

BUDGET PAPER B: FEDERAL FISCAL ISSUES

The Federal Budget of February 16, 1999, included several significant announcements regarding Prince Edward Island's two largest federal transfer payments - the Canada Health and Social Transfer and Equalization. The Budget announced additional funding and formula changes under both programmes. This section provides historical background of these changes and discusses their implications for Prince Edward Island.

CANADA HEALTH AND SOCIAL TRANSFER

The Federal Minister announced two major changes to the Canada Health and Social Transfer (CHST).

- First, in response to provincial demands, the amount of cash transferred specifically to finance provincial health care will be increased. This change will raise Prince Edward Island's CHST revenues by \$9 million in 1999/00, rising to \$11 million by 2001/2002.
- Second, the formula which determines each province's CHST Entitlement is to be amended to approach a per capita arrangement within three years. This change does not significantly alter Prince Edward Island's revenues from this transfer. However, the change has major implications for provinces receiving greater than national average shares, such as Quebec, and those receiving less than the national average, such as Ontario.

Increase in CHST transfers

The enrichment to the CHST was made in response to provincial demands to improve funding for Health Care following major reductions in federal support.

In 1995, the Federal Government announced that it would replace two long-standing federal social transfers to provinces, the Canada Assistance Plan and Established Programs Financing with the CHST. These funds were paid to all provinces to support their delivery of Health, Education and Social Services. The change to the CHST was explicitly made to reduce expenditures in a year when the federal deficit stood at \$38 billion as compared to annual budgetary revenues of \$123 billion. Within three years, Ottawa's cash transfers to the provinces through these programmes fell from \$18.7 billion to \$12.5 billion. For Prince Edward Island, annual Entitlements from the federal government fell by \$29 million to stand at \$60.1 million in 1998/99.

These cuts occurred at a time when provinces were also struggling to reduce deficits, despite steadily

increasing health cost pressures. Premiers have been united in their position that funding to the CHST would have to be restored to allow Canadians to receive adequate levels of basic health care. This position was an integral part of the Health Accord, recently agreed to by all provinces and territories and the federal government, as well as the Social Union Agreement, which was signed on February 4, 1999 by the federal government and all provinces and territories except Quebec.

The Health Accord commits provinces to spend additional CHST funds on Health Care. The Social Union Agreement commits the federal and provincial governments to process arrangements which should make programme delivery more orderly in areas where both orders of government have a policy presence. The Social Union discussions were initiated by provinces with an eye to restricting the federal use of its spending power. Specifically, provinces were concerned over the federal desire to unilaterally introduce new programmes in areas of provincial jurisdiction, given provincial budgetary difficulties in providing core services in Health, Education and Social Services.

Having fallen from \$18.8 billion in 1993/94, the CHST cash transfer to provinces will rise from its current level of \$12.5 billion to \$14.5 billion in 1999/00 and to \$15 billion in 2001/02. There is no current provision for future increments to the transfer beyond that date. The impacts for Prince Edward Island are detailed in Table B.1.

Table B.1 Financial Implications of Federal CHST Enrichment

	1999/00	2000/01	2001/02	2002/03	2003/04
National Impact	(\$ billions)				
Existing CHST Cash	12.5	12.5	12.5	12.5	12.5
Increased funding for CHST:					
<i>CHST</i>		1.0	2.0	2.5	2.5
<i>CHST supplement</i> ¹	2.0	1.0	0.5		
	2.0	2.0	2.5	2.5	2.5
New CHST Cash Total	14.5	14.5	15.0	15.0	15.0
Prince Edward Island Impact	(\$ millions)				
Existing CHST Cash	60	60	60	60	60
New Money	9	9	11	11	11
New CHST Cash Total	69	69	71	71	71

¹ The \$3.5-billion CHST supplement will be accounted for in 1998/99 by the federal government, but paid over the following three years at the discretion of provinces. Payments will be made in a manner that treats all jurisdictions equitably, regardless of when they draw down funds.

Source: 1999 Federal Budget and Provincial Treasury Forecast

The increase in the value of the CHST will alleviate some of the immediate cost pressures that have arisen in the health care field. With the additional \$9 million per year, rising to \$11 million, Prince Edward Island's CHST cash transfer will rise from \$60 million in 1998/99 to \$69 million in 1999/00 and \$71 million in 2001/02.

Change in the CHST formula

When the CHST replaced the Canada Assistance Plan (CAP) and Established Programs Financing (EPF) in 1996/97, the new transfer preserved the combined payment distribution of the two transfers, but distributed a significantly smaller amount of cash. At the time, EPF was a per capita grant, but CAP Entitlements varied by province. As well, the new CHST continued the federal government's practice of reporting the value of specific tax points transferred to provinces in 1977 as an on-going federal contribution to provincial social spending. Inclusion of these "tax point values" yields CHST Entitlements which are much higher than the cash actually transferred to provinces in any given year. For example, in 1998/99, CHST Entitlements were 108 per cent higher than the amount of money received by Provinces.

