

**The Evolution of Federal Transfers
since the O'Brien Report¹**

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1. Introduction

The 2007 federal budget enacted fundamental changes to Equalization and other transfers that were to “put all major fiscal arrangements on a long-term, principles-based track to 2013-14”. Less than 18 months later, in November 2008, the Government were forced to reopen the file again, announcing that, for the first time in the history of the program, Ontario would qualify for and receive Equalization payments, beginning in 2009-10. At the same time, changes to the Equalization formula were announced that limit the growth of the program's cost and change the treatment of natural resource revenues under the formula.

These changes were subsequently confirmed in Budget 2009, which also included related changes to numerous other intergovernmental transfer and regionally targeted spending programs – including the Atlantic Offshore Accords, the Canada Health Transfer, and the establishment of a Southern Ontario Development Agency, to name but a few. The changes have naturally brought criticism from many of the other traditional Equalization-receiving provinces, which have decried the restraints on Equalization in particular as an abandonment of the principles underlying the 2007 reform, as inherently unfair to receiving provinces, and as having been effected in a unilateral and non-transparent way by the federal government – a fact in itself a violation of the principles of “open federalism” promised by the federal government in 2006 and 2007.

The main objective of this paper are to review the most significant changes to federal transfers since 2007, as well as the arguments for (from the federal government) and against (from various receiving provinces) the changes. More provisionally, I also look ahead to what Equalization and other transfers might look like in the future.

While the changes are far-reaching and complex, the key change is undoubtedly the decision to impose a ceiling on the growth of total Equalization payments. This converts Equalization to a closed-ended grant – that is, one in which the total cost is a direct policy lever – in contrast to the open-ended grant that existed during 2007-8 and prior to 2004 – in which total cost of the program was determined residually, as a function of various other policy parameters in the formula. Indeed, as I argue below, with the introduction of a ceiling on the program, together with other changes of the treatment of natural resource revenues in the formula, the Equalization program is now for practical purposes very little different (though larger) than the closed-ended Fixed Framework for Equalization that was in place under the previous federal government during 2004-6. This is obviously an inconvenient fact from the point of view of a

government that promised a different approach to fiscal federalism, but it is an important one for assessment of the reforms and the way forward.

The entry of Ontario to the program and its simultaneous restraint are obviously no coincidence: without changes to the formula, paying Equalization to a province as large as Ontario has the potential to be very expensive for the federal government. As I argue below, this simple fact is likely to have a significant impact on Equalization and other federal transfers for many years to come. As a means to control the fiscal risks to which the federal government is now exposed under Equalization – and to limit the possibly destabilizing procyclical features of the program if energy revenues are to recover with the economy in future – the decision to limit Equalization growth therefore appears inevitable.

The reforms are not mere federal penny pinching, however. In spite of provincial criticisms, a closed-ended equalization grant is just as much “principles-based” as the open-ended grant that existed during 2007-8 and prior to 2004. Moreover, the level of Equalization spending promised by the government for future years seems adequate, as long as fiscal disparities among provinces do not become significantly worse (as for example could happen if the economic decline in Ontario proves to be worse than currently forecast). On the basis of economic principle, relatively little has changed with the 2009 reforms.

Regardless of these justifications, the renewed controversy over the Equalization formula seems regrettable. Traditionally, the Equalization program has had a much lower degree of political salience and scrutiny than in the last five years – and federal-provincial relations have operated different as a consequence. Lowering the political visibility of the program might improve accountability in Canadian politics, if officials are more inclined to stick to their knitting and avoid blame-shifting exercises. To blame provincial budget deficits on federal transfer reform, as more than one provincial government did in 2009, seems like simple misdirection.

The political dynamics behind the program have nevertheless changed considerably, which may affect how the program will continue evolve in future. First, high energy revenues (which will persist for several years in the Equalization formula due to data lags) mean that Newfoundland, British Columbia, and Saskatchewan are no longer receiving provinces – so that the regional political pressures led to the 2007 reforms to the treatment of natural resources in Equalization are for the time being at least much reduced.²

2 Indeed, many of the most controversial elements of the 2007 reform – partial inclusion of resource revenues, and the fiscal capacity cap – are now of little quantitative significance,

Second, there is some suggestion that federal political calculus has changed as well, so that across-the-board enhancement of Equalization is no longer seen as a useful component of electoral strategy. Both these factors create some hope of greater peace and stability on the Equalization file in the medium-term future.

On the other hand, debate over the appropriate level and growth rate of Equalization and other transfers will surely intensify over the longer term. Provincial objections were initially muted, but are likely to increase as the cumulative impact of the ceiling increases in turn, relative to entitlements under the 2007 formula. The entry of Ontario into the program has the potential to change political support for Equalization as well – arguably, the median voter now lives in a receiving province. At the same time, pressure on the federal government to further reduce major transfers is apt to increase as solutions to bringing federal deficits under control are sought.

With the latest changes, the federal government operates three distinct lump-sum grants as its major transfers, each allocated based on different principles, and each legislated to grow at a different rate – the Canada Health Transfer (CHT) at 6 per cent annually, the Canada Social Transfer (CST) at 3 per cent, and now Equalization at the growth rate of nominal GDP. Grappling with fiscal arrangements in coming years is therefore going to require decisions about the relative priority of vertical versus horizontal grants, and an articulation of what each of the grants is intended to achieve.

