Equalization and Stabilization Post-Recession

Is Canada Ready?

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Executive Summary

Is Canada's existing system of federal transfers designed to respond adequately to economic volatility across the country and more precisely to rapid changes in relative income levels across provinces? The purpose of this paper is to investigate this question and to identify dimensions and characteristics of existing programs and rules that may inhibit the capacity of Canada's fiscal arrangements to respond adequately to sudden changes in the absolute or relative changes in the fortunes of provincial economies. Given the oil price collapse of early 2020 and the severe economic effects resulting from the COVID-19 crisis, this question has taken on increased urgency.

In other words, the gap between richer and poorer provinces has shrunk in recent years and is likely to continue shrinking in the years ahead. This paper examines the extent to which our institutions of fiscal federalism are designed to respond adequately to these changes.

Specifically, we examine the following issues:

- Whether Canada's "Fiscal Stabilization Program" is well designed to meet its objective of helping provinces cope with sharp revenue shocks.
- How the Fixed Growth Rate rule will prevent the aggregate Equalization envelope from contracting even if fiscal capacity disparities shrink.
- The extent to which lags in the Equalization formula produce potentially misleading estimates of the variation in fiscal capacity among the provinces over a given period.

Taken together, our investigation of these issues provides worrying evidence that Canada's fiscal arrangements have features that limit their ability to respond effectively to rapid changes in the relative fiscal capacity of Canada's provinces.

More specifically, Canada's Fiscal Stabilization Program, which is the program explicitly intended to help provinces cope with sudden revenue downturns, is constrained by an arbitrary per-capita cap that renders it essentially useless at achieving its stated objectives.

Meanwhile, the flexibility of the Equalization Program during periods of rapid fiscal capacity convergence whereby provinces are becoming increasingly able to generate similar per-capita tax revenues is constrained by a Fixed Growth Rate rule that requires the program to continue growing year after year, even if the gap between richer and poorer provinces shrinks. Further, a combination of lags in data collection and the use of a multi-year average to assess provincial fiscal capacities restricts the ability of the program to respond to rapid but long-lasting changes in provincial fiscal capacity.

Identifying solutions to these problems is not straightforward. Balancing considerations of equity and affordability while simultaneously seeking to minimize the harmful unintended policy incentives of these programs is the ongoing and constant work of Canadian fiscal federalism policymakers. Nevertheless, this paper presents evidence that suggests that Canada is likely entering another period of significant fiscal convergence and raises worrying questions about whether our existing system of fiscal transfers is designed to respond adequately to this development.

This paper identifies these issues and questions, but generally does not prescribe policy reforms. Instead, our purpose is to point out program features and characteristics that could potentially produce undesirable results or exacerbate regional tensions, particularly during and in the immediate wake of the COVID-19 economic crisis. While it is beyond the scope of the paper to define clear solutions to the challenges identified here, we do at times suggest policy options that may improve the performance of our fiscal federalism arrangements at the margin. However, this paper's overarching objective is to generate public discussion and encourage further analysis about whether the programs in question stand in need of reform and, if so, what types of reforms would in fact be salutary.

Introduction

Equalization is a federal program, the purpose of which is to ensure that Canadians across the country have access to comparable public services at comparable rates of taxation (Canada, Department of Finance, 2011). The program attempts to achieve this objective by providing payments from the federal government to lower-income provinces or, more specifically, provinces with lower "fiscal capacity" than average. Fiscal capacity refers to a government's ability to raise revenues at a given rate of taxation.

The Equalization Program sometimes causes friction among the provinces. It accounts for a large share of all government revenue in recipient provinces (approximately 10 to 20 percent). On the other hand, some residents of non-recipient provinces understandably question the need for an expensive federal program from which their province derives no direct benefit and, in some cases (such as Ontario and Alberta), have received negligible direct benefits over the course of the program's history.

In recent years, equalization has come under increased criticism during periods of economic difficulty in non-recipient provinces. Specifically, following the resource price collapse that began in 2014, leaders of non-recipient provinces sharply criticized the program. Saskatchewan Premier Scott Moe called the program "incredibly inequitable and flawed," because it did not deliver payments to resource-intensive economies that have struggled in recent years (Saskatchewan, 2018). Meanwhile, now-Premier Jason Kenney of Alberta (in opposition at the time of the quotation) argued that Alberta "deserves an Equalization Program that will be there when times are bad" (Clancy, 2018).

These comments, though they referred specifically to the Equalization Program, are perhaps best understood as criticisms of Canada's system of fiscal transfers more generally. For instance, it is not the role of Canada's Equalization Program to help provinces adjust to sharp economic downturns. Rather, the federal government's Stabilization Program is the policy tool intended to serve this purpose.[1]

Although the implicit suggestion of Premiers Moe and Kenney that their provinces should have received equalization payments during the

[1] The Stabilization Program seeks to make up for sharp reductions in government revenue. For more, see Dahlby, 2019 and Tombe, 2020.

downturn resulting from the oil collapse beginning in 2014 (which is hard to reconcile with that program's objectives given that both provinces had meaningfully more fiscal capacity than the national average at the time), their comments point to an important question about equalization and Canada's system of federal transfers more broadly.

That specific question is this: Is Canada's existing system of federal transfers designed to respond adequately to economic volatility across the country and more precisely to rapid absolute and relative changes in relative income levels across provinces? This paper's purpose is to investigate this question, and to identify dimensions and characteristics of existing programs and rules that may inhibit the capacity of Canada's fiscal arrangements to respond adequately to absolute or relative changes in the fortunes of provincial economies. Given the oil price collapse of early 2020 and the severe economic effects resulting from the COVID-19 crisis, this question has taken on increased urgency.

This paper begins with a short description of Canada's Equalization and Stabilization Programs and their objectives. The second section assesses the extent to which there has been a convergence in fiscal capacity between richer and poorer provinces in recent years. Subsequent sections identify program features and characteristics that may interfere with the ability of our fiscal arrangements to adapt quickly to changing circumstances should fiscal capacity among the provinces resume its convergence in future—a prospect that looks likely at this moment given the recent collapse in oil prices and the sharp economic contraction under way in Alberta. Specifically, we examine the following issues:

- Whether Canada's "Fiscal Stabilization Program" is well designed to meet its objective of helping provinces cope with sharp revenue shocks.
- How the Fixed Growth Rate rule will prevent the aggregate equalization envelope from contracting even if fiscal capacity disparities shrink.
- The extent to which lags in the Equalization formula produce potentially misleading estimates of the variation in fiscal capacity of various provinces over a given period.

Our approach in this paper is generally not prescriptive. We identify the issues and questions, but generally do not prescribe policy reforms and (unless otherwise stated) do not seek to argue that the existing arrangements are necessarily faulty. Instead, our purpose is to identify program features and characteristics that have the potential to produce undesirable results or exacerbate regional tensions, particularly during and in the immediate wake of the COVID-19 economic crisis. In so doing, we aim to generate public discussion and encourage further analysis about whether the programs in question stand in need of reform and, if so, what types of reforms would in fact be salutary.[2]

[2] Strictly speaking, the Canadian Constitution requires some type of equalization between the provinces. However, the Constitution commits the federal government only to the principle of equalization, not to any specific level to be paid to any one province at any given time. As such, there is no historical precedent for successful constitutional challenges to possible reforms that would address the issues raised in this paper.

