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**EQUALIZATION REFORM**

**A FAIR DEAL FOR SASKATCHEWAN**

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Presented to the Expert Panel on Equalization and Territorial Formula Financing  
June 2005

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## **EQUALIZATION REFORM A FAIR DEAL FOR SASKATCHEWAN**

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### **EXECUTIVE SUMMARY**

Saskatchewan supports the need for a strong and reliable federal Equalization program to address the significant fiscal disparities between provinces in Canada, based on the established principles of adequacy, effectiveness, transparency, responsiveness, stability and equity.

The current Equalization program, however, is a patchwork quilt, the result of many ad hoc changes made over time by the federal government. The most significant change was in 1982 with the conversion from a 10-province to a 5-province standard and full inclusion of non-renewable resources. The result is a \$10.9 billion federal program that is understood only by a select few and produces very questionable results.

The current program fails to acknowledge that ownership of natural resources rests with individual provinces under the Constitution. Saskatchewan's rights of ownership extend to the financial rewards from those resources, to be used for the benefit of its citizens. Equalization transfers most of those benefits to other parts of Canada and to the federal government. The provisions that granted Saskatchewan ownership of natural resources did so in order that our province is placed in a position of equality with other provinces. The current situation does not accomplish this end as other provinces are permitted to retain the benefits from their resource development.

Saskatchewan has both technical and policy concerns over the existing program.

- inequitable treatment of energy revenues in Canada that significantly impairs Saskatchewan's ability to strengthen its economy and finance public services;
- unfair treatment of Saskatchewan's mining revenues, where the use of a proxy calculation undermines the credibility of the mining tax base and significantly reduces program entitlements for our province;
- inappropriate determination of the national standard through the use of the 5-province standard and an ad hoc top-up of federal program benefits;
- inaccurate base measurements particularly in the energy and mining sectors;
- unpredictable and volatile financial consequences under the existing formula basis for determining program entitlements, especially for Saskatchewan; and,
- questionable overall program consequences as Saskatchewan's Equalization entitlements are historically lower than other provinces while broader measures of economic activity, like per capita personal income, suggest Saskatchewan should receive much higher program entitlements.

Saskatchewan supports the federal appointment of an independent expert panel to examine Equalization. It represents an excellent opportunity for an independent and informed review to recommend the best course for determining fiscal disparities between provinces and allocating available federal resources to meet the federal constitutional commitment. The panel's review of Equalization must be open-minded and be prepared to consider alternate Equalization approaches that might avoid the pitfalls of the status quo.

## **RECOMMENDATIONS - SASKATCHEWAN'S CASE FOR FAIRNESS**

Saskatchewan strongly advocates reform of Equalization, effective for fiscal 2006-07 that provides a more effective, transparent and equitable distribution of program entitlements that is based on provincial fiscal disparities determined by all provinces and recognizing the unique circumstances of natural resource revenues. In Saskatchewan's view, the best start in the direction of meaningful reform to the existing Equalization program would be a return to a 10-province standard and the full exclusion of all non-renewable resources from the program.

Saskatchewan also encourages the expert panel to review all possible directions with respect to Equalization reform and not be restricted to the existing program.

The panel's work should also not be restricted in its review by the federal government's financial commitment over the medium-term. It should review alternate directions and determine the one that achieves an effective, transparent and responsive program and then determine how it can be implemented within the federal financial guidelines. As we have seen, financial constraints can change rapidly and a key element of the future program will be the manner in which it achieves the federal constitutional commitment.

Specifically, the Government of Saskatchewan recommends the following actions to reform Equalization.

### **1. Immediate Negotiation of a Saskatchewan Energy Accord**

The current treatment of energy revenues in Canada is inequitable. Newfoundland and Labrador and Nova Scotia are guaranteed to retain at least 100 per cent of their energy revenues while Alberta is unaffected by Equalization clawbacks. Saskatchewan is left with little financial return from its non-renewable resources to achieve a competitive tax and royalty environment to encourage new exploration and development and adequately service and regulate this sector.

The federal government must recognize this inequity and provide similar protection from high energy clawback rates under a Saskatchewan Energy Accord. While Saskatchewan supports the need for comprehensive Equalization reform, the federal decision to proceed in advance of the panel's deliberations on addressing other provinces' issues respecting the treatment of energy revenues should also be applied to our province.

In Saskatchewan's view, there is fundamentally no difference between offshore and onshore ownership of non-renewable resources. The federal government long ago transferred ownership and custody of resources to the provinces for the benefit of their residents.

Over the past ten years, Saskatchewan would have received an additional \$4 billion in Equalization entitlements if we had been allowed to retain 100 per cent of our energy revenues in the years for which the province was a recipient province. This money would have been of significant benefit to Saskatchewan in addressing the relatively high debt levels experienced in the 1990s. Instead, Saskatchewan was forced to rely on a relatively high tax effort to reduce debt that limits future economic development opportunities.

Saskatchewan faces an additional challenge as we share a border with the wealthiest province in Canada – Alberta. Due to the high degree of mobility of goods, capital and labour, differences in the levels of taxation and public services between the two provinces can have significant economic and financial implications. In the absence of an improved Equalization program, Saskatchewan will continue to struggle in its efforts to compete with its resource-rich neighbour.

## **2. Full Exclusion of Non-Renewable Resource Revenues From Provincial Revenues to be Equalized**

Non-renewable resources are assets of the provincial Crown and the associated royalties and related provincial revenues received from the sale of those assets should be considered one-time payments that recognize the depleting nature of these assets. This type of transaction is very different from the recognition of an ongoing revenue source such as income tax that continually regenerates.

By agreeing to the new and enhanced offshore energy accords, the federal government has implicitly recognized that revenues from the one-time sale of a finite asset should be treated differently from other revenue sources within the Equalization program.

The retention of the proceeds from non-renewable resource revenues presents an opportunity for a province to invest in its long-term economic future, as has been aptly demonstrated in Alberta over the years. However, our province is confronted with Equalization clawback rates averaging close to 100 per cent, while Alberta retains 100 per cent of the financial rewards from its vast resource wealth. This significantly impairs our province's ability to compete with Alberta in attracting future resource developments.

The existing program also allows other recipient provinces to benefit from Saskatchewan's natural resources, given our substantial contribution to the 5-province standard in many of the resource bases. Even as the incremental benefits to Newfoundland and Labrador and Nova Scotia from their new accords accrue outside the Equalization program, these provinces continue to benefit additionally inside the program from Saskatchewan's energy revenues.

The current Equalization program fails to recognize, as Professor Tom Courchene has long argued, the costs associated with servicing and regulating non-renewable resource development in a province. In conjunction with high clawback rates, this tends to severely limit the provincial financial benefits from the development and sale of non-renewable resource assets.

