Time for New Budget Rules

A Savings and Surplus Management Act for Alberta

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January 2008

Canada West Foundation

INVESTING WISELY PROJECT

This paper is part of the Canada West Foundation's *Investing Wisely Project.* The project has explored two key issues: 1) the case for saving a larger portion of Alberta's non-renewable resources revenue for future use; and 2) creative and strategic ways of using the earnings on the savings to transform Alberta in positive ways. The project has been funded by over 60 foundations, businesses, and individuals. The Canada West Foundation expresses its sincere appreciation for this generous support.

This paper was written by Canada West Foundation Research Fellow Ken Boessenkool. Without implication for errors, omissions or the ideas contained herein, the author wishes to thank the following individuals for providing helpful comments on this and previous iterations of this paper: Murray Edwards, Peggy Garrity, Roger Gibbins, Ron Kneebone, Lennie Kaplan, Jack Mintz, Al O'Brien, and Robert Roach.

ISBN 1-897423-12-7

Graphic Design and Layout by Jason Azmier

1. Introduction

In the early 1990s, the Alberta government set the standard for having a clear and closely controlled fiscal framework. The focus of that fiscal framework was on eliminating deficits and debt. Today, Alberta faces a period of surpluses and savings, yet the fiscal framework has not been adjusted to reflect this reality.

Recent budgets have shown a propensity for rapid spending increases, for *ad hoc* capital spending plans, and a seemingly random system for putting aside money in the Alberta Heritage Savings Trust Fund—the Alberta government's savings account. Alberta is not alone in losing its way in the new era of surpluses.[1] This makes it all the more important for Alberta to once again set the standard and devise a new fiscal framework for a time of surpluses and savings.

Any new framework must recognize that the fiscal rules that emerged from the time of deficits and debts has produced chronic "unanticipated" surpluses as zero-deficit rules force policy-makers to be very conservative in their revenue and expenditure forecasts.[2] If the zero-deficit rule is to be maintained—and the political implication of abandoning it would appear reckless at best—then new fiscal rules must address the issue of unanticipated surpluses. Further, if these substantial planned and unanticipated surpluses are to be saved—and the politics of doing so would appear noble at worst—then the new fiscal rules must also increase the incentives to save.

Through its *Investing Wisely Project*, the Canada West Foundation has been calling for greater fiscal discipline in Alberta and for a transparent and durable commitment to save a significant portion of its non-renewable resource revenues. This paper is an extension of that work and argues in favour of a *legislated* commitment to greater fiscal discipline and saving. The result will be greater accountability and improved fiscal performance—both of which Albertans expect and deserve.

The paper starts with a look back at the evolution of fiscal rules in Alberta and then discusses principles for creating fiscal rules in an era of surpluses and savings. The paper concludes with policy recommendations for a new *Savings and Surplus Management Act* for Alberta.

2. Fiscal Rules in Alberta

Alberta has had various fiscal rules going for at least 30 years.[3] The Alberta Heritage Savings Trust Fund (Heritage Fund) was created in 1976, three years after the OPEC oil price shock of 1973 created a significant jump in non-renewable resource revenues. The Heritage Fund was created with an initial endowment of $1.5 billion and the government of Peter Lougheed committed to putting 30% of future resource revenues into the Heritage Fund. By the end of the 1970s, the government even mused about raising that percentage. All income earned by the Heritage Fund also stayed within the Fund.

1 See Reid S. Adrian, Yvan Guillemette and William B.P. Robson. 2007. *Missed Targets: Canada's 2007 Fiscal Accountability Ranking.* CD Howe Institute. March.

2 For a full discussion of the impact of zero-deficit rules, see Ronald D. Kneebone. 2006. "From Famine to Feast: The Evolution of Budgeting Rules in Alberta." *Canadian Tax Journal.* Vol. 54, No. 3, pp. 657-673.

3 This section borrows heavily from Ronald D. Kneebone. 2006. "From Famine to Feast: The Evolution of Budgeting Rules in Alberta." *Canadian Tax Journal.* Vol. 54, No. 3, pp. 657-673. The author retains blame for any errors or omissions.

