

Fiscal Federalism and the Future of Canada
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Equalization Reform in Canada
Principles and Compromises

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Foreword

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

The Institute of Intergovernmental Relations is also offering this working paper series to scholars and policy analysts who were not conference participants. In this regard, we are pleased to release Folio 5 authored by Joe Ruggeri.

The views expressed in these folios are those of the authors, not those of the Institute of Intergovernmental Relations.

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

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I. INTRODUCTION

After nearly fifty years of life as a formula-based program driven by evolving inter-provincial differences in fiscal capacity, Equalization was severed from its foundations in 2004 by a unilateral federal decision that established both the total level of the entitlements in 2004-05, their growth over time, and the interim allocation among provinces for three years. Under the New Framework, the federal government (a) set the total level of entitlements for 2005-06 at \$10.9 billion, and guaranteed that no province would receive less than had previously been announced, (b) set a guaranteed growth rate of total entitlements at 3.5 percent per year, (c) used fixed shares for receiving provinces for the first two years of the new program, later extended also to 2006-07, to allocate the total amount, and (d) in March 2005 established a Panel of Experts "to review a broad range of issues" related to Equalization. Two months later, the Council of the Federation established its own Advisory Panel on Fiscal Imbalances with a broader mandate which included an evaluation of both horizontal and vertical fiscal imbalances.

These two Panels have released their reports, which are identified in this paper as the federal report and the provincial report, respectively. They contain specific suggestions for reforming the equalization program, which can be placed under three separate headings: (a) principles, (b) the treatment of resource revenues and the structure of the formula, and (c) secondary adjustments. This paper addresses the first two items. With respect to the first item, I argue in Section II that the

principles selected in these two reports are directed at the structure of the program and not at its *raison d'être*. I suggest that greater emphasis should be placed on the fundamental rationale for the existence of the equalization program and that this rationale is inextricably linked to our collective view of the role of government. With respect to the formula, I argue in Section III that the two reports offer compromises that, while holding back the cost of the program for the federal government, add some inequities (federal report) or facilitate discretionary decisions (provincial and federal reports). In Section IV, I suggest that there is no need for compromises if we let the program run on automatic pilot and focus on two consistent options: (a) the ten-province standard with full inclusion of resource revenues (the option preferred by the provincial Panel) and a two-stage approach that provides an explicit separation of the effects of resource revenues on total entitlements and their allocation among receiving provinces.

II. PRINCIPLES

In developing a package of reforms, the federal and provincial reports start by identifying a list of fundamental principles. A comparison of these principles is shown in Table 1. The principles selected by the federal Panel of Experts are listed on pages 42 and 43 of the report. The provincial report identifies explicitly only three principles - fairness, transparency and affordability - when it presents its analysis of potential options (p.80). However, one can also find references to other principles scattered throughout chapter 6 and other parts of the report. Out of the 12 principles listed in Table 1, ten pertain strictly to the structure of the program. Only two of them - sharing and consistency with the constitution - touch on the fundamental purposes of the program. Consistency with the constitution is interpreted in the general sense of citizenship rights by the Provincial Advisory Panel, which states on page 14 of its report that "the constitutional principle is grounded in widespread public support for the notion that the benefits of Canadian citizenship should be comparable across the country no matter which province a person lives in." The federal Panel of Experts is more specific, stating on page 26 of its report that the purpose of

Equalization outlined in Section 36(2) of the constitution "is on making sure that all provinces have the fiscal capacity to deliver reasonably comparable education, health care, social services, roads and transportation services to their residents at reasonably comparable levels of taxation." The principle of sharing is explicitly identified in the provincial report, but as one of the core values held by Canadians.

While a primary focus on principles related to the structure of the program is useful in the development of formulas for determining entitlements, it also tends to direct our attention away from the fundamental principles upon which this program rests. These principles were not developed as abstract notions produced by academic theorizing. They were born of a vision of Canada created collectively by millions of Canadians as they reflected on the experience of their daily life and worked on their dreams for a better future. That vision of Canada, which has evolved over the entire span of the country's history, was translated into a certain view of the role of government and materialized into a set of government programs. That history shows the resilience of Canadian federalism, as it responded to internal developments and external shocks, because of the collective will of Canadians with diverse origins to build a country where their children and grandchildren could prosper and live in liberty and peace with their neighbors, free to move from coast to coast, and sharing the benefits of citizenship regardless of where they settled.

For the first seventy or so years of Canada's history, this vision of a "North strong and free" was associated with a belief that prosperity would spread to all provinces and they would be able to finance the public services demanded by their citizens. This was the period of *disentanglement* in the fiscal activities of federal and provincial governments, an approach to federalism that was consistent with both current fiscal ideologies and existing fiscal realities. The spending responsibilities of government in general were very limited and provincial governments had little involvement in what we now call "social programs." On the revenue side, disentanglement was consistent with constitutional provisions that gave broad access to taxation to both federal and provincial governments.

Table 1. Principles for Reforming Equalization Listed in the Federal Report and the Provincial Report.

| Principles | Federal Report | Provincial Report |
|--|-----------------------|--------------------------|
| Consistency with Canada’s Constitution | X | X |
| Fairness | X | X |
| Adequacy | X | X |
| Responsiveness | X | X |
| Policy Neutrality and Sound Incentives | X | |
| Equity between Receiving and Non-Receiving Provinces | X | |
| Simplicity | X | |
| Transparency | X | X |
| Predictability and Stability | X | X |
| Affordability | X | X |
| Accountability | X | X |
| Sharing | | X |

While disentanglement did not imply the absence of federal transfers to the provinces, it incorporated an understanding that these transfers would decline over time as provinces developed their own revenue structures and economic growth generated the necessary tax bases for fiscal self-sufficiency. Accordingly, federal transfers to the provinces, which in 1874 had amounted to 56.7 percent of provincial revenues and 20.4 percent of federal revenues, by 1930 accounted for only 9.7 percent of provincial revenues and 3.6 percent of federal revenues.

The resilience of this type of fiscal federalism in Canada was tested by a variety of internal pressures and external shocks. The dream of unbounded prosperity that had accompanied the birth of the nation had been shattered by numerous recessions and a disastrous Great Depression while the stability of the fiscal arrangements was tested by the need to finance two world wars. The response to these shocks resulted in ad hoc changes to the original fiscal arrangements. World War I led to the imposition of personal income taxes by the federal government. The Great Depression gave justification to constitutional changes that transferred to the federal government full responsibility for unemployment insurance and concurrent power over old age pensions. The financing of World War II led to special fiscal arrangements that gave the federal government exclusive power over the collection of personal

and corporate income taxes and inheritance taxes in exchange for cash payments.

