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Canada's New Equalization Formula

INTRODUCTION

Equalization is a federal transfer payment program designed to smooth out the differences in revenue-generating capacity across the provinces. By compensating poorer provinces for their relatively weak tax bases or resource endowments, equalization works to ensure that all Canadians have access to a reasonably similar level of provincial government services at reasonably similar levels of taxation, regardless of where in the country they live.(1)

Equalization is financed entirely from federal government general revenues. The provinces are uninvolved in the transfer, except to the extent that they may qualify for cash payments; provincial governments do not contribute financially to equalization, and each province's ability to raise tax revenues is unaffected by the transfer.

The mechanism for determining the total value of the equalization program, as well as the amount which qualifying provinces receive, has undergone numerous changes in recent years. The most recent series of reforms occurred in 2007 when the federal government reintroduced a formula-based approach to equalization, replacing the fixed-sum program that had been in place since 2004. Today's equalization program is broadly similar to that which existed before 2004.

DISTRIBUTION OF PAYMENTS, 2008–2009

The total value of equalization payments to provinces in 2008–2009 is $13.62 billion, up 5.4% from 2007–2008. Six provinces qualify for the transfer – Manitoba, Quebec and the four Atlantic provinces. Quebec is by far the largest recipient of equalization dollars, accounting for well over half (59%) of total payments. 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 total payments has risen considerably since the new equalization formula was introduced in 2007, in large part because of changes to how the formula measures property tax revenues.

On a per capita basis, Prince Edward Island is the largest recipient of equalization, with payments of $2,310 per head in 2008–2009. Per capita payments are lowest in Newfoundland and Labrador at $313.(2) It is expected that within the next few years, Newfoundland and Labrador will no longer qualify for equalization.

HOW DOES EQUALIZATION WORK?

A. Overview

Equalization employs a mathematical formula using actual tax rates, revenues and other economic indicators to determine which provinces qualify for the transfer and the value of each qualifying province's entitlement. This means that the federal government does not directly establish the total cost or distribution of equalization in any given year, although it does have the ability to make changes to the equalization formula itself.

The basic structure of the equalization program is relatively straightforward. Equalization assesses, on a per capita basis, a province's ability to generate own-source revenues and compares that "fiscal capacity" to the average fiscal capacity for all provinces. All provincial government revenue sources, except for user fees, are lumped into one of five categories: personal income taxes; business income taxes; sales taxes; property taxes; and natural resource revenues.

With the exception of natural resource revenues, the equalization formula estimates fiscal capacity in each of the above categories by determining how much per capita revenue each province could generate if all provinces had identical tax rates. In the case of natural resource revenues, because of the wide range of resources and royalty structures across the provinces, instead of creating a national average tax rate to measure fiscal capacity, actual resource revenues are used.

To determine which provinces qualify 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 qualifies for equalization payments to make up the difference. If a province's revenue-generating ability exceeds the 10-province average, then it does not receive any equalization.

B. Other Features of Equalization

Beneath the surface of equalization, the program becomes more complex. This has been especially true since changes were made to the program in 2007.

1. Treatment of Natural Resources Revenues

Foremost among these complicating factors is the treatment of natural resource revenues. In the pre-2004 formula, 100% of resource revenues were included in equalization calculations, but Alberta's resource wealth was kept out of the standard against which equalization entitlements were determined. Since 2007, Alberta's energy wealth has been back in, and each province has had the option of receiving equalization payments based on a calculation that includes either 50% of natural resource revenues, or one which excludes those revenues entirely. Under the program as it operates today, provinces automatically receive payments each year according to whichever option yields the largest per capita entitlement.

The decision to create two parallel equalization programs for resource revenues is the result of a political compromise. On the 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.

In spite of this effort at a compromise, the treatment of resource revenues in equalization calculations remains controversial. It has created an ongoing debate between the federal government and the government of Newfoundland and Labrador over the treatment of Atlantic Accord revenues under the new program.(4)

2. The Fiscal Capacity Cap

The equalization program also includes a cap that can limit provinces' per capita entitlements. The cap, a feature of equalization since 2007, was introduced because of the impact that partially excluding natural resources can have on provincial fiscal capacities.

Since provinces are free to collect resource rents and spend the proceeds as they see fit, a province's *actual* fiscal capacity includes 100% of its resource revenues. However, only half of those revenues count towards equalization's measure of provincial fiscal capacity. The possibility therefore exists that a province could qualify for equalization, but after receiving those payments, would end up with a higher *actual* fiscal capacity (including equalization cash and 100% of resource revenues) than a province that did not qualify for the transfer.

The purpose of the equalization cap is to ensure that this scenario does not take place. Under the cap, the combination of own-source fiscal capacity (including all resource revenues) and equalization payments in any recipient province cannot exceed the fiscal capacity of the poorest non-recipient province.

3. Moving Average on Actual Payments

Equalization payments in any given year are based on a weighted three-year moving average, lagged two years. Actual payments for any one province in 2008–2009, for example, is the sum of 50% of its entitlements as calculated for the 2006–2007 fiscal year, 25% of its entitlements in 2005–2006, and 25% of its entitlements in 2004–2005.

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

CONCLUSION

Equalization is one of the federal government's most important transfer payment programs. While it has been in a continual state of evolution since its introduction in 1957, equalization has undergone dramatic changes in the last few years, affecting both the total value and the distribution of payments.

Additional changes may also be on the horizon. It has recently been announced that Ontario will qualify for equalization payments beginning in 2009–2010. Although its entitlement that year will be small – about $29 per person – it will likely rise in the years ahead; because of the lagged moving average, payments in 2009–2010 will not include the effects of high oil prices in 2007 and much of 2008.

Given Ontario's large population, higher per capita payments to the province could result in a huge increase in the total cost of the equalization program, which has already grown by 57% since 2003–2004. As such, there are indications that the federal government is considering new measures aimed at capping growth in the overall size of the transfer.

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(1) Equalization addresses fiscal disparities across the provinces. Another federal transfer program, Territorial Formula Financing, serves a similar purpose for territorial governments.

(2) Equalization payments to Nova Scotia and Newfoundland and Labrador do not include cash transferred to those provinces under their respective Atlantic Accords.

(3) Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track*, Ottawa, May 2006, http://www.eqtff-pfft.ca/english/epreports.asp. Implementing the expert panel's recommendations accounted for the vast majority of the reforms to equalization in 2007.

(4) According to Budget 2007 documents, the money received by Newfoundland and Labrador (and Nova Scotia) under the Atlantic Accord is included in the measure of total fiscal capacity, discussed in the section entitled "The Fiscal Capacity Cap." Newfoundland and Labrador objects to this arrangement because it could cause equalization entitlements to decrease and, in the provincial government's view, it contradicts the provisions of the 2005 Accord. The Accord allows the province to keep all of its offshore oil and gas revenues, with no clawback from the equalization program. The federal government has given Newfoundland and Labrador (and Nova Scotia) the option of continuing to receive payments under the 2004–2007 fixed-sum equalization program. Under that option, the Atlantic Accord payments would not be clawed back, but the equalization program itself is less generous than the current version.