

# **Stabilization Policy in Canada: A Proposal for Reform**

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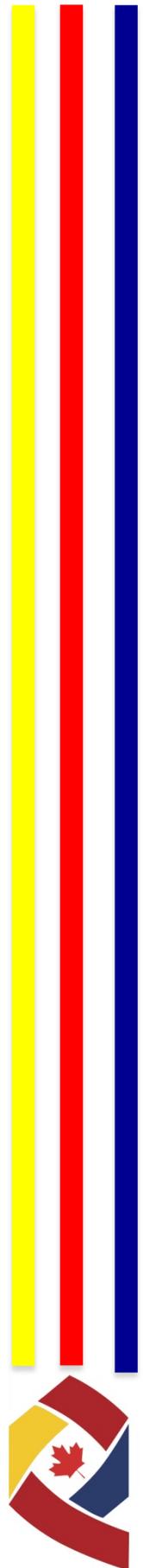
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Ensuring provinces have sufficient revenues to carry out their responsibilities is the central challenge of fiscal federalism in Canada. For persistent structural challenges, we have equalization; for temporary shocks, we have stabilization.

Sharp revenue declines in Alberta, Saskatchewan, and Newfoundland and Labrador recently raise the question of whether current stabilization policies are sufficient. Alberta revenues, for example, dropped nearly \$7 billion from 2014-15 to 2015-16, largely on account of low oil prices, and federal stabilization payments that totalled \$251 million that year. There are two main reasons stabilization is so small: (1) there's a cap of \$60 per capita in payments (roughly 1 percent of provincial revenues); and (2) there's a deductible of 5 percent for non-resource revenues and 50 percent for resource revenues.

Consequently, there's no material federal stabilization of provincial revenues in Canada today. It has been nearly a quarter century since we reformed stabilization in a substantive way; it is time for a change. But as with any insurance arrangement, details matter. A lot.

I will briefly summarize some historical context around stabilization policy before proceeding to a proposal for a radical proposal, grounded in first-principles, for reform.

### **The Historical Context of Provincial Revenue Stabilization**

Since Confederation, the federal government provided direct support to ailing provincial governments. These "special grants" proliferated over many years and exploded during the Great Depression when Manitoba, Saskatchewan, British Columbia, and the Maritimes received substantially boosted subsidies.

After the Second World War, stabilization took a more deliberate and formulaic approach. Every formal arrangement since 1941 has featured some provision or another to stabilize provincial revenues. The 1941 deal set a floor under provincial gas tax revenues, for example, whereby any shortfall was topped-up dollar-for-dollar by the federal government. In 1962, there was an arrangement to stabilize the yield on "standard taxes" (taxes on personal income, corporate income, and succession duties shared with the federal government at certain rates) and equalization payments. If such revenues fell by more than 5 percent relative to an average of the previous two fiscal years, then the federal government would make up the difference. And beginning in 1967, when many of the arrangements we have today took shape, there was stabilization for all provincial revenues from any source.

A number of notable dates and developments followed:

- 1972: The 5 percent deductible was eliminated.
- 1977: A 50 percent deductible was added for natural resource revenues.
- 1983: The first payment is made (to British Columbia).
- 1987: A \$60 per capita limit on stabilization payments was set, and interest-free loans beyond that limit became possible.

- 1989-1996: Multiple payments to nine of ten provinces totalled \$2.8 billion (in 2018 dollars).
- 1995: The 5 percent deductible on non-resource revenues was reinstated.
- 2015: Alberta and Newfoundland and Labrador receive a combined \$283 million.

Today, the calls for reform are loud in provinces like Alberta but few provide coherent proposals beyond eliminating the \$60 per capita limit. There are better options.

