

---

# Federal-provincial financial equalization and the Canadian Constitution

---

D A L Auld

Department of Economics, University of Guelph, Guelph, Ontario N1G 2W1, Canada

L B Eden

Brock University, St Catharines, Ontario L2S 3A1, Canada

Received 5 April 1983; in revised form 23 May 1983

---

**Abstract.** The development of federal-provincial financial equalization in Canada is reviewed in this essay. Also included is a discussion of the 1982-1987 fiscal arrangements; an explanation of two competing philosophies of equalization—fiscal need and fiscal equity; and an exploration of some implications of the 1982 *Constitution Act* for the future of equalization in Canada. It is concluded that the 1982 Act offers substantial support to the narrow-based fiscal equity principle and that future equalization programs in Canada should therefore be similar to current practice.

## 1 Introduction

Unconditional grants from the federal government to the provincial governments have been an important part of the Canadian fiscal system since 1867. The original statutory subsidies at Confederation progressed through several ad hoc adjustments until 1957 when federal-provincial financial equalization became an explicit component of the federal-provincial fiscal agreements. The 1957 formula, which brought the per-capita provincial yield from three standard income taxes up to the yield of the two richest provinces, was later modified, and in 1967 was replaced by a 'representative-tax' approach to equalization, which assessed provincial fiscal capacities on the basis of all major provincial revenue sources. With several modifications (most noteworthy being those to accommodate energy price increases), this approach to equalization persisted until the 1977-1982 arrangements expired<sup>(1)</sup>.

The renegotiation of the *Federal-Provincial Fiscal Arrangements and Established Financing Act* 1982 (Bill C-97), together with the debate on the 1982 *Constitution Act* (Government of Canada, 1982), generated much discussion concerning the philosophy of equalization in Canada, and several proposals for changes in the funding and calculation of these grants<sup>(2)</sup>. However, as Perry (1983, page 47) notes, the negotiations between the federal and provincial governments were "later, briefer, and more acrimonious" and "produced less agreement than in the recent past". The new 1982-1987 equalization formula, which raises per-capita provincial fiscal capacities (defined so as to include all provincial revenues) up to a five-province standard, was passed as Bill C-97 by Parliament, without the unanimous agreement of the provincial governments and with little reference to the analytical, empirical, and political material prepared for the discussions [see Courchene (1983), Dobell (1982), and Simeon (1982) for details of the renegotiations]. On the other hand, all provinces unanimously supported the enshrinement of the principle of equalization in the 1982 *Constitution Act*. Part III.36(2) of the Act now commits the federal government to "making equalization payments to ensure that provincial governments have sufficient revenues to provide

(1) Several excellent summaries of the history of Canadian equalization grants are available [for example, see Boadway (1980), Courchene (1979; 1983), Hunter (1977), and Moore et al (1966)].

(2) For some alternative proposals, see Boadway and Flatters (1982a; 1982b), Courchene and Copplestone (1980), Davenport (1983), Economic Council of Canada (1982), Moore (1981), Powrie (1981), Sewell and Slater (1982), and Task Force (1981).

reasonably comparable levels of public services at reasonably comparable levels of taxation”.

The purpose of this essay is threefold: (1) to review briefly the development of federal-provincial financial equalization in Canada; (2) to outline two competing philosophies of equalization—fiscal need and fiscal equity—and their implications for the equalization formula; and (3) to link the philosophies and practices of equalization with the 1982 *Constitution Act*. We conclude that the Act has several implications for the future of equalization in Canada. First, we interpret the Act as supporting the fiscal equity principle of equalization, that is, it supports a federal commitment to raise provincial per-capita fiscal capacities up to a representative standard. Equalization would therefore continue as unconditional grants to the provincial governments from the federal government, financed out of general federal revenues and based on the representative tax system. Second, because the Act in section 92A gives provincial governments proprietary rights to develop, manage, and price all forestry, nonrenewable natural resources, and electrical energy within provincial borders, the theoretical narrow-based fiscal equity rationale for only partial inclusion of natural resource revenues in the equalization formula is now much stronger. And third, although the Act in subsection 36(1)(c) also commits the federal and provincial governments to provide essential public services to all Canadians, this commitment may be fulfilled, not by equalization, but by fiscal need transfers in the form of equal per-capita Established Programs Financing (EPF) grants to the provincial governments. We argue, therefore, that the long-run implications of the 1982 *Constitution Act* are for an equalization program similar, in many respects, to current practice.

## 2 The development of equalization payments in Canada

As stated above, the new Canadian Constitution calls for the provision of basic public services and the payment of equalization grants to less wealthy provinces.

It took over a century of internal political bargaining to repatriate the Canadian Constitution and just as long to achieve formal political recognition of the concept (and ad hoc use) of equalization payments from the federal government to selected provincial governments<sup>(3)</sup>. Although provisions in the federal-provincial arrangements of 1957 marked the beginning of an explicit equalization scheme, there were, in the latter part of the nineteenth century, special federal grants (over and above those set out in 1874) to provinces to assist them in providing a ‘reasonable’ level of public service<sup>(4)</sup>. This continued into the 1920s, culminating in a series of increases in grants to the Maritime Provinces during the late 1930s as a result of the report of a royal commission (White Commission, 1935). The breakdown in federal-provincial relations combined with the effects of the depression, led to the establishment of one of the more famous of Canada’s royal commissions: the Rowell-Sirois Commission (1939). Its most important recommendation was the establishment of annual payments to

<sup>(3)</sup> The term equalization payments or grants is somewhat of a misnomer—levels of public services are not equal across the provinces, nor are tax burdens. The term is more appropriate in the dynamic sense of grants, that average per-capita tax burdens and services tend towards equality across provinces. What is equalized is the per-capita revenues of provinces receiving equalization with respect to some bench mark, such as national per-capita average revenues.

