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Backgrounder

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Who Gets What? The 1999 Federal Budget and the CHST

by

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The Canada Health and Social Transfer (CHST), the largest program of federal-provincial payments, was front and center in the February 1999 federal budget. The budget proposed to raise Ottawa's CHST payments to the provinces from $12.5 billion to $15 billion in fiscal year 2001/02, and distribute CHST money more equally on a per person basis among the provinces.

Since the budget, there have been conflicting statements from Ottawa and some provincial capitals about how much money will go where. The new arrangement does mark a major step toward a more equal distribution of CHST money. As is typical with federal-provincial transfers, however, the CHST's evolution has yielded a program rather different from what Canadians would choose today if they could start from scratch. It has several wrinkles that obscure the flow of money.

This *Backgrounder* attempts to lay out the current and future distribution of CHST money as clearly as possible. We present some background, show the numbers that underlie the budget proposals, and close with some thoughts about possible further reform and simplification of the program.

How We Got Here: A Brief History

The CHST redresses what is often called "vertical imbalance" in the taxing powers and spending responsibilities of Canada's federal and provincial governments. Thanks largely to changes made before and during World War II, Ottawa has had readier access than the provinces to rapidly expanding personal and corporate income tax bases. But over the past 40 years, the bulk of rapidly expanding social programs have been under provincial jurisdiction. The response was a series of transfers, both of tax "room" and cash, related to postsecondary education, health care, and welfare: precursors to today's CHST. By contrast, equalization, the other major federal provincial transfer, addresses "horizontal imbalance" among the revenue-raising capacities of different provinces by topping up the budgets of the less well off.

The CHST's Precursors

An early CHST precursor was federal cash grants to the provinces in support of universities, which started in the early 1950s. Quebec's dissatisfaction with this arrangement prompted a transfer of tax room in 1960: Quebec received a special tax reduction (an abatement) of federal corporate taxes that allowed it to collect revenue to fund its universities directly.

Federal cost sharing in health care began in the late 1950s. In 1965, Ottawa offered an abatement of personal income taxes to provinces wishing to finance more of their health and education programs themselves, an offer only Quebec took up. In 1966, the Canada Assistance Plan (CAP) established 50-50 cost sharing between Ottawa and the provinces for specified provincial welfare programs. And in 1967, Ottawa established abatements of corporate and personal taxes for all provinces, giving them room to raise additional revenue for health and education. These abatements appeared as a line on the tax form reducing federal tax otherwise payable until 1972, when they became straight reductions in federal tax rates.

The Established Programs Financing (EPF) agreements of 1977 and 1982 pushed federal-provincial fiscal arrangements toward their current form. In 1977, Ottawa ceded further tax room, cutting its personal tax rates, while the provinces increased theirs. EPF also entailed cash payments distributed among the provinces according to their past spending on health and education. Total EPF entitlements grew over time according to a formula that tracked growth in the economy.

In 1982, a new formula made equal per person EPF entitlements — tax room plus cash — the benchmark for each province. This approach meant that the cash component offset the different yield of the ceded tax room in richer and poorer provinces, so that total per person notional federal support for provincial health and postsecondary education programs was the same everywhere.

