



Royal Commission on Renewing and Strengthening Our Place in Canada

Options for Fiscal Federalism

By:
Robin Boadway

March 2003

The views expressed herein are solely those of the author and do not necessarily reflect those of the Royal Commission on Renewing and Strengthening Our Place in Canada.

Abstract

This paper presents an overview of the system of the federal-provincial fiscal arrangements as they have evolved in Canada. The system is evaluated from the point of view of the obligations set out in the Constitution, and from the point of view of the principles of a sound social and economic union. Problems of the various constituent elements are outlined, and their relevance for Newfoundland and Labrador are discussed. Various policy options for reforming the fiscal arrangements to improve the efficiency and equity of the social and economic union and the functioning of the federation from the province's perspective are proposed.

Prepared for the Royal Commission on Renewing and Strengthening Our Place in Canada. Extensive comments by internal and external reviewers on an earlier version of this paper were most helpful. The paper has been revised to take account of them, although differences in evaluating existing and proposed changes to the federal-provincial fiscal arrangements undoubtedly stand.

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I. Introduction

The Canadian system of federal-provincial fiscal arrangements has evolved considerably over the post-war period. The enormous growth of the welfare state in the early postwar period was a joint venture with the provinces delivering the social programs and the federal government providing conditional transfers. An Equalization system was put in place whose essential features remain with us today. And, the system of income tax harmonization evolved naturally from a situation in which the federal government was the sole income tax collector during the war. Gradually and persistently, the federation has become more and more decentralized. Provincial expenditures have grown rapidly relative to those of the federal government, and more important, provinces have become more and more responsible for financing their own spending programs. At the same time, provincial economies have not grown at the same rate. Some regions have enjoyed strong growth in their goods-producing sectors, and others have enjoyed the windfall gains of natural resource discoveries. These changes, along with the impact of globalization, have put enormous pressures on the fiscal arrangements. The province of Newfoundland and Labrador has much at stake in the outcome given its recent history of being the most dependent of all provinces on fiscal transfers. Now that the prospects of the province are finally turning around, new issues arise as to how suitable are the fiscal arrangements for facilitating resource-led growth.

The purpose of this paper is to provide a review of the fiscal arrangements with a view to their suitability for achieving the objectives of the federation — the so-called social and economic union — both from the point of view of Canada as a whole and from the point of view of Newfoundland and Labrador. Our objective is to evaluate the current arrangements, and where appropriate to suggest suitable reforms.

We begin with a summary of the current fiscal arrangements. The objectives of the fiscal arrangements as set out by the Canadian Constitution, as enunciated in federal-provincial agreements, and as generally accepted by economists and policy experts are used to set the context for a description of the arrangements. Then the various problems that exist with the current arrangements are outlined. The relevance of these problems for Newfoundland and Labrador is discussed. Finally, various policy options for reform of the fiscal arrangements are proposed and evaluated.

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II. The Fiscal Arrangements in Canada

The fiscal arrangements between the federal government and the provinces contain a variety of elements that taken together address a number of objectives.¹ It is worth at the outset summarizing what those objectives are, and how they have evolved over the postwar period. Since the objectives are not spelled out explicitly in either the Canadian Constitution or in legislation, and since they are ultimately political in nature, different observers may take different views about them. Before offering what seems to me to be a reasonable set of views that are broadly consistent both with the manner in which the system is designed and with the accepted principles of fiscal federalism, it is useful to begin by setting out the constitutional context that should undoubtedly inform the objectives and the practice of fiscal federalism.

A. The Constitutional Context

There are various sections in the Constitution that have a bearing on the fiscal arrangements, and some of these are more important than others. At the core of fiscal federalism is the assignment of legislative responsibilities, which are mainly set out in Section 91 for the federal government, Sections 92-93 for the provinces, and Sections 94-95 for concurrent responsibilities.

Of particular relevance in the case of the provinces are two elements. The first is the exclusive provincial legislative responsibilities in health, education, and social services, and the second is the assignment to the provinces of the management of non-renewable resources in Section 92A, as well as affirmation of their right to tax resources in any manner they see fit. The former of these elements implies that the provinces are the main providers of social programs involving public services, while the federal government is largely restricted to social programs that involve transfers, such as employment insurance, and transfers to the elderly, to families and to children. The fact that such social programs comprise a significant proportion of program spending at both levels of government underlines the importance of redistributive equity as an objective of government policy. The latter of these involving resource management and taxation is the source of much of the inter-regional conflict that animates the Canadian federal system. Taken together — the joint responsibility for various aspects of redistributive equity, and the provincial ‘ownership’ of natural resources within their borders — these elements account for most of the contentious issues that afflict our federal system, and that are of particular relevance to Newfoundland and Labrador.²

With respect to the federal government, by far the most important of their powers is the one that is the least explicit — *the spending power*. It is this power that enables the federal government to make transfers of all sorts, which constitute the bulk of federal program spending. Federal spending on goods and services is largely non-controversial from a federalism point of view. Transfers to provinces are much more controversial both with respect to the magnitude and the form of the transfers. While there seems to be some consensus that this use of the spending power is constitutional,³ there is nonetheless ongoing concern of a political nature as to its rationale. Until recently the main concern of the provinces revolved around the

conditional nature of some federal-provincial transfers, especially where the conditions applied in the major social program areas in exclusive provincial jurisdiction.

In the past several years, provincial concern has also emerged over the use of the federal spending power simply as a means of transferring revenues to the provinces. Canada, like virtually all federations, is characterized by a *vertical fiscal gap*: federal revenues exceed what are required to finance federal program spending, with the excess being transferred to the provinces in one form or another.⁴ Over time, the size of the vertical gap has gradually decreased implying that provinces have gradually become more and more self-sufficient. But in recent years, there has been growing concern over whether, in addition to the existence of the vertical gap, there is also some imbalance in the vertical relationship. The concept of a *vertical fiscal imbalance* (VFI) — which is distinct from that of a vertical fiscal gap⁵ — is an ambiguous one. Roughly speaking, a VFI exists to the extent that the size of federal-provincial transfers are not compatible with the amount of tax room the federal government is occupying relative to its own spending requirements. There has been a claim from the provinces — most forcefully put by the Séguin Commission — that the size of federal transfers is too small in the sense that provincial deficits and federal surpluses are projected to rise over time under the existing set of policies. This problem has gained prominence since the federal government unilaterally made significant cuts in cash transfers to the provinces as part of their deficit-reducing measures of the early 1990s. This has allegedly exposed one of the problems of a vertical fiscal gap: it is said to leave the provinces vulnerable to unilateral and unannounced changes by the federal government.

There are political and economic arguments for a vertical fiscal gap (at least one that does not entail a VFI), as discussed below. However, for now it is worth noting the constitutional rationale (as opposed to the constitutional authority, which lies elsewhere) for the federal government engaging in federal-provincial transfers, some of which have conditions attached. It can be found mainly in the two parts of Section 36, which set out the principles governing the federal interest in influencing the provincial delivery of social programs. This section is of utmost importance for our discussion. Section 36(2) is the more familiar and less controversial part. It commits the federal government ‘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.’

The potential import of Section 36(1) has been much less recognized in the past, despite the fact that it speaks directly to the conditionality of transfers. It reads as follows:

Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to

- (a) promoting equal opportunities for the well-being of Canadians;*
- (b) furthering economic development to reduce disparity in opportunities; and*
- (c) providing essential public services of reasonable quality to all Canadians.*

Two aspects are relevant for our purposes. The first is that items (a) and (c) clearly enunciate the interest the federal government has in redistributive equity over and above what it can achieve using its own tax-transfer system applying to individuals. The promotion of equal opportunity and the provision of essential public services of reasonable quality necessarily involve the important public services in the areas of health, education and welfare. Since these are the legislative responsibility of the provinces, the main feasible way that the federal government can fulfill this constitutional mandate is via the spending power. Alternative mechanisms, such as legislative disallowance, federal-provincial negotiation, and moral suasion, are either more intrusive or less effective than the use of the spending power. The second aspect is also especially relevant for this Royal Commission. Item (b) refers to furthering economic development to reduce disparities in opportunities. To the extent that the development of offshore oil and gas, hydroelectric power generation and major mineral deposits constitute such types of economic development, it is reasonable to expect the federal-provincial fiscal arrangements to facilitate them.

The system of fiscal transfers taken as a whole addresses these federal constitutional obligations. There are also other political economy arguments supporting these and other objectives of the fiscal arrangements. A summary of them is as follows.

B. The Objectives of the Fiscal Arrangements

The broad objective of the federal-provincial fiscal arrangements can be put succinctly: They serve to facilitate the decentralization of responsibility to the provinces while at the same time maintaining the integrity of national objectives. To appreciate what is at stake, it is important to recount the case for decentralization as well as the national objectives that are served by the fiscal arrangements.

1. The Case for Decentralization

Decentralization is obviously a constitutional requirement in the sense that the provinces have exclusive legislative responsibility for the delivery of very important health, education and welfare services, as well as for civil and property rights and other items of purely provincial and local interest. As well, they share responsibility in areas of pensions, immigration, agriculture, and the environment. Nonetheless, legislative responsibility is not the be-all and end-all since the federal government can influence provincial legislative outcomes. Therefore, the case for decentralization must be made if only as a way of defining the limits of federal intervention.

The economic argument for decentralization is largely one of efficiency, although notions of community, language and culture may well augment it.⁶ Provinces are better able to cater public programs to local needs and preferences. Innovations in program design are likely when several provinces are involved in providing services. Inter-provincial competition makes provinces most accountable and cost-effective. Managerial efficiencies are also possible the more decentralized is program administration. Lower-level managers are better able to monitor and control the quality of program delivery. It is now widely accepted throughout the world, even in unitary-type nations, that decentralization improves the efficiency and effectiveness of

the delivery of public services to local persons and business, and of transfer programs that must be targeted using discretionary means. It is therefore not surprising that the kinds of services that are delivered by provinces in Canada are also delivered by sub-national jurisdictions in other OECD countries.

2. National Objectives and the Limits to Decentralization

At the same time, there are limits to decentralization. Inter-provincial competition can be detrimental if it is used simply to provide fiscal incentives to attract economic activity from other provinces, or if it is used to provide an incentive to the activities of a province's own residents and businesses. For some items, the scope of benefits is nationwide rather than provincial, such as the case of national public goods like defense and foreign affairs. As well, there may be economies of scale associated with some programs that make it more efficient to deliver them nationally. This is especially true of the administration of broad-based taxes and transfers. However, the most important issues in designing the fiscal arrangements arise from the ways in which provincially legislated programs might impinge on national objectives. Apart what one finds in Section 36, the Constitution does not provide a comprehensive statement of national objectives. The fiscal federalism literature emphasizes three important national objectives of an economic nature that might justify the federal government using the fiscal arrangements to influence provincial policies.

1. *Efficiency in the Internal Economic Union.* This requires that labour, capital, goods and services be able to move across provincial boundaries both unfettered and undistorted by provincial policies. Like all economic objectives, this one is not absolute: there may be legitimate social and political objectives served by provincial policies that interfere with inter-provincial trade, such as language policies, cultural policies, and policies that foster provincial social and development objectives. Achieving efficiency in the internal economic union involves measures of both *negative integration* and *positive integration*. The former entails proscriptions on provincial behaviour that distorts inter-provincial flows or discriminates against non-residents. The latter involves measures, such as tax, spending and regulatory harmonization, that facilitate inter-provincial flows.
2. *Fiscal Equity.* This is the application of the notion of horizontal equity — like persons ought to be treated alike by the public sector — to a federal setting. This is based on the idea that citizenship entitles all persons to be 'counted' equally from the point of view of government policy. In a federal context, horizontal equity would require that like-persons be treated equally by both the federal and provincial levels of government wherever they reside. In its strictest version, horizontal equity conflicts with the principle of federalism since it would require that all provinces adopt identical policies. Instead, the weaker notion of fiscal equity is prescribed: provinces should have the fiscal potential to ensure that all persons be treated comparably across the nation (cf. Section 36(2)). The decision as to how far fiscal equity should deviate from horizontal equity then amounts to the same thing as how decentralized the federation should be. In Canada, we have evolved to a situation where the extent of decentralization is amongst the highest in the world, but at the same time fiscal equity remains an objective.