<sup>(4)</sup> At the founding conferences between 1864 and 1867, the fiscal powers of the federal and provincial governments were clarified and set out in what was to become the 1867 *British North America Act (BNA Act, 1867)*. The federal government was granted unlimited taxing rights, the provinces and municipalities only direct taxation rights. Since the latter form of taxation was extremely unpopular at the time, it was evident that the Fathers of Confederation were anxious to see that provincial and municipal powers were restricted. The small revenues from such sources as fees and licenses were insufficient for the provinces to cover their expenditures, and hence some small subsidies were granted by the federal government to make up the difference.

certain provinces, the less wealthy ones, to ensure that all provinces could provide a reasonable level of public services without the imposition of high taxes. In effect, the Commission was suggesting an equalization scheme, albeit without a very rigorous formula.

Although the recommendations were presented to a conference in 1941, the pressing problem of financing the war took precedence and the Commission's proposals were shelved.

After World War Two, an arrangement was agreed to for five years under which Ottawa and the provinces would share certain tax fields. There was an element of equalization in the scheme, since the payments by Ottawa to the provinces for the 'taxation rights' were based on population and the growth in gross national product (GNP). Thus, although the arrangement helped to equalize rates of change in wealth, it did little to equalize absolute levels of per-capita wealth. The basic arrangement remained in force for the next five years, 1952-1957.

Negotiations for the 1957-1962 financial arrangement laid the groundwork for a new formula-based assistance scheme known as equalization payments. Ottawa proposed unconditional grants to be made to all provinces whose per-capita tax revenue (using a standard tax rate) fell short of that of the two wealthiest provinces. The three standard taxes, personal income, corporate income, and succession duties, would be the base from which the revenues would be calculated, and the payments from Ottawa would 'equalize' per-capita revenue from these sources.

Although there was a good deal of discussion about what proportion of the standard taxes would go to the provinces—and several alternative schemes were put forward—the new federal equalization scheme went ahead as originally suggested, with the grant,  $G$ , to a given province,  $j$ , being calculated as follows:

$$G_j = N_j \left[ \left( \frac{0.10T_w^1 + 0.09T_w^2 + 0.50T_w^3}{N_w} \right) - \left( \frac{0.10T_j^1 + 0.09T_j^2 + 0.50T_j^3}{N_j} \right) \right],$$

where

$T_w^1, T_w^2, T_w^3$  are the average revenues (based on the two wealthiest provinces) from the three standard taxes;

$T_j^1, T_j^2, T_j^3$  are the revenues from each of the standard taxes in province  $j$ ;

$N_w$  is the average population of the two wealthiest provinces;

$N_j$  is the population of province  $j$ .

After the general election in 1957, the new Prime Minister called a conference in late 1957 to discuss an alternative formula to the current fiscal scheme. The view of the Maritimes on equalization was that all provincial and municipal revenues, not just the three standard taxes, should be included in the formula. Manitoba felt that the bench mark for these payments should be the richest province, not the average of the two richest. In the end, the federal government decided to raise by 3% the share of the personal-income tax allocated to the provinces. This increased the revenue generated by the standard taxes and hence the equalization payments.

Major changes were agreed upon for the five-year period commencing in 1962. First, the portion of federal personal-income tax included in the revenue from standard taxes would be 16% for the first year of the agreement, increasing each year until it reached 20% in the fifth year. Second, the bench mark would be the national per-capita average revenue from standard taxes, not the average of the two richest provinces. Third, provincial revenues from resource extraction would be included in the standard tax base. The provinces currently receiving grants were concerned that payments from Ottawa would decline, but were assured that, under the national average formula, "no province shall be worse off than it would be under a continuation of the present equalization formula" (Prime Minister, 1961).

The general election of 1963 saw the Liberals returned to power with plans to restructure the fiscal arrangements. After several federal-provincial conferences, the following changes were made. First, the personal-income tax abatement would be increased by 2% for each of the years 1965 and 1966. In addition, the federal government would abate 75% of estate taxes, although the additional 25% would be included in the overall formula for equalization. Second, equalization would again be made with respect to the average tax revenue for the two richest provinces, *after* a deduction had been made, for each province, equal to one-half of a province's per-capita national resource yield over and above that of the national per-capita average. This adjustment was necessary in Ottawa's view because, without it, Ontario would have been entitled to equalization grants, since Alberta and British Columbia would be the richest provinces.

The revenue equalization grant scheme for the period 1967-1972 incorporated a number of major changes, but the essence of the new scheme is captured in the formula below.

