

ARE THE PROVINCES REALLY SHORTCHANGED BY FEDERAL TRANSFERS?

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Executive Summary

In recent years, government officials from several provinces and a number of commentators have suggested that inadequate transfers from the federal government are a contributing factor to the persistent deficits that exist in several provinces. This study steps away from the political rhetoric and examines data on federal transfers to the provinces to assess whether these transfers have been growing or shrinking in recent years, and at what rate. It also compares the rate of growth for federal transfers to other metrics—including spending growth, own-source revenue growth, and the combination of inflation and population growth—to begin to assess the validity of claims that inadequate federal transfers are partially responsible for the fiscal challenges facing many provinces.

The study finds that federal transfers to the provinces and territories have grown substantially in recent years, increasing by 62.3 percent from 2005/06 to 2015/16—a rate much higher than would have been required to keep pace with inflation and population growth. Furthermore, the share of all provincial revenues that come in the form of transfers from Ottawa has increased significantly between 2005/06 and 2015/16.

Contrary to claims that federal transfers to the provinces are inadequate, the study finds that major federal transfers to the provinces and territories are currently higher on an inflation-adjusted per-capita basis than at any other point in Canadian history. The most important reason for the persistence of budget deficits at the provincial level in Canada has been significant spending growth over the past decade. Provincial program spending increased by 56.1 percent during this timeframe, whereas spending would only have needed to increase by 31.6 percent to offset the effects of inflation and population growth. Spending growth, which has dramatically outstripped own-source revenues and inflation plus population growth, is the primary cause of persistent deficits in the provinces, not inadequate federal transfers.

After discussing trends on aggregate transfers to the provinces, the study turns to recent developments surrounding transfer payments to specific provinces, identifying the jurisdictions that have experienced particularly rapid growth in federal transfers and discussing the reasons for these trends. In both nominal and real per-capita terms, transfer payments to Alberta, Quebec, and Ontario have increased at a significantly faster rate than transfers to other provinces.

The rapid increase in transfers to Ontario is primarily a function of that province becoming a “have-not province,” which means that since 2008/09, Ontario has been receiving equalization payments. Ontario’s transition to a have-not jurisdiction and the substantial resulting increase in transfers to

the country's largest province has had a number of important implications. Federal transfers to Ontario increased by 87.8 percent between 2005/06, far faster than the rate of transfer growth for the country as a whole, and also far faster than a number of relevant metrics including GDP, inflation plus population growth, and provincial own-source revenue. Whereas federal transfers represented 12.0 percent of Ontario's revenue in 2005/06, that figure had climbed to 16.4 percent in 2015/16.

Introduction

A longstanding feature of Canada's federation is the constant cries from the provinces suggesting that inadequate transfer payments from the federal government are partly responsible for the fiscal challenges they face. For example, in the autumn of 2014, the Premiers met in Charlottetown for their annual Council of the Federation meeting, where they collectively stated that Ottawa should redress an existing "fiscal imbalance" by increasing fiscal support to the provinces. Quebec's then finance minister Nicolas Marceau assigned partial blame to Ottawa for the hard choices facing that province, stating that "everything is in place for a return of the fiscal imbalance" (Yakubuski, 2014). Outgoing PEI premier Robert Ghiz suggested that because Ottawa has returned to budget balance, the federal government should now increase support to the provinces to assist with their fiscal problems (Taber, 2014). Ontario's most recent budget devoted an entire chapter to complaining about alleged federal stinginess towards the province with respect to transfers (Ontario, 2015: Ch. 3).

The implicit claim in these statements is that the simultaneous existence of large budget deficits in a province and a relatively smaller deficit at the federal level demonstrates the existence of a "fiscal imbalance" that requires corrective action.¹ However, this line of argument discounts the important role that effective fiscal management plays in determining the health of a government's finances and provides a convenient and perpetually available excuse for fiscal mismanagement at the provincial level (Dahlby, 2005). In fact, the persistence of this argument in public discourse provides an active disincentive for provincial governments to prioritize deficit reduction, as spending restraint is perceived to weaken their case for additional increases to federal transfers (Smart and Bird, 2006). For these reasons, merely observing the relatively perilous fiscal position of several provinces compared to the federal government is not evidence that federal transfers are inadequate.²

1. Traditionally, the term "fiscal imbalance" referred simply to the fact that historically the federal government raised more money than it needed to provide its services, whereas the provincial governments did not raise enough. This factual imbalance gave rise to the creation of the federal transfer system. The term is now used loosely and inconsistently in public debate, and is now often simply used as an argument that the provinces are not receiving "enough" money in transfers from the federal government, with the term "enough" never being precisely defined. Because of the confusion surrounding this term in popular discourse, we generally avoid its use in this paper except when quoting others.

2. It should be noted that the federal government recorded a budget surplus in 2014/15 after six consecutive deficits. However, it is now projecting a budget deficit for 2015/16 and the newly elected government campaigned on additional deficit spending for the next three years. See the Liberal Party of Canada's election platform here: <<https://www.liberal.ca/files/2015/10/New-plan-for-a-strong-middle-class.pdf>>.

This paper steps away from the political rhetoric and examines data on federal transfers to the provinces to assess whether these transfers have been growing or shrinking in recent years, and at what rate. We also compare the rate of growth for federal transfers to other metrics, including spending growth, own-source revenue growth, and the combined effects of inflation and population growth, in order to begin to assess the validity of claims that inadequate federal transfers are partially responsible for the fiscal challenges facing many provinces. After discussing trends in aggregate transfers to the provinces, we turn to recent developments surrounding transfer payments to specific provinces, identifying the jurisdictions that have experienced particularly rapid growth in federal transfers and discussing the reasons for these trends. The final section provides a more detailed discussion of the case of Ontario, which merits specific attention because its status with respect to transfer payments has been fundamentally altered by its new position as a “have-not” province—and because Ontario’s fiscal position has deteriorated markedly in recent years.

Canada's System of Fiscal Transfers: A Brief Overview

Payments from the federal government to the provinces date back to the founding of the country (Milke, 2013). The precise structure of the modern transfer system has changed at different points since its creation during the post-war era. In the 1950s and 1960s, health and social transfers were primarily provided on a cost-sharing basis. In 1977, the Established Programs Financing (EPF) transfer was introduced, which replaced cost-sharing for health and post-secondary education. The EPF was divided between a tax point transfer and a cash transfer to the provinces.³ During this period, the Canada Assistance Plan continued to provide funding for social welfare programs under cost-sharing arrangements. In 1984, the Canada Health Act was enacted; it made EPF funding contingent upon provincial governments adhering to the law's five criteria (universality, portability, comprehensiveness, accessibility, and public administration) and created provisions for withholding transfers if those criteria were not met. In the 1990s, cost-sharing provisions for welfare programs were also eliminated when these too were converted to a block grant with the creation of the Canada Health and Social Transfer (Canada, 2015c). Finally, in 2004, the Canada Health and Social Transfer was split into the Canada Health Transfer and the Canada Social Transfer (Canada, 2015b).

The gradual shift away from cost-sharing arrangements towards provincial block grants for health and social services has been one of the most important ways in which the federal transfer system has evolved. Under cost-sharing, provinces faced a disincentive to restrain spending and develop strategies to make spending more efficient and effective, because the benefits of any efficiency gains to the province would be partially offset by a resulting reduction in federal transfers. Further, the removal of the "strings" that were generally attached to cost-sharing programs, as they were replaced with block grants, has given the provinces more flexibility with respect to how they deliver social welfare programs, allowing for increased innovation and improved program delivery (Clemens, 2011).

Today, the major transfers from the federal government to the provinces can be grouped into two broad categories: 1) transfers paid to all provinces to support health and social programs (based on population size), and 2) transfers paid only to some provinces (based on fiscal capacity).

3. A tax point transfer is simply a permanent transfer of income tax room from the federal government to the provincial governments. Federal transfer totals presented in this report represent the cumulative total of both cash and tax point transfers to the provinces.

Transfers Paid to All Provinces to Support Health and Social Programs

These transfers are given to all the provinces and territories based on their population. All provinces receive equal per-capita transfers in nominal terms, meaning no adjustments are made for differences in the purchasing power of a dollar across jurisdictions (Crowley and O’Keefe, 2006). The transfers increase at an annual rate set by the federal government. Although the specific names of the transfers have changed over time, their objective has consistently been to assist provinces in meeting the financial responsibilities associated with delivering health care, post-secondary educational services, and social programs. Today, the major per-capita transfers are the Canada Health Transfer and the Canada Social Transfer. The Canada Health Transfer, which amounts to \$34.0 billion in 2015/16, is a block grant provided to the provinces to help finance healthcare costs. These transfer payments remain contingent upon compliance with the five provisions of the Canada Health Act. The Canada Social Transfer, which totals roughly \$13.0 billion, is also a block grant that provides financial support to the provinces to help finance social welfare programs and other social programs and services. This transfer is provided on a “no strings attached” basis, and there are no cost-sharing provisions, as was the case for transfers related to social programs prior to the reforms of the 1990s. In total, these per-capita transfers are projected to be \$47.0 billion in 2015/16.

