

THE GREAT CONVERGENCE

Measuring the Fiscal Capacity Gap Between “Have” and “Have-Not” Provinces

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Executive Summary

Since 2007/08, the fiscal capacity gap between richer and poorer Canadian provinces has shrunk dramatically, with the trend accelerating significantly after 2014–15. Fiscal capacity refers to a province’s ability to raise own-source revenues at tax rates set to the national average, plus any additional revenues from natural resource royalties. We here refer to this trend of a shrinking fiscal capacity gap as “the great convergence.”

In 2007/08, using 2020 dollars, the fiscal capacity gap between the richest province (Alberta) and the poorest (PEI) was \$10,999. By 2018/19, that number had fallen to \$6,138. With the 2020 COVID shock and sudden fall in natural resource prices, we estimate the gap will fall further to \$3,758 in 2020. In the 2020/21 fiscal year, we estimate that British Columbia will overtake Alberta as the province with the highest fiscal capacity, and New Brunswick will replace PEI as the province with the lowest. A similar directional trend prevails if we consider fiscal capacity convergence between other oil-rich provinces (Newfoundland and Labrador and Saskatchewan) and other provinces.

In this paper, we calculate the scale of this convergence and discuss the budgeting implications for high- and low-income provinces. We pay particular attention to the case of Alberta.

The collapse in Alberta’s fiscal capacity has been remarkable and is likely to produce historic results. We estimate that the resource revenue collapse this fiscal year 2020/21 will essentially complete the process of Alberta’s fiscal capacity convergence with the rest of Canada. We estimate per-person fiscal capacity in Alberta for 2020/21 will be \$9,189. This is almost identical to the per-person fiscal capacity in the rest of Canada (\$8,832). Since 2007/08, the gap has shrunk from 92.8 per cent to 4 per cent. Further, we forecast that Alberta will lose its spot as having the highest per-capita fiscal capacity in Canada for the first time since the modern notion of fiscal capacity was developed in 1967.

These results have important implications for budgeting. Because it has lost its fiscal capacity advantage, the province’s existing combination of low tax rates and high spending is no longer possible without running large budget deficits. Alberta’s deficit has been over \$6 billion every year since 2015, while multiple analyses show that the province’s current policy bundle of low taxes and high spending is fiscally unsustainable given reasonable assumptions about future demographic and economic conditions. Saskatchewan and Newfoundland and Labrador will also likely face additional fiscal pressures due to their declines in per-person fiscal policy capacity that have occurred already and that we estimate will continue in 2020.

There are also implications for budgeting in current have-not provinces due to the current rules of the equalization program. If current fiscal capacity levels persist Newfoundland and Labrador is likely to become an equalization recipient in the years ahead. More worryingly, if Alberta’s per-person fiscal capacity continues to stagnate or fall, that province could become equalization eligible in coming years—a possibility

that would have been unthinkable just a half-decade ago. This is potentially problematic because under the current fixed-rate rules of the equalization program, new arrivals as recipients reduce the pool of equalization revenues available to existing recipients. We saw evidence of this fact in the early 2010s when Ontario became eligible for grants, and equalization payments as a share of total revenue fell meaningfully in all previous recipient provinces.

The “great convergence” in the relative fiscal strength of Canadian jurisdictions has different but significant implications for public finances in both higher-income and lower-income provinces. This study is the first to rigorously measure the reality of a great convergence in Canada and provides a starting point for future policy discussions surrounding the policy implications for current equalization recipients, non-recipients, and federal policymaking surrounding fiscal federalism.

Introduction

During the late 2000s, the economic and fiscal capacity [1] gaps between richer and poorer provinces was growing quickly, primarily due to rapid economic growth and increasing natural resource royalties in high-income energy intensive provinces. These facts placed significant upward pressure on the cost of Canada’s equalization program which, at the time, grew when the gap between “have” and “have-not” provinces became larger.

In its 2009 Budget, the federal government asserted that the trend of fiscal capacity divergence between “have” and “have-nots” was so great that to protect federal finances from growing costs, a new rule would be implemented that essentially tied the rate of growth in the overall equalization envelope to the national rate of national nominal GDP growth. The stated purpose was to protect federal finances from further rapid increases to the cost of equalization resulting from continued growth in the gap between richer and poorer provinces.

A little more than a decade later these concerns seem to have been, at least in the short-term, misplaced. Instead of continued growth in the gap between richer and poorer provinces, the exact opposite has occurred. The gap between high- and low-income provinces has shrunk dramatically—primarily due to the energy price crashes of 2014/15 and 2020, which hit high-income, oil and gas rich provinces particularly hard. This collapse in the gap between richer and poorer provinces in terms of their ability to raise revenue is so pronounced that we here refer to it as “the great convergence” in provincial fiscal capacity.

