Manitoba

Budget Paper C

FISCAL ARRANGEMENTS: A NEW COURSE

FISCAL ARRANGEMENTS: SETTING A NEW COURSE

Contents

Introduction

2004 was a watershed year in respect of fiscal arrangements between the federal and provincial governments, with two major First Ministers' meetings that have set health care funding and fiscal arrangements on a new course. The future of the Equalization Program, the federal role in supporting post-secondary education (PSE) and other social programs, and the issue of fiscal imbalance in Canada will come under intense scrutiny over the course of the next year. The federal government plans to establish a panel to examine the Equalization Program and make recommendations for change. As well, a subcommittee of the House of Commons Finance Committee has been set up to propose "tangible solutions" to Canada's fiscal imbalance.

In setting a new fiscal course for the federation, Manitoba believes that governments must be guided by clear principles and objectives. The principles in which the Equalization Program are grounded and to which the federal government is committed are built into Section 36(2) of the *Constitution Act, 1982*.

> *Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public service at reasonably comparable levels of taxation.*

While the federal government has re-established its key funding role in health care, it has yet to address its role in respect of supporting PSE and social services. In this regard, Manitoba is looking for the federal government to restore its funding partnership with the provinces and territories in support of PSE and social services as it has for health care.

PRINCIPLES TO GUIDE FISCAL ARRANGEMENTS

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

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

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

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

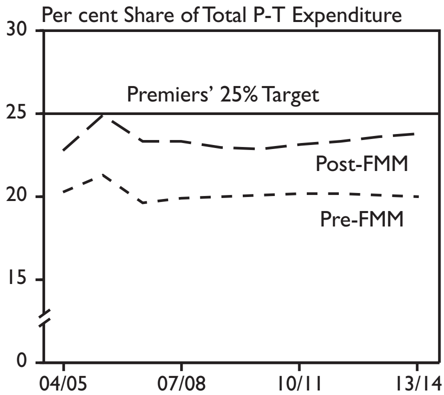
First Ministers' Meeting on Health Care Funding

First Ministers met in Ottawa and held a series of public and private meetings between September 13th and 16th, 2004 to hammer out a long-term deal on federal funding for health care. These negotiations successfully concluded with the unanimous signing of a 10-year agreement on health care funding. The agreement provides for a substantial increase in funding to the Canada Health Transfer (CHT) base, a commitment to increase base funding by 6% per year and a long-term funding initiative to help provinces and territories address wait times. In addition, the agreement includes a commitment from the federal government to work with provinces and territories on a national Pharmacare strategy.

The September 2004 FMM concluded with a unanimous, signed agreement that provides for a significant increase in the federal contribution to health care over the next decade.

The agreement represents an effective negotiation between governments, with substantial give-and-take on both sides. It substantially achieves the premiers' goal of seeing the federal share of funding for health care restored to 25%. As Chart 1 illustrates, the agreement is expected to boost the federal share of health care funding from its pre-September 2004 First Ministers' Meeting (FMM) level of 20% into the 23–24% range over the long term. Total federal funding for health care will rise from $18.9 billion in 2004/05 to $30.5 billion in 2013/14.

Chart 1
Federal Contribution to Health Care Funding



Sources: Finance Canada, Manitoba Finance and Conference Board of Canada

The agreement also significantly addresses the premiers' concern that all of the increase in federal funding in the 2003 Health Funding Arrangement was either "one-time" or conditional and not built into the base. Premiers have long maintained that in order to do the planning and make the investments needed to sustain health care, federal funding must be sufficient, secure and ongoing. Under the revised deal, the Health Reform Fund Transfer will be rolled into the CHT base in 2005/06. The only part of the health care Agreement that is not built into the base is that dedicated to reducing wait times. This funding is to be used by provinces and territories to advance their wait time reduction strategies (ex: training and hiring more health professionals, clearing backlogs, building capacity for regional centres of excellence, expanding appropriate ambulatory and community care programs and/or tools to manage wait times).

