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Punishing Productivity

A comparison of equalization programs in Australia and Canada

By Tahlia Maslin

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The Frontier Centre for Public Policy is an independent, non-profit organization that undertakes research and education in support of economic growth and social outcomes that will enhance the quality of life in our communities. Through a variety of publications and public forums, the Centre explores policy innovations required to make the prairies region a winner in the open economy. It also provides new insights into solving important issues facing our cities, towns and provinces. These include improving the performance of public expenditures in important areas like local government, education, health and social policy. The author of this study has worked independently and the opinions expressed are therefore their own, and do not necessarily reflect the opinions of the board of the Frontier Centre for Public Policy.

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Table of Contents

Executive summary

Has equalization outlived its original purpose of helping all provinces provide roughly the same level of services to their citizens? According to Alberta's Minister of Finance, Ted Morton, it has: "If Ontario's not happy with it, if it doesn't do any good for Saskatchewan, B.C. or Alberta, it seems to me there's room for productive discussion."[1]

In Canada, the public has expressed similar sentiments. A poll commissioned by the Association for Canadian Studies asked respondents whether, regarding "money and other considerations," their province or territory "puts more into Confederation than it takes out." In Alberta, 78 per cent said they give more than they take—more than 20 percentage points higher than in B.C. (55 per cent), Ontario (50 per cent) and the national average (46 per cent).[2]

The reality, as will be noted in this brief review of equalization, is that Canada and Australia harm the productive provinces and states by sending tax money from productive regions to under-performing regions. By comparing equalization systems in Canada and Australia, this paper explores whether equalization really serves its intended purpose, and it provides alternatives to the current system.

In theory, equalization enables less prosperous provincial governments to provide their residents with public services that are comparable to those in other provinces, at comparable levels of taxation.
This is questionable...

A primer on imbalances

In general, two kinds of fiscal imbalance can arise in a federation: vertical and horizontal. *Vertical* imbalances occur between two levels of government when, for example, the responsibilities of a province are disproportionately large compared with its share of revenue. A *horizontal* imbalance is a fiscal imbalance *among* the provinces—some provinces have more sources of (or more lucrative) revenue and are therefore richer than other provinces. For the purpose of this paper, the focus will be on the horizontal imbalance.

Mechanisms exist in both Canada and Australia to attempt to equalize these imbalances. In Australia, transfers from the Commonwealth[3] to Australian states constitute just under half of state government's expenditure, while Canada depends on these transfers to fund less than 20 per cent of the provincial expenditures on average.

In theory, equalization enables less prosperous provincial governments to provide their residents with public services that are comparable to those in other provinces, at comparable levels of taxation. This is questionable as evidenced in both Australia and Canada, where strategic behaviour induced by equalization leads to under-provision of public services in contributing provinces and over-provision in recipient provinces, relative to efficient levels.[4]

However, insofar as the programs exist, there must be mechanisms in place to ensure that there is a balance between efficiency and equity. This paper discusses both Australia and Canada's equalization systems and the effects of these systems.

Australia's equalization system

Since federation, the Australian federal government has been the predominant collector of tax revenue with some revenue then redistributed to the states. The federal government collects approximately 80 per cent of all taxes in Australia (including the Goods and Services Tax) and is responsible for roughly 54 per cent of own-purpose expenditure. The states, on the other hand, collect about 16 per cent of the taxes and are responsible for around 40 percent of own-purpose expenditure.

As a result, Australia has a very high degree of vertical fiscal imbalance by international standards and "arguably the most complex transfer mechanism of any comparator federation."[5] Due to this high vertical fiscal imbalance, (i.e., between the federal government and the states) the states rely heavily on transfers of revenue from the federal government.

This reliance on transfers emphasizes the tight hold the Commonwealth has on the purse strings of the states and the importance of getting the transfer mechanism right.

