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**COMMENTARY/COMMENTAIRE**

# Turning Point: Balancing the Budget While Confronting Rising Healthcare Costs

by Jason Clemens

## Executive Summary

Canada's federal government is struggling with two fiscal problems, budget deficits and rising national debt, and unsustainable increases in federal healthcare transfers to the provinces.

- While better than most other industrial countries, the fiscal position of Canada's federal government needs to improve. Current budget projections forecast deficits and increasing national debt through the fiscal year 2014-15.
- The government's plan for a strategic review of all spending in order to find savings is laudable but insufficient.
- The budget deficit is largely a result of increased spending. While revenues did decline during the recession, the reduction was nowhere near the magnitude of the increases in spending. For example, between 2008-09 and 2009-10, revenues declined by \$14.5 billion while spending increased by \$34.5 billion, resulting in a \$55.6 billion deficit for the year.
- The federal plan to balance the budget relies on: (1) slowing the growth in program spending, (2) continued low interest rates, and (3) revenues rebounding sufficiently to catch up with spending.
- This approach relies on factors beyond the control of the government, compared to alternative methods used with great success in the past.
- The "temporary" stimulus spending undertaken to combat the recession was initially design in such a way as to return program spending to its pre-stimulus level once the stimulus was exhausted. This is the traditional concept of Keynesian stimulus. Subsequent budgets, however, have made the "temporary" spending permanent. An elimination of the "temporary" spending would restore fiscal balance sooner than currently planned.

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- Federal transfers to the provinces in support of healthcare spending are growing at rates that will be difficult to sustain over time, which poses a real risk to the long-term sustainability of the federal budget.
- Using the base year of 2006-07, transfers to the provinces for healthcare (known as the Canada Health Transfer or CHT) will increase by 70 percent compared to an increase in total program spending (net of the CHT) of 37.6 percent. In other words, federal program spending on health transfers is increasing at almost twice the rate of all other program spending by the federal government.
- Just as provincial government spending on healthcare is crowding-out the resources available for other purposes, disproportionate increases in healthcare transfers by the federal government mean that other vital spending is similarly being crowded out.
- The solution to the deficit and debt challenges facing the federal government is a more proactive approach based on immediate spending reductions, which unlike other factors, the federal government directly controls.
- The federal government must acknowledge the folly of simply throwing more money at the provinces to provide healthcare, a strategy that has resulted in little tangible improvements. Real reform of the system is critical. The federal government needs to reform the transfer system, similar to what it did with social transfers in the mid-1990s.

## Introduction

The federal budget passed in June 2011,[1] which was essentially an update to the pre-election budget presented in March,[2] indicated a deficit for the current year (2011-12) of $32.3 billion.[3] Between the current year and 2015-16, when the formal plan projects a balanced budget, the federal government expects to incur deficits totalling $61.4 billion. The national debt is projected to reach a little over $585 billion this year, on its way to a peak of $614.5 billion in 2014-15, when it starts to decline.[4]

The federal plan to balance the budget relies on three critical points: (1) slowing the growth in program spending, (2) relatively low interest rates, and (3) revenues rebounding sufficiently to catch up with spending. This approach relies to a greater extent on factors beyond the control of the government, such as interest rates and economic growth, than alternative strategies used in the past with great success. Specifically, the federal government's current plan ignores the lessons and success of the 1995 budget in tackling the deficit. In addition, the federal government continues to ignore the mounting pressures placed on federal finances by transfers to the provinces to support healthcare spending.

This commentary details the "status quo" approach to budgeting employed by the federal government, the risks related to this passive approach, and the consequences of rapidly expanding healthcare transfers. Although Canada's fiscal position is not as dire as that many other nations, notably the United

[1] Available at http://www.budget.gc.ca/2011/home-accueil-eng.html.
[2] Available at http://www.budget.gc.ca/march-mars-2011/home-accueil-eng.html.
[3] For a succinct summary of the 2011 Budget (June) see TD Economics (2011). *The 2011 Federal Budget: The Sequel*. Available at http://www.td.com/economics/budgets/fed_jun11.pdf.
[4] This projection does not take into account the enormous unfunded liabilities of the federal government or the many debts and liabilities of provincial and local governments.

