

**Balancing Affordability with Principles:**  
*Policy alternatives to the cap on Canada's*  
*Equalization program*

by

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Policy alternatives to the cap on Canada's Equalization  
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## **Abstract**

The GDP cap placed on Canada's Equalization program in 2009 ties the program's size to economic growth. This limits Equalization's ability to address disparities in fiscal capacities among the provinces. This paper relies on the literature, key-informant interviews, and data analysis to propose options aimed at balancing the program's affordability with its principles. It is recommended that the Fluctuating Cap option be adopted. This option allows the federal government to stay within its budget for the program while still allowing the program to fluctuate in size as needed to realize its objectives. As well, it is also recommended that the resource revenue inclusion rate increase to 70%, that the fiscal capacity cap is eliminated, and that hydroelectric rent is included in the RTS.

**Keywords:** Equalization, Canada's Equalization program, Canadian federal-provincial fiscal transfers, GDP cap

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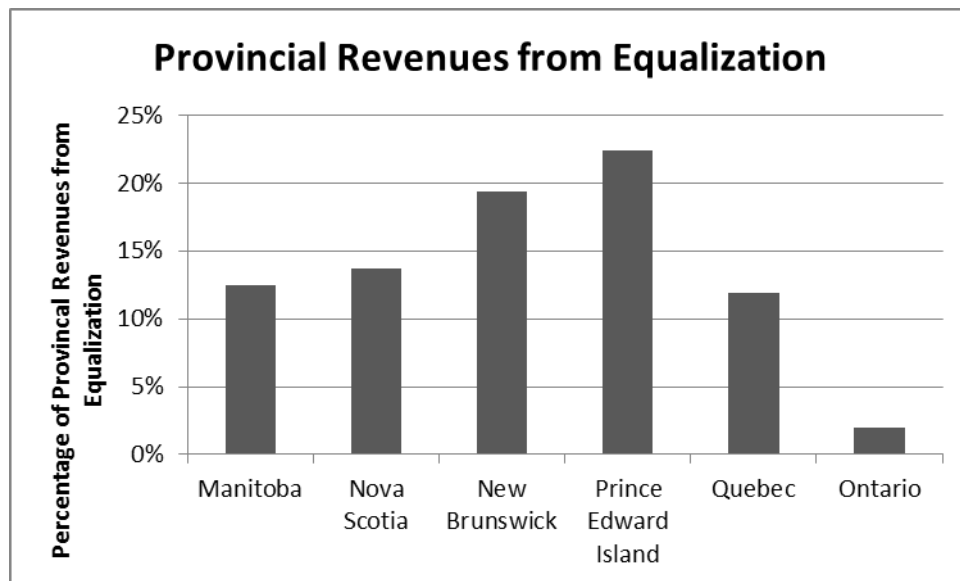
RTS          Representative tax system

# 1. Introduction

Canada's Equalization program has long been considered the backbone of Canadian federalism. Since its inception in 1957 it has supplemented the budgets of receiving provinces to create a national uniformity in the quality of services provided by provincial governments. So important is its function to the country's fabric, it was enshrined in the Canadian Constitution in 1982. This put into law the Government of Canada's commitment to the program:

*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." (Subsection 36(2) of the Constitution Act, 1982)*

Entrenched in this passage is the basic principle of Equalization: no matter in what province a Canadian resides, he or she will have the opportunity to access the same quality of education, healthcare, and other core government services. In essence Equalization provides uniformity to the quality of life enjoyed by Canadians regardless of region. Underlining this main feature of the program is a formula designed to ensure that each province is capable of delivering services of comparable quality while maintaining comparable tax policies. The means of achieving this purpose have been left to negotiations between Ottawa and the provinces at regular intervals. This leaves flexibility for the program to adapt to shifting realities, changing provincial fortunes, and criticism of the prevailing equalization formula. Since the program's start it has been the convention that the details agreed upon by Ottawa and the provinces are renegotiated every five years. Through this evolutionary process we have arrived at the system that currently governs which provinces receive payments and their size. Figure 1 shows the varying impact that Equalization payments have on provincial budgets.



**Figure 1 Share of provincial revenue from equalization, Equalization-receiving provinces, 2011-12 budget**

## 1.1. How the Program Works

The current program allocates payments to provinces based on their fiscal capacities. This is done by defining a representative tax system (RTS). The current RTS uses five tax bases (personal income tax, corporate income tax, sales tax, property tax, and natural resource revenues) to calculate an average per-capita national standard fiscal capacity across all provinces. At present, the RTS applies the average provincial tax rate from each of five tax bases to the national sum of each base. Summing the potential tax revenues and adjusting the results to a per-capita level yields the national standard. Repeating this procedure for each province (multiplying each national average tax rate by each province's corresponding tax base, summing the results, and adjusting to the per-capita level) identifies each province's fiscal capacity. The provinces with a fiscal capacity below the national average qualify for equalization. The difference

between the national standard and the fiscal capacity of a qualifying province is referred to as that province's entitlement. Prior to 2009, payments received by provinces were equal to their entitlement.<sup>1</sup> Under this system (where payments equal entitlements) the program's overall size (the sum of all payments) fluctuates freely from year to year based on the extent of divergences in provincial fiscal capacities; the greater the divergences, the larger the program. Likewise, when fiscal capacities converge, the size of the program gets smaller.

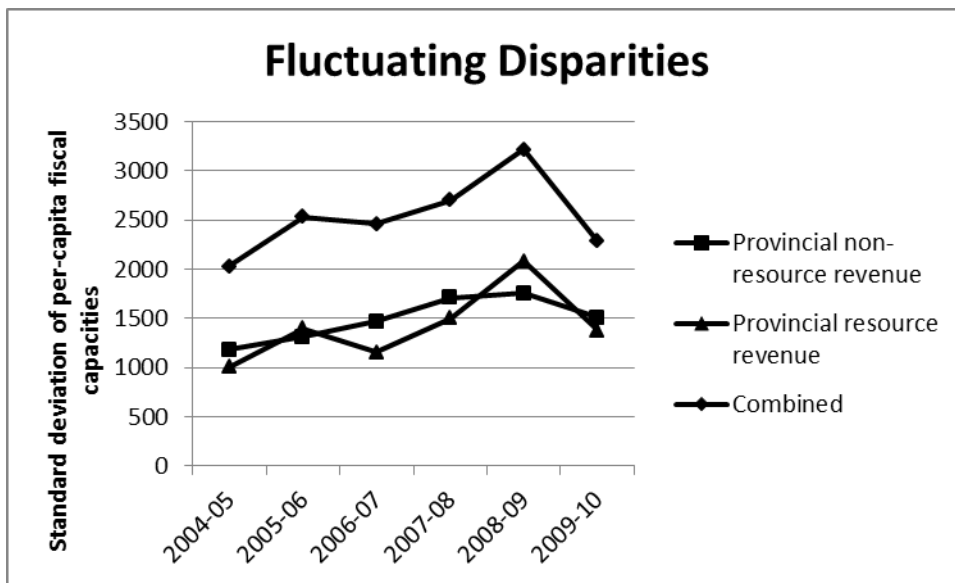
Following the 2009 Federal Budget a GDP cap was placed on the overall size of the program. The GDP cap limited the growth rate of the program (sum of all payments) to the growth rate of the national economy. When the GDP cap is binding (when the increase in total entitlements exceeds the allowable size of the program), provincial payments are scaled back by an equal per-capita amount such that total payments fall into the limits of the program's size. The GDP cap also acts as a cost floor. In the event that the cap is not binding, it stipulates that the sum of payments must grow at the rate of the economy.

## **1.2. Problems Posed by the Cap**

The introduction of a cap on Equalization has transformed the program from an open-ended grant system that fluctuates freely with provincial fortunes to a close-ended system which is bounded by a policy regulation. There is concern that the cap represents a violation of the program's principles and jeopardizes the ability of Equalization to fulfill its mandates. With the cap in place, receiving provinces are not guaranteed payments that will bring their fiscal capacities up to the national standard. This introduces the risk that receiving provinces may not be able to afford the same level of services as the non-receiving provinces.

<sup>1</sup> This was true up to point that an Equalization payment did not put a receiving province's fiscal capacity above that of any non-receiving province.

In fiscal year 2009-10 Ontario joined the list of receiving provinces. Due to its large population, even small per-capita shortfalls in Ontario's fiscal capacity from the national standard result in payments that dwarf those of most other provinces. Based on the size of Ontario's payments it is no coincidence that the introduction of the cap coincided with Ontario's addition to the list of receiving provinces. In the absence of any measures to restrict size of the program, Ontario's inclusion would contribute to its rapid expansion. From the perspective of Finance Canada, this would place pressure on the federal budget. However, from the perspective of the program's purpose, capping the size of all payments is a contradiction. The program is supposed to contribute to the offsetting of divergences in the fiscal capacities of the provinces. As the divergence increases, the program should expand and as the fiscal capacities converge, the program should contract. Figure 2 shows how the divergences in provincial fiscal capacities fluctuate from year to year.



**Figure 2 Divergences in fiscal capacities: standard deviation of per-capita provincial fiscal capacities for all provinces**

The cap restricts this flexibility and threatens to increase gaps in the level of services provided by receiving provinces in relation to the national standard. Further violating the principles of the program is the addition of a provision that aims to counterbalance the effects of the GDP cap. To ensure the cap does not subtract from



payments received in previous years, the Canadian Government has committed to making protection payments to prevent total federal transfers to a receiving province (the sum of Equalization payments, the Canadian Health Transfer, the Canadian Social Transfer, and transfers relating to the Offshore Accords) from falling year to year. These are temporary payments that have been announced every year since the introduction of the GDP cap. With both a payment ceiling (the GDP cap) and a payment floor (the protection payments) in place, there is little room for payments to adjust to changing circumstances. The addition of these patchwork policies distances the current system from the program's purpose. Since provinces are now locked into a virtually fixed payment scheme, the national standard has become irrelevant in the program's implementation. This has elevated the issue of the GDP cap from a purely efficiency question to one that calls into question the legitimacy of the Equalization program.

### **1.3. The Aim: Balancing Principles with Affordability**

The goal of this analysis is to assess policies that would restore a more principled-based approach to Equalization. This is needed to ensure that future divergences in fiscal capacities among the provinces do not result in divergences in the level of services provided to Canadians. As well, it will aim to restore legitimacy to the program by realigning the payments received by provinces with their entitlements as defined by the national standard. In order to maintain relevance with the current debate surrounding the GDP cap, any recommendations made will take into full consideration the need for the program to be financially sustainable as well as predictable and stable. All options considered will be weighed based on their political feasibility, cost, efficiency, principles, and the incentive structure they give to provinces to develop their natural resources.

### **1.4. Policy Options and Recommendation**

Based on the discussion of the problem posed by the cap, the policy options considered in this study are briefly described below. Detailed analysis of these options and the recommendation are found in chapters 7 and 8.

### ***1.4.1. Eliminate the cap and base the national standard on the median as opposed to the mean***

This approach reflects an attempt to balance the elimination of the cap with efforts to reduce the size of the program. Using the median as the base of the national standard as opposed to the mean limits the effect that outlier provinces have on the national standard. Under this approach receiving provinces are equalized to the full value of their entitlements. However, their entitlements are based on a national standard that is reflective of a median capacity and not a mean average of capacities. Under present conditions this will reduce the size of the program but restore its principles.

### ***1.4.2. Equalize Hydro Rents***

This option seeks to reduce the overall costs of the program below the level of the GDP cap. In doing so, this provides room for the program to operate on a principles-based formula not subject to a binding cap. The reduction in costs is obtained by accounting for the benefits of hydroelectric generation in provincial fiscal capacities. Equalization receiving provinces with significant hydroelectric capacity receive smaller payments under this option, which reduces overall program costs.

### ***1.4.3. Fluctuating Cap***

This option adopts a cap that is tied to the standard deviation of provincial fiscal capacities. This allows program funding to grow and contract with the divergence of provincial fiscal capacities.

### ***1.4.4. Increase Inclusion of Natural Resource Revenues and Eliminate the Fiscal Capacity Cap***

This option explores the impact of reconfiguring the Equalization formula to account for 100% and 70% of a province's natural resource revenues, as opposed to 50% at present. The treatment of natural resource revenues is a heavily debated subject surrounding Equalization. This option acknowledges this debate and assesses the virtues as well as consequences of readjusting the formula in this context. Two

scenarios are examined regarding this option. The first is under an uncapped configuration of the program and the second is under a capped configuration. In addition, the impact of the fiscal capacity cap is analysed under each scenario.

#### ***1.4.5. Maintain the Status Quo***

This option would see no change to the current Equalization program. Entitlements would be calculated using the current formula and actual payments would be scaled back to meet the limits of the cap.

### **1.5. Recommendation**

Based on the following analysis of the Equalization program and the options mentioned above, it is recommended that the next Equalization agreement see the program consider the Fluctuating Cap option. . This option allows the federal government to stay within its budget for the program while still allowing the program to fluctuate in size as needed to realize its objectives. As well, it is also recommended that the resource revenue inclusion rate increase to 70%, that the fiscal capacity cap is eliminated, and that hydroelectric rent is included in the RTS.

