“Equalization: The Help that Hurts”

A talk by Brian Lee Crowley, President, AIMS

At the Frontier Centre for Public Policy

Winnipeg, 21 April 2005

=======================================

Ladies and gentlemen,

Many thanks to Peter Holle of the Frontier Centre for Public Policy for the kind invitation to be here today. Before I say anything, let me say a word of congratulations to Peter for the excellent work that he and the Frontier Centre are doing for Manitoba and Saskatchewan, as well as the country at large. I am delighted and honoured to be able to say that I have had the pleasure of collaborating with Peter on a number of initiatives, including one I am going to speak to you about today, and I can assure you that Peter’s and the Frontier Centre’s reputation across the country as a thoughtful and energetic contributor to the public policy debate is an impressive and well-deserved one. I wonder if you realise how lucky you are in Manitoba to have someone of Peter’s calibre speaking out on public policy issues.

Now, at Peter’s request, I want to speak to you about a topic of vital importance to my region, as well as the country as a whole: equalization

What is equalization?

The equalization program is intended to solve a potential problem within federalism. The tax base is not equally distributed across the country, so that means that people living in less developed provinces are less able to finance public services, such as education or health or welfare. In order to avoid what Canadians might consider unacceptable disparities in important services to some citizens merely because they live in poorer jurisdictions, equalization was invented. The program was placed in the Constitution in 1982 (virtually the only spending program to have been constitutionalized), where its stated intention is to allow provinces to provide “reasonably comparable” public services at “reasonably comparable” levels of taxation.

The formula measures the per capita fiscal capacity (i.e. ability to raise tax revenues) of each province on the basis of each of 33 different revenue sources. It then takes the difference between that fiscal capacity and the capacity as measured by the average of five provinces (Alberta and the four Atlantic provinces are excluded for reasons which we may have a chance to discuss later).

Ottawa sums these differences to come up with a per capita entitlement for each province. Provinces whose total measured fiscal capacity (the pluses and minuses across the 33 different tax bases) is above the five-province standard receive nothing, and provinces below the standard receive a per capita payment to bring them up to the 5 province standard.

In 2000/2001, these calculations produced a maximum payment of $2,159 per person in Newfoundland and a low of $174 per person in Saskatchewan. Equalization makes up a fifth to a quarter of provincial revenues in Atlantic Canada, and about 20% in Manitoba, while two provinces (Alberta and Ontario) receive no equalization payments at all. BC these days hovers on the edge, but traditionally has been a net contributor to equalization, and soon will be again.

Two things are worth noting here. First, Canada would likely not have achieved the level of decentralization that it has without some form of equalization payments. A national government that provides equal services to all its citizens, wherever they may be in the country, and that charges uniform tax rates across the country, automatically “equalizes” services to poorer areas. It is only when large portions of public services are delivered by provincial or state governments that the rationale of payments to such poorer regions emerges.

Second, equalization is nonetheless not an essential feature of federal states. The United States, to take the most obvious example, has no equalization programme. As Tom Courchene and others have noted, America's view is that such payments are unnecessary. Why? Because while it is true that California and New York have access to rich tax bases with which to finance their public services, they also must face high costs: real estate, wages and salaries, construction and equipment costs, all tend to be higher than in poorer but lower cost jurisdictions like, say, West Virginia or Iowa. So America tends to look to the economy's self-correcting mechanisms to overcome the problem of regional disparities. We'll come back to this point in a few minutes.

For now, let me sum up my own understanding of equalization that emerges from this discussion. Equalization is a social programme – it is an income support programme for provinces.

But like any social programme, in order to understand its effects on society, you must look both at the intentions behind it, and the actual results that it produces, because as we all know, good intentions are no guarantee of good outcomes.

In analysing social programmes, we must look at two key things. These are what I call the first order effects and the second order effects. Rather than starting with equalization, let's start with a programme whose first and second order effects are more easily observable.

The analogy I wish to draw is with individual welfare recipients. The good intentions of welfare are that, in a wealthy society, no individual should be left destitute because of the vicissitudes of life. We can all suffer the slings and arrows of outrageous fortune, and it is both generous and sensible for us as a society that we ensure that no one be left unable to fend for themselves. And there are certain persons who, for a variety of reasons, are permanently unable to fend for themselves, and it is appropriate that we as a society offer them a reasonable basic income.

