ENERGY PRICES, EQUALIZATION AND FEDERALISM

Thomas J. Courchene

The rise in oil prices over the last three decades has been accompanied by and shaped the debate on the equalization formula and on the nature of fiscal federalism. The oil shocks of 1973 and 1979 also inspired the National Energy Program (NEP) in 1980 and the Energy Pricing and Taxation Agreement (EPTA) between Ottawa and Alberta in 1981 — projecting prices near C$60 a barrel, a level not reached until the summer of 2005. The current surge in oil prices, to recent highs of $70 a barrel, has sparked a new a debate on energy pricing, equalization and fiscal frameworks. IRPP's Thomas J. Courchene, a leading authority in the field, reviews the history of oil and federalism, and proposes a remedy to the horizontal fiscal imbalance by allocating the fixed equalization pool in accordance with fiscal capacity disparities relating to non-resource revenues, and creating a modest interprovincial revenue-sharing pool for resource revenues agreed to and operated by the provinces.

La hausse du prix du pétrole des trente dernières années est allée de pair avec le débat sur la péréquation et la nature du fédéralisme fiscal. Les chocs pétroliers de 1973 et 1979 ont aussi inspiré le Programme énergétique national en 1980 et, en 1986, le Energy Pricing and Taxation Agreement entre Ottawa et l'Alberta, qui anticipait que le prix du baril atteindrait 60 dollars canadiens. Une prédiction accomplie... à l'été 2005. La récente poussée des prix, qui a culminé à 70 dollars le baril, a relancé le débat sur le prix de l'énergie, la péréquation et les régimes fiscaux. Sans doute un des plus grands spécialistes canadiens du domaine, Thomas J. Courchene, de l'IRPP, retrace l'histoire du lien entre pétrole et fédéralisme, proposant de remédier au déséquilibre fiscal horizontal en répartissant « le fonds de péréquation fixe » selon les capacité fiscale liées aux recettes non issues de l'exploitation des ressources naturelles et en créant, avec l'accord des provinces, un modeste fonds interprovincial pour partager les recettes issues des ressources.

As Canadians wrestle with the financial and fiscal implications of the current surge in energy prices, it is instructive to harken back to the range of implications triggered by the first energy price cycle, defined for present purposes as the period from 1972 to the mid-1980s. Toward this end, the accompanying graph presents the trends in world energy prices from the early 1970s to the present. The "US$" line is the per-barrel price for Brent Sea crude in US dollars. The "C$" line is this US dollar price expressed in Canadian dollars. From a level of about $2 per barrel in 1972, world prices soared to US$36 (C$45) in the early 1980s before falling back to under $20 in both Canadian and US dollars by 1988.

The ongoing oil price increase from US$14 in 1998 to US$66 in August 2005 (or C$22 to C$82) is larger in absolute value, but cannot compare in relative terms with the 20-fold increase over the 1972-82 period.

The final line is the real (inflation adjusted, in 2004 dollars) Canadian dollar price. Note that the 2005 real Canadian dollar price is considerably lower than it was in 1980. But because Canadian domestic energy prices were less than half of world prices in 1980, real *domestic* prices are higher in 2005 than they were in 1980. In other words, the cost of gas at the pumps is now at an all-time high.

Turning to the equalization program, although it was introduced in 1957 it was the 1967 revision that made the program comprehensive, one aspect of which was that 100 percent of all energy revenues was equalized to the national average standard (NAS). As an aside, 1967 to 1973 would turn out to be the only period to date where energy revenues were fully equalized.

