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A lesser known (& lagged) provincial inflation hedge

By Warren Lovely

It would be a stretch to say that Canadian governments possess a *perfect* hedge against still-worrisome inflation. But since governments generally tax the *value* of economic activity (be it personal/corporate incomes or consumption, among other things), when *nominal* output is inflated (for one reason or another), key government revenue streams go up with it. We saw this plain as day in 2021-22 and again in 2022-23.

Historically, the link between nominal output and government revenue has been a bit stronger at the federal level than for the provincial aggregate. In part, that's because federal transfers—which comprise a non-trivial share (~25% on average) of provincial revenue—haven't always been directly or immediately tied to nominal output. Starting in 2017-18, total Canada Health Transfer (CHT) cash—the largest federal transfer program and one every province receives on an equal per capita basis—was explicitly linked to smoothed nominal GDP growth (subject to a 3% floor). Note that the total Equalization entitlement—allocated only to the so-called 'have not' provinces—is similarly linked to smoothed nominal GDP growth (and has been for years). Meantime, the total Canada Social Transfer (CST) envelop—another major transfer program for all provinces—has been growing 3% per year since 2009-10, regardless of whether price deflators were raging or well contained.

In years' past, the nominal GDP tie-in for CHT and Equalization might not have been anything to get too excited about. In fact, during the first year of the new CHT funding formula (2017-18), the lagged impact of stunted GDP growth saw the 3% floor kick in. Fast forward to 2023-24; even with economic growth poised to stall, the lagged impact of blowout nominal GDP gains in both 2021 and 2022 will pay handsome dividends in terms of transfer support to the provinces. This was confirmed via the end-of-year transfer envelopes Chrystia Freeland handed out. For the 2023-24 fiscal year (starting April 1st), Canada's provinces and territories are set to receive a record C\$94.6 billion in major cash transfers. That's up C\$7 billion or 7.9% vs. the outgoing 2022-23 fiscal year. Driving that increase are 9.3% scheduled bumps in total CHT dollars and Equalization—heady rates of expansion for two major transfer programs that capture a lofty three-year average nominal GDP gain.

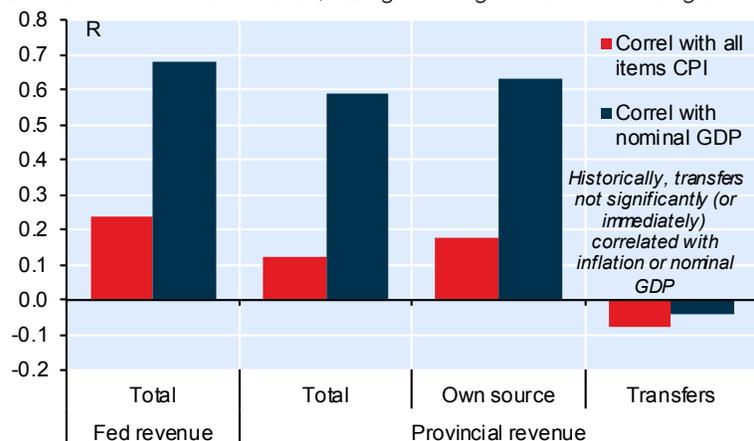
All else equal, per capita formulas mean provinces with disproportionately larger/(smaller) population gains can see faster/(slower) transfer growth. Then there's Equalization. Simply put, not all provinces are created equal, in terms of economic make-up/leverage and resulting fiscal capacity (which we tend to proxy via nominal GDP per capita). Consistent with a constitutional principle and parliamentary commitment (see Subsection 36(2) of the *Constitution Act, 1982*), Equalization aims to dull fairly striking inter-provincial fiscal disparities. The Equalization program channels general federal revenue to jurisdictions possessing below-average tax-raising ability, pursuant to a complex formula.

Equalization is hardly new. The program has operated since the 1950s. But unlike CHT or CST, only *some* provinces can qualify. For 2023-24, six provinces are entitled to Equalization, as detailed fiscal capacity calculations (both lagged and weighted) put Ontario back into so-called 'have not' territory. Since it's essentially a zero-sum game and not necessarily sympathetic to shifting conditions in sufficiently 'rich' provinces, the program remains a source of regional controversy. The dollars at stake are none-too-trivial, total Equalization payments just short of C\$24 billion for 2023-24, which for context is almost 50% larger than total CST cash. Given its size, Quebec collects the largest share of the Equalization dollars on offer (C\$14 billion or almost 60% of the total for 2023-24). Of note, however, Quebec's relatively solid economic performance of late means slower growth in Equalization vs. other receiving provinces, its share of a growing Equalization pie thus shrinking.

