

EQUALIZATION ON THE BASIS OF NEED IN CANADA

Douglas M. Brown

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**Queen's University
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Canada K7L 3N6**

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PREFACE

This paper is the completion of a project inspired some time ago by my friends and former colleagues in the Government of Newfoundland and Labrador. The text has benefitted from the careful reading of officials in the Government, but the views expressed are not necessarily those of the Government and any errors or omissions are the author's alone.

The paper attempts to uncover the original rationale for the equalization program in Canada, with an emphasis on why it has not been based, as originally envisaged in the Rowell-Sirois Report, on a calculation of expenditure needs across the provinces. This led in turn to an essential diversion to Australian practice as the leading example of an operating program based on this principle. In the process, as well, I have tried to provide an overview of the original and developing rationale for Canadian equalization program, the constitutional commitment of 1982 and its significance, and the fate of the program in the context of deficit reduction and major transfer review.

I would like to thank Dwight Herperger and Alice McLafferty for research assistance. Ronald Watts and Robert Young read earlier drafts and provided helpful comments. I would also like to acknowledge my intellectual debt to two Queen's colleagues, Tom Courchene and Robin Boadway — who may not wholly agree with my views but have taught me much about fiscal federalism. For indispensable help in getting this paper to publication, I am grateful to Kathy Sharf, Patti Candido, Mary Kennedy and Valerie Jarus.

Douglas M. Brown
May 1996

SOMMAIRE

La péréquation fiscale est devenue l'une des pierres angulaires du système fédéral canadien. Enchâssé dans la constitution en 1982, le principe de la péréquation tire ses origines du rapport Rowell-Sirois de 1940 et c'est manifestement grâce à lui que les provinces ont reçu des paiements depuis 1957.

Cet article étudie la logique et le développement de la péréquation selon son concept original et selon le principe permanent qui consisterait à tenir compte des besoins fiscaux. Parmi les arguments justificatifs mentionnés, on note l'équilibre fiscal, l'équité économique et régionale, l'efficacité et l'intégration économiques, l'autonomie provinciale et l'unité canadienne.

Le programme canadien des paiements de péréquation repose techniquement sur une formule de partage des recettes sans considération pour les besoins budgétaires des provinces. Le meilleur exemple de fonctionnement d'un système de péréquation qui se préoccupe des besoins budgétaires se trouve dans les travaux de la Commission australienne portant sur les octrois du Commonwealth (Commonwealth Grant Commission). Ce document étudie l'expérience australienne, y compris l'indépendance de la Commission elle-même, en rapport avec l'histoire du programme canadien. Le modèle australien n'est vraisemblablement pas applicable au Canada, mais on pourrait s'en inspirer pour améliorer la méthode actuelle utilisée pour déterminer les droits à la péréquation et pour réviser la méthode de calcul qui ne tient pas compte des besoins budgétaires.

Le texte précise également que le programme actuel de péréquation ne remplit pas tout à fait les engagements constitutionnels de 1982. Il est peu probable que les dispositions de la constitution soient utilisées dans le but de remettre en question les caractéristiques du programme, mais il faut dire que leur existence a constitué une protection contre toute tentative d'érosion de la péréquation par suite des politiques fédérales de réduction du déficit. Les plus récents changements apportés aux transferts de paiements fédéraux d'importance n'ont pas vraiment touché la péréquation, du moins jusqu'ici. Mais il reste toujours possible que des exigences ultérieures en viennent à forcer un retour au concept original des besoins fiscaux, ce qui entraînerait une révision de la formule de péréquation pour la mettre davantage en accord avec ce principe.

Pour résumer, ce bref commentaire permet au lecteur profane de s'initier à l'histoire du concept canadien de la péréquation, au développement des programmes gouvernementaux de transferts fiscaux pour fins de péréquation depuis les tout débuts ainsi qu'aux débats constitutionnels portant sur la question. L'auteur espère que son effort contribuera à mieux faire connaître le rôle de la péréquation au sein de la fédération.

ABSTRACT

Fiscal equalization has become one of the cornerstones of the Canadian federal system. Enshrined in the Constitution in 1982, the equalization principle has its roots in the Rowell-Sirois report of 1940, and has inspired explicit payments to the provinces since 1957.

This paper examines the rationale and development of equalization, from the perspective of the original concept and the continuing principle of meeting fiscal need. Among the rationales reviewed here are fiscal balance, economic and regional equity, economic efficiency and integration, provincial autonomy and Canadian unity.

Canada's program of equalization payments is technically based on a revenue equalization formula without regard to disparate expenditure needs among the provinces. The best example of an operating equalization scheme that takes expenditure needs into account is the work of the Commonwealth Grants Commission in Australia. This paper reviews Australian experience, including the independence of the Commission itself, against the history of the Canadian program. While the Australian practice is unlikely to be completely applicable to Canada, it remains a workable alternative to the current method of determining equalization entitlements and the method for calculating payments which does not consider expenditure need.

The paper finds as well that the 1982 constitutional commitment to equalization is not completely met by the existing equalization program. While the constitutional provisions are unlikely to be used to challenge the specifics of the program, their existence has prevented any significant erosion of equalization as a result of federal deficit reduction. The most recent changes to major federal transfers have left equalization relatively unscathed — for now. Further developments may yet provide the need to return to the original concept of fiscal need, and require a revision of the equalization formula to more completely meet that principle.

In sum, this brief commentary provides to the nontechnical reader an introduction to the history of the equalization concept in Canada, the development of the

federal government's fiscal transfer programs for equalization purposes since the earliest days, and the constitutional debates on the issue. The author hopes it will contribute to a better understanding of the role of equalization in the federation.

EQUALIZATION ON THE BASIS OF NEED IN CANADA

INTRODUCTION

The system of fiscal equalization payments in Canada, first established in 1957, has become a central feature of the institutions of our federal system. Indeed, a commitment to the principle of equalization was enshrined in the Constitution in 1982. The purpose of this paper is to review and examine the rationale for equalization and, in particular, the concept of equalizing both revenue capacities and expenditure need in the recipient provinces.

Equalization in Canada has not embraced the concept of fiscal need in calculating payments to the poorer provinces, despite its initial articulation in the *Report of the Royal Commission on Dominion-Provincial Relations* of 1940 (the Rowell-Sirois Report), and the many changes in fiscal arrangements since then. Rather, the payments made to provinces from the federal treasury have attempted to equalize provincial revenues relative to a representative system of taxes. The result has been important and beneficial for the recipient provinces and the federation as a whole, but has fallen short of meeting genuine needs in terms of disparate expenditure requirements and differing costs of programs across all provinces. In the current context of major reform to intergovernmental fiscal relations, an opportunity exists to revisit the original design of equalization and to consider the options for addressing fiscal need.

The rationale for equalization in federal systems, exemplified by the original and continuing system of needs-based equalization in the case of Australia, is one focus of this paper. The Australian case, within certain limits, is relevant to Canada as the chief example of an operating program of payments based on fiscal need, as well as an example of an institutional process which produces legitimate and independent assessments of relative need.

Further, the Canadian history of equalization, beginning with its roots in the Rowell-Sirois Report and the initial idea of a program based on fiscal need, is worth serious review. To understand why the needs-based approach was abandoned, this paper examines the rationale for the revenue-based equalization system which was adopted, and traces briefly the program's development since 1957. Next is examined the entrenchment of a constitutional commitment to equalization in 1982, a commitment that has had a continuing impact on assessments of the adequacy and design of equalization. Finally, stresses on the system in the 1990s are assessed with a view to considering the pressure for reform. With the advent of a simpler and much-reduced single major federal transfer in the form of the Canada Health and Social Transfer (CHST), equalization remains alone as unchanged among the major fiscal transfer programs.

In light of the potential pressure for reform of equalization, the final section of this paper addresses the options and prospects for a needs-based system of equalization in Canada. The chief obstacles to such reform are examined, and comments are offered on the feasibility and likely framework in which a needs-based approach might be considered.

WHY EQUALIZATION?

Before launching into the Canadian and comparative experience with a needs-based equalization approach, it is important to restate the original rationale for equalization. The ideas for equalization come from a combination of concepts in public finance, intergovernmental relations and constitutional law. From these fields emerge certain basic norms that can be applied to assess continuing attempts to design equalization programs.

