How Alberta's shrinking economy could shake up the billions Canada spends on equalization

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Pumpjacks draw oil out of the ground near Olds, Alta., on July 16, 2020.

JEFF MCINTOSH/THE CANADIAN PRESS

For decades, Alberta has been a province unlike all the others, with its massive oil and gas revenues giving it fiscal firepower vastly greater than any other part of Canada.

The summer of 2008 was the apex of Alberta’s ascendance. In June that year, the price of West Texas Intermediate Oil reached a staggering US$140 a barrel, sparking predictions of an era of peak oil and permanently high prices.

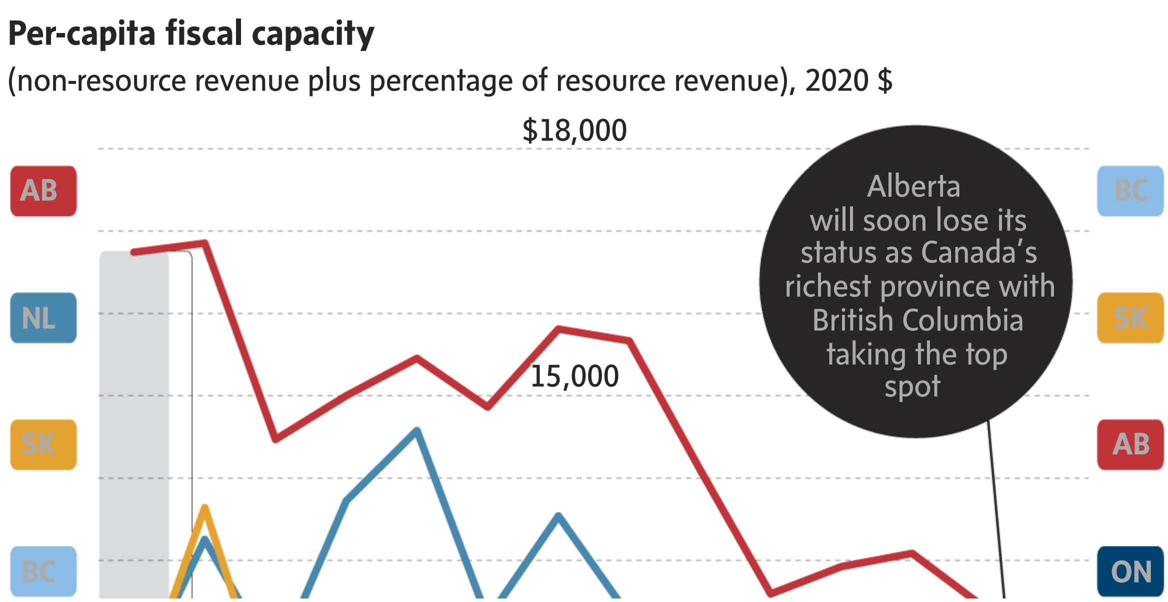
Alberta had paid off its provincial debt, and was lavishing billions on roads, hospitals and schools. All that, and low taxes too, made possible by the explosion in natural resource revenues, which had more than doubled since the start of the decade.