3. *Vertical or Redistributive Equity.* This refers to the pursuit of a more egalitarian society, and can take many forms (some of which are hinted at in Section 36(1)). It could take the form of redistribution from the better-off to the less well-off in society. It could involve equality of opportunity: an ex ante form of redistribution. Or, it could take the form of social insurance: redistribution from the lucky to the unlucky. Instruments used for redistributive equity purposes range from the income tax-transfer system to more targeted transfers to in-kind transfers (e.g., health, education, housing) to social insurance programs (unemployment insurance, health insurance) to job creation and even regional development programs. Provincial fiscal programs are extremely relevant for redistributive equity purposes, since many of the instruments used for this purpose are in the hands of the provinces. The issue for fiscal federalism concerns the extent to which national standards of redistributive equity should apply: to what extent is the nation the relevant sharing community as opposed to the province?⁷ This is obviously a matter of consensus, but one with far-reaching consequences. Presumably, national and provincial notions of redistributive equity coincide to some extent. The greater is the consensus for the nation being the sharing community, the more might the federal government intervene in influencing the structure of provincial social programs.

There will inevitably be disputes about the weight of these national objectives in defining the fiscal arrangements, and therefore the extent to which one advocates decentralization of provincial responsibilities, especially over social program design. At the same time, the three main objectives are not fundamentally in conflict. One can advocate a federal role in achieving greater efficiency in the internal economic union without buying into a federal role in equity. Perhaps more important, one can advocate fiscal equity among provinces while at the same time treating provinces as the relevant community for the purposes of defining vertical equity. In this case, Equalization would be the primary goal used by the federal government to achieve equity. The more consensus there is for the nation being the relevant sharing community for redistributive equity purposes, the most important becomes the spending power as a national policy instrument.

One further point that relates to the mandate of this Royal Commission should be stressed. The main purpose of the fiscal arrangements, following the principles set out in Section 36, involves ensuring an adequate level of basic public services in all provinces. Transfers to the provinces should be seen primarily in that light. They should not be seen either as substituting for transfers to individuals as a means of enhancing their private incomes and thus their access to market goods. Nor should they be assessed in terms of their potential for regional economic development, except to the extent that good public services contribute to that goal. This is important because some observers have a tendency to judge transfers to the have-not provinces as being analogous to welfare schemes for low-income persons, and to base their policy proposals on that view.

3. Technical Diversion on Fiscal Equity

Since the principle of fiscal equity is critical to the design of the fiscal arrangements, it is worth digressing to mention the circumstances in which it might be violated in a federation. (This discussion is somewhat technical and can be skipped without losing the thread of

argument.) As mentioned, fiscal equity is based on the notion of horizontal equity — the ideal that like-persons be treated alike by the fiscal system. The notion of net fiscal benefits (NFBs) has been developed to characterize horizontal equity in a federation. The NFB a person receives from the government is the difference between the value of public goods and services and the tax liability imposed on the person. Given the importance of redistributive activities of governments, this NFB will typically be positive for lower-income persons and negative for higher-income persons. Horizontal equity applies among provinces if persons of a given real income level obtain the same NFBs in all provinces. Differences in NFBs arise from three basic sources: differences in needs, differences in per capita source-based revenue sources (e.g., natural resources), and differences in residence-based revenue sources.⁸ In the first case, if provinces differ in the proportions of their population to whom public services are directed, they will differ in the per capita expenditures required to satisfy those needs. In the second case, if they differ in their endowment of natural resources, they will be able to provide a given level of public services at lower tax rates to their residents. The third case of differences in residence-based revenue sources, such as income, payrolls, or sales, is subtler. These will give rise to NFB differences to the extent that they are used in a redistributive way. For example, if incomes were taxed on a proportional basis to finance public services that are equally available to all residents, those with higher incomes will obtain negative NFBs, and vice-versa. Moreover, persons in higher average income provinces will be able to provide a given level of public services at lower tax rates than those in lower income provinces, implying higher NFBs for all persons in the former. By the same token, if residence taxes were entirely benefit-based, they would lead to no NFB differentials between provinces, and no equalization would be called for to undo them.

C. The Components of the Fiscal Arrangements

The various components of the fiscal arrangements can be seen as contributing to both the constitutional and the political economy objectives of the Canadian fiscal federalism system. One can classify the fiscal arrangements into three main components: the system of federal-provincial transfers, the tax harmonization system, and the various inter-governmental agreements that inform and moderate government policy choices.

1. Federal-Provincial Transfers

Two components make up the bulk of federal transfers to the provinces — Equalization and the Canada Health and Social Transfer (CHST). Equalization payments are made to all provinces that have tax capacities below a national standard. Currently, all provinces except Alberta and Ontario are ‘have-not provinces’ in receipt of Equalization payments. In 2002-03, total Equalization transfers were \$10.348 billion, of which \$1.019 billion accrued to Newfoundland and Labrador. Equalization entitlements are calculated using the representative tax system (RTS) approach. Thirty-three provincial revenues sources comprising most of those used by the provinces are included. These range from broad-based taxes like individual and corporate income, sales, payroll and property taxes, to specific taxes like excise taxes and

capital taxes, to the various forms of resource revenues, to miscellaneous revenues like user fees. The basic procedure is as follows. For each revenue source, a common national tax base is defined, which is meant to be representative of the bases the provinces actually use. Then, a national average tax rate on each base is calculated as the ratio of total provincial revenues to the aggregate of the base over all 10 provinces. A province's per capita equalization entitlement for a given revenue source is then calculated by multiplying the national average tax rate by the difference between the per capita average tax base across five 'standard' provinces and the province's own per capita tax base. The five standard provinces include the middle income ones — British Columbia, Saskatchewan, Manitoba, Ontario and Quebec. These entitlements are then summed over all 33 revenue sources to give the province's total per capita equalization entitlement. For those provinces with a positive total entitlement (the 'have-not' provinces), a transfer is made from the federal government's general revenues in an amount equal to the total per capita entitlement times the province's population.

There are a number of other features of Equalization that should be mentioned. The transfers are unconditional, implying that the provinces can use them as they see fit. A number of special provisions apply. There is a ceiling applying to Equalization transfers as a whole and a floor applying to each province. Roughly speaking, the ceiling precludes total Equalization transfers from rising more rapidly than the percentage change in GDP. In the event that entitlements increase more rapidly than that, payments of all provinces are scaled back proportionately. The ceiling has been binding in several different years, most recently in 2000-01. The floor prevents any given province's per capita Equalization entitlement from falling in any given year by more than a prescribed amount, currently 1.6 per cent of the per capita value of the equalization standard. This occurs if a province has a sudden increase in one or more of its tax bases, and has applied for Newfoundland and Labrador only in 2001-02. There are some circumstances in which full Equalization entitlements are not applied. If one province constitutes at least 70 per cent of any given revenue source, only 70 per cent of the province's base is included in determining its entitlements from that source. This implies, roughly speaking, that the province loses only 70 per cent of the increase in revenues from these bases, rather than 100 per cent in the absence of the special provision. This so-called *generic solution* is intended to preclude the province from having an incentive to reduce its tax rate on the revenue source: the so-called *rate tax-back* problem. The same solution has been provided as an option to the provinces of Nova Scotia and Newfoundland and Labrador as part of the Nova Scotia and Atlantic Accords dealing with offshore oil and gas revenues. Whether a 30 per cent saving in Equalization tax-back is sufficient to avoid the disincentive effects associated with exploiting such resources is a matter that we return to later. In the case of some revenue sources, the bases are not calculated as described above. For example, the individual income tax base is effectively disaggregated into several bases, each one associated with a different income bracket. In the case of the property tax, the base does not correspond with that used by the provinces, which tends to be assessed property values. Instead, the standard base is the result of a rather complex calculation in which provincial capital stock data is adjusted by factors reflecting personal income, the degree of urbanization and demographic shifts. Some bases are defined very differently from those used in some provinces, such as the sales tax, whose base differs widely across provinces. And, some provincial revenue sources, such as lotteries and other gambling revenues, are not included in the formula.

The Equalization program contributes to the commitment of Section 36 of the Constitution by making it possible for provinces to have access to some national standard of per capita revenues, were they to use comparable tax rates. In so doing it contributes to the goal of fiscal equity by providing provinces with the potential to undertake comparable levels of per capita spending if they so choose. At the same time, the absence of conditions implies that the provinces are free to raise revenues as they see fit, and to use those revenues as they see fit, thereby facilitating the principles of decentralized decision-making. As a side benefit, Equalization is said also to provide some insurance to the provinces in the face of changes in their own tax bases. However, given that a province's Equalization entitlement depends not only on its own tax base but also on that of the five-province standard and the national average tax rate, it is not clear that on balance provincial revenues are stabilized. On the contrary, there is compelling evidence that the system actually destabilizes the revenues of have-not provinces.⁹

The CHST is in principle simpler than Equalization, but in practice it is more contentious because of the way it is structured. Unlike Equalization, the CHST is available to all provinces on comparable terms. The CHST evolved from two earlier transfer programs — Established Programs Financing (EPF) and the Canada Assistance plan (CAP) — and as such it took on some features of these schemes. Following the EPF system, the Department of Finance treats the CHST as being composed of two components — a tax-transfer component and a cash component. The tax-transfer component includes the current value of equalized income tax points that has been transferred to the provinces when the EPF was put in place in 1977. The total cash component is now determined at the discretion of the federal government. It has committed to increase the total cash transfer from \$18.3 billion in 2001-02 to \$21.0 billion in 2005-6. By the same time, the tax-transfer component will be \$19.3 billion by 2005-6. The CHST is allocated among the provinces in equal per capita amounts after accounting for differences in values to the provinces of equalized tax points. (Since equalization only applies to the have-not provinces, equalized tax points are worth the same to all have-nots, but more to the two other provinces.)

Like the EPF and CAP that it replaced, the CHST is intended to share in the provincial costs of health, social services and post-secondary education, and the federal government notionally divides the CHST into those three components. However, the funds are fully fungible and the attributed shares bear little relation to the actual provincial shares of spending in those areas. The transfers are not completely unconditional. To be eligible for their full entitlements, provincial public health insurance systems must abide by the five general criteria set out in the *Canada Health Act* 1985 (public administration, accessibility, comprehensiveness, universality and portability) as well as the specific admonitions not to allow extra billing or user fees. As well, welfare systems must not have discriminatory residence requirements. These sorts of conditions can be rationalized as reflecting the federal government's social policy commitments set out in Section 36(1). From a political economy perspective, they contribute to efficiency and equity in the internal economic union, and reflect at least a political consensus about minimum standards of redistributive equity or national sharing that should apply to health insurance programs.

