Section G

UPDATE ON FEDERAL TRANSFERS

2009-2010 Budget

Budget Plan

Finances Québec

Section G

Update on Federal Transfers

1. INTRODUCTION

Canada, like most other federations, has an equalization program. In fact, equalization is a fundamental component of Canadian fiscal federalism. It is the only program of transfers to the provinces whose objective is enshrined in the Constitution:

> 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.[1]

In recent years, numerous experts have examined the issue of equalization in Canada. In 2006, three reports concerning this issue were submitted:

- *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance* by the Advisory Panel on Fiscal Imbalance, set up by the Council of the Federation and chaired by Robert Gagné and Janice Gross Stein;
- *Achieving a National Purpose: Putting Equalization Back on Track* by the Expert Panel on Equalization and Territorial Formula Financing, set up by the federal government and chaired by Al O'Brien;
- *The Horizontal Fiscal Balance: Towards a Principled Approach* by the Standing Senate Committee on National Finance.

These three reports arrived at the conclusion that the equalization envelope and its allocation among the recipient provinces should be determined by a formula, and that this formula should take into account the average of the fiscal capacities of the ten provinces, commonly referred to as the "ten-province standard."

In its March 2007 budget, the federal government announced a thorough reform of the equalization program based on the recommendations of the O'Brien report. This reform, which at that time was presented by the federal government as one of the components of its solution for the fiscal imbalance, broadly met Québec's expectations.

In a letter dated March 19, 2007, addressed to the Premier of Québec, the Prime Minister of Canada stated that the 2007 federal budget marked "a fundamental return to fiscal balance in Canada" and that "henceforth all governments will receive resources in a way that is based on principles, predictable and defined over a long-term basis to carry out their responsibilities." [TRANSLATION]

1 Subsection 36(2) of the *Constitution Act, 1982*.

In that regard, the legislation implementing the 2007 equalization reform provided that the changes to the program were to be maintained until the end of 2013-2014.

Yet less than two years later, on November 3, 2008, the federal government announced that it intended to modify the equalization program, in particular so as to limit its growth to that of the nominal Canadian GDP.

Thus, faced with a significant economic slowdown, one of the federal government's first decisions was to unilaterally modify the equalization program, thereby taking revenues away from the provinces which at the outset have a lower per capita fiscal capacity than the national average.

The federal government asserts that the growth in equalization payments was not viable. Québec does not share this opinion. For example, because of the mechanism to smooth equalization entitlements applied since 2007, the recent decline in oil and natural gas prices would have automatically entailed a reduction in the cost of the equalization program in the coming years. The federal government therefore had no need to put a cap on the equalization program in order to limit its structural growth.

The changes to the equalization program were confirmed in the January 2009 federal budget. In that budget, the federal government also announced that it would unilaterally modify the formula for allocating the Canada Health Transfer (CHT) among the provinces.

The changes made by the federal government to these important programs for transfers to the provinces, without prior discussions with the provinces, have major consequences both on Québec's public finances and on the dynamic of federal transfers to the provinces.

This section is intended to provide an update on the changes recently made by the federal government to the equalization program and to the CHT. It also provides an update on other issues relating to the Canada Social Transfer (CST), as well as the conduct of federal-provincial relations in Canada, that must be discussed with the federal government.

2. Equalization: unilateral changes with major consequences

2.1 Impact on Québec's public finances

When Quebec's March 2008 Budget was tabled, $8 430 million in equalization revenue was anticipated for 2009-2010. On November 3, 2008, the federal government announced that, based on changes that it intended to make to the equalization program, Québec's equalization entitlements for 2009-2010 would amount to $8 355 million, that is, $75 million less than what had been anticipated in the March 2008 budget.

For 2010-2011 and the following years, the federal government provided no information to the provinces about the impact of the changes to the equalization program. Québec estimates, nevertheless, that these changes will have a major financial impact. Compared to the March 2008 Budget, the negative impact of these changes is estimated to be $695 million for 2010-2011 and more than $1 billion for each year thereafter.

TABLE G.1

Impact on Québec's revenues of the changes to the equalization program announced on November 3, 2008
(millions of dollars)

	2009-2010	2010-2011
Equalization anticipated in the March 2008 Budget	8 430	9 164
Equalization anticipated in the March 2009 Budget	8 355	8 469
Difference	– 75	– 695

2.2 New caps on equalization

On November 3, 2008, the federal government announced the introduction of new caps on equalization. These caps place limits on the equalization entitlements of recipient provinces.

