WHAT NOW?

The need to review Canada's Fiscal Stabilization Program for provinces after COVID-19

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The public health response to contain the spread of COVID-19 came with significant economic disruption. Not since the Great Depression has employment declined so severely and abruptly. And not since World War II have government deficits grown so large.

The federal government has (rightly, and responsibly) borne the bulk of the fiscal cost, but provinces and municipalities have not been spared. New provincial spending for additional healthcare costs, testing and tracing programs, income support to individuals and businesses, childcare services, and so on, will potentially exceed $30 billion this year. Perhaps more.

Compounding this challenge, provincial revenues are falling rapidly. Employment losses, evaporating corporate profits, lower retail and restaurant sales, less travel and gasoline use, all mean lower income and sales tax revenues.

While the federal government has absorbed much (perhaps most) of the spending pressures provinces face — through a $19 billion "safe restart agreement," plus billions more for healthcare, support to the oil and gas sector, essential worker wage top-ups, and more — there has been no explicit commitment to help with rapidly declining revenues.

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This brief analysis attempts to quantify the potential scale of the revenue challenge facing Canada's provincial governments and some policy options available to help. To be clear, as with most everything in recent months, there is much uncertainty facing our fiscal and economic situation and forecasting with any degree of reliable precision is nearly impossible. Thus, the analysis presented here reflects my best effort to reasonably ballpark the state of provincial government finances. It will hopefully clarify what are the key drivers of recent declines, the challenges that policy makers face, and what factors we should anticipate will dominate the federal-provincial relationship in the months (and, indeed, years) to come.

The Provincial Revenue Hit from COVID-19

Not all provinces have updated their own forecasts, but it's possible to estimate the scale of the challenge. The federal government's recent "fiscal snapshot" provides a useful starting point. Specifically, they project Canada's real GDP to decline by 6.8 per cent in 2020. This is in line with many private sector forecasts, though is lower than some alternative notable projections, such as the 7.8 per cent contraction projected by the Bank of Canada. In terms of revenues, they project 14.4 per cent lower personal income tax revenue, for example, and 22.2 per cent lower corporate tax revenue. This means that for each point of GDP reduction, the government expected a 2.1 point decline in personal income taxes and a 3.3 point decline in corporate taxes. We can use these "revenue elasticity" estimates to project changes for each of Canada's provinces. To be conservative, I will use an elasticity of 2 for personal income tax and sales tax revenues and an elasticity of 3 for corporate tax revenues. I include gasoline and tobacco sales within broader sales tax revenues.

Based on a selection of private sector forecasts (all made since June 2020), combined with the federal fiscal snapshot's forecast of 6.8 per cent contraction for Canada, I extrapolate what the potential revenue loss is for each province this fiscal year. Overall, provinces might be on track for revenue declines of about $35 billion in 2020/21, compared to 2019/20. That is equivalent to roughly $1,000 per person. And this ignores potential declines in profits of government-owned businesses, declines in fees and license revenues, investment income, and many other sources.

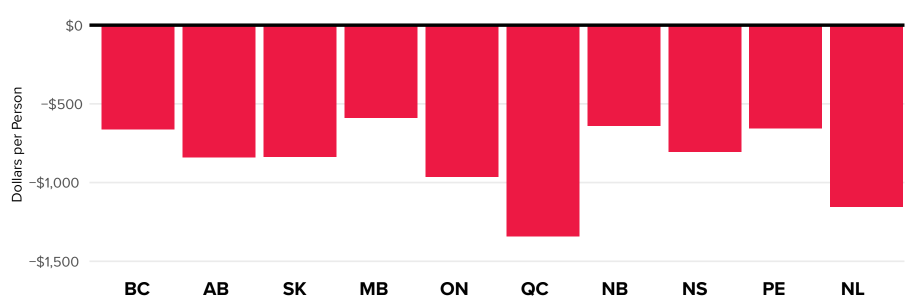
But this overstates the problem. Provinces will indirectly benefit from federal emergency measures like the Canada Emergency Response Benefit to individuals, the Canada Emergency Wage Subsidy to employers, the boost to the Canada Child Benefit and Old Age Security, and so on. Over $180 billion may be spent to support Canadians during the COVID-19 crisis. And rightly so. This income support, however, is in many cases taxable income. The CERB, for example, is taxable income and even tax-exempt payments, such as the GST credit, are implicitly taxed when individuals spend this income on goods and services subject to sales and excise taxes. There are important differences across provinces but, on average, each additional $1 of individual income results in roughly 8 cents of additional provincial revenue. And each additional $1 in consumption results in over 5 cents of revenue.

What's the overall effect of this explicit and implicit taxation of federal emergency measures? There's clearly significant uncertainty, but I estimate a range of effects and find such measures might boost provincial revenues by somewhere between $12 billion to $23 billion. This is significant, but a significant revenue challenge remains. Many provinces are therefore going to look to a special federal program to help: the fiscal stabilization program.

Drop in selected provincial revenues before Federal Emergency Measures

Displays a not terrible guestimate of the decline in provincial income tax and sales tax revenues per person. Gasoline and tobacco tax revenues are included with general sales taxes.

