Institute for
Competitiveness & Prosperity

Fixing fiscal federalism

The Institute for Competitiveness & Prosperity
Working Paper 8
October 2005

Institute for
Competitiveness & Prosperity

The Institute for Competitiveness & Prosperity is an independent not-for-profit organization established in 2001 to serve as the research arm of Ontario's Task Force on Competitiveness, Productivity, and Economic Progress.

Working papers published by the Institute are primarily intended to inform the work of the Task Force. In addition, they are designed to raise public awareness and stimulate debate on a range of issues related to competitiveness and prosperity.

The mandate of the Task Force, announced in the April 2001 Speech from the Throne, is to measure and monitor Ontario's competitiveness, productivity, and economic progress compared to other provinces and US states and to report to the public on a regular basis. In the 2004 Budget, the Government asked the Task Force to incorporate innovation and commercialization issues into its mandate.

It is the aspiration of the Task Force to have a significant influence in increasing Ontario's competitiveness, productivity, and capacity for innovation. The Task Force believes this will help ensure continued success in the creation of good jobs, increased prosperity, and a higher quality of life for all Ontarians. The Task Force seeks breakthrough findings from their research and proposes significant innovations in public policy to stimulate businesses, governments, and educational institutions to take action.

ISBN 0-9737377-2-7

The Task Force published its First Annual Report to the people of Ontario, *Closing the prosperity gap*, in November 2002. The Second Annual Report, *Investing for prosperity*, was published in November 2003. The Third Annual Report, *Realizing our prosperity potential,* was published in November 2004.

Comments on this working paper are welcome and should be directed to the Institute for Competitiveness & Prosperity.
The Institute for Competitiveness & Prosperity is funded by the Government of Ontario through the Ministry of Economic, Development, and Trade.

Fixing fiscal federalism

Exhibits

Exhibit 1	Have provinces generate more federal revenue and receive less federal spending than have-not provinces	12
Exhibit 2	Have provinces generate higher revenues per capita than have-not provinces	13
Exhibit A	Ontario has a $16 billion fiscal federalism gap	14
Exhibit 3	Federal program expenditures are mainly directed to the have-not provinces	16
Exhibit 4	Governments in Canada have been shifting spending from investment to consumption	20
Exhibit B	More prosperous states and provinces generate higher federal revenues per capita	21
Exhibit C	Regional income drives federal expenditures more in Canada than in the United States	22
Exhibit D	Fiscal federalism creates significant disadvantages for Ontario vs. peer states	23
Exhibit 5	Personal disposable income grew more in have-not than have provinces, 1984-2004	24
Exhibit 6	Regional income inequalities narrowed more in Canada than in the United States, 1984-2004	26
Exhibit 7	GDP inequality has stayed higher in Canada than in the United States	27
Exhibit 8	Provincial economic rankings changed little, 1978-2003	28
Exhibit 9	US states' economic rankings were fluid, 1978-2003	29
Exhibit 10	Four elements drive GDP	30
Exhibit 11	Canada has achieved less convergence than the United States in the elements that drive GDP per capita	31
Exhibit E	Ireland grew with relatively low EU transfer payments	32
Exhibit 12	Surpluses persist despite growing federal program expenditures	36
Exhibit 13	Federal budget forecasts have been conservative – by $64 billion in the last decade	37
Exhibit 14	Planned and unplanned federal transfer programs increased significantly	38
Exhibit 15	Smarter approaches to fiscal federalism could boost GDP in all regions of Canada	44

Contents

Foreword and acknowledgements 4

Executive summary 6

How fiscal federalism works 10

The federal government controls transfers to provinces *11*

The numbers tell the story *12*

How fiscal federalism affects Canada's prosperity 18

To be effective, fiscal federalism must strike an appropriate consumption/investment balance *19*

Personal disposable income and GDP measure the consumption/investment trade-off *20*

Fiscal federalism is narrowing regional differences in personal disposable income *25*

GDP disparity is greater in Canada than in the United States *26*

Persistent disparities in productivity and employment slowed GDP convergence *28*

Fiscal federalism hurts Canada's competitiveness *31*

Fiscal federalism hurts Ontario's competitiveness *33*

Why federal surplus surprises hurt fiscal federalism 34

Federal surplus surprises are not always good *35*

Federal forecast misses are costly to Canadians *35*

EI creates excessive surpluses and the wrong kind of transfers *39*

How to overhaul fiscal federalism for Canada's future prosperity 42

Shift transfer spending to tax relief that stimulates business investment *43*

Rethink approaches to equalization and transfer payments *44*

Build more discipline in dealing with federal budget surplus surprises *45*

Make EI a true insurance program *45*

References 46

Foreword and acknowledgements

I am pleased to present the eighth working paper of the Institute for Competitiveness & Prosperity in support of the Task Force on Competitiveness, Productivity, and Economic Progress.

In it we look at "fiscal federalism" from the perspective of competitiveness and prosperity. Through the regional patterns of federal government revenues and expenditures, Canadians do well in sharing the benefits of Canada's current prosperity between the have and have-not provinces. But how well are we reducing regional inequalities in long-term competitiveness and prosperity potential? Here our system is wanting.

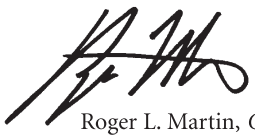
While we have succeeded in achieving greater equality in personal disposable income, we are relatively less successful in reducing provincial disparities in per capita gross domestic product – the measure of economic value creation. Truly successful fiscal federalism would lead to faster development of competitiveness and prosperity in the have-not provinces, which in turn would lessen the requirement for transfers from the have provinces. In Ontario, this would free up resources to invest in strengthening our productivity, thereby reducing the prosperity gap we have with the US states that are our peers.

In our previous work, the Institute has identified the need for individuals, businesses, and governments across Canada to shift their emphasis towards investing for future prosperity and away from consuming current prosperity. Many of the mechanisms of fiscal federalism help have-not provinces increase spending on health care and social services – both consumption expenditures. Obviously these are the highest priorities for Canadians, but they are not the only priorities. We need to stimulate investment in productivity-enhancing physical capital – such as machinery and equipment, and human capital – such as post-secondary education. We need creative ways to shift current spending to tax relief that stimulates business investment to enhance all regions' prosperity. This investment in future prosperity enables sustainable consumption of prosperity.

The federal government has succeeded in achieving budget surpluses; but these are a mixed blessing, because better-than-expected surpluses are being used to fund expenditures for consumption at a much higher rate than for investment. We encourage Canadian governments to develop better processes for dealing with positive surplus surprises. Finally, we encourage fixing the Employment Insurance system. It is an important driver of Ontario's $23 billion fiscal federal gap and is not reducing regional employment disparities. We need to make it a true employment insurance program and assess separately its inter provincial transfer aspects.

Fixing fiscal federalism will help our have-not provinces enhance their competitiveness and prosperity. It will free up resources for have provinces to invest in their own prosperity. And it will make Canadians even prouder of a sustainable system that shares resources and fosters wealth creation.

The Institute gratefully acknowledges the funding support from the Ontario Ministry of Economic Development and Trade.



Roger L. Martin, *Chairman*
Institute for Competitiveness & Prosperity

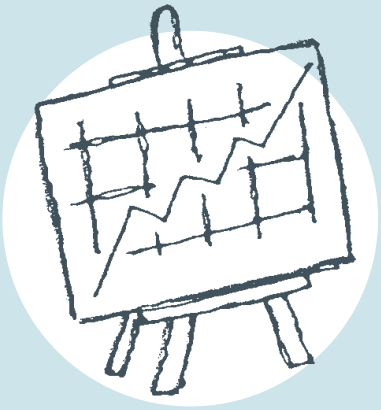
Executive summary

Fixing fiscal federalism

Through the regional patterns of federal government revenues and expenditures, Canadians have created a system that shares the benefits of our current prosperity. But we have been less successful in creating a sustainable system that enhances our long-term potential for creating prosperity across Canada's regions

A debate on the strengths and weaknesses of Canada's system of fiscal federalism is underway. Here in Ontario the question that has been posed is: Is the $23 billion transfer – the so-called fiscal gap – fair to Ontario? That gap is the difference between what Ontarians contribute to the federal government versus what is spent here by the federal government.

The question is difficult to answer, because fairness is often in the eye of the beholder. There is a longstanding consensus in Canada that the better off provinces, the haves, should support the less well off, the have-nots. Since Ontario has consistently been a have province, it should be no surprise that Ontarians are major donors of support to the have-not regions of Canada.



Instead, we argue that there is a more important question. The mandate for the Institute is to study productivity and competitiveness in order to improve economic progress and prosperity in Ontario specifically but also in Canada generally. For us, the critical question is about effectiveness: To what degree is the net transfer of resources out of Ontario effective in building the long-term competitiveness and prosperity of Canada? Our answer is clear.

Fiscal federalism is not effective in increasing Canada's future prosperity

We conclude that fiscal federalism is not effective in promoting the competitiveness and prosperity of Canada. It is simply a set of net transfer programs that has the effect of transferring resources at the rate of $1,400 per capita from high-productivity uses to low-productivity uses, lowering Canada's absolute level of productivity. On the positive side, it raises the level of personal disposable income in the have-not provinces through the vehicle of federal expenditures and transfer payments. However, it is less successful in increasing the rate of growth in gross domestic product or productivity in the have-not provinces.

When compared to the progress of the have-not versus have states in the United States, Canadian fiscal federalism produces no greater convergence in the competitiveness or productivity of the have-not jurisdictions. The fundamental problem is that fiscal federalism in Canada is weighted dramatically towards the consumption of current prosperity – in this case consumption by the have-not provinces of the current prosperity of the have provinces – rather than investment in building future prosperity.

This cannot be seen as a successful program. In a successful program of fiscal federalism, the resources transferred to have-not provinces would lead to faster development of productivity and competitiveness in the have-not provinces. This would justify diverting resources from a higher productivity jurisdiction to a lower productivity jurisdiction whose productivity could be induced to grow much faster. That has not happened. For example, private sector per capita investment in machinery, equipment, and software is 25 percent lower in have-not provinces than the have provinces – unchanged from twenty years ago.

For Ontario, reduced regional disparities in prosperity creation potential would mean lower transfers from Ontario to other provinces. This would create greater opportunity for investment in Ontario's future prosperity.

It is incumbent on the federal government to rethink the way fiscal federalism works because it is too costly to Canadian prosperity to spend resources generated in the have provinces as ineffectively as today. It should consider providing substantial tax relief to stimulate investment in the have-not provinces as opposed to transfer programs. Increased capital investment in Canada's have-not provinces will help boost productivity and in turn this will increase their capacity for wealth creation.

Federal budget surplus surprises contribute to this ineffectiveness

Our previous work has shown that, on many fronts, Canada consumes too much current prosperity instead of investing in generating future prosperity. Our system of fiscal federalism is another such example, and the bias towards consumption of current prosperity has worsened because of the series of consistent inadvertent federal surpluses. Each year, the federal government presents and debates a budget in which it asks Canadians to accept a tax regime designed to collect a projected amount of revenue and to accept a spending program designed to use the projected resources collected through the tax system. In each of the past five years, the federal government has missed on its estimates, running up large inadvertent surpluses, which it has decided how to spend without the public or parliamentary debate usually associated with federal budgets.

The problem for Ontario is that it contributes disproportionately to the high federal revenues that produce the surprise surpluses and receives a disproportionately low share of the extra spending. This net transfer can be seen to be unfair to Ontario in that it has not been asked for, publicly discussed, or been part of a planned transfer from have to have-not provinces. Instead, it happens by stealth and hurts Ontario's prosperity and competitiveness. It is perfectly fair for Ontario to pay a net transfer in the amount that is contemplated and is passed by Parliament in the federal budget, but it is not fair for Ontario to pay an additional stealth tax.

Regardless of the fairness of the collection and spending of the additional revenues, a more important question is whether the federal government is spending these resources wisely. The metric we have used to discuss government spending is the ratio of spending on consumption of current prosperity versus spending for investment in future prosperity. Our analysis of the deployment of the surpluses generated over the past decade, both anticipated and unanticipated, is that the federal government dramatically biased spending towards consumption of current prosperity instead of investing in generating future prosperity.

When the federal government has extra resources to deploy, good stewardship for the future prosperity of Canada ought to lead to the spending of these resources on investments that will generate future prosperity, including debt reduction. Long-term, this spending would provide more capacity for spending on current consumption. Instead, the federal government used the extra resources disproportionately to consume today's prosperity. For every new dollar of consumption spending, it invested only 31 cents.

Ontarians – and all Canadians – should insist that, in the event of a surprise surplus, there be an established mechanism for dealing with it. And this mechanism should place a higher priority on increasing investment in future prosperity and reducing debt than on consuming current prosperity. If these surplus surprises are to be transferred to provinces, we argue that they should be returned to each province in proportion to its contribution to the inadvertent surplus.

EI is an important part of the fiscal federalism problem

Employment Insurance represents nearly a quarter of Ontario's fiscal gap. It is a taxation program that consistently and massively imposes costs in excess of benefits. It does not operate as an insurance program, but rather as a regional transfer program in which Ontario is the major net contributor. Given the ongoing higher levels of unemployment in the provinces that are net recipients of EI funds, it is hard to argue that the program has been effective in reducing regional competitiveness disparities.

Employment Insurance should be separated into two portions. One portion should be directed towards an experience rated program that can be run efficiently and effectively for the benefit of Canadian firms and their workers. The second portion should be moved into an explicit interprovincial transfer program so that it is visible and accounted for.

In summary, we see fiscal federalism as a monumental missed opportunity for raising Canadian prosperity and competitiveness. More ineffective than unfair, it needs an overhaul to improve its impact on Canada. The biggest shortcoming of fiscal federalism as currently constructed is that it represents a large consumption of current prosperity, not an investment in generating future prosperity.

We recommend the following changes to the structure of fiscal federalism:

- Shift transfer spending to tax relief that stimulates business investment
- Rethink approaches to equalization and transfer payments
- Build more discipline in dealing with federal budget surplus surprises
- Make EI a true insurance program.


How fiscal
federalism works

Canada's system of fiscal federalism levels provincial income disparities

In most federations, national governments transfer resources from more prosperous to less prosperous regions, and Canada is no exception. Every year, the federal government transfers resources from some Canadians to others. Through such programs as Old Age Security, Child Tax Credits, and income supplements, we assist less-advantaged Canadians to live with a sense of security and to invest in their own future. As it turns out, more of the less-advantaged Canadians tend to live in certain provinces than in others – the have-not provinces; and more prosperous Canadians tend to be found in other provinces, mainly Ontario and Alberta – the have provinces. As a result, transfers from higher income Canadians to lower income Canadians redistribute resources among regions.

The federal government controls transfers to provinces

The transfer of resources from Canadians in have provinces to Canadians in have-not provinces occurs through federal government taxing and spending mechanisms:

- **First, most federal taxes are progressive.** This means that provinces with above average incomes pay a higher share of taxes. Higher income individuals pay more per person than average, and lower income individuals pay less per person. So provinces with a greater proportion of people earning above average incomes pay a greater share of taxes levied on individuals than other provinces. Businesses also pay federal taxes – primarily through taxes on their profits. Profits at large corporations tend to be taxed at a higher rate than those in smaller businesses. The result is that those provinces with more and larger businesses tend to pay a higher percentage of corporate taxes than their share of the national population and of gross domestic product (GDP).

- **Second, many of the federal government's spending programs are geared to lower income individuals.** The result is that provinces with below average incomes attract a greater share of this spending. Federal social spending, such as Old Age Security or various tax credits, is aimed at lower income Canadians. Payments of Employment Insurance (EI) benefits are higher in areas with higher unemployment. Transfers to support businesses are higher in areas with a less developed business sector. As a consequence, in those provinces with above average incomes, federal government spending is below the national average on both a per capita and per dollar of GDP basis.

- **Third, the federal government transfers money directly to the provincial and territorial governments.** There are two major types of these government-to-government transfers. The first is *equalization payments*, which are specifically designed to transfer resources from provinces with above average incomes to provinces with below average incomes. Equalization payments aim to "ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."[1] The federal government determines how much it will transfer through equalization. Through a series of formulas, the federal government determines which provinces are eligible to receive equalization and

[1] *Constitution Act*, 1982 Section 36 (2)

how much each of them will receive. Currently, Ontario and Alberta do not receive equalization payments, while all the other provinces receive some payments.

The second type is *equal per capita transfers*. The main examples are the Canada Health Transfer (CHT), which provides funds to provinces to support health care, and the Canada Social Transfer (CST), which funds social programs and education. All provinces receive these transfers on a nearly equal per capita basis.[2]

In total, the federal government raised $186 billion in 2002 from Canadian individuals and businesses. Since most taxes are progressive, these revenues are raised disproportionately from the have provinces (Exhibit 1).[3]

Similarly, the federal government spends $179 billion disproportionately across Canada. Its program spending is higher in the have-not provinces than their share of population or their GDP. And government-to-government transfers are higher in the have-not provinces, because the equalization portion of these transfers is designed to do exactly that.

