AIMS Commentary
Atlantic Institute for Market Studies

The brick on the scale: How equalization weighs heavily on us all.

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AIMS has published a series of commentaries discussing in detail the subject of equalization. Drawing from that material and from previous and ongoing AIMS research on this subject, we would make the following observations:

1. If there is a vertical fiscal imbalance, it is ***in favour*** *of equalization receiving provinces (ERPs).*

2. If there is a horizontal fiscal imbalance, it is ***in favour*** *of equalization receiving provinces.*

3. The equalization program ***perpetuates the dependence*** *of ERPs. It should instead be used as an incentive for sound fiscal management. The treatment of non-renewable resource revenues and debt are two such opportunities.*

Why there is no vertical fiscal imbalance

Starting in 1993[1], the federal government began to pursue vigorously a balanced budget in an effort to reduce the level of national debt. The provinces followed suit, with all provinces improving their operating balances, primarily during the period between 1992 and 1999. By 2005-2006, only Prince Edward Island and Ontario projected budget deficits.

The means by which these balanced budgets have been achieved, however, has been very different. Between 1992 and 1999, Ontario and Alberta, non-equalization-receiving provinces, achieved budgetary balances by keeping program spending in check while own source revenues increased.[2] Extending this analysis to 2004-2005, while relying increas-

[1] While the federal government prior to 1993 had succeeded in balancing the operating budget, that is program spending and own source revenues, the new government at that time went further and pursued elimination of the overall deficit, which includes interest obligations on the national debt in addition to program spending. While the government did not officially balance the overall budget until 1996, 1991-92 is used as the base fiscal year for when the efforts to reach a balanced budget were achieved.

[2] Richards, John, June 2000, "Now that the Coat Fits the Cloth...Spending Wisely in a Trimmed-Down Age" C.D. Howe Institute Commentary, 143: 20-24.

ingly on growth in transfers, Ontario and Alberta remained ahead of the national average in balancing transfers with own source revenue growth to reduce operating deficits.

During this same period, one of the equalization-receiving provinces followed a similar trend, as Saskatchewan's own initiatives in improving its operating balance rivaled that of Alberta. Quebec also performed respectably in this regard, with its own initiatives at about the national average.

Three of the four Atlantic Provinces and Manitoba, however, relied on significant increases in Federal Cash Transfers to improve their operating balance. Only Nova Scotia had increases in own source revenues greater than increases in program spending. And four of these provinces had their federal transfers increase at a rate greater than the national average.

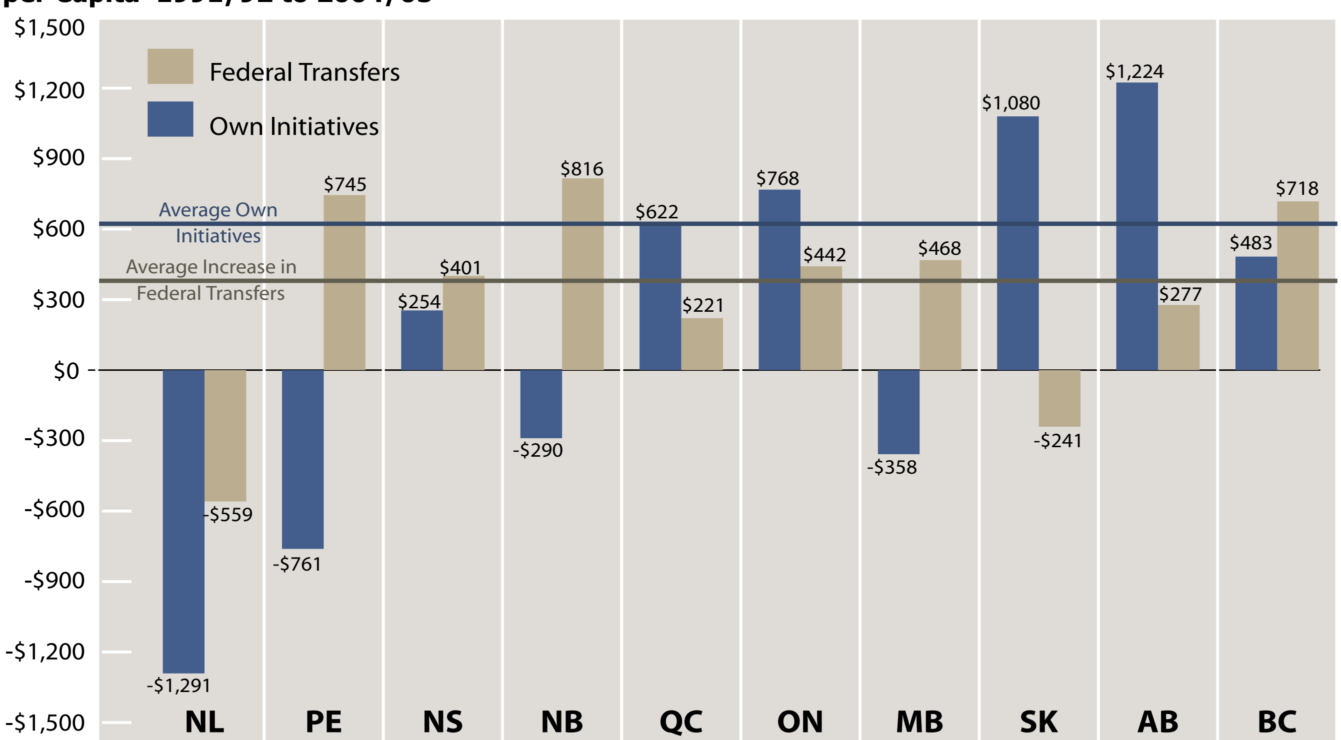
Also interesting to note is the fact that only two provinces, Saskatchewan and Newfoundland, saw their federal transfers decrease during this period. All other provinces, both equalization receiving and non-receiving, saw their transfers from federal sources increase.

