Equalization Reform That Works:
Taking seriously the idea that incentives matter

Presentation to the Expert Panel on Equalization and Territorial Financing Formula

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Introduction

Imagine for a moment that you are the finance minister of an equalization-receiving province. If you and your cabinet colleagues want to find new revenues for program spending, you can encourage economic growth, raise taxes, borrow, or secure new federal transfers. As it turns out the rational choices, given the incentives implicit in equalization, are not the ones that build the economy and thereby increase the government's fiscal capacity, but rather the ones that raise taxes, deepen dependency, damage growth prospects, and increase debt. Equalization recipients have failed to take the tough decisions that growth and innovation require, they have underdeveloped their natural resource sectors, and overdeveloped government sectors, they are deep in debt and levy high taxes. These results can almost certainly be laid, in large part, at the doorstep of equalization. After almost 50 years of equalization, it is perhaps time to conclude that the program is not working and to ask what we should do instead.

The Expert Panel on Equalization and Territorial Formula Financing has an important opportunity to recommend options to rebuild the equalization program to better meet the needs of all Canadians. The backdrop for the panel's work encompasses the ongoing debate about a federal-provincial fiscal imbalance, concerns about fairness in financing such services as health care, education and social programs, and the federal-provincial agreement in the fall of 2004 that established a trajectory for equalization payments, but did not include revisions to the equalization formula.

The terms of reference for the panel, as outlined by the federal finance minister, are:

- The allocation of provincial and territorial equalization and TFF entitlements;
- Ways to make these payments more stable and predictable;
- The role of interprovincial fiscal disparities, the cost of providing services in the North and the function of various provincial own-source revenues (such as natural resource revenues, property taxes and user fees) in determining overall levels of federal support; and
- Whether a permanent independent body should be created to provide advice to the Government of Canada on these matters.

The panel's paper, *Key Issues for the Review of Equalization and Territorial Formula Financing* (2005), identifies seven key program objectives: adequacy, fairness, stability, predictability, responsiveness, sound incentives, and transparency (or accountability and governance). These objectives require that recommendations made by the panel seek to improve on existing gaps in the program. Although it is often asserted that the program is neither intended to alter provincial policy decisions nor help provinces with lagging fiscal capacities to grow their economy, equalization has had a profound impact on both. In addressing these seven objectives and in meeting the expert panel's terms of reference, remedies to correct equalization's impact on economic growth must be part of the expert panel's recommendations.

This submission is an overview based on the Atlantic Institute for Market Studies' work on equalization. Points outlined in this brief are supported by AIMS studies; observations and recommendations are based on 10 years of thinking, discussion, debate, and writing by AIMS authors. As a public policy think tank located in Atlantic Canada, the equalization program and its effects on economic growth in the region have been important and regular subjects of the Institute's research. To date, AIMS has published more than 30 books, papers and commentaries on the topic.

In studying economic development in Atlantic Canada, the Institute has found that no government program functions in isolation. Equalization, Employment Insurance, federal income support for seniors, and regional business support agencies and programs have had a combined and adverse impact on the region's economic growth. AIMS' Fred McMahon addressed this in the 1996 book, *Looking the Gift Horse in the Mouth*, and then in a 2000 paper. Brian Lee Crowley and Don McIver have also written extensively on that point (Crowley 2002; Crowley and McIver 2004). From AIMS' perspective, it is vital that all federal programs support the natural economic processes by which the economic performance of lagging regions and provinces converges with the rest of the country's. This objective must be an important part of reformulating equalization.

Equalization impacts both provincial and national policies. As the expert panel outlined in its issue paper, there is growing concern that equalization is having unintended policy impacts. This is certainly borne out by AIMS research. Provincially, equalization changes the policy dynamic:

- Regarding trade-offs between sensible economic policy and politically popular measures that are nonetheless economically destructive;
- On decisions about developing provincial natural resources;
- In terms of the structure of provincial taxes; and
- On debt financing decisions.

Equalization also has a threefold impact on national policy and policy choices:

- As a result of imperfections in the current equalization formula, there have been a number of ad hoc deals between the federal government and provinces. This in turn has caused a great deal of acrimony and jealousy between the provinces, and circumventing the rules has made the program less predictable;
- Given the natural process of economic convergence, there ought to have been more substantial re-ordering of the equalization recipients and overall cost should have been reduced. Equalization's failure to promote growth has important implications with respect to national productivity; and
- When taxpayers in one province help to fund decisions made by a government in another province, the principle of democratic accountability for spending decisions is broken.

These serious issues, discussed in greater detail below, will continue to challenge the Canadian federation if we are not able to construct federal programs that work in our collective interests.

