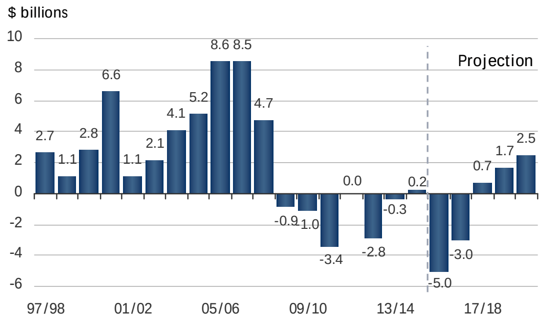
ALBERTA BUDGET 2015
March 27, 2015

Assessing the damage and setting the path back to balance

When crude oil prices began their sharp descent in June 2014, the Alberta government started to raise cautionary flags, warning of the looming fiscal blow and gradually setting the stage for yesterday's release of the province's updated fiscal plan. While much of the contents of Budget 2015 were announced by the Premier in the days leading up to the event, the budget details confirmed several "critical changes" as part of a proposed 10-year strategic plan and exposed the fiscal shortfall resulting from the oil price slump. As expected, the province is facing a record budget deficit in 2015/16 ($5.0 billion), although revenue enhancing initiatives, spending restraint and the use of funds in the contingency account will act as 'levers' to temper the near-term shortfall and return the province back to balance by 2017/18.

The intervening period between the beginning of the oil price plunge and yesterday's Alberta budget was marked by numerous assessments of the extent of province's potential budgetary shortfall. Given the dependency on revenues from the energy sector, the Premier hammered home that the revenue shortfall would exceed $7 billion in the upcoming fiscal year, resulting in a period of budget deficits. In yesterday's release, the budgetary documents revealed significant deterioration in the province's fiscal situation relative to the assessment a year ago, however, it was somewhat less dire than had been alluded to ahead of yesterday's release. The province expects a budget deficit of $5 billion in fiscal year 2015/16 (on a consolidated basis) followed by a $3 billion shortfall in 2016/17 before an anticipated return to sustained budgetary surpluses in the latter three years of the fiscal plan (of $0.7 billion, $1.7 billion and $2.5 billion, respectively).

Alberta government fiscal balance



Note: Balance numbers were calculated using the old methodology for comparison purpose
Source: Government of Alberta Finance, RBC Economics Research

Changing the fiscal framework…again

The Alberta government embraced a new strategic direction in Budget 2015, only two years after introducing a re-designed fiscal framework that shook up how the financial position of the province was presented. In the recent release, the budget documents were based on a fully consolidated basis (incorporates schools, universities, colleges, health entities and the Alberta Innovates corporations); in contrast to the previous fiscal plan framework that was divided into three components: an operational plan, a savings plan and a capital plan (the latter was introduced to "set Alberta on the path towards less reliance on non-renewable resource revenues"). On the basis of the previous framework, the new fiscal plan would show slightly smaller deficits and larger surpluses through the projection period (at -$4.6 billion in 2015/16, -$2.6 billion in 2016/17 and +$1.0 billion in 2017/18).

A (short-lived) surplus

The extent of the fiscal impact resulting from the crude oil price slump in the 2014/15 fiscal year became progressively larger with each quarterly fiscal

Laura Cooper
Economist
(416) 974-8593
laura.cooper@rbc.com

update as it became clear that the price decline was unabating. From an initial Budget 2014 estimated surplus of $1.09 billion, the excess dwindled to $933 million in the mid-year update in November 2014 and $465 million in the third-quarter update provided in February. The latest estimate for the province's bottom line in 2014/15 came in, on a comparable fiscal plan basis, at $431 million. On account of the new fiscal framework, however, the province's bottom line in 2014/15 is reported at an estimated $248 million. The deterioration predominantly reflects non-renewable resource revenues bearing the brunt of oil price weakness, with the 2014/15 crude oil price assumption declining by more than $15 from the Budget 2014 forecast to US$79.87/bbl in the latest budget.

The Strategic Plan

The critical changes required to shift how the province manages its finances alluded to by the Premier ahead of Budget resulted in the introduction of a 10-year fiscal management strategy and a five-year fiscal plan. The 10-year comprehensive plan rests on three fundamental pillars meant to "ensure long-term financial sustainability" and represent a new attempt to reduce the government's reliance on revenues derived from the resource sector. The first pillar, a strong fiscal foundation, is premised on returning to a balanced budget in part through diversifying revenues. The second pillar, building a lasting legacy, emphasizes the government's desire to diversify its economy by restoring the Heritage Savings Fund. Finally, 'securing Alberta's future' focuses on the near-term need to control government expenditures.

