

CANADA'S EQUALIZATION FORMULA: PEERING INSIDE THE BLACK BOX ... AND BEYOND[†]

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SUMMARY

Ontario only started receiving equalization payments, for the first time in its history, in 2009. As soon as Ontario slipped into that “have-not” status, the federal government imposed a cap on the growth of equalization payouts. That led to substantial federal savings, but has cost Ontario and other recipients what would have been much larger payments since then. The federal government's move to rein in the potential ballooning cost of equalization may have been understandable, from a cost-control perspective, but it ultimately defied the very purpose of equalization.

The fixed-growth rule imposed by the federal government is just one of several elements within the current equalization arrangement that should be corrected. The federal government should end that practice and absorb any resulting increase in cost. However, if that cost is onerous, then it could consider adjustments of its other major transfers to the provinces – Canada Health Transfer and the Canada Social Transfer – and reduce those per-capita transfers to provinces that are well ahead of the equalization norm. That would be better than shifting the entire burden to the those below the norm.

Another flaw in the current equalization arrangement is the inclusion of Crown-owned hydro corporations' remittances of earnings to their provincial owners in the natural resources category of equalization calculations. Many of these corporations are not simply energy producers, but are also vertically integrated, with transmission and retail sales operations, and some have no resources at all, but rely instead on fuel purchased in the marketplace. Moreover, taxes paid by private energy corporations are not considered part of the natural resource category but are included in the business income tax category. This means the formula is essentially inconsistent, discriminating based on the ownership profile. Hydro remittances should be removed from the natural resource revenue category in the formula that calculates equalization. They should go in the business income tax category, just as do the earnings of other commercial Crown corporations and taxes paid by private businesses. Going beyond the formula, it is time to re-consider the practice of exempting commercial Crown corporations from corporate income taxation.

A more fundamental and long-recognized problem is the incentive for provinces receiving equalization payments to underprice the water-rental rates they charge for hydro production. Lowering water-rental rates has the effect of reducing provincial hydro revenues, which can entitle those provinces to larger equalization payments, while benefitting residents with cheaper hydro rates. Looked at empirically, “have-not” provinces do charge lower average rates for hydro than do “have” provinces, lending credence to the criticism that non-recipient provinces subsidize cheaper energy for residents of recipient provinces. The increased development of competitive North American wholesale electricity markets in recent decades has made it more feasible to assess what a fair market price for water-rental rates could be. Updating the equalization formula to consider not water-rental revenue, but water-rental fiscal capacity, should be the highest priority of all in reforming Canada's equalization formula to align it more closely to the principles behind its creation.

It is also time to include municipal government revenues from user fees in the formula. Those revenues are significant and it makes little sense to exclude them when municipal property tax revenues are included.

Equalization is not out of control but reform is needed. Action on these fronts should be the priorities. These inside-the-box issues should be resolved before going beyond and considering the more complex task of extending the formula to account for provincial governments' different expenditure needs and costs.

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INTRODUCTION

Canada's system of federal-provincial relationships is complex. There are areas of joint or overlapping federal and provincial jurisdictions, grey areas of jurisdiction, complex tax-harmonization and co-ordination arrangements, shared-cost and joint programs, and substantial transfers from the federal to provincial governments and territories. The pillars of those federal transfers are the Canada Health Transfer (CHT), the Canada Social Transfer (CST) and equalization payments. The CST and CHT serve, at least primarily, to address the vertical fiscal imbalance in the federation. This imbalance reflects the fact that, compared to any one province, the federal government has superior revenue-raising capacity on the one hand, and the provinces have, on the other hand, greater spending responsibilities. The CST and CHT have evolved from earlier forms of federal transfers, such as 50-50 cost sharing, and are now equal per capita grants with relatively few strings attached. Provincial governments can use these funds in any way they want, subject to adherence to certain principles regarding their health- and hospital-insurance regimes, social-welfare policies and post-secondary education policies.

Equalization is different. It is a system of variable transfers to those provincial governments that, according to some measure, are not able to raise revenues to the same extent as others. In the language of the program, equalization payments are made to provincial governments that have weak fiscal capacities. That is to say, if these provinces were to tax at "average" rates, their economies are such that the resulting revenue per capita would be less than average. In this sense, equalization serves to address the horizontal fiscal imbalance — that is, differences in provincial governments' fiscal capacities.¹ Without equalization payments, those with weaker fiscal capacities would not be able to give their residents a mix of tax burdens and public services as attractive as those in other provinces with much higher fiscal capacities. Implicit in this reasoning is an assumption that differences in fiscal capacities across provinces are long lasting. Otherwise, a provincial government could borrow in years when it goes below the norm, and run budget surpluses to pay down debts in years when its fiscal capacity is above average. That would not work for a province with a persistently weak fiscal capacity. As it turns out, history confirms that a provincial government's position, either below or above some fiscal capacity norm or standard, is very long lasting. However, recent events demonstrate that positions need not be permanent. There have been dramatic shifts for some provinces in the past decade. These shifts have ignited concerns about the design of the equalization program and its effectiveness.

Since its inception, the equalization program has been subject to formal renewal processes. Normally, these renewals take place every five years and — despite the fact that equalization is a federal government program, and there are no provincial government contributions to it — involve consultations with the provinces. While the federal government can, and has at times, changed aspects of the program in the years between renewals, the renewal process is intended to set the course until the next five-year period. Much has happened since the current formula was put in place in fiscal year 2007-08. This essay reflects on those developments and discusses some of the challenges to the program and how they might be addressed in the 2014 renewal or thereafter. The focus will be on the inner workings of the formula but, before the conclusion, some observations on the broader context will be made.

¹ In the form of equal per capita grants, the CST and CHT also narrow the vertical imbalance to some extent.

BACKGROUND

There is extensive literature on Canada's equalization program. Nevertheless, it is worthwhile to provide a brief overview for completeness and to help set the stage for the remainder of this essay. There are a number of excellent histories of Canada's equalization program, notably Courchene, for the earlier years, and Perry.² While suggestions for an equalization-type program can be found earlier, it was in 1957 that the equalization program was first instituted by the federal government. In essence, the program was the product of tax decentralization following the Second World War. To finance the war effort, taxation had been highly concentrated with the federal government and, under tax-rental agreements, provincial governments received compensation for agreeing to discontinue levying some major taxes such as income taxes. These arrangements provided the federal government with the scope to raise the enormous sums needed for the military. After the war, however, the federal government no longer needed such concentrated taxation power and, with the great expansion of the welfare state, provincial governments faced greater expenditure pressure. Short of a constitutional shift of provincial responsibilities to the federal government, which was not a serious option and which some provinces, particularly Quebec, would have strongly opposed, the provinces needed more money. As the federal government opened up "tax room," by lowering its rates and facilitating co-ordinated and orderly provincial re-entry into certain tax areas, notably personal and corporate income taxation, the need for some form of equalization became more apparent. Quite simply, some provincial governments had weaker economies so, at any tax rate, less revenue would be raised per capita than in the more prosperous provinces. Those provincial governments would be less able to meet the growing demands for the public services in areas under their jurisdiction, such as health services, social welfare and education.³

At the beginning, only three revenue sources were subject to equalization, namely personal income tax, corporate income tax and succession duties. In 1962, with the first five-year renewal, a fourth source came into play with the inclusion of half of provincial natural resource revenues. By 1967, there were 16 sources, and by 1987, through the addition of more revenue sources such as local property tax revenue in 1977, and the disaggregation of others, a total of

² Thomas J. Courchene, *Equalization Payments: Past, Present and Future* (Toronto: Ontario Economic Council, 1984); David B. Perry, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change* (Toronto: Canadian Tax Foundation, 1997). Also, for a more up-to-date and an excellent compact history, see: Thomas Courchene, "A Short History of Equalization," *Policy Options* (Montreal: Institute for Research on Public Policy, March 2007).

³ After the beginning of the program, scholars developed more formal rationales for equalization. One rationale was based on the notion of fiscal equity, a normative concept that argues that similar people should be similarly treated by their federal and provincial governments regardless of their province of residence. This rationale is closely related to the constitutional one mentioned in the text. Some economists took a different line and argued that different mixes of provincial taxes and public services could induce migration, solely for reasons of obtaining a better mix. Such migration can be inconsistent with the migration needed to achieve economic efficiency. Equalization payments could serve to counteract that phenomenon. This is the efficiency argument for equalization. For seminal work in this area, see: Frank Flatters, Vernon Henderson and Peter Mieszkowski, "Public Goods, Efficiency and Regional Equalization," *Journal of Public Economics* 3 (1974): 99-112; and Robin W. Boadway and Frank Flatters, "Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results," *Canadian Journal of Economics* 14 (1982): 613-633. For an overview, see: Robin W. Boadway, "The Theory and Practice of Equalization," *CESifo Economic Studies* 50, 1 (2004): 211-254; and for a pioneering work, see: James Buchanan, "Federal Grants and Resource Allocation," *Journal of Political Economy* 60 (1952): 208-217.

37 sources were subject to equalization.⁴ Whatever the number of sources, the essential calculation of a provincial government's equalization entitlement is conceptually straightforward. At the core of the calculation is the difference between two numbers. Letting E denote a provincial government's equalization entitlement per capita, it is calculated as:

$$(1) \quad E = S - F$$

where

S (the standard) is the estimated potential revenue a group of reference provinces could raise if they applied a set of given (or "standard") tax rates to specified revenue sources within provincial jurisdiction; and

F (the province's fiscal capacity) is the estimated potential revenue the provincial government could raise if it imposed the same set of standard tax rates to the same specified revenue sources within its jurisdiction;

and both are expressed on a per capita basis. The "standard tax rates" have varied over time according to federal government changes in the program, but for the most part, these have been the average rate across all 10 provinces for each tax source. The reference group of provinces has also varied, from being comprised of the top two provinces, all 10, and five (British Columbia, Saskatchewan, Manitoba, Ontario and Quebec). Once those choices are made, the calculation is straightforward in principle. If the province in question lags the reference-group standard (i.e., $F < S$), then it is said to have a weak fiscal capacity and is entitled to an equalization grant from the federal government equal to E , the gap between S and F , for each person residing there. Conversely, if a provincial government's revenue-raising capacity exceeds the standard ($F > S$), then it receives no equalization entitlement. With revenue sources so comprehensively included, this method of equalization grant calculation is known as the representative tax system (RTS).