Equalization arises in federal systems of government to meet both very practical reasons of public finance and broader constitutional values. Federal systems consist of interdependent governments which are, nonetheless, sovereign in their own spheres of jurisdiction. Regardless of legal jurisdiction, however, governments have varying abilities to finance the responsibilities assigned to them by constitutions. In most federal systems the central government, by virtue of its broader jurisdiction over taxation and its ability to collect those taxes over the full territory of the federation, can more easily and effectively raise revenues than the constituent units of the federation. In these cases "vertical imbalance" is said to occur where taxing power and ability is concentrated in the central government, while expenditure responsibilities are concentrated in the regional governments.¹

In many modern federal systems (e.g. the United States of America, Australia, Switzerland and Canada) the basic constitutional design preceded the development of the expanded role of government implied in the "welfare state" and its attendant expenditure requirements. The growth in government expenditures in all four of these federations has been particularly pronounced at the regional government (provincial) level, as regionally-based constitutional responsibilities

for health, education and welfare have taken on new importance, exacerbated by the difficulty individual provinces face in dealing with spillover effects of policy in these fields. Over time, the revenue-generating capacities of the regional governments to match expanded expenditure growth have rarely kept pace, thereby creating the vertical imbalance.

Redressing vertical imbalance — through intergovernmental transfers from the central government to the regional governments — is a key feature of the operation of most federations, including the United States, Germany, Australia and Switzerland. Historically, Canada has done so through a variety of shared-cost and unconditional grant programs. Such payments improve the balance between the federal and provincial governments as a whole. However, these transfers may not be sufficient in themselves to redress the other sort of imbalance which commonly occurs in federal systems, which is called “horizontal imbalance.” This occurs when the regional governments in the federation have varying capabilities among themselves to meet public needs, and therefore possess sometimes widely differing capacities to meet their constitutional responsibilities. Redressing horizontal inequities thus requires redistribution of funds from richer regions to poorer ones, either through the central government’s taxing powers (“gross” equalization) or through direct payments from rich units to poor ones (“net” equalization).

If all important revenues are raised by the central government, and redistributed on an equalized basis to the regional governments, the result would combine both vertical and horizontal rebalancing. In Australia, where most major tax sources are collected by the Commonwealth and then redistributed to the States according to a system which attempts to equalize per capita requirements, equalization is currently achieved by the general system of transfer payments. (See below for a further discussion of the Australian model.)

Canadians, however, have long favoured a federal system in which provinces retain a comparatively significant degree of autonomy in their powers of taxation, and in the expenditure responsibilities as allocated by the constitution. The government of Quebec has led the way as a proponent of provincial autonomy, supported to varying degrees by other provincial governments and political interests in general.

In 1940, the Rowell-Sirois Commission sought to restore the fiscal autonomy of the provinces, badly damaged during the Great Depression, as part of an overall attempt to restore a healthy balance between national integration and provincial autonomy in the federal system.² Strong, autonomous provinces require a large degree of fiscal independence. This independence, in turn, requires measures that address inevitable vertical and horizontal fiscal imbalances. In the fiscal arrangements that evolved in the post-war period (discussed more fully below), the centralizing features of war-time finance gradually gave way to negotiated agreements which either returned part of the tax room to the provinces or transferred funds largely without strings attached, culminating in the Established Programs Financing (EPF) block transfers in place since 1977. Equalization payments made since 1957 have also contributed significantly to the unconditional nature

of intergovernmental fiscal arrangements. The Canadian federation is now a leading example of the practice of such explicit payments to achieve horizontal fiscal balance.

Thus the rationale for equalization is based in the practical requirements of public finance as well as on the principles of constitutional autonomy. Over time, however, a more comprehensive rationale has been articulated: equalization is needed to promote both equity and efficiency in the Canadian economic and political community.³

The element of equity contained in these arguments is perhaps the most obvious. Persons living in different parts of the country but with identical incomes are not being treated equally if one is taxed more heavily than the other, or receives less in public services and benefits than the other.⁴ While the federal personal income tax system can be adjusted to redress such inequities, and personal transfer payments can also be regionally or provincially differentiated, these measures cannot fully account for provincial differences without in turn transforming federal fiscal policy into an inequitable patchwork of varying entitlements and obligations. As a result, intergovernmental transfers for equalization purposes are required if the provincial governments are to come closer to being able to treat persons of identical incomes in identical ways. One must stress that intergovernmental transfers by definition are payments to governments, and as such the granting government cannot automatically achieve horizontal equity among the recipient governments, but rather can help to create the conditions for such equity.

From these essentially economic arguments, the broader political arguments for equity are also important to consider. To begin with, regional disparities of income and public goods and services have been sources of regional tension and resentment since Confederation. Thus the issues of regional equity, regardless of the salience of efficiency or policy equity rationales, can have a strong political impact. Most federations adopt equalization schemes as explicit measures for maintaining national unity and integration. Because Canadian unity has also been premised on a strong measure of provincial autonomy, such equalization measures were bound to be achieved in ways which enhanced autonomy.

Canadians have also come increasingly to view individual entitlements to certain economic and social services and programs as a right of national citizenship.⁵ Whether or not such rights are founded in constitutional or other law, they do have a certain political significance. The development since the 1940s of Canada-wide programs which maintain similar standards in health care, social assistance and other social services, post-secondary education among other fields, would not have been possible without either the assumption of provincial responsibilities by the federal government or a system of equalization payments. Thus equalization has become an essential part of the provision of "national" (i.e. Canada-wide) standards in social and other public programs.

It has become increasingly obvious to economists and other analysts that the efficiency arguments for equalization are also important. Indeed, the Rowell-Sirois

Commission first recognized the importance to Canada of promoting national economic integration by means of assisting the provinces to meet their social and economic obligations. The Commission's report concluded that uneven economic activity had induced migration from the depressed provinces to the more prosperous provinces. At the time, with the bleak decade of the 1930s just over, the Commissioners gave the following blunt assessment: "Migrants must be admitted from depressed provinces, and it is not merely a nuisance and an expense but a positive danger to the more prosperous provinces if the migrants are illiterate or diseased or undernourished."⁶ Fifty years later the disparities are not as bleak — partly as a result, of course, of equalization programs — but the basic rationale remains. Interprovincial migration from Saskatchewan to Alberta, for example, or from Nova Scotia to Ontario, will not occur if social standards in the poorer provinces are too far below the national average.

The issue of migration also lies at the root of economic analysis based on the concept of fiscally-induced migration. Unless provincial services are more or less the same, many people will move chiefly to benefit from health or social services in the richer province, ultimately lowering both national efficiency and the level of services that the richer province can afford. Equalization enhances national economic efficiency by helping to ensure that labour migration occurs for reasons which contribute to economic growth and development, i.e. for improved wages or return on capital, not for access to better public services.

Finally, there are the more broadly based arguments which extend the arguments based on equity and efficiency. Equalization is important not only for offsetting the natural advantages of the richer provincial economies, but to offset institutional advantages as well. Some economists criticize the equalization program as contributing to a disequilibrium in the wage economy, thereby creating a dependency on transfers in the recipient provinces. However, the perspective on the economic effect of such redistribution changes when one considers that equalization is also a response to the policy-induced advantages which other provinces, such as Ontario, enjoy. Such advantages arise from size and economies of scale in public administration, and by economic diversification (these advantages being determined at least to some degree by historical factors related to provincial boundaries). The debate over whether economic advantages and disadvantages are "natural," or institutional and political is inconclusive,⁷ but nonetheless this perspective on the advantages of some provinces over others sheds further light on the underlying policy rationale for equalization.

In summary, there are several interrelated sets of reasons for adopting an equalization approach to fiscal relations in federal systems. First, vertical and horizontal imbalances between fiscal powers and capabilities and expenditure responsibilities must be alleviated if the federation is to operate equitably and efficiently. Second, and in Canada especially, the preference for strong provincial autonomy has also required a larger degree of provincial fiscal independence as compared to other federations, placing an emphasis on unconditional fiscal transfers

to poorer provinces as a key guarantor of balanced provincial autonomy. Third, political and economic equity rationales have also grown, in tandem with the growing importance of public sector tax effort and services provided to individuals since the onset of the welfare state. Concepts of economic and political equality have come to be tied to ensuring like treatment in the provision of public goods and services, and the taxation of individuals to pay for it. Finally, economic efficiency increasingly demands labour mobility on terms that maximize the economic return both to the migrant and to the larger community.

From these rationales however, it is not always as easy to apply and adopt a working system of equalization. The next section briefly reviews the conceptual range of possible equalization schemes and draws on the comparative experience of other federations to highlight examples in practice.

COMPARATIVE PERSPECTIVES ON EQUALIZATION

Essentially, the principle of equalization in federal systems is to provide supplementary revenues to the poorer constituent units in the federation, so as to enable them to provide public goods and services at levels comparable to federation-wide standards, and at comparable levels of taxation. Because revenue returns and expenditure costs change rapidly, no federal system has been able to match perfectly this principle in practice, and indeed many federal systems have continuing debates and negotiations about just how to measure and to compensate for disparities in the provision of public goods and services and in levels of taxation. When compared to other federal systems, the size of equalization payments made under the Canadian system is considerable when measured as a proportion of overall intergovernmental transfers. However, such comparisons belie the complexity and uniqueness of individual arrangements in each country.

