

## *Fiscal Federalism and the Future of Canada*

*Selected Proceedings from the Conference – September 28-29, 2006*

### **Is Equalization Broken? Can Equalization be Fixed?**

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#### **Foreword**

In September of 2006, Queen's Institute of Intergovernmental Relations hosted *Fiscal Federalism and the Future of Canada*, a conference organized by the then IIGR Director Sean Conway, Peter Leslie and Christian Leuprecht. Given that several of the conference presentations dealt with the future of equalization and given that the 2007 federal budget will outline the Harper government's preferred future for equalization, the Institute felt it appropriate to publish these contributions in working paper format prior to the federal budget.

Appropriately this working paper series begins with brief summaries of the two commissioned reports on equalization and territorial formula financing – one from the Council of the Federation's Advisory Panel on Fiscal Imbalance and the other from the federal Expert Panel on Equalization and Territorial Formula Financing. These will be followed by analyses by other conference participants whose contributions will relate to these two proposals as well as to the larger fiscal federalism issues now in play. The views expressed in these working papers are those of the authors, not those of the Institute of Intergovernmental Relations.

As the only organization in Canada whose mandate is solely to promote research and communication on the challenges facing the federal system, we are pleased to introduce these working papers into the public debate on equalization and fiscal imbalance

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#### **Introduction**

Equalization has been described as “the glue that holds our federation together” and a program that “reflects a distinctly Canadian commitment to fairness.”<sup>1</sup> The principle of fairness is reflected in the redistributive nature of the program in that equalization has the effect of redistributing revenue from the richer to the poorer provinces. Its role in fostering national unity is related to the fact that the goal of the inter-provincial redistribution of resources is to ensure that Canadians from all regions “have access to comparable public services at reasonably comparable levels of taxation”.<sup>2</sup> The importance of equalization to Canada is reflected in the fact that it is part of the Canadian Constitution.

Despite the importance of equalization to Canada's sense of identity, recently there has been evidence that equalization is ‘broken’. The program has been the source of federal-provincial tension and of controversy among the provinces. Moreover, both levels of government have commissioned reviews of equalization. The federal report, *Achieving a National Purpose: Putting Equalization Back on Track*, was prepared by a panel of experts commissioned by the government of Prime Minister Paul Martin. The provincial-territorial report, *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance*<sup>3</sup>, was done by the Advisory Panel to the Council of the Federation – which represents the provinces and territories – and it considered equalization as well as the issue of the fiscal imbalance. Both the federal and provincial-territorial reports agree that equalization needs to be changed, although they diverge in their views of what changes are required. This evidence that equalization is ‘broken’ leaves two related

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questions unanswered: how badly is equalization 'broken' and how can it be 'fixed'?

### **The Issues**

The most compelling evidence that equalization is not irreparably broken is the fact that no province disputes the principle of equalization. Instead, the debate among Canadian governments and academics is about the scope and decision-making structure of the equalization program. In terms of the decision-making structure, the Council of the Federation report recommends the creation of a First Ministers' Fiscal Council by the federal, provincial and territorial governments "as the principal institution in Canada for dealing with intergovernmental fiscal issues".<sup>4</sup> Because the Council would negotiate all federal-provincial transfers every five years, it is argued that there would be "greater stability and predictability to the process".<sup>5</sup> Also, the power of the federal government to make unilateral decisions about equalization and other federal transfers would be curtailed.

An even more contentious debate centers on the scope of the equalization program. Many provinces that receive equalization argue in favor of expanding the program, while provinces like Ontario that do not receive equalization contend that such enhancements are unaffordable. Thus, a key issue that has to be addressed is the extent to which equalization should address what has been called the horizontal fiscal imbalance – the "great disparity in the ability of individual provinces and territories to deliver comparable levels of services at reasonably comparable rates of taxation."<sup>6</sup>

### **The Approach**

My approach in addressing these issues has been influenced by my experience as a provincial Finance Minister in the 1990s and by my career as a Canadian historian. From a historical perspective, it is important to understand the role that equalization played when it was created and the extent to which circumstances have changed since the program was established in 1957. From a political perspective, during my tenure as Saskatchewan's Finance Minister, I was involved in the 1993

negotiations over proposed changes to the equalization formula.

