# Responding to Canada's Growth Challenge

Options to Reform Equalization – Position Paper

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## Introduction[1]

Canada must respond to the urgent need to bolster economic growth. Without an improvement in investment and productivity, Canadian living standards are at risk. This paper looks specifically at reforms to the Equalization Program in the context of creating the conditions necessary for shared prosperity and sustainable growth. It explores potential options to simplify the program, encourage growth, and make it more transparent and fairer to Canadian taxpayers.

## Canada's Growth Problem

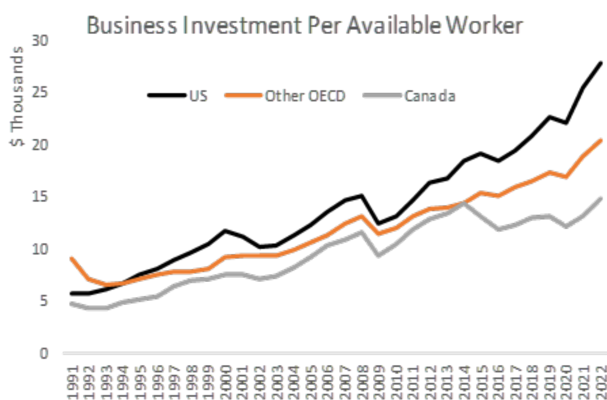
Canada's economy faces serious challenges. Since 2015, Canada's growth has been propped up by consumers, housing and government spending. This is not sustainable, especially in a higher interest rate environment. Canada is falling further behind its competitors, which poses a significant threat to our future prosperity.

As a result of sluggish investment and productivity, the OECD now expects that Canada will be the worst-performing advanced economy—as measured by per capita GDP growth—over the next 40 years. Business investment is lagging the U.S. and OECD countries, while Canada's productivity level has slipped relative to the U.S. and is behind most other G7 countries.[2]

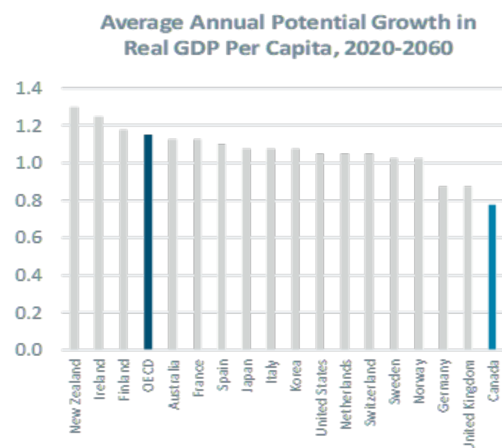
*"The federal government has neglected economic growth, and needs to prioritize it. Faster growth of productive capacity in Canada would help lower inflation. It would yield higher living standards. And it would reduce the risk of recession"*
Bill Morneau, former Finance Minister of Canada.

The urgency of acting is only compounded with the passage of the U.S. Inflation Reduction Act, which provides hundreds of billions in investments and incentives related to energy security and climate action, making it the largest investment targeting emissions reductions in US history.

*"Other countries – in particular the United States – are moving faster to attract the investments that will be needed to achieve a low-carbon future. Without an ambitious Canadian response, we will be at risk of losing valuable human and financial capital."*
Goldy Hyder, President of Business Council of Canada (Federal Budget 2023 submission)




Source: CD Howe Institute, Commentary 625 (August 2022)




Source: OECD and Finance Canada.

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[1] The Government of Alberta would like to thank the C.D. Howe Institute, Fairness Alberta, the Macdonald-Laurier Institute, and Dr. Trevor Tombe for reviewing and commenting on this paper. These reviewers have no responsibility for any errors or views expressed in this paper.

[2] OECD (2021). "The Long Game: Fiscal Outlooks to 2060 Underline Need for Structural Reform", Policy Paper No 29

## Responding to the Challenge

Given this backdrop, there is a growing need to prioritize policies that drive economic growth. Actions should include:

1. **Renewing private sector investment and investor confidence.** There is a growing recognition that it is difficult to get major projects approved and built in Canada.[3] Delays stifle growth not only in the resource sector, but also in emerging areas such as hydrogen, carbon capture utilization and storage (CCUS) and critical minerals. In addition to regulatory issues, a competitive tax environment, a skilled workforce, and quality infrastructure are required to improve investment across all sectors.

2. **Demonstrating leadership on addressing global energy security.** Canada is in a unique position to displace energy from dictatorships like Russia and support our allies with responsibly produced energy. Canada needs to play a much larger role on the global stage in global emissions reductions through the export of hydrogen and LNG, which would displace higher emitting sources like coal.

3. **Addressing fiscal imbalances and fairness issues.** Federal transfers should be reformed to encourage growth. Protecting taxpayers through affordable federal programs, delivering transfers on an equitable basis, and ensuring that provinces and territories have the tax room to fulfill their obligations would be important steps.

This paper takes a closer look at the third challenge with a focus on the federal Equalization Program. Even under the current program, adopting pro-growth policies in lower income provinces could reduce fiscal disparities and reliance on the program. That is, as living standards improve, 'receiving' provinces would benefit from a stronger tax base and higher own-source revenues, helping offset declines in equalization payments. But more could be done within the program itself. This paper outlines the flaws with the current Equalization Program, demonstrates the case for significant changes and explores options for long-term reform.

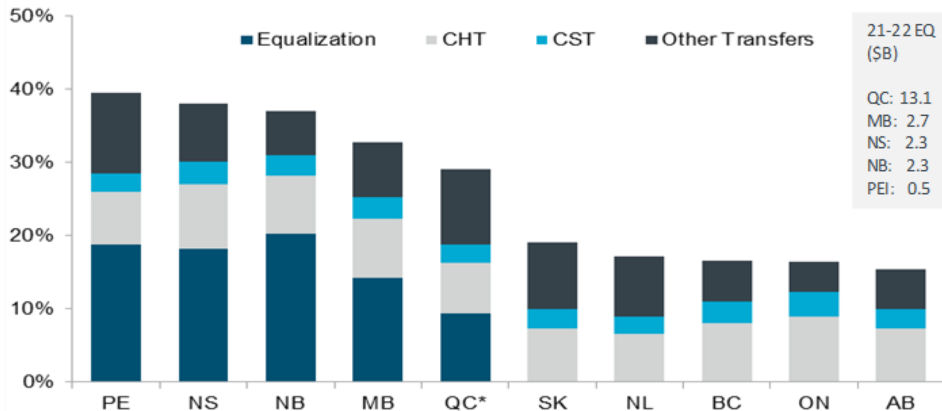
While there are no perfect solutions, major improvements are possible. This paper explores an option that increases simplicity and transparency, reduces perverse growth disincentives, and improves fairness.

