New Nouveau Brunswick

Fiscal Imbalance and Equalization

A New Brunswick Perspective

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ISBN 1-55236-716-9
Department of Intergovernmental Affairs
Department of Finance

Fall 2001

CNB 946

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Executive Summary

This paper delivers on the government commitment to issue a public discussion paper on Canada's fiscal imbalance and the Equalization Program, as established in the 2000 New Brunswick Speech from the Throne. The objective of this paper is to build awareness of the fiscal imbalance that exists within the country, the importance of the Equalization Program in addressing it, and the New Brunswick perspective on these issues.

The Equalization Program has served the country well since its inception, and is a foundation of federal-provincial fiscal arrangements in Canada. The importance of Equalization is underscored by its inclusion in section 36(2) of the Constitution, which commits the federal government to making equalization payments in order that provinces have sufficient revenues to provide reasonably comparable levels of public services and taxation.

Equalization is the primary vehicle in the federation to address fiscal imbalance among provinces, and has contributed to a significant narrowing of fiscal disparities. However, the question remains: does the current Equalization Program fully meet the constitutional objective, and, if not, what can be done to ensure that it does?

The success of the Equalization Program in achieving the constitutional objective is debatable. Considerable fiscal disparities among provinces continue to persist, and less affluent provinces continue to be challenged in providing reasonably comparable levels of public services and taxation relative to the most affluent provinces.

Currently, the Equalization Program is receiving considerable attention in both the media and academic community. This not only reflects on its importance, but also suggests that the time is ripe to re-examine the program and its effectiveness in addressing fiscal disparities.

It is important that New Brunswickers, indeed all Canadians, have a clear understanding of the objective of the Equalization Program and the important role it plays in the federation. It is equally important that certain misconceptions are clarified in order to have a balanced, informed discussion on the Equalization Program.

- All governments in Canada support the principle of equalization. In fact, premiers have recently called for a strengthening of the Equalization Program.
- Equalization is about Canadians supporting Canadians. Payments are made out of the federal treasury, to which Canadian taxpayers from all provinces and territories contribute.
- Equalization is a formula-determined transfer that provides support to all provinces that fall below the revenue-raising capacity of the program standard. Currently, seven provinces receive equalization, not solely the Atlantic Provinces. In the past, all provinces with the exception of Ontario have received equalization.
- The primary objective of Equalization is to reduce fiscal disparities among provinces, not economic disparities, although it has undoubtedly contributed to the narrowing of economic disparities as well.
- Equalization provides key support by which provincial economies can become more competitive. It is not a "disincentive" to economic development.

All governments in Canada recognize the importance of a competitive economy, within and outside their borders. Competitiveness requires lower taxes, quality public services and social safety net, and strong financial management. The Equalization Program is a critical tool for less affluent provinces to achieve these objectives, and move towards greater self-sufficiency.

The current environment, however, has seen a widening of fiscal disparities among provinces. This has made it increasingly difficult for less affluent provinces to provide relatively comparable levels of public services and taxation to their residents, and to ensure their relative competitiveness both inter-provincially and internationally.

The Government of New Brunswick firmly believes that improvements are required to the current Equalization Program in order that fiscal disparities are narrowed further, and the constitutional commitment can be better met. These include: permanent removal of the program ceiling, a national average (i.e., 10-province) standard, and comprehensive revenue coverage.

The Equalization Program is not intended however, to address the considerable economic disparities that persist in the federation. Section 36(1) of the Constitution addresses the issue of economic opportunity. In concert with economic growth and fiscal discipline measures undertaken by provinces, federal funding targeted at strategic investments is one further means by which to effect the reduction of relative economic disparities among regions and provinces. This would, in turn, contribute to reduced dependence on the Equalization Program over time. Such funding should complement, as opposed to replace, equalization funding, with the goal of narrowing both economic and fiscal disparities in the country.

Introduction

The November 14, 2000 New Brunswick Speech from the Throne identified the growing fiscal imbalance between provinces and the federal government, and between regions and provinces of Canada, as the most important federal-provincial issue facing this country. It noted that

> *Nowhere is this most acute than in Atlantic Canada, and nowhere is the Equalization program of such significance. Equalization is meant to ensure that Canadians, regardless of where they live, are able to receive reasonably comparable levels of service at reasonably comparable levels of taxation.*

The New Brunswick Speech from the Throne also provided for the development of a public discussion paper on fiscal imbalance and Equalization. More specifically,

> *In recognition of the importance of this issue to New Brunswick, your government will issue a public discussion paper on Canada's fiscal imbalance and the future of the Equalization program for all New Brunswickers to read and comment upon.*

This paper meets the commitment in the 2000 Speech from the Throne.

The objective of this paper is to build awareness of the fiscal imbalance that exists within the country, the importance of the Equalization Program in addressing it, and the New Brunswick perspective on these issues. It is important that New Brunswickers, indeed all Canadians, have a better understanding of this fundamental program, and the important role it plays in the federation.

Fiscal Imbalance

Within Canada, both vertical and horizontal fiscal imbalances exist among governments. Vertical fiscal imbalance exists when the distribution of revenue resources between federal and provincial/territorial governments is inconsistent with the distribution of spending responsibilities. The vertical fiscal imbalance in Canada favours the federal government. Horizontal fiscal imbalance exists when revenue resources are unevenly distributed among provinces and territories.[1]

Over the past five years, provincial/territorial governments have focused considerable attention on the fiscal imbalance issue, culminating in the release of joint provincial/territorial discussion and position papers (see Appendix A). Provincial/territorial governments continue to pursue more durable means to address the vertical and horizontal fiscal imbalances in Canada with the federal government.

The Canada Health and Social Transfer (CHST), a federal transfer in support of key provincial social programs including health care, post-secondary education, and social services, is the primary vehicle in the federation to address vertical fiscal imbalance. By providing financing in support of these programs of national interest, the federal government plays a role in ensuring national standards are preserved.

The introduction of the CHST in 1996-97, however, was accompanied by a significant reduction in federal transfer payments in support of these key programs. These reductions exacerbated the vertical fiscal imbalance by reducing revenues to provincial governments at a time when health care costs in particular are under considerable pressure. Despite recent federal reinvestments in CHST, federal cash transfers in support of provincial social programs have not yet attained 1994-95 levels. At the same time, provincial program costs have grown considerably over this period.

It is expected the vertical fiscal imbalance will widen, given cost pressures on key provincial social programs, particularly health care. Recent work undertaken by Professor G.C. Ruggeri, Vaughan Chair in Regional Economics at the University of New Brunswick, concludes the vertical fiscal imbalance will become more severe in the future. In the absence of further cash infusions, the federal funding share of provincial expenditures in these key program areas will continue to erode.

