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Communiqué

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1999 equalization negotiations should take into account Canada's role in new global economic order, says C.D. Howe Institute study

The 1999 renegotiation of Canada's equalization payments program could be the most problematic on record. For the first time, the Canadian federation will be attempting to come to grips with interregional equity in the context of international competitiveness, says the latest issue of *C.D. Howe Institute Commentary*, released today.

The study, *Renegotiating Equalization: National Polity, Federal State, International Economy*, was written by Queen's University economist Thomas J. Courchene, a Senior Fellow and Scholar-in-Residence at the C.D. Howe Institute.

Courchene explains that, despite the major cuts to other intergovernmental transfers that occurred in the 1990s, the equalization program emerged essentially unscathed. What is now needed, he says, is a set of general design and implementation principles that will allow progress toward reforming equalization, and fiscal federalism generally, in line with emerging national and international imperatives.

Courchene says that, in renegotiating the equalization program, it is fundamental to recognize that Canada is a decentralized federal system, not a centralized federation, let alone a unitary state. Thus, recent proposals for a much more generous equalization program, based on a unitary-state / closed-economy model of the federation, are misguided. Such proposals would effectively undo provincial fiscal policy decisions where they differ from province to province — surely the very antithesis of federalism. Moreover, says Courchene, a revenue-sharing system that completely ignores the reality of North American (and global) markets, as the closed-economy model does, could spell economic disaster for Canada.

Courchene argues that two rationales, a federal one and a citizenship one, underpin Canada's system of intergovernmental transfers. Under the federal rationale, the provinces must have revenues sufficient to exercise the powers assigned to them under the Constitution. Under the citizenship rationale, Canadians, wherever they live, must have access to certain key economic and social rights; for those rights that fall under provincial jurisdiction, provinces should have access to adequate funds to provide them. In this way, the equalization formula should reflect the federation's view of what is equitable, appropriate, and acceptable in light of major shifts in political economy, whether policy driven or externally driven.

The current formula is far from perfect, however. It is based on five, rather than ten, provinces; it is not neutral toward provincial fiscal policy decisions; and it fails to account for redistribution done through other programs. All of these drawbacks will need attention in the upcoming negotiations.

This study is the second in a special series of Commentaries called "The Transfer Papers," prompted by the expectation that new legislation on provincial fiscal equalization will be tabled in fiscal year 1998 / 99 following federal-provincial review of the program. The series aims to encourage debate about new ways to finance the Canadian federation and how to accomplish the twin goals of an efficient and prosperous economy and fairness for all Canadians. The general editor of the series is Paul Boothe, Professor of Economics at the University of Alberta and an Adjunct Scholar of the C.D. Howe Institute.

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- 30 -

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Communiqué

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Les négociations de péréquation pour 1999 devraient tenir compte du rôle du Canada au sein du nouvel ordre économique mondial, affirme une étude de l'Institut C.D. Howe

La renégociation en 1999 du programme des paiements de péréquation au Canada pourrait s'avérer des plus épineuses. En effet, pour la première fois, la fédération canadienne va s'efforcer de saisir par les cornes l'équité interrégionale dans le contexte de la compétitivité internationale. C'est du moins ce qu'affirme le plus récent *Commentaire de l'Institut C.D. Howe* publié aujourd'hui.

L'étude, intitulée *Renegotiating Equalization: National Polity, Federal State, International Economy (La renégociation de la péréquation : l'administration nationale, l'État fédéral, l'économie internationale)*, est rédigée par un économiste de l'Université Queen's, Thomas J. Courchene, qui est également chargé de recherche principal et chercheur invité auprès de l'Institut C.D. Howe.

M. Courchene explique qu'en dépit des coupures importantes qui ont été faites dans les transferts intergouvernementaux au cours des années 90, le programme de péréquation s'en est sorti à peu près indemne. Selon lui, ce qu'il faut maintenant, c'est un ensemble de principes généraux de conception et de mise en œuvre qui permettront de réaliser des progrès en matière de réforme de la péréquation, et du fédéralisme fiscal en général, face aux nouvelles réalités nationales et internationales.

Dans le cadre de la renégociation du programme de péréquation, M. Courchene indique qu'il est fondamental de reconnaître que le Canada est un système fédéral décentralisé et non une fédération centralisée, et encore moins un État unitaire. Les récentes propositions qui envisagent un programme de péréquation beaucoup plus généreux, en fonction d'un modèle d'État unitaire ou de fédération à économie fermée, sont donc peu judicieuses. En effet, elles auraient pour effet d'annuler les décisions provinciales de politique financière lorsque celles-ci diffèrent d'une province à l'autre — ce qui serait assurément l'antithèse du fédéralisme. De plus, explique M. Courchene, un système de partage des recettes qui ignore totalement la réalité des marchés nord-américains (et mondiaux), comme le fait le modèle de l'économie fermée, pourrait signifier un désastre économique pour le Canada.

M. Courchene soutient que deux raisons d'être, soit celle de la fédération et celle de la citoyenneté, soutiennent le système canadien des transferts intergouvernementaux. Selon la première, les provinces doivent disposer de recettes suffisantes pour exercer les pouvoirs qui leur ont été conférés par la Constitution. Selon la seconde, les Canadiennes et les Canadiens, où qu'ils vivent, doivent avoir accès à certains droits économiques et sociaux clés; lorsqu'il s'agit des droits qui relèvent des provinces, ces dernières doivent donc disposer d'un financement suffisant pour les fournir. De cette façon, la formule de péréquation doit exprimer le point de vue de la fédération, soit ce qui est équitable, pertinent et acceptable à la lumière des diverses modifications de l'économie politique, qu'elle soit menée par les politiques, ou par les forces extérieures.

Or, la formule actuelle est loin d'être parfaite. Elle repose sur cinq plutôt que dix provinces; elle n'est pas neutre pour ce qui est des décisions de politique financière; et elle ne tient pas compte de la redistribution effectuée grâce à d'autres programmes. Tous ces désavantages devront recevoir l'attention voulue au cours des négociations à venir.

Cette étude est la deuxième dans la série spéciale de Commentaires intitulée « Les cahiers du transfert », et elle repose sur la prévision selon laquelle on présentera un nouveau projet de loi lors de l'exercice 1998-1999 sur la péréquation fiscale des provinces à l'issue d'un examen fédéral-provincial du programme. La série vise à stimuler le débat sur de nouvelles façons de financer la fédération canadienne et sur la réalisation de l'objectif double d'une économie efficiente et prospère, et de l'équité pour tous les Canadiens. La série est publiée sous la direction de Paul Boothe, professeur d'économie à l'Université de l'Alberta et attaché de recherche auprès de l'Institut C.D. Howe.

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- 30 -

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The Transfer Papers

Renegotiating Equalization:

National Polity, Federal State, International Economy

by

Thomas J. Courchene

In the 1999 renegotiation of Canada's equalization program, the federation, for the first time, will attempt to come to grips with interregional equity in the context of international competitiveness. What is needed is a set of general design and implementation principles that will allow progress toward reforming fiscal federalism, with a major focus on equalization, while remaining sufficiently flexible to allow alternative paths for the evolution of Canada within the new global order.

The most fundamental principle to keep in mind is that Canada is a decentralized federal system, not a centralized federation, let alone a unitary state. Thus, recent attempts to develop a case for a much more comprehensive and egalitarian approach to equalization, based on a unitary-state/closed-economy model of the federation, are misguided in that such equalization would undo the fiscal implications of different provincial policy decisions — surely the very antithesis of federalism. Moreover, a revenue-sharing system that completely ignores the reality of North American (and global) markets, as the closed-economy model does, runs the risk that Canada will commit economic suicide.

Two rationales, a federal one and a citizenship one, underlie intergovernmental transfers. Under the first, the provinces must have revenues sufficient to exercise the powers assigned to them under the Constitution. Under the second, Canadians, wherever they live, must have access to certain key economic and social rights; for those rights that fall under provincial jurisdiction, provinces should have access to adequate funds to provide them. The equalization formula thus reflects the federation's view of what is equitable, appropriate, and acceptable in light of major shifts in political economy.

Main Findings of the Commentary

- The last half-dozen years of this century will be seen as being as much a watershed in Canada's social evolution as were the formative Pearson years of the 1960s. Yet the equalization program has skated through this process essentially unscathed. Now needed is a set of general design and implementation principles that will allow some progress toward reforming fiscal federalism, with a major focus on equalization, while remaining sufficiently flexible to accommodate alternative paths for the evolution of Canada's economy and society.
- The nature of any federation's transfer system is inextricably linked to the underlying nature of the federation itself. There must, therefore, be some constraints on the design options for intergovernmental grants. These conditions are of two sorts: *static initial conditions* that reflect the federation as it stands now, and *dynamic initial conditions* that reflect those current trends that are reshaping the federation.
- The most fundamental principle for rethinking equalization (and fiscal federalism generally) is to focus on Canada as a *decentralized federal system* — not a centralized federation, let alone a unitary state.
- Two rationales, a *federal* one and a *citizenship* one, underlie intergovernmental transfers. Under the first, the provinces must have revenues sufficient to exercise the powers assigned to them under the Constitution. Under the second, Canadians, wherever they live, must have access to certain key economic and social rights; for those rights that fall under provincial jurisdiction, provinces should have access to adequate funds to provide them.
- The equalization formula reflects the federation's view of what is equitable, appropriate, and acceptable in light of major shifts in political economy, whether policy driven (the evolution of the welfare state) or externally driven (for example, energy shocks).
- As the 1999 equalization-renewal deadline nears, researchers are developing a case for a much more comprehensive and egalitarian approach to equalization, based on a unitary-state / closed-economy (US / CE) model of the Canadian federation. Yet US / CE equalization would undo provincial policy decisions where they differ from province to province — *surely the very antithesis of federalism*. In particular, this model assumes that an increase in revenues is directly linked to an increase in net fiscal benefits — that there is *zero capitalization* arising from increases in levels of economic activity and, therefore, from rising activity. This is demonstrably wrong. Beyond this, to devise a revenue-sharing system that completely ignores the reality of North American (and global) markets runs the risk that Canada will commit economic suicide.
- Incorporating "expenditure needs" into the equalization program would not fit well in the Canadian context, where all transfers are unconditional.
- The upcoming renegotiation of equalization could be the most problematic on record. For the first time, the Canadian federation will be attempting to come to grips with inter- regional equity in the context of international competitiveness.

Social Canada is in full evolutionary flight. Beginning with Finance Minister Paul Martin's 1995 budget, virtually all aspects of Canada's social envelope have undergone significant and, in some cases, rather dramatic restructuring. The 1995 budget rolled the former Canada Assistance Plan (CAP) and Established Programs Financing (EPF) into the "super" block-funded Canada Health and Social Transfer (CHST), replete with massive cuts in cash transfers to the provinces. On the personal transfer front, the Canada and Quebec Pension Plans have been redesigned to incorporate a very large increase in premiums, employment insurance (EI) has been scaled back and converted into an "hours" rather than a "job" basis and, while the proposed seniors benefit has been abandoned, new proposals are presumably pending.

At the provincial level, many provinces are rethinking and reworking their workers' compensation schemes and most have scaled back welfare benefits, with Ontario embarking on a workfare scheme. More important from the vantage point of citizens, provinces are reacting to Ottawa's "deficit downloading" by rationing the supply of health care services and some are engaging in a wholesale restructuring of the design and delivery of medicare.

Beyond these specific program-related changes, the underlying reality is that (aggregate) government program spending as a proportion of gross domestic product (GDP) will have fallen from roughly 36 percent in 1994 to a forecast 26 percent by the turn of the century — a decrease from 17 percent to 11 percent on Ottawa's part and from 19 percent to 15 percent at the provincial level. Historians will surely rank the last half-dozen years of the twentieth century as every bit as much a watershed in Canada's social evolution as were the formative Pearson years of the 1960s.

Intriguingly, the equalization program has skated through this process essentially unscathed. The program is slated for renewal in 1999, however, and the on-going equalization renegotiations[1] appear to be serving as a focal point for yet another review of the entire transfer system.[2] It is in this context that this *Commentary* finds its rationale.

Ideally, one would like to go beyond "principles" to develop an "optimal set" of transfers for twenty-first century Canada. Unfortunately, what is optimal on the transfer front will depend on the manner in which the Canadian federation itself is likely to evolve in the emerging North American and global order. Since this evolution is anything but clear, the role of this *Commentary* is limited to developing a set of general design and implementation principles that will allow some progress toward reforming fiscal federalism for the next century while incorporating sufficient flexibility to accommodate alternative paths for the broader evolution of Canada's economy and society.

The ensuing analysis is structured as follows. The first part focuses on a set of initial conditions, both static and dynamic, that will inform the development of the transfer principles. Also included here (although largely relegated to an Appendix) is an assessment of where Canada currently stands with respect to key intergovernmental transfer programs such as equalization and the CHST, as well as some brief reference to the manner in which other federations currently approach key aspects of fiscal federalism.

With this as backdrop, the remainder of the *Commentary* is devoted to isolating transfer design and implementation principles, with major focus on the equalization program. The first order of business is to provide a rationale for equalization and intergovernmental transfers that resonates with these static and dynamic initial conditions — namely, a national polity, a federal nation, and an (increasingly) international economy. In particular, it is critical to conceptualize equalization in the framework of a decentralized federation. This is the role of the second part. There, I offer two overarching principles or rationales for equalization — a *federal* rationale and a *citizenship* rationale. This is followed by a brief review of the history of the equalization formula and how this evolution accords with the federal and citizenship principles.

While conceiving of intergovernmental transfers from the perspective of a decentralized federation is the analytical cornerstone of this *Commentary*, it is nonetheless the case that the prevailing equalization literature is rooted in a unitary-state and closed-economy context. More to the point, the unitary-state approach is the core of several recent papers associated with the 1999 equalization negotiations. Accordingly, the third part represents an attempt to debunk several key assumptions of this unitary-state, closed-economy model.

The development of a set of implementation principles as well as the singling out of a series of design faults with respect to the status quo constitute the core of the fourth part. Issues addressed include the appropriate equalization standard, fiscal neutrality, the confiscatory nature of the current program, expenditure needs, the erosion of the stabilization component of transfers, the resource-rent challenge, and the concept of equalization as the overarching intergovernmental transfer. Most of this analysis is conducted in a revenue-neutral context. That is, the focus is on the structure of, and incentives within, intergovernmental transfers rather than on the appropriate level of transfers. In the final section of the fourth part, I drop this assumption and address a range of issues that may influence the aggregate level of intergovernmental transfers.

An integrative conclusion completes the *Commentary*.

Static and Dynamic Initial Conditions

To illustrate the nature of the challenges that attend the derivation of transfer principles, and also why there can be no first-best approach to transfer design, consider the following rather uncontroversial observation: the Canadian federation is, in most ways, more decentralized than that of the United States. But why is this so? Is it because section 92 of the Canadian Constitution contains an explicit enumeration of exclusive provincial powers whereas the US Constitution does not do so for the states? Is it because the United States has a triple-E Senate that provides a key role for the states in the operations of the central governing agencies of that federation? The corollary here would be that, lacking such influence at the center, provincial interests in Canada tend to be articulated via provincial legislatures and their respective premiers. Is it because there is no equivalent to the economic and population dominance of Ontario and Quebec in the US federation and, therefore, no equivalent focal point for the concentration of subnational powers? Is it because there is no US state, or group of states, that has the distinctiveness on the linguistic, cultural, and legal (civil law) fronts that Quebec has?

Or, and more germane to the task at hand, is Canada more decentralized because its intergovernmental transfer system is dominated by unconditional grants rather than conditional grants, since the former are much more consistent with enhanced subnational autonomy? Or could it be that Canada's intergovernmental transfers are more unconditional than those in the United States *precisely because* Canada is the more decentralized federation?

Frustratingly for the analysis that follows, the answer to why the Canadian federation is more decentralized is probably "all of the above." In other words, the nature of the transfer system in any federation is almost certainly inextricably linked to the underlying nature of the federation itself. Thus, Australia's egalitarian equalization system exists alongside a highly egalitarian society (Courchene 1998b). Similarly, the "life, liberty, and pursuit of happiness" rhetoric of the US Constitution presumably preordains that the United States has among the least developed intergovernmental transfer systems of any modern federation.

The link between the nature of intergovernmental transfers and that of the federation itself necessarily means that there have to be some limits or constraints on the design options for intergovernmental grants: one size or structure cannot, and does not, fit all federations. In what follows, I assume that these limits must relate to and respect the nature of the federation as it currently exists. Otherwise, one could be tempted, wrongly, to recommend Canada's equalization system for the United States or the (nonexistent) US equalization system for Canada.