Taken together, Equalization and the CHST (financed out of federal general revenues) represent almost the full extent of the extent of the vertical fiscal gap in the Canadian federation. A vertical fiscal gap serves various purposes in a federation. It facilitates the extensive

decentralization of expenditure responsibilities to the provinces while at the same time maintaining a harmonized tax system and one that embodies national standards of efficiency and equity. It contributes to the equalization responsibilities of the federal government in two ways. First, by limiting the decentralization of tax responsibilities, it reduces the extent of differential tax capacities across provinces. Second, the form of the fiscal transfers directly contributes to equalization. In fact, the CHST is in a sense an ideal system of revenue equalization to the extent that it provides equal per capita transfers financed by a nationwide tax system. That is, it implicitly equalizes the have-not provinces up and the have-provinces down, complementing the formal Equalization system. Finally, the vertical fiscal gap provides an instrument — virtually the only instrument — by which the federal government can exercise its responsibilities for national equity and efficiency in areas of provincial legislative authority (e.g., under the authority of Section 36(1)). Of course, this latter role of federal transfers is controversial, and has the potential for excessive federal intrusion into provincial areas of responsibility. That is why some commentators, such as the Séguin Commission, have suggested reducing the size of the vertical fiscal gap to Equalization alone.

2. Tax Harmonization

Canada has a system of tax harmonization comprising some elements that are enviable and others that are incomplete or even non-existent. The enviable elements are the systems of Tax Collection Agreements (TCAs) involving individual and corporate income taxes. The incomplete system is in the sales tax area. For the rest of the tax system, there is no harmonization. Tax harmonization contributes to the efficiency of the internal economic union as well as to the administrative integrity of the tax system. It can also lead to a more equitable national tax system by making the basis on which persons are taxed more uniform across provinces. The following summarizes the main features of the system of tax harmonization in Canada.

Harmonization of the personal income tax system (PIT) is accomplished by bilateral TCAs between the federal government and agreeing provinces, which include all provinces except Quebec. The system has been in a process of transition, so we describe the elements of the new system to which provinces have been moving. Provinces who choose to participate in PIT harmonization agree to abide by the federally-defined tax base and to have their revenues collected centrally by the Canadian Customs and Revenue Agency (CCRA). In return, they are allowed within limits to set their own rate structures and province-specific nonrefundable tax credits. In addition, provinces are allowed to impose their own rebates, surtaxes and refundable credits provided they are not discriminatory or administratively complicated. Provinces also agree to a common principle for allocating taxable income among themselves — basically in accordance with the province of residence of taxpayers on Dec. 31 in the tax year. The result is an income tax system among the nine participating provinces that has a harmonized base, and that combines provincial preferences for redistribution with that of the federal government. The extent to which federal redistributive norms apply, and presumably the willingness of the provinces to continue to participate, depends on the share of the income tax room occupied by the federal government.

The corporate income tax (CIT) is harmonized according to very similar principles. Agreeing provinces — all except Alberta, Ontario and Quebec in this case — sign a TCA

with the federal government that binds them to abide by the federal tax base and to have their taxes administered by the CCRA. They are allowed to set their own corporate tax rates as well as non-distorting credits, rebates and surtaxes. The allocation formula is somewhat more complicated owing to the fact that many corporations operate simultaneously in more than one province. A province's allocation equals the average of its share of the revenues and of the payroll of the corporations within its boundaries. In the case of the CIT, a much higher proportion of taxable income comes from non-participating provinces. Although one might expect that would result in a more diverse set of provincial corporate tax systems, in practice they are surprisingly similar, and all abide by the same allocation formula. No doubt this owes much to the fact that the system evolved from one in which the federal government was sole collector of the CIT.

While the system of income tax harmonization is a model one, sales tax harmonization is much less complete, and varies considerably across provinces. Of the nine provinces with general sales tax systems, five have retail sales taxes (RST) that are completely un-harmonized with either the federal goods and services tax (GST) or with each other. Moreover, these RSTs are plagued by inefficiency due to their narrow bases relative to the GST and to the fact that they unavoidably tax business inputs. The remaining four provinces harmonize their sales taxes with the GST in two different ways. Quebec operates the Quebec sales tax (QST) in a manner unique among federations. It harmonizes its base closely with the federal government and structures the tax as a multi-stage tax similar to the GST. Two features distinguish it from the system used in the other provinces. First, Quebec is allowed to set its own general rate of sales tax alongside the federal rate. The QST rate then consists of the sum of the provincial and federal tax rates. Second, the Quebec government administers the QST on behalf of both itself and the federal government. There are special provisions in the QST to ensure that, in the absence of border controls, imports to the province are fully taxed and exports are zero-rated (i.e., sales to non-resident buyers are not taxed and tax credits are given on previous business purchases in the province). The taxation of imports into the province is accomplished not by taxing purchases by resident from non-resident firms (since the latter are not necessarily registered as Quebec taxpayers), but by deferring sales tax liabilities until the importing firm makes the first sale. (Consumers are, however, liable to pay the QST on purchases made outside the province for consumption within Quebec, as is the case with all other provincial sales taxes.)

The remaining provinces — New Brunswick, Newfoundland and Labrador, and Nova Scotia — participate in the harmonized sales tax (HST) with the federal government. The HST is a fully harmonized tax that takes on exactly the same structure as the GST in other provinces, but has a common rate of 15 per cent covering the 7 per cent GST rate plus a further 8 per cent for the participating provinces. Unlike the QST, the CCRA administers the HST. Moreover, the provinces have no individual discretion over their own rate, although they could agree in common to change the rate. Similar principles apply to border transactions with buyers or sellers outside the three provinces: exports are zero-rated and taxes on imports are deferred until the first sale within the three-province region occurs. Revenues are allocated among the three provinces in proportion to their final consumption. Effectively, the HST system is a revenue-sharing scheme that achieves harmonization at the expense of the discretion of the provinces.

Given the diversity of federal and provincial sales tax systems, it remains an open question as to how additional provinces could participate in a sales tax harmonization scheme. The larger ones seem unlikely to agree to join an HST-type arrangement, given the absence of discretion over tax policy. At the same time, it is not at all clear that extending a QST-type arrangement to other provinces would be workable, not just from the point of view of decentralized administration but also with respect to discretion over tax rates. The more different provincial tax rates there are, the more complicated it would be for administrators and taxpayers alike to comply with the system. There are no good precedents for operating fully decentralized value-added tax systems in a decentralized federal setting with taxes operating at both levels. The closest analogue might be the European Union, but in that case there is no central government tax.¹⁰

No provincial taxes other than the income and sales taxes are harmonized at all. This is especially problematic for taxes that impinge on cross-border transactions or influence investment flows. Particularly important among these are taxes on businesses, including the plethora of different resource levies imposed by the provinces; capital taxes, which vary from province to province; and non-residential property taxes that account for more provincial revenue than the CIT. The Report of the Technical Committee on Business Taxation (Department of Finance, 1997) identified non-harmonized provincial taxes on businesses as a major source of tax distortion in the Canadian economy.

3. Inter-Governmental Agreements

A final component of the fiscal arrangements consists of agreements negotiated between the federal government and the provinces. These potentially constitute an alternative to the federal spending power as a means of ensuring that national objectives are taken into account in programs legislated by both levels of government. Indeed, some have even suggested that the provinces alone might come to collective agreements in defining and implementing national goals (e.g., Courchene, 1996). However, virtually all substantial inter-governmental agreements affecting the federal fiscal system include the federal government as a signatory.

For our purposes, the two most important federal-provincial agreements are the Agreement on Internal Trade of 1995 (AIT), and the Social Union Framework Agreement of 1999 (SUFA). These agreements are complementary in the sense that the AIT focuses on the efficiency dimension of national policy objectives, while the SUFA focuses on national equity. As such, they affirm the principles outlined above, but they do so in quite distinct ways. The AIT is the analogue of an international free trade agreement adapted to a federal setting in which labour mobility is relatively more important. Basically, the AIT sets out rules governing the conduct of provinces where their policies are liable to have effects on the efficiency of the internal economic union. These include both negative and positive integration measures — those that discourage certain types of behaviour and those that encourage others, respectively. Thus, provinces are precluded from engaging in behaviour that discriminates against non-residents or that distorts the free flow of products and factors of production across borders. On the positive side, they have agreed to cooperate in harmonizing various policies, such as professional licensing, so as to reduce barriers to inter-provincial mobility. The AIT thus sets out to fill a void in the Constitution by committing the provinces to adopting policies

that further efficiency in the internal economic union, an objective that seemingly commands widespread support.

The AIT illustrates both the strengths and weaknesses of relying on inter-governmental negotiation for achieving national objectives in a decentralized federation in which provincial policies have extra-jurisdictional consequences. The AIT exemplifies how unanimous agreement on substantive issues might be attained on matters where all jurisdictions have something to gain. After all, efficiency issues involve creating gains from trade that potentially benefit all provinces. At the same time, the limitations of the AIT are also instructive. First, despite the consensus by the provinces to commit themselves to what are relatively strong and constraining measures on their behaviour, the enforcement of the AIT commitments is largely toothless because of the absence of an effective and binding dispute settlement mechanism. Voluntary compliance seems to be inadequate, suggesting that some supra-provincial inducement — of which the spending power would be an example — might be required to ensure that the provinces will abide by the agreement. Second, the difficulty in consummating an effective agreement intended to bring efficiency gains across the federation underscores the fact that inter-governmental agreement is not likely to suffice as a means of achieving nation equity goals. By their nature, there would be gainers and losers across provinces, making unanimity a most unlikely outcome.

While the AIT with all its flaws is mainly intended to influence and constrain provincial government behaviour, the main significance of SUFA for our purposes is as a device for defining the role of the federal government in pursuing its social policy responsibilities in concert with the provinces. Indeed, the principles outlined in the SUFA reinforce many of the constitutional commitments of Section 36(1), specifically in section 1 of SUFA the commitment to, among other things:

Treat all Canadians with fairness and equity;

Promote equality of opportunity for all Canadians;

Ensure access for all Canadians, wherever they live or move in Canada, to essential social programs and services of reasonably comparable quality;

Promote the full and active participation of all Canadians in Canada's social and economic life; and

Ensure adequate, affordable, stable and sustainable funding for social programs.

The SUFA also affirms the role of the federal spending power as an instrument that 'has been essential to the development of Canada's social union'. It anticipated the future use of the spending power in the social policy area, but stipulated that any new initiatives a) be implemented with the collaboration of the provinces in defining objectives, b) be introduced only if a majority of provinces agree, and c) allow provinces to determine the detailed program design. The agreement also deals with process matter, such as accountability, predictability and dispute settlement, but for our purposes the relevance of the SUFA is mainly in its confirmation of the joint federal-provincial interest in social policy matters and the important role of the spending power in achieving social policy objectives.

There are, of course, numerous other federal-provincial agreements in a myriad of individual areas, such as national child policy, immigration, and the environment. But in these cases, the agreements take the form of coordinating policies in areas where there is no real dispute about the joint responsibilities of the two levels of government.

To summarize briefly the message of this section, the fiscal arrangements are an integral part of the Canadian system of fiscal federalism. The form and extent of federal-provincial transfers and the system of tax harmonization and other federal-provincial agreements serve to facilitate the decentralization of fiscal responsibilities to the provinces while at the same time maintaining the integrity of the internal economic union. The Canadian federation is the most decentralized in the world. The provinces have legislative responsibility for providing the most important public services, and have considerable discretion in designing them to suit their residents' needs and preferences. They also have substantial revenue-raising responsibility, and occupy a relatively large amount of tax room compared with other federations elsewhere the world. Yet at the same time, the income tax system remains highly harmonized; the provinces are able to provide roughly comparable levels of public services; the levels of taxes and transfers are similar across provinces; and transactions across provincial borders are relatively free. There is a reasonable compromise between the benefits of decentralization that are central to an efficient federation, and the adherence to some basic national principles that flow from redistributive equity or community sharing at the national level. Most important, the federal government has a commitment to ensuring both fiscal equity across provinces and redistributive equity jointly with the provinces. The main concern for the federation is how lasting this favourable compromise will be, given the secular trend to greater and greater fiscal decentralization.

