Canada: a noisy squabble over offshore oil and equalization

A bit of hot rhetoric and brinkmanship ends in a deal between the federal government and two Atlantic provinces.

BY *JENNIFER SMITH*

Last fall Canadian Prime Minister Paul Martin and the premiers of the provinces and territories – together referred to as "first ministers" – met to consider the key points of the federal government's proposed new equalization package. At the conclusion of the meeting the prime minister announced broad support for the package. On the very same day, however, Premier Danny Williams of Newfoundland and Labrador, the country's easternmost and poorest province, quit the meeting and went home, accusing the prime minister of reneging on a deal to permit the province to keep 100 per cent of its offshore oil and gas revenues.

Newfoundland Premier Danny Williams.

Premier Williams ordered Canadian flags to be removed from provincial buildings, and menacing words flew back and forth between the province's capital and the federal government. Then suddenly, before Parliament resumed from its winter break at the end of January, an agreement was announced: the federal government had compromised and struck a new deal with Newfoundland and Labrador and with its fellow Atlantic province, Nova Scotia.

Clearly an equalization agreement is an emotionally-charged issue in Canada. What happened? And what have offshore oil and gas to do with equalization? (*see Box "How Canadian fiscal equalization works"*)

Not just about money

The negotiations on equalization that preceded the agreement were among the most interesting to date for several reasons. First, the offer that the federal government made to the provinces and the three territories contained some innovative elements. Second, there were the rents from offshore oil and gas. Third, there was the precarious minority-government status of the Martin federal government.

What the federal government offered was not simply a matter of more money than before, although there is that. For the last several years, the federal government has received more tax revenues than it has spent, and therefore it can afford to be generous. To give a sense of the amounts involved, in 2004-2005, the provinces were slated to receive some C$9.66 billion. Under last fall's offer, in 2004-2005 they would receive C$10 billion, and the territories would receive C$1.9 billion. In 2005-2006, the figures are C$10.9 billion and C$2 billion respectively. The new deal with Newfoundland and Labrador now guarantees that province alone C$2 billion over eight years.

In addition, the federal offer last fall included a promised increase of 3.5 per cent per year until 2009-2010; and the establishment of an independent panel to review various elements of the equalization programme and make recommendations for improvements.

The significance of the second and third proposals is worth pausing to consider.

Arguably, the promised 3.5 per cent per year is inconsistent with the idea of equalization, which is to ensure that no province falls below a standard fiscal capacity as measured by specified revenue sources. It is not impossible to imagine a scenario in which each province is close to the standard, in which case the equalization figures would fall. The promise of increases each year injects into equalization an element of the "no-strings attached" grant programme.

Take out the politics…?

One new factor of interest was the independent panel proposed by the federal government to review the current formula used to measure fiscal capacity. It will also examine alternative approaches that might be employed to measure it; consider the public level of support for the equalization programme; and finally advise on whether the independent panel should be made permanent.

A second factor was the fact that oil and gas producer companies are doing very well, but so are the governments that receive rents from the companies. No one can predict the future of oil and gas prices.

Finally, in the general election in June 2004, the governing Liberals lost their majority-party status. Prime Minister Martin leads a minority government that is dependent upon support from elected members of the other parties in the House of Commons. Unhappy provincial governments have more leverage with this federal government than they would with a government supported by a solid majority in the House.

Unfinished business

Offshore resources have a significant effect on equalization payments. As the rents that the provinces derive from these resources increase, so does their fiscal capacity. They move closer to the five-province measure of the standard provincial tax yield. As a result, they receive less in

Jennifer Smith *is a professor and chair of the Department of Political Science at Dalhousie University in Halifax, Nova Scotia.*

equalization payments. Currently the federal government takes back about 70 cents in equalization for every dollar earned in offshore energy revenues.

From the standpoint of the two provinces in question, this was hard to take. Their argument, in a nutshell, was that the offshore oil and gas resources constitute a windfall, rather like winning a lottery. They wanted to reap one hundred per cent of the rents from the windfall, *without those rents jeopardizing their current share of the equalization payments.* They wanted a chance to vault to the "have" status.

