

# Cracks in the Country's Foundation: the Importance of repairing Equalization

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## Abstract

*Dramatic variations across provinces in per capita fiscal capacity have created serious problems for Canadian federalism. The Equalization program addresses this challenge but in recent years ad hoc accommodations resulting from a desire to satisfy Newfoundland's demands have threatened the integrity and coherence of that program. This article argues that the 2006 O'Brien report should be viewed as a welcome attempt at remedying this situation; the article also examines the prospects for its successful implementation.*

## Introduction

Relative to most countries of the world, Canadian political problems are trivial. There are however two deep cracks in the country's foundation that require ongoing attention if the political edifice of a federal state is to remain intact. The first is the linguistic/cultural divide between English-speaking Canadians and francophone Quebecers; the second is the large, politically destabilizing differences in provincial fiscal capacity, of which the most important feature is the unequal division of resource revenues. Over the last half-century both cracks have widened.<sup>1</sup>

Following the Second World War, Quebecers abandoned the parish, became more educated and more mobile, thereby raising the fear that "celui qui perd la foi perd la langue." Simultaneously, Allophone immigrants reached Montreal in large numbers. The combination imperiled the survival of French as Quebec's lingua franca. Camille Laurin performed a great – if unintended – service for Canadian unity by enacting Bill 101. It embodies a workable compromise on a contentious subject, namely protecting the status of French as the dominant public language in Quebec while affording reasonable minority language services to English speakers. Pierre Trudeau proposed an idealistic but naive alternative: that Canadians become so fluently French-English bilingual that Quebecers feel no need to protect French in "their" province. He performed a great – again unintended – disservice to Canadian unity by demonizing Bill 101 and insisting (via sections 16-23 of the *Charter*) that official language minorities enjoy broad rights to litigate in the domain of public language policy. The elites among the Liberal Party of Canada,

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the Reform/Alliance/Conservatives and the Supreme Court justices all made decisions in the 1980s and 1990s that widened this crack. The near-victory of the Parti québécois in the 1995 referendum campaign induced a reassessment. Belatedly, Canadian elites have come to the realization that Bill 101 is the centre-piece of any viable policy to prevent the widening of this first crack.

As interpreted by the Judicial Committee of the Privy Council, Canada's ultimate constitutional arbiter until the mid-20<sup>th</sup> century, section 92 of the *British North America Act* affords paramount jurisdiction over the core social programs of education, health care, and social assistance to the provinces. The Constitution also affords provincial access to most tax bases. Given Quebecers' expectations of autonomy and the constraints on Ottawa's ability to manage social programs efficiently in a country of continental dimensions, this decentralization of tax and spending authority has always made sense. It posed few fiscal problems at the level of modest 19<sup>th</sup> century public expectations. But dramatic variations across provinces in per capita fiscal capacity created serious problems in the 20<sup>th</sup> century as Canadians came to expect more from government. The centre-piece of policy to manage this second crack is Equalization.

## The Role of Equalization

The logic underlying calculation of a province's Equalization entitlement is straightforward. It requires an estimation of provincial fiscal capacity based on a so-called representative tax system. This in turn requires the definition of the tax bases accessible to each provincial government, and an estimation of how much each province could raise by imposing average provincial tax rates on accessible tax bases. Equalization provides to "have not" provinces – those with per capita fiscal capacity below a specified benchmark – a grant sufficient to bring them up to it. The "have" provinces – those with per capita fiscal capacity above the benchmark – receive no grant. Negotiation of the representative tax system and the Equalization benchmark has usually been thrashed out among Ottawa and the ten provinces once every five years. Between these sessions, the expectation is that Equalization grants be rules-based and free from political lobbying.

The details of the calculation of Equalization entitlements are complex and obviously matter. For purposes of this article, however, what matters is an appreciation of the three broad goals that the program is attempting to realize:

1. *Reconciliation of equal social citizenship rights with the advantages of decentralized management:*

As Canadian citizens, residents of each province expect reasonably similar core social services. Without Equalization, residents of have-not provinces – Quebec aside – would almost certainly by now have prevailed on Ottawa to assume direct funding and perhaps direct managerial responsibility for provision of these core services. There are good managerial reasons to prevent such centralization under Ottawa's tutelage. Whether in the private or public sector, large organizations with many employees are more efficiently managed with autonomous sub-units, and the bureaucracies required to

deliver major public services such as medicare are *very* large bureaucracies. Relative to a hypothetical alternative in which a federal ministry manages medicare, the information burden on senior managers responsible for programming in any one province is lower. Moreover, program innovation in smaller units, such as a province, is easier than at the national level.

