

Budget Paper C

**RECENT DEVELOPMENTS IN
FISCAL ARRANGEMENTS**

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■ RECENT DEVELOPMENTS IN FISCAL ARRANGEMENTS

Manitoba has long promoted the need for a sound and comprehensive approach to fiscal arrangements, including the need for a principles-based Equalization Program. The implementation of a new Equalization Program in 2007, based on the findings of the Expert Panel on Equalization and Territorial Formula Financing, was endorsed by Manitoba and viewed as significant progress toward improving Canadian fiscal arrangements overall.

The Importance of Equalization

The Equalization Program is a fundamental component of Canadian fiscal arrangements. The purpose of Equalization, as outlined in *The Constitution Act, 1982*, is to ensure that all Canadians in all provinces have access to reasonably comparable public services at reasonably comparable levels of taxation.

The Organization for Economic Co-operation and Development (OECD), in its 2007 report “Fiscal Equalisation in OECD Countries,” described the reasons equalization programs are important. The report noted that equalization programs assist with equity, by ensuring a balance between revenue raising capacity and the cost of providing services across regions. The report also identified the importance of equalization programs in addressing “fiscal externalities” that may lead to labour and capital being inappropriately allocated across regions due to regional tax rates as opposed to demand. Finally, it identified the “insurance” effect equalization provides against income or employment shocks that may be experienced in a particular region. See Appendix 1 for a full description of the OECD’s assessment of the importance of equalization programs generally.

Canada is a highly decentralized federation. The constitution has given provinces important spending responsibilities, such as the provision of social services and social assistance, health care, child care, justice and education, including post-secondary education and training. However, geographical size, populations, incomes and access to natural resources vary greatly among provinces and territories. This gives provincial governments differing capacities with which to raise revenue and a differing ability to provide necessary public services. At various times, for example, certain provinces have benefited from high natural resource prices that increased their capacity to provide public services without having to resort to higher taxation.

In the past, arrangements have been struck to ensure the fiscal capacity of a particular level of government was appropriate for the time. For example, “at a federal-provincial conference in 1941 the provinces temporarily relinquished

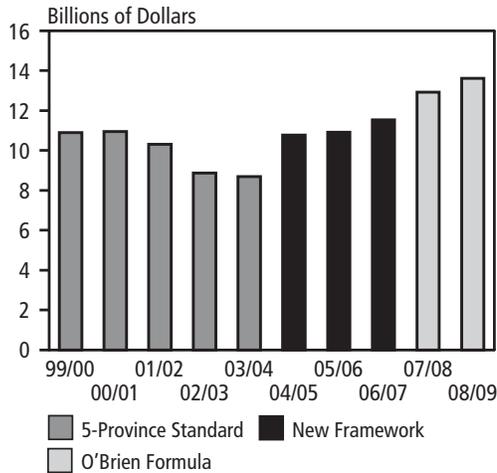
“Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

Section 36(2) *The Constitution Act, 1982*

“The government of Canada is committed to the principle of ensuring long-term funding support for shared priorities and a transparent, principle-based approach to its transfers to provinces and territories.”

The Budget Plan, Restoring Fiscal Balance in Canada, 2006 (p. 63)

Total Equalization Program Payments under the Various Approaches



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their access to personal, corporate and inheritance taxes in recognition of the Government of Canada's need to occupy those tax fields to finance the war effort. In return, the provinces received grants from the federal government. This wartime experience moved the country into a system of federal-provincial interdependence – a system that has been central to Canadian federalism ever since.”¹

Manitoba believes that fiscal arrangements, including Equalization, are an important feature of our Canadian federation. Because of this importance, governments should be guided by clear principles and objectives in developing and altering federal/provincial/territorial fiscal arrangements.

Improving Fiscal Arrangements

In 2004, concerns about declining and unstable Equalization payments under the “five-province standard” formula at the time led the federal government to introduce the *New Framework for Equalization* (see chart). Under the New Framework, the Equalization payments to provinces would be increased by about \$28 billion over ten years relative to 2004/05 budget levels.² Year-over-year growth in overall program payments was legislated and payments to provinces were fixed in advance for 2004/05 and 2005/06, thereby suspending the formula for measuring provincial revenue disparities. As well, the federal government announced that it would undertake an “expert review” of the program (as well as Territorial Formula Financing, the parallel program for the territories), particularly with respect to the allocation of Equalization among provinces and the treatment of various revenue sources, including natural resources.