Therefore, in order to proceed, one needs a set of initial conditions relating to the characteristics of the Canadian federation. These are of two sorts: *static initial conditions* that reflect the federation as it stands now, and *dynamic initial conditions* that reflect those current trends that are reshaping the federation.

Static Initial Conditions

The most obvious of the static initial conditions is that, at any point in time, the structures and processes of the federation are far from haphazard. Phrased differently, this suggests that political markets are "efficient" in that the existing institutional design of the federation, including the system of intergovernmental grants, embodies and reflects both historical and current social, cultural, and economic forces.[3] It is important to note that this view of initial conditions does not confer any notion of "desirability" or "permanence" on existing arrangements. This is abundantly clear from the way in which grants for health, welfare, and postsecondary education have evolved over recent years and also from the manner in which the equalization standard has been altered since its inception. But the status quo is, nonetheless, an important starting point for contemplating further evolution.

More important still, these initial conditions also embody key societal principles. Consider, for example, section 36 of the *Constitution Act, 1982*:

> **36.** (1) 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.
>
> (2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

It may well be that section 36 is not justiciable, but presumably it would rule out a wholesale abandonment of the equalization principle. Likewise, designing intergovernmental transfers in a manner that effectively revokes provincial constitutional authority over, say, resources would be ruled out. More generally, the static approach to initial conditions would reflect and respect policy evolution and, in particular, would embrace the dictates of the Constitution.

Dynamic Initial Conditions

The dynamic component of initial conditions is more forward looking in nature. It is designed to embody emerging trends that are reflected in either recent policy initiatives or the influences of external forces on the federation. Of necessity, this creates a natural tension with the status quo nature of the static initial conditions. The list here could be indefinitely long, but I limit myself to three items.

The first trend relates to the significant decrease in the role of government in the lives of Canadians. The increase in privatization, deregulation, and contracting out on the one hand, and the effort to restore fiscal balance at both levels of government on the other, has caused program spending to fall dramatically from roughly 36 percent of GDP in 1994 to a projected 26 percent by the end of the century. The implications of this sea change in the citizen-government relationship have not yet been fully recognized. Moreover, it is a development that is bound to reverberate on the evolution of intergovernmental transfers.

The second trend is that the system of intergovernmental grants appears to be undergoing a major conceptual shift on Ottawa's part. Specifically, as Ottawa gains fiscal room, it is not unwinding the massive CHST transfer cuts. Rather, it is spending directly on citizens in programs such as the National Child Benefit and the Millennium Fund, which are, arguably, substitutes for provincial transfers relating to welfare and postsecondary education, respectively. While the federal government rationalizes this shift in terms of enhanced visibility and accountability, among other reasons, this by-passing of the provinces nonetheless represents a potential watershed in the evolution of intergovernmental transfers.[4]

In tandem, these two "forward-looking" aspects of the status quo will have to be factored into any analysis of the evolution of federal-provincial transfers.

The third dynamic initial condition that will inform the ensuing analysis is quite different in nature. It reflects Canada's changing geo-economic environment. In 1981, Ontario's exports to the rest of Canada and to the rest of the world were both of the order of $40 billion. By 1995, Ontario's international exports (predominantly to the United States) were close to two and a half times as large as its exports to the other provinces and growing nearly a magnitude faster (Courchene and Telmer 1998, chart 9.1). Indeed, in 1994 every province except Prince Edward Island exported more internationally than to the rest of Canada (ibid., table 9.1). In turn, it is increasingly problematical to view Canada as a single east-west economy. Rather, it is best viewed as a series of crossborder (and for British Columbia, Pacific Rim) economies. The related challenge on the transfer front is how to sustain the east-west transfer system in the presence of an increasingly north-south trading system. And in terms of the implications for the analysis that follows, at what point does the pursuit of east-west equity or equality in terms of provincial fiscal fortunes begin to impede Canada's ability to compete north-south?

An example may be instructive. The prevailing view in the federation is that Ontario has always been more supportive of intergovernmental redistribution than has British Columbia. On reflection, this makes eminent economic sense. This is so because, under the old paradigm, where trade was largely east-west and Ontario was the principal north-south conduit, the second-round spending impacts of transfers to "have-not" provinces probably ended up somewhere in the Golden Horseshoe. With trade flows increasingly going north-south, those second-round spending impacts could well end up in North Carolina or Minnesota. This could lead to Ontario's position with respect to transfers converging on British Columbia's, which never did receive much of the second-round spending. And this potential shift in Ontario's position could occur even if its inherent taste for transfers is unaffected, because the *benefits* to Ontario of these transfers would have diminished.

While these static and dynamic initial conditions are a reflection of the current and emerging Canadian reality and, therefore, presumably are uncontroversial at this level, their implications are far-reaching. In particular, the tendency for the fiscal federalism literature to be cast in a unitary-state / closed-economy framework is way off side with these initial conditions, as is articulated later in this paper.

Fiscal Federalism in Other Federations

The remainder of this section directs attention to fiscal federalism practices in other federations — specifically, Germany, Australia, and the United States. The Canadian details are relegated to the Appendix, which contains a brief description of Canada's two key intergovernmental transfer systems, equalization and the CHST. The elaboration of these programs also provides the needed backdrop for several issues that are highlighted later, such as fiscal neutrality and the conception of equalization as an overarching reconciler of intergovernmental transfers. The Appendix concludes with a brief reference to EI and other government-to-person transfers and argues that any regional preferences in these programs should be viewed as part of the overall horizontal and fiscal balance dimensions of intergovernmental grants.

The German Model

In terms of fiscal federalism approaches in other federal states, the German federation holds considerable interest for Canadians. One component of Germany's intergovernmental grant system involves an inter-*Länder* (interprovincial, in Canadian terms) revenue-sharing pool. The specifics of this pool (or, more correctly, the model that applied prior to German reunification)[5] were as follows. The richer *Länder* contributed a share of their per capita revenues in excess of 102 percent of the all-*Länder* average (70 percent of revenues between 102 and 110 percent, and 100 percent of any revenues in excess of 110 percent of the all-*Länder* average), and the poorer *Länder* drew funds from the pool to bring them up to 95 percent of the all-*Länder* average.

Two aspects of Germany's approach to horizontal equalization merit highlight. The first is that revenues relate to "standardized" revenues. Specifically, the equalization program incorporates "needs" into standardized revenues. The dominant form of needs relates to population densities. *Länder* with large cities and / or high overall average population density are deemed to require more revenues, and this is built into the revenue estimates alluded to earlier. Since the wealthier *Länder* also tend to have the largest cities and to be more densely populated, this serves to lessen the magnitude of transfers arising from the inter-*Länder* revenue-sharing pool. The second aspect is that the revenue-sharing pool is an overarching equalization program: in its calculations, it incorporates payments resulting from the other programs relating to vertical or horizontal fiscal balance.

Finally, one should note that the German system is highly centralized. One example of this is that the tax rates on the four taxes (wages and assessed income tax, other income taxes, the trade tax, and the value-added tax) that contribute to vertical fiscal balance are set centrally and are invariant across *Länder*. More important, the German Basic Law (that country's constitution) embodies a provision relating to "the uniformity of living conditions" — a considerable contrast from Canada's "reasonably comparable levels of public services at reasonably comparable levels of taxation."[6]

The Australian Model

By far the most frequently referenced fiscal federalism model is that of Australia. The Australians pursue a comprehensive approach to equalization that is of the unitary-state/closed-economy variety, one that resonates well with the thrust of the prevailing literature on equalization. Specifically, the Commonwealth Grants Commission (CGC) equalizes state fiscal capacities up and down for both revenue-raising capacity and expenditure needs (Courchene 1998a; Wilson 1998).

However, and as documented in more detail later, one must exercise caution in falling back on Australian experience as a model for Canadian fiscal federalism. Australia is not only a highly centralized but also a highly egalitarian nation. Welfare benefits, for example, are run from Canberra and are essentially identical across the country; wage grids are also essentially uniform across the country — university professors are on the same wage grid whether they work in Perth or Sydney. More important, Australian states are highly transfer dependent. They have no effective access to broad-based taxes (income taxes and general sales taxes), and the taxes they do levy are being eroded by a combination of global forces and High Court decisions (Courchene 1998b). As Walsh observes:

> Particularly because of the remarkably low share of the *state* sector in tax revenues — about 21 percent of the total, lower even than local governments' share in many so-called unitary systems — Australia has by far the highest degree of vertical fiscal imbalance among the major federations in the industrialized world....It is even high by the standards of most unitary countries. (1996, 115.)

By way of further elaboration, the *least* transfer-dependent state, New South Wales, still receives Commonwealth grants equal to 90 percent of its own-source revenues whereas Canada's *most* transfer-dependent province, Newfoundland, receives transfers that represent just 70 percent of its own-source revenues (Courchene 1998b). And Alberta's budget *surplus* last year exceeded its federal cash transfers, so that this province is fully autonomous, fiscally.

Another reason to be cautious about using the Australian example relates to the nature of Australia's grant system. Specifically, Special Purpose Payments (SPPs) — what Canadians would call conditional grants — now exceed the unconditional grants that flow from the CGC equalization model. This is in sharp contrast to Canadian intergovernmental transfers, which are now fully unconditional, at least in terms of where they are spent. In part, this trend toward increasing the proportion of conditional grants in Australia may relate to the fact that "expenditure needs" are incorporated into the CGC model. As the CGC provides more information relating to its detailed and complex computations, special interest groups are, not surprisingly, making greater attempts to influence how these CGC grants are spent. For example, if a state receives more grant money because it is deemed to be needy in terms of a particular expenditure category, interest groups within the state will lobby to have the money actually spent on the expenditure category for which it was intended. If the state refuses, the interest group will lobby Canberra to convert that component of the CGC grant to an SPP. In other words, the inclusion of expenditure needs as an integral component of the CGC grant model appears to be progressively serving to "conditionalize" the grants. This, too, is consistent with the already highly centralized nature of the Australian federation. But it would not be consistent with Canada's evolution toward the unconditionality of intergovernmental transfers.

A third reason for caution in the Australian case relates to the driving force behind the expenditure needs component of equalization.

Earlier, I noted that, in the German system, the greater its population density the more revenue needy a *Land* is deemed to be. Precisely the opposite applies in Australia — sparsely populated areas are deemed to be revenue needy, as it were. One possible rationale for the German position is that population density embodies a "capitalization" effect — rents, wages, and prices generally are higher in urban areas than they are in the countryside. The Australian CGC model has been very slow to take account of these "cost" or capitalization effects, as distinct from "needs" factors, although in the past few years the CGC has been introducing a wage-rate component in calculating expenditure needs.

By way of recapitulation with respect to the Australian model, Richard Bird, in his impressive overview of comparative fiscal federalism, ventures that the degree of homogeneity and egalitarianism in that country is such that "had Australia not been established initially as a federal country, it seems rather unlikely that it would be one today" (1986, 242). Likewise, no less an authority on federalism than W.H. Riker has proclaimed that "the divisions in Australian culture seem to be economic and religious with hardly any geographic base....One wonders why they bother with federalism in Australia" (1964, 113). Neither of these comments is intended in any way to downplay the Australian model *for Australians*, who have latched on to a highly egalitarian equalization program that meshes well with the underlying homogeneous and egalitarian nature of their federation. In other words, the static and dynamic initial conditions appropriate to Australia are vastly different than those that apply in Canada.

The US Model

To round out this brief comparative survey, let us look at the United States, which has a federal system that probably suffers least from vertical fiscal imbalance, in part because US states engage in a narrower range of activities than do Canadian provinces, for example. What is most fascinating about the US approach to intergovernmental transfers is the a*bsence* of a formal revenue equalization program, although, on the expenditure side (for example, with respect to defense), regional considerations enter into allocation decisions, as they do in Canada.

One view of the US approach is that the Americans simply ignore any horizontal fiscal imbalances. Another view is that there really are no horizontal imbalances since any meaningful per capita revenue differences across states will be capitalized in property values and rents. Wallace Oates, one of the foremost scholars of US federalism, takes this latter view of horizontal fiscal imbalances and equalization:

> [E]xisting fiscal differentials (e.g., varying levels of taxable capacity) across jurisdictions will tend, to some extent at least, to be capitalized into property values so that those who choose to live in fiscally disadvantaged areas are compensated by having to pay lower land rents; from this perspective, horizontal equity under a federal system is, to some degree, self-policing. The need for equalizing grants in a federation is thus questionable. Perhaps it is best to regard their role as a matter of "taste." (1983, 95–96.)

It may well be that assuming full (or 100 percent) capitalization of fiscal capacity differences is going too far. But so does the existing equalization literature, which, in general, assumes *zero* capitalization. The degree of capitalization plays a critical role in the analysis later in this paper.

Intergovernmental Transfers in a Decentralized Federation: Two Fundamental Rationales

In this section, I begin the process of isolating design and implementation principles to inform the rethinking and reworking of Canadian fiscal federalism. And the most fundamental of these principles is to focus on equalization (and fiscal federalism generally) from the perspective of a *decentralized federal system* — not a centralized federation, let alone a unitary state.

Federations are characterized by a formal division of powers between two orders of government, powers that are assigned on a self-rule / shared-rule basis. It is theoretically possible that there could be a serendipitous matching of revenue and expenditure responsi-bilities among the two orders of government such that there would be no need for a set of intergovernmental transfers. But, at a practical level, this is essentially a null set. In virtually all federal systems, the central government has, *de facto* if not *de jure*, access to revenues in excess of its expenditure responsibilities.

By way of a brief detour, one could probably argue that there is, *de jure*, no vertical imbalance in most federations. Specifically, most subnational governments have access to a range of tax sources sufficient to finance their expenditure responsibilities. However, having *ex ante* or *de jure* access is not the same as *de facto* or *ex post* access. This is because national governments in federal states typically have preempted access to these tax bases. In Canada's case, taxing authority was centralized during World War II. While Ottawa has transferred some of this tax room back to the provinces, this tax transfer has not kept pace with the postwar explosion in provincial expenditure responsibilities. Thus, while the provinces could, in principle, raise their personal income tax (PIT) rates, for example, to finance these expenditures, the result would be unacceptably high marginal tax rates, unless the federal government transferred additional PIT tax room to the provinces. And the introduction of the goods and services tax has effectively placed an upper limit on the provinces' ability to enhance their revenues from provincial sales taxes. Hence, as a matter of *realpolitik*, the provinces suffer from a vertical fiscal imbalance.

One obvious solution would be to transfer expenditure responsibilities upward — that is, to centralize the federation. While Canadian history contains important examples of this (for example, the 1940 constitutional amendment that transferred responsibility for unemployment insurance to Ottawa), the "initial conditions" underpinning this analysis rule out this avenue as a general solution. Hence, there is a need for a system of intergovernmental grants to offset these fiscal imbalances.

In general, two sorts of fiscal-balance issues arise in federal systems, vertical fiscal balance and horizontal fiscal balance. *Vertical fiscal balance*, as already noted, relates to the allocation of revenue-raising capacities (relative to the allocation of expenditure responsibilities) between the two orders of government. Since the provinces suffer from a relative revenue deficiency, from their vantage point there is a vertical fiscal imbalance calling for intergovernmental transfers. *Horizontal fiscal balance* has to do with the relative fiscal capacities across the various provinces. The intergovernmental transfers associated with alleviating these horizontal fiscal imbalances in federal systems are typically referred to as equalization programs.

With this brief detour on horizontal and fiscal imbalance, let us turn to the underlying rationales for intergovernmental transfers in federal systems. Drawing on the penetrating analysis of the Report of the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Report) (Canada 1939) and building on earlier writings of mine (Courchene 1984; 1994) and a recent insightful paper by Milne (1998), one can derive two conceptually distinct rationales for such transfers: a *federal* rationale and a *citizenship* rationale.

The Federal Rationale

The federal rationale for intergovernmental transfers is straightforward. If the federal principle is to be effective, then the second order of government must have revenues sufficient to exercise the powers assigned to it under the Constitution. Or, more generally, "each level of government in our federation should have the requisite financial means and financial security to carry out its constitutional responsibilities" (Milne 1998, forthcoming). And in a decentralized federation, these transfers should be unconditional. Intriguingly, the Rowell-Sirois Report's call for "National Adjustment Grants" was premised on this dual notion of providing provinces with the fiscal independence needed to ensure their ability to fulfill their constitutional responsibilities and to do so in a way that also ensured their autonomy:

> The Commission's plan [for National Adjustment Grants] seeks to ensure every province a real and not illusory autonomy by guaranteeing to it, free from conditions or control, the revenues necessary to perform those functions which relate closely to its social and cultural development. (Canada 1939, 80.)

