



Fiscal Pulse

Mary Webb (416) 866-4202
mary_webb@scotiacapital.com

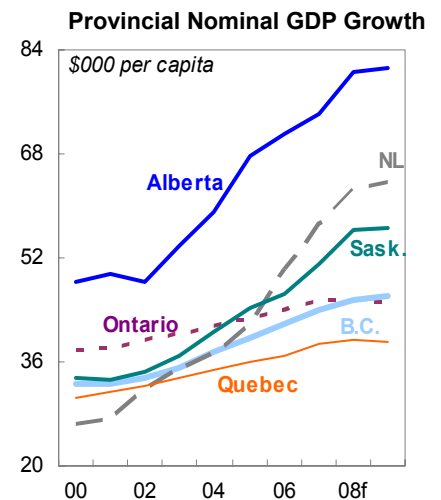
Federal Equalization Update for Fiscal 2009-10 ... Ontario Becomes a Recipient

The Provinces' fiscal picture is shifting. First is the reality of slowing revenues, even resource receipts, during the current year, fiscal 2008-09 (FY09), and the challenge of preparing the spring FY10 *Budgets* given the outlook for further revenue weakness. The change is dramatic, given that final results for eight of the ten Provinces for FY08 (ending March 31, 2008) point to a combined provincial surplus topping \$11 billion. By FY10, the aggregate provincial budget balance is expected to remain positive, but considerably diminished.

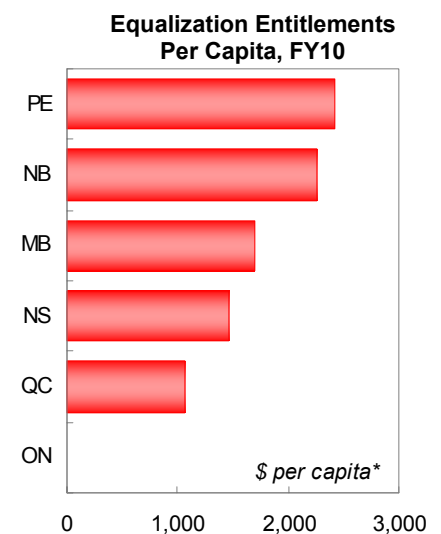
A second development is the slide in Ontario's economic performance relative to the other Provinces, reflecting the multiple headwinds buffeting this economy for several years. Across a range of measures, such as nominal GDP per capita, Ontario's lead has slipped. Thus, for the first time in history, the Equalization program is recognizing Ontario's need, and the announced entitlements for FY10 include \$347 million for Ontario. The Equalization formula introduced by Ottawa in the 2007 *Budget* captures some of Ontario's challenges given its shift from a five- to a ten-Province standard, its inclusion of resource receipts and its lagged, three-year moving average calculation. The calculation for FY10 gives a 50% weight to FY08 data and a 25% weight to each of FY07 and FY06, incorporating the commodity price surge that ended just a couple of months ago.

Conversely, joining Alberta as "non-recipient" Provinces are other resource-rich jurisdictions — British Columbia in FY08, Saskatchewan in FY09 and now Newfoundland and Labrador (NL) in FY10. Easing the transition for NL are payments under the 1985 *Atlantic Accord* that Ottawa estimates at \$399 million for FY09¹. As well, NL, subsequent to its \$2.0 billion up-front payment under the 2005 *Atlantic Accord*, is accruing the offset payments under this *Accord* annually, with this year's \$343 million offset payment reflecting Newfoundland's choice to remain under the pre-2007 Equalization framework in FY09. Newfoundland and Labrador and Nova Scotia will each qualify for the eight-year extension of the 2005 *Atlantic Accord* from FY13 to FY20 if they receive Equalization in either FY11 or FY12 and for NL, if its debt service per capita, and for NS, if its net debt per capita, do not drop below at least four other Provinces².

The federal government also is facing a revenue squeeze that makes the projected ramp-up in major federal transfers to junior governments appear increasingly unaffordable after their jump from \$31.3 billion in FY04 to \$49.1 billion in FY09. Through FY14, Ottawa has reconfirmed the scheduled annual increases of 6.0% for the Canada Health Transfer and 3.0% for the Canada Social Transfer, considerably higher



Source for historical data: Statistics Canada. Forecast: Scotia Economics.