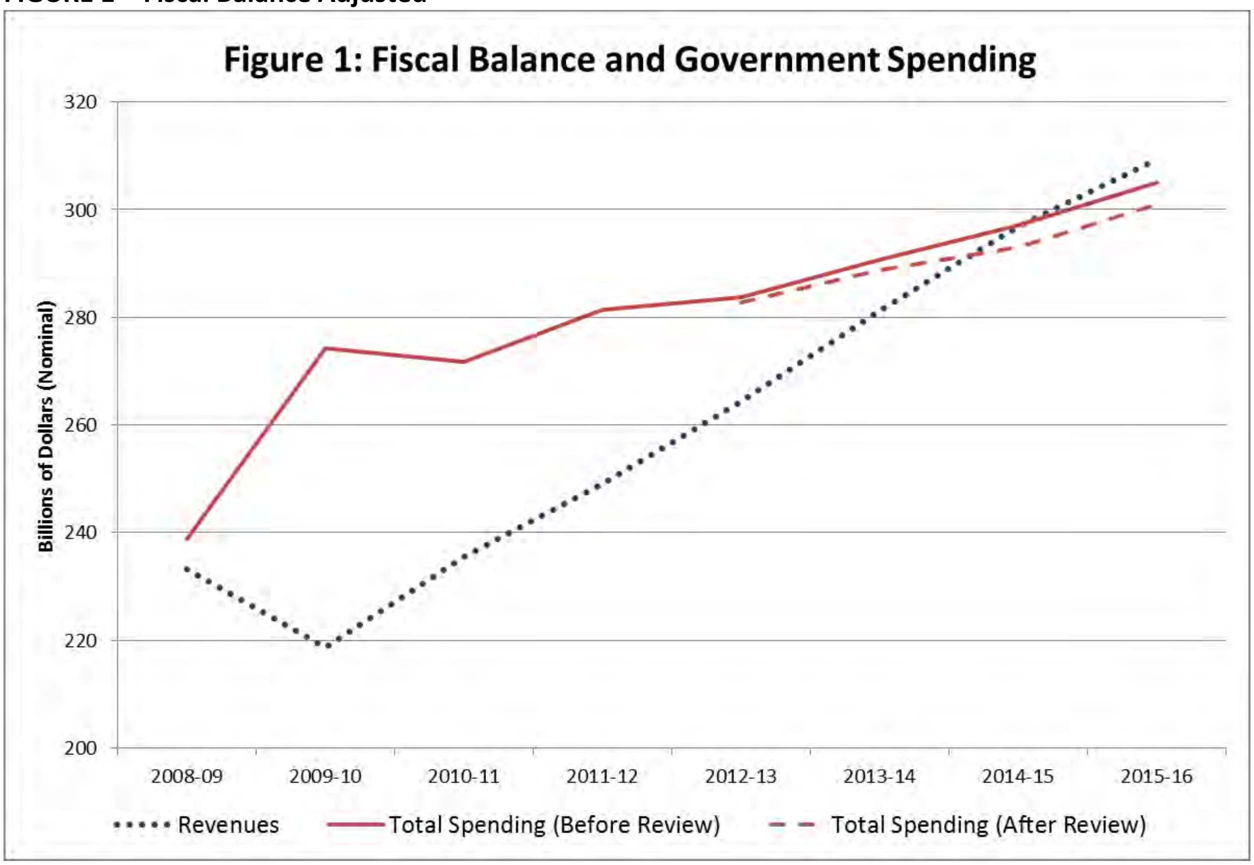
States, our federal government clearly still needs to take action to resolve the current state of its finances.

## I. The State of Federal Finances

Canada did not escape the recent global recession. Like almost every industrial country, Canada's economy suffered from negative economic growth, higher unemployment, and generally depressed conditions. These facts influenced the finances of the government by reducing revenues and increasing spending. Figure 1 illustrates federal government spending—including both program spending and debt charges—as well as revenues, beginning in 2008-09 through to 2015-16.

As the global recession took hold, revenues collected by the federal government dropped by some $14.5 billion between 2008-09 and 2009-10 (figure 1). At the same time, total spending by the federal government increased by $35.4 billion, from $238.8 billion to $274.2 billion (figure 1). The result of the combination of increased spending coupled with lower revenues was a $55.6 billion deficit (figure 2).

**FIGURE 1 – Fiscal Balance Adjusted**

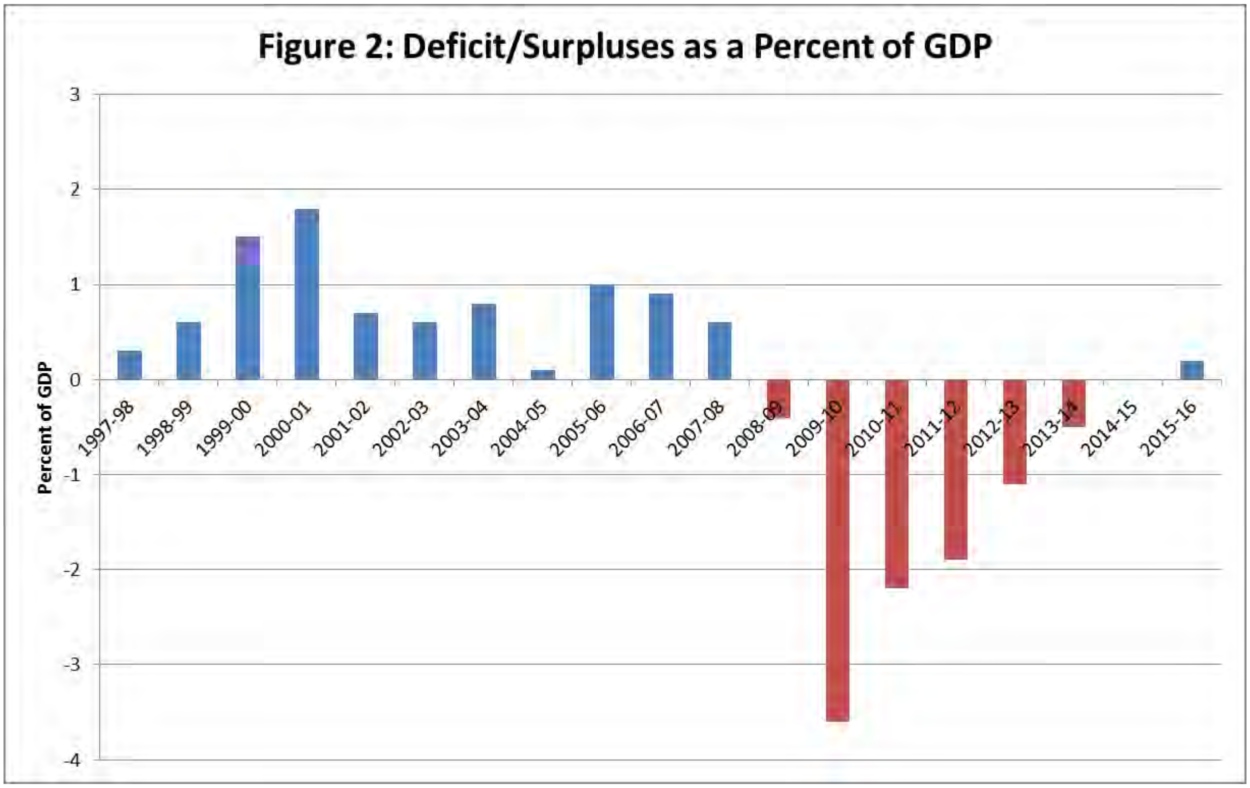



**Sources:** Department of Finance, Canada (2010), Fiscal and Economic Update 2010; Department of Finance, Canada (2011), Budget 2011 (June).

