Energy prices have had a profound and pervasive impact on the political economy of Canada, running the gamut from the constitutional dossier, to Canada-US relations, to federal-provincial relations and, of course, to equalization payments. Finance Minister Flaherty’s challenge on the equalization front is to find a stable, formula-based and equitable framework that will allow all provinces to work together again in our nation-building project. Daunting as this task will be, it will not be the end of the energy challenges: the controversial environment-energy nexus is already waiting in the wings.

While it is commonplace to assert that Canada needs to make the transition from a resource-based economy and society to a knowledge-based economy and society, the dramatic rise of China and India with their insatiable appetites for resources has driven home to Canadians that there are still huge rewards to being hewers of wood and drawers of water. Nowhere is this more true than in the energy sector, where activities associated with oil and gas development and exports are serving to ensure that Canada’s overall economic growth remains in the respectable range. This is obviously good news for Finance Minister Jim Flaherty: Ottawa’s overall revenues are certainly buoyed by the performance of the energy sector, even if most of the direct energy-related revenues accrue to the producing provinces.

However, the irony here is that these burgeoning provincial energy revenues are interacting with Canada’s approach to horizontal and vertical fiscal imbalance in ways that ensure that Flaherty’s budget must address what arguably qualifies as the most intractable distributional tug-of-war that Canadian federalism has ever experienced. Fiscal imbalance has all the markings of a negative-sum economic and political game, and it will therefore take adroit stewardship to convert it to a mere zero-sum game.

Anyone who is even mildly interested in the arcane details of fiscal federalism, let alone equalization, could see this challenge coming — a tripling of energy prices under the five-province standard was bound to trigger huge revenue differences across provinces on the one hand and to lead to confiscatory tax rates for non-Alberta energy producers on the other. But when Prime Minister Paul Martin in rapid succession tossed out Canada’s traditional approach to equalization and then effectively promised Newfoundland and Nova Scotia that there would be no equalization clawbacks on their energy revenues, Canada’s system of equalization payments imploded.

The purpose of the ensuing historical overview is to highlight the reality that fossil energy has always created challenges for the operation of Canada’s Equalization Program but as well has also played and continues to play a pivotal role in the political, economic and even constitutional evolution of the federation itself. For example, as problematic as the National Energy Program was, it arguably facilitated the passing of the Canada-US Free Trade Agreement. The convenient entry point to this history-cum-analysis is to cast our attention back a half-century ago to the advent of Canada’s Equalization Program.

While the analytical (and rhetorical) underpinnings of equalization may have been best expressed in the Rowell-Sirois Commission’s recommendations for regional adjustment grants, the 1957 introduction of our formal Equalization Program had its origins in more practical considerations. Specifically, following on the recommendation of the mid-1950s Tremblay Commission (Quebec’s Royal Commission of
In the 1962 quinquennial revision of the tax arrangements, the share of PIT entering the equalization formula was increased to 16 percent (with an interim increase to 13 percent in 1958). For present purposes, however, the importance of the 1962 revisions is that natural resources entered the formula for the first time, thereby beginning a complex and volatile relationship that has influenced the evolution of Canadian federalism well beyond the fiscal arena. The concern at issue in this time frame was that resource-rich Alberta was receiving equalization. To prevent this, the formula was expanded to include resource revenues — 50 percent of the three-year average of provincial resource revenues would now be eligible for equalization. While this would exclude Alberta from receiving equalization, it would have substantially increased the total level of equalization. To temper this expansion the equalization standard was reduced from the TTPS to a national-average standard (NAS).

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At this juncture, it is important to recognize that equalization has played another key role in the evolution of our federation. Over the years the federal government transferred progressively larger shares of the PIT and CIT to the provinces, which made Canada one of the most tax-decentralized federations in the world. Arguably this tax decentralization would not have been politically acceptable to the “have-not” provinces were it not for the existence of equalization. In this sense, equalization also benefits the rich provinces, since it allows them to reap the benefits of their superior tax bases.

