



TD Economics

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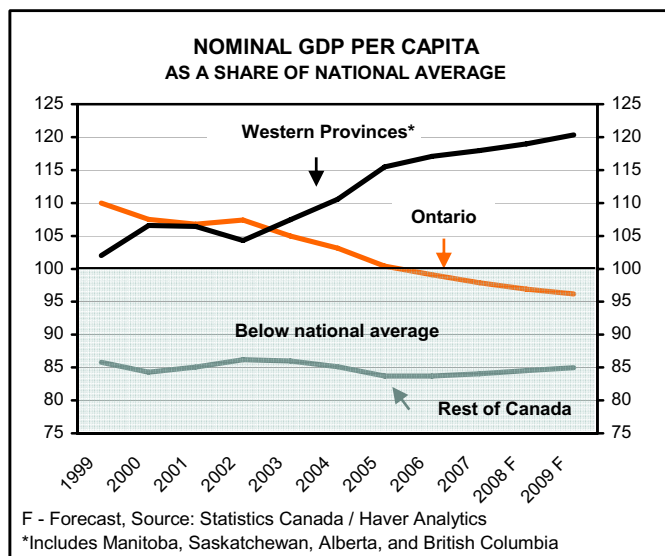
ONTARIO POISED TO COLLECT EQUALIZATION IN 2010-11 Interaction of Soaring Commodity Prices with New Formula is a Key Driver

There has been a lot of ink spilt about the prospect of Ontario receiving equalization payments. Yet few have backed up their predictions with specifics on when that might occur. Fewer still have analyzed the reasons why Ontario may become a receiving province. The inference has been left that it is all about deteriorating economic prospects in the province. In this note we crunch the numbers. And we put this in a broader context of economic performance in the rest of the country and the changes recently made to the equalization formula. There is much more at play here than just Ontario's economy.

Based on TD Economics' economic and revenue projections for 2008 and 2009, we indeed find that Ontario will ultimately qualify for an entitlement under the new federal equalization formula that was announced in last year's federal budget. We calculate that the province stands to collect as much as \$400 million in fiscal 2010-11 and \$1.3

