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Backgrounder

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Keeping Alberta on the Path of Fiscal Happiness

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Alberta's fiscal performance in the second half of the 1990s made possible two significant achievements: lower debt and tax reform. But more recently, Alberta has allowed its underlying spending path to grow much faster than a reasonable estimate of future revenues. In order to remain on the path of fiscal happiness, therefore, Alberta must scale back its spending path to keep it in line with future revenue growth. This will require more than the recently announced postponement of infrastructure projects. To remain fiscally happy, Alberta must significantly slow the growth of its underlying program spending.

Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.

— Mr. Micawber, in Charles Dickens' *David Copperfield*

Alberta's fiscal tightening in the early 1990s moved the province from fiscal misery to fiscal happiness and made it a paragon of fiscal rectitude in Canada. During the 1980s and early 1990s, the province's spending continuously exceeded revenues, and the resulting deficits caused debt-service costs to balloon from $100 to $740 per Albertan.[1] Alberta reacted by reducing spending by 20 percent between fiscal years 1992/93 and 1995/96 so that, by the late 1990s, burgeoning revenues — largely a result of a significant jump in resources revenues — exceeded spending.

But greatly increased revenues have had the unfortunate side-effect of eroding spending discipline, which now threatens a return to past fiscal miseries, and the attendant increase in debt-service costs that would follow.

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1 All dollar amounts are in real 2001 dollars.

The mid-1990s' reduction in spending allowed for two significant achievements: reduced debt and tax reform. The former came as a consequence of a lower spending path and a number of years of higher-than-average resources revenues, which together produced consistent surpluses in the later part of the 1990s. And Alberta aggressively lowered both personal and corporate taxes as fiscal room opened up as a consequence of lower debt-service costs.

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Micawberian math dictates, however, that if the spending trends of the past two budgets — real per capita spending growth averaging 6 percent — continue, a collision with real per capita revenue growth of just 1 percent is bound to occur, with deficits due again within three short years. Other governments, both federal and provincial, which learned from Alberta's earlier successful experiment with fiscal rectitude, will now be watching how Alberta manages its budget in the face of this inevitable collision.

Provincial Spending

Alberta's expenditures can usefully be split into three categories: health spending; other program spending, and debt-service costs. Over the past two decades, the relative importance and absolute size of each of these categories have fluctuated widely (see Figure 1).

Between the early 1980s and the early 1990s, per capita health spending was fairly stable at about $1,900 per Albertan. But by the mid-1990s, health spending declined to a low of $1,534 per Albertan. In the past few years, however, Alberta, like other provinces, has rapidly increased health care spending. Between fiscal year 1996/97 and the most recent budget, real per capita health spending grew by nearly a third.

