



DOLLARS & SENSE

A CASE FOR MODERNIZING CANADA'S TRANSFER AGREEMENTS

FEBRUARY 2011

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Prepared for the Ontario Chamber of Commerce
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FORWARD

The principle of equalization is a fundamental part of the Canadian way. At its most basic level, equalization promises that kids in Brandon, Manitoba can attend school systems as good as those in Vancouver, or that a sick child in Moncton, New Brunswick will be able to get the same quality of medical care as the one in Oakville, Ontario.

Equalization is an expression of Canadians' commitment to the principle that all of us, wherever we live, should have full access to the benefits of Canadian citizenship and equality of opportunity.

According to our Constitution, the federal government is required to make equalization payments to ensure that all "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Over the life of the program, it has redistributed \$267 billion, mostly from Canadians in Ontario (and Alberta) to the governments of other provinces. Few question the rationale for the program.

However, given the magnitude of the redistribution, it is surprising that the federal government has never sought to assess whether in fact provincial governments have sufficient revenues to provide reasonably comparable levels of public services. Canadians simply do not know how we are performing against this constitutional principle. This has allowed some provincial governments to use the program as a platform for extracting more and more revenue from Ottawa.

Many provincial governments see equalization payments as entitlements and their demands for "more equalization" are now permanent features of their relations with the federal government and the rest of the country. Unfortunately, they are often rewarded for making ever-escalating demands – even though they may have no evidence to back up their claims that more equalization is needed.

The funds to satisfy these demands do not magically grow on trees. They come from the general tax base of the federal government and Ontarians pay a disproportionately large share of that bill.

The fact that Ontario has received a small equalization cheque in the past two years doesn't change the fact that Ontarians still pick up the tab for the lion's share of inter-regional redistribution in Canada, even at a time when the Ontario economy and many Ontario businesses face real challenges.

The politicization of the program by many governments outside Ontario is tragic. The commitment of equalization speaks to what is best within Canadians and expresses our desire to share good fortune across the country; the politicization of the program speaks to what is worst about our regional politics and has compromised a key principle of our social contract.

We need to return in Canada to principle-based federal fiscal transfers that ensure that all provincial governments are able to offer their residents good quality public services at comparable levels of taxation. That means that the way federal fiscal transfers are calculated needs to adjust to the changing economic capabilities of various provinces. The work of David MacKinnon, supported by the Ontario Chamber of Commerce, is an important attempt to engage in that principled dialogue and discussion.

MacKinnon and the Ontario Chamber of Commerce have been working tirelessly on these issues for many years and they continue to focus on the key question - do all provincial governments have the fiscal means to offer comparable levels of programs at comparable levels of taxation? The Ontario Chamber of Commerce paper finds that the answer is 'no' – that it is in fact the less prosperous provinces – due to generous federal fiscal transfers – that have more fiscal means than Ontario.

Some will no doubt question this conclusion, but this paper has the courage to conduct this analysis and present its data for others to judge. It should be equally incumbent upon critics – including the federal government or other provincial governments – to present their data as openly and subject it to the scrutiny that David MacKinnon and the Ontario Chamber of Commerce are prepared to face.

Let the debate begin!

Matthew Mendelsohn, Director

Mowat Centre, School of Public Policy and Governance, University of Toronto

(Former Ontario Deputy Minister of Intergovernmental Relations and Associate Secretary of the Cabinet)

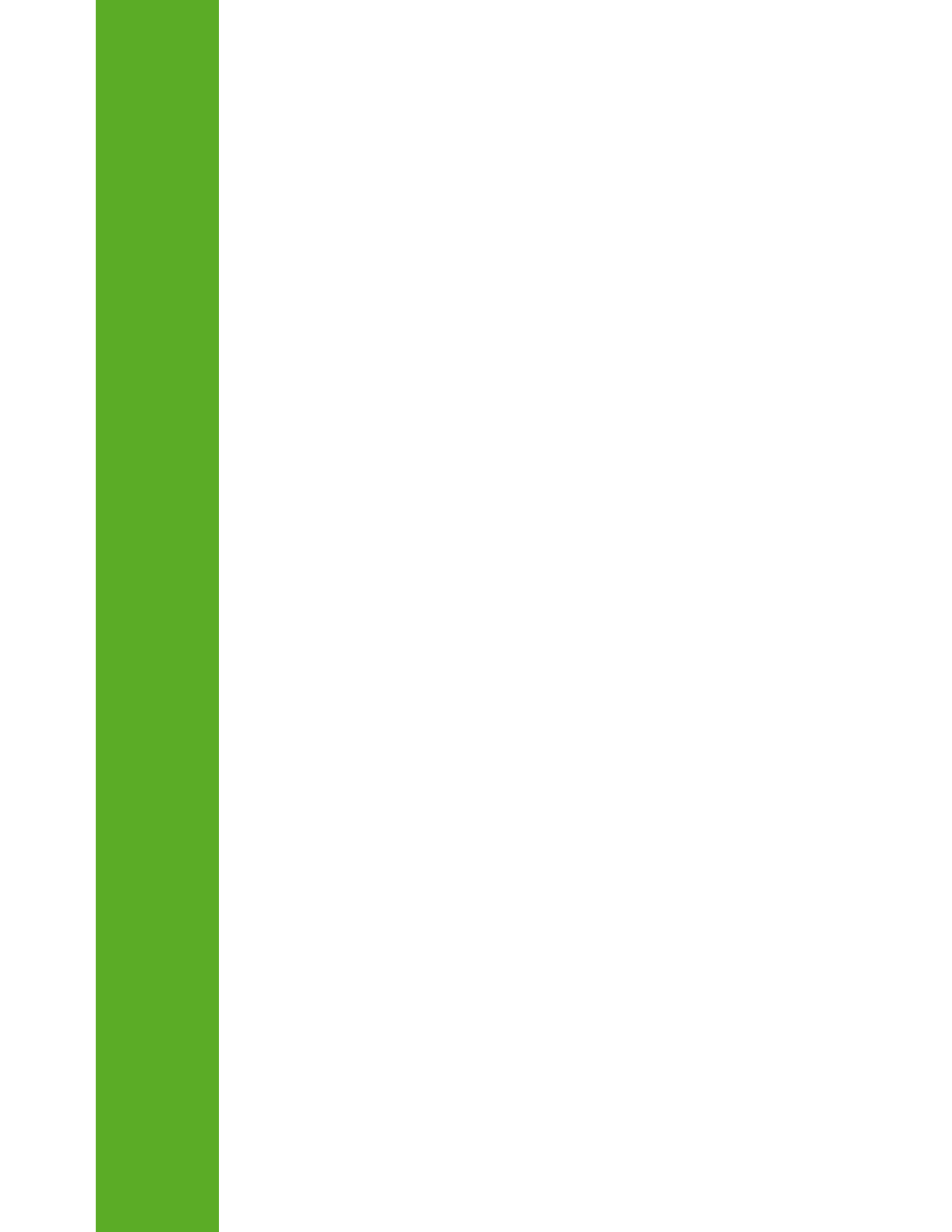


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INTRODUCTION

The Ontario Chamber of Commerce is a federation of 160 local chambers of commerce and boards of trade, representing 60,000 businesses of all sizes across Ontario and from every sector of the economy. It was founded in 1911 to be the voice of business in Ontario.

