Federal Transfer Programs to the Provinces

Background Paper
for public consultation

Québec
Commission sur le déséquilibre fiscal

COMMISSION ON FISCAL IMBALANCE

FEDERAL TRANSFER PROGRAMS TO THE PROVINCES

BACKGROUND PAPER FOR PUBLIC CONSULTATION

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INTRODUCTION

There is an elaborate and complex set of transfer programs in Canada from the federal government to the provinces. These programs have a variety of objectives: redistribution of wealth among the regions, funding of programs dealing with pan-Canadian concerns, specific regional or sectoral objectives, etc. This background paper describes these programs, their objectives and how they work.

The first chapter gives a general overview of federal transfer programs in the specific context of Québec. Chapters 2 and 3 respectively describe the two major programs: the Canada Health and Social Transfer, and Equalization. Chapter 4 discusses the major features of the process of renewing these programs, while the last chapter deals with other federal transfer programs.

Chapter 1

OVERVIEW OF FEDERAL TRANSFER PROGRAMS TO THE PROVINCES

Many programs transfer funds from the federal government to the provinces. This chapter briefly describes these programs in the specific context of Québec.

Federal transfers to Québec

In 2001-2002, the federal government is expected to pay transfers to Québec totalling $9.5 billion.

TABLE 1

FEDERAL TRANSFERS TO QUÉBEC, 2001-2002
(millions of dollars)

	Amount
Canada Health and Social Transfer (CHST)	2 960
Equalization	5 615
Sub-total	8 575
Other programs	
Transfers to the Québec government	535
Transfers to consolidated organizations	359
Sub-total	894
Other transfers tied to the fiscal arrangements	
The Fiscal Stabilization Program	—
The preferred share dividend tax payment	15
Sub-total	15
Total	**9 484**

Source: 2001-2002 Québec Budget.

These transfers include the following components:

- the Canada Health and Social Transfer ($3 billion) is the main federal funding contribution to provincial health, education and social assistance programs.
- Equalization ($5.6 billion) is designed to enable all provinces to offer generally comparable services at generally comparable levels of taxation.
- Other programs ($894 million) encompass a series of programs covering specific activities arising mostly from bilateral agreements between the federal government and Québec.

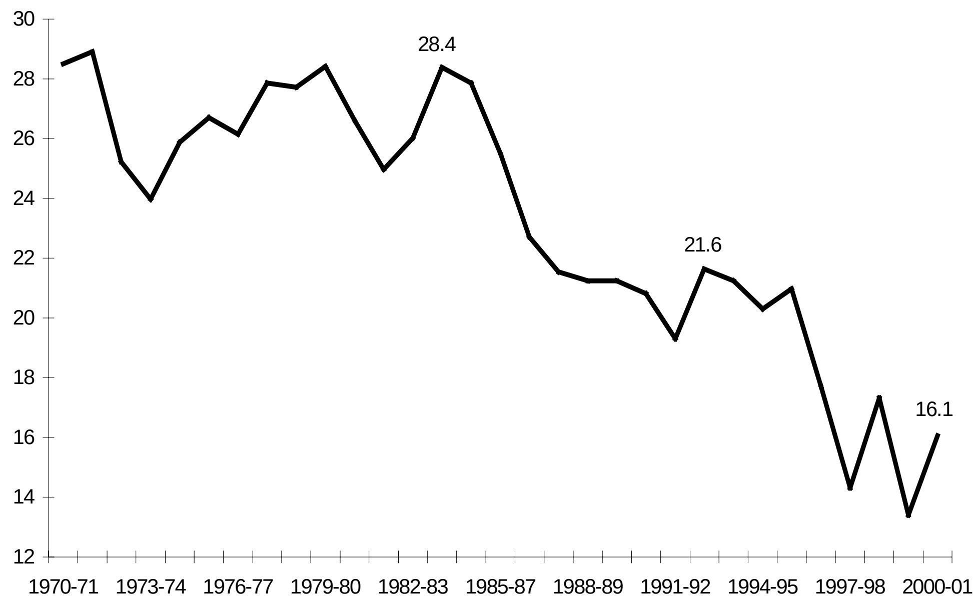
➢ Other transfers tied to the fiscal arrangements, including payments under the Fiscal Stabilization Program, for which no payment is expected in 2001-2002, and those under the transfer to the provinces of a portion of the yield of the federal tax collected on preferred share dividends ($15 million).

Federal transfers in context

Federal transfers have accounted for a decreasing share of the Québec government's revenue since the early 1980s. In 2000-2001, they amounted to only 16% of Québec's revenue compared to over 28% in 1983-1984.

CHART 1

FEDERAL CASH TRANSFERS TO QUÉBEC, 1970-1971 TO 2000-2001
(as a percentage of Québec's total revenue)

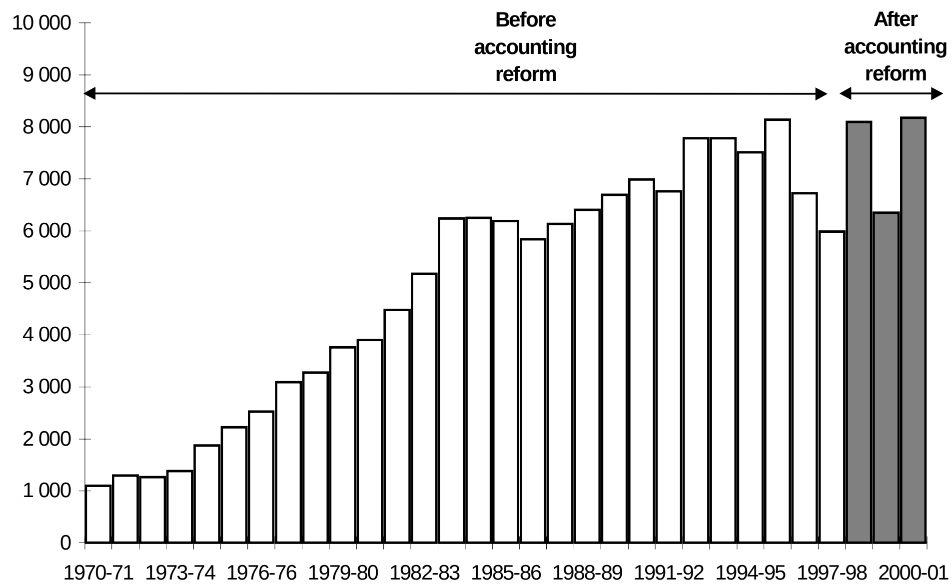


Source: 2001-2002 Québec Budget.

These transfers had grown substantially in absolute value prior to 1983-1984, then began falling in 1993-1994, before finally stabilizing in 2000-2001.

CHART 2

FEDERAL CASH TRANSFERS TO QUÉBEC, 1970-1971 TO 2000-2001
(millions of dollars)



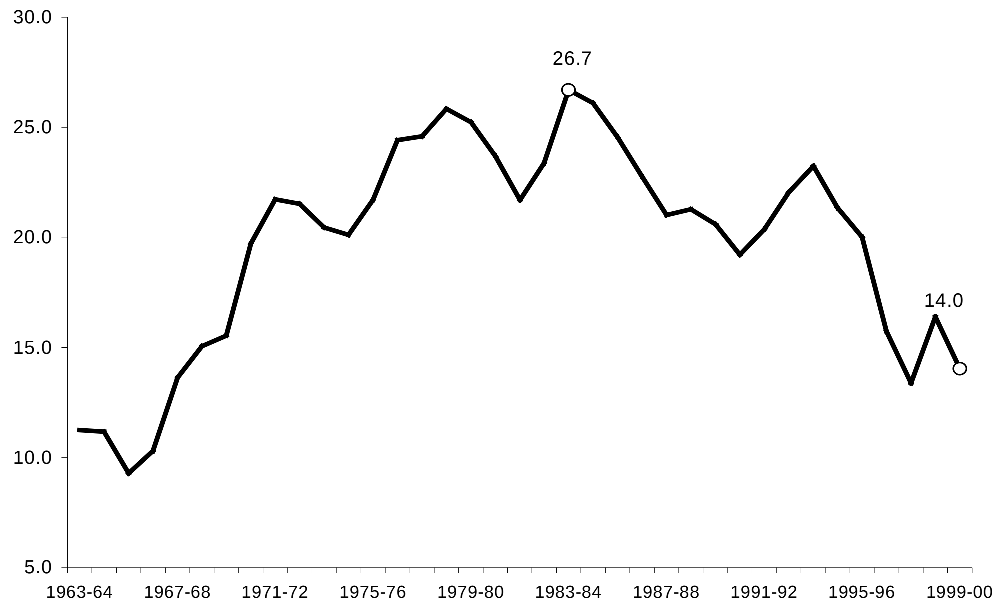
Note: In 1998-1999, the Québec government undertook a reform that expanded the government accounting entity to include various organizations under its jurisdiction. Under this reform, federal transfers paid to these organizations are consolidated with those paid to the Québec government directly.

