Budget Paper C

RESTORING FISCAL BALANCE

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RESTORING FISCAL BALANCE

To succeed as a country, Canada needs effective federal and provincial/territorial institutions and fiscal arrangements. The creation of the Council of the Federation represents an important step in this regard, bringing together the provinces and territories for the purpose of improving working relations with each other and the federal government.

Demographic forces are such that within the next five years, Canadians on the leading edge of the baby boom will be reaching retirement age and starting to leave the active labour force. Also, within the next decade, the costs associated with the ageing of the population will begin to be reflected in health budgets throughout the country. The revenue and cost implications of these trends are such that, without a fairer sharing of the costs with the federal government, provinces and territories will face severe resource constraints over the foreseeable future.

In February, the Conference Board of Canada produced a study looking at the fiscal prospects of both orders of government out to 2020[1]. A key finding of the study was that, in the absence of any major new policy initiatives, the federal government is expected to post increasingly large surpluses over the long term. Moreover, the magnitude of these surpluses is expected to significantly exceed provincial/territorial deficits, which the Conference Board projects will persist over the next two decades. This suggests that Canadians already pay enough in taxes to fund the activities of government as a whole, and that the problem is one of matching revenue up with the government that supplies the service. For provinces and territories, this means that, if a rebalancing of resources with responsibilities could be achieved, they need not be faced with the dilemma of either having to run deficits or compromise on other important economic and social programs in order to fund health care.

The creation of the Council of the Federation represents an important step, bringing together the provinces and territories for the purpose of improving working relations with each other and the federal government.

... achieving a proper balance between social and economic priorities is key to improving Canada's standard of living and the quality of life it offers its citizens

While tools exist to solve the distribution problem, governments collectively lack effective institutional arrangements to give force and direction to them. This is important, since achieving a proper balance between social and economic priorities is key to improving Canada's standard of living and the quality of life it offers its citizens.

Federations around the world use a variety of mechanisms to address the problem of balancing resources with responsibilities. Some, like Australia, India and South Africa, have independent commissions that make recommendations on the division of revenue-raising capacity and transfer payments. Some, such as Germany and the United States, have effective regional representation through a second legislative chamber, with powers over national program spending and transfer payments. In Canada, we have relied on a set of meetings of officials, Finance and other program Ministers, and First Ministers to discuss arrangements. This process is known as "executive federalism."

Through the 1960s and into the 1970s, these mechanisms resulted in major agreements which enabled and cost-shared, usually on a 50:50 basis, the major social programs which have become the foundation of the Canadian identity – the Hospital and Diagnostic Services Act and Medicare, the Canada Assistance Plan for social services, and the Post-secondary Education Funding Act. Prior to this, in 1957, the Equalization Program was instituted.

Unfortunately, for the last quarter century, agreements have been amended through unilateral federal action, breaking the covenants of the original agreements. These actions have reduced the federal contribution to health and social programs, and resulted in the fiscal imbalance identified in the Conference Board's study.

The Prime Minister and many Premiers have called for a new era of federal-provincial relations. The Government of Manitoba wants to be in the forefront of establishing this new relationship.

■ The Council of the Federation

On December 5, 2003, Canada's Premiers signed the founding agreement of the new Council of the Federation. The Council, which is comprised of the thirteen Premiers of the provinces and territories, builds on the annual conferences of Premiers which began in 1960.

Premiers recognized the need to develop a new institution to enhance provincial-territorial collaboration, and develop more effective relations with the federal government. In seeking to better meet the current and changing needs of Canadians, Premiers identified several key objectives:

a) strengthening interprovincial-territorial co-operation, forging closer ties between the members and contributing to the evolution of the Canadian federation;

b) exercising leadership on national issues of importance to provinces and territories and in improving federal-provincial/territorial relations;

c) promoting relations between governments which are based on respect for the Constitution and recognition of the diversity within the federation; and

d) working with the greatest respect for transparency and better communication with Canadians.

As improving federal-provincial relations is one of the primary objectives of the Council of the Federation, a key question is, what should be the role of the federal government in addressing the present and future challenges facing the Federation?

■ The Nature of the Challenge

There are many challenges to maintaining fiscal equilibrium in a federal state. However, to be effective in meeting the needs of its citizenry, a workable balance needs to be struck in terms of sharing the responsibility for providing services and the sharing of resources to address them.

PRINCIPLES AND MECHANISMS

The principles that must guide intergovernmental fiscal relations include the following.

