"Incentives Matter…Including in Federal Transfers"
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Remarks to the Federal-Provincial Relations Division,
Finance Canada; Panel discussion on
Factors influencing the future of federal transfers
Ottawa, Ontario, March 10th, 2010

Thank you for the invitation to be here today.

Alfred Leblanc asked me to focus my remarks on two aspects of the issues before us: 1) the future evolution of the domestic and the global economy and 2) issues that could have a large impact on transfers but that are not yet receiving sufficient attention.

Let me talk first about some global and domestic economic considerations.

Canada has enjoyed an enviable economic performance over the last decade or so, including throughout the recent recession. We enjoyed both economic and employment growth that outperformed that of the G7 and the United States prior to the recession, and we are suffering more modest (but still very real) ill effects than many of our peers among industrialised economies. As I will argue in a new book due out in May, a very great deal of the credit for this performance is due to a series of reforms largely carried out in what I call the Redemptive Decade, that stretches from the free trade agreement and the tax reforms of the late eighties, and ends with the first balanced budget in a generation in 1997-98.

However, the weak spot in this otherwise sterling performance has been our productivity growth. Our productivity performance is not just bad; on the whole it has been getting worse. Our labour productivity since 2000 has deteriorated compared to both our own performance in the latter half of the 1990s and to American performances since 2000. In both cases our performance since 2000 has been one third of these two benchmarks. The productivity gap between Canada and the US has gone from 17 percentage points to 26.[1] The effects of the recession on productivity are not yet clear, but I don"t see much evidence yet that it has changed anything fundamental except that some productivity gains in the financial sector may have proven to be illusory. If anything,

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[1] According to StatsCan, "In 2003, in the goods sector (agriculture and manufacturing), the level of labour productivity in Canada was about 72% of that in the United States; in the services sector, it was about 74%; in the engineering sector (transportation, communications, energy and construction) it was about 95%." See Statistics Canada, *The Daily*, (July 21,2008) available at http://www.statcan.ca/Daily/English/080721/d080721.pdf

the experience in the United States is that because of their flexible labour markets, they come out of recessions with productivity enhanced.

Canada‟s manufacturing productivity performance since 2000 has been even worse than the business sector performance. Output per hour advanced at only a 0.6 percent average annual rate between 2000 and 2006, compared to 5.5 percent per year in the United States. In other words, US manufacturing labour productivity growth has been nearly *ten times as fast* as that of Canada!

The result, of course, has been a divergence in standard of living between Canada and the United States[2] and a decline in our standing among OECD countries in terms of our productivity performance. Our output per hour worked, the third highest in the OECD in 1973, had fallen to 16th in 2006, but I haven‟t looked more recently. Ours has risen, but been overtaken by many others who saw their relative standard of living advance more quickly.

This matters hugely in a world where trade barriers are being removed (even with the hiccups caused by the recession), and where in most cases international trade grows faster than national economies, meaning that countries that can increase their participation in trade are likely to improve their economic performance overall. Canada already exports roughly one half of everything made in the private sector, so we are among the most trade dependent countries in the world. But it is important to understand the nature of that trade dependence.

We all know about the huge proportion of our exports that go to the US. Given the economic challenges that our neighbour faces, that has given rise to renewed calls for us to reduce our dependence on the US, but this is easier said than done. In fact as one historian has remarked, virtually every Canadian government comes to office promising to diversify our trade away from the US, and yet each of them leaves office with America looming even larger as our chief market.

Why? Retreating from deeper integration with the Americans is simply not available as a choice, or at least not without a wrenching decline in our standard of living. The issue is not the usual statistics trotted out in favour of free trade, that goods and services worth $1.9 billion cross the border every day, that we export 40 percent of what we produce, and of that, nearly 80 percent goes to the Americans, representing roughly half of the production of Canada‟s private sector. It

[2] See Jim Milway and Roger Martin, *Commercialization and the Canadian Business Environment: A Systems Perspective*, Comments on Public Policy Support for Innovation and Commercialization in Canada, (Toronto: Institute for Competitiveness and Prosperity, July 2005).

is not that 37 states have Canada as their largest international market although this is true and significant.[3]

It is rather the depth of the integration within companies and industries that really matters now. Forty percent of all exports from Canada to the U.S. are so called intra-company trade, meaning that companies carry on integrated production processes on both sides of the border, moving pieces of production to one country or the other depending on the availability of expertise and capacity.[4] And this very high degree of integration happens not just within companies, but within industries as well, as Canada fills specific niches in larger industries such as chemicals, telecommunications and transport. Our major railways use Canadian ports to service Canadian and American customers throughout the continent without distinction. American markets provide the investment and end-users for many natural resources that our smaller local markets could never justify. Electricity generation capacity has been spurred by easy access to American markets thanks to continentally-integrated infrastructure.[5]