Some of the increase in spending is explained by programs such as Employment Insurance, which automatically increase in times of economic difficulty—specifically times of higher unemployment. The bulk of the increase, however, is explained by discretionary spending increases initiated by the federal government in an attempt to combat the recession.[5]

The consequence of these fiscal policies is a marked move from consistent surpluses to persistent deficits. Figure 2 illustrates the size of the deficits as a share of the economy, starting in 1997-98 when the federal government recorded the first of its many post-1995 budget surpluses, through to the final year of the current budget plan (2015-16). As depicted in figure 2, the federal government formally expects to record a negligible deficit in 2014-15 before it returns to a small surplus in 2015-16.

**FIGURE 2 - Deficits**




**Sources:** Department of Finance, Canada (2011), Fiscal Reference Tables (Access July 2011); Department of Finance, Canada (2011), Budget 2011 (June).

## Strategic and Operating Review

In addition to the formal budget presented by the government, the June budget formalized an important review of federal spending designed to yield savings in the future.[6] Specifically, the federal government has initiated a strategic and operating review of spending, with a specific goal of reaching $4-billion in savings by 2014-15. The plan projects savings that begin in 2012-13 at $1 billion, then rise to $2 billion in 2013-14, before they reach a permanent level of savings of $4 billion in 2014-15. These

[5] For information on the 2009-10 stimulus plan please see the 2009 Budget, available at http://www.budget.gc.ca/2009/pdf/budget-planbugetaire-eng.pdf. In particular, table 1.2 provides a broad overview of the stimulus plan and tables 3.5, 3.6, 3.7, and 3.8 provide summaries of different components of the stimulus program. In addition, chapter 3 of the budget contains both financial and operational details regarding the stimulus plan.

[6] For information on the strategic and operating review please see Table 5.2 in Budget 2011 (June), which is available at http://www.budget.gc.ca/2011/home-accueil-eng.html. Please note that this review of spending was announced during the federal election campaign of 2011.

savings are illustrated by the dashed spending line in figure 1. The savings would result in a balanced budget one year sooner (2014-15) than the formal budget plan.

While the introduction of a spending review aimed to identify and secure savings is a positive step in federal fiscal policy, it falls short on several counts. First, while the program identifies a total for savings, the details of the savings have not yet been developed. Second, the goal is to achieve savings in the future rather than immediately. Third, the review only looks at direct federal spending and therefore excludes transfers to individuals, businesses, and the provinces and territories. And fourth, the overall approach of the government to balance the budget still relies on slowing the growth of spending while hoping that revenues catch up.

It is the latter point that poses the greatest threat to the government's fiscal plan. Any deviation from the plan, including higher than expected growth in spending, slowly growing revenues, and/or higher than anticipated interest costs could all result in higher deficits and a longer timeline to achieve a balanced budget. Indeed, given the slowing U.S. economy and ongoing turmoil in Europe,[7] it is likely that the government's expectations for revenues and spending are already behind schedule.

Passively relying on slowing the growth in spending while counting on revenues to catch up ignores the lessons of the 1980s and 1990s. During those years, the federal government, along with many of the provinces, relied on similar plans, with no success. Spending inevitably came in higher than expected and revenues never seemed to grow at the rates assumed; the result was persistent deficits and rising debt.[8]

The 1995 federal budget took a dramatically different approach to solving the national deficit.[9] The governing Liberals, under the leadership of Prime Minister Jean Chrétien and Finance Minister Paul Martin, initiated a near 10-percent reduction in federal spending over two years, a policy that resulted in a budget surplus just a few years later (1997-98). Put differently, rather than relying passively on external events like faster-growing revenues or lower interest costs, the federal government actively reduced program spending immediately in order to move towards a balanced budget. This approach was subsequently replicated by many provinces across the country.[10]

**Stimulus Spending Becomes Just More Spending**

Another important consideration regarding the nature of federal spending programs is that increased spending to stimulate economic activity, which should be temporary, more often than not tends to become permanently embedded in future budgets. Figure 3 presents the program spending plans

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[7] An example of this slowing in economic activity has already emerged. The report on second quarter GDP (value of all goods and services produced in the country) indicated a 0.1% decline in economic activity in the second quarter of 2011 compared to the first quarter. Please see for further information www.statcan.gc.ca/daily-quotidien/110831/dq110831a-eng.htm.

