2014-2015 Federal Transfers to Provinces and Territories

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The mandate of the Parliamentary Budget Officer (PBO) is to provide independent analysis to Parliament on the state of the nation's finances, the government's estimates and trends in the national economy; and upon request from a committee or parliamentarian, to estimate the financial cost of any proposal for matters over which Parliament has jurisdiction.

The Parliamentary Budget Officer was asked, under section 79.2(d) of the Parliament of Canada Act, to analyze the financial cost of the Federal support to Provinces and Territories with respect to the Canada Health Transfer, the Canada Social Transfer, the Equalization Program and Territorial Formula Financing as well as Total Transfer Protection payments for the fiscal year 2014-15.

This report responds to that request. It shows provincial and territorial entitlements for each of these programs for fiscal year 2014-15. The provincial entitlements used in this report are identical to those presented by the federal government to provinces and territories and are not calculated independently by the Parliamentary Budget Office. Instead, the report focuses mostly on how provincial and territorial entitlements with respect to each of these programs evolve between 2013-14 and 2014-15 and sheds light on the factors underlying this evolution.

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Summary

Since 1983-84, transfers to provincial and territorial governments have represented an average of 22 per cent of the federal government's program spending.

At the request of a parliamentarian, this report analyzes provincial and territorial entitlements with respect to the Canada Health Transfer, the Canada Social Transfer, Equalization and Territorial Formula Financing and Total Transfer Protection for the fiscal year 2014-15, comparing them with 2013-14 levels. The report pays special attention to the Equalization program.

Canada Health Transfer

The Canada Health Transfer (CHT) is the primary federal contribution to health care in Canada. Between 2013-14 and 2014-15, aggregate cash transfers to the provinces and territories will increase by 6 per cent, as per the legislated escalator.

However, 2014-15 is the first year in which CHT cash is distributed on an *equal per capita basis* to all provinces, even though that program design change had been announced in Budget 2007.

As a result, Alberta and Northwest Territories experience substantial growth in their CHT entitlements (37.8 per cent and 45.2 per cent respectively), while most other provinces and territories experience increases of less than 4 per cent.

Canada Social Transfer

The Canada Social Transfer (CST) is a transfer to provinces in support of social services and has been distributed on an equal per capita cash basis since 2007-08. As per the legislated escalator, aggregate cash transfer will increase by 3 per cent in 2014-15.

As Canada's population is expected to increase by 1.2 per cent during that year, *per capita* entitlements will rise by 1.8 per cent. Differentials in aggregate entitlements reflect differences in provincial and territorial population growth. The fastest growth is anticipated in Alberta at 5.3 per cent, and the slowest in Nova Scotia, at 1.4 per cent.

Equalization and Territorial Formula Financing

With respect to Equalization and Territorial Formula Financing, aggregate federal transfers are estimated to increase 3.5 per cent in 2014-15. Quebec, New Brunswick and Nova Scotia will incur double-digit increases in their entitlements; Ontario will experience a significant decline of $1.2 billion or 37.3%.

These entitlements are the result of a three-step process. First, initial provincial entitlements are calculated using a metric-based formula introduced in Budget 2007. Then, a Fiscal Capacity Cap (FCC) aimed at ensuring fairness in the Equalization program is applied.

Finally, entitlements are adjusted to ensure that growth in the overall Equalization envelope does not exceed growth in nominal GDP. This growth cap, introduced in Budget 2009, was implemented essentially to lower the federal government's financial exposure to the Equalization program.

The combination of the FCC and the growth restriction on the overall Equalization envelope will reduce federal transfers to the provinces by $2.4 billion for 2014-15. Quebec, the province most affected by the FCC, will lose $686.5 million. Ontario loses $668.9 million because of the growth restriction on the overall Equalization envelope.

Total Transfer Protection

In 2010-11, the federal government announced that it would provide total transfer protection (TTP) to provinces to ensure that no province receives less in a given fiscal year in combined Equalization, CHT, CST and TTP payments than it received in the previous fiscal year.

TTP payments are made at the discretion of the Minister of Finance, who chose to stop them in 2014-15. This results in foregone revenue of $640 million for Ontario, which would have been the sole benefactor of such payments in 2014-15.

Equalization Program

Further looking at Equalization, two specific design features of the current Equalization program warrant the attention of parliamentarians so they fully understand how provincial entitlements evolve through time.

First, Equalization entitlements are calculated by comparing a province's situation relative to a national average. Any province's policy decision that affects the national average can adversely affect other provinces' entitlements. However, this negative externality is compounded by the growth cap on the overall Equalization envelope.

Second, the Fiscal Capacity Cap, whose purpose is to ensure fairness to the Equalization program, might actually not be fair to Manitoba, Nova Scotia and Quebec, which are resource-richer than the average of Equalization-receiving provinces.

