

FILLING THE GAP

Measuring Ontario's Balance
with the Federation

BY NOAH ZON



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SUMMARY

This *Mowat Note* examines the balance between what Ontarians pay to the federal government and the amount returned in services and transfers to Ontario and Ontarians. We find that based on the latest available figures, Ontarians transfer approximately \$11B on net to the rest of Canada. This transfer is equivalent to 1.9% of the province's GDP. This can be referred to as the gap between what Ontarians contribute to the federal government and what is returned to the province in the form of transfers and spending. This gap exists despite the fact that Ontario's fiscal capacity is below the Canadian average.





FILLING THE GAP

For many years, residents of Ontario have funded a disproportionate share of federal spending, at a time when the province was relatively wealthy compared to other Canadian provinces. However, Ontario is no longer wealthier than the Canadian average, with below-average GDP per capita (since 2006)¹ and below-average government fiscal capacity (since the 2009–10 fiscal year).²

Several factors have combined to drive this relative decline, including:

- ◆ structural changes in the Ontario economy;
- ◆ a resource-driven boom in some other provinces; and
- ◆ weakness in the U.S. economy, Ontario's main trading partner.³

One might assume that, given Ontario's below average fiscal capacity, it would now be a net recipient of redistribution in the federation, but that turns out not to be the case. Canada's fiscal arrangements have not evolved to reflect changing circumstances. As a result, Ontarians continue to see their federal taxes redistributed away from Ontario on a net basis at a time when the province can ill-afford it, at a rate estimated at approximately \$11B in the 2009-10 fiscal year, the most recent year for which numbers are published.

The gap is almost entirely a result of federal spending and program decisions that leave Ontarians receiving less than their per capita share of spending and transfers, rather than regional inequities in revenue collection. This *Mowat Note* is intended to provide context for Ontarians on the complicated relationship between the taxes they pay to the federal government and the services they receive.

WHY STUDY THIS ISSUE NOW?

Looking at the “fiscal gap” Ontarians face in the federation is not a new exercise. In the mid 2000s, a number of voices highlighted the substantial gap between the revenues collected by the federal government in Ontario and the federal funds they received (whether through federal-provincial transfers or federal spending).⁴ Nonetheless, there is now good reason to revisit these early analyses.

THE GAP
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¹ *Public Services For Ontarians: A Path To Sustainability And Excellence*, the report of the Commission on the Reform of Ontario's Public Services <http://www.fin.gov.on.ca/en/reformcommission/chapters/ch1.html>

² Based on the technical measure of fiscal capacity used to determine Provinces' entitlements under the federal Equalization program. As described in the 2009 Federal Budget. <http://www.budget.gc.ca/2009/pdf/budget-planbudgetaire-eng.pdf>

³ These are explored more fully in other Mowat Centre publications, most recently in Mendelsohn, Matthew. *Back to Basics: The Future of the Fiscal Arrangements*. <http://www.mowatcentre.ca/research-topic-mowat.php?mowatResearchID=75>

⁴ For example, TD Economics “How Much Does Ontario Contribute to Federal Coffers?” published March 3, 2005 <http://www.td.com/document/PDF/economics/topic/td-economics-topic-db0305-ont.pdf>; Ontario Chamber of Commerce “Fiscal Imbalance: Driving Ontario to “have-not” status” published August 2005. <http://www.occ.on.ca/assets/FICReportAugust2005.pdf>

WE FIND THAT THERE IS ROUGHLY AN **\$11B** STRUCTURAL GAP BETWEEN WHAT ONTARIANS PAY TO THE FEDERAL GOVERNMENT AND WHAT THEY RECEIVE.

First, while these early studies served to draw attention to Ontario's fiscal imbalance with the federation, they faced some legitimate methodological criticisms. Most notably, whether the federal government was in a surplus or deficit position could artificially inflate or deflate the size of the reported gap regardless of its actual magnitude.⁵

Secondly, since those initial calculations were undertaken, some important changes have taken place. Ontario's relative fiscal capacity has declined compared to other provinces, and the province now receives payments through the federal Equalization program.