The National Energy Program,[4] combined with a deep recession in the early 1980s, began the process that ultimately resulted in the Alberta government abandoning these rules. In 1982, the government began to divert interest income from the Heritage Fund into general revenues and also reduced the percentage of resource revenues going into the Fund to 15% from 30%. It is noteworthy that these two changes were presented as temporary measures that were to last for two years. Regardless, these changes helped keep the Alberta budget balanced until 1985.[5]

Then oil prices collapsed in 1986, resulting in a precipitous decline in resource revenues and the abandonment of saving any fraction of non-renewable resource revenues. All income plus all non-renewable resource revenues would henceforth go directly into general revenues. Despite these changes, the province ran deficits averaging over $2 billion annually for nine consecutive years.

The election of June 1993 was fought over whether the reigning Progressive Conservatives, led by former free-spending Calgary mayor Ralph Klein, were more serious about deficit reduction than their main challengers, the Liberals led by the much much more fiscally conservative mayor of Edmonton, Lawrence Decore.[6]

Ralph Klein won a solid majority, largely on the credibility of changes made prior to the election call. Those changes included eliminating MLA pensions, cutting spending, and introducing the *Deficit Elimination Act* (DEA) that contained strict limits on deficits for the next three years culminating with outlawing deficit financing on an annual basis following budget balance.

A key feature of the DEA was the requirement that the government could only spend the average amount of resource revenue that the province collected over the previous five years. Any amount above that average had to be used to reduce the debt. This ensured that resource windfalls could not be used to ratchet up spending—which is what got the province in trouble in the first place.

When the budget was balanced in 1995, attention turned to eliminating the debt. Again, the province turned to legislation, introducing the *Balanced Budget and Debt Retirement Act* (BBDRA). The key features of the BBDRA included a 25-year debt repayment schedule and continued outlawing of annual deficits. It also said the government could spend the lower of the average amount of resource revenue in the previous five years and 90% of the amount forecast for the current year. This change set a floor under the revenues the province could expect in any given year. The province's net debt (roughly the accumulated deficit minus the assets in the Heritage Fund) reached zero in 1999.

The elimination of deficits and debt and the continuation of substantial surpluses from booming resource revenues resulted in a number of further adjustments to fiscal rules in Alberta. The *Fiscal Responsibility Act* (FRA) was introduced in 1999. It added a requirement that the annual budget contain an "economic cushion" of 3.5% of forecast revenues, which came to $600 million in 1999. This was done to protect the budget from reductions in resource revenues such as

4 The National Energy Program controlled oil prices in Canada. A series of negotiations between Alberta and the federal government set the price of oil discovered before 1980, with oil discovered after 1980 being allowed to rise with world prices. This policy devastated the Alberta economy.

5 Alberta's fiscal year ends on March 31 of each year. I have adopted the convention of referring to the 1984/85 Budget by the year in which it ended, namely 1985.

6 Kenneth J. Boessenkool. 2003. "A Rumpled Rogue From Calgary Becomes a Fiscal Revolutionary" in Paul Bunner. Ed. *Alberta in the 20th Century, Volume 12: Alberta Takes the Lead.*

occurred in 1998, when resource revenues dropped from $3.8 to $2.4 billion.[7]

Continued revenue windfalls in subsequent years created new challenges, as the five-year average for resource revenues created fiscal room that threatened to push spending to unsustainable levels. This was dealt with by various amendments to the FRA that stated the maximum amount of resource revenues that could be brought into general revenues should be capped at $3.5 billion (2003), then $4.0 billion (2004), then $4.75 billion (2005), then $5.3 billion (2006), which remained unchanged for 2007.[8] In addition, the required size of the economic cushion fell over this period to 1.0% from 3.5%.

The amendments of 2003 also created an Alberta Sustainability Fund (ASF) to which resource revenues above the $3.5 billion cap had to go. The size of the ASF was capped at $2.5 billion, and amounts above $2.5 billion could go to capital projects, various endowment funds created in the early 2000s, or to the Heritage Fund.

This brief tour of Alberta's various fiscal rules raises three issues.

First, the introduction of fiscal rules with clear objectives was followed in short order by the attainment of the stated objective. A sizeable savings account was established within four years of the creation of the Heritage Fund with a 30% savings rule. The deficit was eliminated within two years of the introduction of the *Deficit Elimination Act* and the net debt was eliminated four years after the introduction of the *Balanced Budget and Debt Retirement Act.* It is surely not too strong of a conclusion to say that, in these cases, correlation was also indicative of causation. It might also be said that since the elimination of the net debt, the purpose of the rules became much less clear, not to mention much more *ad hoc* and, hence, arguably meaningless. Without a clearly defined objective, "rules for the sake of rules" appear to be, if not ineffective, at least more subject to the whims of politicians or economic pressures. In short, it could be argued that clear fiscal rules with a clearly defined objective appear to be an important part of achieving that objective.

