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Alberta's 2012 Fiscal Time Bomb: A higher deficit and a steep decline in financial assets

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Main Conclusions

- **Alberta's provincial deficit will likely be higher than the government forecast of $886 million in 2012/13.**
- **In its budget, the government was too optimistic about oil and gas price assumptions. It was also unrealistic about Alberta's real GDP growth in 2012 and 2013, growth in real personal income, and growth in corporate profits**
- **With yet another deficit year the substantial decline in Alberta's net financial assets will continue. In just five years, the value of Alberta's net financial assets has dropped by over half ($17.7-billion), to $16.4 billion in 2011/12 from $34.1 billion in the 2007/08 fiscal year, in inflation-adjusted dollars.**
- **The recent decline mimics Alberta's net financial assets plunge between 1984/85 and 1993/94 of $35.9 billion.**
- **Between 2007/08 and 2011/12, the decline has averaged just over $3.5 billion annually; the 1984/85 to 1993/94 decline saw an average annual decline of just under $4 billion annually (all figures adjusted for inflation)**
- **Alberta's politicians must acknowledge the reality that they are spending beyond the province's current means.**
- **Politicians must restrain and cut per-person program spending sooner rather than later so that they can balance the Alberta budget quickly. If that option is not palatable, they could hold overall program spending to a rate of growth below that of overall government revenues.**

Why Alberta's optimistic budget forecasts are a problem

Alberta's provincial government is unlikely to hit its deficit forecast this year of $886 million—it will be higher. The reason is two-fold: first, the pre-election budget (Budget 2012) made assumptions that must be revised because the government was too optimistic about natural gas and oil prices; second, the government's budget estimates for real GDP growth in 2012 and 2013, growth in real personal income, and growth in corporate profits were significantly higher than average private sector forecasts.

All these assumptions helped shape the province's revenues forecasts for the 2012/13 fiscal year. For example, by the province's own estimates, a $1.00 difference between the budget's assumption and the actual per barrel price of oil throughout fiscal 2012/13 will lead to a net $223 million reduction in revenues. For every ten cents per gigajoule (GJ) that natural gas prices are lower, the province is out $28 million. When personal income growth is 1% less than expected, government coffers will suffer a drop of $119 million (Alberta, 2012a: 125).

The relationship between such estimates is not linear—a $4 per barrel difference in the price of oil does not necessarily lead to an estimate four times that provided previously (in this case, an $892 million drop in revenue). That is because these revenue sensitivities vary at different price and rate levels. However, the relationship does point to the possibility that Alberta will incur a significantly higher deficit this year than forecast by Budget 2012. In the aggregate, if the price differences were limited to those outlined in table 1, namely, a $1.00 a barrel difference in the price of oil, a 10 cent per GJ difference in the price of natural gas, and personal income growth that is 1% less than expected, the budget would be off by some $370 million more than expected.

Table 1: Sensitivities to fiscal year assumptions, 2012-13

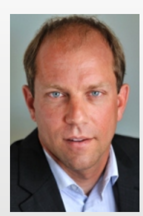
	Change	Net impact, 2012-13 ($ millions)
Oil price (WTI US$bbl)	-$1.00	-223
Natural Gas Price (CA$/GJ)	-10 cents	-28
Exchange Rate (US$/CA$)	+1 cent	-247
Interest rates	+1%	-223
Personal income	-1%	-119

Source: Alberta, 2012a: 125.

Even if one indicator were to move positively—a lower Canadian dollar, for instance, which would increase revenues—the lower-than-forecast revenues from oil and gas, together with the estimates on growth in GDP, corporate profits, and personal income (all of which were substantially out of line with the average of private sector forecasts), point to a much higher Alberta deficit in 2012/13.

In its February pre-election budget, the province relied on unrealistic economic assumptions. In many instances, it ignored private sector forecasts that were more realistic than its own. It appears to have been overly optimistic about oil and gas forecasts—albeit just slightly below the average of private sector forecasts on those two commodities (Alberta, 2012b: 89-90)—and on much else was significantly higher than the average of private sector forecasts.

