



TREVOR TOMBE

REBALANCING CANADA

A two-pillar reform of equalization and federal transfers

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Executive summary | *sommaire*

Federal-provincial transfers are among the most important – and politically contested – features of Canadian public finance, yet they remain among the least understood.

Based on the principle that Canadians, regardless of where they live, should have reasonably comparable access to public services at reasonably comparable levels of taxation, the equalization system serves a core stabilizing role in Canada’s decentralized federation. It is, in effect, the quiet machinery that helps hold the country together.

Balancing the fiscal realities of “have” and “have-not” provinces is a central challenge in Canadian federalism.

Provinces deliver many of the country’s most important public services, including healthcare and education. But they do not all have the same ability to raise revenue. Some have stronger tax bases, younger populations, higher incomes, or larger resource revenues, while others face weaker fiscal capacity or greater service pressures.

Transfers help bridge those gaps – and that matters because debates about fairness in the federation are growing louder. Alberta’s grievances about net contributions, Quebec’s receipt of large equalization transfers, demographic pressures in Atlantic Canada, and rising uncertainty facing Ontario’s manufacturing sector all point to the same conclusion: Canada’s transfer system no longer fits today’s realities.

Some critics argue Canada should abandon equalization or federal transfers altogether. But the better path forward is to renew the system with a simpler structure built around two main programs.

The first would be a broad, unconditional, equal per capita transfer to all provinces – a “Canada Grant.” It would address the vertical fiscal imbalance between Ottawa and the provinces: the mismatch between federal revenue-raising capacity and provincial spending responsibilities. This grant would be simple, transparent, and distributed on the same basis to every province.

The second would be a reformed equalization program focused on horizontal fiscal imbalance: the differences among provinces in their ability to raise revenue and meet public service needs. Equalization would remain, but be clearer, more formula-driven, and

better aligned with differences in provincial economic strength and fiscal pressure. That would be a major improvement over today's system.

The current equalization formula has several weaknesses:

- *Resource revenues*: The treatment of resource revenues can weaken incentives to fully monetize provincial assets. Quebec's hydroelectricity pricing is one example: lower domestic prices reduce Hydro-Québec's revenues, lower measured fiscal capacity, and increase equalization entitlements.
- *Fixed envelope*: Equalization is constrained by a "fixed federal envelope," so program size is only loosely tied to actual fiscal disparities. Funding does not automatically rise when inequality increases or fall when it narrows. A formula-driven approach with a federal ceiling would better align payments with need while controlling federal costs.
- *Costs and needs*: The formula fails to reflect real-world differences in public services across Canada. A dollar does not buy the same level of services everywhere. Regional price differences matter. So do demographics. A modern transfer system should account for those pressures.

So what is the solution?

One option is to move toward a simpler macro-based formula tied to broad measures such as GDP per capita, adjusted for price levels and demographics. This would be easier to understand and could better reflect true differences in fiscal capacity and need.

But equalization is only part of the story. Much of Canada's interprovincial redistribution happens through the broader federal budget, especially the tax system. Uniform federal income taxes raise more from higher-income provinces, while federal programs often spend more in provinces with older populations or lower incomes.

This is especially important for Alberta. In 2024, the adjusted fiscal transfer out of Alberta through the federal budget was equivalent to 5.9 per cent of the province's economy. But that outflow is driven mainly by income and consumption taxes, not equalization alone. That means concerns about regional fairness may often be better addressed through tax reform than through changes to equal per capita transfers such as the Canada Health Transfer.

Canada has renewed its fiscal arrangements before when circumstances changed. They have changed again. A clearer two-part system – a Canada Grant for vertical imbalance and a modernized equalization program for horizontal imbalance – would be fairer, simpler, more transparent, more growth-oriented, and more fiscally sustainable. Waiting until fiscal pressures worsen or regional grievances deepen will only make reform harder. [MLI](#)

Les transferts fédéraux-provinciaux sont une pièce maîtresse, mais aussi l'un des aspects les plus controversés et les plus mal compris des finances publiques canadiennes.

La péréquation, qui repose sur le principe que tous les individus, peu importe où ils vivent, doivent bénéficier de services publics équivalents à un niveau d'imposition similaire, exerce une fonction stabilisatrice essentielle au sein de la fédération décentralisée du Canada. Il s'agit du mécanisme discret qui participe au maintien de l'unité nationale.

L'harmonisation des réalités budgétaires des provinces dites « riches » et « pauvres » représente un enjeu majeur du fédéralisme canadien.

Les provinces fournissent de nombreux services publics essentiels, notamment en santé et en éducation. Cependant, elles ne parviennent pas toutes à mobiliser les recettes nécessaires. Certaines disposent d'une base d'imposition robuste, d'une population jeune, de revenus élevés ou de ressources naturelles abondantes, alors que d'autres font face à des contraintes budgétaires ou des pressions financières.

Les transferts contribuent à combler ces écarts – et ils intéressent encore plus en raison des intenses débats actuels sur l'équité dans la fédération. Les doléances de l'Alberta quant à ses versements nets, les substantiels paiements de péréquation reçus par le Québec, les pressions démographiques dans les provinces de l'Atlantique et l'insécurité grandissante pour le secteur manufacturier de l'Ontario aboutissent tous à la même conclusion : le système de transferts canadien ne correspond plus aux réalités actuelles.

Certains affirment que le Canada doit complètement renoncer à la péréquation et aux transferts fédéraux. Or, la meilleure voie à suivre réside plutôt dans le renouvellement du système au moyen d'une structure simplifiée, articulée autour de deux programmes clés.

Le premier consisterait en un transfert par habitant général, inconditionnel et uniforme versé à toutes les provinces – une « subvention canadienne » – pour régler le déséquilibre fiscal vertical entre Ottawa et les provinces : à savoir le décalage entre la capacité fédérale en matière de recettes et les responsabilités provinciales en matière de dépenses. Ce transfert serait simple, transparent et distribué selon les mêmes critères à chaque province.

Le deuxième prévoirait un mécanisme de péréquation réformé se concentrant sur le déséquilibre fiscal horizontal, c'est-à-dire sur les inégalités entre les provinces en matière de capacité à mobiliser des recettes et à satisfaire les besoins en services publics. La péréquation serait maintenue, mais deviendrait plus transparente et mieux adaptée au pouvoir économique et aux contraintes budgétaires de chaque province. Il s'agirait d'une amélioration majeure par rapport au système actuel.

La formule de péréquation actuelle comporte plusieurs lacunes :

- Recettes tirées des ressources : le traitement des sources de recettes peut entraver les incitations à monétiser pleinement les actifs provinciaux. C'est ce qui se passe avec l'électricité au Québec, où les bas prix intérieurs réduisent*

les revenus, sous-estiment la capacité fiscale et augmentent les droits à la péréquation.

- *Enveloppe fixe : la péréquation est limitée par une « enveloppe fédérale fixe », de sorte qu'elle n'est que partiellement corrélée aux disparités budgétaires effectives. Le financement n'est pas systématiquement lié aux fluctuations des inégalités. Une formule dotée d'un plafond fédéral permettrait de mieux ajuster les versements en fonction des besoins tout en maîtrisant les dépenses.*
- *Coûts et besoins : la formule ne traduit pas fidèlement les différences réelles en matière de services publics au Canada. Un dollar n'offre pas les mêmes services partout. Les disparités régionales ainsi que les développements démographiques ont un impact. Un système de transferts moderne doit tenir compte de ces pressions.*

Quelle est donc la solution ?

Une option serait de choisir une formule globale simplifiée liée à des indicateurs généraux comme le PIB par habitant, les niveaux de prix et les facteurs démographiques. Cette formule serait plus compréhensible et fidèle aux différences de budget et de besoins.

Toutefois, la péréquation ne constitue qu'un aspect du tableau. Une grande partie de la redistribution interprovinciale au Canada passe par le budget fédéral, notamment le système fiscal. L'impôt fédéral uniforme prélève davantage dans les provinces à revenus élevés, tandis que les programmes fédéraux favorisent souvent les provinces où la population est plus âgée et les revenus, plus faibles.

Cet aspect est d'une importance capitale pour l'Alberta. En 2024, après ajustement, ses transferts fiscaux par l'intermédiaire du budget fédéral représentaient 5,9 % de son PIB. Toutefois, cette sortie de fonds résultait principalement des impôts sur le revenu et la consommation, et non exclusivement de la péréquation. En d'autres termes, les questions d'équité régionale peuvent être souvent mieux abordées par une réforme fiscale que par des modifications des transferts égalitaires par habitant, tels que le Transfert canadien en matière de santé.

*Le Canada avait déjà révisé ses accords fiscaux lorsque les circonstances ont changé, mais celles-ci ont de nouveau évolué. Un système à deux volets – subvention canadienne pour les déséquilibres verticaux et programme de péréquation modernisé pour les déséquilibres horizontaux – serait plus équitable, simple, transparent, axé sur la croissance et viable sur le plan budgétaire. Attendre l'aggravation des pressions budgétaires ou l'intensification des doléances régionales compliquera la réforme. **MLI***

Introduction

Debates and disagreements around federal-provincial transfers are nothing new in Canada. Disputes between federal and provincial governments run through the country's entire history. From the anti-Confederates in Nova Scotia to more recent concerns raised in Alberta about fairness in the federation, these regional tensions are a recurring feature of Canadian federalism. They are not signs that Canada is broken. They are part of how it works. But they do draw attention to the ways in which longstanding fiscal arrangements can become less suited to changing social, economic, and political realities.

