Budget Paper D

UPDATE ON MAJOR TRANSFER ARRANGEMENTS

Manitoba

UPDATE ON MAJOR TRANSFER ARRANGEMENTS

CONTENTS

INTRODUCTION

Canada is a federation, meaning that it has multiple orders of government. Federal and provincial/territorial governments have varying roles and responsibilities within the federation which are set out in the Canadian Constitution.

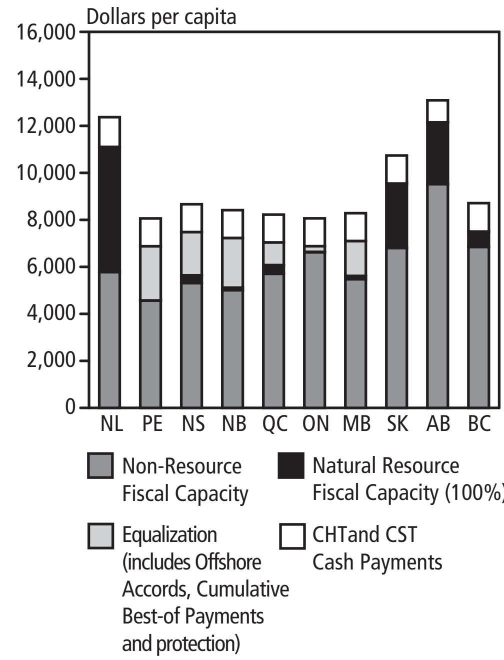
In Canada, the federal government has an important and constitutionally defined role to collect revenues through taxation on behalf of all Canadians in order to meet national priorities and objectives. Program delivery is largely the responsibility of the provinces and territories, including primary spending responsibilities in the areas of health care, education and social services. Federal transfers, including the Canada Health Transfer (CHT), Canada Social Transfer (CST), Equalization and Territorial Formula Financing (TFF), are an important source of revenue for all provinces and territories to help fund these critical public services.

Provinces and territories have the power to raise their own revenues. However, while the provinces and territories endeavor to provide comparable services to their citizens, not all provinces have the same revenue-raising capacity to address those responsibilities. This is due to a number of factors, including the extent to which a province has access to revenues related to natural resources.

Ensuring that all Canadians have access to needed public programs and services is why Canada has major federal transfer programs. All provinces and territories receive the CHT and CST, and all provinces have received payments from the Equalization Program at one time or another.

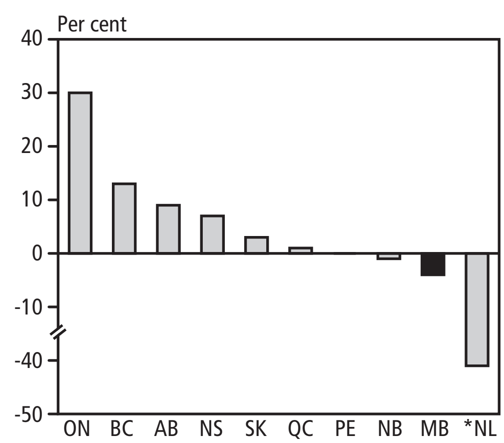
In Manitoba, the total amount of major transfers funding has not increased on a year-over-year basis since 2009/10. However, over the same period, total major transfers to many other provinces, including Ontario, Saskatchewan, Alberta, British Columbia and Nova Scotia have increased substantially. Even after adjusting for population, most provinces experienced increases in their major transfer payments since 2009/10. With the exception of Newfoundland and Labrador, Manitoba saw the largest per capita decrease in major transfers of all the provinces between 2009/10 and 2012/13.

Sources of Provincial Government Fiscal Capacity



Source: Finance Canada

Per Capita Change in Total Major Transfers, 2009/10 to 2012/13



Note: Total Major Transfers (CHT, CST, Equalization, includes Offshore Accords, Cumulative Best-of Payments and protection)

*NL no longer qualifies for Equalization or Offshore Accord payments, resulting in a marked decrease in total transfers in 2012/13.

Source: Finance Canada

THE COMMITMENT TO WORK TOGETHER ON FISCAL ARRANGEMENTS

Given the varying responsibilities of the orders of government in our Canadian federation, the effectiveness of fiscal arrangements in Canada continues to be a key factor in our success as a nation.

In its 2006 budget, the federal government clearly noted the importance of working co-operatively with the provinces and territories on fiscal arrangements.