Finally, an economic argument can be made that the rents from the extraction of non-renewable natural resources are effectively capitalized in other prices in the economy. A 2001 study by Kenneth Boessenkool, entitled *Taking off the Shackles: Equalization and the Development of Non-Renewable Resources in Atlantic Canada*, identified that house prices and wages in Alberta tracked with oil and gas price fluctuations over the period 1985 to 2000.

Higher wages and housing prices reflect the additional fiscal capacity that results from the discovery and exploitation of non-renewable resources and related provincial and local tax bases adjust accordingly. Since these tax bases are reflected in a province's Equalization entitlements, the inclusion of resource rents constitute a form of double inclusion that negatively affects Saskatchewan.

### **3. The Return to a 10-Province Measurement of Provincial Fiscal Disparities**

In order to be fair and equitable to all provinces, Saskatchewan recommends a return to a national determination of provincial fiscal disparities. This would establish the basic framework for a renewed program that would more accurately measure provincial fiscal capacities and better achieve the federal Constitutional commitment to Equalization.

The current arrangement of a 5-province standard and a top-up to a prescribed federal funding contribution is ad hoc and promotes a beggar-thy-neighbour attitude among recipient provinces, as a change in the amount received by one province will negatively affect the amount received by others.

Saskatchewan recognizes that there are financial constraints on the federal fiscal situation. However, that constraint should not affect the selection of the most effective Equalization design. It should only affect the extent to which the federal government meets its financial responsibilities under section 36(2) of the *Constitution Act, 1982*.

#### **4. A Reduction in the Reliance on Proxy Measurements**

The experience in using proxies to measure tax bases has not been positive. The replacement of actual provincial mining data with a series of federal assumptions and calculations to arbitrarily determine provincial entitlements has caused significant financial harm to Saskatchewan and produces inconsistent results that are difficult to accept.

Wherever possible, it is recommended that actual provincial data should be applied in determining Equalization tax bases.

#### **5. A Reduction in the Clawback Rates Generally**

Saskatchewan rejects the current program's fundamental principle that a dollar of incremental provincial own source revenue should result in a dollar of Equalization transfer lost. This promotes a welfare mentality among recipient provinces and creates a significant financial disincentive for recipient provinces to expand their economic base through lower tax rates.

If the existing formula basis is to continue, it is recommended that clawback rates should be reduced significantly.

#### **6. Consideration of Macro Formulas/Expenditure Need**

Saskatchewan favours a broad-based examination of all alternatives, including macro formulas and expenditure need.

Macro formulas could promote greater certainty, transparency and overall fairness. Saskatchewan does not consider the current distribution of program benefits to be fair. The interaction of complex formulas can create perverse financial and distributional consequences that could be avoided by a simpler allocation methodology. While it is noted that macro formulas can suffer data concerns and time lags, this is also true with the current formula-based approach.

Expenditure need approaches are also worth pursuing as they could offer a different perspective on determining interprovincial fiscal disparities associated with having to deal with Alberta's fiscal capacity.

Saskatchewan recognizes that timing constraints may limit the ability of the federal government to introduce an alternate Equalization approach involving macro formulas for 2006-07. However, any measurable change in the existing Equalization approach will cause transitional issues. Short-term considerations should not deter the expert panel from seriously considering comprehensive reform alternatives.

## **BACKGROUND**

### **A Brief History of Equalization**

When the Equalization program was first established in 1957, it included only three bases of direct taxation in the measurement of fiscal capacity (personal income tax, corporation taxes and succession duties), and included only two provinces in establishing the standard to which other provinces would be equalized (Ontario and British Columbia).

With each successive five-year renewal, the program has become significantly more complex through an ongoing process of revision and adjustment. Many of the changes made to the Equalization program could only be described as ad hoc, with some of the more contentious introduced primarily for federal fiscal reasons. When considered collectively, the impact of these changes have significantly increased the complexity of the program and reduced its effectiveness.

The most significant example of a fiscally motivated change to Equalization came in 1982. This renewal caused conversion of the 10-province standard to a 5-province standard in order to exclude Alberta and its vast energy wealth. The 5-province standard, still in existence today, was based on per capita fiscal capacity of the five “middle” provinces and results in much lower program entitlements.

A second key change was a return to the full inclusion of non-renewable natural resource revenues in determining program entitlements. This change, when combined with the decision to exclude Alberta from the standard, created a significant negative effect on how Saskatchewan’s energy revenues were treated under Equalization.

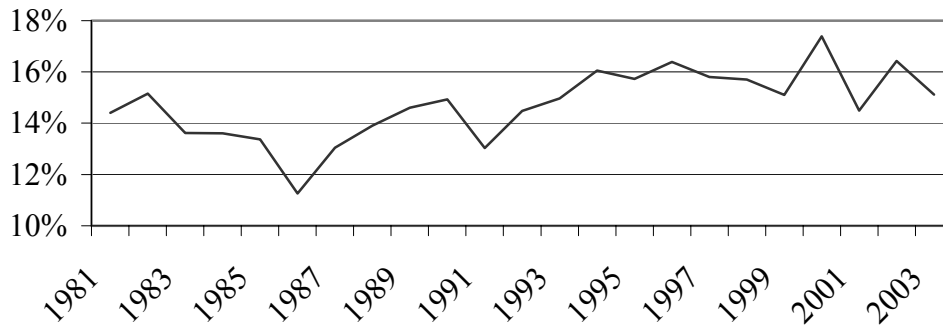
In 1999, the federal government combined the four existing mining tax bases into one and replaced actual provincial mining data with a proxy calculation to determine provincial entitlements. These changes significantly reduced Saskatchewan’s mining tax base entitlement and effectively removed the province’s access to the generic solution for potash revenues.

### **Saskatchewan’s Reliance on Equalization**

Equalization is an important factor in managing Saskatchewan’s fiscal situation. Saskatchewan has experienced greater volatility in own source revenues than any other province, with the possible exception of Alberta. As a result, our province has relied on the Equalization program over time to address periods in our history where provincial and local revenues are weaker.

The following graph illustrates the volatility in Saskatchewan's revenues that has occurred over time.

**Saskatchewan's Revenues as a Per Cent of  
GDP Excluding Federal Transfers**



Over the last ten years, Saskatchewan averaged \$318 million in revenues from Equalization. This represents 5.5 per cent of our total revenues over this period. It has been an integral component in our province's ability to sustain balanced budgets for the last 11 years. Over the last three years, Saskatchewan has been a "have" province as a result of strong international market prices for non-renewable resources.

However, as Professor Courchene identified in a 2004 paper entitled *Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues*, the province's non-energy Equalization entitlements are rising at a much faster pace than are those for any other Equalization recipient province.