That is especially true today. Canada faces a growing number of pressures that are testing the current structure of federal-provincial finances. The population is ageing, placing a mounting strain on provincial health systems while also reducing labour force participation and slowing economic growth. Natural disasters are becoming more costly and are not affecting all regions equally. The international environment is also more uncertain and volatile than it has been in decades. All of this matters because Canada is a highly decentralized federation in which provinces are responsible for delivering many of the most important public services. Yet the distribution of revenues across orders of government does not match the distribution of spending responsibilities, a challenge often referred to as the “vertical fiscal imbalance.” In addition, the strength of provincial economies varies widely, which makes it easier for some to fund public services than others even at the same tax rates, a challenge known as the “horizontal fiscal imbalance.” Federal-provincial transfers are therefore central to how the federation functions as they can help address both vertical and horizontal imbalances.

This paper argues that Canada's transfer system remains necessary, but that important parts of it need reform. More specifically, it makes three broad

contributions. First, it unpacks the current transfer system: how it evolved, how the major programs now operate, how large they have become, and why their projected growth matters in a period of tighter federal fiscal constraints. Second, it examines equalization in detail and identifies several weaknesses in its current design, especially in the treatment of resource revenues, the use of a fixed federal envelope, the omission of regional price differences, and the lack of meaningful demographic adjustment. Third, it broadens the discussion beyond equalization to show that substantial redistribution across provinces also occurs through the wider federal budget, particularly through the tax system. That broader perspective matters because it changes how questions of regional fairness should be understood and where reform efforts might be focused.

Overall, Canada should consider reforms that simplify the very structure of federal-provincial fiscal arrangements. Rather than rely on the current mix of major transfers and a growing number of smaller, conditional, and often program-specific arrangements, governments could move toward a clearer structure with distinct purposes. One program would address vertical fiscal imbalance through a broad, unconditional, and equal per capita grant to provinces. A second, formula-driven program would address horizontal imbalances by supporting provinces with below-average fiscal capacity or above-average fiscal need. That second stream, called equalization, could be made simpler, more transparent, and less distortionary.

That fiscal transfers need reform should not be surprising. The structure of transfers has evolved repeatedly in response to changing circumstances. Transfers were once small because governments themselves were small. They expanded significantly with the rise of the modern welfare state and the growth of provincial responsibilities in health care and education. They were cut sharply in the 1990s as part of the federal government's effort to restore fiscal sustainability before later expanding again as federal finances improved. Throughout this history, the underlying lesson is the same: transfer arrangements are regularly reviewed and renewed if they are to remain effective. The time for another major renewal has returned.

The paper focuses first on equalization, both because of its importance and because it is the program where the most fundamental design questions arise. Equalization exists for a good reason. In a decentralized federation, provinces with weaker revenue-raising capacity must still be able to provide

reasonably comparable public services without being forced into much higher tax rates than elsewhere. Without such a program, there would be growing pressure for the federal government to assume a larger direct role in areas of provincial responsibility. Equalization is therefore part of what sustains Canada's decentralized structure. It also serves a broader national purpose in a country where people move across provincial boundaries and where the fiscal effects of internal migration are not evenly shared.



*Equalization exists for a good reason.
It's part of what sustains
Canada's decentralized structure.*

Yet the current equalization formula may no longer be well suited to current circumstances. Resource revenues remain one of the thorniest areas in the program, and the existing treatment creates important distortions. It can reduce incentives for provinces to develop resources or to price them in a way that reflects their true value. Quebec's hydroelectricity pricing policies, for example, affect its measured fiscal capacity and therefore the allocation of equalization payments. More broadly, the formula can imply very high clawback rates on any efforts to increase resource revenues or, indeed, other revenues. Atlantic provinces, for example, maintain higher corporate income tax rates, and lowering those rates could increase their per capita corporate tax bases and therefore reduce their equalization entitlements. This, in turn, substantially reduces the rewards for growth-enhancing decisions, a point raised by Newfoundland and Labrador in its recent court challenge to the program. These features raise legitimate concerns not only about fairness, but also about efficiency.

The paper therefore examines several possible reforms to equalization. Some are technical, such as altering the treatment of resource revenues. Others are more structural, such as allowing the formula to determine the size of the program more directly rather than relying on a rigid federal envelope. Still others are more fundamental, including replacing the current detailed approach to fiscal capacity with a simpler macro-based formula tied

to GDP per capita. The paper also explores the implications of adjusting for differences in regional price levels, which matter because a dollar of public revenue does not buy the same quantity of goods and services in every province. Taken together, these reforms point to an important insight: the current program may not fully reflect the real differences in fiscal capacity and need across provinces, and in some cases may allocate support in ways that are difficult to justify on economic grounds.

And then there is our aging population. Currently, federal-provincial transfers do not include any meaningful demographic adjustment, even though the pressures from population aging are not evenly distributed across the country. Given the central role of age in shaping health care costs, this omission may become increasingly difficult to maintain. Incorporating demographics into equalization, or into a separate transfer program, is one possible response. Similarly, internal migration may create uneven burdens and benefits across provinces, especially where younger workers leave provinces that invested in their education and training. These are not reasons to abandon the current framework, but they are reasons to modernize it.

But equalization is only one part of the redistributive story. Uniform national taxes and spending programs also shift substantial resources across provinces. Some major transfers, such as the Canada Health Transfer and the Canada Social Transfer, are allocated on an equal per capita basis and are not themselves redistributive in a strict accounting sense, though equal per capita funding can still leave provinces unequally placed where the cost of delivering a given level of service differs, for example because of differences in wages or demographics. The larger source of implicit interprovincial redistribution lies mainly in the federal tax system, especially taxes on income. That means concerns about regional fairness may often be better addressed through tax reform than through changes to equal per capita transfers. In particular, a modest shift toward greater reliance on the GST and less reliance on income taxes could boost both the national economy and dampen the degree of implicit fiscal redistribution through the federal budget.

The case for reform is not an argument against redistribution, against decentralization, or against federal-provincial transfers themselves. It is a case for ensuring that these arrangements better reflect today's realities. The arrangements we inherited were built in response to earlier circumstances. Some parts of it still work well; other parts less so. There are many options

available to governments, and this paper explores several of them. Whichever route forward one might prefer, the need to begin serious reform discussions is becoming harder to postpone. Waiting until fiscal pressures mount or regional grievances become more inflamed would only make addressing them even more difficult. Early action would provide more room to renew our transfers in a way that is fairer, simpler, more growth-oriented, and more fiscally sustainable.

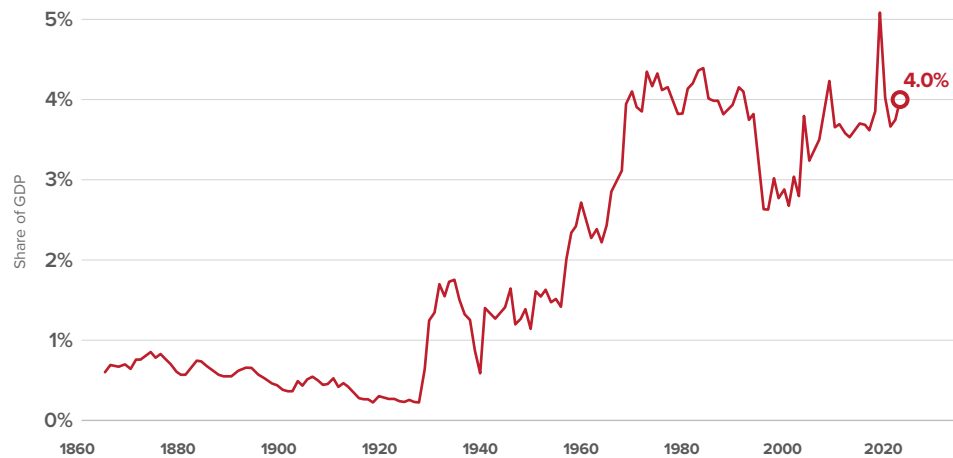
The evolution of federal transfers

It is important to note that Canada's transfer system did not emerge all at once or from any single design. It evolved gradually in response to changing fiscal pressures, economic conditions, and political priorities, and has grown into one of the most important elements of Canadian public finance. Intergovernmental transfers evolved from the modest arrangements of the late nineteenth century through the dramatic expansion of the postwar welfare state, the fiscal retrenchment of the 1990s, and the fiscal framework in place today.

