



A FINE CANADIAN COMPROMISE

PERSPECTIVES ON THE REPORT OF THE EXPERT PANEL ON
EQUALIZATION AND TERRITORIAL FUNDING FINANCING

EDITED BY PAUL BOOTHE AND FRANÇOIS VAILLANCOURT

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INTRODUCTION AND SUMMARY¹

PAUL BOOTHE | IPE AND UNIVERSITY OF ALBERTA

In March 2005, the Minister of Finance announced the formation of the Expert Panel on Equalization and Territorial Formula Financing (TFF). This followed the agreement by First Ministers in October 2004 to consider further changes to these programs. The panel was comprised of five members including chairman Allison O'Brien (former Alberta Deputy Provincial Treasurer), Fred Gorbet (former federal Deputy Minister of Finance), Robert Lacroix (former Rector of the University of Montreal), Elizabeth Parr-Johnson (former President of the University of New Brunswick) and Michael Percy (University of Alberta Dean of Business). Dean Percy was given special responsibility for considering changes to TFF.

The mandate of the Panel was to consider and provide advice to the Government of Canada on the allocation of equalization among the provinces and TFF among the territories, mechanisms to ensure payments are stable and predictable, evidence-based aggregate measures of fiscal disparities, and whether a permanent, independent body should be established to advise the Minister on Equalization and TFF.

After more than a year of consultations and deliberations, the Panel provided its report to the Minister of Finance on

¹ The views expressed in this volume are the authors and should not be attributed to any other individual or organization. The IPE and CIRANO are grateful to Finance Canada for their financial support of the Roundtable and this volume.

June 5th 2006. The Minister immediately made the Panel's report available to the public.

The following day, the Institute for Public Economics (IPE) at the University of Alberta and the Centre interuniversitaire de recherche en analyse des organisations (CIRANO) assembled leading policy researchers and commentators from across Canada in Ottawa for a roundtable discussion with the Panel of their findings and recommendations. The roundtable had three goals. The first was to help policy researchers understand the Panel's recommendations and the reasons behind them. The second was to give their initial reaction to the Panel in advance of their upcoming meetings with Premiers in Edmonton and, later, with Ministers of Finance in Niagara on the Lake. Finally, with Finance Canada officials present as observers, the third goal was to provide the Department with some early reaction as part of the Minister's commitment in Budget 2006 to consult with interested parties before proposing changes to Equalization and TFF to Parliament in Budget 2007.

The roundtable had the following format. The day began with a presentation by the Panel of their recommendations and the reasons behind them. From there, we had a series of four papers by policy experts outlining key issues to motivate the discussion. The first paper, by Don Drummond, senior vice-president and chief economist of TD Bank Financial Group looked at the Equalization standard. The second, by Michael Smart of the University of Toronto, examined the treatment of natural resource revenue. These two morning papers were followed by a discussion period addressing both sets of issues. The third paper by François Vaillancourt of CIRANO and Université de Montréal looked at measurement issues. The final paper by James Feehan of Memorial University reviewed the Panel's recommendations regarding TFF. These two afternoon papers were also followed by a discussion period addressing both sets of issues. The day ended with a wide-ranging discussion of the Panel's recommendations as a complete policy package and looked ahead to the meetings

of the Panel with Premiers and with federal, provincial and territorial Finance Ministers.

This volume, which forms a record of the roundtable discussion, is organized as follows. The remainder of this introductory paper provides a summary of the volume. Next, we include the Panel's recommendations regarding Equalization and TFF. These are followed by four papers that were presented at the roundtable laying out issues to be considered. The volume concludes with a final paper, written by John Richards following the roundtable discussion, looking at the recommendations as an integrated package and discussing the way forward for Equalization and TFF reform.

EQUALIZATION STANDARD

Don Drummond led off the discussion by focusing on the Equalization standard – the fiscal capacity to which provinces will be equalized. This topic encompasses many of the key debates surrounding equalization, including: Should the standard be constructed using a 'representative tax system' (RTS) or a macro approach? Should the standard be based on five provinces (as it was before 2004) or on all ten provinces as many provinces have advocated? Should the affordability of the program for the federal government be considered? How can the volatility of payments be reduced in order to aid good fiscal planning by provinces? Should there be a cap or upper limit on payments to ensure that recipient provinces do not, through Equalization, end up with higher fiscal capacity than non recipients?

In Drummond's view, the post-2004 program with exogenous growth did not fit with the constitutional rationale for equalization, principally because it did not respond to absolute changes in disparities. Drummond congratulates the Panel on proposing a return to a principles-driven, formula-based program. Drummond also feels that the Panel was correct to deal with the complexity problem by simplifying the RTS rather than

going to macro approach since, in his view, macro indicators can't measure fiscal capacity as well as an RTS approach.

Unlike a number of commentators, Drummond does not feel any affinity for a ten-province standard. He believes that a ten-province standard makes a good deal of sense with a net equalization scheme, (i.e. one that levels provinces down as well as up to the standard). However, given that Canada operates a gross equalization scheme, (i.e. one that levels up to the standard but not down), he feels other standards could be equally appropriate. For example, if provinces were more equal in size, a median province standard might be more representative.

Drummond compares (with appropriate caveats) the cost of the Panel's proposal with the costs associated with proposal of the Council of the Federation's panel (CoF). He dismisses the notion that any increased costs that are incurred will simply be paid from future federal surpluses, since these surpluses represent potential tax cuts for all Canadians – including those in provinces that do not receive Equalization.

Turning to the Equalization cap, Drummond views this as a severe measure and wonders if the cap should be based on a 50 percent inclusion of natural resource revenue or whether the public costs of exploiting natural resources should be taken into account. He believes that the Panel's proposed measures to reduce the volatility of Equalization payments will enhance the ability of the provinces to plan. Finally, he is in agreement with the Panel's comment (strictly speaking, outside their mandate) that all equalization should be delivered through the formal Equalization program, and that, in the interest of fairness to both non-recipient and recipient provinces, specific-purpose transfers like the Canadian Health Transfer and the Canadian Social Transfers should be distributed on a per capita basis.

THE TREATMENT OF NATURAL RESOURCES

Michael Smart led the discussion on the Panel's proposals regarding the treatment of natural resource revenues (NRR). In his view, these constitute the "...interesting, complex and controversial" part of the Panel's report. Smart argues that while the proposals may address equity concerns, they do not pay enough attention to the incentives created for receiving provinces in taxing their natural resources.

Smart focuses attention on three features of the recommendations that he believes serve to reduce the incentive to tax natural resource revenue in receiving provinces: the 50 percent inclusion of NRR in the calculation of fiscal capacity, the use of actual resource revenues as the base, and the cap that limits total equalization to the fiscal capacity of the lowest non-recipient province. Smart cites empirical evidence that suggests that receiving provinces tax natural resources less when there is partial inclusion of NRR in Equalization. He believes that natural resources are currently under taxed in Canada, so this is a negative incentive.

Turning to the proposal to use actual revenues as the base for natural resources, Smart believes that aggregating all natural resources into a single base is a positive reform. However, he argues that measuring resource rents rather than actual revenues would be a better measure of fiscal capacity. Further, he is concerned that the cap (which amounts to 100 percent inclusion above a certain level) will lead recipient provinces to develop natural resources less aggressively than they otherwise would. In sum, because of the negative impact of the Panel's proposals on taxation and development of natural resources, Smart advocates that the post-2004 status quo be retained.

Discussion

The discussion from the Panel and Roundtable participants was wide-ranging. Many points of clarification were raised and dealt

with. Much of the debate centered on the inclusion rate for natural resource revenues and its interaction with the cap. Some participants questioned why a full inclusion of natural resource revenue was used for the purposes of calculating the cap, while a 50 percent rate was used for calculating entitlement below the cap. Others asked if the treatment of natural resources was motivated by concerns regarding the affordability of the program for the federal government. The Panel made clear that the 50 percent inclusion rate for natural resources was not motivated by affordability concerns. Rather, it flowed from the principle that provinces should enjoy some net benefit from their ownership of resources – even if they were recipients of Equalization payments. At the same time, the introduction of the cap was motivated by a basic principle of fairness. Namely, Canadians in non-recipient provinces should not be taxed to provide Equalization transfers to provinces with higher fiscal capacity than their own.

On the treatment of natural resource revenue, some participants argued that provincial governments maximized employment rather than revenue in making natural resource development and taxation decisions. The Panel agreed that it would be better to equalize natural resource rents rather than actual revenues, but argued that measurement issues make the equalization of natural resource rents impossible given the current state of knowledge

INCLUSION AND MEASUREMENT ISSUES

François Vaillancourt examines some of the proposals the Panel made to measure fiscal capacity. Vaillancourt agrees with the Panel's recommendation not to include expenditure need in the Equalization formula for two reasons. The first is that expenditure need is very difficult to measure. The second is that, in his view, including it would not make a material difference to the distribution of Equalization payments.

Vaillancourt next turns to the question of RTS versus macro approach that was also addressed earlier by Drummond.

On this issue, he again agrees with the Panel's proposal. Like Drummond, he believes that an RTS approach does a better job of measuring the actual fiscal capacity of provinces. However, Vaillancourt does not agree with the Panel on the question of user fees. Since there is potential for substitutability between user fees and taxes, he argues that provinces could affect their Equalization entitlements by choosing user fees for bases where they improve their entitlements. For this reason, Vaillancourt argues for inclusion of user fees as well as taxes.

Vaillancourt agrees with the simplification strategy adopted by the Panel, although he believes it could have gone further. Finally, while he finds the Panel's approach to equalizing property tax acceptable, he believes better strategies exist and they should be investigated.

TERRITORIAL FORMULA FINANCING

James Feehan of Memorial University looked at the Panel's recommendations regarding TFF. Feehan begins by underlining the importance of TFF to territories: TFF comprises more than 60 percent of total territorial revenues. Thus, the overarching concern of the territories in TFF reform is adequacy. Feehan draws attention to a number of factors that are of particular importance in the territories. Examples include the barriers faced by many, especially aboriginal people, to participating in economic development, the high cost of providing government services and building public infrastructure, and special development needs of Nunavut.

In Feehan's view, TFF was originally well founded. However, over time the program has been weighed down by piecemeal, ad hoc fixes to specific problems. The new framework of 2004 was a workable short-term solution, but it created significant concerns in territories, especially around the zero-sum nature of the allocation mechanism.

The Panel proposals update and simplify TFF. Fiscal capacity would be measured as 70 percent of the revenue-raising ability from seven of the territories' own sources of revenues. Natural resources, largely controlled by Ottawa, are excluded. The Panel recommends moving away from the zero-sum approach of the new framework of 2004. Overall, Feehan finds that the Panel's proposal represents "...a reasonable and practical set of recommendations that improve TFF."

Feehan argues that there may be a need to study the measure of expenditure need used in the TFF formula to ensure it is fully up to date. In addition, further devolution may require revisiting the treatment of natural resources. Finally, special programs outside of TFF may be needed to address the development challenges facing Nunavut. Feehan concludes by endorsing the Panel's recommendations: "The federal government would be wise to accept the thrust of these TFF proposals."

Discussion

Once again, a wide-ranging discussion of the issues ensued with many questions of clarification. The inclusion of user fees was an area of particular focus. The Panel clarified their use of the term "user fees" to mean only payments for services that did not generate net profit for government. The Panel was asked whether a different treatment of property tax would result in British Columbia qualifying as a recipient province under the proposed formula. In the Panel's view, it would not.

Another issue that was discussed at some length was the role played by the capitalization of net fiscal benefits. Traditionally, equalization schemes in Canada have implicitly assumed that net fiscal benefits are not capitalized. If they are, it may be that disparities between recipient and non-recipient provinces are smaller than measured by past formulas and by the one proposed by the Panel. However, as with natural resource rents, capitalization is not directly observed or measured.

This measurement issue played a decisive role in the Panel's decision not to explore the capitalization issue further.

Participants were, in general, very supportive of the Panel's proposal regarding TFF. The positive incentives for economic and social development in the North were highlighted.

WRAP-UP SESSION

In the final session of the Roundtable, participants reflected on the discussion that had taken place over the day and tried to focus on the Panel's recommendations as an integrated policy package rather than on specific aspects of the Report. The discussion of the day did a good job of drawing attention to the principles that underpin the report. These principles included being true to the constitutional mandate (Section 36(2)) of the program and avoiding other goals such as promoting economic development or equalizing incomes. A second principle was fairness to all Canadian taxpayers, whether they lived in recipient or non-recipient provinces. A third was that provinces, even if they are Equalization recipients, should get some net benefit from their ownership of natural resources.

Although there was a great deal of support, consensus was elusive on some specific issues. The two issues that received the most attention were the inclusion rate for natural resource revenue and the operation of the cap. These issues continue to divide provinces as well as the public policy researchers and commentators that participated in the Roundtable.



THE EQUALIZATION STANDARD

DON DRUMMOND | TD BANK FINANCIAL GROUP

I have been asked to open the discussion of the expert panel's report and the presentation they have just made to us. In particular, I have been asked to address the choice of the equalization standard. I am assuming that this is to be taken as a discussion of the relative merits of things like a macro-variable approach versus the Representative Tax System (RTS) and including five provinces versus ten provinces in the standard. I will try not to wander into the areas for subsequent debate but the breadth and complexity of equalization does make it difficult to strictly compartmentalize the discussion. For example, a shift from a five-province to a ten-province standard has implications for the treatment of non-renewable resource revenues since a good chunk of them are in the five provinces now excluded. Finally, as they don't seem to fit neatly elsewhere in the agenda, I will discuss affordability, a cap and stability as well. Of course, these also have important interactions with the choice of standard and the treatment of resource revenues.

