EQUALIZATION:
MILESTONE OR MILLSTONE?

ROLAND T. MARTIN

The AIMS Equalization Papers
Brian Lee Crowley, Series Editor

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1657 Barrington Street, Suite 521
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Telephone: 902-429-1143
Fax: 902-425-1393
E-mail: aims@aims.ca
Web site: www.aims.ca

Editing by Lenore d'Anjou
Page layout and design by Gwen North
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Where Tomorrow's Public Policy Begins Today

The Atlantic Institute for Market Studies (AIMS) is an independent, non-partisan, social and economic policy think tank based in Halifax. The Institute was founded by a group of Atlantic Canadians to broaden the debate about the realistic options available to build our economy.

AIMS was incorporated as a non-profit corporation under Part II of the Canada Corporations Act, and was granted charitable registration by Revenue Canada as of October 3, 1994.

The Institute's chief objectives include:

a) initiating and conducting research identifying current and emerging economic and public policy issues facing Atlantic Canadians, and Canadians more generally, including research into the economic and social characteristics and potentials of Atlantic Canada and its four constituent provinces

b) investigating and analysing the full range of options for public and private sector responses to the issues identified and to act as a catalyst for informed debate on those options, with a particular focus on strategies for overcoming Atlantic Canada's economic challenges in terms of regional disparities

c) communicating the conclusions of its research to a regional and national audience in a clear, non-partisan way

d) sponsoring or organising conferences, meetings, seminars, lectures, training programs, and publications, using all media of communication (including, without restriction, the electronic media) for the purpose of achieving these objectives

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Foreword

Equalization is one of the most prominent features of Ottawa's presence in the less well-off provinces of Canada. Its intentions are excellent; no Canadian should be deprived of good quality services in health, education or other areas of provincial jurisdiction merely because they live in a province with a poor tax base. But the effects of equalization reach far beyond these good intentions, as Roland Martin shows so clearly in this paper. And those effects may well be damaging, not merely to Atlantic Canada, but to the country as a whole.

Within a few short years it will be time to renegotiate the five-year agreement that defines equalization. Politicians of all political persuasions have already let it be known that they think it is time for a fundamental rethink of equalization. All Canadians, whether they live in provinces that are net contributors or net beneficiaries of equalization, deserve to see this $10-billion program in all its aspects and ramifications as the debate over its future gains momentum. It is with this thought in mind that AIMS is launching a series of major new papers on equalization and the future of Canada.

I would like to thank all of those who have contributed and will continue to contribute to making this project possible, including authors, editors, support staff at the Institute and numerous outside readers, all of whom gave generously of their time and talents. My thanks also go to the Dobson Foundation and another foundation that wishes to remain anonymous, without whose financial support this project would not have been possible.

Brian Lee Crowley
Series Editor

About the Author

Roland Martin is an experienced executive in both the private and government sectors. These experiences include being Deputy Minister of Finance for the Province of Newfoundland and Labrador and President and CEO of a number of organizations, including a Toronto Stock Exchange listed company. He has taught finance, investments and business policy at a Canadian university. He has also been a stockbroker and written on public policy issues. For over 20 years, he was a director of the fourth largest electrical utility in Canada.

Mr. Martin has an MBA from the University of Western Ontario, a Bachelor of Commerce and Bachelor of Arts (Economics) from Memorial University of Newfoundland, and the Canadian Securities Course designation. He has served as a corporate director of over 30 private and crown corporations.

Mr. Martin lives in Bedford, Nova Scotia and is a sailor, skier, and community participant. He was the Maritime Provinces Chair of the recently successful Memorial University Opportunity Fund. He is Chairman of Martillac Limited, an Atlantic Canada based professional services company.

PREFACE

This essay is written in the hope of motivating a discussion on Canada's equalization program, which has become known as "the cornerstone of federal-provincial fiscal relations" and a globally respected sharing of national wealth. I have used the ideas and writings of others without specific acknowledgement. A list of many of the materials I read in preparing this report concludes the publication.

The objective has been to write as clearly and simply as possible, presenting the important issues and projecting future challenges and alternatives in a manner that can be fully understood by a reader without previous exposure to the principles and operating elements of equalization. Because the essay is part of the research program of the Atlantic Institute for Market Studies, it focuses primarily on the Atlantic provinces, yet within the context of equalization's being a federal program and administered as a national fiscal arrangement involving all 10 provinces.

The ideas, analysis, and views contained in this report are solely those of the author, as are any interpretations, errors, or omissions. I would like to acknowledge the people who assisted me in the preparation of this paper. In particular I would like to mention a number of officials in the federal and different provincial departments of finance, several university professors, the various external readers of earlier drafts of this paper, and Dr. Brian Lee Crowley, President of AIMS and editor of the Institute's series on equalization. I would also like to recognize the tremendous contribution to this paper made by my editorial advisor, Lee d'Anjou.

Roland T. Martin
Halifax, May 2001

Executive Summary

The economic and fiscal disparities and the widening gap in taxation levels among the 10 Canadian provinces are a rapidly evolving threat to the nation's political, social, and economic survival. Equalization, the prime intergovernmental fiscal tool, must be significantly reformed as part of an innovative solution to these national challenges. This serious social and fiscal problem is not being addressed in the current political debates on the shortcomings of equalization. The solution is an action plan that accelerates the growth rates of the economically lagging provinces and reduces their individual and corporate taxation levels.

The new plan must be based on incentives to achieve comparable levels of public services from each province's own sources, not merely for provinces to be "equalized up" to these levels by transfers from the federal government's rapidly growing treasury. The long-term goal is to assist the equalization-receiving provinces achieve a much higher degree of fiscal self-reliance.

The four Atlantic provinces now have per capita fiscal capacities relative to the national average that are only marginally higher than they were when the program was introduced in 1957. During this 44-year period, the federal government has unconditionally transferred an estimated $180 billion (in current dollars) to the seven receiving provinces.

Equalization has been a program much "managed" and tinkered with for most of its history. Little fundamental change has occurred since the renewal of 1982, when equalization was formally written into the Constitution Act of that year.

This essay recommends several actions that the federal government could take to accelerate the economies of lagging provinces and, over the long term, reduce their dependence on equalization payments. The suggested options are:

1. Remove oil and gas tax revenues from the equalization formula and return to a 10-province standard for the remaining tax revenues, thereby treating all provinces equally with respect to oil and gas and still providing an equalization program that meets its original fiscal and public services objectives. A less preferable alternative would be to significantly change the generic taxback percentage to reward the provinces whose nonrenewable oil and gas resources are being depleted, thereby providing an incentive and funding for an acceleration of their economies.

2. Add selective expenditure needs to the equalization formula in areas such as education, health, and transportation. These public services could be measured, and appropriate benchmark unit costs established to calculate provinces' relative fiscal capacities.

3. Implement a differential tax structure for personal and corporate income taxes by transferring sufficient tax points to the lagging provinces. This move should be combined with a mutually acceptable long-term growth-acceleration plan that includes immediate personal and corporate tax reductions and increased spending in economically leveraged areas, such as education, training, and transportation.

The country's major trends of decentralization, widening gaps between provincial taxation levels, and disparities in relative economic performance clearly demonstrate that the status quo is no longer an option for Canadians and their political leaders. Urgent action is required if equalization, currently recognized globally as a milestone for intergovernmental sharing of public resources, is to avoid becoming a fiscal millstone for a significant proportion of Canadians.

SECTION 1
INTRODUCTION

Equalization, likely the most confusing and complex of Canada's federal-provincial fiscal arrangements, has recently evolved into a popular subject of discussion and media material. Its rise to prominence is not because it is being recognized for achieving its objectives after 44 years of existence. To the contrary, many political leaders are calling for more transfer funds, a broader formula, and fundamental changes to some of the program's components because, in their opinion, equalization is failing to reduce the differences in fiscal opportunities among the provinces, and payments must therefore be increased.

What was the prime goal for equalization when it was established? Was it to eliminate the provinces' differences in spending and taxation capacity levels? Or was it meant predominantly to ensure all Canadians, regardless of location or economic circumstance, access to generally equal standards of public services? It was the latter, but has it proved the correct choice? If provincial governments are to achieve self-reliance and stronger local economies—the frequent mantra of federal and provincial politicians since long before the introduction of the equalization program—then the more appropriate goal is the former: the elimination of differences in fiscal capacities among the provinces.

After 44 years and the transfer of almost $180 billion (in current dollars) from the federal government to the equalization-receiving provinces, the fiscal gaps for most of these provinces are still significant. In 1999, Atlantic Canada had 7.8 percent of the nation's population, 6.9 percent of its employment, and only 4.8 percent of its real gross domestic product (GDP). Furthermore, equalization payments to each of the four Atlantic provinces represented on average more than 25 percent of the total revenue they collected and, in the case of Newfoundland and Labrador, equalled 55 percent of that province's own source revenues. In brief, rather than assisting provinces to higher percentages of spending from their own resources, equalization may be contributing to the reverse outcome: a poorer quality economy, and a higher dependency on the resources of other Canadians.

The current debate about equalization raises a number of questions. Has it become confused with economic development programs? Has it been misused by governments to mask poor policymaking in public service expenditure areas, such as health and education, and to mask poor provincial budgeting and financial management in many fiscal years?

This paper examines the following hypotheses: first, that the problem with the political interpretation of the main principles of equalization as set out in Section 36(2) of the Constitution Act, 1982—to make "equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable public services at reasonably comparable levels of taxation"—is that by definition these principles mean subsidizing some provinces just to tread water at a comparable level of services rather than being based on incentives to close these gaps through their own efforts; and second, that existing provincial and federal government taxation policies will have the long-term impact of increasing, not decreasing, taxation levels in many of the receiving provinces.

If these hypotheses are correct, then equalization must be restructured and reinvented. The central focus of this essay's analysis and suggested solutions is that the redesign of equalization should become part of a national economic strategy with a special goal of accelerating economic growth in the poorer provinces. This focus is essential if Canada is to remain a strong and globally competitive nation from coast to coast well into the 21st century.

To build the case for this conclusion, the essay is organized as follows. Section 2 explains the workings of the equalization program, including the calculation of receiving provinces' entitlements and the "taxback" of any increase in their revenues from a particular tax source, including natural resources. The next section examines the program's results on a variety of statistical measures. Section 4 looks to the future if the equalization program continues more or less unreformed; it also explains some other countries' approaches to revenue-sharing.

The case for reform is set out in Section 5, which includes three options for action. Section 6 provides a brief conclusion.

SECTION 2: HOW DOES EQUALIZATION WORK?

Some provinces within the Canadian federation can collect higher per capita tax revenues from their citizens and corporations because their economies are stronger and more diversified and their taxpayers are wealthier. Therefore, the various tax sources of the stronger provinces are often larger than those of the economically poorer ones. In order to level the public services and taxation playing fields, the federal government unconditionally transfers funds directly from its treasury to those provinces that have, on balance, fiscal capacity deficiencies in comparison to a "standardized" (average) Canadian province.

Intergovernmental transfers, especially equalization, are essential and defining characteristics of Canadian federalism. This system of sharing among the provinces is all about enabling equal access to needed services by all Canadians, none of whom should be disadvantaged by living in economically poorer provinces. Without it, Albertans and Ontarians would be bound to have much better schools, health care, and highways and much lower taxation levels than fellow Canadians in Manitoba or Nova Scotia.

