
Walsh, Leo, Deputy Minister of Intergovernmental Affairs, Government of Prince Edward Island
Whitehead, John, Assistant Deputy Minister, Department of Finance, Government of Ontario
Wood, Heather, Government of Manitoba

Others Who Were Consulted or Prepared Submissions

Atlantic Institute for Market Studies
Atlantic Provinces Economic Council
Beale, Elizabeth, Nova Scotia
Bernard, Jean-Thomas, Québec
Boisseau, Marc, Australia
Côté, Marcel, Québec
Dennison, Donald G., New Brunswick
Drummond, Donald, Ontario
Eldridge, Jim, Manitoba
MacNevin, Alex, Nova Scotia
Morris, Alan, Australia
Norrie, Kenneth, Ontario
Palmer, John, Prince Edward Island
Protti, Gerry, Alberta
Purchase, Bryne, Ontario
Robinson, T. Russell, Ontario
Shah, Anwar, United States
St-Cerny, Suzie, Québec
Taylor, Paul, British Columbia
The Honourable Peter Lougheed, P.C., Alberta
Zuker, Richard, Ontario

Annex 2: History of the Equalization Standard

This chart summarizes historical changes in the Equalization standard. Such changes were often accompanied by offsetting changes in the revenue coverage of Equalization (i.e., an expansion of revenue coverage was often accompanied by reductions in the standard). Both the level of the standard and the degree of revenue coverage affect the total size of the Equalization program.

Period	Standard	Comments
1957–1962	Top-two standard (average of two most well-off provinces)	The first Equalization program measured only three bases: personal income tax, corporate income tax and succession duties. Other revenue sources were not equalized.
1962–1964	10-province standard	Expansion of revenues subject to Equalization (notably inclusion of 50 percent of resource revenues) accompanied a move from the top-two standard to the lower 10-province standard.
1964–1967	Top-two standard	Temporary return to higher top-two standard followed the change in government in 1963.
1967–1974	10-province standard	Return to 10-province standard accompanied expansion of revenues subject to Equalization to include virtually all provincial government revenues and, from 1973, property taxes levied for education purposes. Local government revenues remained outside Equalization.
1974–1982	10-province standard	While maintaining the 10-province standard, reforms made in the wake of the major oil price shock of the early 1970s reduced the size of the program by restricting revenue coverage (e.g., through a series of changes resulting in partial inclusion of resources) and eligibility for Equalization (an "Ontario override" to prevent Ontario from becoming eligible for Equalization).
1982–2004	Five-province standard (average of B.C., Saskatchewan, Manitoba, Ontario and Québec)	The five-province standard replaced the 10-province standard. The five-province standard was considered more stable by the federal government as it did not include Alberta's fiscal capacity, which was volatile due to its high resource revenues. Ceiling and floor provisions were also introduced. The growth rate of aggregate entitlements was constrained to the growth rate of the Gross Domestic Product. Floor provisions protected provinces against significant reductions in their Equalization entitlements. The ceiling had the effect in some years of reducing aggregate payouts below the level of the five-province standard, while the floor occasionally allowed certain provinces to receive more than the standard. The post-1982 regime moved to nearly full revenue inclusion, including a return to full inclusion of resource revenues and the incorporation of virtually all local government revenues. Starting in 1999, however, 50 percent of user fees were excluded from Equalization.

Period	Standard	Comments
2005–	New Framework Fixed pool	The New Framework abandoned the five-province standard. Total payments were fixed outside the Equalization formula, and the allocation among provinces was based on an interim quasi-formula (based on an interim arrangement announced at the First Ministers' Meeting in October 2004). As a result, there was no common standard: all receiving provinces were brought to different post-Equalization fiscal capacities.

The Panel's assessment

Many different standards have been proposed, discussed, and implemented over the history of the Equalization program. Some experts and academics take the view that any choice of standard is ultimately a political choice reflecting community values regarding the degree of equality and redistribution (and the ensuing costs) acceptable to Canadian voters. Others take the view that there are principle-based arguments in favour of a 10-province standard, which is an average of all provinces.

The Panel believes that the choice of standard is an important policy decision and should be explicit. There is no unambiguously correct standard, but the Panel believes that the 10-province standard is the appropriate standard to use as a benchmark for the Equalization program. Should the federal government determine that it is not feasible to achieve this benchmark standard, then it should explicitly scale back all entitlements, on an equal per capita basis, to the level it considers appropriate.

Annex 3: Expenditure Need

What is expenditure need?

The Constitution refers to "making Equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

Some interpret this objective to mean taking into account not only the differences in fiscal capacity (revenue-raising ability) of provincial governments, but also their expenditure need. Two jurisdictions with very different program needs for their population (e.g., different health care, education, and social services pressures) may not be able to provide comparable levels of public services if their Equalization entitlements only take into account the differences in their ability to raise revenues.

The concept of expenditure need encompasses two notions. First is the relative demand for public services. A province with a larger proportion of elderly people requiring expensive health care, with a higher share of low-income residents needing social services, or with a higher ratio of school-age children has a greater need for public services. This is referred to by experts as the workload facing their public services. It is usually measured by the socio-demographic and economic characteristics of a province's population.

The second dimension of expenditure need is the financial cost of providing a given set of services. Some provinces face higher wages, property costs and material expenses. These can be due to different wage rates in the public sector, higher costs of serving remote or sparsely populated areas, diseconomies of scale where fixed costs must be spread among a smaller population, or even to differences in the efficiency and effectiveness of government service delivery.

The complexity of measuring expenditure need

The most rigorous way of incorporating expenditure need in Equalization, as developed in Australia, is to construct the expenditure equivalent of the Representative Tax System (RTS). A Representative Expenditure System (RES) measures, for each spending area of a provincial government, the per capita expenditures it would have to make in order to provide typical provincial services of national average quality to its residents, assuming a national average rate of efficiency.

Like the RTS, an RES requires constructing and costing a standard for each spending area – a typical basket of public programs and services, representative of the average preferences and practices of all provinces. Such a basket would be dominated by the weight of the larger provinces, Ontario and Québec. Workload and costs in each sector would then be measured to arrive at an estimate of what each provincial government would need to spend to provide the standardized basket of services. Depending on whether that amount exceeds or falls short of the national average, the province is said to have an expenditure disadvantage or advantage. For a similar fiscal capacity, a jurisdiction with an expenditure disadvantage would receive higher Equalization entitlements. Similarly, a jurisdiction with an expenditure advantage would find its Equalization entitlement reduced.

For example, the measurement of expenditure need for child care, elementary, and secondary education would require first constructing a basket of education services representative of the average across Canada (teacher-pupil ratios, availability of special education services, etc.). One would then measure the cost of providing this basket of services across different provinces, taking into account workload differences (e.g., proportion of school-age children in the population, children requiring special education, children with English or French as a second language, etc.) and differences in the cost of providing that standardized basket (e.g., wage and salary conditions, real estate prices, and material costs).

All these steps require numerous judgement calls and adjustments in order to fairly measure the expenditure need for each province. For example, if a province had more rural or remote areas, adjustments would have to be made for class size and the additional cost of transportation. If one province had been more generous in its wage settlements with teachers' unions, adjustments would have to be made to determine the wage costs to the province had it paid national average wages, adjusted for differences in the cost of living and supply and demand conditions.

Policy neutrality

Not only would an RES be extremely complex to construct, involving many judgements about how to appropriately measure expenditure need, but it would also be very difficult to design a system that would maintain policy neutrality.

Most experts agree that, on grounds of policy neutrality, differences in expenditure need should be equalized only to the extent that they are beyond the control of governments. Otherwise, Equalization distorts incentives for sound public management. That is why, for example, the RTS does not recognize debt or debt service levels as a cost of providing public services. To do so would provide an incentive for provinces to incur higher levels of debt. Similarly, when considering the possibility of designing an RES, it would be necessary to protect against compensating a government that has conceded higher salaries to its public sector, or that adopts less efficient modes of delivery for public services, compared with neighbouring jurisdictions.

The inability in practice to easily sort out what governments can and cannot control creates much concern about moral hazard and perverse incentives. How can one ever be sure how much of a province's expenditure disadvantage with respect to health care or secondary education is due to workload or costs beyond its control?

Intrusiveness into provincial decision-making

The need to disentangle the sources of expenditure disadvantages requires extensive data and answers to many detailed questions from provincial departments administering public services and programs. Moreover, this data must be comparable. And it must be constructed on the basis of an agreed-upon standardized basket of services.

Beyond the extensive data demands, there are real issues about intrusiveness into provincial decision-making once this data enters the public domain. Comparisons would inevitably be made between actual provincial expenditures and the representative expenditure standard, putting pressure on governments that provide less than the standardized basket of services, or that provide services at a higher cost. Some governments would object to the use of a representative basket heavily weighted by the preferences of Canada's largest provinces. After all, the purpose of federalism is to allow regional differences in policy preferences to be reflected in the services offered by provincial governments.

The gain in public accountability would have to be weighed against concerns about federal intrusion into areas of provincial responsibility. More importantly, it would have to be weighed against the materiality of the contribution of an RES to Equalization.

Materiality

Ultimately, the case for incorporating expenditure need into Equalization must rest on a presumption that it would make a significant difference to the level and allocation of Equalization payments. If it does not, there is no point in devoting public funds to the expensive conceptual and data investments required.

The Panel is not aware of any comprehensive attempt to measure expenditure need in Canada. It has heard many conjectures, based on fragmentary evidence, relating to a few key spending sectors (e.g., health, education, social services). It has noted the work of Anwar Shah suggesting that had expenditure need applied in 1991–92, it would have lowered total Equalization payments overall, reduced the share of all receiving provinces except Québec, and raised Québec's share.[1] Other efforts have suggested that non-receiving provinces, which are often heavily urbanised, would have a much greater expenditure need (relating to both workload and cost factors) than some receiving provinces. There have also been suggestions that expenditure need disparities in Canada are likely much smaller than those arising from fiscal capacity, but this has not been supported by detailed investigation.

The Panel's assessment

On balance, the Panel considers that the case for incorporating expenditure need into Equalization has not been made. There is no conclusive evidence that it would have a material effect on the size and allocation of Equalization payments. It would be premature to recommend a comprehensive effort at constructing an RES, given the conceptual and data difficulties involved and the issues it would raise with respect to jurisdictional responsibilities.

One of the principal concerns with introducing expenditure need assessment into the Equalization program is that it must be done on a comprehensive basis. Recognizing expenditure need may be easier and less controversial to do with specific transfer programs such as the Canada Health Transfer or the Canada Social Transfer.

[1] Shah, Anwar (1996). *A Fiscal Need Approach to Equalization* In Canadian Public Policy 99-115, vol. 22, no. 2.

Annex 4: Representative Tax System Simplification

Since the Equalization program was introduced in the 1950s, there have been a number of changes in how the program operates. The current approach for measuring provincial revenue-raising capacity uses the Representative Tax System (RTS). The Panel considered whether the RTS should be retained, and if so, whether it could be simplified without compromising accuracy.

Should the RTS be retained?

The RTS

Canada's Equalization system is essentially a gap-filling formula. The formula determines how much revenue a province could raise on its own if it levied national average tax rates, and compares this to a given standard. If a province's per capita revenue-raising capacity falls short of this standard, Equalization fills the gap. In this way, consistent with Canada's Constitution, a province then has sufficient revenues to provide "reasonably comparable levels of public service" if it levies "reasonably comparable levels (rates) of taxation".

To measure how much revenue a province can raise on its own, the Equalization formula uses the RTS. It simulates how much revenue a province could raise if it levied national average tax rates on virtually all revenue sources currently used by provinces. To do this, revenues are grouped into 33 Equalization bases (e.g., personal income tax, business income tax, property tax, lottery revenues, etc.). For each base, a capacity to raise revenues at average tax rates is calculated. When aggregated, the 33 bases give a measure of how much revenue a province could raise if it levied national average tax rates on each of these bases.

There is no expectation or obligation for a province to use national average tax rates or to take advantage of all 33 revenue sources. Provinces are free to choose their own approach as to whether they want to levy high, average or low tax rates, and which tax fields they want to occupy. The RTS, however, simulates average taxing practices, to allow for a fair and objective comparison of provincial revenue-raising capacity.

The macro approach

Another approach for measuring a government's ability to raise revenue is called the macro approach (short for macro-economic indicator-based approach). Rather than measuring what a province could raise if it levied average rates of taxation, it focuses on what is available to be taxed (the income of a province), and how much revenue a province could raise if it levied a uniform tax rate on all measured income within a province. The choice of the macro base varies, but is typically a measure such as Gross Domestic Product (GDP) or total personal income. As with the RTS, Equalization would then fill in the gap between what a province could raise and the standard.

The Panel's recommendations

The Panel undertook considerable research to compare the two systems and discussed the desirability of moving to a macro approach with academics and federal and provincial finance officials. While the simplicity of the macro approach appealed to the Panel, it recommends that the RTS should be maintained for two reasons.

First, within the Canadian context, each dollar of economic activity is not taxed uniformly by governments. For example, the Canadian tax system recognizes that people with higher incomes have a greater ability to pay taxes. Therefore, all provinces have adopted a personal income tax system with a progressive structure. Similarly, certain types of consumption are typically taxed across Canada, while others (e.g., most food sold in grocery stores) are not taxed. Ideally, the Equalization formula should take these realities into account, if it can be done in a transparent and reasonably simple way. By modelling actual taxing practices, the RTS (unlike the macro approach) can reflect the fact that two provinces with identical aggregate income, but very different economic activity, would raise very different levels of tax if they adopted the kind of tax systems generally accepted in Canada.

Second, a macro approach does not adequately deal with tax exportation. While a measure such as GDP can conceptually capture what income is available to be taxed, it does not reflect the fact that the burden of some taxes can be shifted by one provincial government to another province or even another country. Take for example two provinces with identical aggregate income, with one province deriving its income from oil extraction (through exporting its oil to another country) and collecting more revenue than the other province. Under the macro approach, the two provinces have identical aggregate income and would therefore be considered to have the same revenue-raising capacity. The RTS approach, however, recognizes that the province rich in oil is able to collect royalty revenues, partially paid by owners of oil and gas companies, which reduces the tax burden on its citizens. While adjustments could be made to a macro approach to reflect tax exportation, it would defeat the primary advantage of the macro approach, its potential simplicity.

Can the measure of revenue-raising capacity within the RTS be simplified?

While the Panel recommends maintaining the RTS, it also believes that there is considerable scope for simplifying the way that fiscal capacity is calculated. This must be done without losing the essential character of the RTS, its ability to reflect the broad patterns of actual taxing practices exhibited across Canada.

The Canadian RTS started in 1957 with only three bases. Today, it has grown to measure 33 distinct provincial tax bases. In fact, the 33 bases mask the true number, as a number of tax bases are divided into sub-bases. Many of the Equalization bases have become extremely complex and require several pages of data, adjustments, and calculations to derive fiscal capacity. This steady proliferation in complex tax bases, particularly for small revenue sources, raises many concerns. There are currently 15 small non-resource Equalization bases, which together account for less than 20 percent of revenues subject to Equalization.

ANNEX 4

Concerns raised over the proliferation of small non-resource bases

The proliferation of bases has not necessarily led to greater accuracy in the measurement of fiscal capacity. While the Panel is reasonably confident that the personal income tax, business income tax, and sales tax bases accurately measure fiscal capacity, it is not confident that the same can be said for the many small, non-resource bases that have been incorporated into the Equalization program. For example, the other games of chance base (for casino and related revenues) includes a complex formula with several debatable assumptions used to simulate how much revenue a province could raise if it had the average number of casinos. Similarly, the capital tax base attempts to weave together information from multiple data sources, involving many debatable assumptions and adjustments, to derive fiscal capacity. Federal and provincial finance officials have been struggling for years to improve this base.

In some cases, the establishment of smaller tax bases has interfered with the policy neutrality of Equalization. Some of the small bases create incentives for provinces to change their revenue-raising behaviour in order to maximize Equalization entitlements. For example, fiscal capacity for the lottery ticket base is calculated using the net receipt of lottery tickets. Receiving provinces, therefore, have little incentive to sell lottery tickets; they can reduce their efforts and be compensated by increased Equalization payments. Similarly, the tobacco base uses only officially reported sales to calculate fiscal capacity. Revenues lost through smuggling and non-reporting are compensated through Equalization, leaving receiving provinces little financial incentive to address these problems.

The smaller revenue sources are sometimes not used by most provinces. For example, less than half the provinces collect hospital medical insurance premiums and payroll taxes. Moreover, the structure of these smaller taxes can vary greatly among the few provinces that use them. In this sense, there is no typical tax base – and the related Equalization bases are not representative of taxing practices.

Small tax bases are often more costly to administer than large tax bases, and yet have a minor impact on Equalization entitlements. A number of the smaller tax bases are data intensive, imposing a considerable compliance burden on receiving and non-receiving provinces and on the federal government. Moreover, significant resources are being used throughout each Equalization renewal to update these bases to reflect the latest changes in taxing practices and the latest theories on how to measure fiscal capacity for each base. When added together, the overall administrative cost for these small bases is substantial.