First of all, the federal government announced the introduction of a capping mechanism designed so that a recipient province cannot be “richer” than the average of all provinces receiving equalization. This mechanism replaces the one introduced in 2007 by the federal government in accordance with the recommendations of the O’Brien report. The “O’Brien cap” was intended to avoid the possibility of a recipient province being “richer” than a province not receiving equalization.

In concrete terms, this change substantially reduces the cost of the equalization program. In 2009-2010, whereas the level of the “O’Brien cap” would have been $7 945 per capita, the level of the cap announced by the federal government on November 3, 2008 is only $7 162 per capita.

One factor explaining this disparity is the federal government’s decision to exclude revenues from offshore resources agreements with Newfoundland and Labrador and with Nova Scotia from the calculation of the capping mechanism that will now be applied. Those revenues were taken into account in calculating the “O’Brien cap.”

Furthermore, the federal government introduced a second capping mechanism, this one based on the nominal Canadian GDP. This “GDP cap” was not among the changes recommended by the O’Brien report.

Because of this cap, the increase in equalization entitlements in Canada will correspond, at its maximum, to the moving average over three years in the growth of the nominal Canadian GDP. For example, the growth in equalization entitlements in Canada in 2009-2010 was limited to the average growth in the nominal Canadian GDP for 2007, 2008 and 2009.

In 2009-2010, Ontario, for the first time in its history, will receive equalization payments totalling $347 million. It should be noted that if the federal government had introduced the “GDP cap” without first modifying the “O’Brien cap” described above, Ontario would not have received equalization in 2009-2010.

Finally, for 2009-2010, the federal government offered Nova Scotia and Manitoba transitional payments totalling $167 million to ensure that these two provinces would receive revenues at least equal to those they received in 2008-2009.[2] However, the federal government decided to offset the $167 million paid to Nova Scotia and Manitoba against the equalization entitlements of the other provinces receiving equalization, that is, Ontario, Québec, New Brunswick and Prince Edward Island.

In its economic statement of November 27, 2008, the federal government indicated that the changes made to equalization were "consistent with the O'Brien report." However, this is not the case.

The O'Brien report severely criticized the closed-envelope program applied from 2004-2005 to 2006-2007, which the system introduced on November 3, 2008, closely resembles. The O'Brien report recommended a return to an uncapped program, based on a formula and principles utilizing the ten-province standard:

> … the concept of a fixed pool runs counter to the fundamental nature of Equalization—that it is intended to respond to changes in fiscal capacity of the provinces, rather than acting as a fixed entitlement over time. Establishing a fixed pool with a growth track divorces the Equalization program from the actual financial situation in provinces and the overall need for Equalization over time (page 44 of the O'Brien report).

Moreover, concerning the federal government's ability to pay, the O'Brien report had this to say:

> Any material changes to the Equalization program, particularly funding changes (e.g., any scaling back of the overall amount allocated by the federal government to the Equalization program), made within the five-year renewal period should be the subject of a public discussion paper (page 67 of the O'Brien report).

The changes of November 3, 2008, to the equalization program were not the subject of any prior public discussion paper.

2 It should also be noted that a few days after its 2009 budget was tabled, the federal government announced that Nova Scotia would receive an additional payment of $74 M in 2009-2010, so that the equalization entitlements of that province for 2009-2010 would be at the same level as in 2008-2009.

2.3 Unfair treatment of dividends paid by Hydro-Québec to the Québec government

The equalization entitlements of the provinces for 2009-2010 announced by the federal government on November 3, 2008, took into account other changes applied by the federal government that were announced to the provinces only on November 14, 2008, that is, 11 days later. These changes, which required amendments to the regulation respecting equalization, were made public in the *Canada Gazette* on December 24, 2008.

One of these changes concerns a modification in how dividends paid by Hydro One to the Ontario government are treated under the equalization program. The federal government decided to include this source of revenue in the corporate income tax base rather than in the natural resource tax base, as had been the case in 2007-2008 and in 2008-2009. In 2009-2010, the effect of this federal decision was to reduce Ontario's relative fiscal capacity and thereby increase its equalization entitlements.

The argument advanced by the federal government is that this government corporation transmits and distributes electricity, but does not produce it. Such an orientation does not seem to contradict the logic of the equalization program.

