

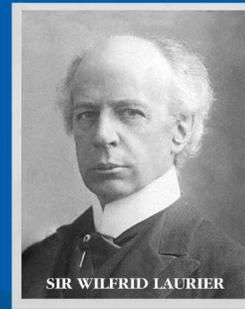
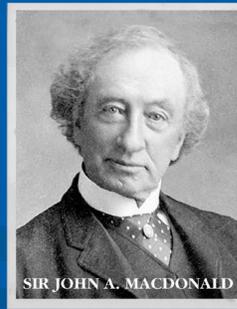
April 2020

Thomas J. Courchene
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FISCAL FAIRNESS

How equalization failed
Alberta in its time of
need and how to fix it





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Executive Summary

There has been a growing perception that Canada's equalization program is broken, especially in Western Canada.

And with good reason. Already unique among the provinces in running consecutive fiscal surpluses, in 2018-19 Quebec received \$11.7 billion in equalization payments (\$1392 per Quebecer) while fiscally challenged Alberta received nothing. For fiscal 2019-20, Quebec's equalization increased to \$13.1 billion with again nothing for Alberta. Total equalization for these two years was \$19.0 and \$19.8 billion respectively.

Why did the equalization formula deem Alberta to be a rich or "have" province for equalization?

Given Alberta's dire fiscal straits, why is it not receiving any equalization? Or, phrased differently, why did the equalization formula deem Alberta to be a rich or "have" province for equalization?

To explain this differing treatment, we need to look at the "mechanics" underpinning the equalization program. First, the equalization formula is based on data from three-year moving averages of provincial per-capita revenues calculated with a two-year lag. As a result, Alberta's revenues for equalization purposes for fiscal years 2018-2019 and 2019-2020 were much higher than its actual revenues because they did not reflect the impact of the ongoing collapse in energy prices.

Second, Alberta is assumed to be levying a sales tax under the equalization formula, even if it does not in fact do so. Third, the

total equalization envelope is no longer tied to the formula; instead, it increases each year by the rate of growth of nominal GDP, which results in provinces striving (and competing against each other) to maximize their equalization payments as a major source of revenue.

Alberta does qualify, however, for compensation under Ottawa's Fiscal Stabilization Program. Unfortunately, this program is woefully underfunded. For example, Alberta's cumulative shortfall in own-source revenues from 2014-15 levels in the subsequent five years amounted to almost \$25 billion. Yet under the federal Fiscal Stabilization program, Alberta's cumulative fiscal offset totalled only \$503 million.

To overcome these challenges facing Canada's current equalization formula, this paper offers the following recommendations for the federal government:

- Eliminate inordinately long lags in the system so that it better captures current provincial fiscal realities;
- Review the new financing model which sees equalization grow at the rate of GDP growth and creates a zero-sum game among the provinces;

- Reform the dramatically underfunded Fiscal Stabilization Program, which does relatively little to address provincial revenue collapses compared to the size of the broader equalization program.

Yet this does not mean that Alberta has no role to play in fixing its own fiscal woes. Alberta's fiscal reality is that resource revenues are inherently volatile. In an earlier era Premier Lougheed's Alberta Heritage Fund could be deployed in the case of a resource revenue collapse. This avenue is not available today. One alternative would be for Alberta to introduce a sales tax along the lines suggested recently by Jack Mintz and Philip Bazel, two Alberta economists, with revenues offset by reductions in corporate and personal taxes, which would serve both to ameliorate much of its fiscal woes and to enhance its attractiveness for immigration and inward corporate capital investment from the rest of Canada.

However, as this study demonstrates, Alberta residents have a strong case that in their current economic plight, Canada's equalization formula has failed them and urgent reforms are needed.

Sommaire

De plus en plus de personnes croient que le Programme canadien de péréquation s'est dérégulé, tout particulièrement dans l'Ouest canadien.

Et pour cause, puisque le Québec, seule province à avoir affiché des excédents budgétaires consécutifs, a reçu 11,7 milliards de dollars en péréquation pour l'exercice 2018-2019 (1 392 \$ par Québécois), pendant que l'Alberta, qui traversait une période difficile sur le plan budgétaire, n'a rien reçu. Pour l'exercice 2019-2020, les paiements de péréquation versés au Québec s'élevaient à 13,1 milliards de dollars, tandis que l'Alberta ne recevait toujours rien. Les montants de péréquation accordés aux provinces et territoires ont totalisé 19,0 milliards de dollars en 2018-2019 et 19,8 milliards de dollars en 2019-2020.

