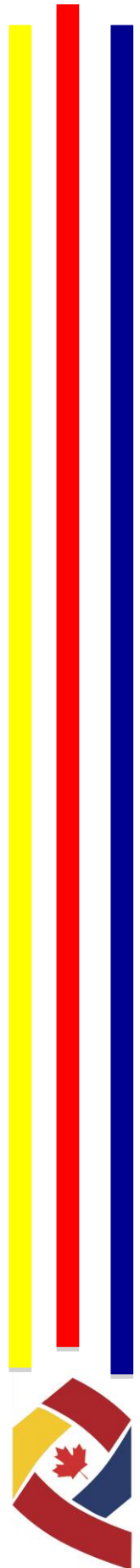


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**SURPLUS RECYCLING AND THE  
CANADIAN FEDERATION:  
Reassessing the Allocation of  
Money and Power**

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## I: INTRODUCTION<sup>1</sup>

In his 2011 book, *The Global Minotaur: America, the True Origins of the Financial Crisis and the Future of the World Economy*, Yanis Varoufakis makes a convincing case that effective surplus-recycling mechanisms (SRMs) are essential for maintaining the internal stability and resiliency of macro-economic systems. While his analysis both novel and insightful, it is nonetheless the case that the role of surplus-recycling mechanisms has long been centre-stage in ensuring international macroeconomic equilibrium. Arguably the most familiar SRM was the “rules of the game” under the gold standard or, more instructively, under the price-specie-flow mechanism. Countries running balance-of-payments surpluses will experience inflows of gold (specie) that in turn will increase domestic wages and prices thereby eroding their balance-of-payments surpluses by decreasing exports and increasing imports. Balance-of-payments-deficit countries will experience the opposite impacts, with the result that the system will re-equilibrate. However, if the balance-of-payments-surplus countries sterilize the gold or specie inflow, then the surplus-recycling mechanism is stymied and the burden of adjustment is shifted to the deficit countries in the form of austerity or exchange-rate depreciation, both of which significantly increase the political and economic adjustment costs, and undermine the principles of the system.

By way of an ongoing example, Varoufakis argues that the euro version of a SRM likewise undermines the entire system. In effect, while Germany runs an overall surplus with the other euro countries (especially those in the southern core), it invests these surpluses in the dollar area, not in the euro area. This perpetuates the euro-related German surpluses and it effectively transfers the adjustment back on to the deficit countries, an adjustment that without access to exchange rate depreciation will almost certainly exacerbate the likelihood of recovery in the short term and may eventually lead to the exit of these countries from the Eurozone.

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<sup>1</sup> \*An early version was presented to the Queen’s Institute of Intergovernmental Relations 2012 *State of the Federation* conference “Regions, Resources, Resiliency”.

The US-China relationship presents another example, one where China's trade surpluses are indeed cycled back to the US but in a manner that has served to perpetuate the US fiscal and balance of payments challenge. Specifically, China has pegged its Yuan to the greenback and in spite of its huge trade surplus with the US it has essentially maintained the peg. However, this requires China to become the buyer of last resort of any and all US treasuries that, in turn, effectively removes the US budget constraint and serves to entice the US to defer setting its fiscal house in order, even to the point where US indebtedness is now endangering its very economic future. Readers will recognize that China's approach is a modern version of renegeing on the gold standard "rules of the game."

With this as brief backdrop relating to the concept of surplus recycling, the role of this paper is to identify and assess the efficacy of some of Canada's surplus recycling mechanisms as relate to interprovincial and federal-provincial fiscal and economic stability. In the present paper attention will be directed toward three areas where our surplus recycling mechanisms appear inadequate or at least are not operating as effectively as they might. The first of these is the constitutionally mandated equalization program that is designed to ensure that the fiscally weak provinces have access to revenues sufficient to mount reasonably comparable provincial public goods and services. The key conclusion here will be that the equalization is too generous to the traditional have-not provinces (PEI, NS, NB, QB and MB) whereas it falls short with respect to Ontario.

The second recycling system, or lack thereof, is also interprovincial but it focuses on the high-fiscal-capacity provinces, essentially the resource-rich provinces. Here the challenge is to ensure that these provinces do not veer too far off in the direction of becoming tax havens or the providers of superior provincial public goods and services. However, simmering just below the surface are several complex and loaded policy issues – ensuring that a hydro-carbon/hydro-electric industrial strategy will benefit all of Canada; managing the so-called Dutch Disease and the associated manufacturing-resources tug-of-war; stewarding resources to ensure that they will benefit future and well as current generations, among others.

The final SRM addressed in the ensuing analysis is federal-provincial. With their open-ended or demand-driven expenditure responsibilities in the context of a rapidly aging population (such as those relating to medical practitioners, hospitals, home care, pharmaceuticals and, to a lesser, degree,) the provinces will find it progressively difficult to provide adequate public services across their current range of constitutional responsibilities. Arguably, Ottawa is in the opposite position. In other words, Canada will soon need to consider creative processes and/or programs relating to the re-allocation of money and powers in the federation.

Readers will recognize that these are highly explosive issues: they embrace the high politics of altering the division of powers; they tamper, albeit indirectly, with provincial entitlements; at the inter-provincial level they are inherently zero-sum games; they embody empirical assessments that are both complex and controversial, and so on. Phrased differently, there can be no first-best solutions. As such, the policy recommendations cannot consist of doctrinaire remedies, but rather must of necessity take the form of a series of options or avenues for improving the operations of these three macro-equilibrating mechanisms. Indeed, the primary contribution of the paper may well lie not in providing solutions but, rather, in shedding political and empirical light on some existing inadequacies of the status quo in respect of the ability of these SRMs to provide the resilience and stability that the Canadian federation requires.

## **II: EQUALIZATION AS AN INTERPROVINCIAL SURPLUS-RECYCLING MECHANISM**

There are many programs that recycle revenues/incomes/benefits across individuals and provinces. Employment Insurance serves to transfer benefits at the individual level from the employed to the unemployed and at the interprovincial level (via the special regional provisions relating to entry qualifications and benefit duration) from low-unemployment provinces to high-unemployment provinces. Progressive tax systems combined with proportional expenditure systems transfer benefits from high-income individuals (and provinces) to lower-income individuals

(and provinces). Within each province, tax-financed health care transfers benefits from rich and healthy citizens to poor and unhealthy citizens. And so on.

However, important as these transfers are in terms of creating an equitable and resilient society, they are interpersonal or interprovincial transfers to *persons*, whereas the surplus-recycling mechanisms that are the focus of this paper relate to transfers between *governments* and in particular to interprovincial and federal-provincial governmental transfers. While transfers like the CHT and the CST would qualify as SRMs -- indeed one of the policy options flowing from the ensuing analysis is that these transfers might play an even larger surplus-recycling role in the future -- the dominant interprovincial surplus-recycling mechanism is the equalization program, to which the analysis now turns.

## *II: A. Philosophy and Principles*

From Section 36(2) of the *Constitution Act, 1982*:

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.

Canada's system of equalization payments was introduced as part of the 1957 *Tax Sharing Arrangements* that transferred shares of federal taxes back to the provinces -- 10% of federal income taxes, 9% of the corporate income taxes and 50% of succession duties. Since these federal abatements were allocated to the provinces on a *derivation* basis (i.e., on the basis of what was actually collected in the respective provinces) this generated larger per capita revenues in the richer provinces. In order to compensate for these differentials, Ottawa introduced an equalization program to equalize these three abatements. (Note that the current version of the equalization program includes all provincial revenues.) From the outset, equalization payments have always been unconditional transfers in that they can be spent as and where the recipient provinces please. This makes eminent sense in the rich provinces can obviously spend their revenues as and where they please.

While equalization payments are a key component of interprovincial surplus recycling, this recycling does not involve direct transfers of provincial revenues from rich to poor provinces. Rather, Ottawa makes these payments to the poorer provinces from its consolidated revenue fund (CRF). Although identically situated citizens, no matter where they reside, will contribute the same amount to the CRF, this nevertheless means that in aggregate residents of rich provinces will pay higher per capita revenues to Ottawa than will residents of poorer provinces. In this sense it can be said that Albertans (but not Alberta) contribute more per capita to the cost of equalization than say, residents of Nova Scotia, but this is also the case for National Defence or Old Age Security or any other federal spending program.

A final point merits airing, namely that equalization also benefits the richer provinces. Specifically, without the presence of an equalization program, there is no way that Canada would be as decentralized on the taxation front as we currently are, which clearly and hugely privileges the rich provinces.

Attention is now directed to the operations of the equalization program since fiscal year 2005-06, after which focus will turn to the performance of equalization in fiscal year 2012-13.

## *II:B. The Recent Evolution of Canada's Equalization Program*

Table 1 presents per capita data on equalization (and the associated payments from the Offshore Accords) from fiscal year 2005-06 through to 2012-13. While this period covers the operations of the program under the Harper era, the more important reason for this time frame is that it coincides with the introduction of the dramatic changes Prime Minister Paul Martin introduced in fiscal year 2004-05. Although for completeness the table also contains the per capita values for Territorial Formula Financing for Yukon, Northwest Territories and Nunavut, the focus in this paper will only be on the provinces.

These last eight years rank among the most turbulent periods in the history of equalization. At the First Ministers' summit on equalization in October of 2004, newly elected Prime Minister Paul Martin acted on the July 2004 *Council of the Federation's* recommendation and restored total equalization to its historic high (i.e.,

to \$10.9 billion). Then Martin fundamentally transformed the future of the program by introducing the so-called *New Framework*. Henceforth overall equalization would grow annually by 3.5% -- irrespective of the degree of interprovincial fiscal disparities -- so that the role of the equalization formula would henceforth only determine the allocation of this fixed pool and not the size of the pool. Further

**TABLE 1**  
The Evolution of Equalization Payments  
(2005-2013, \$ million)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
NL -- Equalization -- Offshore Accord	861 (189)	687 (329)	477 (494)	0 (557)	0 (465)	0 (642)	0 (536)	0 0
PEI	277	291	294	322	340	330	329	337
NS -- Equalization -- Offshore Accord	1,344 (31)	1,386 (57)	1,465 (68)	1,465 (106)	1,391 (180)	1,110 (227)	1,167 (250)	1,268 (458)
NB	1,348	1,451	1,477	1,584	1,689	1,581	1,483	1,495
QB	4,798	5,539	7,160	8,028	8,355	8,552	7,815	7,391
ON	0	0	0	0	347	972	2,200	3,261
MB	1,601	1,709	1,826	2,063	2,063	1,826	1,666	1,671
SK	89	13	226	0	0	0	0	0
AB	0	0	0	0	0	0	0	0
BC	590	459	0	0	0	0	0	0
YUKON TFF	501	517	544	564	612	653	705	767
NWT TFF	737	757	843	805	864	920	996	1,070
GN TFF	821	844	893	944	1,022	1,091	1,175	1,273
CA -- Equalization -- Offshore Accords -- TFF	10,907 (220) 2,058	11,535 (386) 2,118	12,925 (562) 2,279	13,462 (663) 2,313	14,185 (645) 2,498	14,372 (869) 2,664	14,659 (786) 2,876	15,423 (458) 3,111

Source: Finance Canada: Federal Support to the Provinces and Territories; Major Transfers (<http://fin.gc.ca/fedprov/mtp--eng.asp>)

complicating the operations of the formula was the implementation of Martin's electoral promise (conferred privately) to Newfoundland and Nova Scotia, namely

that their offshore energy revenues would be protected from equalization clawbacks at least until 2011-12<sup>1</sup>.