Despite the preceding simple illustration of a province's equalization entitlement, there are many complexities within the black box of equalization arithmetic. There are many revenue sources and the tax bases of some of these are difficult to measure or are defined differently across the provinces, making their comparability a challenge. There are time lags in data availability, which can require re-calculations and adjustments in payments. Also, various limits, adjustments, exclusions and special exemptions can be placed within the formula to enrich or reduce a provincial government's entitlements, or may be imposed to reduce the aggregate cost of the program to the federal government. These considerations not only create complexity, but changes in them or in the methodology for measuring underlying data can have substantial budgetary implications for provincial and federal governments. Here, the federal government is in the driver's seat. Despite institutionalized consultations with the provinces prior to renewals, equalization is a federal government program and the federal government alone determines the formula and can change the formula as it sees fit, whether at renewal time or not. Whenever the federal government proposes or makes changes, the provinces react.

⁴ For a list of those 37 sources, see Perry, *Financing the Canadian*, 163-164.

Recipient provinces may see their entitlements rise or fall, and react accordingly. Even non-recipient provincial governments are affected because a change in federal funding support for equalization payments can have implications for other federal-provincial transfer programs and expenditures that these “have” provinces do receive. Also, their residents, like those of other provinces still contribute to the program via their payment of federal taxes.

Yet, the RTS-type equalization program is well embedded in the fabric of Canada’s federal-provincial arrangements. Indeed, some 25 years after the program’s beginning, a commitment to equalization payments was included in the Constitution Act of 1982. Section 36(2) commits Parliament and the federal government to the principle of making equalization payments to the provinces. That constitutional commitment does not directly refer to the program that has existed since 1957; even equal per capita federal grants to all provincial governments have an equalizing effect since disproportionately larger revenues would naturally come from provinces with relatively stronger economies. However, this commitment can be readily interpreted as support for the type of equalization program as has existed. After all, the framers of Section 36(2) were quite familiar with that program and it would have been the obvious point of reference when using the term “equalization payments.” As of 2013, more than 30 years after the Constitution Act of 1982, there has been no constitutional court challenge claiming that the commitment means something different.

The most significant deviation from the RTS equalization formula occurred over fiscal years 2004-05 to 2006-07. In October 2004, then prime minister Paul Martin announced an interruption in the equalization program, the five-year renewal of which had only started six months earlier. A “new funding formula framework” would entail an immediate increase in funding for equalization above the amount determined from the formula.⁵ In addition, and again regardless of the formula, total payments were set to increase at a fixed rate of 3.5 per cent annually thereafter. The total payout was allocated partly according to recent past shares among recipients and partly on a per capita basis. If left in place, these arrangements would have made equalization payments ever more unrelated to provinces’ fiscal capacities. Reinforcing this movement of equalization away from the objective of mitigating differences in fiscal capacities across provinces, Martin, during the federal election of June 2004, had promised Nova Scotia and Newfoundland and Labrador an arrangement whereby they would be compensated fully for any loss in equalization caused by improvements to those provincial governments’ fiscal capacities due to offshore oil and gas production.⁶

⁵ For an excellent summary, see: Michael Holden, “Equalization: Implications of Recent Changes,” Library of Parliament PRB 05-91E (Ottawa: Parliamentary Information and Research Service, January 4, 2006).

⁶ These agreements for offsetting payments were finalized in early 2005 and separate for each province. They were for specified periods and subject to renewal if certain fiscal and debt measures of each provincial government did not improve by agreed targets; for more details see: James P. Feehan, “Equalization 2007: Natural Resources, the Cap, and the Offset Payment Agreements,” in *Canada: The State of the Federation*, ed. John R. Allan, Thomas J. Courchene and Christian Leuprecht (Montreal- Kingston: McGill-Queen’s University Press, 2009), 175-200. Previous agreements in the 1980s (the Atlantic Accord with Newfoundland and Labrador, and the Offshore Accord with Nova Scotia) had already been in place and, as well as establishing respective joint management of offshore oil and gas development, provided for partial compensation to those provinces during the early years of oil and gas production for declines in equalization payments that were expected to arise from offshore royalties and related revenues. However, by 2004, these provinces argued that those compensating payments had been very modest and would end before offshore revenues would peak.

Fortunately, the new framework also included the formation of the Expert Panel on Equalization and Territorial Formula Financing. That panel was tasked with advising the federal government on those two important programs. Chaired by Al O'Brien, the panel reported in May of 2006.⁷ The crux of the report's advice was that equalization should be returned to an RTS-type formula, one that determined equalization payments across provinces according to the extent to which their respective fiscal capacities falls below a standard. Thus, the total amount of equalization payments would be formula-driven, not determined in advance by a fixed allotment as under the new framework. In addition, the panel considered many other aspects of equalization and made several recommendations, some of the key ones are as follows.

- The standard should be a 10-province one. Since 1982, a five-province standard had been in place.⁸ The apparent motive for the latter was to exclude Alberta's huge oil and gas revenues, thereby lowering the standard and making the program more affordable.
- Half of provincial natural resource revenues should be equalized. In particular, the equalization of this revenue source should be based on actual revenues, not fiscal capacity, which is a measure of the ability to raise revenue, whether it is raised or not.
- All the 33 revenue sources that were in the previous formula should be aggregated into five categories; namely,
 - personal income tax,
 - business income tax,
 - sales tax,
 - natural resource revenues, and
 - property tax.
- There should be a fiscal-capacity cap on equalization payments to recipient provincial governments. The cap would be determined by examining the set of non-recipient provinces and finding the one with the lowest sum of fiscal capacity and its remaining 50 per cent of natural resources. That lowest sum would be the cap. For any recipient province, its equalization entitlement would be reduced to the extent that its fiscal capacity plus its remaining 50 per cent of natural resource revenues plus its equalization entitlement (and for Newfoundland and Labrador and Nova Scotia, their offshore-related offset payments) exceeds the cap.⁹
- Equalization entitlements should be based on a weighted average of a province's annual fiscal capacities, lagged two years. This technical change was to avoid the numerous adjustments and corrections to estimated entitlements prior to 2004. This would make payments more stable and predictable, desirable features for both the federal government and recipient provincial governments.

⁷ The panel issued two comprehensive reports, one for equalization and one for territorial financing. For the former, see: Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track* (Ottawa: Department of Finance, Government of Canada, 2006).

⁸ The five-province standard was somewhat of a hybrid. It was calculated by applying the average tax rates across all 10 (not the five) provinces to five select provinces' corresponding tax bases, and dividing the result by those provinces' total population to arrive at the per capita standard.

⁹ This was very controversial for those two provinces. Their equalization-loss offset payments under their respective offshore agreements with the federal government were to compensate for reductions in equalization. Feehan ("Equalization 2007," 88) observes that an inconsistency arises when a payment intended to offset a reduction in equalization is used as a basis for reducing an equalization payment.

CURRENT SITUATION

Despite a change in the ruling party, from Liberal to Conservative, the federal government accepted practically all the expert panel's advice and re-instituted an RTS system beginning with fiscal year 2007-08. There were some add-ons as well, two of which are of note. First, if a provincial government's equalization entitlement were larger with all natural resource revenue excluded from the formula, then it would receive that larger amount. The second add-on is related to special treatment of Newfoundland and Labrador and Nova Scotia. To avoid the fiscal-capacity cap, these provinces were given the option to continue to have their equalization payments determined as if the previous new framework were still in operation.¹⁰

In short, the core of the formula introduced in 2007 defined the standard (S) and a province's fiscal capacity (F) in the following ways:

$$(3) \quad S = t_1B_1 + t_2B_2 + t_3B_3 + t_4B_4 + 0.5N$$

and

$$(4) \quad F = t_1b_1 + t_2b_2 + t_3b_3 + t_4b_4 + 0.5n$$

where the t_1 , t_2 , t_3 , and t_4 represent the national average of provincial tax rates applicable to personal income, business income, consumption expenditure, and property, respectively. Each B denotes the corresponding amount of the relevant tax base summed across all provinces and expressed on a per capita basis, while N is the sum of all natural resource revenues collected by provincial governments expressed on a per capita basis. The lower case b 's and n are the corresponding amounts for a particular province; thus, for each province, there is a different value of F while S is invariant.¹¹

Under the 2007 formula, a provincial government becomes eligible for an equalization payment when its fiscal capacity (F) is less than the standard (S). However, whether it receives a payment then depends on the workings of the fiscal-capacity cap, as defined earlier. The actual per capita payment (P) to an eligible provincial government would correspond to

$$(5) \quad P = (S - F) - A$$

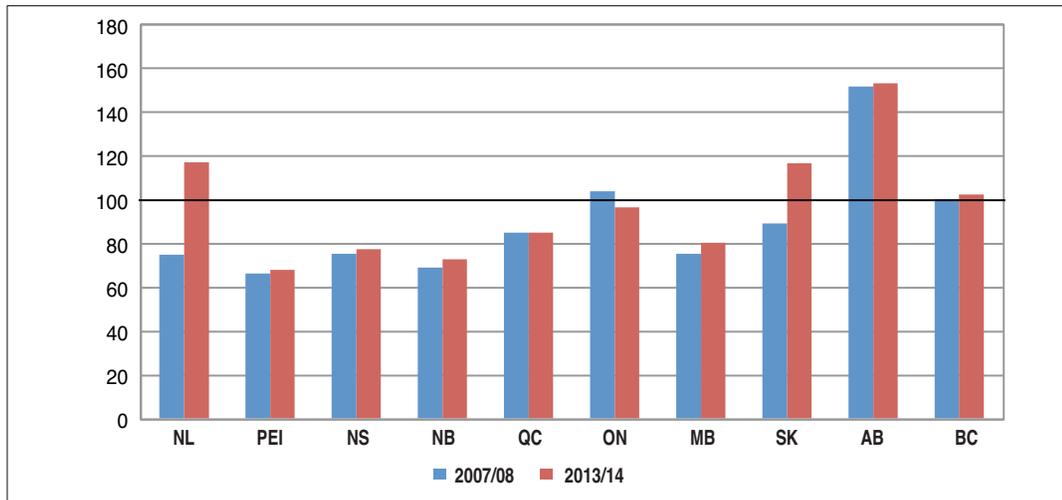
where A represents the adjustment arising from the application of the fiscal-capacity cap; it would be zero if the cap did not apply, or a positive number up to the value of $(S-F)$ if the cap was triggered.