Transfers Contingent on Fiscal Capacity (Equalization and its “Side Deals”)

While the Canada Health Transfer and Canada Social Transfer are paid to all provinces on an equal per-capita basis (in nominal terms) to assist with the cost of health and post-secondary education spending, another category of transfers is paid only to provinces with comparatively weaker fiscal capacity. This category consists of Canada’s equalization program, the stated objective of which is to ensure that all provinces are able to deliver comparable public services to their residents at comparable rates of taxation. Which provinces receive grants, and how large they are, is determined by a complex formula that calculates the “fiscal capacity” of each province, which means their ability to raise own-source revenues at tax rates that are equal to the Canadian average across a range of types of taxation. Provinces whose fiscal capacity falls short of the national average are given equalization grants, with the size of those grants determined by the size of the gap between a province’s fiscal capacity and the national average. In 2015/16, equalization transfers total approximately \$17.3 billion.

While equalization itself comprises the bulk of this second category, it also includes additional programs that were created in “side deals” to the equalization program to address perceived shortfalls in equalization under the existing formula to particular provinces at various points. Examples include the payments to Newfoundland and Nova Scotia under the offshore accords in recent years, and payments to several provinces under the short-lived “total transfer protection” program. These side deals amount to \$116.0 million in 2015/16.

In this second broad category, we include the Territorial Formula Financing Transfer, which provides federal funding to the territorial governments to enable them to fund services that are comparable to those offered by provincial governments (cost: \$3.6 billion). In total, the transfers in this second category are projected to cost \$21.0 Billion in 2015/16.

Table 1: Major Federal Transfers to the Provinces/Territories (\$ millions), 2015/16

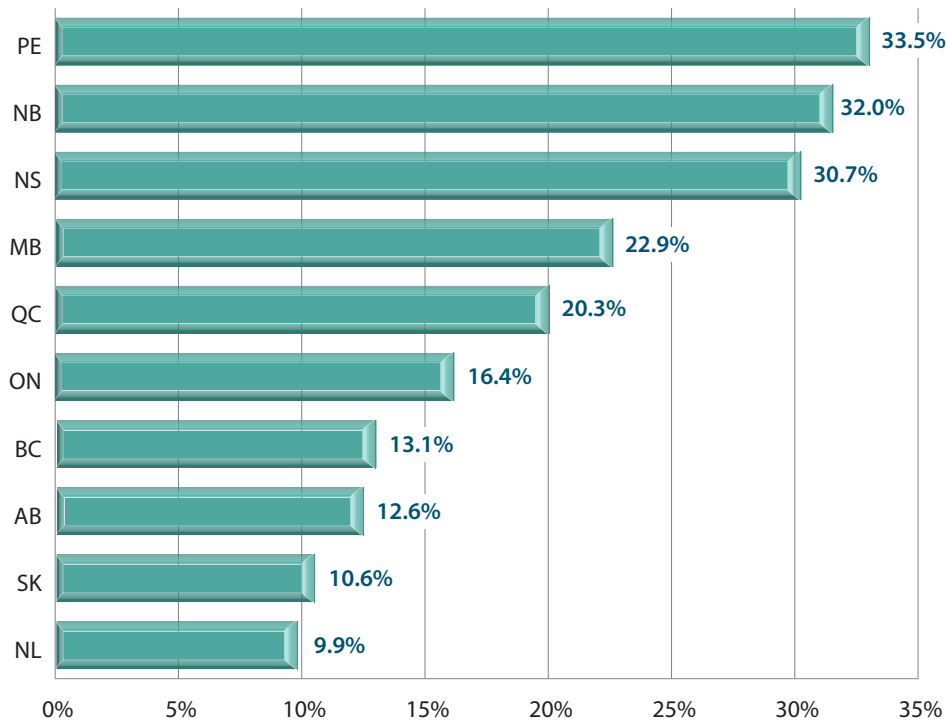
Transfers to all provinces to support health and social programs (A)	46,985
Canada Health Transfer	34,026
Canada Social Transfer	12,959
Transfers contingent on fiscal capacity (B)	21,018
Equalization	17,341
Offshore Offset Payments	116
Territorial Formula Financing	3,561
Total Transfer Protection	n/a
Total major federal transfers (A + B)	68,004

Source: Canada, Department of Finance, 2015a.

Cumulatively, the two types of transfer represent a major expenditure for the federal government. In 2015/16, the federal government will issue a total of \$68.0 billion in transfers to the provinces and territories (**table 1**), representing roughly one quarter (25.8 percent) of all federal program spending.

Major federal transfers represent a significant source of revenue for all ten provinces; however, the provinces vary considerably in terms of the extent to which they are reliant on federal transfers to fund their operations. **Figure 1** displays the percentage of each province's revenue that comes from federal transfers. The Maritime Provinces (Prince Edward Island, New Brunswick, and Nova Scotia) are the most heavily reliant on transfers, as transfers make up between 30 and 34 percent of total provincial revenue in all three provinces. Some analysts have argued that these figures actually understate the reliance of these provinces on federal subsidies and that the smaller have-not provinces (the Maritimes and Manitoba) also receive a host of additional subsidies including disproportionate federal employment and preferential treatment for residents under the Employment Insurance program (Mackinnon et al., 2013). Newfoundland, Saskatchewan, Alberta, and British Columbia are the least reliant on transfers. In these provinces, transfers as a share of revenue range from approximately 10 to 13 percent.

Figure 1: Major Federal Transfers as a Share of Provincial Revenue, 2015/16



Note: Includes Offshore Accord Payments to Nova Scotia.

Sources: Canada, Department of Finance, 2015a; British Columbia, Ministry of Finance, 2015b; Alberta, Ministry of Finance, 2015b; Saskatchewan, Ministry of Finance, 2015b; Manitoba, Ministry of Finance, 2015b; Ontario, Ministry of Finance, 2015b; Québec, Ministère des Finances, 2015; New Brunswick, Ministry of Finance, 2015b; Nova Scotia, Ministry of Finance, 2015b; Prince Edward Island, Ministry of Finance, 2015b; Newfoundland & Labrador, Ministry of Finance, 2015.

We have seen that the per-capita transfers are a significantly greater expense to the federal government than equalization. However, the equalization program does represent a major source of revenue for several of the have-not provinces. Of particular note, the three Maritime Provinces all receive substantially more from equalization than they do from per-capita transfers. Equalization payments make up more than 55 percent of major federal transfers to each of the Maritime Provinces. For Manitoba and Quebec, transfers are approximately evenly divided between equalization and per-capita transfers. **Table 2** shows major federal transfers to each province as a share of total provincial revenues, as well as the per-capita division between transfers for health and social programs and transfers contingent on fiscal capacity (almost entirely equalization). Clearly, federal transfers are an important part of Canadian fiscal policy and an important component of provincial revenue in every jurisdiction, albeit to varying degrees.

Table 2: Major Federal Transfers, by Province, 2015/16

Province	Health and social programs (\$ per capita)	Equalization (\$ per capita)	As a share of revenue (%)
British Columbia	1,311	0	13.1
Alberta	1,310	0	12.6
Saskatchewan	1,311	0	10.6
Manitoba	1,310	1,344	22.9
Ontario	1,310	171	16.4
Quebec	1,311	1,152	20.3
New Brunswick	1,312	2,214	32.0
Nova Scotia	1,312	1,792	30.7
Prince Edward Island	1,311	2,465	33.5
Newfoundland & Labrador	1,313	0	9.9

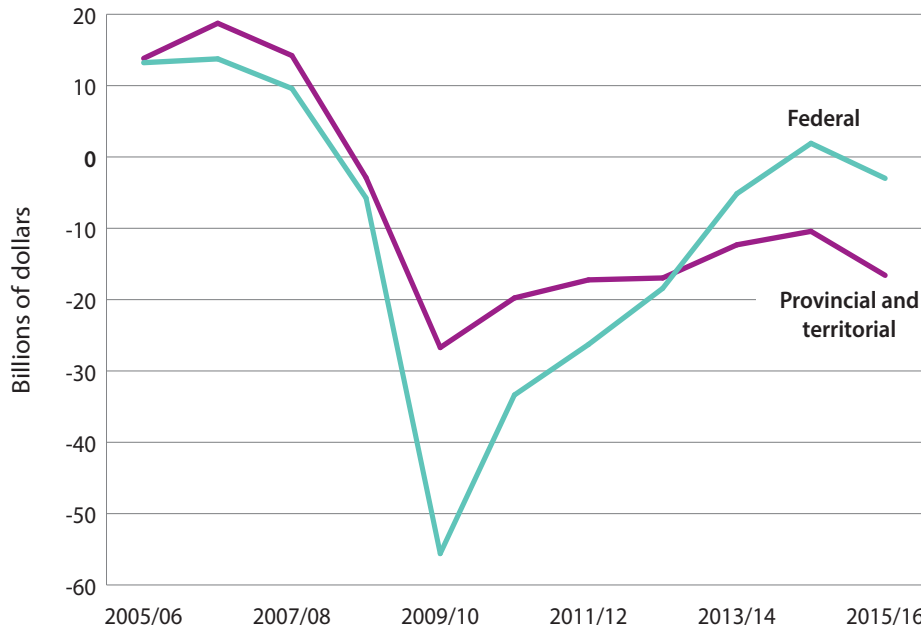
Note: Equalization includes Offshore Accord Payments to Nova Scotia.

