

**THE TRANSFER OF TAX POINTS TO PROVINCES
UNDER THE CANADA HEALTH AND SOCIAL TRANSFER**

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THE TRANSFER OF TAX POINTS TO PROVINCES UNDER THE CANADA HEALTH AND SOCIAL TRANSFER

INTRODUCTION

The federal government provides transfer payments under the Canada Health and Social Transfer (CHST) to help the provinces carry out their responsibilities with respect to health, post-secondary education and social assistance. The CHST consists of a cash transfer and a transfer of tax points. There is a dichotomy between the views of the federal government and those of the provinces concerning the tax transfer. For the federal government, the transfer of tax points is a means of transferring fiscal resources to the provinces to help them with their expenditure responsibilities in designated areas. By contrast, the provinces consider that only the cash transfer is a federal contribution.

Tax points transferred to the provinces are certainly the most complicated aspect of federal-provincial fiscal arrangements. The context in which tax transfers were instituted and how they are evaluated may help to explain them. This paper provides a definition of tax transfers, reviews their history, explains how they are calculated, provides comparative statistics on the evolution of CHST cash and tax transfers and highlights some of the issues related to tax points.

DEFINITION

A tax point is a permanent transfer of income tax room from the federal government to the provincial governments. The federal government reduces its basic tax rate by a specific percentage and the provinces increase theirs by an equivalent amount, thereby leaving total federal and provincial tax unaffected. Tax points can be applied to personal income tax (PIT) or to corporate income tax (CIT).

A tax point or tax room can also be defined as the fiscal compensation offered by the federal government to replace a federal cash contribution. When it negotiated fiscal arrangements, the federal government generally offered the provinces the opportunity to “opt-out” of a program and to receive some substitute for the federal contribution to such a program in the form of tax transfers.

A transfer of tax points is different from a tax abatement, although the latter is also a form of compensation in lieu of cash contribution. A tax abatement is a special deduction after the basic federal tax⁽¹⁾ has been determined; tax points directly reduce the federal income tax rate. Moreover, a tax abatement is not permanent and can therefore be recovered: if the total transfers to which a province is entitled are less than the value of the tax abatement, the federal government must recover the difference through either a reduction in other federal cash transfers or repayment by the provincial government. Similarly, if a federal program of cash contribution is cancelled, the opting-out provinces must reimburse the value of the tax abatement either directly or through a reduction in other cash transfers. Tax points transferred to the provinces and tax abatements do have the same outcome, however: they reduce federal revenues from income tax. As we will see in the following section, tax abatements led the way to formal tax transfers in fiscal arrangements⁽¹⁾ between the federal and provincial governments.

HISTORY⁽²⁾

Tax transfers and tax abatements have long been an important part of federal-provincial fiscal relations. The first transfer of tax points between the federal government and

(1) The basic federal tax corresponds to the revenue raised by the federal government through income tax. The tax abatement appears in the federal tax form as a specified reduction (expressed as a percentage of federal taxes owing).

(2) This section is based on information from the following documents: T.J. Courchene, “Historical Annex on the Quebec Abatement,” in *Redistributing Money and Power – A Guide to the Canada Health and Social Transfer*, Observation 39, C.D. Howe Institute, Toronto, 1995; P.A.R. Hobson and F. St-Hilaire, Chapter 3, “EPF and the Devolution of Tax Room,” in *Reforming Federal-Provincial Fiscal Arrangements - Towards Sustainable Federalism*, Institute for Research on Social Policy, Montreal, 1993; J.C. Strick, Chapter 7: “Federal/Provincial Fiscal Relations: Historical Development,” in *Canadian Public Finance - Fourth Edition*, Toronto, 1992; Robin W. Boadway, Chapter 2, “The Existing Structure of Intergovernmental Transfers in Canada,” in *Intergovernmental Transfers in Canada*, Canadian Tax Foundation, 1980, p. 4-40.

the provinces was in 1941 during the Second World War. In contrast to current tax points, however, this transfer went from the provinces to the federal government. More specifically, from 1941 to 1962, the federal government “rented” all the taxation powers of the provinces.⁽³⁾ This centralization of taxation powers enabled the federal government to deal with the increase in war and military spending and then to finance expenditures in the post-war period. In return for giving up their right to levy taxes, the provinces received a cash contribution calculated on a per capita basis (from 1941 to 1957) or as a percentage of personal and corporate income tax revenues collected by the federal government within their jurisdictions (from 1957 to 1962).