Adequacy and Sustainability: *Ensuring that financial resources match the cost of providing priority public services, given the revenues that are available to governments over the immediate and longer term.*

Equity: *Ensuring, on behalf of all Canadians, that provinces are able to maintain comparable levels of public services at comparable levels of taxation.*

Efficiency: *Ensuring that the fiscal environment in Canada is such that business decisions, especially with respect to location, are made on the basis of economic factors, rather than on differences in "net fiscal benefits" (the difference between taxes paid and benefits received in a given province as compared to that offered by other provinces with differing fiscal capacities).*

Transparency and Accountability: *Ensuring clear information on funding and expenditure is provided by each order of government in respect of the public services provided to the public (outputs) and the benefits (outcomes) derived. This also means that governments take responsibility for their decisions about financing and/or service delivery.*

These principles must be applied to the Canada Health and Social Transfers and the Equalization Program, in order to achieve a fiscal balance between the resources and responsibilities of the federal and provincial governments, in a way that addresses the fact that revenue-generating capacities differ among provinces. They should also appy to the broader range of federal-provincial programs.

...the federal government has, over the past decade, structured its financial obligations with respect to transfer payments to provinces and other programs so that it is not exposed to program cost pressures or the cyclical risk on the social program side associated with an economic downturn

Under Canada's Constitution, provinces are charged with the responsibility for providing health care, education and social services. To fund these and other important public services, they have access to broad powers of taxation. However, the capacity to generate the revenue necessary to fund these programs is unevenly distributed across provinces. Provinces are currently hard-pressed to meet the demands of health care, education, social programs and infrastructure while maintaining balanced budgets and commitments to tax competitiveness. Given current fiscal capacity and program commitments, provinces are finding it increasingly difficult to deal with the consequence of slower economic growth and the economic costs associated with major unforeseen disruptions, like BSE or SARS, and natural disasters, such as droughts, floods and forest fires.

At the same time, studies indicate that, in the absence of any new major policy initiatives, the federal government could post increasingly large budgetary surpluses over the foreseeable future without having to increase taxes. In addition, the federal government has, over the past decade, structured its financial obligations with respect to transfer payments to provinces and other programs so that it is not exposed to program cost pressures or the cyclical risk on the social program side associated with an economic downturn. Indeed, transfers in respect of health and other major social programs are provided as block payments which are unrelated to actual provincial program costs or funding needs.

In these circumstances, without the benefit of adequate federal transfer payments, the majority of the provinces face the prospect of either reducing access to, or quality of, public services below current standards, or resorting to increases in taxes or fees. This dilemma underscores the need for effective institutional arrangement so that priorities can be arbitrated and reasonable fiscal equity among provinces (horizontal balance) and between the federal and provincial governments (vertical balance) achieved. It is clear that these fiscal imbalances can, and must, be addressed.

The creation of the Council of the Federation may be understood as an evolutionary step in developing the institutions needed to make federalism in Canada work more effectively. It offers a more structured framework for co-operation and co-ordination among provinces and territories and with the federal government. In this regard, it provides provinces and territories with an opportunity to more clearly articulate the kind of partnership they are looking for with the federal government.

At its February 2004 meeting, the Council of the Federation laid out its plans for discussing health care reform and sustainability and the enhancement of the Equalization Program with Prime Minister Martin at the First Ministers' Meeting scheduled for later in the year. It also announced a health care focussed workplan to examine:

a) the medium- and long-term impact of key cost drivers in health care;

b) a sustainable track for health care funding;

c) the examination of a broad range of health care reform priorities; and

d) unique challenges faced by rural and remote communities.

■ Role of the Federal Government

The federal government has played a role in funding a wide variety of major and minor programs that fall under provincial jurisdiction for more than 100 years. Since World War II, it has played a key role in funding major social programs like public health care, and in designing transfer programs like Equalization, both of which have become defining features of the federation.

HEALTH CARE CONTEXT

Health care costs in Canada are currently about 10% of GDP, up from 9% five years ago. In the U.S., over the same period, health care costs have risen to 15% of GDP, from 13%.

Considering the fact that when Medicare was first introduced in Canada in 1966, health care costs in both countries were about 6% of GDP, it is clear that Canada's model of health care delivery and administration has been relatively more successful in managing cost pressures.

However, there remain significant challenges in adequately servicing a population that is both ageing and geographically dispersed. In this regard, there continues to be a number of areas where substantial resources and reform are yet required.

With the Equalization Program and the Canada Health and Social Transfers, Canada has the basic fiscal mechanisms in place to address the main priorities of Canadians. What is currently lacking is the commitment to fully utilize them in a way that is effective, accountable and transparent to the public. For these mechanisms to meet both current and future challenges, what is needed is a funding partnership between the federal and provincial/ territorial governments that assures adequate resources are devoted to addressing them.

The federal government is involved in funding provincial programs in several different ways, and through them addresses, to a degree, the fiscal imbalances between it and the provinces and those among provinces.

The Equalization Program, the principle of which is enshrined in the Constitution, is the backbone of federal-provincial fiscal arrangements.

Through the Canada Health Transfer (CHT) and Canada Social Transfer (CST) the federal government provides all provinces and territories with cash payments to help defray the expense of major social programs like health, post-secondary education, early childhood development and social services. In so doing, the fiscal imbalance between the two orders of government is narrowed.

