Budget Paper C

A RENEWED FISCAL PARTNERSHIP TO SUPPORT CANADA'S SOCIAL UNION

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■ Introduction

The manner in which responsibilities and revenues are shared between the federal and provincial governments defines and shapes the nature of Canada's federation. Provincial governments have responsibility for providing the vital public services with the greatest demands and cost pressures. However, it is the federal government that has access to a larger share of revenue, as well as the fastest growing revenue sources. A system of financial arrangements has evolved over time to respond to this situation. These arrangements are highly interdependent and influence a wide range of programs, including income support, health care, post-secondary education and training, Aboriginal issues, and taxation.

The Social Union Framework Agreement, signed on February 4, 1999, by the Prime Minister and all Premiers and Territorial Leaders, except the Premier of Quebec, commits governments to working more closely together to respond to Canada-wide social policy priorities. The Agreement sets out the ground rules concerning the design and delivery of social programs, including specific provisions for governments to report to Canadians on how well these programs fulfil their intended purposes. It also provides the basis for improved financial arrangements through the following principle:

Ensure adequate, affordable, stable and sustainable funding for social programs.

The Agreement does not, however, specify the nature of the fiscal partnership that is required to support Canada's social union.

Consistent with the terms and spirit of the Social Union Framework Agreement, Manitoba expects the federal government to work with provinces and territories to ensure that they have the resources necessary to fulfil their social policy commitments to Canadians. The fiscal arrangements that underpin the Social Union must be re-examined, and in Manitoba's view, reformed. In particular, improvements must be made to the main pillars of fiscal arrangements – the Canada Health and Social Transfer (CHST), the Equalization Program, and the Tax Collection Agreements. A more effective fiscal partnership will:

- correct the current imbalance between responsibilities and revenue;
- reduce the inequities in provinces' abilities to raise adequate revenue and to provide a comparable level of services to all Canadians, regardless of where they live; and
- co-ordinate tax policy.

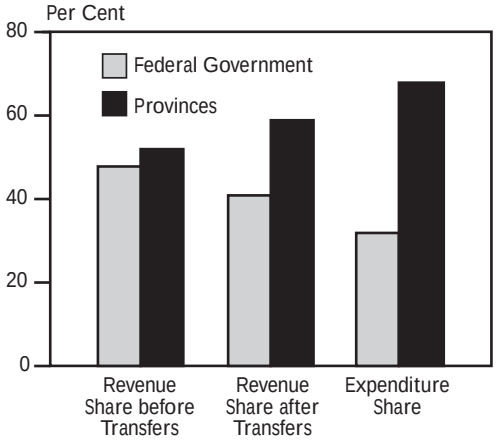
■ Balancing Responsibilities and Resources

In terms of responsibility for providing services to the public, the Canadian federation is one of the most decentralized in the world. Indeed, the total dollar value of services provided by provinces (provincial and local governments) is more than double the total value of services provided by the federal government. At the same time, however, provinces generate about 20% less total revenue than the federal government.

Throughout Canada's history, there has been an imbalance between the federal and provincial governments in terms of their mandates to provide services and the financial resources to meet them (also referred to as a "vertical fiscal imbalance.") Achieving the "right" balance has been an ongoing challenge for the nation. It is clear that, over time, circumstances change and the mix of responsibilities and resources between orders of government also changes. The balance that was appropriate for Canada during World War II is far different from what is required today and in the future to sustain the demands of health care and other social programs.

The degree of imbalance may be broadly measured by the difference between provinces' and federal government's share of total government program spending – their responsibilities to provide services – and their share of total government revenue. The chart titled Revenue and Expenditure Shares, 1998, summarizes the revenue for the federal government and provinces, before and after transfer payments, and their program expenditures.

Revenue and Expenditure Shares, 1998



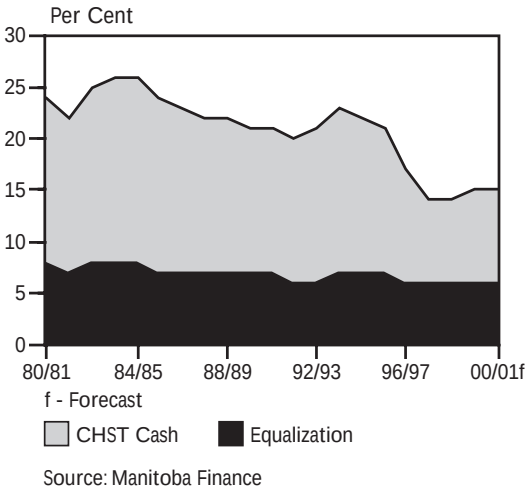
Source: Statistics Canada

It is apparent that the federal government's revenue exceeds its program responsibilities, while the converse is true for provinces. In the past, differences in debt costs have partially justified this imbalance, but federal debt costs now are contained, and cost pressures on provincial programs are increasing. In particular, health care costs are expected to continue to outstrip other government programs given the implementation of new technology and the anticipated needs of an aging and better-informed population. It is expected that the gap between the demand for health care services and the financial resources provinces have available to provide them will widen over time and become more acute as the baby boom generation ages.