Sources: Figure 1; Statistics Canada, 2015a; calculations by authors.

Comparing the Fiscal Condition of the Federal Government and the Provinces

It is true that the overall fiscal position of the provinces, taken as a group, has deteriorated in recent years. It is also true that the fiscal position of the federal government, which returned to a balanced budget in 2014/15, is currently stronger than the fiscal position of the provinces and territories taken as a whole; they are projected to run a collective budget deficit of \$16.6 billion in the 2015/16 fiscal year. Although the federal government's November fiscal update announced that it would return to deficit spending in 2015/16, the projected deficit (at \$3 billion) is still relatively small in comparison to the combined projected deficit of the provinces. More generally, the federal government's overall fiscal position at present is still stronger than that of the provinces taken as a group.

Figure 2 shows that, during the recent recession, both the federal government and the provinces (collectively) fell into large budget deficits. During the worst depths of recession in 2009/10, the federal government's deficit reached nearly \$56 billion, approximately twice as large as the cumulative provincial/territorial budget deficit that year (\$26.7 billion). Since that time, the federal government's fiscal position has improved more quickly than that of the provincial and territorial governments taken as a whole. It should be noted that the deeper fiscal trough during the recession and stronger bounce back in subsequent years at the federal level is partly a function of the structure of federal revenues, which are more responsive to cyclical forces than the provinces' main areas of spending and their revenue base. Recognizing this should not distract from the fact that fiscal management choices also play an important role in determining the size of budget deficits during recessions and the speed at which they are eliminated during periods of recovery (Kneebone, 2015a, 2015b; Kneebone and Wilkins, 2014). In 2014/15, the federal government returned to a budget surplus for the first time since 2007/08. As figure 2 shows, the cumulative provincial/territorial deficit for the 2015/16 fiscal year is expected to be \$16.6 billion.

Figure 2: Fiscal Balance: Federal vs. Provincial/Territorial Governments, 2005/06 to 2015/16

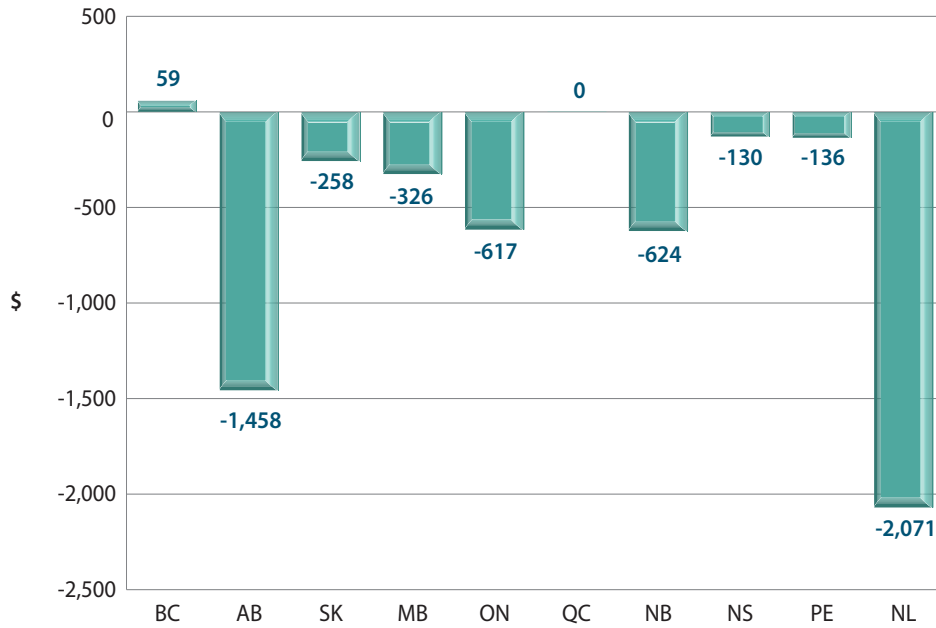
Note: The surplus or deficit data between 2005/06 and 2014/15 come from the Fiscal Reference Tables (Department of Finance, 2015b). The collective provincial and territorial fiscal balance for 2015/16 is estimated by the various surpluses and deficits.

Sources: Figure 1; Canada, Department of Finance, 2015b, 2015d; Yukon, Department of Finance, 2015; Nunavut, Department of Finance, 2015; Northwest Territories, Department of Finance, 2015; calculations by authors.

The cumulative operating deficit facing the provinces in 2015/16 is largely driven by the existence of substantial deficits projected in Ontario and Alberta (amounting to \$14.6 billion), Canada's first and third largest economies, respectively. However, a number of provinces currently face budget deficits, while the federal government balanced its budget in 2014/15 and is now projected to run a budget deficit in 2015/16 that is relatively smaller than the combined deficit of the provinces.⁴ **Figure 3a** shows the per-capita deficit or surplus in each province. Eight out of the ten provinces are projected to run budget deficits in this year. Comparing provincial budget deficits as a share of GDP produces similar results, as Newfoundland's deficit is by far the largest in the country using this metric at 3.5 percent of GDP (**figure 3b**). Alberta, New Brunswick, and Ontario all have projected provincial budget deficits that are more than 1 percent of GDP in 2015/16.

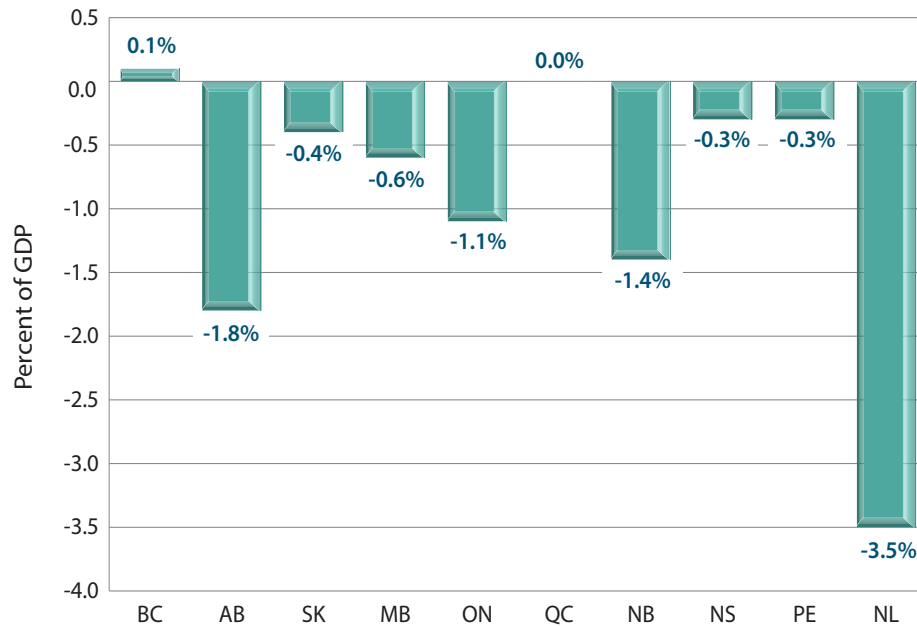
4. This federal government's fiscal position may worsen if the newly formed federal government enacts the policies it campaigned on.

Figure 3a: Projected Budget Deficit Per Capita, by Province, 2015/16



Sources: Figure 1; Statistics Canada, 2015a; calculations by authors.

Figure 3b: Projected Budget Deficit as Share of GDP, by Province, 2015/16



Sources: Figure 1; Statistics Canada, 2015b; TD Economics, 2015; calculations by authors.

Some commentators have suggested that the mere existence of a balanced or nearly balanced federal budget and large provincial budget deficits is evidence of a “fiscal imbalance” requiring corrective action (e.g., Simpson, 2015). This argument discounts the important role that effective fiscal management plays in determining the health of a government’s finances and provides a convenient and perpetually available excuse for fiscal mismanagement at the provincial level (Dahlby, 2005). In fact, the persistence of this argument in public discourse provides an active disincentive for provincial governments to prioritize deficit reduction, as spending restraint is perceived to weaken their case for additional increases to federal transfers (Smart and Bird, 2006). Merely observing the relatively perilous fiscal position of several provinces compared to a balanced federal budget is not evidence that federal transfers are inadequate.

So the question remains, are the provinces being shortchanged by Ottawa? In the next section, we examine the evidence to determine whether transfers to the provinces are growing or shrinking, and at what rate.