Compte tenu de la situation difficile de l'Alberta sur le plan budgétaire, pourquoi ne reçoit-elle aucune péréquation? Ou, pour dire les choses autrement, pourquoi l'Alberta serait-elle considérée comme une province riche ou « favorisée » dans la formule de péréquation?

Afin d'expliquer les différences de traitement, nous devons examiner le « mécanisme » utilisé pour établir le montant des paiements au titre du Programme de péréquation. Tout d'abord, la formule de péréquation se fonde sur la moyenne mobile triennale des revenus

Compte tenu de la situation difficile de l'Alberta sur le plan budgétaire, pourquoi ne reçoit-elle aucune péréquation?

provinciaux par habitant décalés de deux ans. Par conséquent, en Alberta, pour l'exercice 2018-2019, les revenus calculés aux fins de la péréquation étaient beaucoup plus élevés que les revenus effectivement gagnés qui, eux, subissaient le contrecoup de l'effondrement soutenu des prix de l'énergie.

Ensuite, la formule de péréquation impute à l'Alberta une capacité fiscale à la taxe de vente même si cette province n'utilise pas ce champ de taxation. Enfin, l'enveloppe de péréquation n'est plus liée à la formule; la péréquation totale est plutôt indexée chaque année en fonction de la croissance du PIB nominal avec, comme conséquence, d'inciter les provinces à décupler leurs efforts (et à rivaliser l'une avec l'autre) pour en tirer le maximum de manière à en faire leur principale source de revenus.

L'Alberta est cependant admissible aux paiements accordés dans le cadre du Programme fédéral de stabilisation fiscale. Malheureusement, ce programme est gravement sous-financé. Ainsi, au cours de la période de cinq ans à compter de l'exercice 2014-2015, le manque à gagner cumulatif de l'Alberta découlant de ses propres revenus s'est élevé à près de 25 milliards de dollars. Or, le paiement compensatoire au titre du Programme fédéral de stabilisation fiscale n'a totalisé que 503 millions de dollars.

En vue d'aplanir les difficultés liées à la formule de péréquation actuelle, le présent document propose au gouvernement fédéral les recommandations que voici :

- Éliminer les décalages excessivement longs du système afin de mieux tenir compte de la situation fiscale actuelle des provinces;
- Revoir le nouveau modèle de financement qui arrime la croissance des paiements de péréquation à celle du PIB et crée un jeu où il y a nécessairement des gagnants et des perdants;
- Réformer le Programme de stabilisation fiscale qui, par rapport à la taille du programme élargi de péréquation, ne contribue guère – étant gravement sous-financé – à compenser les baisses dramatiques des recettes provinciales.

Pourtant, cela ne veut pas dire que l'Alberta n'a aucun rôle à jouer pour régler ses propres difficultés fiscales car, dans les faits, les revenus que cette province tire de ses ressources sont intrinsèquement irréguliers. Dans le passé, l'*Alberta Heritage Fund* mis sur pied par l'ancien premier ministre Peter Lougheed pouvait être appelé en renfort en cas d'effondrement des revenus tirés des ressources. Cette avenue n'est plus offerte. Une solution pour l'Alberta serait d'introduire une taxe de vente, conformément aux suggestions faites récemment par Jack Mintz et Philip Bazel, deux économistes de l'Alberta : les recettes de cette taxe seraient contrebalancées par des réductions de l'impôt sur le revenu des sociétés et des particuliers, ce qui permettrait à la fois d'atténuer une grande partie des problèmes fiscaux de la province et d'accroître son attrait en matière d'immigration et d'investissements en immobilisations de la part des entreprises du reste du Canada.

Cependant, comme le démontre cette étude, les résidents de l'Alberta disposent d'arguments solides pour justifier que, dans leur situation économique actuelle, le système de péréquation du Canada a échoué et que des réformes urgentes sont nécessaires.

