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Backgrounder

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The Social Union Agreement: Too Flawed to Last

by

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The dominant reaction to last week's social union agreement among Ottawa and nine provinces has been congratulatory. The governments involved have been fulsome in praising their accomplishment: boosting Ottawa's transfers to the provinces, giving the federal government new legitimacy when it acts in areas of provincial jurisdiction, and demonstrating the flexibility that is said to be the hallmark of Canadian federalism. Although the package contains a number of measures that can enhance the benefits Canadians enjoy from the national economic and social union, a longer view suggests that the congratulations are misplaced.

Canadians have spent almost two decades trying to reduce the friction in the Canadian federation and ease the consequent threat to national unity. With the effort and thought of those years to draw on, the participants in the social union negotiations might reasonably have been expected to strike a deal that would have sorted out federal-provincial overlaps, made federal-provincial transfers fairer and more transparent, and brought Quebec in as a cooperative partner.

The agreement reached on February 4, however, failed on all these counts. Even the short-term euphoria over bigger federal injections of health care money may fade quickly unless Ontario and Alberta in particular can remedy, after the fact, the adverse fiscal consequences of their over-hasty agreement. And the more protracted efforts needed to blunt the centralizing features of the package so that Quebec can sign on as a full partner will be daunting indeed.

Background

Last week's package had two elements. One was a document entitled *A Framework to Improve the Social Union for Canadians*, signed by the federal government and the governments of all the provinces excluding Quebec. The other was a commitment of some sort — the details are probably not clear even to the parties to the deal — by Ottawa to increase its health-related transfers to the provinces.

The thinking about jurisdictional issues that underlies the social union document goes back years. The provinces, Quebec foremost among them, have sought to restrain Ottawa's use of transfer payments and direct spending in areas of provincial jurisdiction. Drawing on the political analysis of supporters of "classical" federalism, elements in these proposals have included ensuring that new federal programs in those areas meet with substantial provincial approval, requiring advance notice for modifications to funding or other program conditions, and ultimately spelling out a provincial right to opt out under certain conditions.

The objective of these proposals was to enhance the efficiency, accountability, and flexibility of social programs by promoting cooperation among governments while containing the conflicts that arise when jurisdictions overlap. The National Child Benefit — which provides a common federal base (an augmented federal child tax credit) on which rest various provincial programs aimed at improving the job prospects of low-income families with children — provides a useful example of what can be achieved under such a framework.

Ottawa also had some key, longstanding aims in the social union negotiations: to secure Canadians' right to move freely across the country, and to improve the portability and comparability of social programs across provinces. These objectives have the obvious potential to enhance the benefits of Canada's economic and social union for individual Canadians. Ottawa also clearly believed that it could better achieve these aims if the provinces signalled their acquiescence to the contentious spending power.

In addition to these longstanding jurisdictional issues, shorter-term fiscal forces determined the timing and nature of the agreement. On the federal side, past spending cuts and current high taxes have produced a sizable (though deliberately understated) budget surplus. From Ottawa's point of view, the prudent paying down of debt or a broad-based tax cut appears less politically rewarding than more spending, especially if the lure of bigger transfers proved powerful enough to win provincial agreement on some mobility provisions. Having more money to put on the table may also have led Ottawa to feel that it had a tool with which to win over a reluctant Quebec.

On the provincial side, seven provinces are net gainers from federal transfers, since their citizens pay a smaller share of federal taxes than their governments receive from Ottawa. The interest of those provinces in bigger federal-provincial transfers is straightforward. In the other three provinces — Ontario, Alberta, and British Columbia — the net impact of federal transfers is negative. In their case, a combination of inattentiveness and accidents of the electoral cycle seem to have led to a judgment that additional fiscal penalties, federal-provincial friction, and the isolation of Quebec were costs worth bearing for the sake of having Ottawa raise the money to fund their health care services rather than raising it themselves.

The Agreement: What We Know

Last week's package reflected these cross-cutting forces. The stated aim of the social union agreement is to commit the federal, provincial, and territorial governments to work more cooperatively and efficiently in the funding and delivery of social programs for Canadians while leaving existing constitutional jurisdictions and powers untouched.