A Short Summary of Canada's Equalization and Stabilization Programs

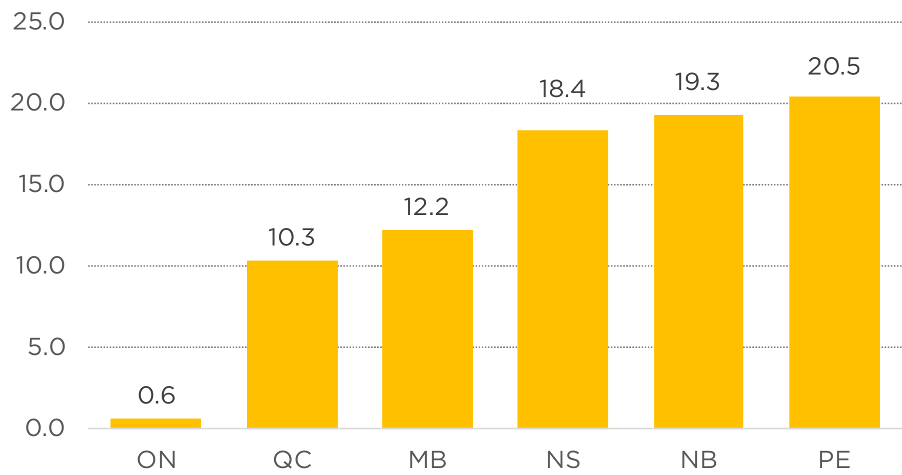
Canada's Equalization Program is designed to ensure that all provinces can provide "reasonably comparable services at reasonably comparable levels of taxation" (Canada, Department of Justice, 1982).[3] To simplify, the federal government tries to achieve this objective by directly sending money to the governments of relatively low-income provinces that are less easily able to generate own-source revenue than higher income provinces.

The amount of the transfer each province receives is determined by a formula that calculates each province's fiscal capacity. Fiscal capacity is the ability each provincial government has to raise revenue. The Equalization formula determines which provinces receive money and how much, with provinces that have the lowest fiscal capacity receiving the largest per-person grants. Equalization represents a substantial share of government revenue in most recipient provinces. Figure 1 shows that equalization payments comprised between 18.4 and 20.5 percent of provincial revenues in the Maritime provinces in 2018-19. Equalization accounted for 10.3 percent of all revenue in Quebec and 12.2 percent in Manitoba. Per-capita payments were much lower for Ontario (which has since become a non-recipient province), with equalization payments to that province representing just 0.6 percent of revenue in 2018-19.

Although the program's objectives are generally straightforward, the formula that determines the actual entitlements is somewhat complex. This formula is evolving almost constantly. In addition to regular five-year reviews of the program, governments of all stripes have frequently developed ad hoc program changes in response to economic and political considerations. These changes include measures to incorporate resource revenues, which have long been a point of contention.

[3] For further details, see Part III (Equalization and Regional Disparities) of the Constitution Act of 1982 (Department of Justice, 1982).

Figure 1: Equalization as a Share of Total Provincial Revenue, 2018-19



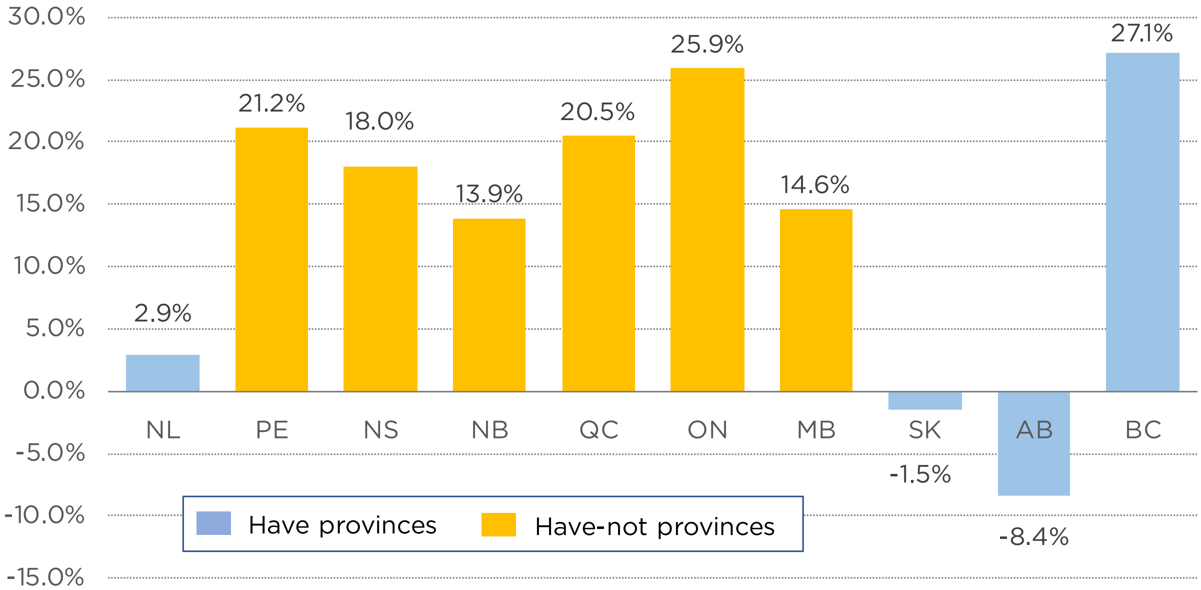
Sources: Canada, Department of Finance (2020a); Canada, Department of Finance, 2020.

The Equalization Program is not, however, designed or intended to quickly cushion provinces from the effect of rapid drops in fiscal capacity that may occur in either have- or have-not provinces at any given time. There is another, much less frequently discussed program that exists explicitly for this purpose—the fiscal Stabilization Program, which provides federal revenue to provinces that experience sharp declines in their revenue from one year to the next.

Broadly speaking, the Equalization and Stabilization Programs serve related but clearly distinct purposes. The Equalization Program aims to ensure that rich and poor provinces alike can provide high quality public services over time. The Stabilization Program aims to ensure that rich and poor provinces alike are cushioned from the fiscal effects of sharp revenue downturns due to economic developments in a given year.

The rest of this study will explore the extent to which these two programs, taken together, are designed well enough to achieve these objectives during periods of economic volatility and, more specifically, during periods of marked fiscal capacity convergence between richer and poorer provinces (ie., in which provinces are becoming increasingly able to generate similar per-capita tax revenues). We will now briefly demonstrate that such a convergence has occurred in recent years and then discuss the relevant features of these programs.

Figure 2: Percentage Change in Per-Capita Fiscal Capacity (Non Resource plus 50 Percent Resource Fiscal Capacity), 2014-15 to 2018-19



Source: Canada, Department of Finance, 2020.