From a fiscal federalism perspective, the hardest blow came from the Great Depression, which devastated the finances of federal and provincial governments. Hard pressed to balance their budgets, both orders of governments searched for new revenue sources. The result was a “jungle” of uncoordinated taxes. By 1939, federal and provincial governments imposed personal and corporate income taxes and sales taxes. In addition, the federal government levied custom and excise duties and the provinces levied motor fuel taxes, real property taxes, and collected revenues from natural resources. An attempt at rationalizing the country's revenue system was made in 1935 at a Dominion-Provincial Conference, but without concrete results. A similar fate awaited the meetings of a permanent committee of Dominion-Provincial Ministers of Finance. In 1937, the federal government appointed the Royal Commission on Dominion-Provincial Relations, commonly known as the Rowell-Sirois Commission, to look into issues of taxation, government spending, the public debt, federal grants and subsidies and the constitutional allocation of revenue sources. The Commission presented its report in May 1940. From the perspective of this paper, the most important recommendation was the payment by the federal government of “national adjustment grants,” a set of unconditional transfers aimed at

equalizing provincial fiscal capacity. These “equalization grants” were not simply an attempt to redress existing horizontal fiscal imbalances within the framework of a given federal revenue structure. Rather, they represented a major shift towards fiscal centralization because in return the federal government would have acquired exclusive jurisdiction over personal and corporate income taxes and succession duties. Efforts at implementing the Commission's recommendations were interrupted by World War II, which led to a different kind of fiscal arrangement, the “temporary wartime experiment” known as tax rental agreements.

By the beginning of the postwar period, it had become evident that the conditions that could support a policy of disentanglement no longer existed. The end of World War II exposed the need for a national effort to transform the wartime economy into a peacetime economy. This national effort, in turn, required close cooperation among all governments. This effort also required an expansion in the role of government, an expansion that was facilitated by the rapid non-inflationary growth of the domestic economy, which boosted government revenues and strengthened federal spending powers. As a result, during the period from the early 1950s to the beginning of the 1970s there was a proliferation of Canada's social programs. Non-contributory Old Age Security pensions started to be paid in 1952. Coverage under the Unemployment Insurance program was expanded in 1965 and again in 1971. The compulsory Canada Pension Plan, with equal contributions by employers and employees, was introduced in 1966. The federal Hospital Insurance and Diagnostic Services Act took effect in 1958 and was followed ten years later by the introduction of Medicare (publicly funded medical care). The early 1960s also witnessed the official birth of regional development policies with the introduction of the Agricultural Rehabilitation and Development Act in 1962, followed seven years later by the creation of the Department of Regional Economic Expansion.

During this period there was also a major shift in the approach to fiscal federalism, which resulted in the consolidation of some programs and a change in the financing of other programs. In 1966 federal grants for a variety of small

provincial social assistance programs were consolidated into a single program called the Canada Assistance Plan (CAP) with a 50/50 sharing of eligible expenditures between federal and provincial governments. One year later, federal per capita grants to universities were replaced by a 50/50 cost-sharing agreement with the provinces. A similar cost-sharing arrangement was made for medical care costs with federal funding contingent on a province meeting four requirements: comprehensiveness of service coverage, universality of access, public administration, and full inter-provincial portability. These new inter-governmental fiscal arrangements, which required joint financing and some degree of policy coordination, represented a drastic departure from the principle of disentanglement. A final attempt at restoring disentanglement was made by Prime Minister Lester Pearson in 1966 (*the opting out option*) when he offered a package of tax point transfers in exchange for full provincial responsibility for financing the shared-cost programs. The rejection of this offer by the provinces reaffirmed the new structure of fiscal federalism and institutionalized two new principles of fiscal federalism in Canada: (a) *interdependence* and (b) *equal partnership*.

The principle of interdependence reflected the explicit recognition that economic and social developments in Canada had created conditions that required a higher degree of cooperation and policy coordination between the senior orders of government. The expanded role of government and the new fiscal arrangements resulted in three categories of government spending. The first category may be called “federal programs” because it includes only those spending programs that are constitutionally assigned to the federal government and are financed entirely by it. By parallel, we may call the second category “provincial programs” those spending programs constitutionally assigned to the provinces and financed by their own revenue. I call the third category “national programs” because they reflect the principle of interdependence underlying the post-war inter-governmental fiscal relations. These are spending programs which are constitutionally the responsibility of the provinces, but are financed jointly by federal and provincial governments because they benefit all Canadians in accordance with their rights of

citizenship. In the joint financing of national programs, federal and provincial governments in the 1950s and 1960s chose the principle of equal partnership. This principle was applied through cost-sharing agreements that entrenched equal contributions by both orders of government.

The creation of national programs brought to the fore the need to address horizontal fiscal imbalances through a formal program. If Canadians have the right to publicly-financed universal health care and education and to a social safety net regardless of their economic status or place of residence, then all provincial governments, who are constitutionally responsible for these programs, must have the necessary fiscal means to deliver these programs at comparable national standards. It is no mere coincidence that a formal equalization program was introduced in 1957, in the early stages of the expansion of the role of government in Canada, and its dimensions were expanded during the following twenty-five years.

The evolution of fiscal federalism during the first century of Canada's history highlights two fundamental issues. First, the institutions and programs of fiscal federalism are largely determined by the general scope of government. When the scope of government is very limited, fiscal disentanglement is a feasible option. The federal government delivers and pays for federal programs and the provinces deliver provincial programs and finance them with their own revenues. This arrangement may no longer be feasible when the scope of government expands considerably and includes large spending programs, such as the provision of universal and publicly-funded health care and education, which are constitutionally under provincial jurisdiction. Second, the scope of government also determines the significance of vertical and horizontal fiscal imbalances. When the limited scope of government facilitates disentanglement, the concept of vertical fiscal imbalance is no longer meaningful if both orders of government have broad access to all tax bases. A limited scope of government also weakens the rationale for a formal program to address horizontal fiscal imbalances. If provinces have only a few spending responsibilities, such as those directed primarily at local matters like road building, maintenance and the protection of persons and

property, it may be hard to argue for equalization-type federal transfers. I doubt that Equalization would have been enshrined in the constitution if its purpose was to ensure that all provinces have "the fiscal capacity to deliver reasonably comparable.... roads and transportation services to their residents at reasonably comparable levels of taxation," to paraphrase the constitution.

