



backgrounder

Canada's Equalization Program

August 2006

Summary

The federal equalization program has once again become an issue of considerable public debate in Canada (for current figures on federal transfer payments to the provinces see Appendix 1).

The following is a summary of the most pertinent recent developments.

- **National Union campaign on equalization issue**

A policy pamphlet and resolution were presented at the Triennial Convention and passed. In the aftermath, the National Union and many Components lobbied, through meetings and letters, both provincial and federal governments. There were three principle policy recommendations made:

- Return to the 10-Province Standard – including resource revenue;
- No Caps Imposed on Equalization; and
- Establish a Federal-Provincial Fiscal Secretariat.

- **October 26, 2004 First Ministers meeting**

Despite Newfoundland and Labrador Premier Danny Williams storming away from the meeting, Prime Minister Paul Martin reached an agreement with the remaining nine Premiers.

Following the meeting there was some heated rhetoric between Premier Williams and the Prime Minister's office over the agreement. This was resolved in early 2005 when the federal government signed a new revenue sharing agreement with the province.

This led to a renewed series of calls from provinces for similar deals for themselves, some of which were reached and others not. This politically motivated series of individual deals frustrated almost everyone. The provinces, through the Council of the Federation, and the federal government committed to study the situation.

- **Federal election**

During the last federal election the Liberals used the recently negotiated agreements with the provinces as an argument for re-election. For their part the Harper Conservatives pledged to honour the existing agreements and to keep resource revenues out of the calculations for the equalization program.

- **Federal and provincial reports released**

The federal experts panel report, entitled Achieving a National Purpose: Putting Equalization Back on Track (a similar report on funding territorial

governments was also prepared), was released on June 5, 2006. The other was drafted by an Advisory Panel for the Council of the Federation, entitled Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance, and presented to the Premiers at their April meeting of the Council.

- **Recommendations made by the National Union compared to those in the two reports**

- Both reports generally support a move to a 10-province standard including resource revenue (the federal panel only includes 50% of provincial resource revenue);
- Both reports place caps on the program, although of a nature that are likely more palatable politically than meaningful; and
- The Council of the Federation report proposes establishing a First Minister' Fiscal Council while the federal expert panel rejects the need for it.

- **The Council of the Federation meeting on June 8th in Edmonton.**

The meeting showed that the provinces are quite far apart on how to address the situation. The next major meeting that will address this issue is the upcoming summer Conference of the Council of the Federation, taking place in July in Newfoundland.

- **The Harper government, for its part, appears to have made resolving the situation a priority.**

During the election campaign the Conservatives promised the Maritime provinces that the agreements they had reached with the Martin government would not be renegotiated. Similarly, Harper had written Alberta saying that resource revenues would not be included in the calculations.

Harper and Finance Minister Flaherty are now more circumspect about it. The need for the federal Conservative Party to make inroads in Quebec probably plays a significant factor in its willingness to consider these proposals.

Premiers Klein and McGuinty have both raised the possibility of the federal government imposing a deal on the provinces should a consensus not be reached.

- **Canadian Centre for Policy Alternatives releases paper *The Art of the Impossible: Fiscal Federalism and Fiscal Balance in Canada*.**

Researcher Hugh Mackenzie demonstrated that much of the "fiscal imbalance" was created by the provinces themselves in a tax-cut competition. In addition, most provinces responded to federal government

cuts to transfer payments to the provinces in the late 1990s by making deep cuts in their own transfers to local governments – creating a substantial problem at the community level.

- **The Council of the Federation meeting held July 26 to 28 in St. John's, Newfoundland.**

The meeting had been intended to provide an opportunity for provincial Premiers and territorial leaders to reach a consensus on the equalization program. From the start of the meeting it was readily apparent that the assembled leaders remained quite far apart on the issues. The meeting closed with a considerable amount of acrimony between the provinces.

The most interesting development to come out of the meeting was an “offer” from the Premier of Ontario to support an increase in the equalization program on condition that the other provinces support Ontario’s demand for an increase to federal transfers – in particular to support post-secondary education – to bring Ontario’s transfers into line with other regions (the amount is lower because Ontario has a greater ability to raise tax revenue).

Following the failure of these talks, many Premiers speculated that the federal government will impose an agreement on the provinces.

This backgrounder document is intended to provide a brief historical overview of the equalization program focusing on major developments that have shaped today’s policy debate. It then provides a quick summary of recent developments.