The Calculation of Equalization Payments

Although the concept of levelling the field sounds simple, its application can be a bit confusing for three reasons. First, the standard to which the weaker provinces are raised is not the cross-country average or the level of the two strongest provinces (both of which were used at times during the early years of the program—see Appendix II): Rather, it is what is called the five-province standard, a weighted average of the five "middle" provinces—British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec,—which gives the formula a certain symmetry. In 1982, the year this standard was instituted, the Atlantic provinces as a group and Alberta each had 9.2 percent of the total population. Dropping them eliminated both the volatility of Alberta's high natural resources revenues and Atlantic Canada's low fiscal capacities.

Second, each province's revenue-raising (fiscal) capacity is measured by examining a great many actual or potential revenue sources—currently 33 of them (see Table 1).

TABLE 1: Revenues Subject to Equalization, 1999/2000

	Source	Revenues Equalized
		(thousands of $)
1.	Personal income taxes	45,269,626
2.	Business income taxes	12,777,374
3.	Capital taxes	3,979,946
4.	General and miscellaneous sales taxes	25,561,101
5.	Tobacco taxes	2,273,334
6.	Gasoline taxes	5,032,276
7.	Diesel fuel taxes	1,655,434
8.	Noncommercial vehicle licences	2,109,291
9.	Commercial vehicle licences	917,424
10.	Revenues from the sale of alcoholic beverages	3,788,625
11.	Hospital and medical insurance premiums	1,588,000
12.	Race track taxes	23,990
13.	Forestry revenues	1,615,631
14.	New oil revenues	614,172
15.	Old oil revenues	161,459
16.	Heavy oil revenues	64,133
17.	Mined oil revenues	146,059
18.	Third-tier oil revenues	92,440
19.	Heavy third-tier revenues	24,627
20.	Natural gas revenues	2,420,856
21.	Sales of crown leases	445,096
22.	Other oil and gas revenues	250,789
23.	Mineral resources	392,907
24.	Water power rentals	628,440
25.	Insurance premiums	1,342,747
26.	Payroll taxes	6,037,604
27.	Provincial-local property taxes	32,726,422
28.	Lottery ticket revenue	1,382,498
29.	Other games of chance revenues	2,450,552
30.	Miscellaneous provincial-local taxes and Revenue	7,584,598
31.	Shared revenues: Offshore activities/Newfoundland	0
32.	Shared revenues: Offshore activities/Nova Scotia	0
33.	Shared revenues: Preferred share division	84,878
Total		163,442,329

Source: Canada, Department of Finance, Provincial Fiscal Equalization Second Estimate 1999/2000. Explanations of the Tax bases are included.

Third, the calculation is based on determining each province's per capita fiscal capacity for each potential tax base. This is not the same as determining how much each province actually collects from each base, but rather what it could collect if it imposed an "average tax effort" on that tax source. How the province actually taxes does not directly affect its equalization entitlement. The formula also does not take into account the public services needs or spending patterns of any provincial government. The payment is structured as an unconditional transfer of equalization payments from the federal treasury to the eligible provinces.

To determine how much equalization should be transferred to each province, Ottawa has constructed a representative tax system (RTS) model that is intended to accurately reflect the tax and revenue sources. Since April 1, 2000, the RTS has comprised 33 different tax bases, each with a detailed definition of procedures and rules for calculating its financial amounts.

For fiscal year 1999/2000, the six major tax bases—personal income taxes (PITs); provincial-local property taxes; general and miscellaneous sales taxes; miscellaneous provincial and local taxes; business income taxes (mostly corporate income taxes—CITs) and payroll taxes—represented 79.5 percent of the total revenues to be equalized and 90.5 percent of the equalization entitlements (see Table 1).

To implement these principles and calculate the entitlements of each province under all of the 33 tax bases involves a large number of data sources and continuous technical interpretations. Table 2 sets out a five-step summary of the calculation of an entitlement and gives two tax base examples: Newfoundland's sales tax fiscal deficiency, and Nova Scotia's gasoline tax fiscal excess.

Table 2: Calculating Equalization Entitlements

A: The Five Steps

Step 1

(a) Each of the tax bases and quasi-taxes of the RTS is totalled for all 10 provinces. (b) The actual provincial tax revenues collected from each of these 33 typical taxes and quasi-taxes in the RTS are determined. (c) A national tax rate for tax base is calculated by dividing each total representative base into the 10-province total revenue for that base (i.e. b÷a).

Step 2

The RTS is calculated for the provinces in the five-province standard: Quebec, Ontario, British Columbia, Manitoba and Saskatchewan. Each of the 33 tax bases is divided by the total population of five provinces to arrive at an average per capita tax base for the standard provinces.

Step 3

To obtain a per capita revenue yield (fiscal capacity) for each standardized tax base of each of the 10 provinces and the standard province, the national tax rate for each tax base is multiplied by the representative tax base.

Step 4

The five-province per capita fiscal capacity for a standardized tax base is subtracted from each province's per capita fiscal capacity of the same standardized tax base. The resulting number is either a deficiency or an excess for that province with respect to that tax base, and it is multiplied by the province's population to get the amount of equalization entitlement for that specific tax base

Step 5

Each of the per capita entitlements as calculated in Step 4, both fiscal deficiencies and excesses, is totalled for each of the ten provinces. Seven of the provinces regularly have more fiscal deficiencies than excesses, so they receive equalization payments from the federal government (which totalled approximately $9.8 billion in 1999/2000). The other three provinces, Ontario, Alberta, and British Columbia, have more fiscal excesses than deficiencies and therefore receive no equalization payments.

B: Illustration: Estimated Newfoundland Sales Tax Entitlement

Line No.	Calculation	Yield
	Step 1	
1.	total ten-province sales tax base	$315,801,900,000
2.	total ten-province sales tax revenues	$ 25,561,101,000
3.	national average tax rate (line 2 / line 1)	8.1%
	Step 2	
4.	five-province standard tax base	$258,035,300,000
5.	five-province standard population	25,105,344
6.	standard tax base per capita (line 4 / line 5)	$10,278
	Step 3	
7.	Newfoundland fiscal capacity	
	Newfoundland per capita base x national average tax rate	
	8,034[a] x 8.1%	$650
8.	five-province fiscal capacity	
	standard per capita base x national average tax rate	
	10,278 x 8.1%	$832
	Step 4	
9.	Newfoundland fiscal deficiency	
	Newfoundland fiscal capacity – five-province fiscal capacity	
	$650 - $832	$182
10.	Newfoundland sales tax equalization entitlement	
	Newfoundland deficiency x Newfoundland Population	
	$182 x 541,179	$98,000,000
	Step 5	
11.	Repeat process for all sources of RTS	
12.	Sum the positive and negative entitlements	

C: Illustration: Estimated Nova Scotia Gasoline Tax Entitlement

Line No.	Calculation	Yield
	Step 1	
1.	total ten-province gasoline tax base	$41,121,000,000
2.	total ten-province gasoline tax revenues	$5,032,200,000
3.	national average tax rate (line 2 / line 1)	12.2 %
	Step 2	
4.	five-province standard tax base	$32,593,800,000
5.	five-province standard population	25,105,344
6.	standard tax base per capita (line 4 / line 5)	$1,298
	Step 3	
7.	Nova Scotia fiscal capacity	
	Nova Scotia per capita base[b] x national average tax rate	
	$1,436 x 12.2%	$175
8.	five-province fiscal capacity	
	standard per capita base x national average tax rate	
	$1,298 x 12.2%	$158
	Step 4	
9.	Nova Scotia fiscal deficiency (excess)[c]	
	Nova Scotia fiscal capacity – five-province fiscal capacity	
	$175 - $158	($17)
10.	Nova Scotia gasoline tax equalization entitlement[c]	
	Nova Scotia deficiency (excess) x Nova Scotia population	
	$17 x 940,215	($16,000,000)
	Step 5	
11.	Repeat process for all sources of RTS	
12.	Sum the positive and negative entitlements	

[a] Sales tax base of $4.35 billion ÷ by population of 541,179 = per capita tax base of $8,034.
[b] Gasoline tax base of $1.35 billion ÷ by population of 940,215 = per capita tax base of $1,436.
[c] Notice that because of the way the formula works a dollar amount that is negative here is a fiscal capacity excess, which results in a negative equalization.

Source: Based on data from Canada, Department of Finance, Provincial Fiscal Equalization, Second Estimate, 1999–2000, computation table 4 (April 1, 1999 Regulations).

Despite all the past concerns caused by volatile oil and gas revenues (See Appendix II), the net impact of these tax bases on equalization payments during recent years has generally been almost a zero-sum game. Neither Ontario nor British Columbia is eligible for equalization payments because their respective taxpayers have high average personal income levels. Saskatchewan, though a net equalization recipient, is a significant oil-producing province and, therefore, loses some equalization payments; the federal government's savings from Saskatchewan's excesses are almost equal to the oil and gas equalization payments to the other six receiving provinces. Alberta, the largest oil- and gas-producing province, is neither in the five-province standard nor a receiving province. If its oil and gas revenues were equalized, total annual payments in 2000/01 would be an estimated $3 billion to 4 billion dollars higher (30 to 40 percent higher than budgeted) and British Columbia would likely be entitled to equalization!

Equalization's Revenue Clawback Mechanisms

One of the most important adjustment mechanisms of the equalization formula is its built-in taxback or clawback. If a province has an increase in revenues from a particular tax source, such as the PIT, its per capita yield on that tax base also increases, and there is an offsetting decrease in its equalization entitlement because the per capita fiscal deficiency with respect to that tax source has gone down.

Before the 1970s' emergence of natural resources as a major financial weight in provincial revenues, the taxback was a normal part of the interactions of the formula. Rarely did a province undertake a sufficient tax policy action or did economic events change so quickly as to materially affect the per capita fiscal capacity of a particular tax base. Although policymakers might have taken equalization implications into account in certain instances, there is no evidence to indicate they changed any major economic project or fiscal policy decision of significance. The only exceptions involved major resources, such as potash, asbestos, and offshore gas and oil. In these cases, public debate concerned whether sufficient incentives existed to develop and extract these nonrenewable assets. Because of the offsetting decreases in equalization entitlements, exploiting these natural resources could be projected to produce few incremental and direct revenue benefits for the provincial treasuries and its citizens.

This type of situation was eventually recognized as requiring a special mechanism within the equalization formula. Three specific events in the 1980s brought the taxback issue into discussion, debate, and finally a series of negotiated special resolutions:

- The 1982 renewal of the equalization program restored natural resources to a tax base fully counted within the formula. (In the 1970s, it had varied from inclusion of 100 percent of receipts from renewable resources and 50 percent from nonrenewable resources to a mixed situation in which some resources were equalized and others excluded.)

- In 1987 the government of Canada and of Nova Scotia passed legislation to implement the offshore Accord with respect to the latter's offshore gas and oil potential. This act, among other things, introduced a 10-year phase-in of the full equalization offset or taxback of any resulting offshore royalties and provincial corporate income taxes. Newfoundland had entered a similar accord ("Atlantic Accord") in 1986 for its projected offshore oil revenues, with a 12-year phase-in; the agreement ensured that, during this period, the provinces' total equalization payments from all tax bases for any year would be at least equal to 95 percent of its entitlements for the previous year.

- Saskatchewan conducted negotiations to have a lower taxback on potash from 1986 until 1994, when finally the federal government created the generic taxback, retroactive to1993.