The current era of fiscal capacity convergence

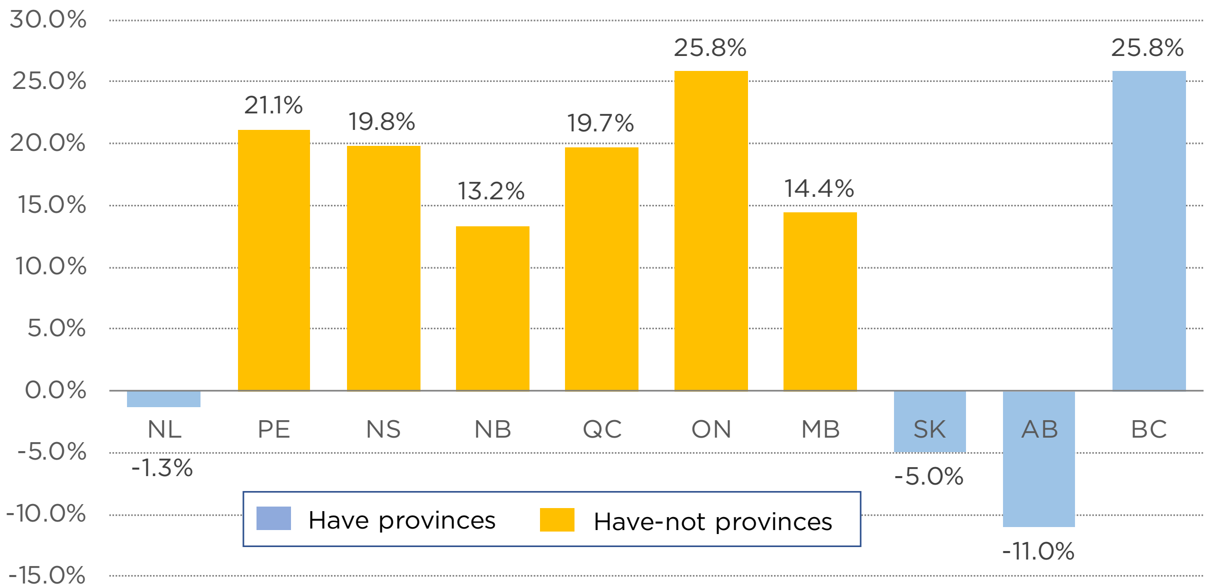
Starting with the fall in oil prices that started in late 2014-15, Canada entered an era of fiscal capacity convergence. Provinces that receive significant oil and gas related income saw their revenues shrink sharply, so the gap between their per-person fiscal capacities and that of other provinces began to shrink.

This era of convergence was ushered in by an oil price shock that triggered an economic downturn in non-recipient provinces, Newfoundland & Labrador, Saskatchewan, and Alberta (Eisen et al., 2016). This downturn, followed by a tepid recovery, has meant that these three provinces have experienced, by far, the worst fiscal capacity growth in Canada since that time. Figure 2 illustrates this point.[4]

Figure 2 calculates the change in fiscal capacity that occurred between 2014-15 and 2018-19 in all provinces. It shows fiscal capacity

[4] "Fiscal capacity" here differs from the use of the term in the Equalization formula. Values shown throughout this paper are based on the "fiscal capacity yields" for a given year rather than the three-year "weighted average" used in the formula.

Figure 3: Percentage Change in Fiscal Capacity (Non Resource plus 100 Percent Resource Fiscal Capacity), 2014-15 to 2018-19



Source: Canada, Department of Finance, 2020.

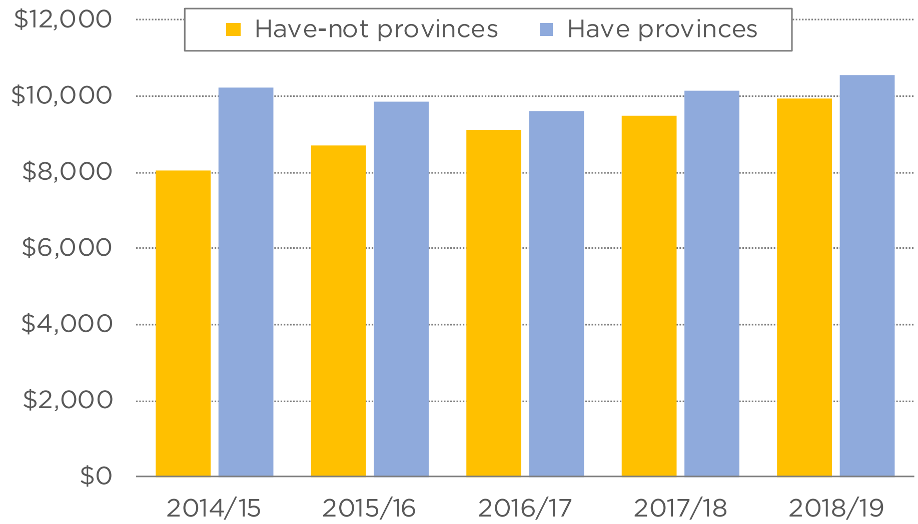
including 50 percent of all revenues from natural resources, which is the primary measure the Equalization formula uses to determine fiscal capacity except the determination of the fiscal capacity cap.[5]

The differences between the fiscal capacity growth of recipients and most non-recipients is stark. Fiscal capacity growth ranged from 13.9 percent in New Brunswick to 25.9 percent in Ontario during this time. Meanwhile, fiscal capacity in Saskatchewan and Alberta fell during this period, by 1.5 percent and 8.4 percent respectively. Newfoundland & Labrador saw its fiscal capacity stay nearly flat, with 2.9 percent growth. Among the non-equalization-receiving provinces, only British Columbia experienced strong fiscal capacity growth during this period at 27.1 percent. In total, using a population-weighted average, fiscal capacity in recipient provinces grew by 23.4 percent during this time, compared to just 5.8 percent in non-recipient provinces.

Figure 3 further illustrates the differences in fiscal capacity growth among the recipient and most non-recipient provinces by showing each

5 For a more detailed discussion of the fiscal capacity cap (FCC) and other technical dimensions of the Equalization formula, see (Eisen et al., 2016).

Figure 4: Per Capita Fiscal Capacity in Have- versus Have-Not Provinces Using 100 Percent Inclusion Rate



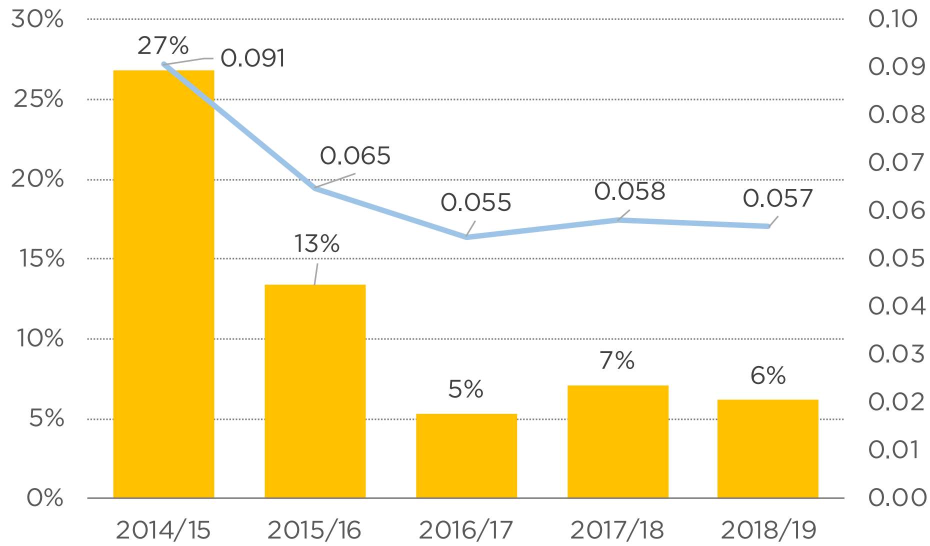
Source: Canada, Department of Finance, 2020.

province's percentage change including 100 percent of natural resource revenues. Since no province is currently implementing an explicit policy to save natural resource revenues, figure 3 may provide a measure of fiscal capacity growth that sheds more light on the change in each province's ability to fund public services in recent years. Using this measure, the gaps among the recipient and most non-recipient provinces are even larger. Newfoundland & Labrador, Saskatchewan, and Alberta all have seen their fiscal capacity shrink with 100 percent resource revenue inclusion, with Alberta experiencing the largest decline at 11 percent.

