



No. 29

The Flypaper Effect:

Does equalization really contribute to better public services,
or does it just "stick to" politicians and civil servants?



July 2006

By Brian Lee Crowley, PhD,
and Bobby O'Keefe, MBA

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POLICY SERIES NO. 29



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*Equalization is intended to ensure "that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."*¹

That seems reasonable enough. But is that what really results? Do recipient provinces really provide "reasonably comparable" public services to those offered in richer provinces? What are the recipient provinces really buying with their equalization? What are federal taxpayers, who finance these transfers, really getting for their money?

How many and how much?

First, let's take a look at the public service in each province. In particular we want to examine both *how much* provinces pay their public servants and *how many* public servants each province has. In order to be sure we are comparing like with like, our analysis includes both provincial and local government employees in each province to account for the differences in the distribution of responsibilities of the two levels of government within each province. By counting them together, we arrive at a true picture of the size of each province's public sector.

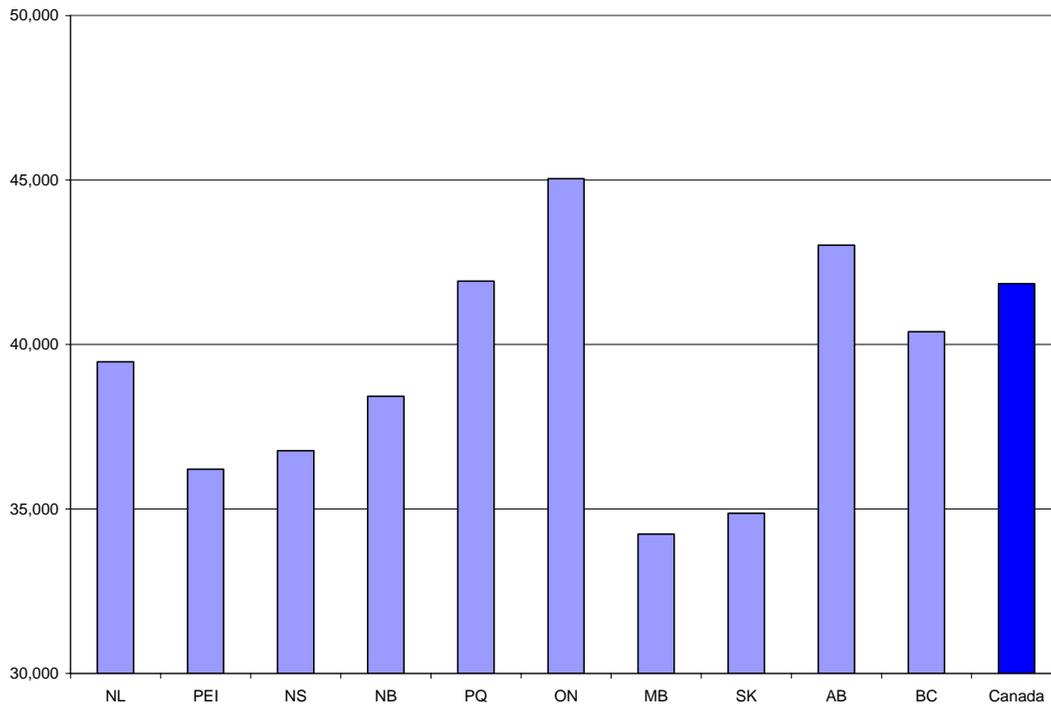
The point of our comparison is to try and establish some measures of the value that local residents are getting for the money spent on provincial and municipal services compared to citizens of other provinces. If, for example, equalization-receiving provinces (ERPs) overpay their civil servants compared to other jurisdictions, then equalization is simply going to support higher wage levels for civil servants, not better levels of public services. Similarly, if the ERPs have many more civil servants than other jurisdictions, equalization is simply being used to support unnecessary levels of public sector employment, since the other jurisdictions offer a reasonable benchmark of the level of public sector employment that is really required to offer the full range of provincial and local public services.

As is the case with any province-to-province comparison, we have to ensure we compare apples to apples. If we simply compare the average wages for public servants in each province, as in Chart 1, things look as they should given the relative size of the economies of the different provinces. Each of

¹ The Constitution Act, 1982, Section 36 (2).

the ERPs² except Quebec is well below the national average, while Ontario and Alberta, the non-ERPs, pay above national-average wages to their employees.

