

BUDGET PAPER B: FEDERAL FISCAL ISSUES

“Federal revenue performance is weak for a variety of reasons, and there is added uncertainty in the coming year over exactly what can be expected.”

Hon. Patricia J. Mella - March 26, 2002

This paper summarizes outstanding issues and recent developments related to Prince Edward Island’s fiscal relationship with the Federal Government. In particular, the Province’s two largest transfer revenues, Equalization and the Canada Health and Social Transfer, are examined. Federal investments in regional economic development initiatives are also considered in turn.

During the past fiscal year, Prince Edward Island has pursued improvements to Canada’s fiscal arrangements in consensus-based provincial-territorial discussions. Further, the Provincial Treasurer took the extraordinary step of appearing before the Parliamentary Standing Committee on Finance and the Senate Committee on National Finance to discuss her concerns regarding the Equalization program. While provinces and territories as a group have worked hard during the year to achieve unanimity in their ranking of national fiscal priorities, the Federal Government has resisted action on any of the provincial policy recommendations.

The Federal Government tabled its first full budget in two years in December of 2001. Its focus was to improve the nation’s security and economy in the wake of the terrorist attacks of September 11. The budget ear-marked any surplus funds beyond these priorities to create a federal infrastructure program, expand international aid and pay down debt. It did not provide for any improvements to provincial financing for health care or Equalization, despite the unanimous appeal from Canada’s Premiers.

For Prince Edward Island, federal revenues in the past fiscal year were somewhat higher than projected in last year’s provincial budget, although until February 28, 2002, the federal Equalization payments were \$28 million below the Province’s budget estimate.

In the coming fiscal year, federal revenues to Prince Edward Island are expected to decline and will be subject to an exceptional degree of uncertainty.

Sharp absolute declines in Equalization during 2002-03 will outpace modest expansion in the cash transferred through the CHST and result in a level decrease in federal transfers. As well, the last of Prince Edward Island’s Regional Economic Development Agreements (REDA’s) with the Federal Government expired in 2001-02.

This fiscal instability stems largely from federal policy measures such as the current application of both the Equalization ceiling and floor for Prince Edward Island. Additionally, the Federal Government has yet to design its fiscal treatment to correct long-standing accounting errors made by the Canada Customs and Revenue Agency in assessing Provincial Personal Income Taxes, as described in Figure B.1. Although Prince Edward Island was not directly affected by the accounting errors, eventual corrections to provincial income tax revenues could lower provincial transfers substantially through both Equalization and the Canada Health and Social Transfer.

The results from the 2001 Census give rise to further concern as to revenue declines as population is a primary determinant of federal transfer financing. Subsequent adjustments to annual population figures will not be known until September 2003.

The Federal Budget in December 2001 announced a new federal infrastructure program to be cost-shared with provinces but without detail as to the type of projects to be undertaken or the basis of funding. This contributes to further budget uncertainties for provinces.

I. Provincial-Territorial Consensus

The 42nd Annual Premiers Conference was held in August 2001 in Victoria, British Columbia.

In the Premiers' joint statement following their meeting they made a very clear appeal to the Federal Government. In it, Premiers, "*invited the Prime Minister to join with them in following through on his commitment to achieve adequate and sustainable fiscal arrangements over the immediate to medium term, including:*

- c Immediate removal of the equalization ceiling;*
- c Immediate work on the development of a strengthened and fairer equalization program formula, including as one possible alternative, a ten-province standard that recognizes the volatility around resource revenues, and comprehensive revenue coverage;*
- c Restoration of federal health funding through the CHST to at least 18% and introduction of an appropriate escalator; and*
- c Work on other CHST measures, including tax-point transfers as one possible alternative to the current CHST cash transfer."*

Annual Premiers Conference Communiqué - August 2, 2001

The Premiers' consensus position underlines the serious harm that is done to fiscal equity in Canada by federal restrictions to its two largest and most important transfer programs.

Equalization, as enshrined in the Constitution, is mandated to “ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.” At the heart of this commitment is the guarantee that Canadians should expect their provincial government services and taxes to correspond to those enjoyed by Canadians living in other provinces. As provincial revenues and program responsibilities across the country increase, so too will the need for a well-functioning Equalization program. Arbitrary fiscal restrictions to the Equalization program widen existing gaps in Canadians’ provincial public services and taxation rates across the country.

