by Paul Boothe

IS IT TIME TO REFORM FISCAL TRANSFERS?

Le programme de péréquation fera bientôt l'objet d'une révision quinquennale. L'auteur souhaiterait que l'on profite de l'occasion pour procéder à des modifications majeures du système de transfert fiscal. Le système actuel comporte de graves lacunes en termes d'efficacité, d'équité, de transparence et d'imputabilité. L'auteur propose au gouvernement fédéral qu'il cède aux provinces les points d'impôt sur le revenu des particuliers qui correspondent à l'ampleur réelle des transferts fiscaux. Dans un premier temps, un fonds de réserve inter-provincial serait créé à partir de contributions provinciales determinées de façon à refléter leur situation budgétaire actuelle. Une formule macro-économique simplifiée servirait ensuite à établir les contributions et les retraits. Le gouvernement fédéral agirait comme garant et administrateur du fonds de réserve.

Introduction

Few things make Canadians' eyes glaze over faster than talk of intergovernmental fiscal relations. I doubt that this arcane subject is even on the list of Canadians' concerns, let alone near the top. Yet, fiscal transfers are critically important to a number of the social programs Canadians care deeply about — health care, post-secondary education, and social services. Ottawa and the provinces are now in the midst of their regular five-year review of the centre-piece of the transfer system — Equalization. Should average Canadians be paying attention?

I think they should. In its first mandate, the Liberal government in Ottawa placed the main burden of its deficit-elimination efforts squarely on transfers for health, education and social assistance. From 1994-95 to 1998-99 the Canadian Health and Social Transfer (CHST), which is Ottawa's contribution to these programs, was cut by 35 percent, from $19.3 to $12.5 billion. Total federal program spending excluding the CHST was cut by only seven percent. Equalization emerged relatively unaffected by federal deficit elimination. It was reduced by only one percent over the same period.

This approach to federal deficit elimination was a political triumph and resulted in a second mandate for the Liberals. However, the strategy also had the effect of leaving the provinces angry and divided. Angry, because they felt that they had been targeted for bigger reductions than the federal government was itself willing to take on, even as provinces were struggling to control their own deficits. Divided, because the transfer cuts fell disproportionately on the three provinces not receiving Equalization (BC, Alberta and Ontario) as a result of the inequitable distribution of the CHST.

The federal government now seems to be embarking on a new strategy: using its post-deficit fiscal room to expand spending in areas of provincial jurisdiction. Sometimes this expanded spending is done cooperatively with provinces, as in the case of the Child Tax Benefit. Sometimes it is unilateral, as in the case the Millenium Scholarship Fund — a program that seems designed to force provinces to raise tuition fees at post-secondary institutions.

One wonders whether we will use the opportunity presented by the regular review of Equalization to address some of the growing problems of the transfer system, or whether we will allow these problems to fester until they become critical sometime down the road. In this essay, I argue that the time to act is now, before already serious problems become critical. I begin by briefly outlining some of the problems with the current transfer system. Next, I make the case for a fundamental reform that I believe will restore balance to the transfer system that has served us so well.

What's the problem?

Intergovernmental transfers form the backbone of our federal system of government. Everyone knows that

Canada is the best place in the world to live — just ask the United Nations. So what's the problem? The problem is that our federal system is like any machine — it needs regular maintenance. For at least the past decade, governments in Ottawa have been focused on deficit reduction and these maintenance issues have been ignored. Worse (carrying this analogy further) Ottawa has had to steal some parts (funding) from the federalism machine for other purposes. Now the machine is starting to make ominous noises and wobble and bump rather than run smoothly. The time for a tune up is past due.

Changes to the global economy and technology are also driving the need to renew our transfer system. As Thomas Courchene has pointed out, the growth of north-south trade means that the beneficiaries of Equalization are now more likely to buy their refrigerators in Boston than Toronto. This shift in trading patterns changes the economics of the transfer system profoundly. The second-round benefits of transfers no longer flow back to central Canada — the main contributors to the program. Advances in information technology mean that New Brunswick can now compete with Ireland or India for back-office data processing. Such opportunities, however, require a tax and transfer system that recognizes not just Canadian realities, but also global ones.

Some of the problems with the transfer system are longstanding. Economists have long known that running an intergovernmental system side-by-side with an inter-personal transfer system could result in some perverse redistributions of income. Recent estimates by Finn Poschmann at the C.D. Howe Institute show that the net effect of federal transfers is redistribution, not only between families with similar incomes, but even from lower- to higher-income families in different provinces. All intergovernmental transfer schemes are, to some degree, susceptible to this problem. The question is, how much of it should we tolerate?

One of the main theoretical rationales for intergovernmental transfers is that they allow improved government services in poorer regions which, in turn, inhibits economically inefficient migration in search of lower taxes and better public services. However, the empirical evidence suggests that transfers have actually had the opposite effect. Thomas Courchene has long argued that poorly-designed transfer programs trap Canadians in poorer provinces in a cycle of dependency. New evidence gathered by Serge Coulombe and Kathleen Day seems to confirm this view.

Coulombe and Day compared income per capita, output per capita and output per worker for Canadian provinces and the 12 US border states over time. They found that inter-jurisdictional disparities in the US converged much faster than in Canada. The US also attained a lower level of dispersion. Delving deeper, they discovered that that the problem for poorer Canadian provinces is not the productivity of their employed workers, but rather, that unemployed residents are less willing to migrate to find work. These findings are fully consistent with an earlier body of empirical work on the effects of transfers (especially unemployment insurance) on migration.

