

**SENATE**

**SÉNAT**

**CANADA**

**THE HORIZONTAL FISCAL BALANCE: TOWARDS A  
PRINCIPLED APPROACH**

**Interim Report on the Committee's Study of the Fiscal Balance between the  
Different Levels of Government in Canada**

**Standing Senate Committee on  
National Finance**

**SEVENTH REPORT**

*Chair*

The Honourable Joseph A. Day

*Deputy Chair*

The Honourable Nancy Ruth

December 2006



## MEMBERSHIP

The Honourable Joseph A. Day, *Chair*  
The Honourable Nancy Ruth, *Deputy Chair*

and

The Honourable Senators:

Michel Biron	*Marjory LeBreton, P.C. (or Gerald Comeau)
James Cowan	Grant Mitchell
Consiglio Di Nino	Lowell Murray, P.C.
Art Eggleton, P.C.	Pierrette Ringuette
Francis Fox, P.C.	William Rompkey, P.C.
*Daniel Hays (or Joan Fraser)	Terry Stratton

\**Ex Officio* members

In addition, the Honourable Senators Willie Adams, Raynell Andreychuk, George Baker, P.C., Maria Chaput, Dennis Dawson, Percy Downe, Terry Mercer, and Pierre Claude Nolin were members of the Committee at different times during this study or participated in its work on this matter.

*Research Staff from the Library of Parliament:*

Tara Gray  
Lydia Scratch

Till Heyde  
*Clerk of the Committee*

## ORDER OF REFERENCE

Extract from the *Journals of the Senate* of Wednesday, September 27, 2006:

The Honourable Senator Nancy Ruth, for the Honourable Senator Day, moved, seconded by the Honourable Senator Stratton:

That the Standing Senate Committee on National Finance be authorized to examine and report on issues relating to the vertical and horizontal fiscal balances among the various orders of government in Canada; and

That the Committee report no later than June 30, 2007.

After debate,

The question being put on the motion, it was adopted.

Paul Bélisle  
*Clerk of the Senate*

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# **THE HORIZONTAL FISCAL BALANCE: TOWARDS A PRINCIPLED APPROACH**

## **INTRODUCTION**

The Government of Canada is expected to make significant changes to federal-provincial/territorial fiscal arrangements over the next few months. At stake will be the fiscal position of the provinces and territories and the values of fairness and equality that underlie the Canadian economic and social union.

The Standing Senate Committee on National Finance has had a long-standing interest in Canada's fiscal arrangements. In the fall of 2001, the Committee examined the Equalization program, the federal government's most important program for reducing fiscal disparities among the provinces and in March 2002, presented its report entitled *The Effectiveness of and Possible Improvements to the Present Equalization Policy*.

A number of major events have occurred since that time prompting the Committee's interest in revisiting the government's fiscal arrangements, starting with the current Equalization program. To begin with, in October 2004, the federal government implemented the *New Framework for Equalization and Territorial Formula Financing* (the "New Framework"). The New Framework was a fundamental departure from the previous approach to the Equalization program, the basic structure of which had been in place since 1967. Under the New Framework, the formula-based calculations of provincial and territorial entitlements were suspended, replaced by a fixed pool of funding with a legislated annual growth rate, allocated on the basis of historical data and entitlements. At the same time, the federal government launched an independent review of both programs.

In the spring of 2006, two major reports were released on the subject of reforming the Equalization and Territorial Formula Funding programs: the first by the Advisory Panel on Fiscal Imbalance of the provincial/territorial Council of the Federation, and the second by the Expert Panel on Equalization and Territorial Formula Funding, the panel appointed by the federal government. The two reports have become central to the public debate on fiscal arrangements in Canada; few would disagree that this debate intensified following the release of

the May 2006 Budget in which the federal government explicitly acknowledged the existence of a fiscal imbalance in Canada and stated its commitment to address it. Part of this commitment included addressing the horizontal fiscal imbalance by introducing within the next year “renewed, transparent and principle-based Equalization and Territorial Formula Financing programs”<sup>1</sup>. The federal government’s task will not be an easy one: the June 2006 federal-provincial/territorial finance minister’s conference made clear that while there is widespread support for the principle of Equalization, provincial opinion on the structure of the program continues to be divided.

Equalization is a program so highly valued by Canadians that its principle was enshrined by Parliament in the *Constitution Act, 1982*. The Committee hopes that its review will broaden the public’s understanding of this important federal program. The Committee also believes that federal-territorial fiscal arrangements merit special attention, particularly in light of the special circumstances and urgent needs of Canada’s newest territory, Nunavut.

The Equalization program is intrinsically linked to other major federal-provincial/territorial transfer programs — as became apparent during the hearings, it is difficult to consider these programs in isolation. With this in mind, the Committee intends to study other aspects of federal-provincial/territorial fiscal arrangements over the next few months including the vertical fiscal balance and municipal funding issues. It intends to report on these issues no later than June 30, 2007.

For this review, the Committee extended invitations to all provincial and territorial governments to present their views on the horizontal fiscal imbalance. Over the course of six weeks of hearings in the fall of 2006, the Committee heard from the Ministers of Finance of Nova Scotia and of Nunavut, the Minister for Intergovernmental Affairs for Ontario, and the Provincial Treasurer of Prince Edward Island. Yukon and the provinces of New Brunswick and Saskatchewan provided written submissions. In addition, the Committee heard from academics and policy experts including Professor Robin Boadway of Queen’s University, Professor

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<sup>1</sup> Government of Canada. *The Budget Plan 2006: Focusing on Priorities*. May 2006. p. 141.



Michael Smart of the University of Toronto, Professor Paul Boothe of the University of Alberta (who is also a former Deputy Minister of Finance of Saskatchewan and served as Associate Deputy Minister of Finance for the Government of Canada) and representatives from the Atlantic Institute of Market Studies.

Over the course of its hearings, the Committee devoted considerable time to reviewing the various recommendations put forward by the Expert and Advisory panels as it expects the federal government to base any reforms on their work. It heard from two members of the Expert Panel: the Chairperson, Al O'Brien, who is also a former Deputy Provincial Treasurer of the Province of Alberta, and Professor Emeritus Robert Lacroix, former Rector of the Université de Montréal. The Committee also heard from the Co-chair of the Advisory Panel of the Council of the Federation, Robert Gagné, a Professor at HEC Montréal. In addition, the Committee benefited from the insight and expertise of one of its members who was also a member of the Advisory Panel, Senator Lowell Murray.

## **THE VERTICAL AND HORIZONTAL FISCAL IMBALANCES**

In Canada, the term *fiscal balance* refers to the balance between the expenditure responsibilities of the various orders of government and the ability to fund the services resulting from those responsibilities. The current system of federal-provincial/territorial fiscal transfers includes both a horizontal and a vertical component designed to address the two aspects of the fiscal imbalance<sup>2</sup>:

The **vertical fiscal imbalance** refers to a gap between revenue sources and spending responsibilities *between* orders of government, that is, between the federal and provincial governments.<sup>3</sup> The primary vehicles used by the federal government to address the vertical

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<sup>2</sup> Reference is sometimes made to a third aspect of the fiscal balance: the provincial/municipal fiscal imbalance. This refers to the inability of municipalities to meet their growing expenditure responsibilities since the ability of municipalities to raise revenues by increasing taxes and user fees is limited, and the revenue sources to which municipalities have access are constrained by provincial governments.

