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

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Executive Summary

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.

Introduction

Equalization is a federal government program that aims to ensure that Canadians across the country enjoy access to comparable public services. More specifically, its objective is to provide Canadians in all provinces with access to "reasonably comparable public services at comparable levels of taxation" (Canada, Dep't of Finance, 2011). The program attempts to achieve this objective by providing cash payments from the federal government to governments of less prosperous provinces that have a lower *fiscal capacity*, a term that refers to the ability to raise revenues at average rates of taxation.

Since the explicit goal of the program is to *equalize* the ability of various provinces to fund public services, the logic of the program suggests that if the disparity between the fiscal capacity of rich and poor provinces grows, overall equalization payments should grow as well. Similarly, the logic of the program suggests that if the disparity between rich and poor provinces contracts, equalization payments should shrink. Under the program's current rules, however, equalization payments can never shrink from one year to the next: total spending on the program must grow no matter how well the transfer-receiving provinces are doing economically or how poorly non-recipient provinces are faring. [1] This means that, even if disparity between the fiscal capacity of rich and poor provinces were to shrink quickly, equalization payments would be required to keep growing.

This counter-intuitive feature of the program's current design is the result of a rule introduced in 2009 which requires overall equalization payments to increase each year on a growth path that reflects a three-year moving average of nominal gross domestic product (GDP) growth (Canada, Dep't of Finance, 2009). The rule was implemented in an effort to control program costs, which had been rising quickly in previous years. However, because the disparity between the fiscal capacity of recipient and non-recipient provinces has begun to contract considerably since 2014, the country is quickly approaching the point at which the rule setting a fixed growth rate will require an upward adjustment to equalization payments rather than a downward adjustment. In other words, a rule introduced to serve as a ceiling on equalization payments from the federal government will soon come to act as a floor, driving costs up.

In the absence of a compelling objective served by maintaining a payment floor, this publication argues that the program's own logic requires this rule to be amended. It also presents a simple option for doing so without undermining the current rule's advantages of affordability and certainty about

[1] The only possible exception would be if average national nominal GDP growth over a three-year period were actually negative.

costs for the federal government. Further, it assesses the extent to which the continued existence of a growth floor creates an obstacle to any future cost-saving reform.

There are, of course, many controversial and problematic aspects of the equalization formula and program. In focusing narrowly on one—possible upward pressure on program costs from the fixed-growth-rate rule—we do not aim to minimize the importance of such issues or suggest that a more comprehensive review and renovation of the program is unnecessary. No matter how other issues are addressed, the fixed-growth-rate rule within the program's current framework is problematic, and the objective of this paper is to identify and quantify the potential costs of its ability to act as a floor on payments. The equalization formula is due for a regular quinquennial review in 2019. At that time, the federal government will have an opportunity to consider large and small reforms to the program's framework. This represents an important opportunity for the government to consider the fairness and wisdom of a rule that forces the equalization program to grow in perpetuity even if the disparity in fiscal capacity between provinces becomes smaller over time.

Equalization in Canada—Program Objectives and Structure

On its face, the objective of the federal equalization program is relatively straightforward. The program's stated goal is to ensure that all provincial governments, regardless of economic disparities, are able to provide "comparable public services" at "reasonably comparable levels of taxation" (Canada, Dep't of Finance, 2011). In short, the program's goal is to ensure that poorer provinces are able to deliver public services that are of comparable quality to those found higher-income provinces. [2] To simplify somewhat, the federal government tries to achieve this objective by directly sending money to the governments of lower-income provinces that are less easily able to generate revenues.

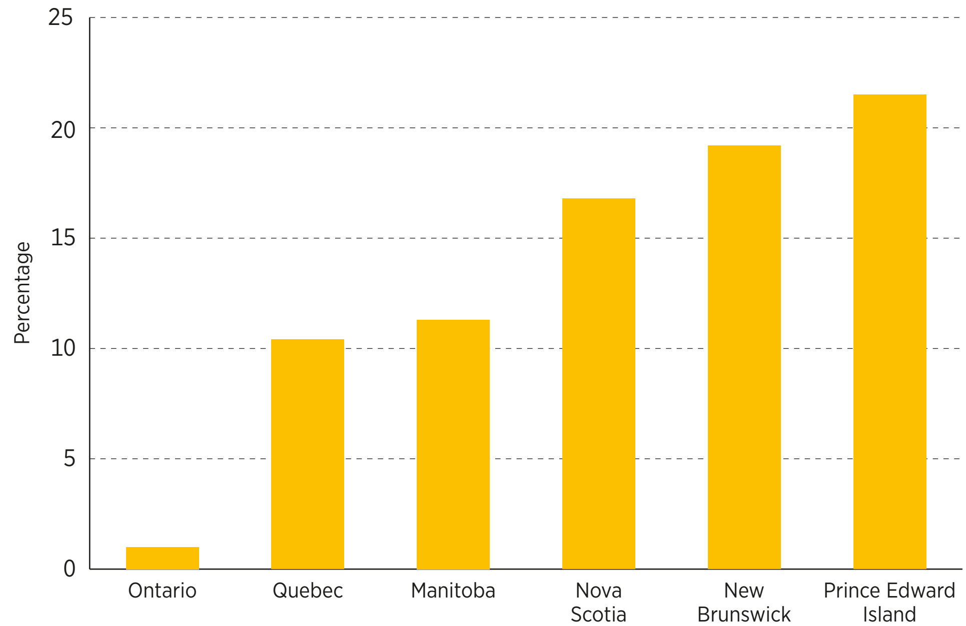
The amount of the transfer each province receives is determined by a formula that calculates each province's fiscal capacity. Fiscal capacity, simply put, is the ability each provincial government has to raise revenue. The equalization formula determines which provinces receive money and how much, with provinces that have the lowest fiscal capacity receiving the largest per-person grants.

The equalization payment is a substantial source of revenue for most recipient provinces. Currently, six of the ten provinces receive payments. These are Ontario, Quebec, Manitoba, and the three Maritime provinces. For all of these provinces except Ontario, equalization in 2017/18 will be the largest source of federal transfer payments and will represent over 10% of provincial revenues or more. For Quebec, Manitoba, and the Maritime provinces equalization represents between 10% and 22% of total revenue. Equalization represented just 1% of total revenue in Ontario in 2017/18 (Canada, Dep't of Finance, 2017; Provincial Budgets, 2017/18). Figure 1 shows equalization payments as a share of total provincial revenue in the six "have-not" provinces in 2017/18.

