

Fiscal Federalism and the Future of Canada

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

Strengthening Canada's Territories and Putting Equalization Back on Track: The Report of the Expert Panel on Equalization and Territorial Formula Financing

Al O'Brien*

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 by the Council of the Federation's Advisory Panel on Fiscal Imbalance and the other by 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

Thomas J. Courchene
Acting Director
February 2007

*Fellow of the Institute for Public Economics, University of Alberta, a Senior Fellow of the C. D. Howe Institute and a member of the Institute of Intergovernmental Relations Advisory Council.

I am very pleased to participate in the Institute of Intergovernmental Relations conference on Fiscal Federalism and the Future of Canada. I have long had much admiration for the Institute both as a Deputy Minister in Alberta and especially as the Chair of the Expert panel on Equalization and Territorial Formula Financing. My assigned task today is to summarize 14 months of consultations and two one hundred page Reports in just a few pages. I will do my best, but I do hope that you will refer to our Reports for a more comprehensive outline of our review of the recommendations. [Note: Links to the Panel's two reports – Equalization and Territorial Formula Financing are provided on page seven, as are the formal recommendations of the Expert Panel's reports.]

What we were asked to do

In March 2005, the federal Minister of Finance established the Expert Panel to undertake a comprehensive review of Canada's Equalization program and Territorial Formula Financing (TFF). We were asked to advise on:

- The allocation of provincial Equalization and TFF entitlements, including consideration of:
 - The current Representative Tax System (RTS) approach
 - How to treat various provincial and local revenue sources, including natural resources, property taxes and user fees

- Macroeconomic approaches to measuring fiscal capacity
- Whether to introduce expenditure need to the equalization formula
- Mechanisms to improve the stability and predictability of payments
- Measures to assist in evaluation of the overall level of support for Equalization and Territorial Formula Financing
- Whether to create a permanent independent advisory body.

Our mandate was to address inter-provincial fiscal disparities in the context of Section 36(2) of the Canadian Constitution, which commits the Government of Canada to ensuring that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

In the case of TFF, our terms of reference also indicated “that the Government of Canada is committed to ensuring that citizens living in the Yukon, Northwest Territories and Nunavut have access to basic services, reasonably comparable to those available to other Canadians,” paralleling the constitutional objective of Equalization.

Our mandate did not include broader issues of national fiscal arrangements, in particular the question of “vertical fiscal imbalance” between the federal and provincial levels of government which the Council of the Federation Panel addressed.

Early on, our Panel concluded that separate reports were required for Equalization and TFF. While both programs start with a common purpose, they are very different in terms of how they are designed, what they measure, how they operate, and how significant they are in comparison to the revenues provinces and territories can raise from their own sources.

What we recommended – Equalization

I will turn first to our recommendations on Equalization. Our report contained 18 specific

recommendations [which are appended], but for present purposes I will highlight only our basic approach.

The Panel was initiated in the context of the October 2004 “New Framework” which established a “fixed envelope” for Equalization for fiscal year 2004-05, with growth of overall equalization funding fixed at 3.5% annually for ten years. The allocation of the envelope among provinces would be based on relative measures of fiscal capacity, but the overall size of the program was to be reviewed only every five years. The Panel was asked to provide advice on “evidence-based aggregate measures of the evolution in fiscal disparities ... to assist in future re-evaluations of the overall level of federal support for Equalization and TFF.”

This approach raised the critical question of whether the standard of fiscal capacity to which receiving provinces are raised should fall out of a “fixed pool”, or rather the “pool” should derive from a standard which is based on the program’s objectives. We found virtually no support for the “fixed envelope” among provinces or the academic community. Our most fundamental recommendation is that both the size of the program and provincial allocations should be returned to a principles-based formula.

We concluded that a 10-province average is a “natural” basis for establishing the standard that reflects the reality of the financial circumstances of all provinces. While acknowledging that the determination of a standard is clearly a political decision, in our view the standard should start with a principles-based formula and be adjusted on a per capita basis if required to address concerns regarding affordability.

We also concluded that a “representative tax system” remains the best conceptual basis for measuring fiscal capacity, but recommend that the existing 33 revenue bases be collapsed to five (see appendix for details). We recommend a single calculation of entitlements based on a three-year moving average and data lagged two years. We believe these simplifications would provide much improved transparency and certainty in the program, with virtually no loss in accuracy and a reasonable trade-off in the responsiveness of the

program to changing economic and fiscal circumstances.

Undoubtedly the most contentious issue regarding the measurement of fiscal capacity is the treatment of revenues from provincially-owned natural resources. Our panel concluded that inclusion of 50% of actual resource revenues is the most appropriate way of addressing the conflicting goals of ensuring that provinces receive a net fiscal benefit from exploitation of the resources which they own, while achieving the constitutional objective of ensuring that provincial governments have sufficient revenue capacity to provide reasonably comparable levels of public services.

