Resourcing Health and Pensions

Comments to The Alberta Financial Management Commission

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Introduction

Any current discussion of Alberta financial management must come to grips with the central role of resources revenues and the future financing of health and pensions. I will bring these together today in the service of putting forward a proposal that I believe will ensure that future generations get the health care and pensions they deserve without bankrupting future taxpayers. Many of the themes are developed further in a *C.D. Howe Backgrounder* "Keeping Alberta on the Path of Fiscal Happiness". These ideas will also be contained in a forthcoming publication by the University of Alberta's Institute for Public Economics.

Resource Revenues

First, a quick review of Alberta's revenues, which for convenience I divide into three components – income taxes, other revenues, and resource royalties.

Income Taxes. In the past two decades, revenues from income taxes (personal and corporate) have followed a more-or-less upward trend. Recent substantial tax cuts on both the personal and corporate side have interrupted this upward trend, but only temporarily.

Other Revenues. Other revenues have been basically stable over the past few decades, with the exception of recent jumps in health care premiums and cigarette taxes, should continue to remain fairly stable in the future.

Resource Revenues. Alberta's resource revenues have exhibited neither growth nor stability. In the past four years they have fluctuated between $2.5 and $10.8 billion. Over the past two decades, they have made up as little as 15 and as much as 40 percent of Alberta's budgetary revenues.

A revenue source that fluctuated between 15 and 40 percent of total revenues would strain all but the best of administrations. As the past two decades in Alberta readily attest, resource revenues have been both a blessing and a curse.

I would like to make the case that nonrenewable resource royalties are of a fundamentally different nature from other types of revenues, and therefore should not properly be considered revenues like income taxes, sales taxes or other revenue sources..

When oil or gas is sold all that happens is that a physical asset has been converted into a financial asset. The proceeds from the sale of oil or gas are not properly income – they are the proceeds from the sale of an asset, and royalties that the provincial government collects are Albertan's share of that asset.

Treating resource revenue as the proceeds from the sale of an asset was at least part of the explanation for diverting some of this money into the Alberta Heritage Savings Trust Fund in the 70s and 80s and for paying down its debt in the 1990s. In the former case, the Alberta government used resource revenues to build up an asset – a nest egg, if you will – and in the latter case it reduced a liability.

In the early 1990s, the Alberta government substantially reduced its reliance on resource revenues to fund regular program spending – which is why it still ran a surplus when resource revenues fell to $2.5 billion in 1998/99. More recently, that has changed. The Alberta government has increased substantially its reliance on natural resource revenues to fund regular program expenditures. If resource revenues fell to $2.5 billion this year, the Alberta government would run a substantial deficit.

This is unsustainable from an historic perspective, and wrong from an economic perspective. From an historic perspective the current reliance on resource revenues is higher than at any point since the provincial budget was balanced. The Alberta government's current reliance on resource revenues is worryingly reflective of its dependence on resource revenues during the 1980s.

From an economic perspective, the Alberta government should not be relying on resource revenues to sustain current program spending to this extent. In fact, since resource royalties are not properly income, they should not be used to fund current expenditures at

all – doing so is a bit like selling your house to buy food.

Health and Pensions

I now turn to a discussion on the impact of the baby boomer bulge on public health care expenditures and the Canada Pension Plan.

On health, William Robson of the C.D. Howe Institute has calculated a health care liability of $20,000 per Albertan or $60 billion dollars. Another way to look at this liability is to say: If the Alberta government wanted to keep its taxes stable, it could only meet rising health expenditures in the next forty years if it had a $60 billion nest egg yielding a 6 percent return. But it would have to have that nest egg today.

Without that nest egg, health care spending will have to rise from today's 30 percent of total revenues to 36 percent by 2020 and a whopping 50 percent by 2040. (Alternatively, health expenditures will rise from just under 5 percent of GDP in 2000 to just under 9 percent of GDP in 2040.) I agree with the Mazankowski report that says these numbers suggest that the current health care system is unsustainable.

While there is plenty of room for argument around these specific projections, there is little doubt about the direction. In fact, there are good reasons to think the situation is graver than Robson allows. Double-digit growth rates for health expenditures have become the norm in the past few years, and the demographic shifts due to the baby boom haven't yet begun.

For example, Robson calculates that if real health spending and health-cost inflation outpace overall growth and inflation by only half a percent for a decade (a more accurate reflection of what has actually been happening in the past few years), and then somehow get reigned in to grow in line with the overall economy, the size of the next egg required would rise to more than $90 billion, or $30,000 per Albertan.

