Expanding the Debate

Investing Wisely Project

Discussion Paper Series

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Learning from the Past and Preparing for the Future

Dr. Bev Dahlby

1. Introduction

The celebration of Alberta's 100th anniversary is a time for looking back—to recognize our accomplishments—and a time for looking forward—to put in place the policies and institutions that will make Alberta an attractive place to work and live over the next 100 years. At this pivotal time, the Canada West Foundation has made a major contribution to this process by issuing its *Investing Wisely* document and holding conferences on Alberta's future fiscal policy. This paper is a contribution to the ongoing debate concerning Alberta's fiscal future. Like the other commentaries in this series, it is meant to stimulate discussion and debate. My ideas and opinions reflect my dual identity—that of a professor of economics at the University of Alberta, whose specialty is public sector economics, and that of an Alberta resident since 1978.

2. Learning From Our Mistakes

We have been through a resource boom before. Charts 1 to 4 on the following page neatly summarize the roller coaster ride that Alberta has experienced over the last 30 years. A society that does not learn from its mistakes is bound to repeat them.

These are the lessons that we need to learn from the 1974-84 oil price boom:

Recognize that resource revenues and resource economies are inherently unstable. While the current spike in oil and natural gas prices may last longer than the 1974-84 spike because this time it is demand-driven, rather than based on OPEC's ability to push up prices by restricting production, we should not discount the fact that numerous demand and supply adjustments may significantly reduce the real price of our natural resources in the future. Furthermore, as we deplete our current stocks of conventional oil and natural gas, the economic rents that we can extract from future, higher cost, reserves will be considerably lower than today, and royalty revenues will be proportionately lower.

Keep program spending within reasonable bounds. During the 1974-1984 boom, the Alberta government ramped up program spending to more than 40 percent above the Canadian average. At the time, few people expressed caution about the level of provincial spending. Because there was a disconnect between the services that the provincial government provided and the perceived cost of these services by the public, the pressure on provincial politicians was for more, not less, spending. As a young professor at the University of Alberta in the late 1970s and early 1980s, I was struck by the attitude of my students who regarded provincial government spending decisions as having no effect on their current or future taxes. Public services were simply gifts that the government bestowed on its people. This disconnect between the provision of public services and the cost of providing them led to the acceleration of program spending and large deficits when resource revenues declined in the mid-1980s. This necessitated the 20 percent cutback in expenditures that occurred in the 1993-94. No one wants a repeat of that painful and divisive experience.

CHART 1: Tax, Resource, and Total Revenues, 1977/78 to 2004/05(F)

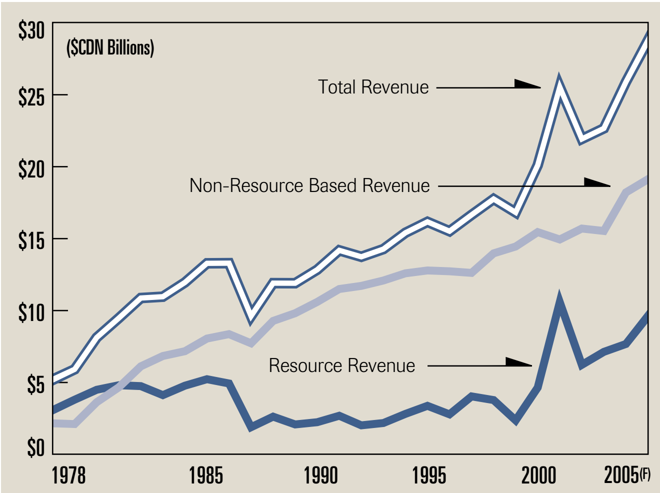


CHART 3: Consolidated Budget Balance, 1977/78 to 2004/05(F)