The Chamber has four core values: supporting strong, vibrant markets; achieving a balance among economic, social and environmental considerations; encouraging a shared sense of responsibility among Ontarians and seeking opportunity for all citizens to achieve their goals and dreams.

For some years, the OCC has been concerned about the impact of the fiscal deficit Ontario has long experienced with the rest of Canada and in 2005 it produced an innovative report on this important subject.

Data on the net fiscal deficit that Ontario experiences with the rest of Canada is published by Statistics Canada every two years. Stats Can estimated the net fiscal deficit to range from approximately \$21 billion to \$22.5 billion each year from 2004-2007. This figure dramatically declined in 2008, where it dropped to approximately \$14.4 billion.

It is important to note that, aside from the decline in 2008, the net fiscal deficit in the range of \$21 billion-plus have been generally consistent for a long period of time. After adjusting for the federal deficits of the early 1990s, the negative balance for Ontario was about \$25 billion in 1990 and fell to about \$20 billion in the middle of the decade before starting to rise to the levels stated above.¹

This deficit results, in part, from Canada's complex and partly hidden system of regional subsidies. The system has four major components: equalization, uneven features in transfer programs targeted at individuals, an imbalance in many federal operating programs and the location of government offices far from their customer base as economic development projects.

This deficit is also attributable to the regular operations of the federal government including, for example, per capita transfers which extract funding from regions such as Ontario (which supports per capita transfers) and transfer it equitably to all Canadians.

In 2005, the Chamber produced two reports on this complex subject entitled *Fairness in Confederation: Fiscal Imbalance: Driving Ontario to Have Not Status* and *Fiscal Imbalance: A Roadmap to Recovery*. This initiative was the product of extensive research and discussions, primarily among Chambers of Commerce and Boards of Trade across Ontario.

The OCC concluded that a fiscal deficit of this size was driving Ontario to have-not status and predicted that Ontario's real GDP per capita would fall below the national average by 2010.

Unfortunately, this projection proved to be too optimistic when Ontario's real GDP per capita fell below the average in 2008.

The federal government of the day paid little attention to this warning, disputing the likelihood of Ontario falling below the national average. The general complacency about and lack of understanding of Ontario's economic prospects did not change.

At the time, the Ontario government was engaged in a campaign to achieve fiscal fairness for Ontario. Speeches and presentations by the Ontario Premier and the Minister of Finance echoed some of the Chamber's themes.

¹ For a detailed analysis of these flows over time, see *Fiscal Federalism and Ontario's Competitiveness*, Institute for Competitiveness and Prosperity (2006) and *The Fiscal Background to a Fiscal Gap* by Finn Poschmann, a paper prepared for the C.C. Howe Institute, 2005.

The 2005 report made several recommendations:

- equalization expenditures should be frozen until a system to measure comparability of provincial programming, the avowed goal of federal efforts, was put in place;
- new benchmarks for all provincial programming in all provinces be developed and that federal regional subsidies outside the transfer system should be reduced;
- Ontario should research and provide public information on all tax policies to identify partial solutions to the Ontario fiscal deficit problem;
- Ontario should partner with Alberta, the only other contributing province at the time, to perform public research and access existing research to improve public understanding of the issue and identify policy options for its amelioration;
- Ontario should turn up the volume on its fiscal fairness campaign and broaden the public access to information that was necessary to sustain it; and
- the federal Auditor General should examine the lack of metrics associated with federal regional subsidies because it appeared to violate federal audit requirements that measures be put in place to determine the effectiveness of all programs.

While the province made limited progress in areas such as immigration support payments, it became clear within a few months that no basic change was contemplated in federal fiscal policies toward Ontario. In fact, the problem continued to grow, in part because the federal government dramatically increased equalization payments far beyond expectations at the time the 2005 paper was written and in part because fundamental program inequities remain, such as the federal decision not to distribute training funds on a per capita basis. Despite the Chamber's recommendation, the Auditor General did not examine the federal transfer system.

Later in the decade, significant one time initiatives favourable to Ontario were undertaken by the federal government but these were more a response to the world financial crisis rather than an attempt to rectify any deficiencies with the regional subsidy system that remained one of the principal defining characteristics of Canadian federalism.

DEVELOPMENTS SINCE 2005

- This study is an important step to understanding regional differences in provincial government programming. In future, much more needs to be done including comparisons of more types of services provided by or funded by provincial governments and comparisons that address quality as well as access, the primary focus of the work of the Frontier Centre for Public Policy in Winnipeg. In February 2010, the Frontier Centre released a major study on accessibility of provincial programs across Canada. This study showed conclusively that accessibility of provincial programs in Ontario (and Alberta) is well below the standards of traditional receiving provinces in most program areas. This conclusion, supported by ample statistical evidence, shows that Canada has over-equalized, with particularly tragic consequences for the people of Ontario. These will be explored later.
- Late in this past decade, the government of Canada took several steps which had a positive impact on Ontario. These included \$9.1 billion in support for automobile companies; a payment of \$4.3 billion to support conversion to the HST; and the elimination, for Ontario, of the principal discriminatory provisions in the Canada Health and Social Transfers. It also established a new Southern Ontario Development Agency for the province with an appropriation of \$200 million in 2009-10, or \$1 billion over five years.

Some of these initiatives were onetime events and some of the assistance is repayable or potentially recoverable, including automotive industry assistance.

- Expenditures on equalization by the federal government increased dramatically, which meant that Ontario did not benefit significantly from the program even though it started to receive equalization payments for the first time in 2009. Ontario taxpayers paid an additional \$1.282 billion to support the expanded equalization program over the five year period beginning in 2005, on the assumption that 37 per cent of federal tax revenue is raised in Ontario, a proportion that matches Ontario's share of national GDP in 2008. The government of Ontario received an additional \$1.319 billion from the federal government over the same five years as equalization payments to the province commenced. The outflows from Ontario taxpayers essentially matched the inflow to the Ontario government.

It seems counter intuitive that there would be little or no net benefit to provincial taxpayers as the province received equalization payments for the first time but that is exactly what transpired due to dramatic increases in the size of the equalization program.

