

CURRENT ANALYSIS

December 20, 2011

Canada's Finance Minister sets the rules on transfers to provinces beyond 2014

In a surprise move yesterday, Canada's Finance Minister Jim Flaherty announced his government's plan for future health and social transfers to the provinces. The current accord between the provinces and the federal government is set to expire in 2014, and observers had been preparing for a long round of negotiations leading up a new agreement. Instead, the Finance Minister presented what is in effect a "take it or leave it" offer, which will eventually tie future health transfer increases to nominal GDP growth. The government also confirmed that other major transfers would continue to grow according to their current formulas.

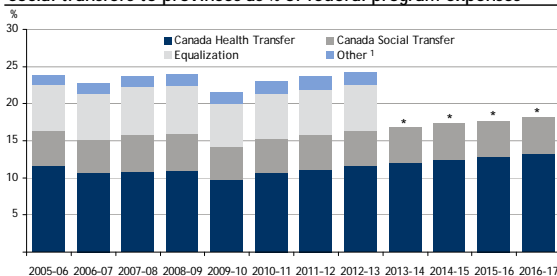
Although health care in Canada is a provincial responsibility, the federal government provides funding for health care to the provinces through Canada Health Transfer (CHT.) This funding is conditional on the provinces meeting the provisions of the Canada Health Act, which requires provinces receiving funding to run universal, publicly funded health systems. The federal government also provides funding for provincial social programs through the Canada Social Transfer (CST), and undirected funding through equalization (which is designed to ensure that all provinces can provide a similar level of services with similar taxation policies.)

A 2004 accord between the provinces and the federal government guaranteed a 6% annual increase in the CHT and a 3% annual increase in the CST until 2014. In return for the CHT funding, the provinces agreed to certain conditions, such as wait time reductions at hospitals. Yesterday's offer from the federal government would no longer place such conditions on the provinces (except for the standard provisions of the Canada Health Act). Under this offer, the CHT would continue to increase by 6% until 2016-17, beyond which it will increase at the three year average of nominal GDP growth until the program is next reviewed in 2024. Nominal GDP growth reflects the combined effect of real GDP growth plus inflation. The offer also sets a floor of 3% on growth in the CHT in the case of a recession or a period of unusually weak nominal GDP growth. The CST will continue to grow at 3% per year (also until 2024), and equalization will continue to grow at a three year average of nominal GDP growth. Minister Flaherty shut the door for negotiations with the provinces, casting his announcement as a "take it or leave it" offer.

With growth in transfers fixed at current levels until 2016/17, health and social transfers are likely to increase as a share of federal program expenditures (see Exhibit 1.) The increase in transfers will mean intense pressure to contain growth in other federal expenses, given the government's plan to limit average annual program expenditure growth to 2.3% per year in the next five years. Growth in other expenditures will be limited to just 1.8% per year. The pace of increase in transfers is likely to slow beyond 2016/17, with

Exhibit 1

Social transfers to provinces as % of federal program expenses



Source: Department of Finance Canada, RBC Economics Research

¹Other consists of Offshore Accords, Territorial Formula Financing and other federal payments to provinces

* For 2013/2014 to 2016/2017, Canada Health Transfer is projected to grow by 6% and Canada Social Transfer by 3% per year.

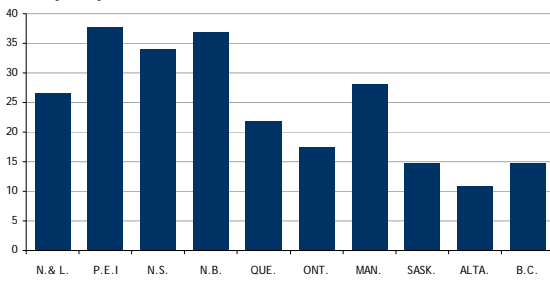
Projections for other transfer programs are unavailable.

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Exhibit 2

Federal transfers as % of total provincial revenues

%, average during 2006/07 - 2010/11

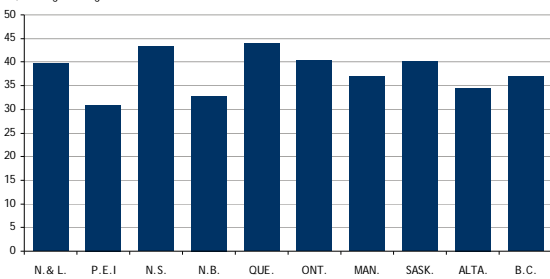


Source: Provincial governments of Canada, RBC Economics Research

Exhibit 3

Health care as % of program spending

%, average during 2006/07 - 2010/11



Source: Provincial governments of Canada, RBC Economics Research

the government expecting nominal GDP growth (and therefore the rate of CHT increases) to be around 4%.

Federal transfers make up an important source of provincial revenues, at around 20% of total revenues over the past five years (see Exhibit 2.) If the pace of these transfers slows after 2016/17, it could have a noticeable impact on total revenue growth for the provinces. Furthermore, given the aging of Canada's population, increasing health expenditures are likely to put further pressure on provincial budgets. Provincial health spending is one of the fastest growing expenditure items, with an average annual growth rate of more than 7% per year over the past ten years, and this is unlikely to slow meaningfully in the coming years. A recent paper by David Dodge and Richard Dion estimates that total health care spending will continue to rise by around 6.4% per year over the long term.ⁱ Health care spending already represents between 31% and 44% of provincial program spending (Exhibit 3) and could well represent more than 50% in some provinces in the years ahead. Sustained rapid growth in health care expenditures and the diminishing share of federal contribution will intensify pressure on provincial governments' budget through the longer term.

The extension of the federal government's commitment to maintain growth in transfers to provinces at current rates until 2016-2017 will bring welcome certainty to the provinces' budget planning exercises as they pursue plans to eliminate their deficits. With the share taken up by transfers to provinces in total federal spending scheduled to rise in the coming years (Exhibit 1), it is not surprising that the federal government will seek ways to stabilize that path post 2016-2017. However, the slower pace of growth in these transfers beyond this point will add further to the fiscal challenges facing the provinces.

ⁱ Dodge, David A. and Richard Dion. "Chronic Health Care Spending Disease: A Macro Diagnosis and Prognosis." C.D. Howe Institute Commentary No. 327, April 2011.

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