Contrary to the assertions of those who would turn back the clock, the integration of our two economies is not limited to dying automobile manufacturers, although the auto industry is certainly a major beneficiary.[6]

The reality is that we do not, by and large, make finished products in Canada as a result of self-contained production processes. We contribute a piece of production in many companies and industries within vast continental supply and production chains. Our production is fitted to niches within that continental production.[7] In other parts of the world production is configured differently, they have different supply, distribution and retail chains. It is not impossible to shift some part of our production to other markets, but the effort to do so would be significant and the benefits meagre.

[3] See Madhavi Acharya and Tom Yew, "Canada: Land of Opportunity," *Toronto Star*, (June 6, 2009), B1; and Michael Kergin and Birgit Matthiesen, *A New Bridge for Old Allies*, (Toronto: Canadian International Council, November 2008), p. 1.
[4] See Someshwar Rao, *North American Economic Integration: Opportunities and Challenges for Canada*, IRPP Working Paper Series no. 2004-09a (2004): 1-14; and Michael Kergin and Brigit Matthiesen, *A New Bridge for Old Allies*, (Toronto: Canadian International Council, November 2008).
[5] Paul G. Bradley and G. Campbell Watkins, "Canada and the U.S.: A Seamless Energy Border?" *C.D. Howe Institute Commentary* No. 178, (April 2003): 1-35.
[6] According to Michael Hart and Bill Dymond, "the typical automobile, for example, assembled in Canada and exported to the United States, is made up of inputs that may already have crossed the border up to five times as they wended their way up the value chain." See Hart and Dymond, "Policy Implications of a Canada-US Customs Union," *PRI Research Discussion Paper*, (June 2005), p. 6.
[7] As Hart and Dymond put it, There are fewer and fewer "Canadian" products, even as Canadian integration into the global economy increases." See Hart and Dymond, "Navigating the New Trade Routes: The Rise of Value Chains and the Challenges for Canadian Trade Policy*," C.D. Howe Institute Commentary* No. 259, (March 2008), p.2.

It is for these reasons that all efforts by governments in Ottawa to "diversify" our economy away from dependence on U.S. markets are doomed to make little headway. We are not separate closed economies, able to shift our production of a wide range of finished products to customers anywhere in the world. In fact official statistics undoubtedly understate the extent of our exports to other countries because so many of our exports lie buried inside products and services sold to others by companies based in the United States. We are a deeply integrated part of a continental economy, and the border represents perhaps the single greatest threat to our economic future.

The consequence of this relationship for productivity differences, however, is one that we need to pay careful attention to. Shifting our exports of goods to non North American markets is exceptionally challenging because of our integration into the US. That means that our productivity measures vis-à-vis our American competitors are absolutely key for improving our standard of living because if we lose competitiveness vis-à-vis American suppliers in the North American supply chain it is exceptionally difficult to replace those customers with ones in other countries.

This is relevant to transfers for two reasons. First inter-regional transfers such as equalization and regionally-enhanced EI benefits are entrenching low-productivity performance in recipient regions while driving up costs in higher productivity regions. Second, because the federal transfers blunt the incentives for productivity improvements in many provincially-delivered services, we are helping to entrench higher than necessary taxes to pay for wastefully delivered services.

Let‟s talk about some of the inter-regional effects. In particular I am increasingly interested in the growing resistance from contributor provinces such as Alberta and Ontario to the edifice of federal transfers. In the face of what I consider to be pretty stark evidence about the self-defeating nature of much inter-regional redistribution, why did Ontario in particular remain so silent over the years, only to become an increasingly vocal critic of such redistribution since the mid-nineties?

While the increasing evidence of the failure of these inter-regional redistributive policies has become hard to ignore in the past few years, the true cause of Ontario‟s change of heart does not come from looking at the bad effects of regional policy on Quebec and the rest of the taking nation, primarily the country east of the Ottawa River. Ontario‟s increasing angst and anger is much more due to how free trade and continental integration have changed the political economy of Confederation then it is to the manifest failings of EI or the Atlantic Canada Opportunities Agency.

