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Communiqué

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Consolidate all interprovincial redistribution in equalization, says C.D. Howe Institute study

Equalization, the centerpiece of Canada's interprovincial redistribution system, has been significantly undermined by Ottawa's ability and willingness to use other programs to effect further redistribution, says the latest issue of *C.D. Howe Institute Commentary*, released today. The 1999 quinquennial review of equalization provides the opportunity to reverse this trend and bolster sagging support for the program. The report recommends an overarching approach to equalization that includes redistribution among provinces that takes place outside of equalization.

The study, *Clearly Canadian: Improving Equity and Accountability with an Overarching Equalization Program*, was written by Kenneth J. Boessenkool, a Policy Analyst at the C.D. Howe Institute.

Boessenkool argues that transfers outside of equalization should respect the principle of fiscal equality by treating Canadians the same wherever they live. A number of programs violate this principle, however. For example, in fiscal year 1996/97, cash payments under the Canada Health and Social Transfer (CHST) — which provides federal funds for provincial health, postsecondary education, and welfare programs — varied between $622 per capita in Quebec and $423 per capita in Alberta. Other shared-cost programs in areas such as agriculture, culture, the environment, justice, and transportation provided per person cash transfers that were nearly twice as large in British Columbia as in Alberta, and four times as large in Newfoundland as in British Columbia. Transfers of employment insurance (EI) premiums to provinces for training programs similarly varied between $38 per person in Saskatchewan and $348 per person in New Brunswick.

These violations of fiscal equality undermine the rationale for equalization, Boessenkool says. Rather than a rules-based determination of the appropriate level of transfers that is universally determined, the current system of federal expenditures pits winners against losers and "haves" against "have nots," in a destructive zero-sum game.

Boessenkool points out that Ottawa can take one of two approaches to a system of transfers based on the principle of fiscal equality: a piecemeal approach of reforming individual programs that offend the principle of fiscal equality or an overarching approach that makes equalization the reconciler of all federal redistribution. The latter approach, which Boessenkool recommends, requires offsetting equalization payments to each province by the amounts of redistribution in other transfers.

Boessenkool argues that Ottawa should treat CHST, shared-cost, and EI developmental uses expenditures as part of the provincial revenue base to be equalized. The resulting reduction in equalization payments would be $178 million if, at the same time, equalization was boosted by moving to an all-province standard from the current five-province standard. Phasing in these changes over ten years would result in annual adjustments that are within the historical deviation of equalization payments in recipient provinces.

These reforms, Boessenkool, says, hold out the promise of ending the *ad hoc* nature of current interprovincial redistribution. They would also make progress toward a system of intergovernmental transfers that is a concrete expression of the kind of federalism that preserves healthy local autonomy and builds a stronger, more united nation.

This study is the third 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 a 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 Institute.

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Communiqué

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Il faut consolider toutes les redistributions interprovinciales au sein de la péréquation, affirme une étude de l'Institut C.D. Howe

La péréquation, la pièce maîtresse du système de redistribution interprovinciale au Canada, a été considérablement sapée par la capacité et la volonté d'Ottawa d'utiliser d'autres programmes de redistribution, affirme le plus récent *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. L'examen quinquennal de la péréquation qui aura lieu en 1999 offrira la possibilité de renverser la vapeur et de raffermir le soutien chancelant du programme. Le rapport recommande notamment une formule générale de péréquation qui englobe toute redistribution entre les provinces qui lui est extérieure.

L'étude, intitulée *Clearly Canadian: Improving Equity and Accountability with an Overarching Equalization Program (Clairement canadien : une équité et une responsabilité améliorées grâce à un programme général de péréquation)*, est rédigée par Kenneth J. Boessenkool, un analyste de politique auprès de l'Institut C.D. Howe.

L'auteur soutient que les transferts extérieurs à la péréquation doivent suivre le principe d'équité fiscale en traitant les Canadiens, où qu'ils vivent, de la même manière. Or, un certain nombre de programmes ne respectent pas ce principe. À titre d'exemple, au cours de l'exercice financier 1996-1997, les paiements en espèces au titre du Transfert canadien en matière de santé et de programmes sociaux — lequel est la source des financements fédéraux pour les programmes provinciaux de santé, d'éducation postsecondaire et d'aide sociale — variaient de 622 $ par habitant au Québec à 423 $ par habitant en Alberta. D'autres programmes à coûts partagés dans des domaines comme l'agriculture, la culture, l'environnement, la justice, et les transports prévoyaient des transferts pécuniaires par habitant qui étaient près de deux fois plus élevés en Colombie-Britannique qu'en Alberta, et quatre fois plus élevés à Terre-Neuve qu'en Colombie-Britannique. Les transferts des cotisations d'assurance-emploi aux provinces destinés aux programmes de formation affichaient également des divergences, de 38 $ par personne en Saskatchewan à 348 $ par personne au Nouveau-Brunswick.

Ces violations de l'équité fiscale sapent la raison d'être de la péréquation, affirme M. Boessenkool. Plutôt que d'appliquer une détermination selon les règles du niveau pertinent de transfert qui est établi unanimement, la méthode actuelle des dépenses fédérales oppose les gagnants aux perdants, et les « nantis » aux « démunis » dans le cadre d'un jeu à somme nulle destructeur.

M. Boessenkool souligne qu'Ottawa dispose de deux choix quant à un régime de transferts fondé sur le principe de l'équité fiscale : une approche fragmentée consistant à réformer les programmes qui violent le principe d'équité fiscale, ou une approche générale qui fait de la péréquation l'élément qui réconcilie toute la redistribution fédérale. Cette deuxième méthode, que recommande l'auteur, exige que l'on compense les versements de péréquation à chaque province par le montant de redistribution des autres transferts.

L'auteur soutient qu'Ottawa devrait traiter le Transfert canadien en matière de santé et de programmes sociaux, les dépenses des programmes à frais partagés et l'utilisation des fonds de l'assurance-emploi à des fins productives comme faisant partie de l'assiette du revenu provincial devant faire partie de la péréquation. Il en découlerait une diminution de 178 millions de dollars des paiements de péréquation si, dans un même temps, on adoptait une norme comprenant toutes les provinces plutôt que la norme présente, qui porte sur cinq provinces. En introduisant progressivement ces changements sur une période de dix ans, on donnerait lieu à des rajustements annuels qui seraient conformes à la variation historique des paiements de péréquation dans les provinces bénéficiaires.

Selon M. Boessenkool, ces réformes pourraient mettre fin à la nature ponctuelle de la redistribution provinciale actuelle. Elles permettraient également de progresser vers un régime de transferts intergouvernementaux exprimant concrètement le type de fédéralisme qui préserve une autonomie locale saine et qui donne corps à une nation plus forte et unifiée.

Cette étude est la troisième dans la série spéciale de Commentaires intitulée « Les cahiers du transfert », et elle repose sur la prévision selon laquelle on déposera 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.

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Clearly Canadian:

Improving Equity and Accountability with an Overarching Equalization Program

by

Kenneth J. Boessenkool

The equalization program is the centerpiece of the federal government's redistributive efforts among the provinces. Equalization's distributional impact, however, has been significantly undermined by Ottawa's ability, and desire, to use other programs to effect further redistribution. In too many of its programs, Ottawa treats Canadians differently based on where they live. This situation is unstable, and threatens to weaken the broad support that the equalization has historically enjoyed.

The 1999 quinquennial review of equalization will provide the opportunity to right these wrongs. Specifically, an over-arching equalization program that took account of interprovincial redistribution undertaken elsewhere in the federal budget holds out the promise of a more transparent system of interregional transfers. By confining its redistributional efforts to equalization, Ottawa would become more accountable to Canadians and increase the perception of fairness in Canada's complex system of federal-provincial transfers.

These benefits would surely reverse flagging support for equalization, reduce the game-playing that the current structure engenders, and make the entire federal-provincial interface more stable. Canadians would be clear winners as a result.