*Population estimates: Scotia Economics. Source for Equalization: Finance Canada.

¹ The 1985 *Canada-Newfoundland Atlantic Accord* offers NL transitional protection from FY00 to FY11 with the offset floor component guaranteeing at least 85% of the previous year's Equalization and offset floor entitlement and the phase-out component guaranteeing a gradually decreasing share of the y/y declines in these payments.

² From FY13 to FY20, if either NL or N.S. cease to receive Equalization, they no longer qualify for the 2005 *Atlantic Accord*, and will receive two years of transitional payments. Each Province could requalify for the *Accord* if it begins to receive Equalization



than Scotia Economics' forecast rise in the national GDP deflator of just over 1.0% in 2009 and an average of slightly less than 2% over the following four years. The sheer size of the Equalization program — \$13.6 billion in FY09 plus *Offshore Accord* payments of \$0.8 billion — makes the annual absolute dollar increases formidable. Moreover, the Equalization formula adopted in 2007 caps the per capita transfer to each recipient Province at the fiscal capacity of the lowest non-recipient Province. As Ontario shifts to recipient status in FY10, the cap would rise to the next lowest non-recipient Province, a resource-rich jurisdiction.

To put Equalization on a more sustainable path, Ottawa is redefining the cap on each Province's per capita transfer to equal the average post-Equalization fiscal capacity of the recipient Provinces. In addition, a ceiling on the growth of the entire program is introduced at the three-year moving average of GDP growth. For FY10, for example, the increase in total Equalization payments is limited to average GDP growth in 2007, 2008 and 2009. For FY10, excluding *Accord* payments, the result is a 4.0% increase in total Equalization transfers to \$14.2 billion. A future challenge is that the recipient Provinces now account for 71% of Canada's population. For the Territories, Ottawa will not amend the Territorial Formula Financing transfer, deeming it unaffected by commodity price volatility.

For the Provinces receiving Equalization in both FY09 and FY10, New Brunswick receives the largest percentage increase at 6.6% and Quebec witnesses the largest absolute increase at \$327 million. Nova Scotia's 2005 *Accord* offset payment is estimated to rise from \$106 million in FY09 to \$197 million in FY10, leaving its Equalization \$91 million lower in FY10, though it has the choice of selecting its negotiated pre-2007 Equalization framework if this is more advantageous.

On a per capita basis, Ontario's FY10 transfer is less than \$30. With the federal government relying on non-resource revenues to finance a transfer that also takes into account resource receipts, Ontario in FY10 will be both a contributor and a recipient in the Equalization program. Ontario's Equalization transfer for FY10 is far less than its net average annual contribution of more than \$20 billion to the federal government, and a fraction of the redress it proposes on other federal programs such as Employment Insurance.

Finance Canada's Equalization amendments likely represent the first of many adjustments forced by the emerging budgetary squeeze. After several years of significant fiscal flexibility that allowed the federal and provincial governments to accomplish fiscal repair alongside tax reduction and new spending initiatives, resources are expected to be more scarce over the next couple of years.

Equalization Transfers**

	FY06	FY07	FY08	FY09	FY10
	\$ million				
Newfoundland & Labrador	1,050	1,016	972	900	n.a.
Equalization	861	687	477	158	0
1985 Accord	0	110	189	399	n.a.
2005 Accord	189	219	306	343	n.a.
Prince Edward Island	277	291	294	322	340
Nova Scotia	1,375	1,443	1,533	1,571	1,571
Equalization	1,344	1,386	1,465	1,465	1,374
1985 Accord	4	0	0	0	0
2005 Accord	27	57	68	106	197*
New Brunswick	1,348	1,451	1,477	1,584	1,689
Quebec	4,798	5,539	7,160	8,028	8,355
Ontario	0	0	0	0	347
Manitoba	1,601	1,709	1,826	2,063	2,063
Saskatchewan	89	13	226	0	0
Alberta	0	0	0	0	0
British Columbia	590	459	0	0	0
Total: Equalization	10,907	11,535	12,925	13,620	14,168
Total: Offshore Accords	219	386	563	848	n.a.

* Estimate.

** Source: Finance Canada.

Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor
 Toronto, Ontario Canada M5H 1H1
 Tel: (416) 866-6253 Fax: (416) 866-2829
 Email: scotia_economics@scotiacapital.com