Provincial Policy Impacts

Sensible Economic Policy Trade-Offs

By way of importance, equalization accounts for a significant portion of provincial revenues in PEI, Newfoundland, New Brunswick, Nova Scotia, and Manitoba. In all five provinces, equalization accounts for between 25 and 43 percent of own-source revenues. In the case of PEI, every dollar it raises on its own is matched by 40 cents in equalization money, and in Manitoba every dollar raised results in 25 cents in equalization money. Over the years, this high degree of reliance has caused receiving provinces to view economic policy decisions through the lens of maximizing equalization entitlements. A recipient province faced with the need to generate more revenue may, for example, opt to increase tax rates, rather than pursue policies that grow that province's economy. When economic growth increases fiscal capacity, then provinces receiving equalization are penalized for that growth by having as much as 100 per cent or in some cases even more of their equalization entitlement taxed back. But unlike increasing an existing tax, promoting growth may not actually increase revenues by an amount equal to or greater than the lost equalization revenue. This type of Catch-22 encourages poor provincial policy decisions.

In fact, the tendency away from economic growth and convergence is so ingrained that since 1957, there has been very little change in ratios of provincial dependence on equalization. It is not that the recipients ought to have been re-ordered in terms of weakest to strongest fiscal capacities, but that the overall level of provincial dependence on equalization should have declined by now. Had economic convergence been encouraged, then the magnitude of equalization payments as a proportion of own-source provincial revenues would have also declined. Economic growth can have a substantial impact in a short period of time. For instance, Ireland moved from having 85 percent of Canada's standard of living to 105 percent in 15 short years. However, using federal transfers to help less affluent provinces is really a poor second-choice solution to the problem. The first choice is economic growth and therefore more local fiscal capacity. In the short-term the impulse for generosity and a helping hand inherent in the Canadian federation has turned into a program or set of programs that are an impediment to long-term growth.

According to AIMS author Fred McMahon (2000) who has studied economic convergence in Atlantic Canada, "Lagging regions that converge with the greatest speed are those with open economies, fiscal balance, low public sector consumption, and governments focused on providing essential services." Prior to the 1960s Atlantic Canada's economy was growing faster than the rest of Canada's and was therefore converging with the national average. After 1970, however, that convergence not only ceased, but the region's gross domestic product (GDP) actually lost ground, relatively speaking.

Rapid economic growth rates experienced in peripheral regions of the United States and in Ireland illustrate how these regions can experience the kind of convergence that ought to have already occurred among Canada's lagging provinces. But the evidence of nearly half a century and more than $237 billion in equalization payments (adjusted for inflation) is that incentives matter, and the incentives attached to equalization can penalize the poorer provinces for developing their economy and encourage them to settle for permanent reliance on federal transfers. The notion of "sharing" has its virtues, but fiscal arrangements should not maintain poorer provinces in a state of splendid dependence. Fiscal arrangements should instead help provinces build the capacity to better pay their own way. Rather than pursuing pro-growth policies such as reforming labour markets, developing natural resources, divesting provincial Crown corporations, and lowering taxes, equalization has encouraged the opposite.

Development of Natural Resources

Natural resource revenues have long been problematic for the equalization formula. The five-province (British Columbia, Saskatchewan, Manitoba, Ontario and Quebec) standard for determining the Representative Tax System (RTS) in part reflected that problem by excluding Alberta and its substantial natural resource revenues from this benchmark calculation. At the same time, the inclusion of these non-renewable natural resource revenues in the calculations of total available equalization benefits helped to reduce overall the amount of benefits paid, as AIMS author Roland Martin pointed out in his 2001 paper. With 2004's fixed and indexed pool of equalization funds, this mechanism no longer functions as a brake on overall equalization entitlements.

The Canada-Nova Scotia Offshore Petroleum Resources Accord and the Atlantic Accord have circumvented the equalization formula, effectively removing royalties from offshore non-renewable natural resource revenues from the calculation of equalization entitlements. In response, the government of Saskatchewan has argued forcefully in favour of removing all non-renewable natural resources from the formula (2005). Indeed, given the current agreements between Nova Scotia, Newfoundland and the federal government, the simple need for fairness is adequate reason to consider removing non-renewable natural resources from the equalization formula. It is with a degree of pride that AIMS notes that our work on non-renewable natural resources and its impact on equalization helped give rise to the two offshore agreements. Though perhaps only a first step in removing these resources from the equalization formula, political pressure to deliver 100 percent of offshore resources to Nova Scotia and Newfoundland was bolstered by studies by AIMS authors, most notably Kenneth Boessenkool and Roland Martin, in 2001 and 2002.

AIMS has made the case for a number of years that equalization doesn't treat natural resource revenues properly. The principal reason is not just the clawback, which punishes provinces with a natural resource endowment for developing it. We treat natural resource revenues very unintelligently because we forget that they are fundamentally different from almost every other kind of government revenue. They are different from income taxes, they are different from corporate taxes, and they are different from sales taxes.

