

Preserving  
Prosperity

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## Challenging Alberta to Save

Alberta Financial Investment  
and Planning Advisory Commission

### **Report and Recommendations**

December 2007

# Letter of transmittal

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Hon. Dr. Lyle Oberg  
Minister of Finance  
#408 Legislature Building  
10800 - 97 Avenue  
Edmonton, Alberta  
T5K 2B6

January 31, 2008

Dear Dr. Oberg:

As members of the Alberta Financial Investment and Planning Advisory Commission, we are pleased to provide our report and recommendations regarding Alberta's current and future approach to savings.

As part of our review, we consulted with and heard the views of many Albertans as well as several organizations, experts and key stakeholders. We have considered that advice along with information and analysis regarding the current financial situation of the province, past trends in savings, the current status of various funds and endowments, and forecasts of Alberta's future financial needs.

All of this leads us to conclude that Alberta must step up its efforts to save more of its revenues. We are enjoying tremendous prosperity today and, as a result, the province's financial situation is very positive. However, in our view, the current fiscal policy (including relatively high rates of spending and low rates of taxation) is unsustainable over the longer term.

To preserve today's prosperity and pass on the benefits to current and future generations of Albertans, we urge you and your government to make savings the new fiscal anchor for Alberta. Just as the call to eliminate deficits and debts shaped key decisions in the past, we believe it is time to usher in a new era of savings.

We appreciated the opportunity to participate in this important task. We would like to thank all those who shared their time, their ideas and their expertise. We sincerely hope that our work will contribute to a new policy on savings for the province of Alberta.

Sincerely,

Jack Mintz, Chair

Harry Buddle

Daniel K. Halyk

Judith M. Romanchuk

David T. Weyant

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## Executive Summary

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Alberta is at a critical point in its history. The province's economy has consistently outpaced the rest of Canada. We enjoy the tremendous benefits of the lowest income taxes in the country, no sales tax, the highest per capita spending on health care in the country and an education system that outranks some of the best in the world. We have retired the provincial debt and maintained a competitive tax environment that attracts individuals, businesses and investors from around the world. These advantages make Alberta a very prosperous place today.

At the same time, warning signs should be heeded. To a very great extent, the level of spending and the low taxes we enjoy today are the direct result of our abundance of resource wealth. Alberta's aging population and the expected lack of growth in resource revenues suggest that it will be difficult for Alberta to preserve our current prosperity for present and future generations. In fact, if action is not taken now, Albertans could face a substantial tax hike by 2030, compromising Alberta's prosperity. That is not the kind of legacy we want to leave to future generations of Albertans.

Against this background, this Commission was asked by the Minister of Finance, Dr. Lyle Oberg, to review government's approach to savings and in particular, the various endowments and foundations that currently are in place. We considered important questions about how and how much Alberta has saved in the past, what approaches should be used for the future, and how we can raise the profile on the importance of saving for Alberta's future.

It is clear from the submissions and consultations that Albertans care about the future of the province and future generations of Albertans. The majority of submissions recommended that the Alberta government save more so that present and future generations obtain more benefit from Alberta's current non-renewable assets.

The Commission agrees.

The government's financial investment and planning policies are extremely important to the long-term stability and growth of the Alberta economy. To put it in clear terms, Alberta's non-renewable resources should provide significant benefits not just to Albertans today, but also for our children and grandchildren. When Alberta sells its resources, it has given up wealth that can either be spent today or saved for the future. When our stock of non-renewable resources dwindles, Alberta's economy will need to rely only on its people – not its natural resources – to create wealth. The government itself will have to rely on investment income from the financial assets that it has accumulated and taxes paid by future Albertans to fund essential public services needed by a growing and aging population.

Alberta should not look like a ghost town in the next century when the resources are depleted. Instead, Albertans want to have a dynamic economy attracting people from around the world to enjoy Alberta's advantages long after the resources are used up.

For those reasons, our Commission is proposing a new approach to savings. The approach is designed to simplify the current approach, to make savings a clear and deliberate objective with tangible targets, to provide the necessary fiscal discipline, and to encourage proper stewardship of Alberta's savings to maximize the benefits to Albertans. It is intended to capture Albertans' interest and attention, to renew their commitment to savings, and to hold the government accountable.

To achieve those objectives, this report recommends:

- Setting a bold target of achieving \$100 billion in net financial assets in a reinvigorated Alberta Heritage Fund by 2030.
- Saving a fixed percentage of Alberta's total revenues each year as part of the budget.
- Establishing a clear and specific purpose – to preserve and enhance Alberta's prosperity for the benefit of current and future generations – and changing the name of the Alberta Heritage Savings Trust Fund to the Alberta Heritage Fund.
- Consolidating endowments under the umbrella of the Alberta Heritage Fund that would fund foundations focused on programs to provide long-term benefits to Albertans.
- Setting clear criteria for disbursing income from the Alberta Heritage Fund and earmarking funds for special purposes.
- Providing stable and predictable funding to existing foundations including the Alberta Heritage Foundation for Medical Research, the Alberta Heritage Foundation for Science and Technology Research, and the Alberta Heritage Scholarship program.
- Retaining a separate Alberta Heritage Capital Fund to support Alberta's future infrastructure needs.
- Retaining the Sustainability Fund but limiting its function to addressing unanticipated financial circumstances.
- Establishing a clear and effective approach to governance and decision-making.
- Taking steps to raise the profile of the Alberta Heritage Fund.
- Putting strong legislation in place to reinforce Alberta's commitment to saving.

It is time to usher in a new era of savings. Like any family, it means taking a disciplined approach, making sure that money is set aside to continue the same lifestyle in the future. We recognize that fiscal discipline is not always an easy course; it means some difficult choices need to be made. But just as deficit and debt elimination were the fiscal rallying cries in the 1990s and up to the mid 2000s, it is time to commit the same determination and discipline to preserving and harnessing today's prosperity for the benefit of current and future generations of Albertans.

## Purpose and process

### Mandate

In August 2007, Alberta Finance Minister Dr. Lyle Oberg appointed the Financial Investment and Planning Advisory Commission. The objective was to ensure that Albertans are receiving the maximum benefits from the province's savings and investment funds, including the Alberta Heritage Savings Trust Fund.

The Commission was specifically asked to assess whether the purposes, management and governance of Alberta's various funds are clear, and to review whether investment policies are consistent with the long-term interests of Albertans. The major funds included in the review include:

- the Alberta Heritage Savings Trust Fund (which also funds the Access to the Future program),
- the Capital Account,
- the Alberta Heritage Medical Research Endowment Fund,
- the Alberta Heritage Science and Engineering Research Endowment Fund,
- the Alberta Heritage Scholarship Fund,
- the Sustainability Fund.

As part of its mandate, the Commission was asked to address a number of key questions.

#### Regarding the framework for the Alberta Heritage Savings Trust Fund:

- Are the purposes and goals of the Heritage Fund in need of refinement or change?
- Are the broad investment and spending objectives and policies consistent with the long-term interests of Albertans?
- Are there better uses for new savings?
- Is the governance structure for the Heritage Fund appropriate?
- Are the purpose and functions of the Heritage Fund clear and can they be better communicated to Albertans? If so, how?

*"The **Alberta** government has nearly \$40 billion in savings, endowments and investment funds. We want to be sure these dollars are put to the best use not only for current Albertans, but for future generations."*

**Finance Minister  
Dr. Lyle Oberg**

Additional questions about the Heritage Fund included:

- Should the real value of the Heritage Fund be preserved? Should it grow?
- Should a specified portion of the Heritage Fund be earmarked for investing in Alberta?
- Should a portion of the Fund be used to provide venture capital in Alberta?
- Should some portion of the income of the Heritage Fund be transferred to the General Revenue Fund to fund current programs and services?
- If so, should the Heritage Fund adopt a spending rule to smooth transfers to the General Revenue Fund?
- Of any portion to be transferred, should any or all of it be directed to support certain specific types of spending, such as community grants?
- Should the Heritage Fund adopt some or all of the characteristics of similar funds held by other jurisdictions, such as Norway or Alaska?

**Regarding the province’s shorter term savings framework, including the Sustainability Fund and the Capital Account:**

- Are the purposes of these accounts/funds sufficiently clear?
- Are there better uses of these funds or new savings?
- Are the broad investment objectives and policies consistent with the purposes?
- Would alternative savings vehicles better achieve the desired purposes?

**Regarding the various endowment and other special purpose funds established by government:**

- Are the purposes of the funds still valid or in need of refinement or change?
- Are these purposes best served by continuing the current savings mechanism as defined in the legislation?
- Are there any scenarios or purposes under which new endowments should be created?
- Are the purposes of the funds clear and can they be communicated more effectively to Albertans?

Additional questions about the endowments included:

- Should the real value of the funds be protected?
- Are the broad investment and spending objectives and policies consistent with the long-term interests of Albertans?
- Should endowments with similar objectives be consolidated into one large fund?

### **Regarding transparency and communication:**

- What steps could and should be taken to improve transparency and communication of the governance, management and results of Alberta's various long-term investment funds.

## **Seeking input and ideas**

Albertans were invited to provide their advice and ideas directly to the Commission through written submissions or presentations. Key stakeholders met with Commission members to outline their views and a roundtable discussion with leading economists and financial experts was held. (A list of submissions and participants in the review is included in Appendix 1.)

The Commission also relied on the expertise and assistance of Dr. Bev Dahlby, University of Alberta Professor of Economics and Fellow, Institute for Public Economics. Extensive background information and support was also provided by staff of Alberta Finance.

### **Developing recommendations**

Based on its review of comprehensive background information, Alberta's current approach to savings, approaches used in some other jurisdictions, and the challenges ahead, the Commission has developed a comprehensive set of recommendations to guide Alberta's future policy on savings.

Perhaps most important to confirm at the outset is the Commission's firm view that, because of Alberta's unique position and our heavy reliance on non-renewable resource revenues, the province needs to renew and expand its commitment to save a greater portion of its revenues. This view shapes the Commission's report and its specific recommendations on how we should proceed with saving for the future.

## Why should Alberta save?

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This is the key question to be addressed at the outset: Why should Alberta save?

In their daily lives, Albertans typically understand their own personal reasons for saving. It could be to provide a cushion against unexpected times when they could be short of money. It could include saving for a major purchase, or saving for retirement. It is fair to say that, while Albertans understand their own reasons for saving, the reasons why the province should save more are not always as clear.

The Commission begins from the starting point that Alberta's long-term prosperity should be preserved. Saving more of Alberta's revenues is critical to achieve that goal. In the past, the Alberta Heritage Savings Trust Fund was described as a "rainy day" fund, protecting the province from a time when resources might decline. Our recommendations are based on a desire to ensure that Alberta's sunny days – the times of prosperity and opportunity we are enjoying today – continue well into the future.

It is important to distinguish between the short-to-medium term need for saving and the long-term motivation. The short-to-medium term need for saving arises from the annual fluctuations in the Alberta government's revenues relative to its expenditure requirements. The long-term motivation arises because non-renewable resource revenues will almost certainly decline over the next 20 years, in relation to the government's expenditure requirements, and population aging and pressures on health care costs will drive up the spending side of the budget. So if we do not save today, it is entirely possible that, unless they significantly increase taxes, future governments will not have the necessary revenues to pay for core services that Albertans require and expect, particularly education and health care.

The following sections outline some of the key reasons why it is important for Alberta to save a significant portion of its revenues today.

### Long-term saving to replace declining resource revenues

The long-term motivation for savings by the Alberta government arises out of the likelihood of a decline in real per capita non-renewable resource revenue, along with demographic changes and expenditure trends that will put additional fiscal pressures on the government.

Forecasting future resource revenues in Alberta is extremely difficult because of the uncertainty about the long-run trends in oil and natural gas prices. Future technological changes may also have significant impacts on the amounts of conventional oil, natural gas, and synthetic oil that will be produced. However, several trends can be forecast with reasonable confidence. Annual production of natural gas and oil from conventional sources in Alberta is likely to decline. These are the energy sources that generate the most "economic rent" – revenues in excess of the costs of producing them – and therefore they contribute most to Alberta's resource revenues. Oil sands production has rapidly increased and will replace the declining production of oil from conventional sources. However, the oil sands production will not generate the same volume of economic rents as the conventional oil and gas industry because of its much higher costs of production, and therefore it will not generate the same levels of resource revenues that conventional oil and gas production has in the past.

For these reasons, in conducting analyses of the Alberta fiscal situation, many analysts are adopting scenarios in which future resource revenues decline in real per capita terms, i.e. the average annual growth rate of resource revenues is less than the average annual population growth rate and the rate of inflation. Alberta's 2007 Budget forecasts a 13 percent decline per year in nominal resource revenues to 2009-10. Other approaches used by Professor Ron Kneebone (2006) and Professor Paul Boothe (2006) range from constant real per capita non-renewable resource revenues to an annual 10.2 percent decline.

The recent Report of the Alberta Royalty Review Commission forecast a 23 percent decline in resource revenues between 2010 and 2016 in the absence of an adjustment to royalty rates. Even if we assume that the recently announced changes to the royalty regime will increase the level of resource revenues by \$1.4 billion annually beginning in 2010, future declines in resource revenues are still likely to occur.

## Population aging and health care costs

Demographic trends are also likely to contribute to budgetary pressures in the future. The Conference Board of Canada has recently projected the effects of demographic trends on provincial governments' expenditures on health care and education to the fiscal year 2024-25. For Alberta, they project real per capita health care spending increases of 2.0 to 3.0 percent per year. (Population aging is responsible for a 1.0 percentage point increase in real per capita health care spending while ongoing cost pressures push health care spending up by 1.0 to 2.0 percent per year.) For education, they project an annual 1.0 to 2.0 percent increase in real per student spending in elementary and secondary education and 0.75 to 1.75 percent increase in post-secondary spending. With a rising number of students, real per capita spending on education is expected to increase by 1.4 to 2.4 percent per year to 2024-25. (Conference Board 2006)

An aging population may also have implications for Alberta's tax revenues. An increase in the number of seniors in the population may lower provincial personal income tax revenues because individuals' incomes generally drop when they retire. Population aging may have a greater effect on Alberta's tax revenues compared to other provinces because Alberta does not have a sales tax. Therefore, the Alberta government will not benefit from increased consumer spending by seniors to the same degree as other provinces. Furthermore, population aging may affect labour productivity leading to slower income growth and less buoyant income tax revenues.