This study starts by examining the recent development of fiscal capacity in the ten Canadian provinces. The next section briefly examines the implications for provincial finances in current “have” provinces. The following section discusses implications for the equalization program and current equalization recipients.

[1] “Fiscal capacity” refers to a government’s ability to raise revenue at a given level of taxation. Generally richer provinces have higher ‘fiscal capacities’ than lower-income provinces, which is to say the higher-income jurisdiction would generate more revenue at identical rates of taxation.

The Great Convergence in Provincial Fiscal Capacity

In Budget 2009, the federal government expressed concerns about growing equalization payments resulting from a growing fiscal capacity gap between richer and poorer provinces. Fiscal capacity refers to the ability of a province to raise own-source revenue if each of its tax rates were set at the national average. Broadly, higher income provinces have high fiscal capacities, and lower-income provinces have lower. High levels of natural resource royalties are also a major contributor to higher fiscal capacities in the provinces that benefit from them. [2]

Specifically, Budget 2009 noted “Equalization has grown by 56 percent since 2003–04. This rate of growth is clearly not sustainable” (Canada, 2009). To slow the rate of growth and ensure cost certainty, the federal government implemented a new rule saying that equalization would grow in line with average national nominal GDP growth over the past three years. [3] As such, the equalization formula no longer determined the size of the overall equalization envelope, but instead only showed how the envelope would be allocated. This rule is often referred to as the Fixed Growth Rule (FGR). [4]

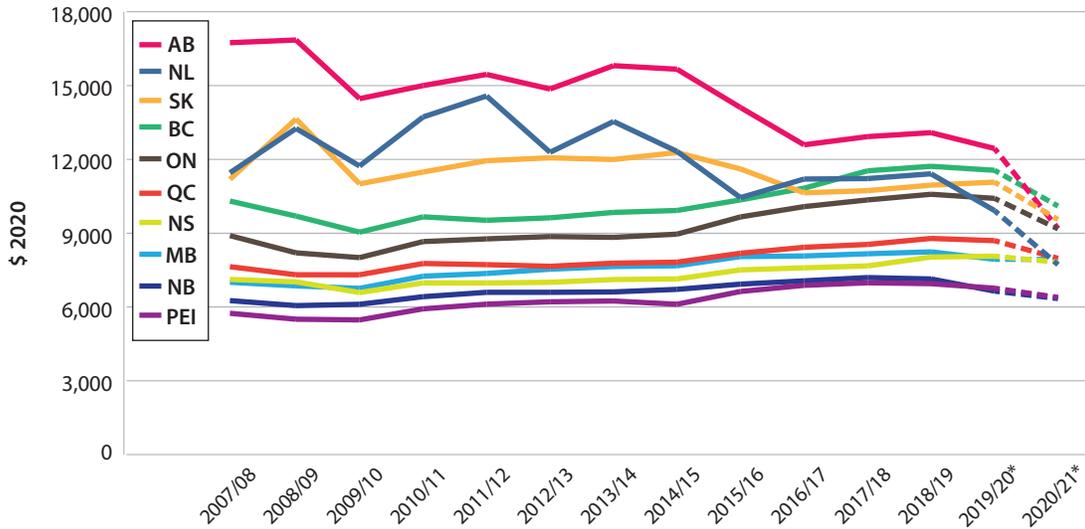
In reality, however, the continued growth in the gap between higher and lower income provinces that helped prompted the creation of the FGR did not come to pass. In fact, the exact opposite trend has emerged. Since 2007/08, the gap between richer and poorer provinces with respect to fiscal capacity has shrunk dramatically, with the trend accelerating significantly after 2014/15. We here refer to this trend as “the great convergence.” The convergence in fiscal capacity closely mirrors convergence in provincial GDP per capita, given the close connection between GDP growth and non-resource revenue growth.

[2] Throughout, except where noted otherwise, we measure fiscal capacity using 100 percent of natural resource revenues rather than the 50 percent inclusion rate that most often determines outcome in the equalization formula. The formula does, however, take account of the 100 percent natural resource revenue calculation in determining the fiscal capacity cap. We use the 100 percent inclusion because it provides a more accurate picture of each province’s ability to generate revenue and finance expenditures.

[3] Another important motivation may well have been the federal government’s recognition that Ontario would soon become a “have-not” province, which would have important implications in the absence of a fixed growth rate rule. Ontario’s transition to a have-not would have mechanically increased the total cost of the program for reasons having to do with the province’s size and the intricacies of the formula. In either event, the change is reasonably viewed as an expedient adopted during a severe recession to reduce the potential growth of program costs at a time federal finances were strained.

[4] For more information on the details and history of the Fixed Growth Rule, see Eisen, Emes, and Lafleur (2017).

