TOWARDS A FISCALLY SUSTAINABLE ALBERTA

A REVIEW OF PROVINCIAL GOVERNMENT FINANCES

BUSINESS COUNCIL OF ALBERTA

Policy Paper
February 2021

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Report Citation

"Towards a Fiscally Sustainable Alberta: A Review of Provincial Government Finances" Business Council of Alberta Policy Paper. February 2021

About Business Council of Alberta

The Business Council of Alberta is a non-partisan, non-profit, and for-purpose organization dedicated to building a better Alberta within a more dynamic Canada. Composed of the chief executives and leading entrepreneurs of the province's largest enterprises, Council members are proud to represent the majority of Alberta's private sector investment, job creation, exports, and research and development. The Council is committed to working with leaders and stakeholders across Alberta and Canada in proposing bold and innovative public policy solutions and initiatives that will make life better for Albertans.

Introduction: an underlying problem revealed

Alberta is in the midst of an unprecedented fiscal challenge. With a record-setting $21.3 billion deficit expected in 2020/21 and a deteriorating provincial credit rating, it might be tempting to blame our fiscal issues on the pandemic. Though it has certainly made the situation worse, Alberta's fiscal challenges long pre-date COVID. The pandemic simply made the problem more difficult to ignore.

Alberta is not alone in seeing its fiscal situation deteriorate due to COVID. Other jurisdictions in Canada have faced similar budget challenges: collapsing revenues, new and greater spending needs, and soaring deficits. What sets Alberta on a different, and more concerning, financial trajectory is its underlying fiscal and economic fundamentals—less dramatic but longer-term trends which were further exacerbated by COVID. These challenges include:

- revenues highly dependent upon volatile and declining resource royalties;
- a relatively low tax burden on Albertans, combined with sluggish economic growth;
- per capita spending levels that are 11% higher than the average of the other nine provinces;
- a political/social climate resistant to fiscal restraint or increased taxation; and
- an outdated mythology about being home to no provincial consumption tax.

Looking down the road, the current provincial government—and future governments—will need to make some difficult choices to return to a path of fiscal sustainability. Put simply, Alberta has both a revenue and expense problem. To be sure, a post-COVID recovery will help, while record-low interest rates will ease the burden of large deficits in the short term.

Fiscal sustainability

When we think about a fiscally sustainable Alberta, what does that mean? Let's start by what it is not.

Fiscal sustainability is not about the size of government; a low-tax, low-service government is equally as valid as a high-tax, high-service government. Each is a matter of public choice.

It is also not an expectation that Alberta never runs a deficit. Deficit spending may be needed to jump-start a weak economy or finance productivity-enhancing infrastructure to yield long-term benefits.

Instead, it is the provincial government's persistent ability to manage its debt in the long run, while continuing to provide goods and services at the given tax rate.

Fiscal sustainability is determined based upon what we expect in future revenues and expenses. This will vary based on the rate of economic growth, as a growing economy means more government revenues, and thus a greater capacity to service debt, while a shrinking one means the opposite. Therefore, fiscal sustainability must also consider the role of economic growth.

When interest owed on debt begins to crowd out spending on other goods and services, it limits the government's ability to finance and meet current needs. A government can borrow more to pay interest on existing debt, as happened at the federal level in the 1990s, but this causes debt to further spiral. Either way, a fiscally unsustainable government must eventually raise taxes or cut spending.

However, Alberta's underlying fiscal challenges will remain. The choices we face will involve hard decisions around policies to increase revenue, decrease spending, and grow the tax base.

The good news is that part of the groundwork has already been laid. The MacKinnon Panel on Alberta's Finances issued a 2019 report that examined the expenditure side of the equation in considerable detail and offers a number of recommendations on how Alberta can bring its spending more in line with other provinces.

To better understand the magnitude of the overarching problem, our own paper examines fiscal trends in Alberta to highlight how we got to where we are today. However, because the spending side has been well-covered by the MacKinnon report, our recommendations for action focus exclusively on the revenue side—including the importance of economic growth in expanding and enriching the provincial tax base.

Background: resources bought us a good life, but this is changing

Alberta owes a lot to its natural resources. In addition to attracting significant investment, employment and economic growth to the province, our resources generate royalty revenues that represent an additional source of income for the provincial government over and above traditional forms of taxation.

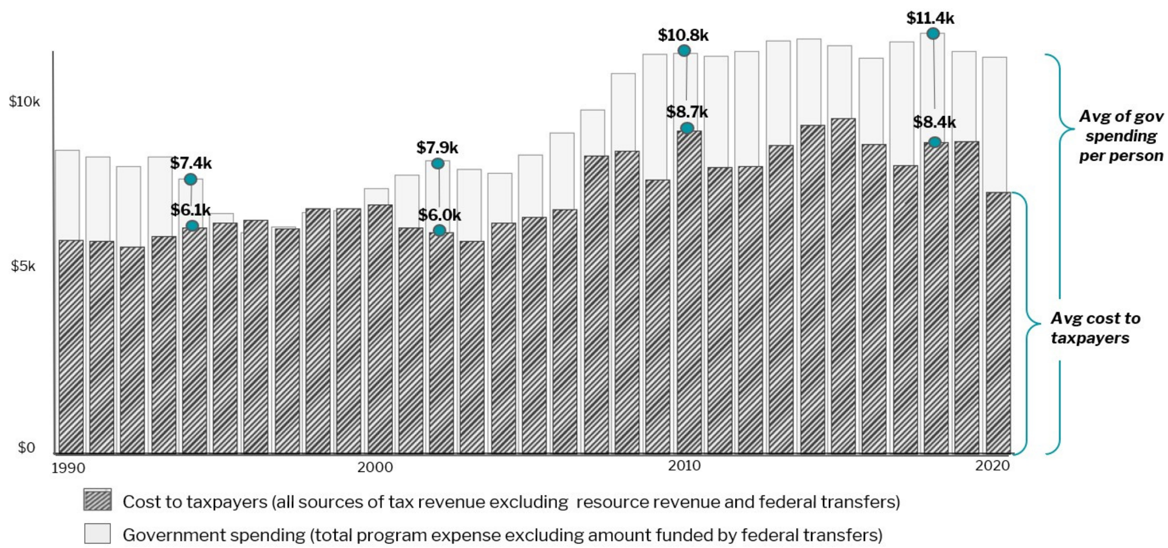
Resource royalties differ from other government revenue sources in that they are not a tax, but rather a fee that companies pay to extract resources owned by Albertans.

