OFFICE OF THE PARLIAMENTARY BUDGET OFFICER

BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

Renewing the Canada Health Transfer: Implications for Federal and Provincial-Territorial Fiscal Sustainability

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This note provides an update of PBO's baseline long-term fiscal projections and fiscal gap estimates (published in its *Fiscal Sustainability Report 2011*) that incorporates the recent Canada Health Transfer (CHT) renewal. On December 19, 2011 the Government of Canada announced that: the CHT would continue to grow at 6 per cent annually until 2016-17; starting in 2017-18 the CHT would then grow in line with a 3-year moving average of nominal GDP growth (with a minimum increase of 3 per cent per year guaranteed); and, the CHT will be reviewed again in 2024.

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Summary

- Based on the Government of Canada's recent announcement, growth in CHT cash transfers over the period 2007-08 to 2016-17 will average 6.0 per cent annually. This rate of increase is only marginally lower than PBO's projected growth in provincial-territorial government health spending over 2007-2016 (6.1 per cent average annual growth).

- PBO projects that CHT cash transfers will then grow at 3.9 per cent annually, on average, over 2017-18 to 2024-25, which is significantly lower than PBO's projected growth in provincial-territorial health spending over the same period (5.1 per cent average annual growth). PBO projects that growth in provincial-territorial health spending will further outpace growth in CHT cash transfers over 2025-26 to 2040-41 (5.3 versus 3.8 per cent average annual growth) if the new escalator is maintained beyond 2024.

- Assuming that the new CHT escalator is maintained indefinitely, PBO projects that the share of federal CHT cash payments in provincial-territorial health spending will decrease substantially from 20.4 per cent in 2010-11 to average 18.6 per cent over 2011-12 to 2035-36; then 13.8 per cent over the following 25 years; and, 11.9 per cent over the remainder of the projection horizon. This would ultimately bring the level of federal cash support to historical lows observed under the 1996-97 to 2001-02 period of CHST (Canada Health and Social Transfer) funding.

- PBO's updated consolidated federal and provincial-territorial government net debt-to-GDP projection continues to indicate that the overall fiscal structure is not sustainable over the long term given projected demographic and economic trends. PBO's updated consolidated fiscal gap estimate indicates that achieving sustainability would require permanent policy actions of 2.4 per cent of GDP, either to raise revenue, reduce program spending, or some combination of both. This would represent $42 billion of fiscal actions in 2011-12, increasing over time in line with nominal GDP.

- However, as a result of incorporating the new CHT escalator the fiscal structure at the federal level is now sustainable. Indeed, PBO projects that the federal net debt-to-GDP ratio will decline steadily from its current level, ultimately resulting in a net asset position. PBO estimates that the federal fiscal gap is now -0.4 per cent of GDP, indicating that – relative to PBO's projection – the federal government could *reduce* revenue, *increase* program spending or some combination of both (by $7 billion in 2011-12 and increasing over time in line with nominal GDP) while maintaining fiscal sustainability.

- In contrast, provincial-territorial net debt relative to GDP is projected to increase substantially over the long term from 20 per cent in 2010-11 to over 125 per cent in 2050-51 and to over 480 per cent by 2085-86. PBO estimates that the provincial-territorial fiscal gap is now +2.9 per cent of GDP, indicating that – relative to PBO's projection – provincial-territorial governments would need to *raise* revenue, *reduce* program spending or some combination of both (by $49 billion in 2011-12 and increasing over time in line with nominal GDP) to achieve fiscal sustainability.

- PBO believes that long-term economic and fiscal projections are an essential element of fiscal transparency and sustainability analysis. The Government of Canada could improve fiscal transparency by fulfilling its Budget 2007 commitment to publish its "comprehensive fiscal sustainability and intergenerational report" that would provide a "broad analysis of current and future demographic changes and the implication of these changes for Canada's long-run economic and fiscal outlook".

1 Background

PBO published its most recent *Fiscal Sustainability Report* (FSR) on September 29, 2011.[1] The 2011 report expanded PBO's analysis to include provincial-territorial governments on a consolidated basis in order to assess fiscal sustainability[2] for the broader government sector (i.e., federal and provincial-territorial) and to examine the implications of existing and alternative federal health and social transfers.