¹⁰ For more details, see: Finance Canada, "Restoring Fiscal Balance for a Stronger Federation," Budget 2007, Annex 4, 2007.

¹¹ Following the recommendation of the expert panel report, the three-year weighted average of the annual values of the standard and province's fiscal capacity — lagged two years, with a 50 per cent weight on the most recent year and 25 per cent weights on the other years' values — are used.

While equations (3), (4) and (5) capture the essence of the formula introduced in 2007, there have been some changes since then. Before turning to those changes, it is worthwhile to look at how provinces' fiscal capacities have fared since 2007. Chart 1 shows each provincial government's fiscal capacity (F) relative to the standard, which is normalized to 100 for the purpose of comparison, for 2007-08 and for 2013-14, the last year before program renewal.¹²

CHART 1 FISCAL CAPACITIES OF PROVINCES: 2007-08 VERSUS 2013-14



Based on data provided by Finance Canada

Three outstanding developments can be gleaned from the chart:

- Saskatchewan's fiscal capacity increased to the point where it is no longer eligible to receive equalization.¹³ This is a significant development because, except for 1975-76 and 1981-82 to 1985-86, that province had been in receipt of equalization. Its transition to "have" status occurred in 2008-09 and was primarily due to increasing oil-and-gas tax and royalty revenues.
- Newfoundland and Labrador (NL) also ceased to qualify for equalization. This change was even more significant insofar as that province had been a recipient of equalization since 1957 and was very heavily dependent on equalization payments for most of those years. Like Saskatchewan, it ceased qualifying for equalization in 2008-09. Surging provincial revenues from offshore oil was the cause of this change in status. Also, under the Atlantic Accord of 1985 and the more recent 2005 agreement with the federal government, that province continued to receive offsetting payments to compensate for reductions in equalization until 2011-12. Its revenue circumstances improved to the point that, in 2012-13, it no longer qualified for such payments either and all special arrangements in that regard have now lapsed.¹⁴

¹² I am grateful to the officials in the federal-provincial relations division of Finance Canada for their assistance in providing data.

¹³ See: Alex S. MacNevin, *The Canadian Federal-Provincial Equalization Regime: An Assessment*, Canadian Tax Paper 109 (Toronto: Canadian Tax Foundation, 2004), 293-294.

¹⁴ The government of Nova Scotia still has such arrangements in place. Its offshore revenues are relatively modest and not enough to trigger an end to the compensating payments in 2012. However, under the agreements, those payments will end by 2020. In the meantime, its equalization payments are governed by the existing formula but with a guarantee of receipt of compensation as if it had opted to remain under the 2004 framework.

- Ontario's fiscal capacity exceeded the standard in 2007-08 but by 2013-14 it had fallen below. The actual change occurred in 2009-10, the first time in the history of Canada's equalization program that Ontario became a recipient.¹⁵

While the change in status for Saskatchewan and, especially, Newfoundland and Labrador was a major development for those provinces, it was Ontario's change in status that had far-reaching implications for the equalization program. Looking at Chart 1, Ontario's 2013-14 shortfall from the standard appears quite modest, but the implications are not. Ontario has a huge population, so even if its fiscal capacity is modestly below *S*, which is a per capita measure, its total entitlement becomes a large portion of the total equalization payout. Table 1 illustrates this phenomenon. That table shows the evolution of equalization payments during the new-framework regime and the current formula. The year 2008-09 was pivotal. It was the first year in which Newfoundland and Labrador and Saskatchewan were no longer recipients and the last year that Ontario enjoyed "have" status. More significantly, however, is what happened thereafter. In 2009-10, Ontario received its first ever equalization payment: only \$0.3 billion out of total payments of approximately \$14.2 billion. However, by 2013-14 the payment to Ontario was almost \$3.2 billion, while the sum of payments across all recipient provinces was \$16.1 billion. Thus, the increase in payments to Ontario exceeded the increase in total payments.

Indeed, it was Ontario's entry into equalization eligibility status that led to the two most significant changes in the equalization formula over the 2007-08 to 2013-14 interval. Both were introduced in the 2009-10 federal budget.¹⁶ They were: (i) the redefinition of the fiscal-capacity cap and, far more significantly, (ii) the introduction of a fixed growth rate in total payments.

TABLE 1 EQUALIZATION PAYMENTS BY PROVINCE (\$ MILLIONS)

	NL	PEI	NS	NB	QC	ON	MB	SK	AB	BC	Total
2004-05	\$761.8	\$277.4	\$1,313.1	\$1,326.4	\$4,154.7	\$0	\$1,606.9	\$652.2	\$0	\$682.0	\$10,774.5
2005-06	\$861.0	\$276.6	\$1,343.5	\$1,348.0	\$4,798.1	\$0	\$1,601.0	\$82.2	\$0	\$589.7	\$10,900.0
2006-07	\$686.6	\$291.3	\$1,385.5	\$1,450.8	\$5,539.3	\$0	\$1,709.4	\$12.7	\$0	\$459.4	\$11,535.1
2007-08	\$477.4	\$294.0	\$1,464.5	\$1,476.5	\$7,160.4	\$0	\$1,825.8	\$226.1	\$0	\$0	\$12,924.7
2008-09	\$0	\$321.7	\$1,464.9	\$1,583.8	\$8,028.4	\$0	\$2,063.4	\$0	\$0	\$0	\$13,462.2
2009-10	\$0	\$339.9	\$1,390.7	\$1,689.4	\$8,354.5	\$347.0	\$2,063.4	\$0	\$0	\$0	\$14,185.0
2010-11	\$0	\$329.8	\$1,110.3	\$1,581.5	\$8,552.2	\$972.1	\$1,826.0	\$0	\$0	\$0	\$14,372.0
2011-12	\$0	\$328.8	\$1,167.0	\$1,482.8	\$7,814.5	\$2,199.5	\$1,665.9	\$0	\$0	\$0	\$14,658.6
2012-13	\$0	\$337.1	\$1,268.0	\$1,494.9	\$7,391.1	\$3,260.7	\$1,670.7	\$0	\$0	\$0	\$15,422.5
2013-14	\$0	\$339.5	\$1,457.9	\$1,513.1	\$7,833.0	\$3,169.4	\$1,792.3	\$0	\$0	\$0	\$16,105.2

Source: Finance Canada

¹⁵ Ontario did qualify for equalization from 1977-78 to 1982, but a personal-income override was added to the formula, which made that province ineligible; see: Perry, *Financing the Canadian*, 139-140. The override denied equalization to any equalization-eligible provincial government where per capita personal income exceeded the national figure. Only Ontario was affected by that provision.

¹⁶ For further elaboration and assessment of these changes, as well as changes to the other major federal transfers to the provinces, see: Michael Smart, "The Evolution of Federal Transfers since the O'Brien Report," paper prepared for "The Federal Budget: Challenge, response and Retrospect," John Deutsch Institute conference, 2009.

Originally, and consistent with the expert-panel report, the fiscal-capacity cap was defined as the lowest value from the set of fiscal capacities plus the remaining 50 per cent of natural resource revenues of the non-eligible provinces. Up to that time, Ontario's fiscal capacity was the fiscal-capacity cap. As Smart points out,¹⁷ with no change in definition, once Ontario was no longer a non-recipient, the fiscal-capacity cap would be set by British Columbia and be much higher. In other words, it would be less binding on recipients and therefore increase equalization costs. However, the federal government redefined the fiscal-capacity cap as the average of the sum of equalization recipients' (a) fiscal capacity (as given by equation 4), (b) their remaining 50 per cent of natural resource revenues per capita, and (c) their equalization payments per capita. The effect of this redefinition was to avoid a large increase in total payments.¹⁸

The second change was also motivated by a desire to limit growth in program costs. The federal government imposed a fixed rate of growth in total payments: the growth rate of nominal gross domestic product (GDP). As a result, the core calculation of a province's per capita equalization payment is no longer given by (5). It became:

$$(6) \quad P = (S - F) - A^* - R,$$

where A^* is the value of any reduction due to the redefined fiscal-capacity cap, and R denotes the reduction in the payment necessary to keep aggregate payments at the level dictated by the set growth rate. In essence, the application of (6) follows a sequential process. First, the difference $S-F$ is determined for all provinces and only those for which the difference is positive are eligible for an equalization payment. Next, for each of those provinces, the value of $(S-F) - A^*$ is calculated. Finally, if the sum of the amounts so calculated exceed the total budget limit, then an equal per capita amount, R , is subtracted from each province's $(S-F) - A^*$, sufficient to achieve the budget limit.

Since 2009-10, equalization payments have been determined according to (6) in conjunction with (3) and (4). The program is scheduled to be renewed for 2014-15 to 2018-19. The change in Ontario's status and the associated 2009 changes to the formula raise significant issues that need to be addressed in a revised formula. Also, those developments are intertwined with other debates about equalization that have been in play for a long time.

ISSUE: THE FIXED GROWTH RATE

The most troublesome change to the equalization formula since 2007 has been the re-introduction of a fixed aggregate for total equalization payments.¹⁹ It marks a dramatic turn away from the expert-panel-based formula and a return to the flawed 2004 new framework.²⁰

¹⁷ Smart, "The Evolution of."