"Cooperation and collaboration between the Government of Canada and the provinces and territories have been critical to the development of the Canadian federation. Federal, provincial, territorial and municipal governments, working together, have created a network of programs covering health, education, social services, infrastructure, justice and a range of economic and social policies designed both to improve the quality of life of Canadians and to enhance the economic performance of the country.

Fiscal arrangements underpin the relationship between governments. They support the achievement of shared national objectives, reduce interprovincial disparities and provide territories with funding in recognition of the unique challenges of Canada's North."

Page 7 of the (federal) Budget 2006 Restoring Fiscal Balance in Canada

"Premiers are working together because they are all committed to the basic principle that no jurisdiction should be worse off. Canada's fiscal arrangements should be a win-win for all Canadians regardless of where they live."

Council of the Federation (2012) communiqué "Premiers Appoint Working Group on Fiscal Arrangements"

Canada's premiers have also demonstrated their ongoing commitment to working together to achieve effective fiscal arrangements. Premiers share the objective of having a federal transfer system that works for the benefit of all Canadians. This was reiterated at the January 16-17, 2012, Council of the Federation meeting in Victoria where Premiers shared their views on fiscal arrangements. They appointed a Working Group on Fiscal Arrangements, led by Manitoba Premier Greg Selinger, and composed of finance ministers from all provinces and territories, to assess the impact of current federal fiscal proposals for renewal.

Major transfers to provinces and territories are governed by federal legislation and typically include a set term with built-in renewal timeframes. All three major transfers, the CHT, CST and Equalization, are due to expire at the end of 2013/14. While there are no constitutional or legal provisions for intergovernmental consultations, the federal government has historically consulted with the provinces and territories before making significant changes to transfer arrangements.

The World Bank's 2005 submission to the Expert Panel on Equalization evaluated various institutional arrangements for fiscal equalization around the world. In its report, the World Bank noted that "The Federal Government of Canada… places a strong emphasis on intergovernmental consultation and shared decision making on intergovernmental fiscal transfers. Federal-provincial fiscal arrangement committees play a pivotal role in providing substance to such dialogues...."

A Framework for Evaluating Alternate Institutional Arrangements For Fiscal Equalization Transfers by Anwar Shah, World Bank, April 2005

In the past, premiers and finance ministers have been able to share their perspectives at federal/provincial/territorial meetings prior to program renewal, and have generally been engaged by the federal government when proposals for modifying major transfers are being considered.

The federal government made a commitment in federal budgets 2006 and 2007 to work with provincial and territorial governments to build a stronger federation through increased collaboration and openness, particularly as it related to fiscal arrangements.

In Budget 2007, the federal government committed to "…building a stronger federation… built on a vision of open federalism and respectful relations, where governments collaborate effectively to deliver results for Canadians."

Page 106 of The (federal) Budget Plan 2007

In recent years, however, the federal government has implemented significant changes to major transfers without consulting provinces and territories through the various forums developed for that purpose. Examples include the changes to the Equalization Program announced in November 2008, and more recently the December 19, 2011 announcement, regarding the federal government's intentions for the renewal of the major transfers which were confirmed in the 2012 federal budget. Manitoba is disappointed with this lack of consultation and continues to believe that a successful transfer renewal process must include an opportunity for engagement and meaningful input and dialogue between the federal government and the provinces and territories.

The Federal Proposal

In December 2011, the federal government set out its plans to provinces and territories for the renewal of major transfers in support of the provision of health care, education and other programs and services for all Canadians.

The Canada Health Transfer (CHT) will move to a per capita cash allocation model and will grow by 6% between 2014/15 and 2016/17. Starting in 2017/18, the CHT will grow based on a three-year moving average of nominal GDP growth until 2023/24 with a floor provision to ensure an increase of at least three per cent per year. Protection from year-over-year declines is also included so that no province or territory will receive less than its 2013/14 CHT cash allocation in subsequent years as a result of the move to equal per capita cash.

The Canada Social Transfer (CST) for post-secondary education, social assistance and social services, as well as programs for children will grow at three per cent per year beginning in 2014/15, continuing until 2023/24.

Equalization will continue to grow in line with GDP, and Territorial Formula Financing (TFF) will continue to grow based on its current formula. Federal/provincial territorial officials will complete the review of the technical aspects of Equalization and TFF in time for their renewal in 2014/15.

Source: (federal) Economic Action Plan 2012

Manitoba believes that fiscal arrangements, including Equalization, are an important feature of our Canadian federation. Because of this importance, governments should be guided by a clear set of principles and objectives in developing and altering any aspect of federal/provincial/territorial fiscal arrangements. Manitoba encourages the federal government to take full advantage of existing mechanisms of consultation with the provinces and territories to ensure the success of this renewal process.

