Addressing Fiscal Imbalance

Report of Provincial and Territorial Finance Ministers

Prepared for discussion at the
2001 Annual Premiers' Conference
Victoria, British Columbia

August 1-3, 2001

Executive Summary

At the 2000 Annual Premiers' Conference, Premiers instructed their Finance Ministers to identify reform proposals which would more durably address the vertical and horizontal fiscal imbalances in Canada.

In response to Premiers' direction, and with a view to revitalizing federal-provincial-territorial fiscal relations, provincial and territorial Finance Ministers have developed a range of options which would result in an increased federal funding share for social programming, and have completed further analysis of means by which the Equalization Program may be strengthened. *Addressing Fiscal Imbalance*, the 2001 Report of Provincial and Territorial Finance Ministers, presents these options for Premiers' consideration.

Context of Fiscal Imbalance

Provinces and territories are constitutionally mandated to deliver priority health, education and social programs; however, they do not collect sufficient own-source revenue to meet the expectations of Canadians with respect to these priority services, along with the other services they are called upon to deliver. The imbalances in fiscal capacity between the federal and provincial/territorial governments, and among provinces and territories, are addressed mainly by the Canada Health and Social Transfer (CHST) and by the Equalization Program.

However, the federal government's cuts to the CHST and its imposition of a ceiling on Equalization entitlements have made it increasingly difficult for provinces and territories to deliver these priority services.

At their June 2001 meeting in Montréal, Finance Ministers pointed out that provinces and territories are bearing the brunt of cost pressures in health, education and social services. Ministers reiterated Premiers' call to strengthen the Equalization Program, including an immediate and permanent removal of the ceiling, in conjunction with their urgent call to the federal government to fund an increased and more equitable share of vital social programs.

Fiscal Imbalance Between Federal and Provincial/Territorial Governments

Finance Ministers have agreed on a package of solutions for consideration, which would reduce the fiscal imbalances between the federal and provincial/territorial governments. Because the federal government is realizing multi-billion-dollar surpluses, it clearly has the means to increase its funding support for Canadians' top program priorities while, at the same time, ensuring that there will be no risk of a federal deficit.

Option 1: To have the CHST cover the same share of provincial/territorial social program costs as in 1994/95 by 2004/05. This would be accomplished by restoring CHST funding to its 1994/95 level of $18.7 billion in 2000/01. The 1994/95 federal funding share of approximately 18 percent of total health, education and social services expenditures would be accomplished by 2004/05 by using an enhanced escalator and, once realized, a nominal GDP escalator would be used thereafter.

Option 2: To have the federal government and provinces/territories share equally new health care costs through the period to 2002/03, as an interim measure toward the goal of having the CHST cover 18 percent of social program costs, by 2004/05.

Option 3: To have the CHST rise in 2000/01 to its 1994/95 level of $18.7 billion, and subsequently implement an escalator based on nominal GDP growth beginning in 2001/02. This option will result in a federal contribution to social programs delivered by provincial/territorial governments of about 15 percent.

Option 4: To replace the current CHST payments mechanism with a tax point transfer equal to the same share of provincial/territorial spending on health, education and social services as the option to which it would be considered an alternative.

✍✍ *Fiscal Imbalance Among Provinces and Territories*

Premiers and Finance Ministers have consistently called on the federal government to strengthen its commitment to the Equalization Program, in order that it can meet its Constitutional objective of ensuring that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

Ministers called upon the federal government to live up to its commitment to lift the ceiling for 1999/2000 and to allow the Program to grow thereafter at a rate up to nominal GDP growth. The federal decision to amend the ceiling for 1999/2000 only will not allow the Program to grow with nominal GDP and does not fulfill this commitment.

Finance Ministers have continued their analysis of the ten-province standard which, while more representative of the fiscal capacity of all provinces, raises an issue of resource revenue volatility. Models have been developed to address this issue, as well as that of comprehensive revenue coverage. These models could serve as options for advancing Premiers' call to strengthen the Equalization Program, in addition to the immediate removal of the ceiling.

✍✍ *Next Steps*

Finance Ministers recommend that:

?? Premiers confirm the joint goals of strengthening the Equalization Program and restoring the federal government's share of provincial/territorial social program funding;

?? Premiers provide direction to finalize a common provincial/territorial position on the preferred options for increasing federal funding support for Canadians' top program priorities and strengthening the Equalization Program; and

?? Premiers urge the Prime Minister to work with them to create a forum for the negotiation of these key finance issues.

✍✍Introduction

At their 2000 Annual Conference, Premiers agreed that addressing the question of fiscal imbalance was an urgent financial challenge facing the federation. As a result, "Premiers instructed their Finance Ministers to advance their previous work on these issues and to identify reform proposals which would more durably address the vertical[1] and horizontal[2] fiscal imbalance in Canada."

