March 19, 2015

ALBERTA FISCAL OUTLOOK: SEIZING THE DAY TO SET THE PROVINCE ON A STRONGER LONG-TERM FOOTING

Highlights

- The drop in oil prices has created a sizeable fiscal gap in the Alberta fiscal plan. Current government estimates peg the estimated shortfall at $7 billion in fiscal 2015-16. And, given the more subdued outlook for oil prices, a structural deficit is projected in the absence of any policy action.
- While the government has discussed a number of policy tools to address its fiscal challenge, a slash and burn approach to achieving fiscal balance in quick time can be costly to the economy and does not address current inefficiencies in program spending and an overreliance on non-renewable resource revenues. A more drawn out plan - with interim targets clearly mapped out - is likely the best route for the government to take.
- Given its current bind, the Province has an opportunity to put its finances on a stronger footing for the longer term. In that vein, the forthcoming 10-year fiscal plan that will accompany Budget 2015 is of equal importance. More notably, rather than depleting its resource endowment, the Alberta government needs to shift its longer-term attention on reducing its reliance on volatile non-renewable resource revenues as a funding source for operating spending and, in turn, build savings for the future.

The recent slide in oil prices has left governments in oil-producing regions scrambling to adjust their fiscal plans. Alberta faces a particularly daunting challenge, with the news from the Premier that without policy action the Province is on track to post a hefty budget shortfall of $7 billion next year. As such, the government is currently mulling over choices to fill the budget gap. The spotlight has now shifted to the March 26th budget, where key decisions will be unveiled.

The Alberta government's willingness to move sooner, rather than later, to tackle its fiscal challenge should be applauded. If left alone, deficits will rise, necessitating the need for even harsher medicine down the road. Many of the actions on the table are no doubt unappetizing, but the stakes are high. The Province has an enormous opportunity to make changes that will put its finances on a stronger and more stable longer-term track, hence helping to sustain its economic advantage over other jurisdictions.

While the strategies that Alberta undertakes will need to fit its unique circumstances, the government can benefit from lessons of past deficit-cutting exercises – both within the province and outside. In particular, certain strategies have proved more effective in delivering sustainable fiscal improvement. Setting a clear and achievable deficit elimination timetable, favouring thoughtful program redesign over "slash and burn" type strategies and focusing on tax reform (not just hikes) all deserve careful consideration. Perhaps most importantly, rather than depleting its resource endowment, the Alberta government needs to shift its longer-term attention on reducing its reliance on volatile non-renewable resource revenues as a funding source for operating spending and, in turn, build savings for the future.

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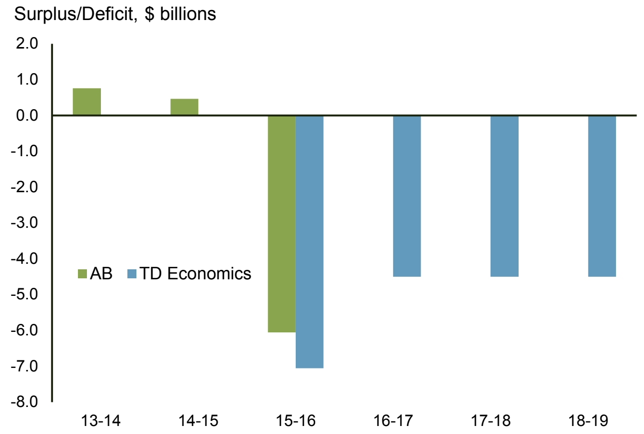
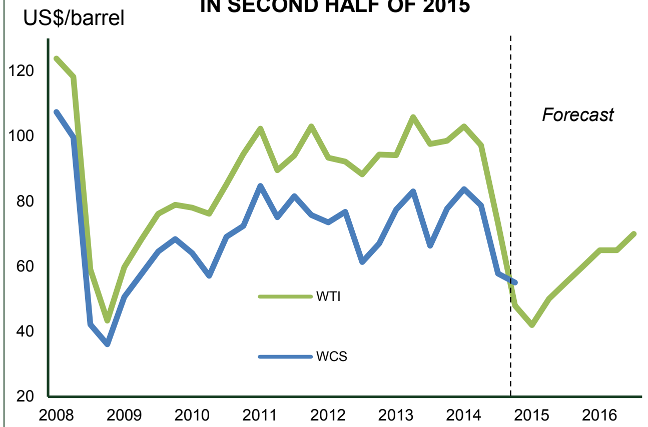
CHART 1: STATUS QUO FORECAST SHOWS STRUCTURAL DEFICIT FOR ALBERTA



Source: Alberta Government and TD Economics.

