

## **Should Equalization be reformed?**

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Feb 24, 2011**

### **Executive Summary:**

The Equalization program is one of Canada's most important yet least understood programs. Though it is enshrined in the Canadian Constitution, and seeks to address the issue of maintaining fiscal parity amongst provinces, it is a perennially controversial subject. The impact of Equalization on a province is substantial, and although it addresses the fiscal capacity disparity between provinces, its implementation throughout the years has caused other issues to emerge.

After the most recent reforms to the program in 2007, several issues still remain unresolved. Mainly, the lack of transparency and thorough research on Equalization's impact on different provinces, maintaining horizontal equity without causing distortionary behavior, closing the social welfare gap between net contributor provinces (traditionally B.C, Ontario, Alberta) and net recipient provinces (Atlantic provinces, Quebec, Manitoba), and reducing recipient provinces' dependency on transfer payments and natural resources, while keeping growth of the program stable.

Recognizing that there must always be a tradeoff between equity and efficiency, two main policy proposals are recommended: one proposal to address the social welfare and dependence disparity between provinces by eliminating any bias to any specific province or region, while accounting for population differences. The second proposal aims to make the Equalization program open to discussion between the public and policy experts, with regular reviews from government departments; this will help make the program more transparent, and increase awareness from the Canadian people.

### **Rationale**

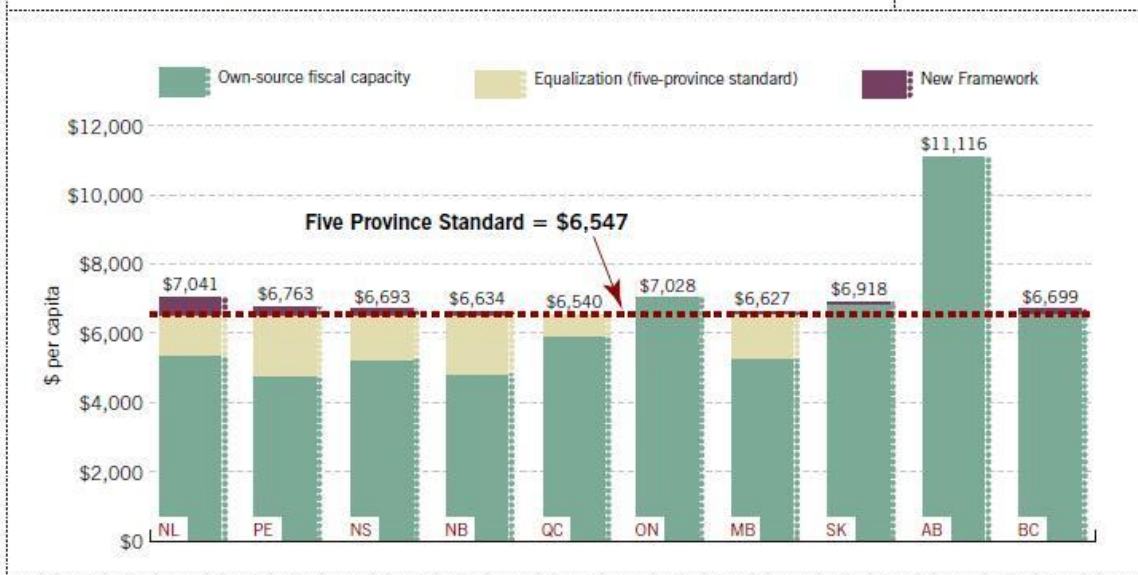
The Equalization policy has been fundamental to the concept of balancing horizontal equity in Canada since its introduction in 1957, originally based on the proposals of economist James Buchanan. In 1982, the Constitution Act revised the Canadian Constitution to specifically mention the equalization policy, and it has been expanded and modified numerous times since its initial inception. At its core, Equalization seeks to address the fiscal imbalances between provinces; a smaller province may not be able to provide the same level of public services as a larger province because of decreased tax revenues from a smaller population and/or economy. Equalization thus takes some tax revenue from the bigger provinces (referred to as the 'have' provinces) and distributes it amongst the smaller provinces (referred to as the 'have not' provinces). Though the provinces can spend these equalization transfer payments however they like, ideally it is assumed that these provinces are able to provide a reasonable level of public services as a result (defined by CAD\$ per capita).

