KILLING WITH KINDNESS

How Equalization Harms Manitoba

PRESENTATION TO:

Calgary Congress

Calgary, September 30, 2006

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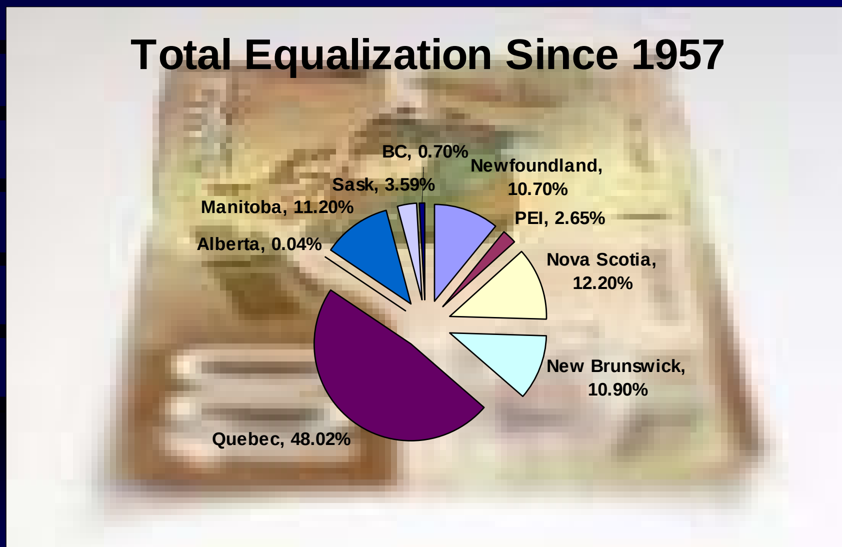
FRONTIER CENTRE
FOR PUBLIC POLICY

WHAT IS EQUALIZATION?

- A federal program started in 1957 that transfers revenues from “have” to “have-not” provinces.
- “To ensure reasonably comparable levels of public services at reasonably comparable levels of taxation”
- Transfers resources to provinces with below average tax bases.
- Designed to help less well-off provinces fund services , without the need to tax their residents excessively.
- $11.3 billion in 2006-07



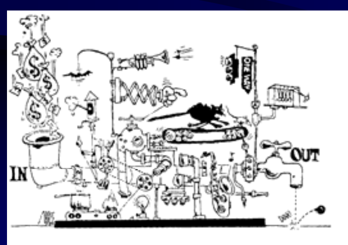
About $225 billion since 1957

EQUALIZATION'S HISTORY IN CANADA

- 1957 - Simplicity
  - based on 3 taxes
  - Ontario only "have" province
- 1957-67 - Growing Complexity
- 1982
  - Enshrined in Constitution
  - Shift to five province standard
    - Drop "rich" Alberta from standard
    - Drop "poor" Atlantic provinces
- 1982 – 2006
  - Five Province standard includes Ontario, Quebec, Manitoba, Saskatchewan, B.C.
  - 33 tax bases
- 2006? More . . . ?

EQUALIZATION FORMULA

- Very Complex
- Understood by a few dozen people in Canada
- Evidence that it has dysfunctional impacts – unintended consequences
- Giant welfare trap?



The equalization formula for the FPS can be expressed as follows:

$$\frac{E_{ij}}{P_i} = t_{cj}\left(\frac{B_{rj}}{P_r} - \frac{B_{ij}}{P_i}\right) \qquad \text{E1}$$

where

E_{ij} = equalization to province i from revenue source j;

P_i = population of province i;

E_{ij}/P_i = per capita equalization to province i from revenue source j;

t_{cj} = the national-average (all-province) tax rate, defined as total revenues from revenue source j (that is, TR_j) divided by the total base for source j (that is, B_{cj}), where subscript c refers to Canada or, more correctly, the all-province total;

B_{rj}/P_r = the per capita base for source j in the FPS provinces, where subscript r relates to the five-province standard;

B_{ij}/P_i = province i's per capita base for revenue source j.

