HOW WELL IS THE EQUALIZATION SYSTEM REDUCING FISCAL DISPARITIES?

by

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1. Introduction

Equalization is a cornerstone of the Canadian federation. Its intent is to enable all Canadians to have access to reasonably comparable levels of public services regardless of their province of residence. As such, it is a prerequisite for both efficiency in the internal economic union and the important equity objective of equal treatment of equals in all parts of Canada. Equalization should facilitate the decentralization of fiscal responsibilities to provincial and local governments, which is a defining characteristic of federations. It should do so in a way that does not compromise the discretion of these orders of government to pursue their objectives in the way they see most fit. Equalization also complements the complex system of interpersonal redistribution at both the federal and provincial levels of government. While the latter is concerned largely with equalizing access to private goods and services among households with different incomes and wealth, equalization is concerned with equalizing access to public services among households of a given type in different provinces.

The principles on which equalization should be based are widely accepted. They are explicitly set out in Section 36 of the *Constitution Act*, 1982, which reads as follows:

(1) *Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to*

   (a) *promoting equal opportunities for the well-being of Canadians;*

   (b) *furthering economic development to reduce disparity in opportunities; and*

   (c) *providing essential public services of reasonable quality to all Canadians.*

(2) *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.*

Although Section 36(2) is the part that is primarily relevant for equalization, the two

parts should be considered jointly. The two main federal-provincial transfer components—equalization and social transfers—jointly contribute to the obligations of both parts. The equalization system is designed mainly to achieve the objectives of Section 36(2), but it also provides funding for spending programs that are crucial to the commitments of Section 36(1). Similarly, the social transfers are implicitly equalizing in their design, as much so as the equalization system per se.

Concerns have been expressed by the Province of Prince Edward Island that the current equalization system is not satisfactorily addressing the commitments set out in Section 36. For one, there are a number of structural problems with equalization—outlined in more detail below—that systematically lead to both under-equalization in total and uneven treatment across provinces. For example, some provinces with substantial natural resource endowments and high property values are favoured under the program relative to other provinces. Related to these structural problems, there has been a history of ad hoc changes made to the equalization system, most recently in the 2004 federal budget, that have compromised the integrity of the equalization system when judged against the principles of Section 36(2). Finally, evidence presented in the recent budget indicates that, even according to the criterion embedded in the current equalization system, significant fiscal disparities remain between the have-not and the have provinces, particularly Alberta. For example, Alberta's per capita revenue-raising capacity is more than 50 percent higher than the standard entitlement to which the have-not provinces are equalized. Given that much of this is due to oil and gas revenues, this differential is likely to increase considerably in the coming years. The purpose of this study is to consider these concerns and to provide policy recommendations to address them.

Our approach in what follows is to evaluate equalization mainly in terms of the commitment set out in Section 36(2), though with one main caveat. Our emphasis will be mainly on revenue equalization, reflecting the orientation of the current equalization system. In principle, Section 36(2) would require differences in needs for public services to be incorporated in equalization entitlements. The current system of federal-provincial transfers implicitly assumes that needs are equal per capita in all provinces. Needs could in prin-

ciple be incorporated into the equalization or social transfer system. However, doing so would have no impact on the design of the revenue equalization component.

Within the confines of revenue equalization, there are two dimensions along which equalization can be evaluated. One is its adequacy with respect to the size or extent of equalization overall. The other is its fairness among equalization receiving provinces. Although these two are interrelated—under-equalization may well work to the relative disadvantage of some provinces—it is worth maintaining a conceptual distinction between the two.

In what follows, we begin with a review of the broad features of the current system. We then outline as a benchmark what would be required for revenue equalization to be full, and discuss some of the problems with implementing such a system. Next, deviations of the existing system from the ideal are recounted along with some of their consequences. Some current proposals for reform are then evaluated, and finally a preferred list of potential directions for reform is presented.

2. Review of the Main Features of the Current System

The equalization system is often criticized for being complicated, and no doubt the detailed calculations that Finance Canada must do to implement it are complicated. But, the basic methodology is easy enough to understand. Equalization entitlements are based on the main revenue sources that provinces actually use, 33 of them in total. For each revenue source, a province's per capita equalization entitlement is proportional to the difference between that province's per capita tax base and a five-province standard per capita tax base. The proportion used is the national average provincial tax rate for that revenue source. Thus, for revenue source i, province k's per capita equalization entitlement e_i^k is simply:

$$e_i^k = \overline{t}_i(\overline{b}_i - b_i^k) \tag{1}$$

where $\overline{t}_i$ is the national average provincial tax rate applied to revenue source i and $\overline{b}_i$ is the average per capita tax base in five 'standard' provinces (British Columbia, Saskatchewan, Manitoba, Ontario and Quebec). This calculation is repeated for each of the 33 revenue sources and an aggregate per capita entitlement is calculated by summing up the

entitlements by revenue source for each province.[1] For those provinces with positive aggregate entitlements—the have-not provinces—equalization payments are made, while for those with negative entitlements, no payments are made. This method of calculating equalization entitlement is called the Representative Tax System (RTS) approach, using a five-province standard. It is referred to as a 'gross system', whereby only positive equalization entitlements are paid, as opposed to a net system which makes both positive and negative transfers. Note that the equalization entitlements are based on actual provincial tax systems rather than some hypothetical nationally determined standard. This is fully consistent with the principles enunciated in Section 36(2).

The above methodology is subject to some special provisions that affect the operation of the RTS system for particular revenue sources. First, there are two provisions to deal with the year-to-year variation in entitlements. A floor provision temporarily protects equalization recipients from changes that would cause their entitlements to fall below a certain threshold. As well, with the 2004 five-year renewal, equalization entitlements are to be smoothed out using a three-year moving average procedure.

Second, there are provisions that can affect the treatment of natural resources in selected provinces. The so-called generic solution means that for provinces that have at least 70 percent of a given revenue source, only 70 percent of the base enters the equalization calculation, so that 30 percent goes unequalized. When the generic solution was introduced, it applied to asbestos in Quebec and potash in Saskatchewan, though these no longer apply, but does continue to apply to the offshore revenues of Newfoundland and Nova Scotia. The Offshore Accords applying to oil and gas offshore from these provinces allow them the option of using the generic formula each year to shelter a proportion of their revenues from equalization, effectively ensuring that they do no worse than that.

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[1] In fact, the calculation is slightly more complicated for some revenue sources. For example, the personal income tax base used up to this year accounts for the fact that different tax rates apply to different tax brackets by disaggregating personal income into several income ranges and applying a separate national average tax rate for each. This has the effect of treating each tax bracket as a separate revenue source. As noted below, this system will be replaced by one that uses each of the province's actual tax structures, but whose effect is also to account for the fact that tax rates differ by income levels.

