



# Saskatchewan



# Notes

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## Equalization

— *by Gary Tompkins*

Canada's equalization program is complex. Its intent is to ensure that all provinces have the ability to provide equivalent levels of public services at equivalent levels of taxation. The program does not require provinces to offer equivalent levels of public service but attempts to enable provinces to do so without resorting to levying tax rates that are higher than those in other provinces.

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The equalization program is based on a national average, or "standard", for both the various provincial per capital tax bases as well as the average tax rate on each base. This standard is calculated over 34 different potential tax bases. Saskatchewan's equalization entitlement is the difference between:

- a) the revenues the Saskatchewan government would have raised if it possessed an average tax base over all 34 tax bases and had levied the average tax rate on each tax base; and
- b) the revenues the Saskatchewan government would have received if it had applied the 34 average tax rates on the actual value of its 34 tax bases.

In other words, equalization tries to mitigate the disparities between provinces in tax bases (or potential tax revenue). The actual tax rates used by a province does not affect its entitlement, other than its effect on the estimation of the Canadian provincial average tax rate. If the calculation generates a positive equalization entitlement, that amount is transferred from the federal government to the province. This program is not symmetric—a negative entitlement, as would be the result from a "rich" province, does not result in that province transferring money to the federal government.

One of the historical challenges faced by the equalization program has been how resource revenues, particularly Alberta's, have been the predominant determinant of equalization entitlements. This has led to a number of temporary changes in the program, from reducing the amount of resource revenues that are counted in the average, to excluding Ontario from being a recipient, and other measures. The current system represents a compromise agreement that was reached between the federal and provincial governments where the resource revenue issue was resolved by changing the way the national average or standard is calculated. Under the current system, Alberta's provincial tax bases and rates are excluded from the calculation of the Canadian average. Agreement was reached in this case by compensation for the loss of Alberta in computing the average by also excluding the historically poorer Atlantic provinces. The remaining provinces form the "Representative Five Province Standard", or RFPS.

#### **Problems with the system:**

1. It equalizes "up" but not "down". Provinces with positive entitlements receive federal transfers while provinces above the standard do not pay into the system. In 2001/02, three provinces—Ontario, Alberta, and British Columbia—did not receive entitlements but were not "taxed down" to the national standard. This means that disparities are reduced but not eliminated.
2. As in any social safety net program geared to need, there is an unfortunate effect on recipients known as the economic welfare trap. If a recipient province improves its economy and the province's tax base, a significant portion of the increase in potential revenues will be lost through the reduction (or clawback) of equalization payments. Once a province becomes a "have" province and no longer receives equalization, this problem disappears since there is no transfer of revenues from "have" provinces to the federal government.
3. With the exclusion of Alberta from the average, Saskatchewan is the primary determinant of "average" per capita resource tax bases and tax rates. Enhancing our tax collection from resources may improve the provincial government's fiscal situation before equalization is netted out, but it also serves to raise the standard and thereby frustrate the province's attempt to end its recipient status.

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4. There is no recognition of the costs of developing new tax bases, such as needed infrastructure like roads and collection and administration costs.
5. It is difficult to develop an appropriate measure of tax base, especially with respect to resources. Most economists feel that the way the base is measured is disadvantageous to Saskatchewan in particular. A recent change was the revision of the tax base for Crown leases, a change that implicitly assumes Saskatchewan's resources generate the same surplus revenues per unit of production as do resources in other provinces. This is despite the fact that there is plenty of evidence suggesting that they do not.
6. There is no provision for taking into account differences between the provinces in the cost of delivering public services.

In addition, the exclusion of Alberta raises particular issues for Saskatchewan. While equalization does not recognize it, the geographic proximity of Alberta and the similarity of our resource driven economies mean that Alberta is a “standard” individuals and businesses often measure Saskatchewan against when deciding where to locate themselves or their oil exploration activities.

There are more general problems with the equalization program, mostly based on the potential for provinces to engage in strategic behaviour—*i.e.*, to design tax systems to maximize equalization payments rather than on the usual criteria of efficiency and equity, especially for the provinces that are included in calculating the national standard.

In addition, the exclusion of Alberta raises particular issues for Saskatchewan. While equalization does not recognize it, the geographic proximity of Alberta and the similarity of our resource driven economies mean that Alberta is a “standard” individuals and businesses often measure Saskatchewan against when deciding where to locate themselves or their oil exploration activities. Our resource base, while significant, does not compare favourably with Alberta on volume or on the cost of extraction. This disadvantage is not recognized in the equalization formula.

Finally, it should be pointed out that other federal government programs like Employment Insurance (EI), Canadian Pension Plan (CPP), and the Canadian Health and Social Transfer (CHST) have inter-provincial equalizing effects as well.

A recent study by Tom Courchene of the Institute for Research on Public Policy<sup>1</sup> set out in detail the various problems faced by Saskatchewan with respect to equalization. Two points stand out:

- a) In the most recent year, the effective clawback of Saskatchewan’s energy revenues was 108%; and
- b) In 2001/02, the per capita equalization entitlement in Manitoba was \$1,030, more than four times Saskatchewan’s entitlement of \$236.

Courchene concluded that while none of the recent changes were intended to target Saskatchewan, “...the cumulative impact represents a wholesale assault on the fiscal, incentive and competitive environments of Saskatchewan’s energy sector, with obvious spillovers to the province’s entire budgetary environment” (p. 15).

The Alternative Budget of Choice coalition urges the federal and provincial governments to try to improve the equalization system. Included in any set of reforms should be the inclusion of all or a portion of Alberta resource revenues, a limitation on the effective clawback rate faced by recipient provinces, a fairer method of assessing the size of resource tax bases, and a recognition of any extraordinary costs funded by government in order to develop new tax bases.

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<sup>1</sup> Thomas J. Courchene, *Confiscatory Equalization: The Intriguing Case of Saskatchewan’s Vanishing Energy Revenues*, Institute for Research on Public Policy Choices, Vol. 10, No. 2 March 2004

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