Introduction¹

Traditionally heralded as an essential part of the “policy glue” that underpins our east-west federation, Canada’s equalization program is now seen in some quarters as serving to undermine the notion of interprovincial fiscal fairness that has long been the hallmark of our federation. The triggering event was the 2018-19 fiscal year equalization allocations. Already unique among the provinces in running consecutive fiscal surpluses (in the \$3-5 billion range), Quebec received \$11.7 billion in equalization payments (\$1392 per Quebecer) while fiscally challenged Alberta received nothing. For fiscal 2019-20, Quebec’s equalization increased to \$13.1 billion with again nothing for Alberta. Total equalization for these two years was \$19.0 and \$19.8 billion respectively.

With this as backdrop, the role of this paper is to focus on the “mechanics” underpinning the equalization program and to highlight the key assumptions and features that have led to these recent equalization allocations across provinces. Toward this end, the first section of the paper focuses on the details of the 2018-19 allocations and the later part delves more deeply into the underlying reasons why Alberta does not qualify for equalization. Alberta does qualify, however, for compensation under Ottawa’s Fiscal Stabilization Program. Unfortunately, as will be argued later, this program is woefully underfunded. The paper concludes with a reminder that, were Alberta to pursue the politically improbable course of introducing a sales tax along the lines suggested recently by Mintz and Bazel, two Alberta economists, this would serve both to ameliorate much of its fiscal woes and to enhance its attractiveness for immigration and inward corporate capital investment from the rest of Canada.

Equalization and provincial per capita revenues

Table 1 updates the data from University of Calgary Professor Trevor Tombe’s informative analytical and quantitative blog on the salient features of Canada’s equalization program to fiscal 2018-19. The first data column presents overall own-source provincial per capita revenues. What at first blush may be surprising is that, except for Newfoundland, Quebec has the highest own-source per capita revenues – \$10,694 compared, for example, with Ontario (\$8905) and Alberta (\$9597).

The reason for this is that Quebec’s tax rates are typically higher than those of all other provinces. In the jargon of equalization, higher provincial tax rates imply a province is making a greater “tax effort,” a category in which Quebec leads. This is clear from Chart 1. The equalization calculations, however, utilize the national-average tax effort, and not those of the provinces whose equalization entitlements are being calculated. Hence the fact that Quebec has the highest tax effort does not influence its equalization entitlement (although it obviously increases its overall revenues). The end result is that Quebec’s overall revenues per capita (own-source and equalization) are \$12,086, almost \$2500 higher than those for Alberta (\$9597).

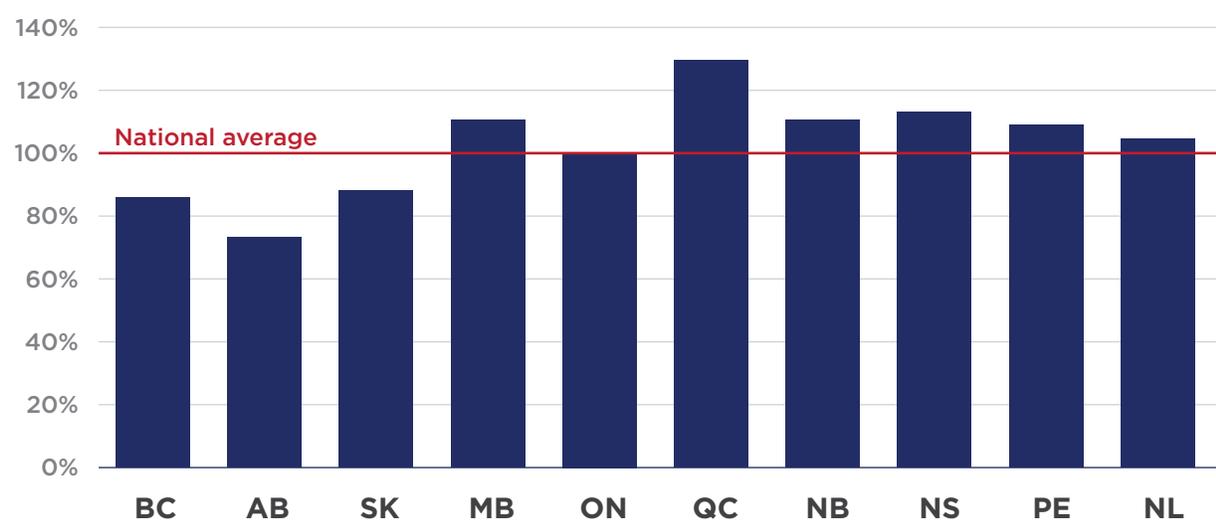
Given Alberta’s dire fiscal straits, why is it not receiving any equalization? Phrased differently, why did the equalization formula deem Alberta to be a rich or “have” province for equalization?