<sup>3</sup> The existence of a vertical fiscal imbalance is still a matter of some debate. Opponents argue that provinces have access to basically the same revenue sources as the federal government and are free to set their tax rates as high or as low as they wish. Supporters of the existence of a vertical fiscal imbalance point to the dramatic federal cost-cutting exercises in the 1990s in the area of federal transfers to the provinces as proof of its existence.

fiscal imbalance are its transfer payments for health under the Canada Health Transfer (CHT), and its transfers for post-secondary education and various social services under the Canada Social Transfer (CST). These transfers are conditional and include both a cash payment and the 1977 tax transfer. In the fiscal year 2006-2007, provinces and territories will receive a total of \$47.5 billion in CHT/CST payments. This includes tax point transfers valued at \$18.9 billion and cash transfers of \$28.6 billion<sup>4</sup>. As noted earlier, the Committee intends to study the issue of the vertical fiscal imbalance over the coming months. The current report focuses on the horizontal imbalance issue. The Committee intends to look at the vertical fiscal balance from a number of perspectives, including key international and constitutional obligations, as well as from the municipal/provincial perspective.

The **horizontal fiscal imbalance** refers to the differences in the ability of individual provinces and territories to raise revenues. The federal Equalization program, established in 1957, is the main policy tool for reducing the fiscal disparities among provinces. The purpose of the program was entrenched in the Canadian Constitution in 1982:

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.

(Subsection 36(2) of the *Constitution Act, 1982*)

Territorial Formula Financing (TFF) is an annual, unconditional federal transfer to the three territorial governments that has been in place since the fiscal year 1985-1986. While it is not mentioned in the Constitution, it is similar to Equalization in that its objective is to enable the territories to provide a range of public services reasonably comparable to those offered by provincial governments at reasonably comparable rates of taxation.

In 2006-2007, the federal government will transfer \$13.6 billion to the provinces and territories under the two programs. Currently, eight provinces receive equalization:

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<sup>4</sup> Tax point transfers involve the Government of Canada reducing its tax room and making this room available to the provinces and territories. In 1977 the federal government agreed to give up 13.5% of personal income tax and 1% of corporate income tax to the provinces and territories. The federal government considers these tax points as ongoing contributions to provincial health and social programs.

Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba, Saskatchewan and British Columbia.

**Table 1: Equalization Entitlements, 1993-1994 to 2006-2007 (\$ millions)**

YEAR	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
1993-94	900	175	889	835	3,878	0	901	486	0	0	8,063
1994-95	958	192	1,065	927	3,965	0	1,085	413	0	0	8,607
1995-96	932	192	1,137	876	4,307	0	1,051	264	0	0	8,759
1996-97	1,030	208	1,182	1,019	4,169	0	1,126	224	0	0	8,959
1997-98	1,093	238	1,302	1,112	4,745	0	1,053	196	0	0	9,738
1998-99	1,068	238	1,221	1,112	4,394	0	1,092	477	0	0	9,602
1999-00	1,169	255	1,290	1,183	5,280	0	1,219	379	0	125	10,900
2000-01	1,112	269	1,404	1,260	5,380	0	1,314	208	0	0	10,948
2001-02	1,055	256	1,315	1,202	4,679	0	1,362	200	0	240	10,310
2002-03	875	235	1,122	1,143	4,004	0	1,303	106	0	71	8,859
2003-04	766	232	1,130	1,142	3,764	0	1,336	0	0	320	8,690
2004-05 <sup>1</sup>	762	277	1,313	1,326	4,155	0	1,607	652	0	682	10,774
2005-06	861	277	1,344	1,348	4,798	0	1,601	82	0	590	10,900
2006-07 <sup>2</sup>	687	291	1,386	1,451	5,539	0	1,709	13	0	459	11,535

1. Figures for 2004-05 exclude the additional \$150 million in Equalization announced in Budget 2004.

2. Figures for 2006-07 are as proposed in Budget 2006 and include one-time adjustments.

Source: Department of Finance

As witnesses observed, the Equalization program has been incorrectly characterized by some as a transfer from more prosperous provinces to less prosperous provinces. While true that on average, the funding for Equalization comes from provinces that have higher federal tax bases, it is not a program that explicitly transfers funds from one province to another province. As a constitutional obligation of the Government of Canada, Equalization is federal program paid out of general federal tax revenues that are collected from all provinces. The Committee considers this redistribution of wealth across the federation to be one of the fundamental roles of the federal government.

The payments under Equalization and TFF are unconditional; that is, the recipient provinces and territories are free to spend the funds on public services according to their own priorities. For some witnesses, the unconditional nature of the payments was a concern, as was the level of “reasonable comparability” in public services across provinces. According to witnesses from the Atlantic Institute of Market Studies, many of the Equalization-receiving provinces spend more per capita on government services than do non-receiving provinces, and

carry higher debt loads. Their proposed solution is to fundamentally restructure the program in order to provide incentives for sound provincial financial management<sup>5</sup>. However, the Committee recognizes that each province faces its own unique set of fiscal and economic circumstances, and for these reasons may show deviations from the provincial norm in term of per capita spending, revenues, deficits and debt burdens. As the Committee heard, the Equalization program reflects the federal government's commitment to fairness and to provincial autonomy. The Committee believes that provincial governments are ultimately accountable to their own residents for the choices they make with respect to public services and taxation, and that these choices are not part of Equalization reform. However, accountability issues can be addressed in part by making the programs more transparent, open and consistent. These points are addressed in the discussion below.

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<sup>5</sup> For example, AIMS suggests that the calculation could reflect the provinces' use of natural resource revenues. As an example, if an equalization-receiving province with natural resource revenues uses those revenues to pay down debt, they should not be considered as contributing to the province's fiscal capacity. On the other hand, should it use those revenues to finance ordinary program spending, those revenues should be counted in the province's fiscal capacity and deducted from the Equalization entitlement. As another example, the federal government would encourage better debt management practices by paying a portion of a province's debt servicing costs in exchange for a reduction in equalization payments.

## PART I: EQUALIZATION

### A. Pre-2004: The Formula-Based Equalization Program

As the Committee heard, prior to the changes introduced with the October 2004 New Framework, Equalization payments were calculated according to a formula set out in federal legislation and regulations. The formula determined both the total size of the program and the distribution of payments across provinces. As a starting point, the formula measured the per capita fiscal capacity of each province. *Fiscal capacity* is a measure of the province's ability to raise revenues from each of 33 revenue sources – including personal income tax, corporate income tax, sales taxes, property tax, and other revenue sources – assuming that the province levies an average tax (this is referred to as the Representative Taxation System or RTS). Provinces with fiscal capacity below a threshold or standard amount received Equalization payments from the federal government to bring their capacity up to that standard. The standard measured the average fiscal capacity of the five “middle income” provinces – Quebec, Ontario, Manitoba, Saskatchewan and British Columbia.<sup>6</sup> Based on this formula, total Equalization payments depended on the variation in provinces' fiscal capacities: the wider the fiscal disparity between provinces, the larger the total size of the Equalization program.