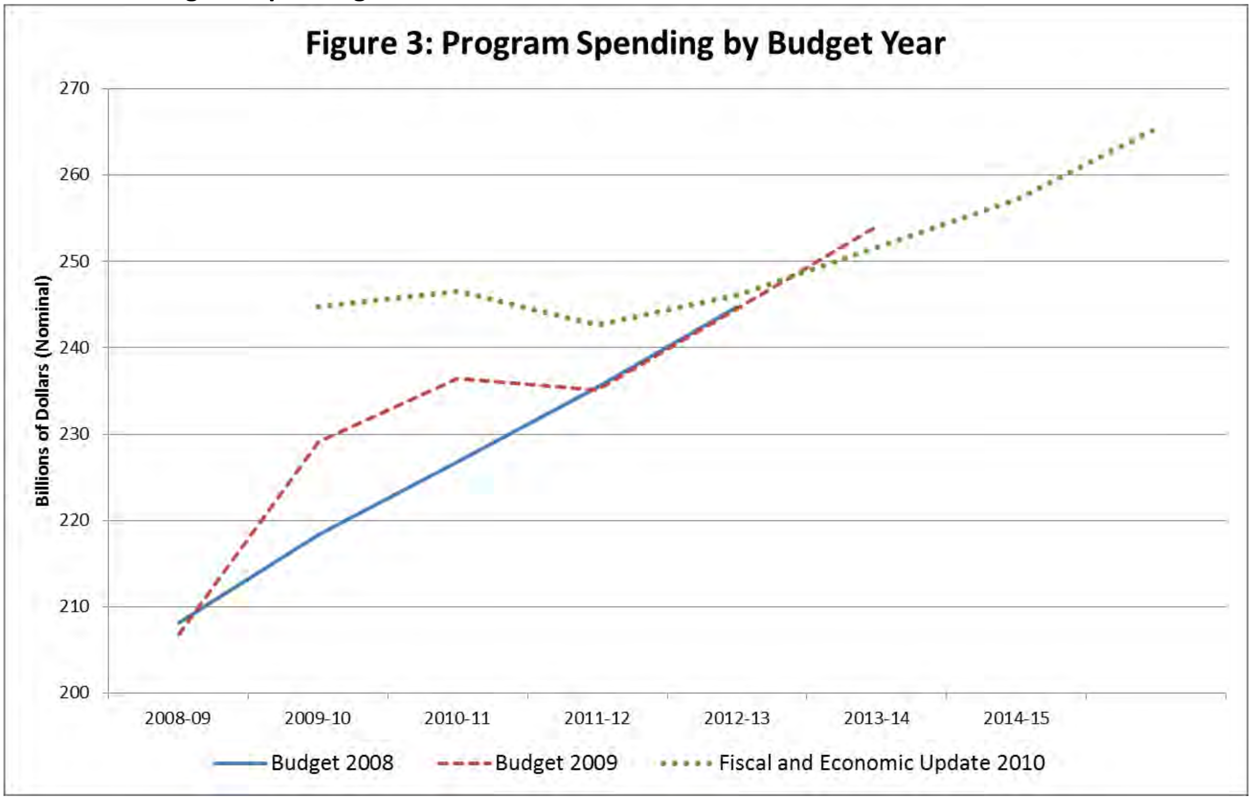
[8] For a more thorough discussion of the experience of the 1980s and 1990s, please see Brian Lee Crowley, Jason Clemens, and Niels Veldhuis (2010). *The Canadian Century: Moving Out of America's Shadow*. (Toronto, ON: Key Porter); a related and shorter synopsis is also available by Niels Veldhuis, Jason Clemens, and Milagros Palacios (2011). *Budget Blueprint: How Lessons from Canada's 1995 Budget Can Be Applied Today*. Studies in Tax and Budget (February 2011). Available at http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/BudgetBlueprint.pdf.

[9] For information on the 1995 federal budget see http://www.fin.gc.ca/toc/1995/buddoclist95-eng.asp.

[10] Note that reforms in SK and AB preceded the federal reforms in 1995. For a quick summary of these reforms and there results please see: Jason Clemens (2011). *Balancing Budgets: Good Politics, Good Policy*. Ottawa, ON: Macdonald-Laurier Institute. Available at http://www.macdonaldlaurier.ca/new-mli-commentary-balancing-budgets-is-good-politics-and-good-policy/.

presented by the federal government in the 2008, 2009, and 2010 budgets.[11] From it we can glean two important insights.

**FIGURE 3 – Program Spending**




**Sources:** Department of Finance, Canada (2008), Budget 2008;
Department of Finance, Canada (2009), Budget 2009;
Department of Finance, Canada (2010), Budget 2010;
Department of Finance, Canada (2010), Fiscal and Economic Update 2010.

First, the jump in program spending from Budget 2008 to Budget 2009 is the traditional Keynesian-type of stimulus. Under a Keynesian stimulus plan, temporary spending is initiated in order to increase aggregate demand and stimulate or encourage private consumption. Once the temporary spending is exhausted, program spending returns to its previous levels. This is exactly what was planned in the 2009 budget, as illustrated by the deviation in spending between the two budgets (2008 and 2009) in fiscal years 2009-10 and 2010-11 (figure 3). It's clear that Budget 2009 introduced higher levels of program spending than were planned for in the previous budget (2008). However, the higher levels of program spending are only temporary and spending levels return to their pre-stimulus levels in 2011-12 (figure 3)

