REDISTRIBUTION, RISK, AND INCENTIVES IN EQUALIZATION: A COMPARISON OF RTS AND MACRO APPROACHES*

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1 INTRODUCTION

Equalization is sometimes called the "glue" that holds the Canadian federation together. Perhaps, but those bonds have been loosening in recent

levied the average of all provinces' tax rates. Increasingly, it appears that the common critiques of Equalization relate to the mechanics of the RTS approach, and the incremental reforms of previous years may no longer be

deficiency relative to the standard level, in the [redacted]

policies. It is sometimes suggested that non-transparency is desirable, in that it sublimates political conflict and negotiation over the size of intergovernmental transfers. To

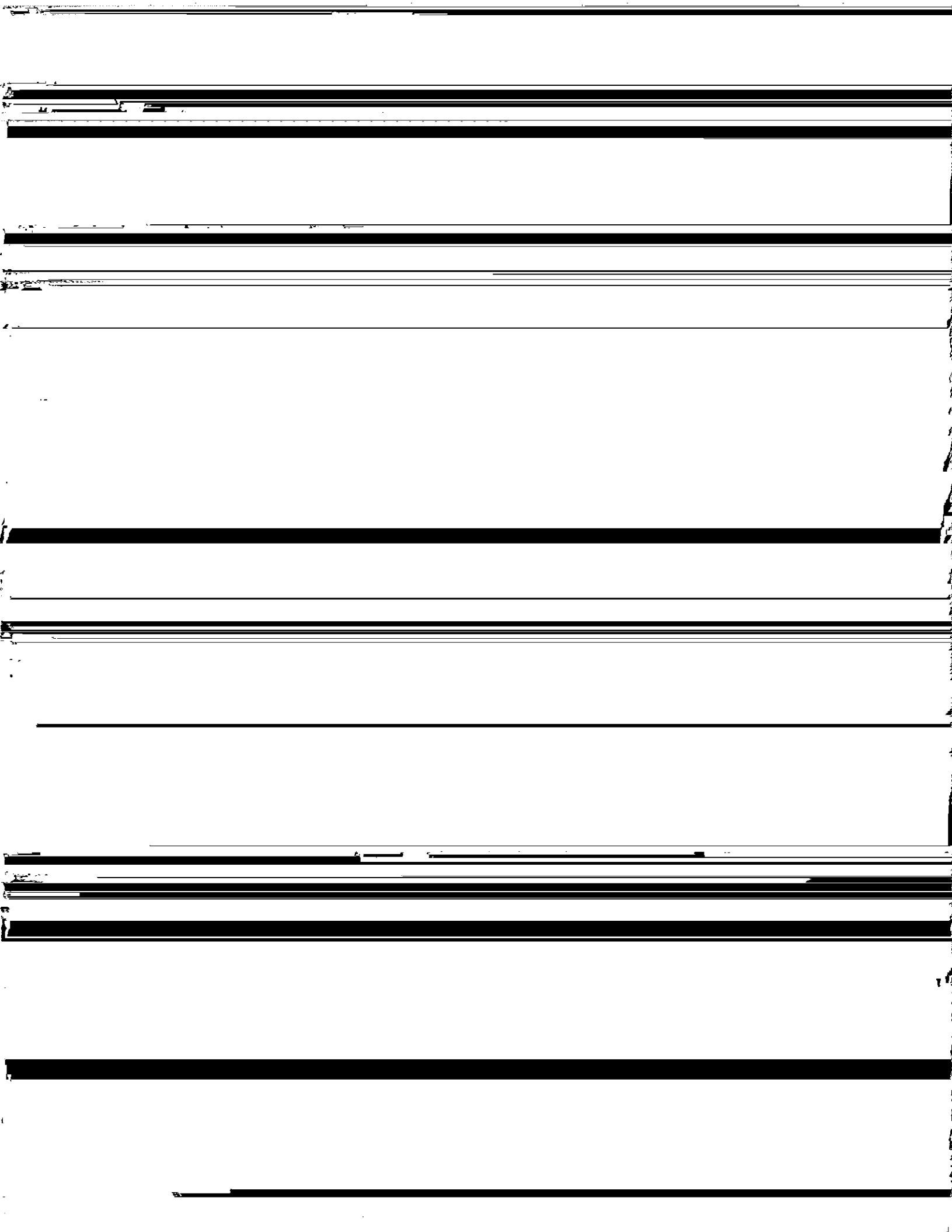
entitlements. If the province is not in the standard (the obvious example is the offshore oil categories), the problem is extreme: since the

create a "cycle of dependency" for receiving governments. He proposed that the generic solution of partial equalization be extended to all bases to deal with the disincentive problem.

Smart (1998) argues that the adverse incentive effects of Equalization are even more extensive and potentially harmful. Under an RTS formula, receiving provinces have a financial incentive to set tax rates too high, above efficient

Jackson, 2001). This is consistent with the notion that Equalization insulates receiving provinces from the pressures of tax competition and so allows them to set higher rates.[4] However, the evidence is quite indirect, and more work on this is needed.

