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THE IMPACT OF FEDERAL FISCAL ARRANGEMENTS: EVIDENCE FROM THE "CAP ON CAP"

Les années 1990 ont été marquées par une période de réformes en profondeur des transferts fédéraux en matière d'assistance publique. D'aucuns diront que ces transformations se sont accompagnées d'une érosion correspondante du droit de regard fédéral dans la politique sociale au Canada. La question est de déterminer si les modalités des ententes de transfert ont un réel impact sur les décisions de dépenser des gouvernements provinciaux. Dans cet article, les auteurs examinent une réforme du Régime d'assistance publique du Canada au début des années 1990. Ils constatent que la réforme a bien entraîné une diminution notable de la croissance des dépenses provinciales dans les programmes sociaux, mais que l'ampleur des retombées apparaît relativement modeste.

In 1996, the federal government introduced the Canada Health and Social Transfer (CHST), providing lump-sum, block funding for provincial expenditures on social assistance, and replacing the dollar-for-dollar matching grants of the earlier Canada Assistance Plan (CAP). This change has led many commentators to speculate that provincial expenditures for social assistance will decline, and more broadly that federal influence over social policy in Canada will diminish.

Are these concerns valid? As a theoretical matter, certainly: matching grants reduce the "price" of social assistance programs to provincial governments, and so should increase expenditures. Block grants, in contrast, should have little impact, as provinces are effectively free to divert funds to alternative uses. In practice, however, there is surprisingly little evidence that sub-national governments respond differently to matching and block grants. Previous research, surveying evidence for welfare programs in the US, has found that one dollar of matching grants has been estimated to stimulate anywhere from \$0.29 (about the same as a block grant) to \$1.23 (much more) of spending. Clearly, these results leave little basis for predicting the impact of the introduction of the CHST in Canada. In this paper we report the results of an analysis of reforms to CHST's precursor, CAP. This research provides new evidence of how transfer arrangements affect provincial spending decisions, a useful input to predicting the consequences of the switch to CHST.

Originally, CAP was an open-ended matching grant, and all provinces faced a fixed matching rate of 100 percent for expenditures allocated to social assistance and social services. In 1990, the federal government constrained CAP transfers to grow by no more than five percent annually in three of the 10 provinces. Any increases in expenditures in excess of the federal ceiling were not subject to matching. This reform provides a straightforward test of how provincial governments respond to the incentives provided by fiscal arrangements. If the conventional view is correct, then social assistance expenditures should be smaller in the affected provinces than they would have been in the absence of the ceiling.

Our results indicate the "cap on CAP" did in fact lead to a decline in the growth rate of social assistance expenditures in the affected provinces. Nevertheless, the effect appears to have been small in magnitude. We estimate the growth rates in these provinces were eight to nine percentage points lower on average during the 1990-94 period than they would have been had the ceiling not been in place.

The cap on CAP

Historically, the CAP required the federal government to contribute 50 percent of the costs of eligible provincial social assistance programs on an open-ended basis. Beginning with the 1990 budget, the increase in federal contributions was limited to five percent a year for Alberta, British Columbia and Ontario.

The ceiling was in effect for these three provinces to the end of the 1994/95 fiscal year. In 1995/96, the cap was extended to all provinces and the growth rate of the ceiling was set to zero. This change was formalized by the introduction of the CHST in 1996/97.

The affected provinces could respond to the cap in a number of ways. While CAP required that assistance be provided to "persons in need," rules for the administration, design and delivery of specific programs were left to provincial discretion. For example, provinces have varied in their classification of beneficiaries, the structure and levels of benefits, their definitions of employable individuals and the incentives they provided for these individuals to seek employment.

Although changes to cash welfare assistance rates were likely the direct way for affected provinces to reduce expenditures, anecdotal evidence suggests they also relied on other measures (perhaps because indirect cost-control measures were more politically palatable than across-the-board benefit cuts). These included programs to detect fraud and abuse by beneficiaries and changes to the classification of some beneficiaries (e.g., from unemployable to employable). As a result, in our analysis we examine the impact of the reform on total eligible expenditures, on benefit rates, and on the number of beneficiaries.

Results

To determine the effect of the reform on the behaviour of provincial governments, we use regression analysis to relate changes in social assistance expenditures during the 1980-94 period to the presence of the cap, as well as to changes in other factors likely to influence provincial spending decisions. Our method also allows us to control for unobserved fixed differences in the growth of expenditures across provinces, and for changes in expenditures that were concurrent with the imposition of the cap but common to all provinces. This is one of the principal contributions of our study. Our technique allows us to distinguish the effects of the policy reform from these other factors. The failure of previous studies to do so may account for their wide-ranging results.

