Fixing Fiscal Federalism to Improve Canada's Productivity Performance

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A DEBATE ON THE STRENGTHS and weaknesses of Canada's system of fiscal federalism is underway. Here in Ontario the question that has been posed is: is the $23 billion transfer — the so-called fiscal gap — fair to Ontario? That gap is the difference between what Ontarians contribute to the federal government versus what is spent by the federal government in the province.

The question is difficult to answer, because fairness is often in the eye of the beholder. There is a longstanding consensus in Canada that the better off provinces, the haves, should support the less well off, the have-nots. Since Ontario has always been a have province, it should be no surprise that Ontarians are major donors of support to the have-not regions of Canada.

Instead, we argue that there is a more important question. The mandate for the Institute for Competitiveness and Prosperity is to study productivity and competitiveness in order to improve economic progress and prosperity in Ontario specifically, but also in Canada generally. From an Ontario perspective, our focus is on whether this net expenditure of $23 billion per year in the rest of Canada serves to enhance competitiveness and prosperity across the country — and in Ontario. For us the critical question is about effectiveness: to what degree is the net transfer of resources out of Ontario effective in building the long-term competitiveness and prosperity of Canada?

Our answer is clear. Fiscal federalism is not effective in increasing Canada's productivity and its future prosperity.

This article has three objectives. It first analyzes Canada's "prosperity gap" and its roots in under-investing for productivity. It then discusses how fiscal federalism promotes consumption of current prosperity instead of investment for future prosperity and is therefore ineffective in reducing regional productivity and prosperity inequalities. Finally, it proposes some solutions for fixing fiscal federalism.

Canada's Prosperity and Productivity Gaps

Canada is one of the most prosperous countries in the world — in fact, among countries with half our population or greater, only the United States has higher GDP per capita. Yet, our work has shown that Canada has been less competitive than the United States for over two decades. And our prosperity gap — the difference in GDP per capita — with the United

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States has grown worrisomely since 1981. In 2003, GDP per capita was $7,200 higher in the United States than in Canada; in 1981, that gap was $1,800 ($2003).

This prosperity gap indicates that with a similar endowment of natural, physical, and human resources, Canadians are less successful at adding value to create goods and services for consumers here and around the world. The prosperity gap means that Canadians are not achieving their potential standard of living and that as a society we risk weakening the social safety net in which we all take great pride.

What drives this prosperity gap? Our review of the elements that drive prosperity indicates that strengthening productivity has the greatest potential for raising Canadians' standard of living. We conclude that Canada's supply of labour is close to the United States. We have advantages over the United States in our demographic profile — the percentage of our population who are of working age - and the utilization of our potential work force - the number of jobs per working age population. We do have a disadvantage in hours worked per job — and recent work by Statistics Canada indicates this disadvantage is worse than most observers had thought. But, taken together, these factors in the supply of labour account for less than a third of our $7,200 prosperity gap with the United States.

Productivity accounts for the largest portion of our prosperity gap.

What then drives the productivity gap? In our work (Institute for Competitiveness and Prosperity, 2005), we have identified four key factors that drive our disadvantage relative to the United States.

Lower Urbanization. A smaller percentage of Canadians lives in metropolitan settings, Census Metropolitan Areas, than Americans living in Metropolitan Statistical Areas. Urban geographers and economists agree on the importance of urban agglomeration for creating network effects and scale economies. We observe a positive relationship between a state's or province's degree of urbanization and its productivity. Canada's lower degree of urbanization reduces our productivity and prosperity potential by $3,300 per capita.

Lower educational attainment. More educated workers are more productive. Canadians are less well educated than their counterparts in the United States. Fewer Canadians have a university degree, causing wages to be lower. By our estimates, our under-attainment in education translates into a negative impact on GDP per capita of $1,100.

Under-investment in capital. Between 1991 and 2003, Canada's private sector invested about 13 per cent less per dollar of GDP in machinery, equipment, and software than their counterparts in the United States. This under-investment slowly erodes the relative strength of our capital stock. This erosion in turn reduces the productivity of our labour force and hence our prosperity. We estimate this under-investment to be worth at least $400 per capita in lost GDP.

