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Oil Rents and the Politics of Equalization in Canadian Federalism

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Abstract

Oil production and Equalization payments are two contentious and often overlapping subjects in Canadian politics. Alberta's Premier recently argued that his province's energy sector pays a disproportionate share of the Equalization payments that Quebec receives. This came after Quebec's Premier referred to Alberta oil sands as "dirty energy." Canadian federalism has become the stage for the debate on oil rents and the politics of Equalization.

The purpose of Canada's Equalization program is to reduce the horizontal fiscal imbalance between provinces to ensure public services of comparable quality. Whereas Canada is the world's fourth largest producer and exporter of oil, proven reserves are largely concentrated in the Prairies' oil sands. Eastern Canadian provinces, including Quebec, have so far been the main recipients of federal Equalization payments. But to what extent do oil revenues sustain Canada's Equalization program? This paper argues that oil rents in no way sustain the Equalization program, because these are revenues that belong exclusively to the provinces. However, provincial ownership of natural resources and their uneven geographic distribution actually contribute significantly to the regional wealth disparities that Equalization tries to mitigate. This study provides an overview of oil policy and federal transfer payments, paying close attention to the structure of Equalization. The objective is to demystify some of the claims surrounding the relationship between oil revenues and their redistribution and thus better inform policy debates on equalization in Canada.

Résumé

La production pétrolière et les transferts en péréquation sont deux sujets contentieux en politique canadienne qui souvent se chevauchent. Le premier ministre albertain a déclaré récemment que le secteur énergétique de sa province paie une part disproportionnée des transferts en péréquation que reçoit le Québec. Cette déclaration est en réponse à celle du premier ministre du Québec qui a qualifié les sables bitumineux albertains « d'énergie sale ». Le fédéralisme canadien s'est ainsi retrouvé au cœur d'un débat sur les rentes pétrolières et la politique de la péréquation.

Le but du programme de péréquation au Canada est de réduire le déséquilibre fiscal horizontal entre les provinces afin d'assurer des services publics de qualité équivalente. Alors que le Canada est le quatrième producteur et exportateur de pétrole au monde, ses réserves établies sont largement concentrées dans les sables bitumineux des Prairies. Les provinces de l'Est canadien, incluant le Québec, ont jusqu'à présent été les principaux bénéficiaires des transferts fédéraux en péréquation. Mais dans quelle mesure les revenus pétroliers financent-ils le programme de péréquation canadien? Le texte soutient que les rentes pétrolières ne financent pas la péréquation, car ces revenus appartiennent exclusivement aux provinces. Toutefois, puisque les provinces possèdent ces ressources naturelles et qu'elles sont répandues de manière inégale sur le territoire canadien, cela accentue de façon significative les disparités économiques régionales que la péréquation tente d'atténuer. L'étude offre un survol des politiques qui encadrent la production pétrolière et les principaux transferts fédéraux, accordant une attention toute particulière à la péréquation. L'objectif est de démystifier certaines affirmations à l'égard

de la relation entre les revenus pétroliers et leur redistribution afin d'éclairer les débats politiques sur la péréquation au Canada.

Introduction

The collection of revenues from non-renewable energies and the redistribution of those revenues has been the subject of ongoing debate in Canada since Confederation in 1867. These familiar lines of contention have intensified over the last few years amidst a sharp decline in oil prices, which represent a substantial loss of revenue for oil-rich provinces. At the heart of this debate lie competing claims over Canada's Equalization Program that tap into strongly held provincial identities and grievances.

Tensions resurfaced in the context of the 2019 Alberta general election, but the roots of the conflict extend back to 2005 in the leadup to the Canadian general election. Led by the MP for Calgary Southwest in Alberta, Stephen Harper, the Conservative Party of Canada (CPC) promised reforms to the Equalization formula if elected. The modified formula would remove non-renewable resource revenues from the equation. The then Opposition Leader in the Saskatchewan legislature and later Premier, Brad Wall, agreed that "any new equalization formula should not penalize Saskatchewan for having natural resources" (Mandryk 2018). The CPC succeeded in its bid to win the 2006 general election, albeit with a minority government. As a result, the Harper government made a compromise: the reforms would flow from the recommendations of an Expert Panel on Equalization and Territorial Formula Financing, chaired by Al O'Brien, a Fellow at the University of Alberta's Institute of Public Economics.

The Expert Panel, however, was adamant in debunking some of the myths circulating, most notably by asserting that "provinces keep all the money they raise from resources and all their other tax bases" and that "no provincial government funds go to support Equalization" (Government of Canada 2006: 3). In the end, its recommendations maintained the prevailing compromise, whereby up to fifty percent of resource revenues can be included in the calculation to determine the overall size of the equalization pool.

More than a decade since the Expert Panel's report, the same tensions and myths about provincial oil rents[1] financing Canada's Equalization Program resurfaced. The growing irritant was triggered by remarks from Quebec's Premier, François Legault, following his refusal to allow the proposed Energy East pipeline to pass through his province. The decision sparked outrage in the oil producing Prairie provinces, to which, Legault brazenly responded having no qualms over "refusing