The Citizenship Rationale

Side by side with the federal or constitutional rationale for intergovernmental transfers is the citizenship or, perhaps, nationhood rationale: Canadians, wherever they may live, ought to have access to certain key economic and social rights — rights that ought to attend citizenship, as it were. Since some of these basic rights fall under provincial jurisdiction, it is imperative that the provinces have adequate funds to provide them. Again, the Rowell-Sirois Report merits quotation:

> In considering the relative fiscal needs of provincial governments, we are mainly concerned with a few divisions of their expenditures: on education, on social services, on development. *It is of national interest that no provincial government should be unduly cramped in any of these respects.* Education is basic to the quality of Canadian citizens of the future and it is highly undesirable that marked disparities in the financial resources available for education should exist as between Canadian provinces. Social services, like education, cannot be subjected to marked disparities without serious reactions on the general welfare and on national unity. (Ibid.; emphasis added.)

But even here, with its emphasis on ensuring adequate funding for the provinces to deliver key national or pan-Canadian goods or services, the Rowell-Sirois Report is highly respective of provincial autonomy:

> An appropriate developmental policy is required in each province, and the only standard which can be fairly applied is the policy of the province itself. (Ibid.)

By way of historical elaboration, one can view Canada's equalization system as falling largely under the federalism rationale and the original shared-cost programs (for medicare, hospitals, postsecondary education, and welfare) as falling largely under the citizenship rationale. These latter programs were conditional in that not only were the federal monies tied to actual expenditures on them but the federal conditions also included (among other principles) "portability" of these benefits across provinces. In this way, individual provincial programs became pan-Canadian, as befits the citizenship rationale. More recently, as these programs became "established," the grants became unconditional in terms of where they were spent, but conditionality still applies to ensure that provincial expenditures on these programs comply with selected pan-Canadian imperatives — the five principles embodied in the *Canada Health Act*[7] and the prohibition of residency requirements for welfare.

With knowledge increasingly becoming the cutting edge of competitiveness, the latest version of a "merit good" that would probably fall under the citizenship rationale is access to postsecondary education, and skills accumulation generally. As indicated earlier, the new twist here is that the federal government is, via the Millennium Fund, attempting to play a leading role in providing citizen access. Setting aside the constitutional and political implications of whether or not this is a usurpation of provincial powers, it represents a significant development in federal-provincial relations: Ottawa is by-passing the provinces and taking on itself the responsibility to provide "citizen-type" public goods, with likely important implications for the evolution of intergovernmental grants.

One potential problem with these overarching principles is that they lack precision in specifying the level and distribution of equalization payments and intergovernmental transfers generally. But that is precisely their strength. As Milne (1998, forthcoming) notes, even though the equalization principle is now entrenched,

> the equalization program still depends upon finding its place in the deeper political logic and interests of our time

and, in more general terms,

> fiscal arrangements conform to prevailing beliefs and assumptions at different times about what governments should do and how they should acquire the resources to do them.

To elaborate on this theme — namely, that the evolution of equalization has always been in the nature of societal "high politics" reflecting the static and dynamic forces of the era, but underpinned by the federalism and citizenship rationales — it is instructive to review briefly the history of the equalization program.

The Evolution of the Equalization Formula

When the equalization program was inaugurated in 1957, only three taxes shared between Ottawa and the provinces were subject to equalization — 10 percent of personal income taxes, 9 percent of corporate income taxes, and 50 percent of succession duties. The equalization standard was the average per capita yield in the two wealthiest provinces. In the 1962 renegotiations, the PIT share entering the formula was increased to 16 percent (rising to 24 percent by 1967); one-half of provincial revenues and taxes from natural resources also entered the formula. At the same time, the national average became the equalization standard. In fiscal year 1964/65, the equalization standard again reverted to the top two provinces. In addition, resources were pulled out of the formula and provinces were entitled to equalization only to the extent that their per capita entitlements exceeded 50 percent of the amount by which their per capita resource revenues exceeded the national-average level.

The 1967 fiscal arrangements represented a watershed in the annals of equalization. Canada adopted the representative-tax-system approach to equalization, which remains in place today, with 16 provincial revenue categories (including all resource revenues) eligible for equalization and with the national average again becoming the equalization standard. This approach was extended in the 1972 negotiations, and three new provincial revenues — race track revenues, medical premiums, and hospital premiums — entered the formula.

These were previously lumped into the miscellaneous revenue category. In fiscal year 1974/75, a new tax — that portion of property taxes devoted to financing education — was brought into the formula.

Then the first energy shock hit the system and Canada abandoned the principle of equalizing all energy rents. Henceforth, "basic" energy revenues (those existing in 1973/74) would continue to be equalized to the national average, but only one-third of any "additional" energy revenues would enter the formula. In the 1977 arrangements, revenues were reclassified to incorporate 29 specific revenue sources. Treatment of energy resources was altered to allow 50 percent of all energy revenues (whether "basic" or "additional") to enter the formula. This latter provision turned out to be a mistake, since Ontario almost immediately qualified for equalization.

In the 1982 renegotiations, this "Ontario" issue was resolved by way of two initiatives. The first was retroactive legislation to strip Ontario of its equalization entitlements. The second and more significant step was to remove Alberta from the formula. As compensation, the Atlantic provinces were also removed. The result was the five-province standard (British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec) which remains in force. Also by way of compensation, henceforth *all* municipal revenues (not just the education component) and 100 percent of energy revenues would enter the formula (but the Alberta energy *base* was removed because that province was excluded from the five-province standard). The 1982 revisions also introduced equalization ceilings and floors in order, among other things, to minimize the volatility of equalization flows.

Other than "housekeeping" changes, the formula has remained more or less intact since 1982, with one important exception. In 1994, effective for the previous year, Ottawa introduced the "tax-back provision." This relates to the situation where a recipient province has 70 percent or more of the total tax base for a revenue source (as can occur for selected resource and energy tax sources, especially since Alberta is no longer part of the standard). In this case, the revenues subject to equalization for this revenue source are scaled back by 30 percent for all provinces. The impact of this measure is to ensure that the equalization program is not confiscatory in terms of revenues arising from tax sources that are highly concentrated in a province. More on this provision later.

To round out this brief history of the equalization formula, I note that equalization was left untouched (except for the tax-back provision) in the context of the major reworking of intergovernmental transfers in the 1995 and subsequent federal budgets.

The Role of the Equalization Formula

What lessons can be drawn from this history? One is that, as the Canadian welfare state broadened and deepened and as provincial programs expanded, the equalization program became more comprehensive. This is precisely what one would anticipate from an application of the federal and citizenship rationales, as *de facto* provincial responsibilities increased. And equalization was supplemented by programs such as the CAP for welfare and EPF for health and postsecondary education — programs that were not alluded to in the above history. (Readers may want to associate these latter developments rather directly with the citizenship rationale for intergovernmental transfers, since they relate to the provision of pan-Canadian public goods and services.) Equalization also served another critical role: without compensatory equalization payments to the "have-not" provinces, it would have been politically impossible to transfer increased income tax room (both corporate and personal) from Ottawa to the provinces.

For present purposes, however, the more intriguing lesson is that the equalization formula itself changed quite radically over time. Indeed, one could probably mount a convincing case that, in the face of emerging events and challenges, the formula was altered to reflect societal views on the appropriate level and distribution of equalization.

For example, consider the 1982 shift to the five-province standard. The two major concerns at that time were to find a way to exclude Ontario from the formula and, relatedly, to ensure that Alberta's mushrooming revenues did not make the system too expensive. One alternative approach that was seriously considered was to make Ontario the standard. This would have resolved both issues — Ontario, by definition, could never have become a "have-not" province if it were the standard, and the energy resource bases would have been excluded. But then-finance minister Allan MacEachen argued against using Ontario as the standard as follows:

> Provinces had expressed concern about the initial [Ontario] proposal because, in their view, no single province can be sufficiently representative of the 10 to constitute a standard, and equalization levels could become unstable over time if they depended on the economic developments in only one province. Provinces were also concerned that such a formula would result in undesirable treatment of natural resource revenues because of the relatively small resource base of Ontario. The federal government has consequently agreed to put into the bill provisions for the more broadly-based [that is, five-province] standard. (1982, 2.)

This suggests, following a line of reasoning frequently expressed by Richard Bird, that the equalization formula is, to a degree, endogenous. That is, the formula reflects the federation's view of what is equitable, appropriate, and acceptable in light of major shifts in political economy, whether policy driven (the evolution of the welfare state) or externally driven (for example, energy shocks). Nonetheless, the formula, once established, became very important because it provided some predictability in terms of future flows of payments. Perhaps more important, at any point in time, the existence of a formula serves to depoliticize equalization and interprovincial redistribution generally. The fact that the formula has changed little since 1982 reflects its comprehensive coverage and built-in safety factors in terms of floors and ceilings.

Time marches on, however, and most analysts and participants alike are approaching the 1999 equalization renegotiations with considerable anxiety. This is heightened by the fact that the rest of the set of intergovernmental transfers has undergone dramatic change. Moreover, in a break with tradition, the future evolution of equalization has recently entered the realm of partisan politics. Former Nova Scotia premier John Savage (1996) not only challenged the decentralist vision of the federation emanating from Ontario and Alberta (based in part on my ACCESS model; see Courchene 1996) but asserted that the growing gulf between the "have" and "have-not" provinces required that *all* of Ottawa's transfers contain special provisions for the "have-nots." In sharp contrast, the emerging positions of Ontario and the other "have" provinces was that fiscal neutrality ought to carry the day — that all preferences for "have-not" provinces should be incorporated in the equalization program and that all other federal transfers should treat similarly situated citizens equally no matter where they reside. And at the federal level, the Reform Party's 1997 election platform embodied a proposal to cut equalization by several billion dollars by focusing equalization largely on the poorer of the "have-not" provinces. All in all, the equalization stakes have seldom been higher.

A Critique of the Unitary-State/Closed-Economy Approach to Equalization

As the spring 1999 deadline for renegotiating equalization payments draws near, a flurry of research is developing a case for a much more comprehensive and egalitarian approach to equalization.[8] This approach — largely, though not wholly, modeled on the Australian experience — is based on the unitary-state / closed-economy (US / CE) model. Indeed, the theoretical literature on equalization generally gives pride of place to this approach, rather than to the notion that, as I have argued, equalization should draw its rationale from federal principles. Accordingly, before moving on to develop a set of design and implementation principles for equalization, I must first address and assess this US / CE concept.

Under the US / CE approach to equalization, the Canadian transfer system would have the following characteristics, among others:

- The equalization standard would be the national-average standard.
- Provincial revenues would be leveled both upward and downward to this per capita national-average standard.
- Only the rich provinces would be responsible for financing equalization.
- Financing could take place in one of two ways: (i) transfer revenue directly from "have" to "have-not" provinces — that is, equalization would take the form of an interprovincial revenue-sharing pool, as in the German federation; (ii) offset the excess fiscal capacity of the "have" provinces against cash transfers from other federal-provincial transfer programs.
- A further variant, not always endorsed by the proponents of US / CE equalization, would be to extend equalization to the expenditure side, again with symmetric upward and downward leveling.

With US / CE equalization, all provinces would end up with *identical* per capita revenues if they levied taxes at the national-average tax rate. Alberta, with its low PIT rates and lack of a provincial sales tax, would end up with much less than average per capita revenues unless, of course, it moved its PIT and sales tax rates to the all-province average.

One significant difference between recent research on US / CE equalization and that conducted in the early 1980s is that the former recognizes that the model derives from an explicit unitary-state framework. For example, underpinning the fiscal-equity approach to equalization (elaborated below) is the concept of broad-based horizontal equity; as Boadway puts it,

> persons who are equally well off in the absence of government should also be equally well off in its presence. This implies that differences in [net fiscal benefits] arising from fiscal decentralization [that is, from the operations of provincial budgets] ought to be undone. (1998, forthcoming.)

The net result, as Boadway notes, is that

> equalization of this sort essentially makes the financial structure of the federation comparable to what it would be if the country was a unitary nation with a single national tax system and uniform public services applying across all regions. (Ibid.)

Hobson notes that "the standard used here has been the level of implicit equalization that would exist in a unitary state" (1997). In essence, therefore, the role of US / CE equalization is to convert the operations of a de-centralized federation into the "virtues" of a unitary state.

One reason the US / CE model is so influential is that there is no comparable federal approach to equalization in the literature; indeed, the federal approach lacks the precision of the US / CE model in generating precise formulas for equalization. To be fair, the proponents of the US/CE model do allow for some modifications when it runs counter to, say, constitutional provisions. In this sense, the US / CE approach is as much a benchmark for assessing the status quo as a model that ought to be implemented.

As a final introductory aside, readers will note that I have focused thus far only on the unitary-state component of the US / CE model. The closed-economy implications will be highlighted later.

The US/CE Model in Theory

Typically, the extensive theoretical literature on equalization starts by defining an individual's "aggregate" income as the sum of his or her earnings or market income (*w*) and net fiscal benefits (NFBs) — the difference between benefits received from government expenditures and taxes paid. In equilibrium, individuals will ensure, via migration, that their aggregate incomes are the same (net of migration costs) across different provinces. Assume, initially, that migration costs are zero and that NFBs are not identical between provinces i and j. Specifically, let NFB_i exceed NFB_j.[9] These NFB differentials provide the analytical basis for what the theoretical literature refers to as the *fiscal efficiency* and the *fiscal equity* arguments for equalization.

Fiscal Efficiency

Consider fiscal efficiency first. Output maximization requires that $w_i = w_j$ — namely, that individuals distribute themselves across jurisdictions until their market-based marginal products everywhere are identical. However, if $NFB_i > NFB_j$, then people will move to province i (and in the process may drive down w_i) to ensure that their overall aggregate income is equal regardless of jurisdiction. In other words, individuals would be willing to accept lower market incomes in i (that is, $w_i < w_j$) as long as this is offset by $NFB_i > NFB_j$. This is inefficient, or *fiscal-induced*, migration. The solution proposed in the theoretical literature is to provide equalization payments to province j in order that $NFB_i = NFB_j$, which then implies that migration will ensure that $w_i = w_j$ — that is, that migration will be efficiency driven, not NFB driven.

However, making the case that differing NFBs require US / CE equalization implies at least three key assumptions. The first and most important is that an increase in revenues in province i or j means that NFBs in province i or j have also risen apace. This is a truly heroic assumption since it implies that increases in tax revenues will never be capitalized in wages, rents, and the like. Thus, one can adhere to the theoretical notion that differing NFBs across provinces ought to be equalized without adhering to the view that this implies US / CE equalization. Indeed, as noted in the earlier reference to the US system, if capitalization is "full," then differences in per capita provincial revenues do *not* alter provincial NFBs. Surprisingly, the theoretical literature essentially ignores capitalization.[10] More on this later.

The second assumption, while much less critical, is nonetheless instructive — namely, that the US / CE approach requires eliminating differential NFBs for similarly situated individuals in different provinces. In fact, it will not and, indeed, cannot. Equalization payments are made to provinces, not to individuals. Eliminating NFBs across similarly situated individuals in different provinces would require that all provinces allocate taxes and expenditures across individuals in an identical manner. This is highly unlikely, so that even with full revenue equalization, identically situated individuals in province i will have different NFBs than those in province j, although these differences may well be small compared with the pre-equalization situation. In other words, the underlying theory focuses on individuals, not on provinces *per se*. Hence, the logic points to grants to individuals, not to provinces.

To be fair, proponents of full equalization fully recognize this problem; their response is to argue that paying equalization to provinces is a second-best approach to the efficiency issue, since the first-best (transfers to individuals) is ruled out. The result is that provinces are given transfers that, if they so wish, *could* be distributed to their citizens in a manner that would serve to eliminate differential NFBs. But since provinces are, in practice, unable to do this even if they wanted to, it calls into question the use of such a model to derive the appropriate aggregate level of equalization.

To see this, it is useful to focus on the potential implications of the recent federal decision to allow provinces to shift from the current tax-on-tax approach for their share of the PIT to a tax-on-base or tax-on-income approach (see Courchene 1998a). Suppose that Alberta opted for a flat PIT rate while Nova Scotia opted for a highly progressive tax structure. Other things being equal, high-income Nova Scotians would then be tempted to migrate to Alberta to take advantage of lower PIT rates. Even under US/CE equalization, this would result in provincial-policy-induced NFBs. But these NFB differences should not be subject to equalization, since they represent preferences of provincial governments. Thus, even under US/ CE equalization, NFBs would not be equalized for similarly situated individuals in different provinces. This being the case, why formulate the efficiency case for comprehensive equalization in terms of individual NFBs?

