2008

Report of the

Auditor General of Canada

to the House of Commons

DECEMBER

Chapter 1

A Study of Federal Transfers to Provinces and Territories

Office of the Auditor General of Canada

The December 2008 Report of the Auditor General of Canada comprises Matters of Special Importance—2008, Main Points—Chapters 1 to 8, Appendices, and eight chapters. The main table of contents for the Report is found at the end of this publication.

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Ce document est également publié en français.

Cat. No. FA1-2008/2-1E
ISBN 978-1-100-10968-8

Chapter

1

A Study of Federal Transfers to Provinces and Territories

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A Study of Federal Transfers to Provinces and Territories

Main Points

What we examined

The federal government uses a number of mechanisms to transfer funds to the provinces and territories for general areas of spending such as health or for specific purposes such as improving infrastructure. In 2006–07, these federal transfers amounted to approximately $50 billion, or just under 23 percent of federal spending.

Our study examined the three main mechanisms used by the federal government to transfer funds to the provinces and territories. We also looked at the nature and extent of conditions attached to these transfers.

We undertook this study to inform parliamentarians about the federal government's transfers to the provinces and territories. Because this is a study and not an audit, it is descriptive, and does not include recommendations.

As auditors, we recognize that decisions on whether, and to what extent, conditions attached to transfers are policy decisions, often involving sensitive federal-provincial/territorial negotiations. We do not question these decisions.

We did not examine funding arrangements with First Nations, payments to foundations or municipal governments, or transfer payments to individual Canadians.

Why it's important

Federal transfers to the provinces and territories make up a significant portion of the federal government's annual spending. They are a major source of funds for services provided to Canadians in areas such as health, post-secondary education, and housing.

The nature and extent of conditions attached to federal transfers to the provinces and territories varies significantly. While some transfers have specific conditions that recipients must meet, others are unconditional and there is no requirement for a province or territory to report to the federal government on the use of the transferred funds. It is not always clear to parliamentarians which transfers have conditions attached and what the nature and extent of those conditions are.

What we found

- The federal government uses three main mechanisms to transfer funds to the provinces and territories. The first and largest includes four major transfers that recur annually by law and are managed by Finance Canada: the Canada Health Transfer, the Canada Social Transfer, Equalization Program transfers, and Territorial Formula Financing (just over $42 billion transferred in the 2006–07 fiscal year). The second mechanism involves the transfer of funds by individual federal departments to support specific program areas (just over $5 billion in 2006–07). Finally, the federal government also transfers funds to the provinces and territories using trusts (just over $3 billion in 2006–07).
- According to the federal government, the extent of federal accountability for how the provinces and territories spend transferred funds depends on the nature and extent of conditions attached to the transfers. In all cases, the federal government is accountable to Parliament for its decision to use transfers with or without conditions as the best policy choice available in the circumstances.
- Some transfers involve conditions that, for example, obligate recipients to provide the federal government with information on how they spent the transferred funds and to what effect. The federal government must demonstrate that it is monitoring provincial and territorial compliance with these conditions and that it is taking action in cases of non-compliance. Where transfers have limited or no conditions, the provinces and territories have the flexibility to spend the funds according to their own priorities, with no legal obligation to account to the federal government for the spending.
- A significant addition to the transfer mechanisms used by the federal government was its introduction of trusts in 1999. Since then, 23 trusts have been established to transfer almost $27 billion to the provinces and territories. In each case, the federal government has stated the intended purposes of the trusts in public announcements. Once the eligibility conditions for these trusts have been met, no additional legal conditions obligate provinces and territories to spend the funds for the purposes announced.
- Once the provinces and territories have established their eligibility to draw funds from the trust, they become accountable in principle to their own citizens, not to the federal government, for how they use the funds. In this sense, these trusts are similar to the four major transfers.
- Where transfers have conditions, how well the federal government monitors the conditions is subject to performance audits by our Office and our audit reports are provided to Parliament. For all transfers audited, we ensure that the amount paid is properly recorded in accordance with Public Sector Accounting Board standards.

Introduction

1.1 The *Constitution Act* of 1867 assigns a range of exclusive legislative powers to the federal and provincial orders of government, as well as joint jurisdiction over other specific areas. Over time, however, it has become common in practice for the federal government to spend in areas over which it does not exercise legislative jurisdiction. Exhibit 1.1 lists areas of federal, provincial, and shared activity as described by Finance Canada.

