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CANADA'S EQUALIZATION FORMULA

Publication No. 2008-20-E

12 September 2024

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Research and Education

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Canada's Equalization Formula
(HillStudies)

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Ce document est également publié en français.

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EXECUTIVE SUMMARY

Equalization is a federal transfer payment program designed to reduce the differences in revenue-generating capacity among Canada's 10 provinces. The program helps ensure that all Canadians have access to broadly comparable levels of public services.

The Equalization program is fully funded from the federal government's general revenues. The provinces do not contribute financially to the program, and transfers do not affect a province's ability to raise tax revenues.

To determine which provinces are entitled to Equalization payments and their amounts, the per capita fiscal capacity of each province is compared with the average fiscal capacity of all the provinces. If a province's fiscal capacity is below average, it is entitled to Equalization payments to make up the difference. However, if a province's fiscal capacity is above average, it will not receive any payments.

The mechanism used to calculate the total amount of Equalization payments has been modified many times since the program was created in 1957. The two most recent series of major reforms occurred in 2007 and 2009. In 2007, the treatment of government revenues from natural resources was changed, and a fiscal capacity cap was introduced. In 2009, the growth in the total amount of Equalization payments was limited based on the growth in Canada's nominal gross domestic product.

The Equalization program has come under criticism for various reasons. For instance, some observers argue that the program may encourage recipient provinces to make decisions that maximize their Equalization payments rather than their long-term economic growth and that decision making regarding the Equalization program is often politicized.

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 changed numerous times since the program was established. The two most recent series of major 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. Since then, the Equalization program has been renewed for five-year periods with no significant changes. Most recently through the *Budget Implementation Act, 2023, 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 2029.

2 DISTRIBUTION OF PAYMENTS IN 2024–2025

The total amount of Equalization payments in 2024–2025 is \$25.3 billion, which amounts to 4.7% of total federal expenditures.¹ At present, seven provinces are

eligible for the transfer: Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador. Quebec receives the largest Equalization payment, accounting for 52.7% of the total amount of Equalization payments in 2024–2025. Quebec’s large share of Equalization payments is mostly due to its greater population relative to other Equalization-receiving provinces. At \$3,718 per capita in 2024–2025, Prince Edward Island has the highest per capita Equalization payment; the per capita payment is lowest for Ontario, at \$38.² As Table 1 shows, Equalization payments can account for about 20% of government revenue in some provinces, including Manitoba, New Brunswick, Nova Scotia and Prince Edward Island.

Table 1 – Equalization Payments, 2024–2025

Province	\$ Millions	\$ Per Capita	% of Total Revenue
Manitoba	4,352	3,109	19.4
Ontario	576	38	0.3
Quebec	13,316	1,545	8.9
New Brunswick	2,897	3,629	21.9
Nova Scotia	3,284	3,252	20.7
Prince Edward Island	610	3,718	19.4
Newfoundland and Labrador	218	412	2.1

Sources: Table prepared by the Library of Parliament using data obtained from Government of Canada, [Major federal transfers](#); Trevor Tombe, “[Equalization Simulator](#),” Finances of the Nation Equalization Payments Simulator, Database, accessed 12 September 2024; and provincial budget documents for 2024–2025.

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).

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 provincial 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 increases in accordance with a three-year moving average rate of growth in nominal GDP.

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.

The ceiling also functions as a floor in that the total amount of Equalization payments increases with GDP, even when fiscal disparities among the provinces shrink, an event that would have reduced the total amount of Equalization payments when payments were determined by changes in fiscal disparities. When the total amount of Equalization payments determined based on fiscal disparities is below the total determined based on GDP growth, the federal government can distribute the difference on an equal per capita basis to the Equalization-receiving provinces; the resulting amounts are called adjustment payments. However, if a non-recipient province ends up with a lower per capita fiscal capacity than a recipient province after the adjustment payments are made, the non-recipient province becomes eligible for adjustment payments. That is why Ontario received Equalization payments in 2018–2019, 2023–2024 and 2024–2025.