The third assumption relates to the degree of interprovincial mobility. Thus far in the analysis, migration has been assumed to be costless. If one assumes that there are costs to migration, as there surely are, then NFBs across provinces can differ by these costs (appropriately discounted) without triggering fiscally induced migration. And if citizens are immobile across provinces, then NFBs could vary all over the map with no implications for the efficiency case for equalization. The assumption of zero mobility is, no doubt, off base, but so is full and costless mobility.

None of this assessment is meant to downplay potential efficiency issues arising from differing NFBs across provinces, provided one discounts for provincial priorities relating to taxation and expenditure policies. Increases in differences in NFBs across provinces (although not necessarily increases in fiscal capacity, as noted under the first assumption) *would* trigger migration, and this fiscally induced migration would be inefficient from a national output perspective. But this is not the key point at issue here. Rather, it is whether there is a case on efficiency grounds for US/CE equalization (up and down) of provincial revenues. Actually, many proponents of full equalization are shifting emphasis away from the fiscal-efficiency case (and toward the fiscal-equity case) because empirical evidence suggests that the efficiency gains may not be very significant in any event.[11]

Fiscal Equity

The equity argument for comprehensive equalization focuses directly on differences in NFBs across provinces. Under what has come to be referred to as broad-based horizontal equity, the underlying assumption is that persons who are equally well off in the absence of government should also be equally well off in the presence of government. And this relates to both levels of government. Hence, the role of the federal government under broad-based horizontal equity is to design discriminatory or inequitable policies (essentially via equalization) *vis-à-vis* provincial governments so as to undo any differential NFBs that arise because of provincial policies. This, as Boadway suggests, implies turning the federation into something comparable to a unitary state. *Surely, however, broad-based horizontal equity is the very antithesis of federalism*.

To be sure, proponents of comprehensive equalization recognize, albeit reluctantly, that it may be inappropriate in a federal system (for constitutional reasons, for example) for the central government to "undo" the results of fiscal decentralization. In other words, they typically refer to the alternative of narrow-based horizontal equity, where each level of government would treat its citizens equitably. Specifically, under narrow-based horizontal equity, the central government would take the fiscal actions of the provinces as given. Or almost. The important caveat is that some provincial revenue categories (especially such source-based revenues as energy rents) generate significant NFBs for citizens of the relevant province, in part because these revenues escape federal taxation (this is the result of section 125 of the Constitution, the "Crown cannot tax the Crown"). Thus, the application of narrow-based horizontal equity would still require that these NFBs be included (imputed) in individuals' incomes for federal income tax purposes. Since this is impractical, the second-best approach would be to equalize these source-based NFBs at a rate equal to the federal average tax rate. Note that the funding for this equalization would come from provinces with these NFBs, either via a direct transfer from high-NFB provinces to low-NFB provinces or as an offset against cash transfers from other federal transfer programs.

In a 1982 report, the Economic Council of Canada (ECC) took the position that, in general, broad-based horizontal equity is the appropriate concept:

> In our judgment, ...there is little ethical support for the view that residents of a province have some form of property right to the benefits that accrue to them simply by virtue of living in a province with a higher-than-average per capita income. (P. 30.)

This led the ECC to argue in favor of comprehensive equalization for all non-source-based taxes (essentially all nonresource revenues). In terms of resource revenues, however, the ECC did recognize the constitutional assignment of resources to the provinces and, therefore, argued that the proportion of resource-based revenues that would be subject to comprehensive equalization would be limited to the average federal income tax rate.

While the theoretical literature retains a strong preference for broad-based equalization across the board, the fact that provinces are assigned property rights over natural resources frequently leads US / CE proponents to the ECC-type compromise: comprehensive equalization of all nonresource revenues and comprehensive equalization of a portion of resource revenues.

As was the case for the efficiency grounds for equalization, the equity approach runs into major hurdles, such as the direct linking of increased revenues with increased NFBs and the substitution of transfers to provinces for transfers to individuals (since both the equity and efficiency models relate to individuals rather than to provinces *per se*). Beyond these concerns, however, the equity case runs into another key issue. If the focus is on ensuring that individuals have access to similar NFBs, then the solution could take the form of migration subsidies to allow individuals to move to provinces with high NFBs. This may well run counter to the efficiency case for the US / CE model, but the focus here is on equity. The point is that, in a unitary-state model, fiscal equity could be addressed either by *in situ* transfers or by migration subsidies. To ignore the latter in the context of a unitary-state model involves the “importing” of federal considerations. While one may not favor large population shifts in a federation, this is not the issue: a unitary-state approach to fiscal equity should be indifferent to how NFBs are equalized. But it is not.

US/CE Equalization in Action

Before subjecting this conceptual approach to further analysis, it is instructive to assess the implications of US/CE equalization in more detail.

Conveniently, Hobson develops the details of what it might look like in the Canadian context. He approaches what he refers to as the “ideal” equalization system in the following philosophical comment:

> The essential point is that a broad-based notion of horizontal equity coupled with the objective of attaining an efficient allocation of resources across provinces would require full equalization of all revenue sources, including resource revenues, to a national average standard. *In effect, this would replicate the outcome in the unitary state while allowing for the full benefits of local decision making.* (1997; emphasis added.)

The results of this model appear in Table 1. Row A reproduces actual equalization for fiscal year 1994/95, where the equalization standard is the existing five-province standard. Row B then presents the “net” equivalent of the actual system. Implicitly, Ottawa finances the $8.476 billion equalization in row A by levying taxes on all Canadians. (Estimates of Ottawa’s share of revenues, by province, appear as row 4 of Table A-1 in the Appendix.) The “net” equalization in row B equals actual equalization (row A) minus the amount of financing for equalization derived from each province (the row 4, Table A-1 shares multiplied by $8.476 billion). Quebec’s total is now $2.037 billion — that is, $3.868 billion from row A minus its citizens’ share (21.58 percent from row 4, Table A-1) of financing the $8.476 billion of equalization in row A. The –$3.579 billion figure for Ontario represents what that province’s residents pay for equalization (that is, 42.22 percent of the $8.476 billion).

However, Ottawa’s share of revenues across provinces does not correspond to the provinces’ shares of fiscal capacity. This is especially the case for Alberta, where Ottawa does not have the constitutional right to tax energy royalties accruing to the province. Row C presents Hobson’s “ideal” (US/CE) equalization, where the negative and positive entries reflect the corresponding negative and positive entitlements resulting from the application of the “ideal” equalization formula (with the national-average standard replacing the five-province standard). This is full US/CE equalization in that Ontario’s, Alberta’s, and British Columbia’s negative entitlements are somehow “transferred” to finance the positive equalization entitlements of the “have-not” provinces. Alberta is the clear loser, for reasons alluded to above. Likewise, Ontario “gains” because its share of funding of equalization falls off dramatically. And the “have-not” provinces obviously gain because *none* of the funding for equalization comes from their residents. And so on.

Hobson is realistic enough to focus on these results as “benchmarks” since, short of outright confiscation, there is no way for Ottawa to force Alberta to shell out its $5.73 billion share of the equalization bill. In the limit, Ottawa could reduce Alberta’s CHST cash transfer to zero but, under the reduced level of cash transfers associated with the CHST, this offset would amount to less than one-fifth of Alberta’s alleged financial responsibility under the row C “ideal” equalization. Not surprisingly, most advocates of US/CE equalization favor cash transfers rather than tax-point transfers for other programs since this would

Table 1: ***Actual vs. US/CE Equalization, fiscal year 1994/95***

	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta	BC	Total, Receiving Provinces
						($ millions)					
A. Actual equalization (gross)	950	190	1,059	918	3,869	0	1,079	413	0	0	8,476
B. Actual equalization (net)[a]	841	159	804	722	2,039	–3,579	809	191	–874	–1,112	5,566
C. Comprehensive equalization[b]	1,007	201	1,149	982	4,576	–1,464	1,171	409	–5,730	–2,300	9,494

[a] Row B "finances" row A by allocating the cost of row equalization across provinces in accordance with the shares of Ottawa's revenues that come from these provinces (row 5, Table A-1). Since this becomes a net scheme, the sum of entitlements across all provinces equals zero.

[b] Row C embodies a national-average standard and is financed by the negative entitlements of the "have" provinces. Overall, the sum of across "have" and "have-not" provinces equals zero, by definition of a net system.

Source: Hobson 1997, tables 2, 3, 5.

allow for larger cash offsets to effect the leveling down of "have" provinces' revenues.

Now to an assessment of US / CE equalization based on both the earlier analytical points and the data in Table 1. Apart from the obvious point that this is a unitary-state approach, the assessment begins by focusing on capitalization or, rather, the lack of it.

Capitalization

As I see it, the key deficiency of the US / CE model is its assumption that an increase in revenues is linked on a direct one-to-one basis with an increase in net fiscal benefits — in other words, that there is *zero capitalization* arising from increases in levels of economic activity and, therefore, from rising tax revenues. But this is demonstrably wrong.

Wages, salaries, and rents are all higher, often considerably so, in Ontario, Alberta, and British Columbia than they are in Atlantic Canada. For our purposes, it does not matter whether higher tax bases are capitalized via wages and rents or whether the causation runs in the other direction — that is, to compete in a progressively integrated North American market, Toronto, Calgary, and Vancouver must be competitive, in terms of compensation, with New York, Houston, and Seattle, with the result that tax revenues will correspondingly rise. As Richards (1997) notes, roughly 60 percent of provincial expenditures take the form of wages of some sort or another — teachers, civil servants, social workers, health care providers, and, indirectly, welfare recipients. Thus, if, say, Ontario's revenues are 15 percent higher than those in the Atlantic region but its private sector wages are 25 percent higher (where the 15 percent is 60 percent of the 25 percent), the province enjoys *no increase in net fiscal benefits* despite its higher revenues.

Indeed, why not assume, as Americans do, that capitalization of revenues is 100 percent, so that, under this scenario, the US / CE model's appropriate level of equalization payments is *zero*. The assumption that there is zero capitalization of revenues and resource rents has absolutely no *a priori* empirical claim over an assumption of 100 percent capitalization. Indeed, the latter would be the prevailing assumption of mainstream economists, whatever their social conscience. Thus, one can buy into the theoretical notion of equalizing NFBs without associating this with the US / CE equalization data Hobson offers.

One can view this from the other perspective. Under the US / CE equalization scheme shown in Table 1, Ontario would have per capita revenues that are identical to those in the Atlantic provinces, since any excess Ontario fiscal capacity would be "confiscated" to ensure this equality. Is Ontario supposed to reduce its public sector wages for university professors, social workers, doctors, and the like to those prevailing in Fredericton? Should it reduce welfare benefits to New Brunswick's levels, which, even after the Harris government's cuts, are half of Ontario's?

Beyond the capitalization issue, Hobson (and the literature) is silent about the incentive implications of US / CE equalization. Why would Alberta bother levying royalties in the first place, if they were to be fully confiscated by US / CE equalization? Collecting these royalties is hardly costless: they require Alberta to make enormous investments in physical and human infrastructure, which would end up as *net costs* to the province, since the revenues (except for Alberta's population share of the royalties) would go elsewhere.

The bottom line is that US / CE equalization has little to say about the key issue — net fiscal benefits across provinces. Until proponents of the US / CE model introduce and justify estimates relating to the degree of capitalization across provinces, the implementation aspects of their analyses should be ignored. And in any case, US / CE equalization system does not reflect, and certainly does not respect, the constitutional division of powers in the resource area.

True, unitary-state equalization theorists can point to Australia as a working example of a version of US / CE equalization. But the egalitarianism of Australian society — with its centralization of welfare benefits, uniformity of pay scales, and so on — predates its current equalization system. As noted earlier, Australia's is a situation where federal fiscal relationships accommodate the underlying nature of the federal society. But even here, as globalization erodes Australia's physical isolation, its equalization system is evolving by introducing a version of capitalization (with respect to wage rates, for example) into its calculation process. Importing the Australian approach would result in the total upheaval of Canada's system, much as Germany's version of inter-*Länder* revenue sharing has led to a dramatic version of *transfer dependency* for the former East German *Länder*. And it is not as if transfer dependency, under current arrangements, is a foreign issue to the Canadian economy (see Courchene 1994, chap. 4).

International Interdependency

At this juncture, I finally broach the closed-economy component of the US / CE model. Not only does Canada share a border with the world's superpower, which has a quite different philosophy with respect to taxes and expenditures, but all provinces except Prince Edward Island now export more to the rest of the world (some export more to the United States alone) than they do to the rest of Canada (Courchene and Telmer 1998, table 9.1). Thus, to devise for Canada an internal "ideal" revenue-sharing system that is completely impervious to this reality runs the risk of committing societal economic suicide. Like it or not, Canada's economic survival requires that we pay appropriate attention to the nature of the net fiscal and, indeed, societal benefits that arise south of the border. Canada is not a closed economy, and to focus on the ideal fiscal-sharing community for such an economy almost certainly would run afoul of comparative advantage issues in the progressively integrating North American (and global) market. The challenge for Canada, then, is to proceed as far possible on the east-west transfer and equalization fronts without imperiling north-south comparative and competitive fronts.

Yet, to the best of my knowledge, none of the Canadian-based literature on equalization refers to the fact that Canada is integrally related, economically and even fiscally, to the North American market. If, by introducing some version of a US / CE equalization system, Ontario is left with a revenue base that cannot match the public sector benefits of Michigan, or Alberta is saddled with a tax-expenditure mix that cannot compete with that of Texas, what would have been accomplished?

More to the point, to try to match the combined private and public sector benefits of Michigan or Texas inevitably would involve Canadian jurisdictions in a process that effectively would "capitalize" any revenue bases they generate, a capitalization that equalization theorists totally ignore. It is not just that the emperors of theoretical equalization have no clothes but that they would leave the upper half of an integrated North American economy competitively naked.

This said, however, I do not mean to reject the theoretical analysis totally. The concept of net fiscal benefits across jurisdictions, if correctly measured and embedded in the larger North American economic and fiscal reality, is important to the evolution of Canadian fiscal federalism. What I have tried to show in this critique is that the transfer of the NFB theory into US/CE equalization is demonstrably inappropriate.

Summary

It is important to recognize that some aspects of US/CE theory merit further consideration. First, other things being equal, Canada should avoid situations where otherwise optimally or efficiently allocated factors of production in "have-not" regions are enticed to migrate in response to differentials in NFBs (see Graham 1964). In this sense, the NFB calculus, if appropriate account is taken of capitalization effects, does represent a valuable benchmark for assessing whether Canada is over- or underequalizing. But such a calculation would have to incorporate the impact of the broader set of federal transfers, including EI.

Second, there is probably a case for moving the equalization standard back to a national-average standard.

And, third, even after applying corrections for capitalization, one should probably be concerned with differences in fiscal capacities across provinces on the one hand and the manner in which Canada funds its equalization program on the other. However, both of these latter issues have been around for a long time. For example, both were front and center in the 1982 reworking of the formula, as elaborated earlier.

Where, however, does all of this leave us in terms of the "grand design" for equalization? The answer is that it leaves us where we always were: intergovernmental transfers remain the cornerstone of the Canadian federation. They are an integral part of the "high politics" of the federation, given their inherently zero-sum nature. Yet, over the years, Canadians have always found the requisite "political logic" and the "political fit" (to use Milne's terms) to maintain these programs because the federal rationale resonates well for *all* provinces, albeit for different reasons, and because the citizenship rationale for equalization and other transfers serves as a key and enduring part of Canada's national identity.

Nonetheless, while the existing equalization program will continue to have pride of place in the future, it is probably slated for some further evolution. Identifying a set of principles on which to base that evolution is the role of the remainder of this *Commentary*.

An Outline of Reform Principles

In isolating a set of design and implementation principles that ought to inform the evolution of equalization and fiscal federalism, I focus on two conceptually distinct but nonetheless related types of principles: those that stem from design or implementation problems associated with Canada's existing programs and practices, and those that are not part of the existing system but ought to be in light of the emerging political economy of the Canadian federation.

For the most part, my analysis assumes that the end result should be revenue neutral. Essentially, I am interested in principles relating to the structure of, and incentives within, the existing intergovernmental transfer arrangements. This means that, by and large, I shy away from the politically charged issue of whether the aggregate level of equalization payments is too high or too low, although in the final section I address a range of issues and forces that may influence both the level and distribution of intergovernmental transfers.

The range of principles developed in the following analysis is not meant to be exhaustive. Boadway (1998) also develops a set of design principles as well as a valuable catalogue of some outstanding structural issues that in many areas extend beyond the range of the principles I highlight here. Despite important differences in the approaches Boadway and I adopt, readers will profit by comparing the two.

A Five-Province or a National-Average Standard?

I begin with the choice of the equalization standard. Specifically, should the system jettison the five-province standard (FPS) and once again embrace a national-average standard (NAS)?