Finally, the proliferation of tax bases has reduced transparency. The large number of often complex tax bases that are now included in the RTS has made the system much more difficult to understand by academics, Parliamentarians, provincial governments, and Canadians. This reduced transparency means there is less scrutiny of the program and more potential for deals and ad hoc arrangements.

ANNEX 4

The Panel's recommendations for simplifying the 15 smaller non-resource bases

The Panel examined the scope for simplifying 15 smaller, non-resource bases. It considered two approaches to simplification:

1) Consolidating the smaller bases into larger, well-established RTS bases, with which the smaller bases have a natural macro-economic affinity (i.e., their distribution among provinces likely resembles that of the larger base); or

2) Replacing the smaller bases with a new single proxy base (e.g., a macro-economic indicator such as personal disposable income or GDP).

After careful examination of these two approaches, the Panel recommends the first approach, an RTS consolidation approach. This is most consistent with the RTS and avoids mixing together two very different approaches – the RTS and macro approaches. Moreover, using the first approach precludes the need to create a number of additional proxy bases and manage all the complexities associated with determining and maintaining them.

Specifically, the Panel recommends that:

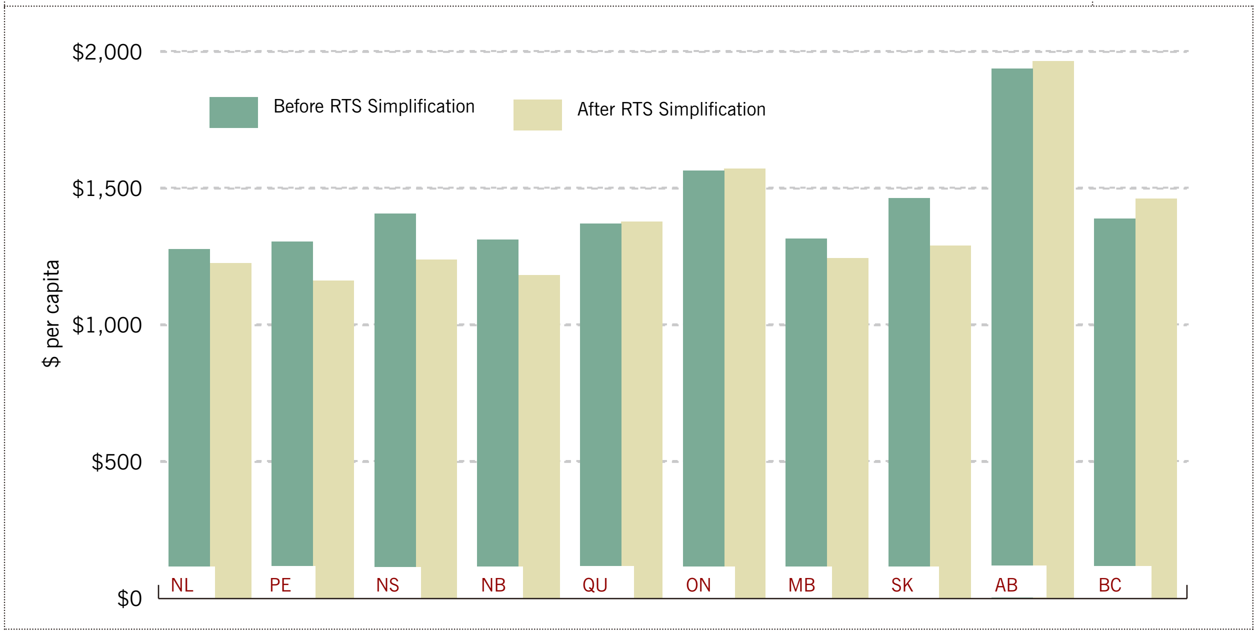
- Payroll tax revenues be equalized in the personal income tax base.
- Capital tax revenues be equalized in the business income tax base.
- Miscellaneous revenues (excluding user fees) be equalized in the property tax base.
- All the other smaller consumption levies be treated as part of the general and miscellaneous sales tax base. The smaller consumption levies include: tobacco taxes, gasoline taxes, diesel fuel taxes, non-commercial vehicle licences, commercial vehicle licences, alcohol sales, hospital and medical insurance premiums, race track taxes, insurance premiums, lottery tickets, other games of chances, and preferred share dividends.

These changes are illustrated in Figure 2.

Figure 1 provides a comparison of the per capita revenue-raising capacity of each province from the 15 small non-resource bases using the current method (with 15 bases) and the method proposed by the Panel. Given the significant uncertainty as to how to accurately measure fiscal capacity for a number of the small tax bases, compared with the small differences resulting from adopting the much simplified proposed approach, the Panel is confident that the proposed measure of fiscal capacity is as valid as the current system, and that there would be no deterioration in the accuracy of the overall measurement of fiscal capacity.

More generally, in the Panel's opinion, folding the 15 small non-resource bases into the major tax bases would make the RTS simpler, easier to understand, and less costly to administer. It would also eliminate many of the incentive problems of the small non-resource bases without reducing the overall accuracy of the measurement of fiscal capacity.

FIGURE 1 – Fiscal Capacity for the 15 Targeted Tax Bases Before and After the Panel's RTS Simplification (Weighted average 2003–04 to 2005–06)



Concerns raised over the 14 natural resource bases

The Panel also examined the scope for improving and simplifying the 14 tax bases that are currently used to measure fiscal capacity for natural resource revenues.

The issue of how to measure resource revenues has been an ongoing policy challenge since the inception of Equalization, and is discussed in detail in Annex 7. In summary, the view of the Panel is that the current measurement of revenue-raising capacity for natural resources (using a complex array of measures including profits, value, volume, proxy and actual revenues spread over 14 tax bases) is inappropriate. In the Panel's view, the current approach often does not accurately measure the true revenue-raising capacity (economic rent). Also, the system has created some serious incentive problems, where Equalization reductions exceed the net revenues collected by provincial governments, thus undermining the policy neutrality principle of the Equalization program. Finally, as in the case of non-resource bases, the proliferation of resource tax bases has increased the administrative cost and complexity of the program, and reduced its transparency.

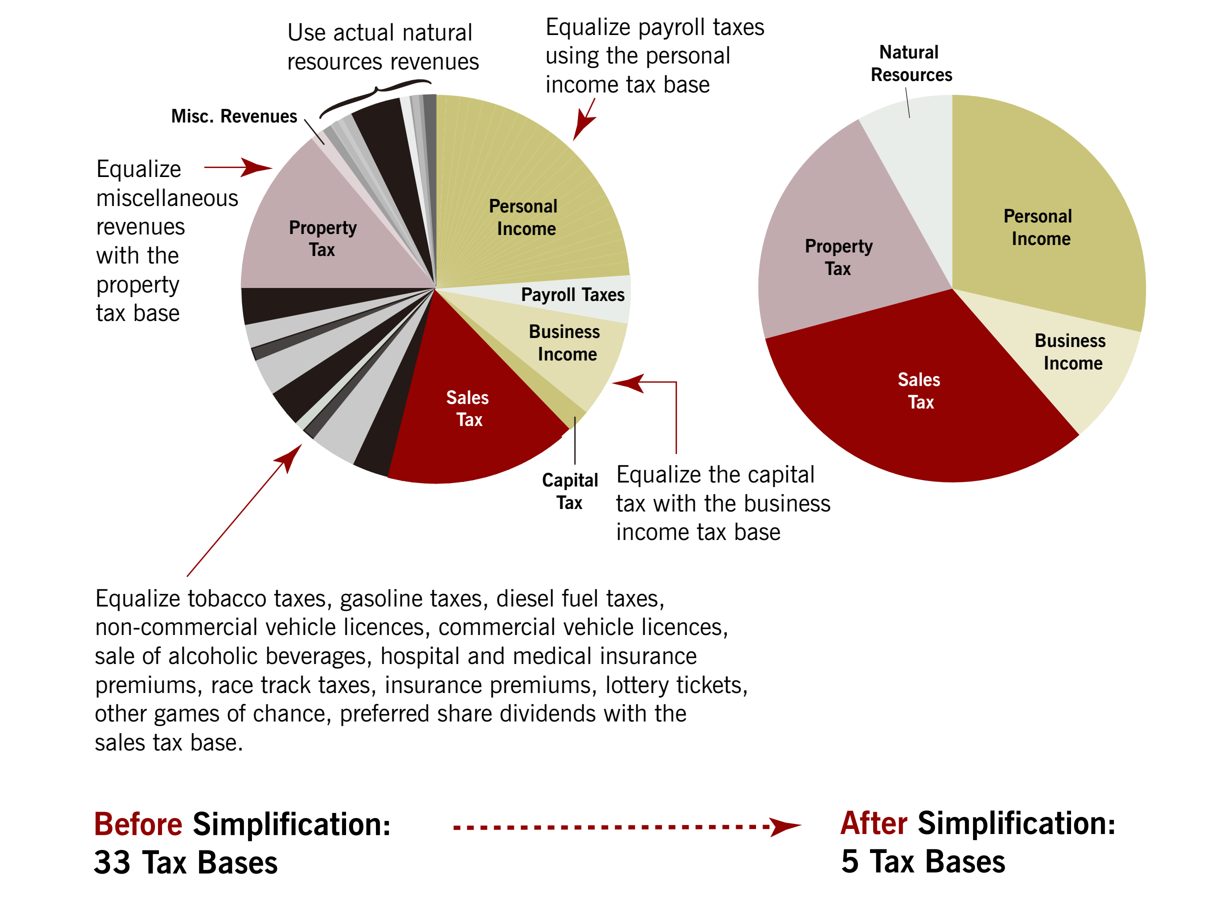
The Panel's recommendations for simplifying 14 resource bases

Given the problems with the current system, and the fact that no reliable measure of economic rent is available at this point, the Panel recommends that the 14 tax bases for natural resources be collapsed into a single base, using actual resource revenues to determine fiscal capacity.

Incentives to reduce tax effort (e.g., lower royalty rates) that are normally associated with using actual revenues as the measure of fiscal capacity would be mitigated by two other Panel recommendations. First, as discussed in Annex 7, only 50 percent of resource revenues would be included in Equalization under the Panel's recommendations, leaving provinces with sufficient incentives to continue taxing at the rent-maximizing level. Second, as discussed in Annex 8, the Panel recommends using lagged data with three-year moving averages for all tax bases. This means that a provincial government tempted to reduce its tax effort could only reap the full benefits of increased Equalization payments five years later, with all the attendant uncertainty of results.

The Panel believes that adopting a single Equalization base for resources that uses actual revenues would be a significant improvement over the current system. This approach would make the system simpler and more transparent, more accurately measure fiscal capacity, and enhance Equalization's goal of policy neutrality.

FIGURE 2 – Representative Tax Systems (RTS) Simplification



Annex 5: Property Tax

Property taxes are a large source of revenue for provinces and municipalities. In 2003–04, the last year in which the five-province standard was used, they amounted to $38 billion, or about $1,200 per capita. This was the second largest revenue source subject to Equalization, after personal income tax revenues ($47.5 billion). In that year, Equalization paid out $2.3 billion in respect of property tax, second only to the $3.8 billion paid out for personal income taxes.

The measurement of fiscal capacity arising from property tax revenues has consistently been one of the most controversial issues in the Equalization program. These controversies call into question the very nature of the tax. Is the property tax a levy on property values (wealth), as appearances suggest, or is it really a tax on underlying incomes (where property values are used to allocate the total income tax bill among property holders)? Is the property tax even a tax at all, or is it more like a user fee, a charge for benefits received?

Beyond the disputes about the fundamental nature of the tax, there are conceptual and measurement controversies arising from the unique features of property tax. This makes it extremely difficult to construct a robust Equalization tax base to reflect the taxing practices of provinces and their 3,500 municipalities.[1]

This annex provides a brief history of the property tax base, explains the development and justification of a new residential property tax base (based on actual taxing practices), and explains the Panel's decision to recommend that this new base be adopted.

A Brief History

Provincial property taxes were first included in Equalization starting in 1967. At first, only the provincial portion of property taxes was included and it was equalized on the basis of a weighted average of personal and business income taxes. Property taxes were equalized on the basis of what we would call today proxy bases, or economic indicators thought to be closely related to property tax revenue-raising capacity. Locally-levied property taxes were brought in gradually, starting in 1973–74.

In 1977, the property tax base was replaced by another proxy base, based on a multi-concept approach, which was in place until the 2004 Renewal. The multiconcept approach distinguished between three types of property: residential (about 57 percent of the total), commercial-industrial (42 percent), and the farm sector (one percent). It then used a mix of indicators to allocate fiscal capacity, including capital stock measures, provincial Gross Domestic Product (GDP), disposable income, agricultural land values, urbanization, and demographic changes.

It was a pragmatic approach, mixing together a number of concepts: income as a proxy for fiscal capacity, urbanization and demographic change as proxies for scarcity and market values, etc. Most notable in this base was the absence of the very measure which provincial and local governments actually tax: the market value of property. This reflected the fact that tax practices across provinces and municipalities were inconsistent and comparable property value data were not available.

[1] About 83 percent of property tax revenues are collected by municipal governments. Provincial governments collect the remainder. For example, the Government of Ontario collects a property tax, and transfers these funds to School Boards in Ontario.

Under the circumstances, the base represented perhaps the best that could be done. It was also periodically adjusted to reflect updated data and special circumstances. However, it was often criticized because its conceptual underpinnings were very weak and because it was a major departure from the RTS philosophy.

Pressure to develop a new residential property tax base

The criticism of the multiconcept approach became stronger in the late 1990s as the adoption of market value assessment for residential property made it possible to use market value data for Equalization purposes.

The federal government, in the lead-up to the 2004 Renewal, invited all governments to work together to devise a better base for the residential property tax. About 50 meetings with ministers and senior officials were held between June 1999 and February 2004, 12 of which dealt in detail with the property tax base.

While a number of approaches were considered, the work focused on developing a property tax base that reflected actual taxing practices.

The structure of property taxes

The structure of property tax rates (mill rates applied to the value of residential property) exhibits a consistent pattern. The rate of tax is systematically lower where property values are high. Every municipality sets a uniform mill rate for the property values in its area. However, those with higher average prices typically set a lower mill rate than those with lower property prices.

When tax rates of municipalities are aggregated for a whole province, there is an inverse relationship between individual property values and the tax rate they attract. In Ontario, for instance, a property worth less than $50,000 but located in municipalities with low average market values will have a mill rate in the three percent range, compared to rates under one percent for a property valued at over $200,000 in municipalities with high average property values.

Proposal for a new property base to reflect actual taxing practices

Given that taxing practices had become consistent across provinces and municipalities, and property value data had become available, the federal government suggested the development of a stratified market value approach that would model actual taxing practices for residential properties.

Specifically, the federal government developed an equalization model that grouped municipalities according to brackets of average market values, and applied a representative average tax rate to each bracket. For example, if Canadian municipalities with average property values of $100,000 levied an average tax rate of two percent, the fiscal capacity for municipalities with such average property values would be the total market value of properties in these communities multiplied by two percent. If the average tax rate were 1.7 percent for municipalities with an average property value of $200,000, then the total market value of properties in these communities would be multiplied by 1.7 percent. This calculation would be repeated for communities with higher and lower property values, each with its corresponding tax rate. The sum would be the province’s fiscal capacity for the property tax base.

This approach is in keeping with the RTS approach. No value judgement is made as to whether the taxing practices are appropriate or not. They are observed and modelled in the same way as personal income tax revenues are modelled to reflect the average progressive rate structures that provinces have chosen. Similarly, sales tax revenue-raising capacity is modelled in Equalization to reflect the revenues that could be raised if average tax rates applied to goods and services that are actually taxed by provinces.

Views of academics and experts on the stratified approach

In June of 2003, provincial finance departments were invited to a conference where six academics were asked to judge the new proposal for stratifying market values. A second academic conference took place in November 2003 with ten leading academics, along with the provincial and federal governments.

Experts made varied and useful comments on measuring the fiscal capacity of the property tax base. One particularly helpful suggestion was that the national price elasticity of property tax rates with respect to nominal property values would be a simpler way of capturing the fact that municipalities tend to charge a lower rate of tax as nominal property values go up.

Using this suggestion, the federal government estimated the national elasticity of property tax revenues with respect to nominal property prices to be 70 percent. In less technical terms, it means that a municipality with twice the average market value would collect only 70 percent more tax revenue.

This elasticity approach was tested and found to yield results that were very close to those of the stratified market value approach. This simplified approach is less complex and avoids the need to define brackets (which runs the risk of stratification bias).

Three alternative bases for the property tax

As well as the stratified market value approach, government officials and academics closely examined three other options: (1) the simple market value approach (2) the real value approach, and (3) the income approach.

