Number 28/February 1995

Alberta's Fiscal Update
One-Track (Thinking) Towards Deficit Reduction

by
Melville L. McMillan
and
Allan A. Warrack
Department of Economics
and
Faculty of Business
University of Alberta

To appear in a chapter

Mortgaging the Future: Inside Ralph Klein's Alberta

G. Laxer and T. Harrison, editors.
February 1995

2

INTRODUCTION

Ralph Klein became Premier of Alberta in December 1992. Almost immediately, the severity of the Province's fiscal difficulties emerged to become the focus of attention with a January budget revision announcing an extraordinarily large and unexpectedly high deficit and the Auditor General's Annual Report for 1991-92 announcing an unprecedented level of provincial debt. The concerns raised were reinforced by a sequence of three reports; one from the Institute of Chartered Accountants of Alberta (ICAA, January 1993), a second from the Province's own Alberta Financial Review Commission (March 1993) and the third by McMillan and Warrack of the University of Alberta (April 1993). The Commission implored the urgency of deficit elimination, found that budget monitoring and reporting was inadequate, and noted that the Heritage Fund gave Albertans a false sense of security. McMillan and Warrack agreed with deficit elimination objectives and proposed that the magnitude of the problem was so great that a balanced approach of expenditure cuts and concurrent revenue increases was necessary to rid Alberta quickly of its fiscal difficulties.

The provincial government's response came in its May 1993 budget. It outlined a plan to eliminate the deficit within four years by cutting expenditures 20 percent and without increasing taxes. Mr. Klein took this budget to the voters in the June election which his provincial Progressive Conservative party won. Interestingly, the two parties which won seats, the provincial Conservatives and Liberals, both campaigned for deficit reduction through expenditure cuts. The Klein government affirmed its commitment to its deficit elimination plan in a post-election September 1993 budget update and followed through in its February 1994 budget which stayed the course on the planned deep expenditure reductions, increased revenues somewhat through higher fees and charges but without tax increases, and introduced privatization initiatives.

Public concerns about deficits and government debt are national and heightened by their magnitude at the federal level and by their ubiquity and magnitudes across the provinces. Consequently, there is extensive policy and political debate everywhere in Canada. The uniqueness of the Klein government's plan to eliminate the deficit through expenditure cuts alone has caused much attention to be focussed on Alberta. Much of that attention, especially from the business community and business press, has been very positive. While there is much to say on behalf of the Province's initiatives, the potential of the Klein government's approach may be overstated.

Our concern with the Alberta's fiscal situation led us to investigate the problems and explore solutions in our earlier study (McMillan and Warrack, 1993). We update and extend that analysis here from the clearer perspective available as of January 1995. Examining the current realities and policy options, we find them surprisingly and regrettably similar to those of 1993. Indeed, the situation defined by the current fiscal circumstances and the present provincial deficit elimination plan only reinforces our earlier position. The fiscal problems of the Province are greater than is generally acknowledged and, we believe, so large that they cannot be solved successfully by expenditure reductions alone because provincial services would be reduced to extraordinary (and unacceptably) low levels. We expect that in the absence of exceptional improvement in natural resource revenues, a long term and sustainable solution to the difficulties imposed by the structural deficit and the stock of debt will require also some increase in taxes. Fortunately, because of the high tax capacity and low tax effort, Albertans can increase provincial taxes somewhat in order to preserve reasonable services and still enjoy lower provincial taxes than residents of other provinces. Consequently, we predict, and would recommend, that ultimately a balanced or two-track approach will be taken to righting Alberta's fiscal situation; that is, a policy combining expenditure reduction with some increase in tax revenue.

The arguments and evidence bringing us to these conclusions are outlined below. Initially, the revenue and expenditure history of the Province since 1970 is reviewed to illustrate how the current problems developed. Following that, we first outline the Province's deficit elimination plan and implications of it and then we consider the revenue options of the Province. The scope of the Alberta Heritage Savings Trust Fund (AHSTF) to soften the deficit/debt burden is analyzed. We then define the new fiscal realities and options. The chapter ends with a brief conclusion.

1.0 WHERE WE WERE, WHERE WE ARE, AND HOW WE GOT HERE

This section of the paper reviews the recent history of Alberta's provincial public finances with the aim of providing context for assessing our current fiscal predicament. We rely upon the Financial Management Series (FMS) provided by Statistics Canada. These data permit us to compare Alberta's fiscal position with that of other provinces through time using data that adjusts for differences in provincial accounting practices to ensure comparability. The adjustments incorporated into the FMS data provide a comprehensive picture of provincial government finances in Canada. The cost of this comparability is that we are restricted to using data that ends with estimates for the fiscal year 1993-94, the most recent FMS available. Fortunately, these data clearly highlight the sources of Alberta's current fiscal problems, the dramatic changes which occurred, and the difficult choices being made.

1.1 REVENUE HISTORY

The Alberta government's revenue history post 1970 is summarized in Figure 1. This graph and subsequent ones show the data in per capita real (1986 dollars) so as to avoid the complications of population and price changes. For the purposes of comparison the average per capita real provincial revenue for all provinces is also given.

Alberta's provincial government per capita real revenues were $2274 in 1970, a level slightly higher than the all province average. The impact of the energy boom and bust clearly stand out. From 1974 to 1986 Alberta's per capita real revenues far exceed those of other provinces because of surging energy revenues. The rise in Alberta's resource revenues is also depicted in Figure 1. Between 1978 and 1981, natural resource revenues actually accounted for more than 50 percent of the province's total revenues. However, with the collapse of energy prices in 1986, resource revenues fell to less than 25 percent of provincial government revenues. Alberta's per capita real provincial revenues declined relative to the all province average and actually fell below the average in 1993-1994: $4171 for Alberta vs. $4245 the provincial average. Having had the benefit of significant resource revenues, Alberta's non-resource revenues have been consistently below provincial average revenues and has been reflected largely in lower taxes in Alberta.

1.2 "RAINY DAYS" AND THE ALBERTA HERITAGE SAVINGS TRUST FUND

Surging energy revenues allowed the provincial government to save some of that revenue in the Alberta Heritage Savings Trust Fund (AHSTF). The AHSTF was established in 1976 and contributions were made to it between 1976 and 1986. With contributions and investment income, the book value of financial assets of the fund grew to exceed $12 billion by 1985 and have since stabilized at about that level; $11.9 billion in 1993-94. In 1987, the provincial government ceased to earmark any energy revenues for the AHSTF and since 1983 all interest income from the fund has been allocated to the General Revenue Fund. Figure 2 clearly illustrates the demise of the fund as a savings account. Also, in real terms, the AHSTF is now only 72 percent of its value in 1986, the last year a contribution was made to it.

1.3 EXPENDITURE HISTORY

Real expenditures per capita in Alberta have consistently exceeded the average of other provinces. The magnitude of this expenditure difference is shown in Figure 3 by the top line for Alberta and the lower line for all provinces. Since 1970, real expenditures per capita have risen from $1907 to $4840 per capita for all provinces and from $2334 to $4842 per capita in Alberta. While the increase in real per capita expenditures has been relatively steady over time for all provinces, the pattern for Alberta has been far more erratic. Expenditures ratchetted up in Alberta in 1975 (for 1975-79), again for the 1980-82 period and then again to a much higher level during 1983-87. Since 1988, expenditures in Alberta have been moving down towards the Canadian average, reaching it in 1994. Alberta is no longer the high expenditure province. Notice too that, while expenditure declined, the reduction in real expenditures per capita in time and amount lagged significantly behind revenue declines thus creating the deficit problem that is discussed later.

Figure 1: Provincial Real Per Capita Revenues (1969-70 to 1993-94)