1 Introduction

The legislative mandate of the Parliamentary Budget Officer (PBO) includes providing independent analysis on the state of the nation's finances.[1] Consistent with this mandate and at the request of a parliamentarian, this report analyzes the evolution of the federal government's support to provinces and territories between the fiscal years 2013-14 and 2014-15.

In particular, it discusses the Canada Health Transfer (CHT), the Canada Social Transfer (CST), Equalization and Territorial Formula Financing (TFF) and Total Transfer Protection (section 2). Finally, it analyzes two specific design features of the current Equalization program that warrant the attention of parliamentarians so they fully understand how provincial entitlements evolve through time (section 3).

2 Major transfer to provinces and territories

Federal support to provincial and territorial governments represents a significant portion of the federal government's program spending. Since 1983-84, transfers to other levels of governments have represented an average of 22 per cent of federal program spending.[2]

Each of these transfers helps provinces and territories provide various programs and services to their respective population. This section looks at each major transfer.

2.1 Canada Health Transfer

The Canada Health Transfer is the primary federal contribution to health care in Canada and supports the principles of the *Canada Health Act*. The CHT is the largest major transfer to provinces.[3] For 2014-15, the CHT cash transfer will amount to $32.1 billion and represent nearly half of all federal support to provinces.

Table 2-1 provides provincial CHT cash entitlements for 2013-14 and 2014-15.

Table 2-1

Provincial CHT cash entitlements, millions of dollars

	2013-2014	2014-2015	% Change
NL	489.7	489.7	0.0%
PEI	128.0	131.2	2.5%
NS	829.9	846.8	2.0%
NB	666.6	682.4	2.4%
QC	7183.8	7426.7	3.4%
ON	11925.1	12334.9	3.4%
MB	1114.4	1156.3	3.8%
SK	976.6	1019.3	4.4%
AL	2722.9	3750.9	37.8%
BC	4154.4	4169.5	0.4%
YT	31.0	33.4	7.7%
NT	27.0	39.2	45.2%
NU	33.7	33.7	0.0%
Canada	30283.1	32114.0	6.0%

Sources: Finance Canada, PBO calculations.

Overall CHT cash entitlement will increase by 6.0 per cent between 2013-14 and 2014-15, as legislated in the *Federal-Provincial Fiscal Arrangements Act*.[4]

However, while Alberta and the Northwest Territories will experience substantial growth in their CHT entitlements (37.8 per cent and 45.2 per cent respectively), most other provinces will receive increases of less than 4 per cent.

The main reason for provincial disparity in CHT cash entitlement growth is a program design change announced in Budget 2007 and reaffirmed in December 2011. Under this change, CHT cash allocation would be distributed on an equal *per capita* basis to all provinces starting with 2014-15.

[1] *Parliament of Canada Act* (2007)
[2] Department of Finance, *Fiscal Reference Tables*, p.15. PBO calculations.
[3] When discussing the CHT and CST, the term "province" includes both provinces and territories, which is consistent with the definition that applies within legislation relevant to the CHT, through Part V.1

[4] See section 24.1(a)(iv) of the *Federal-Provincial Fiscal Arrangements Act*.

Previously, it was the combination of both cash and tax point transfers that were distributed on an equal per capita basis. This usually led equalization-receiving provinces to receive larger per capita cash transfers than other provinces and territories (Box 2-1).[5] Table 2-2 shows provincial and territorial *per capita* cash entitlements for 2013-14 and 2014-15.

Table 2-2

Per Capita Provincial CHT cash entitlements, dollars

	2013-2014	2014-2015	% Change
NL	929.53	928.27	-0.1%
PEI	881.81	903.58	2.5%
NS	881.81	903.58	2.5%
NB	881.81	903.58	2.5%
QC	881.81	903.58	2.5%
ON	881.81	903.58	2.5%
MB	881.81	903.58	2.5%
SK	882.53	903.58	2.4%
AL	678.66	903.58	33.1%
BC	907.65	903.58	-0.4%
YT	848.74	903.58	6.5%
NT	621.18	903.58	45.5%
NU	950.86	928.52	-2.3%
Canada	862.42	903.97	4.8%

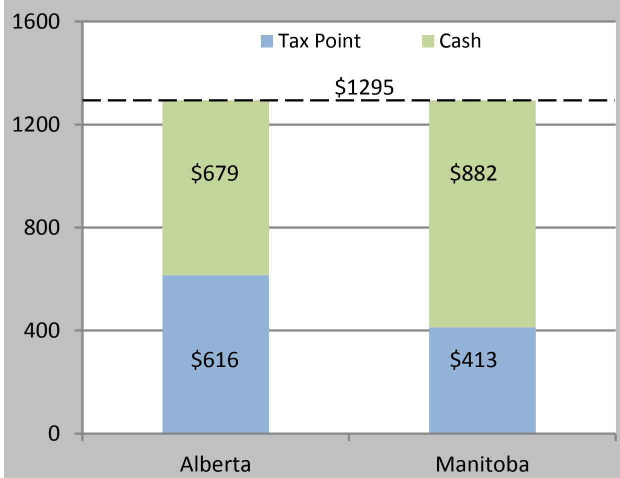
Sources: Finance Canada, PBO calculations.

