

Equalization in Canada

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Features of the Canadian Federation

- ▶ Large country with 10 provinces of different sizes
- ▶ Very decentralized: revenue-raising, spending autonomy, unrestricted borrowing
- ▶ Variability of relative provincial fiscal capacities over time
Differences in natural resource revenues particularly important
- ▶ Comprehensive system of federal-provincial fiscal arrangements with following characteristics
 - ▶ Revenue equalization, equal per capita social transfers, some specific grants
 - ▶ Equalization formula-driven, but for five-year periods
 - ▶ Federal influence via spending power
 - ▶ Personal, corporate and value-added tax co-occupied and harmonized; resource taxation provincial
 - ▶ No Grants Commission, but Council of the Federation
 - ▶ Some asymmetric treatment of Quebec (French-speaking province)

Constitutional Context

Equalization Commitment

“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.”

Regional Disparities

“Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to (a) promoting equal opportunities for the well-being of Canadians; (b) furthering the economic development to reduce disparity in opportunities; and (c) providing essential public services of reasonable quality to all Canadians.”

Two Key Roles of Equalization

Solidarity

- ▶ Equalization promotes horizontal equity/social citizenship regardless of province of residence
- ▶ Facilitates decentralization by undoing interprovincial inequalities from decentralized fiscal responsibilities
- ▶ Equalizes the ability to provide public goods and services, while allowing state discretion in program design
- ▶ Note difference with interpersonal income redistribution

Insurance

- ▶ Equalization insures provinces against regional shocks of both short-run and long-run nature
- ▶ Constitution provides commitment mechanism for insurance against long-run shocks
- ▶ Relative fiscal capacities of provinces vary greatly over time

The Approach to Equalization in Canada

- ▶ Differences in ability to provide comparable levels of public services at comparable tax rates affected by
 - ▶ **Revenue-raising** ability
 - ▶ **Costs** of providing services (wage costs, geography, scale)
 - ▶ **Needs** for public services due to demographic differences
- ▶ In Canada, equalization based solely on equalizing revenue-raising ability
 - ▶ Equalize the ability of provinces to raise revenues from own tax bases at average provincial tax rates
 - ▶ Default presumption is that a dollar worth of spending yields comparable public services in different provinces
- ▶ Social transfers also equalizing: equal per capita transfers financed by federal general revenues (with broad conditions)

Canadian equalization system is remarkably simple and transparent

Equalization Design: Representative Tax System (RTS)

- ▶ For each provincial tax base j , per capita equalization entitlement of province i given by $e_i^j = \bar{t}^j (\bar{b}^j - b_i^j)$
where \bar{t}^j is average provincial tax rate, b_i^j is province i tax base j , \bar{b}^j is national average per capita tax base j
- ▶ Total equalization entitlement for province i : $E_i = \sum_j n_i e_i^j$
- ▶ Equalization payments E_i paid to all provinces with $E_i > 0$, financed by federal general revenues (**gross system**)
- ▶ Five major provincial tax bases included: personal income, corporation, value-added, property, natural resources
- ▶ Natural resources treated differently: 50 percent of aggregate resource revenues equalized (RTS not used)
- ▶ Personal tax complicated by tax brackets: each tax bracket treated as separate revenue source
- ▶ Entitlements subject to three-year moving average and (binding) GDP growth cap

Some Variations in System over Time

- ▶ Number of tax types included
 - ▶ Natural resources consolidated from 16 separate taxes to single aggregate category
 - ▶ Small revenue sources eliminated: excise taxes, user fees, social insurance contributions
- ▶ \bar{b}^j based on national average versus five-province standard
 - ▶ Five-province standard excluded poorest provinces and resource-rich province
- ▶ Natural resources fully or partially equalized
- ▶ GDP growth cap imposed by federal government for affordability reasons
- ▶ Social transfers converted to 50 percent cost-sharing to equal per capita with discretionary amounts

Horizontal Imbalance after Equalization

- ▶ Index of revenue capacity relative to national average
 - ▶ Alberta \approx 170, Newfoundland \approx 150 and Saskatchewan \approx 130
 - ▶ Have-not provinces \approx 95 (GDP growth cap)
 - ▶ Before equalization, revenue capacities of have-not provinces range from 67% to 93% of national average
- ▶ Relative imbalances vary over last 40 years
 - ▶ Alberta has been between 130 and 230 (was bankrupt in 1930s!)
 - ▶ Identities of have-not provinces change: Nfld, Ont, Sask, BC
- ▶ **Absolute fiscal capacities increased tenfold since 1972-3**
 - ▶ Growth of provincial/local spending
 - ▶ Revenue decentralization

Problems I

Gross System

- ▶ Below-average provinces equalized up
- ▶ Above average provinces not equalized down
- ▶ Horizontal imbalance remains
- ▶ Partly mitigated by equal per capita social transfers: form of net equalization

Natural Resources

- ▶ Main source of horizontal imbalance
- ▶ Equalization of resource-rich provinces difficult since federal government does not tax resources
- ▶ Provincial ownership of resources conflicts with constitutional commitment to equalization: an argument for special treatment?

Problems II

Revenue vs expenditure equalization

- ▶ $\$X$ may not buy same public services in all provinces
- ▶ Needs for public services differ due to demographics
- ▶ Costs of public services differ due to geography, wage costs, rents
- ▶ In principle, Representative Expenditure System could be deployed, but difficult because public services are heterogeneous
- ▶ May not want to equalize fully for cost differences: efficiency-equity trade-off
- ▶ Simple fix: Adjust for costs by weighting equalization entitlements by relative public sector wage indices
- ▶ Infrastructure spending raises special problems: needs, benefits of agglomeration

Problems III

Incentives

- ▶ Equalization depends on $n_i, \bar{t}^j, b_i^j, \bar{b}^j$
- ▶ b^j might be influenced by provincial policy, especially for natural resource base
Argument for less than full equalization of resource revenues
- ▶ Province may be able to influence \bar{t}^j if a large share of base
Special arrangements have been made
- ▶ Incentives have not been influential in policy debates except for resource revenues

Problems increase with fiscal decentralization

- ▶ RTS difficult if provincial tax bases not harmonized
- ▶ Affordability more difficult: rationale for imposing caps
- ▶ Solidarity more difficult to maintain

Other Approaches

- ▶ Broaden equalization to include transfers to individuals (negative taxes)
- ▶ Separate resource revenues in net scheme to overcome problem of federal government lacking access to resource revenues
- ▶ Consider needs-based equalization: very difficult given heterogeneity in provincial public services
- ▶ Equalization entitlements could be adjusted by wage costs
- ▶ Increase social transfers (vertical balance)
- ▶ Macro approaches: personal income, provincial GDP, etc.
 - ▶ Don't reflect ability to finance public services
 - ▶ Confuse interpersonal with interprovincial equalization
- ▶ Nothing sacred about national average standard in gross equalization system: could equalize to above national average

Concluding Comments

Canadian equalization system relatively simple and transparent

Harmonization of main taxes important for integrity of RTS

Main challenges

- ▶ Natural resource revenues: owned by provinces, unequally distributed, hard for federal government to equalize
- ▶ Highly decentralized federation makes equalization costly
- ▶ Pressures on social consensus for fiscal equity
- ▶ Substantial differences in wage costs across provinces

Relationship between vertical and horizontal balance important