First Ministers' Meeting on Fiscal Arrangements

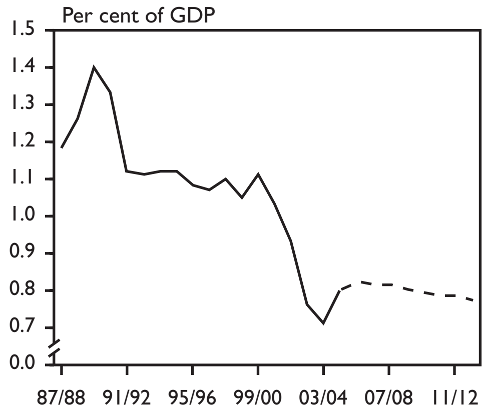
A second meeting of First Ministers was convened on October 26, 2004 to deal with provincial and territorial concerns about funding for the Equalization Program and Territorial Formula Financing – matters that were not resolved at their September meeting. At the meeting, the federal government confirmed its long-term funding plan for the Equalization Program. The plan involves a two-year transitional funding and allocation scheme, which supersedes the existing fiscal arrangements. Funding for 2004/05 was set at \$10 billion plus protection for individual provinces against declines in payments. Total funding for 2005/06 was set at \$10.9 billion and is to increase by 3.5% per year thereafter.

While the federal government has set total entitlements above what the current Equalization Program would have provided in the short run, they are below earlier federal projections and what the program would be providing if the federal government had not decided to move away from a 10-province standard for measuring fiscal disparities and had not reduced revenue coverage[1].

It is estimated that a 10-province standard would restore funding as a percentage of GDP to 1.1%, more in line with historical levels of support. Under the current plan, federal support is projected to continue to decline as a percentage of GDP

Chart 2

New Federal Equalization Plan



Sources: Finance Canada, Statistics Canada

Under current legislation Equalization payments will grow by less than GDP over the next decade.

into the future (see Chart 2). Thus, despite the changes to funding that have been implemented by the federal government, the overall adequacy of the program continues to be an issue for recipient provinces.

While the new federal Equalization plan creates certainty for the federal government in terms of its own financial obligations, it does not address the uncertainty faced by Equalization-recipient provinces. The allocation for 2006/07 and beyond will be decided by the federal government based on the advice of an expert panel. However, Manitoba is pleased that at the October 26, 2004 FMM, the Prime Minister provided assurances to premiers that no province will face significant reductions in Equalization entitlements because of a change in the allocation of the program.

At the October 26, 2004 First Ministers' Meeting, the Prime Minister provided assurances to premiers that no province will face significant reductions in Equalization entitlements because of a change in the allocation of the program.

Equalization under the Microscope

The September 2004 FMM health care funding agreement has set the health care system on a more sustainable path. The federal Equalization plan, however, left important issues unresolved. Given the importance of the program, provinces will be closely monitoring the work of the panel and the federal response to its recommendations. Following the October 2004 FMM, opposition parties in the House of Commons passed a motion setting up a special subcommittee of the Finance Committee to look at fiscal imbalance.

The fate of the Equalization Program looms large as the subject of the deliberations of the federal and premiers' panels and the subcommittee. How funding will be allocated in the future is a key component of the mandate for the federal panel responsible for reviewing the Equalization Program. At the core of the upcoming debate on Equalization is the question of how to most accurately measure fiscal disparity – the difference between provincial governments' ability to raise revenue to support a national standard of public services.

The Representative Tax System (RTS) approach has evolved over time and reflects decades of detailed and comprehensive research and examination by senior federal and provincial officials. The RTS approach compares the taxation practices of provinces to determine whether a province lacks the tax resources to provide a level of service to its citizens that is comparable to that enjoyed by other Canadians. This approach reflects the choices provinces have made about how to raise revenue given the competitive constraints on taxation that exist in an open economic federation. It is a comprehensive approach that provides a robust and formula-driven framework to assess fiscal disparities among provinces.

Manitoba believes that the RTS system can be improved upon to address virtually all of the major concerns that provinces have voiced in respect of Equalization over the past decade. Indeed, premiers have made recommendations over the past several years that, if implemented, would have strengthened the Equalization Program and addressed its perceived shortcomings. Specifically, they have called on the federal government to consider approaches that include a 10-province standard with comprehensive revenue coverage that recognizes the volatility of resource revenue.

Manitoba does not believe there is a short-cut to measuring fiscal disparity that will not short change at least some provinces. The macro approach that the federal panel is to consider as an alternative to the RTS tries to measure fiscal disparities among provinces using a single macroeconomic measure (like GDP or personal income). The preliminary results of the macro approach suggest that it does not track very well the results of the more-detailed RTS approach and allocations among provinces vary considerably, depending on the macroeconomic measure used. It is thought that

EQUALIZATION AND FISCAL IMBALANCE

Equalization will be a primary, if not exclusive, focus of two major reviews this year – one by the federal government and one by a special subcommittee of the House of Commons' Finance Committee.