The grant with respect to each of sixteen separate revenue sources was equal to

$$\sum_i T_i^k \left( \frac{N_i}{\sum_i N_i} - \frac{B_i^k}{\sum_i B_i^k} \right),$$

where

$T_i^k$  is the revenue from source  $k$  for province  $i$ ;

$N_i$  is the population of any province  $i$ ; and

$B_i^k$  is the tax base for province  $i$  for the tax revenue from source  $k$ .

In its simplest terms, this formula provided that a province received a positive equalization entitlement for a revenue source if its share of the tax base was less than its share of the population of Canada. If its share of the base exceeded its share of the population, its entitlement was a negative one. The positive and negative entitlements were summed to determine the grant to a province.

The grant to a province would change year by year if its population growth differed from the national average, if its tax base increased (or decreased) faster (slower) than the national average, and if its tax rate was changed. Tax 'effort' by a province is not penalized by this scheme. If a province raises its tax rate, national total revenue from the tax source increases and, if nothing else changes, that province, if it receives equalization, will receive a fraction of every dollar it raises in grants. Notice, however, that other provinces which are grant recipients will also receive increased payments. For example, when Ontario raised its sales tax to 7% in April 1973, payment to those provinces receiving an equalization grant with respect to sales taxes were all increased. [A detailed and necessarily technical analysis of the 1967-1972 equalization formula can be found in Courchene and Beavis (1973).]

The 1972-1977 period called for several new revenue sources to be included in the formula, but the arrangement collapsed in 1974 as a result of the dramatic rise in energy prices. Although Ontario always had a deficiency payment with respect to energy revenues in the previous arrangement, other positive entitlements outweighed this fact. The fourfold rise in oil prices, however, created such a negative entitlement that Ontario would become, in 1974, a 'have-not' province. Ottawa moved unilaterally to prevent this by passing legislation to include only one-third of energy revenue in the equalization formula.

The main focus of the changes in 1977 was directed to resolving the problems created by the accelerating energy prices and by royalties that accrued largely to one province (Alberta). The escalating oil and gas prices meant that the total revenue used to calculate the payments was growing rapidly, as was the fiscal deficiency for

some provinces. The changes embodied in the 1977-1982 arrangements called for one-half of all revenues from nonrenewable resources to be included in the formula. Furthermore, equalization due to resource revenue entitlements could only be, at maximum, one-third of total equalization. In addition to this, the federal government introduced amendments to the *Fiscal Arrangement Act* in late 1978, placing special interpretation on the 'one-third resource limit' that would change Ontario's status. The reinterpretation was that Ontario's entitlement to equalization, because of a 'deficiency' in the resources base, would not be counted as part of the maximum resource equalization revenue that could be distributed to 'have-not' provinces.

On 7 April 1982, the 1977-1982 arrangements were amended by Bill C-97 as the 1982 *Federal-Provincial Fiscal Arrangements and Established Financing Act*. The key change in equalization was the shift from a national average bench mark for fiscal capacity to a representative average standard (RAS) bench mark<sup>(5)</sup>. The RAS is based on the average fiscal capacity of five provinces (British Columbia, Manitoba, Ontario, Quebec, and Saskatchewan), excluding the 'outliers' (Alberta with substantially above, and the Maritimes with substantially below, average fiscal capacities). The formula is still based on a national average tax rate for each revenue source, but the provincial per-capita yield (derived by applying the national average tax rate to the provincial tax base) is compared to the per-capita yield of the RAS. Positive and negative entitlements are summed, and those provinces with aggregate positive entitlements receive equalization. Those with aggregate negative entitlements receive zero equalization, that is, the rich provinces still do not directly contribute to the program.

The list of revenue sources for equalization is extended from twenty-nine to thirty-three, with natural resource revenues added back in full and all local government revenues from sales of goods and services and from property taxes included. The new legislation sets floors (related to the per-capita revenues of each recipient province in relation to the national average) and ceilings (based on the growth rate of GNP) and establishes transitional payments. The override provision that excludes provinces with above-national-average per-capita incomes (that is, Ontario) from receiving equalization is also eliminated.

Because the 1982-1987 equalization formula basically includes all provincial and municipal revenues, it now measures the broadest definition of the representative tax approach. It therefore eliminates some of the arbitrariness of earlier formulas. However, by excluding Alberta from the RAS, the impact on equalization of the tremendous differences in provincial oil and gas revenues is substantially eliminated. Total equalization payments may decline, and Ontario, because its fiscal capacity is above the RAS, is not expected to receive equalization. A somewhat rueful assessment of the effects of Bill C-97 is recorded by Norrie et al (1982, page 293):

"The final word must go to a wonderfully ironic touch in the new legislation which serves as a commentary on the role research has played in this area. Bill C-97, in moving to a five-province standard for calculating base revenues that excludes Alberta, has effectively removed oil and gas revenues from the equalization program. Financial pressure on Ottawa has meant that this most obvious source of fiscal surplus is henceforth simply to be virtually ignored. At the same time, the federal government has managed to increase its share of oil and gas revenues significantly. In a complete reversal of the previous scheme, Ottawa is now collecting oil and gas revenues to help pay for the now higher equalization entitlements arising from the personal and corporate income taxes categories. All this work, and we are not much closer to a theoretically consistent equalization scheme than we were in 1957."

<sup>(5)</sup> This description of the 1982-1987 equalization formula is based largely on Courchene (1983) and Perry (1983).

