

**Submission to the
Standing Senate Committee on National Finance
in regards to the Equalization Program**

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Mr. Chairman, and Committee members, I welcome the opportunity to appear this evening before the Standing Senate Committee on National Finance on an issue that is of importance to the government of New Brunswick, New Brunswickers, and indeed Canadians as a whole. That issue is equalization. More specifically, I want to address the Equalization Program, and its important role in the federation.

It is encouraging that this Committee recognizes the importance of equalization to the federation, and is undertaking a review of the effectiveness of, and possible improvements to, the present equalization policy, in ensuring that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

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

On September 28, the government of New Brunswick tabled a public discussion paper entitled *Fiscal Imbalance and Equalization: A New Brunswick Perspective*, which I am tabling before you as well. The objective of this paper is to build awareness of the fiscal imbalance that exists within the country, the importance of the Equalization Program in addressing it, and the New Brunswick perspective on these issues. It also provides the basis for my appearance today.

It is important to recognize that, within Canada, both vertical and horizontal fiscal imbalances exist among governments. While my primary purpose today is to address the issue of horizontal fiscal imbalance within the federation, some context on the vertical imbalance is necessary.

Vertical fiscal imbalance exists when the distribution of revenue resources between federal and provincial/territorial governments is inconsistent with the distribution of spending responsibilities. The vertical fiscal imbalance in Canada favors the federal government.

The Canada Health and Social Transfer, or CHST, provides federal support for key provincial social programs including health care, post-secondary education, and social services, and is the primary vehicle in the federation to address vertical fiscal imbalance.

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

provincial program costs have grown considerably over this period, and will continue to do so.

It is expected that the vertical fiscal imbalance will widen in the future. The federal government is expected to realize growing surpluses over time, whereas provinces will be challenged to balance budgets, particularly in light of growing demands on the health care system now and in the future. In the absence of further cash infusions, the federal funding share of provincial expenditures in these key program areas will continue to erode, further diminishing the federal-provincial partnership that has existed since the advent of these key social programs.

Equally important, if not more important, is the fiscal imbalance among provinces. Horizontal fiscal imbalance exists when revenue resources are unevenly distributed among provinces and territories. In the absence of some form of equalization, residents of provinces with relatively low fiscal capacity, or revenue-raising ability, will face higher tax burdens and/or lower levels of public services than residents of provinces with higher revenue-raising ability.

The importance of equalization is underscored by its inclusion in section 36(2) of the Constitution, which states that

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.

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

The Equalization Program is the primary vehicle in the federation to address fiscal imbalance among provinces. It goes to the root of the constitutional commitment. The purpose of the Equalization Program is to raise, to a standard level, the per capita revenue-raising capacity of less affluent provinces, which better enables provinces to provide reasonably comparable levels of public services and taxation to their residents.

In order to have an informed discussion on the Equalization Program and its merits, it is important that certain misconceptions are clarified:

- First, all governments in Canada support the principle of equalization, not just some governments. In fact, all Premiers have called for a strengthening of the Equalization Program as recently as August.
- Second, equalization payments are made out of the federal treasury, to which Canadian taxpayers from all provinces and territories contribute. It is not a transfer from more affluent provinces to less affluent provinces.

- Third, seven provinces receive equalization, not solely the Atlantic Provinces. In the past, all provinces with the exception of Ontario have received equalization.
- Fourth, the primary objective of Equalization is to reduce fiscal disparities among provinces, not economic disparities, although it has undoubtedly contributed to the narrowing of economic disparities as well.
- Fifth, maintaining a competitive tax regime is part and parcel of the federal transfer system. The constitutional commitment refers not only to reasonably comparable levels of public services, but also reasonably comparable levels of taxation.
- Finally, Equalization is not a “disincentive” to economic development. It provides key support by which provincial economies can become more competitive. Governments strive for greater economic growth and self-sufficiency, independent of the Equalization Program.

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

It would not be appropriate for me to appear here today and say that the Equalization Program does not significantly narrow fiscal disparities. It does. Without it, New Brunswick would not have the ability to provide its residents with similar levels of public services and taxation as in other parts of the country. To provide some context of the importance of the Equalization Program to New Brunswick:

- In 2001-02, equalization revenues for New Brunswick are estimated at \$1.2 billion, or 24 percent of budgetary revenues.
- In terms of public service delivery, equalization revenues represent over 90 percent of gross budgetary expenditures for the Department of Health and Wellness, and exceed the cumulative gross budgetary expenditures on education, post-secondary education, and transportation.
- From a revenue perspective, equalization revenues exceed combined personal and corporation income taxes.

In the absence of equalization, New Brunswick residents would receive far less health care, education and other services than Canadians residing in other provinces, and face a considerably higher tax burden.

While Equalization indeed contributes to a narrowing of fiscal disparities, there is considerable debate whether provinces have the ability, after Equalization, to provide reasonably comparable levels of public services and taxation.

In 2001-02, New Brunswick’s per capita fiscal capacity from own-source revenues is \$4,313. After Equalization, New Brunswick’s per capita fiscal capacity is raised to the level of the program standard of \$5,879, as is that of other recipient provinces. This translates into an equalization payment of \$1,566 per capita for New Brunswick. This is

not pocket change. However, is it enough to ensure that the constitutional commitment can be met?

One of the few comprehensive measures is relative fiscal capacity. Despite the narrowing of fiscal disparities that occurs through Equalization, the fact remains that significant disparities in relative fiscal capacity persist, and have been widening in recent years.

After Equalization, New Brunswick's revenue-raising ability, relative to the national average, is only 91 percent in 2001-02. Relative to the more affluent provinces of Ontario, Alberta and British Columbia, it is 87 percent, while relative to Alberta it is only 63 percent.

Less affluent provinces continue to be challenged in providing similar levels of public services, and maintaining tax competitiveness, relative to the most affluent provinces. This has never been as apparent as in today's environment. The personal income tax regimes and general corporation income tax rates adopted by Alberta and Ontario, and Alberta's significant investment into health care in its latest budget, are examples of initiatives that would have considerable cost for a province like New Brunswick to adopt.

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

The Government of New Brunswick strongly believes that the Equalization Program must be improved so that it more adequately levels the playing field among provinces.

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

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

Permanent removal of equalization ceiling

The ceiling on equalization was introduced in 1982-83 as a federal affordability measure. Since its inception, the ceiling has applied in four fiscal years, with a total cost to recipient provinces of \$3 billion. The ceiling has cost New Brunswick close to \$200 million. There is a good possibility that the ceiling will apply for 2000-01 and perhaps future years.

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

In April 2001, five provincial finance ministers, including my colleague, the former New Brunswick finance minister Norman Betts, made representations before the House of Commons Standing Committee on Finance in regards to the equalization ceiling, calling for its removal.

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

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

National Average Standard

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

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

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

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

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

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

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

Comprehensive revenue coverage

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

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

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

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

In closing, I would like to thank the Committee for the opportunity to appear today. The principle of equalization is accepted, and embraced, throughout Canada, and is fundamental in ensuring that Canadians, regardless of where they live, are entitled to relatively comparable levels of public services and taxation.

The Equalization Program provides us a vehicle to address the considerable horizontal fiscal imbalances that continue to persist in the federation. What the Program requires is a strengthening, not a complete overhaul. Removal of the ceiling, adopting a national average standard, and restoring revenue coverage would serve to further reduce fiscal disparities among provinces, and better enable the constitutional commitment to be met.

Thank you.