



No. 30

Do We Over-Equalize?

**Why some provinces are more equal than others:
How Canada over-equalizes and why the Expert Panel's
recommendations will make a bad system worse**



July 2006

**By Brian Lee Crowley, PhD,
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Do We Over-Equalize?

"The purpose of Canada's Equalization program stems from a basic commitment to fairness and equity. In a diverse federation like Canada, Equalization has a specific purpose: to ensure that across the country, people have access to reasonably comparable public services at reasonably comparable levels of taxation."¹

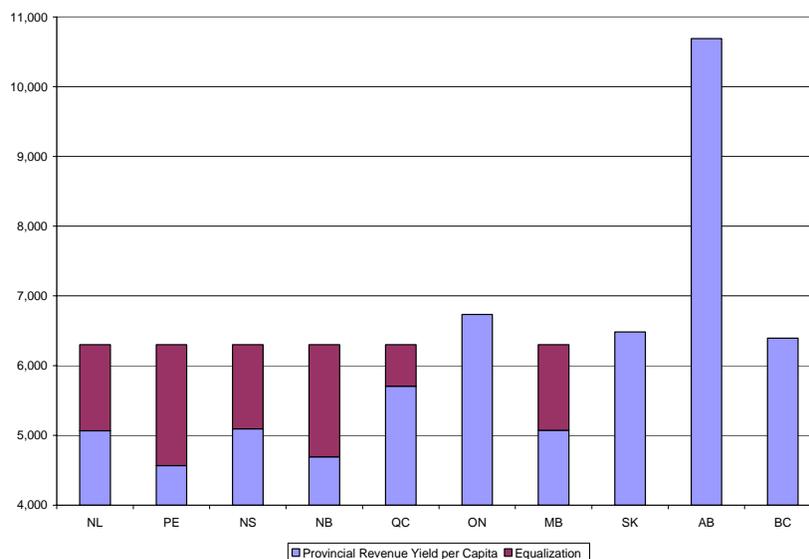
So says the Expert Panel on Equalization and Territorial Formula Financing in their May 2006 Report on repairing Canada's equalization program. Measuring whether we meet this goal would seem to be a rather simple affair. We would check to see whether, after equalization payments are made, each province in the country has pretty similar amounts of money to spend on public services. And indeed this is what the data show. But scratch beneath the surface just a bit, and a far more complicated picture emerges — one where many equalization-receiving provinces (ERPs) actually effectively have higher per capita revenues to spend on public services than the national average and more than Ontario, one of our wealthiest provinces.

How much do the provinces have to spend?

Chart 1 shows the per capita tax take of each province for the 2004-2005 fiscal year, based on national average tax rates. It also shows the equalization payments transferred to recipient provinces to bring those provinces' ability to spend up to the national standard.

¹ Achieving A National Purpose: *Putting Equalization Back on Track*, Expert Panel on Equalization and Territorial Formula Financing May 2006

Chart 1 – Tax Yields at National Average Tax Rates and Equalized Revenues, 2004-2005²



“Equalization brings less wealthy provinces up to a common standard, but it doesn’t bring wealthier provinces like Alberta and Ontario down to the standard.”³

Based solely on the figures in Chart 1, it appears as though equalization brings those recipient provinces up to a level that is about the national average, while those non-equalization receiving provinces maintain their fiscal capacity. The chart clearly shows that those provinces that enjoy above-average levels of prosperity still enjoy a small advantage in spending capacity compared to the ERPs, and in the case of Alberta, the gap is a very significant one.

What these figures leave out of account is the relative cost of services the provinces provide. Equalizing revenues to a common standard, after all, 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?

In *Vertical and Horizontal Fiscal Imbalances: An Ontario Perspective*⁴, one of Canada’s leading authorities on equalization, Queen’s University Professor Tom Courchene, suggests 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. Unfortunately, detailed information on the differences in costs across provinces for the delivery of services are not available (in itself an

² 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

³ Achieving A National Purpose: *Putting Equalization Back on Track*, Expert Panel on Equalization and Territorial Formula Financing, May 2006

⁴ 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

interesting fact in a country committed to equality and fairness). However, there are detailed proxies which might reasonably be used to establish fair cost comparisons. In our case, we are going to rely on a detailed annual comparison of the cost of carrying on business in various jurisdictions around the country, KPMG's 2006 Competitive Alternatives⁵. In order to focus on the costs of providing *public* services, we have removed the weighting relating to tax burden.