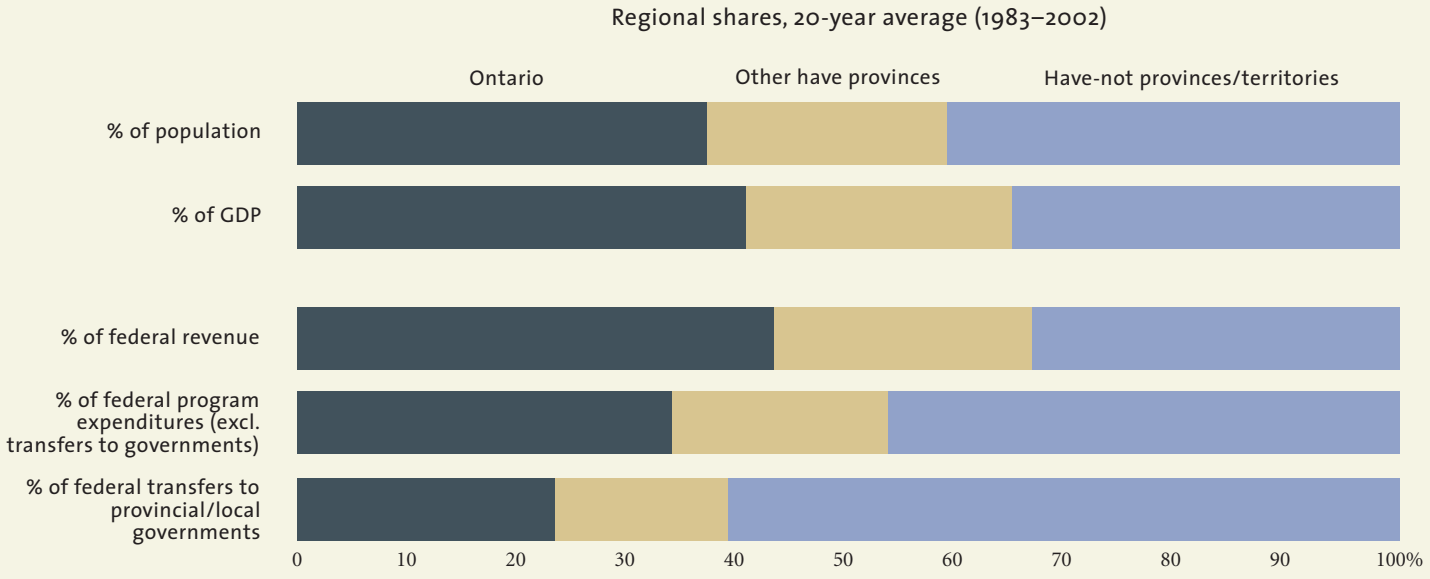
The numbers tell the story

As we have seen, the progressivity of many of our taxes means that the have provinces generate more federal revenue than their population. On the expenditure side, federal government spending is decidedly tilted towards lower income or have-not provinces. Our analysis shows the detail behind the revenues and expenditures in Exhibit 1 and the extent of the fiscal federalism gap.[4]

Have provinces generate more federal revenue than have-not provinces

Federal tax revenues vary substantially per capita across the provinces.[5] In Ontario, per capita federal tax revenue over the 1983-2002 period is 16 percent higher than its share of the national population. In have-not provinces, per capita tax revenue is 19 percent lower than their population share (Exhibit 2).

Exhibit 1 Have provinces generate more federal revenue and receive less federal spending than have-not provinces



Source: Statistics Canada, *Provincial Economic Accounts,* CANSIM II Table 510001; Institute for Competitiveness & Prosperity analysis.

[2] The CHT and CST payments are made up of both cash transfers and tax point transfers. Tax point transfers involve the federal government reducing its tax rates to allow provinces to raise their tax rates by an equivalent amount. Ontario, having a more prosperous tax base, gets more value from these tax points; therefore, cash payments to Ontario are less than those in all other provinces except Alberta. In 2004/05, this difference versus the national average amounted to $36 per capita.

[3] In this analysis, we define have provinces in each year between 1983 and 2002 as those that have the highest GDP per capita and account for half of Canada's population. These are Alberta, Ontario, and British Columbia in all 20 years.

[4] For our more detailed analysis we must draw on Statistics Canada data to the end of December 31, 2002. We rely on the Statistics Canada publication *Provincial Economic Accounts*, an annual review of government revenue and spending across provinces and territories. This publication takes revenue and expenditure data from federal, provincial, and territorial governments, makes the data consistent, and reports everything on a calendar year basis rather than the fiscal year ending March 31. In its public statements, the Government of Ontario has estimated the results for more recent years.

[5] Our analysis in the following pages focuses on per capita difference; the pattern is similar on per dollar GDP basis, but less pronounced on the revenue side and more pronounced on the expenditure side.

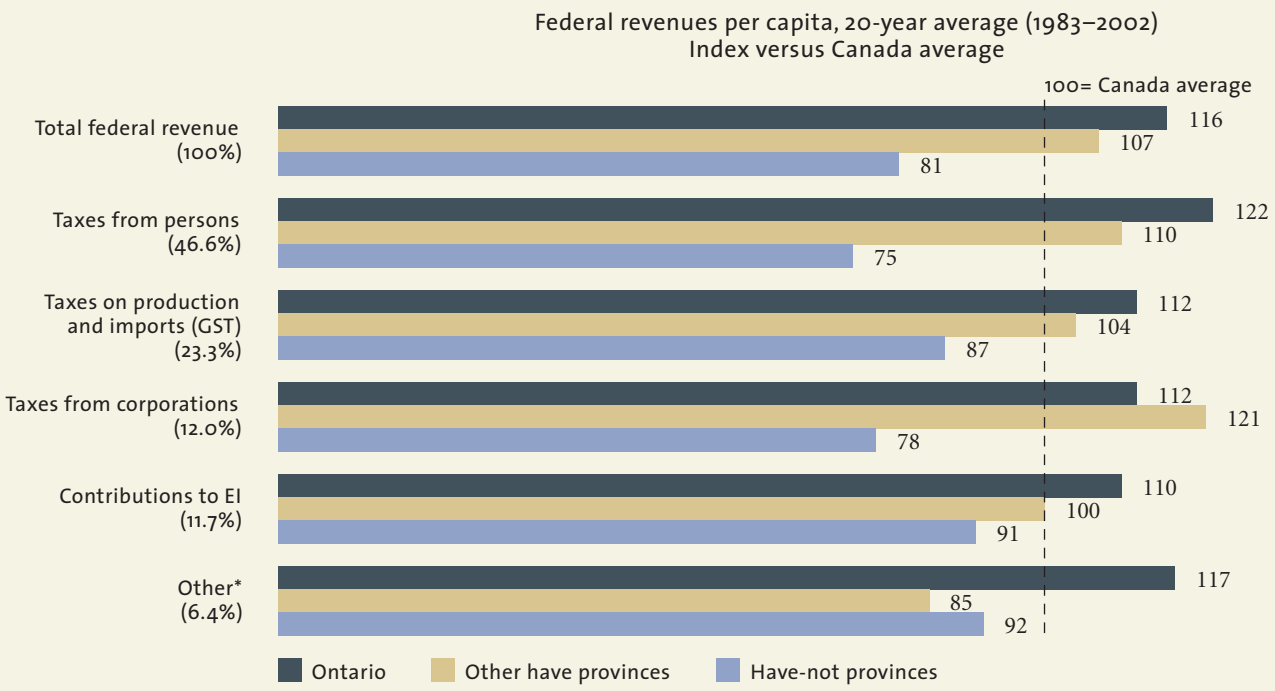
We can see that, in particular, personal income taxes are progressive – that is, higher income people pay a higher percentage of the tax, with the have provinces generating well above the average revenue per capita. Other sources of tax revenue, such as the GST and EI premiums are less progressive – the share of revenue generated in each province is closer to its share of national population.

The largest source of federal revenue is the **personal income tax**, accounting for 46.6 percent of the total over the last twenty years – or just under half of all federal government revenue. More than half of this comes from Ontario and Alberta. In 2002,[6] the federal government raised $40.0 billion in personal income taxes from Ontarians, accounting for 46.1 percent of all personal income tax revenue raised across Canada. This compares with Ontario's 38.6 percent of population in 2002. Alberta, generated 12.3 percent of personal income tax revenues from 9.9 percent of the population. Provinces with below average incomes paid less than their share of population. In fact, in every year since 1982, Ontario and Alberta have generated a higher share of Canada's personal tax revenue than their share of population.

The second largest source of federal revenue is **taxes on production and imports,** accounting for 23.3 percent of all federal revenues in the last twenty years. These taxes include the Goods and Services Tax (GST) and to a lesser extent customs and excise duties. The GST is a value added tax – an indirect sales tax paid on products and services at each stage of production and distribution, based on the value added at that stage and included in the cost to the ultimate consumer.[7] On a per capita basis, Ontario generates 12 percent more than the national average and have-not provinces 13 percent less.

The next most important source of federal revenue is **direct taxes from corporations.** These are primarily corporate income taxes, but they also include corporate capital taxes and taxes paid by government business enterprises. They accounted for 12.0 percent

Exhibit 2 Have provinces generate higher revenues per capita than have-not provinces



*Other includes investment income and taxes from non-residents.
Source: Statistics Canada, *Provincial Economic Accounts;* Institute for Competitiveness & Prosperity analysis.

[6] This refers to the calendar year; in this Working Paper, when we refer to government fiscal years – April 1 to March 31 – we use the 2001/02 convention.
[7] www.eyefortransport.com/glossary/uv.shtml

Ontario's fiscal federalism gap is significant

Much of the recent public discussion of the impact of Canada's fiscal federalism has focused on the $23 billion gap in Ontario. This $23 billion gap refers to the difference in the amount of revenues raised by the federal government in Ontario in the year ended March 31, 2005, versus the amount of expenditures by the federal government in the province. As Premier McGuinty has put it, "Every year the people of Ontario lose $23 billion to the federal government, for distribution to the rest of the country."[a]

The $23 billion is a good estimate of the overall difference in federal revenues and expenditures in Ontario for the latest government fiscal year. However, a more detailed analysis of this gap can only be carried out with results to the end of December 31, 2002, since these are the latest data in Statistics Canada publication *Provincial Economic Accounts*, an annual review of government revenue and spending across provinces and territories.

Based on these results, the amount of federal revenue generated in Ontario less the amount of federal expenditure in Ontario was $21.2 billion in 2002. This calculation is on the same basis as the widely quoted $23 billion in 2004/5. However, in our view an analysis of this gap needs to reflect two adjustments.

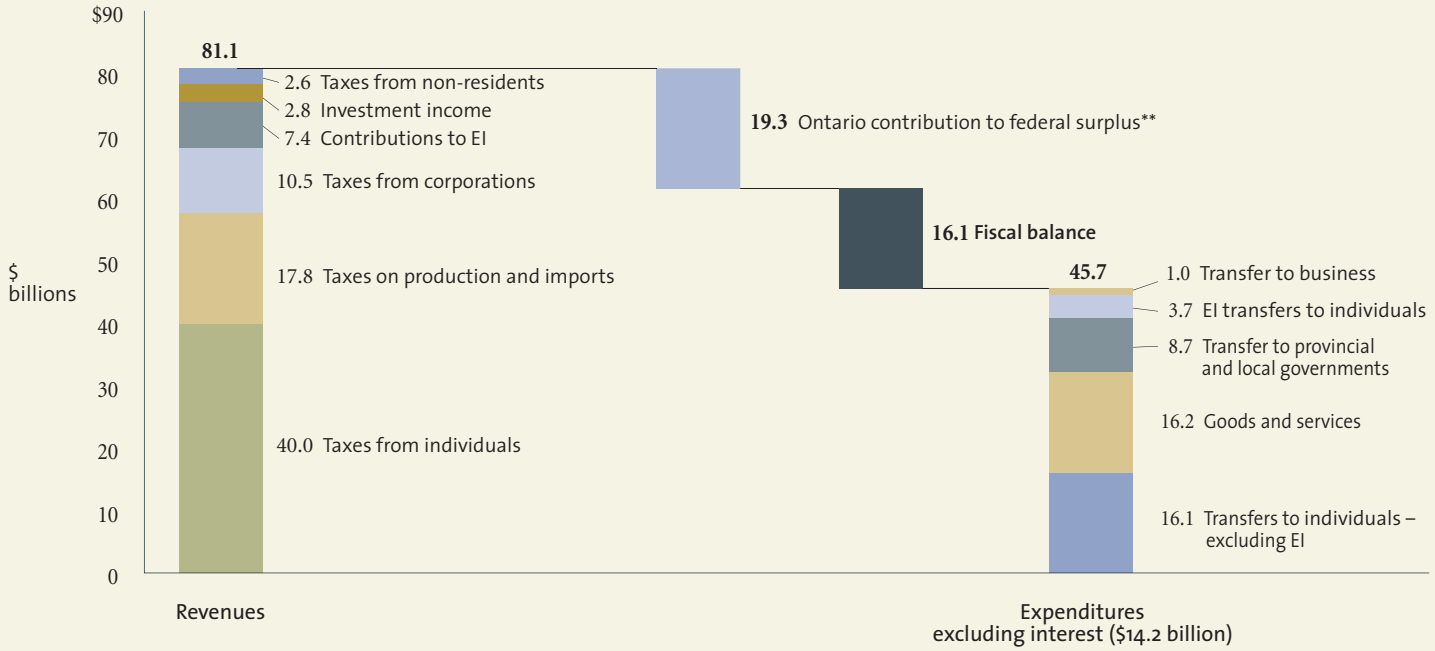
The net effect of these two adjustments takes the fiscal gap reported by Statistics Canada down by $5.1 billion for Ontario, from $21.2 billion to $16.1 billion (Exhibit A); for Alberta, these adjustments take the gap as reported by Statistics Canada from $7.8 billion to $5.3 billion.

Federal interest expenditures are not included in our calculations

The first adjustment we make is to exclude federal interest payments in determining how much is spent by the federal government in an individual province. These payments are investment returns to individuals and businesses who previously lent money to the federal government by purchasing government bonds, such as Canada Savings Bonds. They are not expenditures in the same way as EI benefits or

Exhibit A Ontario has a $16 billion fiscal federalism gap

Federal revenues and expenditures in Ontario, 2002 results*



*Calendar year.
** Based on Ontario's share of GDP; includes $1.2 billion as Ontario's share of transfers to non–residents.
Source: Statistics Canada, *Provincial Economic Accounts;* Institute for Competitiveness & Prosperity analysis.

Old Age Security payments or equalization payments are. They cannot be considered as a fiscal stimulus, since they are merely payments for the use of funds – which financed previous expenditures already captured in the province-by-province assessments. Statistics Canada reports that, in 2002, $14.2 billion of interest payments were in Ontario and in our calculations we reduce federal expenditures in Ontario by the same amount. This adjustment – because it reduces federal expenditures in Ontario – actually increases the fiscal gap in Ontario by $14.2 billion. For Alberta, the adjustment is $3.6 billion.

Federal revenues in each province are reduced by its share of the program surplus

In years when federal program spending is in surplus,[b] some portion of federal revenue is not spent in any province – it is used for interest and debt payments. Consequently, we adjust downward the federal revenue raised in all provinces to equal the federal program surplus. We adjust each province in proportion to its share of national GDP. In years of program deficit, federal expenditures in all provinces have been reduced. Over time, as the cumulative amount of federal program surpluses equals program deficits, these annual adjustments will cancel each other out. For 2002, this reduces federal revenues raised in Ontario by $19.3 billion, and in Alberta by $6.1 billion. However, annual surpluses (and annual deficits) themselves are not transfers from one province to another, and so we eliminate them from this analysis of fiscal federalism.

of federal revenues in the last twenty years. Provincial shares of federal corporate taxes vary by business cycles. Over the twenty-year period 1983-2002, the portion of these taxes generated cumulatively in Ontario was 41.7 percent, versus an average population share of 37.2 percent over the same period.

Included in federal revenues are premiums collected through **Employment Insurance** (EI).[8] EI premiums and benefits are part of the federal government's finances – and are included in the calculation of federal fiscal transfers. EI premiums are based on employment so, once again, have-not provinces tend to contribute less, mainly because they have chronically higher underemployment.

The two other sources of revenue for the federal government are **investment income** and **direct taxes from non-residents**. These represent only 6.4 percent of total federal revenues.

Revenues generated through the Canada Pension Plan (CPP) and the benefits paid under the plan are not included in federal government finances. Thus they are not part of fiscal federalism analysis.

Have-not provinces receive more federal government expenditures than have provinces

Overall, the federal government's expenditures are aimed at individuals and regions with below average income (Exhibit 3). Ontario's and Alberta's relatively high level of prosperity means that they receive a smaller share of federal expenditures than their population shares.

The largest group of federal government expenditures, accounting for 28.1 percent of the total over the last twenty years, is **transfers to persons, excluding EI**. These include Old Age Security payments and tax credits aimed at lower income Canadians, including the Child Tax Credit and GST tax credit.[9] Since the have-not provinces have proportionately more individuals qualifying for such transfers, federal per capita expenditures there are 11 percent above these provinces' share of population.

The second largest category of federal expenditures is for **goods and services**. This category, accounting for 27.5 percent of all federal government expenditures, includes salaries for federal employees and the purchases by the government to carry out its program delivery and national defence functions. In 2002, 44.1 percent of goods and services expenditures went to have-not provinces, versus their 38.4 percent share of the population. Unlike other expenditures categories, the federal government actually spends more in Ontario than its share of population, largely because Ontario is home to the national government.

Next in importance are **federal transfers to provinces and local governments**. These payments, which include equalization payments and the Canada health and social transfers, have probably garnered the most publicity in the debate over fiscal federalism.[10] They account for 26.9 percent of federal government spending. Equalization payments help less prosperous provinces provide a level of services to their residents that they could not otherwise afford. They are calculated on the basis of each province's potential tax base – the less prosperous a province, the lower its potential to collect provincial taxes and the

[a] Premier Dalton McGuinty in speech to United Way of Greater Toronto Annual General Meeting, May 25, 2005.
[b] Program surplus refers to federal revenues minus expenditures on all programs except interest on the public debt.

[8] Employment Insurance benefits are included in federal expenditures.
[9] These tax credits are included as expenditures rather than reductions in revenues because they are actually directly paid to individuals and are not reductions in taxes payable.
[10] Until 2004/05 these transfers were primarily in one program – the CHST; now there are two programs the CHT and CST.

higher the equalization payment from the federal government. In 2002, eight provinces received equalization payments, while Ontario and Alberta did not qualify.

The health and social transfers are payments from the federal government to all provinces on an equal per capita basis. They are bloc grants to ensure equal services across the country. In 2004/05 Ontario received 36.9 percent of the CHT and CST cash payments, almost in line with its population.