## Overview of Equalization

The Equalization Program is a federal program that has been in place since 1957. The program is intended to ensure each province can "provide reasonably comparable levels of public services at reasonably comparable levels of taxation" as per sec. 36(2) of the Constitution Act, 1982. Equalization is financed entirely by federal taxes paid by all Canadians and flows directly to provincial governments that fall below the average fiscal capacity as determined by the Equalization formula. As shown in the table below, Equalization also drives major variations in the distribution of fiscal transfers. In 2021-22, Quebec received $13.1 billion, by far the largest of all provinces. However, as a share of revenue and per person, the Atlantic provinces receive a higher proportion.

[3] For example, according to the most recent survey by CFIB, the total number of federal administrative requirements increased by 9.8 per cent from 2020 to 2021.

**FEDERAL TRANSFERS AS A PERCENTAGE OF TOTAL REVENUES (2021-22)**




*Quebec's transfer amounts include the Quebec Abatement

Source: Finance Canada, Provincial Financial Reports

On the surface, the general idea of Equalization is relatively simple and intuitive. It calculates how much money each province could hypothetically generate if they all applied a national average tax structure to their own tax bases – that is, their fiscal capacity. It then compares each province's fiscal capacity per capita to the national average. If they are below the average, provinces get enough Equalization (per person) to bring them up to the national average. Provinces above the average do not receive Equalization, but neither are they required to make any payments.

However, Equalization gets very complicated once you dig deeper. There are different rules surrounding the inclusion of resource revenues, revenue sources and their bases are not always easy to measure consistently across jurisdictions, and there are mechanisms in place to determine the total size of the program or to limit the Equalization that is paid out. More information on the Equalization Program is provided in Appendix 1.

## Key Challenges with the Equalization Program

### Challenge 1: Growth disincentives

Equalization can reduce the incentive for provinces to implement policies that promote growth. Whether a province follows pro-growth policies or not, provinces are provided the means to fund public services at roughly the average level of the country. This creates a situation where taxpayers may be less inclined to demand growth-friendly policies.

In addition, the program does not recognize the initial cost of pro-growth policies, such as robust regulatory systems that are required to develop resources. As a result, it is conceivable that a jurisdiction is no better off fiscally, at least in the short term, by following a pro-growth agenda. The simplified illustration below helps make this point.

### Box 1: Illustrative Example

Suppose there are two otherwise equivalent jurisdictions, one of which is considering pro-growth policies, while the other is not.

- The jurisdiction implementing the growth policy would gain $20 million from development but must dedicate $11 million in expenditures to regulating that development. The result is a net positive gain of more than $9 million.
- The second jurisdiction does not pursue this opportunity but receives Equalization to ensure that they can deliver core services at the national average.
- In the longer-term, without a steady revenue stream generated through pro-growth policies, the status quo province would likely have to raise taxes to continue providing the same level of public services. Smart (2017) finds evidence that Equalization leads 'receiving' provinces to raise their tax rates (see footnote 4).

| | Pro-Growth Policy | Status Quo |
|---|---|---|
| Baseline Revenues | $100 Million | |
| Added revenues from pro-growth policies | $20 Million | |
| **Total Revenue for Equalization** | **$120 Million** | **$100 Million** |
| **Average fiscal capacity** | $110 Million | |
| Equalization | $0 | $10 million |
| **Revenue after Equalization** | **$120 Million** | **$110 Million** |
| Developmental Costs | $11 Million | $0 |
| **Residual Funding for Public Services** (Health, Education, Social Services, etc.) | **$109 Million** | **$110 Million** |

*Note this is a simplified illustration. Actual impacts will vary based on the formula, costs and source of revenues.

Some have argued that fiscal redistribution through Equalization could help to prevent inefficient migration to provinces that levy lower taxes and/or offer better public services. That is, people may be compelled to move to these provinces to take advantage of the fiscal benefits. However, Equalization is not the only program that provides for fiscal redistribution. For example, a large number of federal programs, such as Employment Insurance, Old Age Security and Canada Pension Plan, disproportionately flow to lower income provinces relative to size of their population. Tombe (2019) estimates that most fiscal redistribution is 'implicit' through federal spending and taxation, with Equalization and fiscal stabilization accounting for 23 per cent of transfers, less than personal income taxes alone. Various sources have also noted Alberta's large net fiscal contributions to a range of federal programs.[4]

Some recent studies have found evidence that Equalization and the broader system of fiscal transfers in general reduces efficiency and productivity. Smart (2007) shows that Equalization can lead provincial governments to raise taxes.[5] Albouy (2012) finds the current[6] Equalization Program reduces efficiency, resulting in lower national incomes and overpopulation in low-income provinces. More generally, Tombe and Winter (2021) find the overall system of federal fiscal transfers lowers national real GDP by between 0.8 and 1.2 per cent, including the Equalization Program which was found to lower productivity by 0.2 per cent.[7]

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[4] See for example, https://fairnessalberta.ca/equalization/

[5] See for example, Smart, M. (2007). Raising taxes through Equalization. Canadian Journal of Economics.

[6] Albouy (2012) "Evaluating the Efficiency and Equity of Federal Fiscal Equalization", Journal of Public Economics.

[7] Tombe, Trevor and J. Winter (2021), "Fiscal integration with internal trade: Quantifying the effects of federal transfers in Canada", Volume 54 Issue 2, Canadian Journal of Economics

### Challenge 2: Floor payments over-equalize provinces

The Equalization Program continues to grow even when fiscal disparities shrink, resulting in provinces being over equalized. The problem stems from the GDP growth constraint, which ties the size of the program to a three-year moving average of Canadian nominal GDP growth.