## Saving to promote intergenerational equity

With declining resource revenues and rising expenditures to support a growing and aging population, present and future generations face the prospect of higher taxes, reduced public services, or both. Given our current levels of spending and taxation, Albertans currently enjoy a net fiscal benefit from the resource revenues that will not be available to future generations. Within 20 to 30 years, a significant portion of the benefits of Alberta's non-renewable resources, especially low-cost conventional oil and gas, will have been consumed by the current residents of Alberta. Is this fair or equitable to future generations?

This question of intergenerational equity is not unique to non-renewable resource revenues. It also arises with regard to the funding of public pensions and many aspects of environmental policy. For example, much of the debate among economists concerning the level of carbon taxes that should be levied to reduce the impact of global warming concerns the question of how much of the burden of reducing carbon emissions should be borne by current generations compared to future generations.

As in the cases of pensions and environment policy, there is no easy way to answer the question of intergenerational equity in the consumption of Alberta's resource revenues.

How much of the resource revenue should we put aside now to benefit individuals 30 years from now? On the one hand, if we view the natural resources of the province as the birthright of current and future generations, then we should save a high proportion of non-renewable resource revenues to provide an equitable division of the benefits of the resources between current and future generations. On the other hand, if future generations could be richer on average than us, why should we provide a legacy for those who could have a higher standard of living than we enjoy today?

These opposing views lead to a conclusion that neither extreme is an appropriate policy for Alberta. We should not save 100 percent of today's non-renewable resource revenues for future generations nor should we spend all of the revenues today and save nothing for the future.

On balance, the Commission believes that intergenerational fairness means that we should save a substantial share of Alberta's revenues for the benefit of future generations of Albertans.

## Increasing saving to achieve a sustainable fiscal policy

The province's key fiscal variables for the 2006-07 fiscal year are shown in Table 1.

**Table 1: The Revenues and Spending of the Alberta Government in 2006-07**

	Total (in \$ billions)	Per Capita (\$ per person)	Percentage of Total Provincial Output <sup>d</sup>
Total Program Spending <sup>a</sup>	\$30.065	\$8,702	12.2%
Total Tax Revenues <sup>b</sup>	\$19.667	\$5,692	8.0%
<b>The Fiscal Gap</b>	<b>\$10.398</b>	<b>\$3,010</b>	<b>4.2%</b>
<b>Additional Revenues</b>			
Resource Revenues	\$12.260	\$3,548	5.0%
Federal Transfers	\$3.077	\$891	1.2%
Net Investment Income	\$2.798	\$810	1.1%
<b>Net Financial Assets<sup>c</sup></b>	<b>\$36.047</b>	<b>\$10,433</b>	<b>14.6%</b>

<sup>a</sup> Includes current and capital spending.

<sup>b</sup> Includes other own source revenues.

<sup>c</sup> Investment income minus debt service costs. The value of goods and services produced in the province.

<sup>d</sup> The value of goods and services produced in the province.

In 2006-07, total per capita program spending of \$8,702 was financed in part by per capita tax revenues of \$5,692. There was a fiscal gap – the difference between provincial spending and the taxes paid by Albertans – of \$3,010 per capita. This gap was financed from three sources – resource revenues of \$3,548 per capita, federal transfers of \$891 per capita, and net investment income of \$810 per capita. In 2006-2007, the province’s revenues from these three sources were more than enough to finance the fiscal gap, and the province was able to save the surplus in the form of financial assets.

While the province seems to be in a rosy fiscal position, the more important issue is: Is this fiscal policy sustainable? Can the province continue to spend 12.2 percent of Gross Provincial Product while only levying taxes equal to 8.0 percent of Gross Provincial Product? In other words, is a fiscal gap of 4.2 percent of provincial Gross Provincial Product sustainable in view of the expected decline in resource revenues?

The reason why the government should pay attention to the sustainability issue is that Albertans would like to avoid a repetition of the spending cuts that were carried out in the mid-1990s. However, the interest in this issue goes beyond a concern for avoiding future reductions in public services. If large cuts in spending on education and infrastructure are required in the future to address a significant fiscal gap, that may, in turn, reduce the growth potential of Alberta’s economy because these two investments contribute directly to higher private sector productivity. Future public spending cuts may be more difficult to achieve given the ongoing spending pressures in health care that are likely to come with a growing and aging population.

In any future fiscal adjustment, relatively large tax increases may be required if we cannot make all of the adjustment on the spending side. In the absence of a provincial sales tax, the tax increases will likely take the form of increased personal and corporate income taxes, impairing Alberta’s future international competitiveness and prosperity. These tax increases would reduce the future growth rate of the economy.

In other words, correcting the budgetary imbalance in the future may come at a high economic cost.

A sustainable fiscal policy can be defined as one where the government can maintain, over time, the same tax burdens and program spending as a share of the province’s economic activity, as measured by Gross Provincial Product (see box below).

### ***What is a sustainable fiscal policy?***

*A government’s fiscal policy will be sustainable if it can maintain a consistent ratio of tax to Gross Provincial Product over time and keep spending increases from growing faster than growth in the economy. A province can sustain a fiscal gap between its expenditure rate and its tax rate if it has enough revenues from other sources (i.e. resource revenues, investment income and federal transfers) and if it can count on those additional sources of revenue being maintained over time, relative to the size of the economy. If the province’s fiscal position is unsustainable, investors will anticipate that the province will have to cut back spending and/or raise taxes at some point in the future. This will make the province a less attractive place to invest even before the fiscal adjustment occurs, leading to lower rates of investment and slower economic growth. This would, in turn, exacerbate the province’s fiscal position, making the required fiscal adjustment even larger.*

Whether or not Alberta's current fiscal policy is sustainable depends on how fast spending, resource revenues, federal transfers, and net investment income will grow in the future.

- If spending rises faster than economic growth, in part due to demographic pressures, it will put pressure on future taxes to cover public expenditures.
- If the growth rates of revenue sources do not keep pace with the growth of the rest of the Alberta economy, then the current fiscal policy is unsustainable. As was previously discussed, Alberta's non-renewable resource revenues will likely decline in real per capita terms in the future.
- Future federal transfers will depend on future federal policies towards financing the provinces. It may be wise to expect federal transfers to grow more slowly than the provincial economy.
- Future investment income will depend in part on the future rate of return that Alberta earns on its investment funds, but most importantly, it will depend on how much Alberta saves to provide future investment income to offset the expected decline in resource revenues.

The Commission evaluated the sustainability of Alberta's fiscal policy by considering not just non-renewable resources, as conventionally done, but total own-source revenues.<sup>1</sup> We use total revenues as a benchmark for savings for three reasons:

- The depletion of natural resources affects not only non-renewable resource revenues but also other government revenues that depend on the oil and gas activities, including corporate and personal income taxes.
- Demographic changes due to a growing and aging population will affect the overall fiscal balances of the government, including spending on health care and education. These pressures will lead to higher tax rates over time.
- From our analysis, total revenues are somewhat less volatile than non-renewable resource revenues so that any rule to save a portion of total revenues would lead to less volatility in amounts saved.

### **Implications of Savings on Fiscal Sustainability**

Non-renewable resource revenues are "capital" revenues in the sense that once the oil and gas deposits are sold, the royalties paid to the Alberta government will not be replaced. Depleting the natural resource assets without replacing them with another investment earning the same return reduces the net assets owned by the Alberta government. While future discovery and development of existing potential reserves will provide revenues, the expectation is that non-renewable resource revenues will not grow as quickly as spending and economic growth.

<sup>1</sup> Own source revenues includes all provincial revenues, excluding federal transfers.

Under a reasonable set of assumptions about future rates of population and economic growth, rates of returns on investment, and the long-term trend in resource revenues, the sustainable fiscal gap in Alberta is about 1.3 percent of Gross Provincial Product, substantially less than the current fiscal gap of 4.2 percent of Gross Provincial Product.<sup>2</sup>

Unquestionably, the current rates of spending and taxation are unsustainable over the long-term and that, sooner or later, the province will have to make a fiscal adjustment by cutting its spending rate, increasing taxes, or a combination of both. If we make more of the fiscal adjustment now, by increasing our savings rate and reducing our reliance on resource revenues, we will reduce the magnitude of the fiscal adjustment that will be required in the future.

## Forestalling Tax Increases

An implication of the fiscal sustainability analysis is that, in the absence of significant restraint in spending, tax rates will need to rise to accommodate not only the lack of growth in non-renewable resource revenues but also increased spending pressures resulting from Alberta's growing and aging population.

To assess the likelihood and magnitude of potential tax increases in the future, the Commission considered several scenarios with different assumptions about health and education spending and revenue projections. The implications of alternative assumptions change the forecasts but not the overall conclusion that a major fiscal adjustment (tax rate increase and spending restraints) will be needed in future decades.

The fiscal implications of increasing cost pressures in health care and education, in addition to declining resource revenues, are illustrated below.<sup>3</sup> Other assumptions were considered but the Commission found that the same qualitative conclusion would be reached even if the quantitative values change.<sup>4</sup>

*"Alberta is once again on a fiscal crash-course. Reliance on non-renewable resource revenues for ongoing spending is nearing all time highs. If (and when) resource prices crash, the Alberta government's finances will be left with a large revenue gap. This gap will be filled through deficits, spending cuts and/or tax hikes. The only other option is if the Alberta government is able to create a new stable source of renewable revenues before prices drop or spending out-strips even these record-high prices. This can only be accomplished if the Alberta government controls spending and begins saving."*

**Canadian Taxpayers Federation  
submission to the Commission, page 5.**

2 See Appendix 4 for calculations of the size of the fiscal gap and the future fiscal adjustment that would be required at different rates of savings.

3 The key assumption in this scenario is that real resource revenues decline at an average annual rate of 3 percent. Real per capita health care expenditures increase at 2.0 percent per year and real per capita education spending is assumed to increase at 1.5 percent. The population growth rate is assumed to be 2.0 percent while the productivity growth rate is 1.5 percent per year, implying that real Gross Provincial Product grows at 3.5 percent per year. All other provincial program expenditures are assumed to increase at 3.5 percent – the same rate as the Gross Provincial Product. Federal transfers to Alberta are assumed to remain constant in real per capita terms at their 2006-07 level. Tax revenues and other own-source revenues are assumed to grow at the same rate as provincial GDP, 3.5 percent.

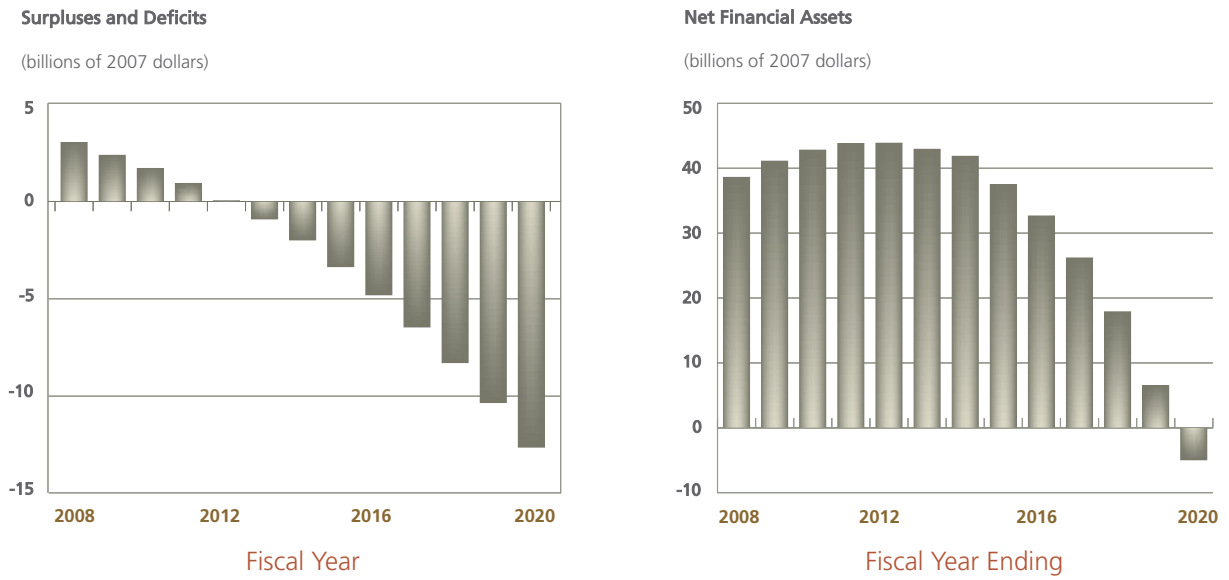
4 Some cautionary remarks should be made. The model that generates these results is very simplistic and does not capture the many interactions and behavioural responses that would likely occur as the province's fiscal position deteriorates. For example, once it is widely recognized that the province's fiscal position is unsustainable, investors will anticipate that the province will have to cut-back spending and/or raise taxes at some point in the future. This will make the province a less attractive place to invest even before the fiscal adjustment occurs, leading to lower rates of investment and slower economic growth. In turn, this would exacerbate the province's fiscal position, making the required fiscal adjustment even larger. The interactions between economic growth and the fiscal position of the province are potentially important, but are not incorporated in this analysis.

The Commission's analysis suggests that program expenditures as a percentage of Gross Provincial Product would slowly increase from 12.2 percent in 2007 to 13.7 percent in 2030. If taxes (and other own source revenues) as a percentage of Gross Provincial Product remained at 8.0 percent, the decline in resource revenues would result in progressively smaller provincial surpluses and eventually lead to provincial deficits. This trend is shown in Figure 1. In the absence of any fiscal adjustment, the province would start to run deficits after 2013. The province's net financial assets would then decline as it borrowed to finance the deficit or sold financial assets. The province's net financial assets would be eliminated by 2020.

