

# **BUDGET PAPER B: FEDERAL FISCAL ISSUES**

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During 2000-01 there were intensive negotiations between the Federal Government and provinces on Canada's two largest fiscal transfers, Equalization and the Canada Health and Social Transfer. On September 11, 2000, the Prime Minister made commitments to Premiers to partially restore the federal cutbacks of transfers to Provinces for Health Care, and to lift the ceiling on Equalization.

Ceiling restrictions on the Equalization program however will remain in place during 2001-02 and future years. Given that Equalization is by far Prince Edward Island's largest revenue source we will be particularly impacted by this restriction. Prince Edward Island's ability to provide reasonably comparable public services at competitive rates of taxation is therefore placed at risk.

This Budget Paper examines the Constitutional requirements for fiscal transfers to provinces and describes recent changes to these transfers.

## **EQUALIZATION**

### *The "Glue That Holds the Federation Together"*

Canada's Equalization program is a system of annual payments to less affluent provinces from the Federal Government which should allow them to provide reasonably comparable levels of public services to their residents at reasonably comparable levels of taxation, as stated in the Constitution. In its absence, the less affluent provinces would be constrained to provide a significantly lower standard of provincial public services such as health care, education and transportation than other provinces.

Alternately, tax rates in less affluent provinces would have to be set at markedly elevated levels to deliver comparable services to their residents. This in turn would hamper the ability of local businesses to compete with those in richer provinces or other countries and so impede provincial efforts toward economic growth.

It has long been the position of Equalization receiving provinces that the Federal Government has used its legislative power over the Equalization program to reduce payments to levels that fall short of those required to truly equalize levels of services.

In June 2000, Atlantic Premiers called on the Federal Government to remove the limits on the Equalization formula that essentially keep the program from fully functioning. Specifically, they endorsed a removal of the Equalization ceiling that limits payments to a prescribed budget figure, adoption of a National Average standard for the program rather than the current 5-province standard and removal of new technical restrictions introduced in federal legislation in April 1999.

## Figure B.1 - Provincial Transfers and the Canadian Constitution

The Canada Act, 1982 dedicates a full section to provincial economic and fiscal equity. Part III of Canada's Constitution is entitled "Equalization and Regional Disparities". Its full text is as follows:

*36. (1) Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to*

*(a) promoting equal opportunities for the well-being of Canadians;*

*(b) furthering economic development to reduce disparity in opportunities; and*

*(c) providing essential public services of reasonable quality to all Canadians.*

*(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

Sections 36.1(a) and 36.1(b) of the Constitution commit the Federal Government to co-operate with provinces to promote equal opportunities, furthering economic development and reducing disparity in opportunities.

Section 36.1(c) provides motivation for the Federal Government's Canada Health and Social Transfer which enforces federal objectives under the Canada Health Act and supports provincial spending on Health, Social Services and Post-secondary Education.

Section 36.2 delivers a clear direction to the Federal Government as to the level of Equalization transfers that it should make to provincial governments.

### *The Prime Minister's Pledge*

The Federal Government introduced legislation in April 1999 that lowered the Equalization ceiling, on total annual payments to provinces from its previous level of \$11.1 billion to \$10 billion, beginning in 1999-2000, to increase with national GDP thereafter.

Premiers met with the Prime Minister on September 11, 2000 to discuss the Canada Health and Social Transfer and the Equalization program. Substantial commitments were made by the Federal Government on CHST transfers to provinces, as well as a more limited but firm commitment from the Prime Minister regarding the ceiling on Equalization payments, which follows:

“The Prime Minister agreed that necessary steps would be taken to ensure that no ceiling will apply to the 1999-2000 fiscal year. Thereafter, the established Equalization formula will apply, which allows the program to grow up to the rate of growth in GDP.”

*- Prime Ministerial communique, September 11, 2000*

The most recent official federal estimates calculate total Equalization Entitlements for 1999-2000 at \$10.79 billion, with further revisions to follow. Statistics Canada has determined that nominal GDP growth in 2000 was 8.4 per cent. As such, adopting Minister Martin’s ceiling proposal would set the 2000-2001 ceiling at \$10.84 billion, which allows program growth in 2000-2001 of only 0.4 percent, much lower than the Prime Minister’s commitment of program growth at the rate of GDP.