- The federal government did place a cap on the program, after double digit increases had been incurred over several years. In one recent four year period, for example, equalization for Quebec increased by 68 percent at a time when Ontario's economy, the principal funder, grew by less than 10 percent. The growth of the Ontario economy is the determinant of the ability of its taxpayers to support transfers to other provinces. From this point of view, such contributions are not sustainable if the rate of growth in transfer payments exceeds the rate of economic growth of contributing jurisdictions.

It seems counter intuitive that there would be little or no net benefit to provincial taxpayers as the province received equalization payments for the first time but that is exactly what transpired due to dramatic increases in the size of the equalization program.

- By 2008, it became apparent that the Ontario government was no longer pursuing its own fairness campaign, as the global recession encouraged both the federal and provincial governments to set aside long standing disputes and to collaborate more visibly as initiatives to deal with the crisis were put in place.

- The Mowat Centre for Policy Innovation at the University of Toronto commenced operations. It produced ground breaking research which showed, among other things, that public confidence in the direction the federal government was taking in its relationship with Ontario was eroding and that Ontario was seriously underrepresented in the House of Commons. (The federal government has proposed legislation that will increase MP representation for provinces like Ontario, but the bill has yet to be passed by Parliament).
- The global financial crisis developed and showed the fiscal problems Ontario faced in bold relief. This led to three separate crises for Ontario: a budgetary crisis with the province incurring an initial estimated deficit of almost \$25 billion; a crisis in manufacturing employment, with the province losing 126,000 manufacturing jobs between 2007 and 2010; and finally, a major employment crisis for the City of Toronto which, with an unemployment rate of over 9 percent, rapidly became one of Canada's top unemployment regions.
- Traditional recipient jurisdictions in Canada were protected from the immediate impact of the global crisis by transfers from contributing jurisdictions, such as Ontario and Alberta. In 2009, the first full year of the crisis, the economy of Prince Edward Island grew by 0.6 percent, and the economies of Nova Scotia, New Brunswick and Quebec shrank by 0.5 percent, 0.8 percent and 1.0 percent respectively. By contrast, Ontario's economy (then a contributing jurisdiction) shrank by 3.1 percent and Alberta's by 5.1 percent. In other words, the 2009 contractions in Alberta and Ontario were respectively five times and three times as severe as in most recipient jurisdictions. There were no immediate adjustments to the equalization program to reflect the sudden deterioration in the circumstances of Alberta and Ontario because a two-year delay is built into the program due to the publishing cycle of the data. It is possible that adjustments will be made after 2011-12, long after the immediate impact of the global crisis was first felt, and when the need to adjust equalization to the new environment was most needed.

- Concern about equalization and other regional subsidies has grown in Alberta in recent years and is frequently debated in that province. A well informed critic of the regional subsidy effort was appointed as Alberta's Minister of Finance in 2009. For some years, the question about whether to include resource revenue in the calculation for equalization was the subject of much debate. This ended in 2006 when the government accepted the recommendation of the expert panel on equalization that 50% of resource revenue be included in the calculation of equalization entitlements.
- The federal government conducted a study on needs based equalization which it released in heavily redacted form to the Mowat Centre for Policy Innovation in response to an FOI request. This is important because a fair assessment of population need, would likely show that population need is greatest in Ontario and B.C., not traditional recipient provinces.

Unfortunately the study as released is so heavily redacted that it is difficult to understand. However, the reluctance to release the study seemingly confirms that equalization is coming from the people least able to afford it, going to regions that have much more accessible services than Ontario.²

Testimony by Professor Tom Courchene of Queen's University to the Finance Committee of the House of Commons on May 4, 2005 hints at this, as do other studies and commentaries. In any event, the federal study on needs based equalization is needed to inform public debate, and we therefore encourage the Federal Government to release it publicly in a timely fashion.

PRESENT SITUATION

Unfortunately the present situation reflects past realities. The problem remains and has likely been exacerbated by both federal policy and the global crisis in the years since the 2005 OCC report was released.

It is also becoming increasingly clear that the effects on everyday life in Ontario are quite real, that the system is limiting growth in recipient provinces and that federal regional subsidies are one of the principal causes of Canada's very poor recent productivity performance. It is also crucial for governments to acquire the knowledge and understanding to manage the problem properly or inform thoughtful public debate, a particular problem as discussions to renew transfer programs get underway. Finally, the problem is intractable for both financial and political reasons.

Each of these will be explored in turn.

EFFECT ON EVERYDAY LIFE IN ONTARIO

The impact of over-equalization and excessive regional subsidies of all types on Ontario's citizens is dramatic.

The Frontier Centre report entitled "The Real Have-Nots in Confederation" notes that: "The evidence suggests... that, in many important areas, levels of government service in the traditional and largest have provinces are significantly below those that exist in most recipient provinces. Specifically, the data suggest that large transfers allow recipient provinces to spend more freely on a range of government services including health and education".³

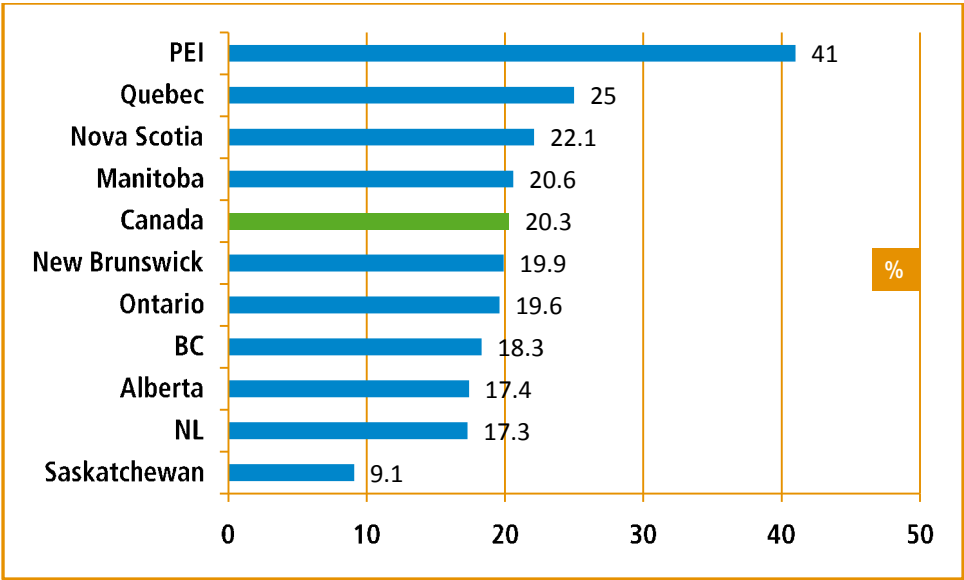
Even as a 'have' province, Ontario's public services lagged behind those provinces which historically have received transfer payments.

