Budget Paper D

AN UPDATE ON FISCAL TRANSFER ARRANGEMENTS

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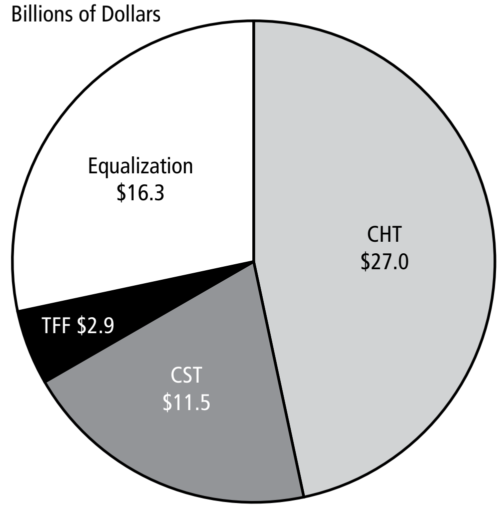
The legislation governing Canada's major federal transfer programs will expire on March 31, 2014. Manitoba has begun work with the federal government and the other provinces and territories to renew Canada's fiscal transfer arrangements. The key objectives of the renewal process must be to develop an approach that provides an adequate and appropriate level of transfers overall and allocates these funds to jurisdictions in a fair and principled manner.

THE IMPORTANCE OF TRANSFERS

In 2011/12, the federal government will transfer close to $58 billion, approximately 23% of total federal program expenses, to the provinces and territories through the major transfer arrangements: the Canada Health Transfer (CHT), the Canada Social Transfer (CST), Equalization[1] and Territorial Formula Financing (TFF). Payments provided through these programs are a significant source of revenue for all provinces and territories to provide the services important to all Canadians. A variety of approaches to allocating these funds have been applied over the years.

Total Major Federal Transfers, Canada, 2011/12

Billions of Dollars



Note: Equalization also includes Total Transfers Protection and Offshore Accord payments.

Source: Department of Finance Canada

Effective fiscal arrangements are now, and will continue to be, a key factor in Canada's success as a federation. Provinces have primary constitutional spending responsibilities in areas such as health care, post-secondary education and social services. However, not all provinces have the same revenue-raising capacity to address these responsibilities due to differences in a number of areas, including demographics, geography, natural resource endowments, and personal and business incomes.

As a federation, Canada is different from countries with a single level of government. In those countries, the central government can apply a single tax system and provide a consistent level of public services for residents in all parts of the country. In a decentralized country like Canada, a strong fiscal transfer program is critical to ensure that all Canadians in all parts of the country have reasonably comparable levels of public services at reasonably comparable levels of taxation. The federal government has a key role in collecting and distributing funds on behalf of all Canadians.

All provinces and territories receive major federal transfer payments, and these programs are 100% funded by federal revenues collected from across Canada.[2] Among these transfers is Canada's Equalization Program. This program, the principle of which is enshrined in the Constitution, is the backbone of Canada's federal-provincial fiscal arrangements.

Both sections 36(1) and 36(2) of the *Constitution Act, 1982*, are important to understanding the rationale for the Canadian Equalization Program and its context within the broader federal transfer system. In his paper, "Evaluating the Equalization Program–Notes for the Expert Panel on Equalization and Territorial Formula Financing," Robin Boadway supports this view. He notes: "Section 36(2) is specific to equalization, but section 36(1) reinforces the role of equalization along with the system of social transfers (CHT and CST) as instruments for the promoting equality of opportunity, furthering economic development and providing essential public services of reasonable quality."

1 includes Equalization, Total Transfers Protection, and Offshore Accord payments

2 Equalization entitlements are determined by measuring provinces' abilities to raise revenues – known as "fiscal capacity." Before any adjustments, a province's per capita Equalization entitlement is equal to the amount by which its fiscal capacity is below the average fiscal capacity of all provinces – known as the "10-province standard." (Department of Finance Canada) It is worth noting that federal transfers, including Equalization, do not reduce the fiscal capacity of non-Equalization-receiving provinces (i.e., those above the established standard).