For the rest, the first order effect of welfare matches our intentions: we intend to prevent destitution and tide people over. Welfare achieves this.

But there are undeniably second order effects of welfare. In particular, there are the problems associated with what has come to be known as the welfare trap. As we, in our good intentions, make welfare benefits more generous, we blunt the economic and social enticements to return to the workforce and to become self-supporting. This takes the form, not merely of higher benefits, but also of taxes that are too high on low-income people, plus the added penalty of the withdrawal of benefits as income rises.

The combined result of these factors is that the highest marginal tax rates in our society are paid, not by people at the top end of the income scale, but by people trying to escape poverty and dependence. They actually make themselves worse off by working.

So the second order effects of a social welfare policy intended to be kind and generous, can in fact be cruel and destructive if you believe that pride and self-worth come from each person putting forth their best efforts to be a productive and contributing member of society, and if you believe that the long term result of dependence on state benefits is a whole host of social dysfunctions.

When trapped on social assistance, the most one can aspire to in terms of improved standard of living is whatever the government is willing to give in terms of increased benefits, which will never be much more than subsistence. Yet people who return to the labour market vastly improve their chances of moving up the career ladder, and consistently improving their standard of living as they acquire job skills that make them continuously more valuable to employers.

II

Let’s return now to equalization. What are the first order effects of equalization? Well, the idea is quite a simple one. Canadians, wherever they may live, are entitled to a certain minimum standard of public services. Yet certain services are the responsibility of provincial governments, things like education, health care, highways, etc. Since some provinces are richer than others, that means that residents of poorer provinces might not be able to afford decent public services in those areas if they had to depend only on their local tax base. Either that or they would have to bankrupt themselves with taxes that were ruinously high.

The function of equalization is to even out those differences in tax bases. And the first order effects, like those of welfare, are quite successful. Less wealthy provinces' revenues are topped up by equalization to very close to the national average. Newfoundland gets over 25% of its total revenues from equalization (and nearly 40% of its total budget from federal transfers overall). As a result, government spending is far higher provincially than it would otherwise be.

Now equalization would be fine if the story ended there. But as in the case of welfare, we must examine the second order effects of this policy, and add up *all* of the pluses and minuses to arrive at an understanding of its overall effects.

One of the cardinal rules of economics is that if you subsidise something, you will get more of it, and if you tax something, you will get less of it. If we subsidise the production of milk or post-secondary education or health care, it is because we think that the market, if left to itself, will produce less of these things than governments think is best. We want more, so we pay for it.

On the other hand, we all know that taxing things like effort or work, or consumption or saving or productive economic activity in general, results in less of these things than we would otherwise have, and the higher the tax rate, the greater the loss of economic activity.

The reason that I raise this in the context of equalization is that this massive federal programme subsidizes some very specific things and taxes some others. And the net effect has been significant damage to the ability of the less-developed provinces to close the disparity gap with either the national average, or the wealthier provinces.

Apologists for the current regime say that it was never equalization's purpose to "close the disparity gap" with the rest of the country, but simply to compensate for its existence. But what we have discovered after nearly half a century and nearly $200-billion in equalization payments (NOT 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.

"Sharing" has its virtues, but surely the prime object behind our fiscal arrangements should not be to maintain poorer provinces in a state of splendid dependence, but rather to build their capacity to pay their own way. The greatest victory of fiscal federalism could and should be the elimination of the need for equalization payments.

In trying to make clear the perverse incentives in equalization, let me come back to the question of what equalization subsidises and what it taxes. Let me take the taxing part first. What does equalization tax, and therefore lead us to produce less of?

The answer, in my view, is two chief things:
1) productive economic activity in the less well-off provinces;
2) provincial assets being shifted from one form to another without the creation of new wealth.

To illustrate the first point, I always think a concrete example helps best. Let's look at Voisey's Bay. If that mineral deposit were in Ontario, the wealthiest province in Canada, that mine would be developed today. Yet the deposit is in the poorest province, Newfoundland, and after numerous years of hard negotiating, it is only really getting underway now. For years, the project was totally stalled, depriving the province of much needed investment and job creation. Why?