The Canada Health and Social Transfer is governed by federal legislation. Its mandate as stated in the *Federal Provincial Fiscal Arrangements Act* is to provide financing “for social programs in a manner that provides provincial flexibility”, to ensure that the provisions of the *Canada Health Act* are maintained, to contribute “to providing the best possible health care system for Canadians”.

Equalization addresses relative fiscal means across provinces, or *horizontal equity*. The CHST addresses the relative fiscal means of the Federal Government as compared to provinces as a group, or *vertical equity*.

In September 2000, the Federal Government established The Commission on the Future of Health Care in Canada, as chaired by former Saskatchewan Premier, Hon. Roy Romanow, to examine the sustainability of Canada’s health care system. The final report of the commission is to be available in November 2002.

The Annual Premiers Conference also initiated a co-operative process to examine ways to improve service, manage costs and adequately fund Canada’s health care system. Premiers, unwilling to wait two years to address health care challenges, convened the first of a series of meetings wholly dedicated to finding new approaches to improving health care for Canadians.

II. Federal Committees

Parliamentary Standing Committee on Finance

On April 26, 2001 Provincial Treasurer Patricia Mella addressed the Parliamentary Standing Committee on Finance in Ottawa to encourage them to honour Prime Minister Chrétien’s pledge to raise the Equalization ceiling. She made a joint appearance before the committee together with the Finance Ministers from Newfoundland and Labrador, Nova Scotia and New Brunswick. Manitoba’s Finance Minister addressed the committee as well.

The Standing Finance Committee was reviewing *Bill C-18, An Act to Amend the Federal Provincial Fiscal Arrangements Act* after its second reading, before it returned to Parliament for its third reading in the House of Commons. This act amended the existing Equalization legislation to lift the ceiling on

Equalization payments temporarily for the 1999-2000 year only, to return it to its lower level thereafter.

Finance Ministers emphasized to the committee that this bill enacted only part of a commitment made to Premiers by Prime Minister Chrétien on September 11, 2000. At that meeting the Prime Minister issued a press release with the following commitment to provinces:

“The Minister of Finance will examine this issue further after consultation with provincial Ministers of Finance. ... 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.”

Rt. Hon. Jean Chrétien - September 11, 2000

Premiers and their Finance Ministers viewed this as a very clear three-part commitment. The ceiling would be lifted for 1999-2000 and thereafter the ceiling would continue from this higher level and grow at the rate of growth in GDP. Premiers also understood that the federal Minister of Finance would hold meaningful discussions on this issue. Instead federal Finance Minister Martin held only cursory regional meetings with his provincial counterparts, providing no flexibility regarding any ceiling or other program changes.

Bill C-18 carries out only the first of these commitments. It was carried without amendment by the Parliamentary Finance Committee. The bill re-imposed a ceiling of \$10.8 billion on national payments for the 2000-2001 Equalization year, following payments of \$10.7 billion for the 1999-2000 Equalization year. Thus the program was constrained to growth of only 1.0 per cent, as compared to the 8.3 per cent increase in the Equalization ceiling that was consistent with the Prime Minister’s commitment to Provincial Premiers. The ceiling currently reduces national Equalization payments by \$142 million for 2000-2001.

The federal Senate later passed Bill C-18 without amendment.

Senate Committee on National Finance

“After five years as Provincial Treasurer, I find myself the longest serving Provincial Minister of Finance and during this period I have developed growing concerns over the inadequacies of this vital Program.”

Hon. Patricia J. Mella - October 24, 2001

On October 24, 2001 Provincial Treasurer Mella made a second presentation to a federal Parliamentary committee, this time to the Senate Committee on National Finance Concerning the Equalization Program. This committee was given a mandate by the full Senate to review Canada’s Equalization program more thoroughly, partly as a result of concerns raised during debate on Bill C-18.