THE IMPORTANCE OF FEDERAL TRANSFERS TO PROVINCES AND TERRITORIES

The federal government uses its major transfer programs to support provinces and territories to achieve their primary constitutional spending responsibilities in areas of health care, post-secondary education, child programming and other social services. This is reasonable in that provinces and territories have the practical experience and administrative expertise when it comes to managing the vast and complex range of major social programs that Canadians rely on.

The federal government also uses transfers to build national programs that strengthen the nation. In the 1950s and 1960s, the federal government encouraged the development of nationwide hospital, medical care, social and post-secondary education programs. The costs of these programs were generally shared between the orders of government. However, by 1977, federal support moved from cost sharing to block funding, thereby placing increased cost pressures on the provinces.

Effective fiscal arrangements are an important feature of Canada and its success as a federation. All Canadians contribute to the cost of providing these federal programs through federal personal and corporation income taxes, GST and other taxes. They are not funded by provincial or territorial governments themselves. About 20% of federal government spending is directed through transfers to provinces and territories primarily the CHT, CST, Equalization and TFF.

In 2010/11, federal transfers accounted for between 14% and 41% of total revenue in each province. In 2010/11, 31% of Manitoba's total summary revenue was related to federal transfers. Manitoba's total transfers also include a variety of time-limited and/or program-specific funding; major transfers to Manitoba only accounted for about 25% of both summary revenue and expenditure. Interestingly, the CHT currently only covers about 20% of Manitoba's health expenditures, down from about 24% in 2004/05.

The Role of the Equalization Program

The majority of major transfer funds are distributed to all the provinces and territories through the CHT and CST; only a quarter is distributed through the Equalization Program.

"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."
Constitution Act, 1982 Subsection 36(2)

Equalization is the federal government's transfer program for addressing differences in fiscal/revenue-raising capacity between provinces. The principle of making revenue-equalizing transfers to provinces has been enshrined in the Constitution since 1982.

Manitoba is one of six provinces who will receive Equalization payments in 2012/13; Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island also qualify for Equalization this year. While qualifying provinces change from time to time, all ten provinces have qualified for Equalization at one time or another since the program was introduced in 1957.

Equalization transfers are not intended to be a permanent entitlement; as a province's fiscal capacity increases, its Equalization entitlement declines. Equalization is designed to fill the gap between a province's own fiscal capacity and a national standard, making it possible for provinces to offer their residents reasonably comparable levels of public services at reasonably comparable rates of taxation. Without this equalizing transfer, the residents of provinces with lower fiscal capacity could face higher taxes, higher levels of net provincial debt and/or lower levels of services than those residents in provinces with higher capacity.

The ability to provide comparable public services is important to the success of all provinces individually and the country as a whole. To achieve that objective, Manitoba believes it is important to have a responsive, fair and sustainable Equalization Program that adequately addresses differences in provinces' fiscal capacities.

Sources of Fiscal Disparities in the Equalization Program

The current Equalization Program measures a province's total own-source fiscal capacity based on its ability to raise revenue from five major revenue bases – consumption, business income, property values, personal income and natural resources.

The own-source fiscal capacity of each province for each base is then compared to the benchmark standard – the average revenue-raising capacity of all 10 provinces. Any province whose fiscal capacity is below the national standard qualifies for equalizing payments sufficient to raise its own-source capacity to the standard.

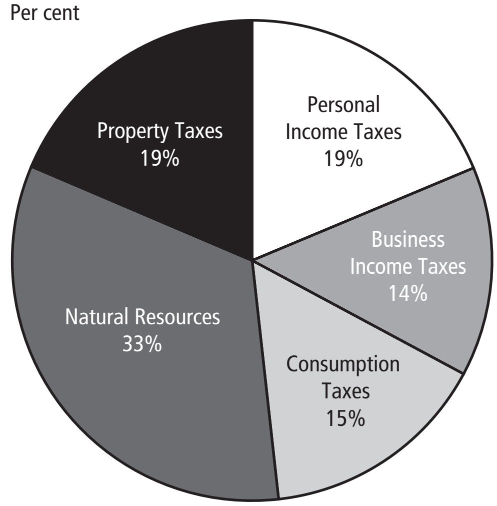
The "contribution" of each revenue base to total Equalization depends on a number of factors, including the size of the base, the amount of revenues to be equalized and the disparities between the provinces within the base.

