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TEN REASONS TO REMOVE NONRENEWABLE RESOURCES FROM EQUALIZATION

KENNETH J. BOESSENKOOL

Equalization: Welfare Trap or Helping Hand? (PAPER #5)

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Contact Information:

AIMS
2000 Barrington Street, Suite 1006
Halifax, NS, Canada B3J 3K1
Phone: (902) 429-1143
Fax: (902) 425-1393
E-mail: aims@aims.ca
Website: www.aims.ca

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FCPP
201-63 Albert Street
Winnipeg, Manitoba, Canada R3B 1G4
Phone: (204) 957-1567
Fax: (204) 957-1570
E-mail: newideas@fcpp.org
Website: www.fcpp.org

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Contact Information:

MEI
6418, St-Hubert Street, 2nd Floor
Montreal, Quebec, Canada H2S 2M2
Phone: (514) 273-0969
Fax: (514) 273-0967
E-mail: pdesrochers@iedm.org
Website: www.iedm.org

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by

KENNETH J. BOESSENKOOL

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2000 Barrington Street, Suite 1006
Halifax, Nova Scotia B3J 3K1
Telephone: (902) 429-1143
Fax: (902) 425-1393
E-mail: aims@aims.ca
Web site: www.aims.ca

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About the Author

Kenneth J. Boessenkool is the President of Sidicus Consulting Ltd., an economic and public policy consulting firm. Ken has published extensively on public policy issues including papers on federal-provincial transfers, provincial welfare, the tax treatment of the family and monetary policy. His opinion pieces have appeared in the Calgary Herald, the Edmonton Journal, the Ottawa Citizen, the National Post and the Globe and Mail. He was formerly a policy advisor to the Provincial Treasurer of Alberta, a policy analyst at the C.D. Howe Institute and an economic policy advisor to an opposition party in Ottawa. Ken currently resides in Airdrie, Alberta, with his wife and three daughters.

INTRODUCTION

After 44 years and $180-billion dollars in equalization spending the Atlantic provinces are only barely more able to meet the needs of their citizens with their own revenue sources than they were when equalization was introduced in 1957. On average, about 40% of provincial budgets in the four Atlantic Provinces comes from federal transfers, most in the form of equalization.

The time has never been better, however, for the Atlantic Provinces to lessen their dependence on federal transfers and to become masters of their own fate. The picture is positive for the newly emerging offshore oil and gas industry in Atlantic Canada. Within a few years, Newfoundland is projected to be producing around 40% of Canada's conventional oil, while a natural gas pipeline, possibly the first of several, already connects Nova Scotia with New England. It appears that offshore and onshore petroleum resources may be discovered in or around virtually every province in the region.

The development of natural resources, primarily oil and gas but also other minerals, creates the conditions in which economic growth in the region could well outstrip that of the rest of the country.

Unfortunately, because of the treatment of natural resources in equalization, the potential for growth, and realizing that potential, are two different things for Atlantic Canada.

To address this problem I have recently proposed that nonrenewable resources be removed from the Equalization program. What follows are my top 10 reasons for removing nonrenewable resource revenues from equalization, though this is not the type of top ten list you will ever hear on David Letterman.

Ten Reasons to Remove Nonrenewable Resources from Equalization:

1. Resource revenues have been nothing but trouble for the equalization program

2. Removing nonrenewable resources would vastly simplify the program

3. Having nonrenewable resources in equalization produces perverse incentives

4. Having nonrenewable resources in the formula causes fiscal problems for Ottawa

5. Having resource revenues in equalization is arguably unconstitutional

6. Having nonrenewable resource in equalization does not make economic sense

7. The equalization formula double counts the fiscal capacity from resources

8. Removing resources would allow the program to reflect all province's fiscal capacity

9. Removing non-renewable resources would mean very small adjustments for recipients

10. The politics of the proposal look good

1. Resource revenues have been nothing but trouble for the equalization program

When equalization was created in 1956, resource revenues were not included. Half of resource revenues were added in 1962, and for the next twenty years (particularly during the 1970s OPEC crisis) Ottawa fiddled with the treatment of resource revenues within equalization eight times—from full inclusion, to partial inclusion to full exclusion and nearly everything in between.

In 1982 Ottawa moved to the current five province standard, excluding Alberta, and hence its resource revenues, from the calculation of payments to recipient provinces (the Atlantic Provinces were also excluded). More recently, Ottawa has tinkered with the resource formula to try to reduce its disincentive effects and has also initiated a number of cash transfers into the Atlantic Region, such as Hibernia and various development funds, to offset the impact of falling equalization payments as resource royalties grew.

