

Don't Spend Away the Windfall: Better Options for Alberta's Unexpected Revenues

Contributions by Jack M. Mintz, Trevor Tombe, Joel Emes, and Tegan Hill



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Executive Summary

Due largely to a record high windfall in resource revenue—worth an expected \$28.1 billion in 2022/23—Alberta is projected to run a \$12.3 billion budget surplus in 2022/23 with additional surpluses anticipated over the next two fiscal years. History has shown that spending these surpluses only leads the province back into deficits when resource revenues inevitably decline, which sets the province up for hard times down the road. Instead of wasting this extraordinary opportunity by spending away the temporary surpluses, the provincial government could use them to improve Alberta's finances and economy for the long-term. This essay series presents three such options, all of which are preferable to spending away the windfall.

University of Calgary economist Trevor Tombe suggests the provincial government consider using the surpluses to eliminate the province's debt. Professor Tombe argues that debt elimination is an attractive option as for the first time in well over a decade government borrowing rates are projected to exceed the expected return on investment savings. In other words, the cost of provincial debt (estimated by long-run bond yields) is expected to exceed the return on investments (such as those in the Alberta's Heritage Savings Trust Fund). Given mounting global economic and geopolitical risks, the financial gains from lowering debt—in the form of reduced interest payments for Albertans—provide welcomed certainty where financial investments may not. Professor Tombe finds that if the provincial government holds growth in program spending to its plan in Budget 2022 (updated for 2022/23 in its first quarter update) and to inflation and population growth thereafter, Alberta could eliminate its debt by 2030. Eliminating provincial debt within a decade could save nearly \$20 billion in cumulative interest costs by 2030, costs that Albertans are ultimately responsible for paying.

Alternatively, argue Fraser Institute economists Tegan Hill and Joel Emes, the province should consider using the current surpluses to re-establish the rainy-day account based on the previous Alberta Sustainability Fund (ASF) so as to avoid future deficits when commodity prices and thus resource revenues are lower. The first step is to determine a “stable” amount of resource revenue to be included in the budget annually, which limits the amount of money available for spending. As Hill and Emes

explain, any resource revenue above the stable amount for the budget is automatically saved in the ASF to be withdrawn in the future to cover any shortfall when resource revenue falls below the stable amount. Put differently, savings in the ASF during periods of relatively high resource revenue (as Alberta is currently experiencing) are used to support the stable amount of resource revenue in the budget during periods of relatively low resource revenue, which would help avoid deficits. In this way, the ASF could prevent another substantial run-up in provincial debt in the future. Moreover, once the ASF is adequately funded, Hill and Emes argue that additional surplus funds, if available, should be allocated in their entirety to the Heritage Fund to provide long-term economic and financial benefits to the province.

Finally, economist and professor at the University of Calgary Jack Mintz suggests another option for consideration: using Alberta's surpluses to improve tax competitiveness and stimulate economic growth. Mintz specifically recommends reducing and simplifying personal income taxes to attract highly skilled workers, entrepreneurs, and business owners, while generally encouraging more work, savings, and risk-taking. Mintz includes two main proposals in his essay: returning to a single-rate tax of 8 percent, or levying an 8 percent basic personal income tax rate with a second 12 percent tax rate on income of more than \$131,220. Either of these options would use up no more than roughly a third of Alberta's projected surplus this fiscal year. Mintz argues the provincial government could use other revenues to cover the lost personal income tax revenue as needed, rather than rely on volatile oil and gas revenues. This could include repatriating the federal consumer carbon tax for a made-in-Alberta approach, introducing variable health premiums to fund health care, and/or levying an Alberta sales tax of 3 percent on the federal GST for an 8 percent HST.

The provincial government has an incredible opportunity to introduce significant policy changes for the benefit of Albertans today and in the future. Among the alternatives that the authors in this series provide are using the current windfall to eliminate Alberta's debt, reintroducing a rainy-day account and saving for the long-term, or improving Alberta's tax competitiveness. All avoid the main risk of simply increasing government spending as has occurred in the past, which sets the province up for yet another boom-bust cycle. Avoiding spending increases and limiting the growth in spending over the next few years while pursuing any of the reforms outlined in this series would strengthen the provincial economy and establish a path for Alberta's improved long-term prosperity.

—*Tegan Hill*

CHAPTER 1

Paid in Full, Again? Using Alberta's Windfall Revenues to Eliminate Provincial Debt

By Trevor Tombe

“Our debt is dead,” declared a front-page *Calgary Herald* headline on July 13, 2004 (Hudes, 2021). The paper was covering a famous event in Alberta’s fiscal history: Premier Ralph Klein holding a “Paid in Full” sign high above his head, marking the end of a 10-year plan to eliminate provincial debt as detailed in Budget 1994. To be clear, Alberta was not literally debt free, but by March 31, 2005, it was projected that the province’s Debt Retirement Account would have sufficient assets (\$3.5 billion) to fully repay remaining debt as it came due over the coming years (Alberta, 2005). For many, that was close enough. And accounting details aside, Alberta’s fiscal turnaround—thanks largely to high resource revenues—was indisputably substantial. Net provincial debt (total debt minus financial assets) declined from nearly 15 percent of GDP in 1994 to less than -5 percent 10 years later (when our financial assets exceeded our debt (Finances of the Nation, 2022)—a 20 percentage-point improvement.

Today, Alberta again has the potential to be debt free within a similar time span. In 2022, resource revenues blew past their previous record highs, which, combined with several years of restrained program spending growth, generated significant fiscal surpluses.¹ While strong cases can be made for using such surpluses to achieve other objectives, such as saving more within the province’s Heritage Fund, the current situation may be one where debt repayments are a uniquely attractive option. For

¹ In Alberta, resource revenue includes royalties from natural gas and by-products, conventional oil, oil sands, coal, and revenues from bonuses and sales of crown leases, rentals, and fees (Alberta, 2022a).

the first time in well over a decade, government borrowing rates exceed the expected return on investment savings. And given mounting global economic and geopolitical risks, the financial gain from lowering debt—in the form of lower interest payments—provides welcome certainty where financial investments do not.