The program has been subject to numerous adjustments over its decades-long history including (among other changes): an increase in the number of revenue sources used to measure fiscal capacity; revisions to the inclusion rate for natural resource revenues; and the imposition of floor and ceiling provisions on payments. These adjustments have not been without controversy as even small changes to the methodology have an enormous potential to change both the total value of Equalization payments and their distribution across the provinces. As several witnesses observed, in a diverse country such as Canada where wealth is distributed unequally across provinces and regions, Equalization is an important source of revenue for provinces (as Chart 1 below demonstrates). For many provinces, these payments are essential to their ability to offer reasonably comparable level of public services. For example, New Brunswick's Equalization payment in the fiscal year 2006-2007 totals \$1.45 billion. According to the province, this

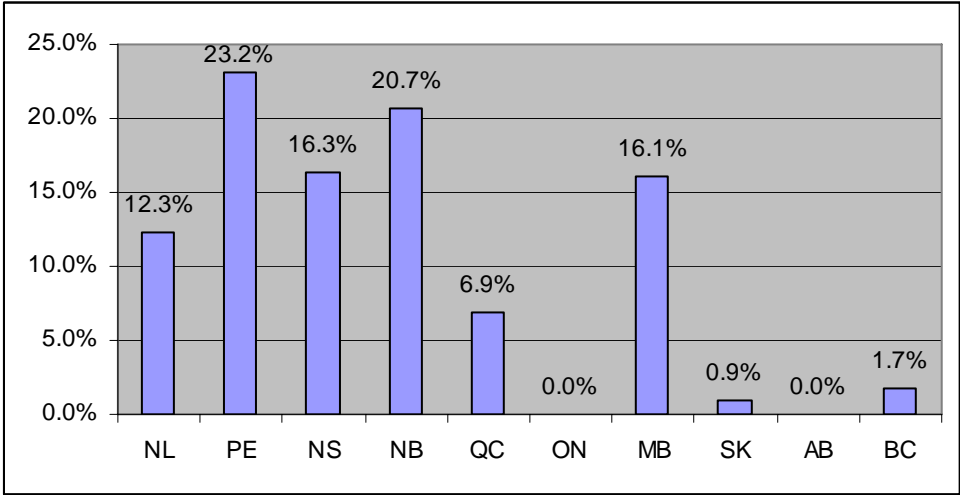
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<sup>6</sup> From 1967 to 1982, the estimated fiscal capacity of each province was compared to the national average, or what is known as the ten-province standard. In 1982, the federal government excluded Alberta and the Atlantic Provinces from the standard, with the result that the standard has become the average fiscal capacity of the five remaining provinces.

exceeds what it collects annually in personal and corporate income tax. It is evident that without Equalization, residents of that province could face considerably higher taxes and fewer public services.

As a result, it is not surprising that the Equalization program has been subject to constant criticism and demands for change over the years. This has been especially true in recent years when the operation of the formula generated a sharp decline in Equalization payments, reflecting the combined impact of a reduction in fiscal disparities between provinces, tax reductions, and a series of data revisions (see Table 1).

**Chart 1: Equalization as a percentage of provincial general government revenues (2005-2006)**



Source: Department of Finance, Statistics Canada (Public Sector Statistics, Financial Management System)

**B. Post 2004: A New Framework for Equalization and Territorial Formula Financing**

In the fall of 2004, Canada’s First Ministers agreed upon a New Framework for Equalization and TFF. As a result of this announcement, a number of important changes occurred. First, a new financial "framework" for Equalization was introduced. Funding levels for the fiscal year 2005-2006 were set at \$10.9 billion and legislated to grow at a rate of 3.5% annually thereafter. In addition, normal formula-based calculations of entitlements were suspended and the distribution of the total funding across the provinces was based on a combination of fiscal capacity and historical entitlements.

Witnesses remarked that the New Framework represents a significant departure from the formula-based approach of years past. The vast majority of the witnesses appearing before the Committee did not support the New Framework approach: the main issue is that both the size of program and its allocation are no longer tied to fiscal disparities among provinces. As witnesses observed, Equalization is no longer equalizing fiscal capacities in any given year. Rather, it is basing future payments on past entitlements and, as a result, recipient provinces are now being raised to different standards of fiscal capacity.

The Committee recognizes that the New Framework was introduced by the federal government as an interim solution. The intent was to address long-standing provincial concerns by bringing stability, predictability and growth to the overall level of funding for the programs, pending the outcome of the federally-appointed Expert Panel's work and the development of a new program structure in consultation with the provinces.

### **C. Expert and Advisory Panels**

As noted earlier in this report, over the last year two major reports have been released on the subject of reforming Canada's Equalization program. The first was released in April 2006 and was issued by the Council of the Federation, the representative body of the ten provincial and three territorial leaders. The Council's report, entitled *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance*, was prepared by its Advisory Panel on Fiscal Imbalance (the "Advisory Panel"). The Advisory Panel's mandate was to examine the issue of fiscal imbalance -- vertical and horizontal -- in Canada and make recommendations on how that imbalance should be remedied. The second report, *Achieving a National Purpose: Putting Equalization Back on Track*, was released in May 2006 by the federal government's Expert Panel on Equalization and Territorial Formula Financing (the "Expert Panel"). The Expert Panel's mandate was narrower: it was charged with considering how future Equalization (and TFF) payments were to be determined and distributed across the provinces.

The Committee found many similarities both between the recommendations of the two reports, and between those reports and the recommendations it made in its own report of March 2002. At the same time, the Committee found that the two panels differ in some key respects.

Most notably, the panels disagree on the treatment of natural resource revenues in the Equalization formula. This has significant implications not only for the overall cost of the program, but also for some existing bilateral arrangements between the federal government and the provinces. By way of comparison, the Committee heard that the Advisory Panel recommends a program that, in the fiscal year 2007-2008, provides \$13.8 billion to be transferred to qualifying provinces; the Expert Panel recommends a \$12.6 billion program that year.

#### **D. The Major Issues**

Most witnesses expressed broad support for the Equalization program. Nevertheless, they were critical both of the New Framework and of the federal government's past approach to ongoing program reform. The Chairperson of the Expert Panel, Mr. O'Brien observed that in its own consultations, the panel consistently heard concerns about what many see as an increasingly *ad hoc* approach to Equalization. He added that "over the past year, the purpose and effectiveness of the program have been questioned, often fuelled by provincial concerns about fiscal imbalances, both horizontal and vertical". Professor Smart expressed similar concerns, testifying, "there is now a tendency to view transfer reform in this country as a kind of zero-sum game in which all that matters in considering reforms is the impact on the bottom line for one particular province – that overarching principles no longer matter, as they did for many participants in the past. That is a fundamental aspect of the current situation that we need to address". As a case in point, some recipient provinces told the Committee that without adequate funding for the program, fiscal disparities between the provinces will widen, placing even greater pressure on their ability to deliver adequate public services, reduce debt levels and maintain tax competitiveness. Other provinces are strongly of the view that the program does not need further enrichment in order to meet its constitutional objectives, while viewing the New Framework as inconsistent in its treatment of provinces.

The Committee shares many of the same concerns. Current arrangements are not effective and past attempts at reform did not resolve many of the underlying issues of the provinces. It is the Committee's belief, echoed by a number of witnesses, that a return to a principles based, formula-driven approach to the Equalization program would help resolve these issues and put the program on a sustainable course, as well as improve accountability.



In examining the program in 2002, the Committee was guided by five broad principles.

These are:

1. The program should be **equitable**. The system of equalization payments should provide a fair distribution of entitlements among provinces.
2. Equalization payments should be **adequate** to allow recipient provinces to provide comparable services without resorting to unreasonable taxation levels.
3. The program should be **sustainable** over time.
4. The program should be designed so that it is **neutral** in its effects on other government policies. Changes in the program should not influence government behaviour, nor should a province's revenue policies affect its level of entitlement.
5. The workings of the Equalization program should be **transparent**. Formulas and criteria should be as clear as possible.

