

APPENDIX

TRANSLATION

Québec, January 21, 2009

Mr James M. Flaherty
Minister of Finance
Finance Canada
Esplanade Laurier, East Tower, 21st Floor
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Re: Changes to equalization

Dear Colleague,

In recent days, authorities of the federal government, among them yourself and emissaries from your government, have said that all the relevant information on the changes you are considering for equalization were communicated at the federal-provincial meeting of Finance Ministers in Toronto last November 3.

That is incorrect. Allow me to set the record straight.

November 3: federal-provincial meeting of Finance Ministers

At this meeting, you informed your fellow Finance Ministers of the amounts of equalization each province will receive for fiscal year 2009-2010 only. Accordingly, you informed me that Québec would receive \$8 355 million in equalization entitlements, i.e. \$75 million less than the \$8 430 million estimated by my department in Québec's last budget tabled in March 2008.

You also informed your colleagues of your intention to make changes to the equalization program, though without revealing either the details or the impact.

You provided this information five minutes before the end of the meeting. You did not accept any questions and it was not possible to have any discussion whatsoever despite the importance of the subject.

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Accordingly, when we left the November 3 meeting, we did not know the details of the changes you wanted to impose on the equalization program as well as the impact of these changes on Québec's equalization entitlements in subsequent years.

November 10: federal-provincial meeting of First Ministers

At the federal-provincial meeting of First Ministers held in Ottawa on November 10, the Premier of Québec tried, in vain, to obtain from the Prime Minister of Canada the details of the changes announced on November 3.

Your government deliberately refused to share the information you had with the provinces.

November 27: federal economic statement

Subsequently, in your economic statement of November 27, 2008, you indicated that had the program not been changed, its total cost would have been \$16 billion in 2009-2010 and almost \$20 billion in 2010-2011. However, your statement provided no impact, by province, of the changes under consideration compared to what the provinces would have obtained had the program not been changed.

December 16 and 17: federal-provincial meeting of Finance Ministers

At the federal-provincial meeting of Finance Ministers in Saskatoon last December 16 and 17, I clearly indicated our indignation with your intention to make major changes to the equalization program without prior notice, without consultation and without sharing all the relevant information. I clearly indicated, in person and by press release, that the Québec government opposed the changes being considered.

January 16: federal-provincial meeting of First Ministers

Last January 16, at the federal-provincial meeting of First Ministers, the Premier of Québec was very clear in expressing Québec's opposition to the changes being considered. He also condemned the authoritarian approach you have adopted, pointing out that it was incompatible with open federalism.

To date, the federal government has provided no estimate of the impact by province, for the years following 2009-2010, of the major changes it intends to make to equalization. You will agree that at the very least, the governments and the people of the provinces that will suffer the financial consequences of your decisions should, in all transparency, have been correctly informed.

Today I am reiterating that the changes you intend to unilaterally impose are unacceptable, as I mentioned last December in Saskatoon.

I trust this letter leaves you in no doubt as to the position of the Québec government on the changes announced November 3.

For a frank and open discussion

Allow me to remind you of the remarks made by the Prime Minister of Canada.

In a letter sent to the Premier of Québec on March 19, 2007, 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]

However, barely 18 months later, we are forced to conclude that the federal government has broken its word regarding the equalization program. Québec is of the view that the federal government cannot change the rules of the game as it sees fit, in particular when we face an economic downturn.

In your economic statement of November 27, you said that the changes proposed November 3, 2008, are, in your view, "consistent with the O'Brien Report". That is incorrect. For example, the O'Brien Report, on page 44, was highly critical of the closed-envelope program in place from 2004-2005 to 2006-2007 and recommended a return to an open envelope, based on a formula and principles and using the ten-province standard.

On the question of 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)

The argument that the cost of the equalization program is rising by 15% per year, a rate you describe as "unsustainable", is an exaggeration to justify major changes to the equalization program. Over the last ten years, the cost of the equalization program has risen by 4.1% per year on average.

In addition, the federal government is currently allocating the equivalent of 0.8% of Canada's nominal GDP to the equalization program. That is substantially less than the historical average of 1% over the course of the last 40 years. Furthermore, according to a recent OECD study, the governments of 18 member countries examined allocated the equivalent of 2.26% of their nominal GDP to equalization.

The federal government invokes the budgetary consequences of the equalization program to justify the changes that it intends to bring to the program. In light of the numbers shown before, we do not believe that there really is a problem in this regard. The need to set up a cap mechanism, and *a fortiori* the implementation of the mechanisms you announced last November 3, has yet to be demonstrated.

That is why, in accordance with the recommendation of the O'Brien Report, Québec is asking the federal government to suspend the application of the changes announced last November 3 until a genuine process of frank, honest and transparent discussions with the provinces, analysing among other things the fears of the federal government, has been completed.

Fair treatment of Hydro-Québec dividends

I also want to raise a matter of first importance for Québec that was raised by the Premier of Québec at the meeting of First Ministers last January 16.

On November 14, 2008, your officials advised their provincial counterparts that changes to the equalization regulations were under consideration. These changes were announced in the Canada Gazette on December 24, 2008. One of them concerns a change to the treatment of dividends paid by Hydro One to the government of Ontario. The federal government has decided to consider this source of revenue under the corporate tax base rather than the natural resources base.

The argument made by your department is that this enterprise 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 remain included in the natural resources base, even if a good portion of these dividends results, as is the case with Hydro One, from electricity transmission and distribution activities. Consequently, the result of the change made to the equalization regulations on December 24, 2008 is that revenues generated by identical activities of Hydro-Québec (transport and distribution) and Hydro One are treated differently. This unfair treatment will deprive Québec of an amount estimated at more than 250 millions of dollars per year.

It is important to quickly come up with a fair solution to correct the question of the treatment of Hydro-Québec's revenues.

Yours truly,

MONIQUE JÉRÔME-FORGET