# HEDGING OUR BETS

## Making the Case for Saving Alberta's Natural Resource Revenues

Economic & Fiscal Policy
DIVISION

RESEARCH REPORT

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Canada West
FOUNDATION

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## CANADA WEST FOUNDATION

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Canada West FOUNDATION | Economic & Fiscal Policy DIVISION

**The Economic & Fiscal Policy Division** analyzes and comments on economic developments in western Canada, and focuses on the broad and emerging economic, social and fiscal issues facing the West.

# EXECUTIVE SUMMARY

Alberta's vast resource wealth has made it among the most prosperous jurisdictions in the world. Yet for as long as we continue to sell our natural assets to pay for today's needs, our future prosperity will be in doubt. The Alberta government needs to resume setting aside and investing a significant share of its resource revenues. Only in this way can we ensure that our current prosperity is sustainable.

### The Imperative to Save

Past efforts to save resource revenues in Alberta were motivated by the belief that the province would one day run out of oil and gas. That is no longer a concern; we now know there is enough recoverable oil in the province to last for generations.

However, the presence of vast oil reserves does not diminish the urgency to save. Any one of several political, social or economic factors could have a profound effect on future demand for Alberta's crude oil, causing the flow of resource revenues to dry up:

- → Alberta is a relatively high-cost producer, making it vulnerable to a sustained drop in oil prices.
- → Failure to achieve or maintain social licence could erode markets for oil sands output.
- → Booming production of shale oil in the US, combined with flat petroleum demand, could undermine access to our biggest market.
- → Technological innovation could see oil largely replaced as a transportation fuel within a generation or two.

These risks are not an imminent threat to our current prosperity, but they do speak to the fact that we cannot count on resource revenues to backstop government spending indefinitely. The prudent response in the face of this uncertainty is to once again begin setting aside resource revenues for the future.

## The Reasons to Save

Besides insulating Alberta against the risks in an uncertain future, there are two basic reasons to save.

- **Intergenerational equity**. The oil and gas that lies under our feet belongs not just to us but to the next generation of Albertans as well. As stewards of those resources, Albertans have a responsibility to cultivate that wealth for the future by converting the one-time sale of our natural assets into a lasting benefit.
- **Addressing revenue volatility**. It is extraordinarily difficult for the provincial government to consistently fund programs or engage in long-term strategic planning when 30% of its revenues come from resource income which is notoriously volatile and unpredictable. A well-constructed savings plan eliminates much of that uncertainty, making it easier to mitigate the impact of the resource boom/bust cycle.

## The Objective of a Savings Plan

Twenty years ago, Albertans accepted the sacrifices necessary to balance the budget and eliminated the provincial debt. The motivation was the promise of freedom from financial liability. The reward was an annual benefit of $1.4 billion in interest payments that no longer have to be made. Effective stewardship of resource windfalls made it all possible.

Saving our resource revenues will also require sacrifice: specifically, foregoing the benefits of spending that money now. Albertans will be far more likely to accept the need to do so if they are presented with a compelling or inspiring objective – something they agree is worth the sacrifice and effort it will take to achieve.

There are numerous possible goals for a savings plan. The proceeds from savings could be used to eliminate the provincial income tax. They could finance annual dividend payments to Albertans, as is the case in Alaska. They could be used to make Alberta a world leader in environmental innovation technologies. They could be used to finance an endowment to our post-secondary institutions. The list goes on.

Albertans and their government will need to debate and discuss the alternatives and settle on an overarching purpose before embarking on a savings plan. This is a critical step if such a plan is to win broad public support.

## Issues and Challenges

Saving at least a portion of our resource revenue may be the right thing to do, but doing the right thing is seldom easy. Alberta's policy landscape is littered with the corpses of savings plans and proposals that have failed, were rejected or ignored outright. We need to be wary of the pitfalls that prevented those efforts from succeeding.

Perhaps the most important of these pitfalls is the tendency for both governments and individuals to value short-term desires over longer-term interests. Another is the fact that resource revenues allow Alberta taxpayers to pay only 70 cents for every dollar of government services they receive. The transition to a savings plan will require taxpayers to recalibrate their expectations about the cost of government.

An additional challenge is that some Albertans have a lingering mistrust of government as an effective steward of our resource wealth. Finally, there are concerns that building up a large and conspicuous sovereign wealth fund creates a risk that the federal government could redistribute or appropriate some of those funds.

## Next Steps

Ultimately, it is up to Albertans to decide if the benefits of savings outweigh the risks and the immediate costs. This speaks to the need for proponents to develop a clear and compelling vision for a savings plan. It also means engaging in an open dialogue with Albertans about the specifics of such a plan and the steps along the way.

A host of questions need to be articulated, debated and settled before proceeding. These questions include determining how much to set aside, to what purpose funds would be directed and how the transition would take place.

The Canada West Foundation's view is that Albertans need to boldly step forward and commit to a plan that secures today's prosperity for tomorrow and beyond. It is time to take responsibility and make the hard choices necessary to ensure that the value of our resources lasts beyond the point when the last barrel of oil is sold. The legacy of that wealth should be more than a dim memory of more opulent times. It should be a sustainable and prosperous Alberta.

## INTRODUCTION

# Thanks to its vast resource wealth, Alberta is one of the most prosperous jurisdictions in the world. There may be enough oil in the ground to last for generations, but there are compelling and even urgent reasons to begin today setting aside resource revenues for the future. Albertans and their government need to unite behind this goal and make a sustained commitment to saving. Our future depends on it.

Albertans might be forgiven for thinking that now is a particularly bad time to reopen the discussion on saving our resource revenues. Last year, the province posted a $2.8 billion fiscal shortfall. This year's budget projected a $4.8 billion decrease in Alberta's net financial asset position. And that was before record floods devastated southern Alberta, the recovery from which will cost billions.

Albertans might also be forgiven for thinking they have heard this song before. For decades, there has been a seemingly never-ending series of debates, discussions, studies, plans, strategies, commissions and council reports looking at the issue of what Alberta should do with its non-renewable resource revenues. While many insights and compelling ideas have been proposed along the way, we have been unsuccessful at adopting a plan and sticking with it. It seems as if each new study is a substitute for actual progress.