THE PURPOSE OF EQUALIZATION

There is probably no better general description of the purpose of equalization than the wording in Section 36 (2) of the Constitution Act, 1982. Equalization is to ensure "that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable

levels of taxation.” I think we would all agree that the current regime does not respect the general purposes of equalization. In particular, the “exogenization” of payments (\$10.9 billion per year with a scalar of 3.5 percent per annum) does not do justice to the notion that the overall amounts to be paid should reflect the divergences across provinces in their revenue-raising capacities. If incomes converge across provinces, equalization should diminish and vice versa. A fixed overall pot also means that a province’s share is whipped around by what goes on with every other recipient and this compromises planning. So let me congratulate the Expert Panel for interpreting their mandate rather broadly rather than just offering a view on how the fixed pot should be allocated. The Expert Panel is absolutely correct in recommending that Equalization be returned to a formula-driven program that reflects changes in provinces’ revenue-raising capacities.

MACRO APPROACHES VERSUS THE REPRESENTATIVE TAX SYSTEM (RTS)

The next question becomes – what formula? Historically, the program has been based upon the RTS and there is naturally a certain amount of inertia around changing that. At the broadest level, the nearest competitor would be a macro approach such as equalizing around provincial Gross Domestic Products. First off, GDP would not be a very good indicator because it does not necessarily reflect the income that stays in a province. (This is particularly relevant at this time for provinces such as Newfoundland & Labrador where a good part of the income from offshore development leaves the province.) I don’t want to get too hung up on that because we could probably come up with a more appropriate macro variable, such as a provincial counterpart to Gross National Product (Statistics Canada is beginning to think about this) or perhaps personal incomes. The more telling criticism of such a macro approach is that it does not deliver against the stated purpose of equalization. In other words, divergences across provinces in GDP per capita might have little to do with their abilities to provide “reasonably

comparable levels of public service at reasonable comparable levels of taxation.” The RTS (which measures the fiscal capacity of a province to raise revenues from each of thirty-three revenue sources assuming that province has average tax rates) at least satisfies the “reasonably comparable levels of taxation” part. It does not, however, directly address the “reasonably comparable levels of public service” part.

Addressing the public service aspect would require measuring public service needs and costs. As a start, something akin to a Representative Expenditure System would need to be constructed. But this would be difficult given data problems and the greater divergences in services and costs than observed across provincial revenue schemes. It would likely be perceived as unduly intrusive to have the federal government attempt to shoe-horn diverse provincial programs into a representative model. I think the Expert Panel was wise in not recommending going that way at this time.

The RTS has its flaws. It is charged with being overly complex. That really only applies to a few revenue sources, however, such as property taxes, non-renewable resources and rents from some renewable revenue sources. The Expert Panel has some recommendations to deal with these issues but I don’t want to wander into the agenda of subsequent sessions. Suffice it to say that the Panel’s recommendations, to my mind, sufficiently address the complexity issue. The RTS is also charged with creating perverse incentive effects where a province could try to manipulate its tax base through changes in its rates. But there is precious little evidence that there is much to this. The only exception might be for resource revenues where a province can control the rate of exploitation. But again I leave that to another session.

FIVE PROVINCES VERSUS TEN PROVINCES

On the grounds of fairness and transparency there is a lot of superficial appeal in shifting to a ten-province standard. If we want to think of fiscal capacities being equalized across the country then we should be including all provinces. The move away from the ten-province standard to a five-province standard in 1982 was much more about affordability than principle. But much of that superficial appeal applies more to a net equalization scheme than the arrangement we have in Canada. And some institutional features of the Canadian federation should also give some pause about the ten-province standard.

In a net equalization scheme money would be taken away from the richer provinces and transferred to the poorer. It would be grossly unfair to exclude certain wealthy provinces from such a scheme. But under Canada's Equalization program, funds are not taken directly from the wealthier provinces. Rather, the federal government uses its general revenues to transfer money to the poorer provinces. Under the net concept the choice of a standard seems more arbitrary. If it were not for the severe disparity in provincial populations, one might be tempted to use medians rather than averages in deriving a standard. That might make the standard more "representative" as Alberta's income levels pull so far away from those in other provinces, including Ontario.

Alberta's wealth stems largely from its oil and natural gas resources and the high prices the province is current enjoying for these commodities. For the most part, the federal government cannot get its hands on the revenues that flow from these resources. So including Alberta and its resource revenues in Equalization would raise the standard but the federal funding would have to come largely from Ontario taxpayers. As Alberta's wealth rises, federal taxation of Ontario residents would need to rise in order for the federal government to raise Equalization payments to other provinces. This particular feature of the federation surely dulls the superficial appeal of the ten-province standard.

THE AFFORDABILITY CHALLENGE

Affordability needs to be examined from the perspectives of the federal government and the non-equalization-receiving provinces.

The May 2, 2006 federal budget did not make any allowance for increased costs of Equalization and after the promised \$3 billion of annual debt retirement, there is only \$0.6 billion this year and \$1.4 billion next. Even if larger surpluses become available in later years, a good part would be soaked up by the commitment to cut another point off the GST rate. So it is not clear the federal government can “afford” a sharply higher cost of equalization. Not, that is, without dramatically cutting other programs or raising taxes.

With due respect to Alberta, I will make a few comments on affordability from the Ontario perspective. Ontario taxpayers foot a disproportionate amount of the equalization bill through the taxes they send the federal government. In respect of this, we need to start with some principles. When Equalization began, Ontario’s industrial base was largely insulated from international competition behind a tariff wall and most of its trade was with other provinces such that any money distributed out of the province largely came back through purchases of Ontario’s goods and services. But the tariff wall is gone (the Auto Pact, too) and Ontario ships almost \$3 of goods to the U.S. for every \$1 to other provinces. So there are enormous leakages to funds being distributed away from the province. The net federal take from Ontario (federal revenue collections from Ontario less federal spending in Ontario) was already \$18.2 billion in 2003 (Provincial Economic Accounts) or 3.7 percent of Ontario’s GDP. On average, the other provinces, excluding Alberta, had a net federal injection of 3.9 percent of their GDP. That is a lot of fiscal drag for Ontario to absorb.

Increases in Equalization would exacerbate the differences.

The Financial Management System shows that for 2005 Ontario received \$1,235 less per capita from the federal government than the median of all provinces. It had similar own-source revenues to the all-province median, meaning that it had to keep its expenditures per capita \$1,109 below the all-province median. Excluding royalties and investment income, Ontario's own-source revenues were actually \$449 per capita or 9.2 percent above the median. This is largely explained by Ontario's stronger income bases, although it should be noted that Ontario's personal and corporate income tax rates are above those of several other large provinces and some of the equalization-receiving provinces. Increases in Equalization would force Ontario to either further raise own-source revenues, compromising its competitiveness, or cut its spending per capita, which is already 10th or last among the provinces. We need to question the fairness of Ontario taxpayers financing much of Equalization and ending up with the least public services. This is a competitiveness issue as well to the degree Ontario's education and infrastructure systems are compromised.

Some say that any increases in Equalization would be financed simply through lower federal surpluses and would not cost Ontario taxpayers anything. That is only true as a first-round effect. Lower federal surpluses mean less chance of future federal tax cuts which would disproportionately aid Ontario taxpayers.

In sum, it is not in any Canadian's interest to batter the Golden Goose too badly because the egg will surely break. As a general proposition we need to think carefully about how much redistribution can be afforded in an open economy model in a competitive international environment. There is no doubt a limit and that limit is less than in the relatively closed economy model when Equalization began half a century ago.

From the perspectives of the federal government and the taxpayers of Ontario and Alberta, there may be some relief

that the Expert Panel's recommendations are estimated to increase the cost of Equalization by only \$0.9 billion per year (the recommendations on territorial formula financing raise costs another \$0.3 billion). I say only because the report of the Council of the Federation likely conditioned many to expect a larger number given that its estimate of the cost increase of shifting to its preferred ten-province standard with 100 percent resource revenue inclusion was \$5.7 billion. Even with 50 percent resource inclusion the estimated cost increase was \$4.3 billion. So, at first glance, it seems inconsistent to see a similar overall recommendation from the Expert Panel being pegged at such a lower cost increment. But we have to be very careful about comparing the impacts of the two reports.

First, the Expert Panel chooses as its benchmark the estimated cost of the current regime for 2007-08. That disguises the likelihood that a return to the previous regime would have resulted in a lower cost. In other words, the Panel glosses over the possibility of a saving in overall Equalization costs. On the other hand, the Council's report benchmarked costs against what the previous five-province standard would have cost. Note that the breakdown of the cost changes on page 137 of the Panel's report is carefully ordered. It starts with treatment of resources and shows a net cost of zero. Had it started with the ten-province standard it would have presumably shown a much higher figure for that and then have netted off a significant number for restricting resource inclusion to 50 percent. In effect, the \$1.9 billion cost increase from going to a ten-province standard should be viewed as a net figure between the change in the standard and the treatment of resources.

The second source of discrepancy between the cost estimates of the Expert Panel and the Council is the Panel's recommendation of a fiscal capacity cap. That saves \$805 million. (Changes to user fees, property taxes and RTS simplification largely net out in aggregate – why does it always cost more to make things simpler?)

The Expert Panel provided cost estimates only for 2007-08. Given the three-year moving averages, all lagged two years, that cost estimate does not fully reflect recent commodity price levels. It is important to know how costs would evolve under various commodity price assumptions. It may be that the cap contains costs to a fair degree, but that too has some important implications that warrant attention.

MORE THAN ONE WAY TO ADDRESS AFFORDABILITY

Like the federal government did in 1982, affordability could be addressed by sticking to the five-province standard. But that compromises the program's principles of transparency and fairness. A superior way would be to use the RTS to generate a ten-province standard and then lower the standard by whatever amount is required to fit the notion of what is affordable. The cut in payments to provinces should be affected on an equal per capita basis. This is what the Panel recommends should there be affordability concerns.

A CAP ON EQUALIZATION

If there is less than full inclusion of revenues then it is possible for an equalization-receiving province to have a higher overall fiscal capacity than a non-equalization-receiving province. In the ten-province standard with 50 percent resource revenue inclusion, Saskatchewan and Newfoundland & Labrador have a higher overall fiscal capacity than Ontario. I think most would agree that it would be unfair to have Ontario taxpayers implicitly footing the bill to send Equalization payments to provinces that have higher fiscal capacities than their own. Hence the attractiveness of the recommendation of a cap that dictates that no receiving province can have a higher fiscal capacity than a non-receiving province. Note that the test is applied to fiscal capacity counting all provincial resource revenues.

To effect the cap, the Equalization payments would be pulled back sufficiently to ensure no province has a higher fiscal

capacity than a non-receiving province. The panel estimates the cap saves \$887 million of equalization costs. That is split between Saskatchewan (\$506 million) and Newfoundland & Labrador (\$105 million). It should be pointed out that, from the perspective of Saskatchewan and Newfoundland & Labrador, this will seem like a side-door return to the “clawback” of resource revenues. Indeed, at the margin, for amounts above Ontario’s fiscal capacity, the “clawback” is 100 percent. That could delay exploitation of the natural resources and give provinces an incentive to keep royalties artificially low.

The Panel acknowledges that the cap runs afoul of the 2005 Offshore Accords but simply suggests “it’s up to the federal government to determine how this should be resolved.” The notion of a cap may well be the most controversial aspect of the recommendations. It is in Ontario’s interest to have one, but some of the other provinces can be expected to mightily disagree.

The difficulty with the cap proposal does not relate just to the political difficulties it will face. There is a conceptual problem. Some of the reasons that convinced the Expert Panel to recommend only 50 percent resource inclusion in the standard should dictate that less than the entire remaining 50 percent of resource revenues should be counted for purposes of the cap. For example, if a province incurs costs in exploiting natural resources, then these costs should be protected from the cap. The Panel acknowledges this point but felt it could not come up with a particular number that could be justified. But conceptually it must be acknowledged that the cap is too severe in that it does not allow for any protection of provincial resource revenues.

VOLATILITY OF PAYMENTS

A good part of the volatility comes from non-renewable resources, but I will leave that to the next session. I will just address volatility that comes from data revisions. This has been a serious flaw in the program historically as it wreaks havoc on both federal and provincial fiscal planning (more so the latter as

payments are a much larger portion of their budgets). The Expert Panel has a clever recommendation of only letting revisions affect payments going forward. Bygones would remain bygones. (You can, however, hear the phone ringing from the province that would have received a bump to their prior payments.) The revisions would only gradually filter into future payment changes because the Panel recommends that data for all revenue bases be put on three-year moving averages, lagged two years. Thus there will be a loss in responsiveness to changes in economic conditions. But this seems an acceptable price for greater stability and predictability.

ASSOCIATED EQUALIZATION

The Expert Panel quite rightly recommended the end of associated equalization whereby Ontario and Alberta receive less than their per capita share of federal transfers under the Canada Health Transfer and Canada Social Transfer. This all relates back to the equalization of tax point transfers from 1977. Associated equalization is not fair. It should be terminated, if for no other reason than to save the few people in the country who understand it from the pain of constantly explaining it to others who will never understand it. The Expert Panel gets it right when it says that attempts at equalization should be restricted to an explicit equalization program.

REALITY CHECK AGAINST THE THEORY OF SECOND BEST

I fairly quickly dismissed the current equalization regime and a macro approach as being inferior. But in the interests of affordability and fairness it is unlikely that we will end up with a “pure” equalization system. For example, the standard might be reduced to lower the cost, some provincial revenues might not be included, some shortcuts will be required to equalize certain revenue sources, and there could be a cap. So before settling upon something with all the inevitable compromises, there had better be a final reality check on what truly is second best.

The current regime and a macro approach might not look so bad after all. It would require, at a minimum, much further reflection on my part to be able to answer that. More realistically, this may be a set of simultaneous equations whose solution is beyond the computing power of my brain.