History of the Equalization Program

Canada's equalization program is intended to give provinces the necessary financial resources to provide "comparable levels of service at comparable levels of taxation" (the northern territories receive funding through a separate federal transfer program). The goal is to ensure that residents of all provinces have access to roughly the same level of services without extreme differences in the amount of tax being paid in an individual province. It is one of four major federal transfer programs: the Canada Health Transfer (CHT); the Canada Social Transfer (CST); and, the Territorial Formula Financing (TFF).

The program is the federal government's primary tool for addressing fiscal disparities between "have and have-not" provinces and has evolved over decades.

Its origins can be dated back to Confederation and the Constitution Act of 1867. Possibly the most fundamental Canadian political reality dates back to this period and the division of legislative powers set out then:

- The federal government has the majority of revenue-generating power for the purposes of economic development and national projects; and
- Provincial governments are basically independent and autonomous within a set of strictly defined powers.

In the aftermath of the Great Depression of the 1930s, which saw some provinces go virtually bankrupt while trying to cope with the period's social and economic effects, the federal government established a Royal Commission on Dominion-Provincial relations (the Rowell-Sirois Commission). The Commission found that the Constitution did not allow the provinces the necessary taxing power to meet their constitutional responsibilities in those social policy sectors for which they were responsible (sections 92 and 93 of the Constitution Act). The Rowell-Sirois Commission concluded that the problems faced by the provinces and territories were systemic in nature (though exacerbated by the Depression).

The Rowell-Sirois report rejected any constitutional changes that would alter the division of powers or give the provinces greater fiscal capacity. Instead it recommended centralizing taxation powers in the federal government and the provision of a guaranteed annual income to the provinces and territories by the federal government - "National Administration Grants".

These Grants would allow provinces to “provide adequate services (at the average Canadian standard) without excessive taxation (on the average Canadian basis)”.¹

Not surprisingly provincial governments refused to give up their taxation powers even with the promise of increased funding from the federal government. The federal government responded by initiating a series of “tax rental agreements” with provinces – basically the provinces rented out their tax collecting powers to the federal government.

This lasted until 1956, with Ontario joining late in the process and Quebec never doing so. The principle of equalization did not appear in the tax rental agreements until 1957 when changes introduced allowed those provinces whose per capita tax revenues fell below a national standard to receive additional federal compensation.

In 1962 the federal government offered the provinces the choice between a lump sum tax rental payment or an equalization payment that would bring a province’s compensation up to a standard level. This was the last year in which the provinces rented out their taxing powers to the federal government. Then, in 1967, provinces reverted back to collecting their own taxes.

The next major development in the program occurred in 1982 when the principle of equalization was enshrined in the Constitution. Section 36 (2) of the Constitution Act, 1982, states:

“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 service at reasonably comparable levels of taxation.”

Some constitutional experts argue that Section 36 does not clearly spell out the federal government’s responsibilities regarding equalization and would be unlikely to survive a legal challenge. The proposed 1992 constitutional amendment (the Charlottetown Accord) would have explicitly committed the federal government to equalization in practice. The Charlottetown Accord would also have committed the federal government to more meaningful consultations with provincial governments on any proposed alterations to the legislation governing equalization payments. The Charlottetown Accord was rejected by 54 percent of Canadians in a national referendum.

¹ Rowell-Sirois made three major recommendations for the federal government to:

- take control of unemployment insurance and old age pensions;
- collect all major taxes (including personal income tax and succession duties); and
- compensate the provinces for the lost tax revenue (and the removal of previous subsidies) by paying annual “National Administration Grants”.

Calculating Equalization Payments

The calculation of whether or not a province receives equalization, and how much, is fairly complicated:

- A province's fiscal capacity is calculated by looking at how much money it would raise by applying an average tax rate to 33 different sources of revenue – e.g. personal and corporate income taxes, and property taxes.
- The calculation is made on a per capita basis to allow comparison between provinces with different populations.
- Each province's fiscal capacity is compared to a national standard which is determined by averaging the tax yield from the five "middle-income" provinces (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia).
- Those provinces whose tax yield fall below the national standard receive equalization payments.
- A province with a fiscal capacity above the national standard does not receive equalization payments.
- Equalization funds are unconditional – provinces can spend the payments however they wish.

In 1982, the federal government set both a lower limit and a ceiling on total equalization payments. These provisions were intended to protect individual provinces from sudden drops in revenue and to protect the federal government from unaffordable annual increases in equalization payments.

Responding to pressure from the provinces, the ceiling on equalization transfers was removed for the fiscal year 1999–2000, but then reinstated the next year, and then removed again for the 2002–03 fiscal year. The equalization floor has never been lifted.

The total amount of equalization paid by the federal government is tied to the overall performance of the Canadian economy. When the country's Gross Domestic Product (GDP) falls below a specified level the amount of equalization paid is similarly reduced.