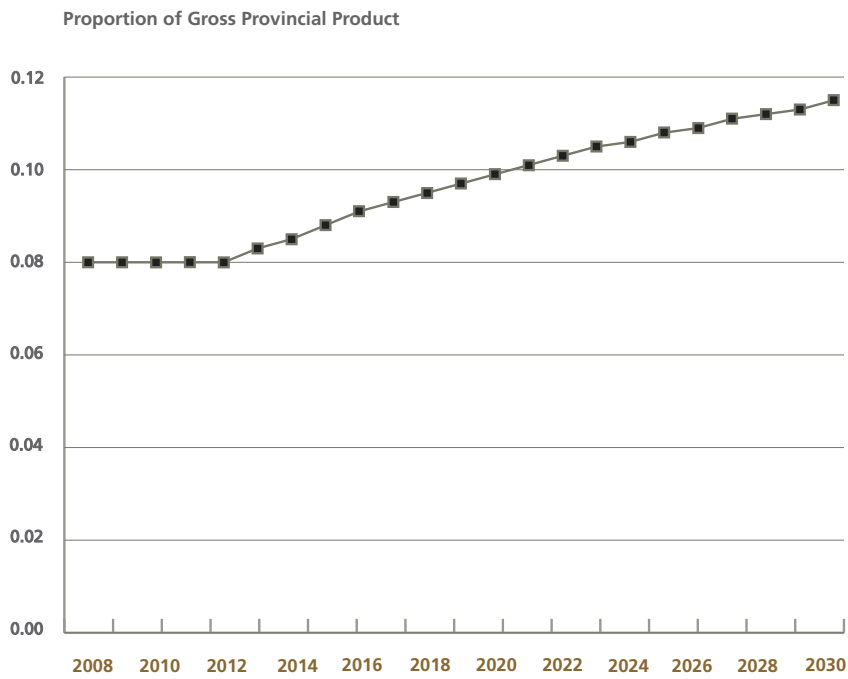
If, after 2012, the provincial government increased taxes and other own source revenues to avoid running deficits, the ratio of taxes and other own source revenues to Gross Provincial Product would increase from 8.0 percent in 2012 to 11.5 percent in 2030. This upward trend in tax rates is shown in Figure 2. The average tax increase each year from 2012 to 2030 would be 8.1 percent or about \$2,668.00 for a family of four. Thus, there would be a substantial increase in the tax burden on present and future generations that will also reduce the prospects for economic growth.

The Commission, therefore, concludes that it is important for Alberta to save more money to preserve Alberta's prosperity in the future – high taxes in later years will make it harder for Alberta to compete for people and investment.

**Figure 1: Projected Trends in Surpluses and Net Financial Assets**



**Figure 2: Tax Revenues Required to Prevent Deficits**

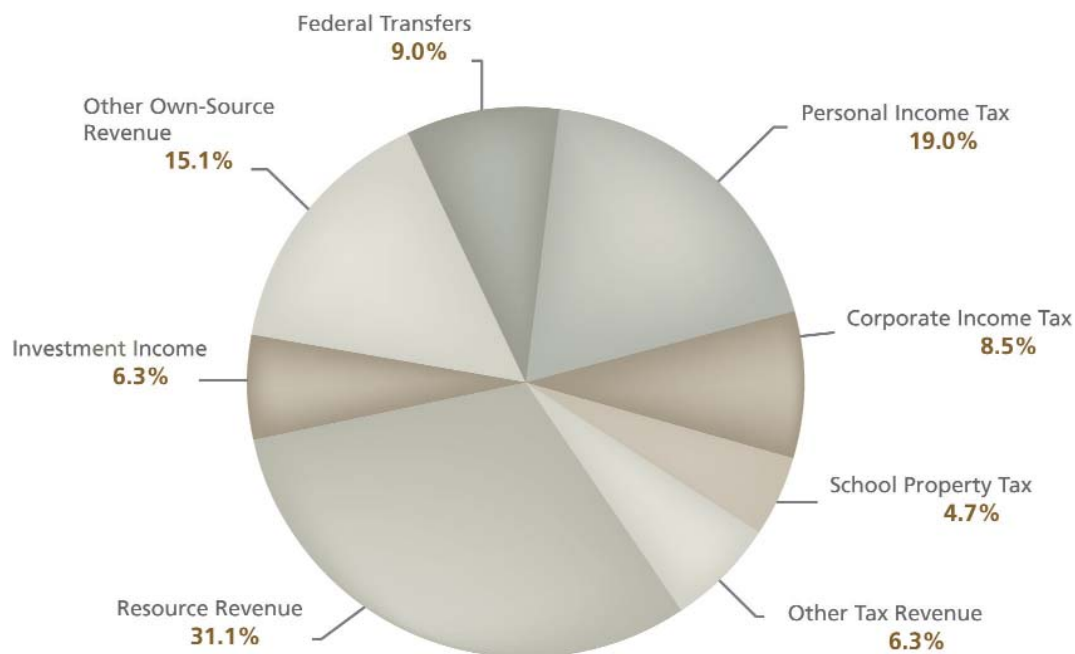


## Saving to smooth short-to-medium term fluctuations in revenues and expenditure requirements

All provincial governments, including Alberta, face short-term fluctuations in their expenditures and revenues. Significant year-to-year fluctuations in current expenditures can arise due to emergency situations. Recent examples include spending because of BSE, droughts, or forest fires. Governments may also face short-to-medium term fluctuations in capital spending because some capital projects are large or because there is an “infrastructure deficit” and a backlog of capital projects that need to be funded. Many governments have dealt with these fluctuations in capital spending through the establishment of a capital budget or a capital fund, a subject that will be discussed in more detail later in this report.

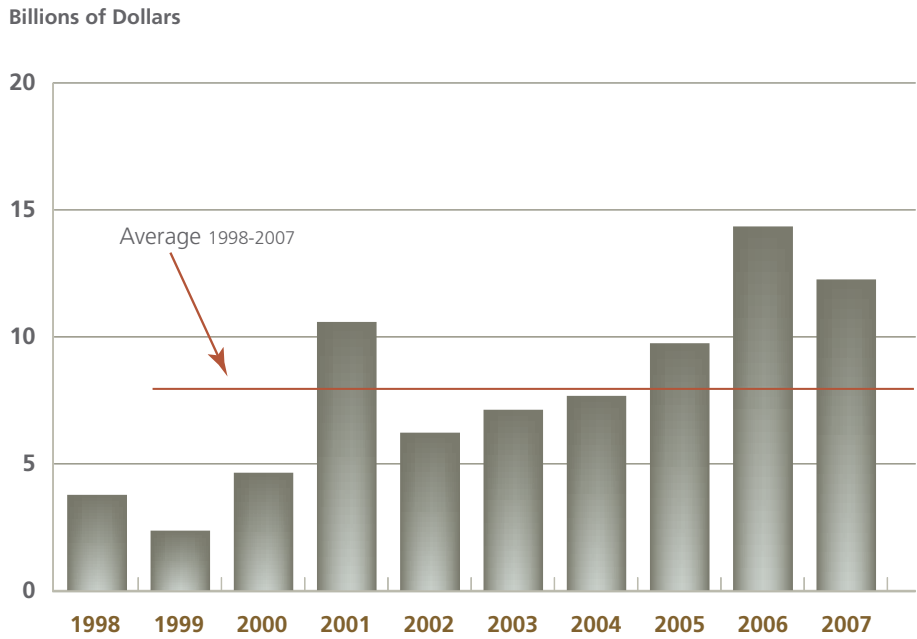
While expenditure fluctuations can have significant impacts on provincial governments’ budgets, the largest source of budgetary uncertainty for the Alberta government is its volatile resource revenues. As Figures 3 and 4 show, resource revenues are a major component of the total revenue structure of the Alberta government, and they have exhibited large fluctuations in recent years. Alberta’s heavy reliance on royalties from natural gas makes resource revenues particularly susceptible to short-term fluctuations in natural gas prices.

**Figure 3: Shares of Total Revenues of the Government of Alberta, 1998-2007**



Source: Calculations based on Consolidated Financial Statements, 2006-2007, page 19.

**Figure 4: Annual Resource Revenues Received by the Government of Alberta**



Source: Consolidated Financial Statements, 2006-2007, Page 19.

Figure 5 shows that the fluctuations of resource revenues around their ten-year average values are much larger than the fluctuations in the other major revenue sources.

**Figure 5: Annual Deviations of Major Sources of Revenue from Their Average Values 1998-2007**



Source: Calculations based on Consolidated Financial Statements, 2006-2007, Page 19.

Generally speaking, short-term fluctuations in revenues should not drive spending decisions. Governments should not increase spending just because revenues have increased in the short-run or cut back on spending to avoid a deficit because of a short-term reduction in revenues. If revenue fluctuations are allowed to drive short-term spending decisions, low value, marginal services will be funded in good years, and there will be cut-backs in essential (or high value) services in bad years. The overall quality of public services will be impaired. Furthermore, the economy will become more unstable and the business cycle would be exacerbated if government spending is pro-cyclical.

In the absence of a long-term savings objective, a government could run a surplus (i.e. save) in good years and run deficits in bad years, with the goal of achieving an overall balanced budget over the short-to-medium term. (In Alberta, however, legislation prevents the government from running an annual deficit, accounting for the Sustainability Fund transfers to cover shortfalls.) If a government needs to save because of long-term fiscal or demographic trends, then it should adopt an annual target for saving.

## Obstacles to increased savings

Currently, a significant amount of government spending is financed from resource revenues, which will likely decline over time, and from investment income earned by the Alberta Heritage Savings Trust Fund. Other jurisdictions, such as Norway and Alaska have achieved much higher savings rates from their petroleum resources. Why has it been so difficult to save more of our resource revenues?

It should be acknowledged first that, in spite of hearing from many Albertans and organizations which support increased savings, there are challenges involved in increasing savings. It is difficult to have a high rate of public sector savings when many Albertans are facing financial challenges and would prefer tax reductions or more government spending today rather than the long-term benefits of increased savings. It may be very difficult to persuade the public that the government should save a substantial portion of its revenues when households have difficulty meeting their fiscal obligations. However, if the government does not ensure adequate resources to support public services, Albertans will find that it will be difficult to meet their own personal needs if they face higher tax rates in the future.

Current residents of Alberta may oppose a sharp increase in public sector savings because they or their children may not be residing in Alberta in the future and therefore they may not benefit if the province saves more today. For example, some Albertans may look to retire to another province or country. As they should be, young Albertans are highly mobile, and they seek job and education opportunities in the rest of Canada and around the world. Therefore, it is reasonable to assume that a significant number of Albertans will not bear the burden of the future fiscal adjustment because they, or their children, may reside outside of Alberta. The Commission, however, is of the view that Albertans should accept the principle of preserving the province's prosperity and the prosperity of its communities because it is important to Albertans who have lived, worked and thrived here.

Finally, low public sector savings rates are sometimes blamed on politicians who, it is argued, have short-time horizons. According to this view, politicians are only in office for a short period of time and will not directly benefit from decisions that improve the economic and fiscal prospects of the province many years in the future. They argue that our political institutions are to blame because politicians are not rewarded for making decisions that have short-term costs but long-term benefits.

The argument that political institutions are to blame should be challenged. We have important examples of the federal and provincial governments addressing the funding problems of the Canada Pension Plan and their own structural deficits in the 1990s. Alberta virtually eliminated its entire debt, given its commitment to avoid leaving liabilities to future generations. These policies, which involved significant short-term sacrifices, indicate that if the public is convinced that higher public sector savings rates will generate significant long-term benefits, then politicians will adopt these policies.

One of the Commission's tasks is to inform the public about the need to save a substantial portion of revenues in Alberta and to help develop a consensus that the politicians can build upon to implement new policies in that regard.

## Private vs public savings

One significant issue for debate is whether the province should promote private savings (i.e. leaving more money in the hands of individual Albertans for them to invest and save privately to take care of their own futures) or support more public saving for the good of the entire province.

Although it is sometimes argued that public sector and private savings rates are closely linked, such that tax reductions that reduce public savings will increase private sector savings, the effect is less than dollar for dollar.

In simple terms, the question comes down to paying a dividend, reducing taxes, or building up a substantial public savings account to provide overall benefits for current and future generations. The Alaska Permanent Fund, for example, (which operates under decidedly different circumstances as discussed later in our report) provides annual dividends to its residents and, in fact, Alberta had one recent experience of providing prosperity cheques to its residents.

Providing annual dividends to Albertans certainly has some merit and may be well received by individual Albertans. Some have argued that individuals are in the best position to manage their own wealth and plan for their and their family's futures. Others suggest that the best way of sharing the benefits of resource wealth is to return a portion of that wealth directly to Albertans in the form of annual cheques. Still others argue that a direct financial benefit is the best way of encouraging fiscal discipline and limiting demands for increased spending.

On the other hand, once dividends are paid on an annual basis, the money is paid out as a cheque to those living in Alberta in the year that it is received. Albertans have had mixed reviews of the prosperity cheques provided in 2005. While many benefit from getting some money to pay for bills, we would lose the opportunity to use Alberta's non-renewable resource revenues more effectively by funding essential public services like health, education and pensions or to reduce taxes. In particular, the Commission believes it would be far better to return the money to Albertans as tax cuts in order to maintain Alberta's competitive tax environment, so as to encourage entrepreneurship, hard work, private savings, and investment.

On balance, the Commission's view is that paying out a dividend has less "*bang for the buck*" in creating long-term prosperity for the province.

## How and how much does Alberta save today?

The previous chapter made the case that saving can achieve some very important goals for the province and for present and future generations of Albertans. Against that backdrop, it is important to look at how Alberta approaches saving today, what types of saving mechanisms are in place, and how much has Alberta saved to date.

### How does Alberta save today?

Many Albertans have heard of the Alberta Heritage Savings Trust Fund and view it as the primary savings fund for the province, but several surveys have indicated that, aside from a general awareness, most Albertans know very little, if anything, about the size or purpose of the Fund. In fact, the province also has a number of distinct funds and endowments where money has been set aside to be used for specific purposes.<sup>5</sup>

**Table 2: Government Funds – September 30, 2007**

Government Funds – September 30, 2007 (in \$ billions)	
Alberta Heritage Savings Trust Fund	16.10
Alberta Heritage Medical Research Endowment Fund	1.62
Alberta Heritage Science and Engineering Research Endowment Fund	0.88
Alberta Heritage Scholarship Fund	0.86
Capital Account	6.64
Sustainability Fund	7.79
<b>Total</b>	<b>34.28</b>
<b>Other*</b>	
Alberta Cancer Prevention Legacy Fund*	0.50
Debt Retirement Account*	2.10
Energy Innovation Fund*	0.20
General Revenue Fund (Float)*	2.73
<b>Other Total</b>	<b>5.53</b>
<b>Combined Total</b>	<b>39.81</b>

\* Not included in the Commission's review.

### Alberta Heritage Savings Trust Fund

The Alberta Heritage Savings Trust Fund (AHSTF) was established in 1976 with an initial investment of \$1.5 billion. Its stated goals at the time were to save for the future, diversify the economy, and improve the quality of life of Albertans. The AHSTF is the province's primary savings vehicle. Its mandate today is to provide prudent stewardship of the savings from non-renewable resource revenues by providing the greatest financial returns on those savings for current and future generations of Albertans.