EQUALIZATION AND RESOURCE TAXATION

MICHAEL SMART | UNIVERSITY OF TORONTO

The Expert Panel's recommendations concerning the equalization of natural resource revenues are the most interesting, complex, and controversial in the report. In this short paper, I review the Panel's proposals, I offer a critical assessment of the arguments in principle for the reforms advanced in the report, and I analyze their likely implications, if adopted, for the future of resource taxation in Canada.

It is common to evaluate the Panel's report and other reform proposals in terms of their implications for inter-regional fairness or sometimes, more baldly, for the expected transfer entitlements of one province or another. Such considerations have their place, of course, but the focus on the bottom line is apt to obscure considerations of principle, of efficiency, and of good tax policy more generally.

Instead, I will focus on the effects the proposed reform would likely have on the resource tax policies adopted by receiving provinces in future. By their nature, Equalization grants tend to be lower when a province's tax revenues (or tax bases) are higher, and this problem of "tax back incentives" was one of the factors that led to a decline in support for the pre-2004 Equalization formula. Tax back incentives are given some consideration in the Panel's report, but the precise implications

of their proposals for provincial government incentives remain to be fully understood.

Several aspects of the Panel's proposed treatment of resource revenues are apt to induce provinces to reduce resource tax effort in future. First among these is the proposal to include only 50 percent of resource revenues for purposes of equalization. For reasons discussed below, partial inclusion would cause receiving governments to prefer greater resource exploitation (for its effects on employment and local economic development) even at the cost of significant losses in own-source revenues. Consistent with this view, I present evidence below on the actual Canadian experience with resource taxation in the 1970s when a partial inclusion regime similar to the Panel's proposal was in place. I show that affected resource tax rates in receiving provinces were about five percentage points lower (about one-fifth of average levels) in those years than in non-receiving provinces, compared to full inclusion years. That is, partial inclusion appeared to induce lower resource tax effort, precisely as the incentive theory predicts.

Perhaps even more important, the Panel has proposed that provinces' resource fiscal capacities be measured by their actual resource revenues, in place of the 14 proxies for resource economic activity now employed in the formula. I show below that this would change Equalization from a capacity equalization grant (the international "best practice" of horizontal grant formulas) into a revenue pooling formula, in which each receiving province in effect simply paid its resource revenues to Ottawa, and in exchange it received an equal per capita share of total provincial resource revenues. Under such a formula, no receiving province would have any incentive at all to tax resource rents in province, if doing so would harm its economic prospects.

This disincentive is attenuated by the Panel's recommendation that only 50 percent of revenues are to be included and subject to tax back under the proposal. But the Panel has also proposed

a cap on Equalization payments such that no province's equalized fiscal capacity may exceed that of non-receiving provinces. This cap is likely to bind on resource-intensive receiving provinces, and it would effectively subject 100 percent of resource revenues to tax back, once again leaving no incentive for provincial tax effort.

In short, all aspects of the Panel's proposals for equalization of resource revenues are likely to reduce the taxation of resources in Canada. Given that this sector of the economy is already taxed preferentially through a variety of measures (Department of Finance, 2003), and is undertaxed by international standards, such an outcome is almost certainly undesirable. The Panel's efforts to return Equalization to a formula basis are laudable, but the precise formula proposed for resources leaves a great deal to be desired.

THE PANEL REPORT AND THE "ZERO-SUM GAME"

The Panel's recommendations that bear on resource revenues are:

- (i) a return to a Representative Tax System (RTS) formula², but using a Representative National Average Standard (RNAS) in place of the Representative Five-Province Standard (RFPS) used during 1982-2003;
- (ii) inclusion of 50 percent of natural resource revenues (renewable and non-renewable), in place of the 100 percent inclusion of the previous formula;
- (iii) calculation of entitlements using provinces' actual resource revenues as the single aggregate measure of fiscal capacity, in place of the various measures of tax bases used for the 14 resource categories defined under the previous formula;
- (iv) a cap on entitlements, specifying that the equalized fiscal capacity of receiving provinces not rise above the fiscal capacity of any province not receiving equalization; for

the purposes of the cap, fiscal capacity is to be measured including 100 percent of resource revenues, in contrast to the 50 percent rule used to calculate entitlements.

Not all these recommendations deal explicitly with resource revenues, but the proposal to adopt the RNAS is understood as being mainly about whether transfers to have-not provinces should increase with Alberta's energy revenues or not, and the cap in any reasonable scenario for the near-term future would act only to reduce transfers to Newfoundland & Labrador and Saskatchewan as energy revenues in these provinces increase.

Therefore, the Panel's proposals must be seen in the context of the recent ad hoc adjustments to Equalization, including the New Framework agreement and its abandonment of the RTS principle that has governed equalization, in one way or another, for over 50 years, the Atlantic Accords concluded with Newfoundland & Labrador and Nova Scotia, and the other bilateral arrangements between the federal government and individual provinces that likewise affected transfers. The Panel's proposals are a bid for a return to a formulary basis for Equalization³, while pragmatically attempting to ensure that no province's entitlements are much reduced relative to the status quo and to limit the overall fiscal cost of the program, and paying heed to the pronouncements of elected officials about the appropriate treatment of resource revenues.

Viewed in this simple accounting sense, the proposal to adopt the RNAS would increase the entitlements of all have-not provinces in an equal per capita way, and so increase the net cost of the program for taxpayers in Ontario, Alberta, and

1 Even Quebec, with about 20 percent of the national population, would get to keep only 20 percent of its own resource revenues.

2 The status quo system is the 2004 New Framework Agreement, which departs from RTS inasmuch as the standard to which have-not provinces are raised adjusts automatically to keep total entitlements fixed at the legislated levels. However, the revenue categories and measurement conventions with which entitlements are calculated remain those of the RTS formula in place prior to 2004. Smart (2005a) shows that the New Framework system is in fact equivalent to RTS equalization where the standard is an average of the fiscal capacities of the receiving provinces themselves.

probably British Columbia. The proposal to include only 50 percent of resource revenues in the calculation, on the other hand, benefits have-not provinces – Newfoundland & Labrador, Saskatchewan and perhaps British Columbia – whose resource capacity exceeds the national average – but it reduces aggregate entitlements by counting only half of Alberta’s resource revenues⁴. Since the proposed cap would “tax back” most of these gains to energy-rich recipients, partial inclusion is perhaps mainly intended by the Panel to control the overall fiscal cost of the program.

In the current environment, Equalization is subject to an extraordinary degree of public scrutiny and political involvement, which makes constructive, principle-based reform appear an almost impossible task. Some commentators, no doubt confused by the admittedly complex calculation of entitlements under past formulas, and perhaps ignorant of the underlying economic issues, are apt to focus on the immediate impact of the proposals on entitlements of individual provinces, so much so that the reform process is now viewed by many as a zero-sum game, in which gains to one group of taxpayers in the country can come only at the expense of others⁵. This, of course, is nonsense: some potential reforms to the system are better for the country as a whole than others, and the goal should be to look for reforms that benefit all Canadians, or nearly so. Therefore, I focus on the likely implications of the proposed formula for the levels of resource taxation in receiving provinces. A transfer formula that seeks an equitable way to share resource revenues among the provinces, but which leaves aggregate provincial revenues substantially lower, is unlikely to be optimal.

3 The return to a stable formula is certainly to be desired. See Smart (2005b) for a discussion of how the federal government’s revealed preference for negotiated block grants has reduced, not increased, fiscal stability for all governments in Canada.

4 In contrast, as noted by Tom Courchene, under the RFPS, partial inclusion of resource revenues would in some years have increased total entitlements, because the resource fiscal capacity of receiving provinces in fact exceeded the much lower standard capacity under the RFPS.

5 For one example of the prevalence of this approach, see the discussion in “Equalization a raw deal for Ontario, experts say,” *The Globe and Mail*, June 12, 2006, p. A7.

PARTIAL INCLUSION

The mechanics of equalization grants are most easily understood by judicious use of algebra. Consider a receiving province that is deemed to have per capita fiscal capacity (local economic activity that is available to be taxed) equal to F , and which has own-source revenues R . A capacity equalization grant formula determines a standard fiscal capacity F_s and a standard tax rate t_s . If $F < F_s$, the province has deficient fiscal capacity, and it receives a per capita equalization transfer

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$$(1) \quad E = t_s (F_s - F)$$

That is, capacity equalization ensures that any province can, by setting its own tax rate equal to the standard rate t_s , obtain fiscal resources equal to

$$(2) \quad R + E = t_s F + t_s (F_s - F) = t_s F_s$$

which is independent of their own fiscal capacity F .

In the Panel's proposal, the standard fiscal capacity for resources is the average of the ten provinces' fiscal capacities, in place of the pre-2004 five-province average. The standard tax rate, given partial inclusion, is to be defined as 50 percent of the actual resource revenues of the ten provinces, divided by the aggregate of their fiscal capacities. That is, partial inclusion lowers the target tax rate used in the formula.

The formula also shows that the standard tax rate is the rate at which increases in a province's fiscal capacity cause decreases in the province's equalization transfer, and so it is the key to understanding the "tax back incentives" of the formula. Courchene (1994) appears to be the first to point out that the link between capacity and transfers might induce receiving provinces to be reluctant to develop tax bases, particularly in the resource sector, that would reduce their federal transfers. If the province levies the standard tax rate on its own base, the effective rate of tax back as a percentage of revenues is exactly 100 percent; if

the provincial rate is below the national average, however, then tax back even exceeds 100 percent. Thus, Courchene argued, the RTS formula deters governments in receiving provinces from attracting new investment and developing new revenue sources. As such, the program may create a “cycle of dependency” for receiving governments. He proposed partial inclusion of revenues to deal with the disincentive problem.

Smart (1998) argues that the adverse incentive effects of Equalization are even more extensive and potentially harmful. Under the formula, receiving provinces have a financial incentive to drive their own tax rates in all categories higher than they would in absence of the grant. The reason is that measured tax bases will generally decrease as tax rates rise – for instance as higher taxes are capitalized in property values and as economic activity moves to other jurisdictions or to more lightly-taxed transactions. Consequently, local governments that raise their tax rates will see their tax bases depressed and their transfers rise in consequence. This effect is clearest when considering a receiving province with a tax rate equal to the national average for the base. At this point, further increases in the rate will generate increases in transfers that exactly compensate for the dollar value of “deadweight” economic losses resulting from higher tax rates. Thus Equalization tends to drive tax rates in receiving provinces above the national average. As well, Equalization creates incentives to change the tax mix. Provinces can increase federal transfers by relying more on tax bases that are very elastic or that have high national average tax rates, and less on other bases.

In the context of natural resources, the issues raised by Courchene and Smart are largely the same. One may imagine provincial officials designing resource royalty schedules that take into account their effects on own-source revenues as well as on the willingness of private-sector entities to invest in new resource exploitation projects. Indeed, in the case of large-scale projects, royalty rates may be negotiated⁶ directly with owners of the resource. By creating a wedge between the royalty rate

paid by the firm and that received by the provincial government (the wedge being the standard tax rate, effectively paid to the federal government), the Equalization formula makes provincial governments less willing to subsidize resource exploitation by forgoing royalties.

In this view, partial inclusion of resource revenues in the formula would reduce the standard tax rate and so induce governments in receiving provinces to accept lower royalty rates in exchange for resource development.

An emerging empirical literature provides some evidence of the incentive-raising effects of capacity equalization. Boadway and Hayashi (2004) report that provinces in Canada that receive Equalization are more inclined than others to raise business tax rates when the national average rate goes up, as the theory predicts. This is consistent with the notion that Equalization insulates receiving provinces from the pressures of tax competition and so allows them to set higher rates. Esteller More and Sole Olle (2002) find a similar effect for personal tax rates in Canada. Dahlby and Warren (2003) report that equalization grants induce higher levels of taxation by state governments in Australia. Buettner (2005) finds the same for the municipal business taxes that are equalized in many German states.

But, in the case of resource taxation, more direct evidence on tax back incentives is available from examination of actual resource revenues during Canada's previous experiment with partial inclusion during the 1970s.⁷ If the incentive theory is correct, effective resource tax rates in the receiving provinces should

6 Or, as is presently the case in Newfoundland & Labrador, renegotiated.

7 Beginning in 1974, in response to then high world energy prices, the fraction of incremental energy revenues equalized was reduced to one-third from 100 percent; however, so-called "basic" energy revenues—those deemed to be available at pre-1973 energy prices—continued to be fully equalized. In the 1977 reform, the basic-incremental distinction was abandoned, and 50 percent of all provincial revenues from non-renewable natural resources were made subject to equalization. In 1982, the federal government returned to 100 percent equalization of resource revenues, but the five-province standard of revenue capacity was adopted in order to keep aggregate transfers roughly the same. Full equalization of all revenue categories to the lower standard has remained in place since 1982.

have been lower in the years of partial inclusion than in the full inclusion years prior to 1973 and after 1981.

In what follows, I summarize the quantitative evidence on this point presented in Smart (2006).⁸ The principal source of data for the analysis is an administrative data set recording tax bases and revenues of the 10 provinces for the 1971-2002⁹ period which is used by the federal Department of Finance to compute each province's transfer entitlements under the Equalization program. The ratio of tax revenues to tax base for each province, year, and revenue category defines the respective effective tax rate, which is the focus of our interest.¹⁰

Table 1 presents the simple average of effective tax rates for the relevant sets of provinces, years, and revenue categories. The first row reports resource tax rates in equalization-receiving provinces – precisely those taxes that are affected by partial inclusion – on average for the partial inclusion years 1974-81 and for the other, full inclusion years. Observe that tax rates were indeed lower, by 1.93 percentage points, in the partial inclusion years, precisely as the incentive theory predicts.