The Committee is of the opinion that these principles should continue to guide any reforms to the Equalization system while recognizing, as it did in 2002, that conflicts between the principles may force policy-makers to seek a balance in formulating key elements of the program. Influenced by both the Expert and Advisory reports, the Committee would add two additional principles to those of its 2002 report: **predictability** and **stability**. A formula-based approach automatically adjusts to changes in economic conditions and the relative fiscal capacities of provinces. Without unduly limiting the responsiveness of the program, it should minimize the year-over-year volatility of Equalization payments.

**Recommendation**

The federal government should return to a formula-based approach to Equalization guided by a clear set of principles.

There are several long-standing issues in the debate over Equalization reform. What the Committee heard and supports is summarized below.

**1. The Provincial Standard**

Prior to the implementation of the New Framework in 2004, the average revenue-generating capacity of five provinces (Ontario, Quebec, Manitoba, Saskatchewan and British Columbia) was the standard against which all provinces were measured to determine whether they qualified for equalization payments. This was not always the case. In 1967 – when the

Representative Tax System was first introduced – all ten provinces were included in the equalization standard. Problems began to appear in the late 1970s and early 1980s when the rise in oil and gas prices increased Alberta’s revenue-generating capacity well beyond that of the other provinces. In fact, Alberta’s oil revenues raised the national standard to the point that all other provinces, including Ontario, qualified for equalization payments. Subsequently, in 1982 the federal government excluded Alberta and the Atlantic provinces from the standard.

The majority of witnesses, including the provinces of PEI, New Brunswick, and Nova Scotia, endorsed a return to a 10-province standard as a principled, inclusive approach that reflects the real fiscal diversity across the provinces. Some characterized the move to a 5-province standard as arbitrary and costly to recipient provinces. A 10-provinces standard is essentially a recommendation that the fiscal capacities of recipient provinces be brought up to the national average (which is currently that of Ontario). Mr. O’Brien cautioned that the Expert Panel adds two caveats to this recommendation which are discussed in more detail below: the 10-province standard is only appropriate in the context of a 50% inclusion rate for natural resources; and the 50% inclusion rate is only appropriate in the context of a fiscal cap on recipient provinces. As witnesses observed, this package of recommendations would help contain the overall cost to the federal government.

The Committee acknowledges that the move from a five-province standard to a ten-province standard could increase the cost of the program substantially, particularly in periods of high energy prices. However, as it did in 2002, it believes that the ten-province standard comes closest to fulfilling the Constitutional intent of the program. The issue of affordability to the federal government is a concern that is addressed later in this report.

**Recommendation**

The federal government return to a 10-province standard in the calculation of entitlements under the Equalization program.

**2. The Representative Tax System and the Measurement of Tax Bases**

As witnesses remarked, provinces will have different abilities to raise revenues to the extent that the revenues they can obtain from applying comparable tax rates to their tax bases

differ. The Representative Tax System (RTS) approach used in the pre-2004 Equalization formula addressed this problem by including each tax base that provinces use separately and, for each base, measuring the ability to raise revenues by applying the average tax rate used in all provinces to the province's tax base. The key strengths of the RTS approach are that it provides a more accurate measure of a province's fiscal capacity, reflects provinces' actual tax practices, and it is more in keeping with the Constitutional commitment to provide "reasonably comparable" levels of taxation. On the other hand, the Committee heard that the RTS approach has become increasingly complex, without necessarily adding to the accuracy of the measurement of provincial fiscal capacity.

As first established in 1957, the program contained only three equalized tax bases: personal income tax, corporate income tax and succession duties; natural resource revenues were not taken into account. The number of tax bases increased substantially over time and, prior to the implementation of the New Framework, up to 33 different tax bases were used. Witnesses explained that some of these taxes led to only moderate disparities in provincial fiscal capacity and, for others, difficulty in measurement and/or the considerable variability in provincial practices made the RTS difficult to apply. In the interests of simplicity, ease of calculation and transparency, Mr. O'Brien noted that the Expert Panel recommends retaining the RTS but collapsing the tax bases to five: personal income tax, business income tax, property tax, sales tax, and resource revenues.

A major component of this simplification would result from using actual resource revenues to replace the 14 natural resource bases applied under the previous formula. The Committee heard that natural resource revenues are more heterogeneous than other tax bases: the different resource deposits are of different qualities and have different costs of extraction. Thus, the ability to raise revenues using the royalty system varies from one deposit to another. Using actual revenues as a basis for Equalization simplifies the system and addresses the difficulties in the consistent measurability of resource revenues. As Professor Boothe remarked, "using actual revenues is a much more transparent way of measuring than the complex and, frankly, judgment-based measures that we have relied on in the past". However, as one witness noted, it may do so at the expense of introducing incentive concerns into the system, thus undermining the

principle of policy neutrality: provinces may tax natural resources at a lower rate in order to reduce actual revenues.

Throughout the hearings, the Committee consistently heard that the RTS approach should be retained, although witnesses were divided on the correct number of tax bases for inclusion. The Committee supports the RTS approach and the simplifications proposed by the Expert Panel, while making an exception for resource revenues. While recognizing that the incentive concerns are not without merit, it also supports the use of *actual* resource revenues to replace the 14 natural resource bases applied under the previous formula. The appropriate inclusion rate for natural resource revenues is a complex issue and is discussed later in this report, as is the distinction between renewable and non-renewable natural resources.

The Committee heard that both the Expert and Advisory panels recommend full inclusion of property taxes within the RTS. The Expert Panel supports using a “stratified market value” approach. As explained to the Committee, this groups together all municipalities that have similar property values into the same “tax bracket”, then assumes that all municipalities in that bracket are able to levy a similar average tax rate. In 2004, the federal government decided to phase-in a variant of the stratified market value approach but it was superseded by the implementation of the New Framework. The Committee agrees with witnesses that the market value approach is a sensible one and should be adopted.

Many witnesses, including the provinces of Nova Scotia, Prince Edward Island, and New Brunswick, advocated retaining user fees as one of the equalized tax bases. These provinces maintain that a true measure of a province’s fiscal capacity should include all sources of revenue that contribute to that capacity, including user fees (a similar argument was made for comprehensive resource revenue coverage). In their view, to not do so would underestimate provincial fiscal capacity and serve to further widen fiscal disparities between provinces. The opposing view is that user fees do not represent fiscal capacity for a government as they are imposed largely on a cost-recovery basis; only the portion that generates profit, if any, should be included. It is evident to the Committee that given the wide range of user fees, this measurement would add enormous complexity to the system. In the past, perhaps for these reasons, user fees

were included at different rates. While sensitive to the provinces' views, the Committee believes that in the interest of simplicity and ease of calculation, user fees should not be included in the measurement of a province's fiscal capacity.

**Recommendation**

The federal government should retain the Representative Tax System approach, but reduce the number of tax bases used to measure provincial fiscal capacity to five: personal income tax, business income tax, property tax, sales tax, and resource revenues. Actual resource revenues should be used. Property taxes should be measured using a stratified market value approach. User fees should not be included.

**3. The Inclusion Rate for Natural Resources**

One of the more contentious and complex issues related to Equalization is the treatment of natural resources revenues. Certainly, it was the subject of considerable debate during the Committee's hearings. Natural resource revenues are one of the largest sources of disparities in provincial fiscal capacity and a source of considerable volatility in payments. Their comprehensive inclusion increases the cost of the program substantially. For these reasons, there has been a longstanding debate about whether or not resource revenues – particularly in the case of non-renewable resources – should be subject to equalization, and, if so, the extent to which they should be equalized. This uncertainty is reflected in the numerous changes made to the treatment of resource revenues in the Equalization formula over the years<sup>7</sup>.

