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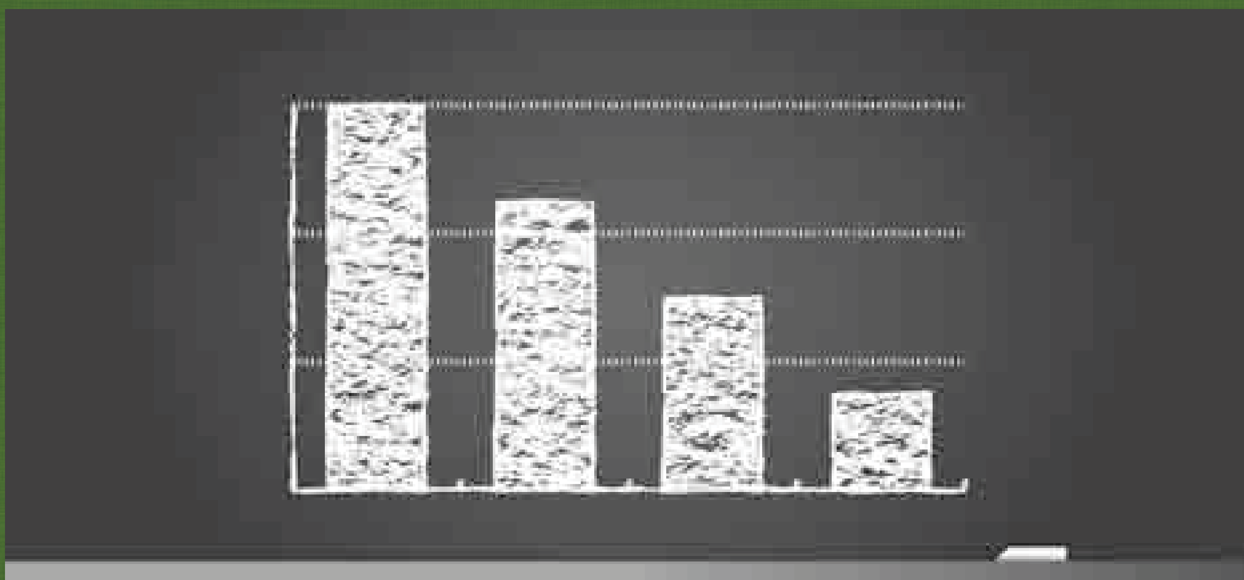

BACK TO BASICS

THE FUTURE OF THE FISCAL ARRANGEMENTS

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MOWAT CENTRE
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ABOUT THE FISCAL TRANSFERS SERIES

Every year, the federal government transfers over $50 billion to the provinces and territories. These funds help provinces and territories deliver the services Canadians count on. The major agreements that underpin these transfers are set to be renewed by 2014. There is broad consensus that the transfer system could improve.

The Mowat Centre is releasing a series of research papers outlining options for reform of the fiscal transfer system—reforms that offer a more principled approach to federal redistribution and reflect a dynamic, evolving federation.

Back to Basics: The Future of the Fiscal Arrangements is the fifth paper in the Mowat Centre's Fiscal Transfers Series.

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EXECUTIVE SUMMARY

Canada's fiscal arrangements—the Canada Health Transfer, the Canada Social Transfer and Equalization—are meant to serve a simple purpose: ensure that all provincial governments in Canada have the fiscal capacity to provide their residents with comparable levels of public services at comparable levels of taxation. They clearly no longer do that.

Fiscal disparities in Canada are increasingly driven by commodities, yet our fiscal arrangements do not redistribute commodity wealth. This places Ontario in a unique situation, lacking the natural resources of the oil and gas provinces, but also significantly more prosperous than the traditional Equalization-receiving provinces.

In practice, this means that funds continue to be redistributed away from Ontario to support traditional Equalization-receiving provinces at a time when Ontario's fiscal capacity is below the national average. This is not the fault of any one government but a result of fiscal arrangements that have not kept pace with changes in the Canadian economy.

This is not sustainable for Ontario and it is not in keeping with the most basic understanding of equity. This redistribution undermines Ontario's ability to provide comparable levels of public services to its residents and also undermines its ability to make capital investments that will ensure its future prosperity.

Addressing this problem will require creative but principled solutions. Reform options must acknowledge that the federal government collects almost no resource royalties and that the funds available to the federal government for redistribution come disproportionately from the Ontario corporate, personal, and consumption tax bases.

Reform options should be resilient to potential macroeconomic changes, including a sustained commodity boom or a slowdown in the natural resource sector. They should strive to achieve their constitutional purpose of ensuring that provincial governments have comparable ability to provide their residents with public services.

They should also dispense with unhelpful conflations of terms like "have-not" or "poor" with "Equalization-receiving." For many provinces, whether they have fiscal capacity above or below the national average will be determined by the internationally set prices for oil and gas. Receiving equalization (or not) is not a verdict on the entrepreneurial spirit or economic policies of a province; it is merely a relative measure of fiscal capacity over which provincial governments currently have little influence.

Moving forward, it is far more useful to think of two groups of provinces: prosperous provinces with commodities demanding high prices on international markets and less prosperous provinces with less natural resource income. Ontario, however, does not fit easily into either group and has its own unique interests in the fiscal arrangements. Currently, those interests are not well-reflected in the design of the system.

Given these realities, in the short-term the federal government should:

- Immediately remove the GDP growth cap that it arbitrarily applied to Equalization

  - The cap violates the agreement with the federal government that saw a movement toward per capita allocation in the CST and CHT accompanied with a move toward a formula-driven program. Although the federal government has honoured the commitment to Alberta to move towards per capita cash transfers, providing the province with approximately 900 million in 2014-15, it will violate its commitment to formula-driven equalization and clawback approximately 1.1 billion from Ontario this year.

  - The cap was applied in a manner that was punitive towards Ontario in particular. Ontario loses 25 per cent of its entitlement, or $1.1 billion, while other provinces lose only 7.5 per cent of their entitlements. A full 55 per cent of the clawback comes from Ontario's transfers.

- Create an Independent Council to report on Canada's fiscal arrangements

  - Many have an interest in concealing the true nature of inter-regional redistribution in Canada. An independent, disinterested body could report on fiscal capacity and net redistribution and related issues. Much like the Canadian Institute for Health Information does for health care, a new Fiscal Transfers Council could similarly improve transparency and governance in Canada's fiscal arrangements.

- Include the cost of providing public services in the Equalization formula

  - The Equalization formula measures differences among provinces in fiscal capacity only. It does not include any measure of variations in what it actually costs to provide services. In reality, it simply costs more to provide public services in Ontario and British Columbia than in other provinces. If we are serious about trying to achieve our constitutional commitment, both the revenue and the expense side of the balance sheet must be included.

  - A more comprehensive "needs-based" approach should also be considered. Such a system would look at not only the cost of labour, but also the socio-demographic characteristics of the population as well as the geographic characteristics of the province.

- Use the real imputed value of hydro revenues when assessing provincial fiscal capacity in order to prevent provinces from under-pricing their electricity and gaming the equalization system.

- Include a measure of federal spending in measures of provincial fiscal capacity because high federal spending in some provinces offsets provincial governments' actual requirement to spend own source revenues on public programs.

These reform options would improve the operation of the fiscal arrangements under the existing framework. Yet the structure of Canada's fiscal arrangements is so inconsistent with the nature of our national economy that over the medium-term, more fundamental reform is necessary.

The paper avoids easy clichés like "Fixing a leaking roof when the foundation is crumbling" or "putting lipstick on a pig," but it is clear that Canada's fiscal arrangements are no longer consistent with Canadian realities. They fail their most basic tests. They do not consistently allocate more federal money to less prosperous provinces than to more prosperous ones, and they don't come anywhere close to ensuring that all provinces have comparable ability to provide public services. Our fiscal arrangements should be re-designed from the ground up.

Over the medium-term, the federal government should implement one of two possible transformations:

- Create a single needs-tested federal fiscal transfer that would provide more fiscal resources to less prosperous provinces and fewer resources to more prosperous provinces; or

- Remove natural resource revenues entirely from calculations of provincial capacity, but then create a separate federally-funded transfer to partially equalize natural resource revenue fiscal capacity.

Historically, Canada's fiscal arrangements have undergone a number of changes to respond to new circumstances. Changes are again in order to address a pressing national problem. This paper outlines the short- and medium-term options that should be pursued to bring us closer to achieving our constitutional commitment.

Funds continue to be redistributed away from Ontario to support traditional Equalization-receiving provinces at a time when Ontario’s fiscal capacity is below the national average. This is not the fault of any one government but a result of fiscal arrangements that have not kept pace with changes in the Canadian economy.

