Federal Restraints on the Growth of Transfer Payments to the Provinces Since 1986-87: An Assessment

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PRÉCIS

Les augmentations constantes et alarmantes des déficits et de la dette du gouvernement fédéral ont amené celui-ci à réduire la croissance de ses trois principaux transferts aux provinces. Les diminutions dans le financement des programmes établis (FPE) dans les domaines des soins de santé et de l'enseignement postsecondaire touchant toutes les provinces ont commencé en 1986-87 et ont été les plus importantes. L'année suivante les restrictions dans la croissance des droits à la péréquation sont entrées en vigueur, augmentant les difficultés financières des sept provinces les moins prospères. Enfin, les diminutions de la part fédérale dans le financement aux termes du Régime d'assistance publique (RAP), introduites en 1990-91, ont eu des répercussions sérieuses pour les trois provinces les mieux nanties, notamment l'Alberta, la Colombie-Britannique et l'Ontario, et surtout cette dernière.

Cet article donne une brève description des trois programmes et une estimation de la perte en revenus des provinces ou des économies réalisées par le gouvernement fédéral pour chaque programme, et examine ensuite les réactions qu'a suscité dans les provinces cette politique fédérale. L'auteur conclut que, bien qu'il serait difficile pour des raisons économiques et politiques d'exempter ces programmes des mesures fédérales visant à réduire le déficit, il sera impossible de maintenir le FPE et le RAP encore longtemps sous leur forme actuelle. De plus, en décidant de se décharger d'une partie de son déficit au moyen de coupures dans les transferts aux provinces, Ottawa a créé un climat de conflit dans ses relations avec les provinces; de plus des tensions risquent de surgir également entre les régions.

Les coupures additionnelles dans les transferts intensifieront les pressions de la part des provinces pour obtenir un transfert supplémentaire de points d'impôt sur le revenu, ce qui pourrait compromettre le rôle de redistribution du gouvernement fédéral. De plus, la décentralisation des revenus pourrait affaiblir la capacité du

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gouvernement fédéral d'utiliser son pouvoir de dépenser dans des domaines relevant de la juridiction des provinces (santé, éducation et bien-être social) lorsque les intérêts nationaux sont en cause. En outre, la perte de sa position dominante dans le domaine de l'impôt sur le revenu pourrait affaiblir la capacité du gouvernement fédéral de gérer la politique de stabilisation et d'harmoniser le régime d'impôt sur le revenu. Cependant, en bout de ligne la réforme des transferts intergouvernementaux entraînera entre les deux niveaux de gouvernement une réaffectation des revenus et des responsabilités dans les dépenses. Les négociations seront difficiles, mais une réforme est indispensable si l'on veut maintenir le système de fédéralisme fiscal canadien.

ABSTRACT

The persistent and alarming increases in federal deficits and the debt in recent years led the federal government to restrict the growth of its three major transfers to the provinces. Cutbacks to established programs financing (EPF) for health care and post-secondary education, affecting all provinces, came first in 1986-87 and have involved the most federal funds. In the following year, restraints on the growth of equalization entitlements became effective, compounding the financial difficulties of the seven less prosperous provinces. Finally, restrictions on the federal share of funding under the Canada assistance plan (CAP), introduced in 1990-91, have had a severe impact on the three wealthiest provinces— Ontario, Alberta, and British Columbia—and particularly on Ontario.

This article offers a brief description of the three programs, estimates the provincial loss of revenues—or the federal saving—with respect to each program, and examines provincial reaction to this federal policy. The author concludes that, although it would be difficult on economic and political grounds to exempt these programs from federal measures to reduce the deficit, it will be impossible for EPF and the CAP to survive for long in their present form. Moreover, Ottawa's decision to unload the federal deficit onto the provinces by cuts in transfers has created a climate of conflict in federal-provincial relations, and interregional tensions are likely to emerge as well.

Continued cuts in transfers will intensify provincial pressure for an additional transfer of income tax room, which may compromise the federal government's redistributive role. Further decentralization of revenues would weaken the ability of the federal government to use its spending power in areas of provincial jurisdiction (health, education, and social welfare) when the national interest is involved. In addition, loss of dominance in the income tax field would undermine the role of the federal government in orchestrating stabilization policy and income tax harmonization. Ultimately, however, the reform of intergovernmental transfers will involve a reallocation of revenues and expenditure responsibilities between the two orders of government. Negotiations will be difficult, but reform is essential if Canada's system of fiscal federalism is to be sustained.

INTRODUCTION

For the past 50 years, following the wartime tax agreements of 1941, federal-provincial fiscal arrangements have been reviewed and renegotiated every five years. The 1987-1992 arrangements were to expire on March 31, 1992; however, the preoccupation of the federal and provincial governments with the constitutional proposals of the Charlottetown accord led to an extension of the renewal date. The equalization program is subject to automatically expiring parliamentary authority and thus had to be renewed by legislation by April 1, 1992. Bill C-60, passed in April 1992, applied only to the equalization payments and extended them for two years, to March 31, 1994, rather than the customary five years. Subsequently, the Charlottetown accord was rejected in the referendum of October 1992, and the changes to the fiscal arrangements that had been anticipated were shelved. Bill C-3,² passed earlier this year, extended the equalization program, with only minor changes, for a further five years to the end of 1998-99. The other major component of the fiscal arrangements, established programs financing (EPF) for health care and post-secondary education, had already been dealt with in the 1991 federal budget, which extended the existing freeze on these per capita payments to the end of 1994-95. Also extended for the same period was the 5 percent ceiling on the growth of transfers under the Canada assistance plan (CAP) to the three provinces that are ineligible for equalization grants—Ontario, Alberta, and British Columbia.

Considering the persistent and alarming increases in the federal deficit and debt, the government's decision to continue to limit the growth of its transfers to the provinces came as no surprise. As then Finance Minister Michael Wilson stated, such expenditures are "simply too large to exempt from our expenditure restraint program." Indeed, the minister noted that because the three programs—equalization, EPF, and CAP—account for more than 90 percent of federal transfers to the provinces, their growth had to reflect current "fiscal realities." The fact that discussions with the provinces concerning the updating and improvement of the equalization system were under way well before the expiry of the 1987-1992 agreement doubtless explains why, in 1992, the program was renewed for only two years.

This article examines the federal government's efforts in recent years to restrain the growth in its transfer payments to the provinces. It presents a brief description of EPF, equalization, and the CAP, with estimates of the revenue losses suffered by the provinces with respect to each program.

¹ Bill C-60, An Act To Amend the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act; SC 1992, c. 10; given royal assent April 9, 1992.

² Bill C-3, An Act To Amend the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act; SC 1994, c. 2.

³ Canada, Department of Finance, 1991 Budget, Budget Speech, February 16, 1991, 18.

⁴ Ibid., at 19.

Two conclusions are reached. First, because of the sheer size of these programs and the fact that other federal expenditures have been cut, it is difficult on economic and political grounds to exempt them from the federal deficit reduction policy. Second, continued "offloading" of a part of the deficit onto the provinces by further reductions in transfers will lead inevitably to fundamental changes in the fiscal arrangements.

ESTABLISHED PROGRAMS FINANCING

In 1977, three large federal conditional grants for financing hospital insurance, medicare, and post-secondary education were consolidated into a block grant called established programs financing. The term "established" implied that close federal supervision and control were no longer considered necessary to ensure the continuation of these programs; public pressure would force provincial governments to maintain existing program standards.

The EPF transfer has two main elements: equalized "tax room" and cash payments. The first part requires a federal reduction of 13.5 personal and 1.0 corporate income tax points to make room for provincial tax increases; and because of wide interprovincial differences in these tax yields, an equalization payment is made under the equalization program. The cash payments, the critical element of EPF that has become the target for federal cutbacks, are residual amounts. Each province's total entitlement is determined by a formula that takes the total per capita federal contribution in 1975-76 as a base, adjusts it upward by a three-year moving average of nominal gross national product (GNP), and multiplies it by the provincial population. The amount of the cash payment is obtained simply by subtracting the equalized value of the tax points from the total amount. As a result of this procedure, provinces whose per capita tax yields exceed the national average will have their cash payments reduced so that total EPF transfers are equal per capita for all provinces. Quebec's cash payment is further reduced by the value of a special abatement of 8.5 personal income tax points, which it receives in lieu of a portion of the basic cash transfer.

