

TWO PANELS ON TWO BALANCES

Robin Boadway

The current discussion about fiscal federalism is motivated by significant changes on both sides of the fiscal relationship, among the provinces, on the one hand, and between Ottawa and the provinces, on the other. In this article, Robin Boadway critically examines issues involving both, with the reports of the Expert Panel on Equalization and that of the Advisory Panel on Fiscal Imbalance as the backdrop. He specifically addresses the issue of including natural resources in the equalization formula and the question of whether the federal government should turn over further tax room to the provinces. He concludes by arguing strongly that natural resources should be included, and that Ottawa should not only keep its taxroom but consolidate it, because the federal government is exclusively responsible for national objectives, whether they be equity, solidarity or efficiency.

L'actuel débat sur le fédéralisme fiscal est motivé par d'importants changements intervenus des deux côtés de la relation fiscale qui unit les gouvernements au Canada, soit entre les provinces elles-mêmes et entre celles-ci et Ottawa. Robin Boadway scrute les enjeux auxquels les deux parties sont confrontées à la lumière des rapports du Groupe d'experts sur la péréquation et du Comité consultatif sur le déséquilibre fiscal. Il s'intéresse plus précisément à l'éventuelle inclusion des ressources naturelles dans la formule de péréquation et s'interroge sur l'intérêt pour Ottawa d'accorder aux provinces une plus grande marge fiscale. Sa conclusion est sans appel : les ressources naturelles doivent être incluses et Ottawa doit non seulement préserver mais accroître sa marge fiscale puisqu'il est seul responsable des objectifs nationaux, que ce soit en matière d'équité, de solidarité ou d'efficacité.



Two more commissions have now provided their advice on the structure of the Canadian fiscal transfer system. The Expert Panel on Equalization and Territorial Formula Financing and the Advisory Panel on Fiscal Imbalance follow a long and distinguished list of bodies to make recommendations on the appropriate form of federal-provincial transfers, including the Parliamentary Task Force on Fiscal Arrangements between the Federal Government and the Provinces (the Breau Committee) in 1981, the Economic Council of Canada in 1982, the Royal Commission on the Economic Union and Development Prospects for Canada (the Macdonald Commission) in 1985, the Office of the Auditor General in 1997, the Senate of Canada Standing Committee on National Finance in 2002, the Quebec Commission on Fiscal Imbalance (the Séguin Commission) in 2003, the Newfoundland and Labrador Royal Commission on Renewing and Strengthening Our Place in Canada in 2003, and the House of Commons Standing Committee on Finance in 2005. These various

reports are remarkable, on the one hand, for the extent of consensus about the basic structure of Equalization needed to achieve horizontal balance and, on the other, for the lack of consensus about the appropriate vertical balance — that is, the extent to which provincial revenues should come from federal transfers versus their own sources.

What the reports of the Advisory Panel and the Expert Panel made slightly more apparent is the inherent interdependency between horizontal and vertical balance. Put simply, the need for equalization increases commensurately as the vertical fiscal gap falls. Moreover, all the usual ways of addressing the vertical fiscal gap by transfers are equalizing. Both the horizontal and the vertical balance are jointly determined by equalization and the system of block transfers. In what follows, issues involving horizontal and vertical balance are addressed in turn. In the process, some critical reaction to the Expert Panel and the Advisory Panel will be enunciated as well as some personal views about the way forward.

The general consensus about Equalization reiterated by the two panels contains a number of important elements, albeit with nuanced differences. The system should be based on principles informed by, but not limited to, section 36(2) of the *Constitution Act* of 1982. Equalization entitlements should be formula-driven, at least with respect to their horizontal allocation. The formula used should reflect what provinces actu-

in the public debate over Equalization by both experts and stakeholders, such as those who would adopt a macro formula instead of the RTS, and those who would exclude natural resources entirely from Equalization.

Despite agreement on these common principles, the two panels' recommendations differ in some key respects. The main one involves the treatment of natural resources, which arguably is

by section 125 suggest to some that provincial natural resources should either not be equalized, or be equalized as if the revenues were in the hands of provincial taxpayers. The counterarguments are that equalization does not constitute taxation of natural resources; that the federal government does in fact tax natural resources through its income tax; and that the same argument for special treatment on provincial ownership grounds would, if valid, apply to any provincial revenue source by virtue of the right that provinces have by section 92(2) to impose direct taxes for their own purposes.