In that sense, they represent an indirect way of funding government expenditures—loosening the connection between taxes and fees on the one hand and government spending on the other. As a result, when royalties were high, driving strong government revenues, Albertans grew accustomed to spending levels that were not in line with the taxes they paid. Indeed, high public spending and low taxes have become a part of the Alberta brand.

The magnitude is notable. Thanks to resource royalties, it became the norm for Albertans to receive, on average, over $1,000 more from public spending on goods and services per year than they paid as taxes and user fees into the system. To pick one example, in 1993/94 Albertans paid an average of $6,100 in taxes and fees (this includes all sources of revenue, with the exception of resource revenues and federal transfers) but the provincial government spent an average of $7,400 per person on program expenses. The entire gap that year was covered by resource revenues.

1. We exclude the role of federal transfers in order to focus solely on the direct cost/benefit of Alberta's taxes and spending. All dollar figures in this paper are inflation-adjusted.

Provincial spending versus taxes collected per person

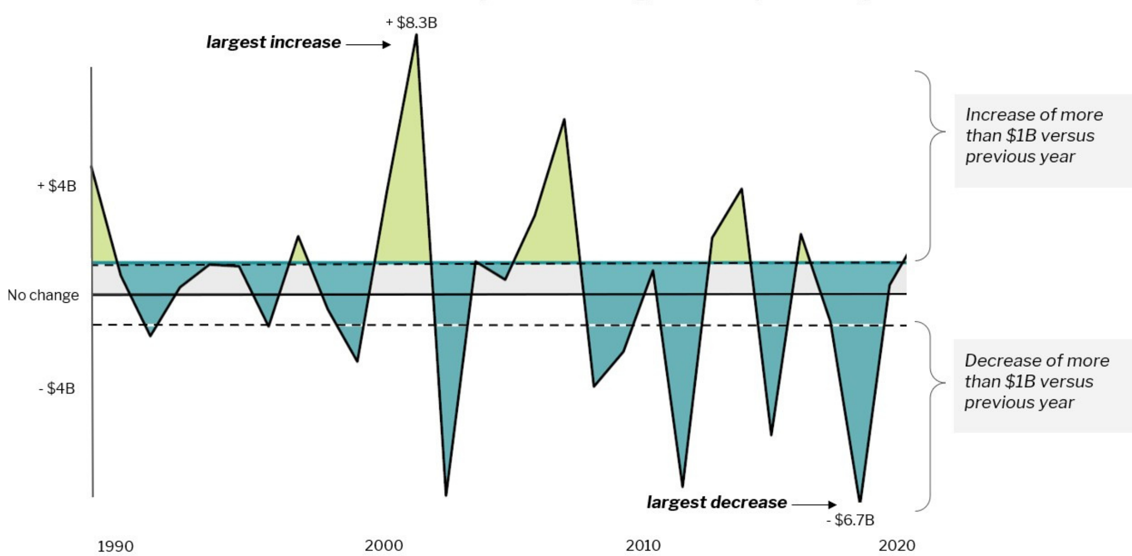


Source: Alberta Fiscal Plan 1997, 2009, and November 2020, Historical Fiscal Summary. Fiscal years are denoted by fiscal year end (e.g. 2020 represents the 2019/20 fiscal year.) Own calculations, adjusted for inflation and population size with data from Statistics Canada.

But with a reliance on resource revenue has come high revenue volatility. Over the last two decades, resource revenues have increased by as much as $8.3B and have decreased by as much as $6.7B year-over-year. Most years, the swing is at least $1B; eight times over the last 20 years Alberta has seen swings of more than $3B; and six times, over $6B.

These fluctuations are considerable. A $3B swing represents about 6.5% of the province's most recent budget. A $6B swing would be 13% of the budget—enough to wipe out one-third of health care, half of education, or all social services spending for Albertans.

Alberta resource revenue volatility: dollar change versus previous year



Source: Alberta Fiscal Plan 1997, 2009, and November 2020, Historical Fiscal Summary. Fiscal years are denoted by fiscal year end (e.g. 2020 represents the 2019/20 fiscal year.) Own calculation of resource revenue change, adjusted for inflation with data from Statistics Canada.

This has created an obvious problem. The unpredictable nature of commodity prices makes it difficult for the provincial government to accurately forecast revenues. Like a family that does not know whether it will earn $40,000 or $80,000 in the coming year, it is difficult for the government to make major spending decisions for the next 12 months when a large portion of its revenue base is so variable.

This lack of predictability creates an additional problem: in years where there is an unexpected royalty windfall, pressures to increase spending mount. In fact, research estimates Alberta's debt has accumulated more as a result of policy (spending) decisions related to commodity prices than because of swings in commodity prices themselves. Basically, provincial governments dependent on resource revenues tend to increase spending in response to high commodity prices but resist curtailing spending when prices decline. In Alberta, from 1983/84 to 2013/14, the impact of government policy on debt outweighed the impact of swings in the business cycle and commodity prices by a factor of three.

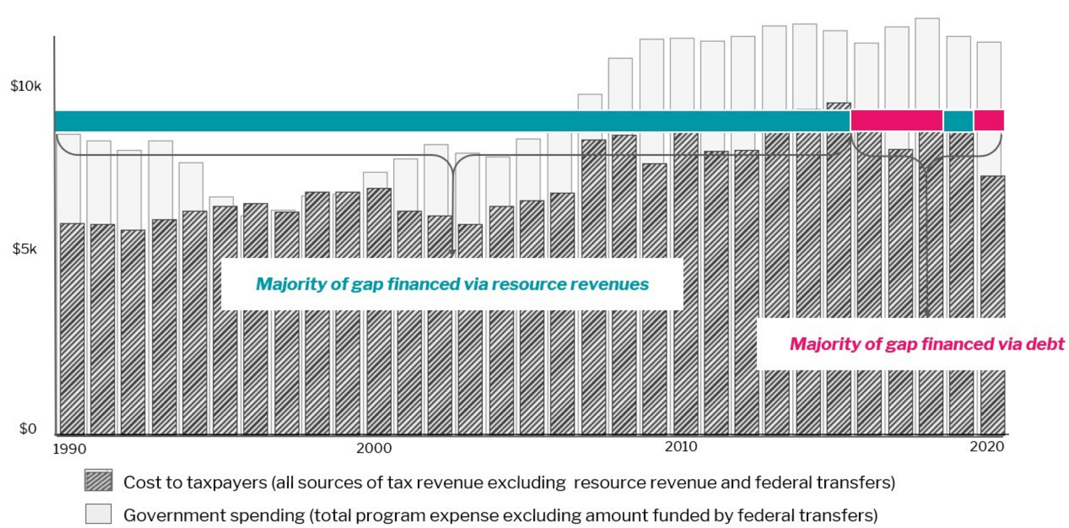
In other words, not only does reliance on resource income create a revenue problem; it also creates an adjacent spending problem.

