

# FISCAL EQUALIZATION: COUNTRY EXPERIENCES

## THE CANADIAN FEDERAL-PROVINCIAL FISCAL EQUALIZATION SYSTEM

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The federal-provincial fiscal equalization system plays a very important role in Canadian public finances. This report describes this program, which has recently undergone major changes. We also provide some background on intergovernmental finances in Canada to put the equalization system in its constitutional, historic and economic contexts. The report focuses on the main federal equalization grant program to the provincial governments and discusses only in passing the other major federal transfers to the provinces. It does not cover the federal transfers to the territorial governments, which are determined under a different program, or the transfers that the ten provincial governments make to municipal governments.<sup>1</sup>

### Background on federal-provincial finances in Canada

The federal-provincial equalization program began in 1957 in response to the desire of the two largest provinces in Canada, Ontario and Quebec, to reassert their control over their revenues and recommitte levying income taxes. (During World War II, the federal government had taken control of all of the major tax bases and distributed grants in lieu of taxes to the provinces.) Given the inequality in the fiscal capacities of the provinces, the move to greater provincial taxation would have resulted in large variations in the revenue-raising abilities of the provinces. Hence, the federal government imple-

mented the first equalization program to reduce the fiscal disparities of the provinces. The initial equalization program was based on three revenue sources – personal income tax, corporate income tax, and succession duties – and the standard of equalization was based on the average fiscal capacities of the two richest provinces at the time, Ontario and British Columbia. A history of the evolution of the equalization program is contained in annex of the report of Expert Panel on Equalization and Territorial Formula Financing (2006b).



The importance of the equalization program was recognized in 1982 in the following provision of the Canadian constitution:

*Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

While the obligation of the federal government to make equalization payments to the provinces was enshrined in the Canadian constitution in 1982, the wording is sufficiently ambiguous that it gives the federal government considerable flexibility in determining the distribution and the level of the equalization payments.

Other aspects of the Canadian constitutional arrangements have also shaped the equalization program. These include:

The provinces have “exclusive responsibility” for health, education, and social welfare. These are the “big ticket” items for modern governments, and responsibility for these activities requires substantial amounts of revenue. Major differences in the provision of these key services, because of differences in the revenue-raising abilities of the provinces, would be inconsistent with the spirit of section 36(1) of the Canadian constitution which enjoins the federal and provincial governments to promote “equal opportunities for the well-being of Canadians...”.

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<sup>1</sup> For information on transfers to the territorial governments, see Department of Finance (2007a and 2007c) and Expert Panel on Equalization and Territorial Formula Financing (2006a).

Notwithstanding the assignment of exclusive responsibility of key functions to the provinces, the courts have determined that the federal government can offer conditional grants to the provinces to promote national programs in areas of provincial jurisdiction, such as health care, post-secondary education, infrastructure, and other social programs. This is referred to as the federal “spending power”, and it provides the basis for the other major federal transfer programs – currently called the Canada Health Transfer (CHT) and the Canada Social Transfer (CST).

The constitution restricts the provincial governments to levying “direct taxation within the province”. This means that the provinces are not able to levy taxes on imports to the province, as this would restrict the free flow of goods and services within the federation. In practice, the provincial governments have extensive tax powers, and they impose taxes on all of the major tax bases, including personal and corporate income taxes, sales taxes, payroll taxes, excise taxes, and property taxes. The federal government also co-occupies these tax fields, with the exception of property taxes. The Canadian tax system is characterized by a high percentage of revenue raised at the subnational level and the joint occupation of the main tax bases by the two levels of government.

The Canadian constitution also gives the provincial governments ownership and control over natural resources. Natural resource revenues, especially from royalties on the production of oil and natural gas, have become major sources of revenue for some provincial governments, especially in Alberta, Saskatchewan, and British Columbia. Two eastern provinces, Newfoundland and Labrador and Nova Scotia, have also negotiated the right to receive revenues from offshore oil and gas fields. Revenues from hydro-electric developments are also important for Quebec. Other provinces receive relatively little resource revenues, and this inequality in the distribution of resource revenues, combined with the absence of federal revenues from these sources, has created major problems in determining the appropriate level of equalization payments.

