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Alberta's Fiscal Situation: Identifying the Problem, Looking for Solutions

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INTRODUCTION

In late January of 1993 the Provincial Treasurer released a Budget Update for the fiscal year 1992-93 which forecast a budgetary deficit of $2,757 million for the year. This deficit follows upon successive deficits occurring since 1984-85. Shortly thereafter, the Auditor General's office released its Annual Report for 1991-92 which placed the Provincial unmatured debt at $17,403 as of March 31, 1992. These sobering data on deficits and debt followed public concerns already heightened by the magnitude of federal deficits and debt.

This study assesses the fiscal position of Alberta. It attempts to provide a historical context for our pattern of provincial government expenditures and revenues and to place our fiscal position in the national context. The study concludes by offering options to eliminate the structural deficit and move to deal with the stock of debt. It is our view that realistic options necessarily require some increase in taxes as the Province does not have sufficient flexibility on the expenditure side to address the problem of the deficit.

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

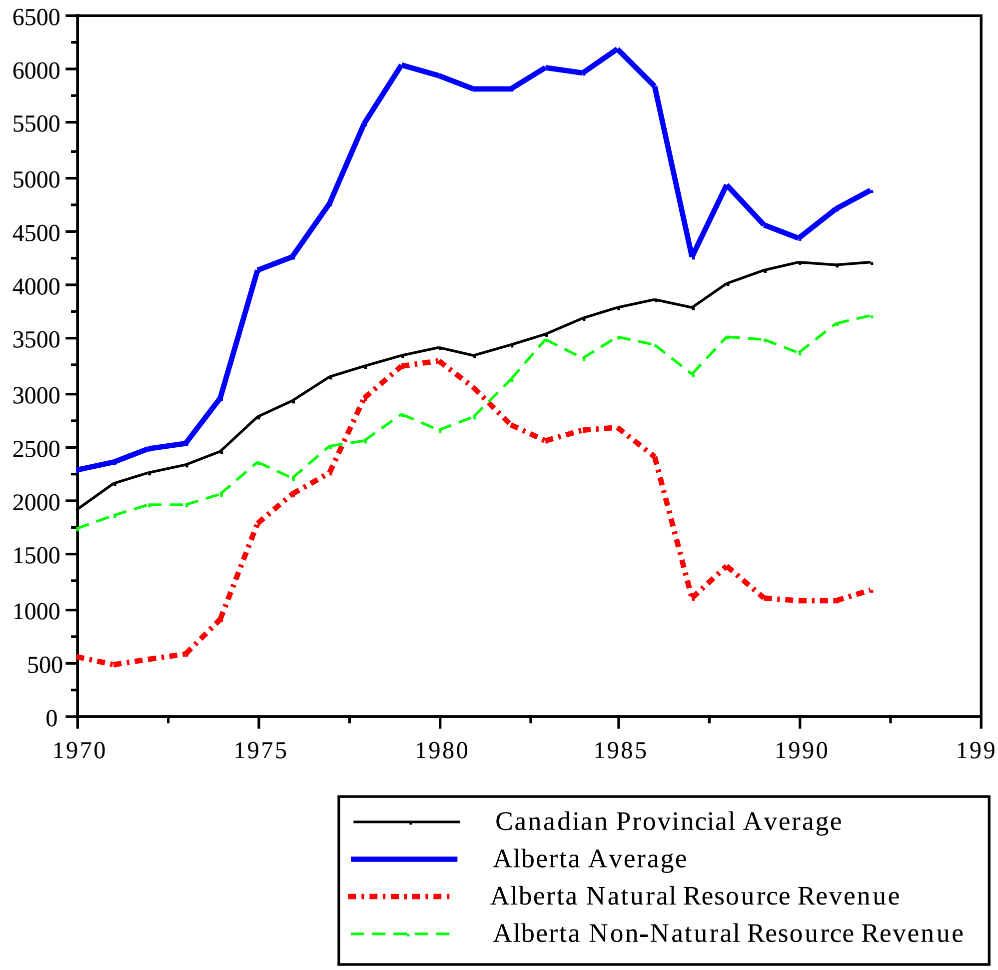
This section of the paper reviews the recent history of Alberta's provincial public finances with the aim of providing context for assessing our current fiscal predicament. We rely upon the Financial Management Series (FMS) provided by Statistics Canada. These data permit us to compare Alberta's fiscal 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 in 1991, 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 which lie ahead.

