



HOUSE OF COMMONS
CANADA

**CHAPTER 1, A STUDY OF FEDERAL TRANSFERS
TO PROVINCES AND TERRITORIES OF THE
DECEMBER 2008 REPORT OF THE AUDITOR
GENERAL OF CANADA**

**Report of the Standing Committee on
Public Accounts**

**Hon. Shawn Murphy, MP
Chair**

MAY 2009

40th PARLIAMENT, 2nd SESSION



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THE STANDING COMMITTEE ON PUBLIC ACCOUNTS

has the honour to present its

ELEVENTH REPORT

Pursuant to its mandate under Standing Order 108(3)(g), the Committee has studied Chapter 1, A Study of Federal Transfers to Provinces and Territories of the December 2008 Report of the Auditor General of Canada and has agreed to report the following:

INTRODUCTION

Each year, the federal government transfers considerable funds to the provinces and territories, which in turn use these funds to deliver programs and services to Canadians. Some of the transfers are conditional in that the federal government requires provinces and territories to fulfill certain commitments. Other transfers are unconditional in that the provinces and territories can spend the payments according to their own priorities. In 2006-2007, federal transfers to the provinces and territories amounted to approximately \$50 billion, or just under 23 percent of all federal expenses.

The Office of the Auditor General (OAG) conducted a study of the federal government's transfers to provinces and territories in order to describe to parliamentarians the main mechanisms the federal government uses to accomplish these transfers.¹ The OAG also wanted to outline the Office's mandate to audit these transfers.

As the use of certain types of transfers with limited conditions, such as trusts, raises concerns about accountability, the Public Accounts Committee held a meeting on this study on 3 March 2009.² The Committee heard from a number of witnesses: from the Office of the Auditor General of Canada: Sheila Fraser, Auditor General of Canada; Neil Maxwell, Assistant Auditor General; from the Department of Finance: Rob Wright, Deputy Minister; Barbara Anderson, Assistant Deputy Minister, Federal-Provincial Relations and Social Policy Branch; from the Treasury Board Secretariat: Rod Monette, Comptroller General of Canada; John M. Morgan, Assistant Comptroller General, Financial Management and Analysis Sector; from the Privy Council Office: Alfred A. MacLeod, Assistant Deputy Minister, Intergovernmental Policy; Krista Campbell, Acting Director General, Sectoral Analysis; and from the Public Sector Accounting Board: Nola Buhr, Chair; Tim Beauchamp, Director.

BACKGROUND

There are three main mechanisms the federal government uses to transfer funds to the provinces and territories. They are:

¹ Auditor General of Canada, December 2008 Report, Chapter 1, *A Study of Federal Transfers to Provinces and Territories*.

² House of Commons Standing Committee on Public Accounts, 40th Parliament, 2nd Session, Meeting 7.

1. The four major statutory transfers managed by Finance Canada;
2. Program-specific transfers managed by individual departments and agencies;
and
3. Trusts, which are also managed by Finance Canada.

Finance Canada manages four major recurring transfers that are authorized by the *Federal Provincial Fiscal Arrangements Act*. These transfers are the Canada Health Transfer, the Canada Social Transfer, the Equalization Program, and Territorial Formula Financing. In the 2006-2007 fiscal year, the federal government provided \$42.3 billion, or 19 percent of its total expenses, to provinces and territories through these four transfers. The Canada Health Transfer carries the condition that provinces and territories must comply with the provisions of the *Canada Health Act*. The sole condition of the Canada Social Transfer is that there is no requirement to live in a province or territory for a minimum period before becoming eligible to receive social assistance. The Equalization Program and the Territorial Formula Financing program have no conditions.

Individual federal departments and agencies also transfer funds to provinces and territories to support specific program areas. These transfers are governed by the Treasury Board's *Policy on Transfer Payments*, which was updated in October 2008. In the 2006-2007 fiscal year, program-specific transfers amounted to over \$5 billion, or just over 2 percent of the federal government's expenses. The conditions attached to these program-specific transfers include such things as the provision of defined services, financial and compliance audits, performance measurement, progress reports, and program evaluation. Examples of program specific transfers are the Facilitation of the Disposal of Specified Risk Materials program, managed by Agriculture and Agri-Food Canada, and funding to support labour market development programs, managed by Human Resources and Skills Development Canada.