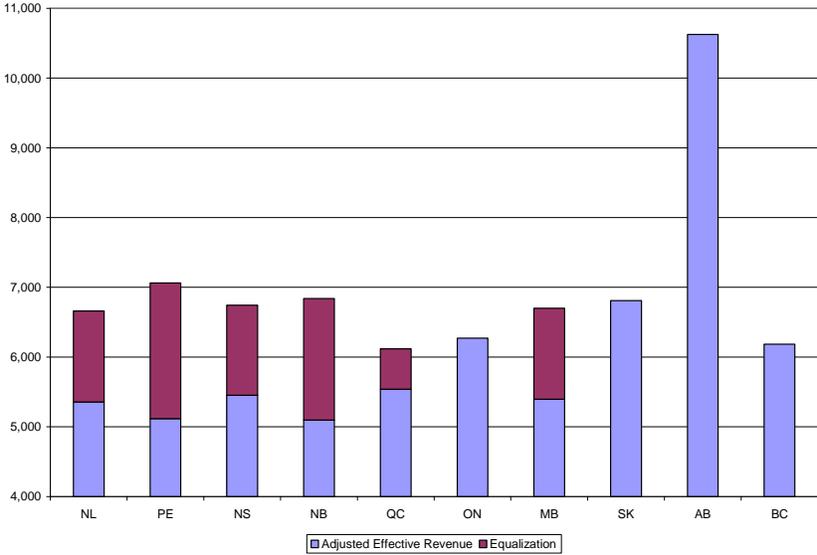
Using the data in KPMG's 2006 study for each province's largest city, the following cost adjustment factors were determined for each province:

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 chart means 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 Chart 2.

Chart 2 – Adjusted Revenues Before and After Equalization, 2004-2005⁶



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

⁵ *Competitive Alternatives.Com Cost Model Detailed Comparison Report*, <http://www.competitivealternatives.com/results/reports.asp>
⁶ 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

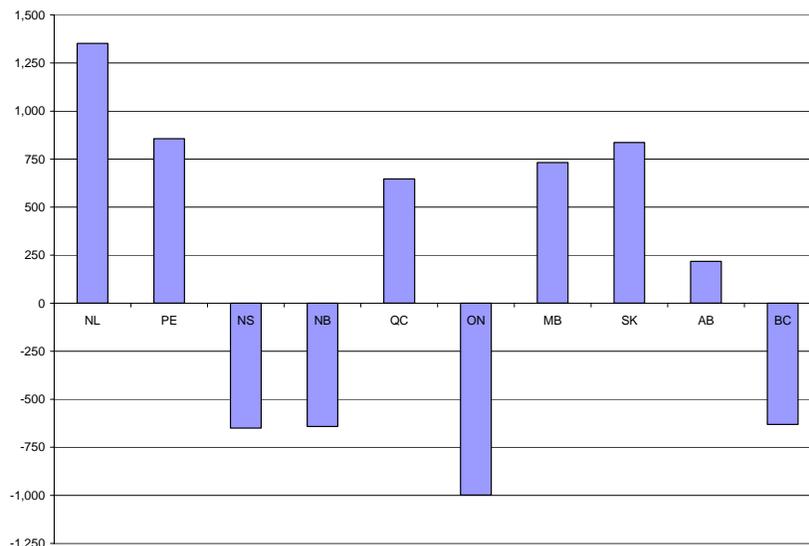
Ontario is not “brought down” by equalization to a standard level, it appears that equalization has brought 5 out of 6 equalization-receiving provinces up to a level of effective revenues that is above that of the country’s largest province.

How much do the provinces spend?

That tells us about the income the provinces enjoy. What about their spending? Given equalization’s goal to provide “reasonably comparable” levels of public services, it would also be expected that government spending on public services should be relatively similar. As every province has a different distribution of responsibilities and revenues between provincial and local government, the only fair way to compare across provinces is to lump provincial and local government spending together, which we do below.

Chart 3 looks at provincial and local government spending per capita. As the cost of providing services will differ by province, the same adjustment factors used above are applied to public sector spending to provide a more accurate “apples to apples” comparison.⁷ Chart 3 shows the difference between each province’s spending levels and the national average.