Clearly, equalization represents a major source of provincial revenue for half of the provincial governments in Confederation. Furthermore, it represents by far the largest federal program that provides no direct benefit each year for several provinces—those that do not receive any equalization payments. It

[2] Some critics have argued that the equalization program does not in fact achieve these objectives. For example, Crowley and O'Keefe (2006) argue that the program does not meaningfully produce better public services in recipient provinces but, rather, the primary effect is simply to increase public-sector compensation costs. It is beyond the scope of this paper to evaluate these arguments about the extent to which the program achieves its stated objective.

Figure 1: Equalization as share (%) of provincial revenue, 2017/18



Sources: Canada, Dep't of Finance, 2017; Provincial Budgets, 2017/18.

is certainly true that the recipients of equalization and dollar amounts for various provinces have changed over time. Nevertheless the program's benefits are (by design) much less evenly spread across the country than those from any other major federal program. For example, Alberta has not received a dollar in equalization payments since the early 1960s. Ontario, meanwhile, has received less money from equalization in its history than Quebec has received over the past two years. Given these different regional experiences, it is unsurprising that the program has been a source of heated political debate in Canada and a touchstone of regional tension and resentments at various points.

The specific rules governing equalization payments have changed many times over the years. For example, the program's treatment of resource revenues has been a constant source of contention between provinces and the federal government and has changed repeatedly over the years. [3] The broad framework of the program as it exists today are described by the Department of Finance as follows:

[3] For a review of the program's history in the broader context of the history of federal transfers, see Clemens and Veldhuis, 2007. For more on natural resource issues, see Feehan, 2005. Unlike other categories, natural-resource revenues are calculated based on the actual amount of revenue a province collects, not on a formula-driven determination of how much they could raise.

- Before any adjustments, a province's per-capita Equalization entitlement is equal to the amount by which its fiscal capacity is below the average fiscal capacity of all provinces – known as the "10 province standard".

- Provinces get the greater of the amount they would receive by fully excluding natural resource revenues, or by excluding 50 per cent of natural resource revenues.

- Equalization is adjusted to ensure fairness among provinces while continuing to provide a net fiscal benefit to receiving provinces from their resources equivalent to half of their per capita resource revenues. [4]

- Equalization is also adjusted to keep the total program payout growing in line with the economy. The growth path is based on a three-year moving average of gross domestic product (GDP) growth. This helps to ensure stability and predictability while still being responsive to economic growth. (Canada, Dep't of Finance, 2011)

The GDP growth rate rule

The final bullet point describes a feature of the equalization program introduced in *Budget 2009*, and its possible future impact is the main topic of this paper. This rule, which we call the "GDP growth rate rule", requires that overall spending on equalization grow at a fixed rate pegged to the growth of nominal GDP going forward. As Feehan (2014) notes, this fundamentally changed the equalization program, as it meant that the equalization formula would no longer be used to determine the size of the equalization envelope but only to determine how the funds within it would be allocated. In the next section, we discuss the origins of the GDP growth rate rule and the problems it was meant to solve.

[4] This bullet point refers to the application of the Fiscal Capacity Cap (FCC). The FCC was introduced in 2007 to ensure that no province receiving equalization would wind up with a higher total fiscal capacity, including all of its natural resource revenues, than any non-receiving province. In 2009, the FCC standard was changed to the average of all Equalization-receiving provinces.

GDP Growth Rate Rule—Origins and Rationale

The GDP growth rate rule was introduced in 2009 primarily in response to two developments. First, a resource boom in several provinces was leading to rapid growth in the gap between the fiscal capacities of provinces receiving equalization payments and those that did not, adding to a rapid increase in program costs. As noted in the *2009 Budget*, equalization payments in that year were 56% more than they were just a few years earlier, in 2003/04. The *Budget* claimed this growth level was "clearly not sustainable" and introduced the GDP growth rate rule to slow down what the federal government of the day viewed as an unsustainable trajectory for program costs (Canada, Dep't of Finance, 2009).

Second, 2009/10 marked the year of a development that had potentially seismic implications for the nature and cost of the equalization program: Ontario became eligible for equalization payments for the first time in its history. With populous Quebec already eligible, this development meant that approximately 70% of the country now lived in provinces receiving equalization payments. Although equalization payments to Ontario in 2009/10 were trivial, the prospect that Ontario could soon become entitled to large per-capita entitlements threatened to drive substantial growth in the program cost for the federal government in the future. The arrival of Ontario as an equalization-receiving province had such potentially profound implications for equalization that some, including former Bank of Canada governor David Dodge, argued it required a fundamental rethink of the goals of our federal transfer programs. Dodge, along with co-authors, wrote that the country's approach to equalization and transfers should evolve to have less of a focus on the "comparability" of public services, and a greater focus on "quality or adequacy" (Dodge, Burn, and Dion, 2012).

Given the pressures on equalization payments at the time and the prospect of those pressures growing in the future if Ontario's per-capita entitlements were to grow quickly, the federal government's concerns about program affordability and sustainability were reasonable. This is particularly true given the state of federal finances at the time, which were mired in deficit spending as a result of the global financial crisis and recession, and the federal government's stimulus response to same. It was in this context, and with the reasonable objective of ensuring the affordability and sustainability of the program for the federal government, that the GDP growth rate rule pegging the growth rate of the overall equalization envelope to the rate of growth for nominal GDP was introduced.

That the government's objectives were legitimate does not mean its introduction of a ceiling on growth would prove uncontroversial. Feehan (2014), for example, argued that the GDP growth rate rule undermined the fundamental objectives of the equalization program and therefore, (while recognizing the risks to program affordability and predictability) argued for its removal: "... under such an arrangement, the aggregate of equalization payments becomes less and less reflective of the fiscal gaps across provinces. The fundamental principle that payments should rise when fiscal gaps become relatively more severe, and should fall when those gaps diminish, is violated by this allocation rule". As Feehan argued, the introduction of a pre-determined rate of growth in equalization payments ran counter to the logic of the equalization program, which suggests that, if the gap in fiscal capacity between provinces grows, equalization payments should be able to grow commensurately.

Ultimately, whether one concludes the introduction of the ceiling was a sound policy change depends on how heavily one weights two policy criteria: on the one hand, affordability and fiscal sustainability from the perspective of the federal government; on the other, the principle that larger fiscal disparity among provinces should be matched with commensurately larger equalization payments to support equality in public services. It is beyond the scope of this paper to offer an assessment of how these criteria should be weighted, except to say they are both legitimate considerations, at least to anybody who accepts the fundamental animating objectives of the equalization program in its current form.

In this section we have sought to explain the pressures that the government of the day was responding to in creating it and have argued that the GDP growth rate rule was introduced in an effort to address reasonable concerns and achieve legitimate policy objectives. However, another feature of the GDP growth rate rule is not similarly defensible—that being its capacity to act as a floor on equalization payments and, therefore, a driver of costs rather than a constraint. We turn now to address this issue.