In words, the formula can be recast as follows:

$$\text{Equalization per capita} = \text{national average tax rate} \cdot \left[\left(\text{the five provinces' per capita base}\right) - \left(\text{the province's own per capita base}\right)\right] \qquad \text{E2}$$

Background

- Nobel prize winning (1986) Economist James Buchanan generally seen as “Father of Equalization”
- 1950 published paper which provided a theoretical argument for equalization – to discourage movement of people to high service areas
- Key points of his argument were ignored
  - Regionally differentiated rates of federal taxation
  - Conditional grants tied to activities which increase productivity and mobility of resources
    - Transport
    - Education
- Predicted that Government to government equalization will expand the size of the public sector in recipient areas (Frontier interview 2001)

SUBSIDIES "STICK" TO GOVERNMENT - Commonwealth State Funding Report

Review of Australian equalization in 2002

The Flypaper Effect:

- " Money "thrown" at a State Government tends to stick, even though the welfare of households would be better served if the money was passed through to them as lower taxes"
- "Heavily subsidized states have high per capita expenditures on state government services"

SUBSIDIES CAPTURED BY PUBLIC SECTOR

AIMS Paper (2006) observes:

- "The equalization-receiving provinces have larger than average public service employment, higher than average public sector wages, and higher than average levels of debt. **Simply arriving at national average levels of these performance indicators would release two provinces – Manitoba and Québec – entirely from reliance on equalization,** and reduce the dependence of the others to a very significant degree. Instead of providing reasonably comparable services at reasonably comparable levels of taxation, the recipients of equalization appear to be providing inflated levels of public service costs."

- 32 more civil servants per thousand in Mb (AIMS)

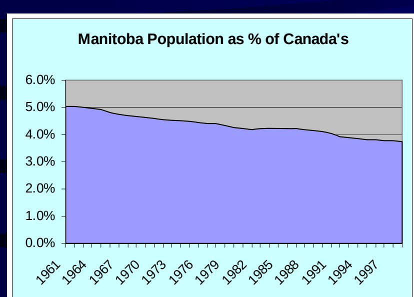
KILLING MANITOBA WITH KINDNESS

Politicized, Transfer-Dependent Economy

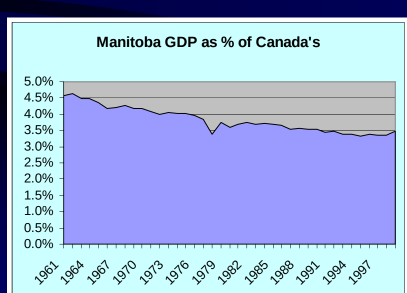
Entrenched anti-growth "Have Not" Economic Model

Trapped in Slow Growth Purgatory

RELATIVE POPULATION AND GDP DECLINE SINCE 1961



Manitoba's relative share of Canada's population has fallen 25.7% since 1961



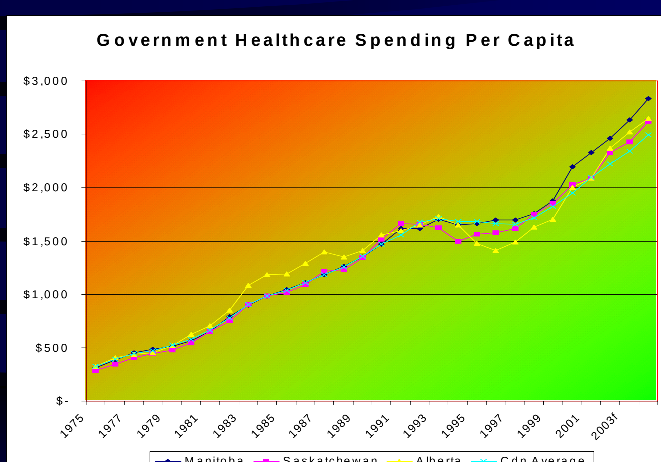
Manitoba's relative share of Canada's GDP has fallen 24.1% since 1961

MANITOBA FLY PAPER IMPACTS

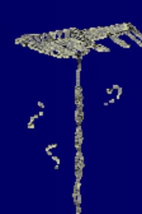
- Bigger government per capita
- Expensive public services
- Higher taxes
- Lower investment