### **Principles for Stabilization Policy Design**

There are some first principles upon which stabilization policy in particular, and fiscal transfer arrangements in general, should be built. Consider the words of Mitchell Sharp, former federal finance minister and the person responsible for many of the federal transfer arrangements we have today. In 1967, he outlined six principles that should govern fiscal arrangements in Canada; three are relevant for stabilization policy. I paraphrase them here. First, fiscal resources should be sufficient to discharge federal and provincial responsibilities under the constitution. Second, federal and provincial governments should be accountable to their own electors for their taxing and spending decisions, and each should make decisions with due regard for their effect on other governments. Third, policy should be uniform in its application across provinces.

Applying these principles is not straightforward. If a province's revenues collapse – for example, the 14 percent drop in Alberta government revenues in 2015-16 – providing federal support may ensure the province can undertake its responsibilities (the first principle). But Alberta's volatility is a choice, so insuring against resource revenue declines, for example, offloads the consequences of its decisions onto other governments and therefore violates the second principle. Finally, the third principle suggests a single formula-driven policy should govern payments. But there are occasional crisis moments where the formula is insufficient and the first principle might demand discretion.

Stabilization policy is also like insurance. Risk pooling is a central argument for stabilization policy. Smoothing out shocks across individuals can increase aggregate welfare. After all, people are generally risk-averse and therefore willing to pay to avoid wild swings between good times and bad. But we must recognize that behaviour will itself respond to the presence of insurance. If we insure against revenue declines then provinces will, at the margin, be more likely to adopt policies that exacerbate such declines. That is not only inefficient but also potentially unjust. Such “moral hazard” concerns are central to optimal insurance design.

I propose a formula-driven approach to stabilization consistent with all three of the principles described above, and one that attempts to minimize both moral hazard and the ability to shift avoidable risks onto others.

## A Proposal for Reform

To provide federal insurance for provincial revenue, but to minimize moral hazard concerns, we should consider only changes in provincial revenues *due to factors beyond their control*.

Adjusting for changing tax rates and structures over time is one dimension, and has been a feature of stabilization since 1967. But some taxes are more volatile than others, and the different composition of revenue sources across provinces is not currently considered in the formula. Instead, we could adjust for different tax rates and structures across provinces. That is, we could insure what a province *would* raise *if* it had national average tax rates and structures. This is the principle measure of “fiscal capacity” found within the equalization formula already. Insuring it would further help minimize moral hazard concerns, but the bigger consideration concerns the treatment of resource revenues.

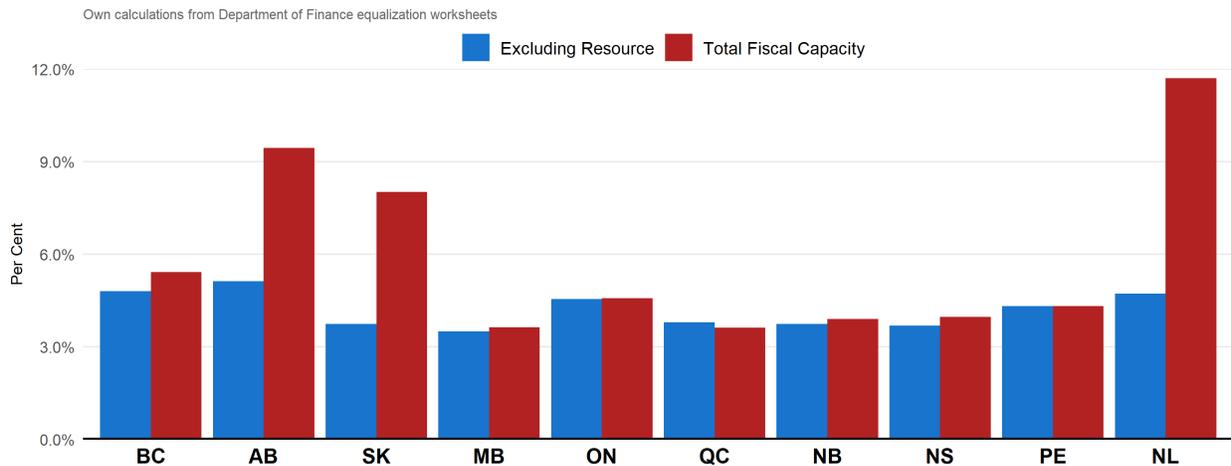
Alberta, Newfoundland and Labrador, and Saskatchewan – by far – have the most unstable revenues. Such volatility, however, is a choice and results from a deliberate reliance on resource revenues by those provincial governments. Not only are resource revenues volatile across years, but they are unpredictable across months within the same fiscal year. The average swing in Alberta’s primary budget (its standard deviation) is over 2 percent of GDP. But the difference between resource revenues projected at the beginning of a fiscal year in the provincial budget and the final amount actually seen that year after all the accounting is complete is typically 1.3 percent of GDP. Some years are particularly pronounced. Between 2000 and 2005, unexpected swings in annual resource revenues averaged 2.2 percent of GDP (or nearly 16 percent of total government revenue). Resource revenue is unambiguously risky. And oil-producing provinces voluntarily choose to fund public services with it, rather than with more stable forms of revenue. It is an easily avoidable risk that should not be transferred to other Canadians through the federal government.