Taxes on such things as income and sales and the like are the ordinary income of the provincial government, just as a salary is ordinary income. Income taxes and sales taxes and so on, in effect, represent a slice off the top of the infinitely renewable economic energy of all the people in a province. People work every year, they buy things, and those activities generate taxes. The province takes a slice off the top. That is its ordinary income.

Natural resource revenues are completely different. These revenues aren't like a salary. What a province has, for instance, is oil and gas in the ground. It's already owned; it's an asset. With oil and gas, a company comes along, pulls a dollar's worth of natural gas out of the ground, and gives the provincial government a dollar in royalties. The resource asset has been transformed from a dollar's worth of natural gas into a dollar. Nothing new has occurred for the province from the point of view of its balance sheet. No new value has been created.

The consequence of applying the equalization formula to this asset, which has now been changed from one form to another – from a natural resource into cash – is that Ottawa seizes the asset. The equalization formula forces provinces to sell natural resource capital in order to finance ordinary public services.

The proper way to treat natural resource revenues is as an asset. That means that they should fund one of two objectives. They should be used to create a heritage fund, which would invest that money on behalf of the people of the province, so that it's not just the people who happen to be alive on the day that the oil or gas comes out of the ground that benefit from it, but all future generations, because those assets belong to all people, including future generations. Or money raised from extracting these assets should be used to pay down debt; in other words, to clean up the balance sheet of the province. Those are the two legitimate uses of natural resource revenues. But under the equalization formula, that possibility is not available because Ottawa seizes those assets.

Kenneth Boessenkool, in *Taking Off the Shackles: Equalization and the development of non-renewable resources in Atlantic Canada* (2001), notes an additional difficulty with non-renewable natural resources. The problem with respect to the formula nationally is that these revenues are geographically so concentrated that including them in a 10-province standard means that Alberta would be the dominant and possibly the sole net contributor to the program.

In the case of Saskatchewan, the taxback rate on non-renewable natural resource royalties has been a long-standing problem. This taxback or clawback essentially penalizes provinces that grow their fiscal capacity as a result of increasing economic activity and royalties from a natural resources like oil and gas. In some cases, the taxback impact can exceed 100 percent of provincial revenues from royalties: Saskatchewan experiences taxback rates on oil and gas royalties as high as 118 to 125 percent. Earlier this year, federal Finance Minister Ralph Goodale announced a recalculation of Saskatchewan's historical equalization entitlements. This additional payment has not changed the functioning of the taxback, but has been viewed as compensation for that province's lower equalization payments resulting from growing oil and gas royalties. Saskatchewan is another instance where a side deal has been used to avoid problems arising from having non-renewable natural resource revenues included in the equalization formula.

Tax Policy

The five-province RTS standard that is applied to tax capacities tends to encourage recipient provinces to tax at higher rates than the national average. Bev Dahlby in *The Incentive Effects of Fiscal Equalization Grants* (2002) explored the theoretical reasons underpinning this tendency. At issue are the equalization gains that can result for recipients with higher tax rates, as their rates are only part of the RTS average. At first glance, it would seem that those recipients with smaller populations would be most likely to benefit from pushing the RTS upwards without dramatically changing fiscal capacities. However, recipients with large populations such as Quebec also benefit, since their overall equalization entitlement is so much larger. In effect, there is no penalty for provinces with higher tax rates, particularly higher personal and business income taxes and capital taxes on businesses. Rather, higher taxes allow a province to collect more revenue and still qualify for equalization to offset the poor policy choice of economic growth-killing tax rates.

Of the 33 fiscal capacities measured in the equalization formula, personal income tax and business income and capital tax capacities account for approximately 60 percent of average equalization entitlements. These taxes account for a substantial portion of provincial revenues, but also have an important impact on economic growth. Weak fiscal capacities can be worsened by the wrong provincial tax policies. An AIMS study (Boessenkool 2002(b)) found evidence that equalization-receiving provinces had a tendency to levy higher-than-average tax rates; levied higher taxes on weaker tax bases; and increased the national rate, thus increasing equalization entitlements. In terms of promoting a pro-growth climate, provinces that levy higher taxes, and in particular high taxes on business capital, will experience weaker economic growth.