1.2 The federal government delivers programs and services to Canadians in a number of distinct ways. It directly administers some programs and services (for example, issuing passports). In other cases, it transfers funds to the provinces and territories, with the approval of Parliament, for specified purposes (for example, to support labour market development). Provinces and territories are then responsible for designing and delivering related programs and services to Canadians.

1.3 Federal transfers to the provinces and territories constitute a significant portion of the federal government's annual expenses. They are a major source of funds for services provided to Canadians in areas such as health care, post-secondary education, and housing. In the 2006–07 fiscal year, these transfers amounted to approximately $50 billion, or just under 23 percent of federal expenses.

1.4 Some federal transfers to the provinces and territories are conditional, meaning that the federal government requires recipients of the funding to fulfill certain commitments, with consequences for failing to meet the conditions. Such conditions may be explicitly stated in agreements between the federal government and provincial or territorial governments, or found in other sources, such as statutes.

1.5 Other transfers are unconditional, meaning that recipient provinces and territories can spend these payments according to their own priorities, and are not obligated to report to the federal government how they spent the transferred funds or what effect that spending had.

Focus of the study

1.6 We carried out this study to inform parliamentarians about the federal government's transfers to the provinces and territories. In particular, we wanted to describe the main mechanisms that the federal government uses to accomplish these transfers, in order to answer questions parliamentarians have about them. We also wanted to outline the Office's mandate to audit these transfers.

Exhibit 1.1 Areas of federal, provincial, and shared activity

Sector	Federal	Provincial
Money and banking	√	
International and interprovincial trade	√	
Airlines and railways	√	
Telecommunications and broadcasting	√	
Foreign affairs/international assistance	√	
Defence and veterans affairs	√	
Border security	√	
Employment insurance	√	
Criminal law	√	
Fiscal equalization	√	
Indirect taxation	√	
Direct taxation	√	√
Pensions and income support	√	√
Aboriginal peoples	√	√
Immigration	√	√
Agriculture	√	√
Industry	√	√
Environment	√	√
Policing	√	√
Transportation infrastructure	√	√
Housing	√	√
Post-secondary education, training, and research	√	√
Public health	√	√
Primary and secondary education		√
Health care		√
Municipal institutions		√
Social assistance and social services		√
Natural resources		√
Administration of justice		√

Source: Focusing on Priorities, Budget 2006, Department of Finance Canada

1.7 We examined only mechanisms that the federal government uses to transfer funds to the provinces and territories. Because this is a study rather than an audit, it is descriptive, and does not include recommendations.

1.8 More details on the objectives, scope, and approach of the study are in **About the Study** at the end of this chapter.

Observations

1.9 For the purposes of this study, we identified three main mechanisms used by the federal government to transfer funds to the provinces and territories. These are

- four major statutory transfers managed by Finance Canada,
- program-specific transfers managed by individual departments and agencies, and
- trusts (also managed by Finance Canada).

Four major federal transfers to provinces and territories

1.10 In the 2006–07 fiscal year, the federal government provided $42.3 billion—or 19 percent of its total expenses of $222 billion—to provincial and territorial governments, through four major recurring transfers managed by Finance Canada as authorized by the *Federal-Provincial Fiscal Arrangements Act*. These transfers, and the amounts transferred in the 2006–07 fiscal year, are listed in Exhibit 1.2.

Exhibit 1.2 Four major transfers to the provinces and territories accounted for 19% of federal expenses in the 2006–07 fiscal year

Transfer	($ millions)
Total federal expenses	222,214
Major transfers	
Canada Health Transfer	20,140
Canada Social Transfer	8,500
Equalization Program	11,535
Territorial Formula Financing	2,118
Total	**42,293** (19.0% of total federal expenses)

Source: Department of Finance Canada and the Public Accounts of Canada

Federal tax transfer—Reduction by the federal government of its tax rates, upon agreement, to allow provinces and territories to raise their tax rates by an equivalent amount. With a tax transfer, the changes in federal and provincial/territorial tax rates offset one another, and revenue that once flowed to the federal government now flows to the provincial/territorial governments. There is no change in the overall taxes paid by Canadians. Specifically, a federal tax transfer involves the federal government ceding some of its tax room to provincial and territorial governments.

