Equalization:

Financing Canadians' Commitment to Sharing and Social Solidarity

by Errol Black and Jim Silver

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Executive Summary

Canada's equalization program is a crucial part of the financial foundation of our social programs, and of Canadians' collective commitment to sharing and social solidarity. It is a formula-based program of unconditional grants paid annually by the federal government to all provinces with a less-than-average tax capacity. The purpose of the equalization grants is to ensure that all Canadians will be the beneficiaries of reasonably comparable levels of public services at reasonably comparable levels of taxation. Canada's equalization program is so important that it has been called "the glue that holds Confederation together". Since 1982 it has been embodied in Canada's constitution.

However, Canada's equalization program is not currently meeting its constitutionally required objectives. The program needs reform.

In this paper we describe the historical origins of Canada's equalization program, and we describe how equalization works. The calculations associated with Canada's equalization formula are complex, and we attempt to describe these in such a way as to make them comprehensible. Of particular importance in understanding how equalization works is the realization that, contrary to what some Canadians believe, equalization does *not* involve transferring money from well-off to less well-off provinces. Rather, equalization payments come from federal government revenues so that well-off provinces, such as Alberta for example, are not adversely affected by equalization.

We describe various rationales for the existence of Canada's equalization program, and address the criticisms of equalization, most of which are rooted in the view that more of the services now offered publicly ought to be offered by the private sector. A major criticism, associated primarily with those on the ideological Right, is that equalization payments sap the vitality of people in lower-income provinces, making them dependent upon government transfers. The implication of this view is that poor people and provinces are poor because of some kind of moral failing, and that people and provinces that are better off are in some way morally superior. We reject this reasoning entirely.

Canada's equalization program is necessary, we argue, because of the economic disparities across provinces, including the historical accident of disparities in the geographic distribution of natural resources, which is no credit to the richly-endowed provinces and no fault of the poorly-endowed provinces. We produce data that demonstrate the considerable economic disparities between equalization recipient and non-recipient provinces, and which show the interprovincial movement of Canadians from recipient to non-recipient provinces. Canada is dominated economically by the provinces of Ontario, British Columbia and Alberta; this domination became more pronounced in the 1990s. The interprovincial movement of Canada's population—and especially that part of the population that is of working age— is dramatically toward these three provinces, and particularly Alberta. The economic gap between have and

have-not provinces has been considerably aggravated by the fiscal policies of the 1990s. Cuts to taxes, which reduced the levels of equalization payments to have-not provinces, have been combined with massive cuts in all transfer payments from the federal government to the provinces. The result of these fiscal policies and trends over the past two decades has been to increase the need for equalization.

However, while current fiscal policies make a strong equalization program more necessary, Canada continues to implement the five-province standard for calculating equalization payments, which was introduced in 1982. This standard excludes Alberta's vast oil and gas revenues from the equalization calculations, significantly weakening Canada's equalization program. Because of this exclusion, the gap is widening between Alberta, which is able to offer richer public services at lower levels of taxation, and have-not provinces which fear the prospect of losing skilled workers and businesses to Alberta unless they too lower their taxes, which then impairs their ability to offer needed public services. This situation sets in motion a process of reduced levels of public services and declining standards of living that is sometimes called the "race to the bottom". The exclusion from the equalization formula of these oil and gas revenues defeats the purpose of the equalization program, as described in Section 32.2 of the Constitution Act 1982, which is to provide to Canadians, no matter where they may live, " reasonably comparable levels of public services at reasonably comparable levels of taxation".

The issue of how to deal with natural resource revenues is rooted in the historical accident of unevenly distributed natural resources, and has implications not only for Alberta, which has the good fortune of being located on top of vast oil and gas revenues, but also for Newfoundland, Nova Scotia and Saskatchewan, with Saskatchewan having been particularly and unfairly disadvantaged in recent years.

We conclude by advancing three recommendations for reform which we believe are achievable and which, if implemented, will remove the current flaws in the equalization program, and enable Canada to meet the program's constitutionally-mandated goals. These are: the establishment of a Federal-Provincial Fiscal Secretariat, which will provide the machinery by which to make the necessary, on-going adjustments to Canada's equalization program; a commitment to the permanent elimination of the ceiling on equalization payments that was imposed from 1982 to 2002, and which had no principled justification; and most importantly, a return to the ten-province standard for use in the equalization formula, in order that all revenues, including Alberta's oil and gas revenues, can be included in calculating the amounts of equalization payments. The implementation of these reforms will enable Canada's equalization formula to achieve the worthy goals for which it was intended—to be the financial foundation for Canada's commitment to sharing and social solidarity.

Equalization:

Financing Canadians' Commitment to Sharing and Social Solidarity

By Errol Black and Jim Silver

Canada's equalization program is the financial foundation of the social programs that contribute so much to defining who we are as Canadians. These social programs give tangible expression to the core Canadian values of sharing and social solidarity. Canada's equalization program is not just an arcane and complex financial mechanism; it is the financial foundation of our core values as Canadians. It is an important part of the means by which we institutionalize a commitment to sharing and social solidarity among all Canadians.

These values are now at risk. Changes to our institutional arrangements over the past twenty years, including various free trade agreements, pose a threat to the continued integrity of Canada as a country, and to the programs which express our identity and our core values (Clarkson, 2002). This threat is growing as a small but powerful minority of Canadians call for even deeper integration of Canada into the United States (Dobson, 2002). We need strong institutions to offset this pull, and to protect and promote our defining values. This is why a healthy equalization program is so important.

Although Canadians are deeply committed to and concerned about social programs, most people know little about the ways in which these programs are financed. The erosion of social programs in recent decades has been the result, among other things, of subtle changes to the financing arrangements. These financing arrangements, especially with respect to equalization, are rather complex. In this paper we attempt to make equalization more comprehensible to the public. We hope this will contribute to a more robust and informed public debate, and to the reform of this vital program. A window for reform is about to be created by the expiry of the current five-year equalization agreement on March 31, 2004, and the need to negotiate a new five-year equalization agreement scheduled to commence April 1, 2004. We conclude this paper with recommendations for necessary and achievable reforms to Canada's equalization program.

What is Equalization?

Equalization is a formula-based program of unconditional grants paid annually by the federal government to all provinces with a less-than-average tax capacity. It is important to note that equalization payments are not transfers from rich provinces to less well-off provinces, as is often claimed. Rather, equalization payments are made by the federal government out of federal funds. The purpose of the equalization grants is to ensure that all Canadians will be the beneficiaries of reasonably comparable levels of public services at reasonably comparable levels of taxation. Thus equalization gives expression to Canadians' commitment to the core values of sharing and social solidarity, and has long been considered exceptionally important for that reason (see sidebar on page 4).

Indeed, so important is the principle of equalization that it is now embodied in the Canadian Constitution, as Section 32.2 of the Constitution Act 1982:

"Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that the provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (Constitution Act 1982, S. 32.2).

The experience in Manitoba since at least the 1930s can be used to exemplify how important equalization is to those provinces which are, in relative terms, have-not provinces. Manitoba played a key role in bringing into existence the Rowell-Sirois Commission in 1937, and has, since that time and irrespective of the party label, the ideological orientation or the fiscal philosophy of the provincial government in office, been consistently a strong supporter of federal redistributive mechanisms such as the equalization program. Even those provincial governments in Manitoba which have been committed to rolling back state expenditures and relying more on market forces have been strong advocates of equalization, arguing that such redistributive measures are an essential mechanism for making Canadian federalism work (Silver, 1992, 243-251).

