Journal of Official Statistics, Vol. 18, No. 3, 2002, pp. 393–407

The Canadian Equalization Program

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A significant feature of Canadian federal-provincial fiscal relations is the broad system of federal-provincial transfer payments. The Equalization program represents one of these transfers and is specifically designed to recognize that provincial governments do not have the same ability to raise revenues to provide public services. Thus, Equalization transfers are made to the less prosperous provinces to ensure that all provinces, regardless of their ability to raise revenue, can provide roughly comparable levels of services at roughly comparable levels of taxation. Eligibility to receive Equalization funding is determined by a formula measuring each province's revenue-raising capacity against a representative standard. This program is built on a long history beginning in 1957 when the first Equalization program was officially established. This article provides a description of the Canadian Equalization program, its formula, administration, and history.

Key words: Canada; fiscal transfers; fiscal arrangements; fiscal capacity, federal-provincial relations.

1. Introduction

A federal system of government, in which subnational governments exercise unique taxation and expenditure authority, is complicated by the fact that not all subnational units are endowed with similar riches. In most federations, there are programs to distribute resources to subnational governments to ensure that they are all able to provide comparable levels of services. In Canada, the federal Equalization program acts as the primary means by which fiscal disparities across provinces are reduced to ensure that all provinces can provide their residents with comparable levels of public services.

This article provides an overview of the goals, formula, administration, and underlying historical foundation of the Canadian Equalization system, as it exists today.

2. Equalization Beneficiaries

Canada's Equalization program is part of a broad system of federal-provincial fiscal arrangements, which also includes other provincial and territorial unconditional and conditional transfers. The other major components of these fiscal arrangements include the Canada Health and Social Transfer (CHST) and Territorial Formula Financing (TFF)[3].

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Acknowledgments: The authors appreciate the assistance and comments of Christopher Mackie of the U.S. National Academy of Statistics and Robert Tannenwald of the Federal Reserve Bank of Boston.

Together, these programs result in over 45 billion CnD[4] being transferred from the federal government to the provinces and territories each year[5] and represent over 95 per cent of all transfers from the federal government to provinces and territories. In total these transfers represent approximately 38 per cent of total federal program spending.[6]

The federal government makes Equalization payments directly to provincial governments in the form of a block fund. These payments are unconditional — provinces have the flexibility to spend the funds according to their own priorities. Provincial governments use federal transfers to supplement their own revenues to pay for public services such as health care, education, social assistance, and the administration of justice and public infrastructure.

Currently seven provinces receive Equalization payments: Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba, and Saskatchewan. These seven provinces have a combined population of approximately twelve million or 39 per cent of the national population. Equalization payments currently amount to 10.4 billion CnD, roughly nine per cent of federal program spending, and represent between four per cent and 29 per cent of the revenues of Equalization-receiving provinces.

3. The Goals of the Canadian Equalization Program

Although the Equalization program has existed since 1957, the principle underlying the program was enshrined in the Canadian Constitution in 1982. Section 36(2) of the Constitution Act, 1982, 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.'' This section of the Canadian Constitution is the primary basis for the Equalization program.

Underlying the constitutional commitment is the principle of equity — that all Canadians should have access to a comparable level of public service, no matter where they live. The goal of equity is also achieved by the fact that Equalization is a formula-based program, which is applied consistently across the ten provinces and compares all the provinces to the same standard. Equity is further enhanced by the fact that the program attempts to measure provincial capacity as comprehensively as possible by taking into consideration the majority of the tax and nontax sources from which provinces derive revenue.