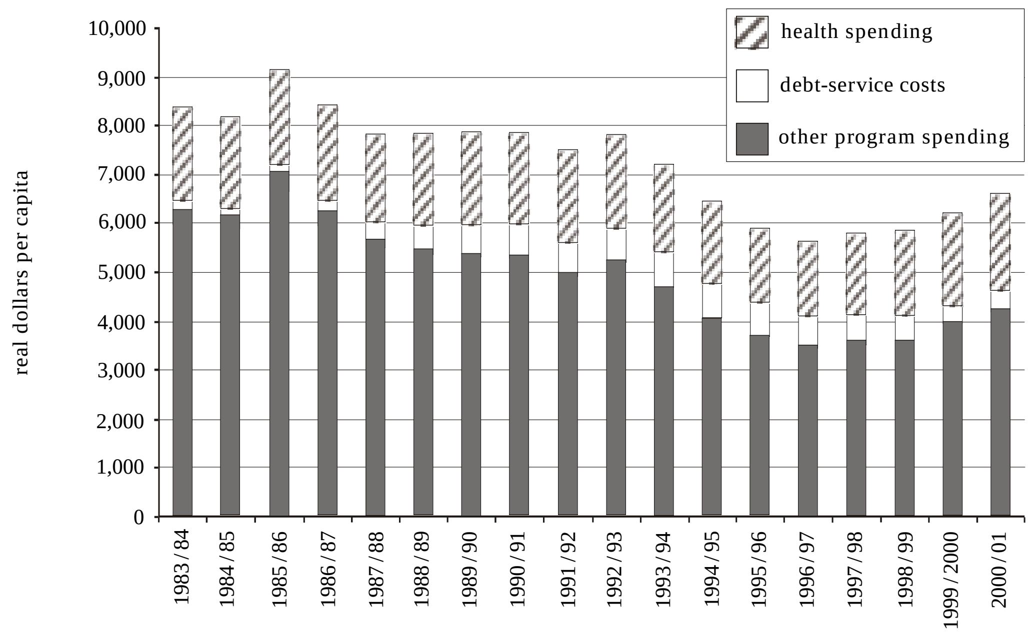
While some of this increase can be attributed to rising federal dollars flowing to the provinces, another significant factor has been the inability of provincial governments to maintain the spending discipline they exercised in the early 1990s. And as long as health budgets are driven by the combined demands of consumers unconstrained by price and health care providers demanding higher wages,[2] there is little hope that this trend will be reversed.

Other program spending in Alberta has gone through a much more radical transformation. At the fiscal year 1985/86 spending peak, these programs consumed nearly 80 percent of total spending, or $7,080 per Albertan. A decade later, spending on non-health programs had declined to just over 60 percent of total spending, or about half as much per capita as in the mid-1980s. Spending discipline in these areas was maintained a little longer than in health, but the last two budgets produced an 8 percent increase, from $3,606 to $4,252 per Albertan.

Debt-service costs have fluctuated with Alberta's swings in and out of fiscal happiness. During the fiscal misery of the 1980s and early 1990s, those costs grew from 1 percent of total spending to a peak of 12 percent. Once Alberta moved onto the path of fiscal happiness, however, debt-service costs began their downward slide, but they still consume 5 percent of total spending.

2 The most recent budget of the Calgary Health Authority is an example of the latter. Fully four-fifths of the 14 percent increase in its provincial grant over the previous year was allocated to higher wages and extra staff.

Figure 1: ***Real per Capita Government Spending, Alberta, fiscal years 1983/84 to 2000/01***



Note: Data for fiscal year 2000/01 are forecasts.

Sources: Alberta Budget 2001; author's calculations.

Albertans have to go back to the time before the Getty government to find program spending growing at today's rates.

To recap, in the past two years, total real per capita spending in Alberta has been growing at a rate of over 6 percent — faster than at any time in the past 15 years. And this during a time of falling debt-service costs. Moreover, the spending rise is due not just to rising health care expenditures; other program spending is also growing at record rates.[3] Albertans have to go back to the time before the Getty government to find program spending growing at today's rates. In short, the spending discipline of the mid-1990s has been abandoned.

The recent spending trend is especially worrying if one recalls what happened during the last bust-boom cycle. During the bust (fiscal years 1985/86 to 1987/88), real per capita spending fell by $1,300, but during the subsequent boom it remained stable. Unfortunately, however, total spending was not brought below the path of revenues, an unsustainable spending level that produced a predictable string of deficits. After 1992/93, spending fell by $1,900 per capita, which brought it below the path of revenues, but since 1995/96, it has bounced back up by half that amount. The current spending path is once again rising above a sustainable path of revenues (see the next section).

Alberta's Revenue Structure

Like its expenditures, Alberta's revenues can also be grouped into three types: natural resources revenues, personal and corporate income taxes, and other revenues. The

3 One should note, however, that some of the recent increases are due to spending on infrastructure and energy rebates, which the Alberta government classifies as one-time spending. But leaving aside these items, spending over the past two years has still grown faster than in any two-year period since fiscal year 1983/84.

relative contribution of each to the bottom line has fluctuated widely, driven mainly by swings in resources revenues.