The Importance of Equalization

- Two decades ago the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements reported that equalization was "...variously described by witnesses before the Task Force as 'the glue that holds Confederation together', and 'a pillar of Confederation'" (Canada, 1981, 157).
- In 2002 the Standing Senate Committee on National Finance stated: "We are united in our belief that this is an important, in fact a defining national program" (Canada, March, 2002).
- A recent academic study of the equalization program found: "The concept of equalization, enshrined in the Constitution Act 1982, enjoys almost unanimous support among Canadian politicians and academics" (Boothe and Hermanutz, 1999, p. 3).
- The Economic Council of Canada reported that it considered "the sharing of costs and benefits" embodied in Canada's system of equalization payments to be "one of the major foundations of Canadian nationhood" (Economic Council of Canada, 1985, 125).

Federalism and Equalization

Canada's equalization system is a product of our federal form of government. Federalism is a system of government with two levels of governmental authority in Canada, the federal and provincial levels, and a division of powers and responsibilities between these two levels of government. A federal system of government was adopted in Canada at the time of Confederation in 1867 because of a desire by the founding provinces to maintain a measure of control over local matters.

Immediately following Confederation an ad hoc arrangement of grants and subsidies to provinces became necessary because some provinces did not

Fiscal Federalism

Federalism is a system of governance in which there is a division of powers between central and regional governments such that neither is subordinate to the other. In Canada we call these the federal and the provincial governments. Each has constitutionally guaranteed jurisdiction with respect to specific subject areas. A reality, and problem, of Canadian federalism is that the provincial governments have constitutional responsibility for health, education and social assistance, which are very expensive. However, most provincial governments do not have the fiscal capacity to finance these programs; hence the importance in Canada of transfer payments, including equalization, from the federal to provincial governments. The details of the financing arrangements respecting transfer payments are often referred to as 'fiscal federalism.'

have sufficient revenues to meet their spending responsibilities. The ad hoc system did not work satisfactorily (Courchene, 1984,14-15). This became glaringly apparent during the Great Depression. Provincial expenditures had been growing rapidly. Education and public welfare expenditures, for example, grew from $4 million per year to $360 million per year between 1874 and 1937, but provincial revenues did not keep pace (Canada, 1981, 14-15). The result was a fiscal crisis for most provinces.

The Rowell-Sirois Commission

The Royal Commission on Dominion-Provincial Relations, more commonly known as the Rowell-Sirois Commission, was established in 1937 to enquire into the crisis of fiscal federalism. Reporting in 1940, the Commission called for an end to the "chaotic and illogical" ad hoc grant system and its replacement with "National Adjustment Grants" to be paid "whenever a provincial government established that it could not supply Canadian average standards of service and balance its budget without taxation (provincial and municipal) appreciably exceeding the national average in relation to income" (Canada, 1940, 83).

At the heart of the Rowell-Sirois Report was the idea that: "The provision of a national minimum standard of social services in Canada cannot (without complete centralization of all social services) be divorced from the assurance to every government of Canada of the revenues necessary for the adequate performance of its recognized functions" (Canada, 1981, 26). Rowell-Sirois argued that to make such revenues available to the provinces, a regularized system of National Adjustment Grants was required. In 1957 such a system was implemented in the form of equalization payments from the federal government to those provinces with less than average ability to raise revenues. The principle and mechanism which the Royal Commission advanced were embodied eventually in Section 32.2 of the Constitution Act 1982: "the wording of the equalization provision in the Constitution Act 1982 is virtually identical to the wording used by the Commission in discussing the National Adjustment Grants" (Courchene, 1984, 26).

Rationales for Equalization

Numerous rationales have been advanced for the existence of an equalization program in Canada. The following are the most important.

The Federal, or Constitutional, Rationale:

Equalization payments are necessary to ensure that all provinces have sufficient funds to fulfill the responsibilities spelled out for them in the constitution. The cost of provincial responsibilities, particularly health, education and social assistance, has grown dramatically throughout the twentieth century. Equalization payments are intended to enable each province to meet those responsibilities by providing reasonably comparable levels of public services at reasonably comparable levels of taxation.

> “equalization should also be justified on moral grounds, as a question of decency and social justice”

The ‘Citizenship’ Rationale:

There are certain public goods and services to which all Canadians, irrespective of where they may live, are equally entitled as a right of citizenship. Equalization payments are necessary to enable all provinces, especially the less affluent, to offer such services (Milne, 1998, 185). As a recent study put it: “The fundamental role of equalization is to help the less affluent provinces finance the national programs that largely define who we are as Canadians” (Ruggeri, 2002).

Inter-Jurisdictional Spillover:

In the absence of equalization, financially stronger provinces would be able to offer significantly lower taxes, thus luring skilled workers and businesses away from financially weaker provinces with higher taxes. These financially weaker provinces would feel the need to compete by lowering taxes, and would be inclined to under-invest in the development of skilled workers because such workers might be lured away by the higher wages and/or lower taxes of a wealthier province. The risk of such a chain of events is that the quality of life in the less well-off provinces would deteriorate; the education and health care and other public services that they could offer would be inferior to those offered in economically stronger provinces.

The “Nation-Building” Rationale:

When Canadians in all parts of the country enjoy reasonably comparable levels of public services at reasonably comparable levels of taxation, as an entitlement of citizenship made possible by equalization payments, equalization becomes a means of binding the country and its citizens together. This is crucial given the powerful centrifugal forces of regionalism which set Canadians apart from one another, and the powerful pull from our neighbour to the south, which threatens to draw us ever deeper into the American orbit.

The Social Justice Rationale:

Constitutional authority David Milne has argued that “equalization should also be justified on moral grounds, as a question of decency and social justice" (Milne, 1998, 186). This is certainly a position with which we agree. Canada's equalization program embodies a set of values rooted in the virtues of sharing and of social solidarity. Canadians support these values. A recent study of the last ten years of Canadian public opinion data found that "support for the equalization programme remains high across the country, even in the 'have provinces.' Canadians overwhelmingly believe that people in small town Newfoundland should have access to schools and hospitals of comparable quality to those in suburban Toronto" (Mendelsohn, 2002, vi and 10).

How Does Equalization Work?

The amount of equalization payable annually to each eligible province is determined by a rather complex formula. The formula determines the average revenue-raising capacity for Canadian provinces on a per capita basis, then determines the revenue-raising capacity of a given province, on a per capita basis. Any province whose revenue-raising capacity is below what is determined to be the "average', or standard, is entitled to an equalization payment. The payment comes from federal government revenues and is sufficient to bring that province's per capita revenue up to the standard. Complications arise, however, in establishing the standard against which each province's revenue-raising capacity is measured, and in determining what constitutes revenue.

What is the Standard?

When the equalization program began in 1957, the standard was set at the average revenue-raising capacity of the two wealthiest provinces. This meant that by definition, nine of the ten provinces had per capita revenue-raising capacity below the standard and thus were entitled to equalization payments. From the perspective of the federal government, out of whose coffers equalization is paid, this was expensive.

In 1962 the standard was changed to the average of all ten Canadian provinces. This ten-province standard came to be known as the Representative National Average Standard (RNAS). From the federal government's perspective this was less expensive, but when oil prices skyrocketed during the energy crisis, first in the early, and then in the late 1970s, the huge energy revenues accruing to the energy-producing provinces, especially Alberta, drove the standard up and thus increased the cost of equalization to the federal government.

As a result the standard was changed again in 1982, this time to the Representative Five-Province Standard (RFPS). The RFPS excluded Alberta and the four Atlantic provinces. This is the standard that prevails today.

The five-province standard is part of the problem from the perspective of the relatively have-not provinces like Manitoba. With Alberta's large oil and gas revenues excluded from the standard, none of that revenue is reflected in the size of the equalization payments. As Robin Boadway explains it, "...the consequence is a system that effectively amputates a good part of the economic purpose of equalization" (1986, 26).