Ministers, as any deputy minister knows, always say that they intend to focus on the general principles and practical political realities involved in programs like equalization because the truth is they do not understand the complex technical issues involved. (That, of course, is why we have deputy ministers.) True to form, I will focus on the broader issues and practical political realities involved in assessing and fixing the shortcomings of equalization. In short, I will focus on the big picture issues and leave others to address the specific changes to equalization that are being recommended by the federal and provincial-territorial reports.

Fixing equalization requires a big picture perspective in two senses. Equalization has to be seen in the much broader context of federal-provincial fiscal relations. Also, it has to be remembered that equalization is only one policy tool available to the federal government to address inequalities in Canada. Assuming that there are significant limits to the federal government's capacity to use equalization to address the horizontal fiscal imbalance this does not necessarily mean that the federal government can not act to lessen inequalities in Canada. There are other programs that can be enhanced to promote greater fairness in Canada.

### **What is Broken: the 'Side Deals'**

Deciding what needs to be 'fixed' and what does not need to be 'fixed' about equalization requires an understanding of what is broken. Most recently, the decision by the government of Prime Minister Paul Martin to abandon the rules based formula-driven approach to equalization and to sign "side deals" with Newfoundland and Nova Scotia did a lot of damage to equalization. Almost as important as the terms of the side deals was the process used by the Premier of Newfoundland to pressure the federal government. Newfoundland Premier Danny Williams' tactic of relying heavily on the media to make his province's case and his use of antics like taking down the Canadian flag were not lost on other provinces. Nor was the success that he achieved using these kinds of tactics. In the 1990s, when I was a provincial finance minister and was involved in the renegotiation of equalization, success by a

provincial government required working with other provinces on specific issues to find common ground. The lesson of the side deals was that success requires aggressive, persistent and high profile advocacy of a province's own interests, and the rallying of its electorate to its cause, rather than seeking common ground with other provinces. Hence, other provinces became more aggressive in their positions and more narrowly focused on their own provincial interests.

The terms of the side deals also led to an understandable sense of unfairness in other provinces and this was reflected in the positions taken by the provinces of Saskatchewan and Ontario. Consider the case of Saskatchewan. For years Saskatchewan has used the federal-provincial negotiating process to make its case about an equalization formula that allows claw-backs of resource revenues that have at times exceeded 100 percent.<sup>7</sup> When the side deals with Newfoundland and Nova Scotia excluded natural resources from equalization in the two Atlantic provinces, Saskatchewan had good reason to feel aggrieved and to question the merits of using 'quiet diplomacy' to achieve success in federal-provincial fiscal controversies. But to take the position that 'one bad deal deserves another' – that Saskatchewan should have the same deal as Newfoundland and Nova Scotia – only worsened an equally justified sense of grievance in Ontario.

If natural resources are excluded from equalization calculations, then the fiscal capacity of provinces receiving equalization, like Newfoundland, are greater than that of Ontario – a situation that defies common sense. But to take the next step, as Ontario has done, and talk about the 23 or 18 billion dollar gap between what Ontario taxpayers contribute to federal coffers and what they receive in return from transfers and other federal programs is equally troubling. The majority of the gap can be explained by Canada's progressive tax system – the fact that Ontario has more rich taxpayers than most other provinces – and surely the Ontario government is not challenging the principle of a progressive tax system.