The 1972 arrangements largely involved tinkering — removing medicare premiums and racetrack revenues from the miscellaneous category and creating separate revenue categories for them.

It is clear then that resource revenues, and particularly energy revenues, were a complicating factor even before the energy price shocks. Indeed, and as will become evident, the period 1967 to 1973 is the only period in the history of Canada’s Equalization Program when 100 percent of both energy revenues and energy tax bases was included in the formula.
Enter the first energy price spike, which sent the world price of oil from about $8 in 1972 to $40 in 1974 (in 2004 Canadian dollars). Canada’s reaction was immediate and dramatic. First, we froze the domestic energy price, initially at $4 per barrel in 1974 dollars when the actual Canadian dollar world price was $10 (see the orange and red lines, respectively, on figure 1). Consequently and simultaneously, Ottawa imposed a $6 per barrel tax on exported oil, where this export price rose automatically to bridge the gap between the domestic price and the continuing-to-rise world price. Part of the rationale for this tax was to generate funds to subsidize foreign oil imports entering eastern Canada in order to maintain the uniform and policy-determined price of gasoline across the country.

In this same time frame, the energy-producing provinces substantially increased their royalty rates for oil and gas, which Ottawa countered in part by disallowing the deduction of these royalty payments for purposes of corporate income tax calculations. Motivating much of this was the interplay between equalization and energy prices. Calculations made at the time indicated that if Canada went to world energy prices in 1974, equalization payments would have tripled, Ontario would have become a have-not province, each additional dollar of energy revenue accruing to the producing provinces would have cost Ottawa 75 cents in equalization, and the overall equalization bill would have been such that it would have required a 25 percent increase in overall personal income taxation.

Not surprisingly, Ottawa’s series of measures (subsidized prices, export taxes, disallowing provincial royalties for CIT) still fell way short of what the minority Trudeau government could live with on the fiscal front. Therefore, abruptly and without consultation, Ottawa altered the equalization formula. So-called basic energy revenues (defined as the energy revenues that existed in 1973-74) would continue to be equalized in full, while only one-third of additional energy revenues would henceforth enter the formula. Among other things, this would allow Ottawa to gradually raise the fixed domestic price without putting the federal fiscal house in jeopardy.

From Alberta’s vantage point, Ottawa’s overall approach to the global energy price shock was viewed as an effective confiscation of their rents: revenues that ought to be flowing into provincial treasuries were being effectively transferred to Canadians in the form of subsidized domestic energy prices on the one hand and transferred to Ottawa via the export tax on the other. And these forgone royalties soared as the difference between the world price and the domestic price likewise soared.

The 1977 reworking of the fiscal arrangements attempted to fine-tune the relationship between energy revenues and equalization. One change was the introduction of a resource cap: energy-related equalization could not exceed one-third of total equalization. The second was to jettison the “basic and additional” approach to energy revenues and to replace it by allowing 50 percent of all non-renewable resource revenues to enter the formula. This was a strategic error since, as domestic energy prices rose, the 50 percent regime generated much larger equalization flows than did the basic-additional variant, especially when international prices skyrocketed in connection with the 1978-79 Iranian revolution and the 1980 Iran-Iraq war. The intriguing but obviously very troubling consequence of this strategic

**FIGURE 1. CRUDE OIL PRICES, 1972-2005**

“That’s my plane.”

Thousands of Canadians are behind Bombardier projects. They’re revolutionizing transportation around the world. And they’re proud of it.
error was that the province of Ontario became entitled to equalization payments for each and every fiscal year from 1977-78 to 1981-82.

Ottawa’s way of dealing with Ontario joining the ranks of the have-not provinces was to prevent it retroactively from receiving equalization. This was accomplished by a provision of Bill C-24, passed in 1981, commonly referred to as the "personal income override" which stated that a province with per capita personal income above the national average was ineligible for equalization. Although it was cast in these general terms, it affected only Ontario (as planned!). Ontario agreed to this override, on the understanding that Ottawa would rework the program in ways that would ensure that more of the cost of equalization would be paid by those provinces triggering the increases, i.e., by the energy-rich provinces. However, and as already noted, Alberta could mount a claim that it was contributing enormously to Ottawa and the rest of Canada and Canadians via the federally legislated low domestic oil price.