Under EPF, in effect, conditional grants have been replaced by block grants that are unrelated to actual program expenditures (other than the now remote connection to the 1975-76 base). Apart from the imposition of federal restraints, discussed below, total annual EPF transfers reflect only the growth of GNP and population. Provinces have gained flexibility in the expenditure of their own funds—an important objective of EPF—as well as the transfers within the broad areas of health and post-secondary education. In addition, there is no requirement that the base ratio (67.9) percent for health and 32.1 percent for post-secondary education in 1975-76) be maintained, even though these amounts are shown separately in the official statistics. Only in health care must provinces maintain national standards by satisfying the federal criteria specified in the Canada Health Act; these include the controversial disallowance of user fees and extra-billing by provincial health care providers.

Table 1 Federal EPF Transfers by Intended Expenditure Program, 1994-95a

Program	Amount
	thousands of current dollars
Health care:	· ·
Cash	7,006,013
Tax	8,218,050
Total	15,224,063
Post-secondary education:	
Cash	2,256,733
Tax	3,889,392
Total	6,146,125
Total EPF:	
Cash	9,262,746
Tax	12,107,442 ^b
Total	21,370,188

^a Includes transfers (approximately \$71 million) to Northwest Territories and Yukon. ^b Includes Quebec's special abatement of 8.5 personal income tax points (\$1,189.9 million).

The federal EPF transfers for 1994-95 shown in table 1, following official practice, are divided into their cash and tax components and also into their designated areas of expenditure (health care and post-secondary education). On this basis, of the estimated \$21.3 billion to be transferred by the federal government to EPF, about \$15.2 billion is intended for health care and \$6.1 billion for post-secondary education. As mentioned though, this division is purely notional; the provinces are under no obligation to adhere to the two proportions of health and education expenditure that happened to exist in 1975-76. In any case, since the amount of federal transfers is exceeded by the provinces' own expenditures in these areas, it is impossible to know whether the block funds are spent in their intended areas or diverted to other programs. A more controversial issue is whether it makes sense to continue to regard a tax concession made in 1976 as a part of the federal contribution today. Even though originally intended as compensation for federal grants withdrawn, these income tax yields belong unequivocally in the provinces' own revenues to be spent as the provinces wish. Unlike federal grants, which can be reduced or eliminated, a transfer of tax points tends to become permanent. Only the cash transfer (\$9.3 billion in 1994-95) has retained a federal identity, and this is the element of current expenditures over which the federal government has control. Consequently, only the cash payments are relevant to the following discussion of federal restraints in the growth of EPF transfers.

Reductions in EPF Cash Transfers

In 1986, as part of the strategy for decreasing the federal deficit, Ottawa restricted the growth of EPF transfers by reducing the GNP escalator by

Source: Canada, Department of Finance, Federal-Provincial Relations Division, "Established Programs Financing, Advance Calculation, 1994-95" (April 11, 1994).

2 percent for 1986-87 and subsequent years.⁵ Special adjustment payments (equal per capita amounts) would be paid to the provinces if the growth of EPF payments fell below the rate of inflation. In the 1989 budget, the federal government announced a further reduction of 1 percent in the growth of the GNP escalator for 1990-91, but this was superseded in the 1990 budget by a freeze on per capita entitlements for two years at the 1989-90 level. In the 1991 budget, the freeze was extended to the end of 1994-95, after which growth in per capita entitlements will be limited to the growth rate of GNP less 3 percent. Under the freeze, of course, EPF payments to the provinces will reflect only annual changes in population growth.

Table 2 illustrates the cumulative effect of these cutbacks on the growth of the GNP escalator and hence per capita EPF entitlements. According to these estimates, despite very slow growth in GNP per capita, total per capita entitlements would have amounted to \$938.02 by 1994-95 (\$203.33 more than the \$734.69 per capita that the provinces will actually receive). This per capita differential represents the reduction of the federal cash transfer, which, of course, may also be determined by subtracting the per capita value of the tax points (\$416.24) from the per capita totals and calculating the difference.

Estimated provincial revenue losses from federal reductions in EPF transfers from 1986-87 to 1994-95 are given in table 3. These annual cutbacks, equal in per capita terms for all provinces, have resulted in enormous revenue losses, which are estimated to reach \$5.9 billion in 1994-95.6 Obviously, cuts of this magnitude have had a serious impact on all provincial government budgets, but such equal per capita reductions impose disproportionately heavy burdens on the provinces with relatively inferior fiscal capacities. Only by increasing efficiency in service delivery, by raising taxes, and by borrowing have the provinces been able to resist drastic cuts in their systems of health care and higher education. Indeed, one result of federal cuts to EPF (and to equalization and the CAP) has been the dramatic rise in provincial government deficits, which have ballooned from \$1.5 billion in 1989 to \$22.8 billion in 1992.7 In consequence, the provinces have accused the federal government of "offloading" part of its deficit onto them, implying that for some reason transfer payments should be exempt from the federal deficit-reducing strategy.

⁵ For a full discussion and appraisal, see George E. Carter, "Established Programs Financing: A Critical Review of the Record" (1988), vol. 36, no. 5 Canadian Tax Journal 1225-43.

⁶ Note that growth restraints were imposed earlier on the post-secondary education transfer as part of the anti-inflationary "6 and 5" program; limits on the GNP escalator restrained its per capita growth to 6 percent in 1982-83 and 5 percent in 1983-84. These restraints cannot be ignored here because their impact on the per capita base continues; subsequent transfers are smaller since the escalator is applied to a smaller base. This element, of course, had to be built into the per capita amounts calculated before federal cutbacks (table 2) in order that provincial revenue losses from reductions in EPF transfers could be estimated (table 3).

⁷ The National Finances 1993 (Toronto: Canadian Tax Foundation, 1993), 3:5, table 3.4.

GNP Escalators and Per Capita EPF Entitlements Before and After Federal Cutbacks, 1986-87 to 1994-95

Table 2

	Before fec	Before federal cutbacks	Actual (after	Actual (after federal cutbacks)
Fiscal year	GNP escalator (%)	EPF transfer (\$ per capita)	GNP escalator (%)	EPF transfer (\$ per capita)
1986-87	7.575195	665.758668	5.575195	642.656625
1987-88	6.448279	708.688644	4.448279	671.243781
1988-89	6.316987	753.456414	4.316987	700.221287
1989-90	6.922028	805.610878	4.922028	734.686378
1990-91	7.181535	863.466105	0.000000	734.686378
1991-92	4.930931	906.043022	0.000000	734.686378
1992-93	2.115526	925.210598	0.000000	734.686378
1993-94	0.538323	930.191219	0.000000	734.686378
1994-95	0.841973	938.023178	0.000000	734.686378

Note: The EPF escalator is a three-year compound average of GNP growth per capita. For each year between 1986-87 and 1989-90, the escalator was reduced by 2 percent; for the years following, the per capita transfer has been frozen at the 1989-90 level. In the absence of constraints, however, the escalator for 1990-91 (for example) would be calculated as the cube root of the following ratio: GNP per capita (1989)

Source: Calculations based on Canada, Department of Finance, Federal-Provincial Relations Division, "Established Programs Financing, Advance GNP per capita (1986) Calculation 1994-95," table 10 (April 11, 1994).

Table 3 Estimated Provincial Revenue Losses from Federal Reductions in EPF Transfers, 1986-87 to 1994-95

Province	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
				thousa	nds of current	dollars			
Nfld.	13,367	21,617	30,706	40,994	74,538	99,370	110,714	113,608	118,464
PEI	2,980	4,838	6,910	9,277	16,870	22,448	24,825	25,709	26,881
NS	20,600	33,554	47,880	64,251	117,499	157,499	175,339	180,392	188,737
NB	16,802	27,331	39,005	52,300	92,606	128,192	142,684	146,726	153,621
Que	155,440	254,681	362,212	492,493	903,171	1,212,485	1,361,143	1,408,358	1,476,734
Ont.	218,559	361,770	524,840	718,522	1,329,483	1,792,202	2,019,004	2,098,099	2,217,937
Man	25,283	41,238	58,830	78,478	142,701	190,600	211,901	218,086	227,595
Sask.	23,851	38,808	54,944	72,577	130,299	172,488	191,343	196,072	203,723
Alta	56,367	91,616	131,049	177,503	328,517	444,979	501,174	520,141	550,514
BC	69,673	114,491	166,094	226,944	423,969	577,832	656,642	690,113	730,813
Total ^a	604,775	992,997	1,429,565	1,939,374	3,573,882	4,813,151	5,412,355	5,615,798	5,914,559

^a Includes Northwest Territories and Yukon.