The plan of the rest of the paper is as follows. Section 2 describes the changes in federal transfers since 2007. Section 3 offers an assessment of the main changes that have occurred to the Equalization program, and Section 4 concludes with a discussion of the further changes that are likely – or desirable – in future.

2. Changes to Federal Transfers: An Overview

The most complex and far-reaching recent changes in transfers concern the Equalization program, and the bulk of this paper is concerned with Equalization. Nevertheless, there have been changes to other transfers of importance to certain provinces, which I consider below.

At a meeting of Finance Ministers in November, 2008, the federal government announced several important changes to the Equalization program aimed at

since resource-rich provinces are out of the program regardless.

ensuring the cost of the program would grow (in the words of the news release) “at a sustainable rate”. The changes, which do indeed reduce the cost of the program substantially below status quo projections, were confirmed in the 2009 Budget and included in the Budget Implementation Act.

Understanding the changes requires a bit of background knowledge of the 2007 changes to the Equalization formula – many of which have been effectively reversed by the latest changes. The 2007 formula was based closely on the recommendations of the O'Brien expert panel, whose core elements were:

- Equalization payments were to be calculated by comparing the fiscal capacity of each province to the average capacity of all ten provinces (“the ten-province standard”) – replacing the five-province standard operating during the 1982-2004 period that crucially excluded Alberta's fiscal capacity. The new standard was therefore higher than the old one, resulting in higher total payments, and exposing the program to additional volatility, associated with the rise and fall in Alberta's energy revenues;
- Only 50 per cent of provinces' resource revenues were to be included in fiscal capacity – and so also in the ten-province Equalization standard. The key implication of partial inclusion was to increase payments to resource-rich provinces then receiving Equalization³ by reducing “tax-back” of their resource revenues. At the same time, partial inclusion made the reform affordable, since it meant that only half of Alberta's energy revenues were included in the standard to which provinces were being raised.
- Notwithstanding partial inclusion, a fiscal capacity cap was introduced that ensured that Equalization would not raise the full fiscal capacity (i.e. counting 100 per cent of resource revenues) above that of any non-receiving province. While the cap was a new element never previously part of the Equalization formula, in effect it meant that – for resource-rich provinces subject to the cap – payments were determined by including 100 per cent of resource revenues, and the effective Equalization standard for these provinces became the full fiscal capacity of the lowest non-receiving province – which during 2007-8 and 2008-9 was Ontario.

These changes were controversial (and expensive) when implemented and were seen as a key part of a strategy to “restore fiscal balance” with the provinces in a way that would put an end to controversy and reap long-term political gains for the Government.

3 Notably, Saskatchewan, and Newfoundland and Labrador – neither of which will receive Equalization in 2009-10.

The latest changes however affect all these key elements of the 2007 formula in a fundamental way. In brief,

- The annual growth in total payments is not to exceed a specified rate (4.2 per cent for 2009-10), and payments to all receiving provinces are reduced by an equal per capita amount to keep payments under the ceiling. This converts the Equalization program from an open-ended grant, in which the specified standard determines the total payments, to a closed-ended grant, in which the specified total payments in effect determines the standard. The implication is of course that the ten-province standard is now entirely irrelevant to payments.
- With Ontario entering the program, the “lowest non-receiving province” cap would have risen in an undesirable way. The cap has therefore been redefined to be the average fiscal capacity (including Equalization payments and 100 per cent of resource revenues) of the receiving provinces themselves – a provision that nicely echoes the use of all-province averages elsewhere in the formula.
- While partial resource inclusion remains, its importance is now severely diminished, as most of the previous receiving provinces are now subject to the fiscal capacity cap (and so to 100 per cent effective inclusion) – or are out of the program entirely by virtue of their high resource revenues.

As such, the 2009 Equalization program is very similar in structure to the Fixed Framework of 2004-6, which was also a closed-ended formula that legislated the total cost of the program and which counted 100 per cent of resource revenues towards fiscal capacity. The key difference, indeed, is simply that the program is now more expensive than ever – about \$1.7 billion more than the Fixed Framework would have been if it had remained in place in 2009-10.⁴

2.1 Fiscal Impacts of Equalization Changes

To understand how the 2009 changes affect all these elements, it may be useful to go through the steps of the new calculation using actual data for 2009-10, as reported in Table 1. The first row of the table reports Equalization payment each province⁵ would have received in 2009-10 based on the old (2008-09) formula. The remaining rows show the impact of each component of the new formula

4 The Five Province Standard that operated during 1982-2004 would have generated a total payment even lower in turn.

5 Evidently, the table excludes Saskatchewan, and Newfoundland and Labrador, as well as the other non-receiving provinces. Payments to these provinces under Equalization are zero for 2009-10 – and they would have been zero even if the formula had not been changed.

Table 1
Impact of Reforms on Equalization Entitlements, 2009-10

	(\$ millions)						
	PE	NS	NB	QC	ON	MB	Total
Entitlements based on 2008-09 formula	347	1,645	1,727	9,346	980	2,042	16,086
Impact of reforms:							
- Ceiling on payments	-11	-76	-61	-623	-1,033	-97	-1,904
- Receiving province cap	5	-271	29	-308	500	44	0
- Floor protections	-1	93	-6	-61	-101	74	0
Entitlements based on 2009-10 formula	340	1,391	1,689	8,353	345	2,063	14,182
Population (thousands)	138	937	746	7,641	12,679	1,186	23,328

Source: Department of Finance

changes, followed by the actual payment for 2009-10.⁶

The GDP growth ceiling

The first element of the reform is a ceiling on the total cost of the program, which is now to grow from year to year at the same rate as the growth rate of nominal GDP (4.2 per cent this year), rather than to be determined endogenously from the ten-province standard as before. As Table 1 shows, without this provision, the total cost of the program would have been \$16.1 billion in 2009-10, but the ceiling constrains it to just under \$14.2 billion.