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III. Problems with the Fiscal Arrangements

However admirable the design of the fiscal arrangements, they are not perfect. As the federation has evolved and become gradually more decentralized, some of the tensions in the system of fiscal federalism have become apparent. In this section, we review some of the general problems of the current system, especially those that are important for this Royal Commission. What is particularly relevant is the extent to which the system of fiscal arrangements is fulfilling the commitments set out in the two parts of Section 36. To that end, the discussion is arranged around the main components of the fiscal arrangements.

A. Equalization

Equalization is the backbone of the Canadian federal system. It is the instrument that facilitates fiscal decentralization, but it is also one that becomes increasingly fragile the more decentralized the federation becomes. The goal of Equalization is fiscal equity — to ensure that the provinces have the fiscal capacity to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Absolute comparability is not attainable for various reasons. For one, the provinces undertake a wide variety of responsibilities and finance them in a wide variety of ways to meet the differing needs of their residents. Given the diversity of provincial fiscal policies and needs, the meaning of comparability is not clear-cut. Moreover, the provinces face very different physical and cost conditions. If it is more costly to provide public services in, say, remote areas, there will be a trade-off between efficiency and horizontal equity that will preclude absolutely equal access to public services from being achievable, or even desirable. Indeed, differences in the level and quality of public services may be greater between urban and rural areas within provinces than between comparably situated persons across provinces. As well, as with any redistributive program, Equalization inevitably brings with it adverse incentive effects that may temper the extent to which full fiscal equity can be achieved. There may be other objectives that are affected by Equalization, such as regional development, that may affect program design. And, perhaps the thorniest issue is the apparent contradiction between equalizing resource revenues on the one hand, and the provincial ‘ownership’ of natural resources hinted at in Section 92A on the other. Resolving all these issues necessarily involves a dose of value and political judgment.

These problems can be illustrated by listing a number of more important specific problems with the Equalization system, some of which are fundamental for our purposes.

1. Gross Versus Net Equalization

The Equalization system is a gross one that finances transfers to the have-not provinces out of federal general revenues, rather than a net one that finances transfers to have-not provinces by revenues obtained directly from the have-provinces. In such a net system, there is necessarily asymmetric treatment of have and have-not provinces, even if the system is otherwise perfect. Full fiscal equity cannot be achieved with the result that the have-provinces will have greater

capacity to provide public services than the have-not provinces, although this is mitigated to the extent that federal general revenues come disproportionately from the have-provinces.

As with most problems with Equalization, the use of a gross rather than a net system is more important the more decentralized is the federation, and the more inherent inequality in fiscal capacity there is among provinces. If the decentralization of spending responsibilities is accompanied by a large vertical fiscal gap, the problem is considerably mitigated. For example, if the vertical fiscal gap is closed by equal per capita transfers to the provinces — as in the CHST case — tax capacities are partly implicitly equalized: general revenues raised from all provinces using a tax system that is geared to income is used to finance equal per capita transfers. In this sense, the CHST can be accurately described as a perfect system of net revenue equalization. However, as the extent of tax decentralization increases, so too does the fiscal inequity arising from a gross system. It is partly for this reason that the existence of a vertical fiscal gap can be an important aspect of the fiscal arrangements.

2. Tax Capacity and Needs Equalization

The Canadian Equalization system equalizes only for differences in revenue-raising capacity. Equalizing the ability of provinces to provide comparable public services at comparable tax rates would require both tax capacity and needs to be equalized. Many public programs are targeted at certain elements of the population (the ill, school age children, the disabled, etc.), so that the amount of spending needed to provide a given level of services will vary according to demographic composition. Needs-based equalization is common in some countries (e.g., Australia, South Africa). In principle, it can be implemented by a method analogous to the RTS. Given the speed with which the demographics of the country are changing, it would not be surprising to find that the same provinces that have below-average tax capacities also have above-average needs, since higher needs are often associated with lower current earning power.

This is particularly relevant to Newfoundland and Labrador. In 1996, the elderly dependency ratio — the population aged 65 and above as a proportion of the working age population 15-64 — was 16.2 in this province compared with 19.2 nationwide (Mérette, 2002). While the national rate is projected to increase to 38.5 by 2040, that for Newfoundland and Labrador will go to the astounding level of 56.0, significantly above all other provinces. (For example, it will rise to only 39.8 in Quebec, the largest have-not province and 36.1 in Ontario.) Given the extra costs that the elderly impose on public expenditures, especially health services, this divergence in dependency ratios points to sizeable differences in the per capita costs of providing reasonably comparable levels of public services across provinces.

It might be noted that in earlier years, there was an element of needs implicitly built into the fiscal arrangements, albeit in a rather inefficient way. Federal-provincial shared cost programs in welfare (CAP) and in health provided transfers directly related to actual expenditures in these areas. Once they were replaced with block funding, the needs element disappeared. There is no reason why a needs element cannot be incorporated into block grants, such as the Canada Health Transfer, rather than through Equalization.

3. Five-Province Versus National Average Standard

The have-not provinces are equalized to a standard consisting of the amount of revenue that could be raised at national average tax rates applied to the average per capita tax bases in the five standard provinces — all except Alberta and the four Atlantic provinces. The choice of the five standard provinces was not accidental. By eliminating Alberta, the bulk of oil and gas revenues fell outside the equalization system. While this is partly offset by excluding the four lowest-income provinces, on balance the five-province standard results in less Equalization than under a full ten-province standard.

This exacerbates the fiscal inequity between the have-provinces and the have-not ones to the extent that Equalization is reduced. As well, it especially results in very differing treatments of oil and gas revenues earned in Alberta and those earned in Equalization-receiving provinces, an issue addressed next. It is understandable why the federal government may not want to include Alberta oil and gas in the formula: after all, it has no direct access to resource revenues in the provinces. This is a problem that arises because of the gross nature of the Equalization system. To the extent that the system were a net one, the problem would not arise for the federal government. For example, if the vertical fiscal gap were filled not by equal per capita transfers, but transfers directly related to provincial tax capacities, an element of net Equalization could be achieved.

4. Treatment of Natural Resources

The treatment of provincial resource revenues is the Achilles heel of the Equalization system (and one that is fairly unique to Canada, since not all federations assign property rights to resources to sub-national governments). As alluded to above, part of the problem is that resource wealth is both the source of considerable inter-provincial disparity and also a revenue source to which the federal government has limited access. A gross equalization system necessarily treats resource revenues differently in the hands of a have-not province than a have-province. Given the absence of federal access to resource revenues, a gross system is doubly deficient: not only do the standard differences in treatment apply to have-not and have-provinces, but also there is no implicit undoing of that inequitable treatment via federal general revenues, since these do not include resource revenues. The problem is further exacerbated by the five-province standard, which as we have seen leaves Alberta oil and gas revenues unequalized.

In addition to these general problems, there are a number of other special problems that come up with resource revenues. These problems and their consequences for reforming the Equalization system have been explored in some detail in Feehan (2002).

Should Resources be Fully Equalized?

We have mentioned already the conceptual anomaly or conflict between the assignment of property rights to natural resources within their boundaries to the provinces and Section 36(2). There is a certain inconsistency between giving ownership on the one hand and taking it away on the other. One can react to this in different ways. On the one hand, one can take the view that there is no unconditional assignment of property rights to resources in the Constitution. That is, while it is true that the provinces have the authority by Section 92A to tax resources in

any way they see fit, it is also true that the federal government has both unlimited power to tax as well as an obligation to provide full equalization. On the other hand, one can find ways of recognizing provincial resource ownership while at the same time fulfilling Equalization. The Economic Council of Canada (1982), following the analysis of Boadway and Flatters (1982), and more recently Feehan (2002) have suggested a so-called *narrow-based view of horizontal equity* as a way of avoiding the conflict. According to this view, provincial resource ownership and the revenues that that ownership entailed would be taken as accruing on behalf of provincial residents, comparable to their other sources of personal income. Equalization would then only entail bringing that income into the federal tax system, which involves equalizing only a proportion of it given by the average federal rate if income tax (e.g., 30 per cent). What is clear is that whatever remedy is used to address the conflict between Equalization and resource ownership, it involves non-economic principles.

Incentive Problems

Any system of redistribution can in principle give rise to incentive problems: recipients will have an incentive to change their behaviour in order to increase their transfers. In the Equalization system, this seems to be a problem mainly in the resource sector. The elements that go into determining Equalization entitlements for a have-not province include its population, its per capita tax base, the national average tax rate, and the average per capita five-province tax base. For revenue sources other than resources, it is reasonable to suppose that provinces have relatively little influence over any of these elements. However, with resources, there are two possible problems. One arises when a significant proportion of a given resource base is located in a single have-not province. In this case, the province will have a perceptible influence on the national average tax rate, and will therefore have an incentive to reduce it. This is the rate tax-back problem mentioned earlier that is addressed by the generic solution. This becomes operative only rarely.

The more serious problem is the *base tax-back problem*. Provinces can directly influence the rate of development of their resource properties, especially new ones, which implies that they can directly influence their own base for Equalization purposes. Given that an increase in the base for a have-not province causes entitlements to fall by the change in the base times the national average tax rate, this is a significant disincentive to develop the resource. For example, if the provincial tax rate were equal to the national average tax rate, the province would gain no net revenue from exploiting the resource. This is a significant disincentive that only applies to the have-not provinces. It was, of course, partly in recognition of this problem that what later became the generic option in the Equalization system was made available in the Nova Scotia and Atlantic Accords (i.e., that only 70 per cent of offshore resource revenues would be included in the Equalization bases of Nova Scotia and Newfoundland). But, the same problem applies to all resource developments over which the provinces have direct control, and not just those that that would otherwise satisfy the requirements for the generic solution.

Given the objective of equalizing for differences in the ability to raise revenues from one's tax bases, it is not apparent how the base tax-back problem can be avoided without abandoning the purpose of Equalization. Since the incentives and equalizing effects are in direct conflict, there is a trade-off that seemingly can only be addressed by compromising both effects.

Deficiencies in the RTS Method when Applied to Resources

Resources are unlike other revenue sources in the sense that their cost of extraction can vary considerably. For some types of resources, revenues are obtained from royalties applied to the value of the resource extracted. Although royalties are intended to provide resource owners (i.e., the province) with a share of the rents, the tax bases are poor proxies for rents. To the extent that royalties are charged on the value of resources extracted, the rates of royalty that can be charged will be lower for high-cost resources than low-cost ones, since rents as a share of revenues will be higher for the latter. This implies that if a have-not province has higher-than-average costs of extracting resources, its tax capacity will be overestimated by the RTS method, and vice versa. This problem is made more pronounced to the extent that the province has to undertake infrastructure expenditures in order to make the resource accessible to resource firms, since these are part of the social costs of exploiting the resources.

Another problem that arises with resources is that some of the benefits can accrue to the province in a form other than revenues. An example of this might be hydroelectricity rents. Rather than collecting revenues from hydroelectric firms in the form of taxes, provincial governments may instead use hydroelectric facilities to provide cheaper electricity to its domestic residents and firms. This is not uncommon in the case where hydroelectric utilities are provincial public corporations. Of course, some of these lower prices will give rise to increased incomes to local producers, which then enter into the Equalization formula, and to that extent the problem is undone.

5. Other Problems with Equalization

There are a number of other specific problems that confront the current Equalization system. Since these problems are well known, we simply mention them here.¹¹

1. *Property Taxes.* The procedure for determining entitlements to the property tax base does not accord with the standard procedure. Rather than actual property assessments being used, adjusted indicators of residential capital are used. Compared with the standard procedure, this procedure yields lower entitlements for provinces where the market value of real estate properties is relatively low.
2. *User Fees.* A general principle of equalization is that benefit taxes should not be equalized since they do not give rise to NFB differentials across provinces. On those grounds, one could argue that fees of various sorts need not be equalized. In practice, matters might not be so straightforward since user fees often cover only a part of the costs of particular services, the remainder coming from general revenues (e.g., university tuition fees).
3. *Lotteries and Gambling Revenues.* These are becoming an increasing source of provincial revenues. From an economic perspective, they are essentially like excise taxes (at relatively high rates). However, they differ from other revenue sources in that their bases only become operative if gambling is legalized. This makes it difficult to construct a representative tax base among provinces that have differing standards of legalization of gambling. The ability of a province to control its own gambling revenue bases also implies that the base tax-back problem could be relevant.