Recognizing that the equalization program had become increasingly arbitrary, Liberal Finance Minister Ralph Goodale in his 2005 federal budget established the *Expert Panel on Equalization and Territorial Formula Financing*, whose 2006 report will henceforth be referred to as the O'Brien Report, after the Panel's chair Al O'Brien. Remarkably, the O'Brien Report's recommendations were fully implemented in Conservative Finance Minister Jim Flaherty's inaugural (2007) budget. Among these new equalization provisions were: a return to the old regime where the formula would determine both the size and the distribution of the equalization pool; a reallocation of the 30+ tax bases into five bases (personal income taxes, corporate income taxes, property taxes, sales taxes and 50% of all resources revenues); a cap on equalization so that no receiving province could end up with more overall revenues per capita than the lowest of the non-receiving provinces); and the provision that the data entering the formula would be in the form of three-year averages lagged two years.

However, the open-ended nature of the revised program (i.e., open ended in that the formula would determine the total amount of equalization) fell into disarray almost immediately, thanks to the dramatic upward spike in the price of oil to the \$150 per barrel range in 2008 and the resulting descent of Ontario into have-not status. Accordingly, and to control the overall growth of the program, the 2009 budget re-introduced the spirit of the *New Framework* by limiting the growth of equalization to the three-year moving average of nominal GDP (which would constitute both a ceiling and a floor), a provision that still exists.

Turning now in more detail to operations of equalization as revealed in Table 1, at one time or another over the 2005-06 to 2012-13 period all provinces except Alberta have been recipients of equalization.<sup>2</sup> While Newfoundland's revenues from offshore energy have made it a "have" (i.e., non-equalization-receiving) province since 2008-09, it still averaged over half a billion a year in rebates under the Offshore Accords until 2011-12. On the other hand, Nova Scotia's offshore rebates have grown every year, with presumably larger increases to come.



However, the major economic news in the table is the descent of Ontario into the ranks of the receiving provinces. In 2012-13, its \$3.261 billion in equalization payments represents 21% of total equalization (\$15.423 billion, from the last row panel of the table). Given this rapid rise in populous Ontario's equalization entitlements in the presence of an overall cap on the system, the inevitable result was that all other recipient provinces would see declines in their annual entitlements. (Nova Scotia is an exception if one includes its offshore payments.) Not surprisingly, this had led to major concerns on the part of the traditional recipients, even to the point of pressing Ottawa to prevent Ontario's entitlement from having a negative impact on their own entitlements.<sup>3</sup> The more general point here is that equalization is becoming increasingly problematical when six provinces with over 70% of the population fall into the have-not category: without the equalization cap, each net additional dollar accruing to a have province would lead to an increase in equalization of 70 cents!

Prior to turning to a more detailed description of the workings of the program, it should be noted that the data in Table 1 for the three territories (referred to as Territorial Formula Financing) reveals that the entitlements for all three have risen each and every year.

### *II:C. The Anatomy of Provincial Finances: 2012-13*

Table 2 presents per capita data relating to an overview of provincial finances for fiscal year 2012-13 based on the December 16, 2011 equalization estimates.<sup>4</sup> The overall total depicted in row 7 ("overall fiscal capacity") is the sum of equalization-defined fiscal capacity including all resource revenues plus the offshore accords plus the CHT/CST transfers.

In more detail, row 1 contains the provincial per capita values for fiscal capacity that enter the equalization formula. These are the sum of 100% of the per capita fiscal capacity for the components of four of the five tax bases (personal income taxes, corporate income taxes, sales taxes and property taxes) plus 50% of the fiscal capacity values for resource revenues. In turn, the fiscal capacity estimates for the four non-energy tax bases for each province are the product of the value of

the province's tax base multiplied by the national average tax rate (not the province's own rate).

Row 2 contains the per capita values of equalization payments. If equalization payments were strictly formula driven, these values would be the difference (where positive) between the all-Canada average for fiscal capacity in the

**TABLE 2**  
The Anatomy of Provincial Finances  
2012-13, \$/capita

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	CAN Ave
1. Fiscal Capacity	8,444	4,711	5,501	5,097	6,036	6,840	5,721	8,466	11,351	7,453	7,174
2. Equalization	0	2,377	1,347	1,993	943	249	1,368	0	0	0	
3. Other 50% of Resource Revenues	2,663	2	164	54	188	9	73	1,420	1,379	339	
4. Offshore Accords			155								
5. Sub-total (1-4)	11,107	7,090	7,167	7,144	7,167	7,098	7,162	9,886	12,730	7,792	7,509
6. CHT/CST Transfers	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	
7. Overall Fiscal Capacity	12,307	8,290	8,367	8,344	8,367	8,298	8,362	11,086	13,930	8,992	8,709

Source: Department of Finance: December 16, 2011 Equalization estimates.

final column of row 1 of Table 2 and the respective provincial fiscal capacities. However, overall equalization was scaled back (on an equal-per-capita basis) to ensure that they would be in line with the overall cap on equalization.<sup>5</sup>

Row 3 then adds the other 50% of resource revenues (where relevant)<sup>6</sup> and row 4 contains the Offshore Accord offset payment for Nova Scotia. Row 5 sums the previous four rows to obtain what might be called the aggregate taxation-cum-equalization measures of provincial fiscal capacity. Row 6 then contains the equal-per-capita federal-provincial CHT/CST transfers (i.e., effectively about \$1,200 per capita).<sup>7</sup> Finally, row 7 is the sum of the previous 6 rows and, as such, represents the overall per capita fiscal capacity available to the individual provinces. Note that this

is not quite the same as *actual* overall per capita provincial revenues because it assumes that provinces levy taxes at the all-province-average tax rates, among other reasons.

These overall or aggregate fiscal capacities vary from roughly \$8,300 per capita for the six equalization-receiving provinces to \$8,992 for BC, \$11,086 for Saskatchewan, \$12,307 for Newfoundland and Labrador and, finally, \$13,930 for Alberta. These are dramatic differences, so much so that if they persist the likely outcome will surely lead to superior public goods and/or tax havens in the high fiscal capacity provinces, on which much more later.

#### An Alberta Detour

A brief detour is in order because many readers will be puzzled by these results, especially since supposedly super-rich Alberta is currently struggling with a significant billion *deficit* this year. Not surprisingly, the principal reason for this is the sharp reduction in expected energy revenues. However, there are at least three additional reasons for the difference between the Alberta's superior fiscal capacity in Table 2 on the one hand and its current deficit woes on the other. The first relates to the earlier-noted "lag" in the formula, namely a three-year average (with weights of 50-25-25 respectively) lagged two years. For fiscal year 2012-13 this means that the data entering the equalization formula are as follows -- 50% of the 2010-11 data, 25% of the 2009-10 data and 25% of the 2008-09 data. Hence, the \$150 dollar oil price of 2008 has a 25% weight in the Table 2 results. In this volatile world the equalization authorities should surely take steps to ensure that the formula embodies more up-to-date.

The second reason is that the data that do enter the formula relate to a province's fiscal *capacity*, not to its actual fiscal revenues. If a province opts not to tax one of its revenue sources, it still will be assigned its relevant fiscal capacity. This is especially relevant for Alberta – it obviously has a fiscal capacity for generating sales tax revenues, but it chooses not to levy such a tax. Thus the Table 2 fiscal capacity data for Alberta in row 1 includes what it *could raise, not what it did raise* from a provincial sales tax levied at national-average tax rates. Currently, the

value of the sales tax entry (and, therefore the value of the foregone revenue) for Alberta is reported to be in the order of \$ 5 to 6 billion.

The third reason has already been alluded to, namely that Alberta has been moving in the direction of becoming both a tax haven (it has no provincial sales tax, as just noted and it has the lowest personal income tax) and a provider of superior public goods. In terms of the latter, the Fraser Institute's Mark Milke points out that Alberta has some of the highest per capita program spending of any of the provinces, including paying its teachers 20% more than in other provinces (cited in Gerson (2012)).

This detour aside, Part III will attempt to make the case that the equalization formula and overall macroeconomic policy more generally are having trouble reconciling the presence of resource royalties with the equalization principles as reflected in S. 36(2).

In the interim, the role of the next two sections is to make the case that the conceptual basis of Canada's approach to equalization – ensuring that the receiving provinces end up with approximately the same *nominal* (actual) per-capita dollars – should be reconsidered. Specifically, the analysis will focus on the implications of ignoring the cost/price differentials in the provision of provincial public goods and services on the one hand and the differential needs across the various provinces on the other.

#### *II:D. Capitalization and Equalization*

Alone among mature federations, the Americans have no formal revenue-equalization program. No doubt, part of the reason relates to the reality that point-in-time income distribution is not a high priority in the US. Indeed, as detailed in my *Rekindling the American Dream* (2011), the US has the most unequal distribution of income in the rich nations' club, so it is perhaps not much of a stretch that this mentality underpins the indifference to the distribution of per capita revenues across American states.

However, Wallace Oates (1983, 94-7), one of the leading experts on US federalism, rationalizes the absence of an equalization program in economic terms.

Specifically, while it is certainly true that states with higher per capita incomes have the potential for having correspondingly higher per capita revenues, these differential state incomes will be capitalized in terms of higher wages and rents which, in turn, will increase the costs/prices of producing state-level public goods and services. Similarly, lower income states will also have lower wages and rents so that they do not need the higher level of per capita revenues of the higher income and revenue states in order to provide comparable levels of public goods and services. In other words, income differentials will be “capitalized” in terms of wages and prices, so that in the final analysis there may be little or nothing to equalize, as it were. In Oates’ view, the decision to have an equalization program in a federal system is more a matter of “taste” than of social or economic principles.

Within the above framework and under the assumption of full or 100% capitalization there would be no need for an equalization program since higher wages and rents in high-income states would offset their revenue advantage and vice versa for states with low wages and rents. However, most analysts would take the view that the assumption of 100% capitalization is rather extreme. But so is the opposite assumption that Canada embraces in its equalization program, namely that there is *zero capitalization* so that one can ignore the prices/costs of provincial public goods and services in the calculation of equalization payments. This issue merits further attention.