## **2. Methodology**

The following study draws on three sources to develop, analyze, and evaluate alternatives to the cap currently applied to the Equalization formula. The three sources are literature, expert interviews, and data.

The literature review was conducted to gain a better knowledge of the program's details, history, and current issues. The literature consulted was identified by searching academic journals and databases. As well, the Expert Panel on Equalization and Territorial Financing published a report in 2006 with a comprehensive bibliography that was also used to identify literature (Expert Panel, 2006). The 2006 report is considered to be the most complete independent review of Equalization conducted in the program's recent history and has helped frame many of the current debates associated with the program.

After consulting the literature, interviews were conducted to better gauge the program's logistics, dynamics, and political influences. The individuals interviewed, former and current finance officials as well as academics, all have experience and expert knowledge regarding Equalization. Those interviewed were selected based on the researcher's personal connections and the literature. Appendix A lists the details of those interviewed. Since several interviewees continue to hold government or research positions, they asked not to be named. For this reason as well as consistency, no names are used in reporting the findings from the interviews. Instead references to individuals are limited to their experience or role with the program.

Interview participants were contacted via e-mail and provided with a brief description of the research. This was included along with a letter of consent outlining the considerations required by the researcher's ethics application. Verbal consent to this document was obtained at the beginning of each interview.

The interviews followed a semi-structured format. The researcher had a list of questions but the order they were asked varied depending on the flow of the conversation. Interviews began by asking the interviewees to identify the role of Equalization in Canada from their perspective. They were then asked to identify any challenges facing the program either in the near or long-term. Depending on the interviewee's experience with the program, the subsequent questions dealt with specific areas of interest to the researcher. The conversation was then directed towards the affordability vs. principles trade-off and the interviewees' conclusion how best the program could achieve this balance. The options considered in this study were then put forth to gauge the interviewee's reaction.

The third component of the methodology used in this study is data. To produce the tables and figures in this report national and provincial data are used. Provincial data were retrieved from provincial 2011-2012 budgets and national economic growth data from Statistics Canada. To evaluate the impact specific policy options would have on the Equalization program a dataset was requested from Finance Canada. This data set provides the inputs used by Finance Canada in the Equalization formula. Finance Canada uses provincial economic data to calculate the fiscal capacities of each province using the current RTS. Since the scope of this research is focused on the system of caps in the program's formula, the details of the RTS calculations are not a point of interest. Only the aggregate data from these calculations were used to evaluate policy options. The data provided by Finance Canada were broken down into two aggregates: 1) the aggregate fiscal capacity from sales, corporate, income, and property taxes, and 2) the aggregate revenues from natural resources for each province. Also included in the dataset was the population count used to calculate per-capita fiscal capacities. Finance Canada makes this dataset available upon request.

## **3. History**

No discourse on the future of Equalization can take place without first delving into its history. The program's current characteristics reflect a long narrative of evolving federal-provincial relations and changing economic fortunes. A comprehensive understanding of Equalization's origins, past challenges, and criticisms is essential for addressing its current issues. This chapter details the causes and consequences of major developments in the Equalization program. It provides insight into the current structure of the program.

### **3.1. Equalization's Origins**

Although federal lump sum transfers to the provinces have been the practice since Confederation, it is commonly agreed (Courchene 1984, Expert Panel 2006, Boadway and Flatters 1982, Burns 1977) that the foundations for the Equalization program derive from the 1937 Rowell-Sirois Royal Commission Report. The report, commissioned during the Great Depression, addressed how the Federal Government would respond to the risk of bankruptcies faced by the Prairie Provinces. The report proposed a framework for how future federal transfers to the provinces should take place. It has been suggested by Courchene (1984) and Burns (1977) that a new framework was needed to coordinate the tax collecting systems of the federal government and the provinces. The Great Depression amplified the difficulty of governments to raise needed revenues, resulting in provincial governments expanding their tax-collecting practices. This led to competing efforts between the provinces and the federal government and a system of inefficient and uncoordinated tax schemes (Courchene 1984, 22-23). To rectify this situation, the report recommended that the federal government be the sole collector of income and corporate tax. It also proposed the implementation of National Adjustment Grants for poor provinces to raise their fiscal capacity so they could provide services of average national quality. In the words of the

report, “the amount, if any, which each individual province should receive from the Dominion annually to enable it to provide normal Canadian services with no more than normal Canadian taxation” (quoted in Courchene 1984, 22). The essence of today’s Equalization program is found in this language and it bears striking resemblance to the language used, a half century later, in the Constitution. From the beginning the program’s foundations were based on equalizing the revenues a government was able to raise through taxation using rates that were comparable across provinces. This convention steered the program until these guidelines were made law in 1982. It can be argued that this system was the most appropriate: by the 1930s Ottawa had already established the mechanism to collect and distribute income taxes back to the provinces.<sup>2</sup> Instead of distributing back to the provinces their share of income taxes, some provinces would be ‘topped-up’ in order to put them in a fiscal position capable of providing services available in richer provinces.

### **3.2. The Birth of the Program: 1957**

Despite having its foundations laid out in the 1937 Rowell-Sirois Report, the inaugural year of the Equalization program was 1957. This marked the first application of a formula that resembles the one currently in use. It is widely held that the gap between the release of the Rowell-Sirois Report and the program’s first year is the result of the Second World War. During this period the federal government, which was financing the war effort, entered into various agreements with the provinces to “rent” their tax bases (Burns 1977,13). Each province was able to choose from list of compensation arrangements for relinquishing control of their taxation rights. These arrangements were based on a fixed level of per-capita compensation to each province. Therefore, the compensation allocated to each receiving province was roughly equal on a per-capita basis. It is important to note that this arrangement had an equalization

<sup>2</sup> To this day the Canadian Revenue Agency is the sole collector of both federal and provincial income taxes in Canada; another instance of an early convention surviving to this day.

scheme built into it since the per-capita payments were comparable across all provinces regardless of the amount of tax collected from each province.

The statement that Equalization started in 1957 does not imply the launch of an entirely new initiative. Instead, the agreement reached between Ottawa and the provinces in 1957 stood apart from previous agreements because it was the first time Ottawa recognized the right of provinces to collect their own income, corporate, and estate taxes. This realization coincided with the release of the Tremblay Report. The Tremblay Report supported the claim by the Quebec provincial government that it should have autonomy over direct taxation (Kwavnick 1973,vii-vii). Courchene (1984,91) notes that the findings of the Tremblay Report were interpreted to suggest that political autonomy of the provinces could not be achieved without fiscal autonomy. Provinces were given the choice to raise their own taxes or to continue renting their tax bases out to the federal government. If they decided to rent, they received 10% of the income tax collected, 9% of the corporate tax, and 50% of the estate tax. These compensation arrangements with the participating provinces (all provinces except Quebec) created large variances in the transfers to the provinces on a per-capita basis. To reconcile this, Ottawa supplemented all the transfers to the poor provinces to bring them in line with the average transfer size received by the two richest provinces: Ontario and British Columbia. Burns (1977,27) argues that Ottawa relinquished its exclusive rights to income, corporate, and estate taxes because of increasing pressure from the provinces to levy their own taxes. To avoid a situation where the provinces would levy taxes on top of federal ones, a portion of the collected revenues was distributed back to the provinces. Courchene goes on to suggest that, since these transfers varied from province to province based on the size of their tax base, this system was a departure from the equalized per-capita rents paid prior to 1957 (Courchene 1984,36). To provide the same level of equalization under the new system, Ottawa had to offer supplemental payments to the poorer provinces.

The new arrangement of 1957 also introduced another convention that has persisted in Equalization's history: the stabilization mechanism. This provision guaranteed that provinces would never receive payments less than 95% of the average payment over the two previous years. This helped provinces predict the size of their federal transfers.



### 3.3. The Program Prior to 1982

Following the establishment of Equalization in 1957, two key events took place that impacted the program. The first was the election of Diefenbaker's Conservative government; the second was the rising resource revenues associated with Alberta's oil wealth. The change of government in 1957 ushered in new autonomous powers to the provinces (Courchene 1984, 39). Ottawa handed over a large share of tax collection revenue and thus increased the size of federal-provincial transfers. The rise in Alberta's resource revenue (not equalized in the 1957 agreement) generated criticism from Ontario and British Columbia. They claimed Alberta was in a position to provide quality services without the need of supplementary payments. The increased size of transfers to provinces and the flagging support of the two richest provinces brought new changes to the program. No longer was the standard set at the average of the two richest provinces. Instead a national standard was introduced which took an average of all ten provinces. This reduced the size of the program by reducing the number of provinces receiving payments<sup>3</sup> and by lowering the level to which receiving provinces were equalized. Another change was the inclusion of 50% of natural resource revenues. This had the effect of excluding Alberta from qualifying for payments. Burns (1977) notes that these changes were only enacted after Ottawa's original proposal of freezing the size of equalization payments was rejected by both receiving and non-receiving provinces. A freeze in payments would have resulted in some provinces being over-equalized and some under-equalized.

Adhering to the convention of renegotiating the program every five years, the 1962 agreement should have remained intact until 1967. However, the 1963 election saw another change in government when Pearson's Liberals assumed power. The Liberals had run on a campaign promise to bring the program back to the two-province standard and to increase the share of taxes returned to the provinces. Both of these

<sup>3</sup> Under the previous scheme all provinces with the exception of Ontario received payments. Despite being one of the two richest provinces, British Columbia still received payments since its fiscal capacity would have fallen below the average of itself and Ontario.

changes were made following the election and serve as a reminder of the program's sensitive political history.

The agreement of 1967 marked another milestone. Instead of using a percentage of taxes collected to calculate fiscal capacity (and thus Equalization payments), the Department of Finance switched to a 'Representative Tax System' (RTS). Under this system, a province's fiscal capacity was determined based on how much revenue it would be able to collect from its tax bases if it applied the national tax average to those bases. The introduction of the RTS increased the number of tax bases under the Equalization arrangement from four (income, corporate, estate, and natural resource) to sixteen. The program also reinstated the ten-province national standard. Provinces receiving Equalization now had their transfers from Ottawa topped up using the ten-province standard and the new RTS formula.

This new system became necessary as the Federal Government looked to end the trend of conceding further tax shares to the provinces. Ottawa now allowed provinces desiring more revenues to raise their own taxes over and above the prevailing federal ones. The introduction of the RTS into the Equalization formula is another instance of the program's evolution as a result of shifting federal-provincial relations.

The 1972 and 1977 agreements were marked by further increases to the number of tax bases that fell under the RTS. This was the result of provinces expanding their taxation efforts. If provincial revenue from a new taxation initiative became sufficiently important, then eventually the RTS took it into account. The 1977 agreement counted 29 tax bases in its formula.

Agreements during this period also saw changes to the handling of natural resource revenues. In response to rising world oil prices, amendments were made to reduce their impact on the Equalization program. More detail will be shed on this subject in a subsequent section on the treatment of natural resource revenues.

### **3.4. 1982**

The period 1977-1982 saw policy makers in Ottawa struggle with the reality that, using the formula in place, Ontario would qualify for equalization payments (Parliamentary Task Force 1981, 37). To eliminate this eventuality, legislation was passed in 1981 that excluded any province with a personal income tax capacity exceeding the national average.

There followed another shift in definition of the national standard in the 1982 agreement. Following a failed attempt to set Ontario as the national standard (by definition it would not be eligible to receive equalization if it was the standard), policy makers settled on a five-province (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia) standard. This new standard isolated Equalization from the effects of Alberta's rising natural resource wealth and therefore prevented Ontario from falling into the list of receiving provinces. The Atlantic Provinces were removed from the standard as not to bring it down too low following Alberta's removal (Courchene 1984,61). The 1982 agreement saw the number of tax bases under the RTS increase to 33.

Perhaps the most important development associated with the 1982 agreement is the program's entrenchment in the Canadian Constitution. Again it is worth pointing out how similar the language in the Constitution is to the original language of the Rowell-Sirois Report. Courchene (1984) also notes that the 1982 agreement marked the first time extensive consultations and review of the program were carried out. It was the first time a Parliamentary Task Force produced a report on the program. It did so as part of a study on all federal-provincial transfers.

The Equalization program remained relatively unchanged between the years 1982 and 2004. There were no changes to the national five-province standard and the Representative Tax System (RTS) remained in place. However, outside of these parameters the program underwent changes regarding the addition of floors and ceilings to payments, and a series of accords with Nova Scotia and Newfoundland and Labrador. These amendments will be discussed further in the following sections.

### **3.4.1. Ceilings, Floors, and Transition Payments**

When the five-province standard was introduced, it lowered the bar to which all receiving provinces were equalized.<sup>4</sup> This resulted in lower equalization entitlements for receiving provinces. To compensate for this, Ottawa made transitional payments to ensure no province's payment fell below what it had been prior to the transition to the new standard. These transitional payments remained binding for the next three years. In effect they neutralized the short term negative impact from switching to a new standard. Due to their temporary nature, they were phased out after three years and provinces were then subject to the full impact of the new standard. Transitional payments bear a similarity to today's protection payments discussed in the introductory chapter. Protection payments are used to compensate provinces for the most recent changes to the program. Originally introduced as a temporary measure, protection payments continue to be paid.