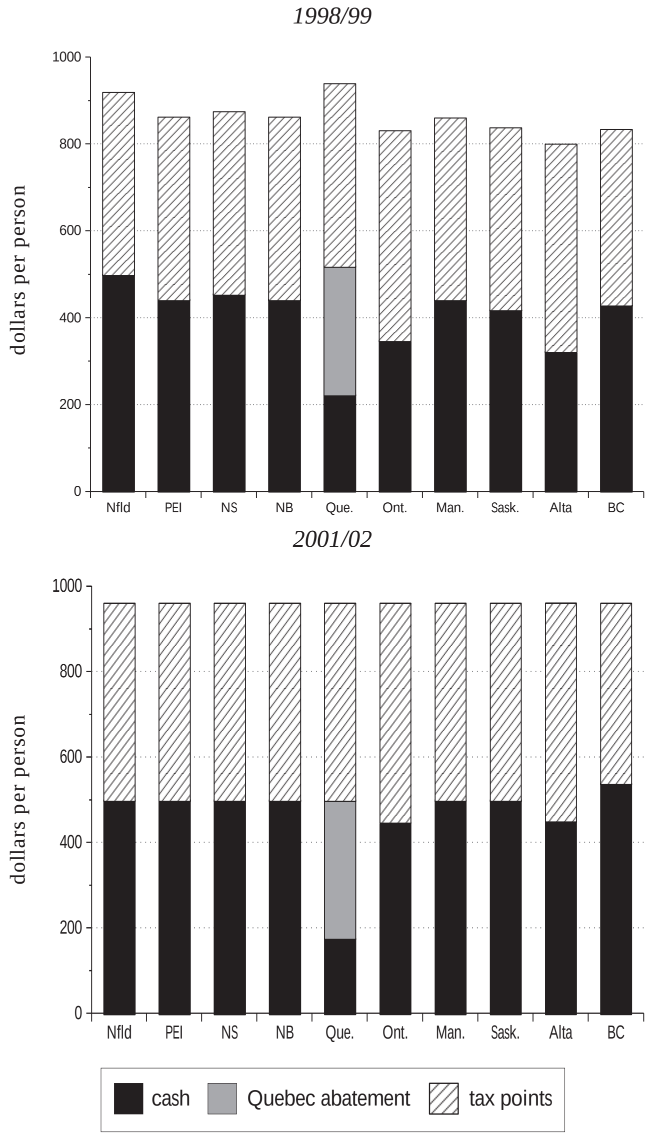
For the next 13 years, increasing budgetary problems led Ottawa to scale back the formula determining total EPF entitlements. And since economic growth was raising the notional value of the tax points, limits on the growth of the total entitlement meant that the aggregate cash transfer grew more slowly — which, in turn, meant that differences between the per capita cash transfers to provinces with healthier tax bases and those with less healthy tax bases began to loom larger. Fiscal pressure further complicated the design of the CHST's ancestors in 1990, when Ottawa capped growth in CAP transfers to Ontario, Alberta, and British Columbia to limit its exposure to the then-exploding growth in welfare programs.

The Advent of the CHST

The 1995 federal budget folded EPF and the CAP into the CHST. Its ancestry marked the CHST in two ways. First, its basic structure was inspired by EPF: federal legislation determined each province's entitlement — tax room plus cash — and actual cash transfers were determined by subtracting the notional value of the tax points from the entitlement. Second, the provincial allocation of the aggregate entitlement in the CHST's first year reflected the distribution of EPF and CAP entitlements in their last year, perpetuating — in fact, thanks to its neglect of different rates of population growth, accentuating — the differences between the cash transfers to Ontario, Alberta, and British Columbia and those to other provinces that existed in the mid-1990s.

Subsequent budgets attended to both wrinkles. In 1996, Ottawa, by putting a floor (set at $11 billion and later raised to $12.5 billion) under the aggregate CHST cash transfer, implicitly acknowledged that the provinces now “owned” the tax room and that cash was what counted in federal-provincial relations. Then in fiscal year 1997 / 98, Ottawa began a phased reallocation of provincial entitlements, so that by 2002 / 03, half of the difference between the historical distribution and an equal per capita entitlement would disappear.

Figure 1: ***CHST Entitlements by Province, fiscal years 1998/99 and 2001/02***



The 1999 Budget

The changes in the February 1999 budget addressed these same two wrinkles again. Total CHST cash is now set to increase from $12.5 to $15 billion by fiscal year 2001 / 02. The additional $2.5 billion will be distributed among the provinces on an equal per person basis. Second, the elimination of differences among per capita CHST entitlements by province will accelerate, so that total tax points plus cash per person will be the same in all provinces by 2001 / 02.

