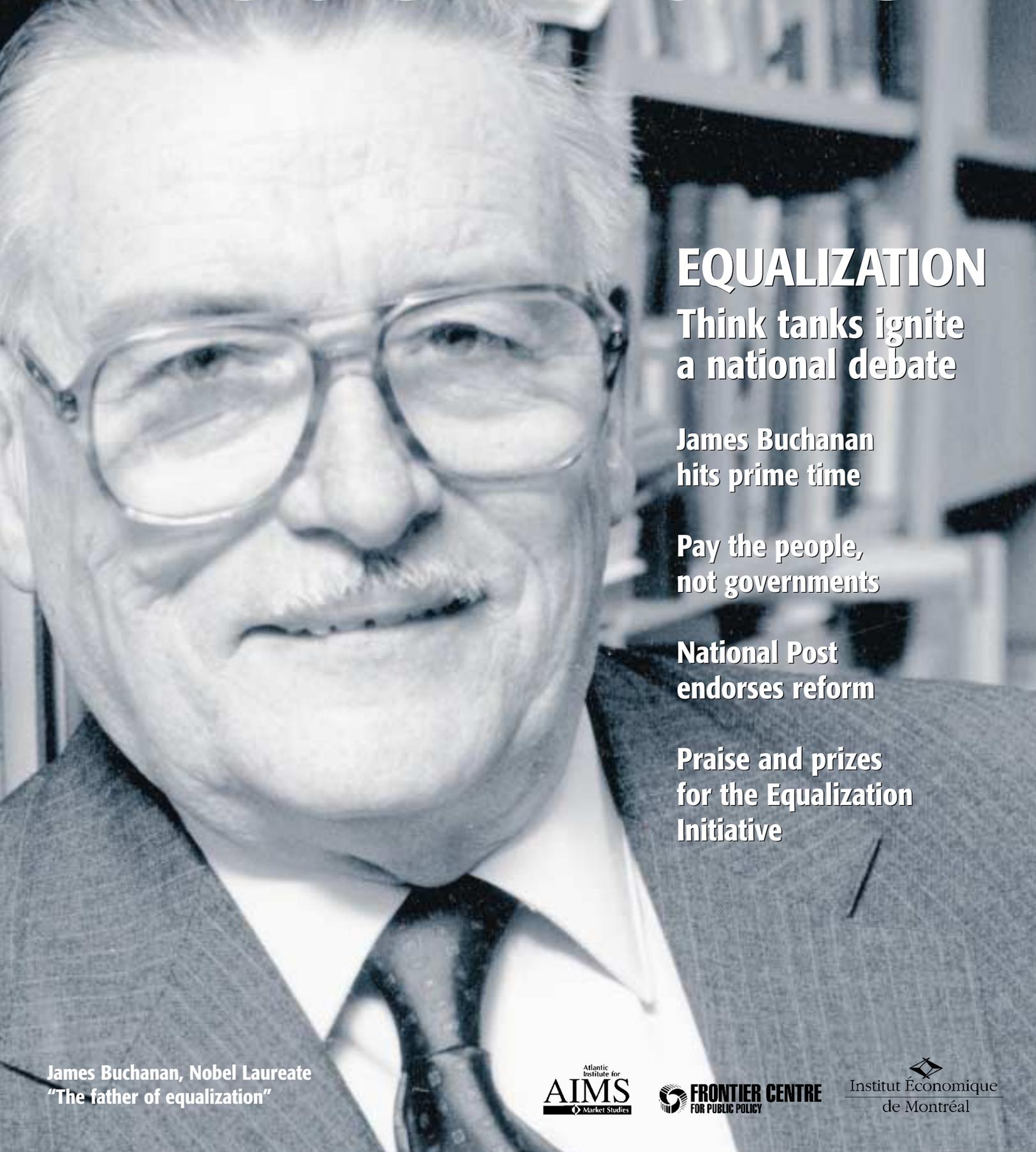


ideas matter



EQUALIZATION

**Think tanks ignite
a national debate**

**James Buchanan
hits prime time**

**Pay the people,
not governments**

**National Post
endorses reform**

**Praise and prizes
for the Equalization
Initiative**

**James Buchanan, Nobel Laureate
"The father of equalization"**

Atlantic
Institute for
AIMS
Market Studies

FRONTIER CENTRE
FOR PUBLIC POLICY


Institut Économique
de Montréal

The Equalization Initiative garners praise and prizes

For the third time in six years, AIMS has been awarded the prestigious Sir Antony Fisher International Memorial Award in the innovative projects category for its equalization initiative. Two aspects of the project merited the award: the broad range of means used to carry out the work, and the collaborative nature of the initiative.

According to the judges, "The institute [AIMS], along with the Frontier Centre for Public Policy and the Montreal Economic Institute, launched this broad-based initiative to illustrate the costs and consequences of 'equalization' – a Canadian federal programme of income transfer from wealthy to poor provinces. In addition to the standard production of opinion-editorials, research papers and media interviews, the institutes invited American Nobel Laureate James Buchanan to help elevate their efforts to a national



Michel Kelly-Gagnon, Montreal Economic Institute; Brian Lee Crowley, AIMS; Alex Chafuen, president and CEO of Atlas Economic Research Foundation; Peter Holle, Frontier Centre; Linda Whetstone, president, Atlas UK, and daughter of the founder Sir Antony Fisher

level through a co-ordinated programme of lectures and interviews."

The panel of judges for the Fisher Award includes a number of distinguished international economists and public policy figures, including Don Boudreaux, former head of the Foundation for Economic Education in New York; former New Zealand cabinet minister and High Commissioner to Canada, Maurice McTigue; Carl-Johan Westholm of the Mont Pelerin Society, Stockholm; Christian Watrin of the Hayek Institute, Cologne, Germany; and Alex Chafuen, president of the Atlas Economic Research Foundation.

"While AIMS, as the lead institute and the one that got the Equalization Initiative off the ground, was the official recipient of this award, the magnificent collaboration of our partners, the Frontier Centre and the Montreal Economic Institute, was essential in getting and sustaining the significant national attention that this project received," says AIMS president Brian Lee Crowley. "They are every bit as much recipients of this award as AIMS. Together, the three institutes represent all of the equalization-receiving provinces, contributing greatly to the credibility of the argument that equalization poses significant obstacles to the economic progress of the less well-off provinces within Canada."

More than 100 institutes in more than 40 countries were eligible for the award; AIMS competed against 15 other institutes this year. The awards commemorate the life and work of Sir Antony Fisher, a founder of the Institute for Economic Affairs in London and the Atlas Economic Research Foundation. ■

Contents

- 3** Why the Equalization Initiative?
- 4** Equalization: What is it?
- 5** L'IEDM et AIMS lancent le débat sur la péréquation au Québec
- 6** Chronology of events
- 7** Why natural resources don't belong in equalization
- 9** Equalization hits prime time: CPAC-TV interviews Nobel Laureate James Buchanan
- 10** What the national media has had to say
- 11** Something has to change: Peter Holle in conversation with James Buchanan
- 12** Pay the people, not governments
- 13** Paul Martin's endorsement
- 14** A better way to help the have-nots
- 15** Frank McKenna's take on equalization

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Why the Equalization Initiative?