To the extent that the welfare state is an exercise in approximating the median voter's desire to redistribute income from richer to poorer individuals, the above discussion is largely irrelevant. There is little evidence to indicate that typical citizens in one region of Canada differ substantially from typical citizens in other regions with respect to their willingness to use the tax/transfer system for this purpose. Social programs to redistribute income among individuals could just as well cut out the provinces altogether. Not surprisingly, if we restrict attention to the relatively simple social programs that redistribute income across individuals – programs such as old age security and redistributive features of the personal income tax – there exist administrative economies of scale, and Ottawa has in most cases taken the lead.

2. *Reconciliation of intergovernmental income redistribution with the benefits of own-source taxation as means to promote a responsible political culture at the provincial level:*

More-or-less, provincial governments operate on the basis of the coincidence of taxing and spending: most of what they spend arises from the taxes they impose on provincial residents. Canadian provinces enjoy a large measure of autonomy over the design and management of their respective social programs, and also over their tax regimes. Arguably, both these features contribute to Canadian social programs which compare well on an international basis, and both are necessary if provincial politicians are to garner electoral support based on efficient decision-making, rather than garner support based on lobbying Ottawa over discretionary transfers. While increasing the revenue available to a have-not province from its tax effort, Equalization does not – at least not intentionally – distort provincial political priorities by providing incentives to develop particular programs or exploit particular tax bases.

Implicit in this discussion is that reliance by politicians on own-source tax revenue is important in preserving a responsible political culture at the provincial level. Own-source taxation provides a powerful incentive to politicians to assess the costs of their proposals as well as the benefits. And the expectation – that those who stand to benefit from *additional* public services must agree to pay the *additional* taxes required – is a powerful incentive on citizens to engage in provincial political debates. The dynamic of assessing benefits against costs usually operates more transparently at the provincial than at the federal level. This is not because provincial politicians are wiser or more fiscally prudent than their federal counterparts but because the per capita impact on provincial taxes of spending \$x million is much larger than if the same amount were spent federally.

3. *Provision of interprovincial insurance:*

Opening and closing hospitals or schools as a province's terms of trade fluctuate is not conducive to good policy outcomes. The funding of core social programs should remain stable. Relying on a regional tax base, provincial revenues at constant tax rates are inevitably subject to higher variance than those of Ottawa, whose taxing effort is spread across all sectors of the Canadian economy. Hence, taxes paid to Ottawa should be considered to include insurance premiums needed to finance revenue shortfalls in provinces facing adverse economic shocks. The two provinces most susceptible to such shocks in the last two decades have been Saskatchewan and British Columbia. Both have switched between have and have-not status in terms of Equalization eligibility.

## **A little history**

Following the virtual bankruptcy of the Prairie provinces in the Great Depression, the Rowell-Sirois Commission in 1940 recommended a federal grant to provinces with weak fiscal capacity. The first program to define provincial fiscal capacity and top up the revenues of low-capacity provinces came into being in 1957.

Starting in the 1960s, Canadian social policy diverged from that of the Americans. Over the next three decades, Canadian public spending as share of GDP roughly tracked the increase displayed by the median OECD country, whereas the comparable US statistic remained static. Some of this Canada-US divergence came from provincial initiatives (for example, medicare in Saskatchewan and creation of a large network of community colleges in Quebec) and some from Ottawa's. In addition to launching programs within its own jurisdiction (such as incorporation of a negative income tax into old age security), Ottawa employed its spending power in areas of provincial jurisdiction, thereby inducing the provinces to spend on programs of interest to the federal government. For example, Ottawa launched in 1966 a conditional transfer (the Canada Assistance Plan) to finance 50 percent of eligible provincial social assistance spending. By 1980, the value of these conditional transfers exceeded that of Equalization.<sup>2</sup>

Equalization evolved over time and had become sufficiently important by the 1982 patriation exercise to warrant a clause in the *Constitution Act, 1982*. Ottawa is required to make Equalization payments such that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (s.36(2)).

Starting in the mid-1970s, two interrelated conundrums emerged: how to generate electoral support for social program redesign (flaws in design became increasingly serious as time passed) and how to reconcile public expectations of services with public willingness to pay the necessary taxes. From the mid-1970s to the mid-1990s, the Canadian public sector (federal + provincial) was in continuous deficit. These deficits inevitably created a rising public sector debt/GDP ratio. At its peak in mid-1990s, Canada ranked third among OECD members – only Italy and Belgium were relatively more indebted.

