



Fiscal Imbalance in Canada

**A Look at the Opportunity Costs
of Equalization**

Eric Merkley

Executive Summary

Findings
suggest that the program acts as a drag on growth, bloats the public sector in recipient provinces and harms Canada's productivity...

Ontario, Alberta, and British Columbia taxpayers have faced a long-standing fiscal gap between the federal transfers they receive and the transfers they deserve based on their share of federal revenue. The gap between the winners and losers of equalization has widened considerably since 1963.

The fiscal burden of equalization faced by Ontario, Alberta and British Columbia has real opportunity costs for their governments. For example, without the fiscal burden of equalization since 2005, the government of Alberta could have been in a position to increase its health budget by 13 per cent annually or double the Heritage Fund. British Columbia could eliminate its ongoing budget deficit, or it could have increased capital expenditure by 41 per cent per year.

Alternatively, if residents were to have received the money, a family of four in Alberta could have afforded the average tuition for a three-year undergraduate program, or they could have paid 90 per cent of the minimum down payment on an average house.

Economists and public policy analysts have identified problems with the equalization program. Findings suggest that the program acts as a drag on growth, bloats the public sector in recipient provinces and harms Canada's productivity. Instead of equalizing fiscal capacities between jurisdictions as intended by the pioneer of equalization theory, public choice economist James Buchanan, it further harms their capacity to raise revenue. We must ask whether the program as it stands is worth the cost to Alberta, Ontario and British Columbia.

Introduction

Fiscal transfers, including equalization, have a long and contentious history in Canada. Supporters argue that they are necessary, at least in part, to even out the inequities in the Canadian Confederation created by disparities in natural resources and human capital. Critics see it as a subsidy for poor fiscal policy. No one can dispute that, whatever the merits of equalization and other fiscal transfers, they have come at the expense of the three leading economies in Canada: Alberta, Ontario and British Columbia. This paper will look at the fiscal burden the taxpayers of these provinces have had to carry historically because of federal government transfers to the provinces and at the equalization program more specifically. It will also provide illustrations of the opportunity costs these provinces have faced because of equalization. Any debate over the merits or failures of the status quo needs to address the systematic and unending costs that these provinces face in the absence of meaningful reform.

“*...whatever the merits of equalization and other fiscal transfers, they have come at the expense of the three leading economies in Canada...*”

Fiscal transfers in the Canadian confederation

Canada is one of the most decentralized federations in the world. Neither John A. Macdonald nor many of the Fathers of Confederation intended this. They envisioned a quasi-unitary state along the British model that avoided the problems that they saw as plaguing the U.S. federation and which culminated in the Civil War. As a result, the *BNA Act of 1867* disproportionately placed taxation powers in the hands of the federal government. Macdonald and others failed to predict the important changes that the Dominion would face in later years. Jurisdictions under the domain of the provinces, such as health and education, began to eclipse many federal areas of responsibility in cost and importance. Not surprisingly, cash-strapped provinces turned to Ottawa for funding. Ottawa, hoping to use these programs to aid national unity and to expand the scope of federal influence into provincial jurisdictions, was more than happy to acquiesce.

There are three primary transfers made by the federal government to the provinces:

- Canada Health Transfer “provides long-term predictable funding for health care, and supports the principles of the *Canada Health Act*” (Department of Finance 2011a).¹
- Canada Social Transfer is “a federal block transfer to provinces and territories in support of post-secondary education, social assistance and social services, and early childhood development and early learning and childcare” (Department of Finance 2011b).
- Equalization “[addresses] fiscal disparities among provinces. 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” (Department of Finance 2011c).

Commentators in the media have raised questions over which provinces are pulling their weight in Confederation. Politicians in leading net contributors to fiscal transfers (Alberta, British Columbia and Ontario) have argued that they are systematically giving more to the federal government than they are receiving in the form of transfer payments. This goes far beyond transfer payments—to the distribution of goods and services and to the federal civil service in the form of stealth equalization (Eisen 2010). These issues, however, are beyond the scope of this paper.

