HOURGLASS FEDERALISM — HOW THE FEDS GOT THE PROVINCES TO RUN OUT OF MONEY IN A DECADE OF LIBERAL BUDGETS

Thomas J. Courchene

Paul Martin's landmark budget of 1995 cut federal funding for health care and other provincially delivered entitlements in such a way that Ottawa was able to balance its books while the provinces saw health costs rise to increasingly unsustainable levels — in many cases now approaching half their budgets. The 1995 cuts, suggests Tom Courchene, "compromised every provincial program except health care, since gutting medicare would spell certain electoral defeat." Meanwhile, after balancing the books in 1997 and presenting surpluses ever since, Ottawa has used the fiscal dividend to move into areas of exclusive provincial jurisdiction, such as cities and education, while the cash-starved provinces look on, helpless to spend any new money in their own constitutional domains. "The cities fully welcome these initiatives," Courchene writes, "because the provinces are effectively broke." He concludes: "While none of this was part of a grand design, Machiavelli would be proud."

Paul Martin déposait en 1995 un budget marquant qui sabrait dans le financement des soins de santé et de plusieurs autres programmes de compétence provinciale, ce qui a permis à Ottawa d'atteindre l'équilibre budgétaire au détriment des provinces, dont les dépenses de santé ont bondi au point d'accaparer souvent presque la moitié de leurs budgets. Selon Tom Courchene, ces compressions de 1995 ont compromis tous les programmes provinciaux sauf le régime d'assurance-maladie, intouchable pour tout gouvernement qui veut être réélu. Une fois son budget équilibré en 1997, Ottawa n'a cessé d'engranger des surplus et d'en profiter pour s'immiscer dans des domaines de compétence exclusivement provinciale, notamment l'éducation et les municipalités, tandis que les provinces lessivées ne pouvaient plus injecter la moindre somme dans leurs propres domaines constitutionnels. Les municipalités se réjouissent évidemment de cette intrusion d'Ottawa puisque les provinces sont effectivement à sec. Machiavel lui-même serait fier d'un résultat aussi impressionnant, note l'auteur, même s'il n'est pas le fruit d'une planification à proprement parler machiavélique.

The March 23, 2004, federal budget can lay claim to be the formal launching pad for what might be termed "hourglass federalism," namely the growing range of federal government initiatives that bypass the provinces and deal directly with citizens and cities, leaving the provinces as the squeezed middle of the division-of-powers hourglass, as it were. To be sure, this did not begin with the 2004 budget. Indeed, in the wake of the new fiscal relationships arising from Paul Martin's 1995 budget, federal incursions into the various (inherently provincial) areas such as education/human capital and welfare have become budgetary commonplace. However, what is remarkable about the 2004 budget is that it extends this provincial end run to embrace the cities which, constitutionally, are creatures of the provinces. Among other things, the budget details the composition of municipal revenues, expenditures and debt structures by province as part of the section *The Importance of Communities*, one of the five priority areas highlighted in the budget. Finance Minister Ralph Goodale is surely correct when he notes that the many provisions in the budget relating to cities constitute "a historic commitment to forge a New Deal for Canada's communities."

This is enough of a preview of the ensuing storyline to frame the issue at hand, namely the de facto evolution of the division of powers in ways that privilege Ottawa and citizens/cities at the expense of the provinces. The associated issue is that the force driving this evolution is Ottawa's superior fiscal position and its creative exercise of the federal spending power, on the one hand, and the (related) inability of the provinces to find revenues to finance anything other than medicare, on the other.

The analysis begins by addressing how and why the federal government might want to enlarge its sphere of policy influence. The answer has to do with the policy and electoral implications arising from the new global order, both the globalization component and the knowledge/human-capital component. Attention will then focus on the ways in which Ottawa has levered off its favourable fiscal balance vis-à-vis the provinces to make inroads in key areas that were traditionally viewed as falling under provincial jurisdiction. This will be followed by an elaboration of some of these policies as they affect citizens and cities as well as the range of options open to the provinces to counter these incursions. The essay ends with a few reflections about where this process is likely to lead Canadian federalism.