In her presentation, Minister Mella emphasized the following points:

- C The Equalization Program is an essential part of the Public Finances of Canada. It has a critical role in leveling the playing field across the country so that all persons and businesses can access reasonably comparable provincial services at reasonably comparable levels of taxation.
- C The Equalization Program is a declining share of federal expenditures and its absolute amount will automatically rise and fall with general economic conditions. It has not been a burdensome program to the national finances.
- C The Program has not been enhanced by the Federal Government over many years. Rather, the Federal Government has taken steps to reduce the standard by moving to five provinces and to gradually lower the ceiling. Recent federal claims that receiving provinces have been treated favorably are misleading. Relative to other provinces, the fiscal means of provinces that receive Equalization have clearly declined.
- C The Representative Tax System is the basis of the present formula. It can be shown that this formulation provides the correct results in terms of estimating fiscal disparities between provinces and should be maintained for this reason.
- C Concerns over the alleged disincentive effects of the RTS are misplaced and unproven.
- C The ceiling is a direct attack on the very goals of the Program. The recent federal decision to further lower the ceiling by an unprecedented amount is very harmful to the Program. The Federal Government should respect the views of Premiers that the ceiling be abolished.
- C The five-province standard presently in use results in rapidly increasing disparities between Alberta and other provinces. A ten province standard will allow the formula to more properly reduce fiscal disparities.
- C The Program can only work adequately with comprehensive revenue coverage, which the Federal Government took active steps to restrict in 1999.

The Senate Finance Committee released its report on the Equalization program on March 21, 2002.

Both submissions by Minister Mella are available on the internet at:

www.gov.pe.ca/equalizationceiling

III. Prince Edward Island Federal Revenues

In 2001-2002, Prince Edward Island received \$282.3 million in Equalization revenues and \$86.6 million in CHST revenues. In 2002-03, Provincial Treasury estimates that the Province will record \$255.0 million in Equalization revenues and \$89.1 million in CHST revenues.

Federal Entitlements vs Federal Revenues

In recent years there has been some degree of confusion regarding the difference between the “provincial numbers” and the “federal numbers” in the statement of the Province’s revenues, particularly Equalization. Provincial Equalization revenues at year-end equal the most current federal Equalization estimate for the year, plus or minus federal adjustments to past entitlements that have been made throughout that fiscal year. Historically-large prior year adjustments have increased the difference between year-end federal entitlement estimates and provincial revenue statements recently.

Provincial *revenue* figures differ from the current year *entitlement* figures for Equalization, and CHST, as normally reported by the Federal Department of Finance. The connection between the two fiscal concepts is explained below.

The Federal Government calculates the amount of transfers to Prince Edward Island for Equalization on the basis of a detailed formula that reflects population, fiscal and economic data. Entitlement estimates remain open for three and a half years and are revised every six months as more accurate data becomes available from Statistics Canada and Provincial Public Accounts. Just before a new fiscal year begins, the Federal Government produces an official estimate of the transfer Entitlements that it will provide to provinces for the following fiscal year.

The Entitlement revision process is similar for the CHST, although the formula is much simpler than the Equalization formula in that CHST reflects only population and income tax data in its re-calculations.

Table B.1 shows the evolution of Prince Edward Island’s Equalization Entitlements for recent years. The first estimate for the 1997-98 Entitlement Year, made in February of 1997, determined that Prince Edward Island would receive \$185,135,000 in Equalization so that it could provide public services to each of its residents to the standard in the five “representative” provinces. When the estimates for that year were finalized in October 2000, the Equalization formula determined that the actual amount of Equalization necessary to lift provincial finances to the five-province standard was \$238,401,000. In other words, the initial estimate for the 1997-98 year was assessed to have been low by \$53,266,000, or 22.3 per cent of the final figure.

Table B.1 - Prince Edward Island Equalization Entitlements: 1997-98 to 2002-03

Estimate Date	Equalization Entitlement Year					
	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
	(\$000's)					
February 1997	185,135					
October 1997	193,767					
February 1998	198,882	198,584				
October 1998	211,710	201,255				
February 1999	233,100	221,546	222,000			
October 1999	236,243	227,793	231,564			
February 2000	238,491	231,602	240,567	236,094		
October 2000	238,401	233,339	247,903	257,017		
February 2001		236,888	249,587	256,112	254,302	
October 2001		237,504	245,456	256,367	250,844	
February 2002			254,703	272,821 ¹	259,863 ²	247,239
Current Estimate	238,401	237,504	254,703	272,821	259,863	247,239
Difference in First to Current Estimate	53,266	38,920	32,703	36,727	5,561	-

Notes to Table:

- ¹ The Fifth Estimate of Equalization Entitlements for 2000-01 includes a *ceiling* penalty of \$1.6 million for Prince Edward Island. This amount is withheld from payments to the Province because national Entitlements under the program exceeded the legislated maximum of \$10.8 billion, consistent with Bill C-18.
- ² The Third Estimate of Equalization Entitlements for 2001-02 includes a *floor* payment of \$5.9 million. This amount is paid to Prince Edward Island in response to a marked drop in Equalization payments after the 2000-01 year. Without the floor payment, Equalization Entitlements for 2001-02 are \$254.0 million, which is effectively unchanged from the first estimate for 2001-02.