Prince Edward Island's CHST Entitlements have been very close to the national average since 1996/97. Quebec, Newfoundland and Nova Scotia have been receiving CHST transfers that are significantly higher than the national average, while those received by Ontario, Alberta and British Columbia lag behind the average.

The provincial shares of CHST had originally been scheduled to approach a per capita distribution over ten years. The 1999 Federal Budget accelerated this adjustment to be complete by 2001/02. At that point the CHST Entitlement for all provinces will equal the national average. This change corrects a long-standing grievance held by Ontario, Alberta and British Columbia. In 1990, the Federal Government limited the growth in CAP for these provinces. Over the following five years this "cap on CAP" resulted in a significant shift in the share of CAP transfers away from the three provinces.

EQUALIZATION

The Federal Budget also announced significant funding increases for the Equalization program. The increases stem from two sources - updated federal estimates and legislated changes to the Equalization formula which became effective on April 1, 1999.

Higher National Equalization Payments for 1997/98 and 1998/99

Equalization Entitlements are adjusted twice a year over four fiscal years to reflect the most recent statistical data as available. Any changes made within a fiscal year that affect previous years Entitlements become revenues within that fiscal year. This feature of "catch-up payments" or prior year adjustments can sometimes lead to large swings in Prince Edward Island's revenues.

In 1998/99, strong prior year adjustments and favourable results from the 1996 Census served to increase Prince Edward Island's Equalization revenues significantly as compared to 1997/98

revenues and the 1998/99 Budget revenues.

The 1999 Federal Budget documents prominently announced an increase in Equalization funding to receiving provinces in 1998/99 of \$2.2 billion. This figure corrects for under-payments to provinces over three years. The new level of Equalization payments is in fact remarkably close to the stream predicted in the 1995 and 1996 Federal Budgets, as outlined in Table B.2.

Table B.2 - Federal Equalization Forecasts: 1996 and 1999

	1994/95	1995/96	1996/97	1997/98	1998/99
	(\$ billions)				
Federal Budget 96	8.5	8.7	8.8	9.2	9.6
Federal Budget 99	8.6	8.8	8.8	9.6	9.6
Difference	0.1	0.1	0	0.4	0

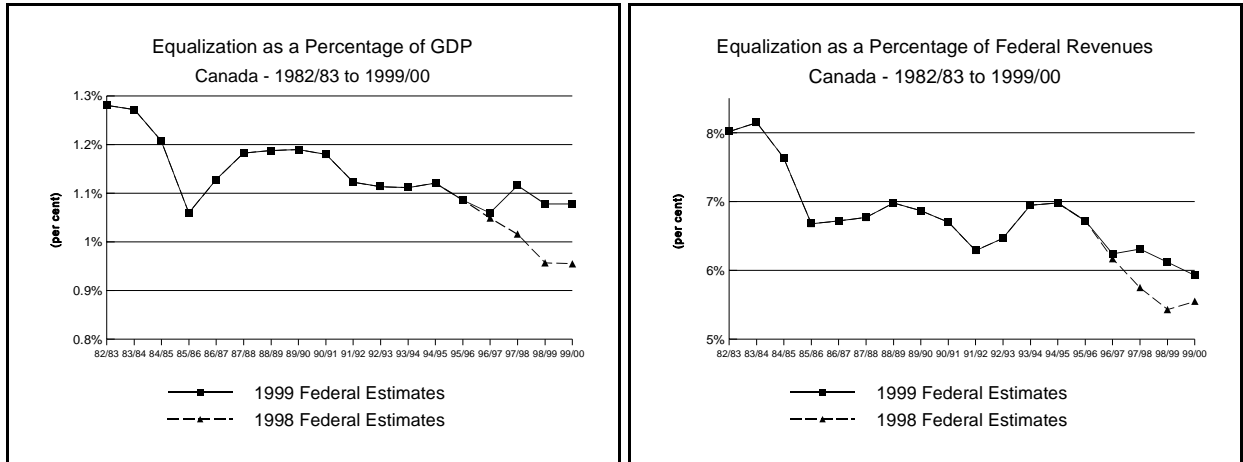
Source: Federal Budget 1996 and Federal Budget 1999

The updated federal estimate of \$9.6 billion for 1998/99 exactly matches the figure projected in the 1996 Budget. The \$2.2 billion adjustment is obtained by comparing new Equalization Entitlements to low federal projections in the 1998 Budget.

The new totals are also very much in line with historical trends in Equalization payments, whereas the original 1998 estimates were exceptionally low.

The following chart indicates that, as a percentage of Gross Domestic Product, the 1999 Equalization Estimates are similar to the level of payments since 1991/92. Viewed as a percentage of Federal revenues, Equalization continues to decline, but not as rapidly as had been forecast in the 1998 Federal Budget.

Figure B.1 - Equalization Compared to Gross Domestic Product and Federal Revenues



Source: Public Accounts of Canada and National Accounts of Canada

In discussing the specifics of higher Equalization payments, it is important to consider the interactions among Equalization, other federal transfers to provinces and provincial own-source revenues. When the federal government slashed provincial transfers in 1996/97, provinces were forced to rely more heavily on own-source revenues to maintain service levels to the public. As provincial revenues increased to offset lost federal transfers, Equalization payments to recipient provinces increased accordingly, as Equalization is scaled to the total of provincial own-source revenues across Canada.