5 A list of current endowments and funds and their market value is included in Appendix 3.

When the Alberta Heritage Savings Trust Fund was first established, the government's policy was to save 30 percent of non-renewable resource revenues in the Fund. In the early 1980s, in the face of falling resource prices and rising public expenditures, the investment income earned by the AHSTF was transferred to the general revenues of the province and the annual contribution to the AHSTF was reduced to 15 percent of resource revenues. In 1987, the province stopped all transfers of resource revenues to the AHSTF.<sup>6</sup> In the mid-1990s, the province made a deliberate choice to eliminate deficits and pay down its debt rather than resume contributions to the AHSTF. Since 1982-83, \$26.5 billion of investment income has been transferred from the AHSTF to support government priorities such as health care, education and infrastructure.<sup>7</sup>

Several public reviews of the AHSTF have been conducted, starting in 1996 and continuing through to 2003. As a result of strong support for savings and for the AHSTF in particular, several changes have been made to the structure and mandate of the Fund. In 1997, a major change was introduced to manage the AHSTF as an endowment fund with the goal of maximizing long-term returns at an acceptable level of risk. A new governance model was established along with new investment objectives and performance measures. A decision was also made that the AHSTF would no longer be used for economic development or social investment purposes. In 2005-06, Alberta's accumulated debt had been eliminated and, through a province-wide survey, Albertans indicated their support for preserving the value of the AHSTF over the longer term. Once Alberta's debt was eliminated, the government began to inflation-proof the AHSTF by retaining a portion of investment earnings in the Fund to preserve its real value over time.

The Alberta Heritage Savings Trust Fund consists of investments in bonds, equities, real estate and other assets such as private investments, hedge funds and timberlands. The Fund's assets are managed with a long-term focus and are invested globally. As of January 1, 2008, the AHSTF will be managed by the newly-created Alberta Investment Management Corporation (AIMCo) according to investment policies set by the Minister of Finance.

The value of the Alberta Heritage Savings Trust Fund is forecast to be \$17.2 billion at March 31, 2008. In the past three years, the provincial government has transferred an additional \$3.825 billion from year-end surpluses into the AHSTF. In 2007-08, income from the Alberta Heritage Savings Trust Fund is forecast to be almost \$1.4 billion. Of that amount, \$496 million will be retained in the Fund for inflation proofing, \$825 million will be returned to the AHSTF by the government, with the balance transferred to the government's General Revenue Fund.

The Alberta Heritage Savings Trust Fund also includes an endowment of assets specifically dedicated to the Access to the Future program. The Access to the Future program was created in 2005. Its purpose is to provide seed money for innovations in the post-secondary system as well as matching grants to stimulate private sector, industry and other contributions to the advanced learning system.

<sup>6</sup> Emery, *The Future of the Alberta Heritage Fund*.

<sup>7</sup> Alberta Heritage Savings Trust Fund Business Plan 2007-10, page 33.

In 2005, \$1 billion was allocated to the Alberta Heritage Savings Trust Fund for this program. These funds are invested along with the other assets in the Alberta Heritage Savings Trust Fund. Each year the provincial government's General Revenue Fund transfers 4.5 percent of the amount allocated to the Alberta Heritage Savings Trust Fund to the Access to the Future Fund. As outlined in current legislation, up to \$2 billion more will be allocated to the Alberta Heritage Savings Trust Fund "as considered appropriate by the Minister of Finance."

To date, \$98.1 million has been allocated to the Access to the Future Fund to support Alberta's universities, colleges and technical institutes. These funds can be matched by private donations to Alberta's higher education institutions.

### **Alberta Heritage Medical Research Endowment Fund**

The Alberta Heritage Foundation for Medical Research (AHFMR) was established in 1980 with an initial endowment of \$300 million. Its mandate is to establish a long-term program of medical and health research in the province. The AHFMR Endowment Fund operates under the authority of the *Alberta Heritage Foundation for Medical Research Act*.

The AHFMR Endowment Fund was valued at \$1.616 billion at September 30, 2007. In 2005, the provincial government committed an additional \$500 million to the endowment. The final \$150 million of this commitment was deposited in June 2007. By law, the AHFMR Endowment Fund's value cannot be reduced below the initial endowment of \$300 million.

The Alberta Heritage Foundation for Medical Research operates at arm's length from government. It is governed by a board of trustees and its spending decisions are supported by an international panel of experts.

The Minister of Finance is responsible for managing the investments of the AHFMR Endowment Fund. Investments include a balanced investment portfolio similar to the Alberta Heritage Savings Trust Fund although with slightly different proportions in asset classes. The investments are managed similar to an endowment with a very long-term horizon. Funds are invested to provide the greatest financial returns within acceptable risk limits.

The AHFMR Endowment Fund retains all of its investment earnings. The Foundation's goal is to transfer an average of 5 percent of the Endowment Fund's value on an annual basis to support research projects deemed worthy by the trustees and its expert advisors. In 2007-08, \$65 million was transferred from the endowment to the Foundation. All other investment income is reinvested within the AHFMR Endowment Fund.

### **Alberta Heritage Science and Engineering Research Endowment Fund**

This endowment fund was established in 2000 with an initial deposit of \$500 million. Its mandate is to develop internationally recognized science and engineering expertise in the province by promoting the use of existing provincial resources, supporting Alberta's research facilities, encouraging cooperation, encouraging young Albertans to pursue careers in science and engineering, and attracting top graduate students and researchers to Alberta. More commonly known as Alberta Ingenuity, the organization supports science and engineering research of the highest calibre and invests in areas of strategic importance to the province, such as energy, water and nanotechnology.<sup>8</sup>

8 Ingenuity Inside. 2006/07 Annual Report. Alberta Ingenuity.

Similar to the Alberta Heritage Foundation for Medical Research, the Alberta Heritage Science and Engineering Research Endowment Fund is governed by legislation that establishes a board of directors. Spending decisions are made by the board and guided by a Science and Engineering Advisory Council of international experts as well as a rigorous peer review process. The Minister of Finance is responsible for managing the investments of the AHSER Endowment Fund in the same way as the Alberta Heritage Foundation for Medical Research and the Alberta Heritage Savings Trust Fund.

The original endowment was established with an investment of \$500 million from the provincial government. As a result of additional contributions to the fund and returns generated by investment of the principal of the fund, the Alberta Heritage Science and Engineering Research Endowment Fund totals approximately \$881 million (September 30, 2007). The provincial government has committed another \$500 million for the Fund, but no fixed date has been set for this contribution.

In terms of spending from the endowment, by law, the Alberta Heritage Science and Engineering Research Endowment Fund can only spend 4.5 percent of its value, defined as the average market value in the previous three years. All investment income is reinvested within the AHSER Endowment Fund. For 2007-08, total spending is about \$28 million.

### **Alberta Heritage Scholarship Fund**

The Alberta Heritage Scholarship Fund is the second oldest specific-purpose fund. Originally established in 1980, the Fund is designed to manage money received from government and non-government sources which provide funds for over 40 different scholarships. In 1995, legislation was amended to allow the Heritage Scholarship Fund to accept donations for the express purposes of providing scholarships.

Like many of the other special-purpose funds, the Alberta Heritage Scholarship Fund is established in legislation; however, it does not have an arm's-length board responsible for funding decisions. Spending is dedicated to specific scholarships according to established formulas. In 2007-08, the Alberta Heritage Scholarship Fund will spend \$27 million to support scholarships for high school to post-secondary and graduate level students.

The original endowment was funded with a provincial government investment of \$100 million. Like other special-purpose funds, investments are managed according to the same investment policies as the other funds. In 2005, the provincial government committed to adding an additional \$1 billion to the Scholarship Fund. To date, \$497 million has been contributed. There is no set timeline for adding the remaining \$503 million.

### **Sustainability Fund**

The provincial government established the Sustainability Fund in 2003. As noted in the previous section, Alberta's revenues are heavily dependent on resource revenues which are notoriously volatile on a year-to-year basis. The Sustainability Fund sets aside funds to offset the cost of emergencies and disasters, to pay for natural gas rebates, to manage unexpected declines in budget revenues, and to fund settlements with First Nations.

All unallocated year-end surpluses must go first to the Sustainability Fund and can only be allocated to other accounts if the balance of the Sustainability Fund exceeds \$2.5 billion.

The Sustainability Fund is established under legislation as an account within the General Revenue Fund. The Minister of Finance is responsible for managing the investments in the Fund. The base amount of \$2.5 billion is invested in a portfolio of liquid investments ranging from near cash to high quality short-term bonds. All income of the Sustainability Fund remains in the General Revenue Fund of the province. As of September 30, 2007, the balance in the Sustainability Fund was close to \$7.7 billion.

### **Capital Account**

The Capital Account was established in 2002-03 with an initial deposit of \$910 million. The Capital Account funds capital projects both for local authorities (e.g. school boards, regional health authorities, post-secondary institutions) and for the provincial government. With unprecedented spending on capital in recent years, the Capital Account has enabled the province to allocate surpluses to fund future requirements as outlined in the province's capital plan.

Similar to the Sustainability Fund, the Capital Account is established in legislation as an account within the General Revenue Fund. Management of the investments in the Capital Account is the responsibility of the Minister of Finance. Funds are invested in a portfolio of liquid investments ranging from near cash to high quality short-term bonds. All income from Capital Account investments remains within the General Revenue Fund.

As of September 30, 2007 the balance in the Capital Account stands at \$6.7 billion.

### **How are investment decisions made?**

As noted above, the Minister of Finance is responsible for the investment policies of the various funds and endowments.

In 2003, the Minister established the Endowment Fund Policy Committee to provide a broad range of advice to the Minister and to assist in carrying out the Minister's responsibilities for the investment policy of the Heritage Fund and other government endowment funds.

Execution of the investment policy will be the responsibility of the newly established Alberta Investment Management Corporation (AIMCo). This provincial corporation will assume investment management operations formerly carried out by Alberta Finance. A new board (with membership announced in October 2007) will oversee the management of the province's savings, public sector pensions and endowments. It will be responsible for supervising the corporation, appointing a chief executive officer, establishing bylaws, and approving the corporation's financial statements. The Auditor General of Alberta will continue to audit the accounts.

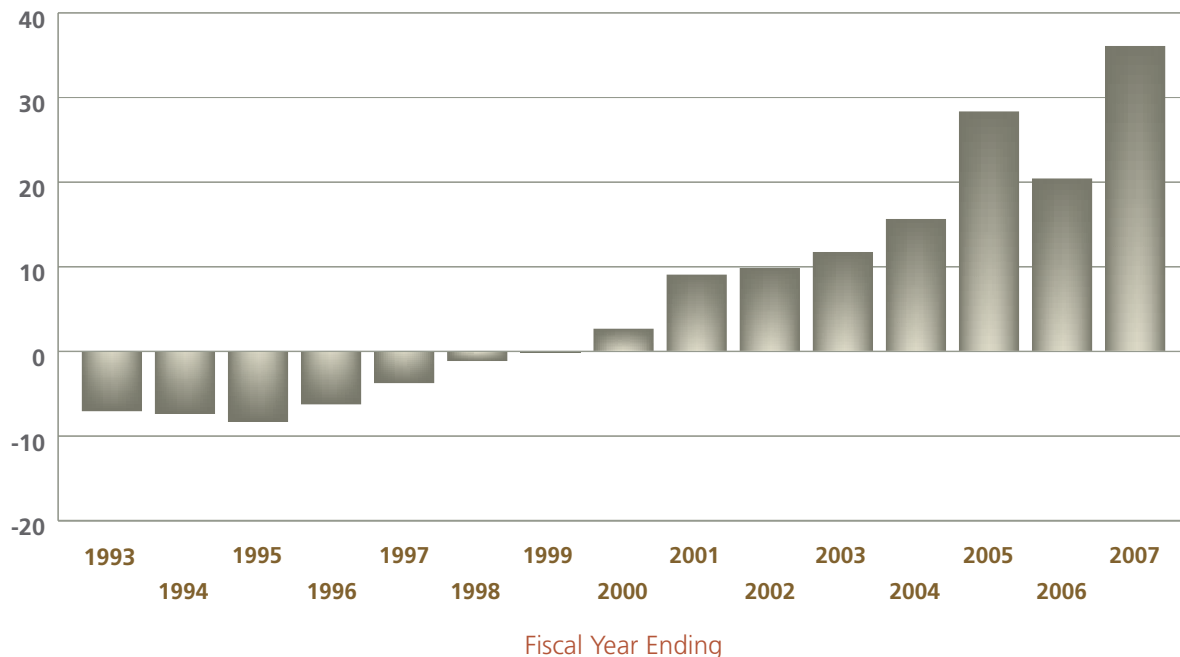
## How much has Alberta saved?

Now that we know how Alberta saves and the various funds and endowments it has established, the key question is: how much has the province saved?

Just as a household can measure how much it has saved over time by looking at the change in its financial assets, so, too, can we measure the amount that Alberta has saved by looking at the change in the province's net financial assets. Figure 6 shows the evolution of the province's net financial assets since 1992-93. Reasonably comparable figures on the province's net financial assets are only available since the fiscal year 1992-93, therefore we will use that as the starting point for our analysis. In that year, the province had a net debt of \$7.054 billion. The following year the province ran a deficit and the net debt increased to \$8.313 billion at the end of the fiscal year 1993-94. Then the province adopted a policy of fiscal restraint, which included large expenditure cuts. The province ran fiscal surpluses, and the net debt was reduced. As with a household, paying off debt is a form of saving, and the province was saving by paying down its debt. By 1998, the net debt was virtually eliminated, and the province's budgetary surpluses in recent years have led to an increase in its net financial assets. By the end of 2006-07, the province's net financial assets stood at \$36.047 billion. Consequently over this 14 year period, the province has gone from a net debt of \$7.054 billion to net financial assets of \$36.047 billion. In other words, the province has saved \$43.101 billion.

