BUDGET PAPER B:
FEDERAL FISCAL ISSUES

This Budget Paper provides further information on the Province's federal fiscal issues.

Federal Budget Impacts

A critical problem for Provincial Government finances is reductions in the transfer payments received from the Federal Government. The 1998 Federal Budget introduced measures to halt future cuts to transfers, but failed to restore provincial funding to previous levels.

The Federal Government has succeeded in solving its deficit problem through significant increases in tax revenues and reductions in program spending. The dramatic improvement in federal finances over the last four years was achieved through a $32 billion revenue increase and a $14 billion cut in program expenditures, despite a $4 billion increase in debt charges. Federal program spending levels are currently 13.2 per cent lower than they were four years ago. Major expenditure cutbacks, although necessary to restore health to federal finances, have direct negative consequences for Canadians.

The cutbacks that were chosen by the Federal Government have had their greatest impacts on the budgets of provincial governments. The biggest cash saving for the Federal Government has come from reductions in the federal financial assistance provided to provinces for the support of social programs - health, welfare and post-secondary education.

In 1996-97, the Federal Government replaced two long-standing federal social transfers to provinces, the Canada Assistance Plan (CAP) and Established Programs Financing (EPF) with the new Canada Health and Social Transfer (CHST). As an explicit measure to cut federal expenditures, the federal government provided considerably less cash funding for provinces under the new regime. For 1997-98, CHST cash entitlements for provinces are **$5.9 billion lower** than the entitlements for the social programs in 1995-96. This amount closely matches the $6.0 billion reduction in overall federal program spending between 1995-96 and 1997-98.

The federal government also claims that the value of income tax percentage points transferred to the provinces in the 1960's and 1970's, whose value grows every year, is part of their transfer to provinces for social programs. Provinces, on the other hand, consider the value of transfers to be the actual cash amounts received from the federal government, as the tax points are not recorded as program expenditures in the federal Public Accounts.

The large reductions in transfers are occurring in a world where the cost pressures for social programs are rising.

During the 1997 Federal Election campaign, Prime Minister Chrétien announced that a Liberal government would extend the CHST cash floor beginning in 1998-99, thereby guaranteeing that total annual payments to provinces under the CHST would not fall below $12.5 billion after that year. The federal government later expanded this commitment to apply in 1997-98 as well and amended the relevant legislation in the 1998 Federal Budget.

Previous to this program change, Prince Edward Island's CHST cash transfer had been slated to drop by a further $1 million in 1997-98, $3 million in 1998-99, and $3 million in 1999-00, and then stabilize. That would have represented a $35 million short-fall in annual revenues by 1999-00, as compared to 1995-96 - from $88.8 million down to $53.2 million. As officially announced in the 1998 Federal Budget, these **additional** declines will not be implemented. Instead, annual CHST revenue for the Province is projected to level out at $60.2 million in 1999-00, for an annual loss of $28.6 million in federal funding for health, education and social services on Prince Edward Island.

This is still a substantial reduction. Taking these amounts out of the Provincial Budget has a major impact on the level of public services. This in turn puts a large damper on the provincial economy.

Federal Social Cash Transfers to PEI
1995-96 to 1999-00

	CHST Cash	EPF Revenue	CAP Revenue	Total
		($ 000's)		
1995-96	-	52,394	36,411	88,805
1996-97	71,635	(1,482)	6,028	76,181
1997-98*	61,697	700	4,500	66,897
1998-99*	60,050	(100)	400	60,350
1999-00*	60,200	0	0	60,200

* *PEI Provincial Treasury projections*

Note: EPF (Established Programs Financing) and CAP (Canada Assistance Plan) revenues are not the same as the Entitlements. Program revenues continue to accrue after 1995-96 as open claims are settled. CHST and EPF revenues are combined in Provincial Budget revenue schedules.

Significant cutbacks have also been made to other provincial transfers:

- regional economic development monies to the Province under the Economic Regional Development Agreement program were reduced from $19.2 million in 1994-95 to $4.6 million in 1997-98 - a decrease of $14.6 million per year.

- the elimination of the PUITTA transfer reduces government revenue by about $2.5 million annually; and

- changes to the Fiscal Stabilization Program will increase the Province's exposure to large revenue declines in the future. The program's intent is to insure provincial revenues against year-over-year decreases, but eligibility has been severely restricted in recent years.

The net result of all the federal changes to the Provincial Budget has been a significantly lower share of revenue from the federal government as evidenced in the table below.

Own-Source vs. Federal Revenues of the Government of Prince Edward Island
1994-95 to 1998-99

	1994-95	**1995-96**	**1996-97**	**1997-98***	**1998-99***
Current Revenue			**($ millions)**		
Provincial	441.8	448.2	466.2	461.6	458.3
Federal	332.4	308.4	286.9	287.2	287.6
Current Revenue Shares			**(per cent)**		
Provincial	57.1	59.2	61.9	61.6	61.4
Federal	42.9	40.8	38.1	38.4	38.6

* *PEI Provincial Treasury projections*

Federal Equalization

The federal Equalization transfer is the single largest source of revenue of the Government of Prince Edward Island. Without it, Prince Edward Island could not offer the level of public services it does. Unfortunately, for budget purposes, it has proven to be a variable and highly unpredictable revenue source.