4. *Ceiling.* The ceiling provision that restricts the rate of growth of total Equalization entitlements runs directly counter to the objectives of the program. As provinces become more self-sufficient, and as their expenditures grow more rapidly than GDP, it is natural to expect that the ceiling provisions will become more binding. Since their impact is mainly on the have-not provinces, the differential treatment of them relative to the have-provinces is enhanced.
5. *Transfers to Individuals.* To an economist, transfers are simply negative taxes. Transfers delivered through the tax system are implicitly equalized, at least roughly. However, those delivered outside the tax system, such as through provincial welfare systems, are not equalized. This works to the disadvantage of provinces with higher welfare caseloads, and detracts from the commitments set out in both parts of Section 36.
6. *Representative Tax Bases.* The integrity of the RTS system of Equalization depends upon being able to define representative tax bases that are comparable to those actually used by the provinces. In cases like the income taxes where harmonization applies, this is not a problem. However, where there is no inter-provincial harmonization, tax bases can diverge significantly, and there may be a tendency for greater diversity the more decentralized is revenue-raising responsibility to the provinces. This is particularly important where major tax bases take very different forms in different provinces, such as the case of sales taxes. This has led some observers to suggest radical changes to the Equalization system by, for example, replacing the RTS with a single measure of provincial fiscal capacity, such as provincial output or income. While these so-called *macro approaches* will certainly avoid the problems of defining representative tax bases, they suffer from the disadvantage of not accurately reflecting the ability of provinces to raise revenues from the various sources that are actually used. Supporters of the RTS argue that such a system is better suited to achieving the fiscal equity goals that Equalization is meant to achieve.

B. The CHST

The CHST is result of a gradual process of consolidation of various federal-provincial transfers in support of provincial expenditures on health, welfare and post-secondary education. Although that evolution is helpful in explaining some of the elements of the CHST, for our purposes it is sufficient to take a forward-looking perspective and evaluate it as it now stands.¹² Unlike Equalization, the structure of the CHST is relatively simple. The problems with the program revolve less around its structure than around its financial adequacy, its role as an instrument for fulfilling the commitments of Section 36 and the SUFA, and more generally its ability to meet the political economic objectives of efficiency and equity in the internal economic union in tandem with Equalization. These are addressed in the following subsections.

1. The Role of Tax Points

According to the federal government, the CHST consists of two parts — a cash component and a tax-transfer component. In fact, the tax-transfer component plays no essential role in the transfer, unlike in the EPF from which the CHST evolved. The aggregate cash allocation is set independently of the tax transfer: the latter affects only the allocation to the better-off provinces. Moreover, there is no sense in which tax transfers that were made in 1977 can be thought of as anything except provincial own-revenue sources. Nonetheless, the federal government has found it convenient to consider the tax transfer as part of their contribution, and this has led to confusion, lack of transparency and outright misleading claims. Thus, the share of the federal contribution to, say, provincial health care spending can be exaggerated. Moreover, the proportionate reduction in federal-provincial transfers in the early 1990s was vastly understated by stating it as a proportion of cash plus tax transfers in federal government budgetary documents. There is no reason for any longer including tax transfers as part of the CHST. By the same token, there is little purpose to attributing shares of the CHST to health, welfare and post-secondary education. The funds are completely fungible in the hands of the provinces. Although these reporting issues are not substantive in terms of their effect on the size of the CHST transfer, they are a source of mistrust and confusion for the public.

2. Adequacy, Predictability and the VFI

The CHST differs from Equalization, as well as from the EPF and CAP transfers that preceded it, in the sense that it is not formula-driven. It is determined by the discretion of the federal government according to its budgetary priorities of the day, albeit sometimes over a time horizon of up to five years. Not only is there no explicit escalator, the allocation among provinces is also discretionary and in the process of evolving. The absence of an objective formula for the CHST is troublesome to the provinces partly because it makes future entitlements unpredictable, but also because of an apparent mistrust of the federal government as a result of unilateral and unannounced changes to the transfer system in the past. Given the role of the CHST as a vehicle for addressing the joint commitments the federal government has with the provinces for achieving the redistributive equity objectives set out on Section 36(1), this tendency for unilateralism is a concern. Partly as a result of this concern, the two levels of government agreed as part of the SUFA to give prior notice of major changes in policy that are likely to affect another government, and to consult one another before implementing new social policies and programs. Whether this will assuage the concerns of the provinces about the predictability of the CHST remains to be seen.

There is a more general issue with respect to size of the CHST and that is whether it adequately fills the vertical fiscal gap between the province's room to raise revenues and their expenditure responsibilities. The provinces have argued, based on projections of future expenditures and revenues, that there is a structural imbalance in current fiscal arrangements. While provincial budget deficits are predicted to increase, federal budget surpluses are set to accumulate, unless there is a major adjustment either to the amount of transfers or the tax room allocation.¹³ The federal government disputes this finding of a significant VFI, arguing that their debt problem is more serious than that of the provinces, that their expenditures will also rise substantially as well, and that the provinces have in fact been reducing their tax rates

in recent years. The question remains an open one, although the provincial case seems well documented and convincing.

3. Conditions

The CHST comes with minimal conditions that the provinces must satisfy in order to be eligible for the full transfer. Provincial health care systems must abide by the terms of the Canada Health Act, and welfare systems must have no undue residence requirements, while no conditions apply to post-secondary education. While the case for such conditions rests on the federal government's possible role in fostering redistributive equity in the social union as set out in Section 36(1) and reaffirmed in the SUFA, their use is contentious. The province of Quebec questions the use of any conditions applicable to areas of exclusive provincial jurisdiction, and the Séguin Commission questions even their constitutional legitimacy. (Quebec feels less bound by the Constitution Act, 1982, to which it was not a signatory.) Other provinces have questioned the scope of the conditions of the Canada Health Act, especially those requiring public administration and precluding user fees. Some also argue that the legitimacy of the ability of the federal government to impose such conditions — sometimes against the will of the provinces — and to enforce them has been considerably weakened as its share of provincial health care spending has diminished.¹⁴ At the same time, others argue that the conditions in the CHST are inadequate. The Romanow Commission on the Future of Health Care in Canada (2002) has proposed adding accountability to the conditions on health care, and extending conditional health transfers to areas other than hospitals. At the same time they recommend increasing the size of transfers to improve the legitimacy of the use of the federal spending power for health.

Matters of process are also important. Historically, the federal government has set the conditions, decided when they are violated and enforced them unilaterally. Quite apart from the reduced legitimacy of this process when the provinces are footing most of the bill, this unilateralism seems to violate the spirit of Section 36(1), which emphasizes the joint commitment of the federal government and the provinces to redistributive equity goals. This concern has been recognized in the SUFA, which makes special reference to the partnership between the two levels of government in addressing social policy objectives, at least with respect to new initiatives. One method of formalizing this partnership would be to create a special arms-length institution that might consult and advise on matters of the social union. Alternatively, following the Romanow Commission, such a body could perform an accountability function by monitoring and evaluating the efficacy of social programs.

4. Inter-Provincial Allocation Formula

After a period of transition, the principle was established that the CHST should be allocated among provinces on an equal per capita basis, and this will presumably be carried forward as the CHST is split into two components. The advantage of this approach is that the CHST is implicitly a perfect system of equalization on the revenue side of provincial budgets. The drawback is that no account is taken in the fiscal arrangements of differences in expenditure needs across provinces. In principle, it is clear that needs should be an element

of equalization. Different provinces will incur different per capita expenditure obligations to provide comparable levels of public services that are targeted to particular demographic groups. It is also fairly clear how in principle to design a needs-based equalization system: define a representative set of provincial public services; calculate a national average standard cost of providing the service to the various demographic groups involved; and use these to calculate what each province would have to spend to provide services to its population using the common set of costs. Proposals for needs-based equalization typically base transfers on a common national-average service cost to determine the rate of equalization (analogous to a national-average tax rate for revenue equalization). It might be argued that provinces incur different costs of providing a given level of services, such as wages and salaries of service providers. For example, if doctors' salaries are lower in Newfoundland and Labrador, it might be argued that needs for equalization would be correspondingly lower. However, to use actual provincial costs to determine needs equalization would open the system up to adverse incentives for the provinces.

In practice, the process is not so simple. Provincial spending programs provide a very large number of types and qualities of public services. Delineating them for equalization purposes and assigning a standard cost factor is an ambitious task. Costs would have to include both operating and capital costs, and take account of capital replacement and maintenance and overhead. This makes applying a comprehensive system of needs-based equalization difficult. However, it is possible to apply needs-based equalization more selectively. For example, health, education and welfare services comprise the bulk of provincial expenditures. It would be feasible to construct a basic system that takes account of major demographic differences among provinces in delivering these services. The demographic groups could include those that actually determine expenditure requirements in health, education and welfare, such as age, disability, caseloads, etc.¹⁵ Although the calculations have not been made for Canada, one might expect that those provinces with below average revenue-raising capacities also have above average expenditure needs, especially given demographic projections into the future. For example, elderly dependency ratios projected by Statistics Canada to the year 2040 predict that all have-not provinces will have higher than average elderly dependency ratios, and especially Newfoundland and Labrador as mentioned earlier (Mérette, 2002).

C. Other Issues

The issues arising from the design of Equalization and the CHST are no doubt the major ones. However, there are other federal-provincial issues apart from that. A major concern voiced by those who favour a reduced federal role is that some federal policies work to the detriment of efficiency in the internal economic union by distorting economic activity among provinces. For example, the employment insurance (EI) system contains elements that discourage intersectoral and interregional mobility, and in the process retard regional development. The fact that the self-employed in the fishery are eligible for EI is alleged to have been partly responsible for excessive employment in that industry. Differential EI benefit provisions in high unemployment regions is said to discourage out-migration. Generous eligibility provisions induce workers and employers to opt for short-term and seasonal work.

And so on. The existence of these kinds of provisions have led some observers to suggest that on second-best grounds, Equalization should be less generous than it is. At the same time, the efficacy of regional development programs that provide investment incentives and financing the less-developed regions have been frequently attacked as being inefficient and cost-ineffective.

While it might be argued that the existing set of regional development and EI policies are ill-designed, a case can be made that regional development is a legitimate economic objective over and above Equalization and redistributive equity. Indeed, as mentioned above, item (b) of Section 36(1) commits the federal government and the provinces to ‘furthering economic development to reduce disparity in opportunities’. The principle of decentralization suggests that the provinces might be better placed to implement regional development programs within their provinces. If so, a legitimate federal role might be to recognize that in the structure of federal-provincial transfers. This is potentially important for Newfoundland and Labrador, and we return to it below.

Finally, tax harmonization remains an important goal for the efficiency of the internal economic union. There is a need to preserve the harmonization that exists for personal and corporate income taxes. Its erosion is more likely to come about the greater the share of the income tax room is occupied by the provinces. This has obvious relevance for the preservation of a vertical fiscal gap between the provinces and the federal government. The case of sales tax harmonization remains a difficult question, at least with respect to those provinces that maintain a separate RST. This is a difficult question because the ideal sales tax system — a value-added tax — is also the most difficult one to operate in a decentralized federation. It is unlikely that an HST-type system will appeal to the larger provinces. Perhaps the best that can be hoped for is that these provinces will harmonize the bases of their RSTs to the GST base. As well, harmonization of other provincial business taxes remains a priority, albeit one that will have to be resolved by the provinces themselves, given that the federal government plays little role in most provincial business taxes. It is conceivable that the spur of tax competition from the US will lead provinces in that direction.

