AIMS Commentary
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Sticky Fingers

How governments cling to transfer payments

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A major tenet of much of modern economic theory is the expectation that market participants will act rationally. That is to say, given the available information set, they will collectively choose the outcome that optimizes their interests. So what happens when governments present taxpayers with projects that appear to cost only pennies on the dollar? Although rationally we recognize that we are each single taxpayers and that various levels of government are simply extracting taxes from our different pockets, all too frequently governments somehow make it appear that shared cost programs are a good bargain.

Examples abound. The federal government has "invested" $250,000 in the renewal of the iconic Victorian band shell featured in the Halifax Public Gardens. A private bequest provides an additional $100,000—leaving the municipality to contribute just $150,000. Seems like a good deal. Haligonians get a $500,000 facility for just $150,000. Nice of all those people across the country to chip in to help restore a local amenity! Of course that isn't how it works. Haligonians contribute their share of the seeming $250,000 federal munificence—just as they have also helped fund the new $250,000 Bennett Lake Viewing Platform and public restroom in Carcross, Yukon, along with countless local and regional projects across the country.

Such conditional transfers have become Canadian fixtures. They are demonstrably inefficient. There are, on occasion, circumstances where local projects have regional spill-overs. An integrated regional transit system may, for example, benefit both the hub and the spokes. In such circumstances, multiple levels of government may justifiably coordinate spending. Where the benefits are purely local—such as most recreational or tourist-related facilities—shared cost programs end up encouraging overspending. Taxpayers in a municipality that does not participate in such programs are the biggest losers. They continue to fund projects across the province or country without maximizing local benefit. Unchecked, the activity creates a "me too" bid from competing jurisdictions clamouring for their "fair share" of transfers. The solution is simple: let the level of government that spends the money, raise the revenue.

How do such activities square with the supposed rationality of taxpayers? The answer lies is something known as a "fiscal illusion". Identified more than a century ago by an Italian economist Amilcare Puviani, the argument goes that when the true source of government revenues are poorly perceived, the real cost of public spending is underestimated. Taxpayers may rail against the federal tax burden but may think those funds are necessary to provide pensions, defence and healthcare. They do not equate high federal taxes with the refurbishment of band shells in their local park. Another example of the phenomenon is where renters raise demands for increased local services, without recognizing that they are paying for the facility through indirect property taxes hidden in their rent payment. Tax payers are not acting irrationally; it is simply that their information set is obscured by the fiscal illusion.

IS EQUALIZATION A HELPING HAND – OR A SLEIGHT OF HAND?

In the Canadian context, one of the more glaring examples of fiscal illusion is manifest in the unconditional federal-provincial transfer system—equalization, and the health and social transfers.

There is a considerable volume of international economic literature devoted to understanding what happens when higher levels of government remit block grants to lower tier governments. Analysis suggests that rather than simply sharing a portion of the cost of the services provided by the subordinate government, the practice actually results in inflated government services—leading to reduced efficiency. Simply stated, the argument is that transfers from senior levels of government tend to increase overall spending. Noted US economist Arthur Okun coined the term *flypaper effect*, in this context noting that "money seems to stick where it hits."

As we approach the regular five-year review of the support programs in 2014, it is an appropriate time to look beyond just how the payment system is structured and consider whether the process itself is flawed. On the evidence, federal transfers are not lightening the tax burden on less wealthy provinces, but are inflating provincial revenues and funding expensive and inefficient spending. What prevents taxpayers from rejecting this wasteful practice is simply the financial legerdemain of the "fiscal illusion"—the notion that somehow we are getting something for nothing.