Compounding the challenge, resource revenues have grown more volatile in recent decades. In the 1990s, the range between the highest and lowest revenue-generating years for resource royalties was $2.9 billion. In each of the decades since, the variance has been greater than $10 billion.

Making matters worse, even as resource revenues are notoriously volatile, they are also trending downward. While the Alberta population increased about 47% from 2000 to 2020, resource revenues decreased by about 2% adjusted for inflation. Much of that decline has taken place since 2006.

As resource revenues fall and spending pressures remain, the province has closed the gap with debt. Every year from 1989/90 to 2014/15, the majority of the low-tax, high-spend gap was covered by revenue from resource royalties. However, over the last five years, that has changed. Alberta now maintains an artificial—and unsustainable—high-spend, low-taxation fiscal model, financed primarily through additional government borrowing.

What has financed the majority of the cost - spend gap for Alberta taxpayers



Source: Alberta Fiscal Plan 1997, 2009, and November 2020, Historical Fiscal Summary. Fiscal years are denotated by fiscal year end (e.g. 2020 represents the 2019/20 fiscal year.) Own calculations, adjusted for inflation and population size with data from Statistics Canada.

In 2020, these problems all converged. Policy decisions in the 2020/21 budget were based on overly optimistic WTI price assumptions. Shortly thereafter, the Russia–Saudi Arabia price war hit, followed by a collapse in demand due to the pandemic. As a result, resource revenue projections for the 2020/21 fiscal year are now down $3.8 billion versus initial expectations in the March 2020 budget. The province expects to collect just $1.7 billion in royalties for that year—the lowest total in more than 30 years.

The problem: Alberta undertaxes and overspends

Exacerbating the problem of volatile and declining resource revenues, Alberta has also struggled with falling revenues from other sources in recent years, as well as the lingering effects of higher government spending in the early 2000s. As a result, Alberta now collects less revenue than all but two provinces but is still among the highest spenders.

As noted earlier, the size of government is not the issue. A well-run, high-tax, high-spend government can function well and generate economic growth and prosperity. The same is true of a low-tax, low-spend government.

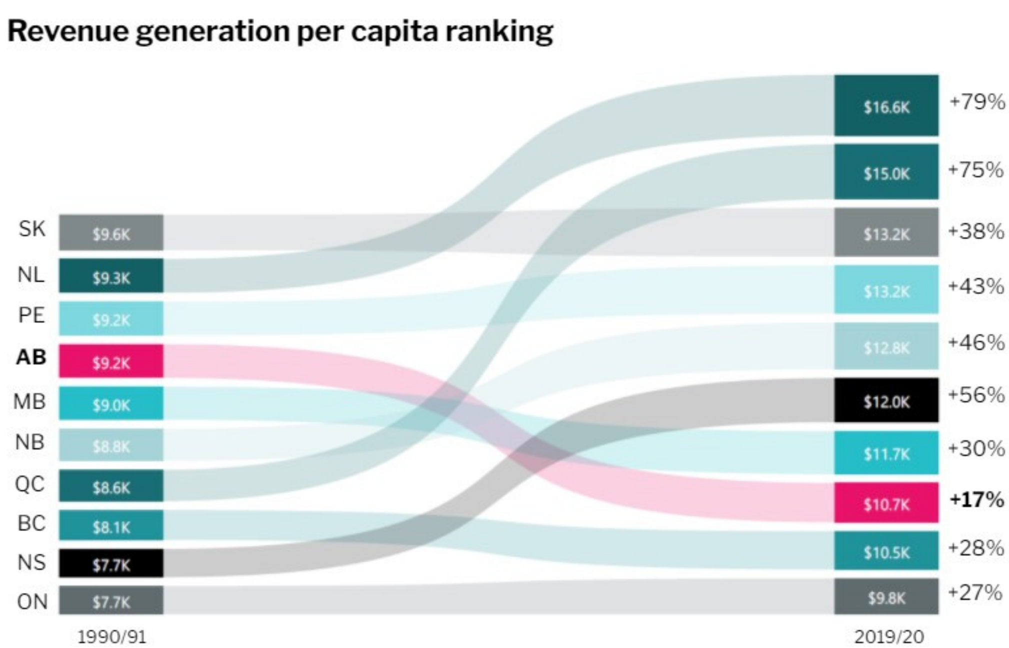
We cannot, however, sustainably run a high-spend, low-tax government in the province. This option was available for a period of time when resource revenues were high, but it would be inadvisable—to say nothing of fiscally imprudent—to count on such an approach succeeding in the future.

Government revenues

Overview

While resource revenues have declined over the last decade, other revenue sources have not picked up the slack. As a result, Alberta's total per capita revenue (from all sources, including federal transfers) has been trending downward in recent years, declining by an average of about 1% per year since 2009/10. Meanwhile, every other province has seen per capita revenues increase over that time—by an average of about 1% per year across all nine provinces.[2]

These divergent trends have had a dramatic impact on Alberta's fiscal strength relative to the other provinces. Two decades ago, the Alberta government collected the fourth most total revenue per capita of the provinces. Fast forward to 2019/20, and Alberta now ranks third to last on the list. That year, the province collected an average of $10,700 in revenues per person. Most other provinces had revenues in the range of $12,000 to $15,000 per capita.



Source: Finances of the Nation—Real per capita total revenue

Revenue trends by type

Provincial government revenues can be broken down into two broad categories. The first of these is what is known as "own-source revenues"—taxes, fees and any other revenue source collected directly by the provincial government itself.

The second is transfer payments from the federal government. Every year, Ottawa sends billions of dollars to the provinces through a range of cash transfers intended to help provincial governments finance health care, post-secondary education, infrastructure spending, and a range of other activities.

2. We use Finances of the Nation data when comparing total revenues and total expenditures across provinces because their approach accounts for differences in accounting methodologies by province.

Own-source revenues

Provincial government own-source revenues in Alberta can be broken down into six broad categories: personal income taxes (PIT), corporate income taxes (CIT), resource revenues, excise taxes (fuel, liquor and tobacco, insurance premiums), education property taxes, investment income (mostly from the Heritage Fund), and a range of smaller taxes and fees (such as gambling revenues). In every other province, there is another major category: a general sales/consumption tax.