As witnesses observed, there are number of arguments both for and against the special treatment of natural resource revenues. One of the main arguments for excluding natural resource revenue from the calculation of provincial fiscal capacity, or including them at a partial rate, stems from provincial ownership. Under section 109 the Canadian Constitution, provinces own their natural resources. Many witnesses remarked that as owners, provinces should receive a net fiscal benefit from those resources, *even if* they are recipients of Equalization. Full equalization

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<sup>7</sup> When Equalization was introduced in 1957, natural resource revenues were not among the revenue sources that were included in the calculation of payments. In 1962, when natural resource revenues were first included in Equalization, only 50% of those revenues were included. Since then, natural resources have been taken out again, later added back at the same 50% rate, and finally expanded to include 100% of resource revenues, but only following the removal of Alberta (and its resource revenues) from the standard.

of natural resource revenues effectively offsets the financial benefits of resource ownership<sup>8</sup>. As a consequence, it is argued, there is little, if any, incentive for recipient provinces to develop their natural resources.

A related argument against the inclusion of natural resources is the contention that including them within the Equalization program creates incentives for provinces to develop their natural resources inefficiently. According to Professor Smart, full Equalization can be thought of as subsidizing higher royalty rates. Thus, it follows that the impact of a partial inclusion rate would be to lower the level of natural resource taxation by Equalization-receiving provinces. In contrast, Professor Boadway testified that he found no historical evidence that full Equalization induced provinces to restrict resource development through higher taxation. Professor Boothe argued that governments seek to maximize employment not tax revenue. The Committee agrees with the latter assertion and does not believe that many provinces would implement policies aimed at reducing resource development for the sake of maintaining Equalization entitlements.

Natural resource development may require provinces to incur substantial public costs at all stages of development (for example, infrastructure and later, social costs). To compensate for these costs, some argue that these revenues should not be included in the measurement of a province's fiscal capacity. However, as more than one witnesses observed, public costs are not restricted to natural resources. For example, provincial income taxes reflect provincial expenditures on education and health but are included in the measurement of provincial fiscal capacity.

A more compelling argument that the Committee heard against the special treatment of natural resource revenues is that this would contradict the commitment of Section 36(2). Many provinces and experts made this point—that comprehensive revenue coverage is an important principle of a fair and equitable Equalization program and is necessary to ensure that difference in provincial revenue-raising ability is adequately captured. They also noted that Section 36(2)

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<sup>8</sup> In recognition of this issue, in 1994 the federal government implemented the “generic solution” for tax bases concentrated in one province. The generic solution mitigates Equalization reductions under very specific circumstances i.e., when a tax base is concentrated in a specific province (as is the case with some natural resources), such that a \$1.00 increase in a province's revenue results in an Equalization reduction of only \$0.70.

does not distinguish among types of revenue. The Provincial Treasurer of PEI considers reducing the proportion of resource revenues included in the measurement of fiscal capacity to be discrimination against recipient provinces that are resource-poor. The Minister of Finance of Nova Scotia added, “with respect to natural resource revenues, excluding them from the Equalization formula would unfairly favour resource-rich provinces that also receive Equalization transfers. Those provinces would get to keep the full benefit of their resource revenues as well as reap the full benefits of Equalization. At the same time, however, the exclusion of resource revenues would lower the average fiscal capacity to which provinces are equalized and thereby negatively impact less-advantaged provinces by forcing them to reduce services below the national norm or to increase taxes above that norm”.

This is not a view shared by all provinces. As it notes in its submission to the Committee, Saskatchewan supports removing non-renewable resource revenues from the program entirely. It feels that this change is necessary in order to recognize the “current inequality in Canada regarding the treatment of provincial energy revenues”. As a non-recipient province with relatively few natural resources, Minister of Intergovernmental Affairs for Ontario informed the Committee that Ontario supports partial inclusion in order to lessen what it considers an unfair financial burden on its taxpayers.

An additional reason for special treatment of natural resource revenues is that the federal government does not have direct access to taxes on resource revenues, which may compromise its ability to maintain the program when prices for natural resources are increasing. It is possible for the federal government to address affordability issues caused by rising energy prices by reducing the proportion of natural resource revenues included in the measurement of fiscal capacity. However, many witnesses disagreed with the basic premise of this argument, noting that the federal government has substantial access to these revenues through corporate and personal income taxes. In addition, as the Minister of Finance of Nova Scotia pointed out, affordability seems to be less of a concern in the current environment of federal surpluses: in 1982, the Equalization Program represented 8% of federal revenues; today, that figure has fallen to 5.1%.

The Committee also considered the distinction between renewable and non-renewable natural resources. The main rationale for partially or fully excluding non-renewable resources (for example, mines and energy deposits) is because those resources have a finite lifespan, the revenues derived from those sources do not represent income, but rather proceeds from the sale of capital assets. A number of witnesses observed that the distinction between renewable and non-renewable resources may not be meaningful for Equalization purposes: for instance, oil and gas deposits may last for generations while renewable resources, such as fishing stocks and forests, may in fact have shorter economic life-spans than previously thought.

In addition, the Committee considered the special case of one renewable natural resource, hydroelectricity. Unlike oil and gas whose prices are largely determined by world markets, hydro prices are often set by individual governments. This is because in many cases, provinces with substantial hydroelectric-generating capacity have chosen to develop and distribute those resources through Crown corporations. Under the RTS approach, provincial revenues from hydroelectricity were captured using two tax bases: water power rentals and profits of Crown corporations paid to provincial governments. This approach understates the fiscal capacity of provinces that have chosen to charge less than the full economic value of electricity, as it essentially passes on profits directly to consumers in the form of lower energy prices. In this case, Equalization entitlements would be over-estimated for hydro-intensive provinces.

As Professor Lacroix explained, the Expert Panel believes that all natural resources revenues, including hydroelectricity, should be treated the same way. Essentially, the two tax bases previously in use would be replaced by one – measured by actual revenues – and included as part of a province’s resource revenues only. Thus, under this approach, remittances from Crown corporations involved in resource extraction and development, *including* hydroelectricity Crown corporations, would be included as part of a province’s resource revenues and not as part of business income. The Committee agrees with the recommendation of the Expert Panel.

Professor Lacroix also noted that with the development of new distribution networks, energy markets are no longer local; they are now part of a North American market where excess energy can be sold at a considerable profit. Thus, provinces have less incentive to under-price



electricity as the gains outweigh any resulting loss in Equalization entitlements. However, Senators observed that some provinces with substantial hydroelectric-generating capacity (for example, Manitoba) continue to charge less than full market rates to provincial residents although they may price export sales substantially higher.

The Committee found that it is in their treatment of natural resources revenues that the recommendations of the two expert panels differ the most. Support for each approach among the witnesses was divided, although it should be noted that Nova Scotia, Prince Edward Island and Nunavut expressed support for the Advisory Panel's approach while Ontario supports the Expert Panel's approach.

The Advisory Panel recommends a comprehensive approach: a 10-province standard with the inclusion of 100% of natural resource revenues. It believes that this is the most accurate and the fairest measurement of fiscal disparities. As Mr. Gagné explained, they considered all of the reasons for the special treatment of natural resources revenues but could not find any solid arguments for their exclusion. He went on to note that the Advisory Panel is aware of the increased costs of their recommendations. To address concerns about affordability, it recommends scaling back the standard established by the above recommendations, the degree to which should be negotiated between the two orders of government. Under the Advisory Panel's recommendations, the size of the program is a political decision of the federal government, entirely separate from the allocation of entitlements which would be determined by the proposed formula. An advantage of this approach is its transparency: affordability issues can be addressed in the open and debated in Parliament and with the provinces, instead of unilaterally by the federal government through a less transparent mechanism i.e., formula manipulations.