Weaker effectiveness of our industry clusters. While Canada has an excellent mix of industry clusters, productivity is much lower in Canadian clusters than the same US clusters. The lower wage premium achieved by our clusters of traded industries versus local industries indicates that our clusters are 14 per cent less productive than their US counterparts. This translates to a $1,400 per capita reduction in Canada's GDP. Canada has a more attractive mix of industry clusters than the United States which benefits Canada's GDP by $1,100 per capita, thus offsetting their weaker effectiveness.

Our work indicates that Canada is not investing as aggressively as the United States. Competitive rates of investment in human and physical capital are necessary, if we want to strengthen our capacity for innovation and productivity enhancement. Our under-investment is a major factor in explaining the $7,200 GDP per capita, or 15.7 per cent, shortfall between us and the United States.

Initially, as in the United States, we invest in the basic requirements for keeping our businesses and individuals competitive in the global setting. But after the last investment dollar in Canada is spent, US stakeholders in prosperity continue right on investing. This pattern of attenuation is true for Canadian individuals, Canadian businesses, and Canadian governments.

Our under-investment is wide ranging. Relative to the United States

- we under-invest in machinery, equipment, and software that drive productivity gains;
- we under-invest in education as students move through the system and forgo the higher benefits to the economy of more capable human resources;
- we under-invest in integrating immigrants and do not benefit fully from their economic potential; and
- we under-invest in our future prosperity as government spending has been shifting from areas that are investments for future prosperity to those that consume current income.

In our analysis of spending by all governments in Canada between 1992 and 2002, we find that in 1992 for every dollar spent on consuming current prosperity (primarily health care and social services), governments invested 55 cents in areas such as education and infrastructure. As governments across Canada tackled their deficits, they cut investment spending more than consumption. By 2002, for every dollar of consumption, our governments invested 50 cents. Meanwhile, in the United States this proportion was moving in the opposite direction — from 52 cents to 55 cents. We are concerned that our governments, under public pressure to be sure, are not investing adequately for our future prosperity.

Fiscal Federalism: Missed Opportunities for Greater Prosperity

Fiscal federalism is another example of structures that promote consumption for current prosperity over investment in future prosperity. The transfer of resources from Canadians in have provinces to Canadians in have-not provinces occurs through federal government taxing and spending mechanisms:

- **First, most federal taxes are progressive.** This means that provinces with above average personal incomes and larger corporate sectors pay a higher share of taxes than their share of the national population and of gross domestic product (GDP).
- **Second, many of the federal government's spending programs are geared to lower income individuals.** Federal social spending, such as Old Age Security/Guaranteed Income Supplement or various tax credits, is aimed at lower income Canadians. Payments of Employment Insurance (EI) benefits are higher in areas with higher unemployment. Transfers to support businesses are higher in areas with a less developed business sector.
- **Third, the federal government transfers money directly to the provincial and territorial governments.** There are two types of these government-to-government transfers. The first is *equalization payments*, which are specifically designed to transfer resources from provinces with above average incomes to provinces with below average incomes. Through a series of formulas, the federal government determines which provinces are eligible to receive equalization and how much each will receive. Currently, Ontario and Alberta do not receive equalization payments, while all the other provinces receive some payments. The second type is *equal per capita transfers*. The main examples

are the Canada Health Transfer (CHT), which provides funds to provinces to support health care, and the Canada Social Transfer (CST), which funds social programs and education. All provinces receive these transfers on a nearly equal per capita basis.

For Ontario the difference between what is collected from residents of the province versus what is spent there by the federal government was $23 billion in the 2004-05 fiscal year.

A well-functioning fiscal federalism system ought to reduce regional differences in current living standards. Equally important, it should also reduce the differences in future living standards by increasing productivity in the have-not regions. If it did both, it would unambiguously raise living standards for all Canadians.

But does Canada's current system of fiscal federalism reduce regional imbalances in incomes and competitiveness? Does it actually equalize and raise living standards across the country? The answers are important as Canada seeks to increase the capacity for wealth creation and to ensure higher prosperity for everyone.

We conclude that fiscal federalism is not effective in promoting the competitiveness and prosperity of Canada. It is simply a set of net transfer programs that has the effect of transferring resources from high-productivity uses to low-productivity uses, lowering the absolute level of productivity.

On the positive side, Canada's fiscal federalism raises the level of personal disposable income in the have-not provinces through the vehicle of federal transfer payments. We have achieved a lower level of inequality between our provinces than the United States has achieved across its states. And we are reducing this inequality at a faster rate than in the United States.