Thirdly, the fiscal obligations (e.g., health and social services) that fall under provincial responsibility are growing at a faster rate than federal obligations. This leaves the federal government with greater fiscal flexibility in comparison to the pressures facing Ontario and most other provinces.⁶

This *Mowat Note* seeks to renew the conversation by using a balanced budget approach. This approach controls for variations in the size of the gap driven by swings in the size of the federal surplus or deficit (see Appendix for a more detailed explanation). This was the approach recommended by critics of Ontario's calculation of the gap in the mid 2000s. Using a balanced budget approach, the gap can now be reported in a manner that is not affected by the size of the federal deficit or surplus.⁷

Based on this methodology, **we find that there is roughly an \$11B structural gap between what Ontarians pay to the federal government and what they receive back from the federal government.**

This *Note* is not intended to measure the value of Canada to Ontario. We reject any discussion of "balance sheet federalism".⁸ Ontario, like all regions, benefits economically and socially from being part of Canada.⁹

Nonetheless, Ontario is facing a significant budget deficit, despite already having the lowest per capita expenditures on public services of Canadian provinces. It is appropriate to ask whether federal tax and spending decisions are unduly harming any province or region.

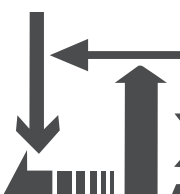
⁵ For an explanation of how federal budget surpluses and deficits affect Ontarians' net fiscal transfer to Canada, see Holden, Michael "A Closer Look at Ontario's \$23 Billion Gap" published by the Library of Parliament <http://www.parl.gc.ca/Content/LOP/researchpublications/prb0515-e.htm>

⁶ This issue was explored in greater detail by the Parliamentary Budget Officer in the Fiscal Sustainability Report, 2012. http://www.pbo-dpb.gc.ca/files/files/FSR_2012.pdf. That report finds that the federal government's balance of revenues and spending obligations is fiscally sustainable on the long-term while provincial/territorial/local governments (collectively) are not in a fiscally sustainable position.

⁷ A balanced budget approach controls for fluctuation by using assessing the size of the gap if the federal budget were balanced. A more detailed explanation of the approach can be found in the Appendix.

⁸ This *Note* is focused on the effectiveness of federal fiscal arrangements and its spending and transfer decisions. We do not suggest that the value of the country can be reduced to interregional fiscal flows (see Bird, Richard M. "Fiscal Flows, Fiscal Balance and Fiscal Sustainability" in *Perspectives on Fiscal Federalism* eds. Richard M. Bird and François Vaillancourt).

⁹ Nor can we easily measure the benefit to each province of spending on national defence, for example.



ONTARIO'S BALANCE WITH THE FEDERATION

There are two slightly different ways to calculate Ontario's imbalance with the federation using a balanced budget approach. Based on the latest available figures, and taking an average of the two approaches, the net contribution of Ontario to the federation is **\$11.1B** (see Appendix for calculations). This is a net redistribution of funds from Ontario to other parts of the country.

This \$11.1B gap represents 1.9% of Ontario's 2009 GDP.¹⁰ It results from the substantial difference that remains between the share of federal revenues collected in Ontario and Ontario's share of federal expenditures including direct spending, transfers to individuals and businesses, and transfers to provincial and local governments.

Is this gap the result of the federal government collecting a disproportionately high share of taxes from

Ontarians, relatively low federal spending in Ontario, or a combination of both? The numbers show quite clearly that this is not a revenue issue. The share of federal revenue collected in Ontario (39%) is very close to Ontario's share of the population (38.7%) (see Figure 1).

As seen in Figure 1, the gap is almost entirely a result of federal spending and program decisions that leave Ontarians receiving less than their per capita share of spending and transfers. Based on the most recent published data, Ontarians benefit directly from about 34% of federal spending and transfers.

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¹⁰ Based on 2009 figures, the year closest to the 2009-10 fiscal year, which forms the basis for this analysis.