About the authors



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Assumptions about oil and gas

The government assumed a natural gas price of CA$3.00/GJ for the fiscal year ending March 31, 2013 (Alberta, 2012a: 125). However, the closing AECO-NGX (i.e., Alberta market) price on July 23, 2012 was only $2.39/GJ and the average in the calendar year thus far is $2.06 (Petroleum Services Association of Canada, 2012). Assuming that the price of natural gas doesn't fall further, it appears reasonable to assume an average price for fiscal year 2012-13 somewhere between that price and the government's assumption—which means less revenue than expected. Even if the price of natural gas returns to the estimated level used by the provincial government, the average for the year will likely be well under their estimate, which means lower revenues for the fiscal year.

With regard to oil, the government assumed a West Texas Intermediate (WTI) price of US$99.25 per barrel (bbl) (Alberta, 2012a: 125). The WTI spot price (for immediate delivery) on July 23, 2012 was only US$87.91/bbl. Because the price of oil is currently volatile and the average price during the first quarter (April to June inclusive) was US$93.48/bbl, it is possible that the government's prediction could turn out to be accurate. However, if the average price during the nine months of fiscal year 2012-13 commencing July 1, 2012 turns out to be closer to the July 23, 2012 price, the average price for the fiscal year as whole would be $89.30/bbl—a 10% and $10 discrepancy—which means far less revenue than expected.

Table 2: Private versus government estimates of growth in Alberta in 2012 and 2013

	Average of private sector forecasts (%)	Alberta government forecast (%)	Difference (%)
GDP 2012	3.1	3.8	23%
GDP 2013	3.2	3.8	19%
Personal income growth 2012	4.5	6.2	38%
Personal income growth 2013	4.7	6	28%
Corporate profits 2012	2.3	11.8	413%
Corporate profits 2013	6.2	17.5	182%

Source: Alberta, 2012b: 92-93.

Assumptions about growth

The Budget 2012 forecasts for growth in real GDP, corporate profits, and personal income were significantly higher than the average of private sector forecasts.

- ***Alberta real GDP growth in 2012 and 2013***: The average private sector forecast for GDP growth is 3.1% in 2012 and 3.2% in 2013; the Alberta government forecasts 3.8% growth in each year, or higher than the private sector estimate by about one-fifth in both years;

- ***Alberta real personal income growth***: The average private sector forecast for real personal income growth is 4.5% in 2012 and 4.7% in 2013; the Alberta government forecast is for 6.2% growth in 2012 and 6.0% in 2013. The government's 2012 estimate is 38% higher and its 2013 estimate is 28% higher than the private sector's;

- ***Corporate profits***: The average private sector forecast estimates growth in corporate profits will be 2.3% in 2012 and 6.2% in 2013. The Alberta government has forecast growth of 11.8% in 2012 and 17.5% in 2013. The government's 2012 estimate is five times as optimistic as the average of private sector forecasters in 2012 and almost three times as high in 2013 (all points above from Alberta, 2012b: 92-93)

The problem in a nutshell

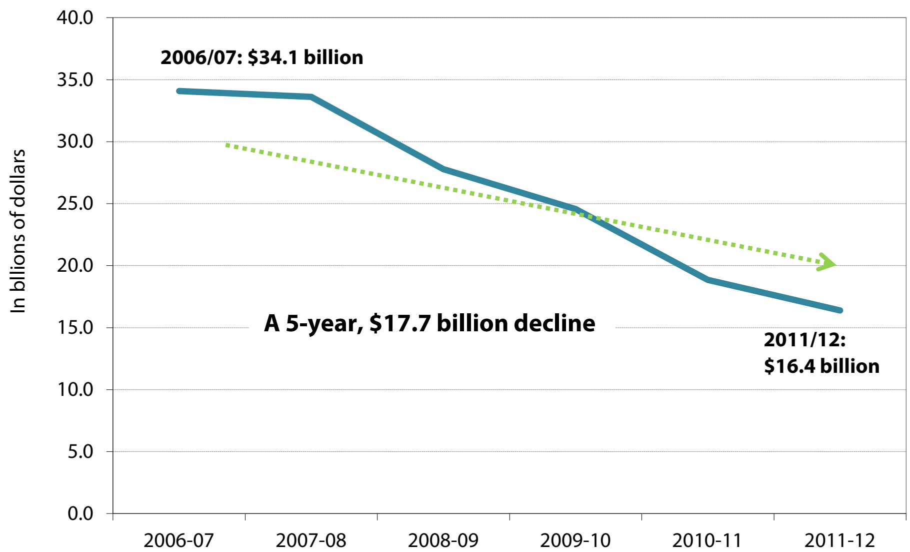
The result of the above assumptions is that the Alberta government will have less revenue than it expected. In short, the risks built into the assumptions behind Budget 2012 are almost entirely downside not just for resource revenues, but for the growth of the economy, income, and corporate profits. Alberta's deficit will almost certainly be higher than the one forecast in February. One consequence is that the already substantial decline in Alberta's net financial assets will continue unabated.