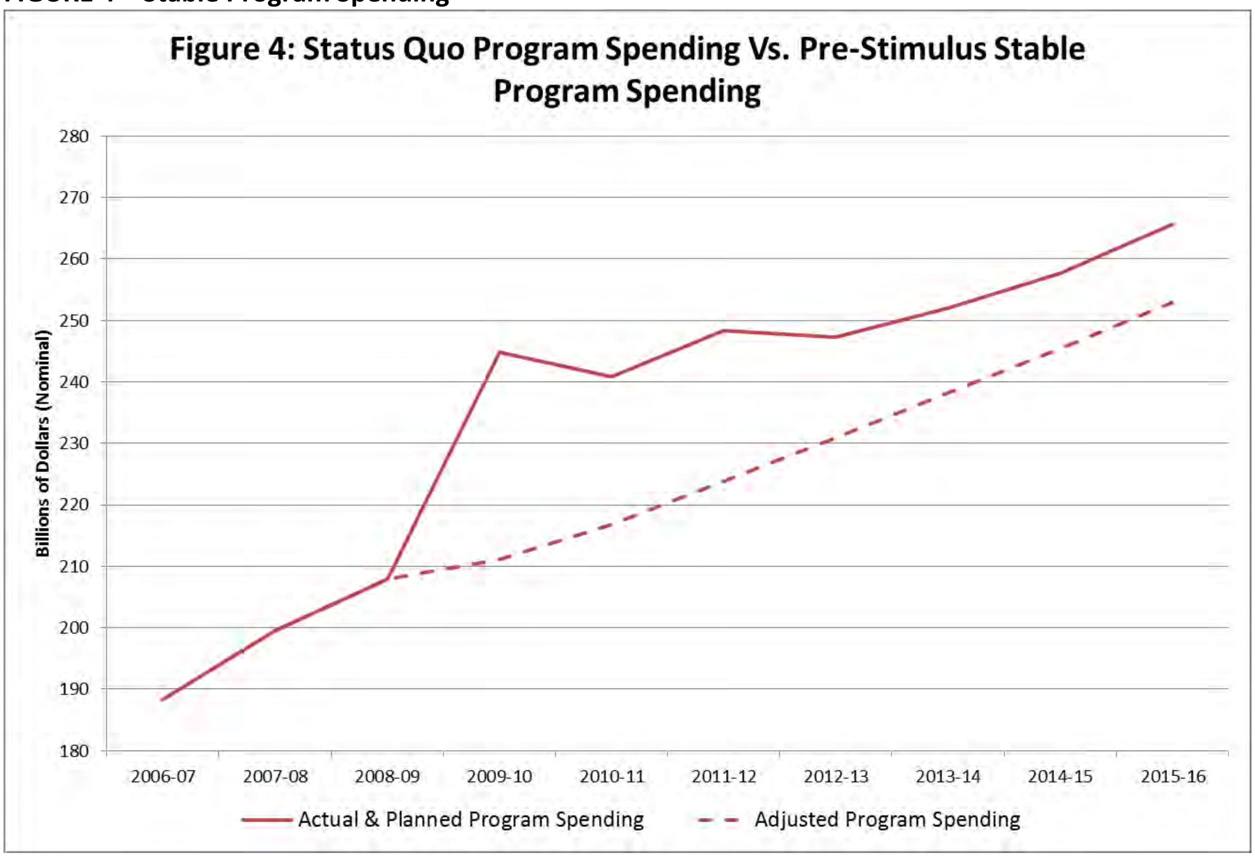
Second, and more pertinent to the current discussion, is the change initiated by Budget 2010. Rather than returning to the previous level of spending outlined in both the 2008 and 2009 budgets, the 2010 budget proposed and implemented program spending at a new, permanently higher level (albeit with a slower rate of growth in the future). Put differently, the 2010 budget implemented higher levels of program spending for 2009-10, 2010-11, and 2011-12, which then became the baseline or starting points for future spending.

[11] Note that the figures used for the 2010 plan were taken from the fall Economic and Fiscal Update (2010) rather than the spring budget. This was done in order to present the most up-to-date figures for the 2010 plan before the 2011 Budget. Details regarding the update are available at http://www.fin.gc.ca/ec2010/efp-pef-eng.asp.

In other words, what were supposed to be temporarily higher levels of program spending did not return to their pre-stimulus levels but simply became the new floor or base from which future program spending would grow. This is clearly illustrated in figure 3, wherein the program spending for budget 2010 is well above the levels proposed in the 2008 and 2009 budget.

Figure 4 presents an alternative way to understand and visualize the permanence of “temporary” stimulus spending. It illustrates the actual and planned program spending, as well as what is termed the stable program spending, starting in 2006-07 through to 2015-16. The solid line represents the actual and planned program spending by the federal government. The dashed line, which begins in 2008-09, illustrates what program spending would have been to maintain stable inflation-adjusted per-person program spending at pre-stimulus levels. Program spending above this level (dashed line) means permanent additional per-person spending.

