

Still More Equal Than Others: Capped equalization still too much.

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Do We Over-Equalize?

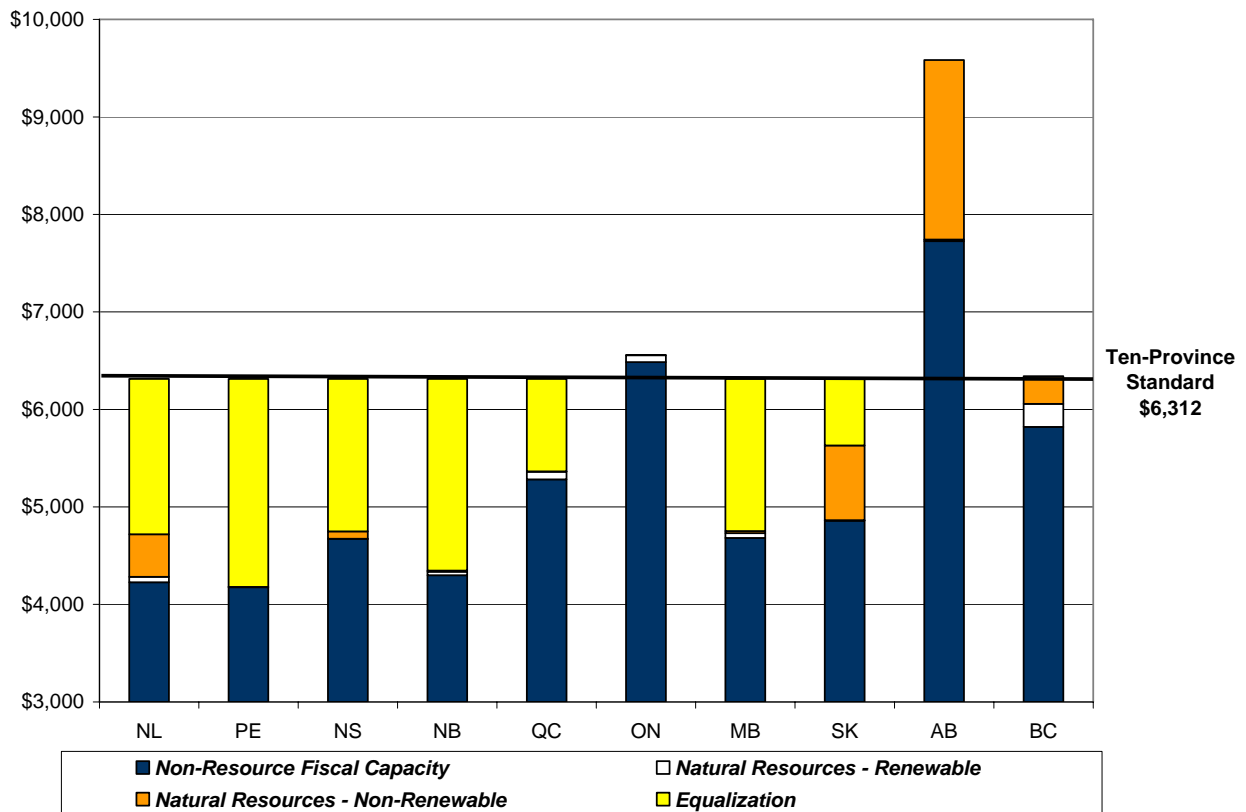
In response to the May 2006 report of the Expert Panel on Equalization and Territorial Formula Financing on repairing Canada's equalization program, AIMS examined whether or not the equalization program truly delivered on its promise of "equalized" fiscal capacity for the provinces. In that Commentary, "*Why some provinces are more equal than others*", we discovered that the two "have" provinces, Ontario and Alberta, retained a fiscal advantage over the other provinces once equalization entitlements were included in the fiscal capacity of the receiving provinces. However, when the different costs of providing services were considered, under the recommendations of the Expert Panel, Ontario would have the lowest fiscal capacity of all provinces. This occurs despite a "cap" on equalization to prevent equalization receiving provinces (ERPs) from gaining a fiscal advantage over their non-receiving counterparts.