What this means: Alberta's five-year fiscal decline will continue

In its recent review of the final budget numbers for the 2011/12 fiscal year, released in June 2012, the province boasted that Alberta still had net financial assets (Alberta, 2012c). These assets include major funds, such as the Alberta Heritage Savings Trust Fund, the Sustainability Fund, and other funds including endowments. Liabilities include accumulated debt, pension liabilities, and other accounts payable (Alberta, 2012a: 109 and 130). Net financial assets are arrived at by subtracting liabilities from the assets, and are thus the broadest, most comprehensive measurement of the province's financial assets.

In its June news release, the provincial government noted that Alberta is the only province "in a net financial position" (Alberta, 2012c). However, it is a mistake for Alberta to note its current position while ignoring the decline in its net financial assets, or merely to compare itself with other provinces. It is more apt to compare Alberta to other resource-rich jurisdictions such as Alaska and Norway, and consider what actions those two jurisdictions have taken to boost their resource funds (see Milke, 2006; Gibbins and Roach, 2006; and Alberta, 2007.) In any event, given the provincial government's attention to such figures, the province's net financial assets warrant a closer look.

Figure 1: The recent decline in Alberta's net financial assets: 2006/07-2011/12, including pension liabilities (in inflation-adjusted 2011 dollars)



Sources: Alberta 2001, 88; Alberta 2012a, 130; Alberta 2012c. inflation calculations by Milagros Palacios using Statistics Canada data (2012a).

In 2007/08, Alberta's net financial assets stood at $34.1 billion. As of 2011/12, they declined to $16.4 billion (all figures in inflation adjusted 2011 dollars).[1] That is a $17.7 billion decline in real terms, or 52% (see figure 1 and its sources).

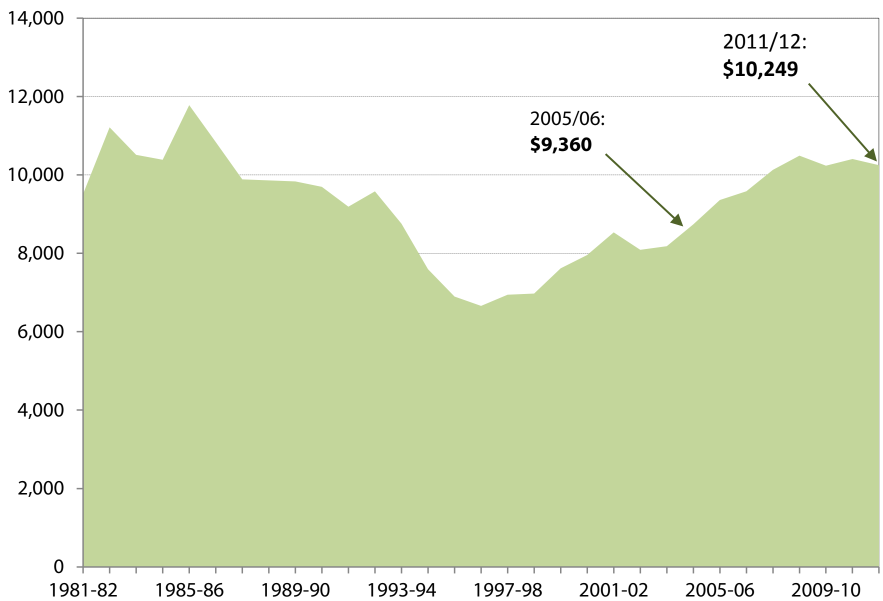
Even more decline to come

Of note, getting the books to balance is not helped by per capita program spending which is high relative to past years. While the province's natural resource revenues bounced back in 2011/12 from post-recession lows, revenues are still lower on that front (and overall) when compared to pre-recession highs (Alberta 2012d, 14).