In May 2006, the Expert Panel on Equalization and Territorial Formula Financing, chaired by Al O'Brien, former Deputy Minister of Finance in Alberta, delivered its report to the federal Minister of Finance. The O'Brien recommendations were ultimately accepted by the federal government and formed the basis of the renewed and strengthened Equalization program announced in federal Budget 2007. The strengthened program increased total payments to the provinces by \$3.5 billion in 2007/08 and 2008/09 compared to 2006/07 levels, and followed the pattern of restoring adequacy that was initiated under the New Framework (see chart).

¹ Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance, The Council of the Federation, Advisory Panel on Fiscal Imbalance, 2006 (p.22-23)

Note: While provinces ceded tax powers to the federal government to help finance Canada's efforts during World War II, the federal government partially restored those powers to provinces in 1977 with the introduction of the Established Programs Financing (EPF) transfer program.

² Finance Canada

The Expert Panel's Consultations and Manitoba's Contribution

In developing its report, the Expert Panel commissioned reports and analysis, and consulted extensively with provinces, academics and subject matter experts, government officials, business representatives and Canadians. Consultations were conducted over a one-year period through a website, meetings and round tables. The Panel also reviewed a wide range of opinions and ideas on the subject, and conducted its own thorough technical analysis of the issues.

Manitoba's formal presentation to the Panel emphasized that "the Equalization Program should be based on a set of sound and comprehensive principles to ensure the Program meets its Constitutional objective." It further suggested that a principled approach to Equalization should include the following key principles: adequacy, comprehensiveness, responsiveness, equity, stability and predictability.

Manitoba noted that to achieve adherence to the principles underlying Equalization as reflected in Section 36(2) of *The Constitution Act, 1982* would require: a 10-province standard; representative tax system (RTS); full revenue coverage; and that the Program grow in line with (or be responsive to) changes in provincial fiscal disparities, rather than being constrained to a fixed pot with a fixed escalator. Manitoba felt those components would lead to a reasonable program such that, as a province's relative economic position improves, its Equalization payments would decline and vice versa.

In addition to specific suggestions related to Equalization, Manitoba also asked that the panel give thought to all "three tiers" of fiscal transfers. In this context Tier 1 is Equalization, Tier 2 is the Canada Health Transfer (CHT) and the Canada Social Transfer (CST), and Tier 3 is other transfers. The presentation emphasized the need to consider all the three tiers when considering any fiscal arrangements.

The third tier in this model addresses the unique issues facing individual provinces or geographical regions, in a way that respects jurisdictional authority and the major transfer programs, while allowing for the achievement of the principles outlined in Section 36(1) of the Canadian Constitution. This section of the Constitution is important for several reasons, particularly: respect for jurisdictional authority; the use of economic development as a method for addressing disparities; and the need for collective action to provide all Canadians with quality public services.

Through the consultation and discussion process, the Expert Panel identified three key issues that were important to its work. These were:

1. "Most want to see the Equalization Program improved, not abandoned."
2. "Equalization should be put back on track through a principle-based, formula-driven approach."

Three-Tier System for future Transfer Arrangements

Tier 1 – A strong Equalization Program (10-province standard, comprehensive revenue coverage, no fixed pot)

Tier 2 – Consideration of equal per capita cash CHT and adequate equal per capita cash funding for the CST

Tier 3 – Transfers delivered on the basis of expenditure need, outside of the Equalization Program, but consistent with the Constitution

"Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to

- (a) promoting equal opportunities for the well-being of Canadians;**
- (b) furthering economic development to reduce disparity in opportunities;**

and

- (c) providing essential public services of reasonable quality to all Canadians."**

Section 36(1) *The Constitution Act, 1982*

■ THE PANEL'S RECOMMENDATIONS

Starting with principles

1. A clear set of principles should be adopted to guide future development of the Equalization program in Canada.
11. Fifty percent of provincial resource revenues should be included in determining the overall size of the Equalization pool.