The Prime Minister’s statement commits the Federal Government to a ceiling of at least \$11.7 billion for 2000-2001, not the \$10.84 that has been put in place.

The ceiling levels necessary to meet the Prime Minister’s pledge of September 11, 2000 are displayed in the Table B.1, as compared to the amounts proposed by Minister Martin and the ceiling levels under the current and previous federal legislation.

**Table B.1 Alternate Ceiling Amounts: 1999-00 to 2003-04**

	1999-00	2000-01	2001-02	2002-03	2003-04
<i>Nominal GDP Growth</i>	6.2%	8.4%	5%	5%	5%
Previous Federal Legislation	\$11.1 B	\$12.0 B	\$12.6 B	\$13.2 B	\$13.9 B
Current Federal Legislation	\$10 B	\$10.8 B	\$11.4 B	\$12.0 B	\$12.5 B
September 11, 2000 Pledge	No Ceiling	\$11.7 B *	\$12.3 B	\$12.9 B	\$13.5 B
Minister Martin’s Proposal	No Ceiling	\$10.8 B	\$11.4 B	\$12.0 B	\$12.5 B

\* The figure of \$11.7 billion equals the 1999-00 total Entitlement of \$10.792 billion escalated by nominal GDP growth thereafter.

The Equalization ceiling was first introduced in 1982. When it applies, payments to provinces are scaled back to the ceiling totals with the national reductions shared equally among receiving provinces, according to population.

Additional to being contrary to the Prime Minister’s commitment, Minister Martin’s proposal to restrict Equalization payments to provinces is unprecedented in several distinct ways.

The ceiling has been re-based downward as a per cent of GNP twice before, in the program renewals in 1987 and 1992, but the ceiling was not revised downward in the legislative review of 1994. As the federal Auditor General has noted, previous re-basing’s occurred in periods of fiscal difficulty for the Federal Government.

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**In previous legislative reviews the value of the Equalization ceiling fell from...**

1.34 per cent of GNP in 1982 to  
1.24 per cent of GNP in 1987 to  
1.17 per cent of GNP in 1992 to  
1.08 per cent of GNP in 1999 or 1.04 per cent of GDP in 1999.

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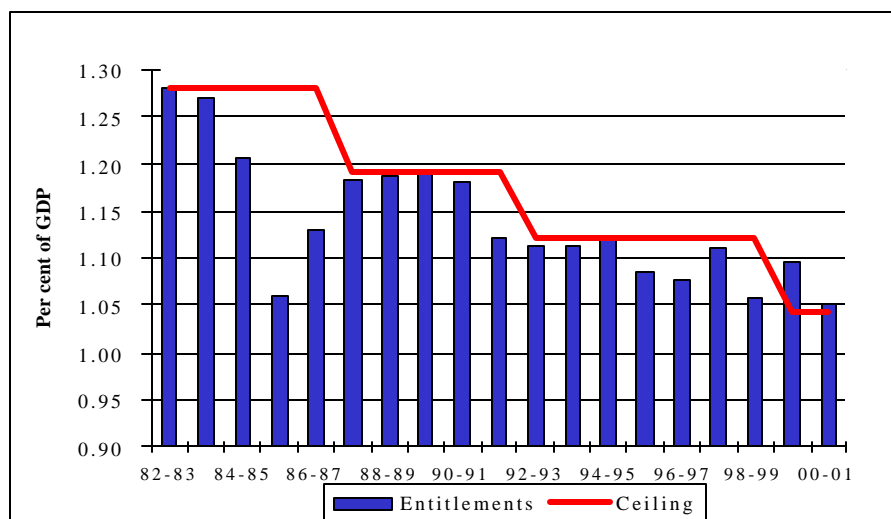
**In previous legislative review years the federal (deficit) surplus stood at...**

(\$29 billion) in 1982  
(\$28 billion) in 1987  
(\$41 billion) in 1992  
(\$37 billion) in 1994  
\$12 billion in 1999.