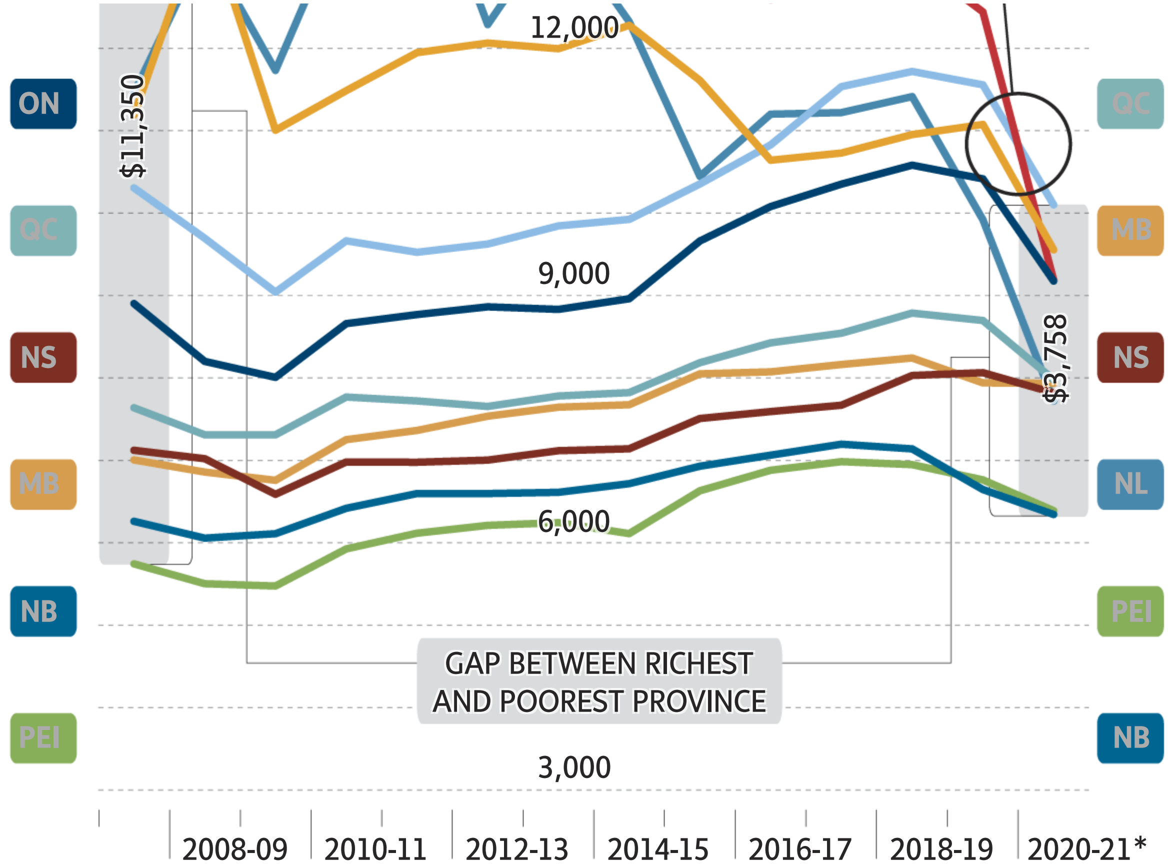
Canada was well on its way to realizing the ambition to become an energy superpower, as envisioned by then prime minister Stephen Harper, as the oil sands industry ramped up what was expected to be decades worth of growing output, and an unending flow of billions into the Alberta treasury.

Twelve years later, that summer of prosperity is a fading memory. Oil prices were falling sharply even before the novel coronavirus froze the global economy last spring, with Alberta crude selling at deep discounts because of pipeline bottlenecks. But during the early months of the pandemic, oil prices went into freefall, briefly dropping to less than zero. Oil, Alberta's lifeblood, was worthless.

While crude prices have rallied, Alberta is still facing an unprecedented decline in its economic fortunes. Its natural resource revenues this year are projected to be less than a fifth of what the province reaped in 2008-09. Now, the provincial government is struggling to roll back the excesses of the past two decades as it looks to drive down the cost of public services, while it hopes for the return of fossil fuel riches.

The decline is so steep that Alberta will soon lose its status as Canada's richest province – a title its formerly booming energy industry allowed it to hold for decades. Alberta has had the biggest fiscal capacity by far for all 53 years that measurement has existed. The lead allowed Alberta to spend a lot while keeping taxes low, but also opened up a gap with other provinces that Ottawa then had to counterbalance through equalization, the program established in 1957 that sends billions in federal tax dollars each year to poorer provinces to ensure a rough parity in services across the country.





SOURCE: BEN EISEN, FRASER INSTITUTE

So outsized was Alberta's strength that various federal administrations attempted to limit the growth of equalization payments – even by excluding the province altogether from the calculation of the fiscal capacity gap from 1982 to 2004. Twelve years ago, the Harper government erected a cost ceiling on the program, limiting increases to the three-year average growth rate of Canada's nominal gross domestic product.

Those fiscal realities are now being turned on their head, as the vaunted "Alberta advantage" of low taxes with high spending vanishes, transformed into a morass of massive deficits.

Alberta is not alone. All provinces have seen their fiscal outlooks deteriorate during the pandemic, with Newfoundland and Labrador sliding toward have-not status as its offshore oil revenues evaporate. Economist Ben Eisen with the Fraser Institute calls it the "great convergence" of the provinces' fiscal capacities, as the gap narrows between Alberta and everyone else. That might seem like a warm egalitarian moment, were it not for the small matter that it is a convergence of economic misery.