Incentives. With full natural resource equalization, provinces would have a disincentive to develop their natural resources since each dollar of extra public revenue received could reduce equalization entitlements by the same amount. This is probably the strongest argument, since provinces apparently do have more control over the natural resource base than

over other tax bases. But it is less than compelling for a couple of reasons. First, there is little evidence that equalization-receiving provinces have been deterred from developing their natural resources in the past despite full inclusion of natural resource revenues. An exception might be Newfoundland and Labrador with respect to the Voisey's Bay project, but that may well be a matter of when, rather than whether, to develop. This leads to the second, more subtle, point, which is that the real disincentive for the province is whether to explore for resources rather than to develop them once found. Once they are found, the equalization tax-back will apply whenever the resources are developed, and there is little advantage from postponing development on that account. Since the province has less discretion over the exploration decision than over the development one, the incentive argument is considerably blunted.

The general consensus about Equalization reiterated by the two panels contains a number of important elements, albeit with nuanced differences. The system should be based on principles informed by, but not limited to, section 36(2) of the *Constitution Act* of 1982. Equalization entitlements should be formula-driven, at least with respect to their horizontal allocation. The formula used should reflect what provinces actually do rather than using some abstract measure of fiscal capacity. Equalization should focus on disparities in revenue raising alone (and not needs or costs), and the Representative Tax System (RTS) should be used. A 10-province standard should determine the level of equalization to which the recipient provinces are brought. And calculating entitlements using moving averages should be used to enhance predictability and stability of payments.

ally do rather than using some abstract measure of fiscal capacity. Equalization should focus on disparities in revenue raising alone (and not needs or costs), and the Representative Tax System (RTS) should be used. A comprehensive set of revenue sources should be included in the formula, including notably natural resource revenues as well as revenue sources of both provincial and municipal governments (which, in turn, implicitly recognizes the need for provinces to equalize among municipalities). A 10-province standard should determine the level of equalization to which the recipient provinces are brought. And calculating entitlements using moving averages should be used to enhance predictability and stability of payments.

Agreement on these basic principles is remarkable, more so since the similarity extends to most of the previous reports mentioned above. This is despite the diversity of views expressed

the single most important and contentious revenue source. Its importance arises from the fact that natural resources contribute disproportionately to disparities in fiscal capacity among provinces. Its contentiousness arises from the allegation that natural resource revenues are somehow different from other revenue sources. The supposed sources of the differences are many, and it is important for the public debate to confront them explicitly, especially since they inform the Expert Panel's proposals. Of particular importance (and concern) is the proposal to move from the current system of full inclusion of natural resource revenues to one of 50 percent inclusion. Let's examine the main arguments.

Constitutionality. Provincial ownership of natural resource revenues by virtue of sections 109 and 117 of the Constitution and the proscription of federal taxation of provincial property

Costs of development. Provinces incur a cost of developing natural resources, and this should be taken into account by reducing the amount of resource revenues subject to equalization. There are also two main problems with this argument. First, there are costs to the province from obtaining virtually all sources of revenue. Thus, the education system leads to higher incomes, which generate higher income taxes. It is by no means clear that the cost of acquiring revenues applies more to natural resources than to other revenue sources. Second, taking account of the cost of natural resource exploitation would open the door to equalizing for the cost of (and need for) other government spending as well. It would be inconsistent to take account of one source of expenditure requirement and not others.

Measurability. Fiscal capacity of natural resources is inherently difficult to measure, and the RTS system is inadequate because of the way that natural resource revenues are taxed. Royalty structures reflect to some extent the different costs of obtaining natural resources depending on the geological characteristics of the deposit. An RTS system that applied a single national average royalty rate would overstate the ability to obtain revenues from high-cost sources. This is a serious argument about the feasibility of implementing an RTS system in natural resources. Similar issues apply in other revenue categories, such as property taxes, and the resolution (accepted by the Expert Panel) has been to propose a so-called stratified system whereby natural resources are stratified into comparable types and a type-specific representative tax rate used for each.

Affordability. Finally, some might argue that natural resources should not be fully equalized because, since the federal government has no direct access to natural resource revenues,

federal affordability is a problem. But in a fundamental sense, federal affordability cannot be a problem. Not only does the federal government have access to natural resource revenues indirectly through its income tax sys-

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tem — which it could exploit more effectively — but also the affordability issue can in principle be ameliorated by changing the vertical balance without changing total federal and provincial tax rates significantly.