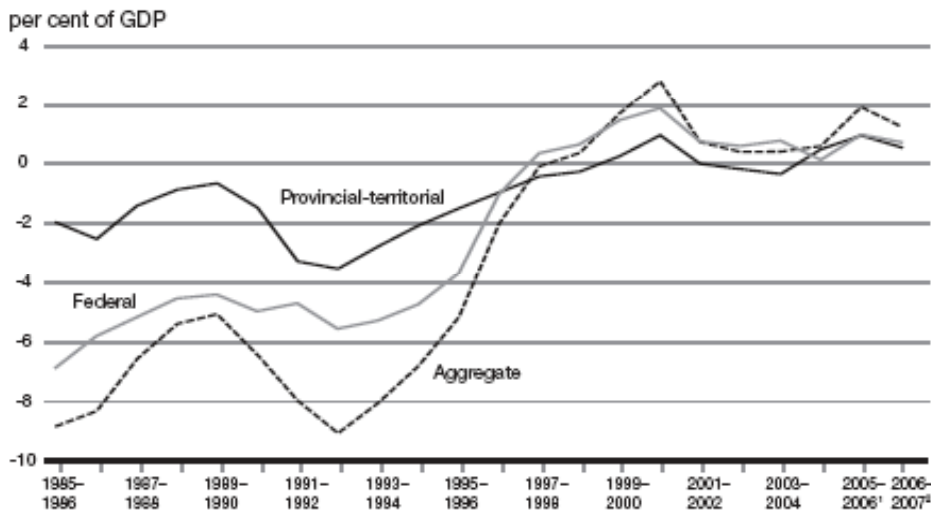
By the early 1990s, the cash value of major intergovernmental transfers had grown to approximately one-quarter of all federal program spending. Whereas Equalization remained a well defined rules-based program, conditional transfers were subject to high-profile acrimonious federal-provincial bargaining and the rules governing them varied from year to year. They contributed to a political culture, both in Ottawa and the provinces, of ambiguous responsibility for both program design and financial accountability.

Ottawa blamed the provinces for distorting the intent of conditional transfers and worsening the federal deficit. For example, in the late 1980s, Ottawa accused Ontario, a prosperous province, of financing an overly generous social assistance regime with “50¢ dollars” made feasible by the shared-cost design of the Canada Assistance Plan (CAP). Ottawa subsequently capped the rate of growth of CAP transfers to Ontario and the two other “have” provinces. In turn, the provinces blamed Ottawa for their worsening provincial deficits when the federal government unilaterally redefined conditional transfers, for example the “capping of CAP.”

Canadian politicians ultimately de-escalated this tit-for-tat bickering. The first senior government to act was Saskatchewan, in 1992. At the time it was the most indebted province. Next to act was Alberta, in 1993. Both governments simultaneously cut spending and raised taxes, bringing their respective accounts into balance by 1995. In explaining the decisions leading to Finance Minister Paul Martin’s epic 1995 budget, it is probable that the success of the Reform Party in the 1993 federal election was a factor. This conservative populist movement came within a few seats of becoming the Official Opposition. (Narrowly, the Bloc québécois bested it.) In one of the most dramatic fiscal turnarounds in OECD history, Ottawa and the provinces jointly restored fiscal balance by 1998. In aggregate, the Canadian public sector has remained in surplus since.<sup>3</sup> (See Figure 1. - Source: Canada (2007, 300)

### Federal and Provincial-Territorial Budgetary Balances

(Public Accounts Basis)



<sup>1</sup> For this and subsequent charts, figures for the combined provincial-territorial sector and the aggregate surplus for 2005-06 are estimates.

<sup>2</sup> Projection.

### **The “vertical fiscal imbalance”**

After two decades of continuous public-sector deficits in Canada, Finance officials in Ottawa and the provincial capitals have been understandably anxious that their respective governments not fall back into deficit. In Ottawa’s case, this has been relatively easy. A steadily growing economy has allowed Ottawa both to increase spending on core programs and to realize sizeable budgetary surpluses. Federal politicians have used their fiscal room to launch new programs and to undertake strategic reductions in tax rates. Not so in the case of many provinces. In most years of the last decade, the provincial public sector has in aggregate remained in surplus, but the public pressure to increase spending on core programs, health care in particular, has been intense and many provinces have incurred intermittent deficits. Quebec governments have summarized this state of affairs as a “vertical fiscal imbalance” between Ottawa and the provinces in terms of fiscal capacity and program expenditure expectations (Quebec 2002).

Not surprisingly, the provinces have lobbied Ottawa to provide more fiscal room. In principle, Ottawa could oblige in several ways: 1) tax transfer (i.e., lower federal rates and raise provincial rates, with potentially no impact on aggregate tax rates), 2) increase conditional transfers intended to share the cost of provincial social programs, or 3) rely on reform and enrichment of the Equalization program.