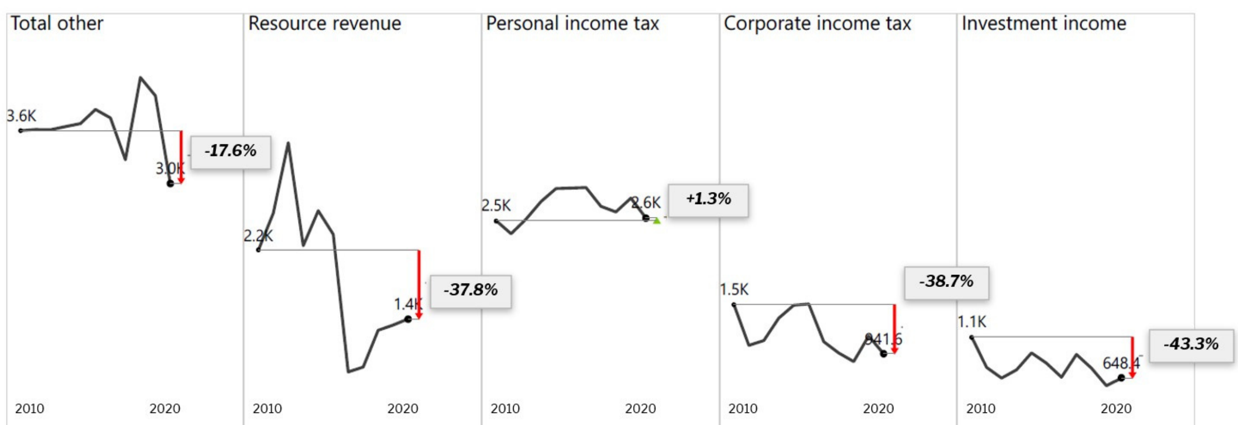
With the exception of the PIT, revenues from all major sources have declined over the past 10 years. Resource revenues accounted for the largest dollar loss, falling by 38% on a per capita basis. Leading the way on the tax side is the CIT, where per capita revenues fell by 39%, with most of that drop taking place in the years immediately following the 2014 oil price crash.

It is worth noting that declining CIT revenues coincided with an increase in general corporate tax rates by 20% since 2015; however, the impact of the higher tax rates was more than offset by weak economic conditions and declining investment, as well as a reduction in the small business tax rate. The most recent cuts to CIT rates are only visible in the 2019/20 fiscal year. While CIT revenues did fall by 17%, the decline was largely a retreat from a one-year revenue spike in 2018/19 and complicated by factors such as the early impact of the pandemic. CIT revenues in 2019/20 were moderately higher than they were in each of the two years prior to the spike.

Although a much smaller overall source of government revenue, investment income has also been weak, falling by 43% since 2009/10. Other revenues, in aggregate, decreased by about 18%.

For their part, personal income taxes did see a modest increase since 2009/10, increasing by 1.3% on a per capita basis from 2009/10 to 2019/20. However, all of this growth took place in the first half of this 10-year period. Since 2014/15, PIT revenues per person have been flat or declining.

Alberta per capita revenue by source



Source: Alberta Fiscal Plan 2009 and November 2020, Historical Fiscal Summary. Fiscal years are denotated by fiscal year end (e.g. 2020 represents the 2019/20 fiscal year. Own calculation, adjusted for inflation and population size with data from Statistics Canada.

Federal transfers

The federal government provides a range of transfer payments to the provinces to support their spending in a variety of areas. The three largest of these are the Canada Health Transfer (CHT), the Canada Social Transfer (CST) and equalization. Together, they add up to more than $75 billion in total payments from Ottawa to the provincial governments. There are, however, a wide range of other ad hoc, emergency, or temporary transfers that may take place in any given year.

Alberta receives less in federal transfers than most other provinces. On a per capita basis, Ottawa sent about $2,080 to the provincial government in 2019/20. Only BC and Ontario received less. Meanwhile, Quebec received about $2,960 per person that year, while figures in the Atlantic provinces were considerably higher.

Much of the gap is the result of equalization payments. Equalization is a federal program designed to compensate poorer provinces for their relatively low ability to generate own-source revenues. In 2019/20, five provinces received a share of roughly $20 billion in equalization—Quebec, Manitoba, and the three Maritime Provinces. Quebec received by far the largest total amount, while on a per capita basis, payments were much higher in the Maritimes.

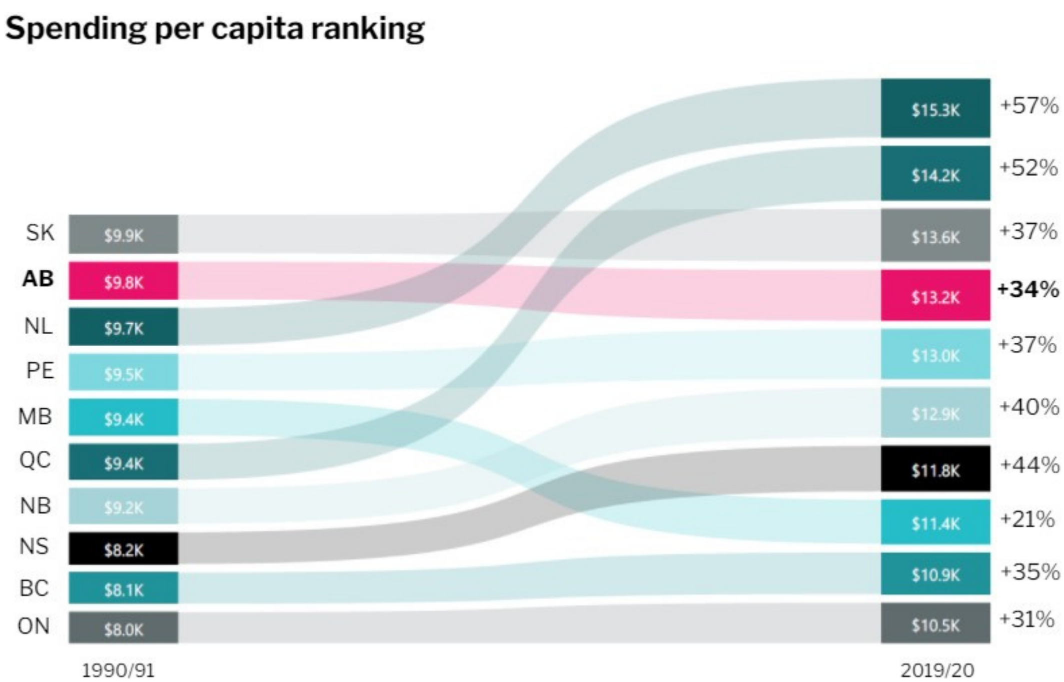
The federal government has historically collected far more revenue from Alberta taxpayers than it spends back in this province. However, the amount of federal cash flowing into Alberta has increased considerably over the last decade—at a rate far higher than elsewhere in Canada. Since 2009/10, per capita federal transfer payments to the Alberta government have increased by 20%, about double the average growth rate in the other nine provinces. As of 2019/20, federal transfers account for about[3] 18% of all provincial government revenues in Alberta, up from less than 10% in the mid-2000s.

