ECONOMIC NOTE

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Ideas for a More Prosperous Nation

Equalization: Towards a Formula that Promotes Further Resource Development

by **Youri Chassin**

The federal equalization program will distribute over $15 billion to the relatively "poorer" Canadian provinces in 2012-2013. The formula used to calculate the amounts to be paid out was significantly modified in 2007. In recent months, numerous criticisms have been expressed,[1] which may be a sign of more contentious debates to come until the revision of the equalization formula in 2014. Whereas in Alberta, many believe the program unfairly transfers the wealth of their province to Quebec and the Maritimes, in Ontario the formula is criticized for not being generous enough to that province.

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The goal of the equalization program is to allow provincial governments to offer public services to their populations at levels of quality and levels of taxation that are reasonably comparable.[2] This *Economic Note* attempts to determine if the incentives built into the equalization formula are sufficient to support the development of Quebec's economy, and specifically its natural resource sector. Could new calculation parameters better promote Quebec's economic development so that it could catch up to the other provinces in terms of wealth level and then cease being a beneficiary of this redistribution program?

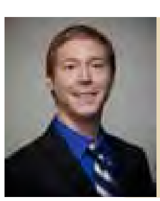
Equalization today

Quebec is the main beneficiary of equalization in terms of total amount of money received, followed by Ontario.[3] However, these two populous provinces receive less than other provinces when we compare amounts per capita, as illustrated in Figure 1. For Ontario, receiving equalization payments is an uncommon situation, and one that developed recently. For Quebec, on the other hand, this situation has remained unchanged since the program was established in 1957,[4] and this province receives around half of the total amount paid out. In contrast, provinces like British Columbia, Newfoundland and Labrador and Saskatchewan no longer receive equalization payments today, whereas they once did.

The equalization program is a transfer financed by the federal government and paid out to the provinces.[5] The calculation of the amounts paid rests on the notion of fiscal capacity. To grasp what this means, it is useful to recall a basic principle of government revenue. When a government collects a tax, it generally sets a rate that is applied to what is called a tax base. For example, Quebec's 9.5% provincial sales tax is calculated on the sale price of each taxed product. The total sales of taxed products during a year thus represent the tax base to which this rate is applied. In the equalization program, the tax bases of five major categories of taxes constitute the "fiscal capacity" of each province.

These five categories are individual income taxes, corporate income taxes, consumption taxes, property taxes and natural resource revenues. Individual income, corporate income, consumption and property values therefore determine the fiscal capacity of the provinces in each of the first four categories.

Whether the tax rate is high or low makes no difference in the calculation of equalization; only the fiscal capacity counts. Since



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one percentage point of individual income tax generates less revenue per capita in Quebec than it does in Alberta, Quebec's fiscal capacity for this category is lower. The fact that Quebec's income tax rates are much higher than Alberta's is not taken into consideration.

The fiscal capacity of each province is compared with the average fiscal capacity of the ten provinces. Those that are situated below the average are entitled to an equalization transfer. Total equalization transfers cannot shrink, nor can they grow faster than the economy as a whole.

The particular case of natural resources

In the case of natural resources, there is an important difference: Fiscal capacity is measured according to the revenues actually collected by the government. There is no tax base independent of the rate. Therefore, what a government receives in forest royalties, mining royalties or profits earned by an electricity-producing public corporation, among others, form the fiscal capacity of that province with regard to natural resources. Since a higher fiscal capacity has the effect of reducing the equalization payments a receiving province gets, the decisions of the government to authorize the exploitation of natural resources or to determine royalty rates will have a direct impact on the amounts received.

