Federal Transfers to the Provinces

May 1993

Canada

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Introduction

This background paper focuses on transfers to provincial governments, also known as fiscal or intergovernmental transfers, and their contribution to the functioning of the federation. It is intended to provide factual information about the major federal-provincial transfer programs, which are an important part of Canadian public finances.

In 1993-94, these transfers will total $40.5 billion, representing some $1,400 for every Canadian. But transfers are more than just dollars and cents. They help ensure that provinces have the means to provide the services Canadians expect to receive from their provincial governments. They support our Canada-wide system of medicare, our higher education system, and our network of assistance to the needy.

Transfers give meaning to the fundamental rights and benefits which Canadians associate with Canadian citizenship. They enable all Canadians to receive essential public services like health, education and social services while allowing provinces the flexibility to offer different services in response to local needs and priorities within their jurisdictions. Transfers also enable all Canadians – whether they live in a rich or a poor province – to receive reasonably comparable public services while paying reasonably comparable levels of taxation. They help maintain the Canadian economic union by ensuring that Canadians know they will receive reasonably comparable public services across Canada. This facilitates the mobility of people that contributes to our economic prosperity, our standard of living, and our sense of nationhood.

From the very outset, federal transfers to provinces have been integral to Canada's development: the use of transfers dates from Confederation itself. They helped Canada through the Great Depression of the 1930s, when provincial governments came under severe fiscal pressure. After the Second World War, they were instrumental in building a social security system of which Canadians are justly proud.

Throughout our history, transfers evolved and adapted to changing economic circumstances and social needs. Today's transfer programs are a legacy of the 1960s and 1970s. They will continue to evolve in step with the broader renewal of the federation.

Why Intergovernmental Transfers Are Necessary

In considering the major federal transfers in Canada, it is important to ask why intergovernmental transfers are necessary. The rationale for transfers lies not only in Canadian tradition or history, but also in the nature of federalism. So the first step in thinking about intergovernmental transfers in Canada is to ask of federations in general:

- does a federal system of government need intergovernmental transfers?
- why would the federal government use its taxation powers to transfer the proceeds to provincial governments?
- in short, what purposes do transfers serve?

There are several reasons why intergovernmental transfers are necessary – that is, why it is important for one order of government to tax more than it spends, and make transfers to another:

- to reduce interprovincial fiscal disparities;
- to balance the fiscal resources of federal and provincial governments in a flexible way;
- to ensure that the federal government has the revenues necessary for national economic management and effective tax harmonization;
- to offset interprovincial "spillovers";
- to develop and maintain national standards.

The emphasis here is on the fiscal and economic purposes served by transfers in federations generally. It will be recognized, of course, that each transfer program in a federation such as Canada has specific policy objectives behind it – health, for instance, or education or social assistance policy objectives.

■ *Reducing interprovincial fiscal disparities*

Provincial economies differ and provincial tax bases yield very different levels of revenue. Some provincial governments are able to collect more dollars from a given tax base than other provinces, and thus, are able to finance their programs with a lower level of taxation. Conversely, without transfers less advantaged provinces would either have to tax more than others to provide comparable services to their residents, or settle for providing less than comparable services. The issue is one of ensuring reasonable "horizontal balance" across provinces.

Interprovincial disparities produce two types of problems for a federation. If Canadians take into account the value of public services received minus the taxes paid – in economic terms "net fiscal benefits" – as well as their real earnings prospects when deciding where to take up a job, they might well move to those jurisdictions offering greater public benefits, regardless of their market productivity in the new jurisdiction. For the economy, such migration is inefficient.

A well-functioning economic union seeks to reduce perverse migration incentives by providing less wealthy provinces with transfers to allow them to provide reasonably comparable public services at reasonably comparable rates of taxation.

There are equity and fairness considerations as well. If some provincial governments can provide the same services at lower tax rates or more and better services at the same tax rates, some Canadians could be much better served by their provincial governments than would others. Roads, schools, medical facilities and all the other services governments provide would be more available or of better quality in richer than in poorer provinces. This violates the principle of equity that all citizens should be treated in a reasonably comparable way wherever they live – a problem which may be particularly important in respect of the most essential public services.

Equalization transfers are a major means of reducing fiscal disparities among provinces, and thereby reducing both disparities in public services and the incentive to migrate simply because of more attractive public services or taxation rates. Both equity and efficiency problems are mitigated by equalizing transfers. Equalization payments are unconditional, because they are intended to reduce interprovincial disparities, not to influence provincial spending priorities.

In Canada, the federal government makes Equalization payments from its general revenues. Through their national taxes, all Canadians assist those living in provinces with less capacity to finance services. In addition to Equalization payments, other transfers may also implicitly promote equity and fairness through supporting particular pan-Canadian programs and objectives.

■ *Balancing federal and provincial revenues and expenditures*

In a federation, the revenue-generating capacity of each order of government may not coincide with its spending responsibilities. Depending upon the taxation authority constitutionally assigned to each order of government, and how governments share jointly accessible tax bases, one order of government may have greater difficulty than another in raising the revenue needed to meet its responsibilities. In such circumstances, transfers can be a flexible instrument for establishing and adjusting the fiscal balance (sometimes called "vertical balance") between the federal and provincial levels of government.

In Canada, this was the dominant argument for intergovernmental transfers at the birth of Confederation in 1867. For reasons of both efficiency and national economic policy, the federal government was given exclusive authority to levy customs duties and taxes. These were by far the most lucrative sources of revenue at the time, accounting for about 85 per cent of total government revenue. To compensate for its exclusive occupancy of this field, the federal government made transfers to provinces to allow them to carry out their responsibilities. The payments were unconditional, because their purpose was to close the vertical gap, not to influence the spending priorities of the provinces or to support pan-Canadian programs and objectives important to Canadians wherever they reside.

An important shift in vertical balance emerged during the Second World War. In order to manage the wartime economy and the war effort, the federal government took over exclusive occupancy of the personal, corporate, and estate tax fields and provided "tax rental" payments to the provinces to enable them to meet their responsibilities.

During the 1950s and 1960s, the federal government maintained its predominant share of tax revenues, including the personal and corporate tax fields, while the provincial governments were facing rapid increases in demand for services in their jurisdiction, such as education, health care, social services, and transportation. During this period the federal government introduced a number of new transfer programs to support these expanding provincial services in light of Canada-wide priorities.

Currently, both the federal and provincial governments occupy the major tax bases. In theory, each level of government could generate any level of necessary revenues by adjusting its taxes. While this is generally the case, not all provinces are equally capable of raising sufficient revenues by themselves.

Transfers add flexibility to the fiscal framework of governments by providing a means of shifting revenues among levels of government as fiscal, economic, and social circumstances warrant. In the absence of transfers, any shift in spending responsibilities between the two orders of government would require co-ordinated changes in federal and provincial tax rates and structures, which would be difficult to implement and confusing for taxpayers.

■ *National economic management*

Following the Great Depression and the Second World War, a new view of the economic role of government emerged as national governments around the world undertook responsibility for managing their economies. As part of its overall economic management role, the federal government acts to stabilize the economy. To this end, the federal government has incorporated "automatic stabilizers" into the tax and personal transfer system. Personal and corporate income taxes are structured so that taxes rise more rapidly than the economy when it is growing and fall more rapidly than the economy when it is declining. Many federal spending programs (such as unemployment insurance, the Canada Assistance Plan, and income support programs for the depressed farm sector) help to maintain income in regional economies that are experiencing downturns. In addition, the federal government is responsible for monetary policy which is directed at stabilizing the overall level of prices.

Transfers to provinces are potential tools for fiscal stabilization. In an economic downturn provinces can face a cyclical imbalance between their spending responsibilities and revenue means. While provinces undertake fiscal stabilization policies of their own, the magnitude of the swings in economic activity and the open nature of most provincial economies often places effective stabilization beyond the reach of provincial governments. The federal government can, therefore, play an important supporting role for provinces by providing transfers which both equalize and stabilize. This allows provinces to maintain spending on a smoother path than their own revenues would allow.