1.11 The $42.3 billion does not include **federal tax transfers**, which in the 2006–07 fiscal year provided additional support of approximately $20 billion, including $12.6 billion through the Canada Health Transfer and $7.8 billion through the Canada Social Transfer. According to Finance Canada, the value of this tax transfer reflects the current value of the federal taxation transferred, or ceded, to provinces in 1977 (equalling 13.5 percentage points of its Personal Income Tax and 1.0 percentage point of its Corporate Income Tax). This value is calculated in accordance with applicable legislation.

Evolution of federal support for health and social programs

1.12 The federal government has used transfers to support provincial and territorial governments in providing health care, post-secondary education, social assistance and social services, and programs for children. In the 1950s and 1960s, the federal government encouraged development of nation-wide hospital, medical care, social, and post-secondary education programs. The costs of these programs were for the most part shared equally between the federal government and the provinces and territories. Federal legislation and related agreements outlined program objectives and standards, and stipulated which types of expenses were eligible to be covered. Provincial and territorial governments provided detailed documentation of their expenditures to the federal government.

1.13 By 1977, health care and post-secondary education programs were well established. To allow provinces greater flexibility in allocating funding and to reduce the administrative burden, federal transfer support shifted away from cost sharing to block funding. In 1996, two existing support programs, Established Programs Financing (a **block transfer** supporting health and post-secondary education) and the Canada Assistance Plan (the last major cost-sharing program supporting social programs), were merged into the Canada Health and Social Transfer program, which supported broad federal spending priorities, including health care and social programs.

Block transfers—Payments based on legislation or an arrangement, which normally includes a formula or schedule as one element used to determine the amount. However, once payments are made, the recipient may redistribute the funds among the several approved categories in the arrangement.

1.14 Effective 1 April 2004, the Canada Health and Social Transfer was restructured into the Canada Health Transfer and the Canada Social Transfer.

1.15 **The Canada Health Transfer.** This is a federal transfer provided to each province and territory to support health care. Funding is provided through both cash payments and tax transfers. The requirement attached to this transfer is that provinces and territories meet the conditions in the *Canada Health Act*. These conditions include the five criteria that apply to health services (public administration,

comprehensiveness, universality, portability, and accessibility), provisions relating to extra-billing and user charges, and conditions related to the provision of information and recognition of federal financial contributions. Health Canada is responsible for monitoring compliance with these conditions.

1.16 **The Canada Social Transfer.** This is a federal transfer to provinces and territories to support post-secondary education, social assistance and social services, and programs for children. This transfer consists of both cash and tax transfer components. The sole condition of this transfer is that provinces and territories meet a national standard: no one is required to live in a province or territory for a minimum period of time before becoming eligible to receive social assistance. The *Federal-Provincial Fiscal Arrangements Act* also states that the social transfer must finance social programs in a manner that provides provincial flexibility. The Act also states that all provincial and territorial governments are invited to work together to develop a set of shared principles and objectives that could form a foundation for promoting the well-being of Canadians.

1.17 **Equalization Program Transfer.** This transfer was established in 1957 and enshrined in the Constitution. It is intended to enable less-prosperous provinces to provide public services that are reasonably comparable to those provided by more-prosperous provinces, at reasonably comparable levels of taxation. Equalization Program payments are unconditional. The provinces that receive them can spend the funds according to their own priorities.

1.18 **Territorial Formula Financing.** This is an annual, unconditional federal transfer to territorial governments designed to take into account the higher costs of providing public services in the territories. This transfer is similar to that of the Equalization Program, in that its objective is to enable the territories to provide a range of public services that are reasonably comparable to those offered by the provincial governments, at reasonably comparable levels of taxation.

1.19 As transfer mechanisms have evolved, so too have reporting arrangements. The nature of cost-sharing programs required that provincial governments report their expenses directly to the federal government. More recent large transfers reflect a shift away from government-to-government reporting and toward government-to-citizen reporting. Under this model, the federal government reports to Parliament on how much it transferred to provincial and territorial governments and why. Recipient governments are then expected to report to their legislative assemblies,

their citizens, and their stakeholders on how they use public funds, including federal transfers. Provincial and territorial compliance with these reporting expectations may be subject to audit by their respective auditors.