Main Findings of the Commentary

- A quick glance at federal expenditures suggests that the federal government's primary function is to redistribute money, both among persons and among provinces. One way to look at this redistribution is in the light of the principle of fiscal equality — namely, apart from equalization, federal programs should treat similarly situated individuals equally, regardless of where they live.
- Any system of intergovernmental transfers in Canada must satisfy the underlying principles of federalism, as expressed in the Constitution. First, provinces must have unconditional revenues sufficient to meaningfully exercise the constitutional powers assigned to them — the *federal rationale*, which finds its expression in the equalization program. Second, citizens, wherever they live, ought to have access to basic economic and social rights, and provinces ought to have sufficient revenues to provide these services — the *citizenship rationale*, which finds its expression in, for example, the Canada Health and Social Transfer (CHST) and in the tax-sharing arrangements between Ottawa and the provinces.
- Since equalization addresses differences across provinces, programs that are the expression of the citizenship rationale should, like citizenship, be provided to all Canadians equally.
- Current federal expenditures on the CHST, shared-cost programs, employment insurance (EI) developmental uses transfers, and regionally sensitive EI entrance and benefit structures all significantly violate the principle of fiscal equality.
- These violations undermine the rationale for equalization. Rather than a rules-based determination of the appropriate level of transfers that is universally determined, the current system threatens to pit winners against losers and "haves" against "have-nots" in a destructive game of one-upmanship.
- The federal government can take one of two approaches to move to a system of transfers based on the principle of fiscal equality: a piecemeal approach whereby individual programs that offend the principle are reformed, or an overarching approach that makes equalization the reconciler of all federal redistribution. The latter, recommended, approach requires offsetting equalization payments to each province by the amounts of redistribution in other transfers.
- Ottawa should treat CHST, shared-cost, and EI developmental uses expenditures as part of the provincial revenue base to be equalized. The resulting reduction in equalization payments would be a modest $178 million if, at the same time, equalization was boosted by moving from to an all-province standard from the current five-province standard. Phasing in these changes over ten years would result in annual adjustments that are within the historical deviation of equalization payments in recipient provinces.
- These reforms hold out the promise of ending the *ad hoc* nature of current interprovincial redistribution and moving toward a system that is a concrete expression of the kind of federalism that will preserve healthy local autonomy and build a stronger and more united nation.

A quick glance at federal expenditures suggests that the federal government's primary function is to redistribute money, both among persons and among provinces. Transfers to the elderly, the unemployed, and provincial governments make up over half of Ottawa's program expenditures. The provinces, by contrast, spend most of their money on providing goods and services, such as health care, education, roads, and policing.

The federal government transfers money to provinces through a number of different mechanisms. First, the equalization program gives money to certain provinces to bring their revenues up to a federally determined standard level. Second, the Canada Health and Social Transfer (CHST) provides cash to all provinces, ostensibly to help in the funding of health, postsecondary education, and welfare. Third, Ottawa sends money to certain provinces or groups of provinces through a myriad *ad hoc* smaller transfers for specific purposes. Finally, when economic cycles cause annual revenues in a province to fall by more than 5 percent, a federal stabilization program compensates that province for revenue losses beyond this threshold.

Ottawa also spends money on three types of transfers to individuals: programs for the elderly, programs for the unemployed, and transfers to families with children. Of course, the income tax also plays a redistributionary role among individuals.

This *Commentary* is the third in a special series examining federal- provincial transfers in anticipation of the legislative review of the federal equalization program in 1999. The first of these commentaries, by Finn Poschmann, examines the major federal redistributional programs by province and family income.[1] In the second, Thomas J. Courchene proposes some design and implementation principles for Canada's system of interprovincial and personal transfers.[2]

In this *Commentary*, I attempt to translate Courchene's design and implementation principles into specific program changes. My primary focus is on the program implications of the principle of fiscal equality: "that, apart from equalization, federal programs should treat similarly situated individuals equally, regardless of place of residence."[3] I then evaluate those proposed program changes against other principles, such as temporal predictability, transparency, and accountability.

This *Commentary* does not, however, include a target *level* for interprovincial redistribution, although its analysis will make discussions of this level much more transparent. Similarly, I give little attention to the mechanics of equalization, except in areas where they relate to the principle of fiscal equality.

The paper takes as given the current federal and constitutional nature of Canada, particularly as it is expressed in 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.

Outline of the Commentary

The *Commentary* is organized as follows. The opening section lays out a rationale for intergovernmental transfers in a federal state and provides a brief overview of Ottawa's current redistributionary programs. Many of these transfers, both to provinces and to individuals, either duplicate or reverse the work done by equalization — Ottawa is topping up its formal redistributionary program with a significant amount of *ad hoc* redistribution among provinces. The result is a significant departure from the principle of fiscal equality.

The second section argues that the current structure of Canada's redistributionary programs is politically unstable because it encourages the federal government to hide the extent and nature of its redistributionary activity and also encourages provinces to seek out special deals.

The next section presents two proposals for moving the system of transfers in the direction of fiscal equality: the federal government can either transform the offending programs individually to conform to the principle of fiscal equality, or incorporate the other forms of redistribution into an overarching equalization program. I recommend the latter choice.

The fourth section discusses transition issues. Implementing the changes I recommend requires boosting the equalization standard by moving from a five-province to a ten-province standard and by phasing in any additional reductions to recipient provinces over ten years.

The penultimate section then evaluates overarching equalization in terms of temporal predictability, transparency, and accountability, as well as discussing its potential for reducing the confiscatory nature of the existing program.

The final section offers some concluding observations.

A Federal Approach to Intergovernmental Transfers

Courchene emphasizes that any system for intergovernmental transfers in Canada must satisfy the underlying principles of federalism. He approvingly quotes the 1939 Report of the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Report), which supports two fundamental or overarching principles underpinning intergovernmental grants in federal states.[4] Courchene calls these two principles the "federal rationale" and the "citizenship rationale"; both also find their expression in Canada's Constitution.

The Federal Rationale and Equalization

Courchene defines the federal rationale as follows: "the second order of government must have revenues sufficient to exercise the powers assigned to it under the Constitution."[5] In the words of the Rowell-Sirois Report, transfers must

> 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.[6]

This rationale is, broadly speaking, consistent with the wording of section 36(2) of the *Constitution Act, 1982*, as cited above.

The federal rationale and section 36(2) find expression in Canada's equalization program. Equalization is not concerned with the *level* of revenues that all provinces have access to, but with *differences* among provinces in their ability to extract revenue from their tax bases. (For more detail on how the equalization program works, see Box 1.)

Box 1: *The Mechanics of Equalization*

As it is currently set up, the equalization program focuses exclusively on a province's ability to raise revenues from various tax bases, all of which are theoretically available to all provinces. It guarantees all provinces access to per capita revenues equal to a standard comprised of the per capita average in five provinces: British Columbia, Manitoba, Saskatchewan, Ontario, and Quebec.

The mechanics of the program are roughly as follows. For each of 33 revenue sources, the national-average tax rate is applied to the standardized five-province tax base to provide the *equalization standard*. Applying the national-average tax rate to each province's base determines the *provincial yield*. The difference between a province's yield and the standard for each of the 33 bases represent its entitlement for that revenue source, which may be either positive or negative. If the sum of a province's 33 entitlements is negative, Ottawa pays the province this amount. If the sum is positive, the province receives nothing. So "have-not" provinces are brought up to the standard, but "have" provinces are not brought down to it. Ottawa makes equalization payments from consolidated revenues, so, although provinces make no direct transfers to one another, "have" provinces provide the bulk of the funding for equalization since, by definition, they have stronger tax bases. Equalization payments are unconditional.

Fiscal Equality and the Citizenship Rationale

As Canada's official mechanism for interprovincial redistribution, equalization is at the core of what the Group of 22 has called the "principle of fiscal equality":

> Other than through the formal equalization program, federal government spending programs should be governed by the principle of equal treatment of provinces. Federal spending directed to individuals should not depend on province of residence.[7]

This principle of equal treatment is closely linked with the citizenship rationale, which Courchene defines as follows:

> Citizens, wherever they may live, ought to have access to certain basic 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.[8]

In other words, provinces should have an adequate revenue base from which to fund services that provide for the basic economic and social rights of Canadian citizens.