While it is not the only explanation, I would argue that equalization plays a major role here, because it deprives the province of one of the two major streams of benefits that development normally allows.

A similar example is to be found in the way Nova Scotia gets oil and gas companies to pay for exploration rights in the offshore. There are two ways to get companies to pay. One is to get cash up front. The other is to get so-called “work commitments”, or promises to carry out a certain minimum amount of exploration work. If NS takes the money up front, Ottawa would take 70% under the equalization clawback. If, on the other hand, NS takes no cash, but requires the companies to offer work commitments, the bulk of the economic value stays in NS. But this requires the province with the lowest amount of money per capita to spend on programmes to forgo a major revenue source.

And then there’s Hibernia and the gravity based structure, or GBS, a huge and hugely outdated approach to developing offshore oil and gas in which the Government of Newfoundland gave up a stream of royalties from Hibernia in exchange for a large amount of relatively low-skill short-term employment.

And this view of the economic disincentives implicit in equalization is more and more widespread. Former New Brunswick Premier Frank McKenna, in an interview with Peter Holle at the Frontier Centre, said that equalization and other federal transfers “give very little incentive to create greater own-source revenue, because those revenue sources are taxed back.”

I mentioned in addition that equalization also taxes equalization-receiving provinces that take a stock of assets and turns them from one form to another, but without creating any new economic value. Again, a concrete example may help to illustrate. Nova Scotia has one of the highest per capita debts in the country. Yet it also has major economic assets on its balance sheet, such as forestlands, crown corporations such as the liquor commission and future cash flow from offshore gas royalties. A sensible economic strategy would see them clean up their balance sheet by selling some of the assets and retiring debt. No new economic value would be created (other than, perhaps, a more efficient use of the assets). Existing assets would merely be transformed from capital stock to cash. But as soon as this conversion is completed, Ottawa, one of the wealthiest governments in Canada, then seizes the assets by clawing back the vast majority under equalization. In most cases the clawback is on the order of about 90%, a very high marginal tax rate indeed on a transaction which, if undertaken by a company or an individual, would not be treated as taxable income at all.

With your permission, I will turn now to the question of what equalization subsidizes, because while equalization taxes economic activity, and does so very hard, guaranteeing that we get less of it in equalization-receiving provinces, it also subsidizes certain things quite a lot, ensuring we get a lot of it. The most important thing equalization subsidizes, of course, is provincial government, and we get quite a lot of that!

In fact it is a commonplace that Atlantic Canada, for example is overgoverned, and a lot of people shake their heads at the continued existence of so many provinces serving such small populations. But really there should be little surprise that government in our region looms so large relative to the size of the productive economy: taxpayers in other parts of the country pay for us to have a much larger public sector than we would choose to have for ourselves if we had to foot the entire bill.

It seems clear that Newfoundland would not have the lowest pupil teacher ratio in the country, Nova Scotia would not have the highest number of universities per capita, Manitoba would not spend the most per capita on health care of any province in the country if the taxpayers in each of those provinces had to foot the bill themselves. And it is a virtual certainty that if the Atlantic provinces did not receive such a large subsidy from federal taxpayers that there would be a lot more co-operation and collaboration across provincial boundaries.

As an aside, I would draw your attention to the problem that equalization introduces for traditional notions of democratic accountability. Note that under the principle of no taxation without representation, we normally expect that the electorate voting for policies is also the electorate that must bear the burden of taxation to pay for the policies it supports. With equalization this accountability loop is broken.

Politicians in equalization-receiving provinces may promise programmes to their voters knowing that they will not have to impose the burden of taxation necessary to pay for those programmes, and voters can vote for spending secure in the knowledge that they can pass the bill along to others who do not vote in the province. To this extent, equalization subsidises democratic irresponsibility.

In addition, equalization subsidises poor economic policy. In a sense, we've known this ever since Tom Courchene did his analysis showing all the ways in which equalization compensated a province for the lost economic activity and lost revenue caused by economically-destructive but politically popular programmes in equalization-receiving provinces. Courchene's example, as I recall, was the then prevailing policy in Quebec of having the highest minimum wage in the country, if not the continent.