A formal system of equalization was implemented in 1933 to compensate states which have lower capacities to raise revenue. This has resulted in a grants system whereby in 2009-10 the States received $41.8 billion (in Australian dollars) in general revenue assistance from the Commonwealth, as shown in Table 1, comprising $41.3 billion in GST payments and $494 million of other general revenue assistance. This general revenue assistance to the States will represent 12.4 per cent of total Commonwealth expendi-ture. The majority of these grants are General Purpose Payments (GPPs) that states can use for any purpose. The remainder, Specific Purpose Payments (SPP),

Table 1: Effect of horizontal fiscal equalization in Australia 2009-2010

	GST distributed using adjusted population ($million)	Equal per capita distribution of GST ($million)	Redistribution ($million)	Projected population (million)	Per capita redistribution ($)
New South Wales	12,481.1	13,384.0	-902.9	7.125	-126.7
Victoria	9,420.1	10,245.7	-825.6	5.454	-151.4
Queensland	7,659.8	8,360.2	-700.4	4.451	-157.4
Western Australia	3,332.2	4,242.5	-910.3	2.259	-403.1
South Australia	3,819.4	3,060.1	759.4	1.629	466.1
Tasmania	1,537.5	948.1	589.3	0.505	1,167.6
Australian Capital Territory	844.1	663.9	180.2	0.353	509.9
Northern Territory	2,235.8	425.5	1,810.3	0.227	7,992.0
TOTAL	41,330.0	41,330.0	3,339.2	22.002	

are intended for specific services such as health, education, roads and housing, and they often include agreed-upon national objectives, with certain conditions to help ensure those objectives are achieved.

GPPs can be seen as the equivalent of equalization payments in Canada. The main component of these payments (97 per cent) is funded by the Goods and Services Tax (GST) revenue collected by the Australian government. The GST revenue pool is distributed among all states based on a two-part calculation by the Commonwealth Grants Commission (CGC): an equal per capita part and an equalization part made up of expenditure and revenue needs. The CGC's calculations are based on principles of horizontal fiscal equalization, which it describes as follows: "Each state should be given the capacity to provide the average standard of state-type public services, assuming that it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources."[6]

A major goal of the CGC is to be policy-neutral. States receive extra money if it can be demonstrated that they face higher costs in providing services or have a lower capacity, for reasons outside their control, to raise their own revenue. For example, states with a higher proportion of their population in remote and/or high-cost areas or with a higher proportion of their population requiring higher service levels (e.g., indigenous people, seniors, students) receive a larger share of grants. Similarly, states with smaller mining industries, for example, receive a larger share of grants in recognition of their lower capacity to raise revenue from royalties.

Table 1 provides a snapshot of the effect of equalization on the individual states. The column showing per capita redistribution clearly indicates which states give and which states receive in terms of equalization with Northern Territory, Tasmania, the Australian Capital Territory and South Australia being subsidized by New South Wales, Victoria, Queensland and Western Australia.[7]

> ***GPPs can be seen as the equivalent of equalization payments in Canada. The main component of these payments is funded by Australia's Goods and Services Tax.***

Canada's equalization system

In Canada, equalization is the federal government's transfer program for addressing fiscal disparities among provinces. Similar to Australia, in theory, equalization payments enable less prosperous provincial governments to provide their residents with public services that are reasonably comparable to those in other provinces, at reasonably comparable levels of taxation.

The purpose of the program was entrenched in the Canadian Constitution in 1982:

> *Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. (Subsection 36(2) of the* Constitution Act*, 1982)*[8]

However, in practice, the notion that the provinces provide roughly equal services is, in fact, questionable. For example, Quebec provides universal daycare at $7 per day to all families regardless of income. Such a generous—and expensive program—exists nowhere else in Canada. Equalization allows Quebec to have generous social programs funded at the expense of taxpayers elsewhere. Thus, equalization makes it too easy for provincial politicians to spend other provinces' money, instead of improving their economies. It is like a welfare trap for entire provinces.

This is but one example of how equalization allows a Canadian "have-not" province to provide services far above those in the "have" provinces, and at the expense to taxpayers in those same "have" provinces. This is possible because equalization payments are unconditional; the receiving provinces are free to spend the funds according to their priorities.

