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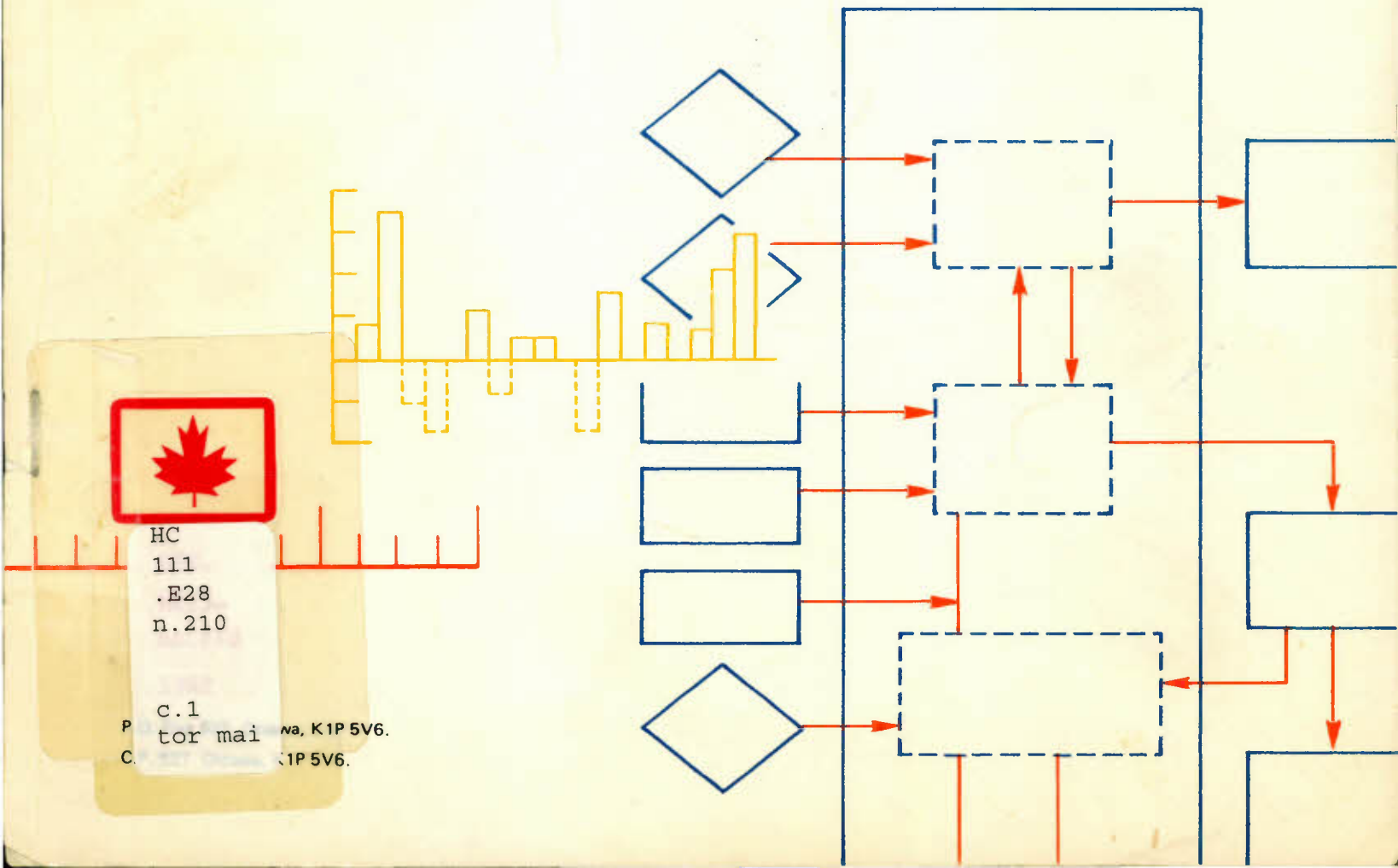

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DISCUSSION PAPER NO. 210

Block Funding and Provincial Spending on Social Programs

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*The author would like to thank Dr. D. Sewell and Mr. R. Lyle of the Economic Council of Canada for their comments on an earlier draft of the paper.

