

IAPR POLICY BRIEF

McGUINTY'S COMPLAINT

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Introduction

Over the past few weeks, Canadians have been witness to a good deal of interesting political manoeuvring. The federal government, stuck in a minority position and under attack as a result of testimony coming out of the Gomery Commission, has been busy making deals in an effort to maintain power. Hence, the demands coming from Newfoundland and Labrador for a better deal on revenues coming from oil and gas development resulted in an *ad hoc* adjustment to the federal equalization program. More recently, the federal NDP has managed to extract promises for a delay in corporation income tax cuts and increases in spending in return for supporting the Liberal government. Over the past few months, the provincial Liberal government in Ontario has seen the opportunity to force the federal Liberal government to address a concern of the newly-elected McGuinty government; that the federal government extracts from Ontario taxpayers significantly more than they receive in the way of federal expenditures. After what appears to have been a marathon 9-hour meeting on May 7, 2005, Premier Dalton McGuinty has extracted a commitment from Prime Minister Martin for \$5.75 billion in federal "financial support" over the next 5 years. Details of this financial support are sketchy at this point, but in any event Premier McGuinty apparently judges this to be only a "down-payment" made toward addressing his concerns and expects further negotiations.

What is McGuinty's complaint? Is it a legitimate complaint? Are taxpayers in Ontario the only taxpayers with this complaint? The purpose of this policy brief is to provide background to this issue and a means by which taxpayers in Ontario and in other provinces might be able to access the validity of Ontario's complaint.

What's the Issue?

The federal government, all ten provincial governments, and all local governments in Canada collect taxes from citizens. The tax system in Canada is said to be "progressive" by which is meant that those who earn relatively high incomes pay a larger share of their income in taxes than do those who earn relatively low incomes. This is the nature of the personal income tax, for example. The tax revenues governments raise in this way are used to pay for expenditures on goods and services and to pay for transfers of income from those with relatively high incomes to those with relatively low incomes. Examples here include Employment Insurance, social assistance, and old age security. In this way, the system of government taxation and spending in Canada redistributes income from those with relatively high incomes to those with relatively low incomes. It does so both via the tax system and via income transfers on the spending side.

If it is the case that relatively high-income earners live in one geographic location and relatively low-income earners live in another, the level of government spending and the amount of revenue collected by any government will vary by those geographic locations. Thus, a government may find that it collects more in revenue from region A than it does from region B because region A is populated by a higher proportion of high-income earners than is region B. For that same reason, it may find that it spends less in region A than it does in region B. If so, the result will be

what is oft-times referred to as a *fiscal imbalance* wherein the citizens of region A subsidize the higher level of government services provided to the citizens of region B.¹

No government in Canada is immune to the problem of possibly producing a fiscal imbalance between regions within its jurisdiction. Thus, as we'll see below, it is the case that the federal government collects more in revenue and spends more providing government services in some provinces than in others. This reflects provincial differences in average income, income distribution, age, population, and industrial composition. It is also likely the case that every provincial government collects more in revenue and spends more providing government services in some regions of the province than in others. In Ontario, for example, the citizens of the southern part of the province pay more in taxes and receive less in the way of government spending than do citizens living in the northern part of the province. Even within the boundaries of a city, it is possible for fiscal imbalances to arise. Thus the City of Calgary may collect more in tax revenue and spend less providing government services in the south-west quadrant of the city than in the north-east.

Is McGuinty's Complaint Legitimate?

If the nature of progressive taxation and redistributive government transfers are such to cause those living in areas with higher levels of average income to spend more in taxes and receive less in government transfers than those living in areas with lower levels of average income, what is Ontario's complaint? Ontario is Canada's second richest province. The average citizen of Ontario enjoys an income of \$31,700 per year. This compares to an average income of \$34,712 in the richest province, Alberta, \$28,373 in Quebec, and \$24,677 in Newfoundland and Labrador, the province with the lowest average income.² It would not be surprising, then, to find that the citizens of Ontario pay more in taxes to the federal government than they receive in transfers and other benefits from the federal government while the opposite is true for, say, the citizens of Newfoundland and Labrador. This is, in fact, exactly what we see in the data.