HIGHLIGHTS

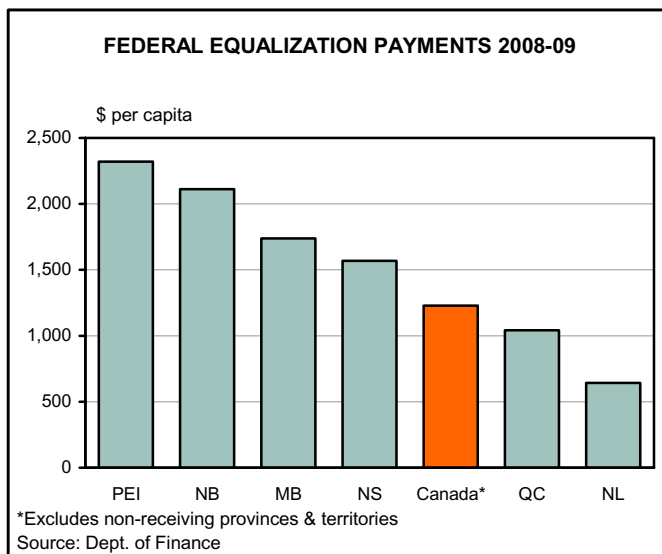
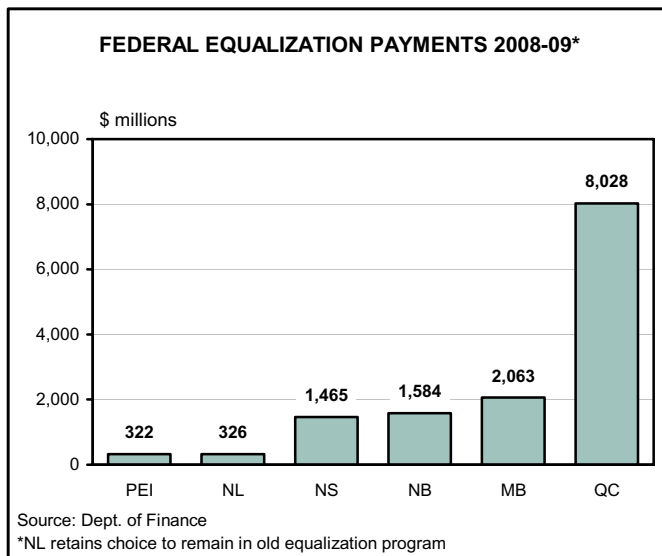
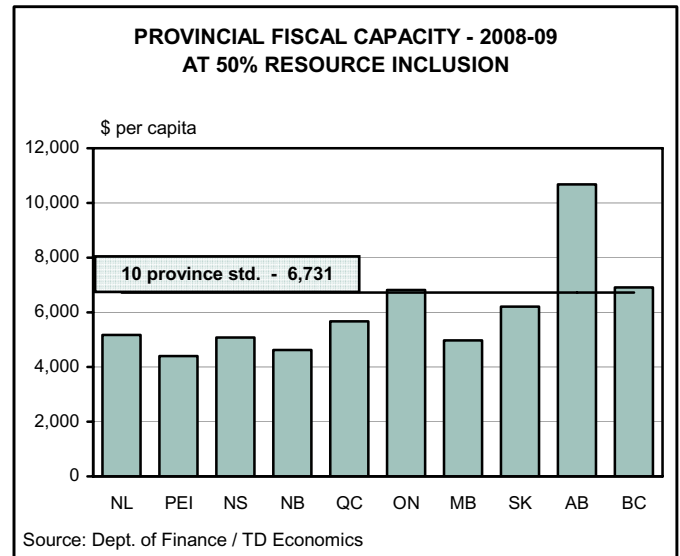
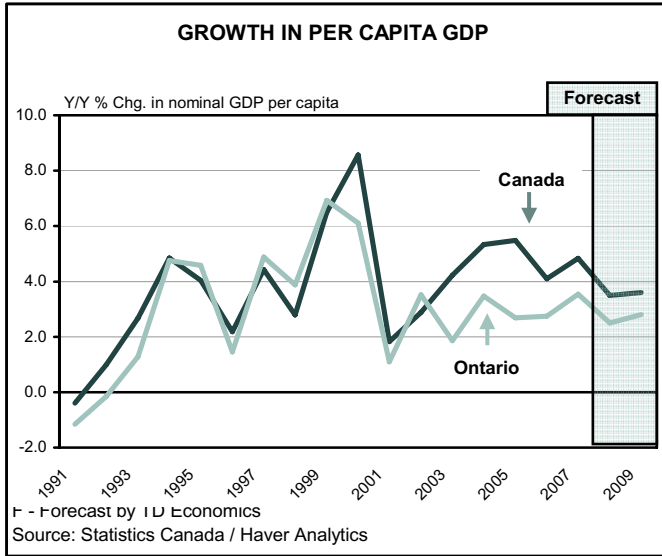
- **Ontario set to receive payments under the federal equalization program**
- **Based on TD Economics' economic and revenue projections, Ontario is projected to qualify for equalization payments of \$400 million in FY 10-11 and \$1.3 billion in FY 11-12**
- **Weakness in Ontario's economy is only part of the story; economic growth in the west and the switch to a 10 province standard have driven up the equalization base**
- **The province's have-not status could prove fleeting if the economy turns in a strong economic recovery in 2010 and 2011**
- **Equalization was reformed just last year but already important questions arise about the design**



billion in fiscal 2011-12.

Current data do not suggest Ontario would qualify for a payment in 2009-10 but that could easily change. In our calculations Ontario is sitting on the edge for 2009-10 and much of the data driving payments that year are still to come.

We first examine the role of Ontario's economic performance in sending it to recipient status. Then we turn to a broader perspective. The change in Ontario's equalization status is essentially a story of soaring commodity prices. Strong commodity prices have raised revenues in other provinces, principally those in the west. The shift from a 5-province to 10-province standard in the 2007 equaliza-



tion reforms brought Alberta into the picture and their soaring resource revenues have particularly raised the fiscal capacity standard. High commodity prices also explain much of Ontario's economic malaise. As a commodity-importing province its economic performance is directly hurt. Then it is indirectly hit through the exchange rate as soaring commodity prices are the primary catalyst for the rise in the Canadian dollar that has hurt export-oriented manufacturers.