The federal government also uses trusts to respond to particular short-term priority issues in well-established areas of provincial responsibility by funding trusts from money available to the federal government at the year-end when they are running a budgetary surplus. In the trust mechanism, the federal government transfers funds to

a trustee (an independent financial institution), who then allocates the funds to the beneficiaries of the trusts, i.e. the provinces and territories, in accordance with the trust agreement. In order to become eligible to draw on the trusts, provinces and territories must confirm in writing their understanding of the purposes of the trust and name an authorized agent. Once the funds are transferred to the trustee, these trusts have no additional legal conditions that obligate provinces and territories to spend the funds in a certain way. Although, provinces and territories are accountable to their respective legislatures and citizens for their use of funds. Between 1999 and 2008, the federal government transferred almost \$27 billion to the provinces and territories using trusts.

The report by the Office of the Auditor General on federal transfers did not contain any recommendations as it was a study rather than an audit. In other words, it was descriptive rather than an assessment of findings against established criteria. Nonetheless, the Committee found the study to be very worthwhile, as it highlighted a very important issue: accountability.

ACCOUNTABILITY FOR FEDERAL TRANSFERS

The federal government is accountable to Parliament, and through Members of Parliament to Canadians, for how it spends public funds. It provides information to Parliament and Canadians on its expenditures and the results it achieves with those expenditures. Similarly, the provincial and territorial governments are accountable to their legislatures, with the assistance of their auditors general, and their constituents for how they have spent public funds within their jurisdictions. However, the accountability for federal transfers to the provinces and territories is less clear as the funds are federal but the program delivery is provincial and territorial.

With the Equalization Program and the Territorial Formula Financing, it is clear that these transfers are unconditional. The goal of the transfers is to enable less prosperous provinces and territories to offer services reasonably comparable to those provided in more prosperous regions of the country. The objective of these transfers is to support the general delivery of services.

With program specific transfers managed by individual departments, the federal government seeks to support specific program areas. The objectives of these

transfers are unique to each program area, and the federal government should have information to support the results of these transfers. In one initiative, the federal government requires funding recipients to demonstrate that the federal funding is used to support activities that are in addition to those normally supported.

The Equalization Program and program specific transfer represent the possible range of conditions attached to federal transfers. **It would be reasonable to expect that the level of conditions attached to the transferred funds would relate to the need for accountability and the specificity of program objectives, and the federal government would choose the appropriate transfer mechanism based upon the conditions required.** If the federal government claims that its funds are being used to achieve specific results, then it should be able to account for achieving those results. Indeed, the Treasury Board *Directive on Transfer payments* requires departmental managers to identify expected results for transfer payments programs, along with performance measures and indicators for monitoring and reporting. For example, in March 2008, the federal government announced the creation of a new Police Officers Recruitment Fund, whereby the federal government transferred \$400 million to the provinces and territories to allow them to recruit 2,500 police officers across the country. Given the specificity of this announcement, the government should be able to subsequently demonstrate that the police officers were recruited.

As noted above, the objective of the Equalization program is to support the general delivery of services, and these transfers are unconditional. Program specific transfers have more concrete objectives, and there are often quite specific conditions attached to the transfers. However, the use of the trust mechanism to transfer funds is ambiguous. The federal government claims certain objectives for the transfer (e.g. the hiring of 2,500 police officers), but requires little in the way of ongoing commitments from recipient provinces and territories in order to establish that these objectives are met. Recent trust announcements have included “operating principles,” but these principles do not form a part of the trust agreements and are thus not legally binding. In some trust agreements, provinces and territories must make a public announcement of how they will use the funds in order to become eligible for the funds, but a public announcement is similarly not binding. The public announcements also “encourage”

provinces and territories to report directly to their residents on the expenditures and outcomes, but there is no requirement to do so. The trust announcements provide the impression of accountability by including “operating principles” and a public announcement by the recipient of how the funds will be used, but the lack of ongoing conditions means that there is little in the way of subsequent accountability.

Federal officials argue that the reporting model for these transfers is largely government-to-citizen reporting rather than government-to-government. In other words, the federal government reports to Parliament and Canadians on how much it has transferred to provinces and territories, and the provinces and territories in turn are expected to report to their respective legislative assemblies and residents on how they use public funds, including transfers. However, this misses the concern with respect to accountability.