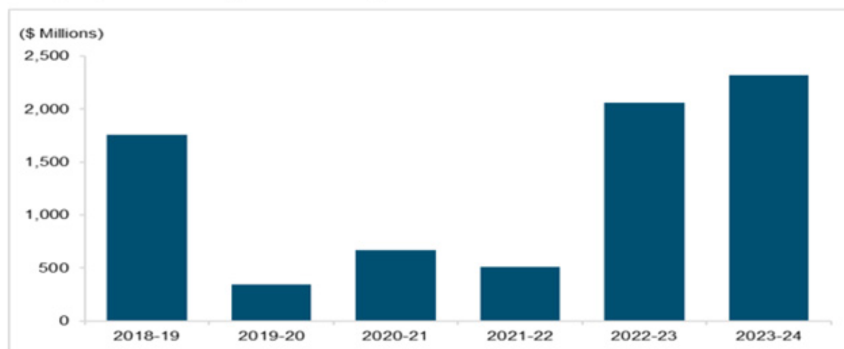
The result of the GDP growth rule is that in some years there is more money in the Equalization Program than necessary to bring "have not" provinces up to the average level provincial fiscal capacity. When this occurs, floor payments are made. These excessive payments have ballooned in recent years and add to the sentiment by many that the program is unfair to taxpayers in non-recipient provinces.

Depending on fiscal disparities, the GDP constraint can act either as a ceiling (cap) or as a floor (top-up) for payments calculated under the formula. From 2009-10 through 2017-18, the GDP constraint acted as a ceiling, reducing total Equalization payments (by over $17.5 billion) to below the amounts determined by the formula.

Since then, however, the GDP constraint has acted as a floor. From 2018-19 to 2023-24, the federal government paid an extra $7.7 billion to Equalization-receiving provinces through floor payments, above and beyond what was needed to equalize those provinces to the average fiscal capacity. Removing the GDP floor would reduce 2023-24 payments to $21.6 billion, saving Canadian taxpayers $2.3 billion.

Floor payments add a further complication, creating potential situations where a "have" province can actually receive Equalization. In 2023-24, for the second time in six years, floor payments will be made to Ontario, a province with above-average fiscal capacity that would not ordinarily be a recipient.[8] As Tombe (2023) highlights, "Ontario getting hundreds of millions in equalization means the program isn't serving its purpose."[9]

**Yearly Equalization Program 'Floor Payments'**




[8] This year, large floor payments to Quebec would have resulted in their equalization payments pushing their fiscal capacity above Ontario's (the lowest non-receiving province). This outcome violates another condition of the program known as the Fiscal Capacity Cap. To remedy this, Ontario was paid a portion of the floor payments – exactly the amount necessary to make their fiscal capacity equal to Quebec's after equalization payments are included.

[9] Tombe (2023) "Ontario getting hundreds of millions in equalization means the program isn't serving its purpose", The Hub, January 16, 2023

## Challenge 3: Complexity of Equalization

The current Equalization Program is complex, lacks transparency and creates numerous unintended consequences. The complexity in the program stems from three main features:

1. **Defining revenues to be equalized**
   Provinces differ in their accounting treatment of revenue, the revenues they collect (e.g., some provinces own utility companies while in other provinces these services are owned by municipalities or private corporations), and how revenues are shared with municipalities and other entities (e.g., some provinces collect property tax on behalf of their municipalities). As a result, the federal government makes several complex adjustments to provincial publicly reported revenues to ensure that a more standardized definition is applied to all provinces. In doing so, however, the basis for the revenues becomes less transparent and the amount of revenue that ought to be included is not always clear as the fair market value of the revenue stream is difficult to assess (e.g., revenues of hydroelectricity-generating government business enterprises).

2. **Defining the revenue base used to determine fiscal capacity**
   In some cases, the revenue base used to determine the fiscal capacity associated with the base is relatively straightforward. For example, using personal income or corporate profits for the personal income tax system and corporate income tax system is intuitive. In other cases, however, the base used for assessing the revenue is more complex. For example, what is the proper base for miscellaneous revenues or for resource revenues? In these cases, the federal government tends to use arbitrary proxies, which often creates disagreements among the provinces.

3. **A lack of a standard definition of fiscal capacity**
   There is currently no single definition of fiscal capacity within the Equalization Program, as the formula includes several methods to calculate it. Specifically, fiscal capacity is calculated using zero per cent, 50 per cent and 100 per cent of resource revenues, as well as including a province's calculated Equalization payment.

   a. First, provinces have the option to calculate their fiscal capacity by excluding resource revenues entirely or including 50 per cent of these revenues. The province's pre-cap Equalization uses whichever of these two options gives the larger benefit.
   b. Second, the Fiscal Capacity Cap (FCC) compares total fiscal capacity among all provinces, including 100 per cent of resource revenues and the Equalization payment a province would otherwise receive, and ensures that no recipient province has a higher post-Equalization fiscal capacity than the lowest non-receiving province.[10] If the fiscal capacity is too high, the Equalization payment is reduced accordingly.

While some of this complexity is intended to help make the program fair, it adds significant red tape, results in a far less transparent program and can lead to unintended consequences.

[10] This form of FCC applies when provinces that receive equalization payments are home to less than 50 per cent of Canadians, as has been the case in recent years. If a half or more of the population live in receiving provinces (as was the case when Ontario received equalization), the FCC caps fiscal capacity at the average level of receiving provinces rather than the lowest fiscal capacity of non-receiving provinces.

## Equalization Reform

The previous section highlighted major shortcomings of the current program. This section outlines a potential option for long-term reform with the following principles in mind:

1. Simplifying the program and making it more transparent
2. Encouraging provincial economic growth, by addressing perverse incentives and unintended consequences of the existing formula
3. Improving fairness to taxpayers

This paper proposes the following sequenced approach, expanded in more detail below:[11]

1. Year 1-4: Maintain the existing Equalization system but redistribute any amounts in excess of the GDP floor to all provinces on a per capita basis.
2. Year 5: Simplify the program through the introduction of a new macro approach based on using nominal GDP per capita to measure fiscal disparities.
    a. At introduction, provinces would be equalized to 100 per cent of the mean of the new macro-based fiscal disparity.
    b. To ensure the Equalization system's growth remains sustainable, the retention of a GDP cap would be evaluated at the time the new system is introduced.
3. Year 6-10: Gradually reduce the mean fiscal capacity that provinces are equalized to from 100% in year 5 to 95% by year 10.
    a. The GDP growth cap would be permanently eliminated at this point.
4. A number of potential add-ons could be considered to encourage economic growth, protect small economies and reduce volatility.