Ontario's advantage has been slipping

The chance of Ontario becoming an equalization-receiving province has been increasing over the past few years. A common way to assess relative prosperity across the provinces is GDP per capita. And, as depicted in the chart to the left, the province's relative position has deteriorated steadily over the past half decade. In 2002, Ontario had the second highest nominal GDP per capita, behind Alberta, and a 7% advantage over the national-average level. By 2007, per-capita GDP in Ontario had fallen to 2% below the Canadian average, or the equivalent of fourth place in the provincial rankings.

It is not a coincidence that Ontario's recent slippage in terms of relative standard of living has occurred in lockstep with the rise in the loonie, soaring energy prices and heightened competition, all of which have created a perfect storm for manufacturers. However, a closer look reveals that the relative decline is not so much a story of Ontario weakness as it is of booming economic strength in Canada's commodity-based economies. In fact, despite its manufacturing woes, Ontario's GDP per capita grew by 3% per year during the 2002-07 period – a healthy rate taken on

its own, but one that paled in comparison to the sizzling 5-8% annual advances turned in by the four westernmost provinces. Incidentally, Newfoundland & Labrador managed to take top prize among Canada's provinces, as rising offshore oil activity fuelled a double-digit annual increase in GDP per capita over the six-year period.

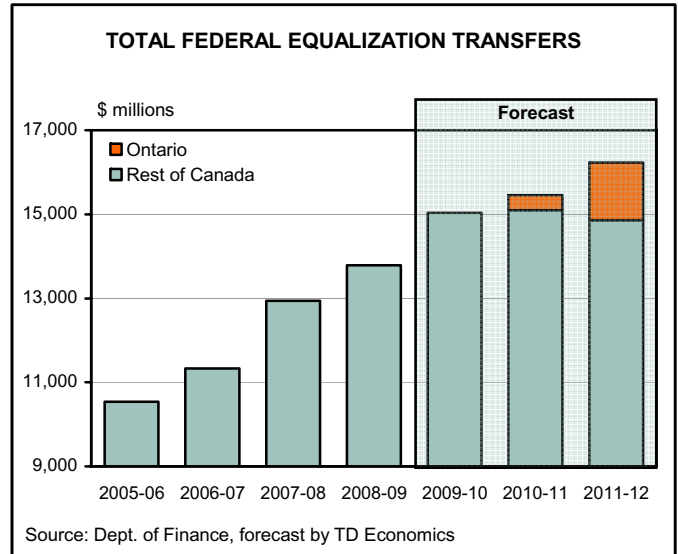
As revealed in the chart on page 1, we expect to see Ontario's GDP per capita slip further in relative terms over the next few years. But with a U.S. recession this year joining the list of headwinds facing manufacturing, Ontario's own performance is likely to become a more significant driver of the decline. Next year, Ontario's per-capita GDP is projected to sit 4% below the national average, while the west's advantage is set to climb to around 20%.

Ontario not a recipient ... yet

Assessing differences in GDP per capita is a useful exercise. However, the discussion of Ontario's potential slippage into recipient status has revolved around the likelihood of the province qualifying for entitlements under the federal equalization formula, which is a more complex calculation.

That being said, the changes announced to the equalization formula in Budget 2007 – based on recommendations made in the O'Brien report – have simplified the program significantly. While an in-depth look at equalization is beyond the scope of this analysis, a few highlights include:

- Fiscal capacity is the amount of money that provinces can raise from 5 aggregated tax bases – personal income, business income, consumption, natural resources and property taxes/miscellaneous – if they tax those