**Chart 1: Provincial and Local Government Average Wages
Five Year Average (2000-2004)**



Source: Statistics Canada, FMS Data

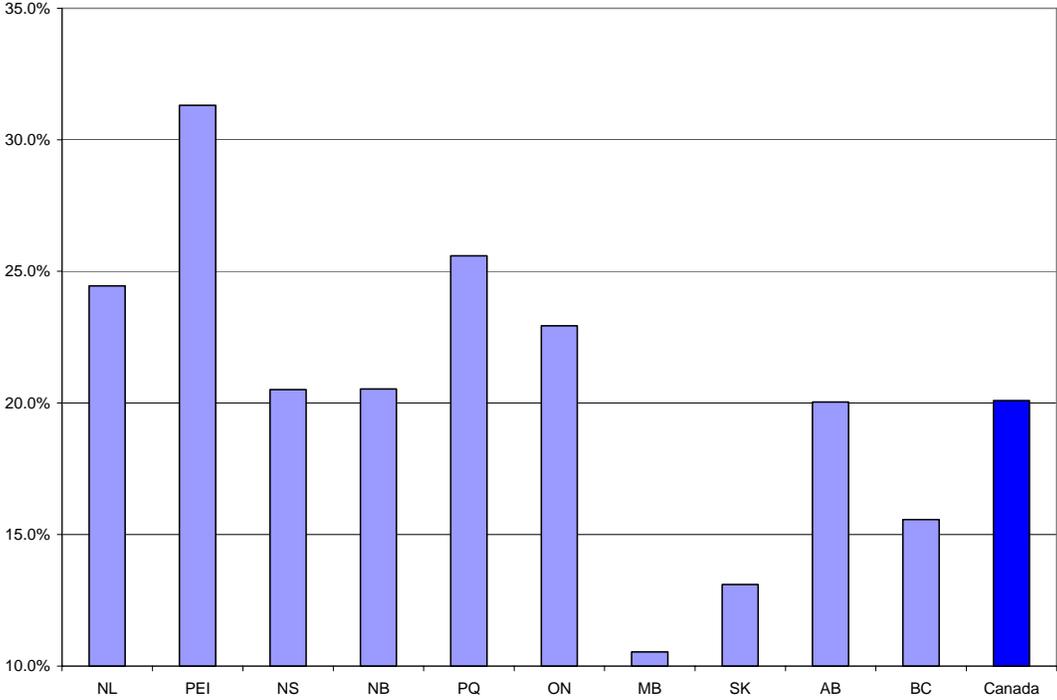
If, however, we take into account the relative incomes of the entire population of each province individually, a different picture emerges. In Chart 2, we look at the wage premiums that provincial and local governments pay their public servants over and above the average industrial wage in the province. Since the cost of living and other labour market conditions vary from province to province,³ this seems a fair way of establishing how provincial employees' pay compares to others within their respective provincial labour markets.

² For the purposes of this commentary, we consider that there are 7 ERPs – Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba, and Saskatchewan. Saskatchewan is included as they are traditionally an ERP, only recently having stopped receiving equalization payment due to increases in oil and gas revenues, which could easily fall with the price of these resources. British Columbia is not included as they have only recently received equalization payments and these payments have accounted for less than 0.5% of B.C.'s own source revenues annually. It is widely expected that B.C. will no longer be receiving equalization within a relatively few years.

³ While the wage premium approach does take into account some inter-provincial cost of living differences, the average wages are not adjusted by a relative wage or cost index in this commentary.

In this case, two of the four Atlantic provinces as well as Quebec provide a wage premium significantly above the national average. Prince Edward Island leads the way by providing its public servants with an average wage 31.3 percent greater than the industrial average wage of its population compared to the national average wage premium of 20.1 percent.

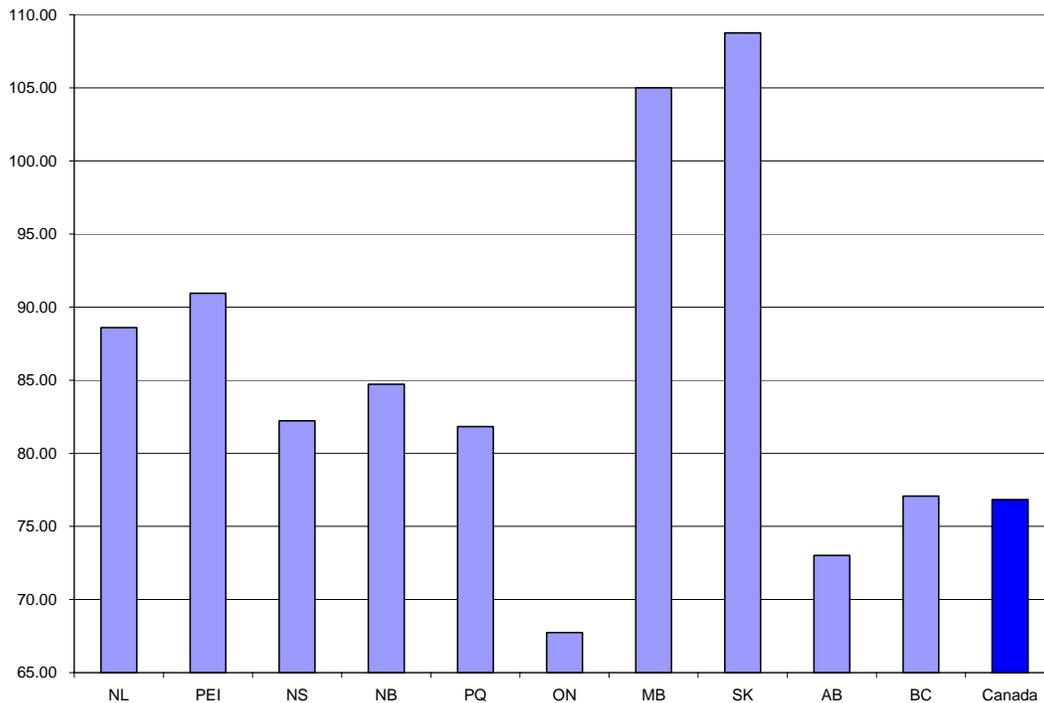
**Chart 2: Provincial and Local Government Wage Premiums
Five Year Average (2000-2004)**