The conclusion from the spending trends of the last 15 years is clear. Federal transfers have allowed almost all of the provinces to maintain spending levels beyond the reach of their own source revenues and ERPs have especially benefited from this federal largesse. This does not, of course, address the moral and political question of whether the federal largesse has been sufficient to meet the broader goals of the Canadian federation, or whether the existence of the largesse itself actually does more harm than good. It does, however, conclusively demonstrate who the winners are under the current system.

Why there is no horizontal fiscal imbalance

The question of winners and losers is also tied directly to the question of horizontal fiscal imbalance and the idea that not every province has enough revenue to provide the same level of services that are provided in other provinces. This imbalance has most often been portrayed as the poorer provinces, such as those in Atlantic Canada, not having the money to provide the same services as the richer provinces, like Alberta and Ontario.

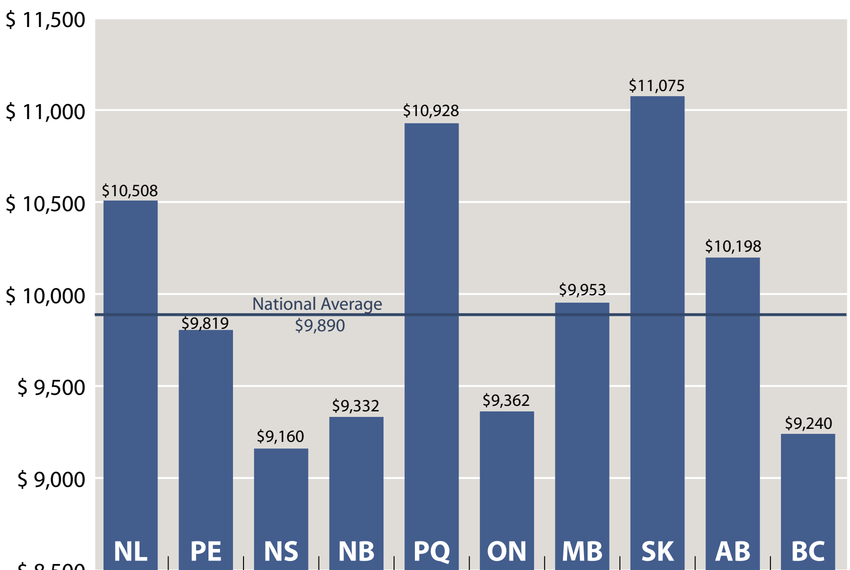
Figure 1: Own Initiatives and Federal Cash Transfers per Capita 1991/92 to 2004/05



Source: Richards, 2000 and Provincial Budget Documents 1992 to 2005

The problem with this assertion is that many of the equalization recipients spend more per capita on government services than do the richer provinces. If we look at total government spending per capita by the provinces, of the five provinces with spending greater than the national average, four are-equalization recipients.