Description of Major Federal Transfers

Canada Health Transfer and Canada Social Transfer

Through the CHT and the CST the federal government provides payments to all provinces and territories to help support the delivery of vital health and social programs. In 2011/12, combined national CHT and CST payments will total over $38 billion.

The CHT is the main federal transfer in support of health care. The CHT supports the federal government's commitment to maintaining a national program as well as the conditions of the *Canada Health Act* (comprehensiveness, universality, portability, accessibility and public administration and specific provisions related to extra billing and user charges). Provinces and territories must comply with the conditions of the Act to qualify for the full cash transfer. In 2011/12, the national total CHT will be $27 billion.

Total annual CHT cash levels are set in legislation until 2013/14 and reflect the agreement on the 10-Year Plan to Strengthen Health Care, signed by all First Ministers in September 2004. Under the 10-Year Plan, the federal government committed $41 billion in new, long-term funding, including a 6% annual escalator, beginning in 2006/07.

The CST is a block transfer to provinces and territories in support of post-secondary education, social assistance and social services; early childhood development and early learning; and child care. The CST has been allocated on an equal per capita basis since 2007/08. Prior to that, the CST allocation included cash and a notional equalized tax transfer component, similar to the current CHT allocation. In 2011/12, the national total CST will be $11.5 billion.

Equalization

Equalization is Canada's transfer program for addressing differences in revenue-raising capacity between the provinces and reflects a long-standing Canadian commitment, enshrined in the Constitution (1982), to sharing and equal opportunity. The Program also facilitates growth, stability and the reduction of regional economic disparities.

Through the Equalization Program, the federal government provides additional financial support to provinces that have relatively less fiscal capacity and are therefore less able to provide programs and services to their residents that are comparable to other provinces without having to charge high rates of tax or incur high levels of debt. In 2011/12, federal Equalization payments will total $15.8 billion; this includes Total Transfer Protection (TTP) payments.

Territorial Formula Financing

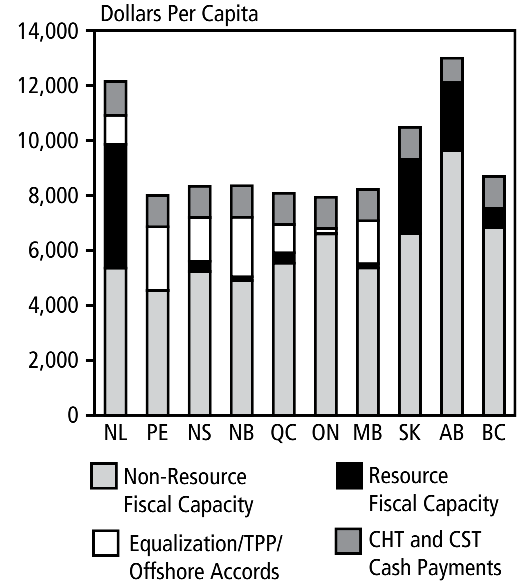
TFF is an annual unconditional transfer from the federal government to the territorial governments to enable them to provide their residents a range of public services comparable to those offered by provincial governments at comparable levels of taxation. TFF helps territorial governments fund essential public services in the North, such as hospitals, schools, infrastructure and social services, and recognizes the high cost of providing public services in the North as well as the challenges the territorial governments face in providing these services to a large number of small, isolated communities. For 2011/12, the three territories will receive $2.9 billion in TFF payments.