Program-specific transfers to provinces and territories

Contributions—Conditional transfer payments to an individual or organization for a specified purpose. These payments are pursuant to a contribution agreement and are subject to being accounted for and audited.

Grants—Transfer payments made to individuals or organizations. Although grant payments are not subject to being accounted for or audited, the eligibility and entitlement of grant recipients may be verified, and they may need to meet certain preconditions.

1.20 A second mechanism for federal transfers is one in which individual federal departments transfer funds to provinces and territories to support specific program areas. The Treasury Board's 2000 Policy on Transfer Payments sets out the types of conditions attached to these transfers. These allow federal departments to require recipients of federal **contributions** (as distinct from recipients of federal **grants**) to report on the use of the funds and to provide audited financial information or submit to an audit by the federal government. Depending on the program, Parliament reviews and approves spending on transfers, either through its approval of enabling statutes or as part of the annual Estimates process.

1.21 In the 2006–07 fiscal year, according to the Public Accounts, just over $5 billion, or just over 2 percent of the federal government's expenses, comprised program-specific transfers to provinces or territories. Close to 75 percent of this total was accounted for by five federal departments: Human Resources and Social Development Canada, Transport Canada (including Infrastructure Canada), Natural Resources Canada, Indian and Northern Affairs Canada, and Agriculture and Agri-Food Canada (including the Canadian Food Inspection Agency).

1.22 Examples from three departments—Agriculture and Agri-Food Canada, the Department of Justice, and Human Resources and Social Development Canada—illustrate the types of conditions attached to these transfers.

Types of conditions

1.23 **Agriculture and Agri-Food Canada.** In 2007, the Department entered into bilateral agreements with nine provinces to share the costs associated with assisting industry to adapt to new controls on animal feed. This program, referred to as the Facilitation of the Disposal of Specified Risk Materials (SRM) Program, was established to address the risk that bovine spongiform encephalopathy (mad cow disease) might affect food safety, the environment, or the agricultural industry. The bilateral agreements provided for federal funding of 60 percent of eligible provincial expenses. Total federal funding for this

program was $76.5 million, to be spent by the end of the 2008–09 fiscal year. Payments are made to the participating provinces for eligible expenses as defined in the federal-provincial agreements.

1.24 In these bilateral agreements, the provinces agree to adhere to a number of conditions, and it is Agriculture and Agri-Food Canada's responsibility to see that they are met. Among the conditions are those related to financial and compliance audits, progress reports, environmental assessments, program evaluation, and acknowledgement in communications materials and products of federal support for the program.

1.25 **Department of Justice.** Criminal legal aid is a shared responsibility between the federal government, which has authority in matters of criminal law and criminal procedure, and provincial and territorial governments, which have authority for the administration of justice. On the basis of this shared responsibility, a long-standing federal-provincial partnership has ensured coordination between federal criminal law-making powers and provincial responsibility for the administration of justice. The provinces and territories deliver legal aid services through entities created under statutory authority in each of the 10 provinces and three territories.

1.26 Through bilateral agreements, the federal government provides contribution funding to the provinces and territories to support criminal legal aid for eligible adults as well as for youth charged under the *Youth Criminal Justice Act*, and for immigration and refugee legal aid in provinces that provide these services. The transfer amounts are based on negotiated funding formulas. Justice officials told us that audited claims for shareable expenses provide assurance that these transfers are being used for the agreed purposes. In the 2006–07 fiscal year, the federal government transferred close to $120 million to the provinces and territories for criminal, and immigration and refugee legal aid. Recipient jurisdictions agreed to conditions, including those related to

- financial auditing of program expenses,
- provision of defined services,
- performance measurement and participation in federally funded program evaluation,
- bilateral sharing of information related to criminal legal aid, and
- provincial acknowledgement of the federal contribution to public legal education activities and materials.

1.27 Human Resources and Social Development Canada. The Department has, since the mid-1990s, made contribution funding available to the provinces and territories to support a range of labour market development programs intended to address labour market challenges that both employers and workers face. These programs focused on enhancing the work-related skills of recipients of Employment Insurance (EI) benefits, for example, through specific skills training programs and work experience, and by assisting employers to hire EI recipients. Training and support services to EI recipients were typically delivered either through provincial programs or by third parties under contract.