Source: 2001-2002 Québec Budget.

In addition, the amount of transfers to the provinces in relation to the revenue collected by the federal government has also fallen substantially since the early 1980s. In 1983-1984, the federal government paid over one quarter of its revenue in transfers to the provinces; by 1999-2000, that proportion had fallen to 14%.

CHART 3

MAJOR FEDERAL CASH TRANSFERS AS A PROPORTION OF FEDERAL GOVERNMENT REVENUE, 1963-1964 TO 1999-2000
(per cent)



Sources: Commission on Fiscal Imbalance; Public Accounts of Canada.

Chapter

2

THE CANADA HEALTH AND SOCIAL TRANSFER (CHST)

The Canada Health and Social Transfer (CHST) is the major federal funding contribution for provincial programs “in respect of health, post-secondary education, social assistance and social services, including early childhood development”.[1] It is a block transfer program, meaning there is no allocation among the various spending sectors it helps to fund.

The CHST was implemented in 1996 and replaced two programs.

- *Established Programs Financing (EPF)*: this program was the federal contribution to funding provincial spending on health and post-secondary education. Amounts paid under EPF were allocated among the provinces according to their share of the population.

- *The Canada Assistance Plan (CAP)*: this program was the federal contribution to funding provincial income security programs. The federal government paid the provinces 50% of their eligible expenditures.[2]

However, it should be noted that until 1977 (the year EPF was created), all the transfer programs that have been replaced by the CHST were programs that, essentially, provided for equal cost sharing between the federal government and the provinces. The CHST accordingly is the culmination of a slow transition from the cost-sharing model of the 1950s and 1960s to a structure based exclusively on block funding.

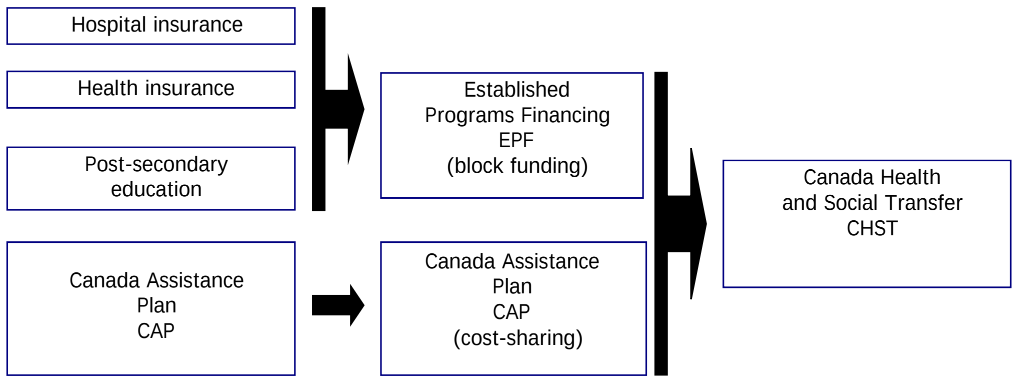
1 See the *Federal-Provincial Fiscal Arrangements Act*, Part V, section 13(4).

2 Some Québec income security programs, such as the PWA program, were not eligible for cost-sharing under the CAP.

CHART 4

FEDERAL FUNDING OF SOCIAL PROGRAMS SINCE 1957

Shared-cost programs	Mixed funding (cost-sharing and block funding)	Block funding
1957-1976	1977-1995	Since 1996



How the program works

The calculation of the amounts paid to the provinces under the CHST involves two major steps.

Step 1: The federal government determines the amount of the transfer for all the provinces.

The amount of the cash transfers to be paid under the CHST until 2005-2006 is stipulated in Part V of the *Federal-Provincial Fiscal Arrangements Act*. The determination of this amount is discretionary. It is independent of economic variables and the cost of programs of the provinces that receive the transfers. There is no formal indexing mechanism that can be used to forecast the amounts paid under the program.

TABLE 2

CHST CASH TRANSFERS STIPULATED UNDER PART V OF THE FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS ACT
(billions of dollars, excluding trust accounts)

Year	Amount
1999-2000	12.5
2000-2001	13.5
2001-2002	17.3
2002-2003	18.6
2003-2004	19.3
2004-2005	20.4
2005-2006	21.0

Step 2: Allocation of federal transfers among the provinces.

The rule for allocating CHST transfers among the provinces is based on three main components:

- The amount of federal cash transfers for Canada as a whole (step 1).
- The federal government's estimate of the value of the tax space it relinquished in favour of the provinces in 1977,[3] i.e. 14.9% of the basic federal tax and 1% of taxable corporate income.
- Each province's share of the population of Canada.

The CHST is allocated first of all by determining the total entitlements under the program for Canada as a whole. These entitlements correspond to the sum of the cash transfers and the value of the tax points ceded back to the provinces as estimated by the federal government. These total entitlements are then allocated among the provinces according to their share of the population of Canada.

[3] In 1977, the federal government increased the number of personal income tax points it relinquished to the provinces to 14.9, and the number of corporate income tax points it relinquished to one point, so that the provinces could occupy these tax fields without affecting the tax burden. In 2001-2002, the value of this tax space amounts to $14.5 billion.

The federal government determines the amount of cash transfers to each province by subtracting the value of tax points from total entitlements. An additional step is needed in Québec's case. Québec is the only province that, in the early 1960s, chose to convert certain cash transfer programs into an additional transfer of tax points. This abatement represents 13.5%[4] of the basic federal personal income tax and its value is subtracted from the transfers paid to Québec under the CHST.

The following table shows, for 2001-2002, the calculation of the amount the federal government will actually pay to Québec under the CHST.

TABLE 3

CALCULATION OF THE CHST CASH TRANSFER TO QUÉBEC, 2001-2002
(in millions of dollars)

CANADA	
Cash transfers in Canada (Part V of the Fiscal Arrangements Act)	17 300
Value of tax points in Canada	15 748
Total entitlements in Canada	**33 048**
QUÉBEC	
Demographic weight of Québec	23.9%
Total entitlements to Québec	**7 884**
Less: value of tax points according to the federal government	
• 14.9% of BFT	-2 639
• Equalization associated with BFT	-580
• 1% of TCI	-306
• Equalization associated with TCI	-1
CHST in Québec	**4 358**
Less: Special Québec abatement (13.5% of BFT)	-2 389
CHST cash transfer to Québec (federal cheque)	**1 969**

BFT: Basic federal tax (personal).
TCI: Taxable corporate income.
Source: Department of Finance Canada.

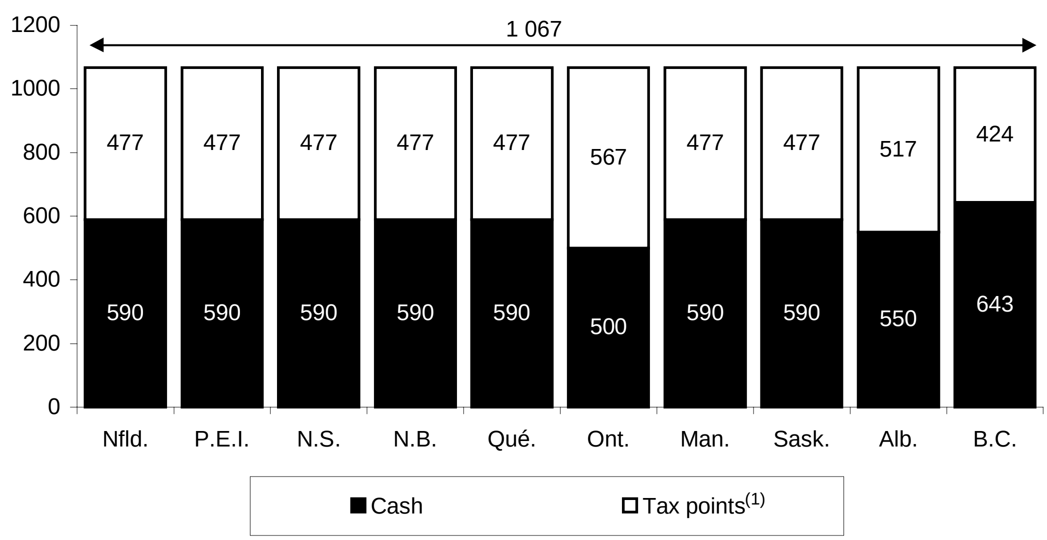
4 The Québec abatement is 16.5 basic federal tax points. However, Québec returns the value of three basic federal tax points to the federal government for the youth allowance, a program that ended in 1974 and for which Québec had negotiated a tax abatement in 1964.