But we can now update Courchene. For example, my Institute has published a paper by Ken Boessenkool, a well-known policy analyst who has published with both the C.D. Howe Institute and AIMS, as well as independently.

As Ken notes, for at least thirty years, we policy wonks have built economic models showing equalization creates incentives for less-developed provinces to raise their taxes. By manipulating their own tax rates, in theory poorer provinces can affect the size of their equalization payment, and get partially compensated for the debilitating effects of those higher taxes.

But until now no one has actually checked the evidence to see whether this prediction about equalization's perverse incentives is actually borne out by the facts. The verdict is now in: there is strong evidence that equalization does, in fact, encourage poorer provinces to overtax their population.

Start with the evidence about tax rates. The burden of personal income taxes in poorer provinces is, on average, one third higher than in richer provinces (British Columbia, Alberta and Ontario). Capital taxes in poorer provinces are more than two times higher than in the rich provinces; sales taxes are half-again as high; and fuel taxes are one-tenth to three-fifths higher. Even if you take low-tax Alberta out of the calculation, and compare taxes in the equalization-receiving provinces only with those in Ontario and B.C., the conclusion still holds.

Now the wonks not only predicted that taxes would be higher in recipient provinces; they also foresaw two other effects of equalization on taxes. First, they predicted that the bigger the province, the stronger the incentives would be – i.e. these incentives should be stronger for Quebec (the largest recipient) than for the Atlantic Provinces. Second, they predicted there would be a perverse incentive to levy higher tax rates on weaker tax bases (those tax bases most likely to shrink under the burden of heavy taxation) and lower tax rates on stronger tax bases (those more resistant to the effects of heavy taxes).

The evidence supports both predictions – tax rates in Quebec are generally higher than tax rates in Manitoba and Saskatchewan, which are in turn higher than in the Atlantic Provinces. To take but one example, average personal income tax rates as measured by Ottawa's equalization calculations, are more than 43 percent higher than the national average in Quebec, 18 percent higher in Manitoba and Saskatchewan and 16 percent higher in the Atlantic Provinces. Recipient provinces also show evidence of levying higher tax rates on relatively weak tax bases, and lower tax rates on relatively stronger tax bases.

These findings are striking, for they confirm not only that the constitutional imperative to ensure “comparable tax rates” is not working, but that the predictions of the theorists about equalization’s perverse incentives are precisely mirrored in the real world. In short, equalization rewards recipient provinces for imposing high and damaging tax rates.

For far too long proponents of equalization have dismissed such concerns about perverse incentive effects as ivory-tower analysts having too much fun with economic models. They were only partly right (we do have fun with our models). It will now be much more difficult to play down these incentive effects in the face of this empirical support.

Of particular interest is the fact that the highest tax rates in recipient provinces tend to be on personal income and, to a slightly lesser extent, taxes on consumption. In other words, the perverse effects seem to be showing themselves most strongly via taxes on people.

These higher tax rates that are a result of equalization’s perverse incentives threaten to derail a prosperous future for Canada’s poorer provinces. At a time when human capital is one of the most important keys to growth in an increasingly globalized and technologically dependent world, these incentives ought to worry all Canadians who are concerned with the future of our more economically dependant regions. These regions have faced enough challenges in the past, and in the present, without the noble intentioned equalization program creating further perverse results.

Moreover, Canada’s wealthier provinces have clearly chosen a low-tax model as the basis for their future growth, and are in competition to lower tax rates. That means that the provinces most in need of growth, the equalization recipients, are now being rewarded for keeping their tax rates too high, as the wealthier provinces drop their taxes to make themselves a magnet for investment and jobs. Such a policy is almost guaranteed to keep the poorer provinces poor and to make dependence on transfers a permanent feature of Canada’s policy landscape.