If there is to be any hope of meeting the funding needs of health care, the Alberta government is going to have to find a way to get through the coming baby-boomer bulge. And if the Alberta government wants to do that without raising taxes or planning for large deficits, it must set aside some money today – in short, it needs to start building that $60 billion nest egg.

Turning to pensions, the 2000 Alberta budget contains the following passage:

> . . . as a result of Alberta's younger population and high employment rates, it could likely deliver a pension plan identical to the CPP with somewhat lower contribution rates.

How much lower? The budget states that an Alberta Pension Plan could deliver benefits equivalent to the CPP with a contribution rate somewhere between 7.8 and 9.1 percent, compared to 9.9 percent for the CPP. That's a ten to twenty percent payroll tax cut.

The Alberta government could unilaterally opt out of the CPP using the *CPP Act*'s three years notice provision. That said, there are plenty of things to iron out if Alberta went this route, from portability issues, to set up and administration costs. All of these are, in my view, surmountable. At the very least, Alberta can copy what Quebec has done with the QPP.

But one of the key issues in setting up an Alberta Pension Plan is the unfounded liability that the Alberta government would inherit from the CPP. In once sense this is a red herring, since, as a cosponsor of the CPP, Alberta already carries its portion of the liability.

Still, the liability is substantial. The present CPP unfounded liability amounts to $19,900 per Canadian. Alberta's demographic and labour force advantages would mean an Alberta Pension Plan would have a liability slightly less than that. Bill Robson has informed me recently that Alberta's per capita amount, based on its demographic profile, would be closer to $18,000, or $54 billion.

The CPP is currently prefunding some of its future obligations by expanding the size of the investment fund through higher contribution rates. It is doing what Robson proposes to do for health – building a nest egg today to cap future contribution rates. If Alberta were to take over the CPP by creating an Alberta Pension Plan, it would also need to set aside this nest egg, and could further reduce the unfounded liability by contributing to this nest egg from other sources.

Resourcing Health and Pensions

The common thread in this discussion of health and pensions is the idea of prefunding – building up a nest egg today to limit future tax increases.

And where might that nest egg come from? If resource revenues should be treated as a capital asset, this means they should be set aside in a capital account, not spent as if they were part of current revenues. And if the Alberta government treated its resource revenues in this way, that capital account would provide the pre-funding necessary to start building nest eggs for health and pensions.

In summary, the government of Alberta should move towards funding current spending out of revenues excluding resource royalties. Resource royalties should be put aside to build up a nest eggs so that health care and pensions can be funded with minimal future tax increases or deficits.

By building up a nest egg, health care and pensions can move away from the pay-as-you go model towards a more user pay model. Alberta's baby boomers in their prime earning years would, through the Alberta government, be setting aside money today to pay for their future government pensions and health care.

Opting out of the Canada Pension Plan and creating an Alberta Pension Plan provides an additional opportunity to meet our future health care needs. With a lower contribution rate than the CPP, the Alberta government could dictate that Albertans direct the difference between an Alberta Pension Plan contribution rate (between 7.8 and 9.1 percent) and the CPP contribution rate (9.9 percent) into separate health care component that could be used to pay for future health needs like prescription drugs – a health care RRSP, if you will. This is not such a radical proposal when you consider that the CPP already has a disability indemnity. Creating a health care RRSP would be another important step towards a more user-pay system in health care. Individual funding of a health care RRSP is similar to the "second pillar" programs for health care that exist in many European countries. A similar plan was proposed in the Quebec Clair Commission Report on health care in that province.

Conclusion

Alberta is uniquely positioned in that it has a capital asset – oil and gas in the ground – that it can convert into a financial asset – a nest egg – that can be used to minimize sizeable future tax increases or deficits that are all but certain if the Alberta government is meet the funding needs of fund health care and pensions as the baby boomers age.

Setting resource revenues aside today will make it more likely that the baby boomers will not bust the health budget, as well as ensuring that younger generations are not forced to pay tax rates for health and pensions that are even more punishing than they are today. I urge the Financial Management Commission to stand in the proud tradition of its predecessors by providing some bold proposals to keep Alberta the fiscal, economic and social powerhouse of Canada. Past bold proposals coming that were initiated by bodies such as yourselves include eliminating the deficit through spending cuts, a single rate of personal income tax, and substantial corporate tax cuts. Using resource revenues to build up a nest egg to ensure that future generations get the health care and pensions they deserve without bankrupting future taxpayers is a bold proposal in this vein.