**FIGURE 4 – Stable Program Spending**



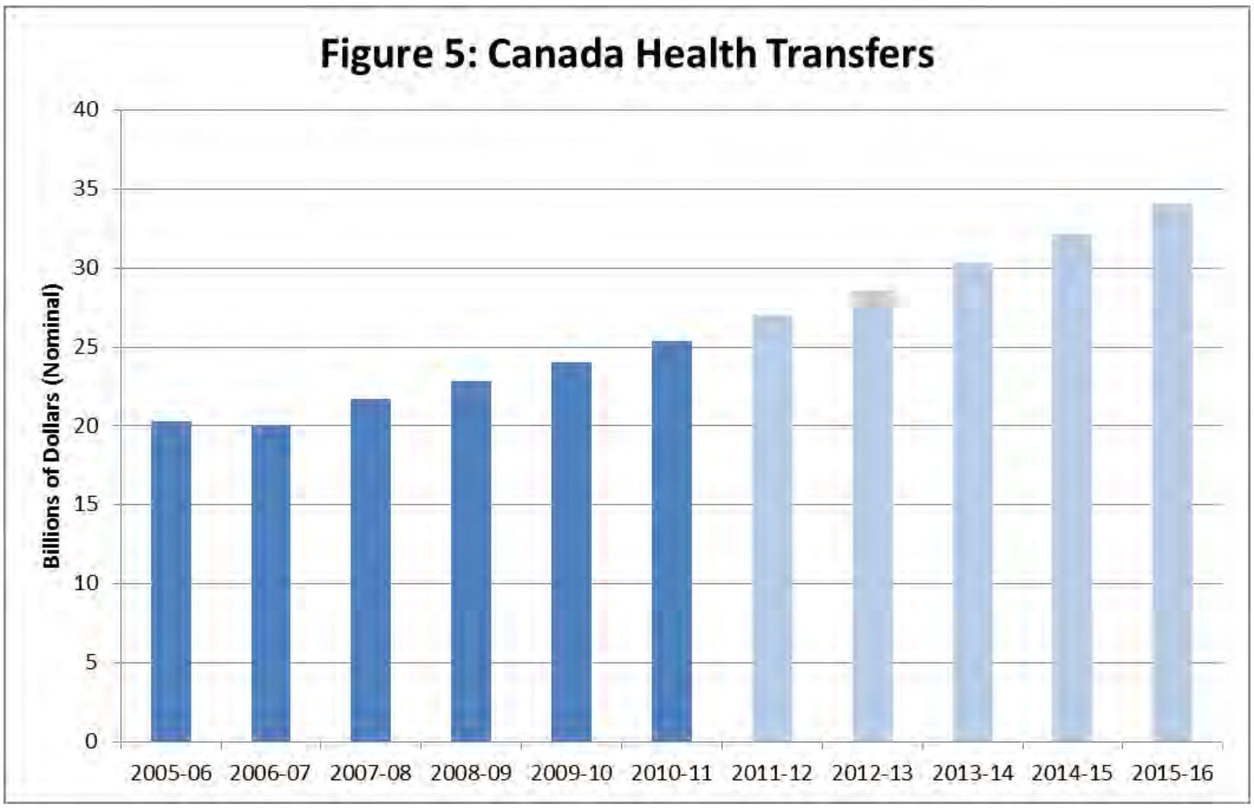

**Sources:** Department of Finance, Canada (2008), Budget 2008;
Department of Finance, Canada (2009), Budget 2009;
Department of Finance, Canada (2010), Budget 2010;
Department of Finance, Canada (2010), Fiscal and Economic Update 2010;
Department of Finance, Canada (2011), Fiscal Reference Tables (Accessed July 2011);
Department of Finance, Canada (2011), Budget 2011 (June).

The federal government’s initiation of a review of spending with an aim of achieving $4 billion in permanent annual savings by 2014-15 is laudable, and a positive step in federal fiscal policy. However, given the state of federal finances, it is insufficient to the task. Specifically, the current approach employed by the federal government relies on factors like revenue growth, which is linked to economic growth, and low interest rates, factors that it cannot directly control. A more purposeful approach, similar to the one used by the Liberals in 1995 that enacted immediate spending reductions, represents a superior plan with less risk to the goal of restoring fiscal balance.

## II. Additional Risk: Rising Healthcare Spending

Beyond the federal government's reliance on slowing the growth of spending and hoping that revenues will rebound strongly, it faces an additional budget risk. Federal transfers to the provinces in support of healthcare spending are growing at rates that will be difficult to sustain over time.[12] Figure 5 illustrates the actual, nominal value of the Canada Health Transfer (CHT) for the past five years, as well as the expected value of the CHT for the next five years.[13] The CHT is expected to increase from a little over $20 billion in 2006-07 to slightly more than $34 billion by 2015-16, an increase of nearly 70 percent over a single decade.