The Health Transfer and the Social Transfer were composed of two components: cash and tax-point transfers.² The cash component took into account the value of a province's tax point in determining the value of the transfer. Provinces with a comparably greater ability to raise revenue (Alberta and Ontario) would receive less per capita funding than the other provinces did. In essence, equalization was built into each transfer despite the separate existence of equalization payments. In 2007, the federal government announced its intention to correct this inequity by moving to a per capita funding formula for the Health Transfer and the Social Transfer (Department of Finance 2011a). For most of this period of study, however, the Health Transfer and the Social Transfer were, in a sense, equalization payments.

Provincial fiscal transfer burdens, 1963-2009

The focus on equalization has diverted attention from the inequity built into fiscal transfers. Data from Statistics Canada allow us to calculate the fiscal burden of each province. Contrary to simplified accounts in media sources and public debate, fiscal transfers such as equalization are not transfers from one province to another, but rather transfers from the federal treasury to provincial governments. Each province's taxpayers contribute a certain share to the treasury, and this percentage can be used to approximate their taxpayers' contribution to certain transfer programs. This is their "deserved transfer," which can be subtracted from the actual transfer to calculate their relative burden or benefit from fiscal transfers in Canada for each province over time. Charts 1-1B presents the results, next page.

There are two modestly different stories depending on whether one looks at per capita or absolute transfer receipts. Regardless of how one parses the data, there are three consistent losers: Ontario, Alberta and British Columbia. Alberta has recently been the most systematically disadvantaged province by the transfer regime if one looks at the per capita burden. As of 2009, the average Albertan sends more than \$1,400 to other provinces in federal transfers. This is an approximate increase of close to 300 per cent since 2004 and dwarfs the \$433 and \$387 transferred by Ontario and British Columbia residents respectively.

Looking at the data in absolute terms reveals Ontario to be the primary net contributor to federal transfers over time, although Alberta is rapidly catching up, as Ontario's economic position continues to deteriorate. Ontario residents have

transferred between \$6-billion and \$8-billion annually for the past decade to other provinces. What is notable about both the absolute and per capita data is that the gap between the provinces has been widening over time. For transfers geared toward equalization, there has been remarkably little equalizing going on.