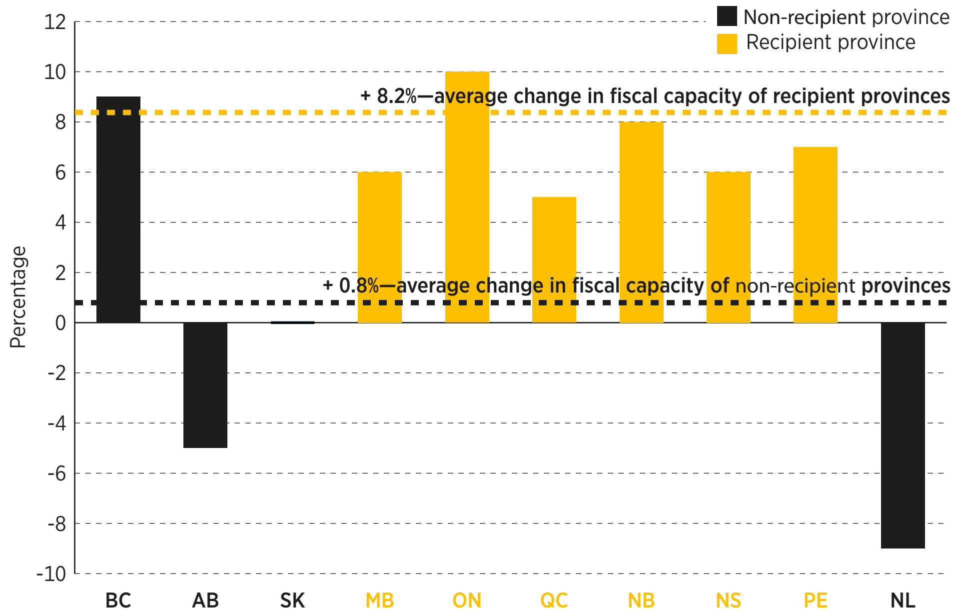
Implications of an Equalization Growth Floor Going Forward

As we have seen, the GDP growth rate rule was introduced to the equalization program in 2009 in an effort to slow down the rapid increase in program costs that had prevailed in recent years. The rationale for a *ceiling* on the growth rate of equalization payments is straightforward (whether or not one finds it convincing). However, it is much more difficult to identify a defensible rationale for the GDP growth rate rule to act as a *floor* on equalization payments, guaranteeing that it must grow in line with nominal GDP even if this results in payments being in excess of what is needed to bring the fiscal capacity of equalization-receiving provinces up to the threshold determined by the "ten-province standard" followed by the application of the Fiscal Capacity Cap (FCC). In other words, the government's 2009 reform meant that *total* equalization payments must continue to grow every year, in line with GDP, even if the disparity in fiscal capacity between the non-recipient and recipient provinces shrinks dramatically over time. A rule designed primarily to ensure affordability and financial sustainability for the federal government, therefore, has the potential to require a *boost* to equalization payments even if the gap between provinces narrows. [5]

And, the disparity in fiscal capacity among the provinces has indeed been contracting. Starting in 2014, a significant oil-price shock contributed to economic downturns in three out of the four non-recipient provinces—Newfoundland & Labrador, Saskatchewan, and Alberta. As a result, fiscal capacity in these provinces either fell between 2013/14 and 2015/16 or, in the case of Saskatchewan, did not materially change (figure 2). Of the non-recipient provinces, only British Columbia enjoyed a significant increase in its fiscal

[5] We here note that there is some discrepancy between public pronouncements and the actual text of the Federal-Provincial Fiscal Arrangements Act (Canada, Dep't of Justice, 2016) about whether the GDP growth rate rule is required to act as a floor if fiscal disparities shrink or whether this is a matter of ministerial discretion. Whereas *Budget 2009* explicitly stated that the pegged growth rate *will* act as a floor on total payments, the legislation itself states that an upward adjustment payment *may* be made in this scenario, appearing to imply Ministerial discretion. Since *Budget 2009*, no public statement has been made suggesting that the GDP growth rate rule is no longer considered to be a floor as well as a ceiling on payments. Despite the ambiguity in the legislation, we therefore proceed on the basis that eliminating the GDP growth rate rule as a payment floor would require a policy change, although one that may or may not require legislative action to bring about.

Figure 2: Change (%) in per-capita fiscal capacity (non-resource plus 50% resource fiscal capacity), 2013/14–2015/16



Source: Canada, Dep't of Finance, 2016a.

capacity (9%) over this two-year period. By contrast, all the provinces that are recipients of equalization have seen their per-capita fiscal capacities increase (by between 5% and 10%) during the same period. To look at the issue from another perspective, consider that, taken together, per-capita fiscal capacity in the four non-recipient provinces has increased by 0.80% over this two-year period. By comparison, over the same period, the fiscal capacity of the six receiving provinces has increased by an average of 8.2%.

Such developments mean that the disparity in fiscal capacity between the non-recipient and recipient provinces has fallen significantly over this two-year period. In 2013/14, the average fiscal capacity of the four provinces that do not receive equalization payments was 42% larger than the average fiscal capacity of the recipient provinces. Over just two years, 2014/15 and 2015/16, this gap fell by ten percentage points to 32%.

In the years since the introduction of the GDP growth rate rule, the possibility that the rule could act as a driver rather than a constraint on costs was of purely academic concern. However, as a result of this narrowing disparity in fiscal capacity between recipient and non-recipient provinces, we are now quickly approaching the point at which the GDP growth rate rule for the overall equalization envelope could begin to act as a driver of program costs rather than a constraint. This could be as soon as next year.

The federal government forecasts that, in 2018/19 it will spend $18.9 billion on the equalization program. (Canada, Dep't of Finance, 2017) However, it is not at all clear that it will be necessary to spend that much in order to bring all of the equalization-receiving provinces up to the level that would be required by the formula in the absence of the GDP growth rate rule. To demonstrate this, we provide a sample projection of what equalization entitlements for all provinces would be in 2018/19 in the absence of the GDP growth rate rule compared to a projection of what they will likely be as a result of the rule. Note that expected total equalization payments for 2018/19 are already a matter of public record. What is uncertain is how the total will be distributed (Canada, Dep't of Finance, 2017).

Annex 1 includes details of the methods, sources, and assumptions underlying the projections. However, we here note that any projection for future equalization payments necessarily involves many assumptions. The purpose of the projections presented here is therefore not to provide a precise estimate of exactly how equalization payments to each province will evolve under the GDP growth rate rule or in its absence in the years ahead. Instead, our projections aim to show that there are plausible scenarios in which the GDP growth rate rule could become a cost driver rather than a constraint on costs as well as what the additional costs could be.