Canadians are masters at the art and practice of reworking the structures and processes of federalism to address external and internal challenges. In terms of altering the formal structures, several constitutional amendments were pivotal, most notably the Constitution Act 1982 replete with patriation and the Charter but, as well, the earlier amendments that transferred UI/EI and a role in pensions to the federal government. However, it is on the process front that Canadian federalism has been most flexible and creative. For example, the provincial/local share of own-source revenues rose from 25 percent at the time of Confederation to nearly 70 percent in the midst of the Great Depression, only to fall back to 30 percent during the Second World War World War and finally back in the 60 percent neighbourhood in recent years. And this ebb and flow of jurisdictional fortunes took place without much, if any, change in the written constitutional word. Essentially, it was driven by shifts in expenditure responsibilities — from the provinces to Ottawa in the Depression and WWII and back to the provinces over the last 50 years — which were accommodated by corresponding shifts in tax shares. Beyond this, variations in the magnitude and the nature of intergovernmental transfers have been tantamount to changes in the effective division of powers, with a shift in the direction of unconditional transfers facilitating enhanced decentralization, and vice versa. More recently, the policy spillovers arising from the increased north-south trade integration have led to a series of new instrumentalities that have embraced federal-provincial co-determination, the best example of which is the Social Union Framework Agreement (SUFA). The core message in all of this is that where there is a Canadian need and will to alter the division of powers, there clearly is a Canadian way.

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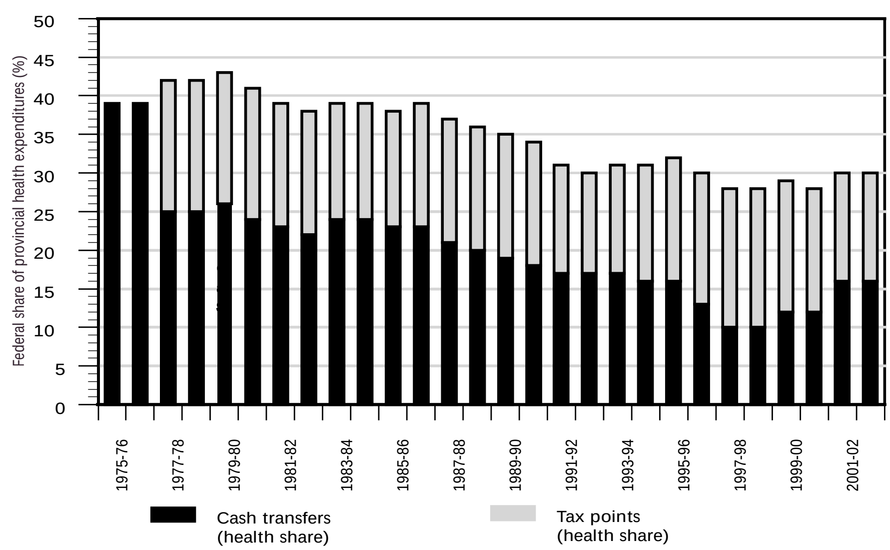
FEDERAL COST-SHARING OF PROVINCIAL SPENDING ON HEALTH CARE



Source: Calculated from Health Canada, "Backgrounder on Federal Support for Health in Canada," March 27, 2000; the September 2000 agreement; Finance Canada's "Backgrounder, Federal Transfers to Provinces and Territories," October 2002; and CIHI, "Preliminary Provincial/Territorial Government Health Expenditure, by Province/Territory and Canada," 2002, table A1.
Note: 2001-02 and 2002-03 are forecasts for provincial expenditures and use the finance department's revised methodology for calculating tax points. Reproduced from Yalnizyan, Armine (2004), "The Health Care Budget: Did it Resolve the 'Crisis'?", in Charles M. Beach and Thomas A. Wilson (eds.), *The 2003 Federal Budget: Conflicting Tensions* (Kingston: John Deutsch Institute, Queen's University), p. 243.

CP Photo

Finance Minister Ralph Goodale defends his 2004 federal budget during Question Period in the House of Commons as Deputy Prime Minister Anne McLellan and Prime Minister Paul Martin look on.

The issue then becomes whether globalization and the knowledge/information revolution are indeed creating a need for a rearrangement of federal and provincial powers. The case that one might make for an enhanced federal role and reach would have at least three separate prongs. The first relates to the shift from a resource-based society and economy to a human-capital or knowledge-based society and economy. Among other things, this means that societal investments in knowledge and human capital formation progressively hold the keys to wealth creation, to competitiveness and to ameliorating the income-distribution implications arising from globalization. It should not come as a surprise that as long as issues relating to Canada's competitiveness and citizens' standards of living are at stake, Ottawa will become a key policy player irrespective of what the Constitution might say.