The current mechanism used by the federal government for bridging this gap and helping provinces and territories finance health, post-secondary education, and other social programs is the Canada Health and Social Transfer. The CHST was instituted in 1996/97 as an unconditional cash transfer, to replace the Established Programs Financing (EPF) and Canada Assistance Plan (CAP), which were the conditional transfer programs created in the 1970s.

Medicare and many other important social programs were introduced in the 1950s and 1960s on the basis of a roughly equal 50-50 shared-cost basis between the federal and provincial governments. When the EPF was instituted in 1977/78, federal cash funding accounted for only about 25% of provincial spending on hospitals and medical services. Annual funding increases were initially based on a formula which took into account inflation and population growth (the three-year moving average of growth in per capita GNP). However, between 1986/87 and 1995/96, the federal government made a series of revisions to the EPF funding formula, such that by the end of this period, the federal government's cash share of health care spending declined to 16.3%. With the introduction of the CHST, the federal government's cash share further declined, and by 1998/99, its share stood at 9.6%.

Major Transfers to Provinces as a Share of Federal Government Revenue



Source: Manitoba Finance

If the federal government had maintained its commitment to supporting social programs at its 1980/81 level (i.e. 24% of revenue), transfers to provinces would be $13.6 billion higher in 1999/2000.

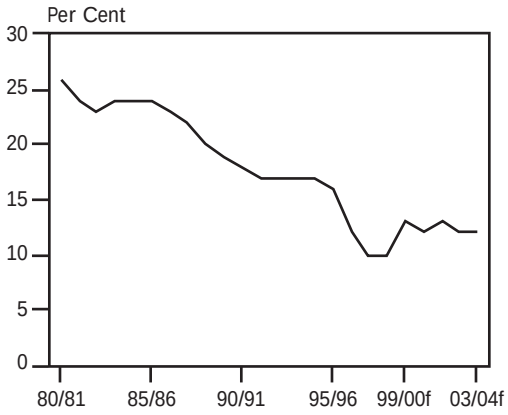
WORK BY PROVINCIAL/TERRITORIAL FINANCE MINISTERS

At the August 1997 Annual Premiers' Conference, Finance Ministers were instructed to begin negotiations with their federal counterpart on renewing Canada's existing financial arrangements. As a first step, Provincial/Territorial Finance Ministers developed a two-part examination of the imbalances that occur in existing arrangements. These papers, *"Redesigning Fiscal Federalism – Issues and Options – Parts 1 and 2,"* were released by Premiers at the August 1998 Annual Premiers' Conference. Finance Ministers also presented another paper called *"Reforming Federal-Provincial Fiscal Arrangements – Towards a National Consensus,"* to the federal Finance Minister in June 1998. The main elements of the 1998 proposal to reform fiscal arrangements are summarized as follows:

- restore over a period of three years, the federal funding taken out of cash transfers to provinces and territories, and escalate CHST cash to ensure that provinces and territories have sufficient future resources to deal with rising cost pressures;
- allocate the CHST among provinces and territories on an equal per capita basis;
- raise the Equalization Program standard to the national average standard; and
- establish a regular process for review of the CHST, similar to the five-year Equalization renewal process.

Contributing, in part, to the sharp decline in the federal government's share of health care funding has been an expansion of what is publicly funded under our health care system. Initially, only hospital and medical services were covered. In response to public demand, provincial governments began to provide funding for home care, personal care homes and prescription drugs. With advances in drug therapy and the needs of an aging population, these programs have become significant and relatively faster growing components of many provincial health care budgets.

Federal Government's Share of Health Care Funding



f - Forecast

Source: Manitoba Finance

The federal government's decision to reduce its share of cash funding shifted a significant financial burden onto provinces, all of which have experienced difficulties in making up the difference. These financial pressures have heightened concern over the ability of a publicly administered health care program to deal with growing demands. Now that the federal government has posted two successive budget surpluses, and with analysts predicting substantial future surpluses, a clear opportunity exists to address this issue.