### Years 1 - 4: Addressing GDP floor payments

While many proposals have been put forward to address the flaws in the existing Equalization formula, none of these reforms would reduce the size of the program unless the GDP floor is eliminated. Under the current structure, modifications simply alter how the payments are allocated among recipients and do little to reduce the reliance on the program. The elimination of floor payments would eliminate excess payments and over-equalization. It would also encourage provinces to implement pro-growth policies that add to own-source revenues.

During this period, savings from eliminating floor payments would be redistributed to provinces on an equal per capita basis. That is, the excess of the amount needed to equalize provinces would flow to all provinces based on their share of the national population.

[11] A number of alternative options that address the principles to varying degrees are discussed in **Appendix 2.**

**IMPACT ON EQUALIZATION: ADDRESSING THE GDP FLOOR**

Illustration based on 2023-24 payments ($M)

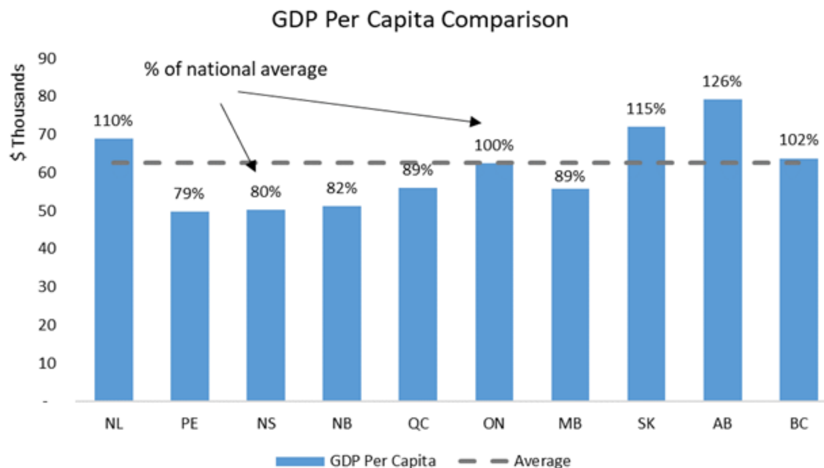
| | NL | PE | NS | NB | QC | ON | MB | SK | AB | BC | **ALL** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Equalization Status Quo | - | 561 | 2,803 | 2,631 | 14,037 | 421 | 3,510 | - | - | - | **23,963** |
| Equalization without Floor Payments | - | 535 | 2,646 | 2,506 | 12,669 | - | 3,289 | - | - | - | **21,646** |
| Equalization with Redistributed Floor Payments | 32 | 545 | 2,706 | 2,554 | 13,194 | 901 | 3,373 | 72 | 270 | 316 | **23,963** |

Source: Finance Canada, Alberta Treasury Board and Finance Calculations

## Year 5: Simplify through a macro measure of fiscal capacity

As discussed, the Equalization Program is complex and difficult to understand due to the intricacies of calculating fiscal capacity and the representative tax system rates, as well as the multiple layers of the formula (two options for the resource revenue inclusion rate, Fiscal Capacity Cap, GDP constraint and their interaction). The estimates are impossible to reproduce without access to the information from Finance Canada and future allocations are difficult to predict. There is also an opportunity to influence the tax bases, and hence payments received, through policy decisions.

A way to address these concerns is the macro-based Equalization formula. Under this approach, Equalization payments are determined based on broad macroeconomic indicators, such as nominal GDP per capita, instead of the multiple layers found in the current formula. The provinces at or above the national average of the macro measure would not receive Equalization. Those below would receive Equalization (see chart below).[12]




Source: Statistics Canada.

[12] Note: The chart depicts a three-year weighted average nominal GDP per capita, applying the same averaging rule that is used in the current equalization formula for fiscal capacity.

This approach has been explored in the past, including by Tombe (2019) and Boothe and Hermanutz (1999).[13] It has many attractive features highlighted in these studies, including improved simplicity, ease of communication and reduced incentives for provinces to manipulate tax bases. Unlike in the current Equalization formula where provinces are, in effect, compensated for the revenues lost to dissipated rents, the macro approach significantly mitigates this risk. For instance, under the current formula, a province's decision to subsidize hydroelectricity directly impacts its measured fiscal capacity and, as a result, its share of the total Equalization payments. Under a macro approach, individual payments are determined by shares of GDP and population and are not directly impacted by these decisions. Moreover, better capturing revenues would increase the size of the Equalization pool and subsequent payments, reducing any incentive to under-report revenues.

Clemens and Veldhuis (2007) also discuss the merits of a macro approach, arguing that it would be "superior" to the approach of using representative tax systems.[14] Booth and Hermanutz (1999) proposed a simplified Equalization formula based on a single macroeconomic indicator of adjusted personal income along with increased tax point transfers, arguing that the new system would improve transparency and accountability. Tombe (2019) explores a macro approach based on nominal GDP per capita and net domestic product per capita. In 1955, New Brunswick recommended that Equalization be based on personal income per capita (a macro measure), with the threshold set at 85 per cent of the national average.

As with any formula, there are disadvantages to a macro approach. Nominal GDP (or any another macroeconomic indicator) is a very general measure of fiscal capacity and may not fully reflect a province's actual ability to raise revenue. For example, some sources of income or types of economic activity may be more difficult to tax. In addition, the location of activity for GDP measurement and for taxation purposes may differ.[15]

However, the benefits outweigh the shortcomings. The new approach would solve the complexity of measuring discrete tax bases, makes it easier to understand, and reduces the incentive to manipulate tax or resource revenue bases to achieve higher payments. Measuring fiscal disparities by broad macroeconomic indicators also largely addresses the issues of provinces being able to increase their Equalization payments by subsidizing certain revenue sources, such as hydro revenues.