As we have seen, the fiscal capacity between recipient and non-recipient provinces has generally been shrinking between 2014-15 and 2018-19.

Figure 4 illustrates the reality of converging fiscal capacity between have- and have-not provinces more comprehensively. It shows the population-weighted average per-capita fiscal capacity of the four provinces that have not received any equalization payments since 2014-15 relative to the same measure in the 6 provinces that have received payments from 2014-15 until 2018-19. This figure includes 100 percent of natural resource revenue. Figure 4 shows that in 2014-15, the average fiscal capacity in

Figure 5: Percentage Gap in Per-Capita Fiscal Capacity between Have- and Have-Not Provinces and the "Robin Hood" Index Using 100 Percent Inclusion Rate



Source: Canada, Department of Finance, 2020.

non-recipient provinces was $2,165 more per capita than in non-recipient provinces. That amount shrunk to just $615 in 2018-19.[6]

Figure 5 highlights that while fiscal capacity was 27 percent higher in the have-provinces than in the have-nots in 2014-15, that amount had shrunk to just 6 percent in 2018-19. Figure 5 also shows a more rigorous way to measure how fiscal capacity has changed. The "Robin Hood" index[7] is a popular inequality measure. It shows the proportion of provincial revenue that would have to be redistributed to achieve a state of perfect equality. Higher index values represent more inequality, requiring more redistribution. The Robin Hood index value for fiscal capacities (100 percent inclusion) fell from 0.091 in 2014-15 to 0.057 in 2018-19, suggesting that the need for equalization fell by 37 percent. During this period, equalization payments in fact increased by 14 percent.

6 Making this comparison using 50 percent inclusion, this gap drops from $1,532 per-capita in 2014/15 to $218 per-capita in 2018/19.

7 Also called the Hoover index, Schultz index or Pietra ratio. See "Inequality Measurement: Development Issue No. 2" at https://www.un.org/en/development/desa/policy/wess/wess_dev_issues/dsp_policy_02.pdf for more detail.

Clearly, the fiscal shock of the 2014-15 oil price collapse on non-recipient provinces led to a sudden convergence in fiscal capacity with "have-not" provinces between 2014-15 and 2016-17, and the gap has remained at this much smaller level in subsequent years.

The best available evidence suggests that the era of fiscal convergence is almost certain to continue in the years immediately ahead. A recent forecast from RBC Economics suggests that non-recipient, resource-intensive economies are likely to be the hardest hit by the current economic contraction (Hogue and Muthukumaran, 2020). The forecast predicts that in 2020, Alberta will suffer the largest real economic contraction in Canada, at 8.2 percent of GDP. Saskatchewan is forecasted to see the second largest contraction, with a 5.2 percent drop in GDP, and Newfoundland & Labrador is next, at 5.1 percent of GDP. All three are forecasted to experience larger contractions than that of the Canadian economy as a whole (4.9 percent).

These figures understate the extent of fiscal capacity contraction that is likely to take place because of the large natural resource revenue drops that are certain to occur in oil-heavy economies. Resource revenues are generally more volatile than other types of revenue, and this is especially true under circumstances such as those that exist today for provinces heavily reliant on royalties from oil, which experienced a severe price shock in 2020. To give a sense of the sensitivity of Alberta's revenue to resource price changes, for example, a $1 drop in the price of a barrel of West Texas Intermediate oil produces a $355 million decline in revenue, according to the provincial budget (Government of Alberta, 2020).[8] For illustrative purposes, consider that in 2015-16 non-renewable natural resource revenue fell by 68 percent compared to the previous year. By comparison, the overall drop in all other revenues was just 1.7 percent. Natural resource revenue went from comprising 18.1 percent of Alberta's total revenue in 2014-15 to 6.3 percent in 2015-16.

All of this is to suggest that given the experience of 2014-15 and the Alberta budget's forecast, and considering the sensitivity of overall revenue to changes in the price of oil, we can expect oil-dependent provinces to experience substantial declines in natural resource revenue, which will contribute further to and likely accelerate the convergence in fiscal capacity between current recipient and most non-recipient provinces that has been occurring in recent years.

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8 The impact of lower prices is not linear—which is to say the drop in revenues associated with falling oil prices will eventually become smaller as the price drops lower. The figure cited is the marginal effect of a $1 price drop from the forecast as shown in Budget 2020.

Canada's Fiscal Arrangements in the Context of Further Fiscal Capacity Convergence

The Fiscal Stabilization Program

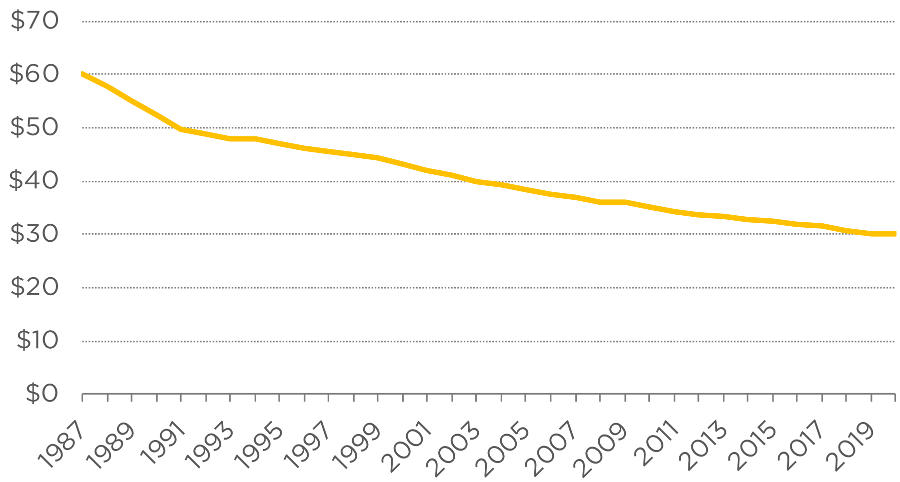
In assessing the extent to which Canada's fiscal arrangements are well equipped to respond to a sudden convergence in fiscal capacity among provinces, it is logical to begin not with the Equalization Program itself, but with the much less well-known and discussed Fiscal Stabilization Program (FSP).

The FSP is intended to help provinces manage a sudden and dramatic downturn in government revenue due to changes in economic conditions. In this section we discuss the FSP and show that it is ill-equipped to achieve or even significantly contribute to this objective when large downturns do in fact occur.

