

Background on Alberta's Fiscal Situation

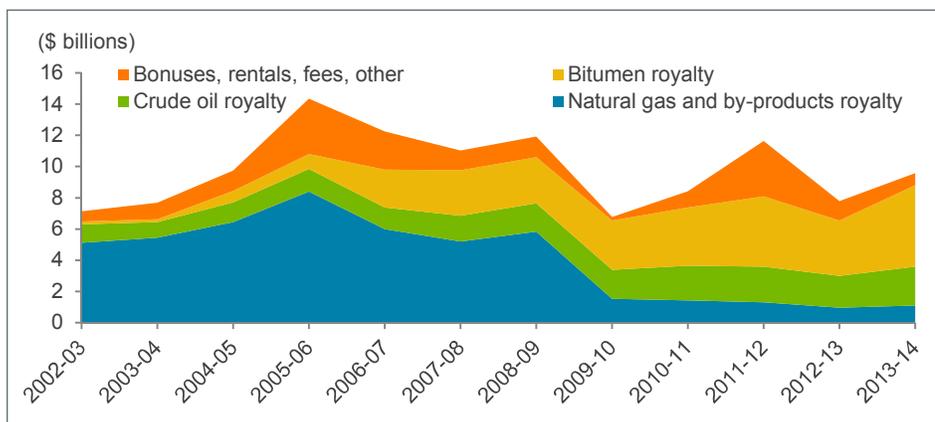
Overview

The recent collapse in oil prices represents a major fiscal challenge for the province. Oil prices have fallen by more than 50% since June 2014, touching below \$50 per barrel recently.

The fiscal implications for Alberta are serious. Due to the severe drop-off in our energy-related revenues, the province is facing an annual revenue shortfall of up to \$7 billion, roughly 15% of total provincial revenue. While the plunge in oil prices is a major issue today, it also illustrates a longer term fiscal issue for the province.

Chart 1: Alberta's resource revenue is highly volatile

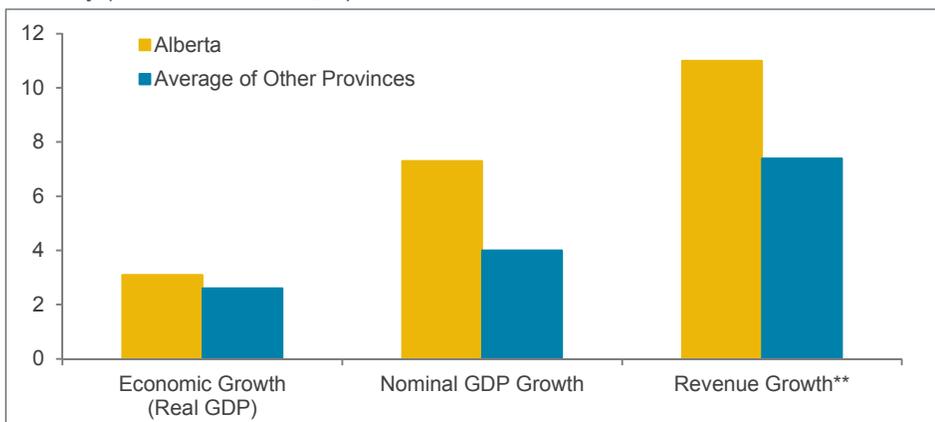
Alberta Non-Renewable Resource Revenue



Source: Government of Alberta, Annual Reports

Chart 2: Revenues much more volatile than the economy

Volatility (standard deviation, %) of Various Measures *



Sources: Finance Canada and Statistics Canada

* Calendar years 1982 to 2013 for GDP; Fiscal years 1987-88 to 2013-14 for revenue

** Excludes federal transfers

Alberta is challenged by the volatile and uncertain nature of our non-renewable resource revenue (NRR), as shown in Chart 1. These revenues have traditionally been a significant source of funding for provincial programs and services, and have enabled Albertans to enjoy by far the lowest overall taxes in Canada. At the same time, the high volatility and unpredictability of NRR has created persistent challenges in determining and managing provincial spending on programs, services and infrastructure, in both good times and bad.

This document outlines the key aspects of Alberta's current and longer-term fiscal challenges.