Figure 2 - Government Spending per Capita 2002-2006 Average



Source: Statistics Canada, National Economic Accounts 2002 to 2006

Spending alone does not tell the whole story since comparative purchasing power must also be considered to determine if these variable spending levels enable the provincial governments to purchase relatively comparable levels of services.

The Federal Government's Expert Panel appeared to address the issue by simply saying it was too difficult to determine what cost side factors were at play. They argued that the expense of determining cost variables accurately would probably not be worth it in the end. In essence the panel accepted the conventional wisdom of "Zero Capitalization" of costs. That is, they agreed with the prevailing assumption that regardless of the provincial economy, the cost of public services in each province is the same. If Ontario has an extra $1 to spend and Nova Scotia has an extra $1, the assumption is the $1 in Ontario buys the same amount of public services as the $1 in Nova Scotia.

Let's explore that assumption for a moment. In the United States they do not equalize the fiscal capacity of states because they assume those differences are fully capitalized in the variable wage, rent and price structures present in each state. In Australia they take the opposite view and do attempt to allow for the variation of the market cost for public services. Queen's University Professor Tom Courchene has done some work in this area using average provincial wage rates to demonstrate that the local economy does have a measurable impact on "effective fiscal capacity" in Canada. We at AIMS have expanded on this work. Where Dr. Courchene used wages to try and correct for this effect, our work looked at the broader costs that a business would face in different provinces, making note of where differences between a private business and a provincial and local government would arise (we eliminated any consideration of relative tax burden for example).

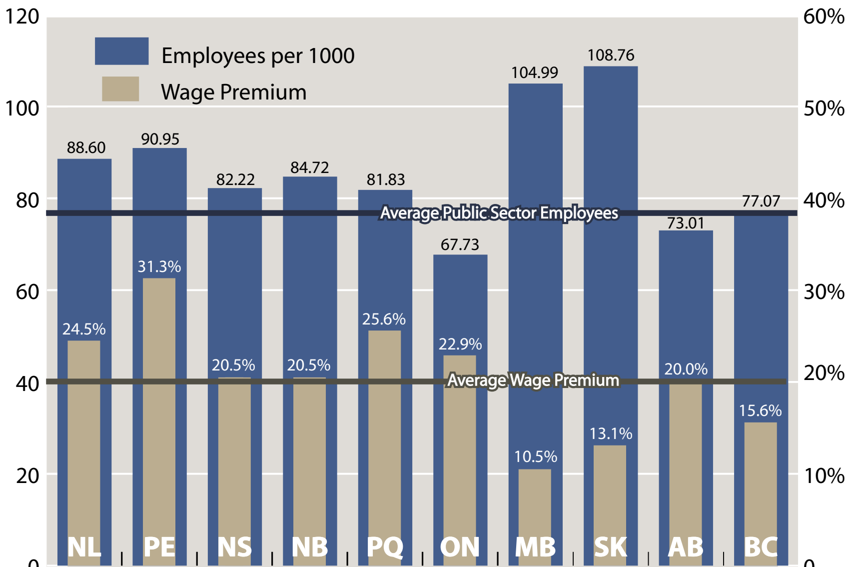
We discovered that a purchasing parity gap does exist, but we also discovered that, in 2004-2005 for example, once equalization is taken into account, seven provinces had effectively more revenue than Ontario once cost considerations were taken into account. Yes, Alberta was one. But the others were the four Atlantic Provinces, Manitoba and Saskatchewan. Equalization gives ERPs the ability to purchase more public services than Ontario and the proposed "Ontario Cap" put forward by the expert panel only mitigates that effect, it does not eliminate it.

Consider next what the ERPs are spending their equalization money on. In our commentary entitled the **The Flypaper Effect** we explore the phenomenon whereby a government receiving subsidies chooses to spend excess amounts on their public service. As a recent Australian report on their equalization system argued, "Money 'thrown' at a State Government tends to stick, even though the welfare of the households would be better served if the money were passed on to them through lower taxes."[3]

[3] Review of Commonwealth-State Funding, Final Report - A review of the allocation of Commonwealth Grants to the States and Territories, August 2002.

