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PAPER

Declining Equalization Payments and Fiscal Challenges in the Small “Have-not” Provinces

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November 2014



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Executive Summary

This paper analyzes the fiscal condition of the four small, comparatively low-income Canadian provinces that rely on equalization payments as a source of revenue: Manitoba, New Brunswick, Nova Scotia, and Prince Edward Island. Specifically, we examine recent trends in the size of equalization payments to these provinces. We find that since Ontario began receiving payments in 2009/10, those provinces have experienced a marked decline in their share of equalization payments. More importantly, equalization payments as a share of nominal provincial GDP in those four provinces have declined. Finally, we analyze the impact of declining equalization payments on provincial finances. We conclude that the four smaller provinces must adjust to the new fiscal realities surrounding equalization payments and exercise spending restraint to align expenditures with revenues.

Introduction

This study analyzes the fiscal conditions of the three Maritime provinces (New Brunswick, Nova Scotia, and Prince Edward Island) and Manitoba. These four provinces share several key characteristics: they are small, relatively low-income provinces that have relied historically on equalization payments from the federal government as an important source of revenue. In addition, these provinces face considerable fiscal challenges, with significant current budget deficits and high levels of net debt exacerbated by declining equalization payments as a share of gross domestic product (GDP).

The long-term trend towards reduced equalization payments has been primarily a function of the gradual economic convergence of lower- and higher-income provinces. Since fiscal year 2009/10, however, when Ontario became a “have-not” province, the share of equalization payments received collectively by Ontario and Quebec—the two largest provinces—has increased markedly, resulting in relatively sudden and steep reductions in equalization payments as a share of nominal GDP to each of the four provinces in our study. This decline in equalization payments has contributed to the size of persistent budget deficits in these provinces.

Importantly, federal “stinginess” with respect to fiscal transfers has not been a primary driver of declining equalization payments. In fact, although total federal transfers as a share of GDP dropped during the cost-cutting period of the 1990s, they have since increased and are now nearly equal to what they were in the high-spending period of the 1970s. Thus, reduced payments to the four provinces in our study are not a function of a shrinking transfer “pie,” but the result of Ontario and Quebec consumer bigger slices of it.

Given that total federal transfer payments as a share of GDP are already high in historical terms, that the federal government has explicitly stated it will not increase transfers, and that it is risky to depend on an economic turnaround in Ontario and Quebec, we conclude that the prudent course for the four provinces in our study is to assume that help is not on the way. Instead, each province will have to address its own fiscal challenges through spending restraint and frugal fiscal management.

The Evolution of Transfer Payments

The evolution of fiscal transfers to the provinces is extremely long and complex, but a brief summary should suffice to explain their fiscal importance to the four provinces examined in this study.

As **Table 1** shows, there was a steady decline in the ratio of federal transfers to GDP (see the bottom line in the table), but the ratio has since risen. Total current federal transfers are, therefore, not low by historical standards and, in fact, align with levels that prevailed in the high-spending 1970s. Moreover, equalization payments as a share of GDP have declined somewhat from the levels of the 1970s, due largely to the gradual decline of differences in per capita nominal GDP across the provinces—mainly because of the migration of capital and labour from one province to another (see Coulombe and Lee 1995; Lee and Coulombe 1995)—although the declining trend has flattened out in recent decades. The equalization payments system is complex, however, it essentially calculates per-capita tax base disparities across provinces for a large number of provincial government tax bases. The federal government then pays equalization transfers to those provinces with sub-average tax base yields.

Table 1: Federal Transfers to the Provinces as a Share of Nominal GDP, 1970/71–2014/15

	1970/71– 1979/80	1980/81– 1989/90	1990/91– 1999/00	2000/01– 2009/10	2010/11– 2014/15
<i>Equalization Payments</i>	1.4	1.3	1.1	0.9	1.0
<i>Establishing Program Financing/Canada Health and Social Transfer Payments</i>	2.3	2.3	1.7	1.8	2.2
<i>Other Transfer Payments (not elsewhere specified)</i>	0.6	0.6	0.6	0.9	1.0
<i>Total Federal Transfers</i>	4.3	4.2	3.4	3.6	4.2

Source: Statistics Canada, CANSIM database, Table 380-0034; Canada 2014b, Table 4.2.6. Nominal GDP data originate from Statistics Canada, CANSIM database, Tables 380-0063 and 380-0016

Of greater importance to the Maritime provinces is, as **Table 2** illustrates, the share of equalization payments consumed by the eight “smaller” provinces (all except Ontario and Quebec) has declined markedly since fiscal year 2004/05. (Newfoundland and Labrador no longer receives equalization, which is the result of natural resource development in recent years.) In contrast, the Maritime provinces’ share of equalization, which had remained roughly constant over the three decades from the 1980s to the 2000s, dropped from 26.5 percent in 2004/05 to 22.8 percent in 2014/15—nearly 4 percentage points. Similarly, Manitoba’s share of equalization declined 4 percentage points from 14.4 to 10.4 percent in the same period.