Federal Expert Panel: *A federally appointed six-person panel of experts will evaluate the current Equalization Program, examine alternative approaches, consider the merits of establishing a permanent independent advisory body and make a recommendation to the federal government by the end of 2005 on the allocation of Equalization payments for 2006/07.*

House of Commons Finance Committee – Special Study on the Fiscal Imbalance: *Dissatisfaction among Opposition parties in the House of Commons with the results of the October 2004 FMM resulted in the passage of a motion to strike a special committee to propose tangible solutions for addressing the fiscal imbalance. It will table its report to the Standing Committee on Finance for adoption, with the final report being tabled in the House of Commons by June 2, 2005.*

EQUALIZATION: WHO REALLY PAYS?

The federal Equalization Program is often misrepresented as being funded by the "have" provinces. In fact, it is a program that the federal government funds out of its general revenue.

Individual Canadians and businesses in every province and territory pay the same federal taxes at the same rates. People in Toronto pay the same federal personal income taxes as do those in St. John's. People in Québec City have to pay GST just the same as those in Red Deer. A business in Steinbach pays the same federal corporation tax as one operating in Vancouver.

Equalization payments are provided to provinces and territories to ensure that all of these individuals and businesses who pay an equally fair share of their earnings to the government of Canada receive, as Canadian citizens and businesses, a reasonably comparable level of service at a reasonably comparable level of taxation. The principle of Equalization, which is enshrined in Canada's constitution, can be understood as a national commitment to fair treatment for all Canadians, regardless of where they live in this country.

one of the main reasons for these divergent results is that these macro variables measure current economic activity and not the actual financial base upon which individuals and businesses make spending decisions. The broader financial base would take into account such things as savings and borrowings over time.

■ Fiscal Transfer Issues beyond Health Care

With First Ministers having negotiated an agreement on health care funding and various processes in place for dealing with the outstanding issues surrounding Equalization, the deck is being cleared to deal with a range of issues that have been largely crowded off the federal-provincial fiscal arrangements agenda.

From Manitoba's perspective, the federal role in funding PSE is the next big issue. Funding for social services is also an issue that needs attention. The federal funding initiative for early learning and child care (ELCC) in the 2005 federal budget is expected to make a positive contribution for children and families in Manitoba.

Provinces and territories are faced with the reality of a weakened funding partnership with the federal government as they attempt to provide adequate funding for PSE and social services. In splitting the Canada Health and Social Transfer (CHST) onto the Canada Health Transfer (CHT) and the Canada Social Transfer (CST), the federal government boosted its support for health care at the expense of its commitment to social services and PSE[2]. In fact, federal funding for these programs in 2004/05 is \$2.7 billion less then it was a decade ago (see Chart 3). The \$7.9 billion provinces and territories will receive in 2004/05 is the same amount they received in 1988/89. Beyond the fact that the real value of the transfer has been eroded by inflation, the transfer places additional responsibilities on provinces and territories to deliver services in respect of both the early childhood development (ECD) and ELCC initiatives.

In order to improve accountability and transparency with respect to the many and varied uses that the CST is believed to support, Manitoba calls upon the federal government to consider splitting the transfer to more clearly reflect the main social program areas (see Appendix: Splitting the CST).

Post-Secondary Education

Knowledge has become the most valuable resource of the information age and an increasingly important determinant of wealth both for individuals and countries. Chart 4 shows that there is a strong correlation between earnings and academic achievement. Compared to individuals without a high school education, high school graduates earn 32% more, college and trades program graduates 90% more, and university graduates 165% more (see Chart 4).

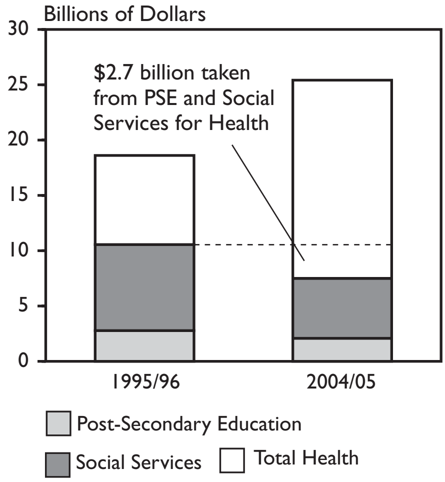
The decline in federal PSE transfers has weakened the capacity of provinces and territories to make all of the improvements in infrastructure for universities and colleges across Canada necessary to provide our country with the knowledge and skills to compete in the global marketplace.

