Intelligence MEMOS

From: Robin Boadway

To: Public Finance Scholars

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Re: **The Case Against Enhancing Fiscal Stabilization for Resource Revenues**

The federal Fiscal Stabilization Program provides support to provinces that experience negative shocks to their tax revenues, providing a transfer to provinces whose tax revenues fall by a prescribed amount in a given year.

Decreases in a province's non-resource revenues of more than 5 percent in a given year are covered by a stabilization transfer up to a maximum of $60 per capita. However, coverage only applies to a province's resource revenues if they fall by at least 50 percent and only in the year in which the decline occurs.

The $60 limit compromises the insurance provided by the program, while the stringent requirements on resource revenues treats resource-rich provinces particularly adversely. These restrictions, combined with the volatility of resource revenues, have led some observers, as well as the provinces themselves to argue for an enhancement to the program for provinces who rely heavily on resource revenues.

I argue that the best solution for provinces with volatile resource revenues would be to save these revenues in a dedicated public fund.

Calgary economist Bev Dahlby has suggested reforming the program so that it mimics a proper insurance program for the provinces and no longer discriminates against resource revenues. This is intended to enhance the insurance provided by fiscal stabilization for resource-rich provinces while blunting the incentive for provinces to exploit the program by taking actions that enhance their chances of payouts (i.e., moral hazard). This, however, would do relatively little to encourage provinces to save their resource revenues.

The case for enhancing fiscal stabilization for resource revenues relies on the idea that fiscal stabilization is like insurance against unexpected provincial revenue shocks. This position reflects the presumption that the federal government is better able to insure a province against unexpected changes in revenues than the province itself can. Regional shocks partly cancel each other out at the national level, so federal transfers based on regional shocks should exhibit limited, but not zero, volatility in the aggregate.

As compelling as that argument might be, there are good reasons to be cautious about extending federal insurance to provinces facing resource revenue volatility. For one thing, resource-rich provinces are able to self-insure against revenue volatility by using a provincial sovereign wealth fund – like Alberta's Heritage Fund – to smooth revenues over time. Arguably, provincial self-insurance is more efficient than federal insurance of volatile resource revenues, given that the federal government does not have direct access to resource revenue, so must rely on distortionary income and sale taxes.

More important, provinces should be saving resource revenues in a sovereign fund, as recommended in multiple C.D. Howe Institute papers. First, unlike non-resource revenues, resource revenues are largely from non-renewable resources that will run out in finite time. Failure to save those revenues implies that their benefits accrue to current generations at the expense of those in the future who arguably have some property rights claim. In that sense, dissipating resource revenues as they occur is analogous to running budget deficits from an intergenerational equity point of view.

Second, the extent to which resource shocks are transmitted to non-resource provinces increases if provinces do not save their resource revenues. A positive resource price shock causes an appreciation of the real exchange rate, and vice versa. When the shock lasts for several years, labour and capital reallocate from the rest of Canada to resource-rich provinces – as has been well-documented empirically – and this can have long-run adverse consequences for industries such as manufacturing in other parts of Canada. (Others, such as the former Governor of the Bank of Canada have disputed the relevance of the Dutch Disease for Canada). This effect is exacerbated to the extent that resource revenues are not saved.

The consequences of resource booms for the rest of Canada can best be dampened by saving resource revenues in a fund whose proceeds are invested in foreign-denominated assets. Doing so greatly reduces the immediate impact of resource booms and busts on the exchange rate, and therefore on traded goods' industries. The rate of return on these assets would be available for spending by the province. This is the practice followed in Norway's sovereign wealth fund, widely regarded as the gold standard in resource wealth management.

Enhancing fiscal stabilization for resources only encourages resource-rich provinces to use current resource revenues to increase expenditures, reduce tax rates, or both. In the long run, this can lead to unsustainable provincial finances when resource revenues dive. More savings solves both problems.

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