Over the past 20 years, natural resources revenues as a proportion of total revenues have fluctuated between 15 and 40 percent. In per capita terms, these fluctuations have been equally large, from highs around $3,600 to lows around $900 (see Figure 2). Between fiscal years 1983/84 and 1985/86, resources revenues averaged $3,400 per capita, then dropped to an average of $1,200 for the next ten years. In the past five years, they have fluctuated between a low of $877 in 1998/99 and a high of $3,601 in 2000/01. The likelihood is slim that resources revenues will remain above $10 billion. Recent declines in oil and gas prices suggest that resources revenues will almost certainly fall in the coming years. Alberta's most recent quarterly report admits that resources revenue projections in the 2001 budget are overly optimistic.[4] Indeed, the Alberta government recently admitted that spending cuts in the order of $1.3 billion will be necessary to keep the budget balanced this year alone.

In the 1980s and earlier, personal and corporate income taxes followed movements in resources revenues. For example, when resources prices collapsed in 1986, income tax revenues also fell. A more diversified Alberta economy weakened this relationship in the 1990s,[5] so that, although resources prices and, hence, resources revenues dropped by a third in fiscal year 1998/99, income taxes did not miss a beat and continued to rise.

Alberta's income tax revenues will fall over the next two years. On the personal side, the move in 2001 to a single tax rate has cost the province an estimated $1.5 billion. On the business side, a four-year phase-in of tax cuts will reduce revenues by a further $1 billion by 2004.

The "other revenues" category has followed a less predictable path, hitting a low of about $3,400 per capita in the early 1980s, rising to more than $3,800 in the early 1990s, then falling to just over $3,000 over the past few years. The recent declines have been due largely to nominal freezes in the provincial take from property taxes.

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Over the next couple of years, Alberta's total revenues will fall steadily, with real per capita declines in all three revenue sources, including productivity-enhancing reductions to income taxes. In the longer term, only the province's personal and corporate income taxes — amounting to a third of total revenues — are likely to see sustained per capita growth. Resources revenues are unpredictable, but are unlikely to remain at recent levels. "Other revenues" are also unlikely to grow.

In the most likely scenario, if income taxes grow at a real rate of 3 percent and resources and other revenues remain constant, the real growth rate for total revenues would be just over 1 percent. Total revenue growth would thus trail growth in the Alberta economy.

Misery or Happiness?

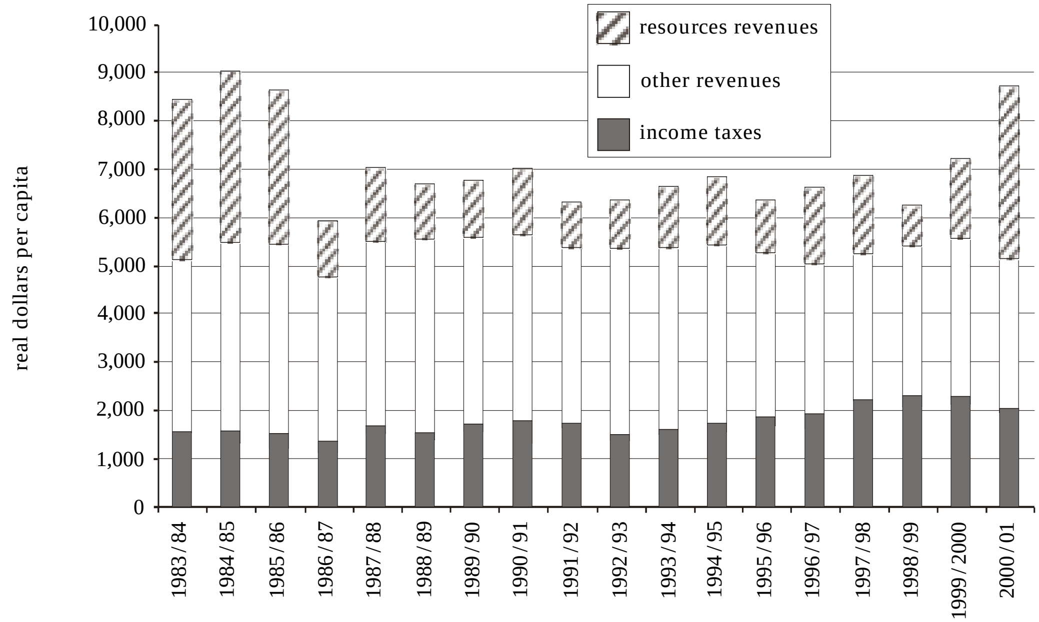
So, to paraphrase Micawber, and exaggerating slightly, "annual income growing at 1 percent, annual expenditure growing at 6 percent, result misery."