### The mechanics of a macro approach to Equalization

The macro-based approach is simple and can form the foundation for additional reforms. This paper explores potential options for a macro-based approach to Equalization and the impact they would have had if implemented over the last 10 years. These options:

1. Use nominal GDP as the revenue base for all revenue sources, greatly simplifying the base calculation.

2. Ensure a single and consistent inclusion rate for resource revenues (assumed at 50 per cent inclusion) and address the problem of excessive claw-back rates for resource development that plague the current system.

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[13] Tombe, Trevor (2018) "Final and unalterable – but up for negotiation: Federal-provincial transfers in Canada", Canadian Tax Journal, 66:4; and Boothe, Paul, and Derek Hermanutz (1999). Simply Sharing: An Interprovincial Equalization Scheme for Canada. C.D. Howe Institute Commentary No. 128. C.D. Howe Institute.

[14] Clemens, Jason, and Niels Velduis (2007). "Beyond Equalization: Examining Fiscal Transfers in a Broader Context", The Fraser Institute.

[15] For example, when businesses employ out-of-province workers, incomes would be taxed in their home province rather than their province of employment.

a. Under the existing Equalization system, resources are treated differently from other forms of revenue. Non-resource fiscal capacity is measured by applying national average tax rates to respective tax bases (such as personal and corporate incomes, consumption, property values). In other words, the program measures not actual revenues from these sources but the amounts provinces could raise if they had average tax rates. In contrast, resource fiscal capacity is measured by actual revenue, which is subject to a set of predetermined inclusion rates. The result is that the negative impacts on equalization associated with resource revenue production are direct and tend to be much greater than the negative impacts associated with other forms of development.[16]

b. Under the macro approach, a province's share of Equalization is driven only by GDP and population, so all forms of development are treated the same (i.e., an increase in GDP associated with manufacturing will have the same impact on relative shares as an equivalent GDP increase associated with resource production). Further, these relative shares are not directly impacted by the amount of resource revenues included.[17]

3. Uses publicly available data to establish baseline revenues using Statistics Canada's Government Finance Statistics (GFS). Statistics Canada uses standardized definitions of revenue and adjusts for different levels of consolidation with related entities. This makes the data more comparable than public accounts reporting. It also makes the approach much simpler and more transparent by eliminating the onerous process of estimating revenues to be equalized, while capturing most of the same revenue streams.

4. Allow for the possibility of using a "fiscal capacity factor" instead of a three-year average national average tax rate to further add simplifies and eliminate incentive problems.

5. Once fully implemented, there would be no ad-hoc constraints on the size of the program or individual allocations such as the GDP constraint or the FCC.

### Year 6-10: Gradually reduce the mean fiscal capacity that provinces are equalized to from 100 per cent to 95 per cent by year 10

To encourage provinces to reduce their reliance on the program, but still provide a protective floor, the program would shift to equalize at 95 per cent of the national average by year 10.

The move to equalize 95 per cent of the national average would treat Equalization in a similar way as the Fiscal Stabilization program (FSP), which does not provide 100 per cent stabilizing support to provinces. Under the FSP, a five per cent non-resource revenue decline is required before payments are paid (for resource revenues, the threshold is set at a much higher 50 per cent). In other words, no payments are made for the first five per cent of declines. For Equalization, provinces that are less than five per cent away from the national average fiscal capacity would be considered to have the means to provide reasonably comparable services and would not receive payments, while those more than five per cent below the average would receive payments to bring them to 95 per cent of the average.

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[16] For example, if a province develops their manufacturing and that increases their corporate income tax base, their increase in measured fiscal capacity would be proportionate to the national average tax rate (around 13 per cent), whereas an increase in resource revenues would be typically subject to much higher marginal claw-back rates that generally range from 50 per cent up to 100 per cent (for provinces bound by the Fiscal Capacity Cap). However, these claw-back rates can vary significantly among provinces and fall outside of the range noted.

[17] For example, say a small province discovers a significant gas reserve and starts to produce this reserve. As a result, their nominal GDP increases by 15 per cent, their population rises by 5 per cent and their revenues increase by 20 per cent. Initially under the macro-approach, their equalization was $1,690 million. However, the GDP and population growth causes their Equalization to fall to $535 million in the absence of resource revenues being included. The inclusion of resource revenues in the formula then boosts their Equalization to $536 million, offsetting the decline associated with GDP and population growth.

Canada would not be the first country to equalize below 100 per cent. Many nations that have an established equalization system do not have equalization rates of 100 per cent to encourage the development of own-source revenues and to prevent the risk of over-equalizing recipient states.[18] In Germany, for example, the equalization rates vary between 60 – 70 per cent and includes the horizontal transfer of revenues from wealthier to lower income states within the same level of government.[19] Other countries use rates below 100 per cent include Belgium (80 per cent of the gap between actual per capita revenues and the mean per capita revenue), Switzerland (86.5 per cent), Sweden (90 – 95 per cent), Italy (60 per cent) and Japan (99 per cent).[20]

To ensure that Equalization remains fiscally sustainable, the GDP cap would be retained during the 10-year transition period. This would ensure that the macro approach would not lead to any unexpected increased cost and reliance on the program. Once additional features such as equalizing to 95 per cent of the mean are added, the macro approach would result in lower equalization payments.

Option to improve stability and outlier impacts through a six-province standard

Equalization payments can be volatile and difficult to predict. To remove volatility in year-to-year payments and reduce the impact of outliers, one option is to move to a six-province standard. This would bring equalization receiving provinces up to an average that excludes outlier provinces. Under a six-province standard, the provinces with the two lowest and two highest levels of GDP per capita would be removed from the average.

Allowing for an adjustment period

Impacted provinces should be given time to adjust, allowing them time to reduce their dependency on the program. This paper proposes equalizing at 100 per cent of the average in the first five years, with this amount falling gradually every year until it reaches 95 per cent in year 10.

In addition, provinces that fall well below the average fiscal capacity would still be protected through some payment under the program. Receiving provinces could also rely on the federal FSP in years of revenue decline and be provided the same level of support that Alberta and other non-receiving provinces received in years of recession. This could motivate a renewed conversation about the need for more fundamental reforms to the FSP to ensure it provides adequate and more lasting protection.