The three tables that follow have the same basic structure. Column 1 shows the results of the first step in the equalization calculation. Column 2 presents equalization after the Fiscal Capacity Cap (FCC) is applied. These are the amounts that would be paid to provinces in the absence of the GDP growth rate rule. Column 3 provides the amounts that we project will be paid after the GDP growth rate rule is applied. Column 4 is the difference between columns 2 and 1 and shows how the FCC changes equalization payments. Column 5 is the difference between columns 3 and 2 and reflects how the GDP growth rate rule increases payments.

Equalization Entitlements, 2018/19

This projection (table 1) shows that there will be six equalization-receiving provinces in 2018/19 (there were also six in 2017/18). These are the three Maritime Provinces (New Brunswick, Nova Scotia, and Prince Edward Island), Quebec, Ontario, and Manitoba. Our projection suggests that, in the absence of the GDP growth rate rule, these provinces would be entitled to equalization payments totaling $18.2 billion in 2018/19, $655 million less than will in fact be paid out. Importantly, if equalization payments were calculated without the GDP growth rate rule being applied under this scenario, the overall equalization envelope would actually shrink slightly in 2018/19 from $18.3 billion to $18.2 billion instead of rising to $18.9 billion.

Given the narrowing of the disparity in fiscal capacity between recipient and non-recipient provinces in recent years, this outcome is consistent with the logic and spirit of the program. However, as a result of the GDP growth rate rule, the program will instead continue to grow in line with national nominal GDP from *previous* years, which translates into a year-over-year increase of 3.3%. While we address the issue more thoroughly in the discussion section

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

	(1) Initial Allocation	(2) After Fiscal Capacity Cap	(3) After GDP growth rate rule	(4) Change due to Fiscal Capacity Cap	(5) Change due to GDP growth rate rule
British Columbia	0	0	0	0	0
Alberta	0	0	0	0	0
Saskatchewan	0	0	0	0	0
Manitoba	1,974	1,974	2,007	0	34
Ontario	289	289	648	0	358
Quebec	13,080	11,972	12,187	−1,108	215
New Brunswick	1,738	1,738	1,757	0	20
Nova Scotia	1,811	1,811	1,835	0	24
Prince Edward Island	410	410	414	0	4
Newfoundland & Labrador	182	0	0	−182	0
Canada	19,484	18,194	18,848	−1,290	655

Sources: Canada, Dep't of Finance, 2016a; Provincial Budgets, 2017/18; Statistics Canada, 2017a: CANSIM table 380-0081; Statistics Canada, 2017b: CANSIM table 380-0080; Statistics Canada, 2017c: CANSIM table 052-0005.

below, it is worth noting here that the GDP growth rate rule partially offsets the constraint imposed by the Fiscal Capacity Cap (FCC). In particular, the FCC lowers Quebec's entitlement by $1.1 billion but the GDP growth rate rule then increases it by $215 million.

Equalization Entitlements, 2019/20

Our projection further suggests that in 2019/20, the GDP growth rate rule will again act as a driver rather than a constraint on payments, and the impact is almost double that in 2018/19 (table 2). Specifically, our projection suggests that the GDP growth rate rule will require equalization payments in 2018/19 to be $655 million larger than would be the case in the absence of the rule, and $1.2 billion larger in 2019/20. [6] As pre-GDP-adjustment equalized fiscal capacity is slightly higher in Quebec than in Ontario under this scenario, Ontario gets some of the adjustment to bring its post-adjustment equalized fiscal capacity up to Quebec's level and then shares the balance equally (in per-capita terms) with all provinces eligible for an adjustment.

[6] Section 3.4(8)(b) of the Fiscal Arrangements Act allows for the possibility of non-recipient provinces sharing in the "surplus" generated by the application of the GDP growth rate rule in years where the rule drives rather than constrains costs. This happens when the per-capita pre-adjustment equalized fiscal capacity in a receiving province is sufficiently close to that of the lowest non-receiving province to yield a higher post-adjustment equalized fiscal capacity in the absence of the non-receiving province sharing in the adjustment payments.

Table 2: Equalization entitlements ($ millions), 2019/20

	(1) Initial Allocation	(2) After Fiscal Capacity Cap	(3) After GDP growth rate rule	(4) Change due to Fiscal Capacity Cap	(5) Change due to GDP growth rate rule
British Columbia	0	0	0	0	0
Alberta	0	0	0	0	0
Saskatchewan	0	0	0	0	0
Manitoba	2,032	2,032	2,066	0	34
Ontario	0	0	911	0	911
Quebec	13,632	12,411	12,629	−1,221	218
New Brunswick	1,723	1,723	1,743	0	20
Nova Scotia	1,805	1,805	1,830	0	25
Prince Edward Island	420	420	424	0	4
Newfoundland & Labrador	140	0	0	−140	0
Canada	19,752	18,391	19,602	−1,361	1,211

Sources: Canada, Dep't of Finance, 2016a; Provincial Budgets, 2017/18; Statistics Canada, 2017a: CANSIM table 380-0081; Statistics Canada, 2017b: CANSIM table 380-0080; Statistics Canada, 2017c: CANSIM table 052-0005.

If it comes to pass, this additional $1.9 billion in equalization payments over this two-year period beyond equalization entitlements that would have been paid had there been no GDP growth rate rule can be characterized as an overpayment, given that it is an additional payment beyond what would be necessary to bring the equalization-receiving provinces up to the fiscal capacity target determined by the "ten-province standard" and Fiscal Capacity Cap. While there are legitimate policy objectives supporting the existence of a ceiling on the growth of equalization, there is no similarly legitimate objective that requires the existence of a floor that boosts the size of equalization payments in this way.

Budget 2009 explicitly noted that the GDP growth rate rule could in fact be allowed to act as a floor, which it argued would "protect provinces against reductions in overall equalization". This argument is problematic, however, because provinces budget individually—not as a group—and under the current rules equalization payments to each province can either rise or fall in a given year despite the GDP growth rate rule, whether the rule is acting as a driver or constraint on costs in a given year. For example, over the two-year period from FY2009/10 to FY2011/12, equalization payments to Quebec fell by over a billion dollars as Ontario came to consume a larger share of the overall equalization envelope. Similarly, next year, Ontario will see its equalization payments fall by almost $800 million even though we forecast the GDP growth rate rule will be acting as a floor on overall payments.