The simple market value approach

This approach was advocated by some provincial governments. Under this approach, property values are aggregated in each province to obtain the base for Equalization purposes. Multiplying the base by a single national average rate of tax (the average rate applied on all property) would give each province's fiscal capacity.

While fairly straightforward, the simple market value proposal came under criticism for a number of reasons, most importantly because it fails to reflect differences in actual taxing practices. Municipalities with higher average market values will typically levy a lower mill rate. Failing to take that into account would be inconsistent with the RTS, just as it would be inconsistent with the RTS to not reflect the progressive nature of income tax rates. The Panel agreed that, wherever feasible, the RTS should reflect actual taxing practices.

Experts also argued that a simple market approach fails to distinguish between pure price differences in market values (caused by relative scarcity) and differences arising from the size or quality of the property. This is explained more fully below.

The real value approach

A number of academics, supported by some provincial officials, argued that simple market value overestimates fiscal capacity. They argued that it overestimates fiscal capacity because market values reflect three main factors: housing size, quality of natural amenities (e.g., beauty of a setting), and pure scarcity (the premium that is paid for land because it is a fixed factor that cannot be reproduced). Only the first two factors actually generate fiscal capacity. Price differentials due to pure scarcity do not reflect higher real housing benefits. Consistent with this theory, a municipality that has higher property values due only to scarcity (e.g., high prices in a crowded city) does not have a greater ability to tax property owners than another municipality with less expensive property that, on average, is the same size and has the same amenities.

If the pure scarcity component could be stripped out of market value, the residual or real value of property prices could be used as an Equalization base to measure underlying fiscal capacity.

Academics at the 2003 conferences on Equalization did not provide data to test the practicality of this approach. However, federal officials did subsequently examine a quality-adjusted price index for shelter costs (essentially a very basic attempt at measuring the real value of property).

Although the results were far from conclusive given the practical difficulty of measuring scarcity, this data indicated that a model based on real value using the quality adjusted price index would generate Equalization entitlements in line with the stratified market approach. The studies also showed that there was a significant correlation between high real values and scarcity.

While it is worth emphasizing again that the studies used only an indirect way of measuring scarcity, the fact that the empirical results of a real value approach were consistent with the stratified approach bolstered the Panel's confidence that the stratified market value approach would be a significant improvement over the multiconcept approach.

The income approach

A third alternative to the stratified approach, the income approach, was also raised in numerous discussions leading up to the 2004 Renewal. True to its name, this approach measures fiscal capacity on the basis of the underlying income of property holders (e.g., personal disposable income). Advocates of this approach argue that, while local governments appear to tax property wealth, they are ultimately attempting to tax the underlying incomes of property holders. All property taxes can only be paid out of incomes. Therefore, it is their incomes that are the best measure of property holders' capacity to pay and of a government's ability to tax.

Like the simplified market value approach, the income approach was viewed by many, including the Panel, as being inconsistent with the RTS approach. The RTS relies on actual tax practices and seeks to measure what a province could raise if it adopted average taxing practices. In contrast, the income approach measures what provinces could theoretically tax. While a macro approach such as this can be conceptually legitimate (see Annex 4), mixing the RTS and macro concepts should be avoided where feasible.

ANNEX 5

Testing the stratified market value approach

The stratified market value approach underwent a significant amount of testing in the lead-up to the 2004 Renewal. The approach was tested for stratification bias (evidence that changes in the parameters defining each price category might bias measurements of fiscal capacity) and found to be robust. The stratified market value approach in its elasticity form generated similar results.

The federal government also considered the real value approach. In its view, the stratified base, while designed to measure capacity based on actual taxing practices, was not inconsistent with a real value approach given the high correlation between real values and scarcity. Given this high correlation, the federal government argued that the real value approach would predict that municipalities with high market values (and by correlation, high scarcity components) would tend to have lower average tax rates (since municipalities would not tax scarcity under this theory). Indeed, the stratification approach, based on actual taxing practices, recognizes the fact that municipalities with high market values tend to have lower tax rates.

Federal officials also suggested that, given the correlation of scarcity and real values, the stratification process would have a natural tendency to group together municipalities displaying high scarcity prices as well as high average market values. This means that real price differences between two provinces for property in the same bracket are likely to be quite small, ensuring that each bracket contains apples, and not apples and oranges.

The federal government concluded that the stratified market value approach, either in its original or elasticity form, could measure capacity based on taxing practices and was not inconsistent with one that would measure differences in real value. Also, it was more consistent with the philosophy and logic of the RTS system than the multiconcept base.

The 2004 Renewal adopted the stratified market value approach

After extensive testing, discussions and debates over the stratified market value approach and other approaches, as part of the 2004 Renewal, the federal government decided to phase in a variant of the stratified market value approach for residential properties calculated by using elasticities.

A special adjustment was made to reflect the high average market values of the British Columbia real estate market. In other provinces, 70 percent of market value differentials (relative to the national average) would be used to determine fiscal capacity; in British Columbia a lower rate of 50 percent would apply.[2] It was argued that this adjustment was necessary to recognize the special circumstances of the British Columbia property market.

Given the significant distributional impacts across provinces, a decision was also made to allow a phase-in period of the new stratified approach, and give the new base a 50 percent weight, with the old multiconcept approach continuing to receive the other 50 percent weighting. This phase-in also provided a period of further testing and study of the new methodology.

However, the New Framework announced by the federal government in October 2004 superseded the 2004 Renewal, and the new stratified market value approach was never implemented in legislation.

[2] For provinces other than British Columbia, 70 percent of the variation of average property prices around the national average is deemed to approximate variations in fiscal capacity. For British Columbia, that proportion was deemed to be 50 percent.

The Panel's assessment of the residential property tax base

The Panel reviewed the arguments put forth by provinces and experts. It also met with British Columbia and Québec officials to better understand their arguments. The Panel believes that the old multi-concept base has outlived its purpose.

The stratified market value approach, using elasticities, is not perfect. But it is based on actual taxing practices, in keeping with the RTS, and it is clearly a marked improvement over the multi-concept base. The new base has been extensively tested. It has also been benchmarked against a real value base using Statistics Canada's quality-adjusted price index for shelter costs, and the results are in keeping with this alternative approach. Barring transition problems or data issues, the stratified market approach should be implemented without a phase-in period, for 100 percent of the residential base.

The Panel considered the issue of the special adjustment for British Columbia that was adopted in the 2004 Renewal. The Panel's understanding is that incorporating this adjustment was a compromise position aimed at mitigating the impacts of moving away from the multiconcept approach. Given that the inclusion of this adjustment would not have any material impact on British Columbia's Equalization entitlements under the Panel's package of recommendations, the Panel believes it is neither necessary nor appropriate to include this special adjustment.

The Panel's assessment of the commercial-industrial-farm property bases

This annex has dealt only with the residential portion of property taxation. The remaining property tax is levied on commercial-industrial and farm property.

The base for the commercial-industrial component is still measured using a multiconcept approach, including the weighted sum of:

(a) the replacement value of industrial and commercial buildings as measured using capital stock data from Statistics Canada; and,

(b) a variable related to land values, estimated for each province by a formula with a number of inputs:

- The province's GDP at market prices for those industrial sectors deemed to be commercial or industrial.
- A complex adjustment factor related to urbanization which is derived from several subvariables.
- The national ratio of land values to building values in the commercial-industrial sector.
- The national stock value of commercial and industrial buildings.

Like the multiconcept base for residential property, a better conceptual framework for measuring revenue-raising capacity from the commercial-industrial-farm property tax is needed. Unfortunately, little progress has been made on developing a replacement base, in part because most of the work undertaken by federal and provincial officials has focused on the residential property base. Developing a new approach for commercial-industrial-farm property tax revenues will require years of conceptual and statistical work. Given that no alternative has been developed that would be clearly preferred over the current multiconcept base, the Panel is not recommending any changes to these components of the property tax base at this time.

Annex 6: User Fees

User fees are charges paid for goods and services provided by the public sector. The fees are wide-ranging, including water, sewer and garbage charges, fees for the use of skating rinks and recreational facilities, rents for low-income housing and long-term care, parking fees, and a host of other miscellaneous charges.

A brief history of user fees and Equalization: 1982–1999

Starting in 1982, virtually all the user fees collected by municipal and provincial governments entered the Equalization formula. By 1999, equalized user fees had grown to approximately $20 billion.

Consistent with past practice, the fees collected by institutions outside of the general provincial and municipal government universe (e.g., post-secondary, health, and social services institutions) were not equalized. These institutions are generally not consolidated in provincial accounts and are not considered to be part of the government universe for purposes of Equalization.

User fees were equalized under the miscellaneous revenues base of the program represented about 70 percent of the revenues in this base (the base also included fines, penalties, and various other small revenues).

A proxy measure was used to allocate the fiscal capacity of miscellaneous revenues. A proxy was chosen because the miscellaneous base included a broad range of revenues, making it very complicated to build representative tax bases to measure disparities for each revenue source. Moreover, even if the magnitude of such disparities had warranted creating a Representative Tax System (RTS) model, based on actual revenue-raising practices, there would have been a great deal of uncertainty as to the conceptually correct way to build the model.

The proxy chosen to determine fiscal capacity for user fees and other miscellaneous revenues was a measure that reflected a province's overall ability to raise revenue from all sources, except for natural resources. This measure was derived by adding up the fiscal capacity measures for all other non-resource tax bases within the Equalization program. This meant that, if a province had low fiscal capacity, as measured by all other non-resource bases, it was deemed to have low capacity to raise user fees and other miscellaneous revenues.

In the 1998–99 fiscal year, just before the 1999 Equalization Renewal, user fees resulted in Equalization payments of $740 million to receiving provinces.

The 1999 Equalization Renewal

As part of the 1999 Renewal, the federal government decided that only 50 percent of user fees would be equalized. This reduced Equalization entitlements for user fees by half.

The federal position was that user fees should generally not be equalized. However, 50 percent of user fees collected by provincial and municipal governments were retained in the formula to mitigate the financial impact on provinces and to reflect provincial views. The majority of provinces strongly supported the equalization of all user fees, disagreed with the change in its treatment, and expressed concern that the federal decision was motivated by a desire to reduce the cost of the program.

In 2003–04, some $8.2 billion – half of eligible user fees – entered the program. The measurement of the base continued to use the sum of the fiscal capacities of all other non-resource bases. That year, under the five-province standard, Equalization entitlements in respect of user fees were $425 million.

Should user fees be equalized?

The Panel heard diametrically opposing views on whether or not user fees should be included in Equalization.

The case to exclude user fees

The majority of academics who have studied this issue contend that user fee revenues should not be equalized, except for the portion that represents profit; that is, the excess of fee revenues over the cost of providing the service.

In their view, user fees are essentially a cost-recovery mechanism. In exchange for the fee, the payer obtains a benefit supplied by a government, much like a private transaction. Such transactions do not generate fiscal disparities and do not give rise to a need for Equalization.

In order to understand the arguments put forth by academics as to why user fees should not be equalized, it is helpful to briefly reflect on why regular taxes should be equalized. Consider, for example, sales taxes. Buyers are obligated to pay sales tax when they purchase taxable goods and services. The buyer receives nothing directly in return from the government for paying the tax on the purchase. This leaves the government with tax revenues (profits) to provide a broad range of government services such as health care and education to its citizens. A province with a low volume of sales (a weak tax base) is obviously less able to provide these services, and needs equalization to help it provide comparable programs.

In contrast to a tax, a cost-recovery user fee is essentially a payment where the buyer gets something directly in return and the government incurs a cost to provide this service, leaving no profit to provide its citizens with public services.

Take the example of a provincially operated residential care facility where individuals pay a cost-recovery user fee to stay there. These user fees pay for staff, meals and maintenance, leaving no profits. The province with a large number of people wishing to use residential care facilities (i.e., a strong user fee base) does not have a fiscal advantage over other provinces. With each additional resident, the province incurs additional costs to hire more staff, provide more meals and secure more space. These additional costs are covered by fees charged to the new resident. As a result, the province cannot use additional revenues from these fees to provide more government services such as health care and education.

Similarly, the province with fewer seniors wishing to use government-operated facilities (i.e., a weak user fee base) is not disadvantaged in providing its citizens with comparable government services, and does not need Equalization for this revenue source. Indeed, if user fees do not cover all costs, it could be argued that the province with a low number of seniors (a weak user fee base) is better off as it does not need to provide as large a subsidy to keep the facilities afloat.

A slightly different perspective on the residential care facility illustrates the argument put forth by academics on why user fees should not be equalized. Consider two provinces that choose to offer residential care in different ways. In the first province, residential care facilities are provided by the government on a full cost-recovery basis, while in the other province all facilities are owned and operated by the private sector. Clearly, the first province collects more user fees for this service than the second province, but does the first province have a financial advantage over the second province? Should the second province receive Equalization because it does not collect user fees? The answer is no to both questions. The province providing the residential care service and charging the user fee is left with no profit and no additional revenues compared to the other province.

While the majority of academics who have examined this issue agree that cost-recovery user fees should not be equalized, they also argue that profits generated when a user fee exceeds the cost of providing the service should be equalized. These profits provide governments with an additional source of revenue to provide public goods and services. A province that generates profits, be it from selling alcohol or lottery tickets, is in a better financial position to provide its residents with public services than a province which generates less profit. Profits should therefore be equalized, and a province with less than average profits should receive Equalization for these revenues.

The case for equalizing user fees

Provinces have argued that all user fee revenues, including some $17 billion of fees collected by colleges, universities, hospitals, and housing authorities, should be fully equalized. In their view, these fees represent revenues used to finance the provision of public services and are equivalent to taxes as a source of funds.

Provinces point out that an RTS system is supposed to mirror what provinces do. If they choose to deliver a service publicly, it is a public service and all revenues financing these services, whether user fees or general taxation, should be equalized. They argue that excluding some or all such fees from the Equalization formula could distort policy choices when it comes to collecting taxes or user fees. In other words, user fees are a source of revenue not distinguishable from any other source of revenue so they are a source of fiscal capacity.

Provinces noted that the inclusion of these fees, with Equalization payments determined by the current proxy base (and no fixed envelope), would enrich the program and raise Equalization payments to all receiving provinces. Provinces with the weakest non-resource fiscal capacity would receive the most benefit per capita.

How could user fees be equalized?

The Panel considered whether or not user fees should be equalized, and discussed with provinces and academics how disparities should be measured if there was a case for continuing to equalize user fees. In the Panel's view, the current approach for equalizing full and partial cost-recovery user fees – based on overall fiscal capacity (excluding resource bases) – is arbitrary and has no conceptual basis.

The Panel heard views that the most obvious approach, in keeping with the RTS, would be to use an approach similar to that used for consumption taxes (e.g., water consumption in litres to equalize water charges). However, in order to do this, an extremely complex model would have to be built to estimate how much revenue each province could raise if it levied a national average user fee on the many activities for which governments levy user fees.

Measuring these disparities would add tremendous complexity to the formula and would require many assumptions. For example, returning to the case of residential care facilities, a model would have to simulate how much a province could raise if it levied average user fees and had the average number of government run facilities. Simulating this result for a province that only had private sector residential facilities would require numerous arbitrary assumptions.

Moreover, the results would be difficult to interpret. For example, would a province that had an above-average number of seniors using public residential care facilities be at a fiscal advantage because it could raise higher than average user fees, or would it be at a disadvantage because it would have to provide higher than average subsidies?

The other approach to measuring user fee capacity that was suggested involves the use of actual revenues. The Panel considers this approach to be extremely problematic. First, provinces receiving Equalization would have an incentive to not levy user fees, as any loss in user fees would be offset by gains in Equalization. Second, even with a partial inclusion rate, provinces would have a strong incentive to structure their financial affairs to report only net revenues or profits (in order to maximize their Equalization entitlements).

The Panel's assessment

Clearly, this is a difficult issue given the diametrically opposed views held by provinces receiving Equalization and academics.

The Panel was persuaded by the argument that user fees are different from taxes, and do not generate additional fiscal disparities that need to be equalized. The conceptual difficulty of interpreting the result of an RTS user fee base reinforced the Panel's view that user fees should not be equalized.

Therefore, the Panel recommends that user fees that do not generate profits not be included in the Equalization formula. Profits generated from user fees by provinces and municipalities (e.g., from the sale of alcohol and lottery tickets) should continue to be fully equalized, as should miscellaneous taxes, such as land transfer fees. Under the simplified approach recommended by the Panel, these profits, as well as other miscellaneous tax revenues, should be equalized under the personal property tax base.

Annex 7: Resource Revenues

No issue in the entire Equalization program is more contentious than how to deal with resource revenues. Through its consultations, the Panel heard strongly held and diametrically opposing views from the provinces and academics. The issue is more than just one of principle. Natural resource revenues are a very significant source of disparities in fiscal capacity among the provinces. There also are very different impacts on provinces depending on whether, and to what extent, natural resources are included in the Equalization formula.