While the federal rationale (and the equalization program) is concerned with differences among provinces in their ability to extract revenue, the citizenship rationale is concerned with levels of revenues. Since equalization gives all provinces access to these revenues, federal transfers based on the citizenship rationale should, like citizenship itself, be provided to all Canadians equally.

The CHST

Two mechanisms provide the bulk of the revenues by which provinces fund programs in their jurisdictions that relate to the citizenship rationale.

First, the provinces and the federal government share tax bases. Both Ottawa and the provinces can levy personal and corporate income taxes, as well as retail-based consumption taxes. From the 1950s through the 1970s, as programs in provincial jurisdiction (such as health and education) saw significant expansion, the federal government's share of the total personal and corporate income tax paid by Canadians went down, while the provinces' share went up. This process is often referred to as "transferring" tax points. The term is misleading, however, since what in fact happened was that, at various points in time, Ottawa reduced its tax rates on personal and corporate income, while the provinces raised tax rates on these bases.[9]

The second mechanism is the CHST, a federal transfer to provincial governments that is nominally directed toward provincial health, postsecondary education, and welfare programs. I say "nominally" because these transfers are, in fact, unconditional, save for the broad principles embodied in the *Canada Health Act*, as well as the prohibition against residency requirements for provincial welfare programs.[10]

The CHST is not primarily a redistributive transfer; rather, it responds to the gap between *aggregate* provincial revenues and *aggregate* provincial expenditures.[11] Following the citizenship rationale for intergovernmental transfers, the CHST should treat Canadians equally regardless of their place of residence. Each province should receive the same amount per capita.

This principle is not as straightforward as it may seem, however, since the CHST is not an equal-per-capita cash transfer. Instead, Ottawa chooses a value for a per capita total entitlement, then subtracts from this amount a calculated value of the equalized tax points given to the provinces in 1967 and 1977 to arrive at a residual cash payment.[12] This complex method is further obscured by the fact that Ottawa has guaranteed that total cash expenditures under the CHST will not fall below $12.5 billion per year. Provinces and most commentators ignore Ottawa's manipulations and focus only on cash transfers.[13]

The history and mechanics of the two programs that were folded together to create the CHST in 1996 produced wide initial variations in provincial per capita cash payments. The federal government has acknowledged that the CHST should move toward an equal-per-capita transfer, but it intends to equalize per capita *total entitlements*, rather than *cash payments*.[14] The result is an illusion of equality.

Here, I provide only a brief sketch of why cash transfers will not move toward equal-per-capita distribution (I explain this situation in detail elsewhere[15]). The main reason is that the value of the tax points as calculated by Ottawa, after they are ground through the equalization formula, is not equal across the provinces, being larger for the "have" provinces (Ontario, Alberta, and British Columbia) than for the "have-not" provinces. Therefore, the residual cash payments will never be equal — even an equal-per-capita total entitlement would produce unequal-per-capita cash transfers. Under Ottawa's plan to eliminate half of the per-capita disparities by fiscal year 2002 / 03, only four provinces (Newfoundland, Quebec, Alberta, and British Columbia) will move toward equal-per-capita cash transfers. The remaining provinces will move away from fiscal equality.

These conclusions depend, of course, on projected provincial growth rates. For example, the disparities will worsen if average growth rates in the "have" provinces exceed those in the "have-not" provinces.

Fiscal equality for the CHST would mean equal-per-capita cash transfers for all provinces. Only such transfers respect the principle of "equal opportunities for the well-being of Canadians" and the citizenship rationale.

How far from fiscal equality is the current CHST? The first row in Table 1 shows the per capita cash payment made to each province in fiscal year 1996 / 97. The biggest beneficiary was Quebec, which received nearly $200 per person more than Alberta and $100 per person more than Prince Edward Island.

Table 1: *Per Capita Transfers, fiscal year 1996–97*

	Nfld	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta	BC	Canada
						(dollars per capita)					
CHST cash	595	519	547	528	622	444	525	501	423	472	504
Shared-cost programs	243	237	119	188	77	70	83	133	44	44	78
EI developmental uses	140	104	61	79	52	38	51	33	23	40	45
Regional EI benefits	503	409	169	348	144	49	42	38	46	83	98
Total	1,481	1,269	896	1,143	895	601	701	705	536	639	725

Sources: Kenneth J. Boessenkool, *The Illusion of Equality: Provincial Distribution of the Canada Health and Social Transfer*, C.D. Howe Institute Commentary 80 (Toronto: C.D. Howe Institute, June 1996); Statistics Canada, CANSIM on CD-ROM; Canadian Tax Foundation, *The National Finances* (Toronto: CTF, 1996); and Canada, *Public Accounts of Canada: 1996* (Ottawa: Canada Communication Group, 1997). Regional EI benefits are calculated from a Human Resources Development Canada estimate of savings from eliminating the regional component of UI benefits: Canada, Department of Human Resources Development, *From Unemployment Insurance to Employment Insurance: A Supplementary Paper* (Ottawa: Supply and Services Canada, 1994), p. 68. These savings are applied against actual EI expenditures for fiscal year 1996/97 and adjusted by the distribution of savings projected for the 1996 EI reforms (idem, *Employment Insurance: Impacts of Reform* [Ottawa: Department of Human Resources Development, 1996], section 1).

Shared-Cost Programs

Besides its federal CHST cash payments and its portion of revenues from the shared tax bases, each province receives additional cash from Ottawa for programs in provincial or joint federal-provincial jurisdiction through a myriad small shared-cost programs.

In fiscal year 1996/97, Ottawa spent $4.4 billion on 139 such federal-provincial shared-cost programs.[16] Most of these transfers paid for programs in areas of joint jurisdiction, such as the environment, agriculture, natural resources, and economic (primarily regional) development. Nearly half were limited to single provinces or regions.

Applying the principle of fiscal equality to these shared-cost programs is not as straightforward as it is for the CHST. While equal-per-capita cash transfers make sense for some programs, this formula seems less clearly suited for others. In reality, any decision as to which programs should be equal per capita would, of course, be subject to political manipulation. But the clearest way, in principle, to differentiate the two types of programs is to apply the citizenship rationale: any federal program that relieves provincial governments of expenditures that are used to supply basic economic and social rights should be distributed on an equal-per-capita basis. Such programs should be enjoyed by all Canadians wherever they live; their funding should therefore be distributed equally to all Canadians.

Among the long list of shared programs, there are nine broad areas in which expenditures can be thought of as supplying basic economic and social rights: agriculture, culture, the environment, health, human resources, regional development, justice, housing, and transportation. (Appendix A lists 35 programs that provide shared-cost funds to provinces in these areas.) Total expenditures on these programs were $2.3 billion dollars in 1996/97. If the total amount transferred to each province for these programs are converted to a per-capita amount, as in the second row of Table 1, wide disparities across the provinces appear.

Another category of expenditures that provides for basic economic and social rights to Canadians is employment insurance (EI) developmental uses. This involves shared-cost, noninsurance expenditures for active labor market measures (mostly training programs) that are nonetheless funded from EI payroll revenues. These expenditures overlap with provincial labor force programs and are distributed unequally across the country. Ottawa recently entered into agreements with all provinces except Ontario to convert most of these expenditures into transfers to the provinces. Ottawa is retaining some of the funds, however, for its own programs, and some provinces have agreed to allow Ottawa to play a role in their provincial programs. These expenditures are an uneasy mix of direct federal expenditures and federal–provincial transfers used to fund active employment measures,[17] and, in the remainder of this paper, I treat them as though they were transfers to the provinces for active labor market programs.

In per capita terms, the amount Ottawa spends for EI developmental uses in Newfoundland is six times that spent in Alberta, four times that spent in Saskatchewan, and twice that spent in Nova Scotia (see row 3 of Table 1).