As it turns out, this analysis applies equally to Canada. Equalization receiving provinces tend to have larger numbers of public service employees on a per capita basis and pay their public servants a greater wage premium (compared to the average industrial wage) than the national average of these measures. On top of this, the equalization receivers have higher than average debt levels.

Figure 3: Provincial and Local Public Sector Employees per 1,000 Population and Provincial and Local Wage Premiums



Source: Statistics Canada, FMS Data and Employment Earnings, and Hours March 2006

To reiterate, ERPs have more buying power and use it to hire more public servants and pay them a higher premium than is generally found in the rest of the country. This definitely sounds like a horizontal imbalance but not the one that has garnered so much attention during the debate to date.

ERPs do not have to be ERPs

To this point we have made the case that equalization represents a boon to ERPs. Giving them the ability to purchase services beyond those available using their own source revenues and, in most cases, given them the ability to spend more on public services, or public servants, than the EPPs (equalization PAYING provinces).

Despite these apparent benefits, equalization remains a long term threat to the economic health of ERPs because as it is structured now there is no incentive to cease being an ERP, in fact, there are powerful disincentives.

Consider first the question of non-renewable natural resource revenues. Non-renewable natural resource revenues are not like income or sales taxes. Such taxes, and most other revenues, are renewable because they flow from the endlessly renewed efforts and activities of people. The same is true of revenues from renewable natural resources, such as forest products or hydro-electric power. Provided these are husbanded properly, they can provide a reasonably sustainable long-term flow of income.

But non-renewable natural resource revenues come from the sale of finite resources. When the oil and gas, or copper, or coal, or nickel, are gone, they are gone. So, when we sell these resources, it is a one-time deal. God is not going to put new oil and gas and coal and copper under the ground when we deplete current resources. Today's people are merely the stewards of those resources, and must manage them in the interests of all present and future citizens of the jurisdictions that own them. We therefore have both a financial responsibility and a moral obligation not to treat this money like a lottery windfall, or to sell the house to finance a splurge on fancy cars and new clothes. Or have them viewed as regular revenues to be included in the equalization formula to the detriment of those provinces that own them.

If it is correct that non-renewable natural resource revenues must be treated as capital, it follows that they should be reinvested, so as to confer benefits on each province's citizens (the ultimate owners of the resource) over a long period of time. That means such revenues should be used exclusively for two things. One of them is debt reduction. When you are heavily indebted, as many provinces are, it makes sense to sell some assets to relieve the pressure of interest payments and free your income for more productive purposes.

The other thing that can be done is to create a heritage or trust fund, whereby a province invests the capital and spends only the income it generates. That would smooth out the huge fluctuations in natural resource revenues that occur, while creating an asset that could be invested in things that confer long-term benefits, like genuine infrastructure, medical research, and top-flight facilities for schools, colleges, and universities.

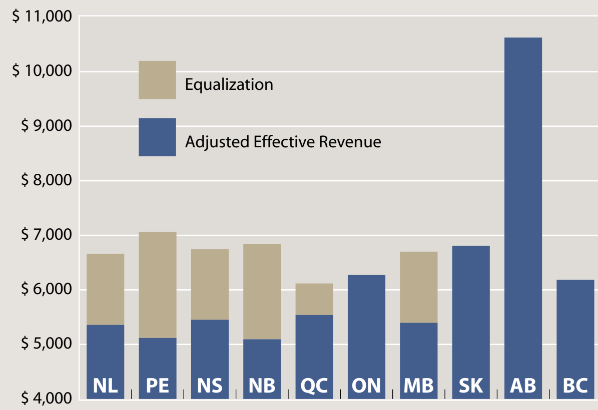
Of course, the challenge for equalization is that many provinces do not act responsibly and instead spend these revenues as if they were ordinary provincial income. While the revenues last, they effectively boost the province's fiscal (that is, spending) capacity, but at the cost of creating an inequity whereby some provinces can afford to offer richer services than others simply by running down their capital assets to finance current consumption. Such abuse, however, is no reason for the equalization program effectively to force all recipient provinces to act in this way.

The solution to this problem appears relatively straightforward. In calculating both the ten-province standard up to which equalization-receiving provinces are to be brought and their equalization entitlements, Ottawa should look at what the provinces actually do with their non-renewable natural resource money. If, like Alberta, a province is a net contributor to equalization and spends these revenues to finance ordinary program spending, that money should count toward its fiscal capacity and, therefore, should feed through to the calculation of the ten-province standard.