Municipal governments do not have an independent status in the Canadian constitution. The provincial governments have complete control over the municipal sector and can create, reform, or merge any municipal governments within their boundaries. The financing of municipal governments is a provincial responsibility, and any equalization programs at the

municipal level are the responsibility of their respective provincial governments. The property tax is the main source of own-revenues for municipal governments, but most municipal governments are heavily reliant on transfers from their provincial governments. In 2006, transfers were the single largest source of income for local governments at 42.7 percent of the total. Thus, in some respects, the provincial governments can be viewed as conduits for revenues raised at the federal level to local governments.

### **Key characteristics of the equalization program**

Although the equalization program has evolved over time and has undergone recent major changes, certain key characteristics of the program have endured.

Equalization payments are lump-sum grants that have been largely determined within a representative tax system (RTS) framework, although the number of tax bases used in the calculation of equalization payments and the equalization standard has varied over time. Broadly speaking, the equalization program has been formula driven, with federal government determining the parameters of the formula. Limitations on the size of the equalization payments have occasionally been imposed, and the fixing of the size of the equalization pool in 2005 was a major source of discontent that led to a major reassessment and revamping of the equalization program in 2007.

Equalization payments have not been based on measures of fiscal need, such as are used to determine equalization payments in Australia. The reasons for not incorporating a needs component in the equalization calculations include the conceptual and statistical problems in defining need, the potential distortions in provincial policies that might arise if the needs components could be affected by provincial policies, and the desire to limit federal interference in areas of provincial jurisdiction.

Equalization payments are only made to the provinces with relatively low fiscal capacities. Ontario, with around 40 percent of the population, has never received equalization payments. Alberta has not received equalization payments since the early 1960s when resource revenues were included in the calculation of fiscal capacity. Other provinces, such as Saskatchewan and British Columbia, have been recipients of equalization in some years, but they have lost their equalization entitlement when

**Table 1****Equalization payments in millions of dollars<sup>a)</sup>**

Fiscal Year	NL	PEI	NS	NB	Que	Man	Sask	BC	Total
1997–98	1,093	238	1,302	1,112	4,745	1,053	196	–	9,738
1998–99	1,068	238	1,221	1,112	4,394	1,092	477	–	9,602
1999–00	1,169	255	1,290	1,183	5,280	1,219	379	125	10,900
2000–01	1,112	269	1,404	1,260	5,380	1,314	208	–	10,948
2001–02	1,055	256	1,315	1,202	4,679	1,362	200	240	10,310
2002–03	875	235	1,122	1,143	4,004	1,303	106	71	8,859
2003–04	766	232	1,130	1,142	3,764	1,336	–	320	8,690
2004–05	762	277	1,313	1,326	4,155	1,607	652	682	10,774
2005–06	861	277	1,344	1,348	4,798	1,601	82	590	10,900
2006–07	632	291	1,386	1,451	5,539	1,709	13	260	11,282
2007–08	477	294	1,465	1,477	7,160	1,826	226	–	12,925
2008–09	158 <sup>b)</sup>	322	1,465 <sup>c)</sup>	1,584	8,028	2,063	–	–	13,620
\$ per capita	313	2,310	1,565	2,111	1,038	1,732	–	–	
Shares of payments (%)	1.2	2.4	10.8	11.6	58.9	15.1	–	–	100.0
Population share (%)	1.5	0.4	2.8	2.3	23.4	3.6			37.1

<sup>a)</sup> The names and abbreviations of the provinces are given in Table 2. On January 31, 2008 a Canadian dollar was worth US\$1.01 or €0.679. – <sup>b)</sup> In addition, Newfoundland and Labrador will receive \$742 million or \$1,469 per capita under the Offshore Accords. – <sup>c)</sup> In addition, Nova Scotia will receive \$106 million or \$113 per capita under the Offshore Accords.