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**The federal decision effectively lowers the ceiling for 2000-01 by \$1.1 billion, the largest ever downward adjustment in the Equalization ceiling, at a time when the Federal Government has the largest surpluses in the history of the country.**

**Figure B.2 - Equalization Entitlements and Ceilings as Percentage of GDP: 1982-83 to 2000-01**



As can be seen in Figure B.2, Minister Martin's new ceiling figure for 2000-01 sets the ceiling at a level that is proportionally lower than Equalization Entitlements have been during the last twenty years. In no year from 1982-1983 to 1999-2000 were Equalization Entitlements lower than 1.05 per cent of GDP. But Minister Martin's ceiling for 2000-2001 is set at 1.04 per cent of GDP, which will force entitlements to a lower level, as a percent of GDP, than they have ever been.

## How Equalization works

Equalization payments to Provinces are determined by a detailed formula that reflects provincial *fiscal capacity*, or the degree to which each province would be able to finance public services from their own taxation sources and natural resources if each province applied the same tax rate.

The Federal Government has chosen to raise the revenues of Equalization receiving provinces to the average fiscal capacity of five “standard” provinces - Quebec, Ontario, Manitoba, Saskatchewan and British Columbia. Provinces that have a fiscal capacity below this standard receive Equalization transfers while provinces that have a fiscal capacity that is greater than the standard do not receive transfers. The per capita fiscal capacities of provinces are before and after Equalization are shown in Table B.2.

**Table B.2 - Per Capita Fiscal Capacities Before and After Equalization: 2001-02**

	NF	PE	NS	NB	QC	ON	MB	SK	AB	BC	5-Province Standard	National Average
<b>Before Equalization</b>												
<b>Per Capita Fiscal Capacity (\$)</b>	3,677	<b>3,915</b>	4,333	4,178	5,030	6,301	4,744	5,699	10,099	5,876	<b>5,766</b>	6,061
Percentage of 5-province standard (%)	63.8	<b>67.9</b>	75.1	72.4	87.2	109.3	82.3	98.8	175.1	109.1	100.0	105.1
<b>After Equalization</b>												
<b>Per Capita Fiscal Capacity (\$)</b>	5,766	<b>5,766</b>	5,766	5,766	5,766	6,301	5,766	5,766	10,099	5,876	5,766	<b>6,408</b>
Percentage of National Average (%)	90.0	90.0	90.0	90.0	90.0	98.3	90.0	90.0	157.6	91.7	94.1	100.0

*Source: Official Federal Equalization Estimates*

The fiscal capacity of the Government of Prince Edward Island from own source revenues is \$3,915 per capita. The current 5-province standard raises provincial revenue to a substantially higher level of \$5,766. A national standard would allow the provincial government to provide services to a standard of \$6,061 per person. For each of its residents, the Government of Alberta is able to provide \$10,099 in government services, at standardized tax rates. The Government of Ontario can provide \$6,301 in government services.

Prince Edward Island’s Equalization Entitlement is calculated as the difference between our per capita fiscal capacity and the 5-province standard, as multiplied by our population, or

*(\$5,766 less \$3,915) multiplied by 138,801 equals \$256,965,000.*

If the Federal Government were to use a national average standard as the basis for Equalization payments, rather than the 5-province standard, payments to Prince Edward Island would be higher by some \$41 million, using the same method of calculation

*(\$6,061 less \$3,915) multiplied by 138,801 equals \$297,914,000.*

The ceiling causes payments to Equalization receiving provinces to be restricted below even the Five Province Standard.

### ***Equalization Revenues - Prince Edward Island***

The revenue forecast for Prince Edward Island for 2001-02 assumes that the ceiling will apply when the early estimates of Equalization are revised. Provincial Treasury estimates that the impact of ceiling restrictions will be to reduce Prince Edward Island's revenues by \$9 million during the next fiscal year.