So why are we bringing this up again? What makes this attempt any different?

First of all, the Alberta government has made it clear that its interest in the savings issue is not mere lip service. Despite a significant deficit, the province's 2013 budget contained the first serious attempt in 25 years to begin regularly setting aside non-renewable resource revenue for long-term savings. It also included a commitment to address short-term volatility by rebuilding its financial buffer to guard against unexpected shortfalls in resource revenues.

In addition, the Alberta government has committed to engage Albertans in an open dialogue about the province's economic and fiscal issues. The Alberta Economic Summit in January convened thought leaders and other Albertans to discuss the budget challenges facing the province, while the Forecasting and Fiscal Planning Summit in July brought together economic experts to discuss the revenue side of the equation in more detail.

Finally, after decades of false starts and failed attempts, there is a dawning realization that there will never be a right time to begin saving for the future. There will always be a persuasive reason to put off savings and deal with more immediate needs, whether it be flood-related reconstruction, eliminating the deficit, coping with economic downturns, addressing long hospital wait times, or fixing leaky school roofs.

Those challenges should not be dismissed, but we need to stop fixating on short-term concerns at the expense of our future. Today's generation of Albertans benefits tremendously from the province's resource wealth. We pay low taxes, enjoy high levels of government services and make up the gap between the two by selling our natural resource assets. This is not sustainable.

It is time to take responsibility and make the hard choices necessary to ensure that our resource wealth is available for future generations. The legacy of that wealth should be more than a dim memory of more opulent times. It should be a sustainable and prosperous Alberta.

BACKGROUND

# PAST EFFORTS TO SAVE NON-RENEWABLE RESOURCE REVENUES IN ALBERTA

Albertans have seen this movie before. Since the creation of the Alberta Heritage Savings Trust Fund, governments have made numerous attempts to use resource revenues to generate long-term benefits. Some efforts have been more successful than others.

## 1

### The Alberta Heritage Savings Trust Fund

The Heritage Fund was created in 1976 out of concern that the province's supply of oil and gas would eventually run out and that some of the proceeds should be invested for the benefit of future generations of Albertans. Initially, the province deposited 30% of all non-renewable resource revenue into the fund and re-invested all accrued income, less some spending on approved capital projects.

In the mid-1980s, the province scaled back annual contributions to 15% of resource revenues and announced that income generated by the Fund would no longer be re-invested, but transferred to general revenues. A few years later, the Alberta government stopped making deposits in the Fund altogether. All resource-related income, including proceeds from Heritage Fund investments, would go to general revenues. At the time, the Heritage Fund held $12.7 billion in assets.

Over the next several years, the province not only transferred Heritage Fund income to general revenues, it also continued to draw down some of the Fund's principal to finance capital projects. By 1994-95, the value of the Heritage Fund had fallen to $11.8 billion.

Beginning in 1996, Alberta made sporadic attempts to re-invest some income back into the Fund to offset the effects of inflation. However, if the Fund lost money in a given year, it was allowed to shrink.

## 2

### 1993-2005: Eliminating the Debt

Although it does not qualify as a direct savings plan, government policy in the 1990s to eliminate the provincial debt could indirectly be considered as such. Where the Heritage Fund invests non-renewable resource revenues to generate an income stream for the Alberta government, debt repayment produced the same result, but from the opposite direction – reducing the province's unproductive spending obligations. Money that had gone to interest payments on the debt would be freed up for more beneficial purposes.

The original plan in 1993 was to balance the budget by 1996-97 through a series of fairly dramatic expenditure cuts. Once the budget was balanced, future surpluses would be used to gradually reduce the provincial debt. The government committed to fully repaying the debt by 2025.

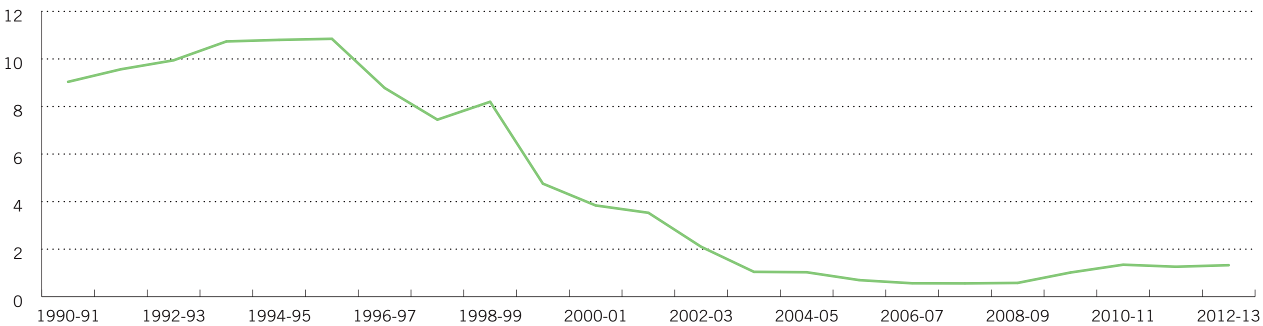
However, the debt repayment timeline was accelerated considerably by a series of resource revenue windfalls in the early 2000s. These windfalls generated large government surpluses which were applied against the provincial debt. As a result, the debt was eliminated twenty years ahead of schedule.

At its peak in 1993-94, the provincial government owed $22.7 billion. Nearly 11 cents of every dollar in revenues ($1.7 billion) had to go to paying the interest on that debt. Fast-forward to today and debt-servicing costs are just $500 million – 1.3 cents per dollar of revenue.[1] By using resource revenues to pay down the debt, the Alberta government has freed up $1.2 billion every year that can now be used for other purposes.

[1] Even though the province has eliminated its net debt, it still has some debt obligations requiring interest payments. However, the value of these debts is more than offset by financial asset holdings.

**ELIMINATING THE DEBT REDUCED UNPRODUCTIVE SPENDING OBLIGATIONS**

Debt-servicing costs (as a % of total revenue)




Source: Canada West Foundation calculations using data from Alberta Finance

3

## 2003-2013: New Savings Initiatives

In its 2003 budget, the provincial government introduced a new savings plan for resource revenues – the Alberta Sustainability Fund. The purpose of the fund was to act as a financial cushion to guard against future shortfalls in highly volatile energy revenues.