And there is one other point. During the June election campaign, Prime Minister Martin, his poll numbers looking none too good, stopped in St. John's (the capital city of Newfoundland and Labrador) and promised Premier Williams – or so the Premier says – that the province could keep 100 per cent of the rents from the offshore oil and gas, no strings attached, meaning no proportionate clawback of equalization payments by the federal government. Needless to say, the federal government has been bedeviled by this event ever since.

A cap and an eight-year limit

Campaign promises aside, from the standpoint of the federal government, the position of the two Atlantic provinces was at odds with the rationale of the equalization program. These provinces have been recipients of equalization for many years, indeed from the start of the programme. The fact that now the rents from the offshore resources bring them closer to the five-province average is a good thing all around even though it means getting less in equalization. The federal government had another argument, too. It owns the resources offshore under the sea bed, a legal point established in the courts many years ago. Therefore it has a role to play in relation to those resources on behalf of the people of Canada.

The federal government chose, post-election, to revise the campaign promise, at least as it was understood by Premier Williams, by attaching conditions to it. One was a proposed cap on how much revenue from the offshore resources the provinces could receive before the resumption of the clawback under the equalization principle. Another was to include equalization payments in the determination of fiscal capacity (the ability to raise revenues from taxes and other sources), the crucial consideration in calculating equalization. Yet another was a proposed eight-year limit on the agreement, after which it would be reviewed, presumably by the federal government.

Neither province was happy with conditions like these, and negotiations continued through the final days of December, in the course of which the federal government sweetened its offer in two key ways: first, by removing the cap and permitting the provinces to keep 100 per cent of the energy revenues; and second, by renewing automatically the arrangement for another eight years should the two provinces still be eligible for equalization payments.

At the end of January, the three governments announced a deal that guarantees Nova Scotia at least C$830 million over an eight-year period, and Newfoundland and Labrador a minimum of C$2.6 billion over the same period.

How Canadian fiscal equalization works

The term "equalization" refers to an intergovernmental transfer program – no strings attached - that is designed to enable the provinces and the territories to provide comparable services in areas like health care, welfare and education at comparable rates of taxation.

Under the Canadian constitution, the provinces are responsible for these services, and have taxing powers to deliver them. However, the economies of the provinces range from rich to poor and in-between. Without equalization there would be enormous variation in the quality of these programs.

Established in 1957, the equalization mechanism measures the gap in the fiscal capacity of the provinces by comparing the revenue sources available to them. A "standard" tax yield is established, and provinces that fall below it receive transfers from the federal government that bring them up to the standard yield. Provinces above the standard receive nothing.

It is worth stressing that the system measures fiscal capacity, not differences in the costs of services or need, as do equalization schemes in other countries such as Australia and South Africa. Further, the federal government makes equalization payments to the recipient provinces out of the federal treasury, in other words, out of taxes paid to it by Canadians across the country, including those who happen to live in the recipient provinces.

In 1982, in an important development in the history of Canadian federalism, a statement on equalization was added to the constitution.

Under the deal, the two provinces will keep 100 per cent of the royalties from the oil and gas resources (no cap), *and* continue to collect equalization payments until they reach the five-province fiscal capacity standard. If they do not reach the fiscal-capacity standard by 2012, then the agreement is extended for another eight years. Should they reach the standard during that period and therefore no longer qualify for equalization payments, then they will get transitional payments for two years.

Certainly the deal is richer than the federal government anticipated. Nonetheless, arguably the outcome is a win-win situation. For its part, the federal government has maintained the principle of equalization subject to the two-year compromise of transitional payments. Moreover, the agreement is subject to a time limit, after which the division of the royalties between the two governments will be renegotiated. Finally, there is nothing in the agreement to disturb the fact that the federal government owns the resources.

It is a classic centre-region conflict in a federal system. And it has been resolved by tough negotiations among the principal players.