

The Great Convergence: Measuring the Fiscal Capacity Gap Between “Have” and “Have-Not” Provinces

By Ben Eisen and Milagros Palacios

Since 2007/08, the fiscal capacity gap between richer and poorer Canadian provinces has shrunk dramatically, with the trend accelerating significantly after 2014–15. Fiscal capacity refers to a province’s ability to raise own-source revenues at tax rates set to the national average, plus any additional revenues from natural resource royalties. We here refer to this trend of a shrinking fiscal capacity gap as “the great convergence.”

In 2007/08, using 2020 dollars, the fiscal capacity gap between the richest province (Alberta) and the poorest (PEI) was \$10,999. By 2018/19, that number had fallen to \$6,138. With the 2020 COVID shock and sudden fall in natural resource prices, we estimate the gap will fall further to \$3,758 in 2020. In the 2020/21 fiscal year, we estimate that British Columbia will overtake Alberta as the province with the highest fiscal capacity, and New Brunswick will replace PEI as the province with the lowest. A similar directional trend prevails if we consider fiscal capacity convergence between other oil-rich provinces (Newfoundland and Labrador and Saskatchewan) with other provinces.

In this paper, we calculate the scale of this convergence and discuss the budgeting implications for high- and low-income provinces. We pay particular attention to the case of Alberta.

The collapse in Alberta’s fiscal capacity has been remarkable and is likely to produce historic results. We estimate that the resource revenue collapse this fiscal year 2020/21 will essen-

tially complete the process of Alberta’s fiscal capacity convergence with the rest of Canada. We estimate per-person fiscal capacity in Alberta for 2020/21 will be \$9,189. This is almost identical to the per-person fiscal capacity in the rest of Canada (\$8,832). Since 2007/08, the gap has shrunk from 92.8 per cent to 4 per cent. Further, we estimate that Alberta will lose its spot as having the highest per-capita fiscal capacity in Canada for the first time since the modern notion of fiscal capacity was developed in 1967.

These results have important implications for public finances in Alberta. Because it has lost its fiscal capacity advantage, the province’s existing combination of low tax rates and high spending is no longer possible without running large budget deficits. Alberta’s deficit has been over \$6 billion every year since 2015, while multiple analyses show that the province’s current policy bundle of low taxes and high spending is fiscally unsustainable given reasonable assumptions about future demographic and economic conditions. Saskatchewan and Newfoundland and Labrador will also likely face additional fiscal pressures due to their declines in

per-person fiscal policy capacity that have occurred already and that we estimate will continue in 2020.

There are also implications for budgeting in current have-not provinces due to the current rules of the equalization program. If current fiscal capacity levels persist Newfoundland and Labrador is likely to become an equalization recipient in the years ahead. More worryingly, if Alberta's per-person fiscal capacity continues to stagnate or fall, that province could become equalization eligible in coming years—a possibility that would have been unthinkable just a half-decade ago. This is potentially problematic because under the current fixed-rate rules of the equalization program, new arrivals as recipients reduce the pool of equalization revenues available to existing recipients. We saw evidence of this fact in the early 2010s when Ontario became eligible for grants, and equalization payments as a share of total revenue fell meaningfully in all previous recipient provinces.

The “great convergence” in the relative fiscal strength of Canadian jurisdictions has different but significant implications

for public finances in both higher-income and lower-income provinces. This study is the first to rigorously measure the reality of a great convergence in Canada and provides a starting point for future policy discussions surrounding the policy implications for current equalization recipients, non-recipients, and federal policymaking surrounding fiscal federalism.



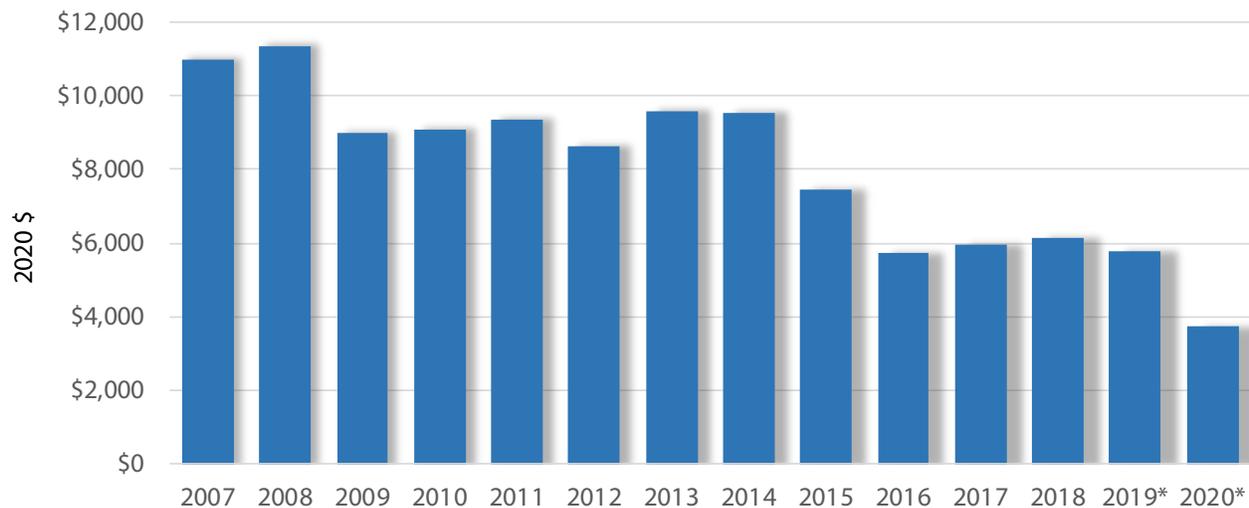
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Per-capita fiscal capacity gap between the highest and the lowest provinces



* = estimates