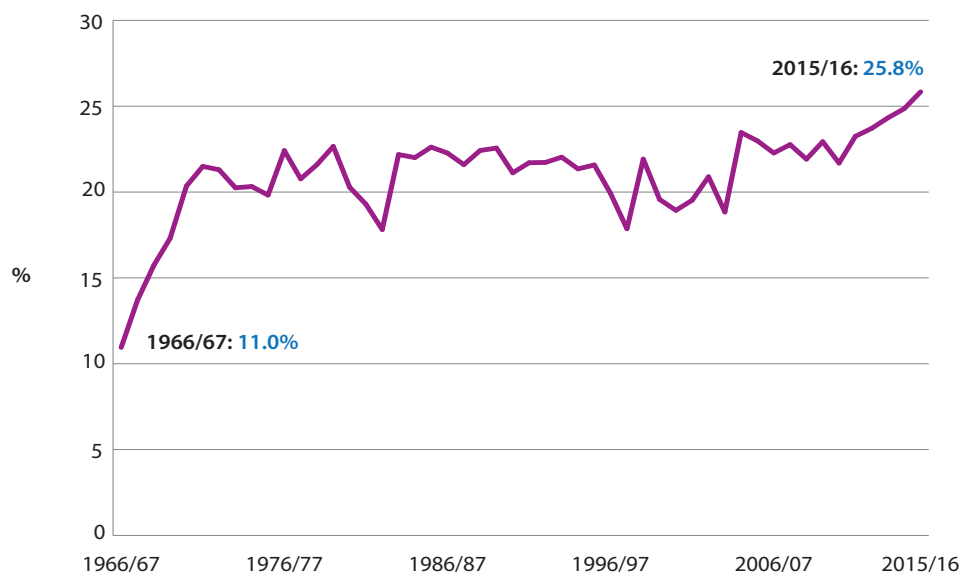
Are Federal Transfers to the Provinces Increasing or Decreasing, and at What Rate?

Historical Context

Senior officials from several provinces have suggested that the challenging fiscal situations facing many of the provinces are partly the result of inadequate transfers from the federal government (Taber, 2014). This section analyzes trends surrounding the overall level of federal transfer payments to the provinces, with a particular focus on developments over the past decade. As the data that follow will make clear, there is little support for the claim that current federal transfer levels are responsible for the fiscal challenges facing the provinces. In fact, the data suggest that the recent trend has been a steady increase in the size of federal transfers to the provinces, which have now reached new historical highs.

Figure 4 illustrates the fact that major transfers to the provinces consume a substantial share of federal program spending, a share that has been increasing over time. In 1966/67, major federal transfers consumed 11.0 percent of federal program spending. By 2015/16, that share had more than doubled, increasing to 25.8 percent. Along with an increase in the size of transfers, federal spending restraint since 2009/10 in areas of federal spending other than transfers is partially responsible for the particularly rapid increase in transfers as a share of program spending in the last five years that is shown in figure 4.

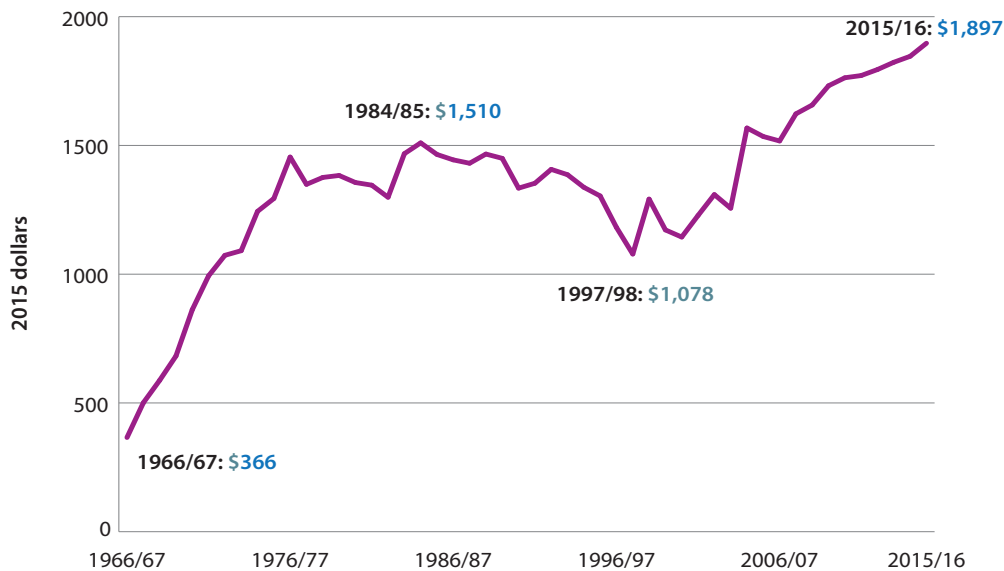
Figure 4: Major Federal Transfers as a Share of Federal Program Spending, 1966/67 to 2015/16



Sources: Canada, Department of Finance, 2015b; calculations by authors.

Figure 5 displays annual major federal transfer payments to the provinces and territories on a per-person basis and adjusted for inflation (in 2015 dollars), between 1966/67 and 2015/16.⁵ The figure shows that transfers rose rapidly in the early years of the modern transfers system but then, during the late 1980s and early 1990s, gradually fell from \$1,510 per person in 1984/85 to a low of \$1,078 per capita in fiscal year 1997/98. Most of this decline occurred during a short period in the early 1990s, when the federal government faced a serious debt problem and was engaged in a process of major fiscal consolidation, reducing expenditures in most areas, including transfers to the provinces. During this period, the federal government not only reduced transfers, it fundamentally reformed Canada's system of fiscal federalism. The 1990s era reforms eliminated several transfers that supported provincial social programs on a partial cost-sharing basis and replaced them with a block grant known as the Canada Health and Social Transfer, which was paid to the provinces without cost-sharing provisions (Clemens, 2011).

Figure 5: Inflation-adjusted Major Federal Transfers to the Provinces and Territories Per Capita, 1966/67 to 2015/16



Notes: For the period 1966/67 to 2014/15, these data are drawn from the Fiscal Reference Tables. The transfers include the categories reported in the Fiscal Reference Tables which are fiscal arrangements, the Canada Health and Social Transfers, insurance and medical care, education support and the Canada Assistance Plan. For 2015/16, the data are from the Department of Finance (2015a).

In fiscal year 1982/83, the Government of Canada switched to full accrual accounting for this data set. Caution should therefore be exercised in making direct comparisons between years before and after this break in the data series.

Sources: Canada, Department of Finance, 2015a, 2015b; Statistics Canada, 2015a, 2015c; TD Economics, 2015; Canada, Office of the Parliamentary Budget Officer, 2015; calculations by authors.

5. Federal transfers (adjusted for inflation) on a per-person basis are more telling of the historical trend than as a share of GDP, since GDP is a volatile denominator that can fluctuate for reasons unrelated to the numerator (federal transfers). As a result, changes in the ratio of federal transfers to GDP would paint a misleading picture of what is actually happening with regards to the trends in federal transfers.

At the end of the consolidation period, the trend reversed and transfers began to climb. By the mid-2000s, major transfers per capita had rebounded to pre-consolidation levels and they continued to climb from there. In 2015/16, they are projected to reach the highest level in history at \$1,897 per capita. Taken together, the data show that the long-term trend has been towards larger federal transfers to the provinces, and that transfers in recent years have reached historically high levels.

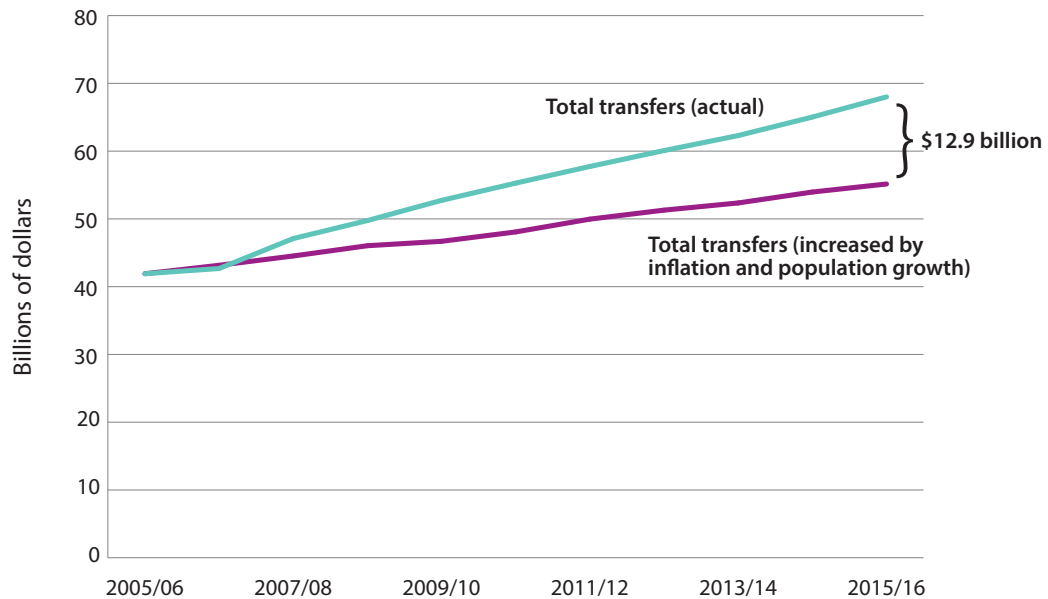
Developments Over the Past Decade

With this historical context in mind, let us now turn to examining shorter term trends in more detail, focusing on changes in aggregate transfers to the provinces over the past decade, between 2005/06 and 2015/16. It is useful to consider this period separately for two reasons. First, it enables us to analyze recent trends and developments. And second, it begins one year after the 2004 health accord reached between then Prime Minister Paul Martin and the provinces, which reset the framework for healthcare transfers (Courchene, 2007). It is important to note that by 2005/06, the first year discussed in this analysis, real per-capita transfer levels had already recovered to pre-consolidation levels and were higher in that year than at any point during the 1990s.