He determined that for the period 1995-96 to 2000-01, this increase was 66 per cent as opposed to 22 per cent for Manitoba and only 15 per cent for Newfoundland and Labrador. His conclusion is that Saskatchewan is "becoming poorer relative to other provinces" and that "the full offset of its energy revenues at the hands of Equalization is, arguably, one of the factors that is leading to the province's relative decline in terms of the rankings of provincial disposable income".

Professor Courchene also noted a similar analysis undertaken by Global Insight's Dale Orr (2003) in which he noted that although Saskatchewan ranks somewhere in the middle in terms of provincial per capita Gross Domestic Product (GDP), it has dropped rank in terms of per capita personal disposable income. Mr. Orr points out that "this is due to the fact that much of the energy value in the province does not flow through to its citizens, and an even larger part arises because Saskatchewan does not have the massive Employment Insurance and Equalization transfer inflows that benefit Atlantic Canada".

## **SASKATCHEWAN'S ISSUES WITH THE EXISTING EQUALIZATION PROGRAM**

### **General**

Saskatchewan lacks confidence in the existing Equalization program's ability to fairly determine provincial fiscal disparities and achieve the federal constitutional commitment. In particular, the unfairness in the treatment of energy revenues between provinces calls into question the current program's ability to treat provinces in an equitable manner. The use of assumptions and proxies in many tax bases, including mining, also promotes indefensible results.

Our Province asserts that the program has reached a point where it no longer works in the manner originally intended and must be fully reformed. Further tinkering through the introduction of ad hoc changes will not achieve the federal Constitutional mandate to "ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

In recent renewals of the Equalization program, Saskatchewan has raised a number of issues related to the existing program: the treatment of energy resources and the Atlantic Accords, the 1999 changes to the mining tax base, the 5-province standard and the federal assumptions/calculations used under the formula-based representative tax system to measure provincial fiscal capacities.

### **1. Treatment of Energy Revenue**

The Equalization program has a long and varied history with respect to the treatment of revenues from the development of non-renewable resources. This is particularly true for oil and natural gas, commonly referred to as energy resources.

Prior to 1962, non-renewable resources were not included in the formula. Their exclusion gave Alberta 15 years of energy development before there were any Equalization offsets.

In 1962, all non-renewable resources were included in the program at a rate of 50 per cent, in conjunction with a move to a 10-province standard. In 1964, the 50 per cent resource inclusion rate was replaced with a mechanism whereby 50 per cent of the amount by which a province's three-year average resource revenues exceeded the national average were deducted from that province's Equalization entitlements.

In the 1967 renewal, this mechanism was discarded and the inclusion rate for resources was increased to 100 per cent, along with a substantial expansion in the number of resource tax bases.

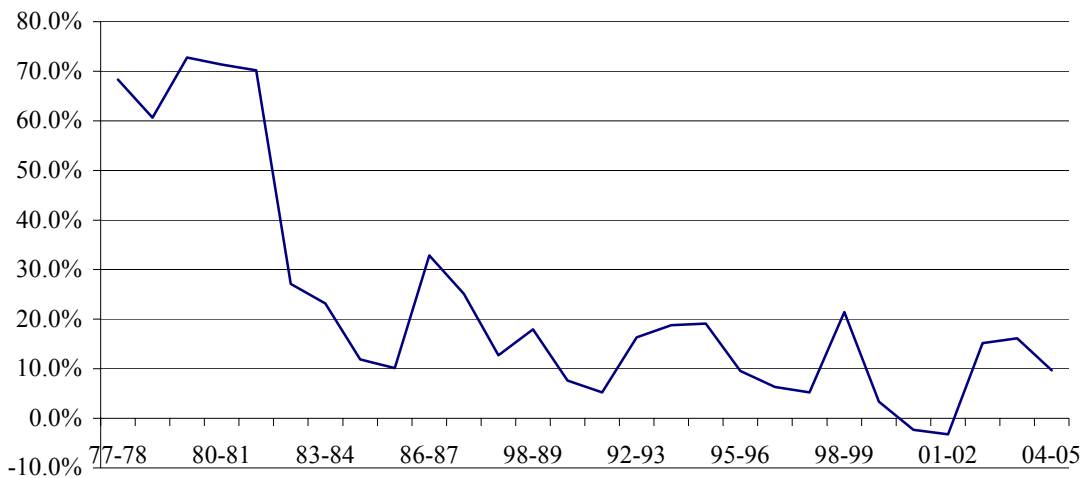
During the 1970s, mainly due to substantial oil price increases driven by the Organization of Petroleum Exporting Countries, the federal government arbitrarily reduced the inclusion rate for resources back to 50 per cent in order to control the cost of the program. It also introduced the National Energy Program to redistribute the value of energy to other parts of Canada.

As mentioned above, the 1982 changes that excluded Alberta’s energy revenues, but fully included Saskatchewan’s energy revenues, had substantial negative financial and economic implications for our Province. While Saskatchewan shared the same negative effect of Alberta’s exclusion on the overall level of program entitlements with other recipient provinces, the province also saw a significant increase in clawback rates on energy revenues.

The term “clawback” is generally understood to mean the amount of negative Equalization entitlement that is associated with a province’s revenues within a given base. For example, oil revenues of \$100 million that resulted in a negative Equalization entitlement of \$90 million would indicate a clawback rate of 90 per cent. In fiscal 1981-82, Saskatchewan’s average Equalization clawback rate for all our energy revenue was 30 per cent. In fiscal 2001-02, it had risen to 103 per cent.

With clawback rates approaching, and sometimes even in excess of 100 per cent, it is extremely difficult for Saskatchewan to encourage the development of energy resources in our province, while being able to afford the cost of servicing and regulating such an important sector of the provincial economy.

**Per Cent of Energy Revenues  
Retained by Saskatchewan**



Source: Computed using Department of Finance publications of Equalization Estimates.

Professor Courchene’s 2004 paper referred to earlier, entitled *Confiscatory Equalization: The Intriguing Case of Saskatchewan’s Vanishing Energy Revenues*, brought increased public attention to the fact that average Equalization clawback rates on Saskatchewan’s energy revenues have been excessive and “confiscatory”. Courchene singles out the “Sales of Crown Leases” base, which is calculated by proxy, as being particularly offensive with a tax back rate of 235.9 per cent in 2000-01.

The following table reproduces these numbers as illustrated in Courchene's analysis of tax back rates.

<b>2000-01 Tax-Back Rates on Saskatchewan's Energy Revenues Under Old Revenue Classification</b>			
<b>(\$000)</b>	<b>Revenues</b>	<b>Equalization Entitlement</b>	<b>Average Tax-Back Rate</b>
New Oil	404,884	-403,495	-99.7%
Old Oil	71,881	-23,732	-33.0%
Heavy Oil	236,117	-219,799	-93.1%
Domestic Natural Gas	239,305	-327,864	-137.0%
Exported Natural Gas	0	19,065	--
Sales of Crown Leases	61,483	-145,011	-235.9%
Other Oil and Gas	24,683	-25,123	-101.8%
<b>Total</b>	<b>1,038,353</b>	<b>-1,125,959</b>	<b>-108.4%</b>

Source: Computed using Department of Finance publications of Equalization Estimates.

