

Back from the grave and ready to party: Federal-provincial transfers in the 1999 budget

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The biggest news in the 1999 budget was the re-emergence of federal-provincial transfers in support of health, education and welfare from a near-death state. Rolled up in the label of the Canada health and social transfer (CHST), these grants were a major casualty of Ottawa's fiscal problems—chopped from a peak of nearly \$18 billion in 1992-93 to less than \$12.5 billion in 1997-98. The 1999 budget proposed to make the CHST more robust again, pumping it up to \$15 billion over the next three fiscal years. Despite some griping about the accompanying proposal to distribute the money more equally on a per-person basis among the provinces, the main reaction from provincial leaders and the public was festive.

The talk of "renewing" and "restoring" surrounding this move highlights the fact that, in this latest round of federal-provincial grants, much that was old is new again. As the initial celebration fades, other relics from the past are sure to return to haunt us: friction over federal intrusions into provincial jurisdiction, bickering over incremental funding, and the overlap and duplication that inspires Canadians to complain about their federal system. However, previous experience also shows how to put those problems back to rest: transfer federal tax room, not money, to the provinces, to match better the revenue capacities and spending responsibilities of each level of government.

ADDRESSING THE "VERTICAL IMBALANCE"

The driving force behind past and present changes to Canada's federal-

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provincial fiscal arrangements is a "vertical imbalance" between the taxing powers and principal programs of the two levels of government. Thanks to fiscal arrangements from the 1930s and 1940s, Ottawa has had readier access to rapidly growing personal and corporate income taxes over the past half-century. Meanwhile, most of the

fastest growing fields of spending have been provincial. This imbalance has generated two waves of new grants and transfers of tax room.

In the early 1950s, Ottawa commenced cash grants to the provinces in support of universities, and later in the decade, cost-sharing grants in support of provincial health care began. Although the money was welcome, the erosion of provincial autonomy that came with it was not. In 1960 and again in 1965, Quebec balked at the grants, and negotiated a reduction—or abatement—of federal taxes in Quebec, allowing the province to fund more of these programs itself. Two years later, following the establishment of 50-50 sharing of provincial welfare costs under the Canada assistance plan (CAP), further abatements of federal corporate and personal taxes provided additional revenue-raising room to all provinces.

A decade later, in 1977, the established programs financing (EPF) agreements marked a new round. Under EPF, Ottawa provided cash grants according to each province's past spending on health and education, while the provinces asked for, and got, another transfer of personal income tax room. Five years after that, the 1982 EPF agreements put federal-provincial transfers for health and education into the framework that persists with today's CHST: an equal per-person "entitlement" composed of a notional tax transfer (the annual value of the room ceded by Ottawa in 1977) and cash, with differences in the cash provided to each province offsetting differences in the calculated yield of the taxes.

FISCAL PROBLEMS AND DISTRIBUTIONAL INEQUITIES

During the next decade and a half, the changed environment of chronic federal fiscal problems sapped the strength of the transfer programs. Ottawa repeatedly scaled back the formula governing growth in total EPF entitlements, which meant that the cash component (the difference between a slowly growing total and a more rapidly growing tax component) stagnated in aggregate and fell in provinces with more robust economies. Then the 1990 "cap on CAP" put a ceiling on welfare-related transfers to the three richest provinces. And when EPF and CAP payments were rolled together into the CHST in 1995, total cash transfers to the provinces dropped by one-quarter over two years, and the disparity among per-person cash payments to each province widened to the point where the transfers to the most favoured province (Quebec) were half again as large as those to the least favoured (Alberta).

Although the dwindling amount of cash in these transfers began to prompt speculation about when they would fade from the scene completely, it was not only their shrinking size, but also their ever-more-skewed distribution, that gave these transfers a deathly hue by the mid-1990s. The provinces that contribute disproportionately to federal coffers—Alberta, Ontario, and British Columbia—were getting steadily less. Since Canada already has a \$9.5 billion-a-year equalization program that addresses the "horizontal imbalance" between the different provinces' revenue-raising capacities by topping up the budgets of the less well off, the CHST's tilt toward these same recipient provinces was undermining political support for transfers in the provinces whose citizens provided the bulk of the money.

Now that a budget surplus has given Ottawa room to increase the size of the CHST and reduce the disparities in cash payments to different provinces, federal-provincial transfers are back from the grave. Provinces are celebrating by pouring new money into health care and cutting taxes.

The pressure for more social spending—especially in health, where there is literally no limit to the demand for services provided free at the point of consumption—will still be strongest at the provincial level. But it makes no more sense now than it ever did for provincial governments to become more and more dependent on transfers from Ottawa to finance their programs.

GHOSTS OF THE PAST

If the past is any guide, however, what now looks new will soon begin to look old again. Ottawa still has a commanding position in raising personal and corporate income taxes, and the pressure for more social spending—especially in health, where there is literally no limit to the demand for services provided free at the point of consumption—will still be strongest at the provincial level. But it makes no more sense now than it ever did for provincial governments to become more and more dependent on transfers from Ottawa to finance their programs. Recycling the resources that go into hospitals, schools, and income support through Ottawa does not make citizens any healthier, smarter or wealthier—in fact, the reverse is more often the case, because the recycling blunts accountability, and injects addi-

tional political tension into a provincial service-delivery job that is already overwhelmingly complicated.

As Ottawa's surplus continues to grow, therefore, Canada's leaders should remember how transfers of tax room have eased the vertical imbalance between federal and provincial fiscal powers and responsibilities in the past. Provincial governments are going to need more resources and management flexibility in social programs over time. While a bigger CHST can deliver the former, only further transfers of taxing power from Ottawa to the provinces can deliver both. Without it, annual bickering over new money and the friction of federal-provincial overlap will soon spoil the party. Federal tax cuts may be the best way to keep our future festivities free from the ghosts of the past. ♦

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ards and raising social assistance incomes to 60 percent of the poverty line immediately. The AFB also redirected the large UI fund surplus to UI benefits, rebuilding a program that now provides benefits to less than one in three of the unemployed. In short, the actual budget called an end to the cuts, but did very little to provide an assured funding base for the social wage.

THE BUDGET AND TAX FAIRNESS

Building on last year's initiatives, the budget adjusted the amount of income that can be earned free of tax, offsetting some of the recent impact of deindexation of the tax system to low inflation, and completed the elimination of the 3 percent federal surtax. In combination, the two budgets delivered a very mod-

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