**Figure 6: The Government of Alberta's Net Financial Assets**

Net Financial Assets in Billion of Dollars



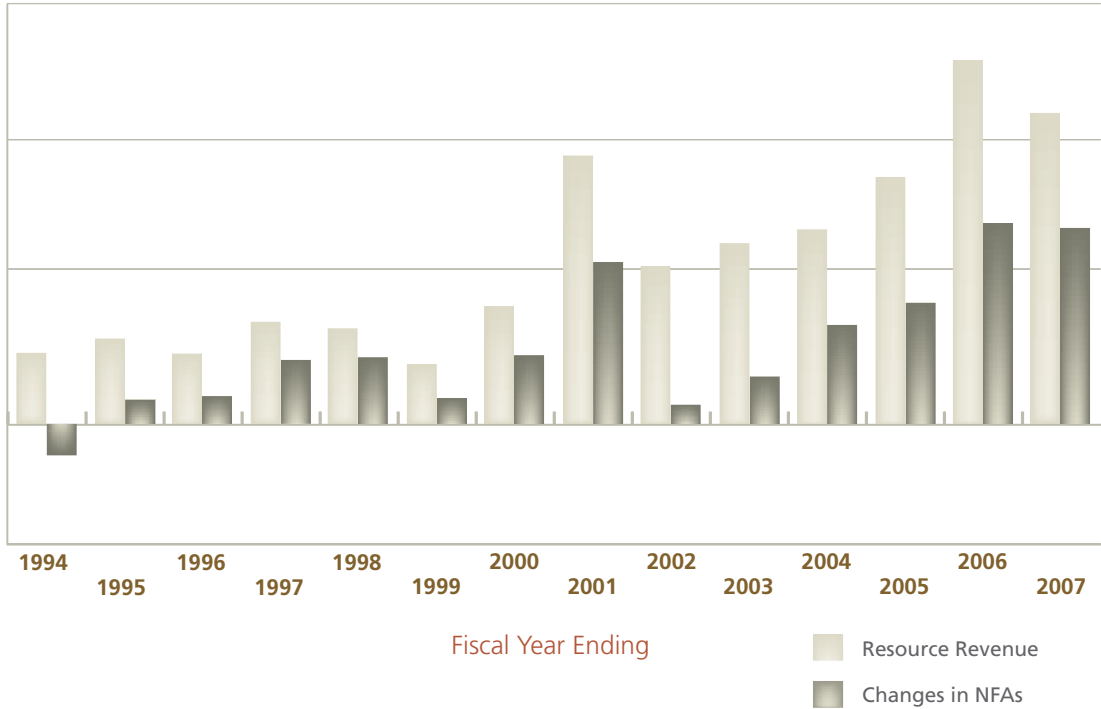
Source: Consolidated Financial Statements, 2006-2007, Page 19.

On an annual basis, we can compare the province’s saving – the increase in its net financial assets – with the resource revenues that it received that year. Figure 7 shows that annual savings and resource revenues have fluctuated substantially from year to year. Figure 8 indicates the province’s annual saving since 1993-94. In that year, the savings rate out of resource revenues was negative, because while the province had positive resource revenues, it incurred a deficit and the net debt increased. Since 1994-95, the savings rates as a percentage of resource revenues have been positive and have fluctuated from a high of 69.9 percent in 1997-98 to a low of 12.4 percent in 2001-02. Overall, the average annual savings rate since 1993-94 has been 30.3 percent of resource revenues.

Of course, the calculation of the savings rate out of resource revenues depends on the time period under consideration. For example, the Canada West Foundation has calculated that Alberta has only saved 8.6 percent of its resource revenues since the 1970s.<sup>9</sup>

To summarize, Alberta has saved a significant proportion of its resource revenues over the last 10 to 15 years (primarily by retiring the provincial debt and transferring surplus funds to the Alberta Heritage Savings Trust Fund and other funds). As our earlier analysis indicated, the rate of savings going forward needs to increase in order to maintain a sustainable fiscal policy in order to avoid increases in future tax rates.

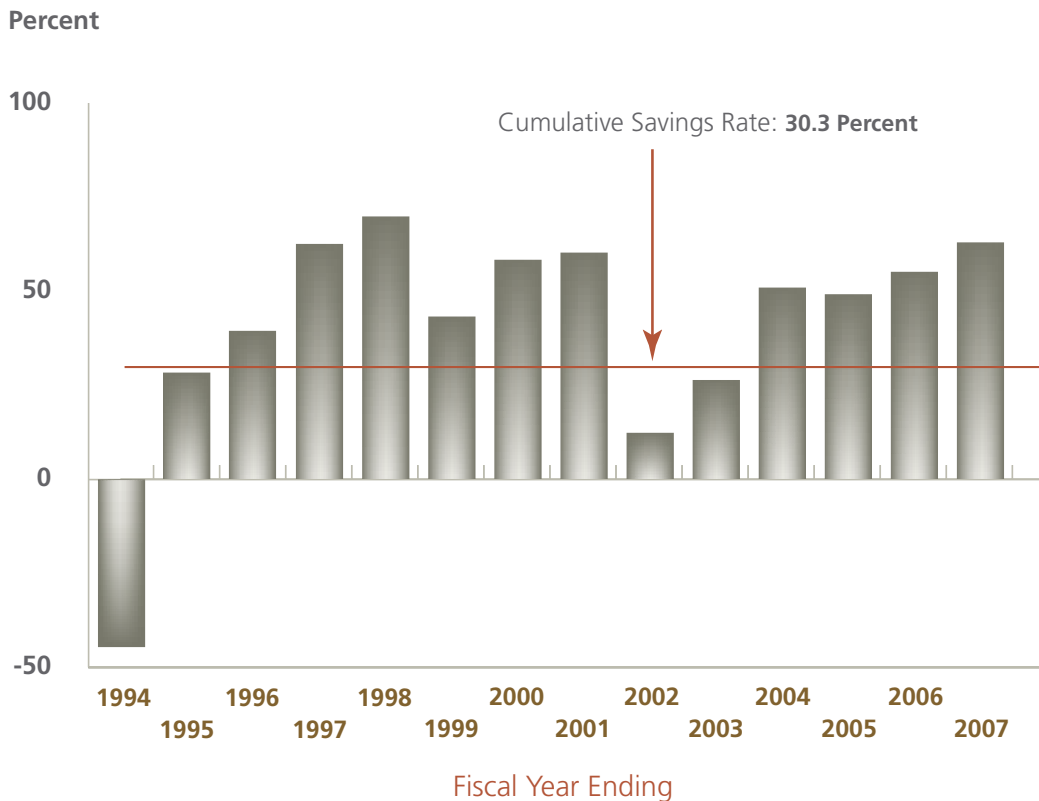
**Figure 7: Annual Resource Revenues and the Change in the Province’s Net Financial Assets**



Source: Consolidated Financial Statements, 2006-2007, Page 19.

9 Gibbins and Roach (2006, p.7).

**Figure 8: Annual Savings Rates Out of Resource Revenues, 1994-2007**



Source: Consolidated Financial Statements, 2006-2007, Page 19.

## How do Alberta's savings compare with other jurisdictions?

Alaska and Norway provide two comparisons for Alberta because they are also small advanced economies that receive substantial resource revenues. The table below, which provides a comparison of the Alberta Heritage Savings Trust Fund, the Norwegian Government Pension Fund and the Alaska Permanent Fund, indicates that the Alberta Heritage Savings Trust Fund is the smallest fund, both in absolute terms and in relation to the economy and the population. At the same time, it is important to state the obvious when it comes to comparisons like this: Alberta is not the same as Norway or Alaska.

**Table 3: A Comparison with Alaska and Norway**

As of September 30, 2007	Alberta Heritage Saving Trust Fund	Norwegian Government Pension Fund -Global	Alaska Permanent Fund
Total Size (In billions of Canadian \$)	\$16.1	\$399.8	\$39.9
Per Capita Value (In Canadian \$)	\$4,657	\$85,355	\$50,169
As a Percentage of GDP	6.5	103.9	84.0

## **Alaska**

The Alaska Permanent Fund was established through an amendment to the state constitution in 1976. Twenty-five percent of the petroleum revenues received by the state are deposited in the Fund. The remainder of the petroleum revenues is used to support the public expenditures of the state government. A distinguishing feature of the Alaska Permanent Fund is the annual dividend payment that is made to all residents of Alaska. Since 1982, annual dividend payments have been made equal to one half of the average net income of the Alaska Permanent Fund over the last five years. The remainder of the income is re-invested in the Fund. In 2007, the estimated dividend will be \$1,654 per person, up from \$1,107 in 2006 and \$846 in 2005 (all in US dollars). The largest dividend of \$1,964 occurred in 2000 when the dividend accounted for 6.2 percent of Alaskans' personal income.

The Alaska Permanent Fund has grown through the annual contributions of petroleum revenues and the reinvestment of roughly half of the investment income generated by the Fund. However, in the past decade the Government of Alaska has run deficits, and this has reduced the net public sector savings rate out of its petroleum revenues. The Alaska Permanent Fund has helped to transform a depleting resource into a permanent income stream for Alaskans and has helped to stabilize the economy.

## **Norway**

The Norwegian government established the Government Petroleum Fund in 1990, but the first deposit to the fund did not occur until 1996 because the Norwegian government was running deficits in the early 1990s. Since 2002, all of the petroleum revenues received by the Norwegian government and the investment income earned by the fund have been retained in the Government Petroleum Fund. There are, however, annual withdrawals from the Fund to finance current government spending. The official policy is that four percent of the value of the Government Petroleum Fund can be used to finance the current operating expenditures of the Norwegian government. In 2006, the Government Petroleum Fund was combined with the National Insurance Fund and renamed the Government Pension Fund-Global (GPF).

The Government Pension Fund-Global has two main goals. The first is to save current petroleum revenues to help fund future spending by the Norwegian government, thereby benefiting future generations. Although it has been re-named the Government Pension Fund, its revenues will help support all of the central government's future expenditures, including its state pension and health care expenditures, both of which are expected to increase rapidly in the coming decades, while oil and gas production are forecast to decline after 2010.

The second reason for depositing petroleum revenues in the Government Pension Fund is to achieve macroeconomic stability. Norway is a small open economy and if the petroleum revenues are not saved and invested offshore, there would be strong upward pressure on the value of the Norwegian currency, reducing the competitiveness of its traditional export and import-competing industries, and possibly leading to widespread layoffs of workers. By saving a substantial portion of its petroleum revenues in the Government Pension Fund and investing these funds offshore, the Norwegian government has to a large degree avoided the “Dutch disease” (i.e. where an increase in the value of resource exports causes output and employment in other sectors of the economy to contract because of an appreciation in the country’s exchange rate).

The most important lesson for Alberta from the Norwegian experience is that it has been possible to save a substantial fraction of the government’s petroleum revenues. However, there are important differences between the two jurisdictions. Norway is a sovereign country whereas Alberta is a province within a larger country. Alberta does not have control over monetary policy so that any Alberta savings results in adjustments to appreciation of the Canadian dollar that are spread over the entire Canadian economy. Furthermore, given that Norway’s population is less mobile internationally, saving petroleum revenues has been relatively more important in Norway to stabilize the economy while in Alberta economic shocks are softened by labour inflows and outflows.

Also, Norway’s offshore oil and gas reserves are large, but there is greater awareness of the finite nature of the resource and the inevitable long-run decline petroleum revenues in Norway than in Alberta where the hydro-carbon resources are more varied and in physical terms much larger. Norwegians have also opted for high government spending and taxes, whereas Albertans have generally supported smaller government involvement in the economy, thereby passing on revenues in the form of tax reductions rather than increasing public sector savings.

## What do Albertans and experts think about future savings plans?

As part of its consultations, the Commission heard a range of ideas and opinions from Albertans, various organizations, stakeholders and experts in economics and public finance. Throughout those consultations, some common themes emerged.

- Alberta should increase its commitment to savings. From individual Albertans to leading public finance experts, the Commission heard a consistent message that Alberta should increase its annual savings and set aside more of its current revenues for the benefit of current and future generations. Most warned about the future impact when

*“My message is this—  
SAVE, SAVE, SAVE,  
like never before.”*

**Individual  
submission to  
the Commission**

resource revenues decline. Others believe that Alberta's resources do not belong only to this generation but to future generations of Albertans as well.

- Alberta is well known for its fiscal discipline in eliminating both deficits and overall debt. Several suggested that it is time to make savings the next "fiscal anchor" for the province.
- There were wide-ranging views on how much the provincial government should save. Many suggested saving a fixed percentage of revenues rather than relying on budget surpluses to determine the amount of savings. Several submissions suggested saving a fixed percentage of resource revenues.
- Several submissions commented on how earnings from investments in the Alberta Heritage Savings Trust Fund should be used. A few suggested dividends should be provided to Albertans but most disagreed with this option. Others suggested more should be invested in education and infrastructure projects, new cancer treatment facilities, renewable energy, venture capital or high tech industries. A few submissions said that if the Alberta Heritage Savings Trust Fund is allowed to grow, the additional returns should be used to reduce taxes. Several suggested that none of the Heritage Fund's income should be transferred to the general revenues of the province – it should all be saved in the Fund.
- A few individuals indicated that Alberta did not need to save more – the current level of savings is enough. They preferred to see higher investments in education, roads and infrastructure, health care, public transit, community projects, or support for farmers.

*"I do, however, believe the **Heritage Savings Trust Fund***

***should grow dramatically. ...***

*A commitment to have the fund grow with an approach*

*identical to paying off the provincial debt*

*would be in the long term best interests of Albertans."*

**Individual submission to the Commission**

*"The **government's greatest success** at controlling spending and maintaining a commitment to saving its non-renewable resource revenues came during a period when it was seeking to eliminate deficits and debt. Since eliminating its debt in 2000, the government has operated without a long-term fiscal goal – a fiscal anchor – and its spending has accelerated with rates of growth which threaten its ability to continue saving even a fraction of its non-renewable resource wealth."*

**Dr. Ronald D. Kneebone,  
University of Calgary**

## Should Alberta change its policy on saving?

Alberta has had an ad hoc approach to saving. Currently, its policy on saving includes three key components:

- Inflation proofing the Heritage Savings Trust Fund so it can retain its real value
- Transferring a portion of higher than expected year-end surpluses to the Alberta Heritage Savings Trust Fund; and
- Maintaining a number of separate funds for specific designated purposes.

In the view of the Commission, there is little doubt that this ad hoc approach has to change. As noted in the earlier chapter on why Alberta should save:

- Resource revenues are expected to decline in the future as the supply of conventional oil and gas diminishes. The oil sands will not provide the same level of economic rents paid in the form of royalties to the province since their costs of production are higher than the costs of producing conventional oil and gas.
- Demographic trends point to a growing and aging population and consequently, increasing demands for spending on essential programs and services.
- Intergenerational equity means that today's generation should not be the only one to benefit from Alberta's abundance of natural resources. It is important to preserve the prosperity created by our resource wealth, invest it wisely, and share those benefits with future generations of Albertans.
- Unless the province embarks on an ambitious savings initiative, current and future generations of Albertans will face substantial tax increases – increases that could compromise our ability to compete with other jurisdictions in Canada and around the world.

Based on this assessment, the Commission strongly believes that it is time to usher in a new era of savings now that Alberta's debt has been eliminated. In fact, savings should be the hallmark of the government's future financial agenda and should be pursued with the same commitment and determination as we approached deficit and debt elimination in the 1990s and early 2000s.

