

# A better way to share

Redistributing Canada's wealth is a noble idea. Too bad the way we do it is so flawed, say university deans **DAVID NAYLOR** and **ROGER MARTIN**

It's budget time in Ottawa — our national feeding frenzy. The Finance Minister sits on a \$9.1-billion surplus. The advocates for a national child-care program are clearly in the pole position in the race for money. Who can argue? We think investing in children, particularly children in low-income households, makes sense from the perspective of equality of opportunity, prosperity, and public health.

There's just one hitch: The main debate so far has been about private versus public daycare. But we also have to figure out a sustainable way to pay for the program. And that leads straight to a much bigger issue: fiscal federalism.

According to national accounts, Ontario's net contribution to the federation was \$22.1-billion in 2002. Alberta contributed \$8-billion and British Columbia contributed \$1.8-billion. In per-capita terms, Alberta led with \$2,560 per resident flowing to other provinces.

So a permanent national child-care program means an increase in the rate of outflow of money from three or four provinces to six or seven other provinces. All will likely accept a share of the proposed \$5-billion fund for daycare as fast money with few strings.

But the prospects for agreement on a sustainable, long-term plan are bleak if it is another inter-provincial cash grab. Indeed, as more one-off financial deals are struck with different provinces, we run the risk of federal-provincial gridlock in an increasingly polarized nation.

An underlying problem is a misalignment of revenues and responsibilities in the Canadian Constitution. The Constitution placed the primary responsibility for health and education squarely with the provinces, while Ottawa retained most revenue-generating powers.

For decades, Ottawa has redistributed money freely to buy regional votes, and used its spending powers to put national conditions on transfers. However, the conditions are often tweaked for Quebec, and difficult to enforce elsewhere.

Another problem is the structure of modern fiscal federalism. It uses

three redistributive mechanisms.

The first is transfers for social programs. Cash is generated unequally, but flows back on a strict per-capita formula. Every "national deal" is a net loss for Ontario, Alberta, and British Columbia (it's still a net contributor to the federation, and one or two other provinces are poised to join the donors' club).

Then there are individual entitlements distributed to Canadians according to specific thresholds. A key part of a national safety net, these flows suffer from the usual perverse effects of means-testing.

The third flow is equalization payments. Equalization originated in 1957 alongside national hospital insurance, a cost-shared program. Richer provinces spent more on hospitals and got more federal money back. Equalization was an adjustment to offset the pro-rich bias of hospital insurance. But once funding shifted to a straight per-capita formula, equalization was already built right into all major social transfers.

Ottawa has not only maintained these "double" equalization payments, it recently lifted all caps on them, resulting in \$10.9-billion flowing to eight provinces this year. From reasonable origins, equalization is now a self-propelling monster based on obscure calculations involving 30-odd different potential sources of provincial revenues. Redistribution is part of our national fabric, but Canada's mechanisms are faulty.

On efficiency: Economists argue about how fast regions such as Atlantic Canada are closing the prosperity gap, but the movement is slow at best. Trend data on job cre-

ation suggest that the Canadian interprovincial gap is narrowing more slowly than U.S. interstate gaps. With the current form of equalization in place, the have-not provinces face a huge disincentive to make smart investments for long-term prosperity.

If we accept that 50-per-cent marginal tax rates discourage individuals from increasing their work, savings and investment, imagine the disincentive for a province with a taxation rate in excess of 70 per cent on incremental work and investment — essentially what happens with equalization adjustments.

On sustainability: Ontario moves twice as much money per capita out of province as peer U.S. states, year after year. Farmers know that you don't starve your cash cows. Ontario is the biggest cash cow, and it's in trouble. Its universities have had the lowest per-student funding of any Canadian province for a decade. By one estimate, Ontario had 390,000 children living in poverty in 2003, even as Ontario's spending on child care lagged that of several other provinces. Manitoba spends more per capita on health care than Ontario. Ontario could afford a superb daycare program, if it weren't subsidizing health care, education, and daycare for other provinces.