CHART 2: OIL PRICES TO RECOVER GRADUALLY IN SECOND HALF OF 2015



Source: Bloomberg, Haver Analytics. Forecasts by TD Economics/TDSI as at March 2015. * WCS Q1-2015 reflects price as of March 12, 2015.

TD Economics estimates $4-5 billion structural budget shortfall

The Alberta government has been forthright in spelling out the sizeable fiscal challenge that the province faces. Still, any estimate of a status-quo shortfall is highly sensitive to expectations on oil prices. While Albertans need to await the upcoming budget for a more fulsome picture of the government's fiscal outlook, the government indicated that its $7 billion estimated shortfall in fiscal 2015-16 hinges on a WTI price that is forecast "to average less than $US65 per barrel". For fiscal 2016-17, a US$70 assumption is made, bringing down the budget gap marginally to $6 billion[1].

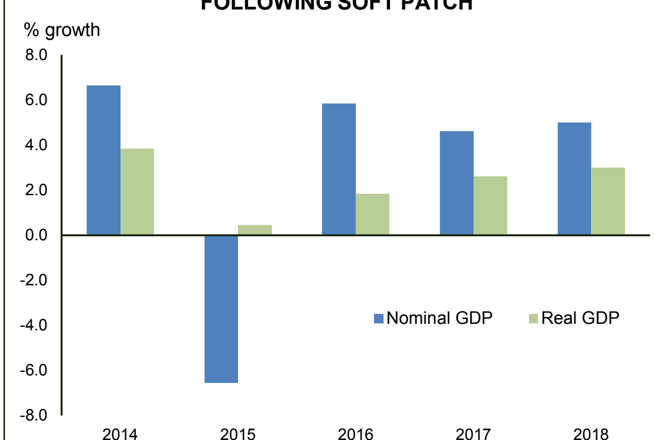
In contrast, TD Economics has adopted a below-consensus view on WTI prices for 2015 and into 2016, reflecting our relatively bearish judgement on fundamentals within the global oil market. More specifically, we expect WTI prices to average only US$52 per barrel in fiscal 2015-16, before rebounding to US$68 in fiscal 2016-17 and US$75 beyond that point. The lower price forecast suggests that without any actions, the budget shortfall could come in by as much as $1 billion higher than the government's cited figure for fiscal 2015-16.

Looking further out, although some of the gap would automatically by addressed by a cyclical pickup in the economy, crude oil prices and government revenue beginning in fiscal 2016-17 (see Charts 2 and 3), we estimate that the Province would still be left with a persistent structural deficit on the order of $4-$5 billion (or around 1.5% of GDP). Borrowing related to fund these shortfalls would transform Alberta's current net asset position into a net debt position by the next fiscal year and rise to as high as 7-8% of GDP by fiscal 2018-19.

Challenging fiscal times not new for Alberta

While the associated levels of net debt would remain very manageable and low when stacked up against other jurisdictions, the government has made clear that it will move swiftly to prevent this sort of fiscal deterioration from materializing. And, the government has been conditioning Albertans to brace themselves for significant spending cuts. Indeed, the province has floated the idea of shaving as much as 5% from departmental spending in the next fiscal year (or 9% in real per-capita terms)[2]. Revenue-raising measures will also form part of the plan, although the government appears to have ruled out the implementation of a provincial sales

CHART 3: ECONOMIC GROWTH TO GAIN A STEP FOLLOWING SOFT PATCH



Estimate|Forecast by TD Economics as at March 2015.

tax. Another lever that is being contemplated is a move to draw down assets, notably the estimated $6 billion currently set aside in the province's contingency fund[3].

