A Renewed Alberta Savings Policy and Fiscal Framework

Key Issues for the 2012 Public Consultations

Introduction

With the Government of Alberta forecasting a return to budget surpluses starting in 2013-14[1], the province may soon be in a position to dedicate a portion of its incoming revenue to savings. Decisions on savings - including any savings rules, savings amounts and timing - will, in turn, have significant implications for Alberta's overall fiscal framework, including the legislation and rules governing budgeting and spending. Savings decisions will also affect the amount of revenue available to fund current programs and services for Albertans.

The issue of saving is of particular importance to Alberta, given our relatively high degree of reliance on revenues from non-renewable resources (NRR). Over the past decade, NRR revenues have accounted for about 30 per cent of Alberta's total revenues, on average (with the annual share ranging from a low of 19 per cent of total revenue to a high of 40 per cent over this period). Since Alberta's NRR revenues represent income from a depleting public asset, it is essential that we become progressively less reliant on these revenues to fund ongoing programs. Over time, as our NRR base is drawn down, the province's NRR revenues will also enter a period of irreversible decline. This point may be far in the future, but it will eventually arrive.

Under Premier Alison Redford, the Government of Alberta has made a commitment to prepare for this eventuality by taking action to reduce our dependence on NRR revenue. In *Budget 2012,* it was announced that, *"in consultations with Albertans*, *(the) government will look at how savings are used, the appropriate use of borrowing for capital, and how to reduce reliance on resource revenues."* The Budget also reaffirmed that these consultations would seek Albertans' input on the future of the Alberta Heritage Savings Trust Fund. The consultations will take place in the fall of 2012.

This discussion paper, including the present overview plus five attached backgrounders, has the following objectives:

- To outline some of the key issues regarding NRR revenue, savings and capital funding that will be addressed in the 2012 public consultations.

[1] In Budget 2012, the Government of Alberta forecast a deficit of $886 million for the 2012-13 fiscal year, followed by budget surpluses of $952 million in 2013-14 (the first budget surplus since 2007-08) and $5.2 billion in 2014-15.

- To provide relevant background on these issues, including an overview of Alberta's historical experience with fiscal/savings frameworks and capital financing, as well as recent fiscal developments that may inform decisions on a fiscal and savings strategy.

- To stimulate thought and discussion on the implications of policy decisions regarding NRR revenue, savings and funding of capital investment for other components of Alberta's fiscal framework (for example, balanced budget and expenditure rules), as well as consideration of the tradeoffs between savings decisions and the resources which will be available to fund current programs.

The five backgrounders to this document provide more in-depth information on various matters of relevance to the development of a renewed provincial savings policy and fiscal framework, and a policy on the financing of capital. These Backgrounders are:

- *Backgrounder A: The Evolution of Alberta's Fiscal and Savings Policies, 1976 to Present*
- *Backgrounder B: Alberta's Current Savings Framework and Savings Accounts*
- *Backgrounder C: Alberta's Record on Savings*
- *Backgrounder D: A Chronology of Major Public Consultations on Fiscal and Savings Policy, 1993 to Present*
- *Backgrounder E: The Evolution of Alberta's Policies on Capital Financing and Accounting*

The upcoming public consultations on NRR, savings policy and capital funding represent an important first step in the development of a renewed provincial fiscal framework. In conjunction with the outcomes of other major provincial initiatives presently underway (most notably, the initiative on results-based budgeting), the direction which Albertans provide on these issues will play a key role in the development of this new framework.

What is a Fiscal Framework?

The fiscal framework is essentially the rules and limitations the government places on itself concerning the budget. It sets the boundaries within which the government can act. Frameworks can be legislated, or they can be established through policy statements which do not include supporting legislation. Currently, elements of the fiscal framework are both in legislation (the *Fiscal Responsibility Act*) and reflective of policy statements. The fiscal framework in Alberta has evolved over the years as circumstances have changed (see Backgrounder A) but generally the frameworks have addressed basic questions such as:

- Whether deficits are allowed and if so under what circumstances.
- The amount of resource revenue that can be used for budget purposes.

- Use of surpluses (or when and how debt will be repaid).
- Limitations on in-year spending.