In short, the GDP growth rate rule does not in fact ensure continued growth for any specific provincial government since entitlements for each receiving province depend on the size of entitlements for other provinces, and these depend on fiscal-capacity calculations using, among other items, final audited revenue values. While the GDP growth rate rule, when it functions as a floor, would protect the provinces as a group from "reductions in overall equalization" as promised in the budget, it does not in fact protect any particular provincial government from year-over-year reductions. Similarly, a floor cannot reasonably be defended as a mechanism to "make up" for lost payments resulting from the GDP growth rate rule in previous years since the money may flow to different recipients depending on which provinces enter and leave the program.

While serving no identifiable policy objective, an automatic escalator attached to equalization payments that requires growth every year regardless of shrinking gaps in fiscal capacity merely guarantees the growth of the cost of a major federal program. The result will be the growth of a cost imposed on taxpayers across the country, including those in provinces that do not receive equalization payments and derive no direct benefit from the program.

Guaranteeing growth in the overall equalization envelope can theoretically be defended as a strategy for partially addressing a perceived *vertical fiscal imbalance* between the federal and provincial governments. [7] However, maintaining a minimum guaranteed growth rate for the equalization program would represent a singularly unfair strategy for achieving this objective since it excludes several provinces from the benefit. [8] Either increasing per-capita transfers or freeing tax room and inviting the provinces to step into it would be a much more logical and fair option for addressing a perceived vertical fiscal imbalance. In short, per-capita fiscal transfers (the CHT and CST) exist to address vertical fiscal imbalances, whereas equalization is intended to respond to horizontal fiscal imbalances. The equalization program is, therefore, by its very design not an appropriate tool with which to attempt to address a perceived vertical fiscal imbalance. Equalization's sole purpose is. and should be,

[7] A *vertical fiscal imbalance* refers to an imbalance between the different orders of government in their capacity to raise sufficient revenues to fund services for which they are responsible. A *horizontal fiscal imbalance* refers to differing revenue-raising capacities among the provinces themselves. For more on these terms, see Standing Senate Committee on National Finance, 2006.

[8] Theoretically, under the GDP growth rate rule disparity in fiscal capacity could narrow to the point that all provinces were receiving equalization payments. In the extreme case, for example, if all provinces were deemed to have identical fiscal capacities, under the current rule the equalization envelope would be distributed to all provinces on a per-capita basis. For the foreseeable future, however, the fiscal benefit of extra growth in equalization resulting from the GDP growth rate rule will exclude specific provinces with high fiscal capacities.

to address horizontal fiscal imbalances among the provinces, and proposals to explicitly address a perceived vertical imbalance through this program should therefore be viewed with skepticism.

The additional projected costs resulting from the fixed growth rate rule are not trivial: our projection suggests they would increase the cost of the equalization program by 3.6% in the first year. Of greater concern, however, is the fact that the emergence of this issue in 2018/19 highlights a fundamental deficiency with the equalization program's current design—that payments must continue to grow no matter how much the disparity between the fiscal capacity of non-recipient and recipient provinces may shrink in the years ahead. In other words, even if non-recipient provinces experience another economic shock or recession and the disparity in the fiscal capacity of the provinces narrows further, equalization payments will continue to climb. Under this scenario, the GDP growth rate rule's new function as a floor on equalization payments could come to be a substantially larger driver of additional program costs in the years ahead, a benefit to receiving provinces but a burden both to taxpayers in struggling non-recipient provinces and, more generally, to everyone paying federal taxes.

Equalization Entitlements, Alternative Scenario, 2019/20

To illustrate this reality, we provide a projection of an alternative economic scenario in which resource revenues do not recover in Alberta and Saskatchewan in 2017/18 and fiscal capacity in the non-recipient provinces is 2% lower in 2017/18 than in the base projection. [9] In this scenario, the gaps between the fiscal capacity of rich and poor provinces in 2017/18 would be smaller than in the base projection but, as we have seen, equalization payments would not be affected.

In this scenario, however, the GDP growth rate rule would become an even bigger driver of cost growth by 2019/20 (table 3), raising program costs by approximately $2.1 billion (approximately 12.2% of total program costs) above what they would be in the absence of the rule. This example illustrates that, under the current rules, equalization is not equipped to respond to a large, prolonged narrowing of the disparity in the fiscal capacity of richer and poorer provinces in the way that the program's logic suggests it should. This is a fundamentally problematic feature of the equalization program that has the potential to create perverse outcomes of "over-equalization" relative to entitlements as they would be calculated in the absence of the GDP growth rate rule.

An important feature of tables 1 and 2 is that they show that the GDP growth rate rule is much more likely to become a driver than a constraint on

[9] This decrease of 2% in fiscal capacity for the non-recipient provinces is chosen simply to illustrate the potential impact of an economic shock. A larger shock could, of course, have a bigger impact on these provinces' fiscal capacity. Detailed assumptions for this scenario are described in Annex 2.

Table 3: Equalization entitlements ($millions), alternative scenario, 2019/20,

	(1) Initial Allocation	(2) After Fiscal Capacity Cap	(3) After GDP growth rate rule	(4) Change due to Fiscal Capacity Cap	(5) Change due to GDP growth rate rule
British Columbia	0	0	0	0	0
Alberta	0	0	0	0	0
Saskatchewan	0	0	0	0	0
Manitoba	1,929	1,929	2,003	0	74
Ontario	0	0	1,492	0	1,492
Quebec	13,076	11,737	12,206	−1,339	469
New Brunswick	1,664	1,658	1,700	−6	43
Nova Scotia	1,731	1,731	1,785	0	53
Prince Edward Island	409	409	417	0	8
Newfoundland & Labrador	150	0	0	−150	0
Canada	18,959	17,463	19,602	−1,495	2,139

Sources: Canada, Dep't of Finance,2016a; Provincial Budgets, 2017/18; Statistics Canada, 2017a: CANSIM table 380-0081; Statistics Canada, 2017b: CANSIM table 380-0080; Statistics Canada, 2017c: CANSIM table 052-0005.

costs if provinces that derive no direct benefit from equalization (particularly Alberta and Saskatchewan) are struggling economically. It is easy to see how a program feature that arbitrarily enhances equalization payments to other provinces could heighten regional tensions and resentments surrounding the program under this scenario in which non-recipient provinces are struggling economically.

The fact that the GDP growth rate rule can act as a floor on equalization payments and actually drive costs rather than constraining them is clearly a design flaw, potentially creating real costs while achieving no defensible policy objective. Fortunately, it is a relatively easy flaw to fix, at least from the perspective of policy design though perhaps not of politics. The next section describes one way this can be done.

