
BUDGET PAPER B:
FEDERAL FISCAL ISSUES

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“ Madam Speaker, discussions concerning health care dominated federal provincial meetings this winter.”

Hon. Patricia J. Mella - April 10, 2003

Budget Paper B provides background material on federal provincial discussions related to the Equalization and Canada Health and Social Transfer programs. These two federal programs form 95 per cent of the value of federal transfers to the Government of Prince Edward Island, involving in the order of \$350 million. They are also the source of much controversy between the federal and provincial governments.

The paper is divided into four parts; 1. The 2003 First Ministers “Health Accord”: 2. Equalization discussions: 3. Implications of the 2001 Census results: and 4. The resolution of the federal mis-allocation of Provincial Income Tax revenues.

1. The 2003 First Ministers “Health Accord”

Premiers met with the Prime Minister on February 4-5, 2003 to negotiate improved health funding arrangements for Canada. The 2003 “Health Accord” that resulted fell far short of provincial and territorial needs and is not viewed as a federal provincial agreement by the Province of Prince Edward Island. The terms of the “accord” were set out by the Federal Government without provincial endorsement.

The discussions were the culmination of several meetings by Health Ministers, Premiers and Finance Ministers prior to and following the submission of the report by Roy Romanow, the *Royal Commission on the Future of Health Care in Canada*, to Parliament on November 28, 2002.

Provincial and Territorial Ministers of Finance met with John Manley, the Federal Minister of Finance, December 17-18 2002, to express their views on the need for significant improvements in federal funding of health care in Canada. The Romanow Report proposed sweeping changes to ensure the long term sustainability of Canada’s health care system. His recommendations were to add approximately \$15 billion to federal payments to provinces over the coming three years, through increased funding of \$3.5 Billion in 2003-04 rising to \$6.5 billion in 2005-06. Federal funding in the first three years was to be targeted to Health Reform in selected areas. In addition the report recommended that a Canada Health Transfer be carved out of the Canada Health and Social Transfer.

Provinces expressed the need for flexibility in dealing with the issue of health reform, and reiterated the need to raise federal funding to at least 18% of provincial expenditures on Health, Education and

Social Services, through the CHST. This was the 1994-95 level of federal support, prior to the cuts that were made in 1996 and 1997. Increased federal support of an estimated \$24.7 billion in the years 2002-03 to 2005-06 was called for by Provincial Finance Ministers.

Provincial and Territorial Premiers met January 23 2003, when they endorsed the call for restoration of CHST to at least 18% of total health and social expenditures in 2002-03, with increasing financial support in the coming years. They proposed that federal support be stepped up to 25% by the end of the decade. As part of the improved federal support for Health care they also called on the Federal Government to remove the equalization ceiling and to strengthen the Equalization program formula. They also agreed with Romanow that to ensure greater accountability, a Canada Health Transfer be created to replace the CHST.

Following the First Ministers meeting on February 4-5, 2003, the terms of the federal package were then incorporated into the Federal 2003 Budget that was presented on February 18, 2003.

Federal descriptions of the Health package exaggerate new funding as they combine previous commitments to increase CHST, made in September 2000 and budgeted in 2001, with the new funding. The following table separates new funding from pre-existing commitments.

Table B.1 Components of Increased Federal Provincial Transfers

	Pre 2003 CHST	Additional CHST/CHT	Health Reform	Medical Equipment	Total Transfer	Transfer Increase
Notes	Previous agreement extended only to 2005-06.	First three years paid as \$2.5 billion Trust from 2002-03.	\$16 billion After 2008 move into the CHT.	To be paid as \$1.5 billion Trust from 2002-03.		Further \$2 billion to be paid in 2003-04 if available.
Year	\$ Billions					
2002-03	19.1				19.1	0.0
2003-04	19.8	1.0	1.0	0.5	22.3	2.5
2004-05	20.4	1.0	1.5	0.5	23.4	3.0
2005-06	21.0	0.5	3.5	0.5	25.5	4.5
2006-07	21.0	0.6	4.5		26.1	5.1
2007-08	21.0	1.2	5.5		27.7	6.7
2008-09	21.0	7.9			28.9	7.9
2009-10	21.0	9.2			30.2	9.2
2010-11	21.0	10.5			31.5	10.5

Source: Federal Budget 2003.