### **Impact**

*"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."*

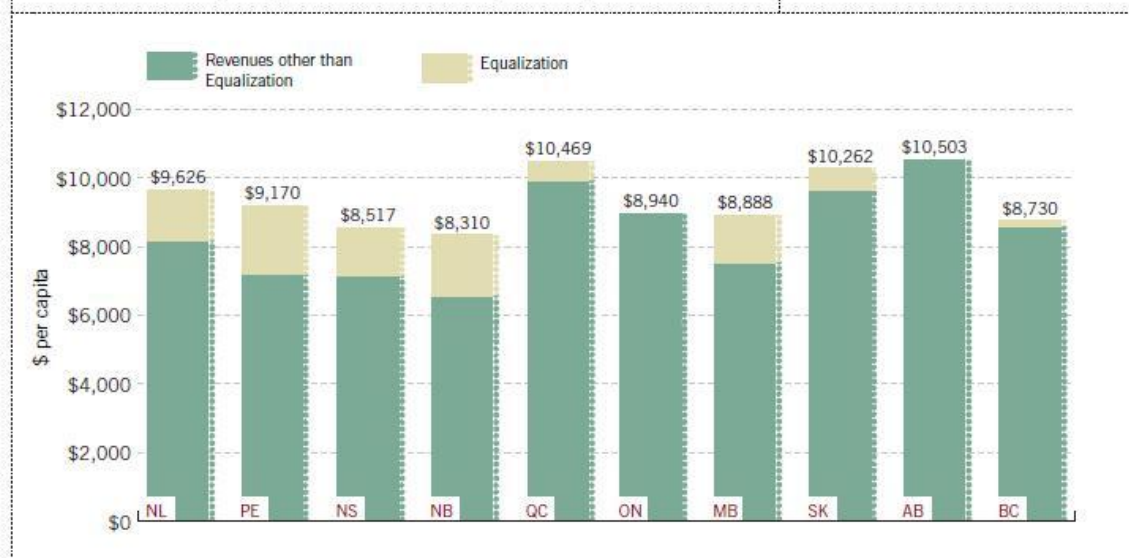
As outlined in the Canadian Constitution, this is the main purpose of Equalization. The following charts demonstrate Equalization's impact on the provincial expenditure and fiscal capacity:

**FIGURE 2 – Fiscal Capacity and Equalization under the New Framework (2005–06)**



Source: Finance Canada

**FIGURE 11 – Provincial and Local Government Program Expenditures Per Capita by Sources of Finance (2004–05)**



Source: Finance Canada, Statistics Canada: Financial Management System

As the Expert Panel on Equalization (2006) noted, judging on the basis of the 'have not' provinces and the 'have' provinces and fiscal capacity per capita, during the 2003-2004 fiscal year, entitlement payments under the old framework (before 2004) had an equalization standard of \$5,916 per capita<sup>ii</sup>. This is taking into account that the benchmarks were the average of the five provinces Ontario, B.C, Manitoba, Quebec and Saskatchewan. This framework resulted in the have-not provinces all receiving different equalization payments but having the same fiscal capacity. Ontario and Alberta were the only two provinces that were above this fiscal per capita average. After the new framework was implemented in 2005-2006, the five province standard was at that time \$6,547, with some have-not provinces receiving more equalization payments than necessary, causing them to be above the average fiscal capacity (shown in Figure 2 above)<sup>iii</sup>. Newfoundland, in particular, had a higher fiscal capacity than Ontario. However, all of the provinces were better off under the new framework than the old one (strictly speaking; Ontario was relatively worse off). The per capita revenues collected in each province are skewed towards the bigger provinces; Ontario, Alberta and B.C were the three highest contributors to the federal government. In terms of equalization entitlements per capita and as a percentage of provincial government revenues, it can be seen that the provinces that benefitted the most were indeed the smaller provinces as expected (shown in Figure 11 above)<sup>iv</sup>. Thus it would seem that Equalization does fulfill its goal of making fiscal capacities equal and having roughly comparable levels of spending between provinces<sup>v</sup>.