The issue is not that provinces and territories should be accountable to the federal government for achieving certain objectives. Rather, the federal government should itself be accountable to Parliament for how it spends federal funds, whether through transfers or otherwise, and the results it claims with those funds. With the use of trusts and their lack of ongoing conditions, the federal government may have little assurance that the funds are being used for their specified purpose, that stated objectives are achieved, and that the funds are not simply funding programs and services that would have been undertaken anyway.

Recent audits by the Office of the Auditor General and the Commissioner for the Environment and Sustainable Development demonstrate the accountability problems that can arise from a lack of conditions on federal transfers.

In the 2000 Health Communiqué and again in the 2003 Health Accord, the Canadian First Ministers agreed that each jurisdiction would measure and report publicly on comparable health indicators. According to the Health Council of Canada, Health Canada and the provinces and territories published comparable health indicators reports in 2002 and 2004.³ However, the Office of the Auditor General found that only

³ Health Council of Canada, *Rekindling Reform: Health Care Renewal in Canada, 2003-2008*, June 2008, page 25.

the federal government continued to report on comparable health indicators in 2006.⁴ The Auditor General commented, “[N]o provinces or territories are producing those reports anymore. That’s why we say that even though there are these statements of agreements with principles, they are not binding, and there is absolutely no consequence if people don’t follow through on them.”⁵

The March 2007 Budget announced a transfer of \$1.519 billion to provincial and territorial governments under the Clean Air and Climate Change Trust fund. The fund supports provincial and territorial efforts to develop technology, improve energy efficiency, and undertake other projects that will result in significant environmental benefits. Environment Canada’s Climate Change Plan states that the fund is expected to reduce greenhouse gas emissions by 16 megatonnes annually from 2008 to 2012, for a total of 80 megatonnes.⁶

However, an audit by the Commissioner for the Environment and Sustainable Development found that the lack of information from the provinces and territories means that Environment Canada cannot monitor or verify the expected results. The audit notes, “The Department has not developed and implemented even a voluntary system for monitoring greenhouse gas emission reductions under the Trust Fund. Nevertheless, Environment Canada made a claim of expected results in 2007 and repeated it in 2008, knowing that the nature of the Trust Fund makes it very unlikely that the Department can report real, measurable, and verifiable results.”⁷

The Public Accounts Committee understands that certain trade-offs are made in the use of trusts to transfer funds to provinces and territories. The Deputy Minister for the Department of Finance Canada put it this way, “Now, the policy trade-off is that there are some occasions when a federal government might have an unanticipated surplus, where it could make some funding available for a priority with a partner that doesn’t require long-term conditions. So if you have those conditions, you might not have that fiscal flexibility in the following few years when the money might be

⁴ Auditor General of Canada, December 2008 Report, Chapter 8, *Reporting on Health Indicators—Health Canada*, paragraph 8.19.

⁵ Meeting 7, 17:55.

⁶ Environment Canada, *A Climate Change Plan for the Purposes of the Kyoto Protocol Implementation Act—2007*, 2007, page 17.

⁷ Commissioner for the Environment and Sustainable Development, December 2008 Report, Chapter 1, *Managing Air Emissions*, paragraph 1.40.

spent. That's the trade-off that's made.”⁸ In other words, the trade-off is between having more conditions against having the flexibility to provide more funding from an unanticipated surplus.

The Committee appreciates that provinces and territories understand their needs best. They must be given sufficient flexibility to innovate and design programs and services to meet their circumstances. It would not be appropriate for the federal government to attempt to impose a one-size-fits-all approach to service delivery.

However, the Committee is concerned that the public announcements accompanying the creation of trusts may be misleading. As the Auditor General put it, “As a minimum, there's an issue around the communication of what these trusts are and what they do, and I think it comes back to the legislatures and the Parliament of Canada deciding what kind of accountability they want around these amounts of money.”⁹

The Committee believes that it is very important to provide a clear and accurate picture of the level of accountability involved in the transfer of funds to provinces and territories, especially in the use of trusts. If there are not going to be conditions attached to the transfer of funds to provinces and territories, then this should be stated clearly, and an explanation should be provided of why there are no ongoing conditions, in other words, of the trade-off that is being made between accountability and fiscal flexibility. The Committee recommends:

RECOMMENDATION 1

That the Government of Canada, when announcing transfers to provinces and territories, clearly explain whether there are ongoing conditions for the use of the funds and if not, explain why not.

MONITORING RESULTS

With funds transferred through trusts the federal government expects that the recipient provinces and territories use the funds as intended and achieve the desired results. However, as there are no ongoing conditions for the use of funds transferred through trusts, it is difficult for the federal government to monitor the use of

⁸ Meeting 7, 17:00.