There's a lot to unpack here, as the following charts and detailed tables try to make clear. Notwithstanding enlarged transfer envelopes, the provinces are hardly appeased. Indeed, one thing *all* provinces can agree on is the need for Ottawa to fundamentally up its support for a strained health care system. So while provincial leaders likely weren't all that effusive in their praise for the fresh transfer announcement, the lagged impact of earlier sizzling GDP inflation will lend provincial revenue some non-trivial support as the national economy starts to sputter.

Chart 1: Historical inflation-revenue link for governments

20Y correlation btw CPI inflation/GDP growth & government revenue growth

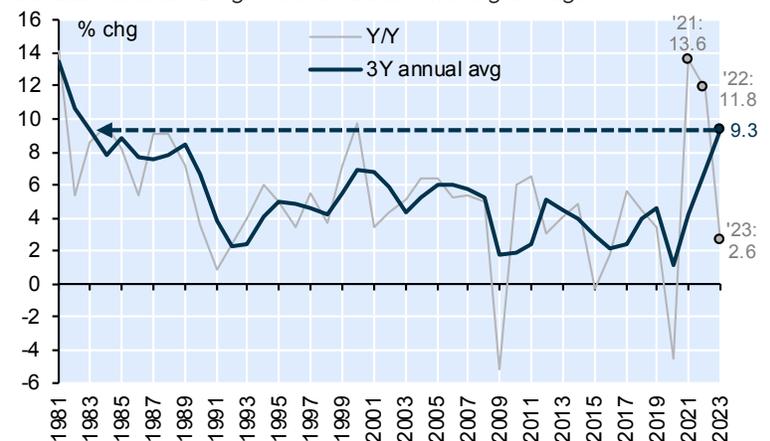


Source: NBF, StatCan, GoC | Note: Based on 20Y to 2019-20 (i.e., pre-pandemic)

Looking back, growth in federal transfers to the provinces hasn't appeared all that connected to CPI inflation or broader price swings captured in nominal GDP. But don't let that fool you...

Chart 2: Smoothing out Canada's recent nominal GDP surge

Canada nominal GDP growth: Annual & 3Y moving average

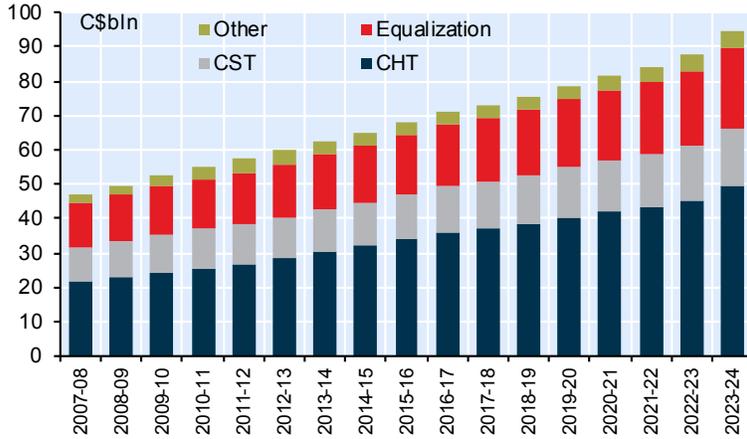


Source: NBF, StatCan, GoC | Note: Actuals to 2021; 2022-23 based on GoC FES (Nov-22)

...as some transfer programs are linked to the three-year average rate of nominal GDP growth. Having booked big GDP gains in 2021 and 2022, key transfers will grow smartly in 2023-24.