CANADA'S SUPPORT SYSTEM

Major Federal Transfers 2009-2010 ($ millions)

	NL	PEI	NS	NB	QC	ON	MB	SK	AB	BC
Canada Health Transfer	450	104	700	557	5,799	9,233	903	843	1,962	3,354
Canada Social Transfer	164	45	302	241	2,520	4,205	392	342	1,181	1,435
Equalization	0	340	1,391	1,689	8,355	347	2,063	0	0	0
Offshore Accords	465		180							
TOTAL	1079	489	2573	2487	16674	13785	3358	1185	3143	4789
TOTAL (per capita)	$2117	$3436	$2730	$3308	$2109	$1043	$2718	$1133	$845	$1057

A good place to begin the review is with an explanation of how Canada's transfer system works—including what it is intended to achieve. There are three major components: equalization, and the health and social contributions.

To the general public, equalization is sometimes seen as a means of shifting income from economically stronger regions of the country to less-wealthy provinces—with the unstated aim of providing a helping hand to enable poorer regions to eventually catch-up.

In fact, equalization has much simpler objectives. Recognizing that individual provinces may, from time to time, experience differing rates of economic performance—which, in consequence, affects the ability of those governments to raise revenue—equalization payments are intended to restore the "fiscal capacity" of those less well off provinces. That is, the transfer attempts to compensate for the lower revenues that arise when poor economic conditions reduce tax receipts.

While the objectives may be simple, even those intimately involved in the program's management freely admit that it is administratively complex—making it difficult to identify whether it is effective—*at any particular point in time.* It was never intended that any individual province or provinces would be permanently entitled to equalization—yet the program itself is a permanent fixture of Canadian policy. In fact, the principles are now protected in the Constitution. Except in the unlikely event of all provinces having identical fiscal capacity, in each year there will always be recipient and non-recipients.

In recent years, formerly "have" provinces British Columbia and Ontario have qualified for equalization payments. That development might suggest that the system is working exactly as intended—providing short-term fiscal support to occasional variations in economic outcomes across the country. But the reality is that some regions have experienced protracted—even perennial—occurrences of below-potential growth. In those cases equalization has shifted from transitory relief to an ongoing source of anticipated revenue. Where that has become the case, the evidence shows convincingly that it has fostered excess revenue collection, over-expenditure and inefficiency. At the same time it has done nothing to close the gap between higher- and lower-performing economies.

Although this paper focuses on the disadvantageous consequences of one particular example—equalization—the economic literature suggests that just the process of one level of government collecting taxes and then transferring resources to another level to oversee spending, contributes to fiscal illusion.

The other key federal-provincial programs consist chiefly of two parts—the Canada Health Transfer and the Canada Social Transfer. Although superficially designated as "earmarked" or "purpose-driven" payments, they are both calculated on an equal per capita cash basis and flow directly into provincial general revenues. (Since they only account for a portion of expenditures under each category, it would, in any case, be meaningless to insist that they be purpose dedicated—since that would just free up discretionary "own source" revenues to be spent in other areas.)

It might be tempting to conclude that such per-capita transfers constitute something of a wash—in contrast to "needs-based" equalization transfers which are overtly intended to be distortionary. However, a one-size-fits-all distribution overlooks demographic differences between regions. For example, the federal health care contribution may less adequately sustain costs in regions, such as Atlantic Canada, which have older average populations.

What all these inter-governmental transfer payments have in common is that they create a disconnect between the tax collector and the service provider. About this, Nobel prize winning economist James Buchanan has written: *A final, and important, means of creating illusion on the tax side lies in the levy of taxes under situations where the individual cannot really know who finally pays; that is, in situations where the incidence of the tax is unknown. … It is clear that the uncertainty that is involved in tax institutions of uncertain incidence does exert an influence on fiscal choice…*[1] Among Buchanan's many claims to fame is the central role he played in devising Canada's equalization program in the 1950s.

Even when the federal government taxes residents from one pocket and returns transfers back into another pocket, there is evidence that the flypaper effect is a genuine phenomenon. It seems, when in comes to even non-equalization transfers, that "money sticks"—that there is an observable correspondence between dependence upon transfers and the overall propensity for provincial governments to spend. That is an important conclusion when it comes to deciding how to proceed with the entire system when it comes under review in 2014.