However, consistent with the principle of equity, we recommend that no province receive equalization payments which would result in that province having greater overall fiscal capacity than that of the lowest non-receiving province. Currently, that means Ontario's fiscal capacity becomes the "cap" for all receiving provinces.

What we recommended – Territorial Formula Financing (Appendix contains detailed recommendations)

As with Equalization, the federal government provides grants to the three territories to help close the gap between the revenue a territory can raise from its own sources and the resources required to provide public services which are reasonably comparable to those available to other Canadians. Clearly, however, the dispersion and isolation of northern populations result in costs of delivering public services which are substantially higher than those in southern Canada. While we concluded that measures of expenditure need were neither necessary nor appropriate in the case of Equalization, the very high costs of delivering public services in the three territories require that the standard to which territorial fiscal capacity is raised must reflect expenditure need, rather than simply raising revenue capacity to a national standard.

This need was historically reflected in the TFF program by a "gap-filling" grant equal to the difference between a "gross expenditure

base" less "eligible revenues". The adoption of a fixed envelope under the Fall 2004 New Framework, growing at a fixed 3.5% regardless of rates of population growth and the evolution of fiscal capacity and expenditure need in the individual territories, and creating a zero-sum game in which gains in one territory come at the expense of the other territories, is particularly problematic.

As with Equalization, the Panel's most fundamental recommendation is to return to a principles-based formula to determine both the size of the TFF program and individual territorial allocations that reflect the very different circumstances in each territory. We recommend that the formula adopt "New Operating Bases" for each territory reflecting the additional funding provided under the New Framework. This re-basing will address territorial concerns regarding the adequacy of funding under the previous gross expenditure base.

We recommend simplifying the TFF formula and improving economic development incentives by establishing a revenue block that includes 70% of the measured revenue capacity from seven of the largest territorial revenue sources. We also recommend replacing the complex "keep-up", "catch-up" and "northern discount" factors used to measure "eligible revenues" under the previous formula with a representative tax system approach.

In the case of resource revenues, the situation of the territories is again distinct from that of the provinces. The federal government has Constitutional authority for natural resource development and management in the three territories. While all territories see natural resources as a key source of economic development opportunity, agreements on devolution and resource revenue sharing with the federal government are in place only in the Yukon. Accordingly, we concluded that resource revenue should be excluded from the calculation of revenues included in Territorial Formula Financing. We do believe the territories should see net fiscal benefits from resource development. Our recommendation provides the flexibility necessary to accommodate both existing and future devolution agreements and to support resource development in the north.

Key Decisions

In my view the most basic decision the Government of Canada must make regarding Equalization and Territorial Formula Financing is whether to return to formula-driven programs based on clear principles which apply uniformly across Canada, or to continue with what in recent years has become an increasingly ad hoc approach based on bilateral negotiations and focussed on pre-determined financial outcomes.

Finding the appropriate balance between ownership of resources and the objective of ensuring that all provinces have the fiscal capacity to provide the basic public services for which they are constitutionally responsible is clearly critical to returning to a principles-based equalization program. Similarly, addressing the issue of devolution and resource revenue sharing is essential in the discussion about TFF.

I also believe a very important decision will be to determine the role of the equalization program in the broader "fiscal balance" debate. Our Panel recommends that Equalization should be the primary vehicle for equalizing fiscal capacity among provinces. In my view, the test of success should be that provinces have the fiscal capacity to fund the public services for which they are constitutionally responsible from their own sources, supplemented by federal transfers under a single, robust equalization program with one standard.

Thoughts on process

The first imperative is to restore clarity to the program. We believe Canadians have become confused about the basic purpose and nature of the Equalization program. For example, many observers have argued that the intent of the program is, or should be, to eliminate fiscal and economic disparities, rather than to permit a decentralized federal system of government to deliver public services efficiently in the inevitable presence of such disparities. The resulting confusion, exacerbated in my view by the appearance that payments are a matter of negotiating power and political expediency, have led many Canadians to accept the view that such payments are simply a subsidy for "inefficient" or "excessive" government.

We believe Canadians' confidence in Equalization and TFF will be improved by ensuring clear, principles-based approaches to the programs, and by adopting our recommendations to simplify and stabilize the basis for determining entitlements and payments.

Our Panel concluded that a permanent independent advisory Commission would not be the most effective means of strengthening the programs. We did recommend that transparency, communications, and governance be improved through:

- Annual reports to Parliament on key measures related to Equalization and TFF in combination with the Canada Health Transfer, the Canada Social Transfer, and any other general-purpose transfers provided to some or all of the provinces and territories.
- The federal government issuing a public discussion paper outlining key issues and options for changes to Equalization and TFF prior to continued five-year renewals, which would serve as the basis for a Parliamentary review process in which provinces, territories, academics and interested parties would be able to express their views.
- Finance Canada making an up-to-date and user-friendly simulation model of the Equalization program available on its website, together with the associated databases.
- Support from federal and provincial governments for ongoing academic research and review of research reports through the intergovernmental process.