Under the previous CHT regime, Alberta and the Northwest Territories received noticeably less CHT cash transfers than other provinces because of their strong personal and corporate income tax bases.[6]

Box 2-1: Calculation of CHT cash entitlement under prior CHT regime.

Prior to the CHT *cash* allocation being distributed on an equal per capita basis, it was the sum of equalized tax point transfers and the CHT cash envelope that was distributed on an equal per capita basis.

Because the value of tax point transfer in equalization-receiving provinces was lower than in wealthier provinces, this typically led them to receive more CHT cash entitlement. This is illustrated in figure 2-1 using 2013-14 data for Alberta and Manitoba.



With the new distribution regime, Alberta and the Northwest Territories experience the sharp increases in their CHT cash entitlements for 2014-15 compared with the previous year. However, because the aggregate CHT cash envelope is closed, higher per capita transfers to Alberta and the Northwest Territories mean less money available to other provinces. This explains the smaller increase in most other provinces.

[5] In fact, budget 2009 announced that starting with 2009-10, all Equalization-receiving provinces would receive the same per capita CHT cash entitlement.

[6] It is interesting to note from table 2-2 that 2013-14 was an odd year, in that 3 of the 4 non-equalization receiving provinces, namely NewFoundland and Labrador, Saskatchewan and British-Columbia, received more per capita CHT cash allocation than equalization-receiving provinces. This happened because the value of their respective tax point transfers used in the calculation of CHT was below the national average.

Per capita entitlements for Newfoundland and Labrador and Nunavut are higher than other provinces. This is because they received CHT transfer protection payments which guarantee that, starting with 2014-15, no province receives lower CHT cash transfers than their 2013-14 entitlement.[7]

2.2 Canada Social Transfer

The Canada Social Transfer is a transfer to provinces in support of social services, early childhood development and post-secondary education. The CST has been distributed on an equal per capita cash basis since 2007-08. Table 2-3 provides overall provincial entitlements for 2013-14 and 2014-15.

Table 2-3

Provincial and Territorial CST cash entitlements, millions of dollars

	2013-2014	2014-2015	% Change
NL	183.3	186.8	1.9%
PEI	50.5	51.4	1.9%
NS	327.4	331.9	1.4%
NB	263.0	267.5	1.7%
QC	2834.0	2910.9	2.7%
ON	4704.4	4834.7	2.8%
MB	439.6	453.2	3.1%
SK	384.9	399.5	3.8%
AL	1395.7	1470.2	5.3%
BC	1592.3	1634.3	2.6%
YT	12.7	13.1	3.0%
NT	15.1	15.4	1.6%
NU	12.3	12.9	4.3%
Canada	12215.3	12581.7	3.0%

Sources: Finance Canada, PBO calculations.

As legislated in the *Federal-Provincial Fiscal Arrangements Act*,[8] aggregate CST cash entitlements will increase 3.0 per cent between 2013-14 and 2014-15. Each province will receive $354 per capita, up 1.8 per cent from the 2013-14 entitlement of $348. Since growth in per capita entitlement is identical for all provinces, differences in overall provincial growth rates essentially capture differences in provincial population growth. The fastest growth is anticipated in Alberta at 5.3 per cent, and the slowest in Nova Scotia, at 1.4 per cent.

2.3 Equalization and Territorial Formula Financing

Equalization and Territorial Formula Financing are the programs that put into operation the Canadian constitutional principle that all Canadians should be provided with reasonably comparable levels of public services at reasonably comparable levels of taxation.[9,10]

These programs are entirely managed and financed by the Government of Canada from federal revenues. They are typically subject to a technical review every five years, in collaboration with provincial and territorial administrations. The fiscal year 2014-15 marks the first year of the current five-year period. The current legislation expires at the end March 2019.

Table 2-4 shows aggregate provincial and territorial entitlements for 2013-14 and 2014-15. Table 2-5 shows provincial and territorial per capita entitlements for the same years.

[7] See section 24.701(1.1) of the *Federal-Provincial Fiscal Arrangements Act*.

[8] See section 24.4(1)(a)(vii) of the *Federal-Provincial Fiscal Arrangements Act*.

[9] See section 36.(2) of the *Constitution Act, 1982*.

[10] This section only discusses the Equalization program. Territorial government entitlements are based on the Territorial Formula Financing, for which the operation is quite distinct from the Equalization formula financing. TFF amounts are only presented for the sake of completeness.