It is important to note that the allocation of total CHST entitlements on an equal per capita basis does not produce equal per capita cash transfers to the provinces. This is because the federal government, in the CHST allocation formula, takes into account the tax space ceded back to the provinces in 1977. Since the value of this tax space is greater in the wealthier provinces and equalization does not completely equalize the fiscal capacities of the provinces, their cash transfers are lower than in the less wealthy provinces.

The following chart illustrates this situation. While the *per capita* entitlements of all the provinces are equal ($1 067 in 2001-2002), Ontario and Alberta receive respectively $90 and $40 less per capita than the other provinces (cash transfers). British Columbia, which does not receive equalization but whose fiscal capacity for personal income tax is less than the standard,[5] receives $53 more per capita than the other provinces under this formula.

CHART 5

COMPOSITION OF TOTAL CHST ENTITLEMENTS, 2001-2002
(dollars per capita)



1 Including the value of the associated equalization.
Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

5 The five-province standard, as described in Chapter 3 on the equalization program.

The CHST in action

The federal trust accounts

In addition to the CHST cash transfers, whose calculation is explained above (see Table 3), the provinces receive monies from trust accounts and special funds the federal government has set up in recent years. These funds are allocated among the province on an equal per capita basis and there is some flexibility as to when the provinces can withdraw funds from these accounts.

In its 1999-2000 budget, the federal government deposited $3.5 billion in trust, of which Québec's share was $840 million. This amount must be withdrawn no later than March 31, 2002. In its 2000-2001 budget, the federal government set up a new trust account of $2.5 billion, of which $596 million is reserved for Québec. The amounts in this second trust account must be withdrawn no later than March 31, 2004. Lastly, following its announcement in September 2000, the federal government deposited $1 billion in a new trust account to fund medical equipment, of which $239 million was earmarked for Québec. Funds must be withdrawn from this last trust account no later than March 31, 2002.

TABLE 4

WITHDRAWALS FROM CHST TRUST ACCOUNTS BY THE QUÉBEC GOVERNMENT
(millions of dollars)

	1999-00	2000-01	2001-02	2002-03	2003-04	Total
Proposed federal timetable						
Trust account 1: $3.5 MM in Canada	480	240	120			840
Trust account 2: $2.5 MM in Canada		238	119	119	119	596
Trust account 3: $1 MM in Canada		120	119			239
Total	**480**	**598**	**358**	**119**	**119**	**1675**
Timetable adopted by Québec						
Trust account 1: $3.5 MM in Canada		420	420			840
Trust account 2: $2.5 MM in Canada			345	251		596
Trust account 3: $1 MM in Canada			239			239
Total	**0**	**420**	**1004**	**251**	**0**	**1675**

Sources: 2000-2001 Federal Budget and 2001-2002 Québec Budget.

Amounts paid to the provinces through these accounts are non-recurring. Once a province has exhausted its allotment, it cannot obtain new funds from the federal government to maintain the level of its spending.

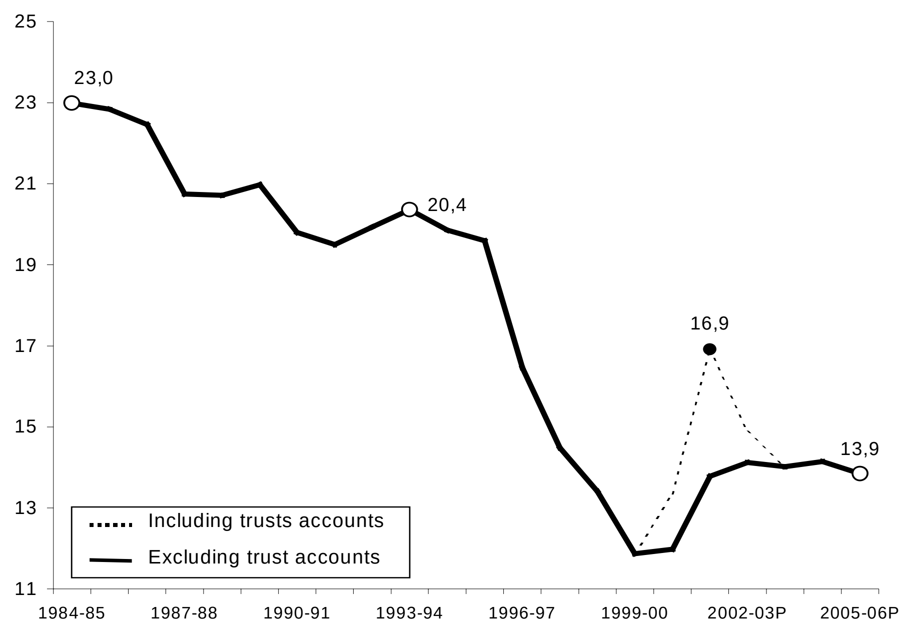
Adequacy of federal funding

The advent of the CHST raises the issue of the adequacy of federal funding in relation to the provinces' financial obligations regarding health, education and income security.

The federal contribution to funding for these programs shows a clear downward trend. For example, the federal contribution, as a proportion of social spending in Québec, is expected to drop from 20.4% in 1993-1994 to 13.9% in 2005-2006, i.e. a decrease of almost seven percentage points in just over a decade. This decline in federal funding comes despite the recent reinvestments in the CHST announced by the federal government.

CHART 6

CHST CASH TRANSFERS TO QUÉBEC AS A PROPORTION OF HEALTH, EDUCATION AND SOCIAL ASSISTANCE SPENDING
(per cent)



Source: 2001-2002 Québec Budget.

Furthermore, the federal cutbacks began well before the CHST was introduced. For instance, limits were imposed on the growth in transfers under Established Programs Financing (EPF) in 1983. This was also true of the Canada Assistance Plan (CAP) in the late 1980s, though the latter measures did not affect Québec until 1993-1994.

The true extent of federal funding

The federal government and the provinces disagree as to the true size of the federal CHST transfer. The disagreement concerns the treatment of tax points.

The federal government considers that the value of the tax space it ceded back to the provinces in 1977 is an integral part of its contribution to the funding of provincial social programs. As the federal government's September 2000 Economic Statement and Budget Update states: "Roughly half of the CHST support to provinces and territories takes the form of tax points."[6]

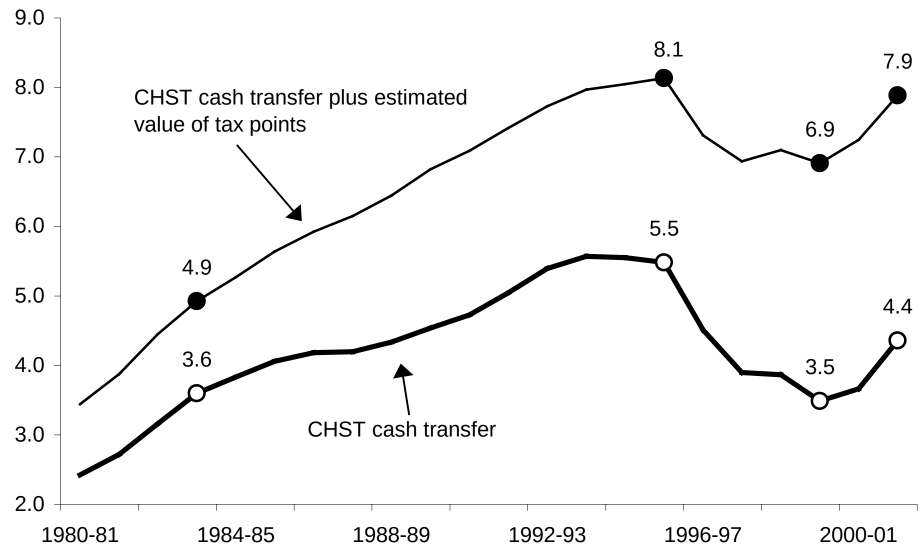
The provinces maintain that it is not legitimate to consider the value of tax points as an integral part of the CHST transfer. To support this position, the provinces note that most experts share this view, including the National Forum on Health set up by the federal government, which said in 1996 that: "*the federal government has no control over the use of these tax points, nor do they constitute an expenditure or revenue item in the federal budget. They do, however, provide a convenient shield for the federal government to reduce its cash outlays while claiming that overall entitlements are only frozen or marginally increasing. For these reasons, the Forum considers the inclusion of tax points in the federal contribution to be confusing and unhelpful.*"[7]

The following chart illustrates this idea. Including the value of tax points, total CHST entitlements in Québec in 2001-2002 are similar to their value in 1994-1995. However, when consideration is restricted to the cash contribution, Québec is seen to have suffered a shortfall of $1.1 billion.