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[18] For more information, see OECD (2021), "Evaluating Fiscal Equalisation: Finding the Right Balance", OECD Working Papers on Fiscal Federalism, May 2021 No. 36.

[19] A state with above-average fiscal capacity faces a "linear progressive skimming-off schedule" which partially reallocates a portion of their revenue to another state with below average fiscal capacity. Likewise, the state with below-average fiscal capacity faces a similarly progressive schedule prescribing the rate at which their revenues are topped up.

[20] There are other examples where jurisdictions equalize to 100 per cent. In Australia, for example, their system equalizes at 100 per cent but only uses a formula based on the Goods and Services Tax.

## Impacts of the macro-based options

The impacts of the macro-based approach vary by year and the option selected. Without a growth constraint applied, the baseline approach (equalizing to 100 per cent of the mean) would have led to higher Equalization payments than the status quo during energy booms and lower Equalization in more typical years. Since 2019-20, the baseline macro approach would have reduced Equalization compared to the status quo. Moving to equalizing to 95 per cent of the mean, or a six-province standard, reduces the size of the program in all years.

Table 1 shows the impact of applying the macro approach using the national tax rate, which is calculated as a three moving year average of actual revenues as a share of GDP.[21]

**TABLE 1: HISTORICAL COMPARISON OF VARS EQUALIZATION OPTIONS**

Total Program Size under Macro Option using Average National Average Tax Rates, $ Millions

| | | Macro Options | | | |
|---|---|---|---|---|---|
| | | 10-province standard | | 6-province standard | |
| | Current Approach | Equalizing to 100% | Equalizing to 95% | Equalizing to 100% | Equalizing to 95% |
| 2014-15 | 16,669 | 21,126 | 11,107 | 8,923 | 4,418 |
| 2015-16 | 17,341 | 24,312 | 12,454 | 9,017 | 4,503 |
| 2016-17 | 17,880 | 26,600 | 13,755 | 9,459 | 4,842 |
| 2017-18 | 18,254 | 23,512 | 12,727 | 10,075 | 5,181 |
| 2018-19 | 18,958 | 19,384 | 11,226 | 11,018 | 5,707 |
| 2019-20 | 19,837 | 18,054 | 10,817 | 11,684 | 6,036 |
| 2020-21 | 20,573 | 17,860 | 10,895 | 12,130 | 6,074 |
| 2021-22 | 20,911 | 17,679 | 10,765 | 12,112 | 5,864 |
| 2022-23 | 21,920 | 14,945 | 8,791 | 11,513 | 5,205 |
| 2023-24 | 23,963 | 16,776 | 9,428 | 12,011 | 5,181 |

Source: TBF calculations, Statistics Canada data: All macro-based options include a three-year weighted average. Allocations are based on GDP, population and revenue with a 2-year lag, i.e. 2023-24 allocations are based on 2021 weighted average nominal GDP and population, and 2021-22 weighted average revenue. 2023-24 allocations under current formula are likewise based on the 2021-22 weighted fiscal capacity

[21] Illustrative options presented in this paper are based on GFS data, approximating the federal definition of revenues to be equalized. The revenues included are equal to total provincial/local consolidated revenue excluding interest revenue, sales of goods and services, grants and 50 per cent of resource revenues (oil and gas royalties, forestry royalties, mineral royalties, water power royalties and other rent and property income), and voluntary transfers. See Statistics Canada Table: 10-10-0147-01.

Option to further simplify the macro approach

While a macro approach based on an observed national tax rate significantly improves Equalization, a fiscal capacity factor could make the program even simpler, reduce volatility and further improve existing incentive problems. The fiscal capacity factor functions like a national tax rate, but it would be fixed based on a long-term average of eligible revenues (such as 10-15 years) relative to GDP (in essence representing a long-term effective tax rate). This fiscal capacity factor could be revisited on a periodic basis (for example, every five years, as part of the regular transfer renewal cycle). This approach would:

1. Further simplify the Equalization Program by avoiding the need to recalculate revenues every fiscal year.
2. Reduce the program's volatility as the payments would be less subject to boom-and-bust cycles.
3. Further reduce the potential for perverse incentives. Some larger provinces could potentially improve their entitlement by raising their tax rates, which under the formula would raise the national average tax rate used to calculate equalization payments. The adjustments help to minimize this risk.

Table 2 shows the impact of applying a fixed fiscal capacity factor. This factor is set at 17.1 per cent, representing the average revenue to GDP ratio over the past 14 years.[22]

**TABLE 2: HISTORICAL COMPARISON OF VARIOUS EQUALIZATION OPTIONS**

Total Program Size Under Macro Option using fiscal capacity factor

| | | Macro Options | | | |
|---|---|---|---|---|---|
| | | 10-province standard | | 6-province standard | |
| | Current Approach | Equalizing to 100% | Equalizing to 95% | Equalizing to 100% | Equalizing to 95% |
| 2014-15 | 16,669 | 21,600 | 11,355 | 8,490 | 4,202 |
| 2015-16 | 17,341 | 24,845 | 12,727 | 8,547 | 4,268 |
| 2016-17 | 17,880 | 27,297 | 14,116 | 8,944 | 4,578 |
| 2017-18 | 18,254 | 23,771 | 12,853 | 9,400 | 4,832 |
| 2018-19 | 18,958 | 19,360 | 11,163 | 10,195 | 5,279 |
| 2019-20 | 19,837 | 17,691 | 10,597 | 10,715 | 5,535 |
| 2020-21 | 20,573 | 17,378 | 10,601 | 11,088 | 5,552 |
| 2021-22 | 20,911 | 17,414 | 10,603 | 11,187 | 5,416 |
| 2022-23 | 21,920 | 14,600 | 8,593 | 10,599 | 4,792 |
| 2023-24 | 23,963 | 15,975 | 9,000 | 10,828 | 4,675 |

Source: TBF calculations, Statistics Canada data: All options include a three-year weighted average. Allocations are based on GDP and population with a 2-year lag, i.e. 2023-24 allocations are based on 2021 nominal GDP. 2023-24 allocations under current formula are likewise based on the 2021-22 weighted fiscal capacity

[22] The 17.15 per cent ratio is the average ratio of defined revenue to GDP from 2008 to 2021. All illustrative options presented in this paper are based on GFS data, approximating the federal definition of revenues to be equalized. The revenues included are equal to total provincial/local consolidated revenue excluding interest revenue, sales of goods and services, grants and 50 per cent of resource revenues (oil and gas royalties, forestry royalties, mineral royalties, water power royalties and other rent and property income), and voluntary transfers. See Statistics Canada Table: 10-10-0147-01. The timeframe for averaging was chosen to capture all the data currently available in the data set. When the approach is implemented, the ratio could be expanded to say 15 years.