An excellent place to start this rethinking is with the Constitution. Section 36(2), reproduced earlier, does not call for equalizing per capita revenues across the recipient provinces. Rather the stated thrust is that provinces should end up with revenues sufficient to provide *reasonably comparable levels of public goods and services*. This being the case, the ability of the recipient provinces to provide comparable levels or bundles of public goods and services will then depend not only on provincial revenues but, as well, on the prices or costs of providing these bundles. In other words, my reading of 36(2) is that equalization is about providing comparable *quantities*, i.e., about providing comparable *real or purchasing-power-corrected* bundles of provincial public goods and services.

What difference would this make to the results in Table 2? Table 3 provides one answer. Row 1 of the table reproduces the overall per capita fiscal capacity figures from row 7 of Table 2. Note that these figures *include* equalization. In order to convert these figures to real or purchasing-power bundles of public goods and services we need an index of the prices/costs of these goods and services.

Thankfully, Peter Gusen (2012a, 2012b) has calculated just such an index for fiscal

**TABLE 3**

Capitalization and Equalization:  
Incorporating Wages and Prices into Equalization  
(2012-13)

	NL	PEI	NS	NB	QB	ON	MB	SK	AB	BC	CA
1. Total Provincial Revenues <sup>1</sup> (\$ per capita)	12,307	8,290	8,367	8,344	8,367	8,298	8,362	11,086	13,930	8,992	8,709
2. Gusen's Price Index (2009) for Public Goods and Services <sup>2</sup>	.969	.895	.934	.943	.959	1.020	.964	.976	1.089	.986	1.00
3. Purchasing Power Bundles row 1 ÷ row 2	12,700	9,263	8,955	8,848	8,725	8,135	8,674	11,359	12,792	9,117	
4. Equalization from row 2, Table 2, \$/ca	0	2,377	1,347	1,993	943	249	1,368	0	0	0	
5. Equalizing Real Fiscal Capacities, \$/capita <sup>3</sup>	0	1,832	1,206	1,691	800	388	1,053	0	0	0	

1. Reproduced from Row 7 of Table 2.
2. Gusen's weighted average of the price of public goods and services incorporates: wages and salaries, transfers, construction contracts, health care purchases, consulting services and "others." Gusen (2012b, 7-8).
3. These equalization entitlements are calculated as follows; i) convert the row 1, Table 2 per capita fiscal capacity values to real terms by dividing them by the Gusen indexes (row 2 of this Table); and ii) bring all the recipient provinces up to the level consistent with exhausting the maximum allowable amount of equalization. Consult the relevant text for additional comments.

year 2008-09 in connection with his path-breaking Mowat Centre research directed toward measuring expenditure need. His indexes by province (with Canada equal to 1.00) appear as row 2 in Table 3. The indexes are calculated as the prices/costs of a weighted average of six categories of public goods and services: wages and salaries<sup>8</sup>; transfers; construction contracts; health care purchases; consulting services and a residual category referred to as “other.” Row A3 is obtained by dividing row A1 by row A2 and the resulting values represent estimates of the real purchasing power of post-equalization aggregate provincial revenues.<sup>9</sup>

The results border on the astounding. Ontario, with \$8,135 per capita in real purchasing-power-revenues comes off as the most fiscal-capacity-deprived province, and by a considerable margin. The next closest are Manitoba with \$8,674 and Quebec with \$8,725. Lest one think that these are small differences, with a population in the neighbourhood of 13 million, Ontario’s near-\$600 per capita shortfall (in real terms) relative to Quebec means that it would take roughly 8 billion dollars (of real purchasing power) to close the Ontario-Quebec gap. Moreover, non-equalization-receiving-province British Columbia ends up with a lower ability to provide per capita real quantities of public goods than does Prince Edward Island.

At one level, row 3 of Table 3 is the appropriate vantage point for assessing the adequacy of Canada’s equalization system in terms of the overall distribution of pre capita revenues across the recipient provinces. From this perspective, the equalization system is failing Ontario as an effective surplus-recycling mechanism. . Although Ontario’s descent into have-not status is in part a *relative* decline (resource rich provinces have fared much better) as well as an *absolute* decline (Ontario has been hurt by US offshoring of manufacturing and by the Dutch Disease, on which more later) the province cannot escape the reality that some sizeable share of its ongoing fiscal woes are of its own doing.

Since the comparison in row 3 includes the equalization payments from row 2 of Table 2, a more appropriate comparison might be to calculate equalization on the basis of purchasing-power-adjusted provincial fiscal capacities. This would involve dividing provincial fiscal capacities in row 1 of Table 2 by the Gusen

price/cost index in row 2 of Table 3. Then one would transfer equalization dollars to the lowest purchasing-power-adjusted fiscal-capacity province until it is brought up to the second lowest, and then transfer equalization dollars to these two provinces until they achieve the level of the third lowest, and so on until the allowable equalization pool runs dry. This process leads to the per capita equalization payments in row 5 of Table 3, with the original equalization payments (row 2 of Table 2) reproduced for convenient comparison in row 4. Not surprisingly, the row 5 equalization for all of the traditional five recipient provinces falls substantially while that for Ontario rises. In particular, Ontario's equalization rises from \$249 per capita to \$388 per capita. The decreases in equalization for PEI, NB, and MB are about \$300 per capita while the decreases for NS and QB are roughly \$150 per capita.

While Ontario's share of overall equalization in 2012-13 from Table 1 was, as noted earlier, just over one-fifth, the \$388 per capita value from row 4 of Table 3 would account for one-third of this same equalization total.<sup>10</sup> This further buttresses the conclusion that, under the assumption that the goal is to ensure that the recipient provinces can provide comparable *real* levels of provincial public goods and services, the current program over-equalizes the transfers to the traditional receiving provinces and under-equalizes the transfers to Ontario. Moreover, the amounts involved are anything but trivial.

However desirable it may be on economic or equity grounds to incorporate prices/costs into the calculation of equalization payments, this will obviously be difficult politically because it would significantly disadvantage six of the seven current have-not provinces. Nonetheless, some implications and recommendations will be proffered later. For present purposes, one technical recommendation is surely in order, namely that Ottawa alter its approach when the formula-driven equalization exceeds the equalization cap. Currently, the approach is to reduce the per capita value of the equalization standard until overall payments fall within the cap. This reduces all provinces' per capita equalization by the same amount. But in the process the percentage reduction in Ontario's equalization is the largest (assuming that it remains the richest of the recipient provinces). However, given



that Ontario is already considerably disadvantaged in terms of providing comparable real public goods and services, this approach would exacerbate Ontario's disadvantage. A equi-proportional reduction seems more appropriate, i.e., take the initial recipient provinces' percentages of overall formula based equalization and then apply these same percentages to the allowable amount of equalization.

By way of a concluding comment, if the US can fall back of the importance of capitalization as a rationale for not having an equalization program, then it seems inappropriate on Canada's part to completely ignore the role of costs and prices in our equalization program. This is even more the case since a straightforward reading of the s.36(2) would appear to support taking the prices/costs of producing provincial public goods and services into account.

However, even if Canada embraced the concept of incorporating prices into the definition of comparable levels of public goods and service, *might it not be the case that, say, New Brunswick or Quebec, would need a larger number of these comparable bundles?* Readers will note that correcting for capitalization as a first step and then assessing the number of these price-corrected bundles different provinces may require is not the generally accepted approach to the concept of expenditure needs. Rather, the generally accepted approach of expenditure-needs advocates is that it should incorporate both differential prices/costs and differential physical needs or requirements.

I will defer my reflections on the appropriate approach until later. In the interim the analysis now turns to the most sophisticated assessment of the generally accepted vision of expenditure-needs equalization.

#### *II:E. Expenditure Needs Equalization: The Peter Gusen Analysis*

Peter Gusen has recently (2012a, 2012b), and courageously, undertaken an impressive and comprehensive approach to developing and measuring an expenditure-needs approach to equalization, one that embraces both differential costs/prices and measures of actual (price/cost-independent) needs. In more detail, his results for expenditure needs in the various provinces are based on a weighted

average over five expenditure areas -- healthcare, elementary and secondary education, post-secondary education, social assistance, and “other social services.” For these areas, he assesses the physical needs involved (e.g., the per cent of population of school age for elementary and secondary education needs, and the age distribution of the population for health needs, etc.). On the prices/costs side, given that the provincial price indexes in row 2 of Table 3 are also weighted averages of these five same expenditure categories, overall expenditure needs are obtained by marrying these prices/costs with the measures of physical need to obtain Gusen’s (and the profession’s) preferred definition of expenditure need.

The results for Gusen’s approach for fiscal year 2008-09 appear in Table 4. The first five rows contain the estimates for relative provincial expenditure needs (i.e., deviations from the all-province average) for the five expenditure categories. The measures of overall expenditure needs by province (i.e., the sum of rows 1 through 5) appear as row 6. These measures sum to zero across all provinces, where the \$3,245 million figure in the final columns of row 6 is the sum of the positive entitlements.

The results are probably not what one would have expected. Only three provinces have less than average overall needs – PEI, Manitoba and Quebec, with latter recording expenditure needs that are over three billion dollars less than the all-province-average measure of needs.

Row 7 contains the data on equalization payments for fiscal year 2008-09, reproduced from the Gusen paper. The final row of the table presents “expenditure needs equalization,” defined as the sum (where positive) of fiscal equalization transfers and the measures of expenditure needs. Where the sum of rows 6 and 7 is negative, the value in row 8 is set equal to zero. Gusen assesses the row 8 figures as follows (2012a, 27-8):

**TABLE 4**

Equalization and Expenditure Need  
(2008-09, \$million)

	NL	PE I	NS	NB	QB	ON	MB	SK	AB	BC	
1. Health	165	-19	167	165	-467	-178	-28	289	-848	752	
2. Elementary and Secondary Education	-43	-9	-154	-96	-1,242	753	191	195	896	-491	
3. Post-Secondary Education	-45	-39	16	-133	-783	286	-89	-70	1,141	-285	
4. Social Assistance	63	-15	46	89	675	26	-160	-82	-821	179	
5. Other Social Services	170	-5	219	57	-1,300	-66	44	0	157	724	
6. Total Expenditure Needs: sum of 1-5	310	-86	294	83	-3,117	822	-42	332	526	879	3,245 (2)
7. Fiscal Equalization (2008-09) <sup>1</sup>	0	322	1,319	1,406	7,632	3,713	1,572	-352	-11,527	-1,379	15,964
8. Expenditure Needs Equalization (row 6 + row 7) <sup>2</sup>	310	235	1,613	1,489	4,515	4,534	1,530	0	0	0	14,227

Source: Gusen (2012a), Table 11 and 12.