PBO's baseline 2011 FSR projection indicated that the fiscal structure at the federal and provincial-territorial level is not sustainable over the long term. Further, PBO estimated that restoring sustainability to public finances would require permanent policy actions of 2.7 per cent of GDP, either to raise taxes, reduce overall program spending, or some combination of both. In PBO's baseline FSR projection, the escalators for cash[3] transfers under the federal Canada Health Transfer (CHT) and Canada Social Transfer (CST) were assumed to be maintained at their current (i.e., until 2013-14) legislated rates – growing at 6 and 3 per cent annually – indefinitely. Based on these assumptions, PBO estimated a federal fiscal gap of 1.2 per cent of GDP and a provincial-territorial fiscal gap of 1.5 per cent of GDP.

On December 19, 2011 the Government of Canada announced that: CHT transfers would continue to grow at 6 per cent annually until 2016-17; and, starting in 2017-18 the CHT would then grow in line with a 3-year moving average of nominal GDP growth (with a minimum increase of 3 per cent per year guaranteed).[4] The Government of Canada also announced that the CST would continue to grow at 3 per cent annually.

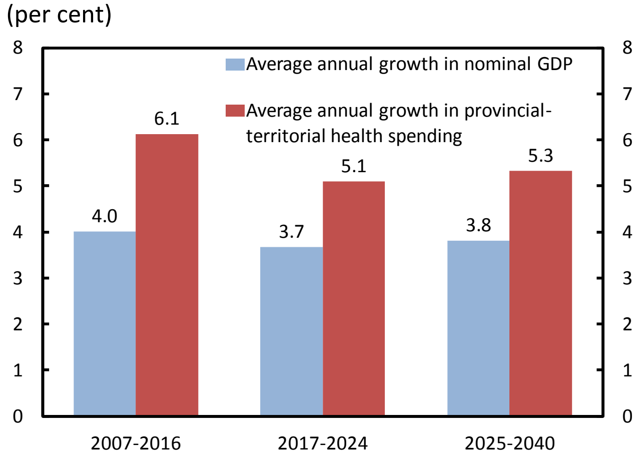
The following provides an update of PBO's baseline projections and fiscal gap estimates from its 2011 FSR that incorporates the recent CHT renewal. That is, beyond 2016-17 PBO assumes that growth in the CHT is equal to a 3-year moving average of nominal GDP growth. All other assumptions and projections are unchanged from the 2011 FSR.

2 Projected Growth in Nominal GDP, CHT and Provincial-Territorial Health Spending

Based on the Government of Canada's recent announcement, growth in the CHT over the period 2007-08 to 2016-17 will average 6.0 per cent annually. This rate of increase is only marginally lower than PBO's projected growth in provincial-territorial government health spending over 2007-2016 (6.1 per cent on an average annual basis) but significantly higher than PBO's projected growth in nominal GDP of 4.0 per cent over the same period (Figure 2-1).

Figure 2-1

Average Annual Growth in Nominal GDP and Provincial-Territorial Health Spending



Source: Office of the Parliamentary Budget Officer; Statistics Canada; Canadian Institute for Health Information (CIHI).
Note: Calendar-year basis.

[1] Available at: http://www.parl.gc.ca/PBO-DPB/documents/FSR_2011.pdf.

[2] PBO's assessment of fiscal sustainability involves projecting government debt relative to the size of the economy over the long term based on assumptions about current program commitments and tax 'burden' given projected demographic and economic trends. Fiscal sustainability requires that government debt cannot ultimately grow faster than the economy. In addition, PBO estimates the degree to which a fiscal structure is not sustainable using the fiscal gap, which is the amount of fiscal action required to achieve fiscal sustainability.

[3] According to Finance Canada, CHT transfer payments include both cash and tax transfers (http://www.fin.gc.ca/fedprov/cht-eng.asp). Unless otherwise noted all references to the CHT pertain to *cash* transfers.

[4] Available at: http://www.fin.gc.ca/n11/data/11-141_1-eng.asp.