Implications for Prince Edward Island's Revenue Position

The February 1999 payments are the basis of the revenue figure for Prince Edward Island for the 1998/99 fiscal year. In the 1998 Provincial Budget the Equalization estimate predicted a strong upward adjustment in Entitlements before year end. The 1998 Budget figure also included generous contingency figures to protect the province's fiscal position against possible negative results from population revisions related to the 1996 Census. In view of the downward adjustment of \$28 million that resulted from the 1991 Census, last year's Equalization figure allowed a \$7 million contingency factor. Prince Edward Island actually gained population share from the 1996 adjustment and saw an upward correction in its Equalization payments of \$8 million, for a combined revenue improvement of \$15 million. These and other revisions to the estimate are detailed in the table which follows:

Table B.3 - Detailed Equalization Revenues: 1998/99 Fiscal Year

	1998 Federal Estimate	1998 Provincial Budget	February 1999 Federal Estimate
1998/99 March Estimate	\$198,600,000	\$207,588,000	\$221,546,000
1997/98 & Prior Adjustments	0	\$13,100,000	\$35,144,000
Census Contingency Factor	0	(\$7,000,000)	\$8,058,000
General Contingency Factor	0	(\$4,688,000)	\$0
Total Equalization Revenues	\$198,600,000	\$209,000,000	\$264,748,000

Source: Provincial Treasury Forecast, Official Federal Equalization Estimates

For 1999/00, Equalization Entitlements are forecast to continue at their new higher level, reaching \$230.4 million by year-end. Provincial Treasury also forecasts further prior year adjustments or “catch-up payments” in 1999/00, but of a smaller magnitude than the unprecedented revisions of 1998/99. Total Equalization revenues to the Province are forecast to decline by \$22.8 million to \$241.9 million in 1999/00 as compared to the final figure of \$264.7 million in 1998/99.

Equalization Renewal

To speak of “new money”, it is more helpful to look at the policy decisions made by the federal government in making changes to the formula which determines future Equalization payments. The legislation which governs the current Equalization formula expired on March 31, 1999. Technical improvements in the new legislation will increase payouts to provinces in 1999/00 by \$48 million over the current estimate, now at \$9.3 billion. Over five years, the amount of new money is estimated to rise to a final improvement of \$242 million nationally. Prince Edward Island expects an additional \$640,000 in 1999/00 from the technical changes, rising to \$3.2 million by 2003/04.

The Equalization formula has been changed to reflect recent provincial tax changes and the availability of new data sources from Statistics Canada. For example, the calculation which equalizes sales tax revenues has been amended significantly to account for the fact that Newfoundland, Nova Scotia and New Brunswick moved from a retail sales tax to the Harmonized Sales Tax in 1997. Four provinces, these three plus Quebec, now levy value added taxes which parallel the federal Goods and Services Tax.

Full implementation of the technical improvements was deemed too costly by the federal government and so the changes will be included gradually over five years on a pro-rated basis. To accomplish this transitional phase-in, the federal government will run parallel calculations using the old and new Equalization formulae, taking a weighted average of the two results.

The following table estimates the value of changes to amended Equalization tax bases by province, when the changes are fully implemented by the federal government in 2003/04.

**Table B.4 - Revenue Impacts of Technical Changes to the Equalization Formula,
By Tax Base and Province: 2003/04**

	Nfld	PEI	NS	NB	Que	Man	Sask	TOTAL
	(\$ millions)							
Forestry	11.2	0.2	4.0	21.5	174.0	18.6	31.0	260.5
Mining	8.0	0.0	3.4	7.0	11.3	-4.7	21.6	46.6
Natural Gas	-1.6	-0.4	-2.5	-2.1	-19.9	-3.1	2.3	-27.2
Oil	0.0	0.0	-0.1	-0.1	-0.5	-0.2	2.8	1.9
Gaming and Race Track	26.4	0.5	1.1	-10.8	124.3	-49.1	-54.0	38.4
Retail Sales	8.7	9.3	88.1	29.1	14.8	20.4	7.9	178.3
Payroll	3.4	0.5	1.5	2.5	9.1	6.3	3.3	26.5
Gas and Diesel	-1.5	0.4	3.2	-7.8	20.5	3.7	3.6	22.1
Hospital and Medical	1.0	0.2	1.1	1.3	6.2	0.4	0.3	10.5
Property	-6.3	-0.8	-9.1	-4.6	-0.7	8.4	24.9	11.8
User Fees	-36.5	-7.0	-41.1	-33.8	-156.8	-39.4	-30.6	-345.2
TOTAL	14.2	3.2	51.0	3.5	188.2	-37.3	14.3	242.0

Source: Federal Department of Finance Press Release

The Equalization legislation has also been amended to include a new ceiling calculation. The Equalization ceiling sets a maximum national pay-out for Equalization payments. In 1998/99, the ceiling had been \$10.3 billion. In 1999/00 it is reset to \$10 billion. This figure will escalate with growth in national Gross Domestic Product over the coming five years.