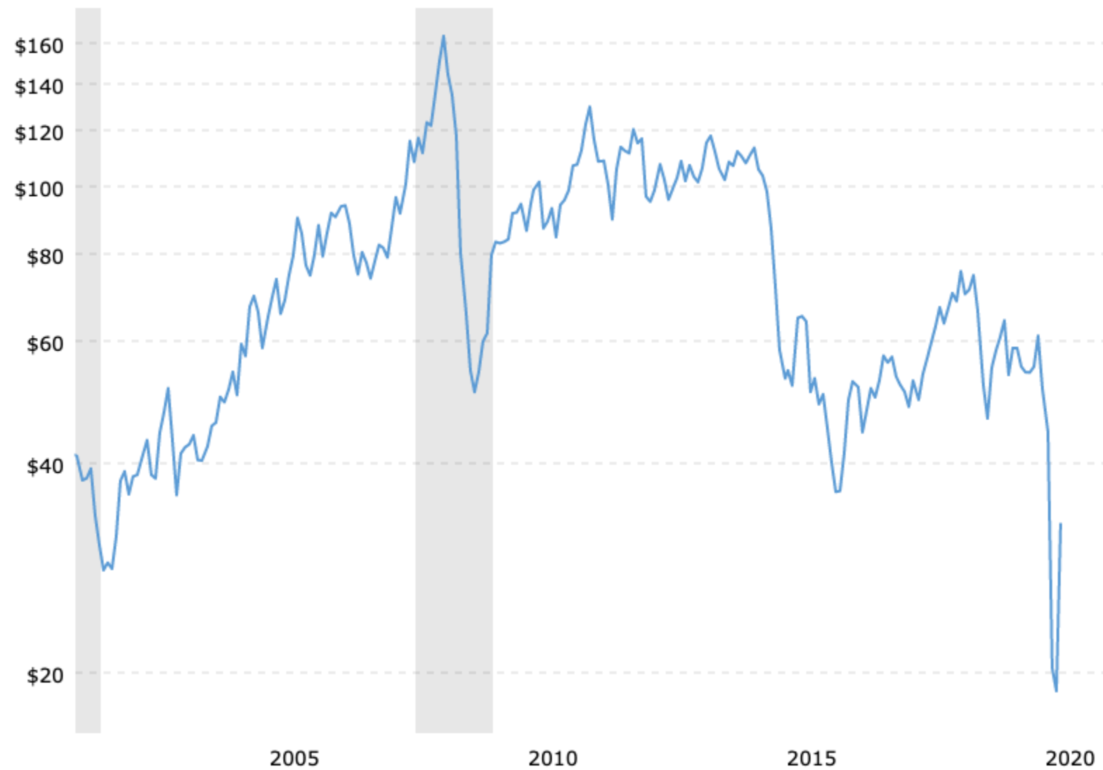
[1] We use the terms "rent" and "revenue" interchangeably in this paper, but it is worth clarifying their respective meanings. Revenues are the income a government collects through taxes and duties. Rents are a type of income that do not originate from the productive activity of the concerned unit. Income is generated simply by granting access to the rent circuit, not through actual productive means. When it comes to oil rents, the state is the main intermediary between the oil sector and the rest of the economy. Without directly engaging in the mode of production or seeking productive efficiency, the state receives revenues which are channelled to the economy through public expenditures (Beblawi and Luciani 1987). A "rentier state" is one that derives a large portion of its revenues from external rents, such as locational rents for pipeline crossings, transit fees, permits, lease agreements, and royalties (Ross 2001).

dirty energy while we're offering clean energy" in reference to Quebec's vast production of hydroelectricity (Curry 2018). Alberta's Finance Minister, Joe Ceci, responded with calls for a new Equalization formula at a meeting with the federal and provincial finance ministers in June 2018. But when Canada's Finance Minister, Bill Morneau, announced a week later the current Equalization formula had been renewed through 2024, Alberta's then Opposition Leader, Jason Kenney called the decision "a slap in the face" to Albertans and promised to hold a referendum on Equalization. In hockey terms, the gloves were off.

Elected with a majority in the April 2019 Alberta general election, Jason Kenney's United Conservative Party (UCP) immediately set-up the Fair Deal Panel to assess if Alberta is treated fairly in the Canadian federation, particularly with regards to Equalization. The irony is that Kenney was Harper's Parliamentary Secretary (2006-07) when the current formula was adopted following the Expert Panel's review. But that was then, and this is now. As shown in Figure 1, the current economic context has been one of substantial decline in world crude oil prices since 2014, after a period of sustained growth that began in 2001, with the exception of the 2008 recession (in grey). By 2015, the sharply declining crude oil prices triggered a recession in the province, which saw a 20 percent collapse of total income and the loss of 130,000 jobs (Tombe 2020). With this major loss of revenue, Alberta's budget balance went from a surplus in 2015 to the largest deficit among Canadian provinces a year later (RBC Economics 2020).

Then, in the context of the October 2019 Canadian general election, the Bloc Québécois leader, Yves-François Blanchet, made headlines when he accused western leaders of "trying to create an oil state" (Forrest 2019) and later prophesized the death of oil sands production (Yakabuski 2020). Naturally, this only served to infuriate western leaders with Kenney responding, "why do you oppose the industry that sends $13 billion to the Quebec government?" (Forrest 2019). His rhetorical question implied that the amount – $13 billion – Quebec would receive in 2019 as part of Canada's Equalization Program was directly financed by Alberta's oil production. Saskatchewan's Premier, Scott Moe, also chimed-in, calling the program "not equitable or fair" (Tait and Cryderman 2018), arguing equalization was never meant to "disburse 66 per cent of its proceeds to one province" (Curry 2018) in reference to Quebec's share of the overall envelope.

Figure 1. West Texas Intermediate (WTI) Crude Oil Prices Per Barrel, 2000-2020



Source: https://www.macrotrends.net/1369/crude-oil-price-history-chart

Quebec is not alone in opposing pipeline expansion for transporting bitumen in Canada. Alberta also had a fallout with its western neighbour when British Columbia's New Democratic Party government introduced new, more stringent environmental regulations in January 2018 that — among other things — interrupted the expansion of Kinder Morgan Inc.'s Trans Mountain pipeline (McElroy 2018). Alberta responded with a two-week boycott of B.C. wines and some turn-off-the-taps legislation to interrupt the energy supply to British Columbia, which was later struck down in Federal Court (Schmunk 2019). The context of acrimonious debate over the production and transportation of oil provides a good opportunity to examine the extent to which oil revenues sustain Canada's Equalization program.

We find that oil revenues in no way sustains the Equalization program because natural resource revenues belong exclusively to the provinces that generate them. This makes it constitutionally impossible to transfer oil rents from one province to another, regardless of the Equalization formula. Paradoxically, this provincial ownership and uneven geographic distribution of crude oil production contributes significantly to the regional wealth disparities that Equalization tries to mitigate. In other words, oil rents create fiscal inequality between provinces. The production of non-renewable energies therefore helps drive the need for the Equalization program. This ensures a relatively similar standard of living for Canadians across the country.

A strong energy sector does, however, contribute to the revenues used to pay for Equalization, because high income earners pay more federal taxes on a per capita basis. Thus, oil production, especially during periods of high market value, raises personal and corporate incomes, along with consumption and property value, thereby raising the federal governments collection of revenue and the fiscal capacity of provinces with a strong energy sector. The following study unpacks the design and purpose of Equalization by first providing an overview of oil policy and Federal transfer payments. The objective is to demystify some of the claims surrounding the relationship between oil revenues and their redistribution to better inform public and policy debates on Equalization in Canada.