Chart 3: Major transfers to provinces stepping up

Major federal transfers to provinces/territories by program

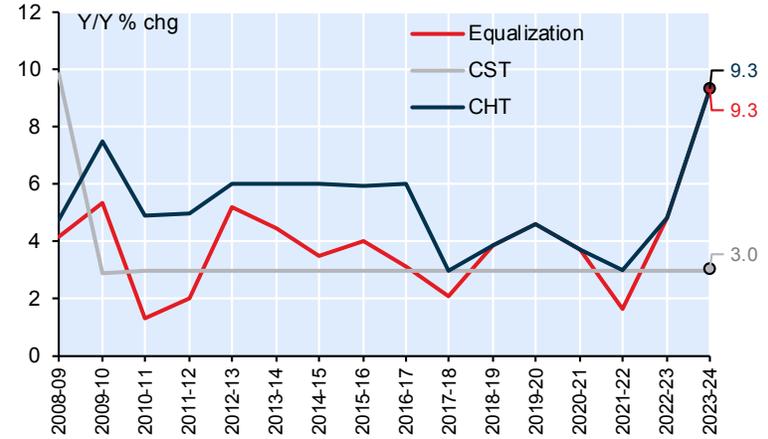


Source: NBF, GoC | Note: 2022-23 & 2023-24 are preliminary; excl. CHT top-ups & FSP

Led by CHT and Equalization, major transfers to the provinces and territories will reach a record \$94.6bn in 2023-24, up \$7bn vs. the prior FY and equivalent to \$2,397 for every Canadian.

Chart 4: Nominal GDP pop means more CHT & Equalization

Growth in major federal transfers to provinces/territories by key program

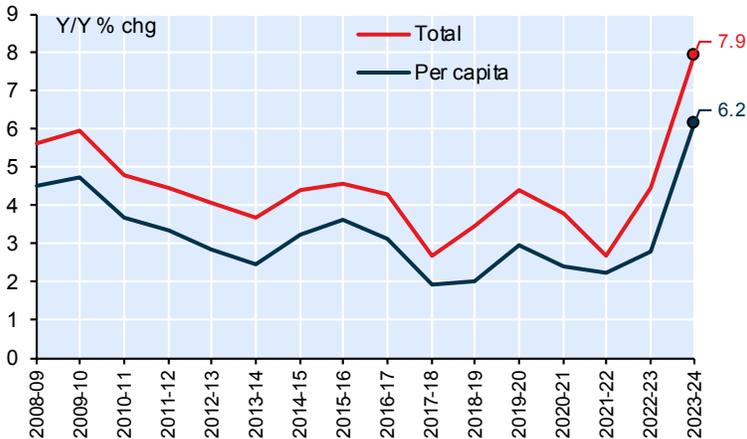


Source: NBF, GoC | 2022-23 & 2023-24 are preliminary; excl. CHT top-ups & FSP

Capturing the lagged impact of heady nominal GDP gains, total CHT cash and the overall Equalization entitlement will spike 9.3% higher. Total CST cash continues to grow by 3%/year.

Chart 5: Overall, notable pick up in major transfer growth...

Growth in major federal transfers to provinces/territories: Total & per capita

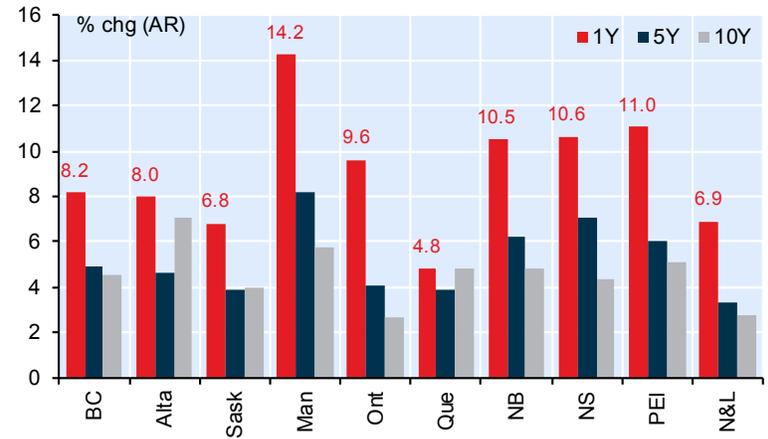


Source: NBF, GoC | Note: 2022-23 & 2023-24 are preliminary; excl. CHT top-ups, FSP

Major transfers to the provinces and territories will increase by 6.2% in per capita terms. All else equal, relative population growth rates impact the total level of support each province receives.