Table B.1 makes it clear that First Entitlements have significantly under-estimated subsequent estimates, which has resulted in the very large in-year revisions to provincial revenue seen in recent years.

Prince Edward Island's accounting rules treat any changes to transfers that occur within the fiscal year as revenue for that year. To use an example, Equalization revenues for 2001-2001 are based on the third federal estimate for 2001-02 Entitlement plus or minus any changes to other open years that have occurred since April 1, 2001. Table B.2 table displays the connection from Entitlements, as shown above, to annual provincial revenues.

Table B.2 - Prince Edward Island Equalization Revenues: 2001-02

	Estimate Year	Estimate Number	Estimate Adjustment (\$)	In-Year Revenues (\$)
Current Year Entitlements	2001-02	Third		259,863,000
<i>Plus:</i>	2000-01	<i>minus</i> Fifth Third	272,821,000 <u>- 256,112,000</u>	
			16,709,000	+ 16,709,000
Adjustments Made To Open Entitlements for Prior Years During 2001-02	1999-00	<i>minus</i> Seventh Fifth	254,703,000 <u>- 249,587,000</u>	
			5,116,000	+ 5,116,000
	1998-99	<i>minus</i> Eighth Seventh	237,504,000 <u>- 236,888,000</u>	
			616,000	+ 616,000
	1997-98	Closed Year: No adjustments		+ 0
<i>Equals:</i>	Total Revenues For 2001-02			282,304,000

The Equalization revenues for the 2001-2002 fiscal year, which are \$282,304,000, consist of the Equalization estimate for the 2001-2002 Entitlement year, at \$259,683,000 plus the adjustments to earlier years of Equalization entitlements made between April 1, 2001 and March 31, 2002, which total \$22,441,000.

Adjustments to prior years' Entitlements occur at regular intervals, as indicated in Table B.1.

At April 1, 2001, the Province had been paid \$256,112,000 in respect of the Entitlement Year 2000-2001, which was calculated in the third federal estimate. By the fifth estimate, received on February 28, 2002, revised economic, fiscal and population data showed that Prince Edward Island was actually entitled to \$272,821,000 for that year. The difference of \$16,709,000 respecting 2000-2001 that was paid during 2001-2002 entered the revenues in the year in which it was received. Additional prior year adjustments of \$5,116,000 and \$616,000 were made for the 1999-2000 and 1998-1999 calculations respectively.

Revenues in 2001-02

In its 2001 Budget, the Province forecast Equalization revenues of \$275 million for 2001-2002. In November, 2001, this forecast was revised down to \$251 million, which matched the federal Entitlement

estimate at the time, before prior year adjustments. The provincial revenue revision reflected revisions by Statistics Canada's to provincial population estimates from 1998 to 2001, as well as potential economic consequences of the terrorist attacks in the United States, particularly as affecting national corporate income tax collections and natural resource prices.

In the federal estimates released on February 28, 2002, Prince Edward Island's entitlements were raised by \$35 million as compared to the total federal estimates in October 2001. Of this amount, \$26 million related to a change by Statistics Canada to its measurement of property values across Canada.

The Federal Department of Finance has announced that it will suspend recovery of the associated fiscal losses resulting from this change to property measurements until Statistics Canada can review its methodology in consultation with provincial statistical offices. This contributes to fiscal uncertainty in the coming fiscal year.

The February Equalization estimates also included a floor payment to Prince Edward Island of \$5.9 million in respect of the fiscal year 2000-2001, which had not been anticipated at the time of the second quarter forecast.

Revenues in 2002-03

Just as the Equalization revenues for 2001-02 were based on that year's Entitlements plus adjustments for prior years, revenues for the coming year will be the sum of current year payments plus or minus any adjustments to prior years' Entitlements.

Prince Edward Island Treasury forecasts Equalization revenues of \$255 million for 2002-03. This figure is based on an expectation that the Entitlement for 2002-03 will increase slightly from the first estimate value of \$247.2 million. However, the Provincial Treasury forecast anticipates no appreciable prior year adjustments in the coming year. As such, Equalization Entitlements are expected to continue the pattern of decline in 2002-03, begun two years previous, when Entitlements peaked at \$272.8 million.