It is important to emphasize that the principle of fiscal equalization can be met in a variety of ways. A component of equalization can be incorporated in almost any intergovernmental transfer. Thus most schemes of central government redistribution to regional governments on a per capita basis achieve some measure of equalization. The degree of equalization inherent in general fiscal arrangements designed, among other things, to redistribute tax revenue rented or collected by the central government on behalf of the regional governments, can outstrip the degree of equalization achieved by explicit equalization transfer programs alone. This is the case under current arrangements in Australia, whereas in Germany and Canada explicit equalization programs are more important.⁸

However, to discuss the policy approach used is to put the cart before the horse. What, after all, is the object of equalization? Is it to equalize the performance of constituent units in a federation to provide uniform policy results? Or is it to equalize the capacity of constituent units to provide more or less similar services at similar levels of taxation? Can and should the two concepts of performance and capacity be linked?

Most federal systems emphasize the *capacity* approach, but at least to some degree many intergovernmental fiscal arrangements have explicit goals to achieve uniform results, i.e. the *performance* approach. However, any attempt to achieve uniform performance in a federal system would defeat the basic purpose of most federal systems, i.e. to allow a degree of diversity. One way to achieve some measure of equalization of performance is to incorporate equalization as one component in program-oriented conditional transfers. The use of such transfers is most prevalent in Germany where a high degree of preference is given to the goal of uniform living standards. In Canada, certain transfer programs have, over the years, emphasized performance, in particular the cost-shared programs initiated in the 1962-77 period used to induce provincial medical and hospital insurance plans. Until 1996, the Canada Assistance Plan remained the most important performance-related program and achieved some degree of equalization.

Nonetheless, most explicit equalization programs — such as those developed in Germany, Switzerland, Australia and of course in Canada — illustrate an attempt to equalize (or rather, to approach the equalization of) the capacity to provide public goods and services rather than to ensure their actual provision. This derives, as noted, from federal principles. If constituent units are to have independence and autonomy over their constitutionally determined responsibilities, and to be responsible and accountable to their electorates, then they must be free to design and implement their own programs. It is this underlying characteristic which has led most explicit equalization programs to concentrate on capacity.

The capacity-focused approach can nonetheless take a variety of forms and must make any number of design choices along the way. The disparate capacities of units within a federation to provide equitable public goods and services can derive either from varying revenue-raising capacity, and/or from varying costs in the provision of public goods and services.

On the revenue side, one must examine what taxes or other revenues are to be included in the pool to be equalized, and on what basis of comparability. One must examine whether all revenues are to be included, or whether there are sound reasons for being selective. One must also consider whether equalization should attempt to match a national average of tax yields, or whether there should be an attempt to assess tax effort.

The Canadian experience reviewed in the next section illustrates a continually changing consensus on these design issues. Switzerland, like Canada, has tended towards an arbitrary tax indicator approach to devise a representative tax system, against which disparities in fiscal capacity can be measured.⁹ In Germany, the system is based on assessments of tax potential for each *Länd* (province), and uses national average tax revenues as the rule against which to measure relative fiscal capacity. Another important feature of the German system is its two-tiered approach. The first tier is an inter-*Länd* pool of funds to which the richer *Länder* contribute, while a smaller second tier is provided by the federal government through a share of the federal value-added tax. The German system is thus a chief

example of a partial system of "net" equalization, the direct transfer from richer constituent units to poorer ones.

Moving from the consideration of varying revenue capacity to varying expenditure costs raises one of the most recurrent problems addressed by the literature on comparative fiscal finance, and by the literature on Canadian equalization. Formulae developed in various federal countries incorporate equations to estimate the fiscal capacity of constituent units. These formulae must also make some assumptions regarding the expenditure needs of the recipient units. After all, the primary principle to be achieved in revenue equalization is to enable all constituent units to provide comparable public goods and services at comparable levels of taxation. Therefore, what if the costs of those goods and services differ from one constituent unit to another, and what if there are divergent needs for the provision of public goods and services in the first place?

In all Canadian equalization programs to date, and in the German, and at least partly in the Swiss programs, the governments simply assume for the purposes of equalization payments that expenditure needs are equal across all constituent units, or at a minimum are equal to a national average. These programs ignore regional differences in physical and economic conditions (e.g. costs of highway construction, and other requirements to provide basic public infrastructure), population-related differences (e.g. dispersion of settlement, urbanization patterns, age structure, social compositions, etc.), and differences in the size and scale of public administration (e.g. the public sector resources available in Prince Edward Island as compared to those in Ontario).

To assume that the constitutional units of a federation have the same per capita expenditure needs clearly distorts reality. The degree of distortion, however, varies from federation to federation. There are many potential examples of disparate expenditure needs. Provinces with widely dispersed populations or more difficult geographical terrain (e.g. in northern regions) will certainly have higher costs. Demographic profiles will also differ, so that one province may have a much higher ratio of employed to dependent persons, or higher costs related to urban infrastructure. Smaller provinces may have to bear a disproportionately large share of general government expenditures, and so on. In addition, some expenditure needs in one constituent unit (e.g. costs and needs associated with urban transportation) could be cancelled out by the needs of other constituent units (e.g. transportation costs to service a widely dispersed population). Where such needs do not, in the aggregate, differ significantly, the results of a formula that incorporates differing expenditure needs will be largely determined by the revenue capacity calculations. Therefore, an equalization formula is not complete without some assessment, however arbitrary, of expenditure need.

There are, of course, a whole set of difficulties inherent in attempting to calculate expenditure need. Should higher land costs and wage costs in more developed economies be discounted? How can the agency responsible for measurement make its calculations without intrusive examination of the detailed accounts of regional government programs? Is there moral hazard in assessing poorer provinces

with higher expenditure needs in anti-poverty programs? Can the data on program expenditures ever be made sufficiently comparable to devise a common standard against which to measure disparities?¹⁰

These and other questions would have to be answered in any expenditure needs assessment in revenue equalization. Before delving into how these issues have been addressed in Canada, it is useful to consider the closest existing example of an expenditure needs-based system for equalization in practice, that of Australia.

AUSTRALIAN EXPERIENCE WITH EQUALIZATION AND THE ROLE OF THE COMMONWEALTH GRANTS COMMISSION

The chief point of interest in Australian fiscal relations from the perspective of this paper is Australia's attempt to calculate expenditure need as one basis for making equalization payments. A brief sketch of the system in Australia as a whole will, however, help to put Australian practice into perspective.

Australia is, in fiscal terms, a relatively centralized federation, certainly much more so than Canada. In 1990-91 the Commonwealth government levied about 78 percent of all taxation (as compared to 50.3 percent for the federal government in Canada)¹¹, and had the highest ratio of tax-to-expenditure vertical imbalance of any developed federation. All of the Australian states are therefore highly dependent on federal transfers. Moreover, for some shared tax bases, such as personal income, the Commonwealth collects the tax but, unlike Canada, does not simply remit to each state the share of revenues collected and levied in that state. Rather, the specific purpose and general purpose grants of the Commonwealth to the states amount to a total redistribution of tax revenues, regardless of the source. And, while Australia had, for many decades, an explicit equalization program, since 1981 the equalization takes place within the confines of these vertical inter-governmental transfers, and is not a separate program.

While the centralization that has occurred in Australia may not be acceptable in Canada, there may be merit for Canadians in examining the processes and institutions by which fiscal relations — and the shares of the fiscal relations pie — are determined in Australia. The centrepiece of the process is an independent body called the Commonwealth Grants Commission (CGC). Established in 1933 to make recommendations about applications by the states for grants of financial assistance from the Commonwealth, the CGC — consisting of a chairman and two commissioners, and a secretariat of approximately 50 persons, is appointed by the Commonwealth government but operates with considerable independence.¹²

Over the years, the chief role of the CGC has been to collect data related to the determination of shares for each state from the pool of general revenue grants. The CGC conducts hearings at which the state treasurers and their officials present their case. And the CGC has developed an unparalleled methodological expertise in estimating expenditure need and comparative needs (called "relativities") among states. The relativities are then applied to the revenues available for transfer to the states.