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.

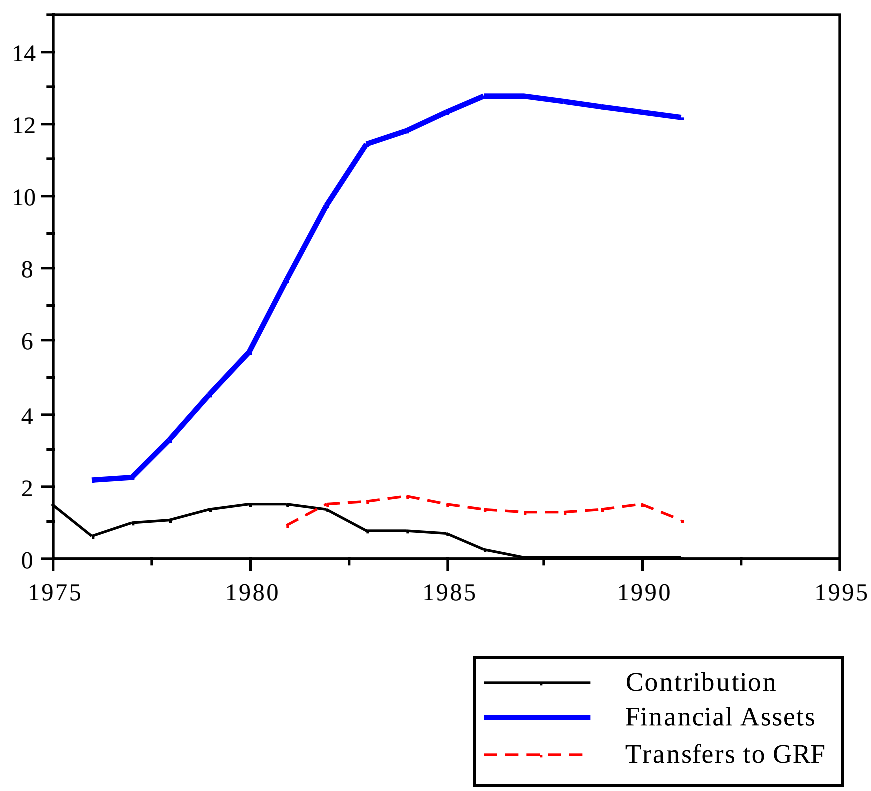
Alberta's provincial government per capita real revenues were $2274 in 1970, a level slightly higher than the all province average. The impact of the energy boom and bust clearly stand out. From 1974 to 1986 Alberta's per capita real revenues far exceed those of other provinces because of surging energy 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: $4866 for Alberta vs. $4192 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.

Figure 1
Provincial Real Per Capita Revenues
(1970-71 to 1990-91, 1986 Dollars)



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 that level. 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 75 percent of its value in 1986, the last year a contribution was made to it.