Under the new plan, the government would spend the first $3.5 billion it received in resource revenues, but any amount in excess of $3.5 billion would go directly into the Sustainability Fund.[2] By 2008-09, the Sustainability Fund was valued at $16.8 billion.[3]

Not long after the Sustainability Fund was created, the Alberta government began to make its first new investments into the Heritage Fund in nearly 20 years. Over three years, beginning in 2005-06, the Alberta government deposited $3.9 billion into the Fund, and began to retain some of its net earnings to offset the effects of inflation. The value of the Heritage Fund climbed to $16.4 billion.

These efforts came to an abrupt halt in 2008-09 when the global economic and financial crisis hit. The Heritage Fund sustained heavy losses that year and budget deficits prompted the government to draw down its Sustainability Fund. Successive budget deficits reduced the value of the Sustainability Fund to $3.3 billion by 2012-13.

4

## Beyond 2013

In its 2013 budget, the provincial government took the first step toward a new savings plan for Alberta. It included a plan to rebuild the Heritage Fund, as well as the creation of a new Contingency Account to replace the nearly-depleted Sustainability Fund.

The Contingency Account serves the same basic purpose as its predecessor – to insulate the province against sudden revenue shortfalls. Specifically, it will be used to cover any deficit in the province's operational balance. To build the Account to its target size of about $5 billion, the province will set aside a certain amount of non-renewable resource revenues every year, beginning in 2014-15:

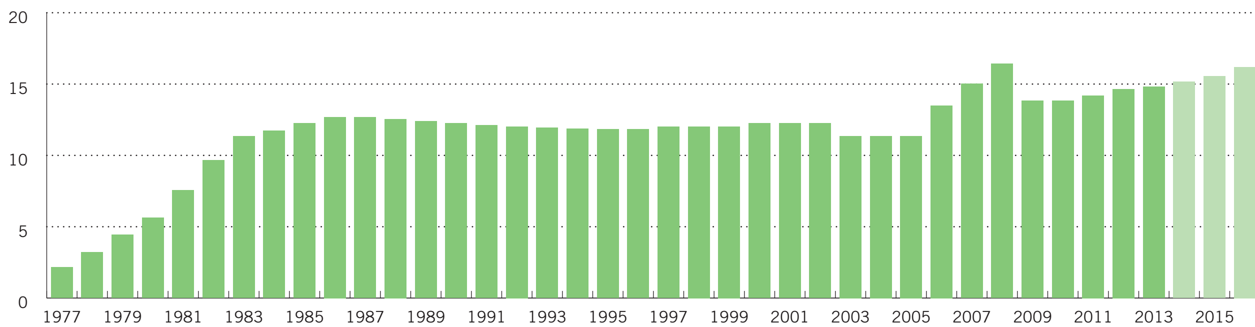
**5%**
of the first $10 billion;

**25%**
of the next $5 billion; and,

**50%**
of any amount over $15 billion.

[2] By the 2006 budget, the threshold had increased to $5.3 billion.
[3] This total includes $7.0 billion in the province's Capital Account, which was absorbed into the Sustainability Fund the following year.

**AFTER DECADES OF STAGNATION, MODEST GROWTH IN THE HERITAGE FUND PROJECTED**
Value of the Heritage Fund ($ billions)




Sources: *Alberta Heritage Savings Trust Fund Annual Report 2012-13*, Alberta Budget 2013
Note: Figures refer to fiscal year-end fund equity at cost

The plan to rebuild the Heritage Fund has two components. First, beginning next year, the government will retain 30% of Fund earnings, rising to 100% by 2017-18. Second, once the Contingency Account reaches $5.0 billion, future set-aside revenues from natural resources will be deposited into the Heritage Fund or some other endowment fund.

# THE IMPERATIVE TO SAVE

Early efforts to save resource revenues were motivated by concerns that Alberta would run out of oil and gas. Today, we know we have enough oil to last hundreds of years. So why do we even need to worry about setting aside royalty revenues?

When the Heritage Fund was created, there was a widespread belief that Alberta's oil and gas boom was temporary and that the province did not have more than a few decades of recoverable supply. Since then, however, production has soared, while exploration and technological innovation have opened up the vast potential in the oil sands.

Now, Alberta is awash in recoverable petroleum. The oil sands hold the third largest proven reserves in the world behind only Saudi Arabia and Venezuela. At current production rates, there is enough oil in the province to last more than 250 years. More remarkable still, that total includes only the 9% of crude bitumen considered to be recoverable using currently-available technologies. Further innovation and technological advances could unlock even more of that potential. Clearly, running out of oil is no longer a pressing concern.

The concern today is that political, social or economic forces could dramatically affect the future of Alberta's oil industry. Any one of several possible developments could undercut the viability of oil and gas extraction in the province and cause the flow of resource royalties to the Alberta government to dry up. These factors include:

- **Booming US oil production.** More than three quarters of the oil produced in Alberta is exported to the United States. However, shale oil production in the US is soaring and North American demand has been flat, meaning that the need for foreign oil in the US is declining rapidly. The market for Alberta's oil will not evaporate overnight, but future growth prospects are definitely at risk, especially if access to offshore markets is not improved.
- **Opposition to the oil sands.** Over the years, Alberta's oil sands have become a lightning rod in an international debate about the environmental costs of fossil fuel extraction. Opposition to pipeline projects – including Northern Gateway and Keystone XL – is motivated in large part by the desire to limit or stop oil sands development. Recent efforts by the EU to label oil sands crude as "dirty" oil, and attempts by US companies and some municipalities to boycott oil sands crude all speak to the same goal. This opposition is a risk to the long-term future of the industry and, consequently, to the Alberta government's ability to collect royalties.
- **Breakthrough in alternative fuel technologies.** Just because Alberta has vast oil supplies does not mean that demand for oil will always be there. Crude oil is used today mainly as a transportation fuel. However, companies and researchers are constantly looking for ways to improve fuel efficiency and explore more environmentally-friendly alternatives. Technological breakthroughs in battery power, alternative fuel sources or even the use of natural gas as a transportation fuel could dramatically undercut oil demand. These innovations need not eliminate the need for crude oil entirely to have an impact on Alberta. They need only to reduce demand and drag prices down to the point where oil sands recovery no longer makes economic sense.
- **Alberta is a high-cost producer.** It costs more, on average, to recover a barrel of oil from the oil sands than from most other deposits around the world. Alberta producers thus require relatively high world prices in order to be profitable. Our oil industry is thus among the most vulnerable. A slowdown in world oil demand could very quickly cause oil prices to drop and put Alberta's industry at risk.