IV. Relevance for Newfoundland and Labrador

This province is a have-not province, heavily reliant on federal transfers, and characterized by high unemployment and lower-than-average per capita incomes. Moreover, one can make the reasonable conjecture that its demographic characteristics are such that it has relatively high needs compared with the Canada-wide average. It has, or will soon have, a significantly higher elderly dependency ratio than the national average; and, it has a higher than average welfare caseload. It has traditionally been heavily reliant on resource industries, especially the fishery, which fell on difficult times after the collapse of the cod stock. However, in recent years, the possibility of several major resource developments coming on-line in oil and gas, minerals and hydroelectricity has made the province one of the most rapidly growing ones in Canada. The question is whether the fiscal arrangements in their current form are adequate to ensure that these developments will facilitate the kind of economic and social progress that should be hoped for and is envisioned in Section 36 of the Constitution and in the SUFA. This includes not just the provision of comparable levels of public services at comparable levels of taxation, but also the fostering of equal opportunities, including regional development, and the promotion of the full and active participation of all Canadians in Canada's social and economic life.

Viewed from this perspective, there are a number of features of the fiscal arrangements that might be of concern for Newfoundland and Labrador. Some of these are issues that apply more generally, such as the adequacy of the level of CSHT transfers, given the possibility of a structural VFI; the absence of a formula-driven escalator in the CHST; some of the structural issues with Equalization, such as the ceiling provision, the five-province standard, the gross nature of the scheme, the lack of accounting for transfers to individuals, and the problems with the treatment of the property tax; and more generally, the extent to which the overall level of federal-provincial transfers (the vertical fiscal gap) has declined, and provinces have become more dependent on own-source revenues. The latter serves to increase the gap between the have-not and the have-provinces, and reduces the ability of the federal government to exercise its commitment in fostering the economic and social union.

There are also a number of issues of special concern to Newfoundland and Labrador. Foremost among these concerns are the implications of future natural resource developments for the province's Equalization entitlement. In the absence of special provisions, much of the gain in revenues from resource development is offset by losses in Equalization. Of course, this might be viewed as being fair to the extent that increases in revenue-raising potential from resource development imply that the need for Equalization transfers to satisfy the requirements of fiscal equity are correspondingly reduced. At the same time, this high rate of base tax-back can be viewed as being detrimental from a number of perspectives. First, it provides a significant disincentive for the province to develop resources, and perhaps leads it to impose substitute requirements on potential resource firms (e.g., domestic employment requirements) that may be inefficient from a national point of view. Second, the high rate of tax-back of resource developments in have-not provinces is highly unfair in the sense that those in the have-provinces are subject to no tax-back whatsoever. Third, it neglects the fact that resource developments might require provincial infrastructure expenditures as a necessary cost of development. Fourth, to the extent that natural resource development is

more costly in Newfoundland and Labrador, the Equalization system's use of national average tax rates would overstate the tax capacity of the province's natural resources. And, fifth, the tax-back of resource revenues under the Equalization system neglects the commitment that the federal government has to regional development as a means of increasing opportunities in less-developed regions of the country. These considerations suggest exploring options to the current treatment of resource revenues to which we return below.

The current system of fiscal arrangements take little account of the higher needs and costs that apply in a province like Newfoundland and Labrador. Unlike the earlier shared-cost transfers that, despite their adverse incentive effects, were sensitive to actual provincial expenditures, the existing system effectively provides no Equalization for needs and costs. On the contrary, by providing equal per capita amounts, it implicitly ignores any such differences. In the case of needs, first principles suggest that they should be equalized fully and symmetrically with differences in tax capacities. The main difficulties are practical ones of implementation. With differences in costs, the case is not so clear. Principles of public finance suggest that if it is more costly to provide given services to a given population, there will be a conflict between efficiency and equity. In these circumstances, it is reasonable to provide partial equalization rather than none at all. This is relevant for Newfoundland and Labrador because of the higher costs of providing services in remote areas, the higher costs of attracting qualified professionals to service the province's health and education systems, and the need for additional infrastructure because of lower than average population densities.

V. Options for Reform

The Canadian fiscal federalism system has been a model for federations around the world. It has enabled the provinces to have a high degree of autonomy, while at the same time retaining a reasonable degree of comparability of public services across provinces, broadly comparable standards of redistributive equity, a mixed record of tax harmonization, and some progress towards improving the efficiency of the internal economic union. But the ongoing process of decentralization combined with the national response to the large debts built up in the 1980s has put enormous pressures on the sustainability of the current federal fiscal system. The support of the two have-provinces — Alberta and Ontario — for many of the established principles of the fiscal arrangements seems to be waning both as decentralization proceeds and as their economies become more and more reliant on the US economy. Newfoundland and Labrador is in a particularly vulnerable position, being the most dependent of the have-not provinces. Moreover, there are a number of aspects of the current fiscal arrangements that serve neither the province's interests nor the principles and commitments of the Constitution and the SUFA well. In this final section, we offer a number of suggestions and observations about directions that the system of fiscal federalism might take so that the integrity of the internal economic and social union is maintained and fostered, and the prospects for development of the provincial economy are facilitated.

A. Vertical Balance

The first priority is to attend to the vertical fiscal alignment of spending and taxing responsibilities. This involves adopting a level of federal-provincial transfers and a sharing of tax room such that an appropriate vertical fiscal gap is in place and there is vertical fiscal balance. An adequate fiscal gap is a prerequisite for the federal government and the provinces achieving the objectives of the economic and social union. What is adequate, of course, depends upon one's view of the appropriate role of the federal government relative to the provinces in furthering these objectives. However, if one abides by the dicta of the Constitution, and one accepts the basic principles enunciated in SUFA and the AIT, it would be hard to deny that a fiscal gap reasonably well above that required to finance Equalization alone would be necessary for the federal government to live up to its share of the responsibilities.

Over the past several decades, the extent of the vertical gap has been gradually declining and provinces have become increasingly responsible for raising more and more of their own revenues. This has occurred gradually and seemingly without any forward-looking grand design. The trend has accelerated rapidly in recent years as a consequence of the federal government's drastic cuts to transfers and the consolidation of the main social program transfers into the CHST bloc grant. Some observers favour this fiscal decentralization since it is supposed to contribute to provincial accountability and autonomy, and thereby to an improvement in the efficiency of the provision of public services. The extent to which this is true is debatable. After all, the decentralization has occurred virtually entirely on the revenue-raising side: provincial spending responsibilities are already decentralized. Whether

making provinces more responsible for raising their own revenues contributes significantly to efficiency and accountability is not a clear-cut issue. Moreover, it also has potentially serious consequences for the Canadian social and economic union. First, fiscal decentralization imperils Equalization by increasing fiscal capacity differentials among provinces, by making it more difficult for the federal government to achieve effective Equalization, and presumably by eroding provincial political support for Equalization. Second, maintaining and extending harmonization in the tax system becomes increasingly difficult as the fiscal system becomes more and more decentralized. Third, the role of the federal government as a partner with the provinces in enhancing the social union depends almost entirely on an adequate level of federal-provincial transfers. And fourth, fiscal decentralization exposed the provinces to the vulnerability of unexpected shocks that are more readily addressed by the federal government. At the same time, maintaining an adequate vertical fiscal gap depends on the gap in tax room being properly financed by the federal government, so there is no vertical imbalance. It also depends upon the system of transfers having some stability and predictability so that the provinces are not subject to unannounced and unexpected cuts to their transfers from the federal government.

The federation has arguably reached the point where the vertical gap is insufficient in size and precarious in terms of its sustainability, although no doubt many observers will disagree with that conclusion. In my view, it is imperative for the deterioration of federal transfers to be halted and for some permanence to be put in place.

B. The CHST

The CHST is the main instrument available for achieving vertical balance. As well, it is the vehicle by which the federal government is able to participate with the provinces in achieving the goals set out in Section 36(1) and further enunciated in the SUFA principles. Several suggestions might be explored for placing the CHST on a firmer footing.

1. *Adequacy.* The level of federal cash transfers took an enormous hit when the CHST was formed. It is hard to imagine that the level of transfers is anywhere near adequate to provide the federal government with the moral and political authority to do its part in fostering the social union. This fostering does not come from the explicit terms put on provincial health and welfare programs as part of the conditions for receiving the full CHST. The federal-provincial share of funding presumably also has an impact on the strength of the federal voice in federal-provincial executive deliberations over social policy. For example, there were never conditions imposed on post-secondary education programs during the EPF period. Yet the provinces tended to abide by certain norms of non-discriminatory treatment of non-resident students. In recent years, provinces has gradually started to treat out-of-province students differentially with respect to in-province students, and it is hard to believe that this is not related to the relatively small federal contribution. It would be beneficial for the future of the social and economic union if federal transfers were enhanced significantly.
2. *Escalator.* The rate of growth of the CHST is as important as the level. At the moment, the growth of the CHST is determined not by formula but by federal government fiat.

- The nation would be better served if an escalator were established that ensured that an appropriate vertical gap is financed on an ongoing basis. Presumably this would bear some relation to the rate of growth of provincial expenditure responsibilities, though not necessarily in as direct a way as suggested by the Romanow Report.
3. *Allocation.* The CHST fulfils in part an equalizing role, enabling provinces to have the finances to provide adequate and comparable levels of essential public services. As such, the allocation among provinces should reflect need. At the moment, this is done by basing the allocation on an equal per capita basis. However, as provinces diverge in terms of their demographic composition, a case can be made for incorporating these differences into the allocation formula. This might be particularly relevant for health care, which makes up a large proportion of expenditures funded by the CHST. It should be relatively easy to adjust CHST allocations to take account of differences in, say, the share of elderly in the population. The same might be said for differences across provinces in the need for social assistance. The proportion of the population below some nationally determined poverty line could be used for this purpose. It should be stressed that these measures are fully in keeping with both the objectives of equalization and the responsibilities of the federal government set out in Section 36.
 4. *Net Equalization Measures.* Correcting the allocation for differences in needs goes only partway to fulfilling the potential of the CHST as a complement to Equalization. As mentioned, one of the main shortcomings of the latter is its gross nature, that is, its failure to equalize down the have-provinces. The CHST could legitimately be adjusted to accommodate this. Since Equalization fully equalizes the revenue-raising capacity of the have-not provinces, the CHST allocation to the have-provinces could be adjusted to account for their above-standard tax capacity. This would be fully consistent with the past practice of equalizing tax-point transfers as part of the EPF and CHST systems. This procedure would also go part way to eliminating the anomalous treatment of resource revenues between have-not and have-provinces in the Equalization system.
 5. *Elimination of Tax Points.* The time is long overdue for simply eliminating any reference to tax point as being part of the federal government's contribution to social program funding, or as influencing the allocation formula.
 6. *Separating Spending Categories.* The CHST allocation is nominally disaggregated into health, welfare and post-secondary education components. The allocation is an accounting convention and bears no relation to the ways in which the funds are actually spent. In fact, the funds are fully fungible in the hands of the provinces. Some have argued that accountability might be better served if the CHST were disaggregated into categories. Thus, the Romanow Commission advocated the creation of a Canada Health Transfer separate from the other components. There is limited economic rationale for this. The argument is based purely on politics and optics, and would have to be judged on the same basis. One substantive implication of dividing the CHST into component parts is that the amounts of federal funding in each part might have to be increased in order to make any conditions imposed credible. Another possible implication is that it might prevent the support for post-secondary and welfare programs from being fully undermined as a larger and larger amount of provincial spending goes to health care.