Table 2-4

Equalization and Territorial Formula Financing entitlements, millions of dollars

	2013-2014	2014-2015	% Change
NL	0.0	0.0	-
PEI	339.5	359.8	6.0%
NS	1457.9	1619.5	11.1%
NB	1513.1	1666.0	10.1%
QC	7833.0	9285.7	18.5%
ON	3169.4	1988.4	-37.3%
MB	1792.3	1749.9	-2.4%
SK	0.0	0.0	-
AL	0.0	0.0	-
BC	0.0	0.0	-
YT	816.6	851.3	4.2%
NT	1121.2	1208.8	7.8%
NU	1350.4	1409.1	4.3%

Sources: Finance Canada, PBO calculations.

Table 2-5

Equalization and Territorial Formula Financing per capita entitlements, dollars

	2013-2014	2014-2015	% Change
NL	0.0	0.0	-
PEI	2339.3	2477.6	5.9%
NS	1549.2	1728.1	11.5%
NB	2001.4	2205.8	10.2%
QC	961.5	1129.7	17.5%
ON	234.4	145.7	-37.8%
MB	1418.2	1367.4	-3.6%
SK	0.0	0.0	-
AL	0.0	0.0	-
BC	0.0	0.0	-
YT	22369.6	23052.7	3.1%
NT	25803.6	27878.5	8.0%
NU	38074.6	38797.0	1.9%

Sources: Finance Canada, PBO calculations.

The formula used to calculate entitlements for 2014-15 onward is slightly different than the one used previously as a result of the five-year review. Differences, which are technical in nature, were announced to provincial and territorial ministers of finance on December 17, 2012.[11]

Discussions with Finance Canada suggest that the technical amendments introduced in 2014-15 had an impact of $15 per capita at most, depending on each province's particular situation.

Notable from tables 2-4 and 2-5 is the large decline in entitlements in Ontario and the relatively large increases in Quebec, Nova Scotia and New Brunswick.

To fully appreciate the evolution of provincial equalization entitlements, it is worth following the process used to calculate them. This is done in three steps. First, initial entitlements are calculated using a metric-based formula. This step uses data for 2010-11 (weight of 25 per cent), 2011-12 (25 per cent) and 2012-13 (50 per cent). Then, a Fiscal Capacity Cap (FCC) intended to ensure fairness in the Equalization program is applied. Finally, entitlements are adjusted to ensure that growth in the overall Equalization envelope does not exceed that of nominal gross domestic product.

Table 2-6 shows provincial entitlements for 2014-15 from the application of all three steps. The numbers under column (3) are identical to those presented in table 2-4. The following subsections look at each step in turn.

[11] Department of Finance News Release 2012-166, accessed March 18, 2014.

Table 2-6

Equalization Entitlements, 2014-2015 millions of dollars

	Initial (1)	FCC (2)	Growth (3)	Δ (2)-(1)	Δ (3)-(2)
NL	463.7	0.0	0.0	-463.7	0.0
PEI	367.1	367.1	359.8	0.0	-7.2
NS	1,740.6	1,667.0	1,619.5	-73.7	-47.5
NB	1,704.0	1,704.0	1,666.0	0.0	-38.0
QC	10,375.7	9,689.2	9,285.7	-686.5	-403.6
ON	2,657.4	2,657.4	1,988.4	0.0	-668.9
MB	1,833.7	1,812.2	1,749.9	-21.5	-62.3
SK	0.0	0.0	0.0	0.0	0.0
AL	0.0	0.0	0.0	0.0	0.0
BC	0.0	0.0	0.0	0.0	0.0
Canada	19,142.2	17,896.8	16,669.3	-1,245.4	-1,227.6

Sources: Finance Canada, PBO calculations.

2.3.1 Formula-based entitlements

The first step consists of calculating provincial entitlements using a metric-based formula introduced in Budget 2007[12] and recommended by the independent Expert Panel on Equalization and Territorial Formula Financing in their final report.[13,14]

Specifically, each province's measured per capita fiscal capacity is compared to a national average. Provinces with fiscal capacity below the national average receive a per capita entitlement that raises them to the national average. Provinces with above average fiscal capacity are not penalized. Two sets of calculations are produced: 1) equalization entitlements when provincial fiscal capacities exclude natural resource revenues; and 2) equalization entitlements when provincial fiscal capacities include 50 per cent of natural resource revenues. A province's initial equalization entitlement corresponds to the larger of the two amounts calculated.

It is interesting to note that as a result of the first step, Newfoundland and Labrador would be entitled to an equalization payment of $463.7 million. This arises because the province has a weaker than average non-resources fiscal capacity, but a much larger than average natural resources fiscal capacity.[15] Therefore, while its per capita fiscal capacity is above the national average when 50 per cent of natural resources revenues are included, it is below the national average when resources revenues are excluded altogether.