The Regulation of Oil Rents

Part of the challenge of building a nation on such a vast and varied landscape is the uneven distribution of people and natural resources. If the smaller and thinly populated Atlantic provinces agreed to form a federation with the much larger provinces of Ontario and Quebec, it is in part because the representation-by-population distribution of seats in the House of Commons would be counterbalanced by a form of equal regional representation in the Senate (Smith 2017). Furthermore, in an effort to maintain a degree of fiscal autonomy towards the federal government, the *Constitution Act* of 1867 granted provincial legislatures the power to levy direct taxation (s. 92(2)), to borrow money (s. 92(3)), and to lease or sell public lands within their territorial boundaries (s. 92(5)). Pursuant to s. 109 of the Constitution, all lands, mines, minerals, and royalties and whatever sums generated from those natural resources belong to the provinces. Thus, provinces have ownership over their lands and whatever economic value they can extract from it.

As they developed into exportable commodities and essential sources of energy, natural resources became important symbolic markers of provincial autonomy and prosperity (*Ibid.*). From the timber industry of British Columbia, to the crude oil of Alberta, minerals of Ontario, and hydroelectric dams of Quebec, natural resources have been an important contributor to their GDP. Even so, natural resources contribute to provincial own-source revenues to varying degrees. For instance, Newfoundland and Labrador accounted for 22 percent of the energy sectors share of Canada's GDP in 2019, compared to Nova Scotia's 2.3 percent share (Government of Canada 2019: Table: 36-10-0400-01). Same thing for the mining, quarrying, and oil and gas extraction sectors, where Quebec and Ontario respectively account for a 1.5 and 0.8 percent share of the industry's contribution to Canada's GDP in 2019, in comparison to Alberta and Saskatchewan each holding a 16 percent share of the industry's total outputs (*ibid.*).

But because provinces are also constitutionally responsible for matters whose costs have accrued over time, such as road and infrastructure maintenance, the education and health care systems, provincial own-source revenues have not kept pace with rising public expenditures. This gap between the cost of providing services and the ability to raise sufficient revenues is referred to as a *vertical fiscal imbalance,* shown for each province in 2018 in the bottom line of Table 1. This occurs in federations when constitutionally assigned expenditure responsibilities exceed constitutionally assigned revenues (Watts 2008: 108). Provincial governments therefore rely on federal transfers to close this vertical fiscal gap and meet their constitutional obligations. As a result, if it were not for federal transfers, most provinces would grow large annual deficits, unless they were to raise taxes or lower the cost of service provision through privatization.

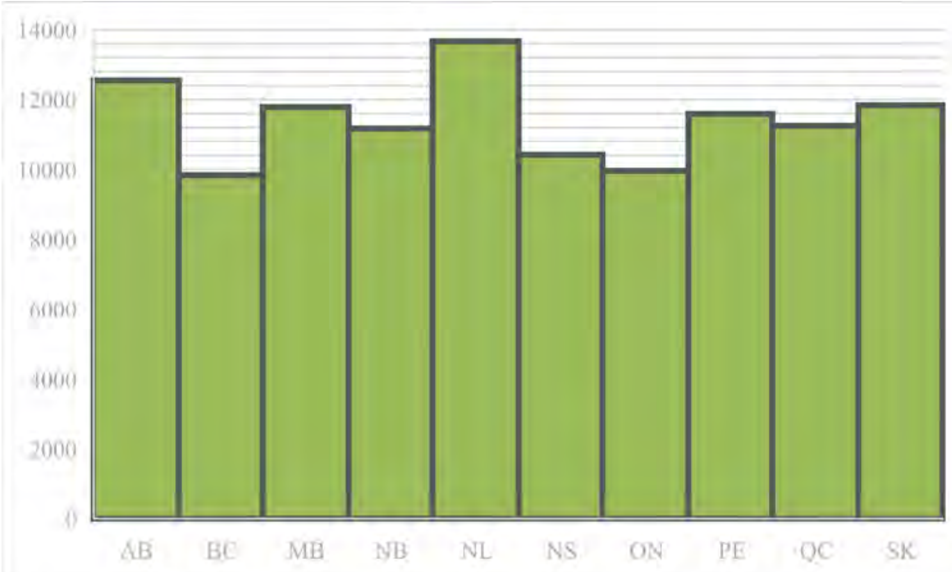
Table 1. Vertical Fiscal Imbalance Per Province (millions of dollars), 1998-2008-2018

	Year	AB	BC	MB	NB	NL	NS	ON	PE	QC	SK
Own-Source Revenues	1998	16571	18131	3920	2822	2110	2718	56264	496	37655	5471
	2008	35277	34081	8899	4467	5353	5156	92976	785	58434	9926
	2018	39688	42965	11995	6100	6096	6996	125734	1191	85718	11599
Program Expenditures	1998	13682	19301	5232	3865	3131	4018	56599	702	38931	4604
	2008	35664	34596	11074	7188	4969	7208	99958	1188	62765	9040
	2018	53898	49096	15938	8605	7193	9976	142363	1773	94249	13761
Debt Charges	1998	1322	834	520	574	865	865	8729	102	7342	1175
	2008	214	2237	864	576	751	925	9220	119	8752	821
	2018	1420	2623	952	667	998	825	11903	124	9240	560
Federal Transfers	1998	1183	1837	1884	1653	2019	1927	5098	292	6461	675
	2008	3048	5942	3957	2721	1788	3023	16802	518	14733	1807
	2018	7606	9055	4200	3239	1184	3585	24860	708	22367	2420
Vertical Fiscal Imbalance	1998	2750	-167	52	36	133	-238	-3966	-16	-2157	367
	2008	2447	3190	918	-576	1421	46	600	-4	1650	1872
	2018	-8024	301	-695	67	-911	-220	-3672	2	4596	-302

Source: Department of Finance Canada. 2019. "Fiscal Reference Tables September 2019." Illustration by author. Data available online: https://www.canada.ca/en/department-finance/services/publications/fiscal-reference-tables/2019.html.

Given their different population size, age structure and density, as well as an array of other socio-economic factors, program expenditures in each province also vary considerably on a per capita basis. While a province with a large population like Ontario's can collect way more tax revenue and accrues greater total public expenditures, what it does spend is less per person than most other provinces. Meanwhile, a thinly populated province like Manitoba is not only limited in its ability to collect sufficient revenues, it might also have additional costs that come with providing services to smaller, isolated communities. Thus, as shown in Figure 2, provincial per capita public expenditures in 2018 ranged from a low of $9,836 in British Columbia to a high of $13,666 in Newfoundland and Labrador, thereby resulting in an average sum of $11,406.