Although Quebec signed the 1941 rental agreement, it refused to be party to the others (1946, 1952 and 1957). Instead, the province requested and received tax abatements. All other provinces maintained the renting agreements.⁽⁴⁾ In 1947, Quebec introduced its own corporate income tax (CIT) and was granted a federal abatement of 7 points on that tax. When, in 1954, Quebec introduced its personal income tax (PIT), the federal government provided an opting-out allowance of 10 PIT points. In 1958, the abatement for Quebec as a non-participating province was increased to 13 PIT points and to 9 CIT points. Overall, it can be said that the Quebec arrangements were in a broad sense precursors of the subsequent federal-provincial agreements as they incorporated the idea of a cash-tax split.

In 1962, the system of tax rentals was replaced by a tax collection agreement under which the federal government collected income taxes on behalf of the provinces, each of which was given the flexibility to set its own income tax rate. All provinces except Quebec accepted the federal government offer to collect tax from PIT (which allowed a single tax form for personal income).⁽⁵⁾ Three provinces, Quebec, Ontario and Alberta, did not participate in the tax collection agreement for the corporate income tax. A tax abatement of 16 points was provided on personal taxable income (which meant an additional 3 PIT points for Quebec), while the CIT abatement was fixed at 9 points. Therefore, under the new tax agreement the participating provinces had the same tax room as Quebec. These arrangements also provided that

(3) By 1940, all provinces were taxing both personal and corporate income.

(4) According to Strick, “renting was politically attractive for provinces since it allowed them to enjoy the revenues from unpopular taxes yet not be responsible for imposing them.” In *Canadian Public Finance - Fourth Edition* (1992), p. 155.

(5) This system of tax collection is currently still in use. Under the agreement, provincial tax bases, except that of Quebec, correspond to the basic federal tax.

the federal government would gradually increase tax abatements to the provinces: by 1966, the abatement had reached 24 PIT points.

During the 1960s, the federal government began to contribute funding for specific programs, and, in compensation for its non-participation, Quebec requested an increase in tax abatements.⁽⁶⁾ For example, in 1960, Quebec was granted an additional abatement point of the CIT in lieu of a specific transfer to universities. Similarly, in 1964, it was offered a further abatement of 3 PIT points for the Youth Allowance Program.⁽⁷⁾ In 1965, the federal government offered the provinces 15 PIT points in lieu of cash transfers under various arrangements in the areas of health and vocational training; only Quebec accepted the federal offer. Arrangements were also made to permit opting out of the Canada Assistance Plan (CAP) which was established in 1966. For all provinces except Quebec, CAP involved cash transfers only. As part of the opting-out agreements, Quebec received a 5-point tax abatement on personal income. As a result of these opting-out provisions, Quebec was receiving, by the end of 1966, 23 additional PIT points and 1 CIT point over and above the tax abatements of the other provinces.

In 1967, the federal government began providing all provinces with a special abatement on both the personal and corporate income taxes in lieu of post-secondary education transfers. More specifically, the provinces were granted 4 additional PIT points and one CIT point (the point previously received only by Quebec). For all provinces except Quebec, this change increased the abatement in PIT from 24 to 28 and in CIT from 9 to 10. Also in 1967, the tax abatement for vocational training (1 PIT point) was withdrawn, thereby reducing Quebec's special abatement to 22 points, (overall, Quebec was now receiving 50 PIT points and 10 CIT points).

Following the 1972-1977 tax agreement, the general abatement system was abandoned (except for the additional 22 abatement points Quebec received under the opting-out agreements) and replaced by true tax point transfers. What was previously shown as an itemized reduction in PIT on federal tax forms was translated into a reduction in federal tax rates. More

(6) Quebec has always argued that by making specific-purpose transfers the federal government is interfering with matters of essentially provincial responsibility.