The principal factor that will constrain Equalization Entitlements in 2002-03 is the slow growth in the national economy forecast during 2002, which reduces provincial revenue capacity across the nation, particularly through marked declines in natural resource royalties and corporate income tax collections. The de-indexation of most provincial personal income taxes, begun in 2001, will also serve to limit Equalization growth in 2002-03. A third factor, federal actions to correct historical administrative errors in its accounting of provincial personal income tax revenues is explained in more detail in Figure B.1. The magnitude of the impacts on Equalization cannot be quantified until the Federal Government makes its plans known to provinces.

Figure B.1 Federal Mis-allocation of Provincial Income Tax Revenues

The federal Canada Customs and Revenue Agency issued a press release on January 29, 2002 advising that it had discovered a very large error in the way that it records Provincial Personal Income Tax related to “T3 Mutual Fund Trusts”. This error, dating back at least as far as 1972, led the Federal Government to make tax over-payments to some provinces of at least \$3.3 billion.

Mutual Fund Trusts pay federal and provincial income tax on realized capital gains. Tax legislation sets out the circumstances under which Mutual Fund Trusts can receive refunds on some or all of this tax. However, no adjustment was made to deduct from provincial government revenues the provincial portion of capital gains refund. The federal share of the personal income tax on capital gains earned by Mutual Fund companies was remitted to those provinces as part of their personal income taxes instead of to the Federal Government. The largest over-payments were made to Ontario and Manitoba, where many Mutual Trust head offices are located, as shown below.

Capital Gains Refunds By Province		
Province	1993-1999	Annual Average
Nova Scotia	\$13,010	\$1,859
New Brunswick	\$20,739	\$2,963
Ontario	\$2,802,539,954	\$400,362,851
Manitoba	\$408,141,180	\$58,305,883
Alberta	\$4,412,858	\$630,408
British Columbia	\$120,623,276	\$17,231,897
Total	\$3,335,751,017	\$476,535,860

Prince Edward Island received none of the misallocated money directly as the Province has no resident mutual fund companies.

The Federal Government has stated that they have corrected the problem for tax year 2000 and into the future. Questions remain over recovery of past overpayments.

In terms of Prince Edward Island, the direct overpayments did result in an indirect overpayment of Equalization of less than \$1 million per year, according to the current formula, because total provincial revenues were incorrectly inflated by CCRA. It is not clear whether the Federal Government will alter the Equalization formula more substantially to reflect the change in relative fiscal capacities of affected provinces. This change to the Equalization “base” would result in further transfer declines for Prince Edward Island.

Finally, the Federal Government may act to recover amounts from past years from the provinces directly affected. Depending on how many past years they target and whether they make changes to transfer payments, the fiscal impact for Prince Edward Island of their decision could be substantial and negative.

Additional to the loss of economic momentum in 2001, prior year adjustments during 2002-03 will be constrained by two legislated features of the Equalization program, namely the ceiling and the floor.

As noted in Table B.1, the Equalization ceiling limits total payments for the 2000-01 Entitlement year. Although unlikely, positive adjustments are possible, if for example economic data were to show relative changes among provinces, or if the Federal Government were to lift the ceiling for that year.

One consequence of the Equalization floor is to limit possible improvements in payments to Prince Edward Island for the 2001-02 Entitlement Year during the coming fiscal year. If the Province's entitlements improve with new data, this increase in entitlements would trigger an off-setting decrease in floor coverage for the Province, restricting revenue gains in fiscal year 2002-2003.

The 2001 Census: A Serious Fiscal Concern

On March 12, 2002, Statistics Canada released its 2001 Census counts. Unlike all other Atlantic provinces, Prince Edward Island posted an increase in the Census count between 1996 and 2001, as shown in Table A.1. Statistics Canada will subsequently revise its official annual population figures to reflect the new Census results, as well as estimated under-enumeration in the Census. The revised annual population figures are scheduled for release in September 2003.

These Census-related population revisions will generate adjustments to revenue calculations in fiscal year 2003-04. Equalization and CHST calculations for all open years will be re-based to reflect the revised provincial population figures. In view of the Province's reduced share of national population, Provincial Treasury expects a negative impact on federal transfer payments when the official population estimates are revised by Statistics Canada in the fall of 2003.