The 2003 Health Accord package consists of the following components; a specific Canada Health Reform Fund to provide \$16 billion to provinces in new funds over 5 years targeted to primary health care, home care and catastrophic drug coverage; a supplement to CHST of \$2.5 billion; a Diagnostic/Medical Equipment Fund of \$1.5 billion to improve access to diagnostic services; improved CHST funding after 2005-06, of \$1.8 billion; and a possible increase of \$2 billion to CHST at the end of 2003-04, depending on the federal fiscal position. In addition to these additional federal-provincial funds the Health Accord includes \$600 million for electronic patient records, \$500 million for research hospitals, increases for First Nations Health, EI compassionate care, and other federal priorities.

The Federal Government intends to split the CHST into a Canada Health Transfer (CHT) and Canada Social Transfer (CST) by April 2004. The Budget indicates that sixty two per cent of the CHST will go to the CHT. Subject to a review of progress in achieving the agreed upon reforms, effective April 1, 2008, the CHT would also receive the Health Reform funds from 2008-09.

The new \$16 billion of Canada Health Reform funding is to allow provinces to accelerate reforms in primary health care services, home care services and catastrophic drug coverage in the next five years. Provinces will prepare annual public reports on their progress in meeting these Health Reform priorities commencing in 2004, though each province will have the flexibility to determine how best to achieve the reform objectives.

The additional dollars being committed to provinces, as shown in Table B.1, sum to \$10 billion over the next three years. This can be compared to the \$24.7 billion that Finance Ministers agreed was needed. It might also be compared to the \$15 billion that Romanow recommended.

Federal statements in the Budget that Health funding was increased by \$17.3 billion are misleading as they include \$3.9 billion that was previously committed in 2001. Also, \$3.4 billion is made up of commitments to First Nations Health, Health Information technology and other direct federal programs, leaving \$10 billion for provinces over three years.

Of the total package of improved Health transfers, \$5.1 billion will be charged against the federal surplus in 2002-03, by using Trust Funds. Also, \$1 billion of the pre 2003 CHST transfers for 2002-03 and 2003-04, that are shown in Table B.1, was actually expended by the Federal Government in 1999-00, through the creation of Trust funds that year.

Bearing this in mind, the overall expenditure impact of the federal measures in the Health package, as indicated in the 2003 Federal Budget documents, is only \$1 billion of additional spending in 2003-04. Not included in this is an amount, up to \$2 billion, that the Federal Government agreed to add to the CHST, if the federal Minister of Finance determines in January 2004 that there is a sufficient surplus above the normal contingency reserve for the 2003-04 year.

An additional aspect of the 2003 “Health Accord” was a statement by the Federal Government reaffirming the importance of the Equalization program, and to permanently remove the ceiling from the formula on a “going-forward basis”. That is described more fully in the following section, but it was made clear in the federal Budget that its removal would not apply to years where the ceiling is presently in effect.

Impacts on Prince Edward Island

The overall financial impact of the “Health Accord” is not fully determined as the utilization of the Health Reform Fund is contingent on the development of specific objectives in the three target areas, and the establishment of provincial programs to meet those targets.

The federal Budget documents state that the various additional health funds for provinces will be shared on an equal per capita basis. As the Province’s share of the Canadian population in the years to come can vary, so any estimate of the provincial impact of the “Accord” is prone to some error. This problem is particularly acute as at present population estimates are subject to significant revision in 2003 to correct for the 2001 Census results. A discussion of the population revisions appears later in this Paper. Bearing this in mind, the estimates in the following table have been made with an allowance for the probable impact of these revisions.