The three institute heads tell their story

Equalization is not a simple helping hand. It is rife with perverse incentives similar to those that plague low-income individuals caught in the “welfare trap.” It rewards poorer provinces for forgoing local revenue, instead making them reliant on taxpayers in other parts of the country. It also frustrates democratic accountability: voters and politicians can make spending decisions knowing they will not have to bear the full consequences of those decisions.

The \$10.5-billion programme is one of the federal government’s largest, but because it is highly technical in nature and is always presented as a requirement of an equitable country, there has been little debate about its true impact on the poorer regions of the country. What criticism there has been has come almost exclusively from wealthier parts of Canada concerned about the cost. This is traditionally dismissed as sour grapes by the powerful interest groups that have coalesced around the equalization programme: public sector unions, provincial and federal politicians from the poorer regions, and others dependent on provincial programmes heavily subsidized by equalization. Virtually no one analysed equalization from the point of view of how it might trap poorer jurisdictions in dependence and actually act as a barrier to their escaping poverty and becoming able to pay their own way.

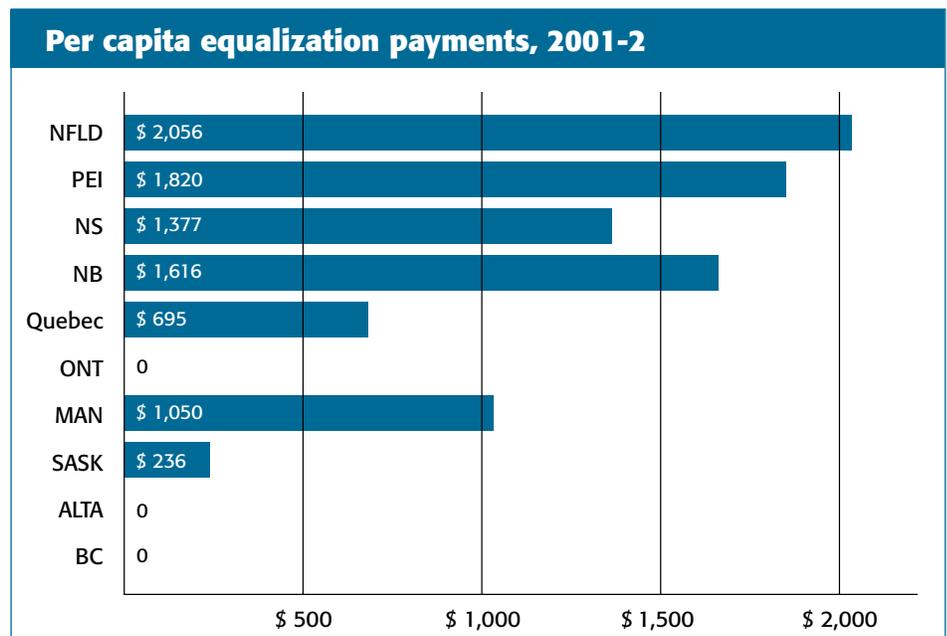
When AIMS launched its equalization initiative, our objective was to trigger a broad national debate, to persuade people to focus on this seemingly arcane system of

transfers and to begin to question conventional wisdom. We were delighted to be joined in this initiative by two other institutes – the Frontier Centre for Public Policy in Winnipeg and the Montreal Economic Institute. Representing as we do all the equalization-receiving provinces, we were able to transform this from a regional to a national issue, and to establish the three institutes as a new source of fresh policy thinking by allowing each organisation to play to its strengths.

AIMS began in early 2000 by highlighting the impact of equalization on a major potential economic development, the rich Voisey’s Bay mineral deposit in Canada’s

poorest province, Newfoundland. With more than 90% of any revenue from mineral royalties going to Ottawa anyway under the equalization programme, Newfoundland had little incentive to agree to economically sensible development. And holding out for a job-maximizing strategy was very popular politically. AIMS’ perspective gave rise to a series of op-ed pieces in the national press and the successful linking in the minds of the public and policy makers of equalization and perverse incentives discouraging prosperity.

AIMS followed up in May with two major papers: an analysis of equalization’s impact over the 40 years of its operation, and one showing how equalization was retarding



Source: Department of Finance & C.D. Howe Institute.

Equalization: What is it?

Since the tax base is unevenly distributed across the country, people living in less-developed provinces can't as easily finance public services, including health care, educational services and welfare. To avoid unacceptable disparities, the federal government invented equalization. Launched in 1957 and placed in the Canadian Constitution in 1982, the programme helps fund services in the less well-off provinces, without the need to tax residents excessively. In the Atlantic provinces, for example, close to 25% of provincial budgets are funded by these payments. Federal taxpayers from across the country contribute to these payments, which go to provinces with below-average tax bases.

the development of the offshore oil and gas potential of Canada's poorest region. Media take-up on this was impressive, with supportive stories and editorials appearing in the *National Post*, *Calgary Herald*, *Canadian Business* magazine and *Maclean's*.

We had clearly succeeded in getting this on the public agenda, so much so that the president of AIMS was invited to a special dinner meeting in Montreal with Canada's powerful finance minister, Paul Martin, to discuss these issues in detail.

To spread awareness of the debate, we created a much-visited special page on the AIMS website dealing exclusively with equalization issues. We also featured our equalization work in our bi-monthly e-mail newsletter, which reaches well over 10,000 Canadians.

The next stage arose as the result of an initiative taken by the Montreal Economic Institute. The MEI's executive director, Michel Kelly-Gagnon, had invited Nobel Laureate James Buchanan to speak at a luncheon in Montreal. The topic was Buchanan's reflections on equalization programmes; he is widely regarded as one of the fathers of this concept, having pioneered it in his doctoral work at the University of Chicago.

A magnificent opportunity was born. The MEI, AIMS and the Frontier Centre for Public Policy (FCPP) in Winnipeg, headed by Peter Holle, used the draw of Professor Buchanan to create a platform for the institutes collaboratively to push forward the work on the damaging effects of equalization.

Together the three institutes built the

event into a national one. We laid on a morning of panels of national experts discussing equalization issues, followed by a sell-out luncheon with Professor Buchanan. The audience included officials from federal and provincial finance, intergovernmental affairs and cabinet office departments; key provincial and federal politicians, including the opposition finance critic in Quebec's National Assembly, and three members of the federal parliament; think tanks and lobby groups, such as the Institute for Research on Public Policy, the Cato Institute and the Canadian Taxpayers Federation; business leaders, academics and students.