Alberta's oil and gas revenues are so lucrative that the province has the fiscal capacity to offer a high level of public services and high public sector salaries to skilled workers like nurses, teachers and medical doctors, while driving down provincial tax rates. Indeed, Alberta has no provincial sales tax, and the provincial government has in recent years speculated openly about the prospect of eliminating the provincial income tax. As Courchene has recently described it, Alberta is able to use its "...energy revenue bonanza to mount a version of a tax haven" (2004, 9). As a result, Alberta can lure skilled public sector workers away from provinces like Manitoba, forcing Manitoba to respond with higher public sector wages and/or lower tax rates, the combination of which would then render the province less able to provide the full range of quality public services, including education, health and safety, environmental protection, social assistance, and many others that Manitobans want and deserve. The resulting "race to the bottom", prompted in large part by Alberta's exclusion from the Representative Five-Province Standard, subverts the intention of the equalization program.

What Is Included As Revenue?

In 1957, three provincial revenues were included in the calculation of revenue-raising capacity: provincial income taxes, corporate income taxes and succession duties. Today, thirty-three revenue streams are separately calculated, adding to the level of complexity (See Table 1).

Who Makes Equalization Payments?

Equalization in Canada is what is called a "gross" scheme. This means that the equalization payments made to the recipient provinces do not come from the better-off provinces (which would be a "net" scheme), but rather the payments are made by the federal government. In effect, then, the equalization program does not take from the rich provinces and give to the less well-to-do provinces. Rather, it uses federal money raised by means of federal taxes paid by all taxpayers, irrespective of the province in which a person resides, to bring the less well-to-do provinces close to the representative five-province standard.

Cuts to Federal Transfer Payments in the 1990s

The social programs that are partly paid for by equalization and the CHST were put in place, for the most part, in the late 1950s and 1960s. It was then that Medicare and the Canada Assistance Plan (CAP) had their beginnings, and that the post-secondary education system began its rapid expansion. The result was a rapid growth in public expenditures. Initially, the federal government picked up approximately 50 percent of the costs of these programs. After 1977 and the introduction of Established Program Financing (EPF), the federal government withdrew its open-ended commitment to pay 50 percent of the costs of these programs. Over the next two decades the federal government's share of the cost dropped so much that Courchene (1994, 98) estimates that the total cost to the provinces of changes to EPF up to 1994 was $27 billion, and the total cost to the three provinces affected by federal limitations on CAP payments was an additional $8.5 billion. In the 1995 federal budget, EPF and CAP were rolled together into the Canada Health and Social Transfer (CHST). The dollar amount payable by the federal government to the provinces under the new CHST was cut by yet another $7 billion between 1994-95 and 1997-98. By 1999-2000 the CHST had declined to a mere 13.3 percent of total health care costs, down from 50 percent under Established Programs Financing (Western Premiers Conference, 2000, 5, figure 3).

Table 1

Revenues Subject to Equalization, 1999-2000

Revenue Sources	Revenues Subject to Equalization ($ thousands)
1. Personal income taxes	45,269,626
2. Business income taxes	12,777,374
3. Capital taxes	3,979,946
4.General and miscellaneous sales taxes	25,561,101
5. Tobacco taxes	2,273,334
6. Gasoline taxes	5,032,276
7. Diesel fuel taxes	1,655,434
8. Noncommercial vehicle licenses	2,109,291
9. Commercial vehicle licenses	917,424
10. Revenues from the sale of alcoholic beverages	3,788,625
11. Hospital and medical insurance premiums	1,588,000
12. Race track taxes	23,990
13. Forestry revenues	1,615,631
14. New oil revenues	614,172
15. Old oil revenues	161,459
16. Heavy oil revenues	64,133
17. Mined oil revenues	146,059
18. Third-tier oil revenues	92,440
19. Heavy third-tier revenues	24,627
20. Natural gas revenues	2,420,856
21. Sales of crown leases	445,096
22. Other oil and gas revenues	250,789
23. Mineral resources	392,907
24. Water power rentals	628,440
25. Insurance premiums	1,342,747
26. Payroll taxes	6,037,604
27. Provincial-local property taxes	32,726,422
28. Lottery ticket revenue	1,382,498
29. Other games of chance revenues	2,450,552
30. Miscellaneous provincial-local taxes and revenue	7,584,598
31. Shared revenues: Offshore activities/Newfoundland	0
32. Shared revenues: Offshore activities/Nova Scotia	0
33. Shared revenues: Preferred share division	84,878
	$163,442,329

Source: Canada, Department of Finance, Provincial Fiscal Equalization Second Estimate 1999/2000.

How are the Calculations Done?

The actual calculations are perhaps the most complex aspect of the equalization formula. They are done as follows:

- For each of the thirty-three revenue sources now included in the equalization formula, a “national average rate” (NAR) of tax is calculated. This is done by: (1) determining the total tax base for all provinces for a revenue source (for example, the alcoholic beverage tax base is the total volume of beer, wine and spirits sold in a province, so the overall tax base for this revenue source is the volume of beer, wine and spirits sold in all provinces); (2) determining how much revenue was raised from taxes on a revenue source, for example, on beer, wine and spirits, in each province and in the sum of all the provinces. The total national revenue divided by the total national tax base produces a national average rate (NAR) of tax for this revenue source. The same calculation is done for each of the revenue sources in the formula.
- For each province, the national average rate of tax for a particular revenue source is applied to that province’s tax base for that revenue source. So, for example, using the case of Manitoba and the province’s sale of beer, wine and spirits, the national average rate of tax for beer, wine and spirits would be applied to the volume of beer, wine and spirits sold in Manitoba. This sum would be divided by Manitoba’s population to determine the per capita yield for Manitoba.
- The per capita yield on beer, wine and spirits for Manitoba, using the national average rate of tax, is compared to the average per capita yield, using the national average rate of tax, for the five “representative” provinces in the formula: Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.
- If a province’s per capita yield for a given revenue source is less than the average per capita yield of the five representative provinces, then that province is entitled to a per capita equalization payment for that revenue source equivalent to the difference.
- The total equalization payment payable to a province is equivalent to the sum of the deficiencies and/or excesses that are calculated for each of the thirty-three revenue sources.
- In 2001/2002, seven provinces received a total of $10.8 billion in equalization payments.

The Erosion of the Broader System of Intergovernmental Fiscal Relations

The equalization program is only one part, although a crucial part, of a broader system of intergovernmental fiscal relations, or transfer payments, as they are often called. The other major transfer payment is the Canada Health and Social Transfer (CHST). Together, equalization and the CHST comprise almost 80 percent of the dollar value of all transfers from the federal to provincial governments, and just over 20 percent of total federal program spending (Beale, 2002, 3). These transfer payments are necessary because the cost to the provinces of delivering health, post-secondary education and social assistance is greater than the provinces' capacity to raise revenue. The gap has recently grown wider because the federal government has systematically reduced its transfer payments to the provinces for the past two decades. (See *Cuts to Federal Transfer Payments in the 1990s*, page 8.)

The reductions in transfer payments is not the only means by which the federal government has diminished its role in provincial economies. There has been a significant reduction in what is called the net fiscal balance (transfers to a province, plus federal expenditures in that province, minus revenues collected in that province). The net fiscal balance has been reduced both in absolute terms, and relative to provincial GDP in all provinces. This is shown in Table 2, which compares the periods 1992-96 and 1997-2000.

The result is that transfer payments from the federal to provincial governments, including equalization, have become increasingly necessary as a means of offsetting the diminished federal spending in provincial economies.