However, the federal transfer system is less successful in increasing the rate of growth in Gross Domestic Product or productivity in the have-not provinces. Canada's record in the convergence of GDP per capita across the provinces and with the United States has not been as strong as its achievement in personal disposable incomes. The evidence indicates that Canada has been less successful than the United States in narrowing the dispersion of GDP per capita, or wealth-creation potential.

In seventeen of the past twenty years, the United States has experienced lower levels of inequality in regional GDP per capita than Canada. The trends in reducing this inequality are almost identical in the two countries. So if these trends continue, Canada will never match the United States in reducing the regional inequalities in GDP per capita.

A province-by-province and state-by-state competitiveness ranking over the past two decades indicates much more fluidity in the United States than in Canada. The have, middle, and have-not provinces are essentially the same today as they were twenty-five years ago in Canada. The rankings of US states moved much more. Where state or provincial rankings remain essentially frozen, it means that have-not regions are not breaking out of their sub-par performance. A culture of defeatism and dependency may have set in across the have-not regions, and their economies can lack diversity of strengths and robustness.

When compared to the progress of the have versus have-not states in the United States, Canadian fiscal federalism drains considerably more resources from the have jurisdictions to give to the have-not jurisdictions, but produces no greater convergence in the competitiveness or productivity of the have-not jurisdictions. The fundamental problem is that fiscal federalism in Canada is weighted dramatically toward the consumption of current prosperity — in this case consumption by the have-not provinces of the current prosperity of the have provinces — rather than investment in building future prosperity.

When we investigate the elements of GDP per capita we find that Canada has been unsuccessful in narrowing regional disparities in several areas. The rate of convergence is slower across Canadian provinces than US states in employment rates, the degree of urbanization, and educational attainment. Disparities across Canadian provinces are actually becoming worse for overall productivity, private investment in machinery, equipment, and software, and hours worked per worker. On the positive side, Canada is achieving faster regional convergence for participation rates than is the United States.

It is hard to imagine that federal transfers have not contributed to the successful regional convergence in personal disposable income. But we conclude that they are doing little to affect convergence in GDP per capita, a measure of prosperity creation potential. Over the past twenty years we estimate that federal transfers and expenditures have conveyed about $1,400 per capita annually from the have provinces to the have-not provinces. Importantly, as a review of the expenditures behind fiscal federalism shows, a significant share of this resource shift has been in areas that support consumption of current prosperity — equalization payments, health and social transfers to provinces, transfers to individuals, and EI benefits.

This cannot be seen as a successful program. In a successful program of fiscal federalism, the resources transferred to have-not provinces would lead to faster development of productivity and competitiveness in the have-not provinces. This would justify diverting resources from a higher productivity jurisdiction to a lower productivity jurisdiction, whose productivity could be induced to grow much faster. That has not happened.

It is incumbent on the federal government to rethink the way fiscal federalism works, because it is too costly to Canadian prosperity to spend resources generated in the have provinces as ineffectively as today. One approach it should consider is to provide substantial tax relief to stimulate investment as opposed to transfer programs. Increased capital investment in Canada's have-not provinces will help boost productivity and in turn this will increase their capacity for wealth creation.

Federal Budget Surpluses

Our previous work has shown that, on many fronts, Canada consumes too much current prosperity instead of investing in future prosperity. Our system of fiscal federalism is another such example, and the bias toward consumption of current prosperity has worsened because of the series of consistent inadvertent federal surpluses. Each year, the federal government presents and debates a budget in which it asks Canadians to accept a tax regime designed to collect a projected amount of revenue and to accept a spending program designed to use the projected resources collected through the tax system. In each of the past five years, the federal government has dramatically missed on its estimates, running up large inadvertent surpluses. It has decided how to spend these surprise surpluses without the public or parliamentary debate usually associated with federal budgets.

The problem for Ontario is that it contributes disproportionately to the inadvertently high revenues that produce the surprise surpluses yet receives a disproportionately low share of the extra spending. In many ways, this represents an accelerator on the $23 billion deficit. This additional amount of net transfer can be seen to be unfair to Ontario in that it has not been asked for, publicly discussed, or been part of a planned transfer from have to have-not provinces. Instead, it happens by stealth and hurts Ontario's prosperity and competitiveness. It is perfectly fair for Ontario to pay a net transfer in the amount that is contemplated and is passed by Parliament in the federal budget, but it is not fair for Ontario to pay an additional stealth tax.