(7) Quebec already had a similar program and wished to continue it. The federal government agreed to allow the province to receive the federal contribution in the form of additional abatement points rather than as a specific cash transfer.

specifically, federal tax rates were reduced by 30.5% of the basic federal tax (this reduction was estimated to be equivalent to the former tax abatement of 28 points). This 30.5% reduction replaced all former tax abatements, including the abatement received in lieu of cash transfers for education in 1967; the 4 PIT abatement points for this purpose were transformed into 4.357 PIT tax points in order to preserve the value of the transfer. Further, the provinces were free to impose whatever tax rate they desired; provincial tax rates were expressed as a percentage of basic federal tax and could be more or less than 30.5%. The abatement system for CIT was retained at 10 points. For Quebec, the PIT points it had received as a result of the former opting-out arrangements were adjusted from 22 to 24.

In 1974, the Youth Allowance Program was dismantled and replaced by the Family Allowances plan, in which all provinces agreed to participate. Thus, the opting-out provision no longer applied to Quebec and the 3 PIT points abatement earmarked for that program had to be recovered. To avoid disrupting Quebec's tax structure, the 3 point abatement was continued, but the amount was, and still is, fully deducted from federal cash payments to the province.

The last transfer of tax points took place in 1977, when a new formula for financing the so-called "established" programs –hospital insurance, medical care and post-secondary education – was adopted. Established Programs Financing (EPF) involved both a cash and a tax component. With respect to tax points, the federal government transferred to the provinces a total of 13.5 points of PIT and one point of CIT. Since the tax point transfers already included the 4.357 points of PIT and the one point of CIT given to the provinces in 1967 for post-secondary education, the new tax room was actually 9.143 points of PIT. The abatement points previously granted Quebec under the opting-out agreements for the purpose of health were readjusted to 8.5 PIT points.⁽⁸⁾

Since 1996-1997, transfers provided under EPF and CAP have been combined in the Canada Health and Social Transfer (CHST). However, this change in legislation had no effects on the level of tax transfers. Consequently, tax points provided under the CHST still

(8) The other abatements provided to Quebec, namely the tax abatement of 5 PIT points for CAP and the 3 PIT points for the youth allowance, remained unchanged.

amount to 13.5 points of PIT and one point of CIT, with the same level of additional tax abatements for Quebec (that is 8.5 PIT points under EPF and 5 PIT points under CAP).⁽⁹⁾

THE CALCULATION OF TAX TRANSFERS

This section explains how tax transfers are calculated and examines their impact on individual taxpayers. These transfers are intended to make no difference in the amount of combined federal and provincial tax paid by the taxpayer.

Tax transfers received by a province are based on the estimated value of past reductions in federal income taxes whereby that province was given room to increase its own income tax revenues. The transfer of tax points has three intertwined outcomes: first, it decreases the federal income tax rate; second, and as a result of the tax reduction, it reduces the basic federal tax (which, in turn, directly reduces the provincial tax base); and third, a province must increase its own income tax rates in order to generate additional revenue equivalent to the decrease in federal income. The following information is based on an example illustrated in Table 1.

TABLE 1
EXAMPLE OF A TAX POINT TRANSFER

	Pre-Transfer	Post-Transfer
Federal Tax	\$ 1,000.00	\$ 908.57
Provincial Tax	\$ 305.00	\$ 396.43
Total Tax	\$ 1,305.00	\$ 1,305.00
Provincial Tax Rate	$\$305/\$1,000 = 30.5\%$	$\$396,43/\$908.57 = 43.63\%$

Nota: For an interesting and complete numerical example of the impact of a tax point transfer, see Treasurer of Ontario, *Ontario Budget 1977*, Budget Paper B, 19 April 1977, pp. 11-18.

(9) The total 16.5 special PIT tax abatements provided to Quebec – 8.5 points under EPF, 5 points under CAP and 3 points under the Youth Allowance Program – appear in the federal tax form for Quebec taxpayers as a specified reduction of 16.5% of federal taxes owing.

A. Federal Income Tax Rate

With respect to PIT, the CHST is currently made up of 13.5 tax points which were part of the former EPF program. When EPF was established, however, 4.357 points had already been transferred, so that the federal government actually reduced its tax rate by 9.143%, rather than 13.5%. The taxpayer who paid \$1,000 of federal income tax before the transfer of tax points paid only \$908.57 (\$1,000-\$91.43) once the transfer had taken place.