The Equalization program also enhances the efficiency of the national economy in keeping with the theory of fiscal equalization first espoused by James Buchanan in 1950. That is, the Equalization program mitigates the effect of fiscally induced migration in Canada by ensuring that labour mobility is based primarily on market considerations — not considerations of access to public services. Buchanan's original ideas were given a Canadian

[3] A brief description of these programs is provided at the end of this article.
[4] All figures are in Canadian dollars (CnD).
[5] In Canada, the fiscal year commences on April 1 and runs until March 31.
[6] Federal program spending excludes interest on the public debt.

grounding by John Graham in the 1960s and by Robin Boadway and Frank Flatters in the 1980s.[7]

4. The Equalization Formula and Administration

Canada's Equalization program uses the concept of relative fiscal capacity as the basis for payments. Each province's ability to generate revenues is measured (using commonly defined tax bases at national average tax rates) and compared to a common standard. Provinces with a fiscal capacity below the standard receive Equalization payments to bring their capacity up to the standard. Provinces with a capacity above the standard do not receive Equalization payments.

Equalization calculations are made on a per capita basis to allow comparisons among provinces with different populations. Population thus also forms the implicit assessment of need across provinces as it is assumed that the capacity to generate a comparable level of per capita revenues translates into a comparable ability to provide services.

4.1. The Representative Tax System

Equalization entitlements are calculated using a Representative Tax System (RTS).[8] Generally speaking, the RTS is based on the ''typical'' taxation practices of the provincial governments and measures provincial revenue-raising capacity for each kind of tax actually levied by provinces. Where provincial taxing practices differ, the RTS system relies on a measure of fiscal capacity that attempts to measure the underlying source of provincial revenues. In practice, this means that separate fiscal capacity calculations are made for more than 30 different sources of provincial revenue.

The use of actual taxing practices ensures that the Equalization program remains grounded in the reality of provincial taxation. While no province actually levies the RTS in its entirety, the RTS is representative of taxing practices in most or all provinces. Through regular review, the RTS is a dynamic structure that responds to changes in provincial taxation practices.

The RTS formula is set out in federal legislation and regulations[9]. The formula contains specific definitions of all data inputs into the determination of Equalization. Expenditures on Equalization for any given year, as well as the distribution among provinces, are determined by the application of this formula and are made under the authority of the Act.

4.1.1. Measuring fiscal capacity

Measuring the fiscal capacity of each province is the first, and most important, step in determining how much Equalization each province is entitled to. Per capita fiscal capacities vary significantly across provinces, as illustrated in Figure 1 below.

[7] Not all economists share the view that reductions in fiscal disparities serve to enhance the efficiency of the internal national economy. By contrast, the argument is made that equalizing grants distort labour markets, reduce productivity in receiving regions and lead to larger than necessary public services. In Canada, this alternative viewpoint has been taken up by the Atlantic Institute for Market Studies (AIMS) and in the U.S. this view can be found in Tannenwald, ed., 1998. In a recent speech celebrating his fifty-year contribution to the field, even Buchanan was less than equivocal in his support for equalization programs.

[8] Alice Rivlin and Selma Mushkin first developed the methodology used to construct the representative tax system in the early 1960s for the U.S. Advisory Commission on Intergovernmental Relations. The RTS has been used in Canada since 1967.

[9] The Federal-Provincial Fiscal Arrangements Act and Regulations.

Fig. 1. Per Capita Fiscal Capacity 2001–2002

4.1.2. The Equalization ''standard''

Once provincial per capita fiscal capacities have been calculated the next step is to establish a benchmark — or standard — against which each province's fiscal capacity can be compared. The current standard, which has been used since 1982, measures the average per capita fiscal capacity of the five ''middle-income'' provinces — Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia. This standard excludes Alberta and its high fiscal capacity as well as the Atlantic Provinces — Newfoundland, Prince Edward Island, Nova Scotia, and New Brunswick — and their low fiscal capacity.

In 2001-02, the average fiscal capacity of the five-province standard is 5,964 CnD per person. This amount represents the revenues that would be available, on average, to the provinces in the standard if they had a common tax system that they applied in a common manner. The five-province standard is shown as the horizontal line in Figure 2.