CHART 1 Fiscal Transfer Burden/Benefit 1963-2009

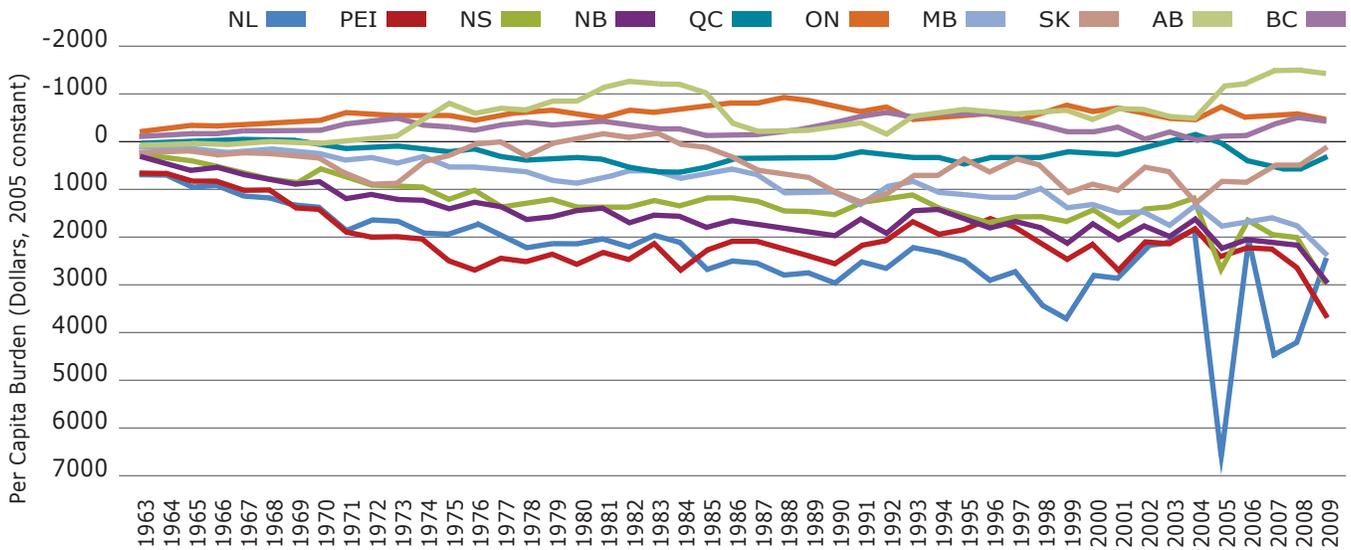
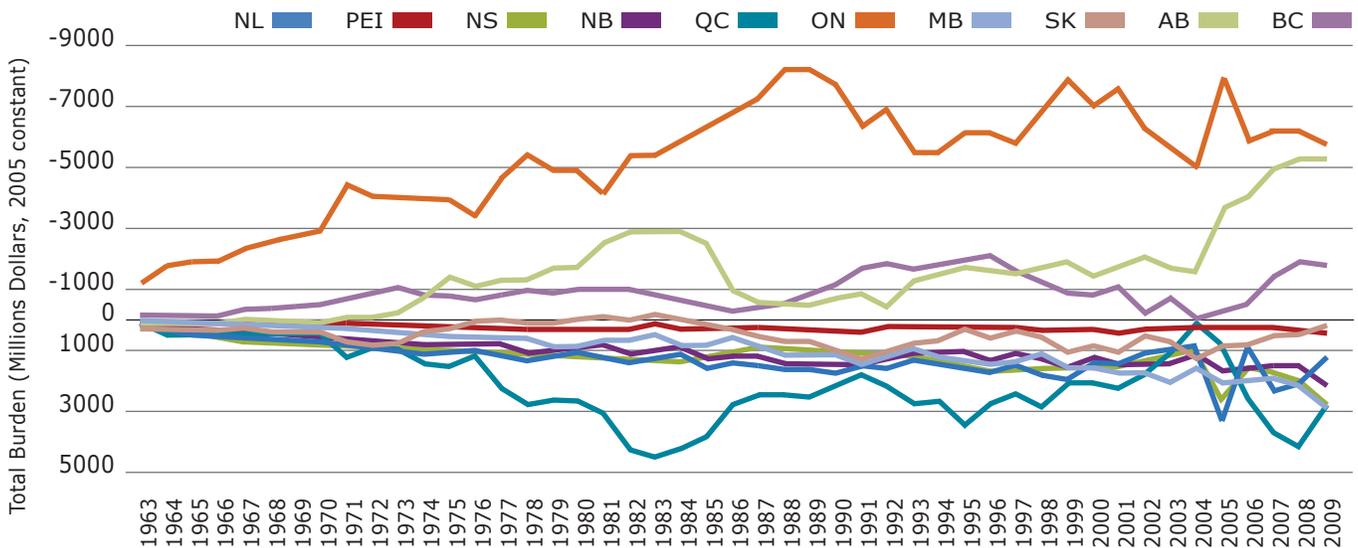


CHART 1B Fiscal Transfer Burden/Benefit 1963-2009



Source: CANSIM Tables 384-0022 and 384-0004; calculations by the author.

Equalization burden, 2005-2013

Equalization is perhaps the most controversial of the transfers presented above. This paper will explore these controversies in a later section. Additionally, as it is the last major transfer to remain unreformed, it is worth a more detailed examination. Unfortunately, Statistics Canada does not have specific equalization figures going