3. One of the main reasons why federal transfers to Alberta grew so quickly over this period was because of changes to the allocation of CHT and CST funding, both of which moved to equal per capita cash transfers to the provinces. Previously, there had been a complicated system in place that saw Alberta receive far less direct cash transfers than other provinces.

Government expenditures

Overview

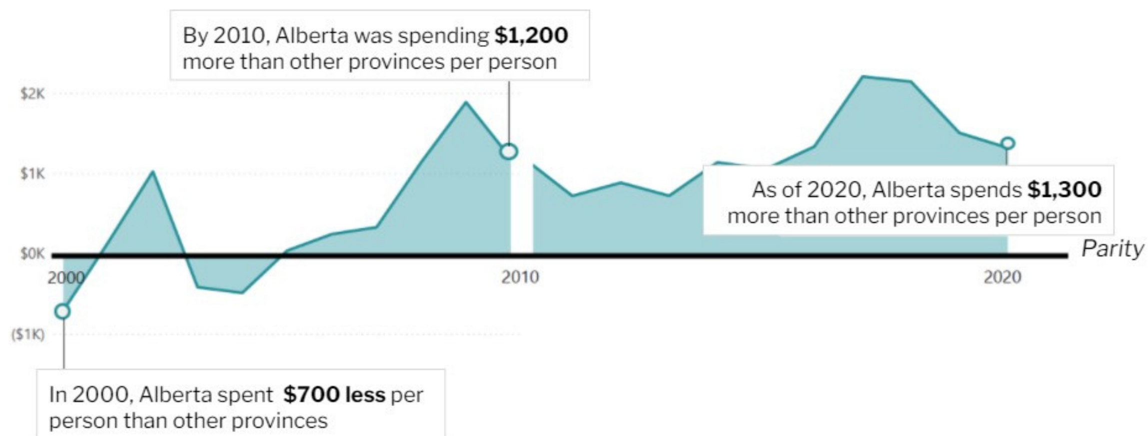
Meanwhile, Alberta's spending has actually been fairly flat over the last ten years—increasing by just 4% per capita over that entire period. But the last ten years is not the problem. Spending increases from 1999/00 to 2009/10 created a wedge between Alberta and other provinces, one that has persisted since. At the beginning of that 10-year period, Alberta spent about $700 less per person than the average for the rest of Canada. By 2009/10, however, Alberta was spending $1,200 more per person.



Source: Finances of the Nation—Real per capita total revenue

Over that time, Alberta's total per capita expenditures increased by nearly 50%—far faster than most other provinces. Spending growth has slowed considerably since then, rising by just 0.5% annually from 2009/10 to 2019/20. But the spending gap remains intact: in 2019/20, the Alberta government spent $1,300 more per person compared to the average of the other nine provinces.

Alberta per capita spending premium relative to the rest of Canada



Source: Finances of the Nation—Nominal total expenditure. "Rest of Canada" is calculated as the sum of all provinces except Alberta. Own calculation, adjusted for inflation and population size with data from Statistics Canada

Often, large increases in government spending coincide with periods of strong economic growth. However, that does not explain Alberta's spending increase from 1999/00 to 2009/10. While the economy was strong over that period, GDP growth was driven largely by an expanding population. On a per capita basis, real GDP in Alberta grew by an average of just 0.4% per year—less than half the national average rate.

Alberta's reliance on resource revenues is a potential explanation for the surge in spending in the early 2000s, along with a related concept known as fiscal illusion. Fiscal illusion is when a person makes a decision without experiencing or knowing the full cost: ordering an entree at a work dinner with an unlimited budget, for instance. In Alberta's case, taxpayers did not incur the full cost of goods and services they were receiving because the gap in taxation was filled by resource revenues. Resource revenues were soaring. The province's debt was "paid in full." As a result, taxpayers were less likely to guard against waste and inefficiencies in public spending. Not surprisingly, spending increased across the board as a result.

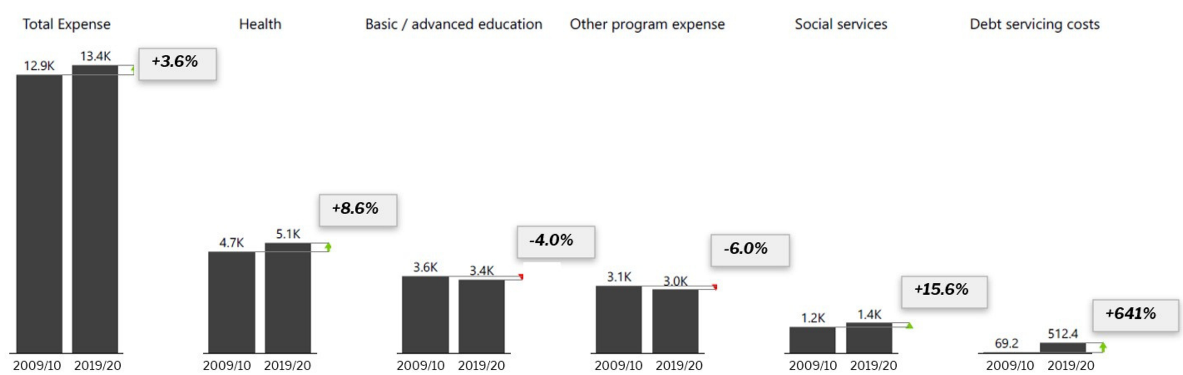
Expenditures by type

The provincial government's key program expenses, in order of importance, are health care; education (including both basic and post-secondary); "other programs" which includes departments such as Economic Development and Environment and Parks; and social services, including supports for children and individuals with disabilities. One remaining expense is interest payments on outstanding debt. However, because this money is not being spent on goods or services, it is not considered a program expense.