BACK TO BASICS
THE FUTURE OF THE FISCAL ARRANGEMENTS

MATTHEW MENDELSOHN

INTRODUCTION

Canada's system of fiscal transfers was established to ensure that all provinces and territories have a comparable fiscal ability to provide public services to their residents. Historically, this meant the redistribution by the federal government of funds from the Ontario tax base (as well as the tax bases in Alberta and usually British Columbia) to provincial governments in other provinces.

The fact that Ontario now collects Equalization is an enormous shock to the country's system of fiscal redistribution and necessitates a principled debate over how best to reorganize the system of federal transfers to provinces in order to accommodate Canada's new political economy. The current system is failing to do what it is supposed to do—and it is failing Ontario in particular. The status quo is not defensible.

Canada's system of fiscal transfers was not designed for our current economic realities. The most important of these realities are growing fiscal disparities between provinces fuelled by differences in endowments of natural resources and a federal government that is doing less than before to moderate inequities between provinces.

Canada's fiscal arrangements have evolved numerous times over the past half century in response to changing circumstances. Circumstances are again changing and further evolution is necessary. This paper outlines options for what a new system might look like.

Fiscal disparities in Canada are increasingly driven by commodities, while our fiscal arrangements do not redistribute commodity wealth, in part because of provincial ownership of natural resources. These realities place Ontario in a unique situation, lacking the natural resources of the oil and gas provinces, but also significantly more prosperous than the traditional Equalization-receiving provinces.

In practice, this means that funds continue to be redistributed away from Ontario to support traditional Equalization-receiving provinces at a time when Ontario's fiscal capacity is below the national average.

How is it possible that a province that is a recipient of Equalization is in fact a net fiscal contributor to the program? Residents of Ontario, like residents of other provinces, pay federal taxes, which pay for federal programs like Equalization.

Because Ontarians pay the share of taxes to be expected given Ontario's population (approximately 40 per cent), but receive a relatively small Equalization cheque, Ontarians get far less out than they put in. Because the federal government collects almost no resource royalties, the funds available to the federal government to be used for redistribution come disproportionately from the Ontario corporate, personal, and consumption tax bases.

This is not sustainable for Ontario. This redistribution undermines Ontario's ability to provide comparable levels of public services to its residents and also undermines its ability to invest in its competitiveness, prosperity, and the transformation toward Ontario's Next Economy.[1]

Given the huge contribution Ontario taxpayers make to the program in return for the relatively small Equalization payment their provincial government receives back, the program is certainly not in the fiscal interests of Ontario or its residents. The most fiscally profitable response for Ontario would be the elimination of the Equalization program, or at least a radical reduction in its size.

> "The most fiscally profitable response for Ontario would be the elimination of the Equalization program, or at least a radical reduction in its size."

Eliminating the program, however, would violate Ontarians' sense of solidarity with other Canadians and place undue hardship on Canadians in other regions. The far better solution is a reform of the fiscal arrangements that results in Ontarians carrying a burden of redistribution more in line with the principle of equity.

A principled and productive debate requires a new discourse and new narratives. Labels like "have" and "have-not" distort the debate. A province can be prosperous and collect Equalization; collecting Equalization is a relative measure of fiscal capacity, not a moral indictment, an indicator of poverty, or evidence of a lack of entrepreneurial spirit.

Manitoba, for example, will not have higher fiscal capacity than Alberta or Ontario in the conceivable future, regardless of how well its economy is performing or how hard its people are working. The equivalence in Canadian political discourse between "poor," "have not," and "Equalization-receiving" distorts our national conversation.

It has become clear that for the foreseeable future, those provinces endowed with natural resources that are demanding high prices on world markets will have higher fiscal capacities than other provinces. Whether Ontario or Saskatchewan receives Equalization ten years from now will depend largely on the internationally determined price for commodities like oil and potash. A commodity boom—or bust—says nothing about the moral worth or economic policies of either Ontario or Saskatchewan.

It is, therefore, far more useful to think of two groups of provinces: prosperous provinces with commodities demanding high prices on international markets and less prosperous provinces with less natural resource income. Under the current system of redistribution, the latter group will receive Equalization, so long as the commodity boom continues.

Ontario, however, does not belong to either group. Some commentators have argued that Ontario must decide whether it is part of the "wealth creating west" or "wealth consuming east" (Coyne, 2012; Ibbitson, 2012). But Ontario is neither a rich petroleum province nor a less-rich non-petroleum province and so cannot simply make a choice between these two sets of competing interests. Ontario shares interests and characteristics with both groups and faces its own unique challenges.

Canada's current regime of per capita transfers, supplemented by Equalization as currently designed, is failing to achieve its purpose and, in practice, is punitive toward Ontario. The Ontario tax base carries an enormous share of the burden to ensure that the governments of Manitoba, Quebec, and the Maritimes have comparable levels of fiscal capacity, at a time when Ontario's own fiscal capacity has fallen below that of provinces with significant oil and gas revenues. The situation needs urgent redress.

Ontario currently has the largest per capita deficit in the country, but spends less per capita on just about every public service than any other province, with its per capita spending tied for last, alongside PEI. Continued redistribution away from Ontario is neither equitable nor sustainable.

The Ontario government has for decades complained about the situation but it cannot fix the fiscal arrangements. Only the federal government can. This paper sketches out realistic and principled reform of Canada's fiscal arrangements, particularly the Canada Health Transfer (CHT), Canada Social Transfer (CST), and Equalization. Table 1 outlines current entitlements for each province in each of the three major transfers.

WHERE ARE WE TODAY?

Equalization and other fiscal transfers are the primary way we ensure that many of the social benefits of Canadian citizenship are enjoyed by residents of all regions, including those that are less prosperous. This is a very worthy goal. Without federal fiscal transfers of some kind, many Canadians would see the ability of their provincial governments to invest in public services significantly curtailed. To achieve the objective, fiscal arrangements must be aligned with the economic realities of the country. Right now they are not.

A significant reason for this misalignment is that the tax base to which the federal government has access closely mirrors the Ontario tax base, heavily weighted toward personal, corporate, and consumption taxes. The federal government relies disproportionately on this base for all its spending, including its spending to help less prosperous provinces. This fact does not change during a commodity boom, when the major contributor to growing imbalances between provinces is the different endowments of natural resources. The major factor increasing the interregional redistributive pressure on Ontarians is one from which the province derives almost no benefit.

Any proposed reforms must deal with a number of realities:

- Canadians' commitment to Equalization—that schools in small town New Brunswick will be able to provide the same quality of education as schools in suburban Vancouver—remains strong and widely embraced. Few suggest we do away with Equalization of some kind. The question is how to better achieve our Constitutional commitment.

- Canada no longer lives under the umbrella of the protected internal markets of John A. Macdonald's National Policy. Equalization was part of a larger, implicit national bargain, whereby Ontario benefited from a greater concentration of manufacturing and other provinces received some share of wealth generated by the sector in the form of federal fiscal transfers. Today, businesses, provinces, and cities compete with their peers globally. Those that produce export and trade oriented goods and services—particularly in geographically mobile sectors like manufacturing and services—are less able to afford a redistributive tithe (Courchene 2008). In fact, an excessive tithe undermines the ability of these sectors to generate wealth for the purpose of inter-regional redistribution.

- The uneven concentration of natural resource wealth has exacerbated differences in fiscal capacity across the country to an extent never before seen. As pointed out by the Manitoba government, "the uneven distribution of natural resources is the single most important source of fiscal disparities among provinces. While the natural resource base is small (only five per cent of total revenues subject to Equalization), it is responsible for approximately one-third of total Equalization entitlements in 2012/13" (Manitoba Budget 2012, D5). Alberta and Saskatchewan have fiscal capacity far greater than most other provinces and have an ability to provide more generous public services at lower rates of taxation. The extent to which Alberta and Saskatchewan are more prosperous than other provinces dwarfs the historic difference between prosperous Ontario and other provinces. Even at times of relative prosperity, Ontario's fiscal capacity was barely above the national average (Figure 1).

- Natural resources are owned by the provinces. The royalties extracted from them belong to provincial governments and are not re-distributed to other provinces or collected by the federal government.

- Ontario will have below average fiscal capacity for the indefinite future, as long as the price of oil remains high. In 2009-10, Ontario officially became an Equalization receiving province. In its first recipient year, the province received $347 million. Ontario's entitlements have rapidly increased and are set to reach $3.26 billion in 2012-13. Though growth in the size of Ontario's Equalization entitlement has been steep (now second only to Quebec in total dollar amounts), the per capita value is by far the lowest in Canada—approximately $241 per Ontarian (Department of Finance 2011).

- Overall federal spending continues to redistribute funds away from rather than toward Ontario. Ontarians contribute approximately 39 per cent of federal revenues but receive only 34 per cent of federal expenditures (Figure 2). "The net result of this revenue and spending pattern on a per capita basis is worth about $12.3 billion or 2.1 per cent of Ontario's 2009 GDP" (Commission on the Reform of Ontario's Public Services 2012, 450).