Table 1 presents data produced by Statistics Canada. The dollar figures define the difference between the amount of tax revenue collected by the federal government in that province and the amount of spending in that province by the federal government. Positive values indicate that the citizens of that province pay more in taxes to the federal government than they receive from the federal government by way of transfers or other financial benefits. The figures are measured in millions of dollars and refer to the year 2002, the last year for which these data are currently available from an independent source.³

¹ Differences in the average age of citizens living in regions A and B will also play a role in determining the size of the fiscal imbalance between regions. This is so because pensions are paid to the elderly but financed through taxes on the relatively young. The composition of industry also plays a role since taxes on corporations differ by whether the firm is large or small, and along other criteria.

² These figures are for 2004 and define personal income per person. Source: Statistics Canada, CANSIM II, Table 3840013.

³ The independent source is Statistics Canada. The government of Ontario claims the fiscal imbalance is currently \$23 billion while the federal government disputes that number. The federal and Ontario governments are likely referring to the current fiscal year and are basing their calculations on their own accounting. I have chosen to stay away from any debate concerning the value of the imbalance and instead use the figure calculated by a disinterested third party; namely Statistics Canada. Statistics Canada applies a common accounting convention to the budgets of all governments in Canada and so allows one to make a fair and honest appraisal of each government's budget position.

The figures in Table 1 indicate that in 2002, the citizens of Ontario paid \$21.2 billion more in taxes than they received in financial benefits from the federal government. Taxpayers in two other provinces, Alberta and British Columbia, also contributed more to the federal treasury than they received in financial benefits from the federal government. In all other provinces taxpayers enjoyed the opposite result; they received more in financial benefits from the federal government than they paid in taxes.

Table 1: Federal Fiscal Balances by Province, 2002

| | |
|-------------------------|----------|
| Ontario | \$21,163 |
| Alberta | \$7,764 |
| British Columbia | \$1,551 |
| Prince Edward Island | -\$698 |
| Saskatchewan | -\$1,851 |
| Newfoundland & Labrador | -\$2,485 |
| New Brunswick | -\$2,915 |
| Manitoba | -\$3,219 |
| Quebec | -\$3,321 |
| Nova Scotia | -\$4,240 |