Data from the federal Department of Finance show that transfers from the federal government have increased substantially over the past decade.⁶ In fact, as **figure 6** illustrates, major transfers to the provinces and territories have increased by 62.3 percent in nominal terms between 2005/06 and 2015/16. The growth of federal transfers has been substantially more than would have been necessary to keep pace with the combination of inflation (as measured by increases in the consumer price index) and population growth during this period, which together grew by 31.6 percent. In fact, if growth in transfer spending had been held to the rate of inflation plus population growth, total transfers for 2015/16 would have been \$12.9 billion less than is projected to be the case.

6. At the time of writing, the federal Department of Finance included transfer data on its website from 2005/06 to 2015/16. The latest period is now from 2007/08 to 2016/17. See <<http://www.fin.gc.ca/fedprov/mtp-eng.asp>>.

Figure 6: Major Federal Transfers to the Provinces/Territories, Actual and Adjusted, 2005/06 to 2015/16

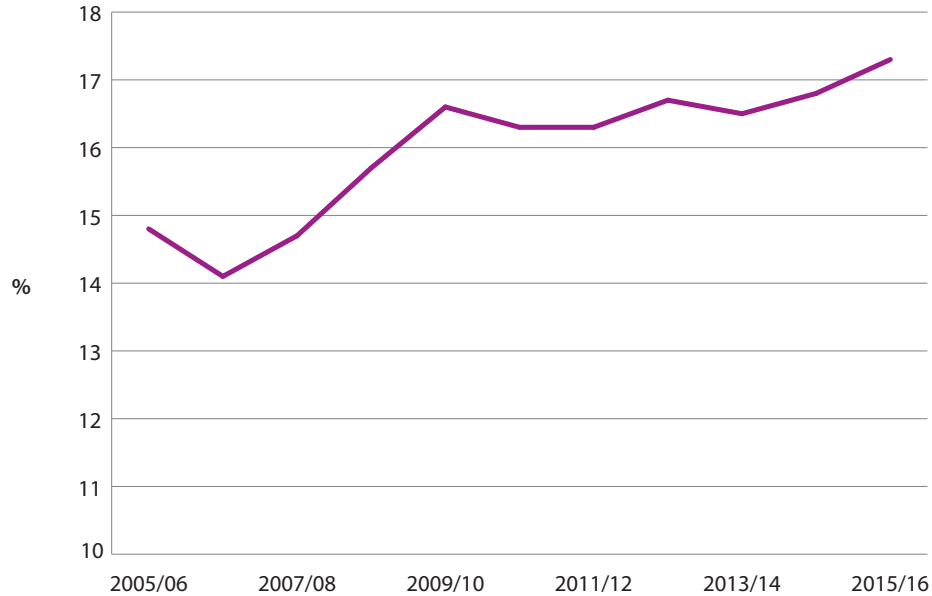


Sources: Figure 5; calculations by authors.

Furthermore, major federal transfers have been increasing at a faster rate than provincial own-source revenues during this period. This means that transfers now represent a larger share of all provincial revenues than was the case a decade ago. **Figure 7a** shows that in 2005/06, major transfers represented 14.8 percent of all provincial revenue. This share has climbed steadily over the subsequent years and is projected to reach 17.3 percent in this fiscal year, the highest level in recent history.

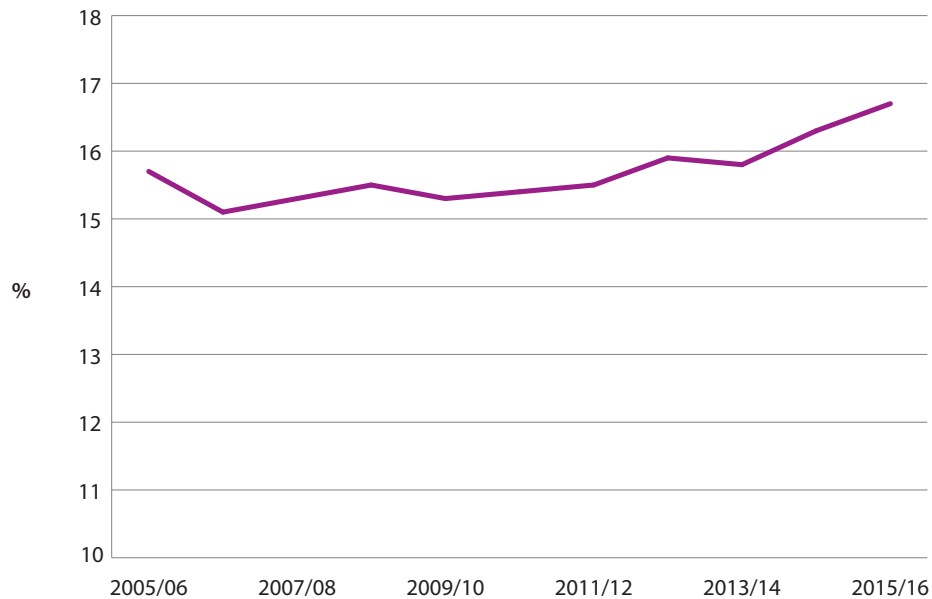
The data also show that major federal transfers as a share of all provincial spending have increased over the past decade, as shown in **figure 7b**. In 2005/06, federal transfers to the provinces were adequate to pay for 15.7 percent of all provincial government spending. In 2015/16, that number has increased to 16.7 percent. This metric is particularly important because it demonstrates that federal transfers have grown faster than provincial spending over the past decade, despite rising costs in healthcare and education. In other words, this metric accounts for the possibility that the prices of inputs to many of the goods and services provinces buy to provide health and education services may be increasing faster than the consumer price index taken as a whole.

The above metrics confirm that federal transfers to the provinces have grown considerably over the last decade. Nominal transfers to the provinces have increased by 62.3 percent during this period, which is faster than inflation and population growth combined, while transfers as a share of both provincial revenues and provincial spending have also increased.

Figure 7a: Major Federal Transfers as a Share of all Provincial Revenue, 2005/06 to 2015/16

Note: Provincial revenue and spending data are on a Consolidated basis except for Nova Scotia in 2015/16 because Nova Scotia projected its revenue and spending on a General Revenue Fund basis.

Sources: Canada, Department of Finance, 2015a; British Columbia, Ministry of Finance, 2015a, 2015b; Alberta, Ministry of Finance, 2006-2015a, 2015b; Saskatchewan, Ministry of Finance, 2006-2015a, 2015b; Manitoba, Ministry of Finance, 2006-2015a, 2015b; Ontario, Ministry of Finance, 2006-2015a, 2015b; Québec, Ministère des Finances, 2006-2015; New Brunswick, Ministry of Finance, 2006-2015a, 2015b; Nova Scotia, Ministry of Finance, 2006-2015a, 2015b; Prince Edward Island, Ministry of Finance, 2006-2015a, 2015b; Newfoundland & Labrador, Ministry of Finance, 2006-2015; calculations by authors.

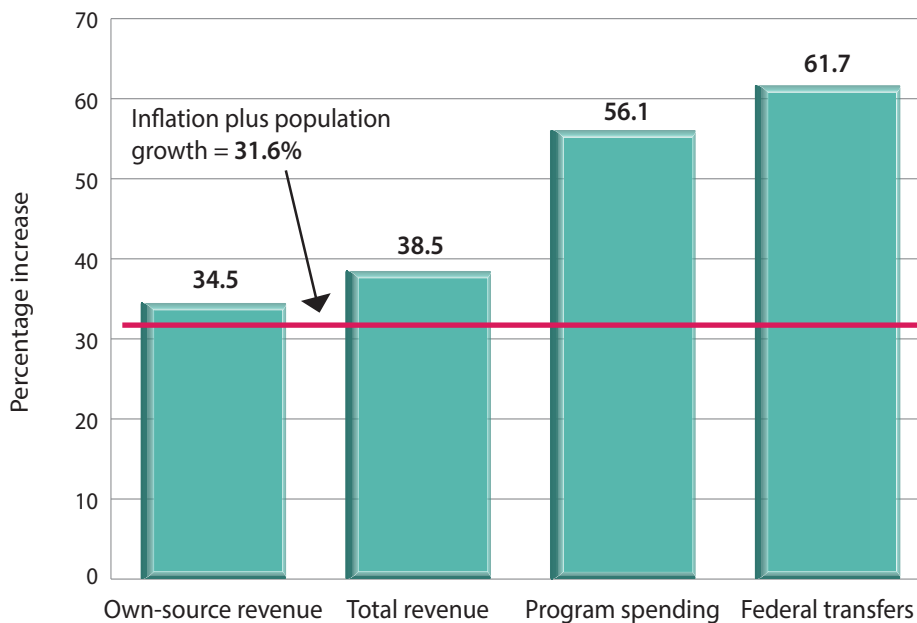
Figure 7b: Major Federal Transfers as a Share of all Provincial Spending, 2005/06 to 2015/16

Sources: Figure 7a; calculations by authors.