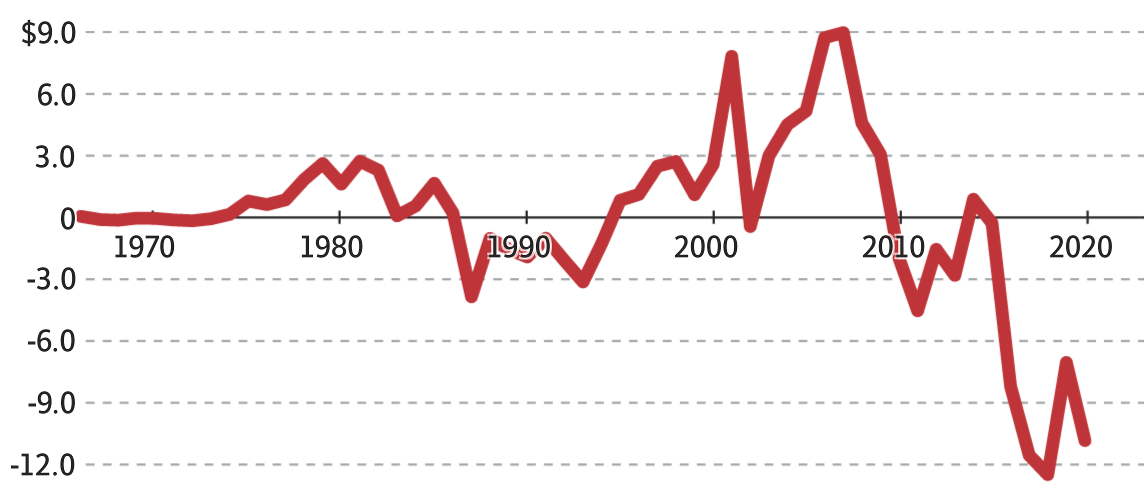
If the equalization program were simply reducing fiscal inequities between the provinces, the collapse of Alberta's fiscal capacity should have resulted in the program shrinking. (Notionally, if all the provinces had the same per capita fiscal capacity – which measures the ability to raise revenue through taxes and natural resources – there would be no gap for equalization to close).

But the changes made 12 years ago to curtail equalization are now working to Ottawa's disadvantage. When Alberta was awash in oil riches, equalization increases tied to the Canada's nominal GDP growth rate functioned as a ceiling, because the formula did not fully account for the surge in the province's fiscal capacity.

Because of Alberta's decline, the opposite is now true. The equalization program is still expanding at a rate tied to economic growth, but those annual increases more than compensate for the fiscal gap between the provinces. What was meant to be a ceiling has instead become a funding floor that forces the federal government to spend more, even as the gaps between provinces shrink.

