

SENATE COMMITTEE ON NATIONAL FINANCE

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OPENING STATEMENT

by

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SENATORS:

It is a privilege to appear before this Committee. Thank you for the invitation

In this opening statement I want to focus on two fiscal-federalism issues, both of which stem from my recent papers published by the IRPP. The first is entitled *Hourglass Federalism* and it appears in the current (April, 2004) issue of *POLICY OPTIONS/OPTIONS POLITIQUES*. The second relates to *Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues*. I assume that copies of these have already been distributed.

Hourglass Federalism

As the name suggests, the thesis underlying hourglass federalism is that the new economic order (globalization and the knowledge/information revolution) is privileging cities/municipalities and the federal government, leaving the provinces as the squeezed middle of the division-of-powers hourglass.

The analysis runs roughly as follows. There are three related reasons why Ottawa wants an enhanced

role to deal with cities and citizens in the information era. The first relates to the shift from a resource-based society and economy to a human-capital or knowledge-based society and economy. Among other things, this means that societal investments in knowledge and human-capital formation progressively hold the keys to wealth creation, to competitiveness and to ameliorating the income-distribution implications arising from globalization. It should not come as a surprise that as long as issues relating to Canada's competitiveness and citizens' standards of living are at stake, Ottawa will become a key policy player in these areas irrespective of what the Constitution might say.

The second has to do with the emergence of global city regions (GCRs) as the dynamic motors of the new economy. This also relates to competitiveness in the dual sense that these GCRs are leading their respective regions' inroads into NAFTA economic space and that GCRs are the key nodes in the knowledge/human-capital networks. Indeed, since Canadians' standard of living will come down to how successful our global city regions are relative to US GCRs, Ottawa will again want to be a key player in this game.

The third, and perhaps overarching, argument for an increased federal presence relates to the fact that the essence of nation-building and electoral salience have also shifted away from resource-based mega projects and towards citizen-driven infrastructure and policies in areas like health, education and income distribution. And whereas these former mega projects tended to be rural, citizen nation-building in the information era is predominantly urban. Unfortunately, from Ottawa's standpoint, most of these areas fall under provincial jurisdiction. But since electoral success is the *sine qua non* of politics, it is only a matter of time before competition among federal parties and between federal and provincial politicians will ensure that Ottawa would become involved in more direct ways with citizens and cities.

How does Ottawa make inroads into provincial jurisdiction? Basically, it starved the provinces fiscally, beginning with the CHST cuts in the 1995 federal budget. Intriguingly, these CHST cuts compromised virtually every provincial program area *except medicare*, since gutting medicare would mean certain electoral defeat for provincial governments. Hence, the provinces diverted funding from everywhere to medicare. The inevitable result was that the provinces had to starve other policy areas, so much so that citizens and cities alike welcomed federal funding in these cash-starved areas.

Thus, utilizing its privileged fiscal-balance position, Ottawa responded on the citizen side with the Canada Child Tax Benefit, with measures related to early childhood development, with Millennium Scholarships and Canada Research Chairs, as well as with the creative measures in the recent budget such as the Canada Learning Bond for children of low income families. On the cities front, Ottawa responded with the GST exemption for cities, with a promise to share the federal gas tax with cities, with an enhanced infrastructure program, as well as with promises of a "New Deal" for cities that includes pre-budget consultations and a say in federal policies that affect, or are implemented by, cities.

In all of this the provinces are finding themselves fiscally sandwiched. To be sure they can counter with charges that there is a fiscal balance in the federation that needs to be corrected. Or they can cater to their cities by, among other ways, promising them that they can use the (provincially created) Council of the Federation as a vehicle to bring city issues to the attention of the federal government. But the fundamental reality is that the provinces remain trapped by the revenue appetite of health care. The only way for the provinces to escape from this is to transfer much of the medicare costs upward to Ottawa (via a fiscal re-balancing of the federation or something like a 25% permanent federal sharing in medicare costs) or to

transfer the costs of medicare downward to citizens (e.g., premiums). Failure to do this will mean that the provinces will continue to be rendered rather helpless to stop the progress of hourglass federalism.

I suspect that Canadians from many quarters would approve of hourglass federalism, if only because this means additional programs and monies for citizens and cities. And certainly the cities are happy since they lobbied for this. My role here is not to approve or disapprove of hourglass federalism, but rather to point out that we are arguably witnessing the most important post-war shift in the division of powers. And, at base, it is being driven by the human-capital and knowledge revolutions: Canada's federal system is simply responding to the resulting challenges and opportunities.

My conclusion is that Canada's cities are destined to become more fully and more formally integrated into the processes and programs of inter-governmental federalism. The only issue is how this will come about. This Committee may wish to play a creative role in the manner in which the intergovernmental nature of our federation might or will evolve.

I now turn to the second issue, the case of Saskatchewan's vanishing energy revenues.