Is Macawberian misery iminent? It certainly is if current spending patterns continue and future revenue growth is realistically assessed. In fact, resources revenues have

4 Alberta, Department of Finance, *2001/02 First Quarter Report* (Edmonton, August 2001).

5 In the mid-1980s, resources-related revenues (royalties plus related corporate income tax) made up 60 percent of provincial revenues, but in recent years, they have declined to as low as 10 percent.

Figure 2: ***Real per Capita Government Revenues, Alberta, fiscal years 1983/84 to 2000/01***



Note: Data for fiscal year 2000/01 are forecasts.

Sources: Alberta Budget 2001; author's calculations.

fallen so far below budget predictions that, without adjustments to spending, there will be a $1.3 billion deficit in the current year. The province recently announced that it is paring back some of its "one-time" capital expenditures in order to put the budget back on track for the current year but, as Figure 3 shows, this will only put off the more difficult decisions: even if one excludes the recent rash of "one-time" expenditures from total spending, underlying program spending is still growing at a rate that will produce a deficit within three years. The drop in revenue for the current year (current revenue in Figure 3) has merely made the deficit risk more immediate — it has not removed the risk of returning to deficits in future years. Clearly, a course correction is required.

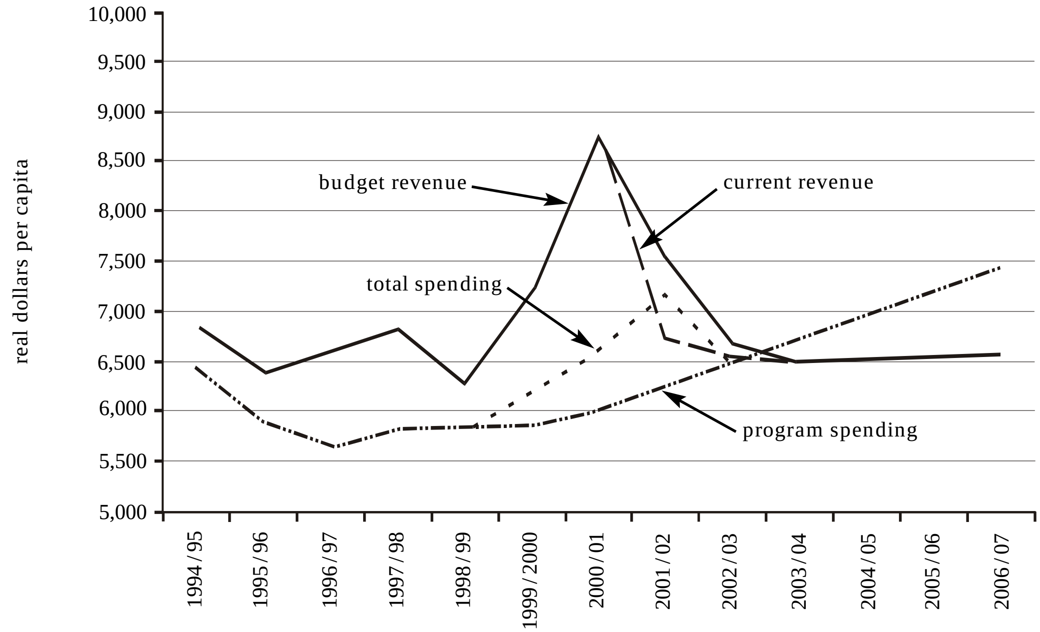
To remain on the path of fiscal happiness, Alberta must keep spending growing in line with its future revenue stream.