If Transfers Aren't To Blame, Why Are The Provinces Running Deficits?

Federal transfers to the provinces have been increasing steadily in recent years, and are now, in real per-capita terms, higher than at any point in Canadian history. These facts do not support the argument that inadequate growth in federal transfers is the cause of the fiscal challenges facing several Canadian provinces. Instead, this section presents evidence suggesting that rapid spending growth is primarily responsible for the emergence of large budget deficits at the provincial level. As **figure 8** shows, major federal transfers to the provinces increased by 61.7 percent from 2005/06 to 2015/16.⁷ This is approximately double the 31.6 percent increase that would have been required to offset the combined effects of inflation and population growth.

Figure 8: Growth in Federal Transfers and Provincial Revenue/Program Spending vs. Inflation + Pop Growth, 2005/06 to 2015/16



Sources: Figure 7a; calculations by authors.

7. The 62.3 percent increase in transfers cited in an earlier section includes transfers to the territories, whereas this slightly smaller figure refers to the increase in transfers to the provinces with the territories excluded.

During this same period, own-source provincial revenue increased by 34.5 percent—slightly above the combined rate of inflation and population growth. Partly as a result of increasing transfers, total provincial revenue increased by 38.5 percent, 6.9 percentage points more than the rate of inflation plus population growth. The data demonstrate that provincial revenues have been adequate during this period to offset the effects of increasing overall prices (inflation) and a growing population. And the growth in provincial revenues has been sufficient to finance moderate increases in inflation-adjusted per-person spending.

During the same period, however, program spending growth has dramatically outstripped provincial revenue gains. In fact, provincial program spending has increased by 56.1 percent during this decade. While this rate of growth has been slower than the rate of growth for federal transfers, it has nonetheless been significantly faster than the rate of own-source and total revenue growth. In other words, revenues have grown but spending has grown faster and the result has been the emergence and persistence of the large aggregate provincial budget deficits documented in figures 3a and 3b.

Where Are the Bigger Transfers Going?

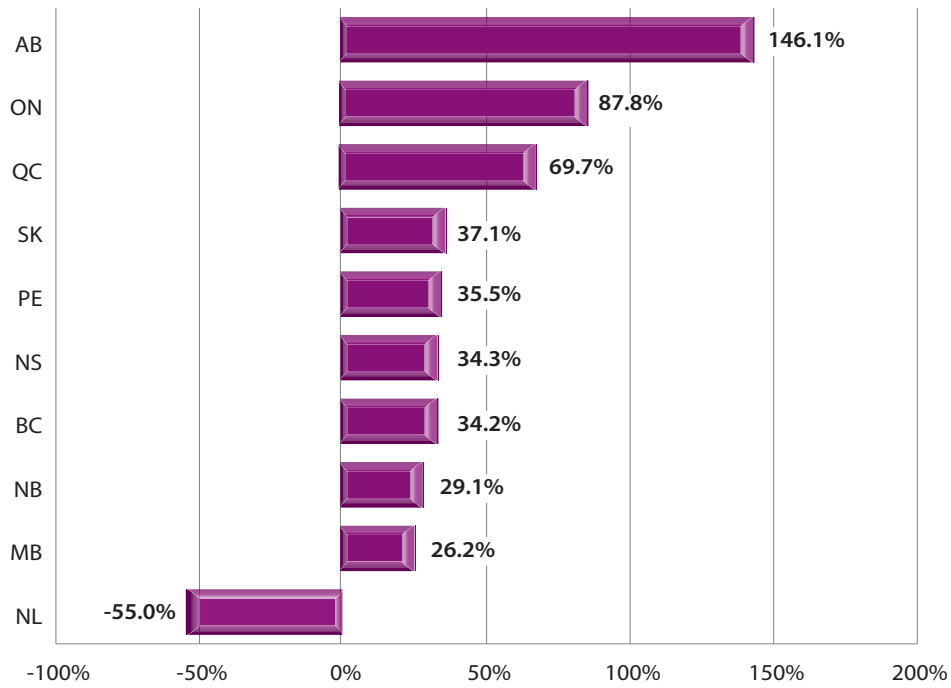
Thus far, we have seen that major federal transfers to the provinces have grown significantly over the past decade. However, there has been significant variation in the rate of growth in transfers received by the various provinces. In this section, we analyze trends over the past decade to assess whether transfers to any particular provinces are growing especially quickly.

Figure 9a displays the percentage change in (nominal) major federal transfers to each of the provinces from 2005/06 to 2015/16. Federal transfers have increased markedly faster in Alberta, Ontario, and Quebec than in the rest of the country. Alberta has experienced the greatest growth in federal transfers over the past decade, primarily due to a change in the formula used to calculate Canada Health Transfer payments that occurred in 2014/15, when the program became a pure per-capita transfer (Di Matteo, 2014). As a result of this policy change, transfers to Alberta increased by 32.6 percent from the previous year's level in 2014/15, by far the largest single year increase for any province during this timeframe. Faster population growth compared to the national average has also contributed to the rapid increase in major transfers to Alberta during this period.

Of greater significance is the fact that transfer payments to Ontario and Quebec, Canada's two most populous provinces, have increased much faster than transfers to most other provinces. Transfers to Quebec have increased by 69.7 percent over this decade, and payments to Ontario have increased by 87.8 percent (figure 9a). In both Ontario and Quebec, the increase in nominal transfers has been more than twice what would be required to keep pace with inflation and population growth. Furthermore, this rapid growth has caused a significant increase in the share of all provincial revenue that comes from federal transfers in both provinces. This share has increased from 12.0 percent to 16.4 percent in Ontario during the last decade, and from 18.8 percent to 20.3 percent in Quebec.

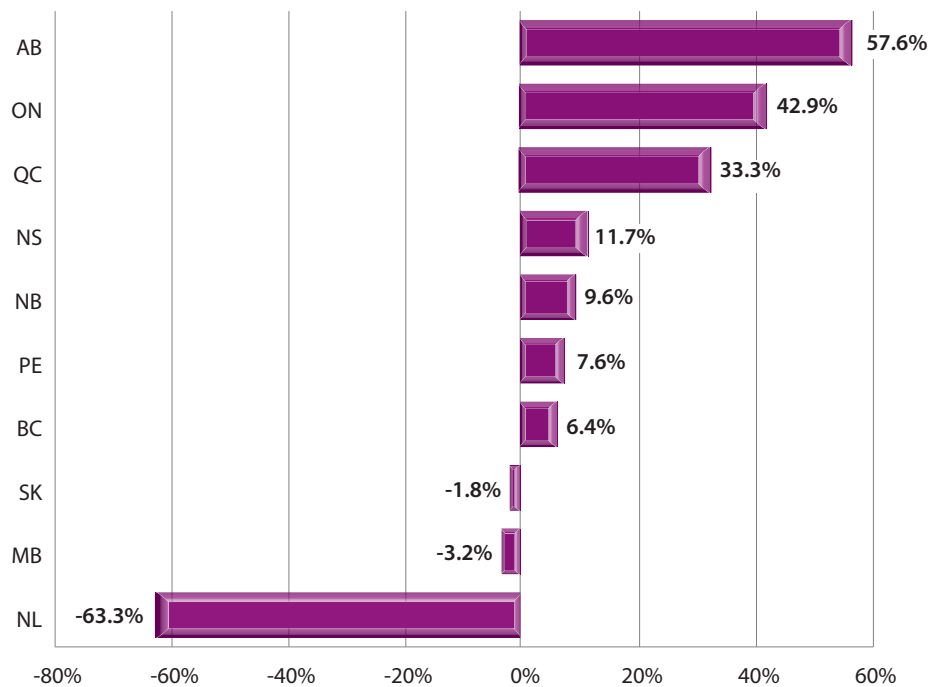
By comparison, transfer payments to Manitoba, Saskatchewan, and the Maritime Provinces have increased between 26.2 and 37.1 percent over the same period (figure 9a). In these provinces, transfer growth has been approximately adequate to offset inflation and population growth. Newfoundland alone has actually seen a nominal decrease in transfers. Once heavily reliant on equalization, Newfoundland is now a "have" province that receives no equalization grants and no longer receives payments under the offshore accord, with the result being the decline in overall transfer payments shown in figures 9a and 9b.