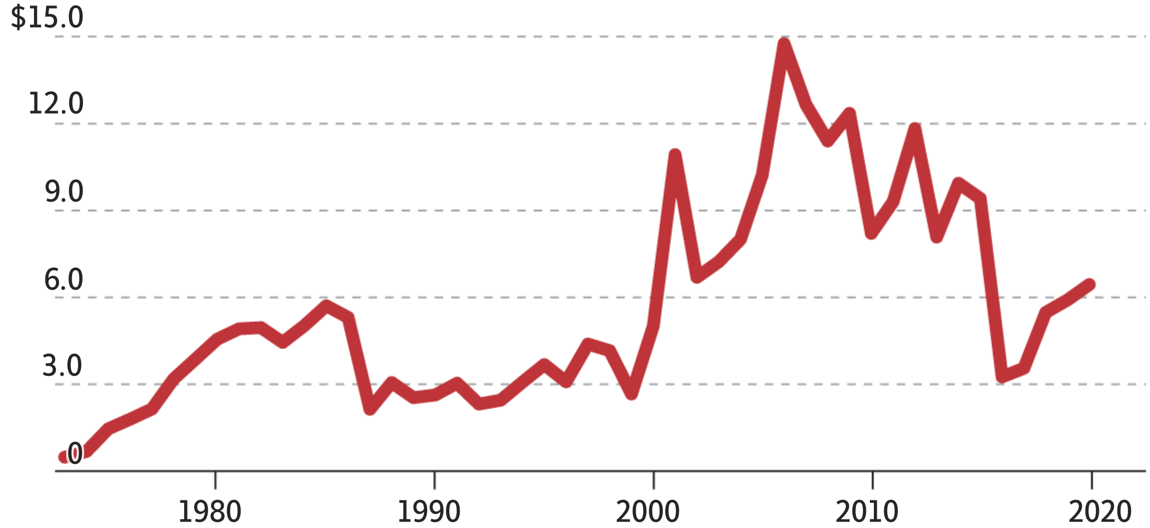
Alberta surplus/deficit 1966-2020

Billions of dollars



Alberta natural resource revenue 1973-2020

Billions of dollars



SOURCE: FINANCESOFTHENATION.CA

At the same time, Alberta's complaints about the unfairness of the program have intensified, with Premier Jason Kenney brandishing the possibility of a provincial referendum as a way to force changes. In the provincial budget this past week – with its swollen $18.2-billion deficit – the government again pressed for changes to equalization, linking that demand to its plea for greater fiscal stabilization payments from Ottawa.

There is a substantial amount of federal spending at stake: For the coming fiscal year, the funding floor will add $513-million to the cost of equalization, on top of the $20.4-billion needed to simply even up the gaps in the provinces' fiscal capacity. But those excess payments are set to soar to $2.3-billion in the fiscal year that begins in 14 months, estimates University of Calgary economist Trevor Tombe. That figure reflects the convergence of the provinces' fiscal capacities, unprecedented in the history of the equalization program, he says. "This is a unique moment."

The $2.3-billion could pay for half of a national basic pharmacare program. It could be used to cut the rates for the top three individual income tax brackets by one-and-a-half percentage points. The funds could be reshuffled into the fiscal stabilization fund that compensates provinces for economic turmoil, like that of the pandemic, as Alberta has argued. Or Ottawa could simply not spend the money, and pare the federal deficit.

Alberta's push to rewrite the rules of equalization has yet to gain much traction. And the federal Liberals haven't given any hint they have an appetite to reduce payments to Quebec and the Maritime provinces, key to maintaining the party's seat count. Prof. Tombe notes that changes to equalization have historically been "incredibly contentious."

But the pandemic is clearly accelerating a tectonic shift in Canada's fiscal structure. Mr. Eisen believes Alberta will soon lose its status as Canada's richest province – for the first time since the fiscal capacity measurement was invented in 1967 – with British Columbia taking the top spot. He says it's "certainly within the realm of possibility" that Alberta could become a have-not province receiving equalization payments, a scenario that would have seemed ludicrous even a half-decade ago.

How Ottawa will respond, if at all, isn't clear. What is certain is Canada is in the midst of an economic upheaval that has presaged fundamental changes to how fiscal federalism operates. "COVID definitely shook the tree," says Kevin Page, a former parliamentary budget officer, and now president and chief executive officer of the Institute of Fiscal Studies and Democracy.

As long as Canada has existed, there has been tension between the federal government and the provinces over the imbalance of revenue and expenses, says tax historian Shirley Tillotson.

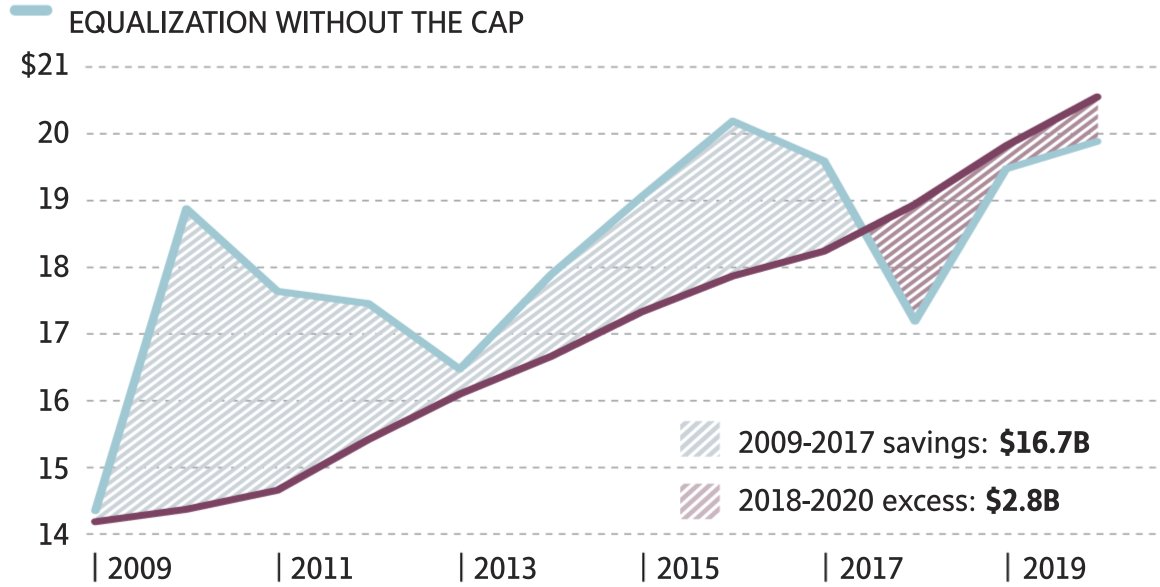
In the early days of Confederation, the Maritime provinces bemoaned the loss of customs and duties revenue – then the most lucrative income source for governments – that had been handed over to the new national government.