There are, of course, strategic responses and other factors that could mitigate these risks. Asian demand could drive the industry well into the future. Environmental breakthroughs or process innovations could even secure the future of Alberta's oil industry for generations to come.

However, these possibilities do not eliminate the risks that come with spending our resource revenues on current needs and wishes. There may be no shortage of oil in the ground and the industry will certainly not disappear overnight. But at the same time, there is no way of knowing just how much of our oil can be developed and sold, or when the flow of resource revenues to the government will dry up. Reducing our dependence on resource revenues to fund basic services lessens that risk. Saving that money allows the fiscal benefits to extend well beyond the economic lifespan of the resource.

# THE REASONS TO SAVE

Saving our resource wealth does more than just insulate Alberta against the risks in an uncertain future. It helps fulfil our moral obligation to our children and provides clear benefits to both the present and future generations of Albertans.

It is easy to view the idea of saving resource revenues as imposing a cost on the current generation of Albertans. And there unquestionably will be costs: we are asking Albertans to forego some of the government's capacity to spend money today in order to secure a better future. But there are important benefits to saving as well – benefits that outweigh the temporary inconvenience of enduring higher taxes or slower growth in government spending.

**WITHOUT ACCESS TO RESOURCE REVENUES,** future Albertans will not be able to afford the same combination of low taxes and government services we enjoy today. We owe it to the next generation of Albertans to have the same options available to them as we have to us.

## 1

## Intergenerational equity: Creating a lasting benefit from the one-time sale of an asset

The oil that lies under our feet belongs not just to this generation of Albertans but to our children as well. Albertans have a responsibility as stewards of that resource to ensure that future generations benefit from our non-renewable resource wealth.

The Alberta government's efforts to use resource windfalls to eliminate the provincial debt in the 1990s were a step in this direction. Eliminating the debt freed up the money spent on debt-servicing costs, allowing it to be put to more productive purposes. So long as the government does not allow the debt to build up again, that money will continue to be available in perpetuity.

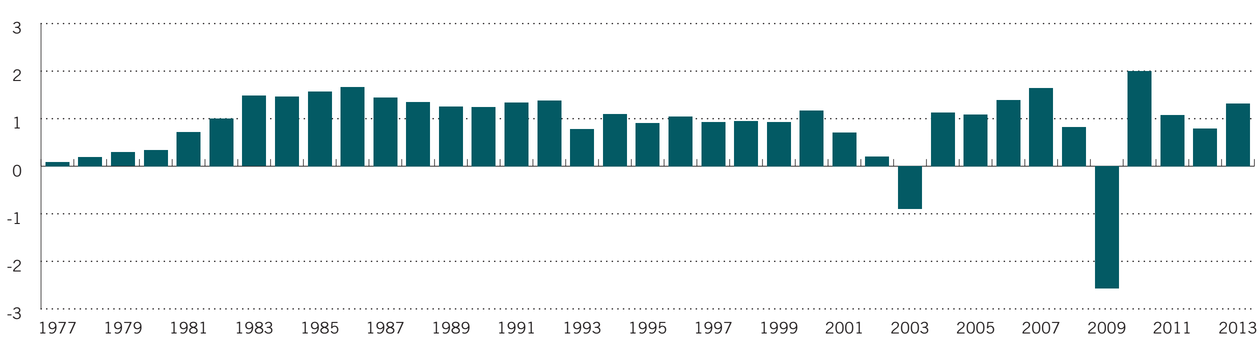
Today, Alberta uses most of its resource money for current spending and to keep taxes low. Undeniably, this policy is beneficial to the current generation of Albertans. It contributes to strong economic growth, investment and high-quality government services. Yet it also means that we can only afford those things because we are underwriting their cost with the sale of our natural assets. This is not a sustainable legacy to pass on.

Without access to resource revenues, future Albertans will not be able to afford the same combination of low taxes and government services we enjoy today. We owe it to the next generation of Albertans to have the same options available to them as we have to us. Otherwise, we risk that the prosperity we pass along to our children is a fleeting illusion.

In some ways, a barrel of oil is like a treasure chest buried under the Alberta government's home. It has no value in the ground beyond the anticipated revenue from its future sale. Once dug up and sold, however, it is gone forever.

**THE HERITAGE FUND PROVIDES AN IMPORTANT REVENUE STREAM FOR ALBERTA**

Annual income from the Heritage Fund ($ billions)




Source: *Alberta Heritage Savings Trust Fund Annual Report 2012-13*

**ON NINE OCCASIONS IN THE PAST 17 YEARS,** resource revenues in Alberta have either risen or fallen by more than 30% compared to the previous year.

This highlights the critical importance of converting the proceeds from the one-time sale of our resource assets into a lasting benefit for Albertans. It is the difference between using the treasure to buy groceries or selling it and investing the money. In the former case, the value of the treasure is gone once the food is eaten. In the latter, it lives on forever in the form of dividends and interest payments.

The Heritage Fund is an example of this kind of benefit. The Alberta government has invested only a small fraction of its resource revenues into the Heritage Fund over the years. But even so, it earns about $1.3 billion every year in income from its investments. That's $1.3 billion the government does not have to raise through taxes or fees (Figure 2). Additional investments in the Heritage Fund will make this income stream even larger.

A financial instrument has the advantage of giving future Albertans the freedom to make their own decisions on how to spend the income. However, this is not the only way to generate lasting benefits from the sale of our natural resource assets. The other option is to use the money to make targeted investments that have a long-term value – such as major public works projects. It is up to Albertans and their government to decide which option, or combination of options, is the best choice.