TABLE 1: PER-CAPITA IMPACT OF EQUALIZATION DOLLARS IN 2018-19

PROVINCE	OWN-SOURCE REVENUES PER CAPITA	EQUALIZATION PER CAPITA	OWN-SOURCE PLUS REVENUES PER CAPITA
British Columbia	9554	-	9554
Alberta	9597	-	9597
Saskatchewan	10,205	-	10,205
Manitoba	8960	1496	10,455
Ontario	8905	67	8972
Québec	10,694	1392	12,086
New Brunswick	8106	2425	10,531
Nova Scotia	7097	2003	9099
Prince Edward Island	8246	2701	10,947
Newfoundland and Labrador	12,457	-	12,457

Source: Department of Finance Canada, Statistics Canada.

CHART 1: PROVINCIAL “TAX EFFORT” IN 2016-17*



Source: Tombe 2019 (Federal Equalization Workbooks, S-Table 5 and S-Table 8 Graph).

*Displays actual revenue from tax bases included from tax bases in equalization, relative to potential revenue if national average tax rates applied. Excluding natural resources.

Why did Alberta not qualify as a have-not province for fiscal years 2019-20?

1. Lags in the formula

Prominent among the reasons why Alberta did not qualify as an equalization-receiving (i.e., a “have-not”) province is that the data entering the equalization formula are three-year moving averages of provincial per-capita revenues calculated with a two-year lag. Of the three years utilized, the most recent year has a 50 percent weight, and the two earlier years each have a 25 percent weight (i.e. 50-25-25 lagged two years). This means that provincial revenues in the two most recent years are omitted from the equalization calculation, while the provincial revenues five years ago have a 25 percent weight in the formula.

This lagged, smoothing approach may be fine for provinces with diversified revenues of low volatility, but it exacerbates the difficulties for provinces whose revenues are highly volatile, a characteristic of those provinces that depend heavily on resource revenues. Phrased differently, this means that Alberta’s revenues *for equalization purposes* for fiscal years 2018-19 and 2019-2020 were much higher than its *actual* revenues because they did not reflect the impact of the ongoing collapse in energy prices. This is one factor contributing to the result that revenue-challenged Alberta was deemed to be a “have” province and, therefore, not eligible for equalization. Surely the lags in the formula are inordinately long, i.e., the formula needs to be altered to capture more of the ongoing fiscal reality across the provinces.

2. All tax bases are included even if not accessed

A second reason why Alberta qualifies as a “have” province for equalization relates to the manner in which provincial tax bases are treated by the formula. Specifically, provinces are assumed to be accessing *all of the common tax bases*. Hence, although Alberta does not have a sales tax, for equalization purposes *Alberta is assumed to be levying a sales tax at the all-province average rate*. This assumption obviously contributes to Alberta’s becoming a “have” province for equalization. In effect, Alberta has too many tax sources as it were – it chooses to collect energy royalties in lieu of levying a sales tax. However the equalization formula effectively assumes it levies both. In the interim the reality that the equalization formula assumes that Alberta is levying a sales tax at national-average rates is a further reason why Alberta falls in the “have” province category.