For Ontario, entitlements resulting from the first step are 21 per cent lower in 2014 than in 2013 ($2,657.4 million in 2014, down from $3,373.6 million in 2013). This reflects the fact that Ontario experienced strong growth in its measured per capita fiscal capacity relative to other equalization-receiving provinces.

2.3.2 Fiscal Capacity Cap

The Fiscal Capacity Cap (FCC) is a measure introduced in Budget 2007, along with the new equalization formula. It is purported to ensure fairness in the Equalization program. Specifically, its aim is to ensure that an equalization-receiving province is not better off, after equalization payments are taken into account, than a non-receiving province.

This situation can happen because excluding 50 per cent of natural resource revenues lowers a province's *measured* fiscal capacity and leads to higher Equalization payments. However, a province's *actual* revenue generating capacity includes 100 per cent of natural resource revenues (see box 2-2).[16]

The measure of the FCC depends on the share of the population receiving Equalization payments (see box 2-3). Currently, the FCC is defined as the average

[12] Budget 2007, Annex 4, *Restoring Fiscal Balance for a Stronger Federation*.

[13] Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization back on Track*, May 2006.

[14] Since 2007, the formula has experienced technical changes that reflect better data and provincial taxation behavior. The underlying principles, however, remain unchanged.

[15] In fact, data from Finance Canada show that Newfoundland and Labrador has the highest per capita natural resources fiscal capacity in Canada, at $4,890. Saskatchewan comes a distant second at $2,516.

[16] Budget 2007, Annex 4, *Restoring Fiscal Balance for a Stronger Federation*, p.341.

total post-equalization per capita fiscal capacity of all equalization-receiving provinces. This means that the total post-equalization per capita fiscal capacity of a receiving province cannot exceed the average of receiving provinces.

Box 2-2: Measuring fiscal capacity

To calculate equalization entitlements, the federal government compares a measure of per capita fiscal capacity to a national standard.

For implementation of the FCC, it uses a different measure, called *total post-equalization per capita fiscal capacity,* which better captures the actual revenues a province collects. This difference is illustrated below:

Fiscal Capacity for Equalization	Fiscal Capacity for FCC *
Non-resources fiscal capacity	Non-resources fiscal capacity
+ 50 per cent resources capacity	+ 100 per cent resources capacity
	+ Pre-FCC equalization entitlement

* In the case of Nova Scotia, the FCC measure also includes Offshore Accounts offset payments, which are not discussed in this report.

The current measure of the FCC affects provinces that have natural resources fiscal capacities above the average of receiving provinces, on a per capita basis. These include Newfoundland and Labrador, Quebec, Nova Scotia and Manitoba.

Implementation of the FCC brings Newfoundland and Labrador's entitlement to zero. Also seeing their equalization entitlements reduced by the FCC are Quebec (-$86 per capita), Nova Scotia (-$78 per capita) and Manitoba (-$17 per capita).

2.3.3 Growth Cap on overall envelope

Starting with 2009-10, the federal government announced it would link the growth of the overall Equalization envelope to that of gross domestic product (GDP).[17] In essence, this measure reduces the federal government's financial risk with respect to the Equalization program.

The growth path for the overall Equalization envelope is based on a three-year moving average of nominal gross domestic product (GDP). The growth rate that applies to the overall envelope for 2014-15 uses nominal GDP growth rate for years 2012, 2013 and 2014.

Box 2-3: Does the Fiscal Capacity Cap ensure fairness?

The FCC depends on the share of the population that receives equalization payments.[18]

When equalization-receiving provinces represent less than 50 per cent of the Canadian population, the FCC is determined by the total post-equalization per capita fiscal capacity of the lowest non-receiving province, in recent years Ontario. This was the measure initially introduced in Budget 2007.

When equalization-receiving provinces represent more than 50 per cent of the Canadian population, as is currently the case, the FCC is determined as the average total post-equalization per capita fiscal capacity of all equalization-receiving provinces. The change in measure was announced in 2008[19] and was justified as follow:

"Up to now, the fiscal capacity of the lowest non-receiving province has been used as the measure to ensure fairness and provide equity and stability. With Ontario entering the Equalization program for the first time in 2009–10, a new benchmark is required to both ensure fairness and ensure that provinces continue to receive a meaningful net fiscal benefit from resources. This would be set at the average post-Equalization fiscal capacity of the Equalization-receiving provinces. This will ensure that Equalization-receiving provinces continue to benefit from their resource revenues".

The growth factor determined by Finance Canada for 2014-15 is 3.5 per cent. This constrains the overall Equalization envelope at $16.7 billion.[20] As shown in Table 2-6, provincial entitlements following the

[17] Finance Canada November 3, 2008 news release 2008-085. *Canada's Finance Ministers Meet to Discuss Global Financial Crisis.* Accessed May 29 2014.

[18] See section 3.4 of the *Federal-Provincial Fiscal Arrangements Act*.