Part 1: Setting the foundation for (revenue) diversification….

As Premier Prentice announced in an address to Albertans ahead of the budget, the fiscal plan adopted a long-term strategy to reduce the government's dependency on a volatile source of revenues, those collected from non-renewable resources. Starting in 2018/19, a growing portion of these revenues will be reallocated annually away from supporting government budgetary operations to: first, replenishing the contingency account (that will be nearly depleted by 2016/17); second, fund the capital plan; and third, boost the province's Heritage Savings Fund. In 2018/19, the government expects 25% of non-renewable resource revenues to be shifted away from budgetary purposes (an estimated $1.6 billion) with the share rising to 50% in 2019/20 ($4.4 billion).

Taxes, taxes and more taxes…but no sales tax

As part of its strategy to create more long-term revenue stability, the government introduced several tax initiatives as part of the fiscal plan including changes to the flat 10% personal income tax rate. Effective January 1, 2016, the personal income tax rate for incomes greater than $100K will rise to 10.5% and will be followed by additional 0.5% increases on the first day of calendar years 2017 and 2018. An additional, albeit temporary 3-year increase will be placed on Albertans whose incomes exceed $250K beginning on January 1, 2016. Collectively, the government anticipates that these tax adjustments will yield a revenue boost of $87 million in 2015/16 with the gain rising to $420 million by 2016/17 and to $820 million by 2018/19.

The government also laid out a plan that requires Albertans to contribute to the costs of the health system with the introduction of the Health Care Contribution Levy, effective July 1, 2015. This cost is to be phased in for incomes over $50K to a maximum contribution of $1,000 in 2016 for incomes over $130.8K. The estimated $396 million lift to total revenues in 2015/16 resulting from this initiative is expected to be accompanied by an additional $1 billion boost stemming predominantly from an immediate 4 cent rise in the fuel tax and from increased 'sin' taxes—higher taxes levied on tobacco (up $5 to $15/carton effective at midnight) and liquor mark-ups (boosting this revenue component by 10%). Increased traffic fines and changes to government fees and insurance premiums round out the remaining revenue initiatives that collectively are set to boost total revenues by $1.5 billion in 2015/16, rising further to $2.7 billion by 2019/20.

Resource revenues to plummet in 2015/16

Even with the introduction of the above measures to boost tax revenues in the short term, **total consolidated revenues** are set to plunge 11.4% in 2015/16 to $43.4 billion. A solid 6.4% increase in revenues derived from personal income taxes (accounting for nearly 30% revenues) will be insufficient to fully offset significant weakness resulting from the crude oil price slump. A more than 50% projected decline in corporate profits is expected to see corporate income tax revenues fall sharply (-21%) while non-renewable resource revenues will nosedive, plunging a whopping 67% to $2.9 billion in 2015/16 (the largest component, bitumen royalties, are projected to freefall by 73% to $1.4 billion). Consequently, the non-renewable resources component of revenues will account for only 6.6% of total revenues in 2015/16, down sharply from the estimated 18% in 2014/15, and is expected to recover only partially to 15% by 2019/20.

A broad-based recovery in revenues is anticipated in 2016/17 predominantly reflecting acceleration in personal income tax revenue growth (reflecting the first full year of income tax increases) although nearly all components of revenues are set to rise. A 21% rebound in non-renewable resource revenues is projected, albeit the amount collected (at $3.5 billion) will represent only 40% of the level in 2014/15. With crude oil prices forecast to remain below $85 over the 5-year plan (and at only $54.84 on average in 2015/16 and $62.80 in 2016/17), non-renewable resource revenues are not expected to return to their 2014/15 level over the entire fiscal plan. From 2016/17 to 2019/20, robust total revenue growth is forecasted with an average annual increase of 7.9%; although the reallocation of non-renewable resource revenues moderates that rate to 5.8%.

Securing Alberta's future through expenditure management

To mitigate the near-term weakness on the revenue side of the ledger, the government plans to "hold the line" on expenditure growth in the first three years of the fiscal plan. Total spending (on a consolidated basis) is slated to edge down by 0.7% in 2015/16 to $48.4 billion with program expenditures falling 1.0% while increased borrowing will see debt charges jump 21.7% (to $891 million). Accounting for the combined growth rates of population and inflation (2.9%), on a real per capita basis, the decline in total expenses is larger. Health expenditure (accounting for nearly 40% of program spending) is slated to decline in 2015/16 as the government sets its sights on aligning growth in departmental spending with the national average. In addition to cost reductions, most departments will also be required to absorb costs resulting from population growth, salary settlements and other growth pressures to the tune of $1.9 billion in 2015/16 and up to $3.8 billion by 2017/18.