This equalization methodology used by the CGC has developed over the years to involve an extensive and continuous review of public sector expenditures and revenues in both the claimant and "standard" states. In recent years this review has entailed the examination, standardization, adjustment and comparison of as many as 23 types of taxation or revenue sources, and 58 categories of expenditures.¹³

In a series of reports since 1933¹⁴, the CGC has presented its assessments of the expenditure needs of the states. Since 1988, the comparative relativities have been updated annually, while the underlying methodology is reviewed at five-year intervals, the latest in 1993. (This is somewhat similar to the Canadian practice of negotiating fiscal arrangements to have effect for 5-year terms.) It is important to emphasize, however, that the CGC's conclusions become policy recommendations only. They are submitted by the Commonwealth to the Annual Premiers Conference (the Commonwealth Prime Minister and the 6 state Premiers). Negotiations then ensue as to the size of the total fiscal pie for general purpose grants, and any modifications to the relativities recommended by the CGC. The reputation of the CGC has been based on the fact that its recommendations have seldom been challenged in any significant way. Their reports have been accepted and implemented by the Commonwealth government in making its fiscal transfers; the resulting shares of revenue granted have been deemed politically acceptable even in the richest states.

Despite a significant reduction in 1988 by the Commonwealth of the general revenue pool to which the equalization is applied, the proportion of special purpose, i.e. conditional, grants of total fiscal transfers has increased steadily, at the rate of inflation. Even though there is no longer an explicit equalization program, the relativities of each state's expenditure and revenue needs as determined by the CGC are now applied to virtually all intergovernmental transfers to the states. These transfers account for roughly half of all state revenues, and up to 80 percent in the case of some states. Thus the role of the CGC is arguably more important than ever. For other federations, the CGC as a model for the process of determining fiscal entitlements continues to be worth examining. Furthermore, its methodology for determining equalization based on expenditure need remains the only fully operable model for other federal systems to consider.¹⁵

The CGC's ground-breaking methodology allows for a comprehensive assessment of expenditure need based on such factors as the scale of public administration; demographic characteristics including population dispersion, urbanization, social composition and age structure; and aspects of the physical and economic environment. The system requires very large amounts of data, collected in full cooperation with state agencies. It has also required important progress in developing the concepts of expenditure need and the standards of comparison among states. It may be important to stress, as well, that the CGC began its work at an early stage in the growth of the state and the role of government in the economy, and has been able to expand incrementally its data gathering and to refine its methodology over the years, as government expenditures have grown. Just as the

intergovernmental fiscal framework that has developed over the past 35 years — so much so that it is only major federal-provincial transfer to receive explicit protection in the Constitution.

The system of equalization that has developed to achieve horizontal fiscal balance across the federation, however, is one that has focused wholly on the revenue raising capacity of provincial governments. However, the Rowell-Sirois report had originally recommended a system of payments to account for varying expenditure needs as well as revenue capacities. In fact this report remains the chief official articulation in Canada of the fiscal need concept. It may, therefore, be useful to examine the initial rationale for a needs-based equalization system, as identified by the Rowell-Sirois Commission, and then to move on to examine the factors that led to the adoption of a formal system of equalization in 1957 that did not incorporate a measurement of fiscal need. This paper will then present a brief review of various developments and modifications to the equalization program since 1957.

THE ROOTS OF THE CONCEPT OF FISCAL NEED

Since Confederation there has been constant consideration of the special needs, financial and otherwise, of certain provinces. A notable example of this has been the payment of statutory subsidies of varying amounts to some of the provinces as they were brought into Confederation, and many such subsidies continue to this day.¹⁷

The Confederation subsidies paid since 1867 to Nova Scotia and New Brunswick (and after 1873 to Prince Edward Island) in part as compensation for the loss to these governments of pre-Confederation excise and duty revenue, continued with only minor alterations until the 1920s. Broader-based complaints about the effects of the federal union on the economic and fiscal development of the Maritime provinces led to the reports of the Duncan Royal Commission of 1926, followed in 1937 by the White Royal Commission, both of which led to increases in these subsidies on the basis of fiscal need. Awards to Saskatchewan, Manitoba and British Columbia were also made after 1933.¹⁸ The reports of the two Royal Commissions played an important role in the specific and explicit recognition that the Maritime provinces were a special case within Canada and suffered from special and continuing difficulties within the federation.

The statutory subsidies proved insufficient to deal with the severity of the Depression years, however, and prompted the Rowell-Sirois Commission to propose a comprehensive package of financial reforms which, to some degree, have laid the basis for the present system of intergovernmental fiscal arrangements. The main features of the plan included: assumption by the federal government of the debts accumulated by each province; a transfer of responsibility for the unemployed to the federal level; surrender by the provinces of certain tax fields (personal and corporate income) and succession duties to the federal government; and, in

place of the existing statutory subsidies, a proposal to introduce a system of National Adjustment Grants to provinces on the basis of financial need.

According to the final report:

The amount of the grant... would be such as to enable each province (including its municipalities), without resort to heavier taxation than the Canadian average, to provide adequate social, educational and developmental services. The weight of taxation is estimated by comparing the provincial and municipal taxation with the total income of the province. The test of adequacy of social and educational services is found in the Canadian average for these services. The adequacy of developmental services is tested by what the province itself has done in years which may be considered normal.¹⁹

The key element in this proposal was the focus on actual expenditure needs of the provinces, which in the view of the Commission could be more satisfactorily determined than a comparison of taxation effort. The method for the calculation of these expenditures involved an accounting of provincial-municipal expenditures on public welfare and education on a per capita basis for every province, which would then be compared to a national average. The calculation also included the annual average of total "normal development" expenditures on highways, agriculture and public domain activities for a particular base period (1928-31).

According to the proposed formula, final payment would not have been based on expenditure needs alone. Taxation comparisons, while not a dominant consideration, would also have been incorporated in the calculation of the National Adjustment Grants:

...so that no province would be penalized for having provided superior services if it had done so by having taxed its residents with more than average severity, and so that no province would receive a payment to enable it to improve inferior services if it had chosen to have inferior services in order to tax its residents less severely than the average.²⁰

Thus, the adjustment grants would have had both a revenue and an expenditure component, and these components would have been roughly commensurate in order to properly determine which provinces would be eligible for the grants, and the amount of funds they would receive.

Of the major reforms proposed by the Rowell-Sirois Commission, only the recommendation to transfer jurisdiction over unemployment insurance to the federal Parliament was ever enacted, and that by constitutional amendment in 1941. The other reforms were by and large rejected. As the Second World War progressed the federal government did eventually persuade the provinces to allow the temporary federal collection of each province's personal and corporate income taxes in exchange for a system of per capita cash transfer payments, which came to be known as tax rental agreements.

The financial plan envisaged by the Rowell-Sirois Commission was rejected not only because of the pressing priorities of the war effort, but also because of

what was perceived to be its weakest recommendation: the permanent surrendering of the power of provincial governments to levy personal and corporate income taxes, and succession duties. The three fiscally strongest provinces at the time — Ontario, Alberta and British Columbia — apparently rejected the proposals because these provinces would not be eligible to receive the National Adjustment Grants. But more importantly, by agreeing to the comprehensive package of reforms, the provinces would also have been surrendering their ability to raise additional revenues in the future, since control over all the major taxes would have been completely centralized.

There were also broader concerns regarding provincial autonomy arising from the Report. Such concerns were ironic in that a major thrust of the Rowell-Sirois recommendations was the conviction that provincial autonomy must be respected and strengthened. This was to have been achieved by a clear separation of federal and provincial jurisdictional responsibilities, matched by the appropriate allocation of powers of taxation, supplemented by unconditional grants to poorer provinces on the basis of fiscal need. The Rowell-Sirois Report recommended that a detailed examination of expenditure needs should be completed by an independent commission modelled on Australia's Commonwealth Grants Commission (see above). The governments were concerned, however, that such a process could potentially invite unwanted intrusions into what are essentially political judgments concerning appropriate minimum standards and benchmarks for cost-effective delivery at the provincial level.

In spite of the initial reaction to the Rowell-Sirois Report, the concept of fiscal equalization, as broadly defined, slowly but surely became an accepted feature of Canadian federalism. Following the precedent of the Duncan and White payments, the Maritime Provinces (as well as Saskatchewan and Manitoba) were granted additional payments from 1942 to 1946 on the basis of fiscal need over and above the tax rental agreement payments.²¹ The recipient provinces held firmly to the need for these payments to continue, and continue they did in the successor tax rental agreements of 1947-1952 and 1952-1957. However, the chief methods for equalizing revenues, where such existed, still lay with the tax rental mechanism. It was in 1947, when introducing the legislation for that year's tax rental agreement, that the federal Minister of Finance, J.L. Ilesley, first explicitly recognized that "by the instrument of equal per capita payments [through the tax rental agreements] the weaker provinces would share equally in the productivity of the three fields of direct taxation [personal income, corporate income and succession duties]."²² Thus, for the first 17 years after the report of the Rowell-Sirois Commission, fiscal arrangements in Canada had an equalizing effect through the per capita payments of the general transfers to the provinces for tax rental, and through ad-hoc continuation and supplementation of special subsidy payments to the five poorer provinces (after 1949, six, following union with Newfoundland).

