POLICY AND PRACTICE IN THE CANADIAN FEDERATION

Jean-Louis Roy, President of Partenariat International and Head of the Observatoire mondial des droits de l'homme

It is a pleasure for me to once again be involved in the Moroccan Initiative for Negotiating an Autonomy Statute for the Sahara Region especially since the theme of our seminar has been at the heart of Canada's experience for almost a century and a half. Indeed, ever since it was created, Canada established financial resources sharing mechanisms between the federal State and federated States. These mechanisms have been evolving constantly since 1867 as a result of national and global changes. They are now at the heart of the federation's public policies and of the priorities laid down by Canadian citizens. They make it possible to implement substantial social programmes and are Canada's distinctive feature in North America.

The most important of these mechanisms is concerned with **health, higher education and social programmes-related transfers**, transfers to provinces and territories of the federal State to help them implement programmes and provide services to Canadian citizens.

These transfers to provinces and territories, which are instruments to ensure solidarity and foster development, will reach a record high in 2013-2014 at 42 billion dollars, i.e. nearly 13% of the federal government's total expenditure. This global financing mechanism must achieve specific goals laid down by laws of the federal parliament. These conditions must absolutely be fulfilled.[16] Governments and provinces therefore have no control over their use.

The second mechanism is concerned with **equalization transfers.**

These transfers will reach 16.1 billion this year, i.e. 5% of the federal government's total expenditure. Provinces and territories that receive equalization payments are free to use them as they please, they are unconditional.

Some provisional conclusions can be drawn from the above: Canadian provinces' own revenues (all Canadian provinces) whose constitutional legality is strictly adhered to, are supplemented by subsidies of the Canadian federal Government. These subsidies come from the budget of the federal government and the equalization mechanism does not result from negotiations between provinces. Finally, Canadian provinces have traditionally been involved in establishing the terms of reference of the equalization mechanism.

This communication focuses on the Canadian equalization mechanism.

The equalization mechanism

The equalization mechanism has been at the heart of Canada's tax federalism for over fifty years and is referred to as the cornerstone of the Canadian federation. It has been enshrined in the Constitution Act of 1982 and is therefore protected from political or other vagaries that may otherwise affect it.

This equalization programme aims at compensating less prosperous Canadian provinces for their weak tax base to allow them to provide comparable public services to all Canadian citizens, wherever they live. Since provinces are primarily responsible for the vast majority of public services, among which education, health and social services in Canada, equalization is neither meant to undermine this autonomy nor to influence strategic directions adopted by provincial Governments. In short, this instrument of solidarity and

[16] See Canada's Health Act, for instance.

development fully respects the principle of equality of provinces, their autonomy and their responsibilities as defined in the country's Constitution.

The underlying principle of equalization, that of **equality of citizens,** is the benchmark for the entire constitutional architecture of the Canadian federation.

The equalization programme was initially deployed in provinces before it was extended to Northwest Territories established after the provinces to allow them to provide services comparable to those offered by provinces, at comparable levels of taxation.[17] To put it in a nutshell, the purpose of the equalization programme is precise. **All Canadians must have access to reasonably comparable services, such as in the health sector for instance, without having to pay more taxes than their fellow citizens in other provinces.** Numerous studies have highlighted that, without such a programme entirely funded by federal government revenues, the level of essential public services in Canada would vary greatly inside the country.

As mentioned by the Expert Panel on Equalization[18] that produced in 2006 an independent examination of equalization and laid the foundation for the current framework, the main purpose of equalization is not to ensure greater income equality between citizens and does not aim at regional economic development either. These goals, which are at the centre of the Moroccan Initiative, are dealt with through separate measures and bilateral agreements between Ottawa and the provinces especially on regional development.

According to a formula based on data from the Representative Tax System (RTS), equalization tries to close the current gap between a province's tax ability to provide provincial services and a common standard applying to the whole country.[19] In 2013-2014, six provinces will receive equalization transfers.[20]

A permanent mechanism in a constantly changing world

While the mechanism is permanent due to its incorporation into the Constitution, it is being deployed in a constantly changing world that keeps affecting economic disparities in Canadian provinces and their economy's performance. Hence the need to adapt the modalities of the programme over the past twenty years.

For some, these changes were deemed indispensable whereas others believe they have undermined this instrument of national cohesion and diminished its effectiveness. The formula is thus at the centre of continuous political debate.