Chart 6: ... but transfer growth continues to vary by province

1-10Y growth in major federal transfers to the provinces: As of 2023-24

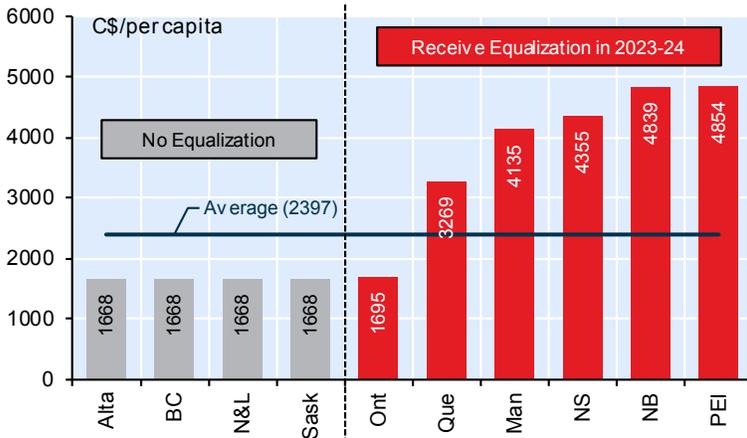


Source: NBF, GoC | Note: Based on preliminary estimates; excl. CHT top-ups, FSP

For 2022-23, all provinces will see transfer support increase (in total dollars and on a per capita basis). The biggest Y/Y percentage increase in total cash: Manitoba. Most modest gain: Quebec.

Chart 7: Six provinces to receive Equalization in 2023-24

Major federal transfers to the provinces: 2023-24 (per capita basis)

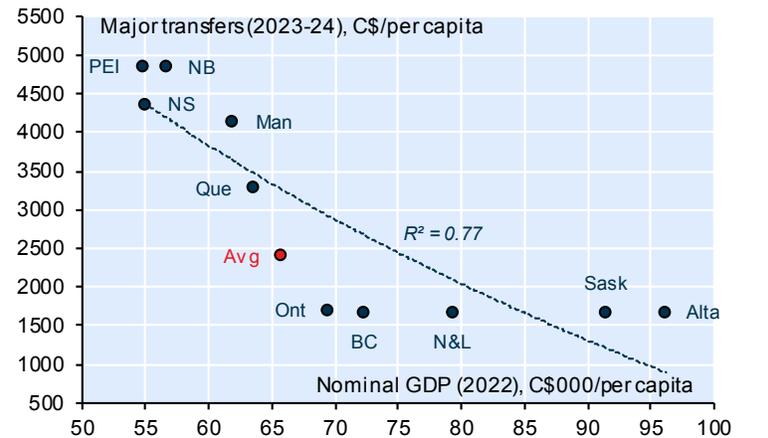


Source: NBF, GoC | Note: Based on preliminary estimates

Fiscal capacity varies considerably across the country, so not all provinces receive the same per capita transfer allocation. For 2023-24, the four 'have' provinces are Alta, BC, N&L & Sask.

Chart 8: 'Richer' provinces get less transfer support (& vice versa)

Major federal transfers per capita vs. nominal GDP per capita

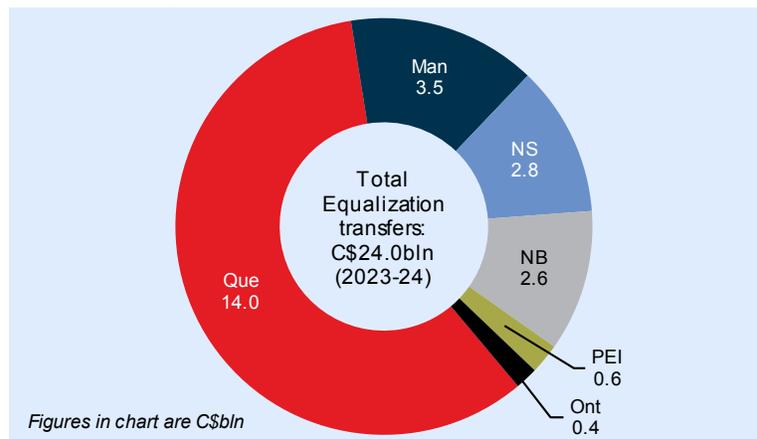


Source: NBF, GoC | Note: Transfer figures preliminary; GDP figures reflect NBF estimates

Equalization reduces (but does not eliminate) regional disparities in tax-raising ability. The resulting fit between proxied fiscal capacity and relative transfer support is ok but hardly perfect