² An Operational Expenditure needs Equalization Formula for Canada, Peter Gusen, 2006. This paper is available in redacted form from the Mowat Centre for Policy Innovation, University of Toronto.

³ The Real Have Nots of Confederation, Frontier Centre for Public Policy, Winnipeg, 2010, Page 4.

Ontario children have less access to regulated childcare spaces than children in Manitoba, Quebec, Nova Scotia and Newfoundland.

% OF CHILDREN UNDER 5 FOR WHOM THERE EXISTS A REGULATED CHILDCARE SPACE

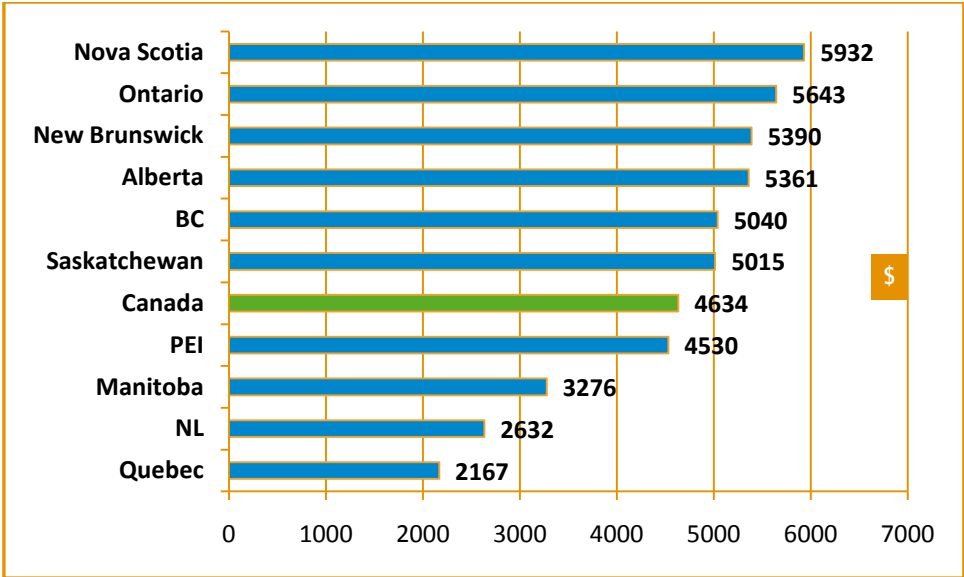


Provincial and National Average of regulated childcare spaces in existence for every 100 children of pre-school age

Source: [Childcare Research and Resource Unit, 2009](#)

Young adults from Ontario pay more for their undergraduate education than similarly situated people in all receiving provinces except Nova Scotia.

AVERAGE ANNUAL UNDERGRADUATE TUITION (\$)

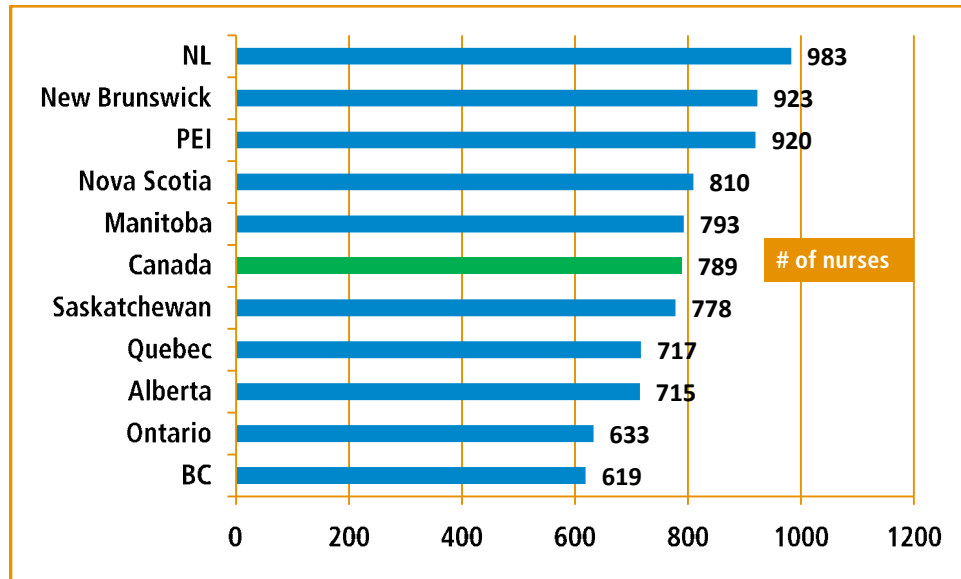


The average tuition payments for full-time undergraduate students in each province is a useful metric to compare the level of a politically popular government subsidies in the have and have-not provinces.

Source: [University of Calgary: Office of Institutional Analysis, 2009](#)

People with illnesses in Ontario are supported by far fewer nurses than in all other provinces except British Columbia and by fewer physicians than in most recipient jurisdictions.

REGISTERED NURSES PER 100,000 PEOPLE

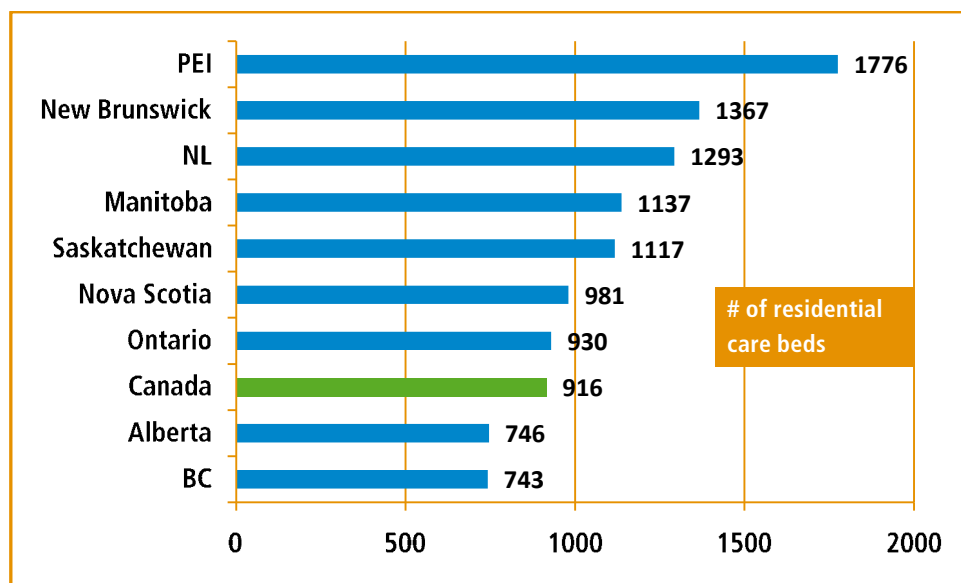


The number of registered nurses per 100,000 population is a useful measure of the availability of healthcare services and hospital capacity, and it is an indicator of the availability of healthcare resources in the provinces.