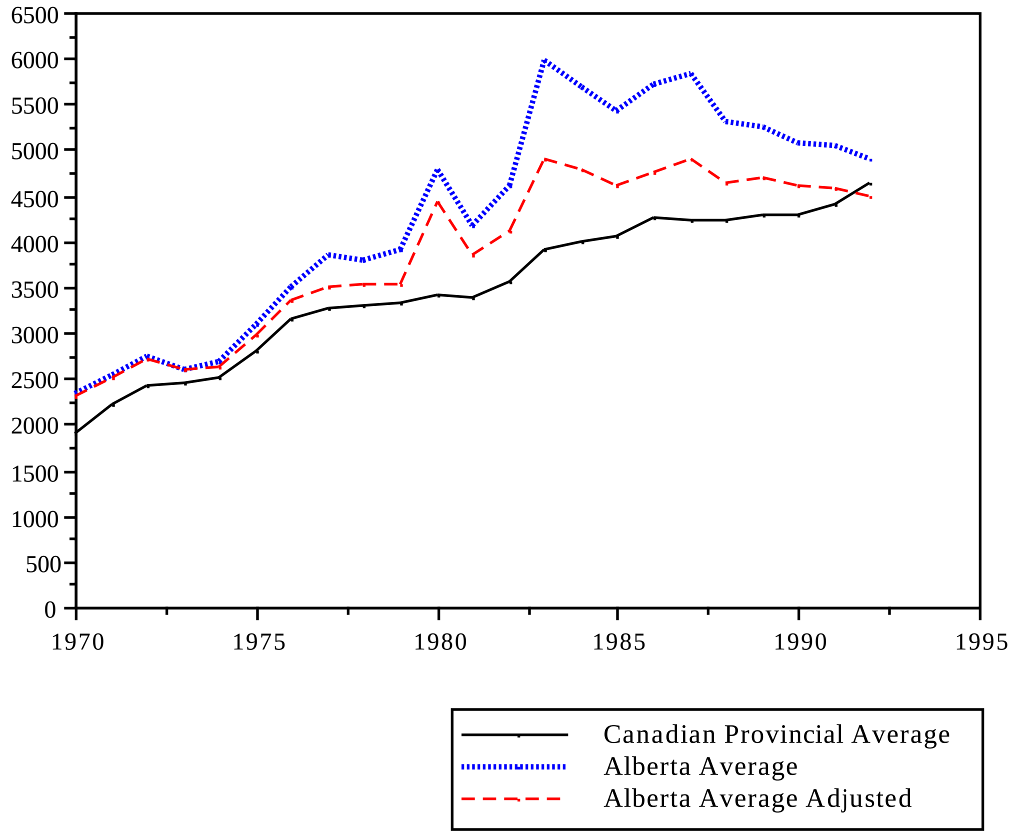
Figure 2
Alberta Heritage Savings Trust Fund
(Billions)



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 $4634 per capita for all provinces and from $2334 to $4883 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. Notice however, that the reduction in real expenditures per capita in time and amount lags significantly behind revenue declines thus creating the deficit problem that we discuss later.

Figure 3
Provincial Real Per Capita Expenditures
(1970-71 to 1992, 1986 Dollars)



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 Alberta spent $423 more per person in the expenditure category "resource conservation and industrial development" than other provinces: $647 versus $224 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: $4478 versus $4633. That is, in 1991-92 Alberta spent **less** per capita than the average of the Canadian provinces for a comparable set of services.

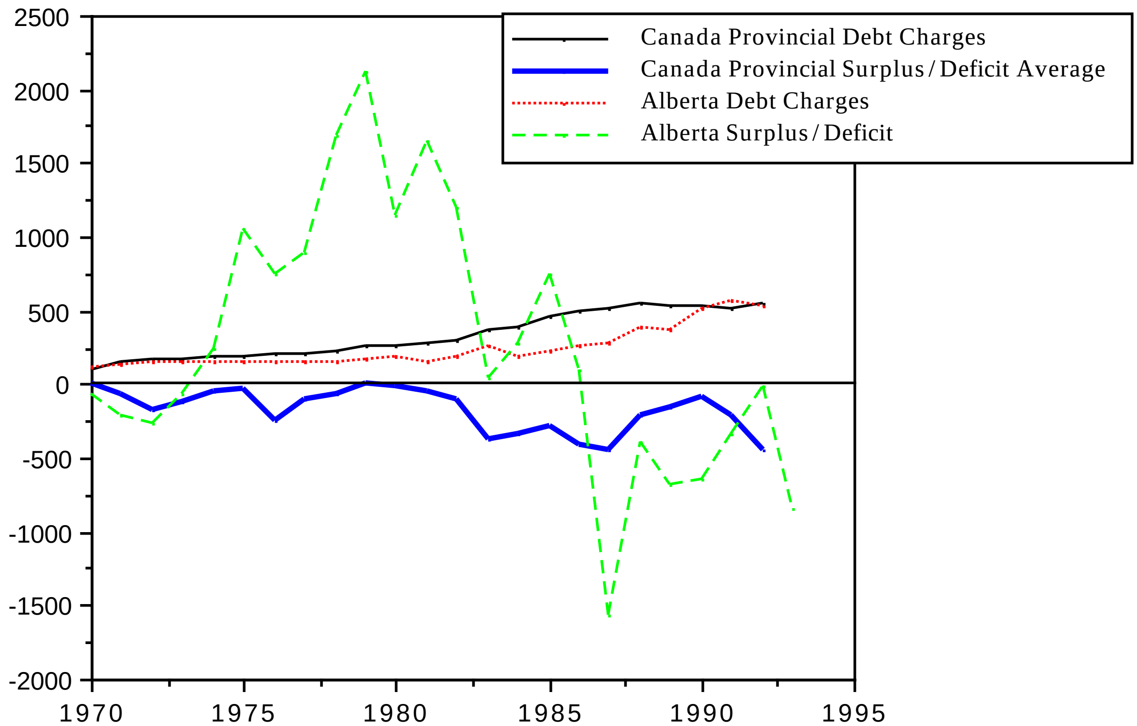
Provincial Expenditures and Local Government