[19] Department of Finance Canada, Protecting Canada's Future, November 2008 federal Economic and Fiscal Statement, page 57.

[20] The overall Equalization envelope for 2013-14 was $16.105 billion. The overall envelope for 2014-15 is thus $16.105*1.0350 = $16.669 billion.

application of the FCC were still at $17.9 billion, some $1.3 billion above the legislated envelope (see Box 2-4).

To ensure that the envelope constraint is respected, the federal government further applied a $50 per capita reduction to provincial entitlements.

Table 2-6 shows that Ontario is most affected by the growth cap. It reduces Ontario's provincial entitlement by $668.9 million, or about 25 per cent of what it would have received without this cap. All other equalization-receiving provinces see their entitlement reduced by less than 5 per cent of their pre-growth cap amount.

2.4 Total Transfer Protection

Starting with 2010-11, the federal government announced that it would provide Total Transfer Protection (TTP) to provinces "in recognition of the short-term challenges they face as they emerge from the recession."[21] TTP compensation is paid at the discretion of the Minister of Finance.

TTP's purpose is to ensure that no province receives less in a given fiscal year in combined Equalization, CHT, CST and prior year TTP payments than it received in the previous fiscal year.

Between 2010-11 and 2013-14, the federal government paid a total of $2.21 billion to the four Atlantic Provinces, Quebec, Manitoba and Saskatchewan. In 2014-15, the government opted to put an end to TTP payments.

This decision negatively affects Ontario, which would have been the sole benefactor of such payments in 2014-15. Had TTP payments been extended, Ontario would have received an additional $640 million in transfer payments from the federal government.

Box 2-4: Growth Cap: ceiling or floor?

A basic principle of the Equalization program is that overall Equalization increases with the degree of fiscal disparity between provinces.

The growth escalator on the overall Equalization envelope can thus represent a ceiling on Equalization payments if aggregate provincial entitlements resulting from the first step and the FCC are higher than the amount eligible for Equalization payments once the growth factor is considered. This is the case most likely to apply in coming years.

However, fiscal disparities could decrease to the point where provincial entitlements resulting from the first step and the FCC would be lower than the amount eligible for Equalization payments once the growth factor is considered.

In that case, the Minister of Finance could elect to increase payments to provinces[22] so that the entire Equalization envelope is spent. In such an instance, the growth escalator would act as a floor on Equalization.

It is worth mentioning that the existence of a fixed envelope for Equalization was one important critique of the Equalization program in existence prior to the 2007 reform.

3 Design of the Equalization program

Since its inception, the Equalization program has undergone many changes. The metric-based formula introduced with Budget 2007 and the Budget 2009 amendments represent the latest major reformulation of the program.

The current design of the program has some intricacies that are worth bearing in mind when analyzing provincial entitlements and the incentives it gives to provinces. This section sheds light on two important ones.

[21] Finance Canada December 18, 2009 News Release 2009-119, *Government of Canada Support to Provinces and Territories at an All-Time High.* Accessed on May 26, 2014.

[22] See section 3.4 (8) of the *Federal-Provincial Fiscal Arrangements Act.*

3.1 "Beggar-thy-neighbour" effect

The Equalization program operates by comparing provincial per capita fiscal capacities relative to a national average. Consequently, it creates a "negative externality" effect whereby one province's policy decisions can affect the equalization entitlement of other provinces. This is particularly true for populous provinces, which bear significant weight on the national average. This negative externality is further amplified by the growth cap imposed since 2009 on the overall Equalization envelope because with a closed envelope, any increase in one province's entitlement must be financed by lowering other provinces' payments

The case of Quebec and Ontario in 2014-15 illustrates this involuntary "beggar-thy-neighbour" effect. As seen in table 2-5, Ontario's per capita entitlement fell by $89 or 37.8 per cent relative to its previous year entitlement, while Quebec's entitlement rose by $168 per capita or 17.5 per cent. Ontario's reduction partly reflects higher than average growth in its non-resources fiscal capacity.

However, it is also influenced by the decision of Hydro-Quebec to shut down instead of refurbishing the Gentilly-2 nuclear power plant in 2012. This closure is the result of a business decision and does not reflect the strength of the fiscal base of Quebec or Ontario. Nevertheless, it still results in a reduction of $298 million in transfers to Ontario.[23]

Using the three-step procedure, it is possible to illustrate the impact of the Gentilly-2 closure on Ontario's entitlement.

The closure of Gentilly-2 in 2012 led to a one-time reduction of $1.88 billion in Hydro-Quebec's profits for that year.[24] Given that Hydro-Quebec legislation stipulates that 75 per cent of the Company's net profits must be distributed to the Quebec government as a dividend,[25] this led to a one-time reduction of $1.41 billion in the dividend paid to the provincial government. This, in turn, weakened Quebec's measured natural resources fiscal capacity by 45 per cent for 2012-13, which lowered the national standard for equalization.