Starting in 2017-18, the CHT is projected to grow in line with a 3-year moving average of nominal GDP growth. PBO projects that nominal GDP growth will average 3.7 per cent annually over 2017-2024, which corresponds to 3.9 per cent growth based on a 3-year moving average.[5] Therefore, PBO projects the CHT to grow at 3.9 per cent annually, on average, over the period 2017-18 to 2024-25, which is significantly lower than PBO's projected growth in provincial-territorial government health spending over the same period (at 5.1 per cent annually on average).

The Government of Canada has committed to reviewing the CHT (and the CST) in 2024. However, beyond 2024-25, PBO assumes that the CHT escalator formula (i.e., the 3-year moving average of nominal GDP growth) will be maintained indefinitely. PBO projects that if the new escalator formula is maintained, growth in the CHT will continue to fall short of projected growth in provincial-territorial government health spending. For example, over the period 2025-26 to 2040-41, PBO projects growth in the CHT to average 3.8 per cent annually while growth in provincial-territorial health spending is projected to average 5.3 per cent per year.

3 Federal Health Cash Transfers Relative to Provincial-Territorial Health Spending[6]

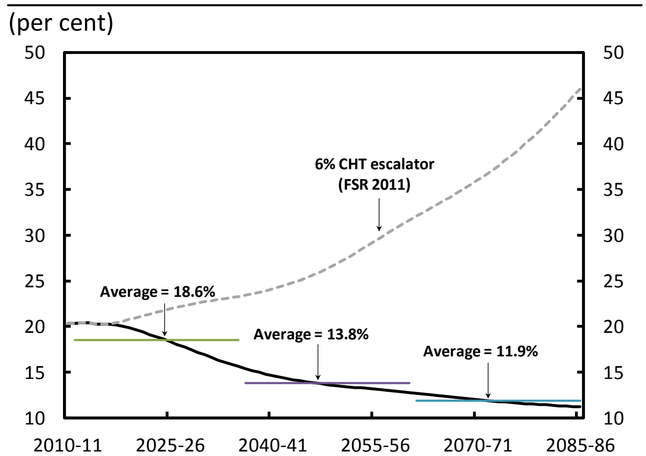
In the 2011 FSR, the CHT cash transfer was assumed to grow at 6 per cent annually – somewhat higher than PBO's projected growth in provincial-territorial health spending – indefinitely. As a result, the share of federal CHT cash in provincial-territorial health spending was projected to increase substantially, albeit at a gradual pace.

In FSR 2011, federal CHT cash was projected to average 21.6 per cent of provincial-territorial health spending over 2011-12 to 2035-36, then 26.8 per cent over the following 25 years and 38.1 per cent over the remaining 25-year period, as projected growth in provincial-territorial health spending continued its downward trend.

In contrast, under the assumption that the new CHT escalator formula is maintained indefinitely, the share of federal CHT cash in provincial-territorial health spending is now projected to decrease substantially from its 2010-11 level of 20.4 per cent (Figure 3-1). PBO projects that federal CHT cash will average 18.6 per cent of provincial-territorial health spending over 2011-12 to 2035-36; then 13.8 per cent over the following 25 years; and, 11.9 per cent over the remaining 25 years of the projection horizon.

Figure 3-1

Federal CHT Cash Transfer Relative to Provincial-Territorial Health Spending



Source: Office of the Parliamentary Budget Officer.

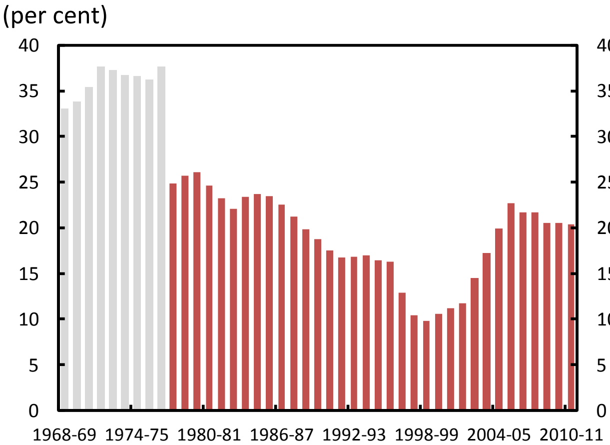
To put this projected decline in context it is helpful to compare the share of federal health cash transfers in provincial-territorial health spending over a long historical period. Over the period 1968-69 to 1976-77 under cost-sharing federal health cash transfers amounted to 36.1 per cent of provincial-territorial health spending on average (Figure 3-2).