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RÉSUMÉ

Le climat actuel de restriction des dépenses, au niveau des provinces, à l'égard des soins de santé et de l'éducation postsecondaire n'est pas imputable à la ratification, en 1977, des accords sur le financement des programmes établis. Malgré les craintes d'une insuffisance de fonds pour le financement de l'assurance-santé et de l'éducation postsecondaire, rien n'indique que les sommes affectées à ce financement aient été sensiblement réduites par l'adoption de ces programmes. Il est même douteux que les anciens arrangements de frais partagés aient donné aux provinces un fort stimulant à accroître leurs dépenses, et par conséquent, que leur remplacement par des subventions globales ait favorisé la restriction des dépenses.

ABSTRACT

The current climate of provincial spending restraint on health and postsecondary education cannot be attributed to the introduction of the EPF arrangements in 1977. Notwithstanding fears that health insurance and postsecondary education may be underfunded, there is no indication that funding has been substantially reduced since the introduction of EPF. Moreover, it is questionable whether the old cost-sharing arrangements provided the provinces with a strong spending incentive and whether, therefore, their replacement by block-funding has encouraged spending restraint.

Block-Funding and Provincial Spending on Social Programs

Current provincial spending restraint in the areas of hospital and medical insurance and postsecondary education has raised fears that the cutbacks may have undermined the quality of services. Additionally, some public interest groups point to the possibility that the increased financial burden on hospitals and postsecondary institutions may force them to impose surcharges for hospital care and increase tuition fees.

This restraint has often been blamed on the change in federal funding from cost-sharing to block-funding that took place in April 1977. Under the old cost-sharing arrangements, the federal government covered about half of the total provincial spending for hospital operating costs and insured medical services, and about half of the operating costs of postsecondary education institutions. Under the Established Programs Financing (EPF) arrangements of 1977, cost-sharing for the above programs was replaced by a "block-fund," the value of which is not related to actual program costs.

Several commentators have expressed concern that block-funding would weaken provincial spending incentives and "divert" federal funding to other areas. A representative view by an economic journalist is that:

> once the federal government said it would pay 50 cents regardless of whether the provinces spent $1 or $2, the provinces would pull back on their own contributions, and the quality and the level of services would suffer.[1]

This view is also shared by many academic researchers. For example, a recent study states that "since the provinces must now bear the full cost of any marginal expenditure on these programs, a sizeable incentive to increase expenditure is removed."[2]

The evidence presented below shows that the current climate of provincial spending restraint cannot be attributed to the introduction of the EPF arrangements. First, it is shown that there is no indication that the "generosity" of provincial funding has substantially diminished since the introduction of EPF.

Second, it is questioned whether the old cost-sharing arrangements provided the provinces with a strong spending incentive and whether, therefore, their replacement by block-funding has encouraged spending restraint. Not only is the conventional wisdom that "50-cent" dollars encourage spending called into question, but it is also shown that in the case of health insurance the provinces were not faced with "50-cent" dollars in the first place.

Section 1 outlines the old and the new federal-provincial fiscal arrangements for hospital and medical insurance and postsecondary education operating expenditures. Section 2 examines whether provincial spending restraint has taken place with respect to the above programs since the introduction of EPF

and analyses the nature of the change in fiscal arrangements and its potential impact on provincial spending decisions. Section 3 considers some of the policy implications of the change to EPF.

1 From Cost-Sharing to Block-Funding

The switch from cost-sharing to block-funding under EPF came about as a result of a growing provincial opposition to the detailed controls exercised by Ottawa under the former system. Despite their increasing criticism of this system, the provinces strongly resisted Ottawa's original proposal on the adoption of block-funding when it was proposed in 1973, because of their overriding concern that the financial resources to be provided by the federal government would fail to keep pace with rapidly rising costs.