However, all the dividends paid by Hydro-Québec to the Québec government continue to be taken into account by the federal government in the natural resource tax base, even though a considerable portion of those dividends are generated by the transmission and distribution of electricity, just as in the case of Hydro One. The result is an unfair treatment.

Hydro One and Hydro-Québec are both government corporations which have only one shareholder: the Ontario government in the case of Hydro One, and the Québec government in the case of Hydro-Québec.

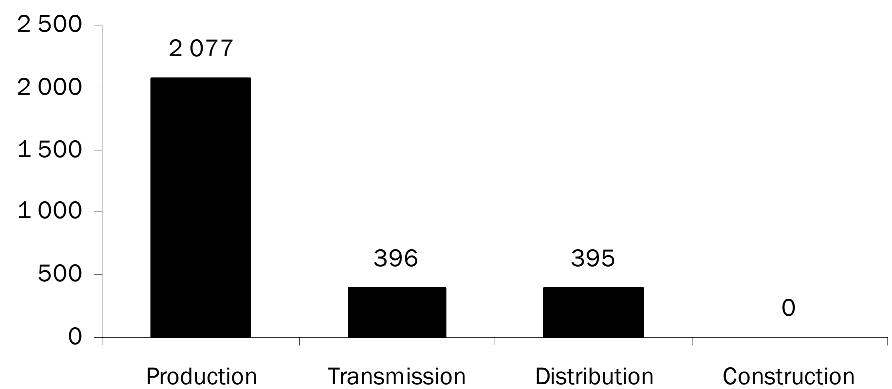
Hydro One's activities differ in no way from the activities carried on by two of Hydro-Québec's four divisions, that is, Hydro-Québec TransÉnergie, which operates the largest power transmission grid in North America, and Hydro-Québec Distribution, which distributes electricity to its customers. In a similar manner, the activities of Hydro-Québec Production, Hydro-Québec's largest division, differ in no way from those of Ontario Power Generation (production), another Ontario government corporation which, like Hydro One, has only one shareholder, the Ontario government.

In this context, there is no justification for the federal government, under the equalization program, to treat Hydro-Québec dividends generated by the transmission and distribution of electricity differently from how Hydro One dividends are treated.

In 2007, Hydro-Québec TransÉnergie generated a net income of $396 million, representing more than 13% of Hydro-Québec's net income. For its part, Hydro-Québec Distribution generated a net income of $395 million, likewise representing more than 13% of Hydro-Québec's net income. Altogether, Hydro-Québec's transmission and distribution sectors represented more than 27% of Hydro-Québec's net income in 2007. The division Hydro-Québec Production, for its part, generated a net income of $2 077 million in 2007.

CHART G.1

Net income of Hydro-Québec in 2007 by sector
(millions of dollars)



Source: 2007 annual report, Hydro-Québec.

By comparison, Ontario Power Generation (production) generated a net income of $528 million in 2007. Hydro One (transmission and distribution), for its part, generated a net income of $399 million in 2007.

A fair treatment of Hydro-Québec dividends by the federal government under the equalization program would increase Québec's equalization entitlements by more than $250 million annually.

2.4 The necessity of imposing caps on equalization has not been demonstrated

To justify the changes made to the equalization program, the federal government claims that equalization payments for Canada as a whole have grown by 56% since 2003-2004 and that this growth rate is not viable. While it is true that equalization payments have grown considerably since 2003-2004, it must also be noted that they declined by more than 20% between 1999-2000 and 2003-2004.

In fact, over the last ten years, equalization entitlements have grown by an average of only 4.1%, while growth in the nominal Canadian GDP has averaged 5.6%.

TABLE G.2

Equalization entitlements in Canada and growth in nominal Canadian GDP
(millions of dollars and percent)