Figure 1: Per-capita fiscal capacity (non-resource revenues plus 100% resource revenues), 2007/08 to 2020/21



Note: The last two years (* and dashed line) are estimates.

Sources: Canada, 2019; Provincial Budgets, 2020; Provincial Fiscal Updates, 2020; Statistics Canada, 2020a, 2020b; RBC Economics, 2020; BMO Economics, 2020; calculations by authors.

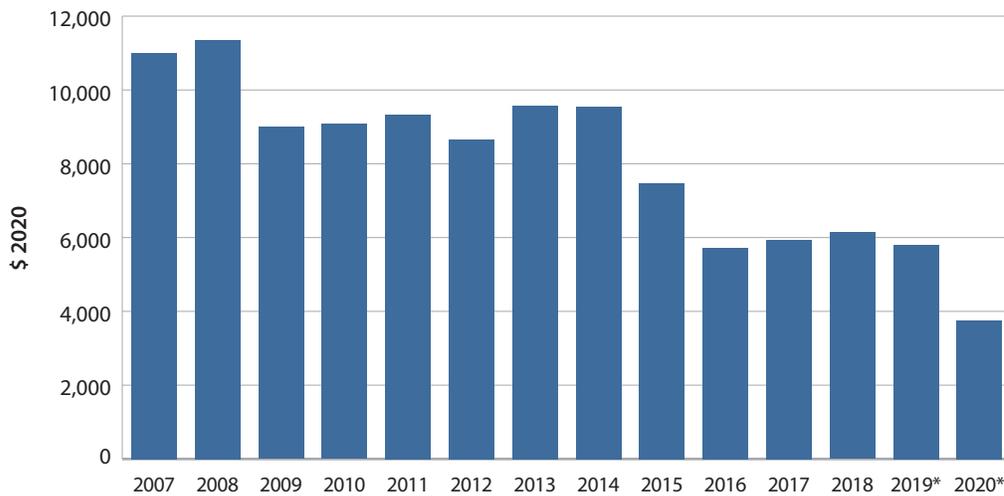
Figure 1 shows that in 2007/08, there was a large gap in the per-capita fiscal capacity of higher-income provinces (particularly oil and gas rich Alberta, Saskatchewan, and Newfoundland which were benefitting from significant resource royalty revenues) and lower-income jurisdictions. [5] For example, Alberta, with the highest fiscal capacity in Canada (\$16,743), had a per-person fiscal capacity that was nearly three times that of the lowest province, PEI (\$5,744). The gap between Alberta and Ontario (the largest province, whose fiscal capacity is often broadly aligned with the national average) was 88.1 percent.

In the years since, a great convergence has occurred and, after 2014/15, accelerated. The acceleration began in earnest in 2015, when energy commodity prices (particularly oil) suffered a price crash. By 2018/19 (the last year of complete data and again in 2020 dollars) the gap between Alberta and Ontario had fallen from 88.1 percent to just 23.7 percent. In 2020 dollar terms, the per-person fiscal capacity gap between Alberta and Ontario fell from \$7,841 in 2007/08 to \$2,504 in 2018/19.

A related story emerges if we visualize the change in the gap between the highest and lowest inflation-adjusted per-capita fiscal capacity levels in the highest and lowest province in Canada (figure 2). In 2007, this gap (between Alberta and PEI) stood at \$10,999. By 2018, the gap (between the same provinces) fell to \$6,138. We estimate that this year, the gap will have fallen still further, with the gap being \$3,758 between the province with the highest fiscal capacity (now British Columbia), and that with the lowest, now New Brunswick.

[5] Figure 1 and the related figures in the text are adjusted for inflation and use 2020 dollars.

Figure 2: Per-capita fiscal capacity gap between the highest and the lowest provinces



Note: Years marked with * are estimates.

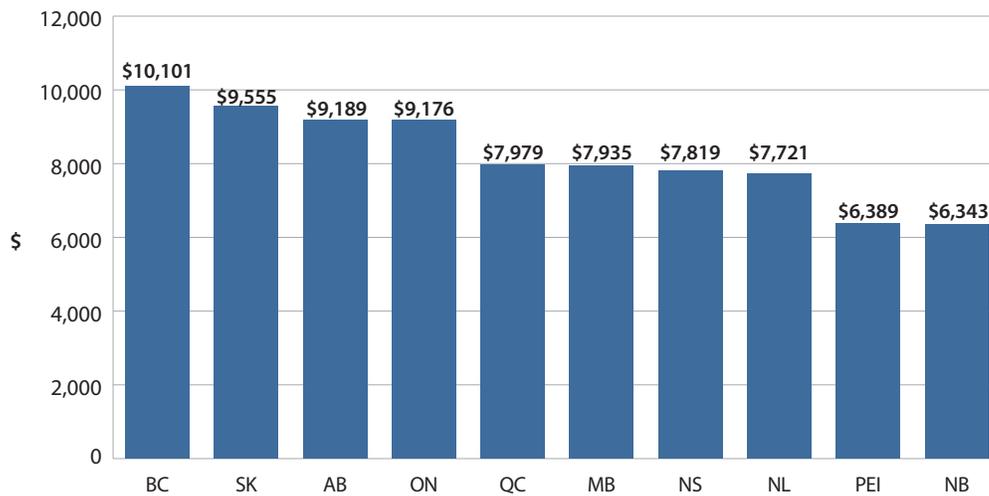
Sources: See figure 1.