FORMAL EQUALIZATION: 1957 ONWARD

With the fiscal arrangements of 1957-62 a system of equalization payments independent of the tax rental agreements was formally established. These new arrangements discarded the per capita basis for cash transfers and put in their place a program of payments based on the principle of revenue equalization by using a representative taxation system (RTS) approach. Under this scheme, payments (in the form of unconditional transfers from the federal treasury) would be based on the average yield of three revenue sources — personal and corporate income taxation, and succession duties — in the two richest provinces, Ontario and British Columbia.

The program was reviewed in 1962 and was modified to include all ten provinces in the calculation for determining the average yield of these combined revenue sources, as well as to include 50 percent of natural resource revenues (although in 1963, there was a temporary return to the two province basis). In 1967, when the base was broadened even further to include most major provincial revenue sources (16 in total), a true RTS approach emerged. Subsequent changes in 1972 and 1977 increased the number of revenue sources to 19, and then later to 20, among which was the addition of provincial and local property taxes.

While the base of tax revenue was clearly becoming more comprehensive, there was increasing concern as to its representativeness — especially with respect to natural resource revenues. The huge increase in petroleum revenues following the OPEC crisis of 1973 wreaked havoc on the effect of the equalization formula, so much so that at one point it appeared that even Ontario would become eligible to receive equalization payments. This set the stage for the last major rejigging of the equalization program to date.

In 1982, under an amendment to the *Fiscal Arrangements Act*, revenue sources were increased to a total of 33, but the average yield of these sources was not calculated on the basis of all ten provinces. Rather, a five province standard was adopted, excluding Alberta (because of the problem of its wildly varying oil revenues) and the four Atlantic provinces. The basic features of the equalization formula have remained essentially the same since that time, although there have been some modifications related to calculation methods and constraint measures (the latter is reviewed below).

Thus, the equalization program in place since 1957 has concentrated on the representative tax system approach of equalizing revenues, and has not attempted to calculate payments on the basis of expenditure need. This does not mean that the system adopted was the only alternative under consideration. Throughout 1955-56 Canadian federal and provincial governments negotiated the severance of the tax rental agreements (to be transformed into tax collection agreements) from the transfers for equalization purposes. This was done largely to accommodate Quebec's continuing desire to levy its own personal income tax (and thus to opt out of a major component of the tax collection agreements) without being penalized for

doing so otherwise rendering it ineligible for federal transfers. The objective, then, was to devise a set of fiscal arrangements that equalized Quebec's revenues to the Canadian average, without going through the tax rental mechanism.

In the process of renegotiation in 1955-56, an opportunity developed to devise an equalization formula that considered expenditure as well as revenue requirements. During the negotiations the provinces of Nova Scotia, New Brunswick, Prince Edward Island and Saskatchewan (occasionally supported by Ontario and Newfoundland) proposed that the new equalization payments be made on the basis of an objective calculation of fiscal need. Most of the proposals dwelt on the use of an indicator such as personal income per capita (PI/C) as a determinant of entitlement, i.e. provincial PI/C below the national average would trigger payments, to the degree of disparity indicated.²³ However none of these proposals went so far as to call for an Australian-style comparison of expenditure need, and the PI/C approach was criticized by the federal Department of Finance as an unreliable and excessively imprecise measure.²⁴

The decision to proceed with equalization payments based on the revenue yields of only three tax sources — personal income, corporate income and succession duties — appears to have been made for reasons of political pragmatism and administrative facility. In 1955-56 the federal government was not anxious to move too quickly to increase its transfer obligations to the provinces. It was willing to consider payments to equalize revenues to the poorer provinces for the three-fold tax base, because these were the very tax revenues being shared and re-shared in the various tax rental negotiations since the end of the war. Faced with strong opposition from some quarters (Ontario and British Columbia) to any payments at all, the most expedient route was, as is so often the case, the most incremental. Thus the separate establishment of equalization payments in 1957 consisted of the same revenue base — the same pie — from which the previous system of payments had been derived.

Nonetheless, one result of this decision not to consider a broader approach to fiscal need and to settle on the incremental 3-tax averaging approach was an adverse political reaction in the Atlantic Provinces. The perceived lack of generosity of the new arrangements helped defeat the federal Liberal government in 1957,²⁵ leading the Diefenbaker government to propose changes. The new federal government initiated a new set of supplementary payments, the Atlantic Provinces Adjustment Grants (APAG), on the basis of a crude fiscal need formula. The payments made from 1957 to 1961 were based, it seems, on a rough approximation of a personal income per capita approach.²⁶ Attempts to put the grants on the more secure footing of an objective and rational formula, however, did not succeed. The federal government, during a recession, sought to cap the payments at \$25 million regardless of any formula. While these funds were significant in terms of their contribution to the provincial budgets concerned (i.e. 25 percent of net revenues in PEI; 18 percent in Newfoundland; 13 percent in Nova Scotia and 12 percent in New Brunswick)²⁷ they provide yet another example of a typical outcome

of any fiscal negotiations: no formula, however elegant, is likely to survive a politically pre-determined bottom line.

The APAG payments were increased to \$35 million among the four provinces from 1962-66. Thus, until 1967, two programs, the general equalization payments and the APAG, co-existed uneasily, without any indication that either would evolve in the direction of a program based wholly on fiscal need criteria. The APAG payments did not have sufficiently strong political support, nor a sufficiently compelling rationale to survive as a separate program after 1967. The *Fiscal Arrangements Act* of that year provided instead for equalization payments to the four provinces to incorporate the APAG payments by ensuring that the Atlantic provinces would receive no less than the equalization they received on the last year of the previous arrangements plus twice the amount that they had been receiving under the APAG. It was a reasonably attractive offer to the four provinces, and more than compensated for the loss of the APAG and its less than comprehensive foundations.

The ultimate result, as already noted, has been to continue to experiment and to evolve in the direction of the representative tax system, i.e. an equalization of revenue yield and not expenditure needs. From an overall perspective, the evolution of fiscal arrangements including equalization, combined with continuous economic growth in most of the years from 1957 to 1982, ensured that all provinces received increasing revenues to match their growing expenditures. Political and intergovernmental negotiation thus continued to concentrate on the game at hand of improving the representative tax system approach, and many significant adjustments were made. Until recently there has been no serious discussion of an equalization formula which considered differing expenditure needs.

EQUALIZATION AND THE CONSTITUTION

The issues of promoting regional development, alleviating regional disparities and providing equal opportunities for all Canadians were prominent political preoccupations during the 1960s and 1970s. The growing importance of equalization payments, and the increasing political acceptability of the principles of the equalization program, despite its many refinements, made equalization a touchstone of Canadian federalism.²⁸ Not surprisingly, when constitutional reform was placed on the national agenda in the 1960s, the recipient provinces began to seek constitutional commitments to what, until then, had been only a unilateral federal program.

As a result of the concerns raised by several provinces and a variety of other interests, the constitutional amendments of 1982 provided as Part III of the *Constitution Act, 1982*, "Equalization and Regional Disparities." This part consists of a single section (36). The text for section 36(1) states the commitment of the federal and provincial legislatures to "promoting equal opportunities for the well-being of Canadians; to furthering economic development to reduce disparities in

opportunities; and to providing essential public services of reasonable quality to all Canadians.”

Section 36(2) entrenches a further commitment on the federal government alone:

Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

These provisions were among the least controversial during an extremely controversial episode in Canadian politics. Nonetheless, there was at least some debate concerning the drafting and scope of what became section 36. Nova Scotia had initially sought the establishment of an intergovernmental council to report on fiscal capacities, but could not get much support for the idea. And British Columbia initially opposed any reference to equalization as such. By holding out British Columbia may have been responsible for the wording: “the *principle* of making equalization payments”²⁹ (emphasis added). The surviving text enshrines, however, the basic principle enunciated by the Rowell-Sirois Report of forty years earlier, and by using the words “equalization payments” makes it reasonably clear that the continuing program of payments is to be the object of the federal government’s commitment. The legal language is nonetheless general, and at least one legal scholar maintains that section 36 is not justiciable.³⁰ Nevertheless, there has been no case law on section 36(2) since its enactment, perhaps confirming that the provision was meant as a general commitment that would not be tested unless there was an attempt to dismantle the equalization scheme altogether.