Currently, the uneven distribution of natural resources is the single most important source of fiscal disparities among provinces. While the natural resource base is small (only five per cent of total revenues subject to Equalization), it is responsible for approximately one-third of total Equalization entitlements in 2012/13. This proportion would be higher if not for the fact that only fifty per cent of natural resource revenue is included in the calculation.

Even with an Equalization Program in place, there remain vast differences in fiscal capacity among the provinces. Equalization payments are not intended to "level the playing field" among provinces – the Program raises the fiscal capacity of receiving provinces to a common standard that is still well below the fiscal capacity of the non-recipient provinces, which remain above average.

Sources of Fiscal Disparities in Canada, 2012/13*

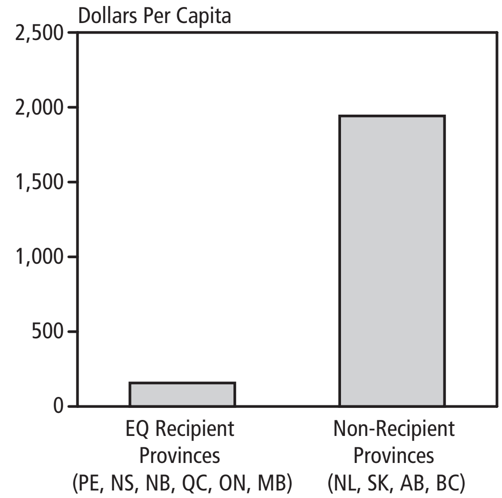
Per cent



* Pre Cap Amounts

Source: Finance Canada (Manitoba Finance calculations)

Combined Fiscal Capacity from Natural Resources, 2012/13



Source: Finance Canada

THE NEED FOR A BALANCED PACKAGE OF FEDERAL TRANSFERS

In a letter to the Council of the Federation in 2006, the Prime Minister acknowledged the existence of a fiscal imbalance in Canada and pledged his commitment to its elimination. Federal budget 2006 also acknowledged the need to restore fiscal balance and committed to developing a principles-based plan to achieve this balance. In budget 2007, the federal government made significant progress on this issue by introducing a complementary package of reforms to major transfer programs that included a commitment to equal per capita cash for CHT and CST balanced with a renewed and strengthened Equalization Program.

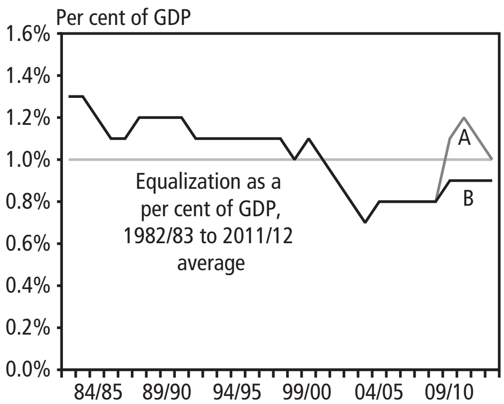
> "A restored fiscal balance will ensure the provinces and territories have the means to build and provide things that matter to Canadians. When the provinces and territories invest in health care, post-secondary education, modern infrastructure, child care and social services, all of Canada is stronger."
> Page 104 of The (federal) Budget Plan 2007

Manitoba supported the plan for improving fiscal arrangements presented in the 2007 federal budget, considering it a reasonable compromise between the divergent views and interests of the provinces. The balance struck in 2007 would allow all provinces, including Manitoba and other non-resource-rich provinces, to better meet their obligations to provide quality programs and services to their citizens.

Part of the plan outlined in budget 2007 included moving both the CST and CHT to per capita funding models. This was achieved for the CST in 2007/08 and will occur for the CHT in 2014/15. The move, in 2014/15, to equal per capita funding will reduce CHT transfers to all provinces and territories except Alberta, which is expected to receive a one-year increase of almost $1 billion. Manitoba's CHT allocation is expected to be about $30 million lower in 2014/15 compared to what it would have received under the current formula.

The 2007 budget also presented a renewed Equalization Program that was based on the recommendations of the federal Expert Panel on Equalization and Territorial Formula Financing, chaired by Al O'Brien, a former Deputy Provincial Treasurer of the Province of Alberta. Manitoba endorsed the strengthened program as progress toward improving Canadian fiscal arrangements overall.

Equalization Payments and GDP: Annual Share and Long-Term Average



A = Level under Budget 2007 Approach

B = Level under capped November 2008 Approach

Sources: Finance Canada and Manitoba Finance

Perhaps the most important feature of the renewed Equalization Program was that the total amount of payments provided to the provinces, and the overall size of the program, would once again be determined using a formula-driven measure of fiscal capacity. Under the strengthened Program, payments would either grow or decline as provincial fiscal capacities shifted over time. Given the intended move to equal per capita CHT and CST payments, a properly functioning Equalization Program is a critical component of a fair and principled system of fiscal transfers.