Source: Canadian Institute for Health Information, 2008

Ontario seniors have less access to residential care beds than the citizens of all recipient provinces. In some cases, access is 50 percent less than in other provinces. Prince Edward Island, a recipient jurisdiction, has nearly twice the number of residential care beds as Ontario in relation to population.

RESIDENTIAL CARE BEDS FOR 100,000 PEOPLE



This indicator suggests the existence of greater financial resources within the healthcare systems of the have-not provinces, provided in large measure by the have provinces of British Columbia, Alberta, Saskatchewan, Newfoundland and Ontario (in most years).

Source: Statistics Canada, 2009

From birth to death, Ontario citizens are the most disadvantaged Canadians in relation to provincial government programming. Albertans are disadvantaged as well through reduced accessibility to provincial programs in Alberta, but this is also related to relatively low levels of provincial taxation in that province. The level of taxation imposed by any provincial government on its citizens has a significant impact on the level of services available in those provinces.

This is all the more unreasonable when one considers the large immigrant populations in Ontario, British Columbia and urban Alberta that really need support. Immigrants should not be locked into a system where they provide disproportionate support to the long established parts of the country, which ideally could be self supporting.

PREVENTING GROWTH IN RECIPIENT PROVINCES

Successive Ontario governments and the people of Ontario generally think they are being helpful to the citizens of receiving jurisdictions by enabling regional subsidies. In the medium and long term, the evidence is that they have done and continue to do great harm. In words often used by the Atlantic Institute for Market Studies on the subject of equalization and federal transfers, this is the “help that hurts.”

Over the years, a substantial body of research has demonstrated that massive federal regional subsidies have greatly hindered economic growth in recipient provinces.

The argument is that the transfers have encouraged the growth of large and inefficient public sectors which dominate recipient economies, have discouraged labour mobility, an essential feature of efficient labour markets and have elevated wage rates to levels that cannot be supported in the market component of the economy.

In 2000, Fred McMahon described this in a seminal book on the endemic growth problems of Atlantic Canada. He noted that: “Regional development policies in Atlantic Canada inflated wages, dampened investment, politicized the economy, weakened business activity, discouraged educational achievement and froze in place declining economic activities. It also likely had an effect on the regional psyche. People came to expect government to support them.”⁴

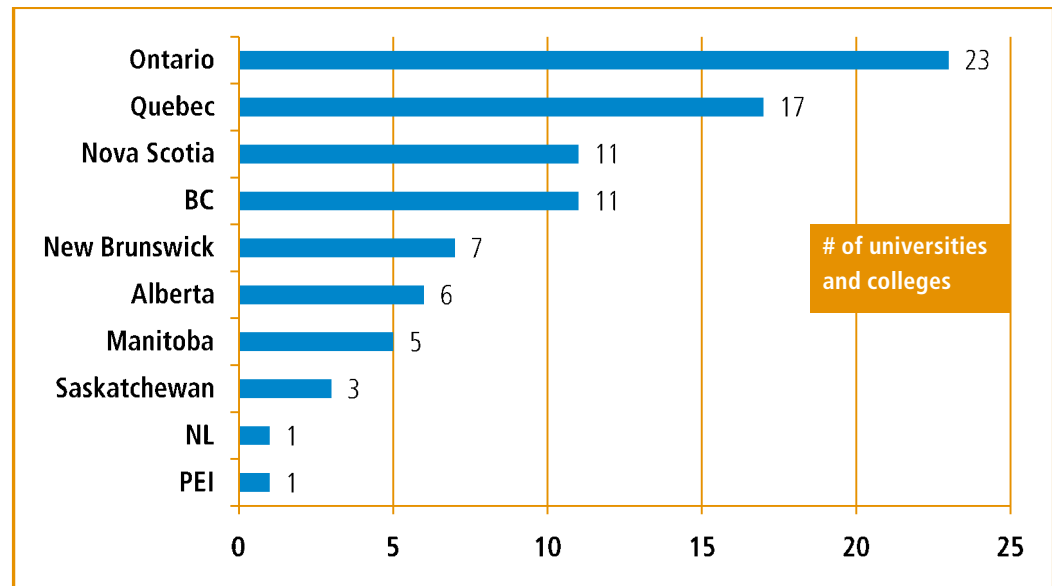
The same policies are in place in Manitoba and Quebec. The relatively slow growth of both provinces and their static position relative to Ontario, British Columbia and Alberta over several decades indicates that to some degree, regional subsidies have the same dampening effects on their economic performances as in Atlantic Canada.

At present, the economic performance of all recipient provinces is very troubling. After 50 years of massive subsidies, their performance in Canadian rankings of relative income performance has changed little, except for Newfoundland and Labrador as a result of offshore oil. While rankings have not changed, personal income gaps among provinces have narrowed, in significant measure due to the scale of regional subsidies provided to the people of traditional receiving provinces.

To a remarkable degree, traditional recipient jurisdictions are public sector driven. Most have public sectors that are about 50 percent of economic output and in one it is nearly 70 percent. In several of them, one in four labour market participants are employed in the public sector.

The public sectors in most traditional recipient jurisdictions are inefficiently organized as well as excessive in their scale. Manitoba has more than 50 hospitals, Nova Scotia has 32 and P.E.I. has eight. Using the standards evident in the rest of North America, each province would have significantly less than half their present number. Ontario, with a population six times the combined population of these three provinces and geography every bit as complex as theirs, has 211 public hospital sites and seven private hospitals that receive government funding. The same pattern is evident in other sectors. Atlantic Canada, for example, has 16 universities for a population of two million. Ontario, with 13 million residents, has 21 including the Royal Military College of Canada, an institution funded by the federal government.

NUMBER OF UNIVERSITIES AND COLLEGES BY PROVINCE



Source: Council of Ontario Universities, 2009

The combination of relatively small private sectors and excessive and inefficient public sectors means that traditional recipient jurisdictions have little or no chance of improving their performance in a market driven world as long as the regional subsidies that have enabled these circumstances are in place. Among other things, this means that other Canadians, particularly Ontarians, British Columbians and Albertans, will be supporting them indefinitely unless there are fundamental changes in federal policy.

REGIONAL SUBSIDIES ARE A PRINCIPAL CAUSE OF CANADA'S POOR PRODUCTIVITY

For many years, Canada's productivity performance has been weak. The weakness has not been understood.

Kevin Lynch, a former Clerk of the Privy Council expressed this clearly in a recent article in the Globe and Mail. Mr. Lynch noted: "The facts of Canada's poor productivity performance are well established, but not well known or understood. Unlike a fiscal deficit or unemployment or inflation, productivity cannot be measured directly. Unobservable it may be, unimportant it is not."