As noted in the introduction, in the immediate wake of the commodity price collapse and subsequent recession in the middle of the 2010s, Premiers Moe and Kenney both criticized the Equalization Program for its failure to deliver assistance to their provinces during a period of economic hardship.

These criticisms of the Equalization Program were misguided. The program's purpose is not to help provinces respond to sudden revenue declines. Rather, its purpose, as described in Section 36.2 of the Constitution Act of 1982, is to ensure that all provincial governments are able to provide "reasonably comparable public services at reasonably comparable levels of taxation." As such, the program is not intended to provide support to provinces with high levels of fiscal capacity, even if they have recently suffered a significant economic shock. Since both Saskatchewan and Alberta had average income levels and fiscal capacities well in excess of the national average even during the difficult years of 2015 and immediately following, it would have defied the program's logic for either province to receive equalization payments.

Figure 6: Value ($) of Fiscal Stabilization Program $60 Per Capita Ceiling, Adjusted for Inflation



Sources: Statistics Canada (2020a); RBC Economics (2020, April 20).

However, the Fiscal Stabilization Program is explicitly intended to function as a "form of insurance" for provinces when their economies experience economic shocks that produce sudden and substantial drops in revenue (Dahlby, 2019). A central theoretical advantage of the FSP is that it pools risk across provinces, by transferring some of the burden of an economic shock experienced in any particular province to the federal government and, therefore, taxpayers across the country rather than just in the affected province (Tombe, 2020).

When the leaders of resource-rich, non-equalization recipient provinces' complained that the Equalization Program did not deliver them payments in recent years, their complaints conflicted with that program's fundamental underlying logic; they would have been on much firmer ground arguing that the FSP failed to achieve its stated purpose in those years. Indeed, a look at the program's performance the during that period shows that the fiscal relief provided to hard-hit resource provinces was negligible.

The FSP transfers cash from the federal government to provinces that experience a substantial and sudden decline in revenue. The current Stabilization Program was created in 1967 and was based on a simple formula—for any province that experienced a 5 percent or greater drop in revenue (due to an economic downturn—not tax rate reductions), the federal government would fully compensate the affected province for any losses to revenue beyond that 5 percent. In short, at its conception and for many years after, the program served as a type of floor that ensured no province (tax policy changes aside) could see their revenues fall by more than 5 percent from one year to the next.

Over time, several changes to the program were implemented.[9] However, the change of greatest importance by far was instituted in 1987, when a $60 (in nominal dollars) per capita limit was placed on stabilization. This $60 cap has come to be the dominant factor in determining the performance of the FSP. Strictly speaking, provinces are eligible for additional stabilization funds beyond the $60 per person grant—but such funds take the form of an interest-free loan rather than a grant and are made available entirely at the discretion of the federal finance minister. In practice, no province has ever received the loan component of the FSP[10] (Tombe, 2020).[11]

The reasoning for the $60 per-capita limit appears to be entirely arbitrary. The figure is the approximate amount of stabilization payments that had, at the time the cap was introduced, been most recently received by any province (ie., British Columbia in the early 1980s). However, this limit made no provision for larger grants if inflation-adjusted revenue losses for any province were greater than those experienced by BC in the early 1980s, or even for the loss of value of a nominal $60 per capita amount over time due to inflation. Indeed, as shown in figure 6, the value of the per-capita $60 nominal cap today has declined with inflation over time and would be equivalent to just $30 dollars per person in 1987, the year the cap was implemented. The real value of the cap has therefore been cut in half since it was introduced as a result of inflation alone.

The cap, and the fact that it was not indexed to inflation, certainly served a purpose—it provided cost certainty for the federal government while also generally reducing the federal government's real exposure to

[9] Tombe (2020) documents the history of these changes in detail.

[10] One option available for the federal and provincial governments in the wake of the 2020 pandemic-induced recession, which will substantially reduce revenues in this year, would be for the federal government, for the first time, to extend these interest free loans to provinces that experience large revenue shocks. This would, essentially, have the effect of moving debt from provincial balance sheets to the federal balance sheet, thereby reducing overall interest costs to governments due to the lower interest rates available to the federal government.

[11] One particularly noteworthy change is that if an otherwise eligible province experiences resource revenue declines of less than 50 percent, stabilization payments are set using the original 1967 formula, but with resource revenues excluded entirely (Tombe, 2020).

costs related to the FSP over time. However, it achieved this objective at the expense of its ability to protect provinces from fiscal capacity shocks.

The per-capita limit on the FSP had not, until the oil price shock of 2014-15, played an important role in determining the outcomes of Canada's fiscal arrangements. All provinces were eligible for stabilization payments at one point or another since the cap's implementation, but it has only been binding in two instances: Nova Scotia in 1991-92 and PEI in 1992-1993.

It was not until the commodity price shock of 2014-15 that the cap began to play an important role in determining the outcome of the program and therefore outcomes of Canada's fiscal arrangements generally.

Starting in late 2014, Alberta saw oil prices decline from over $100 per barrel to a low of under $30 per barrel, which contributed to a drop in nominal provincial GDP of approximately 20 percent over two years (Eisen et al., 2019). Consequently, Alberta saw a substantial decline in revenues in the years following and the province subsequently became eligible for stabilization payments in both 2015-16 and 2016-2017. In each year, the $60 cap played a decisive role in determining the scale of FSP payments made to the province.

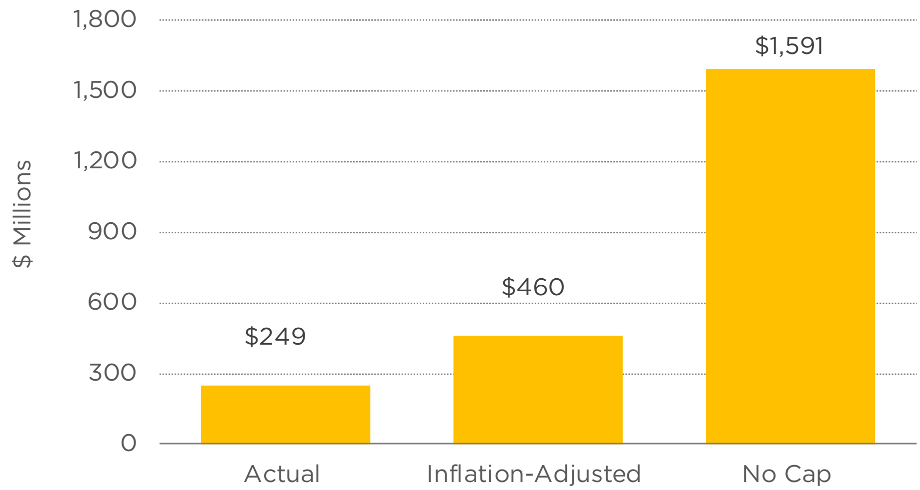
For illustrative purposes, we will look at the 2015-16 tax year. In a recent study for the Institute for Research on Public Policy, Trevor Tombe showed that in that tax year, after adjusting for tax policy changes (which are not meant to be covered by the FSP), Alberta experienced an adjusted revenue loss of $7.2 billion in that fiscal year, a decline of 14.5 percent (Tombe, 2020).