Federal stabilization of provincial revenues highlights one of the benefits of belonging to a federation: it allows for a pooling of risk. Since regional economies will not necessarily be at the same stage of the economic cycle at the same time, federal revenues from regions experiencing stronger economic performance can be directed to support provincial governments in regions suffering from weaker economic activity.

■ *Offsetting interprovincial spillovers*

Yet another rationale for intergovernmental grants stems from the fact that some actions of provincial governments have effects beyond their boundaries. Alberta benefits from the work of petroleum engineers educated at the University of Saskatchewan. Similarly, doctors and lawyers trained in Nova Scotia universities contribute to every part of Canada.

Whenever actions in one province have an effect, positive or negative, on another jurisdiction, we say there are "spillover effects" – the actions spill over provincial boundaries.

In the face of such spillover effects, one will often find that the national or Canada-wide interest and the interests of the provincial governments may not coincide – and provinces may tend to underspend. The Saskatchewan government, for example, might be tempted to cut back on its education of petroleum engineers, especially if it thinks those engineers will probably leave the province. Provinces may, as a result, spend less on education than would be desirable from a broader Canadian perspective. There is no mischief or ill-will involved; it is a natural result of decisions taken from the legitimate perspectives of each individual jurisdiction.

Intergovernmental transfers help remedy the spillover problem. They do so by inducing the jurisdiction providing the service to take a broader view and provide an amount of good or service more appropriate to the national interest.

While spillover considerations provide an argument for transfers between governments, they give little guidance about the size of the transfers required. Whatever the amount, such transfers should be conditional since these transfers exist because there is an explicit interest in how the funds are spent.

■ *Developing and maintaining national standards*

The final rationale for intergovernmental transfers is also the most complex, and fundamental to the development of Canadian transfers. In a sense it is an extension of the previous argument, where transfers were premised on the existence of interprovincial spillovers, although it goes well beyond that.

The need for transfers arises when the national or federal government wishes to develop or maintain programs of national importance in an area that formally lies within provincial constitutional responsibility, when it wishes to promote a greater degree of harmony among provincial programs, or when it feels the national interest is best served by a certain commonality of standards higher than or different from those that individual provinces might be expected to provide on their own initiative. The federal government can offer to fund some portion of expenditure in the area, providing each province respects certain national objectives or standards.

Why might the national or federal government wish to influence provincial programs in this manner? One answer is familiar: to promote economic efficiency. If the federation is viewed as an economic union, the mobility of labour is an important condition for success. To illustrate, if Canadians are to move easily from province to province in search of the most productive employment opportunities, Canada-wide systems of education, health, and social programs, involving some national standards, are an important condition facilitating mobility.

Equity is a second answer. There may be a wish to promote more equal treatment of citizens by governments than would be the case under a more decentralized federation. In Canada, one can argue that there are certain entitlements that all Canadians share as rights of Canadian citizenship. As such, Canadians expect to receive access to comparable services in certain vital areas, regardless of where they live. These rights are pan-Canadian ones, fundamental elements of citizenship in effect, and as such should apply equally to all citizens. Identifying such vital services is a matter for discussion, but most lists would include basic services in the fields of health, education and welfare. By contributing financially to these services and by making the observance of national standards a condition of its contribution to such programs, the federal government is carrying out its commitment to an equitable society.

At the same time, national standards should not be used as a tool to undermine a province's ability to tailor public goods and services to meet local needs and preferences in areas of provincial jurisdiction. The challenge is in finding the right balance between the national interest and the interest of the individual provinces.

This rationale for transfers has played an important role in Canadian history. It underlies the current federal transfers which support our Canada-wide system of medicare, our higher education system, and our network of assistance to the needy. It is also the most controversial argument for transfers, involving fundamental assumptions about the meaning of Canadian citizenship and the boundaries between federal and provincial jurisdiction.

Overview of the Major Transfers

In 1993-94 the Government of Canada will provide transfers of $40.5 billion to the ten provincial and two territorial governments (Chart 1).

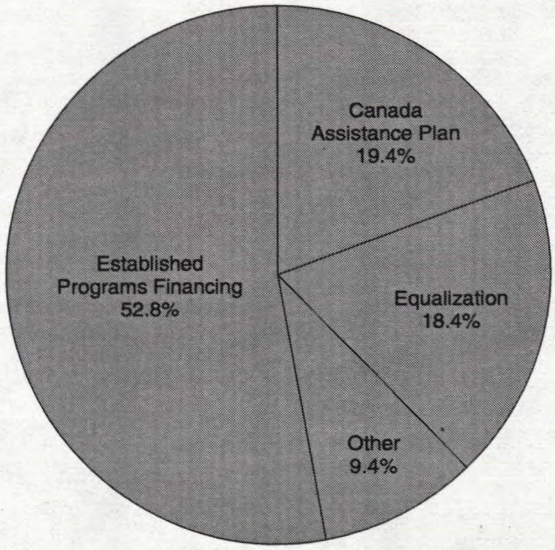
These transfers can be categorized in several ways. Some have a specific constitutional basis, such as the Statutory Subsidies enacted in 1867, or Equalization – the commitment to which was enshrined in the Constitution since 1982.

Other transfers rely largely upon the federal spending power. Among the latter, transfers under the Established Programs Financing (EPF) arrangements support health and higher education, thereby contributing to provincial programs important to the national interest. Transfers under the Canada Assistance Plan (CAP) assist provinces, territories and their local governments to provide social assistance to Canadians in need, in accordance with broad national objectives. Among the host of other transfer programs are those which provide general support to territorial governments, and support joint initiatives with provinces in areas of concurrent jurisdiction such as agriculture.

Federal transfer programs can also be classified according to whether the assistance is conditional or unconditional. Among the former are programs where assistance is conditional upon provincial expenditures in a given sector or upon adherence to a specified program. A related distinction is between specific-purpose programs (such as CAP) and those (such as Equalization) whose purpose is more general in nature.

Chart 1

Total federal transfers[1], 1993-94



[1] Total federal transfers $40.5 billion. Equalization associated with tax transfers under EPF is included under EPF and excluded from Equalization.

Federal financial support to provinces and territories is provided in two ways: through cash and tax transfers. Of the $40.5 billion that will be transferred in 1993-94, around $28 billion will be cash payments. In addition, the federal government will contribute around $13 billion more in tax transfers (See *What is a tax transfer?*).

The three major transfer programs – Established Programs Financing, the Canada Assistance Plan, and Equalization – account for over 90 per cent of all federal transfers to provinces. Transfers under these three programs total close to $37 billion in 1993-94 (Chart 2).

Federal cash and tax transfers to provinces are a very important part of both federal and provincial budgets. In 1993-94, federal cash transfers alone represent around 24 per cent of federal government program spending. In addition, federal tax transfers to provinces reduce federal revenue almost 11 per cent from what it otherwise would be.

Chart 3 illustrates that major federal transfers are important sources of revenue for provincial governments, particularly for the provinces which receive Equalization.

What is a tax transfer?

A tax transfer involves the transfer of "tax room" from one order of government to another, as an alternative to cash transfers. Since 1960, the federal government has at different times shifted tax room to the provinces as a means of contributing to programs under provincial jurisdiction (for example, health and higher education) but important to the national interest.

A tax transfer takes effect when the federal government reduces its tax rates to allow provinces to raise theirs by an equivalent amount. Since all governments act in a co-ordinated fashion, the changes in rates offset one another and there is no net financial impact on the taxpayer.

The last tax transfer occurred when EPF was introduced in 1977. Beginning with the 1977 tax year, the Government of Canada lowered its personal income taxes by agreed amounts and provinces increased their rates by an equivalent amount.