Provinces and territories are bearing the brunt of cost pressures on health, education and other social programs – a responsibility made more challenging in light of current fiscal arrangements. In the communiqué released at the conclusion of their Provincial-Territorial meeting, held in Montréal on June 13-14, 2001:

> *[Finance] Ministers issued an urgent call to the federal government to revitalize the federal-provincial relationship by funding an increased and more equitable share of the vital social programs like health care and education, which the provinces have the constitutional responsibility to provide. Ministers noted that the Premiers had called for a strengthening of Equalization in concert with the renewed federal commitment to funding these programs.*

In seeking a more equitable share of funding for health, education and social services, provincial and territorial Finance Ministers called on the federal government to move, by 2004/05, to at least the same financial commitment it had in 1994/95, when it funded 18 percent of these costs. This year its share of funding is about 14 percent and set to decline over the foreseeable future – a level of commitment that is insufficient to ensure adequate funding for health care and other social programs.

At a September 2000 meeting of First Ministers, the Prime Minister made an offer to provinces and territories that included partial restoration of the Canada Health and Social Transfer (CHST). While this September 2000 federal announcement was generally welcomed as a first step and provided some short-term relief from the pressures facing provincial and territorial governments, the measures taken fell considerably short of the Premiers' position. Professor G.C. Ruggeri observes, in an update to the background paper *A Federation Out of Balance* originally presented at the 2000 Annual Premiers' Conference, that the package fails to provide a sustainable solution to the problems of fiscal imbalance and funding of provincial social programs. This occurs even though the federal government is generating surplus revenue sufficient to sustain a more adequate level of support for these programs over the long term.

---

[1] Vertical Fiscal Imbalance exists when the distribution of revenue resources between the federal and provincial/territorial orders of government is inconsistent with the distribution of spending responsibilities.
[2] Horizontal Fiscal Imbalance exists when revenue resources are unevenly distributed among provinces and territories.

Provincial/territorial Finance Ministers also reiterated the Premiers' call for a strengthened Equalization Program, including an immediate and permanent removal of the ceiling. As the federal-provincial fiscal imbalance has continued to grow and federal surpluses accumulate, so too has the fiscal imbalance among provinces, particularly under the current program standard. This has placed added pressure on provinces to maintain competitive tax regimes while generating sufficient revenues necessary to meet the growing need for essential programs. The federal government's imposition of the ceiling on Equalization entitlements and other unilateral actions, such as reduced revenue coverage have severely limited the Program's ability to meet its goals and emphasizes the need for a strengthened Equalization Program within the Federation.

Provincial/territorial Finance Ministers recommend that Premiers confirm the joint goals of strengthening the Equalization Program and restoring the federal government's share of provincial/territorial social program funding. There is an immediate need to increase the CHST to deal with funding pressures in health care and other social programs. Canadians cannot wait 18 months until Commissioner Romanow presents his report to the Prime Minister before action is taken[3]. There is also a longer-term need for the federal government to make a more substantive commitment to sharing the cost burden associated with these programs.

The federal government must re-order its affairs to recognize health care as the number one priority of Canadians. It must also address the fiscal imbalances between the federal and provincial/territorial governments and among the provinces and territories, while ensuring that no federal deficit results. This will allow Canadians in all parts of the country access to quality health care and other services.

Provincial/territorial Finance Ministers are analysing a range of measures to address fiscal imbalances between federal and provincial/territorial governments and among provincial and territorial governments. They look to Premiers to provide direction to advance their analysis of options to address fiscal imbalance and to finalize a common provincial/territorial position on the best strategy for negotiation with the federal government.

✍✍Fiscal imbalance between Federal and Provincial/Territorial Governments

Provinces and territories do not raise sufficient own-source revenue to meet their obligations under the Constitution to provide health care, education and social services, along with the other services they are called upon to deliver. These programs are key public priorities, the costs of which are projected to grow faster than the major federal programs such as Old Age Security, Employment Insurance and National Defence. Further, the federal government collects more revenue than the provinces and territories, and under current revenue structures, federal revenue is projected to grow faster than provincial and territorial revenue.

[3] The final report of the Commission on the Future of Health Care in Canada is anticipated on or about November, 2002.

Provincial/Territorial Governments (2000/01)		**Federal Government (2000/01)**	
Major Programs:		Major Programs:	
?? Health	($2,040/capita)	?? Old Age Security	($750/capita)
?? Education	($1,270/capita)	?? Employment Insurance	($370/capita)
?? Social Services	($730/capita)	?? National Defence	($350/capita)
		?? CHST and Equalization	($760/capita)
Own-Source Revenue:	$162 billion	Revenue:	$177 billion
Program Expenditure:	$159 billion	Program Expenditure:	$116 billion
Debt Servicing Costs:	$23 billion	Debt Servicing Costs:	$41 billion

Note: In aggregate, provincial/territorial budgets are balanced by including CHST and Equalization transfers.
Source: Federal and provincial/territorial Public Accounts and March 2001 Fiscal Monitor. Per capita expenditure on major programs is estimated on the basis of the latest available data.