Table 1: Provincial Personal Income Tax Rates, 2005

Low rate and high marginal rate relative to five-province RTS

NL	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
Low personal income tax (PIT) rate (percentage)									
10.57	9.80	8.79	9.68	16.00	6.05	10.90	11.00	10.00	6.05
Percentage difference with five-province RTS									
5.7%	-2.0%	-12.1%	-3.2%	60.0%	-39.5%	9.0%	10.0%	0.0%	-39.5%
High marginal PIT rate (percentage)									
19.64	18.37	17.50	17.84	24.00	17.41	17.40	15.00	10.00	14.70
Percentage difference with five-province RTS									
11.0%	3.8%	-1.1%	0.8%	35.6%	-1.7%	-1.7%	-15.3%	-41.8%	-14.5%

Source: Provincial budget documents, 2005

As Table One illustrates, the personal income tax system in every equalization-receiving province except Quebec has low tax rates that are closer to the national average low tax rate. In effect, provinces with weak fiscal capacities extract less tax from those with low incomes, a politically expedient policy. At the highest marginal tax rate, however, there are more pronounced differences. Although PEI, Nova Scotia and New Brunswick had the lowest PIT rates below the national average, at the highest marginal rate only Nova Scotia and Manitoba's rates were below the national average. In the case of Newfoundland, all of its PIT rates were consistently above the national average, in line with that province's long-standing heavy reliance on equalization payments. By tending toward higher taxes on a weak base, namely wealthier individuals who can either move or opt to earn less, these provinces have the wrong tax mix from the perspective of encouraging economic growth. However, from the perspective of an equalization recipient, this matters less because through equalization they are compensated for weakening their own tax base. And those taxpayers who opt to move to a non-equalization receiving province are still taxed by contributing to equalization payments via their federal taxes. In effect, equalization recipients get their cake and eat it, too.

Debt Financing Decisions

Most troubling is the tendency of equalization recipients to amass debt and to frequently spend more than their revenues will support. If this were a passing problem, then most recipients would grow their way out of it, but this latest round of provincial budgets shows that three of the largest equalization recipients continued to increase their debts. Debt financing is a dead-weight cost to provincial government finances. Equalization is supposed to help provinces with weaker fiscal capacities to provide levels of public service that are closer to the national average. But if equalization dollars are simply used to cover debt-financing costs, then little or no public services are bought with these dollars. As has already been noted, equalization has a negative impact on decisions that promote economic growth, and at some point there is little room to increase taxes, so an equalization-receiving government that needs more money will eventually opt for deficit financing. After all, equalization payments are not reduced by the decision to borrow, and one could argue that, up to a point, the cost of borrowing is itself offset by equalization payments.

Table 2: Provincial Debt Servicing and Equalization Payments

as a Percentage of Own-Source Revenues (Average 2000 to 2005 fiscal years)

NL	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
Debt servicing costs									
35.3%	17.0%	22.7%	17.9%	16.8%	15.8%	6.9%	10.7%	2.4%	5.9%
Equalization payments									
40.5%	42.3%	30.7%	35.5%	11.9%	0.0%	24.9%	4.0%	0.0%	1.2%
Net gain from equalization									
5.2%	25.3%	8.0%	17.6%	-4.9%	0.0%	18.0%	-6.7%	0.0%	-4.7%

Source: Provincial budget documents, 2005, and Public Accounts, 2000 to 2004.

Overall, taxpayers in provinces that rely most heavily on equalization do not experience the full impact of debt and deficit financing. If only 60 percent of revenue comes from provincial sources, then equalization can replace some or all of the own-source revenue impact resulting from the cost of borrowing. Provincial fiscal capacities are not diminished, but dollars that could have been used for program spending are used to cover debt-servicing costs.

Over the past five years, equalization payments have offset provincial borrowing costs but with fewer services delivered. As Table Two illustrates, equalization payments therefore don’t just cover the cost of delivering services, their impact and value is lessened by provincial debt costs. In the case of Quebec, debt-servicing costs as a percentage of own-source revenues exceed equalization entitlements as a percentage of own-source revenues by almost five percent, meaning equalization payments do not even cover that province’s borrowing costs. In Newfoundland, debt-servicing costs are barely offset by equalization payments; what is left is only slightly more than five percent of own-source revenues, and in New Brunswick and Nova Scotia this same dynamic cut the program spending impact of equalization payments so that they only buy two-thirds to one-half as many services.

National Policy Impacts

There is no question that equalization is an important national policy. The equalization program has grown from the equivalent of $1 billion in total entitlements in 1957 (adjusted for inflation) to 10 times that amount. By definition it has national impacts, ensuring provincial revenues are grossed up to a national standard. In this respect it is often portrayed as the glue that binds the federation. But it is also a source of contentious debate, inter-provincial jockeying and, occasionally, jealousy. And after 50 years recipients have not experienced the kind of economic convergence that ought to have reduced the size of the program. Finally, it is a program that has broken the democratic link between taxpayers in one province who pay for policy decisions that are made by a government in another province.