Taking on such a tall task head on is not new to Alberta. The province has been home to large swings in economic and fiscal fortunes in the past. In the early 1990s, deficit-to-GDP ratio spiked to more than 4%. More recently, surpluses of more than 4% of GDP evaporated and were transformed into deficits of around 1% as oil prices collapsed following the Great Recession. However, just as quickly as oil prices tumbled they rebounded, leading to a recent string of surpluses. The province can benefit from these past experiences (and others in Canada over the past few decades) as it sharpens its pencil ahead of the 2015 Budget. As the government works through the details of its fiscal plan, there are a number of approaches that merit close consideration.

Set a clear and achievable longer-term plan

The first step is to lay out a clear, multi-year plan. By setting realistic targets, which includes the ongoing use of contingency reserves to protect against nasty surprises, sets the stage for the government to better those targets. A full path to the final destination, including interim deficit goals, needs to be provided up front. Fortunately, the government has been adopting medium-term plans in recent budgets and the Premier has indicated that a 10-year blueprint will be included alongside Budget 2015.

While it will map out a decade long fiscal plan, a question is still raised surrounding an optimal timetable for targeting deficit elimination. In our view, given the sizeable structural deficit, one year appears aggressive. Just as the government in the 2000s fanned the cost bubble by injecting significant new outlays when the economy was in excess demand, drastically restraining spending during a cyclical low would exacerbate near-term economic weakness. The government estimates that a $4 billion reduction in government spending would reduce Alberta's real GDP growth by 1%[4]. At the same time, deficit-reduction plans that are too lengthy increase vulnerability to unanticipated events that might throw finances further off course. A balance in our view – in light of the current challenge – is three to four years.

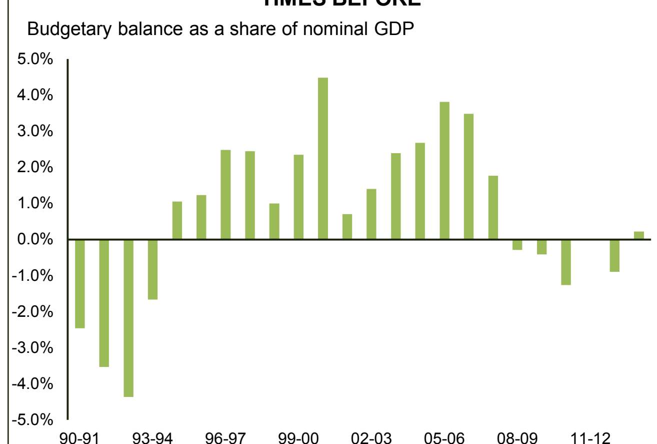
Avoid a slash and burn approach

The government has laid out a convincing case that spending reductions should form a key part of the fiscal repair. After years of rapid spending growth, program outlays on a per capita basis hover $1,300 higher per person in Alberta compared to the national average. This higher spending is not concentrated in one area, as per capita spending in health, education and social services all exceed the national average[5].

Still, spending cuts must balance short-term fiscal objectives with longer-term sustainability. Across the board spending reductions are more straightforward and can make a quick dent in the deficit. Experience has shown, however, that merely starving departments of funding misses the opportunity of securing longer-term savings. Pressures merely build and must be addressed later. Ideally, the medium term fiscal plan would target areas of government where productivity is lowest, so the payoff would be highest. In other words, a meticulous assessment of each ministry and program with eyes focused on value for money needs to be the mantra. Given the potential to reap efficiencies, alternative service delivery should be an important tool in the kit.

While no spending area is likely to be completely immune to restraint in the near term, there is a good case to be made for maintaining infrastructure spending as a key budget priority. Partly due to cash accounting rules, Canadian governments in the 1990s slashed capital spending budgets disproportionately, which later manifested in strained infrastructure systems in the 1990s. In this regard, the Heritage Trust Fund provides a potential avenue for the province to leverage off its savings and good credit rating to continue with infrastructure investment in the coming years. Infrastructure spending that passes the litmus test of adding value could also provide a near-term lift to an economy that is struggling. According to the IMF, "a 1 percent of GDP permanent increase in public investment increases output by about 2 per cent in the same year"[6].

CHART 4: ALBERTA HAS FACED TOUGH FISCAL TIMES BEFORE



Source: 2014 Federal Fiscal Reference Tables and TD Economics.