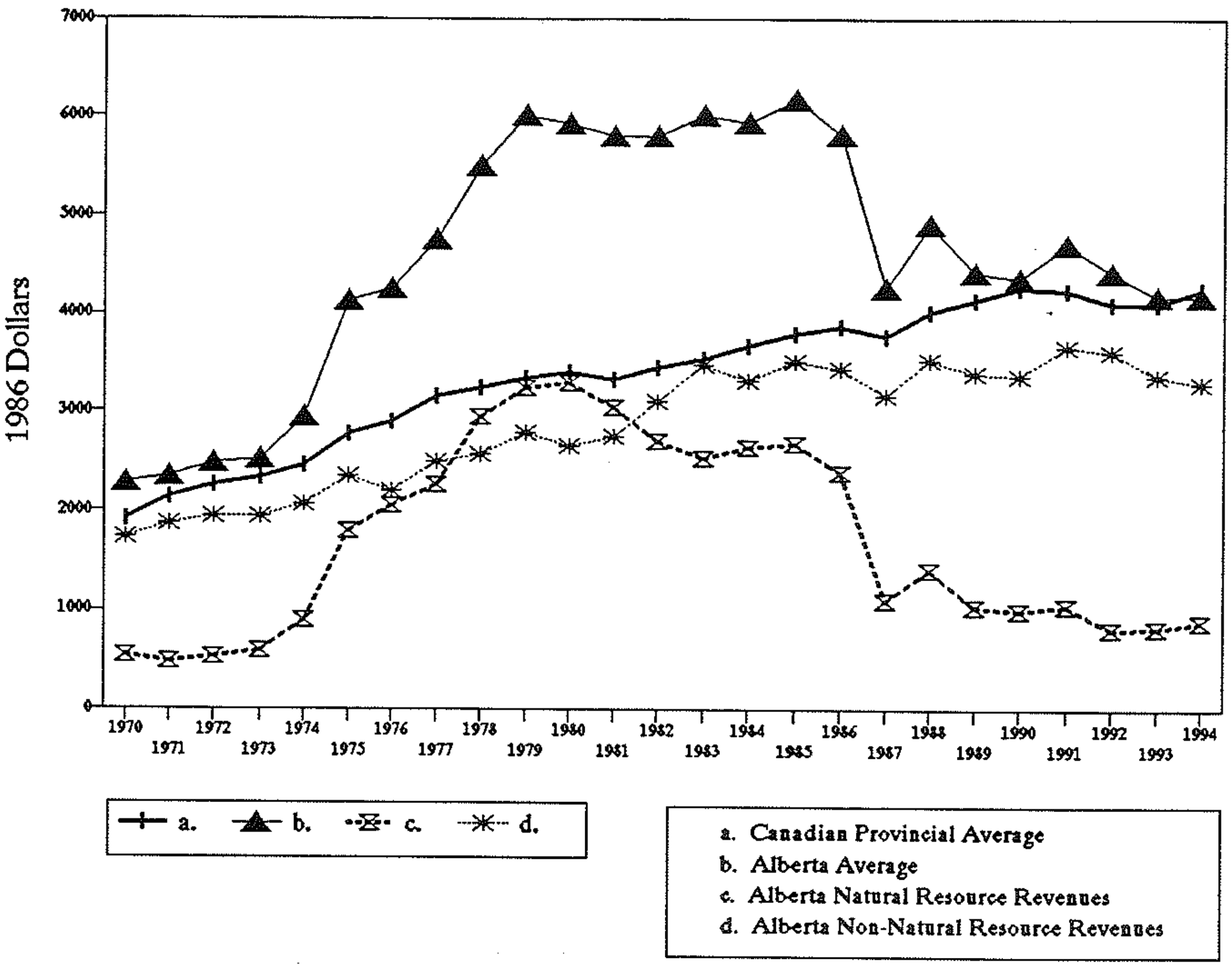


Figure 2: Alberta Heritage Savings Trust Fund

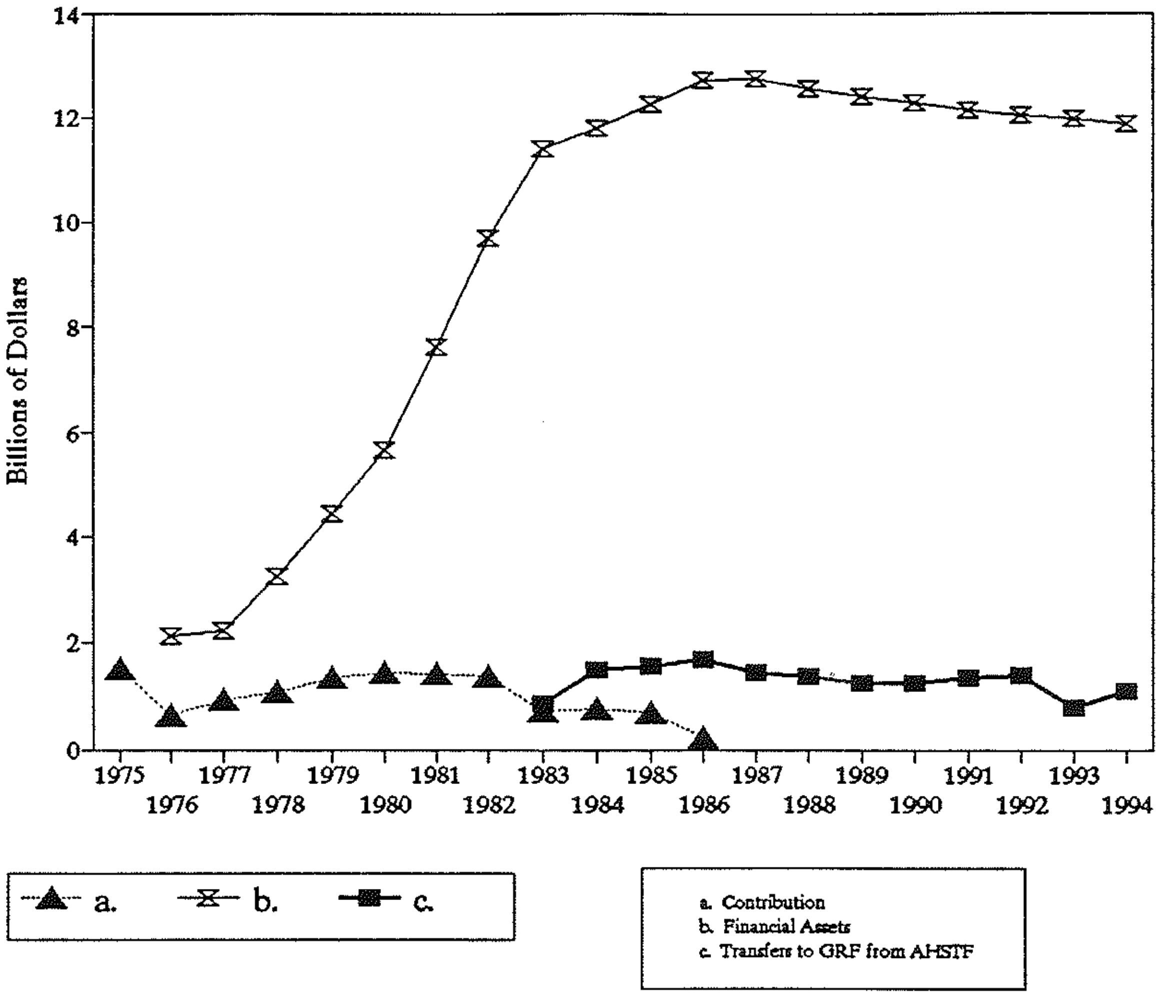
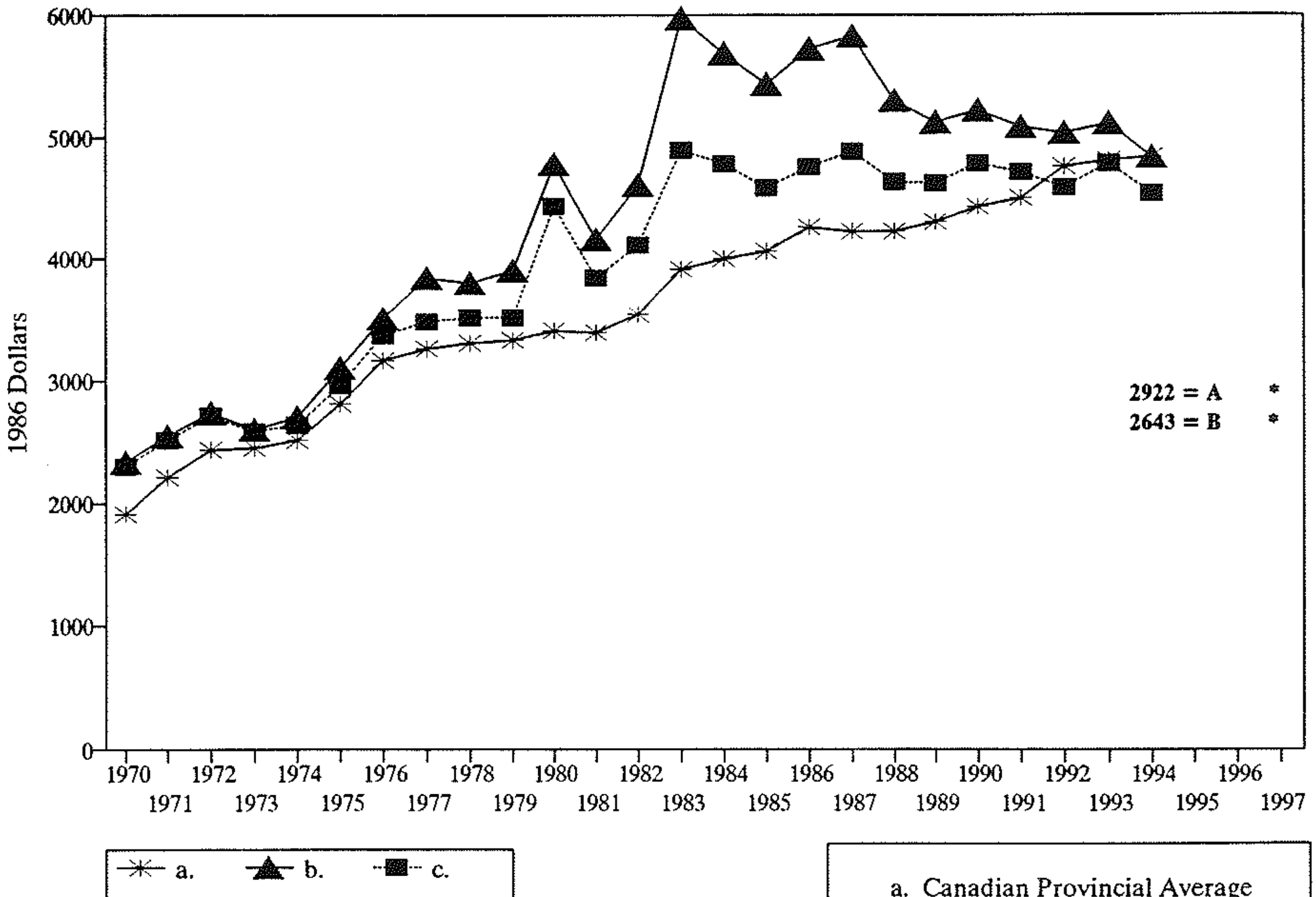