Options to allocate Equalization savings

The above approach would lower Equalization payments and therefore raises the question of what could be done with the savings. These savings could be used to further encourage economic growth by re-profiling the funds to transfers that are geared towards economic development initiatives, including infrastructure. Savings could also be allocated through per capita cash transfers[23] or tax point transfers. Under a tax point transfer, the federal government would reduce its tax rates and give the tax room to provinces. Each province would then decide if they wanted to capture this tax room through a revenue neutral increase in the province's own taxes.[24]

The following table shows the estimated offsetting benefit that each province would receive for each $1 billion in federal savings that would get redistributed back to the provinces via a per capita transfer or via a tax point transfer.

**IMPACT OF $1 BILLION ALLOCATED TO PROVINCES THROUGH VARIOUS MECHANISMS**

| $ millions | BC | AB | SK | MB | ON | QC | NB | NS | PE | NL |
|---|---|---|---|---|---|---|---|---|---|---|
| **Per Capita Transfer** | **136** | **116** | **31** | **36** | **387** | **225** | **21** | **26** | **4** | **14** |
| Tax Point Transfer (PIT) | 145 | 150 | 29 | 29 | 421 | 169 | 15 | 20 | 3 | 13 |
| Tax Point Transfer (CIT) | 142 | 126 | 29 | 24 | 445 | 197 | 10 | 14 | 2 | 8 |

Source: TBF estimates

Option to recognize needs of smaller provinces

Some of Canada's smaller provinces may have structural economic challenges that are more difficult to address in the near term and may not benefit from the same economies of scales in delivering public services. One potential method to address this issue is adjusting the extent to which provinces are brought up to the mean under the macro approach. In other words, the percentage that provinces are equalized to the mean could be calibrated based on population size with smaller provinces benefiting from a smaller means adjustment.[25] The program could be designed to align with the overall target of 95 per cent of mean after 10 years.

## Conclusion

The Equalization Program has major flaws and alternatives that should be explored, along with other policies, to respond to the urgent need to bolster economic growth in Canada. A shift to a macro-based approach that equalizes at 95 per cent of mean would be a major improvement. It would help address several problems that plague the current system, including disincentives for provincial growth, the ability to manipulate tax bases, the continued growth of the program when fiscal disparities decline, and the complexity and lack of transparency of the program. This option is simple and avoids complex tax capacity calculations, focuses on economic growth, provides a floor to protect low-income provinces and allows for an adjustment period.

[23] Moving part of the program to per capita transfers has been proposed in the past. In 2018, Saskatchewan suggested allocating half of equalization on a per capita basis to all provinces, with the remainder allocated according to the formula. For 2023-24, this would result in additional $4.4 billion to Ontario, $1.6 billion to B.C., $1.4 billion to Alberta, $0.4 billion to Saskatchewan and $0.2 billion to Newfoundland and Labrador. Equalization receiving provinces would face a reduction in payments: $4.3 billion in Quebec, $1.3 billion in Manitoba and $0.2-1.1 billion in the three remaining Atlantic Provinces.

[24] A tax point transfer would be more complex than a per capita transfer as provincial rate structures differ significantly from the federal structure. This means that there would be significant distributional impacts on taxpayers even though the overall revenues collected would be neutral.

[25] There is some precedent for differential treatment for smaller provinces. Under the statutory subsidies under the Constitution Act 1907, a population threshold of 2.5 million has been used.

# Appendix 1: Equalization Primer

## Background

The Equalization Program is a federal transfer program that addresses disparities in provincial fiscal capacity to raise revenue.

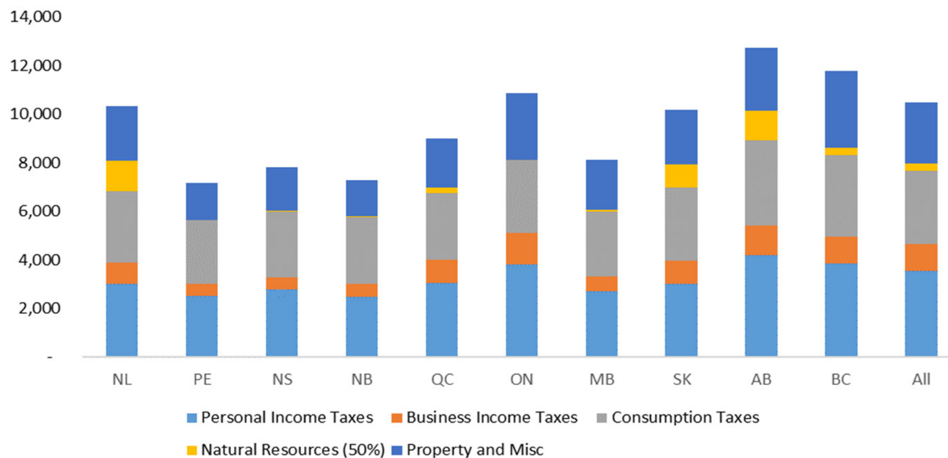
The program has existed in various forms since 1957. In 1982, the principle of Equalization was enshrined in the *Constitution Act: s. 36(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

All provinces have qualified for Equalization during the program's 65 years of existence.

## How Equalization Works

Equalization is funded by federal taxes paid by all Canadian (i.e., federal income taxes, Goods and Services Tax, and other taxes and fees).

Equalization payments are determined by a formula measuring each province's fiscal capacity and then comparing it to the national average. Provinces below the national average generally qualify for Equalization. Five major tax bases are used to determine a province's fiscal capacity: (1) consumption, (2) business income, (3) personal income, (4) property, and (5) resource revenues.