The Equalization Program is the primary vehicle to address fiscal imbalance among provinces. It better enables less affluent provinces to provide relatively comparable levels of public services and taxation to their residents. However, its success in achieving this objective is debatable. While the Equalization Program has continued to grow over the years, considerable fiscal disparities continue to persist among provinces, and have been widening in recent years.

Over the past two decades, certain formula changes have exacerbated fiscal disparities among provinces.[2] In 1982-83, the federal government introduced measures within the Equalization Program which were intended to control the program cost. These included the move to a representative five-province standard[3] from the national average standard, which resulted in recipient provinces being equalized to a lower program standard, and the introduction of a ceiling on equalization payments.[4] In the 1999 program renewal, the federal government reduced the program's revenue coverage, which has resulted in a scaling back of entitlements. It has been argued these measures adversely affect the adequacy of the program.

1 Definitions as set out in *Addressing Fiscal Imbalance, Report of Provincial and Territorial Finance Ministers,* August, 2001

2 In addition to the Equalization formula changes denoted, the move to per capita allocation of CHST has contributed to horizontal fiscal imbalance, by reallocating money from less-affluent provinces to more-affluent jurisdictions.

3 Representative five-province standard (RFPS) includes Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.

4 The program's revenue coverage was expanded at the same time, which negated some of the impacts associated with the lower program standard.

The Equalization Program

Purpose of Equalization

In Canada, there are considerable differences in the relative ability of provinces to raise revenues and provide services to their residents. In the absence of some form of equalization, residents of provinces with relatively low fiscal capacity (i.e., revenue-raising ability) will face higher tax burdens and/or lower levels of public services than those in provinces with higher revenue-raising ability.

The purpose of the Equalization Program is to raise, to a standard level, the per capita revenue-raising capacity of less affluent provinces, such that all provinces have the ability to provide reasonably comparable levels of public services and taxation to their residents.

Since its inception in 1957, the Equalization Program has been a cornerstone of federal-provincial fiscal arrangements, and has become a central feature of our federation. The 1997 Report of the Auditor General of Canada reaffirmed that Equalization is a vital feature, and one of the main successes, of the Canadian federation.

The importance of Equalization is underscored by its inclusion in the Constitution Act, 1982, section 36(2):

> ***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.***

The Equalization Program is generally renewed every five years, with the next renewal scheduled for 2004. The process involves an in-depth review of the formula. While provinces are consulted, Equalization is a federal program, and the federal government has the ultimate authority with respect to any changes made.

Equalization and other public programs are often evaluated in terms of their impact on equity and efficiency. The Government of New Brunswick firmly believes that Equalization contributes to the enhancement of both equity and efficiency within the federation, by contributing to the narrowing of disparities in public service provision and taxation across provinces.

Despite its success in narrowing relative fiscal disparities, however, there is some question as to whether the current level of equalization payments has sufficiently leveled the playing field among provinces. Less affluent provinces continue to be challenged in providing similar levels of public services, and maintaining tax competitiveness, relative to the most affluent provinces.

Dispelling the Myths

In order to have an informed discussion on the Equalization Program and its merits, it is important that New Brunswickers, and Canadians as a whole, have the facts.

First and foremost, all governments in Canada support the principle of equalization, and its importance to the federation.

Over the past five years, federal/provincial fiscal arrangements have received a considerable amount of attention from provincial/territorial leaders and finance ministers. Most recently, at the August 2001 Annual Premiers Conference in Victoria, premiers unanimously called for a strengthening of the program among other reforms, including:

- immediate removal of the equalization ceiling, and
- immediate work on the development of a strengthened and fairer equalization program formula, including as one possible alternative, a ten-province standard that recognizes the volatility around resource revenues, and comprehensive revenue coverage.

Secondly, there is a perception that Equalization is a transfer from the more affluent provinces of Ontario, Alberta and British Columbia to the less affluent provinces. This is not the case.

Equalization is about Canadians supporting Canadians. It is no different than other federal programs. Payments are made out of the federal treasury to which all Canadian taxpayers contribute, regardless of where they live.

There have also been suggestions that it is a transfer from low-income residents in the more affluent provinces to high-income residents in less affluent provinces. This also is not the case. Equalization is not a transfer among or to individuals, but is a transfer to governments which is intended to enable the provision of reasonably comparable levels of public services and taxation to their residents, as established in section 36(2) of the Constitution.

Thirdly, Equalization is not a "welfare payment" to Atlantic Canada. It is a formula-determined program, with the same formula applying to all provinces. There are seven provinces that receive equalization — the Atlantic Provinces, Quebec, Manitoba and Saskatchewan. In the past, all provinces but Ontario have received equalization.

Fourth, there is a perception that the Equalization Program is intended to reduce economic disparities, and that it is ineffective since considerable economic disparities continue to persist among provinces and regions. This is not the intent of the program. The objective of equalization, as set out in section 36(2) of the Constitution, is to address fiscal disparities in the federation, not economic disparities. In fact, section 36(1) of the Constitution addresses specifically the issue of economic opportunity. These are separate, albeit complementary, objectives.

Despite this, it can be argued that since its inception, the Equalization Program has contributed to not only the narrowing of relative fiscal disparities among provinces, but relative economic disparities as well.

Finally, there is a perception that Equalization provides less advantaged provinces with a disincentive to develop their economies and become more self-sufficient. There is no evidence to support this broad contention. All governments strive for greater economic growth and self-sufficiency, independent of the Equalization Program. Ultimately, governments are accountable to their electorate for the public service and tax mix that they provide, and the economic climate that they foster. This alone should ensure that no such disincentive occurs.

Equalization and Competitiveness

It has been argued that provinces are using increased federal transfer payments to reduce taxes, while at the same time soliciting the federal government for additional money to provide for key provincial programs such as health care.

The Equalization Program objective, as set out in the Constitution, refers not only to reasonably comparable levels of public services, but also reasonably comparable levels of taxation. Thus, maintaining a competitive tax regime is part and parcel of the federal transfer system.

All governments in Canada recognize the importance of a competitive economy, within and outside their borders. Competitiveness requires lower taxes, quality public services and social safety net, and strong financial management. The Equalization Program is a critical tool for less affluent provinces to achieve these objectives, and move toward greater self-sufficiency.