Figure 2. Per Capita Provincial Public Expenditures in 2018

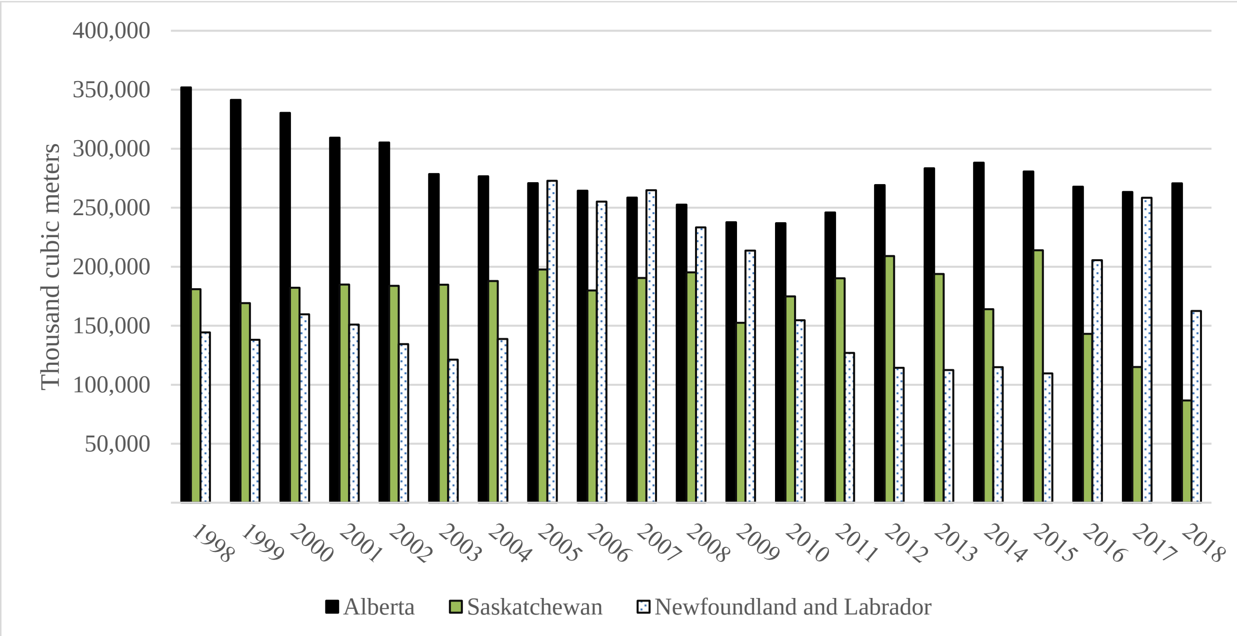


Source: Department of Finance, Government of Canada. 2019. "Provincial Fiscal Equalization. 2019 Formula. Second Estimate of 2018-19." Table 2; Department of Finance Canada. 2019. "Fiscal Reference Tables September 2019." Data available online: https://www.canada.ca/en/department-finance/services/publications/fiscal-reference-tables/2019.html. Illustration by author. Scale at left is in dollars per capita.

For its part, the federal government must find the right balance between supporting provinces in meeting their constitutional responsibilities through payment transfers without being so generous as to incentivise reckless spending or lowering of provincial tax rates to unsustainable levels. As such, negotiations between provincial and federal executives over redressing the vertical fiscal imbalance is an important accountability function in the vertical checks and balances of Canadian federalism.

The main issue with non-renewable natural resources like oil and gas belonging to provinces is that they are unevenly distributed. While Canada is the fourth largest producer and exporter of oil in the world, those resources are highly concentrated in just three provinces. Indeed, 81.8 percent of crude oil production hails from Alberta, 10.8 percent from Saskatchewan, and 5.1 percent from Newfoundland (Natural Resource Canada 2019). No other province reaches crude oil production levels that account for more than 2 percent of Canada's overall production. Figure 3 presents the fluctuating established oil reserves in the three main oil producing provinces over the past two decades.

Figure 3. Remaining Established Oil Reserves in Canada, 1998-2018



Source: Canadian Association of Petroleum Producers. 2020. "Conventional Crude Oil. Remaining Established Reserves in Canada at Year End 1962-2018." Canadian Association of Petroleum Producers. Online: https://www.capp.ca:443/publications-and-statistics/statistics/statistical-handbook.

Another noteworthy aspect of the ongoing irritant surrounding oil production is that Alberta and Saskatchewan are the only two landlocked provinces in Canada. Exporting their crude oil necessarily involves crossing provincial or international boundaries to reach refineries and ports, in addition to Indigenous communities which may also oppose the transportation of bitumen across their territory. All these actors and their often-competing interests make the transformation and transportation of crude oil to its intended markets a complex operation that is susceptible to multiple points of contestation.

The uneven dispersal of natural resources and their price volatility also shape fiscal federalism: both factors have the effect of exacerbating interprovincial wealth disparities and fiscal uncertainty. In 1980, Prime Minister Pierre Trudeau tried to offset these two negative externalities through the establishment of the controversial National Energy Program (NEP). The NEP introduced three new federal taxes on energy and two nationalization provisions, whereby a Crown corporation would hereby hold 25 percent interest in all existing and future petroleum rights along with purchasing foreign-owned oil and gas firms (Courchene 2005). The goals of the NEP rested on three assumptions:

1. Security of supply and independence from world oil markets
2. Development of the energy sector for the benefit of all Canadians
3. Lowering the cost of oil and gas, particularly for the residents of non-producing and less wealthy provinces of Eastern Canada (Blake 2015: 46)

Regardless of its real or perceived economic benefits, the NEP came at a high political cost. It revived Western resentment about federal government trespass upon provincial control of natural resources and a sense of alienation rooted in the perception that the federal government was promoting the interests of Central Canada at the expense of the West (Smith 2010: 19; Lawson 2005: 130). The growing intrusion of the federal government in the energy sector led to demands for and the confirmation of provincial powers over resources as part of the 1982 constitutional reforms (Courchene 2005). The result was s. 92A, whereby provinces have the exclusive authority to make laws for the development, control and regulation of natural resources, including the ability to raise money by any mode or system of taxation.