## 2

## Reducing government exposure to volatility

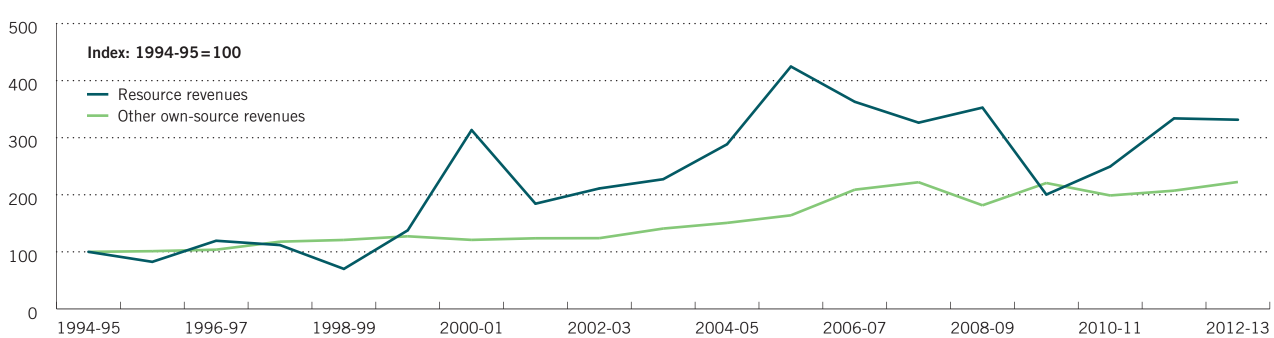
Non-renewable resources are a significant source of income for the Alberta government. On average, they have accounted for 29% of the province's own-source revenues over the past five years.

While these revenues give the Alberta government the fiscal room to pursue all sorts of policies that would otherwise be unaffordable, they are also notoriously volatile and unpredictable. That leaves Alberta vulnerable to massive unexpected fluctuations in income from one year to the next. On nine occasions in the past 17 years, resource revenues in Alberta have either risen or fallen by more than 30% compared to the previous year.

Albertans do not have to look very far back for a reminder of what this volatility can mean. In the 2012 budget, the provincial government expected resource revenues in 2012-13 to be approximately unchanged from the previous year. In fact, those revenues fell by 35%, causing a projected budget deficit of $886 million to balloon to $2.8 billion.

**RESOURCE REVENUES ARE FAR MORE VOLATILE THAN OTHER REVENUE SOURCES**

Growth in Alberta government revenues (year over year)




Source: Canada West Foundation calculations using data from Alberta Finance

Such heavy reliance on such a volatile revenue source creates major challenges for governments. First, it makes it difficult to finance ongoing programs and operations at a reasonably consistent level. Government spending becomes erratic or the public accepts wide swings in budget balances to be the norm.

Second, it raises the cost of government services. Resource windfalls erode the government's position in contract negotiations and encourage provincial employees to demand higher salaries. This results in more generous wage settlements in boom times; governments end up paying more to deliver services without increasing the actual level of services provided.

However, when resource revenues fall, those wage settlements cannot be rolled back. The only way to reduce costs is to decrease the level of services. But, since earlier wage settlements made those services more expensive to provide, the end result is that Albertans end up paying more to receive less.

Finally, it is extraordinarily difficult for governments to make long-term strategic plans when they face a highly inconsistent revenue stream. Governments cannot easily commit to stable and predictable funding over an extended timeframe if they have no confidence that the money will be there when needed. Strategic plans may be frequently aborted partway through because the necessary funding suddenly dried up.

The Sustainability Fund and the new Contingency Account are recent attempts by the Alberta government to address volatility by building in a buffer to protect against unexpected revenue swings. However, those efforts focus on the symptoms of the ailment and not the cause.

The long-term solution is to wean Alberta off its reliance on using resource revenues to fund current spending. Saving those funds removes the most unpredictable components from the government's revenue base while also building up a stock of wealth that can be allocated to long-term strategic purposes.[4]

[4] It is worth noting that the income that comes from resource-savings instruments like the Heritage Fund is itself quite volatile. However, that volatility is easily addressed by placing limits and conditions on how much can be transferred to general revenues in any given year.

# THE OBJECTIVE OF A SAVINGS PLAN

The inescapable truth is that a savings plan requires Albertans to forego some of the present-day benefits associated with resource revenues. For such a plan to be successful it must offer an attractive goal – something Albertans agree is worth the sacrifice and effort it will take to achieve.

Implementing a savings plan will impose costs on Albertans. We will be asked to make a sacrifice today – to pay more in taxes and/or forego growth in government spending – in order to generate a benefit tomorrow and beyond. Not all Albertans will live to see the full realization of that benefit.

The reasons for saving identified above – intergenerational equity and reducing volatility – are critically important, but are not likely to inspire Albertans or capture their imagination. They need a compelling objective if they are to buy in to this undertaking.

Past research by the Canada West Foundation has made clear that Albertans are not attracted by a passive strategy. Saving for the sake of saving or to prepare for some ill-defined "rainy day" are not sufficient reasons to forego resource income in the short term. Indeed, the very notion of building a rainy day fund should be rejected out of hand for the simple reason that no one knows what that actually means.

By contrast, there is a strong appetite within the province for capturing the transformative potential of natural resource wealth. There are two general ways this potential can be harnessed. The first is to invest the money into the Heritage Fund or some comparable instrument. As the fund grows, the income it generates grows as well. This permanent revenue stream can then be earmarked for specific purposes. The second approach is to spend resource revenues on specific projects or initiatives that yield a lasting economic or social benefit.

In either case, it will not take as long to see the benefit of resource savings as some may think. Even if it takes several decades to build a sovereign wealth fund to its desired level, the value of the larger income stream will become apparent within a few years. In the case of using revenues to finance specific investment projects, the benefits could appear even sooner.

**THE VERY NOTION OF BUILDING A RAINY DAY FUND** should be rejected out of hand for the simple reason that no one knows what that actually means.