Expenditure Needs

One objection often posed to an equal-per-capita approach to shared-cost programs is that it eliminates the concept of need from federal-provincial transfers. The argument is roughly as follows. Canada's equalization program is based on *revenue* differences among provinces, but does not take into consideration differences on the *expenditure* side of provincial budgets. Thus, equalization implicitly assumes that the cost of "providing reasonably comparable public services" is identical across the country. Therefore, other programs are needed to compensate for these varying expenditure needs.

The first difficulty with the proposal to account for expenditure differences is deciding what is meant by "need." Defining need in terms of *cost* is quite different from defining it in terms of *demand*. If the equalization program were to incorporate the former definition, then it would have to account for the fact that average wages, rents, and capital costs are much higher in Toronto, Calgary, and Vancouver than in Halifax, Saskatoon, and Fredericton. As Shah shows, defining "need" in terms of costs and incorporating it into equalization would, in fact, require a *reduction* in transfers to the Atlantic provinces and Quebec.[18] Both the CHST and shared-cost programs are therefore tilted in the wrong direction.

If need is defined according to demand, on the other hand, then incorporating differences in need into equalization would mean accounting for, among other things, differential rates of unemployment and income levels. For the most part, this would mean additional compensation for "have-not" provinces.

There are two important reasons to avoid this approach. First, although the current equalization program uses a revenue approach, it still implicitly accounts for a number of demand factors. If employment or income falls in a particular region or province, this affects its tax base relative to the national average, triggering larger equalization payments.[19]

Second, because the transfers listed in Table 1 provide funds for programs to which all Canadians, as citizens, should have access (that is, the CHST and, allowing some room for argument, the shared-cost programs listed in Appendix A), the principle of fiscal equality demands that, once provincial revenues have been equalized, federal transfers directed toward provinces to fund these types of programs should be equal per capita.

The second difficulty with the proposal to account for expenditure needs is that the overarching principle that transfers should remain unconditional precludes a needs-based approach. If, for example, the current equalization program incorporated need, provinces would not necessarily spend the additional money they received on programs that were related to the factor that increased their entitlement. This fact would lead to pressure on Ottawa to impose conditions on the portions of equalization payments that respond to the need variables. (This is true whether need is defined as cost or as demand.[20]) Succumbing to this pressure would lead to heavily conditional or shared-cost programs, which, respectively, increase federal interference in provincial jurisdictions and allow provincial leveraging of Ottawa's budget.

Transfers to Persons

Including federal transfers to persons in a discussion on intergovernmental transfers may seem odd. However, some kinds of personal transfers are worth examining according to two criteria suggested by the discussion thus far: First, does the program violate the principle of fiscal equality? Second, does the program provide an additional, even if indirect, means of financing basic economic and social rights in a province by overlapping with programs under provincial jurisdiction? If the answer to both questions is yes, then these expenditures are functioning just like the intergovernmental transfers discussed so far.

An obvious example of a program component that violates fiscal equality is found in the variable-entry requirements of the EI program. These requirements offend the notion of providing all Canadians with equal opportunities, since they allow similarly situated individuals in different parts of the country access to different levels of economic and social rights. An example of a federal program that does *not* offend fiscal equality in this way is the recently announced National Child Benefit, which operates under the same rules for all Canadians. But both meet the second criterion, since both EI and child benefits overlap with provincial welfare and labor market programs.

These two examples demonstrate how the definition of fiscal equality for transfers to individuals is different from that for transfers to provinces. The latter focuses on equality of *outcomes* (equal-per-capita grants); the former focuses on equality of *treatment*.

An EI program that operated according to the principle of fiscal equality would offer a uniform entry period and benefit structure across the country. Variable entrance requirements are, therefore, the primary reason that EI violates fiscal equality. These requirements are based on local unemployment rates, so workers in a high-unemployment region face very different EI programs than do similar workers in a low-employment region. A recent estimate places the total cost of these variable entrance requirements at $4.5 billion for 1996.[21] Of that expenditure, Newfoundland received 13 times, and Quebec nearly four times, the per capita amount Ottawa spent in Saskatchewan or Manitoba (see row 4 of Table 1).

The difference between outcomes and treatment is made clear by noting that, even under a uniform entry and benefit structure, high-unemployment provinces would continue to receive comparatively higher EI payments on a per capita basis. If Ottawa eliminated regional benefits, Newfoundland would still receive $143 per capita and Quebec $64 per capita more than the Canadian average of $215 per capita. But because these differences are not caused by different treatment of Canadians based on their place of residence, they do not offend the principle of fiscal equality.

"Hide and Seek": Redistribution without Fiscal Equality

Ottawa's expenditures for the CHST, shared-cost programs, EI developmental uses transfers, and regional EI benefits significantly violate fiscal equality. Transfers to the five provinces east of Ontario are between 25 and 100 percent higher per capita than the national average. Further, these disparities are not obviously related to any underlying rationale. This renders the current state of federal-provincial transfers unstable, since it encourages Ottawa to hide the true nature of its redistributionary activities, and provinces to seek out special deals.[22]

Falling Public Support for Redistribution

Most Canadians accept the federal rationale of redistribution among provinces embodied in equalization. However, the notion that all other federal programs should include components that redistribute among provinces is meeting with increased public resistance.[23]

Many recent complaints have focused on the way in which Ottawa reduced spending on provincial transfers under the Canada Assistance Plan (CAP). In 1990, it imposed a cap on the plan (a 50-50 cost-sharing arrangement for provincial welfare programs) for three provinces — British Columbia, Alberta, and Ontario. The cap limited increases in payments to 5 percent annually. Subsequently, the Ontario government alluded to the fact that support for equalization would wane in the face of such brazenly discriminatory treatment.[24] As more individual programs tilt against the "have" provinces and as these additional sources of redistribution become clear, support for the principle of redistribution, and even for equalization itself, may wane among those who pay.

Ottawa has reacted to these criticisms by attempting to hide the inequalities within various programs. The obscure nature of the tax-point transfers that perpetuate the illusion of equality under the CHST is one example. The way transition funds for regions affected by EI reforms became permanent developmental uses expenditures is another.

Political Bargaining

Political bargaining is the flip side of the lack of transparency. As provinces become aware that they can access additional funds through bilateral bargaining with the federal government, the central role of equalization in interprovincial redistribution is undermined. Rather than a transfer system based on a set of rules that apply to all, the interprovincial transfer system becomes politicized as provinces seek out special deals to increase their individual shares.

Fiscal Equality

The forces of "hide and seek" can serve only to undermine intergovernmental redistribution in the longer term. Rather than setting up a rules-based determination of the appropriate level of transfers, the current system threatens to pit winners against losers, "haves" against "have-nots," in a destructive game of one-upmanship.

The principle of fiscal equality can rescue the transfer system by providing both a defensible rationale for those who pay and long-term stability for those who receive. If equalization fulfilled the redistributional federal rationale, other programs that fulfill the citizenship rationale should be blind to where recipients live — that is, they should be distributed according to the principle of fiscal equality.

Two Paths to Fiscal Equality

The federal government can take either a piecemeal approach or an overarching approach to a system of transfers based on the principle of fiscal equality.

A Piecemeal Approach

Ottawa has already taken some tentative steps down the piecemeal-approach path.[25] Some of the recent modest EI reforms and the promise (however illusory) of making CHST transfers more equal are two such steps. If Ottawa continues in this direction, it will have to overcome the important obstacle of placing these individual program reforms in the context of its overall treatment of the receiving provinces. The difficulty in linking rising equalization expenditures with reforms to EI is but one example of this problem.

Even if EI moved toward treating all Canadians equally despite their location and the CHST moved toward equal-per-capita cash transfers, Ottawa could still slip money toward selected provinces through shared-cost programs or enriched EI transfers. As Courchene pointed out nearly 15 years ago, the problem with the piecemeal approach is that it threatens to replace the formula-driven equalization program with "an approach that is determined principally by bilateral pacts between Ottawa and the several provinces."[26] Because of its potential for encouraging hide-and-seek games, I do not recommend this path.