*"This government and all future governments MUST save for the future. Spending all our resource revenue now is robbing future generations of their entitlements to public resources."*

**Individual submission to the Commission**

## Saving more for Alberta's future

### Recommendation

1

**Given that the non-renewable resource revenues received by the Government of Alberta will eventually decline, a share of the province's revenues should be saved to preserve key public services and low taxes in the future.**

Based on their own personal experience, Albertans understand the value of saving. They know they have to set money aside for the time when current sources of income are no longer available. That is why they put money in the bank or a retirement savings plan to finance their spending needs, such as food, shelter and health care, when they retire and no longer work to earn income. Many people with an eye to the future will make sure they put money aside even if it means giving up a vacation or a restaurant meal. We assume Albertans expect their government to think in much the same terms when it comes to its own finances.

As a Commission, we believe it is crucial for the Alberta government to save more for the future. As our report shows, the province has done a commendable job of eliminating debt. However, the challenges ahead demand a higher level of discipline when it comes to saving. Not only will non-renewable resource revenues decline in the future, the aging of Alberta's society, as in other advanced economies, will create significant pressures to fund public services and maintain one of the world's highest standards of living in the next three decades. This combination of declining resource revenues and increasing spending requirements will make it increasingly difficult for future generations of Albertans to benefit from one of Alberta's key advantages – the lowest tax rates in the country.

If current rates of spending on public services are maintained (taking into account demographic changes), and if additional public savings are not put aside, Albertans could face an approximate 40 percent increase in the average provincial tax rate by 2030. Provincial taxes could increase from 8.0 percent of Gross Provincial Product in 2007 to 11.5 percent by 2030, taking into account a falling share of non-renewable resource revenues relative to total government expenditures. Fiscal pressures will make it more difficult to fund basic needs like health, education and infrastructure and higher taxes will impair Alberta's tax advantage. Spending all of the resource revenues now will undermine the future ability of Alberta to compete in the global economy and to attract and retain the people necessary to develop new business opportunities. Saving more could mean slowing down the growth of government spending in the next decade if we are to avoid substantial tax increases, but the long run gain to Alberta is to provide sustained financing and to preserve Alberta's prosperity.

*"Windfall revenues won't last forever – Alberta must do what it can now to set the fund on a **permanent growth track.**"*

**Canadian Federation of Independent Business, submission to the Commission.**

## Making Public Saving a Priority

### Recommendation

**2**

**A fiscal rule should be established that requires the Government of Alberta to set aside a fixed share of the province's total revenues in a savings fund.**

### Recommendation

**3**

**The Commission recommends the Government of Alberta establish a target of saving \$100 billion in net financial assets in a renewed Alberta Heritage Fund by 2030.**

In the 1970s, Alberta's government had a policy of saving 30 percent of its resource revenues in the Alberta Heritage Savings Trust Fund to provide resources for the future. In the face of falling resource prices and rising public expenditures during the 1980s, we stopped saving. In the early 1990s, with large deficits, rising debt levels, and high per capita spending, Alberta went through a painful experience of cutting spending to restore its fiscal strength.

The government then set its sights on paying down its debt in full, just as many of us devote our income to paying off our mortgages. The retirement of Alberta's debt put Alberta in a favourable position to grow its assets and the province has now accumulated over \$36 billion in net financial assets.

As a Commission, we believe it is time for government to shift its priorities to saving more for Alberta's future. We urge the government to develop a more disciplined and predictable approach to saving. A savings policy that ensures that money is put aside every year would require greater fiscal discipline to keep spending growing at a level commensurate with growth in the economy.

Based on the Commission's calculations, a target of \$100 billion in net assets by 2030 is both reasonable and achievable. Once this target is achieved, it would provide ongoing annual investment income of \$4.5 billion to fund public services and/or maintain low taxes in the future.

Committing to a higher rate of savings clearly involves trade-offs and it means that a fiscal adjustment is necessary. If a very high target is set, the government may face a situation where it would have to either significantly reduce spending or increase taxes in order to achieve the target. At the same time, it is important to remind Albertans that, if current spending levels are maintained and additional savings are not put aside, future generations of Albertans could face a 40 percent increase in provincial taxes by 2030. Increasing savings today by a reasonable and affordable amount would prevent that from happening and still allow the province to maintain sustainable levels of spending.

The Commission did not have the mandate to recommend a specific annual savings rate as a percentage of total revenues. Clearly, there are an infinite number of possibilities for a specific savings rate. However, as outlined in Chapter 3, we did analyze the effect of different saving rules on future tax rates and spending levels.

Saving an additional 5 percent of revenues would reduce the sustainable provincial tax rate by almost one percentage point by 2030. In today's terms, this would translate into an \$898 savings in annual taxes paid by each of our children and grandchildren. Saving an additional 15 percent of total revenues means that Albertans would pay the same rate of taxes in 2030 as they pay today, despite an expected reduction in resource revenues.

In terms of spending, it is clear to the Commission that current spending levels are not compatible with a substantive increase in commitment to savings. If, for example, government chose to save an additional 5 percent of its revenues, it would need to slow its growth in spending by 0.8 percent of Gross Provincial Product or \$1.9 billion in 2007-08.

Based on our analysis, we are confident that, with some greater fiscal discipline, it would be possible to build up a larger fund to sustain Alberta's fiscal prosperity without imposing large sacrifices on the existing population. For that reason, the Commission recommends a \$100 billion target to be achieved by 2030.

We also believe that setting a target is important to keep Albertans and the Alberta government focused on the importance of savings. This type of "fiscal anchor" was important in the past when government successfully set and exceeded targets for paying down its debt. The same approach and the same commitment should now be turned to saving and preserving Alberta's advantages for present and future generations.

## A new approach to savings

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The provincial government has established a number of specific-purpose endowment and trust funds including the Alberta Heritage Savings Trust Fund (including funding for the Access to the Future Fund), the Alberta Heritage Medical Research Endowment Fund, the Alberta Heritage Science and Engineering Research Endowment Fund, the Alberta Heritage Scholarship Fund, the Sustainability Fund and the Capital Account. In addition, it has a number of specific endowment funds including the Alberta Cancer Legacy Fund and Energy Innovation Funds that were not reviewed by this Commission. In recent years, targeted endowment funds have also been proposed for agriculture and rural development, quality of life issues and childhood development, to name just a few.

The Commission believes that the province should not only adopt a more disciplined approach to savings, but should also streamline and consolidate its current approach into a new framework for the future.

### A New Alberta Heritage Fund

#### Recommendation

**4**

**The Commission recommends that the primary purpose of saving a portion of Alberta's total revenues should be to preserve and enhance Alberta's prosperity for the benefit of current and future generations. The current Alberta Heritage Savings Trust Fund should be reconstituted as the Alberta Heritage Fund with this objective in mind.**

#### Recommendation

**5**

**The Government of Alberta should consolidate the following funds under the Alberta Heritage Fund: the existing Alberta Heritage Savings Trust Fund (including funds designated for the Access to the Future Fund), the Alberta Heritage Foundation for Medical Research Endowment Fund, the Alberta Heritage Science and Engineering Research Endowment Fund, and the Alberta Heritage Scholarship Fund.**

The Commission reviewed the number of specific endowment funds currently in place. While each of the endowments has achieved considerable success, the result is a complex and fragmented approach. Spending plans for the endowments are not clearly linked to investment return from the various funds and, in some cases, annual spending has exceeded the investment returns. Tying how much an endowment can spend each year to the vagaries of annual investment returns makes it difficult to implement longer term, stable spending plans.

The Commission believes there are several advantages to pooling the individual endowments under a single umbrella fund – a renewed Alberta Heritage Fund. Those advantages include:

- **Simplicity** – Instead of a fragmented approach, Alberta would have a single savings vehicle with a number of designated purposes.
- **Transparency** – A single fund is more transparent and easier to communicate to Albertans.
- **Certainty and sustainability** – The Alberta Heritage Fund would provide a stream of revenue to contribute to the cost of government services today and in the future, in addition to providing sustainable and predictable funding for dedicated functions including research and scholarship. The advantage for the various foundations is that they would receive a predictable and sustainable revenue stream without the risks involved in annual fluctuations in investment income.
- **Flexibility** – A single fund enables governments to determine funding priorities with greater flexibility as decisions regarding the distribution of revenues are clearly separated from the allocation of investments to maximize returns.
- **Efficiency** – A single pool of funds can potentially generate higher investment income with greater efficiencies from simpler administration and investment consolidation.
- **Fiscal discipline** – The benefits of wealth created by our non-renewable resources today will be managed responsibly so the benefits from such savings may be shared with current and future generations of Albertans.
- **Profile and branding** – Combining existing endowments into a single Alberta Heritage Fund would result in a substantial fund with a value of close to \$24 billion. This size of a fund would add considerable profile to Alberta’s primary savings vehicle and assist in communicating the overall value and purpose of the Fund to Albertans.

With the consolidation of various endowment funds, Albertans can benefit from a reinvigorated Alberta Heritage Fund that would support public services and help maintain low taxes in the future. Investment income from the Alberta Heritage Fund would support the ongoing operating expenses of the Alberta government and designated special-purposes that could be enshrined in legislation. The Alberta Heritage Fund will grow through direct contributions of provincial revenues and the retention of some of the investment income it generates.

The government should ensure that it establishes a well-managed fund that earns an investment return in the top quartile of comparable investment funds in the world, with similar investment policies. To achieve that aim, the government’s fund should operate in a structure that incorporates good governance practices and with a clear and simple mandate of maximizing returns within acceptable risk parameters.

*“The Chamber recommends that government articulate an ultimate objective for the Fund that seeks to maintain Albertans’ standard of living long after the energy reserves are depleted.”*

**Calgary Chamber of Commerce, submission to the Commission**

## Disbursing investment income from the Alberta Heritage Fund

### Recommendation

**6**

**A fixed percentage of the market value of assets in the Alberta Heritage Fund should be used to determine annual disbursements from the Fund. We recommend distributing 4.5 percent of the value of assets annually based on a trailing three year average of monthly values.**

Currently, the investment income earned by the separate funds has been retained by the funds or disbursed to the general revenue of the Government of Alberta. In recent years, money has been reinvested in the Alberta Heritage Savings Trust Fund and in several of the endowments to protect their capital values from inflation. Additional new funds have also been created.

In the future, the Commission recommends that the government operate the Alberta Heritage Fund as a disciplined prudent investor, disbursing the investment income according to simple and established endowment rules. The amount disbursed from the Alberta Heritage Fund should be based on the expected long-run real return from the investment funds so that the capital can be protected from inflation. Based on current investment returns, the Commission recommends that 4.5 percent of the three-year monthly averaged market value of the Alberta Heritage Fund should be disbursed on an annual basis. Many private and public endowment funds have adopted a similar rule for disbursements. We also recommend that this rate of disbursement be reviewed on an ongoing basis and adjusted accordingly in order to protect the Fund from inflation and therefore, maintain the real value of the Alberta Heritage Fund.

As noted earlier, several submissions to the Commission questioned why the provincial government continues to use investment returns from the Alberta Heritage Savings Trust Fund to support current spending priorities. In the Commission's view, there are sound reasons for using a portion of the Fund's income to support current priorities. It is consistent with our view that the benefits of today's prosperity should be enjoyed not just by future generations but by Albertans today. It reflects the fact that there are costs associated with economic growth, particularly in terms of infrastructure projects such as highways, schools and hospitals, and that those costs have to be borne today by the current generation of taxpayers. It reflects a disciplined approach where a portion of Alberta Heritage Savings Trust Fund revenues help support essential projects and initiatives and provide more constant and predictable revenues.

## Earmarking Income for Specific Purposes

### Recommendation

**7**

**A portion of the investment income from the Alberta Heritage Fund should be earmarked to ensure long-term commitments and stable predictable funding for current and future foundations. Earmarking should be limited in aggregate to no more than 25 percent of the distributions made from the Alberta Heritage Fund.**

### Recommendation

**8**

**The provincial government should establish a set of criteria to determine when and if any new specific-purpose foundations should be created and to avoid future fragmentation.**

Many Albertans support the concept of spending income from the current Alberta Heritage Savings Trust Fund on key programs such as research or post-secondary scholarships. While this is an admirable objective, long-term commitments like this tie the hands of future voters who might have different priorities. As we have noted in our report, investment income from the Alberta Heritage Fund will be needed in the future to finance core services and to avoid significant tax increases when resource revenues decline. Further, the budget process becomes less transparent and more confused when there is a proliferation of earmarked spending through the various foundations and not through the normal budgeting process.

Because earmarking compromises the decisions that can be made by future generations, a limitation should be imposed on the extent to which investment income from the Alberta Heritage Fund is earmarked for specific-purposes. At present, about one-quarter of the distributed investment income from the Alberta Heritage Savings Trust Fund is needed to cover commitments to existing foundations, leaving the balance of the investment income to be used by the Alberta government to finance its annual budget. The Commission believes that this is an appropriate balance and any future additional earmarking should come from growth of the new Alberta Heritage Fund's market value.

The Commission also believes that the foundations should be governed by strong boards such as those currently in place for medical and scientific research. Independent boards should be created for the Access to Future Fund and the Alberta Heritage Scholarship Fund in order to implement spending policies on a broad range of programs (such as policies for matching salaries of highly distinguished researchers or special scholarships for graduate study). In our view, the allocation of research funds is best left to an arm's length board of directors who are knowledgeable and intimately involved with the wide range of technological and commercial issues at hand.

In terms of any future new foundations, a set of criteria should be developed by the government to determine when and if additional earmarking should be provided from the Alberta Heritage Fund. Any future foundations should be created under the umbrella of the Alberta Heritage Fund and not as separate endowments.

In general terms, the following criteria should be considered when earmarking is proposed for a new spending program:

- Any new endowment considered for earmarking purposes must require stable, long-term funding to achieve its objectives.
- Earmarking should be used only when high social returns for the province can be demonstrated as a justification for creation of a foundation to spend the funds received.
- In some cases, a sunset clause could be adopted for earmarked programs so that they will be terminated once their purpose has been accomplished.
- Foundations operating with earmarked funds from the Alberta Heritage Fund should be evaluated periodically, comparing their performance to measured targets.
- Fragmentation should be avoided in order to operate programs efficiently and on a world-class scale, generating the greatest opportunities for long-term benefits for the people of Alberta, as measured by the social returns generated by the funded projects.

As noted under the subsequent chapter on decision making and accountability, we recommend that criteria for earmarking should be developed and recommended by a Premier's Council on Savings. This Committee should also be charged with assessing the performance of individual foundations established through earmarked funds.