In order to achieve this reduction, payments to each of the receiving provinces are in effect reduced by \$81 per capita relative to what the ten-province standard would have generated, resulting in the fiscal impacts reported in row 2 of the table.⁷ Furthermore, Budget 2009 clarifies that the ceiling on total payments is also a floor on total payments: if the ten-province standard declines in future, for example due to reductions in energy revenues, the total cost of the program will continue to increase at the same rate as nominal GDP, with equal per capita

6 The interested reader may note that the impact figures presented in Table 1 differ substantially from the conceptually similar figures reported in the 2009 Quebec Budget Plan. The Quebec figures compare 2009-10 payments to the payments that had been forecast in Quebec's 2008-9 fiscal plan, whereas Table 1 is based on actual data that were subsequently released to the public by the federal Department of Finance. That is, the impacts in Table 1 are calculated by holding the underlying data constant at 2009-10 actual levels, and changing only the parameters of the Equalization formula.

7 The reported impact for Ontario at \$1,033 million in fact exceeds the \$980 million payment it would have received without the ceiling, a clear impossibility since Equalization payments are non-negative. In other words, the ceiling would have made Ontario once again a non-recipient province if no other changes had been made. This "excess" reduction is however offset by the increase reported in row 3.

increases in payments made to ensure that this is so.

In other words, the ceiling provision essentially abandons the ten-province standard that was the linchpin of the 2007 reform, replacing it with an approach that is equivalent to the Fixed Framework of 2004-6.

The Receiving Province Cap

The 2007 reform reduced the inclusion rate for resource revenues in the formula to 50 per cent from 100 per cent – resulting in higher payments to then-recipient provinces like Saskatchewan and Newfoundland. At the same time, it introduced the “fiscal capacity cap” that limited these gains by stipulating that Equalization payments could not raise a province's fiscal capacity (including 100 per cent of resource revenues) above that of any province not receiving Equalization. In 2007, the non-recipient with the lowest fiscal capacity was Ontario, so this was for all intents an “Ontario standard” for resource-rich provinces. With the entry of Ontario into the program, the cap would under the legislation have jumped to British Columbia's fiscal capacity, about \$800 per capita higher than Ontario's, resulting in higher payments to resource-rich receiving provinces which would, under the ceiling, have been paid for by reducing payments to other provinces.

In what Budget documents termed a fairness measure, the definition of the cap is to be changed. Instead of the lowest fiscal capacity of non-receiving provinces (the BC cap), it is to be set at the average fiscal capacity (including Equalization) of provinces receiving Equalization. Table 1 shows the impact of this mechanism in row 3. The effect of the lower cap is to reduce Equalization paid to the receiving provinces with above-average resource revenues – Nova Scotia and Quebec. The savings are then in effect paid to all provinces in equal per capita amounts as a result of the ceiling, which explains the increased payments to the others in row 3.

The change to the cap makes sense, if one accepts the fairness principles that were behind the Ontario cap in the first place. After all, it makes no sense to say that transfers to resource-rich provinces should have increased in 2009 simply because Ontario's fiscal capacity has fallen relative to the average – but that would have been the result if the definition of the cap were not changed. Furthermore, the adoption of a cap based on the average of the receiving provinces has a certain inherent appeal: other aspects of the program are already based on averaging fiscal capacity across provinces, and as an average the new cap is likely to be far less volatile than the old one was, which helps with fiscal planning for all governments involved.

It is somewhat curious that, as Table 1 shows, the choosing a higher or lower cap today principally induces transfers between the provinces of Ontario and Quebec – neither of which was a proponent of partial inclusion in the first place. While that could change if resource-rich provinces like Saskatchewan were to return to the program with lower energy revenues in future, at present the cap is a sideshow.

The Floor Provision

Finally, for 2009-10 only, floor payments are to be made to ensure that no province experiences a year-over-year nominal decline in Equalization payments (including payments under the Offshore Accords). In practice, this benefits only Nova Scotia and Manitoba – the former because the lower fiscal capacity cap is disproportionately binding on Nova Scotia, and the latter mainly because of the rise in Manitoba's fiscal capacity due to inherent economic growth. Once again, because of the ceiling, these transitional floor payments are “paid for” through a \$8 per capita reduction in Equalization payments to the other four provinces.

The floor payments cannot truly be said to be based on any sound economic or social principle, nor are they small. Nova Scotia's floor payment of \$99 per capita exceeds Ontario's total Equalization payment of \$27 per capita by a factor of two!⁸ But the politicization of Equalization in recent years seems to have contributed to the notion that no province can ever “lose” Equalization in nominal terms. This is antithetical to the underlying principles of the program – which is designed to insure provinces by responding to changes in revenue capacities (Smart, 2004) – but seems to be a necessary part of the political compromises needed to sustain reforms to the program.