A brief historical overview

Prior to the First World War, federal transfers were relatively small compared to the size of the economy.¹ **Figure 1** displays federal-provincial transfers since 1867. Transfers peaked a few decades after Confederation at approximately 1 per cent of GDP, before declining to roughly one-quarter of that level prior to the onset of the Great Depression. Transfers were nonetheless important for provincial governments at many points, and for many provinces they accounted for the overwhelming majority of intergovernmental support. But unforeseen and significant shocks changed the landscape considerably, starting with the global economic crisis of the 1930s, when unemployment benefits rose dramatically. This strained the finances of many provinces and led Alberta to bankruptcy in the mid-1930s, while Saskatchewan came close to doing the same. During the Depression, the federal government supported provinces through considerable transfers and later went further by fully taking over employment insurance through a constitutional amendment. The Second

FIGURE 1: Federal-provincial transfers, 1867–2024 (% of GDP)



Source: Author's calculations from Finances of the Nation aggregate federal transfers database.

World War also brought major changes to federal transfers, as provinces gave up access to personal and corporate income taxes and succession duties, a tax Canada no longer has today.

The biggest change of all followed the Second World War, with the expansion of healthcare and education across the country. The growth of the welfare state in Canada, as in many other countries, required a corresponding growth in the size of government. In Canada's decentralized federation, that meant provinces needed more revenue to fulfill these responsibilities. But during the war, the federal government became dominant in the major sources of revenue, so in the postwar decades provinces pushed for more tax room in personal and corporate income taxes, along with much larger federal transfers. By the 1970s, federal cash transfers had risen to approximately 4 per cent of GDP – roughly four times their level a few decades earlier. It was in this postwar period that equalization in its modern form first emerged. The wartime tax rental agreements, where provinces ceded income tax fields to Ottawa in exchange for federal grants, were replaced in 1957 with a formal equalization program. That program facilitated provinces introducing their own income tax systems without being left worse off than provinces that did not participate in exchange for those grants. Later, by the early 1960s, that system evolved into one that made unconditional payments to provinces with below-average

revenue-raising capacity as it does today. The early formula was simpler than today's but the basic principle established then, that the federation should help provinces provide reasonably comparable services without resorting to far higher tax rates, was later entrenched in the Constitution in 1982.

In addition to reforming transfers to support provinces as they expanded public services, the federal government has also adjusted transfers when its own fiscal challenges have mounted. In the 1990s, for example, rising pressure to reduce deficits and debt led Ottawa to undertake major fiscal adjustment. Following *Budget 1995*, Ottawa reduced transfers to many provinces across nearly all programs. By my calculations using the Finances of the Nation transfers database, the overall size of transfers fell from just under 4 per cent of GDP to approximately 2.5 per cent by 1997. As federal finances recovered and economic growth accelerated, transfers rose again to roughly their pre-adjustment levels. They accounted for approximately 3.5 per cent of GDP and remained near that level until COVID-19 pushed them well above 5 per cent. They have since declined and, by 2024, settled at roughly 4 per cent of GDP, in line with their pre-*Budget 1995* historical average.

The current transfer landscape

Today, the 4 per cent of GDP is delivered through several major programs. The largest is the Canada Health Transfer, which in 2026-27 is projected to exceed \$57 billion. Equalization is the second largest at just over \$27 billion, while the Canada Social Transfer is the third largest at nearly \$18 billion (Department of Finance Canada, n.d.).

The CHT and the CST are allocated on a roughly equal per capita basis across provinces, while equalization is allocated through a formula designed to support provinces with lower fiscal capacity. In addition to these major transfers, large amounts are also transferred to provinces on a conditional basis to support specific programs, including health arrangements, childcare, and infrastructure funds, totaling approximately \$15 billion. There are also a variety of smaller transfer programs that need not concern us here.

Looking ahead, the pace of growth in transfers to governments is projected to exceed that of many other areas of federal operations. *Budget 2025* projects an increase of 14 per cent in these transfers between 2025 and 2029, for an average annual growth rate of 3.6 per cent. By the end of the budget horizon, this rate of growth exceeds that of most other areas of federal

spending, behind only transfers to elderly individuals, military spending, and interest payments.

If that pace continues, transfers to provinces would increase by a further \$30 billion by the middle of 2030. That would account for approximately half of the projected increase in the federal deficit over that horizon (Tombe 2026), and it would be roughly equivalent to the projected increase in transfers to elderly individuals. Slowing the growth of these transfers may therefore prove unavoidable if federal fiscal sustainability is to be preserved while defence expenditures rise substantially in light of new international commitments.

Equalization

There is perhaps no more important federal transfer program in Canada than equalization. Given the wide differences in provincial economic strength across the country, there are naturally large differences in the amount of equalization received by different provinces. Many receive no payment at all and have not for some time. Though difficult to design and often the subject of disagreement, criticism, and even hostility, equalization is a core feature of most federations. Canada is not unique in this respect. Most federations have such a program, and even those that do not, such as the United States, have other mechanisms that redistribute financial resources across subnational governments.²

In Canada's highly decentralized federation, provinces are responsible for delivering major public services such as healthcare and education. Sustaining that degree of decentralization requires a program that assists provinces that may otherwise struggle to raise sufficient revenue. Without some mechanism to preserve at least rough comparability in the quality of public services across provinces, there would be growing pressure for the federal government to take on a larger direct role in program delivery. Equalization is therefore part of what allows Canada's decentralized federation to function.

There is also a mobility rationale. Canadians move across the country, and most interprovincial migrants are relatively young. They take with them the human capital developed in the province where they grew up and then contribute that human capital to another province's labour market, which

benefits from the resulting tax revenues. To the extent that out-migration imposes fiscal and economic costs on origin provinces, as is especially relevant in places such as Newfoundland and Labrador, federal assistance can help ensure that the benefits of internal migration do not accrue only to provinces that receive net inflows of people.

It is worth being clear that the mobility rationale is somewhat contested. One long-standing view, associated with Buchanan (1950) and Boadway and Flatters (1982), holds that fiscal differences across provinces can distort migration, drawing people toward jurisdictions with stronger fiscal capacity for reasons unrelated to the underlying productivity of those locations, and that equalization can offset this distortion. Others (see Albouy 2012; Tombe and Winter 2021) find that actual interprovincial transfers may go far beyond this rationale and distort migration incentives, thereby lowering aggregate productivity in Canada. This paper does not contribute to that debate but instead focuses on incremental reforms that may increase the responsiveness of current transfers to pressing practical challenges and, at the same time, improving the simplicity and transparency of those transfers.

The current equalization formula

Canada's equalization program works by measuring the fiscal capacity of provincial governments and providing a top-up payment to any province whose overall fiscal capacity is below the national average. This measure of fiscal capacity is somewhat involved. This is a simple concept intuitively. In effect, it is a proxy measure for the underlying strength of a province's economy or the overall average level of income and consumption that takes place within each region.

Measuring fiscal capacity

To gauge fiscal capacity from the main sources of revenue available to provincial governments, the formula examines four broad categories: personal income taxes, business income taxes, consumption taxes, and property taxes (a fifth category, natural resource revenues, is discussed separately below). These broad headings encompass a much larger number of individual revenue lines, and the program, in practice, assesses fiscal capacity across a detailed set of distinct tax bases within them. For each category, the formula measures the overall size of the tax base (that is, the thing being taxed). Overall taxable corporate profits,

TABLE 1: Per capita tax bases (national average = 100)

Province	Personal income taxes	Business income taxes	Consumption taxes	Property taxes	Total non-resource revenue bases	Resource revenues
BC	111.6	91.2	105.5	152	115.9	46.8
AB	114.2	150.5	117.9	94.9	115.8	568.5
SK	83	101.4	94.9	82.2	88.7	258.2
MB	71	55.7	88.8	66.8	73.4	11.8
ON	106.4	110.4	99.7	103.5	104.3	3.0
QC	88.1	81.2	92.9	83.2	87.6	50.2
NB	68.2	44.9	89	54.5	68.5	11.9
NS	76.2	51.5	89.3	70.9	75.8	1.2
PE	70.3	47.7	83.6	55	68.1	0.1
NL	83.9	58.4	93	56.3	77.4	376.4

Source: Author's calculations based on equalization worksheets provided by Finance Canada.

for example, form the base of the corporate income tax system. Similarly, overall consumer spending is largely the base of general sales taxes; the assessed value of residential and non-residential properties is the base of the property tax system; and so on.

For fiscal year 2024–25, **Table 1** reports each province's tax base per capita relative to the national average. Values above 100 indicate provinces where the tax base per capita in that category is above average; values below 100 indicate the opposite. British Columbia and Alberta have the largest tax bases in the country. Alberta stands out for its corporate income tax base, while British Columbia stands out for property taxes. Overall, both are about 16 per cent above the national average. Ontario is also above average, reflecting strong personal and corporate income tax bases and, to a lesser extent, above-average property values. Every other province falls below the national average, ranging from about one-third below average in New Brunswick and Prince Edward Island to just under 10 per cent below average in Saskatchewan.