Source: Statistics Canada, FMS Data and Employment Earnings, and Hours March 2006.

While some provinces thus appear to inflate the wages of their public servants, others appear to be inflating the size of the public service. Chart 3 looks at the number of public servants each province has per 1,000 residents. In this case, the seven ERPs all have significantly more public servants than the national average. While Manitoba and Saskatchewan pay their public servants average or below average wages, they make up for it by hiring significantly more public employees – 32 more public servants per 1,000 people in Saskatchewan and 28 more per thousand in Manitoba. Non-ERPs Ontario and Alberta meanwhile, come in well under the national average, with Ontario having ten less public servants per 1,000 people than the national average.

Chart 3: Provincial and Local Government Public Servants per 1,000 Population - Five Year Average (2000-2004)



Source: Statistics Canada, FMS Data

Ontario has recently been very vocal about the fact that it is having increasing doubts about the equity of the distribution of federal spending across provinces, and is particularly concerned about the recent Expert Panel's recommendation that equalization payments to the ERPs be increased. With this in mind, Charts 4 and 5 look at public sector wages and the number of public servants in each province compared to Ontario.

As shown in Chart 4, when looking at average wage premiums in each province, three provinces, all of them ERPs, pay their public servants a higher premium than Ontario does. PEI leads the way, paying a premium (compared to the average industrial wage within PEI) of 36.5 percent greater than the premium Ontario pays to its public employees compared to the average industrial wage in that province.

Chart 5 shows Ontario has the lowest number of public servants per 1,000 residents. Saskatchewan, with 41 more public servants per 1,000 has the largest public service, while Alberta has roughly 5 more employees per 1000 population than Ontario and BC has just under 10 more than Ontario.

Chart 4: Provincial and Local Government Wage Premiums Relative to Ontario (Ontario = 1.000) - Five Year Average (2000-2004)

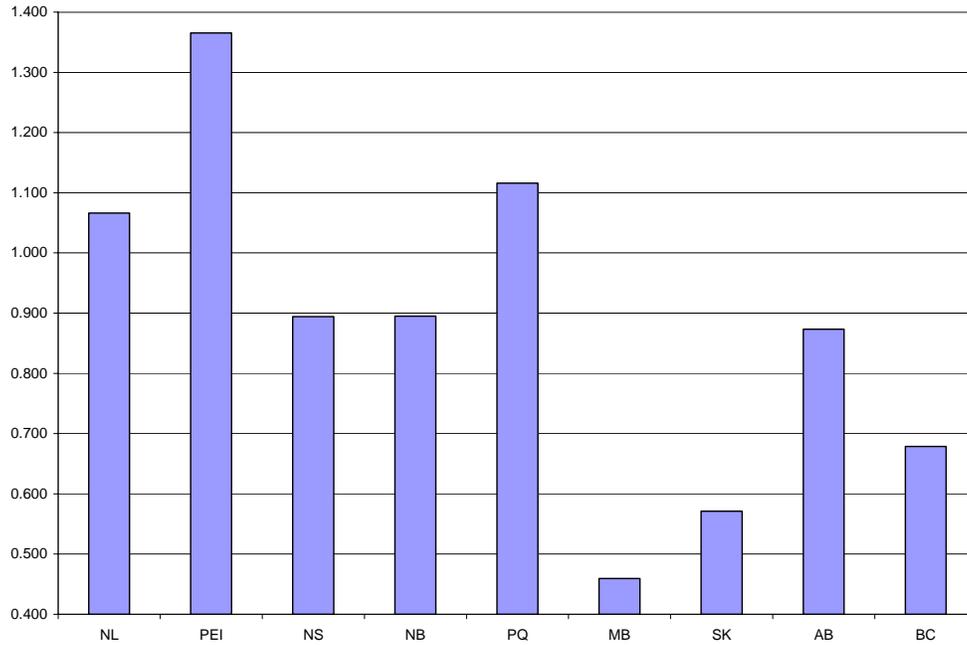
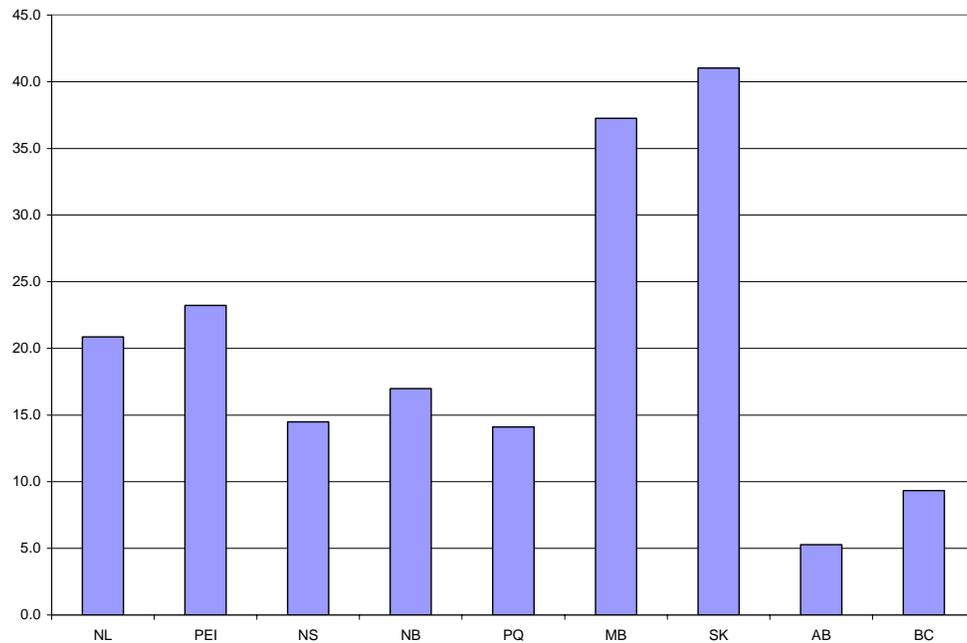