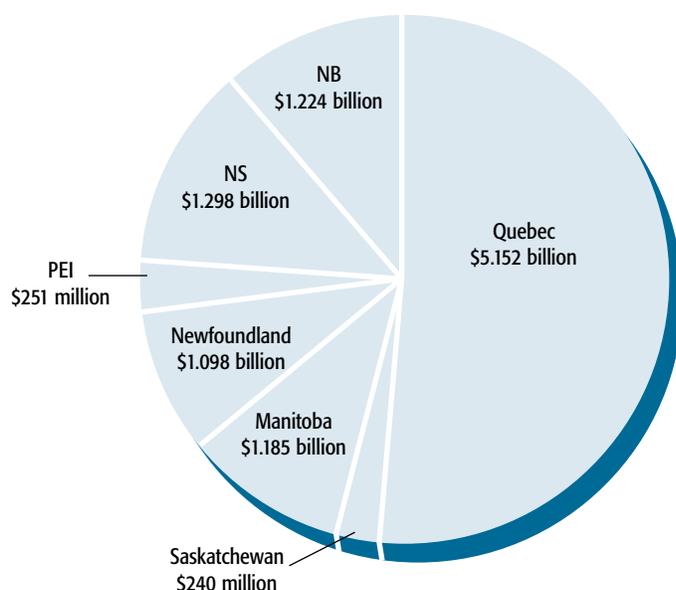
The national print and electronic media covered Professor Buchanan's talk extensively. Peter Holle's interview with him was posted on each institute's website. Crowley, Kelly-Gagnon and Holle then took the essence of that interview and developed it into a major op-ed about complete reform of equalization to pay the people, not governments, and this too was published in the *National Post*.

At a recent speech in Halifax, the minister of finance, Paul Martin, expressed sympathy with the idea of turning many of these inter-governmental transfers into tax reductions, as we had suggested, and the *National Post* wrote a very favourable editorial linking that suggestion with the groundbreaking work our three institutes had been doing on equalization. FCPP recently sponsored events with both Finance Minister Paul Martin and former New Brunswick Premier Frank McKenna where both men expressed considerable sympathy with the idea of reforming equalization to remove its perverse effects.

Our broad communications strategy and collaborative approach allowed AIMS, MEI and FCPP to create a project of national scope and importance that generated a national debate on a vital but hitherto neglected and little understood piece of poorly designed public policy. It was for these reasons that the Atlas Economic Research Foundation honoured our Equalization Initiative with the prestigious 2002 Sir Antony Fisher International Memorial Award, Innovative Projects category. More than 100 institutes in more than 40 countries are eligible for these awards, which recognise excellence in public policy think tank work. ■

Provincial equalization payments, 2001-2

(Canada \$10.5 billion)



Source: Department of Finance & C.D. Howe Institute.

LE DEVOIR

L'IEDM et AIMS lancent le débat sur la péréquation au Québec*

Par Brian Lee Crowley et Michel Kelly-Gagnon

Bernard Landry a raison de se plaindre de la façon inéquitable dont le Canada traite le Québec mais les raisons qu'il cite ne pourraient être plus fausses.

Récemment, le nouveau premier ministre du Québec se débattait comme un diable dans l'eau bénite pour expliquer comment une nouvelle somme de péréquation de 1,5 milliard n'était qu'un autre affront à l'orgueil de la province. Le Québec, a-t-il soutenu, est une région pauvre à l'intérieur d'un pays riche, mais l'indépendance en ferait rapidement une nation prospère. La péréquation, selon lui, ne ferait que quantifier la perte que subit le Québec à l'intérieur du régime fédéral.

Le message sous-entendu est que le Québec possède la bonne recette pour faire bouillonner l'économie mais que les assaisonnements excessifs des marmitons d'Ottawa gâtent la sauce. Le secret de cette recette, celle du fameux Québec inc., n'est rien d'autre que le contrôle de l'économie par une poignée de sociétés d'État et d'entreprises privilégiées. Le rôle de l'État québécois, chef de cette curieuse cuisine, est de tout contrôler par le biais de subventions, d'une réglementation écrasante et d'un régime fiscal manipulateur. Québec veut ainsi substituer son jugement à celui des investisseurs et des gens d'affaires lorsque vient le temps de décider du mouvement des capitaux et de l'emploi.

Le problème du Québec, en fait, ne tient ni au fédéralisme ni à la souveraineté mais plutôt à l'échec profond de cette recette économique. L'approche Québec inc. serait

impossible à maintenir si Ottawa ne comblait pas le manque à gagner que produisent les politiques de la province. La vraie faute du fédéralisme, c'est d'empêcher les Québécois de réaliser le coût de leurs politiques provinciales en les occultant sous le rideau des transferts fiscaux d'Ottawa.

Il convient ici de rappeler l'histoire récente: la montée du nationalisme québécois a contribué à une redéfinition du rôle de l'État, tant fédéral que provincial. Ottawa et Québec se livrent depuis à une surenchère pour gagner les faveurs politiques des Québécois francophones. La pluie de subventions qui s'est ensuivie a modifié de façon insidieuse la relation entre les secteurs privé et public.

L'interventionnisme de l'État a aussi été encouragé, dans d'autres parties du Canada, par tout un pan de la classe politique qui a souscrit aux idées sociales-démocrates ou qui les a empruntées. Ces idées ont été représentées, à l'ouest, par le NPD et, à l'est, par les ailes gauche et pragmatiste des deux grands partis traditionnels. On ne manquera pas de noter que l'État-providence a reçu sa consécration dans la mythologie nationale sous le règne de Pierre Elliott Trudeau.

Cherchant à s'assurer l'affection des électeurs, Ottawa et Québec sont devenus beaucoup plus interventionnistes. Comme le relate Jean-Luc Migué dans son bouquin *Étatisme et déclin du Québec*, publié l'an dernier, les politiciens se sont mis à voir les dépenses publiques d'un bon oeil, non pas en raison des avantages réels qu'elles rappor-

taient à la société mais plutôt à cause de la dépendance politique qu'elles créaient. Au Québec, le secteur privé, jadis dirigé en majeure partie par des anglophones, a perdu de son importance et de son prestige aux yeux des gouvernants provinciaux, plus entichés de leurs institutions publiques, contrôlées par une majorité francophone. Il est spécialement intéressant de noter que la péréquation a mis d'importantes ressources entre les mains de l'État québécois, en grande partie aux dépens des contribuables des provinces de l'Ontario et de l'Ouest en général. Et plus le secteur privé québécois déclinait, plus les transferts augmentaient, contribuant à l'aggravation du problème.

Déjà, pendant les années 70, les analystes soulignaient que la péréquation, par exemple, déchargeait le Québec du coût de ses politiques destructrices, notamment son salaire minimum, nuisible à la compétitivité mais politiquement rentable. On peut faire le même commentaire à propos du fardeau fiscal éreintant qui chassait les entreprises et les hauts salariés.

Par voie de conséquence, l'État québécois a de plus en plus accaparé les décisions économiques à l'intérieur de la province. Récemment, il s'est mis à distribuer des subsides à la volée pour tenter de séduire les investisseurs. Bref, les politiciens québécois utilisent l'argent des contribuables d'autres provinces pour dédommager les entreprises lésées par le contexte économique peu attrayant que créent les politiques dirigistes du Québec. Selon des recherches de

l'Atlantic Institute for Market Studies, l'État québécois a distribué, en 1998, la somme incroyable de 3,18 milliards en subventions aux entreprises, tandis que les subsides versés par les neuf autres gouvernements provinciaux combinés ne représentaient que 2,2 milliards. Et comme le savent si bien les citoyens de Shawinigan, Ottawa y va aussi de ses propres subventions: les subsides fédéraux et provinciaux par employé du secteur privé au Québec dépassent ainsi la moyenne canadienne par une marge de 75 %.