Figure 3: Provincial Real Per Capita Expenditures (1969-70 to 1993-94)



A = $2922, end of fiscal plan level

B = $2648, end of fiscal plan level with debt repayment

a. Canadian Provincial Average
b. Alberta Average
c. Alberta Average Adjusted

1.4 ADJUSTING ALBERTA'S EXPENDITURES: EXPENDITURES ON THE RESOURCE BASE

Our Figure 3 likely exaggerates the magnitude of the difference in provincial public services provided in Alberta relative to other provinces. The large provincially owned resource base in Alberta costs something to manage and those costs are included in expenditures. While they enable the province to earn substantial resource revenues, those outlays themselves do not enhance services to Alberta residents. Our data show that in 1991-92, for example, Alberta spent $441 more per person in the expenditure category "resource conservation and industrial development" than other provinces: $706 versus $265 in 1986 dollars. In order to adjust the expenditures for this extraordinary cost to Alberta, the difference between Alberta and the all province average of resource conservation and industrial development costs are subtracted from the Alberta estimate of real per capita expenditures. This adjustment yields an estimate of what Alberta's expenditures would have been had it only the all province average in the expenditure category resource conservation and industrial development. This revised estimate, although arguably imperfect, better reflects the actual expenditures for services benefiting Albertans directly and, so, is a figure more comparable to expenditures in other provinces.

The levels of expenditure net of extra resource management costs are shown by the middle line in Figure 3. The difference between Alberta and the average is considerably reduced. In fact, per capita expenditures in Alberta **fell below** the Canadian provincial average in 1991-92: $4593 versus $4758 and have remained below since then. That is, since 1991-92 Alberta spent **less** per capita than the average of the Canadian provinces for provincial government services. In 1993-94, Alberta spent $307 less per capita (i.e. 6.3 percent less) than the average of the provinces.

Some may quibble over comparing per capita expenditures in Alberta with the all province average. That is, does what occurs elsewhere matter? Our position is that the all province averages are relevant reference points. Albertans and their politicians have been and continue to be fond of comparing Alberta's taxes and (now less so) services to those in other provinces. We simply continue in that context while attempting to provide a somewhat broader and more complete and exact basis. The Alberta numbers have fluctuated greatly over the past 25 years. Hence, it is helpful to refer to developments in the other provinces where provincial fiscal situations have been much more stable. It is also relevant to consider the choices that have been made in provinces that have not had the fiscal advantages of (still, though now less) large natural resource revenues. It is also a mistake to believe that the expenditure levels in other provinces are inflated relative to those in Alberta by larger debt servicing costs. As shown below (section 1.6), the rapid growth of provincial debt in Alberta has resulted in per capita debt service charges in Alberta equalling the average for the other provinces since 1989-90. Hence, there was no need for adding an adjustment on that account. On the expenditure side of the budget, Alberta paralleled closely the average Canadian province when the Klein government took over.

1.5 PROVINCIAL EXPENDITURES AND LOCAL GOVERNMENT

A further consideration when comparing expenditures across provinces is that local government activities and funding varies among the provinces. In the calendar year 1992 (the latest data available), national consolidated provincial and local expenditures per person in 1992 dollars were $7005. Correcting for the difference in resource management and industrial development costs between Alberta and the average province ($431), comparable expenditures in Alberta were $7197, 2.7 percent greater. In comparison to the two other "have" provinces, Ontario and B.C., Alberta's expenditures were 4.4 and 12.2 percent larger respectively in 1992.[1]

1.6 DEFICITS AND DEBT

In recent years expenditures have surpassed revenues in Alberta with the persistent deficits accumulating into a growing stock of debt. Figure 4 depicts Alberta's deficit record from the 1970s to the present. There were modest deficits in Alberta from 1970 to 1973. From then until 1987, the provincial public sector ran a surplus. In 1987, the Alberta government incurred an extraordinarily large deficit, $1561 (1986 dollars) per capita, and since then, smaller but still relatively large deficits have continued. Alberta is not unique in running deficits as the fiscal position has not been that good in other provinces either. On average, provincial governments have been in a deficit position every year since 1970 except 1979.

Provincial debt in Alberta has grown at a dramatic pace. The speed is evident from Figure 5. Provincial government General Revenue Fund and Capital Fund debt went from almost zero in 1986 to $18.5 billion (or $7100 per person) in 1994. Debt servicing has grown lock-step with the growth of debt

(Figure 6). Before 1982 debt servicing in real per capita terms was consistently less than $200 per capita (Figure 4). By 1988 it had risen to slightly less than $400 in real per capita terms, by 1990 it exceeded $500 and by 1994 it exceeded $600. Debt servicing is now the third largest expenditure item, exceeded only by health and education (and marginally greater than social services). As a result of recent large deficits, Alberta's per capita debt and debt servicing costs rose to equal the all province average by 1990 and have kept abreast of the average since then. It is only in the two years after 1994-95 that the planned deficits will be first small and then zero.

