INSTITUTE OF INTERGOVERNMENTAL RELATIONS WORKING PAPER

SURPLUS RECYCLING AND THE CANADIAN FEDERATION:
Reassessing th45 eW*8N

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The US-China relationship presents another example, one where trade surpluses are indeed cycled back to the US but in a manner that has served to perpetuate the US fiscal and balance of payments challenge. Specifically, China has pegged its Yuan to the greenback and in spite of its huge trade surplus with the US it has essentially maintained the peg. However, this requires China to become the buyer of last resort of any and all US treasuries that, in turn, effectively removes the US budget constraint and serves

The final SRM addressed in the ensuing analysis is federal-provincial. With their open-ended or demand-driven expenditure responsibilities in the context of a rapidly aging population (such as those relating to medical practitioners, hospitals, home care, pharmaceuticals and, to a lesser, degree,) the provinces will find it progressively difficult to provide adequate public services across their current range of constitutional responsibilities. Arguably, Ottawa is in the opposite position. In other words, Canada will soon need to consider creative processes and/ or programs relating to the re-allocation of money and powers in the federation.

Readers will recognize that these are highly explosive issues: they embrace the high politics of altering the division of powers; they tamper, albeit indirectly, with provincial entitlements; at the inter-provincial level they are inherently zero-sum games; they embody empirical assessments that are both complex and controversial, and so on. Phrased differently, there can be no first-best solutions. As such, the policy recommendations cannot consist of doctrinaire remedies, but rather must of necessity take the form of a series of options or avenues for improving the operations of these three macro-equilibrating mechanisms. Indeed, the primary contribution of the paper may well lie not in providing solutions but, rather, in shedding political and empirical light on some existing inadequacies of the status quo in respect of the ability of these SRMs to provide the resilience and stability that the Canadian federation requires.

II: EQUALIZATION AS AN INTERPROVINCIAL SURPLUS-RECYCLING MECHANISM

There are many programs that recycle revenues/ incomes/ benefits across individuals and provinces. Employment Insurance serves to transfer benefits at the individual level from the employed to the unem

(and provinces)

While equalization payments are a key component of interprovincial surplus recycling, this recycling does not involve direct transfers of provincial revenues from rich to poor provinces. Rather, Ottawa makes these payments to the poorer provinces from its consolidated revenue fund (CRF). Although identical

to \$10.9 billion). Then Martin fundamentally transformed the future of the program by introducing the so-called *New Framework*. Henceforth overall equalization would grow annually by 3.5% -- irrespective of the degree of interprovincial fiscal disparities -- so that the role of the equalization formula would henceforth only determine the allocation of this fixed pool and not the size of the pool. Further

TABLE 1The Evolution of Equalization Payments (2005-2013, \$ million)

2005-	2006-	2007-	2008-	2009-	2010-
06	07	08	09	10	11

that their offshore energy revenues would be protected from equalization clawbacks at least until 2011-121.

Recognizing that the equalization program had become increasingly arbitrary, Liberal Finance Minister Ralph Goodale in his 2005 federal budget established the *Expert Panel on Equalization and Territorial Formula Financing*, whose 2006 report will henceforth be referred to as

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fully implemented in Conservative Fina

budget. Among these new equalization provisions were: a return to the old regime where the formula would determine both the size and the distribution of the equalization pool; a reallocation of the 30+ tax bases into five bases (personal income taxes, corporate income taxes, property taxes, sales taxes and 50% of all resources revenues); a cap on equalization so that no receiving province could end up with more overall revenues per capita than the lowest of the non-receiving provinces); and the provision that the data entering the formula would be in the form of three-year averages lagged two years.

However, the open-ended nature of the revised program (i.e., open ended in that the formula would determine the total amount of equalization)

However, the major economic news in the table is the descent of Ontario

value of the sales tax entry (and, therefore the value of the foregone revenue) for Alberta is reported to be in the order of \$5 to 6 billion.