**FIGURE 5 – CHT**



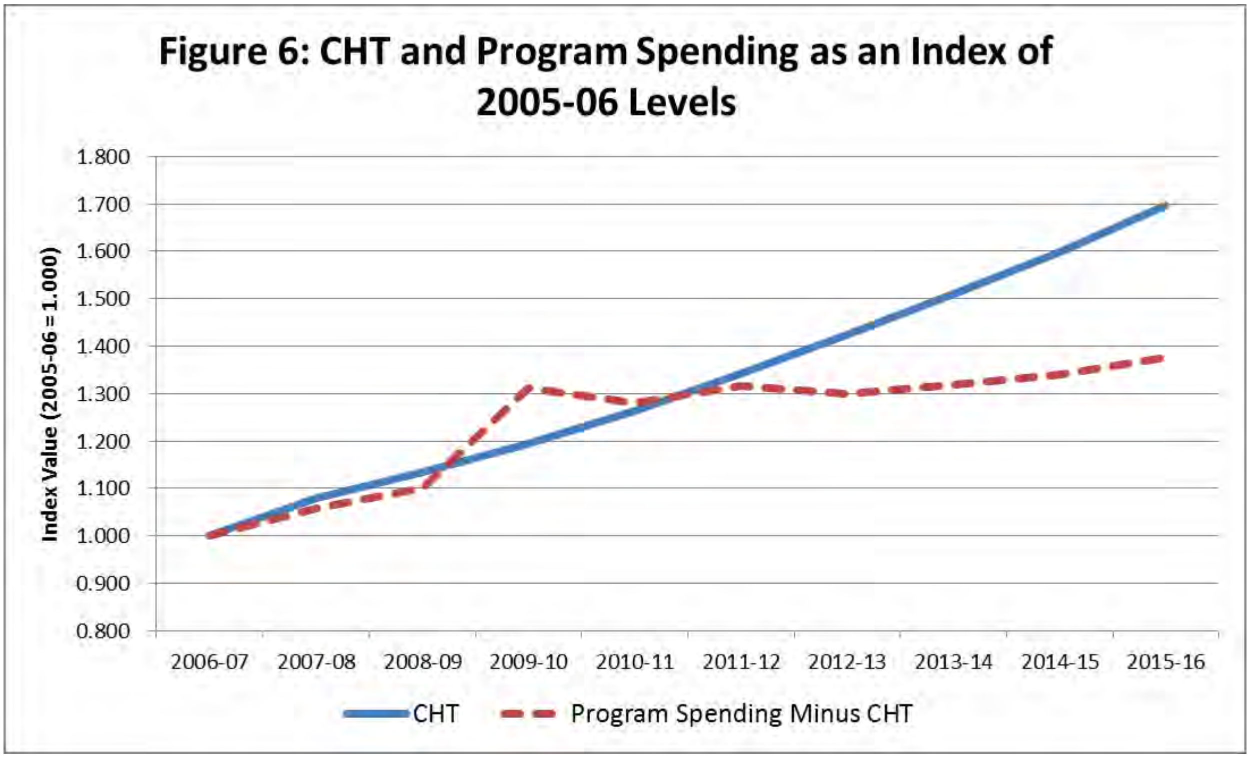

**Notes:** CHT payments for 2012-13 and beyond were calculated based on a 6% escalator in previous year funding. Please note that the budget does not break out CHT and CST payments specifically.
**Sources:** Department of Finance, Canada (2011) Federal Support to Provinces and Territories (May 2011 Update) Available at www.fin.gc.ca/fedprov/mtg-eng.asp; Department of Finance, Canada (2011), Budget 2011 (June).

[12] For an excellent discussion of the fiscal pressures being placed on government finances by healthcare as well as the policy options available please see David Dodge and Richard Dion (2011). *Chronic Healthcare Spending Disease: A Macro Diagnosis and Prognosis*. Toronto, ON: C.D. Howe Institute. Available at http://www.cdhowe.org/pdf/Commentary_327.pdf.

[13] Please note that the specific values of the CHT after 2011-12 were calculated based on a 6% annual increase, which the Minister of Finance has already committed to for the next two years. Precise numbers for CHT payments are only available up to 2011-12. Future CHT payments are combined with the Canada Social Transfer (CST) to form the Canada Health and Social Transfer (CHST), which is specified in the federal budget.

Another way to think about the growth in federal payments to the provinces to support healthcare spending is to consider the total growth in CHT payments compared to the growth in total program spending minus the value of the CHT. Figure 6 compares the growth in the CHT against the growth in all other program spending by the federal government beginning in 2006-07. From the base year of 2006-07, CHT payments will increase by 70 percent, compared to an increase in total program spending (net of the CHT) of 37.6 percent. That means that federal spending on health transfers is increasing at almost twice the rate of all other program spending.

