

Canada's Equalization Program: Political Debates and Opportunities for Reform

James P. Feehan

IN BRIEF

In 2018, the federal government renewed, without change, the formula determining equalization payments to eligible provinces for 2019-24. This status quo has come under heavy criticism from the premiers of struggling, energy-rich provinces that do not receive equalization. However, the program operates by and large as it is meant to. Potential worthwhile changes, such as eliminating the fixed-growth rule for the equalization envelope, would not directly address these provinces' concerns. Rather, they should focus on potential reforms to the federal fiscal stabilization program, starting with removal of the per capita limit on payments to provincial governments experiencing sharp declines in revenues.

EN BREF

En 2018, Ottawa a renouvelé sans modification la formule de péréquation qui détermine les paiements versés aux provinces admissibles. Ce maintien du statu quo pour la période 2019-2024 a été vivement critiqué par les premiers ministres des provinces en difficulté financière mais riches en énergie, qui ne touchent aucun paiement. La décision d'Ottawa est pourtant conforme à l'orientation générale du programme. Et même certains changements potentiellement avantageux, comme l'élimination de la règle de croissance fixe de l'enveloppe, ne répondraient pas directement aux craintes de ces provinces. Celles-ci devraient plutôt viser une réforme du Programme de stabilisation fiscale, à commencer par la suppression du plafond des paiements par habitant destinés aux provinces en forte baisse de recettes.

ABOUT THIS PAPER

This paper was published as part of the Canada's Changing Federal Community program, under the direction of F. Leslie Seidle. The manuscript was copy-edited by Barry Norris, proofreading was by Zofia Laubitz, editorial coordination was by Francesca Worrall, production was by Chantal Létourneau and art direction was by Anne Tremblay.

James Feehan is an honorary research professor at Memorial University of Newfoundland, where he was a professor of economics for more than 30 years. In addition to fiscal federalism, he has published in the economics of public investment, electricity economics, taxation and public policy. He holds a PhD in Canadian economic policy from Carleton University and an MSc (econ) from the London School of Economics.

To cite this document:

Feehan, James. 2020. *Canada's Equalization Program: Political Debates and Opportunities for Reform*. IRPP Insight 30. Montreal: Institute for Research on Public Policy.

ACKNOWLEDGEMENTS

I am very grateful to France St-Hilaire, Leslie Seidle and Tracy Snoddon for helpful comments.

The opinions expressed in this study are those of the author and do not necessarily reflect the views of the IRPP or its Board of Directors.

IRPP Insight is an occasional publication consisting of concise policy analyses or critiques on timely topics by experts in the field.

If you have questions about our publications, please contact irpp@irpp.org. If you would like to subscribe to our newsletter, *IRPP News*, please go to our website, at irpp.org.

Cover photo: xxxx

ISSN 3392-7748 (Online)

CONTENTS

Introduction	4
Equalization and Fiscal Federalism.....	4
“Have” Provinces and Fiscal Stabilization.....	10
Equalization Reform	15
Conclusion.....	20

INTRODUCTION

In 2018, the federal government renewed the equalization program without any changes. The governments of some of the so-called have provinces – those that are ineligible for equalization – were highly critical of the renewal. They were upset to see other provinces receive equalization funding while they were struggling with large budgetary deficits. After the October 2019 federal election, two of those provinces, Alberta and Saskatchewan, renewed their attacks on equalization.

There have been no significant changes to the equalization program since 2009. During this period, the Conservatives held office (until 2015) under Stephen Harper, followed by the Liberals led by Justin Trudeau. This paper argues that the criticisms of equalization from certain “have” provinces are off the mark. The real sources of their frustration are low prices for oil and natural gas, and federal energy and environmental policies. There nevertheless have been a number of worthwhile suggestions to improve equalization, some of which I review here. A broader issue is that the allocations to qualifying provincial governments and other parameters of the program are decided solely by the federal government. Provincial governments have no jurisdiction over it, yet equalization is a crucial support to Canadian federalism, and is constitutionally mandated.

To set the stage for elaborating on these propositions, I begin by explaining how equalization works and situate the program in the context of Canadian federalism. I then summarize the criticisms of the equalization formula from political leaders of the “have” provinces and make the case that reforms to the fiscal stabilization program, not the equalization program, are more appropriately called for. I close with a discussion of various potential reforms to equalization, including the creation of a national agency to provide independent advice on equalization and other federal-provincial fiscal arrangements.

EQUALIZATION AND FISCAL FEDERALISM

The pillars of fiscal federalism in Canada are the transfer payments made by the federal government to the provincial governments. The major transfer payments are the Canada Health Transfer (CHT), the Canada Social Transfer (CST) and equalization payments.¹ The CHT and CST have evolved from a series of cost-sharing arrangements to support provincial health and social programs. In their current form, they are simply block grants made on an equal per capita basis to each provincial and territorial government. The recipient governments are free to use the funds as they wish, subject only to the federal government's prerogative to withhold or reduce payments when certain conditions are not met. For example, CHT funding may be withheld if a province fails to adhere to any of the five principles in the *Canada Health Act*. Equalization

¹ Territorial governments also receive the CHT and CST and, rather than equalization, are supported by Territorial Formula Financing grants.

payments are not subject to any conditions, and not all provincial governments are currently recipients, although every province has received equalization at some time. The payments vary with the federal government's assessment of each provincial government's ability to raise revenue – that is, its fiscal capacity.

The block grants address what is referred to as the *vertical fiscal imbalance*: the co-existence of the greater tax-raising capacity of the federal government and the greater spending responsibilities of provincial governments. On taxation, federal and provincial governments both can levy taxes in largely the same major areas: personal income, corporate income and sales. The notable exceptions are taxation of international trade, which is entirely federal, and the collection of royalties and related revenues from natural resources, which is exclusive to the provinces. For common tax areas, the federal government has access to the entire national tax base; a provincial government, in contrast, is limited to the base within its geographic jurisdiction, and some of its base might move elsewhere if it raises tax rates relative to those of other provinces. On the spending side, provincial governments are saddled with the heavy burden of providing the bulk of public service programs that are expected and needed in a modern developed society, especially health care and education. Other than taking the drastic step of becoming a unitary state or dramatically changing constitutional arrangements, a simple way to overcome this vertical fiscal imbalance is to transfer funds from the federal government to the provinces. That has been the Canadian practice.