Figure 9a: Percent Change in (Nominal) Major Transfers, 2005/06 to 2015/16



Sources: Canada, Department of Finance, 2015a; calculations by authors.

Figure 9b: Percent Change in Inflation-adjusted Major Transfers Per Capita, 2005/06 to 2015/16



Sources: Canada, Department of Finance, 2015a; Statistics Canada, 2015a, 2015c; TD Economics, 2015; calculations by authors.

Figure 9b adjusts for differences in population across the provinces and presents the change in real (inflation-adjusted) per-capita transfers to each of the provinces over the past ten years. While this adjustment shrinks the gap between Alberta and the remaining provinces, transfers to Alberta, Ontario, and Quebec have still increased significantly faster than have those to all of the other provinces.

What is the explanation for the unusually rapid transfer growth to Quebec and Ontario? In short: equalization payments. During the period from 2005/06 to 2008/09, relatively weak economic performance in Quebec caused that province's equalization payments to increase dramatically. Over just three years, equalization payments to Quebec increased by more than \$3 billion, or 67 percent.

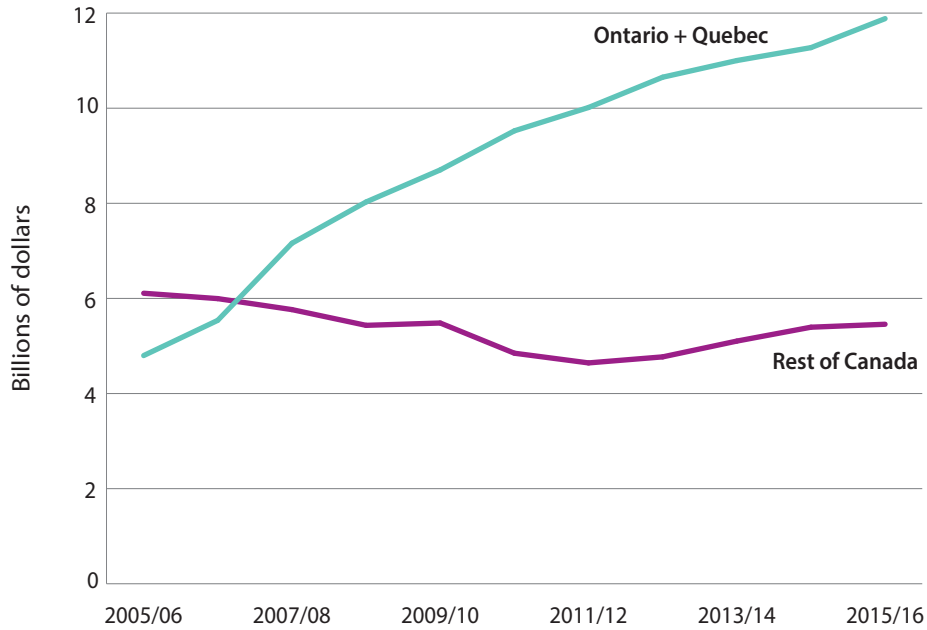
In 2009/10, another crucially important development occurred. In that year, Ontario became a have-not province and became eligible for equalization payments. In 2009/10, Ontario received \$347.0 million in equalization payments, a number that would grow by 839.8 percent to a peak of \$3.3 billion in 2012/13. Equalization payments to Ontario have decreased somewhat since then, but are still projected to be \$2.4 billion in 2015/16.

Figures 10a and 10b illustrate these trends (in dollar and percentage terms, respectively) by comparing total equalization payments received by Ontario and Quebec combined compared to the rest of Canada since 2005/06. In 2005/06, Quebec received \$4.8 billion, or 44.0 percent of all equalization payments, while Ontario received no equalization payments. More than half of equalization payments (56.0 percent) went to the rest of Canada. In 2015/16, Ontario and Quebec—now both have-not provinces—will receive 68.5 percent of equalization payments, compared to the 31.5 percent of payments that will go to the other have-not provinces in the country (figure 10b). This shift in the equalization program is primarily responsible for the differential rates of growth in overall transfers between the provinces discussed at the start of this section.

Although overall transfers to the provinces taken as a group have increased substantially over the past decade, the vast majority of that increase has been absorbed by Ontario and Quebec. The other provinces have seen significant increases in their CHT and CST payments during this timeframe; however, many smaller provinces have seen some of this growth offset by equalization payments that have either grown very slowly or shrunk in absolute terms.

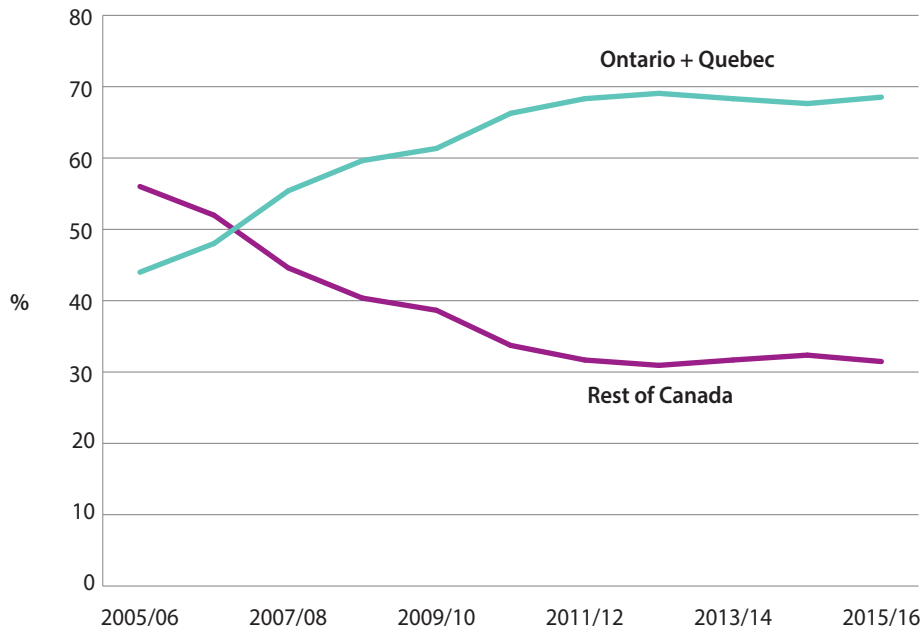
In summary, while overall transfers to the provinces have increased significantly since 2005/06, this increase has not been evenly distributed across the country. Instead, transfer growth has been dramatically faster than the national average in Ontario, Quebec, and Alberta, while the increase in federal transfers to the remaining provinces during the last decade was significantly smaller.

Figure 10a: Equalization Payments to Ontario and Quebec vs. the Rest of Canada, 2005/06 to 2015/16



Sources: Canada, Department of Finance, 2015a; calculations by authors.

Figure 10b: Share of Equalization Payments to Ontario and Quebec vs. Rest of Canada, 2005/06 to 2015/16



Sources: Canada, Department of Finance, 2015a; calculations by authors.

Recent Trends Surrounding Federal Transfers to Ontario

This paper has documented the substantial growth in major federal transfers over the past decade and the fact that the lion's share of transfer growth has gone to Ontario and Quebec. In this section, we turn to discuss the case of Ontario, which deserves particular attention given that it has seen the largest increase in federal transfers of any province over the past decade (excepting Alberta, where the transfer growth was primarily the result of a change in the way CHT payments are calculated). Ontario has seen its transfer payments grow much faster than other provinces primarily because it has become a “have-not” province and equalization recipient, a phenomenon which has important implications for other have-not provinces and even for national unity (Eisen and Fantauzzo, 2014; Milke, 2014). Furthermore, while Quebec, the other province that has experienced rapid transfer growth over the past decade, has worked towards achieving a projected balanced budget in 2015/16, a large budget deficit persists in Ontario despite the large increase in transfers documented in the preceding sections. This section more closely examines recent trends surrounding transfer payments to Ontario and considers the extent to which the growth in transfers can be reasonably identified as a major contributor to Ontario's fiscal challenges.