The generic taxback is applicable to all equalization-receiving provinces and to all revenue sources. If a province that receives equalization is also the beneficiary of 70 percent or more of the total tax base of a revenue source, then the federal government, in administering the equalization formula, reduces by 30 percent the revenues subject to equalization from that source in all provinces that have the resource (for example, potash in New Brunswick and Saskatchewan, prior to the 1999 renewal). If the province with the 70 percent resource share is in the five-province standard, equalization payments can be made to many of the other receiving provinces that are likely to have no revenues from that tax base.

The mechanics of the generic 70:30 are implemented similarly for other tax bases in the formula, even if only one province is affected, as is currently the case with the tax bases created specifically for petroleum revenues from offshore Nova Scotia and Newfoundland. For these offshore petroleum tax bases, the five-province standard is $0 per capita, and when deducted from the provincial per capita revenues from gas or oil, it creates an excess per capita revenue yield. For example, if Newfoundland's oil royalties, CIT, and other offshore fees total $50 million, the revenues to be equalized are 70 percent or $35 million, creating a per capita yield of $65. Since the five-province standard per capita yield is $0, the Newfoundland per capita excess is $65, which when multiplied by the population of 540,000, results in an excess (reduction) of equalization of $35 million.

As a result of the introduction of the 70:30 generic taxback, the special accords negotiated by Nova Scotia and Newfoundland in the mid-1980s became mostly irrelevant with respect to fiscal sharing. For example, Nova Scotia's Accord recognized the disincentive if the then-expected world-scale Venture gas project began generating large economic rents that all went to reduce or offset existing equalization payments. As already noted, the accord, which was to be a one-time arrangement, provided for a 10-year period during which the reductions in equalization from those revenues would be phased in at the rate of 10 percent per year, starting with the province's keeping 90 percent in year one. Unfortunately for Nova Scotia, the phase-out was triggered in 1992 by the oil-equivalent measurement from the small Panuke-Cohasset offshore oil project, the Venture gas project having been indefinitely postponed (it eventually started production in late 1999).

Similarly, Newfoundland's giant Hibernia offshore oil discovery resulted in a special Atlantic Accord for that province. The main difference from Nova Scotia's accord was that the phase-out mechanism was designed to cushion any net decrease in that province's total annual equalization entitlements as a result of increased revenues from offshore petroleum resources and any other major natural resource projects that might be developed during the 12-year phase-out period, and also from any other net fall in equalization.

Although, the two Accords still exist, it is currently in the financial interest of both Nova Scotia and Newfoundland to be governed by the 70:30 generic taxback formula, and that is the path they have chosen. In Newfoundland's case, there may still be circumstances such as a significant decline in Ontario's economy, or new large resource projects like the proposed INCO Nickel development that would make it more advantageous from an equalization entitlements perspective to elect to return to the Atlantic Accord.

The 1999 equalization program renewal created a new tax base entitled "heavy third-tier oil revenues." Given the recent increase in oil prices, the 2001/02 equalization program will probably have a third generic taxback category because Saskatchewan will have more than 70 percent of that tax base (Alberta will have the balance).

SECTION 3
HOW SUCCESSFUL HAS EQUALIZATION BEEN?

The amounts of money paid to the receiving provinces have steadily increased and are projected to continue rising during the current five-year renewal (see Table 3 and Table A.1 in Appendix I). The basic principles embodied in the equalization program have been generally consistent since its introduction in 1957. However, the implementation of those principles has varied considerably. The formula has been administered in an ad hoc fashion in many instances, primarily because the federal government determined that the amounts due to be paid would be either too high or unsustainable, given its own finances. For instance, in the early days of rapidly increasing prices for natural resources, the windfall nature of the tax revenues was, in Ottawa's opinion, inconsistent with the intent of the program, and the equalization amounts under the formula as then applied were not affordable. So the formula (and its revenue categories) required ad hoc changes. It might be said that, like Canada itself, the equalization program keeps evolving.

TABLE 3: Equalization Payments 1994/95 to 2005/06

	Actual					Estimated						
	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
						(millions of dollars)						
Nfld.	958	932	1,030	1,090	1,044	1,051	1,038	1,075	1,099	1,130	1,155	1,193
P.E.I.	192	192	208	236	232	241	236	245	251	260	268	277
N.S.	1,065	1,137	1,182	1,297	1,187	1,260	1,238	1,301	1,339	1,390	1,433	1,478
N.B.	927	876	1,019	1,118	1,120	1,152	1,127	1,166	1,187	1,217	1,252	1,292
Que.	3,965	4,307	4,169	4,686	4,462	4,589	4,493	4,723	4,926	5,130	5,294	5,462
Man.	1,085	1,051	1,126	1,049	1,081	1,114	1,074	1,113	1,127	1,151	1,191	1,229
Sask.	413	264	224	209	482	388	315	352	365	378	393	406
Total	8,607	8,759	8,959	9,685	9,607	9,794	9,522	9,975	10,295	10,655	10,986	11,338

Source: Canada, Department of Finance, Federal-Provincial Relations Division.

Results in Atlantic Canada

Has the equalization program alleviated the fiscal gap between the recipient and the nonrecipient provinces? It has not closed substantially when measured by the relative position of each of the Atlantic provinces to the national average of a number of fiscal capacity indicators. Take, for example, the 10-province average per capita yield from all 33 of the tax bases in the equalization formula; the projected amount for fiscal 1999/2000 is $5508 (see Graph 1). But after 44 years of equalization payments, the four Atlantic provinces' yield for the same fiscal period is only 65 to 76 percent of that national average (see Table 4).

Graph 1 – Fiscal Capacity by Province, 1999/2000 Estimates

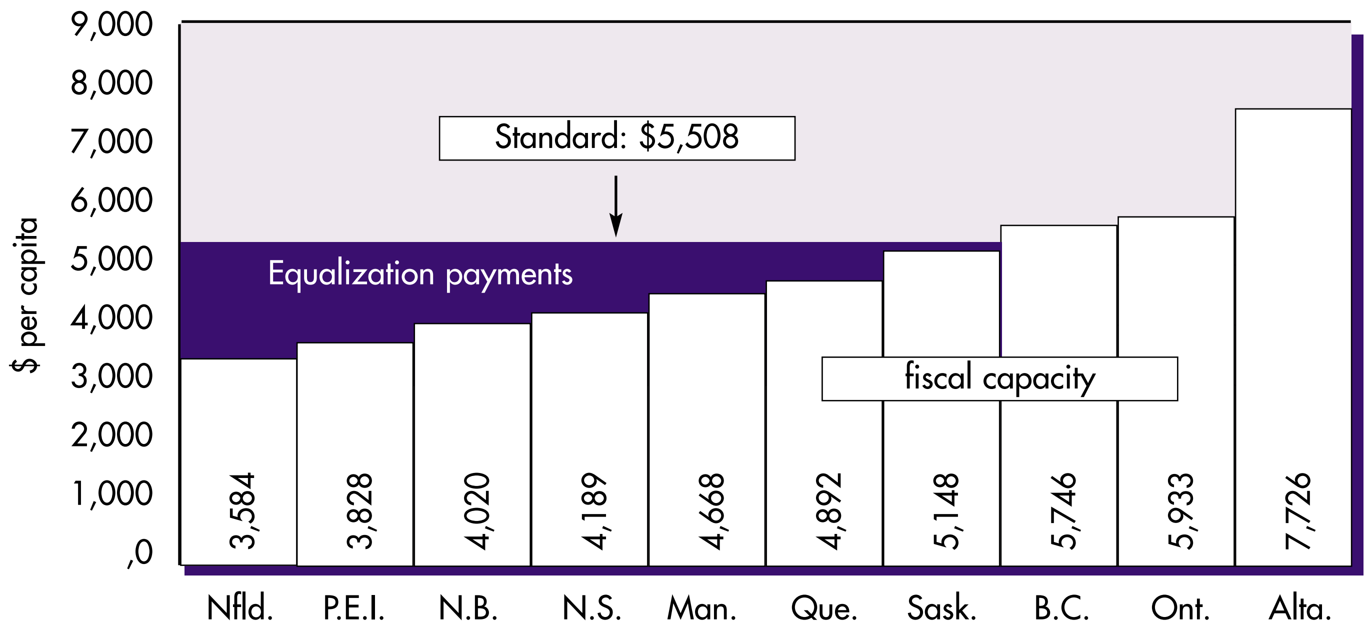

Table 4: Own-Source Fiscal Capacity per Capita, Atlantic Provinces and National Average, 1999/2000

	Current $ Per Capita	% of National Average
	(dollars)	*(percent)*
Newfoundland	$3,584	65.1
Prince Edward Island	$3,828	69.5
Nova Scotia	$4,189	76.1
New Brunswick	$4,020	73.0
National average	$5,508	100.0

Note: The minor variances between the percentages in this table and those in Table A.2 are due to the timing of the data estimates for 1999/2000.

Source: Author's calculations with data from Canada, Department of Finance, Federal-Provincial Relations Division.

This minimal change in dependency on equalization compared to the national averages is further demonstrated by Table A.2 and A.3 (see Appendix I), which track the indices of provincial fiscal capacity to own-source revenues from 1972 to 2000.

For two of the major revenue sources, PITs and CITs, the four Atlantic provinces rank even more poorly, indicating the fundamental gap that still exists in their economic performance relative to the Canadian average (see Table 5). These gaps are even more pronounced when the comparison is to the top-performing provinces of Alberta and Ontario. For example, for 1999/2000, Nova Scotia's per capita PIT projections are only 61.7 percent of Ontario's, and the former's CIT projections only 43 percent of the latter's.

Table 5: Per Capita Income Taxes, Atlantic Provinces as a Percentage of the National Average, 1999/2000

	Percentage of National Average	
	Personal Income Tax	Corporate Income Tax
	(percent)	
Newfoundland	56.0	45.5
Prince Edward Island	60.7	45.8
Nova Scotia	72.3	49.5
New Brunswick	66.7	49.7

Source: Author's calculations with data from Dominion Bond Rating Service, The Canadian Federal and Provincial Governments—2000 Overview, Toronto, September 2000.

This trend is not likely to improve, given the nature of economic and tax policy events that have been occurring at the federal level and in most provinces. For example, equalization as a percentage of Canada's GDP has fallen from approximately 1.3 percent in 1982 to a projected 1.0 percent in 1999/2000. At the same time, equalization as a percentage of federal revenues has decreased from 8.0 percent to approximately 5.5 percent.

In contrast, Atlantic Canada's continued dependence on equalization is forcefully shown by the same two economic indicators for 1999/2000. Nova Scotia comes off best on the measure of equalization as a percentage of its GDP, while Newfoundland's equalization payments are a full 56 percent of its own-source revenues (see Table 6).

Table 6: Dependence on Equalization Payments, Atlantic Provinces, 1999/2000

	Equalization	
	as % of GDP	as % of Own-Source Revenues
	(percent)	
Newfoundland	8.9	56.0
Prince Edward Island	8.1	44.5
Nova Scotia	6.1	40.6
New Brunswick	6.4	39.4

Source: Author's calculations with data from Dominion Bond Rating Service, The Canadian Federal and Provincial Governments—2000 Overview, Toronto, September 2000.