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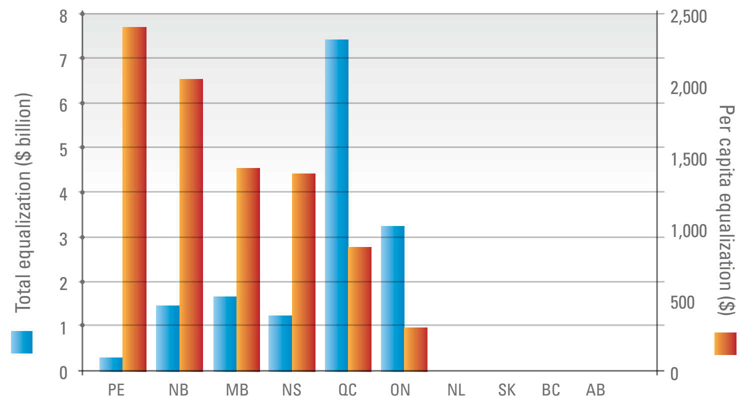
Do governments actually take into account the impact of their decisions on the amount of equalization payments received? A controversy surrounding electricity rates in Quebec suggest that they do.[6] The electricity rates paid by Quebec consumers are lower than the market price. In 2010, the Montmarquette Report on user fees for public services recommended to the Quebec government that it raise these rates.[7]

According to some, the government has not favoured this recommendation because it fears that a substantial rate hike would lead to a reduction in equalization payments by increasing natural resource revenues.

Figure 1
Total and per capita equalization (2012-2013)



Source: Department of Finance Canada, *Equalization Program*, http://www.fin.gc.ca/fedprov/eqp-eng.asp; Institut de la statistique du Québec, *Interprovincial Comparisons*, March 2012.

As for decisions to approve development projects in the natural resources sector, they can sometimes end up being politically costly, for example when highly organized opponents overshadow those who would benefit from such projects. If in addition to this, anticipated tax receipts are lower than expected because of a reduction in equalization payments, it is clear that approval for such projects is far from being an entirely positive affair.

The Quebec government maintains, however, that the calculation of equalization payments does not factor into its decisions.

As hard as it may be to settle this debate, as a rule, economic analysis finds that incentives modify behaviour. Now, we have to recognize that the equalization formula does indeed contain particular incentives for receiving provinces that want to avoid having their natural resource revenues cut into the amounts they receive from Ottawa.

It is telling that when the equalization formula was modified in 2007, the question of natural resources ended up being central to the debate. The federal government's decision was to include only half of the revenues drawn from natural resources in calculating equalization payments. The clawback of equalization entitlements accompanying revenue increases drawn from natural resources is therefore smaller than for the other categories of fiscal capacity. This was an implicit acknowledgement of the necessity of encouraging the provinces to further develop their natural resources.

This implicit recognition also took the form of specific agreements with two Atlantic provinces. Both Newfoundland and Labrador and Nova Scotia signed agreements with the federal government regarding the exploitation of offshore oilfields. Through these agreements, the federal government has effectively ceded its rights to these oilfields to the provinces. It also committed to compensating them for the reduction in equalization transfers stemming from the exploitation of these oilfields. In both cases, the provinces can temporarily enrich themselves by exploiting this oil without being penalized by a reduction in equalization payments.

To ensure that a receiving province does not get equalization payments that are much more generous than what others receive just because of the particular way natural resources are treated, the equalization formula also provides for a second calculation that establishes a "fiscal capacity ceiling." This is obtained by assessing the average fiscal capacities of the receiving provinces only, factoring in 100% of natural resource revenues and adding to this the equalization entitlements that have already been determined. Receiving provinces whose fiscal capacities surpass this ceiling have their equalization entitlements reduced to this level. In sum, a certain balance is preserved between those provinces that receive equalization payments. Quebec in particular has reached this ceiling.[8]

A clawback for natural resources: Is the penalty too severe?

The exploitation of natural resources in Quebec could help the province get out of the "have nots" in the coming years.[9] Oil reserves estimated at 46 billion barrels have been discovered on Anticosti Island, in the Gaspe and in the Gulf of Saint Lawrence, where the Old Harry oilfield is located.[10] The eventual exploitation of shale gas could also generate revenues. Moreover, mining activity has provided the government with more income in 2010-2011 than in the previous ten years.[11] Finally, electricity production still makes up an important part of the government's revenues, Hydro-Québec having registered a $2.5-billion surplus in 2010-2011.[12]

