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# CANADA SHOULD FIX EQUALIZATION AND OTHER REGIONAL SUBSIDIES NOW

BY DAVID MACKINNON, MARCO NAVARRO-GÉNIE,  
AND PETER HOLLE



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AIMS is a distinctive Atlantic Canadian voice on public policy regionally, nationally and internationally. We set the benchmark on public policy by drawing together the freshest most forward looking thinking available from some of the world's foremost experts and applying that thinking to the challenges we face.

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## EXECUTIVE SUMMARY

Canadians who value the democratic process should be concerned about the recent federal announcement that equalization will continue unchanged until 2024.

The federal government buried its decision in a 556-page omnibus bill. The only reason an important announcement relating to a \$20B program would be made public in this way is to ensure that no public debate on it takes place.

The Frontier Centre for Public Policy and the Atlantic Institute for Market Studies reject this approach. Both have contributed for many years to discussions on equalization and other regional subsidies. Both will continue to contribute in this way and suggest that the federal decision be revisited so that the provinces and the public may enter into what should be a public discussion.

This paper is an expression of our continuing interest.

The fundamental objection to equalization and equalization-type provisions in many federal programs is that they are entirely counterproductive. They do exactly the opposite of what legislators intended for them to do.

Equalization and similar provisions fund programming in recipient provinces that is more generous than in those provinces whose citizens are net contributors to them. They also subsidize gross expenditure excesses in recipient provinces. They impair national competitiveness by providing large subsidies to provinces whose productivity is below the national average.

We propose that equalization and other regional subsidies be reformed and modernized to correct these problems without impairing national unity.

Key among the many measures we propose is that half of all current equalization funding be redirected to restructuring grossly oversized public sectors in most recipient jurisdictions.

We propose that the program and its outcomes be evaluated for the first time in its existence, according to stated intentions. In an age of science and information, it is crucial that such a large state program be measured against hoped-for results.

We also propose that equalization be made conditional. For example, it should not be made available to any province that prohibits resource development projects that are underway in an environmentally sensitive manner in other jurisdictions.

We think that reform of a system that is doing fundamental damage to Canada is particularly important at this time.

Canada's relationship with the United States has changed and the pace of technological change has greatly quickened. Complacency about fixing half-century-old programming that is obsolete is no longer an option.

## PURPOSES

The purposes of this presentation are to offer an evidence-based analysis of what has gone wrong in Canada's lagging regions and to propose new steps that could be taken in relation to equalization and other regional subsidies without provoking unmanageable national unity problems.

The authors recognize that the recent federal decision to extend equalization until 2024 greatly complicates reform efforts. The future of equalization has been debated for many years and discussions about it have intensified in recent months and weeks. Cutting this discussion short, particularly when there have been no legislative committee hearings related to it, is not in the national interest and impedes the democratic process. Equalization is a \$20B program and for that reason its renewal by an obscure provision in an omnibus document is especially inappropriate.

## ECONOMIC ISSUES

Fifty years of large subsidies for lagging regions have not achieved the results intended. Prince Edward Island, Quebec, Nova Scotia, New Brunswick and Newfoundland and Labrador are all growing more slowly than the other provinces and all American states. Median net worth in most of these provinces is also increasing at a slower rate than in others.

Gross domestic product (GDP) per person has likewise been growing more slowly in these provinces as well as in Manitoba, and in recent years has been negative in Newfoundland and Labrador. A wide variety of other indicators display similar patterns.

Many of these problems originate in the public sectors of the lagging provinces. Public-sector employment as a share of the total employment in Newfoundland and Labrador is 50 percent higher than in Ontario and Quebec. Manitoba and the rest of Atlantic Canada are not far behind.

These patterns result from expenditure excesses. For example, the number of hospitals in Manitoba and Atlantic Canada in relation to population is two to three times the corresponding level in Ontario, with similar patterns evident in most provincial programming in these provinces.

Program delivery costs per capita in each of the lagging provinces except Quebec are higher than in other jurisdictions.

Overall, the public sectors in most of Canada's lagging provinces are relatively larger than in Greece before the financial crisis affected that country a decade ago.

Canada's regional subsidies have caused significant problems for Ontario. In 1991, the province conducted studies of the fiscal gap between Ontario and the rest of Canada. In 1990, that gap was about seven percent of gross provincial product (GPP) at the peak of a major recession.

Since 1990, Ontario has contributed several hundred billion dollars to the rest of the country. The province's net fiscal deficit with the rest of

Canada declined slowly over most of this period, reaching a low of \$4.1B in 2010. It has since nearly doubled to \$7.7B in 2015. Ontario's net fiscal deficit with Canada over the past 50 years almost certainly exceeds Ontario's total public debt.