A Simple Fix for a Flaw in Policy Design—Eliminate the Equalization Growth Floor

After the GDP growth rate rule was added to the equalization formula in 2009 to ensure that the program remained affordable for the federal government, one critic of the GDP growth rate rule argued that reducing the inclusion rate for natural-resource revenue could largely achieve similar objectives without contravening the underlying logic of the equalization program as directly as the growth ceiling strategy (Dahlby, 2014). Despite the advantages of this approach, it would leave the door open for more rapid program growth in the future. So long as the size of the envelope (as well as its distribution) is determined by formula and unconstrained by a ceiling, the possibility remains of significant growth in program costs over time depending on economic developments across the country. Dahlby's proposed reform would, therefore, not provide the cost certainty to the federal government provided by the GDP growth rate rule.

While affordability and fiscal sustainability is a reasonable policy objective that may justify a ceiling on payments, we have argued in the previous section that there is no similarly compelling justification for maintaining a floor on the rate of growth of the overall equalization envelope. Indeed, a floor that artificially inflates payments beyond what they would be in the absence of a GDP growth rate rule has the potential to substantially increase program costs while exacerbating regional tensions surrounding the program.

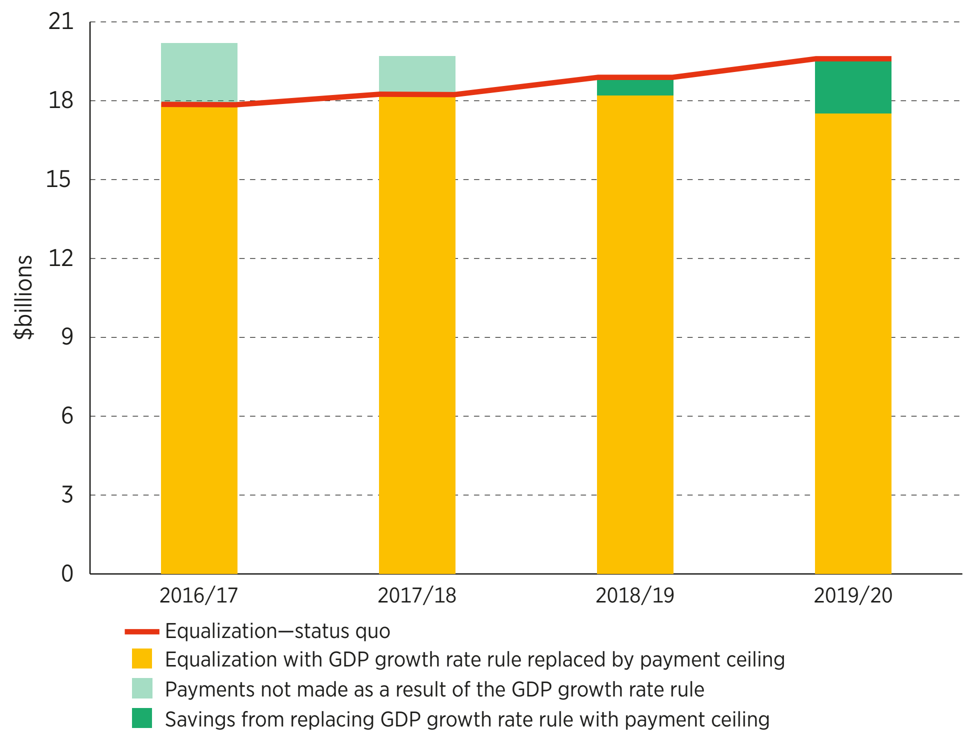
There is at least one relatively straightforward reform that could maintain the cost-constraining advantages of the GDP growth rate rule while avoiding these undesirable outcomes. Quite simply, the equalization program can be changed such that the growth threshold pegged to growth in GDP acts only as an upper limit on equalization payments in a given year but not as a guarantee of a minimum level for the overall size of the equalization envelope. [10] In other words, the GDP growth rate rule would be replaced with a flexible approach to determining the size of the equalization envelope, with upward growth alone constrained by a ceiling that grows with GDP over time.

[10] As noted previously (note 5), this change may not actually require a change to the wording of the Act. Rather, it may simply be a matter of the Minister acting on the flexibility that the actual wording of the Act appears to afford.

This policy change would achieve the primary objective of the GDP growth rate rule—ensuring affordability for the federal government—while allowing equalization payments to shrink if the disparity in the fiscal capacity of richer and poorer provinces shrinks sufficiently, as the program's internal logic suggests that it should.

Figure 3 clarifies how this reform could be implemented in practice. The line on the graph shows how equalization payments are currently set to increase under the GDP growth rate rule. For this example, we use our second forecast scenario from above in which resource prices and economic performance in the non-recipient provinces are weak in 2017/18. The red line represents the actual and projected equalization payments—the status quo—under current rules. The bars (including all colours) represent what equalization payments would be in the absence of a GDP growth rate rule. The yellow portion of the bars shows what equalization payments have been and would be from 2016/17 to 2019/20 if the reform we have outlined were implemented. Specifically, it shows how the GDP growth rate rule served to constrain program costs in 2016/17 and 2017/18, with the light green portion of the bars above the line showing savings in the first two years resulting from the GDP growth rate rule acting as a ceiling on payments.

Figure 3: Impact of GDP growth rate rule on equalization payments, alternative scenario, 2016/17–2019/20



Sources: Canada, Dep't of Finance, 2016a; Provincial Budgets, 2017/18; Statistics Canada , 2017a: Cansim table 380-0081; Statistics Canada, 2017b: CANSIM table 380-0080; Statistics Canada, 2017c: CANSIM table 052-0005.

In 2018/19 and 2019/20, however, the GDP growth rate rule is forecast to drive additional payments of approximately $2.8 billion over a two-year period, as illustrated by yellow component of the bars falling below the line. The green segments of the bars fall below actual equalization payments projected by Finance Canada, and represent extra payments that will be made in 2018/19 and 2019/20 as a result of the GDP growth rate rule. The green segments of the bars therefore also represent the savings that would be realized as a result of our proposed reform. Under the current policy, equalization payments in 2018/19 and 2019/20 would be set at the level of the red line. Under the proposed reform, payments would be allowed to fall to the level of the yellow bars, reducing expenditures significantly in each of the next two years if the assumptions in scenario 2 were to come to pass.

To be clear, under this reform, the equalization ceiling would continue to rise with GDP over time but it would not be allowed to act as a floor. This means that in a given year equalization payments could theoretically increase by more than the rate of GDP growth over the past three years if there is room to spare under the ceiling, and the disparity in fiscal capacity between richer and poorer provinces is widening. However, it would ensure that total equalization payments do not grow over time to consume a larger share of national GDP than it did in 2009/10, when the GDP growth rate rule was introduced. Thus, it would achieve the government's objective of ensuring affordability in any given future year (or at least it would just as well as the original rule itself did), but without the possibility of the perverse outcome implied by the existence of a floor on payments that acts as a driver rather than a constraint on growth.