From 1999/00 to 2009/10, Alberta saw spending increases across all program expense categories—education, social services, and other programs. But the biggest driver was health care. Health care represents the lion's share of the province's budget and of spending growth over this time. It increased by 80%, from about $2,600 per person in 1999/00 to $4,700 by 2009/10. Part of this increase was driven by an external factor—many Canadian family doctors were immigrating to the US at the time so, in order to ensure sufficient supply in Canada, Alberta Health Services raised physician compensation by increasing the provincial fee schedules.

Since then, health spending has grown more slowly. Yet, because of its size, it has continued to drive spending increases from 2009/10 to 2019/20. About $40 of every $100 that the government spends today is allocated to health care services.

Alberta per capita spending by category



Source: Alberta Fiscal Plan November 2020, Historical Fiscal Summary. Fiscal years are denotated by fiscal year end (e.g. 2020 represents the 2019/20 fiscal year.) Own calculation, adjusted for inflation and population size with data from Statistics Canada.

Meanwhile, education, the second largest category, along with other program expenses, have been slipping in relative spending levels. On a per capita basis, spending on each has declined modestly—by about 4% and 6% respectively, over the past decade.

The Alberta government has acknowledged the need to bring spending back in line with that in other provinces, especially in health care where Alberta spends 20% more per person than the average of the three largest provinces—without achieving superior health outcomes. The MacKinnon report laid out the size and scope of the challenge in considerable detail and the province is in the process of addressing those issues.

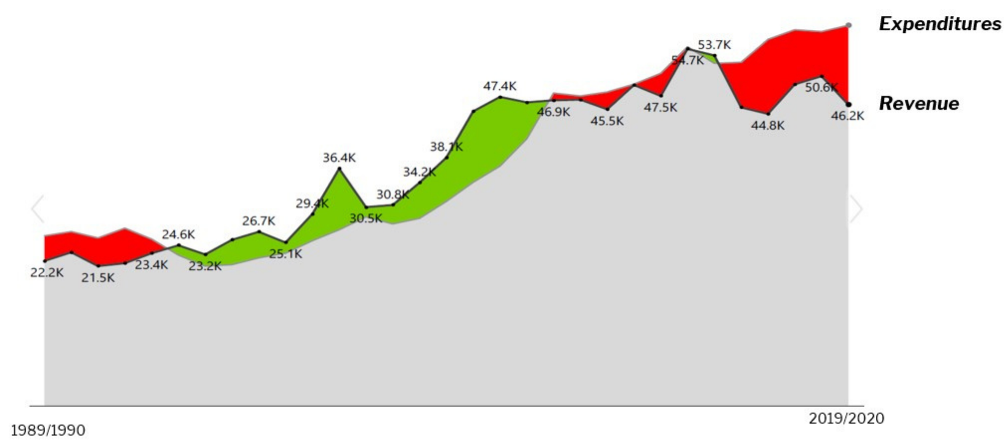
The result: growing debt and concerns of fiscal sustainability

These divergent trends—declining revenues and rising expenditures—have caused Alberta's fiscal situation to deteriorate dramatically. As recently as 2007/08, the provincial government was operating in a net asset position—its total financial assets (in the Heritage Fund and elsewhere) exceeded the value of its outstanding debt by about $50 billion.

Since then, the province has run an almost continuous streak of budget deficits. By 2019/20, that net asset position had turned into a net debt of about $40 billion —a swing of $90 billion in just 12 years. And those figures all pre-date the COVID outbreak.

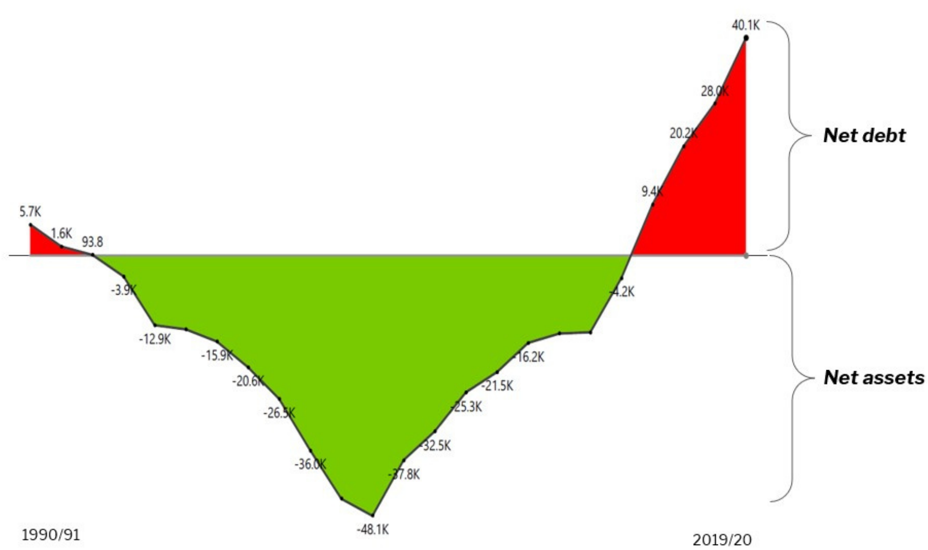
As a percentage of GDP, Alberta's net debt remains small compared to all other provinces. However, as noted above, the issue is one of trajectory, not level. No province has seen as rapid a deterioration in its net fiscal position as Alberta. And even though overall debt levels remain manageable today, they are increasing rapidly, with no clear path to budget balance or fiscal sustainability.

Alberta's budget trend



Source: Alberta Fiscal Plan November 2020, Historical Fiscal Summary.

Alberta's total net financial assets/debt



Source: Alberta Fiscal Plan November 2020, Historical Fiscal Summary.

The future

Economic, social, and demographic trends will magnify Alberta's budget problems and, without offsetting action, widen the gap between revenues and expenditures even further.

The same resource revenues that have allowed government spending to exceed tax revenues for so long face an increasingly uncertain future. Countries around the world are transitioning to lower-carbon fuels. The new US Administration is expected to focus on similar goals. And the pandemic could result in permanent behavioural changes, all of which will lower demand for fossil fuel energy.

Growth in other revenue sources will be tied to the strength of the provincial economy. In the short term, that means that revenue growth will be highly dependent on the duration of the COVID crisis and the success of fiscal stimulus. In the longer term, it will depend on the province's ability to simultaneously diversify its economy and attract investment. Even so, any growth in these revenue sources will need to overcome the drag expected from weaker resource revenues.