Despite the constitutional recognition, the NEP still stood. The Progressive Conservative Party made dismantling the NEP a key campaign promise to western voters during the 1984 federal election. Amidst collapsing world energy prices, Prime Minister Brian Mulroney promptly followed through on his electoral commitment (Courchene 2005). Notwithstanding this, the sense of betrayal and alienation towards the federal government has lived-on, particularly in Alberta. The Liberal Party of Canada has since struggled to make gains in the oil producing provinces of Alberta and Saskatchewan, where they failed to elect a single member in the 2019 Canadian general election despite winning enough seats to form a minority government.

Thus, fossil fuel energy has always created challenges for the operation of fiscal federalism in Canada, but also plays a pivotal role in the political, economic, and constitutional evolution of the federation itself (Courchene 2007). Fiscal federalism takes different forms in various parts of the world, but everywhere the purpose remains the same: it is designed to ensure that constituent units do not fall below what are deemed national standards in the provision of services (Burgess 2006: 148). This principle of equality is enshrined in the *Constitution Act* of 1982 under s. 36(2), whereby the Government of Canada must "ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation". In other words, provinces must have the fiscal capacity to provide similar public services without putting an undue burden on their residents through much higher levels of taxation or user-fees. This is where the Equalization program comes into the fold.

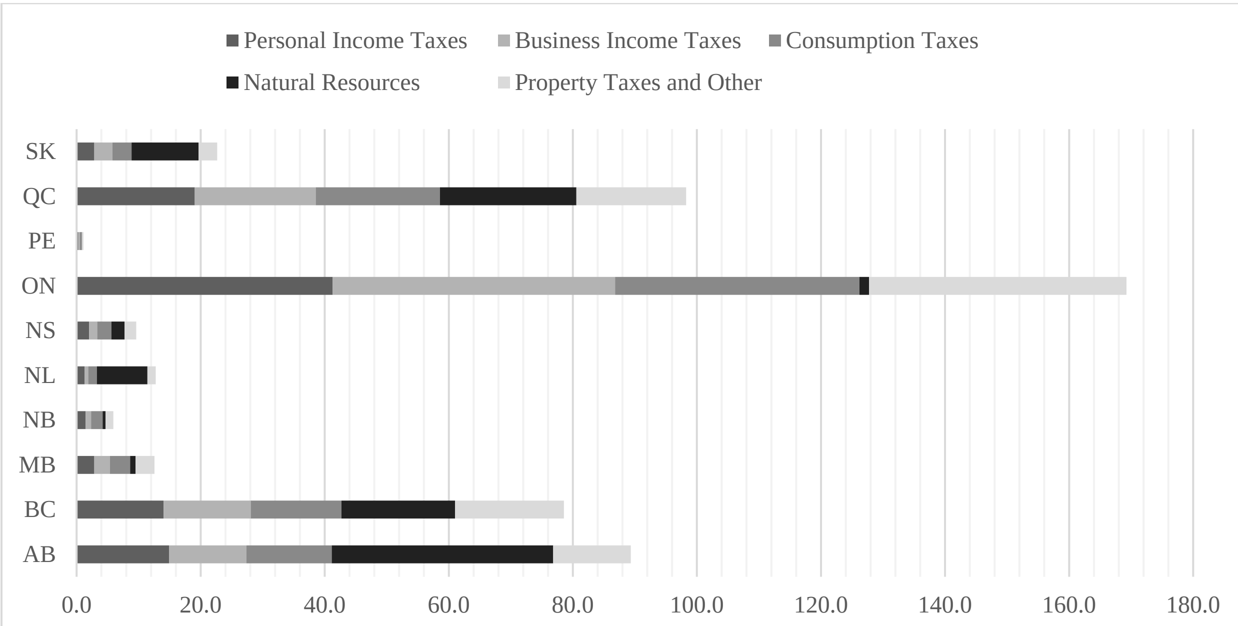
The Design and Purpose of Equalization

Equalization is a federal transfer payment program introduced in 1957 by the Progressive Conservative government of John Diefenbaker, himself the representative of Prince Albert, Saskatchewan. The purpose of the Equalization program is to mitigate fiscal disparities among provinces[2], also known as the *horizontal fiscal imbalance*. This consists of the fiscal disparity between provinces because of their

[2] The Equalization Program only applies to Canadian provinces. The Territorial Formula Financing program is the largest federal transfer to the three territorial governments and has a similar purpose of ensuring public service provision. However, the two major federal transfers operate separately given the high costs of providing public services in the North to many small, isolated communities (Government of Canada 2014).

different tax bases or their costs in providing public services (Béland et al. 2017: 55). When using the same level of taxation, Figure 4 shows how Canadian provinces have significantly different tax bases.

Figure 4. Percentage Distribution of Tax Bases by Province and Revenue Source, 2018-19 Estimates



Source: Department of Finance, Government of Canada. 2019. "Provincial Fiscal Equalization. 2019 Formula. Second Estimate of 2018-19." Table 4. Illustration by author. The scale across the bottom is in percent. The total of each shaded category of all provinces is 100 %.

Their respective population size and natural resource endowments are two important contributing factors to these fiscal disparities. We see that the energy sector can potentially yield substantial revenues in the oil-rich provinces like Alberta, Saskatchewan, and Newfoundland and Labrador, as well as other natural resources in Quebec and British Columbia. Otherwise, population size is the single most important factor, as more people results in the collection of more personal income, consumption, business and property tax revenues, and a generally more diversified tax base. Consequently, Equalization is meant to compensate less-wealthy provinces for their relatively weak tax bases or resource endowments so they can provide similar public services within similar levels of taxation (Roy-César 2013: 1).

Equalization is entirely financed from the federal government's general revenues. Contrary to Alberta Premier Jason Kenney's claims, provinces are not involved in the transfer and do not contribute financially to the program in any way. Moreover, these revenues do not include natural resource rents since these belong exclusively to provincial revenues (Bell and Vaillancourt 2018: 81). In short, the notion that wealthier provinces transfer money to poorer provinces is simply not true. Equalization does not penalize wealthy provinces; it provides support to the provinces that need it most.

Along with the Canada Health Transfer (CHT) and Canada Social Transfer (CST), Equalization is a transfer that flows into the provinces from general revenues funded by uniform tax collection pooled in the federal treasury (Béland et al. 2017: 88). The CHT is the single largest annual transfer to provinces, amounting to over $40.3 billion in 2019-20, followed by Equalization ($19.8 billion) and the CST ($14.5 billion). Combined, they are the three largest federal transfers that help provinces overcome the vertical fiscal imbalance.