Tombe shows that in the absence of the $60 per capita limit, Alberta would have qualified for nearly $1.6 billion in stabilization funds in 2015-16, or $384 per person. The $60 per person cap, however, reduced Alberta's stabilization payments to $248.3 million.

Figure 7 visually illustrates the effect of the $60 cap on Alberta's FSP payments in 2015-16 compared to what the province would have received in the absence of the cap.[12] Figure 7 also shows the effect of the decision to demarcate the cap in nominal rather than inflation-adjusted dollars by showing what payments would have been if the 1987 cap had been indexed to inflation. It shows the amount actually received that year, the uncapped amount that the province would have received and, finally, the amount that would have been received if the cap that was put in place in 1987 was set to $60 per person in real terms, which is to say, adjusted upward over time to account for inflation.

[12] Our numbers are slightly different from those reported by Tombe (2020) because he used population at June 1st (as in the Equalization formula) and we used population at July 1st. The relative differences in actual and theoretical FSP payments are the same.

Figure 7: Fiscal Stabilization Payments to Alberta in 2015-16, Plus Alternatives ($ millions)



Sources: Statistics Canada, 2020a; 2020b; 2020c; RBC Economics, 2020, April 20.

Figure 7 and the discussion above have illustrated the limitations of the FSP to help provinces adjust to large, sudden changes in revenue—the purpose for which the program was created. When Alberta's revenue fell drastically in 2015-16, the FSP replaced just 3.5 percent of the year-over-year total revenue loss. In the absence of a cap, a $1.6 billion stabilization payment would have replaced 22.1 percent of the province's total revenue decline from 2014-15 to 2015-16.

The performance of the FSP during Alberta's last recession has become urgently relevant again with the collapse in commodity prices and economic contraction that have occurred so far in 2020. It now appears that the national economy will experience a significant recession in 2020 and, as such, several provinces are likely to experience meaningful revenue losses. It is therefore possible that several provinces could become eligible for stabilization payments.

Although it is possible that many or all provinces will experience revenue declines this year, those declines are almost certainly going to be largest in provinces that rely on natural resource revenues (specifically from oil royalties) due to the rapid fall in the price of those resources.

As such, a scenario like 2015-16, during which Alberta becomes eligible for FSP payments that are dramatically constrained by the continued existence of the $60 per person cap is now entirely plausible and, in fact, likely this year.[13] Given that every province is expected to experience a meaningful economic contraction (RBC Economics, 2020), other provinces may become eligible, and face the cap, as well.

None of this is to argue that the FSP should necessarily be made more robust, the cap removed, or that the program should even continue to exist. We leave consideration of these important questions to others. And indeed, there are good reasons to be concerned about harmful incentive effects from a more robust FSP, particularly when resource revenues are "stabilized" by the program.[14] For example, entirely uncapped stabilization payments or an FSP with a much higher cap may create even worse budgeting incentives for provinces. In other words, there is a potential for "gaming" the system, with provinces acting on the incentive to spend more freely or make riskier financial decisions more generally knowing that the cost of major revenue drops will be partially pushed onto the federal government and, ultimately, to taxpayers across the country.[15]

Instead, the purpose of this section has been simply to assess whether the FSP is capable of succeeding at its own stated objectives—providing significant compensation to provinces that experience large revenue downturns due to changes in economic conditions. Clearly, it is not. If Alberta or any other jurisdiction experiences a sharp revenue drop in 2020-2021 (as at the moment appears very likely), the FSP will provide little more than a "drop in the bucket" in helping to address the resulting fiscal problems. As such, the FSP is not, as presently constituted, a tool that can meaningfully affect the ability of Canada's arrangements of fiscal federalism as a whole to adjust to large economic shocks such as will be felt in several provinces this year, particularly in energy-rich provinces.

13 For perspective, Alberta's 2020 Budget assumed a Western Canada Select (WCS) price of $51.20 per barrel in 2020/21, Deloitte recently estimated the price will be substantially lower at approximately $22.90 per barrel (see Deloitte, 2020).

14 For example, see (Boadway, 2020), for an argument against enhanced fiscal stabilization for resource revenues. Smart (2004) argues that equalization could be reformed to make it more sensitive to changes in relative revenue between provinces such that the equalization itself could play an important role in stabilizing provincial finances. This analysis—despite the fact that the formula has changed substantially since it was conducted—illustrates that the insurance dimensions of fiscal federalism could theoretically be addressed in large part by a reformed Equalization Program rather than a separate Stabilization Program.

15 In short, there is a reasonable case to be made that there is no need for a federal "insurance program" of this nature, given that provinces—particularly resource-rich ones—have the capacity to self-insure against revenue shocks. The existence, for instance, of a more robust Stabilization Program could therefore create a soft-budget constraint problem that encourages overspending during periods of economic strength.

The Equalization Program: Considering the Fixed Growth Rate rule

Previous sections have shown that the fiscal capacities of Canadian provinces have converged in recent years and are likely to continue converging in the period immediately following the COVID-19 recession and the simultaneous (and related) collapse in oil prices. We have also seen that the Fiscal Stabilization Program will not provide meaningful support to hard-hit energy-producing provinces so long as the $60 per capita limit remains in place.

We now turn to discuss how Canada's Equalization Program is performing and will continue to perform in the context of converging fiscal capacity.

As noted in the previous section, the Equalization Program is not meant to help provinces deal with rapid revenue declines. This is, theoretically, the role of the FSP.

Nevertheless, the logic of the Equalization Program suggests that long-term fiscal capacity convergences such as those being discussed in this paper should shape the performance of the program over time. Specifically, since the program's explicit goal is to equalize the ability of various provinces to fund public services, program logic suggests that if the fiscal capacity gap between richer and poorer provinces shrinks, then overall equalization payments should shrink as well.

Indeed, this is how the program used to function. Prior to 2009, the overall equalization envelope increased if the gap between richer and poorer provinces grew. Conversely, if the gap shrank, so too did equalization payments. This arrangement is consistent with the "equalizing" logic of the program.

In 2009, however, a policy change was implemented that fundamentally changed this dimension of the program. Under the new rule, (heretofore the Fixed Growth Rate rule, or FGR), the overall equalization envelope would grow at a fixed pace, in line with recent nominal economic growth. As such, under the new rule, only the distribution of equalization funds, but no longer the total amount, would be formula-driven, with the amount now determined by the rate of recent economic growth.

The rationale for a ceiling on equalization payments is straightforward (whether or not one finds it convincing)—to provide cost certainty for the federal government and protect federal finances. However, identifying a comparably strong rationale[16] for the FGR to act as a floor

[16] One possible argument for requiring equalization to continue to grow even if the gap between provinces shrinks is to address a perceived fiscal imbalance between

on equalization payments, guaranteeing it must grow in line with nominal GDP even if the gap between richer and poorer provinces shrinks, proves more difficult.[17] But this is precisely what has occurred in some recent years. Because of the converging fiscal capacity issue described above, and the shrinking gap between richer and poorer provinces, we have in 2018-19, 2019-20, and 2020-21 reached the point where overall equalization payments would have been smaller without the FGR than they were with the rule in place.