Fiscal and Economic Disparities in Canada

The need for an equalization program is a function of wide and growing fiscal disparities between provinces. These disparities reflect economic disparities attributable to several factors, including past government economic policies (the National Policy of 1879, for example, which nurtured the development of manufacturing in Ontario and relied on the prairie provinces to produce grains as an export staple), and natural and historical accidents (such as the location of vast oil and natural gas reserves in Alberta). In general, increases or decreases in economic disparities over time are reflected in increases or decreases in fiscal disparities, which, in turn, determine the magnitude of equalization payments.

Table 2

Federal Fiscal Balance By Province

Province	Net Fiscal Balance ($millions)		Per cent of GDP	
	1992-1996	1997-2000	1992-1996	1997-2000
Newfoundland	$3,505	$3,158	34.6	26.6
P.E.I.	696	626	27.2	21.2
Nova Scotia	4,787	3,838	25.5	17.6
New Brunswick	3,200	2,696	20.8	14.9
Quebec	12,019	4,445	7.1	2.2
Ontario	-2,075	-22,009	-0.7	-5.7
Manitoba	3,372	2,677	13.0	8.7
Saskatchewan	2,859	1,310	11.5	4.4
Alberta	-1,097	-6,932	-1.3	-6.0
British Columbia	-320	-3,007	-0.3	-2.5

Source: TEAQ Associates, 2001. *Getting The Right Balance: A Review of Federal Provincial Fiscal Relations And The Funding Of Public Services.*

Table 3 presents comparative 2002 GDP and population data for Canada, selected provinces and selected combinations of provinces. These data indicate that significant economic disparities, as measured by per capita GDP, remain an entrenched feature of Canada's economy. At the extremes, the per capita GDP of P.E.I. ($26,848) is a mere 55 percent of the per capita GDP of Alberta ($48,405).

There is, as well, a significant gap of $6,063 or almost 16 percent, between the provinces receiving equalization payments and the provinces of Ontario, Alberta and British Columbia. Nevertheless, as shown in Table 4, in the period since 1981 there has been a gradual convergence of GDP per capita across provinces.

Population Shifts in Canada

The behaviour of GDP per capita depends on the relative rates of change in the GDP and in population. From 1981 to 2002, the recipient provinces' share of both population and GDP declined: population went from 43.6 to 38.2 percent; and GDP from 36.0 to 33.4 percent.

Differential rates of population change between provinces are strongly influenced by both international and interprovincial migration. Throughout the 1990s the primary destinations for both immigrants and internal migrants were the high-growth and high-income provinces of Ontario, Alberta and British Columbia. Over the period 1991-2000, 99 percent of all net migrants ended up in these three provinces. The percentages were 97.7 in 2001 and 97.1 in 2002. (Two sources are used for data on migration, namely, Statistics Canada, Quarterly Demographic Statistics (91-002-XPB) various numbers; and Statistics Canada web site: http://estat.statcan.ca/cgi-win/CANMCGI.EXE).

Some provinces experienced net emigration during this period. Manitoba, for example, had a negative balance of 10,444 on migration flows. Saskatchewan, Newfoundland and New Brunswick also were on the negative side of the ledger.

Table 3

Comparative GDP and Population Data for Manitoba, Canada and Selected Groupings of Provinces, 2002

	GDP at Market Prices		Population		Per Capita GDP	
	($000)	**% of Canada**	**Total**	**% of Canada**	**$**	**% of Canada**
Canada	1,154,949	100.0	31,315,200	100.0	36,881	100.0
Manitoba	37,075	3.2	1,149,100	3.6	32,264	87.5
P.E.I.	3,748	0.3	139,600	0.4	26,848	72.8
Alberta	149,998	13.0	3,098,800	9.9	48,405	131.2
Recipient provinces*	385,794	33.4	11,976,800	38.2	32,227	87.4
Non-recipient provinces**	763,662	66.1	19,239,000	61.4	38,290	103.8
Five province standard***	930,890	80.6	25,746,300	82.2	36,156	98.0

Note: Canada includes Yukon and territories.
* Nfld., P.E.I, N.S, N.B., Quebec, Manitoba, Saskatchewan.
** Ontario, Alberta, British Columbia (B.C. received transfers in 1999,2001 and 2002).
***Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.
Sources:Statistics Canada: Canadian Economic Observer December 2003 (11-010) for GDP numbers and http://www.infoplease.com/ipa/A0107390.html for population data.

Table 4

GDP Per Capita As A Per Cent of Canada, Selected Provinces

Year	1981	1991	2002
Manitoba	90.4	88.5	87.2
P.E. I.	59.7	71.1	72.8
Alberta	160.1	115.1	131.2
Recipient Provinces*	82.6	86.5	87.4
Non-Recipient Provinces*	113.2	109.1	103.8
Five-province standard*	97.1	100.6	98.0

*See Table 3.

Sources: Table 3, *Canadian Economic Observer Historical Statistical Supplement 2000/01* (11-210-XPB), *Canadian Economic Observer* (11-010-XPB), December 2003, and *Annual Demographic Statistics* 2000 (91-213-XPB)

Manitoba, Saskatchewan and Newfoundland continued to be the main losers of population through net emigration in 2001 and 2002.

Provinces are particularly sensitive to population losses resulting from interprovincial migration. Over the ten-year period ending in 2000, all provinces receiving equalization grants, except P.E.I., experienced a net loss of population through interprovincial migration: Quebec lost 137,279, Newfoundland 54,009, Saskatchewan 47,018, Manitoba 41,607, New Brunswick 10,135, and Nova Scotia 9,600. By contrast Ontario, Alberta and British Columbia experienced net gains of 22,378, 126,374 and 157,787, respectively. These trends have continued in 2001 and 2002 (except that B.C. has in recent years become a consistent loser of population through interprovincial migration). Recipient provinces lost 29,418 people in 2001 and a further 23,922 in 2002 through interprovincial migration. Alberta, which gained 72 percent of interprovincial migrants in 2001-02, is now the main magnet for individuals and families seeking improved economic situations through migration. These population shifts are very important in calculating equalization payments as payments are determined on a per capita basis.

Disproportionate numbers of interprovincial migrants tend to be in the age range most likely to be employed. Provinces losing such people through migration incur two main costs. First, such individuals are likely to be paying more in taxes than they receive in benefits. Second, the province is likely to have made significant investments in their education and training. When these individuals leave the province, the expected return from that investment in the form of increased productivity and earnings is lost. The provinces to which they move reap that gain, at no cost.

For the period 1991-2000 about three-quarters of the net migrants from provinces receiving equalization payments were in the age group 15 to 49. The proportion for Manitoba was 79 percent. The experience on the prairies over this period is instructive.

As shown in Table 5, both Manitoba and Saskatchewan lost population in the age group 15 to 49 in the 1990s while Alberta gained population. The combined loss for Manitoba and Saskatchewan was equivalent to almost 78 percent of the total gain in Alberta. An obvious consequence of these movements is that the productive segment of the population in Alberta is increasing relative to its prairie neighbours. In 2003, for example, the proportion of the population in the age range 15 to 64 was 66.2 in Manitoba and 69.9 in Alberta.

Labour Market Indicators

Labour market indicators reveal a mixed picture regarding the relationship between recipient and non-recipient provinces. Table 6 provides comparative data on employment and unemployment rates for Canada and the provinces. Employment rates in all provinces receiving equalization payments have increased relative to the national average since 1981.

Table 5

Net Interprovincial Migration for the Age Group 15-49, Prairie Provinces, 1991-2000

	Net Migration		
	Male	Female	Total
Manitoba	-16,923	-16,003	-32,926
Saskatchewan	-21,847	-20,226	-42,073
Alberta	+58,848	+39,035	+97,883
Manitoba as % of Alberta	28.8	41.0	33.6
Saskatchewan as % of Alberta	37.1	51.8	43.0

Source: http://estat.statcan.ca/cgi-win/CNSMCGI.EXE

The pattern of unemployment rates has remained quite stable since 1981. Rates are much higher in the Atlantic provinces and Quebec relative to the national average and the provinces of Ontario, Alberta and British Columbia.