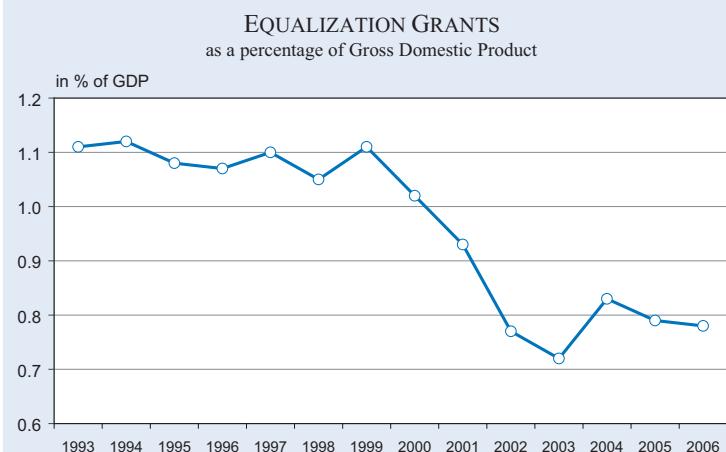
Source: Dept of Finance (2007c, Table 9, 63) and <http://www.fin.gc.ca/news07/07-108e.html>.

economic conditions have improved. Table 1 shows the equalization payments to the recipient provinces since 1997–98. The percentage of the total population that resides in the recipient provinces has ranged from 51.8 percent in 2001–02 to 37.1 percent in 2008–09. Note that there have been at times large fluctuations in the equalization payments to the provinces. For example, Quebec's equalization payment fell by \$1.7 billion or 30 percent between 2000–01 and 2003–04, but it returned to the earlier level by 2006–07. As Figure 1 shows, total equalization payments as a percentage of GDP have declined from an average of 1.09 percent in the 1990s to less than 0.80 percent in 2006.

The advent of the offshore oil and gas revenues to Newfoundland and Labrador and Nova Scotia would have meant that these provinces would also lose equivalent equalization entitlements. The federal government signed the Off Shore Accords in 2005 with these provinces to prevent this from happening. The federal government argued that these special grants to offset the loss of equalization payments were justified because of the low levels of economic development and high indebted-

ness of these provinces, but these offsets led to accusations that the federal government was making “special deals” for certain provinces.

Equalization payments are funded out of the general revenues of the federal government. Provincial governments do not contribute to the funding of the program. Recipient provinces are equalized up to some standard level of fiscal capacity – the ability to raise a certain per capita revenue by levying average provincial tax rates – but provincial governments with relatively high fiscal capacity are not “equalized down”. The residents of Ontario contribute about 43 percent of total federal tax revenues and there-

**Figure 1**

Source: Calculations based on Statistics Canada CANSIM data Table 380:0030 and Table 1.

fore pay a substantial fraction of any increase in the equalization payments, even though their provincial government has never received these funds.

### Total federal-provincial transfers

Equalization grants are a key part of the Canadian fiscal architecture but other transfer programs, notably the Canada Health Transfer (CHT) and the Canada Social Transfer (CST), actually funnel more money to the provincial governments.

Figure 2 shows that equalization grants represented about 27 percent of the total cash transfers to the provinces in 2007–08. The Canada Health Transfer, which provides grants to all of the provinces to aid in the funding of provincial health care programs, is the largest grant program, representing 45.5 percent of the total cash transfers. The Canada Social Transfer nominally helps fund post-secondary education and provincial social programs. It has become an equal per capita cash transfer to all the provinces and represents just under 21 percent of total transfers.