Of course, resource taxes in the 1970s may have been affected by a number of other factors, unrelated to the Equalization formula including the direct impact of energy prices on provincial budgets. A natural approach to deal with this is to compare the result to the change in resource tax rates over the same period for non-receiving provinces. If the other provinces' resource taxes were affected by the extraneous factors in the same way on average, then the difference in the tax changes of the two groups of provinces may be regarded as a good estimate of the incentive effect of the reform. The second row of the table presents the same calculations for the non-receiving provinces. Observe that their resource taxes were in fact 2.6 percentage points higher in partial equalization years. The difference in differences is equal to 4.53 percentage points – the amount by which tax rates were lower through the effect of partial inclusion.

Another potential concern with the result is that non-receiving provinces may be a poor comparison group if, given their rather different economies, their public finances were affected differently by the oil shocks of the 1970s than were receiving provinces. As a check, the remaining two rows of the table present the same calculations for the other non-resource revenue categories, which should not have been affected by partial inclusion incentives. Observe that other taxes were higher on average in both groups of provinces during the partial inclusion years, but this effect is stronger for the receiving provinces. Thus our results do not merely reflect across-the-board changes in tax policies that differed between the two groups of provinces. Receiving provinces had lower resource tax rates on average during partial equalization years, but higher other tax rates, even relative to the same comparisons for non-receiving provinces.

Smart (2006) expands on this analysis, performs robustness checks, and presents regression-based estimates that control for other factors that might influence tax policies, and concludes that the partial inclusion period was associated with lower resource tax rates, and the effect is large and statistically significant. (The average tax rate in the sample is about 23 percent, so the results imply that partial inclusion is associated with tax rates that are about one-fifth to one-third lower.) If the effect is properly interpreted as causative, it is reasonable to predict that the Panel's proposal for partial inclusion would again reduce resource tax effort in receiving provinces.

8 For further details on the methodology, the data, and the results, the interested reader is directed to the Smart (2006) working paper, available at <http://www.economics.utoronto.ca/msmart>.

9 The analysis excludes 1973 and 1981, when tax base data are missing.

10 To construct the data set used in the analysis, I exclude a small number of revenue categories for which the proxy for fiscal capacity used in the formula was clearly unrelated to the underlying economic activity to be taxed. A related concern is technical changes in the measurement of tax bases during the sample period, which give rise to changes in the constructed effective tax rates that are unrelated to the underlying tax policies of the provinces. My data for the 1972-86 period are all measured on a consistent basis, since tax bases were recalculated retrospectively for all preceding years at the time of the 1982 reforms. Smart (2006) lists all the a priori exclusions from the data set and shows that the qualitative results presented here are robust to alternative approaches for dealing with base redefinitions after 1986.

REVENUES AS THE BASE

The Panel has also proposed that Equalization entitlements in respect of resource revenues be calculated on the basis of a single aggregate category in place of the 14 existing categories. The chief advantage of aggregate resource equalization probably lies in its simplicity and transparency. Under the current approach, provinces have much to gain and lose from “below the line” changes in the way resource capacity is aggregated and measured. A move to aggregate equalization is, in this context, akin to a “tax-simplifying reform” of personal or corporate income tax systems, which purge excessive complexity and special deals from the system and return closer to first principles.

The difficulty with the proposal lies in the implementation details. The Panel has proposed that the aggregate measure of resource fiscal capacity used in the formula be the actual resource revenues of the provinces. The reason for this adduced by the Panel is that the revenue-raising potential of resource extraction differs widely among provinces¹¹, so that actual revenues are the only reasonably accurate and comparable measure of resource fiscal capacity.

In terms of the algebraic notation of Section 3, with revenues as the base, the province’s fiscal capacity becomes its per capita revenues $F=R$, the standard fiscal capacity is the national average per capita revenues, say $F_s=R_a$, and the standard tax rate (defined as national aggregate revenues subject to equalization divided by national aggregate fiscal capacity) is by definition equal to exactly one-half. Thus each receiving province gets a transfer in respect of resources of $E=(\frac{1}{2})(R_a-R)$, and its total fiscal resources (revenues plus transfers) become

$$(3) R + E = (\frac{1}{2}) R + (\frac{1}{2}) R_a$$

In other words, under the proposal, receiving provinces keep one half of their resource royalties, but give up the other half in exchange for an equal share of one half the national average revenues.

This kind of sub-national revenue pooling is typically discouraged by fiscal federalism specialists for the obvious reason that it creates a common property problem in which no government has much incentive to levy taxes that will be paid to other governments, instead preferring to leave the potential revenues untaxed in the hands of provincial residents and firms. Indeed, revenue pooling transfers appear almost never to be used when sub-national governments have control over tax rates, as they do in Canada (Bird and Smart, 2002).¹²

In fact, the common pool problem does arise under the existing, multi-category Equalization formula for certain revenue categories, in which most or all of the tax base is in a single receiving province. In these cases, the national average tax rate changes nearly proportionately to changes in the province's own tax rate, so that increases in own-source revenues cause dollar-for-dollar decreases in Equalization entitlements. If the province is not in the standard (the obvious example is the offshore oil categories), the problem is extreme. Since the standard base is equal to zero, the province will receive zero net revenue from the base, regardless of what tax rate it levies. Certainly, this creates incentives for changes in provincial tax mix, with higher tax rates on categories in which the province records a base deficiency, or in which the province's share of the base is small, compensated by lower tax rates where the rate tax-back effect is in operation.¹³

It was this consideration precisely that prompted introduction of the "generic solution," under which only 70 percent of revenues are equalized for categories in which at least 70 percent of the

11 For example, the royalty rates that may be applied to conventional oil deposits in Alberta far exceed those for heavy oil in Saskatchewan or offshore oil in Newfoundland & Labrador.

national base accrues to one receiving province. The Panel's proposal is to create a generic solution at a 50 percent rate, but to extend the incentive problem to all resource categories and all provinces, rather than the very small number affected under the current formula.¹⁴

In fact, the problem is even worse, when one considers the implications of the proposed cap that would not permit the equalized fiscal capacity of receiving provinces to rise above that of non-receiving provinces. Since the proposed fiscal capacity measure includes 100 percent of the provinces' actual own-source resource revenues, the cap would reduce transfers to affected provinces dollar-for-dollar with increases in the resource revenues they choose to raise – a full revenue pooling scheme.

If aggregate resource equalization is good, but the proposed implementation is bad, then what is the alternative?

Smart (2005a) reports the results of a simple simulation exercise in which the aggregate measure of resource fiscal capacity is the value of gross output of the Mining and Oil and Gas Extraction industries in each province, as recorded in the 2001 provincial Input-Output tables. The simulation shows that entitlements would have been reasonably close to those

12 However, see Barette, Huber, and Lichtblau (2000) for a discussion of how revenue pooling may have reduced incentives for subnational governments in Germany to collect federally legislated taxes.

13 Recent statements by Premier Williams of Newfoundland & Labrador suggest that rate tax-back has indeed lowered the royalty rates levied on Newfoundland's offshore energy projects. See "Oil patch irked at Newfoundland," National Post, June 6, 2005, p. F1.

14 Aggregate resource equalization, if correctly implemented, therefore has the potential to eliminate much of the incentive problem associated with the generic solution. As well, in other cases, the proliferation of bases exacerbates the incentives to increase tax rates pointed out by Smart (1998), since it affords more opportunities for provinces to distort their tax mix, increasing rates on some bases while decreasing them on others to exploit the Equalization formula. Under the aggregate approach, these incentives would be mitigated: no province would have a predominant share of the base, and no province could gain by changing relative tax rates on resource subcategories.

actually paid for most provinces, but that resource-rich receiving provinces (Newfoundland & Labrador, Saskatchewan, and British Columbia) would lose from aggregation. The reason is that these provinces' resource production is concentrated in revenue categories in which effective tax rates are comparatively low and where costs of extraction are presumably high.

A more refined approach would attempt to measure resource rents more accurately, using value-added based measures of output and perhaps adjusting for the cost of capital used in resource production. But the preliminary analysis above suggests that these measurement issues would be fairly minor in a world with six receiving provinces. On the other hand, no aggregative approach is likely to do very well in matching current entitlements of all eight potential recipients because of the large differences in effective resource tax rates between eastern and western provinces.

CONCLUDING REMARKS

There is much to like in the Expert Panel's proposal to return Equalization to a formula basis in which each receiving province's transfers are determined as a function of its measured fiscal capacity alone and the total fiscal cost of the program responds automatically to the current economic and fiscal environment facing the provinces, rather than being determined in an ad hoc fashion through high-level negotiations among officials. Moreover, as the Panel report observes, there is a case to be made that Equalization transfers should be higher than they would be under the pre-2004 formula, given the very sharp drop in transfers as a percentage of GDP after 1999. But, as I have argued, the Panel's attempt to address these issues may give short shrift to incentive considerations.

Unfortunately, the package of proposed reforms does not easily admit piecemeal solutions that address the incentive problem while preserving the approximate level and distribution of transfers among provinces under the formula. Maintaining

100 percent resource inclusion while adopting the other recommendations would mitigate under-taxation incentives, but it would simply be unaffordable.¹⁵ Likewise, adopting the package without the cap, or even without aggregate resource equalization on the basis of actual revenues, would likely increase the expected cost of Equalization substantially.

If incentives matter, the alternative appears to be a system that retains 100 percent resource equalization and continues to equalize on the basis of some (one or more) measure of resource tax bases, rather than revenues, and which avoids excessive tax back of offshore oil revenues in Newfoundland & Labrador. To limit the overall cost of the program, this hypothetical formula would set the Equalization standard to some level below that of the ten-province average – though possibly higher than the old five-province average, if the previous levels of equalization are deemed to have been too low. In short, the best solution appears to be a version of the 2004 New Framework agreement.

Any takers?

¹⁵ At present fiscal capacity levels, it would make Ontario a receiving province.

Partial resource equalization and tax effort, 1971-2002

Revenue category and province type	Number of observations	Full equalization years	Partial equalization years	Difference over time
Resource royalties, equalization provinces	423	0.1054	0.0861	-0.0193
Resource royalties, other provinces	485	0.1012	0.1272	-0.026
			Difference in difference:	-0.0453
Other taxes, equalization provinces	3550	0.2055	0.2562	0.0507
Other taxes, other provinces	1560	0.1598	0.1902	0.0304
			Difference in difference:	0.0203
			Triple difference	-0.0656

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INCLUSION AND MEASUREMENT ISSUES

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We first review the mandate of the Panel as set out in the Issues paper of spring 2005 and then turn to the answers given in the report. We examine both the paths not taken – the Representative Expenditure System and the macro approach – and the changes proposed in the treatment of user fees, the property tax and other non-resource bases.

THE MANDATE¹

We first present the inclusion issues then turn to the measurement ones.

Inclusion issues

We present three issues ranked in terms of decreasing order of generality.

- Should Equalization take into account differences in expenditure need?

¹ See part 6 of Key Issues for the Review of Equalization and Territorial Formula Financing at <http://www.eqtf-pfif.ca/english/issuespaper6.asp>. Each issue is taken from an Issue(s) for the Panel box in that paper.

On this topic, the Expert Panel's Issues paper notes that:

Equalization could measure differences in proportions of elderly, aboriginal Canadians, the percentage of school-age population or the proportion of rural residents, on the grounds that these populations are more expensive to serve. Measuring expenditure need is done in the Australian system of Equalization. The approach used in Australia would require sector-by-sector investigations of the program requirements of each province (health, education, social services, transportation, justice, etc) as well as the costs of providing those services.

- Would aggregated measurement approaches—such as macro-economic indicators – simplify Equalization and reduce perverse incentive effects, while preserving “reasonably comparable treatment” of all governments?

On this topic, the Panel's Issues paper notes that:

The steadily increasing complexity of Equalization is one reason that has led academic and government experts to ask whether one might replace the current disaggregated approach to measuring revenue disparities (e.g. the 33 revenue sources tracked by Equalization) with a “macro” approach, relying on one or two macro-economic indicators (for instance, Provincial Gross Domestic Product, or other income measures).

- Can the exclusion of some natural resource revenues or user fees be justified as consistent with the reasonably comparable treatment of receiving governments?

Leaving aside the issue of natural resources addressed elsewhere in this book, on this topic the Panel's Issues paper notes that:

There is also much debate about whether user fees charged by provinces should be equalized. One view is that the sale of goods and services by governments should not be

equalized except when they give rise to a net profit: user fees do not represent fiscal capacity for a government. Moreover, they are different from compulsory taxation, since they can often be avoided by not purchasing the services in question. Another view is that they should be included not only because they do generate substantial “profit” for governments, but also because they pay for essential public services provided by local governments (e.g. garbage collection, water).

Measurement Issues

- How can the measurement of revenue capacity from natural resources and property tax revenues be improved?

Again, leaving aside the issue of natural resources addressed elsewhere in this book, on this topic the Panel’s Issues paper notes that:

There have been extensive debates about how to measure the revenue capacity generated by property wealth. Some have argued that revenue capacity from the property tax should be measured as if it were an income tax, others that it should be derived from market values or property (akin to a wealth tax).

In 2004, a new approach to measuring property tax capacity, a simpler version of the so-called “stratified market value approach” was introduced. It has been set aside under the New Framework.

THE DISCARDED AND PROPOSED CHANGES

We first present changes not recommended then changes recommended by the Expert Panel. In both cases, we first briefly discuss the reasons given by the Panel then assess their choice.

Discarded changes

The Panel does not recommend taking into account expenditure need for four reasons:

- The Representative Expenditure System (RES), which is the best approach to measure expenditure need, is complex, data intensive and judgment-based;
- Expenditure needs should only take into account differences that are not under the control of governments. This is very hard to establish with precision and can vary from province to province;
- This could be seen as an intrusion into provincial expenditure choices with representative taking on a normative dimension; and
- The Panel believes that this may not led to material changes.

We agree with the Panel's recommendation for two reasons: the difficulty of measurement and the non-materiality of the change.