By comparing the size of each tax base across provinces on a per capita basis, one can estimate how much revenue a provincial government would raise

if it applied average tax rates. The national average tax rate in each category is simply the total revenue that all provinces together collect from that source divided by the total size of the corresponding tax base. Applying that single national average rate to a given province's per capita tax base yields its per capita fiscal capacity for that category. Importantly, this is not a measure of what provinces actually raise under their chosen fiscal policies. Provinces remain free to have higher taxes, lower taxes, or, in one case, no sales tax at all. The formula is designed to measure capacity, not actual collections.³

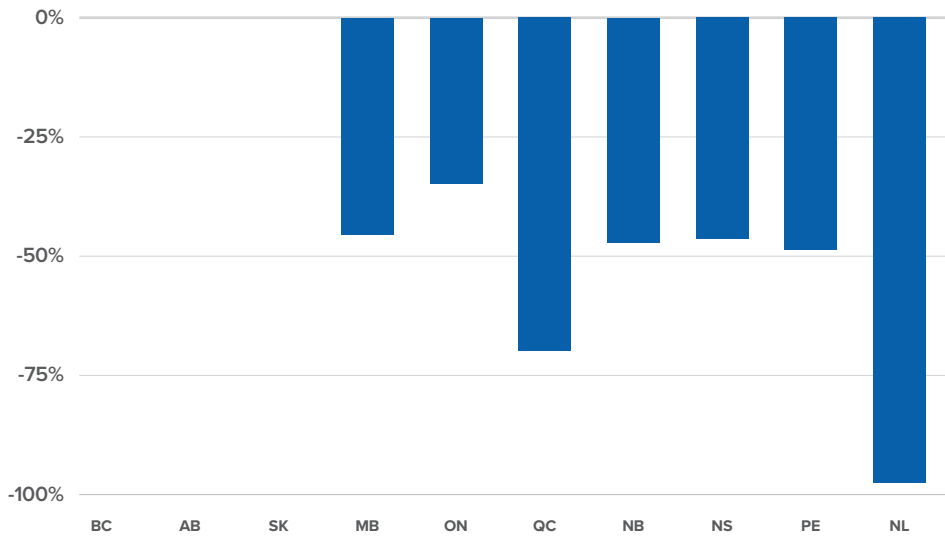
Once tax bases are measured and the implied revenue-raising capacity at average tax rates is determined, resource revenues are added to capture overall fiscal capacity. These revenues are not added dollar for dollar, because doing so would create a strong disincentive to develop natural resources. That concern was especially important for Newfoundland and Labrador in relation to offshore oil and gas development, but it remains relevant more broadly, including in decisions about hydroelectricity pricing and whether to pursue resource development at all. In response to this problem, some have argued that resource revenues should be excluded entirely, while others point out that such revenues plainly contribute to a province's ability to deliver public services. The current formula is a compromise. It includes resource revenues twice: once at a 50 per cent inclusion rate and once excluding them entirely. Provinces then receive the equalization payment that is most favourable to them under either treatment, before some final adjustments are made.

The fiscal capacity cap

The partial treatment of resource revenues means that a province receiving equalization could, in principle, end up better off than a non-receiving province. If resource revenues are ignored entirely or counted at only 50 cents on the dollar, a province will appear to have lower fiscal capacity than it actually does. This could conceivably (and in some cases would) result in an equalization payment being made to a resource-rich province, while a resource-poor one receives nothing. This often arises for Newfoundland and Labrador, Saskatchewan, and Quebec.

To address this, the formula includes a fiscal capacity cap to ensure that no receiving province is made better off than a non-receiving province. In practice, this often means a clawback of equalization payments so that a recipient province either receives nothing or receives an amount that stops

FIGURE 2: Estimated clawback of 10 per cent higher resource revenues



Source: Author's calculations using the Finances of the Nation equalization simulator.

short of putting it ahead of Ontario. This feature has long been contentious. When it was introduced roughly twenty years ago, for example, Saskatchewan and Newfoundland and Labrador both mounted vocal political and legal challenges (Saskatchewan 2007; CBC News 2008).

These features of the program mean that, even under current treatment, there is a substantial implicit clawback built into the calculation of equalization payments. I estimate these clawback rates for all provinces for fiscal year 2026–27 and illustrate in **Figure 2** the effect of a 10 per cent increase in resource revenues. The figure shows the share of that increase that is lost through lower equalization payments.

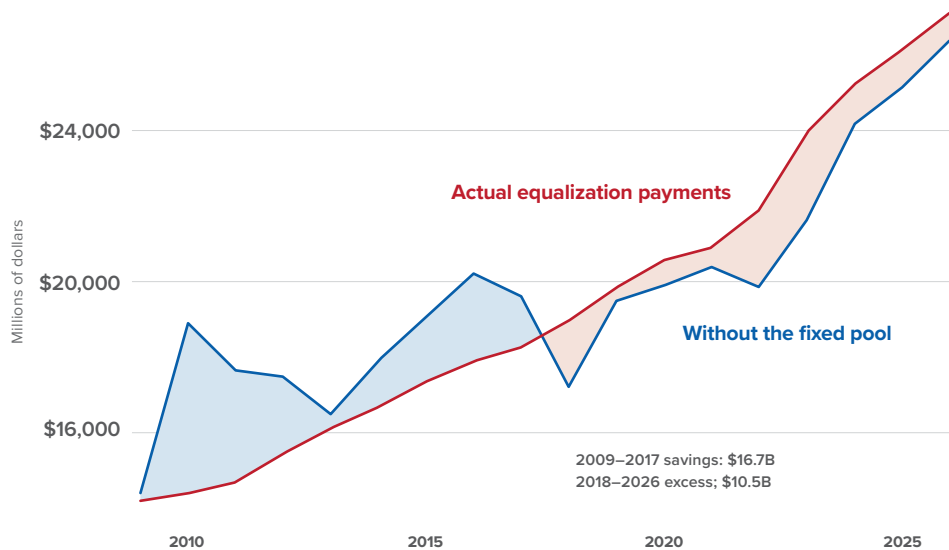
The implicit clawback is currently very high in Newfoundland and Labrador, approaching a dollar-for-dollar reduction, and nearly 75 per cent in Quebec. That high rate is because the fiscal capacity cap for the province binds more tightly than it does when resource revenues are lower. For most other provinces, though, the clawback rate sits just under 50 per cent. In Newfoundland and Labrador and Quebec in particular, this significantly reduces the incentive to increase resource revenues, whether by pursuing development projects or, in Quebec's case, by moving electricity prices closer to the national average.

The fixed envelope and adjustment payments

As a final step, the equalization program operates within a pre-set envelope of dollars that the federal government is willing to distribute. If the formula would otherwise generate payments above that envelope, all recipient payments are reduced on an equal per capita basis until the total cost matches the amount provided for in the federal budget. Since 2018, however, the formula has produced fewer payments than the available envelope, so the residual amounts have been distributed to recipient provinces and to certain non-receiving provinces, notably Ontario, to ensure that they are not left worse off than a receiving province. **Figure 3** illustrates each stage of this process.

Overall, I calculate that since 2018, these excess adjustment payments have exceeded \$10 billion. It is worth noting that when the envelope operated as a cap, the program was reduced by nearly \$17 billion between 2009 and 2017. Looking ahead, however, the prospect of these adjustment payments operating as a floor is high, though much depends on how regional inequality evolves, which has historically been influenced by energy prices.

FIGURE 3: Actual and uncapped equalization payments, 2009–2026



Source: Author's calculations based on equalization worksheets provided by Finance Canada

Equalization reform options

There are a wide variety of ways in which the equalization program can be adjusted to better achieve its central purpose: facilitating the decentralized delivery of comparable-quality public services across the country while minimizing distortions to provincial choices. The reforms discussed below address the treatment of resource revenues, the fixed envelope, the possibility of a simpler macro-based formula, the role of price-level differences, and the growing importance of demographic pressures.

The treatment of resource revenues

Resource revenues are a difficult area that has been examined numerous times throughout the program's history (see, for example, Expert Panel on Equalization and Territorial Formula Financing 2006; Tombe 2018), but there remain significant ways in which it could be improved.

Quebec's electricity pricing illustrates the significance of the problems with the current approach to measuring fiscal capacity with respect to resources. Artificially low power prices in Quebec mean that resource revenues – which in this case take the form of dividends paid to the Government of Quebec from Hydro-Québec on its profits – are lower than they otherwise would be. This shrinks Quebec's measured fiscal capacity and therefore increases its equalization payment. Given the fixed size of the program, this is not primarily a budget concern for the federal government, but it does misallocate equalization dollars.

If Quebec power prices were closer to the national average, Quebec's fiscal capacity would be considerably higher, its equalization payment consequently lower, and other recipient provinces would see an increase in their payments. To illustrate the magnitude of this effect, a two-cent increase in Quebec power prices would result in an equalization payment of \$11.2 billion to Quebec, which is down from the \$13.9 billion that it actually receives for 2026–27. This change would also result in higher equalization payments for all other recipient provinces, who are in effect subsidizing low power prices in Quebec by forgoing payments they would otherwise receive. Ontario, for example, would receive approximately \$2 billion more while Manitoba would receive approximately \$200 million more.

One way to reduce the disincentive to keep resource revenues artificially low would be to stop including them directly in the formula and instead include them within the business income tax category (See Tombe 2018, which explores the technical details). The specifics need not detain us here. The key point is that this would extend the logic already used for certain Crown corporation earnings to resource revenues more generally. Because the main non-resource categories work by measuring tax bases and applying national average tax rates, resource revenues would enter the formula indirectly through their effect on the average revenue raised in that category, much as taxable corporate income already does.