What explains these declines in shares of equalization payments? One key factor is Quebec’s share increased significantly in the years following 2004/05. Another key factor is Ontario became eligible for equalization in fiscal year 2009/10, when it received \$347 million; these payments ballooned to more than \$3 billion in 2013/14 before dropping to roughly \$2 billion in

2014/15. We do not discuss why Ontario has become a “have-not” province here,¹ but we do note that Ontario’s per-capita GDP has converged toward that of other equalization recipients. The complicated equalization formula means that, if a large, high-income province moves toward smaller, lower-income provinces, the large province receives more equalization, leaving less equalization for the smaller, lower-income provinces. This story is the essence of **Table 2**.

Table 2: Share of Equalization, Offshore, and Transitional Payments, 2000/01–2014/15

	00/ 01	01/ 02	02/ 03	03/ 04	04/ 05	05/ 06	06/ 07	07/ 08	08/ 09	09/ 10	10/ 11	11/ 12	12/ 13	13/ 14	14/ 15
<i>Newfoundland and Labrador</i>	10.2	10.7	11.6	11.0	8.9	9.5	8.5	7.3	3.9	3.1	4.1	3.3	0	0	0
<i>Prince Edward Island</i>	2.5	2.5	2.6	2.6	2.5	2.5	2.4	2.2	2.3	2.3	2.1	2.0	2.0	2.1	2.1
<i>Nova Scotia</i>	12.8	12.7	12.4	12.9	12.1	12.4	12.1	11.5	11.1	11.0	10.1	9.6	10.4	11.0	10.8
<i>New Brunswick</i>	11.5	11.6	12.6	12.8	11.9	12.2	12.2	11.1	11.2	11.3	10.5	10.0	9.7	9.5	9.9
<i>Quebec</i>	49.1	45.2	44.3	42.2	37.3	43.3	46.5	53.9	56.8	56.1	54.3	49.9	46.9	47.4	55.0
<i>Ontario</i>	0	0	0	0	0	0	0	0	0	2.3	6.2	13.4	19.7	19.2	11.8
<i>Manitoba</i>	12.0	13.1	14.4	15.0	14.4	14.5	14.3	13.7	14.6	13.8	12.7	11.8	11.3	10.9	10.4
<i>Saskatchewan</i>	1.9	1.9	1.2	0	6.9	0.4	0.1	0.2	0	0	0	0	0	0	0
<i>British Columbia</i>	0	2.3	0.8	3.6	6.1	5.3	3.9	0	0	0	0	0	0	0	0
<i>Total, Ontario and Quebec</i>	49.1	45.2	44.3	42.2	37.3	43.3	46.5	53.9	56.8	58.4	60.4	63.3	66.6	66.6	66.8
<i>Total, Rest of Canada</i>	50.9	54.8	55.7	57.8	62.7	56.7	53.5	46.1	43.2	41.6	39.6	36.7	33.4	33.4	33.2
<i>Subtotal, Maritime Provinces</i>	26.8	26.8	27.7	28.3	26.5	27.1	26.7	24.9	24.6	24.7	22.7	21.6	22.1	22.5	22.8

Note: Offshore payments and transitional payments are the result of government negotiations stemming from lower equalization payments. We include them for the sake of completeness. Moreover, we exclude Alberta from this chart due to the province never having received equalization payments.