Looking ahead, then, Ottawa will determine the CHST cheque to each province in 2001 / 02 by

- calculating the aggregate national CHST entitlement (tax room plus cash) using the old $12.5 billion cash floor;
- dividing it among the provinces on an equal per person basis;
- subtracting the notional value of the tax points in each province to get an interim cash amount (the Quebec abatement further reduces the cash Ottawa sends Quebec); and then
- adding the new money announced in the 1999 budget, distributed equally per person to all provinces.

Figure 1 shows the projected per person entitlements in each province in both 1998 / 99 and 2001 / 02. Table 1 also shows total entitlements and cash for each province for each year.

On a per person basis, cash transfers to Ontario and Alberta will still lag those to other provinces. The notional value of the tax points is greater in those provinces, and the equal per person distribution of new money does not, for obvious reasons, narrow the gap.

But the distribution of cash among the provinces will change profoundly. The big factors are the new emphasis on equal per person entitlements, differing provincial population growth — by 2001 / 02, Ontario, Alberta, and British Columbia will likely have almost 5 percent more people than in 1998 / 99, as opposed to 1 percent more in the other provinces together — and differing economic outlooks, which cause the relative value of tax points to change. Cash transfers to Ontario, Alberta, and British Columbia are projected to rise by 35 percent, while those to the other provinces will rise by 3 percent. Quebec and Newfoundland will actually see their cash amounts fall, as shown in the first panel of the table.

Reactions

Not surprisingly, this pronounced shift in the distribution of CHST money has provoked strong responses. For Ontario and Alberta, which contribute disproportionately to the federal tax revenue that supports these payments, the accelerated move to equal per person entitlements is a major triumph. For Quebec and Newfoundland, which contribute less than their population share to federal revenues, the change in financial arrangements is a bitter blow.

That eliminating an existing unfairness in the distribution of CHST money could provoke such sharp condemnations is a caution that federal-provincial transfers may be less conducive to national unity than is sometimes maintained. In the wake of these announcements, what steps might Canadians take to make these transfers less contentious?

Cash Is King

Ottawa's emphasis in the February 1999 budget on the aggregate amount of CHST cash highlights the fact that the tax room transferred to the provinces in the mid-1970s is, by fiscal standards, ancient history. The fact that differing notional values for these points in the various provinces continues to affect the cash transfers at all is an anomaly. Both fairness and transparency would require that, if money for health care must be recycled through Ottawa, the cash distributions to the provinces should be equal per capita. Unlike the Quebec abatement, which shows as a specific deduction from federal taxes otherwise payable by Quebec residents, the provincial taxes levied on all other tax bases — whether or not they once notionally "belonged" to the federal government — are contributions from provincial taxpayers to provincial social programs.

If, in aggregate, provinces have insufficient ability to collect taxes to meet their needs, Ottawa could step up its cash transfers. But offsetting such an aggregate revenue shortfall does not justify discriminating among provinces. As noted already, the CHST exists to address a vertical imbalance; horizontal imbalances among better and less well off provinces are appropriately dealt with through the equalization program, which directs cash transfers on a scale comparable to the CHST ($10.7 billion in fiscal year 1998 / 99) exclusively to the less well off provinces. On this view, one might argue that the federal government should eliminate the remaining discrepancies among the per person cash transfers to each provincial government after 2001 / 02.

Cutting Ottawa Out of the Loop

The logic of equal per person CHST entitlements, however, forces the question of why Ottawa is involved in provincial social programs in the first place. There are reasons to support a federal role in health activities such as drug approvals and medical research, as well as in benchmarking provincial programs and opposing discriminatory interprovincial practices. None of these roles, however, justifies the friction and distorted accountability involved in recycling through the *federal* treasury the contribution of *provincial* taxpayers to *provincial* service delivery.