Although the gaps between the other energy-intensive provinces and the have-nots was smaller at the start of this process than that with Alberta, a generally similar story emerges with respect to fiscal capacity convergence in those other oil rich provinces. The per-person fiscal capacity gap between Saskatchewan and the rest of the country taken as a whole fell from \$1,698 (after adjusting by inflation) in 2007/08 to just \$567 in 2018/19. For Newfoundland and Labrador, the per-person fiscal capacity gap between the province and the rest of the country taken as a whole fell from \$1,938 to \$1,024 (inflation adjusted) over this period.

With another oil price collapse in 2020, particularly a sharp downturn at the start of the COVID-19 shock, the trend of fiscal capacity convergence between oil and gas rich provinces and the rest of the country has almost certainly continued. Here, we have used straightforward methods to provide estimates of provincial fiscal capacity for 2019/20 and 2020/21. [6] These are included in figure 1.

[6] Provincial fiscal capacity for 2019/20 and 2020/21 was estimated using data from the 2020 provincial budgets and/or most recent fiscal updates. Resource revenues were forecasted using data from these budgets on actual resource revenue for 2019/20 and budget/update forecasts for 2020/21 presented in those documents. Meanwhile, the non-resource fiscal capacities were projected using the growth rate in per-capita non-resource revenues forecasted in the budgets/updates. Changes in tax policy may therefore cause small divergences between the actual growth of non-resource revenue and our estimates non-resource fiscal capacity. These are generally small. However, in one jurisdiction, Alberta, a change in government has produced major tax changes which we have reflected in these estimates. Of greatest importance, we factor in the effect of reduced carbon tax revenues and reduced revenue from the accelerated corporate income tax rate reduction. These changes lead to a higher increased fiscal capacity estimate for Alberta in the current fiscal year than if the adjustments were

Figure 3: Per-capita fiscal capacity (non-resource revenues plus 100% resource revenues), 2020/21 estimate



Sources: Canada, 2019; Provincial Budgets, 2020; Provincial Fiscal Updates, 2020; Statistics Canada, 2020a, 2020b; RBC Economics, 2020; calculations by authors.

Figure 3 focuses on our estimates of 2020/21 fiscal capacities. These estimates show a number of important results. First the gap between the province with the highest fiscal capacity (which we estimate will be BC) and the lowest (now New Brunswick) has continued to shrink, and we estimate will reach 59.2 per cent (down from 88.3 per cent in 2018/19). Perhaps more surprising, however, is that we estimate that the identity of the highest fiscal capacity province has changed. In 2020-21, we estimate that British Columbia will have the highest fiscal capacity in Canada. Saskatchewan will be second; Alberta will fall to third place at \$9,189. Ontario is fourth.

Although there are interesting results for several provinces, the results for Alberta are startling and of significant historical importance. First, with a fiscal capacity per capita of \$9,189 in 2020/21, we estimate Alberta’s inflation-adjusted per-person fiscal capacity will be barely more than half (54.9 per cent) what it was in 2007/08. Further, Alberta’s drop from first place in the fiscal capacity table would be historically significant. Alberta has held the top spot in terms of per-person fiscal capacity ever since our modern notion of the concept was first introduced in 1967. These changes, over the course of such a short period of time, are remarkable.

not made. In the case of Newfoundland and Labrador, due to data constraints, the non-resource fiscal capacity for 2020/21 was estimated based on the GDP growth from private forecasters. The authors recognize there is significant uncertainty in constructing an estimate of how fiscal capacity is changing during the current year and are providing an estimate based on the best available data and assumptions.

Implications for Budgeting in Oil-Rich Provinces

Of course, rapidly declining natural resource revenues in oil and gas rich provinces are a primary driver of the observed convergence since 2007/08, and particularly of its acceleration following 2014/15. The pattern of convergence could, therefore, prove transitory if oil and gas prices recover in a fast and sustained manner. For example, a sustained return to \$90 per barrel oil would drive large gains in natural resource revenue in oil and gas rich provinces that would certainly be sufficient to reverse the trend of fiscal capacity convergence. However, if and when any such reversal will occur or how pronounced it would be are all unknowns. The possibility of the current “converged” era could be long-lived, and if it is, the new realities described above will have important implications for policymaking and budgeting across the country. This section and the next discuss these implications for various groups of provinces.