⁹ Meeting 7, 17:35.

funds and the results achieved. Officials at the hearing claimed that stakeholders knew how the funding was spent. Barbara Anderson of Finance Canada told the Committee that,

One of the first [trusts] we did was for medical equipment, and there was not a radiologist in Canada who could not tell me down to the very last penny how many MRIs his province had bought. It was the same with the child care. The child care groups knew exactly how much money had gone through these trusts to their provinces, and they certainly were very effective in demanding that the money be spent.¹⁰

With respect to accountability, Rob Wright said, “I do know that provinces are stepping up their game in terms of being accountable to their legislatures on action, including on the ecoTrust. Because there is a strong body of public interest in watching those issues and there are very active folks who’ll make sure they’re held to account in that format.”¹¹

However, it is not clear the extent to which federal government knows how the funds it has transferred are being spent. This is important because for the federal government to continue to use the trust fund mechanism, then it should have some assurance that previous transfers through trusts have been used appropriately. While the federal government is no longer responsible for the funds once they have been placed in a trust, it is responsible for making the decision to use the trust mechanism based upon a sound analysis of the reliability of the mechanism to achieve federal objectives as demonstrated by previous experience. In other words, in order to provide sound advice to ministers about whether to use the trust mechanism in the future, government officials should have a good understanding of how well it has worked in the past.

As the above comments demonstrate, it would appear that the federal government is relying upon interested parties to monitor spending rather than undertaking their own analysis. The federal government assumes that recipient provinces and territories are complying with the announced operating principles and objectives, but has no assurance that they are doing so. The federal government, though, should know whether or not its trust in provinces and territories to use the funds as specified is warranted.

¹⁰ Meeting 7, 17:40.

¹¹ Meeting 7, 17:20.

Additionally, if the federal government wishes to claim specific expected results from its funding, then one would expect the federal government to subsequently have a means to monitor and verify those results. This could involve such things as voluntary reporting or independent verification methods. It is up to the parties to the agreement to decide how this best can be achieved, but the Committee believes that Parliament and Canadians should have assurance that the funds have been used as intended and expected results have indeed been achieved. The Committee recommends:

RECOMMENDATION 2

That when designing future trust agreements, the Government of Canada ensure that mechanisms are in place to verify results achieved.

ACCOUNTING FOR TRUST FUNDS

Trusts are usually announced in the Budget sometime in February and then expensed in the same fiscal year ending 31 March—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. If the government attached ongoing conditions to the use of the funds placed in trust, it would not be permitted to expense the transferred funds by 31 March, according to the accounting standards issued by the Public Sector Accounting Board (PSAB) and the stated accounting policies of the federal government. The Auditor General commented in the 2006-2007 *Public Accounts* that the federal government's accounting treatment of trusts was acceptable because the government had entered into agreements with the appropriate authorities; had authorization from Parliament to make the payments; had not included any conditions that would have to be met subsequent to 31 March; and had known the amount of the transfers.¹²

Thus, one of the primary reasons for using the trust mechanism is the desire to book the transferred funds by the end of the fiscal year. Transferring funds into trusts without ongoing conditions allows the federal government to reduce the budgetary

¹² Receiver General of Canada, *Public Accounts of Canada, 2006-2007*, Volume I, page 2.31.

surplus in the given fiscal year by the amount transferred into the trust. This also means that trusts are not likely to be used again until the government returns to a surplus situation.

PSAB sets the accounting standards for all levels of government in Canada, which includes standards for government transfers. The adoption of accrual accounting has led PSAB to provide additional guidance and clarification on its accounting standards. PSAB started the process of clarifying the standard for government transfers in 2002. Normally it takes about 18-24 months to complete an accounting standard, but this issue remains unresolved as it has turned out to be one of the most controversial issues that PSAB has dealt with. The disagreement appears to be that some jurisdictions believe that government transfers create an obligation for recipients to provide services in future periods, i.e. are a liability, and thus revenues from transfers should be deferred to the period in which those services are provided. Others maintain that the transfers are revenue and should be recorded in the year that they are received. The issue is a question of when a term or condition constitutes a liability for future periods.