Correspondingly, if an equalization-receiving province spends its non-renewable natural resource revenues as ordinary program spending, that money should be counted in that province's fiscal capacity and deducted from its equalization entitlement.

If, on the other hand, a province acts responsibly and treats its non-renewable resource revenues as the asset they are, this should be reflected in the way those revenues are treated under equalization. For example, if the money goes to reduce provincial debt, it should not be counted in the province's fiscal capacity. If it goes into a heritage-type fund, as Alberta has done with some of its revenues, only the revenues generated by that fund, not the capital endowment of the fund itself, should be counted in the province's fiscal capacity.

Adjusted Revenues
Before and After Equalization, 2004-2005



* The data in this table is based on the February 28, 2005 estimate as presented in 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

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. But is this assumption correct?

AIMS examined fiscal capacities in the provinces with relative costs taken into account. We used detailed annual comparison of the cost of carrying on business in various jurisdictions around the country, KPMG's 2006 Competitive Alternatives[1]. To focus on the costs of providing public services, we have removed the weighting relating to tax burden.

Applying these adjustment factors to each province's fiscal capacity, after including the effects of equalization on provincial revenues, yields the results shown in the above chart. While Alberta retains its huge fiscal advantage over all the other provinces, once revenues are adjusted for cost differences, Ontario effectively has less fiscal capacity than 5 of the 6 equalization-receiving provinces. While it may be true that Ontario is not "brought down" by equalization to a standard level, it appears that equalization has brought 5 out of 6 equalization-receiving provinces up to a level of effective revenues that is above that of the country's largest province.

[1] Competitive Alternatives.Com Cost Model Detailed Comparison Report, http://www.competitivealternatives.com/results/reports.asp

Interestingly, such an approach would also help to resolve a "horizontal inequity" in the way equalization is financed. Including non-renewable natural resource revenues in the fiscal capacity used to calculate the ten-province standard increases the entitlements of the equalization-receiving provinces. But the extra costs of such equalization payments are financed principally out of federal taxes, not out of a tax levied on, for example, Alberta's oil industry - there is no such tax. As a result, the burden falls chiefly on federal taxpayers resident in Ontario, a province that does not benefit from higher oil and gas prices.

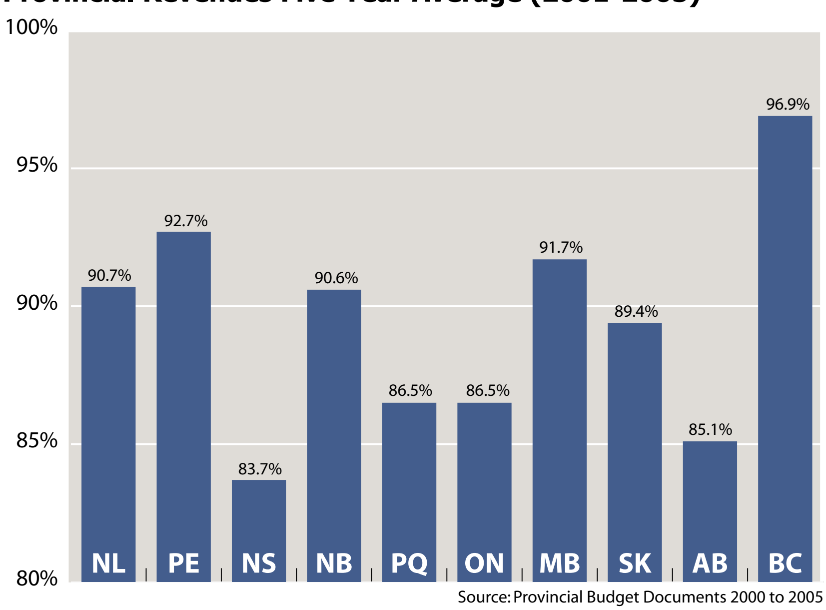
Our proposed approach to non-renewable natural resource revenues would also allow the federal government to honour its promise not to count such revenues in calculating provinces' equalization entitlements (subject only to the condition that these revenues be treated as capital, not income), while improving incentives for those revenues to be handled correctly. This is in marked contrast to the Expert Panel's recommendation that "actual resource revenues should be used as the measure of fiscal capacity [of each province] in the Equalization formula"[4], which continues the bad old practice of treating non-renewable resource revenues in recipient provinces as if they were ordinary revenues.