Through the Equalization Program, provinces with lower fiscal capacity are provided with transfer payments that are designed to ensure that Canadians everywhere have access to comparable public services at comparable rates of taxation. It also facilitates growth, stability and the reduction of regional economic disparities. This program, the principle of which is enshrined in the Constitution, is the backbone of federal-provincial fiscal arrangements.

The third tool utilized by the federal government is shared-cost or tied-funding arrangements. Over the past several decades, it would appear that they have become a preferred mechanism for influencing provincial/territorial government spending decisions and priorities. Provincial/ territorial experience with these programs has been mixed. While some arrangements reflect effective negotiation and shared priorities, others have resulted in duplication of effort, conflicting programs and inefficient utilization of resources.

■ Health Care Reform and Sustainability

Health care is repeatedly cited by Canadians as the first priority they want to see governments address. They have also made it clear that they expect both the federal and provincial governments to be involved.

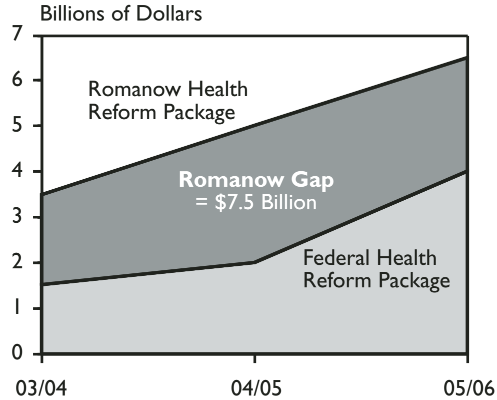
Under the 2003 First Ministers' Health Financing Arrangement, provinces and territories will receive funding targeted for reform of the health care system, and one-time supplements to the CHST to deal with existing problems. However, no additional funds were provided to the CHST base to help provinces and territories fund core health and other social services, beyond what had previously been announced in the October 2002 Economic Statement (see Appendix A).

There is consensus among provinces and territories that the amount of money provided by the federal government for health reform is insufficient to fully implement plans to restructure the health care system. The $7.5 billion committed by the federal government for health reform initiatives over the first three years of the Arrangement is half of what was recommended in the Romanow Report[2] and by Senator Kirby's Committee[3]. This has opened up what has been termed the "Romanow Gap"—the $7.5 billion shortfall in federal funding for health reform (see Chart 1).

Arguably, the orientation of the reform initiatives outlined in the 2003 Health Funding Arrangement is to improve access to care and expand the range of services that are covered by the public health system. While these reforms may improve the quality and quantity of health services, they will

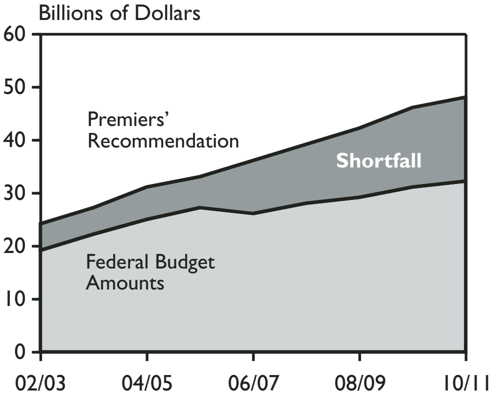
Chart 1

Federal Response to the Romanow Commission



Sources: Finance Canada and Manitoba Finance

Chart 2
Shortfall in Funding for Major Social Programs



Sources: Finance Canada and Manitoba Finance

not reduce the cost of providing health care or moderate its rate of growth. While issues such as waiting lists and shortages among health professionals will require higher levels of funding, reforms which more fundamentally address expectations and utilization are required to place health care costs on a long-term sustainable track.

The 2003 Health Financing Arrangement provided for substantial amounts of one-time only and tied funding in the first few years. While these funds were helpful in dealing with the more immediate problems facing provinces and territories, they are not a durable solution to ongoing cost pressures. In this respect, the federal provision to make the Health Reform Fund part of the CHT cash base in 2008/09 is a useful model for funding reform initiatives. The federal government should consider applying this model to the Diagnostic/ Medical Equipment Fund and CHST Supplement payments. In regard to the former, funding could, in 2006/07, be added into the CHT to help provinces and territories defray ongoing operating and staff training costs.

Federal funding for health and other social programs is projected to continue to fall short of what has been recommended by Premiers. Based on the schedule of payments in the 2003 federal budget, and independent budget projections over the medium to longer term, the federal share of provincial costs is expected to remain in the 16–17% range. To put this in perspective, the current shortfall of roughly $5 billion is expected to triple to about $15 billion by the end of the decade (see Chart 2).

