

**Equalization at a Crossroads<sup>1</sup>**  
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Introduction

The question that has been raised concerns the treatment of provincial revenues obtained from natural resources in the Equalization program. It is the aim of this paper to place this question in the context of current federal provincial discussions on the future of the Equalization program.

In the federal Speech from the Throne October 5, 2004 it is stated,

“The Government’s regional objectives will be complemented by the most fundamental reform of the Equalization program in its 47 year history. The objective is to make more stable and predictable the total payments by the federal government to the less wealthy provinces in support of key public services”.

The timing of this ACEA Conference is very apt in that it falls between the First Ministers’ Meetings (FMM) on Health September 13 to 15, 2004 and their scheduled meeting on Equalization October 26, 2004. The above quotation reflects the federal proposal to Provinces that was put before them at the September FMM and upon which decisions were deferred until the October 26 FMM.

The changes that are presently on the table for discussion are as follows:

- a/ Guarantee the 2004-05 first entitlement for each province, after adjustments to the second entitlement to a total of \$10 billion,
- b/ Provide offsets to prior year’s adjustments where the adjusted second entitlement for 2004-05 would have resulted in a negative payment,
- c/Fix the 2005-06 entitlement at \$10.9 billion, and grow this at 3.5% per year in the coming five years,
- d/Create a Panel of Experts to make recommendations on provincial allocations after 2005-06, the formula itself and the need for a permanent Commission on the formula, for coming years.

Implicit in moving to the new framework is the understanding that further estimates of entitlements under the existing formula are no longer required and federal Finance has indicated that the

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<sup>1</sup> John Palmer is the senior advisor to the Government of P.E.I. on federal fiscal issues. The views expressed in this paper are his alone and should not be interpreted to reflect provincial government policy. He is indebted to Nigel Burns for his support in the preparation of the paper.

estimation process for the current year and prior years could stop immediately, as the 2004-05 Second estimate and prior year estimates have now been concluded. The present legislated basis for the Equalization program must be changed to move to the new framework because there are requirements for entitlement calculations for 2005-06, 2004-05 and prior years, on the basis of the present formula, which will become redundant if the proposal is to go into effect. The Second estimates for 2004-05, provided October 10, 2004 will therefore likely mark the end of the present program.

The program as we know it today is based on the estimation of provincial entitlements in absolute amounts over a four year cycle incorporating improved data until the Final Estimate is concluded, and this process will cease to exist under the federal proposal. The new system is based on the federal government setting annual budgeted allotments of Equalization, predetermined and not subject to future revisions, whose distribution to provinces will be based on the advice of a Panel of Experts. The status of technical changes flowing from the April 2004 renewal of the program, due to be phased in over time, is now very much in doubt.

As part of their mandate under the proposal the Panel is expected to consider alternative ways of treating revenues from natural resources, as well as consideration of macro type indicators of fiscal needs. In other words the present basis of Equalization, which is based on the Representative Tax System will itself be subject to review.

### Natural Resources in Equalization

The purpose of Equalization is to equalize fiscal capacities of provinces. The present formula does this by measuring the per capita ability of each province to generate revenues with their economic bases, using national average tax rates, by comparison to a five province standard. The program raises any province's fiscal capacity to that standard if they fall below it. This calculation is made for each of 33 provincial revenue sources, including oil, gas, mining, etc. The program's principles are very simple and while the federal government and provinces have always endorsed them, there are evidently situations where this basic principle is not necessarily applied in all cases.

The program already includes a rule, the 70/30 rule, or generic solution, that violates the principle of equalizing fiscal capacities per capita<sup>2</sup>. This rule provides for cases where a province has over 70% of the nation's revenue base. In that case only 70% of its revenues in that base go into the formula, thereby protecting the remaining 30% from negative equalization for that province. This rule was initially put into place because of complaints by Saskatchewan Finance that its revenues from potash production were 99% "taxed back" by the equalization calculation. The same applied to asbestos in Quebec. Those revenue bases have since been amalgamated into a larger base in the formula so as to avoid that problem. The concern was that in such cases those provinces would have no incentive to levy any form of tax on production of these resources. As those provinces were in

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<sup>2</sup>The floor provision, which provides temporary relief from large declines in entitlements also violates this principle when it is invoked.

the five province standard there was a possibility that the formula could cause revenues to be equalized in the five province standard to be artificially lowered. That was the main reason for the 70/30 rule.