Table 1 Total Major Federal Transfers to Provinces (including Other Payments), 2012-13 (millions of dollars)

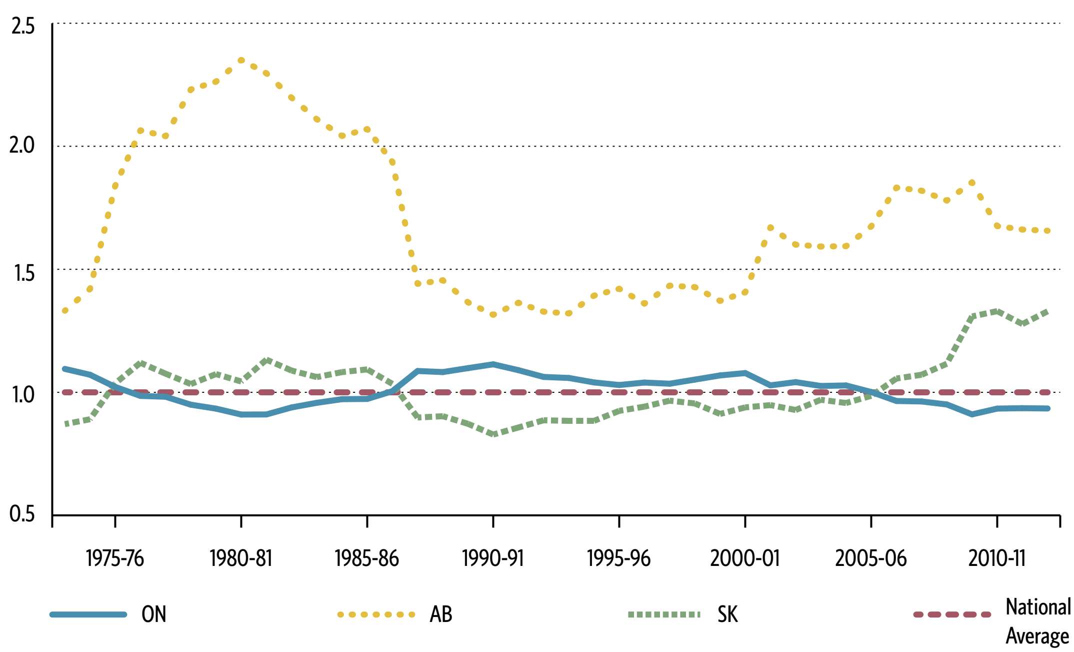
	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	CAN
Canada Health Transfer	**472**	**123**	**797**	**637**	**6,770**	**11,390**	**1,062**	**909**	**2,287**	**4,032**	**28,569**
Per Capita Allocation (dollars)	927	842	843	843	843	843	843	851	595	869	820
Canada Social Transfer	**173**	**50**	**322**	**257**	**2,735**	**4,601**	**429**	**365**	**1,309**	**1,581**	**11,589**
Per Capita Allocation (dollars)	340	342	341	340	341	340	340	342	340	341	340
Equalization		**337**	**1,268**	**1,495**	**7,391**	**3,261**	**1,671**				**15,423**
Per Capita Allocation (dollars)		2,306	1,341	1,978	920	241	1,326				443
Total Transfer Protection			**13**	**103**	**362**		**201**				**680**
Per Capita Allocation (dollars)			14	136	45		159				4
Offshore Accords			**458**								**458**
Total Major Transfers	**645**	**510**	**2,859**	**2,492**	**17,258**	**19,252**	**3,363**	**1,273**	**3,597**	**5,613**	**56,531**

Source: Finance Canada

Notes: Ontario amounts in the table are on an entitlement basis and may not match Ontario public documents.

1. Canada totals for CHT and CST include Territories.
2. Total Transfer Protection was paid in 2010-12, 2011-12 and 2012-13. These are funds provided to provinces despite any empirical or principled justification. Finance Minister Flaherty has stated it will not be continued by the federal government in 2013-14.
3. Per capita numbers based on June 1st, 2012 Statistics Canada estimates.
4. Numbers may not add up due to rounding.

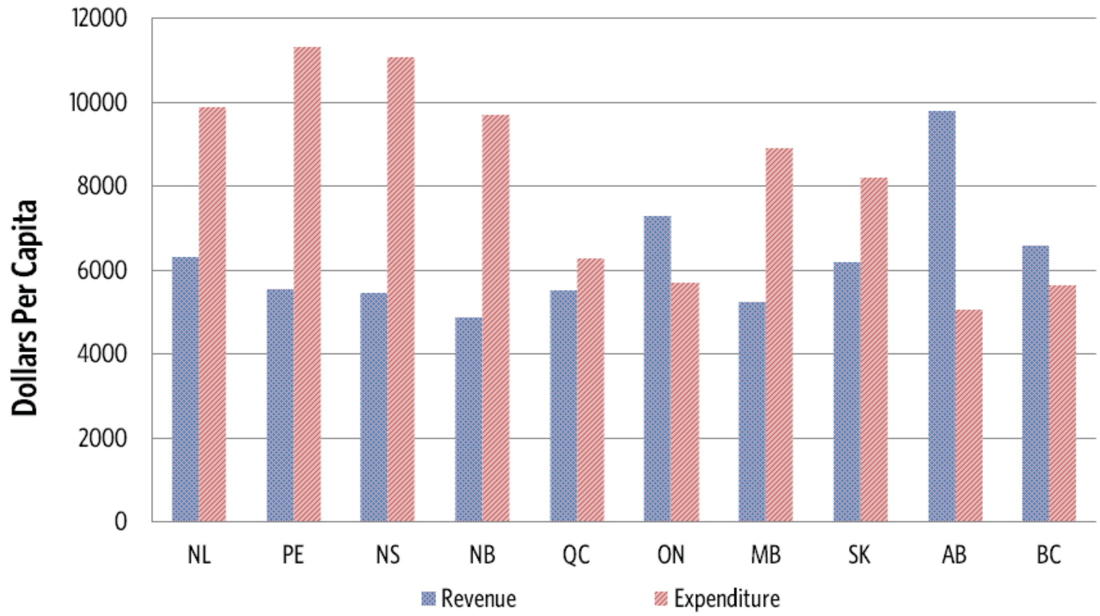
Figure 1 Evolution of Provincial Governments' Fiscal Capacity Compared to National Average, 1972-73 to 2010-11



Source: Author calculations

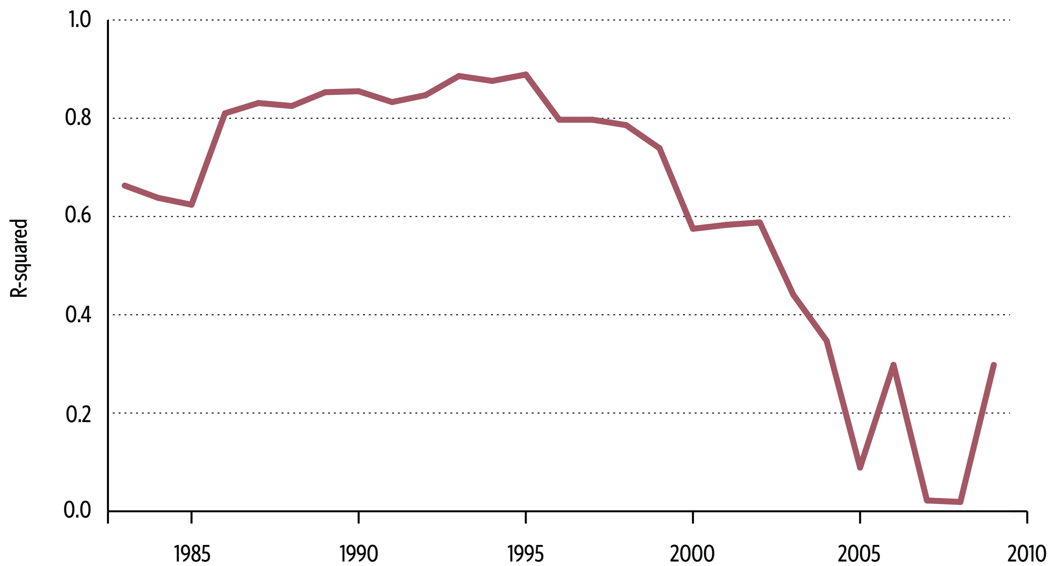
Notes: National Average = 1

Figure 2 Per Capita Federal Government Revenue and Expenditure by Province, 2004-2008 Average



Source: McMillan, 2012

Figure 3 Equity in Treatment of Provinces in Fiscal Arrangements, 1983-2009



Source: Mendelson, 2012
Notes: Results in the figure represent an evolution in the correlation coefficient between provincial GDP and federal transfers per capita. 0 would represent a complete lack of correlation between a province's GDP and its share of federal fiscal transfers; 1 would represent a perfect correlation.