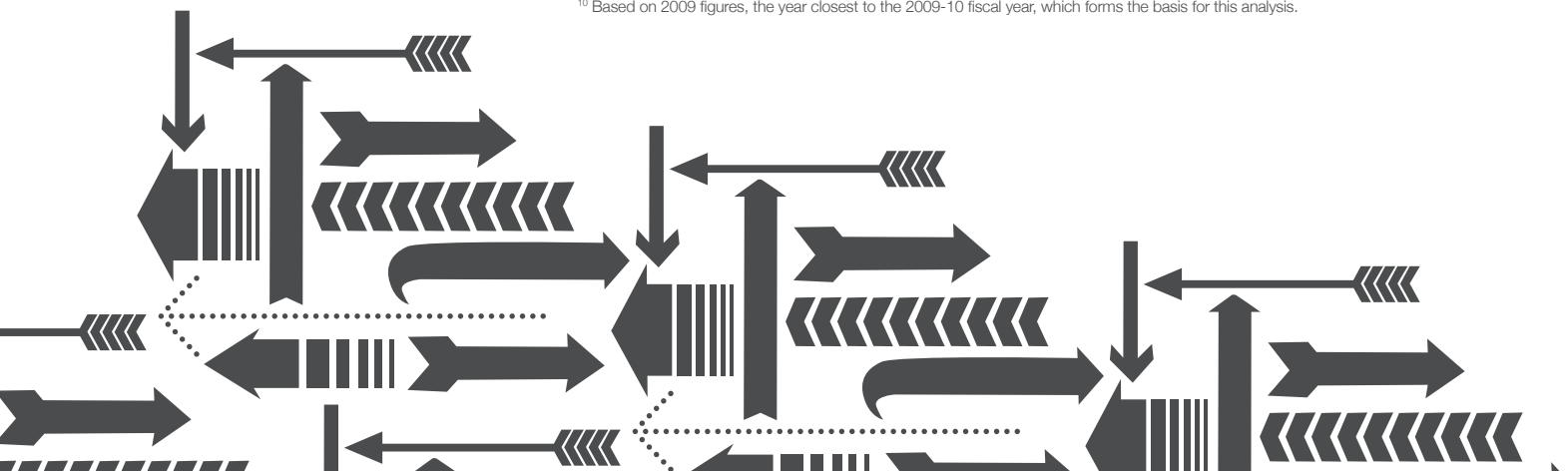
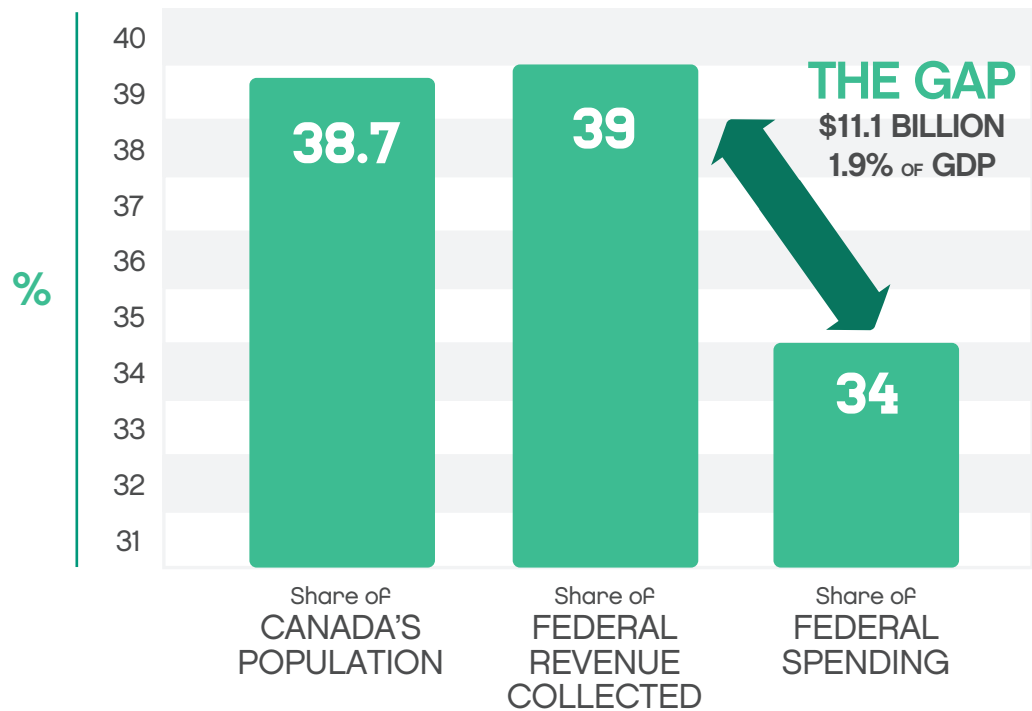