Figure 4: Provincial Per Capita Real Deficit and Debt Servicing Costs

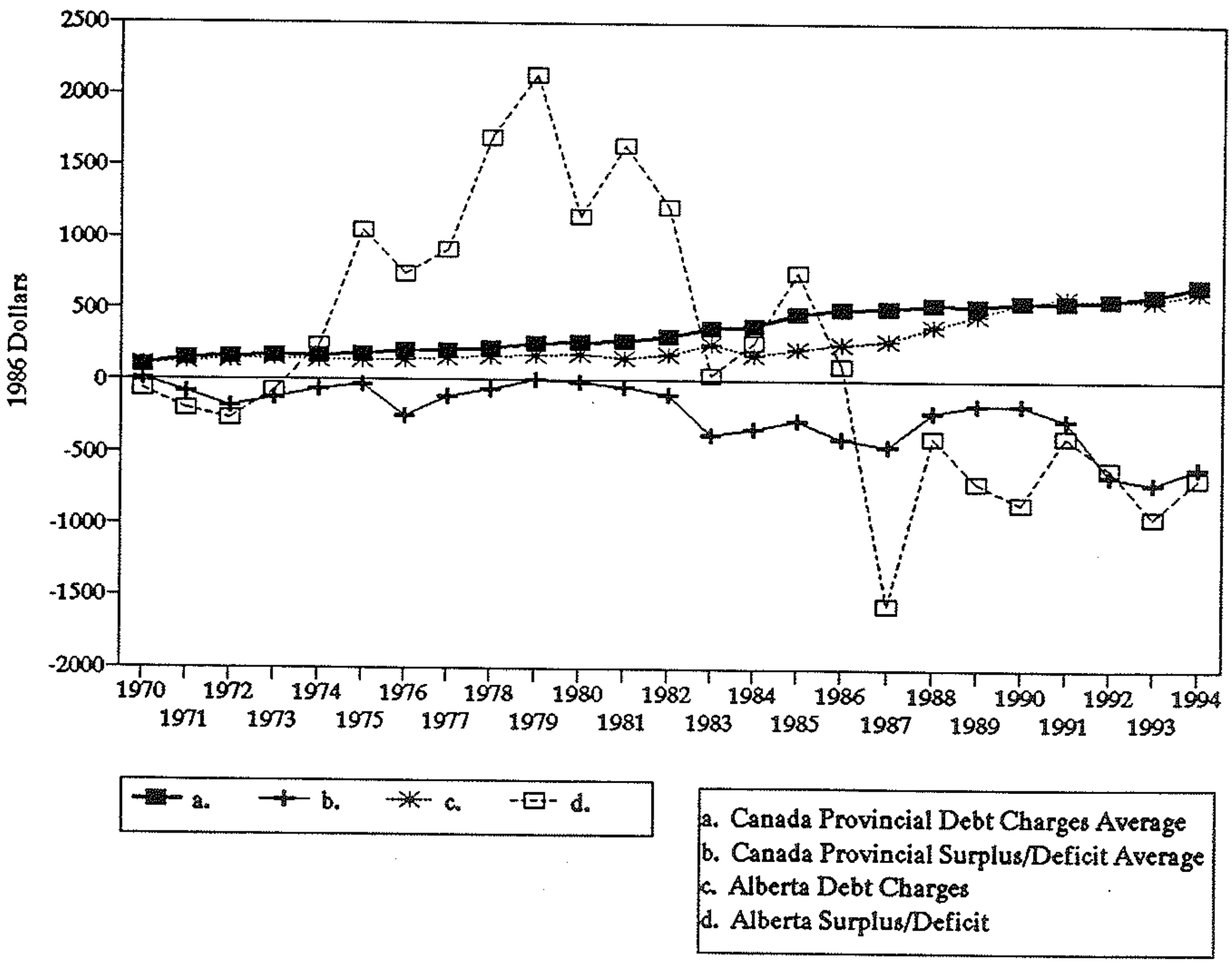


Figure 5: Provincial Unmatured Debt: General Revenue and Capital Funds Total

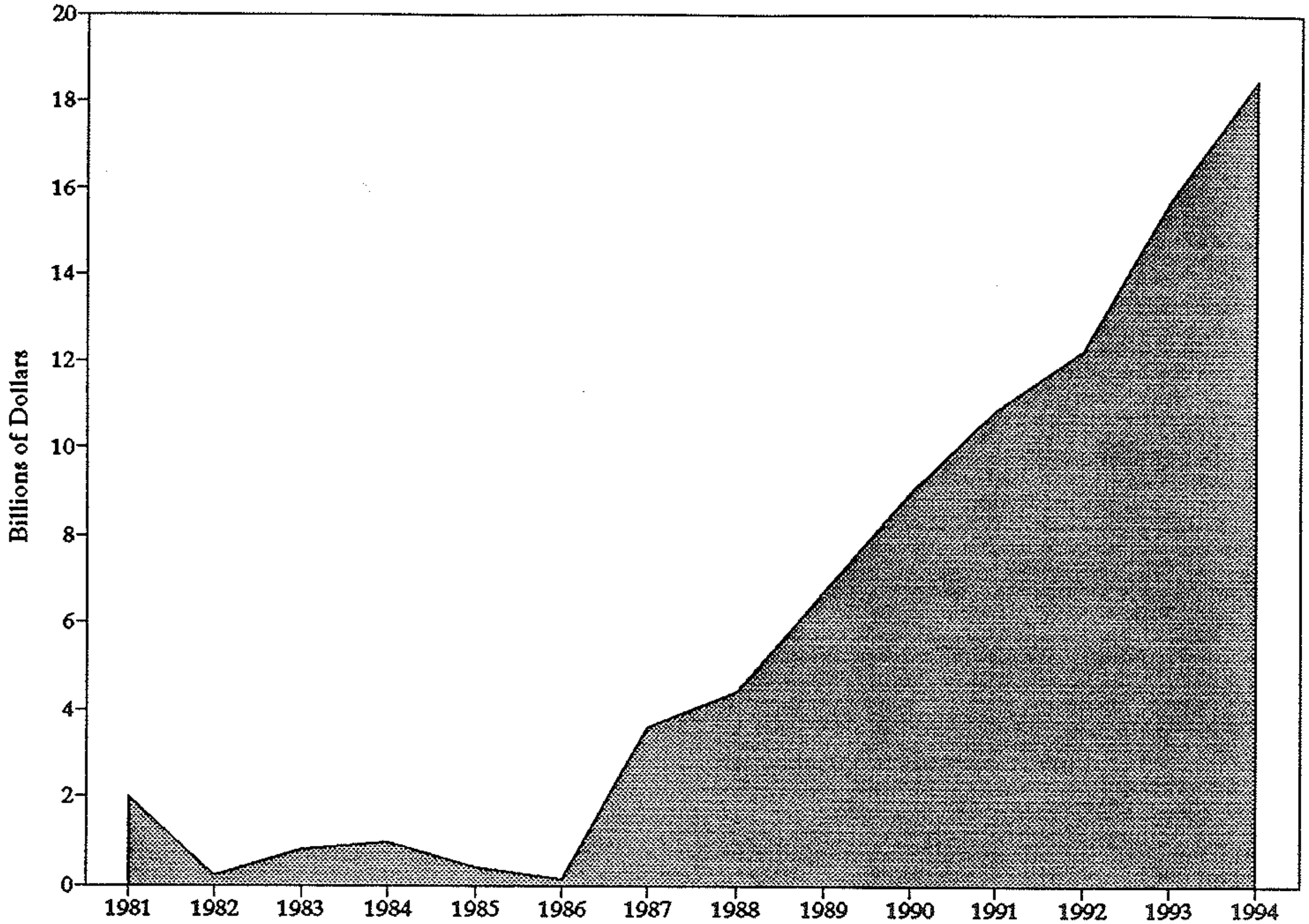
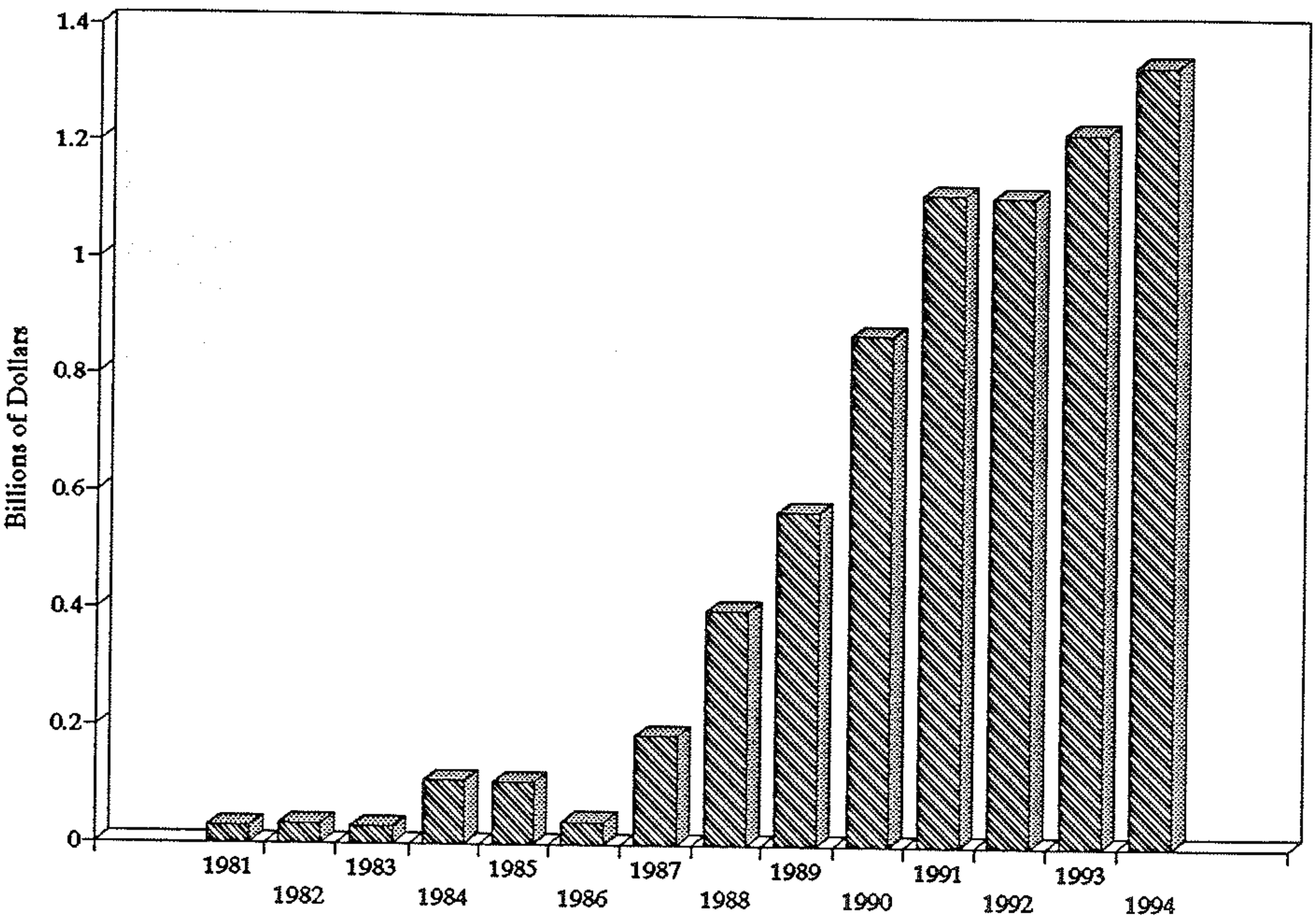


Figure 6: Provincial Debt Servicing Cost: General Revenue Fund



1.7 WHAT'S LEFT: DEBT VERSUS THE ALBERTA HERITAGE FUND

The size of Alberta's gross and net debt can be calculated several ways. Figure 5 showed the combined unmatured debt of the General Revenue Fund and the Capital Fund. The Province also has financial liabilities in other accounts. In response to criticism from the Auditor General and the Alberta Finance Review Committee, the provincial government modified its reporting of provincial liabilities so as to reveal better the financial status of the Provincial Government. As a result, the total unmatured debt for 1992 was shown to be $17.4 billion and is forecast to be $22.5 billion, or $8630 per capita, as of March 31, 1994. These figures still exclude the unfunded pension liabilities ($5.1 billion) and other actual and potential liabilities. Including such items brings the total debt and liabilities to $32 billion, according to 1994 Budget documents.