Equalization and Saskatchewan's Energy Revenues

In fiscal year 2000-01 Saskatchewan's energy revenues totalled \$1.038 billion, or just over \$1,000 per capita. However, the province's equalization offset or tax-back associated with these energy revenues was even larger, namely \$1.126 billion. Viewed over time, the tax back rates were even more confiscatory. Over the 1998-99 to 2000-1 period the province's energy revenues increased by \$668 million, but the equalization clawback increased by \$835 million. This represents an offset rate of 125 percent!

Moreover, neither of the above calculations takes account of the fact that collecting these revenues

is far from costless. Factoring in the monies that the province must spend to develop and regulate the industry, let alone collect the revenues, will further magnify Saskatchewan's overall budgetary loss from the energy patch. In contrast, provinces with no energy revenues pocket significant net fiscal revenues from energy-related equalization—for, example, Manitoba receives about \$120 million and Quebec receives a whopping \$870 million. Indeed, even Nova Scotia, which has off-shore energy, is a net beneficiary from overall energy equalization to the tune of \$104 million.

Surely the role of equalization is not to confiscate a province's resource endowments.

How and why, then, do these confiscatory average and marginal tax rates exist and indeed persist? In *Confiscatory Equalization...* I identify three major reasons, *inter alia*, that have given rise to this situation and then propose a range of approaches that would serve to redress this serious fiscal inequity. The primary reason lies in the early 1980s shift from an all-province (national-average) standard (or NAS), to the present five-province standard (FPS) comprised of B.C., Saskatchewan, Manitoba, Ontario and Quebec. With Alberta thus out of the picture, Saskatchewan becomes, by default, a very rich energy province. For example, for third-tier oil (one of the several revenue sources for energy), Saskatchewan has 37 percent of the NAS base, but it has 97 percent of the FPS base. Since average tax back rates rise apace with the degree of concentration of the base, Saskatchewan's average tax-back rates are higher, often dramatically higher, under the FPS than they would be under the NAS.

The second reason is that the equalization authorities have not allowed Saskatchewan to qualify for the 70 percent maximum tax-back rate that is applicable to off-shore in Nova Scotia and Newfoundland. The eligibility criteria for the special treatment is that the province must have 70 percent of the NAS base. Saskatchewan typically has 70 percent of the FPS base, but not of the NAS or all-province base. Surely,

however, the relevant base under the current operation of the formula is the FPS base. Moreover, the only reason why Nova Scotia and Newfoundland have more than 70 percent of the NAS base is that Ottawa has defined these two bases to only include their respective province's off-shore oil. As a result, Saskatchewan has several tax-back rates near or above the 100 percent range, in contrast to the maximum 70 percent rates that apply to the two Atlantic provinces.

The third reason is that the equalization authorities have adopted or calculated artificial tax bases and tax rates for some revenue sources, which in turn have served to exacerbate the clawbacks. For example, for the revenue category "sales of crown leases," Saskatchewan is viewed as "taxing" these leases at a tax rate of 6.9%, while the national average tax rate is deemed to be 15.6%. These artificial tax rates serve to more than double Saskatchewan's fiscal capacity for equalization purposes, with the result that while the province raises \$61 million in revenues from the sales of crown leases, it loses \$124 million in equalization—an astounding clawback in excess of 200%!

This assigning of very different tax rates for sales of leases across provinces amounts to second-guessing the efficiency of markets, since the revenues are derived from auction processes.

Arguably, these confiscatory clawbacks constitute one of the factors that have triggered Saskatchewan's recent descent to the lowest rank in terms of provincial per capita disposable incomes.

By way of redress, two proposals are in order. The first is longer term in nature, namely that the ongoing quinquennial renegotiation of the fiscal arrangements be extended to address these arbitrary and excessive tax-back rates, and energy/resource equalization in general. Based on the extensive literature in this area, one option that merits consideration is to equalize somewhere in the neighbourhood of 25 percent of resource revenues.

The second proposal could and should be adopted forthwith. Drawing from the treatment accorded Nova Scotia and Newfoundland, the immediate policy imperative is that, beginning with fiscal year 2001-02 (where equalization payments have not as yet been finalized), the maximum equalization tax-back rate for each of Saskatchewan's energy categories be set at 70 percent.

By way of a postscript, the 2004 Federal Budget did respond positively to this tax-back issue by committing the Government to review the treatment of resources and tax bases as part of the next quinquennial review to be completed in 2009. But since energy are depleting assets, this delay seems unacceptable on equity grounds, especially when the same budget reduced the tax-back rates for Nova Scotia, for example, by allowing it to "re-start" the *Canada-Nova Scotia Offshore Petroleum Resources Accord* which means that this province's tax-back rates will effectively fall to 10% for the first year, the 20% in year two and so on until the 70% rate is reached once again. In the meantime, over the five years following fiscal 2000-01, Saskatchewan will have tax-back rates for 6 of the 9 energy categories in excess of 70% in 2001-02, followed by 8, 5, 5, and finally 6 in 2005-06 (from preliminary equalization data for these years).

Long ago I said that equalization is the glue that binds the federation together. If these inequities persist this glue may well become unstuck. This Committee is the natural and national forum to undertake the process of rethinking the role of resource revenues in equalization.