4.1.3. Equalization entitlements

The federal government pays Equalization to provinces whose fiscal capacity is below the five-province standard. The shortfall is referred to as a fiscal deficiency and is also the per capita amount to which each receiving province is entitled. In other words, the per capita Equalization entitlement paid to each province is equal to the difference between provincial per capita fiscal capacity and the per capita fiscal capacity of the standard. For example, in 2001-02, Newfoundland's Equalization entitlement is 2,057 CnD per capita, which is equal to the difference between its fiscal capacity (3,907 CnD) and that of the standard (5,964 CnD). The per capita Equalization entitlement is illustrated in Figure 3 below as the shaded area between the province's fiscal capacity and the standard. The total Equalization entitlement paid to a province is then determined by taking its per capita entitlement and multiplying that by its population.

Fig. 2. The Per Capita Standard 2001–02

Equalization is not a fixed entitlement. Entitlements are calculated for each fiscal year, allowing the program to respond to changes in population and fiscal capacity, regardless of the source of the change. The actual calculations of entitlements are undertaken twice each year to adjust payments, until the final calculation is made 30 months after the end of the fiscal year.

The calculation process does result in some instability in Equalization payments between the initial calculation (made prior to the start of the fiscal year) and final calculation (some 42 months later). During the period 1982-1998, the average difference between the initial and final calculation, for all receiving provinces, was about nine per cent — with a steady decline with each succeeding estimate.

In 2001-02, Equalization entitlements to the seven receiving provinces were an

Fig. 3. Per Capita Equalization Entitlements 2001–02

Table 1. Equalization payments by province 2001–02

	NFL	PEI	NS	NB	QUE	MAN	SASK	Receiving provinces
Fiscal deficiency (CnD per capita)	2,057	1,812	1,377	1,617	696	1,030	236	875
×								
Population ('000)	534	138	943	757	7,407	1,150	1,016	11,944
=								
Equalization entitlements (CnD millions)	1,098	251	1,298	1,224	5,152	1,185	240	10,448
% of Total	10.5	2.4	12.4	11.7	49.3	11.3	2.3	100.0

estimated 10.4 billion CnD. Table 1, above, provides each province's estimated per capita entitlement, its population, its total entitlement (i.e., the product of its per capita entitlement and population) and the percentage of the total program the province receives. (A detailed presentation of the Equalization estimate by revenue source is provided at the end of this article.)

4.1.4. Special provisions in the formula

All Equalization entitlements are initially determined using the Equalization formula specified in legislation and regulations. There are, however, some special regulated provisions that can affect the final calculation.

First, Equalization responds to changes in provincial fiscal capacity, but ideally should not respond to changes in any one province's taxing practices. For most revenue sources, the Equalization formula is derived from average or typical provincial taxing practices (i.e., what tax rates are used and what items are taxed) of the ten provinces and as a result the effect of any one province's choices is minimized. In other words, if a province chooses to set a rate above or below the national average, its choice should not affect its Equalization entitlement.

There are, however, a few rare circumstances when a tax base is concentrated in one province — such as some varieties of oil in Saskatchewan. In such situations, most of the revenues from that tax base are also derived from a single province. Since total revenues and the total tax base determine the national average tax rate used in the RTS, in these situations the provincial tax rate effectively becomes that national average tax rate. As such, the province's tax rate has a direct influence on its Equalization entitlements. To reduce the effect of the provincial rate on Equalization (and to allow provinces to adopt appropriate tax rates for resource management), the ''generic solution'' reduces revenue coverage by 30 per cent in those bases where more than 70 per cent of the tax base is found in a single receiving province. The net effect is that for every 1.00 CnD increase a province generates from a highly concentrated tax base, its Equalization payments go down by about 70 cents — not dollar-for-dollar.

Second, there is a floor provision that limits year-over-year declines in Equalization for each individual province. The floor provision comes into effect when a province's entitlement declines, from one year to the next, beyond a threshold amount. The current Equalization floor limits the year-over-year decline in each province's per capita entitlement to no more than 1.6 per cent of the standard, which in 2001-02 was approximately 95 CnD per capita (1.6 per cent × 5,964 CnD). In other words, for that year, each province's entitlement could not decline by more than 95 CnD per capita. Once the threshold has been surpassed, the affected province receives a floor payment. The total floor payment is equal to the amount of the decline in excess of 95 CnD per capita, multiplied by the province's population.