A further consideration when comparing expenditures across provinces is that local government activities and funding varies among the provinces. In 1991, national consolidated provincial and local expenditures per person in 1991 dollars were $6539. Correcting for the difference in resource management and industrial development costs between Alberta and the average province ($527), comparable expenditures in Alberta were $6736, 3 percent greater. In comparison to the two other "have" provinces, Ontario and B.C., Alberta's expenditures were 5.5 and 12.0 percent larger respectively in 1991.

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.

Figure 4
Provincial Per Capita Real Deficit and Debt Servicing Costs
1970-71 to 1991-92 with 1992-93 Estimated
(1986 Dollars)



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 over $14 billion (or $5500 per person) in 1993. 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). In 1983 it rose to slightly less than $400 in real per capita terms and by 1990 it exceeded $500. It is now the fourth largest expenditure item, exceeded only by social services, education and health. As a result of recent large deficits, Alberta's per capita debt and debt servicing costs equalled by 1990 and now exceed the all province average.

Figure 5
Provincial Unmatured Debt - General Revenue Fund and Capital Fund
Billions

Figure 6
Provincial Debt Servicing Cost: GRF
Billions

Figure 6

What's Left: Debt versus the Alberta Heritage Fund

The size of Alberta's gross and net debt can be calculated various ways. Alberta's gross debt has accumulated from seven consecutive deficits including a forecast 1992-93 deficit of $2.8 billion (Treasury 1993, p. 12). The Auditor-General's estimate of the Province's unmatured debt at March 1992 is $17.4 billion (Auditor General, 1993, p. 38). This estimate, based on consolidated financial statements, excludes internal debt held by the AHSTF and other government entities and comprises only amounts owed by the government to third parties. Including the forecast 1992-93 deficit, Alberta's gross debt amounts to $20.1 billion or in per capita terms, $7960. This total does **not** include the Auditor General's estimate of current unfunded pension liability of $3.7 billion (Auditor General, 1993, p. 28) and other potential losses from existing loan guarantees and other contingent liabilities assumed by the provincial government.

The net debt is gross debt less the value of financial assets held by the Province such as in the AHSTF Fund. The Auditor General estimates the market value of external investments, including highly liquid and less liquid investments, at March 31, 1992 to be $8.0 billion. The market value inclusive of internal investments, government debentures

and market securities, presuming their value could be realized, is $12.7 billion (Auditor General, 1993, p. 40). Mumey (1993) in an independent review of the realizable market value of assets held by the AHSTF as of March 31, 1992 places its value at $9.1 billion.

Alberta's net debt as of March 31, 1993 using the published estimates of the Auditor General and Treasury (assuming the Alberta Heritage Savings Trust Fund at this year end is worth what is was last year and ignoring unfunded pension liabilities and other contingent liabilities) is $7.4 billion ($20.1 - $12.7). This estimate of net debt, the best case scenario, amounts to $2931 in per capita dollars for Albertans. A more conservative estimate (using realizable market value of AHSTF assets i.e. $20.1 - $9.1) is $11 billion or $4356 per person.