The Organization for Economic Co-operation and Development (OECD), in a 2007 report titled "Fiscal Equalization in OECD Countries," provides support for the value of national equalization programs. The report notes that equalization programs assist with equity, by ensuring a balance between revenue-raising capacity and the cost of providing services across regions. The report also identified the importance of equalization programs in addressing fiscal "externalities" that may lead to labour and capital being inappropriately allocated across regions due to regional tax rates rather than in response to economic activity. Finally, it identified the "insurance" effect equalization provides against income or employment shocks that may be experienced in a particular region.

The chart titled "Sources of Provincial Government Fiscal Capacity, 2011/12" provides a snapshot of the differences in total potential revenue between the provinces after accounting for federal transfers. Even after including Equalization payments, which are designed to reduce the fiscal disparities among provinces by increasing the revenue of provinces that fall below an established standard, there remain large differences in per capita fiscal capacity among the provinces. This is particularly evident when natural resource capacity is taken into account, as differences in fiscal capacity are driven largely by the geographical distribution of non-renewable resources, including oil and natural gas.

Federal taxpayers in all provinces and territories contribute to the costs of providing major transfers. For example, Manitobans contribute through personal and corporate income taxes, the GST and other taxes and fees collected by the federal government. Manitoba also contributes when its businesses and citizens conduct business with companies based in other provinces and territories and these entities later pay tax. The contributions of Canadians are also used to cover the costs of other transfer arrangements to address shared priorities (see Appendix 1 for a discussion of other transfers).

Sources of Provincial Government Fiscal Capacity, 2011/12



Note: The chart includes provincial own-source resource and non-resource revenue-raising capacity (i.e. fiscal capacity) as calculated under the Equalization Program, which determines the revenue a government would raise if it applied typical rates of taxation on the various revenue bases typically used by other provinces to raise revenues.

Source: Finance Canada

The purpose of the Equalization Program was entrenched in the Canadian Constitution in 1982.

"36. (1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to

(a) promoting equal opportunities for the well-being of Canadians;

(b) furthering the economic development to reduce disparity in opportunities; and

(c) providing essential public services of reasonable quality to all Canadians.

(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

History of Transfer Arrangements

Canada's Constitution sets out the responsibilities of the federal government and the provinces, including areas of spending and taxing powers. In the early 1900s, provincial expenditure obligations grew and provinces began to rely on progressive income taxation as a source of revenue that grew with the economy, although these taxes were applied differently across the country. During the Great Depression of the 1930s serious weaknesses in provincial finances were exposed, especially in provinces whose economies were hit hardest by the severe downturn. In response, the Government of Canada established the Rowell-Sirois Commission to examine fiscal federalism and make recommendations. The Commission " ... recommended that the federal government exclusively occupy the personal, corporate, and inheritance tax fields and in return should assume all provincial debt and provide what the commission called "national adjustments grants" to financially disadvantaged provinces."[1]

The commission's work was interrupted by World War II, and " ... in 1941 the provinces temporarily relinquished their access to personal, corporate, and inheritance taxes in recognition of the Government of Canada's need to occupy those tax fields to finance the war effort. In return, the provinces received grants from the federal government. This wartime experience moved the country into a system of federal-provincial fiscal interdependence – a system that has been central to Canadian federalism ever since."[2] After the war, the federal government retained much of the income tax room vacated by the provinces, providing it with significant budgetary flexibility.

Throughout the 1950s and 1960s, the federal government promoted the introduction and expansion of national cost-shared health and social programs. The federal Equalization Program was established in 1957 to address fiscal disparities between the provinces. Provinces received an equalizing grant from the federal government if their per capita revenues from personal and corporate income taxes and inheritance taxes were less than what could be raised by the two richest provinces at the time. A further major reform and enhancement of Equalization took place in 1967.

In 1977, federal support for health and post-secondary education moved from equal cost-sharing to block funding with the introduction of Established Programs Financing (EPF). Federal support under EPF was provided in equal parts through a cash transfer and a notional equalized tax transfer. However, social assistance and social services programming remained cost-shared under the Canada Assistance Plan (CAP).