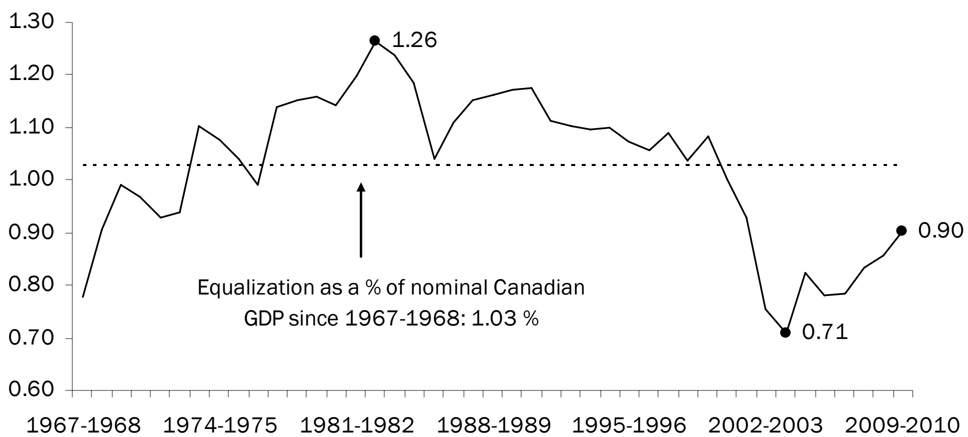
	Equalization entitlements in Canada		Nominal Canadian GDP
	($M)	(annual change in %)	(annual change in %)
1999-2000	10 900	13.5	8.7
2000-2001	10 948	0.4	8.9
2001-2002	10 310	– 5.8	1.3
2002-2003	8 859	– 14.1	6.0
2003-2004	8 690	– 1.9	4.2
2004-2005	10 774	24.0	7.0
2005-2006	10 907	1.2	6.7
2006-2007	11 535	5.8	5.0
2007-2008	12 925	12.1	5.8
2008-2009	13 620	5.4	2.3
Average annual growth (in %)	**N/A**	**4.1**	**5.6**

Sources: Department of Finance Canada, Statistics Canada and ministère des Finances du Québec.

In 2009-2010, the federal government will pay $14.2 billion in equalization entitlements. Although this is the highest amount ever in absolute terms, it represents 0.90% of the nominal Canadian GDP, which is lower than the 1.03% annual average observed since the end of the 1960s. By way of illustration, the cost of an equalization program representing 1.03% of the nominal Canadian GDP in 2009-2010 would amount to $16.1 billion, that is, nearly $2 billion more than the $14.2 billion that the federal government will pay in 2009-2010.

CHART G.2

Equalization in Canada as a proportion of nominal Canadian GDP
(percent)

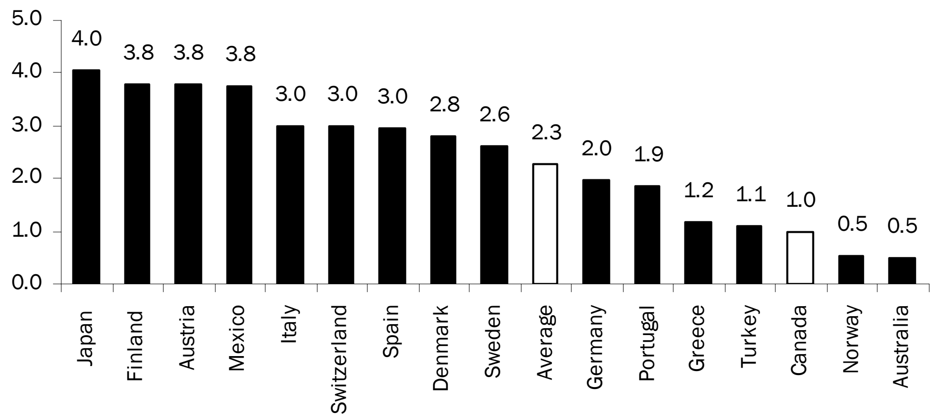


Sources: Department of Finance Canada, Statistics Canada and ministère des Finances du Québec.

What is more, in comparison with other OECD countries that have an equalization program, Canada's program is far from being the most costly. According to a recent study by the OECD,[3] the equalization mechanisms for the 16 countries analysed represented on average 2.26% of their nominal GDP.

CHART G.3

Equalization as a proportion of nominal GDP of certain OECD countries in 2004[1]
(percent)



1 Including territorial formula financing for Canada.
Source: Organization for Economic Co-operation and Development (OECD).

3 OECD. *Fiscal Equalisation in OECD Countries*, [on-line], September 2007, <http://www.oecd.org/dataoecd/51/6/39234016.pdf>.

2.5 A new dynamic that compromises the objective of the program enshrined in the Constitution

Finally, the “GDP cap” introduced by the federal government sets up a fundamental imbalance in the functioning of the equalization program:

— the equalization program will be able to play its role when the disparities in fiscal capacity between the provinces decline, since the cost of the program will decline (which is normal);

— however, the equalization program will not be able to play its role to the full if the disparities in fiscal capacity between the provinces increase markedly, since the growth in the cost of the program will then be limited to the growth in the nominal Canadian GDP (which is not normal).