Le meilleur moyen
d'assurer un avenir
plus prospère à la
Belle Province n'est
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l'État tout court

Les provinces de l'Atlantique ont subi de lourds dommages indirects découlant de cette surenchère de la taxation et des dépenses entre Ottawa et Québec. L'État fédéral, en effet, est tenu d'appliquer ses programmes à l'ensemble du pays. C'est ainsi que les programmes de développement régional, transferts fiscaux et autres béquilles économiques, qui ont amené l'économie québécoise à boitiller, ont aussi eu pour effet de paralyser l'économie des provinces maritimes. Cela n'a pas empêché une partie de la classe politique de ces provinces de jouer aux pères Noël alors que les subventions ne faisaient que miner l'é-

conomie atlantique. Les transferts fiscaux massifs n'ont fait que reporter le jour fatidique où nous devons faire face aux douloureuses solutions alternatives nécessaires à la création d'un contexte économique propice à l'investissement et à la productivité. Notre message à Bernard Landry: si l'État tentaculaire pouvait réellement régler nos problèmes, ceux-ci auraient été résolus il y a belle lurette.

Et que retirent les Québécois de ces décennies de surenchère destinée à gagner leurs faveurs politiques? Selon des recherches récentes de l'Institut économique de Montréal, une économie perd 1 % de son potentiel de croissance, chaque année, chaque fois que les dépenses publiques augmentent de 10 %. Partant de là, l'Institut économique de Montréal estime que le produit intérieur brut du Québec, en 1998, aurait été supérieur de près de la moitié - c'est-à-dire qu'il aurait atteint près de 50 000 \$ de plus pour une famille de quatre personnes! - si les dépenses publiques d'Ottawa et de Québec étaient restées au niveau de 1971 par rapport à l'ensemble de l'économie.

Bernard Landry aime bien citer comme modèle le miracle économique de l'Irlande, un petit pays souverain qui connaît, depuis quelques années, une croissance phénoménale. Malheureusement, comme le démontre l'économiste Fred McMahon dans son ouvrage *Road to Growth*, le Québec est loin de suivre l'exemple de l'île verte. Ainsi, entre 1987 et 1989, l'Irlande a ramené le niveau des dépenses publiques en deçà de 40 % du produit national brut - alors qu'il était auparavant de 50 % - et a réduit le fardeau fiscal à moins d'un tiers du PNB au lieu des 40 % antérieurs. Ces décisions ont marqué le début d'une prodigieuse renaissance économique.

Le cas de l'Irlande démontre que les Québécois ont entre leurs mains l'avenir de leur économie. Le meilleur moyen d'assurer un avenir plus prospère à la Belle Province n'est pas de la rendre indépendante d'Ottawa mais plutôt de la rendre indépendante de l'État tout court, le provincial comme le fédéral. Le même message peut très bien s'appliquer à l'ensemble du Canada. ■

*Cet article est paru sous le titre "Comment le Canada traite le Québec: Landry se plaint pour les mauvaises raisons" dans *Le Devoir* le 15 mars 2001.

2000

Jan. 11 – CBC-TV and Radio include AIMS' perspective in their coverage of Voisey's Bay.

Jan. 18 – An AIMS op-ed entitled "Silent partner in Voisey's Bay" appears in *The Globe & Mail*.

Oct. 31 – AIMS president Brian Lee Crowley's major op-ed, "The Impossible Game," appears in *The Globe & Mail*.

2001

March 15 Michel Kelly-Gagnon, executive director of the Montreal Economic Institute (MEI), and Crowley publish articles in *Le Devoir* and *The Globe & Mail* about the effects of equalization payments on Quebec.

May 29 AIMS releases two major papers on equalization.

May 31 Crowley and AIMS author Ken Boessenkool's op-ed appears in the *National Post*.

June 21 – A *Calgary Herald* editorial endorses the conclusions of the AIMS paper "Taking off the Shackles."

June 30 – *National Post* continues the equalization debate with a column by William Watson.

July 9 – *Canadian Business* magazine writes about the equalization debate, as does *Macleod's*.

July 23 – In a *National Post* op-ed AIMS argues that Ontario Premier Mike Harris should support equalization reform that ends asset seizure and rewards provinces for resource development.

Aug. 14 – The *Daily News* in Halifax publishes a piece by Money editor John Macleod that encourages people to review AIMS' studies on equalization.

Oct. 24 – AIMS author Boessenkool addresses the Senate on equalization.

Oct. 25 – The MEI, AIMS and the Frontier Centre for Public Policy (FCPP) host "Equalization: Welfare Trap or Helping Hand?" at which Nobel Laureate James Buchanan presents his latest views on equalization.

Oct. 26-27 – National media coverage for the Montreal event, with articles appearing in the *Montreal Gazette* and the *National Post*.

Nov.-Dec. – *The Taxpayer* magazine publishes a major piece by Crowley on equalization.

Dec. 21 – Finance Minister Paul Martin endorses the essence of the equalization policy proposal advanced by the heads of AIMS, MEI and FCPP.

2002

March 19 – Newfoundland Premier Roger Grimes announces a Royal Commission on Renewing and Strengthening Our Place in Canada; equalization reform is on the agenda.

April 15 – AIMS wins the prestigious Sir Antony Fisher Memorial Prize, for the third time, this year for its Equalization Initiative, carried out with the collaboration of MEI and FCPP.

April 25 – AIMS, MEI and FCPP jointly publish a series of papers by Canada's leading authorities on equalization.

April 25 – FCPP interviews Frank McKenna, former premier of New Brunswick.

May 1 – FCPP issues "Equalization's good intentions are not enough," in its Fax from the Frontier

June – AIMS releases Ken Boessenkool's "Taxing Incentives: How Equalization Distorts Tax Policy in Recipient Provinces"

Why natural resources don't belong in equalization

Love and marriage may go together, but as AIMS author Ken Boessenkool argued before the Senate, equalization and natural resource revenues are a bad match

The time has never been better for the Atlantic provinces to become masters of their own fate. The picture is positive for the newly emerging offshore oil and gas industry in Atlantic Canada. Within a few years, Newfoundland is projected to be producing approximately 40% of Canada's conventional oil, while a natural gas pipeline, possibly the first of several, already connects Nova Scotia with New England. It appears that offshore and onshore petroleum resources may be discovered in or around virtually every province in the region, which creates the conditions in which economic growth in the region could well outstrip that of the rest of the country.

Unfortunately, because of the treatment of natural resources in equalization, the potential for growth, and realizing that potential, are two different things. To address this problem I have recently proposed that nonrenewable resources be removed from the equalization programme; my top 10 reasons are...

1 Resource revenues have been nothing but trouble for the equalization programme

When equalization was created in 1956, resource revenues weren't included. In 1962, half of resource revenues were added, and for the next 20 years, particularly during the 1970s' OPEC crisis, Ottawa fiddled with its treatment eight times. Then in 1982 it moved

to the current five-province standard, excluding Alberta and hence its resource revenues from the calculation of payments to recipient provinces. It also excluded the Atlantic provinces. More recently, Ottawa has tinkered with the resource formula to try to reduce its disincentive effects and has also initiated a number of cash transfers into the Atlantic region, such as Hibernia and various development funds, to offset the impact of falling equalization payments as resource royalties grew. Of all the problems with equalization, the treatment of resources has been the most persistent.

