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de Montréal

# MODEST BUT MEANINGFUL CHANGE: REFORMING EQUALIZATION

**PAUL BOOTHE**

Equalization: Welfare Trap or  
Helping Hand? (PAPER #8)

CONFERENCE PAPER



April 2002

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Paper presented at the AIMS/MEI/FCPP Conference on  
“Equalization: Welfare Trap or Helping Hand?”

October 25, 2001, Montreal

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Montreal Economic Institute

Published by Atlantic Institute for Market Studies  
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### **Acknowledgements**

We would not have been able to carry out this project without the generous support of the Donner Canadian Foundation and the John Dobson Foundation.

Page layout and design by Gwen North

The author of this report has worked independently and is solely responsible for the views presented here. The opinions are not necessarily those of the Atlantic Institute for Market Studies, the Frontier Centre for Public Policy, the Montreal Economic Institute, their Directors, or Supporters.

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# SECTION 1

## INTRODUCTION

One of Canada's key federal transfer programs, equalization, has been called the 'glue' that binds the Canadian federation. Mandated by the *Constitution Act* (1982), the program's aim is to "...ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (36.2). Indeed, Canada's equalization program is much studied as a key piece of the machinery of one of the world's most decentralized, and successful, federations.

One of the strengths of equalization is that it is renewed on a regular basis to ensure that the program adapts to changes in the fiscal circumstances of Ottawa and the provinces. These regular renewals are facilitated by a sizeable 'invisible college' of experts in government and academe who study the program and debate potential reforms on an ongoing basis.

The next regular renewal of the program is scheduled to take place in 2003-04. The purpose of this paper is to review the current program and concerns that have been expressed in different quarters and to suggest a new direction for modest, but meaningful change.

The remainder of the paper is organized as follows. Section 2 discusses the current program and some of the concerns that have been identified. Some of the changes that have been proposed to address these concerns are considered in Section 3. In Section 4, the radical reform proposed by Boothe and Hermanutz (1999) is outlined and Section 5 contrasts it with a more modest proposal to reform equalization. A brief summary concludes the paper.

## SECTION 2

# CONCERNS WITH THE CURRENT PROGRAM

The current equalization program can be described as a 1) limited, 2) federally funded, 3) gross equalization scheme 4) based on a representative tax system (RTS). It is limited, because it does not encompass all forms of equalization that is paid to provinces. Transfers for health and others social programs (the Canadian Health and Social Transfer— CHST) have an equalizing feature built into the formula. In addition, some would argue that federal spending on ‘active’ labour market measures funded from employment insurance premiums also constitute a form of equalization. It is federally funded because it is funded from general revenues of the federal government rather than transfers between provinces. It is a gross equalization scheme because provinces below the standard are equalized up, but provinces above the standard are not equalized down. It is based on a RTS because provinces’ fiscal capacity, the standard, and deviations from it are calculated using national average tax rates on more than thirty bases actually taxed by provinces. The program contains a number of ad hoc measures to deal with issues related to sustainability, perverse incentives and volatility.

Over time, critics have expressed a number of concerns with the program and have proposed a number of improvements that can and should be made. However, there is not general agreement over what should be included in the lists of concerns. For the most part, this stems from a lack of agreement over the goals of the program and therefore the criteria that should be used to judge its success or failure.

What is included in the list of concerns? The first, has to do with the sustainability (sometimes called the affordability) of the program. In part, sustainability issues arise because the program is a gross scheme and an expansion of benefits to below-standard provinces is not balanced by a reduction in benefits to above-standard provinces. Over the years, the federal government has instituted a number of ad hoc measures to limit the growth of the program. Most important of these has been the move from a national to a five-province standard – removing Alberta and the Atlantic provinces from the calculation, and the ceiling -- limiting the overall growth of the program.

Of course, improving sustainability for the federal government is viewed as worsening adequacy by provinces below the standard. These provinces point to the fact that transfers for equalization have declined from about eight percent of federal revenue in the early 1980s, to about six percent now. By itself, this fact does not tell us much about adequacy since, if disparities among provinces’ fiscal capacity had diminished (and they have), one would expect the program to become smaller. In any case, it is a relative rather than an absolute measure, and says little about whether the constitutional mandate of the program is being fulfilled.



Some academics and independent policy commentators argue that the program creates perverse incentives for provincial policy makers. Two kinds of potential perverse incentives have been identified. The first has to do with the incentive for provinces below that standard to pursue economic development opportunities less vigorously because of the corresponding loss of equalization revenue. The other is that provinces may set tax rates too high because losses in revenue are offset by equalization.