- The inter-regional redistributive principle which should be a core principle of the fiscal transfer system is no longer operative. While once there was a principled redistribution from richer to poorer, our system of fiscal federalism has largely broken down (see Figure 3). This is because redistribution away from Ontario continues, even though its fiscal capacity is below the national average.

Despite these realities, which should, *prima facie*, provide the impetus for significant reforms to the transfer system, a serious discussion about reforms has not happened. Such a conversation faces a number of hurdles:

- Historic resentment in many parts of the country toward Ontario's economic and political power remains strong. Raising legitimate, evidence-based concerns or questions is often greeted with dismissal rather than principled engagement with the facts or arguments being highlighted.

- A checkered history of *ad hoc* and politically-driven adjustments to the fiscal arrangements has fostered a lack of trust between governments, along with a zero-sum competition both horizontally (between the provinces who compete for shares of federal transfers) and vertically (between the provinces and the federal government who compete for shares of the aggregate tax base).

- The legacy of the National Energy Program makes reasoned discussions of the impact of the oil and gas sector on other parts of the country difficult. The Western Canadian resource boom is having a significant impact on the Canadian economy, but anyone who attempts a consideration of these effects in any manner other than adulation is treated by some as attacking Alberta and Saskatchewan.

- The fiscal arrangements are complex and technical, making principled or evidence-based public discussion of them extraordinarily difficult. The politicized nature of fiscal transfers means provincial claims are greeted with skepticism and eye-rolling from the commentariat who shrug: "here we go again." The technical and complicated nature of transfers makes it far easier for observers to avoid the difficult work of engaging with the substance of critiques and simply lump them all into the same category: "more provincial whining."

- Any change will produce provincial winners and losers. Provinces can figure out whether they benefit or not from any proposed change. They tend not to accept principled changes if they hit their own bottom line. Debates are self-interested, with residents of all provinces ready to believe their provincial government when they're told they're getting a raw deal.

"The technical and complicated nature of transfers makes it far easier for observers to avoid the difficult work of engaging with the substance of Ontario's critiques and simply lump them all into the same category: 'more provincial whining.'"

- The Ontario government, for its part, has often complained about federal fiscal transfers but has offered no systematic critique of Equalization. Ontario has articulated no public views on the details of the Equalization formula, unlike other provinces that have had clear objectives on preferred changes to the fiscal arrangements. Ontario barely wants to acknowledge that it now receives Equalization for fear that this will communicate the wrong message about the health of the Ontario economy.

Now that Ontario is a recipient of Equalization, its traditional agnosticism will need to end. Although it will be difficult, Ontario must be prepared to lead an evidence-based and principled national conversation.

Such a conversation would begin by recognizing that the sources of differences in fiscal capacity are different than they once were and the ability of the Ontario tax base to fund redistributive efforts is lower than it once was. This should lead to a new conversation about how to design a principled system grounded in the Canada of today and seek to figure out how to fulfill our commitment to the principle of Equalization—that is, that all provinces have the fiscal capacity to provide reasonably comparable levels of public services at reasonably comparable levels of taxation—in this "new Canada."

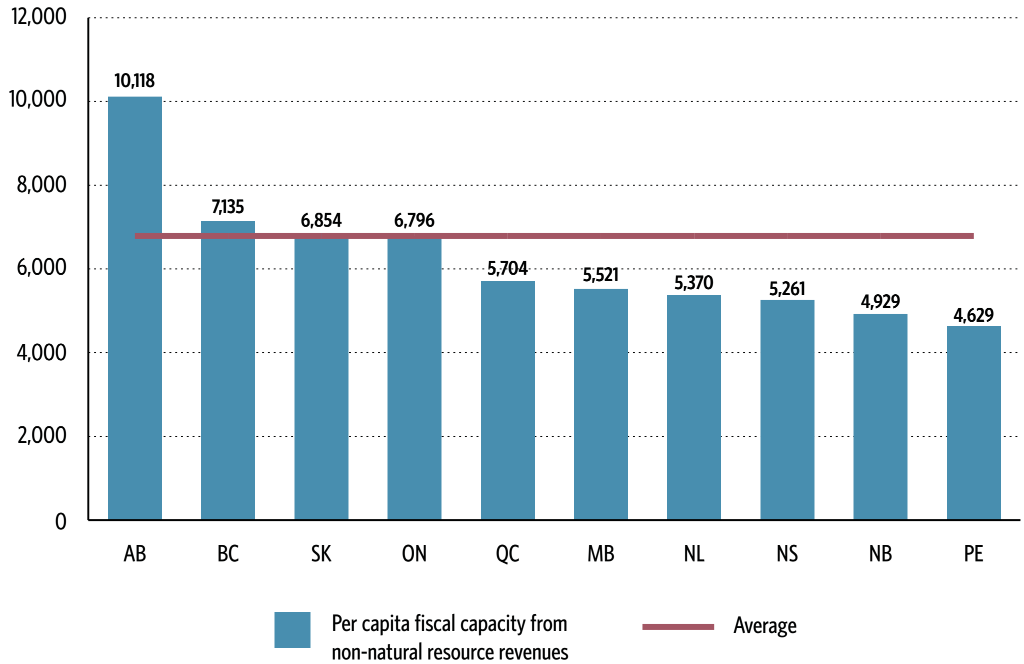
Reforms should consider not just Equalization, but other fiscal transfers—all of which should be properly understood as performing an equalizing function. Per capita transfers like the CHT and CST provide all provinces the same per capita share, regardless of the richness of their tax base, thus representing significant transfers of wealth from places with higher per capita personal and corporate income (such as Ontario and Alberta) to others. Proposals for redesign should be conscious of the interaction of various federal programs and transfers.[2]

COMMODITY BOOM, BUST, AND FISCAL CAPACITY

The rise in importance of resource royalties for some provincial coffers has been matched by a relative decline in the manufacturing sector, historically centred in Ontario. There seems little doubt that there are some negative effects for Canadian manufacturing from a booming oil and gas sector, most notably the increase in the value of the Canadian dollar (Lemphers and Woynillowicz 2012), although the extent of the impact remains open to debate. We will not revisit the discussion of "Dutch Disease" here, except to note that the impact of the resource economy on manufacturing in Canada is unique, with benefits of the resource boom and damage to the manufacturing sector both experienced regionally.[3] Although the country's overall fiscal and economic positions are helped by diversified economic activity, including strength in both the manufacturing and resource sectors, significant strength in one can have negative effects on the other.

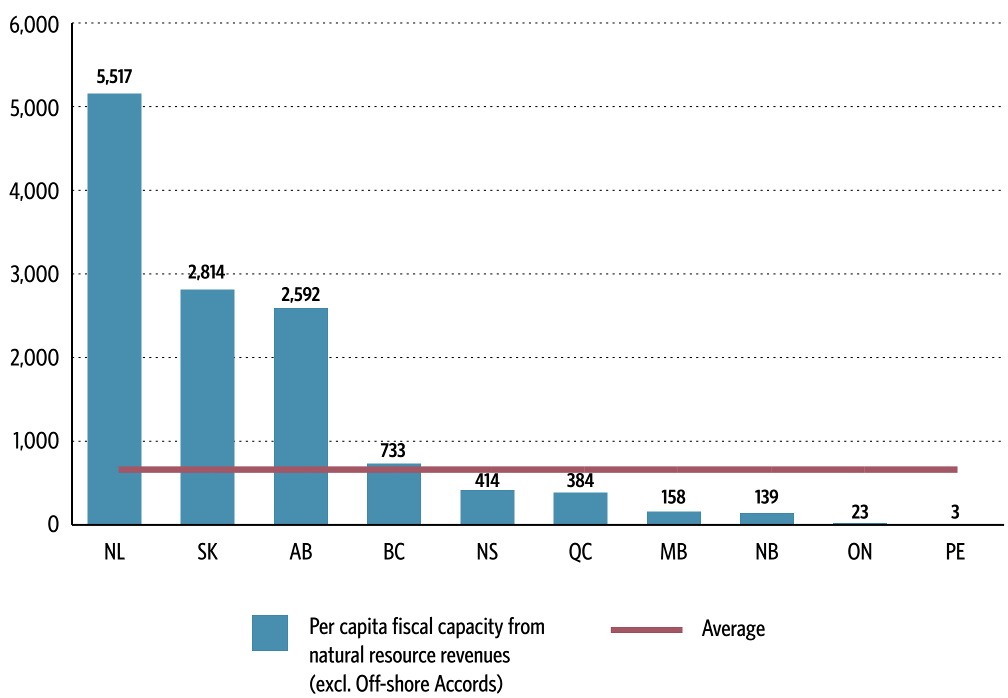
Increased provincial revenues from natural resources in non-recipient provinces put pressure on the Equalization program to grow by raising the national average standard (NAS) fiscal capacity. High oil prices (reaching over $100 per barrel), were not considered when the current formula was designed, and have contributed significantly to the program's growth. In fact, the Expert Panel on Equalization and Territorial Formula Financing, commonly known as the O'Brien Report, estimated a $60 per barrel high (2006, 133). A growth in any revenue source could put pressure on the program and natural resource wealth is no exception. What makes the

Figure 4 Provincial Fiscal Capacity, Excluding Natural Resource Revenues, 2011-12



Source: Finances Québec, 2011

Figure 5 Provincial Fiscal Capacity from Natural Resources, 2011-12



Source: Finances Québec, 2011

commodity boom so challenging for the Equalization program, however, is that the wealth is concentrated in a small number of provinces that do not receive equalization and that the federal government—which pays for Equalization—has only marginal access to revenues from natural resources.