Since that time, all provinces receive a tax transfer of 13.5 points of personal income tax (PIT) and 1 point of corporate income tax (CIT) under EPF. In addition, Quebec has chosen to receive a further abatement of 8.5 points of PIT under EPF, and 5 points of PIT under CAP. (Quebec also receives a three point abatement for other programs). Thus Quebec receives a higher percentage of its entitlements under these programs in the form of tax transfers, than in cash, relative to other provinces. Total EPF and CAP entitlements for Quebec, however, are determined in exactly the same way as for other provinces.

Chart 2

Major federal transfers, 1982-83 to 1993-94

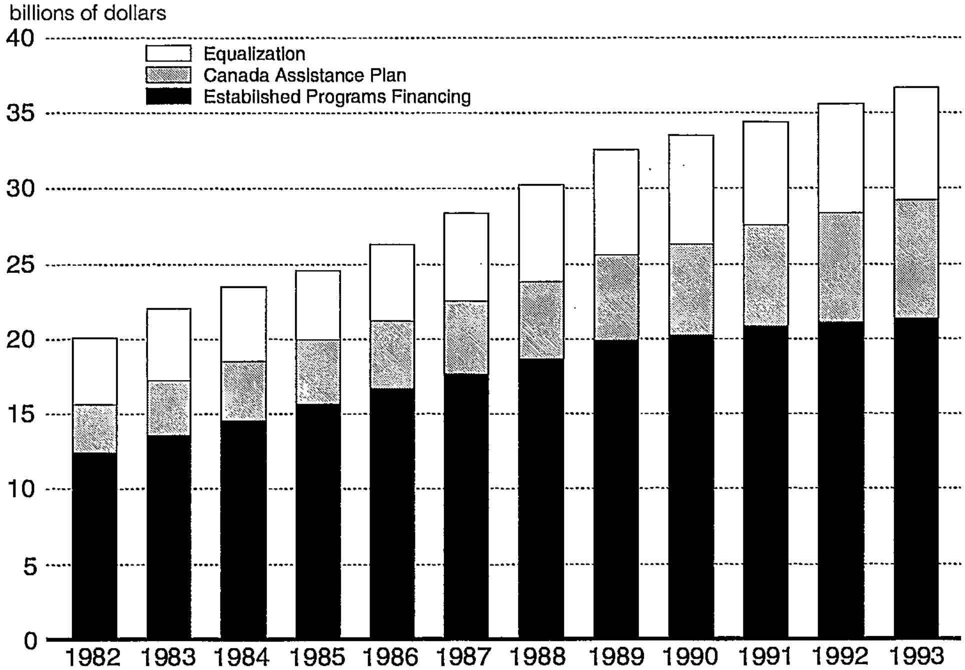
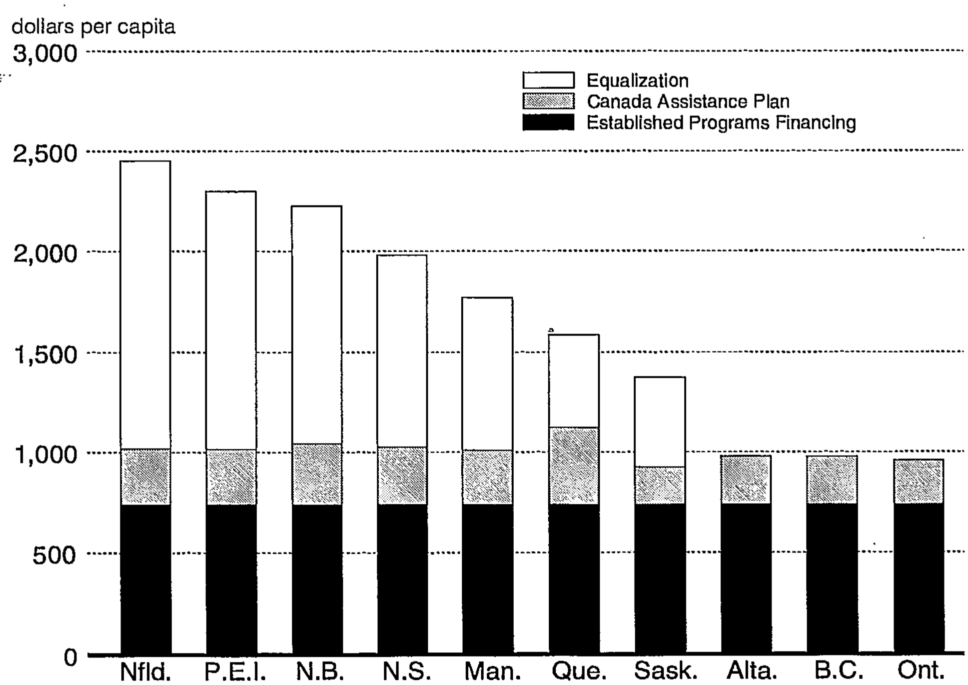


Chart 3

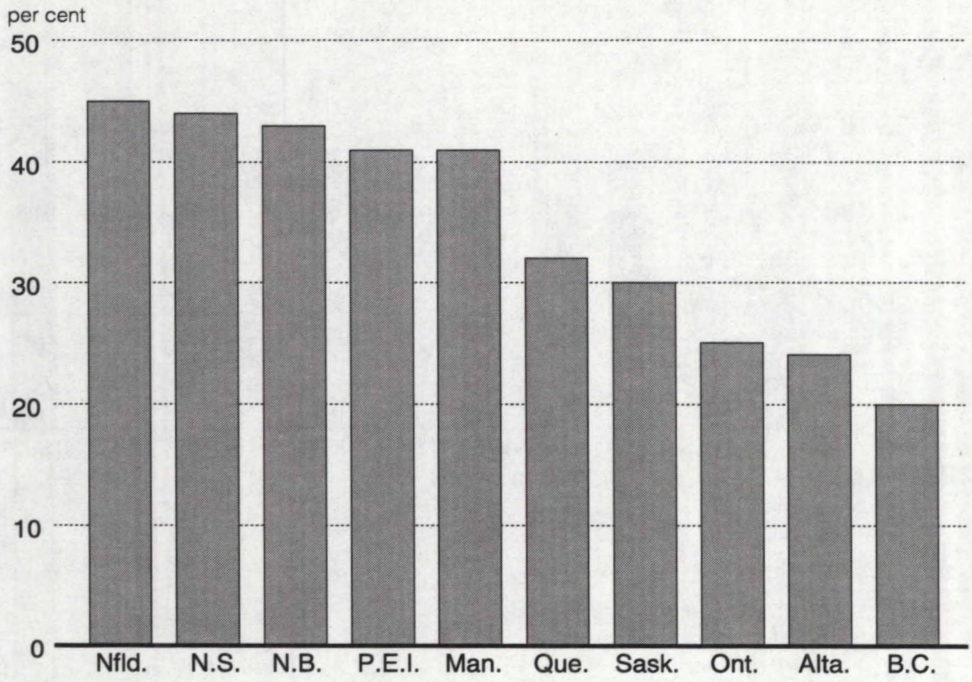
Major federal transfers, 1993-94



These three transfers amount to between 41 and 45 per cent of the total provincial revenues in Manitoba and the four Atlantic provinces and 30 and 32 per cent of revenues in Saskatchewan and Quebec, respectively (Chart 4). In the wealthier provinces of Ontario, Alberta and British Columbia, the major transfers will account for between 20 and 25 per cent of total provincial revenues.

Chart 4

Major federal transfers as a share of provincial revenues, 1993-94



Equalization: The Tradition of Sharing

The Canadian system of Equalization is perhaps Canada's unique contribution to fiscal federalism. It is also unique among the major federal transfers in that its purpose is entrenched in the constitution, Subsection 36(2):

> "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."