1.28 In the 2006–07 fiscal year, payments totalled $1.95 billion, of which just over $1 billion went to participating provinces and territories in the form of transfer payments. The terms of federal-provincial-territorial agreements on labour market development included requirements related to

- performance measurement and reporting,
- program evaluation,
- information sharing,
- recognition of the federal contribution in public information, and
- participation in joint management committees.

1.29 In 2008, a new approach to federal support for labour market programs was introduced. It continued the devolution of primary responsibility for the design and delivery of labour market programs to the provinces and territories. The federal-provincial-territorial agreements, which define this arrangement, provide for $500 million to be distributed annually by the federal government on a *per capita* basis. In exchange for the increased flexibility accorded the provinces and territories in designing and delivering services under the agreements, they agree to accept and adhere to an accountability framework that encompasses planning, financial reporting and auditing, performance measurement, public reporting of results, program evaluation, participation in a joint committee, and public acknowledgement of federal funding. One innovative aspect of this agreement is that it requires funding recipients to demonstrate (with independent verification) that the federal funding has been used to support program activities that are in addition to, and not substituted for, those supported by normal provincial funding.

Revisions to the transfer payment policy

1.30 A renewed version of the federal Policy on Transfer Payments was approved in May 2008 for implementation in October. The changes to the policy are in keeping with the recommendations of an independent panel established in 2006 to examine federal grants and contributions programs. One of the panel's recommendations was that the oversight and reporting requirements for federal transfers be tailored to the capacities and circumstances of funding recipients. The panel's view was that this recommendation applies "quite directly" to federal grants and contributions to the provinces and territories, where "audit standards and capacities may well be as high as those of the federal government."

Federal use of trusts

Trusts—A trust is created when one party, the settlor, transfers legal ownership of property to another party, the trustee, for the benefit of a third party, the beneficiary. In the case of trusts used to transfer federal funds to the provinces and territories, the federal government is the settlor, the provinces and territories are the beneficiaries, and an independent financial institution is the trustee.

1.31 **Trusts** are a third mechanism that the federal government has used since 1999 to transfer funds to the provinces and territories. The trustee (in this case, an independent financial institution) allocates the funds in the trusts to the beneficiaries of the trusts (in this case, the provinces and territories), in accordance with the trust agreement. Trusts have been used by the Government of Canada to respond to particular short-term priority pressures in well-established areas of provincial responsibility (such as medical equipment) by providing targeted funds available to the federal government at year-end. In each case, the federal government has given provinces and territories the flexibility to draw down and use the funds according to their own priorities. With some exceptions, trusts that the federal government has created for these purposes have been announced in federal budget proposals. Parliament has then approved these transfers of funds through the legislative process.

1.32 In accordance with the current standards of the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants and the stated accounting policies of the federal government, transfers are expensed in the year they are announced, provided that a public commitment is made, that enabling legislation or Parliamentary authorization for payment is received prior to completion of the financial statements, and that any conditions are met prior to 31 March. Accordingly, letters of agreement need to be in place and all conditions must be met by the provinces and territories by 31 March. The accounting standard for government transfers, which would apply to intergovernmental transfers through trusts, is currently under review by the accounting profession.

1.33 Between 1999 and 2008, the federal government transferred almost $27 billion to the provinces and territories using trusts (Exhibit 1.3). The individual value of these trusts ranged from $120 million to $4.25 billion. From 1999 to 2003 (inclusively) $13 billion was transferred through the establishment of six trusts. This compares to the $14 billion transferred from 2004 to 2008 (inclusively) through 17 trusts. In the 2006–07 fiscal year, five trusts were created to transfer $3.3 billion to the provinces and territories (compared to the approximately $50 billion in total transfers that year; Exhibit 1.4).

1.34 Transfers provided through trusts payable to the provinces and territories are earmarked for specific purposes in public announcements by the federal government. In order to become eligible to draw on these trust funds, provinces and territories must confirm in writing their understanding of the purposes of the trust and name an authorized agent (typically the deputy minister of finance of the recipient jurisdiction).

1.35 Recent federal trust announcements have included "operating principles," which outline the purpose of the funding and the need for provinces and territories to report to their own citizens on how the funds are spent and what results are achieved. However, because these operating principles are not part of the trust agreements, they are not legally binding on the provinces and territories with respect to how the transferred funds are spent.