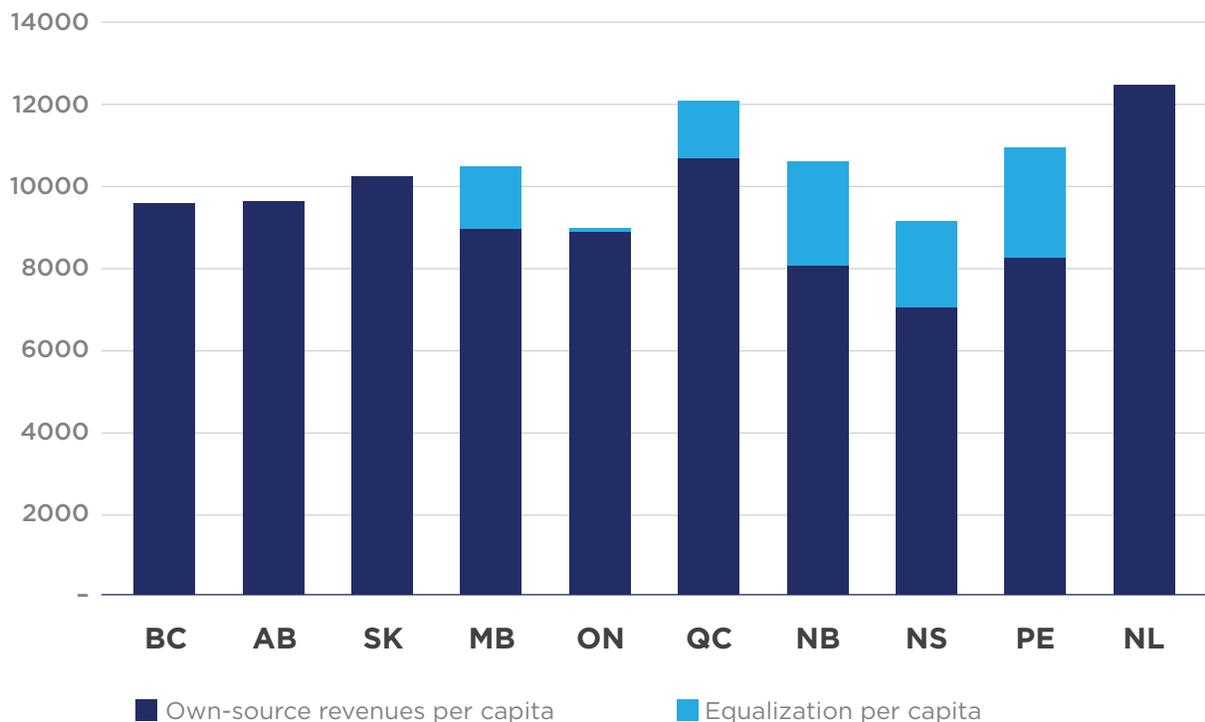
3. Total amount of equalization is now independent of the formula

A further contributing factor to the problematic allocation of equalization payments *is that the total amount of equalization now has nothing to do with the equalization formula*. The total equalization envelope now increases each year by the rate of growth of nominal GDP. This is a major departure from the traditional formula that brought the poorer provinces’ per capita revenues up to the national average of provincial per capita revenues. Moreover, under the old format, the total equalization envelope could increase or decrease year on year. In sharp contrast, however, under the current model overall equalization payments will increase annually in line with nominal GDP growth.

Some further implications of this new financing model are in order. With total equalization for fiscal 2020-2021 year set at \$20,573 million and slated to grow each year in line with GDP growth, equalization will progressively be viewed as a major revenue source. If provincial tax rates are not as yet distributed across their tax bases in order to maximize equalization, the beacon of an ever-increasing equalization pot will ensure that they soon will be. This is apart from the likely reality that the federal budgetary process will progressively be constrained by ever growing equalization, especially in contrast with the former system where equalization payments could move up or down in any given year and were a dramatically smaller drain on the federal purse.

There is a further issue associated with the new equalization model, namely that in any year the total amount of equalization is fixed, i.e., *equalization becomes a “zero-sum game.”* Under the old model if province A receives an additional \$1000 in equalization this does not affect the allotment to the other provinces. This is no longer the case under a fixed-quantum model where, at the limit, an extra \$1000 of equalization to one province will need to be offset by an equivalent reduction in some other province. A related implication of this zero-sum model will be that any perceived over-equalization accruing to a province will now be more likely to be challenged by other provinces. High on the list would be the equalization formula’s treatment of hydro-electric revenues in Quebec and Manitoba (Holle 2012).

CHART 2: PER-CAPITA IMPACT OF EQUALIZATION DOLLARS IN 2018-19



Sources: Department of Finance Canada, Statistics Canada.

Fiscal stabilization to the rescue?