The above considerations motivate a form of federal stabilization to insure “non-resource fiscal capacity”, not actual revenues. As noted, this is already in the equalization formula, so builds on well established administrative and data collection infrastructure. Formally, the stabilization formula could be a simple one:

$$S_{it} = (d \times F_{it-1} - F_{it}) \times P_{it},$$

where  $d$  reflects the desired deductible. If the first 5 percent is covered by provinces, then  $d = 0.95$ . Focusing on non-resource fiscal capacity shrinks dramatically the differences in volatility across provinces, as I illustrate below.

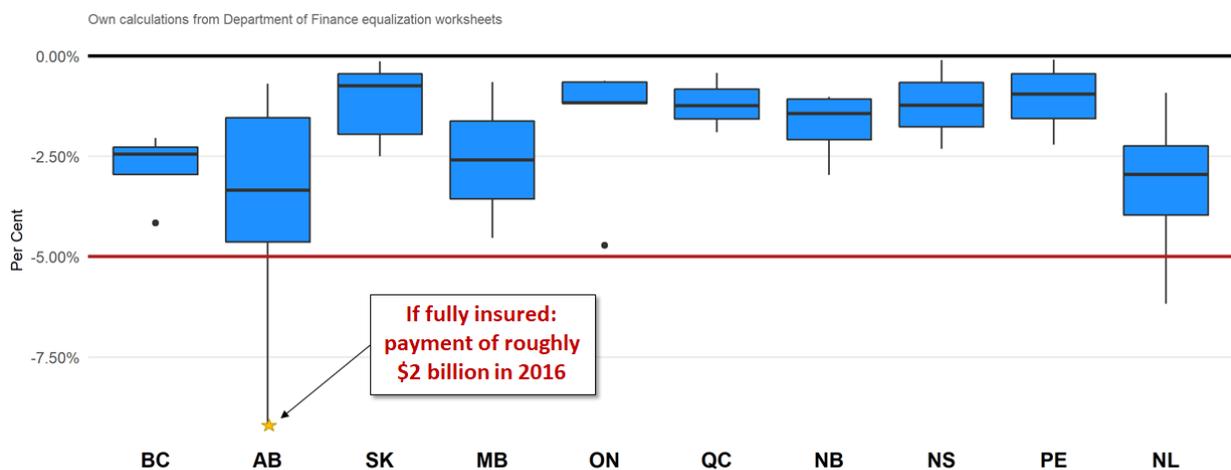
**Figure 1: Standard Deviation of Annual Fiscal Capacity Growth Rates, 1982-2017**



To be sure, the currently long data lags would necessitate certain assumptions and estimates be made to ensure timely payment during periods of provincial fiscal stress for the purpose of stabilization but this is not an insurmountable challenge.