An Overarching Approach

It is possible to end the games and maintain fiscal equality if Canada instead moves toward an overarching approach to equalization. Doing so would reduce both the disinclination to reform existing programs and the incentive to form bilateral pacts.

In its simplest terms, overarching equalization would mean Ottawa treating transfers outside equalization as additional sources of provincial revenues within the equalization formula itself.[27] Equalization would become the sole mechanism for interprovincial redistribution within the federal budget.

Transfers to Provinces

Under an overarching approach, incorporating federal transfers to provinces within the equalization program would be straightforward. These include the CHST, federal-provincial shared-cost programs, and EI developmental uses expenditures that provide active labor market programs. Ottawa should treat these transfers as part of the "sufficient revenues" that a province needs "to provide comparable levels of public services," to quote section 36(2) of the *Constitution Act, 1982*. By including these as provincial revenue sources, using a national-average standard (NAS) rather than a five-province standard (FPS), and applying any portion of these transfers that is above or below an equal-per-capita standard against the current equalization entitlement in each province, Ottawa can make equalization meet the principle of fiscal equality. Appendix B illustrates the mechanics of doing so.

There is, however, a small technical problem. The three kinds of transfers mentioned above are calculated on an equal-per-capita basis using an all-province standard, while the equalization program is based on an FPS. Moving to the FPS for federal-provincial transfers would lower the average, since the Atlantic provinces receive per capita payments farther above the all-province average than Alberta's payments are below that average. On the other hand, shifting the entire equalization program to an NAS would boost the current standard by $107 per capita.[28] The latter would be politically attractive, since moving to an overarching approach without increasing the equalization standard would result in a dramatic decrease in federal dollars flowing to five provincial treasuries.

If the equalization standard were beefed up by moving to an all-province standard (see row 2 in Table 2), total equalization payments would increase by $1.3 billion. But if, at the same time, Ottawa saved the amount by which payments from the main federal-provincial transfers (CHST, EI developmental uses, and shared-cost programs [row 6 of Table 2]) currently exceed the per capita average, this amount would more than offset the increase, netting Ottawa a modest $178 million (row 8 of Table 2).

Table 2: ***An Overarching Equalization Program, Based on fiscal year 1996/97 Figures***

	Nfld	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta	BC	Canada
					($ per capita, except where otherwise noted)						
1. Equalization entitlement	1,688	1,434	1,220	1,224	553		923	416			
Plus: amount required to move to an all-province standard											
2.	107	107	107	107	107		107	107			
Minus: amounts above (below) equal per capita											
3. CHST cash	91	15	43	24	118	–60	21	–3	–81	–32	
4. Shared-cost programs	166	159	42	110	0	–7	5	55	–33	–34	
5. EI developmental uses	95	59	16	34	7	–7	6	–12	–22	–5	
6. Total	352	233	101	168	125	–74	32	40	–136	–71	
Equals:											
7. New entitlement	1,443	1,308	1,226	1,163	535	0	998	483	0	0	
8. Savings *($ millions)*	141	17	–6	46	133		–86	–68			178
Minus: amounts above (below) equal per capita											
9. Regional EI benefits	405	311	71	250	46	–49	–56	–60	–52	–15	
Equals:											
10. New entitlement	1,038	997	1,155	913	489	0	1,054	543	0	0	
11. Cumulative savings *($ millions)*	373	60	61	237	472	0	–150	–129	0	0	924

Of course, the resulting redistribution across provinces would not be even. For example, per capita transfers to Newfoundland would fall by $245 while those to Manitoba would increase by $75 (row 7 minus row 1 in Table 2). The next section of the *Commentary* deals with ways to address these discrepancies.

Transfers to Persons

It is potentially more difficult to incorporate into the equalization program those federal transfers to persons that overlap with provincial areas of jurisdiction. Only the portion of those programs that is a result of unequal treatment should be incorporated. In the case of EI, for example, I have included in Table 1 only those expenditures that result from the regional nature of the program. If these were eliminated, EI would still transfer greater amounts to high-unemployment regions, but only because they have more unemployed residents. Ottawa would need to isolate the regional portion of EI for each province and treat these expenditures as part of the province's "sufficient revenues." The question then is: How should these expenditures be included the equalization program.

There are at least three options. First, Ottawa could count the full per capita expenditure that results from regional benefits against a province's equalization entitlement since, if the EI program operated according to the principle of horizontal equity, none of these transfers would take place. Another approach would be to treat these expenditures as an additional cash transfer from the federal government to the provinces, and therefore net only the portions of regional benefit expenditures that are above or below an equal-per-capita amount against equalization entitlements. Finally, regional benefit expenditures could be allocated according to some index of need, such as the provincial unemployment rate or the share of expenditures that would result from an EI program with a national entry and benefit structure. Differences from this standard would then be applied against equalization entitlements.

The first option violates the principle of equal spending per capita, since it would completely remove dollars spent in recipient provinces, but not in the others. The overarching equalization proposal is not meant to reduce the *level* of transfers from Ottawa to the provinces, but rather to ensure that any federal money *outside* equalization is provided to all Canadians regardless of place of residence. If Ottawa decided that the marginal benefit of regional benefits exceeded the marginal benefit of the same dollars as part of equalization, it should be free to spend these dollars on regional benefits.

The third option, distributing regional benefit expenditures according to need, has some inherent appeal. Money should, after all, be spent where it is needed most. However, an EI program with a national entry and benefit structure would already accomplish this goal. And the fact remains that the equalization program is the national redistributional tool; it does take partial account of poor economic conditions in recipient provinces.

So one is left with the second option — namely, that EI regional benefits should be treated as additional cash transfers to the provinces, with amounts going to any province above or below an equal-per-capita amount netted against its equalization entitlement.

Cutting off regional benefits beyond an equal-per-capita standard would further reduce equalization entitlements for Quebec and the Atlantic provinces. The biggest hits, in per-capita terms, would be felt in Newfoundland, Prince Edward Island, and New Brunswick. Manitoba and Saskatchewan currently receive less than the average-per-capita amount in regional benefits, and thus their equalization entitlement would rise further. The total savings to Ottawa of incorporating regional EI benefits into equalization would be a substantial $746 million,[29] bringing the total savings to just under $1 billion (see line 11 in Table 2).

Getting There: Transition Issues

Incorporating all these transfers into equalization over a short period of time would be neither economically expedient nor politically practical. As Courchene warns,

> 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.[30]

There are a number of reasons to progress in a two-stage process, as Table 2 suggests. In the first stage, Ottawa should incorporate the three federal provincial transfers (CHST, shared-cost programs, and EI developmental uses) into an overarching equalization program, while also moving to an NAS for equalization itself. Reforming regional EI benefits should be the second stage.

The first reason for proceeding in this way is that it would minimize the financial hit on recipient provinces. A number of other competing forces should also, on balance, reduce this hit. Specifically, the interaction between the mechanics of equalization and the current economic environment should result in net increases in equalization entitlements over the next few years, whether or not any changes are introduced to the program. Since equalization entitlements are based on the difference between provincial yields and a standard, any upward movement in that standard would increase entitlements for recipients. Since Ontario's size gives that province a dominant role in determining the equalization standard, the current strength of the Ontario economy will drive up the value of the standard. As a result, even if recipient provinces' yields are stable, when Ontario experiences strong growth, "have-not" entitlements grow.

In 1995, for example, Ontario's gross domestic product grew by 5 percent, while that of the rest of the country grew by 3.5 percent. Naturally, provincial revenues reflected this discrepancy in economic growth, with the result that per capita equalization entitlements grew in Newfoundland by $112, in Prince Edward Island by $117, in Nova Scotia by $184, in New Brunswick by $119, and in Quebec by $8. In fact, per capita entitlements have fluctuated widely from year to year over the past two decades. The average annual change in equalization entitlements has been more than $75 in Newfoundland and New Brunswick, around $60 in Manitoba and Saskatchewan, and $30 in Quebec.