More generally, Courchene argued that the confiscatory aspect of the current Equalization structure becomes apparent in two ways. First, a tax back rate in excess of 100 per cent indicates a flawed base measurement and is indefensible on its own. Second, an over-inflated base measurement not only yields incorrectly high tax back rates for Saskatchewan, but also artificially increases the Equalization entitlements of other recipient provinces. In other words, the financial benefits from Saskatchewan's energy developments are largely transferred to the other provinces.

The intense discussion and public debate that followed prompted some remedial action by the federal government, in the form of a \$120 million payment to address Equalization clawbacks in excess of 100 per cent for the Crown Leases base in prior closed years.

Saskatchewan's main concerns about excessive clawback rates going forward, however, remain unaddressed. Due to the limited or even negative net financial return to our province from the development of our energy resources, there is little financial incentive to encourage new conventional drilling or new higher-cost enhanced oil recovery projects which are essential to the future of oil and gas development in Saskatchewan.

An example of this situation is the development of specific application enhanced oil recovery projects such as carbon dioxide injection. Due to the extremely high cost of such projects, they require special taxation incentives to make them economically viable. By not recognizing the unique nature and high cost of such projects, the existing Equalization program interprets Saskatchewan's incentives as a low tax effort, which results in clawback rates on the revenue from these projects that are regularly in excess of 100 per cent. This situation creates a significant disincentive for this type of development in the existing Equalization program.

In addition, the high energy clawback situation adds to the already difficult challenge of competing with Alberta for new investment dollars in the energy sector. By virtue of its established resource wealth, Alberta is able to take a lower amount of economic rent from the development of its resources than less wealthy provinces such as Saskatchewan. Wherever Saskatchewan attempts to introduce more competitive tax rates on oil and gas development, this is interpreted as a low tax effort as opposed to the more accurate interpretation of a lesser fiscal capacity. The resulting clawback rate on energy revenues from new investments becomes prohibitive.

Saskatchewan and the other three western provinces have had full and exclusive ownership of our natural resources since 1930, when the federal government transferred ownership to these provinces under the *Natural Resources Transfer Act*. As a result of that Act, and similar transfers of natural resources ownership to the other provinces by the federal government, all ten provinces currently have the exclusive right to directly tax the production of natural resources within their geographical boundaries.

The federal government derives revenue from the production of these resources only indirectly, mainly through its taxes on the income of corporations and individuals involved in natural resource development activity. The ownership of offshore resources for the purposes of direct taxation, however, was not clarified until more recently.

Provincial ownership of resources becomes an important issue for Saskatchewan when the financial benefits from the depletion of a non-renewable resource are effectively transferred to the federal government and other provinces under the existing Equalization program through clawback rates that have exceeded 100 per cent.

## **2. Atlantic Offshore Energy Arrangements**

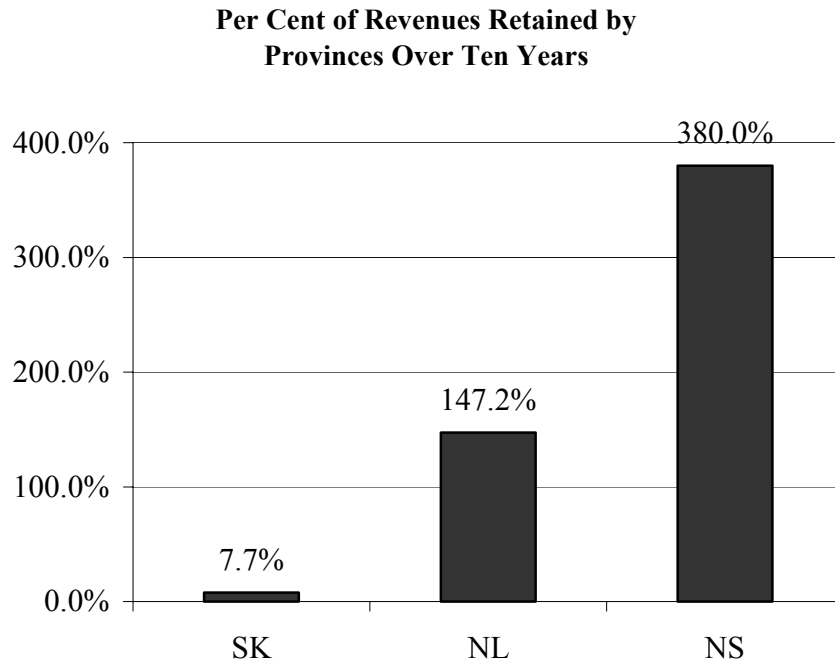
Shortly after the 1982 Equalization renewal, bilateral Atlantic Accords respecting offshore energy developments were established between the federal government and Newfoundland and Labrador and Nova Scotia.

These Accords gave Newfoundland and Labrador in 1985 and Nova Scotia in 1986 the right to manage and tax offshore energy resources as if they owned them. The Accords also contained special provisions to significantly limit Equalization clawbacks on revenues accruing from the development of the offshore energy resources.

In combination with the generic solution provision introduced into the Equalization program in 1994, the net effect of the accords has been to limit the clawback rates to a maximum of 70 per cent of energy revenues, and usually much less. These benefits are further improved with the new offshore arrangements, discussed in greater detail below.

Equalization further distorts the financial impact on provinces by including Saskatchewan's natural resources to be included in determining the Equalization standard, thereby imparting a financial benefit on Newfoundland and Labrador and Nova Scotia, while not including offshore energy revenues in the standard, thereby preventing Saskatchewan from benefiting from increases in this provincial revenue source.

The overall benefit to these provinces from the Accords is illustrated in the following chart and is compared to the excessive clawback rates experienced by Saskatchewan on our energy developments.



Source: Computed using Department of Finance publications of Equalization Estimates.

Prior to the appointment of the independent expert panel to review the Equalization program during calendar 2005 and advise on how it should be changed for 2006-07 and future years, the federal government announced in January 2005 that it had reached agreements with Newfoundland and Labrador and Nova Scotia on new offshore energy agreements.

The new offshore energy agreements for these Atlantic provinces build on the provisions of the existing offshore energy accords to ensure that these provinces benefit from the equivalent of a nil clawback on all their revenues from offshore energy developments.

The benefits of these new accords, in addition to their benefits from the existing accords, are estimated to be \$2.6 billion for Newfoundland and Labrador and \$1.2 billion for Nova Scotia over an eight-year period. Upfront cash payments, representing the absolute minimum benefits attributable to the new accords, were made in the amounts of \$2.0 billion to Newfoundland and Labrador and \$830 million to Nova Scotia. At the end of the initial eight-year period, these accords may be renewed for a further eight years if certain conditions are met, providing significant additional benefits to those provinces.