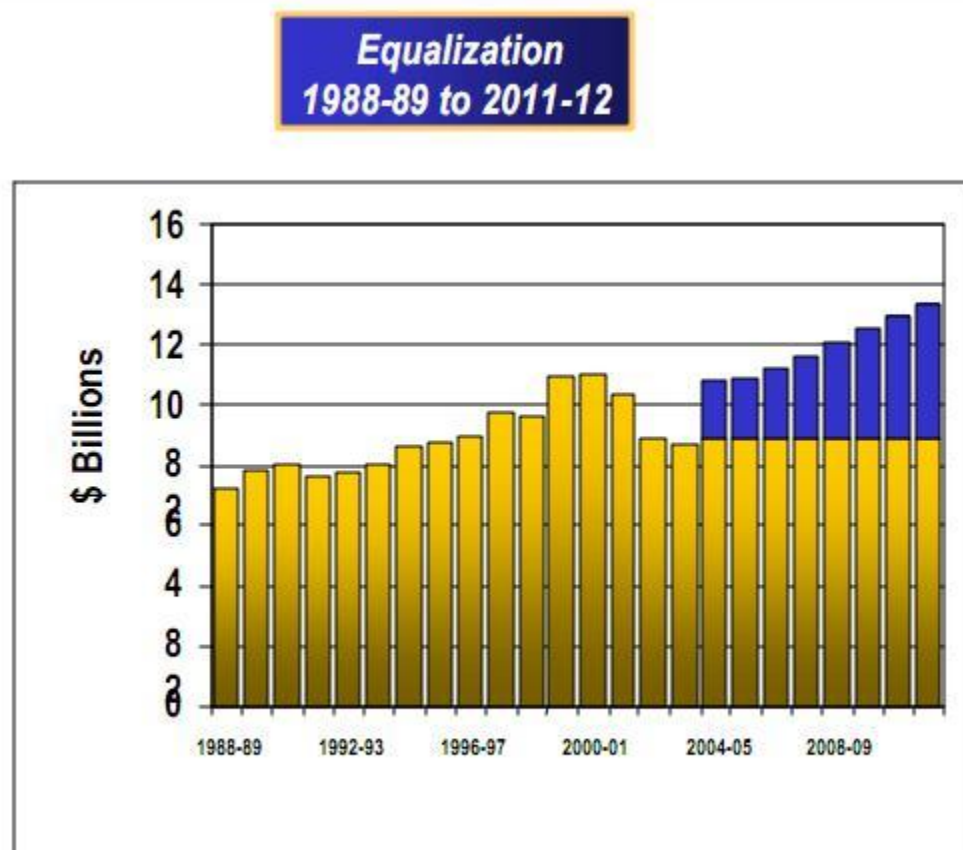
## Issues

Much of the Expert Panel's issues with the Equalization system in 2004-2005 have since been addressed since their recommended policies have been adopted in 2007. These include moving back to a 10-province standard, simplifying the Representative Tax System to only 5 items, excluding user fees, adding a fiscal capacity cap, using three year moving averages to improve stability, including only half of natural resource revenue, and making the process more rigorous to improve transparency, among other changes. However, there are still a number of issues that remain:

1. Economist Michael Smart (2006) argued that have-not provinces have an incentive to raise taxes when potential tax revenues increase, since any harm done to the economy is offset by higher equalization payments. The same inefficiencies that plague the personal income tax system, of having high taxes distort behavior, is therefore present in the Equalization grant system as well<sup>vi</sup>.
2. Equalization encourages dependency from the have-not provinces, since any economic boosting output would reduce equalization payments. This also reduces the incentive for provinces to develop other streams of revenue such as natural resources. Although the Atlantic Accords (2005) were meant to somewhat address this issue, it makes it unbalanced for other provinces who do not have the luxury of being near natural resources such as offshore oil. This was only partly addressed in 2007 by having a cap on natural resource revenue and including only half of that as revenue, but only Nova Scotia agreed to permanently switch to the new formula; Newfoundland remains under the previous system<sup>vii</sup>. The issue of natural resource revenue continues to be a big debate between Western and Eastern provinces, and further highlights the dependency issue.
3. Equalization presents a drain on the economy of 'have' provinces; a province should be entitled to the full rewards of its economic success instead of having its taxpayer dollars given away to another province where its citizens cannot account for them. It is an issue of taxation without

representation, and highlights the fundamental economic problem of an equity-efficiency tradeoff. Redistributing a province's wealth can force that province to collect more taxes from its citizens or charge more fees, in order to preserve horizontal equity between provinces<sup>viii</sup>. This in turn harms productivity and entrepreneurship levels in contributor provinces (explained more in depth by the Ontario Chamber of Commerce's report below).