Table B.2 Estimates of Federal Provincial Transfers to Prince Edward Island

Year	Pre 2003 CHST	CHST Supplement & Addition.	Health Reform	Diagnostic Medical Equipment	Total Transfers	Total Additional Transfers
\$ Millions						
2002-03	90.6				90.6	0
2003-04	93.7	11.0	4.4	2.2	111.3	17.6
2004-05	96.4	8.8	6.6	2.2	114.0	17.6
2005-06	99.0	0	15.3	2.2	116.5	17.5
2006-07	99.0	2.6	19.6	0	121.2	22.2
2007-08	99.0	5.2	23.8	0	128.0	29.0
5 year total		27.6	69.7	6.6		103.9

Source: Federal Budget 2003, Provincial Treasury Calculations

The overall increase in federal transfers to Prince Edward Island under the Health Accord, over the next five years sums to \$103.9 million. Of that amount, \$27.6 million will be available as new CHST funding and \$6.6 million through the Diagnostic and Medical Equipment Fund. The major part of the new funds takes the form of the Health Reform fund, at \$69.7 million.

The Health Reform money grows from \$4.4 million in 2003-04 to \$23.8 million in 2007-08. This money is to be used for the acceleration in development of Primary Care, Home Care and Catastrophic Drug coverage services by the Province, as called for in the Accord. The Province's use of the \$6.6 million in the Diagnostic and Equipment Fund is tied to the support of specialized training and equipment to improve access to publicly funded diagnostic services.

In 2008-09 the Health Reform Fund is to be transferred to the Canada Health Transfer, which will also receive 62% of the CHST in that year, according to federal documents. That arrangement remains subject to further federal provincial discussions, and depends on success in meeting the objectives in the Health Reform targets.

Additional funding through the CHST Supplement is \$11 million in 2003-04 and \$8.8 million in 2004-05, and so on, totaling \$27.6 million. This takes into account the receipt of the Province's share of the \$2.5 billion supplement in 2003-04, and the additional contingent amount in 2004-05. These transfers represent unconditional transfers to the Province for the general purpose of supporting health, post secondary education and social services.

The provincial costs of delivering these services have been increasing, on average, at a rate of \$25.5 million per year (over the last five years). This means that, after 2003-04 the CHST transfer will again represent a falling percentage of provincial costs for health care, post secondary education and social services.

An additional amount was added to the CHST on March 13, 2003 as a result of an agreement between Federal, Provincial and Territorial Ministers responsible for Social Services, for Early Childhood Development programs and services. This addition was \$25 million in 2003-04 nationally, rising to \$75 million in 2004-05, \$150 million in year three and so on, to total \$900 million over five years. For Prince Edward Island this adds \$110,000 to CHST in 2003-04, \$330,000 in 2004-05, and \$660,000 in 2005-06. Budgeted amounts for CHST include these additions.

2. The Equalization Program

Equalization is easily the Government of Prince Edward Island's largest source of revenue valuing some \$239 million in 2002-03. Equalization enables the less prosperous provincial governments to provide their residents with public services that are reasonably comparable to those in other provinces, at reasonably comparable levels of taxation as described in 36(2) of the Canadian Constitution.

36. (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.

Equalization Entitlements are calculated annually according to a formula set out in federal legislation and regulations. Provinces with revenue raising ability, or fiscal capacity below a threshold or standard amount receive an Entitlement from the Federal Government to bring their revenues up to that standard.

How Equalization is Calculated

The present Equalization standard measures the average fiscal capacity of the five ‘middle income’ provinces – Quebec, Ontario, Manitoba, Saskatchewan and British Columbia. The calculation is made on the basis of annual Entitlements that reflect economic data and provincial revenues. For any given Entitlement there are eight estimates made over a period of several years. The final estimate thus occurs three and a half years after the first estimate for that year is made. These revisions take the form of prior year adjustments and can be very large.

The concept of fiscal capacity is critical to the understanding of how the equalization program functions. Fiscal capacity measures how much revenue a province *could* raise from its own tax sources using a definition of tax bases and tax rates that are common to all provinces. This is accomplished by basing the formula on the “representative tax system” or RTS. The total fiscal capacity of a province is a measure of its ability to raise revenues from 33 revenue sources – including personal income tax, corporate income tax, sales taxes, property tax, and other sources – using a national average tax rate for each tax base. This ensures that no individual province can manipulate the program through its own tax practices.