Chart 5: Provincial and Local Government Public Servants per 1,000 Population vs. Ontario Five Year Average (2000-2004)



The findings here are consistent with what James Buchanan, Nobel Laureate and often considered the father of equalization, referred to as rent seeking. "If you create an artificial scarcity through public policy – artificial rent – by

setting up an import quota or giving out a particular office that is very beneficial, people are going to invest money, time, and resources in trying to secure that opportunity." To prevent this he suggests, "We try to prevent artificial rents. Rather than setting up quotas to stop imports, we levy a tariff. Or we pay wages in the public sector that are equivalent to the private sector and we don't make it a special benefit to get a bureaucratic position." Essentially he states that given an incentive (equalization payments), rent seekers (civil servants) will organize and expend resources to capture that incentive.⁴

This phenomenon has also been referred to as the "flypaper" effect, whereby a government receiving subsidies chooses to spend excess amounts on their public service. As a recent Australian report on their equalization system argued, "Money 'thrown' at a State Government tends to stick, even though the welfare of the households would be better served if the money were passed on to them through lower taxes."⁵

Equalization = Deficit Spending?

So it would appear that a great deal of the equalization payments received by ERPs do not go toward the cost of public services, but toward inflated numbers of civil servants and pay much higher than is justified by local labour market conditions. A third major claim on equalization transfers, and again a claim that provides nothing in the way of improved public services, is debt service. Indeed, some equalization analysts have made the case that equalization encourages ERPs to acquire far more debt than they could sustain on their own. As pointed out in *Follow the Cash: Changing Equalization to Promote Sound Budgeting and Prosperity*, provinces financing current expenditures through debt, which is only deferred taxation, experience no impact on their equalization payments, creating incentives for increased debt spending.⁶

This seems to be borne out in the facts. The highest levels of debt per capita are again found in the ERPs Newfoundland, Quebec, Manitoba, Nova Scotia, and Saskatchewan, as shown in Chart 6. By contrast, the superior debt performance of New Brunswick and PEI is a testament to the fact that being an equalization recipient is no excuse for disproportionate levels of debt.⁷ In

⁴ Buchanan, James, *Something has to change*, Interview with Peter Holle, Ideas Matter, Atlantic Institute for Market Studies, Frontier Centre for Public Policy, and the Montreal Economic Institute, 2002.