¹⁸ Smart (ibid.) observes that this redefinition also has some justification based on fairness and has the beneficial effect of reliance on a less volatile metric.

¹⁹ A ceiling was also placed on aggregate equalization payments as part of the 1982-83 renewal but apparently did not become binding until 1988-89; see: Perry, *Financing the Canadian*, 162. It was set at the growth rate of the economy.

²⁰ The new framework was more severe insofar as funding increases were allocated by reference to historical payments rather than changes in relative fiscal capacities.

This measure reduces the formula to an allocator of a pre-determined annual amount, not a determinant of that amount. It is particularly problematic because, under such an arrangement, the aggregate of equalization payments becomes less and less reflective of the fiscal gaps across provinces. The fundamental principle that payments should rise when fiscal gaps become relatively more severe, and should fall when those gaps diminish, is violated by this allocation rule.

The underlying motives for having an annual fixed envelope are predictability and affordability. In this case, the latter seems to be the primary concern. After all, the adoption of the expert-panel report's recommendation to the use of weighted averages of three years of fiscal capacity, lagged two years, to determine a province's equalization entitlement, makes it quite straightforward to forecast provincial entitlements and federal costs. The equalization program is a federal one and only the federal government pays for it. Since 2008-09, the non-recipient provinces have also been those that are particularly rich in oil and gas. Any surge in prices for those commodities impact the formula and eventually raises the standard. The federal government would then be obligated to make larger payments to those provinces below the then-higher standard. Another affordability problem can arise if Ontario, which has been a recipient of equalization since 2009-10, sees its fiscal capacity fall further relative to the standard. Being the most populous province, even a modest increase in its per capita entitlement could translate into a huge increase in its total entitlement.

The fixed envelope was imposed in 2009-10, the same year that Ontario became eligible for equalization. Since then, it has resulted in substantial savings for the federal government. Table 2 shows those savings.²¹ Interestingly, and taking into account the weighted averaging and two-year lap in the formula, the biggest saving, more than \$4.5 billion in 2010-11, appears to reflect two events. The first was the huge spike in petroleum prices in 2008, which benefitted the four current "have" provinces especially, and the second was the recession, which hit Ontario, a province with practically no oil and gas, particularly hard.

Also, Table 2 shows that there would have been a bulge in equalization payments if the fixed growth rate were not in play. However, the circumstances that pushed the standard up while pushing Ontario down may well have been transitory. Oil prices have moderated since the peaks of 2008, natural gas prices have fallen dramatically, and Ontario is out of recession.²² The key question here is whether the equalization formula should have been allowed to work to alleviate the temporary but sharp shift in fiscal capacities of Ontario and the oil and gas provinces. The answer is: yes, it should have been allowed to work. That is its purpose.²³

²¹ Table 2 shows the reduction based on the 2009-10 formula. Smart ("The Evolution of") points out that for 2009-10, the difference between the entitlement under the 2008-09 formula and the 2009-10 formula is larger; approximately \$1.9 billion rather than the \$981 million shown in Table 2.

²² Latest figures from Finance Canada indicate that Ontario's equalization payment for 2014-15 will fall from \$3.17 billion to just under \$2 billion out of a total payout of \$16.7 billion, which reinforces this proposition that the surge in total payments that would have occurred in 2009 to 2012 due to Ontario's "have-not" status was a temporary phenomenon.

²³ Consider the extreme case where the fixed growth rate is in place and nine provinces move very close to the standard and one is slightly below it; that one province, despite being only a little behind the others, would be entitled to a huge and rising payment.

TABLE 2 IMPACT OF THE FIXED-GROWTH-RULE ON EQUALIZATION PAYOUT

	Total Entitlements	minus Total Payments	equals Reduction due to Fixed-growth rule
2009-10	\$15,166.3	\$14,185.0	\$981.3
2010-11	\$18,891.8	\$14,372.0	\$4,519.8
2011-12	\$17,649.8	\$14,658.6	\$2,991.2
2012-13	\$17,465.5	\$15,422.5	\$2,043.0
2013-14	\$16,478.9	\$16,105.2	\$373.7

Based on data from Finance Canada

The preceding answer may seem that of a purist. There is still that nagging, but very legitimate, affordability question. There are two responses. First, if the increase in (uncapped) payments was not long lasting, then shifts in the other direction would at times leave the federal government with considerable offsetting savings. For instance, if Ontario returns to strong economic growth, oil and gas revenues of non-recipient provinces moderate, and the other recipient provinces maintain or improve their fiscal positions, then all may move closer to the standard, from above and below. The result would be substantial reductions in equalization payout. Thus, lower payouts in some years would offset higher payouts in others.

On the other hand, it may be difficult to know if a shift in fiscal capacities, one that entails substantially higher payouts, is temporary or not. Fiscal prudence may require some constraints on program payments rather than waiting in the hope that everything averages out, as suggested above. This brings us to a second response to the affordability question. To start, a fixed growth rate is too blunt an instrument. Since 2009, it has served to claw back equalization entitlements from provinces with below-standard fiscal capacities, while non-recipients have had the good fortune of seeing their fiscal capacities improve dramatically or remain very high. Short of constitutional changes, one cannot expect the non-recipients to contribute directly to the higher cost of the program whenever fiscal capacities diverge. However, one attractive option that appears quite feasible is to adjust federal CHT and CST payments along the lines suggested by Courchene.²⁴ Payments under the CST are made on an equal per capita basis and, starting in 2014-15, so too will payments under the CHT.²⁵ Under a Courchene-type plan, all provinces would be ranked by the sum of their fiscal capacities as defined in the equalization formula plus their other 50 per cent of natural resource revenues,

²⁴ Thomas J. Courchene, "Intergovernmental Transfers and Canadian Values: Retrospect and Prospect," *Policy Options* (Montreal: Institute for Research on Public Policy, May 2010): 32-40; Thomas J. Courchene, "Surplus Recycling and the Canadian Federation: Addressing Horizontal and Vertical Fiscal Imbalances," Mowat Centre Fiscal Transfers Series, University of Toronto, July 2013. Another option is to re-introduce a "personal income over-ride," which had the effect of excluding Ontario in the past (see note 15) and which Ontario did not oppose at the time. However, Ontario's current circumstances are quite different now, so adopting an ad hoc rule to exclude it no longer seems justifiable.

²⁵ This makes more sense for these grants, since expenditures in these areas are most likely to rise over time, whereas equalization entitlements can be up and down as relative fiscal capacities of provinces change.

plus any equalization receipts, all on a per capita basis. Provincial governments whose per capita sum was well above the average would have their CHT and CST grants reduced according to some proportional or progressive scale. This approach is appealing and could be implemented with the following features:

- implement the CHT/CST clawback in conjunction with removal of any arbitrary limit on aggregate equalization payments, thereby allowing the equalization formula to determine the aggregate program payout;
- calculate how much equalization would have been reduced if the growth rule were in place and use that figure to determine the CHT/CST clawbacks;
- if the equalization-growth rule implied negative clawbacks (due to a reduction in the horizontal fiscal gap) then the savings would be transferred to all provinces on an equal per capita basis; and
- no province would have more than a maximum fraction of their CHT and CST grants reduced — for example, they could be assured of at least, say, 50 per cent; if this is binding then the additional funds should come from federal general revenues.

The effect of this scheme would be to shift the equalization clawback away from the equalization receiving provinces to the non-recipients; from the “have-nots” to the “haves.”²⁶

In short, the imposition of a fixed-growth rule is inappropriate and contrary to the purpose of equalization. As a matter of principle, that rule should be eliminated. Additionally, the time lags in the formula mean that the federal government is well warned of upcoming costs and the fiscal-capacity cap acts as a restraint on costs.²⁷ If, despite these considerations, long-lasting and growing gaps in fiscal capacities imply a mushrooming cost over the long term, then shifting some of the cost burden onto the CHT and CST of the wealthier provinces is preferable to equalization clawbacks based on an aggregate-growth-rate rule.

ISSUE: NATURAL RESOURCES

The crux of the preceding section is that the existing formula should be changed to eliminate the reductions to a fixed-growth-rate rule. In terms of the representation given by equation (6), that means eliminating the R . That would leave

$$(7) \quad P = (S-F) - A^*.$$

²⁶ This assumes that, to start with, the per capita CHT and CST are adequate, which is an important but separate issue of vertical fiscal imbalance.

²⁷ Finance Canada data indicate that for 2013-14, the fiscal-capacity cap led to a reduction in total payout of \$1.03 billion, thereby reducing the extent of the reduction due to the aggregate growth-rate rule to only \$375 million.

Also, implicit in that section is the retention of A^* , the reduction in a province's equalization entitlement if it exceeds the fiscal-capacity cap. The fiscal-capacity cap was recommended by the expert panel. The underlying motive was equity. The panel also had recommended that 50 per cent of natural resource revenues be included in the equalization formula. One implication of doing so is that a recipient province with higher-than-average natural resource revenues could surpass other recipients and even non-recipients when the other 50 per cent of natural resource revenue was considered. The fiscal-capacity cap prevents this and, whenever activated, reduces costs to the federal government by invoking a clawback on a province's entitlement. With R dropped from the formula, the fiscal-capacity cap's cost-saving feature would be re-asserted.²⁸ Thus, the 50 per cent provision and the fiscal-capacity cap go hand in hand. As long as the former is retained, the latter should be too. Therefore, the A^* in (7) should be retained.