[5] PBO has assumed that the 3-year moving average of nominal GDP growth is calculated over the 3 calendar years prior to the fiscal year in which the CHT transfer is made.

[6] The comparison of federal health cash transfers relative to provincial-territorial government health spending is not intended to reflect the extent to which the federal government provides financial resources to the provincial and territorial governments. An analysis of the extent of the federal government's contribution could include tax transfers as well as other cash transfers related to Equalization and Territorial Formula Financing. However, such an analysis is beyond the scope and nature of this paper.

Figure 3-2

Federal Health Cash Transfers Relative to Provincial-Territorial Health Spending



Source: Commission on the Future of Health Care in Canada (CFHCC); Finance Canada; Canadian Institute for Health Information (CIHI); Office of the Parliamentary Budget Officer.

Note: Results for 1968-69 to 2001-02 are taken directly from the 2002 Final Report of the CFHCC and results for 2005-06 to 2010-11 are calculated from Finance Canada and CIHI data. The shaded bars from 1968-69 to 1976-77 represent the period during which federal health transfers consisted of cash payments only. Results for 2002-03 to 2004-05 represent a linear interpolation.

With the creation of Established Program Financing (EPF) in 1977 the Government of Canada merged cost-sharing programs (on a cash-only basis) into a block transfer consisting of cash *and* tax transfers, with a notional allocation for health. Over the period of EPF funding (1977-78 to 1995-96), the share of federal cash transfers in provincial-territorial health spending decreased substantially from 24.9 per cent (in 1977-78) to 16.3 per cent in 1995-96. Then with the introduction of the Canada Health and Social Transfer (CHST) in 1996-97 (replacing EPF and the Canada Assistance Plan), the share of federal cash transfers reached an all-time low of 9.8 per cent in 1998-99.

In 2004-05, the CHST was separated into the CHT and the CST. Under CHT financing the share of federal cash transfers increased significantly, averaging 21.3 per cent of provincial-territorial health spending since 2005-06. Under the new CHT escalator formula tied to nominal GDP growth, PBO projects that the share of federal health cash transfers in provincial-territorial health spending will continue to decline, ultimately reaching the historically-low level observed under CHST funding over 1996-97 to 2001-02 (11.1 per cent on average).

4 Updated Long-Term Fiscal Projections

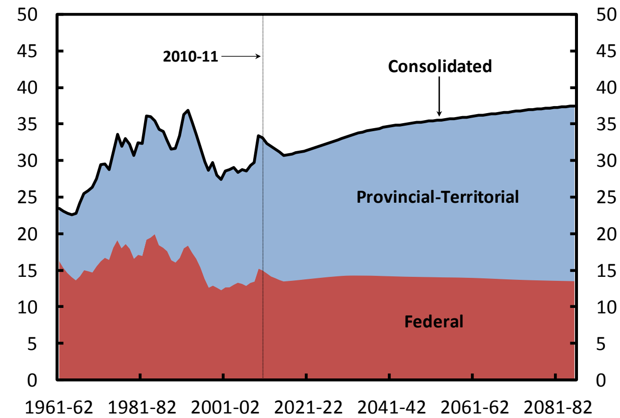
Incorporating the new CHT escalator formula into PBO's long-term projections[7] does not affect projections of consolidated federal and provincial-territorial revenue or program spending since consolidation involves eliminating all transfers between governments. However, the change to the CHT does affect the composition of program spending at the consolidated level. With CHT growing in line with nominal GDP (beyond 2016-17) instead of the 6 per cent annual growth assumed in FSR 2011, the projected increase in consolidated program spending relative to the size of the economy – resulting from population ageing and assumed program enrichment – now falls squarely on provincial and territorial governments. Federal program spending is now projected to increase moderately from 13.6 per cent of GDP in 2016-17 to a peak of 14.3 per cent of GDP in 2032-33 while provincial-territorial program spending (excluding federal transfers) is projected to increase by 6.7 percentage points of GDP from 17.3 to 23.9 per cent of GDP by the end of the projection horizon as the growth in health spending outpaces the growth in federal transfers (Figure 4-1).