Other things being equal, an NAS is probably preferable to an FPS. One reason is that an NAS is far more intuitive and presumably resonates better with society's view of concepts such as equity and transparency. Moreover, the FPS has some peculiar analytical flaws. For example, the transfer of a company headquarters from Toronto to Calgary would reduce equalization for all provinces, since Ontario is in the FPS but Alberta is not. Under an NAS, locational shifts of tax bases would not affect the standard. While these and related analytical issues play well in the classroom, their empirical relevance may not be very substantial. Nonetheless, an NAS does have a more appeal than an FPS.

However, the relationship between the FPS and the NAS has altered considerably since 1982. Before that date, the FPS was about 91 percent of the NAS. In recent years, the FPS has been running as high as 98 or 99 percent of the NAS. As Clark (1998) notes, estimates for 1996 reveal that the NAS yielded $5,200 per capita whereas the FPS equaled $5,093 per capita (97.9 percent). Might not the time be right to switch to the NAS, especially with ceiling provisions in place to prevent a rapid upward escalation of equalization in the face of another energy boom? The complication is that, even with the FPS as high as, say, 98 percent of the NAS, this would still be an expensive shift. From the above data, the increase in the standard for 1996 would be $107 per capita, which, with roughly 12 million people living in the receiving provinces, would mean increasing equalization by about $1.3 billion, or roughly 16 percent.

Two caveats are in order here. First, it is possible, of course, for the FPS to exceed the NAS, at which point the receiving provinces would no doubt quickly cease to argue for the NAS.

The second is the more intriguing. Were one to apply the tax-back provision across the board — that is, apply the 70 percent revenue provision for a concentrated revenue source to *all* provinces, not just the recipient ones — then shifting to an NAS would likely *decrease* equalization because the energy rents and royalties from Alberta that enter the formula would be scaled down. Phrased differently, it would seem inappropriate to bring *all* of Alberta's energy revenues into the formula unless similar treatment were applied to concentrated resource revenues in Newfoundland

and Nova Scotia, among other provinces. From this perspective, the FPS probably already exceeds the NAS.

Setting this latter point aside for the moment, shifting to an NAS would provide some flexibility in accommodating some of the proposals I address later. Since many of them would call for a decrease in equalization, this could be finessed via a shift from an FPS to an NAS.

Confiscatory Taxation and Transfer Neutrality

In the earlier discussion of design principles, I noted that comprehensive equalization — up and down — would mean that Alberta, for example, would have little incentive to collect energy royalties since they would be fully confiscated. What is often ignored is that confiscatory taxation problems also exist under Canada's current equalization program. Specifically, these arise for "have-not" provinces that are not part of the FPS. For example, suppose that all tax bases for "have-not" New Brunswick were to increase by 5 percent. Since this increase, by definition, would have no impact on the FPS, New Brunswick's revenues would fall by precisely the amount that its own-source revenues would increase.[12] In other words, the operations of the equalization program are fully confiscatory with respect to any tax-base-generated increase in revenues in the Atlantic provinces.

The situation of "have-not" provinces Saskatchewan and Manitoba that *are* included in the FPS is only slightly better. If their revenue bases increased, they would retain only their share or "weight" in the FPS, which is about 5 percent. Were one to adopt an NAS rather than an FPS, the degree of confiscation would lessen somewhat for New Brunswick (since its tax base would then be included in the standard) but would worsen for Saskatchewan (since it would have a smaller proportion of the NAS than it currently has of the FPS). In New Brunswick's case, if one assumes that its share of the NAS is similar to its share of federal revenues — that is, 2.31 percent, as shown in row 4 of Table A-1), then the equalization program would confiscate "only" 97.69 percent of any New Brunswick tax-base increase. While the province's overall fiscal position may well improve as a result of an increase in its tax bases (for example, its welfare bill could fall), this high degree of revenue confiscation is surely inappropriate.

A related complication merits attention. For some provinces, such as Newfoundland, the equalization system has been modified to allow less-than-confiscatory tax rates on selected resource revenues, specifically from offshore energy resources. This is the tax-back provision, whereby only 70 percent of revenues of a resource base concentrated in a province enters the formula. This means that, in the presence of this provision, the equalization program for these provinces ceases to be allocatively neutral. If Newfoundland wanted to increase its overall revenues at given tax rates, then it would have to direct its development efforts toward increasing these energy revenues.[13] While there are no doubt any number of excellent reasons why Newfoundland and Nova Scotia should pursue offshore energy development, it is inappropriate for the equalization program, *per se*, to provide additional and overwhelming incentives in this direction.

In one sense, the analytical solution is obvious. If, via economic development policies, the "have-not" provinces increased their tax bases, they should be able to pocket a portion of the revenues associated with this economic development. For illustrative purposes, assume that this portion was 30 percent, which would mirror the tax-back provision. How could equalization be structured to allow this to occur? One obvious approach would be to alter the equalization formula so that "have-not" provinces were eligible to receive only 70 percent (rather than the current 100 percent) of the difference between the equalization standard and their own tax capacity but, *simultaneously*, to increase, or "gross up" the equalization standard such that the equalization flows would remain unchanged, at least in the first instance. Note that part of this grossing up could be accomplished via a shift from the FPS to an NAS. This would, in principle, solve the incentive problem since in future years revenue increases arising from "have-not" provinces' tax bases would be taxed back at 70 percent rather than 100 percent. However, this approach might, as a by-product, complicate the "intuition" associated with the equalization program.

Nonetheless, the confiscatory or near-confiscatory structure of equalization for small provinces represents a serious design flaw in the system. The federation goes to great lengths elsewhere in the tax system to avoid confiscatory taxation, so why has it been allowed to become an integral component of equalization? It seems passing strange that, in this era of heightened global and regional competitiveness, the system ensures that there will be virtually no revenue upside to successful economic development policies in small "have-not" provinces. More to the point, there is no revenue downside to inappropriate policies! Surely, this is an issue that calls for redress. This relates to the design of the equalization program, however, and is not intended as an issue relating to the level of equalization. It follows, therefore, that any move in the direction of offsetting this confiscatory taxation characteristic of the program should not be construed of and by itself as an argument for ratcheting down equalization payments.

The Erosion of the Stabilization Component of Transfers

A formal stabilization program has long been an important adjunct to Canada's intergovernmental transfer system. As initially constituted, the program guaranteed that a province's revenues, at unchanged tax rates, could not fall from one year to the next. Although not articulated as such, the program was probably intended principally for the "have" provinces, since equalization as currently operated provides important stabilizing features for the "have-not" provinces. Over the past decade, however, Ottawa has dramatically scaled back the stabilization program. In the wake of the 1980s' commodity-price crash and the resulting resource-related stabilization claims by Alberta and British Columbia, the stabilization formula was altered to limit payments in any year to $60 per capita. And in 1996, the formula was further altered so that stabilization would apply only if a province's revenues fell from one year to the next (again at unchanged tax rates) by more than 5 percent. In effect, therefore, Ontario's revenues, for example, could fall by 5 percent a year for, say, four years (for a cumulative revenue decline of 18.5 percent) without triggering the stabilization program.

Beyond this, the 50 percent cost-sharing program for the former CAP obviously embodied an important stabilization component, since the federal government financed one-half of any recession-triggered welfare cost. But this stabilization feature was eliminated for the three "have" provinces by the 1990 cap on CAP (which limited the growth of CAP transfers to British Columbia, Alberta, and Ontario to 5 percent a year) and for all provinces when the CHST was inaugurated.

To be sure, the operations of the federal personal and corporate income tax systems do embody an important degree of stabilization, as does the (scaled-down) EI program. Nonetheless, provincial revenue stabilization remains a valid transfer role for the federal government. Indeed, one of the long-standing arguments why Ottawa could not transfer further personal and corporate income tax points to the provinces was that maintaining control over these cyclically sensitive revenues was essential to its capacity for stabilization. (As an important aside, the scaling back of the formal stabilization program strengthens the provinces' case — for the "have" provinces, at least — for converting the CHST cash transfers into a further transfer of PIT tax points [Courchene 1998b]. The issue of a further tax-point transfer will be dealt with in more detail later.)

Ottawa should reconsider resurrecting a stabilization program. In the context of the European Union, Goodhart and Smith (1993) propose a stabilization facility that would address asymmetric shocks to member countries; be timely, but apply for only a limited period; and be a pure stabilization (not a redistribution) facility, which means that stabilization would be triggered not by levels of, say, unemployment or per capita income (since this would be redistribution) but by *changes* in these levels or by deviations from trend.

My purpose is not to press for a brand new transfer — resurrecting aspects of the former program would probably do as well. Rather, I argue that abandoning the stabilization component of the transfer system was not only inappropriate but will likely trigger initiatives on the part of the "have" provinces that would not sit well with Ottawa.

I now turn to a much more highly charged issue, fiscal neutrality.

Overarching Equalization and Fiscal Neutrality

A fourth implementation principle (although some may view this as a design principle) is what the Group of 22 (1996) and I refer to as *fiscal neutrality*: "the proposition that, apart from equalization, federal programs should treat similarly situated individuals equally, regardless of place of residence" (Courchene 1996, 7).

This principle is important for at least two reasons. The first relates to the willingness to maintain the pan-Canadian sharing commitment. Provinces and individual Canadians alike fully accept the principle of equalization and the equalization program as the instrument for delivering monies to "have-not" provinces. Increasingly unacceptable, however, is the notion that other "national" programs (such as EI, training funds, immigration spending, or the CHST) should treat similarly situated Canadians *differently*, based on their province of residence. Indeed, building regional / equalization components into these programs is, arguably, serving to unwind Canadians' support for the transfer system in general and for equalization in particular.

Not surprisingly, this is a contentious issue. As noted earlier, former Nova Scotia premier John Savage (1996) has argued strongly that Ottawa must embody regional / equalization components in programs other than equalization. On the other hand, in pursuing his "fair shares" philosophy, former Ontario premier Bob Rae has suggested (Ontario 1992) that unless Ottawa treated Ontarians in a more even-handed way, Ontario's support for overall equalization could begin to wane. Boothe and Johnston, quoting Rae, present Ontario's position as follows:

> The province warns that the support for equalization "could dissipate" if the current system of transfers is not reformed and the "inappropriate regional biases" removed, and calls for reform to the system so that "the resources available to each level of government match their responsibilities" and "equalizing measures are left to the equalization program." (1993, 3.)

I side with Bob Rae and Ontario on this issue.

The second, related, reason has to do with political bargaining. If the provinces realize that what they failed to win in the equalization negotiations they can then get through the back door of EI, or the CHST, or training funds, the entire transfer system would become politicized and, in the limit, devoid of rules. In effect, Ottawa would become engaged in a one-on-one bargaining process with individual provinces. This would surely be disruptive and destructive to any notion of an equitable transfer system based on a consistent set of rules. And if there are no generally accepted rules, then Rae's warning that support for equalization itself "could dissipate" may well come into play. Thus, fiscal neutrality is an important implementation principle in the evolution of intergovernmental transfers. (As an important aside, however, addressing the non-neutrality of programs such as EI would also have important benefits in terms of the allocation of resources.)

There are two general ways to accomplish fiscal neutrality. The first is to put all "preferential" provincial transfers into the equalization program (which would lead to an enhanced equalization program) and to ensure fiscal neutrality in all other federally run "national programs." Note that my definition of fiscal neutrality means treating similarly situated Canadians equally. It does *not* mean treating all provinces equally. Thus, even if there were no specific regional components to, say, EI, New Brunswickers could still receive more EI benefits, in per capita terms, than Ontarians if there were more unemployed New Brunswickers per capita.

The alternative way to do this would be to allow these national non-neutral programs to exist, but then to reconcile them in the context of an overarching equalization program. Thus, any explicit equalization component in EI would be fully offset by a corresponding decrease in equalization for the province in question. The earlier caveat applies here as well: there may well be good reasons to decrease overall equalization, but these have to be articulated in their own right. The thrust of my proposals relating to fiscal neutrality should not be interpreted as an indirect approach to decrease equalization.

Finally, a separate comment on the CHST is warranted. There is a legitimate on-going debate as to whether the CHST should be defined in terms of equal per capita entitlements (cash plus tax points) or equal per capita cash. I am in the camp that favors the latter, especially since the system is now driven by a $12.5 billion cash floor. As noted in the Appendix, anything other than an equal per capita allocation of this cash transfer would increasingly complicate transparency, let alone the societal view of what is equitable. But let us set this issue aside and focus on the fact that, because of the rolling into the CHST of the impact of the cap on CAP, per capita *entitlements* are not equal across provinces. While Ottawa is committed to halving these differentials in per capita entitlements by fiscal year 2002/03, this is simply not good enough. These inequities in the CHST are highly visible and highly damaging to the fabric of Canada's transfer system. Make entitlements equal now, either by changing the CHST or by subjecting these "top ups" to reconciliation under the equalization program.

This is the minimum acceptable change in the operations of the CHST. More radical options are discussed below.

Temporal Predictability: The CHST

The history of federal transfers is one of a successive set of unilateral federal caps, freezes, and (under the CHST) dramatic cuts. More recently, the system appears to have stabilized somewhat, given the federal commitment to a CHST cash floor of $12.5 billion.

But nothing prevents Ottawa, in its upcoming budgets, from altering that cash floor. This could occur in two quite different ways. One would be a straightforward reduction of the floor, along the lines of earlier CHST cuts. The other, more likely, way would be for Ottawa to argue, for example, that the forthcoming National Child Benefit (NCB) represents spending that relates closely to the goals of the CHST and, therefore, that the value of the NCB will henceforth reduce the value of the CHST cash floor by an equivalent amount. A similar argument could be made for the Millennium Fund, since postsecondary education funding was an integral part of the EPF, now carried over to the CHST.

The provinces cannot, constitutionally, do anything about this, as the Supreme Court has ruled in connection with the cap-on-CAP challenge. While it is foolish to expect complete stability and predictability in intergovernmental grants, the system does need considerably more stability than that which has characterized the past 15 years of federal-provincial fiscal relations.

How can greater stability be achieved?

The obvious solution from the vantage point of the “have” provinces is to convert the $12.5 billion cash floor into the equivalent of a further equalized PIT tax-point transfer. This would guarantee stability in revenue flows to the provinces since these additional tax points would henceforth belong to them. Moreover, the tax points would automatically escalate in value in accordance with increases in income tax revenues.

There are, no doubt, several potential drawbacks to this solution from Ottawa’s perspective. First, it would probably not be very excited about a further transfer of tax points to the provinces. Second, it would likely lose much of its ability to enforce “national standards” if the CHST cash component were converted to tax points. In full recognition of this problem, I argued in my *ACCESS* paper (Courchene 1996) for such a tax-point transfer, predicating it on the existence of a binding commitment by the provinces to promote and preserve some pan-Canadian principles. But if Ottawa cannot be bound to its $12.5 billion cash transfer floor, it is probably also the case that the provinces cannot be bound, short of constitutionalization, to an interprovincial covenant. Hence, this issue remains problematic. The third potential problem for Ottawa (and for “have-not” provinces) is that this tax-transfer approach would generate higher per capita returns for the “have” provinces than for the “have-nots” (even if the NAS were in force).

Other analysts have entered this “options” game. For example, Hobson and St-Hilaire (1994) propose that Ottawa dedicate the tax-point equivalent of the $12.5 billion cash floor to the CHST and then transfer the proceeds to the provinces on an equal-per-capita basis, except that the cash floor would be escalated in line with the growth of the dedicated PIT tax points. From Ottawa’s vantage point, the designation of a share of its own PIT revenues for the CHST would presumably trump the formal transfer of these tax points to the provinces. Among other issues, the continual flow of cash transfers to the provinces would enable Ottawa to enforce national standards. But the provinces would not be out of line in noting that a dedicated allocation of tax points is no different from a dedicated cash floor — both can be changed at will.

In a recent paper, Hermanutz, Robertson, and Smith (1998) propose yet another variant — the Equalized Revenue Share Allocator (ERSA). Basically, the CHST cash would, in the first instance, be allocated in accordance with the provincial shares of federal revenue (row 4 of Table A-1). This CHST (or ERSA) cash would then enter the equalization formula in its own right and all provinces would have their per capita values brought to the standard (FPS or NAS). Although the authors also focus on different distribution approaches — a “no losers” approach, an Ontario standard — their preferred (ERSA) allocation is identical to a further transfer of tax points to the provinces. What both approaches have in common is that the CHST allocations would be fully consistent with the existing equalization formula. But because there would be no formal tax transfer, Ottawa would still retain its ability to leverage national standards.

Some recapitulation is warranted. The CHST poses a problem for the transfer system because it violates fiscal neutrality. In the previous section, I argued that one solution would be to make equalization an overarching program and to include as an equalization offset any non-neutral provincial allocation. In this section, I have focused explicitly on the CHST, and particularly on CHST cash, in terms of both how it might be allocated and how it could be made more predictable. Without taking a position on these contentious issues, I have at least two observations that flow from the analysis.