At this point, it is useful to substitute for S and F , from (3) and (4) respectively, to obtain a more explicit form of that formula. With a little algebraic simplification, the equalization payment (P), with R removed, becomes

$$(8) \quad P = t_1(B_1 - b_1) + t_2(B_2 - b_2) + t_3(B_3 - b_3) + t_4(B_4 - b_4) + 0.5(N - n) - A^*.$$

The purpose of decomposing (7) into (8) is to highlight the distinct treatment of natural resource revenues. The first four terms on the right-hand side of (8) are similar. For instance, $t_1(B_1 - b_1)$ is the national average provincial income tax rate t_1 multiplied by the difference between the average per capita amount of taxable personal income (B) and the average per capita amount of taxable personal income in the province of interest. Similar interpretations apply to the three following terms, respectively: business income taxes, consumption taxes, and property taxes. However, the fifth term, which corresponds to natural resource taxation revenues, is different. The N denotes the actual average of all provincial governments' natural resource revenues per capita, while the n is the corresponding revenue in the province of interest. The national average tax rate on resources does not come into play. The difference is multiplied by 0.5, corresponding to the 50 per cent inclusion, whereas all the others are, implicitly, multiplied by one, reflecting 100 per cent inclusion. In effect, the first four terms in (8) are measures of fiscal-capacity gaps in their respective tax areas. The fifth term, the one relating to the gap in natural resource revenues, is not a measure of fiscal capacity. It is simply the difference, or more precisely, half the difference, in actual natural resource revenues. In contrast, the measures of the fiscal-capacity gaps are based on the difference in revenues that would occur if a province applied the relevant national average tax rate, not its actual tax rate. Thus, the equalization formula is a hybrid of sorts.

²⁸ With the fixed-growth-rate rule on aggregate payments, any reductions due the fiscal-capacity cap are redundant. However, the distributional impact across provinces would be different because the growth-rate rule reduces payments to recipients on an equal per capita basis, while the reductions to recipients based on the fiscal-capacity cap vary with those recipients' natural resource revenues.

This asymmetric treatment of provincial natural resource revenues in the equalization formula is not a new phenomenon. Throughout most of the history of the program, natural resource revenues have been treated differently.²⁹ Without delving into that history, it is worthwhile to point out two challenges associated with equalizing natural resource revenues:

- natural resources, especially high-revenue yielding oil and gas, are very unevenly distributed across the provinces relative to other revenue sources, which makes equalization costly; and
- the provinces own the natural resources within their borders and the Constitution gives them the sole right to impose royalties on them, so the federal government is excluded from this revenue source.

Thus, if 100 per cent of natural resource revenue is equalized across provincial governments, it can become an expensive problem for the federal government, especially during times of high resource prices or large-scale development. At the same time, if a recipient province has increasing natural resource revenue then, as that revenue rises, its equalization entitlement would fall on a dollar-for-dollar basis.³⁰ This seems unfair to those provinces since they would be no better off than if the resource development did not take place, and some could argue that the dollar-for-dollar loss amounts to a tax on their natural resource revenues. On the other hand, if natural resource revenues are excluded in the calculation of equalization, then provinces that are well off in terms of natural resource revenues could be actually become recipients, which was the case for Alberta in the first few years of the program.

Cutting through these opposing perspectives, the expert panel recommended a 50 per cent inclusion rule with its sibling fiscal-capacity cap. This is a reasonable compromise position that recognizes the affordability problem and the equity issues, as well as the concerns of resource-rich recipient provinces. Interestingly, the panel recommended, and the federal government agreed, that this 50 per cent would apply to actual natural resource revenues, not natural resource fiscal capacity. This serves to simplify the calculations. Determining natural resource fiscal capacity is complicated and requires a great deal of disaggregation (e.g., oil of different qualities and locations give rise to different royalty potential). Even then, measurement problems are challenging and can lead to difficulties. For instance, Courchene³¹ shows that the fiscal-capacity approach resulted in Saskatchewan's government losing more than a dollar in equalization for every for revenue dollar for some of its oil and gas revenues. Using actual revenues eliminates the underlying measurement problem. Yet, as Smart points out,³² doing so creates some perverse incentives for recipient provinces to lower their taxes/royalties on natural resources to benefit residents, while being cushioned by equalization. However, considering that forestry, oil and gas, and mining operations, which account for the bulk of provincial natural resource revenues, are owned by widely held corporations, lowering taxes/royalties would benefit non-residents to a substantial degree, thereby reducing that perverse incentive.

²⁹ For an elaboration on that history, see: James P. Feehan, "Equalization and the Provinces' Natural Resource Revenues: Partial Equalization Can Work Better," in *Canadian Fiscal Arrangements: What Works, What Might Work Better*, ed. H. Lazar (Montreal- Kingston: McGill-Queen's University Press, 2005): 185-208; and Feehan "Equalization 2007."

³⁰ This is an approximation because the provincial revenue would raise the standard as well. However, most provinces are not large enough for this to have a significant effect.

³¹ Thomas J. Courchene, "Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues," *Choices* (Montreal: Institute for Research on Public Policy, 2004).

³² Michael Smart, "Equalization and Resource Taxation," in *A Fine Canadian Compromise*, ed. Paul Boothe (Institute of Public Economics and Cirano, 2006).

It seems likely that, had this sort of arrangement been in place at the time, there would have much less likelihood of the special side deals in 2005 with Nova Scotia and Newfoundland to compensate them for reductions in equalization due to offshore oil and gas revenues. Even the provisions for similar compensation for those two provinces, in the Atlantic and Offshore accords signed in the mid-1980s, might not have been necessary, and similarly for the “generic” solution of 1997.³³ Thus, another commendable aspect of the expert-panel recommendation is that it pre-empts pressure for such side deals and special arrangements that tend to undermine the program’s credibility.

Nevertheless, there are two aspects of the natural-resource-revenue component of the formula that still need to be better handled. One is quite prominent in the debate over equalization and has a long history: water-power rentals. The other is much more obscure and of recent vintage: Hydroelectric Crown corporations.

Hydroelectric Crown Corporations

The expert panel recommended that the remittances from provincial Crown corporations engaged in resource extraction and development should be treated as natural resource revenue.³⁴ The federal government acted on this recommendation by including the remittances of “hydroelectric” Crown corporations in the natural-resource-revenue category. This limitation to a single resource, namely hydroelectricity, is not, in current circumstances, a significant deviation from the panel’s recommendation, because the involvement of provincial Crown corporations in other natural resources is quite limited.

The inclusion of these Crown corporations within the natural resource category creates many practical and conceptual problems and contradictions. This is highlighted by the 2009 federal decision to adjust the equalization calculation by moving Hydro One, the major transmission company in Ontario and owned by the Ontario government, from the natural resource category to the business income taxes category. Apparently, the reason for this was that Hydro One has no hydroelectric or other generating assets; it is strictly a transmitter. However, all six provincial hydroelectric Crown corporations are vertically integrated, with substantial transmission assets.³⁵ The implication is that only the portion of those corporations that are involved in natural resource extraction and development (i.e., electricity generation) should be in the natural resource category, and the rest should be in the business income tax category. This clearly creates practical difficulties. To carry this point further, two provincial Crown-owned electric utilities — New Brunswick Power and SaskPower — rely mostly on burning purchased fossil fuels for electricity generation and have very few hydro-generation assets and little or no potential hydro resource left to develop within their borders. How can the remittances from those two corporations be considered natural resource revenues? Indeed, this question applies to the others as well. They operate on a commercial basis and their net incomes include a return on capital.

³³ The generic solution limited the approximate dollar-for-dollar loss in equalization in cases where a province accounted for more than 70 per cent of a single revenue type. With the use of 30 or more disaggregated categories, this was a distinct possibility at the time, especially for some types of natural resource revenues. For example, it benefited Saskatchewan with respect to revenues from potash.

³⁴ See page 61 of the expert panel report for the recommendation and page 113 for further elaboration.

³⁵ The six are: Hydro-Quebec, BC Hydro, SaskPower, Manitoba Hydro, New Brunswick Power and Newfoundland and Labrador Hydro.

Then there is the broader issue of consistency. The profits of all other government-owned business enterprises (GBEs) are included in the business income tax category. To separate out certain GBEs simply because they have some — possibly very small — hydroelectric generating capacity, is very difficult to justify. Moreover, the tax revenue from a privately owned electricity utility is categorized with business income taxes; if the identity of the shareholders is changed to the provincial government, then there is no obvious reason to reclassify that same business's income as natural resource revenue. This principle should also be applied to municipally owned business enterprises that have commercial mandates. Apparently these are not included in equalization despite the fact that some are quite large enterprises (for example, Toronto Hydro).

In light of these considerations, the remittances of hydro corporations should be removed from the natural resource revenues category. The business income tax category of the equalization formula includes the net incomes of all other provincial GBEs. The net income of Crown hydro corporations should also be included there in the same way as any other commercial provincial-government-owned business enterprise.

Water Rentals

Despite the weak case for treating hydro corporation remittances as natural resource revenue, the expert panel did have a noble intent. It pointed out that in provinces with provincially owned, vertically integrated electric utilities, it would be possible for provincial governments to either charge high water-rentals and require low remittances, or the opposite. If water rentals, which are royalties on the use of provincial water resources, are in the natural resource category, and the remittances are in the business income category, then strategic shifting could increase a recipient province's entitlement.³⁶ Whether a province would actually engage in that practice is an open question, but the incentive exists, and surely it would be a consideration of policy-makers. By placing both sources of revenue into the one category, the panel's intent was to eliminate that incentive.

Even more problematic is the incentive for recipient provinces to charge very low water-rentals in the first place. Here, the concerns raised by Smart³⁷ are especially relevant. Hydroelectricity is largely consumed in the province of generation. Therefore, lower electricity rates achieved by charging low water-rentals (and/or taking low returns on hydro-corporation capital) will benefit resident household consumers and businesses. This is not a new issue in the equalization debate. It has been long in play and received considerable attention in the early 1980s from the Economic Council of Canada.³⁸ The council effectively recommended that water rentals be included in the formula and that they should be based on their economic value

³⁶ A dollar of water rental would cause a 50-cent reduction in equalization. However, if that water rental were eliminated and the dollar went into a remittance from profits, then the reduction in equalization would be at a rate equal to the national average provincial tax rate on business income, which is much lower at approximately 10 per cent.

³⁷ Michael Smart, "Raising taxes through equalization," *Canadian Journal of Economics* 40 (2007): 1188-1212.