I"ll explain first by telling you a story told to me by former federal cabinet minister Eric Kierans:

> When I was a member of the Lesage government in Quebec, I attended a first ministers" meeting in Toronto. A proposal was on the table to create a new federal transfer program, the effect of which would have been to take millions of dollars out of the wealthy provinces and distribute it to the poorer ones. No province would foot a higher bill than Ontario, yet then-premier John Robarts looked on benignly and supported the proposal. My curiosity piqued, I cornered Robarts in the corridor and asked him why he looked with such equanimity on a proposal that would cost his province dear. Robarts" response spoke volumes about the political understandings which underpinned all the transfer programs that emerged from those febrile times. Ontario had no quarrel with these programs, he said, because the money came right back to Ontario in the form of the purchase of goods and services. The transfers were simply a way of ensuring that people in the regions had the money to buy Ontario"s products.

Whatever the economic merits of Robarts" view, as a picture of the political economy of the Canada of the day it had a certain logic. Canada had been created as an act of political will, in defiance of natural economic ties. Those ties had led Canadians in every region to look chiefly south for the source of their prosperity. Politics, in the form of Sir John A. Macdonald"s National Policy, had contrived to make that much more difficult, throwing up a tariff wall at the border and investing massively in the CPR (i.e. east-west infrastructure to tie the new national economy together).

But embracing continental free trade in 1988 was a conscious decision to repudiate the National Policy and to revive those north-south links.

The consequences for regional policy are not far to seek. Free trade means that those transfer dollars are no longer shepherded back to Ontario, but may in fact be used to purchase goods and services from Ontario"s competitors in Boston, New York or Chicago. The old political understanding is breaking down.

And while transfers such as equalization are often justified on the grounds that they protect the equality of Canadians in their access to provincial services, that is less and less convincing when we see how equalization has in fact been used, not to guarantee equal levels of services, but to guarantee, for instance, relative levels of provincial government employment and pay in the recipient provinces[8] that exceed those offered in Ontario and Alberta. That is the classic outcome of rent-seekers scrambling to capture the spoils that transfers have put on the table. That no

[8] Brian Lee Crowley and Bobby O"Keefe, "The Flypaper Effect: Does Equalization Really Contribute to Better Public Services, or does it just „Stick to" Politicians and Civil Servants?" *AIMS Commentary*, No. 2 (June 2006): 1-11.

doubt helps to explain why Ontario has roughly 75 municipal and provincial public servants per 1000 population, while Newfoundland has 99 and Manitoba comes top of the league with 108. These differences are far greater than can be explained by mere economies of scale, and help to explain why there is increasingly among the think tank community a sense that Canada over-equalizes and that this is damaging both those who foot the bill and those who get the transfers. The damage to recipients will only be exacerbated in a time of demographic change and tight labour markets, as transfers help to make provincial governments formidable competitors for available labour in local provincial markets. In recipient provinces, public sector wages often tend to be higher compared to local average wages than in richer provinces.[9]

Speaking of emerging consensuses in the think tank community, I would venture to say that there is another one that federal transfers generally (i.e. ones designed to support public services across the country, regardless of local conditions, such as equal per capita CHT, etc.) cause serious efficiency problems for our public sector, ensuring that our tax burden is higher than it needs to be for the level of services we are getting.

Without going into this too deeply, the problems with supporting provincial service delivery through federal transfers are several, but let me mention two. First of all is the issue of buck-passing. As long as Ottawa provides major transfers to finance provincial services, provinces can always shift the blame for low-quality inefficient services to miserly federal transfers. This bait and switch tactic is often highly successful. As Tommy Douglas used to say when he was premier of Saskatchewan, running against Ottawa in a provincial election was always worth another 10 percentage points on his vote. This kind of competitive blame game keeps us from focusing on weaknesses in program design and delivery.

Second is the accountability problem. Transfers allow provinces to deliver 100% of the services, but only charge their taxpayers some fraction of the full costs. This creates the illusion for provincial voters that they can vote for higher levels of service while only paying a part of the bill. The fact that the other part comes out of their pocket at federal tax time is hard for many people to grasp, and in many parts of the country even that share of the bill is shifted onto higher income parts of the country.

Democracy ideally creates an accountability loop where the population who benefit from public services are also the population who pays the bill. That way voters are confronted with something like the real cost of their choices, so that they can make informed decisions. The

[9] Brian Lee Crowley and Bobby O‟Keefe, "The Flypaper Effect: Does Equalization Really Contribute to Better Public Services, or does it just „Stick to‟ Politicians and Civil Servants?" *AIMS Commentary*, No. 2 (June 2006): 1-11.

federal transfer system breaks this accountability loop by obscuring for provincial voters the real cost of provincially-delivered services. That is why many of us in the think tank community think that it is preferable to shift some part of the tax base to provinces rather than for Ottawa to collect the money and sent it in the form of transfers.