The federal government's Fiscal Monitor for March 2001 reported a budgetary surplus of $19.8 billion for the 2000/01 fiscal year, $4.7 billion higher than over the same period in 1999/00. Federal Finance Minister Paul Martin, in his May 17, 2001 Economic Update, indicated that the federal Government would be applying at least $15 billion to debt repayment. In contrast for 2000/01, some provinces and territories are in a deficit position, most are posting only small surpluses and all are under severe cost pressure from health and other social programs.

The federal government expects that the revenue impact of the current slowdown in the economy will be partially offset by a carrying forward of the better-than-expected growth in the economy recorded in 2000/01. The net result is that the budgetary surplus is now projected to be $7.2 billion in 2001/02 and $7.3 billion in 2002/03, down $1.1 billion and $0.3 billion, respectively, from the October 2000 Budget Update. These modest reductions to the projected budgetary surpluses are readily accommodated within the annual $3 billion set aside as Contingency Reserves.

Federal Budgetary Transactions, 1997/98 to 2002/03 ($ billions)

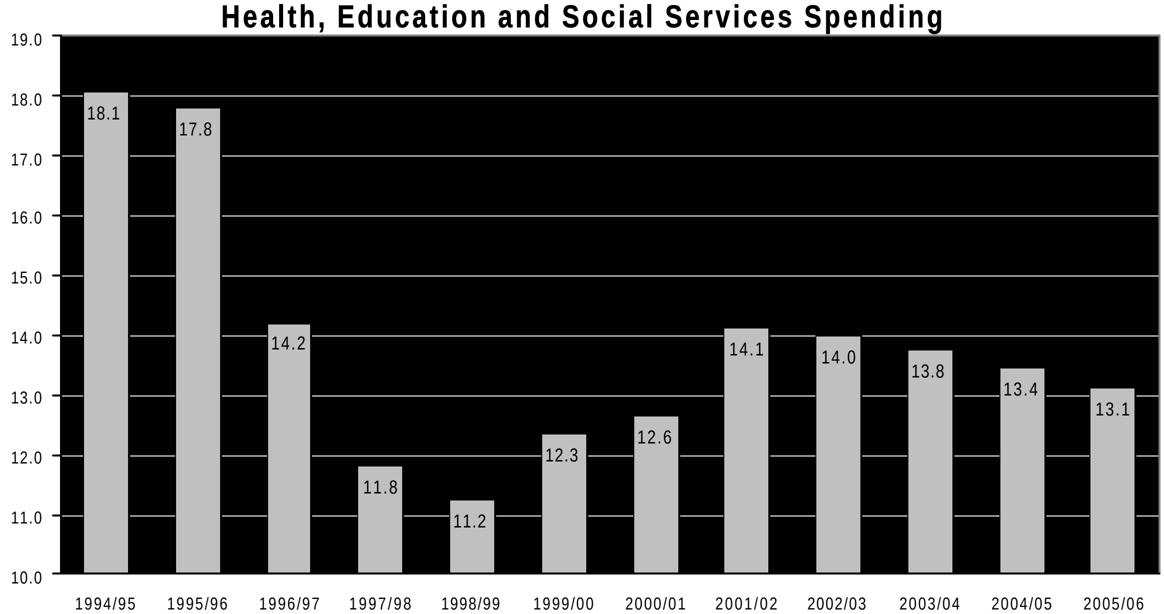
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
Revenue	153.2	155.7	165.7	177.2	174.5	178.4
Program Spending	(108.8)	(111.4)	(111.8)	(116.0)	(124.6)	(129.6)
Public Debt Charges	(40.9)	(41.4)	(41.6)	(41.4)	(41.7)	(41.2)
Budgetary Surplus	**3.5**	**2.9**	**12.3**	**19.8**	**7.2***	**7.3***

Note: Portions of the Budgetary Surpluses in 2001/02 and 2002/03 are allocated by Federal Finance to Economic prudence and a Contingency Reserve, $4 billion in 2001/02 and $5 billion in 2002/03.
* The May 17, 2001 Economic Update provided revised estimates of the Budgetary Surplus but not revised estimates of Revenue, Program Spending or Public Debt Charges. For 2000/01, the budgetary surplus is expected to be less than the $19.8 billion Fiscal Monitor estimate, once end of year spending is taken into account.
Source: Federal Finance, Economic Statement and Budget Update (October 18, 2000), March 2001 Fiscal Monitor and Economic Update (May 17, 2001).

Past cuts to federal support for provincial social programs, especially those that accompanied the implementation of the CHST, have widened the fiscal gap. Between 1994/95 and 1998/99, annual federal transfers under the CHST were cut by one-third – $6.2 billion. Despite a partial restoration in funding in 2000/01, federal CHST payments were still $3.2 billion lower than in 1994/95. In contrast, annual provincial/territorial spending on health care, education and social services was an estimated $18.8 billion higher than in 1994/95.