Table 2. Major Federal Transfers in 2018 (Millions of Dollars)

	AB	BC	MB	NB	NL	NS	ON	PE	QC	SK
Canada Health Transfer	4315	5004	1357	780	538	967	14305	153	8437	1170
Canada Social Transfer	1597	1852	502	289	199	358	5294	57	3122	433
Equalization	0	0	1820	1760	0	1779	1424	390	11081	0
Per Capita Allocation	1395	1394	2761	3692	1395	3306	1496	3993	2731	1395

Source: Canada, Department of Finance. 2017. "Major Federal Transfers." Not available. Department of Finance. February 2, 2017. https://www.canada.ca/en/department-finance/programs/federal-transfers/major-federal-transfers.html.

There is, however, an important distinction between Equalization and the other two major transfer payments. First, Equalization is an unconditional transfer, meaning that it goes into the recipient province's general revenues, which than chooses how to spend it. The CHT and CST, on the other hand, have conditions attached as they are meant to finance a specific set of social programs. Second, the CHT and CST are distributed equally on a per capita basis, whereas Equalization entitlements only go to the provinces that qualify for them based on their fiscal capacity. Table 3 shows the number of years each province was entitled to Equalization since the program's creation.

Table 3. Number of Years Receiving Equalization Entitlements, 1958 to 2020

AB	BC	MB	NB	NL	NS	ON	PE	QC	SK
8	11	62	62	50	62	10	62	62	43

Fiscal capacity calculates a province's ability to generate own-source revenues at an identical tax rate in comparison to all ten provinces over the past three years (Roy-César 2013: 2). The calculation is therefore not based on the actual sums raised by provinces, but on the estimated sums it would raise if using the same tax rate for each tax base on a three-year sliding scale. This uniform measure is used to set a baseline comparison to overcome the significant variation in provincial tax rates. For example, provincial tax rates on consumption vary from a high of 10% in the four Atlantic provinces (NB, NL, NS, PE) to a low of 0% in Alberta. The latter yields such high revenues in the other tax bases, at least in times of high global oil prices and market demand, that it chose to eliminate the sales tax and expect to still generate sufficient revenues to cover its public expenditures.

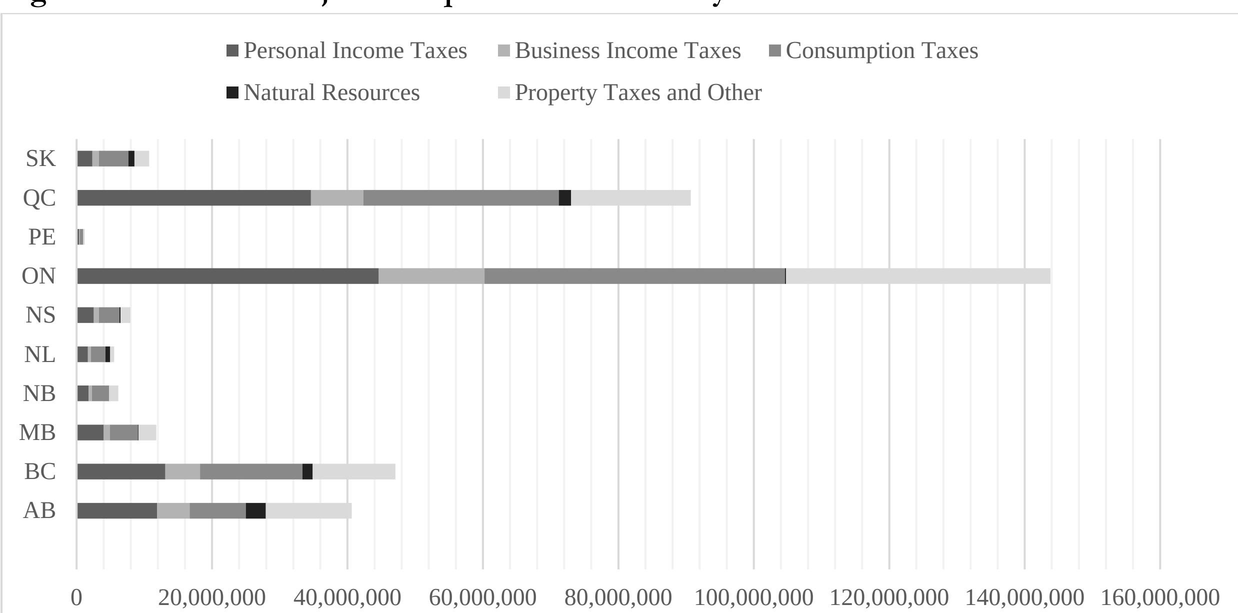
Such varying levels of imposition are the product of political decisions since each province has the legislative authority the levy direct taxation. However, these provincial political decisions should not affect how the Government of Canada redistributes federal revenues. Thus, the Equalization formula ensures that, with all else being equal, the provincial economies that can generate above average revenues are not entitled to Equalization, while the underperforming provincial economies receive transfers that raises their revenues closer to the national average.

Equalization amount ($) = Σ Average effective tax rate per source*

(per capita tax base *standard* – per capita tax base province)* population = 0 if per capita tax base standard < per capita tax base province)

It is important to note that Equalization entitlements are based on a calculation that either includes 50 percent of natural resource revenues or excludes those revenues entirely. This is reflected in the small share of natural resource revenues subject to the Equalization formula as it appears in Figure 5. Eligible provinces automatically receive payments according to the option most favourable to them (Roy-César 2013: 2). This is meant to incentivise the development of natural resources, rather than penalize provinces with high natural resource endowments.