The 2007 Federal Budget delivered on the long awaited promise of a new equalization formula, and included many of the recommendations from the Expert Panel's report. Here, we examine whether or not it delivers on the promise of equalized fiscal capacity.

How much do the provinces have to spend?

Figure 1 shows how equalization entitlements were determined for the 2007-2008 fiscal year according to the 2007 Federal Budget, prior to determining the equalization cap. These figures include 50 percent of all resource revenues in addition to the non-resource fiscal capacity of the provinces. This chart shows the equalization receiving provinces brought up to the national average per capita fiscal capacity. Three provinces, Alberta, Ontario, and British Columbia, do not receive any equalization as they all lie above the ten province standard.

**Figure 1 – Calculation of Equalization Entitlements for 2007-2008
Budget 2007 Formula, 50% Inclusion of All Resource Revenues (\$ per capita)**



Based solely on the data in Figure 1, equalization brings those recipient provinces up to the national average, while those non-equalization receiving provinces maintain a fiscal advantage in that their revenue generating capacity is above the ten province standard, and therefore above all the equalization receiving provinces. Those provinces enjoying above-average levels of prosperity still enjoy a small advantage in spending capacity compared to the ERPs.

However, the new formula goes further in protecting that fiscal advantage by looking at the provinces’ fiscal capacities with 100 percent of resource revenues included.¹ Figure 2 shows

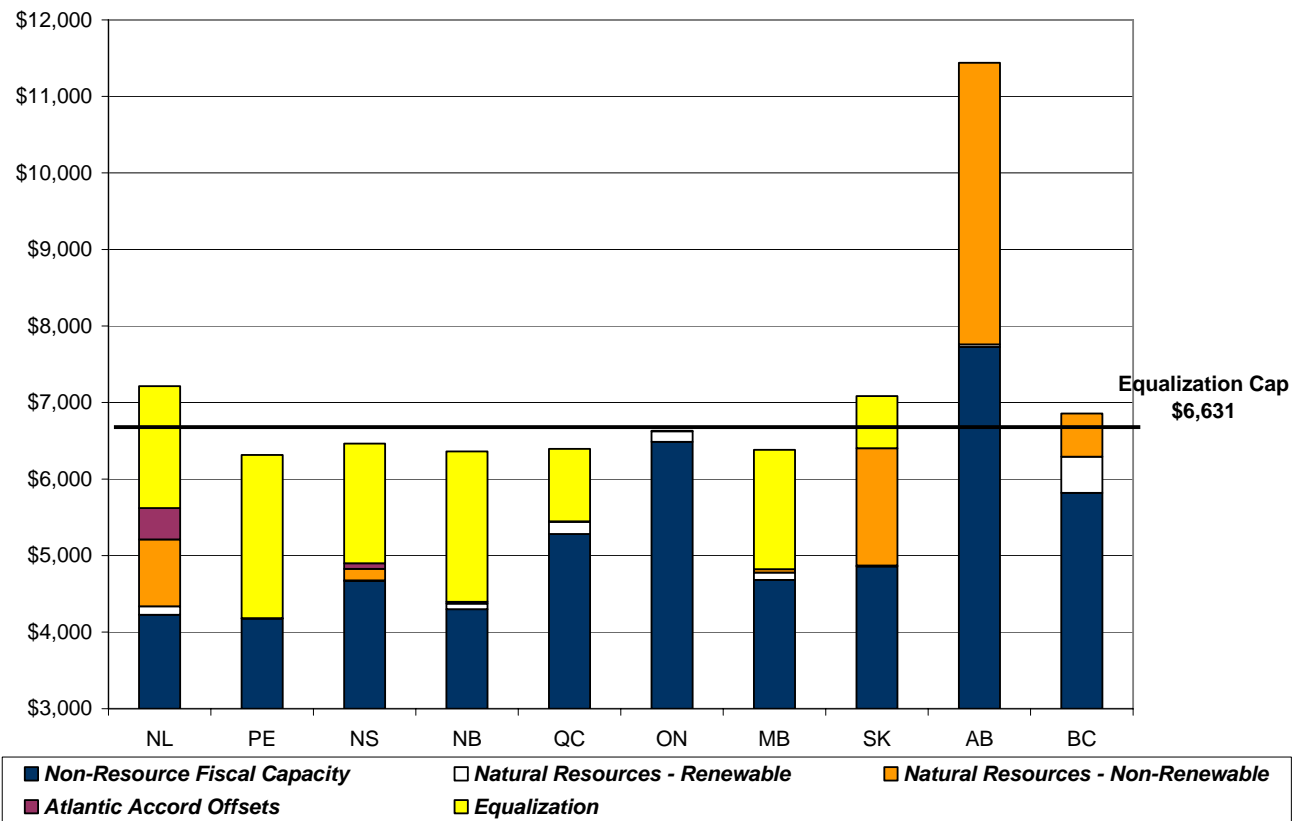
the fiscal capacities of the provinces with 100 percent of resource revenues included, along with their equalization entitlements with 50 percent inclusion of resource revenues. In this scenario, two equalization receiving provinces, Newfoundland and Labrador and Saskatchewan, have fiscal capacities greater than that of Ontario, the non-equalization receiving province with the lowest fiscal capacity. As a result, the equalization entitlement for Newfoundland and Labrador and Saskatchewan is “capped” at the amount that brings them to the same fiscal capacity as Ontario. This reduces Newfoundland and Labrador’s entitlement by \$584 per capita, while Saskatchewan receives \$454 less per capita.