Finally, there is a ceiling provision that sets the maximum annual growth rate of payments, thus ensuring that the program is affordable to and sustainable for the federal government. It sets an annual limit on the maximum payments for the program. This maximum payment, or ceiling, increases each year in line with the growth in the economy. When the formula produces entitlements that exceed the ceiling limit, the program is reduced to the ceiling limit. This is accomplished by reducing each province's entitlements by the same per capita amount, which is equivalent to lowering the Equalization standard.

4.2. Program administration

The Federal-Provincial Relations Division of the Federal Department of Finance administers the Equalization Program. In practice, this involves collecting economic and budgetary information, performing the calculations of entitlements, informing the government, provinces, and public of the result of the calculations and then arranging for payments to the provinces.

Calculations of entitlements are performed in accordance with legislation and regulations that define precisely the revenue sources that must be measured to determine provincial fiscal capacity and specify sources of information and the formula of how entitlements should be calculated. Entitlement calculations require several thousand individual pieces of data. Most data inputs are provided by Statistics Canada and are further described in the following subsection. The official bi-annual estimates document presents over 90 tables of computations. Overall, for each fiscal year seven interim estimates are made prior to the final estimate that is made 30 months following the end of the fiscal year.

Payments to provinces for a fiscal year are made each month throughout the year. Payments are based initially on estimates and these estimates are officially revised twice a year, incorporating the latest available data. Payment adjustments are made after each official estimate and upon the final determination. The final estimate of Equalization entitlements for a fiscal year is not made until 30 months after the end of the fiscal year, by which time all the relevant information is available.

Given that the Equalization program is governed by federal legislation and regulations and that provincial tax systems change over time, program review is a necessary and very important aspect of the program administration. Traditionally, new federal legislation and regulations authorizing the Equalization program are presented and approved by Parliament every five years. This renewal of the legislation and regulations ensures that the program remains up-to-date and that the best possible calculations and data are used to determine Equalization payments.

Thus, prior to the expiry of the Equalization legislation, and before the introduction of new legislation for the next five-year term, the program undergoes an extensive review or ''renewal process.'' Equalization renewals have always been preceded by extensive consultations with the provinces, during which modifications to the program are considered. While both federal and provincial officials continually monitor the program's operation, the renewal process involves a more focused and comprehensive review to identify possible technical changes and improvements to the program's design and structure.

The technical review of the Equalization program is undertaken during technical committee meetings of federal and provincial officials. This committee prepares papers on technical and design issues and analyses. The process allows provinces to provide special knowledge and analyses of the workings of their own tax systems and to contribute to the technical design of the program. Committees of more senior federal and provincial officials meet frequently to review policy proposals. Equalization renewal is also a priority for the Federal-Provincial Finance Ministers meetings.

Following these federal-provincial consultations, the Minister of Finance presents proposals for changes to the program. The government then introduces legislation into Parliament for review, debate, and renewal.

The renewal process that preceded the 1999 Equalization legislation took place over a period of more than two years. The renewal process for the current review was initiated in June 1999.

5. Statistical Inputs

Statistics Canada (the National Bureau of Statistics) provides the data that support the Equalization program. The *Federal-Provincial Fiscal Arrangements Act* requires the Chief Statistician of Canada to provide annual information used to calculate the final value of transfer payments to the provinces. Three Certificates covering Revenue Source, Revenue Base and Population are presented to the Minister of Finance in order to measure the fiscal capacity of each province and calculate Equalization entitlements.

5.1. Revenue Source Certificate

The Revenue Source Certificate contains selected revenue data on taxes, natural resource revenues, lottery revenues, and miscellaneous goods and services revenues collected by provincial and local governments, their boards, commissions, and special funds. Some profits remitted from government business enterprises are also included. All forms of government revenue are identified and summarized by province into 31 revenue categories. In total, for all the provinces, close to 1,000 series are used as input for the compilation of these categories.