Whether funded through investment revenues or direct spending, there is a tremendous range of possible goals for a savings plan. Some options include:

- **An Alberta pension plan.** The Heritage Fund or some other investment vehicle could be used to finance a pension plan for all retired Albertans.
- **Dividend payments to Albertans.** A portion of the income from saved resource revenues could be distributed to Albertans as an annual dividend payment. Such a program exists in Alaska, where roughly half of the annual income from the Permanent Fund is distributed to state residents (the rest is re-invested back into the Fund). Each Alaska resident received $900 in 2013.
- **Economic diversification initiatives.** One of the original intents of the Heritage Fund was to invest some of the income to support economic diversification in Alberta and wean the province off its dependence on the energy sector. Economic diversification developed a bad reputation in some subsequent years because of past high-profile failures. More recent thinking has recognized that diversification remains a worthy goal in Alberta, but it needs to be rooted in our natural resource base. Investment in carbon-reduction technologies, new extraction methods or downstream activities could simultaneously diversify the Alberta economy and buttress the oil industry.

- **A low-tax guarantee.** Income from re-invested resource revenues could be used to offset the cost of delivering government services. Alberta could create a "guarantee" that the province will always be the lowest-tax jurisdiction in Canada. It could even eliminate the provincial income tax outright.
- **A specific visionary goal.** Resource money could be invested in a targeted industry or sector for the purpose of making Alberta a world leader in that area. Potential examples include alternative energy, environmental technologies or cancer research. All Canadians would benefit from developing such expertise within the country.
- **Education bursaries for Alberta post-secondary students**. Every post-secondary student in Alberta could receive a bursary to offset the cost of education and training.
- **A post-secondary endowment fund.** Such a fund could be used to elevate the quality and reputation of Alberta's post-secondary institutions. The province could build a fund that rivals that of Harvard University, which has used its wealth to attract the best and brightest students, teachers and researchers.
- **Building social licence.** Alberta could use its savings income to build national support for the energy sector by investing outside the province. While this option may not seem to directly benefit Albertans, it could help secure social licence for the resource sector by building goodwill in other provinces. In the early years of the Heritage Fund, one of its branches, the Canadian Investment Division, provided low-interest loans to other provinces. It also helps guard against the inflationary pressures that come with overinvesting within the province.
- **Province-building legacy projects.** Resource wealth could be directed to legacy projects that provide an economic or social benefit but would otherwise be too expensive to undertake. One example is building a high-speed rail network linking the province's major urban centres.
- **Creating "magnet cities."** Funds could be used to create world-leading cities aimed at building an Alberta that people are inspired by and want to live in. Endowment money could support arts, culture, parks, public transportation, major public works and other initiatives that enhance the livability of Alberta's cities.

This list of options is far from comprehensive. However, it does illustrate the broad spectrum of possibilities for how Alberta could direct its resource revenue savings towards a specific purpose – a purpose that will not only yield a lasting benefit for future generations, but motivate the current generation as well.

Albertans and their political representatives will need to debate and discuss the alternatives and settle on an overarching purpose before embarking on a savings plan. This is a critical step if such a plan is to win broad public support; that support is vital to ensuring that governments stay on the savings path, even if the going gets rough.

## RECENT PROPOSALS TO SAVE RESOURCE REVENUES

**Many organizations, researchers and special commissions – including the Canada West Foundation – have explored the question of how Alberta should be treating its resource wealth. Here are some examples of recent proposals:**

### Premier's Economic Council

In May 2011, the Premier's Council for Economic Strategy, chaired by the Hon. David Emerson, released *Shaping Alberta's Future* – a report on what Alberta needs to do to sustain prosperity and opportunity for future generations.

Included in that report was a series of recommendations on how the province should manage its resource wealth. The Council recommended that, over a 5-10 year transition period, the Alberta government should move to a position where 100% of operational spending be financed by current revenues (taxes and fees).

By the end of the transition period, all revenue from the sale of non-renewable resource assets would be diverted to a Shaping the Future Fund. That Fund would be used to make strategic investments in firms, projects and public infrastructure that either help solve specific challenges within the province, or push Alberta in new directions critical to its economic future. Investments would be made with clear expectations that they would generate economic growth, but that financial return on investment would not be the sole consideration.

### Canada West Foundation

In 2006, the Canada West Foundation released *Seizing Today and Tomorrow: An Investment Strategy for Alberta's Future*. It recommended that the Alberta government invest 50% of all non-renewable resource revenues into the Heritage Fund and that the remainder be made available for current expenditure needs. The commitment to save should be imbedded in legislation, subject to change only through a province-wide referendum.

Money invested in the Heritage Fund would create a sustainable revenue stream that the province would then use to target strategic investments in the future prosperity of Albertans. The government would not be permitted to draw down the principal of the Fund – it could only finance investments out of the interest earned. All operational, maintenance and replacement costs would also be paid for from Heritage Fund revenues. Finally, investments would have to have a strategic focus and be transformative – not simply be a new way to fund additional status quo spending.

### Alberta Financial Investment and Planning Advisory Commission

In December 2007, the Alberta Financial Investment and Planning Advisory Commission, chaired by Jack Mintz, issued its report and 17 recommendations on Alberta's current and future approach to savings. In *Preserving Prosperity: Challenging Albertans to Save*, the Commission asserted that Alberta's non-renewable resources should not only benefit the current generation of Albertans, but their children and grandchildren as well.

To that end, the Commission recommended that the Alberta government reinvest in the Alberta Heritage Fund with a target of reaching $100 billion in financial assets by 2030. To reach this target, a fixed share of non-renewable resource revenues should be set aside every year and the government should legislate a new approach to savings, including strict savings provisions for at least 10 years.

To address the issue of revenue volatility, the Commission suggested that the government be able to spend 4.5% of the value of the Fund in any given year. Part of that money should support existing Heritage initiatives and part should be used to meet future infrastructure needs. Clear criteria should be set for distributing this income and for earmarking additional funds for specific purposes. The Commission suggested creating a Premier's Council on Savings to develop these criteria.