3.2.3 The Fiscal Capacity Cap

Equalization also includes a cap that can limit eligible provinces' per capita payments. This cap was introduced in 2007 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 a recipient province's overall fiscal capacity when the population of the recipient provinces accounts for 50% or more of Canada's population. In that situation, the standard becomes the average fiscal capacity of all recipient provinces. This change was made as Ontario became a recipient province, pushing the population of the recipient provinces above 50%. Without that change, the fiscal capacity of the poorest non-recipient province would have been that of British Columbia, which was much greater. The reductions stemming from the fiscal capacity cap would therefore have been smaller and total Equalization payments higher.⁴ By instead using the average fiscal capacity of recipient provinces, which is lower than the fiscal capacity of the poorest non-recipient province, total Equalization payments are lower.

3.2.4 Weighted Moving Averages

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 fiscal capacity of a province in 2024–2025 is the sum of 50% of its fiscal capacity for 2020–2021, 25% of its fiscal capacity for 2021–2022 and 25% of its fiscal capacity for 2022–2023. A province's population for a given year is calculated in the same way.

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 CONCERNS ABOUT THE EQUALIZATION PROGRAM

The Equalization program has been criticized for multiple reasons. For instance, it has been argued that it may encourage recipient provinces to make decisions to maximize their Equalization payments rather than their long-term growth. As an example, a large recipient province may be tempted to raise its tax rate in order to raise the national average tax rate used to calculate the average fiscal capacity. As a result, that recipient province would receive a higher Equalization payment.⁵ Similarly, the Equalization program could discourage a recipient province from developing its natural resources, as the revenues it would earn would increase its fiscal capacity faster than the national average, leading to a drop in its Equalization payments.

Other observers have pointed out that the decision-making process for the Equalization program has often been politicized, partly because it is entirely under the control of the federal government, which is not required to consult the provinces. This politicization often sparks conflicts between the federal and provincial governments and could result in decisions based mainly on electoral considerations. To depoliticize Equalization, some observers have proposed assigning the program's management to a neutral, independent body akin to the Commonwealth Grants Commission, which determines how revenues from the goods and services tax are allocated among Australia's states and territories.⁶ In particular, such an entity could make recommendations to the federal government regarding payment levels and potential reforms.

Other concerns expressed about the Equalization program include its potential impact on public spending levels in the provinces, the way revenues from hydroelectric production are calculated and the need to tie the growth in Equalization payments to nominal GDP.

5 CONCLUSION

The Equalization program has been in a continual state of evolution since its introduction in 1957 and underwent relatively dramatic changes in 2007 and in 2009 that affected both the total amount of Equalization payments and their distribution across provinces. Since then, the program has been renewed a number of times with no major changes. In 2023, it was renewed for a further period of five years, ending on 31 March 2029.

NOTES

- * This publication is based on a previous Library of Parliament publication by Michael Holden.
- 1. Department of Finance Canada, "Outlook for Expenses," [Fairness for Every Generation](#), Budget 2024, p. 371.
- 2. Trevor Tombe, "[Equalization Simulator](#)," Finances of the Nation Equalization Payments Simulator, Database, accessed 12 September 2024.
- 3. Expert Panel on Equalization and Territorial Formula Financing, [Achieving a National Purpose: Putting Equalization Back on Track](#), May 2006. Implementing the Expert Panel's recommendations accounted for the vast majority of the reforms to the Equalization program in 2007.
- 4. Trevor Tombe, "[Finances of the Nation: 'Final and Unalterable' – But Up for Negotiation: Federal–Provincial Transfers in Canada](#)," *Canadian Tax Journal*, Vol. 66, No. 4, p. 899.
- 5. Ergete Ferede, "[The Incentive Effects of Equalization Grants on Fiscal Policy](#)," *The School of Public Policy: SPP Research Papers*, Vol. 7, No. 23, September 2014.
- 6. Daniel Béland et al., *Fiscal Federalism and Equalization Policy in Canada: Political and Economic Dimensions*, 2017, pp. 48–50.