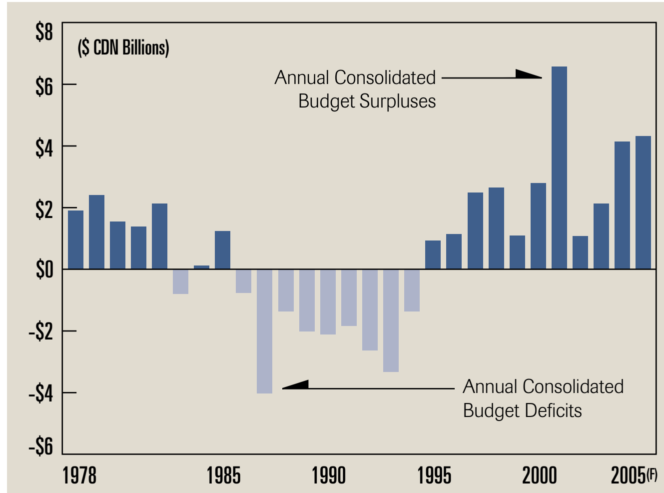


CHART 2: Program, Interest, and Total Spending, 1977/78 to 2004/05(F)

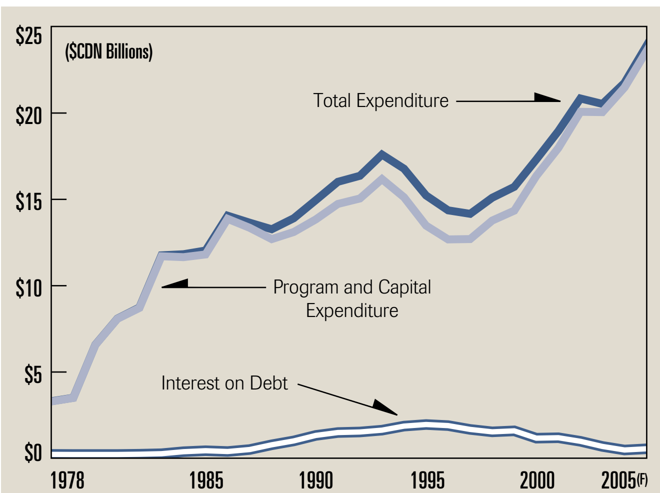
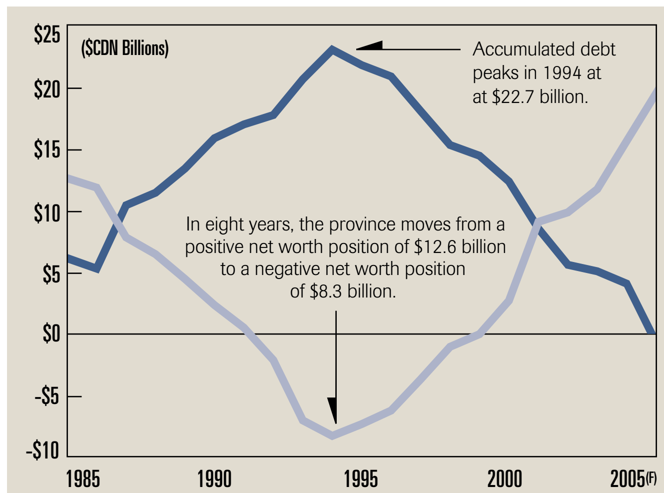


CHART 4: Accumulated Debt and Net Financial Assets, 1984/85 to 2004/05(F)



Source: Roger Gibbins and Casey Vander Ploeg, *Investing Wisely: An Investment Strategy for Creative Leadership,* Canada West Foundation, 2005.

This discussion paper was prepared by Dr. Bev Dahlby, Professor, Department of Economics, University of Alberta.

This paper is part of the Canada West Foundation's **Investing Wisely Project.** The **Investing Wisely Project** explores three key issues: 1) the case for saving a portion of Alberta's non-renewable natural resource revenues for future use; 2) creative and strategic ways of using the earnings on the saved revenues to transform the province in positive ways; and 3) Alberta's non-renewable natural resource revenues in a regional and national context. The project is funded by over 60 foundations, businesses and individuals. The Canada West Foundation expresses its sincere thanks for this generous support. The opinions expressed in this document are those of the author and not necessarily those of the Canada West Foundation's Board of Directors, advisors, or funders. Permission to use or reproduce this document is granted for personal or classroom use without fee and without formal request provided that it is properly cited. Copies may not be made or distributed for profit or commercial advantage. This document is available for free from the CWF website [www.cwf.ca].