Canada Social Transfer

Given the immediacy of the problems such as those associated with funding health care, BSE, SARS, and forest fires in 2003, funding for post-secondary education and social services has not received adequate public debate. Concerned that this issue was being crowded off of the federal-provincial agenda, Provincial/Territorial Finance Ministers at their June 25–26, 2003 Halifax meeting, stated that

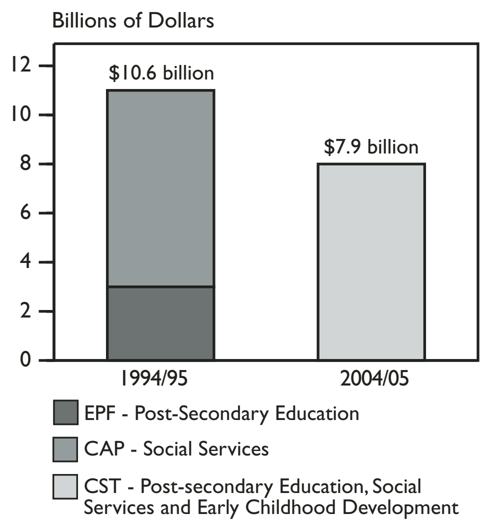
> ... the Federal Government must work with provinces and territories to ensure that adequate and sustainable funding is available under the new Canada Social Transfer for education and social programs, which is due to be implemented in April 2004.

Against the advice of the Romanow Commission, the federal government is reducing funding for post-secondary education and social services under the CST to a level significantly lower than it did prior to the introduction of the CHST. This decision means that a substantial portion – 60% – of the "advertised" increase in federal funding for health care announced in the 2003 Health Financing Arrangement comes at the expense of existing funding for post-secondary education and social services (see Chart 3). This takes place at the same time as expenditure pressures faced by provinces and territories in funding post-secondary education and social services continue to grow. (See Appendix B for a more detailed analysis of the implications of the federal decision to reduce post-secondary education and social service funding as it moved to split the CHST into separate transfers.)

The 2004 federal Budget also introduced a number of measures to increase university enrolment. Because these measures were taken without consultation and co-ordination with the provinces, they do not adequately take into account the increase in costs that will have to be incurred by universities in terms of infrastructure and hiring of staff to service

Chart 3

Federal Transfers for Post-Secondary Education and Social Services, 1994/95 and 2004/05



Note: Social Services were previously funded under the Canada Assistance Plan (CAP) and Post-Secondary Education under Established Programs Financing (EPF). They are currently funded under the Canada Social Transfer (CST).

Source: Finance Canada and Manitoba Finance

SOCIAL UNION FRAMEWORK AGREEMENT

In 1999, First Ministers (except the Premier of Quebec) signed A Framework to Improve the Social Union for Canadians, otherwise known as the Social Union Framework Agreement, or SUFA. The SUFA sets out principles related to, among other things, public accountability and transparency, and the involvement of Canadians in the development of social priorities and review of outcomes.

It also provides a set of "ground rules" that governments are to use when interacting with each other:

- *joint planning and collaboration;*
- *reciprocal notice and offers to consult on changes that could significantly impact on other governments;*
- *funding predictability in federal transfers to provinces; and*
- *consultations with provinces when the federal government initiates new Canada-wide programs, to reduce overlap and duplication in delivery of services.*

Regrettably, the federal government has chosen not to consult with provinces on matters such as the splitting of the creation of the new Canada Health and Canada Social Transfers, nor provide funding predictability in its transfers to provinces. Nonetheless, the principles and rules of conduct embodied in the SUFA are sound, and it remains a potentially important tool for improving Canada's social union and relationships between governments.

this increase in demand. As noted above, the federal government has introduced these measures at the same time as it has drastically reduced its contribution to provincial funding of post-secondary education. To achieve the desired result of higher enrolments, an approach that balances demand for university places with the supply basics like classrooms, labs and instructors is crucial. Such an approach cannot be properly developed without effective consultation with provinces and territories.

The weakness of the institutional arrangements is underscored by the way in which the CST is being implemented. Although sound principles were established in 1999 concerning consultation and negotiation under the Social Union Framework Agreement (SUFA) for proposed federal actions that impact significantly on provinces and territories, there have never been any federal-provincial/territorial discussions concerning the CST. It seems clear that it would have been useful to apply the SUFA principles, since the federal decision will have a tremendous impact on the ability of provinces to fund both post-secondary education and social services.

While the level of support is of concern to provinces and territories, there is also a question of whether the CST funding principle is appropriate. Under the Canada Assistance Plan there was an equal sharing between provinces and the federal government of the risk associated with an economic downturn. The block funding model instituted along with the CHST is not responsive to changes in need. If Canada were to enter a recession, the full burden of the increase in social assistance costs would be borne by provinces and territories.

In a recent study on post-secondary education[4], the TD Bank concluded that knowledge has become the most valuable resource of the information age and an increasingly important determinant of wealth worldwide. It has the potential to not only improve Canada's standard of living, but also to significantly narrow income inequalities.

