Chapter 5

Effective, Flexible, and Affordable: Towards a New System of Federal-Provincial Transfers in *Budget 1995*

By Trevor Tombe[*]

"With this budget," said Finance Minister Paul Martin in his 1995 *Budget Speech*, "we are saying yes to the provinces' desire to sit down for a bottom-up review of the financing of both levels of government… if there are ways to make this federation function better, then by all means let's do it" (Martin, 1995: 19). Over the coming months and years, Ottawa and the provinces did just that.

The goal was to "modernize the federal-provincial fiscal regime, making it more effective, flexible and affordable" (Canada, 1995: 7) and to put transfers "on a basis that is more in line with the actual responsibilities of the two levels of government" (Martin, 1995: 7). The eventual changes were substantial.

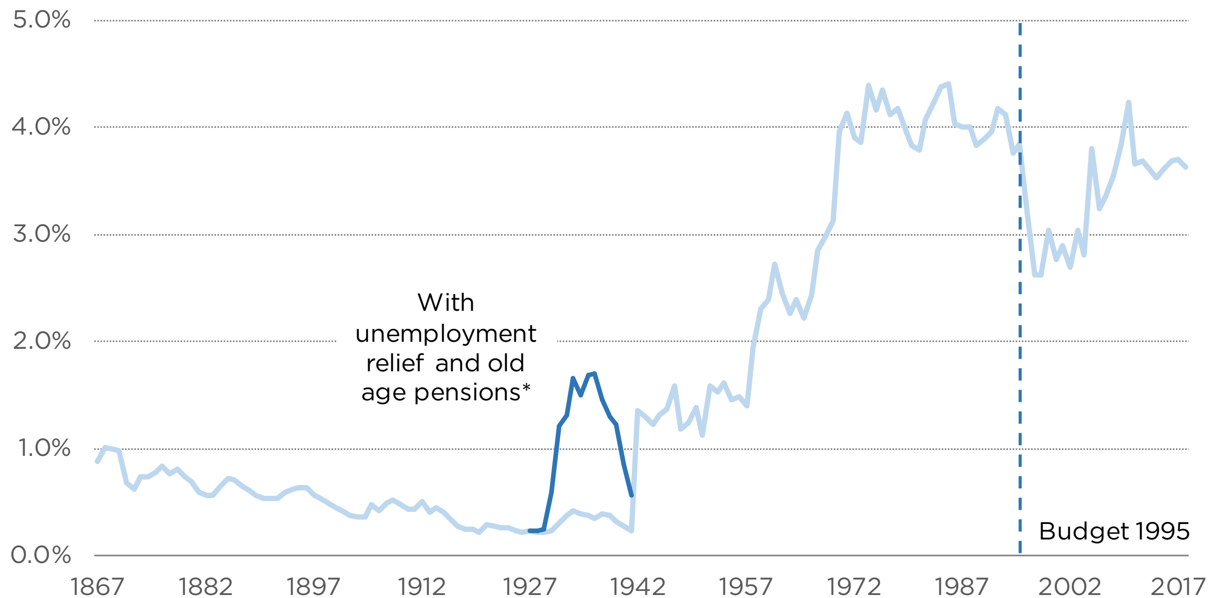
Budget 1995 significantly and fundamentally altered the size and structure of federal-provincial fiscal arrangements in Canada. Today's transfers are less complex, more coherent, more sustainable, and more equitable than what had prevailed throughout most of Canada's history. *Budget 1995* is why.

A new system of transfers to the provinces

First, *Budget 1995* merged two major transfer programs into one. The Established Programs Financing (EPF) and the Canada Assistance Plan

[*] References and the author biography can be found at the end of this document.

Figure 1: Federal Transfers to Provincial Governments, 1867 to 2018[1]



Source: Tombe, 2018.

(CAP) became what *Budget 1995* called a new Canada Social Transfer, later renamed the Canada Health and Social Transfer (CHST).

This was more than a simple consolidation. The previous programs evolved from explicit cost-sharing arrangements and featured many rules that provinces needed to follow. The new CHST was a block grant, with only minor restrictions on provinces imposed through the *Canada Health Act*. This flexibility allowed provinces to innovate in program delivery and disconnected federal spending from provincial decisions.