Even if one views affordability as a problem, using it as an argument for reducing the share of natural resources that enters the RTS system is, in my view, seriously fallacious for a reason that bears explaining. There are two ways that the costs of equalization resulting from natural resources could be reduced. One would be to reduce the proportion of resources subject to equalization (the Expert Panel approach). The other would be to reduce the standard of equalization (the existing approach). The difference between the two is that reducing the standard of equalization reduces per capita equalization entitlements of all provinces without affecting differences in per capita entitlements across provinces, while reducing the share of resources equalized reduces entitlements disproportionately for provinces with fewer natural resources.

From this perspective, addressing affordability issues by adjusting the standard has the advantage that it maintains horizontal balance among recipient provinces. Indeed, this argument points to an important principle, which is that

horizontal balance can be achieved regardless of the size of the total equalization envelope. Indeed, from this point of view, even the 10-province standard has no particular standing relative to any other standard: it merely deter-

mines the balance between recipient and non-recipient provinces. Anything less than a top-province standard represents less than full equalization among all 10 provinces.

These alleged difficulties of equalizing natural resources have led many of the reports to blink unnecessarily and to end up recommending less than full inclusion. The Advisory Panel stands as an exception to this in recommending full inclusion of natural resource revenues in a 10-province RTS approach.

The Expert Panel's recommendations on resources are notable for a number of reasons. It recommends deviating from the RTS for natural resources by equalizing actual per capita resource revenues rather than defining a representative tax base and calculating a national average tax rate. This is based on the measurability argument. Resource revenues would be aggregated across all types of resources, both renewable and non-renewable, and only 50 percent would be equalized. The stated rationale for this special treatment of natural resources is that it strikes a reasonable balance among the competing arguments for and against full inclusion: the constitutional argument, the incentive argument, the costs of developing natural resources and

affordability. Natural resource revenues would also affect the calculation of the cap on equalization proposed by the Expert Panel. A cap would apply whenever a recipient province has a fiscal capacity that exceeds the fiscal capacity

of any non-recipient province, where fiscal capacity for this purpose is measured using 100 percent inclusion of natural resources. Third, the 50 percent inclusion rate is not consistently applied, given that the calculation of the cap recognizes explicitly that fiscal capacity requires including 100 percent of resource revenues. Fourth, consistency

for deviating from the approach taken by the Advisory Panel, with its argument for full inclusion of natural resources, and all other provincial revenue sources for that matter, using a 10-province standard.

Finally, at a more general level, the list of 10 principles that are meant to guide the Equalization Program and the manner in which the Expert Panel draws on them reveal much about the hierarchy of values that they chose to follow. The first two principles require consistency with section 36(2), and equitable and consistent treatment for all provinces. This is clearly trumped in various places by the principles of affordability and simplicity. Indeed, no clear and consistent argument is given for deviating from the approach taken by the Advisory Panel, with its argument for full inclusion of natural resources, and all other provincial revenue sources for that matter, using a 10-province standard.

One can object to this proposed treatment of natural resources on several grounds. First, despite the argument that equalization should ultimately be based on principles, it is hard to think of a principle that would justify 50 percent inclusion. The Expert Panel more or less says that it is splitting the difference among recommendations given by various experts and stakeholders.

None of the arguments favouring less than full inclusion, even if one accepted them, would call for 50 percent. In particular, affordability — which one suspects was particularly persuasive to the panel — can, as mentioned, most fairly be satisfied not by affording special treatment to resources but by changing the standard from a 10-province one to some other equally arbitrary one. Second, equalizing actual resource revenues as opposed to some RTS-like measure exacerbates the incentives problem, and perhaps guarantees that resources will not be fully included in the future, despite what are compelling arguments for full inclu-

also suffers in other respects. The argument that costs of infrastructure should be a relevant consideration in determining the treatment of natural resources violates the principle that only revenue-raising capacity should be equalized, not needs or costs, as discussed above. And, perhaps most seriously, the Expert Panel suggests (page 45) that if the federal government finds that the 10-province standard is too costly in any given year, it should scale back entitlements on an equal per capita basis. No doubt, this way of scaling back is the fairest, but to invite the federal government to deviate from a formula-based approach violates the Expert Panel's own principles. So much for starting from basic principles.