The starting point for the Expert Panel's recommendations is ownership. Mr. O'Brien summarized the panel's position: "We weighted the principle that receiving provinces should get some net fiscal benefit by virtue of resource ownership with the reality that resources are also the greatest source of disparity among provinces. We concluded that 50% of a receiving province's actual resource revenues should be included in the calculation of a province's ability to raise revenues". To address any remaining concerns that the federal government may have with

regard to affordability he noted that, similar to the Advisory Panel's approach, entitlements could be reduced or increased on an equal per capita basis.

As a result of the Expert Panel's recommended 50% inclusion rate, a recipient province could end up with a higher fiscal capacity after Equalization than a non-recipient province – which would be contrary to the principle of fairness. As outlined by witnesses, the solution proposed by Expert Panel is to implement a relative cap on Equalization payments. For the purposes of the cap, 100% of a province's resource revenues would be included in calculating a province's fiscal capacity, in contrast to the 50% used to calculate entitlements. If a province's *post*-Equalization fiscal capacity is higher than that of the lowest non-receiving province, then its entitlement would be capped at that level. Over the near term, the Committee heard that this would reduce payments to two provinces i.e., Saskatchewan and Newfoundland and Labrador; others could be affected by the cap as their resource revenues increase. Witnesses from the Expert Panel characterized their recommendations as a reasonable and workable solution providing the best outcome in terms of the overall impact on the provinces and the federal government. Each proposed change was considered in the context of an entire package that balanced key principles.

Many witnesses remarked that the implementation of the Expert Panel's recommended fiscal cap is complicated by the existence of separate Atlantic Accords for Newfoundland and Labrador and Nova Scotia<sup>9</sup>. Broadly, the 2005 Atlantic Accords provide Nova Scotia and Newfoundland and Labrador with 100% protection from Equalization reductions resulting from the inclusion of offshore revenues in the Equalization program.

The Expert Panel considers that the Atlantic Accords provide a fiscal benefit that increases the fiscal capacity of both Nova Scotia and Newfoundland and Labrador, and accordingly, should be taken into account for the purposes of calculating the fiscal cap. Many witnesses observed that there are legal, political, and constitutional issues about whether it is

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<sup>9</sup> These Atlantic Accords include the 2005 *Arrangement between the Government of Canada and the Government of Nova Scotia on Offshore Revenues* and the 2005 *Arrangement between the Government of Canada and the Government of Newfoundland and Labrador on Offshore Revenues*.

possible to impose that kind of cap in a way that will be consistent with the Atlantic Accords. As the Minister of Finance of Nova Scotia testified, the province considers the Accords to be outside of the Equalization program, representing the settlement of a long-standing dispute with the federal government over offshore resource ownership. He was of the opinion that the agreements were rooted in Canada's obligation under Section 36(1) of the Constitution to further economic development in all regions, and considers the agreements to be similar to other federal/provincial bilateral agreements in support of regional economic development that are not taken into account within the Equalization system. Other witnesses agree that the Atlantic Accords could be considered separate arrangements. As Professor Boadway noted there are distinctions among Equalization, regional development, and interpersonal redistribution programs; they all serve different purposes.

The Committee assessed the arguments put forward by the provinces and witnesses in support of each panel's proposal. Many members of the Committee support the Expert Panel's solution as a pragmatic approach to Equalization reform. However, a majority support the Advisory Panel's position of a 100% inclusion rate for natural resource revenues, which they consider to be a principled approach. It was felt that comprehensive revenue coverage is an important principle of an equitable Equalization program and is necessary to ensure that difference in provincial revenue-raising ability is adequately captured. With respect to the Expert Panel's approach, members noted that it would require the implementation of a fiscal cap in order to ensure fairness between recipient and non-recipient provinces, which may not be possible given the issues surrounding the 2005 Atlantic Accords.

The Committee recognizes that the more comprehensive the program, the greater the cost to the federal government, and that an increase in program size does not have the support of all provinces. For this reason, should the federal government adopt a 100% inclusion rate for natural resource revenues, the Committee believes that it should also consider implementing the scaling mechanism outlined by the Advisory Panel.

In addition, the Committee agrees with Mr. O'Brien and the Expert Panel and other expert witnesses, and continues to support the recommendation that it made in its 2002 report: it

believes that all natural resource revenues should be treated in an equivalent fashion, without regard to whether they are deemed to be renewable or non-renewable. This includes those generated through hydroelectricity. As noted above, these should be measured using actual resource revenues.

**Recommendation**

The federal government include 100 percent of natural resource revenues in the measurement of provincial fiscal capacity. No distinction should be made between renewable and non-renewable natural resource revenues.

**4. Adjustments for Expenditure Needs and Costs**

Comparable levels of public services may require different amounts of per capita spending. As witnesses observed, differences can arise for two reasons: the first is because different provinces have different needs for public services depending upon their demographic makeup; the second is that provinces may have different costs in providing public services because of differences in wage costs and geographic differences, among other factors. Expenditure differences were not explicitly taken into account in the pre-2004 Equalization formula. According to Professor Boadway, it is extremely difficult to measure comparable levels of public services delivered across provinces when public services are heterogeneous both in quality and in cost. Moreover, a measure based on expenditure needs may not be acceptable to provinces as it could imply the implementation of a degree of centralization and standardization. Some witnesses also observed that cost factors are working in opposing directions: the economies of scale associated with providing public services in densely populated areas may be negated by higher wage and property costs. For example, according to the Minister for Intergovernmental Affairs for Ontario, even though it acts efficiently (Ontario's total per capita program spending ranks tenth among the provinces), it costs more to administer social programs in Ontario than other provinces. These factors have led most observers, including this Committee in 2002, and more recently, both the Expert and Advisory Panels, to recommend against considering expenditures as a component of the Equalization system.

**Recommendation**

The federal government should not adopt at this time a system of Equalization payments that attempts to adjust entitlements on the basis of needs or costs.

## **5. Volatility**

Volatility has been an ongoing concern of the provinces and is closely related to the issue of the standard and the treatment of natural resource revenues. Prior to 2004, entitlements were calculated on an annual basis and could fluctuate considerably. In addition, predictability was an issue as Equalization entitlements were recalculated after new information and data were made available. Floor provisions were introduced in 1982 to protect provinces from rapid major declines in entitlements. However, this did not address the underlying issues of volatility and predictability. Both the Advisory Panel and the Expert Panel recommended implementing a smoothing mechanism to improve the predictability payments and minimize year-over-year fluctuations. Their specific recommendations are similar: use three-year moving averages on all revenue bases, lagged two years. Witnesses, including most provinces, expressed broad support for the implementation of a smoothing mechanism.

### **Recommendation**

The federal government should implement a smoothing mechanism based on 3-year moving averages, lagged two years.

## **6. Associated Equalization and Tax Point Transfer**

In 1977, the Government of Canada agreed to transfer 13.5 % of Personal Income Tax and 1% of Corporate Income Tax to the provinces as part of the federal government's contribution for health and post-secondary education. Since tax points are worth more in some provinces than others, it agreed to equalize the tax points on an on-going basis. According to the Department of Finance, the annual amount paid to equalize these tax points is called Associated Equalization because it is the Equalization amount 'associated' with the tax point transfer. The amounts are calculated and paid through the Equalization program; however, they are intended to support health and post-secondary education and as such are included in the CHT and CST. Thus, the CHT/CST tax points valued at \$18.9 billion in 2006-07 are supplemented by a cash payment of approximately \$1.3 billion of Associated Equalization to eight recipient provinces whose revenues from those tax points are below the five-province standard. The Associated Equalization is also accounted for in the Equalization program, since these amounts are calculated and paid out through the Equalization system. Thus, Equalization entitlements of \$11.3 billion in 2006-07 also include the \$1.3 billion of Associated Equalization. In calculating

total transfers, the total is adjusted to avoid double-counting since Associated Equalization is part of both Equalization and the CHT/CST.