Consistent with discussions among First Ministers, as well as Finance and Health Ministers, the federal government announced that it would partially restore the funding it provides to provinces and territories for health care. This marks the first time since the inception of the major health and social programs that the federal government is increasing its share of funding. Although the announced increase in the CHST will result in only a modest shift in funding shares, it does represent a reversal in federal funding policy, and an important first step in moving toward greater equity between the funding responsibilities and the revenue-raising capacities of governments.

It appears that the federal government also is prepared to acknowledge its role in addressing provincial concerns about adequacy of funding. In his February 17, 1999, post-Budget letter to Premiers, the Prime Minister promised that,

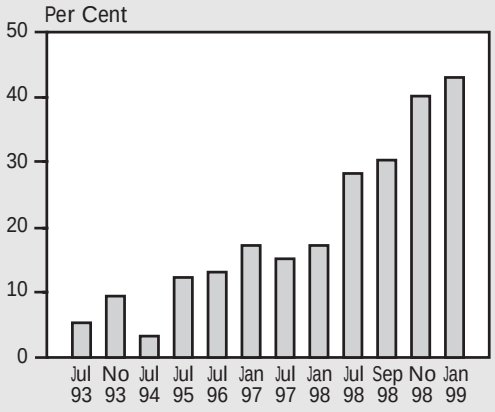
> *As the Government of Canada's financial flexibility improves in the years ahead, health will continue to be a key priority for further action.*

Based on the federal government's funding projections, it is estimated that its share of health care funding will increase to an estimated 13% in 1999/2000. However, increases in health care costs are expected to exceed the value of the announced adjustment, such that by 2003/04, the federal government's cash contribution to health care would decline to under 12%, and continue to fall until the federal government commits additional revenue to Canada's health care system.

HEALTH CARE COST PRESSURES

- Under the Constitution, provincial governments are responsible for health care and other social programs. Health care costs account for about one-third of total provincial expenditures.
- Canadians value their health care system, but past federal funding cuts and growing cost pressures have caused citizens to become increasingly concerned about its future. Public opinion polls consistently rank health care as the top priority for action by governments.
- There are a number of factors causing cost pressures to outpace the revenue growth of provincial governments. Underlying the growth in health care expenditures are our changing demographics. Canada's population is both growing and aging. Over the past five years, Canada's population rose by 1.46 million people – a number equivalent to the combined populations of Manitoba and Prince Edward Island.
- While Canadians are living longer and more productive lives, health care costs and needs rise as people age. In Manitoba, the average cost of medical services for individuals in the 2-14 age group was less than $100 per year in 1997/98. However, for individuals aged 65 and over it was $475.

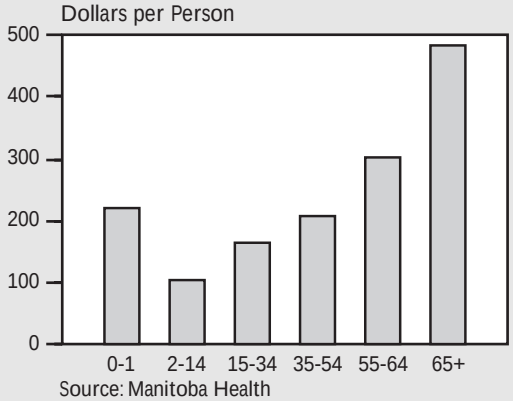
Percentage of Canadians Citing Health Care as the Top Issue for Canada's Leaders



Source: Angus Reid Group, Inc. Feb. 1999

- Information on hospital stays, Pharmacare, home care and personal care home use underscores the fact that health care needs increase with age. Older people are admitted to hospital more frequently, and generally experience longer stays. One in four Manitobans aged 85 or over reside in a personal care home.
- The rate at which Canada's population is aging is expected to accelerate as the first of the baby boomers reach age 65 in 2012, and the majority reach that age in about 2028. As baby boomers age, a major shift in health care services is anticipated. Generally speaking, as a population ages, concerns with sports injuries and pediatric/obstetrical care, give way to a different set of health issues, such as chronic pain management, heart disease and cancers. It is also expected that there will be a need for more long-term care facilities, increased home care support and new drug therapies. It is anticipated that over the long term, costs will continue to rise at a rate in excess of population growth and inflation, presenting a collective challenge for governments to meet.