4. The Equalization program is legislatively set to grow, with funding levels set at 3.5% from 2007 onward. This is referenced in the Annual Financial Report (2010), where major transfers to government account for 20.8% of the budget, increasing by \$1.1 billion in 2009-2010<sup>ix</sup>. The following chart confirms the trend:



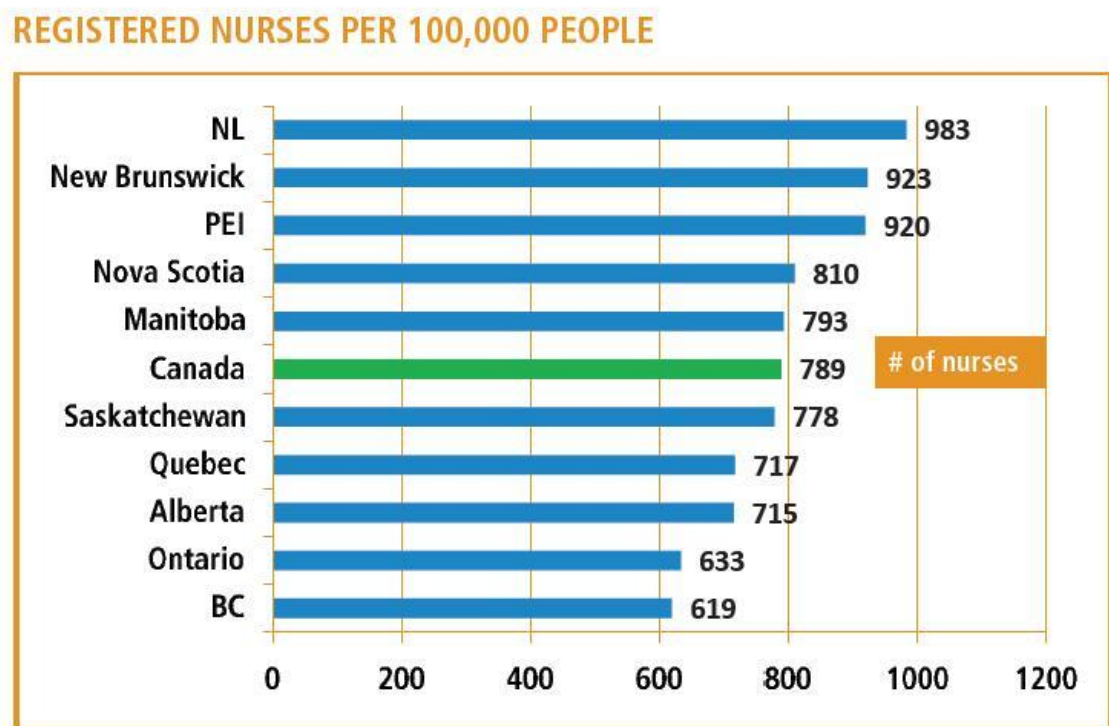
The blue indicates new equalization framework since FY 2004<sup>x</sup>. The growth of Equalization could present potential management problems in the future should it take up a bigger percentage of GDP. Equalization contributions cannot be sustainable if the rate of growth in transfer payments exceeds the economic growth of contributing provinces.

5. The program is still misunderstood and a majority of Canadians are apathetic to it. Furthermore there is still a lack of transparency as several departments have not released recently conducted studies on needs based transfer payments and their impact on provincial economies<sup>xi</sup>.

A recent report released by the Ontario Chamber of Commerce (2011) confirms the growing impact of these issues, amongst others. They noted that over equalization causes significant disparity between