## **II. CANADA HEALTH AND SOCIAL TRANSFER**

### ***Federal Contributions to Provincial Social Programs***

The Canada Health and Social Transfer (CHST) is the largest Federal Government transfer to provinces, with a mandate to support provinces in their provision of health care, social services and post-secondary education. It was introduced in 1995-96 to replace two previous transfer programs with similar mandates, but at a much reduced level of payment. Premiers have consistently called on the Federal Government to re-invest in Canadian social programs by restoring CHST funding to its previous level of \$18.7 billion and escalating that total thereafter, by a rate no less than growth in GDP.

At the meeting of First Ministers on September 11, Prime Minister Chretien committed to restore CHST cash funding to the level of \$18.7 billion with some escalation in the totals thereafter. He declared that some of this funding should go to Early Childhood Development initiatives by provinces and he created a short-term fund to help provinces purchase medical equipment. Table B.3 displays the amounts agreed to.

**Table B.3 - New CHST and Health Funding Arrangements**  
**Canada (\$ Billions): 1994-95 and 2000-01 to 2005-06**

	1994-95	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Previous CHST cash	18.7	15.5	15.5	15.5	15.5	15.5	15.5
CHST cash increase	-	-	2.5	3.2	3.8	4.4	5.0
Early Childhood Development	-	-	0.3	0.4	0.5	0.5	0.5
<b>Total CHST Cash</b>	<b>18.7</b>	<b>15.5</b>	<b>18.3</b>	<b>19.1</b>	<b>19.8</b>	<b>20.4</b>	<b>21.0</b>
Medical Equipment Fund	-	0.5	0.5	-	-	-	-
<b>Total CHST + Fund</b>	<b>18.7</b>	<b>16.0</b>	<b>18.8</b>	<b>19.1</b>	<b>19.8</b>	<b>20.4</b>	<b>21.0</b>
New Cash Increase		0.5	3.3	3.6	4.3	4.9	5.5
<b>CHST vs 1994-95</b>		<b>-2.7</b>	<b>0.1</b>	<b>0.4</b>	<b>1.1</b>	<b>1.7</b>	<b>2.3</b>

The federal funding announcement fell short of the request of Premiers in two ways. The restoration will not happen until 2001-02 and it is not escalated according to growth in GDP, but according to the schedule determined above. The low rate of escalation adopted by the Federal Government leads to declines in the real per capita value of the CHST, as the totals do not reflect inflation or population growth.

The newly enhanced CHST contains a portion that is to be allocated to Early Childhood Development initiatives by provinces after consultations among Federal and Provincial Ministers responsible for children. This amount is \$300 million in 2001-02, rising to \$500 million in 2003-04.

The value of the new cash to Prince Edward Island is displayed in Table B.4.

**Table B.4 - New CHST and Health Funding Arrangements**  
**Prince Edward Island (\$ Millions): 1994-95 and 2000-01 to 2005-06**

	1994-95	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Previous CHST cash	89.0	74.0	74.0	74.0	74.0	74.0	74.0
CHST cash increase		-	11.1	14.0	16.6	19.1	21.5
Early Childhood Development		-	1.3	1.8	2.2	2.2	2.2
<b>Total CHST Cash</b>	<b>89.0</b>	<b>74.0</b>	<b>86.4</b>	<b>89.9</b>	<b>92.8</b>	<b>95.3</b>	<b>97.7</b>
Medical Equipment Fund		2.2	2.2	-	-	-	-
<b>Total CHST + Fund</b>	<b>89.0</b>	<b>76.2</b>	<b>88.6</b>	<b>89.8</b>	<b>92.8</b>	<b>95.3</b>	<b>97.7</b>
New Cash Increase		2.2	14.4	15.8	18.8	21.3	23.7
<b>CHST vs 1994-95</b>		<b>-12.8</b>	<b>-0.4</b>	<b>0.8</b>	<b>3.8</b>	<b>6.3</b>	<b>8.7</b>

The Province received \$89 million in transfer payments through CAP and EPF in 1994-95. Prince Edward Island will not see federal social program transfer payments restored to pre-CHST levels until 2002-03.