Returning to a rules-based, formula-driven approach

2. A renewed Equalization formula should be developed and used to determine both the size of the Equalization pool and the allocation to individual provinces.
12. Actual resource revenues should be used as the measure of fiscal capacity in the Equalization formula.
3. A 10-province standard should be adopted.
13. All resource revenues should be treated in the same way.
4. Equalization should continue to focus on fiscal capacity rather than assessing expenditure needs in individual provinces.
14. A cap should be implemented to ensure that, as a result of Equalization, no receiving province ends up with a fiscal capacity higher than that of the lowest non-receiving province.

5. Equalization should be the primary vehicle for equalizing fiscal capacity among provinces.

Improving the Equalization formula

6. The Representative Tax System (RTS) approach for assessing fiscal capacity of provinces should be retained.
15. The current approach for determining Equalization entitlements and payments should be replaced with a one estimate, one entitlement, one payment approach.
7. Steps should be taken to simplify the Representative Tax System (RTS).
16. Three-year moving averages combined with the use of two-year lagged data should be used to smooth out the impact of year-over-year changes.
8. A new measure for residential property taxes should be implemented based on market value assessment for residential property.
9. User fees should not be included in Equalization.

Striking a balance on the treatment of resource revenues

10. In principle, natural resource revenues should provide a net fiscal benefit to provinces that own them.

Improving predictability and stability

Assessing Equalization

17. The federal government should track and report publicly on measures of fiscal disparities across provinces.

Improving governance and transparency

18. A more rigorous process should be put in place to improve transparency, communications, and governance. This is preferable to setting up a permanent independent commission to oversee Equalization.

Source: Achieving a National Purpose: Putting Equalization Back on Track, Expert Panel on Equalization and Territorial Formula Financing, May 2006

3. “The treatment of resource revenues is the most complex and controversial aspect of Equalization.”

On balance, the recommendations of the Expert Panel reflected many of the key arguments Manitoba made in respect of a renewed Equalization Program. Taken as a whole, the recommendations were thought to be balanced, principled, realistic and fair.

Putting the Expert Panel’s Recommendations into Practice

In its 2007 Budget, the federal government renewed the Equalization Program based on the recommendations of the O’Brien Expert Panel. The changes made the program more fair, stable, predictable and adequate. Total program costs and provincial entitlements would again be determined using a formula-driven measure of fiscal capacity. Under the formula, a province receives Equalization if its fiscal capacity is below the average fiscal capacity of all provinces (the “10-province standard”); provinces above the standard do not receive Equalization. The changes to the Program were legislated through to 2013/14.

The O’Brien-based Program also applied a new approach to the treatment of natural resource revenues by excluding 50% of these revenues from the standard. This provided an incentive to resource-producing provinces to continue developing their resources, while recognizing that fully excluding these revenues would lead to increased fiscal disparities among provinces. A 50% exclusion rate also made the 10-province standard more affordable.

An important feature of the new Program was the introduction of a three-year weighted moving average measurement of fiscal capacity, lagged by two years, for determining Equalization payments. This approach was intended to smooth year-over-year variation in payments caused by changes in economic conditions, making the Program more stable and predictable over time.

As recommended by the O’Brien Expert Panel, there would no longer be a “fixed pot” of payments or a ceiling imposed on the Program; payments would either grow or decline as provincial fiscal capacities shifted over time. As well, fairness would be ensured through the use of a “fiscal capacity cap” to ensure Equalization payments did not raise a province’s total fiscal capacity above that of any non-receiving province.

Manitoba supported the renewed Program announced by the federal government in its 2007 Budget as a reasonable compromise between the divergent views and interests of provinces, particularly with respect to the treatment of natural resources.