The Equalization program provides federal cash transfers to the governments of provinces with below-standard fiscal capacities. All provinces have the same general responsibility to provide public services to their residents, but some provinces are better able to do so than others because they have a stronger economic base from which to raise revenues. Equalization payments offset fiscal disparities among provinces, enabling the receiving provinces (including their local governments) to impose a lower tax burden on their residents, than would otherwise be required, in order to provide levels of services that are reasonably comparable to those in other provinces (See *How Equalization Works*).

Equalization payments are totally unconditional: how they are spent is entirely up to the receiving provinces. The federal government does not prescribe what levels of public services provinces should provide, or what levels of provincial taxation should prevail. These remain matters for each provincial government to decide.

The concept of sharing, which is at the root of Equalization, is as old as the Canadian federation itself. In the early years of Confederation, customs duties and excise taxes were the largest source of all government revenues. Assigning these sources to the federal government in 1867 had a disproportionate impact on the Maritime provinces since Ontario and Quebec still had substantial revenues from land sales to finance their government services. The problem was resolved by the higher Statutory Subsidies provided for Nova Scotia and New Brunswick.

Subsequent changes in federal payments to the provinces contained special assistance as well. However, the Maritime and then the Prairie provinces faced more serious problems in the financial upheavals of the 1930s. As a result, in 1937 the Rowell-Sirois Commission was set up to recommend a financial restructuring of the federation that would deal with the weaknesses the Great Depression had exposed.

The report of the Rowell-Sirois Commission in 1941 recommended, among other things, that the Government of Canada make annual "fiscal need" grants to the provinces. These were to allow all provinces to balance their budgets and to provide a defined standard level of particular services (such as education and welfare).

The Commission's recommendations were not adopted, but the wartime and postwar Tax Rental Agreements implicitly equalized provincial revenues from the personal income, corporate income and estate tax fields rented by the federal government. In 1957, a separate program was introduced to explicitly equalize these three shared taxes, and to do so whether or not a province rented these fields to the federal government.

How Equalization works

The following chart illustrates how Equalization is calculated, as expressed in per capita terms. Equalization payments are calculated on the basis of a formula set out in federal legislation that compares the overall capacity of each province – together with its local governments – to raise revenues from all of the various taxes and fees levied by these governments. This includes personal income taxes, corporate income taxes, general sales taxes, taxes on gasoline, tobacco and alcohol, natural resource levies, property taxes and numerous smaller taxes.

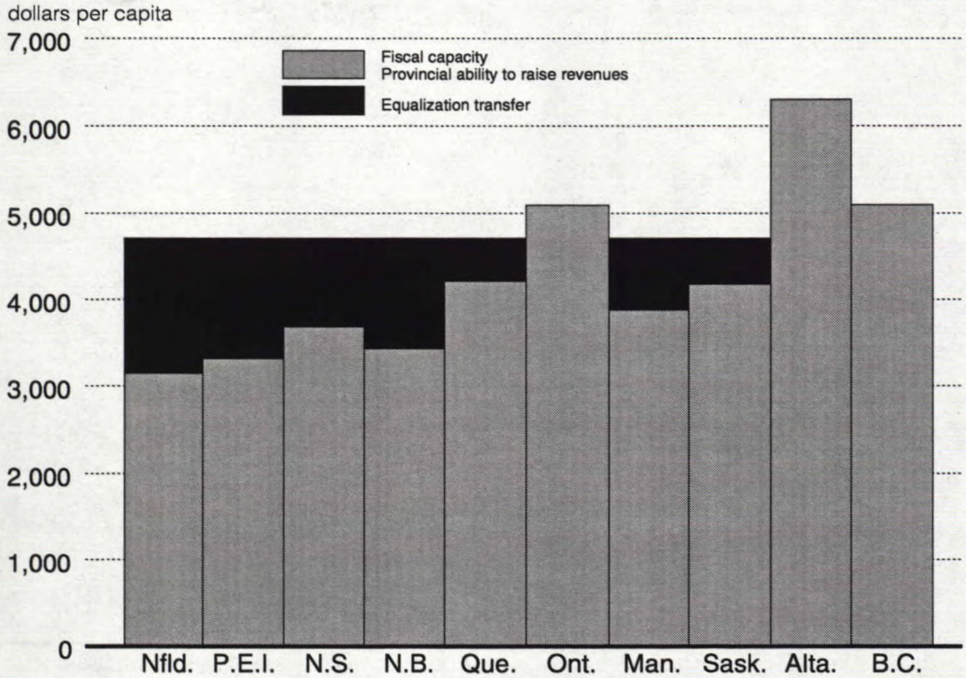
The comparison of revenue raising capacity is made each year by estimating the revenues that would be raised in each province if they were all levying the same taxes with commonly defined tax bases and the same tax rates. This involves developing a standardized tax system known as the Representative Tax System. This Representative Tax System classifies provincial-local government revenues into 33 separate sources, each having a base defined for it that is typical of the bases actually taxed by provinces. The size of these bases is then estimated for each province and, using an average provincial rate of tax for each source, the revenues each province would receive are estimated and totalled for all sources.

The Equalization due to a province is then determined by comparing the total revenues per capita that each province would receive from the Representative Tax System to a prescribed per capita revenue standard. Any province whose per capita total is below the prescribed per capita standard receives Equalization. The amount received is equal to its shortfall from the standard multiplied by its population.

The prescribed Equalization standard is the total per capita revenues that would result from applying the Representative Tax System in five provinces: Ontario, British Columbia, Saskatchewan, Quebec and Manitoba. For 1993-94, the standard is $4,731 per capita. It is, however, subject to a ceiling provision which limits the rate of growth of total Equalization to the rate of growth of the economy (GNP). Equalization also has floor provisions which protect each receiving province against a sharp annual decline in its Equalization.

Chart 5

How Equalization works, 1993-94



This initial Equalization program was expanded in 1962 to include natural resource revenues. In 1967, nearly all provincial revenues from their own sources were brought in when the "Representative Tax System" (the basis of the current system) was introduced. Local government property taxes were introduced in two stages: school purpose taxes in 1973 and municipal taxes in 1982.

The size of Equalization transfers depends on each province's fiscal capacity and population. For 1993-94, per capita payments will vary from $1,587 in Newfoundland to $517 in Quebec (Chart 6). Ontario, Alberta and British Columbia do not receive Equalization payments because their fiscal capacity (ability to raise revenues) places them above the Equalization standard.

Because of its higher fiscal capacity, Quebec receives a relatively small payment per capita compared to the Atlantic provinces. However, because it has six times the population of any other recipient province, its entitlement is close to half of total equalization paid (Chart 7).

Chart 8 reveals that total Equalization payments have grown rapidly, from $4.9 billion in 1982-83 to $8.3 billion this year, an annual average growth rate of 5 per cent.

