



EQUALIZATION REFORMS: POTENTIAL IMPACT

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CANADA

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POTENTIAL IMPACT OF EQUALIZATION REFORMS

INTRODUCTION

In November 2001, the Standing Senate Committee on National Finance concluded a series of public hearings as part of its study on Canada's program of fiscal equalization. The goal of the Committee was to assess the effectiveness of the program and to recommend improvements to ensure that equalization will continue to meet its Constitutionally mandated objective:

to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.⁽¹⁾

This Constitutional commitment reflects the importance to Canadians of evening out horizontal imbalances across the country. In the Canadian context, horizontal imbalances refer to the fact that some provinces are wealthier than others and their provincial governments thus can generate more revenues at comparatively lower levels of taxation. If left unchecked, these imbalances could result in a wide gap in the quality or level of provincial government services across the country.

To ensure that all Canadians enjoy relatively standardized access to government services, the federal government introduced in 1957 a system of unconditional inter-governmental transfers to poorer provinces. This equalization program works to level horizontal imbalances in Canada by compensating recipient provinces if their ability to generate revenues from their own sources is below a national standard.

Equalization has widespread popular support. A poll conducted by the Centre for Research and Information on Canada on 7 November 2001 suggests that 83% of Canadians support the program. However, notwithstanding its popularity with the public at large, equalization is also a source of ongoing debate in Canada.

(1) Section 36(2) of the 1982 *Constitution Act*.

This debate is owing in large part to the program's complexity, its importance to recipient provinces and the somewhat vague nature of its constitutional mandate. Equalization is a simple concept, but the mechanics of the formula and the interplay between various aspects of the program can be extraordinarily complex. Furthermore, equalization has been subject to many seemingly ad hoc adjustments over the years, each time adding more layers of complexity to the debate.

The equalization program is renegotiated every five years and is next up for renewal in 2004. In preparation for the consultations that will precede the renewal, a number of premiers, provincial finance ministers, academics, researchers and others have already entered the highly politicized debate, arguing for various changes to be made to the program. The suggested adjustments have ranged from minor tweaking to more radical measures, such as replacing the byzantine formula with a less complex one, based perhaps on a single macroeconomic indicator (a "macro formula").

While proposals to reform equalization are common, seldom is any detailed information provided on what the ramifications of those changes would be. This paper aims to provide some of that information.

Using the detailed Fiscal Equalization Tables published biannually by the federal Department of Finance, this paper assesses in detail two of the most common provincial reform proposals and their implications for the value and distribution of equalization payments across the country.

A comprehensive analysis of all the various reform proposals is, unfortunately, beyond the scope of this paper. Many suggested reforms, such as implementing a macro formula or incorporating elements of needs-based allocation, cannot be modelled because they imply a wholesale change in the structure of the program.

THE EQUALIZATION PROGRAM IN CANADA

Before examining proposals to reform equalization, it is worthwhile to describe the program in its current form, as well as to review the recent changes in how entitlements are calculated. This will allow a better understanding of the motivation behind some of the current reform proposals.

Equalization is a formula-driven program, administered and controlled by the federal government. In a basic sense, the equalization program is fairly straightforward: provinces are entitled to the transfer if their ability to generate revenues using their own taxation power falls below a national standard. Essentially, provincial equalization entitlements are determined based on the strength of a province's tax base in comparison to that of other provinces.

However, just below that surface explanation lies a complicated series of relationships between various aspects of the transfer. This is the focus of many of the technical reform proposals.

Because equalization is formula-driven, the federal government does not directly control the amount of equalization for which recipient provinces qualify, nor the overall cost of the program in any given year. The mechanics of the formula determine the final payout and distribution. However, the formula itself can be altered to meet various objectives. For example, the federal government imposed an upper limit of \$10 billion on the value of equalization payments in 1999-2000 in order to curtail growth in the cost of the program.

A. How Equalization is Calculated

Determining a province's equalization entitlements in any given year is a long process, subject to numerous revisions. It is perhaps easiest to think of the calculation as a four-step process. The first step is establishing a common set of tax rates for all provinces. This is necessary in order to create an appropriate frame of reference against which to compare each province's revenue-generating ability. Since provinces calculate their taxes in different ways, at different intensities, and do not share access to all revenue sources, no single province's tax system can be considered representative of the remaining nine.

To compare provincial revenue-generating capacity accurately, in tobacco taxes for example, the federal government calculates the average tax rate across the ten provinces, accounting for all the differences in tax structure, size and scope. This national average tax rate (NATR) becomes the measure used to compare provincial wealth in that tax category.

The second step is to apply this "representative" tax rate hypothetically to each province's tax base to see how much provincial government revenue it would generate (per person) if it were actually in place. For example, the NATR on tobacco was 4.88 cents per

cigarette in 2001-2002.⁽²⁾ This tax rate would be applied to tobacco consumption levels in all ten provinces in order to compare them, regardless of the fact that no single province actually levies that tax rate.

The third step is to determine whether or not a province is entitled to receive equalization for that income category. Continuing with the example of tobacco taxes, each province's hypothetical tax earnings under the NATR in step two is then compared with the earnings under a national standard. If a province would generate less tobacco tax revenue per person than the standard, that province is entitled to as much equalization as necessary to attain the standard. This is referred to as a positive entitlement. Conversely, if a province generates more revenue than the national standard, it has a negative entitlement for that income category. The current standard used to calculate equalization payments is the average tax yield of Ontario, Quebec, British Columbia, Saskatchewan and Manitoba using the NATR. This is referred to as the five-province standard (FPS).