How Equalization Works

The Equalization Program is based on a representative tax system (RTS) approach. The RTS is intended to be representative of the actual taxation practices of provinces, and provide a comprehensive and comparable measure of the relative ability of provinces to raise revenues to provide public services. For each of 33 revenue sources (table 1):

- A standardized tax base representative of typical taxation practices is defined, and measured for each province;
- A national average tax rate (NATR) is determined by dividing total revenues of all provinces by the total tax base of all provinces;
- For each province, its revenue-raising capacity under a representative tax system is measured by applying the NATR to its tax base;
- The revenue raising capacity of the program standard[5] is measured by applying the NATR to the total tax base of provinces comprising the standard;

5 Representative five-province standard includes Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.

Table 1
Revenue Sources Subject to Equalization

1	Personal Income Tax	19	Heavy Third-tier Oil Revenues
2	Corporate Income Tax	20	Natural Gas Revenues
3	Capital Tax	21	Sales of Crown Leases
4	General Sales Taxes	22	Other Oil and Gas Revenues
5	Tobacco Taxes	23	Mineral Resources
6	Gasoline Taxes	24	Water Power Rentals
7	Diesel Fuel Taxes	25	Insurance Premium Revenues
8	Non-Commercial Vehicle Licences	26	Payroll Taxes
9	Commercial Vehicle Licences	27	Provincial-Local Property Tax
10	Revenues from the Sale of Alcoholic Beverages	28	Lottery Ticket Revenues
11	Hospital & Medical Insurance Premiums	29	Other Games of Chance Revenues
12	Race Track Taxes	30	Miscellaneous Provincial-Local Taxes and Revenues
13	Forestry Revenues	31	Shared Revenues: Offshore Activities (Nfld.)
14	New Oil Revenues	32	Shared Revenues: Offshore Activities (N.S.)
15	Old Oil Revenues	33	Shared Revenues: Preferred Share Dividends
16	Heavy Oil Revenues		
17	Mined Oil Revenues		
18	Third-tier Oil Revenues		

Source: Federal Department of Finance

- Per capita revenue-raising capacity of each province is compared to that of the standard, to determine per capita excess / shortfall.

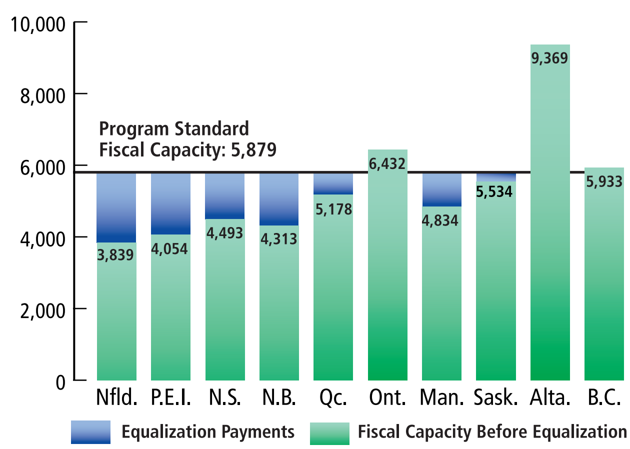
A province receives an equalization payment if, for the sum of 33 revenue sources, it has an overall per capita deficiency relative to the program standard. Entitlements are equal to the per capita deficiency times the provincial population.

For provinces with a per capita excess relative to the standard, they do not receive equalization payments, nor do they make a direct payment to recipient provinces. Equalization is funded out of the federal treasury, to which Canadian taxpayers in all provinces and territories contribute.

Table 2 provides an illustrative example of the determination of equalization for a particular revenue source.

After Equalization, the per capita fiscal capacity of all equalization-recipient provinces is raised to the level of the standard[6], but below that of the more affluent provinces (i.e., provinces not qualifying for an equalization payment). Chart 1 illustrates the effect of equalization payments on the revenue-raising capacity of provinces. Fiscal disparities are narrowed, but not eliminated, among provinces.

Chart 1, Fiscal Capacity Before and After Equalization
$ per capita, 2001-2002



Source: Federal Department of Finance, First Estimate of Fiscal Year 2001-02

6 If the ceiling on equalization applies, the per capita fiscal capacity of recipient provinces is no longer equalized to the level of the program standard. If the floor applies, a recipient province may be equalized to a level above the program standard.

Table 2

Example of How Equalization is Calculated Sales Tax Base, Fiscal Year 1998-99

	RTS Tax Base ($ 000)	Revenues Subject to Equalization ($ 000)	National Average Tax Rate (NATR)	Yield of Tax Base at NATR ($ 000)	Population	Per Capita Yield of Tax Base at NATR ($)	Per Capita Deficiency (+) or Excess (-) ($)	Equalization Entitlement[1] ($ 000)
Nfld.	4,369,156			352,066	545,895	644.93	169.77	92,678
P.E.I.	1,129,907			91,048	136,690	666.09	148.62	20,314
N.S.	8,927,787			719,400	935,824	768.73	45.97	43,022
N.B.	6,743,880			543,421	753,450	721.24	93.46	70,419
Que.	67,837,649			5,466,351	7,322,579	746.51	68.20	499,402
Ont.	119,533,186			9,631,973	11,372,301	846.97	(32.26)	(366,885)
Man.	10,708,732			862,909	1,137,434	758.65	56.06	63,766
Sask.	9,927,311			799,942	1,024,158	781.07	33.63	34,446
Alta.	42,868,533			3,454,342	2,900,034	1,191.14	(376.43)	(1,091,666)
B.C.	43,262,652			3,486,100	3,995,759	872.45	(57.74)	(230,729)
Total	315,308,793	25,407,553	8.058%	25,407,553	30,124,124	843.43		
Standard[2]	251,269,530			20,247,275	24,852,231	814.71		

NATR = Total Revenues/Total Tax Base

Standard to which provinces are compared

1. Provinces having a negative equalization entitlement for the sum of all 33 revenue sources are not eligible for equalization since they have a fiscal capacity that is higher than the standard.

2. The standard is made up of Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.

Source: Federal Department of Finance, Final Estimate of 1998-99

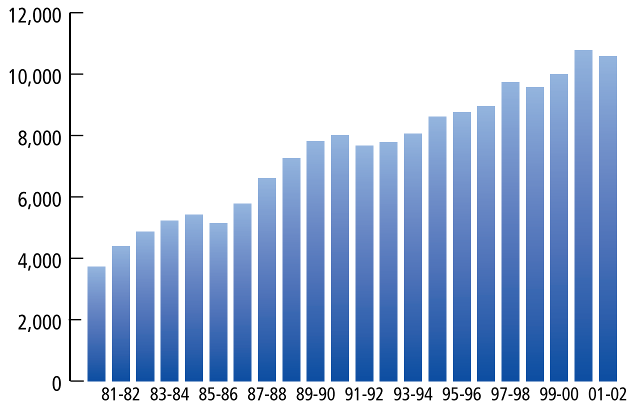
An inherent, and accepted, principle within the Equalization Program is that of tax back. If a province's revenue-raising capacity improves relative to the standard provinces, its equalization entitlement will fall. Conversely, if a province's revenue-raising capacity weakens, it will receive more equalization.