B. Basic Federal Tax and Provincial Tax Base

The reduction in the federal income tax rate translated into a decrease in basic federal tax. Since the base on which the provinces (except Quebec) levy their personal income taxes is the basic federal tax itself, the smaller basic federal tax led to a reduction in the provincial tax bases. To pursue the previous example, a province had to apply its own tax rate on \$1,000 before the transfer of tax points but on only \$908.57, in the post-transfer period.

C. Provincial Income Tax Rates

A reduction in the tax base of the provinces had two implications for their tax rates. With a smaller tax base, provinces needed to raise their rates in order, first, to maintain the level of revenue received under the pre-transfer system and, second, to take full advantage of the vacated tax room, while at the same ensuring that the taxpayer was not affected. In our example, let us assume that the provincial tax rate on personal income was 30.5% of the basic federal tax before the transfer of tax points. In the pre-transfer period, the taxpayer paying \$1,000 in federal income tax paid \$305 in provincial income tax, for a total of \$1,305. When transferred tax points are taken into account, the provincial tax rate could go from 30.5% to 43.6% without affecting the taxpayer.

Table 2 shows provincial income tax rates before the transfer of tax points in 1976 and after the transfer of tax points for both 1977 and 1996. The “Equivalent” column provides the tax rate allowing the province to capture the full impact of the tax point transfer. As can be seen, all provinces increased their rate to occupy the new tax room. Two provinces, Newfoundland and Saskatchewan, raised their rates beyond the level necessary to fill the new tax

room. Over the years, many provincial PIT rates have increased substantially, possibly to offset the limits placed on the growth rate of federal transfer payments.

TABLE 2
PROVINCIAL INCOME TAX RATES (QUEBEC EXCEPTED)
(percent)

PROVINCE	1976	EQUIVALENT	1977	1996
Newfoundland	42.0	56.289	57.5	69.0
Prince Edward Island	36.0	49.686	50.0	59.5
Nova Scotia	38.5	52.437	52.5	59.5
New Brunswick	41.5	55.739	55.5	64.0
Ontario	30.5	43.632	44.0	56.0
Manitoba	42.5	56.840	56.0	52.0
Saskatchewan	40.0	54.088	58.5	50.0
Alberta	26.0	38.680	38.5	45.5
British Columbia	32.5	45.834	46.0	52.0

Source: For the first, second and third columns see George E. Carter, "Financing Health and Post-Secondary Education: A New and Complex Fiscal Arrangement", in *Canadian Tax Journal*, Sept.-Oct. 1977, Vol. 25, No. 5, p. 542; the fourth column is from KPMG International website under *TaxFacts - Canada*.

For purposes of the CHST, the value of tax points transferred to the provinces is calculated in terms of the lower basic federal tax. As already noted, the federal government gave up 13.5 PIT points, which, expressed as a percentage of the new base, become 14.85851 PIT points or $13.5/(1-0.09143)$. This is the rate used to calculate tax points to the provinces under both EPF and the CHST.⁽¹⁰⁾ Once the value of tax points has been determined, the formal equalization formula is applied.

For the fiscal year 1996-97, the Department of Finance estimated that revenues from PIT and CIT in Canada would amount to \$69.4 billion and \$64.7 billion respectively. The value of tax transfers under CHST would therefore be \$11.8 billion, or $(69.4*0.1485851)$

(10) See Federal-Provincial Relations Division, Department of Finance, *Canada Health and Social Transfer, Second Estimate: 1996-97*, Government of Canada, 9 October 1996.

$+(64.7 \times 0.01) + 0.8$ billion in associated equalization.⁽¹¹⁾ The value of equalized tax point transfers are then deducted from the total transfers to which the provinces are entitled and the difference is given in cash transfer.⁽¹²⁾

Because it represents a fixed percentage of federal taxation, the value of tax transfers fluctuates with the variation in federal income tax revenues. In a period of economic growth, when government tax revenues are expected to increase, the value of tax points will increase also. Conversely, poor economic growth reduces federal government tax revenues, resulting in a lower value of tax point transfers. In the same way, any expansion (reduction) of the federal income tax base or increase (decrease) in federal tax rates would increase (decrease) the value of tax points.