Chart 3 – Adjusted Provincial and Local Government Spending per Capita vs. National Average - 5-year Average 2000-2004



Source: Statistics Canada, Federal, provincial and territorial general government revenue and expenditures, CANSIM table 385-0002 and Local government revenue and expenditures, CANSIM table 385-0003

In this case, 6 provinces spend more than the national average, and 4 spend less. Of the 6 spending more, 4 are equalization receiving provinces, and a fifth,

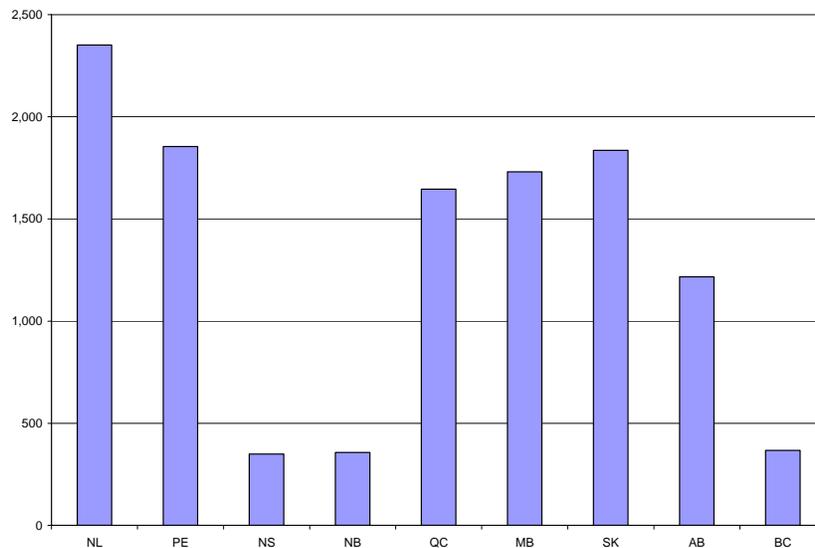
⁷ Debt servicing costs were subtracted from the total expenditure before the adjustment factors were applied because each province’s credit rating automatically adjusts the service costs. Debt servicing was then added after the adjustment to provide a true reflection of per capita **public expenditures**. The debt service cost is not used to calculate the adjustment factor because we are examining the revenue each province has to provide public services, not its ability to repay debt.

Saskatchewan, has only recently stopped receiving equalization payments. Alberta is the 6th above average province, spending just over the national average.

The 4 provinces spending less than the national average are equalization-receiving Nova Scotia and New Brunswick, and non-receivers Ontario and British Columbia. Despite being considered one of the “have” provinces, Ontario spends \$999 less per capita on public services than the national average.

In fact, if instead of using the national average, we were to show adjusted levels of effective spending in each province using Ontario’s spending, rather than the national average as the baseline, the picture becomes even more stark.

Chart 4 – Amount by which Provincial and Local Government Spending per Capita Exceeds Ontario’s 5-year Average 2000-2004



Source: Statistics Canada, Federal, provincial and territorial general government revenue and expenditures, CANSIM table 385-0002 and Local government revenue and expenditures, CANSIM table 385-0003 adjusted by authors using adjustment factor cited above.

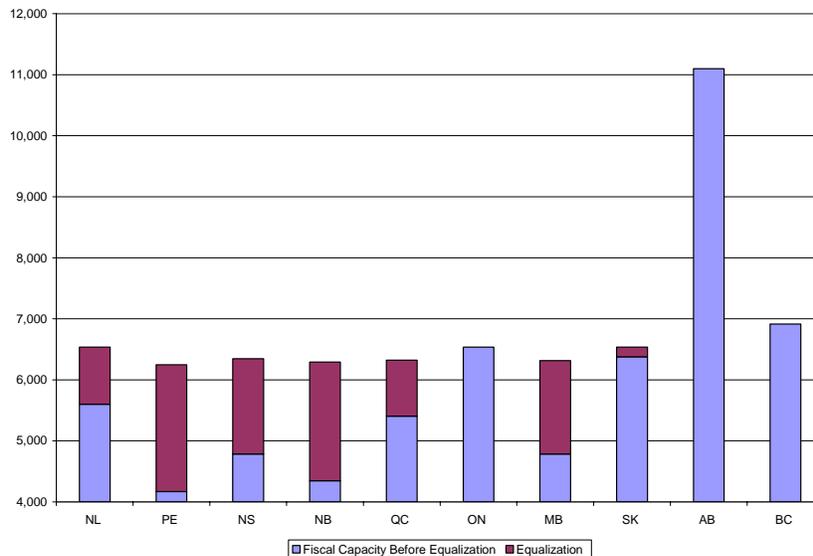
While high natural resource prices are temporarily inflating the strength of Alberta’s public finances, in reality Ontario is, in the long run, the country’s economic heartland, with roughly 39% of the country’s population and 40% of its economic activity. Equalization has been politically justified to wealthier parts of the country on the ground that such transfers are necessary to bring less well-off provinces up to some minimum national standard, without dragging wealthier jurisdictions down to that standard. But in fact our data show that, when one takes account of differences in costs of providing services, Ontario is not only not able to offer comparable services to those offered in equalization-receiving provinces, but lags well behind. Two provinces typically thought of as the most economically disadvantaged, Newfoundland and PEI, effectively spend \$2,351 and \$1,855, respectively, (adjusted) more per person on public services than Ontario.