A second related point is that democratic consensus in defining these objectives is important. Alberta in the 1970s had important debates and elections over the use of windfall revenues, and in the early to mid 1990s, there were important elections that focused on the elimination of deficits and debt. In short, leadership and democratic consent matter in setting fiscal rules.

Third, fiscal rules can have important side effects. As Kneebone points out, strict zero-deficit rules

> …put budget makers in an awkward position. Government revenues and expenditures are sensitive to the state of the economy, which is far from being perfectly predictable. … A legislative or political commitment to avoid deficits forces the government to base expenditure plans on conservative revenue forecasts. By "lowballing" revenue estimates and limiting expenditure allocations to those estimates, the government makes sure that the commitment will be met.[9]

7 Full disclosure: the author was a policy advisor to the Provincial Treasurer of Alberta from the fall of 1998 to summer 2000.

8 The years indicated are the years in which the changes were made. By the convention adopted here, they would affect the following year's budget. So the change to $4.0 billion was made in 2004 and affected the 2004/05 budget, which I am denoting as 2005.

9 Ronald D. Kneebone. 2006. "From Famine to Feast: The Evolution of Budgeting Rules in Alberta." *Canadian Tax Journal.* Vol. 54, No. 3, pp. 660-61.

Kneebone provides evidence from the years 1994 to 2005 that shows the Alberta government underestimated its surpluses by an average of over $2 billion dollars. Resource revenues alone were underestimated by an average of just under $2 billion dollars over this period.[10]

Kneebone focuses his discussion on the revenue side of the equation, but in their comparison of the accuracy of Canadian government's fiscal projections, Adrian *et al.* suggest that more important issues lurk on the expenditure side:

> …in comparing the relative performance of governments, we are mainly concerned with spending, rather than with revenue. … Governments that are more dependant on cyclical revenue sources, such as those from natural resources, will naturally have a tougher time anticipating their incomes. … Program spending, by contrast, is something that legislators vote on in dollar terms. Notwithstanding the influence of economic and other factors that are difficult for legislators to control, all legislatures vote dollar amounts. Even in a world full of surprises, voters are entitled to expect those votes to mean something.[11]

Adrian *et al.* show that, among provinces and the federal government, Alberta fared the worst between 1997 and 2007 in terms of the size with which they missed their budgeted expenditure targets with a mean error in forecasts of nearly 5%, almost 2.5 times larger than the average of other provinces and the federal government. Alberta missed its budget expenditure targets by a cumulative $9.1 billion over the 10-year period. More recently, the Alberta government overspent its 2007 Budget spending target by $1.3 billion. And this doesn't take into account the current treatment of many capital expenditures that are "funded" out of the surplus that goes into a capital account and, hence, are not part of program expenditures.

10 *Ibid.*, p. 661.

11 Reid S. Adrian, Yvan Guillemette and William B.P. Robson. 2007. *Missed Targets: Canada's 2007 Fiscal Accountability Ranking.* CD Howe Institute. March, pp. 2-3.

Worse, in a province such as Alberta with unstable revenue due to its reliance on non-renewable resource revenues, this unbudgeted spending serves to ratchet up spending to increasingly unsustainable levels. Program spending in Alberta has been growing over 10% for the last three years and has averaged nearly 9% since the budget has been balanced. Over the latter, much longer period, non-resource tax revenue has grown by an average of just under 7.5%, meaning that expenditure growth in Alberta is mathematically unsustainable.[12]

3. Principles for an Era of Savings and Surpluses

The foregoing discussion points to a number of principles for creating new rules for a fiscal framework in an era of savings and surpluses.

First, the rules should point to an overriding objective, one that has, and builds, public support. An important part of building public support during an era of savings and surpluses would be giving voters a personal financial stake in the outcome via the potential for direct cash rebates.[13]

12 2007 Alberta Budget. Fiscal Plan Tables, p. 44.