First, the federation needs some new instruments or mechanisms to ensure the longer-term predictability of intergovernmental transfers. Second (and here I confess to a bias), the straightforward, transparent, and societally equitable approach of allocating CHST cash on an equal-per-capita basis should emerge as an inviting option for the "have-not" provinces, since the proposed alternatives (ERSA and formal tax-point transfers, both of which would be equalized under the existing equalization formula) would leave them (relatively) worse off than equal-per-capita cash. Of course, their preferred option would probably be to call on Ottawa to maintain these equalizing features in nonequalization programs.

Expenditure Needs

The concept of equalization as the overarching fiscal reconciler of all transfers or, equivalently, the implementation of fiscal neutrality has led several provinces to argue that Canada should move, in the fashion of Australia and, to a lesser extent, Germany, to extend equalization beyond the revenues side to incorporate "expenditure needs." In their view, the "have-not" provinces have greater "needs" in selected areas and, therefore, merit revenues in addition to those that the system of revenue equalization delivers.

It is hard to argue against the principle that provinces with greater expenditure needs deserve additional revenues. If there is a principled case against introducing expenditure needs into equalization, it would probably run as follows. Equalization payments are unconditional transfers — they can be spent as and where the recipient provinces please. However, adjusting equalization payments for expenditure needs assumes, at least implicitly, that the provinces are actually spending these additional funds in high-need areas. One could, I suppose, take the high road and argue that needs could be calculated across a "representative" bundle of expenditures — in which case, needs equalization would allow all provinces to provide an equivalent bundle of expenditures, should they so choose.

As the Australian experience with needs equalization appears to suggest, however, this approach can run into problems. As noted in the earlier survey of the Australian system, it now appears that special interest groups in that country have realized that a component of the Commonwealth government's Financial Assistance Grants to states are related to specific expenditure categories. This had led those groups to lobby for the funds to be spent in the intended areas or, failing this, to have the Commonwealth government remove those expenditure categories from the equalization (unconditional) grants and transfer them to (conditional) Specific Purpose Payment grants. These pressures are presumably part of the process that is influencing the evolution of Commonwealth-state grants in Australia in the direction of conditionality: from a position a decade or so ago where unconditional grants exceeded conditional grants, the reverse is now true.

The general point here is that needs-related equalization does not fit well into the emerging unconditional direction of the evolution of Canada's intergovernmental transfer system. If Canada does pursue needs-related equalization, and if it wishes to maintain the unconditionality of transfers, then it has to find some rather general economic and social indices by which to assess or allocate need, rather than focusing on detailed expenditure categories.

However, the real problem with equalizing for expenditure needs relates more to implementation than to principle. As noted, the perceived wisdom on this issue is that needs equalization, whether incorporated in equalization or in the operations of the CHST, would result in larger transfers to the "have-not" provinces. But this is far from evident. The Australian approach to needs equalization favors sparsely populated areas, which arguably would benefit equalization-recipient provinces. The German approach to needs, however, rewards urban agglomeration and density generally, which would tilt needs toward the richer provinces.

In earlier research (Courchene 1995), in which I focused on the components of the CHST (welfare, medical and hospital insurance, and postsecondary education), the weight of evidence I presented appeared to point in the direction of *higher* needs for provinces such as British Columbia and Ontario. This was based not only on capitalization criteria — the comparative wage costs of public services such as medicare, hospitals, universities, and social workers, which, ideally, should relate not to actual public sector wages but to private sector equivalents — but also on comparative need indices (at the time, Ontario had the highest per capita welfare caseload of any province). I concluded that any consideration of costs and needs would suggest that equal-per-capita cash for the CHST would emerge as a preferable option for the "have-not" provinces. Thus, it is far from obvious that a thoroughgoing approach to expenditure needs would lead to increased benefits for "have-not" provinces. Indeed, as noted, the opposite would in all likelihood be the case.

My 1995 analysis was conducted, however, in the context of the existing set of transfers to the provinces, including transfers to persons. For example, Newfoundland's welfare caseload does not mirror its high unemployment rate partly because programs such as The Atlantic Groundfish Strategy (TAGS) and EI provide important and pervasive income-support alternatives to welfare. Thus, the appropriate conclusion is that, *under the existing set of transfers*, the "have-not" provinces in general would likely find their transfers reduced if expenditure needs were taken into account. But this conclusion presumably would have to be altered considerably if fiscal neutrality became the order of the day — that is, if TAGS were subject to sunset, if the CHST embodied equal-per-capita cash, or if EI were stripped of its regional preferences. Under this scenario, some temporary or permanent enhancement of equalization could be accomplished by needs equalization.

This is really a reiteration of a previous point: to move to full fiscal neutrality without some temporary or permanent adjustment to equalization would be unconscionable. This would be the case even if the nonequalization programs that embody equalization-type components are deemed inappropriate, since the existing policy "equilibrium" with respect to these programs emerged slowly over decades. Any unwinding of these preferences would also have to proceed gradually.

Resource Rents and the Funding of Equalization

The relationship between resource rents, particularly energy rents, and equalization has been complex and controversial since the inauguration of equalization in 1957. The current manifestation of this interaction is the five-province standard. Yet, not only does the exclusion of Alberta's base from the equalization standard mean that, at present, the FPS is less than the NAS but Ottawa's share of the sources of funding from Albertans to finance equalization is much less than the province's share of all-province revenues. This latter issue is front and center in the US / CE system, where Alberta's equalization bill would be in the order of $5 billion.

Several issues here merit attention. First, the typical approach to resources under Canada's representative-tax-system approach to equalization is to try to define the tax base in terms of some output measure. But the output of a given mine, for example, may be a poor indicator of the "rent" associated with that mine, and it is these potential rents that ought to constitute the appropriate tax base. Beyond this, not all resources are treated similarly. For example, during the energy price spikes of the 1970s, while hydro resources shared in the rent increases, these rents were largely transferred to the electricity-consuming public in the form of lower-than-opportunity-cost prices and, therefore, did not enter the formula. To limit the resource-related equalization issues to the fossil energy sector is clearly inappropriate — that is, it is inappropriate to focus on Alberta's energy rents while ignoring the rent potential of, say, Hydro-Québec. The problem is that assessing the potential rents of the resource sector would be a statistical and political nightmare. Difficult as this may be, this issue will have to be addressed if Ontario Hydro is privatized.

Second, resource bases differ in another key manner from most other tax bases in that not all provinces have resource tax bases. This is important because the equalization formula effectively assumes that there are no costs associated with raising revenues from a given tax base. This is an acceptable compromise when all provinces have access to the tax base (for example, sales from alcohol or tobacco) since the collection costs are, absent economies of scale, presumably roughly equal in per capita terms. But this is not the case for the resource categories. Why should a province with no base for a given resource revenue expect to receive its equalization share of *total* revenues? Should not the formula equalize only that portion of resource revenues in excess of what it costs to collect them? These costs are far from trivial since they typically involve substantial infrastructure costs. Indeed, part of Newfoundland's concern about Hibernia relates to precisely this issue — gross revenues would enter the formula without any consideration of what the province has spent developing the resource base. As noted, the approach adopted within the FPS is to provide an equalization override for offshore oil (the 70 percent offset provision). An alternative approach would be to equalize only "net" revenues (total revenues less the costs of collecting the revenues) for these resource categories.

Then there is the capitalization issue once again. More so than for other revenue sources, increases in resource revenues probably tend to be subject to capitalization in terms of increases in wages, rents, and so on. To the extent that this is the case, the capitalized value will be reflected in increases in revenues from other revenue sources. This is, of course, the earlier issue of whether one can assume that an increase in revenues (in this case resource revenues) leads to a one-to-one increase in NFBs. It is no doubt going too far to assume that resource rents are fully capitalized and, therefore, that they should be excluded from the formula. But so is the option of fully equalizing gross resources revenues, since this is effectively "double equalizing" to the extent that these rents are capitalized and reflected in increased revenues from other tax sources.

One approach to all of this in the above analysis was to generalize the 70 percent tax-back provision to apply to all resource revenues and, in the process, convert the FPS to an NAS. In the context of the issue at hand, one could interpret this provision as a rough-and-ready approach to the capitalization and net-cost issues raised in this section.

The main conclusion I draw from the set of resource challenges elaborated here (and one could easily add to their number) is that the general area is a theoretical and empirical minefield. It is simply not possible to generate a first-best solution for the relationship between resources and the equalization formula, even if there were no constitutional implications. It is one of those issues that one copes with rather than solves. Indeed, the entire history of the equalization formula is one of a successive series of accommodations. Here, the future will repeat the past.

These concerns aside, yet another resource issue merits attention: should the financing of equalization be more related to the various provinces' fiscal capacities? This issue came to the fore in the context of the 1982 shift from the NAS to the FPS. At that time, Ontario argued that Alberta's mushrooming energy rents were triggering huge increases in equalization that Ontario, since it accounted for more than 40 percent of Ottawa's consolidated revenue fund, was largely funding. As noted, the 1982 (and current) solution was to exclude Alberta from the equalization standard. Among the alternative proposals at the time was an interprovincial revenue-sharing pool for resources. To this proposal I now turn.

Interprovincial Revenue Sharing

In the context of the 1982 equalization negotiations, Glen Copplestone and I (Courchene and Copplestone 1980) proposed a "two-tier" equalization program. The first tier would include NAS or FPS equalization of all nonresource revenues. In other words, the existing equalization program would hold sway for this tier. The second tier would be an interprovincial revenue-sharing pool (the German model) for resource revenues. Resource-rich provinces would contribute a share of their resource revenues to the pool and resource-poor provinces would draw a share of these revenues, depending on their fiscal capacity. This second tier would be self-financing. The precise degree of sharing would presumably take into account both the capitalization and net-cost issues discussed in the previous section.

In the context of the early 1980s, there were two quite separate rationales for this two-tier system. The first was to ensure that the energy-rich provinces were paying a more appropriate share of overall equalization, especially since their energy revenues were driving up equalization payments. The second was quite different in nature. At the time, domestic energy prices were well below world prices. From Alberta's perspective, if domestic prices were $12 a barrel and world prices were $24 a barrel, then Ottawa was effectively confiscating $12 a barrel of Alberta's potential energy rents and transferring them to Canadians in the form of low domestic energy prices. Hence, the second rationale for the interprovincial resource-sharing pool was to facilitate a move toward world prices, which, in turn, would benefit energy-rich and recipient provinces alike.

In other words, in the 1980s' context, such a two-tier system might have represented a win-win situation for both "have" and "have-not" provinces and even for Ottawa (but not for consumers of energy!). In today's intergovernmental transfer environment, however, even if were one to discount appropriately for capitalization and the costs of collecting these rents, it is hard to conceive of a resource-sharing pool as a win-win proposal. Desirable as such a scheme may be in terms of funding the resource component of equalization, it is likely to be viable only under a complete reworking of the transfer system that delivers compensating benefits to the contributory provinces.[14]

Other Design and Implementation Principles

Beyond the principles outlined above relating directly to Canada's system of intergovernmental transfers, a further set of design axioms needs to be incorporated into any reform of the system.

Accountability: Governments must be accountable to citizens for the prudent use of public funds and the programs that incorporate them. In the current Canadian context, enhanced accountability means clarifying the roles of the two levels of government in the social sphere. A useful companion to accountability is the *principle of fiscal coincidence*, whereby the jurisdiction responsible for spending funds should in general be the one responsible for raising them in the first place. The existence of intergovernmental transfers is an obvious exception to this principle, one that can be rationalized in a variety of ways (such as economies of scale in raising taxes). In these circumstances, however, the design of the transfer system should be as consistent as possible in isolating the locus of responsibility and, therefore, accountability.

Transparency: This principle is closely related to accountability. If programs are not transparent, accountability will become blurred. The existing CHST transfer system, with its combination of cash transfers and tax-point transfers, is hopelessly complex and, therefore, at cross purposes with any transparency principle. In the recent past, Ottawa has been able to claim that transfers (cash plus tax points) to the provinces have increased while the provinces have argued that federal transfers (that is, cash, since this is all that is really transferred) have fallen. And both parties can substantiate their claims. As a result, citizens have become confused and accountability diffused. In any evolution of intergovernmental transfers, the provisions must be transparent so that all parties (including citizens) recognize where accountability resides.

Instrument Efficiency: This principle has to do with the appropriate linking of targets and instruments. If the target or objective is distributional, it should be delivered via a distributional instrument such as the tax-transfer system, not via an allocative instrument. And where intergovernmental transfers are involved, the incentives should not be such as to encourage what I have elsewhere (Courchene 1994) labeled "intergovernmental gaming" (for example, the incentives under existing legislation for provincial governments to create make-work projects to transfer citizens from provincial welfare to federal EI). It is no doubt impossible to remove all such incentives from intergovernmental transfers, but wherever possible they should be minimized.

Duality: With respect to this principle, let me quote from *Making Canada Work Better*, by the Group of 22:

> Canada is unique among immigrant societies in this hemisphere. Countries of immigration receive people from widely different origins and bring about a convergence around a common public language; for instance, English in the United States, Spanish in Argentina, and Portuguese in Brazil. Canada alone has not one, but two, such languages of convergence, English and French. The centre of the area of geographic convergence on French, within a continent where English predominates massively, is the Province of Quebec. In this important respect, Quebec is not a province like the others; indeed, it is

> unique in this hemisphere. As the jurisdiction at the heart of the French zone of convergence, it has responsibilities and challenges unlike those of other provinces. (1996, 5.)

Although I did not broach duality in the earlier analysis, I do not mean to diminish its importance. The QPP and Quebec's separate PIT system clearly fit within this duality framework. With the Calgary Declaration, there is the intriguing potential for a version of duality with the framework of equal provincial rights. As I interpret it, the Declaration would give Ottawa the freedom to cut special deals with Quebec (or with any other province, for that matter) subject to the proviso that all provinces can obtain a similar deal. But not all other provinces would likely opt for it. This may lead to further *de facto* duality or asymmetry in the context of *de jure* equality or symmetry.

Beyond these four general or framework principles, one could add those designed to preserve and promote the internal economic union, for example, or others, such as subsidiarity. But these would begin to take us well beyond the scope of this paper.

The Political Economy of Canadian Fiscal Federalism

To this point in the development of principles, I have by and large adhered to the premise that the analysis would be revenue or transfer neutral. Where the application of a certain principle would lead to a reduction in transfers, I generally provided for accommodation elsewhere in the system. This was by design, since my main concern was to isolate issues or principles relating to the structure and incentives associated with intergovernmental transfers. However, I conclude this section with a few reflections on the range of forces likely to have a bearing on the magnitude of intergovernmental transfers as the next century approaches.

The first issue to note is that equalization payments have been falling as a percent of GDP since 1994, the last time the program was altered.[15] One reason for this is that the share of Canada's population represented by the recipient provinces has been falling. Hence, other things being equal, aggregate equalization will fall, especially as a proportion of GDP. Per capita equalization payments as a proportion of GDP per capita have fallen as well, largely because Ontario, Quebec, and Alberta[16] have decreased their tax rates.

Ontario is of special interest, since its 30 percent decrease in PIT rates since 1995 — from 58 percent to 40.5 percent — will, *ceteris paribus*, lower the FPS standard for PIT by roughly 12 percent (assuming that it has a 40 percent weight in the calculation of the national-average tax rate for personal income taxes). Even if one takes account of the fact that Ontario has levied a significant health care surcharge and that its overall tax bases may now be growing faster because of lower PIT rates, these factors are not likely, in the short term, to offset the impact of its PIT rate decreases on the equalization standard.

In other words the growth of equalization during the current economic upturn is nowhere near what it would have been had some of the larger provinces not decreased their tax rates. The net result may be a once-and-for-all drop in equalization payments as a percent of GDP, followed by a somewhat larger rate of future growth as the impact of the tax rate decreases feeds through to the future growth of tax bases. No doubt the recipient provinces are very concerned about this and will bring it to Ottawa's attention, but these downward pressures are formula driven, not the result of discretionary policy changes.

While there has been tax-reduction-driven "fiscal convergence," as defined by the equalization formula, it is far from clear that there has been economic convergence. If tax rates matter in a progressively integrated North America, then growth rates in Alberta and Ontario may pull away from those of equalization-recipient provinces.[17] Presumably, this was part of the underlying message of former Nova Scotia premier Savage's Empire Club address (Savage 1996). Indeed, there appears to be a growing view among certain "have-not" provinces that they do not have the fiscal flexibility to match the tax cuts of Ontario and Alberta. While this is far from obvious, they are no doubt carrying this view to Ottawa in terms not only of equalization but of maintaining regional privileges in other programs (EI and the CHST).