The Equalization Program has often been criticized for its complexity. However, the application of the equalization formula itself is relatively straightforward. Much of the complexity arises from the need to define and measure representative tax bases on which provinces raise revenues. Despite this, the program has been well served by the representative tax system approach, which is founded on the actual taxation practices of provinces.

What Equalization Means to New Brunswick and Canada

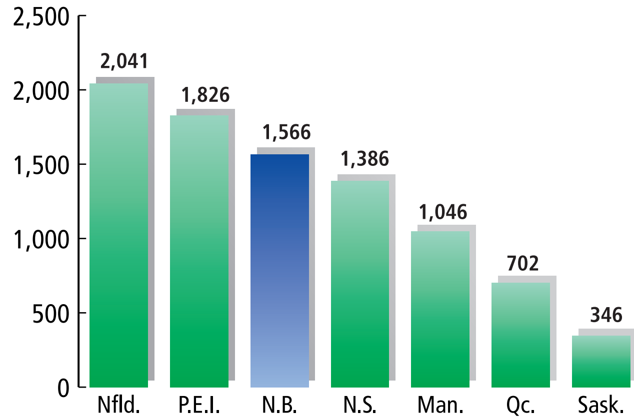
While the total cost of the Equalization Program has continued to grow (chart 2), Equalization represents a smaller proportion of gross domestic product (GDP) than in the past (chart 3). The total cost of the Equalization Program to the federal government is currently estimated at $10.6 billion in 2001-02. Chart 4 shows the distribution of equalization entitlements by province, while chart 5 shows per capita entitlements. New Brunswick receives

Chart 2, Equalization Entitlements in Canada
in $ millions, fiscal years 1980-1981 to 2001-2002



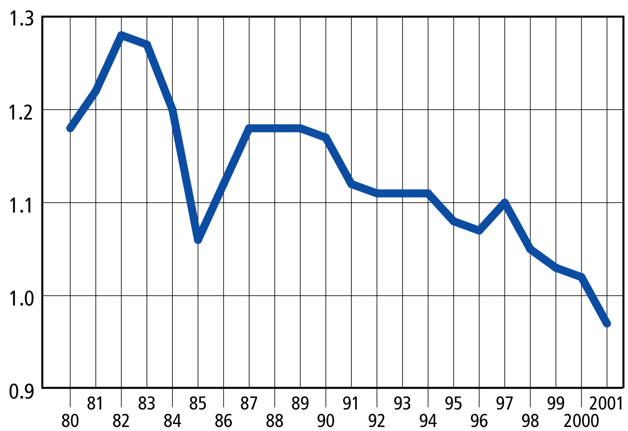
Source: Federal Department of Finance

Chart 5, Equalization Entitlements
$ per capita, 2001-2002



Source: Federal Department of Finance, First Estimate of Fiscal Year 2001-02

Chart 3, Equalization Entitlements in Canada
as a percentage of GDP, 1980 to 2001



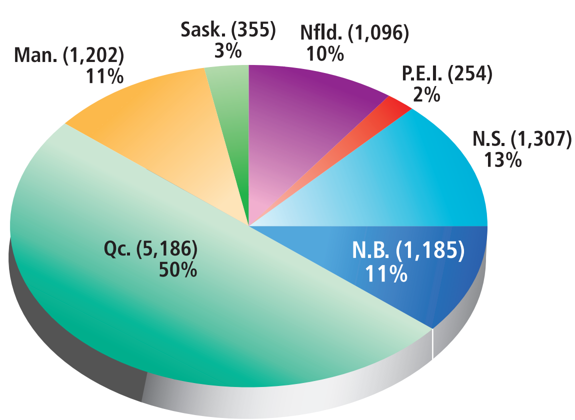
Source: Federal Department of Finance and Statistics Canada

11 per cent of total equalization entitlements, behind that of Quebec, Nova Scotia and Manitoba. On a per capita basis, New Brunswick receives $1,566, behind only Newfoundland and Prince Edward Island.

In the absence of Equalization, New Brunswick would not have the ability to provide its residents with similar levels of public services and taxation as in other parts of the country. Historically, equalization revenues for New Brunswick have averaged about 23 per cent of budgetary revenues (chart 6).

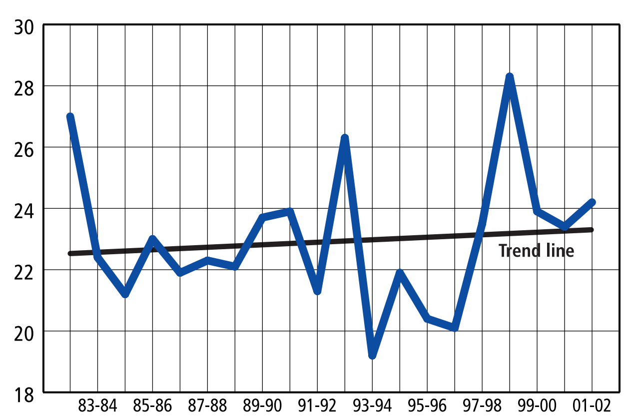
In 2001-02, equalization revenues for New Brunswick are estimated at $1.2 billion, or 24 per cent of

Chart 4, Equalization Entitlements
Per cent share and $ millions, 2001-2002



Source: Federal Department of Finance, First Estimate of Fiscal Year 2001-02

Chart 6, Equalization as a Share of Budgetary Revenues
New Brunswick, in per cent, 1982-83 to 2001-02



Source: New Brunswick Department of Finance budgetary revenues. To put this in context of what it means in terms of public service delivery, equalization revenues:

- represent over 90 per cent of gross budgetary expenditures for the Department of Health and Wellness, which are estimated at $1.3 billion;
- exceed the cumulative gross budgetary expenditures on education, post-secondary education, and transportation.

Thus, in the absence of Equalization, public service provision in New Brunswick would be considerably threatened. New Brunswickers would receive far less health care, education and other services than Canadians residing in other provinces.

In terms of revenues, equalization revenues:

- exceed combined personal and corporate income tax revenues of $1.1 billion;
- exceed consumption tax revenues of $0.9 billion.

In both instances, in the absence of Equalization, New Brunswick revenues from these sources would need to be more than doubled to compensate for the loss in revenues.