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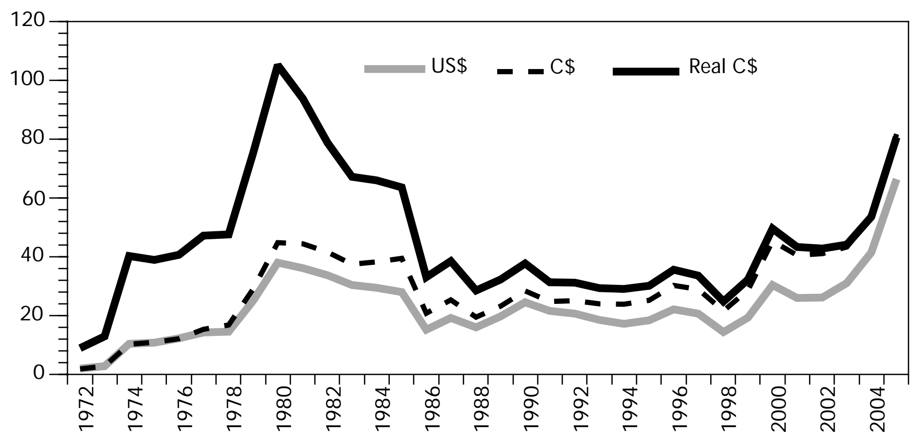
In roughly the same time frame, the producing provinces substantially increased their royalty rates for oil and natural gas. Ottawa responded by disallowing the deduction of these provincial royalty payments for purposes of federal corporate income tax calculations. If the domestic price of energy were allowed to rise and the producing provinces were allowed to pocket the increased royalties, the result would be a very substantial rise in equalization payments. And if, in addition, royalties paid to the provinces were deductible for federal corporate income tax purposes, Ottawa would surely find itself in a serious fiscal bind — its equalization responsibilities arising from energy revenues would be substantially increased while its own revenues from these same energy sources would not have so increased. In particular, Ottawa would not be able to extract much revenue from the very provinces that were benefiting from energy revenues and triggering the increase in equalization payments.

This equalization dilemma can be rephrased as follows. If Canada had gone to world oil prices in 1974, total equalization payments would have tripled, and in the process Ontario would have become a "have-not" province. Indeed, with Ontario as a have-not province, three-quarters of Canadians would then reside in provinces that receive equalization payments. In turn, this would have implied that each additional dollar of energy revenues would generate 75 cents in equalization. Not surprisingly, therefore, in the fall of 1974 Ottawa abruptly and without provincial consultation amended the equalization formula. Henceforth, Ottawa would distinguish between "basic" energy revenues and "additional" energy revenues. ***Basic revenues*** were defined as existing revenues in 1974 (indexed for production increases) and would be equalized in full. ***Additional revenues*** would equal actual revenues for the current year minus basic revenues, i.e., they would reflect the energy price increase since 1973-74. Only one-third of these additional revenues would enter the equalization formula.

An important caveat is in order here. This differentiation between basic and additional equalization represented the abandonment of the concept of "full equalization" embraced in the 1967 fiscal arrangements. However, by continuing to subsidize imports for the eastern provinces (i.e., Quebec and the four Atlantic Provinces) in order to maintain a uniform domestic price below the world price, Ottawa could be viewed as providing an ***alternative*** form of equalization for the residents of these provinces, all of which fell into the "have-not" category. In other words, by maintaining a domestic price below the world price, Ottawa was diverting potential energy revenues from the energy-rich provinces and essentially transferring them directly to Canadians in terms of subsidized energy prices. In this sense, the energy-rich

FIGURE 1. BRENT CRUDE OIL PRICES ($ PER BARREL), 1972-2004



Source: Author's calculations.

provinces, and Alberta in particular, were making an enormous financial contribution to the fiscal basis of the federation. By way of an anticipatory comment, this is quite different from the current environment where domestic energy prices are moving apace with world prices and, therefore, all of the increased revenues from energy price increases are finding their way into provincial coffers.

While the 1977 reworking of the fiscal arrangements are best remembered for the block funding of the Established Programs Financing (EPF), our interest here relates to the two provisions relating to the equalization treatment of resource revenues. The first was the establishment of a "resource ceiling" or a "resource cap" that stipulated that the proportion of equalization that could arise from natural resources (renewable as well as non-renewable) could not exceed one-third. The second was that the distinction between "basic" and "additional" energy revenues was jettisoned: henceforth 50 percent of all non-renewable resource revenues would be eligible for equalization.

