

**Presentation to the
Senate Committee on National Finance
Concerning the Equalization Program
October 24, 2001**

**Honourable Patricia J. Mella
Provincial Treasurer
Province of Prince Edward Island**

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Chairman and Committee Members, I am pleased to have this opportunity to present the views of my Province with respect to the Equalization Program. I am sure you are aware that the inclusion of this Program in the Canadian Constitution signifies its extreme importance to all Canadians.

After five years as Provincial Treasurer, I find myself the longest serving Provincial Minister of Finance and during this period I have developed growing concerns over the inadequacies of this vital Program.

Earlier this year, on April 26th, I joined my colleagues from the neighboring Atlantic Provinces to make presentations to the Commons Standing Committee on Finance concerning Bill C-18, an amendment to the Fiscal Arrangements Act. That amendment specifically concerned the Equalization ceiling, which continues to be a serious concern to provinces.

My remarks this evening address a broad range of Equalization Program issues given that your present task is to examine the Program in a comprehensive way.

I should begin by noting that as Provincial Treasurer I have, on many occasions, expressed my Government's concerns over various aspects of the Program, through correspondence with the Minister of Finance, through private discussions with him, and discussions at Federal Provincial Ministers' Meetings. In addition, the Province has played a vocal role at provincial/territorial meetings of Ministers of Finance and Premiers in support of the Program and there have been exchanges of correspondence between my Premier and the Prime Minister on this subject on several occasions.

Premiers and Provincial Finance Ministers are all agreed that the Equalization ceiling must be removed immediately and that work be undertaken to develop a strengthened and fairer formula. This could be achieved through a move to a ten province standard and comprehensive revenue coverage. These points were repeated by Ministers of Finance at their Vancouver meeting as recently as October 11th.

Notwithstanding the strong case for improving the adequacy of the Program, the Federal Government to date has steadfastly chosen to defend the status quo. Through the course of this presentation, I would hope to clarify the many aspects of this on-going debate. In addition to that discussion, I am sure you have heard from various quarters concerning the issue of the alleged disincentive effects of the present formula, the unnecessary complexity of the formula and the unfairness of the “claw back” effects of the Program for unique resource revenues. I will comment on these important points in turn.

I will begin by saying that Prince Edward Island has a major vested interest in ensuring that the Equalization Program is understood, accepted, properly measured and adequately financed. We count on the Federal Government to ensure that the Program adequately meets its Constitutional objective. While Equalization may not be well understood, vast numbers of Canadians rely on this Program to maintain a balanced playing field across this Nation for government services and tax levels.

The Program is essential to my Province’s finances as it continues to be our single largest revenue source. The Personal Income Tax, for example, contributed \$161 million in revenues to the Provincial Government in 1999/2000 while Equalization was recorded as \$256 million that year.

To be sure, our present dependence on Equalization is not something we are happy about and, we do take pride in the fact that over the long term the percentage contribution of federal transfers to our revenues has been shrinking. In the early 1980’s, equalization formed 32% of revenues, today it is 28%. As our economy expanded relative to that of other provinces, so our dependence has declined. I might note that last year PEI led the country in employment growth.

Let me begin by discussing the response of the Federal Government to provincial concerns.

In reviewing the varying responses of the Federal Government to our calls for improvement, the common thread appears to be that the present Program works well, that it was never cut back like other federal programs during the 90’s, that it has delivered large increases in dollars to Equalization receiving provinces and that the balance of the ceiling, floor and standard are important to the maintenance of the Program.

It is particularly troublesome for us to be told by federal ministers that the Equalization Program has never been cut back when other programs were, and that somehow this provided receiving provinces a special benefit. I might note recent comments by Minister Dion to my Premier in that regard. Also comments at the Commons Finance Committee in April by federal officials emphasized that the Program had grown by 33% since 1993, thereby suggesting that the present Program has been very generous. These remarks entirely ignore the basic purpose of the Program, the automatic nature of the payout of equalization entitlements and the large improvement in federal and provincial finances that has occurred in recent years.

It is important to remember that we need the Program to function adequately in order to allow provinces to deliver provincial government services which are reasonably comparable without resorting to extraordinary levels of taxation. The whole purpose of the Program is to provide a level playing field for our people and businesses so that the Canadian economy is able to function at its optimum. The Program is all about the horizontal balance between provinces. If the Program fails in some measure, then levels of education, standards of health service, highway conditions and other provincial services will deteriorate and taxes will be forced up, causing provincial economies to suffer.