2 Removing nonrenewable resources would vastly simplify the programme

Of the 33 revenue bases used in the equalization formula, 11 are directly related to nonrenewable resources, 10 of those to oil and gas. The 11th category is other mineral resource revenues. Eliminating these tax bases from the formula would vastly simplify equalization, eliminating the number of tax bases by one third.

3 Having nonrenewable resources in equalization produces perverse incentives

Equalization payments can punish recipients for responsible development of nonrenewable resources. To wit: any increase in rev-

enue from those resources is taxed back from a province's equalization entitlement by as much as 100%. As a result, recipient provinces have little incentive to reduce their reliance on equalization in favour of developing provincial resources.

4 Having nonrenewable resources in the formula causes fiscal problems for Ottawa

Volatile oil and gas prices have produced large potential swings in the cost of the equalization programme. When oil prices spiked during the 1970s, including Alberta's resource revenues in the formula skewed the numbers so much that Ontario, the province with the highest per capita income, became an equalization recipient. Currently, Ottawa excludes Alberta (and the Atlantic provinces) from the calculation of equalization entitlements to get around this problem. But that means that the programme does not properly reflect the fiscal capacity of all provinces.

5 Having resource revenues in equalization is arguably unconstitutional

The Constitution puts ownership of and legislative power over nonrenewable resources with the provinces. Although offshore resources legally belong to the federal government, Ottawa has granted *de facto* ownership to Nova Scotia and Newfoundland by

allowing them to collect royalties on oil and gas off their respective coasts. Dan Usher, emeritus professor of economics, Queen's University, has put it this way: the Constitution gives the provinces ownership of the tree as well as entitlement to its fruit. Ottawa therefore has questionable jurisdiction when it comes to redistributing these resources across the country through equalization.

6 **Having nonrenewable resources in equalization does not make economic sense**

Nonrenewable resource royalties are fundamentally different from other types of revenues, but equalization does not make the distinction between income and the proceeds from the sale of a capital asset. It treats royalty revenues the same as it treats personal, corporate and sales taxes. Equalization payments fall in response to changes in royalties even though all the province has done is convert a physical asset – oil, natural gas – into a financial asset.

7 **The equalization formula double counts the fiscal capacity from resources**

Higher wages and housing prices reflect the additional fiscal capacity that results from the discovery and exploitation of nonrenewable resources. And since tax bases such as personal income and housing stock are included in the equalization formula, natural resource revenues do not need to be.

8 **Removing resources would allow the programme to reflect each province's fiscal capacity**

If nonrenewable resources were removed, Alberta as well as the Atlantic provinces could be brought back into the equalization formula. A 10-province standard would be truer to the spirit of the Constitution than the five-province standard.

9 **Removing nonrenewable resources would mean very small adjustments for recipients**

Had my proposal been in place, what would it have meant for recipient provinces in 1999/2000? The total dollar reduction in all

Equalization payments can punish recipients for responsible development of nonrenewable resources, giving them little incentive to reduce reliance on equalization in favour of developing resources

provinces would have been modest – 1% or less in all cases. From Ottawa's perspective, the total cost of the programme would have dropped by a modest \$33 million.

10 **The politics of the proposal look good**

The equalization programme is subject to quinquennial reviews, during which all the provinces and Ottawa look at the programme, make any agreed-on changes, and ratify equalization for another five years. Removing nonrenewable resources from the equalization formula would likely receive support from both ends of the country: Newfoundland, Nova Scotia, and the western provinces have an obvious interest in any move that would result in the provinces having greater autonomy over their natural resources. The impact on Ontario would be minimal, making it unlikely to oppose change. A bigger hurdle might be gaining the approval of Quebec, New Brunswick and Prince Edward Island, which would face reductions under the new formula without the compensation of greater ability to tax existing developments of nonrenewable resources. Consider, however, the pull of four counterweights.

1. The changes would represent only 1% of provincial revenues.

2. For every province (except PEI), the payments would still be larger than what was received only two years ago.

3. The decrease from the status quo would be smaller than the recent increase due to the lifting of the \$10 billion equalization caps.

4. It is now widely accepted that the St. Lawrence basin is one of North America's last remaining major hydrocarbon-bearing basins. Quebec, New Brunswick and Prince Edward Island are all clamouring to negotiate offshore agreements with Ottawa in case oil and gas are found within "their" waters, and onshore drilling is going on in New Brunswick. The whole eastern end of the country may soon be seeing important oil and gas revenues.

If these counterweights are not enough, Ottawa could offer a transition mechanism, with Ottawa guaranteeing payments at the old level until the new formula caught up to those amounts.

Given support from the east and west and no or mild resistance from the centre, Ottawa is unlikely to oppose the proposal. It would mean little to the federal government's bottom line; it would continue to protect the federal balance sheet from the vagaries of the price of nonrenewable resources, particularly oil and gas, and it means a substantial simplification of the programme – an intergovernmental hat trick not often seen in the arcane world of Canada's intergovernmental relations. ■

Kenneth J. Boessenkool is president of Sidicus Consulting Ltd., a Calgary-based economic and public policy consulting firm. He is also an adjunct research fellow at the C.D. Howe Institute and the author of Taking off the Shackles: Equalization and the Development of Nonrenewable Resources in Atlantic Canada published by AIMS in May 2001, and Taxing Incentives, AIMS, June 2002.

The full presentation is available at www.aims.ca under Issues/Equalization/ AIMS commentary

Equalization hits prime time

Nobel prize winner James Buchanan, on CPAC-TV's Primetime Politics

Brian Naud: The 1986 Nobel-prize winner James Buchanan was in Montreal today [at the Equalization Initiative conference] to talk about equalization. In the 1950s, James Buchanan was known as the thinking father, or one of the thinking fathers, of equalization. Today, 50 years later at the Montreal Economic Institute, he revisits his theory. Mr. Buchanan, what was the logic of introducing the equalization concept in the 1950s?

James Buchanan: That was my dissertation, my PhD dissertation, in 1948. I published part of it in 1950. I guess I was motivated pretty much by having a southern background. The south, up until the '50s, was a very poor part of the country. There were great disparities between income levels, fiscal capacity in the south and the rest of the country. I was, in a sense, motivated to try to make an argument on economic efficiency grounds and equity grounds for a transfer system in which the federal government would collect from the provinces or states and provide funds for the poorer states.

It didn't have any impact in the United States, but I think it did have some influence in Canada. A young man named John Graham then picked it up and wrote his dissertation on it in the early '50s. I think he was important in being a policy advisor to some of the discussions that went into making up the Canadian scheme, which was in '57. So in that sense it was influential in Canada, I think.