Source: Calculations based on Canada, Department of Finance, Federal-Provincial Relations Division, "Established Programs Financing, Advance Calculation 1994-95," table 10 (April 11, 1994).

Federal cash contributions under EPF are shown by province in table 4. As one would expect, over the nine years during which restraints have been in effect, their growth has been very modest (6.2 percent) and very uneven from year to year because of the residual nature of these payments. Recall that cash transfers are the result of deducting the value of the equalized tax points from the total transfers; consequently, a fall in tax yields will increase their size, while a rise will decrease it. The increases that occurred in 1991-92 and 1992-93 (during the per capita freeze in payments) are thus explained by the impact of the recent recession on income tax revenues, while the decreases in cash payments of 1993-94 and 1994-95 reflect increases in these tax yields. Indeed, an important outcome of the restraints is that as the equalized tax yields continue to grow, the cash transfer will shrink further and eventually disappear altogether. This will presumably happen first for Quebec because of its additional tax abatement in lieu of cash payments, although sluggish growth of income tax yields in recent years has delayed this event. If the cash grants are allowed to disappear, the federal government will have lost its principal instrument for influencing policy in the areas of health care and higher education.

The gradual decline in the size of the cash transfer is indicated in table 5, which shows the interprovincial variation in the relative value of the cash component to the total EPF transfer for selected years. For all provinces, the ratio of cash payments to total transfer has fallen from 54.7 percent in 1986-87 to 45.9 percent in 1994-95; for Quebec (when the tax points include the value of its special abatement), the corresponding drop has been more dramatic, from 41.6 to 29.4 percent. For the other six provinces whose tax points are equalized, the decline in the ratio of cash to total payments has been, of course, the same (from 59.6 to 51.7 percent). The relatively high income tax yields of Ontario account for its lower cash ratio, which by 1994-95 had dropped to 45.5 percent; the corresponding ratios for Alberta and British Columbia (50.3 and 49.1 percent, respectively) are surprisingly similar to those of the equalization recipients (except Quebec).

Although the erosion of the cash component of EPF has doubtless been more gradual than anticipated, in 1991 Bill C-208 was passed to empower Ottawa to withhold *other* federal payments (not just EPF) in the case of provinces failing to preserve national standards as specified in the Canada Health Act. In particular, the additional federal power is aimed at discouraging the provinces from allowing a re-emergence of user fees and extra-billing—the specific practices that led to the Act in the first place. The federal government's principal concern over its withdrawal of financial support under the EPF program therefore relates to the maintenance of national standards, the next issue to be discussed here.

⁸ Bill C-20, An Act To Amend Certain Statutes To Implement the Budget Tabled in Parliament on February 26, 1991; SC 1991, c. 51; given royal assent December 17, 1991.

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Fiscal year	Nfld.	PEI	NS	NB	Que.a	Ont.	Man.	Sask.	Alta.	BC	Totalb
					million	rs of current	dollars				
1986-87	223.3	49.8	343.0	279.1	1,794.2	1,136.2	420.8	895.9	895.9	1,154.6	8,722.4
1987-88	223.5	50.1	345.5	280.3	1,732.1	3,105.1	424.6	399.7	933.2	1,174.8	8,698.4
1988-89	229.8	51.9	356.3	288.6	1,773.3	3,129.2	438.0	409.4	967.2	1,206.1	8,879.6
1989-90	238.7	54.3	371.2	300.0	1,795.6	3,223.1	454.0	420.7	1,010.4	1,221.8	9,119.9
1990-91	231.9	53.0	365.7	294.8	1,702.1	3,346.6	444.0	405.8	977.1	1,224.8	9,075.4
1991-92	231.2	52.4	366.6	299.0	1,737.2	3,680.5	444.6	402.4	992.9	1,290.7	9,530.2
1992-93	235.1	52.2	372.3	302.4	1,799.4	3,828.0	449.9	406.3	1,030.4	1,312.1	9,822.4
1993-94	228.7	51.8	363.2	295.4	1,699.2	3,726.6	439.1	394.7	1,012.3	1,314.2	9,559.4
1994-95	221.2	50.2	352.5	286.9	1,568.1	3,647.3	425.1	380.5	7.666	1,297.8	9,262.7

a Quebec's cash transfer is reduced by the value of its special abatement of 8.5 personal income tax points. b Includes payments to Northwest Territories and Yukon. Source: Canada, Department of Finance, Federal-Provincial Relations Division, "Established Programs Financing" (various years). Calculations are final except for 1991-92 ("Third Interim Adjustment"); 1992-93 and 1993-94 ("Second Adjustment to Advance"); and 1994-95 ("Advance Calculation").

Transfer, by 110 vince,	ociccica i isc	car rears	
Province	1986-87	1989-90	1994-95
		percent of total	
Nfld	59.6	55.1	51.7
PEI	59.6	55.1	51.7
NS	59.6	55.1	51.7
NB	59.6	55.1	51.7
Que.a	41.6	35.3	29.4
Ont	52.2	44.3	45.5
Man	59.6	55.1	51.7
Sask	59.6	55.1	51.7
Alta	57.2	54.9	50.3
BC	60.6	52.8	49.1
Total ^b	54.7	48.3	45.9

Table 5 Comparison of Cash Component as Ratio of Total EPF Transfer, by Province, Selected Fiscal Years

Source: Canada, Department of Finance, Federal-Provincial Relations Division, "Established Programs Financing" (various years). Calculations are final except for 1991-92 ("Third Interim Adjustment"); 1992-93 and 1993-94 ("Second Adjustment to Advance"); and 1994-95 ("Advance Calculation").

The Issue of National Standards

Since national objectives or federal conditions have never been attached to post-secondary education, the issue of maintaining national standards has so far applied only to health care. The national interest is expressed in the five principles set out in the medicare legislation: comprehensiveness of coverage with respect to services, universality with respect to people covered, public administration, portability of benefits, and access to services. When comprehensiveness of coverage and access were perceived to be threatened by the spread of extra-billing by physicians, the ensuing public controversy led to the enactment of the Canada Health Act in 1984. Under the Act, extra-billing and user fees are outlawed by the imposition of financial sanctions on provinces that allow these practices: the federal cash contribution will be withheld to match any amounts collected by such charges. The cash component of EPF—or when it no longer exists, the power to withhold payments from any other federal programs is therefore considered crucial for the maintenance of federal leverage over the provinces in the health care field.

It is hardly surprising that the provinces have strongly resented the financial penalties threatened under the Canada Health Act; to them, federal enforcement of national standards has amounted to a disregard for constitutional principles. Federal-provincial conflicts aside, the Act does largely discourage experimentation and innovation by those provinces that are trying to improve the efficiency of their health care delivery systems, since use of the market system is effectively denied them. At the same time that diminishing federal financial support has forced the provinces to contain the use (and thus the costs) of their health care services, federal legislation may have hobbled their efforts to do so. Should not

^a Includes the value of Quebec's special abatement of personal income tax points. ^b Excludes the value of Quebec's special abatement.

Ottawa's strict ruling against user charges be relaxed in favour of their limited use by the provinces? Not only would such charges improve efficiency in the allocation of resources to and within the health care sector, but because low-income individuals would be exempt, access would not be compromised. On the other hand, the provinces have had considerable leeway concerning specific services insured (comprehensiveness of coverage) and the setting of fee schedules. In other words, the provinces have been able to respond to regional differences in the demand for health care services and to modify modes of delivery without infringing the broad principles of the national health system.

Nevertheless, there are economic grounds for expecting wide differences to emerge among provincial health care delivery systems in the absence of a federal presence.9 First, it would not be rational for provinces to provide benefits to residents from other provinces if their own taxpayers had to pay for them. Unless the provinces were compensated for such interprovincial externalities, they would rationally supply less than the optimal amount of these services. There is then a vital federal role to compensate for externalities in order to ensure the portability of health benefits across provinces. Second, fiscal capacities differ significantly, so that erosion of the EPF cash transfer puts a relatively heavier strain on the budgets of the poorer provinces. This problem is compounded by the cuts to the equalization program, discussed below.