Finally, the treatment of the property tax base represents a major departure from the RTS principle, largely—but not entirely—for historical reasons. Until the 2004 renewal, actual provincial-municipal property tax bases were not used in defining the property tax base for equalization purposes, reflecting in part the fact that provincial practices were very different. Instead, a macro-type criterion was used. However, now that provinces have moved to market value assessment for properties and their assessment methods are relatively uniform, it has become feasible to use actual market values to determine per capita property tax bases in each province. This has been recognized in the 2004 renewals as market values will be used to compute 50 percent of the residential property tax base (though none of the commercial, industrial or farm property tax bases). The remaining 50 percent will be computed using the old macro-type method. At the same time, special consideration is given to British Columbia to protect it from the impact of moving to an assessed base, in view of their high property values. This represents a step in the direction of RTS principles. Note that the change will not take effect immediately because the new averaging provision introduced with the 2004 reforms implies that there will be delays in moving to the new system.

In addition to these special provisions, there are aspects of the calculation of certain bases that some observers have suggested are anomalous. For example, it has been argued that the calculation of the value of Crown leases does not accurately reflect the ability to raise revenues from that source (Courchene, 2004). As well, a longstanding concern with public utilities, especially hydro, is that part of their profits are dissipated in reduced prices to consumers thereby causing fiscal capacity to be understated. And, some dispute exists about the fact that user fees are not comprehensively included as a revenue source.

It should also be noted that the system of social transfers—the Canada Health Transfer (CHT) and Canada Social Transfer (CST)—is also a very effective revenue equalization system. The combination of financing from federal general revenues and virtually equal per capita transfers makes it essentially equivalent to a net equalization system. Federal tax room substitutes for provincial revenue-raising, and the transfers combined with their financing implicitly redistribute from provinces with large tax bases to those with small

ones. Moreover, the technical details of social transfers incorporate the principle of a net equalization system more directly. The CHT and CST are calculated based on both a cash transfer and the value of income tax points that were transferred from the federal government to the provinces in 1977. These tax points are equalized, and the value of equalized tax points are still used to calculate the cash transfer under the CHT and CST. Because these equalized tax points are worth more to the have provinces than to the have-nots on a per capita basis (since the have provinces are not equalized), cash transfers to the have provinces are reduced accordingly, replicating to a small degree what would be done under a net equalization scheme.

3. Ideal Revenue Equalization and its Problems

In evaluating the structure of the current system, it is necessary to enunciate a benchmark. The benchmark we have chosen is one that most closely reflects the principles underlying Section 36(2) above. It is not necessarily one that policy-makers will regard as feasible, but it is a useful ideal to which one might aspire. And, it is an appropriate standard of comparison against which to judge the existing system and the alternatives that have been suggested.

The Ideal Benchmark

As mentioned, we focus on revenue equalization, assuming that the equalization system should provide enough revenues so that all provinces could obtain comparable revenues using comparable tax rates. The RTS system is suitable for this purpose. Setting aside technical implementation and economic incentive problems—to which we return below—this criterion would be satisfied by a so-called net equalization system using all revenue sources and a ten-province standard. A net equalization system is one that makes both positive equalization payments to those with positive entitlements and negative payments to those with negative entitlements. As a consequence, all provinces end up with the same revenue-raising capacity.

A net equalization scheme on its own might be regarded as infeasible since it requires an extraction of revenues from the have provinces. There are two ways this can be circum-

vented in principle. First, the federal government can combine the equalization system and the CHT/CST system in a way that effectively equalizes the have provinces down without requiring them to transfer revenues. In effect, the have provinces' negative equalization entitlements can be deducted from their CHT/CST per capita entitlements. While this is a feasible way to avoid assessing negative entitlements, it has the disadvantage that it erodes social transfers to the have provinces and reduces whatever federal spending power influence those might buy over provincial program design in health, welfare and post-secondary education (which is presumably part of their intent).

An alternative approach is to leave equalization as a stand-alone program implemented on a gross basis. In this case, for full equalization to be achieved, a *top-province standard* would have to be used rather than a ten-province average standard. That is, even a full ten-province standard would under-equalize relative to the principles of Section 36(2). This is obviously a stark message, and one that will not resonate well with the federal government in the sense that it would entail a substantial increase in equalization program costs. Nonetheless, it is where the logic of Section 36(2) leads, and at the very least, it serves as an ideal against which to judge alternative proposals.[2]

Problems with Ideal Revenue Equalization

The ideal equalization benchmark indicates the extent of equalization needed to ensure that all provinces could, if they so chose, raise comparable amounts of revenue per capita using comparable tax rates. Applying it would entail a greater level of equalization than the current system, as well as some differences in the structure, primarily the avoidance of special treatment of particular revenue sources. Any equalization system faces issues of interpretation and implementation. It is convenient to divide these notionally into three categories: conceptual issues, economic issues and implementation issues.

Conceptual Issues

A key feature of the RTS system—and one that distinguishes it from macro-based

[2] It might be recalled that when the RTS was first introduced in 1957, the standard used was the top two provinces, albeit with a limited number of tax bases.

alternatives—is that it relies on actual provincial behaviour to determine national norms of revenue-raising capacity. This is a highly appropriate property that is worth preserving in any future reforms, but it is one that is inevitably ambiguous to implement when provinces make different fiscal choices. Provinces can define their tax bases in different ways, and they can impose different rate structures on their bases. These problems arise in the current system, and reasonable ways have been devised for dealing with them.

The problems are particularly important in some of the larger revenue sources, like the personal income tax, the sales tax and the property tax. In the case of the personal income tax, it is largely differences in the rate structure that are the issue. This has been dealt with in the past by stratifying the personal tax into income classes each one of which has its own national average tax rate. With the 2004 renewals, this will be replaced by a systems approach in which a separate set of entitlements is calculated using each province's income tax system, and a weighted average of these is taken with weights being each province's share of income tax revenues. (This approach is currently used for the Hospital and Medical Care Insurance Premiums revenue base.)

The sales tax case involves different choices of base among provinces, some retaining a relatively narrow retail sales base, while others opting for a value-added format. A representative tax base and rate is somewhat more difficult to define in this case, so an arbitrary compromise is necessary. Two approaches can be taken to this. In one, a national average sales tax base can be defined that somehow involves a compromise among existing provincial tax bases. Then, the RTS approach can be applied using that tax base and a measure of the national average provincial tax rate constructed using sales tax revenues divided by the size of the representative base nationwide. Alternatively, one could again use the systems approach whereby each province's tax structure is used to calculate a set of entitlements, and a weighted average is taken of these.

The property tax case is perhaps the most problematic because property tax rates tend to differ across municipalities in any given province. In these circumstances, it is difficult to define a representative provincial property tax structure since the mix of municipalities differs considerably across provinces. And, it is also difficult to apply the systems approach.

Some form of stratified approach can feasibly be applied, but again it is bound to be a compromise. Notably, among the major tax bases, the property tax is the only one that has not used the RTS approach based on actual provincial practices to determine equalization entitlements. As mentioned, one of the revisions in the 2004 renewal has been to move partially in that direction.

