

Institute Urges Overhaul of Fiscal Federalism to Strengthen Prosperity in Canada and Ontario

The current fiscal federalism system is not working for Canadians or Ontarians

Toronto, Ontario, October 17, 2005 – Canada’s fiscal federalism is a missed opportunity for improving the potential for long-term prosperity in the have-not provinces. That is the conclusion of Working Paper 8, *Fixing fiscal federalism*, released today by Ontario’s Institute for Competitiveness & Prosperity at the Economic Club of Toronto. The Working Paper concludes that greater success in closing regional disparities would mean higher prosperity across Canada and more and better opportunities for Ontario to invest in its own productivity and prosperity.

“There’s been extensive discussion about Ontario’s \$23 billion federal fiscal gap – the difference between what Ottawa takes from the province in taxation, compared to what it spends in Ontario,” said Roger Martin. Martin is the Chairman of the Institute for Competitiveness & Prosperity and Dean of the Joseph L. Rotman School of Management at the University of Toronto. “This Working Paper assesses the gap from the perspective of competitiveness and prosperity both in Ontario and across Canada and clearly identifies where some of the challenges lie – and how they can be addressed. “

The Working Paper analyzes:

- The structure of Canada’s fiscal federalism
- The results of fiscal transfer policies in Canada and the United States
- The impact of federal budget surplus surprises
- The effect of Employment Insurance on persistent regional disparities in unemployment

The Institute’s research shows that on a per capita basis, Ontario contributes \$1,600 annually to the rest of Canada. That is in sharp contrast with an average contribution of \$400 per capita across Ontario’s 14 peer US states*, the most populous jurisdictions the Institute uses to compare Ontario’s competitiveness and prosperity. The Working Paper notes that this \$1,200 difference contributes significantly to Ontario’s prosperity gap with these leading US states. It also assesses whether these transfers are effective in raising competitiveness and prosperity levels in the rest of Canada.

“Ontario is the largest and most prosperous province in Canada, so we expect to contribute to the rest of the country,” said Martin. “But the transfers to the rest of Canada simply have not been effective in accomplishing the goal of closing the disparities between have and have-not provinces in critical economic indicators such as unemployment and in investment in productivity.

“The result is that Canada has been less successful than the United States in narrowing regional inequalities in prosperity – despite the fact that US fiscal federalism focuses less on reducing interstate differences.

“There’s a depressing sameness in year-over-year rankings of have-not provinces,” added Martin. “We find much more movement among the prosperity ranks of US states.”

The structure of Canada’s fiscal federalism is the main reason the system is not working as well as it should. Many of the mechanisms help have-not provinces, but they typically focus spending on health care and social services - the kinds of expenditures that consume current prosperity.

“Obviously these are the highest priorities for Canadians, but they are not the only priorities. We need to stimulate investment in productivity-enhancing physical capital, such as machinery and equipment, and human capital, such as post-secondary education. Canada’s fiscal federalism does not adequately balance consumption and investment,” Martin observed. “Greater targeted investment in have-not provinces would lead to more jobs and improved productivity. In turn, this would boost the potential for long-term prosperity and reduce the need for interprovincial transfers.”

Federal reaction to unexpectedly high budget surpluses has also contributed to the problems of fiscal federalism.

“We find that when federal budget surpluses appear to be higher than anticipated - through higher-than-expected tax revenues or lower-than-expected expenditures - the federal government has been spending much more of this ‘found’ money in transfers to provinces and other expenditures that consume current prosperity rather than investing in future prosperity or reducing taxes and debt. We think there should be a better balance.”

The Working Paper also reviews the Employment Insurance program, which is a major driver of Ontario’s fiscal federalism gap, since employees and employers in the province contribute \$3.7 billion more than is paid out in benefits.

“EI is not insurance,” said Martin. “It is a tax on labour that hurts Canada’s productive firms and industries and props up the unsuccessful ones.”

Martin was referring to research cited in the Working Paper that shows a small percentage of firms and industries in Canada consistently generates more EI benefits through layoffs than their EI premium contributions. Companies with stable employment practices and their employees are subsidizing these firms. Worse, regional disparities in unemployment have not improved over the past two decades.

Recommendations

The Institute calls for an overhaul of fiscal federalism to improve prosperity in the have-not provinces and Canada as a whole. It recommends:

- finding creative ways to shift current transfer spending to tax relief with the goal of stimulating business investment to enhance prosperity across all regions;
- designing better approaches for dealing with federal budget surplus surprises; and
- fixing the Employment Insurance system so that it actually functions as an insurance program.

About the Institute

The Institute for Competitiveness & Prosperity is an independent not-for-profit organization established in 2001 to serve as the research arm of Ontario's Task Force on Competitiveness, Productivity and Economic Progress. The Institute is supported through the Ontario Ministry of Economic Development and Trade. Reports published by the Institute are primarily intended to inform the work of the Task Force. In addition, they are designed to raise public awareness and stimulate debate on a range of issues related to competitiveness and prosperity. Visit the Institute's Web site www.competeprosper.ca for more information.

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The complete report can be downloaded directly from:
<http://www.competeprosper.ca/public/wp08.pdf>

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* Ontario's peer jurisdictions (14 US states and Quebec)

- California
- Florida
- Georgia
- Illinois
- Indiana
- Massachusetts
- Michigan
- New Jersey
- New York
- North Carolina
- Ohio
- Pennsylvania
- Quebec
- Texas
- Virginia