Regardless of the fairness of the collection and spending of the additional revenues, a more important question is whether the federal government is spending these resources wisely. The metric we have used to discuss government spending is the ratio of spending on consumption of current prosperity versus spending for investment in future prosperity. Our analysis of the deployment of the surpluses generated over the past decade, both anticipated and unanticipated, is that the federal government dramatically biased spending toward consumption of current prosperity instead of investing in generating future prosperity.

When the federal government has extra resources to deploy, good stewardship for the future prosperity of Canada ought to lead to the spending of these resources on debt reduction or investments that will generate future prosperity. In the long-term this spending would provide more capacity for spending on current consumption. Instead, the federal government used the extra resources disproportionately to consume today's current prosperity.

Ontarians — and all Canadians — should insist that, in the event of a surprise surplus, there be an established mechanism for dealing with it. And this mechanism should place a higher priority on reducing debt and increasing investment in future prosperity than on consuming current prosperity. If these surplus surprises are to be transferred to provinces, we argue that they should be returned to each province in proportion to its contribution to the inadvertent surplus.

The Employment Insurance Problem

Employment Insurance is not an insurance program. Rather, it is a taxation program that consistently and massively imposes taxes in excess of expenses. In its pattern of expenses, it does not operate as an insurance program, but rather as a regional transfer program. As a regional transfer program, Ontario is a major net contributor. Given the ongoing higher levels of unemployment in the provinces that are net recipients of EI funds, it is hard to argue that the program has been effective in reducing regional competitiveness disparities.

Employment Insurance should be separated into two portions. One portion should be directed toward an experience-rated program that can be run efficiently and effectively for the benefit of Canadian firms and their workers. The second portion should be moved into an explicit social transfer program so that it is visible and accounted for.

Recommendations

In summary, we see fiscal federalism as a monumental missed opportunity for raising Canadian prosperity and competitiveness. More ineffective than unfair, it needs a relatively dramatic overhaul to improve its impact on Canada. The biggest shortcoming of fiscal federalism as currently constructed is that it represents a large consumption of current prosperity, not an investment in generating future prosperity. We recommend the following changes to the structure of fiscal federalism:

- **Shift transfer spending to tax relief that stimulates business investment to enhance prosperity in all regions.** Eliminating transfers to businesses in the have-not regions and sharply reducing corporate tax rates can be revenue neutral and prosperity enhancing in these regions. This would result in greater business investment which in turn would increase productivity and prosperity. In addition shifting taxation from business investment to consumption by reducing corporate taxes and raising the GST would help all regions and reduce interprovincial transfers.
- **Build more discipline into federal equalization and transfer payments.** The federal government has committed to

increasing equalization by 3.5 per cent annually in the coming decade — a rate which could exceed economic growth in the have provinces whose residents are footing the bill. In response to pleas from the premiers, the federal government has loosened its purse string on health and social transfer payments — adding to these through "in-year initiative" whenever it has a surprise surplus. And it has struck several ad hoc deals with individual provinces. The current system is losing any coherence it might have had, and this needs to be fixed.

- **Develop a consensus for a disciplined approach in dealing with federal budget surplus surprises.** Recently, the Minister of Finance proposed legislation which would create a formula for dealing with surprise surpluses. Another approach might be to indicate in each budget how the government will deal with surplus surprises in the coming year. Thus the approach can be tailored to changing circumstances and can be debated in Parliament.
- **Make EI an insurance program and separate out the interprovincial social transfer aspects.** As a first step, the federal government needs to reduce EI premiums significantly to match unemployment benefits. The accumulating surplus can be put to better use in the hands of employees and employers. This will also reduce the temptation to add new benefits to the EI programs that have only tangential connections to reducing the dislocations of unemployment. Second, the federal government should introduce an experience rating among employers to make EI a true insurance program. Those employers who cost the system more should bear higher costs than those who are currently net contributors.

Reference

Institute for Competitiveness and Prosperity (2005) *Realizing Canada's Prosperity Potential*, January, posted at, www.competeprosper.ca.