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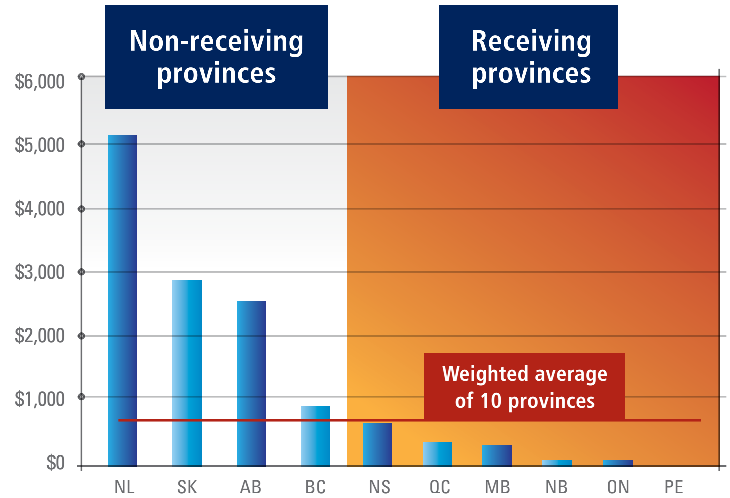
An adjustment to the formula used to calculate equalization that favoured the development of natural resources could foster even more development. However, it is also normal for a province that gets richer relative to the others to end up receiving lower equalization payments. By balancing these two principles, it should be possible to be fair to Canadian taxpayers who shoulder the costs of the program while also avoiding the creation of a "welfare trap" that reduces the attractiveness of autonomous development because such development entails substantial losses in transfers to a receiving province.[13]

Figure 2
Per capita fiscal capacity from natural resources (2011-2012)



Source: Ministère des Finances du Québec, *Budget Plan 2011-2012: Update on Federal Transfers*, March 2011, p. A.16.

At 50%, the current clawback rate adopted in 2007 allowed for the pie to be cut in two as it were, with half of the revenues drawn from natural resources remaining in the province and the other half going to the federal government in the form of a reduction in equalization rights.

A more ambitious solution would be not to have any clawback for revenue from new natural resource projects for a number of years,[14] also excluding this new revenue from the calculation of the fiscal capacity ceiling. In other words, revenue from new development projects would not reduce equalization transfers. This "tax holiday" would increase the receipts generated by the development of natural resources in the medium term and make it more attractive for the program's receiving provinces. After this exemption period, the new revenue would then be considered at 50%, as in the current formula.

Given the delay between the approval of a project and the moment when it generates revenues, as well as the differences between the various types of projects (mining, hydropower, oil and gas, forestry), the exemption period should be determined in such a way as to maximize the financial incentives of provincial governments to develop their resources.

It would in fact be possible for a province to benefit from equalization even while its fiscal capacity places it above the ceiling. Nonetheless, this will only be a temporary situation whose very purpose is to encourage receiving provinces to obtain independent revenues and eventually allow them to move beyond their need for equalization.

Within this new framework, an additional adjustment would be to replace the current calculation of fiscal capacity based on the inclusion of 50% of royalties with a different calculation based on factoring in 50% of corporate profits from the exploitation of natural resources. This way, the royalty rate would no longer influence fiscal capacity,[15] just as tax rates have no impact in the other categories. Equalization transfers would then be more neutral in terms of a province's fiscal policy choices.

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Many other questions surrounding the equalization program could be subject to negotiations from now until 2014. Must equalization be an unconditional program? Should payments be temporary in order to encourage receiving provinces to improve their economic balance sheets? Should the total equalization budget be reduced if the provinces all move closer to the Canadian average? Regardless, a mechanism encouraging more development of natural resources seems like a promising avenue that could appeal to all sides.