With the Iranian revolution and the Iran-Iraq war, global prices doubled from their already high levels. This left our domestic price at something like 40 percent of this new global level. It was not just Canada’s Equalization Program that needed an overhaul; Ottawa’s overall approach to energy policy was in shambles.

Enter the 1980 National Energy Program (NEP), which imposed a range of new taxes directly on the oil patch, exacted a levy to support Canadian ownership of the energy sector, introduced the PIP (Petroleum Incentive Program) grants, which steered exploration away from the provinces to the Canada lands, and introduced the infamous “back-in provision” whereby the federal government could reserve for itself a 25 percent interest in all existing and future petroleum rights on Canada lands. It was not surprising that the reaction from the oil patch, and from Alberta, was openly hostile. This impasse was alleviated somewhat by the 1981 Canada-Alberta Energy Pricing and Taxation Agreements (EPTA), which allowed a more rapid increase in the domestic price. Under the EPTA, the actual domestic price for 1986 was to be $58. By then, however, world prices had collapsed to $20, and since then Canadian prices have remained at world levels. Essentially, therefore, world energy prices collapsed to Canadian levels and effectively unwound the bite of the NEP.

But not quite, since the oil patch was still concerned that Ottawa was able, with abandon, to tax and regulate the energy sector, which is, after all, under provincial ownership. Without going too deeply into detail, the resource provinces were able to lobby successfully to have section 92A enshrined in the Constitution Act, 1982 and from Alberta, was openly hostile. This impasse was alleviated somewhat by the 1981 Canada-Alberta Energy Pricing and Taxation Agreements (EPTA), which allowed a more rapid increase in the domestic price. Under the EPTA, the actual domestic price for 1986 was to be $58. By then, however, world prices had collapsed to $20, and since then Canadian prices have remained at world levels. Essentially, therefore, world energy prices collapsed to Canadian levels and effectively unwound the bite of the NEP.

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The NEP remains indelibly etched in the psyche of Albertans, ready to emerge when their interests are deemed to be at stake. One of the earlier occasions related to the Canada-US FTA. Former premier Peter Lougheed was an ardent supporter of the FTA, arguing that among other reasons the FTA would ensure that there could

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Ed in the FPS are BC, Saskatchewan, Manitoba, Ontario and Quebec.

Excluded are energy-rich Alberta on the high side and the four Atlantic provinces on the low side, where the populations of the two were then roughly equivalent. While 100 percent of resource revenues was included in the of their energy revenues (on a sliding scale over 10 years) from equalization clawbacks. As these accords matured, Ottawa ensured that both provinces qualified for the so-called generic solution, namely that if a province has 70 percent or more of an equalization tax base, then it can shelter 30 percent of these revenues from entering the formula; i.e., the maximum equalization clawback will be 70 percent. In order to ensure that Newfoundland and Nova Scotia would qualify for this 70 percent inclusion rate, they were given separate tax bases for their offshore revenues — one for Newfoundland and one for Nova Scotia — so that by definition they have 100 percent of the tax base, not just the needed 70 percent.

However, major concerns over the operations of the FPS came to the fore with the revelation that Saskatchewan’s energy-related equalization clawbacks (i.e., the reductions in equalization it would otherwise receive because it is a “have” province for energy) actually exceeded its total revenues from its energy sector — $1.126 billion versus $1.038 billion, for an average clawback rate of 108 percent. These confiscatory equalization clawbacks occurred for several reasons. The first has already been noted: with Alberta’s base out of the formula, Saskatchewan becomes a very rich province and for some of the resource categories it has close to 100 percent of the formula tax base, with correspondingly high clawback rates. Second, even though Saskatchewan had over 70 percent of the base in almost all of the resource categories, it was not allowed to qualify for the generic solution because Ottawa arbitrarily required Saskatchewan to have at least 70 percent of the overall tax base, including the tax bases of the non-FPS provinces. This is double jeopardy. A third reason is that somewhere in the back rooms of the equalization secretariat, decisions were effectively made that Saskatchewan is collecting significantly less revenue than it should be. This led to further increases in Saskatchewan’s tax bases for selected energy categories in the formula, thereby exacerbating the clawbacks: e.g., revenues from the category “sales of Crown leases” in 2000-01 were $61.5 million and the associated equalization