2.2 Other Issues

Offshore Accords: Nova Scotia and Newfoundland

The floor provisions are particularly difficult to understand for Nova Scotia, since they merely add another layer to the complex set of protections the province has

8 Furthermore, the figures presented in Table 1 and the protection payment for Nova Scotia reported there do not appear to include the additional “transition” payment of \$74 million to Nova Scotia that represents compensation for the year-over-year reduction in Equalization that is arguably already compensated by higher offset payments under the 2005 Offshore Accord – see Flaherty (2009).

obtained for its Equalization payments. While a full analysis of such protections is outside the scope of this paper, any analysis of the impact of the Equalization changes on Nova Scotia must consider how the changes interact with:

- the offset payments Nova Scotia receives annually through its 2005 Offshore Accord;
- the probability that the cumulative sum of those offset payments eventually exhausts the advance payment of \$830 million received against future offsets in 2005;
- the option Nova Scotia ultimately has under its Cumulative-Best-of Guarantee to revert retroactively to having its Equalization payments calculated under the pre-2007 formula (which is not affected by the restraints on Equalization announced in Budget 2009) instead of the O'Brien formula; and
- the floor payments against year-over-year declines in Equalization (but not offsets) that are part of Budget 2009.

In short, Nova Scotia's fiscal arrangements include a complex web of insurance and reinsurance, and the impact of changes in Equalization on its ultimate net entitlements are far from clear.

More controversial in 2009 were changes to the Equalization legislation that affect offset payments to Newfoundland and Labrador under its 1985 Accord, which was designed to protect the province against *year-over-year declines* in Equalization, rather than protect offshore revenues per se. Since under the 2007 Equalization arrangements, Newfoundland has the right to choose among three different Equalization formulas, and it is likely to opt for a different formula in future than it has in the past, determining how offset payments should protect it against declines is clearly complex. Nevertheless, the choices that have been made in this regard have been controversial. It is perhaps surprising that 1985 Accord offset payments matter at all, since they are credited against 2005 Accord offset payments, and all offsets are in turn clawed back through the fiscal capacity cap of Equalization. But since Newfoundland no longer receives positive Equalization or 2005 Accord payments, these intricacies of past agreements assume real importance.

Hydroelectric Capacity Measurement: Ontario and Quebec

The other change to Equalization of quantitative significance in 2009-10 concerns the way government business enterprises in the electricity sector are

treated for purposes of measuring fiscal capacity. Under new rules coming into force for the current fiscal year, dividends paid to the government of Ontario by the Crown-owned Hydro One will no longer count in the resource revenue base for the purposes of computing fiscal capacity – in contrast to dividends paid from Ontario Power Generation, Hydro Quebec, and the other Crown-owned electricity companies in provinces (British Columbia, Saskatchewan, and New Brunswick) with significant amounts of hydroelectric generation capacity. Instead, Hydro One will be treated like other non-hydro GBEs, which means that the net income of the company will be included in the business income base instead.

Since the effective tax rate at which capacity is equalized under the BIT base is much lower than the 50 per cent inclusion rate for resource revenues, the effect of the change is to reduce Ontario's fiscal capacity relative to that of other provinces, and to increase its Equalization entitlement. The fiscal impact of the change appears to be small relative to the overall size of the Equalization program, but large relative to Ontario's own entitlement in 2009-10 of \$347 million.

The ostensible reason for the change is that Hydro One is involved in the transmission and generation of electric power, but not its production, and so its remittances cannot be regarded as resource revenues. Considerable attention was devoted to the issue in Quebec's 2009 Budget Plan, where it is pointed out that applying the same treatment to the transmission and distribution divisions of the (vertically integrated) Hydro-Québec would increase Quebec's entitlement even more – by \$250 million annually according to Quebec's estimate.

The broader issues at stake is the appropriate measurement of rents from natural resources and, in particular, of how to achieve fairness and efficiency in the treatment of the considerable government-owned investments in electricity generation capacity.

The move to equalizing remitted profits of a named list of hydroelectric GBEs was instituted in 2007 on the recommendation of the O' Brien panel. The change was clearly intended as a way to increase the sensitivity of transfers to the great revenue potential of hydroelectricity in some receiving provinces – particularly Quebec. But the consequence of greater equity in the treatment of hydro may be worsened incentives for the provinces to manage their resource appropriately. Bernard and Ben Mabrouk (2009) point out that Quebec's decision to receive dividends from Hydro-Québec is already reducing its Equalization payments from Ottawa. The decision to change the treatment of Ontario's hydro GBEs has certainly raised the profile of this issue in Quebec.

However, because fiscal capacity for hydro is now measured by remitted profits, the Equalization formula acts like a cash flow tax on Hydro GBEs – which effectively gives the provinces a full credit under Equalization for earnings retained and reinvested in new Hydro assets. In the long run, such a tax is equivalent to a tax on pure economic rent from water power resources. Such a tax has certain desirable features:

- It cannot be avoided in the long run by reducing dividends paid but merely deferred.⁹
- It exempts the normal return on the capital invested by the provinces to exploit the resources (since dividends reinvested and not remitted are not subject to Equalization). Therefore receiving provinces have undiminished incentives to invest in hydroelectric generation capacity in order to sell power at market prices in other provinces or to the United States.

In reality, neither of the two approaches currently used for measuring fiscal capacity from hydro GBEs is adequate. For one thing, the distinction between companies subject to the two different approaches (and two different rates of taxback) is somewhat arbitrary – as Quebec has argued. More importantly, neither approach deals adequately with “dissipated rents,” i.e. the benefits provincial residents receive from consuming power supplied by GBEs at less than its true opportunity cost. A wholesale reform would deal with both problems.