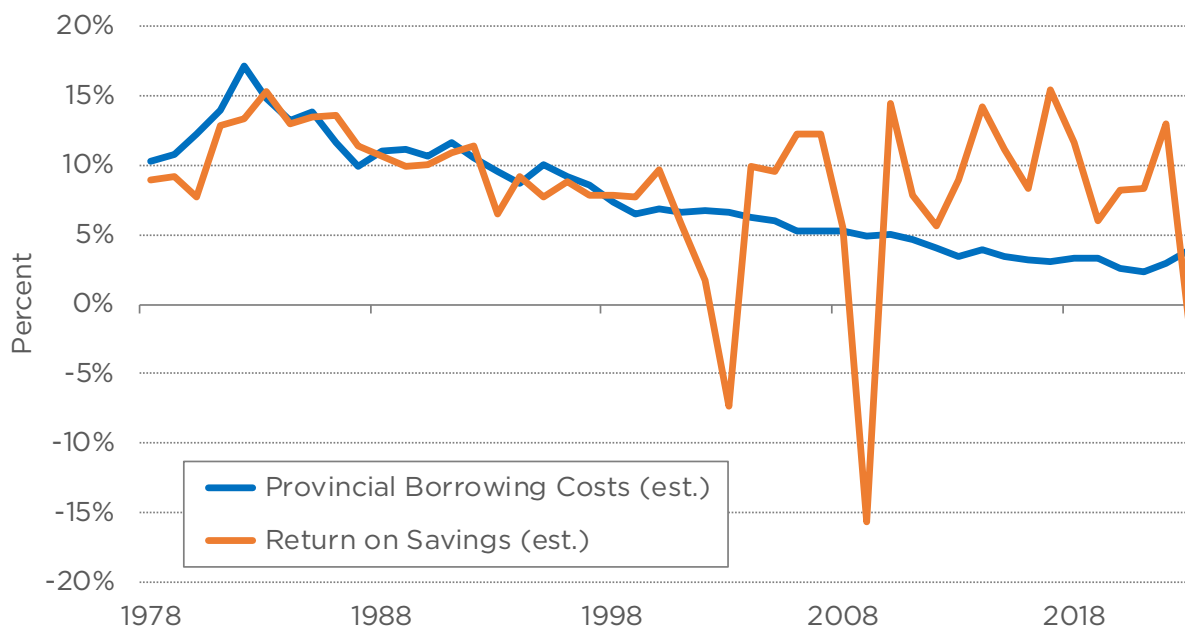
This essay discusses some of the key considerations in evaluating debt repayment as an option. It also illustrates a set of fiscal projections for Alberta that suggests eliminating provincial debt is achievable within roughly one decade. Whether one favours this option or not, it should be a critical part of Alberta's fiscal policy conversation.

The pros and cons of debt repayment

Before exploring specifics, it is worth being clear that public debt can serve several important functions. Therefore, eliminating public debt is not an absolute or uncompromising policy goal. A world where governments cannot run deficits would, for example, require taxes to increase or program expenditures to decrease during recessions. This is often at odds with other policy objectives, such as supporting individuals and business through challenging times or using fiscal policy to boost macroeconomic activity. Such a world may also be costlier to taxpayers. Raising and lowering program spending in response to economic conditions would cost more in the long run than maintaining stable spending. Recruiting and training new workers is not free, nor is laying off existing workers that may be entitled to severance payments. A strict no-deficit policy may also lower the quality of public services to individuals and business, whose demand for them—notably in health and education—may not vary over the business cycle. Raising and lowering tax rates is also costlier to the overall economy than maintaining stable rates since the distortionary effect of taxes accelerates rapidly as rates increase. Borrowing during the bad times and repaying debt in the goods times may therefore be an appropriate policy. Indeed, some refer to this approach as the “golden rule” of fiscal policy.

In addition to smoothing out recessions and booms, public borrowing may be used to better align the costs and benefits of capital projects. Some infrastructure can be very long lived. The \$16 billion Site C hydroelectricity project in British Columbia, for example, has a 70- to 100-year lifespan. Given that it will benefit future generations, one could argue some of the costs should be shifted to the future as well. Debt can accomplish this, so borrowing for capital projects is often viewed differently than borrowing for government operations.²

² Alberta's Fiscal Responsibility Act, which was the province's balanced budget

Figure 1: Comparing Alberta Borrowing Rates versus Returns on Savings

Note: This figure displays an estimate of Alberta's long-run bond yield, assuming a one percentage point premium over the government of Canada long-term yields and the simple rate of return on Heritage Fund savings.

Source: Authors' calculations from Alberta Heritage Savings Trust Fund Annual Reports (various years) and Statistics Canada (2022), table 10-10-0122-01.

As with any policy choice, there are important trade-offs for Alberta to consider when pursuing a debt elimination policy. Public funds allocated to debt repayment, after all, cannot be used for other priorities which include increased program spending, decreased taxation, or increased savings. Each alternative comes with benefits that repaying debt will forgo. A useful measure to compare alternatives is the rate of return each would generate. Consider a simple comparison: repaying debt versus saving. If the return on savings is, for example, 10 percent per year, then each dollar saved yields 10 cents in annual income. If the interest rate on government borrowing is five percent, then each dollar in repaid debt avoids five cents in interest costs annually. In this case, saving additional dollars increases government's overall net financial worth more than repaying debt.

Historical data can shed light on this comparison. Using an estimate of provincial government borrowing costs and returns to Alberta's Herit-

requirement prior to being repealed in 2009, excluded from its measure of accumulated debt amounts raised for capital investments.

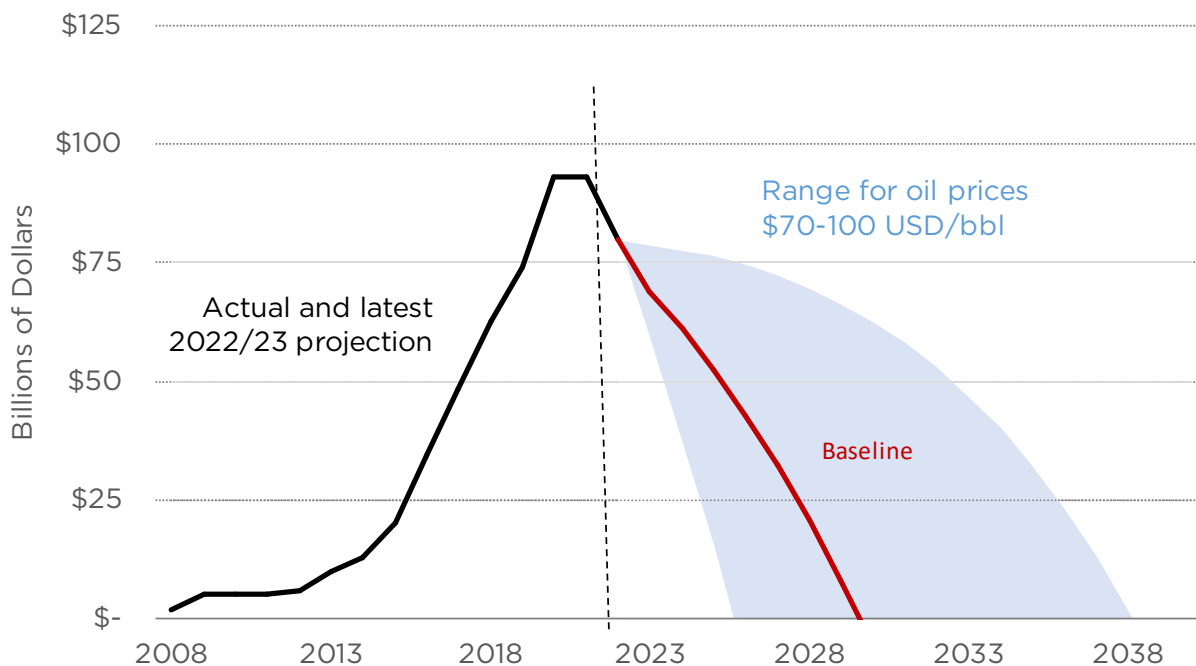
age Savings Trust Fund, I compare the historical returns to debt repayment and savings fund contributions in figure 1.