In recent years, Alberta has faced even more serious problems with Canada's fiscal arrangements. The province's net fiscal gap with the rest of Canada increased from \$20.5B in 2010 to \$23.9B in 2015. In the latter year, Alberta's net fiscal deficit was about seven percent of total provincial output, a burden substantially greater than the burden of defence for the people of the United States. In 2015, U.S. defence spending was 4.5 percent of gross national product (GNP).

The federal government has never studied the economic impact of the fiscal deficits Alberta and Ontario have experienced because of equalization.

Over the years, nearly every independent think tank in Canada has noted these problems. Occasionally, they have attracted attention in some provinces. They were the focus of the Fairness campaign initiated by the Ontario government which took office in 2003. They are also the subject of current suggestions for a referendum on equalization in Alberta. The national media have reported extensively on them.

Many of these observers are puzzled why the federal government has not updated or modernized equalization, except in modest ways, for over 50 years. In the words of former Finance minister Joe Oliver, the program is beyond its best-before date.

Since the problems of Canada's lagging jurisdictions have persisted for more than 50 years, the economic problems of lagging jurisdictions cannot be attributed to either commodity or business cycles alone. The causes are almost certainly related to governance, particularly the federal government's role, and a general failure to adapt sufficiently to technological change and globalization.

The federal role merits close attention. The federal regional subsidy system is large and extends well beyond equalization. The government transfers several thousand dollars per person per year to lagging regions from contributing jurisdictions—that is, those provinces whose citizens pay in more to support equalization and other subsidies to regions than their governments or citizens receive. The scale of this system is unusually large among developed Western countries, most of which avoid regional subsidies except when they directly arise from program structures.

## PROGRAM ADMINISTRATION AND DESIGN ISSUES

Aside from its unusual scale, there are other problems associated with the system.

The first problem is that the largest component, equalization, is not measured against its goal of comparability of provincial programs across Canada. This is because the federal government has no system in place to measure such comparability.

Most of the available data about provincial programming suggest that it is significantly more accessible in the recipient jurisdictions than it is in provinces where taxpayers make a net contribution to the system.

In practice, the lack of evaluation metrics in this vital area means that equalization and the regional subsidy system are doing exactly the opposite of what legislators intended without Parliament having any serious understanding of that circumstance.

The second problem is that all the receiving provinces have lower productivity than others. In effect, the system subsidizes relatively weak productivity on a very large scale which has negatively affected Canada's competitiveness for more than 50 years. Unfortunately, the federal government has never studied the impact of the regional subsidy system on Canada's competitiveness. This is a problem at a time when many analysts, including prominent business leaders, feel that improving competitiveness is one of Canada's most pressing problems due to global developments and challenges.

The scale of the regional subsidy system and its longevity may also be important contributors to the widening gap between Canadian and U.S. productivity in recent decades. In fact, they could be the principal causes of this problem.

The third problem is that the federal government has never tabulated the regional subsidies that are in place. For example, disproportionate federal employment in Nova Scotia that is above the requirements to serve the population, excluding the

Department of Defence, conveys a subsidy to that province that is roughly equal to equalization.

Employment Insurance (EI) conveys another very large subsidy to all regions east of the Ottawa River. The evidence available to us is that, in addition to this, a wide variety of federal programming ranging from heritage funding to airport ground rentals is biased toward the eastern provinces in ways that program requirements cannot explain. EI for fishers is a particularly offensive example of this, as it is made available to self-employed fishers but not to any other category of self-employed workers.

Unfortunately, nobody really knows how big the regional subsidy system is, which means that it cannot be managed appropriately.

The fourth problem is that the federal government has never studied the economic impact of the regional subsidy system or any of its major component parts in a thoughtful way that would help with public understanding. Economic impact was specifically excluded from the terms of reference for the Expert Panel on Equalization that reported in 2006. This omission is like describing winter without mentioning cold, snow, or global warming.

## BEHAVIOURAL CONSIDERATIONS

The behavioural consequences of providing very substantial funding to recipient jurisdictions are in many ways as important as the financial and programming factors listed above. In addressing this issue, Nobel Prize-winning economist Angus Beaton noted “that if poverty and underdevelopment are primarily consequences of poor institutions, then by weakening those institutions or stunting their growth, large aid flows do exactly the opposite of what they are intended to do”.

The very large scale of equalization and other regional subsidies changes the balance between public and private economic influence in recipient jurisdictions in a very negative way. The private sectors in many recipient jurisdictions have become so dependent on government business or other government decisions that they have lost much of their independence and the business voice is correspondingly weakened.