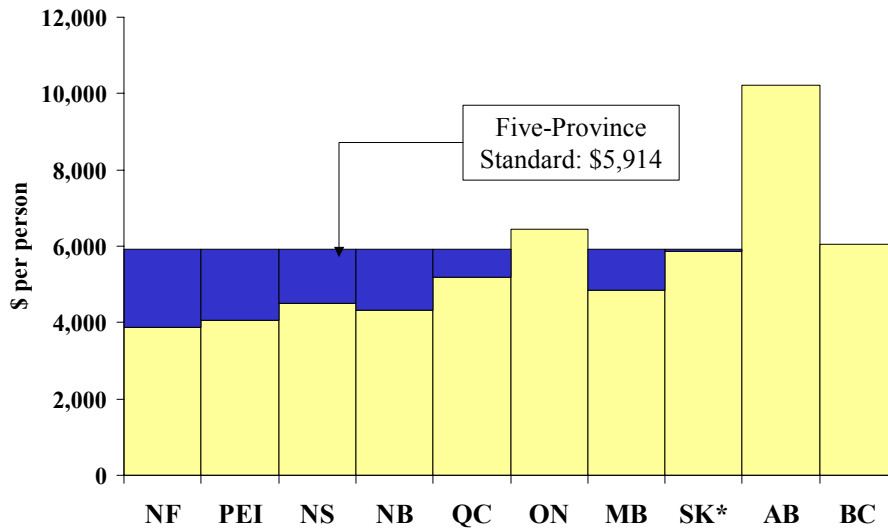
The fourth and final step is to repeat this process for each of the 32 remaining revenue sources. All positive and negative entitlements are then summed up. If a province's overall entitlement is positive – i.e., if its total revenue-generating capacity falls below the five-province standard – then that (have-not) province receives equalization payments equal to the difference between the two. If a (have) province's ability to raise revenues exceeds the FPS, however, it receives no equalization payments.

The overall picture is shown in Chart 1. For the year 2000-2001, the five-province standard (for all 33 revenue sources) was about \$5,914 per capita.⁽³⁾ Seven provinces were below the standard and thus qualified for equalization payments – the four Atlantic provinces, Quebec, Manitoba and Saskatchewan. The largest per capita payment went to Newfoundland, about \$2,042 per person residing in the province. However, because of its relatively large population, nearly half of the total dollar value of equalization was paid to Quebec.

(2) This figure refers to provincial tobacco taxes only. It does not include the most recent increase in tobacco taxes in Ontario, Quebec, New Brunswick and Nova Scotia, or the forthcoming increase in Alberta.

(3) Data are from Department of Finance Fiscal Equalization Tables. These figures are based on the March 2001 estimates for the 2000-2001 year. Equalization estimates are updated every six months for four years. As such, all figures used in this paper from 1999-2000 onwards are subject to re-adjustment.

Chart 1 Per Capita Equalization Entitlements – 2000-2001

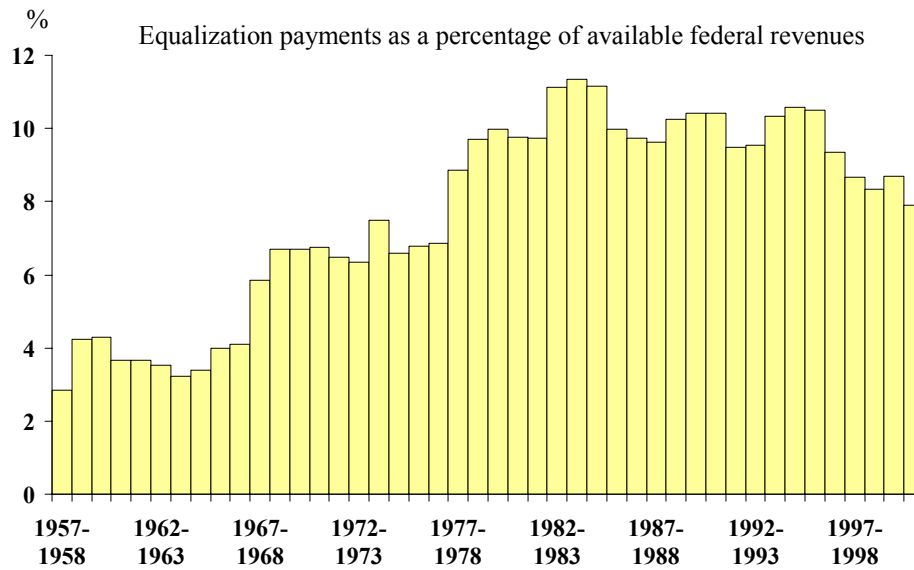


* Does not include floor payments to Saskatchewan Source: Author's calculations using federal Dept. of Finance data

In total, equalization payments are estimated to have cost the federal government a record \$10.8 billion in 2000-2001, equivalent to about 7.9% of available federal revenues.⁽⁴⁾ Although the dollar value of equalization payments has never been higher, the program is consuming a decreasing proportion of Ottawa's available financial resources. The percentage of federal revenues spent on equalization in 2000-2001 was the lowest in 23 years, and considerably below its high of 11.3% in 1983-1984. However, equalization payments today are considerably more generous than during the early days of the program. Until 1967-1968, equalization payments accounted for between 2.8% and 4.1% of available federal revenues (Chart 2).

(4) Author's calculation based on federal Fiscal Reference Tables. "Available federal revenues" refers to the difference between total revenues and debt-servicing obligations.