During the 1980s and 1990s, the returns from both options were approximately 11 percent. In the 2000s, investment income disappointed following declines in the tech sector, the September 11th attacks, and the financial crisis. Alberta's returns to savings in that decade averaged 4.9 percent compared to borrowing costs of 5.9 percent. Then, in the 2010s, investment returns rose to 9.7 percent while borrowing costs continued to decline, averaging only 3.5 percent. Overall, from 1978 to 2022 (forecast) provincial borrowing costs averaged 7.6 percent while investment returns averaged 8.7 percent. This implies a slightly higher return to saving than debt repayment but with substantial risk as investment returns are highly volatile, especially in recent years. We are seeing this now. Disruptions from rising inflation and tightening monetary policy mean investment income may turn modestly negative in 2022 while borrowing costs rise rapidly. Given these rising rates and growing economic and fiscal uncertainties, a policy of using windfall revenues to eliminate Alberta's provincial debt is worthy of serious consideration. It is also now uniquely achievable. Even in less disruptive times debt repayment comes with near-certain payoffs in the form of lower future interest costs while saving comes with potentially higher but far-from-certain payoffs.

A potential path towards a debt-free Alberta

Despite high economic and fiscal uncertainty, it is possible to make a reasonable projection of Alberta's provincial finances. For this essay, I construct several projections based on a published and continuously updated model of Alberta's finances (Tombe, 2018). I do not report the details, but a summary may be helpful.

I assume program spending proceeds as Budget 2022 planned, though updated for 2022/23 in the August first-quarter fiscal update (Alberta, 2022b). Beyond 2025/26, I assume it grows with population and consumer prices. This requires sustained discipline in controlling expenditure growth, as an aging population puts pressure on the demand for health services and an upcoming bulge of young people does the same for postsecondary education and training. But even the previous NDP government in Alberta regularly stated that population growth and inflation was its anchor for expenditure growth, so this projection likely reflects a reasonable compromise between alternative visions that Albertans may see. In addition to program expenditures, I presume debt service costs evolve according to the total public debt owed by the province and with

Figure 2: Alberta's Accumulated Taxpayer-Supported Debt

Note: This figure displays the actual and projected value of Alberta taxpayer-supported accumulated debt. This reflects outstanding debt less any cash set aside to cover future maturities.

Source: Authors' calculations from a detailed model of Alberta's provincial budget.

future interest rates, which I assume gradually increase to an average of four percent by 2030. To be clear, provincial borrowing costs are already higher than this, but what matters for debt service costs is the average of borrowing rates across government bonds issued previously and those being issued now.

On the revenue side, I make several assumptions. Federal transfers grow according to each program's explicit national formula. Revenue from major taxes on income and consumption grow with Alberta's economy and property tax revenues grow with projected K-12 education expenditures, which I assume depends mainly on demographics. Several other minor sources of revenue are also explicitly modeled, but the largest and most volatile source of revenue for Alberta is from natural resources. I assume these revenues grow with future prices and production. In the baseline projection, oil prices average US\$85 per barrel (WTI) through fiscal year 2023/24, consistent with the October 2022 EIA short-term energy outlook projection (US EIA, 2022) and fall to US\$80 per barrel in 2024/25,

remaining constant thereafter. This is modestly more conservative than the latest *Economic and Fiscal Outlook* from the Office of the Parliamentary Budget Officer (PBO, 2022). Of course, oil prices are highly uncertain, so I also estimate several scenarios using a range of prices between US\$70 per barrel at the low end to US\$100 per barrel at the high end. For production, I use the latest projection from the Canada Energy Regulator (2021).

With all these ingredients, I construct a projection of Alberta government revenues, expenditures, and debt levels. Repaying the maturing value of government bonds as they come due constrains how quickly debt levels may fall. One particularly long horizon Alberta government bond issue, for example, does not mature until June 2120.³ Over the next 10 years from 2023/24 to 2032/33, approximately \$64 billion will mature (Alberta, 2022d). If the surplus exceeds the amount of debt maturities in any given year, the excess cash can be saved in a special fund earmarked for debt repayment. This was the province's past practice with its Debt Retirement Account. Its accumulated debt is then total gross debt less cash set aside.

I display the results of these projections in figure 2. My preferred estimate suggests that Alberta's baseline fiscal trajectory could achieve zero accumulated taxpayer-supported debt by 2030. If oil prices average US\$100 per barrel, however, this could be moved up to 2026. And even if oil prices disappoint, averaging US\$70 per barrel in the long-run, provincial taxpayer-supported debt could still be eliminated in the latter half of the next decade. In the baseline projection, debt service costs are more than \$4 billion per year less within a decade compared to a situation where provincial debt levels remain constant at their projected March 2023 levels. In total, in these scenarios, eliminating provincial debt within a decade could save a cumulative total of nearly \$20 billion in interest costs.

Perhaps more importantly, repaying debt with expected future surpluses also ensures that the province is ready to weather inevitable future economic and fiscal disruptions. As argued earlier, borrowing during difficult times is appropriate if repaying that debt in good times follows.

Conclusion

A debt-free Alberta within a decade is possible and implementing a plan for it to achieve that goal is straightforward. The province could allocate resource revenues above a certain amount (say, \$5 or \$10 billion) to a Debt

³ A full list of Alberta bond issues is available online at <https://www.alberta.ca/assets/documents/investor-relations-alberta-term-debt-issues.pdf>

Retirement Account. Alternatively, it could allocate all surpluses to such an account and ensure per capita program spending growth remains restrained over time. Whatever the details of the allocation rule, clear fiscal anchors and discipline are required to sustain improvements in Alberta's finances. The government must also communicate its goals clearly to ensure broad public support for them. The public can easily understand the aim of lowering or eliminating provincial debt during a time of rising interest rates, global uncertainty, and windfall resource revenues. If the government follows such a plan, Albertans will enjoy lower interest costs and greater capacity to absorb future shocks when (not if) they occur. Whatever policy objectives take priority, the potential for Alberta to see a "Paid in Full" sign yet again represents another remarkable turnaround in its finances. It is an opportunity that the province must not ignore.