Cost of Medical Services, by Age Group, Manitoba, 1997/98



Source: Manitoba Health

- In addition to changing demographics, it is clear that expectations about what the health care system can and should deliver also have changed. This is evident in demands for public funding of new technology, along with more preventative care and non-traditional complementary health care. These have the potential to improve the quality and, in all probability, the total cost of health care.

Ensuring that all Canadians have access to a high standard of health services is linked to adequate funding for health care programs. In this regard, provinces and territories recognize the important and positive role the federal government has to play. Given the high priority that Canadians place on health care and other social programs, such as post-secondary education, governments need to work together to follow up on the Prime Minister's commitment by developing a long-term plan that will ensure the viability of these programs.

TAX POINT TRANSFERS

- The federal government asserts that it contributes more to funding health and other social programs than provinces and others recognize. The difference in federal and provincial views centres on their interpretation of the tax point transfer that took place in 1977 with the introduction of the EPF. Provinces, along with numerous experts in the field, do not support the federal claim that these tax points should be counted as part of its annual contribution to social programs for two important reasons.
  - The first is that provinces ceded tax powers to the federal government to help finance Canada's efforts during World War II. The 1977 tax point transfer was simply a partial restoration of what provinces had previously given up to the federal government. At the time, the federal government reduced its tax rates, and provinces increased theirs by a similar amount.
  - The second is that it contradicts the principle of transparency in a government's dealings with taxpayers. For more than two decades, Canadians have paid these amounts to their provincial governments and have held them directly accountable for their use.
- It is noteworthy that the contribution of the tax point transfer to the financing of health care has declined over the years, albeit by far less than the cash transfer. Before EPF was established in 1977/78, the federal government's cash share of health care costs was equal to that of provinces. With the introduction of EPF, the federal government still financed about 50% of the costs of health care and post-secondary education, but its contribution was converted to consist of a tax point transfer and a residual cash transfer. By 1992/93, funding to provinces for health care and post-secondary education based upon the tax point transfer's share of total health spending had declined to 14%. Provincial efforts to constrain health care spending allowed the percentage to rise to 18% in 1998/99. Over the next few years, this percentage is expected to remain in the 17% range, growing at or slightly below forecast needs.
- Manitoba supports the transfer of fully equalized tax points as the best means for the federal government to provide adequate, stable and predictable funding for social programs. Tax point transfers are preferable to cash transfers because they are less subject to federal budgetary discretion, and based on past trends, are more likely to keep pace with the underlying cost increases associated with providing social programs.

For its part, there are several mechanisms available to the federal government to ensure that its funding for social programs is adequate. It could either restore its cash commitment to 25% of the total cost of health care and post-secondary education (50% in respect of social assistance) through the CHST, or it could transfer an appropriate number of tax points to provinces and then fully equalize them. While there are pros and cons to each approach, the consensus of opinion is that resolving the imbalance is more important than the specific mechanism used to do so.

The federal government's commitment to restore $2.5 billion of the $6.2 billion in annual reductions to the CHST was a good first step. As an important next step, the federal government must restore the remaining $3.7 billion, to bring the transfer back up to 1994/95 levels, and set out a plan to bring its share of the total funding for social programs back to 25%. The final step would be to work with provinces and territories to design a formula that regularly and systematically adjusts the value of transfers so that the real per capita value is not eroded over time. Such a formula must take into account increases in demands and resource costs to "ensure adequate, affordable, stable and sustainable funding for social programs."

The Importance of Equalization Payments in Addressing Horizontal Imbalance

The purpose of Canada's Equalization Program, introduced in 1957, is set out in Section 36(2) of the Constitution Act, 1982. It states that,

> *Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

Due, in large part, to the Equalization Program, the Canadian federation has been able to address important efficiency and equity issues associated with a highly decentralized form of government. In recognition of the significant economic disparities that exist among provinces, the Program seeks to ensure that Canadians receive a similar standard of service from their provincial governments, and shoulder a reasonably comparable tax burden to finance it, regardless of where they live. Equalization payments also have helped stabilize provincial revenues during periods of localized economic downturn.

For the Equalization Program to be effective, it must be comprehensive and ensure that a province's capacity to raise revenue is measured accurately. By choosing to narrow the scope of revenue coverage of the Miscellaneous Base in the 1999 renewal, the federal government has begun to weaken the ability of the Equalization Program to ensure that all Canadians have access to similar public services with similar tax burdens. Working with provinces, the federal government must launch a joint full-scale review of revenue coverage issues.