Expenditure differences in providing public services reflect two factors: cost differences and need differences.²

- Cost differences are differences in the cost per unit of a 'standardized' public service. They may arise from climatic or geographic features, density or distance factors, or differences in labor cost across regions. Costs should be calculated using real (not nominal) private sector wages for equivalent inputs and not on the basis of public sector wages which may reflect such political factors as the government's political philosophy or the relative strength of workers unions.
- Need differences – differences in the number of units of standardized service required per capita – usually arise for demographic reasons such as the age structure of

the population and different participation rates in social programs by persons of different ages.

Three questions arise with respect to implementing equalization schemes incorporating expenditure differentials: How are cost differentials measured? How are need differentials measured? How are 'standardized' expenditures determined?

Various ways of establishing cost differences have been proposed such as climate (snowfall, heavy rain), population density/urbanization, frequency of natural disasters (floods, earthquakes), location (remote location), and topography (mountainous or desert regions).

Similarly, among the plausible factors related to need differences are such things as the share in the total population of dependent populations such as infants, elders (health care) and school-age children, new immigrants (language skills acquisition, integration into society) or groups with higher needs (e.g. aboriginal population). Of course, to a considerable extent, the relevance of many of these indicators depends on the role provinces play in delivering public services. For instance, if it is the central government or the private sector that provides health care, the share of infants or elders may not be relevant in determining transfers to provinces.

Expenditure needs may be measured in three ways (Martinez-Vazquez and Boex, 2001). One method is to estimate the cost of providing a standardized set of public services. This requires a determination of what services are to be included and what standards are to be met. Considerable effort is required to obtain the necessary detailed data. Even when such complex methods are used to assess expenditure differentials, the results often are "somewhat crude, imprecise and subjective" (Shah, 1996, p. 103).

² Boadway and Hobson (1993) p.92. Note that this distinction is not always clear. For example, if there are ten snow storms (10cm each) per year in region A and five (20cm each) in region B, leaving in total the same amount (100cm) of snow on the ground, then if there is a fixed and a variable cost to each snow removal operation A will incur higher expenditure even if the marginal cost of an additional cm is the same in both regions. Does A have higher costs or greater need (more storms)?

A simpler alternative is to rely on historical expenditure patterns and use observed average costs for various expenditures. Two problems arise with this approach. First, past observed expenditures on particular activities may not reflect current policy objectives. Second, expenditures that seem the same in the data may in fact be quite different such as spending on school books in majority and minority languages, with the latter being more expensive due to higher production costs.

A third possible approach is to set out a representative expenditure system (RES) analogous to the RTS on the revenue side. Shah (1996) proposes a five-step way to establish the relevant parameters of an RES system. The RES approach is probably the most satisfactory way to meet the normative objectives of the theoretical equalization model but it is difficult and costly to obtain the necessary data in a form that all parties agree is satisfactory.

Assuming that the data issues can be overcome, does it matter if an RES is implemented?

First, Bird (1986) shows that, with respect to Switzerland, formula follows function. That is, what is important is not that the formula used for equalization purposes is 'correct' but that the results of applying it are politically viable. When the results produced by any particular formula become sufficiently unsatisfactory from the perspective of any significant political actors, the formula gets changed.³ Introducing still more elements in the formula on the expenditure side may lead to confusion. Transparency is preferable to complexity when it comes to such central political elements of the intergovernmental fiscal system.

Second, one may also note that Leuprecht and O'Connor (2005) show that, in Canada, equalization receiving provinces tend to have both an older and more rural population. These two factors may explain their lower revenue capacity and thus higher Equalization payments. These two factors were also mentioned

³ Using side deals or accords

as a source of greater needs and costs. Hence, needs factors may be implicitly taken into account, at least in part, in a revenue capacity-based equalization scheme.

The panel recommended retaining the RTS and not using a macro approach for two reasons.

First, within the Canadian context, each dollar of economic activity is not taxed uniformly by governments. Ideally, the Equalization formula should take these realities into account, if it can be done in a transparent and reasonably simple way. By modeling actual taxing practices, the RTS (unlike the macro approach) can reflect the fact that two provinces with identical aggregate income, but different composition of 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.

We agree with the Panel.

The fiscal capacity of a province is defined by its ability to raise revenues from its own tax bases. A number of methods may be employed to determine fiscal capacity in this sense. Perhaps the simplest to implement are measures based on current or past years' revenue collections. Unfortunately, such measures raise serious problems. While potential ability to raise revenue is not directly affected by tax rates,⁴ fiscal effort, taxpayer compliance and actual revenues are affected. Using current revenue collection as a measure of fiscal capacity provides provinces with an obvious incentive to impose lower tax rates or to make

⁴ Indirectly, tax potential may in turn be affected since labor supply and financial decisions can be affected by tax rates.

less effort to collect taxes in order to receive higher Equalization grants. Although using past collections would seem to alleviate this problem, there remains a problem of time-inconsistency since provinces may (reasonably) expect that current increases in revenues obtained by increasing rates or collection effort will reduce future transfers.

Alternatively, such macroeconomic indicators as income or output may be used to measure fiscal capacity; but are they good indicators? Gross Regional Product (GRP) is a comprehensive measure, representing the value of goods and services produced within a region and hence the incomes received by the owners of the economic resources (land, labor, natural resources and capital) used in the region regardless of where they may live. But the composition of GRP is also clearly relevant since some economic sectors (e.g. mining) are easier to tax than others (e.g. agriculture). Similarly, informal activity is more difficult to tax than manufacturing activity, particularly in large enterprises. Provinces with identical GRP may thus have substantial differences in taxable capacity. And a broader measure of GDP accounting for leisure and so on may yield different results (Aubut and Vaillancourt, 2001).

A third possible approach is the RTS which measures the amount of revenue that could be raised by a province if it used standard tax bases and standard (usually average) tax rates. Obviously, to use this approach, information on tax bases and tax revenues for every region is needed.

In theory, the RTS approach appears to provide a complete and accurate method to measure the fiscal capacity of provinces. It may, as in Canada, be broadened to include non-tax revenues (user fees, royalties, sales of Crown land, etc.) and should perhaps be described as the Representative Revenue System (RRS). Provided the tax base information is appropriate and all provinces are equally able to exploit all their 'assigned' tax bases freely, this approach, although very data intensive,

seems superior to either the macroeconomic or actual revenue approaches to measuring fiscal capacity for purposes of equalization. Mixing the RTS and macro approach in terms of two envelopes being allocated, with each using one criterion, does not seem viable. But a reduction in the number of indicators may make sense as discussed below.

The existence of an RTS equalization scheme means that a reduction in the per capita tax base of an equalization-receiving region can be well, if not fully, compensated, by an increase in equalization. Some economists such as Smart (1998) thus argue that at least in the Canadian case, some provinces engage in base reduction behaviour by either delaying new economic activity or setting tax rates at such a high level that it significantly reduces some tax bases.

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. The Panel puts forward two reasons for doing this, one conceptual and one practical.

On the conceptual point, the Panel argues that 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. However, profits generated when a user fee exceeds the cost of providing the service should be equalized.

On the practical side, clearly actual revenues should not be used while the modeling exercise required for assessing what revenues could have been derived from user fees seemed too complex for the Panel.

We disagree with the Panel since this does not take into account the actual behaviour of provinces. Assume for a moment that a province can finance universities by either having low fees and high personal income taxes (PIT) (Québec) or high fees and lower PIT (Nova Scotia). Switching to high fees and lowering PIT will reduce the Equalization owed under that tax base. If the switching province is large in Equalization terms, since this will reduce the effective tax rate for this base and, in a world where total Equalization depends on the sum of equalization due for each base, reduce total Equalization. Why is this appropriate? The example of university fees was used knowing full well that they are not currently included in equalization calculations; they should be. One can switch to fees for long-term care facilities and again imagine two provinces, one financing them fully through user fees with perhaps some means testing and the other using PIT to subsidize them. Why should this change the Equalization amounts? As to the difficulty of finding a proper base, the use of personal income seems a natural choice and in agreement with the principle of simplifying bases.

Proposed changes

The mandate of the Panel included examining the natural resource and property tax bases. It chose to also examine small tax bases and to recommend 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 chance, and preferred share dividends.

It did this for the following five reasons:

- The proliferation of bases has not necessarily led to greater accuracy in the measurement of fiscal capacity
- In some cases, the establishment of smaller tax bases has interfered with the policy neutrality of Equalization
- The smaller revenue sources are sometimes not used by most provinces
- Small tax bases are often more costly to administer than large tax bases, and yet have a minor impact on Equalization entitlements
- Finally, the proliferation of tax bases has reduced transparency

To ascertain the relevance of these recommendations, it is useful to briefly examine the existing bases. We do so in table 1 where we present the current situation, the recommended change in base and our evaluation of that recommendation. The latter is deemed appropriate, weak (weakly appropriate) or inappropriate based on the size (small, medium) of the base, on the quality of the existing base and on the relevance of the proposed base.

TABLE 1.

Tax	Base currently used	Importance (2004 revenues 000000\$)	Recommended base	Evaluation of recommendation
Payroll tax	Statutory base as declared	7,500 - Four provinces	Personal income tax	Inappropriate: medium with good available base
Capital tax	Proxy measure obtained mainly from eligible investments by province and industry	4,000	Business income	Appropriate: small and ill measured
Tobacco tax	Number of cigarettes calculated by dividing tobacco revenue from cigarettes, bulk and cigars by the average cigarette tax rate	4,500	General and Miscellaneous sales tax base	Appropriate small and ill measured
Gasoline taxes	Weighted sum of non-farm, farm and aircrafts use	5,600	General and Miscellaneous sales tax base	Appropriate: medium and ill measured
Diesel fuel taxes	Weighted sum of non-farm, farm and railways use	2,000	General and Miscellaneous sales tax base	Appropriate: small and ill measured

TABLE 1. CONT.

Tax	Base currently used	Importance (2004 revenues 000000\$)	Recommended base	Evaluation of recommendation
Non-commercial vehicle licences.	Number registered +40 percent of motorcycles and mopeds. Drivers licences are not explicitly included	1,800	General and Miscellaneous sales tax base	Weak: small but well measured
Commercial vehicle licences	Number registered by weight (three groups) and broken down into farm and non-farm	960	General and Miscellaneous sales tax base	Weak: small but well measured
Alcohol sales	Volume of each of spirits, wine and beer	4,000	General and Miscellaneous sales tax base	Appropriate: small and ill measured as value, not volume, is taxed
Hospital and medical insurance premiums	Base used in the two provinces simulated for all provinces (personal income, age and marital status are taken into account)	2,300 Alberta and British Columbia only	General and Miscellaneous sales tax base	Weak: would make more sense to treat as payroll tax (which is a substitute in Québec and Ontario)

TABLE 1. CONT.

Tax	Base currently used	Importance (2004 revenues 000000\$)	Recommended base	Evaluation of recommendation
Race track taxes	Amounts wagered	9	General and Miscellaneous sales tax base	Appropriate: very small
Insurance premiums	Value of premiums for property/casualty insurance and value of premiums for life, accident and sickness minus dividends paid	1,600	General and Miscellaneous sales tax base	Appropriate: small and imprecise base
Lottery tickets	Net receipts by government, charities and aboriginal lotteries + personal disposable income + population with 80-10-10 weights	2,000	General and Miscellaneous sales tax base	Inappropriate: small and available base

TABLE 1. CONT.

Tax	Base currently used	Importance (2004 revenues 000000\$)	Recommended base	Evaluation of recommendation
Other games of chance	Net receipts by government, charities and aboriginal lotteries + personal disposable income + population with 20-40-40 weights	4,000	General and Miscellaneous sales tax base	Appropriate: small and very ill measured
Preferred share dividends	Sharing of federal income tax on preferred dividend, using business income tax as base	295	General and Miscellaneous sales tax base	Inappropriate: this should not be part of Equalization but the current base is 'perfect'

Source: F. Vaillancourt, using Equalization one pagers binder, January 2005, Department of Finance, Ottawa.

In the case of the payroll tax, the impact of an ageing population distributed unequally across Canada on the link between the payroll base and the personal income base does not appear to have been considered.

The choice of a residential property tax base was one of the most contested issues in the debate leading to the 2004 Equalization renewal. The stratified market value approach selected by the federal government was not implemented. The Panel recommended that the federal proposal be implemented since:

- The existing formula 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;
- The adoption of market value assessment for residential property since the late 1990s made it possible to use market value data for Equalization purposes;
- It was deemed preferable to three other possibilities: (1) the simple market value approach (2) the real value approach, and (3) the income approach

We agree that the existing formula for residential properties must be replaced. The issue is with what? The recommendation of the Panel is an acceptable one but we would argue not the preferable one. Why? Because individuals have three types of wealth that can be used to generate taxable activities subject to Equalization:

1. Human capital which determines labour income – and thus PIT wage taxes - and consumption(savings) – sales taxes, general and excise taxes (explicit /implicit);

2. Financial capital which determines capital income – PIT and consumption (savings); and
3. Real capital (property), which we simplify to owner-occupied housing which generates real unmeasured services (imputed rent). The stratified assessed value of this capital stock would be used for property tax purposes.

In all cases, an increase/decrease in a provincial tax rate reduces/increases the value of the capital assets but for items 1) and 2), this reduction/increase is not observed in the Equalization process. Why? Because the taxes applied to human and financial capital held by individuals use, as their taxable bases, flows of income coming from human and financial capital; they do not use the value of the stock of each type of capital.

Indeed, if we take labour income, increases in PIT rates may lead to more utilisation of human capital. This would happen if individuals choose to work harder or longer hours or in a second job so as to have the same after-tax income as before the increase in PIT rates. Of course, the reverse is possible, with individuals choosing to work and earn less after tax. It is thus possible to have a decrease in the value of human capital and an increase in the PIT base where changes in the PIT tax base are due to changes in real variables i.e. hours worked, location and so on.