This latter provision was unfathomable, given that the immediate result was to increase equalization to the degree where Ontario became a "have-not" province for each and every year over the 1977-78 to 1981-82 period. Ottawa's bounceback was three-fold. First, it excluded Ontario's equalization entitlements from resource revenue categories for purposes of calculating the so-called resource ceiling. Second, Ottawa retroactively removed the admittedly volatile energy category "sale of crown leases" from the formula. Third, and far and away the most important, the federal government retroactively excluded Ontario from receiving equalization payments by legislating the "personal income override," the thrust of which was that no province could receive equalization payments if its per capita income exceeded the national average.

In the more general political-economy context, the more than doubling of energy prices in 1979-80 rendered Canada's existing energy policies obsolete. Accordingly, in the fall of 1980 the federal government introduced the NEP, a policy whose ramifications transcended the energy patch and the West to profoundly influence Canada's political, constitutional and federal evolution as well as to serve a catalytic role in the introduction of the Canada-US FTA. On the pricing front, the 1980 wellhead price of C$16.75 (less than 40 percent of the 1980 Canadian dollar equivalent of the world price) would, under the provisions of the NEP, increase to about C$40 by 1986, with similar increases for natural gas. On the taxation front, Ottawa introduced three energy taxes (the Natural Gas and Gas Liquid Tax, the Petroleum and Gas Revenue Tax, and the Petroleum Compensation Charge), as well as a Canadian Ownership Charge, designed to increase public ownership of the energy sector. Relatedly, depletion allowances were to be phased out and replaced by the Petroleum Incentive Program (PIP), which established preferential rates for Canadian-owned companies and for activity on the Canada Lands (as distinct from provincial or private lands). Finally, the NEP included two "nationalization" provisions: the federal government reserved for itself (or a federal crown corporation) a 25 percent interest in all existing and future petroleum rights on Canada Lands (i.e., the controversial "back-in provision"), and it also signalled its intention to purchase several large foreign-owned oil and gas firms.

Not surprisingly, the reaction from the provinces and the energy patch ranged from negative to outright hostile, but this was ameliorated somewhat by the September 1981 Canada-Alberta Energy Pricing and Taxation Agreement (EPTA). Among its major provisions was a commitment to a near-C$60 price for oil in 1986 compared with the NEP's projection of roughly C$40. In the 1984 federal election, the victorious Mulroney Tories made the effective dismantling of the NEP one of their key selling points in the west. Admittedly, delivering on this electoral promise was made much easier by the collapse in world energy prices: the near-C$60 EPTA price for 1986 contrasts with the then-world price of roughly C$20. Intriguingly, Canadian prices "fell" to world levels, and they remain at world levels.

However, the NEP and federal energy policy generally had further implications. Ottawa's subsidized oil prices, its initial export tax, its later taxation and exploration measures under the NEP, as well as the Supreme Court's decision in the

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Bob Cooper, PMO

Prime Minister Pierre Trudeau and Alberta Premier Peter Lougheed raise a glass of champagne to toast the 1981 Alberta Energy Pricing and Taxation Agreement (EPTA), which committed to a Canadian oil price of near $60 a barrel — a level that, after the National Energy Program was dismantled by the Mulroney government, was not again attained under world pricing until the summer of 2005.

CIGOL case, all combined to lead the energy-producing provinces to demand and receive a confirmation of provincial powers over resources as part of the ***Constitution Act, 1982***. The result was section 92A, which granted the provinces exclusive authority over the development, conservation and management of natural resources. On the taxation front, section 4 of 92A gave new powers to the provinces, namely the right to "make laws in relation to the raising of money by any mode or system of taxation" in respect of non-renewable natural resources, forestry resources and the generation of electrical energy. In an important related development, while the federal government refused to negotiate constitutional amendments that would cede offshore resources to the relevant provinces during the 1980-82 negotiations, a compromise was reached in 1982 that granted these provinces a revenue stream from these resources without relinquishing federal control. Arguably this paved the way for mid-1980s offshore energy accords with Newfoundland and Labrador and Nova Scotia and the subsequent 2005 bilaterals with Ottawa that eliminated any equalization claw-backs on offshore energy royalties.