The rule today has application in the cases of offshore oil and gas production for the provinces of Newfoundland and Nova Scotia respectively, notwithstanding that those provinces are not part of the five province standard. The equalization formula treats the revenue from production of these resources as unique. Without the 70/30 rule, the value of all revenues to either of those provinces would be 100% offset by an equal reduction in their equalization entitlements. The reason for this is that the “five province standard” for these resource revenues is zero, as the five province standard has no offshore oil and gas revenues. As the revenues to be equalized for Nova Scotia and Newfoundland are equal to the actual revenues from oil and gas received by these provinces so the formula would eliminate any revenues from those sources as equalization losses, dollar for dollar without the 70/30 provision. Until the fiscal capacity of these provinces rises above the five province standard for all revenue sources they will lose all the revenues from the offshore in the form of Equalization losses, without the provision of this partial offset. The 70/30 rule means that 30% of these revenues are kept outside the Equalization program.

**Impact of 70/30 Provision on Equalization  
2004/05 Second Estimate**

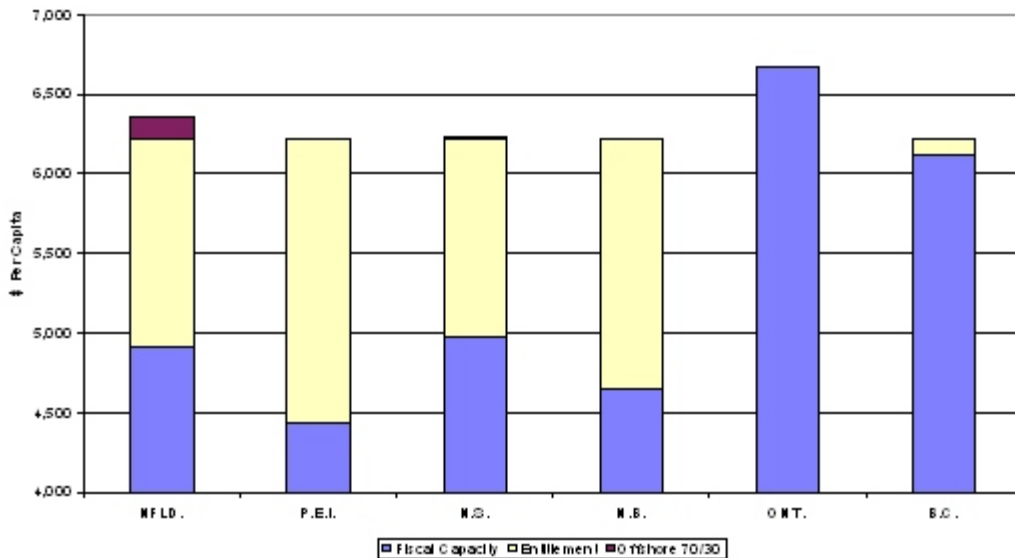


Diagram One

The consequence of the 70/30 rule is to disturb the concept of equalizing all provinces to the same per capita level. This is shown in Diagram One. That diagram uses the most recent Equalization data for 2004-05 and shows P.E.I., New Brunswick and BC equalized to a fiscal capacity of \$6,126, while Newfoundland is provided \$6,350 and Nova Scotia \$6,240, when their 30% offset amounts are

added back in to their fiscal capacity. Manitoba, Saskatchewan and Quebec are not shown but would be at the regular five province standard.

It should be noted that Newfoundland’s additional Equalization revenue amounted to \$70 million, and Nova Scotia’s was \$19 million, as a result of this arrangement. Newfoundland actually elected to receive compensation from its Accord offset, which was worth more than the \$70 million for 2004-05 and so the 70/30 rule was not applied in this case. Thus the actual fiscal capacity of Newfoundland, taking into account the accord offset, is somewhat higher than that indicated in the diagram.