7. *Conditions.* The conditions currently imposed on CHST-supported programs are uneven. Even in the case of the Canada Health Act conditions, their adequacy has been questioned. The Romanow Commission, for example, advocated accountability as an additional condition, and others have argued that performance guarantees should be instituted. While much of the attention has been devoted to the health conditions, it can be argued that there is more urgency for revisiting conditions on welfare and for introducing some mechanism for harmonizing post-secondary education programs. Universities cater to large numbers of out-of-province students and their graduates are among the most mobile. Issues of nondiscriminatory fees and entrance standards and harmonization of professional requirements are relevant for principles of equality of opportunity and inter-provincial mobility.
8. *Federal-Provincial Consensus.* Finally, the Constitution and the SUFA both stress the joint responsibility of the federal and provincial governments in providing adequate social programs to all Canadians. Given that the CHST is such an important policy instrument for that purpose, it would be helpful if the process of designing the form of the CHST and of setting, interpreting and enforcing its conditions were of a more collaborative nature.

C. Equalization

As stressed above, the Equalization program is of immense importance to Newfoundland and Labrador both in terms of the way that it ensures that the province has the capacity to provide national standards of public goods and services and in terms of the way that it facilitates economic development. Concerns with the program are of two principle sorts: those of general program design, and those that apply specifically to resources. Some suggestions for addressing each of these follows.

1. Structural Issues

The equalization objective set out in Section 36(2) is achieved jointly by the Equalization system and the CHST. Indeed, in some ways the latter is more effective as an equalization device than the Equalization program per se. However, the CHST equalizes mainly to the extent that it reflects a vertical fiscal gap. The Equalization program equalizes to the extent that revenue raising is decentralized. Some of the general issues of equalization design have already been taken up in discussing the CHST system. These include incorporating needs into the system and equalizing the have-provinces down to move the system closer to a net one. There remain others that — to the extent they are a problem — can best be achieved by revising the Equalization system. Apart from those involving the treatment of resources, these include the following.

1. *Five- versus Ten-Province Standard.* The five-province standard was adopted more out of expediency than principle. The main argument for it was to remove Alberta's oil and gas revenues from the standard, and thereby reduce the federal government's exposure

to equalizing a revenue source to which it does not have direct access. In principle, this is not a compelling argument, and is one that, combined with the gross nature of the system, leads to outcomes that are anomalous. A strong case can be made for moving back to the ten-province standard.¹⁶

2. *The Ceiling Provision.* The same applies to the ceiling provision. It serves to compromise the integrity of the system by imposing what seems to be an arbitrary cap on Equalization entitlements. To the extent that the ceiling becomes binding, the case for Equalization is all the more compelling. The Senate Committee on National Finance (2002) recognized this, and now it seems as if the federal government is prepared to eliminate the ceiling provision as part of the health accord signed with the provinces this year.
3. *Problems with the RTS Approach.* There are a number of difficulties with applying the RTS approach, such as defining common bases when provincial bases differ widely, rationalizing the treatment of property taxes, and determining how to deal with user fees and gambling revenues. These problems have increased in importance as fiscal decentralization has proceeded. Although most have not reached the level of concern where the Equalization system is compromised, in the case of the property tax base that point is perilously close. Property tax entitlements are one of the most important in terms of magnitude, yet the definition of the base is to a large extent arbitrary. No good case had been made for not using a more representative definition of the base (e.g., one based on market principles). One option worth exploring might be to divide the property tax base into categories corresponding with different levels of property value. However, more study needs to be done, and probably sooner rather than later.
4. *The Macro Alternative?* Some authors have argued that the RTS should be replaced by a simpler alternative, such as a macro-based measure like provincial income.¹⁷ The argument is based on the idea that a macro measure would be a better measure of ‘ability to pay’ by a province, would be less dependent on actual provincial policies, and would be less prone to adverse incentive effects. However, as argued in Boadway (2002a), the notion of ability to pay is inappropriate as a basis for inter-provincial equalization. It is a concept that is used as a measure of individual well-being for the purposes of achieving redistributive (vertical) equity in the interpersonal tax-transfer system, and even for that purpose there is far from a consensus about the appropriate measure to use. The Equalization system is not meant to be an instrument for interpersonal redistribution of purchasing power. On the contrary, it is concerned with the ability of provinces to provide comparable levels of public services, not private incomes. As such, the RTS is conceptually the proper notion. That is not to say that the RTS could not be simplified by reducing the number of revenue sources used by aggregation. However, it is not clear that such a change would solve any of the real problems of Equalization. For example, it would make little difference to the base tax-back incentive problem. Moreover, a more aggregate measure would not reflect the fact that different revenue sources are taxed at quite different rates among provinces.
5. *The National Average Tax Rate?* By using a national average provincial tax rate to determine the rate at which deficiencies in per capita tax bases are equalized, full equalization in the ability of have-not provinces to raise revenues is achieved. While

this seems to be in accord with constitutional principles, some have argued that full equalization is excessive. For example, Courchene (1994) argues, using the analogy with a negative income tax system, that 70 per cent rather than 100 per cent of differences in provincial revenue-raising capacity relative to the national average be equalized. The argument is that this would be an appropriate way to address adverse incentive effects of Equalization, albeit using the unfortunate analogy with an interpersonal tax-transfer system whose purpose is completely different from that of Equalization. It is not at all clear that the incentive problems for Equalization are anywhere near serious enough to restrict Equalization by that extent. An exception may be natural resources revenues to which we return below.

6. *Stability.* The Equalization system can cause provincial revenues to be less stable than they otherwise would be. To the extent that provinces are less able than the federal government to self-insure against uncertainties in revenue streams, this is a perverse outcome. The floor provisions provide some insurance against extreme downside risks, but that is clearly insufficient. One way to address this issue is to calculate Equalization entitlements as a moving average over a period of years. This would at least smooth out year-to-year shocks in a province's entitlements.

2. Treatment of Resources

The treatment of resource revenues presents the thorniest problems for Equalization design from a conceptual and a practical point of view. The unequal distribution of resource properties among provinces is one of the main sources of differences in NFBs, so from a purely economic point of view one might expect that equalizing these differences might be a first priority of the Equalization system. However, there are several problems that have been raised in the literature that *may* detract from that priority.

1. *The Base Tax-Back Problem.* At least with respect to new resource developments, this can be much more important for resources than for other revenue sources. That is because provinces have some direct control over the extent to which resource discoveries are developed. Thus, unlike other major tax bases like personal incomes or sales or payrolls, the province can control the size of the base. Given that for a have-not province, Equalization entitlements fall proportionately with increases in the base, there is a sizeable disincentive to develop resource properties. Moreover, this incentive applies differentially to the Atlantic provinces, which are not part of the five-province standard. However, there is a counterargument. Once resources have been discovered, the decision facing provinces is essentially when to develop them. Since the equalization tax-back will occur whenever they are exploited, the provincial choice amounts to whether to postpone that tax-back that will eventually occur rather than to avoid it altogether. Put that way, the incentive to postpone development is virtually nullified implying that the tax-back problem is mitigated to a considerable extent. The tax-back problem really involves a disincentive to explore for natural resources rather than to development once discovered. Perhaps the best response to that problem is to insist on generous federal tax incentives for exploration since it is the federal government that ultimately reaps the benefit of reduced equalization payments.

2. *Asymmetric Treatment of Have and Have-Not Provinces.* While resource developments are fully equalized for the have-not provinces, they are not equalized at all for the have-provinces, except indirectly through the general revenue financing of Equalization payments. In fact, since Alberta is outside the five-province standard, their vast resource revenues are completely unequalized, even indirectly. This implies that the have-provinces do not face the same disincentive for resource development. Moreover, it raises the issue of the fairness of the Equalization system and its ability to meet the objectives of Section 36(2). It seems fundamentally unfair that a province like Alberta can retain the full proceeds of its vast oil and gas revenues, while have-not provinces like Newfoundland and Labrador are taxed back at very high rates, even where the analogue of the generic solution applies. It might be countered that since the purpose of Equalization is to compensate for differences in tax capacity, it is proper that if resource revenue capacities rise in a have-not province, this should be taken account of in the calculation of entitlements. But, the same logic should also apply to the have-provinces.
3. *Provincial Ownership of Resources.* Perhaps most problematic is the apparent contradiction between the principles of Section 36, which suggest full equalization of resource revenues, and the notion that resource assets are 'owned' by the provinces in which they are located. In charging royalties for the exploitation of resources, the provinces can be viewed as exercising those property rights. The provincial ownership of resources is not enunciated explicitly in the Constitution, but it might be inferred from the assignment of property and civil rights to provinces, by the terms of Section 92A, which confers upon the provinces the right to obtain revenues from resources by any means, and by the proscription against one government taxing another. Thus, while the property rights to resources are given to the provinces by one hand, Section 36 effectively takes them away on the other. Resolving this conflict is at the heart of the debate over equalization of resource revenues, and clearly it involves more than economic input. Those who provide more weight to the Section 36(2) argument than to provincial ownership of resources can point to the fact that not only is Equalization a constitutional commitment, but the federal government also has a very broad right to levy taxes of any form and for any purpose as long as direct taxation of provinces is not involved. This power is sufficient to be able to fully equalize natural resource revenues should they choose to do so. In any case, resolution of this conflict must involve non-economic arguments.
4. *Resource Revenues Represent Asset Depletion.* Boessenkool (2001) has argued the non-renewable resource revenues should not be equalized at all because rather than being income they are simply a transformation of asset wealth into other uses. The argument seems to me to be a *non sequitur*: it is based on nothing other than the observation that resource revenues differ in form from, say, wages and capital income. Why should the proceeds from a windfall endowment of non-renewable natural resource wealth not be deemed eligible for Equalization, while income generated from work effort is? Both contribute indistinguishably to the financing of public services and affect the rate of taxation at which such services can be provided. Of course, one could argue that to the extent that natural resource revenues are put into a fund that is gradually drawn on in

the future, their Equalization should be postponed. But that simply changes the timing of Equalization, not the principle.

5. *Resource Revenues are Capitalized into Local Prices.* Boessenkool (2001) buttresses his argument for the non-taxation of non-renewable resource revenues by the suggestion that all such revenues will be capitalized into wages and property values, and subsequently enter Equalization indirectly. This argument is apparently drawn from the American literature, although it has also been part of the Canadian debate going back to the work of the Economic Council in the 1980s. The problem with the argument is that there is no evidence that there is significant capitalization of resource rents into local property values or other prices. Indeed, the conditions for capitalization are fairly stringent: high and relatively costless mobility would be required. In any case, to the extent that capitalization does occur, it does so because of fiscally induced migration, which is inefficient. Equalization should itself be capitalized in property values in the other direction, thereby both undoing the alleged source of double equalization that is alleged to occur, and in the process mitigating the fiscally induced migration. Therefore, in my view, both these last two arguments against equalizing non-renewable resource revenues can be significantly discounted.

There are also some design problems that apply especially to the RTS treatment of resource revenues. In defining the representative tax base and the national average tax rate, there is a presumption that all provinces could readily apply common tax rates to their given bases and extract the resulting amount of revenues. While this may be true for tax bases like income and sales, it is not so clear in the case of resource royalties. Royalty rates are typically based on some measure of the amount of the resource extracted, and the representative tax bases used for Equalization will reflect that. However, if different resources have very different costs of extraction, it would be difficult for provinces to apply high royalty rates to high-cost resources as to low-cost ones. To some extent this is taken into account in the Equalization system by disaggregating high-cost from low-cost resource properties into separate revenue sources. But, that is bound to be an imperfect solution. If resource bases were defined to reflect the ability to extract revenues, for example by using some notion of resource rents, the problem would at least partly be overcome (see also Feehan, 2002). However, since provincial royalty bases are very different from rents, this would be a departure from the existing RTS methodology and might be difficult for the federal government to implement.