I was asked to come to Montreal to participate in this interesting conference to re-evaluate my position from a 50-year perspective. Lots of things have happened, both



James Buchanan, Nobel Prize winner for economic sciences, 1986.

historically, institutionally and also in developments in analysis since that time. We have now much more developed theories of public economics, we have much more developed theories of intergovernmental and inter-provincial competition, much more developed theories in so-called public choice, a field that I've been involved in, mainly looking at the motivations of the political actors, that is the politicians, the politician parties, the voters, all of which has an influence on this equalization scheme. It's not an Ivory-

tower-type economic efficiency world, or even an equity world, it's a world in which politicians, who are people just like the rest of us, respond to incentives and, as a result, you get a different look on the equalization schemes that do have very perverse incentives. That's been recognized but has come to the fore more in the last few years.

BN: When you say you hadn't taken enough account of how political interference can outweigh such programs as equalization, can

you talk about specific things that you encountered and analyzed?

JB: It came up in the questions at the talk today. You have politicians in these provinces who are recipient provinces of these grants who are able to spend money without being responsible to taxpayers. So you have no cost side. There is a benefit side, but not a cost side. If you have a situation of benefits not offsetting costs, then you're likely to get irresponsible behaviour. The same thing is true of voters.

BN: Here in Canada we have a program that's worth \$10 billion. In your view, what would need to be addressed to make it a better program?

JB: I'm not familiar enough with the Canadian situation. There was one suggestion that came up on a fact that I didn't know about. Discovery of oil and natural gas resources in the Atlantic provinces has made it at least potentially an avenue for reducing substantially, if not eliminating, the equalization schemes. Because if those provinces can use the value of those resources to improve fiscal setting sufficiently, you might get an argument made, and effectively made, that you could gradually eliminate the equalization schemes. That's a new point that I had not thought about until I came up here.

BN: Fifty years later, when you revisit your thinking of the 1940s, what would you

change today, if you had to do a new paper and put out new recommendations?

JB: I don't think I'd change very much of the fundamental analysis except to bring into account all these new developments. And try to analyze the decision-making process a little bit more carefully, with more attention to the politics and less to the economic efficiency considerations. ■

This program was aired on Oct. 25, 2001. To see the Real Player video, go to http://www.aims.ca/video/james_buchanan_interview.rm.

To read James Buchanan's paper, go to <http://www.aims.ca>, Events/Activities, Event Proceedings, October 2001: *Equalization: Welfare Trap or Helping Hand?*

What the national media has had to say

"Far better to exclude natural resources from the calculation altogether. This is not unprecedented. Alberta was already dropped because its massive oil revenues skewed the formula so much it would have made even powerhouse Ontario a have-not province on paper."

— **Calgary Herald**, June 21, 2001

"Economists are a blunt-spoken lot, in their own jargon-ridden way. So when a Nobel Prize winner in the dismal science spoke of our beloved equalization payments as a 'bribe' to keep people in the poorer provinces, all the other economists in the room just nodded... Without this extra money, the idea is, thousands more from Saskatchewan and Newfoundland and the rest would flood into Toronto and Calgary, and that would be a bad thing: better bribe them to stay home."

— **Montreal Gazette**, Oct. 27, 2001

"The Maritime provinces...are concerned that equalization imposes a heavy tax on offshore oil and gas development. For every dollar of revenue they make from the offshore, they get as little as 19¢. Implicit tax rates that high are like the welfare trap poor people face when they lose most of their benefits if they get a job... If equalization weren't already in place, perhaps we wouldn't feel the need to invent it. But now that it's in the Constitution, we're likely never to be rid of it."

— **National Post**, Oct. 27, 2001

"Nova Scotia's offshore hydrocarbon reserves are so rich that people now joke that the province has stopped being a hewer of wood—and become a passer of gas. But Nova Scotia, home to great offshore natural gas deposits, is suffering more gas pain than gain, thanks to Ottawa."

— **Canadian Business** magazine, June 9, 2001

"For months, Nova Scotia Premier John Hamm has argued that the program does not provide sufficient incentive for disadvantaged provinces to develop their non-renewable resources. Instead, transfers to Newfoundland and Nova Scotia are reduced by 70 to 90 cents for every dollar of provincial resource revenue. In desperation, Hamm has reached out to other energy-producing provinces such as Alberta, forging a common front to advocate change."

— **Maclean's** magazine, July 9, 2001

"Canada is a federal nation that has taken a leadership role in generous federal-provincial sharing programs but, after 44 years of the equalization program, and the transfer of almost \$180 billion (in current dollars) to the seven equalization-receiving provinces, the fiscal gaps for those provinces are still very significant."

— **Hon. John Crosbie**,
Atlantic Business magazine,
August/September 2001

"The East Coast energy boom has given Canada a golden opportunity to reduce the distortions caused by equalization payments... the burgeoning wealth from the oil and gas projects off Newfoundland and Nova Scotia should act as a catalyst for change."

— **Financial Post**, Oct. 26, 2001

"If it all seems like a big complicated mess, then the picture is pretty accurate. Given, however, that federal-provincial transfers are a huge part of Ottawa's expenditure, a huge part of the revenues of the weaker provinces and a huge part of the taxes Canadians pay, the transfers are too important to hide behind a cloak of complexity."

— **Canoe Money**, June 27, 2001

Something has to change

James Buchanan updates his views on equalization with the Frontier Centre's Peter Holle



Peter Holle

Peter Holle: You originally saw merit in the policy of equalization that redistributes income from wealthier to poor regions. Today you seemed to qualify your view on that. Why?

James Buchanan: I am more qualified than I was. I now recognise it is much more difficult to get implemented politically what might be desirable economically. Even if you came out with an economic argument in favour of equalization—and I think there are arguments on both sides—I would still come down in favour of some sort of a scheme on strict economic grounds. That's on the presumption that you could get politically implemented precisely what it was you recommended. But the way politics works, it is very unlikely that you would get what you would desire.

PH: There is evidence that government-to-government equalization systems in Canada have meant transfers tending to expand the size of the public sector in receiving provinces, for example, by propping up inefficient and ineffective policy delivery models. Would it not be wiser to transfer resources directly to the individuals in these regions instead of governments?

JB: Yes. In my original analysis of this, back in 1948, I made that point quite specifically. From an ideal economic point-of-view, you would definitely have to give it to individuals. My scheme at that time applied to differential rates of income tax in different provinces. Once you transfer from government to government, you have another source of major inefficiency.

PH: What are the obstacles that you might

see in shifting from government-to-government to an individual transfer system?

JB: That gets back into rent-seeking (see box). Once you have an equalization instrument in place, as you have in Canada, there arise tremendous bureaucratic values—bureaucratic rent so to speak—in maintaining the system. To shift to a system that paid the transfers directly to individuals, by having differential rates of federal income tax levied to adjust to provincial fiscal capacities, which would be my preference, you would have huge bureaucratic opposition. People would try to protect the rents they have in the current system of institutions.

PH: You talked today of fiscal capacity as a commons. Could you briefly describe or explain that?

JB: If you have an area where high-income receivers concentrate, you have a higher fiscal capacity. That fiscal capacity is a valuable resource and will create rent seeking. People will try to get that resource one way or the other, including immigration. It is very much like the medieval peasants putting their sheep on the commons pasture. It is better than the open range, and if you let them have open access they will, in fact, put too many sheep on the pasture and waste the value that the pasture has. We want to limit the exploitation of the fiscal capacity of the richer regions by keeping down the rate of immigration to a level that would be meaningful and efficient. One way to do that is to have a scheme of equalization that essentially bribes people to stay in the poorer regions.