The second has to do with the emergence of global city regions (GCRs) as the dynamic motors of the new economy. This also relates to competitiveness in the dual sense that these GCRs are leading their respective regions' inroads into NAFTA economic space and that GCRs are the key nodes in the knowledge/human-capital networks. Indeed, I endorse the view of Simon Fraser's Richard Harris that Canadians' standard of living will come down to how successful our global city regions are relative to American GCRs.

The third, and perhaps overarching, argument for an increased federal presence relates to the fact that the essence of nation-building and electoral salience have also shifted away from resource-based mega-projects and toward citizen-driven infrastructure and policies in areas like health, education and income distribution. And whereas these former mega-projects tended to be rural, citizen nation-building is predominantly urban. Unfortunately, from Ottawa's standpoint, most of these areas fall under provincial jurisdiction. But since electoral success is the *sine qua non* of politics, it is only a matter of time before competition among federal parties and between federal and provincial politicians will ensure that Ottawa will become involved in more direct ways with citizens and cities.

Intriguingly, except for the introduction of the Canada Child Tax Benefit (CCTB) in the 1997 federal budget, the earlier-noted and time-honoured ways to accommodate a need/desire to alter the de facto division of powers have not proved to be of much use in this context. This is so because the provinces do not share the federal desire to alter jurisdictional responsibilities and, therefore, do not see the need to alter either the structures or processes of Canadian federalism. Hence something else was needed to propel the division of powers in Ottawa's direction, and as already noted this turned out to be the federal government's superior fiscal position and the accompanying federal spending power. To be sure, the underlying motivation here was to put the federal fiscal house in order, with the implications for the division of powers more a matter of result than intent. The relevant point, however, is that not only were the driving forces fiscal in nature, but they were embodied in successive federal budgets.

As part of his watershed 1995 budget, Finance Minister Paul Martin folded the Canada Assistance Plan (CAP) and Established Programs Financing (EPF) into the new Canada Social Transfer (CST) and proceeded to pare the Canada Health and Social Transfer (CHST) cash transfers from $18 billion to $11 billion. This deficit shifting to the provinces was an essential component of Martin's "come hell or high water" commitment to taming the federal deficit. Received wisdom in the federal corridors of power was that former finance minister Michael Wilson's earlier attempt to slay the deficit dragon came up short, in part because the Mulroney Tories did not want to cut transfers to the provinces, at least not during the delicate 1987-90 ratification period for the Meech Lake Accord. The Chrétien Liberals did not make the same mistake, with the result that Canada's fiscal turnaround (with Ralph Goodale delivering the seventh consecutive federal surplus and forecasting two more) was and is so successful that *Business Week* has labelled this feat "The Maple Leaf Miracle."

Some analysts have claimed that these 1995 cuts in CHST cash transfers to the provinces have destroyed Canada's health care system. Actually, the opposite seems to me to be closer to the truth, namely that the CHST cuts compromised every provincial program *except* medicare, since gutting medicare would spell certain electoral defeat. In this context, it is important to recall that by 1995 the health share of federal cash transfers had already fallen from roughly 26 percent to 16 percent (see attached table). Indeed, one of the more popular indoor sports in that time frame for the fiscal federalism crowd was to predict when federal cash transfers to the provinces would fall to zero. This would occur because the pre-determined overall tax-plus-cash transfer was growing slower than the tax transfer sub-component, with the result that the cash transfer (as the residual component) would eventually fall to zero. While the 1995 CHST cuts may have hurried this process along, the pre-existing status quo was itself not sustainable. Those wishing to make a case that Ottawa destroyed medicare are better to focus on the era of federal surpluses (1997-98 and beyond) when the federal government did have ample revenues to put medicare on a stable longer-term funding path, but chose not to do so.

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This caveat aside, the ongoing reality is that provincial governments have no choice, electorally, but to trim proposed spending increases from here, there and everywhere to sustain medicare. And as health budgets inexorably approach 50 percent of provincial program spending, provinces will have to dip deeper and deeper into the existing spending levels of other policy areas in order to keep medicare afloat. Alternatively, they can choose to privatize or otherwise pass on the costs of these other policy areas to users, as is the case with rising tuition fees for post-secondary education (PSE).

Janice MacKinnon, who has a special insight into all of this as both a politician (minister of finance in Saskatchewan responsible for major cuts to the province's health budget including the closing of 52 hospitals) and a policy analyst (author of *Minding the Public Purse,* among other contributions) applies the label "unsustainable" to medicare. One aspect of this label relates to the continuous upward trajectory of health costs. Intriguingly, however, MacKinnon is more concerned about another definition of unsustainability, namely the fact that provincial finance ministers cannot long sustain a situation where health begins to occupy near 50 percent of program spending with continuing deleterious effects on all other policy areas.