In 1996, EPF and CAP were merged into the Canada Health and Social Transfer (CHST), effectively ending the era of equal cost-shared federal support for provincial and territorial health and social programming. The CHT and the CST came into effect on April 1, 2004 when the CHST was split into two block transfers.

Transfer programs, including the Equalization Program, have undergone a number of changes since their inception and all provinces have received all forms of transfers, including Equalization, at one time or another. For example, Alberta was an early recipient of equalization and Ontario became a recipient in 2009/10.

In 2004, concerns about declining and unstable Equalization payments led the federal government to introduce the "New Framework for Equalization," which increased the size of the Program. At this time, the federal government also announced that it would undertake an "expert review" of Equalization. This review was to consider a number of issues related to the allocation of Equalization among provinces and the treatment of various revenue sources, including natural resources.

In 2006, the Expert Panel on Equalization and Territorial Formula Financing delivered its report to the federal Minister of Finance. The Expert Panel recommendations were ultimately accepted and formed the basis of the renewed and strengthened Equalization Program announced in federal Budget 2007. The strengthened program increased total payments to the provinces and followed the pattern of restoring adequacy that was initiated under the New Framework.

1 Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance, The Council of the Federation, Advisory Panel on Fiscal Imbalance (2006) (pages 22-23).

2 ibid

RECENT CHANGES TO MAJOR TRANSFER PROGRAMS

Formal renewals of Canada's federal transfer programs last occurred in 2004 for the CHT and in 2007 for the CST and the Equalization Program (See: History of Transfer Arrangements). However, since these formal renewals, a number of significant ad hoc changes have been implemented by the federal government.

Since 1999/2000 the greatest increases in major federal transfers have been to Ontario, Alberta and British Columbia. Manitoba's total transfers have increased 86% over the same period, below the national average increase of 116%.

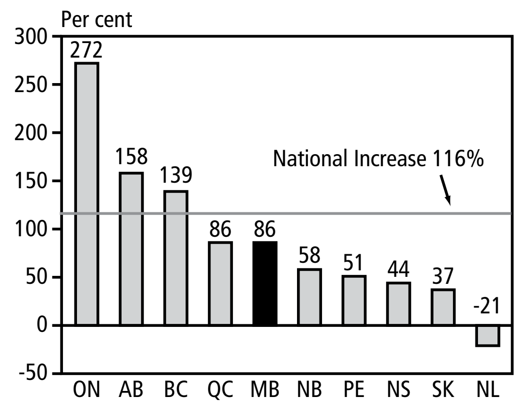
The renewed Equalization Program implemented in 2007 was based on the recommendations of the federal Expert Panel on Equalization and Territorial Formula Financing, chaired by Al O'Brien, a former Alberta Finance Deputy Minister. The 2007 Equalization Program restored the 10-province standard for calculating Equalization and was widely accepted as a principled and more transparent approach to meeting the federal government's constitutional obligations.

In November 2008, after less than two years, the federal government announced changes to the renewed Program, which took effect in 2009/10. The key change was to limit growth in total payments to the provinces to the rate of growth in the national economy by imposing a ceiling or cap on the Program, despite the fact that the Expert Panel recommended against this approach. This approach has compromised the responsiveness and fairness of the Program because the total amount of Equalization distributed to provinces is no longer based completely on changes in provinces' fiscal capacities.

The impact of the cap on Equalization growth has been significant, reducing potential payments by over $9 billion over the past two years compared to what would have been paid under the 2007 Program before the cap was implemented. However, in response to concerns raised by provinces, the federal government has provided total major transfer protection in 2010/11 and 2011/12 to ensure that no province receives less than it did in 2009/10 in combined CHT, CST and Equalization payments.

In addition to announcing changes to the Equalization Program, Federal Budget 2007 also announced the federal government's intention to adopt an equal per capita cash allocation for the CHT in 2014/15, as it did with the CST in 2007/08. The planned change will only benefit some provinces. Manitoba estimates that, without the "further protection" promised by the federal government in 2007, it could lose about $35 to $40 million per year as a result of this change.