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Perhaps the most serious shortcoming of the Expert Panel's approach, reflecting its limited mandate, is the sole focus on the Equalization Program without consideration of the equalizing consequences of the other main component of federal transfers, the CHT/CST system of (roughly) equal per capita transfers. An equal per capita transfer scheme financed by federal general revenues meets many of the criteria for a good equalization system, and in some key ways outperforms the Equalization Program itself. It is essentially a system of net equalization, and is as simple a system as one can imagine. Any evaluation of the design of Equalization should include these transfers as an essential component. Their perceived drawbacks are twofold. First, equal per capita transfers do not equalize natural resource revenues, implying that a formal equalization system cannot be abandoned. Second, the transfers' effectiveness as a system of equalization improves as their size increases, which unavoidably raises issues of vertical balance. This is something that must be faced squarely: What is the appropriate size of the vertical fiscal gap?

Let us sidestep the futile debate over the meaning of vertical imbalance and focus on the key structural issue: to what extent should the provinces be responsible for raising their own revenues as opposed to receiving transfers from the federal government? In the context of the current debate, should the federal government turn over further tax room to the provinces and let them be more self-sufficient in financing their own expenditures?

There is much more ambiguity in principle to this issue than to horizontal balance, and this ambiguity has been reflected in the various advisory reports and in the public debate. The contrast in views is most starkly seen by comparing the Séguin Report with that of the Advisory Panel. The former would abolish all major transfers except for Equalization, and would have the federal government vacate the GST in favour of the provinces. The latter would, on the contrary, retain all federal tax room and actually increase transfers to the provinces. This might be regarded as the prevailing wisdom found explicitly or implicitly in most previous studies. The Séguin proposal, however, is a serious contender with influential supporters, including a political party (the Conservative election promise to reduce the GST), a major think tank (the *Commentary* by Finn Poschmann and Stephen Tapp for the C. D. Howe Institute) and a paper from the academic sector (a recent paper by Richard Bird and Michael Smart). None of them go as far as eliminating the GST, but the general message of substituting sales tax room for transfers is consistent.

In my view, the argument for turning over further tax room to the provinces, whether GST or income tax room, should be vehemently resisted. On the contrary, I would go beyond the Advisory Panel and argue that the opposite is called for: sales taxation should be consolidated at the federal level, albeit with constraints. To appreciate what is at stake, let me lay out the main arguments against and for turning over further tax room to the provinces.

There are three main arguments for maintaining a vertical gap well beyond that needed to finance Equalization. The first is that decentralization of revenue raising both increases the need for equalization and reduces the amount of equalization in

the system, which taken together can affect the sustainability of the program. It increases the need because any increase in revenue raising by the provinces increases disparities in fiscal capacity, and it reduces effective equalization by eliminating equal per capita transfers, which fulfill an important role in equalizing have and have-not provinces alike.

The second is that turning over tax room of any kind to the provinces can be predicted to jeopardize tax harmonization. It has been well documented that provincial tax systems

The fact that the federal government provides significant levels of transfers enhances its moral authority in the day-to-day interchange of governments that constitutes the mechanics of federalism. There is no doubt that the spending power has been used unwisely or even abused sometimes in the past, and that the federal government has been irresponsible in the way that it has changed transfers unilaterally and without notice. The answer to this is not to try to abolish the use of the spending power (which could not reasonably be done in any case) but to seek to find suitable rules of the game for using the spending power responsibly along the lines suggested, for example, by the panels.

constitute a major source of inefficiency in the internal economic union and adversely affect competitiveness of Canadian businesses. This applies both for the provincial sales tax systems and for provincial taxes that fall directly on businesses. All the evidence from the past indicates that tax harmonization among provinces is very difficult to achieve without the federal government playing a leading role, and that role is contingent on it occupying a significant part of the relevant tax bases. Given that tax harmonization is

important in both the income and sales tax fields, turning over further tax points in either can be predicted to have adverse effects on the efficiency of the Canadian tax system.

The third, and most controversial, is that substituting tax points for block transfers removes from the federal government the potential to use those transfers to achieve national equity and efficiency objectives. The use of the federal spending power plays an indispensable role in a federation. In Canada, it is the only instrument available to the federal government to fulfill its constitutional obligations set out in

sections 36(1) and (2), as well as its more general role as the sole government responsible for national objectives. This goes beyond the explicit attachment of conditions to transfers, which themselves are typically of a fairly general nature and difficult to enforce with precision.