Another important conceptual issue concerns the treatment of resource tax revenues. It has long been recognized that there is an apparent conflict between two fundamental principles: Section 36(2) and the provincial right to the ownership of resource revenues.[3] On the one hand, Section 36(2) calls for the equalization of the ability of provinces to raise comparable amounts of revenue using comparable tax rates, which seemingly requires full equalization of resource revenues. On the other, it is argued that full equalization amounts to confiscation of the property rights of provinces and essentially negates the provincial ownership of resources. Obviously, some judgment is involved here. However, it can be argued that the principles of Section 36(2) take precedence. There is no analogous statement of the rights of the provinces to resource rents generated within their jurisdictions, only a right to tax resources freely (Section 94A). But, the federal government also has an unlimited constitutional right to tax resources incomes. The existing system of equalization generally includes resource revenues fully in the RTS system, symmetrically with all other revenue sources. Exceptions to the rule—such as the generic solution or the offshore accords—are based on incentive and implementation problems rather than principles of provincial entitlements. We proceed on the assumption that the commitments of Section 36(2) trumps provincial ownership entitlements, and that in principle resources ought to be equalized on a footing comparable to other revenue sources, subject only to compromises required by incentive or implementation arguments.

Finally, we simply recall that Section 36 entails more than revenue equalization. It would also in principle require equalization for differences in the needs provinces have for revenues

[3] This conflict formed the basis for the alternative proposals put forward by the Economic Council of Canada (1982), based on the study by Boadway and Flatters (1982). More recently, the conflict has been highlighted by Usher (1995), Feehan (2004) and the Newfoundland and Labrador Royal Commission on Renewing and Strengthening Our Place In Canada (2003).

to finance public services targeted to particular groups, since the importance of those targeted groups can vary from province to provinces. While needs equalization may well be desired on those grounds, that can be regarded as a separate issue that can be pursued separately. Any needs equalization can be done as an add-on to revenue equalization without affecting arguments for the latter.

Economic Issues

The economic issues surrounding equalization are well-known, and can compromise the extent to which the ideal system can be implemented in full. First, there are a number of issues concerning adverse incentives that inevitably accompany any fiscal transfer system. Provinces can influence their own equalization entitlements to the extent that they can influence any of the three elements entering into the above formula (1) for a given tax base: the national average tax rate, $\overline{t}_i$, the national standard per capita tax base, $\overline{b}_i$, and the province's own per capita tax base, b_i^k. The first two will be relevant only if the province has a significant proportion of the tax base in question. In these circumstances, the province's entitlement, $\overline{t}_i(\overline{b}_i - b_i^k)$ will be negative, and the province will have an incentive to set their own tax rate t_i too low. The generic formula, which is triggered by a province having at least 70 percent of the national base, is intended to deal with this issue.

A more pervasive incentive problem arises when a province can influence the size of its own base, b_i^k. To the extent that tax bases are elastic, an increase in the tax rate will cause the base to fall. Since this will increase equalization entitlements, it implies that there is an incentive for provinces to set their tax rates excessively high, although it is not clear how much they really act on this incentive.[4] A more important adverse incentive arises for tax bases over which the province has direct control. An important case in point might be natural resource revenues. To the extent that provinces control the pace of resource

[4] In fact, this incentive to set tax rates too high might simply counter an incentive in the opposite direction arising from tax competition to set them too low (Smart, 1998). Overall, it is not clear which direction dominates. Some authors have also argued that the elasticity of tax bases per se can effect the optimal equalization scheme (Dahlby and Wilson 1994). According to this argument an equalization system should take account of the relative costs of raising revenues in different provinces. Although this argument has some merit, it is not clear how it should affect the design of actual equalization systems.

development, they may be induced to do so too slowly since increases in the base will result in a indirect tax-back through equalization. Indeed, revenues from resource developments can be taxed back through equalization at close to 100 percent rates if provincial tax rates are close to the national average. In the case of the Offshore Accord, the tax-back rate is precisely 100 percent since these are treated as unique revenue bases and neither Newfoundland not Nova Scotia are in the five-province standard.

Although this is in principle an important effect, some observations should be made about its importance. First, the normative significance of high tax-back rates for resources can be overstated. Since the whole purpose of equalization is to equalize differences in the ability to raise revenues, high tax-back rates are an inevitable and even desirable consequence. Moreover, exactly the same high tax-back rates apply to any tax base. The only valid reason in my mind for singling out natural resources for attention is the presumption that provinces have more discretion over natural resources than over other bases. This means that any pleading for special treatment for resources must be based on this incentive effect being large. If it is—and the case needs to be made—one has the equivalent of an equity-efficiency trade-off, and an argument might be made for reducing the rate of natural resource tax back on those grounds. Note further the important point that if a case is made on incentive grounds for reducing the rate of tax-back, that case does not depend on the province having a significant share of the national base. Moreover, special treatment on incentive grounds should not affect the standard to which non-resource-owning provinces are equalized. To do so would penalize the latter unnecessarily. We return to this point below.

A further problem that affects the extent of equalization in general and of particular revenue sources concerns differences in price levels. Put simply, if one province has systematically higher prices than another province, the cost of living will be higher and that will affect the real value of given amounts of nominal tax revenues raised. An equalization system that uses nominal values will tend to understate equalization entitlements of provinces that have high costs of living. This turns out to be of particular importance for the equalization of property taxes. If property values are higher in one province than in

another simply because of the scarcity of land, those higher values do not indicate higher abilities to raise property tax revenues. Only to the extent that the higher values reflect some benefit, such as an amenity value, larger houses or lower transportation costs, will the ability to raise revenues be reflected in property values. This will be important in determining the extent to which differential property values should be equalized. In practice, it is difficult to know the extent to which higher property values in one province or community reflect scarcity as opposed to housing benefits, so some compromise is inevitable. The upshot is that as far as the case for equalizing on the basis of market values is concerned, it is fully appropriate except to the extent that property tax values reflect pure scarcity values per unit of housing.

Related to this are differences across provinces in the cost of providing public services. As with needs differences arising from differences in demographic make-up across provinces, differences in the cost of providing public services affect the ability of provinces to meet the commitment of Section 36(2). However, while on economic grounds, needs differences should in principle be fully equalized, that is not the case for differences in costs. If it takes more resources to provide a given level of public services in two different locations, a standard efficiency-equity trade-off is involved, and it is not generally optimal to provide comparable levels of public services in the two locations. This is clearly the case between, say, urban and rural locations within a given province. But it is also the case between provinces. Taking account of these cost differences would be a complicated matter, just like taking account of differences in the cost of living would be. Moreover, it is not at all clear which way the influence would work. That is, it is not obvious whether have-not provinces have higher costs than have provinces, so it is not clear whether equalization should be more or less complete on this account.

A particular case of cost differences relates to population differences. It might be argued that per capita costs of public services fall with population because of overhead costs and economies of scale. If this were the case, the cost of providing public services would be higher for less populated provinces. A case could be made for only partially compensating for these differences in cost on the grounds that an equity-efficiency trade-off precludes

full compensation. Nonetheless, low-population provinces would still be entitled to some additional equalization on that account relative to high-population provinces. Whatever the validity of this argument, it would have to be substantiated empirically and set against other sources of differences in costs among provinces. The current state of knowledge is not sufficient to warrant incorporating costs into equalization.