Perhaps a concrete example will help to illustrate what I have in mind. Perhaps the deepest and broadest example of social program reform in Canada over the last twenty years is welfare reform.

As we know, the federal and provincial governments in the late 1980s and early 1990s were increasingly struggling with budget deficits and how to constrain spending. The combination of needing to restrain and reform spending coupled with the worrying rise in the number (and percentage) of Canadians receiving welfare[10] set the stage for fairly dramatic reforms in the mid-1990s.[11]

A number of smaller reforms[12] had been made in the late 1980s; the fundamental reform of welfare began, however, in 1995. And the trigger was Paul Martin‟s dramatic changes to the financing of social programs in the 1995 federal budget, and specifically the switch from a system of cost-sharing grants to a block grant to the provinces to provide social assistance. This meant that any new extension of programs or benefits would be paid for by the provinces exclusively. It clearly placed the financial responsibility for these programs on the shoulders of

[10] In 1990, some 1.9 million Canadians (including dependents) or 7.0 percent of the population were receiving welfare benefits from government. Provincial and local spending on welfare reached $8.6 billion in 1990/91 (inflation-adjusted 1996 dollars). The combination of the 1991 recession and a general trend towards greater dependency resulted in the number of Canadians receiving welfare benefits reaching 3.1 million in 1994, representing an astonishing 10.7 percent of the population. Real spending on welfare by local and provincial governments hit $14.3 billion in 1993/94. The growth in dependency by the Canadian population coupled with the increasing pressure on governments to balance their fiscal affairs set the stage for reform. See Ross Finnie, Ian Irvine and Roger Sceviour, *Social Assistance Use In Canada: National and Provincial Trends in Incidence, Entry and Exit*, Analytical Studies Research Paper, no, 245. Catalogue no. F0019M1E, (Ottawa: Statistics Canada, May 2005). Available at http://www.statcan.gc.ca/pub/11f0019m/11f0019m2005246-eng.pdf; F. Roy (2004). *Social Assistance by Province, 1993-2003*. Ottawa, ON: Statistics Canada, Canadian Economic Observer, November 2004. Catalogue no. 11-010. Available at http://www.statcan.gc.ca/pub/11-010-x/11-010-x2004011-eng.pdf; and Chris Schafer, Joel Emes, and Jason Clemens (2001). Surveying U.S. and Canadian Welfare Reform. Vancouver, BC: The Fraser Institute. Available at http://www.fraserinstitute.org/researchandpublications/publications/2559.aspx.

[11] Professor John Richards of Simon Fraser University was instrumental in both raising awareness of the fundamental problems present in the country‟s welfare systems as well as offering possible solutions. For an excellent summary of his work please see John Richards (1997). *Retooling the Welfare State: What's Right, What's Wrong, What's To Be Done*. Toronto, ON: C.D. Howe Institute. Also see the more recent John Richards (2007). *Reducing Poverty: What has Worked, and What Should Come Next*. Toronto, ON: The C.D. Howe Institute. Available at http://www.cdhowe.org/pdf/commentary_255.pdf.

[12] For example, the 1990 federal budget imposed a "cap on CAP". It limited the annual increase in federal cost-sharing under CAP to 5 percent for the three "have" provinces: Ontario, Alberta, and British Columbia for the years 1990/91 through 1994/95.

the provincial government. Crucially, the reforms also provided more flexibility and autonomy to the provinces with respect to the delivery and design of social programs (excluding health care).

There were a number of common reforms implemented by most, if not all of the provinces. One common feature of reform was a reduction in benefit levels, particularly for single employable people. While the narrative of reform"s opponents was often about balancing the books on the backs of the poor, the changes were actually rooted in an increasingly widespread acknowledgement that incentives mattered for low-income work decisions.[13] Specifically, there was an increasing understanding that when welfare benefits surpass comparable income available from low-paid work, strong incentives are created to enter or remain on welfare.[14] Many of the reductions in benefit levels and particularly those for single employable people were aimed at returning a balance between welfare benefits and the income available to workers from low-paid work.

Another fairly common reform was to integrate welfare and related services with employment programs provided by the province. For example, Saskatchewan,[15] Newfoundland, and the Northwest Territories all moved fairly quickly to integrate welfare delivery and government-provided employment services. In addition, a number of provinces including Alberta, Ontario, British Columbia and Quebec undertook initiatives to improve the administration of welfare and related programs including reducing fraudulent claims.