On consistency: For years Saskatchewan's oil and gas revenues were subject to federal clawbacks that took 80 to 90 cents on the dollar. Newfoundland and Nova Scotia have just won a radically better deal. By one reckoning, an immigrant arriving in Montreal receives twice as much federal support as an immigrant to Toronto. The incon-

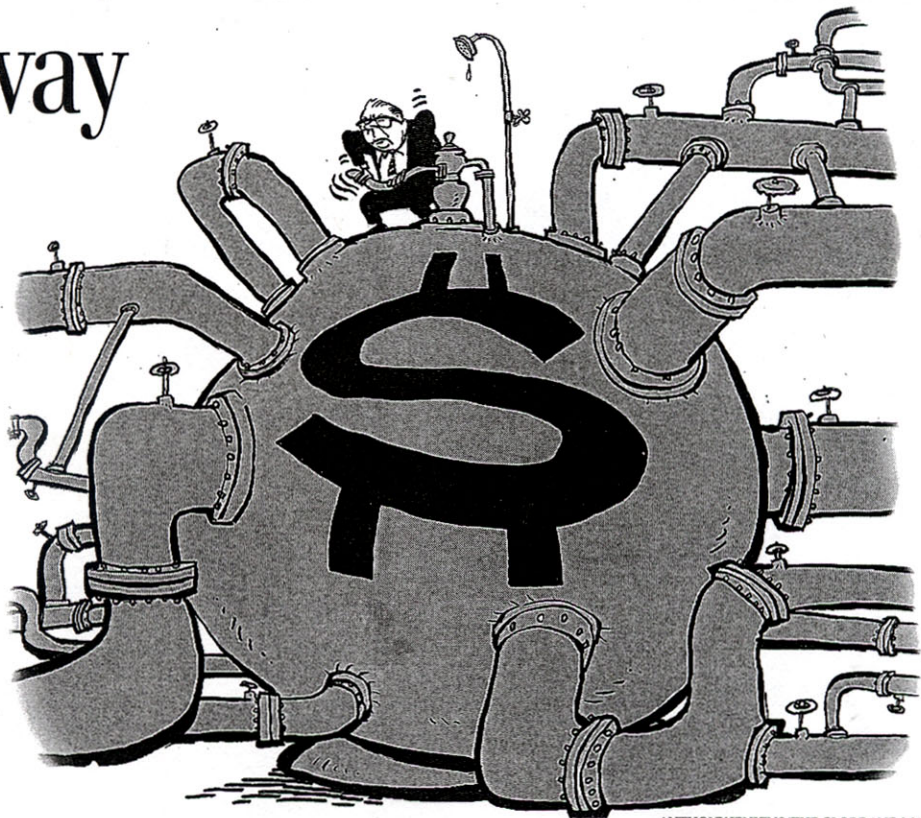
sistencies multiply yearly.

On accountability: The confusing maze of cross-subsidies that now exists in Canadian fiscal federalism violates every principle of public or private management and organizational behaviour. A big part of the solution is giving provinces not only their resource revenues on a consistent basis, but latitude to generate tax revenues to pay for the programs that, under the Constitution, they are ultimately accountable for delivering.

One such program is child care. We believe it must be integrated with existing social, educational and health services in a seamless fashion within each province, and funded mostly by tax points, not new cash transfers. Add in a radical rethinking of equalization, with a focus on genuine economic development, and we might have a country that works better.

Will these arguments mean much to those in Newfoundland outposts who lament the death of the cod fishery? Or to Winnipeggers recalling the 1986 CF-18 airplane deal as evidence of Ottawa's favouritism towards Quebec? Probably not. Canada has become defined by regional *schadenfreude*. But without renewing fiscal federalism, we will short-change not only the children who need care, but an entire generation likely to inherit a country with diminished prosperity.

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