How often, and how much, would such a formula pay out? Of the 350 fiscal years for each provincial government from 1982 to 2017, 39 featured drops of non-resource fiscal capacity of any amount. Below I plot the distribution of those drops. Most provinces, most of the time, see declines of no more than a percentage point or two. But in Alberta, Manitoba, and Newfoundland and Labrador, annual declines of three percent or more are not uncommon. But in only two occasions since 1982 have non-resource fiscal capacities dropped by more than 5 percent in a year. If this were the formula, Alberta would have received \$2 billion in 2016.

**Figure 2: Distribution of Total Nominal Non-Resource Fiscal Capacity Declines, 1982-2017**



This is but one option. The 5 percent deductible could be lowered to provide a better buffer to more provinces. If the threshold were set at 4 percent, Ontario would have received over \$600 million in 2008 – a bad year for the province where they received no stabilization, although they did receive equalization from 2009 until 2018. Instead of insuring only one-year changes, the formula could also use two-year or three-year moving averages. This could nicely bridge between the equalization and stabilization programs, with the former based on a three-year average with a two-year lag. In effect, this would create a rapid-response component of equalization and perhaps explicitly unify it with stabilization.

### More Flexible Federal Debt Allowances

Of course, even if provinces make irresponsible choices there is a role for the federal government to backstop their ability to deliver public services (Sharp’s first principle). However, instead of a special grant like stabilization, federal debt allowances could become more flexible.

A strong efficiency argument for stabilization is that the federal government is better able to carry risks than provincial governments are. Government debt bridges bad times with good, and federal debt faces lower rates than the provinces. Currently, federal long-term debt yields are a full percentage point below provincial. Using provincial debt to smooth over a cycle is therefore less efficient than using federal debt. Better provisions for provinces to borrow *through* the federal government could be on the table.

**Figure 3: Long-Term Borrowing Rates of Canadian Governments (March 2019)**



This is not new. In 1867, for example, the federal government provided roughly \$25 per capita to every province as a “debt allowance”. These were large – equivalent to roughly one-third of Canada’s GDP or over \$20,000 per person today. It was not originally a stabilization program, to

be clear, but was instead an attempt to equalize the burden of colonial debt assumed by the dominion government.

Today, a more easily accessible federal line-of-credit to provinces is an intriguing option to consider. It builds on the current arrangement that allows for interest-free borrowing through the federal government over a five-year period, but this is an emergency power not deployed in nearly three decades. If used more flexibly, at federal rates for longer periods, Alberta's \$10.8 billion deficit in 2016/17 would carry roughly \$100 million *per year* in lower debt service costs. And the over \$41 billion in debt accumulated between 2014-15 and 2018-19 would cost over \$400 million per year less to carry (over \$90 per Albertan per year). If designed well, a federal window for provincial borrowing would not necessarily increase federal riskiness on the credit market so wouldn't materially affect federal yields. Repayment timelines – say, over ten years – could mitigate burdens on federal taxpayers and ensure provincial governments remain ultimately accountable to their own electors for choices they make (Sharp's second principle).

### **Concluding Thoughts**

A blanket guarantee of provincial revenues is inappropriate. As with insurance, it would provide incentives for provincial governments to take risky decisions. They would benefit from the short-term upside, and spread the costs nationally if things turn south. This is particularly true for resource revenues. To provide insurance against resource revenues is akin to insuring a gambling addict about to enter a casino. We should exclude it from consideration. This lesson goes beyond resource revenues and extends to all deliberate actions by provinces that affect their revenues. Insuring non-resource fiscal capacity is a worthwhile reform Canadians should consider.

Not all moral hazard concerns can be addressed, but proposals that do not carefully consider such adverse consequences of policy choices fall short. Stabilization reform is needed, but thoughtful design is necessary.