The third reason has already been alluded to, namely that Alberta has been moving in the direction of becoming both a tax haven (it has no provincial sales tax, as just noted and it has the lowest personal income tax) and a provider of superior public goods. In terms of the latter, the Fr

What difference would this make to the results in Table 2? Table 3 provides one answer. Row 1 of the table reproduces the overall per capita fiscal capacity figures from row 7 of Table 2. Note that these figures *include*

year 2008-09 in connection with his path-breaking Mowat Centre research directed toward measuring expenditure need. His indexes by province (with Canada equal to 1.00) appear as row 2 in Table 3. The indexes are calculated as the prices/ costs of a weighted average of six categories of public goods and services: wages and salaries8; transfers; construction contracts; heath care purchases; consulting services and a residual category referr

row A2 and the resulting values represent estimates of the real purchasing power of post-equalization aggregate provincial revenues.9

The results border on the astounding. Ontario, with \$8,135 per capita in real purchasing-power-revenues comes off as the most fiscal-capacity-deprived province, and by a considerable margin. The next closest are Manitoba with \$8,674 and Quebec with \$8,725. Lest one think that these are small differences, with a population in the neighbourhood of 13 -\$600 per capita shortfall (in real terms) relative to Quebec means that it would take roughly 8 billion dollars (of real purchasing power) to close the Ontario-Quebec gap.

Moreover, non-equalization-receiving-province British Columbia ends up with a lower ability to provide per capita real quantities of public goods than does Prince Edward Island.

At one level, row 3 of Table 3 is the appropriate vantage point for assessing to qualization system in terms of the overall distribution of pre-capita revenues across the recipient provinces. From this perspective, the equalization system is failing

price/ cost index in row 2 of Table 3. Then one would transfer equalization dollars to the lowest purchasing-power-adjusted fiscal-capacity province until it is brought up to the second lowest, and then transfer equalization dollars to these two provinces until they achieve the level of the third lowest, and so on until the allowable equalization pool runs dry. This process leads to the per capita equalization payments in row 5 of Table 3, with the original equalization payments (row 2 of

that Ontario is already considerably disadvantaged in terms of providing comparable real public goods and services, this approach would exacerbate . A equi-proportional reduction seems more appropriate, i.e.,

take formula based equalization and then apply these same percentages to the allowable amount of equalization.

By way of a concluding comment, if the US can fall back of the importance of capitalization as a rationale for not having an equalization program, then it seems

our equalization program. This is even more the case since a straightforward reading of the s.36(2) would appear to support taking the prices/ costs of producing provincial public goods and services into account.

However, even if Canada embraced the concept of incorporating prices into the definition of comparable levels of public goods and service, *might it not be the case that, say, New Brunswick or Quebec, would need a larger number of the these comparable bundles?* Readers will note that correcting for capitalization as a first step and then assessing the number of these price-corrected bundles different provinces may require is not the generally accepted approach to the concept of expenditure needs. Rather, the generally accepted approach of expenditure-needs advocates is that it should incorporate both differential prices/ costs and differential physical needs or requirements.

I will defer my reflections on the appropriate approach until later. In the interim the analysis now turns to the most sophisticated assessment of the generally accepted vision of expenditure-needs equalization.

II:E. Expenditure Needs Equalization: The Peter Gusen Analysis

Peter Gusen has recently (2012a, 2012b), and courageously, undertaken an impressive and comprehensive approach to developing and measuring an expenditure-needs approach to equalization, one that embraces both differential costs/ prices and measures of actual (price/ cost-independent) needs. In more detail, his results for expenditure needs in the various provinces are based on a weighted

TABLE 4

Equalization and Expenditure Need (2008-09, \$million)

	NL	PE I	NS	NB	QB	ON	MB	SK	AB	ВС	
1. Health	165	- 19	167	165	-467	-178	-28	289	-848	752	
Elementary and Secondary Education	-43	-9	-154	-96	-1,242	753	191	195	896	-491	

3. Post-Secondary Education -45

for re-

equalization is also the province whose taxpayers (corporations in his example) are conceptually funding the increase via their enhanced consolidated revenue fund.

On both counts resource royalties are entirely different. First, thanks to s.92(5), s.92A, s.109 and s.125 of our Constitution, energy (and resource) royalties are

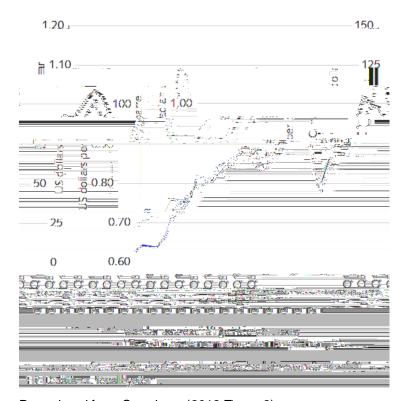
prospect of tax havens and/or superior provincial public goods and services in resource-rich provinces becomes a distinct possibility. Hence, Ottawa has to find indirect ways of recycling these resource revenues, which is in large measure the subject matter of this section. By way of an instructive aside in relation to the tax-haven issue, Canadians ought to be most thankful that Albertans abhor sales taxes since this is the most benign form of tax to eliminate because it has little impact on interprovincial factor flows. In sharp contrast, the interprovincial factor flows (including movement of corporate headquarters) would probably be quite dramatic were Alberta to have reduced its corporate income to zero rather than forgoing a sales tax. Moreover, a zero corporate tax would cost *less* in terms of forgone revenues than does a zero provincial sales tax. Presumably Alberta recognized that Ottawa would probably have had to respond in a countering fashion to a zero CIT, so this may have also served to tilt