[7] FSR 2011 cautions that long-term fiscal projections should not be regarded as forecasts or predictions of the most likely outcomes rather they should be viewed as 'what-if' scenarios. Indeed, an unsustainable fiscal structure could result in an explosive increase in a government's debt-to-GDP ratio over the long term. Such a scenario would not likely be realized as responses by the government, households, firms and financial markets would bring about changes to this structure and likely at higher costs.

Figure 4-1

Consolidated Federal and Provincial-Territorial Program Spending

(per cent of GDP)



Source: Office of the Parliamentary Budget Officer; Statistics Canada.
Note: Excludes intergovernmental transfers received by federal and provincial-territorial government sectors.

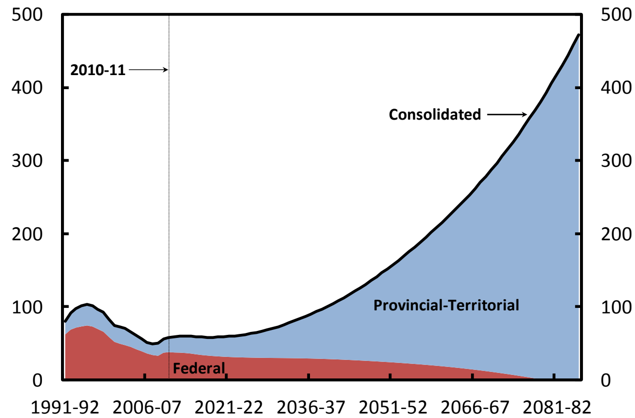
The long-term debt-to-GDP projections in the 2011 FSR are based on the assumption that once the economy has fully recovered, both federal and provincial-territorial revenues grow in line with nominal GDP thereafter. The FSR revenue projections, along with the projected effective interest rates on debt, and the updated program spending projections determine the path of federal and provincial-territorial debt over the long term. Assuming that the new CHT escalator is maintained, consolidated federal and provincial-territorial government net debt relative to GDP is projected to rise steadily from 58 per cent in 2010-11 to over 150 per cent in 2050-51 and to almost 500 per cent by the end of the projection horizon (Figure 4-2).

PBO's updated baseline consolidated federal and provincial-territorial government debt-to-GDP projection indicates that the overall fiscal structure is not sustainable over the long term given projected demographic and economic trends. Consolidated federal and provincial-territorial government net debt, over the long term, is projected to ultimately grow faster than the economy, resulting in ever-increasing debt-to-GDP ratio.

Figure 4-2

Consolidated Federal and Provincial-Territorial Government Net Debt

(per cent of GDP)



Source: Office of the Parliamentary Budget Officer; Statistics Canada.

However, assuming that the new CHT escalator is maintained, the fiscal structure at the federal level is now sustainable. Indeed, PBO projects that the federal net debt-to-GDP ratio will decline steadily from its current level, ultimately resulting in a net asset position by the end of the projection horizon. In contrast, provincial-territorial net debt relative to GDP is projected to increase substantially over the long term from 20 per cent in 2010-11 to over 125 per cent in 2050-51 and to over 480 per cent by the end of the projection horizon.

5 Updated Fiscal Gap Estimates

Fiscal sustainability requires that government debt cannot ultimately grow faster than the economy. The degree to which this structure is not sustainable can be estimated by the 'fiscal gap' – the difference between the current fiscal structure and a structure that is sustainable over the long term.