The Generic Solution and the Atlantic Accords

A recurring problem for federal officials is including calculations for non-renewable natural resources (e.g. oil). In particular, two main issues are present when dealing with natural resources:

- the impact of fluctuations in commodity prices for non-renewable natural resources; and
- the effect that a province's ability to raise revenues from these resources should have on the equalization payments.

Significant fluctuations in commodity prices for resources can result in dramatic year-to-year changes in equalization payments – effecting federal budget planning. On the other hand, including revenues from natural resources into the equalization equation has serious implications for have-not provinces that may see gains made in natural resource revenues taken away through a reduction of their equalization payments.

Another issue of concern occurs when a province increases its revenues from natural resources but lowers its taxation rate to continue receiving equalization payments.

And finally, another related concern is that, under the Constitution, territorial and off-shore natural resources fall within the jurisdiction of the federal government. Provinces have complete ownership over those resources that lie within their provincial boundaries, giving them complete jurisdiction to manage and tax these resources as they see fit. This is a sticky point when looking at the off-shore oil and gas reserves of the Atlantic provinces, in particular Newfoundland and Labrador.

The federal government has attempted to address these issues with adjustments to the equalization formula – most notably when it switched from a “10-province” national standard to a “5-province” national standard to remove oil-rich Alberta from the calculations. Also, the federal government added a provision to the formula referred to as the “generic solution”.

The generic solution, starting in 1994, saw provinces lose only 70 percent of a major increase in fiscal capacity resulting from the development of non-renewable natural resources. Usually for every \$1.00 increase in a province's fiscal capacity its equalization payments decrease by \$1.00. The generic solution, in specific circumstances, allows that for every \$1.00 increase in a province's fiscal capacity, its equalization payments are reduced by only 70 cents.

Newfoundland and Labrador and Nova Scotia, in addition, have long-standing agreements with the federal government, known as the “Atlantic Accords” regarding the management of off-shore oil and gas resources and revenues. The Accords were intended to protect these provinces from reductions in equalization payments, as a result of oil-gas revenues until each of the provinces has established its respective off-shore petroleum industries.

This has some precedent as Alberta was able to continue collecting equalization payments while its oil industry was becoming established. Alberta’s oil boom began in the 1950s and natural resources weren’t included in the calculations of a province’s fiscal capacity until 1964.

The “Fiscal Imbalance”

Fiscal Imbalance is the term referring to a shortfall in the capacity of a province to raise revenue relative to its spending responsibilities. Some Premiers more loosely define fiscal imbalance as the federal government having more money than its spending needs require and the provinces having less money than they need.

In the 1990s the Chretien government, with Paul Martin as Finance Minister, entered into an aggressive program of battling the debt and deficit “problem”. It is highly debatable whether the debt and deficit were the crises that they were portrayed as being. Still, the federal government did use the public perception of a problem to implement deep cuts to the transfer programs and shift away from the targeted funding approach of the Canada Assistance Program to the block-funding model of the Canada Health and Social Transfer.

Many provinces, for their part, used the federal cuts as justification to make their own cuts to health and social programs as well as reductions in funding transfers to local governments. At the same time, provinces governed by political parties enamoured of neo-liberal economics also implemented substantial tax cuts.

From this perspective it is undeniable that much of the “fiscal imbalance” problems being faced by the provinces are of their own making. A recent Canadian Centre for Policy Alternatives paper ***The Art of the Impossible: Fiscal Federalism and Fiscal Balance in Canada***, by researcher Hugh Mackenzie, has fairly well demonstrated that much of the “fiscal imbalance” was created by the provinces themselves in a tax-cut competition.

While federal cuts to transfer payments in the 1990s were unnecessarily deep and hurt social programs across Canada, it is equally true that many provinces implemented quite deep cuts to social programs as part of a political and social agenda. In addition, most provinces responded to federal government cuts to

transfer payments to the provinces by making deep cuts in their own transfers to local governments – creating a substantial problem at the community level.

A number of Premiers, perhaps most notably in Ontario, find themselves in a situation of inheriting funding problems arising from their predecessors' deep cuts to taxes and health and social programs but are unwilling to address them by raising taxes. Other Premiers find themselves competing with their regional neighbours over providing low tax incentives to attract businesses to their province.

It is also true that some serious structural problems did exist within the equalization program. Decades of political wrangling and related policy changes has resulted in a program that is complicated and unevenly applied. Some of the changes made were intended as a cost cutting measure by federal governments who did not want to fund poorer provinces to a level on par with rich provinces – such as Alberta.