A simple illustration of our method can be drawn by comparing the growth rates in the capped and uncapped provinces before and after the ceiling was imposed. Between 1980 and 1989, the average growth rate in Alberta, BC and Ontario was twice that in the other provinces (6.4 percent *versus* 3.2 percent). In the 1990s the average growth rate in the uncapped provinces rose sharply to 5.9 percent, most likely in response to deteriorating economic conditions, while in the capped provinces it fell slightly to 6.0 percent. Thus the difference in average growth rates between the capped and uncapped provinces declined by 3.1 percentage points following imposition of the cap, which suggests affected provinces did indeed respond to the reform by controlling expenditures.

The regression analysis parallels this calculation, but

allows us to control for other factors influencing social assistance policy, and to determine the statistical significance of our estimate of the effect of the reform. Control variables used in the regressions are the growth rates of provinces' population, real GDP, the unemployment rate of prime-age males (age 25-44) and the number of new immigrants settling in the province. These variables, measures of economic and labour market conditions and socio-demographic trends, capture the demand for social assistance. To control for ideological proclivities, we also include a variable equal to one when the New Democratic Party forms the province's government.

Our estimates are summarized in Table 1. (We report only estimates of the effect of the cap, and not other independent variables.) In the first line of the table, we report the estimated effect of the reform on its target: the growth rate of total CAP-eligible expenditures. The estimated effect of the cap is negative and significant. It indicates that after the imposition of the ceiling the

Table 1
Effect of the cap on growth rates of social assistance

Dependent variable:	
CAP total expenditures	-0.084 †
— with "Klein effect"	-0.054 †
Welfare beneficiaries	-0.074 *
Expenditure per beneficiary	-0.010
Expenditure share	-0.107 †

Notes: Estimated change in the difference in growth rates of capped and uncapped provinces as a result of the reform.

* Significantly different from zero at the five percent level.

† Significantly different from zero at the one percent level.

growth rate of these expenditures in the capped provinces was 8.4 percentage points lower than it might have been.

While this suggests that the cap did affect the growth of CAP expenditures, it does not indicate how this was accomplished. This is explored in lines 3 and 4 of the table. In line 3, we report the effect of the cap on the growth rate of the number of beneficiaries of cash welfare assistance programs. Roughly two-thirds of CAP expenditures were for these programs. The estimated effect of the cap mirrors the result for total expenditures, although it is slightly smaller in magnitude. The growth rate of beneficiaries fell 7.4 percentage points more in capped than uncapped provinces after the ceiling was implemented.

In line 4, we examine the impact on a measure of benefit rates, using total CAP expenditures per beneficiary

of cash welfare programs as the dependent variable. These results must be viewed with caution, as the reform could conceivably cause expenditure per beneficiary to rise or fall. For example, a province's response to the ceiling might involve measures which reduce the number of single, employable beneficiaries. Since benefit rates for this category are typically much lower than for families, the result might be a rise in average expenditures per beneficiary. Thus it might not be surprising that our estimate of the effect of the cap in this case is small and not significantly different from zero.

One possible criticism of our estimates is that they simply reflect the election of Ralph Klein as Premier of Alberta in December 1992, and the sharp cuts in provincial spending which followed. To try to address this argument we estimated an alternative specification of the regression equation which in effect discards the data for Alberta in the years Klein was in power. In so doing, we are assuming the election of the Klein government was an exogenous event, and its subsequent move to lower spending was solely the result of its ideology. Our estimate of the effect of the cap in this case, reported in line 2 of Table 1, remains negative and significant, although it is somewhat smaller than previous results.

Similarly, it might be argued that our estimate merely captures across-the-board changes in government spending in the affected provinces. If this were the case, it would be difficult to attribute our results to the change in the federal matching rate. One way to check if this is true is to examine the effect of the reform on CAP-eligible expenditures as a share of total government spending; if we are simply capturing across the board cuts then the share of CAP expenditures should remain constant. The estimated effect of the cap on this variable reported in line 5 is negative and statistically significant. It suggests that the estimated effects of the cap do not reflect general provincial restraint.

Conclusion

We examine the conversion of the Canada Assistance Plan from an open-ended to a closed-ended matching grant for three provinces in 1990. This reform was a precursor to the introduction of the Canada Health and Social Transfer, which converted funding of all provinces to block grants in 1996. In order to evaluate the impact of these changes and prescribe future reforms in federal fiscal arrangements, robust empirical evidence of the reaction of provincial governments to federal funding arrangements is required. The wide range of estimates in the literature of the differential effects of block and matching grants, however, makes

such an evaluation a precarious exercise.

Our results indicate that provinces did respond to the reform by reducing the growth rate of expenditures, although the magnitude of the response over the medium term was modest. Growth rates were eight to nine percentage points lower than predicted in the

Our evidence suggests moderate reductions in social spending following the elimination of federal matching grants under CAP.

absence of the cap over a five year period following the reform. We also present evidence that the ceiling was accommodated through a reduction in the growth rate of the number of beneficiaries. This suggests that the main avenues of adjustment were varia-

tion in eligibility requirements, monitoring, supplemental benefits and classification of beneficiaries rather than changes to statutory benefit rates. This is in accordance with anecdotal evidence of changes to CAP programs over this period.

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