EXECUTIVE SUMMARY

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Should Equalization Keep On Growing in an Era of Converging Fiscal Capacity?

by Ben Eisen, Joel Emes, and Steve Lafleur

Equalization is a federal government program that aims to provide Canadians in all provinces with access to reasonably comparable public services at comparable levels of taxation. It attempts to achieve this objective by providing cash payments from the federal government to governments of provinces that have a lower fiscal capacity—the ability to raise revenues. In recent years, largely as a result of economic slumps in several non-recipient provinces, disparities between the fiscal capacity of recipient and non-recipient provinces have generally shrunk significantly.

The logic of the equalization program suggests that, because the fiscal capacities of recipient and non-recipient provinces are converging, the total equalization envelope should eventually begin to shrink as well. However, under the program's current rules, aggregate equalization payments are required to continue growing (in line with recent national growth in GDP) in perpetuity. This counter-intuitive program feature is the result of a policy change introduced in 2009.

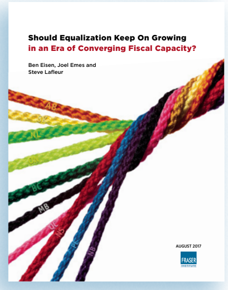
At that time, the federal government was concerned with rapid growth in the cost of the equalization payments and introduced a rule that linked equalization payments to overall national economic growth, requiring the overall equalization payments to grow in line with national GDP. The GDP growth rate rule was introduced primarily to ensure affordability for the federal government. However, as the gap between the fiscal capacity of recipient and non-recipient provinces has narrowed in recent years, it is becoming clear that the rule has the potential to become a driver of program costs rather than a constraint.

The data analysed in this paper shows how the convergence in the fiscal capacities of recipient and non-recipient provinces in recent years will likely soon cause the GDP growth rate rule to begin acting as a floor on equalization payments rather than a ceiling that constrains their growth, which was the purpose for which the rule was introduced. The projections that the paper provides of the evolution of the equalization program in the years ahead show that, if economic growth in non-recipient provinces is weak, the GDP growth rate rule could add as much as $2.7 billion to the cost of the equalization program over the next two fiscal years.

The GDP growth rate rule was introduced to ensure program sustainability and affordability for the federal government, clearly legitimate considerations in the design of any federal program. However, there is no similarly clear policy objective served by allowing it to function as a floor on payments if disparities in provincial fiscal capacity narrow. In fact, an active floor on payments could drive up program costs and exacerbate regional tensions surrounding the program.

There are a number of ways this problem could be addressed. We present one straightforward reform that could eliminate this troubling feature while maintaining certainty about program costs for the federal government. These objectives could be achieved by replacing the GDP growth rate rule with a flexible equalization envelope that expands and contracts along with disparity in fiscal capacity, constrained only at the upper end by a ceiling that grows in line with nominal GDP. This reform would save the federal government money and reduce the threat of exacerbating regional tensions. Further, we show that removing the current floor on the growth rate for equalization payments is a precondition for many other reforms.

There are, of course, many controversial and problematic aspects of the equalization program. By focusing narrowly on one—potential upward pressure on program costs from the GDP growth rate rule—we do not aim to minimize the importance of such issues or suggest that a more comprehensive program renovation is unnecessary. Indeed, with the program's quinquennial review approaching in 2019, a window will soon open during which reforms large and small can be considered. No matter how other issues are addressed, it is time to take a hard look at the likelihood that, as the fiscal capacities of non-recipient and recipient provinces converge, the GDP growth rate rule will act as a floor on aggregate payments.



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