More important, the fact that the federal government provides significant levels of transfers enhances its moral authority in the day-to-day interchange of governments that constitutes the mechanics of federalism. There is no doubt that the spending power has been used unwisely or even abused sometimes in the past, and that the federal government has been irresponsible in the way that it has changed transfers unilaterally and without notice. The answer to this is not to try to abolish the use of the spending power (which could not reasonably be done in any case) but to seek to find suitable rules of the game for using the spending power responsibly along the lines suggested, for example, by the panels.

There still does seem to be a national consensus that the federal government has some role in the financing of social programs. To abolish that role would be to put the existing support for national solidarity in jeopardy, and on those grounds I

remain an unapologetic supporter of the principle of the spending power.

Those who advocate turning over tax points to the provinces do so on three main grounds. The first is that accountability is enhanced: if provinces are responsible for raising their own revenues, they will be more accountable for the way they make their spending decisions. This argument is difficult to accept. Provinces do not use their sales or income tax systems to fine-tune their revenues. Sales tax rates in particular are very rarely changed. Once set, the amount of revenues obtained for provincial treasuries is virtually as exogenous as the transfers they receive from the federal government. Why should they be any less accountable for the way they spend those revenues? Moreover, even if tax points are not turned over to the provinces, they still have the potential to determine the overall size of their budgets by changing their own tax rates. I have yet to hear a convincing argument explaining how accountability is in fact adversely affected by a vertical fiscal gap.

A second argument, perhaps related to the first, is that turning over tax points to the provinces reduces the use of the spending power by the federal government with its possibilities for abuse. In particular, it reduces the possibility not only that the federal government will intrude too much into areas of provincial responsibility but also that federal transfers will be changed abruptly and without notice. This is the flip side of the case for the spending power mentioned above, and the same arguments apply. There is clearly a need for institutional remedies to constrain the federal government from using the spending power in a non-cooperative manner.

The final argument is that decentralization of revenue raising itself can enhance the efficiency of the internal

economic union. It can allow the provinces to choose whatever tax structure is in the interest of their residents. Competitive setting of tax rates can impose fiscal discipline on governments by constraining their ability to

The idea that a system of independent provincial VATs, either with or without a federal GST, would be administratively reasonable may be wishful thinking, even if provinces could agree to a common base. Collection and compliance costs are bound to be a concern when taxpaying firms operate in more than one province at the same time and have to comply with each province's VAT, even if all provinces harmonize their taxes.

raise revenues, forcing them to reduce the size of their public sectors. Some even argue that decentralization of the sales tax can enhance the chances of sales tax harmonization, arguably one of the most crucial prerequisites for a competitive economy.

The latter notion seems to me to be somewhat fanciful. The possibility that provinces will unilaterally, let alone together, choose to harmonize their sales taxes to a national norm seems far-fetched. Moreover, to achieve the ideal sales tax system would require that provinces adopt a harmonized value-added tax (VAT) system. Although the Quebec sales tax system seems to work reasonably well (though even here the empirical evidence is lacking), the idea that a system of independent provincial VATs, either with or without a federal GST, would be administratively reasonable may be wishful thinking, even if provinces could agree to a common base. Collection and compliance costs are bound to be a concern when taxpaying firms operate in more than one province at the same time and have to comply with each province's VAT, even if all provinces harmonize their taxes.

My judgment is that the case for turning over further tax room to the provinces is not well founded. On the contrary, my ideal scheme would consolidate federal revenue raising while taking provincial interests

into account. Briefly, my approach to dealing with the vertical balance is as follows.

Federal GST and provincial sales taxes would be consolidated into a national GST (NGST). This would be

accompanied by an explicit revenue-sharing arrangement whereby a share of NGST proceeds would go to the provinces (as in the Australian case). The share either could be turned over on an origin basis, in which case it would be equalized as own-source revenue, or it could be given in equal per capita amounts to the provinces, which would be a superior form of equalization. (There may need to be an opting-out provision for Quebec to allow it to retain the QST, although that would not be ideal on economic grounds.) The federal government would keep its income tax room, and the system of social transfers would remain intact.

I would also separate the CST into welfare and post-secondary education components, and fold into the latter many of the direct programs that the federal government now provides to that sector. This would ideally be accompanied by institutional reforms that ensure that the use of the spending power is predictable, non-intrusive and above all based on cooperation. Such a system should enhance the efficiency and equity of the federation, while at the same time respecting provincial responsibility for fiscal decisions within their jurisdiction.

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