Table 1 shows how the FGR pushed program costs up in 2018-19. Because of the rapid convergence of previous years, the fiscal capacity gap between have- and have-not provinces had shrunk by 2018-19 to the point that in the absence of the FGR, program costs would have fallen from the previous year. Instead, program costs continued to rise. As table 1 shows, in 2018-19, the FGR increased the size of the equalization envelope by nearly $1.8 billion—10.2 percent higher than without the FGR.

In short, table 1 shows that a rule that was created to act as a ceiling on equalization costs, at least in the short term,[18] in fact acted as a floor—permitting payments from falling to where they would under the formula

the provinces and territories. A fixed growth rate for equalizations, however, would represent a singularly unfair strategy for achieving this objective as only some provinces receive it. As such, equalization is a singularly unhelpful tool for addressing an imbalance between the resources available to provincial governments relative to the federal government. A second potential argument for a floor on equalization payments is that they provide more certainty to provincial governments in making budget plans. In this instance as well, equalization is a tool that is ill-suited to helping provinces since it is the aggregate amount of equalization payments—not payments to any specific province—that is guaranteed by the FGR. As such, a specific province could easily experience a meaningful drop in equalization payments even with the FGR in effect due to formula-driven changes to specific provinces. In short, the problem with relying on the FGR to provide budget certainty to provinces is that the provinces budget individually rather than as a group.

17 Given the severity of the current recession, we must at least note the possibility that at some point average nominal economic growth in Canada over a three-year period may be negative. This possibility does not seem to have been contemplated in the legislation creating the FGR, but is the one scenario in which the size of the overall envelope could conceivably shrink under the present rules. Even in this instance in a scenario of rapid fiscal capacity convergence, however, the FGR could be acting as a floor on payments, preventing larger declines than would occur in the absence of the rule.

18 In announcing the creation of the FGR in Budget ’09 the federal government did recognize the possibility that the FGR could eventually come to act as a floor rather than a ceiling on payments. The problems with potential rationales for allowing the FGR to act as a floor on payments are discussed briefly in footnote 15 earlier, as well as in greater detail in (Eisen et al., 2017).

Table 1: Equalization entitlements, ($ thousands), 2018/19

	Initial Allocation (1)	After Fiscal Capacity Cap (2)	After GDP Growth Rate Rule (3)	Change Due to Fiscal Capacity Cap (4)	Change Due to GDP Growth Rate Rule (5)
British Columbia	0	0	0	0	0
Alberta	0	0	0	0	0
Saskatchewan	0	0	0	0	0
Manitoba	1,948,456	1,946,352	2,036,897	-2,104	90,545
Ontario	0	0	963,165	0	963,165
Quebec	12,461,740	11,156,509	11,732,046	-1,305,231	575,537
New Brunswick	1,824,051	1,821,307	1,873,898	-2,744	52,591
Nova Scotia	1,867,700	1,867,700	1,933,460	0	65,760
Prince Edward Island	408,513	408,513	418,793	0	10,280
Newfoundland & Labrador	208,448	0	0	-208,448	0
Canada	18,718,908	17,200,381	18,958,259	-1,518,527	1,757,878

Source: Canada, Department of Finance, 2020.

in the absence of the rule in 2018-19. In past studies, we have presented a possible "fix" to this rule that would replace the FGR with a "ceiling" on payments that rises with GDP. This would achieve the government's goal of maintaining cost certainty while permitting program costs to shrink in the face of further fiscal capacity convergence (Eisen et al., 2016 and 2019).

Reforming the FGR to allow equalization payments to shrink if so determined by the formula is a particularly relevant idea for consideration today given the likelihood of further fiscal capacity convergence in the years ahead. First, this change has the potential to generate meaningful savings for the federal government, helping slightly with the large deficits it faces. Second, and perhaps more importantly, replacing the FGR with a ceiling on payments could remove a source of regional resentment and tension surrounding the program by avoiding apparent "overpayments" relative to what payments would be in the absence of the rule. If equalization payments continue to grow year after year, even as non-recipient provinces that are not eligible (and, as in the case of Alberta, are almost certain to remain ineligible for the foreseeable future) for payments continue to struggle, the program could inflame regional resentments and tension, particularly in Alberta.[19]

The analysis presented here suggests that the Equalization Program is generally not well equipped to respond to changing (particularly, converging) fiscal capacities across provinces. Indeed, the inflexibility created by the FGR means that no matter how quickly the gap between richer and poorer provinces continues to shrink (thereby intuitively reducing the need for equalization), the program itself must continue to grow. This inflexibility represents a fundamental challenge in the program's ability to adapt to changing relative fiscal capacity levels across the country such as are likely to occur in the wake of the COVID-19 crisis. In short, because of the FGR, the current Equalization Program is ill-equipped to respond in a defensible manner, consistent with program logic, if further fiscal convergence does occur.

Lags in the formula: Another equalization factor to consider

The FGR is the most important single dimension of Canada's current Equalization Program determining that the program is not well-designed to be responsive to sudden or large changes in the relative fiscal capacity of various provinces. There are, however, other factors worthy of brief consideration.

The first of these is the extended period used to measure the fiscal capacity of each province. The Equalization formula determines the fiscal capacity of each province by using a three-year average, with a two-year lag. This means that payments for 2021-22 will be determined on the basis of provincial fiscal capacity in fiscal years 2017-18, 2018-19 and 2019-20.

The rationale for using a weighted average over multiple years was spelled out in the "O'Brien Report," entitled *Strengthening Canada's Territories and Putting Equalization Back on Track*, which was ultimately used as the basis for a significant reform of equalization in the federal government's 2007 Budget (O'Brien, 2007). The report noted that smoothing out fiscal capacity measures for each province using a multi-year weighted average would help the program respond to persistent shocks rather than transitory shocks. It also noted that a moving average could help provinces in their budget planning processed (O'Brien, 2007).

19 Due to nearly flat fiscal capacity changes in Newfoundland & Labrador coupled with strong recent fiscal capacity growth in Ontario and Quebec, it is conceivable that Saskatchewan and Newfoundland & Labrador could become eligible for payments as a result of the FGR in coming years.