“In June 2006, the Government [of Canada] received the final report of the Expert Panel on Equalization ... which proposed a comprehensive, principles-based set of reforms to Canada’s Equalization program. Based on a careful review of the report and extensive consultations with Canadians and provincial governments, the Government has concluded that the Expert Panel’s recommendations strike a reasonable balance among the divergent views and interests of provinces. They form a solid foundation upon which to renew this program.”

The Budget Plan 2007, *Aspire* (p. 113)

In its Report, the O'Brien Expert Panel noted that: "Smoothing mechanisms (where entitlements are based on the average of fiscal capacity over a number of years) delay the program's response to deteriorating or improving fiscal circumstances. However, they also provide greater predictability and stability because entitlements are adjusted gradually with changes in economic circumstances and new data. This allows for better fiscal planning by receiving provincial governments."

Expert Panel on Equalization and Territorial Formula Financing, May 2006 (p. 119)

"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 2014-15, when the current legislation expires. As with the CST, the Government will ensure that no province or territory is unduly affected by the move to equal per capita CHT support. In the interim period, the CHT will continue to operate under existing legislation, taking into account the value of tax points."

The Budget Plan 2007, *Aspire* (p. 361)

Manitoba also supported the balance the federal government achieved in strengthening the Equalization Program while moving to an equal per capita cash transfer for the Canada Social Transfer (CST), an issue of concern to more populated provinces like Alberta and Ontario. To implement the change, the federal government increased the CST base by \$687 million in 2007/08 to provide Ontario and Alberta with the same equal per capita cash support as the other provinces and territories, while ensuring no province or territory was unduly affected by the change.

With respect to the Canada Health Transfer (CHT), federal Budget 2007 announced the move to equal per capita cash would not occur until after the current legislation expired in 2013/14. As in the case of the CST, the federal government indicated provinces and territories would not be unduly affected by the move to equal per capita CHT cash.

■ UNEXPECTED CHANGES TO EQUALIZATION AND THE CANADA HEALTH TRANSFER

The new Equalization Program, as recommended by the O'Brien Expert Panel, was short lived. After only two years and without consulting provinces, the federal government made changes to limit the growth of the Program. These changes were announced on November 3, 2008 and will take effect in 2009/10. Manitoba is concerned that these changes are intended to permanently change the Expert Panel-based version of the program introduced in 2007.

The key change was to limit growth in total payments to the provinces or impose a "ceiling" on the Program, though the O'Brien Panel recommended against this approach. A "fixed-pot" compromises the responsiveness and fairness of the Program because the total amount of Equalization to be distributed to provinces is not based completely on changes in provinces' fiscal capacities (see Appendix 2 for a detailed explanation of the new program "ceiling" and "cap"). Furthermore, under this new approach, the basis for determining total costs of the Program and the basis for determining distribution of payments to provinces are mismatched.

For example, Manitoba enjoyed relatively stronger economic performance in the past several years than most provinces, and therefore Equalization entitlements, under the 2007 approach, would begin to decline in future years. This was consistent with the principle of responsiveness recommended by the O'Brien Panel. However, the new "fixed pot" approach uses lower current and future GDP growth to set the total Program entitlements. This adds another layer of restraint to Manitoba's entitlements that would not have occurred if the O'Brien approach had been maintained. The new "fixed pot"

approach re-introduces significant year-over-year declines in Equalization entitlements that the O'Brien Panel intended to address through the design of a smoothing (averaging) mechanism which is effectively nullified by the decision to impose a "ceiling" on the Program.

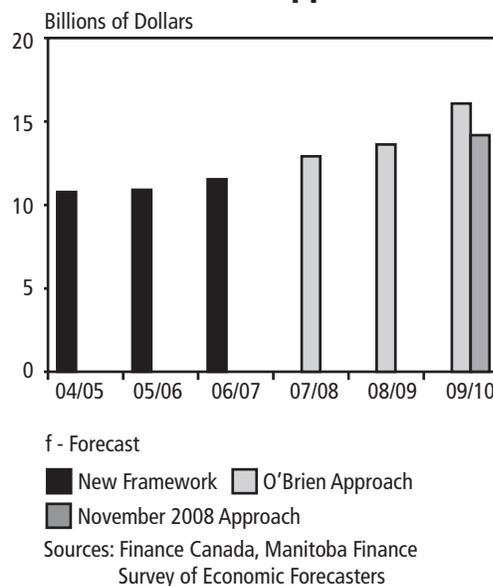
Furthermore, from an adequacy and fairness perspective, the larger revenue growth of the earlier period, particularly related to natural resources, means resource rich provinces have been able to increase services and/or decrease taxes. Now, however, total Equalization payments will not relate to that recent past, but more to the future at a time when GDP growth is slowing. By skipping ahead to a partially forward-looking growth factor, service and funding inequalities (i.e., horizontal imbalance between provinces) fostered by high resource revenues in recent years are less adequately addressed.