“Federal-provincial transfers are a core part of Canada’s federation. But their current structure is increasingly in need of reform.”

A more straightforward alternative would be to remove resource revenues from the formula altogether. Important revenue sources are already excluded. Investment income, for example, matters a great deal for Alberta and increasingly for Quebec through the Generations Fund, a dedicated debt-reduction fund whose pooled assets generate investment income for the province (Ministère des Finances du Québec 2026). Excluding resource revenues would simplify the calculation substantially, though at the cost of a less precise comparison of provincial fiscal capacity. In addition, ignoring a genuine source of fiscal capacity also raises an equity concern: two provinces with the same overall ability to fund services would be treated differently. In any case, such an exclusion would not necessarily produce dramatic changes. I estimate that removing resource revenues entirely would shrink the overall size of the program only modestly in 2026–27. Provincial amounts would also change somewhat, with Quebec, for example, receiving \$13.2 billion rather than its actual \$13.9 billion.

Reforming the fixed envelope

The size of the program could also be determined more directly by the formula itself, rather than by a pre-set federal envelope. A fixed pool creates its own problems because it exposes provinces to the effects of policy choices made elsewhere, as the Quebec hydroelectricity example illustrates.

Allowing the formula to determine the size of the program would make equalization more responsive to actual need. When inequality across provinces rises, the program would expand. When inequality falls, the program would shrink. This would better reflect changing underlying conditions, especially given the volatility of commodity prices and the significant effect they can have on provincial fiscal capacity.

A possible compromise would be to replace the fixed pool with an overall ceiling. That would allow the program to shrink when inequality declines, while still protecting the federal government from potentially unaffordable increases. The ceiling could be set high enough that it would not bind in normal years, as was often the case before 2018. The formula would determine the size of the program most of the time, but the ceiling would apply when necessary. It could, for example, be set at roughly 1 per cent of GDP, in line with the historical size of the program. This would not be unprecedented. For much of the period from 1982 through the early 2000s, the formula operated with a ceiling rather than a floor (Tombe 2018).

Moving to a macro-based formula

Perhaps the simplest reform, and one with a long pedigree, would be to replace the detailed fiscal-capacity calculation with a broader measure of provincial economic strength, such as GDP per capita. GDP per capita is already strongly correlated with fiscal capacity per capita across provinces. Since most provincial revenues come from taxes on income, consumption, and the sale of goods and services, GDP per capita captures much of what matters in a simpler way.

The Finances of the Nation Equalization Simulator (a publicly available tool I maintain that replicates the federal equalization formula; see *Finances of the Nation*, n.d.) suggests that moving to a macro-based formula using only GDP per capita would shrink the program to roughly \$19.5 billion, because inequality in GDP per capita is lower than inequality in measured fiscal

capacity. Payments to Quebec would fall from \$13.7 billion to \$9.9 billion, while Ontario would qualify for \$2.2 billion.

The idea is far from new. Indeed, one of the first formulas proposed for the first equalization program in the 1950s was from New Brunswick, which favoured a simple formula based only on relative average per capita personal income (Tombe 2018). Such macro approaches have not been adopted, however, despite being so much simpler. The numbers above point to a possible reason: a macro-based formula may produce smaller payments and therefore current recipient provinces may resist such a move. So, pairing this kind of reform with adjustments to other transfers may therefore be necessary.

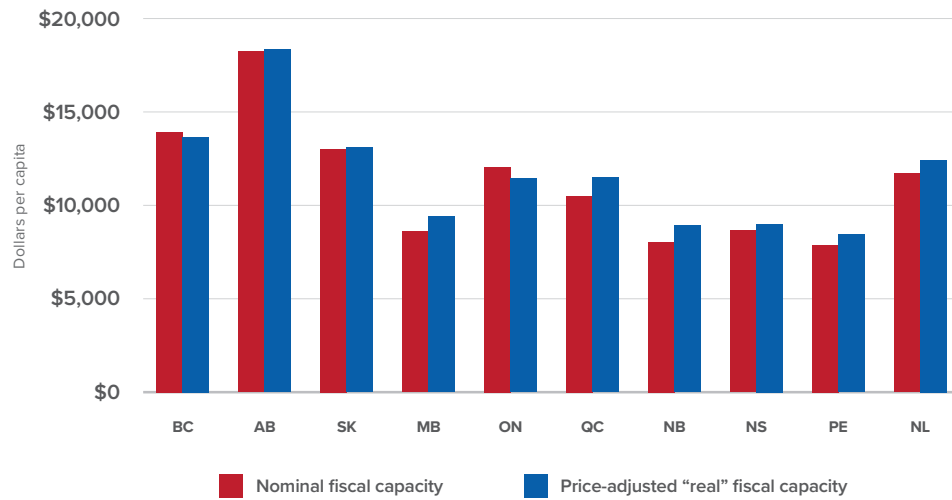
Adjusting for price-level differences

Equalization is intended not only to top up provinces with below-average capacity, but also to account, at least in principle, for differences in need. At present, the formula effectively uses only population. On a per capita basis, there is no additional measure of need at all. One obvious place to begin is with regional differences in price levels. A dollar of public revenue goes further in some provinces than in others. Price levels are generally lower in Atlantic Canada, Quebec, and Manitoba than in Ontario, British Columbia, and, to a lesser extent, Alberta and Saskatchewan (Statistics Canada, Table 18-10-0003-01).

Statistics Canada's work on price level comparisons across major cities helps illustrate the significance of this issue. When lower price levels are taken into account, many provinces have greater real purchasing power than their nominal fiscal capacity suggests. **Figure 4** shows that this can materially increase measured real fiscal capacity in Atlantic Canada, Manitoba, and Quebec. In Quebec's case, real fiscal capacity per capita in 2026–27 is slightly higher than in Ontario: roughly \$11,600 per capita compared with \$11,500.

These differences would have major consequences for both the size and allocation of equalization. Using the Finances of the Nation Equalization Simulator, and first turning off the fixed growth rule, the program in 2026–27 would total \$26.4 billion. Adjusting for price level differences would reduce that to \$24.1 billion. Quebec's payment would fall from \$13.7 billion to \$5.2 billion, while Ontario's would rise from zero to \$8.7 billion. In other words, Quebec's purchasing-power-adjusted fiscal capacity is much higher than the current nominal formula implies.

FIGURE 4: Nominal and real fiscal capacity per capita (2026)



Source: Author's calculations using Finances of the Nation equalization simulator.

Combined with a macro-based formula, price-level adjustments could produce even larger changes. Using purchasing-power-adjusted GDP per capita, the overall size of the program would be roughly \$20.1 billion. Ontario would qualify for \$12.3 billion, while Quebec would receive only \$1.3 billion in that fiscal year. This suggests that the current program may provide substantially more to provinces such as Quebec than the underlying strength of their economies, adjusted for purchasing power, would warrant. That alone may justify serious reform.

Addressing demographic pressures

Looking further ahead, demographics will also become a more significant source of uneven fiscal pressure across provinces. At present, no major federal-provincial transfer incorporates demographic pressures into its allocation formula. Yet the burden of delivering healthcare will rise most sharply in provinces with older populations.

One option would be to introduce a demographic adjustment into the Canada Health Transfer, which is a federal program that nominally aims to support provincial and territorial healthcare systems. That would mark a departure from the equal per capita model put in place following *Budget 2007* and fully implemented by 2014. Another option would be a separate transfer

program targeted specifically at unusually high demographic pressures, based on average age or the share of the population over 65.

A related possibility would be a transfer tied to internal migration patterns. In some provinces, population ageing is accelerated because younger Canadians leave for opportunities elsewhere. A federal transfer to the origin provinces of those migrants would implicitly help support the provinces that age more rapidly as a result. This would be conceptually sensible, since the destination province receives the income tax base associated with those younger workers. Such a program would also recognize that the federal government receives income tax revenue from these workers regardless of where they live, while the origin province has borne part of the cost of developing their human capital through its education system. Compounding this challenge is that retirees may also move toward lower-cost regions, which can raise the age profile and associated health costs.

But as discussed below, an overarching reform proposed in this paper is to simplify the overall structure of federal transfers by consolidating the current array of disparate programs into two: one that addresses the vertical imbalance between the federal and provincial governments, and one that addresses the horizontal imbalances among provincial governments themselves.

Any important source of differences in fiscal capacity or fiscal need would therefore most logically be incorporated into the program specifically designed to address horizontal imbalances, namely equalization. Incorporating demographics into the equalization formula is, in fact, relatively straightforward. One way to do so would be to calculate an index of health expenditures by age, using data readily available from the Canadian Institute for Health Information (2025), and incorporate that into an adjustment factor that scales each province's population accordingly. Adjustments that reflect educational cost pressures from a younger population could also be included, though are quantitatively far less important than healthcare for provincial budgets. Healthcare is the most age-sensitive category and the natural place to start, but it is not the only one. Spending on education, for example, runs in the opposite direction, since provinces with relatively younger populations face higher costs there. A fuller demographic adjustment could in principle net these age-related pressures against one another across the major spending areas, though using health expenditures alone has the advantage of simplicity and reflects the category where age-related cost differences are largest.