**Potential Impact of \$1 Billion of Revenue from Offshore on Equalization:  
2004/05 Second Estimate**

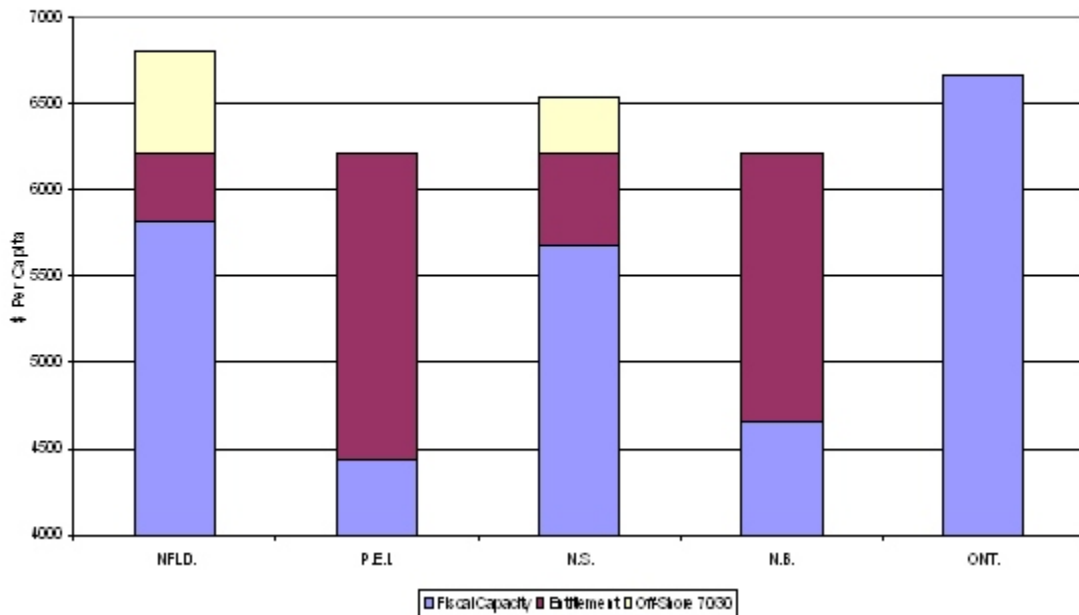


Diagram Two

The amounts involved in these special arrangements are growing, especially in the case of Newfoundland. If revenues from the offshore became \$1 billion per year, the 70/30 rule could raise their fiscal capacity per person to a level over that of Ontario. This is shown in Diagram Two. This result hinges on the likelihood that the fiscal capacity per capita of Newfoundland will remain below the five province standard per capita, when taking into account 70% of their offshore revenues.

In addition to the 70/30 rule both Newfoundland and Nova Scotia have special arrangements with the federal government outside Equalization, as part of their offshore accords. These agreements provide for further compensation for Equalization losses, which smooth out these losses over time. Those accords are presently under renegotiation. Recent public comments by the Premier of

Newfoundland indicate that he wants 100% of all offshore revenues removed from the formula, and the Prime Minister has responded that he is prepared to do this over a certain time frame, so long as the province's fiscal capacity does not exceed that of Ontario. Whatever the final result, these accords further raise the fiscal capacity per capita of Newfoundland and Nova Scotia relative to other Equalization receiving provinces, resulting in further movement away from the equal fiscal capacity objective.

The Province of Saskatchewan has also been provided special compensation for the impact of its oil production on its entitlements recently, in response to a paper by Tom Courchene.<sup>3</sup> In addition the new federal proposal provides special consideration for prior years' adjustments that benefit Saskatchewan and British Columbia as they offset their Equalization losses from the recent increase in oil and gas revenues resulting from escalating energy prices. This is described under the New 2004-05 Arrangement section.