Canada Health Transfer

Budget 2009 also proposed technical changes to the Canada Health Transfer (CHT) allocation formula, which would result in effective transfers among provinces in the amount of several hundred million dollars per year – and which have the potential to change more fundamentally the equity principles that underly the allocation rule for CHT. To understand the proposed changes once again requires some history.

Since the 2004 Health Accord, total payments under the Canada Health Transfer are legislated to increase by six per cent annually until renewal of the program in 2014-15. While CHT is a “vertical” grant in aid of provincial health expenditures, the program does include one significant equalizing element: cash transfers to some provinces are adjusted to reflect the unequal values of personal and

⁹ The perspective described here is known as the “new view of dividend taxation”, familiar from the theory of corporate taxation.

corporate income tax points transferred by the federal government to the provinces in 1977. In previous years, this has meant that Alberta and Ontario (and usually British Columbia) received lower CHT cash transfers per capita than Equalization-receiving provinces, while Saskatchewan (and recently British Columbia) have received higher cash transfers per capita than Equalization-receiving provinces, in the years that they have not received Equalization.

While this arrangement appears curious, it has in fact made sense in the light of the 1977 changes to fiscal arrangements, which replaced certain cash payments to the provinces by a transfer of “tax room” under which the federal government reduced its tax rates on personal and corporate income, while the provinces simultaneously increased their own tax rates by equivalent amounts (see Courchene, 1979). In order for the tax points to have the same value for all provinces, it was decided that the tax points would be fully equalized on a net basis. Consequently, CHT cash payments to Alberta and Ontario (and usually British Columbia) have been reduced by an amount equal to the excess value of the 1977 tax points.

With Ontario's entry into Equalization for the first time in 2009-10, the logic of these adjustments has changed. For each dollar per capita that Ontario's fiscal capacity from the 1977 tax points exceeds the national average, its Equalization payment is automatically reduced by one dollar per capita: this is precisely how Equalization works for receiving provinces. To also reduce its CHT cash payments in respect of the 1977 tax point transfer would therefore constitute “double jeopardy” -- and yet this is what existing legislation requires.¹⁰ The Budget 2009 proposal would eliminate double jeopardy by raising Ontario's CHT cash to the same level as other receiving provinces.

The Budget proposal however goes farther, also eliminating over time the CHT cash premium for provinces (currently Newfoundland and Labrador, and Saskatchewan) that do not receive Equalization, but whose 1977 tax points are below average value, which now rightly triggers higher CHT cash to maintain full equalization of the tax points. As such, the proposed changes would represent an accelerated transitional step towards paying equal per capita CHT cash for all ten provinces – which the Government is committed to doing in 2014-15 anyway.

Reaction from the provinces to this measure was decidedly negative and, perhaps for this reason, it now appears that equal per capita CHT cash will be implemented only for Ontario and not for the provinces receiving above-average

¹⁰ This anomaly has arisen in the legislation presumably because this is the first time a province with above-average value of 1977 tax point points has received Equalization – by virtue of aggregate fiscal capacity that is below-average value.

payments. Furthermore, the change for Ontario will be effected, in the short run at least, in a way that avoids reducing cash payments to other provinces from inside the CHT cash envelope.¹¹

Given the apparent difficulty in implementing this reform, we may anticipate it would be similarly difficult to reduce payments to any province receiving above-average cash in 2014-15, when the move to equal per capita cash for all ten provinces is slated to occur. Top up payments to ensure that no province loses from reallocation – just as is being done this year – are one likely solution.

Of course, if present trends continue, the prime beneficiary of equal per capita CHT cash will not be Ontario but Alberta – which would receive about \$200 per capita (more than \$700 million) in additional federal cash if the change were effected immediately. Regardless of how the 1977 tax point transfer is treated in future, there are broader issues of interprovincial equity in all the major transfers that should be addressed, given the growing disparities among provinces.

3. Evaluation

The 2009 changes to Equalization and related transfers are controversial, far-reaching – and thus far subject to relatively little public scrutiny and debate. In this section I offer an evaluation of the changes, and a look at the pressures Equalization might face in future – and how perhaps it should change to respond to those pressures.

3.1 Was restraint of Equalization necessary?

Restraint on Equalization was advertised by the federal government as an affordability issue. That is a legitimate perspective, but it does not seem like the full story. Given that, without change, Equalization would in 2009-10 have been just \$1.9 billion higher, and given the other spending initiatives undertaken by the Government in the current fiscal year, letting Equalization go would, in some sense, have remained “affordable”. A slightly different perspective holds that it was the risk of further increases in future, if energy prices rebound in 2010 and beyond, that led the Government to act now to limit the program.¹² But those

¹¹ See Quebec's 2009 Budget Plan, pp. G15-16, for details.

¹² Some readers may wonder why Equalization costs are growing at all in 2009-10, given that energy prices (and so provincial revenues) are so much lower now than they were early in 2008. The reason is payments in each year depend on a moving average of revenues

risks are no higher now than they were a year earlier when the program was allowed to grow unfettered – indeed they appear much smaller for the medium term.

