Crushed by the helping hand

Equalization payments look like a friendly boost from a rich brother. Look again, says Rotman dean

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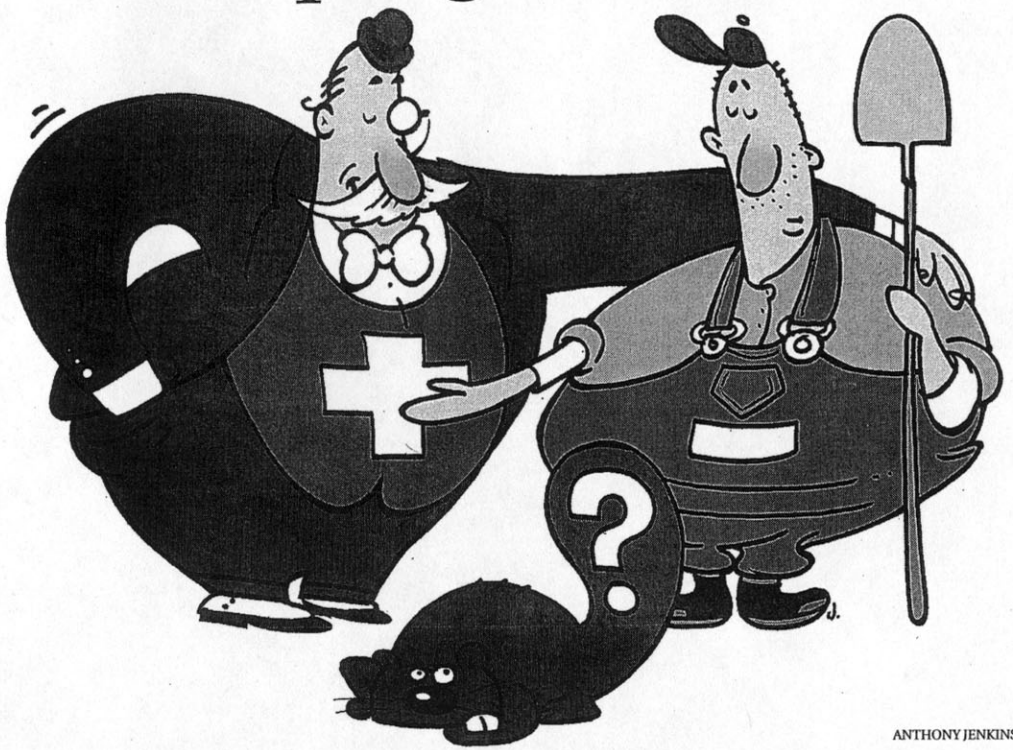

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In the wake of Newfoundland Premier Danny Williams's walking out of the conference on equalization reforms, Ottawa is apparently considering a deal to trim the equalization payment reductions that would result from Newfoundland's successfully developing its offshore oil fields.

This would represent government economic policy at its worst, and all Canadians should be chagrined. But few, if any, will be. Why? Because the specifics are so complex and counterintuitive that few will endeavour to peel the onion. As a consequence, we will have more government spending that produces the opposite of what we want.

To understand what is going on, imagine that I am distinctly poorer than the average Canadian and you are distinctly richer than the average Canadian. You, being of excellent heart, empathize with me and set out to help me. You agree to transfer some of your annual earnings to an agency that provides some services that I'd otherwise be unable to afford. You hope that helps me become more prosperous and self-sufficient over time. You further indicate that you will reassess the gap between your income and mine next year and make appropriate adjustments to the amount of help.

After a couple of years, I figure out that, if I dig down deep and earn another $1,000, you reduce your transfer by $700. As a consequence, I'm disinclined to work for the extra buck — it takes four extra hours of work to take home one extra hour of pay. Despite the good-hearted help, the gap between your income and mine doesn't close one iota.

Years pass. Then someone offers me the chance to make lots of extra income by digging water wells on the weekend. The pay is better than anything I have ever been offered, but it is a real investment in extra work, hard work. I think about it and say to myself: "This is just too difficult for me to do and then give up 70 per cent of my pay through reduced payments from my benefactor. Why don't I go to my benefactor and ask whether I can keep the previous transfer arrangement for the rest of my economic life but exclude the well-digging money."

You, thinking yourself a good-hearted person, agree. Sadly for you, nothing about my behaviour outside well-digging changes. When the well-digging gig is over, everything goes back to the way it was before.

This is exactly the situation playing out in Ottawa and St. John's. I represent Newfoundland and you represent Ontario and Alberta. The problem is that equalization doesn't work because it is structured to place an effective tax of about 70 per cent on increased economic activity. The American economy also has a form of equalization, though its magnitude is about half (proportionately) of that in Canada. Over the past 25 years, America's program of taking from the "have" states to give to the "have not" states has resulted in a decrease in the variance between "have" and "have not" states. Over the same period, Canada's program, even though of about twice the magnitude, has produced no reduction, because it is (inadvertently, I hope) structured to keep the "have nots" in their place by discouraging economic activity.

Now Ottawa has been confronted with a huge piece of evidence that its flawed equalization scheme isn't working. Newfoundland (and, in less vociferous ways, Nova Scotia) is claiming that the scheme decreases its willingness to invest in projects that are otherwise great for the province.

Instead of trying to fix the giant problem staring it in the face, Ottawa has decided to ignore the 70-per-cent clawback issue and use taxpayers' money to fund a workaround that will do nothing to enhance the future prospects of these two provinces.

Citizens of all provinces should be outraged. Those in the "have" provinces should be outraged that another $100-million to $500-million a year will be flowing to the "have not" provinces under a system guaranteed to continue not working. Those in the "have nots" should be outraged that nothing is being done to address the underlying problem that their provinces face 70-per-cent marginal tax rates on economic activity.

But few are outraged. It is similar to the fact that few are outraged by the reality that the Canadians facing the highest marginal tax rates in the country — rates of almost 70 per cent — are single-earner couples with children, earning around $25,000 a year.

Canadian governments have grown accustomed to using means-tested, clawed-back social programs as their preferred means of redistributing income in this country — whether to provinces via equalization or individuals via child-tax credits. Unfortunately, it is a dreadful tool because the benefits come with the problem of super-high marginal tax rates on the kinds of activities that would lift the "have nots" out of their state.

What would be smarter for Newfoundland (and the Atlantic provinces overall)? The elimination of corporate taxation in the region and a reduction in federal personal income-tax rates for residents. Both would create the incentives and the capabilities for the firms and citizens of those provinces to improve their lot in life and not trap them in a "have not" status — as does the current policy mix.

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