Is the reason for special treatment for natural resource revenues because they are over counted in the equalization formula? The Representative Tax System forms the basis for measurement of fiscal capacities and assumes that a revenue from one source is equivalent to the revenue from another. A buck is a buck is a buck. Some argue that because it is a depleting resource it should be regarded as a temporary aberration, or at least be depreciated.<sup>4</sup> In the case of Newfoundland the arguments are more subjective and seem to rely on the notion that government revenues from the offshore should be reinvested in the province's economic development to raise its standard of living. Thus to deprive the province of its equalization is to retard its economic development.

Evidently the concept of Equalization as a method for equalizing fiscal capacities up to a certain common level is not so easy to accept in such cases in practice, as in theory.

Can it be argued that revenues from natural resources are somehow over counted using the Representative Tax System?

The obvious case of a resource rich province is Alberta. According to the RTS its fiscal capacity per capita is in the order of 150-160% of the national average. Perhaps the measurement is wrong? After all, Alberta's personal income per capita is only 115 % higher than the national average.

We can examine whether the fiscal capacity measure in the present formula for natural resources is dubious, by using the Equalization data itself. We can simulate the Alberta tax regime in non resource rich provinces, which has the effect of removing possible measurement problems for oil and gas resources from the calculation. Table One shows the "Alberta Tax Effort" relative to other provinces, both in percentage terms and in absolute amounts.

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<sup>3</sup> Thomas J. Courchene, *Confiscatory Equalization*, IRPP, Vol 10. No.2 March 2004.

<sup>4</sup>Boessenkool, Kenneth, *Taking off the Shackles*, AIMS, 2001.

## Comparison of Alberta's Tax Effort On Provincial Revenues and Program Spending Per Capita

Province	Per Cent	\$ Millions	\$ Per Cap
NFLD.	66.2	(947)	9,315
P.E.I.	68.0	(211)	8,658
N.S.	71.3	(1,373)	7,420
N.B.	68.8	(1,134)	8,034
QUE.	65.4	(16,721)	9,796
ONT.	74.3	(20,904)	8,437
MAN.	64.9	(2,275)	8,583
SASK.	60.8	(2,890)	9,651
B.C.	68.0	(8,614)	8,661
Total	69.8*	(55,071)	8,893
ALTA.	100.0	0	9,277

\* Excluding Alberta

The first column compares the revenues that a particular province would derive if the Alberta tax regime were in place in that province, by comparison to actual revenues received in taxes in that province. Thus, in the case of P.E.I., the Alberta tax regime would generate only 68% of the revenues actually collected in that province. This result stems in large measure from the application of the Alberta zero sales tax to PEI, coupled with the complete lack of sub surface resource production on P.E.I. and consequent revenue losses. On average, as the table indicates, the Alberta tax regime would generate 69.8% of the taxes paid across all other provinces.

The calculation of Alberta tax effort is the sum of the revenues that would be derived in a given province when applying the Alberta tax rates for each of the 33 revenue bases in the Equalization formula to each province, divided by the actual revenues received by each province from those revenue bases.<sup>5</sup>

For each revenue source we know total revenues by province and the tax bases as defined by the Equalization formula, which is consistent across all provinces. Thus (Alberta Revenue/ Alberta Base) X Province Base, for any given revenue source, provides an estimate of the tax revenue that the specific province would generate from its base using the Alberta tax rate (standardised to the

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<sup>5</sup> In the case of offshore oil and gas the actual revenue for Newfoundland and NS was substituted in the equation as these bases are not found in Alberta and consequently there is no applicable Alberta tax rate.

Equalization Base measurement).

In the case of P.E.I. the Alberta tax regime would leave a \$211 million shortfall, which represents approximately 21% of that province's revenues.

One could argue that Alberta has a low tax regime because of low expenditures. While it is true that Alberta has low debt charges, its program spending is comparable to other provinces. The above table shows program spending per capita<sup>6</sup> by province and one can see that Alberta at \$9,277 is somewhat higher than the national average. Alberta's ability to afford public services at this level, with a tax regime that would derive 70 per cent of revenues available elsewhere, is consistent with its estimated fiscal capacity under the Equalization formula.