The Atlantic provinces' dependence on equalization and other transfer programs is further evidenced by the performance of two key economic indicators: personal disposable income and GDP. The average for per capita personal disposable income, which includes personal transfers, such as Employment Insurance (EI) and social assistance payments, grew nationally by an annual compound rate of 3.95 percent from 1981 to 1999, but each of the four Atlantic provinces exceeded that rate (see Table 7). One result was a narrowing of the relative per capita ratios. For example, Newfoundland's per capita personal disposable income moved from 69.8 percent of the national average in 1980 to 80.5 percent in 1999, and Nova Scotia's from 84.1 percent to 90.2 percent during the same period.

Table 7: Per Capita Personal Disposable Income, Canada and Atlantic Provinces, 1981, 1985, 1990, 1995, and 1999

	Canada	Nfld	PEI	NS	NB
1981					
Amount ($)	9,641	6,732	7,395	8,109	7,499
% of national average	100.0	69.8	76.7	84.1	77.8
1985					
Amount ($)	12,533	8,591	9,791	11,002	10,082
% of national average	100.0	68.6	78.1	87.8	80.4
1990					
Amount ($)	16,567	12,570	13,926	14,636	13,727
% of national average	100.0	75.9	84.1	88.3	82.9
1995					
Amount ($)	17,763	14,331	15,372	15,991	15,624
% of national average	100.0	80.7	86.5	90.0	88.0
1999					
Amount ($)	19,369	15,596	16,136	17,478	17,229
% of national average	100.0	80.5	83.3	90.2	89.0
Growth rate	4.0	4.8	4.4	4.4	4.7

Source: Author's calculations with data from Nova Scotia Department of Finance and Statistics Canada.

On the other hand, the GDPs of the Atlantic provinces, although increasing over the 1981–1999 period at faster growth rates than personal disposable incomes, remained at lower percentages of the national average (see Table 8). For example New Brunswick, whose GDP grew over those years at 5.69 percent—a full 1.31 percentage points more than the country at large—is now at 89.0 percent of the national average for personal disposable income but at only 77.6 percent of national GDP levels. This spread indicates the need for these provincial economies to grow even more rapidly so that they can move away from their dependence on transfers (those transfers partially explain why personal disposable incomes in these provinces are closer to the national average than their GDPs).

Table 8: GDP Per Capita, Canada and Atlantic Provinces, 1981 and 1999

	Canada	Nfld	PEI	NS	NB
1981					
Amount ($)	14,524	8,977	8,653	9,338	9,001
% of national average	100.0	61.8	59.6	64.3	62.0
1999					
Amount ($)	31,414	22,384	21,696	23,863	24,390
% of national average	100.0	71.3	69.1	76.0	77.6
Growth rate	4.4	5.2	5.2	5.4	5.7

Source: Author's calculations with data from Statistics Canada, Provincial Economic Accounts 1999 cat. 13-213, Ottawa.

Another trend in equalization payments to the Atlantic provinces is worthy of note. From 1957 to 2000, the average compound growth rate was approximately 11 percent (see Table 9). One can, however, analyze distinct subperiods, noting the impact of the high inflation years of 1957 through 1982, the last major overhaul of the equalization formula in 1982 through 2000, and the low growth years of 1990 through 2000. During the past decade, the annual rate has declined sharply from a low of 1.35 percent for Newfoundland to a high of 2.9 percent for Nova Scotia and New Brunswick.

Table 9: Growth Rates of Equalization, Atlantic Provinces, 1957–2000

	Newfoundland	PEI	Nova Scotia	New Brunswick
		(percent)		
1957–1982	15.43	15.22	14.68	17.10
1957–2000	11.00	10.65	10.50	12.10
1982–2000	5.13	4.60	4.96	5.42
1990–2000	1.35	2.17	2.90	2.90

Source: Author's calculations with data from Canada, Department of Finance, Federal-Provincial Relations Division.

The relatively low growth rates in recent years reflect the success of the federal government's various changes to the formula to slow earlier, more rapid growth rates, and tie them closer to GDP growth rates. In addition and more significantly, the slowdown reflects minimal population growth rates in the Atlantic region, including an absolute decline in the population of Newfoundland.

Prospects for the Medium Term

The foundation of the equalization formula is the comprehensive RTS and the calculation of the per capita fiscal capacity for each of its 33 tax bases. The fiscal capacities of the key tax bases in the Atlantic Provinces have a long way to increase to get closer to the national averages (see Tables 4, 5, and A.4).

At the same time the RTS is gradually being changed by reductions in the taxation rates for PITs, CITs and capital gains in provinces such as Ontario and Alberta and, to a lesser extent in many other provinces. Over time, these reductions in tax rates will likely become large enough to materially affect the ten-province tax base, the national average tax rate, and the five-province standard base and per capita tax yield for those taxes. For example, the overall equalization payout ratio for PIT revenues, that is the percentage of PIT revenues collected by the federal government that must be transferred by way of equalization entitlements to the receiving provinces, is estimated to be 8.66 percent in 2000/01. If cumulative tax reductions eventually result in reductions to the five-province standard tax base for the PIT that total $500 million annually, equalization entitlements would decline by approximately $44 million. For Nova Scotia, equalization payments would decrease by about $4.6 million annually since it has recently been receiving 10.5 percent of all PIT equalization entitlements.

The single biggest impact on a province's equalization entitlements is, however, not changes in its tax bases but growth or decline in its population. Because its fiscal capacity for each of the 33 tax bases is calculated on a per capita basis, changes in population have an immediate effect on annual entitlements. For example, Newfoundland's population fall by approximately 40,000 from 1992 to 2000. This decline translates into an annual reduction in equalization entitlements of almost $78 million (based on 1999/2000 estimates); during the same years, total public services expenditures grew by 9.0 percent. At the same time, Nova Scotia's population grew by 2.1 percent and its total expenditures by 14.0 percent; New Brunswick's population increased 0.8 percent and expenditures by 8.0 percent; and PEI population rose by 5.3 percent and its expenditures by 9.0 percent. In brief, fiscal capacity pressures increased in all four Atlantic provinces.

Given the recent economic performance of the receiving provinces, the near-to-medium term is likely to see Manitoba continuing to experience many of the same challenges as the Atlantic region, while Saskatchewan could cease to receive equalization. Quebec's equalization entitlements are 2.4 percent of GDP and will continue to decline in significance relative to its economy. It should be noted, however, that Quebec has historically received approximately half of all equalization payments, or close to $85 billion. These statistics clearly reflect the significance of population in the equalization formula: Quebec has almost 7.4 million citizens compared to a combined total of 4.6 million for the other six receiving provinces.

SECTION 4: WHAT IS THE ROLE OF EQUALIZATION IN CANADA'S FUTURE?

The objective of equalization is to facilitate treating all Canadians equally. The program's original design was to equalize provincial revenues to the weighted average of the top two provinces, helping to ensure all Canadians could have an equal standard of public services and similar taxation levels. These principles are followed in a unitary state, such as the United Kingdom, where the central government enacts reasonably uniform taxation policies and attempts to administer comparable levels of public services to all its citizens.

Since equalization was introduced in 1957, Canada has become one of the most decentralized nations in the world. Court decisions and other factors have buttressed the strong independence and rights of the provinces. This, plus the political process, has resulted in a set of federal-provincial fiscal and program responsibilities that is very different from what existed nearly half a century ago. In contrast, the United States is a more centralized federation; its percentage of federal revenues to total federal, state, and local revenues is approximately 65 percent; the comparable figure for Canada is 47 percent.

How Do Other Countries Share Revenues?

Many nations have or are considering systems for revenue-sharing (from central or subcentral government to regions, provinces or states, or municipalities). No one model fits all nations throughout the world. Many political scientists and economists have written on this topic and not arrived at any narrow set of conclusions or recommendations. History, culture, and economic circumstances have their own unique influences and have resulted in the diversity and complexity associated with various global equalization systems (see Appendix III).

Countries use three common models to deal with fiscal imbalances across various levels of government. Some (such as Canada) use central grants to the most needy local authorities. Others (for example, Iceland, The Netherlands and Australia) have subnational governments pay into a fund used to make transfers to other levels of government according to their needs and resources. Still others (for example, Sweden and Switzerland) structure the tax sharing of the nation to allow for regional differences in costs or fiscal capacities.

The model referred to most frequently as having potential application for Canada is that of Australia. This federation, established in 1901, today has six states, a capital territory, a northern region, and seven administered territories. The two largest states, Victoria and New South Wales, contain 60 percent of the population. The legislative division of powers is more like that of the United States than Canada, and the country's highly centralized governance results in federal revenues that are approximately 69 percent of the total federal, state, and local revenues, compared to Canada's 47 percent.

The element of Australia's equalization structure that has drawn the most attention and research is its Commonwealth Grants Commission, established in 1933 in response to general unhappiness and a threat of separation by Western Australia. In addition to providing equalization entitlements based on fiscal capacity deficiencies, much as the Canadian system does, the commission evaluates and makes recommendations about whether a state operates at an average level of efficiency; also taken into account in recommending the overall equalization grants are the different expenditure needs of each region.

Glue or Corrosion?

Equalization is an expression of goodwill from Canadians to other Canadians. It is not a specific commitment, notwithstanding the embodiment of a reference to equalization in the Constitution Act, 1982. The language of the constitution reflects the practicality of Canadians and the conventions, policies, and programs that have been put in place over the past 133 years. It is a powerful demonstration of how sharing Canadians are from region to region.

But was equalization designed to be a permanent financial program? If it is meant to ensure comparable public service standards at comparable taxation levels, it is, in fact, ensuring that the only way equalization-receiving provinces will ever be comparable is through subsidization by other Canadians. The equalization formula includes no incentives to exceed comparable standards. By focusing on averages and providing little incentive to promote economic growth or more prudently manage public services, the program's philosophy is one of equalizing the shortfall.

Today, 44 years after equalization was introduced, the Atlantic provinces are equalized at approximately 98 percent of national per capita tax revenue standards (see Table A.3 in the Appendix). Unfortunately, these provinces generate only 56 to 63 percent of their revenue from their own sources. The balance comes from federal government equalization payments and other federal programs, such as the Canada Health and Social Transfer (CHST). Table 10 sets out the huge fiscal relevance these major federal-provincial transfer programs have for the Atlantic provinces.

Table 10: Major Federal-Provincial Transfers, Atlantic Provinces, 1999/2000

	Newfoundland	PEI	Nova Scotia	New Brunswick
		(millions of dollars)		
Equalization[a] ($)	1,041	232	1,240	1,123
CHST ($)	521	130	891	711
Total[b]	1,460	338	2,012	1,713
% of total revenues	43	41	40	37

[a] These amounts do not quite match those in Tables 3 and A.1. The reason may be differences in the timing of the data or perhaps the double counting mentioned in note b.
[b] Total is adjusted to eliminate double counting equalization payments in transfers under both equalization and the CHST.

Source: "Major Federal Transfers to Provinces and Territories," Canada, Department of Finance, www.fin.gc.ca, accessed January 2001.

Given the size of these transfers and the fact that the ratio of equalization payments to own-source revenues has changed little in the receiving provinces over the past quarter century (see Table A.2 in the Appendix), the often-heard expression "equalization is the glue that keeps Canada together" may actually mean that by being unconditional and nonaccountable and by growing automatically because of other provincial economies, equalization payments have become the glue that is preventing the receiving provinces from achieving their potential. No one can doubt that the provinces' incentives and motivation for self-reliance are dulled by the current nature and management of the equalization program. Furthermore, over the decades, the equalization program has become a managed formula through innumerable ad hoc changes, technical adjustments and re-definitions, and political bargaining. For example, the two most recent program renewals have been more of the tinkering variety, rather than based on a fundamental redesign to achieve a set of objectives suited to Canada in the new millennium.