Chart 6

Equalization transfers, 1993-94

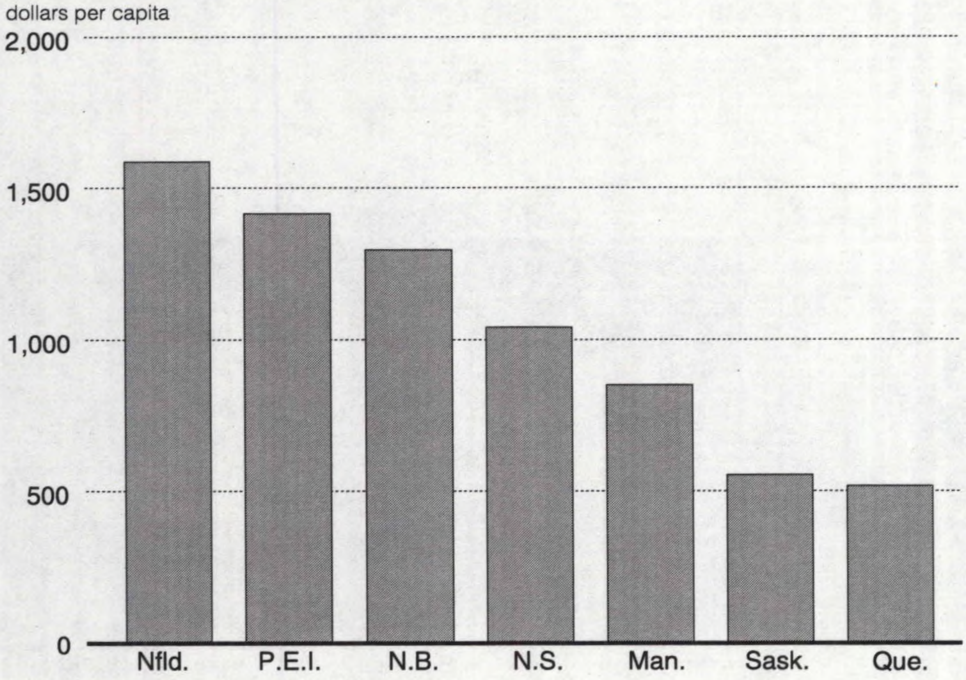
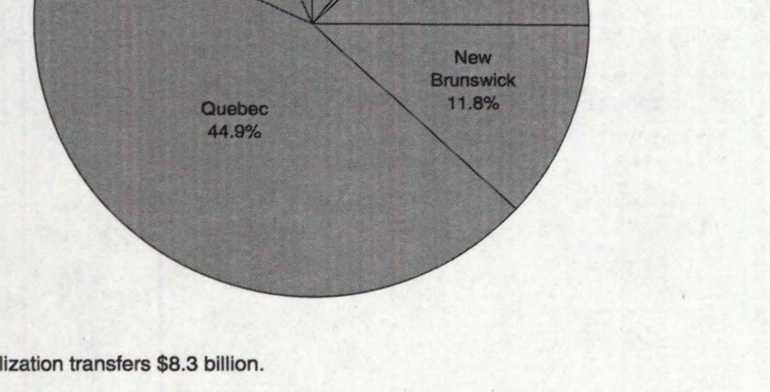


Chart 7

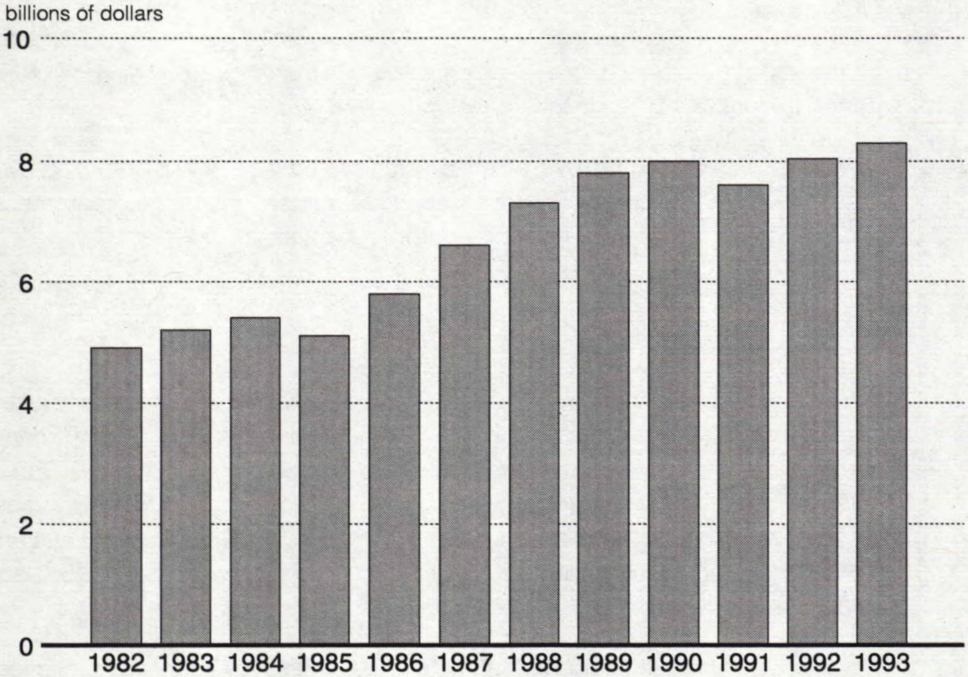
Provincial shares of Equalization[1], 1993-94



[1] Total Equalization transfers $8.3 billion.

Chart 8

Growth of Equalization transfers, 1982-83 to 1993-94



Established Programs Financing: Support for Medicare and Higher Education

Established Programs Financing (EPF) is the largest single federal transfer to the provinces. It will total over $21 billion in 1993-94, and provides financial support to all provinces for health insurance and higher education.

EPF was introduced in 1977 as a block fund to replace the cost-sharing system for hospital insurance, medical care and post-secondary education programs. A brief review of the history may help explain the current arrangements.

■ *Post-secondary education (PSE)*

The federal government's substantial financial involvement in post-secondary education began after the Second World War when large numbers of veterans were provided with university education as a demobilization benefit. By the early 1950s, there was an urgent need to expand Canada's system of universities and colleges. Both the Canadian economy's demand for university graduates and the numbers of potential students were growing rapidly. However, as noted, federal financial support was largely limited to veterans and was declining.

In 1951, following the recommendations of the Massey Commission, the federal government began to make direct grants to universities, although education was formally a matter of provincial jurisdiction. Quebec, in particular, objected to this new direct federal role in financing provincial education institutions. As a result, in 1961, a 1 per cent corporate taxable income transfer from the Government of Canada gave Quebec the fiscal resources to pay equivalent grants to institutions in that province.

In 1967, PSE cost-sharing was revised. Under the new program, the federal government made transfers to all provinces equal to 50 per cent of institutional operating costs for post-secondary education (or a specified per capita amount, if that was greater in a province). This cost-sharing transfer took the form of a tax transfer and cash payments in all provinces. Under this system, provinces retained complete flexibility in structuring their post-secondary education institutions (See *Canada's education system*).

In 1977, these PSE cost-sharing transfers were consolidated under EPF with similar "established programs" in health.

Canada's education system

From kindergarten to university, education now costs Canadians over $50 billion annually. Of this total, more than 90 per cent is contributed by governments, making it the third largest outlay of public funds after health and social welfare. As a result, Canada ranks among the top OECD countries in terms of total spending in this sector.

Close to 30 per cent of the total education bill in Canada is spent at the post-secondary level. This involves expenditures of just over $15 billion, representing around 2 per cent of Canada's gross domestic product.

Responsibility for the provision of post-secondary education rests with the governments of the provinces and territories. Over the years, each jurisdiction has developed its own PSE system. Today, a network of more than 200 community colleges and 69 universities located across Canada provides advanced learning for 1.2 million full-time and part-time students. In addition, these institutions employ approximately 64,000 full-time teachers.

With such an investment and the high participation rate of Canadians in post-secondary education (one of the highest in the world), the educational attainments of the Canadian population are growing rapidly. For example, in 1961, no more than one Canadian adult out of 15 (6.5 per cent) had some post-secondary education and 3 per cent held a university degree. By 1991, over 40 per cent of the population aged 15 and over were enrolled in a trade/vocational program or had attended either a college or a university, and over 10 per cent held a bachelor's degree or higher. This trend will continue as more than 100,000 new university graduates are being added each year to the 1986 "stock" of 1.9 million graduates.

Sources: Statistics Canada: Advanced Statistics of Education, cat. 81-220, September 1992; Education Attainment and School Attendance, cat. 93-328, May 1993.