#### **Tax transfer**

The last time Ottawa entertained this method was in 1975. Ever since, federal Finance officials have reminded Canadians of this agreement by calculating the current value of the tax points transferred in 1975. While Ottawa did indeed lower its income tax rates at the time, the implication of these calculations is that Ottawa owned the tax room yielded and deserves credit in perpetuity for the tax revenue thereby foregone. After three decades in which both orders of government have repeatedly raised and lowered their respective tax rates, it has become meaningless in terms of practical politics to include the value of these tax points in assessing the size of Ottawa’s transfers to the provinces. Nonetheless, federal Finance officials continue to do so.<sup>4</sup>

#### **Conditional transfers**

Since Ottawa gets only short-term political credit for creating tax room to be taken up by the provinces, and since it loses all control over the use made of its foregone tax revenue, federal politicians are unlikely to repeat the 1975 exercise. Ever since the 1960s, the second means, reliance on conditional transfers, has appealed to federal politicians. Ottawa can thereby claim to be engaged in providing popular programs such as medicare and post-secondary education to all Canadians. Furthermore, via the conditions attached to transfers, Ottawa can induce the provinces to spend in ways that Ottawa desires.

Historically, shared-cost conditional transfers served a useful purpose in encouraging conservative provincial administrations to entertain new social programs. Four decades later, the case for them is much weaker. Neither Ottawa nor the provinces have a monopoly on good

ideas for running a mature welfare state. Expansion of conditional transfers risks a return to the muddle over responsibility for program design and financial accountability that characterized intergovernmental relations prior to 1995. There is no need for Ottawa to dispense with conditional transfers, but there is a manifest need for some rules covering their use.

Ottawa's power to spend is also a power *not* to spend.<sup>5</sup> Ottawa's unilateral cut to shared-cost conditional transfers in 1995 prompted the provinces to attempt to introduce rules, via what came to be known as the Social Union Framework Agreement (SUFA), to constrain their future use by the federal government. The essence of the provincial proposal was that Ottawa be required to obtain agreement from a substantial majority of provinces prior to launching a major transfer in an area of provincial jurisdiction, and that provinces be able to opt out of the proposed program with fiscal compensation if they offer a similar program. In the final stages of negotiation with Ottawa, the provinces abandoned their draft text in favour of a vague federal text containing no substantive constraint on use of the spending power. In the form approved in 1999, SUFA has proved irrelevant to federal-provincial relations (Richards 2002).

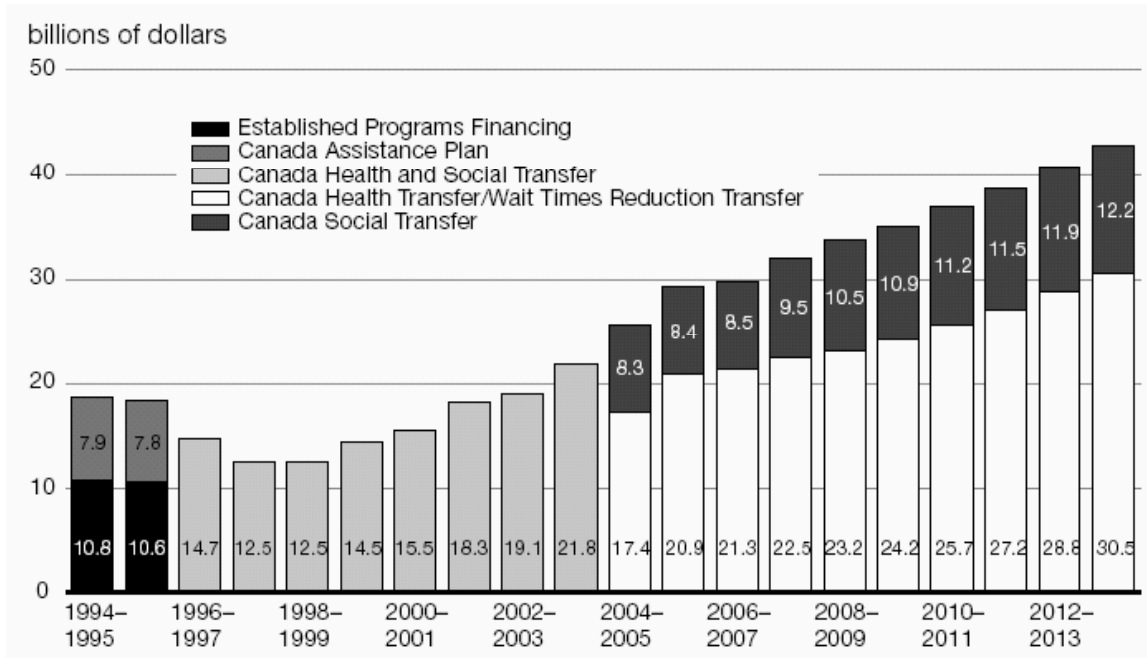
With the federal budget balanced, Ottawa returned to a pre-1995 pattern of increasing conditional transfers. In aggregate, spending on such transfers has more than doubled since the beginning of this decade, and for fiscal 2007-08 is projected to be in excess of \$30 billion. (See Figure 2.) To some extent, these transfers are rules-based. For example, in 2004, Ottawa and the provinces negotiated a ten-year schedule of increases in CHT spending. In the 2007 budget, Ottawa proposed a similar multi-year schedule of increases in the CST. It is unclear however whether these multi-year commitments are credible or will be subject to frequent federal-provincial negotiation, as has occurred in years past.<sup>6</sup>