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Build a consensus on saving resource revenues. Although the provincial government established the Alberta Heritage Saving Trust Fund (AHSTF) in 1976, with the twin goals of providing an alternative source of funds when resource revenues decline in the future and of diversifying the economy, it was not a grass roots idea. Arguably, the provincial government should have allocated more than 30 percent of the resource revenues to the AHSTF, but the lack of public commitment to the basic goal of saving for the future was revealed when, with the first downturns in the economy in 1983, the government quickly cut the contributions to the Fund and used the investment income from it to finance current spending. The abandonment of the savings function of the AHSTF reflected the lack commitment by the Alberta public to the basic goal of saving a significant portion of non-renewable resource revenues for future generations.

Leave the diversification of the Alberta economy to the market. The Lougheed government's attempt to diversify the Alberta economy by "picking winners" was inevitably a costly failure. Its dirigiste policies, which resembled those of the Quebec and French governments, overlooked one of the most important lessons of economics—while government can create favourable conditions for economic development through tax, expenditure, and regulatory policies, private markets remain the best instrument for determining how resources should be allocated in an economy.* Attempts to create "value-added" industries during a resource boom, when labour markets are tight and unemployment rates are low, are inevitably unsuccessful because new industries, which are not closely related to the oil and gas industry, are always at a competitive disadvantage.

Scrutinize and control public infrastructure spending. During the boom, provincial infrastructure spending accelerated. However, much of the spending, such as the construction of rural hospitals, was on projects that provided little long-run benefit to provincial residents, but came with high operating costs. By pushing up public infrastructure spending during the 1974-84 boom, the province became overly dependent on the construction activity, and when the boom faded, the contraction of both private and public construction spending caused a sharp downturn in the economy.

*A recent manifest by 10 leading Quebec opinion makers, including the former Premier of Quebec, Lucien Bouchard, indicates that the interventionist model has lost a lot of its appeal in Quebec. See "Clear Eyed Vision of Quebec" at www.pourunquebeclucide.com.

3. The Importance of Saving Non-Renewable Resource Revenues

Many commentators on Alberta's current fiscal situation argue that we should save a substantial share of our non-renewable resource revenues to promote *intergenerational equity.* Future generations of Albertans, our children and grandchildren, will probably not receive the same fiscal benefit from non-renewable resources because of depletion of the low cost reserves and because the real prices of resources may be lower in the future as new technology, or other sources of energy, erode the market for oil and natural gas.

While concerns about intergenerational equity are important and should be a major factor in determining Alberta's fiscal policy, it should be recognized that Albertans as private individuals have concerns about the well-being of their children and grandchildren, and they can affect their welfare through their private savings and spending decisions. Parents who spend more on their children's education, or who save in order to bequeath more wealth to their children and grandchildren, are also motivated by concerns for intergenerational equity. Private individuals' ability and motivation to make intergenerational transfer are affected by the government's fiscal policies. To some degree, there is a tradeoff between public sector saving and private sector saving. If the public sector saves more, private individuals may save less for future generations, although it is unlikely that it will be on a one-for-one basis as the Ricardian equivalence hypothesis suggests. Still, it is useful to bear in mind that if the government cuts taxes, rather than saving the resource revenue, private sector saving may increase, or private spending on activities that benefit our children and grandchildren may increase. It is not as if the public sector is the only institution that can save for future generations.

Furthermore, the emphasis on intergenerational equity obscures the fact that most current residents of Alberta will be affected by today's fiscal policies if resource revenues are significantly lower in 10 to 15 years, a likely scenario in my view. The current generation, and not just future generations, has a major stake in whether we save resource revenues or not. Saving a significant amount of current resource revenues will allow us to maintain a competitive tax regime in the future when resource resources are no longer so buoyant. This *tax smoothing* motivation for saving resource revenues has been largely overlooked in the current discussions of Alberta's fiscal policy, and it needs to be given more prominence. If we do not save a significant portion of current resource revenue, but instead use it to increase program spending, we will likely be faced with the same painful dilemma that the provincial government faced in 1993-94 of either cutting spending or raising taxes. Whether the fiscal adjustment will be on the tax or the expenditure side next time is difficult to tell. Having to pay substantially higher taxes to pay for services that were not highly valued by most residents, tilted the balance in favour of expenditure cuts the last time.