■ *Hospital and medical care insurance*

At the end of the Second World War, the Government of Canada proposed to share the cost of a national health insurance program with the provinces. Provinces objected to the proposals because staff and facilities were not available to deliver an effective service. The offer was replaced by hospital construction grants and assistance for medical schools and training facilities. By the mid-1950s, both British Columbia and Saskatchewan were able to operate and finance their own universal prepaid hospital insurance programs. Still wishing to initiate a national program, the federal government offered to share half the cost of similar programs in all provinces, and cost-sharing began in 1958. In 1964, additional tax point transfers were offered to finance most hospital insurance cost-sharing. Only Quebec accepted this form of financing.

By 1972, jointly financed medical care insurance had been established in all provinces. In 1977, hospital insurance, medical care and extended health care services (a federal offer of assistance for non-acute care including home care and nursing home care) were consolidated as a block fund transfer.

■ *Cost-sharing versus block funding*

Initially, the federal government contributed to the funding of health and education programs by sharing eligible provincial costs. Federal transfers were based on provincial spending in defined program areas and sharing rates were:

- 50 per cent of national average costs for medical care,
- 25 per cent of own costs and 25 per cent of national average costs for hospital insurance, and
- 50 per cent of the operating costs of post-secondary institutions, with a per capita minimum.

In effect, the federal share was roughly 50 per cent of the defined programs nationally, but as a result of these formulae, both shares and the per capita amounts varied, sometimes very significantly, from province to province, and from program to program (See The "shares" issue).

Cost-sharing helped to establish these new programs nationally and ensured comparable quality across provinces. After the programs were "established", however, a number of problems became apparent.

Because it required a determination of eligible provincial expenditures, cost-sharing became cumbersome to administer and tended to inhibit change and innovation. Hospital insurance, for example, excluded costs of mental hospitals and tuberculosis sanatoria because both were already fully publicly funded in all provinces. New drug treatments significantly reduced the need for separate tuberculosis facilities and made the costs attributable to this exclusion almost impossible to calculate.

Since the cost-sharing arrangements were originally open-ended, major federal expenditure decisions were effectively in provincial hands. In reaction, the federal government introduced ad hoc cost controls in 1972. These meant that provincial governments were less able to predict and control their net costs.

At the same time, some provinces felt cost-sharing involved unwarranted federal intrusions in areas of inherently provincial jurisdiction. In Quebec, for example, the federal accounting rules relating to PSE operating costs imposed an added administrative burden on the province because the design of their new community colleges (the CEGEPs) did not easily fit federal regulations.

Because the provinces had different priorities and fiscal capacities, they spent differently. As a result, federal support in per capita terms was both unequal and not clearly related to need. Some provinces, where administrative systems were more efficient or effective or where the programs were perhaps less needed, felt unfairly treated because their province received less per capita than other, often wealthier, provinces.

The "shares" issue

Many Canadians believe that there was a time when the federal and provincial governments "shared" all health and higher education costs on a straight "fifty-fifty" basis. In fact, the Government of Canada "share" was never exactly 50 per cent of provincial expenditure, in any province, under any of these programs. There were two basic reasons for this: the sharing rules differed from program to program, and not all provincial spending in these areas was eligible in determining federal assistance.

Federal cost-sharing of hospital insurance (from 1957), medical care (from 1968) and post-secondary education (from 1967) only applied to defined, eligible areas of expenditures. For example, mental hospitals and sanatoria were never included in hospital insurance sharing, since these services were already provincially provided to all Canadians in 1957. Post-secondary education sharing applied to the operating costs of teaching institutions (not the spending of provincial governments). Indeed, under post-secondary education cost-sharing, three provinces received a minimum per capita payment instead of any cost-share.

In respect of sharing rules, all provinces received 50 per cent of national (not their own) per capita medicare expenditures, and 25 per cent of their own plus 25 per cent of national per capita hospital insurance expenditures.

Because of different definitions of costs, different sharing formulas, per capita overrides and growth ceilings, the federal share of hospital insurance costs at the end of the cost-sharing regime varied across provinces from 47 to 60 per cent, the share of medicare from 41 to 75 per cent, and the share of PSE institutional costs from 43 to 76 per cent.

With the advent of block funded Established Programs Financing transfers to provinces in 1977, federal contributions were no longer related to provincial expenditures in the program areas.

All governments agreed to end cost-sharing in favour of equal per capita block funded transfers. Although the block funded transfers are notionally divided between health and education, using those calculations to assess federal and provincial shares is outmoded. The federal contributions are unrelated to individual program costs and therefore "shareable cost" statistics are no longer kept.

To overcome these problems, the federal government and the provinces agreed to replace cost-sharing with block funding. Block funding integrated federal support for health and post-secondary education. Since 1977, the growth of federal contributions to the provinces for these "established" programs is no longer tied to provincial spending.

Block funding allows provinces flexibility in allocating the federal contribution. Thus, while EPF support is provided in respect of health care and post-secondary education and separate cheques are issued for the cash portions of each, provinces are free to spend this federal transfer according to their own needs and priorities.

Although there are no national conditions applying to provincial post-secondary education programs, five general principles were included in the original *Hospital Insurance and Diagnostic Services* and *Medical Care Acts*, and subsequently reaffirmed in the 1984 *Canada Health Act* legislation with respect to health care:

- ***universality:*** all residents of Canada must be entitled to services;
- ***comprehensiveness:*** all medically necessary services must be covered;
- ***accessibility:*** services must be provided on uniform terms and conditions, and reasonable access to services must not be impeded. The specific provisions dealing with extra-billing and user fees fall under this principle;
- ***portability:*** persons must remain covered while temporarily absent from their province; and
- ***public administration:*** health plans must be administered by a non-profit, public authority.

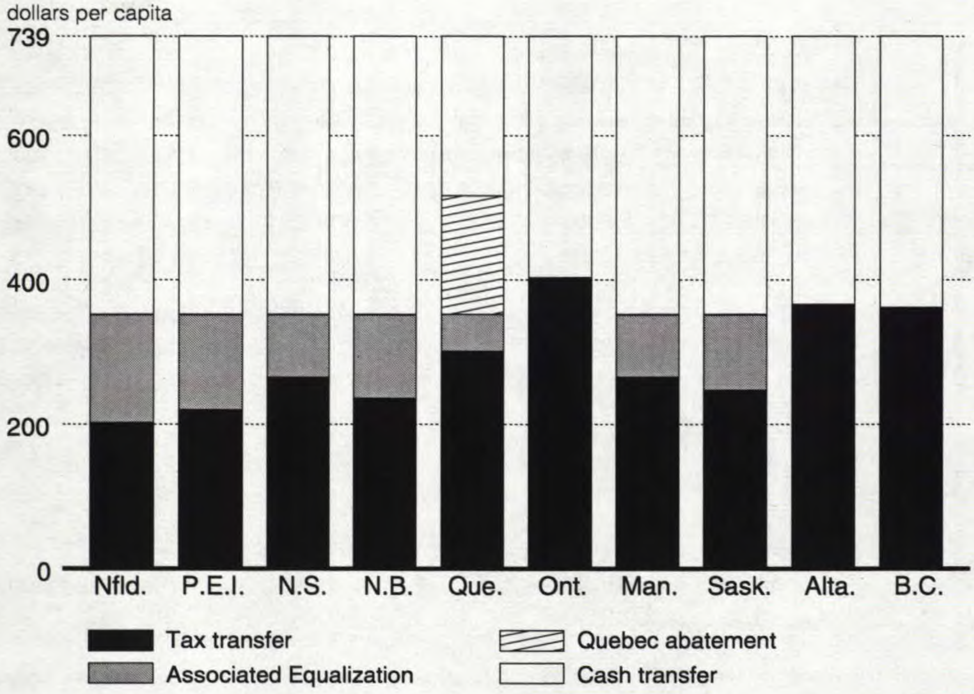
Throughout the late 1970s and early 1980s, some provinces allowed doctors to bill patients for amounts over and above the payments they received from the province. In some cases, the provinces themselves imposed deterrent fees on the use of health facilities. The Government of Canada argued that these practices amounted to barriers to access which violated the EPF principles. Accordingly, the *Canada Health Act* was passed in 1984. This legislation clarified the principles underlying medicare and provided dollar for dollar withholding of transfer payments if provinces permitted extra-billing by physicians or imposed user fees. By 1987, all provinces allowing user charges or extra-billing had eliminated them.