The provinces were truly trapped. The small and unpredictable dollops of new federal cash transfers were not sufficient to meet citizen demands on the health care front, so that the only recourse was to starve other provincial spending areas. It was only a matter of time before citizens welcomed possible federal intrusions in these non-health policy areas, to which the analysis now turns.

The 1997 budget provision creating the CCTB represents at one and the same time the apex of cooperative and collaborative federalism, and the beginning of the federal end run around the provinces. In terms of the former, the proposal originated in the 1996 *Report to Premiers* as a way to develop a national, yet flexible, approach to child poverty. Ottawa would deliver the refundable and income-tested child tax benefit and the provinces, for their part, could reallocate the equivalent amount of funding from welfare to other policy areas dealing with low income families with children. This exercise in co-determination was carried over to the creation of the SUFA, a most innovative federal-provincial instrument, but one that unfortunately now seems mostly honoured in its breach, largely, I suspect, because Ottawa's superior fiscal position no longer requires it to be attentive, let alone accommodative, to the provinces' budgetary needs.

In terms of the cities agenda, beyond the GST tax relief ($7 billion over 10 years) and accelerating the spending of the existing $1 billion infrastructure fund, the 2004 budget has promised to revisit in later budgets the Speech from the Throne provision for sharing a proportion of the federal gas tax with the municipalities.

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In terms of new economy priorities, the CCTB can be viewed as a replacement for some or all of the former Canada Assistance Plan. Whereas CAP funding went to the provinces, the CCTB is a direct transfer to low and middle-income Canadian families. This is the appropriate juncture to emphasize that Ottawa's end run around the provinces may well involve creative and efficient policy measures, as is clearly the case with the CCTB.

On the learning or human capital front, the federal government has been very active — Millennium Scholarships, Canada Research Chairs, measures to support early childhood development, and various measures relating to education and tuition tax credits. The Goodale budget included, among other initiatives, a Canada Learning Bond for children of low-income families ($500 at birth and $100 per year up to age 15), provisions for enhancing generosity of the Canada Education Savings Grant, and a $3,000 grant for first year post-secondary students from low-income families. With these and many related measures Ottawa has clearly signalled that skills and human-capital enhancement (and ensuring equality of access thereto), are and will continue to be major federal priorities, as befits a knowledge/information era.

On the process front, Ottawa has promised to provide a stronger voice to municipalities on the full range of federal policies and programs that are important to them. Prime Minister Martin has appointed a parliamentary secretary to lead the efforts in providing a "New Deal" for communities and has created an External Advisory Committee on Cities and Communities while Finance Minister Ralph Goodale has, for his part, committed the minister of finance to annual, pre-budget consultations with the Federation of Canadian Municipalities. All in all, a rather comprehensive package, eagerly awaiting a goodly share of future surpluses for its implementation. And all in an area that was traditionally thought to be off limits to Ottawa.

Not surprisingly, perhaps, the cities fully welcome these initiatives. They clearly prefer to have two patrons than one, they want direct access to federal infrastructure funding to put them on a level playing field with their US counterparts, and they welcome being brought more fully into the federal decisions relating to them. And most of all they welcome an enhanced federal presence in their lives because, returning to the theme of this essay, the provinces are effectively broke.

Finally, the provinces are even being boxed in on the Medicare front. The controversial Health Council is up and running. Goodale allocated nearly a half-billion dollars to a new Canada Public Health Agency and a public health officer, both of which will report to the federal minister of health. Arguably these institutions should have been federal-provincial in nature, if not under the umbrella of the new Council of the Federation. Matters are not much better in terms of likely impacts of federal actions on provincial health expenditures. The various health agreements/accords appear to be moving in the direction of linking additional funding infusions to new health spending such as home care and catastrophic drug coverage. Moreover, with the CHST now split between a Canada Health Transfer (CHT) and the new Canada Social Transfer (CST), Ottawa will be tempted (and perhaps egged on by Canadians) to place conditions on any increases in the CHT or CST.

In all of this the provinces find themselves sandwiched from both above and below, as it were — caught between Ottawa's spending desires/priorities in the information era and the citizens/cities genuine funding needs. The fact that the Constitution is (largely) on the provinces' side is cold comfort, given that creative processes and cities/citizens' support will likely lead to a de facto political trump over any de jure provincial constitutional aces.