Arguably, what changed in 2009-10 that necessitated restraint on the program was Ontario's transition to receiving-province status. Ontario does not present an immediate affordability challenge for Equalization – its 2009-10 payment is just \$347 million, and even unrestrained it would have been less than \$1 billion. Rather, because of Ontario's large population, what has changed fundamentally is the fiscal risks to which the federal government is exposed through Equalization.¹³

To understand how Ontario's entry affects volatility of Equalization payments, some discussion of the mechanics of the formula is needed. Conceptually, Equalization transfers are calculated in order that each receiving province, if it applies the national average level of tax effort, will receive the same (equalized) revenues per capita as the average of all ten provinces. Practically, under the 2007 formula, this calculation is done by dividing revenues into five categories: Personal Income Taxes, Business Income Taxes, Consumption Taxes, Natural Resource Revenues, and Property plus Miscellaneous Taxes. For each category, each province's deficiency or excess in fiscal capacity is calculated by subtracting its share of the measured tax base from its share of the national population. The province's Equalization entitlement in respect of the category is then calculated by multiplying its deficiency (or excess) percentage by the national total of revenues to be equalized for the category.¹⁴

For example, in 2007-8, Quebec comprised approximately 23 per cent of the national population, but only about 18 per cent of the tax base for personal income taxes, and total provincial personal income tax revenues for the year were about \$80 billion. Thus Quebec's population share of national total revenues would be about \$18.4 billion, but its share of the actual base permits it to obtain only \$14.4 billion in own-source revenues by applying national average tax effort. It therefore has an Equalization entitlement of about \$4 billion – the five percentage point deficiency times the \$80 billion in total revenues – for the

accruing two to four years earlier. Alberta's 2008-09 energy royalties will therefore continue to affect payments up to 2012-13.

13 The same point was made by Courchene (1979) in his discussion of how the Equalization program worked in the 1977-81 period – the last time Ontario's fiscal capacity fell below the national average – and much of this section parallels the analysis there.

14 The reader may be more familiar with Equalization payments being determined by subtracting the province's tax base per capita from the national average level, and multiplying by the national average tax rate. The two approaches are mathematically equivalent, but the one presented here shows more clearly the components of statistical risks in payments.

personal income tax category.¹⁵

Provinces' entitlements for each category are then summed and the total, if positive, represents the province's Equalization payment before “bells and whistles”, that is, before introducing the moving average of three years' data, and before determining the impact of the ceiling, the fiscal capacity cap, and the floor protection payment. Of course, a province with a negative sum of entitlements receives a payment of zero – under Canada's “gross basis” system of equalization, these provinces do not contribute payments to the have-not provinces.

With this background, the figures in Table 2 shows how Ontario's transition to receiving status affects the total payouts at this first (pre-“bells and whistles”) stage of the calculation. The first (leftmost) column of figures shows the national total revenues to be equalized. The next two columns shows the calculation of aggregate entitlements for the other five receiving provinces – which are the “Core Five” (PEI, Nova Scotia, New Brunswick, Quebec, and Manitoba) that have received payments in every year since the program's inception. Thus the 7.5 percentage point PIT base deficiency of the Core Five translates into a \$5.977 billion Equalization cost for PIT, and so on, with the total entitlement to these provinces being \$15.807 billion. The final two columns repeat these calculations with Ontario included in the aggregate base deficiencies – and so in the aggregate entitlements column too.

15 The figures presented are not “O'Brienized”: that is, they refer to actual data for the 2007-08 fiscal year, rather than the moving average of data that determine Equalization payments for a given year under the post-2007 O'Brien formula.

Table 2
The Impact of Ontario on the Equalization Formula

Category:	Revenues to be Equalized (\$ millions)	Equalization Payments to:			
		Core 5 Provinces:		Core 5 + Ontario:	
		Base Deficiency (%)	Equalization Entitlement (\$ millions)	Base Deficiency (%)	Equalization Entitlement (\$ millions)
Personal Income Taxes	79,824	7.5	5,977	4.8	3,809
Business Income taxes	26,521	9.6	2,543	8.3	2,204
Consumption Taxes	71,141	3.2	2,258	4.7	3,340
Natural Resources	11,384	18.8	2,144	56.9	6,477
Property Taxes	51,036	5.7	2,884	2.7	1,372
Total	239,906		15,807		17,202

Notes: The Core 5 provinces are PEI, Nova Scotia, New Brunswick, Quebec, and Manitoba.
The data are for the 2007-8 fiscal year.

Observe that Ontario's entry causes base deficiencies and so entitlements to fall for three categories – PIT, BIT, and Property – where Ontario remains a province with above-average fiscal capacity. (However, Ontario's surplus capacity has slipped considerably in recent years, particularly for the BIT category.) For Consumption Taxes, Ontario has a deficiency of 1.5 percentage points, so that inclusion of Ontario for this category raises entitlements by about \$1.1 billion.

But the striking feature of Table 2 is Ontario's impact on Equalization of the Natural Resources category. Without Ontario, the aggregate deficiency of receiving provinces would be 18.8 per cent, translating into an aggregate payment of \$2.144 billion as a function of the \$11.384 billion in resource revenues that are included in Equalization. But Ontario has less than one per cent of the measured natural resource revenue base, and 39 per cent of the population. Its entry into Equalization therefore causes the aggregate base deficiency for resource to rise by about 38 percentage points, and Equalization payments for the category to rise by \$4.3 billion. On balance, adding positive and negative entitlements, Ontario's inclusion causes this notional calculation of Equalization to rise by \$1.4 billion overall.