increase in resource prices relative to the price of manufacturers. Although not shown in Figure 1, there was an earlier and equally rapid depreciation in the 1990s that also represented exchange-rate overshooting, this time on the downward side.

To be sure, much more than the exchange rate was, and still is, at work in terms of the sharp decline in our manufacturing sector. Specifically, given that the

the wholesale offshoring and outsourcing of US manufacturing to China in order to take advantage of the inexpensive but efficient Chinese labour force clearly played the dominant role in the shrinking of the Canadian manufacturing sector.¹⁴

Figure 1: US-Canada exchange rate and crude-oil price, 2002Q1-2011Q4



Reproduced from Courchene (2012 Figure 2).

Nonetheless, and in contrast to the prevailing wisdom, my view has long been that the Bank of Canada should not have permitted swings in the Ioonie of anywhere near the magnitudes experienced recently. Indeed, even the Swiss monetary authorities, long viewed as the gold standard in the pantheon of central bankers, are

now intervening in currency markets to limit the appreciation of the fabled Swiss franc relative to the euro.

There is a related exchange-rate/ manufacturing issue that merits airing in this context. Everyone recognizes that over the longer term the driver of Canadian living standards will be our productivity growth. Not surprisingly therefore, virtually every week one or another policy analyst weighs on weie/e I7 1 90.024 745.2 450-1

context. Canada has many trump cards as a location for accessing NAFTA economic space—envious macro economic indicators, a qualified labour force, a safe environment, quality public schools, medicare, and on and on. Yet given that the recent evidence suggest that the loonie can have 50 cent swings in both directions for eign investors may shy away from Canada as a location for accessing the US market. For purposes of the ensuing analysis, the relevant message is that a freely floating exchange rate exchange can wreak havoc on the manufacturing sector not only via the operations of the Dutch Disease but as well via the sheer volatility of the Canada-US exchange rate. 16

Figure 2 presents some evidence for the claims in the previous two paragraphs. Focusing on the right hand side of the figure, the uppermost line at the right-hand side of the figure is an index (2002 = 100) of Canadian unit labour costs in manufacturing expressed in USdollars. The lowest line is the index of US unit labour costs in USdollars. In the middle is an index of the Canada-US exchange rate (where higher values of the index represent an appreciation of the loonie). Unit labour costs (ULCs) measure the average cost of labour per unit of output and are calculated as the ratio of total labour costs relative to real output, where wage increases will increase ULCs and productivity increases will decrease ULCs, other things remaining equal. What Figure 2 reveals is that the interaction of wages and productivity resulted $\frac{1}{2}$ ($\frac{1}{2}$) $\frac{1}{2}$ ($\frac{1}{2}$)

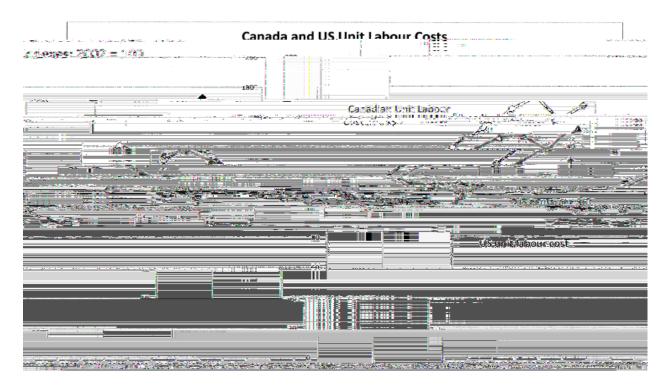
increased by nearly 90%. Small wonder that Canadian manufacturing is under siege!

Admittedly, the implications of the Dutch Disease and exchange-rate overshooting are even more complex still. This is so because the more the exchange-rate appreciation for any given global energy price increase the less will be the Canadian dollar value of resource exports but the more will be the hit visited on manufacturing. Hence, both the manufacturing and energy provinces should be in favour of curtailing exchange-rate overshooting. However, this would complicate the operations of the equalization program since the revenue gap between the energy rich provinces and the rest would widen. There is no free lunch here.