Net debt is the gross debt less the value of financial assets held by the Province. The AHST Fund is the major source of such assets but there is some debate about the value and/or availability of those assets. For example, the Auditor General estimated the funds available from the AHSTF at $8 billion as of March 31, 1992; considerably less than the $12 billion attributed to the Fund by the provincial government. Professor G. Mumey of the University of Alberta has undertaken independent reviews of the realizable market value of the assets held in the Fund. His latest analysis estimates those assets at $8.5 billion. The major sources of the difference between his estimate and the Province's $11.9 billion figure come from obligations of the Province itself that are owed to the Fund and discounting of poorly secured loans to Crown corporations.[2]

The net debt of the Province is influenced significantly by which estimate of the AHSTF assets is used. Focusing only on the unmatured debt of $22.5 billion, using the provincial figure results in an obligation of $10.6 billion ($22.5 - $11.9) or $4069 per capita. Employing the more conservative estimate of the realizable market value of AHSTF assets, the net debt comes to $14 billion ($22.5 - $8.5) or $5374 per capita.

Albertans are fortunate but can take only modest comfort from the existence of the assets in the AHSTF. The Fund is a significant reserve and earnings on it contribute to the general revenues of the Province. However, the Fund is not growing while the provincial debt is still expanding. Furthermore, as Mumey indicates, the AHSTF is increasingly becoming the provincial government's bank account as it comes to account for a larger share of the Province's liquid funds. Hence, less of the AHSTF assets would be available to apply to the provincial debt should such a move be made.

2.0 THE OPTIONS AND THE CHOICE

Ralph Klein faced major fiscal problems immediately upon becoming leader of the Alberta Progressive Conservative party and Premier of the Province in the fall of 1992. In January 1993, the Provincial Treasurer released a Budget Update for the 1992-93 fiscal year which raised the forecast operating deficit from $2.3 billion to almost $2.8 billion or $1100 per person. Not only was this the seventh successive deficit but the largest in a sequence of (almost steadily) growing deficits since 1987-88. Although real per capita expenditures by the provincial government had been declining steadily since 1986-87 (except for 1992-93, the year just preceding the latest provincial election), that reduction had not matched the dramatic drop in the provincial government's natural resource revenues and the moderate loss of other revenues due to the early 1990s recession. That these deficits were accumulating into a large debt was emphasized by the Annual Report of the Auditor General, released early in 1993, which placed the Province's unmatured debt as of March 31, 1992 at $17.4 billion. These sobering data on deficits and debt followed public concerns already heightened by the magnitude of federal deficits and debt. Thus, the provincial government, and the new Premier, faced an extraordinarily large deficit and a growing debt with limited prospects of either coming under control soon with existing policies.

Debt can only be controlled by first tackling the deficit. The deficit can be eliminated by reducing expenditures, increasing revenues, or a combination of the two. We discuss the two distinct options in turn.

2.1 EXPENDITURE CONTROL

In its 1992 Budget, the Alberta government had proposed a plan to deal with the structural deficit. The plan introduced a downward "fiscal correction" to to provincial government expenditure. In effect, the plan was to hold nominal expenditures constant at 1992-93 levels over the next four years, i.e. until 1996-97, by which time revenues were predicted to increase sufficiently to balance the budget. That plan was rejected by the Klein government which, in its pre-election budget of May 6, 1993, announced its plan to balance the provincial budget by 1996-97 through a 20 percent reduction in program expenditures.

The Klein government's Balanced Budget Plan was reaffirmed and refined somewhat (with new deficit figures) in the September 1993 Budget Update. The essence of that plan (under which the government is still operating) and some of the fiscal implications are reported in Table 1. Over the period of the plan, revenue is projected to grow by 8.3 percent from its $11.47 billion level in 1992-93 to $12.425 billion in 1996-97. However, expenditure reduction is the focus of the attack on the deficit. By 1996-97, program expenditures (i.e. those providing goods and services to Alberta residents) are scheduled to fall to $10.195 billion from the 1992-93 level of $13.028 billion; a 21.7 percent decline. Population growth and price changes affect the impact that these expenditure reductions will have upon Albertans. Using Statistics Canada projections of the Alberta population, the per capita expenditure in 1996-97 is expected to be $3813; 26 percent below that in 1992-93. Rising prices might also erode the value of expenditures even though inflation has slowed. However, as part of its cost reducing efforts, the provincial government cut public sector employee compensation by five percent in its 1994 budget. Not all of this cut translated into cost reduction because part was realized by unpaid days off; i.e. reduced service. Reasonable assumptions about the impact of this on the cost of government services leads to a 3.4 percentage point drop in the price index (using the CPI) in 1994-95. Inflation is expected to restore the index to 130.5 by 1996-97. Employing these price adjustments, real expenditures per capita in 1986 dollars fall from $4022 in 1992-93 to $2922 in 1996-97; i.e. by 27.4 percent to point A in Figure 3.

Table 1
Government of Alberta Balanced Budget Plan and Fiscal Implications
(millions of dollars unless otherwise indicated)

	1992-93	1993-94	1994-95	1995-96	1996-97	Percentage Change 1992 to 1996
Revenue[a]	11,470	11,462	11,725	12,065	12,425	8.3
Program Expenditures[a]	13,028	12,021	11,385	10,790	10,195	-21.7
Population[b] (thousands)	2,529	2,568	2,605	2,640	2,674	5.7
Expenditures per Capita	5,152	4,681	4,371	4,087	3,813	-26.0
Price Index[c] (1986-100)	128.1	130.4	127.1	128.8	130.5	1.9
Real Expenditures per Capita (1986$)	4,022	3,590	3,423	3,173	2,922	-27.4
Operating deficit[a]	2,777	1,959	1,310	455	(510)	–
Consolidated Deficit[a]	3,409	2,444	1,790	755	(220)	–
Unmatured Debt[a]	20,181	22,967	24,700	25,450	25,250	25.1
Gross Debt[a]	29,068	32,075	34,101	35,053	35,026	20.5

Notes: (a) From Budget '93 Update, Alberta Treasury, September 1993.
(b) Statistics Canada.
(c) Consumer Price Index adjusted for 1994-95 and projected.

The Klein government's 20 percent cut in program expenditures is expected to translate into a 27.4 percent cut in services to Albertans. This is a very significant reduction in two ways. First, it follows upon a 15 percent real decline in per capita spending that has already been imposed since the mid-1980s. That reduction, although insufficient in itself, indicates the degree of the earlier expenditure control efforts which brought us from an exceptionally high level of per capita services to an average level (although Albertans still benefit from living off the depreciation of a large, high quality stock of public infrastructure). The further 27.4 percent reduction is significant also because it will move Albertans from an about average level of provincial services to well **below** average level. Although changes are occurring elsewhere, it is reasonable to expect that a 27.4 percent cut will result in provincial services significantly below those elsewhere in the country. In 1993-94, no province spent less than 90 percent of the per capita all province average. Furthermore, the success of the planned expenditure cuts only balance the budget and do not begin to generate the revenue to pay down the debt. Continuing the present approach to accomplish debt reduction also would require even further significant expenditure cuts.

Over the course of the Balanced Budget Plan, the operating deficit declines from $2.777 billion in 1992-93 to zero; actually a small surplus ($0.51 billion) is projected for 1996-97. Similar success is expected with the consolidated account. While reducing the deficit to zero, the debt continues to grow (by $5 to $6 billion). The unmatured debt increases 25.1 percent to $25.25 billion and the gross debt (including pension and other liabilities) by 20.5 percent to $35 billion.

The prospect of repaying this debt opens for discussion an unpleasant and largely unmentioned topic. To reduce the accumulated debt will require that the provincial government raise additional revenues or cut expenditures even further. Keeping with the spirit of the deficit elimination strategy, we

Table 2: Provincial Taxes and Revenues, 1993-94

	Percent of Provincial Revenues		Per Capita Revenue	
	All Provinces	Alberta	All Provinces	Alberta
Taxes				
Personal Income	26.4	19.7	$1,460	$1,073
Corporate Income	2.8	4.7	156	255
General Sales	13.1	0	725	0
Motive Fuels	3.8	3.6	210	196
Alcohol & Tobacco	1.7	2.2	93	121
Real Property	3.7	1.7	204	95
Health Insurance Levies	6.7	6.3	370	341
Other Taxes	3.2	2.1	178	113
Total Taxes				
(a) % of Revenue	61.4	40.3		
(b) $ per capita			3,396	2,195
Other Revenue				
Natural Resource	3.6	21.1	199	1,150
Return on Investment	9.8	19.0	539	1,036
Federal Transfers	18.9	15.2	1,045	825
Other	6.2	4.4	344	237
Total Revenue	100.0	100.0	5,523	5,443

Source: Perry, David B., "Fiscal Figures," *Canadian Tax Journal*, Vol. 42, No. 3, 1994, pp. 966-77.

contemplate the effects of repaying the debt by further expenditure reductions. Assuming a level of unmatured debt ($24.15 billion) and interest rates (about 6.3 percent) consistent with the 1994 provincial budget, repayment of the debt over 15 years would require an additional outlay of almost one billion dollars annually. Reducing expenditures again to realize this amount would result in real per capita expenditures falling to $2648 (versus $2922 in 1996-97; point B versus A in Fig. 3). Repaying the debt under these assumptions implies a 34.2 percent reduction in per capita expenditures and service. If the debt were to be amortized over 20 years, the decline would be 31.6 percent (but for a longer time) and if over 10 years the necessary decline would be 40 percent.[3]

Eliminating the deficit according to the Klein government's Balanced Budget Plan is imposing a substantial reduction in services to Alberta residents. Eventually, the decline will be about 27 percent per capita from the 1992-93 level (which was approximately the all province average). Eliminating the deficit is only part of the necessary program. Utilizing the same approach to pay down the provincial debt would require a further cut in expenditures and services. A cutback of 33 percent in total is quite reasonable to project. Cutbacks of this magnitude would certainly leave Alberta, one of Canada's wealthiest provinces, with the lowest level of provincial government services. Although the Alberta government is well along in its deficit reduction program and its efforts appear to have retained considerable popular support thus far, will Albertans wish to pursue to the end this single track route to deficit control and debt reduction?

