

Executive Summary

An Examination of the Interaction Between Natural Resource Revenues and Equalization Payments: Lessons for Atlantic Canada

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Equalization payments from the federal government to the provincial government have been important for federal-provincial relations in Canada since the program was formally adopted in 1957. The equalization program has evolved from a program initially consisting of three revenue categories applied to a two-province equalization standard to a program that includes all revenues categories currently utilized by the provincial governments and a five-province standard. Every province in Canada has received or qualified to receive payments from the equalization program at one time or another. However, issues surrounding natural resource revenues and equalization have proven to be among the most contentious in the ongoing debate over the role and design of Canada's Equalization Program.

Recent and expected future natural resource developments in Atlantic Canada hold out the promise of improving the relative economic performance within the region. Nevertheless, this new prosperity has brought an increased realization that current intergovernmental fiscal arrangements in Canada may influence both the level of economic development that may be achieved within the region and how individual provinces choose to capture the economic rent that flows from these activities. There is a growing concern that the equalization program, as currently structured, introduces distortions into policy decisions related to the exploitation of natural resources and discriminates against "have-not" provinces when the opportunity arises to develop their natural resource endowments. As a result of these concerns, some people have proposed that the Atlantic Provinces not develop their resources until, and unless, they get a better deal on equalization entitlement claw-backs. Others have advocated the complete elimination of equalization, while some analysts have chosen to address technical parameters within the formula to remove the perceived inequities and inefficiencies, which they believe to exist within the current program. Clearly, there are many different proposals advocated publicly to modify Canada's equalization program – many of which are inconsistent with each other and some of which can have dramatic and negative consequences for regional economic development within Atlantic

Canada. Consequently, it is important that agencies and departments charged with the responsibility of facilitating and enhancing regional economic development have an understanding of the issues surrounding the interaction between resource developments and equalization and its implication for the economic development policy framework relevant for the region.

This study contributes to that understanding by analyzing the alternative treatments of natural resource revenues within the Equalization Program. The substantive contribution of this research is the development of 80 scenarios — 20 for each of four fiscal years — involving both “low-revenue” and “high-revenue” variants. The low-revenue scenarios replicate actual revenues from the offshore for both Newfoundland and Nova Scotia during fiscal years 1999-00 to 2002-03. The high-revenue scenarios simulate projected revenues at peak production — \$350 million for Newfoundland and \$250 million for Nova Scotia.

Based on the analysis presented in this paper, it is possible to draw the following conclusions:

- i. Replacing the current five-province equalization standard with a ten-province or national-average standard, as has been advocated by some provincial governments and some analysts,¹ would result in enhanced equalization entitlements for all recipient provinces. However, this move could raise the annual cost of the equalization program to the federal government by between \$2 and \$5 billion and based on the fiscal years considered in this analysis, the average increase would be in the range of \$3.6 billion. This would represent an average annual increase in resources required to support the equalization program in the order of 30 to 40%;
- ii. While the overall cost to the program of switching from a five-province to a ten-province standard would be approximately \$3.6 billion annually, the primary beneficiaries of this change would not be the Atlantic Provinces. Specifically, only 15% of this increased entitlements would find their way into Atlantic Canada² — Newfoundland and Labrador could expect to see its annual equalization entitlements rise by \$125 million, Prince Edward Island

¹ This is also one of the recommendations of the Standing Senate Committee on National Finances, Murray (2002).

² The 15% estimate for Atlantic Canada was also highlighted by Beale (2002, p. 13)

would have \$30 million more per year, Nova Scotia could expect to receive approximately \$220 million per annum in extra equalization entitlements and New Brunswick's treasury would benefit by \$175 million annually in extra equalization entitlements. On the other hand, Quebec would gain by \$1.7 billion in annual equalization entitlements.