## Providing stable funding for key priorities

### Recommendation

9

**Special-purpose foundations should be supported by predictable and stable disbursements from the Alberta Heritage Fund that are indexed to ensure that costs related to inflation are covered.**

The Commission heard strong support for the two Alberta Heritage Foundations for research and praise for their performance in managing expenditures. It is important for the government to maintain its long-term commitment to the goals of these organizations, preferably through a legislated commitment.

The earmarked disbursements made available to the Alberta Heritage Foundation for Medical Research and the Alberta Heritage Foundation for Science and Technology Research are based on the investment experience of the funds. These foundations need to make long-term spending commitments to attract and retain top researchers, making predictability and certainty of funding an important priority for their boards.

Currently, the Alberta Heritage Foundation for Science and Technology Research is provided with a revenue allocation equal to 4.5 percent of the market value of its fund. As a result, it faces unpredictable disbursements to cover expenditures that have been committed in previous years. The Alberta Heritage Foundation for Medical Research has had flexibility to adjust its disbursements in face of market value declines but has been spending at a level that jeopardizes the capital in the fund. As noted in the Fourth International Board of Review of the operation of the Alberta Heritage Foundation for Medical Research (June 2004), “Recently, spending has risen to approximately 6.5% of endowment. The rate of spending from endowments at most universities is at 4.5 – 5.0%, a more realistic rate given the present uncertainties in financial markets. ... Unless this practice is changed, the current financial problems will recur; its resolution will simply be postponed.”<sup>10</sup>

To maintain the important work of the Foundation, the Government of Alberta provided additional funding to the Alberta Heritage Foundation for Medical Research.

The Commission believes that funding for these critical research priorities should be predictable and stable. Rather than relying on disbursements that fluctuate with market conditions, the payments to the foundations should be fixed based on their current funding requirements and indexed according to inflation. The Minister of Finance should have discretion to increase the amount of annual funding to the foundations, within the parameters of the 25 percent cap outlined in Recommendation 7.

Removing fluctuations in the revenues allocated to earmarked activities imposes greater risk on the rest of the province’s programs and ultimately on Alberta taxpayers. However, limiting the total amount of earmarked revenues to 25 percent of the disbursements of the Alberta Heritage Fund will limit the risks imposed on taxpayers.

## A New Alberta Heritage Capital Fund

### Recommendation

# 10

**The provincial government should replace the existing Capital Account with a new Alberta Heritage Capital Fund to assist in meeting the province’s current and future infrastructure needs.**

An important way of sharing the benefits of today’s revenues with future generations is to invest in infrastructure that meets current and future needs of a growing economy and an expanding population. Because of its specific purpose in supporting Alberta’s capital plans and the implications for the investment policy governing assets in such a capital fund, the Commission recommends retaining a separate capital fund within the General Revenue Fund rather than combining it with the Alberta Heritage Fund.

The Alberta Heritage Capital Fund should be used to finance capital expenditures outlined in the government’s capital plan. In addition to funds currently available in the Capital Account, a portion of year end budget surpluses should be put into the Alberta Heritage Capital Fund. Albertans should also be made aware of the capital projects funded by the Alberta Heritage Capital Fund.

<sup>10</sup> Fourth International Board of Review: A review of the operation of the Alberta Heritage Foundation for Medical Research for the period 1998-2004. June 2004.

## The Sustainability Fund

### Recommendation

11

**The provincial government should retain a separate Sustainability Fund but limit its purpose specifically to addressing unanticipated declines in revenues in a given fiscal year. The amount of funds included in the Sustainability Fund should be capped at \$3.5 billion initially and indexed thereafter for inflation.**

In 2003, the Government of Alberta created the Sustainability Fund to provide an additional source of revenues in the event of an unanticipated decline in revenues or increase in spending requirements.<sup>11</sup> This increase is less any funding provided from the Sustainability Fund for public emergencies or disasters, natural gas price protection, the Capital Account, settlements with First Nations, or allocations for savings.

The Commission is concerned that the Sustainability Fund has grown far beyond what would typically be required to support unanticipated demands during a budget year. Its value currently stands at close to \$7.7 billion. Its purposes are vague and include functions that typically should be included within a normal operating budget, such as planning for emergencies or paying for natural gas rebates. This is not what a “sustainability” fund is about. Therefore, the Commission specifically recommends that:

- A cap of \$3.5 billion should be set on the Sustainability Fund for the purpose of stabilizing Alberta’s finances as a result of economic booms and busts. The estimated cap is based on the typical downturn in revenues over two years. The cap should be indexed to inflation and reviewed periodically to determine whether the cap is appropriate relative to the annual government budget.
- All funds currently in the Sustainability Fund in excess of the cap should be transferred to the Alberta Heritage Fund.
- The current rule of requiring resource revenues in excess of \$5.3 billion to go to the Sustainability Fund should be removed.
- If the government uses funds from the Sustainability Fund, it should be required to repay those funds up to the limit of the cap over a subsequent three-year period.
- Expenditures related to emergencies, natural gas protection, the capital account, and settlements with First Nations should be part of the general budget rather than included as a purpose of the Sustainability Fund.
- Other than an immediate transfer of surplus funds in the Sustainability Fund, no transfers should be allowed among the Sustainability Fund, the Alberta Heritage Capital Fund, and the Alberta Heritage Fund. Because a smaller amount of money will be available in the Sustainability Fund, the province should increase the size of the contingency in its annual budget to cover emergencies, natural gas protection and settlements with First Nations, a budgetary practice followed by other governments in general.

<sup>11</sup> Under the current provisions, the Sustainability Fund grows if non-renewable resource revenues are in excess of the lesser of \$5.3 billion or the average of non-renewable resource revenues in the previous year’s forecast and the actual non-renewable resources of the previous two years.

## Allocating Surpluses

### Recommendation

# 12

**Year-end surpluses should be used first to top up the Sustainability Fund as required. At least 75 percent of the remaining year-end surplus should be allocated to the Alberta Heritage Fund.**

As outlined in Recommendations 2 and 3, the Commission strongly believes that a portion of total revenues should be saved “off the top” and placed into the Alberta Heritage Fund with the target of reaching a \$100 billion fund by 2030. That is critically important for Alberta’s future.

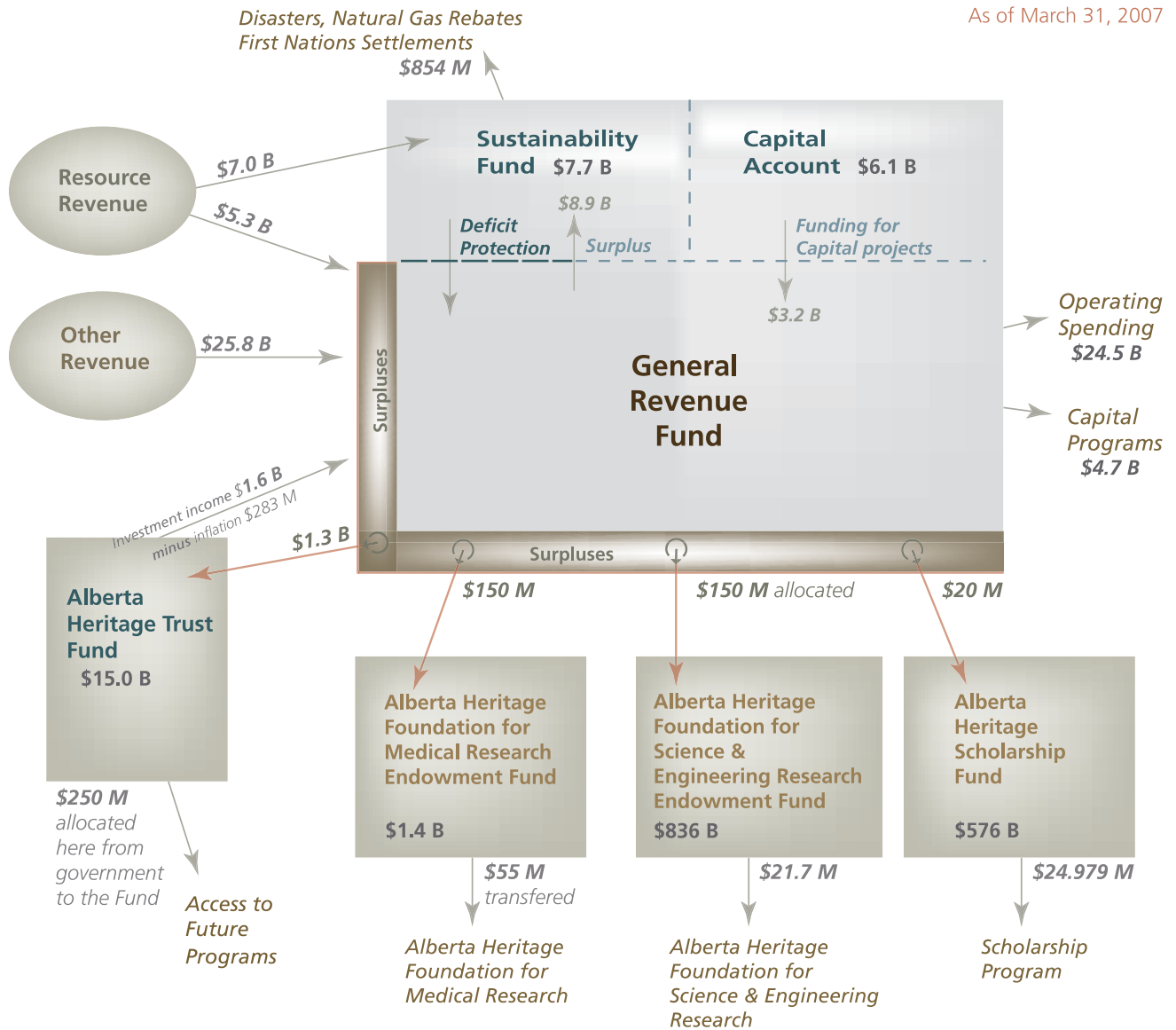
At the same time, the province could have anticipated and unanticipated surpluses at the end of any given fiscal year. Given the fluctuations in oil and gas prices in particular, this is certainly not unusual. We recommend that any future year-end surpluses should be used to maintain the Sustainability Fund at its capped amount, with at least 75 percent of the remaining surplus going to grow the value of the Alberta Heritage Fund. The provincial government could also choose to allocate a portion of surplus funds to the Alberta Heritage Capital Fund.

## A New Fiscal Framework for Alberta

The result of the previous recommendations and a new approach to savings is a simplified fiscal framework for Alberta.

The current budget of the Government of Alberta and the financial reports describing its operations are complex because this is a very large multifaceted organization whose internal controls and procedures have evolved over time and in response to various issues and events. The following diagram shows the flow of government revenues and spending as well as the roles of the Sustainability Fund, the Capital Account, the Alberta Heritage Savings Trust Fund, the Alberta Heritage Medical Research Endowment Fund, the Alberta Heritage Science and Engineering Research Endowment Fund, the Alberta Heritage Scholarship Fund, and other funds.

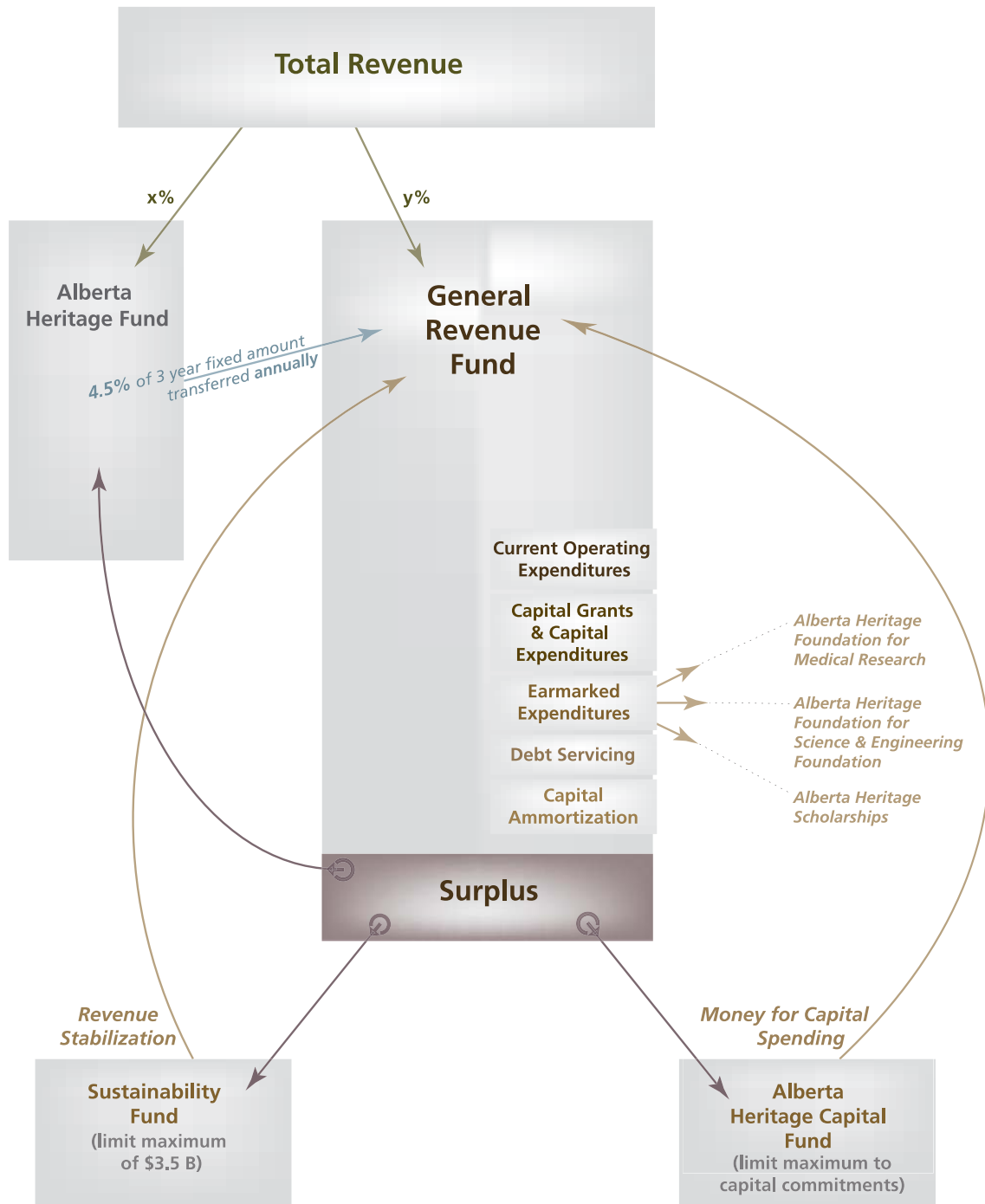
Figure 9: Current Fiscal Framework



The diagram shows the complexity of the current fiscal framework and a lack of transparency. The flows in and out of the Sustainability Fund are difficult to understand. The existence of a range of specific purpose funds makes it difficult for the public to understand how much the province has saved or where the savings are going because the public tends to focus only on the Alberta Heritage Savings Trust Fund when the level of saving is discussed.