Courchene (1984, 2004) has raised the issue of costs of raising revenues as a consideration in determining revenue equalization entitlements. The case is put in terms of resource revenues, and takes the form of arguing that since resource properties are in remote areas, infrastructure costs are borne by the government as a prerequisite to obtaining revenues from these sites. While there is a certain seductive quality to this argument, there are conceptual problems with applying it. For one thing, it is not clear what kinds of costs should be eligible. Presumably, provincial tax bases are also affected by expenditures such as education and health care, and it is not obvious why these should not be eligible costs. As well, implementing such a system even for infrastructure costs would be difficult. It would be hard to identify which costs are eligible. And, any attempt to cost precisely would cause incentive problems. Even to use this as an argument for reducing the proportion of resource revenues subject to equalization would be difficult since presumably very different costs apply to different types of resources in different provinces.

Another resource-related argument applies particularly to provincially run hydro-electricity corporations. A longstanding argument has been that, unlike with other resources, their rents do not show up only as provincial revenues, but are partly passed on to resident firms and households in lower electricity prices. Calculations done in the 1970s indicated that their order of magnitude was comparable to oil and gas revenues at the time. From an equalization perspective, it is as if rents were collected and then passed on to users of electricity as subsidies. An argument can be made that since these go unequalized, equalization entitlements are over-estimated for hydro-intensive provinces and under-estimated for others.

Equalization is said to fulfill other functions besides those set out in Section 36(2). One of these is to provide some insurance to provinces against adverse shocks. The argument is

that the federal government is better able to pool the risks faced by individual provinces. To the extent that this is the case, equalization should smooth provincial revenues over time. On the other hand, if shocks faced by the provinces are correlated, smoothing will not occur. Indeed, there is some evidence that provincial revenues may actually be destabilized by the equalization system (Boothe, 2002; Boadway and Hayashi, 2004; Smart, 2004). In these circumstances, there will be a trade-off between the redistribution function of equalization and its risk-sharing role that can be addressed by smoothing out equalization payments themselves over time. A moving-average procedure, which phases in changes over a period of time, is suitable for this purpose. The length of time that should be used is a matter of judgment and depends on the periodicity of equalization payments that have been observed in the past, and that might be expected in the future. A length of time that is too short will not succeed in averaging fluctuations that occur over longer periods, while one that is too long will delay the response to more permanent changes in fiscal capacities. A three-year period might seem to be reasonable, although a five-year moving average is used in Australia.

Finally, it is argued that the case for equalizing provincial fiscal capacities cannot be evaluated independent of other fiscal programs that have a regional bias in them. Thus, for example, programs like employment insurance, regional development programs and procurement may systematically favour have-not provinces relative to other provinces. This may well be the case, but two responses can be made. First, if it is perceived that unwarranted biases exist in particular programs, they should be addressed by reforming those programs directly rather than interfering with equalization. Second, these arguments often confound the purpose of equalization with those of other programs. Equalization is intended to equalize the ability to provide public services, and not to promote income equality across persons or regions. Programs that do the latter complement equalization rather than substitute for it.

Implementation Issues

Along with conceptual and economic issues involved with achieving the ideal equalization system that conforms fully with the commitment of Section 36(2), there are implementation

problems that would have to be surmounted. Most of these have been alluded to already so they can be recounted briefly. First, a net system may not be feasible, and a gross system would be relatively expensive for the federal government, and would require it to equalize disparities arising from some tax bases to which it does not have direct access. Note, though, that full equalization using a gross system—as opposed to a net system, which is self-financing—would not involve any increase on the overall burden of taxes on Canadians. Rather, it would require a shift of existing tax room from the provinces to the federal government.[5] Moreover, even this could be limited by incorporating some revenue equalization into the social transfer system. And, as we shall argue below, there are some ways that the federal government could even get a larger share of revenues from natural resources.

Second, there are problems associated with heterogeneity of provincial behaviour. The fact that provinces use different tax bases, different rate structures and different tax-expenditure mixes makes it impossible to equalize fiscal capacities exactly since the concept of equal fiscal capacities is inherently ambiguous. In practice, compromises must be made in applying the RTS system, and those compromises will be more significant the more decentralized is the federation. The systems approach taken in the case of the personal income tax, which as mentioned is to use a weighted average of entitlements calculated by applying each province's tax system separately, is a reasonable compromise.

Some problems of heterogeneity arise not so much from provincial behaviour as from the nature of the revenue sources themselves. We have already mentioned the case of property tax revenues and the fact that differences in property values across provinces—or even within provinces—can reflect pure scarcity values, in which case they should not be equalized, or benefits to the owners of the property, in which case they should be.

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[5] This important point may seem paradoxical, but can be easily explained. Moving from a net to a gross equalization system requires the federal government to increase its tax revenues. That increase in tax revenues just equals the increased transfers to the provinces required under a gross equalization system. Therefore, the provinces can just maintain their level of program expenditures by reducing their own tax revenues. On balance, the rise in federal tax revenues just offsets the decline in provincial tax revenues, implying that there is no additional tax burden on citizens.

Measurement problems also arise in the case of natural resources. Resource properties in different locations can be of very different quality, and these differences ought to be reflected in the equalization base for resource revenues. In fact, that is not the case. Resource tax and royalty schemes do not adequately reflect the cost of extracting the resource and the ability of a province to extract revenues. Applying a national average tax rate to conventional resource tax bases may not be a good reflection of revenue-raising capacity.

4. Deviations of the Current System from the Ideal

Quite apart from these problems of measurement and implementation, the current system deviates from the ideal in a number of important general ways, many of which are implicit in our above discussion. A catalogue of some of the more important are listed first, followed by a brief discussion of their consequences.

Shortfalls of the Existing System

The combination of a gross equalization system that only applies to the have-not provinces plus a five-province standard means that the extent of equalization falls short of the ideal, which calls for full net equalization using a ten-province standard, or equivalently, gross equalization using a top-province standard. An exception to this concerns the CHT/CST transfers. As mentioned, an equal per capita transfer financed from federal general revenues is equivalent to a full revenue-equalizing system since is provides the same level of revenues per capita to all provinces.

Beyond the general problem of the standard, there are two areas of particular concern. One is the treatment of resource revenues. A major consequence of the five-province standard is that not only is Alberta not subject to equalization—since its large negative entitlements are not equalized down—but also its vast oil and gas revenues are not included in the standard that determines payments to the have-not provinces. In addition, there are some special cases that affect particular types of resources in particular provinces. One of these is the generic solution which, although perhaps of secondary importance in its own right, nonetheless represents a form of special treatment that some argue should be

extended more generally to other resource revenues, as discussed further below. Likewise, the offshore accords applying to Nova Scotia and Newfoundland represent a form of special treatment to revenues from offshore oil and gas that is at least as generous as generic treatment. All other resources in the have-not provinces are fully equalized on a par with non-resource revenues.