CHART 2 Equalization Burden/Benefit 2005-2012

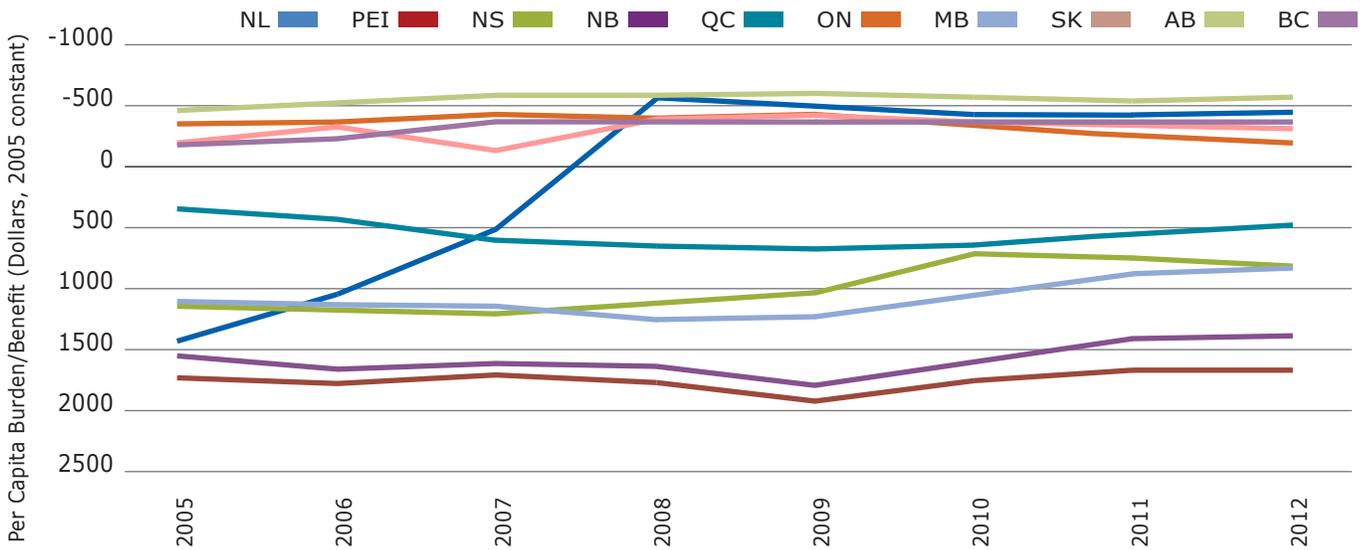
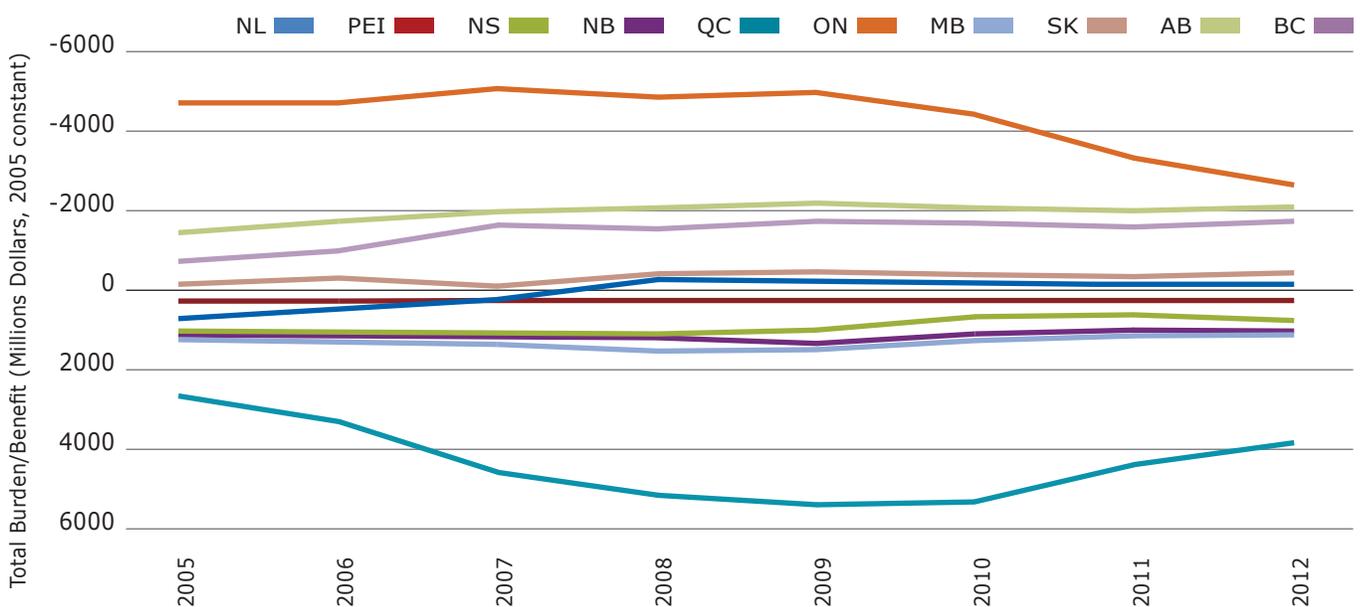


CHART 2B Equalization Burden/Benefit 2005-2012



Source: Department of Finance 2012; calculations by author

back to 1963. However, the fiscal burden and benefit were calculated based on the figures provided by the Department of Finance for the most recent period. The Charts 2-2B reflect the results.