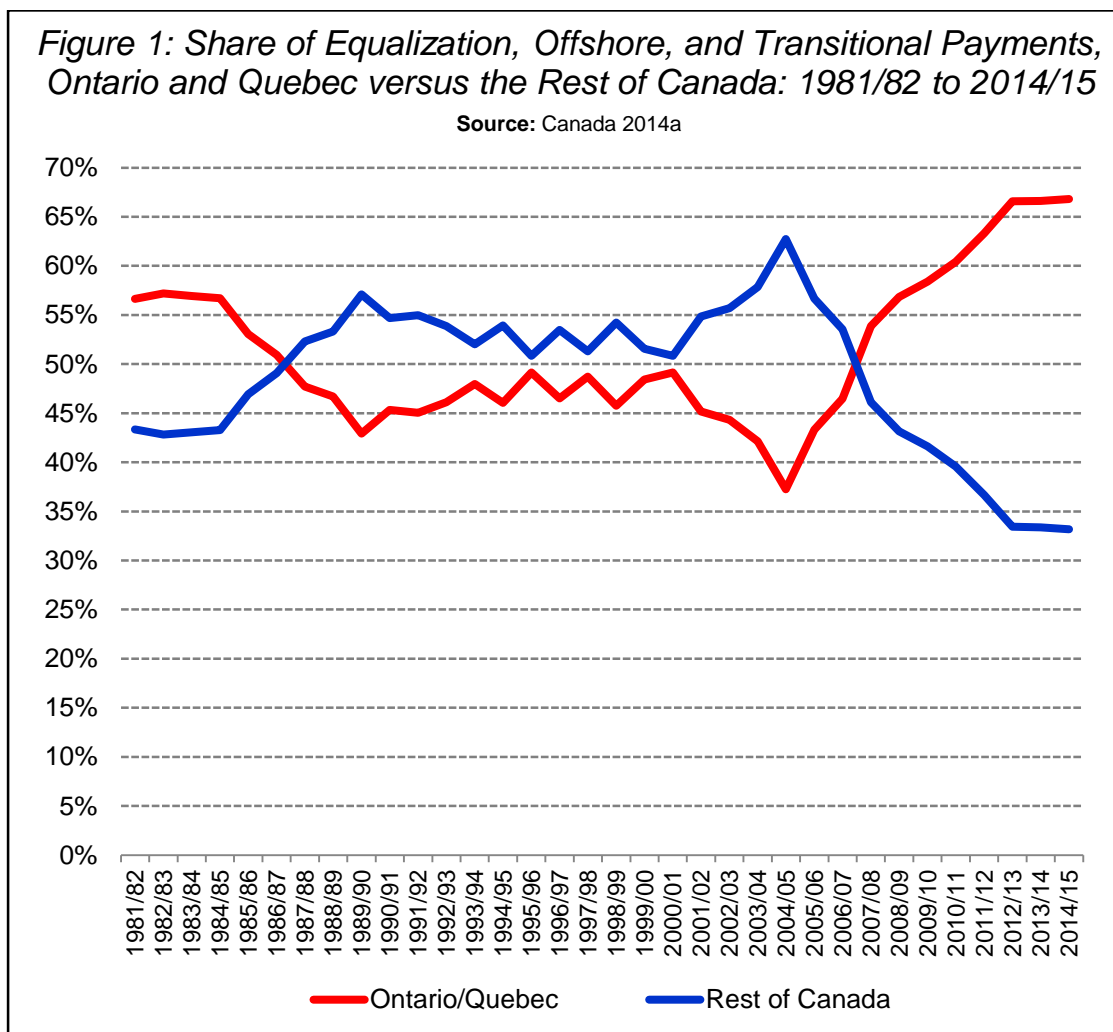
Source: Canada 2014a; unpublished worksheets from Finance Canada.

Figure 1 illustrates these trends graphically. It shows the share of equalization consumed collectively by Quebec and Ontario has increased dramatically in recent years, “squeezing out” the remaining equalization-receiving provinces. In fiscal year 2004/05, Ontario and Quebec consumed roughly 37 percent of equalization payments. By 2014/15, their share increased 30 percentage points to 67 percent.

To summarize, first, provincial per capita tax bases have converged over the past 35 years, such that equalization outlays have fallen relative to nominal GDP. This convergence has taken place while total federal transfers as a share of GDP have increased in the past 20 years. Second, Quebec’s share of equalization increased significantly in the years following 2004/05. Third, Ontario began consuming equalization payments in fiscal year 2009/10, which leaves less for the

¹ Among the reasons suggested are high taxes, high energy prices, and a high Canadian dollar; see Beine, Coulombe, and Vermeulen (2013) and Boadway, Coulombe, and Tremblay (2013).

smaller provinces. In the next section, we discuss how these developments influence fiscal finances in the three Maritime provinces and Manitoba.