**Chart 2 The Cost of Equalization to the Federal Government –
1957-1958 to 2000-2001**



Source: Author's calculations using federal Dept. of Finance data

RECENT CHANGES TO THE EQUALIZATION PROGRAM

Equalization has undergone considerable evolution since its inception in 1957. At that time, portions of only three taxes were included in the formula – 10% of personal income taxes (PIT), 9% of corporate income taxes (CIT) and 50% of succession duties. Provinces were equalized to the average of the two wealthiest jurisdictions at that time, Ontario and British Columbia.

As the years passed, the program grew in size and scope. More provincial revenue sources came to be included in the transfer, the program grew to equalize 100% of most revenue sources, and the two-province standard was abandoned in 1967 in favour of a national (ten-province) standard. By 1977, 29 different provincial revenue sources were included in the formula.

At about the same time, the energy crisis prompted the most significant changes to the equalization program since 1967. Although only 50% of energy revenues were subject to equalization at the time, Alberta's soaring oil and gas revenues pushed the equalization threshold so high that all other provinces, including Ontario, qualified for the transfer.

In 1982, however, Ontario was retroactively stripped of its equalization entitlements. To prevent the recurrence of such an event, Alberta and its volatile resource revenues were dropped from the national standard. However, simply removing Canada's wealthiest province from the standard would have caused too dramatic a reduction in payments to equalization-receiving provinces. To soften the blow, Atlantic Canada was also taken out of the formula. Thus was born the five-province standard still in place today. With Alberta out of the standard, Ottawa restored 100% of natural resource revenues to the formula.

That same year, the federal government introduced automatic "ceiling" and "floor" provisions on the growth rate of equalization. The floor provision protected individual provinces from any sudden drop in their entitlements, and the ceiling protected the federal government from any large increases in its payment obligations.

The next significant change to the program formula was made in 1994 with the introduction of the so-called "generic solution." This initiative was designed to shelter provinces from one of the peculiarities of the program. If a recipient province dominates any particular revenue field, then any increase in revenues from that source can result in up to a dollar-for-dollar reduction in equalization entitlements. For example, Newfoundland's offshore energy resources are one of the 33 provincial revenue sources used in the calculation of equalization. Since Newfoundland is the only province that has access to this tax base, the five-province standard for that revenue category is zero. As such, any increase in offshore royalties would decrease equalization payments by the exact same amount.⁽⁵⁾

In the second half of the 1980s, Nova Scotia and Newfoundland had negotiated offshore accords with Ottawa that allowed those provinces to shelter some of their offshore revenues from this clawback. The generic solution in 1994 represented a broader resolution to this problem, one that benefited other equalization-receiving provinces as well. If a recipient province dominated any given revenue source (i.e., if that province accounted for more than 70% of the national total), then under the generic solution, 30% of that revenue would be protected from an offsetting decline in equalization payments. This not only applied to the Atlantic offshore resources, but offered some protection at that time to Saskatchewan potash and Quebec asbestos production as well.

(5) It is not always the case that the clawback would be 100%. For example, Saskatchewan currently dominates another income category – third-tier oil revenues. Since Saskatchewan is one of the provinces included in the FPS, an increase in its revenue from that income category also increases the value of the standard (albeit by a lesser amount). This reduces the total offset.

The most recent equalization renewal was in 1999. Games of chance were added to the list of revenues; mineral resources were merged into one category; and a new revenue source, third-tier heavy oil, was created. As well, the federal government limited the extent to which it would equalize provincial/local miscellaneous revenues (primarily user fees and proceeds from the sale of other goods and services) to 50% of eligible revenues.⁽⁶⁾ These changes would be phased in over five years.

Most importantly, however, the federal government changed its floor provisions and imposed a new ceiling of \$10.0 billion on equalization payments for the 1999-2000 year.⁽⁷⁾ In subsequent years, the ceiling would rise by the rate of nominal GDP growth. Although a growth ceiling had been in place for nearly 20 years, it had been triggered only four times. The new ceiling, however, would be triggered in its first year and threatened to cut hundreds of millions of dollars from payments.

In response to provincial protests, and as part of the federal/provincial agreement on renewed health care spending in September 2000, the federal government agreed to lift the equalization ceiling for 1999-2000 and then reapply it subsequently. The appropriate Act was passed the following June. As a result, payments for 1999-2000 rose to approximately \$10.8 billion and the ceiling capped growth for the following year at \$10.84 billion – based on 8.4% growth in nominal GDP applied to the original \$10.0-billion ceiling.

This interpretation of the agreement is the source of a major and ongoing dispute between Ottawa and the provinces. The provinces had understood that the ceiling growth rate would be applied to the \$10.8-billion figure. This would have raised the limit to about \$11.7 billion in 2000-2001.⁽⁸⁾

(6) New Brunswick., Department of Finance and Department of Intergovernmental Affairs, *Fiscal Imbalance and Equalization: A New Brunswick Perspective*, Fredericton, 2001; available at <http://www.gov.nb.ca/0158/reports/index.htm>.

(7) The previous ceiling would have restricted total payments to \$11.1 billion.

(8) Interestingly, the economic slowdown that began in the second half of 2001 may lower equalization entitlements to the point that neither interpretation of the ceiling would be binding.

CURRENT PROPOSALS FOR REFORM

With equalization due for renewal in 2004, the program is once again coming under increased scrutiny. Indeed, a number of factors may be contributing to a more heated debate than ever. The development of Atlantic offshore deposits has led Nova Scotia and Newfoundland to protest the way in which their offshore royalties are offset by declines in equalization payments. The removal of equalizing components of other federal transfers, notably the Canada Health and Social Transfer (CHST), has also placed increased stress on equalization as it becomes the sole instrument to address horizontal imbalances across the country. Finally, recent changes to the program, including the growth ceiling imposed in 1999-2000, have met with vociferous provincial opposition.