Such a reform would leave the overall size of the program unchanged if the fixed-envelope rule were maintained. If it were not, however, the overall size of equalization would grow significantly. I estimate that, without the fixed envelope, the program would total \$26.4 billion, and with demographic adjustments included, it would rise to \$32 billion. If the fixed envelope were maintained and the program size in 2026–27 remained at \$27.2 billion, then adding demographics would tend to increase payments to provinces with relatively older populations. This would primarily benefit Quebec, whose payments would rise from \$13.9 billion to \$15.5 billion. Newfoundland and Labrador would also see a modest increase in 2026–27, equivalent to approximately \$100 million, while payments to other provinces would decline.



The federal government faces broader fiscal pressures that will intensify over the coming years.

With all major reforms suggested in this paper combined, including moving to a macro-based formula, adjusting for price level differences and demographics, and eliminating the fixed envelope, the size and allocation of equalization payments would be dramatically different. Overall, I estimate the size of the program would decline to \$21.6 billion, with Ontario receiving just over \$10.1 billion and Quebec only \$5.3 billion. Payments to Manitoba and Atlantic provinces would also decline. This illustrates the growing disconnect between the current equalization formula and one focused on overcoming true differences in economic strength and fiscal need.

The significance of these shifts is worth dwelling on. Quebec's entitlement would fall by more than half, from \$13.9 billion to \$5.3 billion, while Ontario would move from a non-recipient in most years to receiving more than \$10 billion. A reallocation of this size would not be able to occur in isolation, as it would add considerable strain to the budgets of many provinces, especially Quebec. Any credible reform path would therefore need to phase in such adjustments, backstop provinces that may lose out (at least for a time), and potentially also increase the size of other transfers to compensate.

Federal fiscal sustainability

Beyond the design of particular transfer formulas, the federal government faces broader fiscal pressures that will intensify over the coming years (Tombe and Giguere 2026). Most notably, military spending is projected to rise sharply under Canada's commitment to NATO's new pledge to spend 5 per cent of GDP on defence by 2035, made up of 3.5 per cent for core military capabilities and a further 1.5 per cent on measures to "protect critical infrastructure, defend networks, ensure civil preparedness and resilience, innovate, and strengthen the defence industrial base" (NATO 2026). This is up from roughly two per cent today, and the new target must be met by 2035. If that occurs, many other areas of federal spending will have to grow more slowly than currently projected. Transfers to elderly individuals may need to grow more slowly, perhaps through reforms to eligibility ages, income thresholds, or both. Transfers to provincial governments, given their size, are another natural area where slower growth may be necessary if the federal government is to create fiscal room for what has become a central long-term priority.

The 1990s offer a useful precedent (see Watson and Clemens 2025). During the last major federal fiscal restructuring, transfers were reformed in part to help restore fiscal sustainability. Several existing grant programs were consolidated into a simpler block transfer with fewer conditions attached. Given the current proliferation of smaller conditional grants, including those for childcare and targeted health initiatives, there may once again be scope for consolidation. Such a reform could increase flexibility for provinces while slowing the overall pace of growth.

One possible model would be a transfer system built around only two major programs: a broad equal per capita transfer to address vertical fiscal imbalance, perhaps called the Canada Grant, that would be unconditional and uniform; and a second program, say equalization, to address horizontal imbalance by providing additional support to provinces with lower fiscal capacity. The Canada Grant could grow at a fixed nominal rate over time, perhaps 3 per cent, much like the current Canada Social Transfer. That would represent a modest reduction relative to projected growth in transfers today. Equalization, by contrast, could remain formula-driven, though an overall ceiling could be indexed to nominal GDP.

Over time, slower growth in transfers to provinces would help to balance the federal budget over the medium term and might avoid outright nominal

cuts to transfers today, though that possibility cannot be ruled out. Provinces would no doubt resist such a change, but it is important to remember that they retain considerable capacity to raise their own-source revenues, including through efficient taxes such as broad-based sales taxes harmonized with the GST. Slowing federal transfers and requiring provinces to rely more on their own revenue sources, especially when combined with a well-designed equalization program, could also improve accountability by better aligning revenue-raising responsibility with service delivery responsibility in the first place.

Simplifying fiscal arrangements overall

Another potential benefit of restructuring federal-provincial transfers into two programs, one provided on an equal per capita basis and the other through equalization to address horizontal imbalances, would be improved public understanding of the system as a whole.

An unconditional equal per capita Canada Grant, provided to all provinces on the same basis, would likely reduce some of the perceived unfairness that now surrounds federal transfers. The rationale for such a grant would rest primarily on the federal government's greater efficiency in raising revenue, especially from tax bases that are more mobile and therefore more difficult for provinces to tax effectively on their own, such as corporate income. A separate equalization program, clearly focused on addressing differences in provincial fiscal capacity arising from underlying differences in economic strength, would then make the purpose of that redistribution more transparent.

If equalization were also reformed to reflect a macro-based formula adjusted for price levels and potentially demographics, its operation would be easier to explain than the current system. That could help dampen at least some of the sense of unfairness attached to the program today. And if these changes were combined with other institutional reforms, such as the creation of an arm's-length body to regularly assess and report on the overall functioning of federal-provincial transfers, a simplified system might also secure broader public buy-in.

Broader redistribution through the federal budget

Equalization and other explicit transfers are only part of the story. The federal budget as a whole – through uniform national taxes and spending programs – implicitly redistributes substantial resources across provinces. This section measures the size of that redistribution, traces how it has evolved over time, decomposes it by revenue and expenditure category, and considers reform options that could reduce the extent of implicit interregional transfers.

Measuring implicit transfers

There are many ways in which the federal government redistributes financial resources across provinces beyond equalization. Even uniform national programs send more to some provinces than others, and national taxes raise more from some provinces than from others. Programs such as Old Age Security naturally send more to provinces with older populations, while personal and corporate income taxes raise more per capita in provinces with higher average incomes and larger shares of high-income taxpayers.

To measure the size of redistribution through the federal budget, including both revenues and expenditures, I use Statistics Canada data to calculate per capita amounts raised and spent in each province over time and compare those amounts with the national average. I treat any amount as a net outflow where the federal government raises more from a province than the national average or spends less into it than the national average. These amounts are substantial. In aggregate, they equal roughly 2 per cent of national GDP.

For the period from 2007 through 2024, I highlight the resulting fiscal balances and related data in **Table 2**. Negative values represent per capita amounts below the national average, while positive values reflect amounts above the national average. Overall, the federal government raises more from higher-income provinces such as Ontario, British Columbia, and Alberta than the national average, and spends more than it raises in the other provinces. On an adjusted per capita basis, these flows are large: roughly \$1,000 per capita on average over this period for Ontario, nearly \$2,000 for British Columbia, and more than \$5,000 for Alberta.

TABLE 2: Distribution of federal revenue and expenditures (2007–2024)

Province	DOLLARS PER CAPITA			SHARE OF NATIONAL TOTAL (%)			
	Spending	Revenue	Implicit transfers	Population	GDP	Federal revenue	Federal spending
BC	-1,045	662	-1,707	13.4	13.1	14.3	12.1
AB	-1,668	3,557	-5,225	11.4	16	15.3	9.6
SK	980	449	531	3.1	3.8	3.2	3.4
MB	2,810	-1,186	3,996	3.6	3.2	3.2	4.6
ON	15	999	-984	38.7	38	42.4	38.8
QC	-1,378	-3,480	2,102	22.8	19.6	15.1	19.8
NB	5,043	-1,746	6,789	2.1	1.7	1.8	3.2
NS	6,460	-1,361	7,821	2.7	2.1	2.3	4.3
PE	7,371	-1,763	9,134	0.4	0.3	0.3	0.7
NL	4,739	753	3,986	1.5	1.6	1.6	2.1

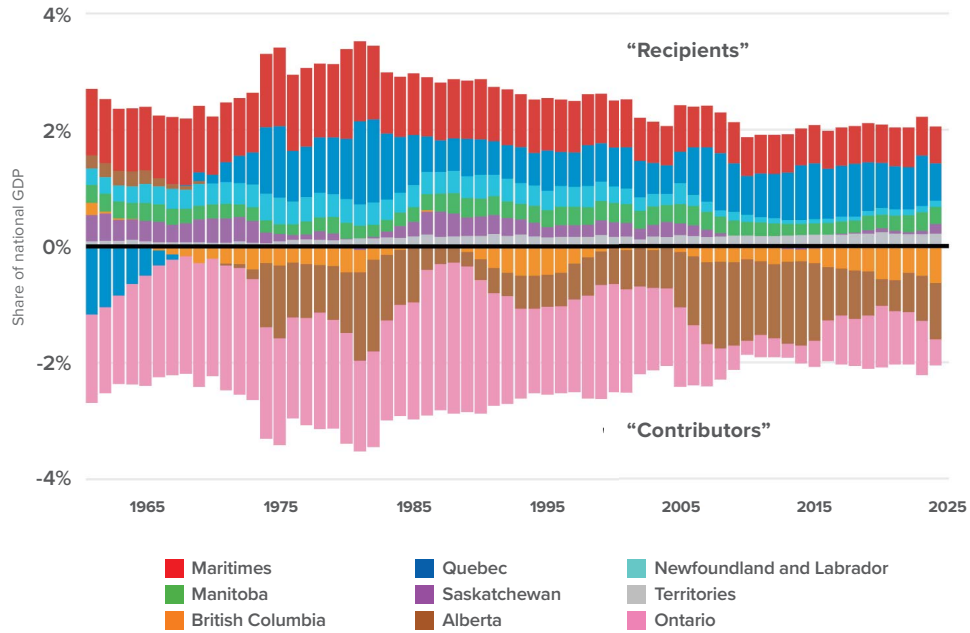
Source: Author's calculations using Statistics Canada data tables 36-10-0450-01, 17-10-0005-01, and 36-10-0222-01.