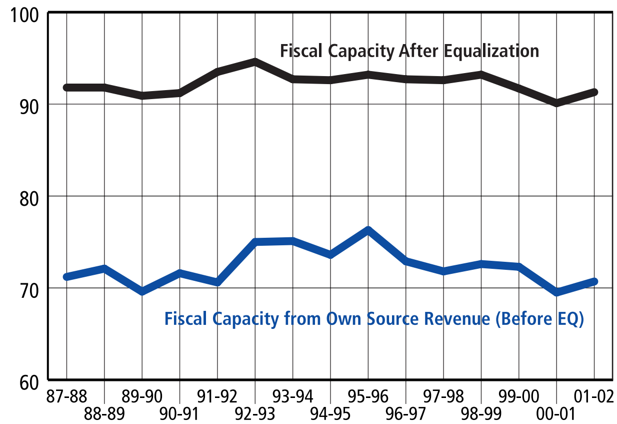
Fiscal Capacity

Whether the Equalization Program is upholding the constitutional commitment has been the source of considerable debate. It is undeniable that equalization has contributed to a narrowing of relative fiscal disparities. However, it is debatable whether provinces have the ability, after Equalization, to provide reasonably comparable levels of public services and taxation.

One of the few comprehensive measures is fiscal capacity (i.e., revenue-raising ability). Significant differences in fiscal capacity continue to exist after the current program (chart 7), and have been widening in recent years. After Equalization, New Brunswick's revenue-raising ability, relative to the national average, is only 91 per cent in 2001-02.

Chart 7, Fiscal Capacity Index Before and After Equalization

New Brunswick (Relative to National Average), in per cent, 1987-88 to 2001-02

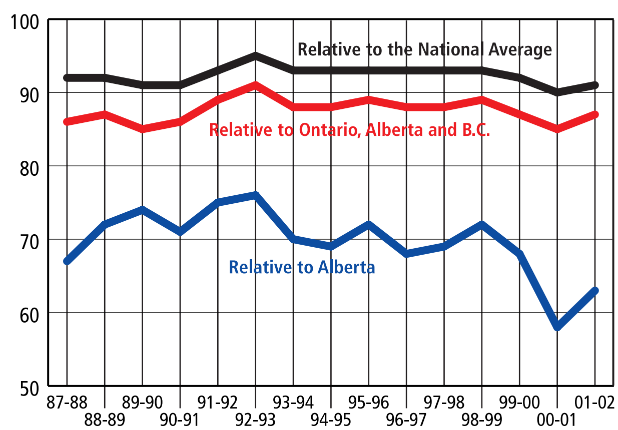


Source: New Brunswick Department of Finance

Relative to the more affluent provinces of Ontario, Alberta and British Columbia, our relative fiscal capacity after Equalization is 87 per cent in 2001-02, while, relative to Alberta, it is only 63 per cent (chart 8).

Chart 8, Fiscal Capacity Index After Equalization

New Brunswick, in per cent, 1987-88 to 2001-02



Source: New Brunswick Department of Finance

The recent fiscal environment in Canada has been characterized by reductions to income taxes, investment in key social programs (primarily health care)[7], and a commitment to fiscal responsibility, all key elements of a competitive economy inter-provincially and internationally.

7 Despite federal reinvestment in provincial social programs through CHST, the 1994-95 federal funding level has not yet been attained. For New Brunswick, since the inception of CHST, the cumulative shortfall is $665 million from the 1994-95 funding level. Since that time, provincial/territorial program expenditures have continued to grow.

Recent taxation and spending initiatives in the most affluent provinces highlight the challenge facing less affluent provinces in providing reasonably comparable levels of public services and taxation, and maintaining competitiveness. The personal income tax regimes and general corporation income tax rates announced by Alberta and Ontario, and Alberta's significant investment into health care in its latest budget, are examples of such initiatives, which would have a considerable cost for a province like New Brunswick to adopt.

Even after Equalization, less affluent provinces do not necessarily have the ability to maintain a competitive tax regime, or undertake similar spending initiatives, within their current fiscal framework or without considerably altering their fiscal policies.

Despite this, New Brunswick has taken significant steps since 1999 to provide for more funding for health care and education, tax relief for people and small business as well as to balance the provincial budget.

Strengthening Equalization

The fiscal imbalance between federal and provincial/territorial governments and among provinces is growing and with it divisions within the country. Addressing the broad issue of the fiscal imbalance requires a comprehensive and integrated approach. The Equalization Program is the primary vehicle to address the horizontal fiscal imbalance in the federation.

The importance of the Equalization Program to New Brunswick was clearly established by the unanimous approval, by all members of the Legislative Assembly, of Motion 89 in May 2001 (Appendix B). This motion, tabled by the Honourable Bernard Lord, Premier of New Brunswick, called upon the Government of Canada to enhance the current Equalization Program, including removal of the ceiling on equalization payments, to ensure it meets its constitutional mandate.

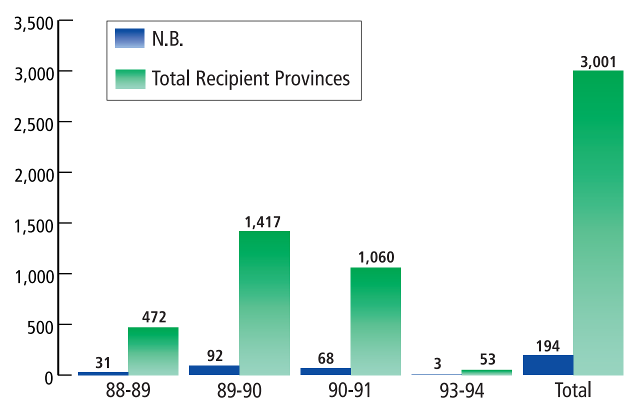
Three specific improvements have been identified by New Brunswick, and other jurisdictions, that would further narrow fiscal disparities and strengthen the Equalization Program. These include: the permanent removal of the equalization ceiling, the return to a national average standard, and comprehensive revenue coverage.

Equalization Ceiling

The ceiling on equalization was introduced in 1982-83 as a federal affordability measure. Since its inception, the ceiling has applied in four fiscal years, with a total cost to recipient provinces of $3 billion. The ceiling has cost New Brunswick close to $200 million to date (chart 9).[8]

Chart 9, Cost to Recipient Provinces of Ceiling on Equalization

$ millions



Source: Federal Department of Finance

When the ceiling applies, equalization-recipient provinces receive entitlements that are less than what is determined by the formula. Formula-determined entitlements are scaled back to the ceiling level on a per capita basis. As a result, recipient provinces are no longer equalized to the level of the program standard, resulting in a widening of fiscal disparities that the formula is designed to reduce. In essence, the ceiling serves as a claw-back of entitlements.