Less formally, there is anecdotal but convincing evidence that, in a small number of cases, Equalization considerations have largely



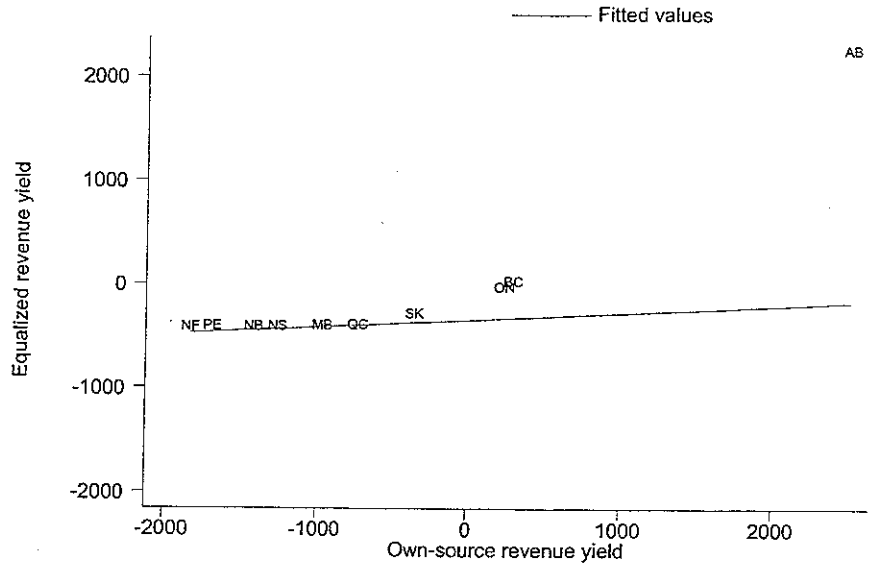
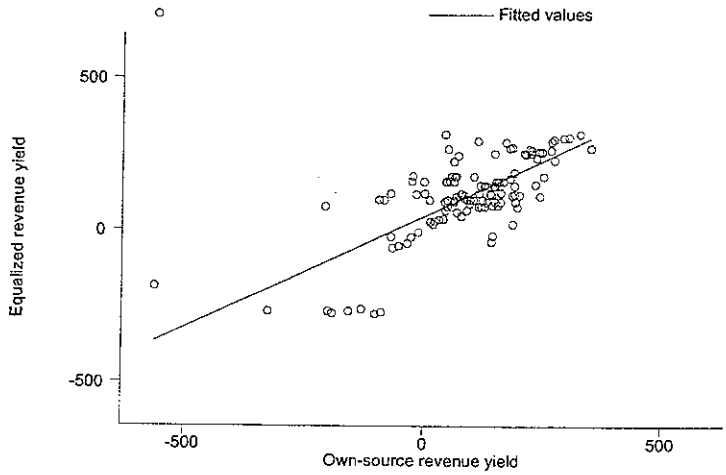


Figure 1: The redistribution function of equalization

indicating the exclusion of the three non-receiving provinces from the formula significantly reduces the average degree of redistribution among the provinces. The second

The stabilization function. While Equalization was conceived of and operates primarily for redistribution to have-not provinces, it also plays

Table 2: Transfers and stabilization



3 TOWARDS A MACRO FORMULA FOR EQUALIZATION

Based on these considerations, it may be that the time has come to consider a fundamental change in the structure of Equalization in Canada. Many

Notice that the current system calculates the entitlement for each revenue source in exactly this way, where the deficiency variable is the level of tax base and the scale factor is the national average tax rate. In what follows we

Table 3: Alternative transfer formulas

	Income Formula	Revenue Sharing Formula	Stabilization Formula
Scale Factor	-0.175	-0.970	-0.115
Average shortfall in simulated transfers ($ per capita):			
Newfoundland	6	-6	586
Prince Edward Island	-6	-12	533
Nova Scotia	-61	-70	348
New Brunswick	42	37	469
Quebec	54	51	245
Manitoba	266	260	464
Saskatchewan	-116	-117	42
Standard deviation of change in net revenues ($ per capita)	172	177	149

Notes: "Income formula" refers to the transfer system that is proportional to differences in GDP per