There are other key lessons that have been learned from past deficit-cutting experiences. A province should be mindful not to simply pass the buck. For example, a number of provincial governments in Canada have passed the onus of spending reductions onto their municipal counterparts either through cuts in transfer payments or increased responsibilities, which left these local jurisdictions in a difficult position. Another key lesson is that spending scrutiny should be an ongoing process. In Canada, a number of governments have conducted program spending reviews. But while these reviews often generated short-term savings, once the initial reductions were identified, the machinery was abandoned.

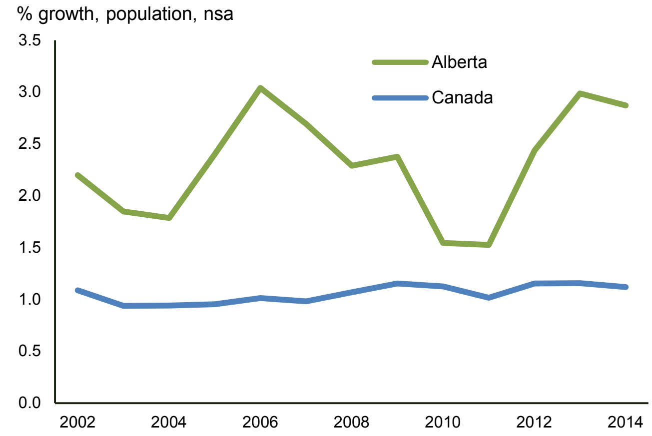
In Alberta's context, the case for re-evaluating program spending is particularly relevant. The province has recorded rapid population growth, which adds to pressure on government spending. Over the next few years, trend population growth is likely to slow, as the province experiences a dramatic reduction in interprovincial migrants. But this slowdown is likely to be only temporary in our view, as the economy likely regains its status as the fastest growing province over the longer haul. What's more, given the aging of the population, health care pressures remain an enormous challenge facing Alberta and other provincial governments. Hence, any efforts to target improved long-run efficiencies must not leave health care off the table.

Perhaps most importantly, as we argue in the final section, Alberta needs to wean itself off volatile non-renewable resources (NRR) as a key source of funding for operating spending over the long run. To the extent that removing NRR lowers the revenue take, even more emphasis will be needed on creating a more efficient government.

Avoid selling assets purely for fiscal reasons

As part of any spending review exercise, Alberta should go through its inventory of assets in order to identify areas where it makes sense to exit the business altogether. However, a government decision to divest assets in order to achieve their short-term fiscal goals alone can be problematic. Not only do asset sales only provide a one-time boost to revenues, but any windfall generated may merely represent the present value of future income stream that would have flowed into government coffers anyway. Thus, assets should only be sold if efficiency gains can be realized or if privatization can unleash some value that is currently being held under public control. Given the thirst for a steady yield in today's market, the valuations on public assets might increase the economic case for asset sales.

CHART 5: POPULATION GROWTH IN ALBERTA OUTSTRIPPING NATIONAL AVERAGE



Source: Haver Analytics.

Focus on tax reforms not tax hikes

The Alberta government has indicated that tax increases are being contemplated as part of the deficit-elimination strategy. There certainly appears scope to raise tax rates and stay competitive within the North American market. Indeed, owing to its significant intake of NRR, the province currently enjoys the lowest tax burden among the provinces and among the lowest in North America[7]. According to the government, if the Province levied tax rates in line with other jurisdictions in Canada, Alberta's individuals and businesses would pay at least $12 billion more in taxes each year. About half of this advantage reflects the fact there is no provincial sales tax (PST) in Alberta[8], although a direct implication is that the province's tax base is relatively more reliant on income taxes than other jurisdictions.

Regardless, the focus should not be on tax hikes per se but on reforms that improve the competitiveness of the Alberta economy over the long run. As we show in Table 1, taxes on capital and income impose the largest negative impact on economic growth, while consumption-based taxes – such as a value-added PST or user fees – are the least distortionary. By closing the door on the introduction of a PST, the government is missing an opportunity in our view. On a positive note, there still appears to be potential to improve the tax system through other avenues. Consider the province's 10% flat tax on personal income, which is the only non-progressive tax system in Canada. Yet there is a growing wave of international research that supports the notion that more progressive PIT systems lower income inequality and thus lead to stronger economic growth over the long run[9].