Saskatchewan embraces the offshore energy agreements as they recognize that non-renewable resource revenues are one-time in nature and should be retained by the rightful provincial owners of those resources to strengthen their economy. Newfoundland and Labrador and Nova Scotia now have a wonderful opportunity in which to reinvest these one-time sources of revenue to achieve a level of self-sufficiency that could not otherwise be attained through the existing Equalization program.

Saskatchewan is asking for the same opportunity. Since 1982, the Province has seen most of the financial rewards from the extraction of non-renewable resources flow out of our province through Equalization while it continues to face the high cost of managing and regulating this sector of our economy. The Province must also ensure that provincial royalty and taxation regimes are competitive to encourage new exploration and development in the province. This is no small challenge when one looks west at our chief competitor who is unaffected by Equalization clawback rates that reached 103 per cent in 2001-02.

Saskatchewan requests the same treatment for its non-renewable natural resources as Newfoundland and Labrador and Nova Scotia retain provincial royalty and tax revenues from energy development for reinvestment in our province. They should not be treated as just another revenue source since there is a fundamental difference between non-renewable resources, whose value is permanently depleted once extracted from the ground, and other sources of government revenue that are ongoing. This is the principle Saskatchewan sees in the new offshore energy accords and it should be applied fairly to all regions of our country.

### **3. Mining Tax Base**

As part of the 1999 renewal of the program, four individual mining tax bases were combined into one tax base. As part of this, the measurement used to determine a province's entitlement from mining was changed from a combination of volume and value of production to an economic rent approach that relies on a determination of mining profits.

Under the 1999 changes, Statistics Canada and the federal Department of Finance use a number of data sources and apply a series of assumptions to estimate mining profits earned in each province, resulting in a questionable relationship between actual mining profits and the federal determination of profits.

This federal estimation of mining profits attempts to reflect a province's underlying fiscal capacity from the mining sector. However, at least for Saskatchewan, it does not reflect actual royalty and taxation practices, as our major mining activities, potash and uranium, rely on ad valorem royalties to a large extent. As a result, the federal reliance on a "proxy" calculation to determine the mining tax base on what should be taxed rather than what is taxed is not supported by our province.

The results of this situation are of significant concern to Saskatchewan. The proxy mining base measurement allocates approximately 40 per cent of the national mining base to our province, although only about 15 per cent of the total value of mining production in Canada occurs in Saskatchewan. Other provinces report mining activity and related provincial revenues but are not considered to have a tax base for determining Equalization entitlements.

The mining tax base has become a prime example of the failure of the current Equalization system to measure provincial fiscal capacities in a fair and effective way. In the 2004 renewal, Saskatchewan and other provinces successfully argued against the introduction of an economic rent approach for the oil and gas bases, citing ongoing concerns with the accuracy of this approach in the mineral resources base.

As part of its analysis of this change prior to its introduction in 1999, the federal government estimated that Saskatchewan would benefit from this change through higher mining base entitlements. In October 2002, the federal government released its first official Equalization estimate of entitlements under the current mining tax base. The result was an unexpected and significant decline in transfers to Saskatchewan.

**Saskatchewan's Equalization Entitlements – Mining Bases**  
**"New" Base vs. "Old" Bases**

(\$000s)	1999-00	2000-01	2001-02	2002-03
<b>New Base – Mining</b>	<u>(207,626)</u>	<u>(186,699)</u>	<u>(140,625)</u>	<u>(164,203)</u>
<b>Old Bases – Mining</b>	<u>(125,849)</u>	<u>(143,344)</u>	<u>(134,333)</u>	<u>(135,285)</u>
<b>Decline in Entitlements</b>	<u><b>(81,777)</b></u>	<u><b>(43,355)</b></u>	<u><b>(6,292)</b></u>	<u><b>(28,918)</b></u>

Source: Computed using Department of Finance publications of Equalization Estimates for February 2005.

Since then, further data updates have proven to be both volatile and difficult to predict. Saskatchewan has lost, on average, about \$40 million per year in mining base entitlements from the application of the federal proxy base when compared to the old bases that relied on volume and value of production.

The surprising results since October 2002 and the volatility of subsequent federal estimates reflect the deficiency in the present mining tax base. In addition, there is little, if any, correlation between the federal proxy base and the level of mining royalties actually collected by the provinces.

During the 2004 Equalization renewal discussions, Saskatchewan formally requested that the federal government withdraw the proxy mining base and return to the four separate bases for mining that existed prior to the 1999 renewal, in order to provide a more predictable and accurate measure of relative fiscal capacities among provinces in the mining sector. The federal government refused this request and introduced minor ad hoc changes that attempt to fix some of the more obvious deficiencies of relying on the existing proxy base for determining mining entitlements.

This situation typifies the risk of determining Equalization tax bases using proxies. Saskatchewan supports the use of actual provincial taxing practices instead of proxy measures wherever possible to measure provincial fiscal capacities. This approach would avoid the unpredictable and questionable results caused by applying proxies, as has been demonstrated with the mining tax base.

#### **4. 5-Province Standard**

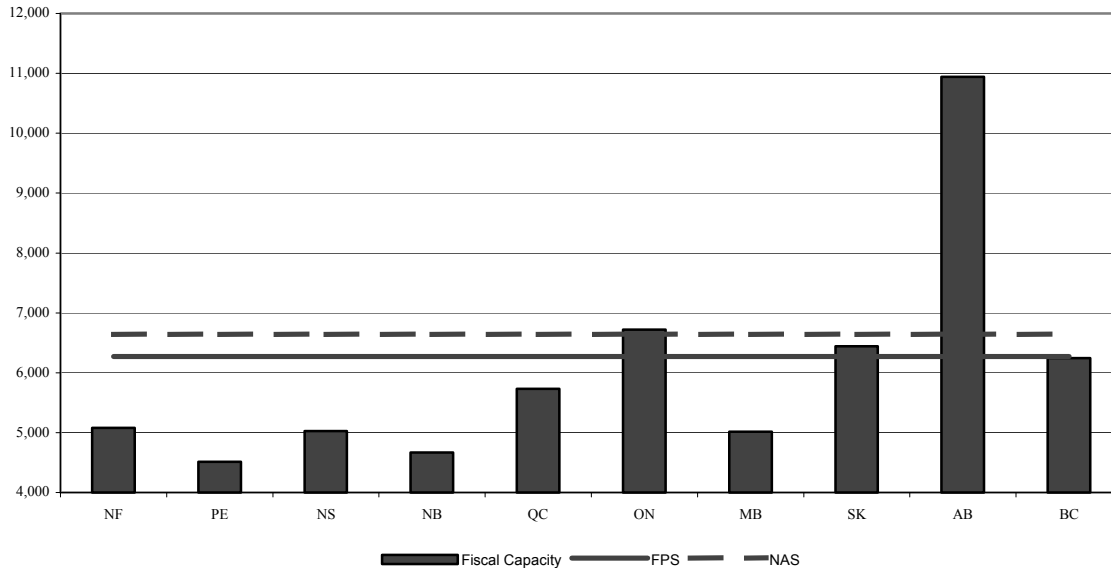
The federal decision to exclude Alberta and its enormous wealth by establishing the current 5-province standard significantly reduces overall program entitlements from what they would be under a 10-province standard. Due to this much lower standard, all recipient provinces suffer substantially reduced entitlements.

