

A CLOSER LOOK AT ONTARIO'S "\$23-BILLION GAP"

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A CLOSER LOOK AT ONTARIO'S "\$23-BILLION GAP"

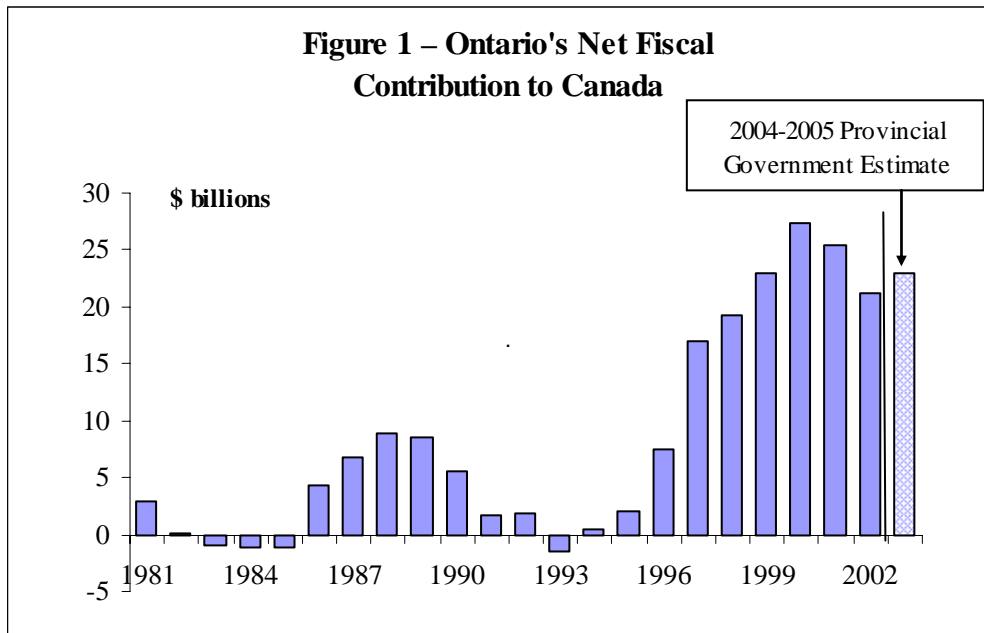
INTRODUCTION

In late January 2005, the Government of Ontario began a campaign arguing that it contributes more than its fair share to confederation. Based on Statistics Canada's Provincial Economic Accounts (PEA) data, the province has claimed that Ontario provides \$23 billion more per year in revenues to the federal government than it receives back in federal expenditures. Moreover, it maintains that this annual contribution has increased from only \$2 billion in 1995.

PEA data are considered to be a comprehensive summary of all federal revenues (taxes and social insurance contributions) and expenditures (direct spending, transfer payments and interest payments on the federal debt) in each province. As such, the dollar figures in the provincial government's claim are not in dispute. However, the intended message – that the rise from a \$2-billion to a \$23-billion gap represents a tremendous increase in the fiscal burden on Ontarians – has been questioned by some.

In fact, as this paper demonstrates, the growth in both federal revenues and expenditures in Ontario since 1995 is in line with the trends in other provinces. The primary reason Ontario's net fiscal contribution to Canada has increased so dramatically since 1995 is that the federal government moved from a deficit to a surplus position over that time. The "\$23-billion gap" argument does not take this into account.

FEDERAL REVENUES AND EXPENDITURES IN ONTARIO



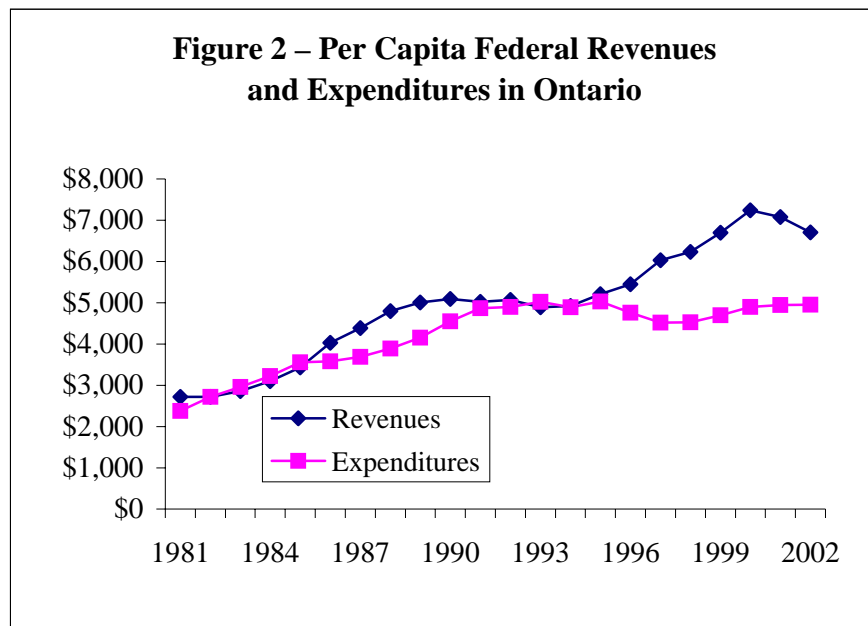
Source: Statistics Canada, Provincial Economic Accounts; figure prepared by Library of Parliament.