References

1. See: Hugo de Grandpré, "Élections en Alberta : les programmes du Québec critiqués," *La Presse*, April 19, 2012; John Ivison, "The coming war of the 'have-nots'", *National Post,* February 8, 2012.
2. *Constitution Act, 1982*, Schedule B to the *Canada Act 1982 (U.K.),* 1982, c. 11, s. 36(2).
3. Quebec will receive nearly half of the $15.4 billion for 2012-2013 ($7,391 million). The other recipients are: Ontario ($3,261 million), Manitoba ($1,671 million), New Brunswick ($1,495 million), Nova Scotia ($1,268 million), Prince Edward Island ($337 million). Department of Finance Canada, *Equalization Program*, http://www.fin.gc.ca/fedprov/eqp-eng.asp.
4. Thomas J. Courchene, "A Short History of Equalization," *Policy Options,* March 2007, p. 22.
5. These explanations come from several sources, including: Al O'Brien et al., *Achieving a National Purpose: Putting Equalization Back on Track,* Report of the Expert Panel on Equalization and Territorial Formula Financing, May 2006; Michael Holden, *Canada's New Equalization Formula*, Parliamentary Information and Research Service, November 2008.
6. Denis Lessard, "La hausse des tarifs d'électricité sera faible," *La Presse,* March 15, 2010. See also: Claude Picher, "Petite mentalité," *La Presse,* March 16, 2010.
7. Claude Montmarquette et al., *The Right Fees to Live Better Together,* Report of the Task Force on Fees for Public Services, March 2008, p. 106.
8. Indeed, among the six receiving provinces, Quebec is second in terms of natural resource revenues per capita, with $384, behind Nova Scotia at $414. Revenues of this kind are much higher for provinces not receiving equalization payments, like Newfoundland and Labrador ($5,157) and Alberta ($2,592), but the calculation of the fiscal capacity ceiling only takes into account receiving provinces' revenues. Ministère des Finances du Québec, *Budget Plan 2011-2012: Update on Federal Transfers,* March 2011, p. A.16.
9. The development of natural resources would probably not be sufficient by itself, as a Desjardins study points out, but it would certainly represent an important and interesting avenue. See: Desjardins Études économiques, "Les ressources naturelles : un potentiel en or?," *Perspective,* Vol. 21 (summer 2011). The Quebec government estimates that it would need to receive an additional $14 billion in revenues from natural resources to reduce its equalization rights to zero (compared to the current $3 billion): Ministère des Finances du Québec, *Budget Plan 2011-2012: Update on Federal Transfers,* March 2011, p. A.17.
10. Germain Belzile, *The Benefits of Oil Production Development in Quebec,* MEI, April 2012, p. 3.
11. Ministère des Finances du Québec, *Update on Québec's economic and financial situation,* October 2011, p. 77. The mining duties collected in 2010-2011 came to $304 million versus $289 million for the years from 2000-2001 to 2009-2010.
12. Ministère des Finances du Québec, *Public Accounts 2010-2011,* Vol. 1, p. 144.
13. The concept of a "welfare trap" has been widely documented. See: Mark W. Plant, "An Empirical Analysis of Welfare Dependence," *American Economic Review,* Vol. 74 (1984), No. 4, pp. 673-684; Martin Cooke, "A Welfare Trap? The Duration and Dynamics of Social Assistance Use Among Lone Mothers in Canada," *Canadian Review of Sociology,* Vol. 46 (2009), No. 3, pp. 179-206; Phillip B. Levine and David J. Zimmerman, *The Intergenerational Correlation in AFDC Participation: Welfare Trap or Poverty Trap?,* Institute for Research on Poverty, July 1996.
14. With regard to the moment of clawback, the amount paid to a province under equalization is also "smoothed," which is to say that in order to avoid changes that are too sudden and unpredictable, the formula takes into account a province's taxing capacity over three years. Therefore, if its situation varies a lot during one year in particular, it will have less of an effect on the amount received since it will just be one of three years. Also, there is a two-year lag to prevent new tax data, which are often revised after their initial estimation, from distorting the amounts paid. The proposed tax holiday therefore modifies the equalization calculation by simply extending the parameters that are already in place.
15. This second possible solution involves particular challenges for electricity rates, since the market value of the electricity produced is not fully reflected in the current rate. By setting rates below market prices, the Quebec government uses a portion of the value of production as a subsidy for electricity consumption. This choice should not affect the equalization calculation, contrary to the current situation.

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