A paradox evident in Table 6 is the situation of Manitoba and Saskatchewan. These provinces (and especially Manitoba) are similar to other provinces receiving equalization payments when the comparison is based on GDP per capita and earnings (Table 7). However, when compared on the basis of employment and unemployment rates, Manitoba and Saskatchewan more closely resemble Ontario, Alberta and British Columbia.

Table 6

Employment and Unemployment Rates, Canada and the Provinces, 1981 and 2003

	Employment Rate		Unemployment Rate	
	1981	2003	1981	2003
Canada	60.0	62.4	7.6	7.6
Newfoundland	46.4	49.6	13.3	16.7
P.E.I.	51.9	60.8	11.3	11.1
Nova Scotia	51.8	57.3	9.9	9.3
New Brunswick	49.7	56.6	11.6	10.6
Quebec	55.3	60.0	10.5	9.1
Manitoba	61.3	65.5	5.9	5.0
Saskatchewan	60.8	64.4	4.5	5.6
Ontario	63.2	63.7	6.5	7.0
Alberta	69.4	69.6	3.9	5.1
British Columbia	60.8	60.1	6.8	8.1

Source: Statistics Canada, Historical Labour Force Statistics, 2000 (71-201-XPB) and http://www.statcan.ca/english/Pgdb/labor07c.htm.

Table 7

Average Weekly Earnings By Province As A Percent of National Average, 1983, 1991, 2002

	1983	1991	2002
Canada	100.0	100.0	100.0
Newfoundland	95.9	93.9	90.9
P.E.I.	83.3	81.1	79.4
Nova Scotia	89.0	89.6	86.7
New Brunswick	91.6	90.2	89.3
Quebec	99.2	97.5	94.6
Manitoba	92.8	90.2	89.0
Saskatchewan	94.8	87.6	89.7
Ontario	98.4	104.6	106.6
Alberta	108.1	100.0	102.7
British Columbia	109.3	100.4	99.1

Source: Canadian Economic Observer, various numbers (Catalogue 11-010-XPBP)

Table 7 provides comparative data on average weekly earnings by province as a percent of the national average. Average weekly earnings in equalization-recipient provinces have been declining relative to the national average since the series was established in its present form in 1983. There has also been slippage in Alberta and British Columbia, and earnings in British Columbia are now slightly below the national average.

In sum, this brief and selective review of the economic situation of the provinces indicates that there are significant disparities between provinces receiving equalization payments, and those not receiving such payments. This is particularly evident in the case of GDP per capita and average weekly earnings. The data relating to the labour market present a mixed picture. In the Atlantic provinces and Quebec employment rates are much below the national average, unemployment rates much above the national average, while in Manitoba and Saskatchewan the reverse is true.

The crucial point in all this is that Canada is economically dominated by the provinces of Ontario, Alberta and British Columbia. This domination became more pronounced in the 1990s. Between 1991 and 2002, the proportion of the total population accounted for by these three provinces increased from 58.5 to 61.4 percent and the proportion of total GDP, from 63.8 to 66.0 percent. The share of total jobs in these provinces increased from 60.8 percent to 63.0 percent over the same period. The other side of the coin is that the proportion of the population, GDP and jobs in provinces receiving equalization payments is decreasing. These trends have important implications for the way in which the increasing wealth of the country gets distributed between provinces and among the population, and reveal the importance of Canada's equalization program.

Fiscal Trends

The broad trends in government policy that became pervasive in the 1990s reflected the influence of neoliberal ideas. Most notable among these ideas were that: deficits and debt are bad; the role of the government in the economy should be drastically reduced; markets should be left to determine economic and social priorities and the allocation of resources; and the key to long-term economic success is the rapid elimination of barriers to trade and the mobility of capital.

In terms of fiscal policy, the main thrust in the 1990s was to eliminate deficits and balance budgets by reducing expenditures. As budgets were balanced the emphasis shifted to reducing taxes, particularly corporate and personal income taxes. Tax cuts directly affect equalization. Equalization payments grew in previous decades consistently with the growth in tax revenues. But now provincial governments, and especially Alberta and Ontario, are downsizing and cutting taxes. Tax cuts are likely to slow the growth of tax revenues, thus reducing equalization payouts. The

Fiscal Trends in the 1990s

- Deficits for all levels of government combined were eliminated in the late 1990s; that is, while some individual provincial governments still had deficits, the sum total of federal and provincial finances was in surplus. At the federal level large deficits were converted into large surpluses reaching $4.5 billion by 1997 and increasing to almost $6 billion by 1999. For all levels of government the total surplus in 1999 was $21 billion (Treff and Perry, 2001, B:12).
- Total revenues of all levels of government peaked at 46.6 percent of GDP in 1998. Revenues of the federal government as a proportion of GDP peaked in 1999 at 19.0 percent of GDP, and at the provincial level in 1997 at 19.5 percent of GDP (Treff and Perry, 2001, B:7). The residual is accounted for primarily by local governments.
- Total government expenditures (excluding grants) as a proportion of GDP peaked in 1992 at 55.2 percent and subsequently declined to 44.0 percent in 1999. At the federal level expenditures declined from 19.8 percent in 1991 to 14.9 percent in 1999; at the provincial level they declined from 22.6 in 1992 to 17.8 percent in 1999 (Treff and Perry, 2001, B:11).
- Between 1992-93 and 1999-2000, federal government transfers as a proportion of provincial government revenues, declined from 22.7 percent to 14.8 percent. For Manitoba the proportion declined from 38.6 to 32.7 percent.

TABLE 8

FEDERAL TRANSFERS AS A PERCENTAGE OF PROVINCIAL REVENUE,*
FISCAL YEAR ENDING MARCH 31, 2001

	Federal Transfers General Purpose**	Federal Transfers Specific Purpose***	Provincial Own Revenues
Newfoundland	30.0	11.6	58.4
P.E.I.	27.7	10.8	61.4
Nova Scotia	26.7	11.1	62.2
New Brunswick	25.4	13.9	60.6
Quebec	9.7	5.4	84.9
Ontario	-	9.7	90.3
Manitoba	18.3	11.8	70.0
Saskatchewan	5.3	9.5	85.3
Alberta	-	7.6	92.4
British Columbia	-	12.6	87.4

*Estimates. **Primarily equalization. ***Primarily CHST.
Source: Treff and Perry, p. 8:3.

impact of the fiscal policy of the 1990s was profound.

These data show that the federal government has shifted a greater share of the burden for financing major social programs - health, education and social welfare - to the provinces. "In 1961, the federal government spent roughly the same amount on program expenditures (excluding intergovernmental transfers) as did provincial and local governments combined. By contrast, today, provincial and local governments deliver about double the level of services of the federal government" (Manitoba Budget 2001, Budget Paper C, 30). These various fiscal trends over the past two decades have increased the need for a strong and effective equalization program. Table 8 summarizes the present situation with respect to federal transfers to provinces.

The Problem of Alberta and the Five-Province Standard:

Fiscal decentralization makes a strong equalization program necessary. However, excluding Alberta's vast oil and gas revenues from the five-province standard significantly weakens Canada's equalization program. Thus a central issue in any consideration of Canada's equalization program is how to deal with Alberta.