A short history of equalization

The initial federal proposal in the November 1981 budget called for an Ontario standard. Since all provinces’ per capita revenues would be brought up to Ontario’s level, by definition Ontario could never be a have-not province. Moreover, given that Ontario had little in the way of an energy revenue base, an Ontario standard would minimize the impact of energy on the formula. In the event, and persuaded by the provinces that a single province might end up being too volatile a standard, Ottawa adapted the famous five-province standard (FPS), where the five provinces included in the formula, the resource tax bases in Alberta and the Atlantic provinces were excluded. Drawing from recent data, in 2003 the FPS embodied only 39 percent of all resource-revenue bases in Canada (i.e., 61 percent were in the excluded provinces). This means that a province with no fossil energy, such as New Brunswick, would receive only 39 percent of the energy equalization that it would receive under a full NAS standard. On the other hand, because Alberta’s base and the east coast offshore base are not in the formula, provinces like Saskatchewan now become very rich in terms of energy resource tax bases, and therefore become subject to very high clawback rates.

All in all, however, the FPS was a stroke of political genius in that it effectively survived for a quarter-century. As a result, the period between 1982 and the recent and on-going energy price spike was relatively calm on the equalization front. The principal exception was the east coast offshore oil and gas discoveries, and the Atlantic and Nova Scotia Offshore Accords that provided some sheltering
But it will obviously have a major impact in terms of the overall payments. The total for any year would be fixed, so that the role of any formula generated both the total amount of equalization and its distribution across the receiving provinces. Henceforth, the total for any year would be fixed, so that the role of any formula would only be to allocate this fixed pool across the recipient provinces. Intriguingly, in this context, whether 100 percent or 0 percent of energy revenues/royalties is in the formula is irrelevant in terms of the overall payments. But it will obviously have a major impact on their distribution.

The final policy decision in this evolution of equalization milestones is at the same time the most inexplicable and most inappropriate. In the final days of the 2004 election, Prime Minister Paul Martin, in private communication with Newfoundland and Labrador premier Danny Williams, committed Ottawa to effectively ensuring that the equalization clawbacks on east coast offshore energy (including energy-related revenues like CIT) would be reduced to zero. After a series of very public negotiation sessions, a deal to this effect was consummated in early 2005. While Newfoundland and Nova Scotia energy revenues would still enter the formula, any equalization clawbacks on these revenues would be repaid to these provinces via the workings of a revised set of the Atlantic and Nova Scotia Offshore Accords. Given that the value of energy-related revenues accruing to Newfoundland and Labrador at, say, US $60 per barrel of oil would be approaching $900 million or $1,800 per capita, and given that, after equalization, this province is now only about $500 per capita below Ontario, the per capita revenue of Newfoundland will easily surpass that of Ontario and of all other provinces except Alberta and maybe BC and Saskatchewan.

The reaction to this was fast and furious. Saskatchewan, with near-confiscatory clawbacks still in place, demanded the same deal as Newfoundland and Nova Scotia. Ontario leapt into the fray, essentially demanding what it did in the early 1980s, namely, that equalization should not increase unless the energy-rich provinces were made to pay a larger share of what were, after all, energy-driven equalization increases. Beyond this, Ontario argued that it was unfair that its Canada Health and Social Transfer (CHST) was clawed back to the tune of a billion dollars (in line with the 1977 tax-point transfer provisions) when arguably richer provinces like BC, Saskatchewan and Newfoundland and Labrador were not subject to these clawbacks. In the end, Ontario obtained a deal of sorts from Ottawa.