Ontario’s net annual fiscal transfers to Canada are shown in Figure 1. Figure 1 confirms that Ontario’s net contribution to Canada rose from \$2 billion in 1995 to \$21.2 billion in 2002 – the most recent year for which official data are available. The \$23-billion figure used by the Ontario government is an estimate made by the provincial Department of Finance of Ontario’s net fiscal transfer in 2004-2005. It is based on previous PEA revenue and expenditure data, and adjusted for taxation and spending initiatives announced in recent federal budgets.⁽¹⁾

In 2002, the federal government collected \$81.1 billion in revenues from Ontarians through various taxes and transfers, equivalent to about \$6,704 per person. At the same time, the federal government made direct expenditures and transfer payments in the province totalling \$59.9 billion, or \$4,955 per person. Ontario makes by far the largest total net contribution to Canada of any province, although Albertans contribute more on a per capita basis.

(1) The Ontario government’s expectation that the province’s net transfer to the federal government will rise, after declining since 2000, is based on recent increases in federal government transfer payments (including for health and equalization) that will primarily accrue outside of Ontario.

The fact that federal revenues frequently exceed expenditures in Ontario (Figure 2) – and the fact that Ontario is usually a net fiscal contributor to Canada – speak to the wealth of the province. While the average Ontarian contributes more to federal government revenues than most other Canadians, this is not because Ontarians are taxed at higher rates or are otherwise discriminated against. All else being equal, an individual earning \$50,000 in Ontario pays the exact same federal tax as someone earning that salary in New Brunswick, or in any other province.⁽²⁾ The reason Ontarians contribute more to federal coffers is simply because, on average, residents of that province have higher incomes.



Source: Statistics Canada, Provincial Economic Accounts; figure prepared by Library of Parliament.

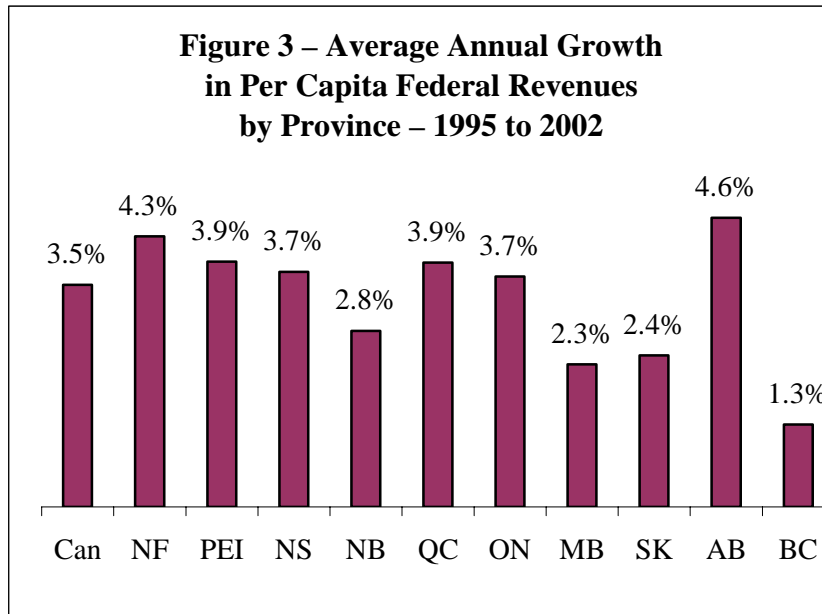
The federal government also spends less in Ontario because it is a wealthy province. For example, fewer individual Ontarians qualify for federal benefits such as Employment Insurance because incomes in the province are higher and unemployment is lower than the national average. Similarly, Ontario does not qualify for equalization payments because the provincial government's revenue-generating capacity is too high.⁽³⁾

(2) This issue is discussed in more detail in Michael Holden, *Seven Notions about Equalization*, PRB 04-58E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, March 2005.