The dilemma is that if Alberta's oil and gas revenues are included in the equalization formula, the amount of equalization owed to the other provinces would rise very considerably, putting financial pressure on the federal government. If Alberta is excluded from the equalization formula, as is now the case, then the large oil and gas revenues accruing to Alberta provide that province with revenues which, on a per capita basis, are far beyond those available to other provinces. Alberta is thus able, if it chooses, to offer better public services and/or lower taxes than other provinces.

This is why Alberta now has no provincial sales tax and the lowest personal income tax rates in the country. At the upper income levels the highest marginal tax rate in Alberta is 39 percent, 6 percentage points lower than anywhere else in Canada. Alberta is considering the possibility of eliminating provincial personal income tax altogether, the likelihood of which will be increased when the province's remaining accumulated debt is paid off, which is expected to happen very soon. In short, Alberta's public finances are wildly out of line with other Canadian provinces thanks to their good fortune in being located on top of vast oil and gas reserves. The exclusion from the equalization formula of these oil and gas revenues defeats the purpose of the equalization program, as described in S.32.2 of the Constitution Act of 1982, which is "to provide reasonably comparable levels of public services at

Natural Resources and the Equalization Formula

1. The 1957 equalization formula included the two richest provinces and three taxes: personal income tax, corporate income tax and succession duties. Revenues from the sale of natural resources, including oil and gas, were not included.

2. In 1962 the formula was changed from the average tax revenue of the top two provinces, to a national average, which included all provinces and thus Alberta. Fifty percent of the three-year average of provincial revenues and taxes from natural resources were included.

3. In 1964-65 the equalization standard returned briefly to the two top provinces and natural resources were again excluded from the formula, except that 50 percent of the amount by which a province's three year average of per capita resource revenue exceeded the national average would be deducted from the equalization payment to that province.

4. In 1967 the Representative National Average Standard (RNAS) was introduced, so all provinces, including Alberta with its oil and gas revenues, were included in the formula.

5. In 1974-75 the equalization formula was modified in the wake of the first energy crisis. Two sorts of energy revenues were designated: 'basic' and 'additional'. Basic revenues were those derived in 1973-74. Additional revenues were those above the 1973-74 level and attributable not to increased output but to higher prices. Basic revenues were fully equalized; only one-third of additional revenues were equalized.

6. A further change was made in 1977, when only 50 percent of the revenue from non-renewable resources entered the equalization formula, and no more than one-third of total equalization could come from resource revenues.

7. In 1982 the Representative Five-Province Standard (RFPS) was adopted, with Alberta outside the formula. The cap on resource revenues was removed, but because Alberta was not part of the RFPS, most oil and gas revenue was excluded.

8. In 1986 and 1987 Newfoundland and Nova Scotia entered into accords with the federal government respecting those governments' offshore oil and gas. The accords were intended to ensure that not all of the revenue from the offshore oil and gas was 'taxed back' in the form of corresponding reductions to equalization payments. These accords featured twelve-year and ten year phase-ins for Newfoundland and Nova Scotia respectively. This meant that for each province, during the period of the phase-in, the equalization payment for any given year could be no less than 95 percent of the previous year's equalization payment.

9. In 1994 the federal government created a generic tax-back program, applicable to all provinces and all revenue sources. If an equalization recipient province generates 70 percent of the total tax base for a given revenue source, then the federal government will reduce by 30 percent the revenues from that source that will be brought into the equalization formula. For example, 30 percent of the offshore oil and gas revenues in Newfoundland and Nova Scotia would be protected from the 'tax-back' created by reduced equalization payments. Conversely, these provinces lose 70 percent of that revenue source by means of reduced equalization payments. The 70:30 generic tax-back applies only to equalization recipient provinces (although this is not the case for Saskatchewan, more than 100 percent of whose natural resource revenues are taxed back, as described recently by Courchene, 2004). It does not, therefore, apply to Alberta, with the result that Alberta keeps all of its oil and gas revenues i.e., 100 percent of Alberta's oil and gas revenues are protected from equalization.

reasonably comparable levels of taxation". The Representative Five-Province Standard subverts our constitutional obligations regarding equalization.

Whether and how to include Alberta's oil and gas revenue in the equalization formula has been a problem since the oil crisis of the early 1970s, and several variations have been tried.

The problem was described in the 1981 Parliamentary Task Force on Federal-Provincial Fiscal Arrangements, which referred to

> "...the basic dilemma of the equalization program at this particular juncture namely the dilemma of unevenly-distributed natural resource revenues. Since the early 1960s, but particularly since the 'oil shock' of 1973, it has become clear that dramatically-skewed distribution of revenues from natural resources can impose severe strains on the federal structure, and especially on the system of equalization payments" (Canada, 1981, 159).

The National Energy Program (NEP)can be seen as a response to this problem.

The National Energy Program

World prices for oil and gas rose dramatically in the 1970s. Oil prices that had been $3 per barrel in the 1960s and up to 1970, were $38 per barrel by the late 1970s (Canada, 1980, 3). Both Alberta and Canada wanted to move the domestic price for oil closer to the world price, because doing so would generate huge economic rents (see *Economic Rent*).

The question would then become: who would capture the very large economic rents that would flow from rising energy prices, Alberta or Canada? The National Energy Program (NEP) was the federal government's strategy to ensure that Canada got a fair share of it. The NEP was all about the struggle between the federal government and Alberta over the control of the economic rent from Alberta's oil and gas production.

One might think that this conflict over access to oil and gas rents could be solved by answering a seemingly simple question: who has constitutional authority with respect to energy, the federal government or the provinces? Unfortunately, the answer to this question is not completely straightforward. It is clear that the provinces have rights as owners of natural resources:

> No one disputes that ownership belongs to the provinces. This is clearly laid out in Section 109 of the BNA Act, which states that 'all Lands, Mines, Minerals, and Royalties belong to the several Provinces of Canada', a right that was granted to the three Prairie provinces in 1930 in an amendment to the BNA Act (Dobson, 1981, 5).

However, there are disputes about how far these ownership rights go. The federal government believes that it has the right to limit provincial ownership rights by virtue of its responsibility for the national economy, and in particular by virtue of the 'trade and commerce' power (s. 91.2 of the

Economic Rent:

Economic rent is the excess income generated over and above a "normal" return to capital and labour; the amount left over after all production costs, including a normal rate of profit, have been paid. In this case the economic rent is the dollar amount attributable not to production costs but simply to rising prices.

Constitution Act), which gives to Ottawa jurisdiction with respect to all interprovincial and international trade, including interprovincial pipelines and international exports (Dobson, 1981, 5).

The federal government and Alberta both had reason to believe, based not only on constitutional reasoning but also on the particular way in which oil and gas were developed in Alberta since 1947, that they were entitled to the bulk of the economic rent from rising oil and gas prices.

From Alberta's point of view, not only did the province own the resource, but also it had been, for much of the twentieth century, a have-not province in the western Canadian hinterland. Alberta had been exploited by the banks, the railways and the grain companies, and forced to pay higher-than-world prices for manufactured goods from central Canada. Also, since 1960 domestic oil prices had been held below the world price, so that Alberta was effectively subsidizing the rest of Canada in the form of lower oil prices than would be paid on the world market. By 1980, following the dramatic increases in oil prices in the 1970s, it has been estimated that Alberta was losing $13 billion per year in energy rents as the result of the ceiling on oil prices. Given that history and the province's ownership of the resources, surely, Alberta argued, it is only fair that it now derive the full benefit of the economic rent from what is, after all, a depleting resource. The Conservative government of Peter Lougheed, elected in 1971, was committed to increasing Alberta's share of oil and gas revenues in order to diversify the province's economy and thereby break out of its have-not status.