EVOLUTION OF CASH AND TAX TRANSFERS UNDER THE CHST

Table 3 provides details of cash and tax transfers to the provinces under the CHST. The *Federal-Provincial Fiscal Arrangements Act* determines the total amount of CHST: it is set at \$26.9 billion for 1996-97 and \$25.1 billion for the period from 1997-98 to 1999-2000. Thereafter, and until 2002-03, the total CHST transfer will be adjusted according to a percentage of the rate of growth in the GDP. As a result of this legislation, total CHST transfers will decrease sharply; from 1995-96 to 1996-97, they fell by nearly \$3 billion and the reduction will amount to \$4.5 billion between 1995-96 and 1999-00.

The value of CHST tax points transferred to the provinces, which varies in proportion to income tax revenues, is expected to increase constantly from 1996-97 to 2002-03. As a result, the cash transfer, which represents the difference between the total CHST transfer and the value of tax points, is expected to decrease steadily until 2000-01. Cash transfers will decline more steeply than total transfers. Beginning in 1997-98, the total CHST transfer will be almost evenly divided between tax points and cash transfers; thereafter, the value of tax points will exceed the amount of the cash transfer.

(11) *Ibid.*

(12) The equalized tax point transfers under the CHST do not reflect the current value of these tax points to provinces; rather, they measure the current cost of this transfer to the federal government.

TABLE 3
CASH AND TAX TRANSFERS UNDER THE CHST
(in millions of dollars)

Fiscal Year	Cash	Tax	Total
1995-96	16,600	13,135	29,735
1996-97	15,127	11,773	26,900
1997-98	12,488	12,612	25,100
1998-99	11,826	13,274	25,100
1999-00	11,129	13,971	25,100
2000-01	11,111	14,591	25,702
2001-02	11,180	15,332	26,512
2002-03	11,303	16,123	27,426

Nota: Data for 1995-96 correspond to the sum of transfers under EPF and CAP.

Source: Department of Finance, Human Resources Development Canada and Parliamentary Research Branch, Library of Parliament.

In short, the effect of the decrease in total transfers under the CHST will be entirely seen in the cash transfer, whereas the gradual increase in the total transfer, beginning in 2000-01, will basically result from the increased value of the tax points.

ISSUES

The value of tax points is growing to represent an increased proportion of total federal transfer payments to the provinces. Whether the transfer of tax points really constitutes a federal contribution is subject to debate. The provinces regard the tax points as a one-time permanent transfer, while the federal government continues to count them as an ongoing contribution to provincial coffers.

The federal government argues that the growing value of the tax points transferred is part of the original fiscal arrangements and, as a result, must be considered an integral part of federal transfers. It also states that “cash and tax transfers are alike in that both represent a cost

to the federal treasury and both contribute to provincial revenues.”⁽¹³⁾ Similarly, some analysts claim that “it was understood at the beginning that the income tax point values would eventually grow faster than total transfer payments and that the cash portion would gradually decrease over time.”⁽¹⁴⁾ They also maintain that “[w]hile declining cash may be an irritant to some provinces, it results from the correct operation of the formula embedded in the EPF and CHST calculation, and not from any federal policy withdrawal.”⁽¹⁵⁾ It must be acknowledged, however, that cash transfers have decreased faster than originally expected, as a result of unilateral changes by the federal government.

By contrast, other experts believe that the federal government claim to be giving the provinces this tax revenue is “pure rhetoric” since the actual collection is left to the provinces themselves. In this view, the tax points turned over to the provinces are now the provinces’ own source revenues, over which they have full discretion.⁽¹⁶⁾ Others suggest that to consider the transfer of tax points as part of the federal transfer may result in “misleading interpretations”: first, it would allow the federal government to overstate the federal contribution to the provinces for the support of post-secondary education, health and social programs and, second, it would allow the federal government to understate the percentage change in the size of federal cutbacks to the provinces.⁽¹⁷⁾ Still, other experts view the tax transfer only as a “notional” transfer used for calculating the CHST, since there is actually no money directly involved. They also maintain that, since the concession of the tax room was intended as compensation for withdrawn federal grants, only the cash transfer has retained a federal identity.⁽¹⁸⁾ It is interesting to note that 20 years ago it was already being argued that “once the size of the equalized tax points comes to

(13) Department of Finance, *Federal Transfers to Provinces*, Government of Canada, May 1990, p. 2.