Ad Hoc Equalization

Over the years a number of one-off deals have been designed to correct perceived inequities and flaws in the equalization formula. The Atlantic Accord and Canada-Nova Scotia Accord have effectively circumvented the equalization formula's treatment of non-renewable natural resource royalties. Because offshore royalties are theoretically a new provincial fiscal capacity, it was possible to exclude these from the formula, but agitation from Saskatchewan raises the question of equity in the treatment of all non-renewable natural resources. In response, the federal finance minister, through a recalculation of historical equalization payments to Saskatchewan, has attempted to offset these concerns with a special payment to that province. These one-off deals, must be replaced with a rules-based equalization formula that allows every province to achieve good results. Not just in terms of securing more equalization funds, but in terms of promoting economic growth. Fairness demands that the equalization formula work without additional deals and agreements designed to circumvent the rules of the program.

Limited Economic Convergence

Although the federal government insists that equalization is only designed to transfer revenues to provinces with weaker fiscal capacities and is not meant to encourage economic growth or convergence, over the long term the program should do just that. It certainly shouldn't discourage growth and convergence, which is the case today. With the exception of Alberta, no equalization recipient has thus far permanently ended its reliance on the program (Saskatchewan has been off the program in some years, but not reliably). Furthermore, the majority of equalization recipients have experienced little or no change in their reliance on equalization payments, despite equalization declining in relation to overall federal spending.

Table 3: Proportion of Total Equalization Entitlements by Province

1957-'58 fiscal year versus 2004-'05 fiscal year

NL	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
1957-'58 fiscal year									
8.5%	2.2%	12.4%	6.2%	33.3%	0.0%	10.2%	14.6%	8.6%	4.0%
2004-'05 fiscal year									
13.6%	2.5%	13.9%	12.0%	38.9%	0.0%	13.9%	4.8%	0.0%	8.5%

Source: Finance Canada

By some measures Table Three illustrates where equalization has failed. All the current recipients were also original recipients of equalization's predecessor program, introduced in 1957. For PEI, Nova Scotia, Quebec, and Manitoba, very little has changed. New Brunswick now receives more, as a proportion of the total, while Saskatchewan receives much less. And despite large economic and natural resource gains in Newfoundland, that province now receives a bigger share than it did in 1957. Some commentators disagree with the notion that equalization should help promote economic growth and convergence with the rest of the country. At the very least, it should not hinder this convergence. As currently arrayed and regardless of its intent, equalization has encouraged many provincial policies that have hampered economic growth.

There are a number of examples. In the late 1990s the government of Newfoundland and Labrador set out demanding stipulations on Inco's bid to develop the mineral deposit at Voisey's Bay. Anticipated equalization taxbacks that would have resulted from the development of this site induced the government of Newfoundland to add these expensive requirements to any deal with Inco. Rather than developing the resource and by extension increasing the province's economic output, the project remained stalled.

Prior to the recent offshore agreements, Newfoundland gave up royalties from the Hibernia energy project and Nova Scotia gave up potential revenues from auctioning offshore exploration rights in favour of work commitments.

Then there is the stark contrast between the growth of the oil and gas industry in Saskatchewan versus Alberta. Alberta, by not being penalized for developing non-renewable natural resources, has been able to move from nominal equalization recipient to the largest contributor to the equalization formula. But Alberta's success came before disincentives around non-renewable natural resources were entrenched into the equalization formula; this is probably a major factor in its being the sole province in the history of the program to have escaped dependence on equalization.

Former New Brunswick Premier Frank McKenna summed it up best when he said (2002), “Equalization and other federal transfers give very little incentive to create greater own-source revenue, because those revenue sources are taxed back.” This kind of equalization welfare trap is troubling at the national level. Equalization has not aided economic convergence nor has it succeeded in helping the original recipients escape dependence. In many cases, in fact, the dependence has either remained relatively stable or even worsened. While helping provinces escape dependence was not one of the program’s objectives, it ought to have happened from the perspective of common sense, and the well-established process of convergence in other jurisdictions gives rise to a *prima facie* case that equalization doesn’t just not help, it actually obstructs recipient provinces from ever standing on their own two feet.

Although the expert panel’s mandate is limited to the question of equalization, it is important to bear in mind that this $10-billion federal program is part of a larger $69 billion in federal transfers to provincial governments and individuals in each of the provinces.

Table 4: Federal Taxes Collected and Spending Received by Province, 2002

NL	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
Federal Taxes Collected ($ million)									
2,187	662	4,387	3,301	38,351	81,096	5,432	4,743	22,248	22,235
Federal Spending Received ($ million)									
4,672	1,360	8,627	6,216	41,672	59,933	8,651	6,594	14,484	20,684
Net Gain (per dollar collected)									
$2.14	$2.05	$1.97	$1.88	$1.09	-$0.74	$1.59	$1.39	-$0.65	-$0.93

Source: Statistics Canada, *Provincial Economic Accounts*, Chart 7, May 2005

In this context, equalization accounts for only one-seventh of total federal transfers to provincial governments and provincial economies. As such, other federal programs contribute to the goal of equalization, and to consider one federal program without some reference to its size and impact relative to other federal programs risks painting an incomplete picture.