The story told by the fiscal burden of equalization is similar to that of other transfers. However, important changes in the Canadian economy are beginning to alter who the winners and losers of the equalization program are. Newfoundland and Labrador has seen its position shift substantially over the past few years, as oil and gas radically changes its fiscal position. From 2005 to 2008, Newfoundland went from one of the largest per capita beneficiaries of equalization to a net contributor. A resident of the province now has more than \$400 sent to net-recipient provinces through the equalization program. Ontario is trending in the opposite direction. Its absolute and per capita fiscal burden has shrunk, as the province began receiving payments from the program. An average resident now sends only approximately \$200 annually to net-recipient provinces, compared to almost \$400 in 2005. Most other provinces have remained stable over this period.

The picture painted by the data suggests remarkable consistency in the provinces that routinely lose out with federal transfers including equalization. The burden has historically fallen to Alberta, Ontario and British Columbia. The historical transfer data suggest that there is little reason to expect anything to change. The burden borne by these three provinces is easy to minimize—the enormity of the money involved is hard to visualize, and we often forget to explore opportunity costs.

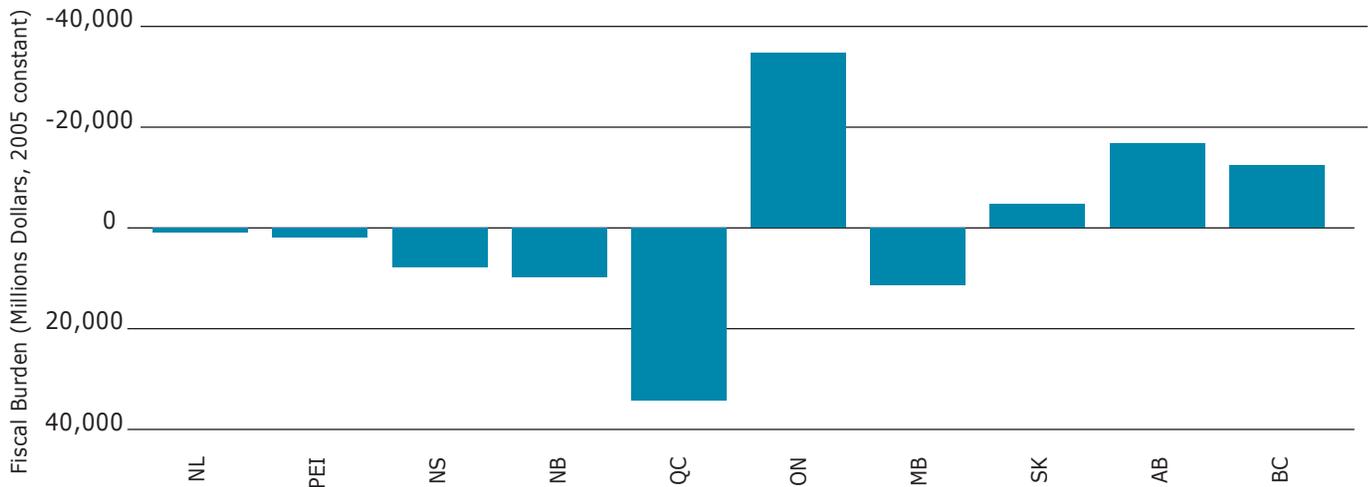
Opportunity costs of the fiscal burden

The cumulative fiscal burden of equalization is staggering. Chart 3 below shows the absolute fiscal burden or benefit of equalization for each province. Ontario residents have sent nearly \$35-billion dollars to net-recipient provinces, while Albertans and British Columbians have sent \$16-billion and \$12-billion respectively. Had this money been returned to taxpayers, Ontarians and British Columbians an extra \$2,700 cumulatively, and Albertans a staggering \$4,300. Alternatively, governments could have spent the money on bolstering public services, whose indicators on many measures lag behind the net-recipient provinces (Eisen and Milke 2010).