If the provincial governments were all similar in their ability to raise revenue from their own sources, then equal per capita grants would be sufficient to address the federation's fiscal asymmetry. That is not the case, as there is also a *horizontal fiscal imbalance* – some provinces are advantaged by location, a strong industrial base or high-value natural resources. As a result, employing similar tax rates would lead to different per capita provincial revenues. Addressing a sizable horizontal fiscal imbalance adequately requires deviation from a simple per capita approach. Equalization directly addresses this imbalance by bringing the revenues of provincial governments with weaker fiscal capacity up to something closer to those with stronger capacity. Equalization payments are intended to allow those governments with weaker capacity to provide public services at levels similar to those in other provinces, and thus support the proper functioning of Canadian federalism.

The *Federal-Provincial Fiscal Arrangements Act* is the legislative mechanism by which the federal government sets the level and allocation of funds it provides the provinces and territories.² The act also governs other related measures, such as tax administration arrangements. Funding under that legislation is considerable. Table 1 shows the allocation of funds to the provincial governments for the CHT, the CST and equalization for fiscal year 2019-20. Of the \$74.5-billion total, 73.4 percent is transferred on an equal per capita basis through the CHT and CST; just over 26 percent is through equalization. To place the total amount in perspective, transfers to the provinces

² See Canada, Justice Laws Website, *Federal-Provincial Fiscal Arrangements Act* (R.S.C., 1985, c. F-8), <https://laws-lois.justice.gc.ca/eng/acts/F-8/>

Table 1. Major federal transfers to provincial governments, fiscal year 2019-20

Transfer	Amount (\$ billions)	Percent of total
Canada Health Transfer	40.2	54.0
Canada Social Transfer	14.5	19.4
Equalization	19.8	26.6
Total	74.5	100.0

Source: Canada, Department of Finance Canada, "Federal Transfers to Provinces and Territories" (Ottawa, October 31, 2019), <https://www.fin.gc.ca/fedprov/mtp-eng.asp>

represent approximately 22.6 percent of total 2019-20 federal program spending.³ Equalization payments alone, however, amount to just 6 percent of total federal program spending. This might seem small, but equalization is vitally important to some of its recipients.

Table 2 provides a breakdown of the allocation of the \$19.8 billion in equalization payments among the provinces. Five received no equalization in fiscal year 2019-20; these are the "have" provinces for that year. Of the five that did receive payments, the "have-nots," Quebec received more than \$13 billion, or two-thirds of the total. Although that figure is rather eye-catching, it is largely a reflection of Quebec's much larger population relative to those of the other recipients. Adjusting for population provides a more balanced picture of which provinces benefit most from equalization payments. Figure 1 illustrates how the \$19.8 billion was allocated on a per capita basis. Quebec received the lowest amount, approximately \$1,600; Prince Edward Island received the most in per capita terms, approximately \$2,830. The range across all provinces is quite substantial, from zero to \$2,830 per person.

The fact that equalization payments differ across provinces should be no surprise: the program's core purpose since it was instituted in 1957 has been to address the horizontal fiscal imbalance.⁴ Moreover, the principle that the federal government makes equalization payments "to ensure that provincial governments have sufficient revenues

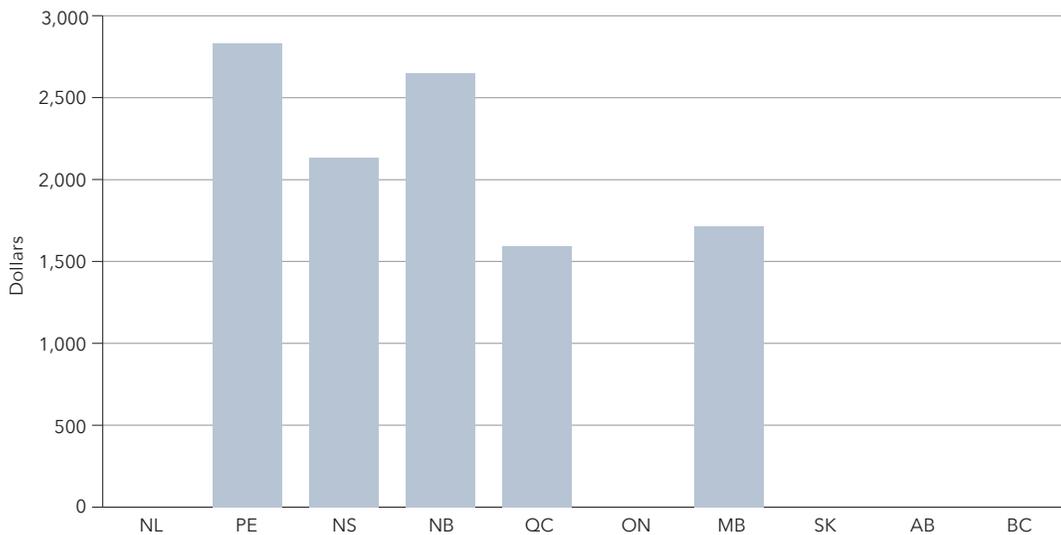
Table 2. Equalization payments, by province, fiscal year 2019-20

Province	Amount (\$ millions)	Province	Amount (\$ millions)
Newfoundland and Labrador	0.0	Ontario	0.0
Prince Edward Island	419.0	Manitoba	2,254.4
Nova Scotia	2,015.2	Saskatchewan	0.0
New Brunswick	2,023.2	Alberta	0.0
Quebec	13,124.4	British Columbia	0.0

Source: Canada, Department of Finance Canada, unpublished equalization calculation tables, December 5, 2018, provided by request.

³ According to the federal budget, total budgeted program spending for fiscal year 2019-20 is \$329.4 billion; see Canada, Minister of Finance, *Investing in the Middle Class: Budget 2019* (Ottawa, March 19, 2019), 289.

⁴ For a comprehensive history of equalization payments to the early 1980s, see T. Courchene, *Equalization Payments: Past, Present and Future* (Toronto: Ontario Economic Council, 1984).

Figure 1. Equalization payments per capita, by province, fiscal year 2019-20

Source: Canada, Department of Finance Canada, unpublished equalization calculation tables, December 5, 2018, provided by request.

to provide reasonably comparable levels of public services at reasonably comparable levels of taxation” is part of Canada’s Constitution.⁵ Although that principle is not difficult to accept as a design feature for a federation, the practical problem of developing the ideal formula is a challenge. It can also be controversial, especially when economic and fiscal circumstances of federal and provincial governments change.