5.2. Revenue Base Certificate

The Revenue Base Certificate contains over 100 categories of actual data on the value of transactions, assets, commodities or services in the economy that give rise to the revenue collected by provincial and local governments and government business enterprises. This certificate also contains data on provincial tax rates. As in the case of the Revenue Source Certificate, there are many individual observations, which are summed to the reported series.

5.3. Certificate of Population

The Certificate of Population contains the official Statistics Canada estimates of the population for each of the provinces and territories as of the first of June. These data are a key component in the calculation of per capita Equalization entitlements.

5.4. Mini-Certificate

In addition to the above Certificates (required by the Fiscal Arrangements Act) that present final estimates more than two years after the reference period, Statistics Canada also provides a Mini-Certificate to the Department of Finance to be used when calculating the interim estimates, which includes only revenue base information. Given the 30-month time lag for finalizing the Equalization entitlements for a particular fiscal year, there will be three years of entitlements requiring revisions at the time of each official bi-annual estimate. Thus, this certificate contains estimated or actual revenue base data for the three most recent years. Most Fiscal Arrangements information refers to the fiscal year beginning April 1 and ending March 31. Data referring to the calendar year are not converted to the fiscal year.

5.5. Role and responsibility of Statistics Canada

Through a rigorous process, Statistics Canada ensures the data meet the needs as defined in the Act. Data are compared to the previous year's submissions to ensure consistency and confidentiality. Confidentiality guarantees that no individual entity reporting to Statistics Canada is identifiable through this process. Changes in concepts and definitions are documented to advise officials of the Department of Finance on the appropriate course of action.

It should also be noted that for the purpose of making a final computation the Act stipulates that if the Chief Statistician of Canada is unable, for any reason including the delay or discontinuation of a survey, to provide the information set out in the certificate for a province, the Minister of Finance can, after consulting with Statistics Canada, estimate a revenue base for the province using any other information that is available. After data are submitted to the Department of Finance there is a 30-day period to include revisions to the data, after which a revised Certificate is released and made available to the provinces.

6. Historical Summary of the Equalization Program[10]

Canada's formal system of Equalization began in 1957, although the principle of providing additional resources to provinces dates back to Confederation. Since 1957, the program has evolved to its current fundamental structure described in the previous section. It had undergone numerous and significant technical changes over the years until 1982, at which time the formula became essentially what it is today. However, much of the program's history prior to 1982 remains a significant part of the foundation upon which today's Equalization program is based.

[10] For a detailed discussion of the history of Canada's Federal-Provincial Fiscal Arrangements see Perry (1997).

6.1. 1937-1940: Rowell-Sirois Commission

The federal government set up the Royal Commission on Dominion-Provincial Relations (Rowell-Sirois) in 1937. The commission had two principle missions — to review and recommend changes to the federal-provincial fiscal relationships and to suggest a new division of government responsibilities and revenues that would be efficient and meet the increased needs of the provinces and local governments (Perry 1997, p. 25).

One of the main recommendations in the report presented to the federal government in May 1940 was that a system of national adjustment grants be put in place. It is this recommendation that remains an integral part of the Equalization foundation. The commission suggested that these grants be unconditional and designed to equalize the basic elements of provincial finance and obtain the desired degree of provincial equality. The grants were to be made to the poorest provinces so that they could provide public services of average quality without placing an undue tax burden on their citizens. Provinces would continue to be able to levy additional taxes to finance programs at levels appropriate to their own needs and policies. This proposal represented an important stage in the evolution of Canadian federal-provincial fiscal relations since it recognized provincial autonomy by taking into consideration ''the wide difference in the social philosophies and the economic and social conditions of the provinces (Perry 1997, p. 27).''