The study argues that Canada is not getting the results it is looking for in terms of post-secondary participation, and that funding seems to be central to the problem. It notes that post-secondary education participation rates are well below those of leading OECD countries.

Concern was expressed about rising student-teacher ratios and a range of issues related to increased tuition fees, much higher student debt loads and increased hours devoted by students to paid work while attending university. In this regard, a recent Statistics Canada study notes that tuition fees in 2000/01 accounted for almost 20% of total university revenue, up from 13% a decade earlier. The TD Bank study notes that, according to OECD statistics, funding from governments in Canada account for less than two-thirds of post-secondary educational institutions revenue compared to the OECD average of 77%.

The study argues that the federal government must work with the provinces to achieve better results and that "...the March 23, 2004 Budget should not throw buckets of new money at more random acts of good intention." In this context, there is a need to ensure adequate core funding within the CST for post-secondary education, rather than more piecemeal programs.

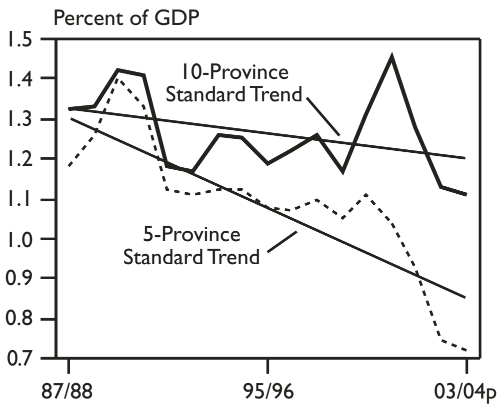
■ Equalization

Canada's Equalization Program was introduced to reduce disparities in provincial fiscal capacity so that Canadians have access to "reasonably comparable services at reasonably comparable levels of taxation" no matter where they live in Canada. All provinces, except Ontario, have received payments under the Program at one time or another. These payments are unconditional and are based on the relative capacity of provinces to raise revenue from a broad range of tax bases, including personal and corporation income taxes.

"There is no denying that jobs are being shifted to emerging economies, such as China and India. The only effective response is for Canada to move further up the value-added economic chain. We must compete by being smarter, not by being cheaper through lower wages."

Time to Wise up on Post-secondary Education in Canada
TD Bank Financial Group
Special Report
March 15, 2004

Chart 4
Equalization Entitlements, 1987/88 to 2003/04



p - Preliminary

10-Province Standard

5-Province Standard

Sources: Finance Canada and Manitoba Finance

The Equalization Program resulted in a more equal playing field across the regions in Canada, providing greater equity in terms of the public services available to citizens, as well as a more balanced distribution of economic growth. A recent study by L.S. Wilson makes the case that the Equalization Program has contributed significantly to Canada's economic growth by reducing economically inefficient "fiscally induced migration."[5] Since its inception, per capita fiscal disparities among provinces have narrowed. However, in recent years, modifications to the Program have caused Equalization payments, as a percentage of GDP, to decline markedly (see Chart 4). Moreover, there are signs that fiscal disparities between the provinces are beginning to widen, leading to dislocation of people and skewing business decisions based on assessments of net fiscal benefits – tax loads and service levels – rather than actual economic factors.

At its February 2004 meeting in Vancouver, the Council of the Federation expressed concern that the federal government has not acted on its recommendations to improve the Equalization formula. It is estimated that the long-term cost of restoring the 10-province standard and comprehensive revenue coverage would be in the range of 1.1% of GDP, less than it cost back in 1987/88 when the 5-province standard was completely implemented (see Chart 4). In this regard, it should be noted that the Conference Board's study already assumes a higher level of support for Equalization (0.9% of GDP) than is currently being funded by the federal government (0.7% of GDP). As a result, the incremental cost of fully implementing the package of reforms called for by the Council would likely be about $3 billion annually – an amount that could be accommodated within projected federal surpluses.

■ Shared or Tied-Cost Funding Programs

Since the late 1990s, the federal government has increasingly utilized tied-cost funding as a preferred method of implementing new programs and initiatives that fall under provincial/territorial jurisdiction. This accounted for much of the increase in transfers outside of Equilization and CHST (see Chart 5). In a few very specific circumstances, these programs have proven to be quite successful and were welcomed by provinces, however, in many circumstances they were not.

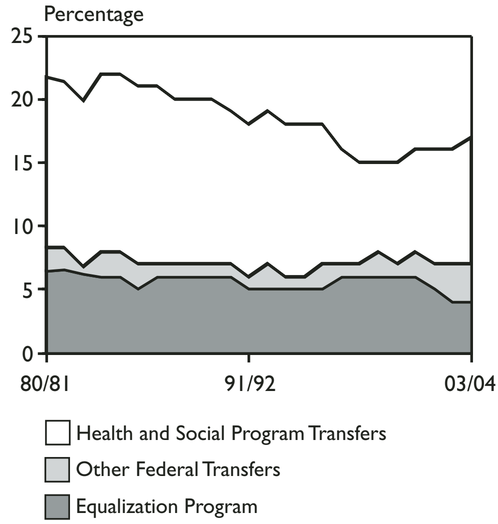
Concern over tied-funding arises primarily because many tied-funding programs have been implemented without provincial consultation or negotiation, even though they affect the provision of services for which provinces have constitutional responsibility. While these programs may be of some merit, participation in them commits provinces to ongoing expenditures. They often include "sustainability" clauses that require the provinces to administer and carry forward these programs long after the federal financial commitment has ended. The arrangements often tend to be relatively inflexible and may not permit the use of more efficient and effective delivery mechanisms.