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CHAPTER 2

Alberta's Windfall—An Opportunity to Stabilize Provincial Finances for the Long-Term

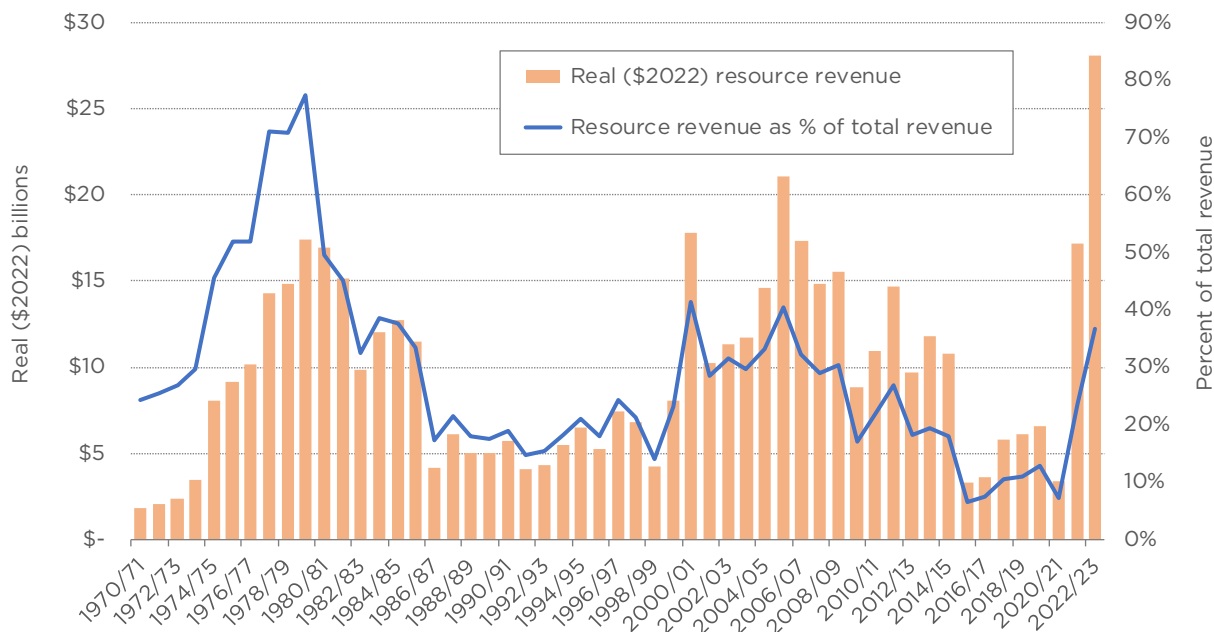
By Joel Emes and Tegan Hill

Introduction

Alberta is projected to collect \$28.1 billion in resource revenue in 2022/23—the highest level on record and \$14.3 billion more than originally projected in Budget 2022 (Alberta, 2022a). This is clearly a positive development with Alberta projected to run a \$12.3 billion surplus in 2022/23 and additional surpluses over the next two fiscal years (Alberta 2022a; 2022b). However, these high natural resource revenues are also part of Alberta's ongoing boom-bust cycle that will only lead back to deficits if the provincial government does not change how it treats resource revenues in the budget.

Fortunately, the provincial government has an opportunity to use these surpluses to break the cycle and stabilize provincial finances for the long-term. This essay reviews Alberta's long-standing fiscal challenge associated with its volatile resource revenues and explains how the provincial government can reintroduce a rainy-day account to temper Alberta's fiscal booms and busts.

Figure 1: Real (\$2022) Resource Revenue and as a Share (%) of Total Provincial Government Revenue



Sources: Alberta, 2021, 2022a, and 2022b; Statistics Canada, Table 18-10-0005-01.

The ongoing challenge with Alberta's volatile resource revenue

Alberta has a significant fiscal problem. Revenues from its resources are wildly inconsistent, which for decades has led to Alberta's finances being unstable (Kneebone and Wilkins, 2018; Hill, Emes, and Clemens 2021). Figure 1 shows Alberta's real resource revenue (in \$2022) and as a share of total provincial revenue since 1970/71. Since 2000 alone, real (\$2022) resource revenue has been as low as \$3.3 billion and accounted for as little as 6.5 percent of the province's total revenues (2015/16). At the other end of the scale, in 2022/23 real resource revenue (in \$2022) is projected to be \$28.1 billion and account for 36.6 percent—or more than one in every three dollars—of total provincial revenue.

This volatility poses a particular challenge for the long-term sustainability of provincial finances because the Alberta government normally includes all resource revenue in its budget. In times of relatively high resource revenue, the provincial government normally enjoys surpluses and faces pressure to increase spending. Increases in spending during such times assumes that the high resource revenues will continue. When

resource revenue inevitably declines, however, the province does not commensurately reduce its spending. In fact, Ferede (2018a; 2018b) found that a \$1 increase in real per-person resource revenue is associated with a 56-cent increase in program spending the following fiscal year, but a \$1 reduction in resource revenue is not similarly followed by a reduction in program spending. As a result, the province's finances turn to deficits when resource revenues decline.⁴

In the early 2000s, the province consistently ran surpluses as resource revenue increased. At the same time, that relatively high resource revenue fuelled increases in spending. As real resource revenue increased from \$4.2 billion in 1998/99 (in \$2022) to \$15.6 billion in 2008/09 (also in \$2022), real per-person program spending grew from \$7,393 to \$13,114—an increase of 77.4 percent (Hill, Fuss and Emes, 2022). A combination of high spending and lower commodity prices led to routine deficits from 2008/09 through 2020/21, excluding only 2014/15. Overall, Alberta's \$35.0 billion net financial asset position in 2007/08 deteriorated to a net debt position of \$60.0 billion in 2020/21—a \$95.0 billion fiscal reversal (Canada, DOE, 2021).

This boom and bust cycle in public finance will continue if the provincial government doesn't take action. Put differently, Alberta's surpluses will only last as long as relatively high resource revenues persist.⁵ To avoid deficits in the future, the provincial government needs a new approach to managing its volatile resource revenue.

Stabilizing resource revenue in the budget: A renewed Sustainability Fund

Surpluses are expected to continue in 2023/24 and 2024/25. While we cannot know the size of these surpluses with any precision, private-sector forecasts (TD Economics, 2022; Deloitte, 2022), current prices, and forward prices for commodities (CME Group, 2022)⁶ suggest they could be

⁴ Alberta's problem with spending and the rise and fall of resource revenue is well documented. For more information, see Milke and Palacios, 2015; Kneebone and Wilkins, 2018; Mackinnon et al., 2019; Hill, Eisen, and Palacios, 2021; Hill, Emes, and Clemens, 2021.