Another way to see these relationships is to compare provinces' shares of national population and GDP with their shares of federal revenues and spending. Ontario accounts for roughly 38 per cent of both GDP and population and receives a similar share of total federal spending, but it contributes 42.4 per cent of federal revenues. Alberta accounts for roughly 16 per cent of GDP and 11.4 per cent of population, contributes 15.3 per cent of federal revenues, and receives only 9.6 per cent of federal spending. Those gaps drive large implicit outflows from both provinces, especially Alberta.

The correlation between provincial GDP shares and federal revenue shares is strong, which is unsurprising given that the federal government relies primarily on income and consumption taxes. Spending tracks population more closely, though imperfectly, and in Atlantic Canada spending shares are notably higher than population shares.

Over time, the overall amount of redistribution across provinces varies. **Figure 5** displays the aggregate amount of fiscal redistribution between net contributors and net recipients as a share of national GDP. On the contributor

FIGURE 5: Implicit transfers in Canada, 1961–2024

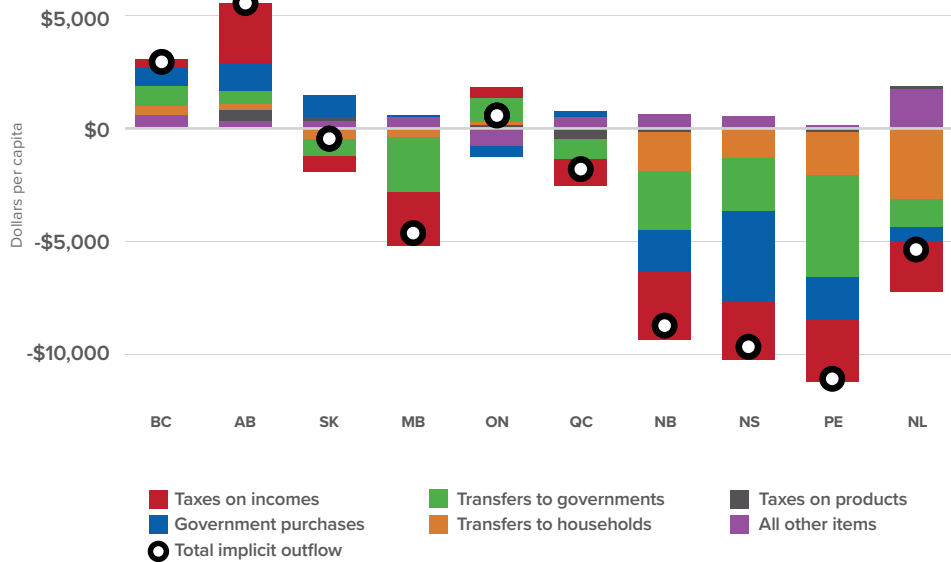


Source: Author's calculations using Tombe (2018) and Statistics Canada data tables 36-10-0450-01, 17-10-0005-01, and 36-10-0222-01

side, Ontario and Alberta are consistently net contributors, though their relative roles change over time. Alberta's contribution grows during periods of high energy prices, such as the 1970s, early 1980s, and 2000s, before receding after the oil price decline of 2015. Ontario's net contribution shrank significantly during and after the financial crisis. On the recipient side, the picture is more stable, though Newfoundland and Labrador's share has declined substantially since the late 1990s as resource revenues and economic strength improved following developments such as Hibernia.

Much of this redistribution arises from uniform national programs. Personal and corporate income taxes, and to a lesser extent withholding taxes, naturally raise more from higher-income provinces because more income is earned there. This is not because tax rates are higher in those provinces. It is because the same tax rates yield more revenue where incomes are higher. Similarly, on the spending side, provinces differ in age structure, so programs such as Old Age Security and the Guaranteed Income Supplement naturally pay more into older provinces. In addition, elderly individuals, who typically earn less, tend to face lower effective tax rates than working-age individuals.

FIGURE 6: Decomposition of federal fiscal balances, by category (2024)



Source: Author's calculations using Finances of the Nation fiscal balance database.

Older provinces therefore tend both to receive more in age-related transfers and pay less in personal income taxes.

Figure 6 decomposes these fiscal balances by category. In Alberta, for example, of the more than \$5,000 per capita net outflow in 2024, roughly half reflects taxes on income, both personal and corporate. Product taxes such as the GST add to that, bringing the combined effect to roughly \$3,200 per capita. Lower federal purchases of goods and services and lower transfers to the provincial government account for the rest. In the Maritime provinces, by contrast, large net inflows reflect a combination of higher transfers to governments, larger transfers to individuals, and lower personal income tax collections.

Not all uneven spending reflects differences in economic or demographic structure. Military spending is one example. Federal operations are much larger in some regions than in others. Nova Scotia, for instance, is home to the Atlantic Fleet headquarters and therefore receives substantial federal purchases of goods and services associated with that presence. This shows up in the province's disproportionately large share of government purchases and helps explain its large net inflow.

This decomposition matters because it shows how and why federal financial resources are redistributed across provinces. Even when programs are not explicitly designed to redistribute, that can still be their effect. These implicit transfers also have macroeconomic consequences. Recent research suggests that they materially reduce economic activity in higher-income provinces while increasing it in lower-income provinces. Unsurprisingly, higher-income provinces, especially Alberta and Ontario, often express concern about these implicit transfers.

Implicit transfers and Alberta

Given the importance of implicit transfers in Alberta, and the rising sense of unfairness in the federation (Tombe and DeCillia 2026), it is worth explicitly unpacking the sources of the federal fiscal imbalance with respect to that province in recent years. In **Table 3**, I report the total revenues raised by the federal government from taxpayers in Alberta and the total federal expenditures within the province, along with selected subcategories for each, using the most recent three years of data available from Statistics Canada.

Overall, in 2024, the federal government raised more than \$73 billion from taxpayers in Alberta, with nearly \$61 billion of that coming from income taxes and the GST alone. This fact is important in its own right. Some in Alberta, especially vocal proponents of Alberta leaving the federation, argue that one fiscal benefit of separation would be the ability of an independent Alberta to eliminate income taxes and the GST entirely (Alberta Prosperity Project 2026). Though such claims are rarely presented with much precision or transparency, the implication is clear enough: doing so would leave a separate Alberta government with only about \$12.5 billion in revenue from all other sources. Once compared with the expenditure side of the ledger, however, it becomes clear that the fiscal arithmetic would not add up. Of course, a separate Alberta that kept the income and consumption tax revenue now collected federally could redirect that surplus to its own priorities, assuming no change in the size of its underlying tax base (which is an extreme assumption, to be clear).

On the expenditure side, in 2024, the federal government spent a little more than \$54 billion on programs and services within Alberta. Purchases of goods and services totaled \$7.4 billion, of which \$2.3 billion was for defence and the remainder for non-defence purposes. Federal direct spending

TABLE 3: Federal revenue and spending in Alberta (\$ millions)

Budget Item	YEAR		
	2022	2023	2024
Total Revenues	60,163	66,747	73,354
<i>Personal income taxes</i>	29,553	31,260	33,383
<i>Corporate incometaxes</i>	12,695	15,376	17,462
<i>Withholding taxes</i>	1,768	2,237	2,915
<i>GST</i>	6,672	7,027	7,096
<i>Tariffs</i>	741	709	697
<i>Gas taxes</i>	850	859	849
<i>Other excise taxes</i>	2,849	3,506	4,452
<i>Other revenues</i>	5,035	5,773	6,500
Total Expenditures	43,061	48,044	54,354
<i>Non-defence purchases</i>	5,025	4,864	5,094
<i>Defence purchases</i>	2,032	2,191	2,256
<i>EI benefits</i>	2,487	2,336	2,781
<i>Old Age Security</i>	5,823	6,577	7,129
<i>Other household transfers</i>	7,631	7,998	9,262
<i>Transfers to government</i>	14,039	16,275	17,974
<i>Other program spending</i>	2,547	2,958	3,882
<i>Interest on debt</i>	3,477	4,845	5,976
Surplus	17,102	18,703	19,000

Source: Author's calculations using Statistics Canada data table 36-10-0450-01.

on goods and services is therefore relatively limited, with most federal expenditure in Alberta taking the form of transfers. These include nearly \$2.8 billion in Employment Insurance benefits to unemployed individuals, \$7.1 billion in Old Age Security payments to seniors, and \$9.3 billion in other transfers to households, from the Canada Child Benefit to a wide range of other programs. There are also transfers to governments, mainly provincial but also local and Indigenous governments, totaling nearly \$18 billion. All other program spending amounts to just under \$4 billion, alongside roughly \$6 billion in federal public debt charges attributed to Alberta on the basis of its share of Canada's population.