A more permanent approach to restrict falling Equalization payments was the introduction of floor payments. These annual payments ensured no province's payment could fall by more than 1.6% of the per-capita standard each year. Marshall (2006,28) notes that in fiscal year 2000-01, the 1.6% floor provision translated into a protection of \$95 per-capita for receiving provinces.

Along with the introduction of floors, the 1982 agreement also saw the permanent use of a program ceiling. The ceiling provision stipulated that the total size of the Equalization program (the sum of all payments) could not grow at a rate faster than national GDP. Marshall (2006,28) weighs both sides of the ceiling policy. To Ottawa's benefit, its budget was now protected from large increases in the program's cost. To the detriment of receiving provinces, uneven regional growth in the country would have little or no effect on overall growth of the program. Uneven regional growth would result in an increased need for equalization, but the ceiling provision acted to restrict the ability of

<sup>4</sup> It technically could have raised the standard but due to the exclusion of Alberta's oil wealth it had a negative impact.

Equalization to meet this increased need. Marshall claims that, because of this, the ceiling provision limits the Equalization program's ability to "fulfill its constitutional purpose" (Marshall 2006, 35).

Courchene (1994) argues that there is a distributional problem posed by the ceiling's impact. In years when the ceiling is binding, the total amount of entitlements calculated by the formula is reduced by a given percentage to conform to the level of the ceiling. The reductions are then carried out on an equal per-capita basis across all receiving provinces. For example, if the ceiling requires that the sum of payments is reduced by 10% this is then translated into a per-capita reduction that is the same for each receiving province. If that reduction is \$50 per-capita it will have varying proportional consequences depending on the size of a province's per-capita entitlement.

Courchene ignores the fact that if provincial entitlements were reduced on a proportional basis then their fiscal capacities would not be brought up to the same standard. Only by reducing entitlements on a per-capita basis can all receiving provinces be brought to the same standard. Additionally, if a province is receiving a low per-capita entitlement then it is in a better position (compared to provinces with a high per-capita entitlement) to raise revenues through its tax bases. Reducing entitlements on a per-capita basis rather than a proportional one reflects this reality. For these reasons the Expert Panel (2006) recommends that if any reductions to entitlements must be made they should be made on a per-capita basis.

Both Marshall (2006) and Courchene (1994) treat the addition of floor and ceiling provisions to the program with scepticism. Marshall refers to them as 'patchwork policies' while Courchene refers to them as 'bells and whistles'.

### ***3.4.2. Offshore Accords with Nova Scotia and Newfoundland and Labrador***

While adopting the five-province standard and reinstating the 100% equalization of resource revenues solved the problem posed by Western Canada's resource wealth, it opened up a new problem in Atlantic Canada. During the 1980s Newfoundland and Labrador and Nova Scotia began to develop their own offshore oil and gas reserves. Using a formula equalizing 100% of resource revenues meant that for every new dollar

of government revenue made from oil and gas extraction a dollar was lost in Equalization payments (Boothe and Hermanutz 1999, 5).<sup>5</sup> Under these conditions, the incentives for Nova Scotia and Newfoundland and Labrador to develop their oil and gas sectors were weak. To reconcile this, the federal government signed agreements (accords) with each province that ensured temporary protection against claw backs in Equalization resulting from offshore revenues. The agreements took place outside of the Equalization program and involved annual payments to offset losses in Equalization. The fact that the accords were intended to provide temporary protection is a reflection of their need to foster development of provincial oil and gas sectors and not provide permanent protection thus undermining the Equalization program. However, in 2004, as part of a series of campaign promises, then Prime Minister, Paul Martin announced that new similar accords would be signed extending protection to 2012.

The Atlantic Accords have been criticized for undermining the principles of Equalization. Marshall (2006, 29-30) argues that since the accords signed in the 1980s were only meant to be temporary, their renewal in 2004 presents a serious controversy. The Expert Panel Report notes that no other province in the history of the program had enjoyed comparable 'side deals' and concludes that the Nova Scotia and Newfoundland and Labrador accords set a dangerous precedent. Like the additions of ceilings, floors, and transitional payments, the Atlantic Accords are another example of amendments taking place to the program outside of a principled formula. Marshall (2006) acknowledges that arguments can be made in favour of these amendments but the fact that they exist are symptoms of an ill-functioning formula. From this position it is argued that a formula is needed that does not rely on special amendments to cover specific policy gaps.

<sup>5</sup> Boothe and Hermanutz (1999) points out that this claw back was worse for the Atlantic Provinces (dollar for dollar) because they were excluded from the five-province standard. New revenues to provinces included in the standard also changed the tax base of the standard provinces and therefore a gain in a dollar of revenue clawed back less than a dollar in Equalization.

### 3.5. Fixed Pool Framework: 2004-2007

In 2004 the Equalization program switched to a fixed pool framework. This represented another milestone in the program's history since it marked the end of opened-ended transfers and the beginning of an era of closed-end grants (Smart 2005). Instead of the program's size being a function of the disparities among the fiscal capacities of provinces, it was fixed with a built-in guaranteed growth rate of 3.5% per annum. Fixing the funds available for Equalization also meant an abandonment of the formula for allocating payments among the provinces. Allocated shares of the fund for the seven receiving provinces (NS, NB, NL, PEI, MN, QB, SK) were fixed for the duration of the agreement. Smart (2005) points out that this fixed system threatened to undermine the key principles of equalization:

- To redistribute revenue-raising capacity (not personal income) from have to have not provinces;
- To do so in a way that does not undermine provincial governments' incentives to set their own tax rates in the best interests of provincial taxpayers; and
- To provide stabilization or "insurance" for short-run swings in provincial revenues.

The first principle is violated since the allocated shares of the fund no longer rely on the formula and the guaranteed growth of the fund results in some provinces receiving Equalization with fiscal capacities above those of non-receiving provinces.<sup>6</sup> The second principle is violated since the fixed system implies that the receiving provinces become their own standard for equalization. Under the fixed framework only those provinces listed as receiving provinces were included in the formula that determined the standard used. The influence of non-receiving provinces on the standard was removed. It is argued that receiving provinces may then adjust their tax policies to lure investments away from other provinces. While this may have been a concern prior to the 2004 reform, it became more pronounced under the Fixed

<sup>6</sup> This was the case with Newfoundland and Labrador's post-Equalization fiscal capacity (excluding payments from offshore agreements) exceeding that of Ontario's (Expert Panel 2006).

Framework because it removed a number of provinces from the formula's standard. The third principle is violated since a closed-ended system means that the payments received by provinces vary according to the fortunes of other receiving provinces. The Expert Panel Report (2006) points out that the fixed pool system provides stability for the federal government at the expense of the program's underlying principles.

The Expert Panel Report (2006) describes the Fixed Framework as a response by the federal government to pressure from the provinces to increase federal transfers to the provinces following a period of decline. Coupled with the cuts to provincial transfers in the 1990s, this decline was affecting the ability of some provinces to provide services such as healthcare. The fixed pool framework was originally negotiated to last ten years (Smart 2005) but was reduced to an interim status following the establishment of the Expert Panel on Equalization. The panel was bestowed with the responsibility of examining the Equalization program's fundamental principles, and making recommendations.

## **3.6. The Expert Panel Report**

The Panel on Equalization and Territorial Formula Financing studied the tax bases on which Equalization payments were calculated, means to ensure payments to provinces were stable and predictable, and assess the need for a recurring independent review of the program. The Panel's research involved numerous interviews and workshops with academics, government officials, policy groups, and politicians. The panel's report was delivered in 2006 (and is commonly referred to as the O'Brien Report, named after the panel's chairman). The recommendations made of interest to this study are discussed below.

### ***3.6.1. Representative Tax System***

The O'Brien Report found strong support for maintaining the Representative Tax System. It identified the RTS as the system best suited to carry out the mandate of Equalization as described by the Constitution. It concluded that the RTS is the most accurate measure of a province's fiscal capacity and best reflects provincial tax policy



conventions in Canada. The Report thereby rejected the case for use of a single macro measure as a proxy for fiscal capacity. However, they agreed to simplify the system by reducing the number of tax bases included under the RTS. The Report recommended aggregating a number of the 33 tax bases into five (personal income, corporate income, sales, property, and resource revenues).

### ***3.6.2. National Standard***

The panel agreed with the support expressed by the majority of provinces and academics to revert to a 10-province standard as the benchmark. They concluded that the 5-province standard did not adequately address fiscal disparities and that using the average of all provinces was a 'natural' way of reflecting the financial circumstances of the provinces. The Report did acknowledge that this would increase the costs of the program to the federal government and conceded that the choice of standard is a political one that conveys the willingness of Canadians to equalize the disparities among provinces.

### ***3.6.3. Stabilization of Payments***

Two main sources of instability of payments are acknowledged by the Report: data revisions leading to unanticipated changes in equalization awards to particular provinces and year-over-year fluctuations in provincial fiscal capacity. Since the program's formula relies on data revised several times after its original publication, payments to the provinces are also revised resulting in surprise debits and credits. To avoid this, the Report recommends issuing payments based on the data available and not revising those payments when the data are revised. This promotes stability over accuracy. The Panel recommends using a three-year moving average weighting the most recent year at 50% and the two earlier years at 25% each. Smoothing out the formula over three years guards against large fluctuations in payments, but risks delivering a payment that is too small to fully compensate for a depressed fiscal capacity. More weight is attached to the most recent year to make the formula more responsive to present fiscal realities.

### ***3.6.4. Treatment of Resource Revenues***

Of all the recommendations made by the O'Brien Report its contribution to the handling of natural resources under the Equalization formula is its most significant. Recognizing that there is no perfect solution, the Report's objective is to 'strike a balance' on their treatment. This led to the recommendation that 50% of provincial natural resource revenues be included under the Equalization formula. The rationale and consequences attached to this recommendation are explored in a subsequent section on the treatment of natural resource revenues.

### ***3.6.5. Side deals and program add-ons***

Throughout the Report there is a strong underlying commitment to a principles-driven formula for Equalization. The recommendations made are an attempt to reconcile the issues that plagued the program. In doing so it tried to eliminate the need for program add-ons and side deals, which detract from the program's integrity and transparency. For example, the panel recommended that any new material changes to the program between the five-year agreement intervals be proposed in public discussion papers. Material changes include the scaling back of payments to fit budgetary constraints on the program. The report also recommends that in the event Ottawa wants to cap the size of the program it should do so by scaling back all payments on an equal per-capita basis.

## ***3.7. Post O'Brien: 2007-Present***

Ottawa adopted nearly every report recommendation and implemented the changes to the program in 2007. At the time this restored the program to an open-ended grant system similar to what existed from 1982 to 2004. The key changes incorporated in 2007 were the establishment of the 10-province standard in place of the 5-province standard, the reduction of tax bases included under the RTS from thirty-three

to five (many of the previous bases were aggregated), a reduction in percentage of resource revenues equalized from 100% to 50%<sup>7</sup>, and the addition of a receiving province cap that effectively limited the equalization of any receiving province so its fiscal capacity does not exceed that of a non-receiving province (at the time this province was Ontario).

In 2009 Ottawa moved to impose a cap on the entire program (tying the size of the program to GDP growth). This again shifted the program to a closed-ended grant program and presents the current program with the problems detailed in the introduction. As well, as a result of Ontario joining the list of receiving provinces the receiving province cap was changed from using the lowest fiscal capacity of a non-receiving province to the average of all receiving provinces.

<sup>7</sup> This was true for most resources. However, exceptions were made for specific resources such as potash mined in Saskatchewan.

## **4. Current Debates**

Throughout the literature on Equalization there are mentions of specific issues that are routinely at the centre of debates for reforming the program. The most prominent of these issues are the treatment of natural resource revenue, limitations of the RTS, the use of macro measures, and using a needs-based approach. The consideration of the first two issues is relevant for the analysis conducted in this study and they are detailed below. The latter two issues, as important as they are, are not relevant to the options considered in this research. Details on these debates and the reason for their irrelevancy are found in Appendix B.

### **4.1. What to do with Natural Resource Revenues**

As previously stated, the formula in the 1957 agreement did not include the equalization of natural resource revenues. The consequence of this was that Alberta continued to qualify for payments despite the rise in its fiscal capacity attributed to the development of its oil and gas reserves. For this reason, the 1962 agreement was expanded to include resource revenues as its fourth tax base. This also had the consequence of increasing overall program costs when the ten-province standard was introduced in the same year (Alberta's fiscal capacity raised the national average thus resulting in greater payments to receiving provinces). The consequences of the disproportionate location of Canada's petroleum reserves in Alberta have become the dominant issues in any debate regarding natural resource revenues in the Equalization formula. The inclusion of natural resource revenue into the program enlarges the fiscal capacity gap between provinces that have resources and those that do not. This results in increased costs to equalize. Excluding resource revenues lowers the national standard and reduces entitlements for most provinces. In resource rich receiving provinces, however, exclusion lowers their calculated fiscal capacities by more than it lowers the national standard and hence their interest is to favour exclusion. Adding to

the complexity of how resource revenues are handled are the issues of ownership and program stability. Natural resources belong to the provinces and not the federal government. This has led some to argue that their full equalization deprives the owning province from the incentive to manage their resources efficiently (Expert Panel 2006, 55-56). Provinces with large natural resource reserves argue that they should be able to use their position to provide their citizens with a higher quality of life. The counter-argument is the 'luck of the draw' dimension to natural resource location, and provinces without significant reserves of natural resources shouldn't be excluded from enjoying the same standard of living experienced by provinces with above-average reserves. As long as ownership of natural resources is provincial, there is no silver-bullet solution to the problem of inclusion/exclusion of resource revenues in the Equalization formula.