---

[17] The TFF (Territorial Formula Financing) established in 1985 aims at closing gaps to take into account the particular situation of the territories. The subsidy paid to each territory is based on the difference between the approximate measure of the territory's financial needs and its ability to generate revenues (admissible revenues). Admissible revenues are divided into two parts: 7 of the main autonomous sources of revenues of the territories are measured through a representative tax regime, similar to the one used for the equalization programme; the 11 other sources of revenues result in a single estimate. (Source: Minister of Finance Canada).

[18] *Achieving a national purpose: Putting equalization back on track. Expert Panel on Equalization and Territorial Formula Financing,* presided over by M. Al O'Brien, former Deputy Provincial Treasurer of Alberta.

[19] According to a report of the Expert Panel, since 1982 equalization has raised the fiscal capacity of the least well-off province from 58 to 68 per cent of the national average to between 91 and 99.7 per cent of the national average. The report however stresses that one should avoid making a direct link between equalization and the comparability of services and outcomes when, in fact, equalization is only one of many contributors to the results. The provision of government services and socio-economic outcomes result from a complex mix of federal and provincial programs and choices, social and economic trends that reach far beyond the scope of equalization. Equalization is, after all, an unconditional grant, meant to enable (not enforce) reasonable comparability of public services in a decentralized federation, where provincial governments are accountable to their residents for the choices they make with respect to public services and taxation. A province alone decides whether it wishes to provide more than comparable, less than comparable or reasonably comparable public services. Equalization should give a province the means to do the latter, without imposing it.

[20] Prince Edward Island (340 million $), Nova Scotia (1 458 million $), New Brunswick (1.513 million $), Quebec (7.833 million $), Ontario (3.169 million $) and Manitoba (1.792 million $).

The equalization mechanism is criticized on three counts. Some hold that it is a scourge for so called "productive" provinces and creates a feeling of dependency among receiving provinces. Others believe that it is not generous enough for some provinces, especially Ontario, now a victim of the 2008 recession and of the decline of its manufacturing sector despite the traditionally stabilizing effect of the Canadian equalization regime. Finally, the level of payments to certain provinces has been criticized on the basis of disparities in cost of living and labour regime.

Finally, the tricky issue of disparities created in the tax bases of provinces depending on whether natural resources revenues are included in the equalization formula or not has been under constant debate. When included, provinces whose natural resources revenues are on the rise would have this increase offset by a reduction in their equalization payments. They would thus not end up better off than if they had no natural resources revenues and would thus have no economic incentive to develop them.

The 2007 reform

In order to address these criticisms, in the framework of its 2007 budget the Canadian Federal Government adopted most of the recommendations contained in the report of an Expert Panel and is implementing a new equalization formula aimed at improving the functioning and predictability of the programme. Faced with an economic downturn, the federal government announced in 2008 its intention to once again unilaterally amend the equalization programme in order to put a ceiling on costs as early as the 2009-2010 financial years.

The equalization mechanism today

The federal government adopted several of the recommendations put forward by the Expert Panel.

1) Rejection of the notion of fixed pot that would overturn the fundamental nature of equalization.

2) Adoption of a 10-province standard to determine a reference average that most accurately reflects national financial disparities and diversity. This reference average previously took into account two, three and then five provinces.

3) Equalization focuses on the fiscal capacity of various provinces rather than on an assessment of their expenditure needs.

4) The fiscal capacity of provinces is measured using five tax bases: personal income tax, corporate income tax, sales tax, property tax and revenues from natural resources. This capacity was previously measured using a much higher number of tax bases (33).

5) 50% of provincial resources revenues should be included in determining the overall fiscal capacity of each province. This choice was considered a compromise solution and reaffirms the principle according to which the equalization programme should not undermine the right of provinces to make the most of their natural resources (after all, the Canadian Constitution states that they own them). A portion of natural resources revenues should nevertheless be included since they do a lot to strengthen the economy and finance public services in provinces.

However, due to an election promise made in 2006 to leave natural resources out of the formula, each province can now receive equalization payments based on the most profitable option (total exclusion or inclusion of 50% of natural resources revenues).

Natural resources raise another concern in that one wonders whether to distinguish between the types of revenues drawn from natural resources. The Expert Panel and the federal government responded negatively to that question.

Whether they come from oil, gas, continental or offshore resources, from forestry, potash or hydropower, these revenues are considered natural resources revenues for equalization purposes.

This decision has serious consequences especially for Quebec that has chosen to use a state-owned company to exploit and distribute hydro-electric resources and that considers that hydropower revenues paid to the provincial government are profits of private companies.

6) The implementation of a cap to ensure, out of a concern for equity, that no receiving province ends up with a fiscal capacity higher than that of a non-receiving province.