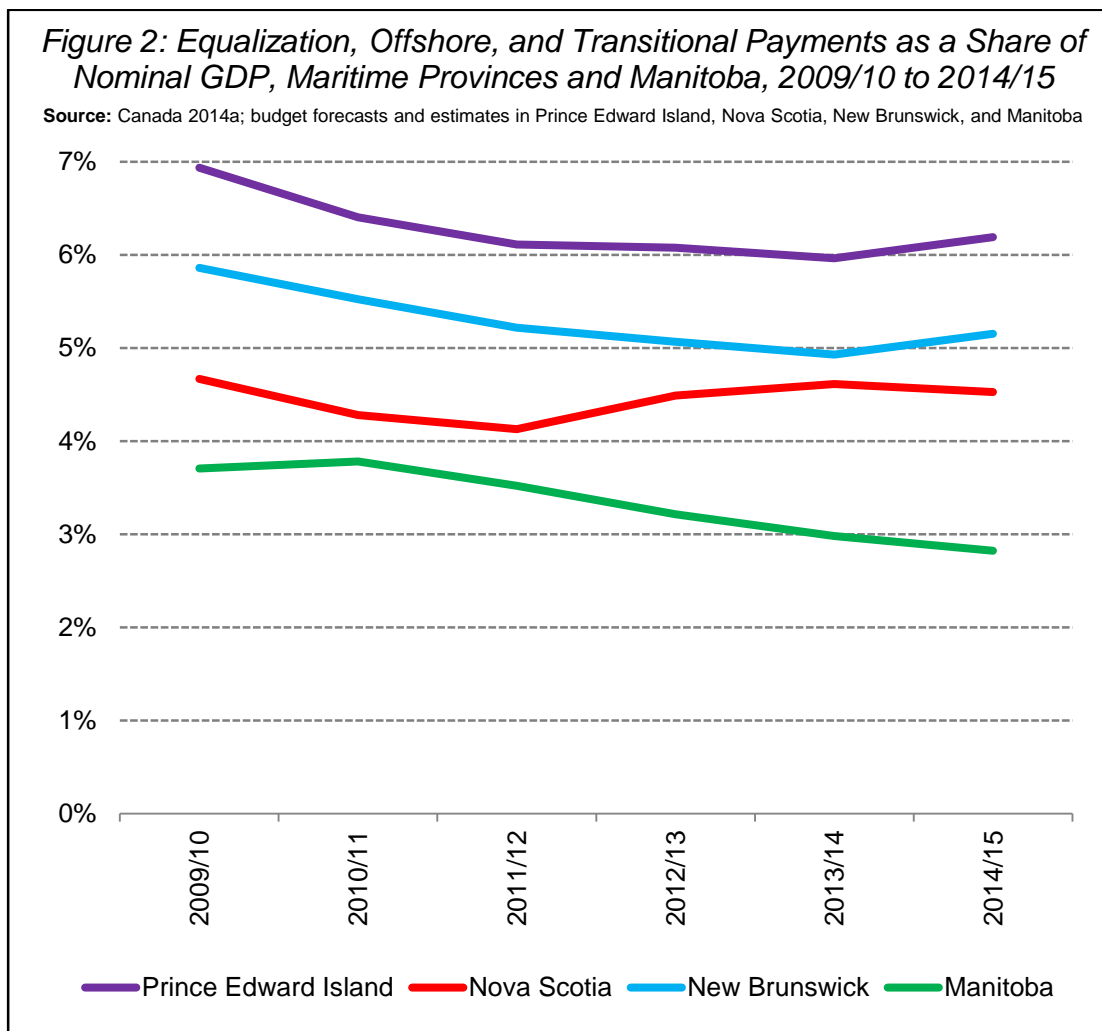


Fiscal Impact of Declining Equalization Payments to Smaller Provinces since Ontario became a “Have-not”

The trend of reduced equalization payments to the three Maritime provinces and Manitoba since Ontario became an equalization-receiving province in fiscal year 2009/10 is graphically illustrated in **Figure 2**. In Nova Scotia, the decline has been slight, but in each of the remaining provinces, equalization payments as a share of GDP have decreased by approximately three-quarters of a percentage point, representing a meaningful loss of revenue for each province.