Source: Finance Canada.
Note: the chart depicts fiscal capacity as measured by the Equalization formula, including the 3-year weighted average.

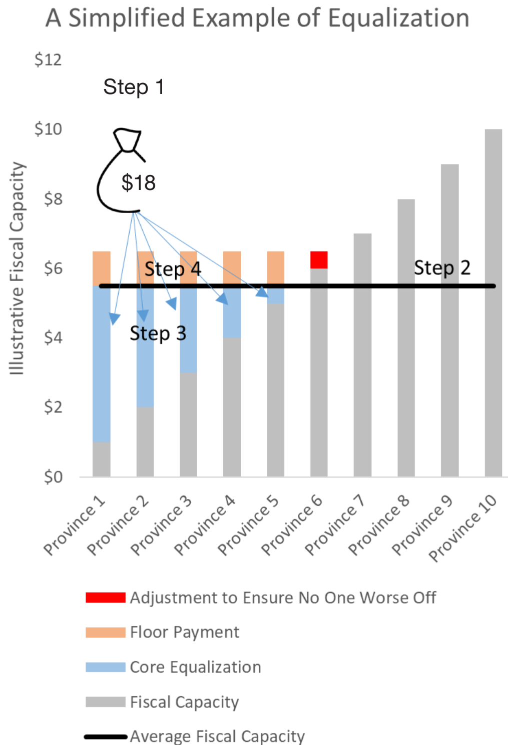
For the non-resource revenue bases, a province's fiscal capacity is measured by estimating how much revenue it would hypothetically generate if it applied the average tax rate (of all provinces) to each of its tax bases. For the resource revenue base, which includes renewable (e.g., hydro) and non-renewable (e.g. oil and gas) resources, the formula uses each province's actual resource revenues to measure fiscal capacity. Fifty per cent of resource revenues are included in the formula unless it is more beneficial to the individual province for which Equalization payments are being calculated for the inclusion rate to be zero. In that case, 0 per cent of natural resource revenues are included for all provinces when determining the Equalization entitlement for that one province.

The Equalization formula includes two adjustments:

1. The fiscal capacity cap (FCC) ensures that, after including both 100 per cent of a province's resource revenue and its Equalization payments, none of the recipient provinces have a higher fiscal capacity than any non-recipient province.
2. When the FCC is binding (i.e. when Equalization payments would give a recipient province a higher fiscal capacity (post-equalization) than a non-recipient province), the cap reduces that province's Equalization entitlement by the amount necessary to prevent such an outcome.

The GDP growth constraint ties growth of the Equalization Program to a three-year moving average of Canadian nominal GDP growth, irrespective of the calculated interprovincial fiscal disparities. Depending on fiscal disparities, the GDP growth rate rule can act either as a "ceiling" (capping) or as a "floor" (topping up) for payments calculated under the formula.

# Appendix 1a: Simplified Example of Equalization




**Step 1:** Use GDP growth constraint to calculate how much federal money will be paid through Equalization (Equalization last year x 3-year average GDP growth). In this example, we assume the federal government has a total of $18 to spend on Equalization.

**Step 2:** Calculate average fiscal capacity. In this example we assume province 1 has a fiscal capacity of $1, province 2 = $2 and so on until province 10 = $10. As such the average fiscal capacity is $5.50.

**Step 3:** Bring recipient provinces up to the average fiscal capacity. In this case, province 1 receives $4.5, province 2 = $3.5, province 3 = $2.5, province 4 = $1.5 and province 5 = $0.5. This represents $12.5 of the total $18 available in Equalization, leaving a residual of $5.5 left in the Equalization pool of funds.

**Step 4:** Distribute the residual funds (i.e., Equalization floor payments) to recipient provinces. In the illustrative example, $1 is paid to each of provinces 1 through 5 for a total of $5 in floor payments. This is represented by the orange bars in the graph.

**Step 5:** Notice however, that the five recipient provinces (Province 1 through 5) have now been made better off than Province 6 (i.e., their fiscal capacity with Equalization inclusive of the floor payments actually exceeds the fiscal capacity of province 6 – a non-recipient). As such, a $0.5 top-up payment is made to province 6 to ensure they are not made worse off than any of the recipients. The result is that a province with above average fiscal capacity pre-equalization receives Equalization. This is what happened for Ontario in 2023-24.

Note: The real Equalization formula is far more complex than the illustrative example provided above; however, the illustrative example demonstrates the main aspects of the program.

# Appendix 2: Additional Program Reform Options

Below are other options that were explored. These options, however, did not fully meet the principles outlined in this paper. A summary is below.

**1. Use current formula, but equalize to less than mean**

This option would limit the distributional changes to the program and help address the incentives problems. However, it does little to address some of the other challenges with equalization including the overly complex formula, potential to manipulate revenue bases and the lack of transparency.

**2. Adjusting for costs**

Equalization, as currently designed, only accounts for provincial revenue raising ability. It does not factor the cost of providing public services in different provinces.

Adjusting for costs is complex. There are a number of factors that will impact the cost of running programs in different provinces, such as difference in wages, cost of living, size and economies of scale, population density, etc. Moreover, each government will have a different composition of services it offers reflecting unique circumstances and policy choices. Standardizing a basket of “public services” to account for cost differences would be a challenging endeavour as the country currently has few consistent and comparable measures that exist.

For years, the federal government explored methods to incorporate fiscal need into the Equalization Program. However, as the work proceeded it became increasingly clear that expenditure need was more difficult to measure than revenue capacity. To date, no decision or method has been agreed upon.

The paper addresses potential adjustments for smaller provinces. Incorporating the differences of the cost of living is an alternative method to adjust a province’s fiscal capacity. This is a method that has been incorporated into the Finances of the Nations Equalization Simulator, which utilizes an adjustment for the price differentials of consumer goods and services among provinces.

The challenge with this spatial price index approach is that it incorporates, in some cases, a potentially biased measure of the price of goods and services to the province as a whole (e.g., assumes one municipality’s cost of living is the same for the whole jurisdiction). It is also captures the cost of consumer goods and services, which do not necessarily align with government costs. Finally, it further complicates an already complex formula by including yet another element into the calculation of a province’s eligibility for equalization payments.