The debate over the equalization program also has a much deeper political core than the ongoing dispute over funding would suggest. The dispute is also rooted in a disagreement over the nature of the Canadian federation. Should the federal government restrict itself to a few core functions, e.g. international relations, defence and security, and leave health and social programs to the provinces? Or does the federal government have a role in the establishment and ongoing oversight of national health and social programs? Given the sovereigntist pressures being exerted in Quebec, this is an important question for Canadians.

For its part, the current Harper government tends towards a much more decentralized federation with a much smaller and limited role for the federal government. On the other hand, most Canadians, outside of Quebec, appear to have a strong attachment to our system of health and social programs, in particular Medicare, and worry about a system with wide variations between provinces.

2004 First Ministers Conference on Equalization

In the aftermath of making deep cuts to, and restructuring of, federal transfers to the provinces Prime Minister Paul Martin was facing a situation where the federal government was sitting on large surpluses while many provinces were bitterly complaining that they could not adequately meet their basic social policy responsibilities.

While it can be debated whether the so-called fiscal imbalance exists the obvious disparity between federal and provincial government finances was a politically charged issue. There was considerable political pressure to address the equalization program.

During this time the National Union took an active interest in the equalization issue. A policy pamphlet and resolution were presented at the Triennial Convention and passed. In the aftermath, the National Union and many Components lobbied, through meetings and letters, both provincial and federal governments. There were three principle policy recommendations made:

- Return to the 10- Province Standard – including resource revenue;
- No Caps Imposed on Equalization; and
- Establish a Federal-Provincial Fiscal Secretariat.

The October 26, 2004 First Ministers meeting was intended to renegotiate the equalization agreement. Despite Newfoundland and Labrador Premier Danny Williams storming away from the meeting, Prime Minister Paul Martin reached an agreement with the remaining nine Premiers. The main features of this new equalization agreement were:

- Increased funding for 2004-05 from \$8.9 billion to \$10.8 billion;
- An ‘escalator clause’ that guarantees that provincial equalization payments will increase by 3.5 percent annually as opposed to the total amount of equalization the federal government pays out each year being tied to the country’s economic performance; and
- Creation of a five-member independent panel of experts to review the equalization program that included two provincial representatives.

Following the meeting there was some heated rhetoric between Premier Williams and the Prime Minister’s office over the agreement. This was resolved in early 2005 when the federal government signed a new revenue sharing agreement with the province that:

- gave Newfoundland and Labrador 100 per cent protection from equalization reductions or “clawbacks” for eight years as long as the province receives equalization payments;
- a further eight-year extension as long as the province is an equalization receiving province in 2010-11 or 2011-12, and that its per capita debt-servicing costs have not become lower than that of at least four other provinces; and
- Newfoundland and Labrador received an up-front payment of \$2 billion which equals about three-quarters of the agreed-upon estimate of potential benefits from this agreement between now and 2012.

No amendments to the Canada-Newfoundland Atlantic Accord or Equalization legislation were required and the payments under the offshore revenue

arrangement were separate from the Atlantic Accord and the new Equalization-Territorial Formula Financing framework.

This led to a renewed series of calls from provinces for similar deals for themselves, some of which were reached and others not.

This politically motivated series of individual deals frustrated almost everyone. Both the provinces, through the Council of the Federation, and the federal government had committed to study the situation. With the election of the Harper government the issue has once again come to the forefront in Canadian politics.

Current Situation

Since April 2006, reports have been released by both the federal government and the Council of the Federation. The federal experts panel report, entitled Achieving a National Purpose: Putting Equalization Back on Track (a similar report on funding territorial governments was also prepared), was released on June 5, 2006. The other was drafted by an Advisory Panel for the Council of the Federation, entitled Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance, and presented to the Premiers at their April meeting of the Council.

Snapshot of the recommendations from both reports

Achieving a National Purpose: Putting Equalization Back on Track

- A renewed equalization formula should be developed and used to determine both the size of the equalization pool and the allocation to individual provinces.
- A 10-province standard should be adopted.
- A cap should be implemented to ensure that, as a result of equalization, no receiving province ends up with fiscal capacity higher than that of the lowest non-receiving province.
- Equalization should continue to focus on fiscal capacity rather than assessing expenditure needs in individual provinces.
- Equalization should be the primary vehicle for equalizing fiscal capacity among provinces.
- Fifty percent of provincial resource revenues should be included in determining the overall size of the equalization pool.
- User fees should not be included in the formula.
- Measurement of residential property tax revenues should be based on market value assessment.
- Steps should be taken to simplify the Representative Tax System (RTS).