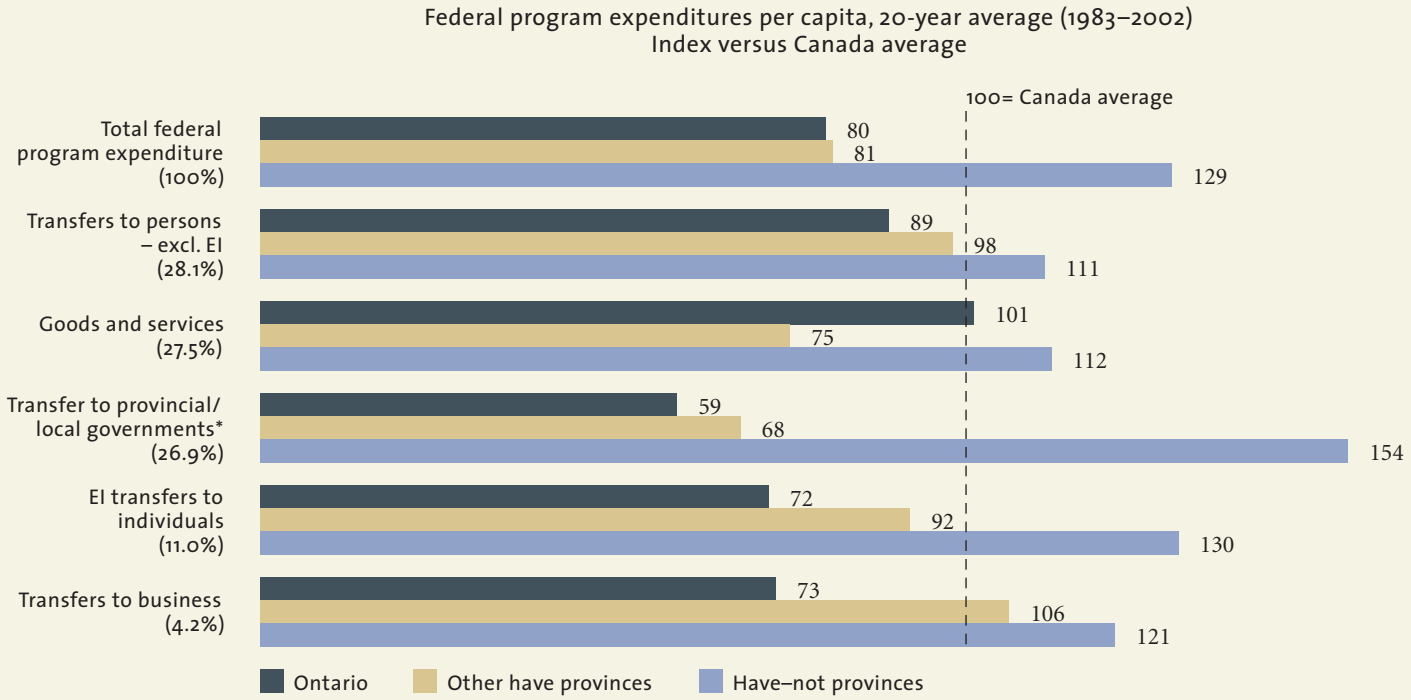
Combining the equalization payments and the health and social transfers, in 2002 the have-not provinces received 60.0 percent of the federal transfers (versus their 38.4 percent share of population), while Ontario received 23.9 percent (versus its 38.6 percent share of population).

EI transfers to individuals account for 11.0 percent of federal government expenditures. In 2002, the have-not provinces received 51.3 percent of these benefits, well above their population share. Because Ontario has a lower unemployment rate than most provinces, its share of EI benefits is 29.1 percent, well below its share of population.

The smallest program expenditure by the federal government is **current transfers to business,** which accounts for 4.2 percent of total. Again, the have-not provinces' share of national spending at 47.7 percent in 2002 exceeds their population share. Ontario's share of these transfers at 31.6 percent is well below its population share.

As intended, the revenue-raising and expenditure patterns in Canada's fiscal federalism regime mean that the key driver of federal transfers between provinces is based largely on provincial income levels. The key questions are: what should Canadians expect from fiscal federalism? Are we meeting these expectations?

Exhibit 3 Federal program expenditures are mainly directed to the have-not provinces



*Adjustment made for Quebec Abatement
Note: Current transfers to non-residents is not shown here. It accounts for 2.3% of federal program expenditure.
Source: Statistics Canada, *Provincial Economic Accounts*; Institute for Competitiveness & Prosperity analysis.

How fiscal federalism affects Canada's prosperity

Fiscal federalism is narrowing income disparities across Canada, but it is also missing opportunities to create higher prosperity potential

A well-functioning fiscal federalism system ought to reduce the regional differences in today's living standards. Equally important, it should also reduce the differences in future living standards by increasing productivity in the have-not regions. If it did both, it would unambiguously raise living standards for all Canadians.

But does Canada's current system of fiscal federalism reduce regional imbalances in incomes and competitiveness? Does it actually equalize and raise living standards across the country? The answers are important as Canada seeks to increase the capacity for wealth creation and to ensure higher prosperity for everyone.

To be effective, fiscal federalism must strike an appropriate consumption/investment balance

This transfer of resources from more prosperous to less prosperous regions has long been one of the fundamental aspects of Canada's Confederation. As described by the Honourable John McCallum, an Ontario minister in the federal cabinet:

> For me, being Canadian is about sharing and fairness to all Canadians, no matter where they live, through a progressive income tax system, universal medicare, and other social programs. It's about support to regions through equalization payments, as well as equality of opportunity and a strong social safety net, sustained by policies that foster the creation of wealth.[11]

This perspective forms a useful yardstick against which to measure the effectiveness of Canada's fiscal federalism. Is it fair? Does it equalize opportunity across the regions? Does it provide strong social safety nets? Does it lead to wealth creation?

Canadians value our strong social safety net and universal health care coverage. So long as Canada generates economic growth that sustains our prosperity, we will be able to fund these important programs. Indeed, it is critical that our fiscal federalism system support a balance between consuming current prosperity and investing for future prosperity. This is a recurring theme in the Institute's work to date.

To ensure economic growth and enduring prosperity, individuals, regions, and countries need to invest some of their current resources. The types of investment that help build for the future prosperity include education to develop human capital and expenditures on transportation and communication, and machinery, equipment, and software to develop physical capital. These expenditures – whether made by the private sector or the public sector – may do very little to enhance current well-being. But they are critical to ensure a high quality of life for all for a long time to come. In contrast, consumption expenditures, primarily health-care and social services, do a great deal to enhance current well-being but much less for building future prosperity.

Governments, then, have two important roles. First, they must spend current prosperity to help secure an adequate quality of life for all Canadians today. Second, they must contribute to future prosperity by investing in upgrading and innovation. At the base level, governments must fund their administration, protect citizens and the environment, and pay interest on

[11] The Honourable John McCallum in a speech to Toronto Board of Trade, April 28, 2005.

the public debt. In both Canada and the United States, this requirement accounts for about 30 percent of spending by federal, provincial/state, and local governments. In allocating the remaining 70 percent, governments trade off consumption and investment.

We do not prescribe a precise balance between the two. But our research indicates that governments in Canada have been shifting their spending away from investment towards consumption (Exhibit 4). This trend is drawing resources away from investment in our future prosperity.

Between 1992 and 2002, governments at all levels in Canada decreased their spending on investment from 55 cents to 50 cents for every dollar of consumption, while our US counterparts raised investment spending from 52 cents to 55 cents for every dollar of consumption. As our governments fought to reduce deficits, they were more aggressive in reducing investment expenditure than consumption expenditure. But Canadian governments' inability to match the investment spending by US governments in the last decade limited our progress in raising productivity and prosperity in Canada.

In our view, we need to assess Canada's fiscal federalism through the lens of our consumption and investment balance. Are we transferring adequate resources from the have to the have-not provinces to reduce regional disparities in the quality of life? To what extent are these resources used for consumption of current prosperity? Is fiscal federalism also driving adequate investment in future prosperity so that regional wealth-creation potential is more evenly distributed?

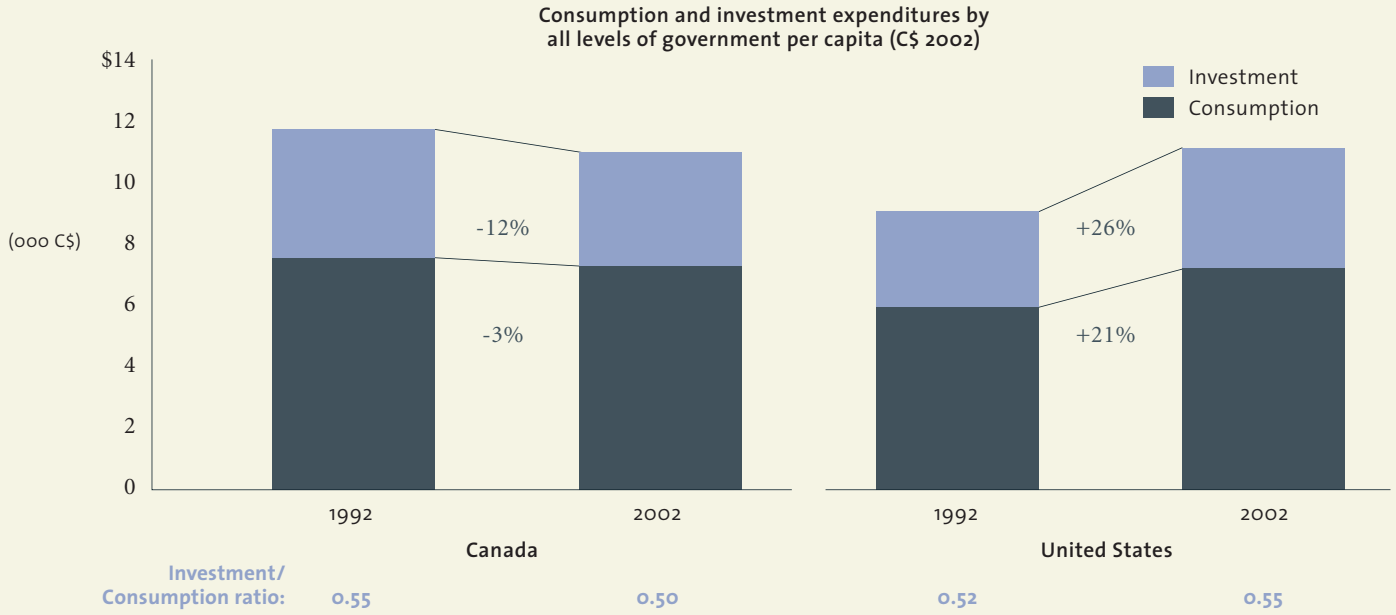
As we shall see, fiscal federalism has tilted far too much towards the first objective, consuming current prosperity, and not enough to the second, investing for future prosperity. Not getting this balance right has meant a lost opportunity for Canadians – and an expensive one.

Personal disposable income and GDP measure the consumption/investment trade-off

To help us assess the success of fiscal federalism in achieving these two objectives it is useful to look at regional disparities and their trends across two measures – gross domestic product (GDP) and personal disposable income.

In all our work, we measure economic well being by GDP per capita, concurring with most economic observers that "GDP per capita is the best measure of how an economy is performing over time and against its peer

Exhibit 4 Governments in Canada have been shifting spending from investment to consumption



Source: Institute for Competitiveness & Prosperity based on data from Statistics Canada, *Public Sector Statistics 2001-2002* (Table 2.2); US Census Bureau, *Statistical Abstract of the United States: 2003* (Table 463, 579).

Fiscal federalism differs in Canada and the United States

As federations, both Canada and the United States have the distribution of major expenditure and revenue responsibilities set out in their constitutions. As in Canada, the federal government in the United States transfers significant financial resources between states. Both constitutions define the financial resources from taxation, borrowing, and commercial activities for each level of government. Both set out areas where the federal government has the responsibility for expenditures.

The interstate transfer of funds occurs in the United States through the same type of mechanisms available to Canada's federal government. Its federal taxation system is progressive; so more prosperous states contribute more per capita and more per dollar of GDP to the federal treasury. The US federal government also spends across states.

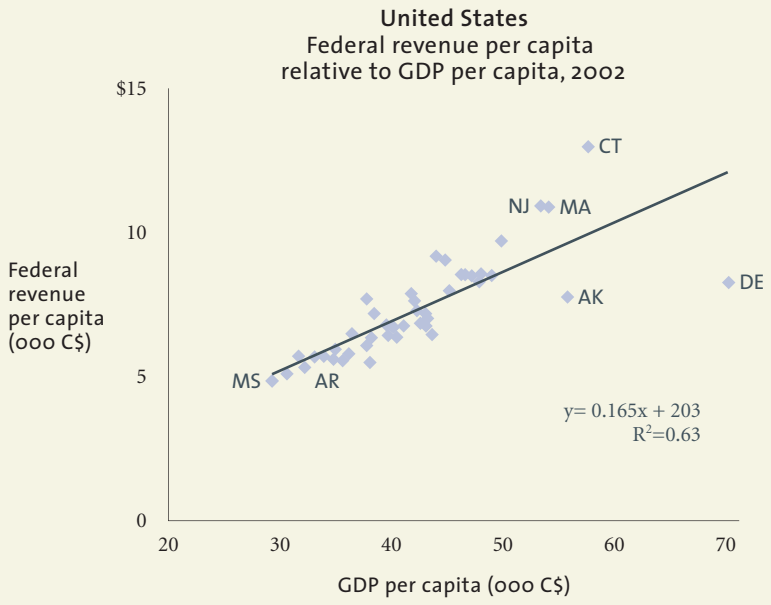
But here is where the major difference occurs. In the United States, combined federal state-by-state spending patterns are not necessarily related to income disparities between the states. There is no formal equalization system as in Canada. The net effect in the United States is a high level of interstate transfers through their structure of fiscal federalism; but these transfers are not related to income disparities to the same degree as in Canada.

With progressive tax systems in both countries, higher income jurisdictions generate an above average share of federal revenue

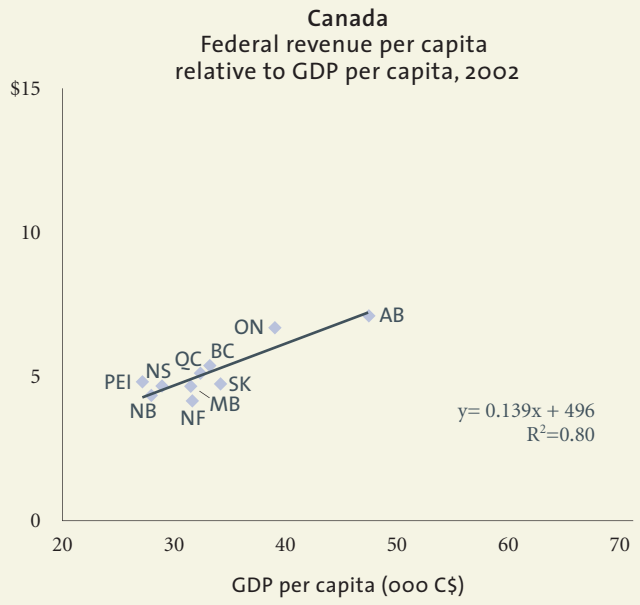
In Canada, as a province's GDP per capita increases, it contributes a greater share of federal tax revenue. For each $1,000 increase in GDP per capita, a province contributes $139 more in tax revenues per capita (Exhibit B). Alberta and Ontario, which account for 49 percent of Canada's population, together raise 55.7 percent of total federal revenue in Canada.

The US system is also progressive. There, an increase of $1,000 per capita in a state's GDP drives a $165 increase in federal revenues per capita. Among Ontario's peer group, the

Exhibit B More prosperous states and provinces generate higher federal revenues per capita



Source: US Census Bureau, Tax Foundation; Institute for Competitiveness & Prosperity analysis.



Source: Statistics Canada, *Provinicial Economic Accounts,* CANSIM II Table 510001; Institute for Competitiveness & Prosperity analysis.

six states with the highest GDP per capita in 2002 – Massachusetts, New Jersey, New York, Virginia, California, and Illinois – make up 31.0 percent of the population and generate 36.7 percent of federal revenue.

Federal state-by-state expenditures are not always income determined

Unlike Canada, the United States has no formal transfer system.[a] Instead, federal laws, shaped by nationally defined policies, determine the extent and nature of transfers to states. Some redistribution does occur among the states where, for instance, federal programs grant funding on the basis of need. Unlike in Canada, however, the majority of transfers are conditional. One of their objectives is to influence state expenditure priorities and programs.[b]

Federal expenditure patterns reflect these differences in the two systems. While the level of federal expenditure in the average US state is similar to the Canadian average federal expenditure across the provinces, the transfers are not based on differences in income or GDP per capita (Exhibit C).

Regional balances track prosperity more in Canada than in the United States

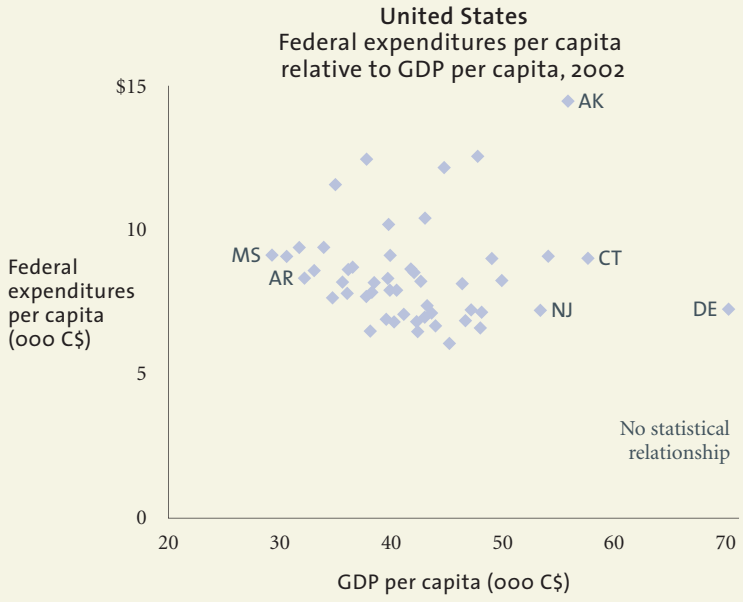
The net federal balance, or federal revenue raised less federal spending, reaches similar levels across jurisdictions in Canada and the United States. Newfoundland received $5,500 per capita more in federal government spending than it generated in federal revenue on average between 1998 and 2002. Similarly, the highest average net transfer to a state between 1998 and 2002 was C$ 5,600 per capita in New Mexico.

While overall levels of transfers between states and provinces are similar, the pattern varies significantly. The relationship between GDP per capita and the net balance across Canadian provinces is stronger than among US states. This is the result of the US state-by-state expenditures not being tied to prosperity (Exhibit C), even though revenues are (Exhibit B).