Compounding this problem is the role that user fees are now beginning to play in provincial finances. Ontario, for example, recently fully deregulated tuition fees for professional programs in universities and partially deregulated other tuition fees. And there are signs that other provincial and municipal services may begin to incorporate a fee-for-service approach. This means that the spread of user fees will result in provincial taxes that are lower than they otherwise would have been. Should user fees, then, enter the equalization formula? I side with Boadway (1998), who argues they should not, since they reflect benefit taxation. But this issue will presumably surface in the renegotiation of equalization.

Given that former premier Savage's Empire Club address did not arise in a vacuum, there is another side to the influences coming to bear on intergovernmental transfers, an integral part of which is fiscal neutrality. One version of fiscal neutrality argues that all non-equalization transfer programs should treat similarly situated Canadians equally. A stronger version argues that the cash transfers for the CHST should be converted into further PIT tax-point transfers, so as to ensure that the cash transfers are not eroded by future unilateral federal action. While I would find either of these approaches acceptable, the analysis above was couched in the context of offsetting some of the potential fiscal fallout via compensating adjustments to equalization. It is not obvious that the "have" provinces would support this.

Instead, an entirely new fiscal federalism dynamic may be emerging, driven by the exigencies of competing under the North American Free Trade Agreement and increasing north-south integration. The straightforward version of this new dynamic is that the magnitude of, and incentives within, east-west transfers are increasingly incompatible with the need to compete successfully in North America. This would make renegotiating interprovincial transfers problematic enough, but a much tougher scenario may be in the making. To be blunt about what is a very delicate issue, Ontario might, in response to pressures from, say, Nova Scotia to increase equalization, suggest that it would consider doing so only after Nova Scotia had undergone the same expenditure revolution as Ontario has. And Ontario would presumably point out that Nova Scotia still has a dozen universities.

This should come as no surprise. It is the inevitable result of the challenge of overlaying an east-west transfer system on a north-south trading system. What would be surprising is that the issue would have taken so long to get to center stage. From this vantage point, the "have-not" provinces would have a tough time pressing their point. Renegotiating equalization has generally been a matter between Ottawa and the recipient provinces, but this time tradition would probably be set aside as the "have" provinces put in their oar to ensure that the transfer regatta included the equalization aspects of other transfer programs.

But then there is Ottawa, armed with a fiscal dividend, a large part of which has arisen because cuts in federal-provincial transfers (especially the CHST) have generated a favorable federal fiscal balance *vis-à-vis* the provinces. Yet Ottawa's recent policy initiatives have not only ignored this provincial fiscal imbalance but have involved direct federal spending in areas that can be viewed as provincial responsibilities under the Constitution (the child tax benefit and the Millennium Fund). Viewed in a different light, this is addressing the provincial fiscal imbalance by increasing federal spending in areas of provincial jurisdiction. While it may be inappropriate to view the CTB as an unwarranted intrusion in an area of provincial jurisdiction, since the program was negotiated between Ottawa and the provinces (except Quebec), it nonetheless could have important implications for the evolution of intergovernmental transfers. At one level, Ottawa could argue that the CTB expenditures are roughly equivalent to the indexing of the $12.5 billion CHST, thereby staving off demands for tax-point transfers. At another, and under more trying fiscal circumstances, Ottawa could argue that on-going funding such as the CTB ought to be viewed as part of the $12.5 billion cash floor.

In more general terms, the increased federal fiscal flexibility means that Ottawa *could* accommodate the concerns of the "have-not" provinces. And on sheer fiscal grounds, it would probably prefer to do this selectively through nonequalization programs. Adding more to equalization would mean that *all* "have-not" provinces would reap the benefits, even though not all might be deemed to be under the same fiscal stress. Were Ottawa to actively pursue this option (which former premier Savage recommends), the result would be a substantial increase in the degree of fiscal non-neutrality, which, in turn, would surely trigger countervailing responses by the "have" provinces. It is far from clear that the "have-not" provinces would be better off by casting their lot with the federal government if the result were a rift between "have" and "have-not" provinces and a general erosion of support for interprovincial redistribution.

It is not evident where all of this leads. It suggests, however, that the upcoming renegotiation of equalization could be the most problematic on record. For the first time, the Canadian federation will be attempting to come to grips with interregional equity in the context of international competitiveness.

Conclusion

Creating the Canadian postwar welfare state required overcoming two separate challenges. The first was the decentralized nature of the federation. Unlike the continental European welfare states, which arose in the context of class politics played out at the national level, Canada's approach required working with and through the provinces via a set of creative intergovernmental transfers (equalization, CAP, EPF, and so on) and a corresponding set of pan-Canadian principles (such as those embodied in the *Canada Health Act*, the prohibition of residency requirements for welfare, and so on). These not only allowed the provinces to mount their own versions of the welfare state but also converted separate provincial programs into national ones. In the process, these intergovernmental transfers facilitated even further decentralization — equalization allowed for greater tax decentralization, and the gradual shift from conditional to unconditional transfers paved the way for enhanced provincial autonomy.

The second challenge was to sustain and enhance this system of intergovernmental transfers in Canada's geographic context — that is, to integrate economically with the United States while pursuing a very different social contract. Equalization emerges as a unique accomplishment in this context, since the United States essentially ignores horizontal fiscal imbalances.

In this *Commentary*, I have tried to identify a set of principles that would inform the evolution of these transfers in the face of new challenges, both domestic (fiscal restraint) and international (globalization and the internationalization of the Canadian economy). I began by making the case that two overarching principles were critical to the evolution of intergovernmental transfers: the federal rationale, which finds unanimous support in all provinces, and the citizenship rationale, which finds broad support among Canadians. While these overarching principles remain steadfast and have been buttressed by constitutional enshrinement, the manner in which they are implemented has differed over time, depending on prevailing social, economic, and fiscal pressures. As Milne (1998) puts it, the set of transfers has to find its place "in the deeper political logic and interests of our time."

Since equalization has been set with the framework of a decentralized federation and an international economy, I find little relevance in the prevailing literature on equalization, which is typically premised on the supposed virtues of unitary states. This is especially so for applications of the model that associate the net-fiscal-benefits calculus on a one-to-one basis with increases in revenues — in other words, that ignore capitalization. Beyond this, the equalization literature tends to be cast in a closed-economy framework.

In effect, my approach to isolating fiscal federalism principles lends some inertial qualities to what I refer to as static initial conditions. I then interpret the federal and citizenship rationales in terms of emerging trends as reflected in recent policy initiatives or the influence of external forces. Among the principles, whether related to design or implementation, that I have identified are the following:

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- Other things being equal, a national-average standard is preferable to the existing five-province standard.
- Equalization should be allocatively neutral with respect to tax bases.
- The high degree of confiscatory taxation in the current formula is inappropriate.
- Fiscal neutrality should prevail. All equalizing transfers should be put into the equalization formula. Other federal-provincial transfers should treat similarly situated Canadians identically, regardless of province of residence.
- Alternatively, equalization should become the overarching intergovernmental transfer, where equalizing features of other transfers are offset against equalization payments.
- Equalizing across "expenditure needs" does not fit well in the Canadian context,

where all transfers are unconditional. However, a move toward fiscal neutrality may require incorporating aspects of expenditure needs in equalization.

- Intergovernmental transfers should become more predictable and stable. If the federal government cannot credibly commit to achieving this, then pressures will increase for a further transfer of tax points to the provinces.
- The recent removal of the stabilization facility relating to provincial revenues should be rethought.
- Resource revenues have posed a challenge for equalization since its inception in 1957 and will no doubt continue to do so. If Canada is to return to a national-average standard, however, it will have to address these resource-related issues (capitalization, the cost of raising resource revenues, and so on).
- Interprovincial revenue-sharing pools, especially for resources, have considerable appeal. However, unless they are conceived of as a component of a larger overall reworking of intergovernmental transfers, they are unlikely to find favor with the resource-rich provinces. And how would one make them binding?

I attempted to derive these and other principles within a transfer-neutral framework, and I concluded with a few reflections on whether intergovernmental transfers in aggregate were likely to rise or fall. Although I took no strong stand on this, I implicitly assumed throughout that the current transfer envelope is probably unsustainable.

By way of a subjective final note, in my view it is unlikely that 1999 will be the potential equalization watershed that many had hoped (or feared). The reason is obvious: not only is there little consensus but the positions of the various parties are polarizing. Thus, there appears to be no easy way out. One potential facilitating factor is that Ottawa does have some fiscal room, so that it could “buy” its way into a compromise. Yet, since embracing the existing status quo is not really an option either, this points in the direction of incrementalism. With luck, the increments will tilt the system in the right directions, which, from the vantage point of this *Commentary*, are toward fiscal neutrality, away from confiscatory taxation, and toward bringing Alberta and the Atlantic provinces back into the standard. This modest set of changes would, in fact, amount to a major shift in the structure of, and incentives within, equalization and intergovernmental transfers, even if politics dictates that this be accomplished in a more or less revenue-neutral manner.

Whatever the outcome, it will not be uncontroversial.

Appendix: Canada's Current Intergovernmental Transfer System

Canada's Equalization Program

Inaugurated in 1957, the equalization program is Canada's response to addressing horizontal fiscal imbalances across the provinces. In the years that followed, the program developed into such an important part of the country's east-west glue that it became enshrined as section 36(2) of the *Constitution Act, 1982*. While the principles embodied in that section are sufficiently broad to accommodate a variety of approaches to horizontal fiscal balance, the specifics of Canada's current programs are as follows.

All provinces are guaranteed access to revenues equal to the per capita average of the five provinces that comprise the equalization standard (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia). For each of the more than 30 tax bases that enter the formula, the per capita revenue standard is defined as the product of the national-average tax rate and the standardized five-province-average tax base. If a province's standardized per capita tax base multiplied by the national-average tax rate is less than the per capita revenue standard, then that province is deemed to be a "have-not" province for this tax base, and the difference constitutes the province's positive equalization entitlement, again for this tax base. If a province's per capita revenue exceeds that of the five-province average, it is a "have" province for this tax base and has a negative equalization entitlement. For each province, these entitlements (positive and negative) are then summed over all tax bases and the total, if positive, constitutes the equalization payment. If the province's aggregate entitlement is negative, equalization is set equal to zero. In effect, this means that, while "have-not" provinces are leveled up, "have" provinces are not leveled down — there are no direct transfers from rich to poor provinces. Rather, equalization payments come from Ottawa's consolidated revenue fund. In turn, this means that all similarly situated Canadians contribute equally toward the funding of equalization, since federal tax rates are uniform across the country.[18] However, because some provinces are richer than others, their residents will pay a larger share (relative to their population) of the costs of equalization. For example, from Table A-1, Ontario residents account for 42.22 percent of equalization funding (row 4) and Newfoundland residents account for 1.29 percent, while their respective population shares are 37.74 percent and 1.91 percent, respectively (row 5).

Equalization payments are unconditional: they can be spent as and where the provinces wish. While this unconditionality is in line with the federal rationale and the dictates of the Rowell-Sirois Report, there is also a practical argument for ensuring that grants not be tied. The rich provinces can spend their taxes as they wish. Hence, it would be politically difficult to circumscribe the manner in which the equalization-receiving provinces spend their equalization payments. Indeed, one could go further. The equalization program was introduced when Ottawa decided, in response to Quebec's mounting its own PIT system, to transfer tax room to the provinces on the basis of the taxes generated in the respective provinces — that is, in line with the "principle of derivation" (explained below). This resulted in different amounts of per capita revenues

Table A-1: ***Equalization Payments, fiscal year 1996/97***

	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Canada
1. Payments *($ millions)*	1,007	197	1,200	984	4,129	0	1,092	225	0	0	8,834
2. Share of payments *(%)*	11.4	2.2	13.6	11.1	46.7	0	12.4	2.5	0	0	100.0
3. Payments per capita *($)*	1,766	1,441	1,276	1,283	559	0	961	221	0	0	296
4. Share of federal revenues *(%)*[a]	1.29	0.36	3.01	2.31	21.58	42.22	3.18	2.62	10.31	13.12	100.0
5. Share of population *(%)*	1.91	0.46	3.15	2.55	24.79	37.74	3.81	3.41	9.32	12.86	

[a] Estimated share, by province, of federal revenues (Hobson 1998).

Source: Data from Canada, Department of Finance (except for row 4).

across the provinces, which, in turn, led to the system of equalization payments. Arguably, without a comprehensive system of equalization, it is unlikely that the existing degree of tax decentralization would have been politically possible. In this sense, the system of equalization payments "benefits" both recipient and nonrecipient provinces, albeit for quite different reasons.

Finally, it is important to note that there is both a ceiling and a floor to equalization payments. The ceiling, introduced in the 1982 quinquennial revision of equalization payments, applies for each five-year period. In the first year of each period, equalization payments are determined by the operations of the equalization program. In each of the remaining four years, the cumulative growth rate of equalization from the base (first) year cannot exceed the cumulative growth rate of GDP from this same base year. The ceiling became binding in the late 1980s, largely as a result of Ontario's economic boom and tax-rate increases. In fiscal year 1989/90, for example, the ceiling constrained actual equalization payments to be $1.4 billion less than the formula would have called for. More recently, the floor provisions have been triggered. Under these provisions, a province's actual equalization cannot

- fall by more than 5 percent year over year if its fiscal capacity is below 70 percent of the national average (this applies to Newfoundland and Prince Edward Island);
- fall more than 10 percent if its fiscal capacity is between 70 and 75 percent of the national average (New Brunswick); or
- fall more than 15 percent if its fiscal capacity is above 75 percent of the national average fiscal capacity (Quebec, Manitoba, Saskatchewan, and Nova Scotia).[19]

Table A-1 presents data on equalization for fiscal year 1996/97. In terms of dollars per capita (row 3), Newfoundland led the list with $1,766, with the three Maritime provinces also above $1,000 per capita. Quebec received $554 per capita and Saskatchewan $221. Saskatchewan was, in fact, close to being a "have" province in that fiscal year, but in this case the floor provisions applied. Hence, Saskatchewan's equalization in 1996/97 was 15 percent lower than in 1995/96, in line with the calculation procedures in the previous paragraph relating to the floor provisions. Although Quebec's per capita equalization payment was the second lowest, in absolute dollar terms it received $4.129 billion, or 46.7 percent of total equalization. Finally, rows 4 and 5 of the table contain the provinces' population shares and the shares of federal revenues. Thus, while Ontario received no equalization, its residents paid for 42.22 percent of equalization funding, since equalization is financed out of Ottawa's Consolidated Revenue Account.

The “Original” CHST

The program typically associated with addressing vertical balance in the Canadian federation is the Canada Health and Social Transfer. Announced in the 1995 federal budget and introduced in fiscal year 1996/97, the CHST effectively rolls the former Canada Assistance Plan and Established Programs Financing into a single “super” block fund. The initial allocation across provinces of CHST entitlements (defined as the sum of the cash and tax-point transfers) was in the same proportions as the 1995/96 allocations of CAP and EPF. The EPF allocations (for the combined tax and cash transfers) for 1995/96 were equal per capita across the provinces. However, the 1995/96 CAP allocations reflected the 1990 imposition of the cap on CAP for the three nonequalization-receiving provinces. This implied per capita CHST entitlements (for the CAP component) of $192 for Alberta, $225 for Ontario, and $235 for British Columbia, in comparison with the national average value of $267, let alone the Quebec transfer of $373. More recent Department of Finance provisions will ensure that these per capita disparities in CHST entitlements are reduced by half by fiscal year 2002/03.

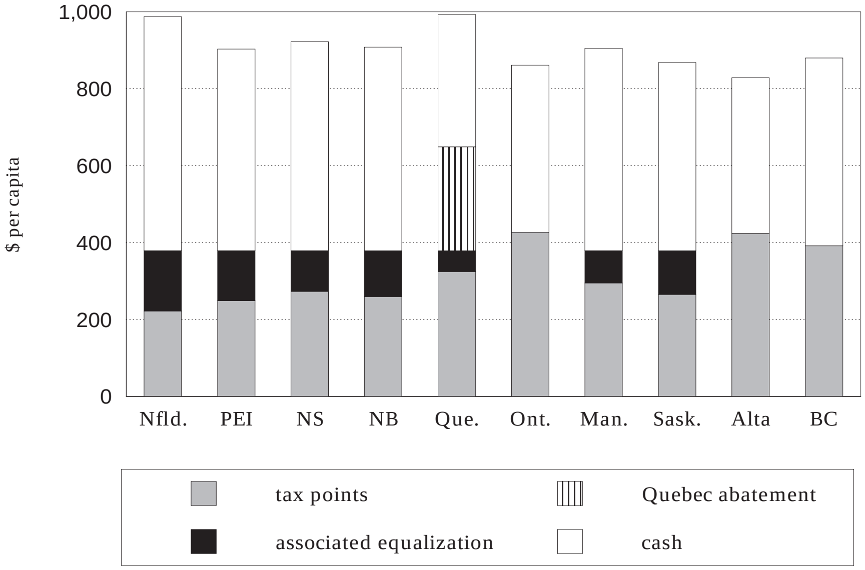
This arbitrary reduction in CHST entitlements for the “have” provinces (arising from rolling the cap on CAP into the CHST entitlements) can and should be viewed as introducing an equalization or horizontal balance component into the operation of this vertical balance program. However, the nature of this equalization component of the CHST extends well beyond that of the formal equalization program.