Table 3
Provincial Tax Capacity and Effort for Selected Taxes, 1990-91

	Per Capita Tax Revenue			Per Capita Revenue	
Tax	**All Province Average**	**Alberta at Alberta Tax Rates**	**Alberta at National Average Tax Rates**	**Alberta Tax Capacity[a]**	**Alberta Tax Effort[a]**
Taxes					
Personal Income	$1,386	$1,131	$1,421	1.03	0.796
Business Income	229	327	376	1.64	0.871
Business Capital	69	15	120	1.73	0.127
Sales Taxes	710	10	881	1.24	0.011
Motive Fuels	173	158	235	1.35	0.673
Alcohol & Tobacco	214	276	230	1.07	1.203
Real Property (provincial and local)	900	968	1,068	1.19	0.907
Total	3,681	2,885	4,331		
All Revenues Subject to Equalization	4,703	4,878	6,405		
Alberta Overall Tax Capacity and Tax Effort (all provincial and local revenues				1.33	0.750

Source: Canada Department of Finance, Provincial Fiscal Equalization, Seventh Estimate, February 1992.

Note: (a) These are not the official Equalization Program indices of capacity and effort which are confidential but are approximate values estimated from available data.

2.2 REVENUE OPTIONS

Reducing expenditures is the logical first step towards controlling the deficit but raising revenues is the other lever and it is one which affords Alberta considerable leeway. The major sources of provincial revenue are shown in Table 2 for 1993-94, the initial year of the deficit elimination program. Again, these data are on an FMS accounting basis and so are comparable among provinces. Note too that these data include the various provincial levies imposed to support health care finances. The per capita dollar amounts are interesting. Per capita taxes borne by firms and individuals are low in Alberta; at $2195 in 1993-94, they are $1200 less than the all province average. On the other hand, natural resource revenues and returns on investments are much greater in Alberta. Together, at $2186 per person, they are almost three times the all province average. Despite these large amounts, total revenue per capita in Alberta actually fell below the provincial average in 1993-94; $5443 versus $5523. As indicated in Figure 1, this below average position is a first in recent history. Normally, natural resource revenues have kept provincial per capita total revenues in Alberta well above the all province average and allowed well below average taxes. For example, in 1991-92, per capita revenue was $904 above the all province average while per capita taxes were $1000 less. Although Alberta has become an average province in terms of total revenue, it continues to raise only 40 percent of its revenue from taxation while other provinces rely upon taxation for over 60 percent.

The potential to raise additional revenue through taxation depends very much upon how much Alberta currently taxes its existing tax base. Does Alberta have under-utilized tax capacity? Information about major taxes are reported in Table 3. Since these data come from a different data source they are not strictly comparable to those in Table 2. That the data are for 1990-91 is not a concern. The relative figures change only slowly from year to year and, at best, the data could be updated by only one year at this time. Also note that business income taxes do not correspond exactly to the corporate income tax, the business capital tax is included as are local property taxes (the major source of local tax revenue). The collection reported here account for about 85 percent of consolidated provincial-local tax revenues and are the major taxes and revenues entering the fiscal equalization formula for determining grants to "have not" provinces. Again we compare the per person tax revenue raised in Alberta with the all province average and, again, Albertans are found to pay less tax than the average province resident; $2885 versus $3681 per capita for the tax sources reported.

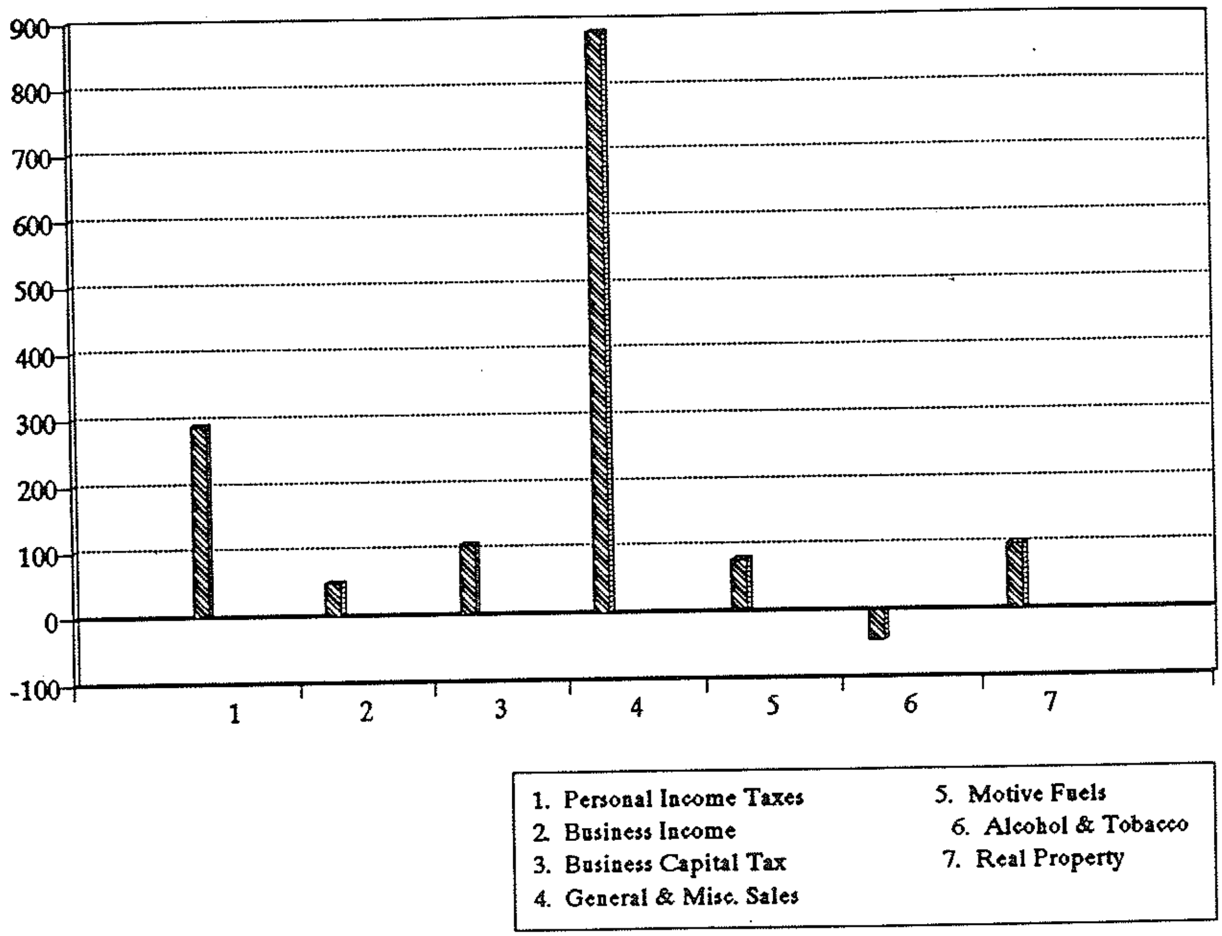
The third column shows the tax per person that would have been generated in Alberta if the Canadian average tax rates were applied to Alberta's 1990-91 tax bases. At the average rates, Alberta would have generated more revenue from all tax bases shown except for alcohol and tobacco. Provincial average rates would have raised $4331 per capita rather than the $2885 that was actually collected. The absence of a provincial sales tax accounts for only 60 percent of the $1446 difference.

Not only are Alberta's tax rates lower but the size of the Alberta tax base is greater than that of the average province. In each case, Alberta's per capita tax base exceeds the average over all provinces for the items of Table 3; i.e. the fiscal capacity index exceeds 1.0. In fact, over the 37 provincial revenue sources that enter equalization calculations, Alberta is below average in very few (revenue from mineral resources other than coal, water power, and sales of beer). Over all the 37 revenue sources, Alberta's fiscal capacity is 33 percent greater than the all province average. Only slightly more than half of the above average fiscal capacity is due to oil and gas resource revenues. Only Ontario and British Columbia also have fiscal capacity measures exceeding one, about 1.10 and 1.08 respectively.

Alberta does not impose as heavy a tax burden as the average province. The measure of tax effort - the ratio of what is raised to what could be raised at Canadian average provincial tax rates - shows Alberta is at 75 percent of the all province average. For only one of the major taxes shown (those on alcohol and tobacco) is the Alberta effort above average. In fact, if more recent data were available, they would likely show that Alberta's tax effort has declined relatively because many provinces have raised taxes somewhat as well as reduced expenditures in their efforts to reduce provincial deficits while Alberta has shunned tax increases. Thus, one of the avenues for addressing the deficit is to consider tax increases.