The present Conservative government is more amenable than its predecessor to the rationale for rules constraining the federal spending power in areas of provincial jurisdiction. There may well be a slip between cup and lip – especially in a minority Parliament – but it is worth noting that the October 2007 Speech from the Throne contained the following commitment:

Our Government believes that the constitutional jurisdiction of each order of government should be respected. To this end ... our Government will introduce legislation to place formal limits on the use of the federal spending power for new shared-cost programs in areas of exclusive provincial jurisdiction. This legislation will allow provinces and territories to opt out with reasonable compensation if they offer compatible programs (Canada 2007b).

An important example of the muddle created by the unilateral federal use of conditional transfers in areas of provincial jurisdiction is childcare programming. The 2005 federal budget introduced a new \$1 billion five-year annual transfer, to induce the provinces to introduce universal childcare programs modeled on that in Quebec (Canada 2005, chap. 4). On a national basis, the cost of Quebec-style childcare would be at least \$10 billion annually. Did Ottawa intend to cost-share such a program beyond five years? If so, on what basis? Ottawa gave no indication. (Since the Conservative government canceled the transfer in 2006, the questions are hypothetical, but still worth posing.)

**Figure 2 - Cash Value of Major Conditional Transfers to the Provinces**



Source: Canada (2007, 354)

### Equalization reform

Until recently, prospects for the reform and enrichment of Equalization, the third means of addressing the “vertical fiscal imbalance,” appeared bleak. As mentioned above, the rules governing the Equalization program have historically been thrashed out between Ottawa and the provinces once every five years. Between these marathon debates, calculation of annual Equalization entitlements is intended to be rules-based and free from intergovernmental bargaining. However, in the closely fought 2004 election campaign, Premier Danny Williams of Newfoundland and Labrador sought a special arrangement to prevent the normal functioning of Equalization based on a representative tax system. Prime Minister Martin capitulated and agreed to the Atlantic Offshore Accords. This agreement protects Equalization payments to Newfoundland and Nova Scotia, potentially until 2020, from any reductions that the Equalization formula would otherwise require, given these provinces’ increased resource revenues.

The Accords are a serious violation of the logic of Equalization as a rules-based transfer, free from political bargaining. Adding to the damage, Ottawa formally introduced a so-called New Framework Equalization program in 2005. It too violated the logic underlying Equalization



(Canada 2005, chap. 3). In addition to incorporating the Atlantic Offshore Accords, the New Framework can be summarized as follows:

- On an interim basis, payments to receiving provinces were based on historical shares. Hence, they did not bring the fiscal capacity of Equalization-receiving have-not provinces to a uniform benchmark.
- The New Framework proposed a predetermined size of aggregate Equalization payments, starting at \$10 billion in 2004-05, to be escalated annually at 3.5 percent over a horizon of 10 years. This destroyed the ability of the program to serve as interprovincial insurance. Aggregate payments would no longer rise to compensate adverse shocks to provincial fiscal capacity or fall in the face of convergence in provincial fiscal capacity.
- The New Framework maintained the status quo of 33 separate tax bases. The conceptual soundness of the estimates for many of these bases was questionable.

Distressed at the prospect of Equalization unraveling with multiple ad hoc arrangements, the federal Finance Department commissioned Al O'Brien, ex-Deputy Finance Minister of Alberta, to rethink the program. The tripling of oil prices since the beginning of the decade exacerbated regional conflicts over the design of Equalization. And Steven Harper, while Leader of the Opposition, poured oil on the fire (so to speak) by staking out the position that provincial nonrenewable resource revenues were equivalent to income derived from running down an asset. They were, he argued, sufficiently different from tax revenues that they should not enter into the calculation of provincial fiscal capacity.<sup>7</sup> To do that, retorted the "have not" premiers, would deny the reality that resource-rich provinces were relying on their nonrenewable resource revenues to finance provision of generous public services at below-average provincial tax rates.