6 Economic Statement and Budget Update, Department of Finance Canada, October 2000, page 120.
7 National Forum on Health, "Maintaining a National Health Care System", February 1996, p.11.

CHART 7

CHST TRANSFERS TO QUÉBEC,
1980-1981 TO 2001-2002
(billions of dollars, including the special Québec abatement)



Source: Department of Finance Canada.

It is questionable whether an assignment of tax space between orders of government constitutes a perpetual contribution to the finances of the receiving government. In 1942, to help finance the war effort, the provinces transferred all their direct taxes to the federal government.[8] However, they have never considered this transfer as a permanent contribution to federal programs (national defence, for instance), nor have they kept an explicit accounting of the value of this tax transfer.

Compliance with pan-Canadian standards

Payment of the CHST is subject to compliance with "*national criteria and conditions in the Canada Health Act, including those respecting public administration, comprehensiveness, universality, portability and accessibility, and the provisions relating to extra-billing and user charges".*[9] In addition, a province may not require a minimum length of residence in the province or in Canada as an eligibility condition for social assistance.

If a province fails to comply with these pan-Canadian standards, the federal government can reduce its transfer to the province by an amount it considers

8 Personal income tax, corporate income tax and succession duties.
9 Federal-Provincial Fiscal Arrangements Act, Part V, section 13(1).

appropriate. Under certain conditions, the federal government may even reduce other transfer programs by the financial penalties it decides to impose on a province that fails to comply with a national standard.

Some provinces maintain that the federal government cannot legitimately impose pan-Canadian standards when its financial contribution accounts for only a minimum part of the spending of programs to which such standards are to apply. Other provinces, including Québec, argue instead that the federal government may not, in any event, impose standards in a sector that lies within their jurisdiction.

Since the *Canada Health Act* was passed in 1984, the federal government has announced withholdings for a total of $255 million. However, the withholdings actually carried out amount to only $8.3 million, reflecting the fact that the provinces have essentially complied with the provisions of the law.

TABLE 5

SUMMARY OF WITHHOLDINGS, BY PROVINCE, SINCE PASSAGE OF THE *CANADA HEALTH ACT*
(millions of dollars)

	Announced withholdings	Actual withholdings
Newfoundland	0.3	0.3
Prince Edward Island	—	—
Nova Scotia	0.3	0.3
New Brunswick	6.9	—
Québec	**14.0**	**—**
Ontario	108.7	—
Manitoba	3.3	2.1
Saskatchewan	2.1	—
Alberta	32.6	3.6
British Columbia	86.8	2.0
Total	**255.0**	**8.3**

Note: Amounts may not add up to the totals shown due to rounding off.
Sources: Commission on Fiscal Imbalance; Health Canada.

Chapter

3

EQUALIZATION

The purpose of the equalization program is to reduce financial inequalities among the provinces by increasing the revenues of the governments of the less wealthy provinces. Federal payments are designed to enable these provinces to offer relatively comparable public services without substantially raising taxes.

The federal government has made equalization payments since 1957. The commitment to the principle of equalization was entrenched in the *Constitution Act, 1982* – section 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 payments are unconditional. The provinces are free to use the amounts paid by the federal government as they see fit.

How the program works

Part I of the *Federal-Provincial Fiscal Arrangements Act* and its regulations stipulate the details of how equalization is calculated and paid.

There are three steps in calculating a province's equalization entitlements.[10]

Step 1: Measure each province's per capita fiscal capacity and compare it with that of the provinces that make up the program's standard.

To set equalization entitlements, the first thing to do is to estimate the fiscal capacity[11] of the provinces for each of the 33 sources of revenue subject to the program. Since the tax structure (tax base, tax rate) can vary from province to province, setting fiscal capacity is based on the notion of a tax system that is representative of the various taxation practices of the provinces. A uniform tax system is thus used to estimate the fiscal capacity of each province. This system generally reflects the taxation practices used on average by the provinces, or those applied by most of them.

[10] Equalization entitlements correspond to the amounts due to a province for a given year pursuant to the application of the program's parameters. Entitlements may differ from payments to the extent that the amounts actually paid to a province reflect entitlements for the current year and adjustments made to those of previous years.

[11] Fiscal capacity corresponds to the capacity to collect revenue. It is generally measured by the per capita tax base.

A province's fiscal capacity as measured for equalization can accordingly differ appreciably from the tax base defined by its tax laws. For example, the equalization program imputes a fiscal capacity to Alberta for sales taxes even though the province has decided not to use this tax field.

The following table shows the 33 sources of revenue subject to equalization and, for each one, the amounts collected for all the provinces. Note that four sources of revenue, namely personal income tax, property taxes, general sales taxes and corporate income tax, account for almost 70% of revenue subject to equalization.

TABLE 6

SOURCES OF REVENUE SUBJECT TO EQUALIZATION FOR ALL PROVINCES, 2000-2001

(millions of dollars)

Source		Amount	Source		Amount
1	Personal income taxes	48 556.2	19	Level three heavy oil	39.2
			20	Natural gas	5975.3
2	Corporation income taxes	14 413.5	21	Oil and natural gas: sales of Crown leases	1026.2
3	Taxes on capital	4 602.8			
4	General sales taxes	28 144.8	22	Oil and natural gas: other revenue	381.9
5	Tobacco taxes	2 377.2	23	Mining resources	484.2
6	Gasoline taxes	5 124.3	24	Water power rentals	811.7
7	Taxes on diesel fuel	1 778.6	25	Insurance premium taxes	1467.2
8	Non-commercial motor vehicle licences	2 238.0	26	Payroll taxes	6570.1
			27	Provincial and local property taxes	33 080.2
9	Commercial motor vehicle licences	979.1			
			28	Lottery revenues	1 808.2
10	Alcoholic beverage revenues	4 319.9			
11	Hospital and medical care insurance premiums	1 545.0	29	Revenue from other games of chance	3 186.1
12	Race track taxes	21.9	30	Miscellaneous provincial and local revenue and taxes	7 842.5
13	Forestry revenues	1 759.8	31	Shared revenues: offshore activities (Newfoundland)	0.0
14	New oil	1191.2			
15	Old oil	285.8	32	Shared revenues: offshore activities (Nova Scotia)	0.2
16	Heavy oil	167.1			
17	Mined oil	979.6	33	Shared revenues: preferred share dividends	97.2
18	Level three oil	207.7			
				Total	**181 472.9**

Note: Amounts may not add up to the totals shown due to rounding off.
Source: Department of Finance Canada, fiscal year 2000-2001 (2nd estimate).

Once the fiscal capacity has been determined, for each source of revenue subject to equalization of each province, it is compared with the fiscal capacity of the provinces that make up the standard. This comparison indicates, for each source, whether a province has a surplus (fiscal capacity greater than the standard) or a deficiency (fiscal capacity lower than the standard).

The five provinces included in the standard are Québec, Ontario, Manitoba, Saskatchewan and British Columbia. The list excludes the province with the greatest capacity to collect revenue (Alberta) and the four provinces with the lowest capacity (the Atlantic provinces).

Step 2: Compensate disparities in fiscal capacity among the provinces.

Once the disparity between the fiscal capacity of each province and the five-province standard for each source of revenue is established, equalization entitlements are obtained by multiplying this disparity by the average tax rate for all the provinces,[12] then by the province's population. It is important to note that the equalization program works on a *per capita* basis, i.e. all these measures are expressed in dollars per capita. In addition, entitlements are negative if a province has a surplus for a given source, and are positive if the province has a deficiency.