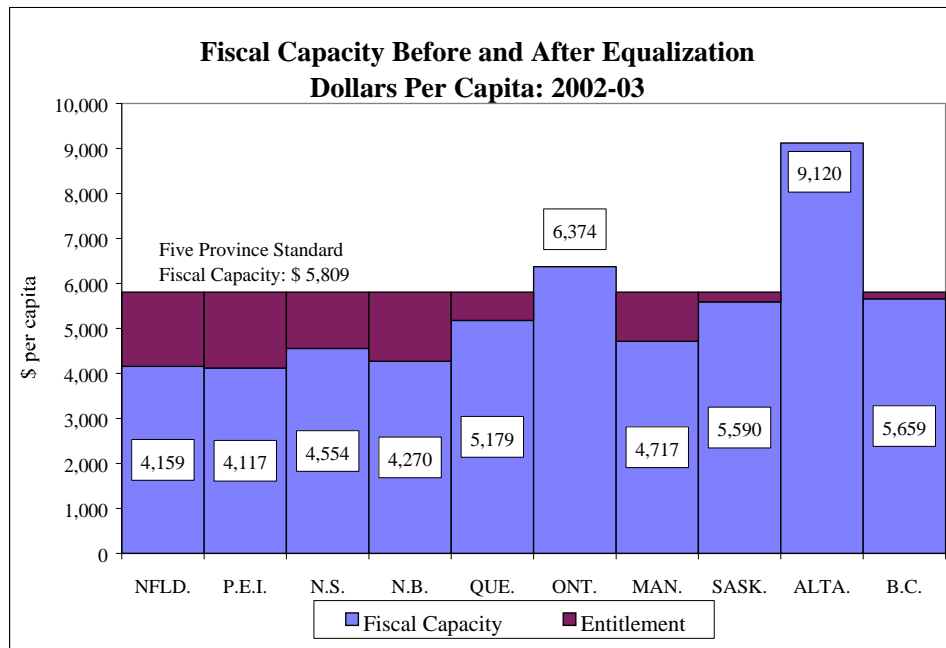
Consider an example using personal income taxes. The formula for 2002-03 estimates that on average the five provinces in the standard could raise \$1,543 per capita from their personal income tax at the national average tax rate. The equivalent calculation for Prince Edward Island, using our own income tax base and the national average tax rate, generates a figure of \$900 per capita. Thus Prince Edward Island has a per capita deficiency of \$643 in personal income tax in 2002-03 relative to the standard amount. Multiply this number by our population and one gets \$89.9 million, which is our deficiency for the personal income tax base. The Federal Government pays Prince Edward Island that amount to offset the revenue deficiency for that tax source.

The same basic calculation is performed for each of the 33 tax bases in the formula. Summing all of the tax bases yields the Province’s total Entitlement. Provinces with a total Entitlement that is positive receive that amount in compensation, while provinces with a negative total, do not receive an Entitlement. The Equalization program only raises fiscal capacity.

Figure B.1 shows the per capita fiscal capacity of each province for 2002-03 relative to the five province standard for all 33 tax bases. One can see that provincial per capita fiscal capacity, represented by the lightly shaded portion of the chart, ranged from \$4,117 for Prince Edward Island to \$9,120 for Alberta in that year. Provinces with a fiscal capacity below the standard amount of \$5,809 per capita for that year receive an Entitlement to bring them up to the standard. For Prince Edward Island the difference between our fiscal capacity and that of the standard was \$1,692 per capita. This was our per capita Entitlement for that year and is represented by the darker shaded

portion of the chart. After Equalization, all receiving provinces have a fiscal capacity of \$5,809 per capita while Ontario and Alberta remain at their higher levels.

Figure B.1



Equalization payments are unconditional, so receiving provinces are free to spend the funds on public services according to their own priorities. Currently, eight of the ten provinces qualify. These are Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba, Saskatchewan and British Columbia. In 2002-03, provinces received approximately \$10.3 billion in Equalization payments from the Federal Government under this formula.

The three territories also receive federal fiscal transfers from the Federal Government through a different program, the Territorial Formula Financing program. This amounted to approximately \$1.3 billion in 2002-03.

Equalization Renewal

The Equalization program is thoroughly reviewed by the Federal Government in consultation with provinces and territories every five years in order to renew the program. The current program expires March 31st, 2004, so this is a critical year in the renewal process. The renewal process ensures that the provinces and the Federal Government have the opportunity to assess the program's effectiveness at accomplishing its objectives as stated in the Constitution.