The following chart shows the recent and projected declines in the federal funding commitment for health, education and social services through the CHST – a shortfall that provinces and territories have to fund from their own-source revenue at the expense of other worthwhile programs. Even with the increased payments announced at the September 2000 First Minister's Meeting, future CHST growth under the announced schedule will be less than that of the cost of the main programs it helps fund. As a result, the federal contribution, expressed as a percentage of provincial and territorial social program expenditures, will once again decline.

CHST cash as a Percentage of Provincial and Territorial Health, Education and Social Services Spending



Source: Public Accounts based data for social program expenditure and federal Department of Finance data for CHST.

While provinces and territories have struggled to meet the basic priority needs of Canadians, they have had insufficient federal support and money has been directed by the federal government to create and expand "boutique" programs[4]. These programs are of concern because they operate at the expense of funding for core services, are often short-term programs and add to provincial program costs. These boutique programs increase public expectations without addressing long-term funding requirements and often distort provincial spending priorities.

It is clear that the changes to the CHST announced by the federal government in September 2000 represent neither an adequate nor durable solution to the problems of fiscal imbalance and funding of major social programs.

[4] Specific programs funded by the federal government, often in areas of provincial/territorial jurisdiction.

✍✍ *Fiscal imbalance between the Federal and Provincial/Territorial Governments: A long-term structural problem*

At their August 2000 Annual Conference, Premiers reviewed a paper by Professor G.C. Ruggeri titled *A Federation Out of Balance*, which examined the projected fiscal situations of the federal and provincial/territorial governments out to 2019/20.
Professor Ruggeri recently updated his paper to take into account the measures introduced in the October 2000 federal Budget Update (which includes the federal announcement at the First Ministers' Meeting) and the current slowdown in the economy. His update draws several important conclusions~~.~~ :

?? Consistent with other private sector analyses, much of the federal surplus over the next four years has already been committed through tax cuts and spending increases. Federal funds targeted for Economic prudence and the Contingency Reserve continue to be available.

?? The underlying structural imbalance between the two orders of government remains. Starting in 2004/05, federal surpluses will resume their fast upward climb, reaching $126 billion by 2020, while the aggregate provincial fiscal position will, at best, barely remain in balance.

?? Provincial budget balances are at greater risk from expenditure pressures than is the federal government and provinces have a greater need for the inclusion of prudence factors. For example, only half a percentage point increase in projected health care spending would result in a string of deficits for provinces, collectively, over the next 20 years.

?? Given individual provincial and territorial circumstances, there may be considerable variation in their capacity to meet public demands for spending on health, education and other social programs, tax reductions and to reduce provincial debt loads.

?? Projected federal surpluses are large enough that the federal government could eliminate its entire debt by 2020. This is in sharp contrast to the situation facing most provinces.

?? The CHST package announced by the federal government at the 2000 First Ministers' Meeting was not adequate to meet current and future spending pressures in health care and post-secondary education. Provinces and territories require an increase in the level of CHST cash payments and a suitable escalator.

?? The vertical fiscal imbalance will worsen in the future, as only the federal government has the financial capacity to pursue substantial debt repayment, tax cuts and discretionary program spending.

Professor Ruggeri maintains that the widening imbalance points to the greater need "… for a fundamental change in intergovernmental fiscal relations aimed at rebalancing the fiscal structures of federal and provincial government in a manner that allows both orders of government to fulfill their constitutional spending responsibilities in a fiscally responsible manner and in a manner that respects jurisdictional integrity."

✍✍ *Addressing the fiscal imbalance between the Federal and Provincial/Territorial Governments*

The CHST and its predecessors (Established Programs Financing (EPF) and the Canada Assistance Plan (CAP)), have been the key mechanisms employed by the federal government to manage the "symptoms" of the imbalance between federal and provincial/territorial financial resources and program responsibilities.