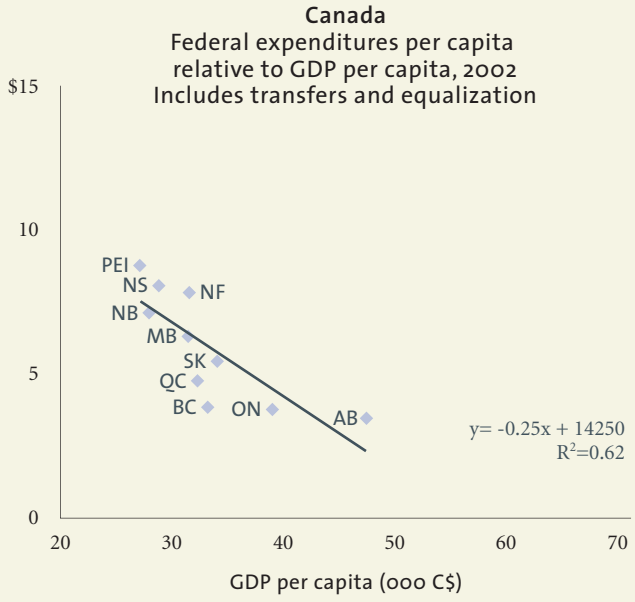
In fact, several US states contribute more through federal revenue and expenditure patterns than Alberta and Ontario. But the overall pattern of federal transfers does not reflect income as much in the United States as in Canada. Prosperous states like Pennsylvania and Alaska are net beneficiaries of US fiscal

[a] Robin Boadway and Ronald L. Watts (2004) "Fiscal Federalism in Canada, the USA, and Germany" Working Paper, Queens University, p. 11.
[b] *Ibid.*, p. 10.

Exhibit C Regional income drives federal expenditures more in Canada than in the United States



Source: US Census Bureau, Tax Foundation; Institute for Competitiveness & Prosperity analysis.



Note: Federal expenditures exclude interest on public debt; Quebec data adjusted for the Quebec Abatement - accounts in 2002 for a $335 increase in federal transfers to provincial and local governments in Quebec.
Source: Statistics Canada, *Provinicial Economic Accounts,* CANSIM II Table 510001; Institute for Competitiveness & Prosperity analysis.

federalism and less prosperous states like Oregon and Indiana are net contributors.

In addition, our research indicates that there is much more year-to-year fluidity in the status of states as beneficiaries or contributors than in Canada. Over the past twenty-four years, twenty-four states have moved between contributor and beneficiary status; of the twenty-six that have not moved, eighteen have always been recipients and eight have always been contributors. In Canada, six provinces have been beneficiaries in every year since 1981; three have been net contributors. Only Saskatchewan has been both a contributor and a beneficiary.

Transfers contribute to Ontario's prosperity gap

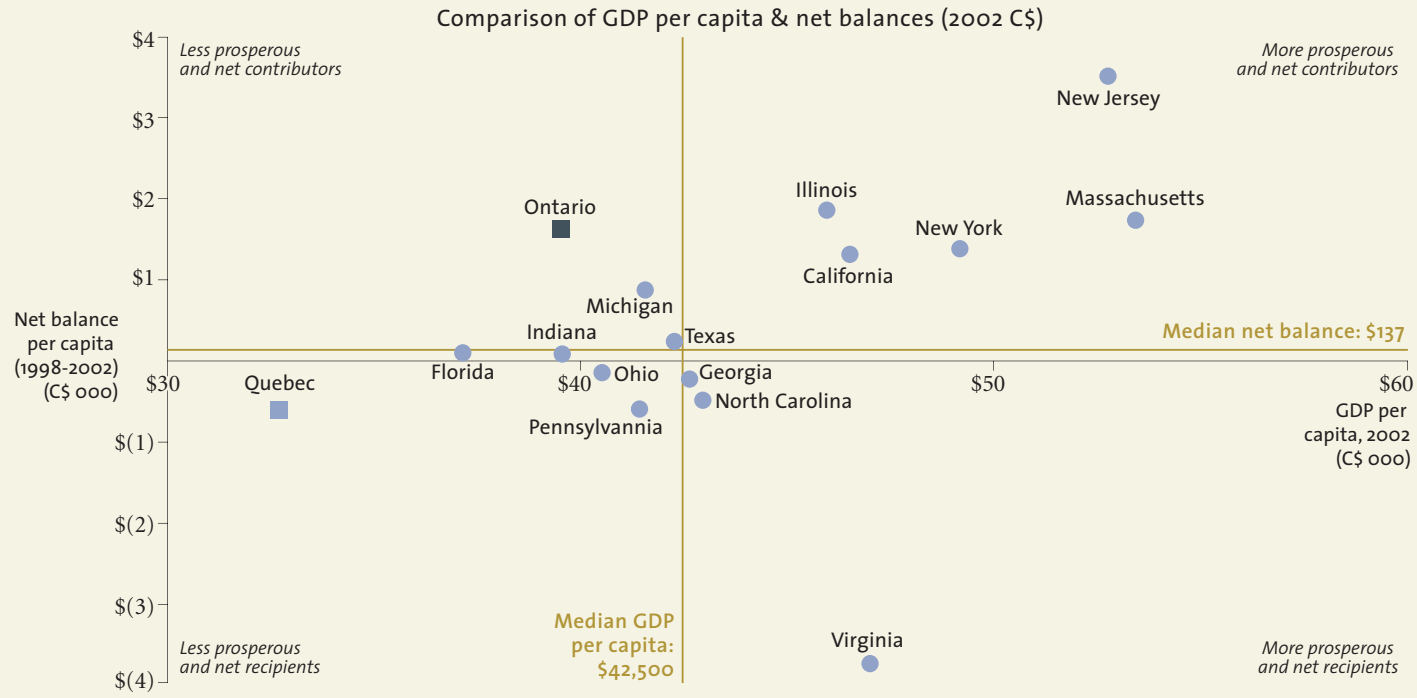
The impact of the differences in the two countries' approaches to fiscal federalism is probably most significant for Ontario. In Ontario, we trail the median GDP performance of our peer states by $3,100 per capita (2003 results).[c] We are concerned about this prosperity gap, because it indicates that in Ontario we are not creating as much economic value from our resources as we could – though we have found no fundamental reason that precludes Canada or Ontario from closing the prosperity gap with the United States.

Over the five-year period between 1998 and 2002, federal revenue and spending patterns cost Ontarians $1,600 annually per capita (Exhibit D). Across our fourteen peer states, nine were net contributors to other states and five were net beneficiaries. This pattern occurs despite the fact that all but one of the peer states had higher GDP per capita than Ontario in 2002. Only three states – New Jersey, Massachusetts, and Illinois – contribute more to other states than Ontario contributes to other provinces. Across Ontario's peer group of 16 states and provinces, the median annual contribution to other jurisdictions was $137. On average, the fourteen peer states were net contributors of $400 per capita over the same time period. Compared to peer states, Ontario is one of the least prosperous but contributes like one of the more prosperous states

As we assess differences in the two countries' approaches to fiscal federalism, we see that the United States is less focused on leveling off prosperity differences between states, particularly with respect to expenditure patterns. This is key because it means that the system is more harmful to competitiveness in the more prosperous regions in Canada than in the United States. This has particular consequences for Ontario's prosperity.

[c] Institute for Competitiveness & Prosperity, *Realizing our prosperity potential*, p. 13.

Exhibit D Fiscal federalism creates significant disadvantages for Ontario vs. peer states



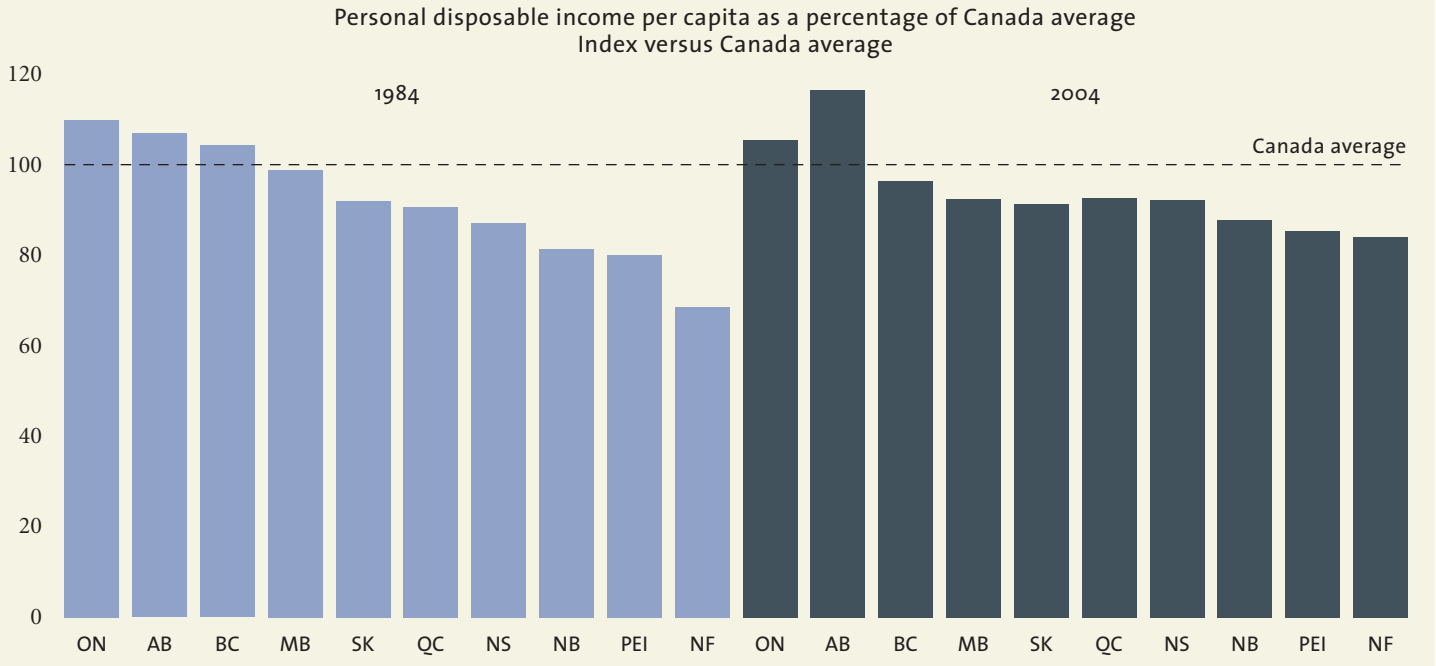
Source: Statistics Canada, *Provinicial Economic Accounts*, CANSIM II Table 510001; Tax Foundation, US Bureau of Economic Analysis, US Census Bureau; Institute for Competitiveness & Prosperity analysis.

group. GDP per capita measures the output of an economy, or the 'value added.' We can think of this as the value created in the conversion of a province's natural, labour, and capital resources into products and services that consumers buy here and around the world."[12] In a sense, GDP is analogous to the investment side of the balance we require. Strengthening an economy's value-creation capability typically means investing for future prosperity. Productivity – a measure of how much value is created by work effort – is the key influencer of GDP, and investment in human and physical capital has been shown to be the critical driver of productivity. To the extent that fiscal federalism is driving above-average investment in have-not regions, it will succeed in reducing regional disparities in wealth creation.

Where GDP measures the economic output of a region or a country, personal disposable income captures the after-tax income that flows to individuals. Statistically, this measure removes from GDP factors such as capital depreciation, corporate profits, net interest payments by businesses, and personal taxes. What's left, therefore, are payments received by individuals. About 85 percent of GDP is distributed to individuals in the form of pre-tax personal income. Two-thirds of this is in the form of wages; the other third is split evenly between returns on investment and government transfers. Where GDP is a measure of how effectively an economy is generating value and building future prosperity, personal disposable income measures the ability of individuals to consume current prosperity.

Over time, trends in a country's or a province's GDP will drive personal disposable income.[13] In an economy where adequate investment is taking place, residents will create value by converting physical, human, and natural resources into goods and services – that is, raise GDP per capita. In turn, this will result in high levels of personal disposable income. If transfers from have provinces to have-not provinces support an adequate level of investment – that is, if they strike the right balance between supporting consumption and investment – fiscal federalism will contribute to reducing regional disparities in both GDP and personal disposable income. That will create a stronger national economy.

Exhibit 5 Personal disposable income grew more in have–not than have provinces, 1984–2004



Source: Statistics Canada, *Provincial Economic Accounts,* CANSIM II Table 510001, U.S. Bureau of Economic Analysis, *Regional Economic Accounts*; Institute for Competitiveness & Prosperity analysis.

[12] Task Force on Competitiveness, Productivity, and Economic Progress, First Annual Report, *Closing the prosperity gap*, November 2002, p.22
[13] See Institute for Competitiveness & Prosperity, Working Paper 3, *Missing opportunities: Ontario's urban prosperity gap*, June 2003, pp. 12-13 for a discussion of the relationship between personal disposable income and GDP.

Over the last two decades, Canada has narrowed personal disposable income disparities among the provinces. By comparison with the United States, we currently have less disparity in per capita personal disposable income between the have and have-not regions. However, we have bigger differences in GDP per capita, and these differences are closing at no faster a rate than in the United States. The key barriers to faster convergence in Canada are slow progress in reducing interprovincial differences in productivity and, to a lesser extent, employment.

Fiscal federalism is narrowing regional differences in personal disposable income

Personal disposable income levels have always varied across Canada. But in the twenty years since 1984, provincial disparities have gotten smaller. In 2004, average provincial per capita disposable income ranged from a low of $19,500 in Newfoundland to a high of $26,900 in Alberta. Ontario ranked second at $24,400. Though these disparities remain wide, their decline over the period is significant (Exhibit 5). For example, in 1984 the province with the lowest per capita disposable income was 31 percent below the national average; by 2004, the difference had fallen to 16 percent.

This regional income convergence trend is part of a common phenomenon that development economists have noted around the world. Poorer regions tend to catch up with more prosperous regions. The pace of convergence can be very slow – and often is. As Barro and Sala-i-Martin observe,[14] this convergence occurs faster within countries than across countries. This is the result of access to similar technologies, shared tastes and cultures, and a common central government, institutions, and legal system. Capital mobility between regions increases the speed of convergence; human migration also increases convergence

[14] Robert Barro and Xavier Sala-i-Martin, *Economic Growth*, Second Edition, The MIT Press, 2004, p. 461

Measuring dispersion and convergence

In all market economies, some individuals and households are more prosperous than others. Similarly, some regions are more prosperous than others. This dispersion can be measured in several ways. For example, we can measure how far below the national average are less prosperous regions and how far above are the more prosperous regions. Or we can compare the most prosperous regions with the least prosperous.

One measure that can be used to compare dispersion across countries or over time is the standard deviation of regional levels of income or prosperity. This indicates how wide the region-by-region variation is from the national average. A low standard deviation indicates little dispersion between rich and poor, while a high standard deviation indicates significant dispersion. To compare dispersion levels between countries with different averages, economists often take the standard deviation of the logarithm of personal disposable income. As we show in Exhibit 6, in 2004 Canada had a lower dispersion of personal disposable income across its provinces than the United States experienced across its states.

What is of equal interest is how fast regional inequality is declining. This is the concept of convergence. In a sense, dispersion is the stock or level of regional differences, while convergence measures the flow or rate of change in dispersion.

Economists have developed two ways of measuring convergence. One way is to measure the rate of change in the standard deviation (called sigma convergence after statisticians' label for standard deviation). This measures how fast differences across regions are converging towards the average. The other way is to measure how fast the poorer regions are growing relative to the richer regions. This is called beta convergence (named after the co-efficient in the equation that measures decline in dispersion). See Chapter 11 of Barro and Sali-i-Martin's university textbook, *Economic Growth,* for a description of the two concepts.

In this working paper we refer to sigma convergence; however, the trend in beta convergence is in the same direction for nearly all variables we discuss.

as people leave poorer regions to settle in richer regions, thus bringing per capita averages closer together.

It is hard to imagine that federal transfers have not contributed to this convergence. Over the past twenty years, we estimate that federal transfers and expenditures, net of revenues, have conveyed about $1,400 per capita annually from the have provinces to the have-not provinces. Importantly, as Exhibit 3 shows, a significant share of this resource shift has been in areas that support consumption of current prosperity – equalization payments, health and social transfers to provinces, transfers to individuals, and EI benefits.

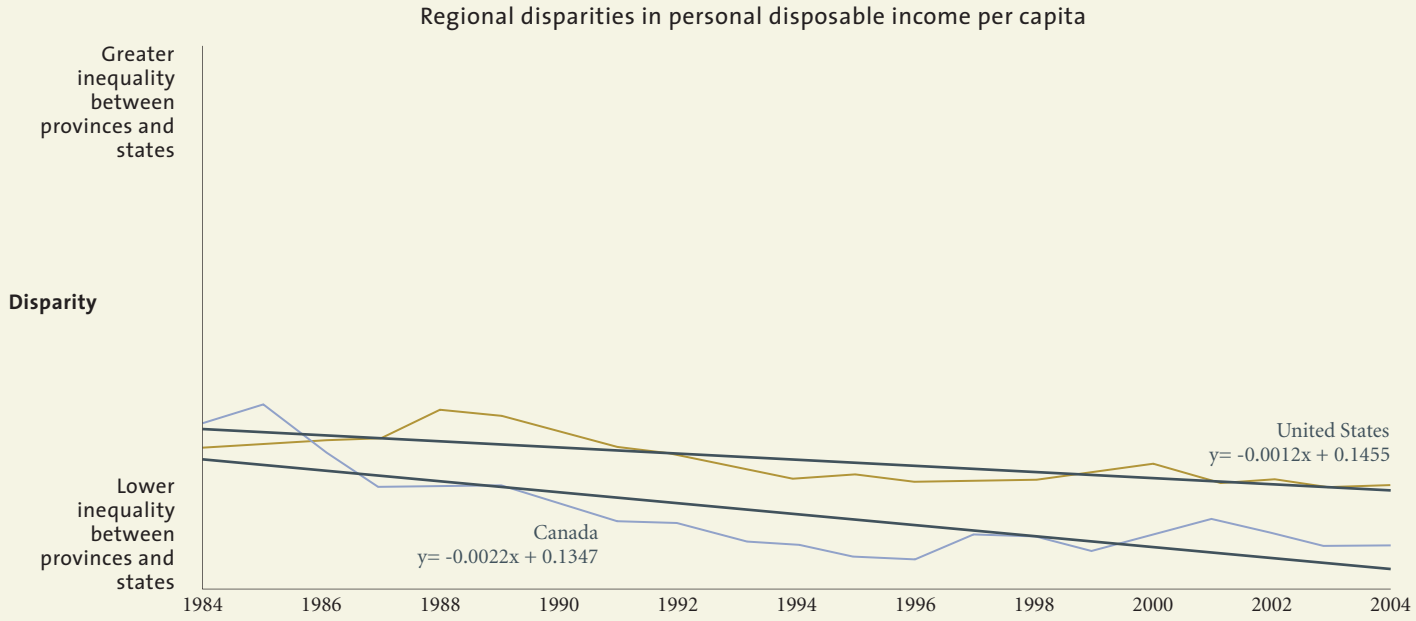
In our past work, we have compared economic performance in Canada, the United States, and peer states to gain a measure of our prosperity. Continuing our comparisons, Canada has experienced more equality in personal disposable income across provinces than the United States has achieved across its states (Exhibit 6). (See *Measuring dispersion and convergence* for more detail on how we measure differences between have and have-not provinces and the rate at which those differences are reduced.) This is consistent with our earlier finding that Canada has a more equitable distribution of income across households.[15] A notable difference is that, although the US federal government distributes a significant amount of money among its states, this shift is not intended to transfer funds from haves to have-not to the same degree as in Canada. (See *Fiscal federalism differs in Canada and the United States*).