Staff from the Economics, Statistics and Federal Fiscal Relations Division of Provincial Treasury play an active role in representing the Province at these negotiations and also provide technical input

and advice to the Minister at Ministerial discussions on the program. The Division has taken the lead on a number of initiatives in the renewal discussions by presenting several technical papers and hosting meetings to aid these discussions. In the fall of 2002, the Province also co-hosted an international conference with the Forum of Federations, on federal fiscal relations and economic development, at which senior government officials and academics from 5 continents came to discuss their country's experience with Equalization. Each country's Equalization program is unique, reflecting each country's different history, social and political circumstances. It was also apparent that the role of the Canadian program in reducing fiscal disparities is much greater than in many other federations.

It is the concern of the Government of Prince Edward Island that fiscal disparities are growing among Canadian provinces. While Equalization reduces these differences, large disparities remain even after provinces are Equalized. In 2002-03 the gap between receiving provinces and the wealthiest province was \$3,311 per capita after Equalization, compared to \$2,223 four years earlier. These fiscal disparities among the Canadian provinces have become a serious concern for receiving provinces and their ability to maintain reasonably comparable services at reasonably comparable levels of taxation for their citizens.

It is for this reason that provinces have called on the Federal Government, on many occasions, to strengthen the program. The following is a discussion of three key renewal issues.

Equalization Ceiling

The Ceiling on the Equalization program was introduced in 1982 to offer the Federal Government protection from potential rapid and unsustainable year over year growth in total Entitlements. The Ceiling is triggered when the cumulative growth in total Entitlements exceeds the rate of growth in GDP from a base year. When the ceiling is triggered, receiving provinces have their Entitlement clawed back on an equal per capita basis.

At the First Ministers' meeting in February 2003 the Prime Minister announced that the government would permanently remove the Equalization ceiling on a "going-forward basis". The Federal Government has interpreted this to mean that the ceiling would be removed for the fiscal year 2002-03 and future years. However, the ceiling presently imposed on 2000-01 and 2001-02 remains in place. Current Equalization payments are still impacted by the ceiling application because the Entitlements for those years have yet to be finalized.

The total impact of the 2000-01 Ceiling on provincial Entitlements are shown in Table B.3. As the table shows, the impact of not removing the Ceiling for 2000-01 and 2001-02 reduces Prince Edward Island's Entitlements by \$4.9 million. The total cost to provinces is \$320 million. For Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick and Quebec the Ceiling reduces Entitlements in two years because of its interaction with the Floor payments in 2001-02.

Table B.3. Ceiling Impact on Receiving Provinces' Payments
2000-01 and 2001-02 Entitlements

Province	Ceiling Impact (\$ Millions)
Newfoundland and Labrador	19.2
Prince Edward Island	4.9
Nova Scotia	33.7
New Brunswick	25.4
Quebec	198.2
Manitoba	20.5
Saskatchewan	18.3
Total	320.1

Source: Federal Department of Finance, PEI Treasury Calculations
Includes multi year impacts.

It is the Government of Prince Edward Island's view that the Ceiling should never have been imposed, because it is contrary to the principles of Equalization.

The federal commitment to remove the Ceiling for 2002-03 and future years is something of an empty promise in light of the reduced levels of Equalization Entitlements in these years. Table B.4 shows the decline in total Entitlements and the Ceiling amounts from 2000-01 to 2003-04 where one can see that the Ceiling in 2003-04 far exceeds Entitlements, and therefore has no effect.

Table B.4 Total Entitlements and Ceiling Amounts: 2000-00 to 2003-04

Year	Entitlements (\$ Billions)	Ceiling
2000-01	11.1	10.9
2001-02	10.4	11.1
2002-03*	10.3	11.6
2003-04*	10.4	12.3

Source: Federal Department of Finance
** Ceiling Removed*

Comprehensive Revenue Coverage

One of the reasons for declining Entitlements, as shown in Table B.4 is the restriction that was placed on the amount of provincial revenue from user fees that are used in the calculation by the Federal Government. In the 1999 Equalization renewal the Federal Government implemented a radical change to reduce the amount of provincial revenue from user fees by 50 per cent in the Miscellaneous Revenue base in the formula by 2003-04.