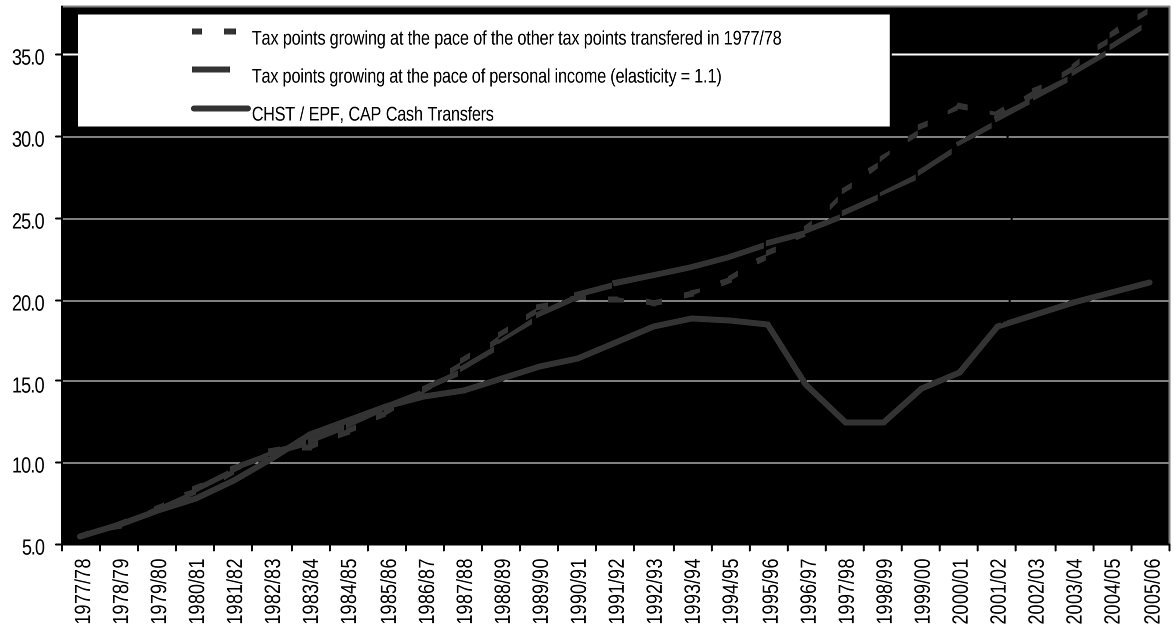
However, despite provincial/territorial efforts to work within this framework, the transfer mechanism has not provided a stable, long-term solution to funding health and other social programs. The unilateral changes to EPF and CAP and the outright reductions in federal support under the CHST, followed by the partial restoration of these cuts without an escalation formula to provide for ongoing adequate increases, have left provinces and territories uncertain of the federal government's commitment.

To a large degree, the current fiscal imbalance is a consequence of the federal government not having lived up to its side of the bargain under the EPF and CAP agreements. Under EPF, growth was to be at the same rate as the Gross National Product (GNP), while under CAP growth was to be at the same rate as actual program spending. In neither case did the federal government meet these commitments.

Furthermore, federal social transfers have not kept pace with the growth of the federal income tax base, leading some provinces to call for a transfer of federal tax room to the provincial/territorial governments.

The following chart compares the value of CHST cash transfers (EPF Cash and CAP prior to 1996/97) with what the value of a tax point transfer would have been under different growth scenarios. The gap between what was actually received and what <u>hypothetically</u> would have been received in 2001/02 is in the order of $13 billion. From a purely fiscal perspective and in the absence of offsetting federal actions, provinces and territories would have received significantly more revenue had the federal government converted all EPF and CAP payments into a tax-point transfer in 1977/78.

What Provinces and Territories would have Hypothetically Received if CAP and EPF Cash Transfers had been Replaced by Tax Points Back in 1977/78



Source: Federal Department of Finance for data on CHST, Statistics Canada and the Conference Board of Canada for data on personal income.

Four options for addressing the vertical fiscal imbalance

At their Annual Conference in August 2000, Premiers called on the federal government to fully restore CHST cash to 1994/95 levels immediately, and to implement an appropriate escalator. While no one specific escalator formula was identified by Premiers, it was generally agreed that CHST cash should, at a minimum, grow at the same rate as nominal Gross Domestic Product (GDP). Consideration also was given to an escalator that would increase CHST cash at a rate greater than nominal GDP growth. With the federal share of provincial/territorial social program funding having fallen so dramatically over the 1990s, an enhanced (i.e. growing faster than GDP) escalator was seen as a possible mechanism whereby a more meaningful funding partnership with the federal government could be established.

In seeking a more durable solution to the problem of adequate funding for health care, education and social services, provincial/territorial Finance Ministers have identified four broad options. Three options propose solutions within the CHST framework, while a fourth involves a tax-point transfer in lieu of CHST payments. While these options are presented as distinct alternatives, it is recognized that a combination of Equalization, CHST and tax-point transfers may be the appropriate method of achieving adequate and sustainable funding for health care and other social programs. These options would require the federal government to reprioritize the use of its projected budgetary surpluses.

OPTION 1: To have the CHST cover the same share of provincial/territorial social program costs as in 1994/95, by 2004/05.

?? CHST cash would be restored to its 1994/95 level of $18.7 billion for 2000/01. The 1994/95 federal funding share of approximately 18 percent of total health, education and social services expenditures would be realized by 2004/05 using an enhanced escalator (nominal GDP plus 5 percent) to determine entitlements in the four years 2001/02 through 2004/05. An escalator based on nominal GDP growth would be used after 2004/05.
?? This proposal would raise federal CHST cash payments to $28.9 billion by 2005/06, $7.9 billion more than in the current federal plan.

OPTION 2: To have the federal government and provinces/territories share equally new health care costs as an interim measure toward the goal of having the CHST cover the same share of social program costs as in 1994/95, by 2004/05.