Decades would roll by before the provinces begrudgingly moved to implement income taxes, leaving them dependent on transfers from the federal government.

The cap on Ottawa's equalization payments since 2009

Billions of dollars

ACTUAL EQUALIZATION PAYMENTS



SOURCE: FINANCESOFTHENATION.CA

But in the 1930s and 1940s, economic catastrophe and war transformed fiscal federalism, and laid the foundation for the equalization system that exists today. The Great Depression dealt a severe blow to provincial finances, with Alberta forced into default in 1936. Then came the Second World War and a massive expansion of Ottawa's fiscal resources and reach, with the federal government assuming control of all income taxes and then transferring some of the proceeds to the provinces.

In the immediate postwar period, there was a debate over setting up a system of fiscal transfers that would have functioned much like the equalization system. The provinces objected to the political dependency that would have resulted; instead, Ottawa struck one-on-one agreements with provinces to share its tax revenue.

The equalization system began to take shape in 1957, with a limited program creating a bridge between Ottawa's ability to raise revenue and the provinces' ability to deliver expanding social services. "Equalization was born of the desire to have national health care," says University of Toronto economics professor Michael Smart.

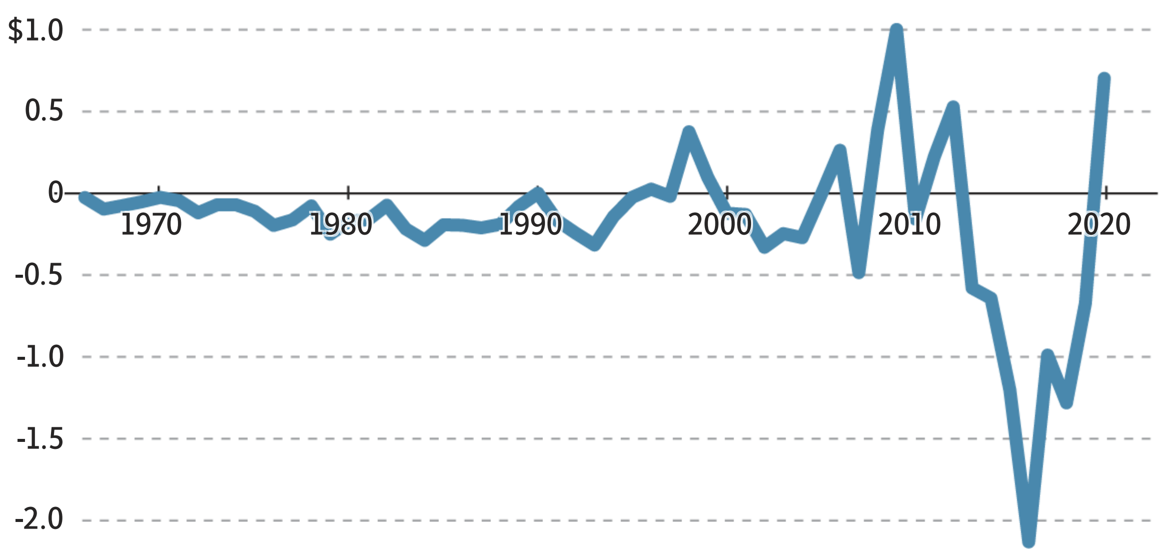
In one sense, that marked an endpoint to decades of political manoeuvring by the provinces and a slew of ad-hoc arrangements, says Dr. Tillotson, professor emeritus at Dalhousie University.

