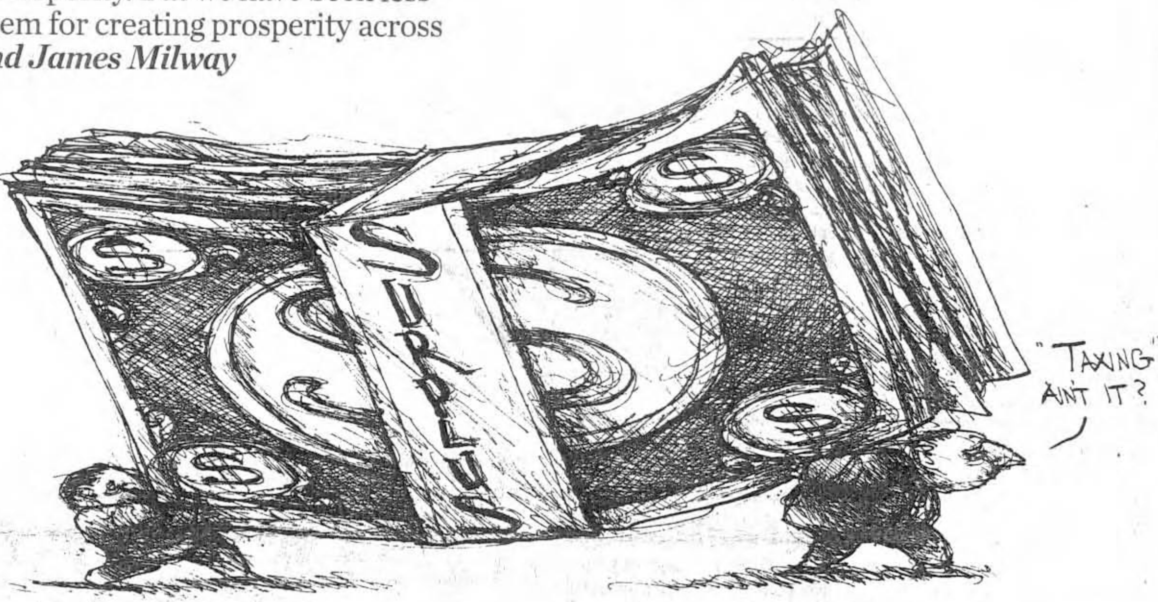
Bridging Canada's fiscal divide

TORONTO STAR, OCT. 17/05

Through federal transfer payments, Canadians have created a system that shares the benefits of our current prosperity. But we have been less successful in creating a sustainable system for creating prosperity across Canada's regions, say ***Roger Martin and James Milway***



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A debate on Canada's fiscal federalism is underway. For some, the question is, "Is the $23 billion fiscal gap fair to Ontario?" That gap is the difference between what Ontarians contribute to the federal government vs. what is spent here by the federal government.

For us, the question isn't about fairness. Most agree that Ontario and other "have" provinces should support the "have-nots."

The important question is about effectiveness: Is the transfer of resources out of Ontario effective in building Canada's long-term competitiveness and prosperity?

Our answer is clear. Fiscal federalism is not effective in helping Canada realize its prosperity potential, as we point out in a report released today by the Institute for Competitiveness and Prosperity.

Our system simply transfers resources, at the rate of $1,400 per capita annually, from high- to low-productivity uses. This lowers Canada's absolute level of productivity in all regions.

Provincial disparities in competitiveness or productivity are wider than across U.S. states and our fiscal federalism has been no better at closing regional gaps.

On the positive side, the pattern of federal revenues, expenditures and transfer payments raises the level of personal disposable income in the have-not provinces.

However, it is relatively less successful in increasing the rate of growth in gross domestic product or productivity in the have-not provinces.

The fundamental problem is that fiscal federalism in Canada is weighted dramatically toward the have-not provinces' consumption of health care and social services from the prosperity of the have provinces, rather than investment for future prosperity in all provinces.

This cannot be seen as a success. If fiscal federalism were successful, we would see faster development of productivity and competitiveness in the have-not provinces. That has not happened.

For example, private sector investment in productivity enhancing machinery, equipment, and software is 25 per cent lower in have-not provinces than the have provinces — unchanged from 20 years ago. Regional disparities in unemployment rates continue.

We have to rethink fiscal federalism because it is too costly to Canadian prosperity to spend resources generated in the have provinces so ineffectively. Greater success in reducing regional wealth gaps across Canada would benefit Ontario since this would mean lower transfers out of the province. With lower transfers, Ontarians would have greater opportunities to invest in their own prosperity.

Federal budget surplus surprises contribute to this ineffectiveness.

Canada's bias toward consumption of current prosperity has worsened because of the series of consistent federal surpluses.

Each year, the federal government presents and debates a budget with a tax regime for collecting a projected amount of revenue and a spending program consistent with this revenue.

In each of the past five years, Ottawa has missed on its estimates and created large inadvertent surpluses, and spending these without the public or parliamentary debate usually associated with federal budgets.

Ontario contributes disproportionately to the high federal revenues that produce the surpluses and receives a disproportionately low share of the extra spending.

In effect, this extra contribution happens by stealth and hurts Ontario's prosperity and competitiveness.

It is perfectly fair for Ontario to contribute to fiscal federalism in the amount set out in the budget, but it is not fair for Ontario to pay an additional stealth tax.

But again, the more important question is about effectiveness.

The measure we have used is the ratio of government spending on consumption of current prosperity to investment in future prosperity.

Our analysis of the surpluses generated over the past decade is that Ottawa dramatically biased spending toward consumption of current prosperity instead of investing for future prosperity.

Good stewardship ought to lead to the spending of these "found" resources on investments to generate future prosperity, including debt reduction.

Long-term, wiser spending in areas such as post-secondary education or infrastructure would increase prosperity and provide future capacity for consumption spending. Instead, Ottawa used the extra resources disproportionately to consume today's prosperity.

For every new dollar of consumption spending, it invested only 31 cents. Ontarians — and all Canadians — should insist on a formal mechanism to deal with surprise surpluses.

This mechanism should place a higher priority on increasing investment in future prosperity and reducing debt than on consuming current prosperity.

EI is an important part of the fiscal federalism problem. Employment insurance represents nearly a quarter of Ontario's fiscal gap.

It is a taxation program that consistently and massively imposes costs in excess of benefits. It does not operate as an insurance program, but rather as a regional transfer program in which Ontario is the major contributor.

With the ongoing higher jobless levels in provinces that are net recipients of EI funds, it is hard to argue that the program succeeds in reducing regional competitiveness disparities.

EI should be made into a real insurance program with a rating system: Employers who lay off workers more frequently should pay higher premiums than those who provide stable employment. This will reduce transfers out of Ontario.

If we want to help areas and employers with chronically high unemployment, make it an explicit transfer program, don't hide it inside EI.

Realizing a good quality of life from our prosperity is the first priority for public policy. But it is not the only priority, and we need to strike a balance.

Fiscal federalism has helped push the balance away from investment and toward consumption.

A more creative approach would encourage investment in future prosperity in the have-not provinces:

➤ Shifting transfer spending to tax relief that stimulates business investment.

➤ Rethinking approaches to equalization and transfer payments.

➤ Building more discipline in dealing with federal budget surplus surprises.

➤ Making EI a true insurance program.

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