With this last comment in mind, we now turn to a discussion of the underlying philosophies of equalization, in which we determine the 'theoretically consistent equalization schemes' implied by these philosophies.

### 3 The philosophical basis of equalization

Basically there are two competing philosophies of equalization that emerge when one reviews the economic literature, government documents, and public statements in Canada over the past forty years: fiscal need and fiscal equity. The two philosophies have quite different implications for an optimal equalization program. As a result, and depending on their philosophical viewpoints, Canadian economists have been, and are, sharply divided in their policy recommendations<sup>(6)</sup>. Let us examine each philosophy in turn.

#### 3.1 *The fiscal need philosophy of equalization*

Historically in Canada the fiscal need principle has been associated with the recommendations of the Rowell-Sirois Commission (1939) for a system of national adjustment grants. These grants were to "enable a province to provide adequate services (at the average Canadian standard) without excessive taxation (on the average Canadian basis)" (Rowell-Sirois Commission, 1939, page 84). Their purpose was to correct horizontal fiscal imbalance (that is, the imbalance between expenditure needs and revenue means) among provincial governments. Such an imbalance could arise from differences in costs of providing public services, in fiscal capacities, and in exceptional needs between governments. The Commission, with respect to expenditure needs, wanted to ensure average provincial service levels for education, welfare, and development expenditures, with revenue means to be calculated on the basis of combined provincial and municipal revenues (Courchene, 1983, pages 14-15).

Although these grants were never implemented, the call by politicians and economists for fiscal need transfers continued. For example, the well-known statement by Finance Minister Sharp in 1966, asserting that the purpose of equalization was to "enable each province to provide an adequate level of public services without having to resort to rates of taxation substantially higher than those of other provinces", has been interpreted as supporting the fiscal need principle (Courchene, 1983, pages 37-38). And some economists, in particular Courchene and Copplestone (1980), Moore (1981), and Courchene (1983), have argued that equalization in Canada is based on the fiscal need principle, since expenditure needs are implicitly assumed in the formula to be identical per capita. Courchene and Copplestone (1980, page 21) state that the philosophy underlying equalization is fiscal need, and Courchene (1983, page 1) defines equalization as "payments to provinces in order that they may provide some basic level of public services without unduly high tax rates". This emphasis on 'basic services' without 'unduly high' tax rates implies that equalization should be based on fiscal need.

The equalization formula implied by the fiscal need principle would adjust for differences between provincial governments both in expenditure needs and in revenue means, as is done in the Australian equalization program [on the Australian equalization program, see Burns (1977), Hunter (1980), and Mathews (1974a; 1974b; 1978)]. The principle also implies that if large disparities in revenue-raising capacity emerge between provincial governments (for example, as in Alberta with its oil royalties), without accompanying changes in costs or needs for basic services, these

<sup>(6)</sup> On the fiscal need principle, see Clark (1969), Courchene (1983), Courchene and Copplestone (1980), Hanson (1961), Moore (1981), and Rowell-Sirois Commission (1939). On the fiscal equity principle, see Boadway and Flatters (1982a; 1982b), Economic Council of Canada (1982), Eden (1980; 1983), Graham (1964; 1980), and Sewell and Slater (1982). For similar discussions in a British setting, see Bennett (1983) on the conflicts between individual and territorial equity.

revenues should not affect equalization. Similarly, if such revenues are spent on non-basic services or on above-normal levels of basic services, the revenues should not be included in equalization [see Courchene and Copplestone (1980, page 23), Moore (1981, page 249), and Task Force (1981, pages 164-165)]. Equalization payments would therefore be smaller than those based on fiscal capacity differences alone, since they would be determined by differences in levels of basic services and by unduly large differences in taxes.

### 3.2 *The fiscal equity philosophy of equalization*

Equalization payments can also be justified on fiscal equity grounds, that is, the federal government must intervene to ensure that similarly situated households receive equal fiscal treatment throughout the nation. The fiscal equity principle is an extension of the horizontal equity principle in the economics of taxation literature, which calls for equal treatment by the tax authority of households with (broadly defined) equal incomes. In the context of equalization in a federal system, horizontal equity calls for equal treatment of individuals with similar incomes and tastes in terms of the taxes they pay and the public benefits they receive, regardless of where they reside. If  $X_i$  measures the value of the benefits received in province  $i$  from provincial government expenditures, and  $Y_i$  the provincial taxes paid by a resident in province  $i$ , then  $X_i - Y_i$  measures the fiscal residuum, or net fiscal benefit (NFB $_i$ ), received by a household in province  $i$ . The fiscal equity principle argues that households with similar incomes and tastes should receive similar NFBs. When NFBs differ between provinces, fiscal equity is not achieved.