1.36 In recent years, as an additional condition of eligibility, provinces and territories must publicly opt-in as a beneficiary of the trust by making a public announcement regarding how they will use the funds. These public announcements must be in line with the federal operating principles for the trust.

1.37 Exhibit 1.5 illustrates the chronology of actions taken to establish the Public Transit Capital Trust 2008, including the requirement that recipient governments publicly announce to their own citizens how the funds will be spent.

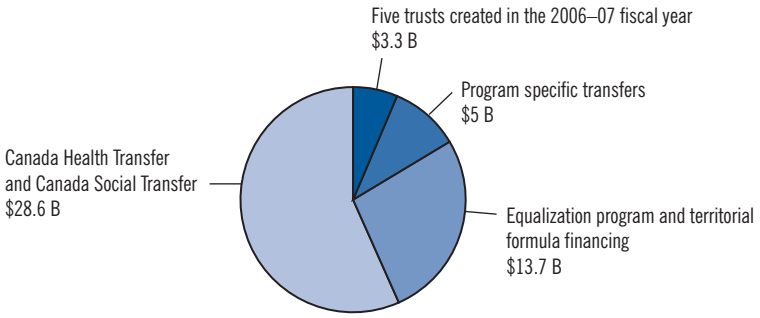
1.38 As noted earlier, provinces and territories must meet all conditions of eligibility in order to qualify as beneficiaries under a federal trust. However, once the federal government has deposited the funds in a trust account, the money becomes the property of the trustee. The trustee pays out the amount allocated to the beneficiaries in accordance with the trust agreements.

Exhibit 1.3 From 1999 to 2008, the federal government transferred some $27 billion to the provinces and territories using trusts

Source of announcement	Purpose	To be drawn down by	($ millions)
Budget 1999	One-time supplement to Canada Health and Social Transfer (for health)	2001–02	3,500
Budget 2000	Supplement to Canada Health and Social Transfer (for post-secondary education and health care)	2003–04	2,500
September 2000 Agreement on Health Renewal	Medical Equipment Fund in support of the 2000 Health Accord	2001–02	1,000
2003 First Ministers' Accord on Health Care Renewal	Cash supplement to Canada Health and Social Transfer	2005–06	2,500
2003 First Ministers' Accord on Health Care Renewal	Diagnostic/Medical Equipment Fund	2005–06	1,500
2003 First Ministers' Accord on Health Care Renewal	Supplement to Canada Health and Social Transfer (for health)	2005–06	2,000
Budget 2004	2004 Public Health and Immunization Fund	2006–07	400
10-Year Plan to Strengthen Health Care	2004 Wait Times Reduction Trust	2008–09	4,250
Budget 2005	Early Learning and Child Care Trust	2005–06	700
Budget 2005	Northern Strategy Trust	2007–08	120
Budget 2006	Post-Secondary Education Infrastructure Trust	2007–08	1,000
Budget 2006	Public Transit Capital Trust	2008–09	900
Budget 2006	Affordable Housing Trust	2008–09	800
Budget 2006	Northern Housing Trust	2008–09	300
Budget 2006	Off-Reserve Aboriginal Housing Trust	2008–09	300
Speech by the Prime Minister in February 2007	Clean Air and Climate Change Trust Fund	2009–10	1,519
Budget 2007	Patient Wait Times Guarantee Trust	2009–10	612
Budget 2007	HPV Immunization Trust	2009–10	300
Budget 2007	Transition Trust (for labour market training agreements and post-secondary education; in Ontario, Manitoba and Saskatchewan)	2007–08	614
Speech by the Prime Minister in January 2008	Community Development Trust	2010–11	1,000
Budget 2008	Police Officers Recruitment Fund	2012–13	400
Budget 2008	Saskatchewan Carbon Capture and Storage Demonstration Trust	2011–12	240
Budget 2008	Public Transit Capital Trust 2008	2009–10	500
Funds transferred 1999–2008 through trusts			26,955

Source: Department of Finance Canada

Exhibit 1.4 Five trusts comprised just over $3 billion of the approximately $50 billion transferred to the provinces and territories in 2006–07



Source: Department of Finance Canada

Exhibit 1.5 Chronology of actions taken to establish the Public Transit Capital Trust 2008