Table 2 shows the provinces' equalization grants in 2006–07 as a percentage of their total revenues. The government of Prince Edward Island relies on equalization grants for almost a quarter of its revenues. Quebec, which is the largest recipient province,

**Table 2**

### Provincial governments' reliance on federal transfers in 2006–07

	Equalization payments as a percentage of total provincial government revenues	Total federal cash transfers as a percentage of total provincial government revenues
Newfoundland and Labrador (NL)	11.9	33.0
Prince Edward Island (PEI)	24.4	39.1
Nova Scotia (NS)	19.4	36.1
New Brunswick (NB)	22.4	38.0
Quebec (Que)	9.2	18.3
Ontario (Ont)	0.0	15.5
Manitoba (Man)	15.7	30.4
Saskatchewan (Sask)	0.2	16.1
Alberta (Alta)	0.0	8.1
British Columbia (BC)	0.7	16.5

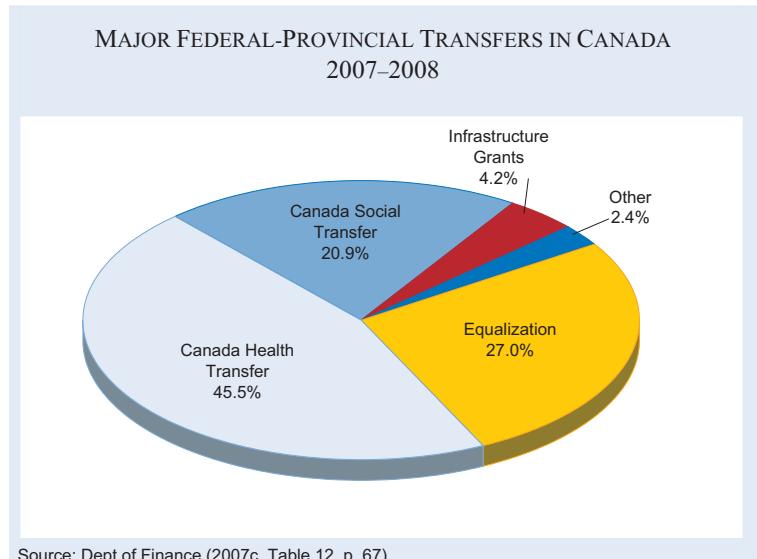
Source: Calculations based on data in Dept of Finance (2007b) and Table 1.

received 9.2 percent of its revenues from equalization grants. The table also shows total federal cash transfers to the provinces as a percentage of their total revenues in 2006–07. The provinces in the Atlantic region receive more than a third of their revenues from transfers from the federal government, while the two richest provinces, Ontario (15.5 percent) and Alberta (8.1 percent), are much less reliant on federal transfers.

### Recent changes to the equalization system

In light of the problems and controversies arising out of the 2005 changes to the equalization program and the Atlantic Accords, the federal government under Prime Minister Paul Martin appointed an expert panel to study the equalization system and recommend changes. The Expert Panel, under the chairmanship of Al O'Brien, a former deputy provincial treasurer in Alberta, presented its report in May 2006.<sup>2</sup> The Expert Panel (2006b) report contained an extensive analysis of the equalization system and made a number of recommendations for significant changes to the sys-

**Figure 2**



<sup>2</sup> The Expert Panel's reports, commentaries on the equalization system by academics and public policy experts, and other background documents can be accessed at the website <http://www.eqtf-pft.ca/index.asp>. See also the report of the Council of the Federation (2006) on fiscal imbalances in Canada.

tem. In its March 2007 budget, the new federal government under Prime Minister Stephen Harper adopted most of the changes proposed by the Expert Panel. Among the most significant changes to the equalization system are the following:

The equalization standard is now based on the average fiscal capacity of all 10 provinces instead of the five province standard which had been used to calculate entitlements since 1982. The adoption of the 10 province (or national average) standard increases the equalization standard because Alberta's fiscal capacity is now included in the computation of the standard. Under the new equalization program, total payments for 2007–08 are \$1.5 billion higher than in 2006–07.