To be sure, replacing the GDP growth rate rule with a ceiling (that grows at the same magnitude as the GDP growth rate rule) would create something of an asymmetry within the actual formula. The federal government could benefit from large savings when disparities grow, while having limited exposure in the opposite scenario. It is important to note, however, that the provincial governments also enjoy some protection against large decreases in their fiscal capacity and revenue from Fiscal Stabilization Payments, which are payments up to $60 per capita that are awarded to provinces that experience a decline in own-source revenue. Further, there is precedent for the creation of programs as needed to protect provinces from the fiscal effects of sudden decreases in transfer payments. A notable recent example was the creation of the Total Transfer Protection program in 2009, which lasted for several years and guaranteed no province would experience a decline in nominal transfers year over year; the program provided substantial additional payments.

In practice, the provinces have at various points enjoyed various types of fiscal protection from major fiscal shocks resulting from formula-driven changes to transfer payments. It would therefore not be completely asymmetrical or out of keeping with the treatment of the provinces in the past to maintain a rule designed to ensure manageable costs for the federal government when fiscal disparities grow quickly. None of this is to defend the creation of any of these temporary measures that were implemented to protect provincial finances but, rather, to demonstrate that there is precedent for the creation of rules that are not entirely formula-driven designed to protect provincial government finances. Indeed, the introduction and repeal in recent years of various rules as the need arose may strengthen the case for a thorough reconsideration of the equalization formula in 2019.

Stating that affordability and predictability for the federal government are legitimate policy objectives furthered by the introduction of a ceiling on the rate of program growth should not hide that the maintenance of either a floor or ceiling on total program costs runs counter to the internal logic of the equalization program, which suggests payments should rise and fall along with disparities in fiscal capacity. Instead, it simply demonstrates that there are competing objectives that must be weighed in assessing the wisdom of maintaining a ceiling, an exercise that is beyond the scope of this paper.

Whether or not the federal government chooses to maintain a ceiling on equalization payments in the future, however, has little or no bearing on the merits of maintaining a floor that achieves no similarly clear objective. While it would not bring the formula into perfect alignment with underlying logic of the program, removing the floor would move it closer to alignment while offering the possibility of significant savings in the years ahead.

Discussion—Eliminating the Growth Floor Is a Necessary Condition for Further Reform

Allowing equalization payments to shrink if disparity in fiscal capacity contracts would be consistent with the program's animating principles. Further, it would not be unprecedented in Canadian history as some may assume. Indeed, between 2001 and 2004, aggregate payments shrank considerably until, in 2004, a fixed aggregate 3.5% annual escalator was introduced. The O'Brien expert panel recommended, in 2006, a move away from this type of fixed pool and returning to a "principle-based formula-driven approach" (Expert Panel on Equalization and Territorial Formula Financing, 2006: 9). This recommendation was indeed enacted, before being largely reversed once again with the introduction in 2009 of the GDP growth rate rule that we are discussing. So there is ample precedent in recent Canadian history of major changes to the equalization program, and also for allowing payments to shrink as disparity in fiscal capacity contracts.

We have so far identified important potential costs of maintaining a floor on equalization payments in the years ahead: the direct costs to the federal treasury as well as possible problems resulting from regional resentments as the application of a rule would almost certainly—reasonably in our view—be seen as unfair by taxpayers in provinces that are not receiving equalization payments. However, another disadvantage of the continued existence of a floor on equalization payments is that so long as the floor exists it would essentially nullify the effect of any other program reforms that would, in the absence of a GDP growth rate rule, reduce program costs.

For example, Saskatchewan Premier Brad Wall recently argued that the time lags used in the determination of each province's fiscal capacity has the effect of disadvantaging provinces that are heavily reliant on resource revenues (which are more volatile than other sources of revenues) in the years immediately following a downturn in energy prices (CBC News, 2015). Premier Wall is certainly right on this score—the fiscal capacity calculations used to determine provincial fiscal capacity for 2017/18 include provincial resource revenues from as far back as 2013. Obviously, the economic and fiscal circumstances of Alberta, Saskatchewan, and Newfoundland & Labrador today bear little resemblance to how they looked in 2013/14. Alberta, for example, raised just under $10.0 billion in non-renewable resource revenues in 2013/14 compared to just $2.8 billion last year (2016/17). Saskatchewan's resource revenues fell from $2.5 billion to $1.3 billion over the same period.

In this light, it is reasonable for Premier Wall to ask about the soundness of including 2013 resource revenues for calculations of equalization payments in 2017/18 and whether narrowing disparity in fiscal capacity should be reflected in reduced equalization payments more quickly. Although Premier Wall raises a valid and important point, it is essentially moot so long as a minimum rate of growth for the overall equalization envelope is ensured. Even if equalization payments for 2017/18 were calculated based on fiscal capacities from the most recent year alone, during which Alberta and Saskatchewan continue to struggle with depressed resource revenues, the GDP growth rate rule would prevent any effect on the size of the overall equalization envelope. Since neither Saskatchewan nor Alberta would qualify for payments themselves under such a scenario, eliminating the time lags used to calculate fiscal capacity and equalization would have no effect either on their provincial budgets or on the burden the equalization program imposes on taxpayers in those provinces.

This is just one (admittedly important) illustrative example. Several other analysts, authors, researchers, and organizations have argued that there are design flaws in the current program that create undesirable uncertainty and outcomes: for example, Joe Oliver writing in the *Financial Post* (2016). Broadly speaking, critics of the equalization program have suggested that various flaws in the design of the program (along with other forms of regional subsidies) have created undue burdens for federal taxpayers, especially in non-recipient provinces (MacKinnon, 2011) or created harmful incentives in recipient provinces that actually undermine their economic growth and prosperity in the long run (Chassin, 2012).

Often, these analyses are accompanied by policy recommendations that would (in the absence of a ceiling) have the effect of shrinking the size of the overall equalization envelope. For example, Alberta's Wildrose Party commissioned a report that recommended changes to the equalization program (Atkins, MacKinnon, and Navarro-Genie, 2016). If put into practice, these changes would likely lead to a reduction of the overall equalization envelope in the absence of the GDP growth rate rule.

It is beyond the scope of this paper to evaluate the merits of these various analyses or proposals. It is important. however, to note that, so long as the GDP growth rate rule is permitted to act as a floor on equalization payments, this rule would either diminish or completely nullify the effects of many reforms that have been proposed at various times. In short, beyond the direct costs to federal taxpayers and the possibility of feeding regional resentments, a further concern with the GDP growth rate rule as it currently exists is that it effectively closes the door on any type of policy reform that would have the effect of shrinking the overall equalization envelope (or even preventing its growth) from current levels. For critics who are persuaded by arguments that the equalization program is causing perverse outcomes and stands in need of reform in other areas, this is likely the most serious negative outcome of a floor for equalization payments. Amending the current GDP growth rate rule is likely a necessary condition for any further major reforms to the equalization program.