⁵ For perspective, Alberta's projected \$12.3 billion surplus would immediately become an \$9.0 billion deficit if resource revenue returned to its average over the past 10 years (2012/13 to 2021/22). If resource revenue were to return to its 2018/19 level, Alberta's surplus would immediately become a \$10.4 billion deficit.

⁶ As of October 6, 2022, the price of West Texas Intermediate crude oil was US\$88.96 per barrel.

significant, particularly as the recent surge in commodity prices pushes a number of large oil sands projects into a higher royalty structure (Tuttle, 2022). Alberta's government has an opportunity to use these surpluses to mitigate the boom-and-bust cycle in provincial finances by reintroducing a rainy-day account based on the previous Alberta Sustainability Fund (ASF).

Originally introduced in 2003, the ASF was one of the provincial government's most effective mechanisms for addressing resource revenue volatility in the budget. The first step in reintroducing such a fund is to determine a stable amount of resource revenue that can be included in the budget annually (\$3.5 billion was used previously) (*Fiscal Statutes Amendment Act, 2003, SA 2003, c. 2*),⁷ which limits the amount of money available for spending. Put differently, restricting the amount of resource revenue included in the budget tempers the pressure for governments to increase spending during periods of relatively high resource revenue (as Alberta is currently experiencing) to levels that are unsustainable without incurring deficits when resource revenues ultimately decline.

Any resource revenue over the stable amount for the budget is automatically saved in the ASF, and when resource revenue is below the stable amount, withdrawn to cover the shortfall. Put differently, savings in the ASF during periods of relatively high resource revenue are used to support the stable allocation of resource revenue to the budget during periods of relatively low resource revenue, which further helps avoid deficits.

As it did with the previous ASF,⁸ the provincial government should set a required balance for the reintroduced ASF. This will ensure that sufficient funds are available to support the stable amount to be included in the budget during periods of relatively low resource revenue. In other words, the provincial government should determine the amount of savings the ASF will require such that funds accumulated during periods of relatively high resource revenues will be sufficient to finance the stable withdrawal amount during periods of relatively low resource revenue. Once sufficient-

⁷ In the previous Alberta Sustainability Fund, the provincial government calculated the set amount by averaging resource revenue for the period from 1981/82 to 2001/02, excluding an unprecedented spike in resource revenue in 2000/01 (Alberta, 2003). This is one example of how the set amount might be calculated; however, there are many reasonable alternative ways to determine the set amount. For instance, the provincial government could assess the set amount that would have worked to stabilize resource revenues over the last commodity cycle. See Hill, Emes, and Clemens (2021) for an illustrative example.

⁸ The previous sustainability fund calculated its required balance by estimating the dollar amount of resource revenue that would be needed to protect against two consecutive years of low resource revenue, or one year of weak resource revenue and a major disaster (Alberta, 2003). Similar to the set amount, there are a number of reasonable ways to determine the required balance for the ASF.

ly funded, any excess resource revenue should be deposited in the Heritage Fund for long-term savings.⁹ Critically, this ensures that resource revenue in the budget continues to be limited to the stable amount.

If designed correctly, a reintroduced ASF could eliminate resource revenue volatility in the budget, which has fuelled the boom-and-bust cycle in provincial finances. This time, rules around the fund—the stabilized amount of resource revenue for the budget, the required balance for the ASF, and the required excess savings in the Heritage Fund—should be made constitutional to protect them from being ignored or eliminated in the future.

Indeed, in the previous ASF, the set amount of resource revenue to be included in the budget was based in statutory law, which the Alberta legislature can change unilaterally. As such, the stable amount was routinely increased and by 2007 nearly all resource revenue was used for annual spending. The fund was eventually drained and eliminated entirely in 2013 (Morton and McDonald, 2015).

As Hill, Emes, and Clemens (2021) explain, a constitutional rule is much more robust than a fiscal rule.¹⁰ Under section 43 of the Constitution Act, 1982, Alberta can introduce a constitutional amendment that affects the province only with support from the federal government.¹¹ The provincial government would first present the rule to Albertans by way of a referendum, as is required by law in the province. Assuming Albertans support the amendment, the provincial government would then pass legislation recognizing the result of the referendum. Alberta's government would then ask the federal government (that is, the House of Commons and the Senate¹²) to pass the same resolution recognizing the will of Albertans to impose such a rule. To reverse the rule or otherwise ignore its requirements would mean a future Alberta government would have to

⁹ It's important to emphasize that the ASF and Heritage Fund should operate as separate funds with clear, distinct purposes—the ASF as a rainy-day account and the Heritage Fund for long-term savings to prepare for a potential permanent decline in resource revenue. For more information on how the Alberta government can effectively renew the Heritage Fund, see Hill, Emes and Lafleur, 2021.

¹⁰ Section 45 of the Constitution Act 1982 says: "Subject to section 41, the legislature of each province may exclusively make laws amending the constitution of the province."

¹¹ The authors would like to acknowledge the assistance of Professor Bruce Pardy in developing the original assessment of how to create a constitutional rule in Alberta. Any errors or omissions are the responsibility of the authors. For more information see Hill, Emes, and Clemens, 2021.

¹² Please note that it is not entirely clear that the Senate has to approve legislation recognizing a provincially requested change in the Constitution.

seek approval by means of a provincial referendum, pass provincial legislation, and request that the federal government approve the legislation.

In other words, though making such a measure constitutional should be used cautiously and judiciously, Alberta does have an option to impose more legally stringent rules on itself to limit the allocation of resource revenue to the budget, reintroduce the ASE, and help stabilize provincial finances for the long-term.

Conclusion

Alberta must stop repeating its past fiscal mistakes—mistakes in large part brought about by the cyclical ups and downs of resource revenue. The provincial government should capitalize on the opportunity to use Alberta's surpluses to re-establish a rainy-day account to stabilize resource revenue in the budget and ultimately help prevent future deficits.

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CHAPTER 3

A Crucial Alberta Fiscal Priority: Tax Competitiveness

By Jack M. Mintz

With surging oil and gas prices, Alberta finds itself in the enviable position of having a \$12 billion surplus in this fiscal year after a devastating \$17 billion deficit in May 2020. Despite a high degree of price volatility, many forecasters expect oil and gas prices to be firm during this decade as a result of inadequate global investment in oil and gas supply.¹³ This will likely mean that Alberta could be in a relatively strong fiscal position throughout this decade.