³⁸ Economic Council of Canada, *Financing Confederation: Today and Tomorrow* (Ottawa: Supply and Services Canada, 1982).

rather than the actual rates charged.³⁹ The expert panel also dealt with this issue and also recognized that the true economic values (i.e., economic rent) should be counted in the equalization formula in principle, but stated that doing so would be “difficult and controversial,” and opted not to recommend action in this regard. As the 2014 renewal approaches, the matter has once again, and not surprisingly, arisen.⁴⁰ It is time to deal with it.

Table 3 provides some elaboration. The first two rows show the relative and absolute amounts of hydroelectricity generated within each province for 2009. By these indicators, four provinces are abundant in hydro power: Newfoundland, Quebec, B.C. and Manitoba. Ontario has some significant amount in absolute terms, but it still derives less than 25 per cent of its power generation from hydro. The other provinces have very little. Focusing on the four that have abundant hydro generation, the third and last rows of the table give some indication of the revenues that these provinces determine from their royalties on water used for hydro generation. Particularly outstanding are the water-rental revenues per megawatt hour (MWh) of hydroelectricity generation. The three traditional equalization recipients, Newfoundland (having been in receipt every year until 2008), Quebec and Manitoba collected \$0.07, \$3.36 and \$3.45 per MWh respectively.⁴¹ In contrast, B.C., the only other hydro-abundant province, took in \$8.40. Even Ontario, the only other province with a significant amount of hydro power, and not even an equalization recipient until 2009, collected \$5.00 per MW hour in rentals.

TABLE 3 HYDRO-ELECTRICITY GENERATION AND WATER RENTALS, BY PROVINCE

	NL	PEI	NS	NB	QC	ON	MB	SK	AB	BC
Proportion of in-province generation from hydro (2011)	96.7%	0%	9.9%	34.0%	97.2%	24.7%	98.4%	20.1%	2.8%	92.1%
Amount of hydro generation, in millions of MW hours (2011)	39.4	0	1.1	3.8	191.3	34.7	34.2	4.6	1.8	61.2
Water rental (2009), millions of dollars	\$2.8	\$0	\$1.5	\$0	\$660.4	\$173.6	\$114.7	\$0	\$1.8	\$514.2
Water rental revenue per capita	\$5.60	\$0	\$1.63	\$0	\$84.48	\$13.30	\$94.21	\$0	\$0.48	\$115.45
Water rental revenue per MW hour	\$0.07	\$0	\$1.39	\$0	\$3.45	\$5.00	\$3.36	\$0	\$0.97	\$8.40

Sources: Water rentals and population data from Finance Canada; Electricity data from Canadian Electricity Association (2012) “Key Canadian Electricity Statistics,” release May 21, 2013, <http://www.electricity.ca/media/IndustryData/KeyCanadianElectricityStatistics21May2013.pdf>.

³⁹ See: *ibid*, 122. For more on the estimation of the true economic value of hydropower, see: Richard Zuker and Glenn Jenkins, *Blue Gold: Hydro-Electric Rent in Canada*, Special Study Series (Ottawa: Economic Council of Canada, 1984).

⁴⁰ See, for example: Peter Holle, “Artificially cheap hydro power, your equalization dollars at work,” in *A Hand Up or a Handout*, The Canadian Taxpayers Federation, 2013.

⁴¹ Even allowing for the fact that most of Newfoundland’s hydro, more than 30 million MWh, is generated at Churchill Falls under a lease arrangement that fixed the rental at a very low rate from 1969 to 2016, the rental revenues on the remaining hydro generation in that province are still practically negligible.

These figures are consistent with the long-standing proposition that hydro-rich equalization-receiving provinces charge lower water-rental rates, and those non-recipients with significant hydro resources charge more. In effect, those provinces can underprice their hydro, which benefits residents, while lower hydro revenues will make them eligible for at least partial compensation via a higher equalization entitlement. This is a unique phenomenon among natural resource revenues, because, as noted earlier, undercharging for other resources gives a much larger share of the benefit to non-resident owners of natural resource enterprises. Many argue that Manitoba and Quebec, with their low electricity rates, receive more equalization than they ought to. Whether they do this to obtain more equalization or, plausibly, to pursue resource and industrial development, their policy decision is partly paid for by equalization.

Now is the time to deal with this lingering sore point of undervalued water rentals. While it has been long recognized as a problem, and a rather unique one, the inherent difficulties of setting an accurate value for hydroelectricity has been cited as a barrier to addressing the matter. Also, the potential dollar-implications for some recipients might have been problematic, especially in the past where the hydro values may have been very high. However, these considerations have changed. First, the increased development of competitive wholesale electricity markets in North America has resulted in prices that can serve as indicators of the value of electricity. In particular, U.S. markets adjacent to the Canadian border — such as the New England, New York, Mid-Columbia, and Midwest markets — are where Canadian electricity can be sold, and both Alberta and Ontario have moved to market-based systems. In effect, these markets provide a “world price” benchmark, much the same as the Brent and West Texas Intermediate (WTI) benchmarks provide for crude oil. Secondly, with declining prices of natural gas, wholesale electricity prices have softened. With these markets providing relatively low reference prices to start with, the use of market prices would be unlikely to cause an immediate dramatic shift in equalization entitlements, especially if water rentals remain subject to the 50 per cent equalization rule. Yet, it would have the advantage of taking windfall gains into account whenever there may be substantial upward movement in U.S. electricity prices — that is, in the underlying value of the hydro resource.

One way to make this market-price approach operational would be to remove water-rental revenue from the equalization formula and replace it with a measure of water-rental fiscal capacity. This would look like:

$$(9) \quad t_H(B_H - b_H)$$

where b_H denotes the amount of hydroelectricity generated and made available to consumers within a province, expressed on a per capita basis. This would be the lesser of (a) actual hydro generation and (b) hydro generation minus any net exports.⁴² B_H denotes the aggregate of such generation, divided by the population of all provinces. Thus, both B and b are in MWh per capita.

⁴² Exports would naturally be sold at whatever price could be obtained.

The challenge here is what to use for t_H . For the other fiscal-capacity measures, the relevant national average tax rate is used. However, the key criticism for this particular revenue source is that such a rate is too low because hydro-rich provinces may be underpricing their rentals in order to provide low-price electricity to their residents. Therefore t_H should be market-based. Once an initial value is determined, it could be indexed to some average of wholesale prices in electricity markets. The choice of the initial value requires more research, but the figures in Table 3 might suggest a starting point. For 2009, the highest rental per MWh was around \$8.50 in B.C.; and in Ontario, not a hydro rich province, but one with significant generation in absolute terms, the figure was about \$5.00. Some figure in that \$5.00 to \$8.50 range might be a candidate for t_H . The actual choice might well be contentious, but once set, everything else follows without difficulty since hydro-generation statistics and wholesale market prices are readily available.

ISSUE: PROPERTY TAXES AND USER FEES

Property tax is a relatively new addition to the equalization formula. In 1967, only revenue from property taxes levied by provincial governments for school financing was included in equalization; property tax revenues of municipal governments remained excluded. In 1973, the revenue from school-purpose property taxes collected by municipal governments was included as well.⁴³ However, the remainder of property tax revenue, which was the bulk of it, was not included in equalization until 1982. At the same time, practically all user fees imposed by provincial and municipal governments were included in the equalization formula. As with property taxes, user fees are disproportionately more important as a revenue source for municipal governments. More generally, since municipal governments are essentially creations of provincial government, and provide services that would otherwise be provided by provincial governments, it is entirely appropriate that their fiscal capacities be included in the calculation of provincial fiscal capacity.

By 1999 the federal government wanted to once again exclude user fees from the equalization formula but, as a compromise with provincial governments, continued to include 50 per cent of such revenues.⁴⁴ The reason may have had to do with affordability, but there were also measurement difficulties associated with defining the base and “tax rate” for this revenue source. Also, some prominent academics argued that inclusion of user fees in the formula was not conceptually valid. On the other hand, there was no question of removing property taxes from the equalization formula. However, there were also serious challenges associated with measuring property tax bases across provinces. Essentially, the problem was that, historically, provincial and municipal governments used a wide variety of means of taxing property. That made the measurement of provincial tax bases and the national average property tax rate problematic. Various indirect measurement techniques were developed. The most long-lasting one was called the multi-concept approach, a system that has been described as “convoluted and obscure.”⁴⁵ This is probably a harsh assessment because the procedures were designed to estimate values that were not directly observable, which is often a difficult task.

⁴³ See: Courchene, *Equalization Payments*, 47-48.

⁴⁴ See: Expert Panel, 101.

⁴⁵ See: MacNevin, *The Canadian Federal-Provincial*, 212.

These were the circumstances when the expert panel took on its task. The panel agreed with federal government sentiments regarding user fees. It recommended against inclusion of user-fee revenues, whether provincial or municipal, in the formula. Regarding property taxes, it recognized that measurement issues were difficult, and the panel indicated a preference for an approach that would be more obviously consistent with property taxation practices, at least for residential property tax.⁴⁶ In response, the federal government acted accordingly. It dropped user fees entirely from the formula and adopted a new methodology for calculating fiscal capacity in relation to residential property tax. In particular, for residential properties, it moved to a method based on property values. Those values are the actual basis for most municipal property taxes, so this is an obvious and welcome improvement.⁴⁷

The business component of property tax is still governed by the multi-concept methodology, but it is almost certain that the federal government would move to a better method if and whenever that were to become feasible. One possible alternative worth considering is to shift revenues from business property taxes into the business income tax category, leaving only residential properties in the property tax base. The business income tax base would not change, but the addition of the tax payments by businesses on their properties would raise the formula's national average tax rate on business income. Doing so could be rationalized by the argument that these taxes ultimately fall on businesses' incomes.⁴⁸

Also, the exclusion of user fees, especially at the municipal level, is a decision worth revisiting. Revenues from user fees are a substantial proportion of most municipal governments' own-source revenues, second only to property-related taxes.⁴⁹ In fact, these two tax sources are the only two significant ones for practically all municipalities. Thus, a decision to change user fees necessarily implies a decision about property tax, and vice versa, given budgeted expenses. With respect to equalization, a shift by municipalities in some provinces towards more user fees and lower property tax rates would lower the national average tax rate on property and have implications for equalization entitlements, despite the fact that there may have been no change in those municipalities' capacities to raise revenue. In light of this substitutability between municipal user fees and property taxation, the former should be included in the equalization formula. This is completely feasible since the user-fee revenues are known and the same tax base (i.e., property) would continue to be used. The only implication of including municipal user fees would be an increase in the national average tax rate for that revenue category, and therefore an increase in the value of the standard.⁵⁰

⁴⁶ The panel also supported such an approach with respect to business properties, but recognized that there were more difficult measurement issues at play, which meant that a change from current practices was not feasible.