The current transfer scheme not only has equity and efficiency problems, but it also has a negative impact on how our federal system of government works. The design of the current scheme does much to reduce the transparency of government programs and blur the lines of accountability for provincial and federal politicians. Like many federations, Canada has mechanisms to deal with two kinds of fiscal imbalances — vertical and horizontal. Vertical fiscal imbalance (VFI) occurs when one level of government (typically the central government) raises more revenue than required for its own spending needs, and the other level of government (the regional governments) raises less than is required for its spending needs. To redress this imbalance, the Canadian federal government makes transfers to all provinces, for example the CHST.

Future entitlements should be based on a macro formula using provincial deviations from national average adjusted personal income.

Horizontal fiscal imbalances (HFI) occur when some provinces have access to more revenue than other provinces. The federal government formally redresses this imbalance through the Equalization program, but also informally through a host of other transfers including CHST and parts of EI.

Where do transparency and accountability fit in? Because everyone pays federal taxes, a good deal of the money transferred from the federal government to provinces actually comes from residents of the particular province receiving the transfer. Therefore, both transparency and accountability could be enhanced by letting the provinces themselves collect the portion of current federal transfers paid by their own residents. It would be much easier for voters/taxpayers to judge the value of a program (and whom to hold responsible) if, to the extent possible, the government spending the money also had to raise the taxes.

In addition, under the current system, HFI is dealt with both in the formal Equalization program and in ad hoc ways in other programs such as CHST and the regionally-sensitive portion of EI. Under the current system it is almost impossible for taxpayers in any province to know how much the federal government is spending on programs for income redistribution and how much is being contributed to help provide social programs.

Finally, the calculation of transfer payments is so complicated that only a handful of people in the country understand how the programs actually work. One wonders if our federal system would work better if voters/taxpayers actually understood it or if, like quantum mechanics, it is simply beyond the grasp of ordinary mortals.

A proposal for fundamental reform

Gradual is the speed at which Canadians generally like to change their national institutions. In the current review of Equalization, there will be no shortage of people suggesting that the time is not right for transfer reform, or that at best we can only cope with small, incremental changes. However, even if only incremental change is in the cards, it is useful to have a clear sense of where we ultimately want to go before starting out. In this section, I will briefly sketch out a proposal for fundamental reform of our transfer system to deal with some of the problems outlined above.

The proposal is based on ongoing work with my colleague, Derek Hermanutz. Our approach has four main elements:

1) Eliminate VFI by transferring from the federal government to the provinces personal income tax (PIT) points equal in value to the current size of federal transfers for Equalization, CHST, and the regionally sensitive portion of EI. This transfer of tax points plus the elimination of the corresponding transfers leaves the federal surplus/deficit position unchanged. Provinces would have more revenue from their own taxes and no federal transfers.

2) Because the distribution of extra tax PIT revenue would not be the same as federal transfers, some provinces would gain net revenue and some would lose. Thus, the next element of the proposal is the creation of an interprovincial revenue pool where provinces contribute or withdraw from the pool exactly the amount needed to leave their surplus/deficit position unchanged.

3) Determine future contributions and withdrawals from the fund based on a macro formula using provincial deviations from national average adjusted personal income.

4) Define a new role for the federal government as guarantor and administrator of the pool, with appropriate mechanisms to ensure its longevity and stability.

How does this proposal deal with the problems inherent in the current scheme? Because it leaves all governments' surplus/deficit positions unchanged at the outset, our approach recognizes the current implicit political bargain between the federal and provincial governments. Thus, the real benefits come from improving the incentives inherent in the transfer system rather than trying to save money at some provinces' expense. For example, eliminating the regionally-sensitive portion of EI, while including the associated dollar amounts in PIT points transferred to provinces should act to reduce existing barriers to workers moving to find jobs, while giving provinces resources to invest in workers' human capital. The proposal also promises improvements on the equity front. Poschmann's findings suggest that the scale of perverse interpersonal transfers is proportional to the overall size of intergovernmental transfers. Thus perverse interpersonal transfers should be smaller because the overall level of intergovernmental transfers is smaller when provinces collect more of their own revenue.

Transparency and accountability should be substantially enhanced under the new approach. As provinces collect directly more of the revenue they spend on programs, voters/taxpayers will be better equipped to judge whether they are getting value for their tax dollar, and how well or poorly provincial governments are doing their jobs. With a simple macro formula replacing the complex calculations currently required for Equalization and CHST, citizens should see more clearly the sharing that stands at the heart of our federal system.

> **Transparency and accountability could be enhanced by letting the provinces themselves collect the portion of current federal transfers paid by their own residents.**

Finally, what about the federal role? Clearly, we are proposing that the federal government transform itself from the paymaster of Confederation to something quite different. The federal government could continue to collect income taxes on behalf of the provinces, and oversee the contributions to, and withdrawals from, the pool. As part of setting up the pool, provinces would agree that the federal transfer of tax points was conditional upon participation. If a province chose to withdraw, the federal government would collect the tax and contribute to the pool directly.

Of course, the details and implications of such a reform would need a lot of development and careful consideration, and better ideas may emerge. It would probably take several years to get any new system in place. However, that is no reason to put off getting the reform process started. The machinery of Canadian federalism has served us well and deserves to be looked after. Yes, it is time to start reforming our system of fiscal transfers. So let's get to work.

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