Meanwhile, spending pressures will continue to mount. In particular, the immediate stress of COVID-related health spending will be compounded by the broader trend of an ageing population. While Alberta is a younger province than most, the population aged 65+ is expected to more than double from 2019 to 2046, while younger demographics are expected to increase by just 30-35%. This growth rate could end up even slower if sluggish economic growth leads more Alberta youth to leave the province in search of better job prospects. Combined with higher average per capita health care spending in Alberta, these trends make for a particularly challenging expenditure trajectory.

Another consideration is the need for education, as well as worker training/retraining.

As the economy recovers and we transition to a lower-carbon future, the kinds of jobs available will change—accelerating the ongoing impacts of technological change on the workplace.

A strong, adaptable, and world-leading system of education and training is central to Alberta's long-term economic competitiveness and to attracting and retaining the best and brightest to Alberta.

Adding to all this is the cost of servicing Alberta's rapidly growing debt. As of now, record-low interest rates make this task manageable; interest payments on the existing debt represent just 4% of the government's budget. But this will not last forever. When interest rates begin to rise, the cost of servicing a debt that is much bigger will increase, eating into the government's ability to finance present needs. Moreover, if credit rating agencies continue to downgrade Alberta's debt, rising interest rates could become a reality sooner than expected.

Towards fiscal sustainability

Achieving fiscal sustainability will require some hard decisions around future government revenues and expenditures in Alberta. While the COVID outbreak has magnified the existing problem, Alberta's fiscal challenges were evident before the shutdown began and will continue once the immediate crisis has passed.

The simplest benchmark for returning Alberta to fiscal sustainability is to bring provincial revenues and expenditures more in line with other provinces. Based on 2019/20 figures, per capita provincial government spending in Alberta is about 11% higher than in the other nine provinces. Lowering expenditures to be in line with the other provinces would have reduced total spending in Alberta by about $5.9 billion in 2019/20. As mentioned earlier, options for realizing savings on the expenditure side were the subject of the 2019 MacKinnon Report.

Meanwhile, per capita own-source revenues are about 7% lower than elsewhere in the country, while federal transfers are about 13% below the nine-province average. Bringing own-source revenues up to the nine-province average would have added \$2.8 billion to provincial coffers, while additional federal transfer payments would have provided the Alberta government with an additional \$1.4 billion.

All told, if Alberta collected as much revenue and spent as much (per person) as the average of the other nine provinces, the provincial deficit in 2019/20 would have been only \$2.0 billion instead of \$12.2 billion.

Figures like these effectively illustrate the size of the challenge Alberta faces today. However, they do not account for future trends and developments, most of which are expected to further magnify the problem.

One difficult-to-predict consideration is the longer-term impacts of COVID—whether that be mass business closure and household bankruptcies; a decline in urbanization and city centres; delayed or limited immigration; or permanent changes to health care, hard-hit industries, or the nature of work–all of which will have profound consequences for the province's fiscal gap. More immediately, another recession or a turnaround in oil prices could have a dramatic impact on Alberta's medium-term fiscal outlook.

Uncertainty aside, the fact remains that the long-term trends which put Alberta on a concerning fiscal path before COVID will likely continue, if not accelerate. This means the time for change is sooner rather than later.

Without action, our current trajectory is alarming.

A snapshot in time does not fully reflect the magnitude of the fiscal gap in Alberta because current trends are expected to make the situation worse over time. Some economists, therefore, have estimated the true fiscal gap based not just on current income and spending, but also on future revenues and expenses—including the trends detailed above—as well as the role of economic growth.

Using this methodology, University of Calgary Economics faculty, Trevor Tombe, found that Alberta's true fiscal gap is equal to about 4.5% of GDP. To fully close this gap would require an increase in taxes of 34% or a decrease in expenditures of 27% versus budget 19/20 (or some combination of the two). Furthermore, he finds within the current trajectory that the biggest problem lies on the revenue side of the ledger, which emphasizes the importance of taking a hard look at Alberta's current revenue model.

Policy changes

Alberta faces significant fiscal challenges. Its per capita revenues are far below those in other provinces. Its per capita spending levels are among the highest in Canada. A very different future for the oil and gas sector compared to the past few decades spells potential trouble not only for royalty revenues, but for the provincial economy in general.

On top of all that, the province is struggling with the impact of the pandemic. The Alberta government has argued that a pandemic is not the right time to introduce major fiscal changes. While we agree, considering the magnitude of the challenge Alberta faces, we believe that now is precisely the time to take a clear-eyed look at the province's challenges, weigh the options, and set a course to change Alberta's fiscal structure to something that is more sustainable and stable over the long term.

At the same time, major changes need to be made with more than just dollar figures in mind. Individual Albertans will pay for tax increases and will be impacted by spending cuts. Any fiscal policy reforms must assess the social and economic costs and consider ways to implement changes such that the negative implications are minimized. To that end, we believe fiscal policy changes should be assessed based on the following criteria. They should:

- Put the province in a stronger long-term fiscal state;
- Optimize the value of government services to Albertans;
- Reflect principles of competitiveness, simplicity, fairness, and stability;
- Seek to limit unintended consequences which would inhibit economic growth or social well-being; and
- Enable greater prosperity generation after generation.

Re-imagining Alberta's revenue model

With the expenditure side of the equation addressed by the MacKinnon Report, what can be done on the revenue side to close the fiscal gap and put Alberta on a more sustainable fiscal footing?

There are, of course, a wide range of taxes that could be raised to increase revenues in the short term. But rather than piecemeal approaches that could hamper economic recovery and our long-term growth trajectory, in our view, now is the time to explore options to fundamentally transform Alberta's revenue model. Comprehensive tax reform and modernization could bring more revenue into provincial coffers, reduce our reliance on resource royalties, and stimulate economic growth. To be clear, there is no silver bullet solution that will generate untold new government revenues without imposing additional costs on Albertans. However, creative and imaginative solutions could minimize the burden on taxpayers, while placing Alberta on an economic growth trajectory that expands the tax base to lower that burden even further.

What might such reform look like? We see two key options that are highly debated in Alberta, yet would not only generate new revenues for the province, but would contribute to achieving the principles of fairness, stability, simplicity and competitiveness, enabling the province to broadly re-imagine our revenue model overall.

Introduce a harmonized sales tax

The most common advice given to the Alberta government on the revenue side is to introduce a harmonized sales tax (HST). As the only province without a sales tax of any kind, an HST would provide an immediate and significant influx of revenues. Though there are a range of estimates, it is reasonable to assume an HST could bring in about $1 billion in revenue for every 1% tax point and, some of this revenue would come not from Albertans but from visitors and tourists. As such, introducing an 8% HST, for example (on top of the existing GST), would net the provincial government about $8 billion, around $800 million of which would come from visitors. This would be more than enough to close the own-source revenue gap between Alberta and the other provinces.