The idea that equalization be used as an incentive to encourage sound provincial fiscal management applies not only to non-renewable natural resource revenues but also to provincial debt. Just as the current system encourages the abuse of non-renewable resource revenues it also encourages provinces to carry far more debt than they otherwise could afford.

Dealing with debt alone would have a substantial impact on the equalization receiving provinces ability to provide comparable public services, primarily because high debt levels result in high debt service costs. And rather than providing the equalization receiving provinces with additional money to provide public services, the majority of equalization dollars go to pay the interest on the debts of the recipient provinces. In fact, between 2000 and 2005, 92.1 percent of equalization payments went to pay the provinces' debt service costs. Consider for a moment what would happen to the provinces' ability to provide services if they were free of debt and its associated debt servicing costs. At present, all provinces' program spending could be fully covered by provincial revenues, including federal transfers at their current levels. Only one province, British Columbia, has program expenditures that exceed 95 percent of their revenues. What this means is that if the provinces had no debt, they would have sufficient revenue to cover their program expenditures, with a percentage left over for tax reduction or other investment.

In effect, the provinces do not need additional equalization cash from the federal government for program spending. They need assistance with managing their debts. Or at the very least, they need incentives for dealing with debts, rather than a handout to allow them to service their debts without having to raise the money themselves. Remember, debt is simply deferred taxation and by encouraging higher than average debt loads, equalization is actually encouraging a perpetual variation in tax levels across the country.

Figure 4: Provincial Program Spending as a Percentage of Provincial Revenues Five Year Average (2001-2005)



[4] Canada. 2006. Expert Panel on Equalization and Territorial Formula Financing. Achieving a National Purpose: Putting Equalization Back on Track. Ottawa: Department of Finance. May.

Earlier, we dealt with one option for rewarding appropriate debt management when discussing non-renewable natural resource revenues. Another option might be using some percentage of the equalization fund to finance a direct debt swap between the federal and provincial governments. Any swap must be tied to certain performance parameters on the provincial side - balanced budgets and matching provincial debt repayment dollars are two that should be considered. These conditions would be crucial in avoiding the moral hazard of seeing provinces simply rack up more debt once the federal government has paid down the existing provincial debt.

Conclusion

If all the provinces were able to reach national average levels of public service employees, wage premiums, and debt, and if the savings achieved were passed on directly to the equalization program, three provinces, Saskatchewan, Manitoba, and Quebec, would effectively have their need for equalization wiped out, with savings totaling more than 100 percent of their average equalization benefit. The Atlantic Provinces would yield lower savings ranging from 19.8 percent of the province's equalization entitlement in New Brunswick to 47.5 percent in Newfoundland.

While not eliminating the need for equalization, this analysis provides further support to the argument that the current system over-equalizes, with the result that the extra cash is captured by well-organized public servants - who turn the extra money into either substantially higher wage premiums, extra public employees, or both - or it allows politicians to shift taxation into the future by using equalization to finance high levels of public debt.[5] None of these outcomes are what is intended by the equalization program, nor are they how the program is justified to those who pay higher taxes to finance the transfer.

In the words of the "father of equalization", James Buchanan, "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."[6]

On the topic of James Buchanan, as we mentioned, the "father of equalization", we would end by pointing out that his vision for the equalization program was never one of cash transfers between a federation and its state or provincial governments. Rather, Buchanan's ideas of equalization centered around transfers to individuals in the poorer regions. Given the difficulties faced in reaching the consensus of the provincial premiers, returning to the original equalization ideal of transfers directly to individuals certainly has its attractions.

5 As stated in Mintz, Jack M. and Poschmann, Finn, Follow the Cash: Changing Equalization to Promote Sound Budgeting and Prosperity, C.D. Howe Institute Backgrounder, no. 85, p. 3, October 2004, the current equalization formula not only allows a shift to future taxation, but actually provides incentive for it.

6 Buchanan, James, Interview with Brian Naud, CPAC TV's Primetime Politics, aired October 25, 2001. Text published in Ideas Matter, Atlantic Institute for Market Studies, Frontier Centre for Public Policy, and the Montreal Economic Institute, 2002.

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