As noted, the current equalization formula has not changed in any major way since 2009. At its core is a calculation that determines a provincial government’s fiscal capacity and compares it to the overall provincial average, all on a per capita basis. The calculation of fiscal capacity involves determining hypothetical provincial revenues from four major sources of tax revenue: personal income taxes, business taxes, consumption taxes and property taxes. The revenues are hypothetical because they are estimates of what revenues would be if the province used the national average tax rate, rather than its actual tax rate. Those estimated revenues from the four tax categories are then added to 50 percent of a provincial government’s actual royalties and other fees from its natural resources.⁶ This sum is expressed in per capita terms and then compared with the overall per capita value for all the provinces, the latter being the “standard” and the former the measure of a province’s “fiscal capacity.” Provinces whose fiscal capacity is less than the “standard” are candidates for receiving equalization payments in the amount needed to bring them up to the standard. Since revenues are not known in advance, and to avoid wide variations in payments to provinces, all

⁵ *Constitution Act, 1982*, section 36(2).

⁶ There is a long history of debate about whether and how to include natural resources in this measure, but this approach reflects the advice of the 2006 report of the Expert Panel on Equalization and Territorial Formula Financing, the most recent thorough review of the equalization program. See Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track* (Ottawa: Expert Panel on Equalization and Territorial Formula Financing, May 2006).

Figure 2. Fiscal capacity per capita, by province, including 50 percent of natural resource revenues, fiscal year 2019-20



Source: Canada, Department of Finance Canada, unpublished equalization calculation tables, December 5, 2018, provided by request.

these figures are calculated using their three-year weighted annual averages, lagged two years.⁷ The results, which can be called the first-round calculation for fiscal year 2019-20, are shown in figure 2.

If figure 2 were the end of the story, the determination of equalization grants would be straightforward: each province's fiscal capacity would be compared with the standard to determine whether it would receive equalization and, if so, how much. As the figure shows, five provinces exceed the standard, and by this simple calculation would not be eligible for equalization payments. The other provinces fall below the standard to varying degrees and would receive equalization payments to cover the gap between their fiscal capacity and the standard. This, however, is not the end of the calculations.

Rather than just the per capita amounts implied in figure 2, provinces can receive more, depending on the next stage of calculations, which relate to considerations of natural resource revenues. Essentially, this involves recalculating the standard and the fiscal capacity of the provinces without including any revenues from natural resources. If, for any province, the recalculated equalization entitlement is larger than that in the first-round calculation, then the province is eligible for the larger amount. For fiscal year 2019-20, that alternative calculation would have been to the benefit of Saskatchewan and Newfoundland and Labrador – neither of which qualified in the first round – and Quebec. However, entitlements are subject to a further hurdle.

⁷ To elaborate, for the fiscal year 2019-20 entitlement calculations, the two-year lag means calculating the annual fiscal capacities for 2017-18, 2016-17 and 2015-16. Those annual fiscal capacities are then weighted 50 percent, 25 percent and 25 percent, respectively, to obtain the average values on which the 2019-20 entitlements are calculated.

A province's entitlement to equalization is subject to the fiscal capacity cap (FCC). This cap reduces an entitlement to ensure that the recipient province does not get ahead of nonrecipients. In this case, "getting ahead" involves calculating, for each of the 10 provinces, the sum of (1) its fiscal capacity from the four tax sources, (2) 100 percent of its natural resource revenues and (3) its equalization entitlement as determined at the pre-FCC stage of the process, all in per capita terms. For any otherwise entitled province, if its sum, so calculated, is more than the FCC, then its equalization entitlement is reduced. The reduction is either the excess of its sum over the FCC or its full equalization entitlement, whichever is less. As for the FCC, if the combined population of the otherwise entitled provinces is less than 50 percent of that of all 10 provinces, then it is the sum of (1) and (2) for the lowest nonrecipient.⁸ In fiscal year 2019-20, Ontario was the nonrecipient with the lowest sum; therefore, its sum was the cap for that year. Consequently, neither Newfoundland and Labrador nor Saskatchewan received an equalization payment in 2019-20 because their substantial per capita natural resource revenues placed them far above the FCC, offsetting any pre-FCC entitlement. In contrast, in Quebec, the sum of (1), (2) and (3) was less than the FCC, so its equalization entitlement was unaffected.

The final stage of the calculation is the strangest. Since 2009, the federal government has increased the total amount in each year's equalization envelope independently of the preceding calculations. The envelope grows by the moving three-year average of the growth rate of nominal gross domestic product (GDP). That means that, if the equalization payments determined by the steps described above yield a total amount that exceeds the total envelope, then each recipient's entitlement is reduced by equal per capita amounts until the total payout is in alignment. If the growth rule results in more money than needed, the surplus is distributed among the recipient provinces on an equal per capita basis. This "adjustment payment" can lead to an odd outcome. If adjustment payments were allocated solely to recipients, then it is possible that a recipient would be made better off than a nonrecipient. To avoid this, the adjustment-payments formula takes as a benchmark the pre-adjustment position of the recipient with the greatest per capita fiscal capacity, including all resource revenues and equalization entitlements. Adjustment payments are then calculated to ensure that no nonrecipient falls below that benchmark after adjustment payments are made. There are times when this requires including in the pool of provinces receiving adjustment payments one that was a nonrecipient prior to this allocation. This occurred in fiscal year 2018-19, when Ontario failed to qualify for equalization but still received an adjustment payment because such payments to the recipients alone would have placed at least one of them above Ontario's fiscal capacity when measured with all resource revenues included. In 2019-20, Ontario was sufficiently far ahead of recipients that adjustment payments were exhausted before that anomaly could arise.

Despite the various steps involved in moving from the first-round calculation to the final determination of equalization payments, the actual result is not much different from the initial calculation, as table 3 shows for fiscal year 2019-20. The first row shows

⁸ When that population is more than 50 percent, which in practical terms means that Ontario qualifies for equalization, the FCC is set at the average sum received by the recipient provinces.