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clawbacks were $145 million, for an average tax rate of 236 percent. With appropriate changes, the possibility still existed to put equalization back on track, but this possibility ended in the immediate aftermath of Paul Martin’s minority election victory in June of 2004. The July 2004 Council of the Federation meeting unanimously proposed to increase equalization to its previous high level (2001) and then to increase it annually. To the surprise of many, Prime Minister Martin in the October 2004 First Ministers’ Conference did restore equalization to its previous high and then set it on a schedule to increase by 3.5 percent annually over the next decade. This effectively jetisoned Canada’s traditional approach to equalization. Hitherto, the equalization formula generated both the total amount of equalization and its distribution across the recipient provinces. In order to provide guidance with respect to the way forward, two formal studies were commissioned from the federal Department of Finance’s Expert Panel on Equalization and Territorial Formula Financing and the Council of the Federation’s Advisory Council on Fiscal Imbalance. The latter recommended 100 percent inclusion of all revenues to be equalized to the NAS. Should this generate a level of equalization deemed to be excessive, then its recommendation would be to scale this standard down on an equal per capita basis until the “appropriate” overall amount of equalization is achieved. The Expert Panel recommended that we return to our long-standing tradition of allowing the formula to generate both the total amount and the distribution of equalization payments. Beyond this it recommended 100 percent inclusion for non-resource revenues but only 50 percent inclusion of resource revenues. It then added a problematic rider: no equalization-receiving province should end up with more revenues than the richest non-equalization-receiving province. Phrased differently, this is an
One approach to enlarging the equalization issue is to combine horizontal and vertical balance transfers into an integrated whole. That is, we would follow Australian practice and address horizontal imbalance via the overall system of federal-provincial cash transfers. By way of a proposal along these lines, consider the following two-tier scheme. Tier 1 would be an equalization program, say, along the Expert Panel lines but without the confiscatory cap. The overarching second tier would involve the monies associated with the vertical balance transfers (i.e., the former CHST, which has become CHT, CST, etc). These CHSTs are now revenue-tested (or clawed back) to a degree for Ontario and Alberta, because they have per capita PIT/CIT revenues larger than the national average. But any such revenue-testing or clawback provisions should relate to the overall revenues of the provinces — own-source revenues plus equalization — and not to a subset. Therefore the second tier would involve the vertical transfers that made up the former CHST. These would become revenue-tested equal per capita transfers. Revenue-testing could work as follows. For provinces that have overall per capita revenues (own-source revenues plus equalization) above, say, 110 percent of the natural average, each additional revenue dollar above this 110 percent threshold would result in a 20 cent decrease in their CHST payment. To ensure that Ottawa does not benefit from this scheme, the clawbacks would then be reallocated to all provinces on an equal per capita basis. Obviously, the parameters can be varied. Were the Conservatives to opt for an Equalization Program with zero inclusion of natural resources (e.g., along the lines of their election platform), this second overarching tier might embody, say, a 30 percent clawback on the CHST transfers in order to offset some of the larger inter-provincial revenue disparities that would exist if resources were removed from the Equalization Program. In any event, the principles should be clear: the second tier is doing some overarching equalization because we cannot agree how to manage this in an equitable or acceptable manner within the stricter confines of the formal Equalization Program.

By way of conclusion, energy prices and energy policy have obviously had an enormous impact on the political economy of Canada, running the gamut from the constitutional dossier, to the FTA and Canada-US relations, to the politics of the federation, to federal-provincial relations and, of course, to Canada’s system of equalization payments. In terms of equalization, the challenge for the Harper Conservatives and Finance Minister Flaherty in particular is to find a stable, formula-based and equitable framework that serves to once again allow all provinces to work together in our nation-building project. The inherently zero-sum nature of any solution makes this a daunting challenge. But this will not be the last of the energy-related challenges that Canadians must confront. The complex and controversial relationship between the environment and the energy sector is already waiting in the wings.

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