13 See Bev Dahlby. 2006. "Learning From the Past and Preparing for the Future" in Roger Gibbins and Robert Roach. Eds. *Seizing Today and Tomorrow: An Investment Strategy for Alberta's Future.* Canada West Foundation, pp. 83-93, especially p. 92 where Dahlby makes the case for returning a portion of resource revenues annually to taxpayers. A similar argument is made in the same volume in Melville L. McMillan's chapter "Investing in Alberta's Future: Improving the Use of Non-Renewable Resource Revenue in a Resource Rich Province," pp. 73-82. Posner and Gordon demonstrate the importance of

Second, the rules should be both *ex ante* and *ex post*. In other words, there should be rules for how the budget is built as well as how the budget is implemented. Third, the rules should pay close attention to, and be motivated by, the incentives they create for policy-makers as well as the public. Fourth, those incentives should affect not just the revenue side of the equation, but the spending side as well. To wit, they should reduce the incentives to ramp up spending in the face of resource revenue windfalls. Fifth, the rules should be sustainable, recognizing that resource revenues fluctuate significantly and that politicians have extremely high discount rates (economist speak for saying politicians want to see tangible benefits to their policy before the next election).

A final principle is that the Alberta government should save more of its non-renewable resource revenues. Non-renewable resource revenues are not like other tax revenues. An analogy perhaps explains it best. A baker receives cash from selling bread, pastries and cakes. This is analogous to personal, corporate and sales taxes as well as to fees from services and other regular tax revenues. The baker can also get cash by selling his oven. This is analogous to the revenues received from non-renewable resources. Royalties in particular are not so much revenue as they are the result of converting an asset from one form to another—from a physical asset (oil or gas in the ground like the baker's oven) to a financial asset (royalty payments like the proceeds from the sale of an oven).[14] Another way to look at this is to consider other tax revenues as income statement transactions while non-renewable resource royalties should be treated as a balance sheet transaction.[15]

In this context, the fact that only 8.6% of non-renewable resources in Alberta from 1977 to 2005 went into the Heritage Fund while over 90% went into general revenues is problematic.[16] While admittedly some of the more recent non-renewable resource revenues assisted in the payment of provincial debt, the fact that resource revenues were treated no different than other tax revenues for most of this period is troubling.

4. A Savings and Surplus Management Act

Alberta used legislated fiscal rules successfully in its battle against deficits and debt. The current environment calls for a new type of rules—legislated rules to deal with surpluses and savings. Elements of a *Savings and Surplus Management Act* along with the purpose of each element consistent with the above principles would include:

- Continue the annual zero-deficit rule.

Purpose: to continue the policy that has widespread public and political support.

"fiscal rewards" in a study of six OECD countries who have made the transition from deficits to savings. Paul L. Posner and Bryon S. Gordon. 2001. "Can Democratic Governments Save? Experiences of Countries with Budget Surpluses." *Public Budgeting and Finance.* Volume 21, Number 2, Summer 2001, pp. 1-28. I thank Ron Kneebone for pointing me to this latter paper, which he cites in Ron Kneebone. 2007. "Managing Non-Renewable Resource Revenues: The Savings Decision." Prepared for the Government of Alberta Financial Investment and Planning Advisory Commission.

14 For a fuller discussion of this point, see Kenneth J. Boessenkool. 2001. "Taking Off the Shackles: Equalization and the Development of Non-Renewable Resources in Atlantic Canada." Atlantic Institute for Market Studies. May 2001.

15 This is an illustrative point only, as I am not suggesting that the province keep the value of oil reserves on its balance sheet. It is, however, worth pointing out that the Canadian Constitution assigns ownership of non-renewable resources to the provinces.

16 Roger Gibbins and Casey Vander Ploeg. 2005. "Investing Wisely: An Investment Strategy for Creative Leadership." If you assume that all debt payments were funded from non-renewable resources, between 1996 and 2005, the split between "spending" and "saving or paying down debt" of these revenues was close to a 50/50 split. See Kenneth J. Boessenkool. 2007. "Equalization and the Fiscal Imbalance: Some Options for Reform." Canada West Foundation. February, p. 6. The split in Saskatchewan was closer to two-thirds spent and one-third saved or used to pay down debt. See Kenneth J. Boessenkool. 2007. "Some Inconvenient Facts on Equalization." *Globe and Mail.* February 7, 2007.

- Set a goal for the size of the Heritage Fund. A reasonable goal would be to at least double the real (i.e., inflation-adjusted) dollar value[17] of the Heritage Fund and other savings to at least $70 billion over the next 10 years.[18]

Purpose: to commit the government and the public to setting a simple and understandable goal for savings. As per below, all funds would be wrapped into the Heritage Fund to improve the transparency of government funds.