The calculation of equalization entitlements for a source of revenue can be summarized in the following formula:

$$\text{Equalization entitlements for a source of revenue in a province} = \left[\text{Fiscal capacity of the standard } (\textit{per capita} \text{ tax base of the provinces that make up the standard}) - \text{Fiscal capacity of the province } (\textit{per capita} \text{ tax base of the province})\right] \times \text{Average tax rate of the 10 provinces} \times \text{Population of the province}$$

The terms in parentheses correspond to the province's deficiency (surplus) for the revenue source considered.

The following table shows the calculation of equalization entitlements for Québec for the tobacco tax base in 2000-2001.

[12] The average taxation rate of the ten provinces corresponds to the revenue subject to equalization divided by the estimated tax base following the application of the representative tax system.

TABLE 7

CALCULATION OF QUÉBEC'S EQUALIZATION ENTITLEMENTS FOR THE TOBACCO TAX BASE, 2000-2001
(dollars, per cent and population)

Equalization entitlements	=	Fiscal capacity (*per capita*) of the standard	–	Fiscal capacity (*per capita*) of the province	X	Average tax rate of the 10 provinces	X	Population of the province
- $92 866 000	=	$1 589	–	$1 847	X	4.9%	X	7 370 833
- $92 866 000	=		- $258		X	4.9%	X	7 370 833
- $92 866 000	=		- $12.6				X	7 370 833

Source: Department of Finance Canada, fiscal year 2000-2001 (2nd estimate).

In 2000-2001, Québec's surplus for the tobacco tax base was estimated at $258 dollars per capita. Since the average tax rate of the ten provinces was 4.9% and Québec's population was 7.4 million, Québec lost $92.9 million in equalization for this source.

Step 3: Add up the equalization entitlements of each tax base for each province.

The total of the estimated equalization entitlements for the 33 revenue sources subject to equalization constitutes the equalization entitlements for a province. If this amount is less than zero, the province receives no equalization. Neither does it have to pay money to the federal government since equalization is a transfer program funded from federal revenue and not through a direct contribution from the wealthier provinces.

The following table summarizes the calculation of equalization entitlements for Québec, Ontario and Canada as a whole for 2000-2001. Equalization entitlements for Québec are estimated at $4.7 billion. Note that Québec has a fiscal capacity above the standard for corporation income taxes, natural resources excluding oil and natural gas, and games of chance.

Ontario does not receive equalization, since the total of the entitlements for each tax base is $5.3 billion to the negative. Nonetheless, Ontario has a deficiency for the natural resources and games of chance tax bases.

TABLE 8

EQUALIZATION ENTITLEMENTS FOR QUÉBEC, ONTARIO AND THE RECIPIENT PROVINCES, 2000-2001
(in millions of dollars)

Sources of revenue		Québec	Ontario	Recipient provinces
1	Personal income taxes	2 104.2	- 3 295.7	4 205.2
2	Corporation income taxes	- 236.7	- 869.0	685.3
3	Taxes on capital	144.6	- 290.8	408.4
4	General sales taxes	599.1	- 596.8	956.7
5	Tobacco taxes	- 92.9	- 35.6	- 63.0
6-7	Taxes on gasoline and diesel fuel	186.9	- 99.5	80.5
8-9	Motor vehicle licences	33.9	- 50.6	55.5
10	Revenues from alcoholic beverages	81.1	- 31.9	109.1
14 à 22	Oil and natural gas revenues	557.1	860.6	38.3
13-23-24	Other natural resources	- 93.8	774.4	- 74.1
26	Payroll taxes	203.9	- 359.4	460.9
27	Provincial and local property taxes	947.2	- 766.5	2 094.9
28-29	Games of chance	- 95.7	46.8	- 2.5
11-12-25-30-33	Other sources	339.3	- 538.8	779.9
	Total	**4 678.2**	**-5 252.8**	**9 824.5**[1]

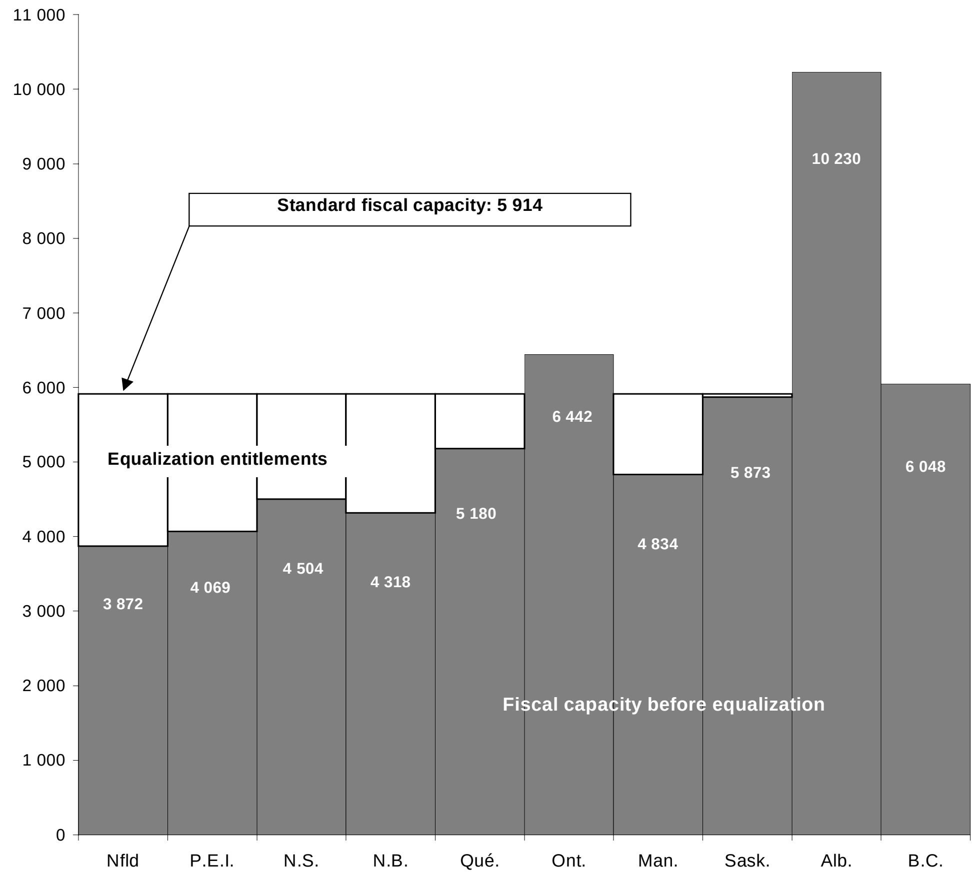
1 Including a payment of $89.6 million for Saskatchewan under the program's floor provision.
Note: Amounts may not add up to the totals shown due to rounding off.
Source: Department of Finance Canada, fiscal year 2000-2001 (2nd estimate).

Equalization in action

In 2000-2001, only three provinces had a fiscal capacity above the five-province standard ($5 914 per capita), namely Ontario, Alberta and British Columbia. Alberta has the highest fiscal capacity in Canada ($10 230 per capita). This is attributable in part to the size of its oil and natural gas revenues in a context of high prices. Newfoundland has the lowest fiscal capacity ($3 872 per capita).

CHART 8

FISCAL CAPACITY OF THE PROVINCES BEFORE AND AFTER EQUALIZATION, 2000-2001
(dollars per capita)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 2000-2001 (3rd estimate).

Changes to the program and to equalization entitlements

The changes to equalization entitlements since the program's creation in 1957 can be divided into three main phases.

- The program's imlementation phase: 1957 to 1966
  - The program applied mainly to three tax bases.[13]
  - The standard used consisted of the two wealthiest provinces.[14]

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[13] Apart from personal income tax, corporate income tax and estate taxes, various provisions allow for partial inclusion of revenue derived from taxes, duties and royalties on natural resources.

[14] In 1962-1963 and 1963-1964, the standard consisted of the ten provinces.

- The program's growth phase: 1967 à 1981

  — The program included all own-source revenue of the provinces as of 1967 and some revenue of local administrations beginning in 1973 (number of tax bases rises from 3 to 29).

  — The yield of the representative tax system rose because of economic growth and the continuous rise in the tax burden imposed by governments (development of new taxes and new tax bases).

  — The standard consisted of the 10 provinces.

  — 50% of oil revenue is excluded from the program.

- A limited growth phase: since 1982.