To put these figures in context, it is helpful to compare the reduction in equalization payments as a share of GDP from the levels of fiscal year 2009/10 in each province, when Ontario began receiving equalization payments, with the budget deficits they face in 2014/15. As **Table 3** shows, in all four provinces, the reduction in equalization payments relative to GDP is a meaningful contributor to the size of their current budget deficit, which is especially true in

Prince Edward Island and Manitoba, where the “lost” revenue from equalization reductions is actually larger than the current budget deficit. In New Brunswick, reduced equalization payments as a share of GDP are more than half as large as the province’s budget deficit for 2014/15. In Nova Scotia, the drop in equalization payments has been much smaller, but still represents nearly \$50 million in reduced revenue, or approximately 8 percent of the province’s budget deficit.



The Fiscal Context of Declining Equalization

Declining equalization payments to the four provinces examined in this study exacerbates the fiscal challenges facing them, particularly sustained deficit spending and rising provincial debt. In Nova Scotia and New Brunswick, net debt per capita now exceeds \$14,000; in Prince Edward Island, it sits at just over \$13,500 per capita; and in Manitoba, net debt per capita totalled over \$12,500 per person in fiscal year 2013/14. The provincial net debt load represents 36 percent of GDP in Nova Scotia and Prince Edward Island, 35 percent of GDP in New Brunswick, and 28 percent of GDP in Manitoba.

The three Maritime provinces project budget deficits in fiscal year 2014/15, and all have net debt

loads that are sufficiently large that debt-servicing costs represent a significant expense each year. Debt-servicing costs in 2012/13 exceeded \$1.6 billion in those provinces, representing roughly 8.7 per cent of regional revenues. This amount is so significant that, in some instances, it equals the difference between generating a surplus and running a deficit. In 2012/13, for instance, taxpayer dollars spent servicing Nova Scotia’s debt exceeded the province’s annual deficit by \$599 million; in New Brunswick by \$153 million; and in Prince Edward Island by \$38 million. In other words, in the absence of such debt-servicing costs, these provinces would have generated budget surpluses, instead of deficits. The story is similar in Manitoba, where debt-servicing costs exceeded the 2012/13 deficit by \$259 million. Moreover, in all four provinces, growing net debt brings the risk of rising debt-servicing costs in the future if interest rates increase. High levels of public debt, therefore, represent a significant risk for taxpayers in these jurisdictions.

Table 3: Equalization Shortfall and Budget Deficit as a Share of Nominal GDP, 2014/15

	<i>Prince Edward Island</i>	<i>Nova Scotia</i>	<i>New Brunswick</i>	<i>Manitoba</i>
<i>Equalization Shortfall</i>	0.74	0.14	0.71	0.88
<i>Budget Deficit</i>	0.69	1.82	1.18	0.82
<i>Shortfall-Deficit Ratio</i>	1.07	0.08	0.61	1.07

Note: “Equalization shortfall” refers to the gap between actual equalization payments in 2014/15 and the amount of equalization payments these provinces would have received if they remained at 2009/10 levels as a share of GDP.

Source: Canada 2014a; 2014/15 budget forecasts and estimates in Prince Edward Island, Nova Scotia, New Brunswick, and Manitoba

These statistics show that the three Maritime provinces and Manitoba face significant fiscal challenges, and that expenditures do not currently align with revenues. The tables in Appendix 1 provide more detail, showing the evolution of several key fiscal indicators in each province over the past 35 years. These challenges must be addressed in the context of an economically weak Ontario and the related phenomenon of reduced equalization payments as a share of GDP in the four small equalization-receiving provinces.

Conclusion

Total federal transfers to the provinces as a share of nominal GDP—that is, equalization, offshore, transitional payments, the Canada Health and Social Transfer, and conditional transfers combined—have increased steadily since the 1990s, and are now at historically high levels. Total equalization payments as a share of nominal GDP, however, have fallen in the past four decades, given the convergence of per capita GDP among the provinces—although average total annual equalization payments during the past five fiscal years (2010/11 to 2014/15) have actually been slightly higher than they were in the preceding decade.

Although aggregate equalization payments to all the provinces combined have not been dropping in recent years, Ontario’s emergence as a recipient province in the federal equalization program leaves comparatively less room for the smaller, equalization-receiving Maritime provinces and

Manitoba, all of which have seen their equalization payments decline in recent years. In Nova Scotia, this decline has been relatively slight; in the other three provinces, however, the decline—equivalent to more than three-quarters of a percentage point of provincial GDP—represents a meaningful and relatively sudden loss of revenue. These declining equalization payments present a significant fiscal challenge to all four provinces, as their expenditures perennially exceed revenues even in the context of Canada’s continuing economic recovery.