But the equalization formula itself was subject to continual tinkering, even after the principle of equalization – that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" – was enshrined in the Constitution. The treatment of natural resource revenues, especially, was revised several times, particularly after the oil crisis of the early 1970s sent energy prices, and Alberta's fiscal capacity, soaring. Under equalization, income from energy royalties, lumber stumpage fees and hydroelectric power are all considered natural resource revenues.

Fully excluding natural resources would tend to shrink equalization, and possibly hand a windfall to provinces heavily dependent on such revenues (such as Newfoundland, when its offshore oil industry took off).

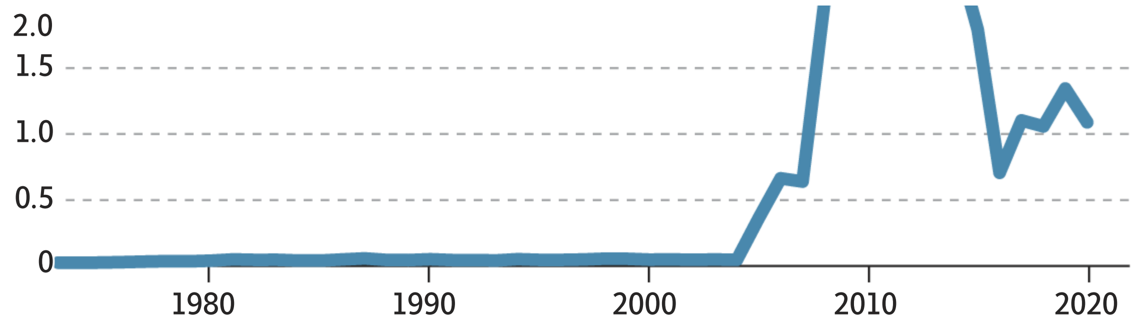
Newfoundland and Labrador surplus/deficit 1966-2020

Billions of dollars



Newfoundland and Labrador natural resource revenue 1973-2020

Billions of dollars



SOURCE: FINANCESOFTHENATION.CA

But fully including natural resource revenues would inflate the cost of equalization. Alberta's lead would grow, and for provinces receiving equalization, the full inclusion of natural resource revenue would effectively mean Ottawa would confiscate any energy riches, since those payments would fall as royalties grew.

By 2005, the system set up to supersede a spiderweb of political side deals had itself become hollowed out by provinces pressing for advantage. The most obvious example was the February, 2005, agreement between then-prime minister Paul Martin and then Newfoundland and Labrador premier Danny Williams that prevented the province's equalization payments from falling as its natural resource revenue shot up. That agreement has now expired.

The next month, the federal finance department commissioned an expert panel, steered by former Alberta deputy finance minister Al O'Brien, to make recommendations on creating a structure for equalization driven by principles, not political deals.

Chief among the panel's recommendations in 2006 was a return to a formula that determined the size of the equalization pool based on the disparities in the provinces' fiscal capacities, rather than a fixed growth rate. That calculation would include Alberta. The commission also recommended that half of natural resource royalties be excluded when calculating a province's equalization entitlement. But it paired that idea with a proposal for a cap on payments that would prevent an equalization-receiving province from leapfrogging a non-receiving province.

The newly elected Harper government largely adopted those recommendations in its second budget in March, 2007. The new rules lasted all of 20 months.

Two developments pushed Ottawa to suddenly rewrite the rules. The first was the surge in energy prices, which dramatically inflated Alberta's natural resource royalties, and the fiscal capacity used to calculate equalization.

The second was the looming prospect of Ontario becoming a have-not province, receiving equalization for the first time as its economy buckled – in part because of higher energy costs. Under the complex rules of the fiscal cap, Ontario acted as the ceiling on payments; no have-not province could exceed Ontario's fiscal capacity after receiving equalization payments. If Ontario were to become a have-not province, British Columbia – with a much higher per capita fiscal capacity – would become the new, higher ceiling.

Rather than see that happen, the Harper government rewrote the rules unilaterally, scrapping the formula that calculated the size of equalization based on all of the province's fiscal capacities and instead limiting the growth of the program to the three-year average increase in nominal GDP. The fiscal capacity cap rules were also rewritten to keep costs in check. Then finance minister Jim Flaherty gave the first hint of those massive changes in a speech to the Empire Club of Canada in October, 2008.

For Al O'Brien, Mr. Flaherty's sudden announcement was a repudiation of months of painstaking work. "Everyone just scrambled around, and that was that," he said in an interview.