### **Fixing Equalization: The Process**

What is critical is that the arguably unreasonable positions taken by Ontario and Saskatchewan and their more aggressive approach in advancing them is a direct result of the side deals with Newfoundland and Nova Scotia and the high profile tactics used to achieve them. What is 'broken', then, is the power of the federal government to use an *ad hoc* process to reach an agreement with two provinces despite the impact these deals have on other provinces. The solution is to return to a rules based formula driven equalization program, which prevents the federal government from using an *ad hoc* decision making process.

There is no reason to believe that adopting the recommendation of the Council of the Federation report to replace the federal power to decide transfers with a federal-provincial Council empowered to make these choices will achieve better results. What is especially interesting is that the provinces and territories could not agree on their response to the report, even though they had commissioned it. Because equalization is effectively a 'zero sum game' in that the advantages gained by one province or group of provinces often come at the expense of other provinces, achieving consensus among the provinces is a difficult if not impossible task. The role of balancing the interests of the various provinces of Canada is one that properly rests with the federal government, with the critical *caveat* that in the case of equalization, federal decision-making has to be rooted in established rules and formulas and can not be subject to the whims of political expediency.

Equalization also has to be seen within the broader context of federal-provincial fiscal relations. Equalization is only one piece of the federal-provincial fiscal pie and in practical terms the redesign of equalization occurs within this broader context. When provincial finance ministers assess federal-provincial fiscal relations, they do not just calculate what their province is getting from equalization. On the contrary, they consider a whole range of federal-provincial fiscal issues from transfers to provincial projects that require federal funding. Consider the case of British Columbia. That province's assessment of how it is faring in federal-provincial fiscal relations will include calculations about what it is

receiving from equalization and other transfers from the federal government. Equally important, however, will be the level of federal support for what can be considered national initiatives within the province, notably the Olympics and the Pacific Gateway Project to upgrade ports in British Columbia.

Considering the size and diversity of Canada, the task of balancing the interests of the various provinces is a task that rightly rests with the federal government and it needs to have the final say about equalization and other federal transfers and programs. But final decision-making power does not mean an unfettered capacity to act unilaterally. What the federal government has to do is build a consensus – an acceptance by enough of the provinces – that the redesign of equalization along with the changes in other transfers and federal programs is reasonably fair. Thus, the task of seeking consensus and compromise among the various provincial interests, and re-jigging equalization in the broader context of federal-provincial relations, requires the political skills of federal politicians not the technical skills of experts.

Although a fundamental change in the decision-making structure of equalization is not warranted, there is at least one other change in the governance of equalization that has merit. In its consultations, the Advisory Panel on Fiscal Balance found that some participants were concerned that “no objective criteria exist for evaluating the effectiveness of the Equalization program.”<sup>8</sup> This is not a small problem for a major federal program that expends billions of taxpayers’ dollars. It could be argued that it would be difficult to find quantitative measures to assess the effectiveness of equalization since so many other factors can affect the fiscal capacity of provinces. Nonetheless, this should not be an excuse for allowing the provinces, territories and federal government to side-step their responsibility to work together to find ways to measure the effectiveness of equalization.

### **The Limits of Equalization: The Historical Dimension**

If the short-term problems with equalization result from the ‘side deals’, the long-term problems relate to the extent to which Canada has changed since equalization was created in

the 1950s. Understanding some of these changes helps to explain a key theme of this paper: if equalization is to be ‘fixed’, then, Canadians have to become more realistic in their expectations of what the program can and can not achieve.

Equalization was established in an era dominated by Keynesian economics and by a vision of Canada that dates back to the 1939 Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission).<sup>9</sup> Keynesian economics was based on the idea that states could engineer their own economies and establish the taxation levels required to fund social programs. The Rowell-Sirois Commission report articulated the vision of the Canadian welfare state that dominated federal policy making for more than a generation and became equated with Canadian unity. It argued in favour of a centralized taxation system that would allow the federal government to manage the economy effectively, establish programs with national standards and use what it called “national adjustment grants” to redistribute money among provinces so that similar programs existed across the country.<sup>10</sup>

For better or worse the world of Keynesian economics has passed and the vision of Canada that flowed from the Rowell-Sirois is no longer as relevant as it was a generation ago. The emergence of the global economy has meant that governments can no longer engineer their economies and their power to set taxation levels at whatever level is deemed necessary to fund social programs has been severely constrained by the need for tax rates to be competitive. The Canadian tax system has become much more decentralized both international and inter-provincial competition has led to further pressure on governments to reduce taxes. Moreover, as the cost of social programs increased and the provinces began paying a greater share of the costs, it has become increasingly difficult if not impossible for the federal government to impose national standards for such programs.