On the other side of the equation, the very large size of government relative to everything else gives public-sector unions far too much power and leads to some of the excesses previously noted. The current agreement between the government of Newfoundland and Labrador and its major union is an example of just how dangerous these imbalances can be. Even academic researchers are affected by these pressures: many feel that they cannot explore the problems summarized in this note because of the budgetary consequences for their institutions if they do so.

Perhaps the most dangerous of the system’s behavioural impacts is on the population.

The careless delivery of massive subsidies—with no sense that they should ever end and the false commentary from governments that equalization payments are guaranteed in the constitution—has led to many people’s sense of unlimited entitlement for more and a corresponding reluctance on the part of others to change behaviour or move to other regions.

## POSSIBLE CHANGES

So, what should change? How can these problems be addressed in a way that avoids an unmanageable national unity crisis?

If funding for equalization and other subsidy arrangements were reduced, most recipient jurisdictions would initially respond with legislative resolutions opposing change. Political leaders fearful of change can be expected to use national unity as a rallying cry in resisting it.

Accordingly, the first change would be to maintain the funding but use it to address the problems noted above in ways that reflect the circumstances of individual provinces or regions. A second is the imposition of conditions that would determine eligibility for equalization in each recipient jurisdiction.

A major portion of equalization funding could be devoted to restructuring initiatives that bring the scale of provincial public sectors in recipient jurisdictions to the levels evident in net contributing provinces and the Organisation for Economic Co-operation and Development (OECD) over a period of five years. This would be very wrenching, but the problems noted above are so serious that at least some leaders would recognize their merit if the change were initiated at the federal level. Many regional leaders feel that they are on a treadmill as they operate what they know to be unsustainable governments but they do not know how to get off. The federal government should supply the off-ramp.

Using equalization funding as noted above should be mandatory for the Atlantic Provinces and Manitoba. It should be optional for Quebec because that province has avoided many of the structural problems caused by excessive funding in relation to the size of provincial and regional economies that are evident elsewhere. Also, while Quebec receives the largest portion of equalization funding, its overall share of the regional subsidy system does not appear to be as large in relation to its economy as is the case in Atlantic Canada and Manitoba.

Some changes should be made to avoid the behavioural consequences noted earlier.

For example, receipt of any equalization funding should be made partially conditional on agreement by each recipient province that it would not prohibit any resource development that is underway in an environmentally sensitive manner in any other province.

Another portion of equalization funding could go toward detailed exploration of a guaranteed income program for the region and implementation of large-scale pilots. This idea is gaining currency all over the world even though there are many problems with it. Experience elsewhere has proven, however, that individuals do not waste the funds they receive and that something must be done to deal with the large numbers of people likely to be displaced by technological change in the next decade.

The federal government should indicate that the goal of the changes we propose is to improve national productivity by bringing the scale of government—and the program costs associated with it—in Atlantic Canada and Manitoba in line with national and OECD averages within the next five years.

Population need should be factored into equalization calculations so that funding based on need matches funding levels determined now by revenue calculations alone. If this change were implemented over a period of years, there would be time for the two negatively affected provinces to make necessary adjustments. Australia provides an excellent example of how this could be done.

Receipt of equalization funding should also be made conditional on limited or no increases in public debt levels in each province. Newfoundland and Labrador would pass many of the tests for insolvency and the other Atlantic Provinces are facing similar problems that are obscured by the scale of the subsidy arrangements noted earlier.

Limiting new debt is vital for other reasons. The federal government has a clear role in this area because lenders to provinces know that the federal government could never allow a province to default. Consequently, there is an implicit federal guarantee on all provincial debt incurred with all the moral hazard implications associated with it.

## CONCLUSION

In summary, the system of regional subsidies in place in Canada should be seen as a major failing of the federation, not a national success.

The problems associated with it have gone on for so long that there are no easy solutions. However, Canada's future well-being, particularly in the current global environment, depends in part on addressing them with the measures we suggest and possibly others from the long list of recommendations that various commentators have suggested over the years.

As noted earlier, the federal decision to postpone any changes to equalization until 2024 greatly complicates reform efforts. AIMS and the Frontier Centre hope that Finance Minister Bill Morneau will revisit this decision and immediately schedule full discussion of the matter by the Commons Finance Committee. We expect others will join us in making this request.

A failure to consider changes in equalization until 2024 is a major national problem for the reasons outlined in our analysis. As another leader from another time noted when advising against delay on an important matter, "every delay only adds to the length of the journey that will ultimately have to be made".