Figure 7 shows the additional tax revenues that could be generated from simply imposing taxes at the 1990-91 all province average rates in Alberta on Alberta's 1990-91 tax bases. For all but taxes on alcohol and tobacco, more revenue would be realized. Even without a provincial sales tax, over $600 per capita could be raised, or approximately $1.5 billion, in additional tax revenue. The striking option is a provincial sales tax which does not exist in Alberta. At the average rate, which is an effective rate of 7.83 percent which is less than Ontario's 8.92 percent

Figure 7: Additional Per Capita Revenue from Major Tax Sources if Alberta Taxed at the Provincial Average Rate, 1990-91



effective rate, $871 per capita or about $2.2 billion would be raised.[4]

Thus looking simply from the revenue side only, a relatively moderate level of sales tax could have handled the structural component of the deficit while leaving other Alberta taxes at their existing, generally below average, level. Alternatively, even without a provincial sales tax, there is room in the existing level of Alberta taxes to go some considerable distance towards deficit reduction. Hence, consideration of tax possibilities did and still does present feasible options and ones that enhance fiscal flexibility by opening up a wide range of alternatives. These options should not be ignored due to a fixation with only one side of the ledger. Indeed, unless there is a substantial recovery of natural resource revenues, it seems likely given the magnitude of expenditure and service reduction otherwise necessary and the low taxes in Alberta that Albertans will reconsider tax alternatives before the deficit and debt issue is fully resolved.

3.0 What About the Heritage Savings Trust Fund?

Should the Fund be retained or liquidated? A recent paper has concluded that the economic impact of the Fund has been limited and that economic development is insufficient reason to retain the fund (Warrack 1994). The current role of the Fund, by direct allocations and indirectly as a source of provincial general revenues, is simply to finance ordinary government expenditures. Notably, investment income from the AHSTF supplements provincial general revenues of the Province by about a billion dollars annually. Orderly liquidation of the Fund and retiring debt with the proceeds would reduce debt servicing requirements but while also lowering available revenue. Initially, one would expect that the net debt position of the Province would remain unchanged. However, partial liquidation has in effect already happened inasmuch as Fund assets increasingly have been held as very close substitutes for cash; the Alberta government holds little other cash (Mumey, 1994, p. 10). That is, the Province has come to rely upon a part of the Fund as its chequing account. The implication of this is that, if considering possible AHSTF disinvestment, less money would be available to pay down debt unless the Province supplemented its liquid reserves from other sources. Mumey suggests that about $2 billion less would be available because that amount of the Fund is now being utilized as the Province's cash reserve.

While the actual fiscal position of the Province is affected little by the presence or liquidation of the AHSTF, its continued existence may obscure the underlying reality of Alberta's current fiscal position. A survey of Chartered Accountants in Alberta revealed that 75% supported orderly liquidation of the Fund (ICAA, 1993). The reality is that the Province is a net debtor and focussing on the assets of the AHSTF causes some to neglect the fact these assets have been more than offset by liabilities incurred elsewhere by the provincial government. Moreover, Canadians outside the Province are misled into perceiving that the Province has a nestegg or "rainy day" fund, instead of the reality that the Province is a net debtor and is still struggling to eliminate its structural deficit and attendant increasing debt.

4.0 Policy Options in the Evolving Fiscal Circumstances

The evidence clearly suggests that Alberta had a structural deficit of at least $2 billion, for realistic energy price and economic growth projections, as it entered the Klein "fiscal renovation" period in 1993. This structural deficit combined with accumulating debt servicing requirements of the growing stock of debt implied, with no change in expenditures nor revenues, an increasing structural deficit through time. Clearly this option was not sustainable. Rising debt and debt servicing requirements would have soon brought a lowering of the Province's debt rating and even greater debt servicing costs. This dynamic implied ever accelerating debt and debt servicing in the absence of expenditure reductions and/or revenue increases to eliminate or reduce the deficit.

Moreover, ongoing structural factors made even more unrealistic a "do nothing" policy response after 1992-93 and they continue to exert pressure for fiscal adjustment. For example, an aging population puts further upward pressure on health care expenditures while the share of producing taxpayers declines. On the revenue side about 20 percent of provincial government revenues arises from non-renewable resources. Declining light crude production and constant real prices for oil mean falling revenue from this source that may or may not be offset by higher revenues from natural gas sales. Payments from the Government of Canada make up approximately 15 percent of provincial government revenues and the evidence is clear that the Federal government is off-loading its financial responsibilities for shared cost programs on to the provinces, especially the "have" provinces. Income from the AHSTF is 7.3 percent of provincial operating revenues in 1994-95 (down from 8.7 percent in 1991-93) but in the absence of capital infusions the fund cannot sustain its absolute or relative level of investment income, especially as inflation erodes its purchasing power. In total, over 40 percent of the forecast revenue base of the Province in 1994-95 is likely to decline further in real value over the coming years. This possibility could only further exacerbate the existing structural deficit, without major corrective measures.

Scarcely half of the structural deficit is being deleted by the 1993-94 and (especially) 1994-95 Alberta government expenditure reductions and fee increases.[5] While cyclical buoyancy of resource revenues may mask this deficit temporarily, the hard reality remains. Looking ahead, it is essential to address the challenges and choices of today's fiscal circumstances beginning in 1995. Deficit reduction to date has been substantial and reflects major policy and political effort by the provincial government but the action taken and planned is inadequate to address the full scope of the problem. Consideration of future options must be in the context of the fiscal realities identified in the foregoing analysis.

4.1 FISCAL REALITIES FOR ALBERTA IN 1995

The realities enumerated below calculate Alberta's new fiscal position. Many of the magnitudes are smaller, and situations are much improved over that which might have prevailed, but the fiscal difficulties continue to be fore-boding. Despite the initiatives, efforts and sacrifices of the last two years, many of the 1995 realities are discouragingly similar to those of 1993.

Reality #1. DEBT: Alberta is a net debtor with net debt equal to at least $11 billion and growing. The assets of the AHSTF are less than half of Alberta's tax-supported gross debt; investment income consequently is much less than debt servicing requirements. Moreover, the value of the Heritage Fund is shrinking gradually whilst debt servicing costs are increasing and have become the third-largest and fastest-growing expenditure item. If recent interest rate and exchange changes sustain, the impact will be even worse.

Reality #2. DEFICIT: Although reduced, a structural deficit remains. However, a firm plan, based on expenditure reductions, is in place to reduce the deficit to zero by 1996-97. For 1994-95, the planned deficit of $1.55 billion or $600 per capita ($2100 per family) amounts to approximately 12.3 percent of expenditures and 13.6 percent of revenue. However, primarily because of unexpected revenues of $680 million, the second quarter budget forecast projects a much smaller deficit for 1994-95 ($655 million). Half the revenue gains came from improved natural resource revenues and one-quarter from unplanned increases in lottery income. Although the Province is already cautious about the resource revenue increases, one cannot be too confident that these increases will continue.

Reality #3. REVENUES: The likelihood of a declining real value of over 40 percent of the provincial government's revenue base (natural resource revenue, investment income and federal transfers) means that revenue erosion is likely to place continuing pressure on budget balancing in the absence of fiscal reforms by the provincial government involving either expenditure reduction or revenue (tax) increases or both.

Reality #4. EXPENDITURES: The evidence shows that in terms of expenditures on goods and services (excluding those on resource conservation and industrial development) Alberta fell below the all province average in 1991-92. The 1994-95 levels are even lower. That is, Albertans now receive a below average level of services from their provincial government and further deterioration is ahead. Alone, the expenditure cuts necessary to balance the budget and then to begin to pay off the accumulated debt would necessitate an additional reduction in the order of 15-20 percent beyond the 15 percent decline that is expected to be realized in the first two years of the deficit elimination program. Cuts of a magnitude at least as large as those realized to date will be more difficult to achieve and to accept.

Reality #5. TAX EFFORT: The evidence on provincial government revenue sources reveals that all Alberta's major tax bases exceed the provincial average while tax effort in the Province is significantly below the national average not only because of no provincial sales tax but also due to lower tax effort on most tax bases.

Reality #6. HERITAGE FUND: The AHSTF is a shrinking financial factor in Alberta's fiscal picture. Depending on which estimate of value is used, it offsets one-third to one-half of Alberta's debt. In contrast with 1993, the provincial government has indicated a willingness to consider orderly liquidation. A Legislative Committee has been formed to assess the future of the Fund.

4.2 A TWO-TRACKED APPROACH TO DEFICIT AND DEBT ELIMINATION

We have noted that the Province's structural deficit can be eliminated and movement towards pay-down of the stock of debt accomplished by provincial government expenditure reductions, revenue increases, or some combination. Thus far, the Province has followed a single track approach; i.e. deficit reduction through expenditure cuts alone. To us the evidence is compelling that a more comprehensive approach involving the following elements is essential if we are to rid Alberta of the deficit and begin to repay what are still increasing levels of debt.