In fact, if there has been a shift in emphasis in recent years over policies that promote growth internationally, and not merely within Canada, it has been a shift away from reliance on government spending to a reliance on lower taxes and the stimulus that provides to investment and entrepreneurial effort. It has been the reduction in tax load, along with reform of social programmes and a move away from intrusive government direction of the economy that has been the dominant theme in economic success stories of recent years such as Ireland, Holland and Georgia in the American South. If you wish to explore this analysis yourself, please read *Road to Growth,* available on the AIMS website at www.aims.ca

Only a similar significant growth spurt in the equalization-receiving provinces can help them to close the disparity gap with the rest of the country. I note that there is a large body of theoretical and empirical literature in economics, called convergence theory, that shows why and how lagging economies can and should, in the right policy conditions, in fact grow faster than leading edge economies, and close the gap over time. Yet in Canada our lagging economies have continued to lag, and have closed the gap much more slowly than in other places, including in the United States, where there is no equalization programme at all.

The final effect of equalization that I want to touch on is the distortion of democratic accountability that it introduces. As I've already remarked, equalization subsidises provincial spending, and any economist will tell you that if you subsidise something you will get more of it. But WHY do you get more of it? Because if people don't have to pay the full cost of what they're consuming, they will demand more of it than they would if they had to pay the full shot. In other words, subsidies allow people to pass along a portion of the costs of their own decisions to others.

The reason that that is important in this context is that it introduces an incentive for provincial governments to promise more spending than local taxpayers would support, and 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. But that means that the electorate that is demanding the spending is not paying the whole shot, and the politicians who are promising the spending are not answerable to all those who are paying.

This helps to create a political culture in which spending is encouraged, and self-reliance and economic growth are discouraged. The ideal, from a democratic accountability point of view, is that those voters who are demanding spending be the ones who bear the cost, and the politicians who promise new spending are answerable to all those whose taxes contribute to the new spending. Equalization short circuits this accountability loop.

You might want to ask yourself the question as to whether Nova Scotia would have kept Sydney Steel alive as long as it did, or kept so many universities dependent on taxpayer support, or bailed out so many municipalities for so long, if local taxpayers had had to foot all the bill.

Federal transfers (the ability to shift costs to non-resident taxpayers) plus deficit financing (the ability to shift costs to taxpayers unborn or too young to vote), meant that we evaded democratic accountability for our decisions and landed ourselves in quite a mess. These were our choices and no one else's, but I think it is a fair question to ask if we would have made the same choices if the incentives we faced were not so badly skewed, including by equalization. I think equalization has been unfair to us, but not in the way that most people mean when they use that phrase.

What's to be done?

Here are two suggestions of things that might be done to equalization to remove its perverse incentives, reduce the cost, reward provinces for developing their economies, and moving equalization-receiving provinces along the path of self-reliance and away from dependence.

1. Take natural resources out of the formula. Accommodating volatile natural resource revenues has always been a huge challenge for the equalization formula. Newfoundland is projected to be producing around 40% of Canada's conventional oil within a few years, while a natural gas pipeline, possibly the first of several, already connects Nova Scotia with New England. It appears that offshore and onshore petroleum resources may be discovered in or around virtually every province in the region.

The development of natural resources, primarily oil and gas but also other minerals, such as the Voisey's Bay nickel deposit, creates the conditions in which economic growth in the region could well outstrip that of the rest of the country. Taking natural resources out of the formula would put the Atlantic provinces in exactly the same position Alberta was in the early days of equalization. Alberta was an equalization recipient, but natural resources were not included in the formula. Within a few years, Alberta had leveraged its resources into a prosperity that allowed it to escape dependence. Ottawa will still get is “clawback” under equalization, but only when natural resource-led growth has fed through to thing s like higher corporate and personal income taxes, sales taxes, real estate values and so on.

Further, the case for redistributing energy revenue is weak on economic grounds. It makes sense to equalize personal income taxes across provinces, because such revenue is properly regarded as ordinary government income. In contrast, the exploitation of natural resources is really the sale of a capital asset. There is only so much oil or gas and the benefits should be spread over more than one year. To put it into accounting terms, natural resource revenue represents a sale of a capital asset rather than current income.

(It is worth mentioning that Ottawa excludes Alberta from the calculation of fiscal capacities in equalization, thus lessening the impact of natural resources on equalization payments.)