On a consolidated basis, the updated baseline federal and provincial-territorial government fiscal gap is estimated at 2.4 per cent of GDP when calculated over a 75-year horizon.[8] This means

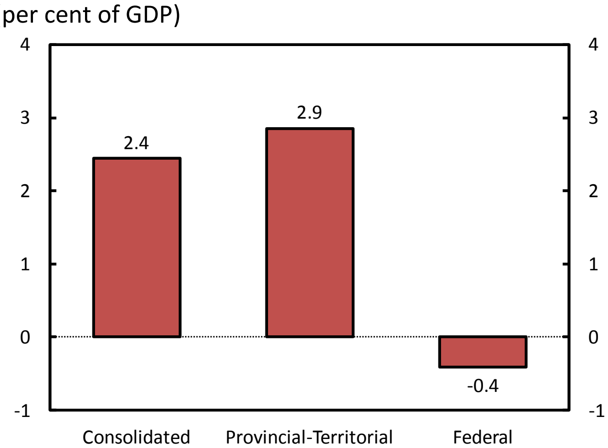
[8] In FSR 2011 the baseline consolidated fiscal gap was estimated at 2.7 per cent of GDP (1.2 and 1.5 per cent of GDP at the federal and

that beginning in 2011-12, the combined federal and provincial-territorial government operating balance (relative to GDP) would need to increase by 2.4 percentage points of GDP above its baseline level, by increasing revenue, reducing program spending or some combination of both from their projected baseline to achieve a consolidated net debt-to-GDP ratio of 57.9 per cent after 75 years (Figure 5-1).

Figure 5-1

Fiscal Gap Estimates

(per cent of GDP)



Source: Office of the Parliamentary Budget Officer.
Note: The projection period starts in 2011-12. Calculations are based on the endpoint (2085-86) consolidated net debt-to-GDP ratio of 57.9 per cent (37.6 per cent federal and 20.3 per cent provincial-territorial).

Under the updated baseline projection, the federal fiscal gap is now estimated at -0.4 per cent of GDP, indicating that the federal government could – relative to its baseline level – reduce revenue, increase program spending or some combination of both (amounting to 0.4 per cent of GDP annually) while maintaining a fiscally sustainable structure. In contrast, the provincial-territorial fiscal gap is estimated at +2.9 per cent of GDP, indicating that beginning in 2011-12, provincial-territorial governments would need to increase revenue, reducing program spending or some combination of both (amounting to 2.9 per cent of GDP annually) to achieve fiscal sustainability.

6 Improving Fiscal Transparency

Governments in several Organisation for Economic Co-operation and Development (OECD) countries have assessed their fiscal sustainability by routinely preparing long-term economic and fiscal projections – indeed many are required to do so by legislation. According to the OECD[9] such reports "offer invaluable signposts to help current governments to respond to known fiscal pressures and risks in a gradual manner, earlier rather than later, and help future governments avoid being forced to adopt sudden policy changes". PBO believes that long-term economic and fiscal projections are an essential element of fiscal transparency and sustainability analysis.

In Budget 2007 the Government of Canada committed to "publish a comprehensive fiscal sustainability and intergenerational report with the 2007 Economic and Fiscal Update".[10] This report would "provide a broad analysis of current and future demographic changes and the implication of these changes for Canada's long-run economic and fiscal outlook". Moreover, Budget 2007 noted that the publication of a report on fiscal sustainability "is motivated by the Government's view that maintaining sustainable public finances at all orders of government is a critical condition to achieving intergenerational equity and strong and sustained economic growth." The Government of Canada's report on fiscal sustainability is yet to be published.

The Government of Canada could improve fiscal transparency by publishing its long-term economic and fiscal projections as well as its assessment of the sustainability of public finances in Canada.

provincial-territorial levels, respectively). Although the consolidated operating balance is unchanged from the 2011 FSR, given the lower effective interest rate on federal debt, the improvement in the federal operating balance in present-value terms more than offsets the corresponding deterioration in the provincial-territorial operating balance. As a result, the consolidated fiscal gap in Figure 5-1 is somewhat smaller than the estimate in the 2011 FSR.

[9] See p. 2 in *The Benefits of Long-term Fiscal Projections* available at: http://www.oecd.org/dataoecd/40/26/43836144.pdf.
[10] See p. 155 in *The Budget Plan 2007* available at: http://www.budget.gc.ca/2007/pdf/bp2007e.pdf.