1) The Economy

a) Alberta's economy impacted less than revenue

Alberta's economy has benefited greatly from the extraction of resources. The development of resources has led to exceptionally high living standards, with GDP per capita leading all provinces over the last 30 years. By building on our resource strength, Alberta has developed globally competitive service and manufacturing industries.

The recent decline in oil prices will slow the momentum of Alberta's fast-growing economy, which has averaged real GDP growth of over 4% per year over the past five years - by far the highest of any province. In 2015, the economy is expected to grow much more slowly, at a rate of less than 2%.

As during previous economic slowdowns, the drop in revenue is far more severe than the slowdown in the economy. This is because the province's key revenue sources - including energy royalties and income taxes - are relatively sensitive to fluctuations in energy prices. In terms of real economic output, though, Alberta businesses are expected to keep producing and exporting more, which will cause the economy to expand, if at a slower pace. As shown in Chart 2,

Alberta's economic growth has historically been only slightly more volatile than that of other provinces despite large swings in revenue caused by commodity prices.

The long-term prospects for Alberta's energy sector, and for the economy, remain sound. A key driver of our energy sector is the oil sands, where projects are based on long-term expectations for prices, and most projects underway already have large amounts of committed capital. Solid growth prospects remain in other key sectors, including manufacturing, professional services, and agriculture.

b) Fiscal policy risks

As the government moves to address these fiscal challenges, one option available is to cut spending sharply in response to lower royalty and tax revenues. However, rapid and deep cuts during a downturn run a significant risk of pushing Alberta's economy into recession. For example, it is estimated that a \$4 billion reduction in government spending would reduce Alberta's real economic growth by over 1%.

Economic experts generally recommend that Alberta carefully calibrate any contractionary fiscal measures, such as spending cuts or revenue increases, to ensure that a slowing provincial economy is not driven into recession. In early January 2015, RBC noted that Alberta is starting from a position of "relative fiscal strength...[and that] the oil price shock need not induce an immediate response via contractionary expenditure and/or restrictive revenue measures".

2) The Revenue Challenge

a) Alberta is dependent on resource revenue

For nearly as long as Alberta has been producing oil and gas, the province has been subject to the volatility which is inherent in energy markets.

Alberta's revenue structure has long made the province susceptible to swings in commodity markets. Over the past decade, about 30% of provincial revenue on average has come directly from NRR through energy royalties (Chart 3). This 30% figure does not capture the full fiscal

contribution of the energy sector, since much of Alberta's corporate and income tax revenue is also tied to the development of oil and gas resources.

A high degree of dependence on NRR makes growth in Alberta's own source revenues (i.e., revenues excluding federal transfers) exceptionally volatile - about 50% more volatile than the average of other provinces. Part of the NRR volatility stems from the structure of the royalty system; as prices fall, the royalty rate falls.

Tax revenue - which is less volatile - makes up about 40% of provincial revenue in Alberta. In other provinces, provincial taxes and fees account for about 60% of government revenue, on average.

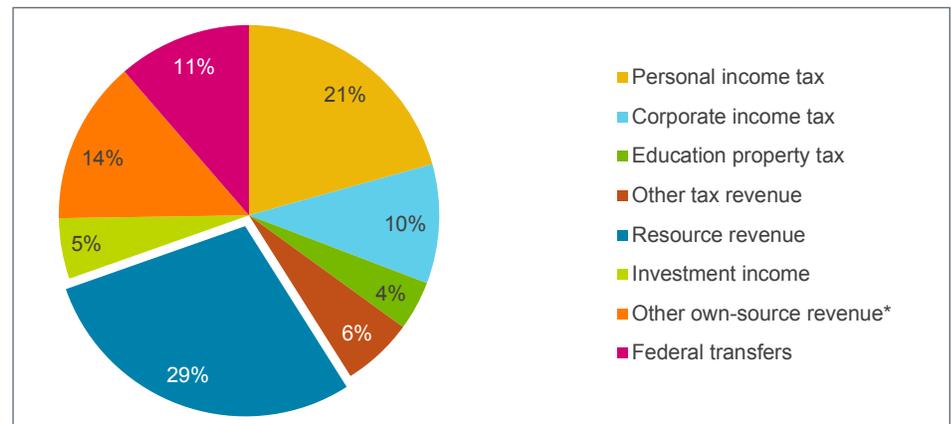
As shown in Chart 4, a considerable share of program expense is funded by resource revenue. For example, personal and corporate income taxes combined are not sufficient to cover annual health care spending.