When the next fiscal crisis arises, the fiscal adjustment may be on the tax side. However, higher taxes on individuals and business would discourage investment and entrepreneurial activity at a time when the economy will need these injections to make up for a deteriorating resource industry. Even the prospect of higher future taxes can discourage investment in long-lived projects before a fiscal crisis emerges. For these reasons, it is important for the government to maintain a fiscal policy that makes a competitive tax regime a sustainable fiscal policy. This means that a significant amount of resource revenue should be saved in order to ensure that the Alberta Advantage in personal and corporate taxes can be preserved.

Another reason for saving a significant portion of resource revenues is to *avoid overheating the economy.* A high level of government spending during a boom drives up the prices of non-tradable goods and services and wages, thereby crowding out some private sector activity that would have helped to strengthen our economic base. Furthermore, saving a significant portion of resource revenues will reduce national tensions, which could result in an NEP II if Alberta uses its resource revenues to greatly boost program spending or reduce taxes.

Given these factors, a strong case can be made for the 50 percent saving rule for natural resource revenues that has been proposed by the Canada West Foundation. Whether 50 percent is the “right” number is, of course, a matter of judgment, both political and economic. As the paper in this series by Ron Kneebone makes clear, if the government of Alberta were to set aside 50 percent of resource revenues in a fund each year, it would be necessary to amend provincial legislation or budgetary practices to allow year-to-year deficits in response to short-term fluctuations in the level of economic activity and resource revenues (Kneebone 2005). Furthermore, it is important to base savings on the annual resource revenue flows rather than on the surplus that is left over at the end of the fiscal year, as is the current policy. Treating savings as a residual means that little savings will occur over time because public spending will ratchet up.

4. Obstacles to Saving Our Non-Renewable Resource Revenue

While there is a strong case for saving 50 percent of non-renewable resource revenues in a fund to be used to finance future program spending, its advocates need to recognize the serious obstacles and counter arguments to this policy.

To begin, there are those who argue that we have a serious infrastructure deficit and that spending on major infrastructure projects is needed now in order to capture the economic benefits that the current resource boom affords. There is no doubt that more infrastructure spending is needed, especially in the Fort McMurray area, and that transportation bottlenecks can constrict economic growth. It is, however, worth repeating that not all infrastructure projects have high social rates of return and that funding too many public infrastructure projects can contribute to an overheated economy, crowding out private sector investment. Furthermore, the use of special capital funds or public private partnerships (P3s) can help smooth the provincial government’s expenditures overtime, allowing it to save resource revenues in a fund while at the same time undertaking key public infrastructure projects. (The use of P3s as a funding device is especially advantageous in creating the appropriate incentives for contractors to build and maintain high quality public infrastructure.)

More generally, a recent opinion survey conducted by the Population Research Lab at the University of Alberta indicates that many Albertans favour using the current year-end surplus to increase program spending, instead of saving it or rebating it to all Albertans (see Krahn 2005). Survey participants were told that: “Some people suggest that most of the extra money should go into an investment fund that will earn interest that can be spent year after year. Others think that most of the money should be used now to improve schools, the health care system, and other government services and programs. And others think that most of the money should be divided up and given to individual Albertans.” They were then asked: “Which approach to using this money do you think is the best?” Thirty-seven percent of the respondents favoured increased spending on existing government programs, 14 percent favoured rebates and less than 12 percent favoured saving the surplus, with the remainder favouring a three way split among these uses.

Do these survey results indicate an overwhelming desire for increased spending on public services and a low level of support for saving resource revenues? The problem, as with any opinion survey, lies with the question. I think that the survey is of limited value in judging Albertans' fiscal preferences because it did not address the main issue that Albertans face—whether we should have a *temporary* increase in spending now versus a *permanent,* though smaller, increase in spending in the future. The survey question probably biased the responses in favour of the spending option by not stressing the temporary nature of a spending increase that can be funded from a year-end surplus, and by specifically listing the expenditure items that could be financed now and leaving undefined the future spending that would be financed out of savings.

That said, there are other reasons why the option of saving resource revenues is a tough sell. Over the last 20 years, we have seen a dramatic reduction in household savings rates in Canada from 17 percent in 1982 to 3 percent in 2001 (Chawla and Wannell 2005, 7). Many Alberta families welcome cash rebates or tax cuts to help them pay off their credit card debts, to ease the burden of their mortgage payments, or to finance their children's university tuition. Given a personal savings rate of less than 10 percent by most individuals, it is difficult, but not impossible, to convince a majority of the population that the public sector should save 50 percent of the non-renewable resource revenues. I say difficult, but not impossible, because if the likely consequences of not saving resource revenues are carefully explained to Albertans, many would favour a higher public sector savings rate than their personal savings rate.