PSAB's delay in approving a new standard has meant that there is currently inconsistent accounting for government transfers amongst provinces and territories. Nola Buhr, the Chair of PSAB, told the Committee that the delay in approving a new standard was due to a lack of consensus on PSAB. The Committee hopes, though, that the independence of PSAB means that it will overcome objections from some jurisdictions and adopt a new standard in a timely manner.

While the Committee is concerned about this delay, the Committee is more troubled that the choice to use the trust mechanism seems to be largely driven by accounting standards rather than a careful consideration of how best to achieve federal government objectives and ensure accountability. Ms. Buhr told the Committee that the accounting standards and accountability are separate issues. She said:

Let me start with the accountability versus the accounting issue. Those are two different things. Accountability is a relationship set up by, in this case, someone providing funds and someone using funds. How that relationship is understood, either formally through terms and conditions or informally through practice, history, and agreement, will determine how the recipient views the transaction and how they treat the transaction. Then

accounting comes in and says, how do we account for that relationship? What has to be established first of all is what that relationship is. What was the expectation for what was to be done with that money? How is that money handled?¹³

However, the Committee believes that transparent, consistent accounting information is an important tool for accountability, and the current accounting standard for government transfers encourages the federal government to minimize the conditions put on transfers through trusts, and thereby limits accountability.

The Committee believes that PSAB should not wait for unanimity and should move as quickly as possible to resolve the outstanding issue of clarifying its standard on government transfers, and it believes that PSAB should do so in a way that enhances accountability to the greatest extent possible.

CONCLUSION

Transfers of funds from the federal government to provinces and territories are an important mechanism for the federal government, as transfers constitute almost 25 percent of federal government expenditures. It is understandable that some transfers, such as the Equalization Program, have minimal conditions because the transfer itself achieves government objectives. However, the federal government's use of the trust mechanism to transfer funds is much more problematic as there are no ongoing conditions attached to these transfers. The government should not make specific claims of expected results that it has no method of verifying.

The Committee believes that the conditions attached to a transfer should be consistent with the accountability required to confirm that the expected results have been achieved. The Committee also believes that the communication of transfers should be clear and consistent. If no ongoing conditions are to be attached to the transfer, then the government should explain why this is the case, and the government should avoid using non-binding operating principles and public statements. Lastly, the Committee is concerned that the use of trusts is complicated by unclear accounting standards.

¹³ Meeting 7, 17:15.

The federal government is accountable to Parliament for how it spends funds and the results it achieves. The Committee believes that transfers to provinces and territories can be a legitimate means of achieving federal objectives, but they should be used in a way that enhances accountability, rather than limiting it.

APPENDIX A LIST OF WITNESSES

Organizations and Individuals	Date	Meeting
<p>Department of Finance Barbara Anderson, Assistant Deputy Minister, Federal-Provincial Relations and Social Policy Branch</p> <p>Rob Wright, Deputy Minister</p>	2009/03/03	7
<p>Office of the Auditor General of Canada Sheila Fraser, Auditor General of Canada</p> <p>Neil Maxwell, Assistant Auditor General</p>		
<p>Privy Council Office Krista Campbell, Acting Director General, Sectoral Analysis</p> <p>Alfred A. MacLeod, Assistant Deputy Minister, Intergovernmental Policy</p>		
<p>Public Sector Accounting Board Tim Beauchamp, Director</p> <p>Nola Buhr, Chair</p>		
<p>Treasury Board Secretariat Rod Monette, Comptroller General of Canada</p> <p>John M. Morgan, Assistant Comptroller General, Financial Management and Analysis Sector</p>		

REQUEST FOR GOVERNMENT RESPONSE

Pursuant to Standing Order 109, the Committee requests that the government table a comprehensive response to this Report.

A copy of the relevant Minutes of Proceedings ([Meetings Nos. 7, 13, 17, 18 and 19](#)) is tabled.

Respectfully submitted,

Hon. Shawn Murphy, MP

Chair

**CHAPTER 1, A STUDY OF FEDERAL TRANSFERS TO PROVINCES
AND TERRITORIES OF THE DECEMBER 2008 REPORT
OF THE AUDITOR GENERAL OF CANADA**

DISSENTING OPINION

Presented by the MP for the Bloc Québécois

Meili Faille (Vaudreuil-Soulanges)

The Bloc Québécois recognizes that Quebec and the provinces must account to the public for their management of public funds. The Bloc Québécois does not however wish to see the federal government impose conditions on Quebec and the provinces when transferring funds. The latter must remain in charge of their own development.