### Canadian Taxpayers Federation

Not all reports advocate that resource revenues be set aside for strategic spending. In 2001, the Canadian Taxpayers Federation (CTF) commissioned a report entitled *Eliminating Alberta Personal Income Tax*. That report suggested that if the Alberta government restricted its spending and put 50% of oil and gas revenues into the Heritage Fund, it could grow to $55 billion by 2015. According to the CTF, the Fund would produce enough income to allow the government to eliminate the provincial income tax in perpetuity.

# ISSUES AND CHALLENGES

The transition from spending to saving our resource wealth is like trying to lose weight. Albertans may readily admit the need, and even see the benefit, of so doing. Yet, like most weight-loss plans, past efforts to save for the future have failed because the temptation to consume was too great.

Saving at least a portion of our resource revenue is clearly the right thing to do. But doing the right thing is not always easy. For a savings plan to be successful, we must be upfront about the fact that there are real present-day costs, concerns and risks associated with setting aside some of today's resource wealth. The Alberta government needs to clearly demonstrate how the benefits of any plan outweigh those obstacles.

We must also be wary of the pitfalls that have prevented previous efforts from succeeding. Alberta's policy landscape is littered with the corpses of savings plans and proposals that have failed, were rejected or ignored outright. The reasons for failure have varied. In some cases, the savings plan was too ambitious. In others, economic or political circumstances prevented ideas from getting off the ground. At other times, savings initiatives were shelved because they were clearly not a priority for Albertans at the moment.

Acknowledging and, to the extent possible, addressing these obstacles and pitfalls is critical to making a savings plan work. Some of the common challenges that have impeded past savings efforts are listed below.

## 1

### The tendency to think short-term

Governments and individuals alike share the tendency to value short-term desires over longer-term interests. In the case of governments, proposing ambitious savings plans is difficult because each dollar set aside for the future is a dollar not spent on today's priorities. There is a political cost associated with leaving current needs and desires unmet.

However, it is not just governments that have this problem. Over the years, the provincial government has consulted with Albertans numerous times about how they think resource revenues or budget surpluses should be spent. Surveys were sent out when the budget was balanced in 1996, after a resource revenue windfall in 2001, and on the eve of eliminating the debt in 2005. Every time, Albertans indicated that the money should go to tax cuts, rebates or be spent on current needs. Saving for the future always ranked at or near the bottom.[5]

This tendency to focus on immediate priorities rather than long-term plans is perhaps the most significant obstacle to implementing a plan to set aside resource revenues. It underscores the need not only to build a strong case for saving, but also to provide Albertans with a compelling purpose for such a plan.

## 2

### Recalibrating expectations of government

Albertans have grown accustomed to paying far less than the actual price of the government services they receive. When about 30% of government revenues come from the extraction of non-renewable resources and that money is used to finance current spending, Albertans are directly paying only 70% of the cost of provincial government services. In other words, we sell our natural assets to subsidize our appetite for low taxes and public spending. This would not necessarily be a problem if our resource revenues were reliable and guaranteed, but they are neither.

A saving plan means reducing our dependence on resource revenues to fund current spending. That, in turn, requires resetting our expectations about how much we have to pay to receive those services. Albertans will have to accept that the true, direct, cost of government services is much higher than their current tax burden suggests.

The idea of resetting expectations extends to the provincial government as well. For decades, the province has used resource revenues as a buffer, distancing its spending decisions from their impact on Alberta taxpayers. If current spending is to be financed out of taxes and other current revenues, Alberta taxpayers will likely become much more vigilant about ensuring that they receive value

[5] Specific surveys include *Straight Talk, Clear Choices* (1996), *Talk it Up, Talk it Out* (1998), *It's Your Money* (2001) and *It's Your Future* (2004). Survey information and details are available at http://alberta.ca/publicopinionotherresearch.cfm

for their tax dollars. Additional vigilance will also encourage the Alberta government to critically examine its current spending practices – to weed out unnecessary programs and to deliver important ones more cost-effectively.

## 3

## Navigating the transition period

An inescapable fact of creating a savings plan is that Albertans will have less resource income at their disposal today. There will be some short-term pain in order to see the long-term benefits. This means accepting that in the immediate term, and possibly beyond, Albertans will face a difficult choice: paying higher taxes for the services they receive; and/or accepting reduced service levels.

Albertans are unlikely to accept significant tax increases or deep cuts to government services as part of a savings plan. A gradual transition is far more likely to succeed. For that reason, the Alberta government deserves credit for the savings measures introduced in its 2013 budget. Its plan to siphon off a small share of resource revenues before they are even counted as general revenues is an excellent start.

The only major criticism is that the planned amounts that would be skimmed off the top are very small. For example, if the Alberta government were to receive a record windfall of $15 billion in resource revenues in the coming year, only $1.8 billion of that total would be set aside. This plan will have to be accelerated at some point down the road for meaningful savings to take place (Figure 4).

Another option that would present minimal hardship to Albertans is long-term restraint in government spending growth. Doing so would allow surpluses to build up, making it easier to set aside resource revenues.

A third option is to increase taxes, whether by introducing a temporary sales tax or raising existing tax rates. This option would be as effective as any other, but far more likely to spark significant resistance from Albertans.

A final factor to consider is that the success of any transition plan depends heavily on what happens to resource income in the coming years. Alberta eliminated its debt 20 years ahead of schedule because of resource windfalls. A similar boom now would make the savings transition relatively painless. Conversely, if resource revenues fall, the economic and social cost of the transition would be magnified and our collective appetite for facing that challenge may well evaporate. This, unfortunately, lies beyond the government's control.