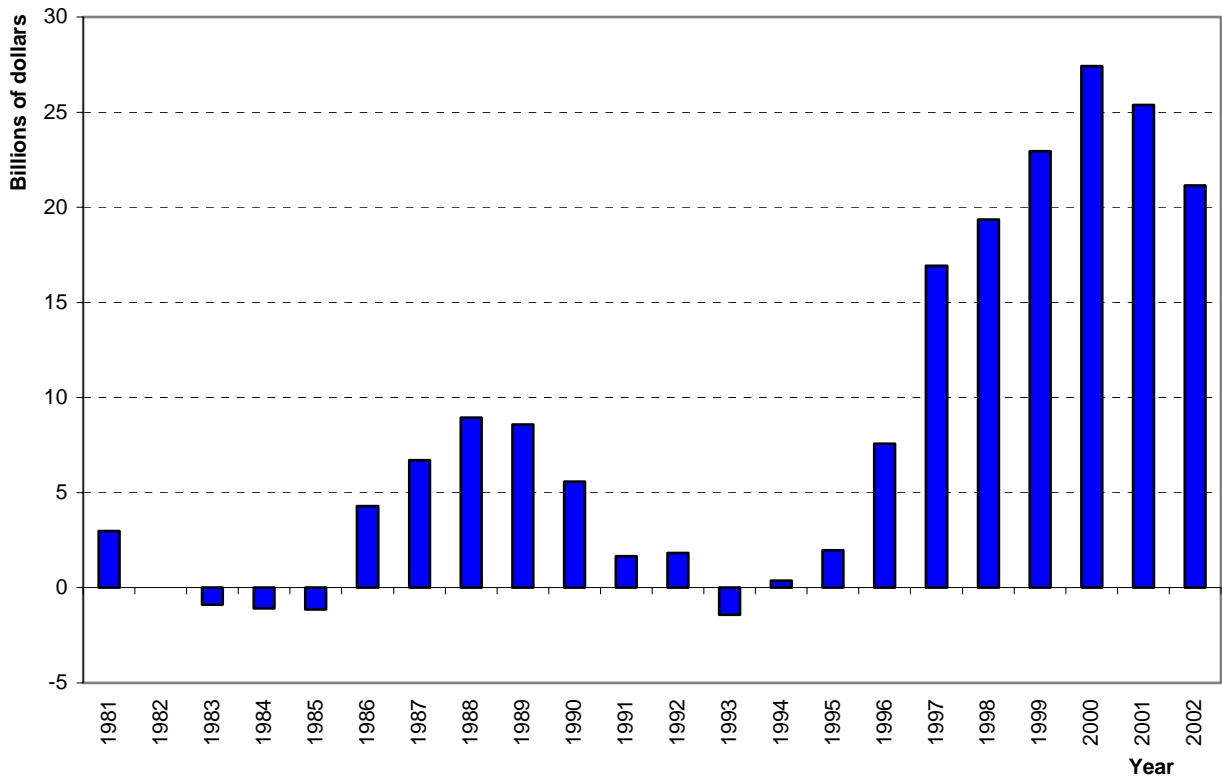
Source: Statistics Canada, CANSIM II, Table 3840004.
 Figures are measured in millions of dollars.

The information presented in Table 1 is useful for showing that taxpayers in Ontario are not the only ones who pay more in taxes to Ottawa than they receive back in financial benefits. However, it lacks in at least two respects. The first problem with the figures in Table 1 is that they present only a snapshot of the fiscal situation at a point in time. As citizens of Canada's second richest province, Ontarians should not be surprised to find that they pay more in taxes to Ottawa than they receive in way of financial benefits. This is, as explained above, the natural consequence of enjoying relatively high incomes in a fiscal regime which redistributes income from the relatively rich to the relatively poor. The simple fact that Ontarians pay to Ottawa more than they receive cannot, then, be a legitimate cause of complaint from the government of the province of Ontario.

Figure 1 (see below) reveals the real reason for Ontario's complaint.⁴ It presents for Ontario the size of the fiscal imbalance between taxpayers in Ontario and the federal government for each year between 1981 and 2002. It shows that while it has not been unusual for the citizens of Ontario to pay more in taxes to Ottawa than they receive in financial benefits, in recent years the imbalance has grown very large indeed. From a rough balance in their relationship with Ottawa in 1994, Ontarians saw their fiscal imbalance with the federal government grow to over \$27 billion in 2000. Indeed, during the years 1994-2002 inclusive, taxpayers in Ontario contributed over \$143 billion more in taxes than they received in financial benefits from Ottawa.

⁴ The data used to construct Figure 1 come from Statistics Canada, CANSIM II Table 3840004.