Leading up to the 1999 program renewal, the ceiling level was determined in a relatively consistent manner. First, a base year was established, in which the ceiling did not apply.

8 Currently, the ceiling is binding for 1999-00, but federal legislation has been passed to remove the ceiling for the year in question. Thus, it is not included in these totals.

In the base year, recipient provinces received their formula-determined entitlement. Then, the ceiling level for future years was established based on the cumulative rate of growth in the economy from the base year, applied to the base year entitlement level.

Current legislation, however, will not allow program entitlements to grow up to the rate of growth in the economy from the formula-determined, base year entitlement level. This despite the following commitment from Prime Minister Jean Chrétien in September 2000:

> "the Prime Minister agreed to take the necessary steps to ensure that no ceiling will apply to the 1999-2000 fiscal year. Thereafter, the established equalization formula will apply, which allows the program to grow up to the rate of growth of GDP".

In April 2001, five provincial finance ministers, including the Honourable Norman Betts of New Brunswick, made representations before the House of Commons Standing Committee on Finance in regards to the equalization ceiling, calling for its removal. The New Brunswick presentation is included as Appendix C.

Furthermore, provincial/territorial leaders have called upon the federal government to permanently remove the ceiling, most recently at the 2001 Annual Premiers Conference in Victoria, British Columbia.

On principle, the Government of New Brunswick believes the ceiling on equalization violates the spirit and intent of the constitutional commitment to equalization, by limiting the capacity of the program to achieve its fundamental objective, and should be permanently removed.

National Average Standard

The 1982 Equalization renewal saw a fundamental change in the program design, including the move from a national average standard (NAS) to the representative five-province standard (RFPS). The move to the RFPS removed the most affluent province, Alberta, from the standard, in addition to the four Atlantic Provinces.

As a result, the standard to which recipient provinces are equalized was lowered considerably. Since the inception of the RFPS, recipient provinces have argued that the lower program standard raises adequacy concerns.

A national average standard is a more accurate and true measurement of the degree of fiscal disparities that exist throughout the country, by taking into account the fiscal capacity of all 10 provinces in the federation. Furthermore, a national average can be perceived as more indicative of references to "reasonably comparable" in section 36(2) of the Constitution. Adopting a NAS would enhance horizontal equity, and efficiency, by further narrowing fiscal disparities which persist after the current Equalization Program.

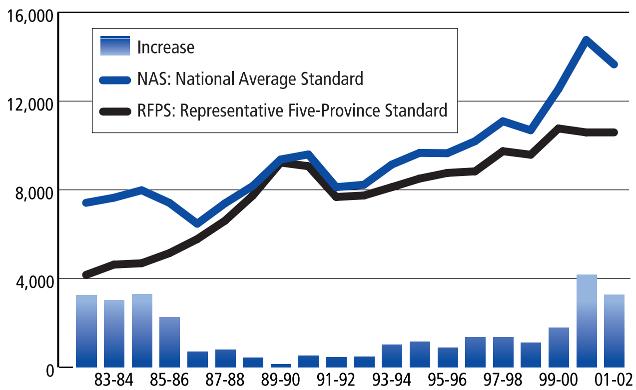
Currently, recipient provinces are equalized to the per capita revenue-raising capacity of the program standard of $5,879. In contrast, the per capita revenue-raising ability of the national average standard, before equalization, is $6,097, a difference of $218 per capita from the level to which provinces are equalized. For New Brunswick, this equates to a shortfall of $165 million for the 2001-02 fiscal year.

Over the 1982-83 to 2001-02 period, the average incremental annual cost of moving to a national average standard is $1.6 billion. Cumulatively, the current standard has resulted in a shortfall exceeding $31 billion over this period, from what a NAS would have provided. For New Brunswick, this translates into $1.8 billion in foregone revenues.

Two concerns generally attributed to a NAS are stability and affordability, primarily related to the inclusion of Alberta's fiscal capacity from oil and natural gas revenues in the standard. Since these revenues are highly volatile, the cost of the program can exhibit considerable instability from year-to-year. Furthermore, in times of high energy prices, widening disparities can result in a considerable increase in entitlements.

Chart 10 shows the impact of moving to a NAS from the current program standard. Of note are the significant financial impacts in the early 1980s and currently, in large part attributable to Alberta's fiscal capacity from oil and natural

Chart 10, Increase in Equalization Entitlements Associated with a National Average Standard
$ millions, 1982-83 to 2001-02



Source: New Brunswick Department of Finance

gas. Otherwise, the cost of a NAS has been relatively stable and affordable.

New Brunswick acknowledges the current cost of a NAS can raise affordability concerns. Provincial/territorial finance ministers have identified options which address the stability and affordability issues associated with adopting a national average standard. Premiers have directed finance ministers to examine these options further.

However, the Province strongly believes a national average standard is more representative of fiscal disparities throughout the country, and is more consistent with the intent of the constitutional commitment than the current standard. Moving to a national average standard would help ensure New Brunswickers receive more truly national levels of health care and other public services, at competitive levels of taxation.

Comprehensive Revenue Coverage

One of the inherent principles of the Equalization Program is that of comprehensive revenue coverage. Since the inception of the Equalization Program in 1957, revenue coverage has been expanded to include most provincial-local own-source revenues.

It is important that the Equalization Program provide for comprehensive coverage of provincial-local own-source revenues, in order that fiscal disparities that result from various revenue sources are adequately captured in the program framework.

Revenue coverage within the Equalization Program needs to be evaluated from two perspectives: in terms of its coverage of the various own-source revenue sources available to provincial-local governments, and its degree of coverage of these revenue sources.

Currently, there are 33 revenue sources subject to equalization, which capture, to a large degree, provincial-local own-source revenues. The federal definition of revenues subject to equalization, however, does preclude certain provincial-local miscellaneous revenues from consideration. Provincial-local miscellaneous revenues are comprised primarily of sales of goods and services.

Of particular concern to New Brunswick and other recipient provinces is a measure that was undertaken by the federal government as part of the 1999 program renewal. At that time, the federal government announced that it would only equalize 50 per cent of provincial-local miscellaneous revenues subject to equalization. Thus, for purposes of determining equalization entitlements, only 50 per cent of these revenues are to be included in the formula. This measure is being phased in over the five-year renewal period.