Since all provinces and territories are hard-pressed to maintain, let alone improve, the major social programs for which they are responsible, there is a sense that funding for these programs distorts spending priorities, and often comes at the expense of funding that could be used for core services, for which there is a clear need. Many of the initiatives could have been accommodated and more efficiently administered through existing provincial programs rather than introducing new "boutique programs."

The public promotion of these new programs, combined with the observed inclination of the

Chart 5

Federal Transfers as a Percentage of Provincial/ Territorial Expenditure, 1983/84 to 2003/04



Source: Finance Canada and Manitoba Finance federal government to approach community organizations and municipal governments prior to engaging in discussions with provinces, strengthens both public demand and expectations, making it more difficult for provinces to resist participation.

Tied-cost programs have the potential to worsen fiscal imbalances among the less affluent provinces, who either cannot afford to take full advantage of the programs or are "induced" to do so at the expense of core program funding, tax cuts or debt reduction.

Tied-cost programs have the potential to worsen fiscal imbalances for the less affluent provinces, who either cannot afford to take full advantage of the programs or are "induced" to do so at the expense of core program funding, tax cuts or debt reduction. With most provinces having difficulty just balancing their budgets in 2004/05, the lack of discretionary revenue threatens to widen the disparity between them and the more affluent provinces.

As noted above, the instances where shared-cost programs have worked are those in which the intent and spirit of the principle underlying SUFA have been honoured. In this regard, it is clear that the federal, provincial and territorial governments have agreed on how to constructively work through funding priorities; the challenge is to actually follow through on them.

■ Affordability

In the long run, our country's capacity to meet the priorities of its citizens is limited by growth in our economy. Fiscal arrangements that overburden the country with taxes, saddle one order of government with unnecessarily large debt loads or constrain efforts to promote productivity and growth, stand in the way of achieving better living standards and a higher quality of life for all Canadians.

While provincial governments recognize that managing the health care system is in many ways the single most important job they do on behalf of their citizens, it is clearly not the only one. Canadians also value economic well-being, job opportunities, safe communities and a healthy environment. With health care costs outstripping the ability of provincial governments to fund it out of current revenues, a dangerous and untenable situation is evolving. As noted above, other economic and social programs contribute to productivity growth and are key to future improvements in our standard of living. However, health care demands are currently crowding out needed funding for these other important programs.

Conference Board Study

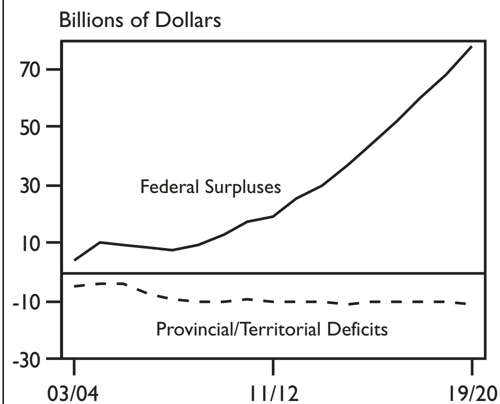
In February 2004, the Conference Board of Canada released a study titled Fiscal Prospects for the Federal and Provincial/Territorial Governments. The study addressed the question of what the budget situations would be for both orders of government in the absence of any changes in policy out to 2020. The results provide a baseline from which governments collectively can weigh both federal and provincial/territorial priorities and make alternative policy decisions.

It is evident from the study that the fiscal prospects for the federal and provincial governments are quite divergent. In the absence of significant policy changes, the federal government's fiscal surplus will rise steadily over the next 17 years, reaching $78 billion by 2019/20. Over the same period, the Conference Board calculates that a structural imbalance between revenues and expenditures facing provinces and territories could result in chronic deficits. According to the study, provinces and territories would collectively post negative budgetary balances throughout the forecasting period. These would rise sharply over the next five years and remain stuck in the $10-11 billion range. By 2019/20, the fiscal imbalance between the two orders of government widens to $89 billion (see Chart 6).