When we debate Equalization, it may be helpful to remind ourselves and others that this cornerstone of Canadian federalism rests on a particular view of the role of government and the rights of citizenship, which include the rights to universal and publicly-funded education and health care and to a public safety net that cushions the effects of drastic reductions in a person's or family's economic conditions. It will also be helpful to remember that these citizenship rights do not exist in a vacuum but arise out of fundamental values held by the population. In Canada, these values were given substance by a collective commitment to five fundamental principles of human and social development: (a) economic justice, which promotes equality of opportunity for all Canadians, a principle enshrined in the constitution, (b) social justice, which aims at reducing inequality of economic outcomes, (c) promotion of human rights, expressed in Canada's support for the United Nations declarations which acknowledge that "everyone has the right to a standard of living adequate for the health and well-being of himself and his family," (d) social cohesion, enhanced by programs that institutionalize some form of wealth sharing among Canadians, and (e) effective democracy, promoted by strengthening the ties that bind Canadians across the country and their sense of belonging to a wider community than their place of residence. These principles should remind us that, when we take sides on debates about reforms of Equalization, we do not simply address technical issues. While issues such as transparency and incentives or disincentives for provincial governments are not irrelevant, ultimately the debate on equalization is about different views of federalism and the role of government and different visions of Canada.

III. COMPROMISES

Inter-governmental discussions on equalization since its inception have been centered around three issues: (a) the list of revenues to be equalized, (b) the standard to which revenues are equalized, and (c) the treatment of resource revenues. The specific formulas developed over time and revised periodically represent compromises among various approaches to these issues. Initially, the equalization program included three revenue sources: personal income taxes, corporate income taxes, and succession duties. The list of revenues rose to sixteen in 1967 and to 30 in 1982. The standard initially was the average of the two richest provinces, which at the time were Ontario and British Columbia. It then was changed to a ten-province standard in 1962 and continued at that level for twenty years, with a temporary return to the top-two average during 1964-67. In 1982, the expansion of the list of revenues was accompanied by a change to a five-province standard (British Columbia, Saskatchewan, Manitoba, Ontario and Quebec). Resource revenues were added to the list of revenues to be equalized in 1962, but with a 50 percent inclusion rate. The inclusion rate was raised to 100 in 1967, was reduced to 33 percent for oil and gas revenues in 1974, and restored to 50 percent in 1977. In 1982, the change from a ten-province to a five-province standard was accompanied by a full inclusion of resource revenues. Since the energy crisis of the early 1970s, the changes in the structure of the equalization program have been partly driven by a need for a compromise that accommodates the volatile nature of resource revenues within the framework of Equalization. This spirit of compromise is also visible in the recommendations of both the federal and provincial reports. A summary of the main recommendations contained in the two reports is shown in Table 2.

The two reports agree entirely on two elements of reform: (a) a return to a ten-province standard, and (b) the need for some form of averaging. They also agree on the importance of a comprehensive revenue coverage, but differ in the details. The provincial report limits itself to the general statement that “the ten province standard with comprehensive revenue coverage provides the most accurate and fairest measurement of

fiscal disparities” (p.81). The federal report recommends some fundamental changes to the representative tax system. First, it compresses the current list of revenues into five major categories: personal income taxes, business income taxes, sales taxes, property taxes, and natural resource revenues. Second, it replaces the current approach to property taxes with a new measure based on market value assessment for residential property. Third, it eliminates user fees. Fourth, it uses actual natural resource revenues. The two reports differ drastically with respect to the treatment of resource revenues and caps on entitlements. The federal Panel evaluated a variety of arguments on the treatment of natural resources and opted for a compromise solution involving a 50 percent inclusion rate. The provincial Panel evaluated the same arguments and opted for full inclusion.

Both panels performed simulations of the proposed approach and compared the results to the current system, in terms of total costs to the federal government and changes in entitlements for individual provinces. The results for the proposed approach without caps were viewed to be inconsistent with some of their stated principles.

In the case of the federal report, the proposed changes excluding the cap would result in an increase in total entitlements of \$1,692 million in 2007-08 (Table 10, p.137). More importantly, it would raise the fiscal capacity of Newfoundland and Saskatchewan above that of Ontario (Table 10, p.137), a result that “runs counter to a fundamental principle of equity that should underlie any changes to the Equalization program” (p.61). As a solution to this cross-over problem, the federal Panel recommends a cap which ensures that no receiving province has a post-equalization fiscal capacity higher than that of the receiving province with the lowest fiscal capacity (currently Ontario). In determining the level of the cap, however, 100 percent of a province’s resource revenues would be included in the calculations.

Under this compromise solution, the treatment of resource revenues affects total entitlements and their allocation among provinces in different ways. The inclusion of 50 percent of resource revenues affects directly the level of

Table 2. Main Recommendations on Equalization in the Federal and Provincial Reports.

| Element | Recommendation | |
|--------------------------------|--|--|
| | Federal Report | Provincial Report |
| Standard | Ten Provinces. | Ten Provinces. |
| Coverage | Simplified Representative Tax System, exclusion of user fees. | Comprehensive revenue coverage. |
| Treatment of Resource Revenues | 50 percent inclusion. | 100 percent inclusion. |
| Caps | A receiving province cannot have higher fiscal capacity than the lowest non-receiving province; potential federal cap on total entitlements. | Cap on total entitlements based on federal affordability determined through negotiations between federal and provincial governments. |
| Volatility | Use of three-year moving average combined with two-year lagged data. | Use of a three-year moving average on data lagged two years. |

total entitlements and the allocation of this amount to receiving provinces with moderate or negligible resource revenues. The cap reduces the additional equalization for 2007-08 under the federal Panel from \$1,692 million to \$887 million. The allocation to resource-rich receiving provinces is affected by the 100 percent inclusion of resource revenues in the calculation of a province's fiscal capacity in determining the cap.

In effect, the proposed equalization system has two standards: a ten-province standard for receiving provinces with little or no resource revenue, and an Ontario standard for the resource-rich receiving provinces. Moreover, differences remain in the after-equalization fiscal capacity of non-resource-rich receiving provinces.

This result is shown in Table 3, where the fiscal capacity after equalization for fiscal year 2007-08 is shown as a percent of Ontario's fiscal capacity.

Table 3. Fiscal Capacity after Equalization as percent of Ontario's Fiscal Capacity under the Federal Proposal, 2007-08.

| Province | Fiscal Capacity after Equalization Relative to Ontario |
|------------------|--|
| Newfoundland | 100.0 |
| PEI | 95.6 |
| Nova Scotia | 97.1 |
| New Brunswick | 96.3 |
| Quebec | 96.8 |
| Ontario | 100.0 |
| Manitoba | 96.6 |
| Saskatchewan | 100.0 |
| Alberta | 169.9 |
| British Columbia | 105.8 |

The provincial Panel also recognizes that the combination of a ten-province standard and 100 percent inclusion rate for resource revenues will

lead to a substantial increase in total equalization entitlements. It estimates that what it calls "the fairest and most transparent formula for

determining the overall level of equalization and for allocating payments among the provinces” (p.84) will result in additional equalization payments by the federal government in the amount of \$5.7 billion in 2005-06. To address potential federal concerns about this large increase in entitlements, the Panel recommended a scaling down of the standard through federal provincial negotiations. For example, reducing the standard by one percent would lower its value in 2005-06 from \$6,207 to \$6,135 and would reduce per capita entitlement in each equalization receiving province by \$62. Under the cap, the standard remains a ten-province average, but equalization falls short of this standard for all provinces.