With the above as backdrop, the analysis now turns to the range of options for ameliorating the likelihood that a hydro-carbon and hydro-electric industrial strategy is not overturned because of the failure of surplus recycling systems at the upper end of the provincial fiscal capacity spectrum. These will take the form of options that serve to indirectly redistribute the royalty revenues and/ or attenuate the operations of the Dutch Disease.

Prior to turning attention to these indirect approaches to surplus recycling, it should be noted that there is one option that would qualify as a *direct* surplus recycling mechanism, namely a direct transfer of royalties from one province to another. Not surprisingly this option has arisen in the BC-Alberta stand-off over the Enbridge Northern Gateway pipeline. Given that Alberta will pocket scores of

FIGURE 2



Source: US Bureau of Labour Statistics

annual return on this investment can be spent or, in the context of this paper, bought into provincial budgets.

Attention is now directed to alternative ways in which resource revenues can be indirectly recycled. Much of what follows has its roots in the existing Canadian policy literature. The most recent contributions would include Boadway, Coulombe and Tremblay (2012), Tremblay (2012) and Courchene (2012).

2. Provincial Sovereign Wealth Funds (PSWFs)

This stewardship perspective points in the direction of PSWFs, preferably along the lines of N . Fuelled by fossil energy revenues, invested in international markets. This serves to offset y related export earnings, thus in turn serving to ameliorate the tendency for the Norwegian currency (krone) to appreciate. PSWFs invested in international markets would play the same role—stewarding energy related revenues for use by future generations and in the process reducing the operations of the Dutch Disease. As noted earlier, by reducing the degree to which the loonie would appreciate in the face of an increase in the international demand for and/ or

\$400 Prosperity Bonus distributed to all tax-

paying Albertans)
represented another way of ensuring that energy royalties do not enter the

deemed these allocations to be exempt from federal income tax. At one level, this seems appropriate since an alternative would have been to reduce provincial income taxes by an equivalent amount. However, since these Ralph Bucks were in effect an energy dividend and since royalties accruing to owners of oil-producing freehold land

inappropriate. This is especially the case in light of the earlier discussion to the effect that public finance principles may well argue for imputing a taxable benefit to individuals that benefit from federal-tax-exempt provincial royalties that are used to provide provincial public goods and services. Phrased differently, Ralph Bucks should have been subject to federal personal income taxation.

3. Redesigning Federal Corporate Profits Taxes

While Ottawa cannot access provincial royalties, it can alter its corporate taxation system in ways that will increase its revenues from the sector. The obvious, albeit controversial, approach here would be to disallow deduction of a

royalty payments to provincial governments in calculating its federal corporate taxes. One likely result of this would be that the provinces would be put

One of the hallmarks of our approach to the social envelope in comparison with the US is that we engage in targeting-cum-income-testing for virtually all of our benefits whereas the Americans do not, i.e., their social security payments are universal rather than targeted (via income testing) to those most in need. In other words we purchase more equity, as it were, than do the Americans from every dollar of social policy spending. Revenue testing is a natural extension of income testing.

It should be clear that there is nothing sacrosanct about the choice of the 115% threshold or the 25% clawback. Others would probably choose different parameters. But what hopefully becomes acceptable is that revenue testing, already the cornerstone of our equalization program, also becomes a defining feature of the rest of our federal-provincial transfer system.

Finally, it is instructive to recognize that the CHT/CST has been subject to revenue testing. The precise details are arcane but, in general terms, provinces with high per capita revenues from the personal tax and to a lesser degree the corporate income tax received smaller per cape tjUl/ Or 2bgn Tm0 1 145.94 392.11 Tm[()Tm58.-

abatement to accrue, via upstream or origin-based emission taxes, to the energy rich provinces that are already receiving huge energy rents/ royalties this would dramatically exacerbate the already challenging differential fiscal capacities across provinces. In a *Policy Options* article John Allan and I (March 2008) argued that the preferred option would be a nationally run, destination-based (i.e., a final-consumption-based) carbon tax regime. Among the reasons for this were: i) that the burden of \mathbf{CO}_2 affects

The anatomy of this failure is three-fold. First, and most important, the pressures from population aging (including medicare, pharmaceutical, hospital and eldercare expenditures) and welfare payments among other areas on the one hand and the influential political constituencies associated with these areas (especially with health and aging) on the other are such that the provinces will be forced to draw funding away from areas such as primary, secondary and tertiary education. Phrased differently, the pressures on provincial dollars will be to direct them toward financing consumption-oriented activities at the expense of financing investment-enhancing activities.