The other revenue source where inadequacies are apparent is the property tax base. It represents a major exception to the rule that equalization be based on the actual taxing practices of the provinces. While there is some movement in the direction of RTS principles in the 2004 renewal, it is quite piecemeal and selective by province. Market valuation of properties is only used for half of the residential property tax base, and even then special treatment is afforded to British Columbia, whose residential property values are above the average. Despite the development of a methodology that takes account of the fact that higher property values may not reflect higher ability to raise revenues, this methodology has not been fully adopted. Rather, as discussed further in the next section, an ad hoc approach is used whereby market values are reduced by 30 percent in nine provinces and 50 percent in British Columbia before calculating that part of the equalization entitlement where market values are used.

Finally, some structural issues exist that could compromise the equalization system to some extent. The floor provision remains intact despite the move to a three-year averaging system intended to smooth fluctuations in entitlements. There may be problems with the way in which resource bases are measured for equalization purposes, given the fact that the base used for taxation may not fully reflect the profitability of the resource and therefore the potential for extracting provincial revenues. And, the complete absence of needs and costs—including the costs of raising various sorts of revenues—from the calculation of entitlements represents a deviation from the ideal.

Consequences of Deviation from the Ideal

As mentioned, inadequacies in the equalization system can conceptually be disaggregated into two types: those that affect total entitlements and those that affect the allocation of

entitlements among provinces. Although there is some uncertainty about the quantitative effect of all deviations from the ideal, some general qualitative comments can be made.

Evidence of under-equalization can be seen in the 2004 federal budget papers where it is reported that, even using the five-province standard, Alberta has an unequalized excess over and above the five-province standard per capita revenue raising ability of about 50 percent, while Ontario is above the norm by a much lesser amount. Perhaps more important from the point of view of the have-not provinces is the use of the five-province standard. Comparison with the ten-province standard is relevant in this regard, even if the system is a gross one. Since the four lowest-income provinces and Alberta are all left out of the five-province standard, in principle the standard could be higher or lower under a ten-province standard. Some documentation has been provided by the Senate Standing Committee on National Finances (2002). They have calculated that, had a ten-province standard been in effect during the period 1994–5 to 2001–2, total equalization entitlements would have been almost 20 percent higher than under the five-province standard. Moreover, all have-not provinces would have gained. Prince Edward Island, for example, would have gained $156 million over the period. The amount of that gain could well be much higher now with the surge in oil and gas revenues accruing to Alberta in more recent years.

The special natural resource provisions (over and above those implied by the five-province standard) tend to have more of an effect on inter-provincial equalization allocations than on the total. That is because most of them apply to bases located in provinces that are not part of the standard. Thus, the Offshore Accords, which guarantee no worse than generic provision treatment, benefit Nova Scotia and Newfoundland exclusively, although the generic provisions have benefited Saskatchewan and Quebec in the past as well. It could be argued that the alleged beneficial treatment of provincial hydro corporations benefits provinces like Quebec, Ontario and Manitoba especially. Since Prince Edward Island has very limited non-renewable natural resources, it would receive virtually no benefit from special treatment of natural resources.

The anomalous property tax treatment has a somewhat unpredictable effect, and depends on the precise way in which property taxes are treated. Calculations done by Quebec for

2001–2 indicate that measuring the property base by market values and applying the RTS using a single national average tax rate would have rather dramatic effects on total entitlements of the have-not provinces as well as their dispersion (Ministère des Finances Québec, 2002). Quebec would gain dramatically—its entitlements would more than double—and the remaining have-not provinces with the exception of British Columbia would also all gain but by lesser amounts. Entitlements in Prince Edward Island would increase by $14.6 million, which represents an increase over entitlements under the existing system of about 35 percent. Calculated entitlements would fall significantly for British Columbia and Ontario, but rise for Alberta. If a stratified approach were taken (by dividing provinces' property tax bases into strata consisting of municipalities of various average property values), the qualitative distribution of the results would be similar, but the changes from the current system would be less pronounced.

The floor provisions also have uneven effects. Since 1992, the provisions have been used 14 times. Of those 14, five have been in Saskatchewan and four in Newfoundland and Labrador, with two in New Brunswick and one each in Nova Scotia, Prince Edward Island and Quebec. Alternatively, Saskatchewan has received 50 percent of all floor amounts, while Newfoundland has received 21 percent. Presumably, these reflect underlying volatility of the resource base in Saskatchewan and Newfoundland and Labrador, volatility that would be addressed by the moving-average provision of the 2004 renewal.

Taken overall, what do these observations sum up to? According to the criteria advocated in this paper, the level of equalization is clearly insufficient. At the same time, some provisions seem to have worked especially in favour of certain provinces relative to others. Of course, the gross nature of the scheme naturally favours the have provinces relative to the ideal. As well, the property tax favours especially British Columbia relative to one fully based on market values. The resource provisions favour especially Newfoundland and Labrador and Nova Scotia, while the floor provision favours Saskatchewan. To the extent that it is an issue, the hydro treatment favours Quebec and Manitoba. Although one is not in a position to aggregate the gain and losses for all provinces, it seems clear that none of the special provisions works in favour of Prince Edward Island or New Brunswick. More

generally, all have-not provinces can legitimately argue that relative to a system that is fully designed according to the Section 36(2) commitments, equalization payments are not generous enough (even taking social transfers into account).

5. Existing Proposals: An Evaluation

The existing system is obviously not perfect, and many observers—going as far back as the Parliamentary Task Force on Fiscal Arrangements Between the Federal Government and the Provinces (1981) and the Economic Council of Canada (1982)—have been aware of the problems. Nor has there been a shortage of suggestions for reform. The most fundamental reform of revenue equalization concerns the RTS system itself. Some have advocated abandoning the RTS approach in favour of a seemingly simpler approach such as the macro approach whereby equalization entitlements would be based on some macro indicator of provincial fiscal capacity such as per capita personal income or gross provincial product (Courchene, 1984; Boothe, 1998; Barro, 2002). The argument is that a macro indicator better reflects the ability-to-pay of the province and is easier to implement. The problem with the macro indicator is that it is based on a misunderstanding of the rationale for equalization. It takes equalization to be a program whose purpose is to redistribute income from high-income provinces to low-income provinces. However, it is not an income redistribution program per se. While it obviously has as a consequence some redistribution from high- to low-income provinces, its real purpose is to equalize the ability of provinces to provide comparable levels of public services. As such, a better indicator of fiscal capacity is the ability to raise revenues using the kinds of tax instruments that are actually used (Boadway, 2002). The suitability of the RTS system has been reaffirmed by many studies, the most recent being the comprehensive report produced by the Senate Finance Committee (2002) on the basis of lengthy hearings involving interested parties and experts representing all points of view.[6] Depending on the particular macro base

[6] Other studies that have supported the use of the RTS system include the Parliamentary Task Force on Fiscal Arrangements Between the Federal Government and the Provinces (1981), Economic Council of Canada (1982), the Royal Commission on the Economic Union and Development Prospects for Canada (1985), and the Newfoundland and Labrador Royal Commission

chosen, differences from the RTS system could be significant. For macro systems based on some measure of per capita income, a big difference would likely be that the ability to obtain resource revenues would have little impact on entitlements. This would work to the detriment Prince Edward Island which has few natural resources.