Table 1: Impact of Revenue Equivalent Tax Initiatives on Welfare and Steady State GDP		
	Welfare loss (in dollars) per dollar of gained present value government revenue	Percentage change in steady state GDP for an ex ante 1%-of-GDP increase in government revenue
Decrease in capital cost allowances on new capital	-1.35	-4.39
A rise in personal capital income taxes	-1.30	-3.36
A rise in sales taxes on capital goods	-1.29	-3.05
A rise in corporate income taxes	-0.37	-1.94
A rise in personal income taxes	-0.32	-1.29
A rise in payroll taxes	-0.15	-0.66
A rise in consumption taxes	-0.13	-0.19
Source: Federal Department of Finance, 2004.		

Less reliance on oil royalty revenues should be a long term goal

The sizeable fiscal gap will only increase the temptation to tap the province's large endowment of financial assets that have accumulated further in recent years through budget surpluses and solid NRR intake. Still, there appears to be little appetite for the government to sell assets within the $17 billion Heritage Trust Fund to lower the deficit. Less clear is the government's intentions with respect to the $6 billion currently set aside in the government's contingency account. This account, which replaced the previous sustainability fund, was created through the *Fiscal Management Act* to provide short term fiscal stabilization. However, government policy dictates that the contingency account maintains a targeted balance of 15% of the provinces operational revenues. As such, with the current balance in the fund at around $6 billion, only some $800 million can be drawn down from the fund in fiscal 2015-16. While a change in policy could allow more of the account proceeds to deficit reduction, these funds would only provide a one-time benefit to coffers and do little to arrest the structural budget shortfall.

Regardless, the focus of discussion needs to shift away from any notion of divesting financial assets to building savings. This would involve a longer-term plan to reduce (or even eliminate) reliance on NRR to fund annual operating spending and, instead, sock it away to the future benefit of Albertans. Over the past ten years, NRR has accounted for around 30% of total government revenues on average (and this does not take into account corporate tax revenue sourced for the oil and gas sector). This high dependency on a revenue source that can be subject to wild swings has translated to increased volatility in Alberta's own source revenues. The government estimates that Alberta's own source revenues are around 50% more volatile than the average across other regions[10].

Reducing reliance on NRR could be considered as part of a longer term fiscal plan. And, the government's forthcoming 10-year fiscal plan provides a good opportunity on this front. Ideally, any resource royalties could be fed directly into the Heritage Fund and saved for future generations. Currently, the Heritage Fund is only legislated to receive a small portion of resource revenues based on an upward sliding scale on the amount of NRR receipts (prior to the contingency account reaching the $5 billion threshold, NRR were first dedicated towards the contingency fund). Beginning in fiscal 2017-18, 100% of net investment income earned from the Fund will be retained. Until such date, only a portion of the Fund's income – to cover inflation – is required to be saved. The remaining income gains are deposited into the General Revenue Fund to help fund existing programs and services[11].

A re-structured fiscal plan that is not as reliant on NRR would lead to less volatility and budget cycles would be more muted. However, if the government moves to remove up to $7-8 billion from use to save for the future, it must replace this with either lower trend spending or higher taxes.

Bottom Line

Budget 2015 will provide a major opportunity to set the province's finances on a more sustainable path. We hope that the government seizes the moment.

End Notes

1. Rotary Club of Edmonton: Pre-Budget Address, Government of Alberta, March 2, 2015.
2. https://soundcloud.com/your-alberta/premier-prentice-and-minister-campbell-media-scrum-feb-11-2015.
3. http://www.cbc.ca/news/canada/edmonton/alberta-s-projected-surplus-could-vanish-in-a-heartbeat-finance-minister-1.2971540
4. "Backgrounder on Alberta's Fiscal Situation", Government of Alberta, January 15, 2015.
5. Ibid.
6. World Economic Outlook: Legacies, Clouds and Uncertainties, International Monetary Fund, October 2014.
7. http://finance.alberta.ca/business/tax_rebates/
8. "Backgrounder on Alberta's Fiscal Situation", Government of Alberta, January 15, 2015.
9. Alexander, Craig and Fong, Francis, "The Case for Leaning Against Income Inequality in Canada", TD Economics, November 24, 2014.
10. "Backgrounder on Alberta's Fiscal Situation", Government of Alberta, January 15, 2015.
11. Ibid.