Table Four illustrates that three provinces – British Columbia, Ontario and Alberta – are paying the freight. By contributing a dollar in federal taxes, but by receiving less than that amount in return, residents and businesses in these provinces are supporting residents and businesses in the remaining seven provinces. They are, in effect, paying to support their competitors. Because international competitiveness and productivity are important, there ought to be more discussion about the negative impact of the costs of these federal transfers on the economies of provinces that are net contributors to the program. As a proportion of provincial GDP, British Columbia transfers the equivalent of one percent, Ontario transfers the equivalent of 4.3 percent, and Alberta transfers the equivalent of 5.2 percent.

The combined impact of equalization and other programs that transfer wealth will continue to be a drag on the performance of these economies. It is crucial that federal programs and federal transfers to provinces help those with low fiscal capacities to deliver similar levels of services, but these programs must not be detrimental to the economic well-being of the rest of the provinces, a point made by Nobel Laureate James Buchanan in his 2002 AIMS paper.

Placing a burden equivalent to slightly more than one percent of the combined provincial GDP of the two or three provinces that do not qualify for equalization may not seem like much, but it's a substantial drag on the national economy. With an average annual growth rate of less than five percent, the cost of equalization represents a 20 percent drain on annual economic growth in the payer provinces. This has major implications in terms of international competitiveness and in terms of pulling down overall national productivity rates. It may be worth these costs to ensure that all Canadians have access to relatively similar levels of service, but a poorly designed and oriented equalization program can worsen these impacts.

In terms of funding equalization payments in particular, only two provinces currently underwrite the program: Ontario and Alberta. Using the Department of Finance's equalization calculations as a benchmark, $4.5 billion in excess fiscal capacity comes from Alberta's oil and gas royalties while $4.7 billion in excess fiscal capacity comes from Ontario's superior personal, business and sales tax revenue bases. These measures of excess fiscal capacity alone account for 90 percent of total equalization payers. As such, Canada's two equalization payers experience very different pressures on their economic and fiscal capacities.

Democratic Accountability

Equalization distorts democratic accountability. Equalization subsidizes provincial spending; if people in a province don't have to pay the full cost of what they're consuming, they will demand more of it.

In this context, equalization introduces an incentive for provincial governments to promise more spending than local taxpayers would support. The local electorates demand more public services than they are willing to pay for, secure in the knowledge that a large chunk of that spending will be drawn from taxpayers elsewhere in the country. The electorate demanding the spending is not the one paying for all of it, and politicians who promise this spending are not answerable to all those paying for it. This creates a political culture in which spending is encouraged, while self-reliance and economic growth are discouraged. The ideal form of accountability is one in which the same voters who demand spending are the ones who bear the cost, while the same politicians who promise new spending are the ones answerable to all whose taxes pay for that new spending. Equalization short-circuits this accountability loop.

Potential Policy Remedies

AIMS has proposed a plethora of policy remedies over the past 10 years. In terms of practical areas for reform, research by AIMS authors suggests the following changes:

- Remove non-renewable natural resources and, indeed, revenues from all sales of capital assets such as Crown corporations from the calculations of fiscal capacities;
- Return to a 10-province standard to determine all averages and representative tax systems;
- Cap payments such that equalization payments do not increase total provincial revenues greater than the average of spending in a bundle of key spending areas;
- Allocate a portion of overall equalization entitlements to the repayment of provincial government debts.

Remove Non-Renewable Natural Resources
As AIMS author Kenneth Boessenkool (2001) has said, Ottawa's deal to exclude offshore oil and gas revenues from the calculation of equalization entitlements is halfway to more positive reforms. The rationale for excluding Newfoundland and Nova Scotia's offshore revenues is not only sound in these two cases, but holds for the rest of the country as well. Alberta's economic advantage is certainly the result of strong oil and gas revenues, and that same advantage should be extended to all provincial non-renewable natural resource revenues. This would solve a major problem for Saskatchewan and would also remove any disincentive for other provinces to develop these kinds of assets when doing so currently costs them in lost equalization entitlements.

The principle of not using the equalization clawback as a way, in effect, of seizing provincial assets when they're converted to cash should be extended to other assets such as Crown corporations. This makes business sense and is more equitable than the current arrangement. Moreover, the current approach rewards provinces for retaining low-value, poorly performing assets such as many Crowns corporations; once privatized, Ottawa essentially confiscates the value of the assets.

As we have argued elsewhere, there are good reasons for the provinces to match this reform with one of their own: dedicating the revenues from such asset sales to either debt retirement or the creation of a heritage fund.

