Intelligence MEMOS

From: Trevor Tombe

To: Provincial Debt Watchers

Date: May 8, 2020

Re: **FEDERAL SUPPORT TO PROVINCES**

Government budgets are under strain from the unprecedented spending being deployed to control the spread of COVID-19 and help bridge individuals and businesses through the crisis. And collapsing revenues from a shrinking economy add to the burden.

In Canada, rising federal debt is, so far, manageable and sustainable. But provincial governments may be in a more difficult situation.

The most detailed recent analysis by RBC Economics projects more than $78 billion in provincial borrowing in 2020/21 – or roughly $53 billion more than the prior year. This will increase total provincial debt by well over 10 percent in a single year.

For most provinces this is manageable in the short-term, but it adds to their already significant fiscal challenges. The Parliamentary Budget Officer's regular analysis finds the finances of many provincial governments largely unsustainable. COVID-19 has made this worse. And as federal borrowing costs are significantly lower, there is a case for their support. The question is what form it should take.

This crisis may represent a critical juncture in fiscal federalism, leading to fundamental reform. But in the short-term, action is constrained by existing arrangements. This memo details two existing federal programs that can provide immediate and significant support, with little to no need for legislative changes.

First, the federal government can help provinces with direct COVID-related costs.

The Disaster Financial Assistance Arrangements aim to "assist provinces with the costs of dealing with a disaster where those costs would otherwise place a significant burden on the provincial economy and would exceed what they might reasonably be expected to fully bear on their own." The current COVID-19 pandemic is surely that. The healthcare spending for treatment, testing, tracing, and so on, could therefore be shifted to the federal government.

The trouble is, DFAA guidelines explicitly exclude "pandemic health emergencies." But this is a regulatory restriction, not a legislative one, so the government could quickly change its own guidelines. Support under this program could be substantial.

The current formula leaves provinces to cover the first $3.25 per capita in costs on their own, with the federal government taking on increasingly large shares of incremental costs: 50 percent of the next $6.51 per capita; 75 percent of the next $6.51; and 90 percent of all costs beyond that. To illustrate, if direct COVID-19 related expenses are on the order of $250 per capita (to pick a random number) then the current DFAA formula implies the federal government would cover $219. Total direct federal support would total $8 billion – or roughly 0.4 percent of GDP.

Though historically unprecedented in Canada, federal relief for pandemic costs is observed elsewhere. South of the border, for example, the US relief package featured $150 billion (USD) to help offset state and local government expenses related to the crisis – equivalent to 0.8 percent of GDP.

Second, on the revenue side, the federal Fiscal Stabilization Program is available. It supports provinces experiencing sudden and significant declines in income, but is currently limited in scale (for details, see this).

Provinces are likely to see massive revenue shortfalls this year. The PBO projects 2020 nominal GDP may contract almost 14 percent. This would directly lower provincial income and sales tax revenue. Ignoring changes in revenue elsewhere in provincial books, the current stabilization program covers revenue losses in excess of 5 percent: that is, provinces would absorb the first 5 percent drop and the federal government the next 9 percent, in this case. This would, very roughly, work out to approximately $17 billion to provinces.

But the current program caps cash transfers to no more than $60 per capita. This limits direct federal support to $2.2 billion – or only a fraction of the projected loss.

The cap is problematic, to say the least. The $60 limit was arbitrary and implemented with little analysis or scrutiny. Given the arbitrary nature of the cap, the federal government has already signaled its willingness to review the program – and that was before COVID-19.

Changing the cap would require legislative changes, but there is a provision within the existing program for the Minister of Finance to provide an interest free five-year loan to provinces for any stabilization claims beyond the $60 per limit cap. Such loans have never been made before. Now may be the moment to consider doing so.

For a federal government facing a $250+ billion deficit, this coming year, the prospect of adding yet more burden may be difficult to swallow. But COVID-related public debt will happen either way. And the federal government is – for a shock of this kind – able to carry the added debt at lower cost than the provinces.

Whatever form support takes, whether through existing arrangements or not, support to provincial governments will soon rise in importance. It's worth exploring options now.

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