Albertans are fortunate but can only take modest comfort from the existence of the assets in the AHSTF. The AHSTF is not growing while the provincial deficit is not under control. The 1992-93 deficit is expected to be $500 million larger than had been planned. At $2.8 billion, the deficit is $1100 per person. Barring unforeseen and especially fortuitous circumstances, it will require strong collective will to balance the provincial budget within the next five years by which time the provincial debt could easily grow by 30 to 40 percent.

CHOICES: WHERE NEXT?

The deficit can be eliminated only by reducing expenditures, increasing revenues, or a combination of the two. We discuss in turn each of these options.

Expenditure Control

In its 1992 Budget, the Alberta government proposed a plan to deal with the structural deficit. The province's forecasts and the implications we draw from them are presented in Table 1. The plan looks at the fiscal position of the Province from 1992-93 to 1996-97. Revenues are forecast to rise at an optimistic rate of 5.27 percent and, in the absence of any "fiscal correction" or expenditure reduction, expenditures to increase at an annual rate of 2.37 percent. In order to balance the general revenue fund budget by 1996-97 under this plan, expenditures must be reduced by $1.1 billion. After this "correction", nominal expenditures are essentially constant across the four years, during which time, revenues catch up to expenditures and the deficit is eliminated.

Provincial deficits until 1996-97 continue to augment the debt and increase debt servicing costs. Combined general and capital funds unmatured debt is projected to increase to $19 billion, or by 57.1 percent, by 1996-97. Even if we assume that the average interest rate on the debt falls by 0.5 percent annually, the cost of servicing the debt will be $1.59 billion or 26.9 percent larger by 1996-97. This estimate does **not** incorporate the Auditor-General's estimate of gross debt of $17.4 billion at March 31, 1992.

Higher debt service costs reduce funds available for planned expenditures for the provision of goods and services by the provincial government; i.e. program expenditures. Fiscally corrected expenditures net of debt service costs fall to $11.85 billion in 1993-94 and remain steady at that level.

Once adjusted for inflation and population growth, real per capita program expenditures fall significantly over the years to 1996-97 (bottom of Table 1). If population growth is 1.5 percent, the Canadian average, and inflation were 2 percent, real per capita expenditures would fall by 3.5 percent annually or by 13.8 percent in 1996-97. Higher assumed rates of the total of inflation and population growth yield correspondingly large reductions in per capita real program expenditures by 1996-97; up to a 21.7 percent decline if the two combine to 6.0 percent. If the government is not successful in reducing debt carrying charges the projected reduction in real per capita expenditures range from 17 to 24 percent.

Although we live in a changing world, any of these possibilities would leave the level of program expenditures in Alberta in 1996-97 at the very best just equal to but, more generally, below that in any other province in Canada today. Starting from what is now an average level of provincial services, a potential cut in the order of 20 percent seems to be a reasonable projection and would leave services at a level likely to be well below those elsewhere in the country. Furthermore, success of the planned program would only balance the budget and would not begin to generate revenue to pay down the debt. For debt reduction, further significant expenditure cuts would be necessary.

The projected cuts to program expenditures follow already significant reductions. Since 1985-86, real (1986$) program spending per capita, using FMS budget data, has been reduced from $5600 to $4600 in 1991-92. This decline speaks well of the Alberta government's expenditure control efforts. To date, expenditure control has brought us from an exceptionally high level of per capita services to an about an average level

Table 1
Government of Alberta Budget Forecast and Fiscal Implications
(millions of dollars)

(although Albertans still benefit from living off the depreciation of a large, high-quality stock of public infrastructure). Will the next 15 to 20 percent reductions required to eliminate the deficit be accepted readily, especially since the easier reductions are likely behind us? Besides, to actually begin to pay off the debt would require additional major expenditure cuts.