The basic structure of EPF has remained essentially unchanged since 1977 (see *How EPF works*). The element of EPF relating to compensation for the 1977 Revenue Guarantee program was removed in 1982, and in subsequent years the overall rate of growth of EPF has been reduced in line with federal budgetary restraint. The February 1990 federal budget announced that per capita EPF transfers would be frozen for two years as part of a broad package of spending controls. Following the February 1991 federal budget, this freeze was extended until 1994-95. As a result, total EPF will grow only with population, or about 1 per cent annually.

Despite the recent restraint on growth, between 1977-78 and 1993-94, EPF transfers for health and post-secondary education grew from $6.7 billion to $21.4 billion, for an average annual increase of close to 8 per cent.

Chart 9

How EPF works, 1993-94



How EPF works

The Chart above illustrates how Established Programs Financing (EPF) is calculated, as expressed in per capita terms. The calculation starts with each province's total per capita entitlement, which is the same for all provinces. It equals the national average per capita federal contribution to shared-cost programs in 1975 plus $20 per capita for Extended Health Care Services, escalated to the current year by the growth in the Canadian economy, as measured by GNP per capita. Beginning in 1986, the rate of escalation was reduced to two percentage points below the GNP escalator. As part of the Expenditure Control Plan, from 1990-91 to 1994-95, the per capita entitlement is frozen at its 1989-90 level.

Next, the current per capita values to provinces of the tax transfer (13.5 points of personal income tax and one point of corporate income tax) is calculated, along with the Equalization associated with it. This Equalization is paid to provinces under the Equalization program.

Finally, the equalized tax transfer for each province is subtracted from the total entitlement per capita and the remainder (times population) is paid to each province in cash.

Under an arrangement offered in 1964, Quebec chose to receive an additional tax transfer (8.5 points of personal income tax) in respect of hospital insurance. As shown above, the current value of this amount is deducted from Quebec's total entitlement to determine its cash payment.

Canada Assistance Plan: Caring for Canadians in Need

Through the Canada Assistance Plan, the Government of Canada shares the cost to the provinces of providing social assistance and welfare services to needy Canadians. Provincial social assistance programs serve as the "last resort" of Canada's social security system, providing financial assistance to the most needy when earnings or other income support programs (such as unemployment insurance, Old Age Security, and private or public pensions) are exhausted, unavailable or inadequate.

By helping the provinces to support needy Canadians, the Canada Assistance Plan has become an essential underpinning for the social safety net in Canada. The primary objectives of the Canada Assistance Plan are to support the provision by the provinces of:

- adequate rates of social assistance and institutional care for persons in need; and
- welfare services which have as their object the lessening, removal or prevention of the causes and effects of poverty, child neglect or dependence on public assistance.

Prior to the enactment of the Canada Assistance Plan in 1966, federal financial support to the provinces on behalf of needy Canadians was largely categorical in nature. Assistance was limited to clearly identifiable groups such as the aged, blind, disabled, and unemployed employables. Under agreements entered into by the provinces pursuant to the Canada Assistance Plan, provinces agreed to provide assistance to needy Canadians on the basis of the fact of need rather than its cause. Additionally, provinces must include the right to appeal within their assistance legislation and must not restrict eligibility for assistance through the imposition of a period of residence in the province as a condition of eligibility (See *What is the Canada Assistance Plan*).

In 1990-91, as part of the federal Expenditure Control Plan, the annual growth of CAP contributions to provinces not eligible to receive equalization (Ontario, Alberta and British Columbia) was limited to 5 per cent per year, but was left open-ended for the other provinces. Following the February 1991 federal budget this limit was extended through 1994-1995. Within this constraint, CAP remains a mechanism for automatic federal response to circumstances which increase provincial social assistance requirements.

Over the past decade, total CAP transfers have grown steadily, from $3.2 billion in 1982-83 to almost $8 billion this year (Chart 10).

The distribution of CAP transfers (Charts 11 and 12) across provinces depends simply on provincial spending levels (subject to the annual growth limit).
A province's spending levels, in turn, reflect the need for social assistance in that province, the design of provincial assistance programs and the fiscal capacity of the province.

What is the Canada Assistance Plan

The Canada Assistance Plan (CAP) Act is a long-standing federal statute (1966) which enables the federal government to cost-share 50 per cent of eligible provincial and municipal government expenditures on social assistance and welfare services.

The purpose of the Plan is to encourage, through cost-sharing, the development of a comprehensive and integrated welfare system in Canada that provides financial assistance to persons in need and encourage the development and expansion of social services. In 1991-92, over two and a half million needy Canadians benefited from CAP supported social assistance programs. Beneficiaries included the disabled, single mothers, children, the aged and the unemployed. A further one million Canadians benefited from a wide range of welfare services including child care, homemakers and rehabilitation.

The conditions of cost-sharing are specified in the CAP Act and Regulations and in standard formal agreements between the federal government and the provinces and territories. While the federal government specifies the terms for obtaining cost-sharing, provinces are solely responsible for the administration of their assistance and social service programs. This includes their design, comprehensiveness, eligibility requirements and method of delivery. Provinces must initially incur the full cost of the program before receiving cost-sharing under CAP.