As the saying goes, "a week is a long time in politics," and our politicians' short time horizon is a major obstacle to implementing a long-term savings program. What is needed is a binding commitment—a referendum—that would tie the hands of future governments and prevent them from pulling out the "rainy day" umbrella when the first shower passes overhead. There should be a referendum in Alberta on whether the government should save 50 percent of the non-renewable resource revenues in the AHSTF, where the funds would be invested in a broad portfolio of financial assets managed by an independent committee of professional advisors, and the real rate of return on the fund would be used to finance program spending. If the referendum passed, future governments would have to follow this savings rule unless it was overturned by another referendum.

5. The Alternatives to Saving Resource Revenues

What if the referendum on saving 50 percent of resource revenues did not pass? Given this possibility, we need to consider briefly the alternatives to saving the resource revenues. In the absence of saving a significant portion of resource revenues, Alberta should consider a general tax reduction by eliminating health care premiums, cutting the personal income tax rate to 8 percent, and reducing corporate income tax rates for large businesses to 8 percent—a long standing goal of the Alberta government. This combination of tax cuts would maintain our internationally competitive tax system and eliminate the most regressive aspect of the provincial tax system.

In addition, we should increase spending on primary and post-secondary education and training programs. If we are not going to give future Albertans a fund of financial assets to replace our depleted natural resources, then we should give them human capital so that they can thrive in an increasingly competitive technological world. But spending wisely on education is as important as spending enough. Misallocations of education spending are clearly evident in my home institution, the University of Alberta, where mammoth capital spending on the science, engineering, and medical faculties has drawn resources away from the social science, humanities, and fine arts programs. It is sad, but true—today's economics students are getting a lower quality education than 10 years ago, but paying higher tuition fees nonetheless.

Finally, if after a general tax cut and higher spending on education, the government of Alberta still has a surplus, it should consider implementing a permanent rebate program. While rebates are not the best way of spending resource revenues, they are definitely not the worst. At least a rebate program does not commit the government to a future stream of spending the way other spending programs can, and it would force the government to compare the benefits of the "pet projects" proposed by various interest groups with more dollars in the hands Albertans at the end of the year. Although rebates have been criticized as a vulgar vote buying measure, democratic governments are expected to provide benefits to their electorates. Building a hospital and sending a cheque to all Albertans are both "vote buying" measures. The benefits of dollars in the hands of individual Albertans should not be undervalued. Families may use their rebates to further their children's education or to help start a new business. The main drawback with rebates is that they may generate envy in the rest of Canada, preparing the political ground for a NEP II, and they may create an artificial incentive for low skilled workers to move to Alberta.

6. Conclusion

We have experienced a resource boom before, only to have the rug pulled out from under our feet. We need to learn from past mistakes. To avoid another painful fiscal adjustment such as the one we experienced in the mid-1990s, the government should save a high percent of our resource revenue and place a binding commitment on future governments by holding a referendum on this policy. It should avoid pushing up program spending to unsustainable levels or funding infrastructure projects that require heavy future commitments. Prices should be charged for using public infrastructure where this is feasible. The public sector should restrict its role to doing only those things that the private sector cannot do. The government should eschew industrial policies that require politicians and bureaucrats to pick winners. Instead, it should promote industrial development by maintaining an internationally competitive, low rate-broad base tax system. CWF

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What is your vision for the future of western Canada?

The Canada West Foundation has launched a western Canadian student essay contest with $5,000 available in prize money.

Students in the four western Canadian provinces (age 17-30) are invited to share their thoughts on the future of the region.

How do you see the West changing?
What role do you see for yourself in the West of the future?
What is YOUR vision for the future of western Canada?

Young western Canadian residents (age 17-30) attending (or planning to attend) a post-secondary institution in 2006 are eligible to earn prizes by submitting an essay before March 1, 2006.
To learn more, visit the Canada West Foundation's NEXT West Generation website at: **www.cwf.ca/nextwest**.