> ***Equalization** makes it too easy for provincial politicians to spend other provinces' money, instead of improving their economies.*
> *It's like a **welfare trap** for entire provinces.*

Table 2: Effect of horizontal equalization in Canada 2008-2009

	Net federal tax ($million)	Per capita tax paid ($)	Federal equalization payments ($million)
Prince Edward Island	277.9	1,966	322
New Brunswick	1,659.6	2,221	1,584
Nova Scotia	2,171.8	2,309	1,465
Newfoundland & Labrador	1,179.8	2,312	
Manitoba	2,937.9	2,396	2,063
Quebec	20,366.1	2,592	8,028
Saskatchewan	2,976.8	2,876	
British Columbia	13,552.6	3,025	
Ontario	42,764.6	3,260	
Alberta	18,248.8	4,927	

How it works

In Canada, the federal government makes payments to less wealthy Canadian prov-inces to, in theory, equalize the ability of provinces to deliver reasonably comparable social programs. A province's equalization entitlement is equal to the difference between its fiscal capacity and the average fiscal capacity of all provinces—known as the "10-province standard." Provinces whose fiscal capacity is above the standard do not receive equalization payments.

Unlike the Australian system's, this formula is based solely on revenue and does not consider the cost of providing services or the expenditure needs of the provinces. In 2009-2010, the total cost of the program will be approximately $14.2-billion Canadian dollars. Equalization has grown by 56 per cent since 2003-2004. Table 2 provides a snapshot of federal taxes paid by the provinces, broken down on a per capita basis.

The pernicious effects of such programs

The current grants distribution system in the two countries does not strike a balance between efficiency and equity. It strives to achieve full horizontal equalization without any regard to the efficiency implications. The system is designed to flatten as much as possible the differences among the provinces and among the provinces in their capacities to deliver services. The benefits that could flow from developing an above-average capacity to raise revenue are "equalized away" under the current system. This provides a disincentive for provinces to engage in activities that might enhance revenue capacities. Similarly, the current equalization system provides no incentive for provinces to become more efficient in providing services or to investigate alternative methods of delivering services.[9] In effect, the system discourages innovation and economic growth in the "have" provinces and is subversive of good policy in the "have-not" provinces (which can spend more tax dollars in inefficient ways, as non-residents are in effect subsidizing provincial expenditures).

In Canada, recent negotiations surrounding the renewal of the program have created considerable tension among provinces. While equalization is paid out of federal coffers, its very existence and any increase come from the taxpayers in the richer provinces through their federal tax payments. Therefore, in reality, cash from taxpayers in "have" provinces subsidizes the cost of living in "have-not" provinces, where services above the pan-Canadian average are provided at a low cost, arguably encouraging poor public policy.

An example of this is housing prices. An average bungalow in a so-called have-not province costs on average $160,000 in Prince Edward Island up to $290,000 in Montreal.[10] Whereas in the so-called have provinces, bungalow prices range from an average of $275,000 in Edmonton to $1,050,000 in greater Vancouver. When tax dollars are sent to provincial governments in the "have-not" regions, the money has to come from somewhere. Because equalization is ultimately a federal transfer of wealth from taxpayers in the "have" provinces to governments in the "have-nots," it is individual taxpayers in the "have" provinces, where the cost of housing is often significantly higher than in the equalization-receiving provinces, who supply the transfer money.[11] As the Frontier Centre's research director Mark Milke has noted,

> The federal equalization program creates the notion there are "have" and "have-not" provinces. It's a fiction. A better description is expensive and cheaper provinces in which to live. And through federal tax and transfer programs such as equalization, it is families in the former who subsidize governments in the latter —along with their poor policy choices.[12]

Another example can be found in Manitoba where the provincially owned hydro-electricity is under-priced by about $1.2-billion every year. This is poor policy from an environmental perspective, given consumers will use more of a product the cheaper it is priced, and less of it as prices become more expensive. Without the $2-billion in equalization, Manitoba's government would be forced to charge market rates.

