

**The Missing Link Between Development
and Equalization**
John Palmer
Speaking Notes for a Panel Discussion with
Lars Osberg and Paul Hobson, Elizabeth Beale as Moderator
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1. Equalization has nothing to do with Economic Development. Equalization has a great deal to do with economic development. How can these diametrically opposed views be reconciled?

The purpose for having Equalization is clearly spelled out in the Canadian Constitution. Professor Osberg has already displayed the wording in the Constitution. It is clearly not explicitly a tool of economic development.

The economic argument for Equalization stems from the generally accepted need to equalize net fiscal benefits. It has been studied from an economic efficiency aspect though there are many disagreements on its economic impacts. The main idea is to prevent unnecessary movement of people around the country seeking fiscal advantages. Some would argue that raising taxes across Canada to transfer monies to areas with weak economies in itself weakens the national economy. Most would agree that the economic efficiency arguments are not as strong as Equalization's equity objective. I would suggest that Equalization is a critical aspect of the Nation's economic development.

While Section 36(1) of the Constitution is more relevant to the goals of Economic Development than Section 36(2), it does not mean that Equalization is irrelevant to Development.

In fact, I would argue, it is dangerous to view Equalization as being opposed to the goals of economic development as many do.

It really hinges on one's concept of "Economic Development". What do we mean by the term "Economic Development"?

2. In trying to clarify this I suggest three ways of looking at Economic Development.

A. The Narrow Perspective.

When many speak of Economic Development they are referring to the Economic Development programs of the federal and provincial governments.

Here we are in the domain of ACOA , provincial Departments of Development, Tourism, provincial lending agencies and so on. These various government agencies are tasked to develop policies and programs to try to "grow" those sectors that are within their purview.

The very narrow perspective is largely oriented to inducing the business community to create manufacturing industries in the region and in many cases it is based on the provision of financial

incentives to encourage manufacturing business to locate or expand in the region.

The somewhat broader “narrow” perspective would take into consideration support for primary sectors such as agriculture, fishing forestry and mineral industries as well as manufacturing, though these sectors are often not part of the Economic Development discussion of governments.

B. The Quantitative Perspective.

The concept of development here is one that focusses on increased GDP, employment and population that stem from the natural features of the province/region. Development is regarded as a quantifiable increase in living standards of people through their occupation and exploitation of the resources of an area. This is not necessarily tied to government efforts but the result of the development of a region’s absolute and comparative economic advantages, coupled with the utilization of new technologies. It would parallel most economists’ definition of economic growth.

C. The Qualitative Perspective.

This concept of economic development is more refined than simply focussing on measures of gross output and human occupation. It is more related to the attributes of a “developed” society. What distinguishes Canada from Nigeria for example is far more than its level of GDP. It lies in the general use of modern, sophisticated, new technologies. Being plugged into modern communication networks, having reliable utilities, and being engaged in the production of goods and services for global markets. These and other attributes are what defines a developed society. Ensuring appropriate environmental standards, governments free of corruption and violence, and so on come to mind.

This goes beyond economic activity that is directed to simply raising GDP and employment. However it is part of our economic development that we often lose sight of, and that is useful to consider when linking Equalization to economic development.

3. How does Equalization interact with these three concepts. What is the Missing Link?

In terms of A. Equalization is basically in competition for federal dollars with those who espouse ACOA type efforts to develop. We can recall Paul Martin as Finance Minister who encouraged the Atlantic Provinces to seek economic development dollars as a substitute for Equalization. Should Equalization be traded off for government programs such as ACOA? Is the Missing Link the desire to move off Equalization and apply funds to “development”?

The implications for Equalization from such a move are mixed. It hinges on what type of economic development is pursued with these funds as well as their success. Government programs to increase employment at low rates of pay will likely reinforce the need for enhanced transfer entitlements. This is because strategies to sustain employment and population at low levels of pay will produce limited tax revenues for large numbers, raising transfer dependency. Substituting development dollars for Equalization standards to pay for such new development programs will then press provincial taxes up and causing competitiveness to suffer. One can expect a general dilution of public services, at higher levels of taxation if Equalization is traded

away for such “economic development”. It is a real danger.

On the other hand development strategies to increase productivity with limited employment gains will cause a reduction in Equalization dependency by raising tax revenues proportionately. Success from such a strategy would automatically reduce transfer dependency. The question is whether government action would be successful in taking us down that path? What are the chances of these programs working?

In terms of B. Equalization’s role is both to allow poorer provinces to have reasonably comparable public services and also to have reasonably comparable taxes. The net fiscal benefits that result essentially leave Equalization as a passive agent of economic improvement. Yet relative tax levels are a critically important part of the ability of the economy to compete. Is it reasonable to press the federal government into substituting Equalization dollars for Development dollars at the risk of losing tax competitiveness? Experience has shown that politicians and development bureaucrats have a distinct tendency to put public monies into very high risk businesses. Is it a reasonable approach to allow taxes to rise in order to invest public funds in such ventures? It is a high risk game of economic development which I would find worrisome.

However I would also strongly disagree with those who suggest that Equalization actually leads governments into discouraging development in order to maximize the equalization take. While one may disagree with provincial and federal strategies for the economic development of their provinces it is evident that decisions to impoverish their economies in order to enhance qualification for Equalization simply do not occur.