Conclusion

The internal logic of equalization clearly suggests that, if disparity between the fiscal capacity of rich and poor provinces shrinks, the need for equalization payments shrinks as well and so the size of the equalization envelope should be allowed to shrink commensurately. A rule that the overall envelope must increase by a certain amount each year is difficult to defend on the grounds of the program's principle or, we have argued, through an appeal to any other legitimate policy objective.

Reforming this rule would allow equalization payments to shrink if reduced disparity in fiscal capacity among provinces suggests there is less need for payments to offset the gaps. Further, doing so could remove a source of the regional resentment and tension surrounding the program by avoiding apparent "overpayments" relative to what would be paid in the absence of the GDP growth rate rule, overpayments that could grow especially quickly if economic conditions in non-recipient provinces remain difficult. Finally, removing the GDP growth rate rule as a floor for the growth of payments is a prerequisite for the effectiveness of other reforms designed to shrink the equalization envelope or slow its growth.

Equalization is a complicated and controversial federal program. Several long-standing issues and points of contention surrounding the program are extraordinarily difficult to solve. These include the appropriate treatment of resource revenue and whether an accounting should be made for the different costs associated with delivering public services in various parts of the country. It is, therefore, particularly important for the federal government to correct clear design flaws that increase program costs without a clear objective. Regardless of how other issues are resolved in the years ahead, the fact that the GDP growth rate rule is currently permitted to act as a driver of costs rather than just a constraint on costs is an example of a design flaw that can be eliminated through the straightforward reform that we have here described.

Annex 1: Projection Method

The projections in this report are based on the detailed equalization workbooks provided by the federal Department of Finance. Specifically, we use the main formula files for fiscal capacity in 2013/14, 2014/15, and 2015/16 and the summary of equalization payment options for 2017/18 as a starting point (Canada, Dep't of Finance, 2016a). From this base, we built estimated fiscal capacity formula files for 2016/17 and 2017/18 with existing data, augmented with data from provincial budgets and Statistics Canada, in order to generate estimated equalization payment option files for 2018/19 and 2019/20.

The estimated 2017/18 fiscal capacity file projects: personal income taxes; business income taxes; consumption taxes; natural resources; and property taxes and miscellaneous tax base yields by province. Projections by revenue source are built as described below.

Personal income taxes

To produce 2016/17 and 2017/18 estimates of the yield of the tax base at the national average tax rate, the 2015/16 national tax base as presented in the files from the Department of Finance ("Finance" henceforth for brevity) is grown by national growth rates for 2016/17 and 2017/18 from the sum of personal income tax, and health and payroll taxes in the provincial budgets. This base is distributed by the ratios of simulated provincial PIT revenues for 2015/16 from Finance. These ratios provide reasonable estimates as they do not change much from year to year as shown by the ratios for 2013/14 through 2015/16. The average difference over all provinces between the three-year average (2013/4–2015/16) and 2015/16 was −0.7%.

Business income taxes

To produce 2016/17 and 2017/18 estimates of the yield of the tax base at the national average tax rate, the 2015/16 provincial yield of tax bases at the national average tax rate as presented in the base files from Finance is grown by annual growth rates in provincial corporate income tax and corporate capital tax revenue in the provincial budgets.

Consumption taxes

To produce 2016/17 and 2017/18 estimates of the yield of the tax base at the national average tax rate, the 2015/16 consumption tax base from Finance is grown by rates calculated from the national sum of: sales taxes; gasoline and motive fuel taxes; tobacco, liquor gallonage and amusement taxes; other excise taxes; motor vehicle licenses; and, licenses, permits, and fees from CANSIM table 380-0081. National total estimates are then distributed by the 2015/16 provincial shares of the consumption tax base and the national tax rate from 2015/16. As with personal income-tax ratios, these ratios do not change much from year to year. The average difference over all provinces between the three-year average (2013/4–2015/16) and 2015/16 was −1.1%.

Natural resources

As in the equalization formula, estimates of provincial natural resource revenue are based on actual revenues. Specifically, 2015/16 resource revenues by province from Finance are grown by annual rates produced from provincial budget revenue estimates.

Property taxes and miscellaneous

To produce 2016/17 and 2017/18 estimates of the yield of the tax base at the national average tax rate, 2015/16 national revenues to be equalized from Finance are grown by rates calculated from real property tax revenue of local general governments from Statistics Canada's CANSIM table 380-0080. These national values are then distributed by the average of Finance's distribution of the property tax base for 2013/14–2015/16. We chose an average of the rates here (rather than the most recent year's values as used elsewhere) because there is more variation in the distributive series. That said, the largest difference in any province between the average ratios we use and the ratios for individual years is 6.2%.

Equalization projections by province

To generate equalization projections for 2018/19 and 2019/20 we start with the 2017/18 summary of equalization payment options file from Finance, replace the existing inputs from the fiscal capacity files with inputs from the new fiscal capacity files described above, and make other adjustments as necessary.

For 2019/20, we use 2015/16 fiscal capacity from Finance (25%) plus the estimated fiscal capacity for 2016/17 (25%) and 2017/18 (50%) to produce fiscal capacity yields.

Population from 2015 from Finance is grown using annual provincial growth rates from Statistics Canada's CANSIM table 052-0005 (M1 scenario).

Offshore Accord offset payments are updated using the formula built into the Finance files with revised resource estimates as described above.

The other major adjustment was to change the receiving provinces' fiscal capacity and the per-capita GDP adjustment to account for our projection that Ontario will only receive equalization payments as a result of the adjustment brought about by the GDP growth rate rule.

Annex 2: Alternative Projection Scenario

The hypothetical scenario where non-recipient provinces end up with lower fiscal capacity is produced with some relatively straightforward changes to both resource and non-resource fiscal capacity yields. Changes are focused solely on non-recipient provinces.

Non-resource fiscal capacity

Estimated fiscal capacities in Newfoundland & Labrador, Ontario, Saskatchewan, Alberta, and British Columbia in 2017/18 are reduced by 2% from the estimate described in Annex 1.

Resource fiscal capacity

We make no adjustments to resource fiscal capacity in Newfoundland & Labrador, Ontario, or British Columbia because their 2017/18 revenues are already below those in 2016/17. Revenues in Saskatchewan and Alberta in 2017/18 are set equal to their values in 2016/17, which removes a good rebound in Saskatchewan and a substantial one in Alberta.

With these adjustments in place, the equalization estimate proceeds as described in Annex 1.

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