Return to a 10-province Standard
Returning to a 10-province standard reduces some incentives for high tax rates among recipients. More importantly, this standard captures a fairer picture of provincial fiscal capacities and spending. Since the federal government and the provinces have agreed to a fixed equalization pot, with an indexed escalator, the dynamics are such that many of the benefits of the five-province standard no longer hold. More importantly, if payments are

to be tied to provincial spending on a bundle of programs, then a 10-province standard will capture a true average of provincial spending.

This has the additional advantage of including low-tax Alberta and the four high-tax Atlantic provinces in establishing the representative tax basis. This will tilt the bias away from higher tax rates and high tax rates on weaker bases that is built into the current system. But it will also include the much stronger and larger fiscal capacity found in Alberta. Instead of encouraging recipient provinces outside of the five-province representative tax base to tax at rates that are slightly higher than average, these higher rates would be included in a 10-province standard, but would be offset by the inclusion of Alberta's low tax rates. With a lower but more accurate representative tax rate, smaller entitlements would be paid on those tax bases. Though this puts some recipient provinces at a small disadvantage, it also builds in an incentive missing from the current regime, thus placing a higher premium on growing own-source capacity as the best way to achieve the national standard in funding provincial programs.

Cap Payments

The intent of equalization is to ensure roughly similar services across the country. By topping up provincial own-source revenues, this encourages provincial governments to increase the overall size of government. Rather than making decisions involving dollars raised locally, equalization recipients have the luxury of increasing spending while having someone else's tax base paying for it. Of course, equalization does not pay out according to spending, but rather in a way that augments fiscal capacity. However, by moving to a fixed equalization pot, it is clear that some limits on entitlements need to be established. Otherwise some level of equalization may eventually be paid to almost every province.

At present, the national average per capita provincial spending on health care, education, social services, justice and security accounts for 54 percent of total provincial revenues. Establishing a cap on equalization entitlements that looks at a 10-province standard basket of per capita spending or as a proportion of overall spending would help to encourage efficient provincial governments and would also help to limit annual expenditure on equalization. Rather than reneging on the 2004 federal-provincial deal and decreasing the total pool of dollars available to the program, the difference could be set aside to fund a provincial debt swap to federal government (more on that below).

The 2004-2005 fiscal year equalization formula increases the guaranteed per capita fiscal capacity of each province to $6,126. If a hypothetical basket of provincial spending were used to cap spending, then a slightly lower level of $5,837 per capita might have been established. In this case, provincial spending per capita on health, education, social services, justice and protection, and transportation and communications was adjusted to reflect per capita federal health and social transfers. The following table illustrates this sort of calculation.

Table 5: Representative Basket of Provincial Spending Per Capita

2003-2004 Fiscal Year

NL	PEI	NS	NB	PQ	ON	MB	SK	AB	BC	Average
Per capita spending on health										
$3,141	2,512	2,689	2,670	2,616	2,713	2,772	2,823	2,675	2,846	2,746
Per capita spending on education										
$2,340	1,988	1,875	1,941	1,931	1,604	1,676	1,672	2,256	1,996	1,928
Per capita spending on social services										
$1,145	863	879	875	2,236	1,082	1,256	1,097	1,196	1,129	1,176
Per capita spending on justice and protection										
$395	269	279	234	298	275	328	337	205	273	289
Per capita spending on transportation and communication										
$654	668	243	678	321	216	273	328	309	416	411
Total per capita basket of provincial spending										
$7,676	6,300	5,964	6,399	7,403	5,889	6,305	6,257	6,642	6,661	6,549
Minus the Canada health and social transfer										
$722	726	733	733	732	655	731	749	607	733	712
Maximum fiscal capacity to be equalized										
$5,828	5,824	5,816	5,817	5,817	5,895	5,818	5,801	5,943	5,816	5,837

Source: Statistics Canada, Public Sector Finance data

Using a standard like the one above, equalization payments could discourage excessively high provincial spending in one province, or would capture an upward trend in spending in one or two provinces. Instead of just tracking capacity, this addition would better gauge how well equalization is meeting the needs of provinces**.** Using a basket of per capita spending is one way to arrest the tendency of recipient provinces toward overspending and deficit financing. Jack Mintz and Finn Poschmann (2004) of the C.D. Howe Institute proposed an adjustment to the formula that takes into account provincial cash flows. This approach would encourage greater use of revenues from natural resource royalties or the sale of Crown corporations if these were used to invest in capital or to retire debt. Equalization must not encourage recipients to increase spending in ways that have a negative impact on economic growth.