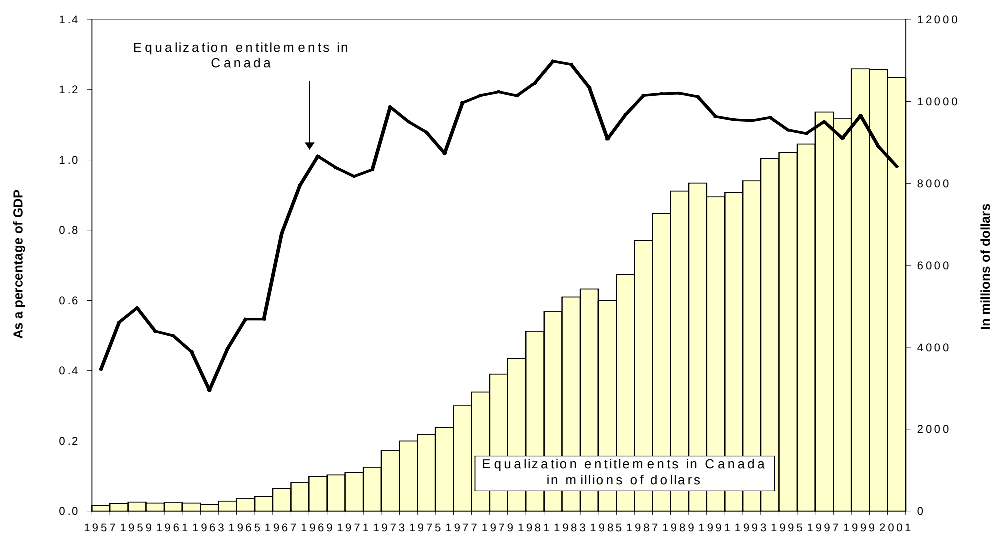
  — The federal government adopted the five-province standard.

  — Oil royalties are fully (100%) included.

  — Imposition of a cap and a floor.

CHART 9

EQUALIZATION ENTITLEMENTS IN CANADA, 1957-1958 TO 2001-2002
(as a percentage of GDP and in millions of dollars)



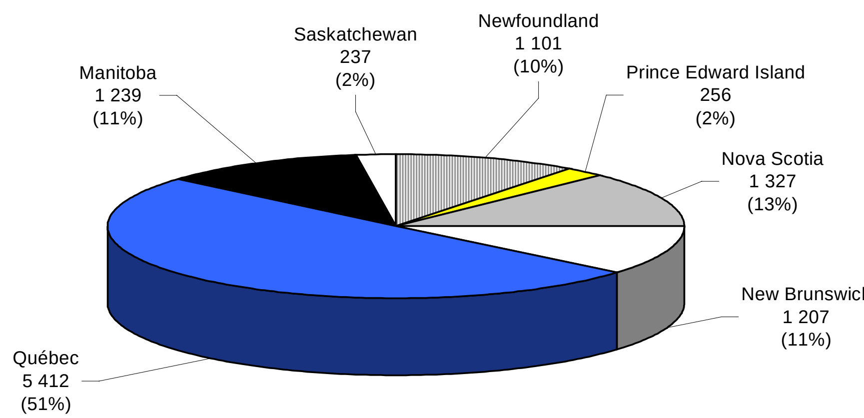
Sources: Commission on Fiscal Imbalance; Department of Finance Canada; Statistics Canada.

Breakdown of equalization entitlements among the provinces

The following two charts show the breakdown of equalization payments for 2000-2001. Québec should receive equalization of $5.4 billion for this year, i.e. about 50% of the payments for all of Canada. However, its per capita equalization entitlements ($734) are the second lowest, after Saskatchewan ($232). Québec therefore receives the largest amount of equalization transfers, not because it is the poorest province, but because of its large population.

CHART 10

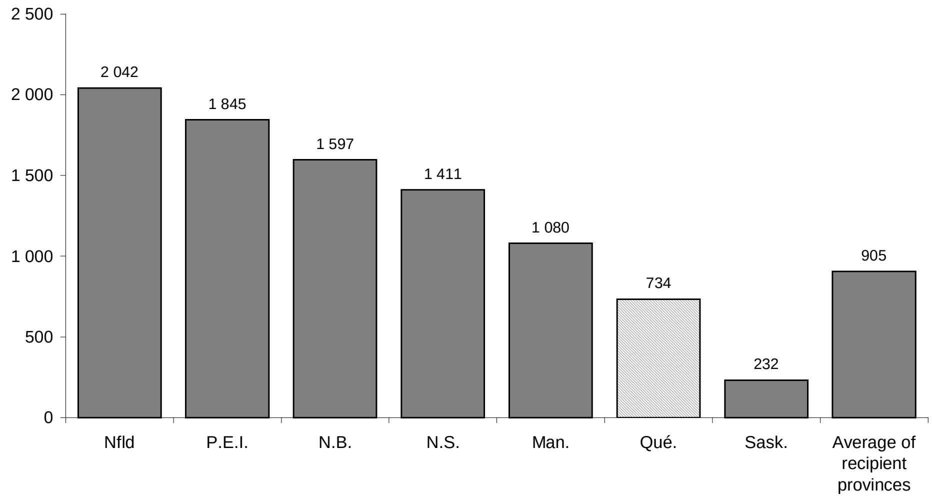
EQUALIZATION ENTITLEMENTS IN CANADA, 2000-2001
(percentage share and in millions of dollars)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 2000-2001 (3rd estimate).

CHART 11

EQUALIZATION ENTITLEMENTS, 2000-2001
(dollars per capita)



Source: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 2000-2001 (3rd estimate).

The mechanics of the payments

The Department of Finance Canada sets the equalization payments that will be paid to each province. The payments for a given fiscal year are made each month as of the first month of the fiscal year (for example: April 2001 for fiscal year 2001-2002). A preliminary calculation is initially made that is then adjusted during the year with the latest data available, each correction changing the remaining monthly payments for the rest of the year.

Other calculations are made once the fiscal year is over to adjust the amounts paid. The final data for a fiscal year are not available until 30 months after it has ended (for example: September 2004 for fiscal year 2001-2002). These calculations are made twice a year, normally in October and February. Accordingly, there are eight estimates for each fiscal year that can result in substantial adjustments to equalization entitlements (see the following table on equalization entitlements for 1997-1998).[15]

15 The same procedure is applied in a very similar manner to CHST payments. However, the resulting adjustments are much less substantial than for equalization.

TABLE 9

ESTIMATE OF EQUALIZATION ENTITLEMENTS FOR QUÉBEC, 1997-1998
(millions of dollars)

Estimate	Amount
1st estimate (February 1997)	3 878
2nd estimate (October 1997)	3 988
3rd estimate (February 1998)	4 059
4th estimate (October 1998)	4 177
5th estimate (February 1999)	4 820
6th estimate (October 1999)	4 673
7th estimate (March 2000)	4 747
Final estimate (September 2000)	4 745

Source: Department of Finance Canada.

The equalization payments a province receives during a given fiscal year depend on two factors:

- Changes to the calculation of entitlements for the current year.
- Adjustments to entitlements for preceding years.

This procedure can give rise to some spectacular adjustments. For instance, last February, the federal government made:

- The 5th estimate of equalization entitlements for 1999-2000.
- The 3rd estimate of equalization entitlements for 2000-2001.

These updates produced a positive adjustment of $1.8 billion to equalization payments compared to the estimated entitlements calculated in October 2000, including $1.5 billion for Québec.

Other features of the program

The program is shaped by many elements that give it a particular character, in particular, its own dynamics, the current reference standard (the five-province standard), the provisions restricting the program (cap and floor provisions) and its intrinsic complexity.

The dynamics of the program

The equalization program is sensitive to changes in provincial fiscal policy and to fluctuations in economic activity.

Provincial tax reductions

Within the last few years, the federal government and the provinces have introduced major tax reductions. However, these reductions cause a decrease in equalization payments for the recipient provinces since they reduce the revenue subject to the program.

The following table illustrates the impact on equalization payments of a reduction in the average tax rate of the ten provinces for three different sources of revenue. For instance, a personal income tax reduction of $1 billion results in a decline of almost $100 million in equalization revenue for all the recipient provinces, including $50 million in Québec alone.

TABLE 10

IMPACT OF A $1-BILLION REDUCTION IN THE TAX BURDEN FROM VARIOUS SOURCES
(millions of dollars)

	Personal income tax	Corporate income tax	Sales tax
Newfoundland	- 8	- 11	- 3
Prince Edward Island	- 2	- 2	- 1
Nova Scotia	- 8	- 13	- 3
New Brunswick	- 9	- 14	- 2
Québec	- 50	4	- 20
Ontario	–	–	–
Manitoba	- 8	- 12	- 4
Saskatchewan	- 11	- 13	- 2
Alberta	–	–	–
British Columbia	–	–	–
Recipient provinces	- 97	- 61	- 35

Sources: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 2000-2001 (3rd estimate).