Multiplying its 160% per capita fiscal capacity by 70 per cent tax effort provides an estimate of total revenue. For Alberta this is 112% of the national average. Those revenues are presently in excess of actual spending, thereby resulting in substantial surpluses. The results based on the present RTS are entirely consistent with the reality of Alberta's present fiscal situation.

Examining Alberta's fiscal advantages in more depth we found that its resource revenues in 2004-05 do not explain all of its fiscal advantage. In particular it has a substantially higher than average personal income tax base, which is 53% higher than the average for this revenue source per capita compared to all Equalizing receiving provinces, according to the most recent 2004-05 estimates. Several other non resource bases are higher in Alberta also. By comparison with Prince Edward Island, we found that approximately 53% of Alberta's relative revenue advantage was from its natural resource bases and the other 47% was from its higher capacity in non resource bases.

When comparing Alberta's derived tax effort in non resource bases with its measured overall fiscal capacity using RTS, we find results that are consistent with its actual revenue performance. We can conclude that it cannot be claimed that there is an untoward bias in the measurement of natural resources in the program.

This is not to say that there may not be specific measurement problems in determining the resource base in Saskatchewan, BC or other provinces. Indeed the mining tax base is fraught with problems. But the solution to those problems is surely to amend the measurements themselves, not to make blanket concessions to resource rich provinces in the name of fiscal equity.

Finally, it might be noted that while the mechanics of the offshore revenues do result in Equalization losses in a comparative static type of analysis, there are other critical factors that should also be considered. New industrial developments in a receiving province bring employment opportunities, incomes, and consequent population effects. While equalization is reduced on a per capita basis, the

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<sup>6</sup> Estimates of Tax Effort are from the 2004-05 second estimate of Equalization entitlements. Expenditures per capita are consolidated provincial municipal expenditures less debt charges, 2003-04 from Statistics Canada, FMS.

total entitlement also hinges on population growth, which would be positively impacted.

### The Context of the New Federal Proposal

Provinces have been pressing the federal government to move to a Ten Province Standard for many years, as well as to remove the restriction on user fee coverage that was imposed as part of the 1999 renewal. It is recognised that a move to a ten province standard will add approximately \$4 to \$5 billion to entitlements per year, depending on oil and gas prices. Removal of the user fee restriction would cost in the order of \$510 million per year.

In the 2003 Federal Budget, expenditures for Fiscal Arrangements of \$14.1 billion were projected for 2004-05, of which approximately \$12.3 billion would be for Equalization, the remainder going to the Territorial Financing Formula (TFF). Equalization entitlements have in fact fallen drastically in recent years, down to \$8.9 billion in 2004-05, according to the latest estimate. Thus the ten province standard would raise entitlements to approximately \$13.9 billion in 2004-05, which is effectively an increase of \$1.6 billion over the earlier federal projections.

Notwithstanding the drop in entitlements the federal government was not prepared to strengthen the formula in this way.

The federal proposal responds in part to the position taken by Premiers at the Council of the Federation meeting at Niagara on the Lake, Ontario in July 2004 where provinces agreed that as part of the discussions on Health funding, that they would recommend that Equalization entitlements should be returned to their 2000-01 level of \$10.9 billion, as an immediate measure. Provinces remained committed to raising the standard to ten provinces in the longer term.

The federal commitment to \$10.9 billion for Equalization in 2005-06, to rise in the coming five years at 3.5% per year, is an increase over the present level of entitlements, but it represents a major saving in federal expenditures by comparison with their earlier budget projections, and by comparison with an increase to a ten province standard. Under the federal proposal the total payout will not exceed their earlier 2004-05 projection until 2009-10.

The advantages to the proposal for the federal government are considerable. In addition to restricting the size of the payout in the coming five years, the expenditure on the program can be conditioned by federal fiscal conditions, and the amount will be certain for budget purposes, leaving no more uncertainty over estimate changes. Further, by opening up discussion of allocation through an Expert Panel they are able to open up the formula to potentially radical changes. In particular they are willing to consider alternative approaches to dealing with the inclusion of natural resource revenues in the program.