At the same time, the federal government was anxious to establish block-funding for the very purpose of achieving better control over escalating program expenditures. Ottawa was prepared to relinquish a significant measure of control over these programs out of conviction that, because these programs were established and mature, the provinces were not likely to make major changes in their structure.

Since the introduction of EPF in 1977, federal transfers are no longer linked to program costs. Instead, the federal government

has transferred "tax room" to the provinces by reducing its personal and corporate income tax, thus enabling the provincial governments to increase their own levies in these fields. In addition, the federal government makes substantial cash payments to the provinces, which are escalated in line with the growth of GNP.

Both the old and the new funding arrangements for provincial hospital and medical insurance plans and postsecondary education are fairly complex. An examination of these arrangements is essential in understanding the potential effects on provincial spending decisions of the switch from cost-sharing to block-funding.

(a) Health Insurance

Prior to 1977, federal contributions were related to actual program costs. Under the federal Hospital Insurance and Diagnostic Services Act, 1957, the federal government paid each province an amount, per insured person, equal to the sum of: (a) 25 per cent of the national per capita cost of approved in-patient hospital services, and (b) 25 per cent of that province's per capita cost of approved in-patient hospital services less any deterrent charges levied. Coverage of out-patient hospital services was optional, and cost was shared in the same proportion as for in-patient services.

Under the federal Medical Care Act, 1966, the federal government paid each province an amount equal to 50 per cent of the per capita cost of insured medical services in all provinces, multiplied by the average number of insured persons in that province.

Federal contributions for hospital and medical insurance were (and still are) subject to the conditions that: (a) there is comprehensive coverage of all medically required services; (b) coverage is universally available under uniform terms and conditions; (c) the plan is administered in such a way that there is no financial impediment or preclusion to any person from receiving necessary care; (d) benefits continue when the insured person is travelling between provinces or is temporarily abroad; (e) adequate standards are maintained; and (f) the plan is administered by a public agency on a non-profit basis.

(b) Postsecondary Education

Under the Federal-Provincial Fiscal Arrangements Act, 1967, the federal government paid each province a grant for postsecondary education equal to 50 per cent of the operating costs of postsecondary education institutions within the province or a $15 per capita grant (escalated annually by the rate of increase of postsecondary education operating costs), whichever was higher.[3]

(c) Established Programs Financing

As of April 1, 1977, federal contributions for health insurance and postsecondary education are not related to actual program costs. Under the terms of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, each province receives a "block-fund" in the form of a federal income tax reduction and cash payments. The detailed components of the new arrangements are as follows:[4]

(i) Federal income tax reduction: each province receives "tax room" consisting of federal reductions equal to 1 per cent of corporate taxable income and 13.5 per cent of federal basic personal income tax. The value of these tax points is automatically equalized under the general equalization formula in the Act. The tax points include those transferred before 1977 for post-secondary education.

(ii) Basic cash contribution: each province receives a cash payment based on 50 per cent of the average per capita federal contribution to the three programs in the base year 1975/76, plus $7.63 per capita. The amount of the grant is increased annually in accordance with the growth of provincial population and a moving average of GNP growth.

(iii) Transitional adjustment payment: as long as the value of the "equalized" federal income tax transfer falls short of the value of the basic cash contribution, the province receives the difference in the form of a cash payment. This assists provinces with below-average tax yields.

The new arrangements include a $20 per capita grant (indexed to the rate of growth of GNP) towards the cost of extended health care services -- such as nursing home intermediate care, adult residential care, home care, and ambulatory care. A substantial proportion of this grant has been offset by a reduction in payments made prior to 1977 under the Canada Assistance Plan.

2 The Effect on Provincial Spending

The suspicion that the replacement of cost-sharing by block-funding under EPF may have weakened provincial spending incentives is based on the belief that under the previous arrangements the provinces were spending "50-cent" dollars, while now every dollar spent costs provincial treasuries one dollar. Thus, the provinces presumably are more cost-conscious now and more likely to reduce spending on health insurance and postsecondary education when faced with economic difficulties.