I also believe the intergovernmental consultation process would be much improved if First Ministers focussed on the principles and goals of the programs and instructed Finance Ministers to address specific mechanisms and formulas for achieving these goals.

Conclusion

Can the confidence of Canadians in the fairness and relevance of the Equalization program be restored? I believe it can.

I believe that Canadians support the objective set out in Section 36(2) of the Canadian constitution, and that the Equalization and TFF programs play a critical role in the effective functioning of Canada's decentralized federation and the competitiveness of the Canadian economy.

I also believe that the Expert Panel's reports provide a balanced and workable basis for putting Equalization back on track and strengthening Canada's Territories.

ANNEX A

Putting Equalization back on track -- Recommendations from the Panel

1. *A clear set of principles should be adopted to guide future development of the Equalization program in Canada.*

Returning to a Rules-based, Formula-driven Approach:

2. *A renewed Equalization formula should be developed and used to determine both the size of the Equalization pool and the allocation to individual provinces.*
3. *A 10-province standard should be adopted.*
4. *Equalization should continue to focus on fiscal capacity rather than assessing expenditure needs in individual provinces.*
5. *Equalization should be the primary vehicle for equalizing fiscal capacity among provinces.*

Improving the Equalization Formula:

6. *The representative Tax System (RTS) approach for assessing fiscal capacity of provinces should be retained.*
7. *Steps should be taken to simplify the Representative Tax Systems (RTS.)*
8. *A new measure for residential property taxes should be implemented based on market value assessment for residential property.*

9. *User fees should not be included in Equalization.*

Striking a Balance on the Treatment of Resource Revenues:

10. *In principle, natural resource revenues should provide a net fiscal benefit to provinces that own them.*

11. *Fifty percent of provincial resource revenues should be included in determining the overall size of the Equalization pool.*

12. *Actual resource revenues should be used as the measure of fiscal capacity in the Equalization formula.*

13. *All resource revenues should be treated in the same way.*

14. *A cap should be implemented to ensure that, as a result of Equalization, no receiving province ends up with a fiscal capacity higher than that of the lowest non-receiving province.*

Improving Predictability and Stability:

15. *The current approach for determining Equalization entitlement and payments should be replaced with a one estimate, one entitlement, one payment approach.*

16. *Three-year moving averages combined with the use of two-year lagged data should be used to smooth out the impact of year-over-year changes.*

Assessing Equalization:

17. *The federal government should track and report publicly on measures of fiscal disparities across provinces.*

Improving Governance and Transparency:

18. *A more rigorous process should be put in place to improve transparency, communications, and governance. This is preferable to setting up a permanent independent commission to oversee Equalization.*

ANNEX B

Territorial Formula Financing: Recommendations

The Panel considered all the ideas and options presented during its consultation process and developed a comprehensive new approach to TFF. The Panel's recommendations are:

1. Replace the fixed pool under the New Framework with a formula-driven approach, providing three separate gap-filling grants to the territories.

While a legislated, fixed pool provides greater financial certainty for the federal government and a predictable and growing source of funds for the territories, the downside impact on the territories outweighs the benefits. It's important to have a program that reflects the differences among the territories and fills the gaps between their expenditure needs and their own fiscal capacity.

2. Address concerns with the adequacy of Territorial Formula Financing through an adjustment to the Gross Expenditure Bases for each of the territories to create New Operating Bases.

The Panel recommends that the current Gross Expenditure Bases (GEBs) for the territories be adjusted to reflect the 2005-06 New Framework funding levels for TFF. The Panel also recommends that these adjusted bases be renamed the New Operating Bases.

3. Simplify the TFF formula by measuring revenue capacity using a Representative Tax System (RTS).

Using a Representative Tax System (RTS) approach simplifies the process, eliminates many of the previous adjustment factors, and is preferable to broader macro measures. The contentious tax effort adjustment factor would also be eliminated. It provides reasonable comparability among the territories and also adds administrative simplicity, greater transparency, and sound incentives.

4. Further simplify the measurement of revenue capacity by establishing a revenue Block that includes seven of the largest own-source revenues for the territories.

Seven tax bases should be used to determine the territories' fiscal capacity: personal income tax, corporate income tax, payroll tax, gas and diesel, tobacco, and alcohol tax revenues. This not only simplifies the formula, but also covers up to two-thirds of the territories' own sources of revenues.

5. Improve the incentives for the territories to raise their own revenues by including only 70 percent of territories' measured revenue capacity in the formula.