The following table illustrates the effect on 2004-05 program entitlements if a 10-province standard had been in place. Overall, program entitlements would be increased by \$5.8 billion and distributed among recipient provinces on a per capita basis. Saskatchewan appreciates the significance of the required federal financial commitment associated with returning to a 10-province standard.

The continuation of the 5-province standard would see these problems worsen over time, as Alberta's economic and fiscal strength grows. Offshore energy revenues in Newfoundland and Labrador and Nova Scotia would continue to be excluded from the standard.

A return to a 10-province standard, as Saskatchewan has long advocated, would go a long way towards restoring adequacy to the Equalization program and resolving many of the current problems and inequities associated with it.

2004-05 Per Capita Fiscal Capacity



Source: February 2005 Federal Finance estimates for 2004-05.

Another concern with a 5-province standard is the financial consequences of tax base movement between provinces that are in and out of the standard. If there is economic migration from Saskatchewan to another province in the standard, such as Ontario, Saskatchewan would receive some compensation through the Equalization program. However, if the migration is to a non-standard province like Alberta, there would be no compensation since it is not in the Equalization standard.

This creates perverse consequences and favours those provinces geographically further away from Alberta, the primary destination for economic relocation given its low tax regime and proximity to Saskatchewan.

Beyond these general concerns over the 5-province standard, Saskatchewan also suffers significantly from being the major oil and gas producer that is included in the standard. As explained above, Saskatchewan experiences greatly increased clawback rates on our incremental energy development as a result of the exclusion of Alberta's energy resources.

## 5. Fixed National Entitlement

The federal government has passed legislation that sets national Equalization entitlements at \$10.9 billion for 2005-06, escalating at 3.5 per cent annually through 2009-10. Saskatchewan sees this change as a major problem that could increase in significance over time.

This is because program entitlements calculated under a 5-province standard are currently estimated to be about \$9.3 billion, requiring an arbitrary allocation of an additional \$1.6 billion to reach the full federal financial commitment. This ad hoc approach encourages a beggar-thy-neighbour attitude in considering program changes, as any revision results in a redistribution of provincial entitlements on a zero-sum basis.

This change also represents a significant move away from the original goals of the program. Equalization was designed to equalize the per capita fiscal capacity of all Canadian provinces. If fiscal disparities grow over the next decade, the program should have the flexibility to adjust. Conversely, if disparities narrow, should the federal government be committed to a minimum level of Equalization payments?

The return to a 10-province standard to determine program entitlements could have been undertaken instead, with total program entitlements determined as a percentage of the 10-province standard that reflects the aggregate federal funding commitment. This approach could avoid the complication and distributional consequences of continually adjusting the financial results produced by the existing 5-province standard.

## **6. Technical Issues With the Existing Program**

### Data Shocks

The current Equalization program's approach to measuring relative provincial fiscal capacities contains 33 tax bases and calculates entitlements at any point in time based on four open fiscal years (current year plus three prior years). There are two general types of data shocks: revenue shocks such as an adjustment to oil and gas revenues caused by changes in international market conditions, and base shocks that can arise from updated economic data or assumption changes by the federal government.

Fully, 14 of all Equalization bases, or 40 per cent, are related to natural resources, with 11 bases dealing specifically with non-renewable energy. Due to Saskatchewan's relatively heavy reliance on oil and gas revenues, this situation has created substantial problems with respect to the measurement of our fiscal capacity and caused extremely high levels of volatility and unpredictability in our Equalization entitlements.

As part of the 2004 Equalization renewal, the federal government introduced a three-year averaging provision in order to smooth out the provincial effects of data shocks and improve stability and predictability of the program. However, this change is ineffective in addressing Saskatchewan's unique concerns about energy revenue volatility and could generally make matters worse in terms of program responsiveness. Saskatchewan will opt out from this change to the program.

This attempt to address the effects of data shocks by the federal government was well intended. However, it is another example where the existing program required an ad hoc change to try and address a problem area within the existing program.

One alternative that could assist Saskatchewan in addressing volatility and lack of responsiveness under the program would be to look at revenue volatility and tax base volatility separately and consider measures that deal with these challenges separately.

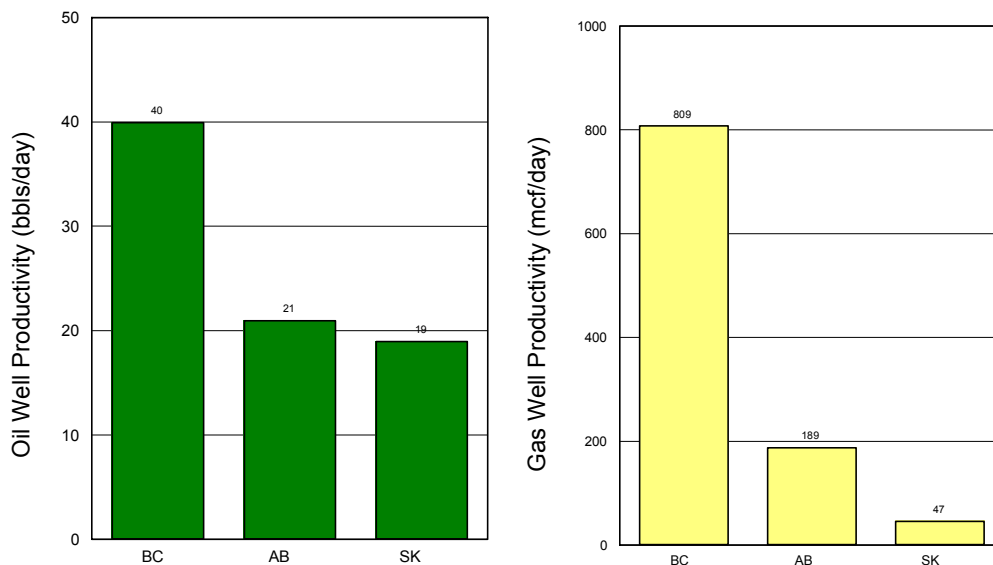
### Measurement of Tax Bases

With respect to the energy bases, and indeed other non-renewable resources such as the mineral resources base, Saskatchewan has expressed concerns that the measurements have consistently overstated our fiscal capacity, thus unfairly reducing our entitlements from the Equalization program. Other provinces have similar concerns with respect to other tax bases that particularly concern them. The following paragraphs elaborate a number of specific examples in this regard.