To remain on the path of fiscal happiness, Alberta must keep spending growing in line with its future revenue stream. If the province can expect long-term real revenue growth of 1 percent and inflation stays at 2 percent, total spending must be held to a nominal growth rate of 3 percent starting next year. This course correction is not as drastic as the one Alberta undertook during the early 1990s, but it will mean a serious scaling back of expectations.

The task becomes more difficult if the three components of spending are examined individually. To begin with, it seems unreasonable to assume that the growth in health expenditures can be kept much below health care inflation rates and population growth. The best-case scenario is probably to hold annual nominal increases in health spending to 5 percent.[6]

6 Bill Robson points out that price changes in health care — largely driven by increased cash infusions from government, rather than increased demand — have been the primary source of increased health spending in recent years. See William B.P. Robson, "Will the Baby Boomers Bust the Health Budget? Demographic Change and Health Care Financing Reform," *C.D. Howe Institute Commentary* 148 (Toronto: C.D. Howe Institute, February 2001).

Figure 3: *Real per Capita Government Revenues and Spending, Alberta, fiscal years 1983/84 to 2000/01*



Note: Data for fiscal years 2000/01 to 2006/07 are forecasts.

Sources: Albert Budget, various years; author's calculations.

If health spending grows at 5 percent, all spending outside health care must be held to a nominal growth rate of less than 2 percent to keep total spending growing at the same rate as revenues — a requirement if long-term budget balance is to be achieved. This means that all provincial expenditures except health care must decline in real per capita terms.

Restraining spending is the surest route to continued fiscal happiness, as Alberta discovered in the early 1990s.

Restraining spending is the surest route to continued fiscal happiness, as Alberta discovered in the early 1990s when it held per capita expenditures relatively constant during the high-growth years following the difficult fiscal year 1987/88. The key difference this time is that the post–1992/93 spending restraint brought per capita spending to a sustainable level, whereas in the late 1980s total per capita spending was never brought in line with a sustainable estimate of per capita revenues. The current danger is that real per capita spending will once again rise to this unsustainable level if spending growth is not curtailed.

Conclusion

Alberta's revenues have seen robust growth in recent years. This is unlikely to continue since, in the short term, all revenue sources will decline and, in the longer term, income tax revenues will be the main driver of growth in overall revenues. Alberta must therefore align its spending growth to reflect these realities. This means holding program spending to a nominal growth rate of 3 percent. And if health care is held to a nominal growth rate of 5 percent — no mean feat — all other spending must fall in real per capita terms. This not as drastic as Alberta's earlier fiscal retrenchment, but well below recent experience.

Alberta has a well-deserved reputation for fiscal management that has served as a lesson for other Canadian governments. The province's superior fiscal management in the mid-1990s allowed it to reduce its debt load significantly and embark on a path of tax reform leading to significantly lower personal and corporate income taxes. But those achievements are currently at risk because program spending has been allowed to grow faster than a sustainable path of revenues. If it does not get control of that spending, Alberta may soon be teaching a lesson on what to avoid — namely, that spending growth in excess of long-term revenue growth means a return to the misery of deficits and growing debt.

It is easy to react to burgeoning revenues in good times by increasing spending — something nearly all Canadian governments, but particularly Alberta, have done recently. It is much more difficult to keep spending on a sustainable path when the good times end. But that is what will have to be done if governments — including Alberta — wish to maintain Micawberian happiness.

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