Then came the 1982 renegotiations of the fiscal arrangements. With world energy prices near C$40 and projected under the EPTA to rise to C$60, and with domestic prices slated to move rapidly to world levels, there were two overarching (and related) issues that had to be addressed. The first was to find a way to lessen the impact of energy revenues on the equalization formula, and the second was to find a formula-driven way (other than the "personal income override") to ensure that Ontario would not become a recipient province. Ottawa's initial and obvious proposal in the fall of 1981 was to adopt an "Ontario standard," which, by definition, would preclude Ontario from ever becoming a have-not province and would simultaneously minimize the impact of energy revenues, because the energy-revenue-receiving provinces and their energy tax bases were excluded from the standard. In 1982, Ottawa took the advice of the provinces to broaden the standard somewhat beyond

Ontario, the result of which is the so-called "five-province standard" (FPS). At the high fiscal capacity end the FPS excluded Alberta and at the low fiscal capacity end it excluded the four Atlantic provinces. As a result, the FPS sharply reduces the impact of energy revenues on the formula, thereby ensuring that Ontario will not qualify for equalization. One often-forgotten feature of the FPS is that it still employs a ten-province tax rate, which further reduces equalization (compared to a five-province tax rate) because it incorporates Alberta's low tax rates.

At one level, the adoption of the FPS in 1982 can be viewed as a stroke of policy genius, especially since it remains in place to this day. However, it created its own set of problems, which are becoming more acute as world energy prices again spiral upward. For example, the potential for high clawback rates on offshore energy revenues arguably led to the Newfoundland and Nova Scotia Accords, to the 70 percent "generic solution", and finally to the offshore revenue bilaterals between Prime Minister Martin and premiers Williams and Hamm. The result is that these provinces have zero clawbacks on their energy revenues whereas Saskatchewan still reels under very high equalization taxbacks. Moreover, at current energy prices, with zero clawbacks on its energy revenues, Newfoundland and Labrador's per capita revenues will be substantially higher than those of Ontario.

By way of summary then, the first energy shock clearly had a dramatic impact on the political economy of Canada, running the gamut from the Constitutional dossier, to the politics of federalism, to Canada-US relations and western support for the FTA and, of course, to equalization payments and fiscal federalism more generally. Beyond this, the first energy-price shock began the process, continuing in the current time frame, of shifting economic power within Canada westward. It is difficult to think of another political or economic event whose implications have been so direct and pervasive.

Will the on-going energy price explosion hold the same potential for altering the political economy of the federation? From Ottawa's own perspective and interests the answer would seem to be "no." Consider, first, the most sensitive issue for the energy-producing provinces, namely a replication of NEP-type interventionist initiatives. The 2005 environment is very different from that of 25 years ago. Instead of running large deficits as in the NEP era, Ottawa is basking in its near-decade-long string of surpluses. Indeed, Ottawa probably already has too much in the way of fiscal capacity, since all three of its policy priorities (children, cities and medicare) are largely or wholly in provincial jurisdiction. Moreover, with domestic prices moving in tandem with world prices, there is no pressing need for revenues at the federal level as there was in the earlier energy price cycle when Ottawa held down the domestic energy price.

Another key difference is that energy price surges cannot send equalization payments soaring as they did the earlier period. This is so because under the provisions of the October 2004 First Ministers' Framework Agreement, the amount of overall equalization will be increased to $10.9 billion for fiscal year 2005-06 and thereafter escalated by 3.5 percent annually. (Note that the new framework was agreed upon because under the FPS approach equalization payments had actually been *falling* of late.) Thus the new role for any formula will only be to allocate this predetermined envelope across the recipient provinces. And because the equalization formula, per se, no longer determines the overall amount of transfer payments under equalization, the methodology for allocating the fixed equalization pool could well be hived off to a dedicated arm's-length institution like Australia's Commonwealth Grants Commission.