PH: You mentioned today some of the challenges around equalization. For example, in Manitoba we are seeing a changing demo-

graphic where the older consuming population is expanding and receiving services paid for by equalization while the younger population, the entrepreneurs and job creators, are moving to places like Alberta that have lower taxes. We are creating a more dependent population as our ability to pay for it shrinks. It is a difficult situation. How would you handle that?

JB: This is happening in many situations but I don't know quite what the solution is. Certainly an equalization scheme won't handle that. You are getting distortion in the way people are spacing themselves out or locating and it has economic consequences that may not be desirable. I don't know of a policy scheme that would handle that very well. ■

Rent seeking

James Buchanan defines one of his most famous insights. "If you create an artificial scarcity through public policy – artificial rent – by setting up a new import quota or giving out a particular office that is very beneficial, people are going to invest money, time and resources in trying to secure that opportunity." To prevent rent seeking, "We try to prevent artificial rents. Rather than setting up quotas to stop imports, we levy a tariff. Or we pay wages in the public sector that are equivalent to the private sector and we don't make it a special benefit to get a bureaucratic position."

Pay the people, not governments

What might Nobel Laureate James Buchanan's ideas mean for equalization in Canada?
Lower taxes and higher-performance government

By Brian Lee Crowley, Peter Holle and Michel Kelly-Gagnon

What does one of the world's most prominent economists, a man whose pioneering work in the 1950s made him the father of equalization programs, think about them today? That question is particularly interesting because that economist, Nobel Laureate James Buchanan, is also a founder of public choice economics, which assumes that politicians and bureaucrats, like everybody else, act rationally to promote their own interests, to gain and keep power and to reward their supporters.

Mr. Buchanan's theoretical defence of equalizing grants, as he called them, influenced the debate that spawned programs like Canada's, launched in the late 1950s. Today, his thinking about equalization has changed. He has come to see how easy it is for the idea to be perverted and captured by politics.

Equalization in theory discourages people in poorer regions from moving to wealthier regions, simply to be able to gain access to the better public services and lower taxes that a wealthier jurisdiction can provide. Without equalization, Mr. Buchanan fears, there will be a general loss of economic efficiency as too many people try to take advantage of public services in wealthy regions, causing a decline in the quality of those services and an exploitation of the rich

What the designers of Canada's equalization system neglected to take from Mr. Buchanan's early work was this: equalization should be paid to individuals, not to governments

provinces' tax base.

But what the designers of Canada's equalization system neglected to take from Mr. Buchanan's early work was this: Equalization should be paid to individuals, not to governments. In fact, equalization would be best accomplished by differential national tax rates in the less-developed jurisdictions. In arriving at this conclusion, Mr. Buchanan was employing what would become public choice economics. He knew

that to transfer the money from a federal to a provincial government would introduce a whole new layer of economic inefficiency.

If equalization is paid to individuals, they decide how to spend the money according to their priorities. They are, of course, free to vote for provincial governments that would take all of the tax differential away through higher provincial taxes. But those governments would be answerable to those voters for this decision.

Moreover, residents would likely demand less costly and more efficient and effective ways of delivering services. Newfoundlanders, for example, might wonder if they wanted to pay the full cost of having, as is the case today, the best pupil/teacher ratio in the country. Having lots of teachers on the public payroll is popular with teachers but doesn't produce better results for students. Nova Scotia might well not have chosen to keep its steel mill operating at huge losses for so many years had equalization not passed a lot of the bill along to taxpayers in other parts of the country. And Manitobans might well balk at being the country's highest spender per capita on health care.

All of these examples point out one of the biggest dangers Mr. Buchanan sees in making equalization payments to governments rather than to individuals. That danger is what is known as rent-seeking. In this case,

when governments control huge resources, and can use those resources to confer benefits on favoured groups, people will organize to capture a share of those benefits for themselves. This is especially true when the benefits are highly concentrated on a privileged few, while the costs can be spread over many people through the tax system.

Pay equalization to governments and powerful bureaucratic interests, such as civil servants, ambitious politicians, and public sector unions see huge opportunities. Teachers in Newfoundland, steel workers in Nova Scotia and health care workers in Manitoba are just some of the examples of how equalization creates opportunities for rent-seekers in equalization-receiving provinces to combine and exert strong political pressure on local politicians to get some share of the money. And local taxpayers have less reason to react to this behaviour than if they had to pay the whole bill.

Existing bureaucracies will vigorously oppose any move to shift equalization payments from governments to individuals. People will try to protect the rents they have in the current system. But payments to individuals would ensure that citizens living in poorer regions of the country have the resources to get public services at current levels with no loss of present income. Perverse incentives on provincial government behaviour would be removed, and those same governments and their voters would be more accountable for their provincial spending. And Ottawa would get to send cheques directly to residents of the less-developed jurisdictions in Canada, rather than to famously ungrateful provinces.

Designing the tax rebates presents its own challenges, and would require some careful thought, but in our view, Mr. Buchanan has challenged Canadians to think afresh about imagining an equalization system that escapes the trap of powerful provincial rent-seeking. ■

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Media Release

For immediate release, Friday Dec. 21, 2001

Federal Finance Minister Paul Martin endorses AIMS policy proposal

HALIFAX — In a speech yesterday, Federal Finance Minister Hon. Paul Martin said that he was supportive of a major policy initiative recently advanced by AIMS in collaboration with two other public policy institutes.

Speaking to the Metropolitan Halifax Chamber of Commerce about his recent budget, the finance minister was asked whether he would consider



replacing federal spending on job creation and economic development in less developed regions with lower federal tax rates. The minister responded that he was favourable to the idea, and had already explored it with a number of premiers from both developed and less-developed parts of the country and found significant support for the concept.

In November, AIMS President Brian Lee Crowley, together with the heads of two other think tanks representing all the equalization receiving provinces in Canada, proposed just such an idea. Drawing on the work of Prof. James

Buchanan, Nobel Laureate in economics, Crowley, together with Michel Kelly-Gagnon of the Montreal Economic Institute and Peter Holle of the Frontier Centre in Winnipeg, proposed replacing Ottawa's major transfer to the less-developed provinces — equalization — with a reduction in the federal tax rate in those provinces.

The argument was developed in an op-ed piece published in the *National Post* (and available at <http://www.aims.ca/Media/2001/prnov2301.htm>). According to Crowley, the advantage of a tax-based approach is that, "Direct transfers between governments are inefficient, creating too many opportunities for patronage and low value use of tax dollars on pork barrel projects and short term creation of poor quality jobs. By leaving more money in the hands of individuals and companies that create value in the local economy, genuine sustainable economic development is encouraged, while governments would be kept lean and focused on their core mission."

While the work of the three institutes was focused on equalization, the general principle is applicable to many federal spending programmes in the less-developed parts of the country, including the job creation funds Minister Martin referred to.

Such differential federal tax rates already exist in Canada. For example, taxpayers in the province of Quebec get a federal tax abatement. For more information on AIMS recent work on equalization, please visit the equalization page on our website at <http://www.aims.ca/Main/equalization.htm>.