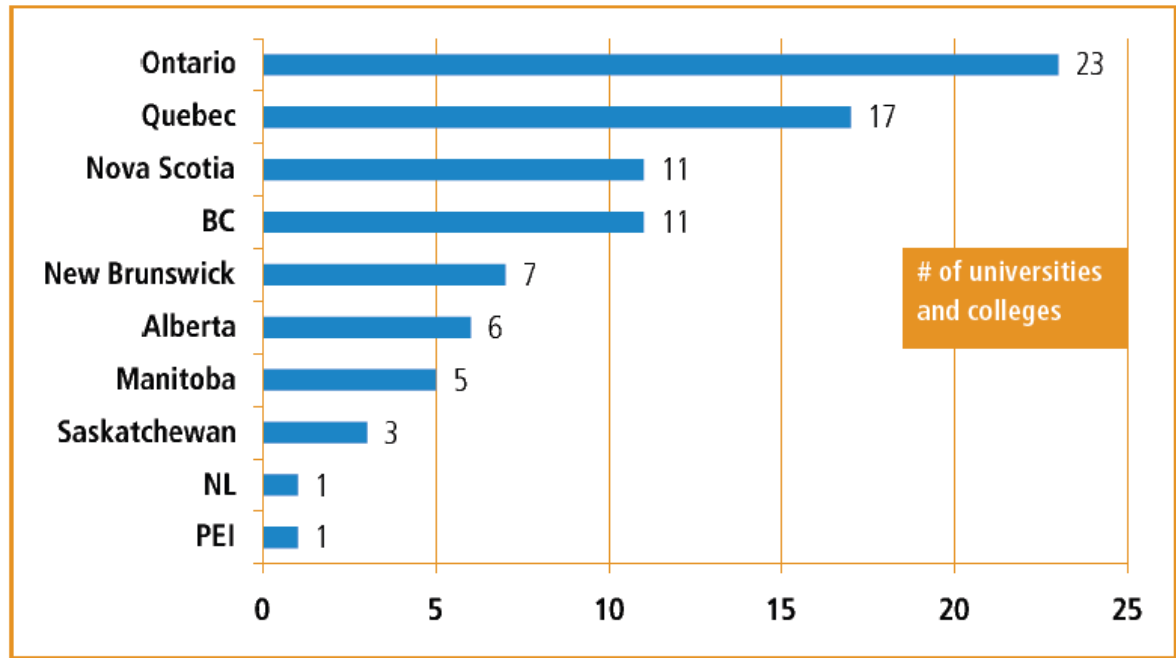
contributor provinces such as Ontario and Alberta, and recipient provinces such as Quebec. According to their report, each Ontarian contribute \$1,800 more per year than they receive, while for Albertans this disparity grows to \$3,800. Ontario is near the bottom of per capita funding of public serves like education and healthcare. It has the second highest average undergraduate tuition, second-lowest number of nurses per 100,000 people, the third-lowest number of residential care beds per 100,000 people, and among the lowest number of child care spaces in Canada<sup>xii</sup>.

*“From birth to death, Ontario citizens are the most disadvantaged Canadians when it comes to public services like education, health care, and child care”* OCC CEO Crispino (2011) said. The report also noted that the dramatic increase in the equalization program offsets any net gain in benefit to Ontarians, despite Ontario receiving Equalization payments for the first time in 2009. The following charts from the report demonstrate a growing gap between the contributor provinces (traditionally Ontario, B.C, Alberta), and the other provinces:



The chart for the registered number of nurses per 100,000 people, and the number of residential care beds per 100,000 people looks similar, with Ontario and the rest of the contributor provinces having lower on average than any of the Atlantic Provinces (traditionally the recipient provinces).

## NUMBER OF UNIVERSITIES AND COLLEGES BY PROVINCE



Source: Council of Ontario Universities, 2009

Atlantic Canada have traditionally received the most transfer payments because of their struggling economy, but this report noted that their relative performance in terms of income have changed very little in 50 years, aside from Newfoundland's added offshore oil revenues. It also highlights the impact of the transfer payments in distorting the wealth of public services in recipient provinces versus contributor provinces. Comparing the most populated contributor province Ontario with the most populated Atlantic province Nova Scotia, Ontario has over 13 times the population yet has only 6.75 times the number of hospitals (211 public hospitals in Ontario, 32 in Nova Scotia), and only 2.1 times the number of universities and colleges (reference chart above). This means that each Ontario college serves on average 565,000 residents, while each Nova Scotia college serves on average 85,000 residents. This represents a violation of the horizontal equity that Equalization was meant to address.

The report also mentions Canada's historic productivity and entrepreneurial gap with the United States, and speculate that part of the reason is due to massive federal transfers (including Equalization payments) from high productivity jurisdictions (\$40-\$50 billion annually) to low productivity jurisdictions, reducing productivity gains by at least 1-2% a year. This, in addition to stealth equalization differences (location of federal offices), results in widening public inefficiency and retarding private sector growth across provinces.

In addition, the Nobel-prize winning American economist who originally proposed the idea of Equalization, James Buchanan, announced that he had made the error of not anticipating the possible corruption of his system by politics, where the disproportionate allocation of parliamentary seats gave the traditional recipient provinces 1.7 times the electing power of contributor provinces<sup>xiii</sup>.