Looking at Figure 4, which removes natural resource fiscal capacity from the data, we see what many might suspect about the relative prosperity of provinces (prior to federal transfers), with Alberta having higher than average fiscal capacity, followed by BC, Saskatchewan, and Ontario, with other provinces trailing. Canada's Equalization program and formula can do a great deal to correct for these differences in fiscal capacity. But our current formula can do very little about the differences in natural resource revenues, seen in Figure 5. And it is these differences that are becoming a more important source of differences in fiscal capacity in the country.

Canada's system of fiscal transfers must be resilient during a commodity boom. Right now it is not, placing pressure on the Ontario tax base to pay for redistribution driven by wealth from which it receives no benefit. But likewise, the system must not place undue burden on a small number of resource-rich provinces and must be resilient during a slowdown or bust in the commodity sector. The major government studies of the mid 2000s—the O'Brien Report and the provincially led report of the Council of the Federation's Advisory Panel on Fiscal Imbalance—did not come to grips with commodity booms, busts, and the reality of provincial ownership of natural resources.

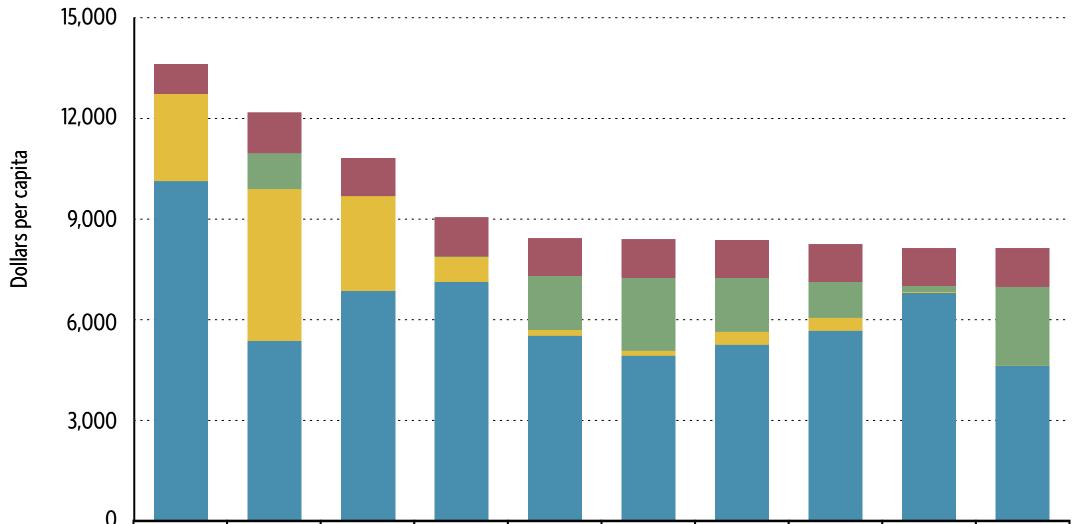
These reports also did not directly address the question of whether fiscal transfers ensured that provinces have comparable ability to provide public services. Instead, these reports focused on technical debates, acknowledging the constitutional commitment without measuring the success of the program in achieving it. It is a question which should be answered: after the operation of the federal fiscal transfer system do provinces have the fiscal capacity to provide reasonably comparable levels of public services at reasonably comparable levels of taxation?

As seen in Figure 4, prior to the inclusion of natural resource revenues (e.g. royalties, payments for exploration rights, profits remitted from provincial electricity utilities, etc.), and federal transfers, Ontario's fiscal capacity is fourth highest in the country. Ontario remains a relatively prosperous province with broad access to corporate, personal, and consumption tax revenues.

Ontario, however, receives almost no revenue from natural resource royalties (Figure 5). Once the value of natural resource fiscal capacity is included in overall provincial fiscal capacity, however, Ontario slides to fifth, below that of the four provinces with above average resource royalties (BC, Alberta, Saskatchewan, and Newfoundland and Labrador). This is due to Ontario's very low level of resource revenues.

Figure 6 reports fiscal capacity including the value of federal transfers. Here we see that Ontario's ability to deliver public services is nearly tied for last, just a few dollars above that of PEI. It is the operation of the federal system of fiscal transfers that leaves Ontario with virtually the lowest real fiscal capacity in the country.

Figure 6 Total Per Capita Provincial Fiscal Capacity after Federal Transfers, 2011-12



	AB	NL	SK	BC	MB	NB	NS	QC	ON	PE
CHT and CST	901	1,221	1,147	1,161	1,138	1,138	1,138	1,138	1,138	1,138
Equalization and Offshore Accords	0	1,058	0	0	1,608	2,183	1,592	1,054	170	2,351
Resource Fiscal Capacity	2,592	4,516	2,184	733	158	139	377	384	23	3
Other Fiscal Capacity	10,128	5,374	6,860	7,147	5,526	4,932	5,266	5,677	6,803	4,632
Total Fiscal Capacity	**13,621**	**12,169**	**10,821**	**9,041**	**8,430**	**8,392**	**8,373**	**8,253**	**8,134**	**8,124**

Source: Commission on the Reform of Ontario's Public Services, 2012

THE PROBLEM IS EVEN BIGGER

The numbers presented above include the three major federal transfers only, along with associated side deals and protections. They do not include other federal spending. They therefore understate the federal role in reducing Ontario's fiscal position relative to the other provinces. In the *Final Report of the Commission on the Reform of Ontario's Public Services*, Don Drummond estimated the difference between Ontarians' contribution to federal revenues and the benefit to Ontarians from federal spending on transfers and services, assuming a balanced federal budget, at $12.3 billion (Drummond 2012, 450).

Many federal programs are simply better designed for other provinces than for Ontario and represent significant transfers from the Ontario tax base to other provinces. For example, the Employment Insurance (EI) program does a far better job supporting the unemployed in other provinces, with unemployed Ontarians less likely to receive EI benefits than residents of any other province. This places added pressure on other provincial programs (Mowat Centre EI Task Force 2011, 11).

As well, although the federal government has moved towards per capita transfers in many areas, it continues to operate random allocation formulae in other areas, including in areas of active labour market measures through the Labour Market Development Agreements (LMDAs), economic development funding through federal agencies, infrastructure funding, and social housing. For example, social housing and training dollars are allocated based on decades-old assessments of provincial need, while some infrastructure funds see all provinces—both big and small—allocated the same amount.

The only province consistently hurt by these formulae is Ontario. For example, Ontario is the only province whose share of national unemployment (42 per cent) exceeds its share of the federal allocation for active labour market measures (33 per cent).[4]

Over time, these and other programs have taken their toll. Ontario, a relatively prosperous province, spends less per capita than other provinces but also has the largest per capita deficit in the country. Ontario's spending on just about every public program is lower than in other provinces (Ontario Common Front 2012, 5), which has a real impact on everything from the availability of affordable housing, to opportunities for those in precarious work to access training funds to improve their employment prospects. It should also be noted that while Ontario spends less than other provinces, its taxes are about average (McMillan 2012).

When compared to other provinces, Ontario is a moderate tax, low spending jurisdiction. Regardless of whether one's long-term goal in Ontario is to reduce taxes or increase spending—or both—failing to deal with the federal fiscal transfer system will make real movement on either of those agendas difficult. Ontario's deficit is the result of many factors, including a significant economic downturn, but a major contributor is the operation of fiscal federalism.

A PRINCIPLED APPROACH

Negotiations around the fiscal arrangements have historically been among the most acrimonious in Canadian federalism. They have been characterized by a zero-sum climate and self-interested position-taking, with little room for principled debate about provinces' relative ability to provide public services. Myriad changes to programs and formulae have been adopted by successive federal governments in an effort to appease angry provinces, leaving a confusing hodgepodge. It is very difficult for even the engaged policy expert—let alone the average citizen—to understand why provincial governments receive the amounts they receive. Many provincial governments have an interest in confusing rather than clarifying the issues.