1. Based on the equalization formula.
2. Negative sums are set equal to zero.

...while the changes in overall payments [from row 7 to row 8] is relatively small, there would be a major shift in the distribution of payments:

-- Ontario and Quebec would receive equally large Equalization payments of just over \$4.5 billion each. Under the current fiscal-capacity-only system [row 7], Quebec receives more than twice as much as Ontario, \$7.6 billion versus \$3.7 billion.

-- Nova Scotia would enjoy a 20 per cent increase in its payments, from \$1.3 billion to \$1.6 billion.

-- PEI would see a near 30 per cent drop, from \$322 million to \$235million.

-- Newfoundland and Labrador would become an Equalization recipient.

The most significant conclusion of this exercise is probably the major redistribution of Equalization payments among provinces arising from expenditure need. It guarantees that discussions of expenditure need, or even the decision to put such discussions on the agenda, will be a contentious interprovincial issue.

Although the expenditure-need figures sum to zero across all provinces, the equalization-receiving provinces receive roughly \$1.7 billion less in positive entitlements than do the have provinces, with the result that overall equalization in row 8 is roughly \$1.7 billion less than the row 7 total. While this could be adjusted to fit within an overall ceiling and/or floor, the appropriate nature of such an adjustment is not evident.

#### *II:F. Capitalization and Needs: Some Personal Reflections*

In principle, one would want to ensure that provinces faced with higher cost/prices for providing public goods and services would end up with higher per capita revenues, other things equal. Beyond this, provinces with greater physical needs (e.g., more elderly citizens per capita) would also acquire higher per capita revenues in order to address these needs, again taking other things such as prices/costs into account. In practice, however, addressing capitalization within equalization would seem to be on much firmer ground than addressing the physical needs component. To see this, it is instructive to note that were all national programs for citizens designed so that similarly situated citizens were treated similarly no matter in which province they reside, then differential needs should be incorporated into the equalization formula. But this is clearly not the case in Canada. We have tended take account of needs within many of the national programs. For example, the privileged entry requirements and the more generous benefit-duration

periods for high-unemployment regions within the EI program are cases in point. Relatedly, as reflected in the often-referenced table produced by Battle *et al* (2006), all cities west of Montreal had a much smaller percentage of their unemployed qualifying for EI than those east of (and including) Montreal. Also of relevance here is the large and long-standing divergence in federal immigration settlement funding that favours Quebec over Ontario. In effect these can be viewed as “equalizing components” that are substitutes for provincial expenditures (e.g. for welfare payments and language programs for new Canadians in terms of the above examples). To the best of my knowledge these types of equalizing component were not taken into account in the Gusen analysis so that the overall expenditure-needs equalization will tend to be overstated to this degree in Table 4 for most of the traditional recipient provinces.

There is another, more philosophical, reason why I have a problem with embracing non-price-related needs. This is because all of our federal-provincial transfers are unconditional, save for some national principles (e.g., no residency requirements for welfare, public administration for medicare). Were we to engage in making transfers related to needs, pressures would develop to convert aspects of these transfers into conditional or specific-purpose transfers. Many Canadian analysts look fondly on the Australian approach to transfers. However, we usually do not recognize that the CGC (Commonwealth Grants Commission) allocation to the states of the federally collected 10% GST represents only slightly more the half of the total transfers to the Australian states; the other half are SPPs (Specific Purpose Payments) that are conditional transfers. Not surprisingly, there have been recent occasions where Australian lobby groups have put pressure on Canberra to convert parts of the CGC’s unconditional grants transfers into SPPs, the reason being that some Australian states are not spending on the programs in question the amounts of money directed to these programs by the CGC’s expenditure-need exercise. The associated lobby typically argues that the particular need in question requires a Specific Purpose Payment in order to ensure that the money is appropriated to its intended purpose. My concern, then, is that a move in Canada in the direction toward embracing needs in our equalization program could become an argument

for re-conditionalizing some of our unconditional transfers. Apart from my philosophical preference for unconditional grants, there is the practical reality that the have provinces could not be bound by this sort of constraint or conditionality. Indeed, this is the strongest argument for the non-conditionality of equalization payments.

Finally, I have long argued that capitalization on the one hand and correcting for expenditure needs on the other are conceptually distinct issues. The former provides for the same overall per capita level of real (purchasing-power) resources to each of the receiving provinces whereas correcting for specific needs recognizes that some provinces may need more of these bundles. However, Ottawa, and I think the majority of the equalization community, would define “expenditure need” as incorporating *both prices and specific needs*. However, this turns out to be a convenient way to ensure that capitalization will never be embraced, since embarking on a wholesale approach to a comprehensive expenditure needs system to match the existing comprehensive revenue equalization system is arguably far too complex and politically volatile to ever be implemented. In turn, however, this then means that one cannot embrace capitalization since it is viewed as having relevance only in the larger context of an overall expenditure-needs perspective. This is a clever exercise in “rent-keeping” by the traditional have-not provinces and it is a good example of what has become known in the economics literature as Stigler’s Law of regulatory capture, namely that regulation tends to evolve in favour of those being regulated.

In the final analysis, given the implications of the results in either Table 3 or Table 4, Gusen is probably right in that these options are not likely to ever see the light of legislative day. Nonetheless, I have two observations-cum-proposals. The first is that since Quebec and Manitoba are much better off under the status quo than under the capitalization or needs exercises, it seems not all that unreasonable to bring their hydro rents more fully into the equalization calculations. The second is to note that probably the most important role we can assign to the implications arising from the Gusen exercise is to use them to forestall the introduction of measures that some provinces are currently harbouring, namely embracing some

specific program needs (e.g., percentage of elderly in the province) irrespective of prices and costs of providing these provincial public goods and services.

Beyond this, the analysis to this point leads to an important policy recommendation. The results, especially in Table 3 but also to a significant degree in Table 4 as well, that indicate that we are over-equalizing the traditional recipient provinces suggests that the time has come to ensure that our national programs be reworked to ensure that similarly situated individuals, no matter where they reside, will be treated similarly. In other words, let us strip out the equalizing components embedded in other national programs and leave the task of equalization to the equalization program. In light of the above analysis this would not only be good socio-economic policy but as well the embracing equal treatment of equals in pan-Canadian programs would promote nation building.

Thus far attention has been directed to surplus recycling (or rather some inadequacies therein) as it relates to the equalization-receiving provinces. However, the more daunting problem may well be how to deal with the non-equalization-receiving provinces and in particular the resource-rich provinces that under some realistic scenarios could end up as tax havens and/or providers of superior public goods.

### **III: ENERGY ROYALTIES AND SURPLUS RECYCLING**

#### *III:A. Equalization In The Context Of A Hydrocarbon and Hydroelectric Industrial Strategy*

Canada's equalization program works tolerably well when provincial revenue sources are shared with Ottawa, as in the case for personal income taxes, corporate income taxes and sales taxes for example. In part this is so because if, say, province A sees its corporate income tax (CIT) receipts rise significantly which, in turn, will lead to an increase in overall equalization, then not only will Ottawa's CIT revenues also have risen apace (and therefore Ottawa can afford to pay the additional equalization) but there is a further appropriate coincidence, namely that the province whose increase in corporate revenues has led to the increase in

equalization is also the province whose taxpayers (corporations in his example) are conceptually funding the increase via their enhanced CIT payments to Ottawa's consolidated revenue fund.

On both counts resource royalties are entirely different. First, thanks to s.92(5), s.92A, s.109 and s.125 of our Constitution, energy (and resource) royalties are constitutionally the prerogative of the provinces, i.e., they cannot be accessed by Ottawa. More generally, s.92A grants the provinces the right to raise money by any mode or system of taxation in relation to resource revenues. To my knowledge, Canada's treatment of royalties is unique among the world's federations: no other federation has anywhere near such a powerful provincial-rights provision. Second, and consequentially, the "who benefits/who pays" coincidence noted above is severed. Hence when Alberta's energy royalties increase Ottawa has to finance the resulting increase in equalization from its consolidated revenue fund that, as noted, is not able to share in provincial energy royalties. This means that Alberta residents contribute somewhat more than their 11% population share (because they are a have province) to the financing and Ontarians probably contribute somewhat near than 39% population share.<sup>11</sup> In other words, Ontarians will be saddled with close to two-fifths of the financing of an increase in equalization triggered by an increase in energy royalties in the resource-rich provinces.

Overall energy royalties accruing to the provinces in 2012-13 were \$22.563 billion and they are the principal reason why NL, SK and AB have overall per capita fiscal capacities well in excess of the other provinces – see row 5 of Table 2. Our existing approach to accommodating these royalties within the equalization program is i) to allow only 50% of these royalties to enter the program, and ii) because these royalties are the principal driver of the recent increases in equalization entitlements, to limit the annual growth of equalization to the rate of the three-year average of GDP growth. However, the reality is that these royalties may well loom even larger in years ahead. For example, the Canadian Energy Research Institute (CERI) estimates that the oil sands in Alberta will lead to \$350 billion in provincial royalties over the next 25 years as well as \$122 billion in provincial and municipal tax revenues.<sup>12</sup> To be sure, overall oil-sands-related



Canadian tax revenue (excluding royalties) will increase by \$444 billion with 70% or \$322 billion flowing to Ottawa.

These data relate only to resulting tax revenues, not the level of economic activity, and then only to Alberta. In other words, the seemingly endless demand for our resources associated with the economic ascendancy of populous China and India is a game-changer, a potential economic bonanza that will only intensify as overall domestic and global economic activity recovers and as China and India begin to narrow the still-dramatic per capita income gap between themselves and the rich nations. The emerging response from influential policy leaders such as CIBC's Senior Vice-president and Vice-Chairman Jim Prentice is in the direction of a resource-based economic future or, in Prentice's words "a hydro-carbon and hydro-electric industrial strategy" (Prentice 2011b). Elsewhere he refers to this resource-based strategy as an "energizing infrastructure" opportunity as part of "Canada's 21<sup>st</sup> century nation-building" (Prentice 2011a). This twinning of fossil energy with hydro-electricity would bring Manitoba and Quebec under the industrial strategy umbrella (joining the three westernmost provinces and Newfoundland and Labrador). Moreover, by integrating hydro-power with the less environmentally benign oil sands and by developing a corresponding green energy policy, the overall energy strategy would arguably be made more saleable both at home and abroad.

### *III:B. Energy Royalties and Differential Provincial Fiscal and Economic Fortunes*

The Achilles heel of such a hydrocarbon/hydroelectric strategy may well lie on the fiscal and federal (indeed fiscal-federalism) fronts. Or in terms of the theme of this paper, the failure to find ways to (indirectly) recycle the resulting fiscal surpluses, inter-provincially and federal-provincially, could seriously complicate, even undermine, any national resource-based industrial strategy.<sup>13</sup> There are two seemingly unrelated, but actually closely intertwined, issues at play here.