While both reports have to introduce caps in order to constrain the potential increase in total entitlements resulting from their recommendations, the rationale for these caps differ and so does the effect on provincial entitlements. The provincial report suggests only one general cap, a scaling down of the standard which would lower the per capita entitlements of each receiving province by an equal amount. The federal report potentially contains two caps, one based on equity between receiving and non-receiving provinces and the other on federal affordability. The main purpose of the first cap is to prevent that a “have-not” province is transformed into a “have” province by equalization. It affects only the resource-rich receiving provinces that would have after-equalization per capita fiscal capacity higher than that of the non-receiving province with the lowest fiscal capacity. The second cap addresses a vague notion of federal affordability. If the resulting total entitlements after the selective cap “exceed what the federal government is prepared to spend on Equalization in any given year, it should explicitly scale back the entitlements to receiving provinces on an equal per capita basis” (p. 45).

The approach to the general caps in the two reports also indicates different views of inter-governmental relations as they apply to equalization. Equalization is strictly a federal program. The federal government collects revenues from all Canadian taxpayers and transfers a portion of it to the governments of provinces with below-average fiscal capacity. The federal panel takes a strict interpretation of

the federal nature of this program and acknowledges explicitly that the determination of total entitlements is a prerogative of the federal government. The report, however suggests that, in exercising this prerogative, the federal government should not act arbitrarily, but “should outline the parameters for determining the affordability of the Equalization program as part of a number of steps to improve the transparency and governance of the program” (p.45). The provincial report implicitly acknowledges that Equalization is a federal program when it raises the issue of affordability for the federal government. However, it also acknowledges implicitly that, while Equalization is a federal program, it is fundamentally an instrument of fiscal federalism and its parameters should not be determined unilaterally by the federal government. Therefore, it recommends that “the degree of scaling should be negotiated between the two orders of government” (p.88).

In my view, the principle of affordability in the context of Equalization has less conceptual validity than the principle of equity for various reasons. First, increases in total entitlements in the range produced by the simulations in the federal and provincial reports are less than the projected levels of the federal surplus. Therefore, if part of this surplus were used to finance increases in equalization payments, there would be no interference with federal spending priorities. In the context of budget surpluses it is difficult to give a meaningful interpretation to the concept of affordability. Second, even in the absence of federal budget surpluses, the issue is one of policy priorities rather than affordability. If the federal government has sufficient financial resources to finance tax cuts it cannot claim that it cannot afford to raise the level of equalization payments. Third, the share of equalization payments in federal budgetary revenues is substantially below its historical value, as shown in Table 4. This table provides evidence on the decline in the share of federal budgetary revenues claimed by equalization payments. During the first sixteen years starting in 1982-83, this share was 6 percent or more. During the first decade it averaged nearly 7 percent and ranged between 8 and 6 percent. During the second decade the average fell to 6.1 percent and the range shifted down and narrowed to between 6.6 and 5.6 percent. This share is currently slightly under 5

percent and is projected to decline further, reaching 4.8 percent in 2011-12 if total entitlements increase at 3.5 percent year for the entire period. The decline would be more

significant if the potential growth of federal revenues under the current fiscal structure were not curtailed by proposed tax cuts.

Table 4. Equalization Payments as Percent of Federal Budgetary Revenues: Actual 1982-83 to 2006-07 and Projected 2007-08 to 2011-12.

| Fiscal Year | Equalization as Percent of Budgetary Revenues | Fiscal Year | Equalization as Percent of Budgetary Revenues |
|--------------------|--|--------------------|--|
| 1982-83 | 7.21 | 1998-99 | 5.8 |
| 1983-84 | 8.01 | 1999-2000 | 6.18 |
| 1984-85 | 7.53 | 2000-01 | 5.63 |
| 1985-86 | 6.62 | 2001-02 | 5.61 |
| 1986-87 | 6.66 | 2002-03 | 4.65 |
| 1987-88 | 6.79 | 2003-04 | 4.38 |
| 1988-89 | 6.83 | 2004-05 | 5.08 |
| 1989-90 | 6.74 | 2005-06 | 4.91 |
| 1990-91 | 6.68 | 2006-07 | 5.03* |
| 1991-92 | 6.08 | | |
| 1992-93 | 6.25 | 2007-08 | 4.91** |
| 1993-94 | 6.51 | 2008-09 | 4.92** |
| 1994-95 | 6.58 | 2009-10 | 4.93** |
| 1995-96 | 6.24 | 2010-11 | 4.89** |
| 1996-97 | 6.00 | 2011-12 | 4.84** |
| 1997-98 | 6.01 | | |

*As proposed in the 2006 Budget and includes one-time adjustments.

**Based on revenue projections included in the 2006 Economic and Fiscal Update and on a 3.5 annual growth rate of entitlements with a base year 2005-06.

Source: Finance Canada, *Budget 2006*, table A3.2; Finance Canada, *2006 Economic and Fiscal Update*; Finance Canada, *Fiscal Reference Tables*.

The compromise solutions presented in the two reports have different implications for the equalization program. In the federal proposal, the treatment of resource revenues influences the total entitlements in two stages, first with the inclusion of 50 percent of those revenues and later with the cap. The cap, in turn, creates three types of provinces: (a) non-receiving provinces, (b) receiving provinces facing an Ontario standard, and (c) receiving provinces facing a ten-province standard. The provincial proposal opens the door to the kind of federal unilateralism that followed the 1977 agreement on Established Program Financing. Under the provincial proposal, the total level of entitlements is exogenously determined through negotiations. Since Equalization is strictly a federal program, and since the constitution mandates neither a specific formula nor a specific federal payment, provinces have no leverage other than political pressures that the federal government may feel from the general public, which depend partly on

the stage of the election cycle. According to the provincial report, inter-provincial differences in fiscal capacity, measured on the basis of a comprehensive list of revenues including 100 of resource revenues, determine how this pre-determined level of entitlements is allocated among receiving provinces. While the selective cap under the federal proposal affects the entitlements of the resource-rich receiving provinces only, the general cap under the provincial proposal (and potentially also under the federal proposal) reduces per capita entitlements by equal amounts for each province.

In my view, these two reform proposal represent a laborious effort at finding a workable compromise that provides receiving provinces with some gains from equalization reform while containing the increase in the financial commitment of the federal government. These attempts at compromises lead to an equalization system that incorporates either arbitrary

components (the 50 percent inclusion of resource revenues in the federal proposal) and complex effects of resource revenues (the special cap in the federal proposal) or an arbitrary determination of the total entitlements (the general cap under the provincial and federal proposals). In the next section I will discuss two options that do not require compromises and place the equalization program on automatic pilot.