Actions taken before 31 March 2008
• **Federal announcement:** On 26 February 2008, the Budget Plan is tabled in Parliament. It commits the federal government to providing $500 million to provinces and territories for investments in public transit. The Budget states that funding will be paid into the trust "for only those beneficiaries that have made public commitments before March 31, 2008, to undertake investments in public transit." • **Governments work together on where to target investments:** The federal government notifies provincial and territorial colleagues of the designated federal funding, and asks provinces to identify priority areas for investment prior to 31 March 2008 to signal their intention to participate. The federal government outlines the purpose of the funding and suggested areas for investments. The federal government also reinforces the importance of reporting to provincial and territorial citizens on the use of the funding. Federal, provincial, and territorial officials work together to confirm priority areas of investment. • **Provincial and territorial announcements:** Provincial and territorial ministers formally reply to the federal government, indicating their intention to participate. They make public announcements in line with federal operating principles regarding their intended use of funding and how they intend to report publicly. • **Budget legislation:** Bill C-50, *Budget Implementation Act 2008* tabled. • **Trust arrangements finalized and trust accounts established with independent financial institution.**
Actions taken after 31 March 2008
• Budget bill moves through Parliament. • Royal Assent given to the Budget bill, authorizing appropriations of public funds. • Payment made to the trust on behalf of the provinces and territories. • Provinces and territories able to draw funds from trust, spend the funds, and follow through on their public reporting commitments.

Source: Department of Finance Canada

1.39 After the funds have been transferred, these trusts have no additional legal conditions that obligate provinces and territories to spend the funds for the announced purposes.

1.40 Instead, once the provinces and territories have established their eligibility to draw funds from the trust, they become accountable in principle to their own citizens, not to the federal government, for how they use the funds. In this sense, trusts, as used by the federal government, are similar to the Equalization Program and the Territorial Formula Financing transfers, in that there are no mechanisms to withhold funds. Trusts are also similar to the Canada Health Transfer and the Canada Social Transfer, in that provinces and territories are not required to report on this spending to the federal government.

1.41 The following are three examples of trusts that the federal government recently established to transfer funds to the provinces and territories.

- **The Diagnostic/Medical Equipment Fund.** Announced as part of the 2003 First Ministers' Accord on Health Care Renewal, this fund was in support of specialized staff training and equipment to improve access to publicly funded diagnostic services. The federal government put $1.5 billion into this trust, to be drawn down by the end of the 2005–06 fiscal year.
- **The Clean Air and Climate Change Trust Fund.** The funding for this $1.5-billion trust was initially announced in February 2007, in a speech by the government. The trust was established to support provincial and territorial projects aimed at reducing greenhouse gas emissions and air pollutants. Environment Canada's use of a trust to accomplish this transfer limited its ability to report on how the transferred funds were spent and the results achieved (see Chapter 1, Managing Air Emissions, of the 2008 Report of the Commissioner of the Environment and Sustainable Development).
- **The Community Development Trust.** On 10 January 2008, the federal government announced $1 billion for the Community Development Trust. This trust was designed to help provinces and territories assist communities and workers suffering economic hardship caused by the current volatility in global financial and commodities markets.

Significance of conditions

1.42 According to federal officials, the extent to which the federal government is accountable for funds it transfers to the provinces and territories depends on the extent to which conditions are attached to these transfers.

1.43 Once the federal government has reached agreement with the provinces and territories about the conditions attached to a transfer, it must demonstrate that it is monitoring provincial and territorial compliance with those conditions, and that it is taking action in cases of non-compliance. Our Office conducts performance audits to determine how well the federal government has carried out this obligation. The 2008 Report of the Commissioner of the Environment and Sustainable Development includes an example of this type of audit. See Chapter 3, Managing Environmental Programming—Agriculture and Agri-Food Canada.

1.44 As noted earlier, if no conditions have been established, the provinces and territories have the flexibility to spend the funds according to their own priorities. Because there are no conditions, our Office does not audit the non-financial elements of these transfers. In these circumstances, the federal government remains accountable to Parliament for choosing an unconditional transfer as the best available policy option. Accountability for results rests with provincial and territorial governments, and to their citizens, not to the federal government.