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. Again, these data are on an FMS accounting basis and so are comparable among provinces. The per capita dollar amounts are interesting. Per capita taxes borne by firms and individuals are low in Alberta; at $2441 in 1991-92, they are almost $1000 less than the provincial average. Despite this, the contribution from natural resource revenues and investment income push provincial total per capita revenue in the Province $904 above the national provincial average. Recall, however, that this difference is in large part offset by the additional $530 per capita expenditure for resource conservation and industrial development incurred by Alberta relative to other provinces. Overall, in 1991-92, Alberta raised only 38.6 percent of provincial revenues from taxes while other provinces relied upon taxes for 63.2 percent.

The potential to raise additional revenue through taxation depends very much upon how much Alberta currently taxes its existing tax base. Do we 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. The latest data on taxes are only available for 1990-91. 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 average 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. Thus, one of the avenues for addressing the deficit is to consider tax increases.

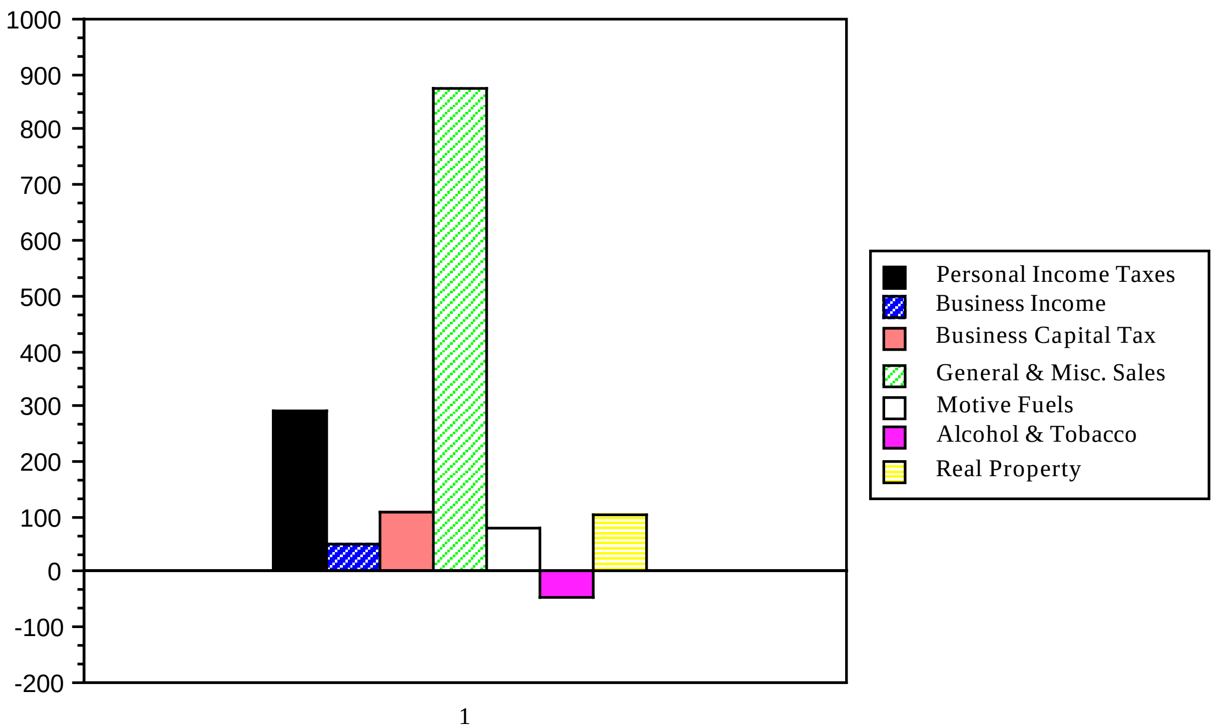
Table 2
Provincial Taxes and Revenues, 1991-92

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

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

Figure 7 shows the additional tax revenues that could be generated from simply imposing taxes at the all province average rates in Alberta. 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 effective rate) $871 per capita or about $2.2 billion would be raised.

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



Thus looking simply from the revenue side only, a relatively moderate level of sales tax could handle the structural component 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 side possibilities is feasible and enhances 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.

WHAT ABOUT THE HERITAGE SAVINGS TRUST FUND?

Should the fund be retained? A recent paper has concluded that the economic impact of the Fund has been limited and that its current role is simply to finance ordinary government expenditures (Warrack 1992). 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. The net debt position of the Province would remain unchanged.