Table 3. First-round equalization entitlements, adjustments and actual payments, by province, fiscal year 2019-20 (\$ millions)

Equalization entitlement calculation	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
(1) Entitlement based on fiscal capacity with 50% of natural resource revenues	0.0	414.5	1,986.7	2,000.1	12,754.9	0.0	2,215.6	0.0	0.0	0.0
(2) Entitlement, excluding all natural resource revenues	314.9	386.7	1,822.8	1,897.2	12,875.2	0.0	2,039.8	152.9	0.0	0.0
(3) Entitlement based on higher of (1) and (2) and after application of fiscal capacity cap	0.0	414.5	1,986.7	2,000.1	12,875.2	0.0	2,215.6	0.0	0.0	0.0
(4) Actual payment after GDP growth rule	0.0	419.0	2,015.2	2,023.2	13,124.4	0.0	2,255.4	0.0	0.0	0.0
Difference between (4) and (1) (percent)	0.0	1.1	1.4	1.2	2.9	0.0	1.8	0.0	0.0	0.0

Source: Canada, Department of Finance Canada, unpublished equalization calculation tables, December 5, 2018, provided by request.

the entitlements that would arise from deviations from the standard in accordance with the numbers in figure 2. The effects of the subsequent steps are shown in rows 2, 3 and 4, the last of which shows the actual payment. The recipient provinces are the same as those determined in the first round; they receive more than under the first-round calculations, but those increments are very small, at 1.1 to 2.9 percent. All the recipients receive more because of the GDP adjustment payments (row 4).

In sum, equalization appears to be doing what it is generally intended to do. Despite some complications in the formula, equalization brings provinces with weaker fiscal capacity up to the standard. If one accepts that standard as reasonable, then equalization succeeds in substantially reducing the horizontal fiscal imbalance. There is nevertheless room for improvement. Unfortunately, however, the criticisms of the recent renewal of equalization by some provincial leaders were off the mark, and have more to do with other federal policies that might affect those provinces adversely than with equalization itself.

“HAVE” PROVINCES AND FISCAL STABILIZATION

In its fiscal year 2018-19 budget process, the federal government renewed the equalization formula. There had been some consultations with the provincial governments, notably at a December 2017 finance ministers' meeting. The renewed formula covers the years 2019-20 to 2023-24, and is practically identical to the one employed for the previous two five-year periods. Despite this maintenance of the status quo, some provincial governments were very critical of the program in the lead-up to the formula's renewal and immediately afterwards. The bulk of the criticism came from provinces with such high revenue-generating capacity that they did not qualify for equalization

payments – namely, British Columbia, Alberta, Saskatchewan, Ontario and Newfoundland and Labrador, all of which have qualified for and received equalization in the past.⁹

The most vociferous attacks came from Alberta. In June 2018, Jason Kenney, then the opposition leader, described the federal government’s renewal of the formula as a “slap in the face” to Albertans.¹⁰ Kenney claimed that the federal government’s communication of renewal was shocking, and he expressed frustration that Albertans would be subsidizing other parts of the country as their own energy industry was struggling. During the 2019 Alberta election campaign, which his party won, Kenney reiterated his threat to call a referendum on equalization payments in order to force discussions with the federal government and the other provinces on amending the constitutional provision – section 36(2) of the *Constitution Act 1982* – that commits the federal government to making equalization payments. After being elected in April 2019, Premier Kenney repeated his threat to hold a provincial referendum.¹¹

Saskatchewan’s premier, Scott Moe, also criticized how the federal government handled the renewal process, as well as the retention of the existing formula for another five years.¹² Although renewal of the equalization formula had been a topic at the December 2017 finance ministers’ meeting, Moe claimed the provinces had not been informed that the federal government would be renewing the formula without change. The Saskatchewan premier had been advocating a 50/50 solution – that is, cut the equalization envelope in two and distribute half to all provinces on an equal per capita basis.

Ontario and Newfoundland and Labrador also had concerns about equalization. For most of the program’s existence Ontario was not a recipient, but it did receive payments from fiscal years 2009-10 to 2018-19. Even though the formula is largely unchanged, Ontario’s improved economic circumstances relative to other provinces meant that its fiscal capacity moved above the standard, so it did not qualify for payments in 2019-20; nor is it expected to over the next four years. Yet, in March 2019, Ontario Finance Minister Vic Fedeli argued that the formula was inequitable. He claimed that Quebec would receive approximately \$13 billion in equalization payments, while Ontario would not be entitled to any in 2019-20, even though federal taxes collected in Ontario exceeded the amount of federal spending there by \$12.9 billion.¹³

On a similar note, Newfoundland and Labrador Finance Minister Tom Osborne expressed the view that equalization was not working for his province. He noted

⁹ Alberta was a beneficiary only in the first seven years of the program, fiscal years 1957-58 to 1963-64. For historical data on payments to provinces, see Canada, Open Government, “Historical Transfer Tables: 1980 to Present,” <https://open.canada.ca/data/en/dataset/4eee1558-45b7-4484-9336-e692897d393f>

¹⁰ A. Toy, “Equalization Renewal a ‘Slap in the Face’ to Albertans: Kenney,” *Global News*, June 22, 2018, <https://globalnews.ca/news/4291609/equalization-economy-alberta-canada-kenney/>

¹¹ E. Mertz, “Kenney Says Bills C-48, C-69 ‘Prejudicial Attack on Alberta’; Bring Referendum on Equalization Closer,” *Global News*, June 21, 2019, <https://globalnews.ca/news/5418579/alberta-kenney-senate-bills-referendum-equalization-pipelines>

¹² C. Priall, “Federal Government Ignores Saskatchewan’s Call for Changes to Equalization,” *Global News*, June 22, 2018, <https://globalnews.ca/news/4291634/federal-government-ignores-calls-changes-equalization/>

¹³ A. Artuso, “Equalization ‘Inequitable’ Across the Country: Ontario Finance Minister,” *Toronto Sun*, June 10, 2018, <https://torontosun.com/news/provincial/equalization-inequitable-across-the-country-ontario-finance-minister>

that neighbouring Nova Scotia would receive \$1.8 billion in equalization, while Newfoundland and Labrador would receive nothing.¹⁴ Of course, this reflects the fact that Newfoundland and Labrador's natural resource revenues place its fiscal capacity above the standard, while Nova Scotia's fiscal capacity is well below the standard.