In the case of financial capital (2), one may expect the composition of assets to change, from more fully taxed ones such as interest paying bonds to less taxed ones yielding dividends or capital gains with more risk. Hence in this case, one adapts to the higher PIT rate by changes in the nominal means of holding financial capital.

For real capital (3) embedded in owner-occupied housing, there is a large amount of empirical literature that shows that capitalisation of tax rates occurs.⁵ This means that an increase/

⁵ see for example, Dahlby, B., and Warren, N.(2002)

decrease in the tax rate reduces/increases the value of the property. In a perfect world, one would observe that changes in property values adjust for increases in the tax rate so as to leave the total tax burden unchanged. This means that 2 percent X \$200,000 = 1 percent X \$400,000. In the real world, uncertainty, the possibility that tax rates are increased to provide new services with different values to different households, and so on will mean that the exact capitalisation rate will vary from one case to another, but there will be capitalisation. This will impact Equalization (if PT values are used in it) but not real flows of services obtained from the stock of owner-occupied housing whose physical characteristics (location, size, age, amenities, etc.) have remained unchanged. So here we have a situation where real activity has not changed (the opposite to the case of 1) yet Equalization would change. Does it make sense to change Equalization payments when real flows have remained unchanged? Or put differently, should we not equalise according to flows of implicit income (rental value of the property to the owner who rents to him/herself a property) in this case?

Given these measurement issues, assessed values used of PT are not a very good base. One possibility is modifying the PIT tax rates for each province proportionally so as to have the corrected PIT generate both the true PIT and the PT amounts and use this for Equalization purposes. So if the PT collected is \$1 billion and the PIT rate is 10 percent (flat rate) and taxable income is \$20 billion, then in the calculations of Equalization, one would assume that the PIT rate was 15 percent, thus notionally yielding \$3 and not \$2 billion. Put differently, we assume away PT and replace it with more PIT.

CONCLUSION

Overall, the choices discarded by the Panel – RES and macro approach – were rightfully discarded. We believe, however that:

- Not including user fees is incorrect;
- Using the stratified approach for property taxes, while acceptable, is not the best choice; and
- The consolidation of minor bases is sound overall but not in all cases.

Finally, one missing feature of the report is detailed analysis of some of the proposals. For example, the discussion on the property tax alludes repeatedly to studies done by the federal Department of Finance and academics, yet they are nowhere to be found. It would have been useful to include these in a technical appendix.

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TERRITORIAL FORMULA FINANCING

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Territorial Formula Financing (TFF) is the key mechanism by which the federal government transfers funds to the governments of Canada's territories: Yukon, the Northwest Territories, and Nunavut. In those territories, as of 2005, there were fewer than 110,000 people. That is only a tiny fraction of the population of the Equalization-receiving provinces. Yet, TFF is extraordinarily important to those people and, more broadly, to Northern development and the well-being of aboriginal people in the North. As such, it was entirely appropriate and pleasing that the Expert Panel on Equalization and Territorial Formula Financing (The Panel) decided to provide its report in two volumes, one dedicated to Equalization and the other to TFF. A separate volume ensured that TFF would not be overwhelmed in a larger single volume on both TFF and Equalization where the latter would surely dominate. The Panel members should be commended for their wisdom in this regard. Another wise move was the Panel's designation of one of their own, Professor Michael Percy, to have special responsibility for ensuring that TFF was appropriately addressed.

In order to initiate the discussion of the Panel's report on TFF, I have organized my remarks as follows. First, I briefly review the context in which the TFF recommendations have been framed.

Then, I sketch out a short history of the evolution of the TFF framework up to the present. That is followed by an overview of the Panel's recommendations and a discussion of some of the issues related to them. A short conclusion then wraps up.

CONTEXT

There are very few experts on the history and mechanics of TFF, a lot fewer than there are even for Equalization. I would certainly not include myself as a TFF expert. Most of my exposure to the workings of TFF has come only since the Panel was formed. Prior to that, I had only a rudimentary knowledge of TFF and even less of an appreciation of its vital importance to the territories. Since then I have learned more, but by no means all, about how TFF has evolved and its complexities.

I also came to appreciate the context in which TFF has to be considered. While I had participated in several meetings with the Panel regarding Equalization, I was also fortunate to be invited by the Panel to its Roundtable on TFF. That Roundtable, for which I also served as rapporteur, was held in Yellowknife in August 2005. With territorial governments relying on TFF for more than 60 percent of their revenues, the overarching concern expressed at the Roundtable had to do with adequacy. Having enough funds to provide adequate public services in relation to those available elsewhere in Canada was practically synonymous with having sufficient funding through TFF. It is also important to appreciate that those concerns over adequacy were expressed in terms of the context of the North and the many challenges that are faced by each of the territories. Among the key elements of that context are:

- the barriers faced by many people in the North, especially aboriginal peoples, in participating in economic development;

¹ For an excellent paper by experts, see R. Zuker and R. Robinson (2005).

² See J. Feehan (2005b).

- natural resource related developments, both underway and prospective, and the need for the people of the territories – those with long-term attachments and aboriginal peoples in particular - to fully participate in and receive fair shares of the benefits of these developments;
- the need to catch up to educational and training levels elsewhere in Canada;
- the very high costs of operating government, providing adequate public services, and building the infrastructure required for economic development to be realized;
- the inadequacy of other transfer programs to persons and the territorial governments where those programs do not take account of the substantially high costs of living in the North;
- the disproportionate needs of Nunavut, including the need to address serious social problems, to overcome educational gaps, and to enhance economic development while ensuring equitable participation by its aboriginal people;
- the desires for people of the North to have greater autonomy and the associated devolution from the federal government; and
- the changing circumstances of aboriginal peoples as they progress towards greater self-government and resolve land claims.

These types of concerns place TFF in a somewhat different context than Equalization. To the people of the North, TFF should not just be seen as a means of providing comparable public services but also as an important source of funds to overcome barriers – barriers to economic development, barriers to inclusion of aboriginal peoples, and barriers to catching up with the rest of the country. To an extent, that perception of TFF is not entirely consistent with its actual intent, which, like Equalization, is to allow the governments in question to provide reasonably

comparable levels of public services at reasonably comparable levels of taxation. That is to say, neither Equalization nor TFF exists to overcome such barriers. However, one may reasonably argue that these programs could at least be designed with those other challenges in mind and with some allowances for them.

PAST TFF MECHANISMS

The TFF has been in place since 1985. Prior to that, the federal government's provision of funds to the territorial governments was not formula-based.³

The initial formula and its basic structure were simple enough. An estimate of the amount of funds needed by each territorial government to adequately provide the services for which it was responsible was determined. It was known as the Gross Expenditure Base (GEB). An estimate was then made of the amount of revenue each territorial government could potentially raise from its own sources plus the amount of funds that it would receive from the federal government through other transfer programs. This total was the so-called eligible revenues (ER). Both the GEB and ER were estimated by the federal authorities. The TFF grant for a territorial government was then determined simply as the difference between the two:

$$(1) \text{ TFF Grant} = \text{GEB} - \text{ER}$$

In practice, the difference has been quite large, so the bulk of each territory's revenues has come from its TFF grant.

While the formula appears straightforward, one should bear in mind that the eligible revenues included an estimate of potential revenues, not actual revenues or even projected revenues based on actual tax rates. Also, the GEB was based on an assessment of how much money the territorial governments needed to carry out their responsibilities. However, in the case of the GEB,

³ A more complete description of the TFF is contained in Annex B of the Panel's discussion paper "Key Issues for the Review of Equalization and Territorial Formula Financing," March 31, 2005 and in Annex 3 of its final report "Improving Territorial Formula Financing and Strengthening Canada's Territories," May 2006.

its basis was a survey of actual spending in 1982, so it was apparently reasonably well grounded in reality.

Changes over the following 20 years greatly complicated the TFF formula and appear to have weakened its relationship to the needs and reality of Northern governments. Basically, the formula took on a form similar to the following:

$$(2) \text{ TFF Grant} = (\text{GEB} + \text{adjustments to GEB}) - (\text{ER} + \text{adjustments to ER}) + (\text{adjustments to TFF Grant})$$

The adjustments to the GEB included standardized changes based on population growth and the general growth in provincial and local government expenditure. It also included allowances for any programs that were shifted from federal government departments to the relevant territorial government, which would cause a ratcheting-up of the GEB. Over time, both adjustments have tended to lose their linkage with the actual needs of the territories. The adjustments to ER included several adjustments over time such as the “catch-up factor,” “keep-up factor,” “Northern discount factor,” and “Economic Development Incentive.” Adjustments were also made to the TFF grant itself. These were typically measures introduced by the federal government to control the total amount paid out and included cuts in the grant based on general austerity rather than being specific to the territories; as well, various ceilings and floors on the TFF grant were introduced at various times.⁴

The cumulative effect of all these adjustments was twofold. Firstly, the formula was made very complicated with few people able to explain all the adjustments and the interaction effects amongst them. Secondly, and more importantly, the linkage between the dollar amounts revealed by the formula and the needs in the territories became less evident. This was further

⁴ The federal government consulted the territorial government in adjusting the formula. However, like Equalization, the program is a federal one and ultimately decided accordingly.

exacerbated by the changing realities of the North including, for instance, the creation of Nunavut, the major natural resource developments and prospects, the changing circumstance of aboriginal peoples, and the greater recognition of their rights. In a nutshell, the amount of the TFF was perceived as being inadequate and unrelated to the new Northern challenges and opportunities.

In October 2004, the federal government announced a dramatically different approach to both TFF and Equalization, “A New Framework for Equalization and Territorial Formula Financing.”⁵ For territorial financing, the TFF formula was gone. The key elements of the federal government’s new way of making transfers to the territorial governments were:

- a higher pre-set amount of funding for the three territories for 2004/05 and 2005/06;
- division of these annual amounts amongst the territories in accordance with their recent shares;
- a provision that, in 2006/07, the aggregate amount for the three territories would increase by 3.5 percent and continue to increase by that rate for each year thereafter; and
- an undetermined formula for sharing the 2006/07 and future allocations amongst the territories but on which the Panel, whose mandate was announced as an element of the October Framework, would advise.

In essence, the Framework was a workable short-term solution. It provided an increase in funding for each of the territorial governments for 2004/05 and 2005/06 with the exact amounts

⁵ For more information see the Department of Finance webpage http://www.fin.gc.ca/toce/2004/eq_tff-e.html

⁶ Of course, while far less likely, it is conceivable that circumstances could change to the point where that set annualized increase would be too much. The key point, however, remains that the 3.5 percent was arbitrary, not related to the changing circumstances in the North. It would be the appropriate increase only by chance.

known to those governments. However, beyond those two years, it had inherent problems. The most serious problem was establishing a fixed amount for territorial funding. That meant that any formula for sharing amongst the territories would have the characteristics of a zero-sum game. If one territory's entitlement had to be increased, it would, by the arithmetic of the arrangement, come at the expense of one or both of the other territories. Not only would this create uncertainty for each individual territory but it was inherently divisive. A broader concern for the longer term was the question of whether the approach would address concerns over adequacy. While an average increase of 3.5 percent more per year might be sufficient, new developments in the North or relatively fast growing populations could lead to substantially greater revenue needs.⁶

THE PANEL'S TFF PROPOSAL

The Panel went beyond the idea of simply providing a formula for dividing the future aggregate allocations among the territories. It proposed a revamped TFF formula (as was in place before the October 2004 Framework) in which the amount received by one territorial government would be determined independently of the amounts allocated to the other two.

Its proposed formula is based on the difference between a New Operating Base (NOB) and a territory's revenue capacity (RC). The former is simply the old GEB at a modestly higher level, while the latter is a measure of revenue-raising ability that is based on a representative tax system (RTS) approach, similar to the approach embodied for so long in the Equalization formula. The RC measure would be equal to 70 percent of a territory's fiscal capacity, or revenue-raising ability, from seven distinct categories of own-source revenues. For each category, the fiscal capacity would be based on the territory's tax base and the national average tax rate applied to such a base. Interestingly, the Panel proposed that any natural resource revenues accruing to

the territorial governments be excluded from this measure of revenue capacity.

Thus, the new streamlined formula applicable independently to each territory, as proposed by the Panel, is simply:

$$(3) \text{ TFF Grant} = \text{NOB} - \text{RC},$$

where RC = 70 percent * (Fiscal Capacity based on seven revenue sources)

To make this operational over time, it was also proposed that the NOB be increased according to the same method that the GEB had been generally increased. That was the PAGE (population-adjusted government expenditure growth) approach under which NOB was increased each year at the average growth rate of provincial and local government spending across the country with allowances for any difference in the growth rate of the population of the territory relative to the rest of the country. To enhance predictability and stability, the Panel also recommended that the actual TFF Grant be based on a three-year moving average of the amounts determined according to equation (3).

There is a great deal of merit in the Panel's recommended approach. The most important and valuable aspect of the Panel's report is its rejection of an aggregate pool to be shared among the three territories. That notion, as put forward in the October 2004 Framework, was inherently problematic and not in the territories' interests. Its only merit was that it was of some advantage to the federal government insofar as it made the expenditure commitment predictable. The Panel's preference to return to a formula that determined the grant for each territory is far more practical and workable.

Fortunately, as well, the Panel recommended a number of ways to revamp that formula which would reduce its complexity somewhat and rid it of the clutter associated with so many adjustments and ad hoc changes that had been attached to it over the past 20 years or so. On the expenditure need side,

the return to the PAGE adjustment was at least better than the arbitrary increase of 3.5 percent annually.