This paper will instead focus on the key principles that should animate reform efforts on the fiscal arrangements. These arrangements should, to the best extent possible, provide provinces with comparable fiscal capacity with which to deliver provincial programs and services at comparable levels of taxation.

A return to principles, with an appreciation of new realities, is necessary. In 2010, the Mowat Centre issued a report card on Canada's fiscal arrangements and identified the principles that should guide reform efforts. A focus on four of these key principles—adequacy, equity, transparency and provincial autonomy—seems most appropriate for dealing with this key challenge to the Canadian federation. The other principles—predictability, efficiency, and accountability—will also be brought to bear on an assessment of the options outlined in the following section.

REFORM OPTIONS FOR THE NEW CANADA[5]

EASY SHORT-TERM ADJUSTMENTS

i. Eliminate the GDP Growth Cap on Equalization

The federal government imposed a cap on the growth of the Equalization program in its 2009 budget. The cap was set at the rate of growth of the national economy. This change was enacted without consultation with the provinces, and it violated the commitment made by the federal government to provinces to return to a formula-driven program. In particular, it broke the bargain to which Ontario had agreed: that a movement toward a formula-driven Equalization program would be coupled with a movement toward per capita allocations in other transfers. Unilateral tinkering with a formula that has been accepted by all governments, albeit grudgingly, clearly violates the principles of transparency and predictability.

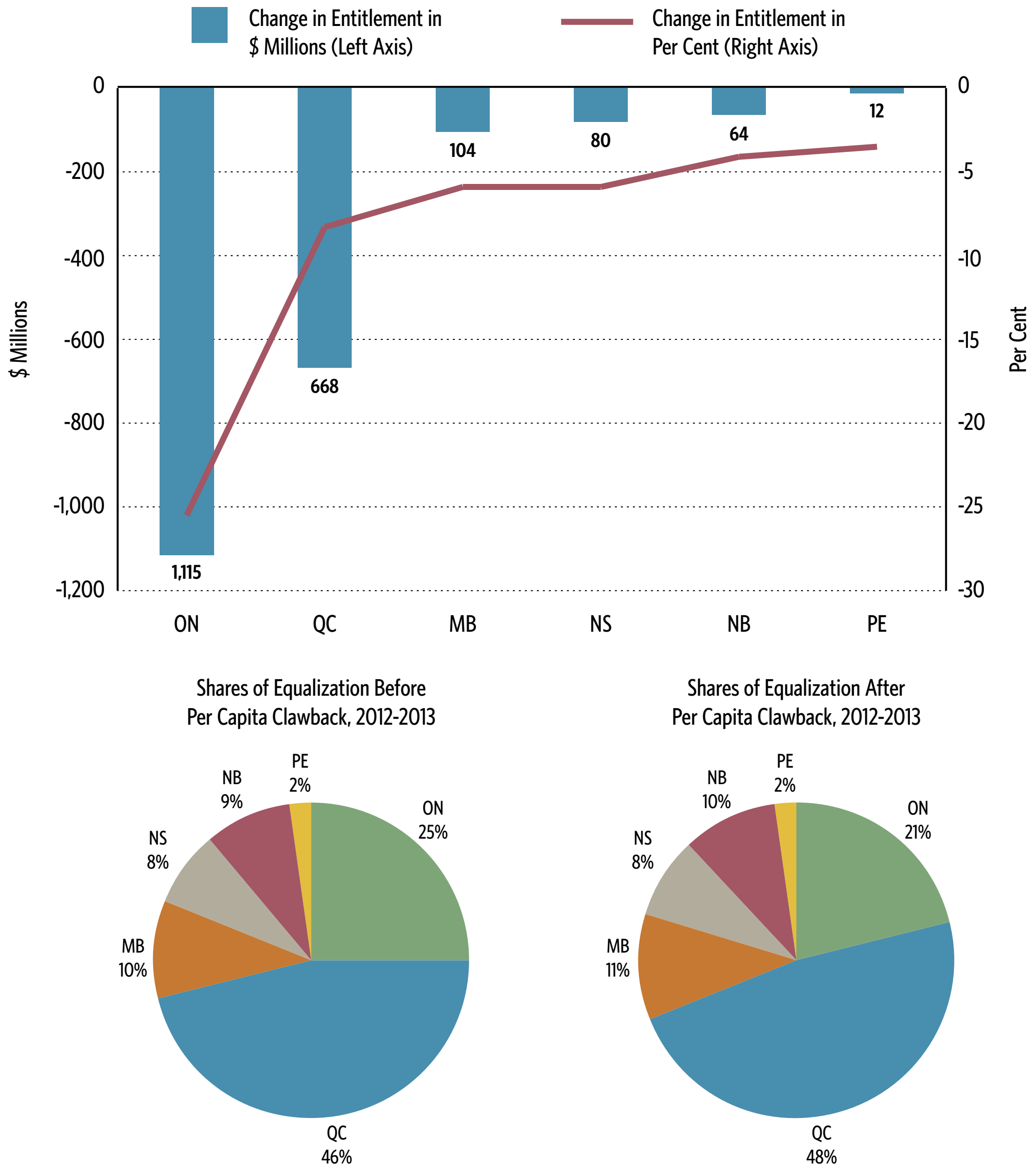
> It is the operation of the federal system of fiscal transfers that leaves Ontario with virtually the lowest real fiscal capacity in the country.

More importantly, the imposition of the cap violates the core principle of revenue adequacy. The rate of national GDP growth is not a relevant measure for a program designed to address differences in provincial fiscal capacity. GDP growth could be flat, while fiscal disparities could be growing. Under such a situation, Equalization-receiving provinces would have inadequate fiscal capacity to meet their responsibilities and Canada would move further away from achieving the spirit of its constitutional commitment.

As noted in Figure 7, all provinces that receive Equalization have taken a fiscal hit due to the imposition of the cap. The federal government has offered no compelling rationale for the cap, nor a compelling rationale for its decision to operationalize the cap in a manner that claws back approximately 25 per cent of Ontario's entitlement and only 7.5 per cent from the other five recipient provinces. A full 55 per cent of the entire federal clawback comes from Ontario. The arbitrary federal decision will deny Ontario approximately $1.1 billion in Equalization entitlements in 2012-13. Ontario's struggle to bring down its deficit is made harder when the federal government disproportionately constrains its transfers to Ontario in particular.

Removing the cap entirely would be most consistent with the principle of equity. An alternative, less costly option for the federal government would be to remove the cap, allow entitlements to increase to their formula-driven level, and then reapply the cap again, beginning in 2014.

Figure 7 **Impact of GDP Growth Cap on Equalization Payments, 2012-13**



Source: Calculations based on data from the Department of Finance Canada

ii. Include Hydroelectricity Revenues at Market Prices

Provinces' entitlements under the Equalization program are dependent on federal decisions about how to treat various forms of revenue. They are also dependent on provincial behavior. Under most circumstances, provinces do not adjust their behavior as a result of federal decisions regarding the Equalization formula but there are some situations in which federal definitions regarding the treatment of various forms of revenue can have an impact on provincial entitlements and, hence, may influence provincial behavior.

If a province under-prices its hydroelectricity, it is passing up revenues that it could have collected. This makes these provinces look poorer than they are and entitles them to higher Equalization payments than they deserve. Provinces should not be able to boost their Equalization payments by refraining from reasonable revenue-raising effort and artificially deflating their measured fiscal capacity. Manitoba and Quebec both have, in the past, offered their residents discounted electricity rates through their provincial utilities. Their measured fiscal capacities were, thus, less than they would be if market rates were applied. From an equity and a transparency perspective, provinces should not be able to game the system by deflating their reported fiscal capacity. Such a process also provides these provinces with revenues that are not, in fact, necessary measured against the adequacy principle.

The issue of under-pricing of hydro power has been noted by others for some time (FCPP 2012). In 2012-13, the issue may be more theoretical than real, given the decline in international prices for hydroelectricity and hence the convergence of what provinces charge to their own residents as opposed to what they charge outside their borders. The impact on entitlements of a change toward real market rates for hydroelectricity would therefore be quite small today.

This convergence of domestic and international prices is an opportunity to change the way hydro revenues are estimated because the impact on entitlements will be small at the moment. However, should there ever again be divergence between domestic and international pricing, equalization entitlements would then be a better reflection of the real fiscal capacities of provinces.

iii. Create an Independent Council to Report on Fiscal Capacity and Federal Transfers

The creation of an independent council that would be responsible for monitoring Canada's major fiscal transfers was a reform considered by the O'Brien Commission in 2006. The O'Brien Report ultimately chose to recommend a softer version of this option, stating that "a more rigorous process should be put in place to improve transparency, communications, and governance" (O'Brien 2006, 65). The creation of such a rigorous process was the one element of the O'Brien Report that the government chose not to accept initially. It should revisit this decision.