While the impact on Manitoba is tempered in 2009/10 through a protection payment, the impact on all provinces becomes more significant in future years since the "ceiling" is tied to current and future years' GDP growth rates. Not unexpectedly, these rates are slowing in response to the economic situation and will result in less funds being available to provinces at a time when they are most needed to address the economic downturn and to support the expectation that provinces cost-match infrastructure projects to stimulate the economy.

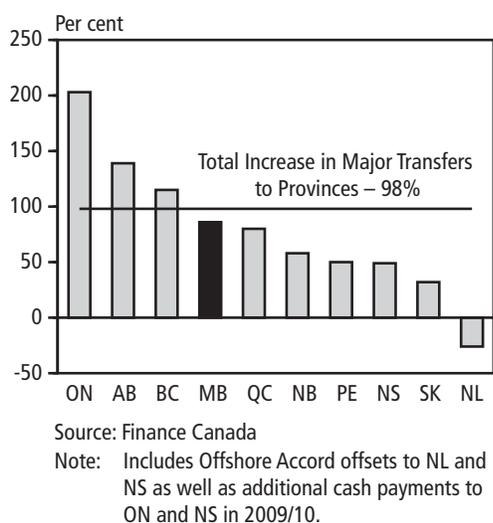
The timing of the potentially larger payouts under the 2007 approach, in respect of 2009/10, had there been no constraints would have been counter-cyclical, occurring as the country is experiencing an economic downturn. Under that unconstrained approach, potentially the largest increases in benefits would go to Ontario and Quebec, two provinces that are expected to be hardest hit. At the same time, the weak economic performance of a number of provinces in 2008/09 would have naturally restrained the 10-province standard and slowed overall program growth under the O'Brien approach, thereby ensuring sustainability of the Program.

In addition to the unanticipated changes to Equalization that will lower the amount of funds available to the provinces, Manitoba is also concerned that much needed funding for public services will be further restrained by the federal government's proposed changes to the CHT program. The federal government proposes to begin moving to an equal per capita cash CHT allocation in 2011/12 (in advance of the previously announced 2014/15 date) without new funding or transition provisions to protect provinces and territories affected by the change. This is in contrast to the process the federal government used in 2007/08 when the CST was moved to an equal per capita allocation. Because total annual CHT cash payments are fixed, the increase in payments to Ontario is expected to reduce support to other

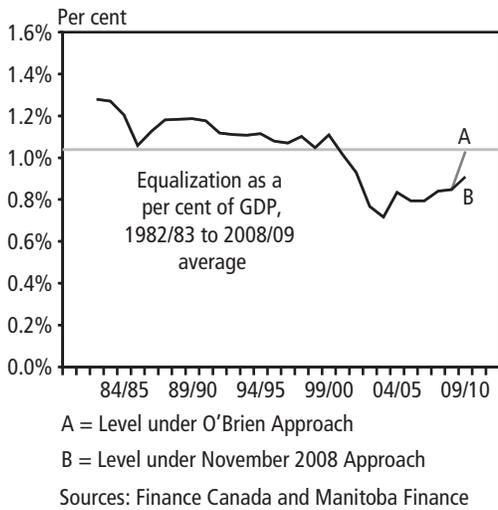
Equalization Program Costs under the Various Approaches