- Oil and Gas Well Productivity – The current program fails to recognize the significant differences in oil and natural gas well productivity between jurisdictions. For example, an average natural gas well in British Columbia produces up to 20 times the daily amount of an average natural gas well in Saskatchewan. Given the higher fixed cost per unit of production, Saskatchewan does not have the ability to extract the same amount of resource rent from this production as British Columbia does.

## Average Well Productivity Comparison

Based on 2003 Data



The Equalization program does not take this into account, and assumes that both provinces should be able to tax their production equivalently. Saskatchewan receives less Equalization because the existing program determines that a “low tax effort” exists when compared to the national average tax rate. In fact, this determination is flawed, as it is unable to acknowledge that Saskatchewan has a lower fiscal capacity associated with this resource.

In addition to these differences in well productivity for oil and natural gas, there are also a number of other factors that we believe have contributed to mismeasurement of the energy bases. Among these is a significant difference among jurisdictions in oil densities.

For example, approximately 50 per cent of oil produced in Saskatchewan is heavy oil, while only about 30 per cent of oil produced in Alberta is heavy oil. Due to the differences in the definition of heavy oil between Saskatchewan, Alberta and the Equalization program, Saskatchewan’s ability to tax this type of oil is overstated by the formula.

Other factors include the amount of freehold producing properties relative to Crown land producing properties, and an inappropriate Equalization classification of certain types of wells and projects.

- Provincial Fees and Charges – As part of the 1999 renewal of the program, the federal government arbitrarily reduced the inclusion rate on provincial fees and charges from 100 per cent to 50 per cent. This change was primarily undertaken to reduce federal program cost; however, it reduced the effectiveness of the program in measuring provincial fiscal capacity.
- Property Tax Base – Prior to the 2004 renewal of the Program, the determination of the property tax base relied heavily on assumptions and proxies that called into question the validity and fairness of this base by some provinces. The recent renewal of the Program introduced a market value basis for the base measurement, although some arbitrariness exists through an ad hoc adjustment to assist provinces having higher property values. This adjustment is intended to reflect the true revenue-raising capacity of provincial and local governments from property taxation.

The introduction of this adjustment was a compromise solution based not as much on sound policy as protection of the current level of transfers to the affected provinces. This provided another telling example of the inherent difficulties posed by the existing formula-based approach to determining Equalization entitlements. It suggests that the search for a better way to measure provincial fiscal capacities should continue.

- Water Power Rentals Base – Tax bases such as the water power rental base that account for products or services supplied and distributed by governments create opportunities to subsidize the cost of the product or service supplied to local consumers and produce favourable Equalization consequences. This is because Equalization is unable to recognize this subsidy and thereby permits higher program entitlement to occur for provinces having this tax base. This situation is in stark contrast to Saskatchewan’s circumstances where our natural resources are sold at market prices determined internationally.

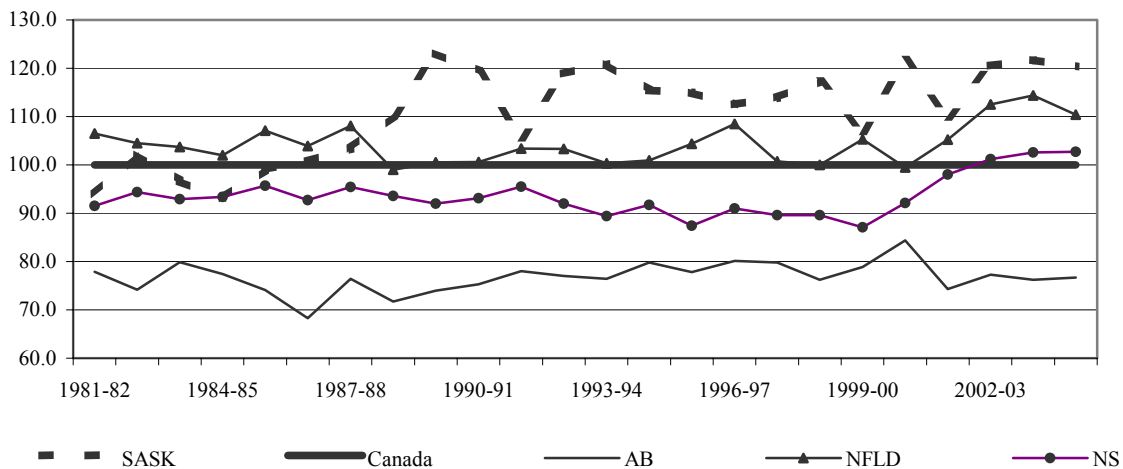
## CONSEQUENCES FOR SASKATCHEWAN

The current Equalization program has become ineffective in meeting its constitutional mandate to enable all provinces to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. In terms of Saskatchewan, a review of macro-economic measures suggests that we are being treated worse than other jurisdictions.

The consequence for Saskatchewan is that in order to provide comparable levels of public services, relatively higher tax levels have to be imposed to compensate for lower Equalization transfers. While this strategy has been successful, it has left the province vulnerable to tax competition from lower tax rate jurisdictions for incremental investment and jobs.

An inter-provincial comparison of local and provincial tax effort by the federal government is illustrated in the following chart, which reveals Saskatchewan has the highest tax effort of all provinces in Canada.

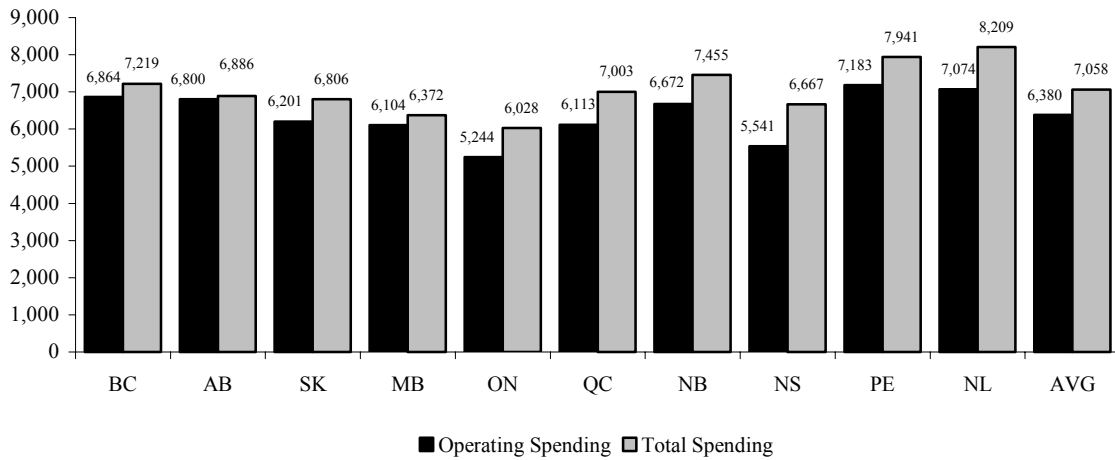
**Tax Effort Comparison**



Source: Department of Finance Canada. Provincial Equalization Entitlements.