Major Federal Cash Transfers, Percentage Change from 1999/2000 to 2011/12



Note: Includes Offshore Accord payments to NL and NS as well as federal Total Transfer Protection payments to provinces.

Source: Finance Canada

Manitoba was pleased that the federal government made a commitment to protect provinces and territories affected by the proposed move to equal per capita CHT in 2014/15: "As with the CST, the Government will ensure that no province or territory is unduly affected by the move to equal per capita CHT support." (Page 361 of the 2007 federal Budget).

Current Approach for Calculating CHT Entitlements

Under the existing federal formula, the CHT is allocated to provinces and territories on an equal per capita basis. Total support includes both cash and transferred tax point revenues. CHT cash is determined by subtracting each province's and territory's transferred tax revenue from its total equal per capita entitlement. To maintain fiscal fairness and ensure an equal per capita allocation, provinces that have higher per capita incomes and are better able to raise tax revenues, such as Alberta, receive lower amounts of per capita CHT cash than provinces and territories with less fiscal capacity (although the tax plus cash amount is the same). In contrast, non-Equalization-receiving provinces with a lower ability to raise tax revenues receive higher levels of per capita CHT cash (ex. Newfoundland and Labrador, Saskatchewan and British Columbia).

The transferred tax revenues were part of a 1977 federal/provincial/territorial fiscal arrangement EPF that notionally transferred federal personal and corporate "tax points" to the provinces and territories without increasing the net tax burden on taxpayers. The tax points are "equalized" to reflect the fact that tax points are worth more in some provinces and territories than others, as described above.

Total CST cash levels now grow by three per cent annually as a result of an automatic escalator introduced in 2009/10. Under an equal per capita allocation, annual growth in CST for individual provinces varies according to each province's relative population growth rate.

It is important to note that when these change occurred, the federal government increased the CST base by $687 million to provide Ontario, Alberta and the Northwest Territories with the same CST per capita cash support as that of the other provinces and territories.

In recognition of the potential impact on all the provinces and territories, the federal government provided further protection by setting a payment floor that ensured no jurisdiction received less in future CHT or CST support relative to what they would have received in 2007/08 prior to the move to equal per capita CST cash (protection from changes resulting from the renewed Equalization Program were also included in the payment floor).

To date, the negative impact of the payment ceiling on the Equalization Program and the move to an equal per capita funding have been mitigated somewhat by federal transfer protection payments that prevent a province's combined major transfers (the CHT, CST and Equalization) from declining year over year. However, these payments do not protect against per capita declines in transfers – Manitoba's per capita major transfer levels declined 1.2% in 2010/11 and a further 0.8% in 2011/12.

In the absence of protection payments, total major federal transfers to Manitoba, Prince Edward Island, Nova Scotia, New Brunswick and Quebec would have fallen, in total, about $1 billion in 2010/11 and 2011/12. In contrast, major federal transfers to Newfoundland and Labrador, Ontario, Saskatchewan, Alberta and British Columbia have increased a combined $4.2 billion over those two years.

LOOKING FORWARD

Provinces and territories are facing significant fiscal challenges in sustaining major social programming, including post-secondary education and the Canadian health care system. In the development of renewed federal/provincial/territorial transfer arrangements, it is crucial that any new approach provides adequate and appropriate levels of funding and that allocation models are both fair and principled. Manitoba will work constructively with its partners to achieve these goals.

Future fiscal arrangements must take into account the differences in fiscal capacity among the provinces. Provinces that are rich in non-renewable natural resources currently have greater fiscal capacity than the other provinces and most are expected to benefit from increasing levels of major transfers under the current shift to per capita funding arrangements. If unaddressed, these disparities could impair the ability of some provinces to provide comparable levels of services to their citizens, as other provinces, at comparable tax rates.