### **The Limits of Equalization: Ontario and Alberta**

Equally important are the changes that have occurred in the two provinces that have consistently been ‘have’ provinces in the sense that they do not receive equalization. In Ontario, governments of all political stripes have argued

since the early 1990s that Canada's largest province is no longer its richest and it can not afford to support the same level of redistribution of resources from richer to poorer provinces. Recently, Premier Dalton McGuinty has focused on the gap, estimated to be between 18 and 23 billion dollars, between what Ontario taxpayers contribute to federal tax revenues and what they receive in return in the form of federal transfers or programs. As mentioned earlier, this position is excessive. However, there is undeniable truth to the argument that Ontario is facing competitive pressures that mean it can no longer sustain the levels of taxation that were possible a generation ago.<sup>11</sup> There is also evidence that the redistribution of resources among the provinces has left Ontario with the "lowest level of per-capita effective revenues" which has curtailed its capacity to fund programs and sustain its infrastructure.<sup>12</sup> In short, there is a very well documented argument that Canada's largest province can no longer support the same level of inter-provincial redistribution of resources as it could a generation ago. Hence, Canadians expectations of what equalization can achieve have to be more limited than they were a generation ago.

While Ontario is facing fiscal pressures, Alberta is reaping a fiscal bonanza from resource revenues and is benefiting from its new status as a debt free jurisdiction. In terms of fiscal capacity Alberta is clearly in a league of its own. Alberta's fiscal capacity after equalization for 2007-2008 was more than \$11,000 per capita, while the fiscal capacity of the other nine provinces ranged from \$6,200 to \$6,900.<sup>13</sup> When one also considers that Alberta is debt-free while other provinces pay billions in interest costs, the gap between what Alberta and the rest of Canada's provinces can afford to spend on programs is dramatic.

Thus, for a variety of reasons the capacity of the federal government to redistribute resources from the richer to the poorer provinces to create a situation where there are similar national programs with similar standards from coast to coast is severely constrained. The gap between what Alberta can afford to spend on social programs and what a province like Prince Edward Island can afford is virtually unbridgeable. It is also true that Ontario can not

or will not continue to sustain increasing levels of redistribution of resources from richer to poorer provinces.

### **Public Expectations of What Equalization Can Achieve**

While much has changed since equalization was created in the 1950s, there is evidence that public opinion has not followed suit. Public expectations of what equalization can or should do are not consistent with the limits on what program can achieve. The panel commissioned by Council of the Federation in its consultations discovered that Canadians were not satisfied with the vague language used in Section 36(2) of *The Constitution Act* to describe equalization. The section states that provinces should provide "reasonably comparable levels of public service at reasonably comparable levels of taxation"<sup>14</sup>. Instead, there was public support for a higher standard. Canadians who were consulted wanted to have the "same acceptable standards" of programs across the country.<sup>15</sup> The title of the panel report, *Reconciling the Irreconcilable*, might aptly describe such a view. Equalization can lessen the inequalities in the fiscal capacities of the provinces, but it simply can not create a situation where the provinces of Alberta and Prince Edward Island have the fiscal capacity to have the "same acceptable standards" of programs.