The impact on receiving provinces by eliminating 50 per cent of user fee revenue coverage in the Miscellaneous Provincial-Local Tax and Revenue base for 2003-04 is shown in Table B.5. One can see that Entitlements were reduced by \$464 million by the federal decision. For Prince Edward Island, Entitlements were reduced by \$9.4 million per year.

Table B.5
Equalization Entitlements for the Miscellaneous Provincial-Local Tax and Revenue Base.
 2003-04

Province	User Fee Revenue Coverage		Reduced Entitlements
	100%	50%	
	\$ Millions		
Newfoundland and Labrador	91.7	57.9	-33.8
Prince Edward Island	22.7	13.3	-9.4
Nova Scotia	114.1	66.0	-48.1
New Brunswick	115.8	67.6	-48.2
Quebec	413.3	249.5	-163.8
Manitoba	128.5	73.3	-55.2
Saskatchewan	108.4	58.8	-49.6
British Columbia	176.6	120.7	-55.9
Total	1171.2	707.1	-464.1

Source: Federal Department of Finance

Provincial governments have been pressing the Federal Government for comprehensive revenue coverage for the Equalization formula in order to restore this base in full.

Equalization Standard

The Government of Prince Edward Island is also concerned that the five province standard is becoming inadequate to meet the programs objectives.

Various Equalization standards have been used in the past including the average of the top two provinces, a national average standard and now the five province standard. The five province standard was adopted in 1982 to replace the national average or ten-province standard that was used to 1981. The five provinces in the standard are Québec, Ontario, Manitoba, Saskatchewan and British Columbia. This five-province standard excludes Alberta, with its high fiscal capacity as well as the four Atlantic provinces, Newfoundland and Labrador, Prince Edward Island, Nova Scotia, and New Brunswick, with their relatively low fiscal capacities.

Table B.6
Increase in Equalization Entitlements From a 10-Province Standard.
2003-04 Third Estimate.

Province	\$ Millions
Newfoundland and Labrador	108.0
Prince Edward Island	28.6
Nova Scotia	192.8
New Brunswick	154.2
Quebec	1,521.2
Manitoba	234.8
Saskatchewan	206.4
British Columbia	854.4
Total	3,300.4

Source: Federal Department of Finance, PEI Provincial Treasury Calculations.

Table B.6 displays the increase in Entitlements for receiving provinces that would occur from adopting a 10-province standard in 2003-04. It is apparent that receiving provinces are presently Equalized to a standard that is considerably less than the national average. An Equalization program designed to bring provinces up to a national average standard would deliver an additional \$3.3 billion in 2003-04. For Prince Edward Island this is an additional \$28.6 million that year, though the amount is highly variable.

Moving to a 10-province standard would improve receiving provinces' ability to provide reasonably comparable services at reasonably comparable levels of taxation - it would also offset the negative impact caused by reduced revenue coverage. Total Entitlements as a share of GDP would rise from 0.9 per cent to approximately 1.138 per cent, which is closer to their level in earlier years.

3. 2001 Census of Population

Estimates of population are a critical component in determining the allocation of federal transfers among provinces and territories. The current population estimates used in the transfer calculations are subject to a major revision in the fall of 2003. At that time, Statistics Canada will release revised estimates of provincial and territorial populations based on the 2001 Census, adjusted for net under-coverage.

Equalization and CHST Entitlements for those years that have not been finalized will incorporate the new population data in the recalculation of Entitlements in October 2003. Box B.1 details how the population revisions impact on Prince Edward Island's transfers from the Federal Government which will affect Prince Edward Island's transfer revenues in the 2003-04 fiscal year.

Box B.1 Census Impact on Federal Transfers

On March 27, 2003 Statistics Canada released estimates of coverage errors in the 2001 Census of population. Estimates of the coverage errors show the proportion of the population that were either completely missed or enumerated more than once. Statistics Canada will incorporate the net coverage error for each province and territory into new population estimates to be released in September of 2003.

Analysis of the 2001 Census shows that Atlantic Canada's population grew at a slower rate than the annual population estimates currently used in the transfer programs indicate. Prince Edward Island's population share of the national total and of the five province standard is expected to fall.