Tax back effect

Because of how the equalization program works, an increase in economic activity in a province results in a more or less significant reduction in equalization payments to the province. This is consistent with the program's objective: a decrease in a province's relative poverty should result in a decrease in payments under the program designed to offset poverty. This corresponds to what is commonly called the tax back effect.

The tax back effect can potentially make it less interesting for provinces receiving equalization to implement measures to stimulate their economic development. For example, Newfoundland and Nova Scotia have, in the past, clearly expressed their concerns that development of their offshore oil and natural gas resources would generate little net benefit for the governments of these provinces because of the equalization tax back effect. In the 1980s, these provinces reached parallel agreements with the federal government to compensate them for the resulting equalization shortfall once their offshore oil and natural gas fields entered production.

The following table shows an estimate for Québec of the tax back effect associated with three revenue sources. It shows, for instance, that a 1% increase in wages and salaries paid in Québec's economy results in an increase in revenue from Québec personal income tax of $200 million. Similarly, this increase in wages and salaries would cause equalization payments to fall by the equivalent of 39% of Québec's additional revenue from personal income tax. There is also a significant tax back effect (60%) in the case of corporate income tax.

TABLE 11

EQUALIZATION TAX BACK EFFECT ON QUÉBEC
(millions of dollars)

Tax base	Event	Impact on own-source revenue	Impact on equalization	Tax back percentage
Personal income tax	1% increase in wages and salaries	200	- 78	39%
Corporate income tax	1% increase in taxable corporate income	40	- 24	60%
General sales taxes	1% increase in total consumption	75	- 25	33%

Sources: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 2000-2001 (3rd estimate).

A standard that fails to fully eliminate disparities in fiscal capacity

The existing standard of the equalization program (five-province standard) does not fully offset disparities in fiscal capacity among the provinces. Even after equalization, a disparity of 10% remains between the recipient provinces and the average of the 10 Canadian provinces. The disparity between Ontario and the recipient provinces is 8%.

Disparities in fiscal capacity among the provinces could be eliminated only by using a standard that corresponds to the fiscal capacity of the wealthiest province (Alberta). However, it would be extremely costly for the federal government ($112 billion in 2000-2001) to adopt such a standard.

Between 1967 and 1982, the period during which the ten-province standard applied, the equalization program was more effective in reducing disparities in fiscal capacity. The following table shows the amount of additional entitlements the provinces would have received had the ten-province standard been applied to equalization for 1998-1999 and 2000-2001.

These estimates show that in 2000-2001, application of a ten-province standard would have led to an increase in equalization transfers of $4.1 billion, or close to four times the estimated impact for 1998-1999. The reason for this difference is that this standard would have fully taken into account the additional fiscal capacity of Alberta resulting from the higher price of hydrocarbons and accordingly included the impact of this increase on the calculation of disparities in fiscal capacity.

TABLE 12

INCREASE IN EQUALIZATION ENTITLEMENTS STEMMING FROM THE APPLICATION OF THE TEN-PROVINCE STANDARD
(millions of dollars)

	1998-1999	2000-2001
Newfoundland	51	159
Prince Edward Island	13	41
Nova Scotia	87	277
New Brunswick	70	223
Québec	**681**	**2 173**
Ontario	—	—
Manitoba	106	338
Saskatchewan	95	302
Alberta	—	—
British Columbia	—	654
Recipient provinces	1 103	4 166

Sources: Commission on Fiscal Imbalance; Department of Finance Canada, fiscal year 1998-1999 (final estimate), fiscal year 2000-2001 (3rd estimate).

The cap on equalization entitlements

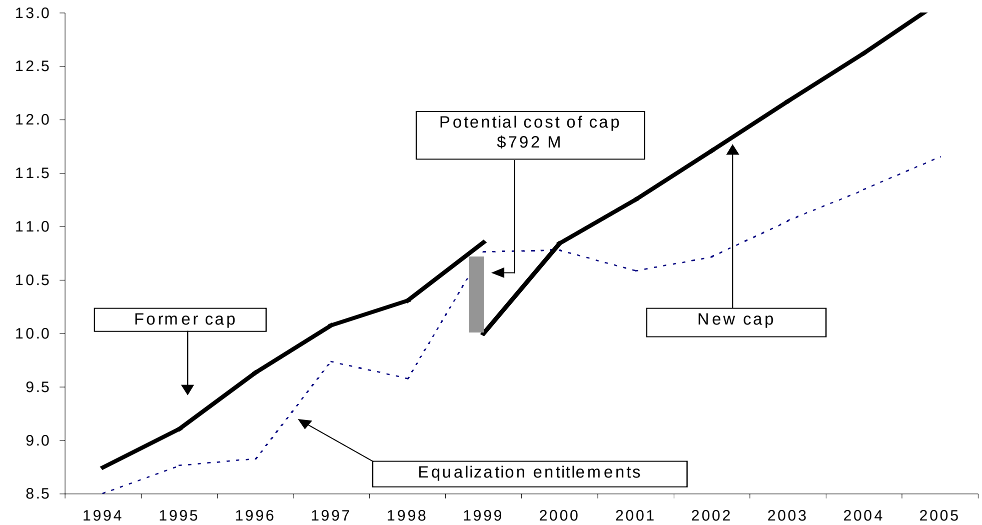
A cap on equalization entitlements was set in 1982. Since then, this provision was changed many times. In 1999, as part of the quinquennial adjustment of the equalization program, the cap was again made more restrictive (see following chart). Set at $10 billion for 1999-2000, the cap has since been indexed to the growth in nominal GDP.

Under the new terms of this provision, the cap would have applied in 1999-2000, depriving the provinces of $792 million. However, following the pressing requests of the provinces, the cap was suspended for 1999-2000.[16]

[16] Bill C-18, *Act to amend the Federal-Provincial Fiscal Arrangements Act*, received royal assent on June 14, 2001.

CHART 12

IMPACT OF THE MORE RESTRICTIVE CAP PROVISION RESULTING FROM THE 1999 RENEWAL
(in billions of dollars)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

The cap has been applied four times since it was implemented in 1982, depriving the recipient provinces of a total of $3 billion of revenue. Québec's shortfall amounts to $1.8 billion or 60% of the total. This share of the shortfall reflects the rule for allocating the impact of the cap among the provinces. Under the rule, the reduction attributable to a province corresponds to its demographic weight among all the recipient provinces rather than its share of equalization entitlements.

TABLE 13

REDUCTION IN EQUALIZATION ENTITLEMENTS STEMMING FROM THE APPLICATION OF THE CAP
(millions of dollars and per cent)

	1988-89	1989-90	1990-91	1993-94	Total $M	Total %	Share of entitle-ments (%)
Newfoundland	24	73	54	3	**154**	5.1	10.2
Prince Edward Island	5	17	12	1	**35**	1.2	2.4
Nova Scotia	38	113	85	4	**240**	8.0	12.3
New Brunswick	31	92	68	3	**194**	6.5	11.2
Québec	**284**	**855**	**644**	**33**	**1 815**	60.5	50.2
Manitoba	46	139	103	5	**293**	9.8	11.5
Saskatchewan	43	129	94	5	**270**	9.0	2.2
Total	**472**	**1 417**	**1 060**	**53**	**3 001**	100	100

Note: Amounts may not add up to the totals shown due to rounding off.
Source: Department of Finance Canada.

The floor provision

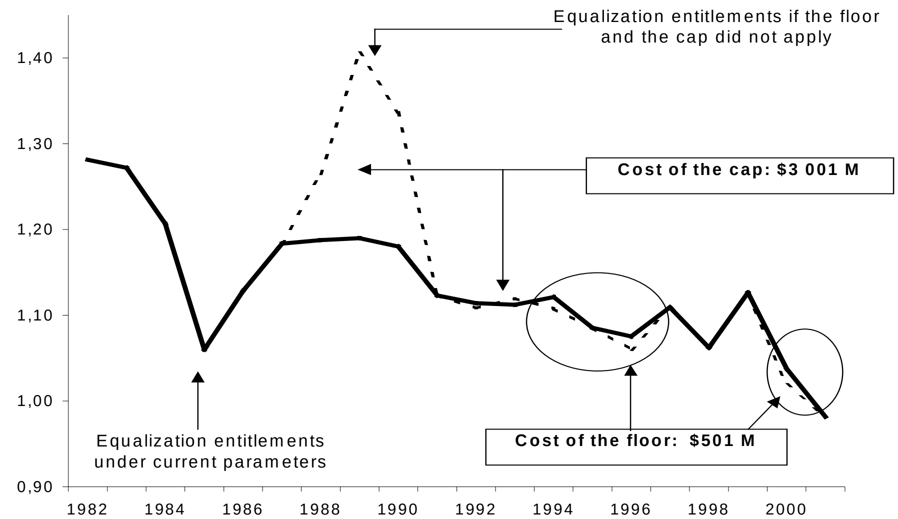
The floor provision is designed to protect provinces against a large sudden drop in equalization payments. In practice, the floor prevents per capita equalization entitlements from falling by more than 1.6% compared to the per capita fiscal capacity of the provinces that form the standard.