¹ This calculation also includes offsets awarded to Newfoundland and Labrador and Nova Scotia under their Offshore Accords with the federal government intended

to prevent their offshore revenues from being “clawed back” from their equalization entitlements.



Figure 2 – Calculation of Fiscal Capacity to Determine the Equalization Cap Budget 2007 Formula, 50% Inclusion of All Resource Revenues (\$ per capita)



As in the Expert Panel’s recommendations, these figures still fail to account for the relative cost of the services the provinces provide. As pointed out in “*Why some provinces are more equal than others*”, equalizing revenues to a common standard assumes that a dollar spent in an ERP buys the same amount of public services as a dollar spent in a wealthier province. Using the work done by Queen’s University Professor Tom Courchene, one of Canada’s leading authorities on equalization, in *Vertical and Horizontal Fiscal Imbalances: An Ontario Perspective*², it is clear that the assumption does not hold, and that the fiscal capacities of the provinces should take

into account the relative cost of providing public services within each province.

Courchene used wages as a kind of proxy adjustment factor, but recognized that a better approach would be to look at the actual specific costs of providing provincial services in each jurisdiction. As detailed information on the differences in costs across provinces for the delivery of services is not available, we used a detailed annual comparison of the cost of carrying on business in various jurisdictions around the country, KPMG’s 2006 Competitive Alternatives.³

² Courchene, Thomas J., *Vertical and Horizontal Fiscal Imbalances: An Ontario Perspective*, Background Notes for a presentation to the House of Commons Standing Committee on Finance, May 4, 2005

³ *Competitive Alternatives.Com Cost Model Detailed Comparison Report*, <http://www.competitivealternatives.com/results/reports.asp>



In order to focus on the costs of providing *public* services, we have removed the weighting relating to tax burden.

Using the data in KPMG’s 2006 study for each province’s largest city, the following cost adjustment factors were determined for each province:

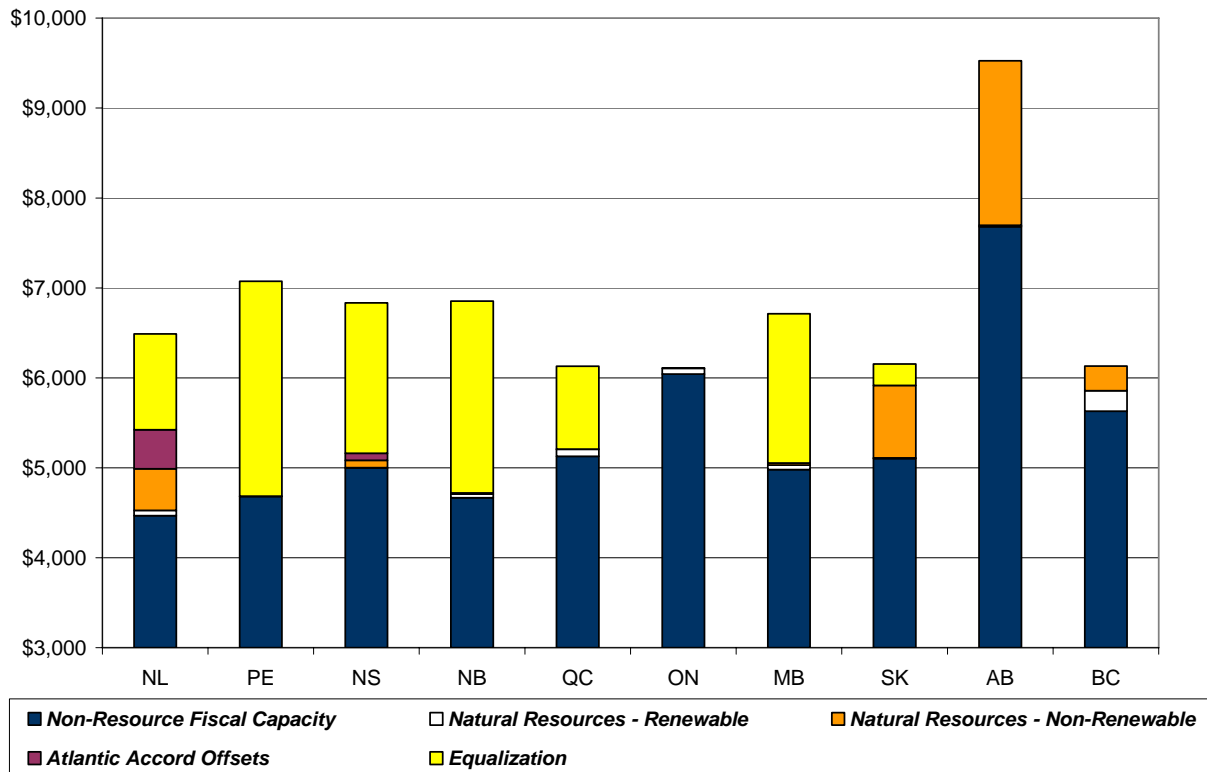
Figure 3 – Adjustment Factors

NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
0.946	0.892	0.934	0.921	1.030	1.073	0.940	0.952	1.006	1.034

To put it at its most simple, what this figure shows is that for a bundle of public services that it costs \$1,073 to deliver in Ontario, that same bundle of public services should only cost \$946 in Newfoundland or \$940 in Manitoba. Put another way, we are trying to

establish a kind of purchasing power parity across provincial governments. Applying these adjustment factors to each province’s fiscal capacity, after including the effects of equalization on provincial revenues, yields the results shown in Figure 4.

**Figure 4 – Adjusted Provincial Fiscal Capacity, 2007-2008
50% Inclusion of All Resource Revenues and Adjusted for Relative Costs (\$ per capita)**



When looking at the adjusted fiscal capacities, Ontario is left with the lowest effective fiscal capacity of all provinces (see Figure 5). Another non-receiving province, British Columbia, sees its effective fiscal capacity fall below that of six out of the seven ERPs. As in the recommendations of the Expert Panel, the equalization changes announced in the 2007 Federal Budget see two of the three richest

provinces before equalization effectively become two of the three poorest after equalization when the difference in costs of providing services are factored in. Meanwhile, the most fiscally disadvantaged province before equalization, PEI, effectively becomes the second richest province (after Alberta) in terms of its effective ability to deliver programs.

Figure 5 – Fiscal Capacity Ranking Before and After Equalization Considering Relative Costs of Providing Public Services

<i>Fiscal Capacity Rank</i>	<i>Fiscal Capacity Ranking before Equalization</i>	<i>Adjusted Fiscal Capacity Ranking after Equalization</i>
1	AB	AB
2	BC	PE
3	ON	NL
4	SK	SK
5	NL	NB
6	QC	NS
7	MB	MB
8	NS	BC
9	NB	QC
10	PE	ON