Analyzing the trends in inequalities of personal disposable income per capita in Exhibit 6, we see that Canada's line is almost always below the US line, indicating that levels of regional inequality are lower in Canada. In addition, the Canadian line is trending down faster (-0.0022 vs. -0.0012), indicating that regional inequalities are falling faster in Canada than in the United States.

GDP disparity is greater in Canada than in the United States

In our work to date, we have shown that Canada has been less competitive than the United States for over two decades. And our prosperity gap – the difference in GDP per capita – with the US has grown worrisomely since 1981. Today, GDP per capita is $7,200 (2003) higher in the United States than in Canada; in 1981, that gap was $1,800.[16] Provincial inequality in GDP per capita contributes to this under performance.

Exhibit 6 Regional income inequalities narrowed more in Canada than in the United States, 1984–2004



Source: Statistics Canada, *Provincial Economic Accounts,* CANSIM II Table 510001, U.S. Bureau of Economic Analysis, *Regional Economic Accounts*; Institute for Competitiveness & Prosperity analysis.

[15] Institute for Competitiveness & Prosperity, *Realizing Canada's prosperity potential*, January 2005, pp. 10-11
[16] *Ibid.*, p. 8

Canada's record in the convergence of GDP per capita across the provinces relative to the United States has not been as strong as its achievement in personal incomes. The evidence indicates that Canada has been less successful than the United States in narrowing the dispersion of GDP per capita, or wealth-creation potential (Exhibit 7).

In seventeen of the past twenty years, the United States has experienced lower levels of inequality in regional GDP per capita than Canada. The trends in reducing this inequality are almost identical in the two countries. But if these trends continue, Canada will never match the United States in reducing the inequalities in GDP per capita.

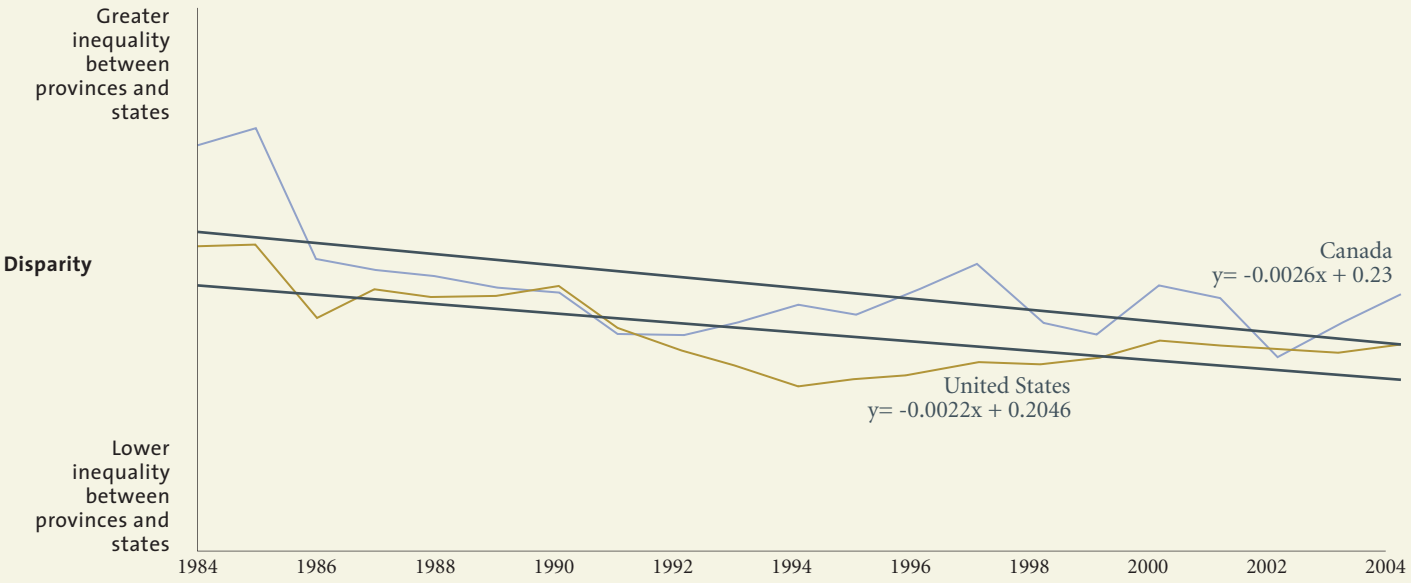
A province-by-province and state-by-state competitiveness ranking over the past two decades indicates much more fluidity in the United States than in Canada. The have, middle, and have-not provinces are essentially the same today as they were twenty-five years ago (Exhibit 8). The rankings of US states moved much more (Exhibit 9). Where provincial rankings remain essentially frozen, it means that have-not regions are not breaking out of their sub-par performance. A culture of dependency may have set in across the have-not regions, and this may be blocking convergence.

Fluidity of rankings indicates a more flexible economy, where local decision makers are succeeding at breaking out of the economic malaise. Two examples in the United States are Massachusetts and Georgia, both in Ontario's peer group.

In 1978, Massachusetts was a mediocre economic performer, ranking 25th out of fifty states in GDP per capita. Within Ontario's peer group of fourteen US states, it ranked 9th. Its traditional industries had fallen on hard times, and many employers and citizens were fleeing to the sun-belt states. Yet by drawing on its highly educated population and its knowledge industries, the state's economic performance improved over the next two decades. By 2003, Massachusetts ranked 4th in GDP per capita across all fifty states and first among Ontario's peer states.

Exhibit 7 GDP inequality has stayed higher in Canada than in the United States

Regional disparities in GDP per capita



Source: Statistics Canada, *Provincial Economic Accounts,* CANSIM II Table 510001, U.S. Bureau of Economic Analysis, *Regional Economic Accounts*; Institute for Competitiveness & Prosperity analysis.

Georgia was a have-not state in 1978 ranking 38th out of fifty. Through a significant commitment to post-secondary education and to attract world-class researchers to the state, Georgia was able to improve its standing in GDP per capita to rank 23rd by 2004.[17] Within Ontario's fourteen peer states, Georgia moved from 12th to 8th.

To be sure, US states' rankings also fell. One of Ontario's peer states, Michigan, toppled from a top third ranking in 1978 to 28th in 2003. Within Ontario's peer group, it fell from 4th in 1978 to 11th by 2003. And a few states – Mississippi, West Virginia, and Arkansas – are persistently near the bottom of US rankings. But, taken as a whole, the US states experienced much greater fluidity in their competitiveness rankings over time than the Canadian provinces.

Clearly, Canada has not achieved a better balance of competitiveness and prosperity among the provinces over time. The challenge facing Canadians is how to ensure that fiscal federalism is achieving the appropriate balance between consuming current prosperity and investing for future prosperity in all regions.

Persistent disparities in productivity and employment slowed GDP convergence

To understand why Canada's have-not provinces are not converging with the have provinces as quickly as they might, it is helpful to look at the four elements that drive GDP per capita (Exhibit 10):

- **Profile** – the proportion of our total population who are of working age and can therefore contribute to our economic performance
- **Utilization** – the proportion of the working age population who actually look for and find employment; this element consists of *participation* (the percentage of working age population in the labour force seeking work or actually working) and *employment* (the percentage of those who are in the labour force who are working)
- **Intensity** – the amount of time those who do work are actually working
- **Productivity** – the success in translating working hours into products and services of value to domestic and international customers.

In assessing differences between Canada and the United States, we see that the level of regional inequality tends to be higher in Canada across the elements that drive GDP per capita, and Canada's provinces have experienced less convergence (Exhibit 11).

The most important element of this framework for investigation is *productivity*. As we have found in our research into Canada's and Ontario's prosperity gaps, productivity is the largest source of the disadvantage relative to the United States and Ontario's peer states. It also has the highest correlation with GDP per capita on a province-by-province basis.

On the positive side, Canada's provinces have been less dispersed in their productivity performance than US states; and, on average, over the last two decades the disparity between the have and have-not provinces is not as great as among US states. But the trend is worrisome. The level of dispersion is growing in Canada, while in the United States

Exhibit 8 Provincial economic rankings changed little, 1978–2003

	1978	1990	2003
3 Highest GDP per capita	Alberta British Columbia Ontario	Alberta Ontario British Columbia	Alberta Ontario Saskatchewan
3 Middle GDP per capita	Saskatchewan Quebec Manitoba Nova Scotia	Quebec Manitoba Saskatchewan Nova Scotia	Newfoundland British Columbia Quebec Manitoba
3 Lowest GDP per capita	New Bruswick Newfoundland Prince Edward Island	New Bruswick Prince Edward Island Newfoundland	Nova Scotia New Bruswick Prince Edward Island

Source: Statistics Canada, *Provincial Economic Accounts*, CANSIM II Table 510001; Institute for Competitiveness & Prosperity analysis.

[17] Institute for Competitiveness & Prosperity, Working Paper 2, *Measuring Ontario's prosperity: Developing an economic indicator system*, July 2002 pp. 36-7

Exhibit 9 US states' economic rankings were fluid, 1978–2003

	1978	1990	2003
15 Highest GDP per capita	Alaska	Alaska	Delaware
	Wyoming	Delaware	Connecticut
	Nevada	Connecticut	Alaska
	California	Wyoming	Massachusetts
	Delaware	Hawaii	New Jersey
	Illinois	New York	Wyoming
	Hawaii	New Jersey	New York
	New York	California	Minnesota
	Louisiana	Nevada	Virginia
	Texas	Massachusetts	Colorado
	Washington	Illinois	California
	Michigan	Maryland	Washington
	Connecticut	Washington	Illinois
	Colorado	Virginia	Nevada
	Iowa	Minnesota	Maryland
20 Middle GDP per capita	Oregon	Texas	New Hampshire
	Minnesota	Colorado	Nebraska
	Ohio	Louisiana	Hawaii
	Nebraska	Georgia	North Carolina
	New Jersey	Rhode Island	Georgia
	North Dakota	New Hampshire	Texas
	Wisconsin	Nebraska	Rhode Island
	Indiana	North Carolina	Wisconsin
	Kansas	Ohio	Pennsylvania
	Massachusetts	Pennsylvania	Michigan
	Montana	Vermont	Ohio
	Missouri	Kansas	Iowa
	New Mexico	Wisconsin	South Dakota
	Pennsylvania	Michigan	Indiana
	Maryland	Missouri	Kansas
	Virginia	Oregon	Tennessee
	Oklahoma	Iowa	Missouri
	Idaho	Florida	Oregon
	Arizona	Indiana	North Dakota
	Kentucky	Tennessee	Vermont
15 Lowest GDP per capita	Utah	Maine	Arizona
	South Dakota	Arizona	Florida
	Georgia	South Carolina	Utah
	North Carolina	South Dakota	Kentucky
	Tennessee	Oklahoma	Maine
	Florida	Kentucky	Louisiana
	West Virginia	Utah	South Carolina
	Rhode Island	North Dakota	New Mexico
	New Hampshire	New Mexico	Idaho
	Vermont	Idaho	Alabama
	Alabama	Alabama	Oklahoma
	Arkansas	Montana	Montana
	South Carolina	Arkansas	Arkansas
	Maine	West Virginia	West Virginia
	Mississippi	Mississippi	Mississippi

Source: U.S. Bureau of Economic Analysis, *Regional Economic Accounts;* Institute for Competitiveness & Prosperity analysis.

it is narrowing. We are actually diverging in productivity performance, and in 2004 our dispersion was actually higher than that in US states. On the most important factor driving our prosperity and income, the gap between higher and lower productivity performers is actually getting wider, not narrower.

In our previous work, we have identified several contributors to productivity performance. For some, we are able to measure dispersion and convergence in Canada and the United States:

- The degree of *urbanization* is an important contributor to productivity. Our research indicates that this is a major disadvantage for Canada's productivity. This inequality between urbanization rates in Canadian provinces is higher than in the US states. Worse, this difference is widening as US states are converging faster. To the extent Canada's fiscal federalism is discouraging a natural movement of people from rural to urban areas, we are hurting prospects for prosperity in Canada's have-not provinces.

- *Educational attainment* is another productivity weakness for Canada as fewer of our managers and workforce have university degrees. As with urbanization, Canadian provinces show greater inequality in this variable than the US states, and the difference is widening.

- *Capital investment* data are unavailable for US states. However, in Canada the inequality in private sector rates of investment in machinery and equipment and infrastructure is worsening. In addition, we are not getting the kind of investment that creates many jobs in the have-not provinces – and this is an important factor in the persistent unemployment in those regions.

In the *utilization* of our human resources, fewer of the working aged population in the have-not provinces are employed in the workforce. The disparity we experience in Canada is worse than in the United States. We are closing this gap at a somewhat faster rate than in the United States, but not enough to have caught up.

- In the *participation* sub-element of utilization Canada has greater disparity between its have-not and have provinces, but we are closing this gap at a faster rate than the United States

- In the other sub-element of utilization, *employment,* Canada has fared badly in the level of disparity between the have and have-not provinces and the pace of change. Our low investment in the have-not provinces is an important factor. In Canada, the employment rate gap between have and have-not provinces has been higher than in the United States over the past twenty years. Worse yet, Canada has experienced no convergence over that period, whereas the United States has experienced convergence.

Exhibit 10 Four elements drive GDP

Prosperity		Profile		Utilization		Intensity		Productivity
GDP per capita	=	Potential labour force / Population	X	Jobs / Potential labour force	X	Hours Worked / Jobs	X	GDP / Hours Worked
				• Participation • Employment				• Cluster mix • Cluster content • Cluster effectiveness • Urbanization • Education • Capital investment • Productivity residual

Source: Adapted from J. Baldwin, J.P. Maynard and S. Wells (2000). "Productivity Growth in Canada and the United States" *Isuma* Vol. 1 No. 1 (Spring 2000), Ottawa Policy Research Institute.

In *intensity* – hours worked per worker – US state data going back twenty years are not available. However, in Canada the dispersion across provinces is growing slightly, indicating that we are not achieving convergence.

In demographic *profile* Canada has a slight advantage over the United States. Nevertheless, profile is the least important factor for a province's GDP per capita, and the level of disparity and rate of convergence is of limited significance.

Fiscal federalism hurts Canada's competitiveness

We conclude that Canada's current system of fiscal federalism is reducing Canada's overall competitiveness.

Our system of fiscal federalism is working to reduce provincial disparities in personal disposable income and thereby allowing more equal consumption of current prosperity. It is contributing positively to Canada's equity in income distribution – a source of pride for Canadians. However, the data indicate that we are less successful in reducing provincial disparities in wealth creation. Our system has not succeeded in reducing differences in productivity; nor does it address persistently high unemployment in Canada's have-not provinces.

We conclude that this mixed result is because the federal expenditure system is geared towards consumption of current prosperity in the have-not regions with its significant imbalance in health and social transfers to provincial governments and in EI benefits.

Exhibit 11 Canada has achieved less convergence than the United States in the elements that drive GDP per capita

	Advantage Canada vs US (2003)	Regional inequality between provinces and states, 1984-2004	Regional convergence between provinces and states, 1984-2004
GDP per capita	15.7% for US	Higher in Canada	Canada and US converging at about the same rate
Profile	2.3% for Canada	Higher in Canada	US states converging faster
Utilization	1.3% for Canada	Much higher in Canada	Canada provinces converging faster, but regional disparities still higher in Canada than in the United States
Participation	2.9% for Canada	Higher in Canada	Canadian provinces converging faster and now match US level of disparity
Employment	1.6% for US	Higher in Canada	Canada's provinces are achieving no convergence and level of disparity is falling further behind US states
Intensity	0.9% for US*	US state-level data not available for comparison	Canadian provinces diverging slightly, not converging
Productivity	19% for US	Lower in Canada	Canadian provinces diverging; US states converging
Urbanization	18.1 % higher incidence of US people living in metro areas	Higher in Canada*	US states converging faster than Canadian provinces*
Education	7.9 % higher incidence of university degrees in US**	Higher in Canada***	US states converging faster than Canadian provinces***
Capital Investment (Private Machinery, Equipment & Software)	7.9% higher investment per GDP dollar for US	US state-level data not available for comparison	Canadian provinces diverging

*1986-2003 results
**2004 results
***1989-2004 results

Advantage for Canada

Advantage for United States

Ireland's rapid growth did not depend on European Union transfers

Ireland's remarkable economic growth through the 1990s is one of Europe's greatest success stories. One of the poorest regions in Europe for more than two centuries, Ireland's GDP increased at a rate of 5.1 percent per year from 1990 to 1995 and at an average rate of 9.7 percent per year from 1996 to 2000.[a] By 2003, GDP per capita in Ireland had reached $37,384 – higher than in both the United Kingdom at $33,883 and Germany at $34,511.[b]

The evidence suggests that net transfers from the European Union (EU)[c] were not responsible for Ireland's remarkable growth. Ireland has received net transfers since 1973 when it joined the European community, but its rapid growth began only in the late 1980s (Exhibit E).[d]

If transfer payments were the cause of improved economic growth, other poor countries in the EU that receive a similar level of subsidies, such as Greece and Portugal, would have experienced similar growth rates. This has not been the case. Through the decade of Ireland's rapid growth, Greece averaged 2.2 percent GDP growth and Portugal averaged 2.6 percent average GDP growth – not nearly as high as Ireland. Of comparative interest to Canadians, transfer payments as a percentage of GDP to Atlantic Canada averaged over twice the level of transfers to Ireland over the 1981–2002 period.