⁴⁷ Regardless of the panel's recommendation, this might have happened anyway because, over time, property taxation policies have become more consistent and relevant data have become more readily available.

⁴⁸ A similar argument could be made about residential property tax with respect to personal income but, with the recent improvements in measuring residential property tax bases, this is unnecessary.

⁴⁹ See: Harry M. Kitchen and Enid Slack, "Special Study: New Finance Options for Municipal Governments," *Canadian Tax Journal* 51 (2003): 2215- 2275.

⁵⁰ Despite the increase in the standard, whether the cost to the program would increase depends on the distribution of the property tax fiscal-capacity gaps. If a recipient province has a negative entitlement under that category, then raising the applicable national average tax would reduce that province's entitlement.

Vaillancourt has made a similar argument for inclusion of all user fees, not just municipal ones as suggested above.⁵¹ He uses the example of provinces that can choose to finance university education via either higher tuition/lower personal income tax rates, or the reverse. However, this is a step too far for two reasons. First, and more importantly, while municipal user fees can be readily related to the existing property tax base, the choice of base for most provincial user fees is not so clear-cut. Provincial fees are tied to a gamut of activities, making it inherently difficult to identify the appropriate base, let alone to measure it accurately.⁵² Secondly, provincial governments have a much wider spectrum of tax instruments and their actual reliance on user fees, at least within the government sector, is very small relative to total revenue. Therefore, as a practical matter, adding provincial user fees would likely be of negligible significance.

BEYOND THE BLACK BOX: SOME OBSERVATIONS

Up to this point, this essay has focused on describing the “black box” of the equalization formula and delving into some of the issues inside of it. However, there are some matters on the outside that are relevant to the equalization debate. This section looks at three.

The Over-equalization Hypothesis

Recently there have been several criticisms of equalization, all of which appear to be related to a general proposition that several recipient provinces receive too much equalization, that too much is spent on equalization, and that equalization spending, at least at current levels, is damaging to the national economy. Broadly speaking, this might be called “the over-equalization hypothesis.” In various forms, this idea has been voiced by, for example, McKinnon, Bateman, Dodge, Burn and Dion, and Milke, among others.⁵³ Particularly interesting is the analysis by Milke. Using 19 measures of provincial government employment and provision of public services, his data analysis led to the finding that, for most of these indicators, the traditional recipient provinces led the non-recipients. This finding supports the proposition that equalization recipients provide more public services than those provinces that are too rich to qualify for equalization, and whose taxpayers contribute disproportionately to financing equalization through their federal tax payments.

⁵¹ Francois Vaillancourt, “Inclusion and Measurement Issues,” in *A Fine Canadian Compromise*, ed. Paul Boothe (Institute of Public Economics and Cirano, 2006).

⁵² An alternative is to use actual revenues, as with natural resources. But, as pointed out by the expert panel (p.104) this is problematic as well.

⁵³ David McKinnon, “Canada’s Broken Equalization Program,” AIMS Commentary (Halifax: Atlantic Institute for Market Studies, 2012); Jordan Bateman, *A Hand Up or A Hand Out: Ideas on how to improve Canada’s Equalization program*, Canadian Taxpayers Federation, 2013; Dodge, David, Peter Burn and Richard Dion, “Federal-Provincial Fiscal Arrangements: Thinking Outside the Box,” Policy Options (Montreal: Institute for Research on Public Policy, 2012); Mark Milke, *Super-sized fiscal federalism* (Vancouver: Fraser Institute, 2013).

On the contrary, McMillan⁵⁴ provides a very different perspective. In a comprehensive examination of the data, he concludes that equalization spending has not been rising relative to overall federal spending or as a percentage of national GDP. Consistent with this, Table 4 shows that relative to CHT and CST spending, federal government expenditure on equalization has not followed an upward trend. The table also brings home the point that equalization has been consistently less than 30 per cent of the total of the three major transfers to provincial governments, although a spike would have occurred from 2010-11 to 2012-13 without the imposition of the growth-rate cap in 2009.

TABLE 4 EQUALIZATION RELATIVE TO CHT AND CST

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
CHT	\$20.1	\$21.7	\$22.7	\$24.4	\$25.6	\$26.9	\$28.5	\$30.2	\$32.0
CST	\$8.5	\$9.6	\$10.5	\$10.8	\$11.1	\$11.5	\$11.8	\$12.2	\$12.5
Equalization	\$11.5	\$12.9	\$13.5	\$14.2	\$14.4	\$14.7	\$15.4	\$16.1	\$16.7
Total	\$40.1	\$44.2	\$46.7	\$49.4	\$51.1	\$53.0	\$55.7	\$58.5	\$61.2
Equalization as % of total	28.8%	29.3%	28.8%	28.7%	28.1%	27.7%	27.7%	27.5%	27.2%

Source: Based on data from Finance Canada, "Federal Support to Provinces and Territories," <http://www.fin.gc.ca/fedprov/mtp-eng.asp>.

A particularly important finding by McMillan is that the overall per capita spending by recipient and non-recipient provinces is roughly the same. This is at odds with the over-equalization hypothesis. Another interesting finding is that the recipient provinces tend to have higher tax rates. This may well be the result of the workings of the equalization program. It is consistent with the important empirical work by Smart,⁵⁵ which established an empirical relationship between the tendency to have higher taxes and the equalization program. The higher tax rates would feed into and raise the national average tax rates, and this would support the notion of over-equalization. On the other hand, there may be opposing forces at work. Non-recipient provinces, especially since 2009, are natural-resource rich, especially in oil and gas. It could be argued that for them, natural resource revenues are "easy" money. The burden of natural resource royalties falls heavily on the resource and the non-resident owners of oil and gas enterprises. With plentiful natural resource revenues, these provinces can engage in high spending and impose low tax rates on resident personal income, business income, property and consumption. Recipient provinces may think of equalization as easy money in the sense that it is not raised by their taxes on locals, but the only way to distribute this money is through higher spending, not via a mix of lower taxes and higher spending, because the lower taxes adversely affect entitlements. Natural resource revenue allows the "haves" to lower other taxes, while equalization dollars leads to an upward tendency in tax rates in the "have-nots." The net effect on national average tax rates becomes ambiguous.

⁵⁴ Melville L. McMillan, "Alberta and 'Equalization': Separating Fact from Fiction or Sorting Out Some Implications and Options in Canadian Fiscal Federalism," Information Bulletin 155 (University of Alberta School of Business/Western Centre for Economic Research, 2012).

⁵⁵ Smart, "Raising taxes."

Regardless of the preceding speculative thinking, it does appear that the worries about over-equalization are overstated. There may well be a tendency for the recipients, at least the traditional ones, to have higher tax rates, but the proposition that this has led to significant excessive expenditure on equalization has yet to be demonstrated. The fact is that spending on equalization has not changed much relative to national income or total federal spending. If there is over-equalization, and there is little evidence of it, then it is not a serious or growing problem.

Needs and Costs.

Another matter well outside the box containing the RTS equalization formula has to do with needs and costs. The RTS approach eliminates, or at least reduces gaps in revenue-raising capacities. Implicit in this approach is an assumption that the cost of providing public services across provinces is the same and that the public-service needs of people are equal on a per capita basis. Such an assumption may not be valid. It might be that a province with strong revenue-raising capacity might also have high costs and more pressing needs, while an equalization-receiving province may have the good fortune of less need and lower costs of providing public services. Similarly, two recipient provinces might have very different needs and costs even though their fiscal capacity to raise revenue might be similar. These are the sorts of considerations put forward by those advocating extending the equalization program to include costs and needs. Buttressing this position is the Canadian Constitution. Indeed, it seems impossible to avoid quoting Section 36(2) of the Constitution Act, 1982, in any essay about equalization. That section 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 services at reasonably comparable levels of taxation.”

Section 36(2)’s reference to “reasonably comparable levels of public services” is almost always cited in arguments in favour of incorporating expenditure needs and adjustments for costs of providing public services. However, the arguments for a system that incorporates need long pre-date this constitutional provision.⁵⁶

Despite the history of this idea, no attempt has ever been made to incorporate need and cost into the formula. While usually considered in major reviews of Canada’s federal-provincial transfer system, inclusion of the spending side of provincial budgets has not been supported. Various difficulties of implementation are cited: data requirements, the potential for intrusion into provincial spending priorities, measurement issues, etc. This issue was also considered by the expert panel, which concluded that “the case for incorporating expenditure need into equalization has not been made” and, very significantly that “There is no conclusive evidence that it would have a material effect on the size and allocation of equalization payments.”

⁵⁶ Brown points out that the notion of equalization-type transfer grants based on need goes back to 1940s, even before the establishment of the program itself (Douglas M. Brown, *Equalization on the Basis of Need in Canada*, Institute of Intergovernmental Relations, Queen’s University, 1996).