The above suspicion is based on the conventional wisdom, according to which a matching grant (cost-sharing) for a particular program leads to more provincial spending on that particular program than an equal-valued non-matching grant (block-funding).[5] According to the conventional grants theory, a non-matching grant would lead to a certain increase in provincial spending on the affected program as a result of the increase in provincial revenue (the "income" effect). However, this increase in spending would be in general less than the amount of the grant since a province could divert part of the grant to other expenditures or reduce its own taxes.

A matching grant, on the other hand, would result in a further increase in provincial spending on the particular program. Due to the fact that each additional dollar spent on the program costs the provincial treasury less than a dollar, there would be an incentive for each province to spend more (the "substitution" effect).

This section questions the above hypothesized effect of the introduction of EPF block grants on three grounds: (a) although it is difficult to establish whether provincial funding of health insurance and postsecondary education is adequate or not, there has not been a tangible reduction in the level of provincial funding since the introduction of EPF; (b) in the case of health insurance, and in particular medical insurance, the provinces

were not faced with "50-cent" dollars, as far as provincial spending incentives were concerned, before the introduction of EPF; and (c) even when the provinces were faced with "50-cent" dollars before the introduction of EPF, as was the case with postsecondary education, the strength of the substitution effect can be questioned.

(a) Provincial Spending Trends

At least at the national level, there is no evidence that the provinces have reduced real per capita funding of health insurance and postsecondary education since the introduction of EPF.

Table 1 shows provincial real total health expenditure on a per capita basis over time. Total health expenditure includes hospital and medical operating expenditures, for which the provinces receive federal funds under the EPF program, as well as other related expenditures, such as hospital capital costs, public health, dental care, pharmacists' services, and paramedical services. Expenditures are expressed in constant prices by using a health costs deflator that reflects increases in physicians' fee schedules, hospital wages and salaries, and the cost of goods and services used in the hospital sector.

The general impression that Table 1 conveys is that there has been a leveling off, or even a small decline in provincial

funding of health programs over time. However, there is no evidence of extensive provincial funding restraint following the introduction of EPF.

A similar conclusion appears to be supported by Table 2 with respect to provincial funding of postsecondary education in most provinces. According to Table 2, provincial funding of postsecondary operating expenditures, adjusted by the GNP deflator, on a per full-time equivalent-student basis, has declined only marginally at the national level -- although there is some interprovincial variation in funding trends.

(b) The Relevance of the "50-cent-Dollar" Argument

Contrary to the widespread impression, in the case of hospital and medical insurance the provinces were not spending "50-cent" dollars before 1977. In the case of medical insurance, for example, the amount of the federal per capita grant was the same for all provinces and it was equal to 50 per cent of the national per capita cost. As a result, a province that spent less on a per capita basis than the national average received more than 50 per cent of provincial costs. The latter was the case, for example, in the Atlantic provinces before 1977.

However, from the point of view of spending incentives, what matters is not the overall matching rate of a province, but rather the marginal matching rate -- i.e., the change in federal

funding that results from an upward or downward revision of provincial spending. After all, even under the current block-funding arrangements, there is an implicit matching rate. As long as provincial spending increases at the same rate as GNP, the matching rate remains 50 per cent.

The significance of the marginal matching rate can be illustrated by the following example. Suppose a province has budgeted $500 million for expenditures on insured medical services. Suppose also that the province is considering an increase in the physician benefit schedule estimated to cost $50 million. According to the conventional theory of the effects of the grants, provincial spending decisions would be affected by the portion of the $50 million additional cost covered by federal funding.