Since total transfer payments as a share of GDP are already high in historical terms, and since it would be risky to depend on an economic turnaround in Ontario and Quebec, we conclude that the prudent course for the four provinces analyzed in our study would be to plan for reduced equalization payments as a permanent reality, and to develop strategies to adjust spending accordingly. All four provinces face significant fiscal challenges, and should not expect increased equalization payments or other transfers to solve their problems. Instead, each province will have to address its own fiscal challenges through spending restraint and frugal fiscal management in the years ahead.

Appendix 1: Fiscal Indicators for the Maritime Provinces and Manitoba

Table A1: Fiscal Indicators as a Share of Nominal GDP in New Brunswick, 1981/82–2014/15

	1981/82– 1990/91	1991/92– 2000/01	2001/02– 2010/11	2011/12– 2014/15
<i>Net Debt</i>	22.1	34.4	29.0	35.5
<i>Change in Net Debt</i>	2.3	2.1	1.1	2.0
<i>Total Expenditures</i>	29.6	26.4	25.3	26.0
<i>Total Revenue</i>	27.4	25.9	25.1	24.8
<i>Own-source Revenue</i>	16.2	15.9	15.5	15.1
<i>Total Federal Cash Transfers</i>	11.2	10.0	9.6	9.0
<i>Equalization Payments</i>	6.2	6.0	5.5	5.1
<i>Other Federal Transfers</i>	5.0	4.0	4.1	3.9

*Note: "Own-source revenue" and "total federal cash transfers" sum to equal "total revenues."
"Equalization payments" and "other federal transfers" sum to equal "total federal cash transfers."
These numbers may not sum accurately due to rounding.*

Source: Canada 2013; New Brunswick 2014; Statistics Canada, Provincial Accounts

Table A2: Fiscal Indicators as a Share of Nominal GDP in Prince Edward Island, 1981/82–2014/15

	1981/82– 1990/91	1991/92– 2000/01	2001/02– 2010/11	2011/12– 2014/15
<i>Net Debt</i>	9.9	30.5	31.5	36.1
<i>Change in Net Debt</i>	0.7	3.0	1.6	2.0
<i>Total Expenditures</i>	32.9	30.2	29.0	29.2
<i>Total Revenue</i>	32.2	29.3	28.3	28.1
<i>Own-source Revenue</i>	17.2	17.7	17.1	17.0
<i>Total Federal Cash Transfers</i>	15.0	11.6	11.3	11.1
<i>Equalization Payments</i>	9.2	7.7	6.6	6.1
<i>Other Federal Transfers</i>	5.8	3.9	4.6	5.0

*Note: "Own-source revenue" and "total federal cash transfers" sum to equal "total revenues."
"Equalization payments" and "other federal transfers" sum to equal "total federal cash transfers."
These numbers may not sum accurately due to rounding.*

Source: Canada 2013; Prince Edward Island 2014; Statistics Canada, Provincial Accounts

Table A3: Fiscal Indicators as a Share of Nominal GDP in Nova Scotia, 1981/82–2014/15

	1981/82– 1990/91	1991/92– 2000/01	2001/02– 2010/11	2011/12– 2014/15
<i>Net Debt</i>	24.1	41.8	38.2	36.4
<i>Change in Net Debt</i>	2.8	3.2	0.5	1.4
<i>Total Expenditures</i>	24.9	21.8	24.1	26.3
<i>Total Revenue</i>	22.2	21.2	24.6	24.8
<i>Own-source Revenue</i>	13.2	13.8	16.8	16.5
<i>Total Federal Cash Transfers</i>	9.0	8.1	7.8	8.4
<i>Equalization Payments</i>	5.3	5.4	4.4	4.4
<i>Other Federal Transfers</i>	3.8	2.7	3.5	3.9

*Note: “Own-source revenue” and “total federal cash transfers” sum to equal “total revenues.”
“Equalization payments” and “other federal transfers” sum to equal “total federal cash transfers.”
These numbers may not sum accurately due to rounding.*

Source: Canada 2013; Nova Scotia 2014a; Nova Scotia 2014b; Statistics Canada, Provincial Accounts

Table A4: Fiscal Indicators as a Share of Nominal GDP in Manitoba, 1981/82–2014/15