Yet, the idea has been recently resurrected. In a pioneering work, Gusen⁵⁷ provided rebuttals to the various rationales that have been put forth for not moving on needs and costs.⁵⁸ Also, he constructed indices of costs and needs and used them to determine what the allocation of equalization would look like if this side of provincial budgets were taken into account. Using the fiscal year 2008-09 for his prototype system, he finds that overall equalization payments would fall modestly and that there would be a significant change in the allocation of that total amount, largely to the benefit of Ontario and to the loss of Quebec.⁵⁹ These results challenge the expert panel's assessment that including needs would not have a "material effect."

Still, there are reasons not to proceed. First, consider incorporation of costs. Ignoring the possibility that a higher cost of providing a unit of public service might be due to inefficiency or market power, which cannot justify equalization grants, suppose the cost is higher. In that case, fewer public services should be provided. Which ones and by how much would depend on the social benefits of the services, but some adjustment is required much in the same way as public services to rural, isolated communities are not provided to the same extent as they are in more urbanized areas. Equalization based on cost is not consistent with efficiency and reduces the incentive for provinces to use their fiscal resources wisely.

Next, assume that costs are the same across provinces but that needs are different. For example, the health cost of caring for an elderly person might be the same across provinces but one province might have a relatively greater proportion of elderly people in its population. Here, the case for some adjustment in equalization is stronger. However, the open-ended nature of provincial spending could create difficulties in drawing the line with respect to what are appropriate levels of public services. It seems that no matter how well off provinces may be, there is always spending pressure. Consider Table 5, which shows the budgetary positions for each provincial government in 2012-13, expressed on a per capita basis. All but Saskatchewan have significant deficits. Saskatchewan, a non-recipient province, had a very small surplus. Of the other three "have" provinces, B.C. has a significant deficit but it is less than the others. On the other extreme, Alberta and Newfoundland, despite their very high fiscal capacities, especially when all natural resource revenue is considered, have the largest deficits. The six recipient provinces fall somewhere in between. It seems that, despite enormous revenue capacity, even the richest provinces' spending rises to match or exceed income. Thus, equalization on the basis of need would likely invite federal limits, which could be seen as interfering with the judgment of provincial governments regarding spending priorities. For Canada's highly decentralized federation, that is not a path worth taking.

⁵⁷ Peter Gusen, "Expenditure Need: Equalization's Other Half," Mowat Centre Fiscal Transfers Series, University of Toronto, 2012.

⁵⁸ Another substantial contribution to the debate regarding the implications of equalization according to fiscal need is: Anwar Shah, "A Fiscal Need Approach to Equalization," *Canadian Public Policy* 22 (1996): 99-115.

⁵⁹ Mendelsohn argues that this only serves to worsen Ontario's treatment with respect to what its citizens contribute to financing equalization and what its provincial government receives. (Matthew Mendelsohn, "Back to Basics: The Future of the Fiscal Arrangements," Mowat Centre Fiscal Transfers Series, University of Toronto, 2012).

TABLE 5 BUDGET BALANCES OF EQUALIZATION RECIPIENTS

Province	Budget Balance, per capita
Non-recipients:	
NL	-\$818.15
SK	+ \$38.62
AL	-\$730.84
BC	-\$252.23
Recipients:	
PE	-\$475.21
NS	-\$319.54
NB	-\$610.07
QU	-\$301.83
ON	-\$687.44
MB	-\$466.40

Sources: Finance Canada, *Fiscal Reference Tables (October 2013)* for budget balances; Statistics Canada for population.

It can be argued that failure to extend the equalization formula to encompass expenditure needs is contrary to Section 36(2), in particular to its reference to “reasonably comparable levels of public services.” However, for the many years preceding, and after, that constitutional provision came into existence, the notion of equalization on only the revenue side was, and continues to be, widely accepted, albeit not universally so. Moreover, the word “reasonably” creates considerable scope for interpretation. It is apparent that within provinces, there are wide variations in the level of public services offered to citizens. These differences are correlated with factors such as urban versus rural, north versus south, isolated versus accessible, and so forth. Such internal gaps are accepted as reasonable when the cost of providing equal services is taken into account. It is an empirical question, but it may well be that intra-provincial variations in the levels of public services are as great or greater than existing interprovincial ones.

Extending the equalization to expenditure needs and costs would be a Pandora’s box, both with respect to the open-ended nature of provincial spending and the autonomy of provincial governments in their areas of expenditure responsibility. A preferable approach is for the federal government to adjust the CHT and CST to reflect relevant demographic and other considerations that affect needs within the set of provincial programs that these grants are intended to help support.

Taxing Provincial Crown Corporations

One vexing aspect of equalization becomes especially pronounced during resource (i.e., oil and gas) booms. The increased revenues of the resource-rich provinces tend to increase the equalization standard and widen the horizontal fiscal gaps. This drives up equalization entitlements. At the same time, the federal government cannot tax natural resources within provincial borders, so any increase in payments must be funded from elsewhere, such as personal and corporate income tax and sales taxes. Revenues from those federal sources come

disproportionately from Ontario. As a result, that province sees itself — or more precisely, its taxpayers — as bearing the burden of equalization despite being less rich than the oil and gas provinces. At present, this troubling distributional complication is worsened by the fact that all four of the “have” provinces are resource rich; if some recipients were resource rich, then a resource boom would reduce their entitlements and lead to some federal savings. Additionally, some might point to the hydro-rich recipient provinces and argue that they underprice their hydroelectricity because of low water-rentals and because their hydro corporations are exempt from federal corporate income tax. The matter of water rentals can be addressed within the equalization formula along the lines suggested earlier. However, the applicability of corporate income tax is an outside-the-box issue. Still, it does fall sufficiently within the broader ambit of federal-provincial fiscal relations to warrant attention.

The dominant provincial Crown corporations are the hydroelectricity ones, but provincial corporations reach into other resources sectors as well, and beyond. For example, BC Hydro has a subsidiary, Powerex, which is a profit-motivated energy trading company; the Newfoundland Crown corporation, Nalcor, has a wholly owned subsidiary that is engaged in oil and gas exploration, development and production; and Quebec has recently stepped up its entry into the oil and gas sector.⁶⁰ In the case of private companies engaged in similar activities, the federal government at least sees increased corporate income tax revenue from those businesses’ increased capital earnings during resource booms. This is not so if the capital is owned by a provincial Crown corporation. This phenomenon worsens the distribution problem within equalization. More broadly, it is a potential source of inefficiency in the national allocation of capital, because returns on capital in exactly the same uses are being treated differently solely on the basis of ownership. The latter observation applies to all provincial commercial Crown corporations, not just those in the resource sector, such as SaskTel.

Under Section 125 of the Constitution Act, neither level of government can tax the other. This is why provincial Crown corporations, even those that have a profit-making mandate, pay no federal corporate income tax. The desirability of this arrangement has been questioned before. As Courchene observes,⁶¹ a 1981 parliamentary task force on federal-provincial fiscal relations raised this matter, and Courchene applauds them for doing so. Concerned at the time primarily with the entry of federal and provincial Crown corporations into the resource sector, the task force concluded that if the practice became more common:

“An amendment to the Constitution permitting the taxation of Crown corporations may be appropriate. Alternatively, the federal and provincial governments could agree to reciprocal taxation of Crown Corporations.”

⁶⁰ Quebec recently announced substantial investment in oil exploration around Anticosti Island. See: Paul Delean, “Quebec buys into Anticosti oil exploration,” *The Gazette*, February 13, 2014, www.montrealgazette.com/business/Quebec+buys+into+Anticosti+exploration/9506226/story.html.

⁶¹ Courchene, *Equalization Payments*, 292.

The second of these options seems entirely feasible. Agreements have long been in place in which both levels of government agree to pay one another's taxes or provide roughly equivalent payments in lieu of taxes, a practice which extends to municipal governments. The only significant exception is the application of corporate income tax. This should be revisited. For-profit municipal, provincial and federal government corporations should be subject to federal corporate income tax or equivalent fiscal arrangements should be made.⁶² To the extent that this encompasses provincial hydro corporations, and ones engaged in oil and gas and other resource-related activity, there would be a likely small but beneficial impact with respect to the affordability question.⁶³ More generally, taxing such enterprises would treat capital employed in similar activities on a similar basis, which is widely accepted as a practice that is supportive of overall economic efficiency.

CONCLUDING REMARKS

The expert panel provided the federal government with sound advice on equalization, advice that not all would agree on, but which reflected a thoughtful assessment of opposing perspectives. In turn, the federal government was wise to accept practically all the panel's recommendations. However, in 2009, the federal government's imposition of the fixed-growth-rate rule for total payout was a serious setback to the principled formula that had been adopted. As in the past, this ad hoc measure was motivated by legitimate concerns about program affordability. Nevertheless, the use of blunt instruments in this regard is a practice that should stop. Payouts ought to be allowed to increase and decrease with the variations in the fiscal gaps across provinces. Affordability, when it arises, should be addressed in another way. One way is to share the burden with the "have" provinces by adjusting the CHT and CST entitlements of the especially well-off ones. Not viewing the three main federal-provincial transfers as three distinct silos should also come into play with respect to the provincial needs and program costs. Adjusting the CHT and CST for factors related to needs would avoid the complexities of extending equalization for that purpose.

In short, the RTS-type formula should remain intact and there should be no imposed limit on aggregate equalization payout. The focus of federal policy-makers should be on improvements to the program within those confines. One of the priorities for improvements should be re-assessment of the exclusion of municipal user fees. Another should be the consistent treatment of government business enterprise income. At the top of the list, however, should be dealing with the persistent question of hydro rentals. The rise of well-developed electricity markets now makes it more feasible than ever to resolve this matter.

⁶² Federal corporations that are for-profit should also be subject to provincial corporate income tax. However, past privatizations of federal Crown corporations leave few, if any, significant ones of that type.

⁶³ A more extreme approach would be for the federal government to seek access to natural resource revenues. That would be much more problematic because, beyond Section 125, the provinces are buttressed by Section 92A. Additionally, as observed in the text, there is precedent for reciprocal tax agreements. In contrast, the incursion of the federal government through the National Energy Program of the early 1980s into provincial oil and gas jurisdiction set an entirely negative precedent.

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