Chart 9: Divvying up a materially larger Equalization pie

Share of total Equalization entitlement: 2023-24



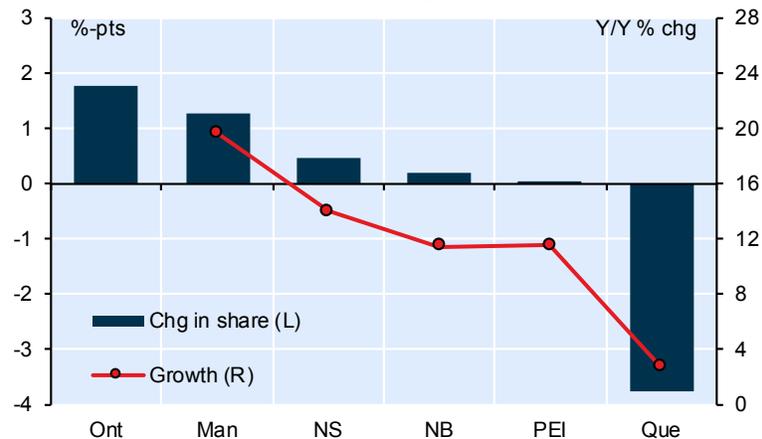
Figures in chart are C\$b/ln

Source: NBF, GoC

For 2023-24, six provinces are set to share just under \$24bn in Equalization dollars. It's a fast-growing pie, owing to the link to nominal GDP growth. Populous Quebec gets the largest slice...

Chart 10: Quebec's share of Equalization down (Ontario back in)

Growth in Equalization entitlement & change in share of total dollars: 2023-24



Source: NBF, GoC | Note: Ontario growth rate N/A, since no Equalization in 2022-23

... but relative economic performance means Equalization grows slower in Quebec, the province's share of total program dollars declining. Ontario once more qualifies for Equalization.

Table 1: Major federal transfer cash to reach record \$94.6 billion in 2023-24, up \$7 billion or 7.9% vs. prior fiscal year

Major federal transfers to provinces/territories by fiscal year & program

	Total	Y/Y: \$m/ln	Y/Y: %	Canada Health Transfer	Canada Social Transfer	Equalization	Offshore Offset Payments	Territorial Formula Financing	Total Transfer Protection	Additional Payment	Per Capita Allocation
Federal support to provinces & territories via Major Transfers (C\$millions)											C\$
2007-08	47,102			21,729	9,607	12,925	563	2,279	-	-	1,434
2008-09	49,758	2,656	5.6	22,768	10,552	13,462	663	2,313	-	-	1,499
2009-10	52,736	2,978	6.0	24,476	10,857	14,185	645	2,498	-	74	1,570
2010-11	55,281	2,545	4.8	25,672	11,179	14,372	869	2,664	525	-	1,628
2011-12	57,739	2,458	4.4	26,952	11,514	14,659	787	2,876	952	-	1,683
2012-13	60,085	2,346	4.1	28,569	11,859	15,423	443	3,111	680	-	1,731
2013-14	62,297	2,212	3.7	30,283	12,215	16,105	350	3,288	56	-	1,774
2014-15	65,029	2,732	4.4	32,113	12,582	16,669	196	3,469	-	-	1,832
2015-16	68,013	2,984	4.6	34,026	12,959	17,341	125	3,561	-	-	1,899
2016-17	70,943	2,930	4.3	36,068	13,348	17,880	44	3,603	-	-	1,959
2017-18	72,870	1,927	2.7	37,150	13,748	18,254	36	3,682	-	-	1,997
2018-19	75,416	2,546	3.5	38,584	14,161	18,958	-72	3,785	-	-	2,038
2019-20	78,746	3,330	4.4	40,373	14,586	19,837	2	3,948	-	-	2,098
2020-21	81,732	2,986	3.8	41,870	15,023	20,573	86	4,180	-	-	2,149
2021-22	83,935	2,203	2.7	43,126	15,474	20,911	44	4,380	-	-	2,197
2022-23	87,667	3,732	4.4	45,208	15,938	21,920	48	4,553	-	-	2,258
2023-24	94,634	6,967	7.9	49,421	16,416	23,963	-	4,834	-	-	2,397
1Y %	7.9			9.3	3.0	9.3	NA	6.2	NA	NA	6.2
3Y % (CAGR)	5.0			5.7	3.0	5.2	NA	5.0	NA	NA	3.7
5Y % (CAGR)	4.6			5.1	3.0	4.8	NA	5.0	NA	NA	3.3
10Y % (CAGR)	4.3			5.0	3.0	4.1	NA	3.9	NA	NA	3.1