Of all the problems with equalization, the treatment of resources has been the most persistent.

2. Removing nonrenewable resources would vastly simplify the program

Of the 33 revenue bases used in the equalization formula, 11 are directly related to nonrenewable resources and 10 of them to oil and gas ("new oil," "old oil," "heavy oil," "mined oil," "third-tier oil," "heavy third-tier oil," and, just in case something was missed, "other oil," as well as two categories of "offshore" oil and gas, and "natural gas"). The 11th category is "other mineral resource revenues."

Eliminating these tax bases from the formula would vastly simplify equalization, eliminating the number of tax bases by one third.

3. Having nonrenewable resources in equalization produces perverse incentives

Equalization exists to provide the less wealthy provinces with funds to bring their revenues up to a standard, or common level. The very existence of the program and the amounts of money involved demonstrate Canadians' willingness to share across provincial boundaries. Yet equalization payments can work against provinces' economic best interests when those payments punish recipients for responsible development of their nonrenewable resources. To wit: any increase in revenue from those resources is taxed back from a province's equalization entitlement by as much as 100 percent. As a result, recipient provinces have little incentive to reduce their reliance on equalization in favour of developing provincial resources.

At a time when fiscal policy is moving away from high marginal tax rates and welfare traps, equalization's treatment of resources is peculiar. Removing resources from equalization moves it away from the equivalent of high marginal tax rates on provincial nonrenewable resource revenues and from the incentive trap that this treatment produces for recipient provinces.

4. Having nonrenewable resources in the formula causes fiscal problems for Ottawa

In his seminal book, *Social Canada in the Millennium*, Tom Courchene notes that Ottawa's approach to nonrenewable resources has been to "downplay the role of resource revenues in the equalization formula" (1994, 302). The federal government has downplayed resources because volatile oil and gas prices have produced large potential swings in the cost of the equalization program. When oil prices spiked during 1970s, the inclusion of Alberta's resource revenues within the formula produced a result that included Ontario (the province with the highest per capita income) among equalization recipients.

Currently, Ottawa excludes Alberta (and the Atlantic Provinces) from the calculation of equalization entitlements to get around this problem. But that means that the program does not properly reflect the fiscal capacity of all provinces in Canada.

5. Having resource revenues in equalization is arguably unconstitutional

The Constitution puts the ownership of, and legislative power over, nonrenewable resources with the provinces. Section 92A, in particular, restricts the right to make laws regarding nonrenewable resources to the provinces. Clause 4 of the same section grants to the provinces the power of direct taxation of natural resources. Section 125 strengthens this provision by stipulating that lands belonging to a province (which include nonrenewable resources) are not to be taxed.

[A caveat: Offshore resources legally belong to the federal government. Ottawa has, however, granted *de facto* ownership to Nova Scotia and Newfoundland by allowing them to collect royalties on oil and gas off their respective coasts.]

Dan Usher has put it this way: the Constitution gives the provinces ownership of the tree as well as entitlement to its fruit. Ottawa therefore has questionable jurisdiction when it comes to redistributing these resources across the country through equalization.

6. Having nonrenewable resource in equalization does not make economic sense

There is a good explanation as to why resource revenues have never quite fit properly within the equalization formula—from an economic point of view, nonrenewable resource royalties are of a fundamentally different nature from other types of revenues.

An accounting illustration provides the backdrop. The revenue from bread that Bill the Baker sells is income—it affects the profits and losses of the bakery. However, if Bill sells one of his ovens, the money from that sale does not enter the income statement. This sale is a balance sheet transaction, because all Bill has done is to exchange a physical asset (the oven) for a financial asset (the case from the sale).

Taxes on personal and corporate income as well as sales are like revenue from the sale of bread. They are properly considered income for the purposes of providing public services.

Nonrenewable resource royalties are quite different. When these resources are sold and a royalty is levied on that sale, all that has changes is that the province has a cash asset instead of an asset in the ground.

The trouble is, equalization does not make the distinction between income and the proceeds from the sale of a capital asset. It treats royalty revenues the same as it treats personal, corporate and sales taxes. Equalization payments fall in response to changes in royalties even though all the province has done is convert a physical asset into a financial asset.