?? CHST cash would be restored to its 1994/95 level of $18.7 billion for 2000/01. The federal government would finance 50 percent of health care cost increases incurred by provinces during 2001/02 and 2002/03, while Commissioner Romanow completes his report. The 1994/95 federal funding share of approximately 18 percent would be realized by 2004/05 using an enhanced escalator (nominal GDP plus 3.5 percent) to determine entitlements in 2003/04 and 2004/05. An escalator based on nominal GDP growth would be used after 2004/05.
?? A variation on this proposal would have the federal government financing half of all provincial/territorial health cost increases during 2001/02 and 2002/03, distributed on an equal per capita basis.
?? This proposal would raise federal CHST cash payments to $28.9 billion by 2005/06, $7.9 billion more than in the current federal plan.

OPTION 3: To have the CHST rise in 2000/01 to the same level it was in 1994/95.

?? CHST cash would be restored to its 1994/95 level of $18.7 billion for 2000/01. An escalator based on nominal GDP growth would be used beginning in 2001/02.
?? This proposal would raise the federal contribution to provincial/territorial social program costs from its current share of 14 percent to about 15 percent.
?? This proposal would also raise federal CHST cash payments to $24.0 billion by 2005/06, $3.0 billion more than in the current federal plan.

OPTION 4: To replace the current CHST payments mechanism with a Tax-Point Transfer.

?? Under this option, CHST cash payments would be replaced with a transfer of tax points from the federal government to provinces and territories. The value of the tax-point transfer would be the same as the Option (1, 2 or 3) to which it is being considered an alternative. With the transfer of tax points, no escalator formula would be required.
?? Growth in the value of the tax-point transfer (assuming it was a personal income tax point transfer) may be expected to be about the same as in the CHST options.

A comprehensive review of the division of the tax base in Canada is a complex undertaking, which has not yet been fully explored. As well, it would be difficult to capture all of the various means whereby an adequate CHST-based mechanism could be achieved. However, there are various pros and cons that can be identified with the approaches to addressing fiscal imbalance that are represented by these four options.

CHST Approach (1) and (2)	**CHST Approach (3)**	**Tax-Point Transfer Approach (4)**
Pros	***Pros***	***Pros***
?? Approach is supported, in principle, by the federal government	?? Approach is supported, in principle, by the federal government	?? Provides P/Ts with a source of financing that would be sheltered from federal government budget cuts
?? Raises the ongoing funding commitment of the federal government in respect of P/T social programs to a more "adequate" level (18%) – Greatest reduction in the fiscal imbalance between orders of government	?? Least costly of the options to federal government. Would raise the ongoing funding commitment of the federal government in respect to P/T social programs (15%)	?? Improves transparency and accountability - the order of government responsible for the delivery of services is also responsible for raising the necessary financial resources
?? Neutral with respect to fiscal imbalances among P/Ts	?? Neutral with respect to fiscal imbalances among P/Ts	?? Would reduce federal-provincial/territorial tension over transfer payments in respect of P/T social programs
Cons	***Cons***	***Cons***
?? Only addresses the symptoms of the fiscal imbalance between orders of government	?? Only addresses the symptoms of fiscal imbalance between orders of government	?? Approach is not supported, in principle, by federal government
?? Vulnerable to unilateral federal decisions and jurisdictional interference by way of "boutique" programs at the expense of basic programs provided by P/Ts	?? Vulnerable to unilateral federal decisions and jurisdictional interference by way of "boutique" programs at the expense of basic programs provided by P/Ts	?? Would increase fiscal imbalances among P/Ts, which would need to be addressed through the Equalization Program or alternative mechanism
?? Historical record indicates the federal government is an unreliable partner	?? Historical record indicates the federal government is an unreliable partner	?? Increases potential revenue volatility
?? Would cost the federal government the most	?? Reduces fiscal imbalance between orders of government the least and does not reach the target of 18%	

The tax-point transfer option raises questions for which no clear consensus has evolved among provinces and territories, particularly with respect to the need, interest, and desirability of there being an ongoing role for the federal government in directly funding provincial social programs.

While some provinces welcome the role of the federal government in enforcing national standards, not all provinces share this opinion, regarding it rather as an intrusion into an area of provincial jurisdiction and expertise. All provinces, however, do agree that the federal government should not be imposing new requirements on provinces and territories without providing adequate and reliable funding.

