Todd Hirsch

Reforming Equalization: a simple solution

I admit it. For an economist, I'm an optimist in an industry known for its dismal scientists. I see the glass as half full.

But in one area of Canada's economic landscape, I have become uncharacteristically pessimistic. The federal Equalization Program has gradually sunk into a quagmire from which, it would appear, no workable solution can possibly emerge. Be it myth or reality, the problem of the vertical fiscal imbalance between Ottawa and the provinces has clawed its way onto the prime minister's agenda, and the Equalization Program has somehow become the assumed tool by which to fix it.

Most of the contention among the provinces is focused on two questions. First, should the federal government enrich the Equalization Program? And second, should provincial non-renewable resources of all 10 provinces be included in the formula? The two issues are intertwined.

My pessimism had degenerated to "The glass is completely empty and smashed on the ground — and now a piece is lodged in my foot." That was until a recent conversation I had with Brian Lee Crowley of the Atlantic Institute for Market Studies. Crowley offers a creative solution for dealing with provincial non-renewable resource revenue.

One of the strongest arguments against including resource revenue in the formula is that it is not tax revenue. In their natural form — oil in the ground, nickel ore in the rocks and so on — resources are assets belonging to the people of the province. Collecting royalties on the sale of these assets is simply changing the form of the asset from molecules in the ground to cash in the provincial coffers. Therefore, resource revenue shouldn't be treated like the other provincial taxes in the formula.

Crowley's solution is simple, and adheres to the basic principles of what Equalization is all about. If an equalization-receiving province spends its non-renewable natural resource revenue on ordinary program spending, that money should be counted in that province's fiscal capacity and therefore deducted from its equalization entitlement.

If a province does not receive equalization payments, and it spends its resource revenues on program spending, that money should also count toward its fiscal capacity, and therefore be included in calculating the 10-province standard.

However, if a recipient province treats its resource revenue as a financial asset and uses it to pay off debt, it should not cause its equalization benefits to be clawed back. Similarly, if a non-recipient province uses its natural resource revenue to pay off debt (or invest), it should not be included in calculating the 10-province standard.

For example, if Alberta collects $10 billion in resource revenues, sets aside $7 billion in the Alberta Heritage Savings and Trust Fund and spends the rest on programs, then only $3 billion would be regarded as "revenue" and considered in calculating the 10-province standard.

Consider what this accomplishes. First, it would give the prime minister a nice way out of the dilemma he faces. He would fulfill a campaign promise to include all 10 provinces and non-renewable resources in the 10-province standard — as long as this revenue is used for program spending.

Second, it does something that the current Equalization Program does not — rewards provincial governments for prudent financial management. Paying off debt is encouraged, as is (in the case of debt-free Alberta) setting aside cash in a long-term investment vehicle. The provinces with debt would benefit not only from improved credit ratings, but more importantly from reduced interest payments on their debt. (Note that interest earned on investment funds in Alberta would be counted in the 10-province standard, if this cash flows back into provincial program spending.)

Finally, Crowley's 100 Percent Solution gets back to the true spirit of the Equalization Program: a redistribution of revenues to provide all Canadians with access to a reasonably comparable level of provincial services. If a province treats resource royalties like general revenue, it should be counted like general revenue. If it treats it like a financial asset, it should *not* be counted like general revenue.

Sadly, I don't give it much chance. Economically, it's spot on. Politically, it's doomed. Which makes me think: perhaps it is the political scientists who are the *real* dismal scientists.

Equalization-receiving provinces that do not have vast marketable non-renewable resources — particularly Manitoba and Quebec, but also PEI and New Brunswick — would without question oppose this plan because there is limited financial upside for them. Because they have very few mineral resources, their chances to shelter revenue by paying off debt are minimal. Worse yet, their entitlements under Equalization would depend heavily on decisions made in Alberta as to how much resource revenue it sets aside as investment.

Perhaps Manitoba and Quebec could be brought onside if we started to factor in a major natural resource endowment that is, so far, excluded from the Equalization calculations: hydroelectricity resources. But that is a whole other column to be dismal about.

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