Figure 1: The Federal Government's Fiscal Balance with Ontario

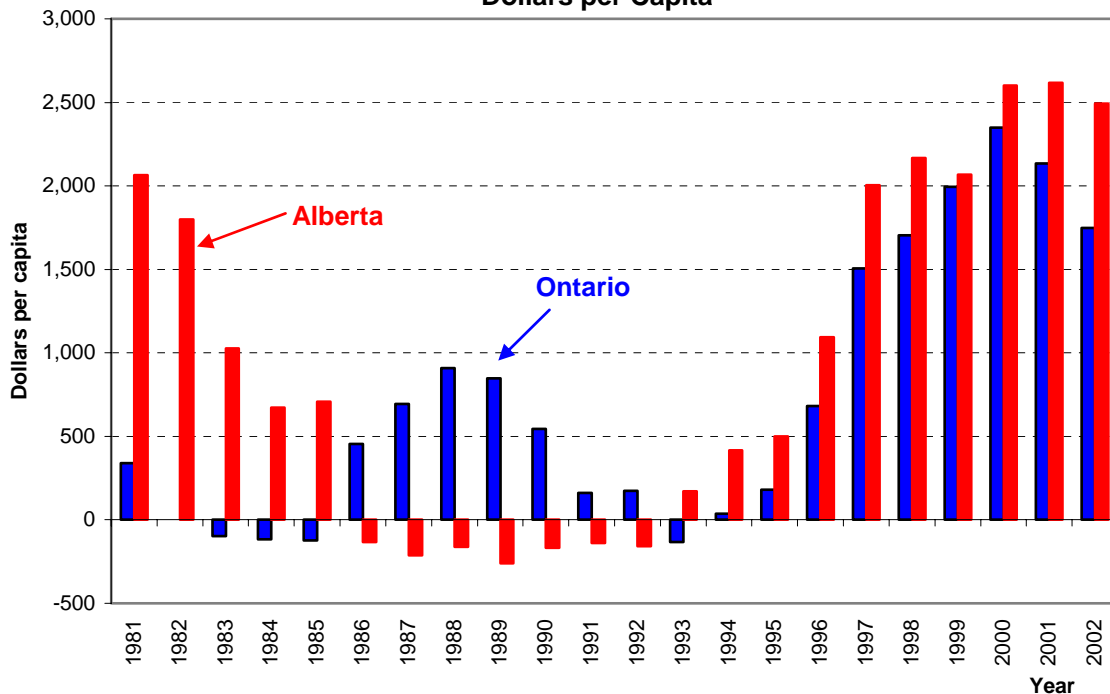


The problem that Premier McGuinty is hoping to address is not the fact Ontarians pay more in taxes to Ottawa than they receive by way of financial benefit – after all, this results from the average Ontarian enjoying a relatively high income and therefore cannot be *per se* a source of complaint -- but, rather, the *size* of that imbalance. Premier McGuinty and Ontario taxpayers no doubt understand that their relatively high incomes mean they will contribute more to Ottawa than they receive, but, the argument would seem to be, the size of the imbalance seems to have recently gotten out of hand.

The second problem with the figures presented in Table 1 is that they take no account of very large differences in provincial populations. Thus, while it is true that in 2002 taxpayers in Ontario paid in total \$21.2 billion more to Ottawa than they received in financial benefits while taxpayers in Alberta paid “only” \$7.8 billion more, the population of Ontario is almost 4 times larger than the population of Alberta. Similarly, while taxpayers in Quebec received \$3.3 billion more in financial benefits from Ottawa than they paid in taxes, a net benefit second only to that realized by taxpayers in Nova Scotia, the population of Quebec was almost 8 times greater than the population of Nova Scotia in 2002. Clearly, a per capita comparison is called for before we can ascertain whether Ontario’s complaint is a complaint unique to that province.

Figure 2 presents data on the size of the fiscal imbalance with Ottawa suffered by taxpayers in Ontario and in Alberta on a per capita basis.⁵ Focussing for a moment on the figures for Ontario, Figure 2 shows that in 2002, the average Ontarian contributed \$1,749 more in taxes to Ottawa than he or she received by way of financial benefits. This is down from a peak of \$2,347 in 2000 but nonetheless represents a considerable increase from the situation in 1994 when there was a rough balance between what Ontarians paid to Ottawa and what they received in return.

Figure 2: Federal Fiscal Balance, Ontario and Alberta, Dollars per Capita



What Figure 2 also shows is that taxpayers in Ontario are not alone when it comes to suffering a fiscal imbalance with Ottawa. Since the early 1990s, taxpayers in Alberta have similarly been witness to a dramatic increase in the imbalance between the taxes they contribute to Ottawa and the financial benefits they receive in return. Indeed, on a per capita basis, in 2002 each Albertan contributed \$2,491 more in taxes to Ottawa than they received by way of financial benefits; an amount that was \$742 more than the amount paid by each Ontarian. Going back to the early 1980s, Figure 2 shows what Alberta taxpayers know only too well; how the National Energy Program (NEP) swept non-renewable resource revenues out of their pockets and into the federal treasury in per capita amounts that taxpayers in Ontario have only recently experienced with alarm. This is, in other words, familiar territory for Albertans.