The inclusion of natural resource revenue can have negative impacts on the program's stability. Since the prices of natural resources are subject to the volatility of world commodity markets, the provincial revenues they generate are also volatile. When these revenues are equalized, the size of the program becomes subject to this volatility. This makes it difficult for receiving provinces and Ottawa to plan their budgets. This challenge has resulted in measures to smooth payments and protect against Equalization shortfalls from year to year.

The problem of incorporating natural resource revenues into the Equalization formula explains many of the program's past problems and reforms. For example, in response to the oil price shocks of the 1970s, measures were taken to insulate the program from spiking oil prices. Revenues collected as a result of the spike<sup>8</sup> were only equalized at 33.3% instead of 100%. This led to the change in the 1977 agreement of equalizing only 50% of all natural resource revenues. Even after reducing to 50% the share by which all natural resource revenues were equalized, Alberta's oil and gas income pushed the ten-province national average standard above Ontario's fiscal

<sup>8</sup> A formula was used to distinguish between regular resource revenues and the revenues generated directly by the spike. Regular revenues were still equalized at 100% and the excess revenues were equalized at 33.3%.

capacity. This led policy makers to pass ‘tax-override’ legislation whose sole purpose was excluding Ontario from qualifying. The 1981 Parliamentary Task Force’s Report on Federal-Provincial Fiscal Arrangements found this to be an unsustainable solution. Citing Ontario’s declining manufacturing sector, the Report questioned, “...whether the special measure taken to prevent Ontario from receiving equalization can be maintained indefinitely” (Parliamentary Task Force 1981, 37). A more permanent solution was the 1982 introduction of the five-province standard. Excluding Alberta from the standard lowered the costs of equalization and allowed the program to return to equalizing 100% of most resource revenues.

Following the O’Brien Report’s recommendation, the program currently includes only 50% of resource revenues in the equalization formula. The move to reduce the share represented by the formula coincided with the move to a ten-province standard. If 100% of revenues were included under the ten-province standard, then the program would be considerably larger today. According to the author’s calculations, this difference would be \$6.2 billion in budget year 2012-13 (assuming no cap is in place).

## **4.2. Including Hydroelectric Rents in the Formula**

Adding to the debate around resource revenues is the issue of economic rents from hydroelectricity generation. The economic value of the energy associated with hydroelectricity is managed differently from the case of oil and gas. It is not captured by provincial governments in the form of royalties. Instead the economic benefits are dissipated throughout the population in the form of reduced electricity rates. For this reason, the benefit hydroelectricity provides to provinces is not captured in the Equalization program’s formula. The main driver behind the difference in treatment is the ability of governments to capture the economic rent of each resource.

Provincial governments capture revenue from hydroelectricity generation in two different ways. They can sell water rental agreements to hydro producers and they can receive dividend payments from crown corporation utilities (Expert Panel 2006,113). The value of water rental agreements enter the Equalization formula under natural resource revenues and are treated similarly to royalties collected through non-renewable

resource extraction (i.e. equalized at a rate of 50%). The dividend payments made to the government by crown utilities enter the formula under the corporate income tax base. The Expert Panel (2006) claims that because the provinces have direct control over these two streams they “...can ensure that hydroelectricity revenues enter the two revenue bases in a way that minimizes the negative impact on its Equalization entitlement...” (Expert Panel 2006,113). This treatment is different from the treatment of non-renewable resource revenues in the program, which enter the formula as the amount the provincial government collects in royalties from their extraction. The assumption underlying this treatment practice is that provinces will maximize their efforts to capture the full amount of the rent associated with the extraction of these resources. Therefore accounting for non-renewable natural resources is only a matter of looking at a province’s revenue stream (Plourde 2005,12).

The difficulty in accounting for the benefits accrued from hydroelectricity is a deterrent from including them under the Equalization formula. Plourde (2005) notes that it would, “...be premature to move to such a treatment of hydro rents in fiscal equalization since much work needed to be done to develop the kinds of instruments required to provide the necessary approximations to the underlying measures of economic rents” (Plourde 2005,22). The lack of these instruments has allowed governments to minimize the impact of hydroelectric capabilities on their equalization entitlements.

### **4.3. Limitations of RTS**

Although the Representative Tax System has been a core component of the Equalization program since 1967, there are legitimate concerns raised regarding its use. Its two most common criticisms are the claw back and base distortion effects. The claw back effect occurs when a receiving province’s Equalization payment is reduced as a result of an increase in revenue from one of its tax bases. On the surface this doesn’t appear to be a serious problem since it reflects the mechanics of the program; as a province’s fiscal capacity increases, it is entitled to less equalization. However, the claw back effect does provide a disincentive for Equalization-receiving provinces to increase their tax bases. This is especially true for smaller provinces. Under the RTS, smaller

provinces exert less influence on the national standard resulting in a higher percentage of their payments being scaled back.<sup>9</sup> This issue has also been cited as a reason to equalize only 50% of resource revenues. A 50% inclusion rate of natural resources protects half of a receiving province's growth in natural resource revenue from being subject to the claw back effect.

The distortion effect refers to the practice of provinces distorting their tax bases by raising taxes in order to receive larger Equalization payments. A receiving province may raise its tax rate on a particular base in order to shrink that base. The higher tax rate raises the average provincial rate resulting in increased payments to receiving provinces. In addition, the depressed tax base also decreases the province's fiscal capacity and consequently qualifies that province for an even greater payout. Smart (2006) studies the impact of the distortion effect and finds that tax rates in receiving provinces were substantially and significantly higher as a result of the program.

Another argument cited by The Expert Panel (2006) for reforming the RTS is complexity. Many Canadians find the formula used for equalization complicated and confusing. The public's lack of understanding of the program raises themes of transparency and program legitimacy. This was more of a problem when the RTS comprised 33 tax bases as opposed to the present day five. However, the amalgamation of the 33 tax bases into five still requires complex calculations that are intimately known only by those who work most closely with the program's formula. Therefore, there are still gains to be made in simplifying the program before it is well understood by the majority of the population.

<sup>9</sup> Under the 5-province standard, excluded provinces had 100% of increased revenues claw backed in reduced Equalization payments.



## **5. Findings**

The interviews conducted for this study focus on insiders' understanding of the workings of the program both operationally and politically. They shed light on the main issues facing the program, the political considerations that underlie policy decisions, and potential options for addressing the balance between affordability and principles. The following findings are organized in sections based on the grouping of questions posed in the interviews. The first section, The Role of Equalization, reports the main objectives that interviewees associated with the program. These responses help guide further analysis to ensure that any proposed policy options are aligned with the program's objectives. The challenges section identifies gaps that alternative policies need to address and consider. The third section, Political Dynamics, is a collection of comments and insights into the political nature of the program. This informs the policy discussion as to the potential political consequences of policies and recognizes the political forces that influence the program. Interviewees were also asked to discuss the trade-offs associated with the balance of affordability and principles. The results of this discussion are presented in the fourth section. The final section of the Findings chapter reports the reaction of the interviewees to a number of potential policy options. These responses bring to light any potential problems with the options and categorize each option's strengths and weaknesses.

### **5.1. The Role of Equalization**

On defining the program's role in Canada's federalism, nearly every respondent made mention of the constitutional obligation that the federal government has to provinces, "...to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Elaborating on this, respondents also mentioned that in doing so, the federal government recognizes the various abilities of provincial governments to raise revenues. The responses can be divided into two different

categories: those that highlighted the need for Equalization in a federal system, and those that touched on the program's political necessity.

Responses highlighting the importance of Equalization in a federal system pointed to the unique needs of each province. As a result of differing regional, economic, social, and cultural factors, each province has different voter preferences. Consequently, governmental priorities are different from province to province. Equalization takes into account that financing this spectrum of priorities is a challenge for provinces with weaker economies. For this reason, Equalization allows a federal system to exist in a country like Canada that is vast in size and diverse in geography. It is the mechanism that addresses the fiscal disparities among provinces that arise from differing economic and geographic conditions. Without this mechanism there would be greater unilateral tax competition between provinces and more pressure for direct federal government intervention resulting in greater centralization.

Interviewees with experience and knowledge of closed door negotiations of the program reflected more on the political importance of Equalization. They focused on the program's role as a peacemaker among provinces. One respondent characterized it as "a political tool (with important financial dimensions) that eases tensions in a federation like Canada." Another respondent defined its role as a way "to minimize the extent that provinces are in the hair of the federal government, more specifically it keeps the premiers out of the face of the Prime Minister." These sentiments were echoed in other portions of the interviews when respondents referred to Equalization as a 'vote loser': policy decisions related to the program have the potential to lose votes but not to gain votes. This tends to promote a slow incremental approach by decision makers and the making of unpopular decisions as quietly as possible. Also implicit among those who took this approach is the desirability of a range of policy levers that can be pulled to minimize the 'losers' from any reforms to Equalization.

## **5.2. Challenges Facing the Program**

The issues cited as posing the greatest challenge to Equalization in coming years are the effect of natural resource wealth on the formula and how best to measure

a province's fiscal capacity. Often cited by interviewees is the fact that these two issues have been at the forefront of Equalization debates throughout its history.

Most interviewees pointed out that natural resource revenues were the single largest contributor to diverging fiscal capacities among the provinces. With larger divergences the cost to Equalize increases and the federal government is faced with the risk of program costs exceeding what it is willing to fund. As well, program costs can become unpredictable depending on the price of natural resources. Since the introduction of the GDP cap, the government has been able to manage the costs of the program, but if the divergences continue to grow, the program's ability to equalize fiscal capacities fades. One federal official questioned whether Ottawa should equalize the disparity in fiscal capacities created by resource revenues. His argument was that since resource revenues fall principally into provincial jurisdiction (unlike income, corporate, and sales taxes), the federal government does not have direct access to them. When these revenues increase, resulting in higher costs to Ottawa, Ottawa is in no better a position to manage these costs. Other interviewees countered this argument by pointing out that the Equalization program would fail to properly address disparities in fiscal capacities if resource revenues were ignored. As well, ignoring resource revenues would result in over-equalization in resource-rich provinces with below average non-resource tax bases.

Resource revenues were also cited as one of the main drivers leading to Ontario's eligibility for Equalization payments. Ontario's entrance into the program was a concern shared by over half the participants interviewed. While a number of interviewees pointed out the significant increase in program costs associated with this development, others lamented the situation's 'absurdity'. These latter responses took issue with the idea that adding Ontario resulted in 70% of the country's population living in Equalization receiving provinces. Claiming that the program was never intended to accommodate this share of the population as recipients, some interviewees objected to the rules that allowed this to happen.

Another major challenge commonly cited as always present in Equalization's history was the methodology used to calculate a province's fiscal capacity. The consensus amongst those who raised the problem was that no perfect solutions exist.

However, the program has always been criticized for either neglecting to include a particular revenue source or unfairly including others. One former finance official pointed out, in reference to the switch from thirty-three revenue sources to five, that the simpler the system gets the less robust it becomes.

One interviewee brought up the issue of the Canadian public's perception of the program. According to this interviewee, many fail to understand Equalization's role and consequently hold negative views towards the program. For this reason, he argued, the government needs to improve its communication of the program's successes. There should also be an effort made to engage Canadians in discussions surrounding changes and major reforms to the program.

### **5.3. Political Dynamics**

Throughout the interviews participants referred to the political dynamics associated with Equalization. Understanding these dynamics is an important component in any research into the program. This section summarizes the main themes touching upon the politics of the program.

From the provincial perspective, one interviewee classified the province's objective as 'budget maximizers'. This was in reference to the actions of receiving provinces to push Ottawa into reforms that enlarge the size of payments to receiving provinces. Likewise, a comment from another interviewee referred to pressure put on the federal government by non-receiving provinces to reduce the size of payments under the program. In the middle of this balancing act is the federal government, which wants to minimize any political fallout from its decisions. An example of this dynamic in play was in the lead-up to the 2007 reforms following the Expert Panel's report. According to one official familiar with the negotiations, receiving provinces, especially Quebec, advocated strongly for a ten-province standard. Western resource-rich provinces made it clear that they did not want natural resource revenues included in the program's formula. Another instance is the formation and later the dissolving of the 2004 fixed framework reform. As one former federal official recalled, the 2004 Fixed Framework was brought in to alleviate the pressure on Ottawa from receiving provinces after these

provinces experienced declines in their Equalization payments. The new framework fixed the amount of funds available for Equalization and had a set list of Equalization receiving provinces. The sentiment at this time from non-receiving provinces was that provinces receiving payments were being over-equalized. According to the official, the growing dissent amongst non-receiving provinces eventually led to the Expert Panel on Equalization's report.