FIGURE 1: ONTARIO'S SHARE OF FEDERAL REVENUE AND SPENDING



While of course it is impossible to attribute the benefit of federal spending on areas like national defence to one province or another, the significance of the difference raises important questions about the responsiveness of federal policy to the needs of people in Ontario. This net outflow is felt in less funding from the federal government for infrastructure, affordable housing, and labour market training, amongst others.

WHY DOES THIS MATTER?

Ontarians pay taxes to and receive public services from both provincial and federal governments. Provincial and federal politicians alike are fond of reminding one another that “there is only one taxpayer” funding their budgets. Ontarians are facing a prolonged period where the province remains a net contributor to the federation, despite having below-average fiscal capacity.

It would be difficult to make a principled case in defense of this situation. The questions are why it has occurred and what can be done about it.

The structural gap between federal revenues and spending in Ontario has occurred because a number of federal spending and transfer programs operate according to conditions that re-direct funds to provinces other than Ontario. While some programs are neutral and some investments benefit Ontario more than other provinces, the net effect remains a flow of funds away from Ontario. A striking example is the Employment Insurance (EI) system.

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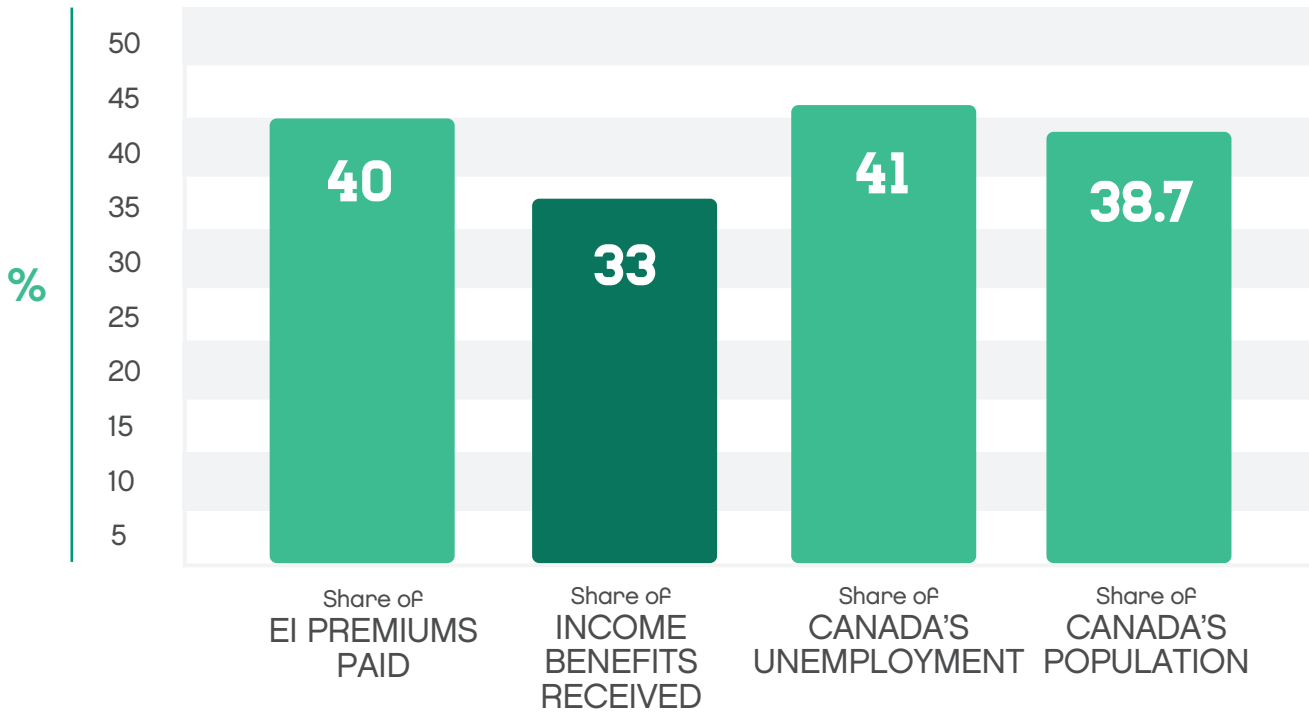
EI rules make it harder for unemployed Ontarians to receive EI than it is elsewhere in the country. Ontario workers and employers continue to pay in at the same rate as all Canadians. As a result Ontarians made a net contribution of roughly \$20B to the EI system over the 2000-2010 period, despite an increasing share of the unemployed population in Canada.¹¹ In 2011, Ontarians paid 40% of EI premiums and received only 33% of income benefits, and only 28% of labour market training funds tied to EI eligibility, despite higher than average unemployment.¹² Even in 2011-12, EI continued to redistribute funds away from Ontario—in this case, through payroll taxes on workers and businesses and a lack of equal access to benefits.