The first and most obvious is that a ratcheting up of resource royalties would dramatically increase the fiscal disparity between the resource-rich and the equalization-receiving provinces. This is because, as noted above, the federal government cannot, constitutionally, *directly* access provincial royalties so that the

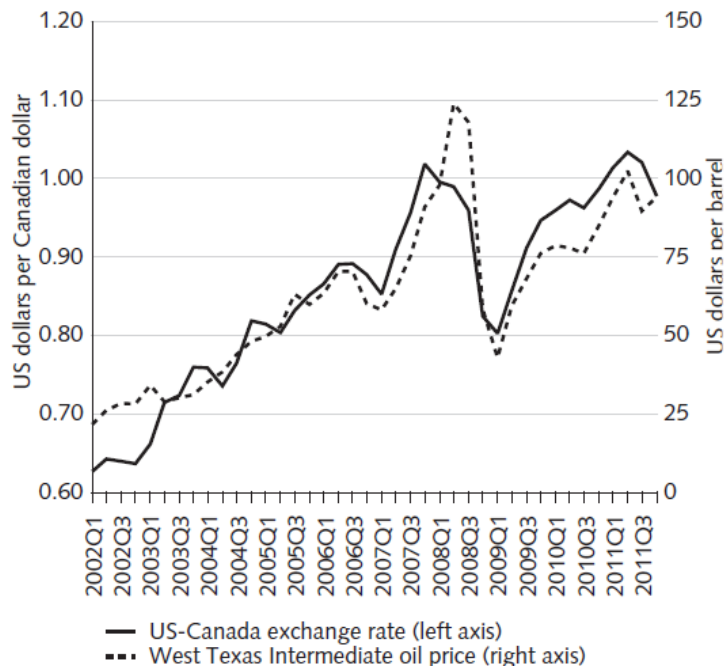
prospect of tax havens and/or superior provincial public goods and services in resource-rich provinces becomes a distinct possibility. Hence, Ottawa has to find indirect ways of recycling these resource revenues, which is in large measure the subject matter of this section. By way of an instructive aside in relation to the tax-haven issue, Canadians ought to be most thankful that Albertans abhor sales taxes since this is the most benign form of tax to eliminate because it has little impact on interprovincial factor flows. In sharp contrast, the interprovincial factor flows (including movement of corporate headquarters) would probably be quite dramatic were Alberta to have reduced its corporate income to zero rather than forgoing a sales tax. Moreover, a zero corporate tax would cost *less* in terms of forgone revenues than does a zero provincial sales tax. Presumably Alberta recognized that Ottawa would probably have had to respond in a countering fashion to a zero CIT, so this may have also served to tilt the Alberta government's preference in favour of sales tax relief.

The second issue falls under the general rubric of the "Dutch Disease", so named because Holland's exports of North Sea oil and gas appreciated the Dutch exchange rate to such a degree that this clobbered its manufacturing sector. Given the utter volatility of the energy prices, my presumption relating to the Canadian reality is that our currency area is too small to accommodate at the same time a world class manufacturing sector and a global energy powerhouse. This is clear from Figure 1 that plots the rise in energy prices (in US dollars per barrel) and the value of the loonie (in US cents per Canadian dollar). The relationship is readily apparent: a rise in global energy prices generates export-driven resource income as well as inward foreign direct investment to our energy patch, both of which will drive up the value of (i.e., appreciate) the loonie. In the process, the global price of resources rises relative to the global price of manufactures – a relative price change that will carry over to Canada. However, because resources play a larger role in the Canadian economy than they do in the US economy, the Canadian dollar will appreciate relative to the US dollar. But the near-doubling of the loonie (from 62 US cents in 2002 to just over 110 cents in 2008) represents very significant *exchange-rate overshooting*, i.e., well beyond the appreciation required to accommodate the

increase in resource prices relative to the price of manufacturers. Although not shown in Figure 1, there was an earlier and equally rapid depreciation in the 1990s that also represented exchange-rate overshooting, this time on the downward side.

To be sure, much more than the exchange rate was, and still is, at work in terms of the sharp decline in our manufacturing sector. Specifically, given that the major markets for Canada's manufacturing are US consumers and manufacturers, the wholesale offshoring and outsourcing of US manufacturing to China in order to take advantage of the inexpensive but efficient Chinese labour force clearly played the dominant role in the shrinking of the Canadian manufacturing sector.<sup>14</sup>

**Figure 1: US-Canada exchange rate and crude-oil price, 2002Q1-2011Q4**



Source: Bank of Canada; US Federal Reserve Bank of St. Louis, FRED data retrieval system.

Reproduced from Courchene (2012 Figure 2).

Nonetheless, and in contrast to the prevailing wisdom, my view has long been that the Bank of Canada should not have permitted swings in the loonie of anywhere near the magnitudes experienced recently. Indeed, even the Swiss monetary authorities, long viewed as the gold standard in the pantheon of central bankers, are

now intervening in currency markets to limit the appreciation of the fabled Swiss franc relative to the euro.

There is a related exchange-rate/manufacturing issue that merits airing in this context. Everyone recognizes that over the longer term the driver of Canadian living standards will be our productivity growth. Not surprisingly therefore, virtually every week one or another policy analyst weighs on Canada's low productivity growth rate in manufacturing.<sup>15</sup> Yet none of them ever mentions the highly volatile exchange rate as a contributing factor. To see why ignoring exchange-rate volatility is likely to be problematical, consider the reality in the late 1990s and early 2000s when the loonie was around 62 US cents and the US was in the midst of its hi-tech boom. As Richard Harris and I (1999) noted, with the loonie barely above sixty cents skilled labour and talent were migrating to the US to take advantage of much higher US wages (in nominal terms let alone after correcting for the exchange-rate differential). Moreover, the depreciated dollar also meant that capital goods and equipment became very expensive, since these were typically priced in US dollars. This led Canadian firms to satisfy the ongoing strong US export demand for their products by adding labour rather than by deepening capital. The result was that we were saddled with lower capital-labour ratios for both physical and human capital than otherwise would have been the case, with consequent negative implications for later productivity growth.

Harris and I duly recognized that if and when the dollar appreciated, capital goods would become cheaper in Canadian dollars and there would then be an incentive to increase capital investment. But we also noted at the time (1999) that if the appreciation turned out to be as sharp and as speedy as was the depreciation (and it was, as Figure 1 shows) this would lead to bankruptcies and closures in the manufacturing sector so that any incentive to accumulate capital would come from a much lower overall capital base. Moreover, this process may not be reciprocal. From its current near-parity level there is no presumption that the exchange rate will fall back to its earlier lows: it might well appreciate further in the context of a resource-driven recovery. Moreover, the utter volatility of the loonie also increases risk, with deleterious implications for attracting inward foreign investment in the NAFTA

context. Canada has many trump cards as a location for accessing NAFTA economic space – enviable macro economic indicators, a qualified labour force, a safe environment, quality public schools, medicare, and on and on. Yet given that the recent evidence suggest that the loonie can have 50 cent swings in both directions foreign investors may shy away from Canada as a location for accessing the US market. For purposes of the ensuing analysis, the relevant message is that a freely floating exchange rate exchange can wreak havoc on the manufacturing sector not only via the operations of the Dutch Disease but as well via the sheer volatility of the Canada-US exchange rate.<sup>16</sup>

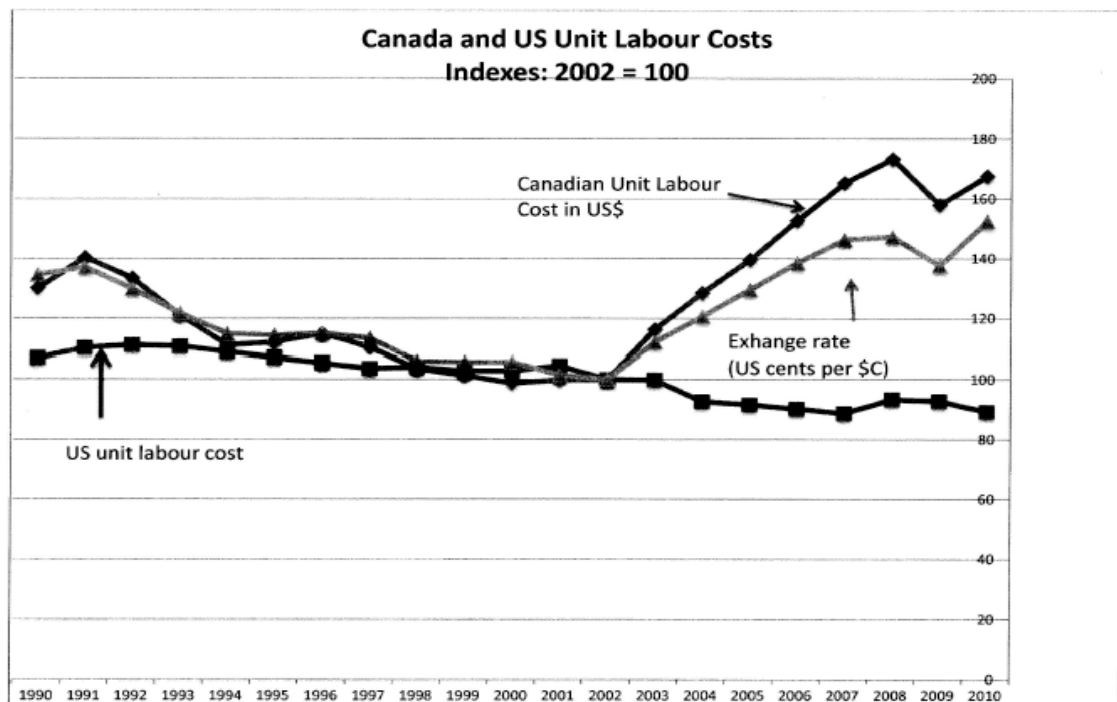
Figure 2 presents some evidence for the claims in the previous two paragraphs. Focusing on the right hand side of the figure, the uppermost line at the right-hand side of the figure is an index (2002 = 100) of Canadian unit labour costs in manufacturing expressed in US dollars. The lowest line is the index of US unit labour costs in US dollars. In the middle is an index of the Canada-US exchange rate (where higher values of the index represent an appreciation of the loonie). Unit labour costs (ULCs) measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs relative to real output, where wage increases will increase ULCs and productivity increases will decrease ULCs, other things remaining equal. What Figure 2 reveals is that the *interaction of wages and productivity resulted in Canada's ULCs rising more than the exchange rate over the 2002-2010, whereas US ULCs actually decreased over this same period*. In percentage terms, while the loonie appreciated by 52% over 2002-2010, Canada's ULCs increased by nearly 90%. Small wonder that Canadian manufacturing is under siege!

Admittedly, the implications of the Dutch Disease and exchange-rate overshooting are even more complex still. This is so because the more the exchange-rate appreciation for any given global energy price increase the less will be the Canadian dollar value of resource exports but the more will be the hit visited on manufacturing. Hence, both the manufacturing and energy provinces should be in favour of curtailing exchange-rate overshooting. However, this would complicate the operations of the equalization program since the revenue gap between the energy rich provinces and the rest would widen. There is no free lunch here.