1. **Expenditure Reduction Alone Is Unlikely to be Enough.** Although up to now it has been "politically correct" to focus solely on expenditure reduction, it must be borne in mind that once Alberta's expenditures are adjusted for extra expenditures on account of its resource base, per capita spending in real terms on programs has been below the all province average since 1991-92. Reducing program expenditures by at least another billion below their current nominal level over the next two years to just balance the budget implies a 27.4 percent cut in expenditures and services to Albertans. By a considerable margin, no province now experiences such a low level of expenditure and service. Alberta, one of the three wealthiest provinces in Canada, would certainly be at the bottom in provincial services. Services in education, health care and social services would reflect this fiscal reality. Additional cuts to enable debt repayment could easily imply provincial services reduced to two-thirds of the average across provinces. Such reductions would only exacerbate the disparities between Alberta and other provinces.

2. **Two Sources of Revenue Increases and Still Below Average Taxes.** The current structural deficit should be tackled by a combination of expenditure reduction and revenue increases. On the revenue side, two options are possible. For example, either (i) increase taxes to the national average rates on all non-sales tax bases but not impose a provincial sales tax (making the Alberta tax effort 90 percent of the average), or (ii) introduce a provincial sales tax and hold tax effort constant on the existing taxes. A sales tax of 5 percent imposed on personal consumption expenditures, or a higher rate for a narrower tax base, would yield about $1.6 billion.[6] The alternative, that of increasing (non-sales tax) tax effort in the Province to the all province average would raise a similar amount. While subsequent provincial budget measures may have reduced some of the disparity in tax effort, they are unlikely to have changed it substantially nor the revenue implications of moving to the all province average.

3. **A Balanced Approach to Deficit Reduction.** If the above revenue initiatives were taken and combined with expenditure cuts already imposed, the remainder of the structural deficit would be cleared. The expenditure cuts would have preceded major new tax initiatives. Although taxes would be increased somewhat, Albertans would continue to enjoy a considerable tax advantage over residents of other provinces. Albertans may prefer some other division between expenditure cuts and tax increases, but we expect that some form of a combined approach will be required to meet Albertans' expectations of provincial government services and still eliminate the deficit and begin to pay the debt. That is, without unexpectedly buoyant

natural resource revenues, the long-run sustainable solution to the Province's fiscal problems will require the combination of reduced expenditures and tax increases.

4. **Liquidate the AHSTF to Reduce Provincial Debt?** To ensure that Albertans recognize the fiscal realities necessitating the above actions, it may be necessary to repeal the AHSTF Act and instead legislate an Alberta debt retirement Act. The Fund assets can be liquidated efficiently over time. An implication of liquidating the AHSTF is that revenues from it would not be available to support the operating budget and specifically contribute towards meeting debt servicing costs. The remaining Alberta debt servicing costs would be funded out of general revenues. The Province has the capacity to carry this debt load if the source of debt growth, the structural deficit, is eliminated.

5. **Strategy for Eliminating Alberta's Debt.** Our accumulated debt came to exceed the Heritage Fund about the end of 1991; now Fund monies can pay off only about 25-30 percent of the debt. Thus a strategy beyond the AHSTF is needed for the future. Expenditure cuts and tax increases could be used to retire the debt in an even and regular pattern. Due to public ownership of highly-valued resources, a unique supplemental strategy is available to Alberta that reduce the size and so ease the burden of the regular payments. Resources markets and revenues inherently are cyclical. Net of the Heritage Fund and after deficit elimination, the debt would be sustainable; hence Alberta could afford to reduce the magnitude of its annual repayments and wait for future "spikes" in resources revenue (oil, natural gas, forestry, coal, tar sands) cycles to provide revenue for irregular but large lump sum payments. With conservative budgetary forecasts and expectations, such revenue windfalls are likely to be available from time to time. Such a strategy demands a commitment to reserve such windfalls for debt reduction.

5.0 CONCLUSION

During 1994, Premier Klein often spoke of the progress that was being made towards reducing Alberta's deficit. He frequently seemed to claim that the worst was past for the Province. His very optimistic perspective culminated at the end of the year when he spoke of looking ahead to 1995 to potential personal income tax cuts and wage increases for civil servants (Edmonton Journal, December 31, 1994). In our opinion, the Premier's view is unduly rosy and downplays, if not neglects, the fiscal realities. Even if realized, the Premier's year-end projections might only amount to teasing concessions made primarily for the benefit of political rhetoric. The evidence we advance in this paper indicates that the Province is now only halfway towards solving its fiscal problems and that Albertans can only expect considerably more of what it has already received from the Klein government; i.e. further expenditure cuts and further reduced services if it continues on this one-track approach to deficit and debt reduction. As they continue, the expenditure cuts become more onerous and move Alberta into a less and less enviable position; perhaps to an "Alberta disadvantage." Consequently, we argue that a balanced approach to resolving the Province's fiscal problems is necessary; that is, one blending expenditure cuts with tax revenue increases.

REFERENCES

Alberta Budget Roundtable, "Beyond the Bottom Line," September 1994.

Alberta Financial Review Commission, "Report to Albertans," March 1993.

Alberta Tax Reform Commission, "A Report to Albertans," February 1994.

Alberta Treasury, Budget Update, January 1993.

Alberta Treasury, 1994-95 Quarterly Budget Report, November 1994.

Alberta Treasury, Alberta Heritage Savings Trust Fund Quarterly Report, December 1994.

Alberta Treasury, Alberta Heritage Trust Fund Annual Report, 1993-94.

Auditor General, Public Accounts 1991-92, Alberta Treasury, January 1993.

Canada, Department of Finance, Provincial Fiscal Equalization, Seventh Estimate, Feb 1992.

Canada West Foundation, *The Red Ink: Alberta's Deficit, Debt and Economic Future*, Sept 93.

Edmonton Journal, December 31, 1994, p. 1.

Institute of Chartered Accountants of Alberta (ICAA), "Facing Fiscal Facts II," January 1993.

Institute of Chartered Accountants of Alberta (ICAA), "Staying the Fiscal Course," Feb 1994.

McMillan, Melville and Allan Warrack, "Alberta's Fiscal Situation: Identifying the Problem, Looking for Solutions," Information Bulletin #14, Western Centre for Economic Research, April 1993.

Mumey, G. "The Alberta Heritage Fund in 1994," Information Bulletin #26, Western Centre for Economic Research, November 1994.

Nesbitt Burns/RBC Dominion/ScotiaMcLeod/Wood Gundy, "Alberta Heritage Savings Trust Fund Assessment of Market Value," December 1994.

Perry, David B. "Fiscal Figures," *Canadian Tax Journal*, Vol. 42, No. 3, 1994, pp. 966-77.

Statistics Canada, Financial Management Series data, CANSIM, Fall 1993.

Warrack, A. "Alberta Heritage Fund: Regional Economic Development Assessment," Western Regional Science Association, Tucson, Arizona, February 1994.

END NOTES

[1]Some might think that the state and local spending of our American neighbours would provide a good example. International comparisons are fraught with difficulties and a really reliable comparison would be a major study but we observe that the average level of state and local expenditures in the United States in 1992 was \$5353 (U.S. dollars). This amount would be equivalent to the Canadian average of \$7005 (Canadian dollars) at an exchange rate of \$0.76, well above recent rates which would imply a greater average in the U.S. That is, at reasonable rates of exchange, the level of per capita total spending of subnational governments in Canada and the United States appear comparable (not larger in Canada). While U.S. state and local governments spend less on debt servicing (4 versus 11 percent), they also spend very much less on health and hospitals (6 versus 22 percent).

[2]The provincial government sought advice from a group of investment dealers regarding the value of the AHSTF. For those elements of the Fund that they were directed to consider, they concluded in general that those assets were highly marketable and liquid (Nesbitt Burns et al., December 1994). However, six assets (with a cost-based value of \$939 million) were excluded from their consideration. Some of the debate about the market value of the Fund relates to these excluded assets. In fact, the Province has since written-down one of these assets (the Lloydminster Upgrader).

[3]If interest rates are higher than the 6.3 percent implied and used for these calculations, the required expenditure cut becomes larger. For example, if the rate were 8.0 percent (which is less than the 9.0 percent paid by the province over the past three years), the resulting real per capita program expenditure with a 15 year amortization would drop to \$2571; that is, a cut of 36.1 percent from the 1992-93 level.

[4]Utilization of the 1990-91 data is expected to underestimate the revenue that could be generated today from the same policies.

[5]Increases in fees and charges have contributed quite modestly towards deficit reduction. From the latest budget estimates, total revenues from premiums, fees and licences in 1994-95 are projected to be \$942 million, \$156 million over the 1992-93 level. \$132 million of this increase is due to higher health insurance premiums. These additional charges are not considered to be tax increases by the government. However, raising an extra \$132 million from alternative tax sources, higher fuel taxes for example, would require a 25 percent increase in fuel taxes.

[6]The possibility of a sales tax in Alberta seems a little less remote today than it did in 1993. We note that the Alberta Tax Review Commission supported introducing a sales tax although under rather different circumstances than argued here. The Commission supported a sales tax only after the deficit was eliminated and only then so as to allow personal and corporate income taxes to be reduced.