Chart 10

Growth of CAP transfers, 1982-83 to 1993-94

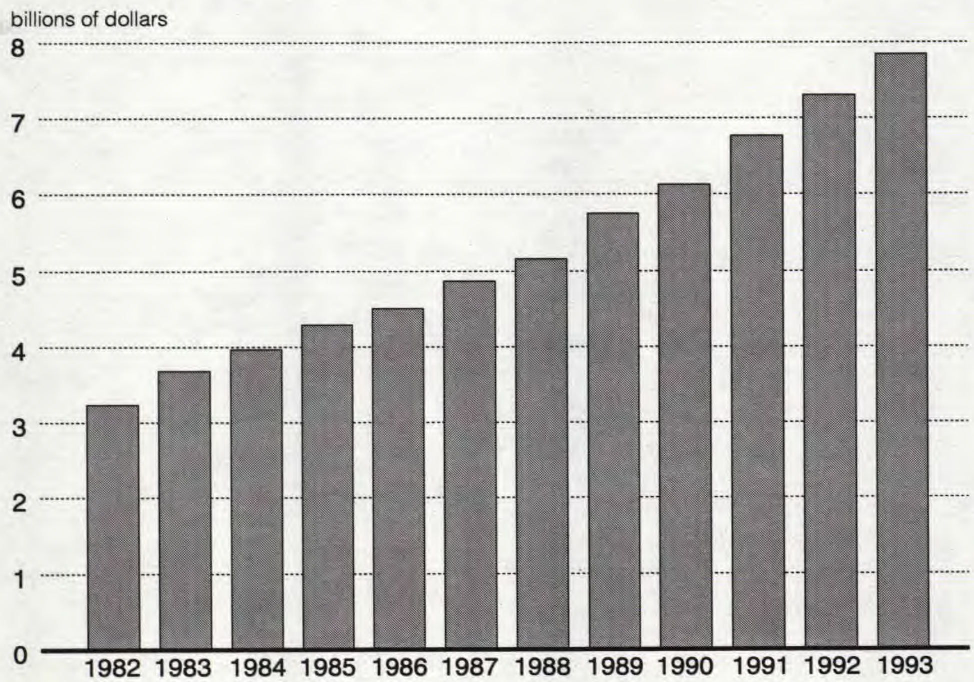


Chart 11

CAP transfers, 1993-94

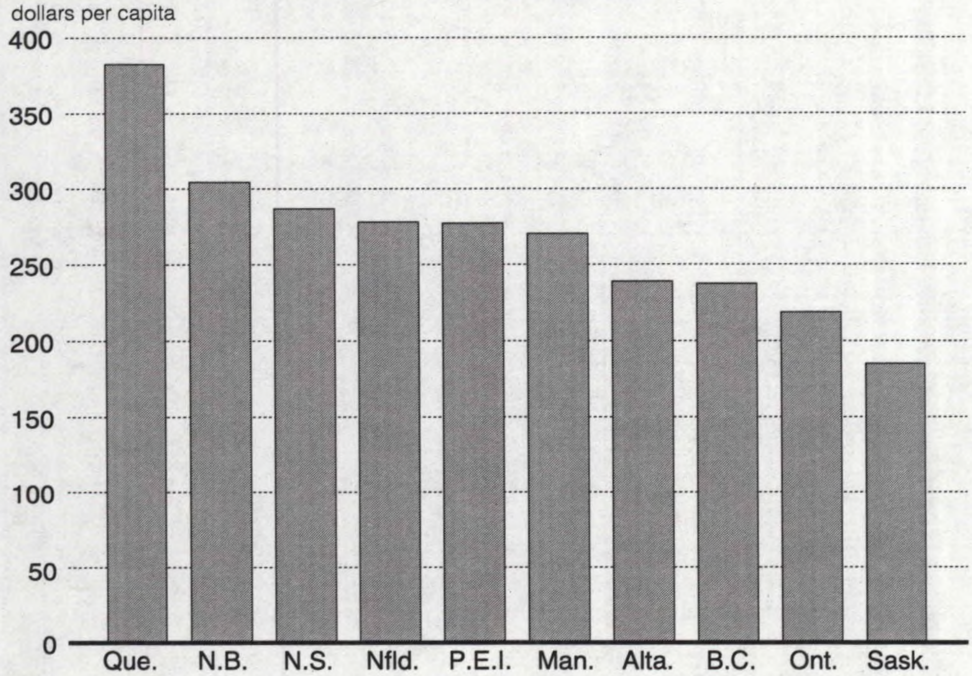
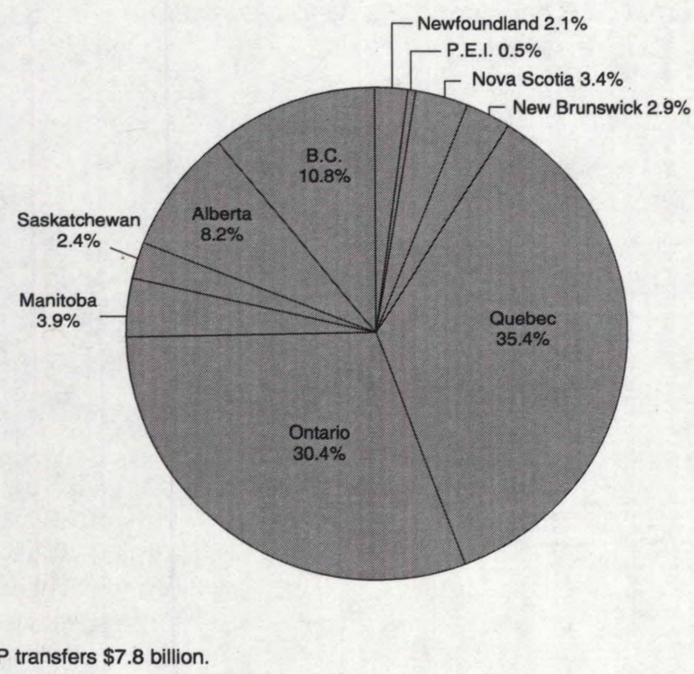


Chart 12

Provincial shares of CAP[1], 1993-94



[1] Total CAP transfers $7.8 billion.

Other Federal-Provincial Transfers

Over and above these major transfer programs are around $3.8 billion in other federal transfers. Table 1 provides a breakdown of other federal transfers.

Table 1
Other transfers
1993-94

	(millions of dollars)
Territorial financing	1,142.0
Grants in lieu of property taxes	423.0
Reciprocal taxation	0.3
Public utilities income tax transfer	211.0
Statutory subsidies	37.0
Gross revenue insurance plan	603.0
Official languages in education	238.0
Miscellaneous health and welfare	253.0
Young offenders	158.0
Justice	91.0
Transportation	275.0
Other	340.0
Total	3,771.3

The governments of the Northwest Territories and Yukon are not eligible for Equalization. Instead, they receive "formula financing" assistance exceeding $1 billion in 1993-94 to enable them to provide a range of public services in the North that is comparable to those offered by provincial governments elsewhere (See *How the territorial governments are financed*).

Over $420 million is paid as grants in lieu of property taxes to local governments in respect of their services to federal facilities. The rest is paid in a number of smaller programs like crop insurance, official languages in education and in areas like justice, transport and immigration.

In addition, the federal government "insures" provinces against a rapid decline in their revenues due to an economic downturn. Under this fiscal stabilization program, the federal government has paid $174 million to British Columbia and $419 million to Alberta due to recessions in these provinces in the 1980s (See *How stabilization works*). More recently, the federal government has made interim payments totalling some $334 million to Ontario, Prince Edward Island and Saskatchewan for claims following the recent recession. Any claims from other provinces will be assessed in accordance with the legislation.

How the territorial governments are financed

Grants under the Formula Financing agreements are the major fiscal transfer from the Government of Canada to each of the territorial governments. The territories also receive EPF and CAP transfers along with the provinces.

For many years, the territorial governments negotiated annual operating and capital grants with the federal government. However, in the late 1970s, the federal government recognized the territorial governments' aspirations for greater autonomy, responsibility and accountability to their residents. The Equalization formula was not appropriate to the Territories, because the provincial standard was not adequate to finance services in the territories due to the higher costs, the geographically dispersed small population and other unique problems of the far north.

Under Formula Financing, first introduced in 1985-86, the fiscal grant to each territorial government is calculated as the difference between a measure of each of the territorial governments' expenditure requirements and eligible territorial revenues. Expenditure requirements start with a base amount (derived from the 1982-83 requirements) which is escalated annually. Eligible revenues include a measure of the territorial government's own source revenue capacity and certain federal transfers.

The program was renewed for five years in 1990-91. For 1993-94 the transfers are estimated at $838 million for the Northwest Territories and $279 million for the Yukon.

How stabilization works

Any province which experiences an annual decline in its revenues due to an economic downturn is eligible to claim for fiscal stabilization assistance from the federal government.

To determine the size of a province's stabilization assistance, the Department of Finance analyzes the province's revenues for the year of the decline and the preceding year. Revenues are adjusted to eliminate the effect of discretionary changes in provincial taxation. This is done to ensure that stabilization is paid to compensate for an economic downturn, and not because of discretionary policy decisions to lower provincial taxes. Because resource revenues are more volatile than other revenue sources, stabilization in respect of resource revenues is paid only if the annual decline exceeds 50 per cent.

Several provinces have received stabilization transfers: British Columbia for 1981-82, Alberta for 1986-87, and Ontario, Prince Edward Island and Saskatchewan for 1991-92. The legislation now requires that future stabilization claims will be paid as grants up to $60 per capita; any additional entitlement would take the form of an interest-free loan.

The Future of Transfers

Today's major transfer programs are a legacy of the 1960s and 1970s, when Canada's fiscal and economic circumstances were quite different. The major transfers will need to meet the new challenges, needs and priorities of the 1990s, within necessary fiscal parameters, as the 1991 federal budget pointed out.

The 1991 budget also set out a commitment by the Government of Canada to ensure that, in the future, the system of transfers:

- provides for the sharing of the opportunities and benefits of Confederation;
- supports a more efficient and competitive Canada; and
- maintains the principles and standards that are the basis of Canadian citizenship while respecting provincial flexibility.