Federal cash transfers for PSE have declined since the introduction of the CHST in 1996/97 and have fallen to an all-time low with the cut to non-health funding under the CST in 2004/05. As a share of provincial-territorial spending on PSE, it is estimated that the federal contribution is only about half of what it was 10 years ago – having declined from about 15% in 1995/96 to just over 7% in 2004/05 (see Chart 5).

Based on Manitoba Finance estimates, the federal government is currently contributing only about $1.8 billion to provincial-territorial PSE programs – a cut in funding of 31% from what it was in 1995/96.

Chart 3

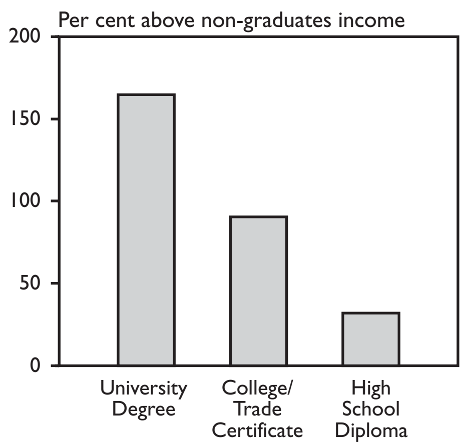
Canada Health and Social Transfer Split



Sources: Finance Canada, Manitoba Finance

Chart 4

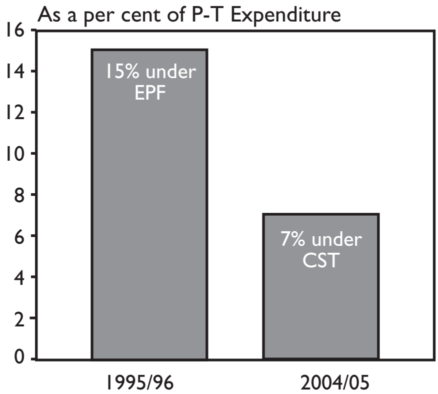
Gains in Annual Income from Education, 2000



Source: Statistics Canada

Chart 5

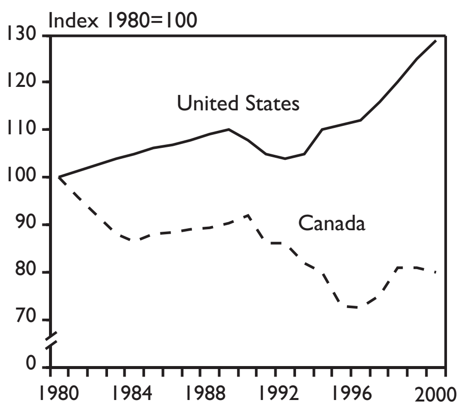
Federal Funding of Post-Secondary Education



Sources: Finance Canada, Manitoba Finance, Statistics Canada and Conference Board of Canada

Chart 6

Government Spending per Student on PSE in Constant Dollars



Source: TD Bank Economics Special Report: *Time to wise up on post-secondary education in Canada* (March 2004)

Taking into account the back-filling that had to be done to offset the cut in the federal contribution, it is estimated that between 1995/96 and 2004/05, own-source funding of PSE by provinces and territories has increased by about $8.6 billion, or 48%.

Manitoba acknowledges that the federal government's involvement in PSE has expanded in other ways, as it has increased its own spending on such things as the Millennium Scholarship Funds, enhanced education tax credits, and the broadened Registered Education Savings Plan (RESP) program, all of which provide direct financial support to students (and supporting individuals). It has also increased financial support for educational institutions through research grants.

Manitoba is concerned, however, that this approach has not proven effective for several reasons. The first is that, in the past, the federal government has proceeded without adequate provincial consultation, thus creating inefficiencies in program delivery. The second is that these programs have fueled demand for services at the same time as the financial resources needed to meet this increased demand have been reduced. The third is that the federal government's Innovation Strategy is not broadening research capacity across the country, but rather perpetuating current imbalances. Indeed, Manitoba's universities are only receiving about two-thirds of what a fair per capita allocation would provide.

Increasing the number of university and college graduates is critical to meeting the skill needs of the private sector and key public sectors like health care. Having a highly trained and knowledgeable workforce will help Canada compete in the global economy and provide the basis for improved living standards. Canada has fallen behind the U.S. in particular in terms of investing in PSE. As Chart 6 indicates, since 1980, real investment in higher education in the U.S. has risen by about 30%, while in Canada it has fallen by 20%.

Social Services

In many respects, the situation in regard to funding other social services parallels that of PSE.