The vast majority of interviewees acknowledged that political impediments underlie Equalization. When interviewees described more efficient and principled ways to structure the Equalization program, they usually prefaced their descriptions with statements such as "...but the provinces would never agree to that", and "...that would work in an ideal world void of politics." Statements like these confirm that the federal government will probably act in a way that minimizes the political reaction from any changes. This conclusion is best summarized by a former federal official:

From the federal perspective [the program] only causes trouble; there is no positive "kickback" from it and Ottawa just wants it to go away. Receiving provinces always hit the government over the head for more and officials in Ottawa just want the monkey off their back. At various times they will toss out reforms to see if they appease the provinces ... Equalization will always be a choice between what they can get away with and what the provinces will let them get away with.

## **5.4. Principles vs. Affordability and the Cap**

On the issue of affordability and the cap there was a consensus that the cost of the program should be determined by the federal government. To illustrate this point three interviewees used the extreme scenario of using a top province standard. Under such a configuration all provinces would be equalized so their fiscal capacities were on par with the top province (the province with the highest per-capita fiscal capacity). The interviewees argued that this would theoretically be full equalization and the costs would not be practical. Therefore the amount the federal government makes available for Equalization can be thought of as the extent it is willing to address the fiscal disparities

among provinces in light of its other priorities. Based on this, interviewees did not have an issue with Ottawa limiting the funds it made available to the Equalization program. Instead, the opposition to the current cap centred on the cap's departure from a formula-driven program. The interviewees identified two ways that this may happen. The first is how the cap is determined, and the second relates to calculation of the fiscal capacity cap that is applied to entitlements before the GDP cap.

Three interviewees questioned the connection between the cap and GDP growth. Their concern was that there is no logical connection between the growth of the economy and the disparities that exist among the provinces. Two interviewees suggested that, if Ottawa wishes to limit costs, it should find a way to do so that better reflects the dynamics and needs of the program. To these individuals the decision to use GDP growth as a basis for the cap seemed arbitrary. However, two other interviewees (including a finance official from a receiving province) had no problem with a cap tied to economic growth. They saw it as a reflection of what the federal government was willing to spend on Equalization. The logic behind this view is that, when the economy grows, the government can afford to equalize more of the disparities among provinces.

The other concern surrounding the system of caps was directed at the fiscal capacity cap that is applied before the GDP cap. One interviewee lamented that this cap was originally in place to protect against any receiving province achieving a greater fiscal capacity than any non-receiving province. However, following Ontario's entrance into the program it was amended so that no receiving province's post-Equalization fiscal capacity exceeded that of the average of all receiving provinces. This change was made to restrict payments to resource-rich Equalization-receiving provinces (specifically Saskatchewan and Newfoundland and Labrador). Since these provinces are no longer eligible for Equalization, the rationale for this capacity-based cap no longer exists. Instead this cap simply becomes a reincarnation of the 100% claw back problem and removes the incentive for receiving provinces to develop their resources. Two interviewees argued that this cap detracted from the program's principles more so than the GDP cap.

Another issue raised was the cap's role as a cost floor. Those familiar with the specifics of the cap policy pointed out that the cap not only limits the amount of money for Equalization but also guarantees funds available for the program. Interviewees found it difficult not to draw the parallels between the current Equalization framework and the Fixed Framework introduced in 2004. One interviewee even went as far to say that the difference between the two frameworks is in name only. He added that the only reason the current framework doesn't suffer from the same criticisms as the 2004 framework is because it is not presented in the same way.

Two interviewees had firsthand knowledge of the process that led to the introduction of the GDP cap. According to these officials, in early 2008 it was clear that Ontario was going to enter the program and resource prices were climbing. These two factors increased cost projections. The officials both pointed out that the projected costs were substantially higher than actual costs because they were based on the data available before the full impacts of the 2008 financial crisis were realized. Faced with these projections, Ottawa introduced the GDP cap. One of the officials remarked that at the time the cap was seen as a stop-gap measure and was not completely thought through. However, no interviewee stated that the cap was intended as a temporary measure. From the federal perspective it had the short-term advantage of containing costs and the long term advantage of stability and predictability. These claims of predictability and stability were echoed by one former finance official involved in overseeing the federal budget process. He saw the cap as a way of minimizing risks associated with program costs.

## **5.5. Views on Options**

Interviewees were asked their opinions on potential policy options that would serve as alternatives to the current cap system. The options were presented in a principles vs. affordability framework. They were asked to provide any foreseeable problems with the options and gauge how well each option would promote a more principled formula while taking into account affordability concerns.

### ***5.5.1. The Median Approach***

The notion of using a median average standard as opposed to a mean average standard was met with mixed reaction. Half of the interviewees saw it as an arbitrary change too narrowly focused on reducing costs of the program. They suggested there were few differences between using a median or the five-province standard that existed prior to the 2004 reforms. Both benchmarks suffer from the same drawbacks: receiving provinces would object to its implementation since it would result in a reduced national standard and it would fail to address the disparity caused by resource-rich provinces. This latter concern was the most insistent. Interviewees felt it would lead to a divided country with resource-rich provinces at one end and non-resource provinces at the other.

Those who reacted more positively to the median approach commented on the advantage of removing outlier provinces from the standard. They recognized the financial pressure that resource-rich provinces such as Alberta put on the program and thought the median standard would reduce costs. Some interviewees suggested including all provinces but lowering a province's weight the further away its fiscal capacity from the average. However, one federal official questioned whether or not reducing the costs of the program would persuade decision makers to remove the cap. Despite lower costs, reverting back to an open-ended formula would still present risk and stability issues. Another comment was that the government has already committed to a certain level of funding for Equalization and back tracking could pose political problems.

### ***5.5.2.A non-binding cap***

Reaction to using a long-term cap to stabilize Equalization was also mixed. Supporters remarked that it would allow Ottawa to smooth program costs over a longer horizon while allowing more flexibility from year to year. One former finance official drew the parallels between this approach and policies surrounding balancing the budget. He compared a yearly point estimate approach to the program (as is currently done) with anti-deficit legislation. Both restrict flexibility. The more desirable option is to allow for flexibility when it is needed. The best way to budget for Equalization would be to put it on a long-term path with horizon targets as opposed to year to year targets. Others



suggested that a multi-year cap could be worked into the formula with no economic drawbacks and that Ottawa could budget accordingly.

Opposition was based on the likelihood that this policy would add costs to the program. The cost of the program without the GDP cap already exceeds the amount the government is willing to provide. Without a cap costs will inevitably increase. If the government raised the cap to offer more flexibility, then it would have to change its fiscal position towards Equalization. Two interviewees pointed out that this would be problematic because Ottawa has already established what it can afford to contribute to the program.

One interviewee was also sceptical of political interference if the amount of funds for Equalization fluctuated at government discretion somewhat arbitrarily from year-to-year. Discretion would open the door to pressure from the provinces to lobby for higher payments.

### ***5.5.3. Equalizing rents from hydroelectricity***

There were no objections to the suggestion of including hydroelectric rents in the Equalization formula. All interviewees agreed that hydroelectric capacity did increase the ability of provinces to provide services to their citizens and therefore should be included in a province's measured fiscal capacity. However, there were major concerns regarding how hydroelectric rents could be measured. Discussions on this matter overlapped with broader discussions of calculating a RTS and the impossible task of ever creating a perfect formula.

On the political feasibility of including hydroelectric rents, one interviewee predicted significant pushback from provinces such as Quebec and Manitoba. One interviewee made the case that Ontario's entrance into the program will put more pressure on Ottawa to include these rents. Ontario accounts for 40% of the Canadian population and is relatively resource-poor. The same interviewee suggested inclusion of hydro rents quietly so as to minimize any political attention.

## **6. Analysis**

### **6.1. Emerging Themes**

Based on the findings from the literature and the interviews several key themes emerge to guide the analysis of this study.

#### ***6.1.1.A Principled Formula-Driven Program***

The Equalization program has a long history of reacting to changing political and economic pressures. These pressures have tended to result in ad hoc amendments to the program in the form of offshore accords, ceilings, floors, and protection payments. These amendments are undesirable in the long-term as they undermine the notion of a principle-based program. The fact such amendments exist is a sign that the current formula is ill-suited to perform its function.

The findings from the interviews do not echo this concern with a principles-based program. There was a sense from the interviewees that principles inevitably take a back seat to politics in establishing the details of the program. From the perspective of the interviewees, Equalization is a political exercise whose goal is appeasing the provinces on terms acceptable to the federal government. However, despite stressing the program's political underpinnings, interviewees acknowledged the need to satisfy the constitution by, "*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.*"

#### ***6.1.2. Political Sensitivities***

Manoeuvring within the political sensitivities of the program is a challenging task considering the current fiscal climate and recent government statements. From the interviews it is clear that the current political objective is not to create any 'losers'. In

addition, the Conservative Party ran in the 2011 general election on a promise that it would not reduce federal-provincial transfers. It is unknown whether the government will interpret this promise as applying to the aggregate amount transferred or to transfers to individual provinces. Nonetheless, in this equalization negotiating round, it is likely that any negative change to a province's transfer from a program reform will be offset with a protection payment to ensure no net loss.

Several interviewees referred to the fact that 70% of the Canadian population now resides in a receiving province. That the median voter is in the program has the potential to alter the federal government's political calculus. Another factor influencing this calculus is that Ontario accounts for 40% of the country's population. There will be increasing pressure for the federal government to accommodate the needs of Ontario. While the decision makers in Ottawa must now contend with the demands of Ontario, they no longer have pressure applied from Saskatchewan and Newfoundland and Labrador. The recent good fortune of these provinces' resource sectors has removed them from the list of receiving provinces. It is probably also safe to say their variance in fiscal capacity has declined and they are unlikely soon to return to Equalization-receiving status. Contrary to the position of these two provinces, resource-poor Ontario benefits from increased inclusion of resource revenues. Ontario has the second-lowest per-capita fiscal capacity from natural resources (second to PEI). Therefore increasing the ratio of resource revenue to be equalized increases the disparity between Ontario and the national standard and increases Ontario's entitlement.

### ***6.1.3. Choosing a Benchmark Standard***

As one interviewee pointed out, there is a connection between the federal government's interpretation of the word 'comparable' from the constitution, the national standard, and the funding the program receives. When Ottawa allocates a fixed amount of funding to the program, it is implicitly redefining the standard to which all receiving provinces will be raised. (In applying the cap, it has imposed equal per-capita reductions among Equalization-receiving provinces.) When the program is left open-ended (no cap), Ottawa allows the national standard to dictate the funding. Since the standard determines the level to which receiving provinces are equalized, the standard is a reflection of the meaning accorded to the term 'comparable' in the constitution. If

provinces were fully equalized to a top-province standard, then the word 'comparable' means 'exactly the same'. As the standard falls, the interpretation of 'comparable' allows for more inter-provincial variation in fiscal capacity. Ottawa's interpretation of 'comparable' is directly tied to economic growth and therefore changes from year to year. Under an open-ended system 'comparable' remains consistent from year to year.

Those who object to using GDP as a determinant of the program cost argue that economic growth does not properly reflect the needs of the provinces in provision of services. This view is essentially advocacy for a consistent interpretation of the purpose outlined in the constitution.

#### ***6.1.4. The Treatment of Resource Revenues***

The research reveals a useful framework for analyzing the trade-offs between full inclusion and exclusion of resource revenues. There is a clear consensus from the interviews and from the literature that higher resource revenues increase a province's ability to provide services to its citizens. Ignoring all else, full inclusion of natural resources in the Equalization formula is desirable since it would better address the fiscal disparities among provinces. In addition, full inclusion helps avoid the issue of over-equalization. Under the current system, over-equalization is addressed by imposing a fiscal capacity cap prior to the GDP cap. Full inclusion of resources would help simplify the formula.

The drawbacks of this approach are that it is expensive, that it erodes incentives to receiving provinces to develop their resources efficiently, and that it threatens to render "null and void" any meaning attached to section 109 of the Constitution, which grants resource ownership to residents of the relevant province. These are valid concerns. The magnitude of consequences depends on the formula. For example, when there is a ceiling cap on the program, including resource revenues in the formula could have a zero effect. Likewise, the claw back effect associated with a province increasing resource revenues depends on the province's impact on the standard used. To conclude, the extent of these drawbacks should be measured against the benefits of including 100% of resource revenues in the formula.

## **6.2. Criteria and Measures**

These emerging themes and findings help identify criteria that can be used to evaluate various policy alternatives to the cap. These criteria are political feasibility, cost to the federal government, level of equalization, and impact on incentive structures.

### ***6.2.1. Political Feasibility***

The degree of political acceptance of any specific option is an important factor to consider. There is no ideal way to measure an option's political acceptability. However, from the above discussion on the political dynamics of the program, there are policy attributes that make some options more feasible than others. The first attribute is, by how much a specific policy reduces payments to a province. When provinces act as budget maximizers, there will be negative political consequences when their payments are reduced. The declines in a province's payment have rarely exceeded 10% under the Status Quo from year to year. This provides a useful benchmark for determining a threshold for political acceptance. In the event that an amendment to the program drastically reduces (by, say, over 30%) a province's entitlement, it should be considered politically unfeasible.

