

# **A new approach to budgeting**

## **Alberta must start thinking about the day when it has to meet its expenditures without resource revenue**

By Colin Busby, The Edmonton Journal March 11, 2009

The recent collapse of commodity prices has obvious negative implications for Alberta's fiscal and economic prosperity, and the best hope for a speedy recovery is, unofficially, a rebound in prices.

While collective finger-crossing may result in a return to large revenues, we Albertans should instead develop a plan for the long-term management of our non-renewable resources.

When energy prices dropped in the early 1980s, and then more severely in 1985, contributions to provincial saving plans gradually fell from 30 per cent of resource revenues to zero. And in 2008, Alberta's only two savings rules -- the in-year surplus allocation policy, which sent annual surpluses to savings funds, and the inflation-proofing of the Heritage Fund -- were discarded.

In the early 1980s, however, Alberta's revenues were somewhat resilient because of an OPEC policy that focused on limiting production to fight downward price pressures. Then in 1985, Saudi Arabia, frustrated with opportunistic supply increases from fellow members, broke ranks and raised production.

Oil producers today are unlikely to collaborate successfully. Many of OPEC's members, not to mention the Russian federation, have built political regimes based on expansive fiscal policy that, in turn, relies on significant resource revenues. Critical to individual members' political stability is the constant flow of money that, in the face of collapsing prices, can only be overcome by boosting production.

Therefore, Albertans who are hoping for dramatically higher oil prices in the near future may be disappointed. Unlike in the past, the reactions to this fiscal crash must address the underlying origins of Alberta's recurring fiscal problems.

In the upcoming April budget, Alberta's fiscal planners face two menacing and competing realities. On one hand, increased government spending will help stabilize the effects of a bursting financial bubble that undermine the flow of credit and investments in Alberta's economy. On the other hand, Alberta's current level of expenditures is, according to the

report of a recently appointed public commission -- the Alberta Financial Investment and Planning Advisory Commission (FIPAC) -- already well beyond sustainable amounts.

So, how should budget planners reconcile these two opposing forces? The key lies in developing a new fiscal framework that can not only accommodate short-term, higher-than-sustainable levels of expenditures but also focus on how the province can reach and maintain a long-term balance.

Two immediate reforms that identify key spending and savings targets are required.

The first necessary reform, and perhaps the most important one proposed by FIPAC, is to collapse nearly all of Alberta's savings accounts into one fund. Most Albertans see the Heritage Fund as the province's true level of savings. But much more of the province's savings are in separate funds, and this tends to blur the government's true fiscal position.

According to the most recent fiscal update, 74 per cent of Alberta's total savings are outside the Heritage Fund. Yet, the deposits and withdrawals affecting pools of capital, such as the sustainability fund and capital account, are subject to scrutiny and rules different from those of the Heritage Fund.

The second reform would see planning shift from the traditional balance between revenue and expenditures to a different but crucial fiscal indicator that shows how much Alberta's spending relies on extremely volatile resource revenues.

How would this indicator be calculated? In simple terms, the new "fiscal gap" would be budget balance (the traditional surplus or deficit number) minus resource revenues.

Using the figures in the most recent government update, the new number -- a different name could be the non-resource gap -- would be \$13.6 billion for the fiscal year now coming to an end. (This is calculated by combining the current deficit number, \$1.4 billion, with the \$12.2-billion contribution resource revenue is now projected to make to revenues for the fiscal year that ends March 31.) This gap -- think of it as what Alberta's deficit would be if we had no royalty income or revenue from sales of resource rights -- is the gap Alberta will eventually have to close, when resources run out, with interest income from our savings.

It makes sense to highlight this number because resource revenues are the most unpredictable, and hence unreliable, revenue source for the province, and more importantly, because they will eventually dry up.

This does not mean that the government should spend without using any of its current resource revenues; it simply grounds expenditures decisions by keeping a close eye on future targets.

Many resource-based jurisdictions in the world, including Norway, use this handy budget indicator.

Over time, narrowing Alberta's current non-resource budget gap will require lower spending, higher non-resource revenues, or both.

The last fiscal year also saw the collapse of investment income from the Heritage Fund. But the importance of this event for budget planners is limited only to lower expectations of annual interest income payments from the fund to the budget.

Over the last 10 years, including the collapse in 2008-09, the fund has earned average annual returns of 3.9 per cent -- reasonable savings returns to make informed budget decisions. This also implies that the government would need a massive fund, much greater than the \$100 billion proposed by the FIPAC, to bridge the current resource-supported fiscal gap and avoid falling into future deficits.

Spending at levels well above next year's revenues must be grounded by a sustainable long-term approach to Alberta's annual budgets.

Although the consolidation of Alberta's accounts will give a clear signal to other provinces about the size of Alberta's wealth, the status quo melange of funds obscures the true level of fiscal prudence.

Long-term targets should, in turn, be guided by annual budgets that clearly present plans to fill Alberta's non-resource fiscal gap. Only then can we see the province's level of exposure to global price shocks, and the amount of savings and non-resource-based taxes needed to close the gap.

The upcoming budget is a critical one for Albertans; it must balance good short- and long-term policy. We should not gamble on a quick return to higher oil and gas prices. And propping up current spending as a means to counter a financial meltdown should not avoid other tough choices -- postponing inevitable reforms will only amplify their costs.

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