As a by product they may have weakened the insistence of provinces to move to a ten province standard, and by restricting discussion of Equalization to allocation issues only, removed the likelihood of provinces agreeing on measurement improvements. The difficulty that provinces had



in agreeing to an allocation of the 2005-06 amount at the September FMM provides an indication of the varied opinions on the formula that exist among provinces.

Advantages to provinces from the federal proposal are the removal of the uncertainty of actual payments under the present formula, which has plagued the program. In addition the decline in the payout that has been occurring since 2000-01 will be reversed. Provinces that were concerned that natural resources were improperly treated in the present formula have an opportunity to suggest formula changes in the Panel review process. Further, special arrangements were put in place that satisfied Saskatchewan and BC that a serious collapse in their entitlements, as a result of increasing oil and gas prices is avoided.

#### The New 2004-05 Arrangement

The federal provincial “accord” on the 2004-05 entitlement provides a sense of how the Equalization program is moving further away from the principles of equalizing per capita fiscal capacities per province.

We show the result of the new 2004-05 arrangement in Diagram 3, which compares fiscal capacities per capita per province, exclusive of the impact of the 70/30 rule discussed previously.

What causes the results to create such divergent fiscal situations? The arrangement starts with the First entitlement for 2004-05, which has formed the basis of payments since April 2004. This would normally be adjusted in accordance with the new Second entitlement estimate that was made in October 2004 and payments would also be adjusted for new entitlement estimates for 2003-04, 2002-03 and 2001-02 at that time. The federal government decided to raise the second entitlement estimate for 2004-05 across all provinces from \$8.9 billion to \$10 billion. This additional \$1.1 billion was allocated to provinces on the basis of their shares of the 2004-05 entitlement, and that method was agreed to by all provinces.

The federal government also decided to forego negative prior year adjustments in the case of Saskatchewan and BC because it would have lowered their second estimate for 2004-05 , after adjustment to below the First Estimate. The forgiveness was worth \$580 million to Saskatchewan and \$192 million to BC.

In addition to the forgiveness of prior years, Saskatchewan was awarded an amount of \$120 million in 2004-05 to compensate them for so called claw backs of oil royalties and leases, apparently in