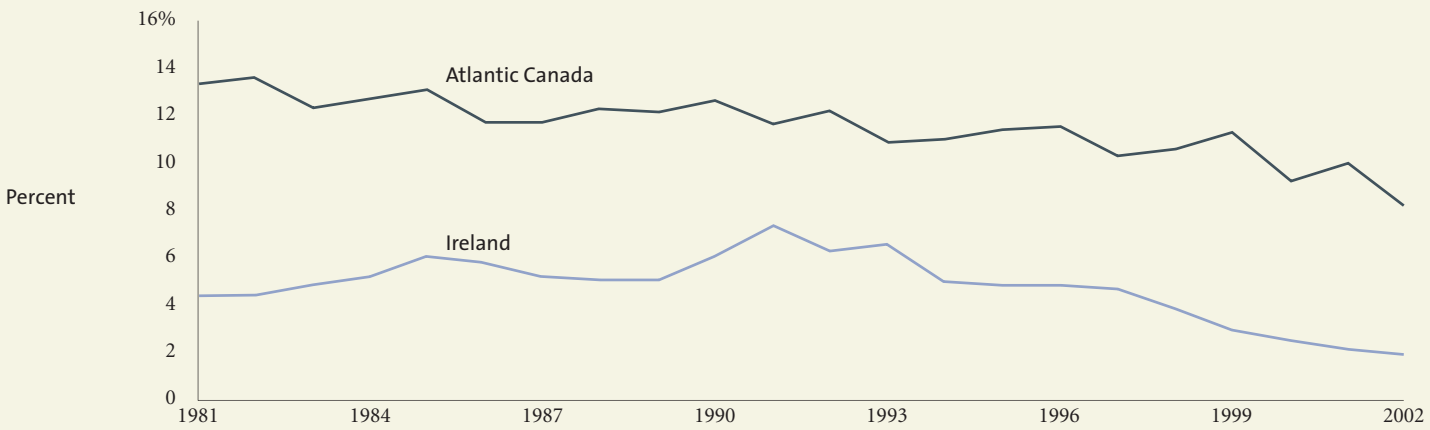
Some analysts have concluded that net transfers to Ireland have not necessarily been wealth enhancing. According to Benjamin Powell in a 2003 Cato Institute report titled *Economic Freedom and Growth: The Case of the Celtic Tiger*, transfers may have actually retarded growth by directing scarce resources to government projects that could have been better used by private entrepreneurs if the government had not bid the resources away.[e] Fred McMahon suggests in his book *Road to Growth: How Lagging Economies Become Prosperous* that, while agricultural subsidies – one component of EU transfers – may boost rural incomes, "they have little impact on investment and may retard economic adjustment by keeping rural populations artificially high.[f]

According to other observers, the more important reasons for Ireland's success can be attributed to development decisions of earlier decades, such as becoming part of the European market and achieving higher levels of education. More recent economic strategies, such as low corporate taxes, new social partnerships, improved performance of Irish management, and greater focus on capital investment and exports, are equally important.[g]

[a] International Monetary Fund 2001.
[b] *The Global Competitiveness Report 2004-2005*. World Economic Forum. 2004.
[c] Net transfers are transfers or subsidies to Ireland from the EU net of Ireland's contributions to the EU.
[d] Benjamin Powell. "Economic Freedom and Growth: The Case of the Celtic Tiger," *Cato Journal*., vol. 22, no. 3 (Winter 2003).
[e] *Ibid*., p. 442.
[f] Fred McMahon (2000). "Road to Growth: How Lagging Economies Become Prosperous," Atlantic Institute for Market Studies, Halifax, Nova Scotia.
[g] See, for example the presentation by Samara McCarthy, Industrial Development Agency of Ireland, at "Why Investment Matters to Ontario" conference. Presentation available at www.competeprosper.ca.

Exhibit E Ireland grew with relatively low EU transfer payments

Transfers as a percentage of GDP for Ireland and Atlantic Canada



Source: Statistics Canada, *Provincial Economic Accounts;* Ireland Department of Finance, *Budgetary & Economic Statistics 2005;* Institute for Competitiveness & Prosperity.

We have not succeeded in reducing regional inequalities any better than the United States, whose system does not attempt to target federal expenditures to its have-not states. If Canada could reduce its regional inequality to the same level as the United States through an increase in the GDP per capita in the have-not provinces, with no change in the have provinces, Canada's GDP per capita would increase by 1.6 percent to 2.4 percent (or on a per capita basis ranging from $654 to $974), depending on the measure of convergence used.

For Ontario, lower inequality between it and the have-not provinces in prosperity creation would lead to a lower requirement for federal transfers. This would mean an ability to invest more in Ontario's future prosperity. And, in turn, this would help raise Canada's prosperity.

Fiscal federalism hurts Ontario's competitiveness

Fiscal federalism results in a large transfer of resources from Ontario to other parts of Canada.

Essentially, this transfer happens because Ontario has a more competitive and prosperous economy than most other provinces in Canada. As we have seen, many of the sources of federal government's tax revenue are progressive – that is, higher income individuals pay a higher percentage of the tax. Many of the federal government's expenditures are aimed at individuals and regions that have lower income. The result is that Ontario generates higher federal tax revenue and receives lower federal expenditures than either its share of population or economic activity.

Few would challenge the conclusion that Ontario's competitiveness is reduced through the transfer of Ontarians' tax dollars to other parts of the country. In nearly every category of federal tax revenues, Ontarians pay a greater share than their population or GDP. In contrast, in nearly every category of federal government expenditure, Ontario's share is less than its population or GDP share. The net effect is that, on average, about $1,600 per capita is removed from the Ontario economy every year (see *Fiscal federalism differs in Canada and the United States*). This compares with a transfer-out of only $400 per capita in the fourteen US states that are Ontario's peer group.

Ontarians are proud of their important role in Confederation and have an expectation that they will always be net financial contributors to Canada. However, it is difficult not to conclude that the current approach to fiscal federalism is destroying potential economic value in Ontario in exchange for only limited success in generating value in the rest of Canada. All Canadians have an interest in reducing disparities in wealth-creation potential.

In summary, Canadians have achieved some success in reducing provincial disparities in income per capita – relative to our largest trading partner and most similar economy. But the evidence indicates that we have not matched this success in the rate of reduction of regional disparities in GDP per capita. Achieving greater convergence in GDP per capita means improved long-term potential for closing the income gap between the have and have-not provinces without large-scale transfers via the federal government. This will come about through strengthening fiscal federalism so that it better balances consumption of current prosperity with investment for future prosperity.

Why federal surplus surprises hurt fiscal federalism

Growing federal surplus surprises are reducing discipline in fiscal federalism and investment in future prosperity

The amount of money being transferred between provinces has been growing since 1997. By itself, this development is not a problem for Canada's competitiveness and prosperity. Our research indicates that the real challenge for Canada's fiscal federalism is to encourage investment for future prosperity in the have-not provinces rather than simply to transfer dollars to support current consumption. This latter approach does not close the interprovincial gaps in wealth-creation potential fast enough. Closing these gaps should be an aspiration for Canadians in all regions.

Equally troubling, however, is that these transfers are becoming less transparent and less disciplined. This is because increases in transfers are being enabled by annual federal surplus surprises that have become routine fixtures in fiscal federalism. A special case of the negative effects of federal surpluses is the EI program, which is not an insurance program but an interprovincial transfer program by stealth.

Federal surplus surprises are not always good

In Fiscal Year 1997/98, the federal government reversed an unbroken trend of deficits beginning in 1970/71. Since this turnaround, it has generated surpluses every year, accumulating more than $61 billion in surpluses (Exhibit 12). This was the result of the federal government's determined battle to eliminate deficits through a variety of tax increases and expenditure control begun in the 1994/95 fiscal year. This control included reduced transfers to provincial governments.

Few would argue that the federal government should return to the days of $30 billion annual deficits. But the current situation of ongoing annual surpluses is not an unalloyed good. This is especially true when the federal government consistently under forecasts the size of the annual surplus. The results have been unplanned spending increases and continuing growth in transfers from the federal to the provincial governments – and these are not always good for prosperity.

Federal forecast misses are costly to Canadians

Each year in the annual budget speech and supporting documents, the federal minister of finance provides a forecast for the coming year's budget surplus. This reflects the Department of Finance's best estimate of the revenues that will be generated through the tax system[18] and the expenditures of the federal government, including debt charges. In the budget, the federal government looks ahead to determine what changes, if any, are necessary in how it raises revenue and spends money in order to achieve its desired fiscal outcome. These forecasts inform choices that the government makes, and Parliament approves. For example, if the government is forecasting robust economic conditions, it can conclude that tax revenues will be buoyant. It may determine that a tax reduction would be the correct response or it may favour expenditure increases that can be carried out with less fear of a deficit. It may also make a few changes in current revenue and expenditure patterns with the expected revenue increase to help pay down the public debt. Or it can determine that some combination of these policies is the appropriate direction.

[18] Although non-tax revenues accounted for 5.4 percent of federal revenue over the period 1994-2004.

The budget and the ensuing public and parliamentary debate are watershed events in the mandate of a government and its accountability. They make clear the government's priorities and intentions and force prime ministers and ministers of finance to "make their case" to individuals, interest groups, the press, and Parliament. Failure to secure parliamentary approval for a budget typically causes the fall of governments.

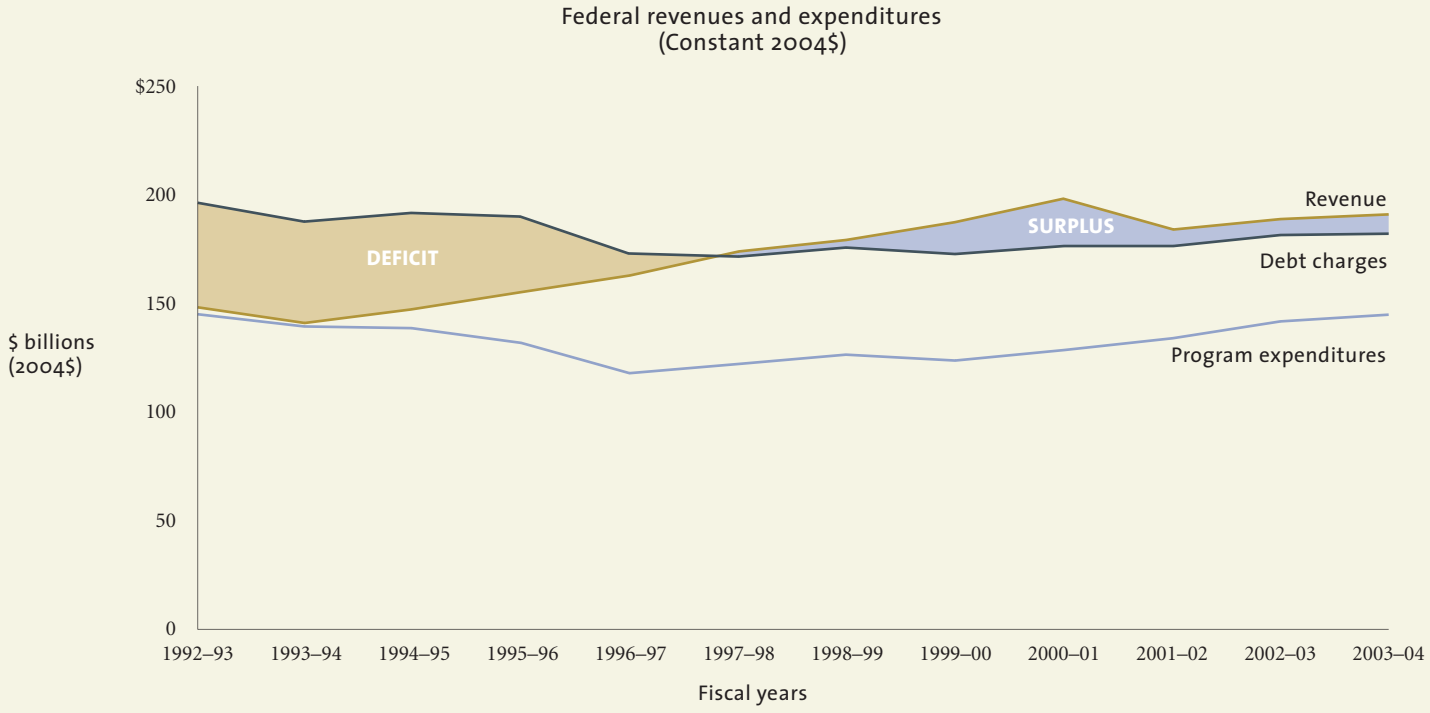
But, as with families and businesses, governments can face surprises as the fiscal year unfolds. Significantly lower revenues than forecast – or higher expenditures than forecast – can force higher than expected deficits or necessitate unplanned spending cuts. Given the period of serious federal budget deficits in the early 1990s, finance ministers and their staffs are still very concerned about this kind of negative forecast error.[19] Consequently, the federal government has consistently produced fiscal results that exceed forecasts. In 2003/04, the latest year for which we have final results, the federal government achieved a $9.1 billion surplus; it had forecast a $4.0 billion surplus at the start of the fiscal year – for a $5.1 billion variance. But 2003/04 was not an exception. In every year between 1994/95 and 2003/04, the federal government had a "positive forecast surprise." These accumulated to $64 billion in missed forecasts (Exhibit 13).

These positive variances are primarily the result of federal revenues exceeding forecasts. But they would have been significantly higher if the federal government had not found ways to spend more money than they had planned in their budgets.

Federal revenues have increased over the past decade as a strong economy has produced growing tax revenues, despite reductions in personal and corporate tax rates. Over the past decade, the federal government's annual forecasts of revenues totaled $1,531 billion. In seven of the ten years, actual revenues exceeded forecasts. In total, the federal government raised $1,581 billion – or $50 billion more than it had forecast.

On a percentage basis, this variance may seem small – 3.3 percent. However, it translates to $142 per capita annually, or $1,420 over

Exhibit 12 Surpluses persist despite growing federal program expenditures



Source: Department of Finance, *Federal Government Public Accounts*; Institute for Competitiveness & Proosperity

[19] See *Review of Canadian Federal Fiscal Forecasting* prepared by Tim O'Neill for Finance Canada (available on its Web site) for a review of the prevailing attitudes among senior officials in the Department on the necessity of avoiding budget deficits.

the decade. As these revenue surprises were occurring, the federal governments could have chosen to reduce taxes even further than they did. However, not since the 2000/01 budget has the federal government announced plans for significant tax reductions.

The federal government spends surprise surpluses mainly on consumption

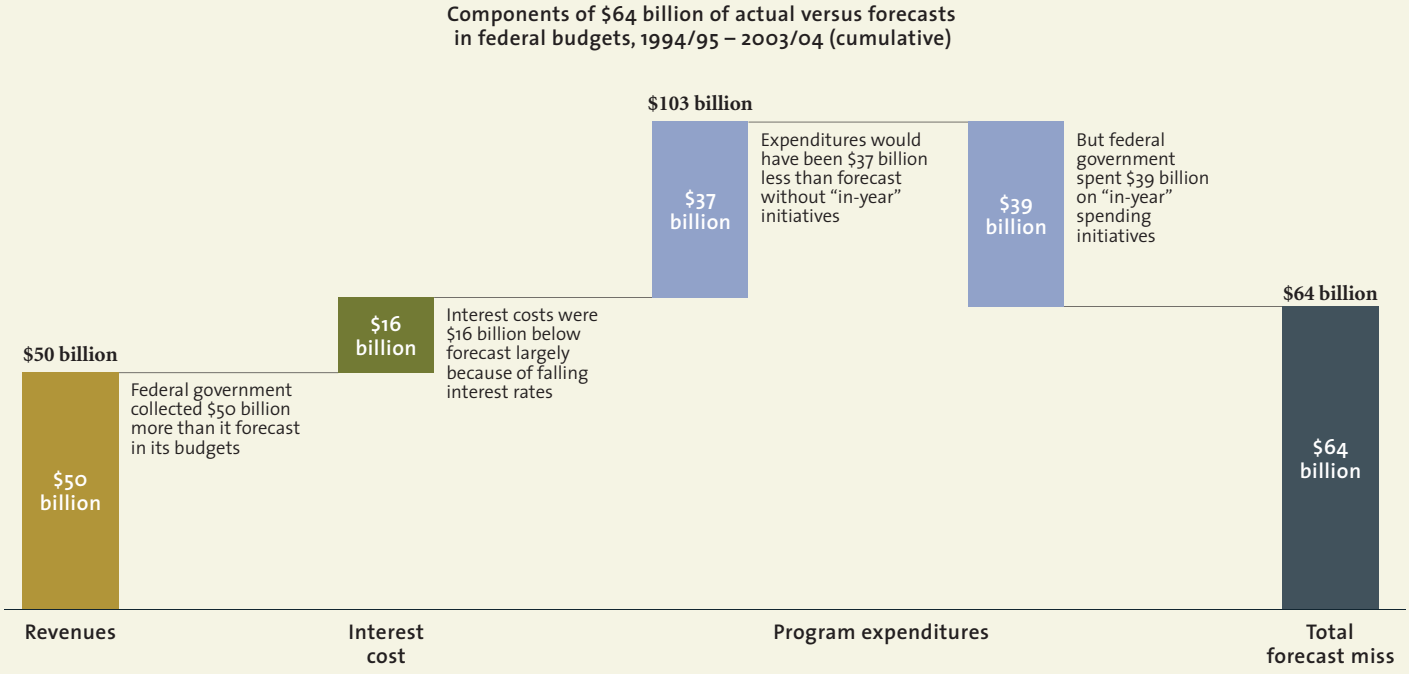
Important to the federal government's success in battling the deficit between 1992/93 and 1996/97 was its reduced spending. In those years, not only did it forecast reduced expenditures, but actual spending also came in even lower than these forecasts. But beginning in 1996/97, as revenues continued to build, the federal government began to increase its spending – growing at an annual real rate of 3 percent between 1996/97 and 2003/04 after an average annual real decline of 5 percent in the five previous years.

Comparison of actual to forecast results under states the extent to which the federal government increased its spending. As with revenue surprises, the federal government had choices when actual expenditure levels were turning out to be lower than budget forecasts. It could have used the unplanned windfall to reduce the overall debt, reduce taxes for future years, or increase spending. The federal government opted in large part for the last option. Over the last decade, it spent $39.2 billion through in-year policy initiatives. In other words, as the government realized the actual surplus would be higher than budgeted, it found $39.2 billion – or $1,100 per capita – worth of opportunities for unbudgeted spending over the decade 1994/95 to 2003/04.