HOW TO "EMPLOY" EQUALIZATION PAYMENTS

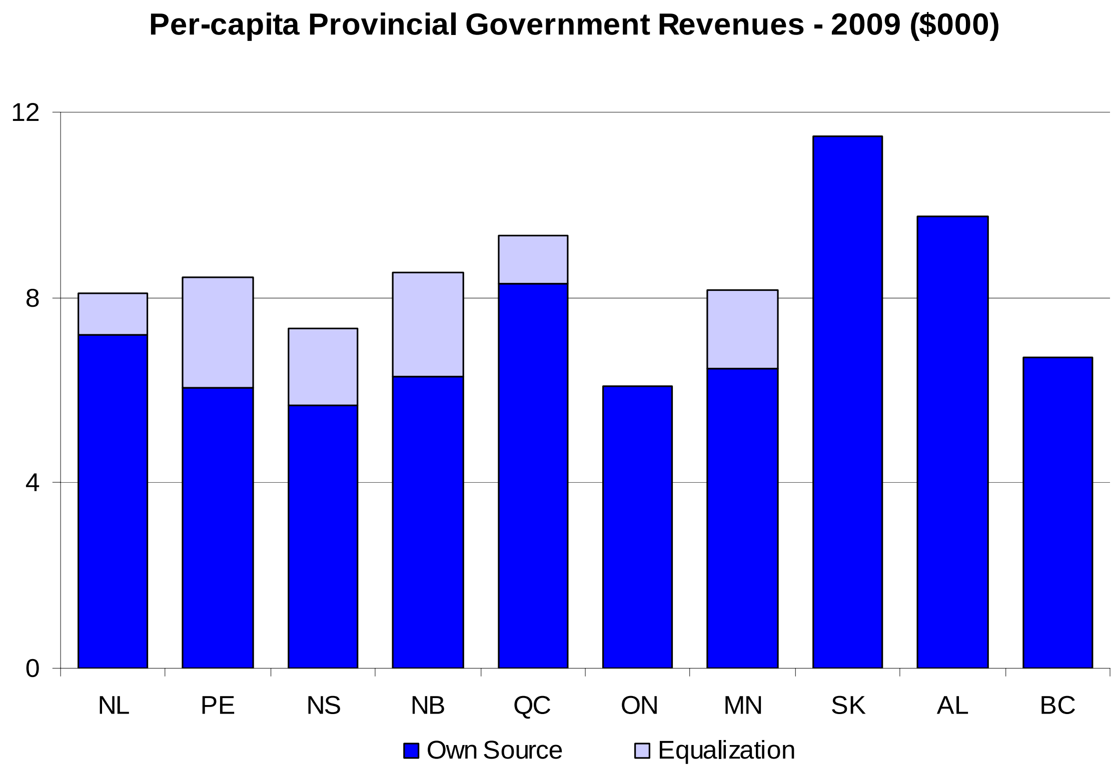
While equalization is <u>not intended</u> to achieve a more even distribution of per-capita incomes across provinces, it <u>does exist</u> precisely because of the presence of such an uneven distribution. It is specifically because per-capita gross domestic product (GDP) is lower in some provinces that it is deemed reasonable to compensate them for their diminished taxation "capacity".

It would seem sensible to assume that raising a thousand dollars in tax from residents in Atlantic Canada imposes a more onerous burden on them than raising the same amount from people in economically better-off Ontario—as an example. Equalization is supposed to provide fiscal relief to provincial governments with below average GDP. It applies a national average tax <u>rate</u> on the lower-than-average tax <u>base</u> in economically-

[1] Public Finance in Demographic Process; James Buchanan http://www.econlib.org/cgi-in/searchbooks.pl?searchtype=BookSearchPara&pgct=1&sortby=R&searchfield=F&id=103&query=fiscal+illusion&x=0&y=0&andor=and

less-well-off regions—and transfers the difference.