There appears to exist a degree of asymmetry between the protection the cap affords the federal government and that available to the provinces as a result of the floor. Since 1982, the cap has deprived the provinces of a total of \$3 billion of revenue[17] while the floor has cost the federal government only \$501 million.

[17] This amount would have been \$3.8 billion had the cap not been suspended for 1999-2000.

CHART 13

EQUALIZATION ENTITLEMENTS IN RELATION TO GDP
(per cent)



Sources: Commission on Fiscal Imbalance; Department of Finance Canada.

The program's complexity

The principle of equalization is relatively simple and can be understood intuitively. However, the application of the principle and the calculation of the amounts paid to the provinces are extremely complex. For instance:

- The estimates produced annually require about 3 000 variables, some of which demand special compilations that are not accessible by provincial ministries of finance.

- The taxation policies of the provinces are complex and varied, so it is often difficult to define a representative tax system that satisfies all the provinces and the federal government at the same time. Accordingly, defining certain tax bases often leads to significant disagreements between the provinces and the federal government and these disagreements are frequently exacerbated by the size of the amounts at stake.

For some, the program's complexity is a screen that prevents taxpayers from appreciating the true basis on which the federal government redistributes close to $10 billion among the provinces. For others, the current degree of complexity is a necessary price to pay to obtain more accurate estimates and, by the same token, a better allocation of equalization funds.

Chapter

4

THE PROCESS OF ADJUSTING EQUALIZATION AND THE CHST

Equalization and the CHST are adjusted on a periodical basis. The equalization program is reviewed every five years. Its Act and Regulations are in effect until March 31, 2004. As for the CHST, the legislation stipulates the amounts until 2005-2006, even though the federal government has undertaken to review the program in 2003-2004 when it will set the amounts to be granted in 2006-2007 and in 2007-2008.

Traditionally, each renewal is the culmination of a consultative process between the federal government and the provinces. Various aspects are discussed, ranging from purely technical matters (for instance, how payments and recaptures are to be made), to more fundamental aspects such as the definition of the equalization program's standard, a re-examination of the representative tax system, etc. In every case, however, the final decisions on the changes to be made rest with the federal government.

During the renewal process, the federal government and the provinces meet at three levels:

- the Sub-Committee on Transfers;
- the Fiscal Arrangements Committee;
- federal-provincial meetings of Ministers of Finance.

The Sub-Committee on Transfers

This sub-committee discusses technical issues. It consists of federal and provincial officials responsible for the administration and management of the programs. During its meetings, representatives of the federal and provincial governments present the results of their analyses and suggest technical improvements to the programs.[18] This sub-committee reports to the Fiscal Arrangements Committee.

[18] For example: changes to the sources of revenue used in equalization, macroeconomic approach.

The Fiscal Arrangements Committee

The Fiscal Arrangements Committee (FAC) consists of the assistant deputy ministers of the federal and provincial administrations responsible for the fiscal arrangements. During the Committee's meetings, the federal government advises the other members of its decisions concerning the renewal of transfer programs in light of the work done by the technical sub-committee. The provincial representatives have an opportunity to express their views on the proposals put forward by the federal government. The FAC also plans the program renewal process.

Federal-provincial meetings of Ministers of Finance

Issues relating to transfer programs are also dealt with at federal-provincial meetings of Ministers of Finance. These meetings provide an opportunity for the federal government and the provinces to discuss the strategic and political issues raised by the proposed changes to the equalization program and the CHST.

Chapter 5

OTHER TRANSFER PROGRAMS

Besides Equalization and the CHST, there are many other transfer programs of lesser financial importance. They can be divided into two main groups, namely other programs and other transfers tied to the fiscal arrangements. In Québec, revenues from these programs are expected to total $909 million in 2001-2002.

TABLE 14

FUNDING FOR OTHER PROGRAMS IN QUÉBEC, 2001-2002
(millions of dollars)

	Amount
Other programs	
Consolidated revenue fund	
Agreement on manpower administration	654
Canada Student Assistance Plan	129
Agreement on integration of immigrants	102
Aboriginal education	74
Other agreements	154
Sub-total	1 113
Repayment of the tax transfer for the youth allowance	- 578
Total	**535**
Consolidated organizations	
Société d'habitation du Québec	231
Financière agricole	97
Other organizations	31
Total	**359**
Other transfers tied to the fiscal arrangements	
Fiscal Stabilization Program	—
Preferred share dividend tax payment	15
Total	**15**
Total	**909**

Source: 2001-2002 Québec Budget.

Other transfer programs

Bilateral agreements

The federal government and the provinces regularly enter into bilateral agreements on the joint delivery of public services.

The main agreements between Québec and the federal government are the agreement on manpower administration ($654 million), the agreement on the Canada Student Assistance Plan ($129 million) and the agreement on the integration of immigrants ($102 million). The first recognizes Québec's jurisdiction over the management and design of active employment measures[19] while the second covers the transfer to Québec of its share of the federal student loan program. The last agreement assigns significant prerogatives to Québec regarding the selection and integration of immigrants.

There are also many (almost 70) bilateral agreements for the delivery of public services. These agreements cover such varied fields as services to handicapped persons, legal aid and the enforcement of the *Young Offenders Act*.

In this context, Québec repays the tax transfer it obtained in 1964 for the youth allowance, a program for which Québec had exercised its right of withdrawal with financial compensation.[20] Québec terminated its youth allowance program when, in 1974, the federal government extended its family allowance program to all children under 18 years of age. Rather than return the tax space to the federal government, Québec prefers to pay back its value.

Funding of consolidated organizations

Besides the financial agreements mentioned above, the federal government has entered into many agreements with Québec government organizations, such as the Société d'habitation du Québec.

Following the 1998-1999 reform, which expanded the Québec government accounting entity to include various organizations under its jurisdiction, the cash transfers paid by the federal government under these agreements are now shown as revenue for Québec in the same way as revenue arising from agreements reached directly by the federal government and the Québec government.

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[19] "Active" measures means training and employment assistance measures as opposed to "passive" measures such as employment insurance allowances.

[20] This refers to a province's decision to voluntarily withdraw from a federal program in a field of provincial jurisdiction and, in so doing, obtaining financial compensation from the federal government equivalent to the expenditure the federal government would have made in the province had it retained control of the program.

Other transfers tied to the fiscal arrangements

The Fiscal Stabilization Program

This measure was introduced in 1967 to provide financial compensation for provinces that suffer a drop in revenue of at least 5% because of the economic situation.

No province received benefits under this program until 1981-1982, when British Columbia received benefits. Québec qualified for a payment twice in the early 1990s. However, since the “minimum 5% decline” threshold was restored in 1995-1996 (after having been abandoned in 1972), no province has received compensation.

The preferred share dividend tax payment

This payment is further to the decision by the provinces to forego collection of a tax on preferred share dividends and in so doing, transfer responsibility for collecting the provincial portion of such tax to the federal government. The provinces made this decision essentially because it was impossible for them to maintain the integrity of this tax base and collect the taxes normally levied.

The inter-provincial mobility of these dividends, which are often paid to companies rather than to individuals and accordingly are rarely taxed under the provisions for the taxation of dividends,[21] makes a preferred share dividend tax base very brittle. To overcome this problem, and the underlying tax avoidance, the provinces and the federal government agreed that the latter, which is not affected by movement of the tax base among provinces, would be in the best position to collect this tax.

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[21] The tax system provides that dividends are taxed solely in the hands of individuals, to avoid double taxation. However, preferred share dividends are an exception. In their case, the tax collected is refunded to companies once the dividends have effectively been paid to an individual. These tax withholdings generate a yield that is divided among the provinces. The collection of a federal tax on such dividends is designed to prevent taxpayers making use of private companies to receive their dividend income.