Equalization's finances come from the federal treasury, and as such, taxpayers in all provinces support it. However, some provinces receive nothing in return, while others receive substantially more than their contributions. As the distribution of net contributors and recipients has remained largely the same, equalization has

CHART 3

Cumulative Fiscal Burden/Benefit of Equalization 2005-2013



Source: Department of Finance 2012; calculations by author

led to a massive cumulative transfer of wealth away from Alberta, Ontario and British Columbia in particular. In Table 1 below are illustrations of the opportunity costs of equalization.

As Alberta is per capita the most disadvantaged, it faces the steepest opportunity cost. A family of four could have been able to afford full tuition for an average three-year undergraduate program with the revenue transfer to other provinces. Alternatively, the family could cover 90 per cent of a minimum down payment on an average-priced home or 15 months of rent for an average three-plus bedroom apartment. Of course, these investments would yield further economic advantages for Alberta downstream—instead, equalization robs taxpayers of these benefits, as it transfers money out of province.

Alternatively, the federal government could have returned the transfer money Alberta deserves as a percentage of its share of federal revenue to the provincial government. This amount of money would make a huge difference. The \$16-billion collected since 2005 could have doubled the current size of the Heritage Fund, leaving greater flexibility for the provincial government to adjust to rapidly fluctuating commodity markets. At \$2-billion per year, on average, the government of Alberta could have used the extra transfer money to increase the annual budget for the Department of Education by 28 per cent or that of the Department of Health by 13 per cent. The opportunities missed by the governments of Ontario and British Columbia are equally problematic.

Table 1 Opportunity Costs of Equalization Program³

	Ontario		Alberta		British Columbia	
	Province	Family of four	Province	Family of four	Province	Family of four
Burden	\$34-billion (\$4.3-billion/yr)	\$10,628	\$16-billion (\$2-billion/yr)	\$17,348	\$12-billion (\$1.5-billion/yr)	\$10,404
Option 1	Three-year infrastructure plan in 2013 budget	Rent for three-plus-bedroom apartment for nine months	One hundred per cent increase in the Heritage Fund	Rent for three-plus-bedroom apartment for 15 months	Forty-one per cent annual increase in capital expenditure	Rent for three-plus-bedroom apartment for nine months
Option 2	Fifteen per cent increase in annual education expenditure	2011 Hyundai Accent	Twenty-eight per cent increase in annual education expenditure	2012 Dodge Caliber	Fifteen per cent annual increase in spending on education and districts	2011 Hyundai Accent
Option 3	Thirty-seven per cent annual reduction in deficit	1 1/2 years of undergraduate tuition	One hundred per cent increase in post-secondary base operating grants	Full tuition for three-year undergraduate program	Elimination of deficit	Two years of undergraduate tuition
Option 4	Four hundred per cent increase in annual development and R&D spending	Fifty per cent of minimum down payment on average house	Thirteen per cent annual increase in health expenditure	Ninety per cent of minimum down payment on average house	Nine per cent annual increase in health expenditure	Forty per cent of minimum down payment on average house

As the equalization data only goes back to the 2005-2006 fiscal year, it does not show the true extent of the burden faced by these three provinces over time. When all transfers are included in the mix, Ontario has faced a cumulative burden of \$250-billion since 1963. Similarly, Alberta and British Columbia have lost \$70-billion and \$40-billion of revenue. Most of this gap has been due to the equalization program.

Discussion

The *Constitution Act of 1982* enshrined equalization, so it is, for better or worse, part of Canadian Confederation for a long time to come. However, there must be a greater recognition that there are real costs to the net contributors of the program. Net-provider governments could have greatly improved quality and quantity of public services, or they could have returned revenue to residents to facilitate economic growth. It is necessary to ask whether the current system of equalization is worth the cost to net contributors.

Public choice economist James Buchanan (1950) pioneered equalization theory in his influential paper on the efficiency and equity basis for equalizing transfers in federations. His theory is the basis for equalization programs in Canada, Australia and Germany. The case for some sort of equalization program is reasonable. Buchanan argued (2001) that federations will have inherent problems with equity if jurisdictions are formed in a way that leads to differences in fiscal capacity (as is the case in Canada). A jurisdiction with poorer residents, on average, will be unable to raise enough revenue to maintain levels of public good provision similar to those of other provinces. Assuming mobility, this will result in the out-migration of residents toward wealthier jurisdictions. This migration will lead to a vicious cycle, as productive resources will increasingly concentrate in regions with an abundance of human and physical capital, and accelerate the decline of poorer regions. This is consistent with the literature on increasing returns and New Economic Geography pioneered by Paul Krugman (1991).