The provinces appear to be putting most of their hopes in the fiscal imbalance basket, to be carried forward by the newly created Council of the Federation. My assessment of this issue is that the provinces do indeed suffer from a fiscal imbalance. The claim that the provinces have access to virtually all tax bases so that a provincial imbalance is not possible simply does not hold water because Ottawa already has the lion's share of direct taxes and further increases here are likely to create competitiveness problems, so that provinces are effectively stymied. There is more room on the indirect tax front, but the obvious tax base, the GST, is constitutionally available only to Ottawa. Moreover, if Ottawa has funds sufficient to contemplate major transfers or tax-sharing to the cities, this is itself evidence of a fiscal imbalance. Nonetheless, unlike the case a few years ago, Ottawa can now argue that it, too, no longer has any fiscal room to manoeuvre; it can legitimately claim to also have a series of underfunded priorities (such as Canada's armed forces). I fear that public opinion will be with the provinces only insofar as the fiscal imbalance issue relates to increased (and presumably conditional) health care infusions, but no further. This is puzzling since one would have thought there must be some point at which deteriorating provincial public services in areas such as education, infrastructure, safety and the environment, among others would begin to rival medicare for pride of place in provincial budgets. Yet it is precisely this puzzle that feeds the shift toward hourglass federalism.

The new global order has re-oriented Ottawa's policy priorities toward issues relating to to citizens and cities. Since these areas tend to fall under provincial jurisdiction, the traditional way of privileging them would be by working with and through the provinces. However, for a variety of arguably legitimate reasons, Ottawa's preference was to deal directly with cities and citizens. To make this possible, Ottawa had somehow to secure dominion over the provinces. More by happenstance than by design, this fell into place as a by-product of Ottawa's approach to taming the deficit. Specifically, the deficit shifting to the provinces on the one hand and the status of medicare as a defining Canadian value on the other led the provinces to protect medicare at the expense of virtually all other policy areas. And the upward trajectory of medicare costs exacerbated the problems for provincial finance ministers. The inevitable result was that Ottawa's fiscal superiority and the exercise of its spending power allowed it to target its new economy priorities directly, rather than going through the provinces. And Ottawa even gained a key measure of control over medicare itself since the provinces became fiscal petitioners for increased health care funding. While none of this was part of a grand design, Machiavelli nonetheless would have been proud.

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It is not clear where all this leads. At one level, these existing trends may serve to establish a new status quo — one that resonates well with the principle of subsidiarity, i.e., passing powers down to cities. Moreover, it is far from clear that Canadians have any problems at all with this shift toward hourglass federalism.

What does seem clear, however, is that the only way for the provinces to extricate themselves from hourglass federalism in to create additional fiscal room. And it seems that the only options here are to download some of the costs of medicare to citizens, or to upload some of the costs to Ottawa, or a bit of both. From the provinces' vantage point (and probably from that of citizens as well), the clear preference would appear to be for Ottawa to increase its cash transfers from their roughly 16 percent current share to the original 25 percent share, as recommended by Tom Kent, among others. This would commit Ottawa to be a partner in sharing future health care costs which, in turn, might set the stage for meaningful health care reform since both levels of government would now be on the same fiscal side of the issue. While this would satisfy provincial needs in the sense of taking a huge chunk of medicare funding off their books, it is unlikely to sit well with Ottawa since it would be a roughly 50 percent increase in cash transfers that would, in turn, serve to tie their fiscal hands for the better part of an electoral mandate. Nonetheless, Prime Minister Martin has promised to sit down with the premiers this summer (electoral gods willing) to discus alternative stable funding arrangements for medicare. By virtue of this promise, Martin has raised expectations that Ottawa will deliver some permanent increases in funding, but a move to 25 percent seems a bit optimistic given the current budget forecasts of the available surpluses looking forward.

There are of course alternative ways to take parts of medicare funding off provincial books. For example, some of the poorer provinces, looking at the health-care-related salary settlements in Alberta, may just say to Ottawa: Here, you take medicare, we can no longer afford it. Other provinces may follow Alberta's route of funding parts of health care with dedicated premiums. And Alberta itself (and possibly Quebec, for other reasons) is the most likely province to be contemplating a new version and vision for medicare, perhaps toward a thorough privatization of health care.

The enduring Canadian reality in all of this is the everything still revolves around medicare!

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