The computation of equalization entitlements has been simplified by reducing the number of tax bases used to calculate fiscal capacity from 33 to five – the personal income tax base, the business income tax base, the property tax base, the sales tax base, and 50 percent of natural resource revenues. This means, for example, that the sales tax base will be used to calculate the fiscal capacity based on revenues from a variety of provincial taxes, such as tobacco taxes, gasoline and diesel fuel taxes, the sale of alcoholic beverages and motor vehicle licenses, in addition to the general sales taxes. The main argument for this change was simplification and the fact that some of the bases were difficult to measure accurately.

The revised treatment of natural resources – the 50 percent inclusion rate and the use of revenues instead of “bases” to calculate fiscal capacity – is particularly significant because this has been a source of controversy since the inception of the equalization program. The 50 percent inclusion rate, which was recommended by the Expert Panel, represents a compromise. On the one hand, some argue that all provincial revenue sources constitute fiscal capacity and therefore natural resource revenues should be fully included in the calculation of the average fiscal capacity of the provinces. On the other hand, partial inclusion, which has been the norm since the equalization program was started, has been justified because full inclusion would greatly increase the amount of equalization that would have to be paid to the recipient provinces. This burden would largely fall on the taxpayers in Ontario, which receives little in the way of resource revenues. It is also argued that full inclusion would effectively eliminate the net benefit that a recipient province receives from its

natural resources, because its equalization payments would be “clawed-back” when it received more resource revenues. This would effectively negate provincial ownership of natural resources which is enshrined in the constitution. Thirdly, full inclusion would reduce incentives for provinces to develop or price their natural resources in an efficient manner.

The other major change to the resource component of the equalization formula is the use of resource revenues, instead of resource tax bases (volume or value measures of resources produced in a province), to calculate fiscal capacity. The justification for this change is that there has been a proliferation of natural resource bases in the equalization program because different types of resources, for example a barrel of heavy oil versus a barrel of conventional oil, can yield different levels of economic rent, and therefore represent different “fiscal capacities”. However, the proliferation of resource bases meant that the adverse incentives to develop or price resources have became more significant because the narrowly defined bases are often concentrated in only one province. In addition, some of the resource bases were entirely “fictional”. For example, the sale of exploration rights, a major source of revenue for the Alberta government, had to be converted into a tax base, even though it was a sale, not a tax. Combining the resource revenues from 14 different natural resources, including hydroelectricity, oil and gas, and forestry, along with the 50 percent inclusion rate, is meant to address these issues.

Another major change in the calculation of fiscal capacity is the use of market-values for the residential property tax base. Previously a proxy for the property tax base had been used based on economic indicators that were thought to approximate the revenue-raising ability of the property tax. A proxy was used because historically assessment and valuation practices for property taxes had varied widely across provinces. In recent years, most provinces have adopted market values as the basis for levying residential property taxes, and the logic of using market values in the equalization formula became very strong. (The procedure for computing fiscal capacity based on market values is complex because it has been observed that most municipalities that have high per capita property tax bases levy significantly lower property tax rates.) The switch to market-values for residential property taxes has resulted in a substantial increase in the measured fiscal capacity of British Columbia, where property values in the