b) Alberta cannot count on higher oil prices

The widely held view among energy experts is that the current price slump is not short-term in nature. Low oil prices are expected to impact Alberta for some time,

Chart 3: Taxes comprise a relatively small share of total revenues

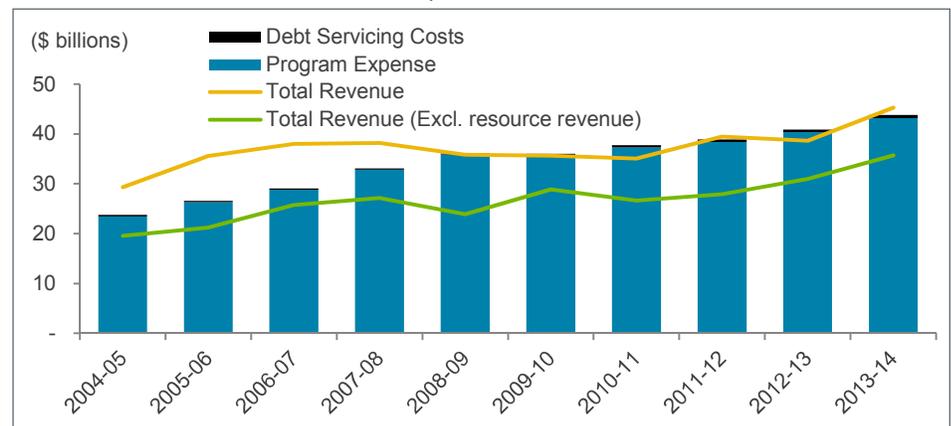
Alberta Government Revenues by Source, 2002-03 to 2013-14 average



Source: Government of Alberta, Annual Reports
* Other revenue excluding federal transfers

Chart 4: Resource revenue required to cover program costs

Alberta Government Revenue and Expenses



Source: Government of Alberta, Annual Reports

and will likely take years to return to the \$80 range. *Even with oil prices at \$75 (roughly 50% above their current level), the province would still not have enough revenue to meet all of its current spending commitments and balance the budget, let alone to save for the future.*

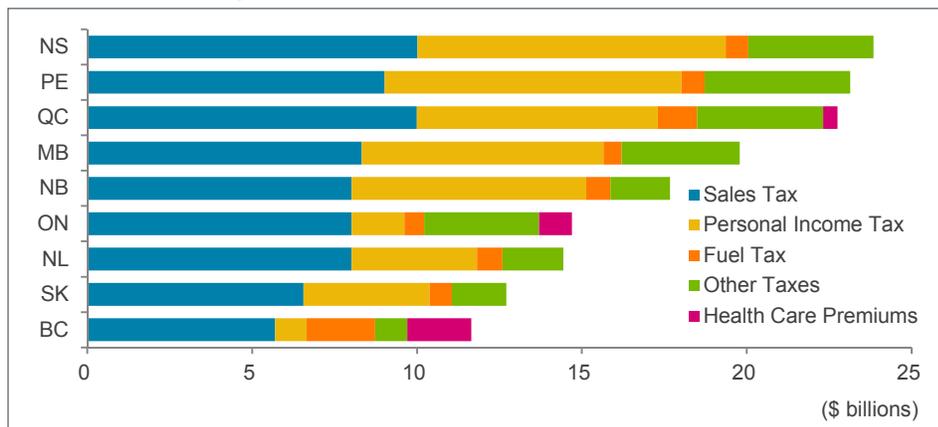
While NRR – and thus total provincial revenue – is both volatile and uncertain, the government's main areas of spending are generally more stable and tend to grow over time. This steady growth reflects a number of spending pressures, including a rapidly growing population, rising labour costs due to Alberta's strong economy, and population ageing.

c) Albertans enjoy a large tax advantage

Alberta relies far less on taxes than any other province because of the historically significant contribution of resource revenue. Albertans presently enjoy by far the lowest overall taxes in Canada. The tax advantage is large – estimated to be \$11.6 billion over the next most competitive province (Chart 5). In other words, Albertans and Alberta businesses presently pay at least \$11.6 billion less annually in taxes than they would if they had the tax system of any other province in Canada. About half of this advantage comes from being the only province without a provincial sales tax, while the remainder comes from other taxes.

