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IN BRIEF



Canada's Equalization Formula

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CANADA'S EQUALIZATION FORMULA*

1 INTRODUCTION

Equalization is a federal transfer payment program that was first introduced in 1957 and is designed to reduce the differences in revenue-generating capacity across Canada's 10 provinces. By compensating poorer provinces for their relatively weak tax bases or resource endowments, Equalization helps to ensure that Canadians residing in provinces have access to a reasonably similar level of provincial government services at reasonably similar levels of taxation, regardless of which province they call home. Another federal transfer program, Territorial Formula Financing, serves a similar purpose for territorial governments.

Equalization is financed entirely from Government of Canada general revenues. The provinces are uninvolved in the transfer except to the extent that they may qualify for Equalization payments; provincial governments do not contribute financially to the Equalization program, and each province's ability to raise tax revenues is unaffected by the transfer. There are no conditions on the use of Equalization payments or the standards that should be achieved by the Equalization-receiving provinces. Instead, the provinces make decisions on behalf of their residents, and they are accountable to voters for the services they provide.

The mechanism for determining the total amount of Equalization payments, as well as the amount that each eligible province receives, has undergone numerous changes in recent years. The two most recent series of reforms occurred in 2007 and 2009.

In 2007, the federal government reintroduced a formula-based approach to Equalization, replacing the fixed-sum program that had been in place since 2004.

In 2009, the federal government changed the Equalization formula in order to limit the total amount of Equalization payments. At that time, Ontario – Canada's most populous province – was about to become an Equalization-receiving province.

2 DISTRIBUTION OF PAYMENTS, 2013–2014

The total amount of Equalization payments in 2013–2014 is \$16.1 billion, an increase of 24.6% from 2007–2008.¹ At present, six provinces are eligible for the transfer: Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Ontario and Manitoba. Quebec is the largest recipient of an Equalization payment, accounting for 48.6% of the total amount of Equalization payments in 2013–2014. While Quebec's large share of Equalization payments is mostly due to its greater population relative to other Equalization-receiving provinces, the province's proportion of the total amount has risen considerably since amendments were made to the Equalization formula in 2007, in large part because of changes to the formula's measurement of property tax revenues.

At \$2,326 per capita in 2013–2014, Prince Edward Island has the highest per capita Equalization payment; per capita payments are lowest in Ontario, at \$230.²

3 HOW DOES EQUALIZATION WORK?

3.1 OVERVIEW

Equalization uses a mathematical formula to determine which provinces are eligible for the transfer and the amount of each eligible province's payment. Since 2009, the total amount of Equalization payments has grown annually in accordance with a three-year moving average rate of growth in Canada's nominal gross domestic product (GDP); between 2007 and 2009, the total amount was based on a formula.

The basic structure of Equalization is relatively straightforward. On a per capita basis, Equalization assesses a province's ability to generate own-source revenues and compares that fiscal capacity to the average fiscal capacity for all provinces. With the exception of user fees (fees for the use of public services), all provincial government revenue sources are allocated to one of five categories: personal income taxes, business income taxes, consumption taxes, property taxes and natural resource revenues.

Save for natural resource revenues, the Equalization formula estimates fiscal capacity in each of the four remaining revenue categories by determining the amount of per capita revenue that each province could generate if all provinces had identical tax rates. Because of the wide range of natural resources and royalty structures across the provinces, actual resource revenues are used to measure fiscal capacity instead of creating a national average tax rate.

To determine which provinces are eligible for Equalization – and, if so, for how much – each province's per capita fiscal capacity in all five revenue categories is compared to the average fiscal capacity of the 10 provinces. If, according to the formula, a province has a below-average ability to generate own-source revenues, then it is eligible for an Equalization payment to make up the difference. If a province's revenue-generating ability exceeds the 10-province average, then it is not eligible for an Equalization payment.

3.2 OTHER FEATURES OF EQUALIZATION

With the changes made to Equalization in 2007 and in 2009, the program has become more complex.

3.2.1 TREATMENT OF NATURAL RESOURCE REVENUES

In the pre-2004 formula, 100% of natural resource revenues were included in Equalization calculations, but Alberta's resources were kept out of the standard against which entitlement to Equalization payments was determined. Since 2007, Alberta's energy resources have been included in the standard, and eligible provinces receive an Equalization payment based on a calculation that either

includes 50% of natural resource revenues or excludes those revenues entirely. Eligible provinces automatically receive payments according to the option that yields the larger per capita Equalization payment.