With respect to the first concern, it is useful to note that policy makers do not always operate on the same margin as economic theorists. Critics have yet to produce concrete evidence of any job-creating economic development proposal in any province that was abandoned because of a potential loss in equalization revenue. With respect to the second concern, while governments may be compensated by equalization for losses associated with too-high tax rates, voters are not. Ultimately, voters call the shots. For these reasons, it may be that potential perverse incentives embodied in the Equalization Program do not pose a problem at the practical policy level.

Another concern that has been expressed is related to the complexity of the program and the attending lack of transparency and accountability. Although the program is based on a relatively simple idea, in practice it is so complex that even experts in federal and provincial ministries of finance cannot predict with any accuracy what actual transfers will be year to year. For some provinces, equalization is an extremely important revenue source. It is extremely difficult for voters to hold governments accountable for their actions if such a large portion of their budget is unpredictable.

A final, related concern has to do with the volatility of equalization payments. Given the design of the program, one would expect that swings in own-source revenue would be offset by equalization payments, thus reducing the overall volatility of revenues. Recent empirical work for Saskatchewan shows that this is not, in fact, the case.<sup>1</sup> Rather, over time, equalization has acted to increase revenue volatility in the province and made the job of fiscal management more difficult.

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<sup>1</sup> See Boothe (2001).

## SECTION 3

# PROPOSED SOLUTIONS

Over time, a number of solutions have been proposed to deal with the concerns listed above. In some cases, the proposals represent wholesale reform of the program while others represent a piecemeal approach. Of course, the issue of sustainability, at least from the viewpoint of the federal government, was dealt with in earlier renewals by the move to the five-province standard and institution of the ceiling. These measures, however, work directly against the concerns of some provinces regarding the adequacy of the program. Thus, it is not surprising, that their proposal to deal with the adequacy issue includes removal of the ceiling and return full revenue base coverage and a ten-province standard. To date, the federal government has not show any sympathy towards these proposals and in this regard, the efforts of the provinces have been hampered by the lack of a convincing demonstration that the adequacy of the program is suffering.

With respect to the issue of perverse incentives embodied in the program, this concern has mostly been raised by policy commentators and is vehemently rejected by recipient provinces and the federal government.<sup>2</sup> One proposal that has been put forward is to remove natural resources from the list of revenue bases to be equalized. According to its proponents, this change would have the effect of improving incentives for Atlantic provinces to develop these resources and also permit a return to a ten-province standard since Alberta's (or other provinces') energy revenues would no longer threaten the sustainability of the program. However, proponents appear to fail to appreciate the short-term consequences of such a move. In the short run (i.e. with the ceiling still in place) such a change would create a massive windfall for Saskatchewan (where energy revenues significantly reduce equalization entitlements) at the expense of the other provinces below the standard.

Turning to the issues of transparency and accountability, most of the concern in this regard has been expressed by policy commentators. To deal with this concern, a fundamental change has been proposed. It has been argued that moving to a simple macro indicator to determine equalization entitlements would make the program much easier to understand for policy makers and the public. Further, if the ad hoc features of the current program add to its volatility, such a move might also reduce the volatility of the program.

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<sup>2</sup> Interestingly, Nova Scotia and Newfoundland seem to be somewhat schizophrenic on the issue – denying the presence of perverse incentives, yet supporting a special treatment of natural resource revenue, at least for them.

## SECTION 4

# A RADICAL REFORM PROPOSAL

In 1999, Derek Hermanutz and Paul Boothe proposed a radical change to Equalization (Boothe and Hermanutz, 1999). Using the framework developed in Section 2 to describe the current program, the (BH) proposal could be described as a 1) comprehensive, 2) provincially funded, 3) net equalization scheme 4) based on a macroeconomic indicator. The BH scheme was comprehensive because it was designed to replace not only the current equalization program but also transfers related to the CHST and regionally-targeted policies related to EI. It was provincially funded because it involved a tax-point transfer from the federal government to the provinces, who in turn either contributed to or withdrew from an equalization pool. It was a net equalization scheme because, with provinces either contributing to or withdrawing from the pool, provinces were equalized down or up to the standard. Finally, it was based on a macroeconomic indicator (adjusted personal income) chosen to best match current transfers and thus reflect the implicit political bargain between Ottawa and the provinces.