**FIGURE 6 – CHT Index**

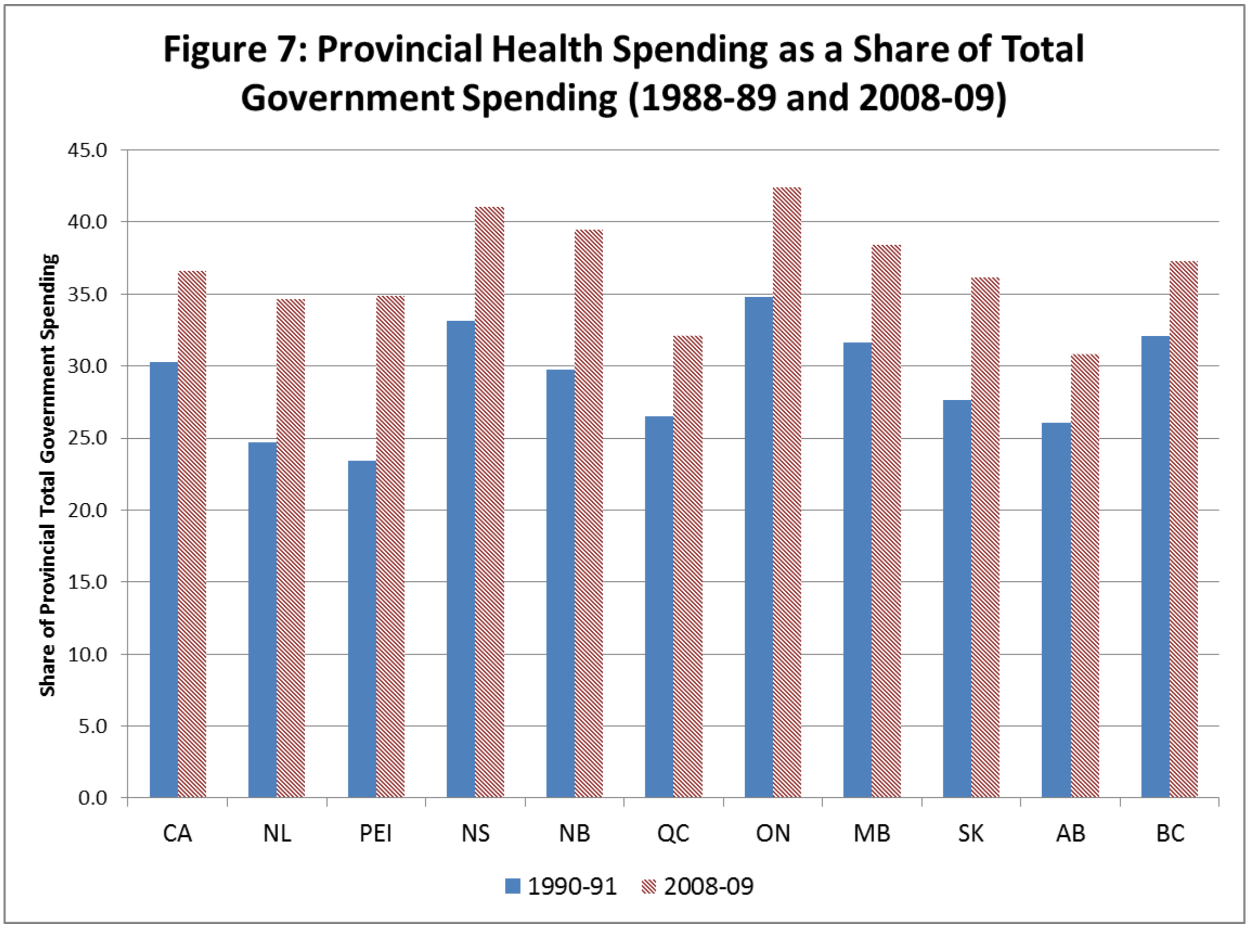



**Notes:** CHT payments for 2012-13 an beyond were calculated based on a 6% escalator in previous year funding.
Please note that the budget does not break out CHT and CST payments specifically.
Total CHST payments for 2012-13 and beyond were taken from the 2011 Budget.
Program spending is adjusted to remove the CHT. In other words, the measure of program spending is net of the CHT.
**Sources:** Department of Finance, Canada (2011). Federal Support to Provinces and Territories (May 2011 Update).
Available at www.fin.gc.ca/fedprov/mtg-eng.asp; Department of Finance, Canada (2011), Budget 2011 (June);
Department of Finance, Canada (2011), Fiscal Reference Tables, Table 7.
Available at www.fin.gc.ca/frt-trf/2010/frt-trf-1002-eng.asp#tbl7, accessed on July 26, 2011.

To understand the impact of relatively high rates of growth in health transfers compared to all other federal spending, one only has to observe provincial spending. Figure 7 illustrates the share of provincial spending, not including interest payments, devoted to healthcare in 1988-89 and 2008-09. (2008-09 is used as the final year of comparison because the data used to calculate this series is no longer available from Statistics Canada).

In every province, the share of total spending devoted to healthcare spending has increased over the time period covered. In many cases, the share of total spending consumed by healthcare is now over 40 percent and approaching 50 percent. In other words, in every province the share of resources collected by the province in the form of taxes and fees has increasingly been allocated to fund healthcare. In the absence of additional borrowing or increases in taxes, the result of these disproportionate increases in healthcare spending is that it is crowding out other spending, particularly in critical areas such as K-12 education, infrastructure, transportation, and justice.

**FIGURE 7 – Provincial Health**




**Source:** Statistics Canada (2010), CANSIM Table 385-0002; calculations by author.

The disproportionate increases in healthcare transfers by the federal government to the provinces—recall that health transfers are growing at 70 percent while all other program spending is growing at roughly half that rate—means that other federal spending, whether on defense, transportation, national security, or other vital areas of federal jurisdiction, continues to be crowded out.

## Conclusion

The federal government must consider new approaches to solving both problems, the current deficit and rising debt, and a better containment of rising healthcare spending.

The current approach relied on to solve the deficit and debt problem, namely slowing the growth of spending while hoping revenues catch up, is inherently risky. It failed throughout the 1980s and early 1990s. The solution to the deficit and debt challenges facing the federal government is a more proactive approach based on immediate spending reductions, which, unlike other factors, the federal government directly controls.

In addition, the federal government must acknowledge the folly of simply throwing more money at the provinces to provide healthcare. Despite large sums of monies spent by both the federal and provincial governments, Canada's healthcare system has not improved.[14] In addition, the crowding-out of provincial spending on key areas of responsibility in order to dedicate more resources to healthcare is now being observed at the federal level. Real reform of the healthcare system is critical.

The federal government needs to become part of the solution by reforming the transfer system, in a similar manner to what it accomplished with social transfers in the mid-1990s. The Canada Health Accord, which governs the Canada Health Transfer, expires in 2014. The federal and provincial governments are preparing for negotiations to renew it, an historic opportunity to reform healthcare spending in a fundamental way.

Canada's national finances are in a precarious state. We face immediate challenges in the form of deficits and rising debt, as well as longer-term problems emanating from ever-increasing healthcare spending. The Macdonald-Laurier Institute has launched a new series, *Turning Point 2014*, to confront these specific problems and offer solutions. This discussion is the first in that series.

[14] For example, see the Canadian Medical Association (2011). *Report of the Advisory Panel on Resourcing Options for Sustainable Health Care in Canada*, July 2011. Available at www.cma.ca/multimedia/CMA/Content_Images/Inside_cma/Annual_Meeting/2011/AdvisoryPanelReport_en.pdf; Canadian Institute for Health Information (CIHI) (2010). *Health Care in Canada, 2010*. Ottawa, ON. Available at http://secure.cihi.ca/cihiweb/products/HCIC_2010_Web_e.pdf; Canadian Institute for Health Information (CIHI) (2011). *Health Indicators 2011*. Ottawa, ON. Available at http://secure.cihi.ca/cihiweb/products/health_indicators_2011_en.pdf; and the Canadian Institute for Health Information (CIHI) (2011). *Wait Times in Canada – A Comparison by Province, 2011*. Ottawa, ON. Available at http://secure.cihi.ca/cihiweb/products/Wait_times_tables_2011_en.pdf.

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