Mr Lynch then laid much of the responsibility for Canada's poor productivity at the door of the business community. In his view, "Canadian business has less capacity to be receptive to innovation, and less of a focus on innovation as part of integrated business strategy in Canada."⁵

And while governments have taken steps to deal with it over the years, Canada's poor productivity performance has never been more evident. According to Statistics Canada, the gap in labour productivity growth favourable to the United States widened during the past decade. From 2000-2006, annual labour productivity growth was 1.9 percent points lower in Canada.⁶

Productivity is, of course, a most complex concept and productivity levels are reflective of many factors including education, scale, labour force configuration, the capacity for entrepreneurship, industrial innovation, and the state and age of the capital base. The Institute for Competitiveness and Prosperity has examined the problem over several years and has reported on each aspect of it.

Productivity must be examined as a cumulative concept. Productivity in any given year is affected by all relevant developments from previous years. And, like compound interest, relatively minor differences in productivity performance in any given year become huge if prolonged over many years.

In every year for the past 50 years, the federal government has engaged in massive transfers from high productivity jurisdictions (currently between \$40 billion and \$50 billion annually) to jurisdictions with lower productivity, with Ontario, British Columbia and Alberta being the principal funding provinces.

From this perspective, the origins of the Canadian productivity problem can be readily explained. One of the principal causes is the federal practice of actively punishing productivity and rewarding inefficiency and doing so on a large scale through regional subsidies. The problem is as much the permanent nature of Canada's regional subsidies as their absolute amount in any given time period. Equalization has been in place for 52 years and the other three methods Canada uses to subsidize regions have been in place for several decades as well.

The result is that in every year for the past 50 years, the federal government has engaged in massive transfers from high productivity jurisdictions (currently between \$40 billion and \$50 billion annually) to jurisdictions with lower productivity, with Ontario, British Columbia and Alberta being the principal funding provinces.

Regional subsidies absorb about five percent of the combined output of Ontario and Alberta, a remarkably high figure and a burden that is comparable to the burden of defence on American taxpayers.

Some Canadian policy analysts have argued that defence spending in the US is a form of backdoor equalization in the United States. But Fred McMahon in *Road to Growth* has examined this in some detail and concludes that "nothing about federal spending patterns, particularly military spending patterns, can be interpreted as a regional programme by stealth in the United States."⁷

The likelihood is that the scale of this shift from high productivity to low productivity jurisdictions would reduce productivity gains by at least one or two percent per year relative to levels that would otherwise be attainable. Compounded over decades, this is likely sufficient to make regional subsidies the root cause of productivity growth in Canada that is far below performance levels achieved by the United States and some other countries.⁸

Over 50 years, regional subsidies have dramatically impacted the vibrancy that used to characterize Ontario's economy. Less vibrant educational institutions, outdated infrastructure and chronic public sector under-investment – all of which are evident in Ontario - would all contribute to less vibrancy and less productivity in the business community and in every sector and corner of the economy. All have been increasingly evident for 30 years or more.

Simply put, Ontario gives too much and gets too little.

6 The Canadian Productivity Accounts: Data 1961 to 2006

7 For a full discussion of the defence spending issue, see Fred McMahon, *Road to Growth*, Halifax, 2000. Pages 146 -148.

8 See *Provincial Labour Productivity Growth, 1997-2005* by Guy Gellally. This is a Statistics Canada research paper incorporating an extensive statistical review of provincial productivity trends.

This situation has happened gradually, but the situation is real.

Brian Crowley, President of the MacDonald-Laurier Institute and a former Visiting Assistant Deputy Minister of Finance in Ottawa, recently captured the essential elements of this process in remarks to senior public officials in Ottawa. He noted that “inter-regional transfers such as equalization and regionally-enhanced EI benefits are entrenching low-productivity performance in recipient regions while driving up costs in high productivity regions.”⁹

In summary, it is probable that the answer to the productivity challenge has long been evident. It is a regional subsidy system that punishes productivity, rewards inefficiency, does so on a massive scale and is difficult to change. It is one of the largest systems of its kind in the world. It is so large that it almost certainly outweighs all other steps taken by the federal government to improve Canada’s productivity performance.

Why has this happened?

An outside observer might well wonder how a problem as serious as the regional subsidy issue could have developed for so long in a G8 country, with such an advanced economy. There are several explanations.

First, the Government of Canada seemingly has not examined the economic impact of regional subsidies on Canada, recipient provinces or contributing provinces. There is no quantifiable data that clearly demonstrates the impact of regional subsidies on growth, consumer spending, productivity, investment or any other important Canadian or provincial economic variable.

Any studies that have been done, such as the recent federal study on needs based equalization, are not known to most legislators and have not generally been made public. Economic impact was not included in the terms of reference of publicly available studies that bear on the regional subsidy system such as the 2006 Report of the Expert Panel on Equalization.¹⁰

Second, large parts of the regional subsidy effort are built into regular federal programming through discriminatory provisions which prevent similarly situated Canadians in different parts of the country from being treated in similar ways.

Canada charges rental fees to Ontario’s Pearson International Airport that are two thirds of all rentals charged to airports across Canada, but Pearson accounts for only a third of the passenger load.

Inter-regional transfers such as equalization and regionally-enhanced EI benefits are entrenching low-productivity performance in recipient regions while driving up costs in high productivity regions.

Canadians living in Ontario are treated much less generously in the Employment Insurance (EI) program than similarly situated Canadians that live elsewhere.

Third, some of the largest components of the regional subsidy effort are not on the radar screen at all. One of these is using the location of federal offices as a form of regional subsidy rather than locating them near the customers they serve, or in a central location.

The statistics on this type of stealth equalization are remarkable. Nova Scotia has half again as many federal public servants in the general category as does Ontario (in relation to population) and more than twice as many as Alberta. Prince Edward Island has more than three times as many as Alberta, again in relation to population, and twice as many as Ontario. Similar imbalances are evident for all traditional recipient jurisdictions except Quebec.

9 Brian Crowley, Remarks to Federal Provincial Relations Division, page 3.

10 The Terms of Reference are included in the report Achieving a National Purpose, report of the Expert Panel on Equalization and Territorial Formula Financing, May, 2006.

This is especially remarkable because the national capital is in Ontario.

The economic impact of this form of regional subsidy is likely to be very large indeed.

The Frontier Centre for Public Policy in Winnipeg has examined this issue as detailed in its November 2010 report, *Stealth Equalization: How Federal Government Employment Acts as a Regional Subsidy in Canada*.

The report indicates that subsidies provided by federal government employment in particular provinces are well above the average employment levels necessary to ensure equal access to services across Canada and are a large fraction of equalization itself.