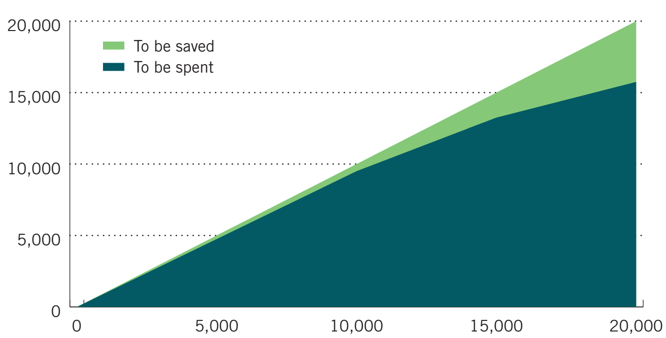
## 4

## Trusting government and relinquishing control

One obstacle to savings that is seldom discussed openly is the issue of trust and accountability. Some

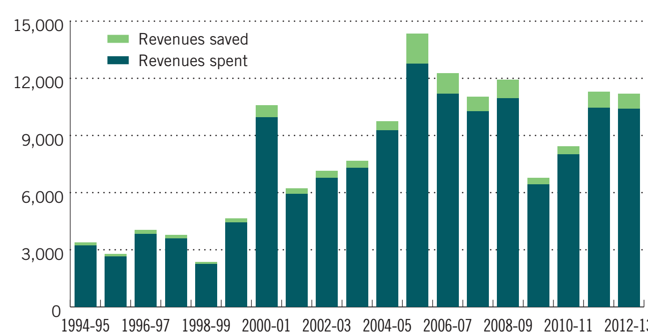
**BUDGET 2013 PROPOSES A MODEST RESOURCE REVENUE SAVINGS PLAN**

The Budget 2013 savings plan
($ millions)




Source: Canada West Foundation

How the plan would have affected resource revenues in the past
($ millions)




Source: Canada West Foundation calculations using data from Alberta Finance

Albertans are inherently untrusting of their government and do not believe it can be an effective steward of Alberta's resource wealth. Fear that savings will be wasted, disappear or be used for secret and/or nefarious purposes has led some to the conclusion that all oil and gas revenues should be spent immediately or returned directly to Albertans. At least then voters are in a position to see where the money went, and judge the government accordingly.

A related concern is that setting aside money for future generations could mean relinquishing control over how it is spent. Simply put, setting aside resource revenues for future generations means letting them spend the money – the fruits of our restraint – as they see fit. Some Albertans are reluctant to make those sacrifices for a better Alberta and simply take it on faith that our children can be trusted to spend the money wisely.

Condescending though it may be, this perspective does exist in Alberta and it can form a strong argument against instruments like the Heritage Fund where the current generation effectively gives up control over what happens to those funds down the road. For these Albertans, it is far better to spend the money now so they can be assured that the funds be directed to some useful purpose.

5

### Risk of federal appropriation

Periodically, Alberta's vast resource wealth becomes a source of distress in other provinces. They express concern that no other jurisdiction in Canada could hope to compete with Alberta's ability to raise revenues, lower taxes and attract investment and growth. Such fears were last raised in 2005 when the Alberta government had eliminated its debt, the provincial economy was booming and resource revenues were soaring.

The Alberta government has been frequently criticized for its failure to emulate Norway and build up a large sovereign wealth fund. But these occasional rumblings about Alberta's wealth are a significant deterrent to so doing. To build the Heritage Fund to $100 billion or $200 billion would create a potent symbol of Alberta's wealth compared to other provinces. Such a vast fund would effectively paint a target on the province's back. It would invite envy in other provinces and could put pressure on the federal government to appropriate or otherwise redistribute that wealth.

Such an event seems highly unlikely today, but it remains a possibility. In the face of even a small risk, it is easy to argue that the appropriate strategic response is to spend our resource wealth immediately – to ensure that Alberta's resources benefit Albertans, first and foremost.

6

### Eroding Alberta's short-term competitive advantage

By spending our resource wealth today, the provincial government is able to provide good-quality services to residents while maintaining the lowest tax burden in the country. Albertans pay no sales tax or health care premiums. Low-and middle-income families the benefit from a generous employment tax credit and general corporate tax rate is the lowest in Canada.

This combination of quality services and low taxes gives Alberta an enormous competitive advantage over other provinces when it comes to attracting businesses, investment and people. Tens of thousands of Canadians migrate to Alberta every year. The provincial economy is consistently one of the strongest in the country.

There are concerns that saving our resource revenue could erode what used to be called the "Alberta Advantage." It is true that the transition to savings will require some combination of spending restraint or (less likely) tax increases, at least in the short term. However, if done gradually, this transition need not erode Alberta's competitive advantage. In fact, if done properly, a savings plan would ensure that that advantage lasts for generations to come.

# CONCLUSION

Albertans have never shied away from a challenge. Our collective ingenuity helped to unlock the vast potential of the oil sands. Our fiscal discipline helped us to become the only debt-free jurisdiction in Canada. Our sense of community helped us endure this summer's floods. Those traits will all be needed for Albertans to face up to another challenge: the need to secure today's resource wealth for tomorrow.

Our natural resources have helped us build a prosperous and enviable society. Yet for as long as we pay the bills by selling off our natural assets, that prosperity is fleeting and will perpetually be at risk. Albertans need to boldly step forward and commit to a plan that secures today's prosperity for tomorrow and beyond. The goal is not just to leave something to our children. It is to ensure that the value of our resources lasts beyond the point when the last barrel of oil is sold.

There are numerous benefits to saving our resource wealth. There are also challenges and sacrifices that need to be made along the way. But the worst mistake we can make is to be complacent – to assume that our resource wealth will always be there.

A generation from now, Albertans may be swimming in resource revenues. Alternatively, our oil industry may be a mere shadow of its current self. We simply have no way to know. In the face of that uncertainty, it is far better to have prudently saved and been wrong about the need to do so, than it is to discover down the road that we should have been saving all along.

The case for saving our resource revenues is relatively straightforward. Articulating the need to save is not, however, licence to proceed. Ultimately, it is up to Albertans to decide if the benefits of savings outweigh the risks and the immediate costs. Twenty years ago, Albertans bought into the need to balance the budget and eliminate the debt. A similar degree of buy-in is necessary if a resource revenue savings plan is to succeed.

This speaks to the need for the Alberta government to engage its residents in an open and honest dialogue about savings – the imperative, the benefits and the challenges along the way. Albertans and their government need to work together to develop a clear and compelling vision for how a savings plan would function, how much would be set aside, and to what purpose funds would be directed. A host of questions need to be articulated, debated and settled before any concrete savings plan can get underway. We need to begin this process as soon as possible – to take the next step towards a sustainable and prosperous Alberta.

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