Source: NBF, GoC

Notes: Table prepared by NBF based on Department of Finance Canada information on federal support to provinces and territories; excludes CHT top-ups & fiscal stabilization payments; 1Y/3Y/5Y/10Y growth rates are in reference to 2023-24 allocation announced in December 2022; 3Y/5Y/10Y figures represent compound annual growth rates; refer to Government of Canada for complete details and additional notes: <https://www.canada.ca/en/department-finance/programs/federal-transfers.html>

Tables 2-4: Divvying up the transfer dollars... all provinces get CHT & CST but not everyone dips into growing Equalization pie

Major federal transfers to provinces/territories by fiscal year & jurisdiction, including detailed composition/distribution of 2023-24 major federal transfers

	Total	Y/Y: \$mln	Y/Y: %	BC	Alta	Sask	Man	Ont	Que	NB	NS	PEI	N&L	Territories
Federal support to provinces & territories via Major Transfers (C\$millions)														
2007-08	47,102			4,376	2,795	1,317	2,982	12,087	14,622	2,204	2,442	429	1,465	2,384
2008-09	49,758	2,656	5.6	4,547	2,920	1,090	3,295	13,071	15,952	2,348	2,529	464	1,120	2,419
2009-10	52,736	2,978	6.0	4,789	3,143	1,178	3,359	14,274	16,673	2,488	2,648	490	1,079	2,614
2010-11	55,281	2,545	4.8	5,034	3,374	1,174	3,348	15,446	17,267	2,491	2,626	490	1,253	2,779
2011-12	57,739	2,458	4.4	5,269	3,495	1,204	3,352	17,335	17,292	2,493	2,652	493	1,157	2,997
2012-13	60,085	2,346	4.1	5,523	3,661	1,277	3,355	19,177	17,349	2,497	2,848	509	648	3,241
2013-14	62,297	2,212	3.7	5,790	3,878	1,354	3,363	19,915	17,911	2,497	2,975	519	670	3,426
2014-15	65,029	2,732	4.4	5,832	5,175	1,411	3,359	19,184	19,614	2,616	3,001	544	677	3,618
2015-16	68,013	2,984	4.6	6,152	5,475	1,484	3,436	20,445	20,348	2,658	3,052	553	694	3,716
2016-17	70,943	2,930	4.3	6,482	5,772	1,565	3,531	21,347	21,372	2,741	3,060	584	724	3,766
2017-18	72,870	1,927	2.7	6,857	5,912	1,602	3,680	21,022	22,640	2,829	3,140	600	737	3,852
2018-19	75,416	2,546	3.5	7,114	6,122	1,657	3,964	21,337	23,674	2,972	3,227	637	750	3,962
2019-20	78,746	3,330	4.4	7,442	6,377	1,714	4,257	21,260	25,554	3,160	3,435	649	767	4,131
2020-21	81,732	2,986	3.8	7,715	6,611	1,764	4,576	22,056	26,083	3,381	3,699	695	781	4,370
2021-22	83,935	2,203	2.7	7,970	6,812	1,813	4,853	22,706	26,309	3,485	3,877	736	798	4,577
2022-23	87,667	3,732	4.4	8,354	7,127	1,877	5,148	23,733	27,334	3,634	4,105	770	827	4,757
2023-24	94,634	6,967	7.9	9,035	7,695	2,005	5,881	26,017	28,652	4,015	4,542	855	884	5,054
1Y %	7.9			8.2	8.0	6.8	14.2	9.6	4.8	10.5	10.6	11.0	6.9	6.2
3Y % (CAGR)	5.0			5.4	5.2	4.4	8.7	5.7	3.2	5.9	7.1	7.2	4.2	5.0
5Y % (CAGR)	4.6			4.9	4.7	3.9	8.2	4.0	3.9	6.2	7.1	6.1	3.3	5.0
10Y % (CAGR)	4.3			4.6	7.1	4.0	5.7	2.7	4.8	4.9	4.3	5.1	2.8	4.0