It should be noted that in the event an amendment to the program does result in reduced payments, transitional protection payments can ease the political opposition. Making protection payments is an ad hoc measure that increases the political feasibility of any option but increases the costs to Ottawa and undermines the principles of a formula-driven program.

### ***6.2.2. Cost***

The issue of affordability and stability is paramount to the federal government. It was cited as the reason behind bringing in the GDP cap and in the current fiscal climate program cost, will dominate decisions affecting Equalization. Ottawa has identified the level of funding it considers affordable and has allowed that funding to increase in line with a three year moving average of nominal GDP growth. In assessing the costs of policy alternatives they should be compared to the status quo either for a specific year or an average over a given time frame.

### ***6.2.3. Level of Equalization***

There needs to be a measure of effectiveness comparable across options. This measure would indicate how well a policy reduces the fiscal disparities among provinces. One statistical approach to this problem is taking a standard deviation of the ten per-capita fiscal capacities. Comparing the standard deviation both post and pre-Equalization provides a metric that is comparable with other configurations of the program.

Another important criterion to report in regards to the level of equalization deals with the approach taken on the type of standard used. As discussed above, a program configuration can either use an interpretation of the word 'comparable' that is consistent from year to year or it can use an interpretation that is directly tied to a moving variable independent of the program. Since a consistent interpretation is more in line with a principles-based formula, it is the more desirable of the two interpretations.

### ***6.2.4. Impact on Incentive Structure***

The fourth criterion is how much of an incentive structure each policy allows so that provinces have a net benefit to develop their tax bases. The partial inclusion of natural resource revenues, for example, is a compromise between inclusion (in order to reduce fiscal disparities) and exclusion (to provide provinces an incentive to develop their resource base). However, under the current configuration, the fiscal capacity cap removes any incentive for resource-rich receiving provinces to develop their resources. To compare different policies on the basis of their incentive structures, a metric can be the equalization claw back rate on incremental own-source provincial revenue.

## **7. Policy Options**

### **7.1. Median National Average**

#### ***7.1.1. Description***

Under this approach entitlements are based on a national standard that is reflective of median capacity and not national average capacity. The median is weighted by provincial population. It is the per-capita fiscal capacity of the median Canadian. To determine the median standard all Canadians are lined up from smallest to largest of the fiscal capacity of the province in which they reside. The standard is then set at the fiscal capacity of the province of the median Canadian. This approach includes resource revenues at 100%. Table 1 uses program data from 2012-13 to determine the median standard for that year and the effect the median approach would have on the program compared to the Status Quo. The median is determined by the cumulative population column. The standard is set at the fiscal capacity of the province in which the median Canadian resides, in this case Ontario (the median Canadian is the 16,835,964<sup>th</sup> Canadian).

**Table 1 Calculation and Effect of a Median Standard using 2012-13 data and full inclusion of resource revenues**

| Province      | Per-Capita Fiscal Capacity | Cumulative Population | Difference from Median Standard | Entitlement ('000\$) | Entitlement under Status Quo ('000\$) | Percentage Difference from S.Q. |
|---------------|----------------------------|-----------------------|---------------------------------|----------------------|---------------------------------------|---------------------------------|
| PE            | 4712                       | 141,735               | 2137                            | 302,899              | 337,075                               | -10.1%                          |
| NB            | 5153                       | 892,346               | 1696                            | 1,273,252            | 1,494,927                             | -14.8%                          |
| NS            | 5665                       | 1,833,748             | 1184                            | 1,114,357            | 1,268,041                             | -12.1%                          |
| MB            | 5794                       | 3,055,357             | 1055                            | 1,288,567            | 1,670,667                             | -22.9%                          |
| QC            | 6224                       | 10,894,544            | 624                             | 4,895,130            | 7,391,127                             | -33.8%                          |
| ON*           | 6849                       | 23,992,025            | 0                               | 0                    | 3,260,666                             | -100.0%                         |
| BC            | 7792                       | 28,461,362            |                                 |                      |                                       |                                 |
| SK            | 9886                       | 28,970,491            |                                 |                      |                                       |                                 |
| NL            | 11107                      | 30,001,919            |                                 |                      |                                       |                                 |
| AB            | 12730                      | 33,671,929            |                                 |                      |                                       |                                 |
| <b>Total:</b> |                            |                       |                                 | <b>8,874,207</b>     | <b>15,422,503</b>                     | <b>-42.5%</b>                   |

### **7.1.2. Rationale**

This approach reflects an attempt to balance the elimination of the cap with efforts to reduce the size of the program. Using the median as opposed to the mean eliminates the effect that outlier provinces have on the national standard. Under present conditions this will reduce the size of the program to below the level of the current cap. Reducing the program's size below the cap allows it to remain open-ended and adjust fully to changing fiscal capacities. Since a median standard is essentially a way of ignoring outlier provinces, it has been compared to the five-province standard. The difference is that under the five-province standard, provinces are chosen arbitrarily and under the median standard all provinces are included in the standard's calculation. Therefore the median standard has more legitimacy than the five-province standard.



### ***7.1.3. Political Feasibility***

Using the guidelines from the political feasibility criterion, it can be argued that the median standard falls on the line between the loss of political capital and the politically unfeasible categories. Every province's entitlement is reduced by at least 10%; reductions for Manitoba, Quebec, and Ontario exceed 20%. Furthermore the total program cost falls by over 42%. Unless these losses are compensated, through other transfers, some provinces will experience a significant decline in federal transfers.

### ***7.1.4. Cost***

Adopting the Median Standard approach would result in substantive savings to the federal government. The total cost of the program using a median standard is over \$6.5 billion less than the Status Quo. However, if the government did decide to adopt this approach, it would likely have to appease the receiving provinces with protection payments, which would reduce the savings.

### ***7.1.5. Level of Equalization***

Table 2 gives the pre- and post- per-capita fiscal capacities of each province for the median standard and the Status Quo. The standard deviation of the post-Equalization under the median approach is higher than that for the Status Quo. This comes as no surprise since the cost of the status quo approach is significantly higher than the costs of the median approach.

The median standard approach returns the Equalization program to an open-ended system and therefore the receiving provinces are topped up in full so that their post-Equalization fiscal capacities are equal to the specified standard. For this reason it can be said that the median standard approach has a consistent interpretation of the word 'comparable' from the Canadian Constitution.

**Table 2 Pre- and post-Equalization fiscal capacities of provinces with standard deviation. Using 2012-13 data and full inclusion of resources**

| <b>Province</b> | <b>Pre-Equalization Per-Capita Fiscal Capacities</b> | <b>Post Equalization Per-Capita Fiscal Capacity using Median Standard</b> | <b>Post Equalization Per-Capita Fiscal Capacity using Status Quo</b> |
|-----------------|--|---|--|
| PE              | 4711   | 6848  | 7089   |
| NB              | 5152   | 6848  | 7144   |
| NS              | 5665   | 6848  | 7012   |
| MB              | 5794   | 6848  | 7161   |
| QC              | 6224   | 6848  | 7167   |
| ON              | 6848   | 6848  | 7097   |
| BC              | 7791   | 7791  | 7791   |
| SK              | 9885   | 9885  | 9885   |
| NL              | 11106  | 11106   | 11106  |
| AB              | 12730  | 12730   | 12730  |
| St.Dev          | <b>2742</b>  | <b>2183</b>   | <b>2072</b>  |

### **7.1.6. Impact on Incentive Structure**

Under the median standard approach the only province that affects the standard is the province that contains the median Canadian citizen. In the case of the example shown here that province is Ontario. Therefore the only way for the standard to increase is for Ontario's fiscal capacity to increase. Since the receiving provinces are not able to influence the standard, every extra dollar of revenue added to their fiscal capacities is clawed back in the form of reduced Equalization payments. At a 100% claw back rate there is little incentive in the program for receiving provinces to expand their tax bases.

## **7.2. Equalizing Hydro rents**

### **7.2.1. Description**

The option of equalizing the potential rents from hydroelectricity generation is a reform for improving the RTS with, secondarily, the objective of reducing overall program

costs. If costs are reduced below the cap, then there is the potential that the system can return to a principle-driven formula. Equalizing hydro rents would involve developing a measure of the benefit that hydroelectric generating provinces experience as a result of their hydro capacity. Based on the literature and interviews this is a desirable policy but it suffers from the absence of a straightforward method for calculating these rents.

### ***7.2.2. Rationale***

The purpose of this analysis is not to propose a methodology for measuring hydroelectric rents but to estimate their impact on the program. Based on the findings from this it can be determined whether or not pursuing a method for measurement is a suitable solution for addressing the problem that this study is focused on.

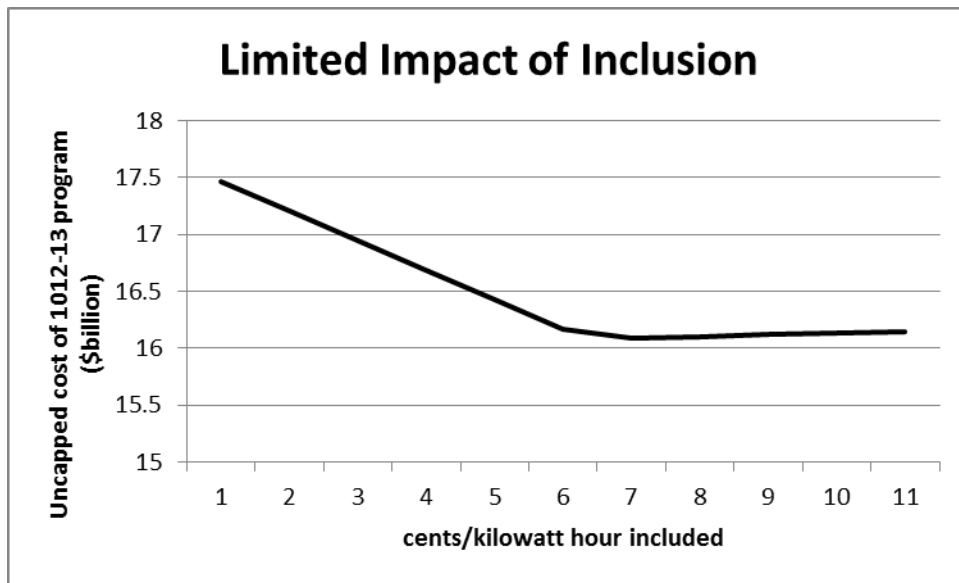
### ***7.2.3. Political Feasibility***

The political feasibility of this option depends on the level of rent recognized in the formula. Even with a two cent per kilowatt hour recognition of hydroelectric rent Quebec payments fall by 19%. At six cents its payments fall by 45% (using 2012-13 data). If a modest rent was recognized, this option would be feasible at some political cost. However, such a modest recognition may not provide the desired benefit of reducing the uncapped costs of the program below the level of funding the federal government currently allocates to Equalization.

### ***7.2.4. Cost***

The savings due to including hydroelectric rents depend on the level of rent measured. Figure 3 shows the uncapped costs of the 2012-13 program under various scenarios of rent measurement. The horizontal axis represents one cent / kWh increases in the level of rent measured by the RTS for all provinces on their hydroelectric capacity. From the graph it is seen that there is a limit to decreasing costs around 6 cents / kWh. Even at 6 cents, the uncapped costs do not fall below the funding level the government had allocated for the program. Up until 6 cents the program experiences cost savings as the payments to Quebec and Manitoba decrease in recognition of their hydro capacities. After a certain point the effect of hydro rent

inclusion on the national standard more than offsets the savings due to lower payments to these two provinces. Based on Figure 3, the savings from including hydroelectricity can bring down uncapped costs by a maximum of \$1.5 billion. However, this involves recognition of hydroelectric rents of 6 cents / kWh – a significant but not unrealistic figure.



**Figure 3 Impact of collecting addition cent per kilowatt hour of hydroelectric rent on program costs in 2012-13**

### **7.2.5. Level of Equalization**

Including hydroelectric rents in the formula would not change the amount of funding the federal government makes available for Equalization. However, it would affect how the fiscal capacities of the provinces are measured before Equalization. The entitlements calculated for other options as well as the Status Quo are based on fiscal capacities that exclude hydroelectric rents. This makes it difficult to compare pre and post fiscal capacities with other configurations. Since the costs of the program with hydro rents included still remain above the capped level of the program, the program would most likely remain capped. For this reason the interpretation of the word ‘comparable’ in the Canadian Constitution would continue to fluctuate from year to year.

## **7.3. Increase the Resource Inclusion Rate and Eliminate the Fiscal Capacity Cap**

### ***7.3.1. Description***

This option considers adjustments to the inclusion rate of natural resource revenues to 70% and 100% from 50%. This option can be configured to both the uncapped and capped (GDP cap) versions of the program. Furthermore, this option sees the elimination of the fiscal capacity cap. The fiscal capacity cap adjusts entitlements to account for additional fiscal capacities not recognized by the formula when natural resource inclusion is less than 100%. When the rate of inclusion is 100% the fiscal capacity cap is irrelevant since 100% of natural resource revenue is recognized by the formula.