As a result, equalization entitlements have been reduced. Recipient provinces are not fully compensated for fiscal disparities from this revenue source. This measure is estimated to cost recipient provinces $230 million in 2001-02, with a cost of $25 million for New Brunswick. If this measure were fully implemented in 2001-02, it would cost recipient provinces $384 million, and New Brunswick $42 million.

New Brunswick believes comprehensive revenue coverage is a fundamental principle of an effective Equalization Program, by ensuring that overall fiscal disparities among provinces resulting from different revenue sources are captured in the program framework.

There are also instances when revenue coverage of particular resource revenues is scaled back from 100 per cent to 70 per cent as a result of the “generic tax back provision” within the program. When the generic provision applies, the principle of comprehensive revenue coverage is affected. However, these instances are limited, and are intended to protect recipient provinces that have a disproportionate share of a particular tax base from high levels of tax back.

Addressing Economic Disparities

As noted earlier, the primary objective of Equalization is to address fiscal disparities, and not economic disparities. While fiscal disparities in the federation are narrowed through the current Equalization Program, significant economic disparities persist.

Section 36(1) of the Constitution addresses the issue of economic opportunity.

> ***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 economic development to reduce disparity in opportunity; and***
>
> ***(c) providing essential public services of reasonable quality to all Canadians.***

In concert with provincial initiatives to generate economic growth and manage finances, federal funding targeted at strategic investments is one further means by which to effect the reduction of relative economic disparities among regions and provinces. This would also contribute to reduced dependence on the Equalization Program over time.

Since 1999, the New Brunswick government has implemented several new initiatives to foster economic growth and build job opportunities, and remains committed to doing so in the future. Examples include:

- significant, and targeted, reductions in personal and corporate income taxes;
- strategic investments such as the Total Development Fund, to help revitalize resource-based industries;
- two consecutive balanced budgets and payments on our net debt.

In addition, the Government of New Brunswick is in the process of developing an economic growth agenda for the future, which could work hand-in-hand with targeted strategic investment funding to address economic disparities.

Such funding should complement, not replace, equalization funding, with the goal of narrowing both economic and fiscal disparities in the country.

Your Comments

The Government of New Brunswick has released this paper to provide information to New Brunswickers, indeed all Canadians, on the important issues of fiscal imbalance and the Equalization Program. Your comments on this paper and the issues raised within are welcome. Comments can be forwarded to either:

Honourable Bernard Lord
Premier and Minister of
Intergovernmental Affairs

Honourable Norman Betts
Minister of Finance

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P.O. Box 6000
Fredericton, NB
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e-mail: equalization@gnb.ca
web site: www.gnb.ca/index-e.asp

APPENDIX A

Publicly Released Provincial-Territorial Papers on Fiscal Arrangements

Addressing Fiscal Imbalance: Report of Provincial and Territorial Finance Ministers, August 2001

Improving the Competitiveness and Standard of Living of Canadians, Provincial and Territorial Finance Ministers, December 1999

Federal Reinvestment in Canada's Health Care System, Provincial and Territorial Finance Ministers, October 1998

Redesigning Fiscal Federalism - Issues and Options, Part One, Provincial and Territorial Finance Ministers, June 1998

Redesigning Fiscal Federalism - Issues and Options, Part Two, Provincial and Territorial Finance Ministers, June 1998

Appendix B

Form C

MOTION 89

Mover : The Hon. the Premier

Seconder : The Hon. Minister of Finance

I move, seconded by The Hon. Minister of Finance

WHEREAS Canada is a federation in which provinces have constitutional responsibility for the delivery of a number of essential public services to citizens, including health, social services and education;

AND WHEREAS section 36(2) of the Constitution Act 1982 recognizes the commitment of Parliament and the Government of Canada to the principle of making equalization payments to ensure provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation;

AND WHEREAS all Premiers of Canada have further agreed the federal government should strengthen its commitment to the Equalization Program so the Program meets its constitutionally mandated objective of addressing the fiscal imbalance in Canada;

AND WHEREAS a properly functioning equalization program is necessary to ensure fiscal disparities across this country do not widen resulting in non-competitive tax rates;

AND WHEREAS the Province of New Brunswick is currently a recipient of equalization payments and relies on a properly functioning program to provide quality services to its citizens and maintain its competitive position relative to the rest of Canada;

AND WHEREAS the people of new Brunswick believe a strong and effective federation is best achieved through the cooperation of all levels of government working to meet the needs of Canadians;

THEREFORE be it resolved that the Legislative Assembly reaffirms its commitment to section 36(2) of the Constitution Act 1982 and the principle of making equalization payments to ensure provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation;

BE IT FURTHER resolved that the Legislative Assembly recognizes the fundamental importance of the provision of equalization payments as an essential characteristic of the Canadian federation;

BE IT FURTHER resolved that the Legislative Assembly call upon the Government of Canada to enhance the current equalization program, including removal of the ceiling on equalization payments, to ensure it meets its constitutional mandate.

Hon. Bernard Lord, Premier

Appendix C

Submission to the House of Commons Standing Committee on Finance in regards to Bill C-18

An Act to amend the Federal-Provincial Fiscal Arrangements Act

by Hon. Norman Betts, Minister of Finance, Province of New Brunswick

I am appearing this morning, along with my Atlantic colleagues, in regards to Bill C-18, ***An Act to amend the Federal-Provincial Fiscal Arrangements Act.***

Bill C-18 relates specifically to the ceiling on the Equalization Program. The ceiling is a longstanding concern to New Brunswick, since its inception in 1982-83.

Atlantic Premiers, and Finance Ministers, are gravely concerned about the potential impacts of the ceiling on equalization, and have called upon the federal government for its permanent removal.

Concerns about the ceiling, and its potential impact, are not limited to equalization-recipient provinces. At the August, 2000 Annual Premiers Conference, premiers joined together to issue a call for removal of the ceiling on equalization payments, in concert with other fiscal reforms.

In effect, Bill C-18 would amend the Act such that the ceiling on the Equalization Program would be removed for 1999-2000. While I view this as a positive step, I am disappointed that the ceiling on equalization has not been permanently removed. In fact, the proposed change in Bill C-18 would not even allow for equalization entitlements to grow up to the level of growth of the economy for 2000-01 and future years, as has historically been the case.

The federal government introduced the ceiling on equalization in 1982-83 as an affordability measure. While cognizant of the perils of open-ended programs, New Brunswick has opposed this measure since its inception, particularly given the unique, and critical, role that the Equalization Program plays within the federation.

The Equalization Program was introduced in 1957, and has become a central feature of our federation. The 1997 Report of the Auditor General of Canada reaffirmed that Equalization is a vital feature, and one of the main successes, of the Canadian federation.