The range of reform proposals is wide. Some researchers advocate replacing the current formula with a more transparent one to improve accountability; others approve of the principle and general structure of equalization but recommend adjustments to the current formula. Still others advocate abandoning any fiscal equalization initiative whatsoever.

Although there is no shortage of opinions on how to improve upon the program, two proposals have emerged at the forefront of the current debate. The reforms called for by these proposals are not exceptionally complex. However, little information is available on how they would affect the level, allocation and volatility of equalization payments.

Using data from the federal Department of Finance, a simulation of the two reform options was run to analyze how each would have affected equalization payments had they been in place over the 1996-1997 to 2001-2002 period. The intent is not to recommend one proposal over any other, but to show how these suggested adjustments might affect equalization payments if they were to be adopted by the federal government in 2004.

THE VICTORIA PROPOSAL

At the August 2001 Annual Premiers' Conference in Victoria, provincial and territorial finance ministers presented a series of reform options aimed at addressing the horizontal and vertical fiscal imbalances in Canada.⁽⁹⁾ These proposals largely focused on ways

(9) As mentioned above, horizontal imbalances refer to the differing capacity to generate revenues across the provinces. Vertical imbalances refer to the mismatch between the federal and provincial governments in terms of their respective taxation powers and spending responsibilities.

in which the federal government might increase its share of funding for health, education and welfare expenditures.⁽¹⁰⁾

However, it was also recognized that there was a corresponding need to ensure the sufficiency of equalization payments, lest any growth in the CHST serve only to widen the fiscal gaps among the provinces. Accordingly, the provincial finance ministers also recommended a handful of changes to the equalization program. These recommendations are referred to here as the Victoria Proposal.

The Victoria Proposal suggests three alterations to the program. The first is to scrap the five-province standard and return to the more representative ten-province standard. As mentioned above, the ten-province standard (10PS) was done away with in 1982 because of the effect of Alberta's energy resources on provincial entitlements. The provinces argue that a 10PS is more in keeping with the spirit of equalization. It would also result in higher entitlements.

The second proposed change is to remove the floor and ceiling provisions permanently. This recommendation was made on the grounds that if the equalization formula was designed to compensate automatically for horizontal imbalances, then imposing any restrictions on the program distorts its ability to do so.

The final recommendation is to restore full (comprehensive) revenue coverage. This recommendation essentially calls on Ottawa to reverse its 1999 decision to equalize only half of all eligible provincial/local miscellaneous revenues. The provinces argue that, in order for equalization to work effectively in reducing horizontal imbalances, the tax base should be as comprehensive as possible. They maintain that including only portions of revenue sources undermines the purpose of the program.

A. Impact of the Proposal

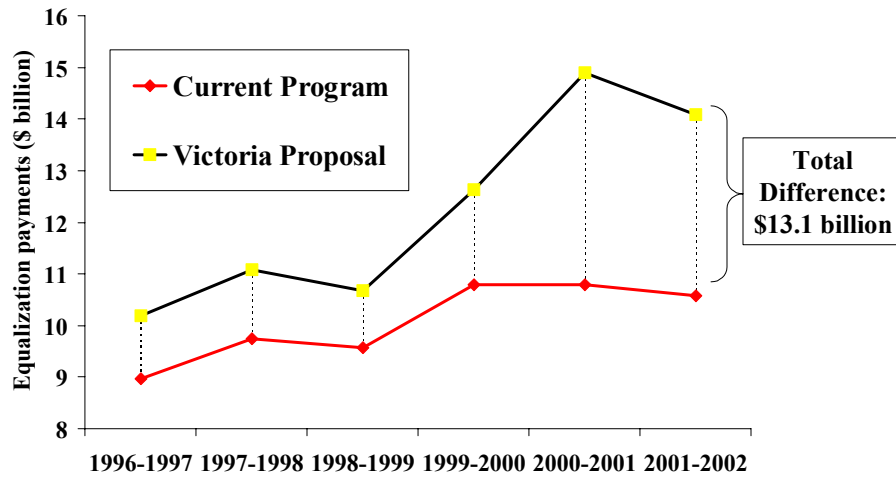
1. Federal Perspective

Implementing the Victoria Proposal would result in a significantly more generous equalization program. Over the 1996-1997 to 2001-2002 period as a whole, the Victoria Proposal would have cost the federal government \$13.1 billion over and above the cost of the

(10) The proposals are contained in the document *Addressing Fiscal Imbalance: Report of Provincial and Territorial Finance Ministers*, Victoria, British Columbia, 2001.

current formula (see Chart 3). The increase in annual payments would have ranged from \$1.1 billion in 1998-1999 to \$4.1 billion in 2000-2001 (Table 1).

Chart 3 Total Value of Equalization Payments under the Victoria Proposal – 1996-1997 to 2001-2002



Source: Author's calculations using federal Dept. of Finance data

As a result, the burden of equalization on total federal spending obligations would have increased, in some years considerably. In 2000-2001, payments under the Victoria Proposal would have been fully 38% higher than under the current program. As shown in Table 1, the increase in payment obligations would have consumed an additional 1-3% of available federal revenues over the analysis period.