Issues such as the merit of further tax point transfers, the treatment of the 1977 tax transfers, and the conceptual and technical difficulties with the presentation of Associated Equalization within the federal transfer system, were discussed at great length during the hearings. While a detailed analysis of these issues is beyond the scope of this interim report, the Committee generally agrees with the witnesses who questioned the federal government's treatment of the 1977 tax point transfer as ongoing contributions to provincial programs. The Committee finds that the adjustments made to the Equalization program and the CST/CHT under Associated Equalization are confusing at best, lack transparency, distort the CHT/CST, and are damaging to the general Equalization program.

In addition, as witnesses observed, one result of equalizing tax points is that per capita cash payments under the CHT/CST differ across provinces. The Committee did hear compelling testimony from the provinces both for and against per capita transfers and additional tax transfers. The Minister of Intergovernmental Affairs of Ontario stated the province's position: that there should be one transparent Equalization program only and that, outside of that program, federal transfers should treat all provinces equally. As with both expert panels, the Committee agrees that the Equalization program should be the primary vehicle for equalizing fiscal capacity among the provinces. However, the Committee reserves a final judgment on these issues for a later report on the vertical fiscal imbalance.

## PART II: TERRITORIAL FORMULA FINANCING

### A. Overview

Prior to the 2004 New Framework, Territorial Formula Financing (TFF) was determined through a formula-based calculation. Unlike the provincial program, the grant was based on the gap between a territory's expenditure requirements and revenue capacity, and explicitly took into account the higher costs of delivering public services in the North. In October 2004, the federal government announced a new framework for TFF replacing the previous approach with a fixed envelope of funding legislated to grow at 3.5% annually. With this change, the total amount of funding was increased from \$1.75 billion in 2003-2004 to \$1.9 billion in 2004-2005 and \$2 billion in 2005-2006. TFF grants to the territories for 2006-2007 outlined in Table 3 include an adjustment factor over and above the 3.5% escalator reflecting more current economic and fiscal data that was made available from the time that the payments were initially set in November 2005 and legislated in 2006.

**Table 2: TFF Payments – 2006-2007 (\$ thousands)**

	Yukon	Northwest Territories	Nunavut	Total
Regular	505,608	739,414	824,978	2,070,000
Adjustment	311	–	1,553	1,864
Total	505,919	739,414	826,531	2,071,864
Per Capita (\$)	16,294	16,950	27,502	–

Source: Department of Finance, Budget 2006.

The Committee recognizes that the situation of the three territories is vastly different from that of southern Canada. All three territories face enormous difficulties in providing basic public services to their residents and must deal with important social issues including lower health and education outcomes compared to the provinces. While the territories share similar characteristics – small, dispersed populations, developing economies, underdeveloped infrastructure, and high living costs – there are significant differences even *between* the three territories. For example, economic development in the Northwest Territories, resulting from diamond mining and oil and gas exploration, far outpaces that of the other two territories. As a result, its per capita GDP currently exceeds that of Alberta. Nunavut, Canada's newest territory, is in the very early stages of its existence as a separate territory. It faces unique challenges that the Committee believes should be addressed separately.

In this context, TFF is critical for the territories who rely heavily on it and other federal transfers to pay for essential public services. In 2005-2006, TFF was approximately 61% of the Yukon's, 66% of the Northwest Territories' and 81% of Nunavut's total financial resources. When it was first established in the mid-1980s, the funding it provided was considered adequate to meet expenditure requirements in the territories. The Committee heard that this is no longer true. As Mr. O'Brien told the Committee, "perhaps the most consistent concern we heard was that TFF funding was inadequate given the unique challenges and higher costs of providing public services in the territories". The Committee noted that the Expert Panel considered the situation in the territories to be of sufficient urgency and importance that it produced a separate report on the TFF, *Achieving a National Purpose: Improving Territorial Formula Financing and Strengthening Canada's Territories*.

## **B. The Main Issues**

### **1. TFF Program Design**

The Committee agrees with witnesses that there is great potential for economic development in the North and that the territories are on the verge of major change. They also agree that this will not be achieved without significant investment by the federal government. The Committee shares the opinion of many witnesses that the current fiscal arrangements with respect to TFF between the federal government and the territories are inadequate.

The New Framework set a pool of funding legislated to grow at a fixed rate regardless of economic developments in the territories. Beyond what the Committee believes is a very real concern over the current adequacy of TFF, the Committee also agrees with witnesses that the New Framework approach is both flawed and contradictory to the original intentions of the TFF program. Under a fixed growth rate of payments, TFF no longer reflects actual changes in expenditure needs in the territories either as a result of population growth or expenditure growth, as originally formulated. This is of particular concern in Nunavut where the Committee learned that the population is growing by 24.5% annually. As witnesses observed, it also results in a zero-sum approach in which an increase in revenue-raising capacity in one territory results in a reduction their grant and an equivalent increase in the grant for the other two territories. As such,



it does not take into account the very different economic growth rates between the territories. The Committee agrees with the general observation that it is important to implement a program that reflects the very substantial differences among the three territories.

Mr. O'Brien and Mr. Lacroix outlined the Expert Panel's approach to TFF. The Panel recommends replacing the existing fixed pool approach with a formula-driven approach and providing three separate gap-filling grants to each of the territories. The Expert Panel also recommends simplifying the formula and improving economic development incentives by establishing a revenue block which includes seven of the largest revenues sources at a 70 % inclusion rate. In addition, resource revenues should be excluded from the calculation of own-source revenues in the TFF formula. The approach would address concerns with the adequacy of TFF by introducing new expenditures bases which would be adjusted annually by the relative growth in population in the territories, and growth in provincial and local spending. They estimated that the implementation of these recommendations would cost an additional \$60 million in the fiscal year 2007-2008 compared to the payments set out under the New Framework.

**Table 3: Comparison of the Panel's Approach with the New Framework (\$ millions)**

	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Panel's Approach	2,000	2,098	2,203	2,304	2,406	11,011
New Framework	2,000	2,070	2,143	2,218	2,295	10,726
Difference	0	28	60	86	111	285

Source: *Achieving a National Purpose: Improving Territorial Financing and Strengthening Canada's Territories.*

This approach was endorsed by the Minister of Finance of Nunavut in his testimony before the Committee, and by the Premier and Minister of Finance of the Yukon in a written submission. The submission notes that all provincial premiers and Finance Ministers have provided their unanimous support to the realization of those recommendations as soon as possible. The Committee also strongly endorses the Expert Panel's recommendation to establish a new approach to TFF that will support the North's vision of a strong and self-reliant future.

**Recommendation**

Without delay, the government implement the specific recommendations of the Expert Panel on Equalization and Territorial Formula Financing as they relate to the calculation of TFF.

**2. Natural Resources**

In the territories, the authority for natural resource development and management lies with the federal government, including the right to set, administer and collect royalties from those resources. As the Committee learned, each territory is in a vastly different stage of discussions with the federal government regarding resource-revenue sharing. To date, the Yukon is the only territory with an agreement in place; devolution and resource revenue sharing negotiations have not begun in Nunavut.

