

# CUTTING THROUGH THE GORDIAN KNOT – An Objective Assessment of the Equalization Implications for Newfoundland and Labrador of the 2007 Federal Budget

BY WADE LOCKE

**W**hile incongruous with the typically muted Canadian reaction to national budgets, the Government of Canada's March 19<sup>th</sup> 2007 annual budget ignited a war of words that continues to persist, albeit in a slightly tempered form. In particular, the premiers of Nova Scotia and Newfoundland and Labrador independently declared that their provinces were betrayed by the Government of Canada as a result of this budget. This led both premiers to request Members of Parliament (MPs) from their respective provinces to vote against the budget, an act that, if successful, would have defeated the minority Conservative government on a vote of confidence. The Premier of Newfoundland and Labrador, a Progressive Conservative, went further by encouraging his constituents to vote for any party but the federal Conservatives in the next general election. This was part of his threat to deliver the Conservatives an electoral "goose egg" in Newfoundland and Labrador for their position on equalization and the Atlantic Accord.

The strong reactions were not limited to these two premiers. For example, an equally surprising and unprecedented reaction was the press release issued by the Newfoundland and Labrador Minister of Finance accusing the federal government of misleading "the Provincial Government and the people of Newfoundland and Labrador regarding the true implications of the new equalization program." As well, the intensity of emotions has spilled over into the Parliament of Canada. One MP was expelled from the House of Commons for calling the Prime Minister a liar for his position on the Atlantic Accord, while another MP was kicked out of the Conservative caucus for voting against the budget.

The anger fuelled by Budget 2007 extended beyond Nova Scotia and Newfoundland and

Labrador when the Government of Saskatchewan waded into the fray and commenced legal action against the Government of Canada. Saskatchewan's reaction came after the heretofore unimaginable dare by the Prime Minister of Canada for the provinces to sue the federal government if they thought the Harper government had broken a contract. This federal arrogance was not confined to the Prime Minister. For instance, in the House of Commons the federal Minister of Natural Resources openly criticized Premier Williams for his managing of the provincial economy as it related to offshore oil and gas developments. The willingness to cross constitutional boundaries to take a shot at a provincial government shows how intense the feelings and animosities were with respect to an otherwise innocuous document, the annual federal budget of all things!

## **Budget 2007 – Equalization Options**

What did this fiscal document contain that it engendered such reactions on all sides? Well, Budget 2007 contained changes to Canada's equalization program, a program that is enshrined in the Constitution; is considered to be the "glue" that binds provinces together; and is a concrete illustration of the commitment to equity that defines Canada as a country.

Before considering the actual changes outlined in the federal budget, it is important to appreciate that although the changes to the equalization program were somewhat controversial in and of themselves, most of the negative reaction was generated by the belief that promises or perceived promises made by the then-Opposition Leader Stephen Harper were not met when he became Prime Minister. Specifically, in a 2006 letter to the Council of the Federation, Mr. Harper suggested

that: “a new equalization formula should exclude non-renewable resource revenues for all provinces.” An almost identical position was also communicated to Premier Williams in a separate 2006 letter.

The equalization scheme tabled with Budget 2007 consisted of two options that may be utilized to calculate provincial equalization entitlement for Newfoundland and Labrador. These two options can be characterized as: (1) the status quo or fixed framework option, (2) the new system which consists of either the 50% resource inclusion option or the 0% resource inclusion option.

### **Status Quo Option**

The status quo option remains available only to Newfoundland and Labrador and Nova Scotia until their existing offshore agreements expire, which will be in 2011-12 if there is no extension of the 2005 Accord deals and 2019-20 if there is an extension. However, at any point in time either province can choose to opt into the new system and permanently forego the status quo.

Under the status quo, there is a fixed pot of money available for equalization payments in each year. This pot grows over time at an annual rate of 3.5%. By way of illustration: in 2005-06, the pot of monies available for equalization was \$10.9 billion; this increased to \$11.3 billion by 2006-07; and will reach \$11.7 billion in 2007-08.

Contrary to popular belief, there is no set equalization standard under the status quo. It is neither a five-province nor a ten-province standard. Instead, it is a residual standard that is calculated to ensure that the fixed pot of money is paid out to recipient provinces in each year. Under this approach, each province’s fiscal capacity is determined by including the “notional” revenue that could be generated by applying the national average tax rate to 33 equalization bases, including 100% of offshore oil and gas revenues. Given these per capita fiscal capacities, the standard is set so that the total amount of equalization entitlements for which provinces qualify matches exactly the pot of monies available to be paid out through the equalization program.

Finally, for Newfoundland and Labrador, the 1985 and 2005 Atlantic Accords are calculated

outside of the equalization program as was intended in the original legislation. Specifically, the payment under the 2005 Atlantic Accord involves first recalculating Newfoundland and Labrador’s equalization entitlements under the assumption that it has no oil and gas revenue. Essentially, the difference in the equalization entitlements with and without oil and gas revenues defines the amount available for payment under the Atlantic Accords. The amount received under the 1985 Accord is deducted from this difference to give the payment under the 2005 Accord.