In addition, pension liabilities may increase faster than expected, which will result in a further erosion of the province's net financial assets. Alberta's Budget 2012 forecast unfunded pension liabilities at just under $10 billion for fiscal 2012 (Alberta, 2011: 88). However, actual pension liabilities came in at $10.3 billion—a figure the province did not expect to reach until fiscal 2014 (Alberta, 2012a: 130; Alberta, 2012c: 6). Also, resource revenues in this fiscal year may not be as high as forecast for reasons already noted.

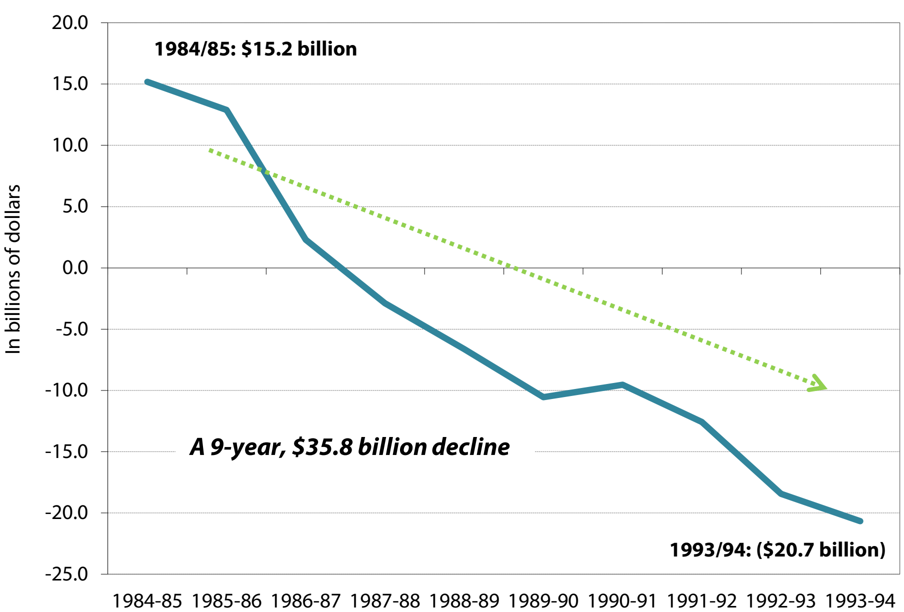
To understand the magnitude of Alberta's spending beyond its means, consider that in 2005/06, the province received a record $16.7 billion in non-renewable resources revenues (adjusted for inflation; the nominal figure is $14.3 billion) and

Figure 2: Alberta per capita program spending 1982- 2012 adjusted for inflation, in 2011 dollars



Sources: Canada, Department of Finance, 2000 and 2010; Alberta, 2012a; Alberta 2012c; Statistics Canada, 2012a and 2012b; calculations by Milagros Palacios.

Figure 3: What happened last time—Alberta's net financial assets 1984/85-1993/94, including pension liabilities (in inflation-adjusted 2011 dollars)



Sources: Alberta 2001, 88; inflation calculations by Milagros Palacios using Statistics Canada data (2012a).

spent $9,360 per capita on programs (also adjusted for inflation to 2011 dollars). In contrast, in the last fiscal year (2011/12), non-renewable resource revenues stood at $11.6 billion, but the province spent $10,249 per capita on programs—$889 more per person (figure 2). The province is spending as if non-renewable resources revenues were still flowing in at levels akin to 2005/06.