From the federal government's point of view, the dramatic increase in oil and gas revenues was driving up the cost of its equalization payments. Between 1973 and 1980 equalization payments grew by 16 percent per year. The cost of equalization is borne by the federal government. The federal perspective, therefore, was that the Canadian government was paying for rising oil prices in the form of higher equalization costs. In addition, Canadians in every province were paying in two ways: in the form of higher oil prices, and in the form of higher federal taxes to pay for rising equalization costs. Moreover, the bulk of the taxes to pay for rising equalization costs were raised in Ontario, which did not qualify for equalization. Finally, the federal government argued that it had the responsibility for the management of the economy as a whole and therefore needed access to the economic rent deriving from oil and gas price rises if a further balkanization of the Canadian economy were to be prevented. As Ed Shaffer put it:

> The federal government...wanted the economic rents not only for its own revenue needs but also to retain its control over the country. If the bulk of the rents flowed into the coffers of the provincial treasuries, the economic power of the provinces would grow relative to that of the federal government. It would then become increasingly difficult, if not impossible, to formulate any effective national economic policy. With their increased economic base, the provinces would be in a position to wield far more political power than in the past. This dispersion of power from the centre to the periphery would pose the danger of the balkanization of Canada...The federal government was not inclined to abdicate its role, especially to a province containing only one-tenth of the population (Shaffer, 1983, 215).

A further argument made by Ottawa was that the federal government had incurred much of the cost of developing Alberta's oil and gas reserves, and so Ottawa deserved some of the economic rents. The federal expenditures relating to the development of Alberta's energy resources included billions of dollars in corporate tax write-offs and/or tax deferrals for exploration "the most favourable national tax expenditures given to any industry" (Cumming, 1986, 68). There in turn were then capitalized in sale prices of Alberta lands "which have generated close to a billion dollars for the producing provinces in some years". According to Courchene, "...the combined federal expenditures on energy-related equalization payments and the oil import compensation program exceeded by a large margin the amount of revenue Ottawa derived from the energy sector. I think it should have been clear to everyone, Alberta included, that Ottawa was going to garner a larger share of the energy revenues. The only unresolved questions were how and how much" (Courchene, 1981, 82).

The result was the National Energy Program, introduced with the federal budget of October 1980. The NEP sought to increase the degree of Canadian ownership of the oil and gas industry, to improve Canadian energy security, to hold the price for Canadian consumers below the world level, and to increase the federal government's share of the economic rents. The latter purpose was to be achieved by means of new federal oil and gas taxes and the so-called "back-in" provision by which the federal government unilaterally took a 25 percent interest in oil and gas produced in what were called the Canada Lands, and restricted production on the Canada Lands to those companies with at least 50 percent Canadian ownership.

A major problem with the NEP was that it was imposed without an agreement being reached between the federal government and Alberta. It was a unilateral federal intervention. Alberta charged that Ottawa had "without negotiation, without agreement, simply walked into our home and occupied the living room" (Premier Lougheed in 1980, quoted in Doern and Toner, 1985, 106). Alberta responded angrily, as of course did the USA. Ronald Reagan was elected president of the USA one week after the October 28, 1980, announcement of the NEP. He and the oil interests that had supported his campaign for the presidency were enraged by the Canadian nationalist and state interventionist character of the NEP. Their opposition to the NEP was a significant factor in the development of the Canada-US Free Trade Agreement, which is designed, among other things, to restrict state interventionist measures, generally and with respect to energy and other natural resources, and serves to ensure US access to oil and gas in Canada.

The NEP was soon dismantled, leaving the federal government in its initial position with no real access to the economic rents generated by rising prices for oil and gas, and for other natural resources which fall under provincial ownership. The result with respect to oil and gas was the shift in 1982 in the equalization formula from the ten province RNAS, to the five province RFPS, which excludes Alberta and its oil and gas revenue.

The result is completely unsatisfactory. Because its massive oil and gas revenues are not included in the equalization formula, the gap is widening between Alberta, which is able to offer richer public services at lower levels of taxation, and have-not provinces which fear the prospect of losing skilled workers and businesses to Alberta unless they too lower their taxes, which then impairs their ability to offer needed public services. It is clear that Alberta needs to be brought into the equalization formula, and the federal government needs access to the economic rents accruing from Alberta's oil and gas in order to offset increased equalization costs.

It is useful to consider the treatment for equalization purposes of Newfoundland and Nova Scotia's offshore oil and gas revenue. In 1993 the

70/30 formula was instituted. Any province with 70 percent or more of a particular revenue has only 70 percent not 100 percent of that revenue stream enter the equalization formula. This is not, however, the case for Saskatchewan, which for reasons which appear to be irrational, is not gaining protection for 30 percent of its energy revenues, but rather is facing the perverse outcome of having more than 100 percent of its energy revenues 'taxed back' (Courchene, 2004).

The Atlantic Institute for Market Studies (AIMS) is mounting a campaign to remove Newfoundland's and Nova Scotia's offshore oil and gas revenues entirely from the equalization formula. They argue that Newfoundland and Nova Scotia should have all of that offshore oil and gas revenue. This arrangement would allow for the massive investment in their economies that is needed if they are ever to get off the equalization system.

We maintain that this would worsen the problem that Alberta's exclusion from the formula has already created. The better solution is to move to a ten-province standard that includes Alberta, and makes 100 percent of natural resource revenue subject to the equalization formula. This would also solve Saskatchewan's problem (Courchene, 2004, 17). As one economist has put it, "a dollar of fiscal capacity is a dollar of fiscal capacity, whatever its source" (Cumming, 1986, 66). There seems to be no coherent justification for treating oil and gas revenue differently from other provincial revenue sources.

Criticisms of Equalization

Canada's equalization program has been subjected to frequent criticism, much of it ideologically inspired. A classical question in political economy, and one which has produced a particularly right-wing answer in the past two decades, is this: to what extent should the state intervene in economic matters, particularly in a redistributive capacity, and alternatively, to what extent should the market be left to allocate resources. The trend in recent years has been to reduce state intervention, especially that which redistributes income. Consistent with this trend, there has emerged a growing opposition to the equalization program. Usher, writing for the Fraser Institute, demonstrated the Fraser Institute's opposition to the redistributive character of equalization and to the core Canadian values of sharing and social solidarity by calling equalization "an elaborate system of bribes...a great pork barrel scheme" (Usher, 1995, 115-16). The Reform Party campaigned on a platform of limiting equalization to "only the poorest provinces", and would by this means have cut several billion dollars from equalization payments (Milne, 1998, 199). The Atlantic Institute for Market Studies argues that equalization creates a form of welfare dependency among recipient provinces. Courchene has argued that unconditional grants to low-income regions distort the allocation of resources "by removing part of the incentive for labour and capital to move to the location where they can be best used". Equalization grants "have reduced the have-not provinces to a state of dependency and have retarded their economic growth by removing the incentive to produce" (Boadway, 1980, 48, referring to Courchene 1978). He calls for less emphasis on 'place prosperity' and more on 'people prosperity' (Courchene, 1994, 97), by which he means that transfer payments should go directly to people, not provinces. Similarly Norrie (1994, 169) calls for federal transfers to go directly to individual Canadians. The fact that federal transfers like the CHST and equalization payments go directly to governments is what makes the public provision of services possible, something that would not be the case if the transfers were to go, as Courchene and Norrie call for, to individuals.

It is only transfers to governments that enable the provision of public goods and services. That, we believe, is the point of many if not most of the critics of equalization—they seek to erode the public provision of services and turn more over to the market place by means of privatization. The future of equalization therefore depends, in large part, upon the extent to which the Canadian public is prepared to support a politics of redistribution and, by doing so, to fly in the face of the current pressures for more market-based solutions. There is consistent evidence of unwavering support among Canadians for a politics of redistribution to keep our social programs strong and to give expression to the core Canadian values of sharing and social solidarity (Mendelsohn, 2002; Canada, November, 2002; Schafer, 2002).