### **New System**

The new system involves two approaches. The first approach, the 50% resource inclusion, involves a 10-province equalization standard applied to five broad revenue sources that excludes 50% of natural resource revenues. Overriding this calculation is a cap on the actual equalization payment that a province can receive in any given year. This cap reduces equalization payments to provinces that have total per capita fiscal capacities, including 100% of oil and gas revenues, exceeding that which exists in the lowest non-receiving province.

It is interesting to note that the Atlantic Accord payments, under the new system, are calculated as the difference between the pre-cap equalization entitlements with and without oil and gas revenues. This is not consistent with the original legislation that references changes in equalization payments due to oil and gas revenues, not entitlements calculated before the cap is imposed. By adopting this change in interpretation, Newfoundland and Labrador qualifies for lower payments under the Atlantic Accords than if the original legislation had been followed precisely. As well, to qualify for payments under the Atlantic Accord with the new approach, a province’s total per capita fiscal capacity must not exceed that of the lowest non-receiving province. This qualifying trigger, as noted below, will effectively preclude Newfoundland and Labrador from receiving payments through the Atlantic Accord under the new system.

The second approach, the 0% resource inclusion option, also has a 10-province standard

that is based on the same five revenue sources, but excludes 100% of natural resource revenues. This 0% option is also subject to the same cap as exists in the 50% option. Whether the 50% or 100% resource exclusion option will apply for any particular province will depend on which of the two options provides the higher equalization payment to the province in question. The federal government will simply do this calculation for each of the provinces and automatically give them the higher amount.

### **Equalization Impacts**

A detailed simulation exercise of the impacts on Newfoundland and Labrador of the equalization changes contained in Budget 2007 was provided in a recent APEC Commentary (Hobson and Locke (2007)). This analysis forms the basis for the argument to follow.

Under the status quo option, Newfoundland and Labrador, because of the revenues associated with offshore oil production, will cease to be an equalization-receiving province by 2009-10. Consequently, it would be eligible only for transitional payments under the terms of the 1985 Accord. Under the 2005 Accord, it would not qualify for an additional offset payment, since it does not qualify to receive equalization. Furthermore, because it would not qualify to receive an equalization payment in either 2010-11 or 2011-12, it would not qualify for the second extension negotiated as part of the 2005 Accord.

With the new equalization option, Newfoundland and Labrador would qualify for equalization entitlements pre-cap in every fiscal year through 2019-20. However, from 2010-11 to 2017-18, Newfoundland and Labrador's own-source total fiscal capacity (non-resource fiscal capacity plus resource fiscal capacity with 100% inclusion) would exceed that of the lowest non-

receiving province. Therefore, under the changes to the Accord passed with the Budget Implementation Act, the province's fiscal capacity would render Newfoundland and Labrador ineligible to receive an additional offset payment under the Atlantic Accords. And, since the Province would not qualify for an additional offset in either of fiscal 2010-2011 or 2011-2012, it would fail the condition for renewal of the Accord.

Based on this analysis and the legislation adopted with Budget 2007, Newfoundland and Labrador would qualify to receive \$3.9 billion in equalization payments under the status quo from 2007-08 to 2019-20 if the status quo continued to be available for the province. With the new equalization option the revenue accruing to the provincial treasury would be \$2.5 billion. In other words, Newfoundland and Labrador would be worse off by \$1.4 billion under the new system than if the status quo had remained in effect.

### **Other Considerations**

While the analysis presented above indicates that Newfoundland and Labrador would have been better off with the status quo option than with the new equalization system introduced in Budget 2007, it is important to note that there were a number of other government policy decisions incorporated in that legislation that further reduced Newfoundland and Labrador's equalization and Accord payments under the new system.

For example, if there were no cap on equalization payments, then Newfoundland and Labrador would have qualified to receive \$7.8 billion in payments under the new equalization option and the Atlantic Accords. This is \$5.3 billion more than the \$2.5 billion currently

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estimated for the new program. Since removing the cap is consistent with Premier Williams' interpretation of Prime Minister Harper's commitment on natural resources, this provides one possible rationale for the ongoing dispute between the provincial and federal government on the changes to the equalization program.

Even as there are other factors on which one could concentrate, the qualifying trigger for the Atlantic Accord under the new system is another way in which the amount of equalization and Accord payments to the province is reduced. If, instead, pre-cap equalization entitlements were used, then the province would have qualified for another \$5.6 billion in Accord and equalization payments. Or, its payments under the new equalization option would have increased from \$2.5 billion to \$8.1 billion over the period 2007-08 to 2019-20.

### **Conclusion**

The changes to the equalization system adversely affect Newfoundland and Labrador

relative to the status quo. Despite numerous claims to the contrary, the letter and spirit of the Atlantic Accords have been violated by the new equalization system. There is no way to characterize the changes to the equalization program and the Atlantic Accords contained in Budget 2007 as being in Newfoundland and Labrador's interest. The full economic and political ramifications of these changes will be felt for years to come. ❏

With reference to Hobson, P. and Locke, W., *Assessing the Equalization Options of Budget 2007 for the Atlantic Provinces*, Commentary, Atlantic Provinces Economic Council, June 13, 2007.

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