To see this, look at Figure 1, which presents both a graphic and a tabular summary of the CHST for fiscal year 1996/97. The different values of the overall entitlements for that fiscal year (for example, $861 per capita for Ontario and $993 for Quebec) reflect the carrying over of the cap on CAP into the calculation procedure for the CHST. While the CHST is, in principle, comprised of both tax-point and cash transfers, all that eventually ends up being transferred is the cash component — the value of the tax points (including associated equalization) by province is deducted from the overall provincial entitlement to determine the value of the cash transfer.

In more detail, the tax-point transfer is the value of the 14.865 PIT points and the 1 CIT point that were part of the EPF and that were carried over to the CHST. The value of these tax points varies considerably by province — Ontario’s per capita value ($427) is nearly double Newfoundland’s ($222). It is critically important to recognize that these tax points are *already incorporated* in the provincial share of PIT and CIT systems. In other words, the provinces’ share of the PIT already includes these 14.865 PIT points, and they are already “equalized” under the provisions of the equalization formula. Figure 1 shows this equalization, referred to as “associated equalization” in the context of the CHST calculations, for the seven “have-not” provinces, the per capita value of which is $379. For these equalization-receiving provinces, the value of the CHST cash transfer is simply the value of the aggregate entitlement less the value of these equalized tax points.

There are two exceptions to this. The first relates to provinces that are “rich” in terms of the PIT and CIT tax bases — namely, Ontario, Alberta, and British Columbia. For them, the value of the “raw” tax-point transfer exceeds the value of the “equalized” tax-point transfer to the equalization-receiving provinces — that is, more than $379 per capita. Unlike the formal equalization program, which allows the rich provinces to “pocket” any revenues above the FPS, the calculation procedure for the CHST takes this excess tax revenue into account to arrive at the value of the cash transfer. In the case of Ontario, for example, the value of its cash

Figure 1: ***The Mechanics of the CHST, fiscal year 1996/97***



Transfer	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC
					($ per capita)					
Tax points	222	249	273	260	325	427	295	265	424	392
Associated equalization	157	130	106	119	54	0	84	114	0	0
Quebec abatement	0	0	0	0	270	0	0	0	0	0
Cash	608	524	543	529	344	434	526	489	404	488
Total	987	903	922	908	993	861	905	868	828	880

Source: Canada, Department of Finance.

transfer is $434 per capita — the difference between its overall entitlement ($861 per capita) and the value of the notional tax-point transfer ($427 per capita).

The second exception relates to Quebec. In the 1960s, all provinces were offered the opportunity to take some federal funding in the form of additional tax-point transfers rather than in the form of cash. Only Quebec chose this option, and its additional 16.5 tax-point transfers are referred to as the “Quebec abatement.” Of this total, 8.5 PIT points were formerly associated with EPF and 5 with CAP,[20] and have now been transferred to the CHST. In effect, Quebec’s cash transfers are reduced by the value of this tax abatement. Since this abatement is a transfer is lieu of cash, for comparison with the other provinces, Quebec’s overall cash transfer should be viewed as $614 per capita.

Intriguingly, the CHST program embodies a degree of equalization that goes well beyond the formal equalization program. There are two components to this “super equalization.” First, the CHST entitlements themselves (the combined tax and cash transfers) embody an equalization feature, reflecting largely but not wholly the cap on CAP for the “have” provinces. Second, the calculation procedure for CHST cash “levels down” the “have” provinces — the value of the 14.865 PIT points and the 1 CIT point in excess of the FPS is fully offset by a reduction in CHST cash. As a result, while Ontario's (cash and tax) entitlements are 87 percent of Quebec's, its cash transfer is only 71 percent of Quebec's. And while Ottawa intends to halve the overall per capita differences in entitlements over the next few years, the cash differential may well widen (Boessenkool 1996).

Arguably, it is this degree of super equalization embodied in the CHST program that is leading many analysts to rethink the adequacy of the formal equalization program itself. This rethinking is taking two conceptually distinct paths. The first approach focuses on what might be termed "symmetrical" or US/CE equalization: provinces with weak fiscal capacities would be brought up, and rich provinces brought down, to the equalization standard. The second approach argues that the equalization program should go beyond its current revenue focus to incorporate considerations relating to expenditure needs. Intriguingly, the CHST appears to incorporate both these features — the former because the full value of tax points is taken into account in determining the value of the cash transfer, and the latter because the differences in entitlements (presumably) reflect the perceived "needs" in the various provinces.

As an important historical note, one should recognize that the CHST embodies a radically different approach than that associated with the original EPF funding arrangements. At the onset of EPF, both the tax-point and the cash components were subject to separate escalation procedures. The tax-point component would obviously grow apace with the revenues associated with PIT and CIT. The cash component was escalated in line with the three-year average growth rate of GDP. In the 1982 fiscal arrangements, an overall ceiling was placed on aggregate EPF entitlements so that the cash component became a residual. This aggregate ceiling was to be escalated by the three-year average of GDP growth. Over the years after 1982, however, Ottawa unilaterally deindexed this ceiling growth — to GDP minus 2 percent in 1986, then to GDP minus 3 percent in 1989 and, finally, to a freeze on the growth of entitlements in 1990. Until then, overall entitlements remained equal in per capita terms. When the EPF and CAP were rolled into the CHST, however, the overall per capita entitlements registered different values across provinces, reflecting the varying per capita CAP transfers, which, in turn, were largely driven by the cap on CAP.

The Relationship between Vertical and Horizontal Imbalances

While transfer programs such as the CHST can serve to ameliorate existing vertical fiscal imbalance, the more important determinant of the degree of vertical fiscal imbalance relates to the relative revenue means and expenditure needs of the two orders of government. In turn, this relates to the allocation of revenues and expenditures under the Constitution. In this context, one of the key features that minimized the degree of vertical fiscal imbalance was the transfer of PIT and CIT tax points from Ottawa to the provinces over the 1950s, 1960s, and 1970s. For example, were the cash component of the CHST converted to a further equalized PIT tax-point transfer, as I and others have recommended (see Courchene 1994), this would effectively remove most of the need for vertical balance transfers. One should add, however, that, depending on the nature of this additional tax-point transfer, accommodating changes might have to be made in equalization — that is, in horizontal transfers across the various provinces.

Hence, there is an important link between vertical and horizontal transfers, as Scott noted as early as 1964 (252–253). Specifically, any transfer of taxing power from Ottawa to the provinces allocated in accordance with the provincial yields of this transfer would create horizontal balance problems since the per capita value of these tax points would differ markedly by province. Scott referred to this approach to addressing vertical imbalance as embodying the “principle of derivation.” Canada’s 1957 equalization program was introduced precisely because the mid-1950s’ transfer of tax points to the provinces was governed by this derivation principle.

However, policies designed to address vertical balance need not be governed by the derivation principle. For example, suppose that, rather than formally transferring tax points to the provinces, Ottawa designated the value of a given number of tax points to be distributed to the provinces on an equal-per-capita basis. Scott referred to this approach to vertical balance as embodying the “principle of equalization” (not to be confused with the formal equalization program). In this case, the resulting horizontal imbalance across provinces would be much ameliorated (in contrast to what would emerge under a derivation-principle approach), so that the formal equalization program would have less “work” to do.

This leads to two observations with respect to the operations of the CHST. First, the CHST embodies aspects of Scott’s “principle of equalization.” Second, and perhaps more important, the equalization program does not take account of the equalizing features of the CHST. In other words, Canada’s horizontal balance program does not incorporate the equalizing impacts embedded in the vertical balance program. As important, it does not take into account the equalizing components that have been built into the federal transfers to persons (for example, the EI program). This failure of equalization as an overarching reconciler of horizontal imbalances features prominently in the earlier analysis.

The $12.5 Billion Cash Floor and the “New” CHST

For the first few years of the CHST, Ottawa specified both the aggregate entitlements and their distribution across provinces, and deducted the value of the equalized tax points from these entitlements to arrive at the cash transfer. Thus, cash was a residual. However, the recent federal decision to place a $12.5 billion floor under the cash component of the CHST significantly alters the nature of the program. Given that this floor is already binding, the cash component is now fixed and aggregate entitlements are now the residual.

Specifically, one begins the CHST calculation process with the $12.5 billion cash floor. To this is added the estimated value of the *aggregate* equalized tax points — that is, for all provinces. This then yields the estimated value of aggregate entitlements. Apart from the $12.5 billion cash floor, the other fixed component of the calculation procedure is the share, by province, of this aggregate entitlement. (The deviations in these shares from per capita equality are, as noted, to be halved by fiscal year 2002/03). Applying these shares to the estimated aggregate entitlement then yields the provincial entitlements. From these provincial entitlements, one then deducts, for the province in question, the estimated value of the equalized tax-point transfer to obtain the CHST cash transfer. (Note that this calculation ensures that the sum of cash transfers across provinces will equal $12.5 billion.) In this roundabout sense, cash transfers are also a residual of sorts in this “new” CHST era.

But in one sense, the “new” CHST represents a huge change. Under the new calculation, all three provincial variables — provincial entitlements, equalized tax points, and cash transfers — will be in a state of flux. Hence, as Ottawa presents successive estimates of the CHST for, say, fiscal year 1998/99, these provincial variables will change from one estimate to the next. Without doubt, this floor-driven CHST will emerge as one of the least transparent transfer programs ever, especially since this calculation procedure is merely allocating $12.5 billion across the provinces. Were Canadians to be asked about the appropriate way to allocate such an amount, they would probably opt for an equal-per-capita distribution. Yet the actual transfers may move away from equality (Boessenkool 1996). Ottawa had better hope that none of the "have" provinces hires effective public relations experts since, under such opaque CHST calculation procedures, equal-per-capital CHST cash across the provinces should become an easy and eminently sensible "sell."

Transfers to Persons

To this point, I have focused on horizontal and vertical fiscal balance with respect to intergovernmental transfers. Here, I want to bring aspects of transfers to persons into the picture. At first blush, mingling intergovernmental and personal transfers might seem inappropriate. However, EI transfers complement and, in some cases, actually substitute for provincial welfare payments; in this sense, they can be viewed as part of the vertical/horizontal fiscal-balance process. The special feature of EI payments is that they are tilted, in terms of both access and duration of benefits, toward "have-not" regions and provinces. A better way to phrase this might be that EI embodies substantial "equalization" characteristics. If the formal equalization program is to be viewed as an overarching reconciler of horizontal fiscal balance across provinces, should it not take into account the explicit regional or equalization features of personal transfers such as EI benefits? The answer is surely in the affirmative.

Beyond this, of course, there are the recent federal initiatives that transfer monies directly to individuals — the new National Child Benefit and the tuition bursaries for qualified low- and middle-income Canadians that will arise under the proposed Millennium Fund. While the CHST is, in principle, an unconditional grant, these new federal initiatives relating to welfare and postsecondary education nonetheless fall within the historical rationale for CHST transfers. Will Ottawa eventually argue that the money allocated to these new programs ought to be incorporated in the CHST's $12.5 billion cash floor? Perhaps more important in terms of the evolution of intergovernmental grants, given that the Millennium Fund scholarships are to be allocated on the basis of merit to low- and middle-income Canadians, if Ottawa decides that poorer provinces deserve a larger-than-population share of the Fund (as Quebec is already arguing), should these differences not be subject to reconciliation under the equalization program, especially if it is viewed as the overarching federal-provincial transfer program? These issues must also be factored into the appropriate evolution of the system of intergovernmental grants.

Notes

It is a pleasure to express my gratitude to Paul Boothe, editor of "The Transfer Papers" series, and the entire C.D. Howe Institute research team for detailed and valuable suggestions and encouragement throughout the preparation of this *Commentary*. I would also like to thank Ken Norrie and an anonymous referee for constructive comments on the penultimate draft, and Barry Norris for his diligent copy editing. Given the subjective nature of the ensuing analysis, the normal caveat applies with even more force.

1 Throughout this *Commentary*, I make reference to the on-going equalization "negotiations" or "renegotiations." In this context, it is important to remember that, while the provinces are very involved in this process of renewal, in the final analysis Ottawa holds the upper hand since the equalization system is an enactment of the federal Parliament.

2 Queen's University's John Deutsch Institute will shortly release a volume dealing with the analytical, historical, and political underpinnings of equalization (Boadway and Hobson 1998). Finn Poschmann's *Where the Money Goe*s (1998) is the first in the C.D. Howe Institute's "The Transfer Papers" series designed to re-assess the citizen-state relationship on the social policy front. And no doubt provincial governments are producing their own visions of the future of intergovernmental transfers.

3 This is the political counterpart of the economists' notion of "efficient markets," where current prices are deemed to embody all past and present information for the market or markets in question.

4 This characterization may be a bit strained with respect to the National Child Benefit, which was the result of a joint federal-provincial initiative. Nonetheless, the implications raised in this statement ring true.

5 Since reunification, the German equalization system has remained similar to that presented below, at least in analytical terms. In practice, however, the system has been tilted dramatically toward transfers to the former East German *Länder*, so much so that two of the richer *Länder* (Baden-Württemberg and Bavaria) have recently challenged it in the German Constitutional Court.

6 Nonetheless, the German approach remains of interest. Indeed, in a forthcoming *Commentary*, Paul Boothe and Derek Hermanutz provide an alternative to Canada's equalization system, one key component of which will be an interprovincial revenue-sharing pool.

7 The five principles embodied in the *Canada Health Act* are public administration, comprehensiveness, universality, portability, and accessibility.

8 Among the most notable contributions are those of Hobson (1997; 1998) and Boadway (1998), which draw implicitly or explicitly on earlier Canadian theorizing — see, for example, Boadway and Flatters (1982); Boadway and Hobson (1993); and Economic Council of Canada (1982).

9 NFBs can differ across jurisdictions for many reasons. For example, provinces with high source-based tax revenues (from, say, resources or corporate income taxes) or high residence-based revenues (from personal income or sales tax) can, in principle, finance a given level of expenditures at lower tax rates. Hence, NFBs might, depending on the degree of capitalization, be higher in these provinces.

10 While the *degree* of capitalization can be viewed as empirical issue, the concept of capitalization ought to be an integral part of the theory.

11 See, for example, Watson (1986). Moreover, the more recent literature (for example, Myers 1990) suggests that optimal-allocation-of-labor considerations should lead an NFB-rich province to engage in lump-sum transfers to other jurisdictions. Thus, federally mandated transfers are unnecessary. See Snodden and Wen (1997) for a review of this recent literature.

12 This assumes that New Brunswick's tax rates are identical to the national-average tax rates. If they were lower, New Brunswick's overall revenues (own-source revenues plus equalization) would actually *fall* in the face of a 5 percent increase in all its tax bases.

13 Of course, Newfoundland's equalization and, therefore, its total revenues would increase if the FPS increased, but here I focus only on Newfoundland's initiatives.

14 In a forthcoming *Commentary*, Paul Boothe and Derek Hermanutz attempt to devise a suitably attractive proposal along some of these lines.

15 Cash payments under the CHST have also decreased significantly, but this has been well documented.

16 While Alberta's tax bases do not enter the FPS, its tax rates enter the calculation of the national-average tax rate that is applied to the FPS base to determine the standard.

17 However, this may not apply across the board to "have-not" provinces. For example, the combination of offshore energy and Voisey's Bay should significantly increase Newfoundland's fiscal capacity.

18 In the earlier analysis, and following Boadway (1998), I broached the issue that, because of section 125 of the Constitution, otherwise similarly treated individuals may have different net fiscal benefits arising from the operations of provincial policies. Since these NFBs are typically not subject to federal taxation, this means that, in theory at least, not all Canadians will be treated identically by federal taxation.

[19] This classification of provinces relates to their fiscal capacities in the early 1990s.

[20] The remaining three tax points were associated with the former Youth Allowance Program. Now that this program is gone, Quebec continues to maintain these tax points and transfers an equivalent cash value to the federal government (or has this value deducted from its equalization transfer).

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