= Have not province "slow growth" purgatory

HIGHEST HEALTHCARE EXPENDITURES



- 12.0% MORE PER CAPITA IN MB VS CANADA (2004F)
- SAVE $391 MILLION IF SPENT AT CDN AVERAGE

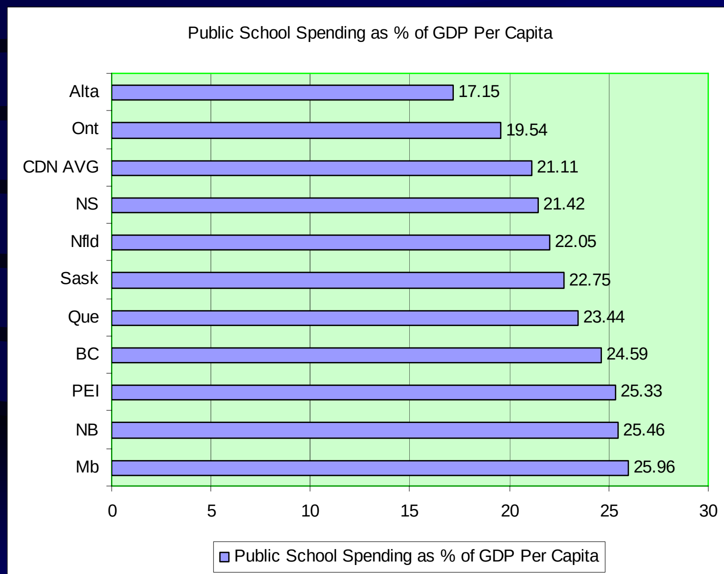


"FLYPAPER EFFECT"

Spending Reduction based on:

Spending	%	Per Capita	Tot
Cdn Avg	12.0%	$ 341	$ 390,956,449
Sask	7.6%	$ 216	$ 247,689,546
Alta	6.8%	$ 191	$ 219,738,668

HIGHEST PROVINCIAL EDUCATION SPENDING



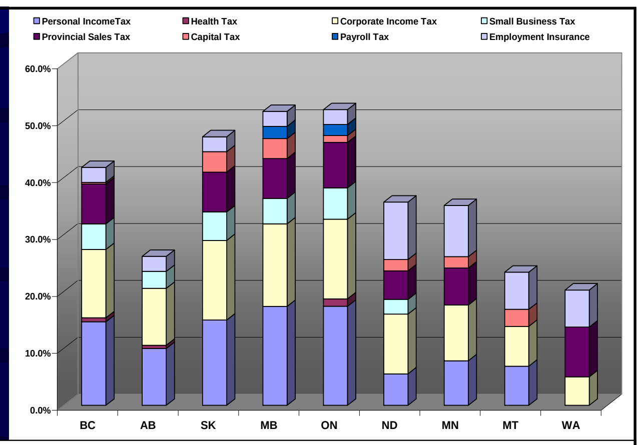
MANITOBA SPENDS MOST PER CAPITA ON SCHOOLS

HIGHEST TAX LOAD

MANITOBA:

Losing lucrative high income tax base

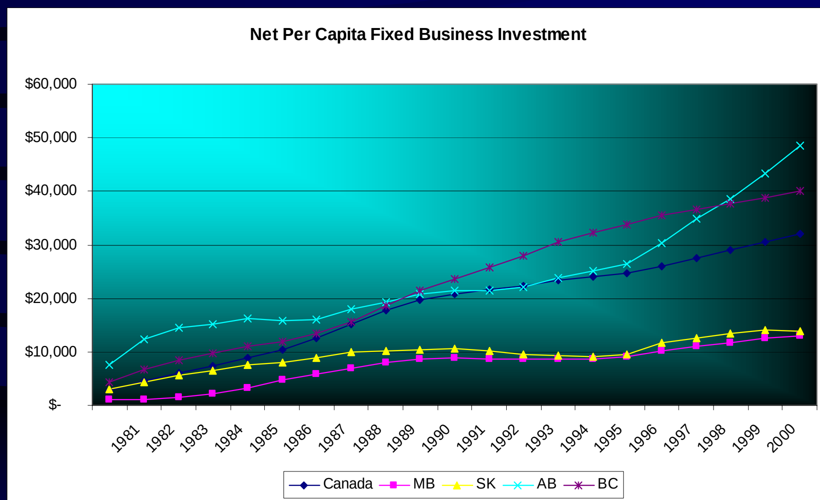
- Top 6% pay 33% of total tax



2006 Northern Plains Tax Load Index

April 2006 Rates	BC	AB	SK	MB	ON	ND	MN	MT	WA
Personal Income Tax	14.70%	10.00%	15.00%	17.40%	17.41%	5.54%	7.85%	6.90%	0.00%
Health Tax	0.70%	0.57%	n/a	n/a	1.32%	n/a	n/a	n/a	n/a
Corporate Income Tax	12.00%	10.00%	14.00%	14.50%	14.00%	10.50%	9.80%	7.00%	5.03%
Small Business Tax	4.50%	3.00%	5.00%	4.50%	5.50%	2.60%	0.00%	0.00%	0.00%
Provincial Sales Tax	7.00%	n/a	7.00%	7.00%	8.00%	5.00%	6.50%	0.00%	8.75%
Capital Tax	0.30%	n/a	3.60%	3.50%	1.20%	2.00%	2.00%	3.00%	0.00%
Payroll Tax	n/a	n/a	n/a	2.15%	1.95%	0.00%	0.00%	0.00%	0.00%
Employment Insurance	2.62%	2.62%	2.62%	2.62%	2.62%	10.09%	9.00%	6.50%	6.50%
Total	**41.82%**	**26.19%**	**47.22%**	**51.67%**	**52.00%**	**35.73%**	**35.15%**	**23.40%**	**20.28%**
Change since 1999	**17.92%**	**14.47%**	**10.69%**	**5.93%**	**5.13%**	**0.32%**	**1.85%**	**3.85%**	**2.25%**

LOW BUSINESS INVESTMENT



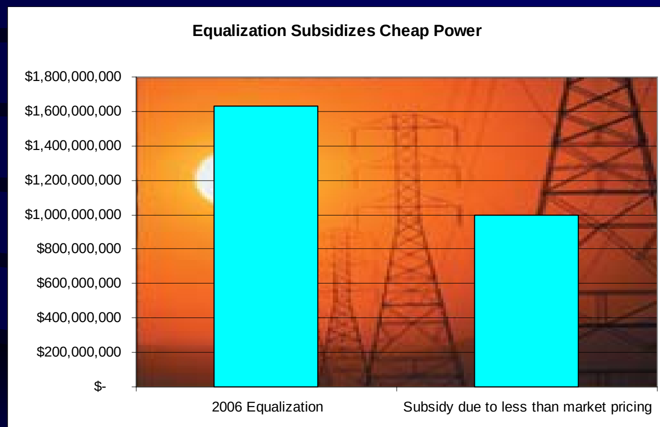
Manitoba has the lowest rate of capital investment per capita in western Canada and the third lowest in the country, after two Maritime provinces

BILLION DOLLAR OPPORTUNITY COST

Imagine "Have-Not" Alberta selling oil for half price

- Tom Adams of Energy Probe in Toronto estimates gap between market and local price at between $840 million and $1.2 billion per year.
- Reasonable estimate = $1 billion
- See www.fcpp.org for calculation.

EQUALIZATION SUBSIDIZES CHEAP ELECTRICITY

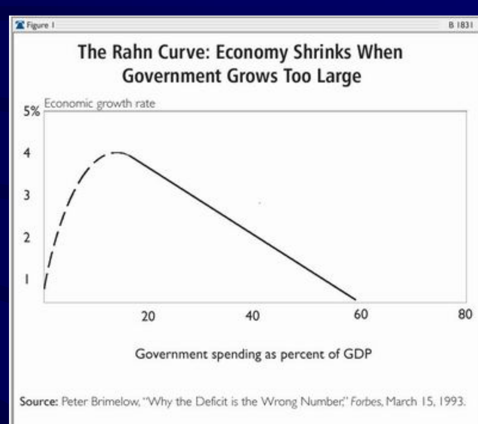


Over 60% of equalization pays for below market electricity pricing

OPTIMUM SIZE OF GOVERNMENT NOT ACHIEVABLE

- Optimum Size of Government
  - Research: 20 to 30% of GDP
  - Canada at 40%
  - Manitoba over 50%