A permanent council would have the ability to assess the impact of the transfer arrangements and potential reforms. Although politics cannot be entirely removed from debates over fiscal arrangements, neutral public reporting on fiscal capacity and other issues could help provide basic factual information to governments and the public. This neutral, independent information would form the backdrop against which provincial governments' arguments regarding perceived injustices in the fiscal arrangements could be assessed.

As Daniel Béland and Andre Lecours note, Canada has used this model before: "The Canadian Institute for Health Information (CIHI) has similarly been providing expert and neutral healthcare information and guidance to Canadian governments since 1994" (2012, 2). One of the current challenges of the transfer system is that there is no way to measure the success of transfers at achieving their intended outcomes. An independent body could assist in measuring these outcomes. It should table an annual report to Parliament.

MEDIUM-TERM CHANGES WITHIN THE CURRENT ARCHITECTURE

i. Adjust Fiscal Capacity to Include Measures of Cost of Living (e.g., wages and salaries)

The Equalization formula measures differences among provinces in fiscal capacity only. It does not include any measure of variations in what it actually costs to provide services. If we are serious about trying to achieve our constitutional commitment, both sides of the balance sheet must be considered.

For example, both Ontario and BC have higher than average costs. It is simply more expensive to provide services in Toronto or Vancouver than in Winnipeg or Saint John. Relying on a narrow measure of fiscal capacity, with no reference to the higher cost of providing public services in Ontario and BC in particular, results in over-equalization to those lower-cost recipient provinces (Courchene 2010, 1).

The evidence to support this change is compelling. Wages and salaries represent the majority of provincial and local government expenditures and those provinces that receive Equalization (not counting Ontario) have the lowest wage and salaries in the country (Gusen 2012). A simple adjustment to allocations to account for differences in wages is consistent with equity. Using the average private sector wage in a province, rather than focusing on public sector wages, would prevent gaming of the system and would ensure that provinces do not have fiscal incentives to drive up public sector wages.

A more ambitious reform option would include "expenditure need" generally, referred to as "needs-based Equalization." A comprehensive needs-based formula would account not only for the unit cost of providing a service (measured as private sector wages), but would also include how different *work load* and *geographic circumstances* impact the provision of public services across the country (Gusen 2012).

Work load generally refers to the level of expenditure required to meet the needs of the population given its characteristics. More senior citizens or school-age children will require heavier workload. Geographic circumstances include remoteness and climate that impact cost. Providing health care in remote communities may cost more than in urban settings.

A needs-based approach to Equalization, which includes the cost of labour, work load, and geography is used by Australia's Commonwealth Grants Commission (CGC), but other federations employ variations of it. Such an approach would be easily understood by provincial governments, as they use variations of it to compute allocations for their school boards, hospitals, and municipalities.

From an equity and adequacy perspective, consideration of expenditure need, in addition to fiscal capacity, clearly makes sense and would better allow Canada to achieve its constitutional commitment to Equalization. Under a comprehensive needs-based approach, the formula would consider a full range of indicators, including demo-

> "The changes that have taken place in Ontario, Canada and the world over the past two decades are fundamental in nature; our system of fiscal federalism requires fundamental change as well."

graphic and geographic indicators that influence the cost of providing comparable levels of services in each province. Equalization cannot adequately fulfill its constitutional responsibility without considering the different needs of the country's diverse regions and populations (Gusen 2006; 2012). Atlantic premiers have been asking for such a change. They point to the rising costs associated with their growing senior citizen population as evidence of the need to consider costs (The Globe and Mail, May 16 2011). So long as a principled approach is adopted and the full range of variables that affect need are considered, there is a strong case to be made for needs-based equalization.

Some have argued that transparency could suffer under a needs-based system. Calculating need is often criticized as being extremely complex. In Australia's case, there are 39 different expenditure categories, each with a sub-set of indicators meant to capture a detailed picture of each state's need profile (Gusen 2006, 5-7). The argument can also be made, however, that complexity does not have to interfere with transparency. Just because the details of a formula may be difficult to understand does not mean that the essential features of its operation cannot be clearly explained. Moreover, Canada's current system lacks transparency and it is not at all self-evident that a move towards a needs-based system would produce less transparency. It is also possible to achieve greater transparency through other mechanisms, like the creation of an independent council.

ii. Include the Imputed Value of Other Federal Transfers

For decades, Ontario has expressed concern about the structural inequities in federal spending decisions and the impact these have had on Ontario. Although there have been evolutions over time, the core issue remains: the federal government disproportionately extracts funds from Ontario and disproportionately spends and transfers them elsewhere. The reasons for this are complex, often unintended, and difficult to change. They include decades-old allocation formulae, provincial ownership of natural resources, major federal programs poorly designed for Ontario, and structural features of the tax system.

Rather than overturn deeply-seated and structural revenue and spending patterns, an alternative way of approaching this issue is to simply account for federal spending and transfers as part of provincial fiscal capacity.

The fact that the federal EI program makes available far more funds for active labour market measures in some provinces than Ontario means that Ontario will have to use its own source revenues to provide comparable levels of training programs for its residents. Recalculating measures of fiscal capacity and adjusting entitlements to account for these and other federal spending patterns would allow the program to more effectively achieve its objective—and would be a simple way of dealing with Ontario's legitimate long-standing concerns about structural inequities within other federal programs.

Provincial fiscal capacity is not a complete measure of a province's ability to provide comparable levels of public services as other provinces. Federal spending must be added to provincial fiscal capacity to have a more accurate measure of a province's ability to deliver programs to its residents. Failing to include federal transfers and spending inflates equalization entitlements to those provinces that have traditionally received equalization but that have also traditionally received higher than average transfers and spending in other federal program areas.

TRANSFORMATIONAL CHANGES

It may be that the structure of our fiscal arrangements is so inconsistent with the nature of our national economy that more fundamental reform is necessary. If our objective is, indeed, to respond to the changes outlined in section one—a sustained commodity boom, global competition for manufacturing and service firms, etc.—while coming closer to achieving our constitutional commitment, there are at least two better ways of achieving this. These options are practical, achievable, and would require no more than legislative changes. They are flexible and could accommodate a variety of different macroeconomic, regional, and fiscal evolutions, and could be achieved in a relatively short time. They are designed to moderate, not accentuate inter-regional tension due to differences in economic activity and regionally differentiated economic cycles. The changes that have taken place in Ontario, Canada and the world over the past two decades are fundamental in nature; our system of fiscal federalism requires fundamental change as well.

i. Create One New Equalized Health and Social Transfer

There is nothing natural or inevitable about Canada's current arrangement—i.e. one major equalizing transfer and two major per capita transfers. In fact, the size and number of these transfers is *ad hoc*, a result of a variety of political deals made over the past four decades.

All three serve an equalizing function and all come with virtually no strings attached. They also serve the purpose of ensuring that the federal government makes a significant contribution to provincial revenues that are used to achieve social purposes, like the provision of publicly funded health care and education. They are intended to help provide provinces with comparable ability to provide services at comparable levels of taxation, but they come up short.

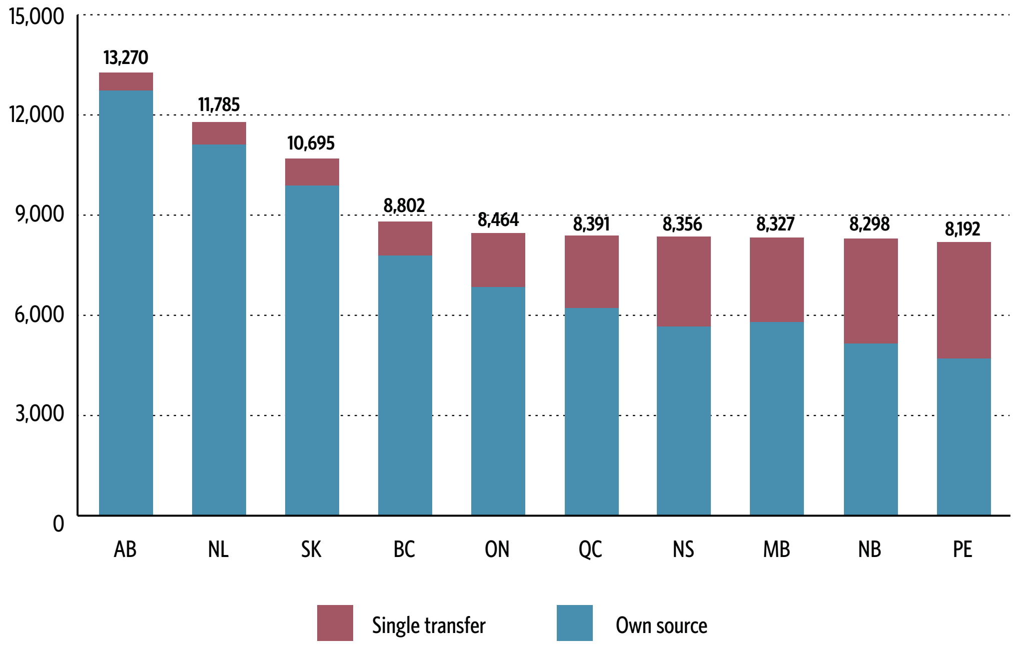
Bundling all three major transfers into one equalized Canada Health and Social Transfer, with more prosperous provinces receiving less per capita and less prosperous provinces receiving more, would do a better job of meeting the principles and objectives outlined earlier.