The decision to have two options in relation to natural resource revenues is the result of a political compromise. On one hand, the federal government accepted the recommendations of the Expert Panel on Equalization and Territorial Formula Financing, which – in 2006 – called for 50% inclusion of resource revenues in the Equalization formula.³ On the other hand, the federal government considered itself bound by a pre-2006 election commitment to exclude natural resource revenues from the formula.

3.2.2 THE GROSS DOMESTIC PRODUCT GROWTH CEILING

In 2009, the Government of Canada added a ceiling to the Equalization program in order to ensure that growth in the total amount of Equalization payments remains sustainable in the future. As mentioned previously, the ceiling is scheduled to increase in accordance with a three-year moving average rate of growth in nominal GDP.

The ceiling also functions as a floor because the total amount of Equalization payments increases in accordance with GDP even when there is a reduction in fiscal disparities among the provinces, an event that would have reduced the total amount of Equalization payments when payments were determined by changes in fiscal disparities.

This ceiling has several implications. For example, as mentioned earlier, the total amount of Equalization payments is no longer formula-driven and does not vary in accordance with changes in fiscal disparities among the provinces; rather, changes in the total amount are linked to changes in nominal GDP. Furthermore, an increase in a province's Equalization payment reduces the payments to other Equalization-receiving provinces when fiscal disparities among the provinces increase more rapidly than growth in Canada's GDP and, hence, the ceiling for the total amount of Equalization payments.

3.2.3 THE FISCAL CAPACITY CAP

Equalization also includes a cap that can limit eligible provinces' per capita payments. The cap, a feature of Equalization since 2007, was introduced because of the impact that partial exclusion of natural resource revenues can have on provincial fiscal capacities.

Since provinces are free to collect resource revenues and to spend those amounts as they see fit, a province's actual fiscal capacity includes 100% of its resource revenues. However, as mentioned previously, half of those revenues – at the most – count towards Equalization's measure of provincial fiscal capacity. Therefore, it is possible for a province to be entitled to an Equalization payment but, after receiving the payment, to have a higher actual fiscal capacity than a province that is not entitled to an Equalization payment. The purpose of the fiscal capacity cap is to eliminate this possibility. Under this cap, which was introduced in 2007, the

combination of own-source fiscal capacity – which includes all revenue sources – and the Equalization payment to any Equalization-receiving province cannot exceed the fiscal capacity of the poorest non-Equalization-receiving province.

In 2009, the federal government modified the standard used to cap an Equalization-receiving province's overall fiscal capacity; the standard became the average of all Equalization-receiving provinces, rather than the poorest non-Equalization-receiving province. Since the average fiscal capacity of Equalization-receiving provinces is lower than the fiscal capacity of the poorest non-Equalization-receiving province, the result has been a lower cost for Equalization when compared to the cost that would have existed using the fiscal capacity cap that was introduced in 2007.

3.2.4 MOVING AVERAGE ON ACTUAL PAYMENTS

A province's Equalization payment in any given year is based on a weighted three-year moving average, lagged by two years. For example, the actual payment for a province in 2013–2014 is the sum of 50% of its payment for 2011–2012, 25% of its payment for 2010–2011 and 25% of its payment for 2009–2010.

This weighted moving average was introduced in 2007 to stabilize year-to-year fluctuations in provincial Equalization payments, and thus to address the volatility and uncertainty that was a feature of the pre-2004 formula. Using data that are at least two years old in the weighted average eliminates the need to recalculate payments each time those data are revised. Under the pre-2004 formula, the frequent revision of Equalization payments made it difficult for provincial governments to plan their budget.

4 CONCLUSION

While the Equalization program has been in a continual state of evolution since its introduction in 1957, it underwent relatively dramatic changes in 2007 and in 2009; these changes have affected both the total amount of Equalization payments and the distribution across provinces.

In the *Economic Action Plan 2013 Act, No. 1*, Parliament extended the authority of the Minister of Finance to make Equalization payments to provinces for another five-year period. That period will end on 31 March 2019.

NOTES

- * A previous version of this paper was prepared by Michael Holden, formerly of the Library of Parliament.
- 1. Department of Finance, [Federal Support to Provinces and Territories](#).

CANADA'S EQUALIZATION FORMULA

2. Calculations by the author using data from the Department of Finance, *Federal Support to Provinces and Territories*, and Statistics Canada, Table 052-0005, "Projected population, by projection scenario, sex and age group as of July 1, Canada, provinces and territories, annual (persons)," CANSIM (database), accessed 12 July 2013.
3. Expert Panel on Equalization and Territorial Formula Financing, [*Achieving a National Purpose: Putting Equalization Back on Track*](#), Ottawa, May 2006. Implementing the Expert Panel's recommendations accounted for the vast majority of the reforms to the Equalization program in 2007.