This cap was placed in 2007 to counter the advantages that may come from the inclusion of 50% of natural resources revenues into the equalization formula for beneficiary provinces that already derive an income from these resources.

7) Calculation of provincial fiscal capacity on the basis of a three-year moving weighted average and two-year lagged data to smooth out the impact of year-over-year changes.

As early as the 2009-2010 financial year, the federal government implemented a cap to ensure that receiving provinces would not be "richer" that the average of provinces receiving equalization payments. Equalization payments having gone up 56% since 2003-2004[21], especially due to increased revenues from the exploitation of natural resources, this measure contributed to bringing down the cost of the equalization programme from $8 000 to $7 000 per inhabitant and will particularly affect the revenues of provinces whose initial per capita fiscal capacity was lower than the national average.

The federal government additionally introduced a second capping mechanism based on Canada's nominal GDP. The increase in equalization entitlements in Canada now corresponds to no more than the three-year moving average growth of Canada's nominal GDP. The growth in equalization entitlements in 2013-2014 would be limited to the average nominal GDP growth for 2011, 2012 and 2013.

The Government of Quebec criticized these changes saying they run counter to the fundamental principles of equalization as identified in the report of the Expert Panel. For Quebec, the equalization programme could thus not fully play its role if fiscal capacity gaps between provinces were to widen substantially while the growth of the cost of the programme would be limited to Canadian nominal GDP growth.

All in all, one should avoid considering these recent changes as accidental or as a deliberate attempt to create division between provinces and the federal government. As underlined by the Government of Quebec, had it not been for these changes, it would seem that in 2009-2010 Ontario wouldn't have received its first equalization payments ever. The implementation of these caps, though unpopular, may have possibly been a lesser evil to control the federal deficit and support Ontario's declining economy thanks to equalization payments of 3.16 billion in 2013-2014 against 347 million in 2009-2010.

With the increase in the global price of oil which favours oil producing provinces and the ensuing appreciation of the Canadian dollar which makes Ontario's international exports less competitive, Ontario's wealth collapsed: its traditional revenues (personal income tax, corporate income tax, consumption taxes and property taxes) no longer compensate its relative poverty in terms of natural resources.

[21] According to the Minister of Finance Canada, from 2005-2006 to 2013-2014, equalization payments went up almost 50% and those under TFF increased by 60%.

This attests to the concentration of natural resources revenues in certain provinces and to the fluctuation in their prices.[22]

Due to the shift in Canadian economic activity towards the West, these two facts will continue to play an important role in determining admissibility, or otherwise, of a given province to equalization payments. Furthermore, as suggested in the case of Ontario, negotiations in 2014 are bound to be tricky knowing that the economic prospects for this province are far from encouraging compared to the rest of the country.

Conclusion

The new formula adopted by the government in the framework of its 2007 budget addressed most of the shortcomings in the old formula, though the financial challenges surrounding the issue of natural resources remain due to the geographical distribution of the latter. The coming into play of Ontario as a beneficiary of the programme nevertheless led to hurriedly modify the formula that many thought would be immune from political pressure, since the publication of the report of the Expert Panel.

This critical analysis does nothing to alter the philosophy of the equalization mechanism and its components:

1) the need for all levels of government to accept the idea and the reality of financial resources sharing;
2) the need to include all federated entities as partners whether or not they benefit from the mechanism;
3) the willpower to ensure they have the same capacity to implement comparable programmes and provide comparable services, despite disparities in their resources and;
4) the need to respect their autonomy. This political architecture is based on the
5) principle of equality of citizens which is the benchmark of the equalization mechanism just the way it is for the whole constitutional architecture of the Canadian federation.

[22] According to the Ministry of Finance of Quebec, in 2011-2012, the four provinces that do not receive equalization payments accounted for 82% of revenues from natural resources, while they only accounted for 28.6% of the Canadian population. The six other provinces, which account for 71.4% of the population, had 18% of revenues from natural resources. In practice this means that whereas the average fiscal capacity of provinces with regards to this revenue source reached $661 par inhabitant in 2011-2012, it was nearly $5 157 per inhabitant in Newfoundland. The availability of considerable natural resources in a province where population is small is also a key equalization factor. By way of example, Quebec received $7.6 billion in equalized funds 2011-2012. For Quebec not to benefit from equalization anymore, it would need to get from its natural resources another 14 billion dollars on top of the 3 billion dollars it already obtained, i.e. a total of 17 billion dollars in revenues, which would represent an increase of 460%. Between 2006 and 2011, Alberta got some 12 billion dollars a year in natural resources revenues.