On the positive side, the agreement does contain renewed commitments by the provinces regarding the mobility of persons within Canada. It also includes commitments by governments to more monitoring of the outcomes of social programs through, for example, the development of comparable indicators. Such monitoring would allow provinces to shape policies in accordance with their own circumstances and preferences, while encouraging a "race to the top" based on the successes of other provinces in addressing the same types of needs.

When it comes to the contentious issue of the federal spending power in areas of provincial jurisdiction, however, the agreement shows little evidence of the decade-plus effort at sorting out this problem. The agreement does state that Ottawa will consult with the provinces regarding renewal of or significant changes to conditional block grants and shared-cost programs, build due notice provisions into any new social transfers, and collaborate with the provinces and territories to identify priorities and objectives of any new transfer. It also provides that, while provinces would essentially have to subscribe to the objectives of new transfers, each would be free to set the "detailed program design and mix" and, if already meeting the objectives, each could allocate the funds to the "same or related" priority area.

Rather than the familiar 7 / 50 (seven provinces containing half of Canada's population) formula for provincial approval, however, the agreement requires only the approval of six provinces — which together could account for as little as 15 percent of Canada's population. The deal also says nothing about the conditions under which provinces might opt out if their own priorities — in, it bears emphasizing, areas under their responsibility — are at odds with those of other provinces. With a minority able to dictate to a majority how much money to spend and what services to provide, the agreement may turn out to promote centralization rather than the flexibility that ought to be the hallmark of federalism.

Little in these provisions holds out hope for avoiding initiatives such as last year's Millennium Scholarship Fund, which increases the awkward overlap of federal and provincial programs in an area of provincial jurisdiction. Indeed, the importance of such direct federal transfers to individuals had led to proposals for limits on Ottawa's spending power in these areas similar to the limits on conditional transfers to provinces. Under the February 4 agreement, however, Ottawa undertakes only to give at least three months' notice to provinces for new transfers of this kind connected with health, postsecondary education, social assistance, and social services, and to consult with the provinces to identify potential duplication and work toward "flexible and effective" implementation.

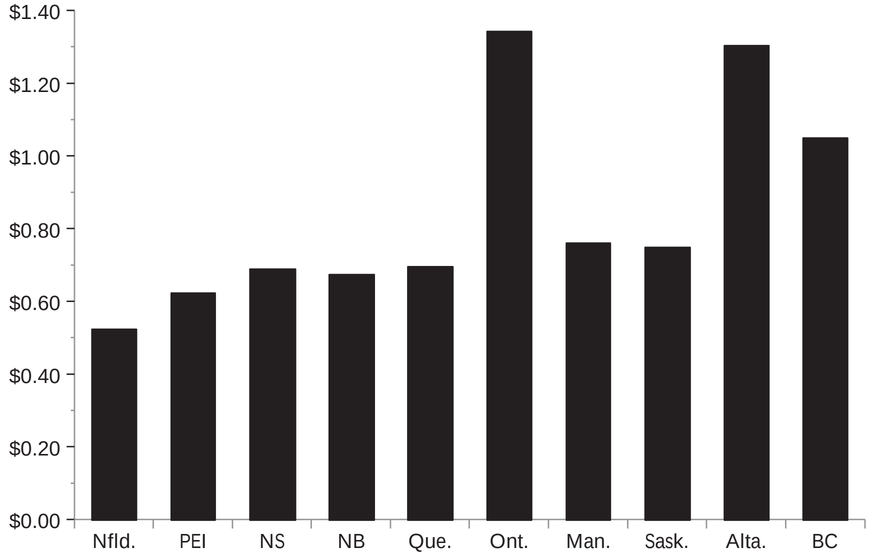
The Agreement: What We Do Not Know

It is clear that the lure of money swayed the nine provinces that signed the deal away from their previous unanimous stance in favor of restraining the spending power. Surprisingly, then, not only are the amounts of new health transfers not specified, but a key and potentially highly contentious issue — their distribution around the country — appears still to be up in the air.

Many commentators — and possibly some provincial negotiators — appear to regard increased federal spending as money from nowhere, or at least raised from taxpayers outside Canada. But all federal tax money is, of course, raised from taxpayers resident in provinces or territories. Increased federal transfers will be reflected in taxes higher than they would otherwise be, either right away if they preclude tax cuts otherwise planned for this year's budget, or over time in higher interest payments if they preclude the paying down of debt. What looks at first glance like new money for everybody will, therefore, ultimately turn into a net loss for taxpayers in some provinces.