The contradictory result, he said, is today's equalization system. Its purpose is to reduce fiscal disparities between the provinces, but equalization payments are not affected even as those disparities narrow. "That's bizarre," he says. "We are right back to where we were when the panel was appointed."

The muddled logic of the equalization system may be similar to the policy puzzle that Mr. O'Brien set out to solve 15 years ago, but the wider world is greatly changed. Canada's ambitions to become an energy superpower built on the fossil fuel powerhouse of Alberta are in the rearview mirror. Newfoundland will shortly fall back to have-not status.

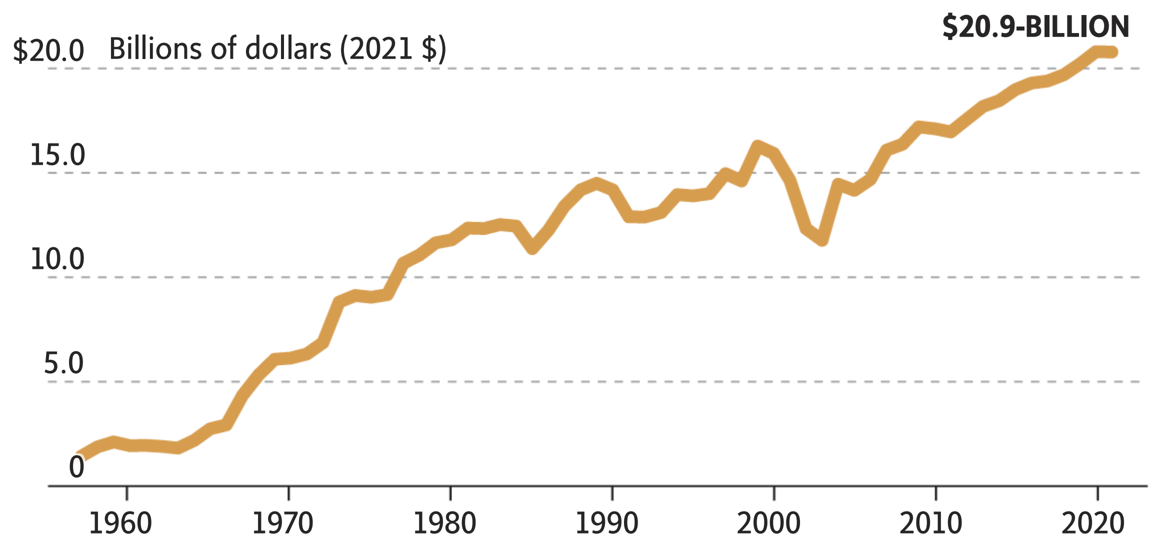
The economic fallout from the pandemic has also degraded the fiscal outlook for the remaining provinces. And Canada's major economic challenges before the pandemic struck – lethargic productivity growth and an aging work force – remain.

All of those pressures will intensify provincial pleas to Ottawa for more money, whether through equalization or by other means. But Mr. O'Brien says those pressures could be the catalyst for a renewed push to reform equalization. "That could bring about some effort to rethink and get back to some arithmetic."

One option would be to simply revert to the framework envisioned by the O'Brien panel 15 years ago, particularly a strict focus on offsetting disparities in the provinces' fiscal capacities. That would mean abandoning the GDP formula – and a drop in payments to have-not provinces at a time when they are already pressing Ottawa for greater support.

Total equalization payments in Canada 1957-2021

Total paid by Ottawa to qualifying provinces



SOURCE: TREVOR TOMBE, UNIVERSITY OF CALGARY

Alberta's push for Ottawa to increase fiscal stabilization payments, while paring back equalization, might be a path to a compromise. For his part, Prof. Tombe says redirecting excess equalization funds into other federal transfers is a realistic scenario.

But there are also ideas for more sweeping changes. Prof. Smart says any changes should be part of wider discussions on transfer payments to the provinces, including Ottawa's support for health care as the population ages. One idea certain to generate opposition in Alberta: requiring richer provinces to pay into equalization, turning the program into a two-way funding stream.

In addition, Prof. Smart says the program should also take into account fiscal needs, not just capacities, allowing for such variables as the average age of a province's population and the cost of delivering services. "Just moving dollars around to reflect different tax capacities ignores a big part of what we're really trying to do, which is to make sure that health, education and social services are roughly equal across the country," he says.