### **Defining the Limits of Equalization**

Equalization can be 'fixed' as long as long as Canadians have realistic ideas about what the program can and can not achieve. In fact, defining those limits will be important to the long-term success of equalization. Equalization should remain as an unconditional transfer designed to lessen the inequalities in provincial fiscal capacities. The important ideal that there should be some redistribution of resources among Canadian provinces so that there is a basic standard of essential services available to Canadians in all regions should be maintained. But it should also be clear that the goal is not to ensure that Canadians in Alberta and Prince Edward Island enjoy the same level of services, and there needs to be strict limits on the extent to which resources are redistributed among the provinces.

The most effective way to restrict the extent of redistribution of resources among provinces is to

establish the principle that equalization is the only program that has an equalizing component. What should be phased out are other transfers and federal programs that have an equalizing dimension. What has been called “back door equalization” has fostered regional discontent, has at times distorted programs and is anything but transparent given how difficult it is to measure the total costs of redistributing fiscal resources from wealthier to poorer provinces.

The problems with such programs are exemplified by the Employment Insurance program and its forerunner which provides more generous benefits to those living in regions that experience high unemployment levels. The program leads to inequities in that the unemployed in major urban centers like Toronto, where the cost of living is very high, have access to lower benefits than the unemployed in Atlantic Canada, where it is much more affordable to live. Also, for some time, western Canadians have believed that the program discriminates against the region which has historically had low unemployment rates even in tough economic times, since westerners have traditionally moved to other parts of Canada to seek work. Today, there is the additional problem of severe labour shortages in western Canada and an Employment Insurance program that does not actively encourage the unemployed in other parts of Canada to move westward in search of work. As these problems with Employment Insurance show, other federal transfers and programs should be based on sound public policy decisions, not on a “back door” way to add on another layer of equalization.

Another consideration is that having only one equalization program would be more transparent. Currently, it is difficult to assess how much revenue is being dedicated to redistributing resources from richer to poorer provinces. If there were only one program whose explicit goal was redistribution among provinces it would be easier to measure the financial resources being devoted to this goal and find mechanisms to evaluate its success.

Not only should equalization be the only program that seeks to redistribute fiscal resources among provinces, the current program should not be changed or expanded in an effort

to address the horizontal fiscal imbalance between Alberta and the other provinces. It has been argued that the equalization program should be expanded to address the yawning gap between resource-rich provinces like Alberta and the other provinces.<sup>16</sup> But equalization was not designed to bridge that kind of gap and it should not be redesigned to do so.

In fact, any attempt to find a new formula or policy that has the effect of tapping into the resource wealth of Alberta and other western provinces would lead to a crisis in Confederation. The battle would not be with Alberta alone but would involve Saskatchewan and British Columbia and it would make the controversy over the National Energy Policy seem pale by comparison. The provinces of Saskatchewan and Alberta fought long and hard from 1905 until 1930 to achieve control of their natural resources and both provinces would deeply resent any attempt by the federal government to find innovative ways to access revenues from those resources. Also, any fundamental change in federal-provincial transfers that had the effect of reducing the transfers to Saskatchewan, Alberta and British Columbia to offset their increasing resource revenue would be seen as very unfair to the region. So in terms of political non-starters, topping the list should be ideas about addressing the horizontal fiscal imbalance by tapping into western Canada’s resource wealth for the benefit of the rest of Canada.

It should be remembered that the rest of Canada already shares in the prosperity of Alberta. The biggest share of revenue from the Alberta Tar Sands development does not accrue to the government of Alberta but goes to the federal government in the form of various taxes and is therefore distributed to the rest of Canada. Much of the machinery, equipment, services and labour that are used in the development of Alberta resources come from other parts of Canada.

### **Other Ways in Which the Federal Government Can Address Inequality**

Although there are significant limitations on the ability of the federal government to use equalization and other federal transfers to lessen inequalities among provinces, this does not mean that the federal government lacks the power to address inequalities among Canadians. In a global

economy one of the greatest challenges for governments is to understand what they can and what they can not control. Smart governments accept that there are areas in which their power to act is limited. Instead, they focus on the areas exclusively within their domain and act strategically and effectively within this sphere. Equalization is clearly a federal program, but there are significant constraints on the extent to which the federal government can use the program to address the horizontal fiscal imbalance or disparities among provinces in Canada.