Where did the federal government increase its spending? Of the $39.2 billion in unplanned spending, **$23.4 billion was for consumption of current prosperity** – primarily in health care and to a lesser extent in social spending. This $23.4 billion consisted of $11.7 billion in transfers to the provinces through the Canada Health and Social Transfer and $11.7 billion in direct spending on consumption by the federal government.

The second major category was investment for future prosperity, primarily in expenditures on research and development and post-secondary

Exhibit 13 Federal budget forecasts have been conservative – by $64 billion in the last decade



Source: Institute of Competitiveness & Prosperity analysis based on Institute for Policy Analysis, *Forecasting Processes and Performance of the Department of Finance,* prepared for *Review of Fiscal Forecasting,* Department of Finance, June 2005

education (e.g., the Millennium Scholarship Foundation, which was an unplanned expenditure in 1997-98). This i**nvestment in future prosperity accounted for $7.2 billion** of the $39.2 billion unplanned spending.

The other categories of unplanned spending were **protection and international relations at $4.3 billion**, **government administration at $4.0 billion**, and the **environment at $0.3 billion**.

This pattern illustrates the trade-off between consumption and investment. For every dollar the federal government spent in consuming current prosperity, it invested 31 cents in future prosperity. Recall that, as we discussed earlier, overall investment by governments in Canada in future investment was 50 cents per dollar of consumption. However, when extra unplanned resources became available, the investment spending's share dipped, instead of going up as would have been prudent. How the federal government chose to spend these found savings contributed to the overall shift from investment to consumption in government spending across Canada between 1992 and 2002, discussed earlier.

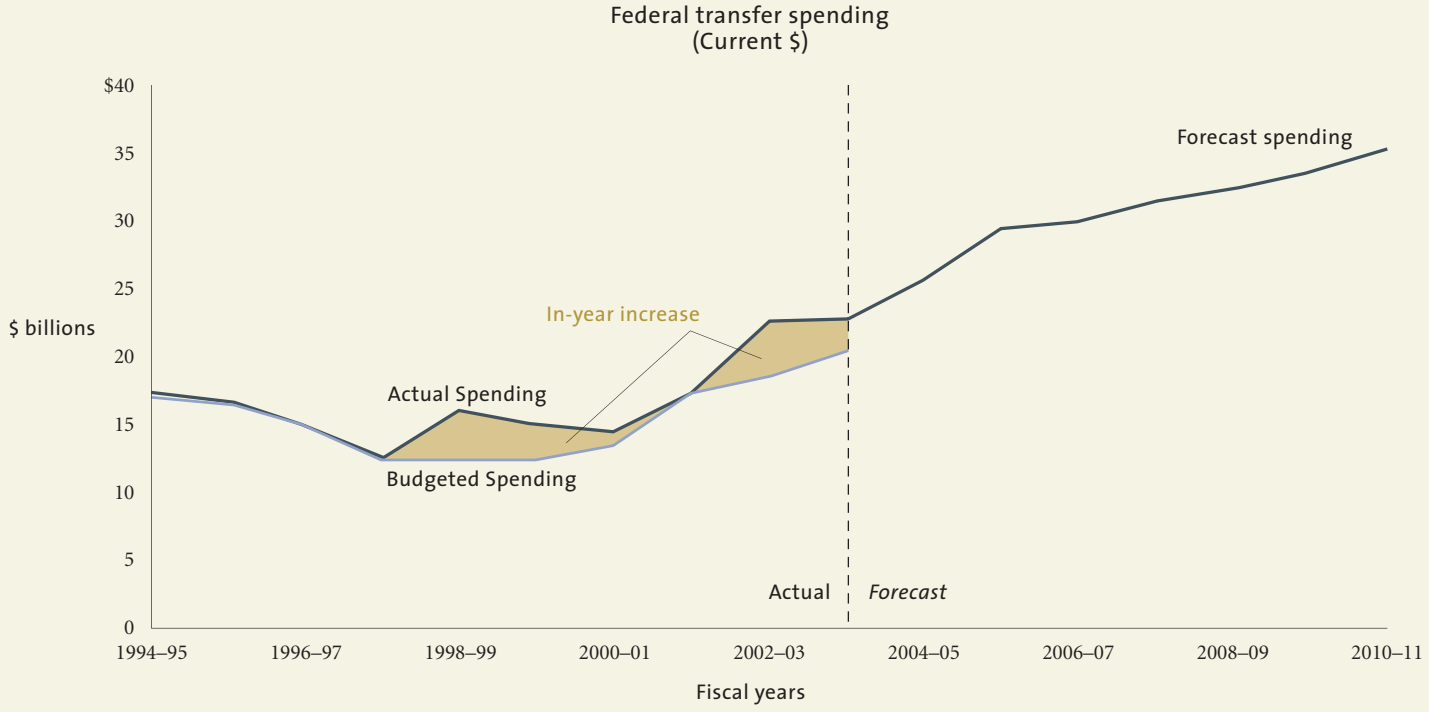
The federal government also benefited from lower debt charges over the decade, primarily because interest rates were lower than budgeted. In total, it budgeted $424.3 billion, while actual debt charges were $408.5 billion – the $16 billion forecast miss.

Recent federal transfer commitments to the provinces may not be sustainable

As we described earlier, the federal government transfers dollars directly to provincial governments in two ways: transfer programs, which are typically done on an equal per capita basis; and equalization payments, which are provided only to have-not provinces on the basis of each province's economic circumstances.

Dollars flowing to the provinces through **federal transfer programs** under the CHT and the CST have been growing significantly since 2000/01 when the federal government realized an overall surplus of $17.1 billion, fully $13.1 billion higher than it had forecast in the budget for the year. Since that time,

Exhibit 14 Planned and unplanned federal transfer programs increased significantly



Source: Institute for Policy Analysis, Forecasting Processes and Performance of the Department of Finance, prepared for Review of Fiscal Forecasting, Department of Finance, June 2005; *The Budget Plan 2005*, Department of Finance; Institute for Competitiveness & Prosperity.

these transfers have increased by 57 percent (Exhibit 14). Part of this increase has been the result of in-year policy decisions – that is, decisions to spend more than originally forecast in the budget because more money became available during the year. In fact, since the start of 2000/01, the federal government has added $7.4 billion to its budgeted spending through in-year policy changes. However, this is not a new pattern – between 1996/97 and 1999/2000, the federal government found a total of $7.3 billion for in-year increases to federal transfers.

Federal transfers to the provinces for health care are set to increase from $18.5 billion in 2004/05 to $30.5 billion in 2013/14.[20] This translates to an annual growth rate of 5.9 percent rate over the next nine years – outstripping any reasonable projection of growth in the economy and in federal revenues.

Trends in **equalization payments** are equally disturbing. After three years of decline, the federal government has committed to a dramatic increase in this spending for 2005/06 – $10.9 billion versus $8.7 billion in 2003/04. It has also committed to a growth rate of 3.5 percent annually over the next ten years.[21] As with the transfer payments, the federal government has locked in a growth rate that potentially exceeds economic growth.

In addition to the planned growth in commitments to the provinces, the federal government has recently reached ad hoc deals with specific provinces. In January 2005, the federal government agreed to allow Newfoundland and Labrador and Nova Scotia to keep 100 percent of offshore oil and gas revenues with offset payments covering any decline in equalization payments resulting from rising offshore revenues. This deal is in effect until 2012 and possibly until 2020. As a result of this deal, the federal government was then forced to conclude a deal in May with Saskatchewan in which it committed an extra $300 million in transfers over the next five years. At the same time, the federal government concluded a deal with Ontario that would result in $5.75 billion of federal money flowing to the province in the coming five years. Shortly after the Saskatchewan and Ontario deals, Alberta announced its intent to ask for $540 million annually for immigrant services and new health and social transfers.

What is surprising is that the have provinces, Alberta and Ontario, continue to press for more transfer programs. In the recent premiers' meeting in Banff, the communiqué[22] called for increased federal transfers for post-secondary education. For have-not provinces, the arithmetic of the request makes sense as their governments' share of these transfers will exceed their residents' share of taxes to pay for the transfers. But for Ontario, every dollar transferred on a per capita basis costs Ontarians $1.16, since they generate more federal revenue per capita. For the average Albertan, the logic is even worse as increased transfers cost $1.19 per capita.

A more logical approach for the have provinces would be to call for the federal government to reduce its tax rates in specific areas and allow each provincial government to determine if it should replace the reduced federal taxes with higher provincial taxes or not to replace the federal taxes and effect a lower overall tax rate for the province.

EI creates excessive surpluses and the wrong kind of transfers

An important part of federal surpluses is the egregious surplus that has been building in the EI account. In every year since 1993, the federal government has collected more EI revenue than it has paid out. And between 1993 and 2002, the federal government accumulated an EI surplus of $67.2 billion. As the program is collecting more than it pays out in benefits, EI is effectively a tax on labour[23] rather than an insurance program.

In addition to its ongoing surplus, EI suffers from weaknesses in its design. First, it interferes with the supply of labour. For example, someone who has worked only twelve weeks (full-time) in a high-unemployment area (where joblessness is above 16 percent) can receive up to thirty-two weeks' benefits. Meanwhile, a claimant who has worked twenty weeks in a low-unemployment area would receive only fourteen weeks' benefits. Moreover, in high-unemployment areas, as individuals accumulate more than twelve weeks of full-time employment, the benefit period is reduced and ultimately approaches the national average. In effect, the regional approaches to EI create what economists call diminishing returns or high marginal costs for employment.[24] And these barriers are created in the regions with the highest and most persistent unemployment rates.

To highlight the problem, Tim Sargent, an economist with Finance Canada, has constructed a region-by-region EI disincentives index. It shows the highest levels of disincentive to secure work are in Atlantic Canada and Quebec, regions where unemployment is highest. The OECD observed that high unemployment rates may, to some

[20] Department of Finance Canada, *The Fiscal Balance in Canada: The Facts*, October 2004, downloaded from http://www.fin.gc.ca/facts/fbcfacts9_e.html.
[21] *Ibid*.
[22] Communiqué from the Council of the Federation, Banff, August 12, 2005, downloaded from http://www.mia.gov.on.ca/Communique%20Aug%2012.pdf
[23] Canada's EI surplus is one of the contributing factors to its high marginal effective tax rate on labour relative to the United States where its equivalent does not generate surpluses. See *Taxing smarter for prosperity*, p. 22 (Exhibit 5) for more information.
[24] See De Raaf, Kapsalis, and Vincent, "Seasonal Employment and Reliance on Employment Insurance: Evidence from SLID, Social Research and Development Corporation Working Paper, Series 03-04, 2003

extent, be self-perpetuating and may need to be addressed by more aggressive case management and job activation measures and with a revised set of benefit rules.[25]

The current EI system also creates perverse incentives for employers. EI benefits allow firms to avoid the natural consequences of high rates of layoffs and closures. The current system encourages firms with seasonal fluctuations to lay off workers rather than bear the costs of keeping them on staff during the down season. According to the OECD "certain [Canadian] firms may have been taking advantage of the existence of EI to keep an experienced workforce available on demand while shifting the costs onto other firms."[26]

One measure of cross-subsidization of industries and firms is the relative benefit-to-tax (RBT) ratio. In industries and firms where employees collect more EI benefits than employers and employees pay in premiums, the RBT ratio is greater than one. If premiums exceed benefits, then the ratio is below one. Industries or firms that have persistent RBT ratios above one are being subsidized within the EI system by firms or industries with RBT ratios below one.

In a 2003 study of the 1986-96 period, Miles Corak and Wen-Hao Chen[27] found that four industries – fishing, forestry, construction, and agriculture – had RBT ratios greater than one,[28] while ratios in eight other industries were below one. At one extreme, in the fishing industry EI benefits paid were $14.76 per dollar of premiums collected. At the other was finance, where the ratio stood at 56 cents. To be sure, the industries with perennially high RBTs are relatively small; nevertheless, the annual subsidy to those industries through EI was $2.2 billion paid from employees and firms in the remaining industries.

Corak and Chen also analyzed the impact of sub-industries and firms[29] by the number of years during the eleven-year study period in which their RBT exceeded one. They found that fully 30 percent of sub-industries were subsidized in every year of the eleven-year period. These "always subsidized" sub-industries accounted for 32 percent of jobs, but 45 percent of EI benefits paid and only 19 percent of EI premiums. At the other extreme, 39 percent of sub-industries were never subsidized. They accounted for 45 percent of jobs, 34 percent of benefits, and fully 61 percent of premiums.

At the firm level Corak and Chen found that only 6 percent of firms were "always subsidized." These firms accounted for 6 percent of jobs but 28 percent of benefits and only 4 percent of premiums. At the other extreme, 22 percent of firms were "never subsidized." These firms accounted for 48 percent of jobs, but only 28 percent of benefits paid out and 60 percent of premiums. The EI benefit claims emanating from "always subsidized" firms were mostly for temporary layoffs (71.5 percent of claims versus an all-firm average of 47.8 percent).

While it is true that most of the "always subsidized" firms are in "always subsidized" sub-industries, many firms in these sub-industries are "never subsidized." In fact, the researchers found that firm-specific practices were twice as important in explaining EI "behaviour" as industry or province. They concluded that "…a considerable number of firms predictably and persistently receive subsidies through the UI program, year after year, regardless of their geographical and industrial conditions."

[25] *OECD Economic Survey of Canada,* OECD (2004), p. 2
[26] *Ibid*. p. 4
[27] Corak and Chen, "Who Benefits from Unemployment Insurance in Canada: Regions, Industries, or Individual Firms?" *SRDC Working Paper Series 03-07,* Social Research and Demonstration Corporation, November 2003
[28] standardized for the national surplus
[29] 228 sub-industries as defined by 3-digit SICs; and 320,000 firms in the database that were in existence in all 11 years of the study.

Overall, the EI system plays havoc with both the supply of and demand for employment. The incentive system works against employees looking for work in high-unemployment regions and encourages firms to avoid hiring workers on a permanent basis. Significant amounts of money are transferred from Ontario to other regions of the country through the EI system. EI accounts for $3.7 billion of Ontario's $16.1 billion fiscal federal gap. EI diminishes Ontario's competitiveness with its peer states and Canada's competitiveness with the US and other trading partners.

In effect, the EI system supports uncompetitive firms, thereby dragging down Canada's overall prosperity.

Experience rating of EI premiums would strengthen fiscal federalism

Part of a solution to the perverse incentives of EI is to make EI premiums responsive to frequency and magnitude of benefits claims through "experience rating." This would mean that firms making greater use of the EI system would be charged higher premiums and firms making less use of the system would be charged lower premiums. In effect, firms would bear more of the costs of their layoffs – especially temporary and seasonal layoffs. Experience rating would provide firms with incentives to offer more stable employment. With reduced EI premiums, firms with better employment records would pay higher wages and be more competitive. The net effect would be a more competitive economy overall, including higher employment. The Macdonald Commission in 1985, the Forget Commission in 1986, and the Government of Newfoundland in 1993 and 1995 have all advocated for the introduction of experience rating into Canada's EI system.[30]

The principle of experience rating has been long employed by worker compensation programs as an incentive for improving occupational safety. A firm's assessment by the Workplace Safety and Insurance Board is affected by its accident record – including both accident costs and frequency. Firms that fall below minimum standards are also subject to a surcharge.

Experience rating is an integral part of the unemployment insurance system in the United States. A firm pays premiums that reflect its layoff history. The marginal tax increase for each additional layoff – the measure of the "tightness" of the system – varies from state to state. According to the US Department of Labor, the objectives of experience rating are to prevent unemployment by inducing employers to stabilize their operations and thus their employment, and to allocate equitably the costs of compensable unemployment.[31]

A recent study by Human Resources Development Canada[32] concludes that lower levels of unemployment can be correlated with tighter experience rating programs, where the marginal cost increase to the employer of each layoff is high. Qualitative data collected suggest the same thing: the greater the marginal tax increase per layoff the more likely it is that a firm will avoid making that layoff.

Our view is that EI is not an insurance program. Rather it is becoming a transfer that places a dysfunctional tax on productive labour and successful businesses. In addition, the excessive surpluses accumulated are a high cost to have provinces and to overall prosperity growth.

The dramatic turnaround that the federal government achieved through the last decade in its fiscal situation has been a positive factor in Canada's economic health. But ongoing surpluses are not an unalloyed good, especially if they are consistently greater than budgeted for. Our research indicates that the federal surplus surprises are leading to a loss of discipline in fiscal federalism, resulting in potentially unsustainable growth in federal transfers. This lack of discipline is also exacerbating the trend away from investing in future prosperity towards consumption of current prosperity. An important part of this lack of discipline is the growing surpluses in EI, a program that is less and less an insurance program and more and more a transfer program.

[30] Franke and Hermanutz, "Employment Insurance: Returning to Insurance Principles, *Canadian Business Economics*, Summer 1997.
[31] US Department of Labor, "General Principles of Experience Rating Under Section 3303 (a) (1), Federal Unemployment Tax Act, Unemployment Insurance Program Letter No. 29-83, June 23, 1983.
[32] Human Resources Development Canada, "Employer Responses to UI Experience Rating: Evidence from Canadian and American Establishments," March 2005.

How to overhaul fiscal federalism for Canada's future prosperity

We see significant improvement opportunities in smarter approaches to transfer and tax policies, transfer payment programs, fiscal management of surplus surprises, and Employment Insurance – all of these will discipline the federal government to shift more resources to investment in prosperity

Our work indicates improvement opportunities in four areas. First, we can reframe the approach to fiscal federalism, so that it is shifted from being a transfer of funds to support consumption of current prosperity and towards a system that encourages investment in future prosperity. New approaches to transfers and taxation will not only reduce the fiscal gaps, they will also improve competitiveness and prosperity in all provinces. Second, we need to change our current ad hoc approach to federal equalization and transfer payment programs. Third, the federal government should develop a consensus for a systematic mechanism for dealing with surprise surpluses rather than treating them as opportunities to consume more current prosperity. Finally, we should make EI into a true insurance program, thereby reducing fiscal gaps and strengthening incentives for employment across Canada.

Shift transfer spending to tax relief that stimulates business investment

As we have shown, the current system of fiscal federalism is tilted towards transferring resources to provinces in a way that encourages consumption of current prosperity over investment for future prosperity. We have also seen that, by not getting a higher level of private sector investment in machinery, equipment, and software in these regions, we are not creating jobs, so that unemployment is a persistent problem that needs to be addressed.