While the prospect of ongoing deficits is disconcerting to provinces and territories, the size of potential federal surpluses indicates that, taken as a whole, there is more than enough revenue

Chart 6

Fiscal Imbalance between Federal and Provincial/ Territorial Governments



Sources: Conference Board of Canada

By 2019/20 the fiscal imbalance between the two orders of government widens to $89 billion.

being collected to sustain programs and balance the budgets of both the federal and provincial governments without increasing taxation. Given the magnitude of its surpluses, the federal government has the capacity to address not only the imbalances between it and the provinces, but also those among provinces. The Board's study underscores the fact that these issues can be readily addressed at the same time as federal goals, like debt reduction, are achieved.

> **"Only the federal government will have the financial capacity to implement new initiatives, such as tax cuts and new discretionary program spending. …In contrast, the provinces and territories will have no leeway to implement new policy initiatives over the next two decades; as a collective group, they will neither be able to increase spending, nor cut taxes, without falling deeper into debt."**
>
> **Conference Board of Canada**
> **Fiscal Prospects for the Federal and Provincial/Territorial Governments**
> **Update February 2004**

One message from the study that must inform the Health Summit and the First Ministers' Meeting on Health Reform and Sustainability, is that health care costs are on a track that provincial treasuries alone cannot sustain. Even with prudent management, these costs are expected to increase by 5.2% per year over the next two decades, and to consistently exceed provincial revenue growth by 1 to 1.5%. Health care costs that grow faster than the economy cannot be sustained indefinitely and would overwhelm the resource capacity of both orders of government. In this regard, the consequences of the federal decision to only provide half of what Romanow said was needed to reform the health care system, if left unaddressed, will be felt for decades to come. Providing adequate funding for health care reform is necessary in order to accelerate the restructuring of the health care system and lower its growth trajectory.

Without a substantial increase in the federal share of funding for health care, the resulting deficits would result in more resources being siphoned off to service debt. This means that even less will be available, after addressing health care pressures, to deal with other important economic and social priorities. If these necessary investments in human and capital infrastructure are not made, Canada may well find itself in a negative loop in which flagging productivity constrains our long-term growth prospects, and in turn our ability to meet the increased health care obligations associated with an ageing population. Crowding out is clearly not just an abstract concern, but one vital to fiscal arrangements and future economic health.

It is also worth noting that the Conference Board thinks that the impact of an ageing population on health care costs may be greater in the years beyond the time frame of the study. This is because the majority of baby boomers will not have reached 65 by 2020, and thus, the peak demand pressure on the health care system will likely come after the period covered by the study.

■ Fiscal Equilibrium in the Canadian Federation

Citizens of Canada understand that taxes are taxes, regardless of whether they are paid to their federal or provincial government, and that if the Conference Board's analysis is correct, they already pay enough to cover the cost of running all orders of government. The inability of the federal and provincial/territorial governments to agree on an efficient revenue allocation is a result of the lack of effective institutions to sort out and meet the priorities of Canadians.

... federal funding should be part of base funding, and not part of what is left over at the end of the fiscal year

The creation of the Council of the Federation could play an important role in strengthening the federation. Building on this initiative, arrangements need to be developed to expand the dialogue to include the federal government. The Premiers' recommendation that annual First Ministers' meetings be held would be a good start. Manitoba is pleased that Prime Minister Martin has committed to meet with Premiers and address the health care sustainability issue.

With the first of the baby boom generation soon approaching retirement age, there is a pressing need to agree on what must be done and a timetable for doing it. In this regard, shared priorities need to be treated as such. For example, in its approach to health care, the federal government should ensure that funding is on a first, not last, dollar basis. This would be consistent with the Premiers' perspective that federal funding should be part of base funding, and not part of what is left over at the end of the fiscal year.

The demographic forces at play in our country and indeed throughout western economies are such that Canada can no longer afford "policy drift." Missed opportunities to achieve efficient allocation of resources to public priorities are becoming increasingly costly for our country in terms of both our standard of living and quality of life. At their February 2004 meeting of the Council of the Federation, Premiers stated in regard to our number one priority that "...it is imperative that Canadians understand that without real reform and renewal and an affordable foundation, health care as we know it will not survive the decade."

The March 23, 2004 federal Budget did not provide provinces with any additional funding to help cover the cost of health care or other major social programs. As well, despite working over the past five years for improvements in the Equalization Program, no substantive progress was offered in the current renewal. Against this background, the federal government announced that it will begin working on a 10-year plan to ensure financial stability for the health care system in time for the Prime Minister's meeting with Premiers this summer.

Rather than working in silos on this common cause, Manitoba invites the federal government to work with provinces and territories to give substance to the principles of effective fiscal arrangements, and to work as partners in developing a comprehensive and viable financing plan for reform and sustainability, not only for health care, but also for other social programs and Equalization.