With the above as backdrop, the analysis now turns to the range of options for ameliorating the likelihood that a hydro-carbon and hydro-electric industrial strategy is not overturned because of the failure of surplus recycling systems at the upper end of the provincial fiscal capacity spectrum. These will take the form of options that serve to indirectly redistribute the royalty revenues and/or attenuate the operations of the Dutch Disease.

Prior to turning attention to these indirect approaches to surplus recycling, it should be noted that there is one option that would qualify as a *direct* surplus recycling mechanism, namely a direct transfer of royalties from one province to another. Not surprisingly this option has arisen in the BC-Alberta stand-off over the Enbridge Northern Gateway pipeline. Given that Alberta will pocket scores of

**FIGURE 2**



Source: US Bureau of Labour Statistics

billions in royalties while BC will be saddled with any environmental catastrophe, it is only natural that BC would be interested in securing a share of Alberta's benefits and/or adequate compensation for any environmental disaster as *quid quo pro* for the pipeline to proceed, all other factors being onside. Although, as noted earlier, this could take the form of a direct province-to-province transfer, it is nonetheless the case that there could hardly be a more appropriate example of the importance of having adequate surplus recycling mechanisms in place in order to pave the way for the emergence of a comprehensive hydrocarbon and hydroelectric industrial strategy.

### *III:C. Options for Ameliorating Resource-Driven Interprovincial Fiscal Inequity and the Dutch Disease*

#### 1. Stewardship as a Principled Perspective

In his insightful June 2012 *Policy Options* article "Reversing the Curse: Starting With Energy" David Emerson provides a principled perspective for addressing the implications of resource revenues for both the Dutch Disease and interprovincial fiscal equity. This principled perspective is *stewardship*:

A longer-term, more disciplined approach to managing energy and resources is required. Natural resources are long-term assets that belong to generations of Canadians now and into the future. Government leaders and decision-makers have an implied custodial and stewardship responsibility to manage across the generations. In fiscal and economic terms, non-renewable energy and natural resources are long-life, fixed assets that, when sold and monetized, should be reinvested in ways that will benefit Canadians over the long term. *Pretending that resource revenue is just another form of operating revenue, to be spent on current consumption of public services, is an abrogation of this responsibility.* (2012, 53, Emphasis added)

In the economics literature, the optimal approach to non-renewable-resource stewardship is the "Hartwick Rule" (named after my Queen's colleague John Hartwick), namely that non-renewable assets when sold should be invested and the

annual return on this investment can be spent or, in the context of this paper, bought into provincial budgets.

Attention is now directed to alternative ways in which resource revenues can be indirectly recycled. Much of what follows has its roots in the existing Canadian policy literature. The most recent contributions would include Boadway, Coulombe and Tremblay (2012), Tremblay (2012) and Courchene (2012).

## 2. Provincial Sovereign Wealth Funds (PSWFs)

This stewardship perspective points in the direction of PSWFs, preferably along the lines of Norway's sovereign wealth fund. Fuelled by fossil energy revenues, Norway's fund invested in international markets. This serves to offset Norway's energy related export earnings, thus in turn serving to ameliorate the tendency for the Norwegian currency (krone) to appreciate. PSWFs invested in international markets would play the same role – stewarding energy related revenues for use by future generations and in the process reducing the operations of the Dutch Disease. As noted earlier, by reducing the degree to which the loonie would appreciate in the face of an increase in the international demand for and/or price of energy, this would mean more Canadian dollars for any given level of exports, a clear gain for both energy exporters and governments alike.

Were Alberta to have introduced a sales tax and created a PSWF (or continued with the Heritage Fund), the current value of such a fund would be in excess of a hundred billion dollars and possibly very much larger. A potential further role for such a fund could be to stabilize the provinces overall revenues in the face of either revenue shortfalls or excesses. To be sure, a PSWF in the hundred-billion-plus area would likely create a challenge of its own to the federation.

Since the energy revenues placed in PSWFs would not enter provincial consolidated revenues for budgetary purposes and, therefore, would not be devoted to the provision of current public goods and services, *these revenues should not enter the equalization formula*. However, when funds are withdrawn from PSWFs and brought back into provincial consolidated revenue funds they would then enter the equalization formula.



Intriguingly, Alberta's 2006 \$400 Prosperity Bonus distributed to all tax-paying Albertans (popularly referred to as "Ralph Bucks," after Premier Klein) represented another way of ensuring that energy royalties do not enter the equalization formula. In Alberta's case the total cost was \$1.4 billion. Ottawa deemed these allocations to be exempt from federal income tax. At one level, this seems appropriate since an alternative would have been to reduce provincial income taxes by an equivalent amount. However, since these Ralph Bucks were in effect an energy dividend and since royalties accruing to owners of oil-producing freehold land are subject to taxation, then Ottawa's exemption might be viewed as inappropriate. This is especially the case in light of the earlier discussion to the effect that public finance principles may well argue for imputing a taxable benefit to individuals that benefit from federal-tax-exempt provincial royalties that are used to provide provincial public goods and services. Phrased differently, Ralph Bucks should have been subject to federal personal income taxation.

### 3. Redesigning Federal Corporate Profits Taxes

While Ottawa cannot access provincial royalties, it can alter its corporate taxation system in ways that will increase its revenues from the sector. The obvious, albeit controversial, approach here would be to disallow deduction of a corporation's royalty payments to provincial governments in calculating its federal corporate taxes. One likely result of this would be that the provinces would be put under pressure to reduce their royalty rates. While disallowing royalty deductions might seem overly punitive, it must be noted that it was the ability for energy firms to deduct provincial royalties in calculating federal corporate taxes that allowed the provinces to set higher royalties in the first place.

An increasingly appealing alternative, in part because it is becoming more acceptable internationally, would be to convert the corporate tax system into a tax on rents. Boadway, Coulombe and Tremblay (2012) reflect on this proposal as follows:

A tax on rents would capture revenues for the public sector from rents or pure profits generated from all sources, including monopoly rents,

resource rents, locational rents, and rents due to special advantages. A corporate tax based on rents would generate for the federal government a share of resource rents using a tax that is not explicitly discriminatory, and would contribute to the federal government's ability to address fiscal imbalances arising from natural resources.

#### 4. Revenue Testing Federal-Provincial Transfers

Canada income tests virtually all its transfers – GIS, OAS, EI, CCTB (Canada child tax benefits), welfare benefits, and probably others. The time has come to “*revenue test*” the equal per capita federal-provincial transfers to the provinces. In an earlier article (2010) I proposed that the CHT/CST combination be subject to revenue testing along the following lines. Using fiscal capacity as measured by the equalization program, if a province has a per capita all-in fiscal capacity (including equalization) above a certain threshold, say 115%, of the per capita national average of all-in fiscal capacity, then for each dollar per capita of the province's revenues above this threshold, Ottawa would reduce its CHT/CST transfer by, say, 25 cents per capita. Given that the current value of the CHT/CST is roughly \$1,200 per capita (row 6 of table 2 above), if a province has an all in fiscal capacity of \$4,800 per capita above the 115% per capita threshold, then its CHT/CST will fall to zero. The resulting CHT/CST clawbacks would then be redistributed to the provinces with per capita revenues below the threshold.

A few comments are in order. While provincial fiscal capacity for purposes of this recommendation would include all revenues, it is likely that energy royalties will be the primary reason for per capita provincial revenues in excess of 115% of the national average. However, this does not amount to a confiscation of royalties any more than a reduction in one's old age pension due to an increase in earned income amounts to a confiscation of the earned income. Moreover, unlike the 100% clawbacks on the Guaranteed Income Supplement (GIS), a 25% revenue clawback is rather moderate. Indeed, under the Australian Commonwealth Grants Commission approach, the clawback of per capita revenues (say Western Australia's resource revenues) is effectively 100% once they exceed the all-state average.

One of the hallmarks of our approach to the social envelope in comparison with the US is that we engage in targeting-cum-income-testing for virtually all of our benefits whereas the Americans do not, i.e., their social security payments are universal rather than targeted (via income testing) to those most in need. In other words we purchase more equity, as it were, than do the Americans from every dollar of social policy spending. Revenue testing is a natural extension of income testing.

It should be clear that there is nothing sacrosanct about the choice of the 115% threshold or the 25% clawback. Others would probably choose different parameters. But what hopefully becomes acceptable is that revenue testing, already the cornerstone of our equalization program, also becomes a defining feature of the rest of our federal-provincial transfer system.

Finally, it is instructive to recognize that *the CHT/CST has been subject to revenue testing*. The precise details are arcane but, in general terms, provinces with high per capita revenues from the personal tax and to a lesser degree the corporate income tax received smaller per capita CHT/CST transfers. The 2007-08 federal budget committed Ottawa to ensuring that the CHT/CST would become equal per capita across the board for all provinces. Ontario has now been brought up to the other provinces' level and Alberta will get there in fiscal year 2014-15. The message here is two-fold: i) revenue testing the federal-provincial cash transfers is not new, and ii) meaningful indirect surplus recycling requires that it be re-instated along the lines outlined above.

## 5. Pricing Carbon Emissions

The fiscal federalism issues associated with carbon pricing provide a convenient transition between the current issues relating to the possibility of resource rich provinces morphing into tax havens and/or suppliers of superior public goods on the one hand and the core issue in the final substantive section dealing with the likelihood that some, if not all, provincial governments will have inadequate revenue sources to meet their growing expenditure responsibilities on the other. In terms of the former, were the bulk of the revenues from pollution

abatement to accrue, via upstream or origin-based emission taxes, to the energy rich provinces that are already receiving huge energy rents/royalties this would dramatically exacerbate the already challenging differential fiscal capacities across provinces. In a *Policy Options* article John Allan and I (March 2008) argued that the preferred option would be a nationally run, destination-based (i.e., a final-consumption-based) carbon tax regime. Among the reasons for this were: i) that the burden of CO<sub>2</sub> affects all Canadians more or less equally; ii) the provinces cannot prevent “carbon leakage” because they cannot levy tariffs inter-provincially or internationally on products produced under less stringent carbon-pricing regimes whereas Ottawa can; and iii) while some of the revenues should be devoted to R&D related to developing low-carbon technologies and processes, the rest of the revenues collected could (and for reasons elaborated in the next section, should) be distributed to the provinces on an equal per capita basis. Allan and I also recommended that Ottawa should treat carbon taxation as it relates to international trade along the lines of the GST or value-added taxation, namely apply the carbon taxes to imports and provide carbon-tax rebates on exports.