On the budgetary level, the federal government has insulated itself against any financial risk: regardless of the factors that might affect the disparities in fiscal capacity between the provinces, such as a substantial increase in the price of oil, the equalization program will never grow faster than the nominal Canadian GDP.

The provinces, however, will be forced to assume a heavier risk. The new equalization formula with caps does not guarantee that the provinces will have, at a minimum, the fiscal capacity provided under the ten-province standard, as they did in 2007-2008 and 2008-2009. Furthermore, because of the “GDP cap” mechanism, any variation in the disparities in fiscal capacity between the provinces leads to a “zero-sum game,” in which the equalization entitlements of one province can be increased only by reducing the entitlements of the other recipient provinces.

Furthermore, as a consequence of the “GDP cap,” equalization as a proportion of the nominal Canadian GDP can never increase. In the future, equalization in Canada will never exceed the proportion of 0.90% observed in 2009-2010. Also, since the equalization program will grow either at the rate of the nominal GDP or at a lower rate, this proportion can only decrease over time.

For Québec, this new dynamic seriously compromises the equalization program’s capacity to achieve the objective enshrined in the Canadian Constitution.

3. CANADA HEALTH TRANSFER: UNILATERAL CHANGES TO THE ALLOCATION FORMULA

The Canada Health Transfer (CHT) was enhanced by the September 2004 Health Accord. One result of this Accord is that cash transfers under the CHT will increase by 6% annually through the end of 2013-2014.

Unlike the Canada Social Transfer (CST), for which the cash amount has been allocated on an equal per capita basis since 2007-2008, the CHT is allocated among the provinces according to a formula that takes into account the value of the tax points that were transferred to the provinces by the federal government in 1977.[4] This means, for example, that a province such as Alberta, the value of whose tax points is higher than the average of the ten provinces due to the strength of its economy, receives a lower cash amount under the CHT. Globally though, taking into account the value of the tax points, all the provinces have identical per capita resources to finance their health systems.

In its 2007 budget, the federal government made a commitment to maintain this allocation formula until the end of the Health Accord, that is, until March 31, 2014.

> To respect the agreement on the *10-Year Plan to Strengthen Health Care*—which was signed by all First Ministers—the move to an equal per capita cash allocation for the CHT will be legislated to take effect in 2014-2015, when the current legislation expires (page 114 of the 2007 federal budget plan).

In its 2007 budget, the federal government also made a commitment to ensure that no province would be penalized financially in 2014-2015 when the CHT allocation formula is to be modified.

Yet on January 27, 2009, the federal government announced in its budget, with no advance notice, that it would modify the CHT allocation formula to allow Ontario to receive the same per capita cash amount as the other provinces that receive equalization, even though the value of Ontario's tax points continues to be higher than the Canadian average.

For 2009-2010 and 2010-2011, so that the other nine provinces will not be negatively affected by this change, the federal government will pay Ontario a sum of approximately $750 million from outside the CHT envelope.

However, for subsequent years, the additional compensation for Ontario will be paid from the legislated CHT envelope. The result will be a reduction in transfer revenues for health to the other nine provinces. For Québec, the negative impact of this federal decision is estimated to be more than $60 million annually for 2011-2012 and subsequent years.

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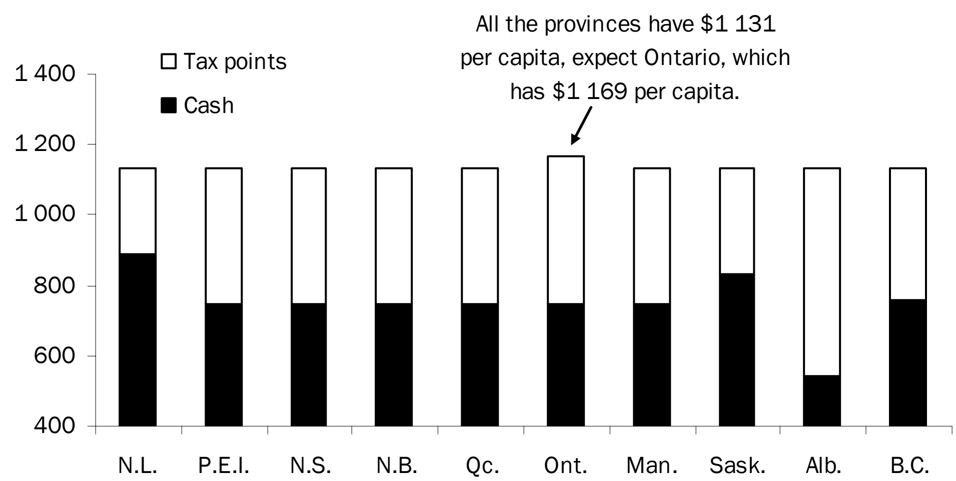
4 The allocation formula also takes into account the associated equalization related to the tax points that were transferred to the provinces by the federal government in 1977.