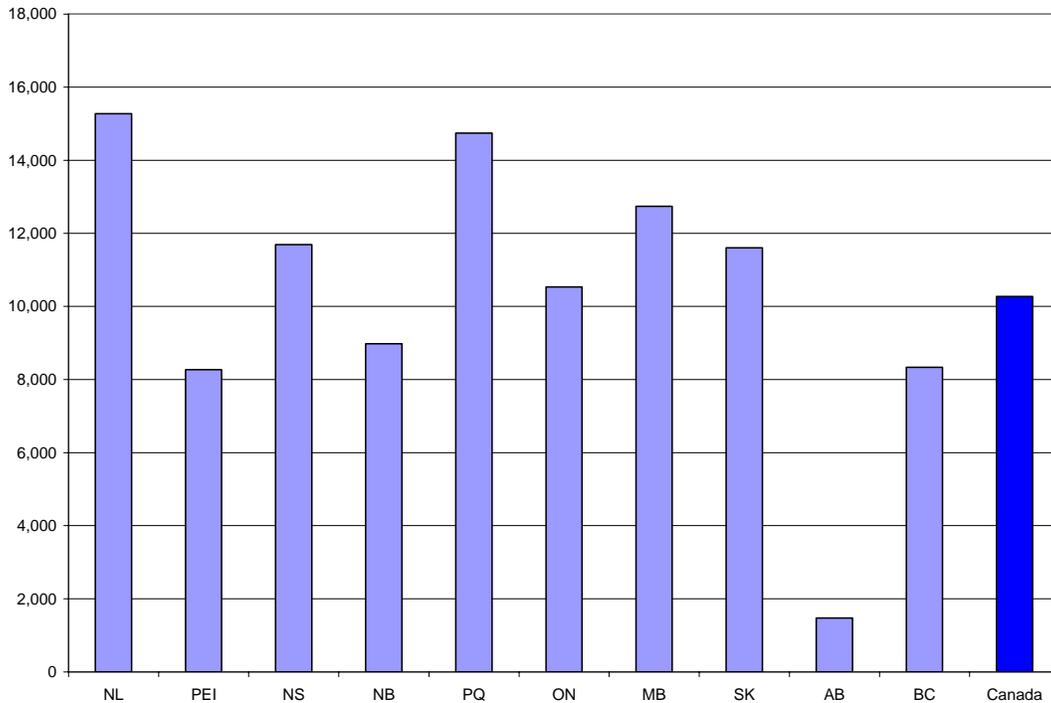
⁵ Review of Commonwealth-State Funding, *Final Report – A review of the allocation of Commonwealth Grants to the States and Territories*, August 2002.

⁶ Mintz, Jack M. and Poschmann, Finn, *Follow the Cash: Changing Equalization to Promote Sound Budgeting and Prosperity*, C.D. Howe Institute Backgrounder, no. 85, p. 3, October 2004.

⁷ We recognize that provincial debt per capita does not count certain kinds of debt for which provincial taxpayers are ultimately responsible. In the case of New Brunswick, for example, New Brunswick Power has accumulated disturbingly high levels of debt. At the same time, the revenues of NB Power are equally not counted in provincial revenues, and it is these revenues that support this debt. We have tried here to focus on debt that is both attributable

other words, ERPs cannot claim that inadequate levels of equalization have forced them to accept higher levels of debt, since these two provinces have avoided this outcome. In any case, as our recent *AIMS Commentary* (“Some Provinces are More Equal Than Others”) shows, the evidence is strong that, far from under-equalizing, Canada in fact *over-equalizes* to a very large degree.

**Chart 6: Provincial Debt per Capita⁸
Five Year Average (2000-2004)**



Source: Provincial Budget Documents 2000-2005

What if?

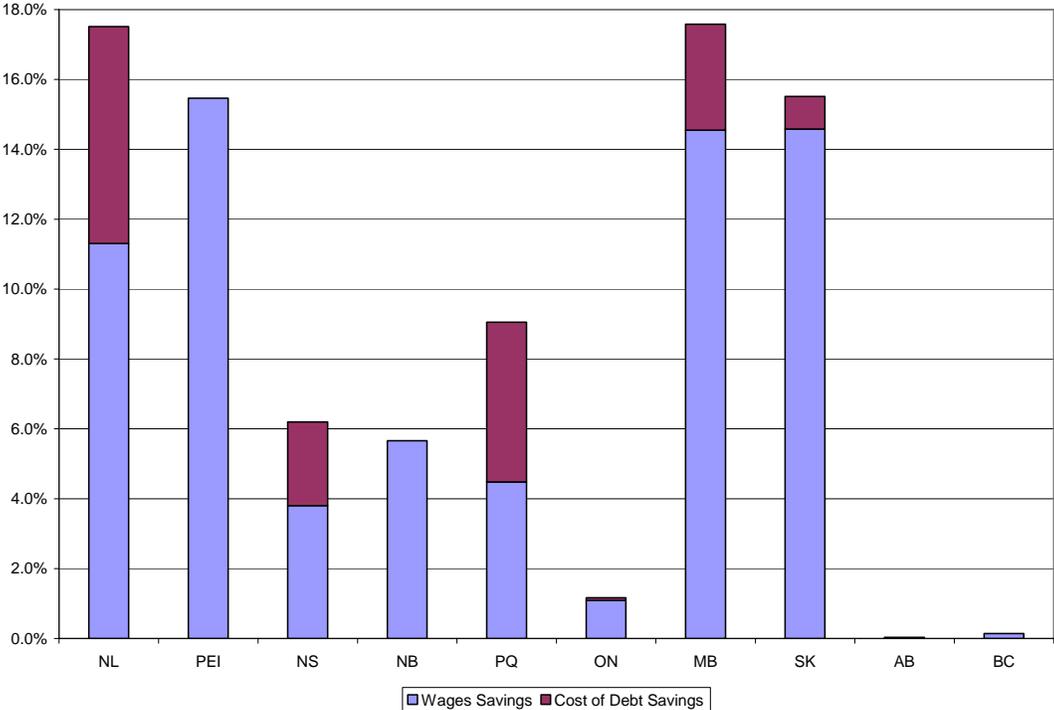
If it is the case that a great deal of the equalization the ERPs receive does not actually go on “reasonably comparable services”, but instead is absorbed by high public sector wages, high levels of public sector employment and high levels of debt, then the actual objectives of equalization could be accomplished with much lower levels of equalization.