Table 1 The Victoria Proposal – Effect on the Total Cost of Equalization

		1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002*
Total Equalization Payments (\$ million)	Victoria	10,189	11,089	10,681	12,624	14,902	14,090
	Original	8,959	9,738	9,578	10,792	10,780	10,585
	Difference	1,230	1,350	1,103	1,832	4,123	3,505
	%	13.7	13.9	11.5	17.0	38.2	33.1
Equalization as a % of Federal Revenues**	Victoria	10.62	9.88	9.35	10.18	10.92	10.67
	Original	9.34	8.68	8.33	8.70	7.90	8.01
	Difference	1.28	1.20	1.02	1.48	3.02	2.65
Equalization as a % of GDP	Victoria	1.21	1.25	1.17	1.29	1.41	1.30
	Original	1.07	1.10	1.04	1.11	1.02	0.98
	Difference	0.15	0.15	0.13	0.19	0.39	0.32

* Federal revenues and GDP data from 2001 federal Budget

** Total revenues less debt-servicing obligations

Note: Totals may not add up exactly, due to rounding.

Although this increase would have represented a significant impact on current federal spending, equalization under the Victoria Proposal would still not have accounted for as much of federal budget spending as in years past. As mentioned earlier, at its peak in the early 1980s, equalization consumed as much as 11.3% of available federal revenues. Under the Victoria Proposal, equalization would have reached a high point of 10.9% in 2000-2001.

In addition to being more expensive than the current formula, the Victoria Proposal is also considerably more volatile. Over the sample period, payments would have fluctuated by as much as \$2.0 billion or more from one year to the next. This volatility is primarily due to the influence of world oil and natural gas prices and to the reinclusion of Alberta into the formula. As shown in Table 1, the value of equalization payments under the Victoria Proposal would have increased steeply late in the 1990s, coinciding with the dramatic rise in energy prices in 1999 and 2000. Similarly, as energy prices began to drop again in 2001, the cost of equalization would have followed suit.

When this proposal was presented in August 2001, the provinces were aware that it would increase program volatility – a significant concern for the federal government. In their report to the Annual Premiers' Conference in August 2001, the provincial finance ministers directed their officials to provide options for addressing this problem. Although no options were specifically mentioned in the report, this task could be accomplished fairly easily without compromising the principles of the program.

2. Provincial Perspective

The most significant aspect of the Victoria Proposal is the move to the ten-province standard. Since this effectively raises the bar against which provincial fiscal capacities are measured, the Victoria Proposal elevates the dollar value of per capita equalization payments to most recipient provinces in a relatively uniform manner. In 2000-2001, for example, the per capita increase in payments to the Atlantic provinces, Quebec and Manitoba would have ranged from \$303 in Quebec to \$318 in Newfoundland – a difference of only \$15 (Table 2).

		NF	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
Total Equalization Payments (\$ million)	Victoria	1,272	300	1,619	1,445	7,648	0	1,595	361	0	663
	Original	1,101	256	1,327	1,207	5,412	0	1,239	237	0	0
	Difference	172	44	291	238	2,236	0	356	123	0	663
	%	15.6	17.1	21.9	19.7	41.3	0	28.7	52.0	0	n/a
Per Capita Equalization Payments (\$)	Victoria	2,360	2,161	1,720	1,911	1,038	0	1,390	352	0	163
	Original	2,042	1,845	1,411	1,597	734	0	1,080	232	0	0
	Difference	318	315	309	315	303	0	310	120	0	163
Equalization as a % of Provincial Revenues	Victoria	32.5	30.1	28.7	28.6	14.4	0	22.4	5.2	0	2.7
	Original	29.4	26.9	24.8	25.0	10.6	0	18.3	3.5	0	0.0
	Difference	3.1	3.2	3.9	3.5	3.8	0	4.1	1.7	0	2.7
Fiscal Capacity as a % of 10-prov. Average*	Victoria	92.8	92.8	92.8	92.8	92.8	96.4	92.8	92.8	152.4	92.8
	Original	89.9	90.0	90.0	90.0	90.1	98.3	90.0	92.9	155.5	92.2
	Difference	2.9	2.9	2.8	2.9	2.7	-2.0	2.8	-0.1	-3.1	0.6

* Average of total revenue-generating capacity; i.e., full user fees included in fiscal capacity for original. Includes Saskatchewan's floor payment.

Note: Totals may not add up exactly, due to rounding.

However, because of Quebec's large population, this \$303 per capita represents a much more significant increase compared to other provinces. The Victoria Proposal would have raised Quebec's total equalization entitlement by \$2.2 billion in 2000-2001 alone, an increase of 41% over current levels. Because current per capita equalization payments to the Atlantic region are much larger than payments to Quebec, the increase resulting from the Victoria Proposal would have been less profound for the Atlantic provinces, ranging from 15.6% in Newfoundland to 21.9% in Nova Scotia.

Saskatchewan stands apart from the other six provinces that typically receive the transfer. Because of its large tax base in natural resources, equalization payments to Saskatchewan are relatively small on a per capita basis and can fluctuate dramatically according to the strength of world crude oil and natural gas prices. This volatility means that Saskatchewan is the province most likely to trigger the floor provision in the equalization program. Indeed, Saskatchewan has qualified for floor payments four times since 1994-1995.

Since the Victoria Proposal eliminates the floor, it does not benefit Saskatchewan as much as other provinces. In 1996-1997, for example, Saskatchewan would have received less equalization under the Victoria Proposal than under the current formula. In 2000-2001, Saskatchewan's gain in per capita transfers from moving to the Victoria Proposal would have been less than half that of the other six traditional recipient provinces.