The Panel has reviewed the various ideas and options and attempted to strike the right balance with its recommendations. This annex provides an overview of the issues and sets out the Panel's recommendations.

Background: the importance of natural resource revenues in Canada

Natural resource revenues are a very significant source of disparities in provincial fiscal capacity in Canada. For instance, in 2004–05, per capita revenues from resources ranged from a low of $6 in Prince Edward Island to a high of $3,150 in Alberta. The national per capita average was around $520. No other major provincial revenue source is distributed as unequally. As a result, the Equalization entitlements of receiving provinces are heavily influenced by natural resource revenues.

While the exact distribution of resource capacity varies over time, it is fair to say that resource capacity is heavily concentrated in Western Canada. This is especially true of Alberta, which has by far the largest endowment of oil and gas, and consequently a fiscal capacity that is much higher than that of any other province. The above-average natural resource revenue capacities of British Columbia and Saskatchewan provide significant offsets to their below-average capacities in other own-source revenue bases. This explains their relatively modest and irregular Equalization entitlements, and their tendency to enter and leave the program. This is also becoming increasingly true for Newfoundland and Labrador, whose growing offshore oil revenues increasingly offset its significantly below-average capacity in other tax bases. Ontario has above-average fiscal capacity in other own-source revenue bases, more than fully offsetting its below-average fiscal capacity in natural resources.

The remaining five provinces all have below-average capacities in both natural resource and other own-source revenues. Natural resource revenues were responsible for 15 percent of their overall Equalization entitlements in 2004–05.

Three major issues of resource revenues and Equalization

The Panel's consultations and examination of the formula revolved around three major issues stemming from the unique features of resource revenues:

1. What is the appropriate inclusion rate for natural resource revenues?
2. How should Equalization measure the capacity to raise resource revenues?
3. How should Equalization deal with the volatility of resource revenues?

The difficulty of finding the right answer to these questions, particularly to the first two, is illustrated in Table 1. As shown, the inclusion rate and measurement of fiscal capacity have changed frequently for natural resource revenues since the program's inception.

TABLE 1 – Major Changes in the Treatment of Resource Revenues in the Equalization Program, 1957 to 2004

Period	Major changes in the treatment of resources in the Equalization program	Number of distinct resource tax bases
1957–1962	Equalization established in 1957 with only three equalized tax bases: personal income tax, corporate income tax, and succession duties. Natural resource revenues were not taken into account.	None
1962–1967	Natural resource equalized. However, inclusion was 50 percent of the three-year moving average of actual provincial resource revenues.	1
1967–1972	Adoption of the Representative Tax System (RTS) in lieu of using actual revenues. One hundred percent inclusion rate of such revenues.	7
1972–1977	Major petroleum price shock in 1973 resulted in reduction of oil and gas inclusion rate to 33.3 percent starting in 1974.	7
1977–1982	Inclusion rate set at 50 percent for all non-renewable resources (including oil and gas).	9
1982–1987	Return to 100 percent inclusion (with a 5-province standard to prevent a dramatic rise in Equalization entitlements).	12
1987–1992	Addition of two new oil and gas bases (including offshore revenues shared with provinces) and subdivision of mineral base into five new bases.	18
1992–1994	Re-consolidation of several oil and gas and mineral tax bases.	15
1994–1999	Implementation of a generic solution (i.e., inclusion at a 70 percent rate) for tax bases concentrated in one province.	15
1999–2004	Further subdivisions and re-consolidations of a number of oil and gas tax bases and consolidation of all distinct mining tax bases into a single one based on profitability (as an approximation for economic rent).	14

What is the appropriate inclusion rate for natural resource revenues?

The Equalization program generally includes all provincial revenues in the formula in order to accurately measure a province's fiscal capacity. Supporters of this approach argue that failing to fully take into account the fiscal capacity from all revenue sources would result in provinces receiving an incorrect amount of Equalization, thus undermining the principle of providing "reasonably comparable services at reasonably comparable tax rates," as set out in Section 36(2) of the Constitution. Indeed, the current Equalization formula is considered to be very comprehensive and includes almost all provincial revenues.

While comprehensive revenue coverage is considered important by most supporters of Equalization, many have also argued that this principle needs to be considered within the context of the unique features of natural resource revenues, and that a strong case can be made for excluding some or all natural resource revenues from the Equalization formula.

The Constitutional arguments for excluding resource revenues

The arguments for excluding natural resource revenue stem from the provincial ownership of natural resources as reflected in Section 109 of the Constitution. Proponents of excluding resource revenues argue that an essential element of resource ownership is that a province and its citizens should be able to receive a net benefit from natural resources. However, if resource revenues are fully included in the formula—and Equalization entitlements go down dollar-for-dollar as resource revenues go up—the fiscal benefit of resource ownership is neutralized.

Numerous academic studies have proposed including less than 100 percent of resources stemming from this constitutional argument. In their seminal article of 1975, Gainer and Powrie proposed that about 70 percent of provincial resource revenues should be equalized. They argued that, conceptually, provincial resource revenues should be treated as if they had accrued to the private citizens or corporations of the province (since they are the ultimate owners). The federal government should therefore receive the portion of natural resource rents that it would get if it had levied personal or corporate income tax on this income. Assuming a federal tax rate of 30 percent (the approximate rate at the time the article was written), only 70 percent of the revenues should be subject to Equalization.[1]

Other contributors to the debate, such as the Economic Council of Canada, have used the constitutional argument in a similar vein. The Council argued that provincial resource revenues are owned by the citizens of the province. The only portion that should therefore enter into the Equalization formula is the amount that would be raised by the provinces if they levied income tax on the resource revenues distributed back to their residents. Assuming a 20–30 percent provincial income tax rate, only 20-30 percent inclusion of resources revenues would be appropriate.

Other arguments for a lower inclusion rate for natural resources

Proponents of a less-than-full inclusion rate point to two additional considerations. First, provincial ownership means that provinces have significant control over the development of resources, much more so than over other economic sectors.

"A provincial government under the constitution has 'vastly greater control over the natural resources it owns than it does over the natural resources it doesn't own. A province can with respect to natural resources it owns: (a) decide whether to develop them, (b) decide by whom, when, and how they're going to be developed, (c) determine the degree of processing that's to take place within the province, (d) dispose of them upon conditions that they only be used in a certain way, or in a certain place, or by certain people, (e) determine the price at which they or the products resulting from their processing will be sold.'"

- Mervin Leitch, (Former Alberta Attorney General)[2]

1 Gainer, W.D., and Powrie, T.L. (1975). Public Revenue from Canadian Crude Petroleum Production. *Canadian Public Policy* 1-12, Vol. 1, no.1, 1975.

2 Leitch, M. The Constitutional Position of Natural Resources, November 21, 1974 reprinted in J.P. Meekison (ed.), (1974), *Canadian Federalism: Myth or Reality?*, pp. 170-178.

Accordingly, it is argued that the Equalization program should be structured to ensure that incentives are in place to support the development of resources by provinces. The dollar-for-dollar reduction in Equalization (that would result from full inclusion) clearly reduces a government's incentive to support resource activity.

Second, and closely related to the issue of provincial control, natural resources are more likely than other revenue sources to involve public costs. Natural resource development often requires substantial infrastructure and entails environmental impacts that need to be regulated, monitored, and managed. For instance, resources found in isolated and largely unpopulated areas, such as the Voisey's Bay nickel deposit in Labrador or hydro-electric installations in northern Québec, require significant provincial infrastructure investments that are essentially dedicated to the extraction of natural resources.

In order for the Equalization program to accurately reflect the net provincial revenues that are left after incurring the costs associated with resource development, and to ensure that provinces have the incentive to invest money to support resource development, it is argued that the inclusion rate of natural resource revenues should be less than 100 percent.

Finally, the Panel also heard arguments to partially or fully exclude non-renewable resources (e.g., mining, oil and gas) from Equalization while continuing to include revenues from renewable resources (e.g., forests and hydro-electricity). The main rationale is that non-renewable resources do not generate an ongoing flow of revenues; their exploitation is akin to the conversion of an asset in the ground into a financial asset, leaving the province no better off financially in the long term.

The Panel's view on the appropriate inclusion rate

The Panel assessed the arguments in support of full inclusion of resource revenues put forward by a number of provinces and experts and does not believe this approach is appropriate. The Panel's view is that full inclusion of natural resource revenues does not recognize that:

- Provincial governments own the resources and should get a net fiscal benefit as owners.
- Provinces have significant control over resource development, and appropriate incentives need to be in place for provinces to support resource development.
- There are public costs involved in providing the infrastructure necessary to develop natural resources.

Moreover, full inclusion does not appear to be sustainable, as evidenced by the special Offshore Accords that essentially reduced the inclusion rate to zero percent for offshore resource revenues for Newfoundland and Labrador and for Nova Scotia.

This being said, the Panel also does not support the view that the ownership argument naturally leads to the conclusion that 100 percent of resource revenues should be excluded from Equalization. That approach would appeal to receiving provinces with natural resource revenues, as it would allow them to receive all the benefits from their own resource developments plus full access to Equalization. Receiving provinces without resource revenues would see a substantial drop in the overall Equalization pool and the amount they receive. Economics and efficiency aside, this does not meet the fairness test for all Canadians.

The Panel weighed the economic and constitutional arguments and considered the distribution impacts of various inclusion rates. The Panel's best judgement indicates that a 50 percent inclusion rate combines the merits of the various arguments and provides the most reasonable results for all receiving provinces, particularly when this is combined with the entire package of changes proposed by the Panel. In this respect, a 50 percent inclusion rate facilitates the Panel's recommendation to adopt a 10-province standard by making it more affordable for the federal government. It also recognizes that 43 cents out of each dollar of revenue raised by the federal government comes from taxpayers in Ontario, a province that does not receive Equalization and has no oil and gas revenues.

The Panel's view on renewable versus non-renewable resources

The Panel also considered the issue of renewable versus non-renewable resources. Although a distinction can be made in theory, in practice it is not that clear-cut. Revenue streams generated by many non-renewable resources extend over many decades, as has been the case in Alberta and Saskatchewan. Moreover, resources thought to be renewable (e.g., forestry or fisheries) can be depleted and may turn out to be more finite than expected.

The Panel was also not persuaded by the argument that revenues from non-renewable resources should be excluded because this was tantamount to a conversion of an asset into a revenue stream. Government revenues of all kinds are derived from different forms of capital (capital assets, human capital [i.e., personal income tax and consumption taxes], corporate capital, hydrological potential, forests), all of which are subject to some depreciation, as are resources in the ground. Non-renewable resource revenues can and are used to provide public services and reduce the level of other forms of taxation.

A province could choose to convert the finite revenue stream from a non-renewable resource into an equivalent permanent income stream through the use of financial market instruments or mechanisms such as heritage funds. Exclusion of revenues set aside in such funds could be justified, as the revenues set aside are not immediately available to fund services. However, it is not clear that even this distinction is meaningful given the interchangeability of revenues, and the possibility that a province could simultaneously borrow and set revenues aside in a fund.

How should the capacity to raise resource revenues be measured?

An RTS tax base should measure how much a province could raise from the revenue source if it levied the national average tax rate. In the case of resources, provinces attempt to capture or tax the economic rent.

What is economic rent?

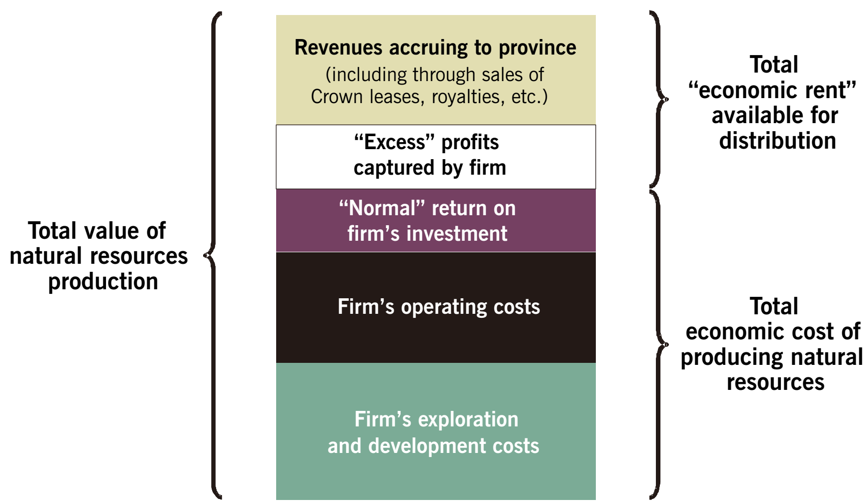
Economic rent is the difference between the selling price of a good or service and the cost of producing it, including a normal return to capital employed. Economic rent is often generated with natural resources, as there is usually a world price for commodities and the cost of bringing natural resources to market is considerably less for some producers, leaving surplus economic rent for provincial governments to capture.

For production to be viable at all, the value of resources must at least cover the up-front fixed costs of exploration and development, including the costs of the inevitable dry holes, the operating costs of actually bringing the resource to market, and a normal rate of return to investors. This is the total economic cost of producing the resource.

The remaining value is the economic rent available to be shared between the resources' owner (i.e., the province) and the producers.

Figure 1 illustrates the way in which the total value of natural resources produced in a jurisdiction is apportioned among the various economic players involved.

FIGURE 1 — Illustrative break-down of the value of natural resource production by its ultimate uses



Differences in the nature of various natural resources, including location and geological factors that are site-specific, translate into large and systematic differences in the economic costs of production and widely differing levels of rent. For example, the cost of production differs for each dollar of output, varies greatly among producers across different resource sectors (e.g., ranging from high-rent oil and gas fields to low-rent gravel deposits), or even in the same resource sector (e.g., between conventional oil and oilsands) and across different provinces (some provinces have oil that is less expensive to extract).

Provincial revenue-raising practices

In order to collect resource rents, provinces use tax structures that take into account the differing levels of rent due to location and geophysical factors. In addition, the revenue-raising systems attempt to take into consideration the high degree of volatility in commodity prices, the difficulty of knowing precisely how large a deposit may ultimately prove to be, and the significant changes in profitability over the various phases of the life cycle of a deposit. As a result, the simple conceptual framework shown in Figure 1 typically translates into very complex revenue-raising mechanisms where provinces attempt to extract economic rents.

Royalty regimes are often the primary vehicle for collecting economic rents. Royalty regimes vary by natural resource type (e.g., various classes of oil, gas, and minerals), and are generally applied to the value of production. Royalty regimes are also sensitive to commodity prices, the volume of output from particular deposits, stage of production, ownership (e.g., production from leases on Crown land vs. freehold lands), and exploration and development costs.

In addition, provinces collect rents through:

- Auctions for exploratory leases on Crown lands
- Resource sector-specific corporate income tax provisions
- Remittances from Crown corporations involved in natural resource extraction.

Measuring revenue-raising capacity in the Equalization program

The RTS system currently uses 14 tax bases to measure the capacity of provinces to raise revenues from natural resources. Most use value of production as the tax base and, in this respect, emulate an important but very basic element of the royalty and stumpage regimes. Using value in the Equalization tax base means that, for example, a province that extracts 20 percent of the value of logs in Canada is assumed to have 20 percent of total provincial fiscal capacity related to forestry stumpage fees. Similarly, a province that extracts 20 percent of the value of natural gas is assumed to have 20 percent of the revenue-raising capacity from natural gas.[3]

This approach is, at best, an extremely crude approximation of the economic rent that is captured by provinces. Most importantly, it fails to take into account different cost structures across provinces and producers. For example, the Equalization tax base implicitly assumes that the cost structure of harvesting one dollar of difficult-to-access small pine trees in one province is identical to the cost structure of harvesting easy-to-access large cedar trees in another province, whereas stumpage fees are determined by such factors. As a result, the Equalization tax bases do not accurately reflect the differences in economic rent that are available for provinces to capture.

[3] Both the log and natural gas examples are somewhat simplified for illustrative purposes. The forestry base, for example, actually uses the value of logs, bolts, pulpwood, fuelwood, firewood, and other industrial roundwood as the base, while revenues include stumpage fees and a variety of other forestry levies.

The current Equalization program has tried to take these different costs into account by dividing tax bases according to resources that have similar cost structures. For example, a separate tax base has been created for heavy oil to recognize that the cost of generating one dollar of oil production is greater for heavy than conventional oil (and accordingly, each dollar of output generates less economic rent). Again, this is a crude approximation since costs vary not just among the different types of oil, but also among heavy oil mining developments across provinces.

The current system also does not deal with other realities of economic rent, such as the high degree of volatility in commodity prices, the difficulty of knowing precisely how large a deposit may ultimately prove to be, and the significant changes in profitability over the various phases of the life cycle. All of these factors are taken into account when provinces collect resource revenues with their full complement of revenue-raising practices.