Economic development is crucial to the future of the territories. Under the recommendation, the territories would be able to keep more of the financial benefits of economic development without seeing a corresponding drop in TFF funding.

6. Exclude resource revenues from the calculation of revenues included in Territorial Formula Financing.

Unlike the provinces, the authority for developing and managing natural resource developments in the territories lies with the federal government. Since the 1980s, the Government of Canada has been engaged in discussions to devolve this authority to the territories. In principle, the Panel believes that, just like the provinces, the territories should see direct benefits from the development of resources in the territories. Each of the territories is in a different stage of discussions regarding devolution and resource revenue sharing. The Yukon is the only territory with an agreement in place. Excluding resource revenues provides the flexibility necessary to accommodate future agreements and support resource development in the territories.

7. Use the New Operating Bases as approximate measures of expenditure needs.

The Panel saw no evidence to suggest that the New Operating Bases, adjusted annually are not an adequate approximation of expenditure needs in the territories. While several suggestions were made on how to develop

comprehensive measures of expenditure needs and costs in the territories, the Panel believes this would be a complex and extensive process and may not result in a better approximation than the recommended New Operating Bases.

8. Undertake a review of significant expenditure needs and higher costs of providing public services in Nunavut.

While the panel does not recommend an extensive study of expenditure needs in the territories, the case for assessing expenditure needs and higher costs of delivering public services in Nunavut is substantially different. Compared with the rest of Canada, initial evidence points to serious disparities in outcomes for health, education, and social well-being in addition to an urgent need for adequate housing. The Panel's recommendations for adjusting the funding bases for TFF and providing annual escalators are designed to address the adequacy of TFF for the territories.

However, these adjustments are not sufficient to address the challenges and gaps in Nunavut. The Panel recommends that more work be done to assess expenditure needs in Nunavut as a starting point for addressing those needs on an urgent basis. The review should be done jointly by the Government of Nunavut and the Government of Canada. Any additional funding necessary to address Nunavut's needs should be provided through targeted programs rather than through adjustments to the TFF formula.

9. Adjust the New Operating Bases annually by the relative growth in population in the territories and growth in provincial and local spending (PAGE).

Instead of escalating the total amount of TFF by a set percentage of 3.5 percent (as is now the case with the New Framework), the Panel recommends returning to the Population-Adjusted Gross Expenditure (PAGE) escalator that takes into account comparable growth in spending in the provinces as well as relative changes in territorial population compared with the rest of Canada.

10. Improve stability and predictability by using three-year moving averages.

Without a fixed pool, there can be substantial year-over-year changes in TFF entitlements. Using three-year averages smoothes out those changes and provides more stability to both the federal and territorial governments.

Address issues of governance, accountability, dispute resolution, and renewal through an expanded and more transparent process.

The Panel does not support the idea of establishing a separate, independent permanent commission to address TFF issues. Continuing the current approach with a legislated TFF program, expanded accountability, annual reporting requirements, and mechanisms for Parliamentary review, is better match for Canada's federation. It also should provide a more open process where issues involving both the territories and the federal government can be identified and addressed.

Links:

Reports Relating to Territorial Financing

<http://www.eqtff-pfft.ca/english/tfftresury/index.asp>

<http://www.eqtff-pfft.ca/francais/tfftresury/index.asp>

Reports Relating to Equalization

<http://www.eqtff-pfft.ca/english/EQTreasury/index.asp>

<http://www.eqtff-pfft.ca/francais/EQTreasury/index.asp>

ANNEX C: Streamlining Revenue Bases

Old Revenue Sources and Tax Bases	New Tax Bases
Personal Income Tax } Payroll Taxes }	Personal Income
Business Income } Capital Taxes }	Business Income
Property Tax } Miscellaneous Tax }	Property Taxes
14 Resource Revenue Categories*	Actual Resource Revenues
Sales Taxes Tobacco Taxes Gasoline Taxes Diesel Fuel Taxes Vehicle Licenses Commercial Vehicle License Alcoholic Beverages Hospital and Medical Insurance Premiums Race Track Revenues Insurance Premiums Lottery Tickets Other games of chance Preferred share dividends	Sales Taxes
<p>*There are: Forestry Revenue, New Oil Revenue, Old Oil Revenue, Heavy Oil Revenue, Mined Oil Revenue, Third-tier Oil Revenues, Mined Third-tier Oil Revenue, Natural Gas Revenue, Sales of Crown Leases, Other Oil and Gas Revenue, Total Mineral Revenue, Water Power Rentals, Shared Revenue, Offshore activities /NFLD, Shared Revenue Offshore Activities/NS. Each had its own tax base.</p> <p>Under the former classification of revenues, each of the 33 revenues sources had its own, separate, tax base. The Expert Panel's proposal is to reduce the number of tax bases from 33 to 5. The chart indicates where these 33 resource revenues sources will be now be allocated.</p>	