According to witnesses, much of the potential for self-reliance and sustained economic growth in the territories lies with natural resource development. The Committee agrees with experts that the territories should see a net fiscal benefit from resource development. Excluding resource revenue from the calculation of TFF grants is part of the solution. Under the previous formula, the TFF grant would be reduced as a territory's own-source revenues increased<sup>10</sup>. The Committee also recognises, along with members of both panels, that there are significant costs, both direct and indirect, to resource development and, in the absence of ownership, the returns to resource development should compensate for those losses. Witnesses cited numerous examples where this was not the case under existing revenue-sharing arrangements with the federal government. Mr. Gagné testified that he was struck by the problems caused by the fact the territories do not own their own natural resources. He outlined the Advisory Panel's recommendation: that the federal government accelerate negotiations to conclude agreements with the territories so that they become principal beneficiaries of revenues and royalties derived from these resources. An additional consideration is that each territory has distinct arrangements in regards to their First Nation and Aboriginal peoples. The Committee agrees with the Advisory Panel that these arrangements and any future arrangements must take into account Aboriginal rights, needs and participation.

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<sup>10</sup> Prior to the implementation of the October 2004 New Framework, the calculation of the TFF grant included an Economic Development Incentive adjustment that allowed territories to exclude 20% of the incremental growth in their tax bases from the calculation of their entitlement.

**Recommendation**

The government should bring to an early conclusion devolution and resource revenue sharing negotiations with the territories and make them the principal beneficiaries of those revenues. The negotiations should take into account Aboriginal rights, needs and participation, including Land Claims and Aboriginal self-government arrangements.

**3. Nunavut**

The Committee believes that there are particularly urgent problems in Nunavut that should be addressed as a distinct issue. To put the issues in context, Nunavut's population is dispersed and isolated: 30,000 people live in 26 small, remote communities over an area of two million square kilometres (or about one fifth of Canada's land mass). The Committee heard that there is an urgent need for new housing and infrastructure. As roads are practically non-existent, these communities depend on air and water transportation. Education and health outcomes are the lowest among the three territories. As an example, average life expectancies are as much as 10 years lower and suicide rates 7 times higher in Nunavut compared to national averages.

As the Minister of Finance of Nunavut told the Committee, "Nunavut has been working from a position of disadvantage since its creation. The initial grant to Nunavut was inadequate to meet the most basic needs of the citizens of Nunavut in areas such as housing, health, education and infrastructure". While Nunavut supports the changes to the TFF formula recommended by the Expert Panel, it feels that those changes will not be sufficient to address its needs and to close the existing gap between the level of services provided in Nunavut and the levels in other jurisdictions.

The Committee agrees: it is clear to members that Nunavut urgently needs additional financial support from the Government of Canada, support that should have been anticipated and provided for at the time of Nunavut's creation. The Committee is also struck by the great potential of Nunavut and the determination of its government to promote and help realize it. As the Minister of Finance of Nunavut noted, "We want to increase employment and revenues, and to reduce our dependence on federal transfers...We need to change the dialogue from dependency to increasing self-reliance". The Committee supports the recommendation of the

Advisory Panel, that Nunavut receive extraordinary investment in areas of housing, infrastructure, and economic and social development from the federal government. Notwithstanding, the Committee also agrees with witnesses from both the Expert Panel and the Advisory Panel who concluded that the core TFF program should focus on providing ongoing basic public services in the North and should not be used as a vehicle to address the unique problems in Nunavut.

**Recommendation**

The government provide Nunavut with adequate funding to meet its immediate and extraordinary needs. This funding should be provided through specific federal program transfers rather than through adjustments to the TFF formula, and should be excluded from TFF calculations.

## CONCLUSION

As the Committee heard, the current arrangements for Equalization and TFF are not effective. A major concern is that the size of the Equalization program and its allocation are no longer tied to fiscal disparities among provinces. Similarly, the current approach to TFF is both flawed and contradictory to the original intentions of the program. In addition, there are particularly urgent problems in Nunavut that should be addressed by the federal government outside of the TFF.

The Committee is of the view that a return to a formula-based approach to Equalization and TFF, guided by a clear set of principles, would be a substantial improvement over the current fixed-framework approach. It believes that this would introduce more transparency and accountability in current fiscal arrangements, and help create a more cooperative intergovernmental environment. Based on these principles, it has presented its proposed approach which has the support of a majority of members.



**APPENDIX A:  
List of Recommendations**

1. The federal government should return to a formula-based approach to Equalization guided by a clear set of principles.
2. The federal government return to a 10-province standard in the calculation of entitlements under the Equalization program.
3. The federal government should retain the Representative Tax System approach, but reduce the number of tax bases used to measure provincial fiscal capacity to five: personal income tax, business income tax, property tax, sales tax, and resource revenues. Actual resource revenues should be used. Property taxes should be measured using a stratified market value approach. User fees should not be included.
4. The federal government include 100 percent of natural resource revenues in the measurement of provincial fiscal capacity. No distinction should be made between renewable and non-renewable natural resource revenues.
5. The federal government should not adopt at this time a system of Equalization payments that attempts to adjust entitlements on the basis of needs or costs.
6. The federal government should implement a smoothing mechanism based on 3-year moving averages, lagged two years.
7. Without delay, the government implement the specific recommendations of the Expert Panel on Equalization and Territorial Formula Financing as they relate to the calculation of TFF.
8. The government should bring to an early conclusion devolution and resource revenue sharing negotiations with the territories and make them the principal beneficiaries of those revenues. The negotiations should take into account Aboriginal rights, needs and participation, including Land Claims and Aboriginal self-government arrangements.
9. The government provide Nunavut with adequate funding to meet its immediate and extraordinary needs. This funding should be provided through specific federal program transfers rather than through adjustments to the TFF formula, and should be excluded from TFF calculations.

**APPENDIX B:  
Witnesses**

Tuesday, October 3, 2006

Robin W. Boadway, Professor, Department of Economics, Queen's University

Tuesday, October 17, 2006

Michael Smart, Professor, Department of Economics, University of Toronto

Wednesday, October 18, 2006

*Atlantic Institute for Market Studies:*

Charles Cirtwill, Vice President

Bobby O'Keefe, Policy Analyst

Tuesday, October 24, 2006

Robert Gagné, Professor and Director, Institute of Applied Economics, École des hautes études commerciales

Al O'Brien, Fellow, Institute for Public Economics, University of Alberta

Tuesday, October 31, 2006

Paul M. Boothe, Professor of Economics, Fellow, Institute for Public Economics, University of Alberta

Robert Lacroix, Emeritus Professor, Economics Department, University of Montreal

Wednesday, November 1, 2006

The Honourable David Simailak, M.L.A., Minister of Finance of Nunavut

The Honourable Mitch Murphy, M.L.A., Provincial Treasurer of Prince Edward Island

Robert Vardy, Associate Deputy Minister of Finance of Nunavut

Nigel Burns, Senior Analyst, Federal Fiscal Relations, Government of Prince Edward Island

Tuesday, November 7, 2006

The Honourable Michael Baker, M.L.A., Minister of Finance of Nova Scotia

Vicki Harnish, Deputy Minister, Nova Scotia Finance

Elizabeth A. Cody, Assistant Deputy Minister, Nova Scotia Finance

Tuesday, November 21, 2006

The Honourable Marie Bountrogianni, M.P.P., Minister of Intergovernmental Affairs and Minister Responsible for Democratic Renewal of Ontario