The Victoria Proposal would also add an eighth province to the list of equalization recipients. British Columbia would first have begun to receive equalization payments in 1999-2000; by 2000-2001, it would have added \$663 million to the cost of the program. This result is significant, but not particularly surprising. In recent years, the fiscal capacity of the B.C. government has slipped relative to that of other provinces. Indeed, the most recent estimates of equalization entitlements suggest that British Columbia now qualifies for the transfer, even under the current equalization formula.

3. Effect on Provincial Fiscal Disparities

The main purpose of equalization is to even out provincial disparities in revenue-generating capacity across Canada. In that sense, the Victoria Proposal represents an improvement over the current equalization program.

Under the current program, equalization transfers raised the revenue-generating capacity of recipient provinces to about 90% of the national provincial average in 2000-2001.⁽¹¹⁾ Under the Victoria Proposal, the gap is narrowed somewhat. The increase in transfer payments to equalization-receiving provinces lifts the revenue-generating capacity of the recipient provinces to close to 93%.⁽¹²⁾

THE NEWFOUNDLAND PROPOSAL

On 18 October 2001, the Premier of Newfoundland and Labrador, Roger Grimes, appeared before the Standing Senate Committee on National Finance. In his presentation, Premier Grimes outlined his province's vision of the purpose and function of the equalization program and how the program could be improved to better meet this vision.

As mentioned above, the provinces were unanimously in favour of the recommendations made in the Victoria Proposal. Those suggested reforms – moving back to a ten-province standard; removing the floor and ceiling provisions; and reinstating comprehensive revenue coverage – are common to all provincial reform proposals, including what is here called the Newfoundland Proposal.

Where the Newfoundland Proposal parts company with other provincial recommendations is in the treatment of non-renewable natural resource revenues. Following arguments by economist Ken Boessenkool,⁽¹³⁾ Mr. Grimes maintained that because mines and energy deposits have a finite lifespan, revenues derived from those sources do not represent income; rather, they represent proceeds from the sale of capital assets.⁽¹⁴⁾

(11) Provincial revenue-generating capacity is measured here to include 100% of all revenue sources, including user fees. The national average refers to the population-weighted mean of fiscal capacity plus equalization payments.

(12) Under the current program, floor payments brought Saskatchewan up to 92.9% of the national average in 2000-2001. As a result, the Victoria Proposal would have offered no improvement for Saskatchewan that year.

(13) See Kenneth Boessenkool, *Clearly Canadian: Improving Equity and Accountability with an Overarching Equalization Program*, Commentary 114, C. D. Howe Institute, Toronto, 1998, available at www.cdhowe.org; and Proceedings of the Standing Senate Committee on National Finance, Issue No. 24, 24 October 2001.

(14) Mr. Grimes' position likens the sale of energy minerals to that of a provincial asset such as a public utility. The province is not wealthier as a result of the sale, but has simply replaced one asset with another.

Newfoundland argues, therefore, that it is inappropriate for non-renewable resource revenues to be subject to equalization. Equalization deducts the proceeds from the one-time sale of a provincial asset, one that can never be recovered. The province maintains that it should be allowed to keep this income and use it towards paying down the provincial debt or making one-time investments in infrastructure. Mr. Grimes stated that such a strategy could allow the province to convert the sale of an asset into a long-term benefit. Eliminating the provincial debt, for example, could eliminate interest payment obligations and free up 15% more spending capacity in perpetuity.⁽¹⁵⁾

A. Impact of the Proposal

1. Federal Perspective

Somewhat surprisingly perhaps, the Newfoundland Proposal is almost expenditure-neutral in comparison with the current fiscal transfer – the difference between the two, in terms of the total amount of equalization payable, is negligible. In fact, from 1996-1997 to 2001-2002, the total increase in equalization payments would have been just under \$600 million, a mere 1% total increase spread over a six-year period (Table 3).

		1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002*
Total Equalization Payments (\$ million)	Newfoundland	8,832	9,782	9,843	10,779	10,831	10,965
	Original	8,959	9,738	9,578	10,792	10,780	10,585
	Difference	-127	44	265	-12	51	379
	%	-1.4	0.4	2.8	-0.1	0.5	3.6
Equalization as a % of Federal Revenues**	Newfoundland	9.21	8.72	8.61	8.69	7.93	8.30
	Original	9.34	8.68	8.33	8.70	7.90	8.01
	Difference	-0.13	0.04	0.28	-0.01	0.04	0.29
Equalization as a % of GDP	Newfoundland	1.05	1.11	1.07	1.11	1.03	1.01
	Original	1.07	1.10	1.04	1.11	1.02	0.98
	Difference	-0.02	0.00	0.04	0.00	0.00	0.04

* Federal revenues and GDP data from 2001 federal Budget.

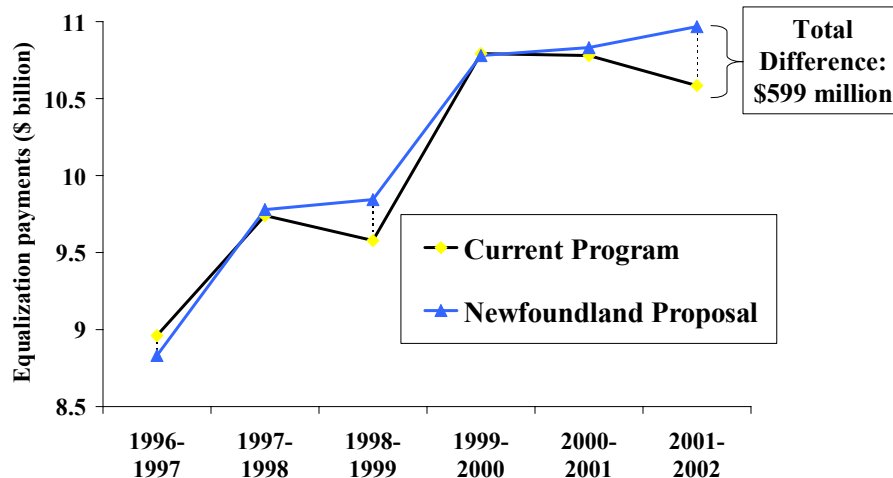
** Total revenues less debt-servicing obligations.