6.2. 1957-1966: The first steps toward Equalization

Although various forms of federal-provincial tax sharing and ad hoc grant programs existed prior to 1957, it is 1957 that remains the year in which the first transfer program aimed toward equalizing yields of provincial revenue sources was introduced. This transfer system was based on the measurement of hypothetical per capita provincial revenues from three sources — personal and corporate income tax and succession duties. The provinces were then equalized up to the two provinces with the highest per capita revenues — at that time Ontario and British Columbia (Perry 1997, p. 120).

Over time this system of Equalization broadened and changed to reflect the greater needs of the provinces. In 1962, 50 per cent of natural resource revenues were added and the Equalization standard changed to reflect the average per capita revenue of all ten provinces (national average standard) rather than the average of the two most revenue-rich provinces. However, the provincial yields remained a federally defined ''hypothetical'' measure.

6.3. 1967-1971: Adopting the Representative Tax System (RTS)

The Equalization system adopted in 1967 differed significantly from the 1957 system. First, the system for computing the Equalization entitlement was replaced with the system used in the current Equalization formula — the representative tax system. It was recognized that the representative tax system would provide a better indicator of provincial fiscal capacity since it is based on actual provincial taxing practices. Second, the category of revenues subject to Equalization was broadened to take into account all provincial revenues — including all natural resource revenues — and equalized them to the national average.

These changes were based on a proposal with the aim of developing a comprehensive ''prosperity index'' that would measure each province's fiscal capacity in its entirety. This process to adopt such a system began in the fall of 1966 when the federal minister of finance at that time presented the principle underlining the proposal: ''The fiscal arrangements should, through a system of equalization grants, enable each province to provide an adequate level of public services without resorting to rates of taxation substantially higher than those of the other provinces.'' (Perry 1997, p. 122).

6.4. 1974-1981: Addressing issues related to oil prices

The Canadian Equalization system faced many significant challenges during the time period of soaring energy prices. This was due in part to the significantly disproportionate economic provincial conditions that exist in Canada with regard to natural resources — some provinces have significantly more natural resource wealth than other provinces. As a result, increasing oil prices in the 1970s and early 1980s resulted in the oil and gas factors of the Equalization formula overshadowing all the other factors and resulted in some perverse provincial comparisons. ''This outcome, in the federal government's view, was not within the spirit of the Equalization system — changes were required to prevent relatively wealthy provinces from receiving Equalization under unusual circumstances.'' (Perry 1997, p. 133).

As a result, a number of ad hoc remedies were adopted in an attempt to deal with the issues surrounding the oil shock effect on Equalization. The various remedies implemented included reducing the resource revenues subject to Equalization, broadening the categories of oil and gas revenues subject to Equalization, limiting natural resource entitlements to no more than one-third of the total Equalization entitlements and lastly introducing a rule that excluded provinces with per capita personal income regularly above the national average from receiving Equalization payments. However, none of these alternatives succeeded in providing a long-term solution to the oil crisis Equalization issue.

6.5. 1982: The year of significant historical milestones

The rapid growth in the program's size, the volatility of Equalization payments and the perverse provincial results that occurred during the 1970s and early 1980s as a result of soaring energy prices led to a number of legislative changes in the formula in 1982. Although the federal government maintained its position that the basic elements of the Equalization program were sound and that the formula should include all provincial and local government revenues, there remained the problem of how to deal with the effect of oil and gas revenues on Equalization. (Perry 1997, p. 149).

In response to this issue, legislation was introduced in 1982 containing three parameters that remain important components of the Equalization program. First, the five-province standard was adopted which represented the average per capita yield of the five ''middle-income'' provinces (Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia). Although the switch from the national average standard to the five-province standard changed both the size and provincial distribution of Equalization, it single-handedly addressed all the issues surrounding the effect of the oil shock on Equalization (Perry 1997, pp. 153–154). The exclusion of Alberta from the standard significantly reduced the possibility that Equalization would experience the uncontrolled growth and volatility or the perverse provincial results that were experienced in the 1970s.