How do differences in NFBs arise in a federal system? An indication of how this can occur is presented in table 1<sup>(7)</sup>. We assume there are three persons in each province and that the benefits of public goods to each person equals total expenditure on public goods (which equals total tax revenue) divided by the number of persons in the province. Province A is 'richer', in that average income is \$15 000, and, with a tax rate of 20%, the per-capita benefits are \$3000 per individual. In province B, where average income is less (\$10 000), per-capita benefits are only \$2000. Though all persons of the same income in each province will receive the same NFB, if we

**Table 1.** Estimation of net fiscal benefit (NFB) for two provinces and for three individual income levels.

| Income, $I_i$ , of individual $i$ (Canadian \$) | Taxes, $X_i$ (0.2 $I$ ) (Canadian \$) | Per-capita benefits of public goods, $X_i$ (Canadian \$) | NFB $_i$ ( $X_i - Y_i$ ) (Canadian \$) |
|---|---------------------------------------|--|--|
| <i>Province A</i>                               |                                       |  |  |
| 5000  | 1000                                  | 3000   | 2000                                   |
| 10000   | 2000                                  | 3000   | 1000                                   |
| 30000   | 6000                                  | 3000   | -3000                                  |
| <i>Province B</i>                               |                                       |  |  |
| 5000  | 1000                                  | 2000   | 1000                                   |
| 10000   | 2000                                  | 2000   | 0                                      |
| 15000   | 3000                                  | 2000   | -1000                                  |

<sup>(7)</sup> Boadway and Flatters (1982a; 1982b) argue that differences in NFBs can arise from differences in distributionally nonneutral residence-based taxes within provinces and from differences in per-capita source-based taxes and public rents between provinces. For NFB calculations using tables similar to the one in this paper, note that there is also an efficiency argument for equalization [see Boadway and Flatters (1982a) and Slater and Sewell (1982)]. Differences in NFBs induce migration, causing marginal products of labor to vary between provinces. Equalization is seen as improving national efficiency by offsetting NFB differences and thus eliminating fiscally induced migration.

compare two persons with identical income who reside in different provinces, their NFBs are not the same. A household at any income level which lives in a province with a high average tax base (province A in our example) can enjoy more public services for the same tax rate. Similarly, a province with a low tax base must levy a higher tax rate to provide the same level of services. Therefore residents of low tax base-high tax effort provinces receive negative NFBs compared with residents of high tax base-low tax effort provinces. Since the fiscal equity principle requires equalization of NFBs between provinces for identical households, equalization grants are justified to compensate for differences in tax bases and tax efforts, that is, for differences in fiscal capacities, between provinces.

In the classic statement of the application of the fiscal equity principle to the Canadian fiscal system, Graham (1964, page 14) argues that equalization should compensate provinces for "their differences in fiscal capacity in the provision of public services". The fiscal equity principle therefore implies that equalization "should make it possible to provide comparable levels of services with comparable tax burdens for citizens wherever they live" (Graham, 1980, page 45). Differences in fiscal capacities must be equalized if provinces are to achieve fiscal equity. The grants should flow from the federal government to the provincial governments, and they should be unconditional (to protect provincial autonomy). All sources of provincial revenues should be included in the formula and revenues should be equalized up to a representative (preferably national average) standard. Basic service levels and unduly high tax rates have no part to play in the fiscal equity principle, and only those differences in costs related to migration (that is, fiscal externalities) should be included in the formula<sup>(8)</sup>.

Recently, another view of fiscal equity has appeared in the Canadian public finance literature [see Boadway and Flatters (1982b) and Economic Council of Canada (1982)]. This 'narrow-based view' of fiscal equity takes as a starting point household incomes *after* provincial fiscal activities, rather than *before*, as in the traditional 'broad-based' view of fiscal equity. In the narrow-based view two households which are equally well-off after provincial expenditures and taxes should remain so after they pay federal income taxes. In this case fiscal inequity arises only if the federal government defines personal income for federal tax purposes differently from the true income of a household. Since NFB is part of household income, but not part of the definition of federal taxable income, the narrow-based view argues that only differences in NFBs multiplied by the federal average marginal income tax rate should be equalized. That is, the narrow-based view would equalize only 20% to 30% of per-capita source-based taxes and public rents, whereas the traditional view would include all provincial (and municipal) revenues.

<sup>(8)</sup> Costs related to migration should not be included in equalization, since efficiency requires that such costs be included in migration decisions (Boadway and Flatters, 1982b, page 59). Fiscal externalities caused by migration, however, should be included. When a household leaves a province, it may impose a benefit externality on remaining households through a reduction in congestion associated with less use of public goods. There is also a cost externality associated with the move, since the emigrant no longer contributes to public revenues. The opposite effects occur in the receiving province. If these costs and benefits in each province cancel each other out, there are no fiscal externalities. This occurs when the value of congestion imposed on existing residents (from a migrant) just equals the value of the taxes paid by the migrant. It is more plausible that these precise balances will not occur and, in such cases, inefficiencies will occur, because a migrant, in making a decision to move, will only take into account the private gains of a move, not the fiscal externalities. It is therefore argued that, to ensure efficient migration in a federal system, equalization grants should be used to offset differences in fiscal externalities [see Boadway and Flatters (1982a), Buchanan and Goetz (1972), and Eden (1983)].



Boadway and Flatters (1982b) argue that whether one accepts the broad-based or the narrow-based fiscal equity principle depends on one's view of the property rights of provincial citizens. If residents of a province have property rights to the NFBs that accrue to them as residents, then the narrow-based view should apply, and only partial equalization of NFBs is required. Since the 1867 *BNA Act* (1867) gives the provincial governments ownership of their natural resources [see sections 92(5) and 109], only partial equalization of source-based taxes and natural resource revenues would be required. We return to this in our discussion of the 1982 *Constitution Act*.