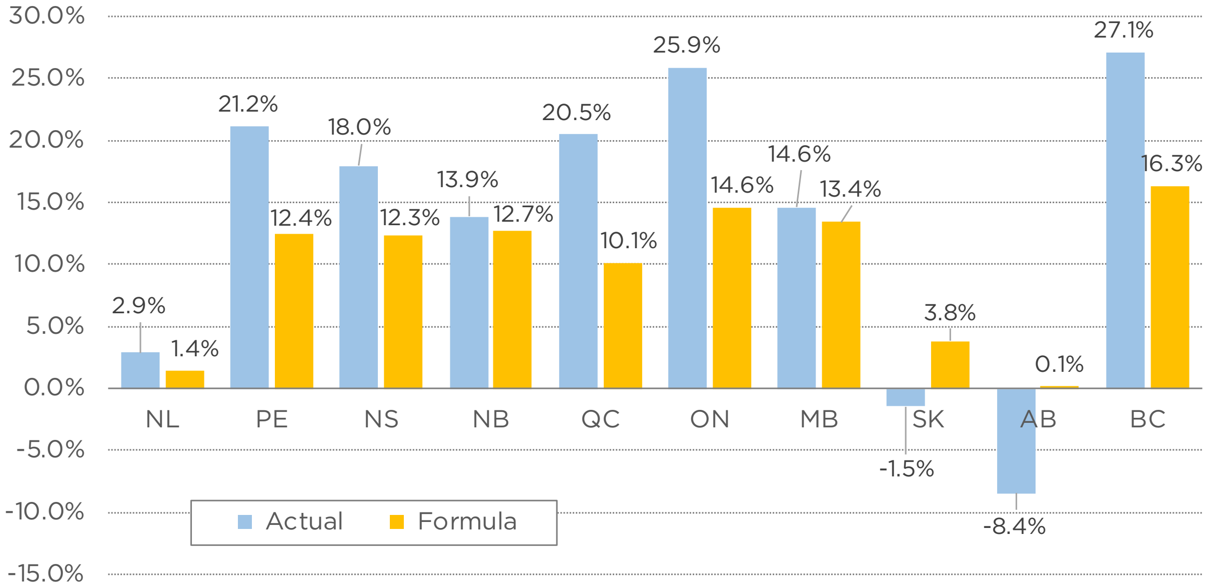
Saskatchewan Premier Brad Wall identified this issue as potentially problematic in 2015, noting that when resource prices drop, “there will be a lag of three to five years before that works its way through the formula, and that could be modernized” (CBC, 2015, August 5). The use of a multi-year formula has obvious advantages in that it can “smooth out” short term fluctuations in resource revenue. However, it may present problems when sudden resource price changes at a given time do not simply represent fluctuations, but instead herald in a lengthy period of consistently lower prices and resource revenue.

Figure 8 helps illustrate how lags in the Equalization formula can make the program unresponsive to sudden but potentially lasting changes in the relative fiscal capacity of various provinces. It compares the actual change in fiscal capacity (in percentage terms) from fiscal years 2014/15 to 2018/19 to the change in each province's fiscal capacity as determined by the equalization formula over that period. Alberta, for example, saw its actual fiscal capacity drop by 8.4 percent over this period. The province’s deemed fiscal capacity under the multi-year formula, however, increased by 0.1 percent. The figure uses the 50 percent resource revenue inclusion rate that dominates much of the Equalization formula, but the results are broadly similar using a 100 percent inclusion rate.

Figure 8 shows that the lags in the formula—and particularly the fact that in 2018-19 provincial fiscal capacities from fiscal years 2014 and 2013 (years prior to the large fall in resource revenues in oil-rich provinces) were still contributing to each province’s deemed fiscal capacity—had important implications in determining the Equalization Program’s outcomes. Between 2014-15 and 2018-19, Alberta’s fiscal capacity fell by 8.4 percent. However, under the formula, the province’s deemed fiscal capacity for that year increased by 0.1 percent from 2014-15 levels. Saskatchewan also experienced an actual decline in fiscal capacity from 2014-15 to 2018-19, but under the formula it was deemed to have experienced a small increase. On the other hand, the formula produced deemed fiscal capacity levels in large recipient provinces—particularly Quebec and Ontario—that were much smaller than the fiscal capacity changes that had in fact occurred.

Given the evidence in recent years of rapid and sustained changes in relative fiscal capacities among provinces, it is reasonable to revisit the question of whether it is appropriate to use a formula that goes back in time by five years to help determine current fiscal capacity. An Albertan in 2017, for instance, could reasonably wonder what the relevance was of the province’s fiscal capacity in 2012, when oil prices were dramatically higher, in determining the province’s current ability to raise revenue. This is particularly true given that the oil price collapse of late 2014 did not just

Figure 8: Actual versus Calculated (Formula) Change in Per Capita Fiscal Capacity (Non-Resource plus 50% Resource Fiscal Capacity), 2014-15 to 2018-19



Source: Canada, Department of Finance, 2020.

create a short-term disruption in revenues but, rather, was the start of a major and enduring shift in energy prices and resource royalties.

When such changes occur, as happened in 2014-15 and may again be happening today with respect to the price of oil, it is noteworthy that the Equalization Program takes fully five years for that change to be factored in, which may disadvantage specific provinces in the meantime. This issue is most likely to be relevant in the near-term for Newfoundland & Labrador, which is a have-province with a fiscal capacity level that is close to the "cut-off" line that would make it eligible for payments, and could conceivably become relevant for Saskatchewan, another have-province with substantial natural resource revenues that is closer to the national average fiscal capacity and incomes than Alberta, which could not plausibly become eligible for payments in the near- or medium-term.

Given the large and possibly enduring oil price fall of early 2020 due in large part to the COVID-19 pandemic, the question of whether it is reasonable to include fiscal capacity levels going back five years to determine current fiscal capacity levels and equalization entitlements has taken on increased urgency.

While there are legitimate reasons to use a multi-year formula to determine equalization entitlements, the lengthy persistence of reduced energy prices following the 2014-15 collapse in the value of oil and the fact that non-recipient oil-reliant provinces are likely to experience the largest fiscal capacity shocks due to the COVID-19 pandemic and its economic effects and aftermath, this issue deserves the attention and consideration of federal policymakers.[20]

[20] One especially straightforward reform option for the federal government to consider would be to move from a two-year lag to just one year. There is no principled reason for the use of a two-year lag; rather, the longer lag time exists because of concern that Statistics Canada and other data collection efforts are too slow to make a one-year lag possible. Speeding up the pace of data collection could address this problem and allow the lag to shrink to one year. Alternatively, payments in initial months could be based on estimates for the year that is one year after the first year currently used in the formula. In other words, 2019-20 data could be used as the first year for determining the 2020-2021 payment instead of starting in 2018-19 as is now the case if estimates were used for the 2019-20 year. Any necessary corrections could be made in later months as data were to become finalized. In short, there are options for reducing the lag time from two years to one, and a shift to a one-year lag is entirely possible.

Conclusion

This paper has shown that in recent years, Canada has gone through a period of fiscal capacity convergence**.** The gap between richer and poorer provinces has shrunk considerably. Further, the most recent economic data and current resource price forecasts suggest that further fiscal capacity convergence lies ahead. This paper has raised concerns about how Canada's fiscal arrangements are likely to respond to the coming changes.

We suggest that Canada's fiscal arrangements are poorly suited to the rapid convergence of fiscal capacity among Canada's provinces. Canada's fiscal Stabilization Program, the program explicitly intended to help provinces cope with sudden revenue downturns, is constrained by an arbitrary per-capita cap that renders it nearly entirely useless for its stated objective.

Meanwhile, the flexibility of the Equalization Program is constrained by a Fixed Growth Rate rule that requires the program to continue growing year after year, even if the gap between richer and poorer provinces shrinks. This creates an inherent tension with the program's logic, which suggests that if the fiscal capacity of provinces becomes more equal, the cost of equalizing that fiscal capacity should shrink. Meanwhile, lengthy lag times in the Equalization formula may put jurisdictions that experience sudden but long-lasting downturns in natural resource revenues at a disadvantage.

Questions about how to solve these problems are not straightforward and answering them is beyond the scope of this paper. Balancing considerations of equity and affordability while simultaneously seeking to minimize harmful unintended policy incentives is the ongoing and constant work of policymakers in the field of Canadian fiscal federalism. The evidence presented in this paper suggests that Canada is likely entering another period of significant fiscal convergence and it raises questions about whether our existing system of fiscal transfers is designed to respond adequately to this development.

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