For example, a mechanism for dealing with this uncertainty, as discussed earlier in this annex, is the use of auctions for exploratory leases on Crown land. While actual revenue collected by provinces is based on numerous complex factors, including speculation on future prices and the size of yet-to-be exploited deposits, the current system assumes that a province with 20 percent of the current fiscal capacity for oil and gas output has the capacity to raise 20 percent of revenues from Crown land. This is clearly not an accurate measure of a province's ability to raise revenues from lease auctions.

Other approaches to measuring fiscal capacity

A much better way to measure fiscal capacity from natural resources would be to equalize all resource revenues into a single tax base that measures the economic rent generated by all natural resources in a province. In other words, create an economic rent tax base. This approach has a precedent: the mineral resources tax base was created in 1999 by combining several distinct tax bases into a single base that attempted to approximate rent by using a measure of profitability in the sector. Unfortunately, due to conceptual and data problems, the measure of profitability used in the mineral tax base did not work well, and created results that were inconsistent with revenues raised.

An alternative approach is to use an aggregate measure of the value of production for all resource sectors in a province as the tax base (i.e., create a resource GDP tax base). This approach would be much cruder than a rent approach, but would likely be less demanding in terms of data requirements.

The Panel's view on measuring fiscal capacity of resource revenues

The Panel believes that the current approach to measuring the capacity to raise resource revenues needs fundamental change. The 14 tax bases are complex and do not accurately take into account the multitude of factors that determine a province's capacity to generate resource revenues.

Alternatives to the RTS such as economic rent or resource sector GDP deserve further consideration. However, the Panel believes that both data shortcomings and conceptual challenges would make it extremely difficult, if not impossible, to create a reliable tax base for all resource-related economic rent. Moreover, it will take time, perhaps years, before a reasonably reliable approach could be devised and implemented.

In the meantime, the Panel recommends using actual revenues. If all provinces are extracting as much of the available rent as possible, there is no need to use an RTS structure to hypothesize how much a province could raise if it levied average tax rates. Actual revenues would be an accurate and fair measure of fiscal capacity. In the Panel's view, the assumption that provinces try to maximize their revenues from resource rents is quite reasonable.

Not only would the use of actual revenues be more accurate than the current approach, it would also greatly simplify the program and make it administratively easier to treat all resource revenues the same way.

A key concern is that actual revenues might provide a disincentive for provinces to extract resource rents because they would lose Equalization as their resource revenues increased (and vice versa). The Panel believes that using a 50 percent inclusion rate and a two-year lag with a three-year moving average would address this concern. A province that decided to reduce its royalty rates, for example, would generally have to wait five years until Equalization payments fully increased. Even then, Equalization would generally only compensate 50 cents for every dollar of reduced resource revenue. This structure should help to ensure that provinces continue to maximize their resource rent revenues.

The Panel's view on hydroelectricity

The measurement of fiscal capacity related to hydroelectricity deserves special mention. Provinces with substantial hydroelectric resources have typically opted to develop and distribute these resources through Crown corporations. They have also chosen in many instances to provide electricity to their residents at close to cost, thus distributing a part of the economic rent directly to their residents in the form of lower prices rather than capturing the rent as revenues.

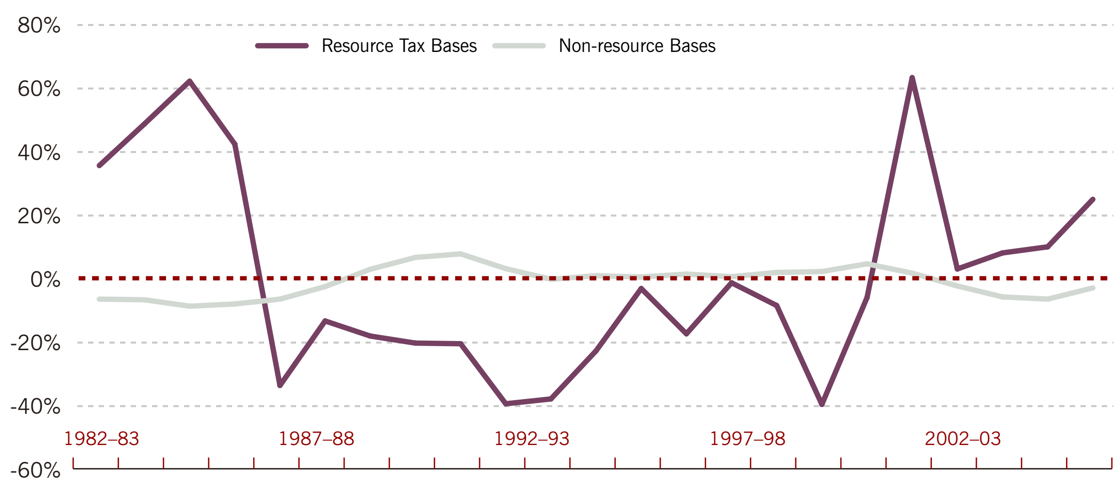
Under the current RTS, provincial revenues from hydroelectricity are counted in two tax bases, depending on the form they take. Charges for the use of hydrological potential enter into the waterpower rentals base. Remittances from provincial Crown corporations engaged in hydroelectric production and distribution are treated as if they are business revenues. Because of its direct control, a province can ensure that its hydroelectricity revenues enter the two revenue bases in a way that minimizes the negative impact on its Equalization entitlement from the production of hydroelectricity.

If a comprehensive rent base for provincial resources was developed in the future, then hydroelectric rents should be calculated and imputed whether they are left in the hands of hydro consumers or accrue to the provincial government. This would, however, be difficult and controversial. The Panel is not recommending such an approach. It is, however, recommending that the playing field be somewhat levelled by treating the remittances to governments from Crown corporations engaged in resource extraction and development as resource revenues, rather than treating them as business income for Equalization purposes.

How should Equalization deal with the volatility of resource revenues?

Figure 2 illustrates the much greater annual volatility of measured natural resource capacity (under the RTS and with full inclusion) than the measured capacity of other provincial revenues.

FIGURE 2 – Volatility of Resource and Non-resource Tax Bases *(percentage deviations from trend, 1982–83 to 2004–05)*



This volatility is mostly the result of world commodity prices, but it also reflects the multiple types of resource revenues (e.g., auction revenues, royalties, etc.) yielding different levels of fiscal capacity at different times. This volatility can result in large and unpredictable swings in Equalization entitlements, complicating the process of fiscal planning for provinces. Whether the RTS revenue bases are retained or replaced by any alternative measure, this volatility in Equalization payments will continue unless new mechanisms are put in place.

The Panel's view on reducing volatility

The Panel is recommending a three-year moving average of all revenues. Further details are presented in Annex 8 on stability and predictability. This should go a long way to smooth out resource revenues entering the Equalization formula and the attendant volatility in payments. A smoothing mechanism will be particularly important if a 10-province standard that includes 50 percent of Alberta's volatile resource capacity is adopted.

The Panel has examined the option of using a longer moving average for resource revenues than for other tax bases. It concluded, however, that the added stability was generally not worth the added complexity and the further reduction in responsiveness of the program to own-source revenue fluctuations.

Annex 8: Improving Predictability and Stability

The Panel's mandate specifically calls for recommendations on how to improve the predictability and stability of the Equalization program.

The Panel discussed these issues with federal and provincial governments, as well as academics. We heard two recurring concerns, particularly from provinces. First, the formula-based system in place before the October 2004 New Framework was not very predictable. It was difficult to predict in advance if, and to what extent, Equalization would go up or down within a year or from one year to the next. Second, Equalization payments were volatile, often changing significantly within a year, as well as from one year to the next.

In examining these issues, the Panel's work focused on two aspects of the Equalization program: the complex estimation and payment system, and the lack of any smoothing (averaging) mechanism to reduce year-over-year volatility in entitlements. This annex provides details on the Panel's consideration of these issues.

The estimation and payment system

The current Equalization formula uses a complex estimation and payment system that makes entitlements volatile and difficult to predict.

The process begins in April, the beginning of a fiscal year. The federal government starts making semi-monthly payments to the provinces based on its first official estimate for Equalization entitlements for that fiscal year. These payments are then revised throughout the fiscal year. The second official estimate is calculated in October and the third official estimate in February. These estimates incorporate the latest available data (e.g., provincial revenues, sales and population).

By the end of the fiscal year, a province will have received a full year's entitlement based on the latest available data—but the process is far from over. The entitlement for that fiscal year is revised using new data every October and February resulting in fourth, fifth, sixth, and seventh estimates and a final (eighth) calculation (3 and a half years after the first estimate). With each new estimate, the federal government makes additional payments if the data show that entitlements should have been higher, and likewise, recovers overpayments from provinces if the data show that entitlements should have been lower. Figure 1 provides additional detail on how this process works.

Since it takes almost four years to finalize the entitlements for a given fiscal year, when new estimates are released, payments are revised for up to four fiscal years at the same time. For example, in October 2003, six months after most provinces had released their annual budgets, provinces were informed of:

- Revised entitlements and a payment schedule for 2003–04 based on the second estimate
- Additional payments or recoveries for 2002–03 entitlements based on the fourth estimate
- Additional payments or recoveries for 2001–02 entitlements based on the sixth estimate
- Additional payments or recoveries for 2000–01 entitlements based on the final (eighth) calculation.

FIGURE 1 – Estimates, Payments And Recoveries under the Current Equalization Program

In any particular fiscal year t, bi-monthly payments are made in respect of year t based on the 1st, 2^{nd}, and 3^{rd} official estimates for that year. In addition, adjusting payments and recoveries are made in respect of year t-1 based on the 4^{th} and 5^{th} official estimates for year t-1. Adjusting payments and recoveries are also made for year t-2 based on the 6^{th} and 7^{th} official estimates for year t-2. And adjusting payments and recoveries are made in respect of year t-3 based on the final calculation for year t-3.

Estimates, payments, and recoveries during year t:

In respect of year…	**Year t**	**Year t-1**	**Year t-2**	**Year t-3**
	In respect of year t, 24 payments (2 per month) are made throughout the year. The amount of each payment is initially based on the 1^{st} official estimate. The bi-monthly amount is adjusted at the time of the 2^{nd} and 3^{rd} official estimates. By the end of the fiscal year, each province will have received an amount exactly equal to its entitlements according to the 3^{rd} official estimate.	In respect of year t-1, adjusting payments or recoveries are made in accordance with the 4^{th} and 5^{th} official estimates. If the 5^{th} estimate reveals that a recovery should be made, that recovery may (pursuant to a request by the province) be deferred until the next fiscal year.	In respect of year t-2, adjusting payments or recoveries are made in accordance with the 6^{th} and 7^{th} estimates. If the 7^{th} estimate reveals that a recovery should be made, that recovery may be deferred until the next fiscal year. Recoveries pursuant to the 5^{th} estimate in respect of year t-2 (5^{th} estimate of the previous year) that were deferred to the current year are also recovered.	In respect of year t-3, adjusting payments or recoveries are made in accordance with the final calculation. Recoveries pursuant to the 7^{th} estimate in respect of year t-3 (7^{th} estimate of the previous year) that were deferred to the current year are also recovered.
April	**1**			
May				
June				
July				
August				
September	**2**	**4**	**6**	**Final**
October				
November				
December				
January				
February	**3**	**5**	**7**	
March				

While in some years new data did not result in huge swings in entitlements, in other years the provinces (and the federal government) could be hit with a perfect storm. New data (i.e., economic, demographic, or revised data) could result in entitlements for all four years being significantly revised upward or downward.

Understandably, some provinces expressed concern that this estimation and payments system makes their budgetary planning very difficult because entitlements are both volatile and unpredictable. For example, if a province, on the eve of its budget, is informed that it owes substantial amounts due to large Equalization overpayments from three years ago, it is put in a difficult fiscal position that adds uncertainty to fiscal planning.

Given the potential for large recoveries due to revised estimates, provisions were adopted in the late 1970s to recover large overpayments over a number of years, rather than immediately after the release of a new estimate. This cash-flow relief was helpful when provinces used cash accounting. But provinces have now largely adopted full or modified accrual accounting, and the change in entitlements (not the cash payments) matters in determining their budgetary balance.

The Panel's assessment of the estimation and payment system

The Panel recognizes that the principle behind the eight-estimate system is to allow current year entitlements to be based on the most recent data (the first estimate); subsequent estimates are revised using more accurate data. However, in the view of the Panel, this approach does not provide an appropriate balance between using the most up-to-date data (which should reflect current economic conditions), and having a system that is sufficiently predictable and stable for government budget planning. This instability is particularly problematic when Equalization makes up a large share of a province's overall revenues.

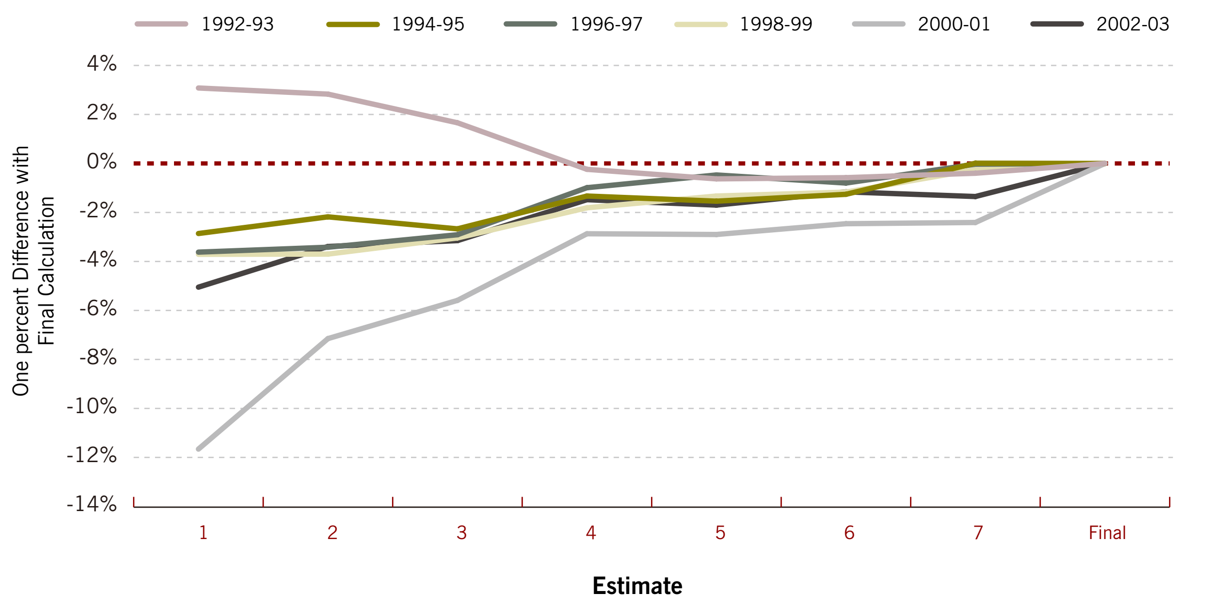
The Panel believes that the current approach for determining Equalization entitlements and payments should be replaced with a one estimate, one entitlement, one payment approach. That is, provinces should be given their entitlements for a fiscal year based on one estimate, and payments should be made based on this estimate, with no subsequent adjustments or revisions. This means that once entitlements are announced for a year, provinces could undertake financial planning with confidence, knowing that their entitlements will not be revised.

This approach would also be much simpler, more transparent, and would enhance accountability to Canadians. In periodic disagreements over Equalization, Canadians have had to contend with contradictory statements from federal and provincial governments about whether a particular province's payments had gone up or down. Under the Panel's recommended system, the single annual estimate would make Equalization payments to each receiving province clear and definitive.

The challenge in designing this kind of system is to use data for the one estimate that are as current as possible, but also sufficiently reliable to support large and important federal Equalization payments. In the Panel's view, the data used for the first three estimates are not sufficiently reliable, and are simply too preliminary to accurately reflect current economic conditions. The use of these data results in significant revisions to entitlements. Data used for the last five estimates, on the other hand, are much more reliable and provide more accurate estimates of final Equalization entitlements.

Figure 2 shows how far each estimate diverges from the final Equalization calculations over a 10-year period.

FIGURE 2 — Convergence of Official Estimates on Final Calculation, Total Yield of All Provinces (1992–93 to 2002–03)



Given the inaccuracy of the preliminary data that are available for arriving at the first three estimates, and the volatility this creates, the Panel is convinced that these estimates should not be used. Instead, it recommends that the one estimate, one entitlement, one payment approach use lagged data that are much more accurate and stable.

The use of lagged data means that Equalization entitlements would be based on economic events that occurred in the past. The Panel is convinced that this slight loss in responsiveness is outweighed by the increase in stability and predictability that would be gained by using a reliable single estimate that is not subject to subsequent revisions. This slight loss in responsiveness should also be put in context; the first three estimates of the eight-estimate system were themselves not very responsive to current economic conditions. Those data were simply too preliminary to give an accurate picture of current year fiscal capacity.