The economic and fiscal health of Canada's most populous province and largest provincial economy is of vital importance not only to Ontarians, but to the economic well-being of the country as a whole (Di Matteo, Clemens, and Palacios, 2014). It is therefore important to analyze trends surrounding transfers to Ontario and to provide the empirical context to assess the extent to which it is reasonable to identify inadequate transfer growth as a significant cause of the fiscal challenges facing the province.⁸

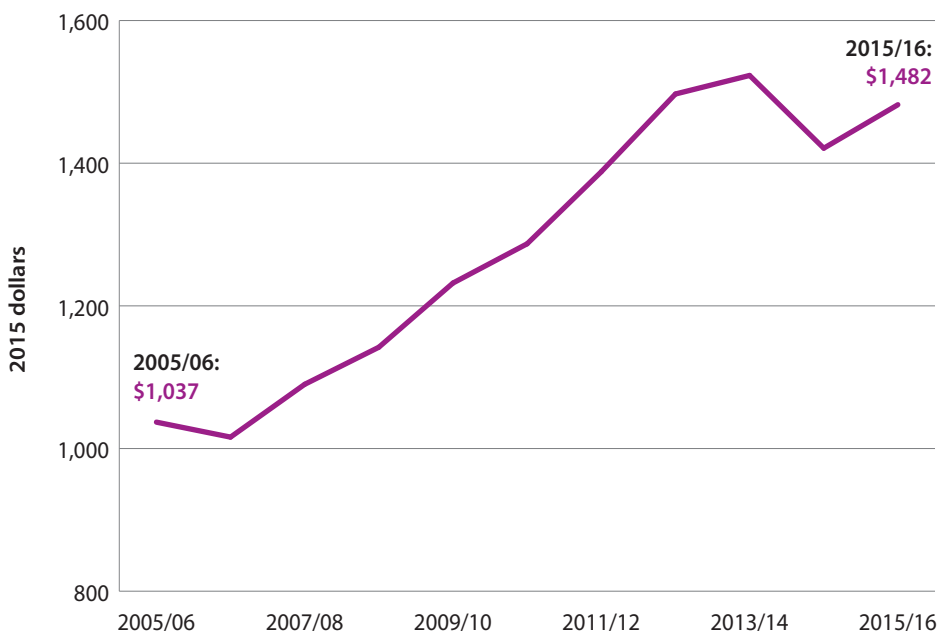
As noted, federal transfers to Ontario have helped drive the national trend of higher federal transfer payments overall. In fact, transfer payments to Ontario have increased at a significantly faster rate than federal transfers

8. Some have argued that Ontario taxpayers pay more in federal taxes than the province receives in transfers and direct federal program spending, and have suggested that this arrangement is unfair. However, it is inevitable, given the existence of an equalization program, progressive taxation, and redistributive federal spending, that residents of some provinces will pay more in taxes than they receive in transfers and program spending. This reality alone does not demonstrate the existence of a problem (Mendelson and Zon, 2013). Others have argued that certain components of the transfer system place Ontario at a disadvantage relative to other jurisdictions (e.g., Mackinnon et al., 2013). An analysis of these claims is beyond the scope of this paper. Our discussion of Ontario provides an analysis of recent trends surrounding the size of transfer payments to Ontario, and a comparison of the growth in transfers to other metrics including inflation plus population growth, own source revenue, and spending. This analysis suggests that transfers to Ontario have risen dramatically over the past decade.

to all the provinces and territories taken collectively. Federal transfers to Ontario have increased from \$10.9 billion in 2005/06 to \$20.4 billion in 2015/16, an increase of 87.8 percent. This increase in federal transfers is dramatically higher than Ontario's combined rate of inflation and population growth (31.1 percent).

Because nominal transfer growth has markedly outstripped inflation and population growth, real (inflation-adjusted) per-capita transfers to the province have increased significantly. **Figure 11** shows that, in 2005/06, per-capita transfers to Ontario stood at \$1,037 (in 2015 dollars). Over the next decade, real per-capita transfers increased by a total of 42.9 percent and are projected to reach \$1,482 in 2015/16. Real transfers per capita in this fiscal year are projected to almost exactly match the recent high-water mark for transfers to Ontario which was set in fiscal year 2013/14, when real per-capita transfers were \$41 higher than transfers in the current year are projected to be.

Figure 11: Inflation-adjusted Per-Capita Transfers to Ontario, 2005/06 to 2015/16

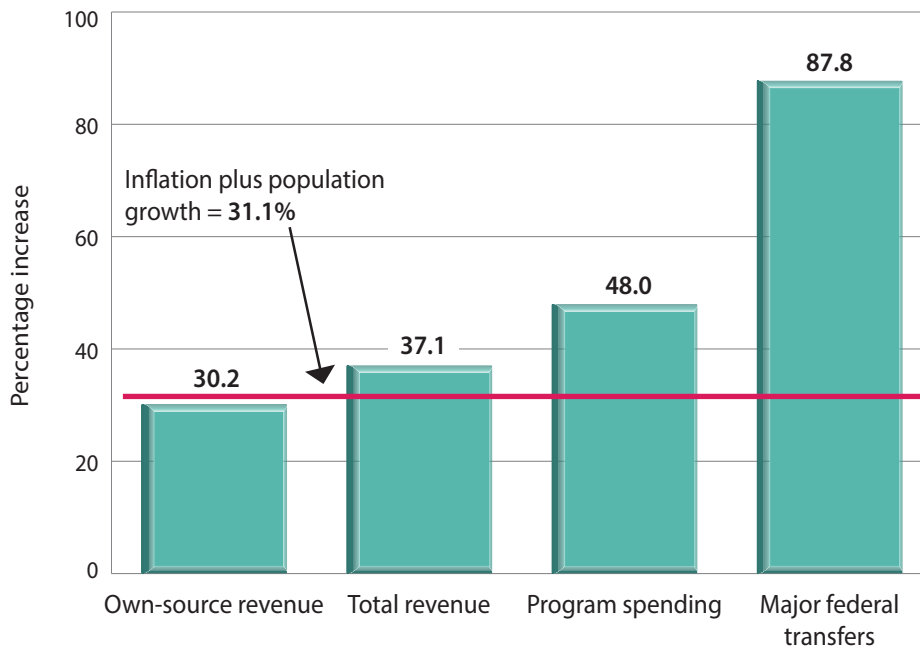


Sources: Canada, Department of Finance, 2015a; Statistics Canada, 2015a, 2015c; TD Economics, 2015; calculations by authors.

Clearly, federal transfers to Ontario have increased markedly since 2005/06 and have increased at an even faster rate than transfers to the provinces taken as a whole. As a result, the share of all federal transfers absorbed by Ontario has increased significantly during this time. In 2005/06, Ontario received 26.0 percent of all federal transfers. In 2015/16, Ontario's share is projected to be 30.1 percent. This means that while the total federal transfer "pie" has grown substantially over the past decade, Ontario's share of the pie has also increased.

As is the case for the provinces taken as a whole, transfer payments to Ontario have grown at a much faster rate than own-source revenue (**figure 12**), which means that federal transfer payments now represent a much larger share of Ontario's total revenue than was the case a decade ago. In 2005/06, 12.0 percent of Ontario's revenue came from federal transfers. That number climbed significantly in subsequent years; as a result, in 2015/16, federal transfers are projected to represent 16.4 percent of Ontario's revenue.

Figure 12: Growth in Federal Transfers and Ontario Revenue/ Program Spending vs. Inflation + Pop Growth, 2005/06 to 2015/16



Sources: Canada, Department of Finance, 2015a; Ontario, Ministry of Finance, 2006, 2015b; Statistics Canada, 2015a, 2015c; TD Economics, 2015; calculations by authors.

Since federal transfer payments to Ontario have increased dramatically over the past decade, it is necessary to look elsewhere for causes of Ontario's fiscal deterioration during that timeframe. Ontario's own-source revenue during this period totaled 30.2 percent, roughly in line with the combined rate of inflation and population (31.1 percent). Once major federal transfers (which have increased very rapidly) are included, total revenue growth for Ontario during this period stands at 37.1 percent, more than enough to offset the effects of inflation and population growth. However, during the same period, provincial program spending in Ontario has increased by 48.0 percent, significantly outstripping the growth in total revenues, despite the large increases in federal transfers.

If Ontario had spent prudently during this period, holding program spending growth to keep pace with inflation and population growth, revenue growth would have exceeded spending and the province would therefore have a substantial budget surplus this year instead of a large budget deficit. Transfers to Ontario have increased by 87.8 percent during this period, far faster than any relevant comparable metric. These data do not support the notion that inadequate transfer growth bears responsibility for the fiscal challenges facing Canada's most populous province.

Conclusion

This paper has shown that, despite provincial complaints of inadequate transfers from Ottawa, major federal transfers to the provinces and territories are currently higher on an inflation-adjusted per-capita basis than at any other point in Canadian history. Federal transfers to the provinces and territories have increased substantially in recent years, by 62.3 percent from 2005/06 to 2015/16—a rate much higher than would have been required to offset the effects of inflation and population growth. Furthermore, the share of all provincial revenues that come in the form of transfers from Ottawa has increased significantly between 2005/06 and 2015/16. These trends are particularly pronounced in Ontario, where federal transfers have increased by 87.8 percent during this time period. Major transfers now represent 16.4 percent of Ontario’s revenues, up from 12.0 percent in 2005/06.

Federal transfers have increased significantly faster than provincial own-source revenues since 2005/06, and the increase in transfer payments has relieved rather than exacerbated the fiscal pressure facing provincial governments across the country. The evidence in this paper suggests that it is not reasonable to claim that inadequate federal transfers are responsible for the deterioration of the fiscal position of several provinces, including Ontario, that has occurred over the past decade.

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