Arguments have been made that the equalization program from 1982 onwards (in particular its treatment of resource revenues and the adoption of the five-province standard) does not meet the commitment embodied in section 36(2) for “reasonably comparable levels of taxation.” On the face of it, the full equalization of revenue capacity across the provinces has never been achieved completely, but it probably came close in the decade between 1972 and 1982.³¹ The difficulty that the federal government had in equalizing skyrocketing energy revenues from Alberta oil — with or without claiming a large share of oil revenue in the process — has, since 1982, prevented a full equalization approach. According to one recent analysis, total equalization entitlements under the current RTS formula fall short of full revenue equalization by 18 percent (in other words, total entitlements in 1990-91 should have increased from \$8.2 billion to \$9.7 billion).³²

It is also important to note that in terms of the language of section 36, the practical development of the equalization program has been wholly focused on the matter of “sufficient revenues” (which has manifested itself in the various attempts at reforming the representative tax approach), while the issue of “reasonably comparable levels of public services” (which was at the heart of the Rowell-Sirois fiscal need approach) has received virtually no attention. It may be asserted that any equalization program which does not consider fiscal (expenditure) need in its calculation is not meeting the spirit of the Constitution. There is

clearly no constitutional impediment to pursuing a needs-based approach, so it would appear that the matter remains a question of political will. (These issues are further addressed in the next section of this paper).

Finally, it is worth noting that the proposed constitutional amendments of the Charlottetown Accord of 1992 would have affected equalization in a number of ways. As part of the bargaining process, certain equalization-receiving provinces fought hard for new provisions which would have tightened the federal commitment to actually making payments, and to consulting with the provinces prior to introducing equalization legislation.

First, the amendments would have protected intergovernmental agreements from change by one party alone. (The federal payments are not now expressly the subject of federal-provincial agreements, but could become so.)

Second, a new section 36(2) was proposed as follows:

(2) Parliament and the government of Canada are committed to making equalization payments that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

(3) The government of Canada is committed to meaningful consultation with provincial governments before introducing legislation relating to making equalization payments.

(4) Parliament, the provincial legislatures and the territorial legislative authorities, together with the government of Canada and the provincial and territorial governments, are committed to the promotion of regional economic development to reduce economic disparities.

Third, it was proposed to expand Part III of the *Constitution Act, 1982* to incorporate "The Social and Economic Union." Although the text of this new provision was also nonjusticiable, it may have drawn greater legal and judicial scrutiny to the equalization provisions.

Of course, as part of the Charlottetown Accord, all of these proposed amendments were still born with the result of the referendum of October 26, 1992. Nonetheless, they illustrate that, in circumstances of the opportunity for constitutional reform, there exists a possibility to build upon and to improve the overall commitment to equalization in the Canadian federation.

In sum, the constitutional entrenchment of the concept of equalization has represented an important, if not very detailed, guarantee to the poorer provinces of the federation. The existing provisions leave considerable scope for potential changes to the actual payments and for any formula for determining these payments. The provisions do not close the door on fundamental reforms such as returning to a formula more expressly concerned with expenditure need. On the contrary, Section 36 retains the basic rationale on which the Rowell-Sirois final need approach was based. And in retrospect, given the past decade's retrenchment in the growth of equalization and federal-provincial transfers generally, the

constitutional amendment of 1982 could not have come at a more timely moment from the perspective of sustaining minimum political support.

As outlined more fully in the next part of this paper, Canadians currently face a period of severe retrenchment of fiscal resources at both the federal and provincial level, and consequently severe pressure to restructure and reduce federal transfers to the provinces. In this setting, the commitment to interprovincial equity and interregional sharing is being sorely tested. It may, nonetheless, be argued that in a climate of fiscal decentralization and retrenchment the objectives of equalization are more valid than ever, even if the means to achieve them may require constant renewal.

THE FUTURE OF EQUALIZATION

CURRENT STRESSES ON THE EQUALIZATION PROGRAM

The past decade has seen less generosity in the equalization program in Canada than in the preceding decade. With federal budgetary deficits in every year since 1975, and debt servicing costs doubling over the decade of 1981-91, pressure has built to reduce the growth if not the real sums of intergovernmental transfers. Since 1977, the system of federal-provincial transfers has become increasingly redistributive across the provinces. Nonetheless, the effects of a series of unilateral federal actions since 1977 have been to steadily check the growth of the overall federal commitment.³³

Beginning in 1982, the federal government imposed a global ceiling on the growth in equalization payments to the growth in GNP. In 1987, with the start of a new five-year period, the ceiling was rebased to 1987. This occurred again in 1992. As a result, the ceiling came into effect to reduce entitlements in three years: 1988/89, 1989/90 and 1990/91, for a cumulative loss of \$2.9 billion.³⁴ Overall, the ceiling on the growth in payments continues to apply. It has been argued that these changes have contributed to making the program procyclical, i.e. exaggerating rather than moderating the booms and busts of the economy, because the changes significantly reduced equalization entitlements (by \$3 billion) during the boom years of 1985-90, when disparities widened between Ontario and the recipient provinces.³⁵ Since 1992-93, the disparity gap narrowed somewhat as a result of the recession of 1991-92. As a result, equalization entitlements have also declined, at least for a year. As tax rates increased in all provinces in the mid 1990s, once again the equalization entitlement has been growing.

If a loose lid has been kept on equalization, the brunt of fiscal restraint has been felt on other federal transfers, notably EPF (Established Programs Financing) and CAP (the Canada Assistance Program). For EPF the federal government imposed growth ceilings in 1984, in 1986 (in that year pegging growth at the percentage growth in GNP minus 2) and again in 1989 ("GNP minus 3"). The transfer was finally frozen altogether in 1991. The CAP payments were frozen at

no more than 5 percent increases in 1990, but only to the three provinces not receiving equalization. The costs to the provinces of all of these changes are substantial, if disputed, and have fallen more heavily on the wealthier provinces than on the poorer ones.

The 1994 federal budget only forestalled more fundamental reform. The equalization payment formula in effect since 1992, extended to March 31, 1994, was extended once again, for another five year period, with a provision to increase the funding envelope by five percent.

In the lead-up to the federal budget of 1995, every indication was that the overall intergovernmental transfer system was under considerable stress.³⁶ The EPF cash portion was dwindling, thereby undermining its rationale as a transfer. The limit on CAP payments to the three "have" provinces had become a major irritant to those provinces. And to these stresses was added the more general push to fiscal decentralization arising from deficit reduction and constitutional politics.

The 1995 budget left equalization intact, and indeed one analyst's projections, based on the budget parameters and forecasts, foresees equalization payments increasing from \$8 billion in 1993-94 to \$9.6 billion in 1997-98, about a 20 percent increase.³⁷ This in strong contrast to the fate of the EPF and CAP transfers, which were combined as a single new transfer, the Canada Health and Social Transfer (CHST). The cash portion of this transfer (the rest being counted as a tax transfer entitlement) will decline from \$18.6 billion in 1993-94 to \$12.5 billion in 1997-98, or about 33 percent.³⁸ Thus, among the major cash transfer programs with significant cuts beginning in fiscal year 1996-97, equalization emerged unscathed, and indeed will become ever more important over time.³⁹

Therefore, equalization payments per se have not borne the full brunt of federal cutbacks, but the decline in per-capita EPF cash payments relative to tax room, and the further cuts inherent in the conversion to the CHST, bring the federal government's commitment to sharing into question. Unemployment insurance and other redistributive transfer payments to individuals are also under severe pressure. Of more fundamental concern, however, is that the wealthier provinces will continue to feel the pinch and will perceive their citizens to be getting fewer and fewer benefits from federal transfers. As a consequence, arguments in favour of fiscal decentralization will increase, and the support for current levels of equalization may be in doubt.

Yet a strong case will continue to be made for equalization as the sustaining intergovernmental transfer. It has tended to be considered as the residual program in the view of many, who advocate a reform of the transfer system as a whole by changing what is wrong with the other major programs first and then to even out the gaps with equalization.⁴⁰ To a point this residual strategy is still in place. As noted, the federal budget of 1995 brought about significant changes to the two programs now to be combined in the CHST, while leaving equalization intact for now.

During the past year there have been difficult consultations with the provinces over the provincial shares of CHST entitlements. If per capita provincial shares

had continued unchanged, a significantly greater burden of the cuts would have fallen on Ontario, and less so, but also on Alberta and British Columbia in the form of less than equal per capita entitlements. However, if the CHST had been immediately allocated on an equal per capita formula, then Quebec, and to a lesser extent Newfoundland, would have faced the largest cut. In the inevitable compromise solution, the Minister of Finance announced in the 1996 Budget a gradual narrowing of the existing funding disparities as a result of CAP limits in the early 1990s. (For resulting entitlements to the provinces for major transfers in 1996-97 see the Appendix.) Through all of this the federal government has maintained its 1995 commitment to hold equalization entitlements steady and indeed to increase them by one billion dollars by 1998-99.