to direct provision of public services and whose interest costs come out of ordinary provincial revenues (including equalization).

⁸ Uses provincial measure of debt provided in Budget documents – for instance some provinces do not include hydro debts while others do.

To demonstrate the potential the ERPs have to reduce their dependence on equalization, let's now look at what each province would save if they had an average-sized public sector with average wages and an average debt load. Charts 7 and 8 show the savings as a percent of each provinces' own source revenue, while Chart 9 shows the difference as a proportion of the provinces' equalization payment.

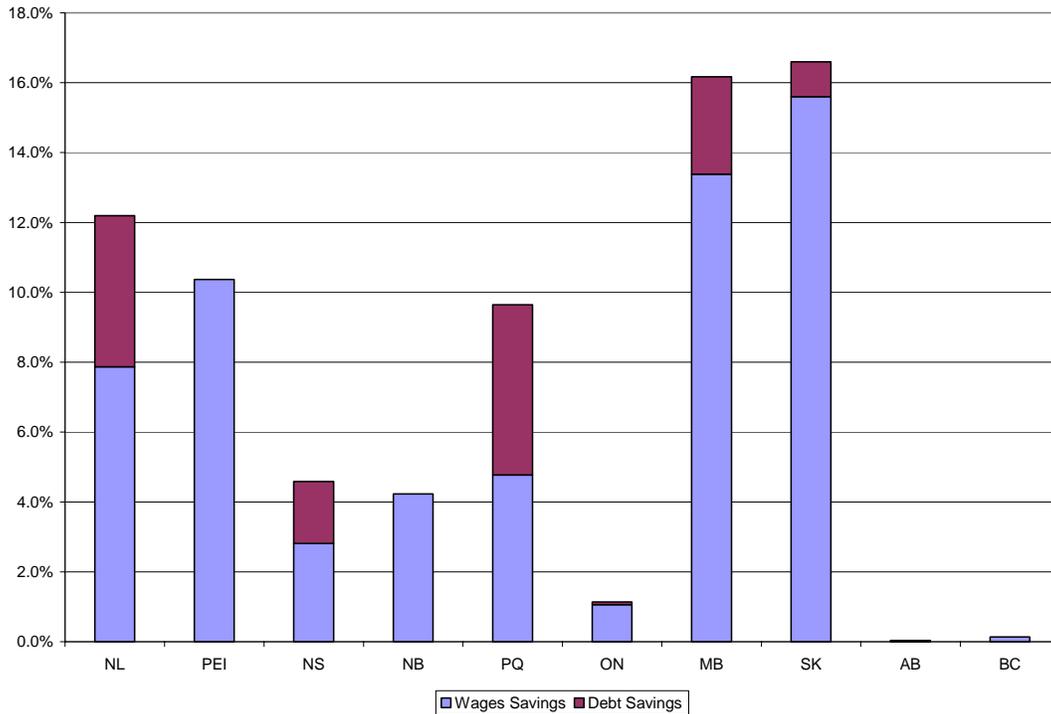
Chart 7: Cost Savings with National Average Debt and Total Public Sector Wages as a Percentage of Own-Source Revenue



Source: Statistics Canada, FMS Data, Provincial Economic Accounts Tables 384-0010, 384-0013, 385-0002, and 385-0003, Provincial Budget Documents 2000-2005, and Authors' calculations

As shown in Chart 7, the ERPs would save significant amounts if they had average levels of debt and an average size public sector, with Newfoundland, PEI, Manitoba, and Saskatchewan all saving more than 15% of own source revenues. The non-ERPs would save little, if anything. While the ERPs could suggest this is a function of lower than average own source revenues, Chart 8 confirms the ERPs would benefit most from reducing their debt and the size of their public service by assuming each province had the national average per capita own source revenue. Manitoba and Saskatchewan would still see savings of over 16%, while Newfoundland and PEI maintain savings greater than 10%. The non-ERPs still have savings of less than 1%.