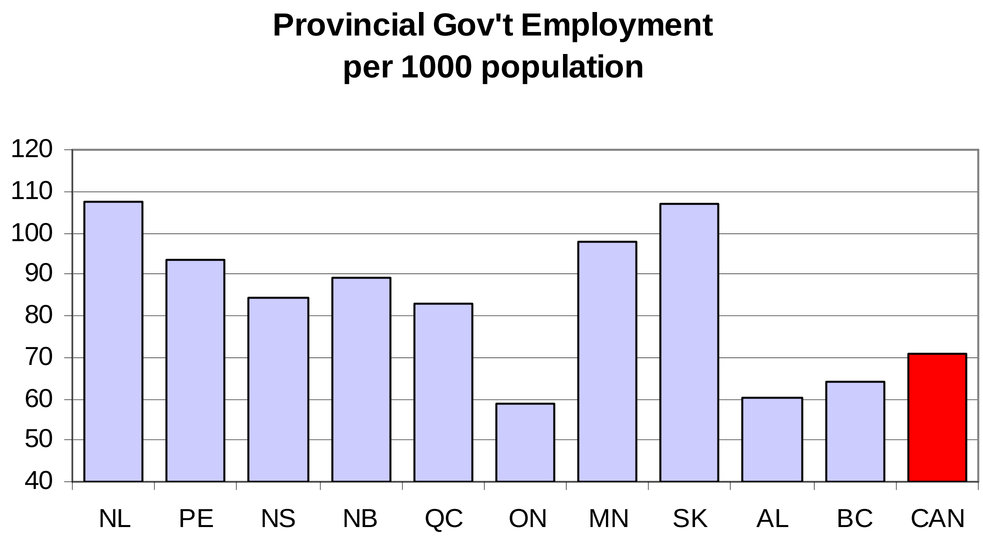
One might think that the transfer would allow the receiving government to provide some relief to their tax payers by collecting fewer dollars in "own source" revenues—to lessen the burden on their citizens. Not so.



From the accompanying chart it is evident that governments in Atlantic Canada, Quebec and Manitoba directly collect essentially the same (or more) per capita revenues than does the government of Ontario. Despite the more onerous per-person burden on their taxpayers, those same provinces do not employ the significant equalization transfers to lessen the load—instead they bump-up their total revenues. As a result total provincial revenues—both on a per-capita basis and as a percentage of gross domestic product—are substantially higher than the national average.