Transfers based on a simple per capita allocation, such as the CHST and the Health Reform Fund, will fall by a proportional amount.

However, the impact on Equalization is more severe, as there are three negative forces at play. As described in Figure B.1 Equalization is determined by the difference in per capita fiscal capacity of a receiving province and the five province standard. This is multiplied by that province's population. Firstly, an increase in the population of the standard provinces reduces the five province fiscal capacity per capita. Secondly, a decrease in Prince Edward Island's population increases our per capita fiscal capacity. So the combined impact reduces the provinces per capita fiscal disparity. Thirdly, this is then multiplied by the revised, lower, population to give the revised total Entitlement.

Revised population data will impact Entitlements for the 2000-01 to 2003-04 fiscal years for Equalization and CHST.

4. Resolution of the Federal Misallocation of Income Tax Revenue

A year ago there remained considerable uncertainty over how the Federal Government intended to resolve the problem of the large overpayment of Personal Income Tax revenues to some provinces resulting from a federal accounting error. The federal Canada Customs and Revenue Agency issued a statement January 29, 2002 to indicate that because of a serious tax accounting problem, four provinces had received in excess of \$3.3 billion in overpayments dating back to 1993, and possibly more, going back to 1972. This was referenced in last year's Provincial Budget Paper B and because it implicated the Equalization program, Prince Edward Island was in a position to lose Equalization in 2002 depending on the federal decision over recovery of the overpayments. The tax accounting problem concerned the way the value of Capital Gains earned by Mutual Fund Trusts were accounted for, and it was known as the T 3 issue.

On September 4, 2002 the Federal Minister of Finance made a decision concerning the overpayments, and the treatment of Equalization. The Minister noted that the Auditor General was able to verify the overpayments for the years 1997 to 1999 only, which amounted to \$2.5 billion of the \$3.4 billion total amount believed to have been overpaid since 1993. Of that amount \$2 billion was overpaid to Ontario, \$364 million to Manitoba, \$96 million to BC and \$3 million to Alberta. She also noted that an estimated \$995 million in excess Equalization entitlements was paid to receiving provinces between 1997 and 1999 as a result of the excess tax revenues that were created.

Acknowledging that the problem was entirely the responsibility of the Federal Government the Finance Minister decided to limit the operable period to the 1997-1999 years, forego recovery of excess Equalization overpayments and allow an equivalent compensating adjustment to apply to all provinces. The result is shown in Table B.7.

Province	1997-1999 Overpayments	Equalization Impact	Equivalent Benefit	Final Amount to be Recovered
\$ Millions				
Newfoundland and Labrador	0	49	0	0
Prince Edward Island	0	13	0	0
Nova Scotia	0	84	0	0
New Brunswick	0	68	0	0
Quebec	0	607	0	0
Ontario	2,074	0	744	1,330
Manitoba	364	(202)	71	91
Saskatchewan	0	92	0	0
Alberta	3	0	3	0
British Columbia	96	285	96	0
Canada	2,537	995	914	1,421

Source: Federal Department of Finance

In the case of Prince Edward Island, the decision removed the provincial concern that an estimated \$13 million of Equalization, that federal Finance claimed had been overpaid, would be recovered. It might be noted that Prince Edward Island and other Equalization receiving provinces disputed the validity of the federal claim, given the circumstances of the accounting error.

The effect of the federal resolution is to limit recoveries to Ontario, in the amount of \$1.33 billion and to Manitoba, \$91 million, for a total recovery of \$1.4 billion. These recoveries will start in 2004-05 and are to be spread over 10 years.

The new arrangement also called for a revision to the Equalization formula backdated to 2001-02. This corrects the measurement of fiscal capacity in the formula, by removing the Mutual Fund T3 Capital Gains amounts from the Equalization income tax base. Manitoba received a one time payment of \$140 million to compensate them for the problem that remains in the 2000-01 year's estimated entitlement. A negative adjustment to equalization entitlements for Prince Edward Island and other receiving provinces has resulted from this revision. For Prince Edward Island it amounts to approximately \$3 million. This was one of the factors reducing Prince Edward Island's Equalization revenue in 2002-03.