That leaves British Columbia as the only nonrecipient province to have expressed little or no serious concern about the equalization formula through the media. Interestingly, in fiscal year 2018-19, British Columbia was the only "have" province with a budgetary surplus (table 4). The other four "have" provinces were running large budgetary deficits and generally facing difficult fiscal challenges. On the other hand, four of the five "have-not" provinces were in budget surplus, Manitoba being the exception.

It appears that criticisms of equalization by political leaders in the four nonrecipient provinces that are running deficits stem from their need to address their budgetary situations and perhaps from some resentment that equalization-receiving provinces are mostly in surplus. However, having a large budgetary deficit is not a basis for equalization, nor should it be. Think of the implications for provincial fiscal discipline! The fact is that the "have" provinces simply have more fiscal capacity than the "have-nots" and exceed the standard. That is why they do not receive equalization.

Still, the frustration of the deficit-running "have" provinces is understandable. They have to deal with their deficits. Moreover, the three that are rich in oil and natural gas (Alberta, Saskatchewan, and Newfoundland and Labrador) face the reality of declining resource prices on world markets. That challenge is compounded by federal government initiatives on carbon taxation and stricter environmental assessment requirements for approval of natural resource developments, particularly Bill C-69. While these measures are undoubtedly important, they will disproportionately affect the oil-rich provinces. However, even if federal policy designs are imperfect and disproportionately impose costs on oil- and gas-producing provinces, these matters are unrelated to equalization. Budgetary deficits are not the basis for equalization. The premiers' criticisms were misplaced, and have led to some federal-provincial sparring that has served only to confuse members of the public. Following the October 2019 federal election, mixed in with their criticisms of federal energy policies, Premier Moe of Saskatchewan and Premier Kenney of Alberta reiterated their demands for a new equalization formula,¹⁵ but again, their attacks seem based more on resentment toward provinces that receive equalization than on their own core issues.

Focusing on those core issues, Jack Mintz argues for some helpful federal energy and environmental policy changes. More importantly for the purpose of this paper, he also

¹⁴ "Equalization Not Working for Newfoundland and Labrador, Says Finance Minister," *CBC News*, December 13, 2017, <https://www.cbc.ca/news/canada/newfoundland-labrador/tom-osborne-equalization-newfoundland-1.4445339>

¹⁵ See J. Guignard and D. Baxter, "Saskatchewan Premier Scott Moe Looking For Immediate Action from Justin Trudeau," *Global News*, October 22, 2019, <https://globalnews.ca/news/6066881/saskatchewan-premier-scott-moe-justin-trudeau/>; and R. Breakenridge, "Alberta Has a Stronger Bargaining Chip Than an Equalization Referendum," *Calgary Herald*, November 6, 2019

Table 4. Budget balances, “have” and “have-not” provinces, fiscal year 2018-19 (\$ millions)

Have-nots		Haves	
Prince Edward Island	14.0	Newfoundland and Labrador	- 522.0
Nova Scotia	28.0	Ontario	- 11,700.0
New Brunswick	5.0	Saskatchewan	- 380.0
Quebec	2,500.0	Alberta	- 6,930.0
Manitoba	- 470.0	British Columbia	374.0

Source: RBC Economic Research, “Canadian Federal and Provincial Fiscal Tables, June 25, 2019,” http://www.rbc.com/economics/economic-reports/pdf/canadian-fiscal/prov_fiscal.pdf

Note: Ontario is included as a “have” province because it received only an adjustment payment and was not otherwise eligible for equalization.

argues for a revamp of the federal government’s fiscal stabilization program.¹⁶ Fiscal stabilization payments are another form of federal transfer payment to provincial governments. Like equalization, CHT and CST, these payments have their legislative basis in the *Federal-Provincial Fiscal Arrangements Act*. Unlike those other transfer programs, the fiscal stabilization program is little known and involves much less money. It has its own distinct purpose: it provides financial assistance to any province that suffers a substantial year-over-year decline in its own-source revenues. That is what happened to Alberta, Saskatchewan, and Newfoundland and Labrador following the downturn in world oil and gas prices. Assistance from the fiscal stabilization program was paltry, yet the initial reaction of those provincial governments was to criticize equalization, and to do so with little substantive basis.

Table 5 shows the assistance the three provinces received under the fiscal stabilization program between 2014-15 and 2016-17. Despite three consecutive years of revenue declines, Saskatchewan received only \$20.3 million. Newfoundland and Labrador received a \$31.7-million payment in 2015-16, despite a nearly \$1-billion decline in revenues; it received nothing in the preceding year, despite a more than half-billion-dollar decline in revenues. In 2015-16, Alberta received \$251.4 million, which amounted to little more than 3 percent of its \$8-billion decline in revenues. In 2016-17, it received another \$251.4 million, although its revenues had declined by a further \$1.16 billion that year. Stabilization payments were clearly minuscule relative to the declines in these provincial governments’ own-source revenues over the period.

There are a number of reasons stabilization payments are so small. There is a cap on a payment to a provincial government of \$60 per provincial resident; there has to be a sufficiently large year-over-year decline in revenues; and the formula for calculating the payment discriminates against declines in natural resource revenues relative to nonresource revenues. The result is a program that is both inadequate and especially unfair to resource-dependent provinces. As Mintz points out, the program needs to be overhauled. Fortunately, there is a proposal for that.

¹⁶ J. Mintz, “Ottawa Has Options to Help Alberta. It’s Just Choosing Not To,” *Financial Post*, December 5, 2018.

Table 5. Stabilization payments to selected provincial governments, fiscal years 2014-15 to 2016-17 (\$ millions)

Fiscal year	NL		Saskatchewan		Alberta	
	Change in revenues	Stabilization payment	Change in revenues	Stabilization payment	Change in revenues	Stabilization payment
2014-15	- 522.3	0.0	- 537.0	0.0	1,124.0	0.0
2015-16	- 997.2	31.7	- 380.5	0.0	- 8,022.0	251.4
2016-17	1,135.4	0.0	- 806.9	20.3	- 1,163.0	251.4

Sources: Canada, Department of Finance Canada, Fiscal Reference Tables (Ottawa, October 2018); and "Federal Support to Provinces and Territories" (Ottawa, October 31, 2019), <https://www.fin.gc.ca/fedprov/mtp-eng.asp>

Bev Dahlby has made an important and timely contribution on how to reform the stabilization payments program.¹⁷ He argues that the program is akin to an insurance policy that protects a provincial government when it suffers a large unexpected loss in own-source revenues, and that in a federation the federal government is the insurer. Dahlby demonstrates, however, that the current program is poorly designed. Not only is the per capita limit restrictive; the formula for calculating a payment is cumbersome, and varies according to whether natural resource revenues increase, decrease by more than 50 percent or decrease by less than 50 percent. He proposes a reform of the fiscal stabilization program based on

- removal of the per capita limit on payments;
- a single formula that does not discriminate among types of provincial own-source revenues; and
- calculation of changes in own-source revenues relative to their moving average over the recent past, such as the previous five years, rather than just the year-over-year change.