Chart 5: Over \$11 billion tax advantage vs. next most competitive province

Alberta Tax Advantage Over Other Provinces*, 2014



Source: Government of Alberta, Budget 2014
 Alberta = \$0 * Additional taxes Alberta individuals and businesses would pay if Alberta had the same tax system of other provinces.

3) The Spending Challenge

a) Demographic pressures to continue

Strong population growth will remain a key expenditure driver. In the last two years, Alberta has added over 100,000 people per year, as large numbers of migrants have come to Alberta to take advantage of a robust labour market. In addition, Alberta has the highest natural population growth rate (i.e., births minus deaths). Population gains are expected to slow from their record pace, but will remain high and continue

to create significant demand pressures on provincial programs and infrastructure.

The province will also face increasing cost pressures in major program areas, such as health care, due to the ageing of our population. Over the next decade, it is projected that the province's senior population will grow almost four times as fast as the working age population – those aged 15 to 64 years.

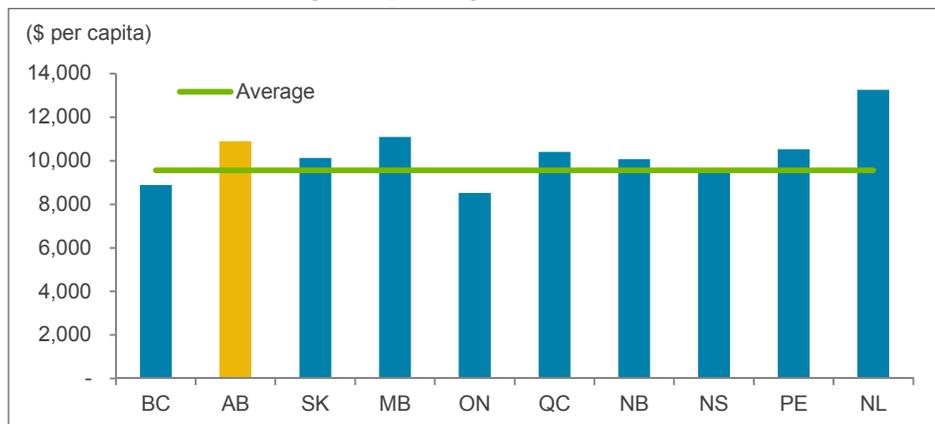
b) Alberta spends more on a per capita basis

Alberta's per capita program spending is roughly \$1,300 above the national average (Chart 6). Higher spending is broad-based, with spending on education, health care, and social services all exceeding the average of the other provinces.

Nearly half of total annual expenditure by the province presently goes to compensation, in the form of wages, salaries, and benefits for public sector workers. The province's total compensation bill was \$22.5 billion in 2013-14. This figure includes compensation costs for individuals employed in provincially supported public institutions such as schools, colleges, universities and health care facilities

Chart 6: Alberta spends more on average

Provincial Government Program Spending*, 2013-14



Source: Finance Canada Fiscal Reference Tables and Statistics Canada.
 * On a fully accrued basis. Includes capital amortization but excludes debt servicing costs.

(including physicians), as well as those directly employed by the provincial government (Chart 7).

A strong economy, and the competitive pressures this places on the labour market, has led to above average wages throughout the province. Average weekly earnings in Alberta exceed that of all other provinces, sitting more than 20% above the national average. In 2013, private sector average weekly earnings in Alberta were 26% higher than the national private sector average. In provincial public administration, average earnings in Alberta were 12% above the national average for provincial public administration employees (Chart 8).