Related to this, it should be emphasized that a system that uses an indicator of provincial revenue requirements rather than relying on actual provincial practices to determine the amount of equalization would be inappropriate. Under such a system, of which the macro approach would be one, an absolute size for equalization payments would be set, say, by the federal government, and the role of the equalization system would be to allocate that sum among the provinces. (Australia uses such a system.) This would enable the federal government to prioritize equalization along with its other commitments and could reduce the volatility that arises from changes in provincial fiscal policies. However, in a system as fiscally decentralized as the Canadian system, where provinces determine their own taxes and expenditures, such a procedure would not meet the requirements of Section 36(2). The best way to ensure that provinces can provide reasonably comparable levels of public services is to use as a standard the levels that they actually provide. The RTS system ensures that. If a lower amount of equalization is available, it is impossible for provinces with low revenue-raising capacities to provide levels of public services that are comparable with those in provinces with high revenue-raising capacities.

Some of the most pervasive suggestions concern the treatment of natural resources. First and foremost is the issue of whether natural resource revenues should be equalized at all. The national Conservative Party's 2004 election platform, following the suggestion of Boessenkoel (2001), advocated removing natural resources from the equalization formula entirely. The rationale seems to be based on some peculiar notion that because resource revenues reflect the running down of natural resource assets, they are not income so should not be equalized. This argument is highly anomalous. It ignores the fact that natural resource revenues represent a source of revenues like any other source, except that some

on Renewing and Strengthening Our Place In Canada (2003). The Royal Commission on the Economic Union made a very explicit recommendation for retaining and strengthening the RTS system.

provinces are luckier than others with respect to their endowments. Virtually all other observers recognize that natural resources are a legitimate source of equalization.

Nonetheless, some persons advocate preferential treatment for natural resources. This ranges from the suggestion that all natural resources might be afforded generic treatment and only included up to 70 percent in the base (Senate Committee, 2002; Newfoundland and Labrador Royal Commission on Renewing and Strengthening Our Place In Canada, 2003) to more extreme suggestions that perhaps only 25 percent of resources be included in equalization (Feehan, 2004; Courchene, 2004). The rationale for offering special treatment to resources is based on two sorts of arguments. The first, enunciated by the Economic Council (1982) as one of two options (the other being full equalization of resource revenues), is that the provincial 'ownership' of resources implies that to equalize them fully is equivalent to undoing those property rights. Although this is a matter of judgment, as we have mentioned a strong case can be made for Section 36(2) trumping provincial property rights. The federal government has a constitutional commitment to equalize the ability of provinces to provide comparable public services. Moreover, they have unlimited taxation powers as well as the spending power to enable them to fulfill this obligation. Indeed, the federal government does in fact impose full business taxation on resource incomes in the same way as it does on any other source of income. No special account is taken of provincial ownership rights.

The second argument, and the one that seems to motivate at least in part the governments of Nova Scotia and Newfoundland and Labrador in making their case for special treatment of offshore resources (and, in the case of the latter province, to onshore ones as well), has to do with efficiency and incentives. The argument is that high marginal tax-back rates—the loss in equalization payments as a proportion of changes in a province's resource revenues—remove the incentive for provinces to develop their resource properties since the revenues that would accrue to the province would be largely taxed back by equalization.[7] Some

[7] Courchene (2004) has recently further argued that provinces that have a high proportion of a given resource and therefore constitute a high proportion of the national base will have a high *average* tax-back rate: a higher proportion of their aggregate revenues from that resource will be taxed back by the equalization program than is the case for revenue sources that are

comments on this argument should be made, since the argument for special treatment of resources is a very common one. First, it is not clear that the disincentive effect of equalization on resource exploitation is so strong. Resources have been fully equalized for some time now, and it is far from clear that this has deterred have-not provinces from exploiting them. One reason for this might be that, once the resources are discovered, the fact that their revenues will be equalized should not affect *when* they are exploited. The tax-back will occur sooner or later so there is no advantage to delaying on that account. Second, the problem of tax-back is not unique to natural resources. Every addition to any base in any have-not province is taxed back at a roughly 100 percent rate. Provinces would therefore have the same disincentive to expanding any tax base, such as personal income, consumer sales, and so on. Third, providing favourable treatment to resources introduces significant inequities among have-not provinces. The mere fact that one province is getting special treatment on tax bases it happens to be endowed with, while a resource-scarce province does not, is inequitable. More than that, when only a proportion of resource revenues are equalized, that adversely affects non-resource owning provinces indirectly by reducing the size of the standard that determines the equalization entitlements of the latter. We return to this in the next section.

Courchene (1984, 2004) has offered two further suggestions with respect to the equalization of natural resources. In addition to less than full equalization, he has suggested separating resources from other revenue sources and equalizing them on a net basis. He has also suggested reducing the equalization revenue base by an amount reflecting the costs to the

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more equally distributed. The latter will have close to 100 percent marginal tax back rates, but substantially lower average tax-back rates. That is because the average tax-back rate depends on the province's base relative to the national average, but the marginal tax-back rate does not. Thus, if provinces all had the same per capita base for some revenue source, the average tax back rate would be close to zero, but the marginal tax-back rate would still be close to 100 percent. Courchene implies that this is not fair, and uses it to argue that provinces that have a high proportion of a given resource (like oil and gas in Saskatchewan under the five-province standard) deserve special consideration. He refers to the case of oil and gas in Saskatchewan pejoratively as being subject to 'confiscatory equalization' since its average tax-back rate is of the order of 100 percent. With all due respect, this is a non sequitur. To suggest that provinces that have something that no other province has should somehow be spared full equalization—which is what this argument implies—defies any reasonable notion of fairness or efficiency and should be dismissed out of hand.

province of generating those revenues. We have discussed this latter proposal earlier and offered some arguments for rejecting it. The former argument obviously does have merit since net equalization is the ideal. However, it is not at all clear how net equalization could be implemented, except indirectly by increasing overall federal transfers substantially, as we have noted. Moreover, if it could, there is no apparent reason for restricting net equalization to natural resources, although as a piecemeal reform it may be attractive.

Reform of the equalization treatment of property taxes has been forcefully proposed by Ministère des Finances Québec (2002). They have argued for using market values for the property tax base and applying to it a simple RTS mechanism. The argument is that all provinces now use market value assessment so that it is now feasible to use provincial practices as is done for other revenue sources. Unfortunately, while the case for using market value assessments as the basis for property tax equalization is a strong one, the case for applying the simple RTS formula with a single national average property tax rate may be less so. There are two problems with a simple RTS approach. The first is that provinces do not use a single property tax rate. Instead, different municipalities use different tax rates, and there is a systematic negative relationship between property tax rates and average property values within municipalities. Since differences in personal income tax rates by income brackets preclude using a simple RTS approach for the income tax, the same principle should apply for the property tax. Second, at least some property tax differences across provinces are due to pure price differences that reflect scarcity rather than any real difference in properties (including amenity values). For both these reasons, using a simply RTS approach for property taxes would tend to be over-equalizing. The former problem might be addressed using a stratified approach to property tax equalization. The latter might be addressed by reducing the extent of equalization to the extent that property value differences reflect pure scarcity rather than differences in the real benefits of properties across provinces (though a stratified approach would have the same effect). Unfortunately, neither is easy to implement, the first because provincial property tax regimes in each province reflect the municipal structure, which makes it difficult to define representative provincial practices, and the second because it is difficult to determine what

proportion of price differences are due to scarcity alone.