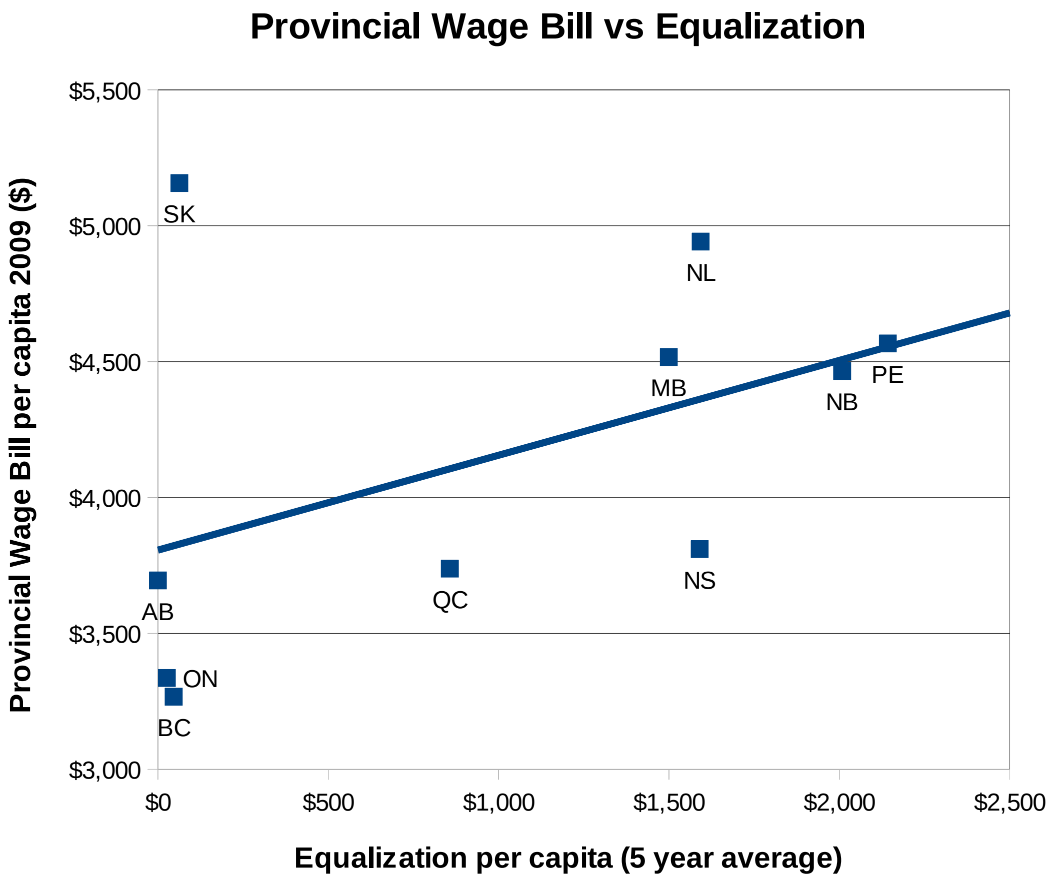
What happens to that "extra" revenue? The emerging discrepancy between the actual revenue capacities of equalization-receiving and non-receiving provinces has not gone un-noticed. A number of studies have high-lighted differences in social and health facilities supposedly occasioned by the uneven resources resulting from the current equalization program. (See for example the Ontario Chamber of Commerce's 2011 report: A Case for Modernizing Canada's Transfer Agreements[2]).

[2] http://occ.on.ca/wp-content/uploads/2011/02/Fiscal-Imbalance_final-electronic1.pdf



From the above chart, it can be seen that traditionally equalization-recipient provinces have built a propensity to enlarge their employment levels. Perhaps a case can be made that additional per-capita spending power delivered by equalization provides recipient provinces with the capacity to provide extra services to their public. Comparisons are problematic. Simply noting differences in physician levels or daycare space availability may overlook the significant demographic differences between the regions as well as explicit policy priorities. Anecdotal evidence does not suggest that those provinces with more public service employment enjoy superior living standards—if they did, provincial outmigration patterns would reverse, of which there is no indication. Simply put, more government doesn't equate to better government.

One of the more worrisome outcomes for Atlantic Canada is that high levels of government employment that have developed under these circumstances are about to collide with demographic realities. Public servants in the region are, on average, older than elsewhere in the country; they are closer to retirement; and they have a tendency to retire earlier than private sector employees. The substantially unfunded public sector pension plans are coming under pressure. The emergence of a class of generously supported retired civil servants (at a time where fiscal constraints limit their replacement) at the same time as private sector employees are growing increasingly anxious about their retirement prospects—constitutes a disturbing social development. Certainly not what the original proponents of equalization intended!



The accompanying chart shows the correlation between provincial wage and salary costs and the longer-term reliance on equalization payments. (See footnote for details[3])

At a glance, it is evident that those provinces with a minimal recent attachment to equalization: Alberta, British Columbia and Ontario provide their public services with significantly lower combined staffing and wage costs. In contrast, the provinces with the greatest reliance on equalization tend to have significantly higher costs. The fit is not perfect: the outlying

[3] Specifically we examine the total wage and salary bill that each province pays for the total of general provincial government services, health and social services, universities and colleges, school boards and provincial government enterprises. This aggregation adjusts for varying cross-provincial practices—for example in some provinces schools are a separate responsibility while in others they are administered through a provincial department. The data can be thought of as the <u>total</u> public sector wage bill in each province—<u>minus</u> federal and local wage costs. To enable comparison, the total is divided by current population. Referencing the accompanying chart, that means that, for example, the New Brunswick wage bill for provincial services is approximately $4,500 for every resident. The data are for 2010.