- A commitment to put a fixed portion of budgeted resource royalties into the Heritage Fund annually. This portion can either be a fixed proportion, say one-third of resource revenues, or a fixed annual dollar amount to ensure that the goal for the size of the Heritage Fund is reached. The former approach mimics the rules when the Heritage Fund was created. The latter approach is consistent with the BBDRA rules to eliminate the provincial debt and would require $3.5 billion (in current dollars) in annual contributions over and above inflation-proofing.

Purpose: to ensure resource revenues are invested for future generations and to protect the government from over reliance on resource revenues. This is the ex ante *rule.*

- Half of all unanticipated surpluses (i.e., surpluses in excess of the annual budget forecast) should be put into the Heritage Fund. The other half, subject to certain minimums, should be returned to taxpayers in the form of a cash dividend or energy rebate.

Purpose: more prudent budgeting and minimizing unsustainable within-year spending binges. It will also give the public a better sense of the size of resource revenues as well as offsetting the increase in costs from rising energy prices which would normally preface a large within-year bump in resource revenues. This will also create an incentive for policy-makers to budget more accurately and to create an instant, tangible benefit for politicians. This is the ex post *rule.*

- Continue the Stability Fund with a $2.5 billion cap as well as an economic contingency of 3.5% of budgeted non resource revenues (i.e., all tax and other revenues except resource revenues).

Purpose: to minimize the risks that setting an ex ante *fixed percentage or dollar amount of resource revenues to be put in the Heritage Fund will put the province into deficit. The economic cushion is also there to ensure that unanticipated or emergency within-year spending demands are covered from a contingency, not from an energy windfall. The size of the economic contingency is based on a calculation excluding resource revenues to stabilize the size of the contingency from year to year.*

- Each budget should lay out a 10-year fiscal framework with reasonable estimates of program spending, capital spending, resource royalties and tax revenues.

Purpose: to give taxpayers a better understanding of the consequences of today's decisions and build support for saving, not spending, current non-renewable resource windfalls.

- Interest from new money put into the Heritage Fund should be earmarked for specific purposes—similar to the Access to the Future Endowment—instead of just flowing into general revenues as is done with existing interest revenues. Enough interest income should stay in the Heritage Fund to ensure it continues to be inflation-proofed and existing funds

17 This rule is expressed in real, not nominal dollars, as I expect the Heritage Fund to continue to be inflation-proofed. Current practice is to take all revenues from the Heritage Fund into current revenues and then "put back" an amount to inflation-proof the fund. My preference would be to keep enough of the revenue in the fund to inflation-proof it so only the real returns go into general revenues or to specified funded projects, as per below.

18 Alberta has a number of funds and accounts—"money jars" in the words of Brett Gartner. See Brett Gartner. 2007. "Alberta's Money Jars: Current Provincial Savings and Endowment Funds" in Robert Roach. Ed. *Alberta's Energy Legacy: Ideas for the Future.* Alberta had net financial assets of nearly $35 billion in 2007. See "Fiscal Tables." *2007 Alberta Budget.* p. 69.

should be folded into the Heritage fund so they all operate with similar rules.

Purpose: to create a "demand for savings" instead of a "demand for spending" as earmarked funds will create an innovative and stable funding source for new initiatives. Interest groups and the public will then "compete" for more savings to create sustainable funding for their projects, rather than just place new demands on general revenues.

5. Conclusion

In the early 1990s, the Alberta government set the standard for having a clean and closely controlled fiscal framework. It created legislative rules that were an important part of eliminating the annual deficit and paying down the debt.

Today, Alberta faces a time of surpluses and savings, yet the fiscal framework has not been adjusted to reflect this reality. A new *Savings and Surplus Management Act* is needed to put the public focus on saving for the future, eliminating unsustainable binge spending, and giving Albertans a stake in resource revenue windfalls.

Alberta's experience with legislated fiscal rules has been a good one, but the rules have not kept pace with reality. With a new *Savings and Surplus Management Act*, Alberta can once again set the standard for the age of surpluses and savings.

About the Canada West Foundation

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In 1970, the One Prairie Province Conference was held in Lethbridge, Alberta. Sponsored by the University of Lethbridge and the Lethbridge Herald, the conference received considerable attention from concerned citizens and community leaders. The consensus at the time was that research on the West (including BC and the Canadian North) should be expanded by a new organization. To fill this need, the Canada West Foundation was created under letters patent on December 31, 1970. Since that time, the Canada West Foundation has established itself as one of Canada's premier research institutes. Non-partisan, accessible research and active citizen engagement are hallmarks of the Foundation's past, present and future endeavours. These efforts are rooted in the belief that a strong West makes for a strong Canada.

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