Whether \$1.4 billion is large or small,¹⁶ it is also clear from Table 2 that the impact of Ontario on the cost of the program could quickly become much larger – volatility of Equalization spending increases with Ontario's inclusion. The figures show that, with the Core Five receiving provinces, each \$1 billion in included resource revenues accruing to a non-receiving province (like Alberta,

¹⁶ As noted, Ontario's actual pre-ceiling entitlement for 2009-10 would be still lower, due to the O'Brien moving average.

Saskatchewan, or British Columbia) would cost the federal government \$188 million in additional Equalization payments. But with inclusion of Ontario, this marginal federal cost rises to \$569 million. A \$1 billion annual swing in included provincial resource revenues is not large relative to its empirical distribution. Indeed, the standard deviation of annual changes in (50 per cent of) resource revenues over the 1982-3 to 2007-8 period is \$3.1 billion (in 2005 constant dollars).

Put more simply, allowing Ontario to enter Equalization while doing nothing to restrain the program would have exposed Ottawa to the risk that program cost would, with high probability, swing from year to year by \$1 billion or more. Whether that would have been desirable or not is of course a matter for debate – recent developments have shown that the federal government is once again willing to use annual deficits as a means of smoothing volatility in revenues and expenditures. But it would have been a significant change in the dynamics of the program, which would have made federal fiscal planning very difficult in any future situation in which the “no deficits” rule has been re-established as the government’s fiscal anchor.¹⁷

The corollary is that Ontario is too big a province to be insured by the Equalization program as it currently operates. This seems like yet another argument in favour of introducing “net basis” elements into our equalization formula, in which revenue risks would be pooled to some extent through direct revenue sharing transfers among the ten provinces.

3.2 Is the fixed pool approach justified?

Even if Ontario's entry into the program necessitated federal action of some kind, is the return to a “fixed pool”, or closed-ended grant, justified? There is a frequent sense among commentators that the fixed pool approach is inconsistent with the principles of Equalization. The O'Brien Panel in particular wrote that: “There also is a sense that the concept of a fixed pool runs counter to the fundamental nature of Equalization—that it is intended to respond to changes in fiscal capacity of the provinces, rather than acting as a fixed entitlement over time. Establishing a fixed pool with a growth track divorces the Equalization program from the actual financial situation in provinces and the overall need for Equalization over time.” (Expert Panel, 2006). The argument is echoed in the critique of the latest changes in Quebec (2009).

17 It also has the potential to undermine macroeconomic stabilization.

In fact, there does not seem to be any strong principle that suggests an open-ended equalization grant should be preferred to a closed-ended grant – particularly not when attention is confined to gross-basis equalization schemes like Canada's that equalize up to the national average but do not require provinces with above average capacity to pay into the system.

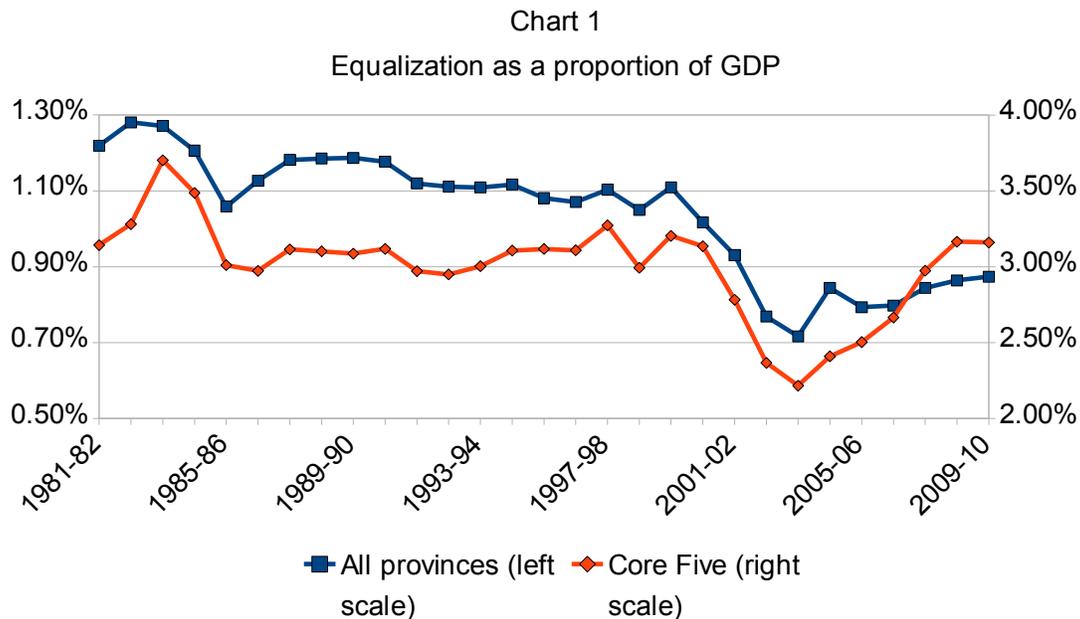
Under the open-ended approach, government policy determines a fiscal capacity standard to which receiving provinces are raised. Under the 2007 formula, the standard was the average per capita revenues of the ten provinces (excluding half of resource revenues); under the 1982-2004 formula it was the average revenues of a group of five provinces, and so on. Under Canada's gross-basis system, transfers do not address the fiscal disparities between receiving and non-receiving provinces, so that there is nothing special about the national average revenues as the standard to which provinces are raised. In 2009-10, the ceiling brings the effective standard for the program about one per cent below the ten-province average of revenues: hardly a violation of fundamental principles of equalization.