This sharpened focus on expenditure restraint was communicated in various reports ahead of the budget release, notably with the Premier announcing that a period of fiscal restraint was imminent to combat the oil price plunge. Members of Alberta's legislative assembly took a 5% reduction in pay earlier in the year and the government aimed to contain costs by restricting hiring, reducing travel expenses and limiting discretionary spending. Further cost reduction measures announced in the budget included the projected elimination of "over 2,000 full-time employments" in the public sector in 2015/16 and a reduction in compensation costs in Alberta Health Services. In the period after 2015/16, total expenses are slated to rise 1.8% with average program spending of 1.4% annually (0.3% in first two years and 2.6% in latter two), on average, and debt charges increasing by a much larger 20.6% (includes capital plan debt servicing costs).

Withdraw from the Contingency Account in the near-term, then save for the future

The introduction of a new Fiscal Sustainability Act will see the province withdraw funds from the Contingency Account to cover budgetary shortfalls (after adjusting for the government's net cash requirements). With a balance of $6.5 billion as of March 31, 2015, the fund will be drawn down to $2.5 billion over the course of the 2015/16 fiscal year and to $1 billion in the following year. A course reversal is expected in 2018/19 as funds from resource revenue savings will see the balance replenished to $5.0 billion by 2019/20. At that time, a share of non-renewable resource revenues from the budgetary operations will be transferred entirely to the Heritage Fund, which at the end of fiscal year 2014/15 had a balance of $15.1 billion. The Fund, which is meant to create a savings channel for the future and provide a means of diversifying the economy, is set to see its balance rise to $16.1 billion by March 31, 2019 before more than doubling over the subsequent five years to $34.5 billion by 2025.

Financing the Capital Plan

The Capital plan includes $29.5 billion in infrastructure projects over the five-year fiscal plan, including $6.4 billion in 2015/16 (incorporating self-financed projects from schools and health facilities, this figure rises to $6.9 billion). Financing for the plan will be done primarily through direct borrowing, which is set to jump to $5.68 billion in 2015/16 from an estimated $3.0 billion in the year prior. Direct borrowing is then set to ease slightly through to 2018/19 with amounts totalling $5.54 billion in 2016/17, $5.23 billion in 2017/18 and $2.78 billion in 2018/19. Total financing requirements, which include borrowings by provincial corporations, are projected to rise from $6.6 billion in 2014/15 to $9.7 billion in 2015/16 before diminishing slightly to $9.1 billion in 2016/17.

Trying to get off the rollercoaster…

The Alberta government continues to struggle to diversify away from the bedrock of its fiscal position, volatile resource revenues. The new fiscal framework does have its merits, notably the inclusion of a resource revenue risk adjustment, that in addition to its objectives of restoring "rainy day" and savings funds, could act as a buffer between the province's bottom line and weaker-than-projected resource revenues should oil prices come in below the government's forecast assumptions (albeit does not come into effect until the latter part of the fiscal plan). Conversely, there is upside risk should a stronger-than-expected recovery in the energy sector materialize (RBC's forecast for the price of WTI is US$77/bbl in 2016 compared to the Budget forecast of $62).

The key energy assumptions in Budget 2015 are in line with the average of private sector forecasts, and the economic assumptions are closely aligned with our view that—despite the presence of significant downside risks, a recession is expected to be closely averted. The government forecasts real GDP growth in the province at 0.4% in 2015 (RBC's current forecast is 0.6%) reflecting a

30% decline in investment in the energy sector. A sustained period of low oil prices will further temper investment in 2016, down 5%, although real economic activity is set to rise 1.7%. Nominal GDP, a broad measure of income, is set to fall sharply in 2015 by 8.1% before a modest energy price recovery will see this measure rebound by 5.7% in 2016.

Alberta's fiscal plan

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
$ billions	**Forecast**	**Estimate**	**Target**	**Target**	**Target**	**Target**
Consolidated Revenue	49.0	43.4	45.8	49.8	52.4	54.4
Consolidated Expense	48.7	48.4	48.9	49.1	50.7	51.9
Consolidated Surplus / (Deficit)	0.248	(4.991)	(3.047)	0.709	1.710	2.488