	1981/82– 1990/91	1991/92– 2000/01	2001/02– 2010/11	2011/12– 2014/15
<i>Net Debt</i>	19.7	27.4	24.8	28.2
<i>Change in Net Debt</i>	2.0	1.8	0.6	0.6
<i>Total Expenditures</i>	20.1	20.1	23.4	25.1
<i>Total Revenue</i>	18.3	19.7	23.8	24.1
<i>Own-source Revenue</i>	11.7	13.3	16.6	17.3
<i>Total Federal Cash Transfers</i>	6.5	6.4	7.2	6.7
<i>Equalization Payments</i>	3.2	3.7	3.8	3.1
<i>Other Federal Transfers</i>	3.3	2.7	3.5	3.6

*Note: “Own-source revenue” and “total federal cash transfers” sum to equal “total revenues.”
“Equalization payments” and “other federal transfers” sum to equal “total federal cash transfers.”
These numbers may not sum accurately due to rounding. Due to a break in the series following the
move to summary account budgeting, data from 2003-04 onward are not directly comparable with
earlier years.*

Source: Canada 2013; Manitoba 2014; Statistics Canada, Provincial Accounts

Appendix 2: Data Sources and Construction of the Data

Table 1: Federal Transfer Payments to the Provinces as a Share of Nominal GDP, fiscal years 1970/71 to 2014/15

To obtain components of federal transfers to the provinces, we used data from Statistics Canada, CANSIM database, table 380-0034, “Income and Expenditure, Sub-sector Accounts, Federal to Government, Quarterly.” Statistics Canada terminated this data set, ending in 2012. For the fiscal years between 1970/71 and 2010/11, we aggregated quarterly raw data to calculate “total

transfers,” “equalization” payments,” and “Established Programs Financing/Canada Health and Social Transfer (EPF/CHST) payments.”

We aggregated “post-secondary education,” “hospital insurance,” “medicare,” “extended health,” and “Canada Assistance Plan” payments for the fiscal years between 1970/71 and 1999/2000, after which we linked them to the CHST data series to obtain a total EPF/CHST series. The “other transfers not elsewhere specified (NES)” series is a residual of total transfers minus equalization payments minus EPF/CHST payments.” The residual contains the following federal transfers: grants to the territories and transfers for language programs, regional development, and other NES.

For fiscal years 2011/12 to 2014/15, we obtained federal transfer data using actual and forecast estimates from the most recent federal budget (Canada 2014b, 276). For the divisors, in the various ratios, we use nominal GDP data at market prices, from Statistics Canada, CANSIM database, table 380-0063, “Gross Domestic Product, Income-based, Quarterly” for 1980/81 to 2012/13. For the 1970/71 to 1979/80 period, we used Statistics Canada, CANSIM database, table 380-0016. These latter data required adjustment to the other data using 1980/81 as an overlap year. Nominal GDP in 2014 is an estimate from the most recent TD Economic Forecast (TD Economics 2014).

Table 2: Share of Equalization and Offshore Payments, by Province, fiscal years 1980/81 to 2014/15

Data were obtained from Canada (2014a) for fiscal years 2005/06 to 2014/15 (so-called entitlement figures). We subsequently obtained data for 1980/81 to 2004/05 in unpublished worksheet form from the Department of Finance. These data are comparable to the published data in Canada (2014a). We summed equalization, offshore, and transitional payments to obtain “total equalization payments” for the ten provinces, after which we summed all nine provinces that ever received such payments to get a “nine-province” total. Lastly, we summed total equalization payments by province in deciles, dividing each province’s payments by the nine-province total to obtain percentage shares.

Table 3: Equalization Shortfall and Budget Deficit as a Share of Nominal GDP, Maritime Provinces and Manitoba, fiscal year 2014/15

We calculated the equalization shortfall by assuming that equalization payments as a share of nominal GDP in fiscal year 2009/10, the year Ontario began receiving payments, remained constant in 2014/15. In other words, we calculated what equalization payments as a share of nominal GDP would have been in 2014/15 had they remained at 2009/10 levels, when Ontario’s share of the equalization pie was insignificant. Next, we calculated the equalization shortfall in comparison to the anticipated 2014/15 budget deficit in each province using data from Canada 2014a and provincial public accounts for 2012/13 in Prince Edward Island, Nova Scotia, New Brunswick, and Manitoba. Importantly, we do not imply that declining equalization payments are *responsible* for deficits; rather, we monetize the equalization shortfall and show them in comparison to budget deficits for interpretation purposes only.

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