4) What the Government has Already Done

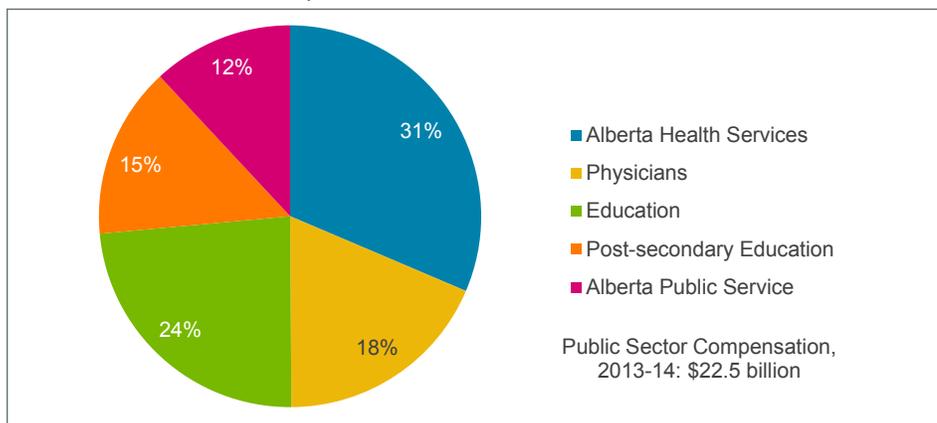
Over the last two fiscal years, government operating expense has been relatively restrained, growing at just over 3% a year. This is well below the combined rate of inflation and population growth. More recently, the government announced a number

of measures to control spending. These have included:

- ◆ Hiring will be limited to those positions that are critical to government operations or provide front line services to Albertans.
- ◆ Procurement of goods and services will be limited, wherever possible, to those required to meet critical operational requirements or legal commitments.
- ◆ Grants and discretionary spending will be limited across government unless they are required to meet critical operational requirements or legal commitments.
- ◆ Sole-source contracts in all but exceptional circumstances are eliminated, conflict of interest guidelines are strengthened, and severance packages for political staff are restricted.

Chart 7: Compensation is nearly half the provincial budget

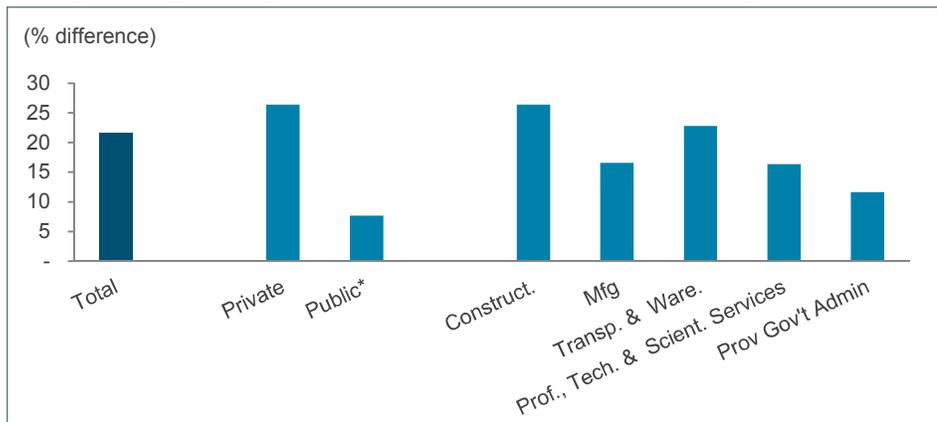
Alberta Public Sector Compensation, 2013-14



Source: Government of Alberta, Annual Report

Chart 8: Earnings are higher across industries

Average Weekly Earnings in Alberta Relative to the National Average, 2013



Source: Statistics Canada

* Public Administration, Health Care and Social Assistance, and Education
 Select industries (in order): Construction; Manufacturing; Transportation and Warehousing, Professional, Technical and Scientific Services; and Provincial and Territorial Public Administration

5) Areas for Discussion

As the Alberta government, and Albertans, review our options for addressing these challenges, there are a number of fundamental questions that need to be considered. These questions include the following:

- ◆ What is the appropriate 'mix' of government policy responses to the shortfall in revenue? Should the government 1) reduce expenditures, 2) raise taxes and user fees, 3) run deficits?
- ◆ In what areas can spending be further restrained or reduced, taking into account current and future public demand for programs and services, including the effects of looming demographic pressures?
- ◆ In what ways can the government act to increase and/or stabilize its revenues, without jeopardizing Alberta's competitive position or future economic growth?