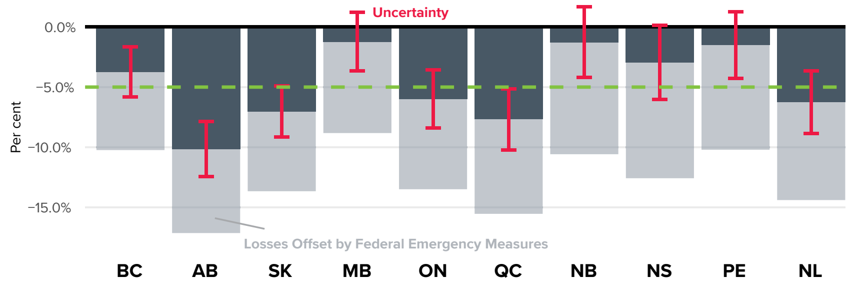
Graph by @trevortombe



Change in provincial non-resource revenues covered by stabilization

Note: Revenues subject to stabilization also equalization payments and certain tax point transfers; these are included here. The green dashed line denotes the 5 per cent threshold to trigger a federal fiscal stabilization payment to a province.

Graph by @trevortombe



The Fiscal Stabilization Program

The logic behind the fiscal stabilization program is straightforward. If a province's non-resource revenues decline by more than 5 per cent from one year to the next, then the federal government steps in to help. It's like an insurance program for provinces with a "deductible" equivalent to 5 per cent of provincial revenues. There is also coverage for resource revenues, but I abstract from that here. In effect, the stabilization program operates like disaster financial assistance and shifts some of the fiscal burden to the federal government where it is usually cheaper to service. (More detailed discussion and analysis of this program and its underlying rationale are provided by Dahlby (2019) and Tombe (2020)).

To see whether this program will payout to provinces for 2020/21, and by how much, I plot the estimated revenue decline for each province above, and mark the 5 per cent threshold as a green dashed line. These results suggest that all provinces would have crossed this threshold in 2020/21 were it not for the potentially large offsetting effect of federal emergency support to individuals and businesses. With those measures, perhaps half of provinces will still cross the threshold and therefore qualify for stabilization payments. Those provinces are Alberta, Saskatchewan, Ontario, Quebec, and Newfoundland and Labrador.

If the federal government were to cover all losses beyond the 5 per cent threshold, this may amount to nearly $4 billion being paid to those five provinces: Quebec, $1.8 billion; Alberta and Ontario, $900 million each; Saskatchewan, over $100 million; and Newfoundland and Labrador, nearly $50 million. Again, these are estimates to get a sense of magnitudes and to illustrate how the program works. This estimate also neglects the potentially large drop in resource revenues that Alberta will experience this year — potentially adding $1 billion to $2 billion to whatever fiscal stabilization claim it makes.

While the basic logic is straightforward, there are numerous design details that limit the program's scale and scope of support.

The Limit on Payments

Since 1986, there has been a limit of $60 per capita on payments available to a province in any given year. For example, the $1.8 billion estimated for Quebec above is equivalent to over $210 per capita. After the $60 per capita limit is imposed, their payment would barely exceed $500 million. In fact, all five of the provinces estimated above to cross the 5 per cent threshold would be capped by this limit.

Such limits are not uncommon in insurance arrangements. They are known as a "stop loss" limit and serve to ensure the insurer (in this case, the federal government) is not overly exposed to risk beyond its capacity. But since $60 per capita is roughly equivalent to 1 per cent of provincial revenues, this effectively limits the program to cover losses following a 5 per cent decline but not beyond a 6 per cent decline. This may be overly stringent. And, as documented in Tombe (2020)[1], the origin of the cap was both arbitrary and fixed. Inflation alone means that $60 per person in 1986 dollars is equivalent to $120 per capita today.

Getting reform right will require thoughtful and rigorous analysis by governments, academics and policy experts throughout the country. We should start with the stabilization program.

Limited Coverage of Provincial Revenues

Not all provincial revenues are covered by the fiscal stabilization program. Most notably during COVID-19 is the exclusion of property taxes. Normally, this is not an issue, as municipal and provincial mill rates adjust continuously from one year to the next to stabilize revenues. But the pandemic has been a massive fiscal shock to municipal governments throughout Canada. Property taxes may be much less than anticipated, especially for those with some form of land transfer tax, and social distancing measures have limited transit use, recreational facilities, and many other important sources of local government revenues. The stabilization program is not currently designed to address this kind of shock.

Overall, slightly more than half of total provincial revenues are covered. Although for some provinces, such as Alberta, the coverage rate may be as low as one-third. Reforms to explore the set of provincial revenues sources covered by the program should be welcomed.

The Need for Robust Analysis

The pressing need to review this program (and, indeed, many other federal-provincial fiscal arrangements) has been revealed by the COVID-19 disruptions. There are complex considerations, and critically important ones. Fiscal arrangements are at the heart of federalism in Canada. And as noted by Béland, Dahlby, and Orsini (2020) and Béland et al. (2020), COVID-19 may represent a critical juncture where governments enact reforms with lasting implications for our country. Getting reform right will require thoughtful and rigorous analysis by governments, academics, and policy experts throughout the country. We should start with the stabilization program. It has never — in its entire history — been the subject of exhaustive review and reforms to the degree that equalization has. It's time to remedy that.

[1] Tombe, Trevor. 2020. An (Overdue) Review of Canada's Fiscal Stabilization Program. IRPP Insight 31. Montreal: Institute for Research on Public Policy.

This work is part of a proposed **Intergovernmental Fiscal Relations Commission** – an independent team of academic experts and policy practitioners from a variety of disciplines across the country, brought together to make research-based recommendations for the reform of fiscal relations among the federal, provincial and municipal governments.

The Canada West Foundation is a member of the steering committee for the Commission.

For more information: cwf.ca/research/publications/intergovernmental-fiscal-relations-commission/

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