Note: Totals may not add up exactly, due to rounding.

(15) Proceedings of the Standing Senate Committee on National Finance, Issue No. 22, 18 October 2001.

This outcome is a result of the fact that the increased cost associated with returning Alberta to the national standard is offset almost exactly by the concurrent removal of non-renewable resources from the list of revenues. Removing non-renewable natural resource revenues also eliminates the volatility associated with the Victoria Proposal. In fact, growth in equalization payments under the Newfoundland Proposal closely tracks the current formula over the sample period, but exhibits less of a tendency towards sharp fluctuations (Chart 4).

Chart 4 Total Value of Equalization Payments under the Newfoundland Proposal – 1996-1997 to 2001-2002



Source: Author's calculations using federal Dept. of Finance data

From the perspective of program cost, the near revenue-neutrality of the Newfoundland Proposal makes it considerably more palatable than the Victoria Proposal. However, it is by no means clear that the Newfoundland Proposal would continue to be revenue-neutral in the future. The cost of the proposal begins to diverge from that of the current equalization formula in 2000-2001. This divergence could grow with the development of mineral and energy deposits in Newfoundland and Nova Scotia.

2. Provincial Perspective

While the Newfoundland Proposal does not greatly affect total equalization payments, it dramatically changes how the transfer is allocated across the country. In essence,

the Newfoundland Proposal would result in a massive transfer of wealth from every other equalization-receiving province to Saskatchewan. Over the entire six-year period, Saskatchewan would have received over \$4.0 billion in *additional* equalization payments.

Saskatchewan's non-renewable resource endowments – oil, natural gas and potash – have been a large equalization offset in that province for years. Removing those revenue sources from the equalization formula would have increased Saskatchewan's equalization entitlements by as much as \$875 per person in 2000-2001. That year, total equalization payments to the province would have risen by \$866 million, a windfall equivalent to a sudden 11% increase in provincial revenues (Table 4).

Table 4 The Newfoundland Proposal – Effect on Provincial Entitlements, 2000-2001

		NF	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
Total Equalization Payments (\$ million)	NF Proposal	1,091	241	1,226	1,146	4,582	0	1,141	1,104	0	299
	Original	1,101	256	1,327	1,207	5,412	0	1,239	237	0	0
	Difference	-10	-15	-102	-61	-830	0	-98	867	0	299
	%	-0.9	-5.8	-7.7	-5.1	-15.3	0	-7.9	365.3	0	n/a
Per Capita Equalization Payments (\$)	NF Proposal	2,023	1,737	1,302	1,516	622	0	995	1,068	0	74
	Original	2,042	1,845	1,411	1,597	734	0	1,080	232	0	0
	Difference	-19	-108	-108	-81	-113	0	-85	836	0	74
Equalization as a % of Provincial Revenues	NF Proposal	29.2	25.7	23.3	24.1	9.2	0.0	17.1	14.5	0.0	1.2
	Original	29.4	26.9	24.8	25.0	10.6	0.0	18.3	3.5	0.0	0.0
	Difference	-0.2	-1.2	-1.5	-1.0	-1.5	0.0	-1.2	11.0	0.0	1.2
Fiscal Capacity as a % of 10- prov. average*	NF Proposal	89.6	88.3	88.4	88.7	88.4	98.3	88.7	105.5	155.5	93.3
	Original	89.9	90.0	90.0	90.0	90.1	98.3	90.0	92.9	155.5	92.2
	Difference	-0.3	-1.6	-1.6	-1.2	-1.7	0.0	-1.3	12.6	0.0	1.1

* Average of total revenue-generating capacity, including user fees.

Note: Totals may not add up exactly, due to rounding.

British Columbia would also benefit from the removal of oil, gas and mineral revenues from the equalization formula. That province would have qualified for the transfer from 1999-2000 onwards; by 2001-2002, it would have received \$416 million in equalization payments. In fact, British Columbia's becoming a recipient province is the single largest reason why the Newfoundland Proposal is more costly than the current program. If British Columbia did not qualify for the transfer, the Newfoundland Proposal would be slightly less generous than

the current equalization program – the federal government would have saved a total of \$133 million over the six years.

Apart from Saskatchewan and British Columbia, no other equalization-receiving province would be better off (in aggregate) under the Newfoundland Proposal over the 1996-1997 to 2000-2001 period. The province of Newfoundland and Labrador comes closest. This proposal would have resulted in higher equalization payments to Newfoundland in 1998-1999 and again in 2001-2002. Over the entire six-year period, payments would have been \$53 million lower than under the current program. In 2001-2002, however, Newfoundland and Labrador would undoubtedly have expected its gains to accelerate as new offshore energy projects came on line.

The impact of the Newfoundland Proposal on the other five equalization-receiving provinces would be severe. Entitlement losses would have ranged from \$81 per capita in New Brunswick to \$113 in Quebec in 2000-2001 – equivalent to a drop of between 1.0% and 1.5% in total provincial revenues. Interestingly, this proposal is clearly of no current benefit to Nova Scotia, which is also home to significant offshore energy deposits. However, this may change in future as new offshore projects get under way.