The purpose of the Equalization Program is to raise, to a standard level, the per capita revenue-raising capacity of recipient provinces, such that all provinces have the ability to provide reasonably comparable levels of public services and taxation to their citizens. It is through this program that the playing field is levelled somewhat among provinces.

The importance of the Equalization Program is underscored by its inclusion in amendments to the Constitution in 1982. Section 36(2) states:

> ***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.***

The ceiling on equalization payments violates the spirit and intent of the constitutional commitment, by limiting the capacity of the Program to achieve its fundamental objectives.

When the ceiling applies, equalization-recipient provinces receive entitlements that are less than what is determined by the formula. Formula-determined entitlements are scaled back to the ceiling level on a per capita basis. As a result, recipient provinces are no longer equalized to the level of the designated program standard, resulting in a widening of fiscal disparities that the formula is designed to reduce.

Prior to 1999-2000, the ceiling applied in four fiscal years - 1988-89, 1989-90, 1990-91 and 1993-94 - and removed in excess of $3 billion in formula-determined entitlements from equalization-recipient provinces. For New Brunswick, this resulted in reductions to formula-determined entitlements exceeding $190 million.

Leading up to the 1999 program renewal, the ceiling level was determined in a relatively consistent manner. First, a base year was established, in which the ceiling on equalization could not apply. In the base year, recipient provinces were guaranteed their formula-determined entitlement. Then, the ceiling level for future years was established based on the cumulative rate of growth in the economy from the base year, applied to the base year entitlement level. The base year entitlement closely mirrored formula-determined entitlements.

The 1999 equalization program renewal represented a departure from past practice. The ceiling was again re-based, to 1999-2000. However, unlike past practices, an arbitrary ceiling level of $10 billion was established for 1999-2000, with future years' entitlements permitted to grow up to the rate of growth in cumulative GDP from the fixed, base year level. As a result, the ceiling could apply in the base year, as well as future years. Under current legislation, for 2000-01, the ceiling level is estimated at $10.8 billion, based on the current GDP growth projection of 8.4 per cent.

This change was implemented in large part due to affordability concerns of the federal government. It was also intended to address concerns expressed previously by the Auditor General of Canada as to the uncertainty associated with a base year entitlement that changed as new data became available.

It should be pointed out that this change resulted in a substantial ratcheting down of the ceiling level for 1999-2000 and future years. In fact, it resulted in an unprecedented reduction to the ceiling level.

If past practice had been followed, the ceiling would not apply in 1999-2000. Formula-determined entitlements for 1999-2000, which are currently estimated to be slightly below $10.8 billion, would serve as the base for establishing the ceiling level for future years. Given the GDP growth projection of 8.4 , the ceiling level for 2000-01 would be in the order of $11.7 billion, as opposed to $10.8 billion under current legislation.

Bill C-18 proposes to remove the fixed ceiling level of $10 billion for 1999-2000. As a result, entitlements for the year in question would be based on the latest estimate of formula-determined entitlements, which, as noted previously, is $10.8 billion. The removal of the ceiling for 1999-2000 would be consistent with past practices, whereby the ceiling could not apply in the base year.

However, under Bill C-18, the ceiling level for 2000-01 and future years would continue to be calculated using the $10 billion fixed level for 1999-2000, and not the latest formula-determined entitlement. As a result, the 2000-01 ceiling level under this Bill would be $10.8 billion, based on 8.4 per cent GDP growth. Given that entitlements for 1999-2000 are currently estimated at just below $10.8 billion, this would allow for minimal program growth, far below the rate of growth of GDP. In contrast, past practice would have allowed for program growth of up to the growth rate of GDP from the 1999-2000 base year entitlement.

It is conceivable that, under the proposed Bill C-18, entitlements for 2000-01 could be restricted to a level below that of 1999-2000 formula-determined entitlements. This would result in a ceiling allowing for negative growth, as opposed to growth, on a year-over-year basis. This situation cannot be permitted to happen.

Given current circumstances, there is a very strong likelihood of the ceiling applying for 2000-01 and, possibly, future years. At the same time that less-affluent provinces are facing the possibility of reductions to formula-determined entitlements, the federal fiscal outlook is very positive, now and for the foreseeable future.

To put the impact of the ceiling on equalization in perspective, the ceiling for 1999-2000 is currently reducing New Brunswick's formula-determined entitlement by $50 million, pending the adoption of Bill C-18. In today's terms, $50 million provides New Brunswickers with approximately 11 days of health care. It provides for in the order of 1,000 nurses. It translates into a further 25 kilometres of new, four-lane highway. From a revenue perspective, it translates into more than 5 percent of provincial personal income tax revenues.

Bill C-18 is all the more troublesome given statements by the Prime Minister at the September, 2000 First Ministers Meeting. It was noted, in a communiqué emanating from that meeting, that "the Prime Minister agreed to take the necessary steps to ensure that no ceiling will apply to the 1999-2000 fiscal year. Thereafter, the established Equalization formula will apply, which allows the program to grow up to the rate of growth of GDP".

As I noted previously, Bill C-18 is a positive step in that it removes the ceiling for 1999-2000. However, it does not uphold the commitment of the Prime Minister. It is also inconsistent with past practice, by not allowing entitlements to grow up to the level of growth in the economy.

The proposed removal of the ceiling for 1999-2000, under Bill C-18, sends some important messages:

One, it recognizes the importance of the Equalization Program to the less-affluent provinces, and its role in ensuring that the constitutional commitment can be better met.

Two, it recognizes that the arbitrary ceiling level of $10 billion was set too low. This level was established at a time when program entitlements were underestimated considerably, which had a direct bearing on the establishment of the ceiling level.

And, three, it indicates that the program, for 1999-2000, is affordable to the federal government, without the need for an equalization ceiling.

By extension, this would suggest that allowing the program to grow with GDP from the 1999-2000 formula-determined level is affordable to the federal government. Gross domestic product is a commonly used indicator of economic growth and prosperity. Since the inception of the ceiling, both GDP growth and growth in gross national product have been used as the federal affordability measure.

New Brunswick strongly believes that, on principle, the ceiling on equalization should be eliminated, and we will continue to pursue the permanent removal of the ceiling on equalization. In the context of Bill C-18, New Brunswick would support an amendment that would remove the ceiling for the duration of the current equalization renewal period, as an interim measure.

Barring its removal, modifications should be made to Bill C-18 such that program entitlements for 2000-01 and future years can grow up to the rate of growth of cumulative GDP from the formula-determined 1999-2000 level.

I thank you for the opportunity to appear before the Committee today, and I trust that my concerns, and those of my Atlantic colleagues, will be given due consideration.