In Nova Scotia, stealth equalization relating to federal employment is about two thirds of that province's formal equalization entitlement. In Prince Edward Island, the corresponding figure would be approximately 50 percent of that province's equalization receipts.

The Government of Canada is providing regions with micro security while putting the country at macro risk through diminished productivity, increasing dependency on subsidies, and political alienation.

There are different types of stealth equalization, as noted, but this may be the most important because of its size and its hidden nature.

Successive Ontario governments must share a portion of the responsibility for the general lack of awareness that

surrounds Canada's regional subsidy arrangements, including those that are hidden from public view and never debated in parliament or elsewhere.

Like the federal government, the Ontario government has demonstrated little interest in understanding the impact of regional subsidies on Ontario. Successive provincial and federal governments cannot, with any quantitative precision, advise the Ontario public on the economic impact of regional subsidies on consumption, investment, productivity or, indeed, any other economic variable of interest to the people of the province.

Ontario governments have also shown no interest in how regional subsidies, half of which are paid for by the province's taxpayers, are used. Even more seriously, they have never acknowledged the possibility that these subsidies may have done great harm to others, as noted earlier.

Finally, no Ontario government has ever been candid about the extent to which access to the province's public services have fallen behind other leading Canadian and American jurisdictions. Data on this vital issue has never been reported by successive Ontario Ministers of Finance and is rarely noticed by Ontarians until they travel elsewhere in Canada.

The most serious issues attached to this 'information deficit' will be familiar to any business practitioner.

The first issue is cumulative impact. Public debate focuses on equalization but it is the sum total of all regional subsidy arrangements that is most important. When one considers the total regional subsidy effort, it is apparent that the economies of several provinces are to a large extent based on subsidy arrangements that are not transparent and that are the main determinants of overall economic activity in those provinces.

This leads to an entirely artificial sense of well being and economic comfort that is not supported by market driven economic activity in those provinces. Second, there is no meaningful measurement of the aggregate of all regional subsidies – the four principal ways they are delivered – which makes it difficult for the federal government to manage the outcomes effectively. It is a long standing business principle that it is very difficult, and often impossible, to manage forces and circumstances that are not measured.

In summary, the Government of Canada is providing regions with micro security while putting the country at macro risk through diminished productivity, increasing dependency on subsidies, and the political alienation which will inevitably flow from these policies as Ontario's relative position in Canada deteriorates and as it struggles to compete in the global environment.

THE PROBLEM IS INTRACTABLE

In economic and financial terms, the problems summarized earlier are intractable.

Broadly speaking traditional recipient jurisdictions have the following characteristics:

- **a combination of excessive public sectors and relatively small private sectors:** Barring great good fortune, such as offshore oil in Newfoundland and Labrador, the performance of recipient jurisdictions relative to other provinces and indeed the world around them cannot be expected to improve because of this combination. Indeed, with the exception of Newfoundland and Labrador, the performance of recipients relative to contributors has changed little in 30 years;
- **excessive expectations by citizens of what government should do for them:** The scale of government in Manitoba, Quebec and Atlantic Canada is relatively excessive, leading to two generations which have grown to maturity with these expectations, making them very deeply entrenched;
- **high debt levels:** The gross public debt levels of Manitoba, Quebec, New Brunswick, Nova Scotia, P.E.I. and Newfoundland and Labrador range from about 25 percent of GPP to 50 percent, with Quebec's ratio the highest. These ratios can be expected to deteriorate seriously in future years which will increase pressure for support, via the federal government, from taxpayers in Ontario and elsewhere who are grappling with their own provincial debt problems;¹¹
- **in some cases, active cultures of resentment against contributing jurisdictions:** citizens of Alberta and Ontario should not imagine for a moment that their past contributions to receiving jurisdictions have bought them any goodwill.

The problem is intractable politically as well:

- the lack of understanding of the regional subsidy system, by federal political leaders - particularly those from Ontario - is routinely evident. In addition, the subject is never debated in the House of Commons, which leads one to infer there is a lack of political will to debate the issue;
- the culture of entitlement makes it very difficult for leaders in recipient jurisdictions who recognize the need for change to address the subsidy issues. Recent commentary on the appropriateness and constitutional legality of Canada's transfer arrangements by Quebec MP Maxine Bernier, a former federal Minister, is a welcome attempt to generate more public debate on this issue. Aside from the efforts of two think tanks in Atlantic Canada and Manitoba, recognition of the problems associated with regional subsidies is very limited in recipient provinces;¹²

Finally, Canadians have embraced minority governments for several years and the prospects for change are not yet in evidence. This makes fundamental change of any kind very difficult.

11 The Quebec Government's Debt, Quebec Ministry of Finance, Quebec City, 2010. This document incorporates a comparative analysis of provincial debt by province.

12 Maxine Bernier, Speech to the Albany Club, Toronto, October 13, 2010.

CONCLUSION

Arguing for change in Canada's fiscal arrangements, especially from an Ontario perspective, is difficult.

Ontario public policy has historically been rooted in a 'Canada-first' mentality. However, public opinion in Ontario, while it is changing quickly in relation to the federal government, is not sufficiently engaged on fiscal arrangements, even though, for the reasons noted above, current Canadian fiscal arrangements are arguably the largest single threat to the economic future of the 13 million people living in the province.¹³

Second, those who are unsympathetic to the Ontario point of view will find it easier to deal with it as a matter of national unity than to respond with financial and economic arguments.

Third, mythology plays a large part in the problem and will continue to do so. Many people in the rest of Canada have been nurtured on the idea that the National Policy of our first federal governments did great damage to others and made Ontario rich. Regardless of the merits of this argument – and there is real doubt about its merits – many people believe it and feel it justifies the present burdens placed on Ontario.

People who advance this argument ignore the long history of tariff reduction agreements beginning at the end of the Second World War and continuing to the free trade agreement of the 1980s. Each of these has lessened the validity, if there was any, of the original national policy argument.

It is also worth noting that in the last 65 years, China has emerged from civil war to prosper and Japan has emerged from total destruction in 1945 to do the same. Viewed from the perspective of these experiences, invoking the national policy of the first 80 years of Canada's history as justification for current arrangements is unreasonable.

Fortunately, voices are emerging which could change the direction of the policy misadventures noted in this paper. The Mowat Centre for Policy Innovation and the Ontario Institute for Public Policy have commenced operations.

In a recent column, Senator Hugh Segal noted that major federal/provincial transfer agreements lapse in the next three years. He noted the fundamental significance of these arrangements and indicates that they should be addressed on the basis of broad public debate and discussion. In his words, "domestic policy development has never faced a more compelling chance for a new beginning."¹⁴

Implied in Senator Segal's comments is recognition that new or replacement agreements, because of the hundreds of billions that are involved, will in significant measure define the policies of the future for all Canadian governments and all Canadians.