These proposals are eminently sensible. Whether there should be a premium payment from the provinces is a legitimate question. Dahlby suggests that the federal government normally earns an excess of revenues over its total expenditures in richer provinces, and this could be considered as equivalent to a "fiscal insurance premium." That might be problematic, because fiscal stabilization payments apply to any province with a large decline in own-source revenues, not just to those from which the federal government collects more revenue than it spends. It would be better to think of the program as no-fault social insurance provided by the federal government. Another challenging question is whether there should be some conditionality on the payments – for example, a requirement that the province provide a plan for fiscal realignment. Still, the Dahlby proposal provides a basis for reform. In short, the criticisms from some of the "have" provinces that the equalization formula was flawed were misplaced. It is the fiscal stabilization program, not the equalization program, that should have been targeted.¹⁸

¹⁷ B. Dahlby, "Reforming the Federal Fiscal Stabilization Program," SPP Briefing Paper 12:18 (School of Public Policy, University of Calgary), June 2019. On potential changes to the fiscal stabilization program, see also Trevor Tombe, "The Past, Present and Future of Fiscal Stabilization in Canada" (IRPP Insight, forthcoming).

¹⁸ Also unrelated to the equalization program, Alberta, Saskatchewan and Newfoundland and Labrador have concerns with how changes in federal environmental and energy policies will disproportionately affect

Later in 2019, Premier Kenney appeared to have come to that realization, calling for the \$60 per capita cap under the fiscal stabilization program to be lifted retroactively, which would increase the federal payment to Alberta following the 2015-16 recession to about \$1.7 billion.¹⁹ As 2019 ended, all the premiers had finally realized that the fiscal stabilization program needed to be changed, and at the beginning of December they called on the federal government for its reform, without mentioning equalization.²⁰ Then, following a meeting later that month with his provincial and territorial counterparts, federal Finance Minister Bill Morneau indicated he had asked his officials to analyze possible changes to the fiscal stabilization program and report in January 2020.²¹ Nevertheless, while some of the premiers' attacks on the equalization program were off the mark and likely confusing, there is still scope for improving it. That is the focus of the following section.

EQUALIZATION REFORM

The federal government's quiet renewal of the equalization formula in 2018 was a missed opportunity. The lead-up to the 2019-24 renewal was a chance to receive feedback and advice from the provinces, policy experts and concerned citizens and groups, and an opportunity to act on that advice. Equalization is a federal program, however, so the federal government has complete jurisdiction to proceed as it wants. That includes maintaining the status quo, as it chose to do. It can also make changes in the formula over the five-year 2019-24 period. It ought to do so where feasible. Four elements in particular are worth highlighting.

The fixed-growth rule

Since 2009, the federal government has been increasing its total equalization payout according to the three-year moving average growth rate of nominal GDP. This is inherently problematic. Equalization payments are supposed to address the horizontal fiscal imbalance across provinces. That imbalance changes as provinces' circumstances change. If the horizontal imbalance worsens, payments should be increased, and vice versa. Resetting each year's total payout according to GDP growth ties it to something unrelated to that imbalance. In years when the increase in the total payout budget is insufficient, the federal government claws back entitlements on an equal per capita basis from the eligible provinces. When the growth rate rule leads to more funding than necessary, the excess is shared among the eligible provinces and possibly even among provinces not otherwise entitled to equalization, as happened with Ontario

them. Compounding these challenges for their oil and gas sectors is the fact that market prices for those commodities have decreased.

¹⁹ J. Giovanetti, "Kenney Seeks Nearly \$1.7 Billion from Ottawa after Collapse in Alberta Oil Prices," *Globe and Mail*, November 13, 2019, <https://www.theglobeandmail.com/canada/alberta/article-alberta-premier-jason-kenney-seeks-nearly-17-billion-bailout-from/>

²⁰ The Council of the Federation, "Premiers United, Call for Federal Partnership and Action" December 2, 2019, https://www.canadaspremiers.ca/wp-content/uploads/2019/12/COF_Communique-Dec2.pdf

²¹ Bill Curry, "Bill Morneau Requests Quick Review of Provinces' Calls for Expanded Stabilization Program," *Globe and Mail*, December 17, 2019. <https://www.theglobeandmail.com/politics/article-health-care-stabilization-transfers-top-provinces-requests-to/>

in fiscal year 2018-19.²² In short, aggregate equalization payments ought to be tied directly to the horizontal imbalance. The GDP growth rule does not allow that. As the Parliamentary Budget Office stated in 2018: "Based on our long-term projections and under the status quo structure, fiscal capacities will not be equalized across provinces when the growth in Equalization payments is capped at nominal GDP growth."²³

Without the fixed-growth rule, the formula would determine the aggregate payout, not just the division of it. If this had been the case in fiscal years 2018-19 and 2019-20, the federal government would actually have saved money. The fixed growth rule was adopted, apparently, to protect the federal government from the risk of having to make large increases in equalization payments at times when the horizontal fiscal imbalance worsens. With respect to the cost of equalization, however, the Parliamentary Budget Officer concluded that "removing the GDP growth cap would have only a marginal long-term impact on federal and subnational sustainability."²⁴ Many experts have criticized the presence of the fixed-growth rule in the equalization formula.²⁵ It should be eliminated, and removing it appears feasible. Yet the federal government apparently did not explore this avenue in the recent renewal. That inaction increases the risk of greater divergence between actual funding and adequate funding.