#### 4 The 1982 *Constitution Act*

We believe that three sections of the 1982 *Constitution Act*, III.36(1), III.36(2), and VI.92A, are of direct importance to the future of equalization in Canada. Each is discussed in turn.

Part III, *Equalization and Regional Disparities*, is broken into two sections. The first section, 36(1), commits Parliament and the provincial legislatures to:

- “(a) promoting equal opportunities for the well-being of Canadians;
- (b) furthering economic development to reduce disparity in opportunities; and
- (c) providing essential public services of reasonable quality to all Canadians”.

We interpret section III.36(1) on regional disparities as endorsing the view that the purpose of equalization is not to reduce regional economic disparities. Several economists [for example, Courchene and Copplestone (1980), Davenport (1983), and Moore (1981)] have argued that the purpose of equalization should be to reduce income inequalities between Canadians. The opposing view [for instance, Boadway and Flatters (1982a; 1982b), Graham (1980), Sewell and Slater (1982), and Task Force (1981)] holds that the purpose of equalization should be to compensate for differences in fiscal capacities caused by income disparities, but not to eliminate such differences. By introducing this separate section in the *Constitution Act*, in addition to the equalization section, Parliament would appear to support the latter view.

In addition, subsection 36(1)(c), committing the governments to provide “essential public services of reasonable quality to all Canadians”, has much of the flavour of the Rowell-Sirois Commission's (1939) recommendation for ensuring average levels of services for education, welfare, and development expenditure (that is, basic public services). Although the Commission recommended unconditional grants to finance these basic services, no such funding arrangement is specified in the 1982 Act. Nor are the essential public services or reasonable quality levels outlined. Unlike in many other federal systems, Canada's ten provinces represent a wide spectrum of political philosophies and interpretations of essential services. Consequently, what might be construed as an essential service of reasonable quality in Quebec or Saskatchewan might not be viewed in the same light in Ontario or Alberta. This possibility suggests that, if the federal government believes that an essential service is not being provided at reasonable quality (for example, using national merit good arguments), the federal government might reason that it should expand or supply such a service. This could place it and one or more provincial governments on a collision course, with recourse to the courts being necessary to settle the dispute. However, we can speculate that equal per-capita grants, along the lines of the 1982-1983 EPF transfers for health and postsecondary education, could satisfy subsection III.36(1)(c) and could also be acceptable to both levels of government. Such grants would contain an element of equalization (since they would be equal per-capita grants), but would clearly be based on fiscal need, that is, on providing basic public services of comparable quality across the nation.

The second section of part III [III.36(2)] enshrines the principle of equalization in the Constitution as:

“III.36(2) Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation”.

The wording of section 36(2) is quite different from that proposed in a 1980 draft (see Courchene, 1983, page 57), and, since it is pertinent to our discussion of the philosophies of equalization, we reproduce the earlier draft here:

“Parliament and the Government of Canada are committed to taking such measures as are appropriate to ensure that provinces are able to provide the essential public services ... without imposing an undue burden of provincial taxation”.

A comparison of the draft and final versions clearly indicates the intentions of the federal and provincial governments with respect to equalization. As Courchene (1983, pages 57–58) notes, the draft version makes no mention of equalization and does not specify that payments must go to the provincial governments or be funded by the federal government. Section III.36(2) mentions all of these things.

For our purposes the most important change is the shift in wording from ‘essential public services’ without ‘undue burdens’ to ‘reasonably comparable’ public services with ‘reasonably comparable’ taxation. We interpret this as a clear shift away from the fiscal need philosophy of equalization, as embodied in the report of the Rowell-Sirois Commission (1939), to the fiscal equity philosophy of equalization, as represented by Graham (1964; 1980) and Task Force (1981). If our interpretation is correct, the implications for the future of equalization are straightforward. Equalization would continue in the form of unconditional revenue equalization grants based on differences in provincial fiscal capacities defined so as to include all provincial and municipal revenue sources. Fiscal capacities would be equalized up to some representative standard. Differences in costs or basic needs would not directly enter the formula. The theoretical rationale for equalization would therefore be fiscal equity, that similarly situated individuals should receive similar fiscal treatment throughout the nation.

As a practical matter, however, we note that section III.36(2) does not guarantee the structure of the equalization grants, nor is the time period of any arrangement specified. Since 1957 the equalization formula has been renegotiated every five years, but nothing in the past history of these arrangements has prevented the federal government from exercising unilateral authority to change the structure or from ‘imposing’ a settlement when intergovernmental consensus was not forthcoming. By excluding any reference to maximum or minimum payments and by not specifying the economic bench mark for making grants, the Constitution implicitly reflects the constantly changing nature of past five-year agreements. Similarly, the term ‘reasonably comparable’ has been defined in the past in terms of equalizing per-capita tax revenues up to that of: (a) the wealthiest two provinces; (b) the wealthiest three provinces; (c) the national average; and, more recently, (d) five specific provinces. Though the federal government clearly has the authority to decide upon the bench mark, the phrase ‘reasonably comparable’ could well be the basis for an appeal by one or more provinces if they felt that this ‘standard’ was not being upheld by the federal government. Such an appeal would obviously challenge the interpretive skills of the Supreme Court, given the varying degrees of equalization in the past agreements.