IV. REFORM WITHOUT COMPROMISES

Conceptual Issues

The history of Equalization in Canada shows how periodic reforms have been influenced by the desire to accommodate natural resource revenues. The recent proposals for reform are no exception. In determining the proper treatment of resource revenues, the federal report stressed a variety of issues. First, it emphasizes ownership: “first and foremost is the fact that, constitutionally, provinces own natural resources within their boundaries. As owners, the provinces determine when and under what conditions a particular natural resource will be developed. This is different from other sources of revenues that are owned privately and simply taxed by provincial governments” (p.57). Second it stresses the volatility of prices. Third, it points out “wide variations in costs of production.” Fourth, it emphasizes “uncertainty over the potential volume of production, and significant changes in profitability.” Finally, the report acknowledges that “there are public costs involved in providing the necessary infrastructure to develop natural resources as well as in monitoring and regulating environmental impacts.”

When one evaluates these and other factors that potentially may influence the way in which resource revenues ought to be treated in the equalization program, it is important to separate them into two main categories, according to the issue they address: (a) those that address the question of whether resource revenues should be included in the list of revenues to be equalized, and (b) how should the tax bases for natural resources be measured if those revenues are included. In the list of factors determining the status of resource revenues found in the federal report, only the first one is fundamentally linked to the structure of the program. It relates to the

fact that fluctuations in resource revenues affect inter-provincial differences in fiscal capacity and total equalization entitlements without corresponding changes in the federal government's revenues. All the other factors are relevant only for the way the resource tax bases are calculated and do not affect the decision whether resource revenues should be included in the list of revenues to be equalized. They become operational only if resource revenues are included.

Resolving the question under (a) requires that we address the following two questions: (i) do resource revenues increase a province's fiscal capacity?, and (ii) should the constitutional constraint on the federal government's capacity to raise revenues from natural resources be considered in determining the federal commitment to the program? The reason why it is important to deal explicitly with both questions is that resource revenues, when they are fully or partially included in the list of revenues to be equalized, affect jointly the number of receiving province, their entitlements and the total federal payments.

The debate among provinces has focused on the first question. Some provinces, notably Saskatchewan and Newfoundland, have given a clear “no” to this question by arguing that non-renewable resources should be excluded from the formula used to calculate equalization payments. In this case, the second question becomes redundant. Other provinces, such as New Brunswick and Prince Edward Island, have answered the first question with a “yes” by arguing for full inclusion of resource revenues in an equalization formula with a ten-province standard. The absence of a cap on total entitlements in their position suggests a “no” to their answer to the second question. The federal government has been focusing on the second question for most of the history of Equalization. The periodic changes in the standard and the treatment of resource revenues, and in particular the recent approach to setting unilaterally the level and annual growth of total payments, may be interpreted as ad hoc solutions to the second question.

The federal and provincial Panels were faced with a variety of conflicting interests. Resource-

rich receiving provinces want resource revenues to be excluded from the equalization calculation while other receiving provinces want full inclusion. The federal government wants to cap the growth and fluctuations in its payments and Ontario opposes increases in total equalization payments before adjustments are made to federal payments for national programs. Their reports offer compromise solutions to what may be seen as “irreconcilable” differences. Both reports give an explicit “yes” response to the first question and an implicit “yes” to the second question through the suggested general caps. With respect to the first question, they differ in the way the resource tax bases would be calculated, a difference which has substantial effects on both total entitlements and their allocation among receiving provinces.

It seems to me that the search for compromises is largely conditioned by a reluctance to separate the effects of the inclusion of resource revenues on total entitlements on the one hand and on the allocation of a given level of entitlements on the other. As will be shown in the rest of this paper, the need for compromises would be eliminated if we answered both questions with an explicit yes and did not impose additional conditions. Answering yes to the second question acknowledges explicitly that the provincial ownership of these resources should be a major determinant of how these revenues ought to be treated for equalization purposes. While ownership of these resources improves a province's fiscal position, thus affecting its fiscal capacity, it does not generate direct revenues to the federal government, which benefits from the development of these resources only through the increase in federal tax revenues, mainly from personal and corporate income taxes. When these resource revenues are included in the equalization formula, increases in their values, as would occur through higher prices, would raise the level of federal equalization payments without a corresponding increase in its revenues. In this case, the federal government would be required to make additional payments because of changes in a tax base that does not affect its fiscal capacity, interpreted as the revenues that it can raise by applying its "national" tax rates to its constitutionally unconstrained revenue sources. It is true that the federal government does not occupy other tax fields where provincial or local

governments are present. But this absence results from a deliberate policy choice not from a constitutional constraint. If we answer yes to both questions, a consistent approach to equalization reform involves a two-stage process. The first stage determines total entitlements on the basis of (a) a comprehensive list of revenues, but excluding resource revenues, and (b) a ten-province standard. The second stage allocates this formula-driven total among receiving provinces based on their relative fiscal capacity that this time includes resource revenues. Details of this suggested approach are discussed in the following sub-section.

A Two-Stage Approach

The elements of the suggested two-stage approach are presented in Table 5. The fundamental difference between this option and the traditional approaches (including those contained in the federal and provincial reports) is the separation between the calculation of total entitlements and their allocation among receiving provinces. This separation is accomplished by excluding resource revenues from the calculation of total entitlements (thus insulating federal payments from fluctuations in resource revenues which do not affect federal revenues) and including them in the allocation of this total among receiving provinces. This approach to the allocation of total entitlements is identical to that recommended in the provincial report and similar to that of the federal Panel and is based on a similar rationale: resource revenues accruing to equalization-receiving provinces raise their capacity to finance public services at given tax rates, therefore, they should be included in the determination of their fiscal capacity.

Table 5. Elements of a Two-Stage Approach to Equalization.

| A. Main Elements | |
|---|---|
| 1. Standard | Ten-province |
| 2. Revenues | Comprehensive list of revenues |
| 3. Determination of total entitlements | Based on relative fiscal capacities calculated from a comprehensive list of revenues that <i>excludes</i> resource revenues. |
| 4. Allocation of total entitlements among receiving provinces | Based on relative fiscal capacities calculated from a comprehensive list of revenues with <i>full inclusion</i> of resource revenues. |
| 5. Caps | None |
| 6. Averaging | May not be needed. |
| B. Calculation Steps | |
| 1. | Start with the allocation of per capita entitlements under a ten-province standard and the full inclusion of resource revenues. |
| 2. | Calculate average per capita entitlements under the full inclusion case above. |
| 3. | Calculate total and average per capita entitlements under a ten-province standard and a comprehensive list of revenues that excludes resource revenues. |
| 4. | Reduce the per capita allocation by province in step 1 by the difference between the average per capita entitlement in step 2 and that in step 3. |
| 5. | Multiply the adjusted per capita entitlements in step 4 by the population of each receiving province to determine total entitlements. |

The determination of equalization entitlements under the two-stage approach requires data routinely collected for the equalization program under the pre-Renewal formula and would involve similar calculations. The required steps are outlined in part B of Table 5. The initial step is the calculation of (a) per capita entitlements by province under a ten-province standard and the inclusion of resource revenues, and (b) the average per capita entitlement for all receiving provinces (total entitlements divided by the total population of the receiving provinces). The second step is the calculation of the average per capita entitlement by the receiving provinces under a ten-province standard, but this time excluding resource revenues. The third step is the determination of the adjustment factor, calculated as the difference between the average per capita entitlement with and without resource revenues. The fourth step is the calculation of the adjusted per capita provincial entitlements by subtracting the adjustment factor from the per capita entitlements under full inclusion. The final step is the calculation of the total entitlements by receiving province as the product of a province's adjusted per capita entitlement and its population.