The 2004 renewal package included for the first time the limited use of market values as the basis for measuring the property tax base, but it fell short of full RTS treatment in three ways. First, market values are used to determine only 50 percent of the residential property tax base, and none of the commercial or industrial property tax base. Second, to address the issue of some property value differences reflecting simply the scarcity value of property—the second of the above problems—nominal property values were reduced to 70 percent of their market values. This implies an assumption that 30 percent of property value differences across provinces reflect pure scarcity and not tax capacity. This seems excessive when one considers the many other determinants of property values, such as size and quality of house and the quality of local services. Third, British Columbia is given preferential treatment. The market value of its residential property is reduced by 50 percent, or 1.67 times that of the other provinces. The argument is apparently that a higher proportion of property prices in British Columbia reflect pure scarcity, although there is no evidence to suggest that this is in fact the case.

The effect of these three measures is to reduce the extent of equalization that would result from applying a pure RTS approach to properties, as proposed by Québec, or a full stratified approach to deal with the above problems. And, the extent of equalization entitlement loss that British Columbia would otherwise face is especially reduced by the preferential treatment given to it. It is obviously difficult to evaluate the validity of the assumptions underlying the 2004 reform. However, it does imply that pure scarcity is relatively important in determining property values relative to, say, size and quality differences in housing, pure amenity values associated with housing location and the quality of local services. A priori one would have attributed a much larger role to these latter factors. On the other hand, the fact that different communities impose different property tax rates is also a factor (and one that a stratified approach might have addressed well). In any case, it is not at all clear that the special treatment afforded British Columbia is warranted.

The Newfoundland and Labrador Royal Commission on Renewing and Strengthening Our Place In Canada (2003), in addition to their recommendation that preferential treatment be

afforded to all natural resources and not just those currently obtaining generic treatment, recommended that a floor provision be instituted with respect to reductions in entitlements due to population declines. The argument is that it will be costly for a province to go from a set of public services that are designed for a given population level to one for a lower population level: per capita costs will rise as the province adjusts to a lower level of needs for public services. Whatever merit this argument might have, it represents an isolated move away from a pure revenue equalization system to one that takes account of some element of the costs of delivering public services. The question is: why should this particular cost of delivering public services be taken into account if no other is? If there are adjustment costs to declining population, should there not be for increasing population as well? What about more permanent differences in costs across provinces? What about differences in need? Moreover, even if population reductions were taken into account, how much protection should be afforded? To incorporate one particular source of costs differences in the equalization system and no other would be a form of ad hoc discretionary treatment that plagues the current system and should be avoided.

A more general issue concerns proposals to set the absolute size of the equalization program by federal discretion and allow only the allocation among provinces to be determined by formula. The federal government has recently announced its intention to fix annual payment levels in order to make the equalization system more predictable and stable (Finance Canada, 2004). The allocation of payments among provinces would be determined after consulting with a panel of experts, and could take one of many approaches, including RTS-based ones, macro indicators and expenditure needs. This would be a major change in the way equalization is determined. Indeed, there have already been some measures taken or proposed that would add some discretion to total entitlements. The 2004 federal budget included some discretionary add-ons to equalization that would have this effect. These include a once-over sum of $150 million to be allocated on an equal per capita basis, and a 10 percent adjustment factor that would apply proportionately to all entitlements to compensate for the delay in receiving equalization entitlements as the three-year moving average system is being phased in. There was also, separate from the budget, a one-time

payment to Saskatchewan for $120 million to compensate for what was regarded as their excessive tax-back for the Crown leases revenue source. All of these things amount to a move in the use of discretion as a means of determining total equalization rather than letting it be formula-driven.

A system that sets the aggregate amount of equalization in a discretionary manner rather than letting it be formula-driven has the potential advantage of being less volatile and more predictable from the provinces point of view, and gives the federal government more control over its budgetary expenditures. However, it would violate the principle that equalization be based on actual provincial behaviour, and could introduce an element of uncertainty to provincial budgets in the future (since presumably discretionary amounts would depend upon the state of the federal budget). There has been, after all, a record of unanticipated reductions in federal transfers to the provinces in the past, and equalization has been to an extent sheltered from these. The standard for what constitutes 'reasonably comparable levels of public services' referred to in Section 36 seems better measured by those levels that provinces actually choose, rather than some arbitrary level chosen by the federal government, even on the advice of an expert panel. Any level of equalization that differs from that obtained under the RTS system would not enable all provinces to provide comparable levels of per capita spending given the levels of taxation that are currently in use. Of course, one could always interpret the statement 'reasonably comparable levels of public services at reasonably comparable levels of taxation' to refer to levels of taxation that are, say, much lower (or higher) than levels of taxation that are currently in use by the provinces. That is, one could use values for $\overline{t}_i$ in the equalization formula (1) above that are lower (or higher) than national average tax rates. However, that would violate the spirit of Section 36(2)—as well as the economic principles that underlie Section 36(2)—since in fact provinces would not provide reasonably comparable levels of public services to their citizens, which is the intent of the equalization commitment. Thus, only if the discretionary level of equalization chosen corresponded with that obtained under the RTS system would the principle of Section 36(2) be fulfilled. In these circumstances, it seems reasonable to argue that the level of equalization continue to be formula-driven.

Under a formula-driven system, the volatility of payments can be readily reduced by the sort of averaging system that is now being phased in. And, while it is true that the federal government loses discretion over the equalization program in its budget, it is not clear that this is a real disadvantage when viewed from the point of view of the federal and provincial budgets taken together. Moreover, under a discretionary system, there is the significant additional problem of determining the allocation of a fixed equalization amount when its level differs from that of the RTS entitlements. For example, if the discretionary level is set below the RTS level, there will be a shortfall of payments relative to that required under the RTS. How is that shortfall to be made up? Should the allocation be made simply by reducing $\overline{t}_i$ so that all provinces are reduced in proportion? Or should priority be given to raising the revenue-raising abilities of the lowest-capacity provinces? An approach that has some appeal is one that uses the ten-province standard as the basis for allocations among have-not provinces. The procedure would be as follows. Entitlements based on the ten-province standard would be calculated. If the discretionary amount available differed from that required to finance the full ten-province standard, entitlements would be adjusted on an equal per capita basis. Thus, if the discretionary amount were greater than the amount required under the ten-province standard, all have-not provinces would obtain an equal per capita increase in equalization, and vice versa if the discretionary amount is too low. This system would equalize fiscal capacities among the have-not provinces, but not necessarily to the national average level.