Chart 8: Cost Savings with National Average Debt and Total Public Sector Wages as a Percentage of National Average Own-Source Revenue



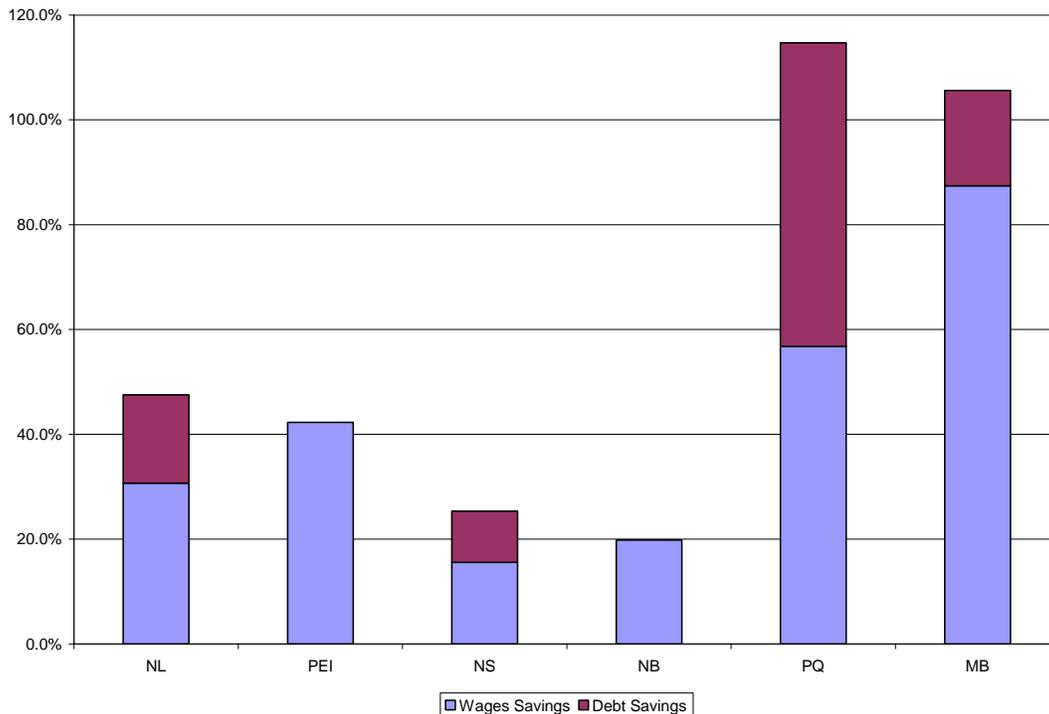
Source: Statistics Canada, FMS Data, Provincial Economic Accounts Tables 384-0010, 384-0013, 385-0002, and 385-0003, Provincial Budget Documents 2000-2005, and Authors' calculations

Finally, if we turn our attention completely to the equalization-receiving provinces, Chart 9 examines the savings each province would see as a percentage of their equalization payments. Three provinces, Saskatchewan, Manitoba, and Quebec,⁹ would effectively have their need for equalization wiped out, with savings totaling more than 100% of their average equalization benefit. The Atlantic Provinces would yield lower savings ranging from 19.8% of the province's equalization entitlement in New Brunswick to 47.5% in Newfoundland.

⁹ Saskatchewan is not included in this chart as their relatively low equalization payments and relatively high public sector wages yield a saving of over 700%.

While not eliminating the need for equalization, this analysis provides further support to the argument that the current system over-equalizes, with the result that the extra cash is captured by well-organized public servants — who turn the extra money into either substantially higher wage premium, extra public employees, or both — or it allows politicians to shift taxation into the future by using equalization to finance high levels of public debt.¹⁰ Neither of these outcomes are what was envisaged by the equalization program, nor are they how the program is justified to those who pay higher taxes to finance the transfer.

Chart 9: Cost Savings with National Average Debt and Total Public Sector Wages as a Percentage of Equalization



Source: Statistics Canada, FMS Data, Provincial Economic Accounts Tables 384-0010, 384-0013, Provincial Budget Documents 2000-2005, Department of Finance Transfer Payments to Provinces, and Authors' calculations

What would be the benefits to Ottawa and to federal taxpayers of ERPs achieving these levels of fiscal discipline? Let's assume that the savings represented here could be passed on directly to Ottawa in the form of reduced equalization entitlements. This would result in savings of \$7.28 billion each year, based on the current formula (see Table 1).

¹⁰ As stated in the above reference to Mintz and Poschmann (2004), the current equalization formula not only allows the shift to future taxation, but actually provides incentive for it.