Economists who oppose fiscal transfers argue that convergence will eventually result as labour costs decrease in disadvantaged regions, which will attract productive resources. It is not entirely clear whether this will happen or whether the advantages that arise from productive capital following other productive capital in a pattern of increasing returns will obviate the benefits of lower labour costs. Buchanan sees public services in productive jurisdictions as a common pool resource open to exploitation by in-migrants. It is then worth it from an efficiency standpoint for wealthier jurisdictions to subsidize poorer jurisdictions to prevent excessive migration.

Buchanan (2001) stepped back from his support for fiscal transfers, because of the perverse political incentives that arise. He argued that equalization is only efficient if it benefits high-income as well as low-income residents, but when coalitions of low-income beneficiaries politically mobilize (more possible in recipient jurisdictions), they can skew the benefits of equalization to themselves. This will discourage

the migration of low-income earners and encourage the migration of high-income earners, further harming the fiscal capacities of these jurisdictions. There is no obvious way to deal with these incentive problems.

In Canada, policy analysts have increasingly acknowledged Buchanan's critique of fiscal transfers as a reality. Equalization has been found to contribute to Canada's labour productivity deficit and has not only failed to attract productive capital to the Maritimes and Manitoba but acts as a drag on growth (McMahon 2000; MacKinnon 2011). As the data indicates, there is a widening gap between the provinces in their burdens or benefits of equalization and other fiscal transfers. The current system of equalization is plainly not worth the cost.

There is little opportunity for reform of the system, as the political incentives at the federal level are stacked against it. Net contributors to equalization are systematically under-represented in Parliament and are a minority of provinces in federal-provincial negotiations.

Ontario residents also distinctly lack a regionalist attachment to their province. This has limited the ability of Ontario governments to stand up for their citizens' interests by removing political incentive to push back against Ottawa—an Ontario premier has been likened by David Cameron, a political science professor at the University of Toronto, to a "general without an army" (Ibbitson 2012). Net recipients also have no incentive for reform. They have been able to develop far more expansive public sectors than net-contributing provinces have—federal equalization has rewarded consistently poor economic performance. The prospects for reform are bleak.

Conclusion

The costs borne by Alberta, Ontario and British Columbia for Canada's system of fiscal transfers—primarily equalization—are substantial. Not only are there direct opportunity costs to these provinces, but they are robbed of the future investments that the lost revenue could have provided. The federal government has made progress recently in increasing the fairness of non-equalization transfers by making them purely on a per capita basis. However, it is clear that the biggest problem is the equalization program. There can be no doubt that equalization was developed with noble intentions. In a world absent of perverse political incentives, it may have even helped struggling regions to converge with their more-productive counterparts. However, that is not the world we live in. Equalization in its present form has been used to bloat the governments of recipient provinces (Eisen and Milke 2010), and it acts as a substantial drag on their economies (McMahon 2000; MacKinnon 2010), further harming their fiscal capacity. Given the massive costs of this program to taxpayers in Alberta, Ontario and British Columbia, we need to ask ourselves if it is worth it.

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- Statistics Canada. Table 384-0004 – Government Sector Revenue and Expenditure, Provincial Economic Accounts, annual (dollars x 1,000,000), CANSIM (database).

Endnotes

1. The Health Transfer and Social Transfers were combined prior to 2004. The federal government constructed both transfers out of earlier transfer arrangements such as Established Program Financing and the Canada Assistance Plan.
2. The permanent reduction of the federal basic tax rate, matched by an equivalent increase in provincial basic tax rates.
3. Per capita examples are crude approximations for illustrative purposes only. In reality, raised revenue for transfers is done largely in proportion to a resident's income. Equalization is in effect a transfer from wealthy individuals in rich provinces to poorer individuals in disadvantaged provinces. Budget figures were taken from the operational expenditure section of each government's 2013 budget. Average tuition costs were gathered from Statistics Canada. Average rent and housing prices were obtained from the Canadian Mortgage and Housing Association.

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