It is my firm belief that the Federal Government has perpetuated the myth that poorer provinces have been treated particularly well in order to justify continuing cost containment of the Program. I want to be clear that the Equalization Program did not confer favorable treatment to less wealthy provinces during the cutbacks of the 90's. In fact, the payout from the Program was essentially in decline through most of that decade when all levels of government were struggling with deficits and shrinking revenues. The federal Public Accounts show that in 1991/92 federal payments to provinces for Equalization were \$9.9 billion. In 1996/97, they were \$9.4 billion and were even less in several intervening years. Only since 1997 have they shown any upward trend. For P.E.I., Equalization revenues peaked in 1990/91 at \$206 million, and fell off to a level as low as \$158 million in 1993/94 and did not regain previous levels until 1997/98. And yes, Equalization receiving provinces also endured the cutbacks to the Canada Health and Social Transfer as well as the effects of EI changes and other reductions in federal spending during those years.

While the Federal Government may claim that the Program was not explicitly targeted for cut backs in this period, it should be recognized that the formula itself delivered the reductions automatically. Further, moves by the Federal Government to lower the ceiling in those years did reduce entitlements in total by over \$3 billion. In more recent years, the entitlements have increased but this is simply the formula working, reflecting growing provincial revenues and responsibilities.

It is thus extremely discouraging to hear the Federal Minister and his counterparts pretend that they have somehow improved the Program when they have actually reduced the Program's adequacy by adding further constraints to the formula. It is extraordinary to observe the degree of publicity the Federal Finance Minister and his colleagues have accorded the release of increased entitlements, as though they have improved the Program, following so many years of stagnation.

The recent growth has come in a period of unprecedented buoyancy in the national economy, and this has automatically raised both provincial and federal revenues. The Equalization Program, over the long term, is actually a shrinking burden to Canadian taxpayers. In the early 1980's, the Federal Government committed some 8% of its revenues to Equalization. Today the proportion is more like 6%. Equalization has not kept pace with the growth of the Canadian economy over the long term. Twenty years ago the ratio of Equalization to Gross Domestic Product was 1.30%, and today it is a mere 1.04%. These percentages have been on a downward trend for a long time.

The Federal Government has successfully reduced the role of the Program over time while

disregarding our calls for sustaining a program to adequately meet its Constitutional goals. Perhaps the Federal Government has come to believe its own rhetoric and convinced itself that the Program is more than adequate? However we believe that the present administration prefers to tightly control the Program payout and to restrict unconditional grants to provinces, wherever possible, notwithstanding the basic purpose of the Program. The status quo serves this purpose well.

At the heart of the present formula is the Five Province Standard which was adopted in the early 1980's. At that time the Federal Government originally proposed a standard based on Ontario's fiscal capacity. Their main concern was the influence of Alberta's oil and gas revenues on entitlements and taking Alberta out of the standard was regarded as a necessary step. Since then Alberta's relative fiscal fortunes have soared and fiscal disparities between Alberta and the rest of Canada have increased very significantly. A standard based on a true average of provincial fiscal capacities would clearly improve comparability. Thus we believe a ten province standard is needed.

In terms of revenue coverage the Equalization formula only provides the correct result if it encompasses all provincial revenue sources. Clearly some provinces choose to depend on some revenues more than others. Thus the formula must take the sweep of all revenue in to account. It would not be sensible to move to a ten province standard with less than comprehensive revenues included. The Federal Government did take steps to reduce revenue coverage in the last renewal which not only increased fiscal disparities, it also made the formula more complex.

At present the ceiling dictates the total level of entitlements to be paid out. Total entitlements are estimated by the Department of Finance and if they exceed the ceiling then the entitlements for each receiving province are scaled back by the amount of the excess, on a per capita basis.