⁵ Data on fiscal imbalances are as cited in footnote 4. Population data is from Statistics Canada, CANSIM II Table 510001.

Concluding Comments

The purpose of this policy brief was to put into perspective the recent negotiations between Ontario Premier Dalton McGuinty and Prime Minister Paul Martin. I have discussed how in Canada government finances are designed in such a way as to redistribute income from the relatively rich to the relatively poor. Given this, it follows that those regions of the country in which the average taxpayer is relatively rich will be regions which contribute more to the federal treasury than they receive by way of financial benefits. Those regions of the country in which the average taxpayer is relatively poor will be regions which receive more by way of financial benefits than they pay in taxes to the federal government. As citizens of a relatively rich province, Ontarians consequently pay more in taxes to Ottawa than they receive in financial benefits. As the source of this fiscal imbalance with Ottawa is the relatively high income of the average Ontarian, the fiscal imbalance cannot *per se* be the source of complaint for Premier McGuinty. The source of contention must, therefore, be the fact the size of the imbalance has grown very quickly and is now quite large; large enough for Premier McGuinty to complain, on behalf of the taxpayers of Ontario, that the imbalance has grown altogether too large.

If that is the bone of contention between Ontario and Ottawa, then surely it is a bone on which taxpayers of other provinces must also be ready to chew. Taxpayers in Alberta suffer a considerably larger fiscal imbalance with Ottawa than do taxpayers in Ontario. If Prime Minister Martin is now recognizing that the size of the imbalance faced by taxpayers in Ontario is too large, will he now be entering into negotiations with Premier Klein to address the exact same problem faced by taxpayers in Alberta? If not, the only conclusion one seems able to draw is that the Prime Minister's response to Premier McGuinty's complaint has little to do with firmly-held principles or a sense of fairness and has everything to do with political expediency; vote-rich and Liberal-friendly (or, at least, friendlier) Ontario is, in the eyes of Prime Minister Martin, worth an investment of \$5.75 billion while Alberta is not.

In its short mandate, the current Liberal federal government has displayed a marked tendency to modify national programs that have implications for all provinces by cutting side-deals with individual provinces. Hence, the *ad hoc* modification to the national equalization program resulting from a side-deal with Newfoundland and Labrador and the other Atlantic provinces over energy royalties; a deal they chose not to extend to other provinces. The \$5.75 billion dollar deal made in answer to Premier McGuinty's complaint is just the most recent example. Not unrelated, this government has displayed a similar tendency to selectively ignore deviations from what they claim to be national principles and programs. Witness their (lack of) response to existing private health clinics in Quebec versus the outpouring of rhetoric in response to mere *discussions* of a "third way" in health care delivery in Alberta.

While there is a long history in Canada of "flexible federalism", this government seems to be engaged more in the practice of "asymmetric federalism." There is an obvious need for flexibility within a federation; for making allowances for local (provincial) circumstances. Indeed, this balancing act is the corner stone of the Canadian federation, and it goes well beyond the mere division of powers in the constitution. But the recent side-deals struck by the federal government are different. They have been arbitrarily, if not unfairly, applied. They pit taxpayers in one part of the country against taxpayers in other parts of the country. They seem to have been designed (more blatantly than usual) to reward, or reinforce, political support rather than to

renew and strengthen the federation. What's more, the side-deals have been conceived with no consideration given to their long run fiscal implications, particularly as other provinces individually clamour for similar deals. This type of federal policymaking is a recipe for interprovincial and regional tension not at all conducive to long-run economic prosperity or to political peace.

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