EQUALIZATION TRANSFERS

Section 36(2) of the Constitution Act, 1982, commits the federal government to providing equalization payments "to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."10 Since 1982, federal equalization grants have been based on the representative five-province standard (RFPS), the five provinces being Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia. Unconditional grants go to those provinces whose per capita yields, at national average rates, from 33 uniformly defined provincial and local revenue sources are below the per capita average of the RFPS. All provinces except three— Ontario, Alberta, and British Columbia—receive these payments.

The calculation of equalization is based on a complex formula that first came into use with the adoption of the "representative revenue system" in 1967, when the level of equalization was to the per capita national average. It involves first the determination of a hypothetical national

⁹ For a succinct discussion, see Allen M. Maslove, "Reconstructing Fiscal Federalism," in Frances Abele, ed., How Ottawa Spends: The Politics of Competitiveness, 1992-93 (Ottawa: Carleton University Press, 1992), 57-77. As Maslove notes, differences in costs and needs might also lead to different provincial health care systems in the absence of a federal presence to ensure standardization.

¹⁰ Part III, section 36(2) of the Constitution Act, 1982, being schedule B of the Canada Act 1982 (UK) 1982, c. 11.

average tax rate by dividing total provincial revenue from each source by the relevant total revenue base. This average rate, applied to each uniform base for each province, gives the potential yield at the average rate; per capita yields are obtained by dividing these results by each province's population. Subtracting a province's per capita yield for each revenue source from the per capita average yield of RFPS indicates either a per capita deficiency or excess for that source. Adding these results for all 33 revenue sources reveals whether or not a province has a net per capita deficiency. If it does, that amount is multiplied by the province's population to determine its equalization entitlement.¹¹

Although virtually all provincial and local revenues are included in the formula, the deliberate exclusion of Alberta from the RFPS means, of course, that Alberta's substantial oil and gas revenues are excluded from equalization. Under the original formula, when equalization was to the per capita national average, the inclusion of these revenues became a problem with the explosive increases in oil prices in the 1970s. Ottawa was forced to make hasty and pragmatic modifications to the formula in order to contain costs and to prevent Ontario from becoming a recipient of payments. Still, full equalization of provincial fiscal capacities would require the inclusion of *all* natural resource revenues, which in 1993-94 would have meant an additional \$549.4 million in equalization payments, had the ceiling not been in effect.¹²

A problem inherent in a comprehensive measure of provincial fiscal capacity is that equalization entitlements tend to rise dramatically when provincial revenues are expanding and to become sluggish or even decline in times of recession. To reduce such instability and uncertainty, minimum (or floor) provisions to protect recipient provinces and a ceiling to protect the federal treasury were introduced in 1982.¹³ The most recent use of the floor occurred in 1992-93, when adjustments of \$3,227 and \$4,968 million were paid to Prince Edward Island and New Brunswick to prevent their total equalization entitlements from declining below 90 percent of their entitlement of the previous year (1991-92).¹⁴ The ceiling is intended to ensure that the rate of increase in total equalization entitlements will not exceed the rate of growth of GNP as compared with those rates in a designated base year. Currently, the base year is 1992-93, from

¹¹ For a detailed analysis of the equalization system, see Thomas J. Courchene, *Equalization Payments: Past, Present, and Future* (Toronto: Ontario Economic Council, 1984); and for a summary of equalization entitlements by revenue source, see *The National Finances 1993*, supra footnote 7, at 1:12, table 1.5.

¹² Calculations based on Department of Finance data.

¹³ The floor provision ensures that the total equalization payment of a province with a fiscal capacity of 70 percent or less than the national average would never fall below 95 percent of the province's entitlement in the previous year. For provinces whose fiscal capacity is 70-75 percent of the national average, the minimum is 90 percent; for the remaining provinces, the floor is 85 percent. The ceiling is described in the text following.

¹⁴ Canada, Department of Finance, Federal-Provincial Relations Division, "Provincial Fiscal Equalization, Fifth Estimate, 1992-93" (December 1993).

which the growth rates of GNP and total equalization entitlements are measured. Total equalization payments are thus subject to limits in both directions; but, of course, it is the ceiling that has been harshly criticized by the recipient provinces.

The Ceiling on Equalization Payments

When the ceiling was first imposed, Allan J. MacEachen, then minister of finance, called it a "contingency measure," which was not expected to come into play during the term of the 1982-1987 fiscal arrangements. The minister's words proved to be correct, for growth in aggregate payments did not exceed that of GNP over the base year (fiscal 1982-83). After the ceiling was extended over the next five-year period (1987-1992), with 1987-88 as the revised base year, however, it did indeed become operative. For the three fiscal years 1988-89, 1989-90, and 1990-91, growth in total equalization payments was restricted to 9.2, 17.3, and 20.3 percent, respectively (rates of GNP increases over the base year—that is, the 1987 GNP). In 1991-92, there were no cutbacks since the growth rate in entitlements was well below the ceiling, nor did the ceiling apply to 1992-93, which became the current base year. Under the present arrangements, growth was again limited in 1993-94 to 3.5 percent over the new reference point. Estimates for 1994-95 indicate that the ceiling will not apply to that year irrespective of substantial increases in equalization entitlements. The explanation is that important technical revisions to update and improve the measurement of provincial fiscal capacity were recently implemented.¹⁵ As a result of these technical improvements, all eligible provinces will receive increased entitlements in 1994-95, and there will be an upward revision in the data for the 1992-93 base year, which will prevent the ceiling from taking effect. For the four years in which the restraint applied, equalization payments were significantly cut back by amounts that were equal per capita for the seven recipient provinces. As table 6 shows, total revenue losses exceeded \$3.2 billion by the end of 1993-94.

The growth in equalization entitlements by province from 1986-87 to 1994-95 is recorded in table 7. Although total entitlements will have grown by 47.5 percent over the nine-year period, their growth from year to year has been very uneven. As one would expect, their rate of growth began to decline with the imposition of the ceiling in 1988-89, although in dollar amounts entitlements continued to increase (at a decreasing rate) until 1990-91. In both 1991-92 and 1992-93, the ceiling had no effect because total payments actually registered respective declines of 4.4 and 1.3 percent, reflecting the impact of recession on entitlements. Total payments in 1993-94 increased by 3.3 percent (a rate that would have been somewhat higher in the absence of the ceiling that took effect). It is

¹⁵ Discussions between the federal government and the provinces for the purpose of updating and improving the measurement of provincial fiscal capacities got under way before the end of the 1982-87 agreement and were to be concluded by April 1994. While Department of Finance officials confirm that the 1994-95 estimates reflect the adoption of an improved measure of provincial fiscal capacity, technical details are not yet available.

	- Equalizati	<u> </u>		
Province	1988-89	1989-90	1990-91	1993-94
		thousands of c	current dollars	
Nfld	25,730	72,920	53,747	12,343
PEI	5,813	16,586	12,283	2,793
NS	39,893	113,422	84,759	19,598
NB	32,311	91,651	68,346	15,941
Que	300,395	855,252	643,510	153,007
Man	49,039	138,703	102,937	23,693
Sask	45,845	128,539	94,062	21,302
Total	499,026	1,417,073	1,059,644	248,677

Table 6 Revenue Losses to Provinces from Ceiling on Growth of Equalization Entitlements

Sources: Canada, Department of Finance, Federal-Provincial Relations Division, "Provincial Fiscal Equalization" (years shown), "Final Calculation" (1988-89), "Adjustment to Final Calculation" (1989-90 and 1990-91), and "Second Estimate" (1993-94).

worth noting that in 1994-95, equalization payments are estimated to increase by a sizable 9.3 percent, as a result of the technical improvements, mentioned earlier, in the measurement of provincial fiscal capacities.