For provinces, though, this flexibility didn't come cheap. *Budget 1995* reduced total transfers by over 15 percent or $4.5 billion in fiscal year 1997-98 relative to what EPF plus CAP would have been. Specifically, the CHST was projected to transfer $25.1 billion in 1997-98 but would have been a combined $29.6 billion had the EPF and CAP continued. This change alone was roughly three percent of total provincial revenues.

But this way of framing the change understates—dramatically—the hit the provinces took. At the time, federal transfers took two forms: tax-point transfers and cash transfers. The former reflected the value of federal income tax room given over to the provinces decades earlier. Because the provinces' average incomes differ, these tax points had unequal value. The

cash transfer portion was a top-up to those tax points that raised all provinces to a common combined standard. In 1994-95, for example, the total nominal size of the EPF transfer was $735 per person, but the mix between tax points and cash varied. Provinces with higher-value tax points, such as Alberta, got less cash. This matters. Federal policy cannot affect the value of tax points (since they are actually provincial taxes), so the reductions in *Budget 1995* came entirely through significantly smaller cash transfers. *Budget 1995* estimated total non-equalization cash transfers to the provinces at $16.9 billion. By 1997-98, that was projected to fall 40 percent to $10.3 billion.

This represented the largest reduction in federal transfers to provincial governments in Canadian history. As figure 1 illustrates, there were large increases in transfers following the Second World War. They rose from roughly 1.3 percent of GDP in 1945 to over 4.0 percent by 1970, where they remained for a quarter century. That ended with *Budget 1995*, however. Within two years, transfers were down nearly 1.5 percent of GDP—equivalent to a $35 billion per year reduction today. And though they subsequently rose again, they remain today roughly 0.5 percent below their pre-*Budget 1995* level.

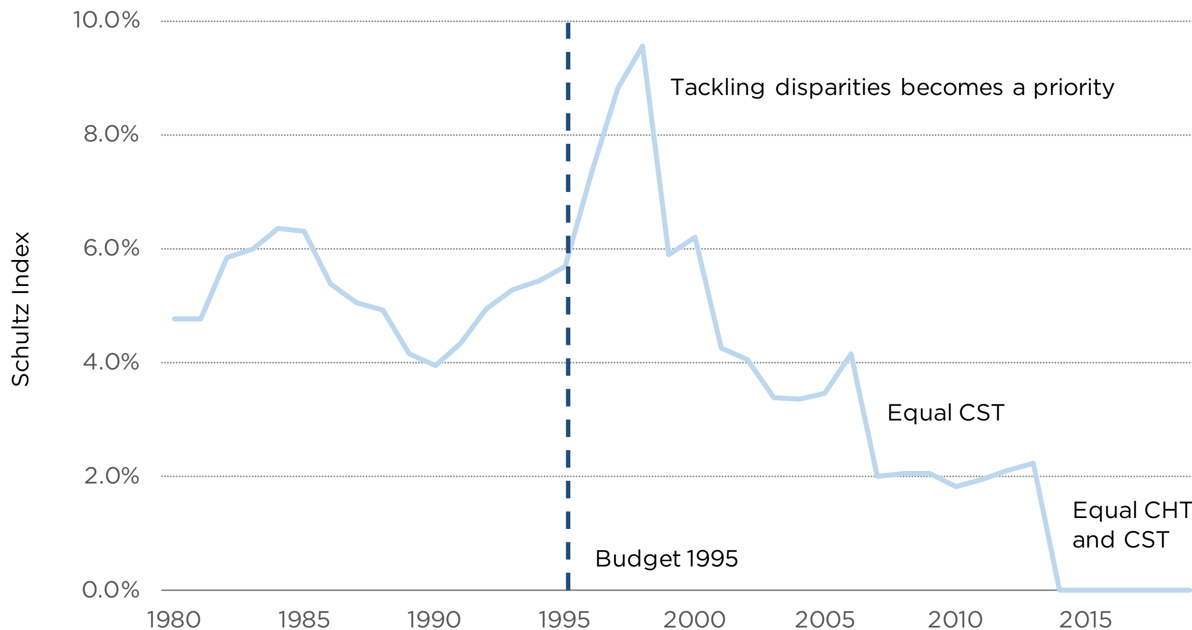
To be sure, *Budget 1995* did not cut all transfer payments. Equalization continued to increase, rising from $8.5 billion in 1994-95 to $9.7 billion in 1997-98. Equalization is designed to address horizontal differences between provinces in terms of their ability to raise revenue (their "fiscal capacity"). And while health and social transfers were not designed to address such differences, they featured significant implicit equalization as cash transfers were larger to provinces with weaker economies and therefore where tax-point transfers were worth less. Because of *Budget 1995*, as we'll see, such differences in the value of cash transfers across provinces would eventually end.