For any minister of finance, surpluses are challenging since voters dislike paying more tax than they receive back in public services. This paper makes the case that the province's tax competitiveness should be a priority for fiscal planning in this year and rest of the decade. The reason is clear. Alberta is undergoing an economic transformation with the digitization of business practices and the decarbonization of energy systems in the coming decades. Taxation has a major impact on resource allocation in the economy and the attraction of labour and capital to the province. Without a competitive tax system, adjustment to an evolving industrial structure is more difficult to pursue.

I examine three issues in this paper. The first lays out principles for a good tax system. The second is a review of Alberta's current tax competitiveness. The third is an agenda for tax reform in Alberta including the "Triple 8" reform that I explain below.

¹³ As one indication, oil price futures are above \$70 per barrel until 2025. See CME Group (2023).

The importance of tax competitiveness

The primary aim of a tax system is to fund public services. Tax policy is not just about the tax level, however. It is also about the tax structure that affects both economic growth and the distribution of the taxes paid by residents. Given the revenue requirement, the best tax structure minimizes distortions to make the best use of scarce resources (economic efficiency), keeps administrative and compliance costs low (simplicity), and is fair.

So where does tax competitiveness come in as a priority? Blessed with abundant resources and an entrepreneurial economy, Alberta enjoys the highest standard of living in Canada by attracting people and capital from across Canada and abroad. It is attractive because it is politically stable, offers public services that are comparable with other parts of Canada, makes good use of its plentiful natural resources, and has competitive taxes.

Tax competitiveness is not just about tax rates. It is also based on an efficient and simple tax system that supports economic growth by putting resources to their best use. Tax competitiveness also contributes to fairness by treating neutrally business activities and households with equal resources. All taxes cause some economic loss, but some taxes are more economically harmful than others. For Alberta, the least damaging revenue sources are consumption taxes while personal and corporate income taxes impose high economic costs.¹⁴ Thus, shifting to consumption taxes from personal income and corporate income taxes would contribute to economic growth.

In 2015, Alberta's NDP government increased the province's general corporate income tax rate by two points from 10 to 12 percent. This was more than reversed by the Kenney government by 2020; it reduced the general provincial corporate income tax rate from 12 to 8 percent (the federal-provincial combined rate is 23 percent).

The corporate tax rate reduction not only reduced the tax on capital, it also reduced distortions in the allocation of capital across industries. The reduction in the corporate tax was also fair because it reduced consumer prices and bid up worker wages. Taking into account the corporate income tax rate and base, sales taxes on capital purchases, and other taxes related to capital, Alberta has a lower marginal effective tax rate on capital than British Columbia or Ontario, but not Quebec due to the latter's many

¹⁴ Dahlby and Ferde estimate that marginal (economic) cost of raising a dollar of funds for corporate taxes and personal income taxes in Alberta for 2020. Each dollar raised costs one dollar plus the economic loss to the economy by discouraging work or investment. For the personal income tax, the cost is \$1.77 and for the corporate income tax the cost is \$1.89. In previous work the authors have shown that the marginal cost of raising sales taxes in Alberta is \$1.00. See Dahlby and Ferde (2022).

Table 1: Marginal Effective Tax Rates for the US, Canada, and Select Provinces, 2015 and 2021

	2015		2021	
	Manufacturing	Aggregate	Manufacturing	Aggregate
Alberta	17.9	18.2	12.0	12.1
British Columbia	20.0	27.0	18.2	25.6
Ontario	14.8	18.2	11.5	15.1
Quebec	10.7	17.2	-0.7	11.5
Canada	15.7	21.1	9.4	15.7
United States	32.1	34.6	23.6	22.6

Note: Aggregate includes all sectors except for financial services, oil and gas and mining.

Source: Bazel and Mintz (2022) for Canada; US and provincial calculations by Philip Bazel.

manufacturing tax incentives. Alberta is at least attractive for investment compared to the United States but it lost two-fifths of its advantage when the US sharply reduced the federal corporate income tax rate from 35 to 21 percent beginning on January 1, 2018.

Temporary accelerated depreciation in both United States and Canada is being phased out beginning in 2023 in the United States and in 2024 in Canada. In Alberta, the marginal effective tax rate on capital will increase by over three percentage points once temporary accelerated depreciation is fully phased out by 2028 (other provincial and the US marginal effective tax rates will rise by a similar percentage-point increase). This will be an issue that future budgets should address.

Where Alberta has lost tax competitiveness the most has been with respect to the personal income tax. Prior to 2015, Alberta had a “flat” personal income tax rate of 10 percent, which added to the 29 percent top federal rate resulted in a combined top rate of 39 percent. That was not only the lowest in Canada but also North America (the top US federal rate was 46.3 percent beginning 2015). In 2015, Alberta’s NDP government levied four new personal income tax rates on incomes above \$125,000 with a top rate of 15 percent on incomes above \$300,000. As announced in December 2015, the federal government raised its top rate from 29 to 33 (beginning January 1, 2016). Both changes resulted in a nine-point increase in the top rate in one year. Meanwhile, in the same period and following its 2017 tax reform, the United States reduced its top personal

Table 2: Top Personal Income Tax Rates for the US, Canada, and Alberta in 2014 and 2021 (in percentages)

	2014	2021
Alberta	39.0	48.0
Canada	49.5	53.5
United States	46.3	43.7

Note: The OECD uses the Ontario personal income tax rate, which is now similar to Quebec, British Columbia, and most provinces except Saskatchewan.

Source: OECD (2023).

income tax rates. By 2022, Alberta had lost almost half of its advantage in top personal income tax rates compared to the rest of Canada (table 2).

There is some evidence now that these increases in the top personal income tax rates led to a decline in the number of taxpayers in Alberta. Given that the top 6 percent of taxpayers (with annual income of more than \$150,000) pay 44 percent of Alberta's federal and provincial personal income tax (Canada Revenue Agency, Various years), the erosion of the personal tax base at the high end means less revenues go to fund public services.

As table 3 shows, the total tax paid shrunk by \$380 million for those Alberta taxpayers with more than \$150,000 in income from 2014 to 2019 (the latest year of available data). This is in contrast with those whose incomes were less than \$150,000 as their taxes increased by \$161 million. Despite the rise by almost 180,000 in the total number of returns and the growth of \$2 billion in taxable income for the whole population, Alberta's total personal income tax collections fell by \$219 million.

The disappearance of high-income taxpayers in Alberta reflects both economic and tax trends. The fall in oil and gas prices in 2014 resulted in lower per-capita incomes at the top end, resulting in people falling into lower income categories. Further, given that they were facing higher marginal tax rates, many taxpayers chose strategies to reduce the taxes they would pay, such as holding assets longer to avoid capital gains taxes or leaving income in a private corporation. The dramatic increase in the top rates also encouraged some high-income taxpayers to retire early or leave the province (and Canada) altogether.