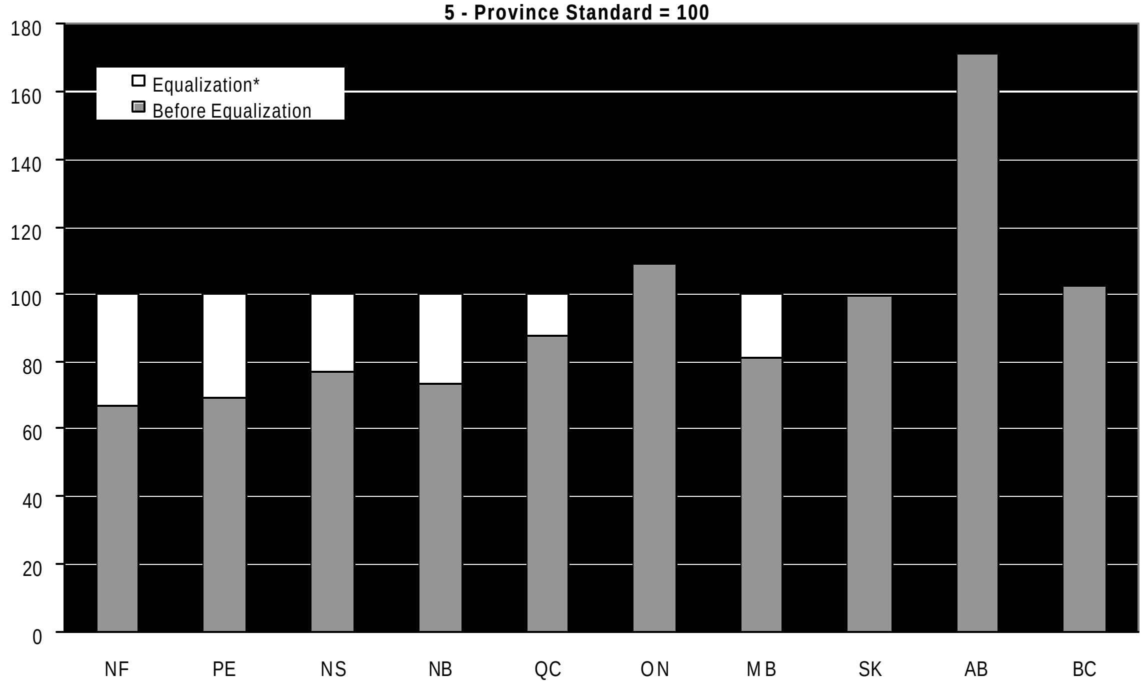
Fiscal imbalance among Provinces and Territories

In recognition of the significant fiscal disparities that exist among provinces, the Equalization Program was established in 1957. The purpose of the Program is set out in Section 36(2) of the *Constitution Act, 1982*. It states that,

> *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.*

The amount of funding allocated under the Equalization Program is estimated to be about $10.8 billion in 2000/01 and is currently capped at this level based on current estimates of GDP growth. The chart below illustrates the effect of the Equalization Program on recipient provinces' fiscal capacities, relative to the current five-province standard.

Measures of Fiscal Capacity, by Province, 2000/01
5 - Province Standard = 100



Source: Federal Department of Finance.
* Does not include Saskatchewan Floor Payment.

In their August 2000 communiqué, Premiers "called on the federal government to strengthen its commitment to the Equalization Program so that the Program meets its constitutionally mandated objectives." There is concern among the less-affluent provinces that the shortcomings of the present Program prevent it from adequately addressing these objectives. The three ways most often identified to strengthen the Program are:

1. Removing the Equalization Program ceiling,
2. Ensuring comprehensive revenue coverage, and
3. Shifting from the five-province to ten-province standard.

At their August 2000 conference, Premiers called for a removal of the ceiling on Equalization entitlements. In the communiqué from the September 2000 First Ministers' Meeting, "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."

Despite the commitment of the Prime Minster to allow the Equalization Program to grow up to the rate of growth in GDP, and in contradiction to the understanding of Premiers, the ceiling provision of the Program will constrain growth to only about 0.3 percent, considerably less than the 8.3 percent growth in GDP. Indeed, after subsequent calculations using revised data, year-over-year entitlements may actually decline.

With recent federal surpluses exceeding by a wide margin the size of the entire Equalization Program, it is clear that the federal government could readily accommodate the Premiers' call to eliminate the ceiling on Equalization entitlements. It is also noteworthy that, at least in the era of the current Program, Equalization entitlements as a per cent of GDP have never been as low as the 1.04 percent that results from the Equalization ceiling for 2000/01.

As indicated in their December 2000 communiqué, Finance Ministers intend to "continue to work on the ten-province standard, including comprehensive revenue coverage and recognizing volatility around resource revenue." A ten-province standard would be more representative of the fiscal capacity of all provinces than the current (five-province) standard. The unilateral decision of the federal government in 1982 to change the basis for Equalization entitlements from a ten to five-province standard[5] has resulted in a systematic discounting of payments to the less-affluent provinces. The difference in entitlements under the two standards varies from year to year and has typically been less than $1.5 billion annually since 1985/86. In 2000/01, however, it is estimated that this difference will be over $4 billion, reflecting the increase in energy prices and other factors.