Manitoba believes there must be a strong ongoing federal role in sharing the cost of providing services, including health care, to Canadians. The 10-Year Plan to Strengthen Health Care provided significant levels of new funding that has helped provinces and territories improve access and the quality of care for all Canadians. It will be extremely important to maintain this kind of commitment in future arrangements.

Looking forward to the renewal of the major transfer arrangements in 2014, Manitoba believes that Equalization, as potentially the only remaining major national program that addresses differences in provincial revenue-raising capacities, will be an even more important feature of our Canadian federation. In this renewal process all governments should be guided by clear principles and objectives in developing new fiscal arrangements. Manitoba, under successive governments, has long promoted the need for a sound and comprehensive approach to fiscal arrangements, including the need for a principles-based Equalization Program, and will continue to do so in the future.

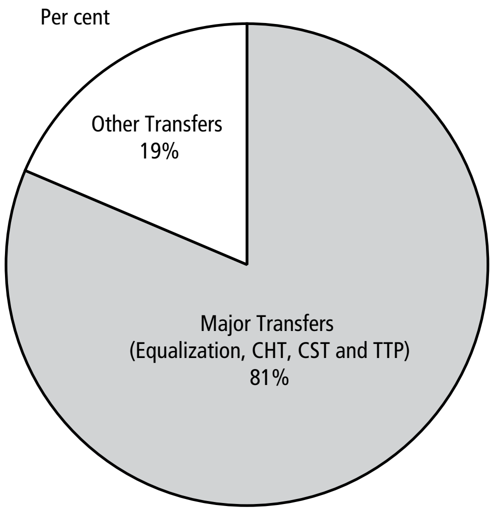
During the Council of the Federation meeting held in Winnipeg in August 2010, Canada's Premiers reached an important consensus that will help guide the renewal process. They agreed that: "Ongoing, stable and predictable federal transfers are necessary to sustain economic growth. Premiers support the federal government's commitment to protect major transfers to other levels of government in support of health care, social services and equalization. Premiers encourage the federal government to work with the provinces and territories in renewing these arrangements which are due to expire in 2014."

Council of the Federation (2010) communique "Premiers Working to Sustain Economic Recovery"

Appendix 1: OTHER TRANSFERS

In addition to major transfers, the federal government provides payments to the provinces and territories through shared-cost and program-specific transfers, through which individual federal departments transfer funds in support of specific program areas to address national priorities. Some current examples are in the areas of agriculture, infrastructure, immigration and labour market training. The federal government also provides direct funding to individuals and to entities under provincial jurisdiction, including municipalities and post-secondary institutions.

Total Federal Transfers to Manitoba, Major and 'Other' Transfers, 2010/11



Note: Other Transfers include Health Funds; Infrastructure Renewal; Manitoba Floodway Expansion; and Shared-Cost and Other Transfers. Does not include transfers to individuals.

Source: Manitoba Budget 2010

The University of Toronto Mowat Centre, in a 2010 paper titled "A Report Card on Canada's Fiscal Arrangements," raises a number of questions regarding the role of other federal transfers within the overall system of fiscal arrangements. The study asked Canadian experts on federalism to assess the performance of Canada's transfer system. According to the report, several experts highlighted the issue of federal "boutique" programs. One expert noted that these federal arrangements in areas of provincial jurisdiction, many of which have conditions and/or cost-sharing features, can take "... a considerable toll on provincial budgets and can distort provincial priorities" (page 22).

Nonetheless, these other fiscal arrangements are a significant component of the overall transfers package. In 2010/11, other transfers comprised almost 20% of total federal transfers to Manitoba. Many of these arrangements are scheduled for renewal or expiration around the time of the expiry of major federal transfers. As the Mowat report points out: "Given their importance to provincial and territorial economies and Canada's overall social union, they [other transfers] must be considered as part of the transfer system" (page 5).