Under block-funding, the province would have to finance the additional expenditure out of its own revenue, since the federal funding is not related to actual provincial outlays. However, this situation is not much different than the one before 1977. Under the previous cost-sharing arrangements, the marginal matching rate in the case of most provinces was practically zero. Thus suppose that the national population is 25 million and the population of the province is one million. The $50 million outlay would result in a $2 increase in the national per capita cost and, therefore, in a $1 increase in the federal per capita grant. As a result, the province would receive $1 million

(i.e. $1 times one million) in additional federal funding. Thus, the marginal matching rate for this province is 2 per cent (i.e., $1 million divided by $50 million). In general the marginal matching rate is equal to half of the province's percentage share of the national population (Table 3).

On the basis of the above discussion, it is clear that the replacement of cost-sharing by block-funding could not be expected to have had a significant effect on provincial spending on insured medical services. In the case of hospital operating costs, some effect could have been expected. The reason is that half of the federal grants to a province before 1977 was related to its own level of spending. As a result, the marginal matching rate was 25 percentage points higher than half the corresponding rate for medical insurance. For most provinces, however, the marginal matching rate for hospital insurance was still substantially lower than 50 per cent.

The above argument would lose some of its validity if there were evidence that the provinces followed similar spending policies. Thus, if the provinces acted in unison in deciding on medicare budget increases, then it may have been appropriate to argue that they were faced with "50-cent" dollars. However, the existence of substantially different budgetary experiences makes it unlikely that there was interprovincial co-ordination. Not only were there substantial differences in per capita costs, but there were also substantial differences in the rate of growth of provincial costs (Table 4).

(c) The Strength of the "50-cent-Dollar" Argument

In the case of postsecondary education, the provinces (with the exception of New Brunswick, Prince Edward Island and Newfoundland) were faced with "50-cent" dollars. One, therefore, would have expected that at least in this case the switch to block-funding would have significantly reduced provincial spending incentives. However, even in this case there are reasons to believe that the reduction in spending incentive was somewhat muted.

First, limits on the federal contribution were already imposed before the introduction of block-funding. Thus, in 1972, the federal government introduced a 15 per cent ceiling on the growth of its contribution to postsecondary education. As a result, to the extent that federal grants could have affected provincial spending, some of this effect probably took place before the introduction of block-funding.

Second, a similar type of change in federal funding in the past did not lead to the result anticipated by the conventional theory. Until 1967, the federal government paid per capita university grants. In principle, such per capita grants have the same incentive effects as equal-yield block-funding. In 1967, these per capita grants were replaced by cost-sharing. Under the new arrangement, the level of federal funding quadrupled and each additional dollar spent by a province attracted 50 cents of

federal funding. According to the conventional theory of grants, one would have anticipated a dramatic increase in spending. Interestingly enough, however, the rate of growth of postsecondary education operating spending actually declined (Chart 1).[6]

Third, one may question the validity of the conventional theory, which treats changes in federal grants as "exogenous."[7] Funding arrangements are the result of federal-provincial negotiation and changes are introduced in response to changing circumstances. Chart 1 is interesting in this respect. It shows that the rate of growth of postsecondary education expenditures did not increase following the introduction of cost-sharing and suggests that cost-sharing may have been introduced in response to already rapidly escalating educational expenditure. The implication is that perhaps the most important rationale for cost-sharing in the past was not the encouragement of provincial spending, but rather the provision of a fiscal mechanism for sharing rapidly escalating costs more equitably between the two levels of government.

3 Conclusions

The 1977 switch from cost-sharing to block-funding under EPF has not substantially reduced the incentive of the provinces to spend on health insurance and postsecondary education. In the case of health insurance, the suspicion that block-funding may

have weakened provincial spending incentives is based mainly on the misconception that the previous cost-sharing arrangements had provided the provinces with "50-cent" dollars. In the case of postsecondary education, the switch to block-funding did reduce the provincial spending incentive. However, this effect is probably not as significant as might have been expected. One reason is that in 1972 a 15 per cent ceiling was imposed by the federal government on the annual rate of increase in grants for postsecondary education. As a result, part of the hypothesized effect of federal block grants in curtailing provincial spending may have already been induced by the previously imposed federal ceiling.