(3) It is important to note that equalization payments are made based on a province's ability to generate revenues on its own. However, the formula is such that even after qualifying provinces collect the transfer, their ability to generate revenues is still not as high as Ontario's.

As Figure 2 suggests, the increase in Ontario's net fiscal transfer to Canada since 1995 is primarily the result of strong revenue growth. On a per capita basis, federal revenues collected in the province grew by an average of 3.7% annually from 1995 to 2002, while expenditures dropped slightly – by an average of 0.2% annually.

These figures are in line with federal revenue and expenditure trends in other provinces. As illustrated in Figure 3, the 3.7% annual growth in federal revenues from Ontario was slightly higher than the national average (3.5%). Federal revenue growth over that period was also higher than the national average, however, in five other provinces – Alberta, Newfoundland and Labrador, Prince Edward Island, Quebec and Nova Scotia.



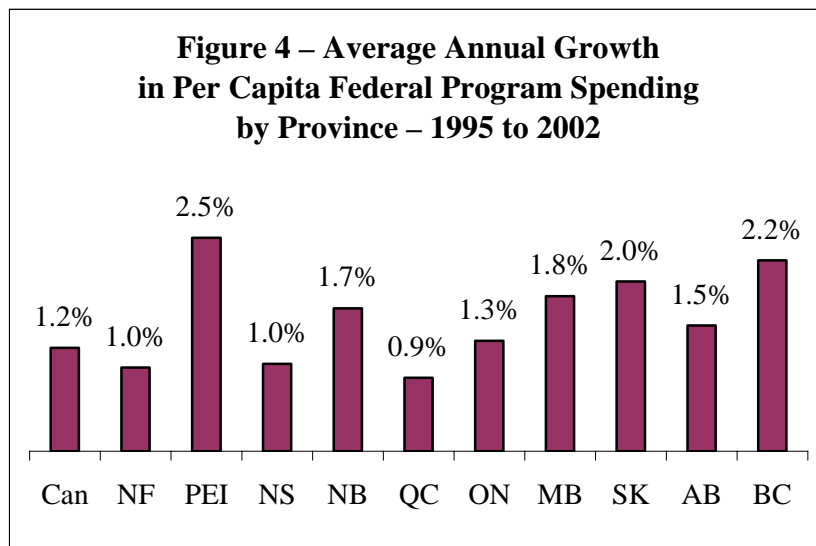
Source: Statistics Canada, Provincial Economic Accounts; figure prepared by Library of Parliament.

As for federal expenditures in Ontario, the average annual decrease of 0.2% from 1995 to 2002 is not because of a withdrawal of federal transfers or direct expenditures, but because of lower federal interest payments on the national debt. As mentioned above, PEA data – upon which the Ontario government's \$23-billion gap argument is based – include all federal revenues and expenditures in the provinces. There is a general assumption that federal revenue

collection represents a “cost” to Ontarians (i.e., money flowing out of the province) while federal expenditures represent a “benefit” (money flowing in). However, one of those expenditure items is federal debt-servicing costs. Unlike all other federal expenditures, interest payment obligations do not yield any benefit.

PEA data allocate federal debt-servicing costs across Canada on an equal-per-capita basis. Since the mid-1990s, lower interest rates and budget surpluses have reduced federal debt-servicing costs considerably. From 1995 to 2002, those costs have fallen by an average of 4.1% per year.

As stated above, because Ontario is a wealthy province, per capita federal expenditures are lower there than in most other provinces. But, since debt-servicing costs are an equal-per-capita “expenditure,” a decrease in federal debt-servicing costs has a greater proportional effect on Ontario than most other provinces. When interest payments on the debt are removed from total expenditures, federal program spending in Ontario is in line with the national average (Figure 4). From 1995 to 2002, federal program spending in Ontario grew by an average of 1.3% annually, compared to the Canada-wide average of 1.2%.



Source: Statistics Canada, Provincial Economic Accounts; figure prepared by Library of Parliament.

This does not change the fact that there is a net outflow of funds from Ontario. The federal government still collects more revenue (per person) from Ontarians than from residents of most other provinces, and it spends less in Ontario (per person) than in most other provinces. However, the growth rates of revenues and expenditures since 1995 suggest that growth in federal revenues and expenditures in Ontario is in line with the national average.