### ***7.3.2. Rationale***

There is much debate in the literature on the most appropriate treatment of natural resource revenues. The Expert Panel recommended an inclusion rate of 50% as a compromise to the demands of resource-poor provinces for 100% inclusion and the demands of resource-rich provinces for reduced inclusion. Now that Saskatchewan and Newfoundland and Labrador (both resource-rich provinces) are no longer recipients of Equalization it is an opportune time to explore the impacts of increasing the inclusion rate of natural resource revenues.

With regards to the elimination of the fiscal capacity cap, there are two reasons to justify its elimination: 1) it was cited in an interview as distorting the incentives of provinces to develop their natural resource reserves and 2) with an increased resource inclusion rate the need to restrict payments to resource-rich receiving provinces becomes diminished.

### ***7.3.3. Political Feasibility***

Table 3 lists the payments to each receiving province (using 2012-13 data) under various scenarios. In the event the program's GDP cap is removed (first 3 rows), payments to all provinces would increase. This is true for 100%, 70%, and 50%

inclusion configurations. For this reason an uncapped option at any rate above 50% inclusion is considered politically feasible. However, this assumes non-receiving provinces do not protest increased program costs (last column).

Under the capped configurations (last four rows of Table 3) total program costs remain the same but the distribution of payments across provinces changes. When the inclusion rate increases under the capped configuration, payments to relatively resource-rich provinces fall while those to relatively resource-poor provinces rise. Nova Scotia and Quebec (relatively resource-rich) see their payments fall the most while Ontario (relatively resource-poor) experiences an increase in payments. The largest proportional loss is experienced by Quebec. Its payment falls by 4% (from Status Quo to 100%). Therefore the option is considered to be politically feasible since this does not exceed the 10% threshold.

Another interesting finding from Table 3 is the impact of removing the fiscal capacity cap. Comparing the last two rows of the table reveals that the elimination of the fiscal capacity cap favours resource rich Nova Scotia and Quebec. These are the two provinces that experience the greatest loss from increased resource inclusion. Therefore a modest increase in resource inclusion (from 50% to 70%) and the elimination of the fiscal capacity cap have relatively offsetting consequences. For this reason an inclusion rate of 70% seems to be ideal.

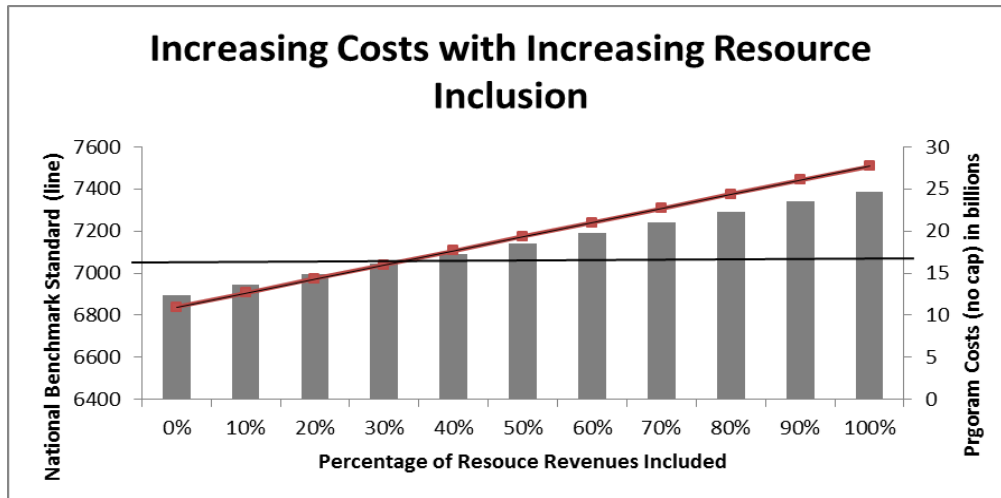
**Table 3 Equalization entitlements and total cost of alternate resource inclusion rates, capped and uncapped, 2012-13, \$million**

|                        | PE  | NS    | NB    | QC     | ON    | MB    | Total  |
|------------------------|-----|-------|-------|--------|-------|-------|--------|
| <b>Uncapped @ 100%</b> | 396 | 1,735 | 1,769 | 10,070 | 8,646 | 2,095 | 24,710 |
| <b>Uncapped @ 70%</b>  | 368 | 1,638 | 1,642 | 9,381  | 6,084 | 1,903 | 21,018 |
| <b>Uncapped @ 50%</b>  | 349 | 1,574 | 1,559 | 8,923  | 4,376 | 1,775 | 18,556 |
| <b>Capped @ 100%</b>   | 342 | 1,370 | 1,478 | 7,035  | 3,575 | 1,622 | 15,423 |
| <b>Capped @ 70%</b>    | 338 | 1,393 | 1,485 | 7,220  | 3,339 | 1,645 | 15,423 |
| <b>Capped @ 50%</b>    | 331 | 1,451 | 1,461 | 7,889  | 2,666 | 1,615 | 15,423 |
| <b>Status Quo*</b>     | 336 | 1,407 | 1,490 | 7,344  | 3,181 | 1,663 | 15,423 |

\*Status Quo is capped at 50% with the fiscal capacity cap. The fiscal capacity cap is eliminated in all other scenarios.

### 7.3.4. Cost

There are two sets of costs associated with this option. If the GDP cap is removed the total cost of the program at a 100% and a 70% inclusion rate would be \$24.7 billion and \$21 billion respectively. This is approximately \$2.5-6.2 billion more than an uncapped program at 50% inclusion. Removing the GDP cap and increasing the inclusion rate to 100% or 70% would result in added program costs of over \$5.5-9.3 billion. This represents an approximate 2-3.4% increase to the total federal budget. Figure 4 shows how the uncapped costs of the program rise as a result of increased resource revenue inclusion. Maintaining the GDP cap and increasing the inclusion rate would require no new funding to the program.



**Figure 4 Uncapped program costs as a result of increasing the resource inclusion rate (no fiscal capacity cap). GDP cap is marked by horizontal line. Diagonal line is national standard benchmark (left axis): 2012-13 data**

### 7.3.5. Level of Equalization

Table 4 shows the per-capita fiscal capacities of all provinces before and after Equalization using a 70% inclusion rate. It is no surprise that the uncapped

configuration results in a significant decline of the standard deviation as more funds are available to equalize across provinces. Uncapping the program and raising the inclusion rate of natural resource revenues to 70% would result in a standard deviation 27.3% less than the pre-Equalization standard deviation. Maintaining the GDP cap and increasing the inclusion rate produces a standard deviation 24.2% less than the pre-Equalization standard deviation.

**Table 4 Per-Capita fiscal capacities pre- and post-Equalization with 70% inclusion capped and uncapped.**

|                         | NL     | PE    | NS    | NB    | QC    | ON    | MB    | SK    | AB     | BC    | S.D          |
|-------------------------|--------|-------|-------|-------|-------|-------|-------|-------|--------|-------|--------------|
| <b>Pre-Equalization</b> | 11,107 | 4,712 | 5,666 | 5,153 | 6,224 | 6,849 | 5,794 | 9,886 | 12,730 | 7,792 | <b>2,742</b> |
| <b>@70% capped</b>      | 11,107 | 7,108 | 6,924 | 7,141 | 7,154 | 7,113 | 7,151 | 9,886 | 12,730 | 7,792 | <b>2,078</b> |
| <b>@ 70% uncapped</b>   | 11,107 | 7,309 | 7,125 | 7,341 | 7,355 | 7,313 | 7,352 | 9,886 | 12,730 | 7,792 | <b>1,994</b> |

### **7.3.6. Impact on Incentive Structure**

Table 5 lists the various claw back rates associated with different scenarios. The rates represent the percentage clawed back (in the form of reduced Equalization payments) from an increase in natural resource revenue. For example, if a receiving province increased its natural resource revenue by \$100 million and had a claw back rate of 70% then its total fiscal capacity would only increase by \$30 million. Larger provinces (by population) have lower claw back rates in any given scenario compared with other provinces. This is because the per-capita increase in fiscal capacity from a gain in resource revenue is smaller in larger provinces, thus the gap between the province's fiscal capacity and the benchmark standard does not decrease as much compared with a province with a smaller population. Since this gap determines the province's entitlement, it does not fall by as much as a smaller province's.



One important observation from Table 5 is the effect of the fiscal capacity cap on claw back rates under any scenario. Any configuration that includes the fiscal capacity cap has higher claw back rates than those that eliminate the cap. Claw back rates are the lowest under 50% inclusion and increase as the rate of inclusion increases. However, even at a 70% inclusion rate there is still a significant incentive for provinces to develop their resource reserves.

**Table 5 Claw back rates under various scenarios\*: 2012-13 data**

| <b>50% Inclusion of Natural Resource Revenues</b>  |       |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|-------|
|  | PE    | NS    | NB    | QB    | ON    | MB    |
| <i>With GDP and Fiscal Capacity Cap</i>            | 87.4% | 94.8% | 79.1% | 57.0% | 32.7% | 86.9% |
| <i>Only with GDP cap</i>                           | 49.7% | 48.0% | 48.4% | 33.7% | 22.7% | 47.5% |
| <i>Only with Fiscal Capacity Cap</i>               | 88.5% | 96.6% | 80.0% | 72.0% | 30.6% | 88.8% |
| <i>No Caps</i>                                     | 49.8% | 48.6% | 48.9% | 38.4% | 30.6% | 48.2% |
| <b>70% Inclusion of Natural Resource Revenues</b>  |       |       |       |       |       |       |
|  | PE    | NS    | NB    | QB    | ON    | MB    |
| <i>With GDP and Fiscal Capacity Cap</i>            | 92.8% | 95.3% | 86.2% | 61.1% | 37.8% | 90.1% |
| <i>Only with GDP cap</i>                           | 69.6% | 67.3% | 67.8% | 47.1% | 31.8% | 66.4% |
| <i>Only with Fiscal Capacity Cap</i>               | 93.0% | 96.9% | 87.1% | 73.9% | 42.8% | 91.8% |
| <i>No Caps</i>                                     | 69.7% | 68.0% | 68.4% | 53.7% | 42.8% | 67.5% |
| <b>100% Inclusion of Natural Resource Revenues</b> |       |       |       |       |       |       |
|  | PE    | NS    | NB    | QB    | ON    | MB    |
| <i>With GDP and Fiscal Capacity Cap</i>            | 99.4% | 96.1% | 96.9% | 67.3% | 45.4% | 94.9% |
| <i>Only with GDP cap</i>                           | 99.4% | 96.1% | 96.9% | 67.3% | 45.4% | 94.9% |
| <i>Only with Fiscal Capacity Cap</i>               | 99.6% | 97.2% | 97.8% | 76.7% | 61.1% | 96.4% |
| <i>No Caps</i>                                     | 99.6% | 97.2% | 97.8% | 76.7% | 61.1% | 96.4% |

**\*The calculations for this table ignore the impact of the Offshore Accord on Nova Scotia's claw back rate.**

## **7.4. Fluctuating Cap**

### **7.4.1. Description**

This configuration of the program uses a program cap tied to the changes in standard deviation of the pre-equalization fiscal capacities of the provinces. The cap would function in the same way as the current cap but would not be tied to GDP. This change allows the costs of the program to fluctuate with changing fiscal fortunes of the provinces and not the national economy. Every year the standard deviation of the pre-equalization per-capita fiscal capacities is calculated. The percent change in standard

deviation from year to year is used to adjust the amount of funding available for Equalization. For example, if the standard deviation grows by 3% (disparities amongst the provinces increase) then the amount of program funding increases by 3% as well. Likewise, if the standard deviation declines by 3% (the fiscal capacities of provinces converge) the amount of funding available for Equalization would decline by 3%. This way the amount of funding available to Equalization is a function of the fiscal disparities among the provinces.

### ***7.4.2. Rationale***

The rationale behind this approach is that it ties the program cap to a more relevant measure of provincial need. As the disparities between provinces grow, more funding would be made available to equalize the gaps among provinces. As the disparities decreased there would be less funding for the program. However, there would still be a cap on the program.

### ***7.4.3. Political Feasibility***

Entitlements under this option are calculated the same way as under the Status Quo. This option only impacts the level of funding the federal government provides for Equalization. Figure 5 shows how funding under the Fluctuating Cap changes from year to year. The largest one year drop in funding from Figure 5 is roughly 6.3% (\$15.7 billion down to \$14.7 billion). While not all entitlements rise and fall proportionally to changes in overall funding (a result of the distributional effects of the GDP cap and the fiscal capacity cap) it is unlikely that any province's payment would fall by over 10% given a 6.3% decrease in overall funding. Furthermore, in the event that the Fluctuating Cap fell by over 10% this would be the result of converging fiscal capacities amongst the provinces. There are two possibilities that would cause this to happen: 1) receiving provinces become better off and are therefore in less need of equalization. 2) Non-receiving provinces become worse off and the benchmark for equalization falls, which would reduce entitlements under the formula. Under the principles of the program, either one of these scenarios would increase the acceptance of receiving provinces to receive smaller payments. For these reasons this option is considered to be politically feasible.