Saskatchewan's higher tax effort is not due to higher spending commitments. Federal data publications show that Saskatchewan's spending is on par with the national average. The following graph shows provincial per capita spending and a national average for 2004-05. Saskatchewan's per capita operational spending is \$6,201 per capita, \$179 below the national average.

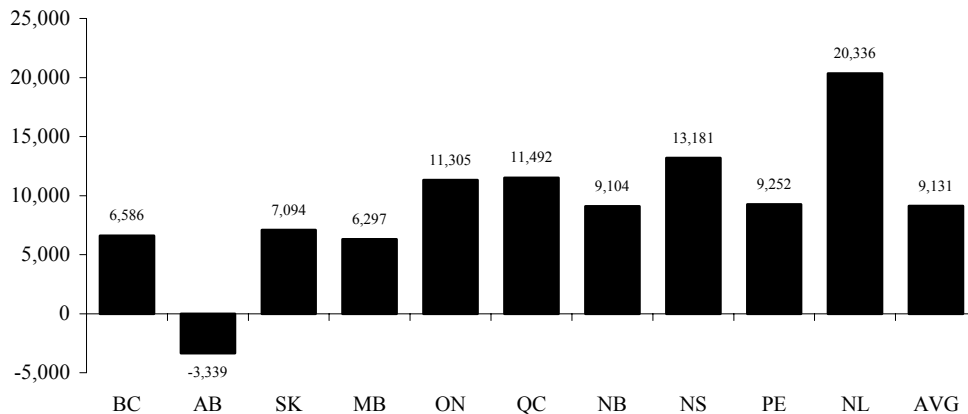
**Provincial Spending Per Capita (2003-04 Fiscal Reference Tables)**



Source: Department of Finance Canada (October 2004). Fiscal Reference Tables, Tables 17 to 31. Population data from Statistics Canada as of July 1, 2003.

Saskatchewan has made significant progress in reducing our provincial debt since it peaked in 1993. Net debt has fallen from a high of \$7,769 million in 1993-94 to \$7,059 million in 2003-04. Saskatchewan currently has a net debt per capita that is \$2,072 lower than the national average. This improvement has been achieved at a considerable sacrifice to provincial residents. Other jurisdictions have not pursued debt reduction as diligently and are seen to have a weaker fiscal circumstance than Saskatchewan even though their tax effort is lower.

**Provincial Net Debt Per Capita (2003-04 Fiscal Reference Tables)**



Source: Department of Finance Canada (October 2004). Fiscal Reference Tables, Tables 17 to 31. Population data from Department of Finance February 2005 Estimates book for 2003-04.

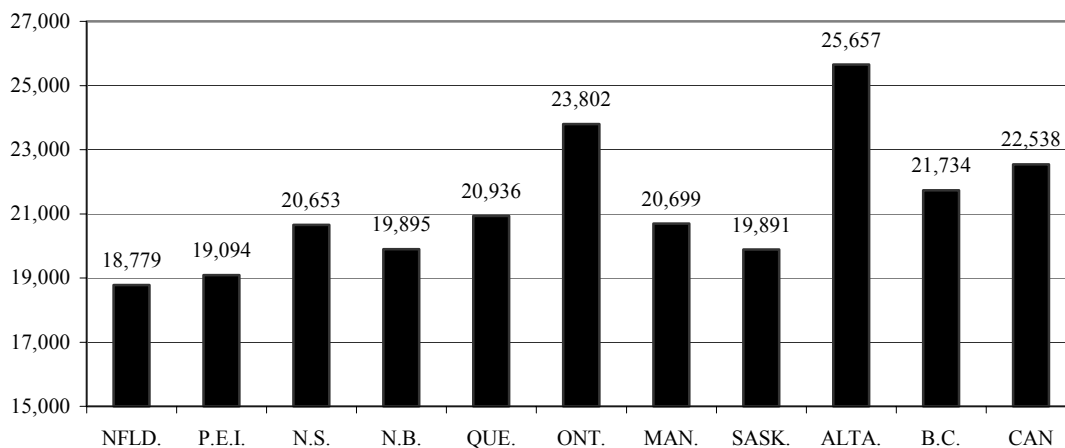
## CONCLUSION

Professor Tom Courchene conclusively identifies in his 2004 paper that Saskatchewan's Equalization entitlements arising from the non-energy bases are rising at a faster pace than those for any other receiving province. This essentially means that Saskatchewan is becoming poorer relative to other provinces when energy revenues are excluded.

To illustrate that the current practice may not be accurately measuring fiscal capacity, it is useful to consider broader measures of fiscal capacity in Saskatchewan, such as per capita personal disposable income, which indicates that Saskatchewan is among the poorer provinces. In 2003, only Newfoundland and Labrador and Prince Edward Island had lower per capita personal disposable incomes.

Comparing with Manitoba, the people of Saskatchewan have lower average incomes than those in that province, yet Manitoba received on average \$1 billion per year more in Equalization than Saskatchewan over the last ten years.

**2003 Per Capita Personal Disposable Income**



The Conference Board of Canada raises a number of issues with the current Equalization program in its article *Equalization: Fix It Permanently and Fix It Nation-wide*.

- British Columbia is a growing economy and its residents enjoy higher incomes than the average resident of Saskatchewan, yet Saskatchewan's Equalization entitlements are falling and British Columbia's are rising.
- Broader measures of economic activity, such as GDP per capita or income per capita, say that Saskatchewan is getting relatively poorer, not richer, during the current period of strong international market prices for non-renewable resources.
- Manitoba's per capita Equalization payments for 2005-06 are estimated at \$1,365 and are beginning to close in on Newfoundland and Labrador's entitlement of \$1,666 per person.
- Saskatchewan does not produce a great deal of oil and gas compared to Alberta, but it has enough that rising energy prices fill up provincial coffers – and trigger drastic clawback provisions in the Equalization formula.
- Saskatchewan's oil revenues do not benefit from the special protections provided to Newfoundland and Labrador and Nova Scotia: no Energy Accord, no generic solution, and no 100 per cent commitment.

Saskatchewan believes that the evidence supports the need for significant reform of the current Equalization program, particularly in its treatment of natural resources. In addition to treating Saskatchewan unfairly, it fails to achieve the basic principles of adequacy, effectiveness, transparency, responsiveness, stability and equity.