In terms of C. This has more to do with the attributes of an economically developed area. It is here that I see a fundamental role for the Equalization program.

Government itself is part of the economy and must operate at a certain level of sophistication to allow modern economies to flourish. Government services themselves have a critical role in supporting and sustaining the development of their economies, not simply from the perspective of the provision of jobs and earnings, but in keeping abreast with the technology of other modern economies and in providing the infrastructures to permit their residents to function in the new world economy.

This covers virtually all aspects of government activities. Just think about the standards that we require from our police force, environmental standards, fire service, roads, airports, telecommunications, health services, education, municipal development, arts, culture, libraries, etc. Where nations fall down in the provision of these services so their economies suffer.

Without Equalization Atlantic Governments would be sadly deficient in their ability to function at the standards of the 21st Century. A diminished Equalization program will reduce the ability of the provinces’ economies to function in the modern world.

However Equalization as applied to these functions of government have ambiguous results in terms of continued transfer dependency given that Equalization is essentially based on population levels. The program only allows a province to compete, not to have an upper hand. As our population growth continues to be slower than other provinces so entitlements will also likely diminish in absolute terms.

4. While it would be a very high risk position to encourage Atlantic provinces today to reduce their efforts to encourage the federal government to strengthen the Equalization program in favour of increased Development dollars, one can make a case that there have been times when this was not the case. I would argue that prior to the 1960's the Atlantic provinces had insufficient dollars to sustain their economies at "modern" standards and overarching supplementary support above that afforded by Equalization was required.

This led to, for example, the fifteen year PEI Comprehensive Development Plan and there is a strong case that Equalization would not have been sufficient to promote the radical economic change that was needed at that time. But I would question whether the Atlantic provinces are in this situation today. Are productive techniques today so backward? Farming is highly mechanised and living standards are comparable with most other rural areas across Canada. While unemployment is high and population growth is weak can development programs work to turn those major forces around? I have my doubts.

Few would claim that basic living standards in the Atlantic Provinces today are at the depths that existed in the years prior to the 1960's. All the kids go to school and have limited obstacles to prevent them from achieving their aspirations, in terms of government support. Health services are at immeasurably higher levels than in the Fifties. Mortality rates are now not very different from the rest of Canada. Basic utilities throughout all areas are now more or less taken for granted. All Provinces are linked to modern communication and transportation systems. Therefore I think the case for a move to programs today to promote economic development as a substitute for Equalization is much weaker.

5. Why choose Equalization? When considering the potential substitution of fiscal transfers such as Equalization for development programming, one should consider the whole mix of federal dollars in the region. How would one adjust the following mix?

- Federal dollars to support provincial services generally through Equalization.
- Federal dollars to support Health and post secondary education through CHST.
- Federal dollars to support unemployment insurance and social services.
- Federal dollars to support direct federal administration in a province.
- Lastly federal dollars for "economic development", through ACOA.

What is the most beneficial mix for the Atlantic Provinces?

Diminution of Equalization would not be the first on my list to be substituted.

6. Conclusion.

Equalization is a critical aspect of the region's economy because the new modern economy demands modern public services.

I would leave government's explicit development efforts as relatively minor, focussed on enhancing the region's natural advantages. The main development functions of government should continue to be focussed on the improvement and maintenance of public services at

modern standards. Strategies to raise employment over productivity should be de emphasised as they are fraught with perils.

The number one priority should be to ensure that Equalization is adequate. Insufficient attention is paid to the critically important role that Equalization plays in what I have described as the qualitative aspects of the nation's development.

Get Equalization right first.

John Palmer
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John Palmer is a recently retired expert on Fiscal Arrangements who worked for the PEI Government for the past 25 years as its main advisor on Equalization and other fiscal arrangements. He holds an MA from Dalhousie University.

Notes. Readers interested in international comparisons of fiscal arrangements and development policies may wish to review papers from the 2002 Charlottetown Conference, which can be found on the Forum of Federations web site.

**Fiscal Equalization and Economic Development
Policy within Federations
An International Conference, Oct. 28-29, 2002
Organized by the
Government of Prince Edward Island
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Chair John Palmer**

Participants:

- Paul Bernd Spahn from the Goethe University in Frankfurt Germany.
- William J. Fox, professor at the Economics Department and Center for Business and Economic Research at the University of Tennessee in Knoxville
- Ronald L. Watts, Principal Emeritus Institute of Intergovernmental Affairs, Queens University, Kingston, Ontario.
- Teresa Garcia Mila, Universitat Pompeu, Fabra.
- Francois Vaillancourt, University of Montreal, will discuss Canadian arrangements.
- Malcolm Nicholas, Commonwealth Grants Commission, Australia.
- Steve Perritaz representing Bernard Dafflon, University of Fribourg, Switzerland will discuss the Swiss experience.
- Ron Neumann from Manitoba Finance, to discuss the South African experience.
- Discussants include Mario Albert, Quebec Finance; Paul Hobson, Acadia University; Francois Delorme (TBC), Federal Finance.
- Welcome from the Hon Pat Mella, PEI Provincial Treasurer

The papers can be found on

<http://www.forumfed.org/programs/llviewpapers.asp>