An obvious—and contentious—result of the ceiling is that it prevents the per capita revenues of the have-not provinces from reaching the representative standard; equalization falls short of its original objective. Table 8 shows the per capita deficiencies that remain after the reduced equalization payments have been made. For the four years in which the ceiling has applied, this per capita shortfall has ranged from a high of \$127.68 in 1989-90 to a relatively modest \$21.24 in 1993-94; in consequence, per capita revenues of the seven provinces were equalized to only 97.2 and 99.6 percent of the standard provinces' yields in those years. Unfortunately, the inevitable effect of the ceiling has been to recreate disparities in per capita revenues between the have-not and the five standard provinces, and as a result to widen the existing gap in per capita revenues between the have-not provinces and the national average.

Equalizing Provincial Fiscal Capacities

A fair measure of relative fiscal capacities is obtained by applying national average tax rates to the standardized revenue bases of each province—the method used to determine equalization payments. The per capita amounts so derived are, of course, notional and will differ from actual yields. On this basis, table 9 indicates the dramatic reduction in provincial per capita revenue disparities achieved by the equalization system for 1993-94. Before equalization, relative fiscal capacities of the have-not provinces ranged from 66.1 percent of the national average in Newfoundland to 88.2 percent in Quebec. Alberta's fiscal capacity was by far the highest at 132 percent of the national average. After equalization, relative fiscal capacities of the have-not provinces are brought up to 93.6 percent of the national average, while Ontario's relative fiscal capacity is 99.5 percent of the national average, Alberta's is 124.8 percent,

Equalization Entitlements, by Province, 1986-87 to 1994-95 Table 7

Fiscal year	Nfld.	PEI	SN	NB	Que.	Man.	Sask.	Total receiving provinces
				thousands of	current dollars			
1986-87	677,728	137,876	619,503	642,593	2,941,642	471,097	284,695	5,775,134
1987-88	821,449	164,209	747,315	743,502	3,167,069	721,594	277,359	6,642,497
1988-89	843,591	176,722	833,059	772,678	3,398,439	780,621	456,170	7,261,280
1989-90	895,081	191,988	885,340	884,124	3,354,536	957,692	628,873	7,807,634
1990-91	918,641	194,210	948,792	867,987	3,626,900	914,488	530,936	8,001,954
1991-92	872,709	185,607	856,142	946,021	3,472,576	843,627	470,630	7,647,312
1992-93	876,001	167,046	833,527	851,419	3,567,458	787,114	463,177	7,545,742
1993-94	914,761	175,755	880,421	888,023	3,633,584	844,025	458,164	7,794,733
1994-95	959,941	185,919	931,029	923,307	3,864,864	963,961	686,791	8,515,812

Source: Canada, Department of Finance, Federal-Provincial Relations Division, "Provincial Fiscal Equalization" (various years); "Final Calculation" for 1986-87, 1987-88, and 1988-89; "Adjustment to Final Calculation" for 1989-90 and 1990-91; "Seventh Estimate" for 1991-92; "Fifth Estimate" for 1992-93; "Second Estimate" for 1993-94; and "First Estimate" for 1994-95.

Table 8 Remaining Per Capita Deficiencies of Recipient Provinces'
Yields Relative to the Five-Province Standard as a Result of
Ceiling on Equalization Transfers

	1			
	1988-89	1989-90	1990-91	1993-94
		current dolla	ırs per capita	
1. Yield in five-province			• •	
standard ^a	4,127.86	4,502.51	4,699.38	4,804.77
2. Yield in receiving				
provinces ^a	3,424.41	3,671.33	3,887.62	4,117.76
3. Deficiency (lines $1-2$)	703.45	831.18	811.76	687.01
4. Actual transfer	658.21	703.50	716.83	665.77
5. Remaining deficiency				
(lines 3 – 4)	45.24	127.68	94.93	21.24
		per	cent	
6. Actual equalization relative to five-province standard		<i>I</i> ·		
$(\text{lines } (2+4)/1) \dots$	98.9	97.2	98.0	99.6

^a Yield of tax bases at national average rates.

Source: Canada, Department of Finance, Federal-Provincial Relations Division, "Provincial Fiscal Equalization" (various years); "Final Calculation" for 1986-87, 1987-88, and 1988-89; "Adjustment to Final Calculation" for 1989-90 and 1990-91; "Seventh Estimate" for 1991-92; "Fifth Estimate" for 1992-93; "Second Estimate" for 1993-94; and "First Estimate" for 1994-95.

and British Columbia's is 104.1 percent.¹⁶ Finally, as expected, the effect of the ceiling on relative fiscal capacities in 1993-94 was minimal, lowering the index to 93.4 in the have-not provinces and fractionally raising it in the other provinces.

CANADA ASSISTANCE PLAN

Four existing categorical programs—old age assistance, blind persons' allowances, disabled persons' allowances, and unemployment assistance—were consolidated into the CAP in 1966. The CAP is a comprehensive program of assistance and welfare services for persons requiring public support for any reason. Besides covering persons in the four original categories, the CAP extends assistance to needy mothers, dependent children, child welfare agencies, homes for unmarried mothers, and anyone else in need of social support. The main advantage of the CAP over the programs it replaces is that federal restrictions and conditions under the plan are few, so that provinces have flexibility with respect to their expenditures within the broad area of social welfare.

¹⁶ Similar results were obtained by Robin W. Boadway and Paul A.R. Hobson, *Intergovernmental Fiscal Relations in Canada*, Canadian Tax Paper no. 96 (Toronto: Canadian Tax Foundation, 1993), 124, and by Paul A.R. Hobson and France St. Hilaire, *Federal-Provincial Fiscal Arrangements—Toward Sustainable Federalism* (Montreal: Institute for Research on Public Policy, 1993), 22.

Table 9 Comparison of Provincial Per Capita Fiscal Capacities Before and After Equalization, 1993-94 (Canada = 100.0)

				(202 - 2000)	(2022					
	Nfid.	PEI	SN	NB	Que.	Ont.	Man.	Sask.	Alta.	BC
Before equalization ^a	66.1	71.0	78.9	74.2	88.2	105.2	83.0	89.2	132.0	110.2
After equalization ^b	93.6	93.6	93.6	93.6	93.6	99.5	93.6	93.6	124.8	104.1
After equalization ^c										
(reduced by ceiling)	93.4	93.4	93.4	93.4	93.4	9.66	93.4	93.4	125.0	104.3

^a Own-source revenues as percentage of national average. ^b Own-source revenues and equalization as percentage of national average (including equalization). c Numerator and denominator are reduced by ceiling.

Source: Canada, Department of Finance, Federal-Provincial Relations Division, "Provincial Fiscal Equalization" (years shown), "Final Calculation" (1988-89), "Adjustment to Final Calculation" (1989-90 and 1990-91), and "Second Estimate" (1993-94). Under the CAP, the federal government pays 50 percent of provincial expenditures for assistance to needy persons and for various social services such as day care, counselling services, child welfare, and homemakers. The only important eligibility requirement is "need," which the provinces must determine by assessing the particular needs of the individual. Recipients must be provided with enough money to meet "basic requirements" defined to include food, shelter, clothing, fuel, utilities, transportation, household supplies, and personal requirements. Also, provinces must not impose a residence requirement as a condition for aid. Since federal support under the CAP is open-ended, the provinces are free to set their own rates appropriate to local conditions.

Table 10 records federal transfers to the CAP by province since 1986-87. In 1993-94, total transfers under the plan are expected to amount to \$7.776 billion.

Unequal Per Capita Transfers

Given that the CAP is an open-ended matching grant under which Ottawa pays 50 percent of a broadly defined category of eligible expenditures, per capita differences in federal CAP contributions across provinces are bound to exist. One obvious reason is that needs (caseloads) vary widely among the provinces; another is that levels of support (benefit payments to individuals and families) also differ significantly. Some of the variation is attributable to differences in living costs, but some part is certainly the result of the open-ended 50:50 matching formula. The wealthier provinces are able to provide more generous benefits and therefore can collect more federal dollars than the less prosperous ones.

In a recent study, Boadway and Hobson compared the provinces in terms of relative "generosity" (measured as expenditure per recipient) and relative "need" (number of welfare recipients per capita) for 1989-90.¹⁷ All three have provinces registered highest above the national average on the generosity index, reflecting the fact that much of the growth in CAP transfers in the late 1980s was attributable to the expenditures of these provinces. The perception that need in the have-not provinces is consistently higher is partially supported; four of them, along with British Columbia, had needs above the national average. To the authors, these data indicate that "national standards are virtually absent from welfare programs at present," a comment that apparently implies that social welfare benefits should be more uniform from province to province. The National Council of Welfare has expressed a similar concern over the wide disparities between provinces in social benefits for typical households, stating that such inequities should be reduced. 19

¹⁷ Boadway and Hobson, supra footnote 16, at 69.