- The existing intergovernmental process should be retained and made more open and transparent rather than establishing a permanent independent commission.

Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance

- Increase total cash for health and social transfers by \$4.9 billion with new funding mainly targeted to the CST, and an automatic escalator of 4.5 per cent for CST and 6 per cent for CHT until 2013–14.
- Create a new Tax Point Adjustment program: de-link the existing tax transfers from CHT/CST cash to create a stand-alone transfer. Tax points would continue to be fully equalized to the "top province" standard.
- Base equalization payments on a 10-province standard with full resource inclusion; address volatility through the use of a moving average; and scale down entitlements to achieve federal affordability.
- Abandon the TFF fixed framework and return to separate formula-based grants with funding increases.
- Provide more than equal per capita funding to the territories for national sectoral programs, expedite negotiations on the devolution of lands and resources and provide Nunavut with "extraordinary investment".
- Establish a First Ministers' Fiscal Council to deal with intergovernmental fiscal issues, and an independent research organization.

When looking at the three recommendations made by the National Union, in light of those made in the two reports, we see that:

- Both reports generally support a move to a 10-province standard including resource revenue (the federal panel only includes 50% of provincial resource revenue);
- Both reports place caps on the program, though of a nature that are likely more palatable politically than meaningful; and
- The Council of the Federation report proposes establishing a First Ministers' Fiscal Council while the federal expert panel rejects the need for it.

The Council of the Federation meeting on June 8th in Edmonton saw the provinces quite far apart on how to address the situation. A quick survey of provincial positions shows.

- Ontario strongly opposes the 10 province calculation as it will likely see its contributions to the program increase (the province currently, through

taxes paid by its citizens, contributes about 43% to the program) – instead they are calling for increases to the transfer payments;

- Alberta strongly opposes the move to the 10 province standard, with the inclusion of resource revenues;
- Saskatchewan wants the resource revenues kept out of the calculation;
- Quebec's current government is generally supportive partly because it will likely receive the lion's share of increased money under both circumstances, more so if the federal panel's recommendations are accepted, helping to bail Charest out of a mess he is in; and
- Newfoundland would lose money under the federal experts' recommendations and is demanding that the agreement reached with the previous federal government stand.

The Harper government, for its part, appears to have made resolving the situation a priority (for current figures on federal transfers to the provinces see Appendix 1). During the election campaign it promised the Maritime provinces that the agreements they had reached with the Martin government would not be renegotiated. Similarly, Harper had written Alberta saying that resource revenues would not be included in the calculations.

More recently however, Harper and Finance Minister Flaherty have been more circumspect about it. Both had repeatedly emphasized that they were waiting to study the federal report and hear from the Premiers before acting. The need for the federal Conservative Party to make inroads in Quebec probably plays a significant factor in its willingness to consider these proposals.

The Council of the Federation meeting held July 26 to 28 in St. John's, Newfoundland had been intended to provide an opportunity for provincial Premiers and territorial leaders to reach a consensus on the equalization program. From the start of the meeting it was readily apparent that the assembled leaders remained quite far apart on the issues. The meeting closed with a considerable amount of acrimony between the provinces.

The most interesting development to come out of the meeting was an "offer" from the Premier of Ontario to support an increase in the equalization program on condition that the other provinces support Ontario's demand for an increase in per-capita federal transfers – in particular to support post-secondary education – to bring it into line with other regions (the amount is lower because Ontario has a greater ability to raise tax revenue). Ontario's proposed resolution to the dispute was rejected by Quebec, Prince Edward Island and Manitoba.

Following the failure of these talks, many provincial Premiers speculated that the federal government is likely going to impose an agreement on the provinces. The Premiers will most likely actively lobby the Harper government on an individual basis.

The stage is now set for the federal government to develop a compromise that will meet its political objectives. Undoubtedly this will include more money in the equalization program. The question is about whether there will be an increase in per-capita funding to the federal transfers, e.g. to post-secondary education. Finance Minister Jim Flaherty has broadly hinted that there will be more money made available in education.

Quebec has stated its opposition to an increase in per-capita funding for post-secondary education as it would see more being money given to Ontario and Alberta. It is thought that this money is likely to come at the expense of equalization. The government of Quebec could also face some political difficulty with a federal program that ties funding to specific programs.

The Harper government, with an eye to the next election, is looking to an agreement that will help them in Quebec without alienating the other provinces too much. Some have suggested that this may take the form of an increase in the equalization program and a new federal program for post-secondary education.

Appendix 1 – Federal Transfers to Provinces and Territories

Note the following graphs are from the website of Department and Finance Canada (www.fin.gc.ca/FEDPROV/ftpte.html).