(14) See for example, T. Russell Robinson, “Canadian Fiscal Arrangements in the 1990s: A Federalist’s Perspective,” *Policy Options*, Vol. 14, December 1993, p. 51.

(15) *Ibid.*, p. 52.

(16) P. Boothe and B. Johnston, “Stealing the Emperor’s Clothes: Deficit Offloading and National Standards in Health Care,” *Commentary*, C.D. Howe Institute, No. 41, March 1993, p. 4; Keith Banting and Robin Boadway, *Presentation to the Standing Committee on Finance*, 9 May 1995, p. 4.

(17) Robin Boadway, *The Canada Health and Social Transfer*, Brief to the House of Commons Standing Committee on Finance, 1995, p. 3.

(18) George E. Carter, “Established Programs Financing: A Critical Review of the Record,” Vol. 36, No. 5, *Canadian Tax Journal*, September-October 1988; Thomas J. Courchene, *Social Canada in the Millennium - Reform Imperatives and Restructuring Principles*, C.D. Howe Institute, 1994, p.112-115.

exceed that of the cash grant in all provinces, the association the tax transfer now has with a specific area of provincial expenditure will vanish.”⁽¹⁹⁾

Recently, there was a proposal to transfer more tax points to the provinces. This would reduce the basic federal tax and limit its power to impose national standards in the area of health or to set other conditions for social programs. Moreover, the federal government has stated that it could not afford to provide more tax room and still meet its deficit targets.⁽²⁰⁾ A larger tax transfer would give greater flexibility to the provinces, who would thus have more room to manoeuvre with respect to the organization and delivery of health care and social services. More tax points would also shelter the provinces from unilateral federal budget cuts. Relying on more tax room as a means of transferring funds to the provinces could, however, eventually give the provinces complete freedom to set their own rates and bases and thus give rise to fragmentation of the uniform tax bases. Further, since tax points are less valuable in the poorer provinces, such provinces could have difficulty in maintaining their current level of services. More tax room could remove the redistributive element involved in federal-provincial fiscal arrangements.

Thomas J. Courchene has suggested that tax points be entirely removed from the CHST calculation and that only an equal per capita cash contribution be transferred to the provinces.⁽²¹⁾ In his view, this approach would ensure both that cash transfers did not fall to zero, thereby preserving the federal government’s role in establishing and maintaining national standards, and that provincial government could rely on a steady contribution. This suggestion could be implemented only if the federal government agreed to forget completely the cost it incurred when it first transferred tax points to the provinces.

CONCLUSION

Through the CHST, the federal government provides both cash and tax transfers to the provinces. Tax transfers are not new under the CHST. Indeed, federal contribution

(19) George E. Carter, “Financing Health and Post-Secondary Education: A New and Complex Fiscal Arrangement,” in *Canadian Tax Journal*, Vol. 25, No. 5, September-October 1977, p. 547.

(20) Canada, Department of Finance, *Briefing Book: Budget 1996*, 6 March 1996, p. 65.

(21) Courchene (1994), p. 102-103.

programs combining a cash and tax component have a long history in Canada. The transfer of tax points is an important component of federal-provincial fiscal arrangements. The calculation of the value of tax points is rather complex but the major characteristic of a tax transfer is its neutrality in terms of its impact on an individual taxpayer. The purpose of a transfer of tax points is to provide provinces with more tax room by reducing federal income tax rate and allowing the provinces to make a corresponding increase in the tax revenue they collect. The federal government believes that the resulting reduction in its revenue must be estimated and taken into account when calculating the amount of CHST transfer payments. The provinces, by contrast, view the tax transfers as part of their own revenues and regard only the cash transfer as a federal contribution.

Under the CHST, the values of cash and tax transfers (\$12.5 and \$12.6 billion respectively) are almost equal; however, it is expected that the value of tax points will soon be greater. It may become increasingly difficult for the federal government to reflect its true financial commitment to health, post-secondary and social assistance with a relatively smaller cash contribution.

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