FEDERAL BUDGET BALANCES AND THE \$23-BILLION GAP

Ontario's \$23-billion gap – or \$21.2-billion gap in 2002 – is a measure of all federal revenues collected in the province, less federal expenditures made there (including debt-servicing costs). The resulting gap is frequently interpreted as the amount of money that is transferred from Ontario to other provinces. This view implies that the amount of money flowing out of the net “contributors” to Canada – Ontario, Alberta and British Columbia in 2002 – equals the amount flowing into the rest of the country. However, this is almost never true.

Unless the federal budget is perfectly balanced each and every year, total federal revenues (collected in all provinces and territories) never equal total federal expenditures (in the provinces and territories). In years where there is a federal deficit, expenditures (made in the provinces and territories) exceed revenues collected. In years with a budget surplus, the inverse holds.

In the context of net financial inflows and outflows to/from the provinces, it can be seen that in times of deficit – the early to mid-1990s, for example – federal expenditures made in the provinces were being financed by revenues from those provinces, plus government borrowing. Thus, in aggregate, more money was being spent in the provinces than was being collected from them. Considered individually, some provinces were net recipients of federal spending; others made net payments to the federal government. When there was a federal deficit, however, the balance was tilted towards the former.

In times of federal surplus – from 1997 to the present – the federal government collects revenues from the provinces and territories that it does not spend there. This means that the total contribution from the provinces and territories is greater than the total benefit they derive as a result. As above, some provinces are net recipients and others net payers. In this case, however, the balance is tilted towards the latter.

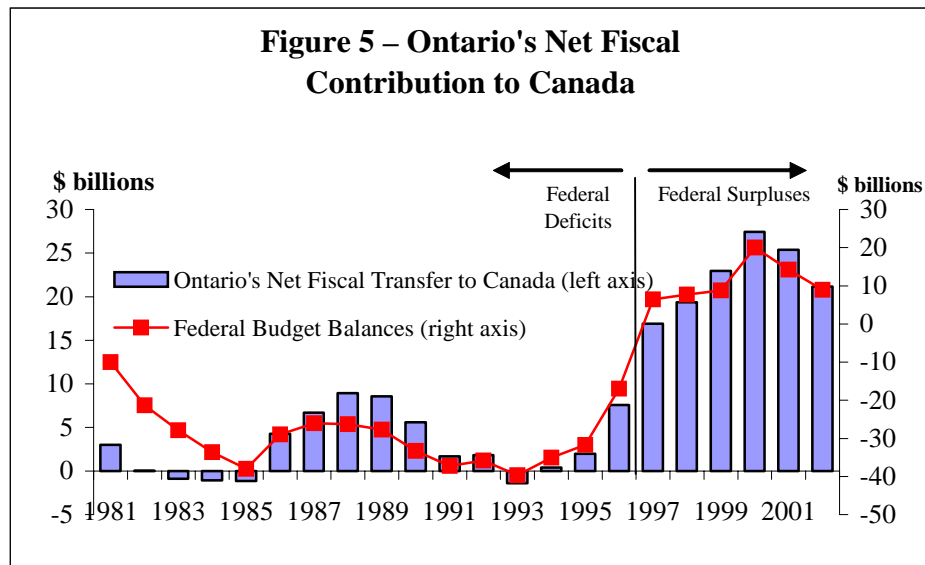
Since the “\$23-billion gap” amounts to a simple balance sheet argument, the presence of federal deficits or surpluses is significant. From the perspective of a province looking at its “balance sheet” (federal revenues flowing out, federal expenditures flowing in), deficits are akin to an unreported source of federal revenue. The larger the federal deficit, the

more money is “available” to spend in the provinces and territories. The best example of this is 1993. That year, the federal deficit was about \$39.7 billion. Federal government borrowing was high enough that even Ontario was a net recipient of federal funds.

Conversely, from a provincial “balance sheet” perspective, federal surpluses are akin to an additional expenditure. So the net transfer out of contributing provinces such as Ontario goes not only to net recipient provinces, but also to “spending” on the surplus.

While this does not change the fact that there was a net transfer of \$21.2 billion out of Ontario in 2002 compared to \$2 billion in 1995, it does change dramatically the context in which that increase took place. The rise in Ontario’s net contribution is not because the federal government collected proportionately less tax revenue from Ontario in 1995, nor is it because federal expenditures were higher then. Rather, it is because the federal government moved from a deficit to a surplus position over that period.