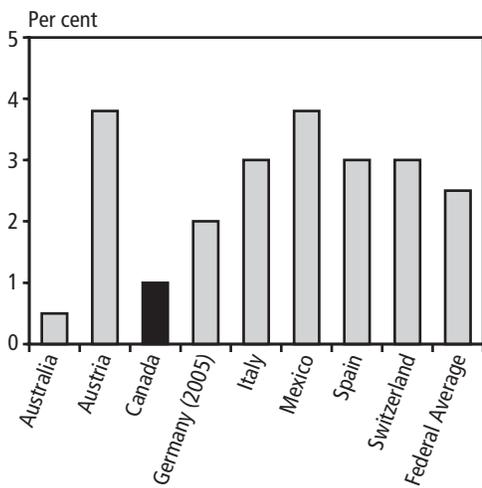
Change in Major Federal Cash Transfers from 1999/00 to 2009/10



Equalization Payments and GDP: Annual Share and Long-Term Average



Total Fiscal Equalization as a Per Cent of GDP in Federal Countries, OECD Survey, 2004



provinces and territories by about \$400 million in 2011/12. A further loss in support to provinces and territories will occur in 2014/15 when Alberta moves to equal per capita CHT cash allocation unless new funding and transition protection is provided.

Recent changes to transfer programs have broken the vital link that was created in federal Budget 2007 when the strengthened Equalization Program made it possible for the federal government to move to equal per capita cash support for the CST in order to provide comparable treatment for all Canadians.

CONCLUSIONS – GETTING BACK ON TRACK

Manitoba feels strongly that the federal government should return to the principles-based Equalization Program, recommended by the O'Brien Expert Panel. The November 2008 approach erodes many of the principles reinstated in the 2007 Expert Panel-based Program, particularly with respect to adequacy, stability and increased predictability of payments to provinces. Provinces as a whole are now less able to provide comparable services at comparable rates of taxation.

With respect to the appropriate level of Equalization, the O'Brien formula would have returned funding to a level closer to the Equalization Program's long-term share of national GDP (see chart). Furthermore, total fiscal Equalization (Equalization payments plus Territorial Formula Financing) in Canada is below average by international standards. According to an OECD study released in 2007, total fiscal equalization as a per cent of GDP in federal countries averaged 2.5% in 2004 compared to 1% in Canada (see chart).

The changes introduced in November 2008, although intended to bring greater stability and affordability to the Program, have come at a time of a significant economic slowdown. The federal government is reducing payments to provinces when additional fiscal stimulus on the part of governments is required.

Manitoba also believes the federal government should respect the agreement on the 10-Year Plan to Strengthen Health Care and delay the move to an equal per capita cash allocation for the CHT until after the current legislation expires in 2013/14. However, should governments determine that the move should occur in advance of this date, new funding should be added to the CHT base to protect provinces from declines resulting from the change. As with the CST, transition protection should also be provided to ensure no province or territory experiences declines in payments relative to what they would have received prior to the move to equal per capita CHT cash.

By returning to full Equalization and delaying or providing transition protection for the move to equal per capita CHT cash support, transfer payments would remain at levels required to protect essential services for all Canadians. It would also ensure that provinces can effectively participate in national efforts to help the Canadian economy recover and grow.

■ APPENDIX 1

In 2007, the Organization for Economic Co-operation and Development (OECD) released a report “Fiscal Equalisation in OECD Countries.” This report was developed with information collected through a survey of OECD countries and covers a range of issues related to Equalization Programs. The report provides both information and recommendations, including a description of the “main reasons for Equalization.”

Main reasons for equalisation

1. EQUITY

To equalise per capita tax revenue raising capacity and the per-beneficiary cost of providing public goods and services across regions. Tax raising capacity per capita and cost of providing public services can differ across regions for geographic or socio-economic reasons. The objective of equalisation is to provide every citizen with an average level of public services at comparable tax rates.

To equalise the marginal benefit of public spending across regions. OECD countries that have central government programs for important public services (such as health and education) administered by subcentral governments, may use equalising transfers to equalise the marginal social benefit of public spending across regions.