## Recommendations and Conclusions

These issues present quite a challenge to the Canadian government. Equalization reform has already been attempted many times throughout the 80s, 90s, and 00s, yet despite roughly equalizing fiscal capacity to an average, the basic principle of horizontal equity is still violated in the other areas that were mentioned. At the core of the problem is efficiency; the violation of horizontal equity occurs when one or more provinces end up being much worse off than before the Equalization transfer, due to several reasons as discussed previously, including increased tax burden on residents, reduced productivity growth, increased fiscal burden, etc. The thing that must be noted is that Equalization is not Pareto-efficient; there is always a tradeoff between equity and efficiency. The government must settle with Kaldor-Hicks efficiency, hoping that Equalization will bring more benefit than harm.

Keeping that in mind, there are two main policy recommendations I can make, with some of the arguments already elaborated upon in the 2011 report by the Ontario Chamber of Commerce:

1. Reform and eliminate any bias in the Equalization program. Currently, from the evidence gathered above, the equalization program have caused detrimental effects in the contributor provinces (mainly Ontario, B.C, Alberta), while the recipient provinces (mainly the Atlantic provinces, Manitoba, Quebec) have benefited disproportionately. To reduce this disparity and the sense of dependency, I feel that any Equalization system should not favor any particular region or province, while accounting for population and demographics in addition to fiscal capacity. A uniform distribution of transfer payments would be more Pareto efficient, working the same way as a lump sum transfer would in redistributing resources and minimizing any distortions from any one province over contributing or over receiving transfer payments; however having lump sum contributions or payments would not be equitable to each province, highlighting the efficiency vs. equity issue mentioned earlier. The natural resource inclusion of 50% and cap should be maintained as a form of compromise between Western and Eastern province's perspectives on the matter, but should also be discussed further.
2. Make the Equalization discussion more transparent, and more thoroughly investigate its impact on provincial economies and the federal budget. The federal and provincial government should include everyone in the discussion, including policy analysts, think tanks, and the Canadian people. This would go a long way in making the Equalization policy better known and understandable. The impact on provincial economies should be reviewed and analyzed regularly by policy experts and areas of reform and improvement should be outlined. The fiscal position of each province, the sustainability of the Equalization program, and assessing each province's fiscal needs should all be reviewed and released by Finance Canada and Statistics Canada.

Going forward, the Equalization program is one that is not widely understood, and a complicated issue to 'fix', given the economic tradeoffs of efficiency versus equity. However, with more discussion and transparency, I believe this program can go a long ways towards achieving its goal of maintaining horizontal equity between provinces, while avoiding significant economic distortions.

## References

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<sup>i</sup> Subsection 36(2) of the Constitution Act, 1982

<sup>ii</sup> Figure 1, Putting Equalization Back on Track, Expert Panel on Equalization and Territorial Financing, 2006

<sup>iii</sup> Figure 2, Putting Equalization Back on Track, Expert Panel on Equalization and Territorial Financing, 2006

<sup>iv</sup> Figure 11, Putting Equalization Back on Track, Expert Panel on Equalization and Territorial Financing, 2006

<sup>v</sup> These are data gathered for 2004-2006. Recent data are hard to come by, so a more accurate assessment of the new framework is not available yet.

<sup>vi</sup> Raising taxes through Equalization, 2006

<sup>vii</sup> <http://www.mapleleafweb.com/features/equalization-program-canada-overview-and-contemporary-issues>

<sup>viii</sup> [http://en.wikipedia.org/wiki/Equalization\\_payments\\_in\\_Canada](http://en.wikipedia.org/wiki/Equalization_payments_in_Canada)

<sup>ix</sup> Finance Canada Annual Financial Report of 2009-2010

<sup>x</sup> Key Issues for the Review of Equalization and Territorial Financing (2005)

<sup>xi</sup> Both the Expert Panel on Equalization mentions this, as well as the Ontario Chamber of Commerce. Furthermore a look on many Canadian political forums such as [www.mapleleafweb.com](http://www.mapleleafweb.com) demonstrates this.

<sup>xii</sup> Dollars and Sense: A case for modernizing Canada's transfer agreements (2011)

<sup>xiii</sup> <http://www.nationalpost.com/opinion/columnists/Canada+haves/4306227/story.html>