The above discussion is not intended as a defence of the status quo. The current difficulties facing provincial health insurance plans and postsecondary education, may well justify a change in the nature and extent of federal involvement -- such as the attachment of stricter health program conditions to federal grants.

It should be emphasized, however, that the 1977 change in the funding method has not been a contributing factor to the above problems. Both block-funding and cost-sharing are viable funding mechanisms. Some forms of cost-sharing -- such as that for medical insurance before 1977 -- provide equal per capita grants and have similar incentive effects to those of block-funding under EPF. A return to some form of cost-sharing, however, is

not very likely given the general satisfaction that has been expressed for the mechanism of block-funding by both the federal and the provincial governments.

Notes

1 Cohen, D. "Provinces Should Examine Other Medicare Programs." The Citizen, Ottawa, July 29, 1980.

2 Boadway, R. Intergovernmental Transfers in Canada. Canadian Tax Foundation, Toronto, 1980 (page 83).

3 The federal grant was paid as follows: each province received 4.356 "equalized" percentage points of the corporate income tax base, plus or minus an adjustment payment to ensure that the value of the "equalized" tax points were equal to the greater of 50 per cent of the operating costs of postsecondary education institutions in each province, or $15 per capita of the provincial population.

4 Initially, a leveling payment was applied to federal cash contributions to smooth the adjustment process of introducing the new funding method. Prior to the new arrangements there were substantial differences in the per capita amount of federal funding. The introduction of equal per capita cash contributions would have created instant winners and losers. To smooth the transition, contributions to the "losing" provinces were "leveled down" over a period of five years, while the contributions to the "winning" provinces were "leveled up" over a period of three years.

5 For a review of the conventional literature on grants and their spending incentive effects see: Gramlich, E.M. "Intergovernmental Grants: A review of the Empirical Literature" in The Political Economy of Fiscal Federalism, edited by W.E. Oates, Lexington Press, Lexington, Massachussetts, 1977; and Scott, A.D. "The Evaluation of Federal Grants" Econometrica, Vol. 19, 1952 (pp 377-394).

6 A similar pattern holds if one examines provincial spending for postsecondary education -- which accounts for over 70 per cent of total postsecondary education spending. The reason why provincial spending is not shown here is that there are no available data for non-university institutions before 1970.

7 In fact, the validity of the conventional theory has been questioned recently. See, for example, Oates, W.E. "Lump-Sum Intergovernmental Grants Have Price Effects" in Fiscal Federalism and Grants-in-Aid, edited by P. Mieszkowski and W.H. Oakland, the Urban Institute, Washington, D.C., 1979. Also, Winer, S.L. "Some Evidence on the Effects of the Separation of Spending and Taxing Decisions." Discussion Paper 80-81, Carleton University, Ottawa, 1980.

Table 1

Indexes of Real Provincial Government Total Health Expenditures[1] per Capita, Canada, by Province, 1975/76 to 1980/81 (1976/77 = 100.0)

	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81
Newfoundland	109.4	100.0	96.9	99.2	101.9	102.3
Prince Edward Island	102.9	100.0	98.4	99.9	98.9	102.6
Nova Scotia	104.8	100.0	99.4	102.1	104.6	104.0
New Brunswick	102.9	100.0	100.2	101.3	100.8	98.1
Quebec	101.0	100.0	99.1	102.2	102.0	99.0
Ontario	102.5	100.0	98.9	99.2	97.9	95.9
Manitoba	103.1	100.0	99.6	96.5	96.4	97.0
Saskatchewan	96.9	100.0	102.5	101.3	106.6	104.7
Alberta	105.2	100.0	96.7	103.9	109.3	110.8
British Columbia	106.7	100.0	102.0	108.6	112.1	114.0
CANADA[2]	102.7	100.0	99.3	101.6	102.2	101.1

1 Deflated by a health cost deflator.

2 Including the Yukon and Northwest Territories.

Source Based on data from Statistics Canada and from Health and Welfare Canada.