Table 3-1 illustrates the relative change in the first step of equalization entitlement calculations between 2013-14 and 2014-15 for Quebec and Ontario. For each province, the line *w/o Gentilly-2 closure* shows the first step entitlement when the impact of the closure of Gentilly-2 is removed from calculations. This essentially captures the effect of the change in the relative strength of their fiscal base.

The second line shows the change when the closure is considered, as is done in actual calculations. The third line shows the marginal impact of the closure of the nuclear power plant on each province's per capita entitlement.

Table 3-1

Change in equalization entitlement, first step calculations, dollars per capita

	Ontario		
	13-14	**14-15**	**Δ**
w/o Gentilly-2 closure	255	210	-45
Actual calculation	255	200	-55
Impact			-10
	Quebec		
	13-14	**14-15**	**Δ**
w/o Gentilly-2 closure	1122	1261	139
Actual calculation	1122	1294	173
Impact			34

Sources: Finance Canada, PBO calculations.

From the table, it can be seen that Ontario's per capita entitlement declined by $55 for 2014-15, $45 or 82 per cent of which is related directly to the relative strength of the Ontario economy. About $10

[23] The 2014 Ontario budget, tabled on May 1st 2014, states that the closure of Gentilly-2 cost Ontario $300 million. See the May 2014 Ontario budget, p.281.

[24] Hydro-Quebec 2012 annual report, p.3.

[25] Hydro-Quebec legislation stipulates that the dividend is equal, subject to some provisions, to 75% of the Company's net profit. Hydro-Québec Act, section 15.2

or 18 per cent is related to the "negative externality" effect embedded in the Equalization formula.

For Quebec, the relative weakness of its fiscal base leads to an increase in its Equalization per capita entitlement of $139, while the closure of Gentilly-2 added an additional $34.

Ontario and Quebec being populous provinces, the impact of the closure at the aggregate level is important. Given its population, the direct impact of the Gentilly-2 closure on Ontario's entitlement is a decline of $136.3 million, while Quebec gains an additional $270 million.

The largest impact of the Gentilly-2 closure on Ontario's entitlement, however, does not come from the direct impact as calculated in the first step, but from the application of the growth cap on the overall envelope. This is illustrated in table 3-2.

Table 3-2

Per capita reduction in equalization entitlement to respect Equalization envelope, dollars

	All receiving provinces		
	13-14	**14-15**	**Δ**
w/o Gentilly-2 closure	-15	-38	-23
Actual calculation	-15	-50	-35
Impact			-12

Sources: Finance Canada, PBO calculations.

The table shows that for the overall Equalization envelope to respect the constraint imposed by the growth cap, per capita entitlement of each receiving province had to be reduced by $15 in 2013-14 and $50 in 2014-15. Of this $50, $12 can be linked directly to the closure of Gentilly-2.

For Ontario, this represents a further decline of $161.7 million relative to the no-closure situation. This happens because the power plant closure makes interprovincial fiscal disparities increase "artificially" more. Given the cap on the overall envelope, the ensuing increase in Quebec's entitlement must be "financed" by a reduction in other provinces' entitlement.

3.2 Fairness of the FCC

When first introduced in Budget 2007, the Fiscal Capacity Cap was described as a measure that ensured fairness of the Equalization program.

Initially, the FCC ensured that the per capita *total post-equalization fiscal capacity* of an equalization-receiving province did not exceed that of a non-receiving province.

While fairness is a subjective concept, there seemed to be general agreement that the tax dollars of a non-receiving province should not be used to fund equalization payments to provinces that would end up in a financial situation better off than their own.

With Ontario becoming an equalization-receiving province in 2009-10, the FCC was redefined from being the per capita total post-equalization fiscal capacity of the lowest non-receiving province. Instead, the FCC became the average per capita total post-equalization fiscal capacity of equalization-receiving provinces.

This change left the level of the cap relatively unaltered. However, it created a differential in treatment between equalization-receiving provinces that have a relatively strong natural resources fiscal capacity (Quebec, Nova Scotia and Manitoba) and those that do not (New Brunswick, Ontario and Prince Edward Island).

To understand this differential in treatment, it is worth remembering that with an inclusion rate of 50 per cent for natural resource revenues, every new dollar of natural resource revenues raised by an equalization-receiving province will be accompanied by a reduction in equalization payments as a result of applying the metric-based formula in the first step of calculating provincial entitlements. For 2014-15, this reduction is about 50 cents for New Brunswick, Nova Scotia, Manitoba and Prince Edward Island. The reduction in Quebec (38 cents) and Ontario (31 cents) are lower because, being populous provinces, increased resource revenues pushes up the national standard. Equalization-receiving provinces thus get a net benefit from further developing their natural resources.