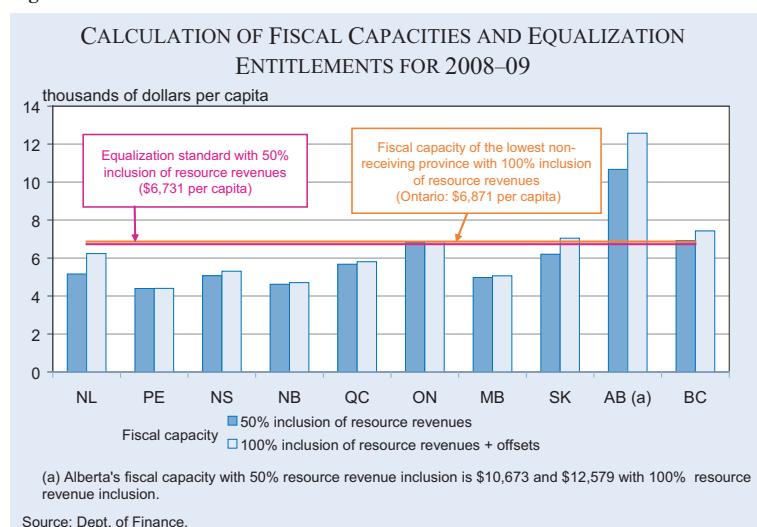
Greater Vancouver area are relatively high, and a corresponding decrease in the relative fiscal capacity of Quebec, where property values are relatively low. As a consequence, Quebec's entitlement to equalization has increased. Further reforms in this area are required because the fiscal capacities arising from commercial, industrial and agriculture property taxes are still based on a proxy.

A further simplification is that equalization entitlements will be based on a three year weighted moving average of measured fiscal capacities with a two year lag. For example, the equalization entitlements for 2007–08 are based on the fiscal capacities of the provinces in 2003–04, 2004–05, and 2005–06, with the first two years having 25 percent weights and the final year a 50 percent weight. This change was introduced because under the previous system, given the lags in data collection, it took up to 42 months before a province received final confirmation of its equalization payment. The new method will make it easier for recipient provinces to make budget plans and will reduce fluctuations in payments.

The final major change to the computation of equalization was the introduction of a fiscal capacity cap to ensure that a recipient province's fiscal capacity with equalization does not exceed that of any non-recipient province. For example, it is possible that with only 50 percent of resource revenues included in the measurement of fiscal capacity a province, such as Saskatchewan, would be eligible for equalization payments and have a fiscal capacity that exceeded Ontario, which would not receive equalization. This is viewed as fundamentally unfair since Ontario taxpayers fund a substantial share of the equalization program. To avoid this situation, a receiving province's fiscal capacity with equalization payments is capped at the fiscal capacity of the lowest non-receiving province, which at this time is Ontario.

Figure 3 shows the fiscal capacities of the provinces for 2008–09 and illustrates how the fiscal capacity cap operates. The first solid bar shows the fiscal capacity of each province using the new standard

**Figure 3**



with the 50 percent inclusion of resource revenues. The average fiscal capacity is \$6,731 per capita. Ontario, British Columbia and Alberta have fiscal capacities that are in excess of this standard and therefore are not eligible for equalization payments. Equalization entitlements are calculated as the gaps between the solid bar and the solid line which represents the standard fiscal capacity. Then the fiscal capacities of the provinces are calculated with 100 percent inclusion of the resource revenues. The fiscal capacity of the lowest non-receiving province is Ontario at \$6,871 per capita. Since Saskatchewan's fiscal capacity with 100 percent inclusion of resource revenues (even without the equalization entitlement calculated at the first stage) is higher than Ontario's fiscal capacity, Saskatchewan is not eligible for equalization payments in 2008–09. In the case of Newfoundland and Labrador and Nova Scotia, equalization payments are reduced by the cap because of the Offshore Accord payments. The entitlements of all of the other provinces are unaffected by the fiscal capacity cap in 2008–09.

## Summary

In the view of most public policy analysts, the 2007 revisions to the equalization system, based on the recommendations of the Expert Panel, represent an improvement over the previous system and address in a balanced manner the irreconcilable goals and controversial issues that have grown up around the equalization program in Canada. As with any new major program, there will be unforeseen problems with the changes to a complex system and in light of

newly emerging fiscal events, but the general directions of the reforms seem reasonable. The new system will likely remain the basis for determining equalization for the foreseeable future.

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