2. EXTERNALITIES

To avoid fiscal externalities resulting in a misallocation of labour and/or capital across regions. A decentralised fiscal system could distort the location decision of mobile factors. Unequal tax bases result in pecuniary incentives to locate in high tax base regions, thereby distorting location decisions of mobile factors of production. Grants that equalize tax bases across regions will eliminate this source of inefficiency.

3. INSURANCE

To provide insurance against asymmetric income or employment shocks. If the regions of a country are subject to asymmetric shocks, redistributive grants may provide regions with insurance against the adverse effects of such shocks on income or employment.

In all countries, the driving force for equalisation is equity, i.e. having similar tax raising capacity and equal access to public services across jurisdictions.

Source: OECD, Fiscal Equalisation in OECD Countries (2007)

■ APPENDIX 2

November 3, 2008 Program Changes – Technical Details

A number of changes to the O'Brien approach were introduced in November 2008. First, a "ceiling" was introduced to limit growth in Equalization payments to the three-year moving average growth of nominal GDP. For 2009/10, the growth in overall entitlements was capped at the average of nominal GDP growth in 2007, 2008 and 2009, and multiplied by the 2008/09 Program cost to establish an overall Program cost for 2009/10 at \$14.185 billion. It is noteworthy that the O'Brien formula did not include a "ceiling" or "fixed pot" of annual Equalization entitlements – based on the principle that the Program should be responsive to changes in provinces' fiscal capacities (this cannot occur when there is an annual "fixed pot" of total Equalization entitlements to be split among Equalization-receiving provinces).

Second, a new fiscal capacity cap replaced the O'Brien fiscal capacity cap that ensured Equalization payments did not raise a province's total fiscal capacity above that of the lowest non-receiving province. With the partial exclusion of natural resource revenues from the formula, provinces with such revenues benefited from higher Equalization entitlements since the exclusion lowered their measured fiscal capacity. To ensure fairness, O'Brien recommended the use of a fiscal capacity cap to ensure that Equalization did not result in a receiving province having a fiscal capacity greater than that of the lowest-receiving province. Under the O'Brien model, the cap would include Equalization entitlements, 100% of natural resource revenues as well as offset payments made with respect to the Offshore Accords.

Under the cap introduced by the federal government on November 3, the cap is no longer set at the fiscal capacity of the lowest non-receiving province but at the average per capita fiscal capacity of all recipient provinces (it is triggered if the number of receiving provinces expands to cover roughly two-thirds of the Canadian economy i.e., if Ontario is a recipient province). The change meant the post-equalization fiscal capacity of receiving provinces was no longer related to the fiscal capacity of non-receiving provinces. In other words, where the O'Brien cap ensured fairness to non-receiving provinces, the new November 3 cap acts only to lower program costs and distribute the remaining "fixed pot" of funds. This will result in reduced Program adequacy, lower responsiveness and increased fiscal disparities among provinces on a go-forward basis.

For 2009/10 transition payments have been promised to recipient provinces to ensure a province does not receive less Equalization in 2009/10 than

it received in 2008/09. Manitoba and Nova Scotia will receive transition payments in 2009/10.

How the new fiscal capacity cap works

Stage 1: A first cap calculation is made to see whether a province would be a recipient (i.e., if its per capita fiscal capacity is less than the standard) if only 50% of natural resource revenues are included. In the new Program, only provinces that qualify as recipients at this stage are eligible to be tested at the next stage.

Stage 2: A second cap is applied with 100% inclusion of natural resource revenues; if full inclusion reduces a province's entitlement to \$0 or less, it is eliminated from the Program.

Stage 3: A third (ceiling) cap is applied to reduce total Program expenditures to the ceiling amount (\$14.185 billion). The third cap is an equal per capita deduction from the reduced entitlements (cap 2) of the recipient provinces.

If based on the new calculation, a province's 2009/10 entitlement is less than its 2008/09 entitlement, it will receive transition relief equal to the difference. Manitoba and Nova Scotia are eligible for transition payments in 2009/10, with no commitment for transition payments beyond 2009/10. To the extent transition payments would drive the cost of the Program above the "ceiling," the excess is recovered by reducing the entitlements of the non-protected receiving provinces on an equal per capita basis.