In addition to adopting a new program standard, the new legislation also introduced minimum (floor) and maximum (ceiling) parameters to provide protection to the provincial and federal governments. The floor provision is designed to protect provincial governments from sudden and significant drops in their Equalization entitlements, while the ceiling provision has improved the stability of total entitlements over time and has protected the federal government from large year-over-year increases and unsustainable growth in the program.

Among these many Equalization milestones of 1982, however, the most significant development with regard to Equalization was the enshrining of government's commitment to the principle of Equalization within the Canadian Constitution. Section 36(2) of Part III of the Canadian Constitution Act 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.''

7. Concluding Remarks

Equalization transfer payments are a significant feature of Canadian federal-provincial fiscal relations, to the extent that they have often been referred to as the fiscal cornerstone of Canadian federalism. The Canadian Equalization program also has a long tradition — the need for this cornerstone became evident in the early decades of the 20th century. After the Second World War, as provinces introduced the social programs that were to become national priorities, it became evident that the tax capacity needed to carry out these responsibilities was not evenly distributed among the provinces. Thus, in 1957, a program — dedicated to this purpose and responding to recommendations made in 1940 by the Rowell-Sirois commission — was officially established as the Equalization program. This program has continuously been renewed and improved ever since. The Equalization program benefits all Canadians by ensuring that they have access to comparable levels of public services, no matter where they live.

8. The Canada Health and Social Transfer

The Canada Health and Social Transfer (CHST) is the largest federal transfer to provinces and territories, providing them with cash payments and tax transfers in support of health care, post-secondary education, social assistance and social services, including early childhood development. In total, CHST transfers are worth almost 35 billion CnD in 2001-02. The CHST is allocated to provinces and territories on an equal per capita basis.

The tax transfer component of the CHST came to being in 1977 when the federal government agreed with provincial and territorial governments to reduce its personal and corporate income tax rates, thus allowing them to raise their tax rates by the same amount. As a result, revenue that would have flowed to the federal government began to flow directly to provincial and territorial governments.

Since the revenues from the tax point transfer are included in provincial revenues covered by the Equalization program, the tax points are said to be ''equalized'' and an interaction between the two programs is created. To avoid double counting the ''equalized'' value of these tax points, the CHST tax transfer includes an ''Associated Equalization'' component that effectively increases the value of the tax points to account for the additional Equalization that provinces already receive.

The CHST gives provinces and territories the flexibility to allocate payments among social programs according to their priorities, while upholding the principles of the *Canada Health Act*[11] and the condition that there be no period of minimum residency with respect to social assistance.

9. Territorial Formula Financing

Territorial Formula Financing (TFF) is an annual unconditional transfer from the federal government to territorial governments. It is governed by agreements between the federal and territorial Finance Ministers, and enables the territories to provide a range of public services comparable to those offered by provincial governments.

Although territorial governments have the authority to raise revenues by taxation, rentals, and the sale of goods and services, a larger portion of their financial resources comes from the federal government through the TFF grant. In 2001-02, transfers under TFF will be over 1.5 billion CnD for the 99,000 residents of the territories.

TFF payments are determined through a formula based on a ''gap-filling'' principle, which takes into account the difference between the expenditure needs and the revenue means of territorial governments, and makes up the difference through a cash payment.

Territorial expenditure needs are represented by the formula's Gross Expenditure Base (GEB), which is indexed to move in line with growth in provincial spending so as to reflect the expenditure pressures facing governments in other parts of the country. It is also adjusted for territorial population growth relative to that of Canada as a whole.

Revenue-raising ability is measured by estimating the revenue a territory would have at its disposal if it exercised a tax effort similar to that in other parts of the country, adjusted to recognize the special circumstances in the North.

TFF includes a financial incentive to promote economic activity and to encourage greater territorial self-sufficiency.

10. Canada's Equalization Entitlements and the RTS in Detail

For details of the Canadian Representative tax system and equalization entitlements for years 2001–2002 see table on next page.

11. References

Boadway, R. and Flatters, F. (1982). Equalization in a Federal State: An Economic Analysis. Ottawa: Economic Council of Canada.