The Ontario Chamber of Commerce recognizes the difficulties legislators face as debate on transfer arrangements gets underway. Each federal party is a fragile coalition and the sensitivity of this issue, if it is not handled wisely, could fracture those coalitions and inflame opinion in particular regions or provinces. It is particularly important to engage public opinion in Quebec.

On the other hand, the Chamber recognizes that continuation of present arrangements means that Canada will not be competitive in the world; alienation in Ontario, B.C. and Alberta will grow; and the 21st Century, which should be one of profound achievement for Canada, will pass it by.

The Ontario Government should also recognize that fear of change and the consequent reluctance to engage in very difficult discussions with partners and the Canadian public poses the greatest possible risk to all of Canada because the underperformance caused by the present system means an underperforming Canada and increased political tension as Ontario's relative position continues to deteriorate.

13 J. Scott Matthews and Matthew Mendelsohn, *The New Ontario: the Shifting Attitudes of Ontarians toward the Federation*. Mowat Note, Mowat Centre for Policy Innovation, 2010.

14 If we let Partisanship Steer Us, We're in for a Train Wreck, *The Globe and Mail*, Toronto, August 12, 2010.

Discussion of all the issues described in this paper is urgently needed and the Ontario Chamber of Commerce will work with other organizations in all parts of the community to ensure that the needed debate and discussion takes place and that business, labour and community organizations have an opportunity to contribute to it.

For all these reasons, the Chamber recommends that the next generation of transfer agreements incorporate a strategy to replace current regional subsidy arrangements with agreements that raise the level of accountability, so ideally the level of government that raises tax revenues is the level of government that spends those tax dollars.

We recognize that the transition phase will take a minimum of five years.

RECOMMENDATIONS

The Chamber has three sets of recommendations: one for both the Ontario and federal governments and a separate set for each:

1 - THE ONTARIO AND FEDERAL GOVERNMENTS SHOULD RECOGNIZE:

- that the period leading up to 2015 when all principal fiscal arrangements must be discussed or renegotiated is an opportunity to renew Canada's fiscal architecture for a century which will be much different from the decades over which the current system evolved;
- that a full and transparent national debate and discussion is essential to the renewal process because fiscal arrangements underpin virtually all areas of public policy;
- that the currency of a national discussion is good information on current and possible future arrangements, including the regional subsidy system and that both levels of government need to make all elements of the regional subsidy system transparent. They also need to ensure that information about it is consumer friendly and accessible to all Canadians;
- that the community of think tanks and policy analysts be full participants in the national debate. This is not a discussion for political leaders and civil servants alone and, indeed, independent commentary and analysis is vital;
- that the process of renegotiation, if it is real, would lead to significant change for some regions. While no region can be insulated from change, appropriate and time limited arrangements should be identified to make change as manageable as possible;
- that regional subsidies are not the only area where Canada's fiscal architecture needs fundamental renewal. Employers and all Canadians would like to ensure that renewal of the Canada health and social transfers incorporates measures to ensure that both health and social security systems are sustainable going forward;
- that if there is to be an equalization program in future, then equalization should be limited to that program alone, without any other mechanism that favours any particular region or particular groups of Canadians defined by where they live.

2 - THE ONTARIO GOVERNMENT SHOULD:

- propose a different equalization system where both fiscal capacity and population need are given equal weight. Australia operates such a system. This should be studied carefully and adapted for Canadian use;
- ask a consortium of academic and policy research organizations to analyze the impact of current regional subsidies on Ontario. The study should assess the impact of the current system on investment, productivity, consumption, personal income, provincial revenues and all types of public institutions and it should do so in quantitative terms. This study should be completed within a year and should be seen as essential preparation for the negotiation of new arrangements;
- eliminate its defunct fairness program but engage Ontarians in a new discussion based on opportunities for change in future and capacity rather than fairness. Fairness is in the eye of the beholder; the capacity to compete and realize future opportunities is not;
- report on the accessibility of provincial programs in Ontario compared with other Canadian provinces and U.S. states as an essential part of each budget and economic update. This is essential information for an informed public and it is currently completely lacking in the Ontario budget process;

- dramatically expand the resources it devotes to research and analysis on regional subsidy and other fiscal arrangements. These are the first order of business for other provincial governments and they should have the same importance, weight and allocation of resources in Ontario during the next four years as new fiscal arrangements are discussed, negotiated and put in place.
- produce a discussion paper on the possibilities of transferring revenues from the federal portion of the Harmonized Sales Tax to provinces, in return for an end to traditional transfer payments. Many commentators have suggested this approach and consequently it merits detailed public discussion based on the best information possible.

3 - THE FEDERAL GOVERNMENT SHOULD:

- study, for the first time, the impact of current regional subsidies on the economies of Canada, recipient jurisdictions and contributors. It should do this with the help of independent organizations and ensure that the resulting reports are available in time for the negotiation process and in a form the public can understand;
- identify and develop time limited transitional arrangements for regions adversely affected by changes to the regional subsidy system;
- outline a process, including timeframes, for the renegotiation of the principal fiscal arrangements in place over the next four years, including a public component. Public participation will be both inadequate and ill informed unless this is done;
- release the study on needs based equalization;
- ask Statistics Canada, as a priority, to expand its reports on the net fiscal position of each province and to compile an annual report on program accessibility in provinces using currently available data. This would not constitute a federal report on provinces. It would simply be a statistical report, without comment, on accessibility of provincial programming. Without this, the effectiveness of a federal program such as equalization cannot be evaluated because the explicit goal is comparability of programs.

BIOGRAPHICAL NOTE FOR DAVID MACKINNON

Mr. MacKinnon is a frequent commentator on Canadian fiscal issues. He has spoken to audiences across Ontario and his work has appeared in the Globe and Mail, the Toronto Star, the National Post and many local newspapers across Canada. He has also been a guest on The Agenda on TVO, the BNN and other national public affairs programs.

Mr. MacKinnon is a native of Prince Edward Island. He was awarded a Bachelor of Arts degree (honours economics) from Dalhousie University and an MBA from York University. He was also awarded a Centennial Fellowship by the Canadian Imperial Bank of Commerce and York University to study at York, Harvard and Oxford Universities as well as the European Institute of Business Studies.

Mr. MacKinnon served as Director, Planning and Economics and Executive Director, Development Strategy in the Nova Scotia Department of Development from 1977 to 1981. He later served in several senior capacities in the Ontario Ministry of Finance, the Bank of Montreal and as CEO of the Ontario Hospital Association from 1996 to 2003.

He currently serves as Chair, West Park Healthcare Center, a Toronto rehabilitation hospital and as a Director and Chair of the Finance committee at the Canadian Standards Association.

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