Appendix A:

Details of the 2003 Health Financing Arrangement

	2003/04	2004/05	2005/06	3-Year Total
		(Billions of Dollars)		
Previously Announced Base Funding				
CHST Increase	0.7	1.3	1.9	**3.9**
New Funding to Provinces/Territories				
One-Time Funding				
CHST Supplement	1.0	1.0	0.5	**2.5**
Additional CHST Supplement[1]	2.0			**2.0**
Diagnostic/Medical Equipment Fund	0.5	0.5	0.5	**1.5**
Total One-Time Funding	3.5	1.5	1.0	**6.0**
Ongoing Funding				
Health Reform Fund	1.0	1.5	3.5	**6.0**
Total New Funding	4.5	3.0	4.5	**12.0**
Funding for the Federal Government's Own Programs				
Total Federal Own Programs[2]	1.0	1.1	1.3	**3.4**
Total Federal Announcements	6.2	5.4	7.7	**19.3**

[1] The Additional CHST Supplement of $2 billion was made available to provinces and territories in 2003/04.

[2] Includes information technology, research hospitals, First Nations health and other federal health initiatives and priorities.

- The 2003 Health Financing Arrangement did not provide provinces and territories with any new money in the CHST base to fund core medical services, beyond that which was previously announced in the federal government's October 2000 Economic Statement and Budget Update.
- The CHST Supplement ($2.5 billion), the additional CHST Supplement ($2 billion) and the Diagnostic/Medical Equipment Fund ($1.5 billion) are one-time funds. Thus $6 billion, or half of the total $12 billion in new funding was one-time and not built into the base.
- The federal government provided $7.5 billion over three years for health reform. Of this total, $6 billion is ongoing related to the Health Reform Fund, and $1.5 billion is one-time funding related to the Diagnostic/Medical Equipment Fund. Federal funding for health reform is only half of the $15 billion recommended in the Romanow Report; there is a $7.5 billion shortfall which is termed the "Romanow Gap."

Appendix B: Splitting the CHST

There is broad support for the federal government's decision to implement the recommendation of the Romanow Commission and split the CHST into separate health (CHT) and social (CST) transfers in order to increase transparency and accountability to the public. While the principle is sound and broadly supported, the manner in which the split has been made creates serious concerns with respect to funding for post-secondary education and social services, in particular.

Base Federal Funding of Major Social Programs, 1994/95 to 2007/08

(Billions of Dollars)

	EPF/CAP		CHST	CHT/CST			
	1994/95	1995/96	Years	2004/05	2005/06	2006/07	2007/08
Health	8.1	8.0	....	12.7	13.0	13.4	13.8
Other Social Programs	10.6	10.5	....	7.9	8.2	8.5	8.8
Total	18.7	18.5	....	20.6	21.2	21.9	22.6

Note: Estimates do not include funds provided by the federal government in respect of health care reform.
Source: Finance Canada

Prior to the creation of the CHST, federal support for health and post-secondary education was provided as a block transfer through Established Programs Financing (EPF) transfers, while support for social services was provided on a 50:50 cost-sharing basis through the Canada Assistance Plan (CAP).

The table above compares federal cash funding levels for health under EPF and the new CHT. It also shows federal cash funding for post-secondary education and social services, as it existed under EPF and CAP, compared with the new CST. Since there was no separate accounting of individual program support under the CHST, no figures are available for the 1996/97 through 2003/04 period.

As the table shows, federal cash transfers for major social programming (CHT plus CST) will be $20.6 billion in 2004/05, or $1.9 billion higher than in 1994/95. This "net" increase is actually comprised of an increase in funding for health of $4.6 billion, and a reduction in funding for post-secondary education and social services of $2.7 billion. This means that about 60% of the apparent increase in federal support for health care comes at the expense of its commitment to social services and post-secondary education.

The $7.9 billion provinces and territories are to receive in 2004/05 through the CST is the same amount they received in 1988/89. Beyond the fact that the real value of this transfer has been eroded by inflation, the transfer puts additional responsibilities on provinces and territories for delivering services in respect of early childhood development.

The decision of the federal government to reallocate funds away from post-secondary education and social services to raise its share of funding for health care is contrary to the explicit recommendations of the Romanow Commission; "In addressing the apparent deficit in health funding, that deficit should not be passed on to post-secondary education and social assistance." [6]

[1] Conference Board of Canada, Fiscal Prospects for the Federal and Provincial/Territorial Governments, February 2004

[2] Building on Values, Final Report of the Commission on the Future of Health Care in Canada. Roy J. Romanow Q.C., Commissioner. November 2002

[3] The Health of Canadians – The Federal Role. Volume Six: Recommendations for Reform. Final Report on the state of the health care system in Canada. Standing Senate Committee on Social Affairs, Science and Technology. The Honourable Michael J. L. Kirby, Chair. October 2002

[4] Time to Wise up on Post-secondary Education in Canada, TD Economics Special Report, March 15, 2004

[5] Wilson, L.S., Equalization, Efficiency and Migration; Watson Revisited, Canadian Public Policy XXIX no. 4. December 2003. pp. 385-396

[6] Building on Values: Final Report of the Commission on the Future of Health Care in Canada, p. 69