¹⁸ Ibid.

 ¹⁹ National Council of Welfare, Welfare Reform (Ottawa: Supply and Services, 1992),
 2. Welfare and other government benefits for single employable persons ranged from 25 percent of the poverty line in New Brunswick to 62 percent in Prince Edward Island.

Table 10 Federal Transfers to CAP, by Province, 1986-87 to 1993-94^a

Fiscal year	Nfld.	PEI	NS	NB	Que.b	Ont.	Man.	Sask.	Alta.	BC	Totalc
					thousa	nds of current	dollars				
1986-87	85,480	19,780	124,405	145,108		1,132,209	154,581	160,705	426,265	632,056	4,438,390
1987-88	88,399	21,729	128,650	152,349	1,580,863	1,319,847	164,194	157,548	442,882	652,787	4,726,339
1988-89	91,353	22,602	152,869	149,789	1,653,783	1,510,970	197,777	155,153	487,870	663,112	5,108,392
1989-90	101,049	23,881	157,211	158,936	1,723,610	1,761,482	194,497	152,857	513,187	693,783	5,502,554
1990-91	118,967	28,729	189,089	173,743	1,899,766	2,474,785	227,057	158,845	554,009	748,881	6,602,136
1991-92	132,859	34,755	217,723	206,936	2,217,945	2,158,851	253,126	177,035	623,276	747,342	6,801,792
1992-93	151,398	35,491	248,611	227,314	2,486,218	2,282,903	294,233	197,050	618,960	803,204	7,382,653
1993-94 ^d	172,700	38,600	264,600	225,800	2,627,100	2,413,800	299,800	220,300	634,000	839,500	7,775,900

a Includes some costs for entitlements for prior years. ^b Includes value of Quebec's special abatement of 5 personal income tax points. ^c Includes Yukon and Northwest Territories. d Estimated.

Source: Canada, Department of National Health and Welfare, Cost-Shared Programs Directorate (Ottawa: the department, January 26, 1994).

It should be remembered, however, that the outstanding advantage of the CAP to the provinces (over the earlier categorical assistance programs) has been the absence of federal restrictions and conditions, which gives the provinces flexibility in their expenditure decisions, including the freedom to choose their own levels of benefits. Differences in welfare expenditures across provinces will obviously exist because of differences in relative program needs as well as in preferences. Nevertheless, a drawback of the CAP is that some part of the difference is surely attributable to the use of an open-ended matching grant whereby Ottawa pays 50 percent of provincial *expenditures*, whether or not they reflect relatively high need or generosity.

Limiting the CAP Transfers

In the 1990 budget, Ottawa announced a 5 percent annual limit on the growth of its contributions to the three provinces not receiving equalization payments (Ontario, Alberta, and British Columbia). The ceiling would apply to two years, 1990-91 and 1991-92. Although this unilateral action to alter a federal-provincial agreement without prior notice was challenged successfully in provincial court by British Columbia, the federal government appealed to the Supreme Court of Canada and ultimately won. Significantly, the ruling means that such agreements are not binding but may be altered without provincial consent whenever unilateral federal action is deemed necessary to permit Parliament to manage its financial responsibilities. The 1991 federal budget extended the ceiling on CAP transfers for another three years to the end of 1994-95.

While it is difficult to argue with the Supreme Court's decision to protect the federal government's flexibility and accountability to Parliament for its expenditures, surely the provinces also are entitled to some form of protection from budgetary instability caused by sudden cuts to federal transfers. Otherwise, credence is given to the familiar complaint of the provinces that they agreed to participate in shared-cost programs on the understanding that federal support would be continued, not unilaterally restricted without prior discussion or warning. Almost 10 years ago, the Macdonald commission, commenting on earlier examples of this problem, suggested that federal-provincial agreements be reviewed every five years and that, between reviews, limits could be specified in advance on the size of federal reductions permissible without provincial approval.²⁰ Indeed, experience with the CAP may mean that provincial support for future shared-cost programs may be secured only by agreements that set explicit limits on unilateral changes that may be made by the federal government without consent of the provinces.

Table 11 provides estimates of the revenue losses to the three provinces from the so-called cap on the CAP. The most severe impact by far has been on Ontario, which is expected to suffer a revenue loss of \$5 billion

²⁰ Canada, Report of the Royal Commission on the Economic Union and Development Prospects of Canada (Toronto: University of Toronto Press, 1985) (the Macdonald report).

	c cup on cirr	
Ontario	Alberta	British Columbia
m	illions of current do	ollars
400	na	48
1,200	30	156
1,700	60	306
1,700	na	432
	Ontario ma 400 1,200 1,700	millions of current do 400 na 1,200 30 1,700 60

Estimated Revenue Losses to Ontario, Alberta, and British Columbia from the Cap on CAP

Source: Ontario, Community and Social Services, Turning Point: New Support Programs for People with Low Incomes (Toronto: Queen's Printer for Ontario, 1993), 9; Harriet L. De Koven, "Federal-Provincial Transfers: Which Way from Here?" (December 1993), 14 Policy Options 45-49; Alberta Treasury, 1992 Budget, April 13, 1992 and 1993 Budget, May 6, 1993; and British Columbia, Ministry of Finance and Corporate Relations, 1991 Budget, May 22, 1991, 1992 Budget, March 26, 1992, and 1993 Budget, March 30, 1993.

(83 percent of the \$6 billion total) by 1993-94.21 Indeed, the cap has coincided with Ontario's worst recession since the 1930s: between 1989-90 and 1992-93, the number of recipients and families dependent on social assistance more than doubled, from 593,000 to 1,221,000.22 British Columbia's cumulative revenue loss also has been substantial (about \$942 million by 1993-94), while Alberta's loss to date has been a relatively modest \$90 million; in fact, Alberta's expenditures remained below the 5 percent ceiling in 1990-91 and again in 1993-94, so that no losses were incurred—that is, all provincial expenditures were eligible for federal matching as under the original formula.

The redistributional effect of the federal policy to restrict its spending on the CAP has been dramatic, especially for Ontario. According to that province's estimates,²³ in 1992-93 the federal contribution covered only 28 percent of Ontario's social assistance expenditures, 36.8 percent of British Columbia's, and 47.4 percent of those eligible for sharing in Alberta. Corresponding data for 1993-94 are estimated to be 29 percent for Ontario and 33 percent for British Columbia, while the federal share of expenditures in the other provinces (including Alberta) will be 50 percent.²⁴

Further evidence of the redistributive shift is provided in table 12, which compares per capita differences in CAP transfers across provinces in 1990-91 (before any federal reductions were actually made²⁵) with

²¹ By 1994-95, the revenues lost are expected to amount to \$6.7 billion. See Ontario, Ministry of Community and Social Services, Turning Point: New Support Programs for People with Low Incomes (Toronto: Queen's Printer for Ontario, 1993), 8.

²³ Ontario, Ministry of Treasury and Economics, 1992 Budget, April 30, 1992, budget paper D, at 104.

²⁴ Harriet L. De Koven, "Federal-Provincial Transfers: Which Way from Here?" (December 1993), 14 Policy Options 45-49.

²⁵ The federal government did not reduce CAP payments until after the ruling by the Supreme Court in August 1991 (Reference Re Canada Assistance Plan, [1991] 2 SCR 525); therefore, no reductions were made before the 1991-92 fiscal year.