O'Brien tabled his report in summer 2006 (Canada 2006c). On the matter of resource revenues, he recommended 50 percent inclusion in the calculation of provincial fiscal capacity ("a fine Canadian compromise" to quote the title of Boothe & Vaillancourt's 2007 book on the topic). To their credit, Harper and his Cabinet colleagues recanted their former position, and accepted most of O'Brien's recommendations. (See the Appendix for a more detailed summary of the Equalization reforms contained in the 2007 budget.)

The Cabinet resisted the "firewall" Albertans who wanted no sharing of resource wealth with "have nots" via Equalization; it resisted the demands, led by Newfoundland and Saskatchewan, on behalf of Martin's tradition of special arrangements;<sup>8</sup> it resisted British Columbia's demand to maintain an artificially low assessment of fiscal capacity available from municipal property taxation. And finally, the Cabinet resisted Ontario's stance that there be no further increase in aggregate Equalization transfers.

## Who wins? Who loses?

The O'Brien commission undertook an exercise to estimate the impact of their recommendations on 2007-08 Equalization entitlements, in aggregate and by province. The exercise entailed a ranking of the importance of each recommendation, and the impacts are calculated on the assumption that the recommendations are introduced sequentially, from most to least important. (See Table 1.)

**Table 1 - Decomposition of Impact of Expert Panel Equalization Recommendations in 2007-08 (relative to estimated entitlements under the "New Framework")**

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	TOTAL
<b>(\$ million)</b>											
1) Treatment of resources	144	-19	-96	-79	-347	0	-117	431	0	84	<b>0</b>
2) 10-province Standard	59	16	107	86	860	0	133	113	0	479	<b>1,853</b>
3) User fees	-37	-11	-55	-49	-156	0	-48	-45	0	-72	<b>-472</b>
4) Property tax	3	0	-17	-10	355	0	19	-9	0	-526	<b>-187</b>
5) RTS simplification	26	20	160	98	-58	0	82	172	0	0	<b>499</b>
6) Fiscal capacity cap	-299	0	0	0	0	0	0	-506	0	0	<b>-805</b>
<b>Total Impact</b>	<b>-105</b>	<b>4</b>	<b>99</b>	<b>45</b>	<b>653</b>	<b>0</b>	<b>69</b>	<b>156</b>	<b>0</b>	<b>-35</b>	<b>887</b>
<b>(\$ per capita)</b>											
1) Treatment of resources	278	-141	-102	-105	-46	0	-100	433	0	20	
2) 10-province Standard	114	114	114	114	114	0	114	114	0	114	
3) User fees	-71	-81	-59	-65	-21	0	-41	-45	0	-17	
4) Property tax	5	-4	-18	-14	47	0	16	-9	0	-125	
5) RTS simplification	50	143	171	130	-8	0	70	173	0	0	
6) Fiscal capacity cap	-579	0	0	0	0	0	0	-509	0	0	
<b>Total Impact</b>	<b>-203</b>	<b>31</b>	<b>105</b>	<b>60</b>	<b>86</b>	<b>0</b>	<b>59</b>	<b>157</b>	<b>0</b>	<b>-8</b>	

Source: Canada (2006c, 137)

**Table 2 - Equalization Entitlements in 2006-07 (under "New Framework") and in 2007-08 (under "Renewed Equalization")**

	N.L. <sup>1</sup>	P.E.I.	N.S. <sup>1</sup>	N.B.	Que.	Man.	Sask.	B.C.	Total
	(millions of dollars)								
2006-07 legislated payments	632	291	1,386	1,451	5,539	1,709	13	260	<b>11,282</b>
Offshore offsets	329		57						<b>386</b>
2007-08 guaranteed minimum allocation	477	291	1,308	1,435	6,462	1,703	-	-	<b>11,676</b>
Offshore offsets	494		130						<b>624</b>
2007-08 renewed Equalization	477	294	1,308	1,477	7,160	1,826	226	-	<b>12,768</b>
Offshore offsets	494		130						<b>624</b>

Note: Totals may not add due to rounding.

1. Ottawa has guaranteed minimum 2007-08 Equalization allocations by province. Under the new Equalization formula (and ignoring the guaranteed minima), Newfoundland would be entitled to \$521 million in Equalization and \$212 million in offset amounts while Nova Scotia would be entitled to \$1,465 million in Equalization and \$68 million in offset amounts for 2007-08. The Budget assumes these provinces remain with the former New Framework system, since the new system does not embody the multi-year benefits of the Offshore Accords.

Source: Canada (2007, 116)

A few conclusions of this exercise are worth highlighting:

- The introduction of the ten-province average as the benchmark increases total annual entitlements by nearly \$2 billion.
- The O'Brien recommendation of the elimination of user fees as separate tax base, lowers entitlements in have-not provinces that were, under the former rules, assumed to have below-average fiscal capacity from this tax base.
- The introduction of a market-value approach to property tax capacity increases estimated overall provincial capacity from this base, particularly in the case of British Columbia.
- The imposition of the fiscal cap dramatically lowers entitlements for Saskatchewan and

Newfoundland.