The Equalization Program must adopt an appropriate standard against which a province's fiscal capacity can be measured. With respect to the latter, there is significant provincial support for the federal government to base the calculation of a province's entitlements on the national or

ten-province average standard, which existed in the early years of the Program. Provinces have expressed concern that the current five-province standard, which is significantly below the national-average standard, does not provide all provinces with an appropriate level of resources to ensure a comparable standard of public services to all Canadians.

As all orders of government seek to reduce the tax burden of Canadians, there is concern that an unintended outcome will be to reduce Equalization payments. Federal tax cuts that reduce provincial revenues usually reduce Equalization payments. In this context, raising all provinces to a national-average standard would help achieve the equity benefits of a unitary state, while maintaining the efficiency benefits of a decentralized federation.

■ Federal-Provincial Co-ordination of Tax Policy

Under the current Tax Collection Agreements, set up in the early 1960s, the federal government administers and collects personal and corporate income taxes in all provinces, except Quebec. These arrangements have served to enhance the overall administrative efficiency of the tax system by avoiding duplication and an unnecessary reporting burden on the public.

However, almost every federal budget has introduced changes to the tax system that have affected provincial as well as federal revenues. Too often, these changes have been made unilaterally by the federal government with minimal consultation or agreement from provinces. For example, in its February 1999 Budget, the federal government increased the basic personal credit. Because provincial personal income taxes are calculated as a percentage of federal tax collections, provincial personal income tax revenues are reduced, and Equalization entitlements also are affected. The federal government estimates that the full-year impact of this particular Budget measure will reduce provincial revenues by close to $600 million. As a consequence, the net improvement in provincial finances resulting from the increase to the CHST has been substantially eroded by the federal government's choice of tax reductions.

Before the 1999 federal Budget, the Government of Canada had a choice with respect to what instrument it would use to deliver tax relief. The federal government could have provided the same amount of income tax relief to Canadians without affecting provincial income tax revenues. For example, it could have cut federal-only personal income taxes, including its surtaxes, increased child tax credits, reduced fuel taxes, or cut Employment Insurance (EI) premiums.

If the federal government had decided to make more substantial cuts to EI premiums, as called for by Premiers and Provincial/Territorial Finance Ministers, provinces/territories, municipalities and the hospital sector, as major employers, would have benefited from lower costs and increased revenues, totaling about $470 million. However, in choosing to increase the basic personal credit rather than cutting EI premiums, the federal government impacted provincial, municipal and the hospital sector revenues by more than $1 billion – the difference between provinces/territories, municipalities and the hospital sector saving $470 million and seeing their revenues decline by $600 million.

Increased co-ordination and co-operation in tax policy is an important element of a renewed fiscal partnership. By working together, governments could develop and implement a plan to provide Canadians with significant tax relief. An example of such a plan would see the federal government make substantial cuts to EI premiums. In turn, provincial and territorial governments would use the increased revenues realized from these reductions to cut personal income taxes, while municipalities, hospitals and indeed all Canadians also would benefit from EI premiums being reduced to levels more in keeping with the costs of the EI Program.

It is clear that greater co-ordination of tax cuts would serve the needs of Canadians as well as the interests of both federal and provincial governments. In this instance, provincial revenues and the flexibility to cut provincial personal income taxes or, possibly, to further increase funding for health or other social programs, could have been achieved through better co-operation and policy co-ordination.

■ Conclusion – Summary of Recommendations

Consistent with the commitments made by governments to work together to improve social programs for Canadians through the new Social Union Framework Agreement, federal and provincial/territorial governments also must renew their fiscal partnership.

The main steps in establishing a renewed fiscal partnership are as follows.

- Establish a plan to ensure the long-term sustainability of health and other social programs.
- Set out the timeframes to restore the federal funds cut from health, post-secondary education, and social assistance to the 1994/95 level of $18.7 billion.
- Agree upon a mechanism to escalate CHST funding so that the federal government's share of the cost of health and post-secondary education returns to 25% of total expenditures (social assistance to 50% of total expenditures). The mechanism could be either the transfer of fully equalized tax points or increased cash transfer payments.
- Develop a formula to ensure that the real per capita value of the CHST is not eroded over time.
- Enhance the Equalization Program by reviewing the current scope of the Program and by adopting the national-average standard.
- Review fiscal arrangements every three years to ensure that these arrangements provide "adequate, affordable, stable and sustainable funding for social programs."
- Co-ordinate tax policy to maximize the benefits for Canadians.