Natural resources

The treatment of natural resource revenues in the equalization formula stands out. First, actual revenues, rather than revenue-raising capacity, is used. Second, in the first-round calculation, only 50 percent of those revenues are included. Third, entitlements are alternatively calculated with those revenues omitted entirely. Fourth, the fiscal capacity cap is applied based on the inclusion of all natural resource revenues. While these steps might seem cumbersome, they do represent a reasonable compromise when it comes to dealing with natural resource revenues. Using actual revenues, rather than something like tax capacity, is a practical approach that avoids the more complex task of estimating economic rents from natural resources, which vary considerably with the characteristics of the resources. Including only 50 percent of revenues provides incentives for provinces to develop their natural resources. It also eases the financial costs of the program because including 100 percent of natural resource revenues could prove costly to the federal government, especially at times of spikes in oil and gas prices. Finally, the FCC, which takes account of the recipient province's entire resource revenues, ensures that a province does not receive so much equalization that it ends up in a better position than a nonrecipient province. Both the 50 percent proportion and the FCC were recommended by the expert panel and accepted by the federal government.

²² As noted earlier, this payment was necessary to prevent any recipient eligible province from getting ahead of Ontario, an otherwise ineligible one.

²³ Canada, Office of the Parliamentary Budget Officer, *Federal Financial Support to Provinces and Territories: A Long-term Scenario Analysis* (Ottawa, March 2018), 1.

²⁴ Canada, Office of the Parliamentary Budget Officer, *Federal Financial Support to Provinces and Territories*, 1.

²⁵ See B. Dahlby, "Eliminate the Ceiling on Equalization Payments," *National Post*, September 9, 2014; and B. Eisen, J. Emes, and S. Lafleur, "Should Equalization Keep on Growing in an Era of Converging Fiscal Capacity?" (Vancouver: Fraser Institute, August 2017).

Still, there are issues with the treatment of natural resource revenues. For example, the calculation of equalization entitlements based on either 50 percent of natural resource revenues or fully excluding those revenues – whichever is to a province’s advantage – is not well justified, nor was it recommended by the expert panel. Rather, its origin appears to be an election promise made by the Conservatives led by Stephen Harper. In fiscal year 2019-20, the only province to benefit from the full exclusion of natural resource revenues was Quebec, and that gain was approximately \$125 million, or only about 1 percent more than it otherwise would have received. Revisiting that provision prior to the recent renewal would have been worthwhile, but the current Liberal government stuck with the Conservatives’ design.

Another issue that has arisen is the treatment of hydroelectricity revenues. Some provinces have an abundance of water resources used in the generation of electricity. That is a substantial potential revenue source. Unlike with other natural resources, a great deal of hydroelectricity produced within a province is also consumed there. Because of this resource, Quebec and Manitoba have quite low electricity retail prices compared with those in other provinces. This might be rent dissipation: rather than collect the potential revenues, provincial policies, through provincially owned hydro corporations, forgo those revenues by effectively turning them over to provincial ratepayers through low prices. The rent-dissipation argument is that, if those hydro-rich provinces charged higher water rentals – that is, rentals consistent with the underlying economic rent, or captured rents in higher hydro corporation profits – their natural resource revenues would be higher and their equalization entitlements lower. This matter is somewhat complex and depends on estimating the extent of potential revenues, if any. There might not be a simple solution, but using export prices could be useful in finding one.²⁶ Again, this is a matter that could have been studied and analyzed in the renewal process, but apparently was not.

One more matter is the relatively new phenomenon of carbon taxes. At present, provincial government carbon tax revenues fall into the consumption tax category within the equalization formula, not the natural resource revenues one. However, the application of carbon taxes to natural resource extraction, particularly oil and gas, raises the question of where to place such revenues in the future. Should they stay where they are, should they go into another category or should they be a stand-alone category?²⁷ Like revenues from natural resources, potential carbon tax revenues are very unevenly distributed across the country; if they become substantial, there could be significant shifts in the distribution of entitlements. Also, to the extent they prove effective in curtailing fossil-fuel projects, such taxes might have a significant impact on oil and gas royalty revenues. There needs to be more study of the implications of the potential effects of carbon taxes on equalization.

²⁶ See J. Feehan, “Canada’s Equalization Formula” Peering inside the Black Box...and Beyond,” *SPP Research Papers* 7, no. 24 (2014).

²⁷ See T. Snoddon and T. Tombe, “Analysis of Carbon Tax Treatment in Canada’s Equalization Program,” *Canadian Public Policy* 45, no. 3 (2019): 377-92.

Expenditure need

A question with more far-reaching implications for the equalization formula is whether expenditure need should be incorporated in it, as is done in some federations, such as Switzerland. Rationales for doing so are usually based on the fact that either the cost of a unit of public services or the amount of needed public services varies by region. Canada's current equalization formula, however, is built exclusively on revenue equalization. Some have advocated for taking expenditure need into account, but generally the federal government has been reluctant to incorporate it as a parameter in the equalization formula, and there has not been a strong consensus among provinces and policy experts as to the merits of doing so. For instance, the expert panel's report concluded the following regarding a representative expenditure system: "On balance, the Panel considers that the case for incorporating expenditure need into Equalization has not been made. There is no conclusive evidence that it would have a material effect on the size and allocation of Equalization payments. It would be premature to recommend a comprehensive effort at constructing [a representative expenditure system], given the conceptual and data difficulties involved and the issues it would raise with respect to jurisdictional responsibilities."²⁸ To the extent that need should be taken into account, the expert panel went on to suggest that it might be more feasible to do so by adjusting the CHT and CST, not equalization.

Nevertheless, the idea of incorporating need has a long history – Douglas Brown points out that the concept goes back to the Rowell-Sirois Report of 1940, 17 years prior to the start of the equalization program.²⁹ Others continue to argue along those lines, notably Peter Gusen, who has developed an equalization prototype that includes differences in need as well as in fiscal capacity, and has estimated how much entitlements in fiscal year 2008-09 would have changed as a result.³⁰ Overall, he suggests, total payments would have decreased in that particular year; Quebec would have faced the largest reduction, while some other provinces would have gained.

Yet, such an approach could have many complications and adverse effects, depending on how it was designed. Consider, for instance, the goal of efficiency in the delivery of public services. It is probably far more expensive to build a kilometre of highway in mountainous British Columbia than in southern Manitoba. Providing the same health care for a scattered population on the coast of Newfoundland is more expensive than it is for the same number of people in a town in southern Ontario. Equalization based on need could address those cost differences. But would it be efficient? The costs are different. It makes sense for the provincial governments in each case to react to these costs by adjusting their programs. Designing public service delivery requires consideration of the true costs as well as the benefits. A need-based equalization that compensated for those cost differences would mask that reality and lead to an inefficient mix or delivery of public services.