The Ontario tax-rate reductions will partly offset this strengthening of the tax bases: lower rates in Ontario will lower the national average rate applied to the personal tax base. The net effect of economic growth and tax rate reductions should, nevertheless, be to increase the equalization standard, since the impact of Ontario's rate reductions has been offset by a marked strengthening of the province's total tax base, particularly sales and corporate taxes. The current strength of Ontario's and Alberta's revenues will further boost the equalization standard, and thus would also help soften the blow.

Nevertheless, reducing Newfoundland's revenues by $141 million (5 percent of its expenditures) in one year or even Quebec's revenues by $133 million (0.3 percent of its expenditures) would be harsh. A mechanism is needed, therefore, to phase in any resulting adjustments.

One such mechanism would be to incorporate federal-provincial transfers into equalization only partially at first. For example, to begin with, Ottawa could net only some of the gap between a province's transfer and an equal-per-capita amount against current entitlements. Over time, the inclusion rate could increase at a fixed percentage rate per year.

How would this work in practice? If Ottawa set the initial inclusion rate at 10 percent, Newfoundland's entitlement would fall by $25 per capita (10 percent of the $245 per capita it would lose under a full overarching program, as discussed in the previous section). Quebec would lose about $2 per capita, while Manitoba's entitlement would rise by about $8. All these changes would be well below the average fluctuations in past entitlements and, therefore, the provinces should be able to absorb them. These amounts should be the maximum that a combination of program reforms and entitlement reductions takes from a province in any year (see Box 2).

Under such a proposal, the total first-year reduction for all equalization-receiving provinces would amount to just over $18 million. If the inclusion rate increased to 20 percent the second year, to 30 percent the next year, and so on, federal-provincial transfers would be fully incorporated into equalization in ten years. A 5 percent initial inclusion rate would reduce the first-year pain by half, but also extend the time required to reach a fully comprehensive program to 20 years.

Besides reducing the initial shock to "have-not" provincial economies, a second

Box 2: *Ensuring the Phase-In Does Not Interfere with Incentives*

One of the difficulties with the phase-in proposal described here is that it would reduce the federal government's incentive to implement piecemeal reforms. Suppose, for example, that Ottawa decided to move the CHST toward an equal-per-capita cash transfer. If this was done while at the same time an overarching equalization program was being phased in, the combination of the two reforms could result in large decreases to recipient provinces. These large decreases would likely dissuade Ottawa from implementing piecemeal changes while overarching equalization was being phased in.

The solution would be to set a maximum by which the combination of the phase-in and any piecemeal reforms could reduce a province's transfers in any one year. If the amounts by which the phase-in reduced equalization were used as this maximum, Ottawa would still have incentives to implement piecemeal reforms. For example, if the CHST were reformed to be an equal-per-capita cash-only transfer while overarching equalization was still being phased in, the maximum would ensure that Newfoundland's total per capita transfers would not fall by more than $25 per year as a result of these policy changes. Transfers falling as a result of underlying economic changes that effect equalization would operate as before.

This interaction between equalization and program reform is one of the main reasons why my recommendation initially excludes employment insurance — recent EI reforms will likely reduce net payments to equalization-receiving provinces for a few years yet.

reason for putting off incorporating regional EI benefits into an overarching equalization program is that the full impact of recent EI reforms has not yet been felt. The reforms affecting repeat users, for example, allowed all recipients to begin with a clean slate;[31] once these reforms are completely phased in, the discrepancies in Table 1 will be lessened. Further, the dynamic effects of the reforms will take some time to be felt, so it makes sense to allow EI to reach a sort of equilibrium before incorporating it into an overarching equalization program.[32]

Additional Benefits of the Overarching Approach

In addition to fiscal equality, Courchene lists a number of principles that ought to underpin an improved interprovincial redistribution program. These include temporal predictability, transparency, accountability, and a reduction in the confiscatory nature of the current program. How well does the proposal for overarching equalization hold up in light of these other considerations?

Temporal Predictability

The history of federal–provincial transfers is littered with examples of unilateral federal caps, freezes, and, more recently, cuts. This lack of predictability has caused all-too-predictable havoc for provincial budgets. Reducing this instability would improve the budget-making process across the country.

Two types of instability are cause for concern. The first has to do with the level of transfers, a problem for which the overarching approach offers no solution since it does not prevent Ottawa from changing the level of transfers it makes to the provinces.

The second source of instability has been the sometimes-discriminatory nature of federal caps and freezes, with the cap on CAP being the foremost example. Overarching equalization would eliminate Ottawa's ability to impose reductions (or increases) in federal-provincial transfers that affect individual provinces differently, because any anomalies caused by a special deal would be netted against a province's equalization entitlements. The overarching approach therefore offers a modest improvement in the temporal predictability of federal-provincial transfers.

Transparency and Accountability

In the areas of transparency and accountability, the overarching approach would be a vast improvement over the current system. As argued above, the status quo provides Ottawa with considerable incentives to hide the true nature of its arrangements with provinces, and encourages provinces to seek special deals. The overarching approach would eliminate the incentive for these bilateral deals and place responsibility for redistribution on the federal equalization program — where it can be seen and easily understood by all.

A Less Confiscatory Nature

Under the current system, when tax bases in equalization-receiving provinces that are not used to establish the current FPS (that is, the Atlantic provinces) improve, the equalization program confiscates 100 percent of the resulting increase in provincial revenues. Economic improvements in these provinces have no impact on the standard. A move to the overarching equalization system proposed here would result in the use of a national standard, which would improve this situation, though only modestly, for the Atlantic provinces.

The strengthening of any province's revenues would increase the standard to the extent that that province's revenue base was reflected in the standard. Thus, compared to the status quo, the confiscation problems would worsen for Saskatchewan, Manitoba, and Quebec, recipient provinces that are part of the current FPS, since their weight would be lessened by a move to a national standard. Those looking for improvement to the confiscatory nature of equalization in the overarching approach will, therefore, be largely disappointed.

The overarching approach focuses greater attention on this issue, however. Under the status quo, Ottawa can always get around the confiscatory nature of equalization by offering special deals to the affected provinces. The current formula, for example, has been modified to bring in only 70 percent of revenues for a resource base concentrated in one province, largely to accommodate the confiscatory outcome of increased revenues for Newfoundland from its offshore energy. Under overarching equalization, Ottawa's ability to bypass the implications of equalization in this manner would be restricted. This can, of course, be seen either as a problem with the overarching approach or as an opportunity to

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deal with the confiscation issue in a more transparent and accountable way.

Conclusion

The federal government's role is largely one of redistribution. The equalization program is the centerpiece of Ottawa's redistributive efforts among the provinces, but its redistributional impact has been significantly undermined by its ability, and desire, to use other programs to effect further redistribution. This situation is unstable, and threatens to weaken the broad support that the equalization program currently enjoys among Canadians.

An overarching equalization program holds out the promise of a more transparent system of interregional transfers. It would make the federal government more accountable to Canadians and increase the perception of fairness in the complex system of federal-provincial transfers. Canada could move to an overarching equalization program with minimal disruption to current levels of redistribution, while at the same time improving incentives to reform programs within that level of redistribution. These benefits would reverse flagging support for equalization, reduce the game playing engendered by the current structure, and make the entire federal-provincial interface more stable.