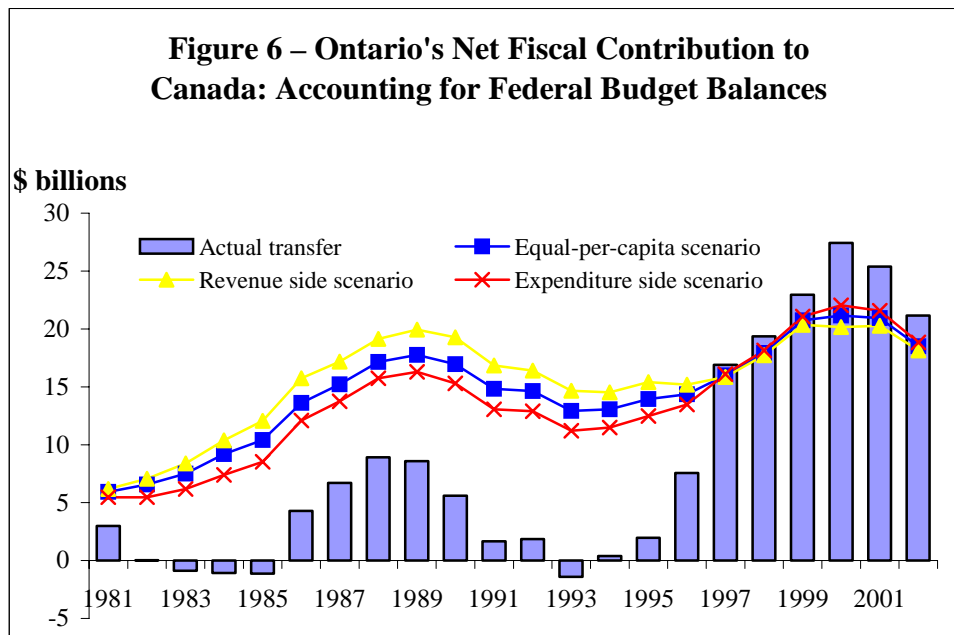
This point is illustrated in Figure 5, which shows the federal fiscal balance alongside Ontario’s annual financial contribution to Canada: the greater the federal deficit, the lower the net transfer out of Ontario; the greater the surplus, the higher the outflow of funds from Ontario.



Source: Statistics Canada, Provincial Economic Accounts; figure prepared by Library of Parliament.

So how would a balanced federal budget have affected Ontario's annual net transfer to the federal government from 1981 to 2002? It is, of course, impossible to say how federal revenue and expenditure decisions might have been different if the federal budget had been balanced over that period. However, by providing a number of possible scenarios, an approximate range of the effects of a balanced federal budget on Ontario's net transfer can be estimated.

Figure 6 shows three such scenarios: that the federal government balanced its budget by raising or lowering *revenues* as needed; that budget balances were achieved by adjusting *expenditures*; and that the federal deficit or surplus is distributed across the provinces and territories on an *equal-per-capita* basis.⁽⁴⁾



Source: Statistics Canada, Provincial Economic Accounts; figure prepared by Library of Parliament.

Under any of the three scenarios, the picture of Ontario's net contribution to Canada would have changed dramatically. In particular, the balanced budget scenarios clearly show that Ontario's net contribution to Canada would have been substantially higher over the

(4) In the first two scenarios, the provincial share of revenues/expenditures is assumed to be unchanged. In other words, if Ontario accounted for 40% of revenues, it would also account for 40% of the total under the hypothetically balanced budget.

1980s and for most of the 1990s – the years when the federal government saw deficits – and would have been a little lower over the last few years, in which the federal government posted budget surpluses. Net transfers from Ontario in 2002 would have been higher than in 1995, but the rate of increase would have been much lower than under the actual transfer. Moreover, net transfers in 2002 would have been about the same level as in the late 1980s.

CONCLUSION

In any federation, there will inevitably be some net redistribution of federal funds from one part of the country to another. This is a function of the fact that some areas are richer than others and that some areas require more expenditures in areas of federal jurisdiction than others (for military installations, for example).

The intent of this paper is not to cast doubt on the fact that Ontario is a net contributor to the financing of federal government activity, nor is it to suggest that Ontario is contributing too little or too much to that cause. Rather, it demonstrates the impact that federal budget deficits and surpluses have had on Ontario's net contribution to Canada.