Recommendations

Equalization is of crucial importance to Canada's continued existence. It is a unique program of enormous value to Canada and Canadians. It reflects a set of values, rooted in a core belief in sharing and social solidarity, that are distinctly Canadian, and that are treasured by many. It is, however, currently in need of repair. Thankfully, the equalization program can be repaired with a handful of reforms.

We recommend three reforms to Canada's equalization program which we believe are achievable and desirable. These are: the establishment of a new, independent Federal-Provincial Fiscal Secretariat; the commitment to the permanent elimination of the cap or ceiling on equalization payments that was imposed from 1982-2002; and the return to a ten-province standard for use in the equalization formula. We recommend that these reforms be part of the next five-year renegotiation of the equalization program, the current version of which expires March 31, 2004. With these reforms in place, the equalization program would be healthy and sustainable and Canada's economic, social and political health would be significantly improved.

Recommendation #1:

Establish a Federal-Provincial Fiscal Secretariat:

> There is and there can be no final solution to the allocation of financial resources in a federal system. There can only be adjustments and reallocations in the light of changing conditions. What a federal government needs, therefore, is machinery adequate to make these adjustments (Courchene, 1984, 81, quoting Wheare, 1964).

The machinery needed to make the necessary adjustments to Canada's equalization program is not adequate. Changes are made to the program virtually unilaterally by the federal government, almost solely for the purpose of cost containment (the cap on equalization payments; the move to a five-province standard), and without adequate research into the extent to which the program is meeting the ever-changing needs to which it is intended to respond. There is a "Subcommittee on Equalization" comprised of federal and provincial officials which meets periodically, and has done so since 1970 (Clark, 1998, 95). But this committee is not enough to change the largely unilateral fashion in which the federal government makes decisions about the program. As Courchene (1984, 405) argues: "Equalization is more than a program for 'have-not' provinces. It is part and parcel of our national fabric. It is important that all provinces (not just have-not) maintain an interest in it".

What is needed is a stand-alone body, structured and governed and financed so as to represent the interests not just of the federal government, but also of the provincial governments and of Canadians more generally. The mandate of this body would be to conduct on-going analyses of and long-term research into the equalization program, and to make recommendations to the federal and provincial governments about modifications to the program as they are needed. Such a body exists in Australia and is called the Australian Commonwealth Grants Commission (Wilson, 1998, 215). In South Africa a similar body is the Financial and Fiscal Grants Commission. Some of Canada's leading economic experts on equalization have called for the establishment of such an institution in this country (See, for example: Boadway and Hobson, 1998; Boadway and Flatters, 1994; Courchene, 1984). The research and analysis done by such a body would improve our ability to redistribute wealth across the country in a way that is consistent with both the intentions of the Rowell-Sirois Commission and S. 32.2 of the Constitution Act 1982. It would also improve the quality of public debate in Canada about equalization. To this end, we recommend the establishment of a Federal-Provincial Fiscal Secretariat.

Recommendation #2:

Avoid Imposing Caps on Equalization:

During the period 1982 to 2002, equalization payouts were subject to a ceiling or cap. This had a significant impact. At the end of the 1980s, for example, the ceiling saved the federal government, and therefore cost the recipient provinces, almost $3 billion in three years (Clark, 1998, 96). For Manitoba and Saskatchewan, the ceiling reduced equalization payments by $628 million for the period 1988-89 to 1991-92 (Report of the Western Finance Ministers, 1991, 9), and Manitoba expected to lose $100 million due to the cap in 2000-01 (Selinger, 2001, 9). Partly as a result of the ceiling, equalization payouts have declined from 1.33 percent of GDP in 1982 to 1.04 percent of GDP in 2001 (Selinger, 2001, 9). The federal government removed the ceiling for the 1999-2000 fiscal year entitlements, re-imposed it in 2000-2001 and then eliminated it again in 2002-2003.

Fifteen years ago Robin Boadway, one of Canada's leading authorities on the equalization program, observed that "there is no economic reason for this ceiling; its imposition is essentially arbitrary" (Boadway, 1986, 30). The provincial and territorial ministers of finance, at their December 2000 meeting in Winnipeg, called for the removal of the ceiling from the equalization program. The four Atlantic provinces have lobbied individually and collectively for the removal of the ceiling (Beale, 2002, 12). In March 2002 the Standing Senate Committee on National Finance called for the elimination of the ceiling.

It is our view that elimination of the ceiling in 2002-2003 reflects the fact that there is no adequate intellectual or policy justification for its continuation. Moreover, given the uncertainty and inequities created by a ceiling, we recommend that there be no future impositions of a cap or ceiling on federal equalization payments.

Recommendation #3:

Return To a Ten-Province Standard:

The five-province standard has no justification in terms of principles. It was implemented simply to remove Alberta's large oil and gas revenues from the formula, and thus reduce the fiscal pressure on the federal government. It is important to be cognizant of the fiscal pressures placed on the federal government by the equalization program.

However, removing Alberta to ease this pressure has had seriously perverse effects. Section 32.2 of the Constitution Act, requiring the provision of "reasonably comparable public services at reasonably comparable levels of taxation", is being violated because Alberta's vast oil and gas revenues are outside the formula. The result is that Alberta is able to establish a tax regime which is not reasonably comparable to other provinces, with the result that fiscal decision-making in other provinces, and especially have-not provinces, is being distorted in a way that is detrimental to Canadians and inconsistent with the values of the equalization program. Alberta and its oil and gas revenues must be brought into the formula. This should be done by means of a return to the ten-province standard. Although it would be best if this were done immediately, the return to the ten-province standard could be phased in over the five-year life of the new equalization agreement that is about to be negotiated, and that will be made retroactive to April 1, 2004.

The impact of returning to a ten-province standard would be significant and profoundly important to the eight provinces that now receive equalization payments. This is shown in Table 9.

TABLE 9

IMPACT OF 10 PROVINCE STANDARD ON TRANSFERS TO RECIPIENT PROVINCES, 2002

	ENTITLEMENTS UNDER 10-PROVINCE STANDARD (000,000)	ENTITLEMENTS UNDER 5-PROVINCE STANDARD (000,000)	DIFFERENCE (000,000)	PER CENT CHANGE
Newfoundland	998.07	855.04	143	16.7
P.E.I.	268.31	228.79	40	17.3
Nova Scotia	1,430.27	1,160.85	269	23.2
New Brunswick	1,362.46	1,146.17	216	18.9
Quebec	6,807.99	4662.20	2,146	46.0
Manitoba	1,643.14	1,309.96	333	25.4
Saskatchewan	318.40	134.70	184	136.4
British Columbia	1,397.58	211.54	1,186	560.6
Total Recipient Provinces	14,226.22	9,709.24	4,517	46.5

Source: Data provided by Ron Neumann and Rob Balacka of Federal-Provincial Relations and Research, Manitoba Finance, Winnipeg.

A redistribution of this magnitude would not only restore the letter and spirit of the original idea of equalization as initially understood and later applied in this country, but would also give recipient provinces additional resources with which to improve and sustain their social infrastructures.

Conclusions

Canada's equalization program is the financial foundation of the social programs that contribute so much to defining who we are as Canadians. However, our equalization program is now badly in need of reform. The recommendations for reform that are identified in this paper are achievable. If they are implemented, Canada's equalization program will be brought into line with the requirements of the Constitution Act 1982, which requires that equalization payments be sufficient "to ensure that the provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation". The reforms will enable provinces to revitalize our social programs in line with the repeatedly expressed desires of the considerable majority of Canadians. The current five-year equalization program expires March 31, 2004. Now is the appropriate time to introduce these reforms.

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