An illustrative example of this calculation, which uses the information contained in the provincial report, is shown in Table 6. Before discussing this example, it is necessary to elaborate on two issues: (a) the meaning of full inclusion of resource revenues and (b) the equal per capita adjustment. With respect to the first issue, the use in my illustrative example of the information from the provincial report takes advantage of the convenience of readily available data and does not imply unquestioned acceptance of the existing approach to the measurement of the natural resource bases. The treatment of natural resources in the allocation of a given level of total entitlements conceptually allows two options only: full inclusion or total exclusion. Either we subscribe to the notion that resource revenues affect a receiving province's fiscal capacity (in which case they are fully in) or we reject that notion (in which case they are totally out). Where there is room for debate is on how we measure those bases once we opt for inclusion. These are technical issues which require technical solutions. In my view, compromise solutions such as the 50 percent inclusion proposed by the federal report are not satisfactory. The issue is not to determine which proportion of resource revenues should be

included in the equalization formula, but what is the most accurate way of measuring the resource revenue bases. In the end, the feasible technical solution may not be perfect, but the effort itself will help improve our understanding of the factors that affect the fluctuations in this revenue base. However this base is measured, it must be included in its entirety in the calculations of the fiscal capacity of receiving provinces for the purpose of allocating a given amount of total entitlements.

The use of an equal per capita adjustment in the determination of the final per capita entitlements by receiving provinces follows the approach suggested by the provincial report in its example of a scaled-down ten-province standard (Table 6.9, p. 87) and also suggested in the federal report for the potential general cap (p.45). The main property of this equal per capita adjustment, as will be shown later, is its capacity to maintain internal consistency by ensuring that,

through equalization, all receiving provinces reach the fiscal capacity under the chosen standard.

In Table 6, the first column shows the per capita entitlements under a ten-province standard and the full inclusion of resource revenues (found in table 1 of the provincial report). The second column shows the adjustment factor calculated as the difference between total entitlements with and without resource revenues (tables 1 and 5 in the provincial report) divided by the population of the receiving provinces. The third column shows the per capita entitlements that would be received, measured by the difference between the first and second columns. The final column shows total entitlements as the product of a province's per capita entitlements and its population. In the next subsection these results are compared with those under the pre-Renewal approach, the proposal by the federal Panel and the preferred option by the provincial Panel.

Table 6. Calculation of Equalization Entitlements by Province: Two-Stage Approach, 2005-06.

| Province | Per Capita Entitlements, \$ | | Two-Stage Approach | Total Entitlement \$Million |
|----------|-----------------------------|--------------------|--------------------|-----------------------------|
| | 100% Inclusion | Average Adjustment | | |
| NFLD | 1,503 | 170 | 1,333 | 687 |
| PEI | 2,166 | 170 | 1,996 | 275 |
| NS | 1,693 | 170 | 1,523 | 1,429 |
| NB | 2,034 | 170 | 1,864 | 1,402 |
| Quebec | 921 | 170 | 751 | 5,705 |
| Man. | 1,609 | 170 | 1,439 | 1,694 |
| Sask. | 153 | 170 | 0 | 0 |
| BC | 445 | 170 | 275 | 1,168 |
| Total | | | | 12,630* |

*This total differs from the total in Table 5 of the provincial report because the amount of equalization lost by Saskatchewan due to the adjustment factor is less than the reduction that would have occurred under the adjustment.

Comparison of Selected Options

A consistent comparison of the provincial entitlements under the different approaches to equalization discussed in this paper is not feasible for a variety of reasons. First, as pointed out in the provincial report, the current allocation under the New Framework is temporary because “the final allocation mechanism under the New Framework has yet to be determined.” Therefore, we would be comparing permanent versus interim arrangements. Second, even under the New

Framework we have two conflicting allocations. One is the actual distribution of payments in 2005-06, and the other is a revised version used by the federal report as its base case, which reflects “a fully implemented 2004 Renewal formula.” Third, a direct comparison with the provincial proposal is not possible because the provincial report does not contain a specific recommendation for the total level of entitlements. If the recommended level were the same as that used in the two-stage approach, the results would be identical to mine. Fourth, each

option has a different level of total entitlements. Finally, the provincial report separates basic equalization and the equalization associated with federal transfers for health care, post-secondary education and social services. In order to facilitate comparisons with the provincial report, which contains the information used in my calculations, I also confined my analysis to basic equalization. The federal report shows results only for the combination of the above two components. In order to provide a consistent comparison for fiscal year 2005-06, I subtracted from the results presented in the federal report the associated equalization shown in Table 6.1 of the provincial report.

With these caveats in mind, the allocation of different levels of total entitlement under the pre-Renewal system, which contains full inclusion of resource revenues and a five-province standard, the federal proposal, the preferred provincial proposal (with 100 percent inclusion of resource revenues and no scaling down), and the two-stage

proposal is shown in Table 7 and the differences from the two-stage approach are shown in Table 8. The two-stage approach uses the same measure of the resource revenue bases for illustrative purposes only.

The first column of Table 8 shows that, compared to the pre-Renewal system, the two-stage proposal provides increases in entitlements to all provinces. Three-quarters of the increase would accrue to Quebec and British Columbia. Compared to the federal proposal, the two-stage approach would reduce entitlements for Newfoundland and Saskatchewan (and to a much lesser extent Quebec) and increase them for the rest of the provinces. The largest increase would accrue to British Columbia. Compared to the preferred provincial proposal, all provinces would experience reductions in entitlements. Nearly three-quarters of the reductions would be borne by Quebec and British Columbia.

