

# NATIONAL POST

## **A failed formula: The federal equalization system is prone to distortions and manipulation. Better to tie payments to per capita GDP**

National Post

Tue 30 May 2006

Page: FP19

Section: Financial Post: Comment

Byline: Jack M. Mintz

Source: National Post

The latest outpouring from the leaders of the only two jurisdictions that do not receive the equalization and territorial financing payments -- Alberta and Ontario -- sets up a classic confrontation among the provinces and the territories. Premiers Ralph Klein and Dalton McGuinty question whether more equalization is needed to be paid to the rest of country since the net cost of the \$11-billion constitutionally required program ends up borne by taxpayers in their provinces. The recipient provinces and territories, of course, will enjoy any handout they can get from the federal government since it relieves them of cutting back spending or taxing their populations.

The stars are being aligned to ramp up equalization payments. The Harper government, looking to form a majority government in the next round, knows that its greatest room for political growth is in Quebec, where solving the "fiscal imbalance" could mean more equalization. The preceding Martin government fixed the total pie to grow 3.5% annually until 2010. A recent report prepared for the provincial and territorial premiers came up with -- guess what -- the fiscally irresponsible view that not only should equalization payments be increased by several billions of dollars but also other federal grants to the provinces.

Thank goodness for Messrs. Klein and McGuinty. Increasing equalization payments does not reflect Canadian reality. If anything, regional inequality has been declining in recent years -- and so should equalization payments.

For example, back in the high oil price recessionary year of 1981, Alberta's per capita GDP was about 60% above the national average -- other provinces with above-average GDP per capital included British Columbia (10%), Saskatchewan (3%) and Ontario (2%). The Atlantic provincial per capita GDP was about 60% of the national average along with poorer provinces Quebec (85%) and Manitoba (90%).

By 2004, differences among provinces have generally become smaller, with only one really rich province, Alberta, whose per capita GDP is 145% of the national average (a smaller difference compared with 1981). Ontario's position has changed little, Saskatchewan is now at the national average and British Columbia has a GDP per capita that has fallen below the national average since 1983. The Atlantic provincial GDP per capita is now three-quarters of the national average with Newfoundland reaching a level close to Manitoba's at 85% of the national average.

These numbers move around over time and GDP, which reflects the provincial output produced, not income received by residents, is uncorrected for differences in cost levels across provinces. Despite these limitations, however, only one conclusion can be reached: Canada is far different today than 25 years ago. Alberta is now the only rich province.

Yet, the equalization formula does not reflect this new reality, since per capita payments seem to have little to do with inequality in per capita incomes. From 1991, the program has grown by \$3-billion with some payments well out of proportion to overall wealth. Newfoundland's per capita payment -- close to \$1,700 -- is sharply higher, by \$400 per capita, than its almost-equal cousin Manitoba and more than \$200 per person above poorer Nova Scotia. Quebec's per capita equalization payment is about \$650,

only half of Manitoba's, even though the latter province's per capita GDP is not that far below Quebec's.

So why are equalization payments out of sync with actual per capita incomes? The problem lies with the formula to determine equalization -- a dog's breakfast that involves 33 revenue sources -- which purportedly ensures that provinces can provide comparable public services at reasonable tax rates. If provinces use their resource revenues to reduce debt -- as New Brunswick has done in recent years -- they still lose equalization payments, even though public services have not increased. Measurements using tax definitions distort tax bases to reflect political choices rather than true economic resources, such as retail sales taxes, that exempt many services or personal taxes that exclude some forms of income. The equalization formula also does not account for under-pricing by provincial Crown corporations that keeps provincial profits low, such as in Quebec's and Manitoba's power systems.

Further, the formula has been manipulated over the years to let the federal government avoid sharp increases or reductions in payments received by some provinces, as well as to smooth federal fiscal costs. For instance, the formula is adjusted to include some provinces in defining national fiscal capacity, especially Alberta with its rich natural resources.

The debate over equalization, to be pushed to the front burner with a soon-to-be-published report by a federally appointed panel, will centre on the opaque formula for determining federal equalization payments that only a few people in Canada understand. Canadians will hear endless comments about a five-province versus national standards and whether resource royalties should be included in the formula.

The panel is unlikely to reject this formula approach, despite its follies. As soon as a recipient province tries to grow, say by cutting taxes, it will be penalized by losing almost a full dollar in equalization payments for each dollar in increased tax revenues. A far better approach would use a formula that minimizes distortions and is less subject to manipulation, such as tying payments to per capita GDP.

The real losers in all this debate will be the taxpayers. Instead of the federal government cutting taxes - - and letting the provinces take up the room if they so wish -- more money will be spent by the federal government on provincial equalization transfers and other inter-governmental grants. The provinces will ramp up their spending and both federal and provincial governments will plead that there is no money left for tax cuts.

Illustration:

• Graphic/Diagram: The Spectator / "Darling, It's Mummy. I've put you in the diary for a cuddle at 6:40 -- You free?"

Edition: National

Story Type: Business; Opinion

Note: Jack M. Mintz is president and CEO of the C.D. Howe Institute and Deloitte LLP professor of taxation, J.L. Rotman School of Management, University of Toronto.

Length: 935 words

---