While many countries operate transfer programs similar in structure to Equalization, Canada is quite unusual in financing open ended equalization grants from federal spending alone. Most countries in the OECD have adopted one of two approaches to dealing with federal fiscal risks (OECD, 2007):

1. fixing the distributable pool as a proportion of certain federal revenues or in absolute terms; or
2. relying to a greater extent on “net basis” horizontal equalization grants that are funded in part by the subnational governments themselves.

For example:

- In Australia, 100% of the revenues from the federal Goods and Services Tax (a VAT) are earmarked for financing the main system of (vertical and horizontal) unconditional grants to the states.
- In Japan and several other countries, the growth rate of equalization grants is linked to the growth rate of total federal revenues.
- In Switzerland since 2008, equalization grants are closed-ended – i.e. fixed in units of the national currency by legislation and the costs are shared between federal and cantonal governments.
- In Denmark, grants are likewise closed-ended, and the total cost to the federal government changes from year to year depending on a formula that depends on the nominal growth of the economy and on expenditure



needs of recipient governments – but not on subnational revenues.

- In Germany, the federal equalization system has two main components, one of which is financed by the earmarking of certain federal taxes, while the other is a net scheme financed by contributions from rich states to poor states. Under neither component is there a fiscal risk to the federal government that is unmatched by countervailing risks in earmarked federal revenues.

In all these cases, equalization transfers are designed to limit federal fiscal risks, either by use of closed-ended grants or grants linked to earmarked revenues, or by explicitly requiring fiscal risk sharing with state governments through net basis equalization schemes. What is more, all this occurs in the context of countries that have much less revenue decentralization and much less regional diversity in resource revenues, which is what makes Equalization so volatile in Canada.

3.3 Is the level of federal spending on Equalization appropriate?

Regardless of how the amount was determined, Ottawa will spend \$14.2 billion on Equalization in 2009-10. Is that amount appropriate? Quebec (2009) has argued that the current level of Equalization is inadequate.

The chief argument Quebec advances for a larger Equalization pool is that the cost of the program is smaller in proportion to national GDP than historical norms.

Since 1967-8, the program has averaged just over one per cent of GDP, whereas it is now about 0.9 per cent. By this metric, spending would be adequate in 2009-10 if the O'Brien formula were applied, without imposing a ceiling. There is of course no reason to expect an open-ended Equalization to grow in proportion with GDP; instead, it is expected to rise and fall with the extent of measured disparities in fiscal capacity among provinces. By some measures, disparities among provinces are certainly on the rise, but this has yet to be reflected in the program. The slower growth of the program in proportion to GDP reflects in part the rising fiscal capacity of resource-rich traditional receiving provinces. When attention is confined to Core Five receiving provinces, the picture is rather different – see Chart 1, which measures Equalization payments as a percentage of GDP since 1981-82.

4 Concluding Remarks: The Future of Equalization

Notwithstanding the careful compromises that went into the latest revamping of the Equalization formula, the pressure for further change is almost certain to increase. Provincial objections to the November announcement were initially muted, but are likely to increase as the cumulative impact of the ceiling increases in turn, relative to entitlements under the 2007 formula. The entry of Ontario into the program has the potential to change political support for Equalization as well – arguably, the median voter now lives in a receiving province. While receiving provinces may push for a return to the 2007 formula, without a ceiling, their efforts may come to focus more realistically on making the case for a ceiling that grows at a faster rate than has been promised by Ottawa. Such a process has the potential once again to undermine fiscal accountability among governments in Canada (Smart, 2005; Kotsogiannis and Schwager, 2008).

At the same time, developments on the federal side will be pulling the program in very different directions. The federal budget will be in deficit for several years to come, and the return to budget balance is likely to be a struggle. With major transfers to the provinces approaching 25 per cent of federal program spending, it is not difficult to imagine that fiscal retrenchment will involve further restraint on transfers. But which transfers? With the 2009 Equalization changes, the federal government now operates three distinct lump-sum grants as its major transfers, each allocated based on different principles, and each legislated to grow at a different rate – the Canada Health Transfer (CHT) at 6 per cent annually, the Canada Social Transfer (CST) at 3 per cent, and now Equalization at the growth rate of nominal GDP. Grappling with fiscal arrangements in coming years is therefore going to require decisions about the relative priority of vertical versus horizontal grants, and an articulation of what each of the grants is intended to achieve.

If, as I have argued here, Equalization is to remain a closed-ended grant, then what is required is an understanding of what is an appropriate way of determining the level of spending on the program in future. One alternative to the current method of growing the ceiling in line with nominal GDP would be to earmark some portion of federal tax revenues for Equalization – and possibly for some of the other major transfers. Thus for example, as in Australia and Germany, Equalization and some portion of the block transfers could be financed by dedicating all future revenues from the federal GST to the transfers.

Earmarking federal revenues to fund block grants would have evident benefits for fiscal risk management of the federal government – transfers would be tied explicitly to affordability. But to the extent that earmarking increased federal power to commit to these arrangements, it could increase predictability of transfers for the provinces as well. Correctly structured, earmarked transfers would be less procyclical than current arrangements, and the greater stability would be fairer to Ontario and other provinces that may move into and out of Equalization in future.

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