Yet another design problem occurs when provinces are able to take the benefits of their resources not as revenues collected but in the form of lower prices to their residents. This might be particularly the case when the resource is developed by a public corporation whose output serves mainly domestic users, such as hydroelectricity. To the extent that the users are final consumers, the benefits of the resource go unequalized. If they are firms, the benefits presumably show up in profits, which are then subject to Equalization. This problem is probably fairly limited in scope, as the example suggests.

Squaring the circle with respect to these conflicting issues in resource equalization is not an easy task, especially since it involves more than economic adjustments. A number of suggestions have been made, and we recount them here only as alternatives worth considering. Where one eventually comes down from a policy point of view involves taking a position on

non-economic issues involving the ownership of resource revenues. Consider each of the first three major problems mentioned above (having discounted the last two).

The second one involving the differential treatment of have and have-not provinces is in principle the easiest to address. If the Equalization system were a net system using a ten-province standard, the have and have-not provinces would be treated on a par. While there is no particular argument against moving to a ten-province standard, the obstacles to moving to a net system would be considerable. Given that, a piecemeal reform of adopting a ten-province standard within the current gross system would be a substantial improvement from the point of view of consistency. It would not be fully consistent since the have-provinces would still be able to retain more of their resource revenues than would the have-not provinces.

The first problem involving adverse incentive for have-not provinces to develop their resources is a typical equity-efficiency problem that economics policy often confronts. There is no easy way to solve this trade-off other than compromising between the two objectives.¹⁸ In this context, that would suggest reducing the rate of tax-back by including only a proportion of the base, analogous to the generic solution. Where the generic solution only applies where a province has a significant proportion of the national tax base, the solution to the base tax-back problem would have to involve all resources no matter how large or small a province's tax base is. The appropriate rate of inclusion of resource revenues would be a matter of judgment, and in principle it could differ from resource to resource. One obvious option is to extend the generic solution to all resource revenues. Including 70 per cent of resource revenues would seem to be sufficiently generous to address the incentive issues. It corresponds with what Courchene (1994) thought to be suitable for that purpose. However, one cannot be categorical about the appropriate rate since not only do we not know the extent of the disincentive involved, but also there are trade-offs between reducing disincentives for resource development and other objectives of Equalization.

The third problem — the conflict between Section 36 and the provincial ownership of resources — also points to some compromise solutions. One solution, explored by the Economic Council of Canada (1982) and recounted by Feehan (2002), would be to interpret provincial ownership of resources as ownership of the resources by the citizens of the province. Provincial resource revenues collected on behalf of the citizens would then be considered as imputed incomes of the residents themselves. Had these revenues been received directly by individuals, they would have been subject to federal tax. But since the provinces are acting as collection agencies on behalf of the provinces, the revenues escape federal tax. The Economic Council of Canada suggests the remedy of equalizing a proportion of provincial resource revenues equal to the average federal tax rate on personal incomes (say, 30 per cent). Whether this a reasonable compromise is a matter of judgment: it is certainly one that goes well beyond what would be required on incentive grounds. Indeed, in a sense it is not really a compromise at all since it treats provincial ownership of resources as being the overriding governing criterion rather than Section 36 (or efficiency considerations¹⁹). Not all observers will view provincial ownership of resources as trumping Section 36(2). Even the Economic Council of Canada presented it as one option and made clear that some political judgment was involved.

The upshot of this discussion is that a case can be made for systematically equalizing resource revenues at a lower rate than other revenues. However, what that rate should be is not at all clear. If any consensus exists, it might be that the generic solution of including only 70 per cent of resource revenues should be applied broadly to all natural resources. Perhaps what

is more important is that recognition be given to the principle that the Equalization of resource revenues carries with it problems of ownership and incentives that other revenue sources do not.

D. Regional Development

Much of the debate over the fiscal arrangements has focused on the two issues of Equalization and the use of the spending power for social policy purposes. This reflects the relative importance of the two main federal-provincial transfer programs. However, there is another element of Section 36 that has received much less attention, and that is item (b) of Section 36(1) committing the federal and provincial governments to ‘furthering economic development to reduce disparities in opportunities’. Regional development policies have been pursued by the federal government through regional development grants, investment incentives, federal spending policies and infrastructure programs. But, it could be argued that the principles of decentralization would suggest that provinces are better placed to enact regional development policies (although some economists might suggest that there should be no such policies in the first place). Given the national interest in regional development, the federal role might be pursued by incorporating the costs of regional development into the system of federal-provincial transfers. This could, for example, be used to offset the disincentives associated with resource development in the Equalization program. There has been virtually no literature on the use of the federal spending power to achieve regional development objectives, despite the fact that it is a shared federal-provincial commitment under Section 36(1). This is a subject that could benefit from further consideration.

E. Tax Mix

Another issue of importance for the social and economic union is tax harmonization and the implications of the tax mix for extending it. Income tax bases are harmonized throughout most of Canada due to the tax collection agreements. As the provinces have occupied more and more of the tax room, harmonization of the rate structure has given way to allowing provinces considerable discretion in choosing their rate structures. This is not necessarily a bad thing, although it seems to be having the consequence of flatter tax schedules at the provincial level. There is much at stake for a low-income province from the income tax structure becoming less progressive. Simply the fact of having lower-than-average per capita incomes implies that with less progressivity, not only is less vertical equity achieved nationwide, but also the implicit redistribution from the rest of Canada to Newfoundland and Labrador is reduced. From the point of view of this province, the greater the share of income tax room occupied by the federal government, the better it is for the province.

The share of income tax room occupied by the federal government is related to the share of sale tax room. In the case of the sales tax, since the GST is much more efficient than retail sales taxes used in many provinces, efficiency in the internal economic union is better served by a larger share of sales tax room being occupied by the federal government. Moreover, the likelihood of sales tax harmonization being extended to non-HST and non-QST provinces is also enhanced by the federal government occupying more tax room.

Given that the federal government cannot be dominant in both the income and sales tax fields, the question is which one should they attempt to protect. A case can be made that from the point of view of Newfoundland and Labrador, it is much more important that the federal government retain dominance in the income tax field than in the sales tax field. Since the province already participates in the HST, there is little to be gained from harmonizing further in the sales tax area. At the same time, there is a lot to be gained from retaining a large federal tax presence in the income tax field since this translated into more vertical equity nationwide. More generally, to the extent that one puts weight on equity relative to efficiency nationwide, one would favour the federal government choosing a tax mix that weights income taxes heavily relative to sales taxes, leaving more room at the provincial level for the latter.

F. Process

Finally, fiscal arrangements are influenced by the institutional process by which they are put into place. In Canada, this has been dominated by federal decision-making taken in the context of year-to-year budgeting, albeit with varying degrees of consultation with the provinces. It can be argued that this process leads to fiscal arrangements being set too much with short-term budgetary considerations in mind, and too little with respect to longer run consequences. Moreover, given the secrecy of the budget process, it leads to deliberations about the shape of the fiscal arrangements being taken behind closed doors without input from the public and the provinces.

Some federations have attempted to supplement the budgetary determination of the fiscal arrangements by an advisory process involving an arms-length institution with representation from the provinces and the public. Thus, Australia has a Commonwealth Grants Commission that advises the central government on fiscal transfers, India has a National Planning Commission that does the same thing, and South Africa has a Financial and Fiscal Commission for the task. In each case, these advisory bodies have achieved considerable reputations for their sound and well-researched advice, and for the manner in which they have served as institutions for taking all stakeholder views into account. From time to time, a similar body has been advocated for Canada, most recently by the Romanow Commission in the area of health transfers. It would be in the spirit of the SUFA to establish such a body. Maybe the time has come to consider instituting a grants commission for Canada.

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Endnotes

- ¹ The discussion in this paper is couched in terms of the federal and provincial governments, since that set of relationships is the most relevant for this Royal Commission. Nonetheless, many of the same principles apply to federal-territorial relations and, to a lesser extent, to federal-first nations fiscal relations.
- ² A third source of contention concerns the different aspirations for the fiscal system that exist in Quebec as a result of linguistic and cultural issues. Since these are not of particular relevance for this Royal Commission, we do not consider them further.
- ³ The case for the legitimacy of the federal spending power in Constitutional law is outlined in Hogg (2000). However, this has recently been put in question by the report of the Séguin Commission in Quebec (Commission on Fiscal Imbalance, Supporting Document 2, 2002). They argue that the spending power has not yet been put to the legal test. See Watts (1999) for a comprehensive discussion of the spending power in various federations around the world.
- ⁴ It is interesting to note that in turn provincial transfers to their municipalities have been roughly the same order of magnitude as federal-provincial transfers.
- ⁵ The distinction between the vertical fiscal gap and a VFI is discussed in Boadway (2002b). Basically, a vertical fiscal gap will exist without a VFI if federal-provincial transfers adequately reflect the differences between provincial revenue-raising and expenditure responsibilities.
- ⁶ For a further discussion of the pros and cons of decentralization, see Boadway (2000).
- ⁷ This idea that the federal versus provincial basis for redistributive equity can be posed as being related to the extent to which the nation or the provinces is the relevant sharing community is developed in the context of health insurance in Banting and Boadway (2002).
- ⁸ This is explained in more detail in Boadway (2000, 2002a).
- ⁹ See Boadway and Hayashi (2002) and Boothe (2002) for evidence that provinces revenue capacities are destabilized by the Equalization system: the revenues of have-not provinces have actually been more volatile in the presence of Equalization than they would have been in its absence.
- ¹⁰ As an aside, this discussion is relevant for evaluating the main proposal of the Séguin Commission to eliminate the CHST and turn over the GST to the provinces. It is not clear how this could be implemented given that five of the provinces maintain RSTs and a sixth (Alberta) has no sales tax at all.
- ¹¹ These are discussed in more detail in Boadway (2002a). See also the recent report of the Senate Committee on National Finance (2002).
- ¹² For a good exposition of the evolution of the CHST, see Lazar, St-Hilaire and Tremblay (2002).

- ¹³ This sort of projection formed the basis for the main recommendation of the Séguin Commission that the federal government simultaneously turn over all the GST tax room to the provinces and eliminate the CHST. They argued that the excess of revenue raised by the GST over the cost of CHST just offset the existing VFI. The details of VFI calculations are discussed in Lazar, St-Hilaire and Tremblay (2002).
- ¹⁴ Lazar, St-Hilaire and Tremblay (2002) recount this argument clearly.
- ¹⁵ A crude version of such a system exists in South Africa, and a more sophisticated version has been proposed by the Financial and Fiscal Commission, an advisory committee to the national government on fiscal federalism (Financial and Fiscal Commission, 2000).
- ¹⁶ The Senate Committee on National Finance (2002) recommended returning to the ten-province standard. They also recommended removing the ceiling provision, maintaining the floor provisions, retaining the RTS approach (rather than the macro one), and increasing the generosity of the generic provision to give more protection to natural resource revenues.
- ¹⁷ A representative argument for a macro formula may be found in Boothe (1998). His proposal would use an adjusted measure of personal income as an index of provincial fiscal capacity. Provinces with per capita personal income below a (ten-province) national standard would receive Equalization based on a rate of about 32 per cent of the deficiency. Note that by using personal income as a base, a substantial proportion of resource revenues escapes Equalization.
- ¹⁸ One might argue that the incentive problem could conceptually be overcome by bringing into the Equalization system a province's resource potential whether or not they choose to develop it. But this solution has several problems. For one, a province only learns its resource potential by exploration. The incentive problem would simply be diverted to the exploration stage. For another, basing Equalization on potential rather than actual tax bases would violate the purpose of Equalization as a mechanism for compensating for actual NFB differentials.
- ¹⁹ It is sometimes argued that the efficiency consequences of Equalization are inconsequential. However, recent work by Wilson (2001) suggests that they can be substantial.

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