Non-Equalization-Receiving Provinces

Equalization-Receiving Provinces

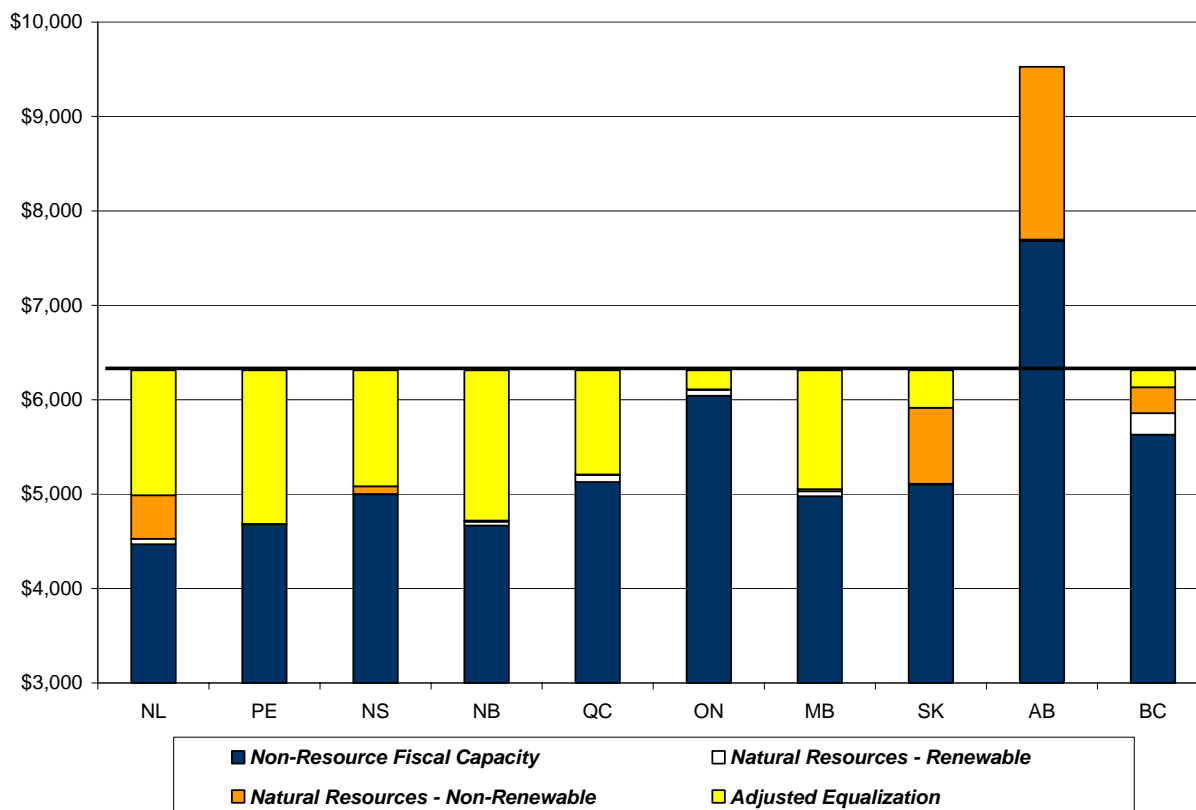
Consider the cost

If cost is taken into consideration when determining equalization entitlements, the result is shown in Figure 6. In this scenario, nine

of 10 provinces, including the traditional “have” provinces Ontario and British Columbia, would become equalization receiving provinces, primarily due to their inflated costs relative to the receiving provinces.



**Figure 6 – Calculation of Equalization Entitlements for 2007-2008
50% Inclusion of All Resource Revenues and Adjusted for Relative Costs (\$ per capita)**



Note that Figure 6 shows fiscal capacity amounts that have been adjusted to consider the relative costs in each province. To determine the actual dollar amounts of

equalization payouts to the provinces, the equalization amounts are re-adjusted by the same adjustment factors shown in Figure 3. Figure 7 shows the actual dollar amounts of equalization for each province.