For all of these reasons it is difficult to envision a central government rationale for taking action with respect to rising energy revenues in the resource-rich provinces. However, there may well be an interprovincial rationale. Specifically, the pressure on the equalization principle and on horizontal fiscal balance, as distinct from the level of equalization payments, may become acute, since a doubling of energy prices has the potential for more than doubling provincial energy revenues (since the increase in prices should correspond to economic rents, all of which could find their way into royalties). And unlike the first energy shock, Canada's domes-

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tic energy prices will move in lockstep with world prices, so that the earlier diversion of royalties away from the producing provinces will not happen this time around. As a result, several provinces may find themselves unable to keep up with some of the energy-rich provinces in providing reasonably comparable levels of public services at reasonably comparable tax rates. The potential for this to become a reality will be heightened if the energy-rich provinces utilize their resource revenues to substantially ramp up their public services or reduce their tax rates well beyond the average elsewhere, and will be diminished to the extent that these provinces shelter their energy revenues in savings funds or invest them outside the country, following Norwegian practice. Note that how to spend or otherwise allocate energy royalties also poses challenges for the energy-producing provinces, and Alberta among others is beginning to address this allocation issue.

Hence, while Ottawa may not have a rationale of its own for reworking aspects of the fiscal framwork, this may not be the case for concerns pressed upon it in the name of restoring horizontal fiscal balance.

It is in light of this concern that I have proposed a two-tier approach to equalization: 1) allocate the $10.9 billion fixed equalization pool (for 2005-06) in accordance with fiscal capacity disparities relating to non-resource revenues, and 2) create a modest interprovincial revenue-sharing pool for resource revenues that would have to be agreed to and operated by the provinces (presumably by the Council of the Federation). For instance, an 8 percent contribution of provincial resource revenues to the second-tier pool would be sufficient to equalize 20 percent of resource revenues. This second tier would have to be voluntary, since the Constitution precludes Ottawa from confiscating provincial revenues. A variant of this proposal would be for the $10.9 billion to be the sum of the two tiers, with the resulting federal savings returned to the provinces in the form of an equivalent tax-point transfer. A roughly similar option proposed in 1980 was rejected by the federal government, by the recipient provinces and, not surprisingly, by the donor provinces. A similar fate appears to await the current version. However, in its defence, let me make two points. The first is that I do not accept the criticism that this proposal smacks of another NEP. Indeed it is actually the reverse of the NEP: apart from the fact that the second tier bypasses Ottawa entirely, it is a creative and strategic initiative orchestrated by the provinces to allow all of them to increase their room to manoeuvre in the federation. The second is to recognize that saying "no" to this or similar proposals will not remove the underlying issue of satisfying the constitutional commitment that Canadians everywhere have access to comparable public services. Failure to come to grips with this societal value could mean that this current energy-price surge might also have dramatic ramifications for the evolution of the federation.

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Finally, another difference this time around is that the current energy-price surge appears to be converting the Canadian dollar into a version of a "petro-currency," rising and falling apace with energy prices. While this serves to decrease the Canadian-dollar value of world oil prices (and the revenues of the energy-rich provinces), the prevailing concern relates to the potential for falling prey to the "Dutch disease," namely, that the resulting appreciation (spurred on by foreign investment in the energy sector) will undermine our manufacturing competitiveness and further complicate Canada's economic geography.

In concluding, it is wise to cast a further glance at the accompanying chart to note just how fast the first energy price shock unwound in the mid-1980s. The same could easily happen this time around. But assuming that $US60+ oil is in our future for the medium term, the above analysis would suggest that the potential fault lines will relate more to horizontal (or interprovincial fiscal) imbalance than to vertical (or federal-provincial) imbalance. Assuming that the provinces are willing to bear a degree of collective responsibility commensurate with their taxing and spending powers, this suggests that the Council of the Federation may be the institution that should take policy centre-stage.

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