Table 2

Indexes of Real Provincial Government Postsecondary Education Operating Expenditures per Student,[1] Canada, by Province, 1974/75 to 1980/81 (1976/77 = 100.0)

	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81
Newfoundland	87.2	98.4	100.0	97.7	103.5	97.7	90.4
Prince Edward Island	103.9	107.1	100.0	89.9	104.9	105.4	101.7
Nova Scotia	101.6	111.8	100.0	107.5	117.2	113.7	110.7
New Brunswick	69.4	88.8	100.0	100.5	100.6	115.2	109.7
Quebec	89.7	95.7	100.0	103.6	107.8	101.5	98.3
Ontario	98.4	97.7	100.0	100.7	102.6	95.2	88.1
Manitoba	91.8	97.0	100.0	110.6	101.3	100.6	93.9
Saskatchewan	88.0	99.8	100.0	102.9	114.8	106.2	105.6
Alberta	89.7	98.5	100.0	111.4	112.9	109.2	108.8
British Columbia	88.1	95.8	100.0	107.5	144.3	120.2	117.6
CANADA[2]	93.2	97.2	100.0	103.7	106.9	102.1	97.5

1 Calculated on a full-time equivalent basis -- i.e., full-time university and college students, plus a full-time equivalent of part-time university students, based on a conversion factor of 3 to 1 (3 part-time to 1 full-time). Expenditures were adjusted by the GNP price deflator.

2 Including the Yukon and the Northwest Territories.

Source Based on data from Statistics Canada.

Table 3

Marginal Matching Rates under Cost-Sharing, Before 1977

Province	Population Share	Medical Insurance	Hospital Insurance	Postsecondary Education
		(Per cent)		
Nfld.	2.4	1.2	25.6	0
P.E.I.	0.5	0.3	25.2	0
N.S.	3.6	1.8	26.0	50
N.B.	2.9	1.5	25.8	0
Que.	27.2	13.6	31.8	50
Ont.	36.0	18.0	34.0	50
Man.	4.5	2.3	26.2	50
Sask.	4.0	2.0	26.0	50
Alta.	7.8	3.9	27.0	50
B.C.	10.7	5.4	27.7	50

Example: Under cost-sharing, if Newfoundland had decided to spend an additional $1 million on medical insurance in a given fiscal year, it would have received an additional $12 thousand in federal funding.

Table 4

Cost of Insured Medical Services Prior to the Introduction of E.P.F.