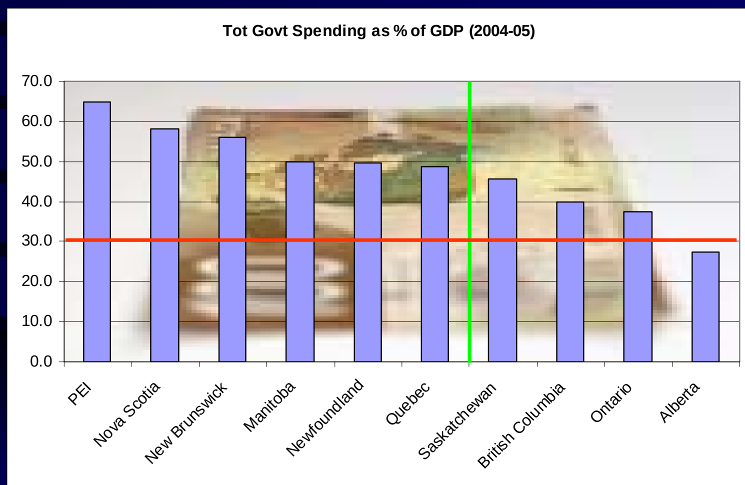
Putin’s Former Economic Advisor Andrei Illarionov



“13%”

GOVERNMENT AS % OF GDP

"HAVE NOTS" ALL ABOVE OPTIMUM SIZE OF GOVERNMENT



ESCAPING THE EQUALIZATION TRAP

3 Strategies for Making Equalization Transformational

1. Simplifying Formula
2. Debt-for Equalization Swap
3. Tax Swap

SIMPLIFYING THE FORMULA

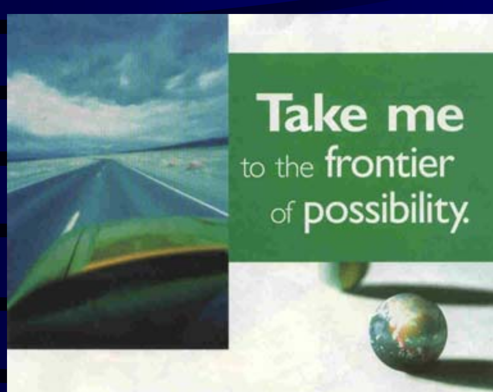
- Remove resource revenues from the formula to greatly simplify the program and ameliorate the welfare trap effect caused by claw backs (see www.aims.ca)
- Make transfers sensitive to the effectiveness of spending in recipient regions, with a simple rule, phased in over five years:
  – Recipient provinces cannot spend more than national per capita averages on public services (flypaper effect)

DEBT-FOR-EQUALIZATION SWAP

- Most equalization goes out the door in the form of provincial debt service charges.
- Debt-for-equalization swap would allow have-nots to clean up balance sheets, swapping the end of debt payments for equalization payments.
- Ottawa's equalization commitment and the accompanying distortions would be eliminated.
- The price? A manageable increase in a steadily falling federal debt with a further saving due to lower debt servicing costs in Ottawa due to its better credit rating.
- Requires strict rules to prevent provinces from simply running up their debt again.

THE TAX SWAP

- Bundling equalization together with other federal transfer programs, including support for health and other social programs (CHST), the transfer in 2004 is about $33 billion.
- GST revenue during the same period is projected at almost $29 billion, or roughly the same amount.
- Subject to harmonizing the GST with provincial sales taxes, the federal government would simply hand provinces the GST as a substitute for equalization and CHST programs.
- Eliminates the unnecessary bureaucratic and political churn that characterize transfers.
- It would also be the least difficult to sell since all provinces benefit from the swap.



www.fcpp.org