Equalization Revenue - Prince Edward Island

	1994-95	1995-96	1996-97 ($ millions)	1997-98*	1998-99*
Equalization Revenue	200.8	187.9	187.2	201.6	209.0

* *PEI Provincial Treasury projections*

The federal government has not explicitly curtailed the Equalization Program as part of its deficit reduction strategy, but past experience has shown it to be subject to major annual variations, making budgetary planning difficult. Equalization Entitlements are determined by a complex formula that measures each province's capacity to generate revenues relative to other provinces. The Equalization formula essentially raises poorer provinces up to a "standard" level of provincial revenue on a per capita basis.

The key determinant of Equalization Entitlement is a province's economic performance relative to that of the "Standard Provinces", which are Quebec, Ontario, Manitoba, Saskatchewan and British Columbia. The specific factors which determine a province's Entitlements under the Equalization formula can be grouped under the following categories:

1. Local economic performance relative to the Standard Provinces;

2. Total own-source provincial revenues in the country; and

3. A province's population relative to the Standard Provinces.

The Prince Edward Island economy performed well in making the transition from the years of construction of the Confederation Bridge, but in 1997 its rate of economic growth fell behind the national average for the first time in recent years. This slower economic growth relative to the Standard Provinces is the primary factor behind Prince Edward Island's increase in Equalization Entitlements in 1997-98 and beyond.

Another important factor affecting Equalization each year is total provincial own-source revenue growth in Canada. This also raises the standard to which recipient provinces are equalized. Steady growth in the national economy throughout 1997-98 improved provincial revenue collections considerably. Weakened prices for natural resources and concern about the Asian financial crisis have slightly dampened revenue growth projections into 1998-99, but the continued growth predicted for Ontario and Alberta outweigh these concerns.

Because the calculations, as well as those which determine CHST entitlements, are on a per capita basis, another key factor in determining Equalization is a province's relative population share. In recent years the Island has maintained its population share with the help of the migration into the province, in part associated with the construction of the Confederation Bridge. Population grew slightly in 1997, which helped revenues under both transfer programs. Continued growth, albeit at a slower pace, forms the basis of revenue forecasts to 2000-01.

In 1998-99, Statistics Canada will finalize their revisions to their national and provincial population series, consistent with the results of the 1996 Census. Prince Edward Island experienced a large downward revision to its population share, and consequently to federal transfers, when revisions consistent with the 1991 Census were finalized. The revenue projections for both Equalization and CHST embodied in this Budget incorporate contingency factors to allow for possible transfer declines from such potential Census revisions.

Short-term Outlook

The Prince Edward Island economy is expected to grow moderately in 1998, but at a pace somewhat below the national average. This will increase Equalization, all other things held equal. Furthermore, there is generally about a one year delay before most of the economic data used in the Equalization formula becomes available. Revenues in a given year are the sum of Entitlements for that year plus adjustments to previous years' Entitlements which are made on the basis of more current statistical and revenue information. As statistics on relative growth become available for 1997 and 1998, upwards adjustments to previous Entitlements are expected throughout 1998-99. The magnitude of these adjustments have been estimated and incorporated into the total Equalization revenue forecasts.

The main factor which is predicted to dampen growth in Prince Edward Island's Equalization Entitlements is population. The Province's national population share is forecast to decrease in 1998-99. Some out-migration is predicted, but not to a degree to overwhelm natural population growth (i.e. births less deaths), for a small net increase in provincial population. This growth is not expected to be sufficient to maintain Prince Edward Island's current population share.

In 1998-99, the Equalization and CHST forecasts both incorporate contingency factors to reflect the fiscal uncertainty which accompanies the release of the final adjustments to population from the 1996 Census.

Medium-term Outlook

In the medium term, Prince Edward Island's Equalization revenue growth will depend on the three factors highlighted above, as well as any changes made to the federal legislation in April 1999. The Equalization program is jointly reviewed every five years by the federal and provincial governments to ensure that the formula is consistent with the constantly-evolving provincial tax structures and the most appropriate statistical sources.

It is expected that continued growth nation-wide in provincial own-source revenues and moderate growth in Prince Edward Island relative to that of the Standard Provinces will serve to increase Entitlements by roughly 2 per cent annually, allowing for decreases in the Province's share of Canada's population.

The fiscal position and public service choices of other provinces will also determine changes to Equalization revenues into the medium term. In the event of tax reductions in other provinces, Equalization payments to poorer provinces would decline in step. If provincial taxes were increased across Canada to cover expanded or more costly public services in the medium term, total own-source provincial revenues would grow, as would Equalization Entitlements, other things held equal.