Therefore, the equalization program has been largely unaffected by the most recent major overhaul of federal-provincial transfer programs. Whether this trend continues in the future depends in part on whether the changes of the 1995 and 1996 federal budgets are to be accompanied by more cuts down the road. If decentralization of tax room and declining cash were to accelerate, equalization will have to be redesigned to take up the slack. However, in such circumstances the political will and fiscal ability of the federal government to provide those payments may be in question.⁴¹ It may be time to fundamentally re-think our approach. In such re-thinking, a return to the basic rationales for equalization may help.

PROSPECTS FOR A NEEDS-BASED EQUALIZATION PROGRAM

To summarize the arguments with which this paper began,⁴² some form of equalization is an essential ingredient for effective intergovernmental finance in Canada. The emphasis upon a set of unconditional transfer payments provided directly to the provincial governments has also come to be an important political and constitutional feature of our federation, and deemed essential to maintaining provincial autonomy. Equalization payments have been shown to contribute significantly to national economic integration, through the promotion of greater economic efficiency and equity. And equalization is also an important means for the promotion of national standards in social and other programs.

Both the theory of public finance and empirical observation indicate that equalization schemes would be more complete if they met real fiscal needs. Such needs should be calculated by taking into account actual expenditure patterns and the need for expenditures, as well as revenues. In this way, equalization would meet the basic principle enshrined in section 36 of the *Constitution Act, 1982*: "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." This principle has been a part of Canadian political thinking since the late 1930s.

The equalization program put in place in 1957, and since modified has concentrated on ensuring revenue equalization; it does not attempt to account directly

and explicitly for differing expenditure needs. While the resulting payments have been an important feature of intergovernmental finance, and have clearly allowed provinces to come closer to matching expenditure requirements on an equal basis, the program is not based on assessments of real expenditure need. Indeed, so long as the poorer provinces revenues are brought up only to a revenue average, the gap between them and richer provinces will never close, but will only be prevented from getting worse. This deficiency may not have been so important in a period when transfer expenditures were growing rapidly, as they did from 1957 to 1977. However, after a decade of retrenchment and the current restructuring of federal-provincial fiscal arrangements, a fundamental reconsideration of the rationale and formulae for equalization on the basis of fiscal need is required.

Canadian governments decided in the 1950s not to pursue an expenditure-needs-based formulae for equalization for a variety of reasons. The pressure to have a system of equalization payments separate from the tax collection agreements (to accommodate Quebec) was met in the most incremental and expedient (and perhaps most politically saleable) way possible through straightforward revenue equalization of three tax sources. It appears that an alternative formula incorporating an assessment of expenditure needs was rejected as taking too long to devise and implement, and as involving an overly technical and complex process. Such an approach was also regarded by many provinces as a potential intrusion by the federal government into the provincial delivery of programs. It may also have been considered to be too expensive in the long run. Furthermore, the measurement of provincial economies using reliable indicators of performance were not as developed in the 1950s as today, thus preventing the development of effective proxies of expenditure need. Finally, the Australian example of the Commonwealth Grants Commission, while admired for its methodological achievements and independence, may have been too tainted by the overall fiscal centralism of the Australian system, a centralism which Canadians in the 1950s and after have sought to avoid, to act as an effective model for Canadian practice.

Some of the practical obstacles facing the implementation of an expenditure needs approach in previous decades continue to present themselves today, although, clearly, some have also been removed. It is important to reexamine the potential options in the light of current knowledge and circumstances. An opportunity exists to fundamentally revise equalization to make it more credible and more effective in meeting its basic objectives, and to bear some of the burden of the reduction of other transfer programs. It is in this spirit that the following options are proposed.

REVIEW OF THE OPTIONS

The Status Quo

It must be said that the status quo equalization program has much to recommend it. The payments are a substantial contribution towards the underlying objectives

of redressing horizontal imbalance in the federal system. They go a long way, if not the total distance, towards meeting the minimum constitutional obligations entrenched in 1982, and they appear to enjoy broad political support. As much as the recipient provinces or other observers may seek to reform the system to more accurately reflect expenditure need, the current system has all the merits of a fixed feature of the institutional landscape. Therefore, any attempt to dislodge the program in order to improve it must also be based on a risk of diminished support for the program in general.

Against an assessment of the merits of the status quo for equalization per se must be weighed considerations of the status quo for the entire set of fiscal arrangements. The other major transfer programs (EPF and CAP) have now been combined and reduced significantly. As noted above, even if equalization is not the primary initial focus of the new arrangements, is unlikely that it will remain unaffected. If there is substantial erosion of CHST benefits to the richer provinces the equalization program could be left exposed. Therefore, if the overall balance of federal-provincial fiscal relations is changing, it may be better to consider options which more directly address the deficiencies in the current equalization program.

A Representative Expenditure System Model

From the perspective of a more complete and comprehensive approach to equalization, the most desirable option would be to develop a fully-fledged equalization formula based on a representative expenditure system. It is not the intent here to describe this option fully. Others have done so who are more able to portray its features to specialists, and specialists are encouraged to go directly to those sources.⁴³ Nonetheless some basic points should be emphasized here.

The representative tax system (RTS) at the base of the current equalization formula consists of a constructed set of benchmarks to which to apply fiscal capacity in the various provinces. The idea of a representative system is to avoid comparing directly one province to another. Similarly a representative expenditure system would devise a standard set of representative expenditure benchmarks against which to measure expenditure needs in the provinces. Such a system would not attempt to compare actual program costs, and therefore would not base payments on actual program performance. Rather, the idea would be to make payments to recipient provinces on the extent to which their standardized costs exceeded the Representative Expenditure System per capita calculations. This approach retains the unconditional nature of equalization payments and does not turn them, by a back door route, into conditional payments.⁴⁴

The data requirements of an RES system, as with the current RTS approach, would be large and complex. Nonetheless, the ability of federal and provincial statistics and finance agencies to provide this data is significantly improved over the post-war years, and with one or two years of preparation it does not seem

unreasonable to assume that the ongoing data inputs could be obtained. The complexity of the data, and the need to determine the special needs of individual provinces based on a series of factors affecting expenditures would require, however, continuous adjustment and the exercise of independent judgement.

Since 1992, the Federal-Provincial Sub-Committee on Major Transfer Reform (established by the federal and provincial Ministers of Finance) has been examining the issues involved in incorporating expenditure need with the existing RTS equalization program. As part of this process, a study has been conducted into the feasibility of measuring expenditure need in the field of primary and secondary education.⁴⁵ This study suggests that there are no insurmountable barriers to availability and applicability of data to an expenditure-needs methodology, but not a small number of policy decisions and ongoing judgements would be required in setting up such a system.

The operation of such an RES requires adjustment to existing intergovernmental mechanisms. Existing intergovernmental finance structures rely on committees of officials. Those committees follow no formal decision-making rules, but conduct their business on the basis of informal consensus. Such federal-provincial committees are probably inadequate for the task of devising and maintaining an RES system of equalization. The model of an arm's length body with sufficient resources and independence to undertake the task, such as the Commonwealth Grants Commission in Australia, is still an important option to consider. However, the creation of such a body in Canada would constitute an important political reform and would not be considered lightly. Canadian governments have normally preferred not to create independent bodies of this sort, but to maintain flexible and non-binding intergovernmental mechanisms. On the other hand, the time may have arrived for a more structured and independent mechanism to determine what could become the most important, continuing federal-provincial transfer program.

Despite the methodological and institutional challenges, a fully developed RES approach to equalization would have several advantages over the current system. By incorporating realistic benchmarks of expenditure need it would be able to assess genuine levels of fiscal disparity in the poorer provinces. Payments based on such a system would have greater political credibility and, even where total resources employed are scarce, the relative entitlements of recipient provinces would be based on a more accurate assessment of their needs, and would not be as skewed to the tax collecting fortunes of over-heated regional economies in other provinces.

Adjusting the RTS Model for Expenditure Need

A more incremental approach to revising the current equalization program would be to adopt a more simple methodology than the full RES system. This could entail a formula for adjusting the entitlements derived from the RTS system to

take into account an excess needs measure based on a more selective set of expenditures of a recipient province, and against a benchmark of the average of those expenditures from a smaller representative sample of some, rather than all, provinces.

Alternatively the RTS yields could be adjusted by other types of measures to account for such objective factors as population distribution, scale factors for public administration costs, or climate and topographic characteristics (e.g. sub-arctic or arctic).

Any of these more partial and possibly incremental approaches would have to meet similar hurdles to those confronting the adoption of the fully fledged RES system. The adjustment factors adopted would need to be credible and objective and their assessment would have to be achieved with the understanding and agreement of all concerned. A considerable degree of ongoing negotiation and refinement would be required, but arguably this would be more manageable within the confines of current intergovernmental mechanisms than the more wholesale approach of option(2).