Table 1: Average Annual Savings to the Equalization Program, assuming national average levels of debt per capita and public sector wages in the ERPs

Province	Average Equalization 2000-2004 (000,000)	Savings at National Average Levels (000,000)
NL	995	473
PE	249	106
NS	1,252	318
NB	1,186	235
PQ	4,621	4,621
MB	1,307	1,307
SK	179	179
BC	151	42
Canada	9,941	7,280

Now, since it is Ontario taxpayers bearing the largest tax burden to finance the equalization program over time, let's see what the savings would be if each province had Ontario's levels of per capita debt, public sector wages, and public sector employees (Table 2). In this case, the average savings over the five years considered would be \$8.1 billion, with four provinces, Quebec, Manitoba, Saskatchewan, and British Columbia effectively removed from the equalization program. The remaining provinces would have their equalization needs reduced by an average 50 percent.

Table 2: Average Annual Savings to the Equalization Program, assuming Ontario average levels of debt per capita and public sector wages in the ERPs

Province	Average Equalization 2000-2004 (000,000)	Savings at Ontario Average Levels (000,000)
NL	995	615
PEI	249	140
NS	1,252	600
NB	1,186	489
PQ	4,621	4,621
MB	1,307	1,307
SK	179	179
BC	151	151
Canada	9,941	8,104

Looking to the future, Expert Panel on Equalization and Territorial Formula Financing recently made recommendations to the Federal Government for a new formula for equalization. The recommendations would result in total equalization payments of more than \$12.5 billion in the 2006-07 fiscal year.¹¹ Let's assume once again that the provinces were able to achieve the savings determined using the historical data (Table 3). In this case the program could save almost \$8 billion and Saskatchewan would no longer need equalization. Newfoundland would have its need reduced by 98.1 percent, Manitoba would require 77.2% less, and Quebec's need would be reduced by 74.3%.

Note that with the expert panel's recommendations only one province would be removed from the need for equalization, not three. Quebec and Manitoba would see large increases in their equalization entitlements under these recommendations, and the increases would outweigh the potential savings. Again, the Expert Panel's proposals will worsen the already perverse effects of the existing equalization program.

Table 3: Projected Savings to the Equalization Program using the Expert Panel of Equalization formula for 2007-2008, assuming national average levels of debt per capita and public sector wages in the ERPs

Province	Equalization 2007-2008 (000,000)	Average Savings (000,000)
NL	482	473
PEI	286	106
NS	1,462	318
NB	1,462	235
PQ	6,926	5,301
MB	1,789	1,380
SK	156	156
Canada	12,563	7,968

So what would an extra seven and a half to eight billion dollars per year mean to Canadian tax payers? First, let's assume that the most fiscally prudent action would be to use the savings to pay down the national debt. This would free approximately \$560 million per year in debt service costs that could be used for additional program spending or finance tax cuts. In Year Five, the cumulative amount available for spending would amount to \$2.8 billion – this amount could be used to increase the basic personal

¹¹ Achieving A National Purpose: *Putting Equalization Back on Track*, Expert Panel on Equalization and Territorial Formula Financing May 2006

exemption by \$500 or lower the general corporate tax rate by two percentage points.

Alternatively, as this would be a repeatable annual saving, the \$7.5 billion could be spent directly on programs in Year One. This amount could finance a 50 percent budget increase in health transfers or defense spending, or double the amount spent on social transfers used for post-secondary education and other provincial social programs. Or simply allow Ottawa to assist in financing the transition among the ERPs to a new equalization system.

Conclusion

The equalization formula tries to address fiscal disparity among the provinces but its unwillingness to look at what the ERPs actually do with the money means that the effects of the program are seriously misrepresented and widely misunderstood. The analysis in this report would seem to indicate that 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 Quebec, entirely from reliance on equalization, and reduce the dependence of the others to a very significant degree. Add to this new virtuous circle a more intelligent treatment of non-renewable natural resource revenue for ERPs and Canada would arrive at a powerful strategy for reducing the cost of equalization while putting the ERPs on the path to self-reliance and strong public finances. Such an approach to non-renewable natural resource revenue will be the subject of a future paper in this continuing series on equalization.

So 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. Put another way, the costs of fiscal laxity are masked by equalization, which gives large amounts of money to politicians vulnerable to pressure from well-organized interest groups such as public sector workers. While the provinces are free to determine their own spending policies, it is clear that the levels of equalization being provided in the country today are far in excess of what is needed by provincial governments with average levels of fiscal discipline to deliver a reasonable package of provincial public services. In other words, the current level of equalization payments appears to be contrary to the principles of the equalization program as stated in the Constitution, and contrary to the principles of political prudence and fiscal discipline.

In the words of the “father of equalization”, James Buchanan, “You have politicians in these provinces who are recipient provinces of these grants

who are able to spend money without being responsible to taxpayers. So you have no cost side. There is a benefit side, but not a cost side. If you have a situation of benefits not offsetting costs, then you're likely to get irresponsible behaviour."¹²

¹² Buchanan, James, Interview with Brian Naud, CPAC TV's *Primetime Politics*, aired October 25, 2001. Text published in *Ideas Matter*, Atlantic Institute for Market Studies, Frontier Centre for Public Policy, and the Montreal Economic Institute, 2002.