On the revenue side of the formula, the Panel proposed greater innovation. In essence, the new Revenue Capacity index would be a move towards greater consistency with the RTS approach embodied in Equalization. Additionally, inclusion of 70 percent, rather than all, of the fiscal capacities from the seven own-source tax bases introduced a simple and positive incentive mechanism for each territorial government to raise more revenues, without having the discouraging result of a dollar-for-dollar reduction in its TFF grant. To a degree, it might also reflect the fact that the application of national average tax rates, which would be used in conjunction with the territory's own tax bases to arrive at fiscal capacity, might not be practical in the North where tax bases might be more sensitive to tax rates.

Overall, the Panel has put together a reasonable and practical set of recommendations that improve TFF. Nevertheless, there are a few issues and questions that come to mind.

- The New Operating Bases

The proposed NOB is essentially the former amounts of the GEB for each of the respective territories. It is not based on a comprehensive review of the expenditure needs of the territories. In a sense then its ultimate foundation is still the 1982 survey on which the initial values of the GEBs were based. It had been suggested by some commentators that such a major review was appropriate and indeed there have been some suggestions that the NOB be increased according to how that index of need changes in the future. The Panel, on the other hand, simply recommends a return to the PAGE-adjustment, which is directly related to the actual change in needs.

While it considered the option of a needs measure, the Panel opted for a more immediate and practical solution.

Since the NOB does start with a ratcheting-up from the GEB and then would increase annually according to PAGE, it does represent an improvement over the previous formula. Therefore, while there may still be some calls for an extensive study of needs in order to ensure that the NOB starts at the right amount, the Panel's approach does ensure somewhat more revenues for the territories and avoids potential quarrels over the needs issue. Practical as it is, this approach may not satisfy everyone.⁷

- The Exclusion of Natural Resource Revenues

The Panel recommended that the measure of fiscal capacity in the proposed TFF formula should not include fiscal capacity related to natural resources. Unlike in the provinces, natural resources in the territories are under federal government jurisdiction and it has the right to impose royalties. However, with devolution and in recognition of aboriginal rights and the continuing growth in aboriginal self-government, more natural resource revenues will be shared with or turned over to territorial and aboriginal governments. While agreements were recently reached in the Yukon, exactly how these developments will unfold is not yet clear. What is clear is that more natural resource revenues will be shared with the territorial governments and the amount of revenue is potentially large.

Therefore, it is somewhat surprising to see a recommendation for complete exclusion of such revenue potential from a measure of fiscal capacity. Of course, the treatment of natural resource revenues in Equalization is also controversial and there are arguments for less than full

⁷ The Panel did call for further assessment of needs in the case of Nunavut.

⁸ See J. Feehan (2005a).

⁹ The 50 percent and actual natural resource revenue are suggested here simply to be consistent with what the Panel had recommended for Equalization. This may be a moot point since under the Constitution Act the provinces own their natural resources whereas the territories do not.

inclusion, my own preference being for including less than half.⁸ Yet, complete exclusion seems rather extreme. The Panel does suggest, with justification, that the benefits from a territory's natural resource revenues should flow to the people of the territory. It also points out that the devolution of authority over Northern resources remains to be finalized. However, that does not justify complete exclusion. It seems that a simple rule, e.g., inclusion of say 50 percent of territorial natural resource revenues, net of any shares subsequently transferred to aboriginal governments from those territorial governments, would be workable.⁹

- Overcoming Barriers

A recurrent theme expressed to the Panel was the need to overcome major challenges facing the North's peoples. The Panel recognized this, particularly in the case of Nunavut. It recommended more assessment of its needs and suggested that the federal government address that territory's greater needs through targeted programs rather than through the proposed revamped TFF formula.

It may be useful to extend that suggestion for targeted programs. Each territory faces challenges. Overcoming barriers to development and making necessary infrastructure investment or other spending that is typically lumpy – in the sense that a large amount has to be spent initially – may require funds that the territories do not have and cannot easily borrow. Spending of this type should not be included in the TFF grant. It is better to have discretionary negotiated agreements with the federal government so that this sort of targeted, short-term, spending can be planned and implemented according to the specific problem it is intended to overcome.

In short, TFF should be placed within an integrated framework as a complement to the more discretionary and targeted programs that are needed. Some may argue that the Panel should have

further developed these notions of targeted programs and an integrated framework or, alternatively, should have embodied all such programs within the recommended TFF formula. The latter, however, would surely have pushed the limits of the terms of reference.

CONCLUSION

The Panel's recommendations on TFF represent a vast improvement over the approach in the October 2004 Framework. Returning to the formula-based method but significantly streamlining it, adding modestly more funding, and re-introducing the PAGE adjustment was a sensible strategy. While the revamped TFF formula cannot be expected to solve all the challenges faced by Northern Canadians, and there are some details that one may debate, the Panel has devised an improved formula that does what it is expected to do. Combined with other well-designed federal policies and targeted federal programs, this new approach will serve the territories well.

The Panel's report on Equalization will give rise to contentious debates among the provincial governments and there will be many disagreements. That outcome is far less likely in regard to the TFF recommendations. I expect that the territorial governments, and other representative groups in the North, will be very satisfied with them. The federal government would be wise to accept the thrust of these TFF proposals.

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A FINE CANADIAN COMPROMISE

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Since its beginnings in the 1950s, all who cared to analyze Equalization have understood that the formulas used over the decades to define provincial fiscal capacity, tax bases, taxing effort, and the Equalization benchmark must entail “rough justice.” Albeit Equalization is the most complex of intergovernmental transfers, the formulas have all included compromises motivated by requirements of administrative simplicity. Other formula elements have emerged from federal-provincial diplomacy, and yet others from Ottawa’s expectation that the cost of the program remain within historically determined limits.

That said, the post-2004 New Framework Equalization program – with its offshore oil accord appendages – crossed a hard-to-define threshold between defensible compromise and raw interest group politics. Few are prepared to defend the status quo on grounds of “rough justice” in the service of a greater good; it appears to have become a set of “rough” deals. The evidence:

- On an interim basis, payments to receiving provinces are based on historical shares. Hence, they do not bring the fiscal capacity of Equalization-receiving have-not provinces to a uniform benchmark.
- The predetermined size of aggregate Equalization payments destroys the ability of the program to serve as inter-

provincial insurance. Aggregate payments cannot rise or fall as a function of shocks to provincial fiscal capacity.

- Even if we set aside the offshore oil accords, one Equalization-receiving province (Newfoundland & Labrador) has a fiscal capacity, as presently defined, above the level of the largest contributor to Ottawa's revenues (Ontario), a province not in receipt of Equalization. Including the impact of the accords aggravates the anomaly.
- The complexity of equalizing 33 separate tax bases and the conceptual weakness in measuring some of the bases are such that no one can comfortably justify it as an approximation to a representative tax system.

I have one major concern with the recommendations of the Expert Panel report – more on it later – but that does not subtract from the value of this report. Set against other recent official documents, this is an admirable example of the genre. In relatively few pages – the total is less than 150 – it provides any interested reader with a history of Equalization, the essence of the various contentious debates over program design, and a set of recommendations that, if adopted, will restore the program's credibility.

A LITTLE HISTORY

Canada nearly doubled the public sector share of GDP over the second half of the 20th century. Most of this expansion took place in the third quarter of the century as Canada, like most OECD countries, introduced new and more generous social programs. In the final quarter, a chronic political conundrum emerged: how to generate electoral support for program redesign (flaws in design became increasingly serious as time passed) and how to reconcile public expectations of services with public willingness to pay the necessary taxes. Described at this level of generality, Canada has been a typical OECD country. All expanded social programs following World War II, and in the

final decades of the century, most OECD countries generated protracted public sector deficits and political conflict over social program redesign.

Prompted by acute early-1990s deficits, the Swedish government appointed Assar Lindbeck, a prominent economist, to chair a commission charged with recommending program redesign. Subsequently, Lindbeck (1995, 9,13) offered the following reflection on his assignment: “the welfare state is a triumph of western civilization [but] the day the ‘Lutheran ethic’ subsides in the population, and ‘Prussian discipline’ ceases to be exercised by the controlling administrators, the welfare state is in trouble.”

Lindbeck’s conclusion – offered with a flourish rare in academic prose – is that social programs may simultaneously redistribute income and improve efficiency relative to a private market alternative. But incentives in social programs may induce citizens to lose the “Lutheran ethic.” A political dialogue that debates the benefits of increased public spending versus the costs of increased taxation may yield to one that discusses the benefits only; in which case, administrators become subject to constraints that prevent the exercise of “Prussian discipline.” In summary, realizing the benefits of this “triumph of western civilization” is not automatic. It requires competent managers who, in turn, derive their legitimacy from election of a reasonably sophisticated set of politicians who do not define their mandate in terms of rent seeking.

Where does Equalization fit in this discussion?¹

In the case of the Canadian welfare state, it has played a crucial role in reconciling 20th century expectations of generous social programs with a 19th century constitution that brought together Canada’s two linguistic communities by resorting to federal institutions. As interpreted by the Judicial Committee

¹ Greg Marchildon (2005) was Deputy Minister to the Premier of Saskatchewan during much of the previous decade. His review of a book by Alex MacNevin provides an accessible introduction to Equalization, as perceived by a senior provincial administrator.

of the Privy Council, Canada's ultimate constitutional arbiter until the mid-20th century, section 92 of the British North America Act afforded clear jurisdiction over the core social programs of education, health care, and social assistance to the provinces. Many provisions of the 1982 patriation exercise strengthened the role of the judiciary but one, entrenchment of Equalization, served to enhance the provinces' role. According to the Constitution Act, Ottawa is required to make Equalization payments such that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (s.36(2)).

In evaluating the Expert Panel proposals, the details matter. But first, it is important to unpack this constitutional language and appreciate three broad functions served by Equalization:

1. Reconciliation of equal social citizenship rights with the advantages of decentralized management: On the one hand, as Canadian citizens, residents of each province expect reasonably similar core social services across the country. Without Equalization, residents of have-not provinces – Québec aside – would almost certainly have prevailed by now on Ottawa to assume direct funding responsibility for provision of these services. On the other hand, there are good managerial reasons to preserve the decentralization implicit in legal decisions made by the Judicial Committee of the Privy Council. Whether in the private or public sector, large organizations with many employees are more efficiently managed with autonomous units, and the bureaucracies required to deliver major public services such as medicare are very large bureaucracies. Relative to a hypothetical alternative in which a federal ministry managed medicare, the information burden on senior managers responsible for programming in a particular province is lower. Similarly, program innovation in smaller units, such as a province, is easier than at the national level.

2. Reconciliation of intergovernmental income redistribution with the benefits of own-source taxation: Canadian provinces enjoy a large measure of autonomy not only with respect to design and management of their respective social programs, but also with respect to their tax systems. Arguably, both these features contribute to Canadian social programs comparing favourably on an international basis. While increasing the revenue available to a have-not province from any given tax effort, Equalization does not – at least not intentionally – distort provincial political priorities by providing incentives to develop particular programs or exploit particular tax sources. At all levels of government, the need for own-source tax revenue provides a powerful incentive to politicians to assess the costs of their proposals as well as the benefits. And this expectation – that those who stand to benefit from additional public services must agree to pay the additional taxes required – is an incentive to citizens to engage in the political dynamic. The dynamic of assessing benefits against costs usually operates more transparently at the provincial than at the federal level. This is not because provincial politicians are more fiscally prudent than their federal counterparts but because the per capita impact on provincial taxes of spending \$x million is much larger than if the \$x million were spent federally.
3. Provision of interprovincial insurance: The funding of core social programs should remain stable; opening and closing hospitals as a province's terms of trade fluctuate is not conducive to good health outcomes. Relying on a regional tax base, provincial revenues at constant tax rates are inevitably subject to higher variance than those of Ottawa, whose taxing effort is spread across all sectors of the Canadian economy. Hence, Ottawa's taxing effort can be perceived, in part, as the levying of insurance premiums needed to finance revenue shortfalls in provinces facing adverse shocks. The two provinces most susceptible to

short-term adverse shocks are Saskatchewan and British Columbia. Both have switched over the last decade between have and have-not status in terms of Equalization eligibility.

To the extent the welfare state is an exercise in approximating the median voter's desire to redistribute income from richer to poorer individuals, the above discussion is largely irrelevant. There is little evidence to indicate that typical citizens in one region of Canada differ substantially from typical citizens in other regions with respect to their willingness to use the tax/transfer system for this purpose. Social programs to redistribute income among individuals could just as well cut out the provinces. Not surprisingly, if we restrict attention to the relatively simple social programs that redistribute income across individuals – programs such as old age security and redistributive features of the personal income tax – scale economies of administration exist, and Ottawa has in most cases taken the lead.

THE PROVINCIAL WISH LIST... TOUGH TO ACCOMMODATE

The have-not provinces have long argued that the 1982-2004 five-province benchmark was arbitrary and that it served as a means to eliminate all interprovincial sharing via Equalization of the large per capita resource rents in Alberta. In recent years, Québec has merged this argument into its thesis on the existence of a "vertical fiscal imbalance." What is meant by imbalance is amorphous and has been much criticized.² Stripped to its core, the imbalance claim is that extrapolation forward of core federal program expenditures (at past growth rates) and tax revenues (at recent tax rates before proposed reductions) yields large federal surpluses. By contrast, an analogous exercise at the provincial level yields deficits due, in particular, to the rapid growth in provincial health budgets.

² A white paper (Canada 2006b) accompanying the latest federal budget affords an introduction to the debate.

The unequal distribution of resources across provinces – an inequality exacerbated by recent increases in hydrocarbon prices – has created an understandable demand by resource-poor have-not provinces (Manitoba, Quebec, and the three Maritime provinces) for inclusion of all provincial resource revenues in order to raise the Equalization benchmark.

What is to be made of this argument? I begin with the Panel's statement of an evident truth: "No issue in the entire Equalization program is more contentious than how to deal with resource revenues" (Canada 2006a, 105). In my opinion, without a more acceptable compromise on resource revenue, one that is less arbitrary than at present, Equalization collapses.