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[13] An important experiment with respect to take-home income and employment incentives was completed in Canada. The Self-Sufficiency Project (SSP) was launched in 1992 by the Human Resources Development Canada (HRDC). The project encouraged single-parent welfare recipients who had been on welfare for at least one year to find full-time employment by offering them up to three years of additional (top-up) income. The supplemental income essentially doubled the average participant"s earning compared to a minimum-wage job or welfare benefits. There have been disagreements about the longer-term implications of the study. For further information please see Reuben Ford, David Gyarmati, Kelly Foley, and Doug Tattrie (2003). *Can Work Incentives Pay for Themselves? Final Report on the Self-Sufficiency Project for Welfare Applicants*. Social Research and Demonstration Corporation; Michalopoulos Card and Phillip Robins (1999). *When Financial Incentives Pay for Themselves: Early Findings from the Self-Sufficiency Project's Applicant Study*. Ottawa: Social Research Demonstration Corporation; and Todd Gabel and Sylvia LeRoy (2003). *The Self-Sufficiency Project: No Solution for Welfare Dependency*. Fraser Forum (September). Vancouver, BC: The Fraser Institute.

[14] For an empirical examination of this issue during the 1990s please see: Joel Emes and Andrei Kreptul (1999). *The Adequacy of Welfare Benefits in Canada*. Vancouver, BC: The Fraser Institute. Available at: http://oldfraser.lexi.net/publications/critical_issues/1999/welfare_benefits/.

[15] For a critical analysis of Saskatchewan welfare reform please see Jason Clemens and Chris Schafer (2002). *Welfare in Saskatchewan: A Critical Evaluation*. Vancouver, BC: The Fraser Institute. Available at http://www.fraserinstitute.org/commerce.web/product_files/WelfareinSaskatchewan.pdf and Garson Hunter (2004). Social Assistance Caseload Impact of the Building Independence Program in Saskatchewan: A Time-Series Analysis. Regina, SK: Social Policy Research Unit, University of Regina. Available at http://dspace.cc.uregina.ca/dspace/bitstream/10294/926/1/occasional_paper_15.pdf; for a summary analysis please see Frontier Centre for Public Policy (2004). *The Triumph of Welfare Reform*. Notes from the FCPP, September 1, 2004. Available at http://www.fcpp.org/publication.php/809.

Unsurprisingly, given the altered incentives created by Paul Martin‟s restructuring of transfers, many provinces also reformed their welfare systems to focus on better results, improved value-for-money in the services and support they offered people, and controlling cost. But different provinces focused their attention on different things, tailoring reform to their local circumstances.

Provincial welfare reform highlights the power of decentralized delivery of government services and the varied and innovative approaches different provinces took to improve their welfare and related programs. The results of these reforms were dramatic. By 2000, the number of welfare beneficiaries in Canada had declined to a little over 2 million (6.8 percent of the population) from a peak of 3.1 million (10.7 percent of the population).[16] In addition, welfare-related spending had been curtailed, helping governments to balance their budgets. Most importantly, however, the programs being delivered seemed to be achieving better results by getting more employable individuals into the job market and dealing with some of the more pressing underlying problems that caused people to consider welfare as an alternative to work. My view is that these reforms would not have occurred without transfer reform at the federal level, reforms that changed fundamentally the incentives for provincial governments by making them much more accountable for their spending decisions and the consequences of poor programme design.

Thank you.

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[16] Ross Finnie, Ian Irvine and Roger Sceviour, *Social Assistance Use In Canada: National and Provincial Trends in Incidence, Entry and Exit*, Analytical Studies Research Paper, no, 245. Catalogue no. F0019M1E, (Ottawa: Statistics Canada, May 2005). Available at http://www.statcan.gc.ca/pub/11f0019m/11f0019m2005246-eng.pdf; F. Roy (2004). *Social Assistance by Province, 1993-2003*. Ottawa, ON: Statistics Canada, Canadian Economic Observer, November 2004. Catalogue no. 11-010. Available at http://www.statcan.gc.ca/pub/11-010-x/11-010-x2004011-eng.pdf; Ross Finnie and Ian Irvine (2008). *The Welfare Enigma: Explaining the Dramatic Decline in Canadians' Use of Social Assistance, 1993–2005*. Toronto, ON: The C.D. Howe Institute. Available at http://www.cdhowe.org/pdf/commentary_267.pdf; and Chris Schafer, Joel Emes, and Jason Clemens (2001). *Surveying U.S. and Canadian Welfare Reform*. Vancouver, BC: The Fraser Institute. Available at http://www.fraserinstitute.org/researchandpublications/publications/2559.aspx.

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