The worldwide movement toward decentralization is bringing equalization to a new level of importance in Canada. It is more, rather than less important that, as our central institution are redesigned and restructured, the principles on which the nation was founded be reinforced. Doing so may mean reinventing and restructuring equalization, together with other fiscal and economic policymaking, to ensure that the regions have sufficient opportunities and incentives to achieve self-dependence in the new political environment.

SECTION 5: SHOULD EQUALIZATION BE REFORMED?

The primary economic assumption of this section is that as economic growth occurs, equalization should become less necessary.

One might take a more radical position by asking, if equalization did not exist, would we invent it today? The answer to this question is easier to deal with than the issue of reform or reinvention. Canada is a modern, strong, and economically successful federal nation. Its nation-building philosophy is based on a foundation of cooperation and sharing by its citizens and its governments. It is a nation of equals from coast to coast. These values have existed since before Confederation, and in the early days it was Eastern Canada that contributed to economic growth in Central Canada and later to Western Canada. The long cycles of regional development have seen rises and falls in almost all provinces during the past 133 years. Evidence of this is that Alberta and British Columbia received equalization in the late 1950s and early 1960s, and that Ontario would have received equalization payments in the late 1970s and early 1980s had the federal government not introduced ad hoc amendments to the fiscal arrangements act to ensure that that wealthy province remained ineligible.

Therefore, eliminating Canada's equalization program is not currently an option. Yet it should not continue as it is today.

Three Important Trends

Three major trends have influenced the economic landscape and the division of wealth and jobs that exist in Canada today. In combination, they raise a number of fundamental challenges to the fiscal relationships that have characterized Canada during the past half-century. They also influence and interact with the political evolution that has been taking place.

The first of these trends is Canada's continual shift to highly decentralized governance. Ironically, the move was speeded by the introduction of Established Program Financing and the Canada Assistance Plan, which transferred federal PIT and CIT points to the provinces as well as creating new cost-shared programs in health care, social assistance and postsecondary education. Negotiations between the federal governments and the provinces continued through the 1970s, 1980s and 1990s. Partly because of federal financial necessities in the mid-1990s and partly because of specific provincial requests, many new or additional responsibilities, such as training, transportation, and some immigration responsibilities, were shifted from the federal government to the provinces. At the same time, demand for public services primarily in the domain of the provinces, such as health care and education, has grown; so has their cost. Compounding the impact of increased provincial expenditures is the reality that the federal government's revenue sources are growing rapidly, while the finances of most provinces are constrained by legislative jurisdiction or practical limitations on taxation levels.

The second major economic trend is the significant growth in employment and in government revenues from the oil and gas sector since the first sharp increase in world energy prices in the early 1970s. Although the energy industry has been especially volatile during the past three decades, its explosion has doubtless created fundamental change in both the Canadian and the international economies. For example, Saskatchewan's natural resource revenues and its strong economy enabled the province to get off equalization during the five-year period of 1981/82 through 1985/86. It subsequently slipped back into becoming a receiving province, but it almost eliminated equalization in 1999/2000 (payments to it were only 1.4 percent of GDP) because its fiscal capacity excesses in oil and gas were estimated at over $400 million.

Also, for 1999/2000, British Columbia was projecting oil and gas excesses of over $300 million. However, British Columbia, Ontario, and Alberta are not eligible to receive equalization. And Alberta is not in the five-province standard, so its enormous oil and gas revenues do not enter the equalization formula. Thus, the net equalization cost to the federal government from rapid oil and gas price increases and large production volumes has actually been modest during most of the past three decades.

When these booms threatened to create a major increase in entitlements, the federal government changed the equalization formula. Today, not surprisingly, the equalization-receiving provinces are arguing for a return to the 10-province standard. If this change occurs, Ottawa's total equalization payments in 2001/02 will be approximately $3 billion to $4 billion higher due to Alberta's fiscal excesses in oil and gas.

Because natural resource revenues are so large and because so much of these tax bases are under provincial jurisdiction, they have the potential to whipsaw the federal treasury. On the one hand, they increase the RTS and fiscal capacity deficiencies of most provinces, yet they generate very little revenue to the federal treasury to offset the increased equalization payments resulting from higher provincial natural resource revenues. The same is true about the equalization effects of forestry and minerals, but revenues from them are neither as large nor as volatile as those from oil and gas.

The third trend is that Ontario is the continued prime beneficiary of the special relationship with the United States. The Auto Pact and the North American Free Trade Agreement have had profoundly expansionary and economically beneficial effects as demonstrated by the fact per capita GDP in Ontario was an estimated $34,451 in 1999 or 110% of the national average. Alberta led the nation with per capita GDP of $39,537 or 126 percent of the average, primarily because of the economic impact of its natural resources. In contrast, Quebec stood at $27,767 per capita or 88 percent of the average, and Nova Scotia's per capita GDP was $23,863 or 76 percent.

Since Alberta is not in the five-province standard, Ontario is the economic engine that drives the equalization formula. But this power is beginning to create mixed results. Ontario's strong fiscal capacity lifts equalization entitlements, while its economic size and performance relative to other provinces continues to widen. On the other hand, the lowering of taxation levels in Ontario and other provinces will have the future effect of slowing growth in entitlements relative to GDP. The implications of increasing divergence in provincial taxation systems is becoming a concern for the equalization-receiving provinces in Canada.

Given these three trends, I expect that the increasingly favourable taxation levels and economic performances in Ontario and Alberta, together with the net fiscal benefits (the standard and quantity of public services and comparative levels of taxation) that these two provinces' citizens will enjoy will become a major consideration in maintaining the equality principles of Canada as a nation.

These trends recast the question, what is the purpose of equalization in a federal state like Canada? Is it to redistribute some of the federal government's tax revenues to the provinces, using a model that permits them to have enough annual cash to carry out their legislative responsibilities to their citizens? Or is it to provide the fiscal incentives and means for receiving provinces to close the gaps just referred to and increase their reliance on their own sources?

Thus, the central thesis of this essay is that an acceleration of economic growth in the equalization-receiving provinces is the only way the country can overcome the widening gaps in taxation levels and eventually in standards of living. To achieve this goal, the federal government must provide innovative fiscal leadership, including undertaking significant reforms to the equalization program.

Options for Reforming Equalization

The biggest challenge for the four Atlantic provinces in achieving long-term economic independence from federal transfer payments is the fact that each of them relies on equalization payments for approximately 25 percent of its total annual revenues, a percentage that has been relatively constant for decades. Any reform proposal or new economic arrangement must be designed with a realistic transitional plan to bridge the time it takes for new economic strategies and federal fiscal arrangement reforms to significantly reduce or wean receiving provinces from equalization and its dependency side effects.

The critical assumption for any reformed equalization program is that individuals who are given the opportunity, together with appropriate incentives, will create a culture of self-reliance. The requirements are leadership, openness, and a belief that hard work and innovation will be rewarded, not confiscated. Also needed is a partnership among the various parties in society: individuals, governments, unions, and businesses.

Only the federal government has control over enough financial resources to ensure a serious effort at equalization reform that has any probability of succeeding and to bridge the transitional period of any adopted plan. What is required is a change of attitude and strategic direction by the national government, away from one of controlling, tinkering, and managing the equalization formula and toward a renewed partnership of setting, together with the provinces that choose to participate, long-term economic growth objectives and then implementing the fundamental policy changes required for their achievement.

Following are three options for such a reform.

Solving the Taxback Dilemma

One of the consequences of the equalization formula's managed nature, compared to consistent adherence to the program's original principles, has been the creation of the generic 70:30 taxback described earlier. This rule applies to any province that has 70 percent or more of a particular tax base source and results in the federal government's reducing its equalization payments by 70 percent of the entitlements associated with that revenue source.

To date, this taxback has applied five times to natural resources: Quebec's asbestos (later redefined and eliminated as a generic taxback); Saskatchewan's potash and, as of 2000, its heavy third-tier oil revenues; Newfoundland's offshore oil; and Nova Scotia's offshore gas. In the April 1, 1999 equalization program renewal, the minerals tax bases were redefined; potash is now grouped with asbestos, uranium, and other minerals and is no longer a separate category, thereby eliminating its taxback status.

The intent of the generic taxback is laudable: allowing 30 percent of these revenues to remain outside the equalization provides a province some degree of incentive to pursue economically driven development policies. This approach is preferable to tax policies that are overly influenced by political factors and short-term judgements against a project or sector because they result in a high proportional reduction in equalization entitlements. (A current example of this disincentive is the drawn-out negotiations between Newfoundland and INCO over potential major nickel development in Labrador, which have been postponed partly because equalization reductions from mining royalties and other taxes are taxed back at such a high percentage—estimated at almost 90 percent.)

Nevertheless, since the generic taxback policy is only ever likely to apply to natural resources, it has an inherent unfairness in its outcome.

For example, the taxback on offshore oil and gas applies to the province's revenues received from royalties, corporate income taxes, and other fees and licences. These moneys are economic rents or the public's return on investment from a depleting or nonrenewable natural resource. In an ironic twist of fate, two of Canada's economically weakest provinces, Newfoundland and Nova Scotia, will generate billions of dollars of energy-related economic rents over the next several decades, yet in the absence of new intergovernment fiscal policies, they are likely to lag further behind other provinces and be the recipients of even larger equalization payments than they receive today. Since the federal government will also be getting its regular share of the corporate taxes generated by petroleum sector businesses, the inequitable outcome will be even further exacerbated, providing Ottawa with more than 80 percent of the projected economic rents on resources offshore of Newfoundland and Nova Scotia.

Yet those offshore economic rents offer Newfoundland and Nova Scotia their single largest opportunity for breaking the cycle of dependence on federal transfers. To allow the taxback situation to evolve as currently projected would be an injustice inconsistent with both the principles of equalization and the national objectives of promoting equal opportunities for all Canadians by furthering economic development to reduce disparity in opportunities.

To solve the inequities and disincentives associated with Newfoundland's and Nova Scotia's not receiving the primary benefits from these resources, I propose a fundamental change to the treatment of oil and gas revenues under equalization. Removing all oil and gas tax bases from the equalization formula and changing back to a 10-province standard for the remaining 22 tax bases would eliminate the decades-old struggle over natural resources. Economic rents (and their volatility) would rest with the constitutional owners of natural resources, the provinces. This outcome would be consistent with the federal government's lack of direct access to these revenues under the constitution.

Preliminary calculations indicate that this narrower 10-province standard would produce total equalization entitlements similar to those received today but with much less volatility. Saskatchewan's payments would be larger, while the six other receiving provinces' would be somewhat smaller. A transitional period of at least 10 years would ensure that provinces would be no worse off under this system than the current one. (This kind of transition formula has been used with the introduction of past changes. For example, the existing 1999 program renewal has such a transitional model.)

This proposed reform to the equalization structure would provide all current and future oil- and gas-producing provinces—Newfoundland and Nova Scotia in particular—with fiscal incentives to accelerate their economic self-reliance.

As an alternative and at a minimum, the federal government should adjust the taxback percentage for Newfoundland's and Nova Scotia's offshore petroleum revenues from 70:30 to one that offers these provinces most, if not all, of the economic rents. As in the differential taxation option reform described below, any changes in economic rents could be conditional upon a province's putting in place an economic strategy that significantly reduces its PIT and CIT, increases investment in infrastructure, such as transportation, training, and education, and encourages the establishment of a strong cultural of self-reliance and cooperation among individuals, businesses, governments, and unions.