Dahlby and Ferede found that the one-point increase in the federal personal income tax rate reduced the personal income tax base by two

Table 3: Disappearing High-Income Taxpayers in Alberta from 2014 to 2019

Income Class	Gain in Returns (%)	Gain in Tax Revenue (\$ millions)	Gain in Tax Revenue (%)
250k+	-8.4	(\$312)	-3.3
150-250k	-0.1	(\$68)	0
100-150k	5.5	\$48	0.7
Other	6.5	\$113	0.9
Total Change	5.8	(\$219)	-0.6

Note: Total tax paid includes both federal and provincial taxes.

Source: Canada Revenue Agency (various years), T1 Final Statistics for taxation years 2019 and 2014.

percent (Dahlby and Ferde, 2022). Milligan and Smart found that a 10 percent increase in the tax rate for the top 1 percent of income earners would reduce their taxable income base by 6.64 percent (Milligan and Smart, 2014). Milligan and Smart estimated a larger behavioural effect in Alberta. They estimated that static revenue increase would be reduced by almost 30 percent when rates were raised from 10 to 15 percent (as happened in 2015).

It is not just the impact of personal tax rates on high-income taxpayers that is a concern. High marginal personal tax rates resulting from income-tested benefits also affect many Albertans with modest incomes. For example, the average marginal tax rate for a worker can reach over 60 percent in Alberta for lower income workers due to the claw-back of benefits (Finance Canada, 2022). High tax rates not only discourage people from working extra hours, but also from participating in the workforce entirely. Further, those facing high marginal tax rates on investment returns, including claw-backs of seniors' benefits or Old Age Security, will reduce their retirement savings to avoid those high taxes.

While the Alberta government has made strides in improving the province's corporate tax, personal tax competitiveness is a priority for the province. Its high value-added sectors including energy, mining, manufacturing, logistics, finance, and technology need to attract high-skilled workers and entrepreneurs. With rapid population aging and retirements, many businesses will find it difficult to hire younger workers who are tax-discouraged from participating in the labour force.

An agenda for tax competitiveness

Personal tax reductions would encourage work, saving, and risk-taking. They will likely come at some revenue cost despite the failure of the 2015 personal tax hikes to raise any revenue. Certainly, Alberta has other priorities, including fixing health care and using its surplus to reduce debt. However, it should also consider tax competitiveness a priority, and, if needed, it can be accommodated by potentially new revenues as explained below.

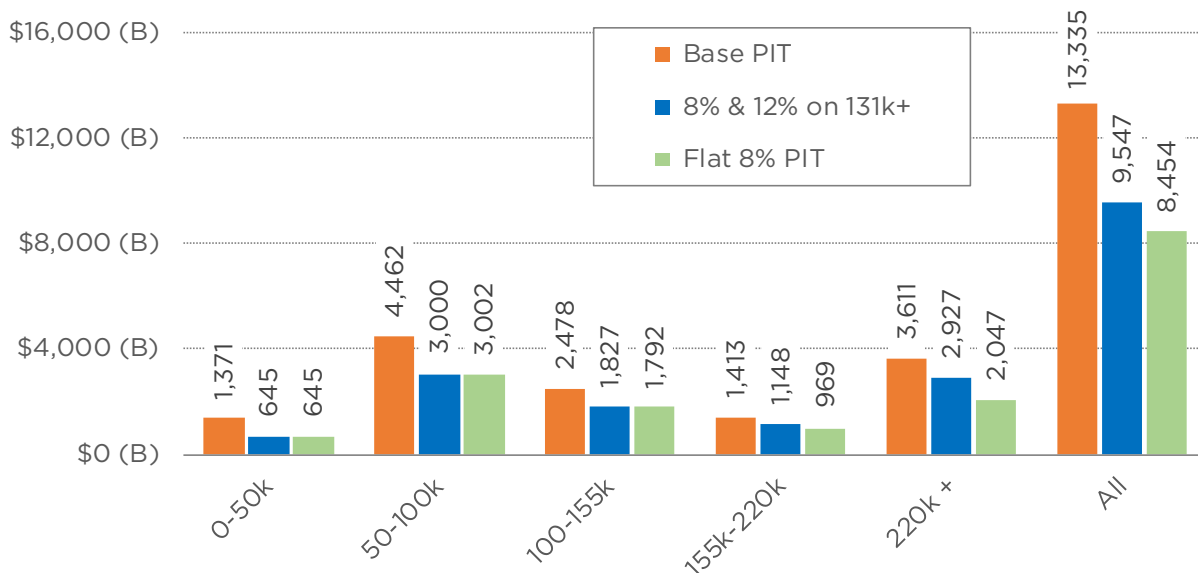
My proposal for tax reform would be implemented over time. The first step would be to reduce and simplify the personal tax rate structure. This would involve levying an across-the-board 8 percent tax rate on all Albertans by reducing the basic rate by two points from 10 percent. For individuals with more than \$131,220 in income (the 2021 top tax bracket), a top rate of 12 points would apply on income above that. Figure 1, which is based on 2021 data, illustrates the amounts paid by different income groups and the total personal tax that would be collected under this plan. The loss in revenue associated with the proposal would be \$3.8 billion assuming no change in behaviour (static analysis). The behavioural effect is estimated to lessen the revenue loss by \$500 million to \$3.3 billion.¹⁵ Since lower personal income taxes provide households with more money, the demand for goods and services—and any excise, corporate, and other taxes related to the services—will increase as well. The estimated revenue cost of \$3.3 billion is conservative since these additional tax revenues are not included in the analysis.

An alternative is to return to the 8 percent flat tax that Alberta had before 2015. The loss in revenue associated with simply reducing all personal income tax rates to 8 percent from 2015 values would be \$4.9 billion (static estimate) or \$4.2 billion (behaviour effect included). Given the higher after-tax incomes that Albertans would receive, they would spend more on goods and services, thereby increasing other revenues such as excise taxes collected by the Alberta government that are not incorporated in estimates here.

Even at a revenue cost of \$3.3 billion, the personal income tax reductions would use up roughly a quarter of Alberta's surplus this year. The province may instead prefer to use the surplus in its entirety to reduce debt or increase savings to help the province to get off the "roller-coaster" of volatile non-renewable resource revenues. Nevertheless, Alberta should not ignore the importance of dealing with its personal tax structure, which is no longer tax competitive with United States.

¹⁵ Estimated using the Dahlby-Ferede (2022) result for those with incomes below \$155,000 and the Milligan-Smart (2014) result for those with incomes above \$155,000.