Provincial ownership of crown resources is not only a feature of Canadian constitutional arrangements (vis s.109); it is also a feature of Canadian political identity in resource-rich provinces. To flout this constitutional/identity reality is politically destabilizing. In other words, citizens should realize a meaningful benefit from their respective resources; the definition of fiscal capacity should not fully equalize resource revenues. In addition to the constitutional/identity argument, provision of a meaningful provincial benefit provides an incentive to a province to manage resources efficiently. Hence, considerations of both constitutional history and economic efficiency militate against 100 percent inclusion of resource revenue. On the other hand, complete exclusion of resource revenue, as advocated by Alberta, is also politically untenable.

Treatment of resource revenues raises further sources of contention. Two further examples:

- The resource-rich Equalization-receiving provinces (Newfoundland & Labrador and Saskatchewan) have joined with Alberta to argue against inclusion of resource revenues. Why? Whatever principled arguments they raise, much of their motivation is immediate fiscal gain: they gain more from exclusion of their resource revenues from calculation

of fiscal capacity than they lose from the lowering of the benchmark that exclusion entails.

- The inherent rationale for the representative tax system basis for Equalization requires definition of tax bases and average taxing effort independently of the fiscal practices of any particular government. This reduces – but does not entirely eliminate – strategic behaviour by particular provinces to increase payments. The Equalization treatment of resource revenue has historically been based on a conceptually cruder basis: some fraction of resource revenues that provinces actually raise. With a modification to include profits of resource-based provincial crown corporations, the Panel proposes to maintain the status quo. To do so admittedly encourages provinces to strategically minimize resource rent extraction. However, to treat resource revenues in the same way as other revenue sources entails politically and conceptually unmanageable estimates of many matters. For example: forest rents captured by unions via collective bargaining or dissipated by “cut or pay” provisions in provincial leases (particularly controversial in BC, Québec and New Brunswick); dissipation of potential hydroelectric rents by low water rentals and sale of electricity to provincial customers at low prices (controversial in BC, Manitoba and Quebec); projected trends in various resource prices and consequent rent-maximizing patterns of resource exploitation.

Finally, the two traditional have provinces (Alberta and Ontario) have concerns.³ The most legitimate is that inter-regional equalization has implicitly entered into many federal programs – from employment insurance to associated equalization in the design of health and social transfers – and hence the claims of have-not provinces for more generous Equalization payments are suspect. Not only is more generous Equalization suspect,

³ The Ontario government has mounted a web site devoted to publicizing its concerns (Ontario 2006).

it is placing an unnecessary tax burden on productive regional economies. Pursuing this line of argument further, some commentators conclude that “over-equalization” is leading to inefficient and costly delivery of services by have-not provinces (AIMS 2006).

EVALUATING THE PANEL RECOMMENDATIONS

The Expert Panel made a large number of recommendations. Many undo “rough” political deals; others address administrative headaches that presently bedevil the program; yet others provide incentives to provinces to improve economic efficiency. (The accompanying table assesses four of the policy recommendations in some detail – in terms of impact on administrative simplicity, generating public legitimacy for the Equalization program, and probable impact on economic efficiency.)

Here, in a summary form, is my interpretation of the Panel’s contribution:

- The proposed ten-province benchmark is intuitively appealing, a benchmark that can credibly be defended across Canada. While desirable, this is an expensive recommendation. As costed by the Panel (Canada 2006a, 137), it increases 2007-08 payments by an estimated \$1.9 billion relative to the status quo. Aggregate Equalization cost is a serious consideration. Rather than define the benchmark as the ten-province average, a compromise is to define it as a fraction – say 95 percent – of the ten-province average. The fraction would inevitably be subject to intergovernmental negotiation, but it is a transparent and simple dimension of intergovernmental diplomacy that does not risk the conceptual integrity of Equalization.
- The Panel recommends that Ottawa restrict intergovernmental – as opposed to interpersonal – redistribution to Equalization, and that Ottawa construct other intergovernmental transfers on a straightforward

per capita basis. This recommendation goes well beyond the Panel's mandate but the Panel's analysis is a useful admonition to Ottawa to be transparent in its use of various policy instruments.

- The Panel recommends against extension of Equalization to include expenditure needs. To avoid massive and contentious additional complexity, this recommendation makes sense. Any consideration of provincial needs, however, raises a looming medium-term problem for Canadian federal arrangements. Polarization is taking place in the distribution of provincial population size, and some sophisticated public services display scale economies such that the six small provinces are now too small to perform them adequately.⁴ The forces underlying this polarization are unlikely to change direction. Technical change in agriculture and agglomeration economies in many industries are leading to ever-higher urbanization rates and to population loss, both relative and absolute, in rural Canada. None of the six major urban centres in Canada (Vancouver-Victoria, Calgary, Edmonton, Toronto-Hamilton, Ottawa, and Montreal) are in the six small provinces. And less than one in seven Canadians now resides in one of these provinces. At present, provincial merger is a matter of historical interest, and interprovincial administrative arrangements have resolved some immediate problems of scale in service delivery. In the medium term, merger of the Atlantic – and perhaps of the Prairie provinces – may well emerge as relevant political issues.

4 An example of sophisticated provincially managed services displaying scale economies is universities offering a full range of professional and doctoral programs. In its 2005 evaluation, Maclean's (2005) ranked 15 such universities, three located in one of the six small provinces. Relative to their one-in-seven population share, a resident of the six has slightly better access to a locally based full-service university than does a Canadian living in the four populous provinces, but the quality of these three universities is almost certainly below average in most disciplines. The three were among the bottom 40 percent in Maclean's ranking: Saskatchewan (ranked 10th), Dalhousie (13th), and Manitoba (15th).

5 For a succinct statement of the case for doing so, see Boothe and Hermanutz (1999).

- The recommendation on treatment of provincial resource rents is a defensible compromise that deserves to “stick”. For reasons discussed above, neither zero nor 100 percent resource revenue inclusion is desirable. The choice of 50 percent is inherently arbitrary but it implies serious consideration of claims by contending provinces.
- The proposed simplification of the representative tax system from 33 to five bases lowers administrative complexity, increases legitimacy of Equalization, and eliminates many conceptually weak tax bases. The present Equalization formula relies on too many tax bases, introduces unnecessary complexity, and many of the tax base definitions are conceptually weak. There is a case for abandoning the representative tax system entirely in favour of a single macro-measure of provincial fiscal capacity.⁵ On the other hand, basing Equalization on the concept of the representative tax system affords more respect to the current political compromises across Canada in terms of provincial taxing effort on particular tax bases.
- The call for a “one estimate, one entitlement” payment enhances the potential for provinces to undertake medium-term budgeting. The status quo entails multiple revisions of initial Equalization payments based on revisions to fiscal and demographic data. On occasion, Equalization adjustments have created windfall gains and losses for particular provinces that approach five percent of annual provincial revenues. Such policy-induced instability hampers rational budgeting at the provincial level. The tradeoff implicit in the Panel recommendation is that, henceforth, payments will be based on lagged data averaged over several years. This weakens the value of Equalization as insurance against large short-run shocks to a province’s tax base.

CAPPING EQUALIZATION TRANSFERS

The proposed cap on Equalization transfers stipulates that equalized per capita fiscal capacity, defined with 100 percent resource revenue inclusion, cannot exceed the fiscal capacity, so defined, of the poorest have province. The rationale is that Newfoundland & Labrador and Saskatchewan, the two resource-rich Equalization-receiving provinces, should not enjoy fiscal capacity, so defined, greater than does Ontario, the poorest have province. An unstated rationale is that the cap reduces the incremental annual cost to Ottawa of the Panel recommendations by an estimated \$800 million.

The cap creates several problems at the level of economic efficiency and political legitimacy.

First, economic efficiency. Except as their decisions impact the level of the Equalization benchmark, resource-rich have-not provinces experience 100 percent Equalization clawback from incremental resource rent capture. Elsewhere, the Panel insists – rightly in my opinion – that preservation of meaningful resource rent to the resource-owning province plays a useful role as incentive to provinces to pursue efficient resource exploitation policies. Introducing the cap flouts that analysis.

Second, political legitimacy of the Equalization program. To the potentially capped provinces (Newfoundland & Labrador and Saskatchewan), the cap appears arbitrary, and has excited predictable opposition. Perhaps this is a minor matter. After all, these are two small provinces that, cumulatively, amount to less than five percent of Canada's population.

More serious in terms of impact on political legitimacy, the cap indicates ambiguity in the Panel's interpretation of the appropriate compromise to draw between, on the one hand, the benefits that should accrue to a province due to provincial resource ownership and, on the other hand, the definition of provincial fiscal capacity. One of the major virtues of the

Panel report is that 50 percent resource revenue inclusion is a compromise on this contentious dilemma that can potentially “stick” for some time.

It is a minor matter but the manner of constructing the summary figures (figures at pp.2 and 139) invites the casual reader to believe that 100 percent resource inclusion is, ultimately, what the Panel believes to be the appropriate definition of fiscal capacity. Were the figure constructed to show fiscal capacity based on 50 percent inclusion, no province would appear to have fiscal capacity above Ontario's.

Admittedly, elimination of the cap increases aggregate program cost. To the extent aggregate Equalization costs are to be contained, a tactic preferable to the proposed cap is, as indicated above, to define the benchmark as a fraction of the ten-province average.

CONCLUSION

Achieving a workable compromise for Equalization matters. Given the evident Gordian knot of interwoven, and incompatible, provincial demands, it falls to the federal Cabinet to wield the sword and propose a new Equalization formula. While I disagree with aspects of the Panel's recommendations – with the cap in particular – the Panel has produced a fine Canadian compromise for an important program underlying Canadian social policy.

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TABLE 1.
Evaluation of Selected Expert Panel Equalization
Recommendations

Panel 1: Equalization benchmark

	Administrative simplicity	Political legitimacy	Difference over time
Options ...			
<i>Ten-province average</i>		HIGH – Has an intuitive appeal of fairness. Provided inclusion of some resource revenue in defining fiscal capacity, all have-not resource-poor provinces realize some Equalization benefit from resource rents.	
Variable fraction of ten-province average		MEDIUM – Less intuitively appealing than above, but affords a good means to contain Equalization cost.	
Five-province average (status quo, 1982-2004)		LOW – An arbitrary definition, introduced to eliminate impact of AB resource revenue on benchmark.	

Note: In each panel of the table, the Expert Panel's recommendation is listed in italics. Where alternate policy options are unlikely to impinge on administration, legitimacy, or efficiency, cells are left blank.

Panel 2: Treatment of economic rent from provincially owned resources in calculation of fiscal capacity

	Administrative simplicity	Political legitimacy	Economic efficiency
Options ...			
<i>50 percent inclusion of rent (rent defined as provincial resource revenues, including profits of resource-based crown corporations)</i>	HIGH – Simpler than status quo	MEDIUM – A typical Canadian compromise	HIGH – Provides significant resource rent to resource-owning provinces, providing incentive to them to manage efficiently.
0 percent inclusion of rent	HIGH – As above	LOW – Denies resource-poor have-not provinces any Equalization benefit from provincial resource rents. Lowers benchmark and hence is attractive to have provinces (such as AB and ON) desirous of limiting aggregate Equalization cost. Also attractive to resource-rich have-not provinces (SK and NL) that gain more from exclusion of their resource revenue than they lose via lower benchmark.	HIGH – As above

Panel 2: Treatment of economic rent from provincially owned resources in calculation of fiscal capacity Cont.

	Administrative simplicity	Political legitimacy	Economic efficiency
<p>Options ...</p> <p>100 percent inclusion of rent</p>	<p>HIGH – Simpler than status quo</p>	<p>MEDIUM – Higher inclusion rate increases average fiscal capacity measure and hence the benchmark. Attractive to have-not provinces with low resource rents. Unattractive to resource-rich provinces for reasons stated above.</p>	<p>LOW – Resource-owning have-not provinces experience 100% clawback of resource rent and lose incentive to manage efficiently.</p>
<p>Multiple inclusion rates and exclusion of AB from benchmark (status quo)</p>	<p>LOW – Multiple categories of resource revenue to which differing inclusion formulas apply</p>	<p>LOW – Given five-province benchmark, the status quo denied any Equalization benefit from AB resource rents to other provinces.</p>	<p>MEDIUM – In some cases partial inclusion provides resource rent to province; in some cases, inclusion rate is too high to permit any provincial rent realization.</p>

Panel 3: Cap on payment to resource-rich have-not provinces

	Administrative simplicity	Political legitimacy	Economic efficiency
Options ...			
<i>Equalized fiscal capacity, defined with 100 percent resource revenue inclusion, cannot exceed fiscal capacity, so defined, of poorest have province (ON)</i>		<p>AMBIGUOUS –Impacts directly on resource-rich have-not provinces (NL and SK) to which this appears arbitrary. On the other hand, will assuage concern among have provinces that Equalization is too generous.</p>	<p>LOW – Capped provinces receive no incremental benefit from resource taxation (except inasmuch as their taxing effort raises the benchmark).</p>
No cap		<p>AMBIGUOUS – Appeals to resource-rich have-not provinces. Offends have provinces for reasons stated above.</p>	<p>HIGH – Same argument as applies to less than 100% resource revenue inclusion rate.</p>

Panel 4: Number of tax bases included in calculating fiscal capacity

	Administrative simplicity	Political legitimacy	Economic efficiency
Options ...			
<i>Reduction to five bases</i>	MEDIUM – An important simplification and conceptual rationalization in definition of tax bases		HIGH – Reduces potential for strategic tax design by provinces.
Single macro-measure	HIGH – Requires minimum administrative calculation		HIGH – As above
33 tax bases (status quo)	LOW – Complex with numerous conceptually dubious definitions of tax bases		LOW – Encourages provinces to preserve arbitrary definition of tax bases where advantageous



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