The section of the 1982 *Constitution Act* that may have a direct impact on the future of equalization is section VI.92A, *Non-Renewable Natural Resources, Forestry Resources, and Electrical Energy*, which is to be added after section 92 of the 1867

*BNA Act* outlining the exclusive powers of the provincial governments. Because section VI.92A is quite long, we paraphrase as follows. With respect to forestry, nonrenewable natural resources, and electrical energy, each provincial government may:

- (1) exclusively make laws relating to exploration, development, conservation, and management, including laws relating to the rate of primary production;
- (2) legislate with respect to exports of primary production from the province, as long as such laws do not discriminate in prices or exported supplies, nor conflict with laws of Parliament (in which case the law of Parliament prevails); and
- (3) raise money from such resources by any mode or system of taxation providing that such taxation does not differentiate between exported and nonexported production.

Although the 1867 *BNA Act* under section 92 does give the provinces exclusive rights to the management and sale of provincial public lands, this right is subject to section 91(2), which gives the regulation of trade and commerce to the federal government. As a result, Paus-Jenssen (1979, page 46) has argued that "while the provinces control the entry to the resources they cannot exercise control over the production, the marketing and the pricing of the resource products if shipped outside the province of origin". The frequent exercising of the trade and commerce power by the Supreme Court led Bushnell (1980, page 317) to conclude that "control over natural resources is passing or indeed has passed to the Dominion through the trade and commerce power". Bushnell argues that only a stronger emphasis in the Constitution of the proprietary rights of the provinces to their natural resources could halt this trend (also see Cairns, 1981). In fact, this is the effect of section VI.92A—to reestablish the provinces' ownership rights to produce, market, price, and tax all natural resources within provincial borders. Note that the 1982 Act allows the provincial governments to levy both direct and indirect taxes on provincial resources, although the 1867 *BNA Act* restricted them to direct taxation. The only restrictions in the new Act are that discrimination is not allowed and that exports of primary production are subject to federal laws (for example, the trade and commerce power).

We therefore argue that the 1982 *Constitution Act* reasserts the proprietary rights of the provinces to their natural resources. As a direct consequence, this strengthens the theoretical arguments for only partial inclusion of natural resource rents in the equalization formula. If provincial residents do have such property rights, and section 92A implies that they do, the narrow-based view of the fiscal equity principle is much stronger (see Economic Council of Canada, 1982). We therefore predict that subsequent equalization arrangements may return to only partial equalization of natural resource rents. These proprietary rights may also have indirect consequences for equalization. If the provinces now use their resources as 'engines of development', regional disparities between the provinces may become more pronounced. Such conflicts between 'province building' and the 'national interest' could raise differences in provincial fiscal capacities (thereby increasing aggregate equalization) and, at the same time, introduce additional disharmony and conflict into future renegotiations.

## 5 Conclusions

In this essay, we reviewed the development of equalization in Canada, explained two competing philosophies of equalization, and explored the implications of the 1982 *Constitution Act* for the future of equalization in Canada. We argued that, historically, two major events shaped the Canadian equalization program: the report of the Rowell-Sirois Commission (1939), based on the fiscal need philosophy, and the 1967-1972 *Federal-Provincial Fiscal Arrangements and Establishment Financing Act*, which introduced the representative tax approach. We also reviewed the

1982-1987 Arrangements. The fiscal equity and fiscal need philosophies and their implications for optimal equalization programs were then developed. And lastly, we concluded that the 1982 *Constitution Act* offers substantial support to the narrow-based view of the fiscal equity principle. As a result, future equalization programs in Canada should be similar, in many respects, to current practice.

**Acknowledgement.** We would like to thank Douglas Clark, Tom Courchene, Paul Davenport, Anthony Scott, and David Sewell for comments on an earlier draft of this paper.