The changes in fiscal capacity in oil-rich provinces have important implications for fiscal planning in those jurisdictions. In short, per-person fiscal capacity in all three provinces have fallen significantly in recent years. Adjusting for inflation, the decline has been 41.3 percent in Alberta, 37.4 percent in Newfoundland and Labrador, and 22.2 percent in Saskatchewan since 2014/15. Alberta’s change in per-person fiscal capacity over this time is the most acute, and is the focus of this section, but the analysis here is also relevant to the other provinces that have seen fiscal capacity decline.

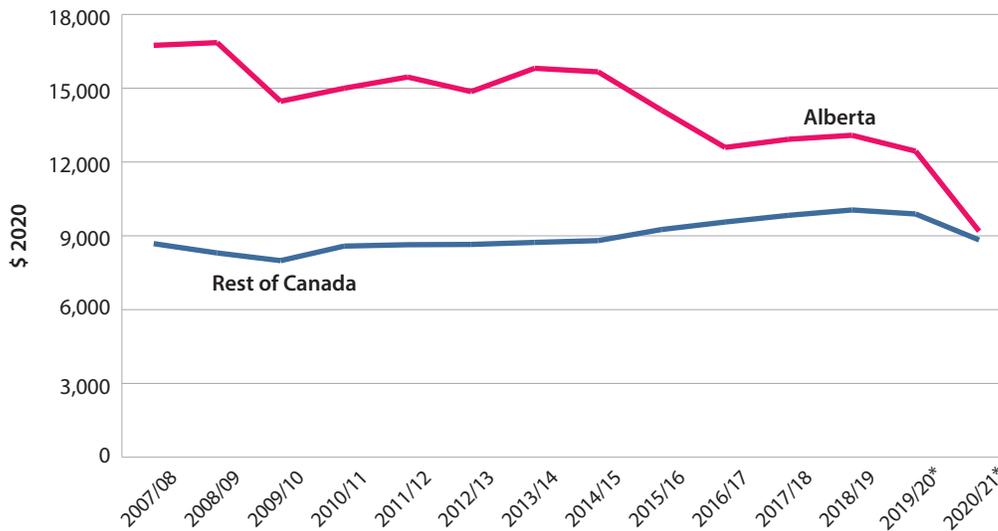
The change in Alberta’s absolute and relative fiscal capacity during the time period in question is stark. Again, the province’s inflation-adjusted per person fiscal capacity has fallen by 41.3 per cent since 2014/15. The province’s per-capita inflation-adjusted fiscal capacity is just over half of what it was in 2007/2008. Further, we estimate the province will fall out of first place for per-person fiscal capacity for the first time since the modern notion was introduced.

A comparison to the average for the rest of Canada is illustrative. In 2007/08, using 2020 dollars, Alberta’s per-capita fiscal capacity was nearly twice (92.8 per cent) as high as that in the rest of the country taken as a whole (**figure 4**). This represented additional fiscal capacity of \$8,060 per person compared to the average elsewhere in Canada.

This means that, after adding in resource revenue, Alberta was able to produce approximately double the ability to generate revenue at any given level of taxation compared to the rest of the country. In fact, the gap in fiscal capacity (largely driven by resource revenues) was so large that Alberta was able to simultaneously maintain by far the lowest overall tax effort [7] in the country, while also having the second highest

[7] The term tax effort refers to the ratio between actual tax revenue collected and the underlying tax capacity of the economy.

Figure 4: Per-capita fiscal capacity (non-resource revenues plus 100% resource revenues), Alberta, 2007/08 to 2020/21



Note: Years marked with * are estimates.

Sources: Canada, 2019; Provincial Budgets, 2020; Provincial Fiscal Updates, 2020; Statistics Canada, 2020a, 2020b; RBC Economics, 2020; BMO Economics, 2020; calculations by authors.

per-person program spending in the country, without incurring large deficits. For example, between 2010 and 2014 (the year before a severe oil price decline hit provincial revenues), Alberta’s largest deficit was 1 percent of GDP, despite its policy mix of high spending and low taxes. However, due to resource revenue and overall fiscal capacity losses, by 2018 the per-person fiscal capacity gap between Alberta and the rest of the country had fallen from \$8,060 in 2007/08 to just \$3,035 (after adjusting for inflation).