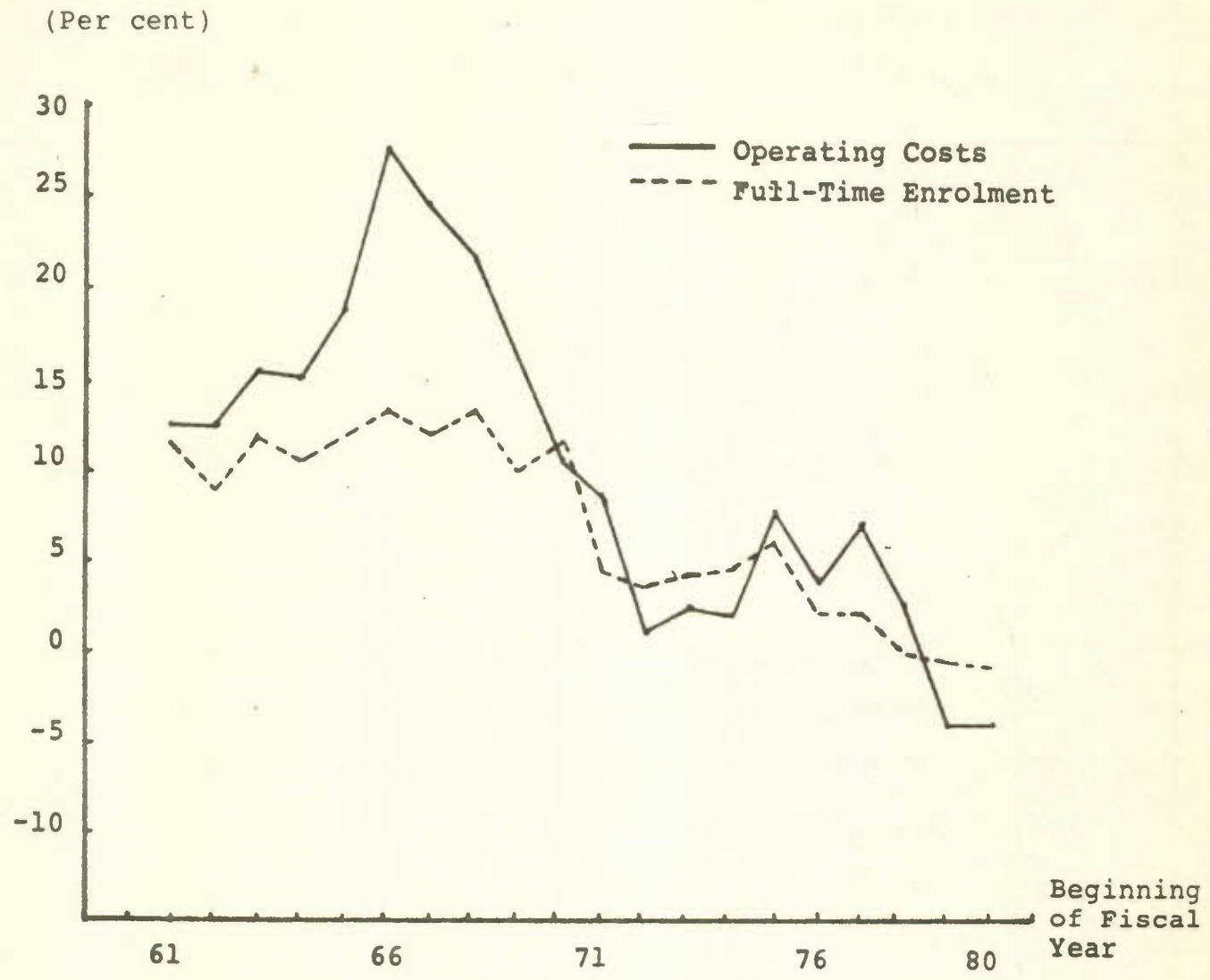
Province	Per Capita Cost in 1976	Annual Rate of Increase of Total Cost 1973/72	1974/73	1975/74	1976/75	1976/73
	(Dollars)			(Per cent)		
Nfld.	54.76	19.6	9.9	19.2	14.2	14.4
P.E.I.	59.73	3.4	20.7	11.5	10.2	14.0
N.S.	75.12	7.4	16.3	23.5	10.4	16.6
N.B.	55.08	10.6	9.0	15.8	10.8	11.9
Que.	85.85	10.0	9.7	14.9	14.2	12.9
Ont.	85.88	3.7	1.6	9.7	15.7	8.9
Man.	69.41	14.3	9.1	9.1	12.2	10.1
Sask.	69.14	4.0	11.5	14.5	12.6	12.9
Alta.	74.44	1.5	13.3	16.6	12.4	14.1
B.C.	103.97	14.0	5.9	28.1	16.0	16.3
Yukon	82.85	10.8	18.4	13.6	17.4	16.4
N.W.T.	64.26	3.0	49.8	9.6	0.0	18.0
CANADA	83.24	7.2	6.6	14.7	14.5	11.8

Note Data are on a fiscal year basis. Years refer to the beginning of fiscal year.

Source Health and Welfare Canada, Medical Insurance, Annual Report, 1976-77.

Chart 1

Rate of Growth of Real[1] Postsecondary Education Operating Costs[2] and of Full-Time Enrolment, 1961/62 to 1980/81



1 Costs are deflated by the GNP price deflator.

2 Operating costs refer here to total operating costs, rather than federally shareable costs.

Source Statistics Canada Financial Statistics of Education, Catalogue 81-208 (Ottawa).