- The impact of changes in entitlements across provinces is largest in Quebec, due to its large population relative to other have-not provinces. If we accumulate the impact of all recommendations, nearly three-quarters of the total impact on entitlements accrue to Quebec.

Table 2 illustrates the legislated 2006-07 Equalization entitlements under the previous New Framework formula and the higher values under the new formula introduced with the 2007 budget.

Obviously, the Cabinet undertook its 2007 reforms with tactical political considerations in mind. The Conservatives hope to increase support among Francophone Quebecers in the next election. Hence, the priority on redesigning Equalization in a manner that can be interpreted in Quebec as a response to the provincial claim of vertical fiscal imbalance. For diplomatic reasons, the Budget makes no reference to the fact that the imbalance is more acute in Quebec than most provinces because Quebec governments have resisted many of the dimensions of fiscal redress undertaken elsewhere. Thus, Quebec tuition fees in post-secondary institutions are very low, as are Quebec Hydro power rates. Quebec funds a highly subsidized universal childcare program whose benefits have disproportionately accrued to wealthier families. Over the last three decades, Quebec welfare utilization protocols have been relatively relaxed and welfare utilization in the province has (except for the early 1990s) been well above the national average. The net effect is that, to balance the provincial budget Quebec provincial tax liabilities are well above the Canadian average (at middle-class family income levels).<sup>9</sup>

An implicit constraint on Equalization design is that Ontario be a “have” province. This means Ontario taxpayers help pay for Equalization, but receive nothing in return. To mollify misgivings in Queen’s Park over higher Equalization entitlements, the Cabinet incorporated O’Brien’s recommendation of a fiscal cap. The cap is an inelegant ad hoc exception to O’Brien’s fundamental recommendation for treatment of resource revenue. If the Cabinet fully subscribed to the recommendation of 50 percent inclusion in definition of provincial fiscal capacity, the matter of a have-not province potentially achieving per capita fiscal capacity above the lowest non-receiving province could not arise. The anomaly arises because the fiscal cap is defined after redefining fiscal capacity, for the purpose of the cap, in terms of 100 percent inclusion of resource revenue.

A final exercise in political finesse is construction of the 100 percent resource revenue exclusion option. Given the fiscal cap and given that most have-not provinces are resource-poor, this option is currently unattractive. (See Box 1 for further elaboration.) Were the cap to be removed, it would become attractive for resource-rich have-not provinces. Presumably, this option has been included to minimize the perception of divergence from the Conservatives’ election promise of complete exclusion.

## Conclusion

The O'Brien Report and the 2007 budget have done good work in undoing the damage to Equalization wrought by the 2005 New Framework. There should be no illusions, however, that all eleven senior governments now subscribe to the importance of a rules-based Equalization program for which political bargaining is restricted to major renegotiation once every five years.

Clearly, there remain important tensions. Quebec considers higher Equalization entitlements as a first payment on the "vertical fiscal imbalance" and would like Ottawa to reduce tax rates further, thereby granting more tax room to the province. Newfoundland and Saskatchewan are adamantly hostile to the cap on Equalization, as defined. Ontario is suspicious of the case for an enriched Equalization program. From the perspective of Queen's Park, Ottawa is returning to a pre-1995 pattern of overly generous intergovernmental transfers paid for, primarily, by Ontario taxpayers.

The next logical step in reform of intergovernmental relations is to make good on the Throne Speech commitment to bring discipline to Ottawa's use of conditional transfers in areas of provincial jurisdiction. Whether such a reform takes place is, to understate matters, subject to the vagaries of politics.

## Appendix - Equalization reforms, 2007

The 2007 budget implemented, with some modifications, the recommendations of the O'Brien report. In point form, the Budget proposed:

- A higher Equalization standard reflecting the fiscal capacity of all 10 provinces (the "10-province standard"). This standard ensures that Equalization brings the revenue-raising capacity of less prosperous provinces up to the national average.
- A new approach to the treatment of natural resource revenues under which resource-producing provinces would retain additional fiscal benefits from their resources through a 50-percent exclusion of those revenues from the calculation of Equalization payments.
- A fiscal capacity cap to ensure that Equalization payments do not unfairly bring a receiving province's overall fiscal capacity to a level higher than that of any non-receiving province.
- An improved measurement of fiscal capacity that adopts a market-value base for residential property taxes and excludes user fee revenues; a simplified measure of capacity that reduces the number of tax bases from 33 to 5; and a simplified estimate and payment system to increase the predictability and stability of payments (Canada 2007, 113).