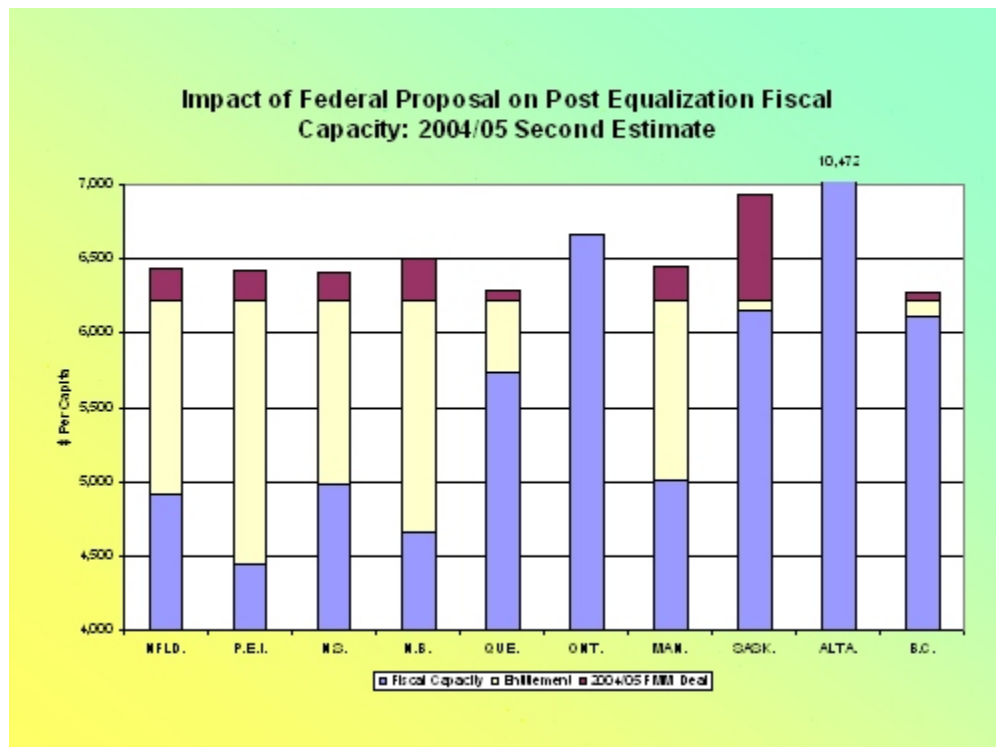


Diagram Three

response to the previously noted paper by Tom Courchene. This amount has also been added into the data in Diagram Three. By tampering with the pay outs for these special considerations, the principle that receiving provinces should be raised to a common per capita fiscal capacity is clearly breached.

The major consequence of the arrangement for 2004-05 is that Saskatchewan's measured fiscal capacity per person is actually above that of Ontario in that year. Other differences occur in accordance with impacts of making special arrangements for prior years and for the allocation of the top up provisions to \$10 billion.

It might be noted that the floor provision in the program has also been particularly beneficial to Saskatchewan in previous years, given their relatively small entitlements per capita, which are very sensitive to changes in the price of oil and gas.<sup>7</sup>

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<sup>7</sup> The impact of the floor payment for that province in 2000-01 actually triggered a ceiling adjustment across all receiving provinces thereby creating the perverse situation of less well off provinces compensating a more well off province for a potential equalization loss. It might be

The new equalization arrangement for years after 2004-05 appears to represent the culmination of a series of federal decisions that offend the principle of maintaining equal fiscal capacities per capita across provinces, based on measurements under the RTS. The following decisions suggest that departures from strict adherence to that formula have already occurred. Concerning the property tax base, notwithstanding extensive criticism of the current formula, the adoption of assessed property values in the 2004 renewal has been severely modified largely to reduce concerns in BC that the new base would have severe impacts on that province's entitlements. The federal government added \$150 million to the total entitlements for all provinces in 2004-05 as part of the 2004 renewal in order to prevent any province from seeing a decline in entitlements from 2003-04 (based on data available at that time). A factor of 10% was incorporated into the formula as an artificial boost factor to improve acceptance of the averaging process planned for introduction in 2005-06. Somewhat arbitrary adjustments have also been made to the mining tax base because of perverse effects of new base measures that were adopted in 1999.

### Conclusion

The subject of the discussion has been the incorporation of resource revenue into the Equalization program. This paper attempts to place this discussion in the context of the reforms to that program being contemplated by the federal government. Clearly the Equalization program will be subject to major reforms following the October 26 2004 First Ministers meeting.

The paper notes that the basis of the Equalization program is to raise less wealthy provinces' fiscal capacity to a specific standard, using the Representative Tax System. Departures from that principle have occurred in the case of Offshore oil and gas production and the implementation of the floor provision. More recently there have been a variety of special measures that have moved the formula off that path.

Decisions concerning the offshore accords suggest that further movement away from that principle is contemplated.

The federal government now wishes to refer all allocation matters to an Expert Panel and to independently budget for Equalization pay outs . Whether this panel will advise the government to adhere to the traditional program in some measure is of course not yet known, but it would appear that the federal government has already shown that it is prepared to move away from the concept of Equalizing fiscal capacities of all receiving provinces to a common level, as would traditionally have been measured.

### PostScript.

The First Ministers Meeting of October 26 2004, which took place 10 days following the ACEA 2004 meetings, confirmed that the federal proposal as described previously would go ahead.

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noted that later entitlement estimates for 2000-01 removed this ceiling/floor impact.

Provincial Premiers are given the opportunity to nominate two members to the six member Expert panel. Premiers also agreed on the provincial distribution of the 2005-06 allotment of \$10.9 billion, based on the Second entitlement estimate for 2004-05, supplemented by \$2 billion, to be shared half on the basis of per capita entitlements and half on the percentage shares of entitlements, over the past three years.

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