The billions of dollars of increased economic rents shared with Newfoundland and Nova Scotia under either form of this proposal would expand to spinoffs in other sectors of the provinces' economies and increase provincial and federal government revenues generally. Over a transitional period of 10 to 20 years, these reforms of the treatment of oil and gas revenues should cause equalization payments to decline significantly as a percentage of provincial revenues.

Identifying Selective Needs

Canada's revenue-based fiscal capacity model does a reasonably good job of addressing disparities in what has become one the most decentralized federal states in the world. However, the nature of the fiscal gaps and the rapidly changing economic and fiscal landscape among provinces threaten to further widen the disparities and leave many provinces stranded in a state of higher dependency.

An important element of the equalization program when it was introduced in 1957 was the assumption that the overall per capita costs of public services were generally equal across the 10 provinces and their governments. In effect, standardized per capita revenues could represent the expenditure needs of the provinces.

But what has happened since 1957? First, the revenue sources of all provinces across Canada have changed dramatically because of the growth and diversification of their economies, especially in the natural resources and service sectors. Second, provincial taxation systems have become less harmonized in recent years. Thirdly, provincial and local governments' requirements for public service infrastructure and the proliferation of program spending have increased substantially.

The result is an underlying flaw in the revenue-based fiscal capacity model because it does not permit the principle of equal per capita costs of public services to be directly factored into calculating equalization entitlements. This weakness is compounded by the fact that no one has benchmarked program costs and infrastructure status among Canadian provinces. Therefore, variances have placed some provinces at a serious disadvantage.

Interestingly, the fiscal arrangements between the federal government and the three northern territories do have a degree of expenditure-needs assessment built into their annual equalization-like program. Furthermore, the funding and financial relationships between many provinces and their local governments are often partly based on measuring expenditure needs. The Australian model referred to earlier includes a comprehensive expenditures component and is administered by an independent commission.

What should Canada do? To create an equalization model that took full account of both fiscal capacity and expenditure needs would be very complex, possibly too expensive, and likely not saleable to the provinces or the federal government. An alternative, however, is to introduce selective expenditures into the formula by measuring "needs capacities" for those policy areas that would enhance a province's ability to accelerate its economic growth. For example, certain education and training standards are essential to labour productivity and innovation; health care and wellness are mandatory for a growing economy; and modern, efficient, and safe transportation systems are critical components of a competitive domestic and export-trading system. These selected public services could be measured and appropriate national benchmark “unit costs” established to calculate relative provincial expenditure needs. (Preferably, this approach should be designed and managed by an independent commission along the Australian model.) The objective would be to build into the equalization formula explicit recognition of differences in public costs throughout Canada because of demographics, geography, population densities, and the condition of economically important infrastructure.

Redistributing Income Tax Revenues

A third option for change is not a direct adjustment to the equalization system but a rearrangement of the federal and provincial shares of the income tax fields. Such an innovation could have large and beneficial effects, by lessening provinces’ need for more revenues from federal transfers.

The PIT and the CIT are two of the country’s dominant revenue sources. These revenues would be the main components of any federal government strategy to ensure Canadians do not have dysfunctional disparities in the public services provided by the various levels of government.

Many economists have argued for decades for income tax harmonization between the federal government and the provinces. Of course, Canada’s tax-collection system has been generally efficient and predictable and has provided competitive balance in taxation rates, both personally and corporately, resulting in a high degree of certainty for individuals and businesses across the country. The system has also operated with minimum collection and compliance costs.

This taxation order is, however, in rapid transition from uniformity to a model tailored to provincial priorities. Provinces are changing the methods of calculating their PIT rates; consider, for example, Alberta’s move, in January 2001, to a single 10.0 percent flat-tax method and Ontario’s new, albeit short-lived policy of having a capital gains rate different from that of the federal government and most other provinces. In addition, the decision by most provinces to change the PIT calculation from a rate applied to the federal government’s tax amount ("tax on tax") to a stand-alone tax on income is almost certainly the beginning of wider deharmonization and abandonment of the current tax collection system operated by the federal government. If these reforms occur, they will eventually translate to significant changes in the RTS that underlies the equalization formula.

Redesigning the federal and provincial PIT and CIT systems provides an opportunity to address the failure of equalization and other transfer programs to fundamentally narrow the disparities within the Canadian federation. Without innovative and real changes to the system, most of the receiving provinces in the future will depend even more on equalization and other transfer programs, given the economic and taxation trends in motion across Canada.

The central issue is how to accelerate economic growth in the lagging provinces at a rate greater than the rate of growth in the currently better-performing provinces. Recent examples of economies that have closed their performance gaps indicate that lower taxation levels, competitive labour rates and productivity indices, a strong private sector, and a cohesive approach to setting economic goals by government, business, and unions have been the key ingredients to success. (See e.g. *Road to Growth* by Fred McMahon, published by the Atlantic Institute for Market Studies, 2000).

One reform option is for the federal government to transfer a number of PIT and CIT points to those equalization-receiving provinces that develop an acceptable long-term strategic plan for significantly improving their own economies. This program would contain conditions, such as at least 50 percent of the benefits' being passed on directly to individual taxpayers and corporations by way of tax reductions, plus an acceptable plan for improved economic development infrastructure in transportation, training, and education. The transfer of federal tax points should be for a fairly long time—say 15 to 20 years or possibly longer—to permit structural and cultural changes to be implemented and show results. During this transitional period, the revenues equal to transferred tax points would be excluded from equalization tax bases and thereby not lower annual payments.

The objective of such a differentiated taxation policy would be to accelerate economic growth and transition in a participating province or region so that it became much less dependent on transfer programs such as equalization. For example, using 1999-2000 estimates, if the tax-transfer incentive were 10 PIT points in each of the Atlantic provinces, it would result in the region's retaining approximately \$455 million additional taxation revenues during year one (\$195 million in Nova Scotia, \$145 million in New Brunswick, \$90 million in Newfoundland, and \$25 million in Prince Edward Island). One could hope that after 15 or 20 years, the provinces' economies would require much lower equalization payments and be on a path to eliminating them.

Moreover, a meaningful tax transfer program would enable a province or region to become a more tax-friendly environment, to be nationally and internationally more competitive, and thereby to retain its younger skilled workers while attracting new people and businesses. It would rejuvenate the spirit and confidence of citizens generally and emphasize the leadership roles required of individuals and businesses if their communities are to achieve self-reliance.

Like the European Union model for structural policy reform, such a differential tax program would be aimed at reducing the development gaps and promoting economic and social cohesion within the Canadian federation. Targets such as per capita GDP, skills and education achievements, employment rates, taxation levels, and other economic indicators could be developed as benchmarks for evaluation and accountability and as aids to defining the transitional mechanisms along the path to self-sufficiency.

SECTION 6
CONCLUSION

Issues such as the nature and amount of intergovernmental transfers, the design of equalization policies, and the control and accountability of public expenditures and revenues are currently at the forefront of political debate in many countries. Fiscal relations have become very complex, making it a difficult challenge to develop policies that enable the sound governance of national priorities while permitting and fostering independence, innovation, and accountability at the provincial and local levels of government.

Canada's challenges are similar to those of other nations around the world. Its equalization program has been the cornerstone of the relationship between the federal government and the provinces for 44 years and has financed fiscal and social disparities across a geographic and politically diverse country. But for a number of provinces, the price has been increased dependence on federal transfers. This price will increase dramatically if economic gaps among provinces continue to widen and if taxation systems are radically redesigned and tax burdens on Canadians are no longer similar from province to province.

Furthermore, several important trends will increase the uncertainty about equalization entitlements. For instance, as already explained, the most significant impact on payments is the population adjustment. The past four decades have seen a steady decline in the relative populations of most of the seven receiving provinces, a trend that is not showing any signs of reversal.

Finally, the decentralization of governance, both at the federal/provincial level and at the provincial/local levels could have significant future implications for equalization and other fiscal arrangements. Decentralization changes attitudes and often levels of government's actual responsibilities for various programs and services. If Canada were a unitary nation, its governance and its responsibilities to its citizens would differ greatly from those it has under the present form of federalism. Each citizen would expect similar taxation burdens, equal standards of public services, and a national standard for much of government's policies. In fact, this is what happens within provinces, which themselves have unitary governments.

Canada's equalization program is in need of significant reform, and it should begin immediately. The strategic focus of a reformed system should be the acceleration of the economic growth in the lagging and fiscally disparate provinces. I recommend that it be achieved through the introduction of one or more innovative economic strategies by the federal government: altering (or removing) the disincentive built into the 70:30 taxback of economic rents on offshore oil and gas; moving to differential tax rates; or removing oil and gas revenues from the formula and returning to a 10-province standard. These actions should be based on the adoption of long-term provincial economic plans that include immediate reductions in personal and corporate taxation levels and increased spending and investment in economic leveraging sectors, such as transportation, training, and education.

The status quo is not an option if Canada is to maintain its competitive position in an increasingly competitive global economy. Without early and fundamental changes to the equalization program, this cornerstone of federalism and fiscal arrangements as we have known it could cease to be recognized as a milestone by other nations and become Canada's fiscal millstone.