An HST offers a number of advantages. In stark contrast with resource royalties, it is one of the most stable sources of government revenue. It is also more efficient that the PIT, which can deter savings and investment. Additionally, it is relatively low cost to administer and difficult to avoid since it is piggybacked on the GST. Moreover, it would be easy to protect lower-income Albertans, including those hit hard by COVID, through a rebate system such as already exists with the GST.

Re-introduce an Alberta consumer carbon tax

Re-introducing the provincial consumer carbon tax would also create a significant revenue stream for the Alberta government. The provincial carbon tax was repealed in June 2019 and replaced in early 2020 by the federal carbon backstop. The province is currently challenging the federal government's jurisdiction in imposing the tax in the court system.

A consumer carbon tax could be structured in the same way as a value-added tax (like the GST). This would allow producers to pass the cost down and preserve business competitiveness while also generating government revenue and increasing the incentive to reduce GHG emissions.

What about increasing federal transfer payments?

Albertans have long been aware that the federal government collects more revenue from the province than it spends here. However, this historical net contribution to confederation is, for the most part, unrelated to the province's fiscal gap. Instead, it is the result of our higher wages leading to Ottawa collecting more taxes per person from Albertans as well as lower federal direct spending and personal transfers. Neither of these factors affect provincial government revenues.

To be sure, the Alberta government does receive less in federal transfers than most other provinces —to the tune of about $1.4 billion in 2019/20. However, the main reason for this difference is that the province does not qualify for equalization payments, which only go to relatively poor provinces.

There is a legitimate case to be made for equalization reform, but any such reforms are unlikely to affect Alberta's fiscal situation, particularly in the near term. The alternative is for Alberta to qualify for equalization. For that to happen, our economic and fiscal challenges would need to be far worse than they are today.

In our view, the Alberta government should absolutely work with its federal counterparts to address barriers to investment and economic growth in the province, including positioning Alberta to take the fullest advantage of its energy assets in a lower-carbon future. However, with own-source revenues well below the average of the other provinces, it is difficult to justify calls for more direct financial support from Ottawa.

However, like the HST, a consumer carbon tax is regressive on its own so it should be tied with a low-income tax credit. The credit would ensure the relative progressivity of the tax system is unchanged and protect the most vulnerable Albertans. Furthermore, this would have an added benefit of signaling Alberta's intention to be a leader in helping meet Canada's emissions targets, something which could be important for Alberta's new Invest Alberta Corporation with the goal of attracting foreign investors.

Estimates suggest that even with a rebate to lower income households, at \$50/tonne, Alberta could net \$1.5 billion from reintroducing a provincial carbon tax. With the federal backstop set to rise to \$170/tonne by 2030, the impact on provincial revenues could be considerable.

These two steps would not only generate billions of dollars in new revenues for Alberta, but they would also open the door for other actions as well. It is no secret that Albertans have historically been resistant to a consumer-level sales tax. However, such a tax could be combined with specific exemptions, lower personal income taxes, or other measures that could mitigate the overall increase in the tax burden, help to achieve fiscal sustainability, and set the province on a competitive economic growth path for generations.

Growing the tax base

While tax increases will help close Alberta's fiscal gap, they are not a substitute for the effects of sustained long-term economic growth. Government revenue growth is closely tied to growth in the provincial economy. Strong economic expansion creates jobs, raises wages, and increases corporate profits. These actions all generate additional revenues for the provincial (and federal) governments, while creating long-term prosperity for Albertans.

As such, not only must any fiscal policy reforms be mindful of the potential negative impact on the economy, stimulative economic policies themselves can help to close the fiscal gap.

It is for this precise reason that many economists support preserving the corporate income tax cut even in the face of large short-term deficits.

In the summer of 2019, the Business Council of Alberta published a report entitled, *Relaunch, Recovery and Beyond: A prosperity framework for Alberta*. In it, we outline a series of pillars and guiding principles we believe need to be central to creating a competitive, innovative, and inclusive Alberta economy. Some of these include:

- Preserving and further re-enforcing Alberta's competitive business climate through an attractive tax environment, accelerating project approvals, and embracing continuous improvement in regulation design, eliminating all that slow or inhibit progress, or offer little benefit to Albertans.
- Investing in education, training, re-skilling, and upskilling to ensure that Albertans are prepared for the jobs of tomorrow.
- Creating a vibrant innovation ecosystem to drive growth in Alberta's technology sector.
- Enabling evolution of our oil and gas sector to be competitive and export oriented in the fuels of today and tomorrow.
- Further diversifying our economy through implementation of strategies for the agriculture, forestry, transportation, manufacturing, and tourism sectors.
- Increasing productivity through strategic investments in physical and digital infrastructure.
- Maximizing labour force participation by expanding access to affordable child care.
- Attracting clean energy capital investment to the province through strategic partnerships, the development of a robust climate action plan, and highlighting Alberta's ESG leadership.

These, and other actions that stimulate economic growth and attract investment to Alberta, are critical to achieving long-term fiscal sustainability and prosperity.

Conclusion

Alberta's fiscal challenges are clear and well-known. The impact of the COVID economic shutdown has added a sense of urgency to an already challenging situation. It is clear that no one policy action or reform will be sufficient to close the province's fiscal gap and put Alberta on a path towards long-term fiscal sustainability.

Closing the fiscal gap will require action on both the revenue and expenditure sides of the equation. The province will have to curtail spending to bring it more in line with that of other provinces. At the same time, it needs to explore options to increase revenues and reduce its reliance on volatile and potentially unsustainable resource royalties. And both need to be done in such a way as to minimize the impact on Albertans, both in terms of financial costs as well as preserving the quality of government services the province offers.

The good news on the revenue side is that we have room to maneuver. Albertans face the lowest tax burden in Canada, meaning that we can explore options such as an HST without compromising our competitive advantage.

That said, the most important consideration in this exercise is to preserve Alberta's attractiveness as a place in which to live and work. Attracting investment and stimulating job creation and economic growth is by far the most effective way to get Alberta back on a more sustainable fiscal footing.

The challenge in front of us is to settle on a plan of action and to get the details right. This paper has identified some of the core proposals that would help restore Alberta's fiscal health. But there are countless options and policy considerations for how these ideas could be designed and executed. The Business Council of Alberta will be exploring some of these in greater detail in the coming months.

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