1	-	_	16
-	1)/	'n

	1990-91		1993-94	
	\$ per capita	Index (Canada = 100)	\$ per capita	Index (Canada = 100)
Nfld	207.5	83	297.3	110
PEI	220.5	89	292.4	108
NS	211.5	85	286.4	106
NB	240.2	97	300.7	111
Que	280.7	113	364.4	135
Ont	254.0	102	224.6	83
Man	208.0	84	268.6	99
Sask	158.9	64	219.6	81
Alta	224.1	90	238.1	88
BC	239.5	96	237.5	88
Total	248.9	100	270.0	100

Table 12 Per Capita Differences in CAP Transfers by Province, 1990-91 and 1993-94

Source: Canada, Department of National Health and Welfare, Cost-Shared Programs Directorate (Ottawa: the department, January 26, 1994); and population estimates from Statistics Canada, Canadian Economic Observer, catalogue no. 11-010.

those in 1993-94. Even though the data mask differences in need and levels of benefits, discussed earlier, the fact that the federal contribution to Ontario plunges from 102 percent of the national average in 1990-91 to 83 percent in 1993-94 is primarily the result of the cap on the CAP. Similarly, per capita transfers to British Columbia and Alberta decline to 88 percent of the national average in 1993-94; and all seven have-not provinces, as expected, register increases on the index, with Quebec in top place (135 percent of the national average).

PROVINCIAL REACTION

Repeated federal reductions in transfers to the provinces since 1986 have caused mounting tension in federal-provincial relations. The provinces have accused the federal government of acting unilaterally, without prior discussion, and of failing to honour agreements with respect to the financing of the three national social programs. As mentioned, they bitterly resent what they perceive to be federal efforts to "offload" part of the deficit onto them, thereby forcing them either to increase taxes (or borrowing) or to cut back their own spending on public services, or both. Ottawa, for its part, has consistently argued that resolving the national debt problem will require the joint effort of the provinces. Besides, as Peter Leslie has observed, it would be "politically very difficult" for the federal government "to concentrate all the budget cuts on federal programs, exempting transfers to other governments."26

²⁶ Peter M. Leslie, "The Fiscal Crisis of Canadian Federalism," in Peter M. Leslie, Kenneth Norrie, and Irene K. Ip, A Partnership in Trouble: Renegotiating Fiscal Federalism, Policy Study no. 18 (Toronto: C.D. Howe Institute, 1993), 1-86, at 45.

From the beginning, federal reductions to EPF transfers were bitterly opposed for their negative effects on provincial health and post-secondary education systems. Since the per capita freeze in 1990, the prospect that the cash component will disappear in a few years has brought further criticism from those concerned about preserving national standards. In Quebec's view, the sharp drop in federal participation is "difficult to reconcile" with maintenance of "federal standards in the health sector,"27 particularly the disallowance of extra-billing by physicians and user charges under the Canada Health Act. Quebec argues vehemently that such "unacceptable... restrictions" prevent the provinces from applying "sound management practices" and from containing costs in health care. It is therefore not surprising that Quebec was equally opposed to Bill C-20, which proposed to strengthen Ottawa's means to enforce the conditions of the medicare system. Indeed, to the Quebec finance minister, the federal move demonstrated a "surprising attitude of confrontation," since it coincided with renewed cuts to EPF transfers and Quebec's announcement that user fees would be introduced for certain hospital visits.²⁹ In addition, in the House of Commons, it has been charged that the federal cuts are a "signal" for the provinces to "unload part of their responsibilities on to the municipalities," which, in turn, "are unloading their responsibilities on to charitable organizations, non-profit organizations, church groups, and special interest groups."30

Opposition to the ceiling on equalization transfers also has been strong. Typically, Newfoundland has condemned the ceiling as an "arbitrary and inequitable feature"31 that inhibits the equalization program from reducing the fiscal disparities among the provinces. More specifically, Quebec has complained that the limit on equalization payments exacerbates the already inequitable result of the reductions in EPF transfers. Since the latter are equal per capita amounts, they impose relatively heavier burdens on the provinces with below-average fiscal capacities. According to Quebec estimates for 1990-91, this means that the have-not provinces would have to raise their tax rates by 17 percent more than the have provinces in order to replace the federal funds withdrawn, before reaching the equalization ceiling.³² After the ceiling is reached, since additional revenues are no longer equalized, the tax effort of the have-not provinces to raise a marginal dollar of revenue averages a full 39 percent above that

²⁷ Québec, Ministère des Finances, 1991-1992 Budget, May 14, 1992, appendix E, at 13 (emphasis added).

²⁸ Ibid., at 14. Recall that Bill C-20, supra footnote 8, empowers Ottawa to withhold any federal grants (not only EPF cash transfers) from provinces that permit extra-billing or user fees. Quebec's recent imposition of a \$5 "orienting" fee for hospital visits other than emergencies and for certain consultations by physicians may violate a strict interpretation of the federal legislation.

²⁹ Québec, 1991-1992 Budget, supra footnote 27, appendix E, at 14-15.

³⁰ Canada, House of Commons, *Debates*, March 19, 1992, 8523.

³¹ Newfoundland, Department of Finance, 1992 Budget, March 26, 1992, C-3.

³² Québec, 1991-1992 Budget, supra footnote 27, appendix E, at 9.

of the have provinces.³³ Relative tax effort varies dramatically among the have-not provinces, ranging from 170 in Newfoundland and 168 in Prince Edward Island up to 134 in Quebec and 133 in Saskatchewan, as compared with an index of 100 for the average of the three have provinces.³⁴

The cap on the CAP, as would be expected from the magnitude of the funds involved, has caused the most acrimony between the three have provinces and the federal government. Ontario, for which the cap has had a particularly severe impact, resents discriminatory treatment, especially at a time of extraordinary demands on its social assistance system. As the Ontario finance minister put it, "[T]axpayers [in the three have provinces] must pay twice for these services—once to Ottawa to help finance CAP and again to their own province, to replace the CAP transfers withheld by the federal government."35 Equally perturbed, the finance minister of the province—British Columbia—that had earlier challenged the federal authority in court, commented similarly, "Targeting the CAP reduction at the three 'have' provinces (Ontario, Alberta and British Columbia) reflects the federal government's desire to redistribute provincial transfers at the same time as reducing them."36 The minister then declared, "The size of the income assistance group in a province is not closely related to that province's fiscal capacity."37 Alberta also is very dissatisfied with existing fiscal arrangements that, among other things, "penalize some provinces in providing national programs."38

TRANSFERS AND THE FEDERAL DEFICIT

The significance of transfers to the federal deficit problem is clearly demonstrated in *The National Finances 1993*, ³⁹ which compares the relative size of the federal and provincial-local deficits in 1992, including and excluding intergovernmental transfers. When grants are included, the federal deficit is \$25.7 billion and the provincial-local deficit is \$18.2 billion. If, however, the grants are excluded, the federal deficit actually turns into a surplus of \$3.8 billion, while the provincial-local deficit soars to \$47.7 billion. As a result of intergovernmental transfers, therefore, the federal government has had to take responsibility for a much larger share of the public sector deficit. These calculations serve to explain the federal determination to restrain the growth of transfers and thus shift part of the deficit to the provinces. But they also remind us that such

³³ Ibid.

³⁴ The index of tax effort for the other have-not provinces relative to the have provinces is as follows: Nova Scotia, 156; New Brunswick, 134; Manitoba, 142; Ontario, 102; Alberta, 85; and British Columbia, 108.

³⁵ Ontario, 1992 Budget, supra footnote 23, budget paper D, at 103.

³⁶ British Columbia, Ministry of Finance and Corporate Relations, 1992 Budget, March 26, 1992, 84.

³⁷ Ibid.

³⁸ Alberta Treasury, 1993 Budget, May 6, 1993, 18.

³⁹ The National Finances 1993, supra footnote 7, at 3:4 and table 3.4.

offloading does little, if anything, to reduce the combined federal-provincial deficit. As reductions in transfers continue, however, mounting provincial pressure must lead ultimately to a reallocation of tax room in favour of the provinces. A shift of personal income tax points to the provinces might have significant consequences for federal-provincial fiscal relations, as discussed below.

A key feature of Canadian fiscal federalism for years has been the existence of a large vertical imbalance. 40 This means that (if the federal deficit is excluded) the federal government collects more tax revenues than it needs for its own expenditures, while the provinces experience a revenue deficiency relative to their expenditure needs. This imbalance is offset by federal transfers, an arrangement that implies that the degree of imbalance must be justified largely on the basis of these transfers. Boadway and Flatters⁴¹ justify continued use of large transfers to the provinces on three main grounds:

- 1) the constitutional commitment to the principle of equalization (which includes the equalizing elements in EPF and the CAP);
- 2) the use of the federal spending power in areas of exclusive provincial jurisdiction where there is a strong national interest, particularly in the fields of health, education, and social welfare; and
- 3) the need for the federal government to remain dominant in the major tax fields for purposes of control (for example, in orchestrating stabilization policies and income tax harmonization) and, especially relevant here, to maintain a sizable EPF cash transfer so as to enforce the conditions of the Canada Health Act.