- iii. As well, provincial equalization entitlements could be subject to bigger fluctuations on a year-over-year basis with the ten-province standard than with the five-province standard. This increased uncertainty would cause problems for both levels of government in deciding on budgetary priorities in each year. However, some provincial governments may feel that the higher levels of funding available under the ten-province standard are sufficient compensation for the increased variability associated with federal transfers under a ten-province standard.
- iv. If natural resource revenues were excluded from the current equalization formula, then, for the scenarios considered in this analysis, almost all of the Atlantic Provinces would have less equalization entitlements. The one exception would be Newfoundland and Labrador in fiscal year 2002-03, the last year considered in this analysis. By 2002-03 the offshore oil industry had transferred enough resources to the provincial treasury to exceed its net equalization entitlements from the other natural resource categories. The provinces that would benefit most from having natural resources excluded from the current equalization formula are British Columbia and Saskatchewan, receiving approximately \$1.3 billion and \$825 million per year in increased equalization entitlements, respectively.
- v. The benefit of removing natural resources from the equalization formula gets magnified for Newfoundland and Labrador under the high-revenue scenarios. As well, in every fiscal year considered but 2000-01, Nova Scotia would be better off having natural resources removed from the current equalization formula because its treasury receives \$250 million from its offshore, which is close to, but exceeds, its net entitlements from the other natural resource categories in the fiscal years considered. In other words, if the amount of revenue flowing to the provincial treasuries from the offshore oil and gas sector is larger enough, then it will outweigh the equalization deficiencies that these province have from the other natural

resource categories. Newfoundland and Labrador is currently at this phase and it is likely that Nova Scotia will get there in the near future. However, the other Atlantic Provinces would be net losers if natural resources were excluded from the current equalization formula.

- vi. Changing to the ten-province standard from the five-province standard, with the exception of fiscal year 2001-02, would have no significant impact on provincial equalization entitlements if natural resource revenues were removed from the equalization calculations. Hence, the real concerns over the use of the five-province versus the ten-province standard revolves around how natural resource revenues ought to be treated within the formula.
- vii. Interestingly, all Atlantic Provinces benefit from a move to the national average standard, even if 30 or 50% of natural resource revenues are excluded from the equalization calculations. However, this change would still add between \$2.5 and \$3.0 billion in extra cost annually to the equalization program. Therefore, removing 30 or 50% of the natural resource revenues from the equalization formula in exchange for adopting the ten-province standard may not be seen by the federal government as much of a concession.
- viii. Switching from the low-revenue to the high-revenue scenario has a small differential impact for most of the scenarios considered in this analysis. This results from the fact that while \$250 to \$350 million in oil and gas revenues are large in relation to Newfoundland and Labrador's and Nova Scotia's equalization entitlements, they insignificant when compared to the amount of natural resource revenues that occur Canada-wide;
- ix. An enhanced Generic Solution for oil and gas would provide significant benefits to Newfoundland and Labrador and Nova Scotia with little impact on the cost of the overall program. However, it raises the issue of equity or fairness. Specifically, it could lead politicians and analysts to question why provinces that get revenues from offshore oil and gas should be treated differently from provinces that collect their revenues from other sources;

- x. While Nova Scotia has suggested that receiving a greater share of resource revenues would allow it to use these monies for economic development and to grow its economy, the analysis presented in this paper demonstrates that the overall level of equalization flowing to the provincial treasury is reduced if natural resources are removed from the current equalization calculations. That is, the saving associated with the additional 70% of equalization losses from offshore oil and gas does not offset the reduction in entitlements to Nova Scotia from the other natural resource categories currently included in the equalization formula. However, if the offshore oil and gas sector is able to generate in the order of \$250 million annually to the Nova Scotia treasury, then, depending what is happening to natural resources in other provinces, Nova Scotia may benefit from having natural resources excluded from the current equalization formula as long as this level of revenue persists. But, as illustrated by the 2000-01 fiscal year analysis, it is not guaranteed that Nova Scotia will gain by excluding natural resources from the equalization formula. Consequently, it might be in Nova Scotia's interest to attempt to address its economic development initiative separate from its concerns with respect to the interaction of natural resource revenues and the equalization formula.

The results of these simulations are consistent with the findings and recommendations of the Standing Senate Committee on National Finances, the Murray Committee. The fiscal impacts of moving to a ten-province standard or removing natural resources from the equalization formula are similar to those reported by the committee. In addition, improving the Generic Solution or enhancing the Atlantic Accord as feasible options falling out of this analysis is also consistent with the committee's recommendations (see, Murray 2002, p. 26). As well, in dealing with the tax-back of Saskatchewan energy revenues, Courchene (2004, p.20) suggest that an expanded Generic Solution applied to energy resource might be a short term solution. This would restrict equalization claw-backs to a maximum of 70% and is also supported by the research presented in this report.