We estimate that the resource revenue collapse this fiscal year 2020/21 will essentially complete the process of Alberta’s fiscal capacity convergence with the rest of Canada, with the two figures being nearly identical. In fact, we estimate per-person fiscal capacity in Alberta for 2020/21 will actually be \$9,189. This is almost identical to the per-person fiscal capacity in the rest of Canada (\$8,832). Since 2007/08, the gap has shrunk from 92.8 to 4.0 percent.

Even if this trend continues in the next few years and Alberta’s per-person fiscal capacity dips below the Canadian average, it would not mean Alberta would become immediately eligible for equalization, as entitlements are predetermined in advance each year by a formula based on a weighted average of three prior years’ fiscal capacity, lagged by two years. Nevertheless, given the fact that Alberta is now very close to falling below the national average, the possibility of Alberta becoming an equalization recipient province in the medium term—which would have been unthinkable five or ten years ago—now looms as an entirely plausible future scenario.

Of course, shrinking natural resource royalties are an important reason for the fall in Alberta’s relative fiscal capacity position within Canada, but it is important to recognize it is not the only reason for the convergence. The gap in non-resource fiscal capacity in Alberta compared to other jurisdictions has also dropped markedly. For instance, in 2014/15, Alberta’s per-capita non-resource fiscal capacity per person was 47 percent higher than Ontario’s. By 2018, that gap had fallen to just 10.6 percent. By 2020, we estimate Ontario’s non-resource fiscal capacity will have caught up to and surpassed Alberta’s, as we estimate Ontario will have an advantage of 2.9 percent on this metric this year.

All of this, of course, has important implications for budgeting. Alberta’s tax effort (largely due to the absence of a sales tax) is the lowest in the country. Meanwhile, program spending per person in Alberta has been significantly higher than in any of the other large provinces in recent years (Alberta Blue Ribbon Panel on Alberta’s Finances, 2020). Because it has lost its fiscal capacity advantage, this combination is no longer possible without running large budget deficits. Alberta’s deficit has been over \$6 billion every year since 2015, while multiple analyses show that the province’s current policy bundle of low taxes and high spending is fiscally unsustainable given reasonable assumptions about future demographic and economic conditions. [8]

A detailed exploration of how this fiscal gap can be closed is beyond the scope of this paper. It suffices to note that international evidence suggests that deficit reduction efforts focused on expenditure reductions are far better for a jurisdiction’s economic growth prospects than one focused on spending increases (Alesina et al., 2019). If Albertans want their government to eliminate the deficit and bring the province’s finances to sustainability without increasing taxes, it will necessarily require significant spending reductions in the years ahead. Alberta’s finance minister succinctly explained this challenge and the need for fiscal consolidation on the spending side of the ledger in the years ahead, stating “We can no longer spend like we’re the rich kids on the block because, quite frankly, we’re not anymore” (Toews, 2019). The data presented above very much supports the minister’s characterization.

These budgeting challenges are not unique to Alberta. Saskatchewan and Newfoundland and Labrador both face significant fiscal challenges, which have been exacerbated by their declines in fiscal capacity over the past decade. As with Alberta, recognizing the change in fiscal capacity and its implications for budgeting is a crucial first step for prudent fiscal planning in the years ahead.

[8] See Parliamentary Budget Office (2020) and Tombe (2020).

Implications for Equalization and Fiscal Planning in Lower-Income Provinces

Canada’s great convergence has obvious implications for budgeting in high-income provinces that have suffered fiscal capacity losses in recent years. There is also, however, the potential for significant implications for budgeting in have-not provinces due to the behavior of Canada’s equalization program under its current formula.

Currently, five provinces benefit from equalization—Quebec, Manitoba, and the three Maritime provinces. In all of these provinces, equalization represents a significant share of revenue. In 2018/19, this share ranged from a low of 10.2 percent of all revenue in Quebec, to 19.3 percent in New Brunswick.

As previously noted, the size of the equalization envelope is set by the fixed growth rule, with the share received by each province determined by a formula that gives more money to the provinces with the lowest fiscal capacity. [9] The great convergence could therefore have significant implications for the size of equalization grants to these provinces.

A simple thought experiment helps illustrate the point. If the great convergence were to become so complete that all of the provinces had identical fiscal capacity under the equalization program, the quirks of the formula would mean that all ten provinces would become “have-not” equalization recipients. The equalization payments would become a simple per-person grant to each province.

In a less extreme example, if fiscal capacities came close enough together but not fully equal, all ten provinces could receive equalization grants, with the size varying based on higher or lower fiscal capacity.