Lack of a smoothing mechanism

In addition to multiple estimates for a given year's Equalization entitlements, the Equalization formula used prior to 2004–05 contained no smoothing mechanism to address year-over-year volatility.[1] The effects of the business cycle, sudden data revisions, or fluctuations in commodity prices were reflected in payments as soon

[1] A three-year moving average was legislated as part of the 2004 Renewal, but was never implemented because that legislation was superseded by the October 2004 New Framework.

as they showed up in the statistical data entering the formula. As a result, payments were responsive to the latest data, but this responsiveness came at a cost—entitlements could change significantly year-over-year, and often these changes could not be predicted.

The Panel noted that other Equalization programs, such as in Australia, use moving averages to smooth fluctuations and reduce instability in year-over-year entitlements. Smoothing mechanisms (where entitlements are based on the average of fiscal capacity over a number of years) delay the program's response to deteriorating or improving fiscal circumstances. However, they also provide greater predictability and stability because entitlements are adjusted gradually with changes in economic circumstances and new data. This allows for better fiscal planning by receiving provincial governments.

The precise choice of the moving average is ultimately a balancing of objectives. A long moving average, such as one based on average fiscal capacity over the past 10 years, would provide significant stability and predictability over time, but would leave the system very unresponsive to changes in economic circumstances. A short moving average would result in greater responsiveness to new data, but also more volatility.

The Panel's assessment

Based on discussions and research, the Panel recommends that a single estimate, single entitlement, and single payment approach, combined with the use of a three-year moving average, would create a system that is more predictable and stable, while still maintaining an appropriate degree of responsiveness.

A single estimate, single entitlement, single payment system would radically simplify the payment system and remove the unpredictability and instability caused by the eight-estimate system. The simplicity of this approach would also significantly increase transparency, making it clear how much Equalization a province would be entitled to receive each year.

The single estimate should be based on a three-year moving average, lagged two years. For instance, for 2007–08 entitlements, payments should be made based on a single estimate using data from 2005–06, 2004–05 and 2003–04, weighted at 50, 25 and 25 percent, respectively. The recommended weighting gives the most weight to the most recent year in the three-year moving average in order to maintain responsiveness. The lag in the data, together with the three-year weighted moving average, would make payments more predictable and more stable by dampening fluctuations in annual payments by approximately 25 percent.

The Panel suggests that the federal government consult with the provinces to determine the most desirable time to announce entitlements for a year. Under the proposed system, the federal government could announce 2007–08 entitlements in the fall of 2006 based on the data available at that time. This would give provinces certainty as they prepare their upcoming budgets. Alternatively, the federal government could wait until somewhat better data are available in early 2007.

Annex 9: Evidence-based Indicators of Fiscal Disparities

The scope of indicators to evaluate federal support for Equalization

The Panel's mandate calls for advice on "evidence-based aggregate measures of fiscal disparities … to provide information to governments and citizens and assist in future re-evaluations of the overall level of federal support for Equalization."

In order for the Panel to determine what information would be most relevant for this task, it had to consider the scope of the indicators that would be appropriate given the purpose of Equalization.

Indicators could be relatively narrow in scope to allow Canadians to judge whether the Equalization program provides adequate fiscal support to enable provinces—"to provide reasonably comparable levels of public services at reasonably comparable levels of taxation," in accordance with the commitment in section 36(2) of the Constitution. Narrow indicators would assess whether Equalization is reducing fiscal disparities among provincial governments so that they can provide comparable services at comparable levels of taxation if they choose to adopt similar policies.

Broader indicators would allow Canadians to evaluate whether or not Equalization is resulting in comparable government services at reasonably comparable levels of taxation. These indicators could answer questions about whether provinces are providing similar services in health, education, social and other expenditure areas.

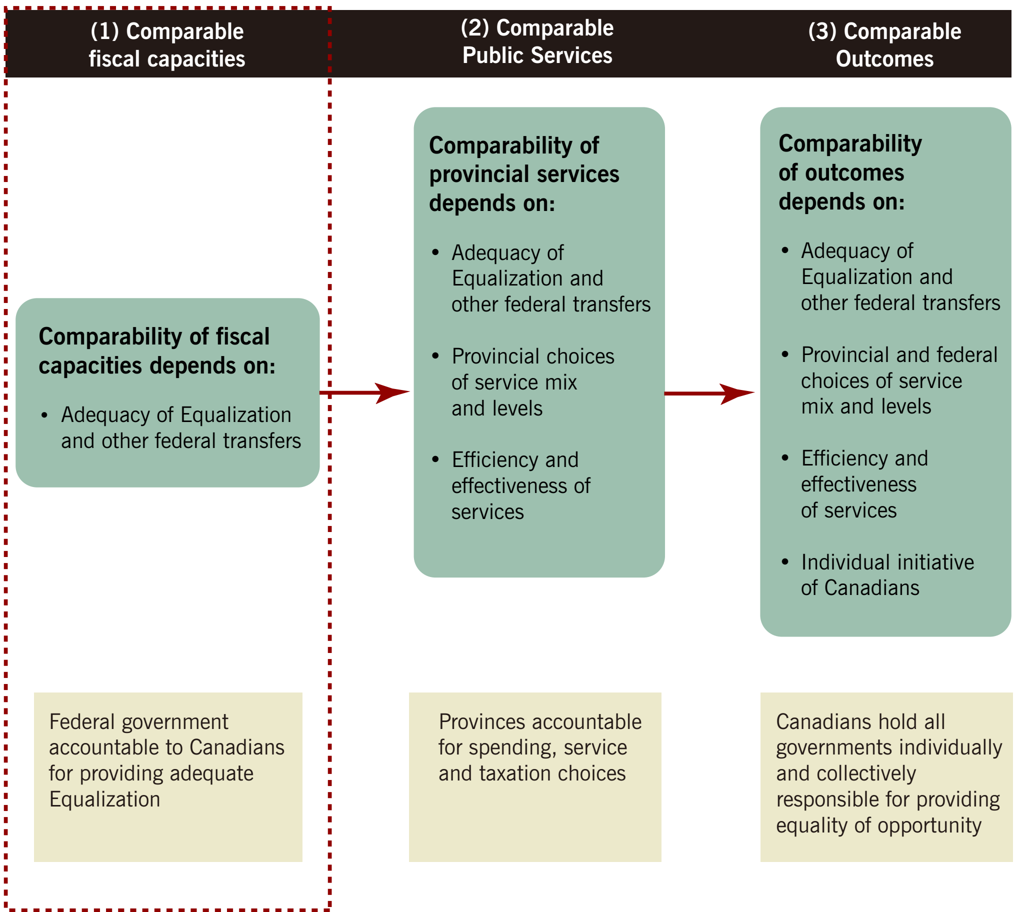
Even broader indicators would allow evaluations to be made on the comparability of outcomes or results achieved by provincial programs and services, which are partly financed by Equalization. These types of indicators could show whether Equalization is producing similar outcomes in areas such as health status, educational achievement and incomes across provinces.

These three very different perspectives are illustrated in Figure 1.

In the Panel's view, while the broader indicators are interesting, they extend well beyond the objective of Equalization. They assume that there is a direct link between Equalization and the comparability of services and outcomes when, in fact, Equalization is only one of many contributors to the results. Indeed, the provision of government services and socio-economic outcomes result from a complex mix of federal and provincial programs and choices, social and economic trends that reach far beyond the scope of Equalization, and less tangible factors such as individual initiative and effort.

ANNEX 9

FIGURE 1 – The Scope of Indicators for Evaluating Federal Support for Equalization



Linking broader indicators back to Equalization would also be incompatible with the spirit of Canadian federalism. Equalization is an unconditional grant, meant to enable (not enforce) reasonable comparability of public services in a decentralized federation, where provincial governments are accountable to their residents for the choices they make with respect to public services and taxation. A province alone decides whether it wishes to provide more than comparable, less than comparable or reasonably comparable public services. Equalization should give a province the means to do the latter, without imposing it.

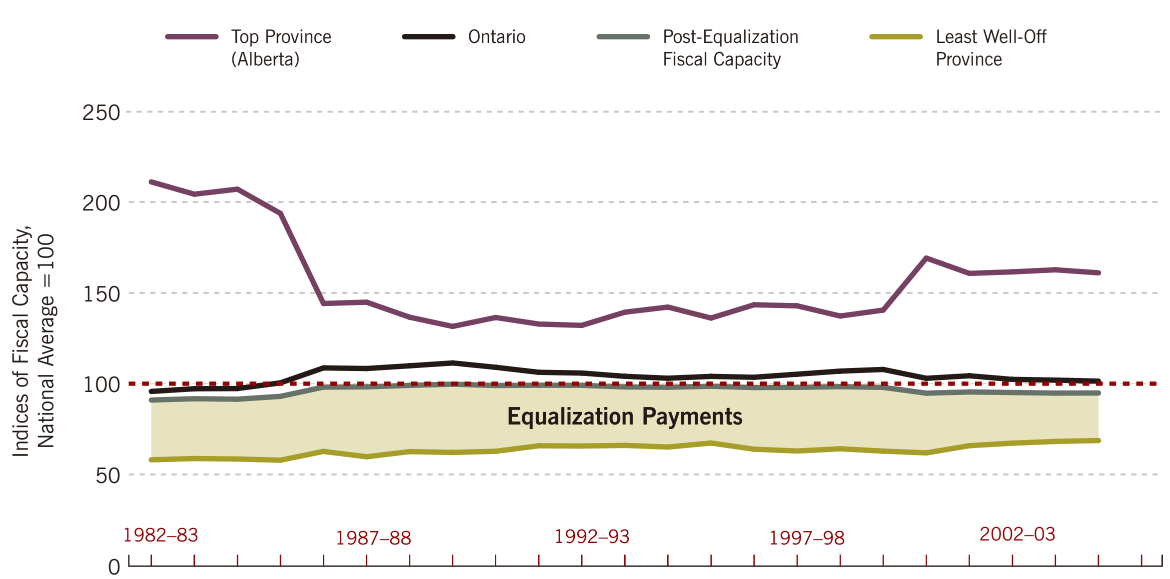
The Panel, therefore, believes that the most relevant indicators are those that show whether Equalization payments reduce fiscal disparities among provincial governments so that they can provide reasonably comparable services at reasonably comparable levels of taxation, if they choose. Such measures are consistent with the Panel's view of the purpose of the Equalization program and with the respective accountabilities of the federal and provincial governments under the Constitution.

Assessing financial adequacy of Equalization to reduce fiscal disparities

The Panel believes that pre- and post-Equalization fiscal disparities are the most important indicators for assessing the adequacy of the Equalization program. These measures can be derived directly from the Equalization formula, and if the Panel's formula is accepted, should be a very accurate measure of fiscal capacity.

Figure 2 illustrates the use of pre- and post Equalization fiscal capacity measures, and provides an indication of the extent to which Equalization has reduced fiscal disparities since 1982–83.

FIGURE 2 — Contribution of Equalization to Reducing Inter-Provincial Disparities (1982–83 to 2004–05)



Canada has experienced significant (and highly variable) pre-Equalization fiscal disparities between its least well-off and most well-off jurisdictions. Equalization has generally succeeded in significantly narrowing this gap.[1] Since 1982, Equalization has raised the fiscal capacity of the least well-off province from 58 to 68 percent of the national average to between 91 and 99.7 percent of the national average.

The Panel's recommendation for a rules-based approach using a 10-province standard would automatically reduce fiscal disparities even further than the five-province standard, which has been in place since 1982–83.

While the Panel believes that pre- and post-Equalization indicators are the single most useful indicator for determining the adequacy of Equalization, they are not the whole story. Canadians clearly have an interest in knowing how much each province receives in Equalization, and how important the program is in relation to the size of the province. To allow Canadians to better judge the adequacy and significance of the program, Equalization entitlements should be presented as a share of provincial revenues, program expenditures, and other measures that put Equalization entitlements into context.

Canadians also need to know whether a given level of support is affordable for the federal government. Equalization as a share of Gross Domestic Product, federal program spending and federal revenues can provide important information in this regard.

Finally, signs that some provincial governments are showing marked deviations from the norm in per capita spending, revenues, tax effort, deficits and debt burdens may be a symptom of inadequacies in Equalization. For instance, a province spending much less than the national per capita average, displaying higher tax levels, or incurring much higher debt burdens might indicate that Equalization is under-compensating that jurisdiction.

The Panel's assessment

The Panel's recommendation for a 10-province standard would return Equalization to a formula and rules-based approach, thereby automatically reducing fiscal disparities to a level that the Panel believes is acceptable. In this respect, the return to a formula (compared with the arbitrariness of the New Framework funding levels) reduces the need for evidence-based indicators of fiscal disparities (in the sense that a furnace fitted with a thermostat reduces the need for its owner to take regular temperature readings).

No formula, however, is perfect, and having benchmarks to periodically assess its adequacy would improve public accountability and transparency. Moreover, if the federal government decides it cannot afford the 10-province standard, Canadians should have benchmarks against which they can assess the adequacy of the lower standard.

[1] The notable exception is the fiscal disparity between Alberta and other provinces. The cost of moving to an Alberta standard, to eliminate the entire gap in fiscal capacity among all provinces, would be approximately $150 billion a year.

The Panel, therefore, recommends that the federal government collect and report annually to Parliament on several key indicators, including:

- Per capita fiscal capacity of provinces, pre- and post-Equalization, on an annual and multi-year basis.
- Equalization payments to receiving provinces as a portion of provincial revenues and program expenditures.
- Equalization payments as a proportion of Canada's Gross Domestic Product, federal revenues and federal spending.
- Other measures of trends in fiscal disparities including changes in tax effort, fiscal capacity and program spending among the provinces.

Annex 10: Illustrative Financial Impacts of the Panel's Recommendations

The Panel understands that the best ideas can sound good in theory, but what people want to know is the bottom line: what is the combined impact of the Panel's recommendations on whether or not a province qualifies for Equalization? The Panel has, therefore, done a thorough technical analysis to address this critical question, and the results are provided in this annex.

The assessment begins with an examination of what the Panel's formula would generate in terms of the overall cost for the Equalization program and the allocation to provinces for 2007–08. Entitlements under the Panel's recommendations are then compared with what provinces would receive in 2007–08 under the 2004 Renewal formula. The robustness of these results is then considered by extending the comparisons to 2006–07 and 2005–06.

Entitlements for 2007–08 under the Panel's formula are also compared with what provinces are expected to receive for 2006–07, which will be determined by the New Framework.

The assessment then considers how entitlements would change under the Panel's formula under different oil and gas revenue scenarios, given the large impacts that changes in oil and gas prices can have on entitlements. Finally, the fiscal impacts of the individual recommendations are presented to give the reader a better understanding of why the Panel's formula generates the results that it does.

While a thorough analysis of impacts has been undertaken, it should be recognized that the simulations within this annex are simply snapshots in time, based on information current as of February 2006. The actual cost of the Equalization program and the allocation to provinces under the Panel's formula will vary as more up-to-date data become available. More important, the actual impacts of adopting the Panel's recommendations will change over the years as provincial economies and disparities among provinces evolve. In this respect, the impacts depicted should be considered indicative of possible impacts.

Equalization entitlements under the Panel's formula: 2007–08

Table 1 presents each province's per capita fiscal capacity before Equalization, its Equalization entitlement, and its total fiscal capacity after Equalization for 2007–08. All figures have been calculated using the Panel's formula with February 2006 data, using a 50 percent weighting for 2005–06 data, and 25 percent weightings for 2004–05 and 2003–04, in the three-year moving average calculation.

TABLE 1 – Provincial Fiscal Capacity Before and After Equalization for 2007–08[1]

	$ per capita									
	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Fiscal Capacity (using the Panel's formula)										
Before Equalization	5,601	4,167	4,784	4,346	5,406	6,534	4,785	6,377	11,099	6,913
Equalization	933	2,079	1,560	1,945	917	0	1,528	157	0	0
After Equalization	**6,534**	**6,246**	**6,344**	**6,291**	**6,322**	**6,534**	**6,313**	**6,534**	**11,099**	**6,913**

[1] Note that Table 1 shows the before-Equalization fiscal capacity of provinces using a 100 percent inclusion rate for resource revenues and includes payments provided through the Offshore Accords. Equalization entitlements are shown net of the fiscal capacity cap. See the final section of this annex for more detail on the fiscal capacity cap.

The first row shows that there are significant differences in provincial fiscal capacity before Equalization. The second row shows that provinces with the lowest fiscal capacity receive the most Equalization per capita; the three richest provinces do not receive any. The final row shows that, after Equalization, receiving provinces are left with very similar fiscal capacities, although they are not identical because of the partial inclusion of resource revenues.

The last line also demonstrates the impact of the fiscal cap. The Panel believes that Equalization should not push a province's fiscal capacity above that of the lowest non-receiving province. As a result, Ontario's fiscal capacity becomes the cap for all receiving provinces for 2007–08. The cap would affect Newfoundland and Labrador and Saskatchewan, ensuring that their overall fiscal capacity after Equalization does not exceed Ontario's.

Total entitlements for 2007–08, using the Panel's formula and multiplying each province's per capita entitlements by their total population, are shown in Table 2.