Treating natural resource revenue as a sale of a capital asset is one of the rationales for Alberta's Heritage Savings Trust Fund -- money saved from high natural resource revenue so future generations benefit from the depletion of a non-renewable asset. It is also why Alberta passed a law requiring 75% of unexpected surpluses in Alberta to be used to pay down debt. For the same reason, only a small portion, certainly much less than 70% and perhaps none, of Nova Scotia's resource revenue should be deducted against its equalization entitlement.

The second reason not to include natural resources in equalization is that the discovery and exploitation of natural resources affects the prices and values of things already included in equalization. For example, when the NEP reduced the effective price Alberta received for its oil, the value of houses plummeted and wages for Alberta employees followed right behind. Because property taxes and personal income taxes are included in equalization, there is effectively double counting. Equalization payments rise and fall with the price of natural resources, and then rise and fall further when prices in the broader economy react to this fact.

You may be interested to hear that I oppose the sort of special deals that Newfoundland and Nova Scotia are seeking under the various Atlantic offshore accords. This is not the way to deal with the perversities created by the inclusion of natural resources in the equalization formula. I think both the politics and the logic of this approach are weak and look too much like special pleading, while also creating some long-term equity problems, which the prime minister is trying to deal with awkwardly with his proposals for caps (tied to Ontario’s fiscal capacity) and time limits.

I am also of the view that if the case is to be made that Ottawa ought not to claw-back the money generated by asset sales (i.e. where no new value is created, but there is merely the transformation of an existing asset from one form to another (natural resource royalties, Crown corporation assets, etc.)), then the corresponding case also needs to be made: the provinces should not spend this money as though it were ordinary revenue.

Instead, these monies should be exempt from the clawback only to the extent that the proceeds are treated as capital assets, by using them either to reduce debt or build up a heritage fund as Alberta has done. The *revenue* from such a fund would then be available to be spent as ordinary income and should be subjected to the clawback, but not the capital.

2. Swap equalization payments for a debt reduction plan. The lion's share of federal equalization payments to provinces go straight back out the door in the form of interest payments on provincial debt. In the case of Nova Scotia, for example, the province spends $900 million annually servicing its debt, and gets roughly $1.3-billion in equalization. Newfoundland's equalization payment almost exactly matches its debt service. Quebec's debt service costs are almost twice its equalization payment. Ottawa could take over part or all of the provincial debt of equalization-receiving provinces, in exchange for corresponding but permanent reductions in equalization payments and firm rules to prevent the accumulation of new debt.

The strengthening of provincial balance sheets and reduction in the depth of dependency on federal transfers would give the provinces much better incentives to develop their own economy, and a firm yet reasonable time frame in which to act. Ottawa can service this debt more cheaply than the provinces, resulting in a mutually beneficial deal.

Is the constitution an obstacle to reform?

I probably need, before leaving the topic of reform, to tackle one last topic. For those willing to look past good intentions, the next big stumbling block to reform can appear to be the constitution. Equalization is constitutionally entrenched, say the defeatists, so we just have to live with it.

Hang on. Let's take a look at exactly what the constitution says: "Parliament and the government of Canada are committed to the principle of making equalization payment to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

Let’s see. The constitution doesn’t say equalization payments must be made, or that Ottawa has an obligation to make them. It doesn’t even say Ottawa is committed to making such payments. It merely says Ottawa is “committed to the principle” of making them. It does not say those payments must go to provinces; a case could be made that payments made to individuals in the equalization-receiving provinces would be sufficient, since those provinces could capture the payments via taxes if they wished. Nobel Laureate James Buchanan, the “father of equalization”, has long argued equalization payments should be made to individuals and not governments.

Nor does the constitution say how much equalization should be paid. It doesn’t say Prince Edward Island should have the same per capita revenues as Ontario, or as the national average, or as the “five province standard” used today. It uses weasel words wherever possible. Revenues have to be “sufficient” (one man’s sufficiency is another’s penury) to provide “reasonably comparable” levels of public services at “reasonably comparable” levels of taxation.

In fact the equalization provision of the constitution bears the marks of its birth. It is not the constitutional embodiment of some high principle. It is the product of sordid political horse-trading. When Pierre Trudeau was desperately seeking provincial support for his constitutional reform package in 1981, New Brunswick and Nova Scotia demanded that equalization be put in the constitution as part of the price for their backing.