However, under the current FCC, Quebec, Nova Scotia and Manitoba, which have per capita natural resource revenues above the average of equalization-receiving provinces, experience a further claw back of their equalization entitlement as a result of applying the FCC. This additional claw back is not experienced by New Brunswick, Ontario and Prince Edward Island. This is illustrated with a numerical example in Annex A.

Thus, some equalization-receiving provinces receive a lower net benefit from developing their natural resources than other receiving provinces, even though none of them is better off, on a per capita basis, than any non-receiving province. This differential in treatment might be deemed “unfair” by the relatively resource-rich provinces. Under the original FCC, all equalization-receiving provinces would benefit equally from further exploiting their natural resources.

Annex A
Fiscal Capacity Cap and Unequal Treatment: an example

Using data for New Brunswick and Manitoba for 2014-15, this annex provides a numerical example showing that under the current FCC, a relatively resource poor equalization-receiving province (New Brunswick) reaps a larger net benefit from natural resources development than a relatively resource rich one (Manitoba).

It is first important to remember that the Equalization program aims to bring equalization-receiving provinces to a national standard of per capita fiscal capacity. For 2014-15, this national standard is estimated at $7,900 and is used to calculate provincial entitlements in the first step of the three-step approach.

This can be seen in table A-1.

Table A-1

Post-equalization per capita fiscal capacity, FCC is the average of equalization receiving provinces

	New Brunswick		Manitoba	
	Aggregate	Per Capita Fiscal Capacity	Aggregate	Per Capita Fiscal Capacity
First Step	1,703,975	7,900	1,833,746	7,900
FCC	1,703,975	7,900	1,812,207	7,882

Sources: Finance Canada, PBO calculations.

Under each province, the column *Aggregate* shows the aggregate entitlement of each province (in thousands of dollars) after the first two steps of the calculations. The column *Per Capita Fiscal Capacity* is the provincial per capita fiscal capacity (in dollars) as defined by the equalization program (see Box 2-2).

Table A-1 shows that if New Brunswick and Manitoba were paid the entitlement calculated by the basic equalization formula (first step), they would both have a per capita fiscal capacity equal to the national standard. Applying the current FCC lowers the per capita fiscal capacity of Manitoba while leaving that of New Brunswick unchanged, despite both of them having per capita fiscal capacity initially below the national standard.

Importantly, Manitoba is not better off, after equalization, than the lowest non-receiving province, which in 2014-15 is British Columbia (data not shown). In a sense, Manitoba is penalized relative to New Brunswick because the composition of its revenues is tilted more towards natural resources.

Now, consider what happens if New Brunswick experienced an increase of 10 per cent or $8.3 million in its natural resources fiscal capacity, assuming everything else remained constant at their 2014-15 level. This would have left the national standard essentially unchanged at $7,900.

Table A-2 shows the ensuing equalization entitlements of New Brunswick and Manitoba.

Table A-2

Per capita fiscal capacity, New Brunswick natural resources fiscal capacity 10 per cent higher

	New Brunswick		Manitoba	
	Aggregate	Per Capita Fiscal Capacity	Aggregate	Per Capita Fiscal Capacity
First Step	1,699,919	7,900	1,833,895	7,900
FCC	1,699,919	7,900	1,812,567	7,883

Sources: Finance Canada, PBO calculations.

The table shows that under this scenario, New Brunswick would receive less aggregate equalization entitlement, as a result of higher natural resources revenues. Since the Equalization formula includes only 50 per cent on natural resources revenues, New Brunswick loses about half of the increase in natural resources through lower Equalization payments. However, its per capita fiscal capacity following the application of the FCC remains unchanged relative to the base case scenario illustrated in Table A-1 because it remains an equalization-receiving province.

Table A-3 shows equalization entitlements of New Brunswick and Manitoba under an alternative scenario where it is Manitoba experiencing a 10 per cent increase ($20 million) in resources fiscal capacity.

Again, this leaves the national standard essentially unchanged at $7,900. As with New Brunswick, Manitoba's equalization entitlement declines by about half of the increase in its natural resources revenues.

However, application of the FCC lowers its per capita fiscal capacity by an additional $7 per capita relative to the base case illustrated in table A-1.

Table A-3

Per capita fiscal capacity, Manitoba natural resources fiscal capacity 10 per cent higher.

	New Brunswick		**Manitoba**	
	Aggregate	Per Capita Fiscal Capacity	Aggregate	Per Capita Fiscal Capacity
First Step	1,704,196	7,900	1,824,092	7,900
FCC	1,704,196	7,900	1,793,047	7,875

Sources: Finance Canada, PBO calculations.

This additional reduction lowers Manitoba's net benefit of further resources development relative to New Brunswick's, even though both provinces are equalization-receiving and remain no better off than the lowest non-receiving province. This illustrates the differential in treatment.