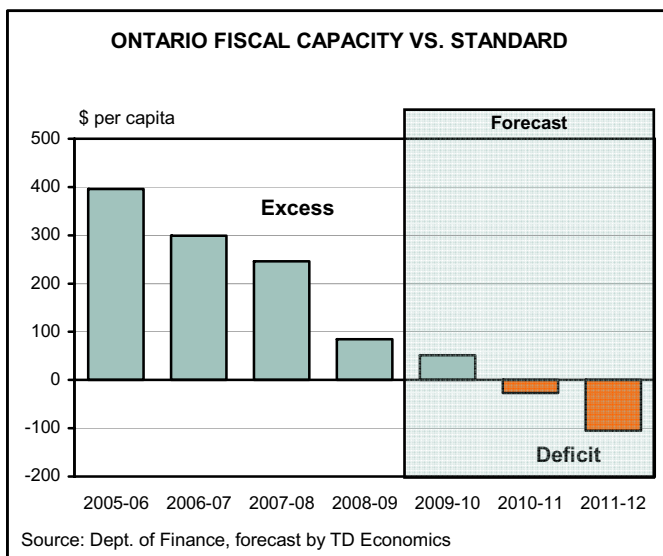


	+ / - Prov. Standard
Personal Income Taxes (PIT)	270
Corporate Income taxes (CIT)	17
Property Taxes (PT)	121
Consumption Taxes (CT)	-20
Sub-Total (PIT, CIT, PT, CT)	388
Resource Revenues (RR)	-303
All sources fiscal capacity	85

*Relative to 10 province standard
Source: Dept. of Finance

bases at national average tax rates. In the case of natural resources, only 50% of revenues are included in the calculation of capacity.

- The province's fiscal capacity, on a per-capita basis, is added up across all those sources and compared to a 10-province average standard. If the result is a shortfall, the province receives an equalization grant to bring it up to the common standard.
- In order to keep payments stable and predictable, equalization payments are based on a three-year weighted moving average (with weights of 25%, 25% and 50%) and a two-year lag. For example, the amount each qualifying province will receive in fiscal 2008-09 has been based on a one-quarter weighting on the calculation in fiscal 2004-05, one-quarter on 2005-06 and 50% on 2006-07.
- A fiscal capacity cap is in place to ensure that equalization payments do not raise a province's total capacity above that of a non-receiving province.



Ontario projected to become a recipient in 2010-11

The federal Department of Finance has made available its fiscal capacity calculations by province for fiscal 2008-09. The fact that Ontario is not collecting equalization this year sends a strong signal that the province's fiscal capacity has kept above the national average, at least during the three years (i.e., 2004-05 to 2006-07) that were used to compute the numbers based on the two-year lag. A few key points flow out of the recent trends:

- Similar to the GDP per capita story, Ontario's advantage in relative fiscal capacity has narrowed steadily – from \$400 per capita in fiscal 2005-06, to \$300 in fiscal 2006-07, to \$250 in fiscal 2007-08 and then to a mere \$85 in 2008-09.
- What's more, the deterioration can largely be attributed to rapid growth in tax bases in the west. Between 2005-06 and 2008-09, Ontario's per-capita fiscal capacity rose by a total of 10%, which was overshadowed by the 17% surge in Canada as a whole. In the west, Alberta and Saskatchewan led the way with gains of 30% and 24%, respectively.
- These recent trends can be traced in good part to the inclusion of 50% of non-renewable resource revenues for all provinces, including Alberta, in the new formula and the exceptional gains in energy prices. These changes have driven up sharply the national average resource capacity relative to that of Ontario.
- Performances in other revenue areas have been mixed. In personal income and property taxes, Ontario has managed to maintain its advantage compared to the national average, while in business income and consumption taxes, the province's edge has been slipping.
- The table on the previous page showing Ontario's relative fiscal capacity by revenue source highlights the significance of the addition of the 50% of non-renewable resource revenues for all provinces into the equalization formula. Excluding resource revenues, Ontario was still \$388 per capita above the fiscal capacity standard for equalization. In contrast, Ontario had a \$303 per capita shortfall from resource revenues.

Using Finance's historical figures and TD Economics' economic and revenue projections for 2008 and 2009, we have extended out the analysis to fiscal 2011-12. In light of Ontario's continued economic underperformance, we expect to witness a further erosion in the province's relative fiscal capacity across the five taxation areas, but especially in business income taxes, where capacity is likely to

fall below the national average. Ontario business profits will not only feel a particular squeeze from a softening domestic performance, but the impact of the credit crunch on financial sector bottom lines. In addition, the momentum in commodity markets will help to keep western profits well supported.