It should be noted that the 2009 federal budget initially provided that the additional compensation for Ontario would be paid out of the CHT envelope beginning from 2009-2010. The federal government changed its mind a few days later and informed the provinces that this would apply only beginning from 2011-2012.

As a result of this unilateral change to the CHT allocation formula by the federal government, Ontario, after taking into account cash transfers for health and the value of the tax points transferred to the provinces in 1977, has greater resources for financing its health system than the other provinces. For example, in 2009-2010, Ontario will have $1 169 per capita, while the other nine provinces will have $1 131 per capita, that is $38 less per capita. For Ontario, this will mean an additional amount of nearly $490 million.

CHART G.4

Canada Health Transfer (CHT) in 2009-2010
(dollars per capita)



Source: Department of Finance Canada.

Québec considers that this new CHT allocation formula ought to have been discussed before it was introduced. Québec is also of the opinion that no province should be penalized by the change made by the federal government, and particularly not before the end date of the September 2004 Health Accord, that is, March 31, 2014, so as to ensure full compliance with the Accord.

4. Canada Social Transfer: an inadequate mechanism

In its May 2007 Budget, Québec indicated, in respect of the fiscal imbalance, that discussions must continue with the federal government and the other provinces on the amount of transfers for post-secondary education and other social programs, as well as on the issues relating to the allocation of these transfers, particularly regarding social assistance.

Taking into account inflation, the amount of the Canada Social Transfer (CST) remains lower than its 1994-1995 level. In 2009-2010, the CST amount for all of Canada will be $10 853 million. However, to equal its 1994-1995 level taking inflation into account, the 2009-2010 CST amount would have to be $14 267 million. This represents a shortfall of more than $3.4 billion for Canada as a whole, and approximately $800 million for Québec.

TABLE G.3

Change in the CST compared to 1994-1995
(millions of dollars)

	Excluding inflation	Including inflation
1994-1995	10 646	14 267
2009-2010	10 853	10 853
Difference	**207**	**– 3 414**

Sources: Department of Finance Canada and ministère des Finances du Québec.

Moreover, the allocation of the federal contribution to provincial spending on social assistance is still a problem. The portion of the CST that supports provincial spending on social assistance is allocated among the provinces based on an equal amount per capita.

As a result, a province such as Alberta receives approximately $12 245 per social assistance recipient, while Québec receives $2 855, and the average contribution per province is $3 803. Such an allocation is difficult to justify, and all the more so in the context of an economic slowdown where the number of social assistance recipients might well increase at a rate that could vary from province to province.

Another way of allocating the federal contribution for social assistance would be to do so based on the number of social assistance recipients per province, instead of on a per capita basis. An allocation based on the number of social assistance recipients would increase transfers to Québec by approximately $500 million annually. Such a change would have no financial impact for the federal government.

TABLE G.4

Federal contribution to provincial social assistance spending in 2009-2010
(millions of dollars and dollars per social assistance recipient)

	CST component funding social assistance		Social assistance recipients[1]		Federal contribution
	$M	% Canada	Number	% Canada	$ per social assistance recipient
Newfoundland and Labrador	97	1.5	48 500	2.9	1 994
Prince Edward Island	27	0.4	6 900	0.4	3 898
Nova Scotia	179	2.8	52 300	3.1	3 421
New Brunswick	143	2.2	45 300	2.7	3 146
Québec	1 479	23.2	518 200	30.8	2 855
Ontario	2 477	38.8	676 500	40.3	3 661
Manitoba	231	3.6	60 900	3.6	3 796
Saskatchewan	195	3.1	48 700	2.9	4 010
Alberta	691	10.8	56 400	3.4	12 245
British Columbia	842	13.2	149 300	8.9	5 638
Territories	28	0.4	16 800	1.0	1 658
Canada	**6 388**	**100.0**	**1 679 800**	**100.0**	**3 803**

Note: Figures may not add up to the totals shown because of rounding off.
1 2005 estimate.
Sources: Department of Finance Canada and National Council of Welfare.