Taken together, these figures imply a federal surplus with respect to Alberta of approximately \$19 billion. As noted above, however, these are only the raw nominal figures. They should be adjusted to account for the overall federal fiscal imbalance, which in 2024, under the Statistics Canada methodology, was \$75.3 billion. On that basis, the surplus raised in Alberta

amounted to just under \$3,900 per capita, while nationally the federal deficit was just over \$1,800 per capita. The adjusted fiscal transfer out of Alberta through the federal budget was therefore just shy of \$5,700 per capita, for a total net outflow of roughly \$28 billion. That is equivalent to 5.9 per cent of Alberta's economy in that year.

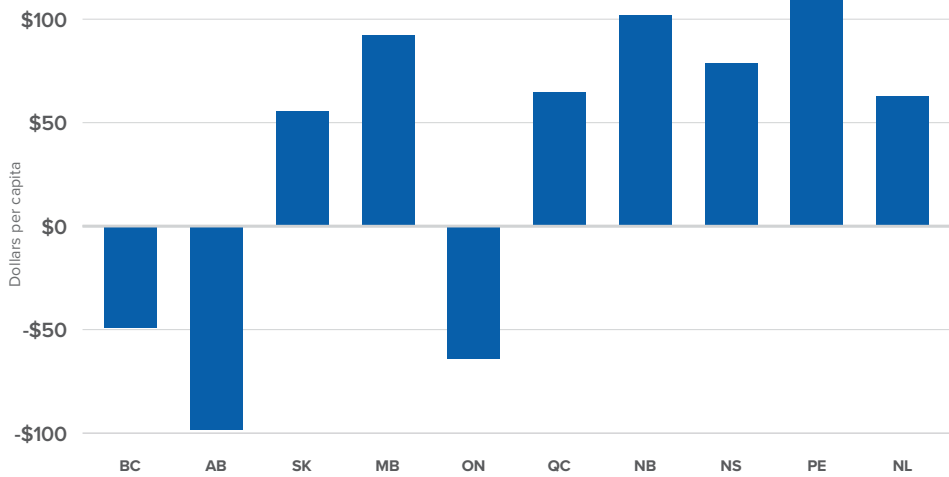
So, while it is certainly true that there are fiscal outflows from Alberta through the federal budget, the underlying sources are, as described above, largely taxes on income and consumption. Alberta's relatively high-income levels mean that federal revenues from these sources are disproportionately large, while its younger population means that federal transfers to the province are lower than in many other parts of the country. Whatever one thinks of the fairness of these flows, the gap between current federal revenues and expenditures in Alberta is far smaller than some separatist proponents suggest. In particular, eliminating federal income and consumption taxes would leave a future Alberta government with far fewer sources of revenue to finance even the direct transfers to individuals that currently exist, let alone replace transfers to governments, cover a share of public debt charges, or bear the costs of creating and operating separate national institutions.

Reform options for implicit redistribution

Before considering possible reforms, it is worth emphasizing that redistribution occurs when a program raises or spends different amounts per capita across provinces relative to the national average. This means that equal per capita transfers such as the Canada Health Transfer and the Canada Social Transfer are not themselves redistributive. Some analysts nevertheless describe them that way because the federal revenues used to finance them are raised disproportionately from some provinces. That observation is true, but if the objective is to reduce regional redistribution, then the focus should be on the revenue instruments that create those differences, not on equal per capita transfers.

That brings us to the largest source of implicit interprovincial redistribution: taxes on income. Reducing per capita differences in income tax collections across provinces would generally require lower tax rates, especially at the top of the income distribution. Such reforms could, of course, be paired with adjustments to basic personal amounts or other elements of the tax schedule so that the benefits are not concentrated solely among higher-income earners.

FIGURE 7: Change in federal fiscal balances resulting from personal income tax rate reductions and a GST rate increase (\$ per capita)



Source: Author's calculations based on Laurin, Dahir, and Mintz (2026) and SPSDM version 34. Specifically, this simulates reductions in the personal income tax rate to 14 per cent, 20.5 per cent, and 26 per cent across a hypothetical three-bracket system with income cutoffs at \$60,000 and \$180,000 per year. This is combined with a 1.5 percentage point increase in the GST to have revenue-neutral impacts on the federal budget, and assuming behavioral responses to the personal income tax change mean net revenue reductions are 70 per cent of the mechanical effect alone.

To illustrate, I consider a tax reform recently proposed by Laurin, Dahir, and Mintz (2026) in a C.D. Howe publication calling for substantial improvements to the personal income tax system, both to lower rates and simplify the overall structure. For the purposes of this paper, I focus only on the proposed lower marginal tax rates, which would reduce the rates applied to the third, fourth, and fifth brackets and lower the top rate to 26 percent. I then assume a revenue-neutral reform that combines these reductions with an increase in the GST of approximately 1.5 percentage points, raising it from 5 per cent to 6.5 per cent.

The resulting reform would not only improve investment incentives but could also strengthen productivity and economic growth while reducing the scale of implicit interprovincial transfers through the federal budget. **Figure 7** illustrates the per capita effect across provinces. Ontario, Alberta, and British Columbia would see their fiscal outflows decline, while fiscal inflows elsewhere would shrink correspondingly. In Alberta, the reduction in implicit transfers would be on the order of roughly \$100 per capita, equivalent to about half a billion dollars per year.

In addition to changes on the personal income tax side, reforms to the corporate income tax system could further reduce the scale of interprovincial redistribution. Assessing the full merits of such tax proposals is beyond the scope of this paper. But to the extent that they would improve national economic performance by strengthening incentives to invest and grow the economy, it is important to recognize that they would also almost certainly reduce the amount of redistribution occurring across provinces through the federal budget.

Conclusion

Federal-provincial transfers are a core part of Canada's federation. But their current structure is increasingly in need of reform. Equalization remains necessary in a decentralized country where provinces have major spending responsibilities and very different revenue-raising capacities. Yet the current formula has important potential weaknesses, particularly in its treatment of resource revenues, its omission of price differences, and its limited attention to demographic pressures. Beyond equalization itself, the broader federal budget redistributes substantial financial resources across provinces through taxes and spending programs that are not always recognized. Taken together, these features suggest that the current system is more complicated, more distortionary, and potentially more costly than it needs to be.

It is worth being explicit about what the approach proposed here is meant to achieve, since it deliberately balances several goals that can pull against one another. The aim is not simply to spend less, though a more sustainable path for transfers is part of it. Rather, the reforms are intended to strike a better balance among competing priorities: reducing the disincentives that the current formula creates against provinces boosting own-source revenue and economic growth; making the resulting redistribution more transparent and easier to understand; and helping ensure that provinces can fund reasonably comparable public services at reasonably comparable rates of taxation. No single design can achieve all of these objectives at once but

a simpler structure with a more growth-oriented equalization formula offers a potentially superior trade-off among them than the present arrangement provides.

Of course, there is no single reform that governments may consider, nor is there any shortage of options. A simpler transfer architecture, one that more clearly separates vertical from horizontal fiscal imbalances, would provide a stronger foundation for reform. Changes to equalization could better reflect real differences in real fiscal capacity and need while reducing disincentives to growth. Broader tax and transfer reforms could also reduce unnecessary redistribution and improve accountability within the federation. The case for acting sooner rather than later is therefore strong. Early reform would give governments more flexibility, more room for compromise, and a better chance to strengthen and renew Canada's fiscal federalism before rising economic, demographic, and geopolitical pressures force more difficult choices in the future. [MLI](#)

About the author



Trevor Tombe is a professor of Economics at the University of Calgary, a senior fellow at the Macdonald-Laurier Institute and the MEI, a fellow at the Public Policy Forum, and co-director of *Finances of the Nation*, a new effort to assemble Canadian public finance data, analysis, and commentary and make it available to researchers, journalists, students, and the general public.

His research spans a wide range of topics in economics, including international and interprovincial trade, fiscal federalism, and public finance. He has published in leading academic journals and is co-author of the textbooks *Public Finance in Canada* and *Macroeconomics*.

Beyond his academic work, Tombe regularly advises governments on economic and fiscal issues. He previously served on the Government of Canada's Working Group on Productivity in the Public Sector, its Advisory Council on Interprovincial Trade, the Bank of Canada's external review panel of its pandemic response, among others.

He holds a PhD and MA in Economics from the University of Toronto and a BBA in Finance from Simon Fraser University. He also contributes to public policy conversations through frequent op-eds, articles, and media appearances. [MLI](#)

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Endnotes

- 1 Measured against total provincial revenues rather than against GDP. However, transfers were still quite significant for many provinces.
- 2 The specific designs vary widely. A fuller comparison of these international approaches, and the lessons they hold for Canada, is beyond the scope of this paper.
- 3 There is, however, an important qualification. Because the national average rate is built up from the actual choices of all provinces, larger provinces can influence that average through policy choices. The lack of a general sales tax in Alberta, for example, lowers the national average consumption tax rate, which in turn reduces the measured fiscal capacity of other provinces in that category.

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