A major advantage that may emerge from Ottawa's proposed move to more equal treat-

Table 1: *Federal Cash Transfers to the Provinces under the Canada Health and Social Transfer*

Fiscal Year	Nfld	PEI	NS	NB	Que.[a]	Ont.	Man.	Sask.	Alta	BC	Total[b]
					Cash Transfers (millions of dollars)						
1998/99	272	60	426	333	3,808	3,954	502	428	937	1,720	12,500
1999/2000	281	69	476	378	3,888	4,936	574	507	1,241	2,091	14,500
2000/01	271	68	467	371	3,797	5,000	564	498	1,256	2,148	14,500
2001/02	265	69	473	378	3,718	5,302	577	515	1,352	2,291	15,000
Growth											
1998/99 to 2001/02	(6)	9	47	45	(90)	1,348	75	87	415	571	2,500
					Cash Transfers (dollars per person)						
1998/99	499	442	455	443	519	347	440	418	322	429	413
1999/2000	521	502	506	502	527	427	501	493	422	510	474
2000/01	507	491	494	491	513	427	490	484	422	514	469
2001/02	499	499	499	499	500	447	500	499	450	538	480
Growth											
1998/99 to 2001/02	(0)	57	44	57	(20)	100	59	82	127	109	67
					Total Cash Plus Tax Transfers (millions of dollars)						
1998/99	499	117	819	648	6,882	9,453	980	858	2,324	3,343	26,021
1999/2000	511	127	877	700	7,035	10,600	1,063	946	2,669	3,765	28,391
2000/01	509	129	885	706	7,084	10,836	1,075	956	2,727	3,873	28,879
2001/02	510	133	909	726	7,145	11,389	1,109	991	2,885	4,090	29,988
Growth											
1998/99 to 2001/02	10	16	91	78	262	1,936	129	133	562	747	3,967
					Total Cash Plus Tax Transfers (dollars per person)						
1998/99	919	861	874	862	939	830	859	837	800	833	860
1999/00	948	928	933	929	954	918	928	920	908	919	928
2000/01	951	934	938	935	956	926	934	928	917	927	934
2001/02	960	960	960	960	960	960	960	960	960	960	960
Growth											
1998/99 to 2001/02	41	99	86	98	21	130	100	123	160	126	100

[a] Includes Quebec abatement.

[b] Totals include transfers to the territories (not shown).

Source: C.D. Howe Institute and Department of Finance, Federal Provincial Fiscal Relations Division.

ment across the country is that it would reduce the vested interest that net recipient provinces have in boosting the scale of federal transfers. Scaling back the recycling might involve, as a first step, other provinces' receiving the equivalent of the Quebec abatement for the taxes that their residents pay, and stepping in with offsetting levies of their own.

Alternatively, a 1977-style transfer of further income tax room to the provinces could put more money directly in the hands of the governments that run the programs. Either way, more tax revenue would flow to provincial governments in support of provincial spending priorities, and less would flow to Ottawa for recycling into the confusing and conflict-generating web of federal-provincial tax-and-spend agreements.

Conclusion

The new CHST arrangements proposed in the 1999 federal budget signify a step toward a fairer distribution of federal financial support for provincial social programs. Since the purpose of the CHST is to reconcile provincial responsibilities for program delivery with the share of their revenue room left over after federal taxation, equal per person support is reasonable.

Despite the volume of praise and blame the changes have inspired, however, the CHST does not deliver equal per person cash support. Its current design, which bears the mark of the old EPF arrangement, all but guarantees that it never will. A simpler mechanism — such as equal per capita cash payments — would produce less confusion and misrepresentation.

Better yet, however, would be for the provinces to tax their citizens in support of their own social programs and to use federal equalization payments to make comparable programs similarly affordable in each province. Canadians could then see more clearly where they pay their taxes and for what. Such an approach would also reduce tension between the provinces and Ottawa and among the provinces themselves over who funds and provides the programs Canadians vote and pay for.

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