The BH proposal addressed some, but not all of the concerns with the current program discussed in the previous section. For example, because the program was a provincially administered, net scheme, the sustainability of the program was ensured by construction. The proposal did not deal with the question of adequacy, because it was designed to reflect the current political bargain, which provinces below the standard now argue is inadequate. It dealt with perverse incentives by using a macroeconomic indicator which switched the focus from provincial revenues to provincial economic activity, thus lowering the implicit tax on additional provincial revenue. It was a much simpler scheme, thus enhancing transparency and accountability and it was likely to reduce volatility and improve predictability by removing the many ad hoc features of the current program and because it was based on a five-year average of macro data.

It is safe to say that although there is currently a good deal of research and debate regarding whether equalization should be based on a macroeconomic indicator, there has been little interest shown in the other, more radical features of the BH proposal. Does this lack of interest simply reflect inertia on the part of federal and provincial governments or are other, political factors at play?

At least two features of the BH proposal are likely to raise political concerns in some quarters. The first is the comprehensive nature of the scheme. Equalization, CHST and regionally-targeted EI measures all have very different constituencies and political dynamics. Although it may make theoretical sense to combine them into a single transfer program, at the practical level combining them may be a barrier rather than an incentive to reform.

The second feature likely to raise political concerns is provincial administration. Although this facilitates the move to a net equalization scheme and thus contributes to the sustainability of the program, removing the federal government from the equation is problematic for provinces below the standard. In the current program, citizens in provinces that receive equalization can respond to unpopular program changes (i.e. reductions in the size of transfers) by voting against the federal government. However, if the program were provincially administered, citizens in provinces below the standard would have no democratic recourse to unilateral changes to the program by provinces above the standard. For this reason, recipient provinces prefer federal to provincial administration of the program.

Of course, the federal government is also opposed to provincial administration for political reasons. First and foremost, the federal government gains some political benefit from providing transfers to receiving provinces, and they would be unlikely to want to give that up. Further, with measures to ensure sustainability in place, the federal government reduces its overall budgetary flexibility by giving up revenues and expenditure responsibilities to provinces. For both these reasons, the federal government is unlikely to support a provincially-administered equalization scheme.

## SECTION 5

# A MODEST REFORM

If the fundamental changes proposed by BH are too radical to form the basis of reform, is there a more modest proposal that might be successful in dealing with the concerns regarding the current program? The answer is a qualified yes. Consider a scheme that is 1) limited, 2) federally funded, 3) net equalization scheme 4) based on a macroeconomic indicator. What might such a scheme look like?

The scheme would be limited in that only the current equalization program would be replaced. Changes to CHST and regionally-targeted EI would be beyond the scope the reform. It would be federally administered like the current program, but rather than being open ended with ad hoc measures such as the five-province standard and the ceiling to limit program growth, the size of the program would be fixed as a proportion of federal revenue. The program would grow at the rate of federal revenue and thus protect the federal government against unsustainable demands for transfers. It would be a net scheme with provinces equalized up to and down to the standard. Finally, the standard would be calculated using a single macroeconomic indicator.

Would such a program address the concerns raised in Section 2? Dealing first with sustainability, fixing the program size as a share of federal revenues should address the concerns of the federal government in this regard. Elimination of the ceiling and moving to a ten province standard should address some of the adequacy concerns of the recipient provinces, although the program size would have to be fixed at a somewhat higher proportion than the six percent of federal revenue that the program currently costs. The trickiest technical issue would be to design a net scheme without requiring some provinces to contribute directly. The solution to this problem is linked to the amount of federal revenue earmarked for the program or alternatively combining the program with a federal transfer program that benefits all provinces. Finally, basing the standard on a single macroeconomic indicator and eliminating a number of the current ad hoc features of the program should lessen the potential for perverse incentives, improve transparency and accountability and perhaps lead to less volatility.

## SECTION 6

# CONCLUSIONS

Equalization is a program that has served the Canadian federation well and deserves its constitutional mandate. One of the reasons for its ongoing utility is the regular process of renewal supported by an invisible college of government practitioners and academic experts. At all times, there is a need to strike a balance between failing to making regular improvements to the program and trying to solve too many policy problems with a single program.

In this paper, I have reviewed a number of concerns that have been expressed regarding the current program and considered some of the changes that have been proposed to deal with those concerns. Overall, we would be better served by a fundamental reform rather than the piecemeal, ad hoc measures advocated by some commentators. A modest proposal like the one outlined here provides the best hope for dealing with current concerns, while maintaining the coherence of the program.

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