Equally sweeping, in a much different way, are proposals from Fairness Alberta, the non-partisan group buttressing the United Conservative Party government's push for a shakeup in Ottawa's transfers to the provinces. Increasing fiscal stabilization payments would be a good first step, says Bill Bewick, executive director of Fairness Alberta. (Mr. Bewick is also the former director of policy for the Wildrose Party that, along with the Progressive Conservatives, merged to form the UCP three years ago.)

But he also wants the size of the program cut in half. At the same time, Ottawa would cut its tax rates, allowing provinces to increase their revenues without an overall increase in the burden on taxpayers. That approach would benefit richer provinces such as Alberta, with their greater fiscal capacity, even without an increase in fiscal stabilization payments. But it would likely leave poorer provinces worse off.

Mr. Page, the former PBO, acknowledges the political pressures are building because of the damage to provincial finances after a year of pandemic and lockdowns. But he cautions that the program shouldn't be turned into a cure-all for the provinces' varied fiscal ills. "You don't want to make equalization the Swiss Army knife."

The principle of Canada's equalization program is straightforward enough

To ensure the provinces can provide roughly comparable services at roughly comparable levels of taxation. But the details of how the program functions are anything but simple. Below are the essentials of equalization.

Who pays: The federal government. Equalization is not a transfer of income between provinces (although in other countries with federal systems and equalization, there are such transfers). In Canada, however, equalization is simply one of the ways Ottawa spends the money it collects in taxes and other levies. So, when someone complains that their province – often Alberta – is paying other provinces through equalization, that is dead wrong. But it is true that high-earning Canadians tend to pay more in taxes, and more of those high-end taxpayers live in the richer provinces. But even if equalization were to disappear, those Canadians would still be obliged to pay high taxes to Ottawa.

Why it's mandatory: Unlike other federal programs, equalization is written into the Constitution, although the language is broad. Despite the constitutional language, the federal government has often acted to unilaterally rewrite equalization rules, often to the detriment of the provinces.

How much Ottawa pays: Since 2009, the growth of equalization has been tied to the three-year moving average of Canada's nominal gross domestic product. That means that the total amount of equalization will increase, but won't vary according to the size of the fiscal gaps between provinces, as has been the case periodically, most recently from 2006 to 2008.

Who gets it: Any province with a per capita fiscal capacity lower than the provincial average. Fiscal capacity measures a province's ability to generate revenue from taxes and natural resource revenues (a category that includes energy, lumber and hydroelectricity). It's important to note that the fiscal capacity calculation does not use actual tax revenues but, rather, the average of tax rates among the provinces. So, Alberta's fiscal capacity includes theoretical revenue from a provincial sales tax, even though the province in fact does not have one.

To add to the complexities, provinces can opt to calculate their equalization entitlement either by including half of natural resource revenues in calculating their capacity and the 10-province average, or by excluding all such revenue from the calculation – whichever would leave them better off.

Any province below the the average per capita fiscal capacity is eligible for an equalization payment. And, depending on some of the complications outlined below, some provinces just above that line can receive funds, too.

How much a province gets: Any province that falls below the 10-province average could get equalization. But Ottawa's fiscal capacity cap sometimes means provinces with large natural resource royalties don't receive those payments. The point of the cap is to make sure equalization-receiving provinces don't end up better off than those not receiving equalization, once actual natural resource revenues are counted.

Newfoundland would have qualified for $208-million in equalization in 2018-19 if all natural resource revenues were excluded from equalization calculations. But paying the province that much would have made it better off than Ontario, which was the reference point for Ottawa's cap in that fiscal year. So, Newfoundland's equalization payment was reduced to zero.

Lastly, the total amount of equalization payments is compared to the overall pool of funds available. If the available pool is smaller, then the equalization payments are reduced on a per capita basis. If it's bigger, "adjustment payments" are made to distribute the surplus.

A final complication in a very complicated program: Some provinces that are not initially entitled to receive equalization can get an adjustment payment if not doing so would leave them worse off than an equalization-receiving province. That's why Ontario – technically a "have" province in 2018-19 – received $963-million that year.

What the territories get: The three territorial governments aren't part of the equalization system, but they do get payments that serve the same purpose, under the Territorial Financing Formula. Actually, there are three formulas, tailored to the needs of each territory. The TFF excludes 30 per cent of revenue capacity from the calculation of payments, allowing territories to benefit from economic growth. Natural resource revenues are excluded altogether.

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