TABLE 2 — Equalization Entitlements for 2007–08 based on the Panel's Recommendations

					$ per capita						
	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
Panel's Recommendations for 2007–08											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	**12,563**
Per capita entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	

Selecting a base case for comparison

How do the entitlements under the Panel's formula compare with entitlements under the current formula? This depends on what is considered to be the base case formula.

Provincial governments and Canadians will naturally wish to know how much the Panel's recommendations would give each province in 2007–08 compared with announced entitlements for 2006–07. This suggests that impacts might be measured against what provinces are scheduled to receive under the interim formula of the New Framework, as extended and updated in November 2005.

However, such comparisons do not tell the full story. They measure impacts against a temporary allocation which, for both Canada's first ministers and its legislators, was never intended to be more than a transitional stopgap, pending a more permanent solution. The allocation under the New Framework has no conceptual underpinning as an ongoing formula.

The Panel believes that the more relevant and rigorous comparison in assessing a return to a principle-based and formula-driven program is against the previous formula-driven Equalization framework. This leaves the 1999 formula or the 2004 formula (which was legislated but never implemented) as candidates for the base case.

ANNEX 10

TABLE 3 – Possible Base Cases

Possible Base Cases	Observations
1999 Equalization Renewal (for 1999–2004)	Legislated by the Parliament of Canada in March 1999. Total payments and their allocation among provinces are formula-determined, using a five-province standard and the Representative Tax System (RTS).
2004 Equalization Renewal (for 2004–2009)	Legislated by the Parliament of Canada in March 2004, but never implemented because it was superseded by the New Framework described below. Total payments as well as their allocation among provinces continue to be formula-determined based on a five-province standard and vary according to provinces' fiscal capacity relative to the standard. Significant formula changes relative to 1999: major reform of property tax base, incorporation of tax-on-income in personal income tax base, introduction of three-year moving average with a one-year data lag and a 10 percent adjustment factor to account for the time value of money. The three-year moving average was to be phased-in over four years.
October 2004 New Framework for Equalization (applies to 2004–05 and 2005–06 entitlements)	Announced by the Prime Minister of Canada after the October 26, 2004 First Ministers' Meeting and subsequently legislated. Total payments became fixed outside the formula (a fixed pay-out) and their allocation among provinces is based on an interim quasi-formula, the result of an interim agreement concluded by first ministers. 2004–05 entitlements were determined by the 1999 formula based on October 2004 data, with a top-up allocated according to each province's share of entitlements for that year. Floor protection was also provided to prevent provincial entitlements from being lower than estimates announced in the February 2004 federal budget. 2005–06 entitlements were based on an average (50/50) of: (a) A three-year average of Equalization shares (lagged one year) under the five-province standard applied to a fixed payout amount. (b) Equalization amounts based on a fixed payout approach using a three-year average of fiscal capacities (lagged one year).
Extension of the New Framework to 2006–07	Announced by the federal Minister of Finance on November 8, 2005, but not legislated. It extends to 2006–07 the allocation methodology adopted for the previous fiscal year and updates it to incorporate more recent fiscal and economic data. No changes were proposed to the fixed funding levels set out in the October 2004 New Framework.

The 1999 Renewal formula omits significant reforms (e.g., residential property tax and improvements to the personal income tax base) which resulted from years of collaborative work between federal and provincial officials, and which were legislated in March 2004.

For this reason, the Panel believes that the 2004 Renewal formula is the most appropriate base case. The Panel made two changes in order to make the base case as relevant as possible:

- First, the 2004 Renewal formula used the five-province standard, but the federal government adopted a higher implicit standard when it announced aggregate entitlements as part of the New Framework. The Panel believes that this higher implicit standard is a more appropriate benchmark for comparing the additional costs and impacts of its formula. Accordingly, the Panel increased the size of the pool for the base case under the 2004 Renewal formula to the actual legislated aggregate levels under the New Framework.
- Second, the 2004 Renewal formula uses a three-year moving average, with a one-year data lag. For example, 2007–08 entitlements would be based on a one-third weighting of 2006–07, 2005–06, and 2004–05 data. The Panel adjusted the 2004 Renewal formula to incorporate the same two-year data lag and weighted three-year moving average that it recommends. This provides a more meaningful comparison. The differences in entitlements are due to formula differences, rather than the year and weights of the data.

Assessing the fiscal impacts

Based on this assessment, the Panel considers the most relevant comparison to be between what provinces would receive if the Panel's formula were adopted against what they would receive if the 2004 Renewal formula were used with aggregate entitlements as legislated under the New Framework. Both formulas use the same two-year data lag and a weighted three-year moving average.

- Table 4 compares 2007–08 Equalization entitlements under the two formulas.
- Tables 5 and 6 compare 2006–07 and 2005–06 Equalization entitlements under the two formulas to assess the robustness of these results.
- Figure 1 summarizes the results of these three tables.
- Table 7 provides an additional perspective by comparing what provinces would receive under the Panel's formula in 2007–08 against what they are expected to receive in 2006–07 based on the extended New Framework announced by the federal Minister of Finance in November 2005.

TABLE 4 — Formula-to-Formula Comparison for 2007–08

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
					$ million / $ per capita						
Panel's Recommendations											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	**12,563**
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
Base Case Scenario											
Total Entitlements	587	282	1,363	1,417	6,273	0	1,720	0	0	35	**11,676**
Per Capita Entitlements	1,136	2,047	1,454	1,885	830	0	1,468	0	0	8	
Changes											
Total Entitlements	***-105***	***4***	***99***	***45***	***653***	***0***	***69***	***156***	***0***	***-35***	***887***
Per Capita Entitlements	***-203***	***31***	***105***	***60***	***86***	***0***	***59***	***157***	***0***	***-8***	

Note: Totals may not add due to rounding.

Observations

Table 4 shows the most relevant comparison. Equalization entitlements under the Panel's formula compared with the 2004 Renewal formula, including the two adjustments discussed earlier.

- Total entitlements in 2007–08 would be $887 million higher under the Panel's formula.
- Saskatchewan would get the largest per capita increase in entitlements, due to the partial (50 percent) exclusion of natural resources. This benefit would be limited, however, by the fiscal capacity cap. The fiscal capacity cap limits Equalization when a province's total fiscal capacity (from own-source revenues, payments from Offshore Accords, and Equalization) reaches Ontario's (the non-receiving province with the lowest fiscal capacity). As shown in Table 1, Saskatchewan's total fiscal capacity is identical to Ontario's under the Panel's formula. In the absence of the cap, Equalization would push Saskatchewan's fiscal capacity well above Ontario's.
- Newfoundland and Labrador's entitlements would go down the most, since the payments from offshore resource accords already effectively exclude 100 percent of offshore resource revenues in the Equalization formula. To prevent Equalization from pushing the province's total fiscal capacity over Ontario's, the province's Equalization entitlements would be limited to $482 million for 2007–08. Table 1 shows that, after the fiscal capacity cap, Newfoundland and Labrador's total fiscal capacity is identical to Ontario's.
- British Columbia would see a small reduction in Equalization ($8 per capita). This is because under the Panel's formula, British Columbia's fiscal capacity increases significantly relative to other provinces, even rising above Ontario's. This is primarily because of technical improvements in the measurement of fiscal capacity for property and other tax bases.
- Québec would receive the largest increase in aggregate entitlements, the third highest increase when measured on a per capita basis. The higher entitlement is due primarily to the 10-province standard, and the improved measure of fiscal capacity for the residential property tax base, which in the past had over-estimated Québec's fiscal capacity.
- Other receiving provinces would receive higher entitlements, due to the impact of moving to the 10-province standard along with changes to the measure of fiscal capacity.

TABLE 5 – Formula-to-Formula Comparison for 2006–07

$ million / $ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
Panel's Recommendations											
Total Entitlements	765	274	1,386	1,393	6,472	0	1,677	426	0	0	**12,393**
Per Capita Entitlements	1,477	1,992	1,480	1,853	862	0	1,441	428	0	0	
Base Case Scenario											
Total Entitlements	751	270	1,306	1,353	5,768	0	1,635	0	0	198	**11,282**
Per Capita Entitlements	1,449	1,964	1,395	1,801	769	0	1,405	0	0	48	
Changes											
Total Entitlements	***15***	***4***	***79***	***39***	***704***	***0***	***42***	***426***	***0***	***-198***	***1,111***
Per Capita Entitlements	***28***	***28***	***85***	***52***	***94***	***0***	***36***	***428***	***0***	***-48***	

Note: Totals may not add due to rounding.

TABLE 6 – Formula-to-Formula Comparison for 2005–06

$ million / $ per capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
Panel's Recommendations											
Total Entitlements	865	253	1,240	1,282	6,237	0	1,580	456	0	0	**11,912**
Per Capita Entitlements	1,664	1,847	1,326	1,708	837	0	1,366	457	0	0	
Base Case Scenario											
Total Entitlements	841	247	1,202	1,259	5,517	0	1,514	85	0	235	**10,900**
Per Capita Entitlements	1,619	1,801	1,286	1,678	740	0	1,308	85	0	57	
Changes											
Total Entitlements	***23***	***6***	***38***	***23***	***720***	***0***	***66***	***371***	***0***	***-235***	***1,012***
Per Capita Entitlements	***45***	***46***	***40***	***30***	***97***	***0***	***57***	***372***	***0***	***-57***	

Note: Totals may not add due to rounding.

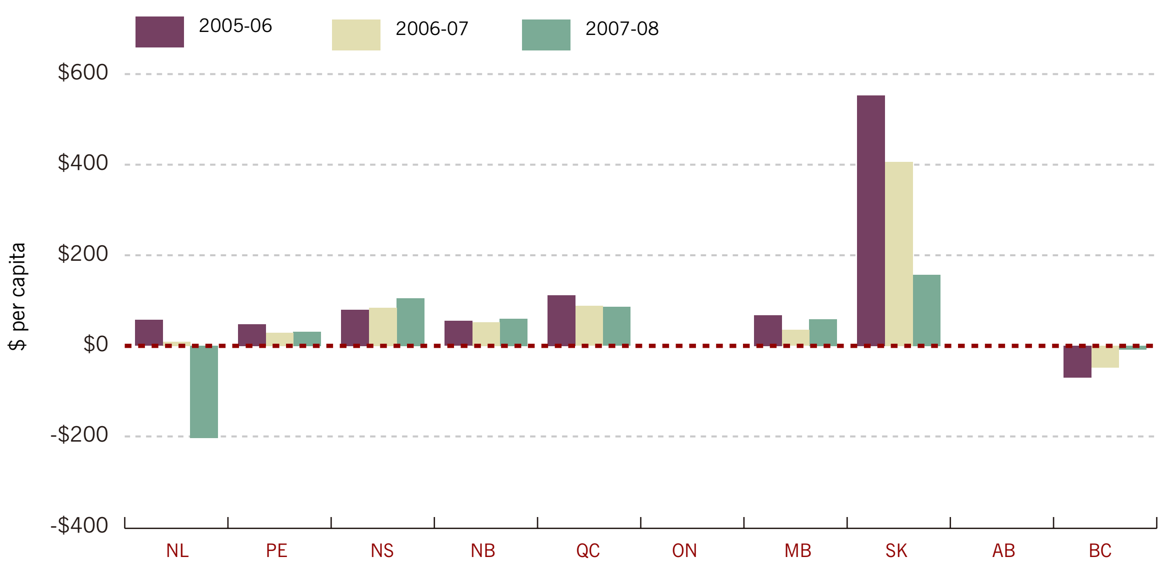
Observations

Tables 5 and 6 provide the equivalent calculation to Table 4, but for 2006–07 and 2005–06, the other years for which a complete set of reliable data is available. To better isolate the impacts due to difference in the two formulas, the base case uses a fully implemented 2004 Renewal formula (under the legislation, it would not have been fully phased in until 2007–08). The results are similar to Table 4, demonstrating the robustness of the results over time.

The change in Equalization entitlements for three provinces deserves special note:

- British Columbia's losses would be somewhat larger in the earlier years. This is because under the base case they would have received a modest amount of Equalization ($48 and $57 per capita) in 2006–07 and 2005–06, respectively. In the Panel's view, by giving only a 50 percent weighting to the stratified property tax base, the 2004 Renewal formula in the base case underestimates the province's fiscal capacity, and fails to appropriately recognize that British Columbia has some of the highest property values in the country.
- In contrast, Newfoundland and Labrador would have received more Equalization under the Panel's formula in these earlier years. This is because resource revenues, and the revenues that are effectively excluded from the Equalization formula by the Offshore Accords, are not as large in the early years. As a result, the cap would have reduced entitlements by $73 million in 2006–07, and would not have impacted the province in 2005–06.
- Saskatchewan would also have received considerably more under the Panel's formula in the early years. This is primarily due to the fiscal benefit that the province would have received from the partial exclusion of resource revenues with the interaction of the fiscal capacity cap, which cuts off a smaller amount of Equalization in these earlier years. The fiscal capacity cap would not have had as big an impact on Saskatchewan's Equalization because its post-Equalization fiscal capacity in the absence of the cap was only slightly above Ontario's.

FIGURE 1 – Financial Impact of the Panel's Recommendations Based on a Formula-to-Formula Comparison (2005–06 to 2007–08)



Observations

Figure 1 summarizes the impacts presented in Tables 4 to 6 for 2007–08, 2006—07, and 2005–06, respectively. As seen in these tables:

- Saskatchewan's gains under the Panel's formula would be larger in 2005–06 and 2006–07. The gains are smaller in 2007–08 as its resource revenues go up and, accordingly, the fiscal capacity cap limits its Equalization entitlements.
- Similarly, Newfoundland and Labrador initially gains under the Panel's formula, but loses in 2007–08 because the province's overall fiscal capacity (including offset payments) rises sharply due to increased resource revenues. Accordingly, the cap limits its entitlements.
- British Columbia would experience small decreases in the early years under the Panel's formula. These decreases would begin to disappear in 2007–08, as the province's fiscal capacity increases to the point that it is no longer eligible for Equalization under the Panel's formula or the 2004 Renewal formula.
- Other provinces—whose fiscal capacities remained relatively constant—would experience similar gains in all three entitlement years.

TABLE 7 – Comparing the Panel's Recommendations for 2007–08 with Announced Entitlements for 2006–07

	$ million / $ per capita										
	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	TOTAL
Panel's Recommendations for 2007–08											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	12,563
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
Announced Entitlements for 2006–07											
Total Entitlements	687	280	1,379	1,432	5,354	0	1,690	0	0	459	11,282
Per Capita Entitlements	1,328	2,030	1,472	1,905	710	0	1,446	0	0	109	
Changes											
Total Entitlements	***-204***	***7***	***82***	***30***	***1,571***	***0***	***99***	***156***	***0***	***-459***	***1,281***
Per Capita Entitlements	***-395***	***49***	***88***	***40***	***207***	***0***	***82***	***157***	***0***	***-109***	

Note: Totals may not add due to rounding.

Observations

Table 7 compares what the Panel's formula would give provinces in 2007–08 with what provinces are expected to receive in 2006–07, based on the New Framework announced by the federal government in October 2004 and extended in November 2005. Since this comparison is not the most relevant for determining the impact of the Panel's formula (because the allocation used for 2006–07 was never intended to be more than a transitional stopgap, pending a more permanent solution), only a few comments are offered.

- If the Panel's recommendations were adopted, total Equalization entitlements would increase by $1.3 billion in 2007–08 compared with announced entitlements for 2006–07 (using October 2005 data).
- Most provinces would see a year-over-year increase in their Equalization entitlements.
- Québec would see the highest year-over-year increase. Like other receiving provinces, it benefits from the move to the 10-province standard and improvements in the measure of fiscal capacity, particularly for the property tax. However, Québec also benefits because under the New Framework allocation agreement it received the lowest per capita entitlements.
- Newfoundland and Labrador's Equalization entitlements would decrease, primarily due to the fiscal capacity cap. In the absence of the cap, Equalization would push Newfoundland and Labrador's fiscal capacity well above Ontario's.
- British Columbia's entitlements also decrease when comparing the Panel's recommendations for 2007–08 to the announced entitlements for 2006–07. The decrease is primarily due to the fact that entitlements under the New Framework were based on earlier data (which indicated that British Columbia had a significantly lower fiscal capacity than subsequent data revealed), primarily because of the method for calculating residential property tax capacity.

ANNEX 10

Robustness of results with respect to oil and gas prices

The Panel also considered it important to examine the results of its formula under different oil and gas prices. These prices have traditionally been very volatile and have had major impacts on Equalization entitlements.

As Table 8 shows, the price of oil and gas has fluctuated from a low of US$13.70 and US$2.00 respectively in 1998–99, to a high of US$59.80 and US$9.40 in 2005–06.