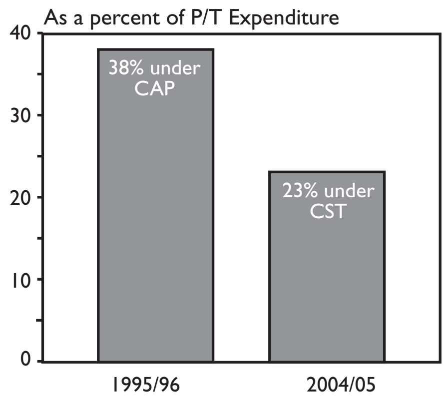
Under the terms of the Canada Assistance Plan (CAP) the federal government paid half of the costs of all eligible social service costs incurred by provincial governments. This 50:50 funding principle was maintained, with the exception of a cap on the growth in payments to non-Equalization-recipient provinces, until the CAP was collapsed, along with Established Program Financing (EPF) into the CHST in 1996/97.

In the final year of CAP, 1995/96, the federal government's share of provincial-territorial social services funding was 38%. Under the CHST, federal support for health and other social programs was cut by one-third over three years. With the splitting of the CHST in 2004/05, it is estimated that the federal share of social services funding has fallen to an all-time low of 23% (see Chart 7).

Based on Manitoba Finance estimates, the federal government is currently contributing about $5.4 billion to the cost of providing social services across provinces and territories. This represents a cut in funding of 31% from its 1995/96 level. Taking into account the back-filling that has been needed to offset the cut in the federal contribution, it is estimated that between 1995/96 and 2004/05, own-source funding by provinces and territories for social services increased by $4.9 billion, or 38%.

Chart 7

Federal Funding of Social Services



Sources: Finance Canada, Manitoba Finance, Statistics Canada and Conference Board of Canada

Early Learning and Child Care

Considerable social and economic benefits are derived when governments invest in ELCC. The early years of a child's life are critical in the development and future well-being of the child. Investments made during this critical period can have long-term benefits that can extend throughout children's lives. Moreover, from an economic perspective, it is clear that by increasing the availability of affordable licensed regulated child care spaces, there will be greater opportunities for labour force participation among parents.

Federal cash transfers to the provinces and territories with respect to children began with the September 2000 FMM at which the federal government announced a five-year, $2.2 billion funding program in respect of ECD beginning in 2001/02. The program was subsequently extended by two years with an additional $1 billion in funding.

In March 2003, following the federal budget, Ministers responsible for Social Services reached agreement on a Multilateral Framework for ELCC, under which the federal government is providing provinces and territories with $1.1 billion over five years (2003/04 to 2007/08).

ECD and ELCC which are funded as part of the CST are making up an increasingly large share of the diminished federal contribution for major social programs outside of health care. In 2004/05, they accounted for 4.4% of the CST, a share that is projected to rise to 9.7% by 2007/08.

In its October 5, 2004 Speech from the Throne, the federal government committed to working with provinces and territories to develop a national system of ELCC, built on the existing F-P-T Multilateral Framework for ELCC. The 2005 federal budget provides provinces and territories with an additional $4.8 billion in funding over five years beginning in 2005/06. The federal 2005 budget indicated that funding for this program would continue indefinitely beyond 2009/10. Prime Minister Martin indicated that this funding would support 250,000 additional child-care spaces across the country over the next five years.

CHILD CARE FUNDING NEGOTIATIONS

Ministers responsible for Social Services are currently engaged in negotiations in respect of the new $5 billion federal investment in ELCC. Manitoba supports the development of this agreement to help advance the implementation of a quality, affordable and accessible ELCC system in the province. It supports flexibility in the new agreement to ensure benefits for children and families are maximized. Manitoba recognizes that there exists a strong unmet demand for child-care services from both an early childhood developmental and a parental labour market participation perspective.

Manitoba does not agree that funding for a First Nations Initiative, or the accountability initiative announced in the 2005 federal budget, should be carved out of this $5 billion commitment. The province maintains that funds promised for provincial and territorial programs should not be used by the federal government to meet its fiduciary responsibilities for First Nations. Those responsibilities must be met with additional funding. Moreover, the federal government must recognize the challenges faced by jurisdictions with large Aboriginal populations living off reserve, and ensure that they receive the necessary funding in respect of these initiatives.