Appendix 1: Tables

Table A.1: Equalization Entitlements by Province, 1957–2000

	Nfld	PEI	NS	NB	Que	Ont	Man	Sask	Alta	BC	Total
					(millions of current dollars)						
1957/58	11.8	3.1	17.2	8.6	46.3		14.2	20.3	12.0	5.5	139.1
1958/59	20.1	5.6	26.3	22.6	63.3	—	13.5	20.4	13.4	6.7	191.9
1959/60	22.1	6.0	27.9	24.6	78.1	—	14.8	23.5	16.4	5.9	219.4
1960/61	20.3	5.6	25.9	24.0	69.9	—	13.3	21.9	15.4	6.1	202.2
1961/62	21.0	5.4	26.3	24.1	72.7	—	13.4	23.3	14.3	5.6	206.0
1962/63	24.0	6.9	29.1	25.5	68.8	—	13.7	22.9	12.3	—	203.3
1963/64	23.8	7.2	31.3	27.0	65.3	—	12.9	21.9	7.1	—	196.5
1964/65	27.1	8.1	37.7	33.0	96.1	—	18.7	22.0	1.2	—	243.9
1965/66	34.9	9.5	43.8	39.9	133.1	—	27.2	29.2	—	—	317.6
1966/67	39.2	10.5	47.9	44.2	151.3	—	30.5	31.4	—	—	355.0
1967/68	65.7	14.2	75.1	63.6	268.7	—	39.9	25.1	—	—	552.3
1968/69	73.2	16.2	84.0	71.8	386.6	—	49.3	26.4	—	—	707.5
1969/70	95.7	19.5	96.8	88.0	430.7	—	52.6	66.1	—	—	849.3
1970/71	97.3	19.9	99.5	93.1	420.1	—	54.7	99.0	—	—	883.6
1971/72	105.2	20.0	107.6	93.0	453.3	—	72.0	88.8	—	—	939.8
1972/73	113.7	25.1	123.9	103.2	534.3	—	68.1	102.0	—	—	1,070.4
1973/74	156.0	33.3	186.0	146.3	737.1	—	112.6	116.2	—	—	1,487.4
1974/75	174.7	42.5	232.0	168.5	918.4	—	124.5	50.6	—	—	1,711.3
1975/76	189.1	47.7	252.0	187.4	1,049.4	—	150.8	—	—	—	1,876.5
1976/77	229.2	54.4	298.1	232.4	1,062.9	—	153.3	10.4	—	—	2,040.7
1977/78	278.1	62.9	342.1	273.3	1,322.0	—	236.5	58.2	—	—	2,573.1
1978/79	321.2	71.6	375.4	331.3	1,482.8	—	291.7	32.7	—	—	2,906.7
1979/80	344.2	80.8	427.5	310.3	1,766.2	—	343.5	73.5	—	—	3,346.0
1980/81	363.8	91.9	468.7	370.4	2,034.9	—	368.1	29.6	—	—	3,727.4
1981/82	426.8	107.0	527.6	445.2	2,489.9	—	398.6	—	—	—	4,395.1
1982/83	464.0	118.0	574.0	488.2	2,781.9	—	439.1	—	—	—	4,865.1
1983/84	539.5	125.3	605.0	516.8	2,976.6	—	466.1	—	—	—	5,229.3
1984/85	578.4	129.0	620.4	540.5	3,074.0	—	479.6	—	—	—	5,421.8
1985/86	653.2	134.0	596.4	603.8	2,727.9	—	427.3	—	—	—	5,142.6
1986/87	677.7	137.9	619.5	642.6	2,941.6	—	471.1	284.7	—	—	5,775.1
1987/88	807.0	163.3	733.5	723.5	3,151.2	—	727.4	299.1	—	—	6,604.9
1988/89	838.7	177.1	835.0	771.1	3,392.5	—	794.9	457.4	—	—	7,266.8
1989/90	895.1	192.0	885.3	884.1	3,354.5	—	957.7	638.9	—	—	7,807.6
1990/91	918.6	194.2	948.8	868.0	3,626.9	—	914.5	530.9	—	—	8,002.0
1991/92	874.3	186.4	850.2	966.8	3,464.1	—	852.7	478.9	—	—	7,673.5
1992/93	886.5	167.9	907.9	870.1	3,588.9	—	872.1	490.5	—	—	7,783.8
1993/94	899.8	174.7	888.7	834.5	3,878.0	—	901.4	486.2	—	—	8,063.3
1994/95	958.6	192.0	1,066.4	927.8	3,966.3	—	1,085.0	413.3	—	—	8,609.3
1995/96	932.2	192.2	1,136.9	876.2	4,306.7	—	1,050.9	264.0	—	—	8,759.1
1996/97	1029.7	208.3	1,182.3	1019.4	4,168.5	—	1,126.4	224.4	—	—	8,959.1
1997/98	1093.4	238.5	1,302.2	1112.7	4,747.1	—	1,053.9	195.9	—	—	9,743.8
1998/99	1043.6	231.6	1,186.5	1120.4	4,462.4	—	1,080.6	481.8	—	—	9,606.9
1999/00	1050.5	240.6	1,260.2	1152.0	4,589.0	—	1,113.7	388.4	—	—	9,794.4

Source: Canada, Department of Finance.

Table A.2: Indices of Provincial-Local Fiscal Capacity for Own-Source Revenues, 1972/73 to 2000/01

	Nfld	PEI	NS	NB	Que	Ont	Man	Sask	Alta	BC	Standard	Receiving Provinces	All
1972/73	62.1	60.7	72.4	70.6	85.1	109.6	89.9	87.2	132.8	121.3	100.6	82.4	100.0
1973/74	62.7	61.5	70.8	70.2	84.3	107.3	87.4	89.2	141.2	125.2	99.9	81.6	100.0
1974/75	62.5	58.6	67.2	68.9	81.1	102.3	85.1	104.1	182.3	116.2	96.2	80.4	100.0
1975/76	59.7	57.6	66.1	67.8	80.0	98.5	83.9	112.0	206.5	111.5	94.0	76.8	100.0
1976/77	59.0	58.1	65.8	66.9	81.8	98.4	84.1	107.3	200.0	112.7	94.4	80.5	100.0
1977/78	57.3	57.0	64.6	65.2	79.5	95.1	79.7	103.7	221.3	115.1	92.2	78.1	100.0
1978/79	56.6	56.5	65.4	62.9	79.3	93.6	77.8	108.2	223.3	115.5	91.7	78.1	100.0
1979/80	57.6	55.3	64.0	67.2	77.1	91.3	75.7	105.6	231.3	120.1	90.4	76.5	100.0
1980/81	56.8	53.4	63.4	64.4	76.6	91.0	75.7	113.4	229.7	117.6	90.2	76.6	100.0
1981/82	57.2	54.2	65.5	64.5	76.9	93.9	78.3	108.8	219.7	111.4	90.7	73.7	100.0
1982/83	59.9	58.1	69.2	66.6	76.8	95.7	81.0	106.2	211.0	107.7	91.0	74.6	100.0
1983/84	58.8	60.0	71.1	66.5	77.5	97.2	80.6	108.2	204.2	105.6	91.7	75.2	100.0
1984/85	58.6	60.2	72.0	66.5	78.6	97.3	79.6	109.3	207.0	100.7	91.5	75.9	100.0
1985/86	57.9	60.3	72.0	66.9	80.2	100.5	80.7	103.4	193.7	99.8	93.0	77.0	100.0
1986/87	62.7	65.8	77.1	71.3	84.8	108.7	85.1	89.8	144.1	102.8	98.1	82.4	100.0
1987/88	60.4	64.1	76.0	71.2	85.4	108.2	80.2	90.3	145.6	103.9	98.1	82.1	100.0
1988/89	62.6	64.9	75.3	72.1	85.8	109.8	80.4	87.2	136.5	105.4	99.1	82.2	100.0
1989/90	62.2	64.2	74.8	69.6	85.8	111.4	77.4	82.8	131.5	107.1	99.7	81.3	100.0
1990/91	62.8	65.4	74.6	71.6	85.7	109.0	79.2	85.7	136.4	107.4	99.0	81.9	100.0
1991/92	65.8	67.7	78.7	70.6	88.3	106.3	82.2	88.6	132.8	108.6	99.2	84.5	100.0
1992/93	65.7	71.1	77.5	75.0	88.1	105.8	82.0	88.4	132.1	109.8	99.1	84.5	100.0
1993/94	66.0	70.8	78.2	75.1	86.9	104.0	81.4	88.1	139.3	111.5	98.2	83.8	100.0
1994/95	65.2	69.6	75.3	73.6	87.2	103.0	78.9	92.0	142.1	112.5	98.0	83.7	100.0
1995/96	67.3	71.2	75.2	76.3	87.3	104.0	80.7	93.5	136.1	111.4	98.6	84.4	100.0
1996/97	64.0	69.6	74.4	72.9	87.3	103.5	79.5	96.1	143.4	107.4	97.9	84.0	100.0
1997/98	63.0	67.0	73.2	71.8	86.4	105.2	81.5	94.6	142.8	104.3	98.0	83.4	100.0
1998/99	64.7	68.5	76.1	72.2	87.7	107.2	81.7	90.2	135.8	100.5	98.5	84.2	100.0
1999/00	64.3	67.7	74.6	71.5	86.9	105.8	80.9	92.9	143.4	99.7	97.6	83.7	100.0
2000/01	64.5	68.2	75.0	72.0	87.3	105.9	81.6	92.5	141.1	99.4	97.8	84.0	100.0

Source: Department of Finance, Federal-Provincial Relations Division.

Table A.3: Indices of Provincial-Local Fiscal Capacity for Own-Source Revenues plus Equalization Transfers 1972/73 to 2000/01

	Post-equalization											Pre-equalization	
	NflD	PEI	NS	NB	Que	Ont	Man	Sask	Alta	BC	Receiving Provinces	Standard	All
1972/73	90.3	90.0	92.9	91.8	96.7	109.6	99.0	101.9	132.8	121.3	96.4	100.6	100.0
1973/74	96.2	95.2	97.5	96.3	98.3	107.3	100.5	104.0	141.2	125.2	98.7	99.9	100.0
1974/75	93.3	93.7	94.5	93.5	95.4	102.3	96.9	109.5	182.3	116.2	96.5	96.2	100.0
1975/76	89.6	92.9	92.8	92.2	94.7	98.5	96.8	112.0	206.5	111.5	94.3	94.0	100.0
1976/77	89.8	92.5	92.8	92.6	94.5	98.4	95.4	108.2	200.0	112.7	95.3	94.4	100.0
1977/78	88.8	90.4	90.6	90.6	92.8	95.1	94.3	107.6	221.3	115.1	93.7	92.2	100.0
1978/79	89.1	90.1	90.8	90.2	92.6	93.6	93.8	110.1	223.3	115.5	93.8	91.7	100.0
1979/80	89.1	89.4	90.2	90.3	91.4	91.3	92.9	109.6	231.3	120.1	92.9	90.4	100.0
1980/81	86.6	88.1	89.1	89.1	91.4	91.0	92.3	114.8	229.7	117.6	93.0	90.2	100.0
1981/82	87.8	89.8	90.9	90.5	92.6	93.9	94.1	108.8	219.7	111.4	92.2	90.7	100.0
1982/83	91.3	95.1	95.1	93.4	93.3	95.7	97.3	106.2	211.0	107.7	93.8	91.0	100.0
1983/84	91.7	95.4	95.8	92.2	93.6	97.2	96.2	108.2	204.2	105.6	93.9	91.7	100.0
1984/85	91.5	93.9	95.5	91.5	94.1	97.3	94.5	109.3	207.0	100.7	93.9	91.5	100.0
1985/86	93.0	93.0	93.0	93.0	93.0	100.5	93.0	103.4	193.6	99.8	93.0	93.0	100.0
1986/87	98.1	98.1	98.1	98.1	98.1	108.7	98.1	98.1	144.1	102.8	98.1	98.1	100.0
1987/88	98.1	98.1	98.1	98.1	98.1	108.2	98.1	98.1	145.6	103.9	98.1	98.1	100.0
1988/89	98.0	98.0	98.0	98.0	98.0	109.8	98.0	98.0	136.6	105.4	98.0	99.1	100.0
1989/90	96.9	96.9	96.9	96.9	96.9	111.4	96.9	96.9	131.5	107.1	96.9	99.7	100.0
1990/91	97.0	97.0	97.0	97.0	97.0	109.0	97.0	97.0	136.4	107.4	97.0	99.0	100.0
1991/92	99.2	99.2	99.2	99.2	99.2	106.3	99.2	99.2	132.8	108.6	99.2	99.2	100.0
1992/93	99.1	99.1	99.1	100.3	99.1	105.8	99.1	99.1	132.1	109.8	99.2	99.1	100.0
1993/94	98.1	98.1	98.1	98.1	98.1	104.0	98.1	98.1	139.3	111.5	98.1	98.2	100.0
1994/95	98.0	98.0	98.0	98.0	98.0	103.0	98.0	100.1	142.1	112.5	98.2	98.0	100.0
1995/96	98.6	98.6	98.6	98.6	98.6	104.0	98.6	98.6	136.1	111.4	98.6	98.6	100.0
1996/97	97.9	97.9	97.9	97.9	97.9	103.5	97.9	100.2	143.4	107.4	98.1	97.9	100.0
1997/98	98.0	98.0	98.0	98.0	98.0	105.2	98.0	98.0	142.8	104.3	98.0	98.0	100.0
1998/99	98.5	98.5	98.5	98.5	98.5	107.2	98.5	98.5	135.8	100.5	98.5	98.5	100.0
1999/00	97.6	97.6	97.6	97.6	97.6	105.8	97.6	99.4	143.4	99.7	97.8	97.7	100.0
2000/01	97.8	97.8	97.8	97.8	97.8	105.9	97.8	97.8	141.1	99.4	97.8	97.8	100.0

Source: Department of Finance, Federal-Provincial Relations Division.