Based on these data, the case seems to be strong that Canada over-equalizes to some considerable degree, endangering both the equity argument underpinning the program and the political support it has enjoyed over the years from provinces that are net contributors to equalization.

Looking Forward

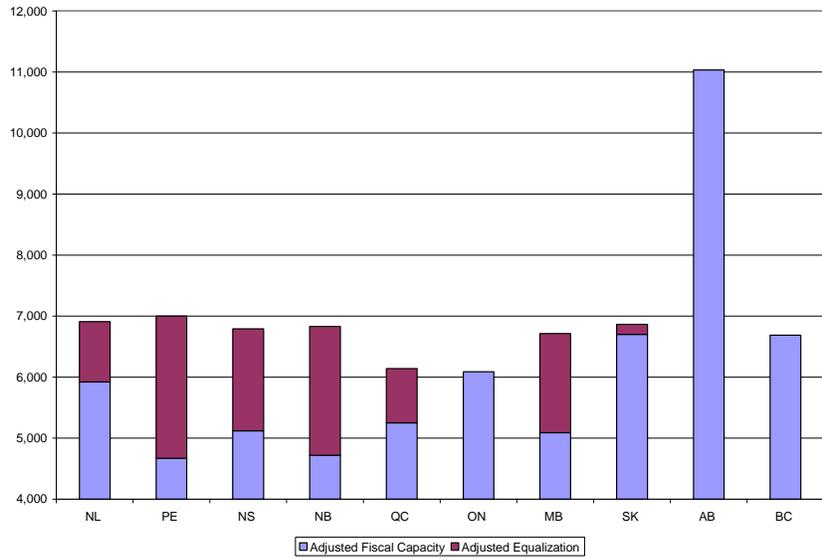
In their May 2006 Report the Expert Panel on Equalization and Territorial Formula Financing recommended several changes to the equalization formula. Their formula yielded the results shown in Chart 5 for the 2007-2008 fiscal year.

Chart 5 – Unadjusted Provincial Fiscal Capacity Based on Expert Panel Recommendations, 2007-2008



Again, this appears to elevate the fiscal capacities of the recipient provinces to a level close to, but not more than Ontario. Keep in mind though that this is due only to the report’s recommended “Ontario cap”, where provinces can only receive equalization up to the level of the lowest non-equalization-receiving province. Note also that this formula shows British Columbia as the second richest province behind Alberta. However, the Expert Panel’s formula still does not use an adjustment factor for the cost of providing services.

Chart 6 – Adjusted Provincial Fiscal Capacity If Expert Panel’s Recommendations Adopted, 2007-2008



When looking at the adjusted fiscal capacities, Ontario is left with the lowest effective fiscal capacity of all provinces and British Columbia’s effective fiscal capacity falls below that of 6 out of the 7 equalization-receiving provinces. Based on the recommendations of the Expert Panel, 2 of the 3 richest provinces before equalization effectively become 2 of the 3 poorest after equalization and the difference in costs of providing services are factored in. Meanwhile, the most fiscally disadvantaged province before equalization, PEI, effectively becomes the 2nd richest province (after Alberta) in terms of its effective ability to deliver programs.

Fiscal Capacity Ranking before Equalization	Adjusted Fiscal Capacity Ranking after Equalization
AB	AB
BC	PE
ON	NL
SK	SK
NL	NB
QC	NS
MB	MB
NS	BC
NB	QC
PE	ON

Non-Equalization-Receiving Provinces
 Equalization-Receiving Provinces

Conclusion

Based on this analysis, the data appears to favour those who suggest 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, which 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.