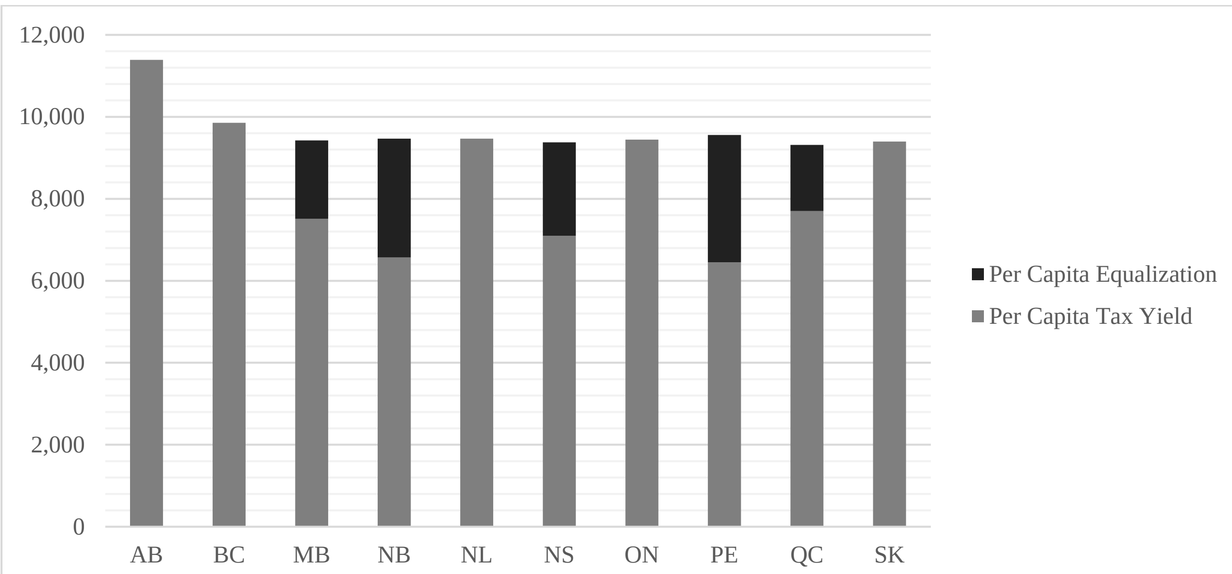
Figure 5. Revenues Subject to Equalization in 2018 by Province and Revenue Source



Source: Department of Finance, Government of Canada. 2019. "Provincial Fiscal Equalization. 2019 Formula. Second Estimate of 2018-19." Table 8. Illustration by author. Scale is in dollars.

Consequently, even though only a fraction or none of the oil rents figure in the calculation of a province's fiscal capacity, the energy sector nevertheless has spillover effects that are important to fiscal federalism. It is an industry that creates a lot of high-income jobs, which can drive up consumption, and property value in certain regions. High income earners effectively pay more federal taxes and a small portion of those revenues are used for Equalization. Thus, even if you remove all non-renewable energy revenues from the equation, a province with generous natural resource endowments will have an above average fiscal capacity, which makes it ineligible to receive Equalization payments. Thus, even if non-renewable energy revenues are excluded from the formula's calculation of fiscal capacity, as demanded by Jason Kenney and others, Alberta still has a fiscal capacity that is above the national average. Additionally, this change would, in fact, increase Quebec's Equalization entitlements most years (Tombe 2020).

Figure 6. Per Capita Equalization and Tax Yield at National Average Tax Rate in 2019



Source: Department of Finance, Government of Canada. 2019. "Provincial Fiscal Equalization. 2019 Formula. Fourth Estimate of 2016-17." Tables 1 and 6. Illustration by author. Scale is in dollars per capita.

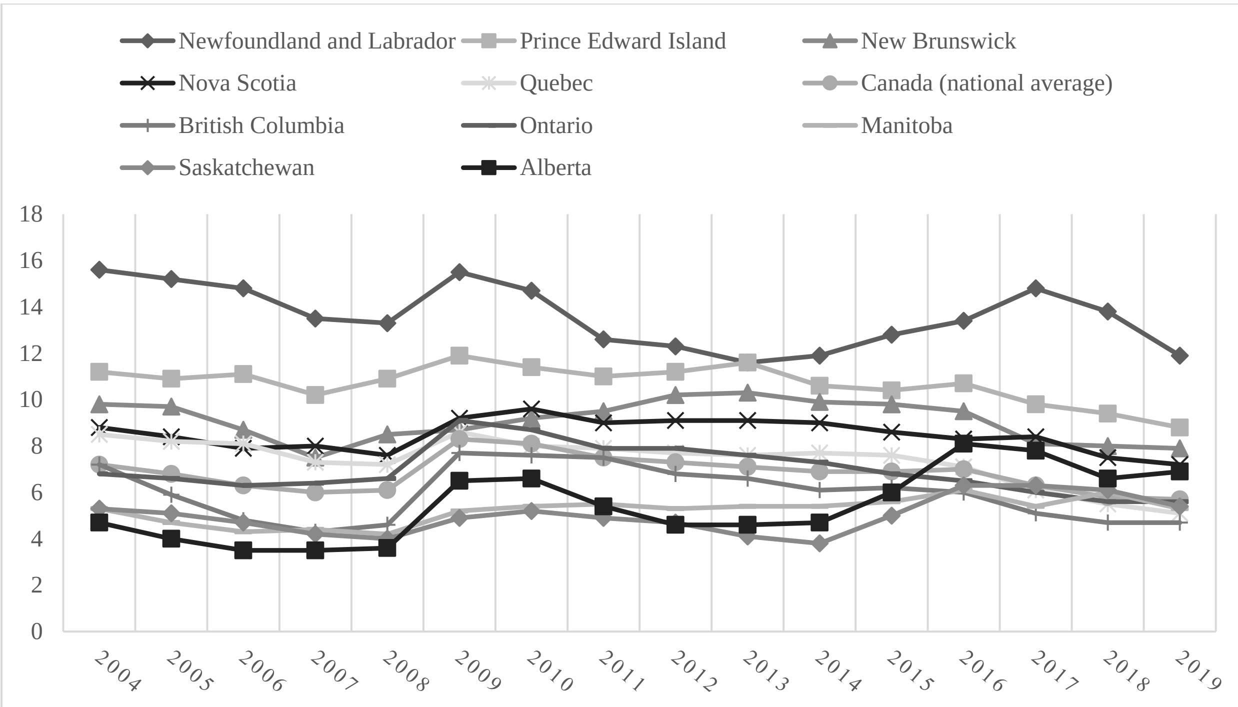
This helps explain why Alberta has rarely received Equalization payments and felt mistreated by the federal program. Because, even though Alberta entered a recession in 2014 when global oil prices began to drop, it still had the largest per capita economy in the country. Figure 6 shows the extent to which provinces have an above or below average capacity to generate revenues when using the Equalization formula's uniform tax rate measure. It shows that despite the economic downturn and massive layoffs, there remains too many high-income earners in Alberta, which help maintain its per capita fiscal capacity at a level beyond that of any other province. Had it received Equalization payments, this would have required the federal government to collect money from every Canadian taxpayer and business and to transfer it to the province with the highest per capita GDP (Mah 2018). Such an act would distort the purpose of equality embedded in the Equalization program, which is to reduce the horizontal fiscal imbalance between provinces, not to reduce income inequality in a province or to reduce provincial deficits. The CHT and CST play a much more significant role in lowering social inequality and the vertical fiscal imbalance. Otherwise, Equalization would appear to condone undisciplined economic policy. Provinces could run large deficits and expect Equalization to cover the financial shortfall. By that account, Alberta's deficit, although certainly driven in part by factors beyond its control, like the volatility of oil prices, is also the result of political decisions of its own, given the revenues it sacrifices by keeping its tax rates much lower than other provinces.