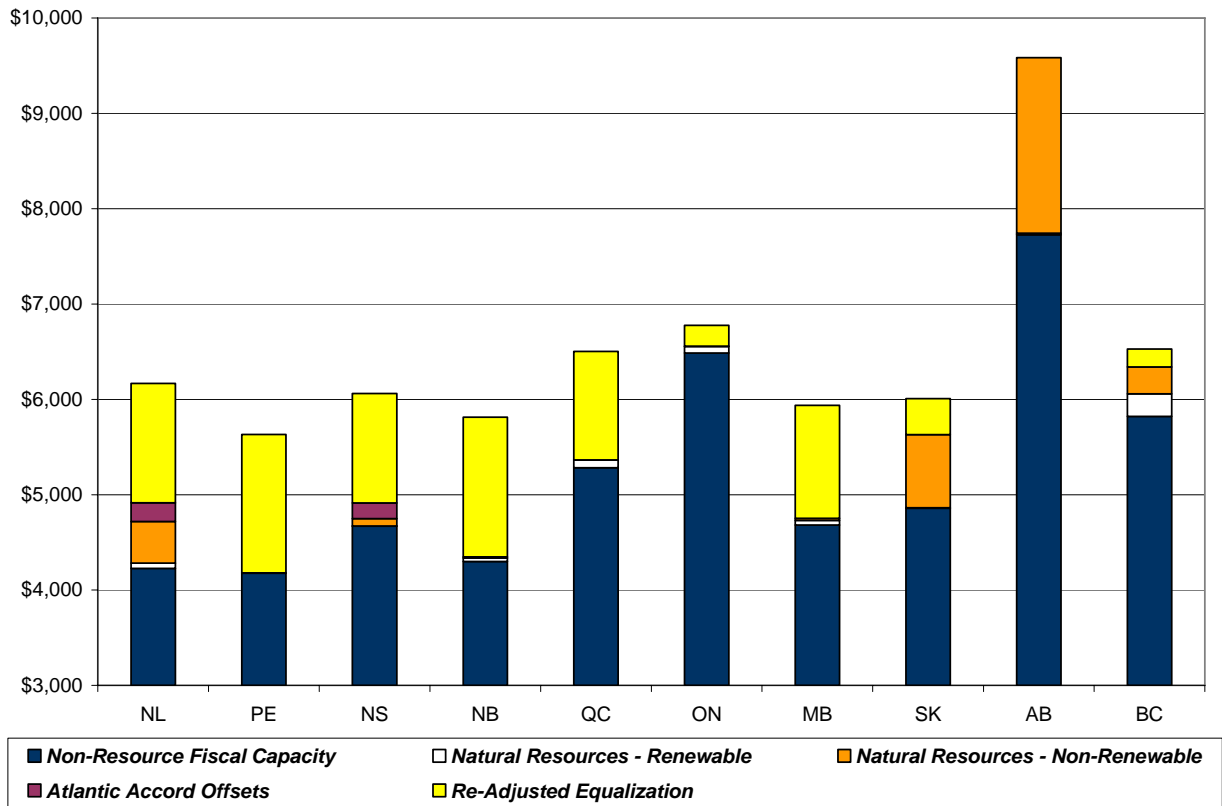
**Figure 7 – Comparison of Equalization Entitlements
2007-2008, in Millions of Dollars**

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
Current Approach	520.5	294.0	1,464.5	1,476.5	7,160.4	0	1,825.8	226.1	0	0	12,967.8
Cost Adjusted Approach	645.9	200.2	1,075.8	1,101.8	8,592.3	2,703.3	1,385.6	374.9	0	791.3	16,871.2

Using the formula introduced in Budget 2007 in addition to considering the relative costs in each province would increase the overall cost of equalization, but it would eliminate the need for a cap, as shown in Figure 8. The

chart shows the fiscal capacities of the provinces with all resource revenues included and equalization entitlements with relative costs considered in the formula.

**Figure 8 – Calculation of Fiscal Capacity to Determine the Equalization Cap
Budget 2007 Formula, 50% Inclusion of All Resource Revenues
and Adjusted for Relative Costs (\$ per capita)**



Conclusion

Based on this analysis, changes made to the equalization program still fail to provide equal access to comparable levels of revenue for the poorer provinces. But rather than provide the poorer provinces with too little, as they would argue, it provides too much.

Here we draw the same conclusion as in the previous version of this Commentary. The data appear to favour a move to a needs-based approach to equalization, including a realistic

evaluation of the differences in the cost of providing public services across jurisdictions. This would result in a system focused on what each jurisdiction actually needs in effective revenues to deliver a given package of services, rather than focusing on unadjusted levels of absolute revenues between provinces. These revenues can vary wildly based on economic cycles, the price of natural resources, and other factors largely irrelevant to the question of ensuring each province has what it needs to provide a reasonable level of public services.