This is a disastrous economic strategy in an increasingly human capital and information era.

Second, Ottawa is in the enviable position of having the most robust fiscal position of the G8 countries and, as will be clear, its expenditure responsibilities are much more amenable to control than are the provincial expenditure responsibilities.

Third, federal piece-meal (perhaps peace-meal is more appropriate) measures directed to the provinces are likely to complicate the implementation of preferable longer-term strategies.

In more detail, the underlying issue is related to open-ended or demanddriven programs. returning to a budgetary balance by 2015-16. When the formula-driven equalization entitlements began to expand rapidly Ottawa reacted by limiting equalization increases to the rate of growth of GDP. Moreover, h generous 6% escalation in the ,r

beneficiaries of the provincial programs play a role in the funding of social spending. The rapid rise in tuition fees for post-secondary education is a case in point. As

preferable would be a tax on consumption rather that investment. Accordingly, the essay will conclude with a proposal for a version of user fees/ co-payments for medical services.

IV:A. Transferring Money/Taxes Downward

Ottawa would presumably view the reduction in the GST from 7% to 5% as akin to a tax transfer to the provinces (albeit with no requirement that the provinces actually incorporate the two percentage points in their own sales tax regimes). However, I would argue that a better approach would have been to maintain the GST intact, but then to devolve the proceeds of the two GST percentage points to the provinces on a revenue-tested basis (as outlined above). This would not only begin to redress the faltering federal-provincial surplus-recycling mechanism but it would also and relatedly ensure that overall fiscal capacity levels across provinces would become more equitable. Readers will recognize that this as a small-scale version of the Australian

Under the assumption that the economy recovers and Ottawa is again running surpluses, the pressures for rethinking the allocation of revenues will heighten, for reasons noted above. Transferring the proceeds of, say, a further one percentage point of the GST to the provinces along the lines outlined in the previous paragraph would merit consideration.

IV:B. Transferring Powers Upward

1. Pharmacare

The other approach to recycling the impending relative, and likely absolute, federal surpluses is for the provinces to pass some of their open-ended expenditure responsibilities upward to Ottawa. This is hardly a far-fetched alternative, since the provinces in their 2004 inaugural meeting of the Council of the Federation voted

unanimously to transfer the responsibility for pharmacare to Ottawa. An integral component of the proposal was that Quebec would maintain its control over pharmacare replete with equivalent federal compensation. By way of an aside, one might note that this corresponds exactly with the essence of s.94 of the constitution which allows the common law provinces (i.e., all but Quebec) to transfer aspects of

Increasingly, events well beyond the control of the provinces are determining their economic fortunes, so that bearing the costs of adjustment should not be the sole responsibility of the provinces.

Elsewhere (*Policy Options*, September, 2009) John Allan and I recommended that Ottawa take over aspects the responsibility of the income-support component of welfare (but not the welfare services components). The context for this recommendation is that we now have a GAI (guaranteed annual income) for seniors, namely OAS/ GIS, and a

surged. Young people no longer dropped out in order to contribute to the family finances.

Senator Segal concludes his article as follows (p.10):

In a mixed free market Canadian economy where enterprise, risk, diligence and hard work matter, equality of opportunity is essential if fairness about access to the economic mainstream is to be real for all. A guaranteed annual income would be a serious pillar of that opportunity, as important to us as universal education, safe communities and health insurance.

A GAI, or a NIT (negative

program would enhance cross-province student mobility in terms of selecting a post-secondary institution. There are models in other countries that could help in the design of such a system. The essential component of such a system is the loan repayments in any period will relat

versions only require the repayment of actual loans and not the associated interest or

use of the health care system, as well as a dollar measure of the benefits received. These benefits, subject to a possible exemption and catastrophic limits, could be subjected to a form of income taxation. The whole process would be integrated with the income tax returns

income-contingent-repayment initiative for financing students

ENDNOTES

¹ While Newfoundland now longer qualified for offsets under its offshore accord after fiscal year 2011-

Table 3, although he does provide the data necessary for one to calculate the index, -needs approach in the next section.

¹⁶ Now that the US is moving in the direction of becoming an energy superpower, the Canada-US exchange rate may not be subject to the degree of volatility in response to changes in global energy prices that has characterized the recent past.

¹⁷ A recent Mowat Centre paper by Jean-François Tremblay (2012) addresses some of the same issues and offers some of the same solutions (often in more detail) as those dealt with in this section.

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