Under such a scheme, carbon taxation would be export-import neutral, would stimulate low-carbon technologies, and would allocate the very substantial carbon-abatement revenues equally in per capita terms across provinces, thereby serving to ameliorate not only the existing interprovincial fiscal capacity differentials but as well addressing the looming imbalance in the division of money and power between Ottawa and the provinces. Addressing this federal-provincial imbalance is the role of the final substantive section of the paper.

#### **IV: FEDERAL-PROVINCIAL SURPLUS RECYCLING: THE DIVISION OF MONEY AND POWER<sup>17</sup>**

As indicated above, the theme of what follows is that the existing distribution of money and power in the federation is increasingly untenable. In terms of the phraseology employed in this essay, the federal-provincial surplus-recycling mechanism is failing and needs rethinking and reworking.

The anatomy of this failure is three-fold. First, and most important, the pressures from population aging (including medicare, pharmaceutical, hospital and eldercare expenditures) and welfare payments among other areas on the one hand and the influential political constituencies associated with these areas (especially with health and aging) on the other are such that the provinces will be forced to draw funding away from areas such as primary, secondary and tertiary education. Phrased differently, the pressures on provincial dollars will be to direct them toward financing *consumption-oriented activities at the expense of financing investment-enhancing activities*.

This is a disastrous economic strategy in an increasingly human capital and information era.

Second, Ottawa is in the enviable position of having the most robust fiscal position of the G8 countries and, as will be clear, its expenditure responsibilities are much more amenable to control than are the provincial expenditure responsibilities.

Third, federal piece-meal (perhaps peace-meal is more appropriate) measures directed to the provinces are likely to complicate the implementation of preferable longer-term strategies.

In more detail, the underlying issue is related to *open-ended or demand-driven programs*. All of the expenditures associated with an aging population are not only demand-driven but they are sure to absorb resource increases well in excess of the rate of overall GDP growth. To be sure, the revenue rich (i.e., resource-rich) provinces may be able to handle this challenge, but they will likely do so in ways that create additional problems for the poorer provinces, for example by raising wages and/or enhancing coverage that will in turn put similar pressures on the other provinces and/or attract their health-care professionals.

To be sure, Ottawa also has some demand-driven and, in principle at least, open-ended programs. One is OAS (Old Age Security). However, not only is OAS income tested but Ottawa has recently increased the retirement age for accessing to OAS to 67. EI is also potentially open ended. But EI is financed by premiums that are adjusted to even out deficits and surpluses. In the current time frame the EI system is running a considerable and is a key factor contributing to Ottawa's goal of

returning to a budgetary balance by 2015-16. When the formula-driven equalization entitlements began to expand rapidly Ottawa reacted by limiting equalization increases to the rate of growth of GDP. Moreover, having lived through Paul Martin's generous 6% escalation in the Canada Health Transfer (CHT) over the 2004-05 to 2013-14 period, Ottawa is replacing the 6% growth rate with a three-year average of nominal income growth subject a minimum 3% growth over the 2014-15 to 2023-24 decade. Earlier, when the CPP had large unfunded liabilities, Prime Minister Martin raised the contribution rate from 5.6% to 9.9%. (The QPP followed suit.)

In other words, Ottawa has been able, in varying degrees, to "close" the open-ended nature of many of its transfer and expenditure programs. While readers may view these measures as most welcome, the relevant message here is that the provinces do not have this degree of flexibility open to them on the expenditure side.

On the revenue front, since the dawning of the millennium federal tax decreases have been the order of the day. During the ongoing James Flaherty reign as Finance Minister the GST has been cut by 2 percentage points, pension splitting for the elderly has been implemented, personal and corporate taxes have been reduced significantly, and so on. Admittedly, Ottawa will be running a deficit, but surpluses are just around the corner, although the stimulus-cum-recession run-up in the national debt will take longer to return to the pre-recession debt-to-GDP ratio.

This juxtaposition of the provinces wrestling with rapidly expanding open-ended programs on the one hand and of Ottawa not only strategically decreasing the demands on its resources from potentially open-ended programs but as well reducing the GST and corporate tax rates on the other hand is ample evidence of the failure of the federal-provincial surplus-recycling mechanism. In the words of the subtitle the time has come to rethink the division of money and power in the federation.

The two polar solutions are clear: i) Ottawa transfers more money to the provinces and/or ii) the provinces transfer more powers to Ottawa. They are dealt with in turn. However, there is an obvious further option, namely having the

beneficiaries of the provincial programs play a role in the funding of social spending. The rapid rise in tuition fees for post-secondary education is a case in point. As already noted, this works against Canada's longer economic prospects. Much preferable would be a tax on consumption rather than investment. Accordingly, the essay will conclude with a proposal for a version of user fees/co-payments for medical services.

#### *IV:A. Transferring Money/Taxes Downward*

Ottawa would presumably view the reduction in the GST from 7% to 5% as akin to a tax transfer to the provinces (albeit with no requirement that the provinces actually incorporate the two percentage points in their own sales tax regimes). However, I would argue that a better approach would have been to maintain the GST intact, but then to devolve the proceeds of the two GST percentage points to the provinces on a revenue-tested basis (as outlined above). This would not only begin to redress the faltering federal-provincial surplus-recycling mechanism but it would also and relatedly ensure that overall fiscal capacity levels across provinces would become more equitable. Readers will recognize that this as a small-scale version of the Australian Commonwealth Grants Commission's approach to equalization.

Under the assumption that the economy recovers and Ottawa is again running surpluses, the pressures for rethinking the allocation of revenues will heighten, for reasons noted above. Transferring the proceeds of, say, a further one percentage point of the GST to the provinces along the lines outlined in the previous paragraph would merit consideration.

#### *IV:B. Transferring Powers Upward*

##### 1. Pharmacare

The other approach to recycling the impending relative, and likely absolute, federal surpluses is for the provinces to pass some of their open-ended expenditure responsibilities upward to Ottawa. This is hardly a far-fetched alternative, since the provinces in their 2004 inaugural meeting of the Council of the Federation voted

unanimously to transfer the responsibility for pharmacare to Ottawa. An integral component of the proposal was that Quebec would maintain its control over pharmacare replete with equivalent federal compensation. By way of an aside, one might note that this corresponds exactly with the essence of s.94 of the constitution which allows the common law provinces (i.e., all but Quebec) to transfer aspects of “property and civil rights” (which would include pharmacare) to Ottawa. In the event, Ottawa declined to accept the responsibility, among other reasons one presumes because the federal government had no intention of being saddled with an expanding and open-ended expenditure – that’s the provinces’ role!

However, if the offer is still on the table, Ottawa might well reconsider. To be sure, there would need to be some agreement on the details of how to allocate responsibility for in-hospital drugs (which could remain with the provinces) and out-of-hospital drugs (which obviously would be Ottawa’s responsibility). On the positive side, Ottawa holds the constitutional power over drug patents and generics so that a transfer of responsibility would mean that the federal government would now have to live with its own decisions on patents/generics. Beyond this, Ottawa may have the capacity to mount some version of a national pharmacare plan, an initiative that would extend our public health coverage in the direction of European systems.

Two other areas merit consideration for an upward transfer of powers. The first is the income-support component of provincial welfare and the second is an income-contingent repayment system for financing post-secondary education. These are dealt with in turn.

## 2. A Guaranteed Annual Income (GAI)

Canadian workers are migrating more frequently to where the jobs are. When they become unemployed in their new employment areas, they often return to their home provinces. For illustrative purposes only, assume that Alberta is one’s province for work and, say, New Brunswick is his/her province for welfare: Alberta gets the taxes from work and New Brunswick bears the welfare costs. This seems to be an inappropriate distribution of costs and benefits of economic adjustment.



Increasingly, events well beyond the control of the provinces are determining their economic fortunes, so that bearing the costs of adjustment should not be the sole responsibility of the provinces.

Elsewhere (*Policy Options*, September, 2009) John Allan and I recommended that Ottawa take over aspects the responsibility of the income-support component of welfare (but not the welfare services components). The context for this recommendation is that we now have a GAI (guaranteed annual income) for seniors, namely OAS/GIS, and an effective income support program for children in the form of the Canada Child Tax Benefit (again income-tested). Both of these are federally funded. All that is missing is some version of an income-tested GAI for adults. Allan and I address this issue in the context of a needed reform of the EI program. Hence one part of the funding could come from EI savings arising from making the entry and benefit structure identical across the country and moving both in the direction of insurance principles, i.e., ensuring that the short-term labour force attachment does not lead to long-term EI benefits. The second funding tranche would come from converting the personal credits under the personal income tax into refundable tax credits. A final tranche, if needed, would come from Ottawa's consolidated revenue fund. If the Canada Social Transfer is not devoted to the revenue-testing exercise elaborated under section III:C.4 then it could be assigned to the funding of the GAI.

A powerful and persuasive recent argument for a GAI (entitled *Scrapping Welfare: The Case for Guaranteeing all Canadians an Income Above the Poverty Line*) comes from the pen of Senator Hugh Segal (2012). Drawing on research by University of Manitoba's Evelyn Forget (2012) based on the MINCOME experiment in Manitoba (a version of a GAI) Segal notes (page 9):

[Evelyn Forget] found that while MINCOME was administered, hospital visits including work-related injuries, domestic abuse and mental health visits dropped by about 8.5%. By her calculations, an 8.5% drop in hospital visits alone would save taxpayers \$4 billion annually. If this were extrapolated to all healthcare spending (\$200 billion), the savings could amount to over \$17 billion. As well, Forget found that teenagers stayed in school and education enrolment

surged. Young people no longer dropped out in order to contribute to the family finances.

Senator Segal concludes his article as follows (p.10):

In a mixed free market Canadian economy where enterprise, risk, diligence and hard work matter, equality of opportunity is essential if fairness about access to the economic mainstream is to be real for all. A guaranteed annual income would be a serious pillar of that opportunity, as important to us as universal education, safe communities and health insurance.

A GAI, or a NIT (negative income tax), has a long analytical history on this side of the Atlantic, reaching back to Milton Friedman's 1962 proposal for a NIT (see Friedman (2002)). In terms of the academic policy agenda a GAI/NIT has risen and then fallen back several times over the post-war period. However, except for the time frame of the Minister of National Health and Welfare Marc Lalonde's 1973 *Working Paper on Social Security in Canada* it has not attracted Ottawa's policy attention. Perhaps this will also be the case in the present time frame. However, the constellation of increasing individual income inequality, increasing inter-provincial revenue inequality, and an increasing recognition that an acceptable minimum standard of living ought to be inherent in Canadian citizenship may well pave the way for a larger federal role in income support, if not for embracing some version of a GSI/NIT. Since this could be delivered via the personal income tax system, there would be no constitutional barrier to such an initiative, whatever other policy or political barriers there may be.