Figure 1: Personal Tax Revenues under Current Personal Income Tax and 8-Point Proposals



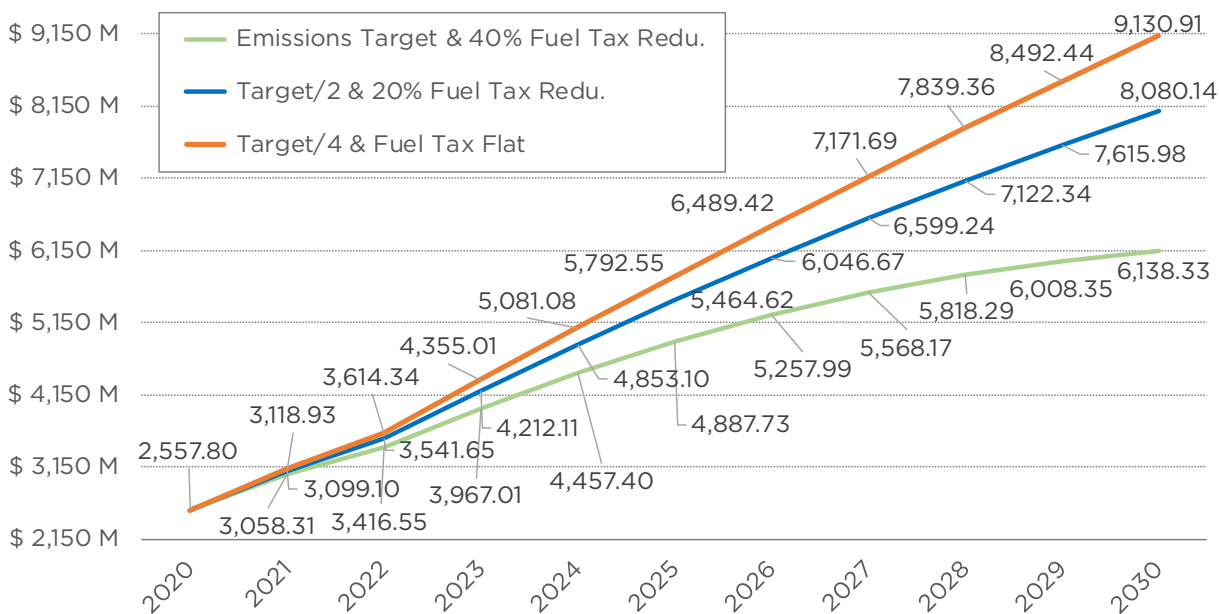
Source: Estimates by Philip Bazel based on Statistics Canada SPDM data.

One area where the province could find more revenue would be in repatriating the federal consumer carbon tax with a made-in-Alberta approach to carbon pricing (carbon tax or cap-and-trade program).¹⁶ By 2030, federal carbon taxes on consumers and industry combined with the fuel excise tax is estimated conservatively to total \$6 to \$9 billion in revenues depending on fuel sales and emission reductions this decade (figure 2). A significant portion of the revenue raised would be returned by the federal government as lump sum rebates to households, but that is an inferior approach to using such revenue to address tax competitiveness (which British Columbia had pursued with its carbon levy when it was introduced). The federal fuel charge itself would range from \$3.9 billion (target fully met) to \$6.1 billion (emissions flat from the pandemic year 2020).

An alternative to using carbon revenues for personal income tax reductions is for the province to levy consumption-related taxes besides those that apply to gambling, alcohol, tobacco, cannabis, and fuels. One possibility is a health premium that could include co-payments related

¹⁶ This is discussed in more detail in MacKinnon and Mintz (2023, forthcoming).

Figure 2: Revenues from the Federal Carbon Taxes and Fuel Excise Tax under Various Scenarios



Source: Calculations by Philip Bazel including revenues from Technology Innovation and Emission Reduction charge, federal fuel charge (depending on emissions according to federal targets) and Alberta fuel excise taxes.

to benefits, such as a tax-based variable premium (Aba, Goodman, and Mintz, 2002).¹⁷

Another alternative is the Triple 8 proposal – an 8 percent HST rate along with 8 percent personal and corporate income tax rates. The HST would have little administrative or compliance cost since the Alberta's tax is effectively a surtax on the federal base with point-of-sale rebates as desired by the province. It is estimated that an Alberta provincial sales tax of 3 percentage points would raise \$3.4 billion, which would offset the revenue loss from reducing the basic personal income tax rate to 8 percent. If the province provides a low-income tax credit and/or increase personal exemptions to make the sales-cum-personal tax cut proposal distributionally neutral, the Triple 8 proposal would likely incur some revenue loss that could be covered by the surplus.

The sales tax proposal is controversial since it would introduce a new tax for Albertans. However, as discussed in the past, a shift from personal

¹⁷ More detailed analysis can be found in Mintz and Tarasov (2008).

income to sales taxation would make Alberta's tax structure pro-growth, less volatile, and distributionally fair.¹⁸

Conclusions

This paper lays out options for a better pro-growth tax structure in Alberta. It could require some of the surplus this year to be directed toward improving tax competitiveness especially with respect to the personal income tax.

The proposal contains different elements for consideration.

- The first is to maintain the corporate income tax rate at 8 percent.
- The second is to reduce the personal income tax rate to a base rate of 8 percent with a surtax for higher income Albertans.
- The third is to use other revenue sources so the province can cover any lost personal income tax revenues rather than rely on oil and gas revenues.
 - » This could include repatriating the federal consumer carbon tax for a made-in-Alberta carbon pricing approach, providing up to \$6 billion in new revenue to the province.
 - » It could introduce variable health premiums to help fund health care.
 - » The province could potentially enact the Triple 8 proposal: levy an Alberta provincial sales tax of 3 percentage points on the federal GST base for an 8 percent HST including the federal rate, along with the 8 percent corporate income tax, and 8 percent basic personal tax rate.

Whatever the Alberta government considers with respect to its surplus, it should keep in mind that personal income tax competitiveness is a priority. There is no excuse for ignoring this important barrier to economic growth in the coming years.

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¹⁸ For a detailed proposal that would be distributionally neutral including a major increase in the personal tax exemption, see Bazel and Mintz (2013).

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The Fraser Institute maintains a rigorous peer review process for its research. New research, major research projects, and substantively modified research conducted by the Fraser Institute are reviewed by experts with a recognized expertise in the topic area being addressed. Whenever possible, external review is a blind process. Updates to previously reviewed research or new editions of previously reviewed research are not reviewed unless the update includes substantive or material changes in the methodology.

The review process is overseen by the directors of the Institute's research departments who are responsible for ensuring all research published by the Institute passes through the appropriate peer review. If a dispute about the recommendations of the reviewers should arise during the Institute's peer review process, the Institute has an Editorial Advisory Board, a panel of scholars from Canada, the United States, and Europe to whom it can turn for help in resolving the dispute.

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