Federal-provincial Debt Swap

Instead of encouraging ill-considered provincial policy, it is time the formula help permanently restore provincial fiscal capacities by encouraging and directly reducing provincial debts. By capping total equalization payments and carving off a portion of allocated equalization dollars for a debt swap, substantial provincial debt interest savings could be realized. For many recipients, equalization merely covers the cost of debt financing, and so the transfer does not augment the fiscal capacity of the recipient provinces to some nationally accepted minimum. In most cases, recipient provinces' fiscal capacity is sufficient to cover program spending. The problem is that many provinces have "mortgaged" their fiscal capacity and need equalization to keep their head above water. Equalization thus creates dependence and makes up for irresponsible fiscal management by recipient provinces.

Simply paying down debt would, however, prove counterproductive if additional fiscal safeguards are not added. For instance, provincial governments would only be eligible for a debt swap if they had balanced their books over the previous three years. Allocated debt swaps would be in proportion to that year's equalization entitlements by province. If not all provinces were eligible for a debt swap, the allocated money would remain on hand for subsequent years. Eventually, balanced books would become more common among the provinces. Indeed, non-equalization receiving provinces might eventually qualify for debt swaps and could eliminate or at least substantially reduce interest costs resulting from debt financing of government operations.

Comparing provincial debt with provincial debt-servicing costs, the following table demonstrates the fiscal room that would be freed in each province per $1 billion of provincial debt retired.

Table 6: Hypothetical Debt Interest Savings

Based on 2003-2004 Provincial Debt Servicing Costs ($ million)

NL	PEI	NS	NB	PQ	ON	MB	SK	AB	BC
$57.3	85.2	100.1	140.0	56.4	79.1	139.4	87.1	n.a.	102.1

There are big differences in the potential cost savings across provinces, in part because of each province's individual credit rating, and in part as a result of the age and type of debt instruments owed by each province. These estimates are based on total provincial debts as reported by Statistics Canada, so excluding Crown corporation debts, for instance, would result in lower savings. There is merit in excluding provincial Crown corporation debts from the debt swap for two reasons. First, this rewards provinces that have not distorted their economies with large Crown sectors. Second, arguably Crown corporations can recoup the cost of borrowing through fees and charges levied on users, something private sector competitors routinely do in the normal course of doing business. Although interest savings are relatively small on a one-year basis, any reduction in debt-servicing costs is a permanent reduction. To put it another way, it's a permanent increase in that province's program spending capacity.

Conclusion

Equalization and other federal programs have harmed the economic prospects of recipient provinces. The expert panel has an opportunity to rebuild our broken equalization program. As the panel has already observed, equalization must meet clear criteria to be effective, and must not continue to have unintended policy impacts. To date, equalization has had negative impacts on both provincial and national policies. At the provincial level it affects policy, regarding trade-offs between sensible economic policy and politically popular measures that are economically destructive; on decisions about developing provincial natural resources; in terms of the structure of provincial taxes; and on debt financing decisions. As a result, recipient provinces have become dependent on equalization to maintain government spending, while their economies have failed to converge with the rest of the country.

Equalization has adversely affected national policy in three ways: In the development of one-off deviations from the equalization rules, which has become a source of inter-provincial jealousy; in discouraging economic convergence between recipients and the national average, which has important ramifications for national productivity and competitiveness; and in creating an accountability gap between those who pay and governments in other provinces that spend. Not unlike the adverse impacts felt by recipient provinces, at a national level, equalization has become an expensive and potentially damaging program.

Research by AIMS authors supports the following four changes to the equalization formula:

1. Remove non-renewable natural resources from the calculations of fiscal capacities;
2. Return to a 10-province standard to determine all averages and representative tax systems;
3. Cap payments such that equalization payments do not increase total provincial revenues greater than the average of spending in a bundle of key spending areas;
4. Allocate a portion of overall equalization entitlements to the repayment of provincial government debts.

These remedies will go a long way to repairing the damage done to date. Rather than treating capital such as non-renewable natural resources as a cash cow to fund current equalization payments, removing these from the formula will benefit both payers and recipients. Re-establishing a rules-based formula that applies to every province means that a complete picture of current fiscal capacities is captured and that national standards of spending are just that, and not a truncated, inaccurate representative version. And rather than pouring equalization dollars out like water into 10 cups of different sizes, by establishing a cap on payments that is based on a national standard for spending, entitlements will be appropriate but limited. Finally, opting to reduce debt with excess equalization allocations will uphold the federal-provincial agreement signed in the fall of 2004, while making a substantial contribution to improving the long-term fiscal health of recipients. Rather than taking a narrow view of funding for one year, these changes offer a long-term solution.

Equalization was not a program developed to promote economic growth, but it certainly does not exist to stunt or hinder prosperity. Recipient provinces need an equalization system that promotes economic convergence. The country needs an equalization program that improves our international competitiveness. Now is the opportunity for positive changes to the program that will ultimately allow for fairness in the Canadian federation and improvements in our overall economic well-being.

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