Non-Renewable Resource Revenue and Savings

The treatment of non-renewable resource (NRR) revenue provides a useful reference point for discussions on savings, due to the ultimately diminishing nature of NRR. A key rationale for saving in a resource-reliant jurisdiction such as Alberta is that this revenue source will eventually decline, and the income from this source will therefore need to be replaced. Savings - or, more precisely, the future provincial income stream generated from savings - will be needed to ensure that future generations of Albertans can receive comparable benefits from our publicly-owned NRRs as do present-day Albertans.

Apart from the fact of its eventual decline, the future course of Albertans' NRR revenue is highly uncertain. As a result, it is difficult to maintain that there is one 'correct' approach to the matter of saving NRR revenue. Views will differ, depending upon one's assumptions about the future course of Alberta's NRR prices, production and revenue - each of which have significant speculative aspects.

Despite this uncertainty about the future, it may nonetheless be instructive to examine Alberta's recent history, to provide a common frame of reference for a policy discussion on the saving of NRR revenue.

Alberta's Recent Record on Savings and Non-Renewable Resource Revenue

Since resource revenues are inherently volatile, the extent to which Alberta relies on NRR revenues to fund current programs fluctuates widely from year to year. On average, however, in the decade preceding the recent global recession (from 1998 to 2008), roughly half of Alberta's NRR revenues were needed to fund current expenditures, while the remaining half was either saved or invested in capital assets.

With the onset of the global recession in 2008, Alberta was no longer in a position to set aside NRR revenue for future needs. All of our current NRR revenue, as well as amounts drawn from the province's Sustainability Fund, were needed to sustain priority programs for Albertans. In the 2008-09 fiscal year, a projected $8.2 billion budget surplus turned into an $852 million deficit – a reversal of $9 billion dollars – over the course of just nine months, when a dramatic drop in energy prices saw Alberta's non-renewable resource revenues decline from a projected $18.8 billion to $11.9 billion.

While the circumstances were extraordinary – notably, the deepest global economic downturn of the post-World War II era, the events of the past four years serve as a powerful reminder of the province's vulnerability to external events, and the importance of preparing and saving for the future, including for the time when declining NRR revenues will be insufficient to sustain priority programs. They also illustrate the difficulties of establishing fiscal and savings policies which are sustainable in an environment of significant uncertainty.

Alberta's Past Experience with Savings Policies and Fiscal Frameworks

The global downturn of 2008-09 is only the most recent example of the inherent revenue volatility which Alberta has experienced in recent decades. As described in *Backgrounder A,* since the energy boom of the mid-1970s the province has faced substantial challenges in charting a stable fiscal course in an environment of uncertain and highly volatile resource income. The province's policy approach on savings and fiscal frameworks has changed numerous times over the past three and half decades, in response to changing economic and fiscal circumstances.

In 1976, amidst rapidly rising provincial energy revenues and budget surpluses, the Heritage Savings Trust Fund was established with a requirement that 30 per cent of the province's NRR revenue be transferred to the fund each year. By the early 1980s, however, fiscal pressures from a major recession brought significant changes to the Heritage Fund. The share of the province's annual non-renewable resource revenues that was transferred to the Heritage Fund was reduced from 30 to 15 per cent in 1983, and eliminated entirely in 1987.

Despite this reversal in provincial savings policy, beginning in 1985-86 Alberta recorded budget deficits for nine consecutive years (through 1993-94), accumulating debt rather than savings. In 1993, the government's focus then turned to aggressive deficit and debt elimination. Several legislated fiscal frameworks were enacted, and included requirements for balanced budgets, paydown of debt and limitations on the amount of NRR revenue that could be used for budget purposes.

In 2003, following nine consecutive years of budget surpluses and fiscal consolidation, the province established the Sustainability Fund. This fund was intended as a repository for year-end cash surpluses, and to serve a budget stabilization function with respect to NRR revenues. When annual resource revenue exceeded a specified amount (initially set at $3.5 billion, increasing to $5.3 billion by 2009), any excess was deposited in the Sustainability Fund. If resource revenues fell short of the specified amount, the amount of the shortage could be withdrawn from the Sustainability Fund for budget purposes. The Sustainability Fund peaked in value at $16.8 billion in 2008-09, but with the province recording budget deficits each year since 2008-09, the fund has been drawn down to $7.5 billion as of March 31, 2012.

