

Equalization: Will The Attacks Ever End?

There seems to be no end to the misunderstandings of the role of equalization and the proposals to reform into oblivion this cornerstone of the Canadian federation. The latest misunderstanding involves a misinterpretation of recent remarks made by the federal Minister of Finance.

In an address to the Greater Halifax Chamber of Commerce delivered in late December, Mr. Martin indicated his support for the idea of levying lower federal tax rates, particularly corporate tax rates, in less affluent provinces as an instrument of regional development policy. The heads of three regional think tanks – the Frontier Centre for Public Policy, the Montreal Economic Institute and the Atlantic Institute for Market Studies – twisted Mr. Martin's remarks into support for using regionally differentiated federal tax rates as a replacement for equalization transfers.

I argue in this commentary that this misinterpretation begets a pernicious idea that not only would undermine the constitutional foundations of the equalization program but also would threaten the existence of the national pro-

grams – health care, education and a social safety net – that Canadians have come to cherish so dearly.

This paper first places the issue within a broad policy framework. It then identifies the role of equalization. Finally, it addresses the issue of regionally differentiated federal tax rates.

The current debate on reforming equalization has been tainted by confusion about the role of different instruments in the policy arsenal available to Canadian governments. The Canadian federation was born with, and still contains, four sets of imbalances. These relate to: regional disparities, vertical fiscal imbalances (i.e., the federal government has the fastest growing revenue sources while provincial governments have the fastest growing spending), horizontal fiscal imbalances (i.e., the capacity to raise revenue at national-average tax rates differs among provinces) and income inequality. The fiscal history of Canada is largely a record of the flexibility exercised by federal and provincial governments in redressing these imbalances.

Over time, Canadian governments have developed four separate policy tools to deal with these imbalances: regional policies, intergovernmental grants and transfer of tax points, equalization and transfers paid both directly to individuals and indirectly through the income tax system. Each policy tool is aimed at a specific imbalance. We can reform these tools individually to ensure that they serve the stated objective in an effective manner, but we should not misdirect them to a role for which they were not designed.

Equalization, in particular, is a distinct policy tool developed to deal directly with disparities in fiscal capacity. As stated in Section 36(2) of the Constitution, the purpose of this program is “to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

Equalization is directed at the provision of public services, not the subsidization of private consumption, the reduction of income inequality among individuals and families, or the narrowing of regional economic disparities. The fundamental role of equalization is to help the less affluent provinces finance the national programs that largely define who we are as Canadians (namely, health care, education and social services).

In fiscal year 1999-2000, expenditures on those programs represented nearly three-quarters of total program spending by equalization-receiving provinces. As Bernard Lord, Premier of New Brunswick reminds us, equalization is about health care and education. Emphasizing the essential public services delivered to Canadians with the support of equalization payments and the commitments of both orders of government enshrined in Section 36 of the Constitution, an earlier commentary identified five fundamen-

tal principles underlying the equalization program: economic justice, social justice, promotion of human rights, social cohesion and effective democracy [Ruggeri and Strain 2001]. Keeping these principles in mind when evaluating potential changes to equalization will help focus on the values to which Canadians gave constitutional protection.

Using lower federal tax rates in the less affluent regions as a tool of regional development policy is not a novel idea. Recently, it has been discussed in connection with the use of the oil and gas revenues generated by energy developments in Atlantic Canada. It is generally recognized that the lion’s share of royalties from those energy developments will be received indirectly by the federal government through lower equalization payments to selected Atlantic provinces. Frank McKenna, former Premier of New Brunswick, suggested that some of these royalties should be used for the creation of “a regional pool of money for collaborative purposes.” Under his proposal, the Atlantic provinces and eastern Quebec would share this regional pool of money for program spending by provincial governments “or better, yet, tax relief.”

I suggested a variation of McKenna’s proposal which includes three basic elements: (a) revenue-sharing confined to the Atlantic provinces, (b) funds provided only by the federal government, and (c) these funds would be used to reduce income tax rates in Atlantic Canada. I argued that this proposal would increase accountability, by clearly identifying the federal government as the sole contributor. It would use revenue indirectly received by the federal government from Atlantic Canada’s resources and would focus the regional development stimulus directly and exclusively on private decision-making.

The suggestions expressed by Finance Minister Martin provide a broader perspective on the use of tax policy as a tool of regional development. They sever the link between sources of federal revenue and tax-based regional development policy and incorporate some notion of regional equity by expanding the program to all the less affluent provinces. Mr. Martin's ideas are a welcome sign of federal policy flexibility and should be given serious consideration in the formulation of regional development policy. At the same time, we should oppose vigorously any attempt at transforming this potential flexibility in regional development policy into an attack on the equalization program for at least two reasons. First, replacing cash payments to provincial governments with lower federal tax rates undermines the constitutional foundations of the program. Without its constitutional underpinnings, equalization would become vulnerable to short-term political pressures. Second, this replacement would undermine the foundations of our national programs.

In Section 36(1) of the Constitution, both federal and provincial governments are committed to "promoting equality of opportunities for the well-being of Canadians and "providing essential public services of reasonable quality to all Canadians." This commitment has been honoured through a Social Union Framework Agreement, which includes federal transfers to all provinces through the Canada Health and Social Transfer (CHST) and federal transfers to the less affluent provinces to enable them to fulfill their constitutional responsibilities. It would be impossible, in my view, to honour the above constitutional commitments by dismantling the

foundations of fiscal federalism upon which these national programs rest.

The smaller Canadian provinces face major economic and fiscal challenges. They will be hard-pressed to maintain both a competitive tax structure and a level of public services that can attract the skilled workers required by the knowledge-based economy. The larger, more prosperous provinces are facing the challenges of international competition by slashing income tax rates. The less prosperous provinces do not have the financial resources to match these tax cuts. Yet these provinces must be given equal opportunities for economic growth and human development if Canada is to prosper in the new millennium through balanced regional development. This balance requires the coordinated strengthening of both equalization and regional development policies, not a trade-off between the two.

Joe Ruggeri

Reference

Ruggeri, J. and F. Strain. (2001). *Equalization: Let's Stick to the Principles*. Caledon Institute of Social Policy, December.

Joe Ruggeri is Vaughan Chair in Regional Economics and Director of the Policy Studies Centre, Department of Economics, University of New Brunswick, P.O. Box 4400, Fredericton, N.B. E3E 5A3, ph: (506) 447-3320, fx: (506) 453-4514, e-mail: ruggeri@unb.ca