Ottawa was horrified. The constitution is no place for spending programs. Despite the fact most Canadians would rank spending on health care and education far above equalization, for example, the constitution is silent on what kind of programs we should have in those areas. That’s a job for politicians, and the politicians should be free, subject to elections and other forms of democratic accountability, to tailor spending and programs according to changing circumstances and priorities.

So Ottawa bargained hard and got the mealy-mouthed language that now “constitutionalizes” equalization. The country’s leading constitutional commentator, Peter Hogg, says this provision is “probably too vague, and too political” to take it to court and have any hope judges would find it committed Ottawa to much of anything.

Thus, despite much huffing and puffing about Ottawa not “living up to its constitutional obligations”, the equalization-receiving provinces have never taken the feds to court to make them cough up what the recipient provinces think is their due. Ottawa has changed the equalization standard many times, and put limits on the total payout, without any province daring to challenge that decision before the courts.

There are many equalization reform proposals on the table that aim to achieve the laudable goals of equalization, but that lessen the perverse incentives of the current approach. Based on history, present practice, and the weak language entrenching equalization, it is hard to see why the constitution should be a serious bar to a cleverly designed equalization reform.

Summary

In summary, the arguments I have laid out here suggest that that equalization-receiving provinces have little reason to try to maximize their long-term tax revenue and economic development, most of which would be scooped up by wealthy Ottawa. Instead, they have every reason to try to extort superficial benefits out of local industry, such as lots of very short term and often relatively low-skilled jobs. In the Atlantic offshore, for example, they build outdated gravity-based structures for oil extraction, or require companies to make vague promises of massive exploration and development spending in exchange for drilling rights. They could sell more of the resource up front, to retire some of their huge debt and reduce their crushing interest payments, but after Ottawa’s huge take, that is a fool’s strategy.

In short, equalization vigorously taxes productive economic activity in the least developed parts of the country, and taxes attempts by the poorest governments in the country to become more reliant on their own-source revenues.

Moreover, equalization subsidises government that is larger than local preferences would be willing to pay for, and creates a public sector that is far too large relative to the local productive economy. The democratic accountability loop that ensures local electorates bear the cost of their own political decisions is broken and we have taxation without representation on a large scale as a result.

Equalization subsidizes poor economic policy, and in particular high tax rates, at a time when low tax rates are thought to be a key ingredient in stimulating prosperity, and at a time when the wealthiest jurisdictions in North America are racing one another to reduce their tax load. Equalization helps to freeze poorer provinces in dependence, underdevelopment and poverty, although regional economic development policy and EI also bear a significant part of the blame for this, especially in Atlantic Canada.

Finally, equalization breaks the democratic accountability chain that should link voters who demand public services, the politicians who make promises and the taxpayers who have to bear the costs of those decisions. The result is that we create incentives for taxpayers, voters and politicians in recipient provinces to spend much more on public services than they would choose for themselves if they had to pay the bills.

Conclusion

While there is some justification for equalization in a federal state, the case for it is not overwhelming. In any case, it would certainly appear that our program has a number of perverse incentives within it that actually help to trap less well-off provinces in a state of dependency and underdevelopment. Those incentives get worse the greater the degree of dependence.

While government leaders in Canada maintain a united front in defence of the current program, under the surface, things are starting to shift. Continental free trade has made many provinces move to a strategy of aggressive tax cutting as a way of attracting new workers and investment. This means that the old tax and spend common front among the provinces is breaking down and the wealthy regions are demanding a better accounting from Ottawa for its spending too. And since under free trade one can no longer assume that transfers from the wealthy regions will return to them in the form of the purchase of goods and services, the economic self-interest that underpinned many transfer programs is gradually being undermined.

Whether the changes will take the form I have suggested, or some other direction is irrelevant. What is clear is that days of the old transfer mentality are numbered. The changes can't come fast enough for the less well-off regions of the country, whose potential has been frustrated for so many years by programs, like equalization, whose effects reach far beyond the good intentions of their authors.

These perverse effects may never have been part of equalization's good intentions, but the effects are no less real for that. We can and should be doing a lot better in closing the economic disparities that plague Canada, but equalization is more and more clearly part of the problem and not the solution.