7. The equalization formula double counts the fiscal capacity from resources

A second economic argument is that the rents (or pure economic profits) from the extraction of natural resources are effectively capitalized in other prices in the wider economy. House prices and wages in Alberta, for example, track oil and gas prices remarkably well.

Higher wages and housing prices reflect the additional fiscal capacity that results from the discovery and exploitation of nonrenewable resources. And since tax bases such as personal income and housing stock are included in the equalization formula, natural resource revenues do not need to be.

The capitalization argument, taken to its limit, is often cited as the reason why the United States has no equivalent of Canada's equalization program despite, wide variations in fiscal capacities across states. The predominant US view is that differences in fiscal capacities across states are reflected (or capitalized) in differences in wages and other prices such as property values (Oates 1972), and therefore equalization is unnecessary.

8. Removing resources would allow the program to reflect all province's fiscal capacity

If non-renewable resources were removed, Alberta as well as the Atlantic Provinces could be brought back into the Equalization formula. A 10-province standard would be truer to the spirit of Section 36 of the Constitution than the five-province standard.

9. Removing nonrenewable resources would mean very small adjustments for recipients

Had my proposal been in place, what would it have meant for recipient provinces in 1999/2000? Newfoundland would have seen a mere $6 reduction in its per capita payment compared to the status quo because its nonrenewable resource revenues are already pulling down its entitlement. The remaining Atlantic Provinces, as well as Quebec and Manitoba, would have seen a drop in their per capita entitlement by between $44 and $69. The most pronounced impact of the proposal would have been for Saskatchewan, where the per capita entitlement would have more than doubled as a result of eliminating oil, nonrenewable gas, and potash revenues from the formula.

When these reductions are put up against total provincial revenues, the total dollar reduction in all provinces would have been modest—one percent or less in all cases.

Are these reductions manageable? Per capita equalization entitlements have fluctuated wildly in the past two decades. The average annual change in entitlements has been more than $75 for Newfoundland and New Brunswick, around $60 for Manitoba and Saskatchewan, and $30 for Quebec. Thus, historical changes have been within the range contemplated here.

In addition, these reductions are smaller than the increases these provinces have seen in equalization payments in recent years as a result of both strong growth in Ontario, and the lifting of the $10 billion cap by Ottawa.

And finally, from Ottawa's perspective, the total cost of the program would have dropped by a modest $33 million.

10. The politics of the proposal look good

The equalization program is subject to quinquennial reviews, during which all the provinces and Ottawa look at the program, make any agreed-on changes, and ratify equalization for another five years. Thus, proposing any changes that lack broad support across provinces seems a pointless exercise.

Removing nonrenewable resources from the equalization formula would likely receive support from both ends of the country. Newfoundland and Nova Scotia have an obvious interest in detaching equalization from nonrenewable resource development, particularly as oil and gas production ramps in the next few years. On the other side of the country, the western provinces, particularly Alberta, have an equally obvious interest in any move that would result in the provinces' having greater autonomy over their natural resources.

At the centre, Ontario would not likely oppose the changes as the impact on that province would be minimal.

A bigger hurdle might be gaining the approval of Quebec, New Brunswick, and Prince Edward Island, which would face reductions under the new formula without the compensation of greater ability to tax existing developments of nonrenewable resources. Consider, however, the pull of four counterweights. First, the changes would represent only 1 percent of provincial revenues.

Second, that for every province (except Prince Edward Island), the payments would still be larger than what was received only two years ago. Third, the decrease from the status quo would be smaller than the recent increase due to the lifting of the $10 billion equalization caps. Fourth, it is now widely accepted that the St. Lawrence basin is one of North America's last remaining major hydrocarbon bearing basins. Quebec, New Brunswick, and Prince Edward Island are all clamoring to negotiate offshore agreements with Ottawa in case oil and gas are found within "their" waters, and onshore drilling going on right now in New Brunswick. The whole eastern end of the country may soon be seeing important oil and gas revenues in the foreseeable future. If these counterweights are not enough, Ottawa could offer a transition mechanism, with Ottawa guaranteeing payments at the old level until the new formula caught up to those amounts.

CONCLUSION

To wrap up: Given support from East and West and no or mild resistance from the centre, Ottawa is unlikely to oppose the proposal. It would mean little to the federal government's bottom line; it would continue to protect the federal balance sheet from the vagaries of the price of nonrenewable resources, particularly oil and gas; and it means a substantial simplification of the program—an intergovernmental hat trick not often seen in the arcane world of Canada's intergovernmental relations.