Finally, some observers have called for the establishment of a credible and independent national commission to advise on transfers to the provinces. The new framework announced in Finance (2004) proposes to ask as expert panel to advise on this matter. Such institutions exist in Australia, India and South Africa, with varying degrees of success. The advantage of such an advisory commission is that it would enhance transparency by making more open to the public the kinds of deliberations and considerations that go into ongoing reform of the system. At the moment, it is actually very hard for the public even to obtain information on the details of federal-provincial transfers and the alternatives being considered for reform. In addition, such a body might also serve to emphasize the

longer-term aspects of transfers, which now appear to be driven by shorter-term budgetary considerations. Of course, such a commission can only be advisory and should be at arms' length from both federal and provincial governments, while at the same time being open to input from both. It seems clear that the inter-provincial Council of the Federation would be quite unsuitable for this role. Apart from representing the provinces alone, it also has the disadvantage of requiring a consensus from all provinces. This requirement would virtually guarantee that it could not adequately advise on a program like equalization because it inherently involves interprovincial conflicts.

7. Directions for Reform

The existing equalization system is fundamentally a good one in its overall design and intent. It remains a suitable way for contributing to the commitments of Section 36 of the *Constitution Act*, 1982, at least as far as revenue equalization is concerned. Combined with the CHT/CST system, equalization serves remarkably well as a means of ensuring that the fiscal decentralization that is characteristic of the Canadian federation does not compromise the level of essential public services that are available across Canada. There is continuing need to reaffirm the value of equalization as well as to ensure that it is designed to continue to meet the requirements of Section 36. To that end, the following is a list of directions for future reform and evolution of the system.

- The RTS system for revenue equalization should be reaffirmed, and a move to a macro system rejected. The RTS system satisfies the requirements of Section 36(2) by recognizing the importance of defining comparability among provinces in terms of actual provincial behaviour rather than on some benchmark defined elsewhere, including by the federal government.
- Equalization should be fully formula-based, including the aggregate amount of equalization. Introducing discretion in the amount of funds paid leads to unpredictability and imposes risks on the provinces that are better borne by the federal government. Moreover, unless the aggregate amount set by discretion is the same as the full RTS system would yield, the spirit of Section 36(2) would be violated, and provinces would

not be able to provide comparable levels of public services at comparable tax rates. Ad hoc changes in equalization payments that benefit particular provinces is unfair.

- The equalization formula should move toward the ideal. First and foremost, this implies moving to a ten-province standard with all provincial general revenue sources being included. Ideally, one might want to move in the direction of a net system as well, but this is difficult to do through the equalization system. An alternative way of achieving the same objective is to use the CHT/CST system as a vehicle for clawing back the negative equalization entitlements of the have provinces. This would likely require increasing the overall per capita size of the social transfers, which in turn would require that the federal government occupy a larger share of total tax room. The total tax burden on Canadians would not have to increase.

- If—contrary to what we have argued—the federal government chooses to make the aggregate amount of equalization payments to the have-not provinces discretionary, the full ten-province standard can still be used as the basis for determining the allocation among provinces, with the absolute equalization payments adjusted on an equal per capita basis to meet the budget constraint. Obviously, this is not ideal to the extent that the discretionary amount is not sufficient to finance the ten-province standard, but at least it would serve to achieve horizontal balance among have-not provinces.

- The five-province standard was adopted largely to avoid the cost of equalizing Alberta's oil and gas revenues to which the federal government has limited access. In principle, there is nothing that pre-determines the federal share of resource revenues accruing to the public sector. The federal government could obtain a larger share of resource revenues, and in so doing both mitigate the large horizontal fiscal imbalance arising between Alberta and the rest of Canada and obtain revenues that can be used to finance the ten-province standard. Data presented in Finance Canada (2003) (p. 10) indicate that in 1997, the federal government's share of public revenues obtained from oil and gas was 23 percent and from mining was 24 percent, the rest accruing to the provinces. Given the importance of these revenues as a source of revenue-raising disparities, these federal shares are low. The federal government could obtain a larger share of revenues

without significant adverse effects on the efficiency of these sectors. For one thing, they could remove the deductibility of provincial royalties and mining taxes from the corporation income tax system. For another, the corporation tax system itself could be reformed so that it acted more as a rent tax to extract revenues from the non-renewable resource sector in an efficient way. This would involve defining deductions and credits so that they more closely reflect true economic costs. Moreover, a good case can be made for having differentially higher statutory tax rates in the non-renewable resource sector precisely on the grounds that there is a high element of rents in the incomes of these sectors. No doubt increases in federal revenues would ultimately crowd out provincial resource revenues to some extent. But this is fully consistent with achieving the equalization objectives of Section 36(2).

- All resource revenues should be treated on a comparable basis without special treatment for particular cases. Moreover, on grounds of fairness and in accordance with the principles of Section 36(2), resource revenues should be treated comparably with all other provincial revenue sources. A case for preferential treatment of resources might potentially be made on incentive grounds, but that case has yet to be made convincingly. That is, there is no good evidence that equalization has deterred resource exploitation by the provinces. And, it is not clear that such a case could be made given that equalization tax-backs cannot be avoided by postponing exploitation. Special provisions like the generic solution are not justified even where a province's share of revenues from a given base is very high. In these cases, a national average tax rate could be set separately to avoid adverse incentive problems. Of course, fair treatment of natural resources requires that provincial tax capacities be properly measured, and that may pose difficulties. Nonetheless, the problem is not insurmountable and need not be used as an argument for ad hoc changes in the formula for particular provinces.

- Equalization of property taxes should respect the RTS principle and use market values as the base. This, after all, is what all provinces now use for all types of properties. Given that within provinces there is no uniform property tax rate and that there may be some element of pure scarcity in property values, the RTS system could be adjusted, as has

been the case for other revenue sources like the personal income tax. Such adjustment could involve some stratification, which would take account both of the non-uniformity problem and the scarcity value problem. But once a procedure is in place, no ad hoc special arrangements should be made for particular provinces.

- As a general principle, if any special provisions are implemented that favour particular provinces or particular revenue sources, they should not be allowed to affect the normal equalization entitlements of any have-not province. That is, equalization entitlements should be calculated using the RTS system with all revenue sources included fully, and any special provisions ought to be calculated over and above that (below the line, so to speak). So, for example, if only 70 percent of resource revenues were to be equalized, the reduced equalization for a given province should be calculated and applied after full equalization entitlements have been calculated. This prevents provinces with limited natural resources (like Prince Edward Island) from being adversely affected by provisions that are meant to give relief to other provinces. Note that this is consistent with the way that the have provinces are now treated. Equalization entitlements are calculated as if all provinces were included, and then negative entitlements are simply not enforced.
- The introduction of a three-year moving average for equalization entitlements is a good reform and should reduce the volatility of payments. It undermines the need for a floor, which in the past has tended to favour some provinces relative to others and can now be eliminated. The case for introducing other transitory measures, such as a floor on changes in equalization arising from declines on population, is not as convincing. It entails basing equalization payments on elements of cost rather than on pure revenue equalization. Any change in that direction would have to take account of all sorts of differences in costs and need across provinces.
- Although a strong case can be made for creating an arms-length institution to advise periodically on reforms to the fiscal arrangements, the Council of the Federation is not well suited for that purpose. It is a body that represents the provinces only, and its requirement for unanimity is not compatible with the objectives of equalization. Moreover, equalization in the end is a commitment of the federal government.

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