Plotted on the opposite axis is the relative reliance of each province on equalization transfers from the federal government (for historical continuity the east coast energy accord payments have been added back in)—all expressed as a percentage of total provincial revenue from all sources. Of course, spending patterns do not emerge overnight, they are shaped over time. To capture developing expectations of provincial governments concerning their ability to finance rising payrolls, we have averaged the annual ratio of federal-transfers-to-total-revenue over a period of 25 years—ending in 2010.

behaviour of Saskatchewan may possibly be explained by both the relatively recent fiscal improvement (so that past service patterns were developed when the province was a significant equalization recipient) as well as historical political/cultural attitudes. Indeed removing Saskatchewan from the data set substantially improves the statistical "fit".

The message appears clear—equalization transfers stick to recipient governments. They are not applied to tax reductions nor are they passed back to residents in the form of improved personal transfers. Instead they swell the ranks and costs of public servants.

The results show a remarkable correspondence. Alberta, Ontario and BC with markedly lower longer-term reliance on federal transfers show noticeable wage and salary restraint. At the opposite end, provinces demonstrating persistent elevated reliance on transfers display considerable less discipline.

One of the more disturbing results of equalization as it is currently practised in Canada is the possibility that equalization may not only allow recipient provinces to maintain elevated "own-source" tax rates at a high level—but may actually encourage them to do so. By maintaining a high-tax jurisdiction, provinces will undoubtedly dampen economic growth possibilities—but since that serves to further reduce their tax base and equalization compensates them for that loss, there is little incentive to act with fiscal responsibility. That logic may serve to perpetuate beggar-thy-neighbour provincial practices—but only so long as "fiscal illusion" is at play.

WHAT'S TO BE DONE?

Fortunately, equalization along with the other major federal-provincial transfer programs is scheduled for periodic review in 2014. There is time yet for a more vigorous assessment of how the program functions and for consideration of how to construct a more effective plan.

If equalization has been a failure—why not simply eliminate the program? That would be an interesting—albeit foolhardy—experiment in "long-term gain". In reality perennially recipient provinces are so heavily dependant upon the transfers that the social and economic upheaval caused by such a move would be of massive proportion. Like it or not, it is a Canadian fixture. The entire structure of provincial services and policies is based on its perpetuation. The only constructive remedy is to obviate the need for it—to employ other means to restore economic vitality to affected areas.

The fundamental issue is not simply rejigging the formulae to somehow provide a more efficient means of compensating provinces for their inability to generate revenue from their underperforming economies. The real problem is identifying why some provinces seem to remain in an apparently perpetual underperforming state. About the only solution that Canada has so far devised in the past half-century has been to hope for the serendipitous discovery of regionally-significant resource/energy deposits. Not much of a national strategy!

The most important economic advantage of political union comes from the freedom to move the "factors of production": capital and labour, to where they can most effectively be employed. Workers can relocate anywhere in the country that their skills are in demand—without passports or border restrictions. Capital can move to its most profitable destination anywhere in the country—without government restriction and free from exchange rate considerations. If policy were directed to sustaining that ideal would the economic disparities across the provinces persist?

Equalization is explicitly not intended to address the underlying issues, but where it can be shown to be not only neutral, but downright perverse, it is time to recommend a fundamental reform. That should clearly be carried out in the context of the myriad other national policies that stand in the way of regional economic rejuvenation—industrial strategies that artificially discourage the efficient movement of capital; labour support practices that actively discourage labour mobility; and regulatory hurdles that still depress inter-provincial trade. Only when those policies have been rationalized—those that address the fundamental deficiency: i.e. an insufficiency of GDP—only then should any future role for equalization be considered.

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