The new CHST would include an equalizing element, which in practice would mean that those provinces with lower fiscal capacity would receive more per capita dollars than those with higher fiscal capacity. The extent to which differences in fiscal capacity are equalized through transfers would be a decision for the federal government. A reasonable starting point for discussion would be to equalize 90 per cent of the difference in fiscal capacity between each province and the national average.

Figure 8 presents a graphical depiction of how such a system would work. Such a system does a far better job than Canada's current system (see Figure 6) in achieving equity while also maintaining incentives for provincial economic growth.

The data in Figure 8 are the result of combining all three major transfers into a single transfer that has both an Equalization component that grants provinces with below average fiscal capacity 90 per cent of their entitlement, and a per capita element that is adjusted downward for provinces with above average fiscal capacity, likewise to 90 per cent of their entitlement.[6] The result is that provinces with below average fiscal capacity receive more and provinces with above average fiscal capacity receive less.

Figure 8 Own Fiscal Capacity and Single Transfer Payments ($ Per Capita), 2012-13



Source: Author calculations

The attractiveness of such a system is that it meets the objectives of the program and advances the principles of autonomy, equity, transparency, and adequacy. It also does not suffer from most of the flaws that critics—on both the left and right—have identified with current arrangements.

For example, some have said there is little financial incentive for provinces receiving Equalization to generate wealth because this results in lower equalization payments, leaving them no better off (Courchene 2004). Although this is likely an overstatement and provinces do indeed have other incentives for becoming more prosperous, the fact remains that, under our current system, increasing prosperity for a province receiving Equalization will result in no net new dollars for the provincial government because of shrinking Equalization payments.

The system proposed here would eliminate this disincentive to wealth-creating activities. Because provinces would not be brought up to the national average fiscal capacity but would receive a percentage of their entitlement (e.g. 90 per cent), provinces with greater fiscal capacity prior to equalization payments would still be better off after inclusion of equalization payments. This contrasts with the current system which provides fully equalized entitlements to any province below the national average—regardless of how relatively poor—and no equalizing element to any province above the national average—regardless of how prosperous.

A single, equalized CHST could still maintain the weak conditionality of the current transfer system and would thus not sacrifice the principle of provincial autonomy. The principle of transparency would be better reflected because the transfer system would be more explicit in identifying how much of the disparities in fiscal capacity it was seeking to redress.

The system would also moderate some of the interprovincial differences in fiscal capacity being driven by natural resource wealth (or any other form of wealth creation), without the federal government making any attempt to access those revenues. It would also bring the contribution of Ontarians and what Ontario receives more in line with principles of equity and adequacy.

ii. Remove Natural Resource Revenues from the Equalization Formula; Create a New Transfer

Some have argued that natural resource royalties should be removed entirely from the calculation of provincial fiscal capacity. However, if one were to do that, the interprovincial differences in post-Equalization fiscal capacity would grow even greater and the imbalances between the resource-rich and the resource-poor would grow even more. The situation would be entirely inconsistent with Canada's constitutional commitment.

There is, however, an elegant solution to this challenge. Natural resource revenues could be removed entirely from the calculation of provincial fiscal capacity, while at the same time, the federal government could create a new transfer out of general revenues to equalize natural resource related differences in fiscal capacity. This would enable the federal government to better meet its constitutional commitment to the principle that all provincial governments should have the ability to provide their residents with comparable levels of services at comparable levels of taxation. At the same time, this would be consistent with provincial ownership of the resource, a lack of federal access to the revenues, and the understanding that natural resources are a depleting asset. Those provinces with higher levels of natural resource royalties would receive no or little funds from this second transfer. Those with lower resource revenues would receive more.

Much like the creation of a single equalized Health and Social Transfer, this approach accomplishes three goals simultaneously: it moderates fiscal disparities between provinces, leaves natural resource wealth entirely in provincial hands, and moderates the unfair burden placed on the Ontario tax base. And again, much like the creation of a single equalized transfer, the federal government would have some discretion in determining how much of the differences in fiscal capacity it seeks to erase through fiscal transfers.

CONCLUSION

The Equalization program, as designed, is no longer working. This paper has sketched out the new economic realities of the federation and has outlined how our fiscal transfer system no longer does a good job of achieving its stated goals. The system is doing a remarkably poor job for Ontario in particular, redistributing funds away from Ontario and leaving the province with virtually the lowest fiscal capacity in the country. The system as designed places increasing pressure on the Ontario tax base to shoulder the responsibility for inter-regional redistribution driven by a commodity boom from which the province derives little benefit.

A simplified form of fiscal transfers is the best one and the system should be designed in a way so that wealthier provinces receive less than poorer provinces. This basic concept has vanished from our fiscal transfer system.

In order to return to basics, the transformative changes discussed above, particularly the proposal for one simplified equalized transfer, merit the most serious consideration. In the meantime, as transformative changes often require time and consultation, the federal government should move immediately to change its most unprincipled practices, such as the application of the GDP cap to claw back Ontario's entitlements.

All of the reforms discussed above would increase the transparency of the country's fiscal transfer system and would more easily allow citizens to hold their governments to account for policy decisions. Many of these reforms could be undertaken together. For example, removal of the GDP growth constraint, inclusion of the cost of providing services, and the creation of an independent reporting mechanism could all be undertaken together. They could also be folded into either of the two transformative reform proposals when more significant changes are brought in at a later date.

It is clear that our system of fiscal federalism was not designed for our current economy and that the current fiscal arrangements are unintentionally punitive toward Ontario. Any principled redesign would either provide Ontario with more or take less from the Ontario tax base. The solutions are likely to be complex and divisive. The proposals presented here are a good, principled, and credible place to start a real national conversation on how to redesign the system from the ground up.

Such a redesign will likely require intense research and debate, which may be helped along by a Royal Commission. Such a study would be even better situated within the context of a modernization of our federal structure. It is clear that the federal government has more revenues than it needs to fulfill its responsibilities, while provinces and municipalities are on the front-lines of demographic and cost pressures. Questions of fiscal federalism relate to questions of roles and responsibilities. Canada is in need of change on both fronts. MC

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ENDNOTES

1. The Next Economy is defined as an innovative, knowledge- and export-driven economy centred in metropolitan areas. It is characterized by networked regional economies that cross international borders (Mendelsohn et al 2011, 8-9).

2. Ontario's emergence as a recipient province has led some to be concerned about the affordability of the program. The concern is not well-founded. If the federal government wished to increase the size of the Equalization program, this could be offset through a reduction in per capita or other non-equalized transfers or program spending. A revenue-neutral growth in transfers designed to equalize fiscal capacity would need to be offset by a decline in other transfers.

3. The fact that oil and gas revenues have not been saved in a sovereign wealth fund (as in Norway), has contributed to the rise of the Canadian dollar and the decline of Ontario's exports (Boadway 2008).

4. These calculations include Labour Market Development Agreements, new LMDA allocations, Strategic Training and Transition Fund, and Labour Market Agreements (Mowat Centre EI Task Force 2011, 58).

5. In addition to the options discussed in this paper, a number of others were considered and modeled. Those include: inclusion of a different and higher percentage of natural resource revenues, inclusion of debt servicing charges in measured fiscal capacity, along with a variety of different tax point transfers and tax swaps. Various technical changes, including changes to the treatment of the residential and property tax bases, were also considered.

6. Under the proposed system, the total amount paid out to the ten provinces ($55.7 billion) is the sum of the existing CHT cash transfer ($28.5 billion) + CST cash transfer ($11.8 billion) + Equalization ($15.4 billion). Under the single transfer scenario, the total amount paid out to the ten provinces would be set at the same value as under the current system ($55.7 billion), but the Equalization portion of the transfer would be the sum of the amounts received by eligible/recipient provinces ($19.8 billion) and the total amount paid out under the per capita component would be $36 billion ($1038 per capita), with provinces with above average fiscal capacity receiving 90 per cent of their entitlement. These are illustrative examples and the parameters of such a transfer system could be adjusted to achieve either more or less horizontal equity. Note that the data in Figure 8 was created using 100 per cent of natural resource revenues and no GDP growth cap.

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Historically, Canada's fiscal arrangements have undergone a number of changes to respond to new circumstances. Changes are again in order to address a pressing national problem.

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