The Budget enabled Newfoundland and Nova Scotia to maintain the benefits of the Atlantic Offshore Accords. But, to do so they must accept the overall less generous New Framework

system. These provinces can switch to the new Equalization formula provided they forego the provisions of the Accords. The premiers concerned have contended that Ottawa is violating the spirit, if not the letter, of the Accords.

When in Opposition, the Conservatives had argued that non-renewable resource revenues comprise income derived from exhausting provincially owned assets, and are conceptually different from tax levies on ongoing economic activities. Hence, they should not be included in calculation of provincial fiscal capacity. How can this contention be squared with O'Brien's 50 percent inclusion recommendation? The Budget did so by including a 0 percent inclusion option. But, as the following passage indicates, no provinces is likely to choose it:

Excluding 100 per cent of natural resource revenues has two effects—operating in opposite directions—on a province's Equalization calculations.

- First, excluding all resource revenues lowers the Equalization standard, potentially decreasing Equalization payments to all provinces.
- Second, the exclusion of resource revenues lowers the measured fiscal capacity of each individual province, potentially increasing Equalization payments to each province, since the gap between the standard and each province's fiscal capacity would increase, and Equalization is designed to fill it.

For provinces with relatively low resource revenues, the drop in the standard outweighs the benefits of their lowered measured fiscal capacity, so their Equalization payments would decline.

For provinces with relatively high resource revenues, the benefit from their lowered measured fiscal capacity exceeds the negative impact of the drop in the standard, resulting in higher potential Equalization payments to these provinces (Canada 2007, 344-45).

The provinces that could potentially benefit from the exclusion option are Newfoundland, Nova Scotia and Saskatchewan. Neither Newfoundland nor Saskatchewan can profit from the exclusion option because their Equalization grants are constrained by another provision of O'Brien's recommendation: the fiscal capacity cap. It prevents the equalized fiscal capacity of any province (fiscal capacity defined to include 100 percent of resource revenues) from exceeding that of the poorest non-Equalization receiving province (in 2007, British Columbia). In the short run, Nova Scotia fares better under the renewed Equalization system, but would have lost Offshore Accord benefits over the long run if it abandoned the New Framework system. Subsequent to the Budget, Ottawa backtracked by offering a guarantee of continuity of the Offshore Accord benefits even if these provinces switch to the new formula (Canada 2007c).

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## Endnotes

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- <sup>1</sup> Without implying they are in agreement with my policy recommendations or historical interpretation of events, I thank Laurent Dobuzinkis, Greg Clarke, and Claude Forget for comments on an earlier draft.
- <sup>2</sup> These transfers have evolved and been variously labeled over the years. Currently, there are two major conditional transfers: the Canada Social Transfer (CST) and the Canada Health Transfer (CHT).
- <sup>3</sup> For more on the remarkable exercise in fiscal redress realized in Canadian public finances in the 1990s, readers may like to refer to my survey article (Richards 2000).
- <sup>4</sup> For the most recent example of tax-transfer calculation, see Canada (2007b).

- <sup>5</sup> When Ottawa cut conditional transfers in 1995, they comprised nearly one quarter of all federal program spending. The provinces protested that Ottawa was “downloading” its deficit to them. True enough. But why should Ottawa have spared the provinces? Ottawa’s core social spending responsibilities are not cost-sharing provincial social programs. The core federal social spending responsibility is for old age security, on-reserve Aboriginal programs, and labour-market programming such as unemployment insurance. Ottawa essentially froze spending on these envelopes. Equalization is a rules-based program governed by five-year agreements with the provinces. It too was spared. Overall, Ottawa reduced all other spending, including conditional transfers to the provinces, by a fifth.
- <sup>6</sup> An improvement over pre-1995 policy is that dollar-for-dollar cost-sharing (so-called 50¢ dollars) and “back door” associated equalization have been eliminated. While their aggregate value remains subject to intergovernmental lobbying, the major conditional grants are now distributed across provinces in annual block grants determined essentially on the basis of provincial population.
- <sup>7</sup> According to the 2006 election platform, a future Conservative government would “work to achieve ... permanent changes to the equalization formula which would ensure that non-renewable natural resource revenue is removed from the equalization formula to encourage economic growth.” (Conservative Party of Canada 2006, 43).
- <sup>8</sup> See qualification in box.
- <sup>9</sup> The British Columbia ministry of finance estimated that in 2007 a two-parent two-child family in Quebec with annual family income of \$60,000 paid \$9400 in provincial direct taxes. Such a family paid \$8000 in Ontario and \$5900 in British Columbia (British Columbia 2007, Table A3).