EI is not an outlier. Other examples of programs that discriminate against Ontarians include federal investments in economic development, infrastructure funding, affordable and social housing, support for the energy sector, and funding for labour market training. By treating Canadians inconsistently, these programs each contribute to the broader structural imbalance that Ontario faces in the federation, and put pressures on Ontario and its municipal governments, as well as community organizations and individuals to pick up the slack.

¹¹ "Making It Work: Final Recommendations of the Mowat Centre Employment Insurance Task Force". November 2011. <http://www.mowateitaskforce.ca/sites/default/files/MakingItWork-online.pdf>

¹² Ontario Budget 2012. http://www.fin.gov.on.ca/en/budget/ontariobudgets/2012/ch3.html#c3_EI



FIGURE 2: ONTARIO'S IMBALANCE WITH THE EI PROGRAM

These kinds of imbalances were understandable as part of a trade-off when Ontario's growth and prosperity were facilitated by federal policies that favoured the growth of Ontario's manufacturing sector, but as circumstances change, our programs, policies, spending decisions and fiscal architecture should keep up.

MOVING FORWARD

The federal government's tax collection system has few overt regional biases, but federal spending decisions are significantly skewed against the people of Ontario. The good news is that this is fixable. The federal government can, and should, reform those programs that discriminate against Ontario and Ontarians. In particular, the broken Equalization program needs to be addressed. In its current form, it produces the perverse result that the second largest recipient (Ontario) of cash remains a net contributor to the program itself and to the federation more generally. Ontario's fiscal capacity is made worse, not improved, relative to other provinces as a result of Equalization and other transfers. Health care, education, transportation—all these areas of importance to Ontarians are adversely affected by the operation of federal spending and transfer policies.

Canadians should also have an opportunity to monitor these policies; the federal government should return to publishing annual revenues and expenditures by province.

Over the coming years, governments across the country will need to make difficult decisions to return to balance and to continue to improve services for Canadians. As they do so, they should work together to ensure that the fiscal arrangements of the federation enhance prosperity and the quality of public services in all provinces. Given current federal spending and program decisions, the burden Ontario is being asked to carry is out of line with the principle of equity and is undermining Ontario's prosperity and quality of life. Many federal programs need to be reconstructed so that they work better for the Canada of 2013.