1.45 For all transfers, the federal government is responsible for ensuring that it sends the correct amount of funds to the provinces and territories. The role of the Office of the Auditor General, as Parliament's auditor, is to carry out financial audits of the Public Accounts of Canada. These audits determine if the government has recorded the amounts paid in accordance with Public Sector Accounting Board standards and with the stated accounting policies of the federal government.

Imposing conditions is a policy decision

1.46 Government officials whom we interviewed cited a number of reasons for choosing transfer mechanisms with limited or no conditions. In a mature federation, provincial and territorial governments have flexibility in matters involving their own jurisdictions, and report directly to their own legislatures and citizens rather than to the federal government. As well, in many areas, provinces and territories are best positioned to determine program priorities and implement programs in response to them. Another reason given by the officials was that the federal government can

achieve its objectives in ways other than by imposing conditions on transfers. For example, shared understanding and expectations may have been established based on a long history of recurring negotiations between the federal government and the provinces.

1.47 According to government officials whom we interviewed, the federal government may, depending on the circumstances, opt for a conditional transfer in order to

- ensure that recipients use the funds for specific purposes,
- encourage uniformity of services across the provinces and territories, and
- receive information on results achieved.

1.48 As auditors, we recognize that decisions on whether and to what extent conditions are attached to transfers are policy decisions that often involve sensitive negotiations among federal, provincial, and territorial governments. We do not question these decisions.

Conclusion

1.49 The federal government uses three main mechanisms to transfer funds to the provinces and territories. The first and largest mechanism includes four major transfers:

- the Canada Health Transfer,
- the Canada Social Transfer,
- the Equalization Program transfer, and
- Territorial Formula Financing.

These four transfers (of just over $42 billion in the 2006–07 fiscal year) recur annually by law. They are managed by Finance Canada. The second mechanism involves the transfer of funds (just over $5 billion in the 2006–07 fiscal year) by individual federal departments and agencies to support specific program areas. With the third mechanism, the federal government transfers funds (just over $3 billion in the 2006–07 fiscal year) to the provinces and territories using trusts.

1.50 According to the federal government, the extent of federal accountability for how the provinces and territories spend transferred funds depends on the nature and extent of conditions attached to the transfers. In all cases, the government is accountable for its decision to use transfers with or without conditions as the best policy choice available in the circumstances.

1.51 Some transfers involve conditions that, for example, oblige recipients to provide the federal government with information on how they have spent the transferred funds and to what effect. The federal government must demonstrate that it is monitoring provincial and territorial compliance with these conditions and that it is taking action in cases of non-compliance. Where transfers have limited or no conditions, the provinces and territories have the flexibility to spend the funds according to their own priorities, with no legal obligation to account to the federal government for the spending.

1.52 A significant addition to the transfer mechanisms used by the federal government was the introduction of trusts in 1999. Since then, 23 trusts have been established to transfer almost $27 billion to the provinces and territories. In each case, the federal government has publicly announced (jointly with recipients for recent trusts) the intended purposes of this funding. Once the eligibility conditions for these trusts have been met, no additional legal conditions obligate provinces and territories to spend the funds for the purposes announced. Instead, once the provinces and territories have established their eligibility to draw funds from the trust, they become accountable in principle to their own citizens, not to the federal government, for how they use the funds. In this sense, these trusts are similar to the four major transfers.

1.53 Where transfers have conditions, how well the federal government monitors the conditions is subject to performance audits by our Office, and our audit reports are provided to Parliament. For all transfers audited, we ensure that the amount paid is properly recorded in accordance with Public Sector Accounting Board standards and the stated accounting policies of the federal government.

About the Study

Objectives

We conducted this study to inform parliamentarians about the federal government's transfers of funds to provinces and territories, and about the Office's mandate to audit them. This study describes the different transfer mechanisms and the extent of the conditions attached to these transfers.

Scope and approach

This study examined

- the three main mechanisms the federal government uses to transfer funds to the provinces and territories, and
- the conditions attached to these transfers.

We reviewed government documentation and literature on federal transfers, including Budget papers, standing committee reports, and other reports. We also reviewed a wide range of literature on Canadian public administration. Finally, we drew upon the knowledge and advice of senior officials across the federal government, including central agencies, as well as experts in the field of public administration.

We did not examine funding arrangements with First Nations, payments to foundations, payments to municipal governments, or transfer payments to individual Canadians.

Study work completed

Examination work for this study was substantially completed on 31 May 2008.

Study team

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