Therefore, under-pricing electricity is neither smart green policy nor smart market policy.[13]

Similarly, in Australia, states that receive payments that are lower than their demographic share have argued that the existing approach to equalization promotes mediocrity rather than efficiency. In a recent paper, the state of Victoria claimed the current approach stifles the evolution of competitive and dynamic state governments and does not adequately take into account changes in public administration that use the best available measurement techniques. It further argued that when assessing states' needs and "disabilities," (i.e., higher costs of service delivery due to rural and remote populations, etc.) the Commission should use standards that reflect best practices in service delivery and revenue collection.[14]

According to the state of Victoria, states that receive above average per capita grants should be accountable to the broader Australian community for the use of the funds. Describing the redistribution of funds to the smaller states as subsidies, Victoria emphasized that the recipient states had an obligation to make effective and efficient use of them.

As might be expected, the views of Victoria and also New South Wales which shares similar concerns are strongly contested by Queensland, South Australia, Tasmania and the two territories, all of which receive more than their demographic share in equalization payments. They have expressed their support for the current system, arguing that it reflects the broad political consensus about the objectives of equalization, which constitute an integral part of the fabric of the federation.

Furthermore, the CGC's calculations have been criticized as being based on questionable and complex methodologies. The CGC's methodology documentation runs to nearly 2,000 pages of annual reports and working papers. The complexity reflects the CGC's attempts to take detailed account of the myriad factors affecting states' expenditures and revenue. Therefore, in Australia, the states' expenditure and revenue capacities are taken into account, and despite many years of close examination by the CGC and the states, the quantification of expenditure and revenue needs continues to generate intense debate and analysis.

…"have" and "have-not" provinces. It's a fiction. A better description is expensive and cheaper provinces in which to live…

Breaking the dependency cycle

In light of the Australian experience with equalization, it seems clear that increasing the number of factors and variables considered in calculating equalization payments (with a view to make them fairer and to better reflect the relative capacities of the various jurisdictions) does not necessarily reduce the level of dissatisfaction with the program. While the Australian system may not offer a solution for those who criticize the Canadian equalization program, it is worth looking at the common problems caused by equalization in both countries.

It appears that much of the evidence and discussion around equalization does lend support to the idea that the system promotes transfer dependency for the recipient provinces. Transfer dependency implies both over-provision of public services in recipient provinces and under-investment by such provinces in growth-creating policy, and hence suggests that equalization payments are just simply bad public policy for Canada.

A change in the equalization system is needed in order to shift provinces away from implementing poor policy and toward providing incentives for smarter, more efficient and more effective public policy. Much of the evidence from Canada and Australia suggests that equalization has outlived its original purpose of helping all provinces provide roughly the same level of services to its citizens and has instead created dependencies.

Three options for removing these dependencies exist:

(i) Remove equalization altogether and then the existing grant pool could be allocated to the provinces on a purely origin basis (each province receives exactly what its citizens contribute to the pool through federal taxes, and there would be no extra compensation in tax shifts to the provinces that lose out).

(ii) Change the current system. Equalization should be geared to efficiency in outcomes rather than equity based in order to promote good public policy and better-performing provinces.

(iii) Swap equalization transfers for the federal GST and/or other tax room that could be made available from the federal government if any province ends up in a net loss position after the GST transfer.

In the view of the Frontier Centre, the third option is preferable, as current equalization policy is undesirable because of the perverse incentives that subsidize bad policies in recipient provinces. Canada should move on from the notion of "have" and "have-not" provinces and instead provide incentives, so the provinces can implement better public policy and invest in growth rather than reward mediocrity.

Endnotes

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Further Reading

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The Real Have-Nots in Confederation: Ontario, Alberta and British Columbia

Ben Eisen and Mark Milke

http://www.fcpp.org/files/1/10-02-24-Equalization%20FINAL.pdf

July 2006

Do We Over-Equalize?

Brian Lee Crowley and Bobby O'Keefe

http://www.fcpp.org/pdf/PolicySeries30DoWeOverEqualizeJul06.pdf

For more see
www.fcpp.org