For provinces whose citizens pay a smaller share of federal taxes than their governments reap in Canada Health and Social Transfer (CHST) payments, the net gain from higher payments under the agreement might be enough to offset the frictions and lost efficien-

Figure 1: ***Effective Cost in Federal Personal Income Taxes of an Extra CHST Dollar, by Province***



cies involved in federal co-management of health care. For these provinces, the extra federal personal income taxes involved in raising CHST payments by enough to give the province one extra dollar averages 67 cents (see Figure 1). But for Ontario, Alberta, and British Columbia, the loss of focus and flexibility in service delivery is compounded by the fact that higher federal transfers will actually cost their residents money.

For these provinces, it will be critical to limit the net cost of higher federal transfers by ensuring that Ottawa doles out an equal amount of new health money per person for every province. Better yet would be to insist that Ottawa use the opportunity presented by this new deal to accelerate the reducing of interprovincial inequities in the allocation of CHST money.

The Agreement: Structural Flaws

The near-term difficulties associated with the new health transfers, however, are only the tip of a much larger iceberg. The agreement could worsen the problem of rich provinces' not being able to set priorities for programs they are ultimately responsible for delivering, and for which their residents pay the lions' share — the same problem that led these provinces to complain bitterly about the "cap on CAP" — because its provisions could well exacerbate Ottawa's unfair treatment of them. If the agreement empowers provinces with roughly one-seventh of Canada's population, in conjunction with a federal government oriented around the desires of swing voters in those same provinces, to decide how residents of other provinces will be taxed and what social programs they will receive, the Canadian federation will suffer from more friction in the future, not less.

The triumph of short-term political considerations over longer-run economic and social benefits is, of course, nothing new. But this deal stands out for having ignored what may be the most decisive political consideration of all: the danger of Quebec's progressive isolation from the rest of the country.

In the short term, the problem is clear: Ottawa and the rest of the provinces, with varying degrees of enthusiasm, have forced Quebec to stand alone in defense of its constitutional rights. That Quebec, which stands to do relatively well out of increased federal transfers, saw other provinces give in so rapidly and completely for the sake of money from Ottawa will do nothing to increase Quebecers' sense that cooperation with the other provinces is worth the effort.

Over the medium and longer term, the social union agreement is divisive in a way that the opponents of the Meech Lake Accord feared. It creates two classes of Canadians, those in Quebec, who will not be subject to the mobility and nondiscrimination commitments, and those outside Quebec, who will be. In practical terms, every new initiative under the agreement will present a fresh dilemma: Quebec will either get transfer money without having had to agree to broad rules of engagement *vis-à-vis* Canadians in other provinces, or the federal government will deny Quebec money that the other provinces are receiving.

Next Steps

The misplaced euphoria surrounding last week's deal is likely to fade quickly. Growing awareness of the longer-term jurisdictional and fiscal implications of more federal involvement in areas of provincial responsibility, without a compensating right of provincial opting out, will temper some of the enthusiasm. And the momentum given to Quebec's disengagement from the rest of Canada by its isolation on this issue threatens even graver consequences. Several steps could help address the longer-term problems before they grow.

First, Ontario, Alberta, and British Columbia need to press Ottawa on the immediate question of how new transfers will be allocated, seeking to undo the CHST's inequities before they get further entrenched. They also need to curb the scope of the program changes that can be approved by Ottawa and six provinces alone or change the amending formula to the more defensible and familiar 7/50 standard.

Second, provinces must seek ways of reopening the social union accord so that Quebec can sign on. Since the agreement contains provisions for re-evaluation after three years, an opportunity to establish more extensive opting-out provisions, balanced by more stringent obligations of transparency, portability of key programs and credentials, and respect for the citizenship rights of all Canadians, will arise shortly. Preparing in advance would help to ensure that this accord's failings — Quebec's exclusion prominent among them — are not repeated.

For almost two decades, Canadians have sought ways to improve the functioning of the federation and enhance Canada's chances of survival as a united country. For almost as long, Canadian governments have wrestled to bring their spending in line with their citizens' willingness to pay. It would be a great shame if the desire for a short-term fix evident in last week's accord overruled the lessons of that effort. Ottawa and the provinces need to stop congratulating themselves on a flawed package, and get back to work fixing it.

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