TABLE 8 – Oil and Natural Gas Prices (1995–96 to 2005–06)

(US Dollars)

	Oil[1]	Natural Gas[2]
1995–96	$18.7	$2.2
1996–97	$22.8	$2.5
1997–98	$18.9	$2.4
1998–99	$13.7	$2.0
1999–00	$23.0	$2.5
2000–01	$30.1	$5.3
2001–02	$24.1	$3.0
2002–03	$29.2	$4.3
2003–04	$31.4	$5.3
2004–05	$45.0	$6.1
2005–06[3]	$59.8	$9.4

[1] *Price of WTI Crude Oil in U.S. dollars (nominal) per barrel*

[2] *Price of U.S. Natural Gas in U.S. dollars (nominal) per MMBtu*

[3] *Average from April 1, 2005 to February 20, 2006*

While many simulations could have been developed to analyze the impact of different oil and gas prices, the Panel wanted to:

- Limit the simulations to two alternative scenarios: a high price and a low price simulation (this annex already contains a large number of other impacts, and the Panel wanted to keep the number of tables manageable)
- Use a range of oil and gas prices (the difference between the high and low prices) that is sufficiently wide to clearly demonstrate the direction of change in entitlements, yet still realistic for the near future
- Use data that were readily available to provinces to allow them to verify the Panel's simulation.

The Panel therefore decided on the following two scenarios:

1. ***The High Energy Price Scenario*** assumes oil and gas revenues[2] identical to those reported by provincial governments for fiscal year 2005–06, when average prices were US$59.80 and US$9.40, respectively. This is equivalent to a 21 percent increase in the oil and gas revenues used to calculate the 2007–08 Equalization entitlements under the Panel's formula.

2. ***The Moderate Energy Price Scenario*** assumes oil and gas revenues identical to 2003–04, when average prices were US$31.40 and US$5.30, respectively. This is equivalent to a 28 percent decrease in the oil and gas revenues used to calculate 2007–08 Equalization entitlements under the Panel's formula.

In the Panel's view, these scenarios reflect a sufficiently wide but realistic price range that can be easily replicated by the provinces based on data readily available from within the Equalization system.

The results for 2007–08 are presented in Table 9.

Impact of individual measures

The Panel has recommended a package of changes to put Equalization back on a sustainable formula-based track. While individual recommendations within the package have distinct fiscal implications, the Panel did not consider each change in isolation. Instead, each change was examined in the context of an entire package that balanced a series of important principles. For example, the recommendation to adopt a 10-province standard was considered appropriate in the context of a 50 percent exclusion of resource revenues, and the 50 percent exclusion was considered appropriate only in the context of a fiscal cap to ensure that Equalization did not push a receiving-province's total capacity above that of a non-receiving province.

In the Panel's view, the recommendations comprise a carefully balanced package that should not to be picked apart by each government endorsing only the elements that provide it with the biggest fiscal benefit.

Nevertheless, governments and Canadians will undoubtedly want to have some sense of the fiscal impact of individual recommendations, if only to assist in their understanding of the overall impact of the package.

The Panel has therefore decided to provide a table breaking down the impacts of individual recommendations. These tables should be reviewed cautiously and with the following caveats in mind:

First, as explained above, the Panel has recommended a carefully balanced package, where each item was examined and recommended in the context of an entire package that balanced a series of important principles.

Second, and of critical importance, the impact of individual items differs radically depending on the methodology.

[2] Recall that the Panel's formula for 2007–08 uses actual revenues based on a 50 percent weighting for 2005–06, 25 percent for 2004–05, and 25 percent for 2003–04. Based on this weighting, average oil and gas prices for calculating 2007–08 Equalization entitlements were US$49.03 and US$7.54, respectively.

TABLE 9 — Responsiveness of the Panel's Formula to Oil and Gas Prices

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	TOTAL
					$ million / $ per capita						
Panel's Recommendations for 2007–08											
Total Entitlements	482	286	1,462	1,462	6,926	0	1,789	156	0	0	**12,563**
Per Capita Entitlements	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
High Energy Price Scenario											
Total Entitlements	259	293	1,499	1,499	7,300	0	1,846	0	0	0	**12,696**
Per Capita Entitlements	501	2,128	1,599	1,994	966	0	1,576	0	0	0	
Moderate Energy Price Scenario											
Total Entitlements	795	277	1,423	1,412	6,424	0	1,713	433	0	0	**12,478**
Per Capita Entitlements	1,538	2,012	1,518	1,878	850	0	1,463	436	0	0	
Impact of an increase in energy prices											
Total Entitlements	***-223***	***7***	***37***	***37***	***374***	***0***	***57***	***-156***	***0***	***0***	***133***
Per Capita Entitlements	***-432***	***50***	***39***	***49***	***50***	***0***	***49***	***-157***	***0***	***0***	
Impact of a decline in energy prices											
Total Entitlements	***313***	***-9***	***-39***	***-50***	***-502***	***0***	***-76***	***277***	***0***	***0***	***-86***
Per Capita Entitlements	***605***	***-66***	***-41***	***-66***	***-66***	***0***	***-65***	***279***	***0***	***0***	

Note: Totals may not add due to rounding.

Observations

Table 9 shows total entitlements for 2007–08 using the Panel's formula, followed by the High Energy Price and the Low Energy Price scenarios (also using the Panel's formula).

The table shows that as oil and gas prices increase (High Energy Price Scenario):

- Saskatchewan's fiscal capacity increases above the 10-province standard, and Saskatchewan no longer receives Equalization.
- Newfoundland and Labrador continues to receive Equalization, but its higher fiscal capacity (including higher payments from the Offshore Accords due to increased oil and gas revenues) results in lower Equalization entitlements.
- Other receiving provinces receive additional Equalization, primarily due to a higher 10-province standard resulting from increases in oil and gas revenues.

Conversely, as oil and gas prices decline (Moderate Energy Price Scenario):

- Saskatchewan and Newfoundland and Labrador's fiscal capacities decrease and they both receive additional Equalization.
- Other receiving provinces receive less, primarily due a lower standard.

Note also that the cost of the Equalization program does not fluctuate significantly as a result of changes in oil and gas revenues. This is because the 50 percent exclusion of resources and the fiscal capacity cap tend to moderate fluctuations in the cost of the program caused by changes in resource prices.

For example, one could calculate the impact of each recommendation, holding the rest of the formula in the base case (the 2004 Renewal formula) constant. Each calculation would show the impact of modifying the base case by adopting a single Panel recommendation. While this approach has some appeal, it results in a residual of billions of dollars. That is, the sum of each individual impact does not equal the total impact of the entire package. The residual is large because this approach fails to take into account the interaction among various recommendations.

A variant of this approach is to modify the base case by adopting all but one of the Panel's recommendations. Each calculation would then show the impact of adopting the recommendation in question. While this approach has appeal, it also generates a large residual as it fails to take into account the interaction among the various recommendations.

Alternatively, one could begin with the base case (the 2004 Renewal formula) and calculate the incremental impact of moving one recommendation at a time toward the Panel's formula. That is, one calculates the impact of the first recommendation on the base case. One then calculates the additional impact of making a further change to the base case. A third recommendation is then incorporated on top of the first two changes, and the impact is calculated. This continues until all of the recommendations have been incorporated. While this approach does not leave a residual, the order in which each recommendation is calculated affects the calculation. For example, the impact of the 10-province standard is different depending on whether it is calculated before or after the recommendation to exclude 50 percent of resource revenues.

With these major caveats in mind, Table 10 provides the breakdown of the impacts of individual recommendations using the last approach described above. The first row shows the impact of adopting the Panel's recommendations on resources (50 percent exclusion rate, using actual revenues, and changing the treatment of hydro revenues), assuming all other aspects of the base case remain constant.

The second row shows the impact of adopting the 10-province standard, after the aforementioned changes to resources are incorporated into the base case.

The third row shows the impact of excluding user fees that do not generate a profit, against a base case that incorporates changes to resource revenues and a 10-province standard.

The fourth, fifth, and sixth rows show the impacts of making successive modifications to include the Panel's recommendations on property tax, RTS simplification, and the fiscal capacity cap.

Given that the order of the calculations has an impact on the cost breakdown of the Panel's recommendations, the text under Table 10 provides a brief explanation of why the Panel chose this specific order.

ANNEX 10

TABLE 10 – Decomposition of the Impact of the Panel's Recommendation for 2007–08

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	**TOTAL**
($ million)											
1) Treatment of resources	144	-19	-96	-79	-347	0	-117	431	0	84	**0**
2) 10-province Standard	59	16	107	86	860	0	133	113	0	479	**1,853**
3) User fees	-37	-11	-55	-49	-156	0	-48	-45	0	-72	**-472**
4) Property tax	3	0	-17	-10	355	0	19	-9	0	-526	**-187**
5) RTS simplification	26	20	160	98	-58	0	82	172	0	0	**499**
6) Fiscal capacity cap	-299	0	0	0	0	0	0	-506	0	0	**-805**
Total Impact	**-105**	**4**	**99**	**45**	**653**	**0**	**69**	**156**	**0**	**-35**	**887**
($ per capita)											
1) Treatment of resources	278	-141	-102	-105	-46	0	-100	433	0	20	
2) 10-province Standard	114	114	114	114	114	0	114	114	0	114	
3) User fees	-71	-81	-59	-65	-21	0	-41	-45	0	-17	
4) Property tax	5	-4	-18	-14	47	0	16	-9	0	-125	
5) RTS simplification	50	143	171	130	-8	0	70	173	0	0	
6) Fiscal capacity cap	-579	0	0	0	0	0	0	-509	0	0	
Total Impact	**-203**	**31**	**105**	**60**	**86**	**0**	**59**	**157**	**0**	**-8**	

Observations

Treatment of resources: The Panel views the treatment of resources (the 50 percent exclusion, the use of actual revenues, and the treatment of hydro revenues) as a critical recommendation that underpins the recommendation to return to a formula-based system. It is therefore presented first. Note that this measure, assuming the 2004 Renewal formula with $11.7 billion fixed aggregate entitlements, increases entitlements for resource-rich provinces.

10-province standard: The Panel examined the impact of moving to a 10-province standard, assuming the 50 percent exclusion of resource revenues. In this context, the Panel considered that the $1.8 billion increase in cost would be in line with historical expenditures on Equalization.

The Panel also made a series of recommendations on non-resource tax bases. The order of presentation here was chosen to minimize the interactive effects.

Exclusion of user fees: The recommendation to stop equalizing user fees that do not generate profits reduces entitlements by $472 million. Provinces with lower overall (non-resource) fiscal capacities experience the largest per capita reduction in entitlements, since they were assumed to have the lowest capacity to raise user fees under the previous formula.

Property tax: The Panel recommends that the multiconcept approach be replaced by the stratified market value approach, and sees this as a significant improvement in the way residential property taxing capacity is calculated. In the Panel's view, the multiconcept approach consistently over estimated the capacity of Québec to collect property taxes, while it under-estimated British Columbia's capacity.

RTS simplification: The Panel's recommendation to simplify the RTS results in a significant reduction in the number of tax bases, from 33 to five. The approach suggested is to move the revenues from small bases (a number of which were not based on strong conceptual models) and to equalize these amounts under the larger Equalization bases.

Fiscal capacity cap: Finally, while the Panel endorses the partial exclusion of natural resources in the formula, the additional entitlements provided by this measure should not push a province's overall fiscal capacity above the lowest non-receiving province. As a result, the cap restrains Saskatchewan and Newfoundland and Labrador's Equalization so that their overall fiscal capacity (own-source revenues, payments from Offshore Accords, and Equalization) is the same as Ontario's.

ANNEX 10

A further explanation of the fiscal capacity cap

While the Panel recommends the partial exclusion of natural resources in the formula, it also believes that it is essential to ensure that the additional Equalization entitlements provided by this measure should not increase a province's overall fiscal capacity above that of the non-receiving province with the lowest fiscal capacity. The principle is clear: provinces that receive Equalization should not have a higher fiscal capacity than provinces that do not receive Equalization.

Implementing this principle means that when a receiving province has a higher post-Equalization fiscal capacity than the non-receiving province with the lowest fiscal capacity (currently Ontario), Equalization payments should be reduced accordingly. Calculating post-Equalization fiscal capacity for the purposes of the cap is complicated by two considerations: the existence of the Offshore Accords for Newfoundland and Labrador and Nova Scotia, and the question of what is the proper inclusion rate for natural resource revenues.

The Offshore Accords

The Panel views the Offshore Accords as inextricably related to the Equalization program. Although they are delivered under the authority of their own specific legislation, they are calculated on the basis of Equalization entitlements with and without offshore oil and gas resources. Their magnitude and timing (with the exception of the prepayment provisions of the 2005 Offshore Accords) depend on the structure of the Equalization program. As well, and most importantly from the perspective of the fiscal capacity calculation, they are unconditional grants to the governments of the provinces concerned. They are, therefore, available to provide public services, and consistent with the principles and practice of the Equalization program, they increase the fiscal capacity of the receiving provinces.

For these reasons the Panel considers it appropriate to include entitlements under the Offshore Accords to measure post-Equalization fiscal capacity for the purposes of applying the fiscal capacity cap.

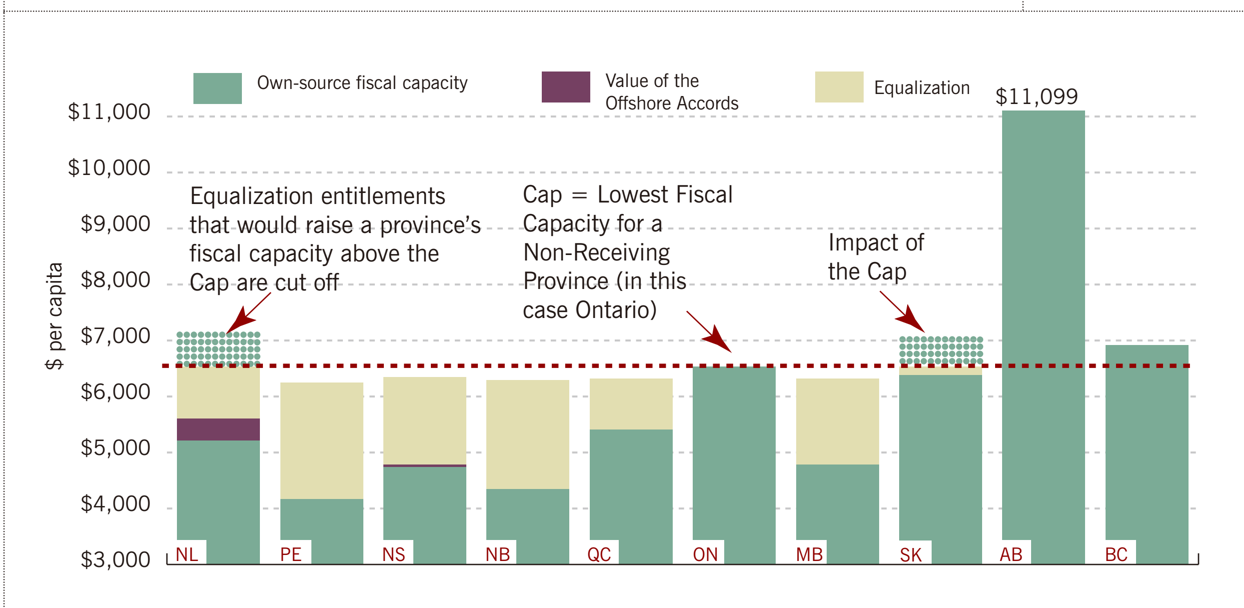
Post-Equalization inclusion rate for fiscal capacity calculations

The Panel considered whether all resource revenues should be included in the calculation of post-Equalization fiscal capacity for the purposes of determining the impact of the cap.

The case can be made that, to the extent that resource revenues do not adequately take into account public expenditures associated with resource development and management (see Annex 7), including 100 percent of resource revenues to calculate post-Equalization fiscal capacity overstates actual fiscal capacity. While appealing in principle, there are practical difficulties with measuring the public expenditure component associated with resource revenues. In principle, this would vary by province, by the nature of the resource from which the revenue is being derived, and by the stage in the life-cycle of the development of that resource. In the absence of any data, and given the methodological difficulties of obtaining such data, the Panel concluded that it is appropriate to include 100 percent of resource revenues in the calculation of post-Equalization fiscal capacities for the purposes of determining the impact of the fiscal capacity cap.

The Panel considered whether a 100 percent resource revenue inclusion rate for calculating the cap would effectively eliminate the net benefit from a 50 percent resource revenue inclusion rate in calculating Equalization entitlements. It concluded that it would not. The cap limits (it does not eliminate) the benefit receiving provinces derive from the partial inclusion of natural resources. As illustrated in Figure 2, Saskatchewan and Newfoundland and Labrador's post-Equalization fiscal capacity still exceeds that of other receiving provinces due to the partial inclusion of resources. The benefit is limited, however, so that their fiscal capacity does not exceed Ontario's.

FIGURE 2 – How the Fiscal Capacity Cap Works: Provincial Fiscal Capacity Before and After Equalization (using the Panel's formula) for 2007–08



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