We need to stress that realizing a good quality of life from our prosperity should always be the first priority for public policy. But it is not the only priority, and public policy needs to strike a balance. We have observed that this balance has been moving away from investment and towards consumption at a greater rate than our most important trading partner, the United States. And we have also observed that the current approach to fiscal federalism has promoted this adverse shift.

A more creative approach to fiscal federalism would move away from transfers towards initiatives that encourage investment in future prosperity in the have-not provinces. This would also lead to higher employment. One measure that would stimulate convergence of wealth-creation potential across the provinces would be to create **special economic tax zones in the have-not provinces**. In this approach, transfers to the provinces would be replaced by reduced federal corporate income taxes in the have-not provinces.

The rationale for this approach was set out by Mintz and Smart in their paper, "Brooking no favorites." In their analysis of the delivery of federal development assistance to Atlantic Canada, they concluded that: "Existing grant programs are well intentioned, though poorly targeted. Governments are usually not good at picking winners – but losers tend to be very good at picking governments. We recommend federal business tax reductions for the region. A broad-based tax credit [replacing cash grants and the existing federal Atlantic Investment Tax Credit would eliminate] the effective tax rate on marginal investment projects in the Atlantic region."[33]

The Institute engaged the Centre for Spatial Economics (C_4SE) to assess the impact of eliminating government transfers to business in the have-not provinces. The savings amount to a 50 percent reduction in corporate taxes. Thus all businesses would have significantly increased motivation to invest in the region, and transfers to business – whose impact is questionable – would disappear. C_4SE's modeling indicates that in the long term,[34] GDP per capita would increase by 0.5 percent in the Atlantic provinces (Exhibit 15).[35]

In implementing such an approach, the federal government could commit to leaving these zones in place for a period of, say, twenty years. Then the provinces benefiting from this policy would be changed to reflect changes in have and have-not status.

What we have modeled is a modest shift in fiscal federalism. But it points the way to even bolder approaches, by which transfers of resources from some provinces to others could be replaced by reduced taxes that encourage investment and reduction of disparities in wealth-creation potential across the provinces.

Another way to shift the fiscal federalism system towards encouraging investment would be to make a broader attack on high taxes on business investment. On the federal revenue side, taxes on corporations are a key driver of

[33] *C.D. Howe Institute Commentary*, No. 192, December 2003.
[34] On average over twenty-five years.
[35] The impact on other provinces through lost tax revenue through tax shifting would be negligible according to C4SE's modeling.

funds transfers from have to have-not provinces. As we have shown in our previous work, Canada taxes business investment at a higher rate than most industrialized economies[36] and this contributes to under investment by business – a major factor in our prosperity gap with the United States. Our research and the work of others indicate that shifting our basis of taxation away from business investment and towards consumption would strengthen our competitiveness and prosperity. More specifically, reducing corporate capital and income taxes and replacing the lost revenue by increasing the GST would improve Canada's investment and prosperity results. Of relevance to fiscal federalism, this taxation shift would also reduce the inequities in tax payments across provinces, since revenues from the GST more closely reflect a province's share of national population and GDP.

To help understand the impact of this kind of tax shift, C_4SE modeled a 50 percent **reduction in corporate capital and income taxes and an increase in the GST** to replace lost revenue. This would result in the GST increasing from 7 percent to 10 percent. The long-term impact of this shift would be to increase Canada's GDP per capita by 0.6 percent over the result without this change. In effect, reducing corporate taxes increases motivations for business investment, which in turn increases productivity and GDP per capita. All provinces would realize an increase in GDP per capita with very little difference in the impact between the three have provinces (Alberta, British Columbia, and Ontario) and the have-not provinces (Exhibit 15). This impact would make the interprovincial makeup of federal tax revenues more closely track GDP shares, and thus reduce the federal fiscal gap.

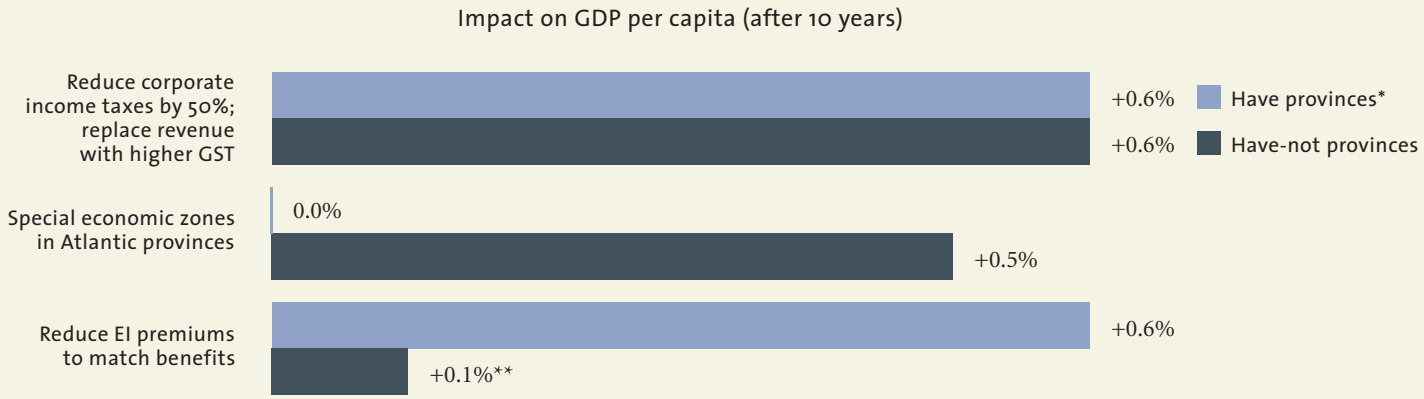
Rethink approaches to equalization and transfer payments

Current patterns in transfers and equalization will result in an ever-increasing share of federal expenditures going to fund consumption of current prosperity by provinces and will disadvantage the have provinces even further. Federal and provincial governments need to rethink these programs.

When the federal government was battling the federal deficit, it cut transfer payments and equalization payments. When the deficit was brought under control and the federal government was treated to surprise revenue and expenditure patterns that exceeded expectations, they began loosening the purse strings. In fact, over the period 1996/97 to 2003/04 the federal government added $11.7 billion to transfer programs through in-year initiatives. It has committed itself to ever increasing health and social payments and to annual increases of 3.5 percent in equalization payments. This will increase the fiscal gap and will also worsen the consumption/investment balance in federal spending.

Recent federal/provincial discussions seem to be leading to increased transfer payments for post-secondary education. This spending has the merit of investing for future prosperity. Yet it will increase the dollars flowing to Ottawa and back to the provinces – making provincial governments more dependent on federal largesse for their operations. This will

Exhibit 15 Smarter approaches to fiscal federalism could boost GDP in all regions of Canada



*Have provinces: Alberta, Ontario, British Columbia; Have-not provinces – All others
**Zero impact in Atlantic Canada; 0.2% increase in Quebec, Manitoba, Saskatchewan

Source: Unpublished study by Centre for Spatial Economics for the Institute for Competitiveness & Prosperity analysis.

[36] *Taxing smarter for prosperity*, pp. 26-30

worsen accountability as one level of government will be raising the revenue and another will be spending it.

Premiers in the have provinces need to question the merit of asking for increased transfers from the federal government instead of seeking expanded provincial taxing authority. As it stands, every dollar transferred to Ontario costs the taxpayer in Ontario $1.16; in Alberta the cost is $1.19.

Build more discipline in dealing with federal budget surplus surprises

In its forecasting of revenues and expenditures in budgets, the federal government's bias is to avoid deficits at any cost. Federal budget surplus surprises have led to in-year spending initiatives of $39 billion over the past ten years – or over $1,100 per Canadian. The pressure has been to spend this "found money" on current consumption – for every dollar the federal government has transferred to provinces for their consumption or spent on consumption itself, it has invested only 31 cents. This ratio is considerably worse than for existing government programs.

These significant additions to federal spending were not part of the formal budget proposals, and it is unlikely that they have received the scrutiny and debate (within cabinet, between political parties in Parliament, or in the press and among the public) that budgeted spending has. In addition, these marginal dollars have come disproportionately from the have provinces, as their share of federal tax payments exceeds their share of GDP and population.

Effectiveness and efficiency in government spending would be better served if the federal government built a consensus for a systematic approach to dealing with surplus surprises. The first step could be to use a percentage of surplus surprises to pay down the national debt even further than projected. Future budgets would then afford greater opportunity for tax reduction or expenditure increases as the debt situation would be less severe. With the funds that remain, the federal government should commit to using a large proportion – no less than 75 percent – for investment in infrastructure, post-secondary education, and research and development for future prosperity. The rest of the surplus surprises could be used for consumption of current prosperity. Alternatively, it could be returned to the Canadian taxpayers in proportion to how the funds were raised. Or it could be transferred to provincial governments in the proportion to the contribution of their taxpayers to the federal surplus.

None of this prevents the federal government from transferring large amounts of resources from have provinces to have-not provinces – if this is the democratic will in the country. We argue that the government should make the case for the amount and type of transfers in fiscal federalism through the formal budget process rather than use found money to consume current prosperity. The current approach creates the incentive for the federal government to under forecast surpluses and then spend the windfall as it sees fit later in the year. A more disciplined approach to dealing with surplus surprises will create the incentive to make more realistic forecasts and make the case for increased transfers to support consumption of current prosperity.

Make EI a true insurance program

The EI surplus is an important factor in the fiscal gap. Worse, EI's structure is likely contributing to persistently high unemployment in Atlantic Canada. As we have seen, the regional disparities in employment have worsened over the past decades not improved. Research by others indicates that EI is essentially a subsidy program – drawing resources from successful employers who are providing stable employment to less successful firms that are regularly laying off their work force. This kind of incentive punishes success and rewards failure. The current EI surplus represents a tax on labour, and is an important contributor to Ontario's disadvantage in marginal effective tax burdens versus the peer states.

As a first step, the federal government needs to reduce EI premiums significantly to match unemployment benefits. The accumulating surplus can be put to better use in the hands of employees and employers. This will also reduce the temptation to add new benefits to the EI programs that have only tangential connections to reducing the dislocations of unemployment. Second, the federal government should introduce experience rating among employers to make EI a true insurance program. Those employers who cost the system more should bear higher costs than those who are currently net contributors.

The impact of an experience rating cannot be modeled precisely. However, C_4SE estimated the impact of reducing premiums in each province to match its level of benefits. In most of Atlantic Canada, as benefits exceed premiums, there would be no impact. For have-not provinces outside Atlantic Canada, where premiums exceed benefits, GDP per capita would increase by 0.2 percent. In the have provinces, GDP per capita would increase in the long term by 0.6 percent (see Exhibit 15).

Canadians are rightly proud of the economy we have built. No other country has achieved the success we have in balancing the level and distribution of prosperity. Ontarians are also proud of the role they have played in building a competitive and prosperous province and in being able to share this success with other Canadians through our system of fiscal federalism. But we conclude that fiscal federalism misses significant opportunities for building long-term competitiveness and prosperity across the country. And we propose that Canadians work together to overhaul fiscal federalism so that it encourages investment for future prosperity.

References

Barro, Robert and Xavier Sala-i-Martin (2004), *Economic Growth,* Second Edition, The MIT Press, p. 461.

Boadway, Robin and Ronald L. Watts (2004) "Fiscal Federalism in Canada, the USA, and Germany" Working Paper, Queens University

Corak and Chen (2003) "Who Benefits from Unemployment Insurance in Canada: Regions, Industries, or Individual Firms?" Working Paper, Social Research and Demonstration Corporation, SRDC Series 03-07.

Coulombe, Serge (1997) "Regional disparities in Canada: characterization, trends and lessons for economic policy" Working Paper number 18, University of Ottawa, November.

The Council of the Federation, Banff (2005) "Communiqué," August 12, 2005. Available online: **http://www.mia.gov.on.ca/Communique%20Aug%2012.pdf**

Department of Finance, Canada (2004) "The Fiscal Balance in Canada: The Facts, October 2004." Available online: **http://www.fin.gc.ca/facts/fbcfacts9_e.html**

Department of Finance, Canada (2005) "Federal Transfers to Provinces and Territories, March 2005."Available online: **http://www.fin.gc.ca**

Department of Finance, Ireland (2005) "Budgetary & Economic Statistics," April.

Department of Justice, Canada "The Constitution Act, 1982, Part III Equalization and Regional Disparities," Section 36 (2). Available online: **http://laws.justice.gc.ca/en/const/annex_e.html#III**

De Raaf, Kapsalis, and Vincent (2003) "Seasonal Employment and Reliance on Employment insurance: Evidence from SLID" Working Paper, Social Research and Development Corporation, Series 03-04.

Eyefortransport transportation glossary. Available online: **http://www.eyefortransport.com/glossary/uv.shtml**

Franke and Hermanutz (1997) "Employment Insurance: Returning to Insurance Principles, Canadian Business Economics."

Human Resources Development Canada (2005) "Employer Responses to UI Experience Rating: Evidence from Canadian and American Establishments," March.

Institute for Competiveness & Prosperity (2005) Canadian Report – *Realizing Canada's prosperity potential,* January. Available online: **www.competeprosper.ca**

– (2005) Working Paper No. 7 – *Taxing smarter for prosperity*, March .

– (2003) Working Paper No. 3 – *Missing opportunities: Ontario's urban prosperity gap,* June.

– (2002) Working Paper No. 2 – *Measuring Ontario's prosperity gap: Developing an economic indicator system,* August.

Institute for Policy Analysis, University of Toronto (2005) "Forecasting Processes and Performance of the Department of Finance," prepared for Review of Federal Fiscal Forecasting, Department of Finance, June.

McCarthy, Samara, Industrial Development Agency of Ireland (2005), "Why Investment Matters to Ontario" conference. Available online: **www.competeprosper.ca**

McMahon, Fred (2000). "Road to Growth: How Lagging Economies Become Prosperous," *Atlantic Institute for Market Studies*, Halifax, Nova Scotia.

Mintz, Jack M. and Michael Smart (2003) "Brooking no favorites: a new approach to regional development in Atlantic Canada" C.D. Howe Institute Commentary. Available online: **http://www.cdhowe.org/pdf/commentary_192.pdf**

OECD (2004a) *OECD Economic Surveys: Canada.* Paris: OECD.

Porter, Michael E., Klaus Schwab, Xavier Sala-i-Martin and Augusto Lopez-Claros (2004). *The Global Competitiveness Report 2004-2005.* Oxford: World Economic Forum.

Powell, Benjamin (2003) "Economic Freedom and Growth: The Case of the Celtic Tiger" *Cato Journal,* Winter, vol. 22, no. 3.

Statistics Canada:
– (2004) CANSIM II: Table 3840002 (GDP Expenditure-based at current prices)

– (2004) CANSIM II: Table 5100001 (Population)

– (2003) *Provincial Economic Accounts 2003.* Table 6, 7, 11, 12, 14, 15 & 16. Catalogue No. 13-213-PPP.

– (2004) CANSIM II: Table 3840012 (Personal income & Personal disposable income)

– (2004) CANSIM II: Table 2820002 (Employment)

– (2004) CANSIM II: Table 2820018 (Hours worked)

Statistics Canada (*continued*):
– (2004) CANSIM II: Table 2820004 (Education)

– (2004) CANSIM II: Table 0320002 (Capital Investment)

– (2004) CANSIM II: Table 0510034 (Census metropolitan areas)

Task Force on Competitiveness, Productivity and Economic Progress (2002) First Annual Report, *Closing the prosperity gap*, November. Available online: **www.competeprosper.ca**

Tax Foundation, Federal Taxing and Spending by State 1981-2003. Available online: **http://www.taxfoundation.org/**

US Census Bureau (2005) population and metropolitan area estimates. Available online: **www.census.gov**

US Department of Commerce, Bureau of Economic Analysis (2005). *NIPA Table Selection 5.* Available online: **www.bea.gov**

US Department of Labor (1983), "General Principles of Experience Rating Under Section 3303 (a) (1), Federal Unemployment Tax Act," Unemployment Insurance Program Letter No. 29-83, June 23.

US Department of Labor, Bureau of Labour Statistics. Available online: **www.bls.gov**

Previous publications

Institute for Competitiveness & Prosperity:

Working Paper 1 – *A View of Ontario: Ontario's Clusters of Innovation* – April 2002

Working Paper 2 – *Measuring Ontario's Prosperity: Developing an Economic Indicator System* – August 2002

Working Paper 3 – *Missing opportunities: Ontario's urban prosperity gap* – June 2003

Working Paper 4 – *Striking similarities: Attitudes and Ontario's prosperity gap* – September 2003

Canadian Report – *Partnering for investment in Canada's prosperity* – January 2004

Working Paper 5– *Strengthening Structures: Upgrading specialized support and competitive pressure* - July 2004

Working Paper 6 – *Reinventing innovation and commercialization policy in Ontario* – October 2004

Canadian Report – *Realizing Canada's prosperity potential*– January 2005

Working Paper 7 – *Taxing smarter for prosperity* – March 2005

Task Force on Competitiveness, Productivity, and Economic Progress:

First Annual Report – *Closing the prosperity gap* – November 2002

Second Annual Report – *Investing for prosperity* – November 2003

Third Annual Report – *Realizing our prosperity potential* – November 2004

Should you wish to obtain a copy of one of the previous publications, please visit **www.competeprosper.ca** for an electronic version or contact the Institute for Competitiveness & Prosperity directly for a hard copy.

How to contact us

Institute for
Competitiveness & Prosperity

To learn more about the Institute and the Task Force please visit us at:
www.competeprosper.ca

Should you have any questions or comments, you may reach us through the web site or at the following address:

The Institute for
Competitiveness & Prosperity
180 Bloor Street West, Suite 1100
Toronto, Ontario
M5S 2V6
Telephone 416 920.1921
Fax 416 920.1922

Executive Director

James Milway
416 920 1921 x222
j.milway@competeprosper.ca

Researchers

Mary Albino
416 920 1921
m.albino@competeprosper.ca

Lance Bialas
416 920 1921 x228
l.bialas@competeprosper.ca

Alberto Isgut
416 920 1921 x227
a.isgut@competeprosper.ca

Jerome McGrath
416 920 1921
j.mcgrath@competeprosper.ca

Sana Nisar
416 920 1921 x223
s.nisar@competeprosper.ca

Claurelle Poole
416 920 1921 x224
c.poole@competeprosper.ca

Ying Wang
416 920 1921 x225
y.wang@competeprosper.ca

ISBN 0-9737377-2-7