	Total	Y/Y: \$mln	Y/Y: %	BC	Alta	Sask	Man	Ont	Que	NB	NS	PEI	N&L	Territories
Per capita allocation (C\$)														
2007-08	1,434			1,021	797	1,316	2,510	948	1,902	2,958	2,611	3,110	2,882	22,270
2008-09	1,499	65	4.5	1,047	814	1,073	2,754	1,016	2,057	3,144	2,703	3,349	2,191	22,344
2009-10	1,570	71	4.7	1,087	856	1,141	2,783	1,100	2,128	3,319	2,824	3,504	2,093	23,888
2010-11	1,628	58	3.7	1,128	905	1,118	2,746	1,178	2,180	3,308	2,788	3,459	2,404	25,056
2011-12	1,683	55	3.4	1,172	924	1,130	2,721	1,309	2,162	3,301	2,810	3,430	2,204	26,548
2012-13	1,731	48	2.9	1,216	946	1,178	2,688	1,431	2,148	3,301	3,014	3,514	1,233	28,379
2013-14	1,774	43	2.5	1,263	973	1,227	2,660	1,471	2,199	3,304	3,154	3,578	1,270	29,752
2014-15	1,832	58	3.3	1,259	1,259	1,259	2,627	1,404	2,390	3,466	3,185	3,722	1,281	30,969
2015-16	1,899	67	3.7	1,312	1,312	1,312	2,655	1,483	2,466	3,525	3,236	3,776	1,312	31,502
2016-17	1,959	60	3.2	1,364	1,364	1,364	2,684	1,530	2,571	3,621	3,228	3,912	1,364	31,448
2017-18	1,997	38	1.9	1,395	1,395	1,395	2,760	1,496	2,732	3,692	3,306	3,991	1,395	31,586
2018-19	2,038	41	2.1	1,425	1,425	1,425	2,932	1,493	2,826	3,858	3,370	4,163	1,425	32,036
2019-20	2,098	60	2.9	1,464	1,464	1,464	3,114	1,464	3,010	4,071	3,547	4,131	1,464	33,052
2020-21	2,149	51	2.4	1,496	1,496	1,496	3,314	1,496	3,041	4,321	3,770	4,316	1,496	34,520
2021-22	2,197	48	2.2	1,534	1,534	1,534	3,488	1,534	3,060	4,416	3,920	4,480	1,534	35,646
2022-23	2,258	61	2.8	1,575	1,575	1,575	3,660	1,575	3,149	4,491	4,042	4,530	1,575	36,633
2023-24	2,397	139	6.2	1,668	1,668	1,668	4,135	1,695	3,269	4,839	4,355	4,854	1,668	38,472
1Y %	6.2			5.9	5.9	5.9	13.0	7.6	3.8	7.7	7.7	7.2	5.9	5.0
3Y % (CAGR)	3.7			3.7	3.7	3.7	7.7	4.3	2.4	3.8	4.9	4.0	3.7	3.7
5Y % (CAGR)	3.3			3.2	3.2	3.2	7.1	2.6	3.0	4.6	5.3	3.1	3.2	3.7
10Y % (CAGR)	3.1			2.8	5.5	3.1	4.5	1.4	4.0	3.9	3.3	3.1	2.8	2.6

	Total	Y/Y: \$mln	Y/Y: %	BC	Alta	Sask	Man	Ont	Que	NB	NS	PEI	N&L	Territories
Distribution of 2023-24 Major Transfers by type (C\$millions)														
CHT	49,421	4,213	9.3	6,782	5,776	1,505	1,780	19,214	10,971	1,039	1,305	220	664	165
CST	16,416	478	3.0	2,253	1,919	500	591	6,382	3,644	345	434	73	220	54
Equalization	23,963	2,043	9.3	-	-	-	3,510	421	14,037	2,631	2,803	561	-	-
TFF	4,834	233	5.1	-	-	-	-	-	-	-	-	-	-	4,834
Total	94,634	6,967	7.9	9,035	7,695	2,005	5,881	26,017	28,652	4,015	4,542	855	884	5,054

Source: NBF, GoC

Notes: Tables prepared by NBF based on Department of Finance Canada information on federal support to provinces and territories; 'Major Transfers' include Canada Health Transfer, Canada Social Transfer, Equalization, Offshore Offset Payments, Territorial Formula Financing, Total Transfer Protection & Additional Payments; excludes CHT top-ups & fiscal stabilization payments; shading denotes receipt of Equalization in a given fiscal year; 1Y/3Y/5Y/10Y growth rates are in reference to 2023-24 allocation announced in December 2022; 3Y/5Y/10Y figures represent compound annual growth rates; refer to Government of Canada for complete details and additional notes: <https://www.canada.ca/en/department-finance/programs/federal-transfers.html>



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