Greater equality between the provinces

The tighter budget constraints of the mid-1990s made allocation rules for cash transfers critical. The federal government committed to "consult with provinces on the principles that should govern allocation of the [Canada Social Transfer] on a permanent basis thereafter" (Canada, 1995: 54. The effects of the resulting changes remain with us today.

Before *Budget 1995*, inequality in health and social transfers varied from year to year but, roughly speaking, approximately five percent of total transfers would have had to be reallocated in order to achieve perfect equality between the provinces. The funding reductions in *Budget 1995*

Figure 2: Inequality in Federal Health and Social Transfers, 1980 to 2018[2]



Source: Own calculations using historical Finance Canada data on the per capita allocations of health and social transfers. Raw data available at https://open.canada.ca/data/en/dataset/4eee1558-45b7-4484-9336-e692897d393f.

dramatically increased disparities among provinces. When the cuts were fully phased in, the level of inequality was roughly double its pre-1995 level, as illustrated in figure 2 using a Schutz Index of inequality.

The cause of the large increase in inequality relates to the distinction between cash and tax-point transfers. As mentioned, only the former could be cut and their uneven distribution meant provinces with small per-capita cash transfers experienced a proportionally larger reduction. The drop in Alberta's transfer by 1997-98, for example, was one-third larger than the national average.

Following consultations with the provinces, the federal government committed in *Budget 1996* to a new five-year funding arrangement that, beginning in 1998-99, would gradually bring the allocation of health and social transfers closer to proportionality with provincial populations. By the government's own measure, it planned to cut disparities in half by 2002-03. And it succeeded. But the process didn't end there. In the government's words, it remained "willing to examine with provinces further

refinements to the allocation that may be appropriate beyond 2002-03" (Martin, 1996: 12).

Eventually, as fiscal pressures eased and federal transfers increased, equal per-capita allocations became the new benchmark for cash transfers. In *Budget 1999,* for example, an additional $11.5 billion in increased CHST funding over five years was announced and the government allocated the entire increase on an equal per-capita basis (Canada, 1999: 83-84). If a province accounted for 10 percent of the Canadian population, it would receive 10 percent of the increased funding. Subsequent budgets, especially the Harper government's *Budget 2007*, provided for the completion of this process by 2014. Today, all major health and social transfers are equal per capita. Were it not for the changes in *Budget 1995*, these transfers would look very different today.

Provincial revenue stabilization

Finally, *Budget 1995* introduced changes to a rarely used but important federal program: Provincial Revenue Stabilization. Begun in 1967, this program provides additional transfers to provinces that experience a sharp drop in their own revenues. Originally, if a province's total revenues declined more than five percent, the federal government would cover the losses. This provided a kind of insurance that helped pool risks associated with severe economic downturns across all provinces. This deductible was removed in 1972, making it easier for provinces to qualify. *Budget 1995*, sensibly, put it back. After all, insurance arrangements must consider moral hazard and deductibles are an effective tool to mitigate this risk.

Much of the *Budget 1995* language grounded this decision in the original principles of fiscal stabilization as designed in 1967. And it reiterated that "the federal government will continue to play a role in stabilizing revenues of provincial governments, but only in times of severe economic shocks, as was originally intended when the program was introduced" (Canada, 1995: 55). This job is not yet finished.

Specifically, there remains a $60 per person cap on payments that was originally imposed in 1987. There was no such cap in 1967, as it severely limits the program's ability to provide meaningful insurance to provincial governments. In effect, provincial revenue declines in excess of five percent are insured—but only up to six percent. There is therefore no material revenue insurance in Canada today. This matters. When two oil-producing provinces (Alberta and Newfoundland & Labrador) qualified for stabilization payments in 2015-16, for example, they received only the small $60 per person amount. And a second payment to Alberta for

2016/17 was also constrained by the $60 per person cap. The sentiment expressed in *Budget 1995*—the commitment of the federal government to stabilize provincial revenues—may motivate further changes to the stabilization program today, such as easing the cap and moving yet closer to the original 1967 principles of stabilization policy design.