Finally, as a variant to the choice of a factor to adjust payments derived from the current RTS approach, the formula might include one or more macroeconomic indicators as a proxy for the calculation of expenditure need. While there is room for considerable debate as to which indicators are more appropriate, the use of a disparity indicator such as earned income per capita as a percentage of the national average could be used as the additional multiplier in the formula. The choice of such indicators would be made, doubtlessly, with an eye to the arithmetical results. But this is true of any of the adjustments made to the equalization system. Nonetheless, by incorporating some element of special adjustment based on an objective indicator of economic disparity, the formula would more closely approximate the ideal of equalization based on real fiscal needs.

CONCLUSION

The Canadian federation has passed through many important and difficult crossroads in its history. Many aspects of public affairs are currently under intense scrutiny, not least of which are the financial arrangements among governments. At many such crossroads in the past (e.g. the 1880s recession, 1890s and 1920s expansion, the 1930s depression, 1914-18 and 1939-45 wars, and the creation of the welfare state in the 1950s and 1960s), the fiscal arrangements of the federation have provided a flexible means of significant change.

The global economic forces affecting our domestic economy, and the changing consensus on the role of social policy and the role of government in society, are now, once again, accelerating the need for changes in fiscal relationships among governments. Since 1993, virtually all governments in Canada have undertaken dramatic changes in expenditure and revenue patterns in order to control their ballooning deficits. Programs and tax structures which have been in place, some

for over 20 to 30 years, are being altered radically. The need to coordinate debt reduction and to reform social and transfer programs in ways which improve economic competitiveness and maintain Canada-wide standards present an enormous challenge to the federal and provincial governments. The federal budget of 1995 signalled a major renegotiation of federal-provincial fiscal transfers under the CHST. Within this process, the trend of recent years towards fiscal decentralization will likely continue. Nonetheless, the need for an equalization program to maintain the integrity of the political and economic union will certainly continue. Indeed, in the absence or decline of other intergovernmental transfers, the importance of equalization is reinforced.

This paper has outlined the history of the equalization program in Canada. It has shown that the representative tax system approach to equalization adopted in the late 1950s, as important as it was, is incomplete in terms of fully equalizing expenditure needs in Canada. Thus, federal and provincial governments have had to examine the prospects and feasibility for introducing to the equalization program elements of an expenditure needs approach.

It is recommended that, as part of the continuing exercise to reform fiscal arrangements, Canadian federal and provincial governments undertake a full study of the desirability, feasibility, and institutional and data requirements of an expenditure needs approach to equalization. This intergovernmental study should include both an examination of a fully-fledged RES approach, as well as intermediate indicator-based approaches. Opportunities should be provided in this review for public and expert advice from outside government.

In conclusion, the recent reform of fiscal arrangements has left the equalization program mainly unchanged, at least it seems, for the medium term. There remains the opportunity for Canadian governments to complete the job, begun fifty years ago with the Rowell-Sirois Report, of providing payments to the poorer provinces based on genuine fiscal need. Whether governments seize this opportunity will depend on the perceived need to improve the effectiveness, viability and legitimacy of the existing program. Should such an opening for reform occur, it is hoped that the discussion in this paper will contribute to a better understanding of the issues.

Appendix
Major Transfers to Provinces 1996-97
(Estimated Entitlements)

(\$Millions)

	A. CHST (Total Entitlement of Tax and Cash)	B. CHST (Cash Transfer)	C. EQUALIZATION	D. TFF ¹	TOTAL ² (A+C+D)
NFLD	557	341	967		1,439
PEI	123	71	196		301
NS	869	515	1,148		1,927
NB	688	402	932		1,537
QUE	7,347	4,583	4,075		11,063
ONT	9,680	4,979	0		9,680
MAN	1,028	600	1,055		1,995
SASK	892	510	423		1,211
ALTA	2,305	1,173	0		2,305
BC	3,312	1,813	0		3,312
NWT	70	43	-	858	927
YUKON	30	18	-	271	301
TOTAL	26,900	15,047	8,796	1,129	35,998

¹TFF = Territorial Formula Financing

²CHST includes Equalization associated with the tax transfer. Because this is paid under the Equalization program, it is included in that program as well. Totals are adjusted to avoid double counting.

Source: Department of Finance, Government of Canada.

NOTES

1. See Hunter (1977) pp. 37-40, 113-114; and Bird (1986) pp. 231-239.
2. Canada (1940), vol. 2, p. 125. Despite the Commission's views on the importance of provincial fiscal autonomy, the prevailing opinion among most observers at the time was that the Report was inherently centralizing, because of its key recommendation to centralize the chief revenue sources of personal and corporate income taxes and succession taxes.
3. For the technical economic arguments, see Boadway and Flatters (1982); for further restatement and commentary see Economic Council of Canada (1982); Courchene (1984); and the "MacDonald" report cited as Canada (1985) vol. III, 182-183.
4. Courchene refers to "net fiscal benefits" as the base measure of interprovincial differences, taking into account both differential tax rates and levels of public benefits. See Courchene (1986) and Courchene (1984).
5. For this argument, see Leslie (1988).
6. Canada (1940), vol. 2, p. 79.
7. For the broader literature on the rationale for regional development and the debate on transfer dependency, see Young (1988); Courchene and Melvin (1986); Savoie (1986); McNiven (1986); and Savoie, Courchene and Matthews, in Savoie (1986), *The Canadian Economy: A Regional Perspective*.
8. See Bird (1986) pp. 196-202.
9. Ibid., pp. 59-66.
10. For a discussion on these points, see Courchene (1984), Ch 9.
11. Figures for Australia for fiscal year 1990-91; calculation for Canada based on 1991 calendar year. For further discussion and comparison see Walsh and Thomson (1994).
12. The States do not appear to have any formal role in the appointment process, but the historical record of the CGC does not appear to indicate any controversy over appointments or the CGC's perceived independence.
13. Bird, (1986) pp. 143-144. For a general critique of the CGC methodology see Bird (1986), pp.131-143; Hunter (1977), pp.122-138, 176-178; and Courchene (1984), pp. 274-277.
14. See Commonwealth Grants Commission, *Annual Reports*, Canberra: Australian Government Publishing Service, 1933 to 1993.
15. For a variety of perspectives on the role of the CGC see Bakvis and Sharman (1993); Galligan and Walsh (1990); Grewel (1989); and Harris (1993).
16. Discussion of the adequacy of such payments featured prominently in the reports of the "Duncan" Royal Commission of 1926 and the "White" Royal Commission of 1935. See Canada (1926) and (1935).
17. These statutory subsidies, not including the cost of other terms of union guarantees such as the provision of ferry services to Newfoundland and Prince Edward Island, are now fixed at \$36 million. For a discussion see Perry (1989), p. 434.

18. See R.M. Burns (1980), p.29. For the "Duncan" report see references Canada (1926); for the "White" report, Canada (1935).
19. Canada (1940), vol.2, p. 86.
20. *Ibid.*, vol.2, p. 125.
21. Burns (1980), p. 33.
22. *Ibid.*, p. 74.
23. *Ibid.*, pp. 131-135; 138-146.
24. *Ibid.*, pp. 133, 146, 201.
25. *Ibid.*, p. 158.
26. Graham (1960).
27. Courchene (1984), p. 39.
28. For example, the discussion in the report of the MacDonald Commission. See Canada (1985) vol. 3, pp. 181-197.
29. Romanow, Whyte and Leeson (1984), pp. 42-43.
30. Hogg (1992), p. 144.
31. For a fuller discussion see Courchene (1984); Cummings (1985); and Boadway and Hobson (1993).
32. Boadway and Hobson (1993) Tables 2.1 and 4.2.
33. Leslie (1993), pp.42-50.
34. Courchene (1994), Table 16, p.95.
35. Leslie (1992), p.58; and Courchene (1994), pp.85-108. This is especially so because Ontario "drives" 50 percent of the five-province average formula.
36. For an independent perspective on diagnosis and prescription see Banting, Brown and Courchene, eds., (1993).
37. Courchene (1995).
38. *Ibid.*
39. See Banting (1995).
40. For variations on this theme see Norrie (1993) and (1994); Fallis (1993); Courchene (1994).
41. See Leslie (1993); Courchene (1994); and Fallis (1993).
42. Above, pp. 2-6.
43. See mainly Courchene (1984), ch.9, in particular his proposed equations 9.3 to 9.6 and accompanying text. See also Boadway and Hobson (1993), pp. 129-132; Newfoundland (1992). For an earlier discussion of methodology which might serve to measure expenditure need, see Hanson (1961), ch.2; and Clark (1969), ch.2.
44. On this point see Canada (1985), vol. 3, p. 185.
45. Tim Sale and Associates, (1993).

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