It might be argued that a decline in Alberta's net financial assets is to be expected. After all, the province experienced a recession in 2008/09 and thus financial assets such as the Alberta Heritage Savings Trust Fund (AHSTF), with half of its holdings in equities, would have been expected to decline in value, as indeed they did (Alberta, 2012e: 5 and 20). It might also be argued that the value of the province's Sustainability Fund, created to provide the General Revenue Fund with a cash infusion when revenues are weaker and/or spending higher, would inevitably decline.

However, Alberta's recession ended in mid-2009, yet the province has incurred deficits in every subsequent year and has forecast a surplus only as of 2013/14—*five years after the recession ended* (Alberta, 2011a: 130; and Alberta, 2012c). That fact brings up an historical precedent.

We've been here before

Alberta has been down this road before, in the mid-1980s to early 1990s when the province also had net financial assets—and boasted about it. Yet Alberta quickly saw its advantage over other provinces ebb away as its net assets eventually turned into net liabilities. At present, the provincial government is treading down the same path and making the same policy choices and repeating the same mistakes.

In 1984/85, the province had net financial assets of $15.2 billion (all figures in inflation-adjusted 2011 dollars). Thus, in 1985, Alberta Treasurer[2] Lou Hyndman noted the net asset position of the general revenue fund as well as the positive balance in the Alberta Heritage Savings and Trust Fund (AHSTF). "There are few governments in the world that can match the financial strength of the Province of Alberta," said Hyndman in his March 1985 budget speech (Alberta, 1985: 12).

However, a drop in oil prices (and thus in provincial government revenues) and per capita program spending that exceeded available revenues created deficits, which by 1991/92 led to Alberta having a net debt . The situation is similar today. Back in the 1980s, per capita program spending ranged from a low of $9,514 in 1981/82 to a peak of $11,781 in 1985/86. In the nine years between 1984/85 and 1993/94, Alberta went from having net financial assets to having net financial debt. The decline in inflation-adjusted dollars was $35.8 billion (see figure 3) (Alberta, 2011: 88; Statistics Canada, 2012a).

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Table 3: Alberta's net financial assets

A comparison of the average annual rate of decline between 2006/07 and 2011/12, and between 1984/85 and 1993/94 (in billions of 2011 dollars, inflation-adjusted)

	Total decline	Annual average decline
2006/07 to 2011/12: The 5-year decline	17.693	3.539
1984/85 to 1993/94: The 9 year decline	35.835	3.982

Sources: Alberta, 2001: 88; Alberta, 2012a: 130; Alberta, 2012c. Inflation calculations by Milagros Palacios using Statistics Canada data.

Striking similarities

On an average annual basis, and accounting for inflation, the nine-year decline in the 1980s is similar to the average annual decline over the last five years: Just under $4 billion, on average, in the 1984/85 to 1993/94 decline, compared to just over $3.5 billion annually, on average, in this latest decline.

Conclusion and recommendation

Alberta's net financial assets have already dropped by 52% since 2008, mimicking a previous decline in Alberta's financial condition that began in the mid-1980s and lasted until 1994. Given the province's optimism on oil and gas prices—and its projections on estimates of growth for the economy, corporate profits, and personal income that are significantly above those from private sector forecasters, the province's deficit in 2012/13 is certain to be higher than expected. The result will be a further decline in Alberta's net financial assets unless the province reforms and reduces its historically high per capita program spending.

Clearly, Alberta's politicians must acknowledge that the province is currently spending beyond its means. They must restrain and pare per capita program spending sooner rather than later. If they find such direct action unpalatable, they could hold program spending to a rate of growth below that of government revenues generally. The former option would obviously lead to balanced budgets sooner than the latter option, and is thus preferable over running red ink budgets for a longer period of time, which would have the consequence of further eroding Alberta's net financial assets.

Notes

1 Note that none of the above includes capital assets. For those familiar with the province's financial statements, the province lists net financial assets on page 109 of its 2012 budget as $13.019 billion, but on page 130 as $23.174 billion. The difference between the two figures is due to pension liabilities of $10.155 billion. This paper thus follows the practice of statements on page 130 of the budget (Alberta, 2012a: 109 and 130). Note that we have adjusted net financial assets

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for inflation (to 2011 dollars) to provide an "apples-to-apples" comparison.

2 The official title of finance ministers in Alberta before 1993 was treasurer.

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