²⁸ Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose*, 88.

²⁹ D. Brown, "Equalization on the Basis of Need in Canada," Reflections Paper 15 (Kingston, ON: Queen's University, Institute of Intergovernmental Relations, 1996), 1.

³⁰ P. Gusen, "Expenditure Need: Equalization's Other Half" (Toronto: University of Toronto, School of Public Policy & Governance, Mowat Centre for Policy Innovation, February 2012), table 12.

Other complications would arise as well, and, as suggested elsewhere, might open a Pandora’s box.³¹ Disagreements would arise over the merits of provincial programs, their costs and provincial autonomy. Recognizing such complexities, Daniel Béland and his co-authors conclude that including need in the formula would be impractical; like the expert panel, they suggest that it may be more feasible to incorporate need in the CHT.³² This matter is unresolved and deserves further research. As with the other aspects of the equalization program, there is little evidence that the federal government devoted any attention to it in the lead-up to its renewal of the equalization formula.

An arm’s-length agency

Daniel Béland and André Lecours propose the establishment of an arm’s-length agency to advise on equalization, and point to Australia’s Commonwealth Grants Commission as a possible model.³³ They see the establishment of such an institution as a way to depoliticize the process of equalization renewals and minimize disagreements between provincial and federal governments and among the provinces. The reactions to the recent renewal and the post-2019-election attacks on equalization serve to strengthen the rationale for this proposal. There is a good case for placing more distance between politicians and the equalization program. Doing so would also be helpful in providing independent expert advice for reforms and potentially better informing the public about equalization. It appears that, from 2009 until now, both Conservative and Liberal governments essentially have left equalization on autopilot. That is not desirable. Having such an agency to provide ongoing analysis and advice would contribute to improvements in the program and support informed debate.

But why stop at equalization? The CHT and CST are also subject to a fixed-spending-growth rule, which is undesirable, and the fiscal stabilization program needs redesign. These programs should not be treated as separate silos or reformed only to the extent the federal government deems appropriate. The constitutional division of government responsibilities in Canada means that the provinces do the heavy lifting when it comes to paying for and delivering most social and public services, but the federal government has advantages when it comes to raising revenues. Federal government assistance is needed to address the consequent vertical and horizontal imbalances and to provide an effective fiscal stabilization program for provincial governments. Yet the federal government alone decides how much is spent on those fiscal transfers, and it can attach unilateral conditions as well as limits on funding and make discretionary changes in funding. An impartial and independent expert agency that analyzes and advises on fiscal transfers – equalization, the block grants (CHT and CST) and the fiscal stabilization payments program – would provide more balance.

³¹ Feehan, “Canada’s Equalization Formula,” 25.

³² D. Béland, A. Lecours, G. Marchildon, H. Mou, and R. Olfert, *Fiscal Federalism and Equalization Policy in Canada*, The Johnson-Shoyama Series on Public Policy (Toronto: University of Toronto Press, 2017), 106.

³³ D. Béland and A. Lecours, “Equalization at Arm’s Length” (Toronto: University of Toronto, School of Public Policy & Governance, Mowat Centre for Policy Innovation, March 2012); and Béland and Lecours, *Canada’s Equalization Policy in Comparative Perspective*, IRPP Insight 9 (Montreal: Institute for Research on Public Policy, September 2016).

This leads to another question: why stop at advice? These transfers are pillars of Canadian fiscal federalism, and they should not be left entirely to the federal government's discretion. Other than for exceptional circumstances, monetary policy is determined at arm's length by the Bank of Canada – with great success. An institution with similar independence and a well-defined mandate for determining the levels and allocation of the major federal-provincial transfers, with appropriate requirements to consider federal budgetary constraints, might strengthen fiscal federalism.

CONCLUSION

In June 2018, the federal government announced the equalization formula for the 2019-24 period. It chose the status quo. It should have at least eliminated the fixed-growth rule for the equalization envelope. Doing so, and dropping the alternative, a resource-revenue-exclusion calculation of entitlements, would have eliminated the main deviations from the advice of the Expert Panel on Equalization and Territorial Formula Financing. It also ought to have reformed the fiscal stabilization program. Enhancements along the lines proposed by Bev Dahlby³⁴ would have addressed the concerns of the deficit-plagued “have” provinces and deflected mischaracterizations of equalization as the problem. These actions could have been implemented without any complex changes to the equalization formula or the formula used for fiscal stabilization payments, and it is not too late to do so.

More broadly, the federal government's sole authority and discretion with respect to equalization, the CHT and CST block grants and the fiscal stabilization program reflect an asymmetry of power in the federation. The idea of a national, nonpartisan and independent agency to advise on or perhaps determine the design and levels of these transfers deserves consideration. Such an institution could study complex issues and devise reforms. With respect to equalization, topics would include funding adequacy, the treatment of natural resource and carbon tax revenues and whether it would be desirable to incorporate expenditure need in the formula. Both the idea of having such an institution and the extent of its mandate are worthwhile research subjects for policy experts, as well as matters that federal legislators and provincial governments should consider.

³⁴ Dahlby, “Reforming the Federal Fiscal Stabilization Program.”



*Institute for
Research on
Public Policy*

*Institut de
recherche
en politiques
publiques*

Founded in 1972, the Institute for Research on Public Policy is an independent, national, bilingual, not-for-profit organization. The IRPP seeks to improve public policy in Canada by generating research, providing insight and informing debate on current and emerging policy issues facing Canadians and their governments.

The Institute's independence is assured by an endowment fund, to which federal and provincial governments and the private sector contributed in the early 1970s.

Fondé en 1972, l'Institut de recherche en politiques publiques est un organisme canadien indépendant, bilingue et sans but lucratif. Sa mission consiste à améliorer les politiques publiques en produisant des recherches, en proposant de nouvelles idées et en éclairant les débats sur les grands enjeux publics auxquels font face les Canadiens et leurs gouvernements.

L'indépendance de l'Institut est assurée par un fonds de dotation établi au début des années 1970 grâce aux contributions des gouvernements fédéral et provinciaux ainsi que du secteur privé.

Copyright belongs to the IRPP.
To order or request permission to reprint, contact:

IRPP
1470 Peel Street, Suite 200
Montreal, Quebec H3A 1T1
Telephone: 514-985-2461
Fax: 514-985-2559
irpp@irpp.org