The federal Department of Finance also has a Fiscal Stabilization Program that enables the federal government to provide financial assistance to any province faced with a year-over-year decline in its non-resource revenues (such as income and sales tax revenues) that is greater than 5 percent. Provinces must apply for payments under the program. Each claim is subject to analysis and verification by the federal government. While a province may submit a claim to the Minister of Finance as late as 18 months after the end of the fiscal year in question, it may instead submit a claim for an advance payment based on as few as five months of data for the fiscal year in question. The maximum payment is \$60 per capita.

In 2016 Alberta applied for a fiscal stabilization payment. Finance Minister Bill Morneau provided Alberta with a fiscal stabilization payment of \$251 million as part of Ottawa's ongoing support to provincial and territorial governments to assist them in the provision of programs and services. This was the maximum amount available under the provisions of the program, i.e., \$60 per person. Alberta also applied for and received a fiscal stabilization payment of \$251 million for 2017.

Some perspective is warranted here. From Alberta's 2020 budget, the following are Alberta's total own-source revenues in millions of dollars:

- 2014-15 (\$43,449)
- 2015-16 (\$35,477)
- 2016-17 (\$34,314)
- 2017-18 (\$39,688)
- 2018-19 (\$41,594)
- 2019-20 (\$41,894)

Alberta's cumulative shortfall in own-source revenues from 2014-15 levels in the subsequent five years amounted to almost \$25 billion, whereas Alberta's cumulative fiscal offset from Ottawa under the Fiscal Stabilization Program was only \$503 million. Surely there is a convincing case to be made that Canada is dramatically underfunding provincial revenue collapses relative to the rapidly escalating monies devoted to equalization. Indeed Premier Kenney's latest position is that Canada owes \$2.4 billion in fiscal stabilization money going back five years.

As the recent election results made clear, the fossil-energy-rich provinces are veering in the direction of desiring more independence from Ottawa. The ongoing equalization allocations and the meagre Fiscal Stabilization payments are surely playing into this scenario.

Attention now focuses on what might be Alberta's role in all of this.

Policy options for Alberta

1. Create a “rainy day” fund to serve as an offset to the inherent volatility of Alberta’s revenue base

Given the inherent volatility of Alberta’s resource revenues, it would make eminent sense for the province to re-energize Premier Peter Lougheed’s Alberta Heritage Savings Trust Fund (AHSTF). Established in 1976, the fund had three objectives: “to save for the future, to strengthen and diversify Alberta’s economy, and to improve the quality of life in Alberta.” While the role of the fund was to ensure that energy revenues would benefit current as well as future Albertans, it would arguably make fiscal sense for the province to borrow from the fund when fiscal times are tough and repay the loan to the fund when revenues recover. However, the politics of accumulating these funds are difficult, evidently requiring more fiscal discipline than, demonstrably, the relevant Alberta governments possessed. After making the initial contributions to the fund from non-renewable resource revenues between 1976 and 1987, Alberta contributed to the fund in only three subsequent years: 2006-2008. With current Heritage Fund assets of \$18 billion, there is limited scope to rely on the existing fund to stabilize provincial own-source revenues.

While provincial wealth funds would make eminent sense as a counter to volatile revenue sources, perhaps they are more suitable for nation-states than they are for competitive provinces in a federal system.

2. What if Alberta did the unthinkable and levied a sales tax?

Albertans take pride in living in the only province that does not have an explicit provincial sales tax, although, in common with the residents of the other provinces and territories, they do pay a variety of consumption-related levies. Might this now change under the pressure of the ongoing fiscal collapse? This would certainly make eminent fiscal sense since sales taxes are ideally suited to be a counterweight to volatile energy revenues because they can provide stable and growing revenues. However, it would take a creative proposal to convince Albertans to forego the so-called “Alberta advantage” and embrace a provincial sales tax.

Nonetheless, Jack Mintz, one of Canada’s foremost fiscal economists, and his co-author Philip Bazel (both from the University of Calgary’s School of Public Policy) provided one version of a creative proposal in their 2013 paper titled *Enhancing the Alberta Tax Advantage With A Harmonized Sales Tax* (i.e., a HST).