APPENDIX

HOW ONTARIO'S FISCAL BALANCE WITH THE FEDERATION WAS CALCULATED

The balance for the federation reflects the difference between federal revenues collected from Ontarians, and funds returned to Ontarians by the federal government through spending and transfers.

Statistics Canada has not published data tables on federal revenue and expenditures by province (the Provincial Economic Accounts) since 2010 (the 2009-10 fiscal year). In the absence of new information, all of our calculations are based on that year's numbers. Going forward, we would strongly encourage Statistics Canada to publish annual figures on federal revenue and expenditure by province.

Mowat's calculations adjust federal revenue and expenditure figures to account for the Quebec abatement, and to distribute federal excise tax revenue on an equal-per-capita basis. In all scenarios, Ontario's "share" of federal spending on public debt interest is set at its share of Canada's population—38.7%.¹³

The Mowat Centre's assessment of Ontario's balance for the federation uses a balanced budget approach. A federal deficit or surplus could be interpreted as distorting the results. For example, a large federal surplus could create an impression that all provinces are contributing more than they are getting back, while a large deficit could create the opposite impression.

To negate the effect of deficits on the calculation, estimates of the gap can be "balanced" in one of two ways: by adjusting revenues upwards to match total spending, or by decreasing program spending to match revenues. Mowat's assessment takes an average of these two calculations.¹⁴

Both methods are presented in Figure 3. Adjusting the revenue side results in a net contribution from Ontarians of \$12.5 Billion, while adjusting the spending side results in an estimated net contribution of \$9.7 Billion from Ontarians. The average of these two methods is \$11.1 Billion.

All data comes from Finance Canada and Statistics Canada.

¹³ The Quebec Abatement reflects the transfer of 16.5 federal income tax points to Quebec, negotiated in the 1960's through the Alternative Payments for Standing Programs, and for the now-defunct federal Youth Allowances Program (the Youth Allowances Recovery).

¹⁴ Mowat calculated both scenarios. A balanced budget scenario based on the revenue side or on the expenditure side would necessarily yield different results, because of the different Ontario shares of federal revenues and spending. Neither is inherently more accurate than the other. The Mowat gap calculation is an average of the final calculations of each of these scenarios. Both use the Ontario share of revenue and expenditure derived from the latest Provincial Economic Accounts data and adjusted to treat excise duties and public debt interest on a per capita basis.

FIGURE 3: ONTARIO'S BALANCE IN THE FEDERATION: REVENUE AND EXPENDITURE-BASED SCENARIOS

REVENUE SIDE BALANCED BUDGET SCENARIO

	National Total (\$B)	Ontario Share (\$B)	Ontario Share (%)
TOTAL FEDERAL SPENDING	277.2	95.6	
Federal Program Spending	247.8	84.2	34.0%
Federal Public Debt Interest	29.4	11.4	38.7%
FEDERAL REVENUES Adjusted upwards to match total spending	277.2	108.1	39.0%
NET CONTRIBUTION (i.e., revenues from Ontario less spending in Ontario)	12.5		

SPENDING SIDE BALANCED BUDGET SCENARIO

	National Total (\$B)	Ontario Share (\$B)	Ontario Share (%)
TOTAL FEDERAL SPENDING Adjusted downwards to match	221.9	76.8	
Federal Program Spending	192.5	65.5	34.0%
Federal Public Debt Interest	29.4	11.4	38.7%
FEDERAL REVENUES	221.9	86.5	39.0%
NET CONTRIBUTION (i.e., revenues from Ontario less spending in Ontario)	9.7		

BALANCED BUDGET GAP

AVERAGE OF REVENUE AND SPENDING SCENARIOS	11.1
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About the Author

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About the Mowat Centre

The Mowat Centre is an independent public policy research centre located at the School of Public Policy & Governance at the University of Toronto. The Mowat Centre is Ontario's non-partisan, evidence-based voice on public policy. It undertakes collaborative applied policy research, proposes innovative research-driven recommendations, and engages in public dialogue on Canada's most important national issues.

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