The Fiscal Imbalance

The federal government has posted budgetary surpluses in each of the last seven years. In its February 2005 budget the federal government forecasts its budgetary surplus to continue and grow over the medium term. As Chart 8 illustrates, the federal government has repeatedly underestimated its surpluses, raising concerns that its forecasts may not represent the most likely course of events but one that is overly cautious. Indeed, in its 2004 budget, the federal government projected a narrow $1.9 billion surplus in respect of 2004/05. This amount was raised to $9.1 billion in the October 2004 Economic Statement. According to the information provided in its 2005 budget, the underlying federal surplus for 2004/05 is actually closer to $13.9 billion.

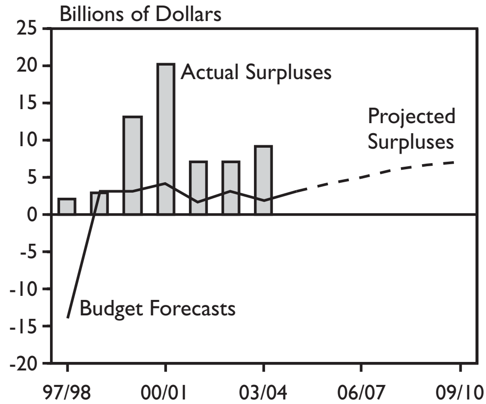
In its 2005 budget the federal government is forecasting a cumulative surplus for the 2004/05 to 2009/10 period of $31.5 billion. This amount is in addition to all of the amounts in respect of health care and Equalization committed by the federal government at the September and October 2004 FMMs as well as the new commitments made in the 2005 budget.

From this chart, at least one other inference is clear: the federal government continues to generate revenue, well in excess of its current needs. This suggests quite strongly that the federal government has the financial scope to meet its obligations to adequately fund Equalization and to restore its funding partnership with provinces and territories in respect of PSE and other social programs.

It is clear that a significant portion of the current narrowing of the gap between the resources and responsibilities of the two orders of government is temporary and may be expected to widen over the medium term. Manitoba is looking for a comprehensive and durable solution to fiscal imbalance.

Chart 8

Federal Government Budgetary Balances



Source: Finance Canada

The federal government has forecast a cumulative budgetary surplus of $31.5 billion over the 2004/05 to 2009/10 period.

Conclusion

In addressing the fiscal imbalance it is clear that improvements to Equalization are necessary. Manitoba believes that fiscal disparities among provinces are best addressed in reference to the constitutional principles and objectives of the Equalization Program.

Provincial and territorial governments are facing significant financing challenges in regard to PSE and other social services. Expanding the knowledge base of our economy is a prerequisite for Canada's global competitiveness. Manitoba is convinced that restoring the financial partnership between the federal and provincial-territorial governments is critical to our success in improving productivity, innovation and our standard of living.

Appendix: Splitting the CST

Prior to the introduction of the CHST, federal funding in respect of PSE was provided as a separate cash transfer under EPF. Likewise, federal support for social services was provided separately under the CAP. The federal government did not seek the agreement of the provinces and territories when it combined funding for health PSE and social services into a single block fund under the CHST.

With the split in the CHST into separate transfers for health (CHT) and other social programs (CST) the federal government missed an opportunity to disentangle funding for two very different program areas with very different requirements. The continuation of a transfer that combines amounts for PSE and social services perpetuates the confusion that exists around the federal government's commitment to these valuable programs.

Manitoba would recommend that the CST be split into separate transfers in respect of PSE and social services as a more effective and transparent way of targeting federal funding. As well, a new block transfer program should be established that is dedicated to children's programs. Funding for this new transfer would be comprised of the existing ECD and ELCC funding in the CST as well as the new child care money currently under negotiation.

End Notes

1 In 1983, the federal government changed the methodology for calculating entitlements under the Equalization Program. Whereas before the change, the revenue from all 10 provinces was used to estimate disparities and entitlements, it removed Alberta and the Atlantic Provinces from the calculation. The national average or 10-Province standard was thus replaced by the five-Province Standard which consisted of Quebec, Ontario, Manitoba, Saskatchewan and British Columbia. In 1997, the federal government decided to exclude one-half of user fees from the calculations. Had these measures not been taken, provinces would have received $4 billion more in 2004/05 than under the October 2004 federal deal.

2 The decision of the federal government to reallocate funds away from PSE and social services to raise its share of funding for health care is contrary to the recommendations of the premiers and the advice of the Romanow Commission. As indicated in the Commission's final report, "In addressing the apparent deficit in health funding, that deficit should not be passed on to PSE and social assistance." *Building on Values: Final Report of the Commission on the Future of Health Care in Canada*, page 69.