Looking Forward: Non-Renewable Resource Revenue and Savings

Despite the significant cautions suggested by Alberta's history and distinct circumstances, the province remains in a strong position going forward. With the continuing expansion of oil sands production and associated revenues, and through prudent management of government spending, the province is expected to, within the relatively near future, be in a position to return to saving in a significant way.

By 2014-15, it is projected that about two-thirds of current NRR revenues will be needed to fund current spending. The remaining one-third, or more than $5 billion, is expected to be available for either saving or investing in the province's future needs (e.g., capital assets). At the same time, the demonstrated unpredictability of resource revenue suggests that these projections should be viewed with caution when considering the various possible approaches to a provincial savings policy.

Beyond questions regarding the appropriate level of, and timetable for, saving NRR revenue, there are fundamental questions to consider regarding both the objectives and the uses of these savings.

As indicated above, two major purposes of saving are long-term income replacement and fiscal stabilization. When Alberta's resource revenues eventually begin to decline, the province will need to replace this revenue with income generated from savings. In addition, the review of savings policy will need to consider Alberta's approach to fiscal stabilization, as presently provided through the Sustainability Fund. Among the questions that need be considered are the appropriate allocations of savings for each of these (or other) purposes, as well as the rules governing the use of fiscal stabilization funds (including, for example, any limitations on the types or amounts of transfers that can take place in any given fiscal year).

Another fundamental question regarding savings policy concerns the uses to which long-term savings are to be applied. For example, what proportion of long-term savings is to be invested in income-yielding financial instruments (e.g., bonds, equities), and what proportion - if any - should be dedicated to strategic investments aimed at supporting future economic growth in the province (for example, in support of value-added activity)? A related question is whether the province should expand upon existing specific-purpose endowment funds, such as the Alberta Heritage Foundation for Medical Research Endowment Fund. A detailed description of the various provincial savings vehicles presently in place in Alberta (including their current financial values) is provided in *Backgrounder B.*

Funding Capital Investment

Unlike many current provincial programs and services, capital investment has the distinct feature that it typically provides benefits over a long period of time (often 30 years or more), not simply during the current fiscal year. In the context of a discussion on savings policy, this feature raises legitimate issues as to how a government should fund investment in long-life capital assets.

As described in *Backgrounder E,* the Government of Alberta's approach to the funding of capital has evolved over time. These policy changes have been influenced by a number of factors and developments, including a change in generally accepted accounting standards. In 2003, the government adopted the Public Sector Accounting Board standard on the accounting treatment of capital assets. As a result, spending on government-owned capital assets was no longer immediately and fully charged to the government's bottom line in the current fiscal year; instead, the expense is amortized over the expected life of the asset. Other significant changes included the creation of the Capital Account in 2003, as a dedicated source of funding for capital investment, and the subsequent discontinuation of this account in 2009 (at which time the assets in the Capital Account were transferred to the Sustainability Fund).

Some key questions regarding the funding of capital investment include the following: should capital investment be funded from current revenues, from accumulated savings, from borrowing, or from some prescribed combination thereof? Also, should consideration be given to reinstating a dedicated funding source for capital, as was the case with the Capital Account from 2003 to 2009?

OTHER ISSUES/QUESTIONS FOR CONSIDERATION

In addition to the issues outlined above, there are a number of other questions that may need to be considered with respect to NRR revenue, savings, and funding of capital. Some examples include the following:

- Should there be rules-based or legislated options for saving a fixed percentage (or dollar amount) of Alberta's non-renewable resources every year, or over a multi-year period corresponding to an economic or 3-year budget cycle? Alternatively, should Alberta's savings policies be more flexible, focusing on savings targets or guidelines?
- Should there be specific timetables for reducing or eliminating the province's dependence on NRR revenues for supporting current operating costs (for example, 5, 10 and/or 20-year targets)?

- Should Alberta consider only modifications to existing savings vehicles, or should there be consideration of new savings institutions/mechanisms, including new specific-purpose funds - for example, in a fund or funds to support long-term strategic economic objectives?
- If borrowing is considered an appropriate funding source for capital investment, should there be limits on the total amount of debt that may be incurred for this purpose?
- At present, more than 75 per cent of total provincial expenditure is dedicated to three core program areas: health, education and social services. In an environment of economic and fiscal volatility, how should the province balance the long-term need for saving with the protection of priority programs? In the event of sharp revenue declines in the future, how should our savings policy be structured to achieve an appropriate balance between these objectives?