That 70s Show

Students of equalization's history will recognize the show currently being performed. Soaring energy prices from 1973 put enormous pressure on the cost of equalization and placed Ontario as a recipient province from 1977-82. In 1973 and 1974 some ad hoc measures were taken to dampen the impact of energy on equalization. Then in 1977 only 50 per cent of resource revenues were made eligible. But still Ontario qualified. Ontario's economy was extremely hard hit by the recession of the early 1980s brought on in good part in the wake of the energy price boom. Ontario was only retroactively excluded from receiving payments through the "personal income override" whereby no province could be eligible if its per-capita income exceeded the national average. Then in 1982 the formula was changed from the 10-province standard to a 5-province standard (Ontario, Quebec, Saskatchewan, Manitoba and British Columbia). With the exclusion of Alberta and its huge energy revenues Ontario no longer qualified. Until now that is.

The parallels to today are uncanny. Soaring energy prices. A 10-province standard. Inclusion of 50 per cent of non-renewable resource revenues. Economic weakness hitting Ontario especially hard. An equalization cap. In brief, the same inputs, the same model and the same result that Ontario qualifies. This begs the obvious question of whether the equalization program will be changed again in response.

Implications

The key implications of this analysis are the following:

- Ontario's per-capita fiscal capacity relative to the Canadian average is expected to decline further over the next three years, but not swing into negative territory until 2010-11. This, as we have noted, is due to the lagged nature of the formula. Data changes could certainly bring Ontario into recipient status in 2009-10, however.
- Based on these projected fiscal capacities, Ontario is projected to qualify for payments of \$400 million in fiscal 2010-11 and \$1.3 billion in fiscal 2011-12. These payments will provide an offset, but only a partial one,

to the negative impact on Ontario finances directly resulting from the current economic slowdown, which is likely to last until the mid-point of 2009.

- Although the federal government will not be required to make equalization payments to the three westernmost provinces over the next few years, the money provided to Ontario will represent a further squeeze on federal finances, since it will drive up the overall cost of the program.
- One of the cost containers embedded in the new equalization program will lose its teeth with Ontario in recipient status. No province can receive equalization if its fiscal capacity is above a non-receiving province. This cap has tended to be thought of as the Ontario ceiling – ie no province would receive equalization if its fiscal capacity were above Ontario's. But with Ontario as a recipient, the cap would shift up to the province with the next lowest capacity. That would be British Columbia. But its fiscal capacity is much higher than Ontario's so any cost containment through the cap would be greatly diminished.
- With Ontario's addition to the list, 70% of Canada's population will be in receiving provinces.
- Ontario's position as the major economic locomotive for Canada is likely to be put under further question over the next few years. In our view, it has more reflected a coming of age of other provincial economies in Canada, notably those in the west. At the same time, however, the province's status as an equalization-recipient could prove fleeting if the economy turns in a strong economic recovery in 2010 and 2011.

Ontario still a net contributor to federal coffers

Related to that last point, Ontario's projected move into equalization-recipient – at least temporarily – would suggest to many Canadians that the province is no longer a net contributor to federal coffers. However, this is not the case. Unfortunately, the most up-to-date figures on the net federal take in Ontario are for 2005. That year, Ontario residents contributed a hefty \$21 billion more to federal coffers than what was returned to the province in federal spending. Even if one takes into account (a) the fact that some of that excess reflects Ontario's share of the federal budget surplus, (b) changes announced in the 2007 federal budget, such as a move to per-capita federal funding of health and education and (c) Ontario's sub-par economic growth over the next few years, it is highly unlikely that this surplus will be eliminated. In actuality then, Ontario residents will, in effect, be paying the equalization tab with their own money.

Were the reforms appropriate?

The new equalization program has only been in place for a year. Ontario's transformation into an equalization-receiving province underscores the impact of the inclusion of 50 per cent of non-renewable resource revenues for all provinces in the formula at a time of soaring energy prices. In the 1970s and early 1980s this exact same situation led to fundamental changes being made to the equalization program. Is it heresy to ask whether once again the standard for equalization is not appropriate?

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