A STEP BACKWARD IN THE PLAN

In November 2008, the federal government took a step backward from its earlier commitment to ensure "that fundamental fairness is brought back to fiscal arrangements." It made a unilateral decision to constrain the ability of the Equalization Program to meet the constitutional objective of ensuring that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

This "capped" Equalization Program, implemented in 2009/10 (and currently in place) puts a limit on the total amount of Equalization provided to provinces based on the growth in nominal GDP. This means that the program is no longer able to raise provinces up to the national standard.

The O'Brien Panel's recommendation for an "adequate and responsive" Equalization Program has become even more salient in the context of the other changes announced in 2007; namely, the move to equal per capita cash payments under the CHT and CST.

> "The Equalization program should provide sufficient revenues to receiving provinces to allow them to meet the goal of providing reasonably comparable public services at reasonably comparable levels of taxation. The program also should be robust enough to respond to changes in provinces' financial situations and to preclude the need for separate agreements with individual provinces."
>
> Page 43 of Achieving a National Purpose: Putting Equalization Back on Track (the Final Report of the Expert Panel on Equalization and Territorial Formula Financing), May 2006

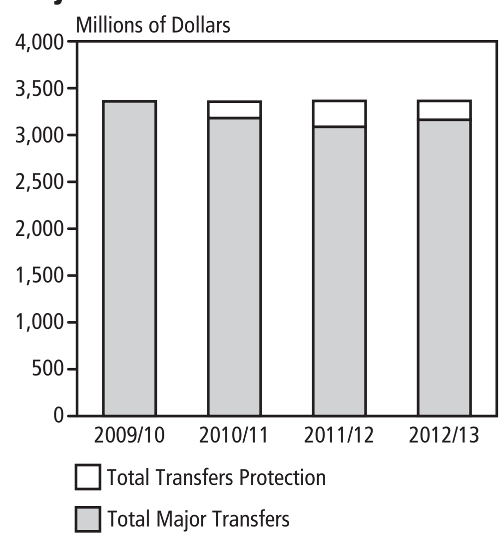
An estimated $15 billion has been removed from the Equalization Program over the past four years as a result of the "capped" program compared to what would have been paid under the fully functioning 2007 program.

Manitoba appreciates that the impacts on Equalization receiving provinces have been partially offset by Total Transfer Protection payments. However, Manitoba believes that the responsiveness and fairness of the Equalization Program has been compromised because the total amount of Program funds distributed to provinces is no longer based on changes in provinces' fiscal capacities. It is now based on growth in the national economy, which is a poor indicator of regional fiscal disparities, particularly in a country as economically diverse as Canada.

Furthermore, by following through on only certain aspects of its 2007 framework, the federal government has compromised the balanced approach to fiscal arrangements it had introduced in 2007. Disparities between the provinces have increased since these constraining changes to the Equalization Program have been implemented.

Manitoba is concerned that these disparities will continue to increase under a transfer arrangement system that allocates the majority of funding to provinces on an equal per capita basis, without a fully functioning Equalization Program, such as the one recommended by the O'Brien Panel.

Major Transfers to Manitoba



Source: Finance Canada

MOVING AHEAD

Manitoba remains committed to working co-operatively with the federal government and the other provinces and territories on renewed fiscal arrangements that provide adequate and appropriate levels of transfers overall and which allocate these funds to jurisdictions in a fair and principled manner.

With the planned move to equal per capita CHT funding in 2014/15, Equalization will be the only remaining major national program that takes into account differences in provincial revenue-raising capacities. This will make it an even more important feature of our Canadian federation

Manitoba knows that the current absence of an adequate and responsive Equalization Program will lead to greater inequities between Canadians with respect to receiving comparable levels of services at comparable levels of taxation, undermining a sense of fairness among Canadians on how they are treated by the federal government.

Manitoba recommends that the federal government restore the fundamental principle of overall fairness to the transfer arrangement system by following through on its 2007 commitment to strengthen the Equalization Program based on the recommendations of the Expert Panel.

Manitoba still believes that the combination of an adequate and responsive Equalization Program and TFF Program, alongside equal per capita cash transfers under the CHT and CST, is a fair compromise and would enable all the governments in our federation to deliver in their combined areas of responsibility to all Canadians.