Table 7. Comparison of Entitlements under Alternative Approaches, 2005-06.

| Province | Entitlement, \$Millions | | | |
|----------|-------------------------|---------|------------|-----------|
| | Pre-Renewal | Federal | Provincial | Two-Stage |
| NFLD | 588 | 767 | 775 | 687 |
| PEI | 249 | 227 | 299 | 275 |
| NS | 1,247 | 1,082 | 1,588 | 1,429 |
| NB | 1,257 | 1,187 | 1,530 | 1,402 |
| Quebec | 4,235 | 5,740 | 6,991 | 5,705 |
| Man. | 1,467 | 1,430 | 1,894 | 1,694 |
| Sask. | 0 | 374 | 152 | 0 |
| BC | 348 | 0 | 1,890 | 1,168 |
| Total | 9,391 | 10,807 | 15,119 | 12,360 |

Table 8. Difference in Provincial Entitlements from the Two-Stage Proposal: 2005-06, \$Million.

| Province | Difference between Two-Stage Proposal and | | |
|----------|---|------------------|---------------------|
| | Pre-Renewal | Federal Proposal | Provincial Proposal |
| NFLD | 99 | (80) | (88) |
| PEI | 26 | 48 | (24) |
| NS | 182 | 347 | (159) |
| NB | 145 | 215 | (128) |
| Quebec | 1,470 | (35) | (1,286) |
| Man. | 227 | 264 | (200) |
| Sask. | 0 | (374) | (152) |
| BC | 820 | 1,168 | (722) |
| Total | 2,969 | 1,553 | (2,759) |

Table 9 compares the fiscal capacity among provinces for three options before and after equalization. The first option is the continuation of the pre-Renewal arrangements (called pre-R) and the second option is the preferred provincial option. The relevant data for these two options are found in Table 1 of the provincial report. The third option is the two-stage approach introduced in this paper. For each option, this table shows per capita fiscal capacity before equalization in the first row, per capita equalization entitlements in the second row and after-equalization fiscal capacity in the third row. The fourth row shows a province's after-equalization fiscal capacity as a percentage of the average for the selected standard. For the two-stage approach, the first row is based on Table 1 of the provincial report and the second row on Table 5 of this paper. A meaningful comparison with the federal option is not possible because data on pre-equalization per capita entitlements are available only for 2007-08 but include associated equalization for which the federal report shows no information and the provincial report shows details only for 2005-06. Information on the after-equalization per capita fiscal capacity under the federal proposal is shown in Table 3.

A comparison of Tables 3 and 9 combined with the information on the elements of each proposal presented in this paper allows an evaluation of the four proposals for internal consistency, interpreted in terms of both the standard to which fiscal capacity is being equalized and the relationship between a receiving province's fiscal capacity and that under the chosen standard. There is general agreement among equalization experts that, as pointed out in the federal report, "a 10-province standard is a 'natural' standard that reflects the reality of the financial circumstances of all 10 provinces" (p.45). A 10-province standard has long been advocated by the vast majority of provinces. In the words of one provincial Minister of Finance "a national-average standard would more accurately reflect the level of fiscal disparities throughout the country and is more consistent with the intent of the constitutional commitment" (Volpe' 2005). Whatever standard is adopted, internal consistency requires that equalization entitlements bring the per capita fiscal capacity of all receiving provinces to this standard.

Table 9. Fiscal Capacity under Selected Options: 2005-06, \$ Per Capita.

| Options | NFLD | PEI | NS | NB | Quebec | Ont. | Man. | Sask. | Alta. | BC |
|--------------|-------|-------|-------|-------|--------|-------|-------|-------|--------|-------|
| Pre-R | | | | | | | | | | |
| Before | 5,402 | 4,740 | 5,212 | 4,871 | 5,985 | 7,009 | 5,297 | 6,752 | 11,158 | 6,460 |
| Equal. | 1,140 | 1,803 | 1,330 | 1,671 | 558 | 0 | 1,246 | 0 | 0 | 82 |
| After | 6,542 | 6,543 | 6,542 | 6,543 | 6,543 | 7,009 | 6,543 | 6,752 | 11,158 | 6,542 |
| %FPS | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 107.1 | 100.0 | 103.2 | 170.6 | 100.0 |
| Prov. | | | | | | | | | | |
| Before | 5,402 | 4,740 | 5,212 | 4,871 | 5,985 | 7,009 | 5,297 | 6,752 | 11,158 | 6,460 |
| Equal. | 1,503 | 2,166 | 1,693 | 2,034 | 921 | 0 | 1,609 | 1536 | 0 | 445 |
| After | 6,905 | 6,906 | 6,905 | 6,905 | 6,905 | 7,009 | 6,905 | 6,905 | 11,158 | 6,905 |
| %TPS. | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 101.5 | 100.0 | 100.0 | 161.6 | 100.0 |
| 2-St. | | | | | | | | | | |
| Before | 5,402 | 4,740 | 5,212 | 4,871 | 5,985 | 7,009 | 5,297 | 6,752 | 11,158 | 6,460 |
| Equal. | 1,333 | 1,996 | 1,523 | 1,864 | 751 | 0 | 1,439 | 0 | 0 | 275 |
| After | 6,735 | 6,736 | 6,735 | 6,735 | 6,736 | 7,009 | 6,736 | 6,752 | 11,158 | 6,735 |
| %TPS | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 104.1 | 100.0 | 100.3 | 165.7 | 100.0 |

As shown in Tables 3 and 9, only the preferred provincial option and the two-stage approach meet the two criteria for full consistency: they use a ten-province standard and raise the per capita fiscal capacity of all receiving provinces to the national average. The federal proposal has a ten-province standard, but is internally inconsistent because it leads to differences in after-equalization per capita fiscal capacity among receiving provinces. The five-province standard is internally consistent, as equalization raises the per capita fiscal capacity of all receiving provinces to the standard, but it has an arbitrary standard implemented as a convenient tool for reducing federal equalization payments. As noted in the federal report “the five province standard...was introduced for a single, but important, purpose - to decrease the federal government's overall costs for Equalization at a time when Alberta's fiscal capacity was increasing dramatically because of high oil prices” (p. 45).

The two fully consistent options result in increases in total equalization payments, but of different amounts, compared to the entitlements under the five-standard regime that existed before the New Framework. In 2005-06, the increase in total entitlements would amount to \$5.7 billion under the preferred provincial option and to \$3.0 billion under the two-stage approach. Since, in the calculations shown in Table 5, I start with the preferred provincial option and scale it down using for the adjustment the same approach employed in the provincial report, one may be tempted to view the two-stage option as a special scale down of the preferred provincial option. That interpretation would be incorrect. The difference between the two approaches is conceptual, not financial. The scaling down under the compromise provincial proposal results in an arbitrary or negotiated level of total entitlements which involves an adjustment to a value determined on the basis of two fundamental principles: (a) resource revenues are part of provincial fiscal capacity, and (b) provincial ownership of these resources and constitutional constraints on the federal government's ability to enter the resources tax base do not affect the magnitude of the federal commitment to equalization. Therefore, resource revenues affect both total entitlements and their allocation among

receiving provinces. The two-stage approach reaffirms the first principle, but excludes the second one. It explicitly incorporates the notion that provincial ownership of natural resources does affect the magnitude of the federal government's commitment. As a result, resource revenues are excluded in the determination of total entitlements (the federal government's commitment), but are included in the allocation of this total among the receiving provinces (full provincial fiscal capacity).