Table A.4: Indices of Provincial-Local Tax Effort for all Own-Source Revenues 1972/73 to 2000/01

	Nfld	PEI	NS	NB	Que	Ont	Man	Sask	Alta	BC	Standard	Receiving Provinces	All
1972-73	84.2	109.3	98.3	89.6	111.4	101.4	102.7	95.8	84.5	90.7	102.4	105.8	100.0
1973-74	86.8	105.8	99.1	92.5	111.6	100.7	96.9	95.3	86.4	93.5	102.2	105.5	100.0
1974-75	88.0	97.0	95.0	87.1	114.2	99.4	98.0	102.2	86.3	96.4	103.1	107.1	100.0
1975-76	100.9	107.2	97.5	93.6	116.3	99.0	101.7	100.7	78.5	102.9	104.7	110.9	100.0
1976-77	105.3	94.9	93.6	89.7	116.3	98.4	104.4	99.7	79.0	103.8	104.7	109.5	100.0
1977-78	102.8	95.7	89.6	83.7	120.8	99.5	97.3	100.7	81.0	98.2	105.3	111.1	100.0
1978-79	101.4	94.0	89.1	91.4	120.4	100.0	95.1	98.3	83.0	96.2	104.8	110.6	100.0
1979-80	107.1	94.0	93.1	85.1	117.2	104.4	97.4	101.0	79.8	96.1	106.0	109.2	100.0
1980-81	114.3	101.5	95.1	90.2	121.7	101.8	97.3	101.8	80.1	93.7	105.7	112.7	100.0
1981-82	106.5	100.7	91.5	88.1	125.2	99.3	91.2	93.9	77.9	103.7	106.5	115.3	100.0
1982-83	104.5	92.6	94.4	85.0	127.0	101.2	96.1	102.2	74.2	97.4	107.4	116.7	100.0
1983-84	103.7	95.9	92.9	92.7	124.3	98.2	105.2	96.7	79.9	98.5	105.6	116.3	100.0
1984-85	102.0	93.7	93.4	95.7	122.5	100.7	104.2	93.1	77.4	99.2	106.2	115.1	100.0
1985-86	107.1	93.0	95.7	98.7	123.6	100.2	104.4	99.1	74.1	97.1	106.3	116.5	100.0
1986-87	103.9	88.0	92.7	94.2	122.3	100.6	104.3	100.7	68.3	93.9	105.7	113.4	100.0
1987-88	108.1	95.2	95.4	96.0	119.7	97.9	114.8	103.4	76.4	92.9	104.1	113.8	100.0
1988-89	99.0	95.0	93.6	95.8	115.2	100.6	112.5	110.2	71.7	95.9	104.8	110.9	100.0
1989-90	100.5	92.5	92.0	99.7	111.0	101.9	109.5	123.1	74.0	93.5	104.2	109.3	100.0
1990-91	100.6	92.3	93.1	95.7	111.8	102.5	103.3	119.4	75.3	93.1	104.2	108.8	100.0
1991-92	103.4	97.4	95.5	100.8	115.9	100.1	104.7	105.7	78.0	91.2	103.4	110.9	100.0
1992-93	103.3	90.6	92.0	90.3	115.9	99.5	104.9	118.9	77.0	93.5	103.9	111.2	100.0
1993-94	100.3	96.7	89.4	94.7	111.7	100.0	107.7	120.9	76.4	99.9	104.3	109.0	100.0
1994-95	100.9	95.7	91.7	97.4	108.7	100.4	109.6	115.4	79.8	100.6	103.6	107.2	100.0
1995-96	104.4	97.7	87.4	95.2	111.2	101.0	108.0	115.0	77.8	97.1	103.9	108.3	100.0
1996-97	108.5	95.5	91.0	103.1	109.0	101.1	107.4	112.5	80.1	98.4	103.4	107.4	100.0
1997-98	100.8	97.2	89.7	95.6	113.0	99.6	103.6	113.8	79.8	99.5	103.8	109.0	100.0
1998-99	101.8	97.4	88.8	93.2	115.8	98.7	109.5	118.8	77.0	97.6	104.2	111.7	100.0
1999-00	110.9	99.0	91.0	97.6	113.7	99.8	111.9	116.2	78.7	95.7	103.9	111.1	100.0
2000-01	104.3	99.8	86.5	96.7	113.8	99.7	112.3	119.0	78.8	96.3	104.1	110.8	100.0

Source: Department of Finance, Federal-Provincial Relations Division.

Appendix II: A Brief History of Equalization

Equalization has travelled a winding road to its current model. The formative thinking came from the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission), which recommended that the federal and provincial governments establish a transfer mechanism to unconditionally redistribute revenues from the richest to the poorer regions of the nation. In those days, the provinces had primary financial responsibility for collection from most major revenue sources. In proposing what the commission called "national adjustment grants," it said:

> They are designed to make it possible for every province to provide for its people services of average Canadian standards and they will thus alleviate distress and shameful conditions which now weaken national unity and handicap many people. They are the concrete expression of the Commission's conception of a federal system which will both preserve a healthy local autonomy and build a stronger and more united nation. ("Recommendations," Book 2, draft, 1939, p. 84.)

During and immediately after the Second World War, the locus of tax collection shifted as the federal government entered into tax rental agreements with eight of the provinces (Ontario and Quebec refused to participate some of the time) and undertook the collection of personal and corporate income taxes and succession duties in return for compensation arrangements with the provinces (10 percent PIT, 9 percent CIT and 50 percent of succession duties). The agreements of 1947 and 1952 promised review after five years, a schedule that carried over in the equalization agreements.

The Program's Beginning

The current structure of equalization was introduced in 1957, using Rowell-Sirois concept of equalizing provincial revenues. The revenues from personal and corporate income taxes and succession duties were to be equalized to the weighted per capita yield of these three tax bases in the two top provinces, Ontario and British Columbia. The federal government was to make annual, unconditional transfer payments to the provinces that fell below that standard. For instance, if Ontario and British Columbia's average revenue from the three sources was $100 per capita and Newfoundland's was $60, the federal government paid Newfoundland the difference between the two amounts, or $40 for each its citizens

Under the 1957 formula, all the provinces except Ontario received equalization payments—an overall total of $139.1 million, of which Newfoundland received $11.8 million. Alberta received payments from 1957 to 1964 and British Columbia from 1957 to 1962.

In the 1962 review, half the three-year average of revenues from provincial natural resources was added to the tax-base calculation. Also, the standard was changed to the 10-province national average, thereby lowering equalization entitlements. But in 1964 a newly elected Liberal government switched back to the average of the two highest provinces. And in 1967, the standard changed yet again—to a weighted average of all 10 provinces—the formula was broadened to contain most provincial tax bases and several quasi-taxes, such as fees for vehicle licences and the volume of wood harvested.

From 1967 to 1982, equalization renewals involved a number of formula changes. The most significant were triggered by the large, unexpected increase in the international prices of oil and gas in the 1970s, which widened fiscal disparities among Canadian provinces. These events so affected equalization entitlements that even Ontario and British Columbia would have been eligible for payments. One result was that the renewal of 1972 and 1977 and ad hoc adjustments in 1974, 1979, and 1980 focused mainly on natural resources.

More Recent Changes

The 1982 renewal contained several fundamental changes.

- The national standard to which provincial revenues were equalized was changed to a weighted average of the five "middle" provinces: Ontario, Saskatchewan, Manitoba, British Columbia, and Quebec. The removal of Alberta solved much of the volatility resulting from the oil and gas tax bases and prevented windfall equalization payments to the receiving provinces at the expense of the federal government's budget. Overall, it lowered the per capita standard and, therefore, equalization payments from most tax bases.

- The natural resources tax base was restored to a definition that includes all revenues.

- The property tax base was expanded to include both municipal and school taxes; the goods and services and miscellaneous sales tax base was broadened to include such revenues raised by local governments.

The 1982 renewal occurred while Canada's Constitution Act, 1982, was being negotiated. And after 25 years of the equalization program's being in place, the federal government set out its general purpose in the new constitution, which states in Section 36(2):

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

Today's equalization formula, renegotiated and renewed for five years effective April 1, 1999, is substantially similar to the one restructured in 1982 (other renewals were 1987, 1992, and for two years, 1994). Most of the changes in the 1999 renewal were technical redefinitions and tinkering, the main objective of which appears to have been containing payments overall growth. For example, the annual ceiling for total entitlements during the five-year period was set at $10.0 billion plus cumulative growth in gross domestic product. The total projected for 1999/2000 was $9.8 billion but is now likely to exceed that amount, and the federal government, after considerable discussion with the provinces, had made an ad hoc lifting of the ceiling for that year.

Appendix III: Other Countries' Equalization Systems

Australia's Commonwealth Grants Commission makes annual recommendations that embody the principle of horizontal equalization to ensure that each state has the capacity to provide the average standard of public services if it makes the same effort to raise revenue as the states on average and it operates at an average level of efficiency. In each state, a commission uses an equalization formula to allocate federal funds to local governments.

Austria's Financial Equalization Act provides for relative stability in fiscal transfers, although it does not prevent ongoing discussion between the Länder (states) and the federal government about revenue distribution in the context of a possible restructuring of competences across levels.

Germany's 16 Länder (states) make equalization grants to municipalities accounting for 28 percent of local revenues. The municipalities also receive allocations for specific purposes, such as investing or running specific local institutions.

Iceland has municipal equalization, which provides block and special grants from the central government to municipalities; the special grants are being directed to those with lower potential for raising revenues.

Mexico has particularly difficult problems of imbalance across the country. It recently created a "municipal promotion fund" to help local bodies with the lowest levels of development to receive support directly from the federal government.

The Netherlands has general grants from the Municipal and Provincial Fund, administered and fed by central government – in part from national tax revenues, the exact percentage being decided each year.

Norway introduced block grants in the 1980s to replace about 50 earmarked grants and become the main instrument for redistributing income. In the 1990s, sector grants were amalgamated into a single expenditure-equalization grant (covering health, transport, and secondary schools for counties and primary schools, culture, health, and social services for municipalities).

Portugal has the central government's Financial Equalization Fund as the principal source of local government revenue (a block grant). It now represents only a third of total revenues, compared with over half in 1986, as funds from the European Union are increasingly being used.

Sweden in 1996 introduced a new equalization system for municipalities and county councils. Its main components are income equalization, equalization of structurally related cost differences, a general block grant, and certain transitional rules. The income equalization system implies a far-reaching equalization of local taxation revenue; all municipalities and county councils should have incomes corresponding to the national average.

Switzerland is examining its existing equalization system with a view to guaranteeing the principle of subsidiarity and strengthening the financial capacity of the cantons.

The United States' federal budget totals 30 percent more than those of the states and localities combined; it is dominated by spending on defence, transfer payments to the elderly and other individuals, and financing the national debt. There are also extensive direct spending and grants-in-aid from the federal government to the states. Many states have equalization schemes for school financing; however, federal courts have found many unfair and unconstitutional.

Source: Organization for Economic Co-operation and Development, Managing Across Levels of Government, Paris: OECD, 1997.

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