5. FOR A BETTER GOVERNANCE OF CANADIAN FISCAL FEDERALISM

In recent decades, the federal government and the provinces set up committees to encourage discussions between governments concerning financial issues:

— the Continuing Committee of Officials (CCO), composed of the deputy ministers of finance from across the country, met almost systematically before each meeting of the finance ministers to review and discuss the ministers' principal concerns;

— the Fiscal Arrangements Committee (FAC), composed of the assistant deputy ministers in charge of federal-provincial policies in each of the finance departments, examined the principal issues involved in federal transfers to the provinces;

— the Sub-Committee on Transfers (SCT), composed of government specialists on equalization and other transfers to the provinces, discussed the technical issues related to provincial transfer programs, such as the treatment of various provincial revenue sources under the equalization program.

In recent years, however, these forums for discussion and co-ordination have almost never been used. In particular, none of the changes recently made by the federal government were discussed beforehand with the provinces, at the level of either ministers or officials.

Québec considers that greater use should be made of these committees so that all matters of concern to the finance ministers, including the sometimes more technical questions involving federal transfers, can be analysed beforehand by officials in order to promote a more harmonious and concerted development of Canadian fiscal federalism.

6. CONCLUSION

In its May 2007 Budget, Québec acknowledged that substantial progress had been made in regard to federal transfers in recent years. Québec acknowledged in particular that the reform of the equalization program, which was its priority, broadly met its expectations.

By unilaterally modifying, in recent months, the equalization program, then the CHT allocation formula, the federal government has reneged on its commitments.

What is more, for the past ten years, the three provinces that have most greatly benefited from increasing federal transfers are Ontario, Alberta and British Columbia.

TABLE G.5

Increase in federal transfers to the provinces since 1999-2000[1]
(millions of dollars and percent)

	1999-2000 ($M)	2009-2010 ($M)	Increase ($M)	Increase (%)
Ontario	4 715	14 292	9 577	203
Alberta	1 311	3 132	1 821	139
British Columbia	2 230	4 785	2 555	115
Manitoba	1 805	3 359	1 554	86
Québec	9 263	16 671	7 408	80
New Brunswick	1 571	2 489	918	58
Nova Scotia[2]	1 778	2 649	871	49
Prince Edward Island	326	490	164	50
Saskatchewan	892	1 171	279	31
Newfoundland and Labrador[2]	1 457	1 080	– 378	– 26
Total	**25 349**	**50 118**	**24 769**	**98**

Note: Figures may not add up to the totals shown because of rounding off.
1 Equalization (including, in the case of Newfoundland and Labrador and Nova Scotia, revenues from offshore resources agreements) and transfers for health, post-secondary education and other social programs (including, in the case of Québec, the portion of the special Québec abatement associated with these transfers).
2 Under the 2005 offshore resources agreements, Newfoundland and Labrador and Nova Scotia received payments of $2 B and $830 M respectively in 2004-2005. Those amounts do not appear in this table.
Source: Department of Finance Canada.

This result stems from the orientation pursued by the federal government since the end of the 1990s, which consists in reducing the redistribution traditionally effected by means of social transfers to the provinces, and instead achieving that goal primarily through the equalization program. The 2007 federal budget was the end result of this logic, where it was notably announced that the CHT and CST cash transfers would be allocated on a per capita basis, in concert with an enhancement of the equalization program.

The federal government's recent decision to impose caps on equalization limits the program's ability to play its role. As a result, the overall level of redistribution of transfers to the provinces has been reduced.

Québec asked the federal government to suspend application of the changes announced on November 3, 2008, until a true process of discussions with the provinces has been completed.

Québec's priority is for the federal government to live up to the commitments it made in its 2007 budget, and thus return to the equalization program implemented on the basis of the O'Brien report's recommendations.

Québec also asks the federal government to correct, as of 2009-2010, the unfair treatment under the equalization program of Hydro-Québec dividends stemming from the transmission and distribution of electricity.