Annex 1 – Breakdown of Figures 1, 2, 4, 6 and 8

Figure 1 Breakdown – Calculation of Equalization Entitlements for 2007-2008
Budget 2007 Formula, 50% Inclusion of All Resource Revenues (\$ per capita)

PER CAPITA FISCAL CAPACITY	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Non-Resource Fiscal Capacity	4,227	4,177	4,669	4,299	5,282	6,486	4,682	4,858	7,727	5,822
Natural Resources – Renewable	55	3	3	37	81	69	48	6	16	235
Natural Resources - Non-Renewable	437	0	76	11	2	3	21	767	1,840	283
Equalization	1,593	2,133	1,564	1,964	948	0	1,561	682	0	0
Total	6,312	6,312	6,312	6,312	6,312	6,558	6,312	6,312	9,583	6,340

Figure 2 Breakdown – Calculation of Fiscal Capacity to Determine the Equalization Cap
Budget 2007 Formula, 50% Inclusion of All Resource Revenues (\$ per capita)

PER CAPITA FISCAL CAPACITY	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Non-Resource Fiscal Capacity	4,227	4,177	4,669	4,299	5,282	6,486	4,682	4,858	7,727	5,822
Natural Resources – Renewable	111	5	6	75	161	139	97	12	33	471
Natural Resources - Non-Renewable	873	1	153	23	4	6	43	1,533	3,680	566
Equalization	1,593	2,133	1,564	1,964	948	0	1,561	682	0	0
Atlantic Accord	411	0	73	0	0	0	0	0	0	0
Total	7,215	6,316	6,465	6,361	6,395	6,631	6,382	7,085	11,440	6,858



Figure 4 Breakdown - Adjusted Provincial Fiscal Capacity, 2007-2008
 50% Inclusion of All Resource Revenues and Adjusted for Relative Costs (\$ per capita)

PER CAPITA FISCAL CAPACITY	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Non-Resource Fiscal Capacity	4,469	4,681	4,998	4,668	5,128	6,042	4,979	5,104	7,681	5,630
Natural Resources - Renewable	59	3	3	41	78	65	51	6	16	228
Natural Resources - Non-Renewable	461	0	82	12	2	3	23	805	1,829	274
Equalization	1,067	2,390	1,674	2,133	920	0	1,660	239	0	0
Atlantic Accord	411	0	73	0	0	0	0	0	0	0
Total	6,467	7,075	6,830	6,854	6,128	6,110	6,713	6,155	9,526	6,131

Figure 6 Breakdown - Calculation of Equalization Entitlements for 2007-2008
 50% Inclusion of All Resource Revenues and Adjusted for Relative Costs (\$ per capita)

PER CAPITA FISCAL CAPACITY	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Non-Resource Fiscal Capacity	4,469	4,681	4,998	4,668	5,128	6,042	4,979	5,104	7,681	5,630
Natural Resources - Renewable	59	3	3	41	78	65	51	6	16	228
Natural Resources - Non-Renewable	461	0	82	12	2	3	23	805	1,829	274
Equalization	1,323	1,627	1,229	1,591	1,104	203	1,258	396	0	181
Total	6,312	6,312	6,312	6,312	6,312	6,312	6,312	6,312	9,526	6,312

Figure 8 Breakdown – Calculation of Fiscal Capacity to Determine the Equalization Cap Budget 2007 Formula, 50% Inclusion of All Resource Revenues and Adjusted for Relative Costs (\$ per capita)

PER CAPITA FISCAL CAPACITY	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Non-Resource Fiscal Capacity	4,227	4,177	4,669	4,299	5,282	6,486	4,682	4,858	7,727	5,822
Natural Resources – Renewable	55	3	3	37	81	69	48	6	16	235
Natural Resources - Non-Renewable	437	0	76	11	2	3	21	767	1,840	283
Equalization	1,252	1,452	1,149	1,456	1,137	217	1,184	378	0	188
Atlantic Accord	197	0	165	0	0	0	0	0	0	0
Total	6,168	5,632	6,063	5,804	6,502	6,775	5,936	6,009	9,583	6,528

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