Provincial/territorial Finance Ministers directed officials to prepare an analysis of options that would lessen the volatility associated with natural resource revenues under a national average (ten-province) standard. This analysis demonstrated that it is possible to design alternative mechanisms under a ten-province standard to address the issue of resource revenue volatility. These models, along with comprehensive revenue coverage, serve as options for consideration in advancing the Premiers' call to strengthen the Equalization Program, in addition to immediate removal of the ceiling on Equalization payments.

---

[5] The existing Program seeks to raise the fiscal capacity of provinces receiving Equalization payments to a level corresponding to the standard of five provinces (Ontario, Québec, Manitoba, Saskatchewan and British Columbia). Accordingly, it is lower than a standard of ten provinces, since it excludes Alberta, the province with the greatest fiscal capacity.

Conclusion

Fiscal imbalances are a persistent and problematic feature of federal-provincial relations. The history of transfer programs and the projections of growing demand pressure on provincial and territorial social programs raise concerns about the federal government as a reliable partner, and by association the CHST and Equalization as reliable and adequate mechanisms. This report examines several options to develop a stronger funding partnership between the federal and provincial/territorial governments. It also identifies an alternative to an adequately enhanced CHST program. This alternative would be a new sharing of the global tax room between the federal and provincial governments, as a means to achieving a long-term fiscal balance between the two orders of government. However, achieving this balance should not come at the expense of widening the fiscal disparities that currently exist among provinces and territories.

To that end, the Report also speaks to the imbalance that exists among the provinces and identifies ways to strengthen the Equalization Program to ensure it adequately satisfies the constitutional commitment.

In this regard, more work still needs to be done to identify the best option(s) for effecting change and ensuring that fundamental issues, such as the equitable distribution of increased funding for health and other social programs, are satisfactorily addressed.

Regardless of which approach is followed in addressing the various dimensions of the fiscal imbalance issue, it is clear that a co-ordinated approach involving both orders of government is required.

✍✍Appendix: Cost Estimates for CHST Options

The Report outlines four options to more durably address the problem of securing adequate funding for health care, education and social services. Options 1, 2 and 3 seek to achieve this by calling on the federal government to increase its share of funding for these programs through the CHST from its current level of 14 percent.

The total and annual incremental costs of these different options are shown in the charts opposite.

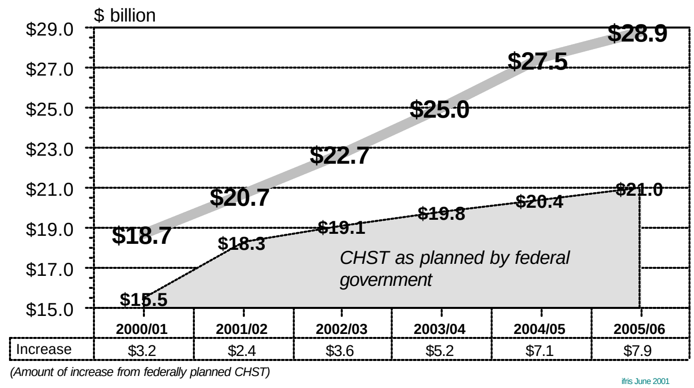
Options 1, 2 and 3 would all entail an additional $3.2 billion for 2000/01 to immediately restore the nominal level of CHST to $18.7 billion, as called for by Premiers.

The increased transfers associated with Options 1 and 2 would rise over time to $7.9 billion by 2005/06. The increased transfers associated with Option 3 would rise over time to $3.0 billion by 2005/06.

Option 4 is for the federal government to transfer an equivalent value in tax points to provincial and territorial governments. The cost of such an option would be approximately equal to the option to which it would be considered an alternative.

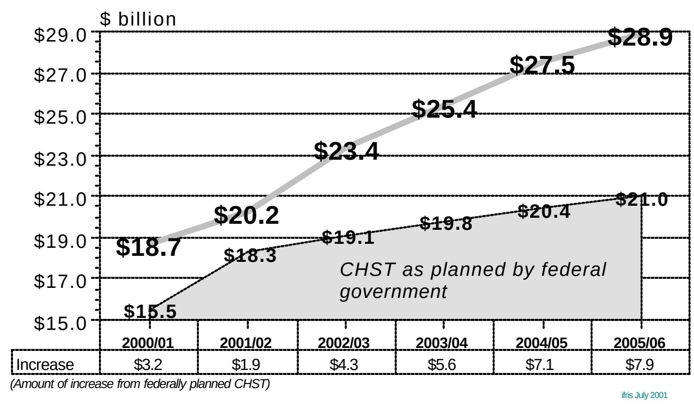
Opt. 1: Enhanced Escalator to Reach Fed. Funding Share of 18% by 2004/05

GDP+5% escalator until 2004/05; GDP escalator thereafter



Opt. 2

Two years of 50:50 sharing of new health costs; two years of enhanced escalator (GDP+3.5%) to reach federal funding share of 18% by 04/05; GDP escalator thereafter



Opt. 3: GDP Escalator (Unenhanced) from 2001/02 Onward