I, along with my Atlantic counterparts, argued at length with the Federal Minister that Bill C-18 contradicted the Prime Minister's commitment to Premiers in September 2000 to allow the formula to grow with GDP. It also has lowered the ceiling to an unprecedented degree and at a time when federal surpluses were burgeoning. By dropping the ceiling by over \$1 billion per year, the Federal Government has raised the risk of the ceiling controlling the equalization payout on an on-going basis. Notwithstanding denials from the Federal Finance Department that this was likely, their most recent estimates show the ceiling impacting on entitlements for 2000/01 as they had for 1999/2000. Atlantic Ministers argued that if the ceiling were not removed, at a minimum it should not be lowered by the \$1 billion amount.

There is nothing in the constitutional commitment to suggest that there are circumstances whereby the Program should be constrained by an artificial dollar limit. The ceiling effectively prevents the Program from achieving its fundamental objectives. It is for this reason that it is so disagreeable to us.

The ceiling is essentially an add on to the basic formula. The floor provision and the special rule for unique resource revenues (the 70/30 rule or generic solution) are other add ons to the basic formula. They not only add to the complexity of the Program, I believe they are of questionable value.

These add ons confer a special benefit to those provinces that qualify for them, and that benefit can be to the cost of less well endowed provinces. Manitoba Finance has pointed out, on several occasions, that the floor provision is unlikely to be triggered by provinces other than those endowed with significant natural resources. Further, the 70/30 provision is designed specifically for provinces with unique resource endowments. It is not surprising then that the major beneficiary of these special additions to the basic formula to date has been the Province of Saskatchewan. By comparison to other receiving provinces its own source fiscal capacity is high and its receipt of Equalization is volatile given the volatility of its natural resource revenues. The result of these special provisions is that additional fiscal capacity is provided to such a qualifying province, raising its capacity above the standard five province amount available to other provinces. For example, in 2000-01 the effect of equalization is to raise the fiscal capacity per capita of Saskatchewan to \$6,405 whereas for PEI, Manitoba and Quebec it is \$6,058. To put this in perspective, this extra Equalization for PEI would be worth \$48 million, an amount equivalent to our revenue from Gasoline and Liquor taxes combined.

A less obvious result of the way the special provisions work is that Provinces such as PEI, Manitoba or Quebec, who are unlikely to qualify for floor provisions or 70/30 revenues, not only are provided a lower fiscal capacity than those that do, but can actually have their entitlements adjusted downwards through the ceiling adjustment. This is not an academic situation. The latest entitlements for 2000/01 indicate that the floor payment for Saskatchewan is \$270 million, and this amount triggers a ceiling reduction, thereby lowering entitlements for receiving provinces. This means that less well off provinces must compensate better off provinces in such cases.

The Provinces of Nova Scotia and Newfoundland are similarly conferred an Equalization entitlement that is higher than that available to non resource based provinces through the 70/30 provision in light of their offshore revenues. If the offshore royalties accelerate in the future to extremely high levels, as some predict, this provision could raise fiscal capacities per capita in such cases to levels even higher than that of Ontario. In other words these provisions allow Equalization to raise the fiscal capacity of provinces with offshore royalty revenues to a level substantially higher not only than that of other receiving provinces but of non recipient provinces as well. This is surely not an acceptable situation.

We find the application of these special rules not only bizarre, they are inequitable. They are a serious distortion to the basis of the Program, which is to equalize fiscal capacities, not distort them. It is our belief that governments that desire special relief from the so called claw back effects of the formula should be provided that compensation outside the Equalization Program.

If the Federal Government is determined to keep the ceiling then the special 70/30 rule and the floor rule should be removed from that calculation. Better still remove all three special provisions, the ceiling, the floor and the 70/30 rule and return the Program to its main objectives. This will also go a long way to help the Program be both more understandable and equitable.

I should now like to turn to other issues that have been raised in the more general debate.

First there are attacks on the formula itself. There appears to be a growing body of ill informed literature that suggests that the present formula over allocates Equalization to receiving provinces and that it should be abandoned in favor of a macro type of formula based on economic criteria. There are also some who claim that the Representative Tax System is an incentive for receiving provinces to discourage economic development and allow taxes to be too high. Several studies by the C.D. Howe Institute and the Atlantic Institute for Market Studies have been quite pointed on these issues.

It is our concern that these institutes' opinions carry far too much weight because the overwhelming body of academic literature indicates that the present RTS delivers the correct theoretical result, by estimating actual fiscal disparities that exist between provinces. The formula does this by measuring the shortfall in revenues that each province might have from the array of taxes actually in place in Canada. It essentially aims to directly compensate each province's inability to raise revenues, given the bases available to them, by comparison to national norms. Implicit in this approach is that a province's relative fiscal capacity is determined by representative tax practices across Canada and actual revenues generated.