Appendix A: *Federal-Provincial Shared-Cost Programs, 1996*

Program	Nfld	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta	BC	Canada
						(contribution in $ thousands)					
Agriculture and agri-food											
Canada / Manitoba Agreement on Municipal Water Infrastructure							4,713				4,713
Canada / Saskatchewan Partnership on Water-Based Economic Development								1,873			1,873
Economic and Regional Development Agreements				674	5,705						6,379
Green Plan	193	251	245	224	3,914	6,227				1,361	12,415
New Brunswick Debt Refinancing Program				181							181
Culture											
Alberta Partnership on Culture									53		53
Canada / Alberta Strategic Alliance									852		852
Newfoundland Agreement on Culture	360										360
Nova Scotia Agreement on Culture			51								51
Official Languages Education Program	2,466	1,309	7,373	17,262	50,059	63,234	10,745	9,010	15,098	11,391	187,947
Winnipeg Development Agreement on Culture							399				399
Environment											
Canada / Newfoundland Climate Network	69										69
Canada / Quebec Climate Network Expansion Agreement					419						419
Water Quantity Survey Agreement	354	15	120	215	200	404					1,308
Health											
New Horizons	500	264	661	535	3,200	4,665	836	761	1,244	2,001	14,667
Human resources development											
Alcohol and Drug Treatment and Rehabilitation	593		704	630	2,466	5,103	805	766	1,579	1,784	14,430
New Brunswick Works			2,800								2,800
Older Worker Adjustment		321		16,882	16,824					5,955	39,982
Strategic Initiatives	2,829	2,201	3,000	8,909	29,829	2,704	5,156	5,265	925	16,466	77,284

Regional development											
Canada / Ontario Infrastructure						159,356					159,356
Industrial and Regional Development					37,567	337					37,904
Tourism Co-operative Partnership Agreements					223						223
Western Economic Partnership Agreements							997	62	28		1,087
ACOA: Co-operation Agreements	12,349	18,332	16,094	23,369		63					70,207
FORD-Q: Tourism and Infrastructure Works					166,224						166,224
WED: Economic and Regional Development										16	16
Justice											
Legal Aid	1,661	229	3,062	1,210	16,234	39,402	3,312	2,503	6,402	8,900	82,915
Young Offender Assistance	4,710	1,860	5,677	4,438	27,423	58,676	5,458	6,824	13,610	16,516	145,192
Housing											
Canada Mortgage and Housing Corporation	48,891	7,946	50,606	32,138	193,933	394,502	58,275	99,387	80,938	98,228	1,064,844
Transportation											
Highway Improvements	62,464		1,362	18,300							82,126
National Safety Code	172	147	284	207	725	968	254		451	347	3,555
Outaouais Road Development					518						518
Quebec Bridge Maintenance					300						300
Highways and Airports	1,999		23,023	32,020	14,100	19,428	3,842	9,000	1,150	5,743	110,305
Total	139,610	32,554	112,583	143,112	569,921	771,893	94,792	135,451	122,330	168,708	2,290,954
Per capita	243	237	119	188	77	70	83	133	44	44	78
Amount above (below) per capita average	166	159	42	110	(0)	(7)	5	55	(33)	(34)	

Source: Canada, *Public Accounts of Canada, 1996* (Ottawa: Canada Communication Group, 1997).

Appendix B: The Mechanics of Overarching Equalization

Equalization gives provinces with weak revenue bases access to revenues equal to what they would receive if they applied the national-average tax rate to a standard revenue base derived from averaging the bases of five designated provinces: British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec. Mathematically, this can be expressed as follows:[a]

$$E_{ij}/P_i = t_{cj}\,(B_{Rj}/P_R - B_{ij}/P_i),$$

where

E_{ij}	=	equalization to province i from revenue source j;
P_i	=	population of province i;
E_{ij}/P_i	=	per capita equalization to province i from revenue source j;
t_{cj}	=	the average all-province tax rate, defined as total revenues from revenue source j divided by the total base for source j (that is, B_{cj}), where subscript c refers to the all-province total;
B_{Rj}/P_R	=	the per capita base for source j in the five-province standard;
B_{ij}/P_i	=	province i's per capita base for revenue source j; and
$\Sigma E_{ij}/P_i$; for all j	=	the total per capita equalization entitlement for province i.

If Ottawa were to adopt the proposal put forward in this *Commentary*, the federal transfers identified in the main text would be considered as an additional base with a tax rate of 100 percent. In other words, the total per capita equalization entitlement would be reduced by one dollar for each dollar that federal transfers to the province in question exceeded the average-per-capita amount. The formula would also have to be modified to reflect an all-province standard. Mathematically, the equalization formula under this proposal could be expressed as:

$$E_{ij}/P_i = t_{cj}\,(B_{cj}/P_c - B_{ij}/P_i) + (T_{cy}/P_c - T_{iy}/P_i),$$

where

B_{cj}/P_c	=	the per capita base for source j in an all-province standard;
T_{cy}	=	the total value of transfer y paid to all provinces;
P_c	=	the population in all provinces;
T_{cy}/P_c	=	the average-per-capita value of transfer y to all provinces; and
T_{iy}/P_i	=	the per capita value of transfer y to province i.

Now,

$\Sigma t_{cj}\,(B_{cj}/P_c - B_{ij}/P_i) + \Sigma(T_{cy}/P_c - T_{iy}/P_i)$; for all j,y
= the total per capita equalization entitlement for province i.

[a] From Thomas J. Courchene, *Social Canada in the Millennium: Reform Imperatives and Restructuring Principles*, The Social Policy Challenge 4 (Toronto: C.D. Howe Institute. 1994), p. 99, n.4.

Appendix C
Flogging a Dead Horse:
Net Fiscal Benefits and Overarching Equalization

Much of the literature on reducing horizontal imbalances is based on the idea of "comprehensive income," which is defined as the sum of earnings, w, and net fiscal benefits, *NFB*s. An NFB is defined as the difference between the benefits received from government expenditures and the taxes paid. Equilibrium requires that individuals migrate across regions until their comprehensive incomes are the same (net of migration costs).

Output is maximized when marginal products are equalized across provinces (w_j equals w_i). However, if for some reason NFBs in one province exceed those in another province (NFB_j exceeds NFB_i), individuals will be induced to migrate to take advantage of this fact. The result is that individuals in the high-NFB province will accept lower market incomes than in those in a low-NFB province (so that w_i exceeds w_j). This *fiscally induced* migration is, therefore, inefficient. The federal government can eliminate this inefficiency by transferring funds to the low-NFB region so that marginal products are again equalized. According to the advocates of this methodology, equalizing provincial revenues can offset these differential NFBs.[a]

Several conceptual difficulties weaken this approach. First, it assumes no relationship between NFBs and marginal products. Yet surely a positive correlation exists between these two elements — even if it is not perfect — in which case NFBs are (partial) signals that people *should* migrate.[b] Second, it ignores capitalization, which equalization of revenues alone cannot capture. Third, differences in comprehensive income between individuals motivate fiscally induced migration, so transfers to provinces offer no guarantee that these inducements will disappear. Finally, the approach overlooks the sometimes significant costs of mobility. Adding to the conceptual difficulties are empirical findings that any efficiency gains from a redistributive program may be overtaken by the cost of raising the revenues to pay for the program.[c]

Assuming these difficulties could be overcome and that the relationship between NFBs and marginal products is not perfect, an equalization program could increase efficiency and reduce fiscally induced migration. However, if, in addition, other federal programs provided large regional NFBs, migration decisions would still be inefficient.[d] Since provinces in receipt of equalization by definition pay less tax to Ottawa, the additional redistribution in Table 1 suggests that these inefficiencies may be significant.

Recent discussions of equalization have played down efficiency considerations. As Boadway, an early proponent of the efficiency case, has written, "though efficiency argument might add some weight to the case for equalization, ultimate justification must be sought elsewhere."[e] In this *Commentary*, that "elsewhere" is the essential federal nature of Canada, as it is expressed in its Constitution.

a See Robin W. Boadway and Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada* (Toronto: Canadian Tax Foundation, 1993).

b I thank Bill Robson for pointing me in this direction. The next three points are from Thomas J. Courchene, *Renegotiating Equalization: National Polity, Federal State, International Economy*, C.D. Howe Institute Commentary 113 (Toronto: C.D. Howe Institute, September 1998).

c William G. Watson, "An Estimate of the Welfare Gain from Fiscal Equalization," *Canadian Journal of Economics* 19 (1986): 298–308.

d See S.L. Winer and D. Gauthier, *Internal Migration and Fiscal Structure: An Econometric Study of the Determinants of Interprovincial Migration in Canada* (Ottawa: Economic Council of Canada, 1982), chap. 2; and Kathleen M. Day and Stanley L. Winer, "Internal Migration and Public Policy: An Introduction to the Issues and a Review of Empirical Research on Canada," in Allan Maslove, ed., *Issues in the Taxation of Individuals* (Toronto: University of Toronto Press, 1994).