They recommended that Alberta introduce an 8 percent provincial value-added sales tax, harmonized with the federal GST that would yield approximately \$8 billion per year and they then elaborated on how these billions might be spent to make Alberta more competitive. Among the key provisions/features were:

- Increasing the personal income exemption under the Alberta income tax system from \$17,595 to \$57,250. This would mean that a couple with an income of \$114,500 would pay no provincial personal income tax;

- Reducing the Alberta personal income tax rate from 10% to 9%;
- Reducing the Alberta corporate income tax rate from 10% to 8.43%; and
- The HST would also bring in an estimated \$800 million annually from tourists and visitors.

If and when the energy revenues return to, or near, their former levels and if Alberta does implement a version of this approach to sales taxation, then the rest of Canada may well find Alberta to be most attractive for inward personal as well as corporate head-office and production relocations.

Conclusion

With Alberta in the throes of a revenue collapse, the announcement of the equalization payments across provinces for fiscal year 2018-19 – \$11.7 billion for Quebec and nothing for Alberta and repeated on a grander scale in 2019-20 – left many Canadians dumbfounded. The role of the foregoing analysis was to elaborate on several factors that led to these allocations and to suggest the ways forward so that this does not recur.

In summary, the following aspects of the current equalization formula require attention by the federal government:

- Eliminate inordinately long lags in the system so that it better captures current provincial fiscal realities;
- Review the new financing model which sees equalization grow at the rate of GDP growth and creates a zero-sum game among the provinces;
- Reform the dramatically underfunded Fiscal Stabilization Program, which does relatively little to address provincial revenue collapses compared to the size of the broader equalization program.

However there is another message that is implicit in the above analysis, namely that Alberta may in part be the author of its own fiscal woes. Alberta's fiscal reality is that resource revenues are inherently volatile. In an earlier era Premier Lougheed's Alberta Heritage Fund could be deployed in the case of a resource revenue collapse. This avenue is not available to present-day Alberta. One obvious alternative way to rein in revenue volatility would be for Alberta to introduce a sales tax, perhaps along the lines of the Mintz-Bazel model highlighted above. This would serve to not only reduce Alberta's overall revenue volatility but as well would enhance Alberta's attractiveness for inward personal and corporate migration.

About the Authors



Thomas J. Courchene, OC, SOM, FRSC, was born in Wakaw, Saskatchewan and educated at the University of Saskatchewan, Princeton University and the University of Chicago. He holds honorary doctorates from the University of Regina, Western University, and the University of Saskatchewan. Tom has authored / edited several hundred publications across a wide range of Canadian public policy areas and is the recipient of numerous awards, including the inaugural Donner Prize in 1998 and the Canada Council Molson Prize for lifetime achievement in the social sciences in 2000. Tom was awarded his second Donner Prize for his 2018 book, *Indigenous Nationals, Canadian Citizens: From First Contact to Canada 150 and Beyond*.

Currently, Tom is Professor Emeritus at Queen's University. He was the founding director of Queen's School of Policy Studies.



Teresa M. Courchene was born in Princeton, New Jersey and educated at Western University, Queen's University and the University of Toronto. Teri spent 13 years in the economics department of the TD Bank, becoming Associate Vice President and Director of Research.

Over the past 15 years, Teri has focused on teaching and research in the areas of early years' learning, mathematics and financial literacy. Teri currently teaches investing at the University of Toronto School of Continuing Studies.

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Endnotes

- 1 While the views expressed in this article are ours alone, we are most thankful for the many valuable substantive and stylistic comments we received from Christian Leuprecht, Al O’Brien, John Allan and John McDonald.



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In its mere five years of existence, the Macdonald-Laurier Institute, under the erudite Brian Lee Crowley's vibrant leadership, has, through its various publications and public events, forged a reputation for brilliance and originality in areas of vital concern to Canadians: from all aspects of the economy to health care reform, aboriginal affairs, justice, and national security.

BARBARA KAY, NATIONAL POST COLUMNIST

Intelligent and informed debate contributes to a stronger, healthier and more competitive Canadian society. In five short years the Macdonald-Laurier Institute has emerged as a significant and respected voice in the shaping of public policy. On a wide range of issues important to our country's future, Brian Lee Crowley and his team are making a difference.

JOHN MANLEY, CEO COUNCIL