#### References

- Bennett R J, 1983, "Individual and territorial equity" *Geographical Analysis* 15 50-57
- BNA Act, 1867 *British North America Act, 1867* 30-31 Victoria, chapter 3 (Queen's Printer, Ottawa)
- Boadway R W, 1980 *Intergovernmental Transfers in Canada* (Canadian Tax Foundation, Toronto)
- Boadway R W, Flatters F R, 1982a, "Efficiency and equalization payments in a federal system of government: a synthesis and extension of recent results" *The Canadian Journal of Economics* 15 613-633
- Boadway R W, Flatters F R, 1982b *Equalization in a Federal State: An Economic Analysis* (Economic Council of Canada, Ottawa)
- Buchanan J M, 1950, "Federalism and fiscal equity" *American Economic Review* 40 93-109
- Buchanan J M, Goetz C J, 1972, "Efficiency limits of fiscal mobility: an assessment of the Tiebout model" *Journal of Public Economics* 1 25-43
- Burns R M, 1977 *Intergovernmental Fiscal Transfers: Canadian and Australian Experiences* research monograph 22, Centre for Research on Federal Financial Relations (Australian National University Press, Canberra)
- Bushnell S I, 1980, "The control of natural resources through the trade and commerce power and proprietary rights" *Canadian Public Policy—Analyse de Politiques* 6 313-324
- Cairns R D, 1981, "The Constitution as regulation: the case of natural resources" *Canadian Public Policy—Analyse de Politiques* 7 66-74
- Clark D H, 1969 *Fiscal Need and Revenue Equalization Grants* Canadian Tax Paper 49 (Canadian Tax Foundation, Toronto)
- Courchene T J, 1979 *Refinancing the Canadian Federalism: A Survey of the 1977 Fiscal Arrangements Act* (C D Howe Research Institute, Montreal)
- Courchene T J, 1983, "The evolution of equalization payments: the BNA Act to the Constitution Act, 1982" DP-5.10, Institute of Economic Research, Queen's University, Kingston, Ontario
- Courchene T J, Beavis D A, 1973, "Federal-provincial tax equalization: an evaluation" *The Canadian Journal of Economics* 6 483-502
- Courchene T J, Copplestone G H, 1980, "Alternative equalization programs: two-tier systems" in *Fiscal Dimensions of Canadian Federalism* Ed. R M Bird (Canadian Tax Foundation, Toronto) pp 8-44
- Davenport P, 1983, "The Constitution Act and the sharing of wealth in Canada" in *The 1982 Reform of the Canadian Constitution* Eds P Davenport, R Leach (Duke University Press, Durham, NC) (forthcoming)
- Dobell A R, 1982, "Financing confederation: politics and process" *Canadian Public Policy—Analyse de Politiques* 8 303-307
- Economic Council of Canada, 1982 *Financing Confederation Today and Tomorrow* (Supply and Services Canada, Ottawa)
- Eden L B, 1980, "Canadian equalization grants in theory and practice" *Atlantic Canada Economics Association Papers* 9 43-63
- Eden L B, 1983, "Efficiency and equalization payments: some comments" research paper; copy available in mimeograph form from L B Eden, Department of Economics, Brock University, St Catharines, Ontario, Canada
- Federal-Provincial Fiscal Arrangements and Established Financing Act, 1982* House of Commons, 29-30-31 Elizabeth II (Supply and Services Canada, Ottawa) pp 2933-2947
- Government of Canada, 1982 *The Constitution Act, 1982* 29-30-31 Elizabeth II, chapter 94 (Supply and Services Canada, Ottawa)
- Graham J F, 1964, "Fiscal adjustment in a federal country" in *Intergovernmental Fiscal Relations* Canadian Tax Paper 40, Eds J F Graham, A W Johnson, J M Andrews (Canadian Tax Foundation, Toronto) pp 5-34
- Graham J F, 1980, "Comments" in *Fiscal Dimensions of Canadian Federalism* Ed. R M Bird (Canadian Tax Foundation, Toronto) pp 45-51

- 
- Hanson E J, 1961 *Fiscal Needs of the Canadian Province* Canadian Tax Paper 23 (Canadian Tax Foundation, Toronto)
- Hunter J S H, 1977 *Federalism and Fiscal Balance—A Comparative Study* Centre for Research on Fiscal Financial Relations (Australian National University Press, Canberra)
- Hunter J S H, 1980, "Intergovernmental fiscal adjustment in Australia: a review of recent developments in the light of experience in Canada and West Germany" *Finanzarchiv* 38 424-442
- Mathews R L (Ed.), 1974a *Fiscal Equalization in a Federal System* research monograph 4, Centre for Research on Federal Financial Relations (Australian National University Press, Canberra)
- Mathews R L (Ed.), 1974b *Fiscal Federalism: Retrospective and Prospect* research monograph 7, Centre for Research on Federal Financial Relations (Australian National University Press, Canberra)
- Mathews R L, 1978, "Federal balance and economic stability" *Economic Record* 54 170-181
- Moore M, 1981, "Some proposals for adapting federal-provincial financial agreements to current conditions" *Canadian Public Administration* 24 232-256
- Moore M, Perry J H, Beach D I, 1966 *The Financing of Canadian Federalism: The First Hundred Years* Canadian Tax Paper 43 (Canadian Tax Foundation, Toronto)
- Norrie K H, Percy M B, Wilson L S, 1982, "Principles and practices of equalization" *Canadian Public Policy—Analyse de Politiques* 8 290-292
- Paus-Jenssen A, 1979, "Resource taxation and the Supreme Court of Canada: the Cigol Case" *Canadian Public Policy—Analyse de Politiques* 5 45-48
- Perry D B, 1983, "The federal-provincial fiscal arrangements for 1982-87" *Canadian Tax Journal* 31 30-47
- Powrie T L, 1981, "Natural resource revenues and federal-provincial fiscal arrangements" *Canadian Tax Journal* 29 499-502
- Prime Minister, 1961, Statement by the Prime Minister to the Dominion-Provincial Conference, 23 February (PCO Office, Ottawa, Canada)
- Rowell-Sirois Commission, 1939 *Report of the Royal Commission on Dominion and Provincial Relations* Chairmen N W Rowell, J Sirois (Queen's Printer, Ottawa)
- Sewell D O, Slater D W, 1982, "The case for equalization" *Policy Options* 3 issue 3, pp 17-24
- Simeon R, 1982, "Fiscal federalism in Canada: a review essay" *Canadian Tax Journal* 30 41-51
- Task Force, 1981 *Fiscal Federalism in Canada* Parliamentary Task Force on Federal-Provincial Fiscal Agreements (Supply and Services Canada, Ottawa)
- White Commission, 1935 *Report of the Royal Commission on Financial Arrangements Between the Dominion and the Maritime Provinces* Chairman R White (Queen's Printer, Ottawa)