By contrast a macro formula would be based on economic criteria such as GDP or personal income and be divorced from actual tax practices. One consequence of this approach is that it ignores choices by governments concerning the adoption of measures such as the progressive income tax, sales tax exemptions aimed at poorer Canadians and a variety of tax credit schemes to lower the tax burden on low income earners. In addition such an approach understates the role of resource revenues available to resource rich provinces. The result of moving away from an RTS would be to severely penalize poorer provinces, and particularly provinces with few natural resources, such as PEI.

Those who would claim that the RTS acts as a disincentive to economic development have never produced sound evidence of this. In fact PEI commits a very large part of its Budget to economic development. The main focus of all provinces is on employment and improved standards of living for our citizens and so it would be politically foolish for us to focus our efforts on raising our Equalization dependency through discouraging economic advancement. As I noted earlier we take

no joy from our reliance on Equalization.

I can categorically state that the Representative Tax System does not act as a disincentive to economic development.

Another issue concerns complexity. Everyone would like a simple formula. In fact, the heart of the present formula is very simple. It estimates the revenue that could be generated by each revenue source in each province using standardized estimators and a provincial average tax rate, and compares that with what could be generated if the five province standard revenue generating capacity were available to that province. The Equalization entitlement is the sum of these differences for all revenue sources. It is basically an exercise in simple addition and subtraction.

Where the Program is complicated lies in, first, the extended number of entitlement estimations that are involved over time, second, the statistical manipulations that are required to identify revenue bases on a standardized basis and, third, the add ons that I previously discussed. Given the immensity of the task at hand, it is not realistic to believe the Program could ever be very simple, though the removal of add ons would help reduce complexity. Federal decisions concerning the introduction of formula changes on a transitional basis in the last renewal also added much complexity.

In any given year, three entitlements can change and this both adds to the complexity of the Program and has major implications for our budgetary planning. We have seen major upswings in the revenues in good times and the reverse in poor times. But I know of no easy and acceptable solution to this problem. Some would suggest that the macro approach would simplify the Program but closer investigation shows that it would add a new level of complexity and volatility.

We feel that the Representative Tax System must be retained as it provides the basic structure necessary to measure fiscal disparities. Many of the anomalies that the present Program produces are the result of the add ons, not the formula itself.

In summary

- a) The Equalization Program is an essential part of the Public Finances of Canada. It has a signal role in leveling the playing field across this vast land so that all persons and businesses can access reasonably similar provincial services at reasonably similar levels of taxation.
- b) The Program is a declining part of federal fiscal requirements and its absolute amount will automatically rise and fall with general economic conditions. It has not been a burdensome Program to the national finances.
- c) The Program has not been enhanced by the Federal Government over many years. Rather, steps have been taken to reduce the standard by moving to five provinces and to gradually lower the ceiling. Recent federal claims that receiving provinces have somehow been treated

favorably are not only misleading, they are insulting to Equalization receiving provinces like ourselves who must struggle to maintain provincial services with inadequate funding.

- d) The Representative Tax System is the basis of the present formula. It can be shown that this formulation provides the correct results in terms of estimating fiscal disparities between provinces. Suggestions that macro type formulas are a simpler and better alternative should be rejected on both theoretical and practical grounds.
- e) Concerns over the alleged disincentive effects of the RTS are misplaced and unproven. Again, claims that a macro approach can improve this are not acceptable.
- f) The ceiling is a direct attack on the very goals of the Program. The recent federal decision to further lower it by an unprecedented amount is most injurious to the Program. The ceiling must go.
- g) The removal of the 70/30 rule and the floor provision should be seriously considered. These add ons to the basic formula have distorted the Program from its main purpose, introduced inequities to the results and added complexity. In the context of the ceiling application their impacts are even more inequitable. They should be removed from the ceiling application if it remains in effect.
- h) The standard presently in application is resulting in increasing disparities between Alberta and other provinces. A ten province standard will allow the formula to more properly reduce fiscal disparities.
- i) The Program can only work adequately with comprehensive revenue coverage.