More effective, efficient, and affordable transfers

Budget 1995 enhanced the effectiveness and efficiency of federal transfers. Provincial flexibility ensured health and social transfers supported provincial autonomy and decentralization. Greater equality (and eventually perfect equality) in the allocation of health and social transfers meant regional differences would be addressed only through a single program: equalization. This division of objectives between the major transfer programs is productive. It may even have helped facilitate reforms to equalization recommended by the Expert Panel on Equalization and Territorial Formula Financing in 2006 and implemented in *Budget 2007*, something no one in 1995 could have foreseen.

While federal-provincial fiscal arrangements are always evolving in response to competing economic, social, and political pressures, the transfer reforms in *Budget 1995* left an important legacy that remains with us to this day.

CHAPTER 3: How the Chrétien-Martin Budgets Cut Corporate Welfare in the Mid-1990s
by Mark Milke

1. A full review of the literature on business subsidies is available in a past report (Milke, 2007: 27-36).

CHAPTER 4: *Budget 1995* and Welfare Reform
by Ronald Kneebone and Jake Fuss

1. For more details on these and other policy changes affecting eligibility, see Kneebone and White (2009) and Berg and Gabel (2015).

2. These percentages varied slightly by province. The outlier is Quebec where the cash payment fell from 74 percent of the total benefit in 1997 to just over 42 percent in 2018. Data on social assistance benefits are from Maytree (Tweddle and Aldridge, 2019).

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1. The federal government shared the provincial cost of unemployment relief and old age pensions until those became federal programs. This calculation includes support for the blind and youth training.

Note: Displays total federal (cash) transfers to provincial governments as a share of national GDP. The shaded region marks the period from 1942 to 1946 when the Wartime Tax Agreement was in effect. Post-war transfers here include conditional grants.

2. Note: Displays the fraction of health and social transfers that would need to be reallocated to achieve equal per-capital allocations across provinces (known as a Schultz Index).

CHAPTER 6: Chrétien's Fiscal Anchor: A Key to His Government's Success
by David Henderson

1. Notes: (i) Actual Revenues come from the Public Accounts rather than Fiscal Reference Tables because of accounting changes made in 2003; (ii) Budgeted numbers in 2002 come from the 2002 Economic and Fiscal Update since there was no budget tabled that year.

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Trevor Tombe is an Associate Professor of Economics at the University of Calgary and a Research Fellow at The School of Public Policy, University of Calgary. He has an MA and a PhD in Economics from the University of Toronto. Much of his research focuses on trade, public finance, productivity, and Canadian economic and fiscal policy. He has published in top economics journals, including the *American Economic Review, Journal of Monetary Economics, Review of Economic Dynamics,* and *Canadian Journal of Economics*, among many others. He is an active contributor to Canadian policy debates, with publications through the University of Calgary's School of Public Policy and in the general media. He has also served on various expert panels, including the Yukon Financial Advisory Panel and the Alberta Market Access Task Force.

Niels Veldhuis is President of the Fraser Institute. He has written six books and more than 50 peer-reviewed studies on a wide range of economic topics. He has written more than 200 articles and commentaries that have appeared in over 50 newspapers including the *Globe and Mail, Wall Street Journal, National Post*, and the *Economist*. He holds a Bachelor's Degree in Business Administration, with joint majors in business and economics, and a Master's Degree in Economics from Simon Fraser University.

William Watson was born and raised in Montreal and educated at McGill and Yale. He taught economics at McGill from 1977 to 2017. He is best known for his regular columns in the National Post and for his appearances on Canadian radio and television. He is a senior fellow at the Fraser Institute, where he blogs weekly. His book, *Globalization and the Meaning of Canadian Life*, published by the University of Toronto Press, was runner-up for the Donner Prize for best book on Canadian public policy of 1998. His latest book is *The Inequality Trap: Fighting Capitalism instead of Poverty*.