3. Effect on Provincial Fiscal Disparities

Because the Newfoundland Proposal is only marginally more generous than the current program and results in a tremendous shift of transfer entitlements from east to west, it does little to reduce the gaps in fiscal disparity between the wealthy and poor provinces. With the Atlantic provinces, Quebec and Manitoba all receiving lower equalization payments, it is hardly surprising that the gap is in fact wider under the Newfoundland Proposal than under the current equalization program (Table 4).

The losses to those six provinces are to the gain of Saskatchewan and British Columbia. In particular, after taking equalization payments into account, Saskatchewan joins Alberta as the only provinces with an above-average revenue-generating capacity.

However, the Newfoundland Proposal is not without its merits. Perhaps its most significant advantage is that it effectively addresses one of the chief criticisms of equalization, that the transfer provides a disincentive for provinces to develop their natural resource bases.

This position is based on the theory that, since any increase in resource royalties is offset by a reduction in equalization payments, recipient provinces do not receive the benefits from the resource, nor are they penalized for deferring development. This argument has been made by a number of researchers, particularly with respect to the Atlantic offshore deposits and Newfoundland's Voisey's Bay nickel deposit.

Whether this disincentive for development in fact exists is a matter open to debate. Paul Boothe, an economist and former Deputy Minister of Finance in Saskatchewan, offered the following testimony before the Senate Finance Committee:

As deputy minister of finance, I learned that policy-makers do not always operate on the same margin as economic theorists. I have never seen an economic development proposal, no matter how ill-conceived, defeated in Treasury Board or cabinet because of a potential loss in equalization revenue....[I]n my experience, the potentially perverse incentives do not pose a problem at the practical policy level.⁽¹⁶⁾

Regardless, the Newfoundland Proposal would render this debate moot. Since resource royalties would no longer be subject to the equalization clawback, provinces would more explicitly bear the full cost, and benefit, of their economic development decisions.

CONCLUSION

Canada's program of fiscal equalization transfers to the provinces is in a perpetual state of evolution. What began in 1957 as a small transfer equalizing only portions of three revenue sources has grown into a significant source of revenue for qualifying provinces. Over time, the program has undergone numerous changes, ranging from minor mechanical adjustments to substantial reforms.

Because the program is subject to renewal every five years, there is a large and diverse body of research on equalization in Canada as academics, analysts and provincial stakeholders study and critique the program, and make suggestions for new adjustments or

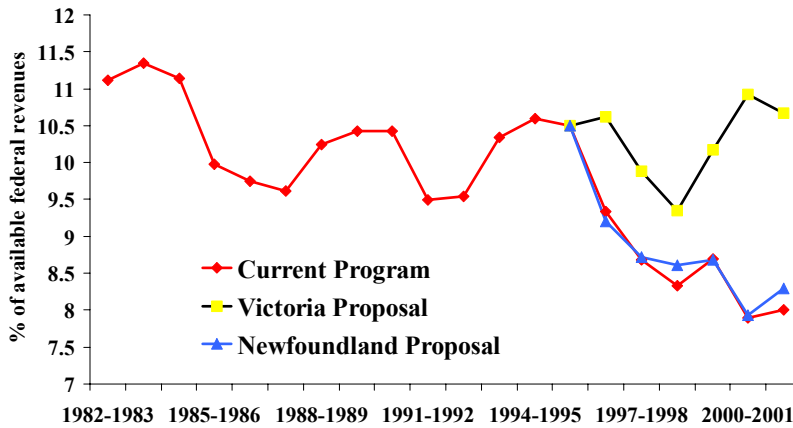
(16) Proceedings of the Standing Senate Committee on National Finance, Issue No. 29, 20 November 2001.

alternative structures. The debate over equalization reforms typically becomes most heated in the period immediately preceding program renewal.

In light of the upcoming renewal in 2004, this paper examined two of the most common suggestions for amending the equalization formula. The aim was to analyze what effect they would have had on equalization payments over the 1996-1987 to 2001-2002 period, thus offering a glimpse into what the future implications might be.

Each suggestion has both merits and drawbacks. The Victoria Proposal – removing the ceiling/floor provisions, returning to a ten-province standard and ensuring comprehensive revenue coverage – greatly increases the size of the transfer to Canada’s less wealthy provinces and helps narrow the gap in revenue-generating capacity between the have and have-not provinces. However, the program also introduces a high degree of volatility in the level of payments from year to year and becomes much more expensive for the federal government to finance.

Chart 5 Effect of Proposed Reforms on Total Value of Equalization



Source: Author's calculations using federal Dept. of Finance data

The Newfoundland Proposal is similar to the Victoria Proposal, with the exception that the former proposal also removes non-renewable resource revenues from the formula. Total equalization payments under the Newfoundland Proposal are not significantly different from the current formula. However, there is a considerable change in how equalization

payments are distributed across the country. Indications are that Newfoundland may benefit in future years from the reform option bearing its name. Over the analysis period, however, the result was a surge in the annual transfer to Saskatchewan at the expense of the Atlantic provinces, Quebec and Manitoba.

Other reform options are certain to be presented prior to 2004. The Standing Senate Committee on National Finance is expected to release its final report and recommendations early in 2002. This and other forays into the debate over equalization should be encouraged; it is through the exchange of ideas and information that solutions to public policy problems can be found. This paper is intended to contribute further details to that exchange.

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