It is worth stressing at this point, that both options are within the fiscal capacity of the federal government. As pointed out earlier, the increases in federal payments associated with these two options are substantially less than the projected federal surplus over the next five years (and beyond in the absence of discretionary policies). The estimated increase under the two-stage approach is equal to the contingency reserve which is automatically used for debt repayment. The total entitlements under the two-stage approach would represent 5.1 percent of federal budgetary revenues (6.1 if we include associated equalization), a total ratio nearly equal to the average over the decade from 1992-93 to 2001-02.

In addition to being consistent and compromise-free, these options possess the desirable property of running on automatic pilot. Under either option, both total entitlements and their distribution among receiving provinces are automatically determined. This property minimizes federal-provincial discord and limits inter-governmental debates on equalization to technical issues on the proper measurement of tax bases. The two-stage option has the additional property of minimizing fluctuations in total entitlements since these fluctuations are largely caused by swings in resource revenues as shown in figure 2 of Annex 7 in the federal report. According to this report, “the much greater volatility of measured natural resource capacity....is mostly the result of world commodity prices, but it also reflects the multiple types of resource revenues (e.g., auction revenues, royalties, etc.) yielding different levels of fiscal capacity at different times. This volatility can result in large and unpredictable swings in equalization entitlements, complicating the

process of financial planning for provinces. Whether the RTS revenue bases are retained or replaced by an alternative measure, this volatility in Equalization payments will continue unless new mechanisms are put in place” (p.114). The two-stage approach is one such mechanism which, by insulating total entitlements from fluctuations in resource revenues, would provide stability to the growth of federal payments and might eliminate the need for complex moving average procedures.

Dynamics

Comparisons among different proposals for a single year are useful in highlighting the implications of some of their special features, but cannot serve as a basis for fundamental reforms of the equalization program. For example, the calculations for 2005-06 show that British Columbia would be a major beneficiary of the two-stage approach. Yet, the federal report indicates that British Columbia is rapidly moving towards have province status and would have a minimal equalization entitlement as early as 2007-08 under the existing New Framework arrangements. Therefore, its potential gains under the two consistent options would be severely curtailed.

This brings me to a fundamental issue in the design of public policy in general and fiscal arrangements in particular. Equalization is a highly dynamic program driven by complex interactions among inter-provincial differences in population, economic performance and fiscal structures. In the future, these interactions will be dominated by inter-provincial changes in population dynamics and associated labour market developments, and economic and fiscal performance. These dynamic elements of the program were given little attention by the two reports and in the design of the New Framework. For example, the annual growth rate of 3.5 percent for total entitlements under the New

Framework is lower than the projected growth rate of nominal GDP over the same period and beyond. This means that the New Framework implicitly incorporates the assumption of shrinking economic and fiscal disparities. Projected demographic and economic trends, however, indicate that the opposite is likely to happen. In a separate paper [Ruggeri 2006, chapter 4] I have shown how demographically-driven changes are likely to generate widening inter-provincial disparities over the long-term. Some indication of this future trend can be found in the federal report. As shown in Table 10, under the federal proposal, per capita equalization entitlements will increase for all receiving provinces except the two resource-rich provinces. Moreover, for the Maritime provinces these increases are substantial and amount to nearly 15 percent in two years.

In theory, either one of the two consistent options should automatically adjust for the effects of demographic and labour market dynamics on fiscal capacity. Fulfilling the intent of section 36(2) of the constitution by equalizing fiscal capacity to the national average assumes implicitly equal per capita spending by provincial governments. Unequal provincial trends in demographic variables, specifically the growth and age structure of the population, will likely generate widening disparities in per capita spending by provincial governments. While equalization may not be the appropriate program for incorporating the effects on the spending side, ignoring the issue is not an appropriate response. Therefore, I recommend that federal and provincial governments undertake jointly a thorough study of the implications of population dynamics - including population growth, population aging, and migration - for labour market conditions, economic performance, fiscal capacity and spending pressures in each province. This study becomes more relevant and more urgent if the negotiated reform of the equalization program includes a compromise formula that imposes limits on the growth of total entitlements.

Table 10. Per Capita Equalization Entitlements under the Federal Panel’s Recommendations: 2005-06 and 2007-09, \$.

| Province | Entitlements | | Change |
|----------|--------------|---------|--------|
| | 2005-06 | 2007-08 | |
| NFLD | 1,664 | 933 | -731 |
| PEI | 1,847 | 2,079 | 232 |
| NS | 1,326 | 1,560 | 234 |
| NB | 1,708 | 1,945 | 237 |
| Quebec | 837 | 917 | 80 |
| Man. | 1,366 | 1,528 | 162 |
| Sask. | 457 | 157 | -300 |

V. CONCLUSIONS

This paper contains a brief evaluation of the equalization reform proposals presented in the reports released by the federal Panel of Experts and by the provincial Advisory Panel on Fiscal Imbalances. It focuses on two aspects of these reports: (a) the principles underlying the suggested proposals, and (b) the compromises incorporated in the proposed formulas.

With respect to the first item, I show that most of the principles used in these reports relate to the structure of the program. I suggest that greater emphasis needs to be placed on the fundamental underpinnings of Equalization. In that respect, I argue that the debate on equalization reform reflects fundamentally different views of federalism and the role of government and different visions of Canada. With respect to the second item, I show that the recommended approaches include unnecessary compromises and introduce arbitrary elements. Pointing out that it is not meaningful to speak about federal affordability in the presence of projected long-term federal surpluses, I suggest that the two consistent reform options are the preferred provincial option (ten-province standard and full inclusion of resource revenues without caps) and the two-stage approach outlined in this paper. The latter option determines total entitlements on the basis of a ten-province standard and a comprehensive list of revenues that excludes resource revenues, but allocates this formula-driven total on the basis of the relative fiscal capacity of receiving provinces where fiscal

capacity is now measured by including resource revenues. Under these two options, both total entitlements and their allocation among receiving provinces are formula-driven and, therefore, minimize discretionary decisions.

I finally note that future demographic trends and associated labour market developments will have a significant impact on fiscal federalism by generating widening disparities in economic performance, fiscal capacity, and spending pressures. As a foundation to the development of long-lasting programs of fiscal federalism, I recommend the undertaking of a joint federal-provincial-territorial study of the economic and fiscal implications of projected inter-provincial changes in the level and structure of the population.

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