[11] The Canada Health Act stipulates that provincial health care insurance plans must, throughout the fiscal year, satisfy the following criteria: public administration; comprehensiveness; universality; portability; and accessibility.

Table 2. Details of the Canadian Representative Tax System and Equalization Entitlements 2001–2002

	Provincial-Local Revenues		Representative Tax Base		Equalization Entitlements	
	Amount ($ millions)	% of Total	Unit of Measure	RTS Base	Amount ($ millions)	Equalization Payout Ratio*
1. Personal Income Tax Revenues	49,200	26.2	$'000	89,943,810	4,667	0.09
2. Business Income Revenues	14,958	8.0	$'000	133,477,043	889	0.06
3. Capital Tax Revenues	4,374	2.3	$'000,000	1,168,184	392	0.09
4. General and Miscellaneous Sales Taxes	30,048	16.0	$'000	353,062	836	0.03
5. Tobacco Taxes	2,576	1.4	'000 Cigarettes	44,595,993	−75	−0.03
6. Gasoline Taxes	5,128	2.7	$'000	41,559,329	43	0.01
7. Diesel Fuel Taxes	1,792	1.0	$'000	14,178,027	7	0.00
8. Non-Commercial Vehicle Licences	2,288	1.2	# Registrations	16,916,638	11	0.00
9. Commercial Vehicle Licences	962	0.5	$'000	93,571,691	32	0.03
10. Revenues from the Sale of Alcoholic Beverages	3,810	2.0	'000 Litre	2,538,357	77	0.02
11. Hospital & Medical Insurance Premiums	1,590	0.8	Persons	1,590,488	12	0.01
12. Race Trace Taxes	25	0.0	$'000	1,788,574	7	0.28
13. Forestry Revenues	1,702	0.9	$'000	1,702,086	276	0.16
14. New Oil Revenues	891	0.5	$'000	8,385,016	−96	−0.11
15. Old Oil Revenues	213	0.1	$'000	3,290,543	−5	−0.02
16. Heavy Oil Revenues	150	0.1	$'000	2,191,959	−55	−0.36
17. Mined Oil Revenues	300	0.2	$'000	8,044,550	0	0.00
18. Third-tier Oil Revenues	182	0.1	$'000	1,707,048	−20	−0.11
19. Heavy Third-Tier Oil Revenues	38	0.0	$'000	1,031,925	−11	−0.28
20. Natural Gas Revenues (Domestic and Exported)	6,792	3.6	$10^6 M^3$	35,497,757	343	0.05
21. Sales of Crown Leases	1,317	0.7	$'000	8,052,898	27	0.02
22. Other Oil and Gas Revenues	182	0.1	'000 M^3	297,336	−3	−0.01
23. Mineral Resources	434	0.2	$'000	5,104,312	−55	−0.13
24. Water Power Rentals	1,000	0.5	10^6 KWH	352,745	−275	−0.28
25. Insurance Premium Revenues	1,368	0.7	$'000	36,524,331	44	0.03
26. Payroll Taxes	7,010	3.7	$'000,000	395,448	491	0.07
27. Provincial-Local Property Tax Revenues	34,049	18.1	$'000,000	2,451,965	2,137	0.06
28. Lottery Ticket Revenues	1,750	0.9	$'000	3,161,357	10	0.01
29. Other Games of Chance Revenues	3,824	2.0	$'000	6,798,740	26	0.01
30. Misc. Provincial-Local Taxes & Revenues	9,964	5.3	$'000	164,873,580	736	0.07
31. Shared Revenues: Offshore Activities/NFLD.	21	0.0	$'000	29,400	−21	−1.00
32. Shared Revenues: Offshore Activities/N.S.	10	0.0	$'000	14,240	−10	−1.00
33. Shared Revenues: Preferred Share Div.	122	0.1	$'000	121,784	9	0.08
34. Total	**188,069**	**100.0**			**10,448**	**0.06**

* Equalization Payout Ratio is defined as Equalization entitlement/Revenues and represents the amount of Equalization paid per dollar equalized.

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