### 3. Income Contingent Repayment Systems for Financing Post-Secondary Education

A final, but hardly exhaustive, candidate for uploading to Ottawa is the financing of post-secondary education, and in particular a federal income-contingent-repayment system for financing students' post-secondary education. Not only is human capital an increasingly important aspect of capital deepening in the information era but post-secondary education is one of the major provincial expenditure areas that is getting squeezed by the above-noted, open-ended and influential-political-constituency programs. Moreover, an Ottawa-driven loan

program would enhance cross-province student mobility in terms of selecting a post-secondary institution. There are models in other countries that could help in the design of such a system. The essential component of such a system is the loan repayments in any period will relate to the student's earnings. Beyond this, some versions only require the repayment of actual loans and not the associated interest or, alternatively, embrace below-market rates of interest. Others have a maximum contribution length after which any remaining loan is forgiven.

An interesting issue here is that an income-contingent repayment system often tends to be viewed as a social policy measure when, progressively, it needs to be viewed as an investment measure. Indeed, in an investment context, one ought to be incorporating depreciation of the post-secondary expenditure in any such scheme, putting it on much the same footing as investments in other sectors. More generally, society is far behind in terms of recognizing that human capital investment is as important as physical capital investment in driving our economic future and, relatedly, that the discourse associated with the former has to shift from a social-policy/subsidy rhetoric to an economic-policy/investment rhetoric.

#### *IV:C. Toward a Modest Privatization of the Funding for Health Care*

Addressing the approaching inadequacy of the federal-provincial recycling mechanism in terms of one or more of the above options is an essential element in coming to grips with the interrelated challenges of aging and health care. However, the beneficiaries of health care should shoulder some of the costs. The range of alternatives approaches is quite familiar – private insurance, parallel medicare systems, co-payments, medicare saving accounts, etc. My long-standing favourite is a *delayed* user fee that would be reconciled via the personal income tax system, and not at the point of treatment. Such an approach would embody both an incentive to remain healthy and the ability-to-pay principle. Drawing largely from an Ontario Economic Council position paper (1976), I summarized the proposal as follows (Courchene, 1987):

... it would be quite feasible, with some adjustments to our current administrative and information system, to establish a given family's

use of the health care system, as well as a dollar measure of the benefits received. These benefits, subject to a possible exemption and catastrophic limits, could be subjected to a form of income taxation. The whole process would be integrated with the income tax returns process in a manner such that the following conditions held:

- a) taxation and hence financing of health care would be related to the use and benefits received;
- b) the poor would avoid paying because taxation can be geared to income, exemptions and other ability-to-pay criteria;
- c) ceilings would exist on the amount of taxation, thus building a catastrophic insurance feature onto the system;
- d) averaging provisions would exist to permit a smoothing out of tax payments; and so on.

Of course, whether such a system is desirable must be judged in terms of a number of factors including ease and cost of administration and how well it permits the achievement of the social and economic objectives of [provincial] health policies.

A similar version could be applied to pharmaceutical expenditures, especially since in varying degrees such schemes currently exist for the elderly.

As noted earlier, provinces seem to be comfortable with saddling post-secondary students with high tuition fees but they shy away from levying fees relating to the consumption of health services. One can defend this approach on grounds that students are increasing their future incomes and, therefore, ought to bear some of the costs of their education. If so, however, they should then have access to an income-contingent repayment system that taxes them on these higher future incomes, should they exist. In any event, the incentives in the current system favour consumption of health service at the expense of increasing human capital. The larger point here is that some version of privatizing the costs of health care should be part of addressing the federal-provincial surplus recycling mechanism.

#### *IV: D. Recent Ottawa Initiatives:*

It would be remiss not to note that Ottawa has been moving in directions that speak to the issues raised in this section. One aspect of this has been its focus on infrastructure spending. It is as if infrastructure has become *de facto* a shared constitutional responsibility. This is good news for the revenue-strapped provinces as well as for the economy since infrastructure expenditure obviously qualifies as

capital deepening and, therefore, productivity enhancing. Even more in line with the above analysis is Ottawa's assuming a much greater role in labour-force training. The major thrust here is the introduction of the Canada Job Grant in the 2013 budget. Training is one of those areas that while nominally under provincial jurisdiction is clearly on the national interest in an information age. Hence, Ottawa should be a player.

#### *IV:E. Summary*

The underlying message in this section is that the provinces are facing progressively insatiable demands for greater spending in those areas that are not only demand-driven but as well have powerful political constituencies – medical practitioners, hospitals, and pharmacare among others. While those delivering the health services typically embody high-level human capital and embrace state-of-the-art technology, the reality is that the services themselves tend to be consumption-oriented. Under the pressures of an aging population these expenditures will be, and already are, crowding out provincial spending in areas that are investment-related such as human-capital development and research areas essential for success in the information era.

One way to rephrase this issue is to recognize that in the information area some areas that fall under *provincial jurisdiction* are now in the *national interest*. This being the case, Ottawa needs to be ready to upload aspects of these provincial-jurisdiction/national-interest areas and/or to work with the provinces to ensure that our economic future is not placed in jeopardy because the provinces have ended up with a larger share of overall federal-provincial expenditures in relation to their share of overall revenues. Intriguingly, this need not be a recipe for a division-of-powers tug of war because i) the provinces themselves may be desirous of uploading the program at issue (e.g., pharmacare) or ii) the area in question can be delivered via instruments under existing federal jurisdiction (e.g., a GAI or a devolution the GST percentage points to the provinces). In other areas, however, a pan-provincial proposal may be required, as is likely to be the case with a federal

income-contingent-repayment initiative for financing students' post-secondary studies.

## **V: CONCLUSION**

The conclusion of this essay is as straightforward as it is important. If effective surplus-recycling systems are essential to the stability and resilience of macro-economic systems (including federations), as I believe they are, then the reality that Canada's three major surplus-recycling systems are far from effective ought to be of major concern alike to our political leaders and to the Canadian policy community. In this regard, the role of the above analysis was to present and to assess a range of options for rethinking and reworking each of the three recycling mechanisms. In turn, the motivation for this exercise is that ensuring the adequacy of these surplus-recycling mechanisms ought to be of primary interest to our First Ministers as they rework the fiscal arrangements for the 2014-15 to 2023-24 decade.

## ENDNOTES

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<sup>1</sup> While Newfoundland now longer qualified for offsets under its offshore accord after fiscal year 2011-12, Nova Scotia continues to qualify, as Table 1 reveals.

<sup>2</sup> In the early years of equalization Alberta qualified for equalization and in the mid-1980s the province also qualified for several hundred million dollars of “stabilization payments.” No longer existing, these payments were designed to ensure that a province’s revenues (at unchanged tax rates) would not decline from one year to the next.

<sup>3</sup> While Ottawa has thus far not acted on this concern, as partial protection it did agree to introduce a TTP (Total Transfer Protection) program that ensures that a province’s current level of total transfers (CHT/CST, equalization and the prior year’s TTP) are no lower than those in the prior year. The moneys associated with TTP are not factored into the tables in this paper.

<sup>4</sup> The equalization payments in Table 1, when converted to a per capita basis, differ somewhat from those in Table 2. Although they are both official estimates they were produced at different dates and with slightly different data availability.

<sup>5</sup> And for Nova Scotia and Quebec another equalization provision is in play, namely that no recipient province can end up with overall per capita revenues (i.e., equalization-defined fiscal capacity plus the other 50% of resource revenues plus equalization plus the offshore-accord monies) that is larger than the per capita revenues of the lowest non-equalization-receiving province. Their equalization entitlements were scaled back on this account.

<sup>6</sup> The sum of the 50% of resource royalties is \$11,281.5 million. Hence total resource royalties associated with the 2012-13 equalization calculations are \$22,563 million.

<sup>7</sup> Actually, Alberta will only receive the same per capita amount of these federal-provincial transfers as the other provinces beginning in 2014-15, but this is ignored for purposes of this table. A revenue-testing approach to these transfers will be developed later in this paper.

<sup>8</sup> In order that provinces not be able to influence their own equalization, the choice for the measure of wages and salaries relates not to public sector wages but rather to the index of average industrial earnings in the relevant province.

<sup>9</sup> Note that Gusen does not undertake this sort of exercise. Rather, he uses these price/cost data as part of the calculation of what he calls “expenditure needs”. Indeed, he does not even present data on the overall index that appears in row 2 of

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Table 3, although he does provide the data necessary for one to calculate the index, which I have done. More on Gusen's expenditure-needs approach in the next section.

<sup>10</sup> Ontario's share would be even larger absolutely and relatively if the row 5 exercise allocated equalization to achieve *real* per capita equality across the six recipient provinces. Rather, the corresponding deficiencies were filled with nominal dollars, not province-specific real dollars.

<sup>11</sup> Note that this is not to say that Ottawa does not benefit revenue-wise from the energy sector. It obviously does: on a per capita basis Alberta is the leading contributor to Ottawa's finances and in addition energy is clearly a major driver of economic activity beyond the borders of royalty-receiving provinces. Moreover, the CIT and other revenues arising from the energy sector fall in the earlier category – they are shared with Ottawa so that the resulting increase in equalization arising from, say, the energy related CIT is financed from the corporate profits in the resource provinces. The point at issue here is that royalties are in a class by themselves. Indeed, around the time of the advent of the 1982 Fiscal Arrangements negotiations there emerged a literature arguing that the value of royalties that were spent on the production of provincial goods and services should be treated as an imputed benefit to residents for purposes of income taxation. The argument then was that this category of provincial public goods is the only type produced with monies that had escaped taxation. Note that this would also apply to royalties from hydro-electric power. This issue will not be pursued further in this paper, although it will likely emerge again in the literature if royalties become increasingly important.

<sup>12</sup> CERI estimates are sourced from the Government of Alberta web entry: <http://oilsands.alberta.ca/economicinvestment.html>

<sup>13</sup> A more comprehensive approach to the surplus-recycling challenge to an energy industrial strategy would embrace the demands of the First Nations.

<sup>14</sup> As noted in the introduction to this paper, the US manufacturing has also been harmed by something akin to the Dutch Disease. The trigger for offshoring to China was the desire to take advantage of the cheap but efficient Chinese labour force. However, because the Chinese sterilized the inflow of dollars the US dollar remained overvalued relative to the yuan and the downward manufacturing spiral continued. The recent shift toward “re-shoring” back to the US owes more to the dramatic rise in Chinese wages than to any appreciation of the yuan.

<sup>15</sup> Recently, however, Erwin Diewert and Emily Yu (2012) have challenged the status quo in this regard, arguing that Statistics Canada has been consistently underestimating our productivity growth. This possibility is not incorporated into the analysis that follows.



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<sup>16</sup> Now that the US is moving in the direction of becoming an energy superpower, the Canada-US exchange rate may not be subject to the degree of volatility in response to changes in global energy prices that has characterized the recent past.

<sup>17</sup> A recent Mowat Centre paper by Jean-François Tremblay (2012) addresses some of the same issues and offers some of the same solutions (often in more detail) as those dealt with in this section.

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