The limitations on the capacity of the federal government to redistribute revenue among provinces have to be seen in the broader context of the various federal programs that can be used to address inequalities in Canadian society. There are several programs that are under the exclusive control of the federal government that can be enhanced to mitigate inequalities among Canadians. The federal government has exclusive jurisdiction over the Child Tax Benefit, a program designed to enhance the incomes and services available to low-income families with children. If the federal government wants to address inequalities among seniors it can unilaterally increase the Guaranteed Income Supplement, a federal program that provides subsidies to low income seniors. And federal student assistance programs can be enhanced to alleviate the fiscal problems of students. Thus, there are various policy tools that are exclusively within federal jurisdiction that can be used to lessen inequalities among Canadians.

### Conclusion

Equalization has been an important part of Canada's political and social fabric, but its continued success requires realistic ideas about its future. As much as policy experts might want the program to be based on technical consistency and clarity, equalization and the other federal transfers and programs will become muddled by the compromises and balancing of provincial interests that are necessary in a large and diverse country like Canada. As much as some Canadians would like to see the same national programs from sea to sea to sea to sea, the diversity of Canada and the disparities in the fiscal capacities of the provinces will mean that a more modest standard will be achieved.

The noble ideal of redistributing resources from richer to poorer provinces with the goal of ensuring some comparability in the services available to all Canadians is worth preserving. However, such a goal should not be achieved at the expense of Canada's two wealthiest provinces. Ontario and Alberta remain committed to the principle of equalization. But that commitment will be sorely tested if Ontario citizens come to believe that the quality of their own services is being compromised or Albertans think that the federal government is trying to tap into resource revenues that rightfully belong to the province. Equalization, though broken, is fixable so long as there is a clear understanding of what it can achieve and what it can NOT achieve and should not even try to tackle.

### Endnotes

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<sup>1</sup> Canada, *Achieving a National Purpose: Putting Equalization Back on Track, Expert Panel on Equalization and Territorial Formula Financing*, (2006) Executive Summary, 1.

<sup>2</sup> Canada, *Achieving a National Purpose*, Equalization 101, 1.

<sup>3</sup> The Council of the Federation, Advisory Panel on Fiscal Imbalance, *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance* (2006).

<sup>4</sup> *Reconciling the Irreconcilable*, 95.

<sup>5</sup> *Reconciling the Irreconcilable*, 96.

<sup>6</sup> *Reconciling the Irreconcilable*, 9.

<sup>7</sup> Courchene, Thomas J. (2004). "Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues," *Choices*, Institute for Research on Public Policy.

<sup>8</sup> *Reconciling the Irreconcilable*, 37.

<sup>9</sup> Government of Canada. (1954) *Report of the Royal Commission on Dominion-Provincial Relations Book I: Canada, 1867-1939*. Ottawa: Queen's Printer.

<sup>10</sup> *Report of the Royal Commission on Dominion-Provincial Relations*, 125-130.

<sup>11</sup> Ontario Chamber of Commerce. (2005). *Fairness in Confederation: Fiscal Balance: Driving Ontario to "Have-Not" Status*.

<sup>12</sup> Courchene, Thomas J. (2005). “Vertical and Horizontal Fiscal Imbalance: An Ontario Perspective,” Institute for Research on Public Policy

<sup>13</sup> *Achieving a National Purpose*, Executive Summary, 2.

<sup>14</sup> Canada, *The Constitution Act* (1982), Section 36(2).

<sup>15</sup> *Reconciling the Irreconcilable*, 39.

<sup>16</sup> See for instance, Courchene, Thomas J. (2006). “Variations on the Federalism Theme,” *Policy Options*, Institute for Research on Public Policy, 46-54.