These arguments do not mean the Government of Canada does not have a role to play in helping Alberta revitalize its economy. Quite the opposite: every Canadian benefits from Alberta's economic strength and the Equalization pool shrinks when there is significant contraction in Canada's GDP. It comes down to providing the right kind of incentives to stimulate economic productivity and careful spending, without undermining the principle of equality that underpins the program. In fact, to ensure that Equalization payments do not raise an eligible province's fiscal capacity above that of a non-receiving province, a Fiscal Capacity Cap was put in place. According to the Parliamentary Budget Officer, however, this limit on an eligible province's per capita payments is more likely to affect provinces with large natural resource endowments, but an otherwise moderate fiscal capacity and high expenditure needs. This is particularly true in the case of Newfoundland and Labrador.

The discovery of offshore oil reserves and long battle for the control and collection of oil rents has been a crucial part of Newfoundland and Labrador's quest to reduce its dependence on federal transfer payments and ensure the province's financial self-sufficiency. Even so, the problem with the Equalization program is that it ignores expenditure needs to focus exclusively on fiscal capacity (Béland et al. 2017: 91). Equalization does not account for the higher per unit costs of service delivery in large geographic areas with a small and dispersed population (Béland et al. 2017: 81). This observation certainly applies to the reality of service delivery in Newfoundland and Labrador, which has the lowest population density per square kilometre of any Canadian province (Government of Canada 2019). Newfoundland and Labrador also consistently has the highest unemployment rate (see Figure 7 below), has an ageing population whose personal income is below average and a GDP that is a fraction of that of the other "have" provinces (Mintz 2019). By all accounts, the province would appear in need of federal support, despite its higher than average fiscal capacity. This explains why Premier Dwight Ball has also pushed for an overhaul of both the Fiscal Stabilization program and the Equalization program (Carmichael 2020).

Canada chose to base its Equalization formula strictly on the calculation of fiscal capacity (i.e. revenues) rather than also consider fiscal needs (i.e. expenditures) (Béland et al. 2017: 27). This is a political decision as much as it is an economic calculation. Consequently, it is part of what makes the Equalization program such a contentious subject among provincial and federal First Ministers in Canada. In fact, Equalization attracts far more debate than the CHT for example, even though it is a less important transfer and imposes less conditions. Thus, while the inclusion of non-renewable natural resources occupies a large part of the public debate over Equalization, there are other legitimate concerns regarding the formula that are far from resolved. This includes the calculation of expenditure needs, better transparency of the sources of income that are subject to Equalization and how they are included in the calculation, as well as who performs the calculation, whether this continues to be the job of federal public servants or should the mandate be transferred to an independent body (Lecours and Béland 2013). Until these points of tension are levelled out, we can expect the debate over oil rents and the politics of Equalization to continue to animate Canadian federalism for years to come.

Figure 7. Unemployment Rate of Canadian Provinces, 2004-2019



Source: Government of Canada, Statistics Canada. 2017. "Labour Force Characteristics by Province, Territory and Economic Region, Annual." Statistics Canada. December 27, 2017. Scale is in percent unemployment.
https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1410009001.

Conclusion

The collection and redistribution of revenues is an essential function of a federal democracy. It helps foster citizens' sense of belonging to their province and country by ensuring comparable public services at a similar tax rate wherever they choose to reside. There are fears that people may otherwise migrate in large numbers to another province to access better public services or benefit from lower levels of taxation. This kind of exodus would deprive the province they left from valuable sources of income.

For the single most important factor to a jurisdiction's revenue base is the number of high-income companies and individuals on whom it can levy taxes. The problem for a country as vast and thinly populated as Canada is the very uneven dispersal of its population and natural resources. Provinces must fund the activities for which they are constitutionally responsible, but most cannot raise enough revenues without placing an undue financial burden on its residents in comparison to other wealthier provinces. This paper examines how the major federal transfers were designed to remedy these vertical and horizontal fiscal imbalances.

Of the three major federal transfers discussed, one has attracted a disproportionate amount of criticism since its creation in 1957. This is the Equalization program whose purpose is to reduce the difference in revenue-generating capacity between Canada's ten provinces. The reason why it is so controversial is in part because only some provinces are entitled to it. These are the less wealthy provinces whose fiscal capacity falls below the national average. Wealthier provinces with abundant natural resource endowments are generally left out given their high fiscal capacity.

This systematic exclusion is at the heart of a growing irritant between the major oil producing provinces of Alberta and, to a lesser extent, Saskatchewan towards the governments of Canada and Quebec—the province that receives the largest Equalization payments. The two Prairie provinces are landlocked, which means that when other provinces refuse to let crude oil pass through their territory, this creates major disruption in the production and export chain. The paper shows that when this occurred in recent years, Alberta and Saskatchewan have tried to retaliate by demanding changes to the Equalization formula, claiming they were paying a disproportionate share of the Program and felt alienated within the federation.

The main objective of this paper was to explain how provinces do not actually pay for the Equalization Program and why some are entitled to this transfer payment while others are not. Equalization is a federally administered program that uses revenues collected within the Government of Canada's tax fields. We showed that provincial revenues are assessed only to calculate their ability to raise own-source revenues and determine which need a bump in support to reach the national average. It does not collect oil rents nor intend to discourage its further development. In fact, the choice of including zero or fifty percent of natural resource revenues in the Equalization formula is part of a political bargain meant to incentivise the further development of this valuable commodity. But as discussed, the uneven distribution and volatile value of natural resources like oil and gas has added to tensions and complicated the calculation of provincial fiscal capacity. It is nonetheless part of what makes Equalization an imperfect yet critical component of Canadian fiscal federalism.

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