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. 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 saddled with an ongoing structural deficit.

POLICY OPTIONS AND THE FISCAL STATUS QUO

The evidence clearly suggests that Alberta has a structural deficit of at least $2 to $2.2 billion for realistic energy price and economic growth projections. This structural deficit combined with accumulating debt servicing requirements of the growing stock of debt implies, with no change in expenditures and revenues, an increasing structural deficit through time. Clearly this option is not sustainable. Rising debt and debt servicing requirements would bring, in the short to medium term, a lowering of the Province's debt rating and even greater debt servicing costs. This dynamic implies 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 make even more unrealistic a "do nothing" policy response of freezing expenditures and taxes at current levels. An aging population is going to put further upward pressure on health care expenditures. On the revenue side 20.9 percent of the 1992-93 forecast 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 which may or may not be offset by higher revenues from natural gas sales. Payments from the Government of Canada make up 15.4 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 provinces, especially the "have" provinces. Income from the AHSTF is 9.5 percent of provincial revenues but in the absence of capital infusions the fund cannot sustain this level of investment income, especially as inflation erodes its purchasing power. In total, 45.8 percent of the forecast revenue base of the Province in 1992-93 may decline in real value in the coming years. This possibility could only further exacerbate the existing structural deficit.

Our consideration of options must be in the context of the following fiscal realities identified above:

Reality #1 Alberta is a net debtor with net debt equal to at least $7.4 billion. The assets of the AHSTF are more than offset by liabilities of the provincial government; investment income consequently is less than debt servicing requirements.

Reality #2 Alberta's structural deficit is unsustainable. For 1992-93, the deficit of $2.8 billion or $1100 per capita (or $3900 per family) amounts to approximately 20 percent of expenditures and 25 percent of revenue.

Reality #3 The likelihood of a declining real value of almost half of the provincial government's revenue base means that the structural deficit will increase significantly in the absence of fiscal reforms by the provincial government involving either expenditure reduction or revenue (tax) increases or both.

Reality #4 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. That is, Albertans now receive an average level of services from their provincial government. Alone, the expenditure cuts necessary to balance the budget and then to pay off the accumulated debt would necessitate a further reduction in the order of 25 percent (or perhaps more).

Reality #5 The evidence on provincial government revenues and its tax base shows that 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.

Choices and Challenges

We noted earlier that the Province's structural deficit could be eliminated and a move towards pay-down of the stock of debt accomplished by provincial government expenditure reductions, revenue increases, or some combination thereof. The evidence to us is compelling that an approach involving the following elements is essential if we are to control the deficit and cap our burgeoning debt.

1. Expenditure Reduction Alone Unlikely to be Enough. Although it is "politically correct" to focus solely on expenditure reduction, it must be borne in mind that once Alberta's expenditures are adjusted for spending on its resource base, per capita spending in real terms on programs was below the national average in 1991-92. Reducing program expenditures by $2 to $2.2 billion below their current nominal levels could represent a 20 percent decrease in services and, in per capita real terms, move Alberta to the bottom among provinces even before allowing funds for debt reduction itself. Services in education, health care and social services would reflect this fiscal reality.

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 tax effort to the national average on all tax bases but not impose a provincial sales tax, 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, in 1990 would have yielded $1.6 billion. The alternative, that of increasing tax effort in the Province, based on data for 1990-91, to the all province average would have raised approximately $1.6 billion. 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, the remainder of the structural deficit, approximately, $400 to $600 million, could be met by expenditure cuts phased in over the course of two to three years. The expenditure cuts should precede or be concurrent with the revenue enhancing measures adopted. While, for illustration, we propose meeting approximately three-quarters of the deficit through tax effort equivalent to the all province average level excluding provincial sales taxation, and one-quarter through further expenditure reductions, Albertans may prefer some other division between the two but we anticipate that they will prefer to utilize both approaches.

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. The residual Alberta debt servicing costs would be funded out of general revenues as efforts were focused on elimination of the structural deficit. The Province has the capacity to carry this debt load if the source of debt growth, the structural deficit, is eliminated.

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