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Surely, then, this proposal would satisfy the recommendations of the Rowell-Sirois Commission, which bemoaned the *ad hoc* nature of interprovincial redistribution in its day, and recommended equalization-type expenditures as "the concrete expression of the Com-mission's conception of a federal system, which will both preserve a healthy local autonomy and build a stronger and more united nation."

Notes

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1 Finn Poschmann, *Where the Money Goes: The Distribution of Taxes and Benefits in Canada*, C.D. Howe Institute Commentary 105 (Toronto: C.D. Howe Institute, April 1998).

2 Thomas .J. Courchene, *Renegotiating Equalization: National Polity, Federal State, International Economy*, C.D. Howe Institute Commentary 113 (Toronto: C.D. Howe Institute, September 1998).

3 Thomas J. Courchene, *ACCESS: A Convention on the Canadian Economic and Social Systems* (Toronto: Ontario Ministry of Intergovernmental Affairs, 1996), p. 7.

4 Canada, Royal Commission on Dominion-Provincial Relations, *Report* (Rowell-Sirois Report) Ottawa: King's Printer, 1939).

5 Courchene, *Renegotiating Equalization*, p. 11.

6 Rowell-Sirois Report, p. 80.

7 Group of 22, *Making Canada Work Better* (Toronto, May 1996), p. 6. Courchene (*ACCESS*, p. 8) refers to this as "fiscal neutrality — this is the proposition that, apart from equalization, federal programs should treat similarly situated individuals equally, regardless of place of residence."

8 Courchene, *ACCESS*, p. 6.

9 The final result was not always revenue neutral, however, as provinces sometimes took advantage of the opportunity to raise their tax rates beyond the level to which Ottawa had lowered them.

10 It has recently been argued that the only plausible rationale for the current CHST is to enable Ottawa to maintain national standards. See D. Hermanutz, G. Robertson, and G. Smith, "Dividing the Canada Health and Social Transfer: The Equalized Revenue Share Allocator," Working Paper (Edmonton: Alberta Treasury, 1998).

11 This is sometimes referred to as the "vertical fiscal gap," as contrasted with the "horizontal fiscal gap" that is dealt with by equalization. I am hesitant to use this terminology, however, as there is nothing stopping provinces from raising provincial tax rates on the shared tax bases to raise the required level of revenues (there are, of course, marginal economic and political costs associated with being a "second mover"). The vertical gap in Canada is not, in fact, the result of inadequate provincial revenue bases, as it is often characterized, but of an inappropriate division of the bases shared by the two levels of government. This point is often confused in the literature on fiscal federalism; see, for example, Anwar Shah, "Perspectives on the Design of Intergovernmental Fiscal Relations," International Monetary Fund Working Paper (Washington, DC: IMF, 1991).

12 This remains true for the per capita transfer to each province, even though, as Courchene points out, the aggregate value of the total entitlement is now a residual because a cash floor has been established for the CHST. See Courchene, *Renegotiating Equalization*, appendix A.

13 See, for example, Premiers' Conference, "Social Policy Renewal," *Communiqué* (St. Andrews, NB, August 8, 1997), p. 4; and Kenneth J. Boessenkool, *The Illusion of Equality: Provincial Distribution of the Canada Health and Social Transfer*, C.D. Howe Institute Commentary 80 (Toronto: C.D. Howe Institute, June 1996), box 2.

14 This is my interpretation of the 1996 budget, in which changes to the CHST formula were accompanied by the following statement: "The new allocation will also gradually narrow existing funding disparities...current disparities in per-capita entitlements among provinces will be reduced by half" (Canada, Department of Finance, *Budget Plan* [Ottawa: Canada Communication Group, 1996], pp. 58–59).

15 Boessenkool, *The Illusion of Equality*.

16 Canada, Receiver General, *Public Accounts of Canada, 1996*, vol 2, Part 2, chapter 11.

17 See Kenneth J. Boessenkool and William B.P. Robson, *Ending the Training Tangle: The Case against Federal-Provincial Programs under EI*, C.D. Howe Institute Commentary 86 (Toronto: C.D. Howe Institute, February 1997). Under the agreements, Ottawa will transfer some of its employees to the provinces. Alberta will gain 203 employees, and New Brunswick will gain 170 — further evidence that fiscal inequalities will continue to be entrenched under the new system.

18 Anwar Shah, "Fiscal Need and Equalization," *Canadian Public Policy* 22(2): 99–115.

19 This is particularly the case for the five provinces that do not form part of the standard, since a reduction in their bases does not affect the denominator of the equalization formula.

20 As Courchene shows, the incorporation of "need" into the Australian system of equalization has put increasing pressure on the Commonwealth government to abandon untied grants to the states in favor of tied grants. See Thomas J. Courchene, "Subnational Budgetary and Stabilization Policies in Canada and Australia," in J. Poterba and J. von Hagen, eds., *Fiscal Institutions and Fiscal Performance* (Chicago: University of Chicago Press, forthcoming).

21 Canada, Department of Human Resources Development, *From Unemployment Insurance to Employment Insurance: A Supplementary Paper* (Ottawa: Supply and Services Canada, 1994).

22 For more on these two points, see Courchene, *Renegotiating Equalization*.

23 See, for example, D. Milne, "Equalization and the Politics of Restraint," in Robin Boadway and Paul Hobson, eds., *Equalization: Its Contribution to Canada's Economic and Fiscal Process* (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1998); Thomas J. Courchene, *Redistributing Money and Power: A Guide to the Canada Health and Social Transfer,* Observation 39 (Toronto: C.D. Howe Institute, 1995), p. 55; and "Fixing transfers tough challenge for premiers," *Globe and Mail* (Toronto), editorial, August 18, 1997, p. A12.

24 "While Ontario still continued to contribute to equalization, the federal government turned its back on Ontarians who were out of work" (Ontario, Ministry of Finance, "Will stand up to federal government for Ontario: Laughren," *Press Release*, Toronto, April 27, 1995); see also Ontario, *1995 Ontario Budget Plan* (Toronto, 1995).

25 This approach is the recommendation of the Group of 22, in *Making Canada Work Better.*

26 Thomas J. Courchene, *Equalization Payments: Past, Present and Future* (Toronto: Ontario Economic Council, 1984), p. 77.

27 This is not a novel idea. Australia incorporates Specific Purpose Transfers outside of equalization into its equalization program. See C.R. Rye and B. Searle, "The Fiscal Transfer System in Australia," in E. Ahmad, ed., *Financing Decentralized Expenditures: An International Comparison of Grants* (Cheltenham, UK: Edward Elgar, 1997). For recommendations along these lines for Canada, see Courchene, *Equalization Payments*, pp. 271–272; and D.H. Clark, "Assessing Provincial Revenue-Raising Capacity for Transfers," in Ahmad, ed., *Financing Decentralized Expenditures*, pp. 37–38.

28 D. Clark, "Canada's Equalization Program in Principle and Practise," in Boadway and Hobson, eds., *Equalization*.

29 This is, of course, much less than the savings that would result from phasing out regional benefits altogether.

30 Courchene, *Renegotiating Equalization*, p. 30.

31 For more details, see Alice Nakamura, *Employment Insurance: A Framework for Real Reform*, C.D. Howe Institute Commentary 85 (Toronto: C.D. Howe Institute, October 1996).

32 The same case cannot be made for the CHST transfers, since they will not be moving toward a more equal-per-capita cash payment, as shown above. Again, see ibid.

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