Yet the existing degree of vertical imbalance may no longer be appropriate or sustainable in the present circumstances. It will become increasingly difficult for the federal government to continue to restrain the growth of transfers without a reallocation of tax room. However, compensation in the form of a transfer of income tax points, even after equalization, benefits high-income provinces more than low-income provinces. A more important consideration is that a transfer of tax points, unlike grants, would effectively be irreversible. On the positive side, a reduction in vertical imbalance would enhance the accountability of provinces for their expenditures and strengthen incentives for more efficient delivery of services, since provincial expenditures would not be separated from the political costs of raising the revenues. For the provinces, a transfer of tax room might bring them greater certainty over revenues by reducing their dependence on the federal treasury.

⁴⁰ For an excellent discussion, see Robin Boadway and Frank Flatters, "Federal-Provincial Fiscal Relations Revisited: Some Consequences of Recent Constitutional and Policy Developments," in Melville McMillan, ed., Provincial Public Finances, vol. 2, Plaudits, Problems, and Prospects, Canadian Tax Paper no. 91 (Toronto: Canadian Tax Foundation, 1991), 87-121.

⁴¹ Ibid., at 111.

CONCLUSION

The federal government's efforts to control the growth of the deficit have led to reductions in its three major transfer payments to the provinces: EPF, fiscal equalization, and the CAP. The financial impact on provincial government budgets has been severe. It is estimated that the cumulative revenue loss with respect to the three programs, from 1986-87 to 1993-94, has been approximately \$33.6 billion; in 1993-94 alone, it amounted to about \$8 billion. To the end of 1993-94, EPF has accounted for by far the greatest provincial loss—or federal saving—of \$24.4 billion. These figures are in current dollars; the loss in real terms has, of course, been considerably higher.

The magnitude and design of the federal cuts to transfers not only have led to federal-provincial conflicts, but also have raised doubts about the survival of the fiscal arrangements in their present form. Most obvious is the case of the EPF cash transfer, which has been declining, especially since 1990 when a per capita freeze was placed on total entitlements. Disappearance of the federal cash component would mean that Ottawa would lose a key instrument for enforcing national standards or influencing policy in the areas of health care and post-secondary education. The significance of this loss, however, may be exaggerated. The fact that national standards have never existed in post-secondary education has not prevented a "national" system from evolving; interprovincial mobility of students and portability of degrees and certificates have been achieved without federal intervention. Moreover, the only experience so far with sanctions in health care has been to enforce federal disallowance of fees by hospitals and physicians. Although growth at the rate of GNP less 3 percent will resume in 1994-95, the federal EPF cash transfer will still disappear, first in Quebec, probably early in the next century. At that point, EPF will cease to exist, as will any pretence of national standards or objectives; differences among provinces in the level and standard of service provision will likely widen because programs will express only provincial interests. It is unclear whether the conditions imposed under the Canada Health Act could effectively be enforced (despite federal authority to withhold funds from any payments in the event that provinces allowed extra-billing or user fees) without a direct federal presence in the health care system.

⁴² Ontario has estimated that the cumulative revenue loss for all provinces from 1982-83 to 1992-93 actually amounted to \$40.8 billion, of which EPF alone accounted for \$33.6 billion: see Ontario, 1993 Budget, supra footnote 23, budget paper D, at 100-1. Although these figures have been widely quoted, the EPF losses are inflated by the inclusion of revenues lost by the withdrawal of the so-called revenue guarantee in 1982. The revenue guarantee dates from federal income tax reforms introduced in 1972, when Ottawa agreed to compensate the provinces for any loss of revenue incurred as a result of adopting the new tax structure. It came to involve substantial amounts of revenue and, in 1977, was incorporated into EPF (as an amount equivalent to two additional personal income tax points). The further reduction of the EPF per capita base by this element explains why Ontario's estimates are so much higher than those shown here.

In contrast to EPF transfers, which are unrelated to actual program costs, federal expenditures on the CAP are far more difficult to control simply because the CAP is an open-ended shared-cost program; the matching formula commits the federal government to cover 50 percent of total expenditures, which are determined by the provinces. Instead of limiting payments to all the provinces, Ottawa applied a ceiling to its transfers to only the three wealthiest provinces. By continuing to pay 50 percent of eligible program expenditures in the other provinces, the federal government is, in effect, honouring its commitment to the equalization principle. Meanwhile, social assistance costs have risen so enormously, especially in Ontario, that a return to the original basis (50:50) of cost-sharing is simply out of the question. As a fiscal instrument, the CAP requires a major overhaul; it is unsustainable in the longer term.

The survival of the equalization program, unlike EPF and the CAP, is not at issue. Recent legislation has renewed the program to 1998-99; and, as noted, technical improvements in measuring provincial fiscal capacity will result in enrichment of equalization entitlements beginning in 1994-95. It is unfortunate, however, that the ceiling will be retained because relative fiscal disparities between the have and the have-not provinces will continue to widen. Moreover, the equalization system is not independent from federal reductions to EPF, or even from those to the CAP. As provinces raise taxes in an effort to replace lost revenues, upward pressure is put on equalization entitlements, thus assuring that the ceiling will go into effect.⁴³ As we have seen, once the ceiling is reached, the tax effort required of the have-not provinces to compensate for EPF dollars withdrawn rises sharply for them, since the deficiency must be made up of unequalized own-source revenues. This interplay between cutbacks to social programs and the equalization system reminds us that the three programs must not be considered in isolation; they make sense only when seen as part of an overall system of fiscal arrangements.

In short, a climate of conflict and stress has developed in federalprovincial relations, and interregional tensions are likely to emerge as well. The three wealthiest provinces, along with Quebec, will increasingly press for an additional transfer of income tax room, which will mean both more decentralization and "disentanglement" of functions in the federation.44 Further decentralization of revenues, however, would weaken the federal redistributive function; it would also weaken the federal ability to use its spending power in areas of provincial jurisdiction (particularly health, education, and social welfare) when the national interest is involved; and loss of dominance in the income tax fields would impair the federal ability to conduct stabilization policy and to harmonize

⁴³ See Paul A.R. Hobson, "Current Issues in Federal-Provincial Fiscal Relations," in Ronald L. Watts and Douglas M. Brown, eds., Canada: The State of the Federation 1993 (Kingston, Ont.: Queen's University, Institute of Intergovernmental Relations, 1993), 175-92, at 188.

⁴⁴ Alberta, 1993 Budget, supra footnote 38, at 19.

the income tax fields. The redistributive function is already at risk of losing public support in the richest provinces. Apart from their bitter resentment over federal withdrawal from the CAP, the support of those provinces for redistributive transfers has rested fundamentally on the preservation of "national" social programs.⁴⁵ Diminishing support for the redistributive element could seriously compromise both fiscal equity and economic efficiency.⁴⁶

The exigencies of controlling large deficits and mounting debt have strained the fiscal relations between the federal and provincial governments. Continued cuts in transfers under the federal deficit reduction policy will intensify provincial pressure for a further transfer of income tax room, perhaps compromising the federal redistributive role. But reforming EPF and the CAP will inevitably involve a reallocation of revenues and expenditure responsibilities between the two levels of government. Negotiations will be difficult, but reform is essential if Canada's system of fiscal federalism is to be sustained.

⁴⁵ See Ontario, 1992 Budget, supra footnote 23, budget paper D, at 115.

⁴⁶ Fiscal equity requires that individuals in equal circumstances be treated equally by the federal fiscal system and by the fiscal system of the province in which they reside. This means that individuals' "net fiscal benefits"—the benefits bestowed upon them by government expenditures less the taxes paid to finance those benefits—must be equal. Equality of net fiscal benefits would also ensure that interprovincial migration of labour would occur only because of wage differences; otherwise, labour would be allocated inefficiently—that is, in response to differences in net fiscal benefits. For a full discussion, see Boadway and Hobson, supra footnote 16, at chapter 1.