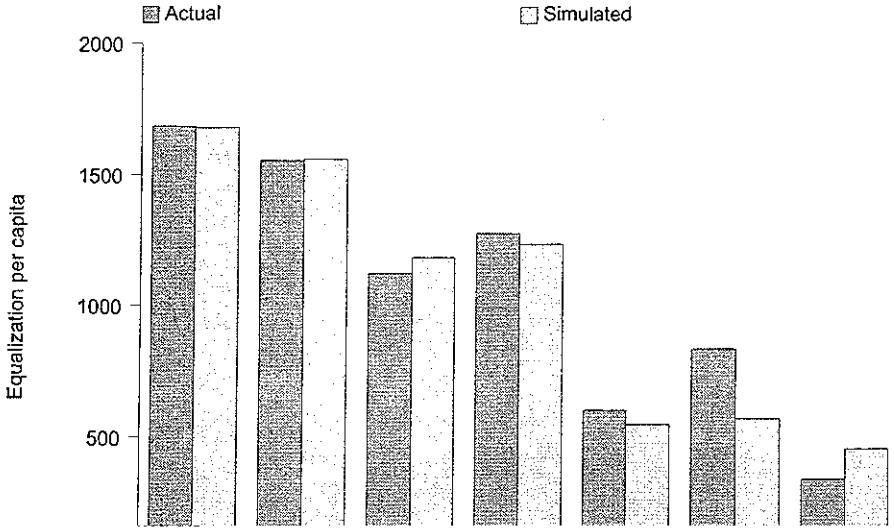

Actual
Simulated
2000
1500
1000
500
Equalization per capita

Table 4: Percentage distribution of equalization entitlements, 1980-99

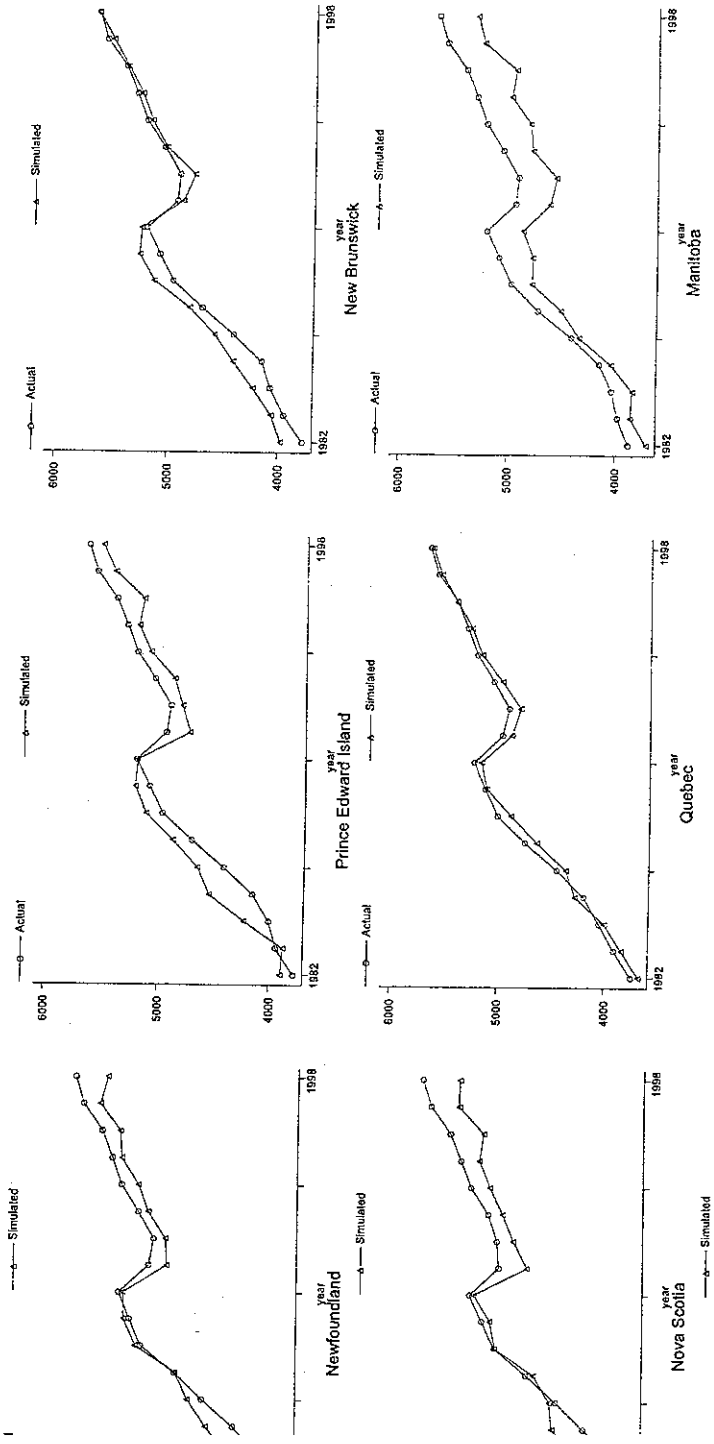
		Tax base:			
Province	PIT	Business taxes	Sales taxes	Property taxes	Resource taxes
Newfoundland	36.4	10.7	10.1	21.1	1.5
PEI	35.2	11.2	9.8	18.7	8.2
Nova Scotia	32.3	15.0	5.5	21.5	10.2
New Brunswick	36.9	11.4	8.6	22.4	2.8
Quebec	38.5	2.5	11.9	18.9	8.3
Manitoba	37.2	16.2	11.4	13.3	6.1
Saskatchewan	80.5	25.3	10.7	21.9	-62.9

and incentives to distort provincial tax mix would

[redacted]

the federal government, which pays Equalization transfers to recipients in Canada's "gross" system of equalization, rather than non-recipients, as in a

is replaced by national GDP Y_t, and the scale factor is adjusted accordingly.


Actual
Simulated
6000
5000
4000
1982
1998
year
New Brunswick
Manitoba
Prince Edward Island
Quebec
Newfoundland
Nova Scotia
Saskatchewan