A better way to help the have-nots

One of Canada's national newspapers gives strong editorial endorsement to the Equalization Initiative

Has the finance minister finally seen the light? Or has he succumbed to the spirit of the season... or an overindulgence in eggnog? Whichever it is, we are heartened by news Paul Martin is considering what could prove to be dramatic and beneficial changes to the method by which the poorer provinces are subsidized by the rest of Canada.

Speaking before the Metropolitan Halifax Chamber of Commerce last week on the subject of his recent budget, Mr. Martin was asked whether he would consider replacing the billions of dollars in annual federal spending on job creation and economic development in have-not regions — and in particular the \$700-million Atlantic Investment Partnership — with lower federal corporate taxes for poorer regions. Mr. Martin stunned the audience when he said he not only liked the idea, but had already explored it with some premiers and found significant support. He added that such a proposal might be tried as an experiment for a period of 10 years and that “it’s not something the federal government would do unilaterally.”

Mr. Martin’s words are encouraging. Such programs as the \$700-million AIP are maintained for political reasons — as they help secure Liberal support in poor areas. But if the goal of federal policy is to improve the economic performance of poorer regions and not merely the performance of the federal Liberals, then we need fewer government bureaucrats scrutinizing application forms and doling out money (the jobs grants disas-

ter of last year was proof enough of that) and greater incentives for people and businesses in those regions to work harder and for new businesses to locate there. Lowering corporate taxes would begin such a process.

In light of what appears to be an important change in Mr. Martin’s thinking, three market-oriented think tanks from have-not provinces — the Frontier Centre for Public

Converting equalization into a tax-reduction program that delivers lower taxes for poorer regions would help eliminate Nova Scotia-style welfare traps

Policy in Manitoba, the Montreal Economic Institute of Quebec and the Atlantic Institute for Market Studies in Nova Scotia — have suggested similar reforms to other federal programs. Following Mr. Martin’s speech, Peter Holle, Michel Kelly-Gagnon and Brian Lee Crowley, the heads of the three institutes respectively, repeated an argument they ini-

tially made in a *National Post* article last month: that equalization should be converted from a transfer system to one that delivers lower tax rates to poorer provinces.

As equalization now functions, Ottawa siphons \$10.8 billion a year from have-not provinces. This creates provincial-scale welfare traps. Recall that earlier this year John Hamm, premier of Nova Scotia, claimed he deserved a greater share of federal resource royalties from offshore oil and gas reserves on top of his existing equalization entitlements. Whatever one may think of the request — former Premier Mike Harris of Ontario summoned the image of a welfare recipient winning \$1 million in the lottery and still wanting to stay on the dole — there is little doubt that the equalization system discourages provinces from developing their natural resources. Converting equalization into a tax-reduction program that delivers lower taxes for poorer regions would help eliminate Nova Scotia-style welfare traps.

In his off-the-cuff remarks in Halifax, Mr. Martin discussed some excellent ideas for reforming the way the rest of the country subsidizes poor provinces. Not only should he make good on these suggestions, but he should follow the lead of Messrs. Holle, Kelly-Gagnon and Crowley, and apply similar logic to other programs. ■

This editorial appeared in the Dec. 27, 2001 edition of the *National Post* and is reprinted with permission.

Frank McKenna's take on equalization



Frank McKenna

The former New Brunswick premier promotes equalization reform as “transformational” for less-developed provinces

The Hon. Frank McKenna is the former premier of New Brunswick (1987-1997) and is currently counsel with the Atlantic law firm McInnes Cooper. He gave a speech entitled “Exiting the ‘Have-Not’ Paradigm” at a Frontier Centre breakfast in Winnipeg on April 25, 2002. He summed up his thoughts in this interview that same day.

Frontier Centre: You are no doubt familiar with the contention by the Atlantic Institute of Market Studies that federal transfer payments have hurt have-not provinces more than they have helped them. What is your opinion?

Frank McKenna: I don’t think they have hurt them more than they have helped them and I don’t think there was any bad intention but I do think they have a perverse impact and that perverse impact is to make regions more dependent. They give very little incentive to create greater own-source revenue because those revenue sources are taxed back. I think it is fair to say that the programmes are well intentioned, have had minor to modest success but, generally speaking, aren’t transformational.

FC: The Nobel-prize winning economist James Buchanan, who is an original proponent of equalization, says that from an ideal economic point of view transfers should be given to individuals instead of various levels of government. He believes the best system would simply apply differential rates of income tax in different provinces. How would you see these old

transfer programmes being modernized?

FM: It’s my view that lowering the tax rate will actually reduce the inequity between the regions. What equalization does is allow governments to deliver reasonably comparable levels of services but it doesn’t allow the economy to grow faster in have-not regions. I believe the judicious use of both would result in the need for equalization dissipating over time.

FC: Won’t certain provinces have a problem with your idea of lower taxes as an alternative to equalization?

FM: I don’t believe that will be the case. The whole country is better off if we can reduce disparity. It means an overall federal expenditure down the road - an overall lower federal expenditure, number one. Number two, it creates more prosperous markets for the goods of all provinces and I think most Canadians who are seeing a lot of money now spent on equalization and other programmes would be prepared to spend money if they knew at the end of the day this would be genuinely transformational in terms of creating greater equity in this country.

FC: What federal programmes would you phase out to pay for this?

FM: You couldn’t do anything from the outset. You would have to introduce the tax changes and allow them to work. Then, over

time, you could look at the regional development agencies and then other federal transfer programmes. As the poorer provinces became more prosperous I think you could look at considerable federal savings.

FC: Would you lower rates or simply have a tax holiday?

FM: My view is that you wouldn’t have it forever, but maybe for a 10-year period you would have a tax holiday.

FC: What do you think of the idea of a one-time buy-out of the equalization system where Manitoba and New Brunswick might, for example, get \$10 billion or \$15 billion in return for an end to an annual payment of \$1.5 billion? That’s just an example. This would temporarily increase the federal debt but would allow the have-not provinces a chance to extinguish their debts, create an endowment fund and/or cut taxes. Does this make sense?

FM: It won’t happen — so in that sense it doesn’t make sense. You can accomplish the same thing effectively, I think, if the government of Canada were to “zero-rate” taxes — corporate taxes, in those provinces. But I do believe that the government of Canada has to look at transformational events and if that involves a fairly large expenditure with some certainty and guarantee that down the road these provinces will require less federal resources, then I am in favour of such an expenditure. ■



The Halifax-based Atlantic Institute for Market Studies is a non-partisan, independent social and economic policy think tank founded by Atlantic Canadians to encourage and promote debate about realistic options to help build the economy. At www.aims.ca



The Frontier Centre for Public Policy is a Winnipeg-based independent public policy think tank whose mission is to explore options for the future by undertaking research and education that supports economic growth and opportunity in the Canadian prairies. At www.fcpp.org



The MEI is an independent, non-profit, non-partisan research and educational institute. Its mission is to put forward original and innovative ideas to help shape efficient public policies. At www.iedm.org

To explore the issue of equalization more fully, please visit the websites of the three institutes to see further in-depth analysis and discussion, including a series of papers by Canada's leading equalization experts.