The data on the “great convergence” suggest a situation that resembles such an outcome is much less far-fetched than it would have seemed a decade ago. Our estimates show per-capita fiscal capacity in Newfoundland and Labrador has dropped below the overall fiscal capacity average across the ten provinces, and Alberta’s is just barely above. Although the program is significantly more complicated, broadly speaking, provinces become eligible for equalization when their per-person fiscal capacity (including 50 percent of natural resource revenue) falls meaningfully below the national average. Equalization entitlements are determined via a formula that includes only 50 percent of

[9] For a discussion of the performance of the equalization program under the FGR during a period of fiscal convergence, see Eisen et al. (2020).

natural resource revenue rather than the 100 percent figures described above. [10] The trends of fiscal convergence have been predictably similar using both measures, and so the discussion above can inform this discussion of possible developments surrounding equalization in the years ahead.

Newfoundland and Labrador is very likely to become eligible for payments in coming years. For 2020, we estimate Newfoundland and Labrador has the third lowest per-person fiscal capacity in Canada, ahead of only PEI and New Brunswick. This is a remarkable change, considering the province had the second highest per-capita fiscal capacity in the country in 2010/11.

Barring a fast turnaround, i.e., a sustained and significant increase in oil prices, these data suggest Newfoundland and Labrador is very likely to return to have-not status in the near future. That province’s ascendancy to “have” status happened in 2008 and was driven almost entirely by the development of its offshore oil fields and high oil prices. Indeed, if oil prices remain low and economic growth is weak, the data suggest it is conceivable Alberta may also become an equalization recipient. Alberta’s fall to rough parity with the rest of the country means that further declines could bring the province into have-not status within a few years—again, a turnaround over the course of a decade that is nothing less than stunning.

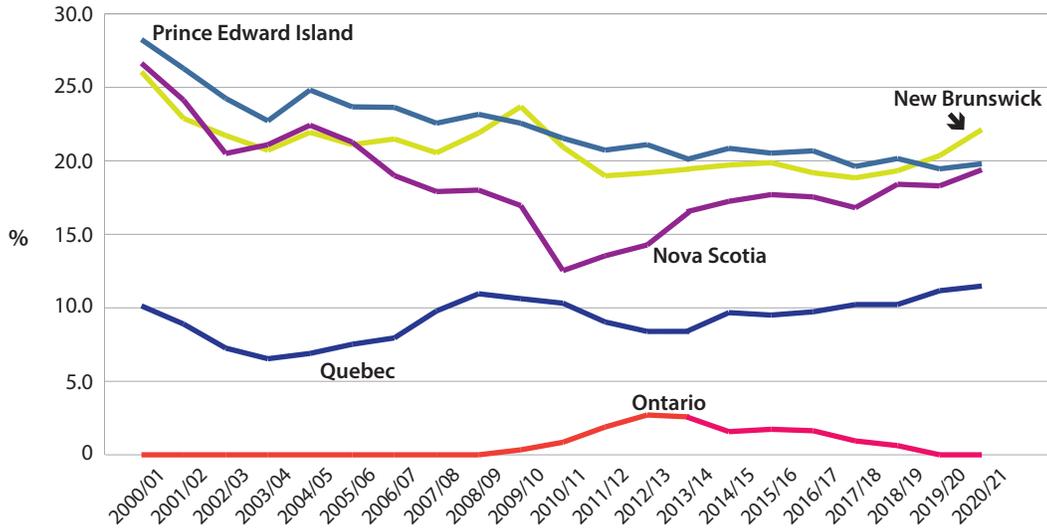
Because of a fixed envelope for equalization, the arrival of new have-not provinces would have important implications for equalization grants in provinces that are already receiving them. Specifically, all else equal, if new provinces became eligible for significant equalization grants, it would reduce the amount available for existing have-not provinces, with implications for their finances because equalization is such a large part of their budgets. For example, on the low end, equalization is forecasted to represent 11.5 percent of revenues in Quebec this year. Manitoba is slightly higher, at 14.2 percent, and the figure ranges from 19.4 to 22.1 percent in the three Maritime provinces.

To show how the arrival of a new equalization recipient (or recipients) can reduce grants in existing have-not provinces, it is useful to consider Canada’s experience in the late 2000s and early 2010s when Ontario became eligible for equalization payments for ten consecutive years. Per-person payments to the province were low, but because of the size of the province, Ontario briefly became the second largest recipient of equalization grants in Canada in nominal dollars, behind only Quebec.