### 7.4.4. Cost

In the first year of this configuration the costs would be the same as the Status Quo. However, with the Fluctuating Cap the difference from this approach and the Status Quo will change from year to year. Figure 5 shows how the fluctuating cap performs against the GDP cap with regards to how much funding is available for the program under each configuration. As can be seen from Figure 5, the Fluctuating Cap is more volatile than the GDP cap. It responds more robustly to changes in fiscal disparities among provinces. Although the years in Figure 5 are too limited to observe any real trends, there is a sense that the Fluctuating Cap converges on the GDP cap in the long-run.

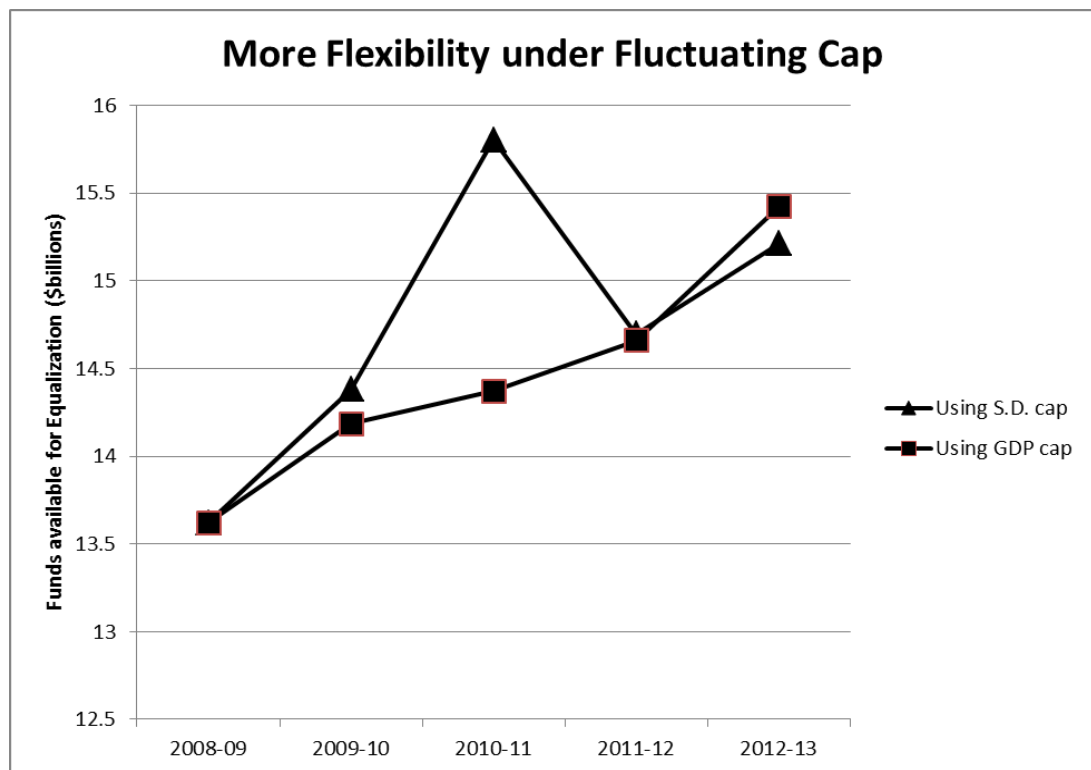


Figure 5 Standard Deviation Cap vs. GDP cap over last 5 years

### 7.4.5. Level of Equalization

In its first year the Fluctuating Cap would be set at the same level as the GDP cap (\$15.4 billion for 2012-13). Therefore the two caps would equalize at the same level (assuming the other details of the program remained the same). In years it allocated

more funding to the program it would have a greater effect on reducing the standard deviation of provincial per-capita fiscal capacities (equalize more). In years the Fluctuating Cap fell below the GDP cap it would have less effect on reducing the standard deviation (equalize less).

However, since the Fluctuating Cap reacts to changing disparities among the provinces, it allows the Equalization program to function more like an open-ended system. For this reason it can be said to have a consistent interpretation of the word 'comparable' from Canada's Constitution.

#### ***7.4.6. Impact on Incentive Structure***

Since the Fluctuating Cap only affects the level of funding available for Equalization, it has no effect on the incentive structures of the provinces to develop their natural resource reserves.

### **7.5. Status Quo**

The Status Quo option is a continuation of the program with the GDP cap in place. This is considered a politically feasible option since it is already in place and would not result in substantial decreases in Equalization payments. With regards to costs, Ottawa would not need to allocate any new funds to the program that it has not already anticipated. Under the Status Quo option policy makers could decide to adjust other policy levers of the program. For example, the inclusion rate of natural resource revenues is a variable that can be adjusted to change the claw back rates of receiving provinces and the distribution of payments across the receiving provinces. Another lever that policy makers can adjust under the Status Quo is the fiscal capacity cap. Removing this cap would not result in any additional costs (costs are contained under the GDP cap) but would affect the distribution of payments across receiving provinces. It would also reduce the claw back rate for some receiving provinces.

## 8. Conclusion and Recommendation

Based on the analysis of options, Table 6 has been created to compare how each option performs against the others for each of the evaluation criteria. The Median Benchmark option performs the least favourably. Its 100% claw back rate and its low efficiency (level of equalization criterion) make it a less attractive option compared to the Fluctuating Cap, the 70% Inclusion option and the Status Quo. It does present the opportunity for significant cost savings on the part of the federal government but the sharp decline in Equalization payments makes it politically unfeasible.

The option of equalizing hydro rents can be combined with any other option. As a stand-alone measure to reduce the costs of the Status Quo below the level of the GDP cap, it does not fulfill its purpose. However, implemented as a component of any other option it serves to better reflect the true fiscal capacities of the provinces and can help in reducing costs.

The Fluctuating Cap option uses the growth rate of the standard deviation of the per-capita provincial fiscal capacities as the guide for its cap. The costs of this option are comparable to the costs of the Status Quo. In years when the fiscal capacities of the provinces converge there is opportunity for cost savings. In the years the fiscal capacities diverge program costs grow at a rate similar to the rate of growth under the GDP cap. The option is politically feasible since changes to entitlements are unlikely to fall by 10% from year to year. With regards to the option's interpretation of the word 'comparable' it is consistent and therefore is seen as a more principled solution than the Status Quo.

**Table 6 Criteria Matrix: A comparison of options across criteria**

|                               | Political Feasibility                               | Cost (Difference from S.Q.)                                 | Level of Equalization (reduction in S.D) | Interpretation of 'Comparable' | Impact on Resource Revenue Incentive Structure |
|-------------------------------|---|---|--|--------------------------------|--|
| <b>Median Benchmark</b>       | Significant loss of political capital to unfeasible | -\$6.5 billion  | 20%                                      | Consistent                     | 100% claw back                                 |
| <b>Equalizing Hydro Rents</b> | Feasible with some loss of political capital        | \$1 billion - \$2billion                                    | N/A                                      | Tied to GDP                    | N/A  |
| <b>Fluctuating Cap</b>        | Feasible  | Short-run: -\$0.2 billion to \$1.5 billion<br>Long-run: \$0 | N/A                                      | Consistent                     | N/A  |
| <b>70% Inclusion</b>          | <b>Capped</b>                                       | \$0   | 24%                                      | Tied to GDP                    | 32%-70% claw back                              |
|                               | <b>Uncapped</b>                                     | \$5.5 billion   | 27%                                      | Consistent                     |  |
| <b>Status Quo</b>             | Feasible  | \$0   | 24%                                      | Tied to GDP                    | 33%-95% claw back                              |

The uncapped configuration of 70% inclusion performs well on all criteria except cost. Uncapping the program would require a significant increase in federal spending or significant cuts in other programs. For this reason this option is not recommend. The capped configuration of the 70% Inclusion rate option performs similarly to the Status Quo. The major difference between the two is that the Status Quo has significantly higher claw back rates due to the fiscal capacity cap. Therefore the 70% inclusion option provides more incentives for provinces to develop their natural resources.

To conclude, the Fluctuating Cap option beats out the Median Benchmark option and the Uncapped option as the best alternative to the Status Quo for establishing the level of funding for Equalization. The Fluctuating Cap option can be strengthened by increasing the resource revenue inclusion rate from 50% to 70% and eliminating the

fiscal capacity cap. Furthermore, it was also found that cost savings can be realized by accounting for hydroelectric rents under the RTS.

The objective of this study is to find a more principled alternative to the GDP cap while acknowledging the federal government's funding limitations. The Fluctuating Cap option is a more principled based approach to Equalization that satisfies the program's funding limitations. This option also allows for improvements to be made to the rate of resource inclusion and the accounting of hydroelectric rents. For these reasons it is recommended that policy makers consider these options for future configurations of the program.

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## **Appendices**

## Appendix A.

### Description of Interviewees

|     | <b>Area of Expertise</b>  | <b>Region</b> |
|-----|---|---------------|
| 1.  | Former federal finance official – Advised government on Equalization and involved in Expert Panel | Ottawa        |
| 2.  | Former finance official in Alberta and on the Expert Panel  | Alberta       |
| 3.  | Academic with several papers on Equalization  | Toronto       |
| 4.  | Former federal finance official in the Equalization division and involved in the Expert Panel     | Ottawa        |
| 5.  | Retired federal finance official in fiscal policy branch  | Ottawa        |
| 6.  | Provincial finance official in receiving province   | Halifax       |
| 7.  | Current federal finance official in federal transfer policy division                              | Ottawa        |
| 8.  | Public policy researcher with decades of experience studying Equalization                         | Toronto       |
| 9.  | Retired federal finance policy manager who at one time oversaw the program                        | Ottawa        |
| 10. | Retired federal finance official who worked on Equalization policy                                | Ottawa        |
| 11. | Academic who has written review of program  | Regina        |

## **Appendix B.**

### **A Macro Approach**

As a result of the RTS's limitations, there is a debate on whether it should be abandoned in favour of another approach. The most commonly cited alternative is the 'macro-indicator' (Expert Panel (2006), Marshall (2006), Boothe and Hermanutz (1999)). Boothe and Hermanutz (1999) propose using a heavily manipulated personal income indicator as a macro indicator for determining equalization. Marshall (2006) puts forward an altered version of the RTS that uses GDP in place of tax bases. Instead of using the national tax average, Marshall proposes using per-capita revenue raised by governments divided by per-capita national GDP. This then gives the rate by which per-capita provincial GDP is multiplied to determine fiscal capacity. Marshall argues that by eliminating unique tax bases and replacing them with a macro-indicator the claw back and distortion effects are neutralized. This is because, "...any policy decision the provincial government were to take would have an insignificant impact on the national average tax rate and the rate of Equalization compensation" (Marshall 2006, 36).

The Expert Panel (2006) discusses the various macro approaches and points out that any macro-indicator would still require a significant amount of manipulation to become a fair indication of fiscal capacity among provinces. This therefore erodes any gains in simplicity. The Expert Panel also points to ways an indicator such as GDP would reflect differently across provinces. Different portions of GDP are more taxable than others, therefore using GDP as indicator would not adequately convey the different tax policies of the provinces. This issue of tax exportation is also identified. Provinces that raise royalties from resource extraction are able to boost their fiscal capacity by collecting royalties but these are not directly reflected in the province's GDP. Therefore comparing the GDP of such a province to one that didn't export natural resources would inappropriately reflect the disparities in their fiscal capacities. For these reasons the Expert Panel is reluctant to embrace the use of a macro-indicator. It is also recognized

that the RTS best reflects the different tax policies across the provinces and this makes it a better fit for the language used in the constitution (Expert Panel 2006, 48). It should be noted, however, that the Expert Panel's recommendation (now adopted) to reduce the number of tax bases under the RTS to five instead of thirty-three does to some effect address the above issues favourably. Acknowledging that there may one day be a method more favourable than the current five-base RTS for calculating Equalization, this analysis does not investigate the matter any further. Instead the presented policy options of this study use the five-base RTS and focus on other means of addressing the balance between affordability and principles.

## **Needs vs. Capacity**

The Equalization Payment program has always used a province's fiscal capacity as the central objective of equalizing. However, a number of studies acknowledge the desire that exists by some to reform the system to cater to a province's service needs instead. Such schemes would potentially ensure uniform standards across the country such as teacher to student, doctor to patient, etc. Most recently, a study by the Ontario Chamber of Commerce went as far to point out differences in these measures among provinces as evidence that the program was not working (MacKinnon, 2011). Adopting a needs-based approach risks overlooking the fact that different provinces have different needs. For example, a province with an aging demographic will require more healthcare workers per-capita to look after the older population. Equalizing based on fiscal capacity allows provinces to identify and address their own unique needs. The Expert Panel (2007) points out that a system which equalizes fiscal capacities as opposed to needs is better suited for Canada's de-centralized federal-provincial relations (Expert Panel 2006, 46). Accepting the arguments for maintaining a program focused on fiscal capacities and dismissing the arguments for a needs-based approach, the options proposed in this study are rooted in maintaining the fiscal-based approach.