

Implications of the Shifting Fiscal and Economic Position of Ontario within the Canadian Economic Union

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The 2009 Federal Budget: Challenge, Response and Retrospect
Conference organized by the John Deutsch Institute, Queen's University, May 7-8, 2009

Introduction

- Although fiscal arrangements were not the central focus of this budget, some important changes to federal-provincial transfers, particularly to equalization
- Ontario is becoming an equalization-receiving province in 2009-10 – arguably leading the federal government to change the system adopted in 2007, and based on the O'Brien report
- Factors leading Ontario to join the ranks of the recipient provinces are, at the same time, increasing the importance of equalization for the efficiency of the economic union
 - High oil and gas prices (until recently)
 - Relative decline of the manufacturing sector
- Going back to a fixed-pool approach, unrelated to the size of fiscal disparities, could have detrimental effects on the efficiency of the Canadian economic union
- Could also have important effects on federal-provincial relations
 - Move away from principles-based approach to fiscal federalism

Pressures on the equalization system

Increasing disparities in provincial fiscal capacities, driven largely by:

- High resource prices in recent years
- Strong growth in western provinces
- Growth slowdown in manufacturing sector
- Large flows of interprovincial migration towards resource-rich provinces – migrants generally young and skilled
- Disparities in capital investment and infrastructure between provinces

The O'Brien compromise

- Move back to formula-based and principles-driven approach
- Equalization entitlements based on ten-province standard
- Inclusion of 50% of resource-revenues in fiscal capacity calculations
- Adoption of a cap to insure that a recipient province cannot have a total fiscal capacity above that of a non-recipient province
- Also emphasized the importance of improving transparency and governance of the system
- O'brien report recommendations largely adopted in 2007 budget

Ontario joining the ranks of the recipient provinces

- For a number of years, GDP growth in Ontario has been below national average, and far below GDP growth of western provinces
- Because of resource revenues, there is even greater disparity in fiscal capacity growth between Ontario and western provinces
- Ontario becoming a recipient province will add pressure on the equalization system
 - Payment to Ontario in 2009-10 is quite small - \$347 million
 - But without the ceiling, entitlement of Ontario could grow substantially in the future, especially if resource prices rebound
 - Raises the cap under the 2007 system – BC becomes the non-recipient province with lowest fiscal capacity

Main changes to equalization in 2009 budget

- Ceilling on the growth of total equalization payments
 - Growth of total payments equal to a three-year moving average of nominal GDP growth
 - Also works as a floor if entitlements go down
- Fiscal capacity benchmark set equal to average fiscal capacity of the equalization-receiving provinces
 - Resource-rich recipient provinces cannot end up with higher fiscal capacity (including all resource revenues) than the average of the recipient provinces
- Total payments in 2009-10: \$14.2 billion

Rationale for the changes

- Limiting growth in the cost of the program – arguably the main motive for reform
 - Equalization payments would otherwise grow very rapidly in the next few years, especially if resource prices rebound and the relative position of Ontario continues to deteriorate
 - Even if oil and gas prices remain at their current levels, high resource prices of the last few years would affect equalization entitlements given the three-year averaging and two-year lag
 - Without the cap, the equalization program could reach \$20 billion by 2010-11
- Reduces volatility in the size of the payments

Arguments against the changes

- Under a ceiling, total equalization payments do not grow in line with inter-provincial fiscal disparities
 - Inconsistent with the main objective of the program
 - Particularly detrimental in a federation where resource prices are generating large swings in fiscal capacity disparities
- Equalization standard should not be entirely determined by the issue of affordability
 - Affordability issue was largely addressed in the previous reform by the inclusion of only 50% of resource revenues
- Objective of increasing stability and predictability was addressed by calculating fiscal capacities and entitlements using three-year averages and lagging two years
- Ideally, need greater stability in provincial fiscal capacity, not stability in equalization payments
 - An unconstrained formula-based system achieves greater stability in provincial fiscal capacity (inclusive of equalization)

Implications for the efficiency of the economic union

- Factors leading Ontario to join the ranks of the recipient provinces and pressuring the equalization system are also increasing the importance of interregional redistribution for the efficiency of the economic union
- Large differences in fiscal capacities raise several efficiency issues in a decentralized federation like Canada
 - Large gaps in net fiscal benefits leads to fiscally induced migration
 - Worsens the problems associated with fiscal competition
 - Shift in economic activity towards resource-rich provinces
 - Tends to depress further the manufacturing sector in other parts of the country
 - Detrimental effects for productivity growth and innovation, if these are largely driven by growth in manufacturing
- Potential for a resource-curse

Efficiency issues – cont'd

- Imposing a ceiling on equalization payments restricts the ability of the system to reduce these efficiency problems
- Matching grants approach for infrastructure, combined with a ceiling on equalization payments, may in fact exacerbate inter-provincial disparities in infrastructure investment
 - Equalization ceiling could reduce the ability of recipient provinces to match federal funding

Implications for federal-provincial relations

- Effect of the ceiling on equalization payments will likely increase over time, especially if oil and gas prices rebound
- Could lead to a period of difficult federal-provincial relations
- Move away from principles-based approach?

Tax harmonization

- The 2009 Ontario budget announced that Ontario would move to a value added tax harmonized with the GST and collected by the federal government
 - Likely induced by the need to improve productivity and the competitiveness of the manufacturing sector
- Several benefits for productivity and competitiveness:
 - Lowers effective taxation of business inputs
 - Reduces the effective marginal tax rate on capital
 - Increases competitiveness of export sector
- Could induce other provinces to join (BC, Saskatchewan, Manitoba, PEI)
- Would have significant benefits for the efficiency of the economic union
 - Increase efficiency of inter-provincial trade
 - Eliminates distortions in the allocation of resources across sectors and across provinces

Conclusions

- The equalization system adopted in 2007 made significant progress in terms of addressing growing differences in fiscal capacities
- Changes induced by relative economic decline of Ontario possibly putting this progress at risk
- On efficiency grounds, moving away from the O'Brien approach and constraining the growth of equalization may not be the optimal way to respond
- Despite Ontario becoming a recipient province, it may be preferable to stick with the O'Brien formula, even though the cost of the program could grow substantially in the future
- Federal government could finance extra costs by increasing the tax revenues it gets from resource industries through the corporate tax system

Longer term questions:

- Rather than determining the equalization standard based on federal affordability, would it be preferable to adopt a net equalization system?
- Would it be desirable to setup an independent commission to oversee equalization?
- Federal government could perhaps use the opportunity created by Ontario's willingness to harmonize sales tax to propose the creation of a unique national VAT?