With a fixed equalization envelope, Ontario’s arrival as a have-not province was a major contributor to significant declines in equalization grants relative to overall budgets in several have-not provinces. **Figure 5** illustrates this by showing equalization grants as a share of total revenue in Ontario and the Maritime provinces during that period. New Brunswick saw its equalization grants as a share of total revenues fall by 4.7 percentage points over just two years from 2009/10 to 2011/12. Nova Scotia saw a 4.5 percentage

[10] The 100 percent inclusion rate does play a role in the formula in that it determines the fiscal capacity cap, which prevents any equalization recipient’s post-equalization fiscal capacity from exceeding that of any non-recipient

Figure 5: Equalization payments as % of total revenues, 2000/01 to 2020/21



Sources: Canada, 2019; Provincial Budgets, 2020; Provincial Fiscal Updates, 2020; calculations by authors.

point drop from 2008/09 to 2011/12. In PEI, the decline was slightly milder, at 2.5 percentage points from 2008/09 to 2011/12. Quebec (2.6 percentage points) and Manitoba (4.4 percentage points) saw similar declines from their highest to their lowest levels during this period. [11]

These data show how the arrival of new equalization recipients can reduce the size of grants to existing recipients. Of course, Newfoundland and Labrador is much smaller than Ontario, but it is likely to become eligible for much larger per-person grants in the years ahead. [12] If Alberta continues its relative fiscal capacity decline compared to the rest of Canada in the years ahead, this would represent the arrival of a second large province (along with Quebec) as an equalization recipient. If per-person grants to Alberta became meaningfully large (for instance, comparable to any current have-not province), the impact on equalization grants to other have-not provinces could certainly be similar to the effect Ontario had during its period as an equalization recipient.

It is beyond the scope of this paper to estimate possible future equalization grants, but the problem in smaller have-not provinces could be further exacerbated if Ontario once again becomes eligible for equalization payments in the years ahead—which it very

[11] The federal government created a program called “total transfer protection” which helped mitigate the impact of Ontario’s arrival as a have-not province on grants to pre-existing recipients. That program has, however, since been cancelled and current have-not provinces cannot confidently expect a new ad hoc program will be created if their equalization grants are adversely affected by the arrival of new have-not provinces in the years ahead.

[12] The broad forecasts here are based on estimates created using the methodology for estimating future fiscal capacity described in Eisen and Emes (2016).

well may using plausible assumptions about fiscal capacity and economic growth. If this does happen, it will almost certainly be due to “adjustment payments” necessitated by the FGR which guarantee the overall size of the equalization envelope.

Possible reforms to the equalization program could make the “great convergence” an even bigger problem for provincial finances in current “have-not” provinces. For instance, Feehan, Dahlby, and other experts have called for the elimination of the FGR, and replacing it with a formula-based approach to determining both the size of the equalization envelope as well as its distribution. [13] Such a policy change would have the potential to shrink the total of equalization grants paid to have-not provinces if convergence continues, which would generate significant savings for the federal government while at the same time allowing payments to increase if the pattern of convergence is reversed.

Even in the absence of any further reform, however, recent developments in the relative fiscal capacity of the provinces is likely to meaningfully influence the performance of the equalization formula in the years ahead. Governments in have-not provinces should recognize the fact of the great convergence, and its possible implications for their equalization entitlements and therefore their overall fiscal outlook.

We have seen that unless it is reversed, “the great convergence” in Canadian provincial fiscal capacities will have important implications for policymakers at the provincial level across the country. It may also have implications for federal policymaking, as it could create new pressures to re-examine multiple dimensions of the arrangements of fiscal federalism, including but not limited to the equalization formula generally, the performance of the FGR, the treatment of natural resource revenue, and the fiscal stabilization program. It is beyond the scope of this paper to discuss these pressures in detail, but it is worth noting that federal policymakers are also likely to face new policy challenges and pressures resulting from this rapid change in the relative economic strength of the Canadian provinces.

[13] See Feehan (2020).

Conclusion

Since 2007/08, there has been a “great convergence” in the fiscal capacity of the Canadian provinces. This is to say that the gap between richer and poorer provinces has shrunk. This convergence has accelerated significantly since 2014/15.

The fiscal capacity convergence described above has been driven in large part by low oil prices, and the rapid fall in oil prices and resulting acceleration in estimated convergence for 2020/21 is at least in part driven by the COVID-19 pandemic. More broadly, the low oil prices of the past half-decade may prove transitory, which would reverse the pattern of convergence described above.

However, after an extended period of weak oil prices and ongoing fiscal convergence, it would be a mistake for policymakers to assume there will be a rapid, significant, or sustained upward movement in oil prices. It would therefore be prudent for policymakers to develop budget plans that do not assume the “great convergence” will soon be quickly reversed.

As such, the changes in the relative fiscal strength of Canadian jurisdictions has different but significant implications for public finances in both higher-income and lower-income provinces. While the higher-income provinces will have to budget in light of new realities of lower own-source revenue at current tax rates, lower-income provinces may have to adjust to slow-growing or even shrinking equalization grants if new provinces become equalization eligible. As such, the great convergence described in this paper represents a crucially important but underdiscussed development in the life of Canada’s economy and its regions over the past decade.

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