The Commission is recommending that the Government of Alberta consolidate most of the existing funds into the Alberta Heritage Fund and that the province adopt a policy of saving a certain share of their total revenues "off the top." The proposed fiscal framework that the Commission is recommending is shown below.

Figure 10: Proposed New Fiscal Framework



This diagram shows the much simpler and more transparent fiscal framework. Revenues go into two funds: the province’s general revenue fund and the Alberta Heritage Fund. A fixed percentage of funds flows from the Alberta Heritage Fund to the province’s general revenues to help fund essential programs and services. Foundations such as the Alberta Heritage Foundation for Medical Research and the Alberta Heritage Foundation for Science and Engineering Research receive stable and certain long-term funding. Any year-end surpluses go primarily into the Alberta Heritage Fund, but also to replenish the Sustainability Fund or to grow the Alberta Heritage Capital Fund.

## Decision making, governance and accountability

The new approach to savings recommended in this report provides a simplified, transparent and effective way of implementing a renewed commitment to saving for the benefit of current and future generations of Albertans. For that approach to achieve the full potential for Alberta and achieve the aggressive target recommended in this report, it needs to be backed up and supported by strong, professional decision making in terms of both the investment policy and the overall direction for the Alberta Heritage Fund.

The recommended approach to governance establishes a clear separation between investment policy and decisions that could be made by the government regarding the overall purpose and direction of the Alberta Heritage Fund.

### Investment policy

#### Recommendation

13

**The provincial government should establish an Investment Policy Committee to provide advice through the Deputy Minister to the Minister of Finance on investment policy for the Alberta Heritage Fund.**

Under this governance model, the Minister of Finance continues to be responsible for overall investment policy. A blue-ribbon Investment Policy Committee should be established to provide advice through the Deputy Minister to the Minister regarding the overall investment policies that a prudent investor would adopt. The Investment Policy Committee should include highly qualified individuals with proven expertise in financial and investment matters.

The Investment Policy Committee should also provide general oversight and advice as to whether the financial assets are being well managed by the newly created Alberta Investment Management Corporation (AIMCo). Starting in 2008, AIMCo, under the direction of a highly qualified board of directors, will implement the Minister's general investment policies. AIMCo should be accountable for its investment performance following commercial principles and the Minister should seek advice from the Investment Policy Committee on whether its performance is adequate when benchmarked against other comparable fund managers.

Proper governance should be applied to ensure that the investment funds operate with the objective of maximizing returns on investments given the risk tolerance that would be established by policies determining the degree to which funds are invested in different classes of assets. The role of the Minister of Finance is to establish and monitor investment policies for the fund in general terms and not to direct any single investment.

## Making prudent investments

### Recommendation

# 14

**The Commission recommends that investment decisions should be governed in accordance with the principle of a “prudent investor.”**

There are two ways of growing the Alberta Heritage Fund so that it can fund future programs that benefit Albertans. The first is to save more. The second is to ensure that the government maximizes the returns it receives from its savings. This need to maximize returns is set out in the *Alberta Heritage Savings Trust Fund Act* (“AHSTFA”).<sup>12</sup> The preamble to that act states that the mission of the Heritage Fund is,

*...to provide prudent stewardship of the savings from Alberta’s non renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans.*<sup>13</sup>

In order to facilitate that mission – which we believe to be important, if not economically imperative – there must be both strong governance and sound management; that is, there must be an appropriate investment policy and excellent investment managers to implement the policy.

We are confident that the management team of AIMCo will build on the good work done by the province and provide strong management for Alberta’s financial assets, including the Alberta Heritage Fund, in accordance with the policies and priorities set by the Minister of Finance.

In setting the investment priorities, the Minister of Finance acts as a prudent investor. A prudent investor makes decisions consistent with the financial circumstances and risk tolerance of the fund. Rather than attempting to control risk by specifying a list of ostensibly safe investments, the prudent investor controls risk by intelligent diversification.<sup>14</sup> The legislation noted above sets out this requirement, stating that the Minister shall adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return that will enable the endowment to meet its objective.<sup>15</sup>

12 R.S.A. 2000, c. A-23.

13 Although the “mission” set out in the preamble to the AHSTFA, (obtaining “the greatest financial returns”) differs from the objectives set out in the body of the act itself, “maximizing long term financial returns” and the more qualified, “avoid undue risk of loss and obtain a reasonable return”, we are of the view that the various sections should be considered as a whole.

14 Alberta Law Reform Institute, Edmonton, Alberta, “Trustee Investment Powers”, Final Report no. 80, February 2000, at page 14.

15 A similar requirement is found in the Financial Administration Act, R.S.A. 2000 c. F-12, s. 43(1) which applies to the General Revenue Fund, the Alberta Heritage Scholarship Fund, the Alberta Heritage Medical Research Endowment Fund, and the Alberta Heritage Science and Engineering Research Endowment Fund.

## Socially Conscious Investing

The concept that investments can be placed for social, environmental, ethical, and political purposes takes on many forms and has many names. There is "green" investing (aimed at benefiting - or reducing damage to - our environment<sup>16</sup>), "ethical" investing (which avoids supporting "sin stocks" such as those associated with gambling, tobacco and alcohol and eliminates weapons manufacturers and suppliers); and an array of other programs, funds and strategies that each purport to shun or support some sector, practice, or corporation based on ethical, religious, social, or moral values. They are often referred to collectively as "responsible" or "ethical" investing, although, for the reasons that follow, we prefer not to use these terms as they imply that other forms of investing are irresponsible or unethical. We instead have adopted the term "socially conscious" to describe this form of investing.

Socially conscious investing takes three forms: avoiding "undesirable" companies, supporting "desirable" companies, and supporting shareholder activism. The common goal is to direct investments in such a way as to make the world a better place while receiving a return on these investments. In other words, doing well by doing good.

Several issues arise in considering a policy on socially conscious investing, the primary one being: who determines what are the "right" values? Even in a province such as Alberta where we may see ourselves as having a common vision, it is unlikely that there could be an agreement on what ethical, religious, social, and moral values should be supported.

Taking the issue one step further, even if there were a suitable ethical standard, the implementation of the practice is problematic. For example, if a decision is made to boycott (in an investment context) companies that abuse animals, does that prohibit supporting a pharmaceutical company that produces lifesaving drugs but tests them on animals before exposing humans? Is hindering the development and availability of those beneficial pharmaceuticals more ethical than protecting the lab animals? Likewise, if investment in a sector or corporation is shunned because its product or practices are deemed unethical, what becomes of the collateral victims of that action? For example, gambling may be viewed by some as evil in principle, but lotteries and casinos in this province provide employment (that feeds families) and tax revenue (that paves roads, employs teachers, nurses and police officers, funds social services, and provides grants to arts and charitable organizations).

<sup>16</sup> These include considerations such as alternative energy, green transport, water and waste management, sustainable living, and global warming sensitive stocks.

Some recent articles have concluded that it is consistent with the fiduciary responsibility for fund decision makers to address socially conscious considerations in managing risk and maximizing return across portfolio investments.<sup>17</sup> It is incumbent on the fund decision maker to consider the impact of socially conscious investments on the long-term financial returns on the Alberta Heritage Fund. When this is done, it must be in the context of the fund's objective, in this case maximizing long term financial returns.

It is not yet clear whether socially conscious investing can create investment returns equal to investments that do not have similar criteria.<sup>18</sup> Some recent studies have found some evidence of a link between socially responsible corporate policies and superior stock returns, at least over the past decade. Given the increase in the general consciousness of issues such as global warming, corporate scandals, and the use of child labour, it is not surprising that the number, strength and public awareness of socially conscious funds<sup>19</sup> is on the increase and is likely to continue, becoming a significant investing issue in years to come. Further, it is reasonable to assume that in the face of that increase, having (or appearing to have) a social conscience may become a competitive advantage for corporations through their relationships with major shareholders. If such funds do maximize investment returns then they are likely to form part of the Alberta Heritage Fund's portfolio.

In conclusion, if a particular socially conscious investment is in keeping with the Alberta Heritage Fund's clearly stated objective of providing the greatest long-term financial returns, then it is permitted. However, requiring – as opposed to permitting – such investments by way of allocating investment dollars, forces investments to be made that may not provide the greatest financial returns, and accordingly are not currently permitted to a prudent investor of the Alberta Heritage Fund.

### **Priority Investments in Alberta: Venture Capital**

To help grow the Alberta economy, it is sometimes argued that the Alberta Heritage Fund's assets should be invested in Alberta small companies especially venture capital.

Venture capital is a type of private equity typically provided by outside investors in start-up and early stage companies with perceived long-term growth potential. Venture capital investments are believed to offer potential for high returns and, as such, are usually high risk. It is generally seen as an important part of portfolio diversification.

17 This conclusion is supported by recommendations to the Government of Canada, published by the National Round Table on the Environment and the Economy entitled, "Capital Markets and Sustainability - Investing in a Sustainable Future", published in 2007 (the "NRT Report"). The NRT Report relies heavily on findings contained in a United Nations sponsored report entitled, "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment" published in October 2005. The NRT Report recommends, among other things, that the federal, provincial, and territorial governments adopt guidelines or regulations to clarify that the fiduciary obligation of the fund decision maker, includes the consideration of socially conscious issues that are financially material to investment decisions.

18 Indeed, it would be logical to assume that a socially conscious fund could not as the additional operating costs associated with ensuring a corporation is providing superior working conditions and promoting environmental responsibility, together with a fund's higher management fees (to cover the cost of checking up on the company's actions), would diminish returns.

19 For example, the Domini 400 Social Index is a relatively new market capitalization weighted stock index designed to help socially conscious investors weigh social and environmental factors in their investment choices. It is comprised of 400 publicly traded companies that are deemed to have met certain standards of social and environmental excellence. Each must have positive records on issues such as employee and human relations, product safety, environmental safety, and corporate governance. Companies engaged in the business of alcohol, tobacco, firearms, gambling, nuclear power and military weapons are automatically excluded.

Although the question of allocating funds for venture capital in Alberta by the Alberta Heritage Fund may seem very different from the issue of socially conscious investing, they each have the same core characteristic relevant here: mandating that the Alberta Heritage Fund use investment considerations other than the greatest long-term financial return. Again, given the clearly stated objective of providing the greatest long-term financial returns, compulsory investing of the Alberta Heritage Fund in Alberta venture capital is not permitted. Instead, upon the advice of the Investment Policy Committee, some funds might be allocated to venture capital for commercial reasons although the location of the investment would not be dictated.

A case has been made for providing specific investments in Alberta, one which the Commission could not fully evaluate outside of recommendations regarding Alberta Heritage Fund investments. It is argued that investments in Alberta bolster our economy in bad times and provide excellent returns in good times. Likewise, investments in venture capital funding in Alberta may be a prudent method of diversification and, if investments can be made with the best fund managers, such investment may provide good long-term financial returns. However, the Commission heard that it is difficult to become an investor in some of the best venture capital funds and, accordingly, a requirement that some of the Alberta Heritage Fund be invested in venture capital would necessitate acquiring less than optimal funds. This will jeopardize the return on Alberta's investments – investments that are badly needed now for provincial savings.

Finally, we heard from many quarters that it is best that investment decisions be based on prudent financial principles as exercised by excellent and experienced financial managers whose performance is benchmarked against the performance of other top managers. We agree and, as stated elsewhere in this report, support such benchmarking. Mandatory allocation of portions of the Alberta Heritage Fund for investments such as Alberta venture capital (or socially conscious investments) restricts the ability of the fund decision makers to maximize returns and achieve such benchmarked performance. For these reasons, the practice should not be permitted.

On balance, our view is that, if the Government of Alberta wishes to fund venture capital in Alberta, it should be done through the regular budgeting process.

## Overall policy and direction for the Alberta Heritage Fund

### Recommendation

# 15

**A Premier's Council on Savings should be established to provide advice to government on specific savings policies, including advice on the establishment of any new earmarked funding and the promotion of awareness about the Alberta Heritage Fund.**

The Commission's recommendations include a clearly-articulated role and purpose for the Alberta Heritage Fund. As a consequence of making prudent investments to maximize returns for current and future Albertans, the Alberta Heritage Fund will play an important role in supporting current foundations as well as providing ongoing funding for government programs and services. Those roles are appropriate for today's circumstances, but there may be new purposes or changes in earmarked funding that could be considered in future years.

The Commission recommends that a Premier's Council on Savings be established to provide advice on specific savings policies, including providing advice on the establishment of any new earmarked funding, promoting greater awareness and raising the profile of the Alberta Heritage Fund. The Council should include a wide cross section of Albertans. Its role as advisory to the Premier reflects the importance of the Heritage Fund to the future of our province. The existing Select Standing Committee should remain in place to fulfill its legislated responsibilities including reporting annually on the Alberta Heritage Fund and approving business plans for the Alberta Heritage Fund.

The Premier's Council on Savings should be responsible for:

- Monitoring progress in achieving the target of saving \$100 billion in the Alberta Heritage Fund by 2030
- Receiving input and advice from Albertans, the foundations, Caucus and Cabinet
- Conducting a range of activities designed to raise the profile and awareness of the Alberta Heritage Fund, and to increase the awareness of the activities supported by the Fund
- Reviewing annual plans and performance of the foundations.
- Establishing accountability standards to measure the performance of the various foundations using transparent criteria that are measurable and understood.
- Establishing and implementing criteria for approving any new foundations and making recommendations to the Premier on the establishment of any new foundations.

## Raising the profile and ensuring commitment

The Commission believes that Albertans understand the value and the importance of saving for Alberta's future. At the same time, the Commission heard there is considerable skepticism about how much Alberta has saved to date and even questions about whether, in fact, the current Heritage Fund continues to exist. Surveys show that the majority of Albertans understand very little about the current Heritage Fund, its role in Alberta's financial picture, and the way in which the Fund has been used to the benefit of Albertans. About all Albertans remember is its initial role as a "rainy day" fund, the loans made from the Fund to other provinces, or the sight of railway cars with the Alberta Heritage Fund logo on the side.

But times have changed.

One of the clear challenges is to raise the profile of the Alberta Heritage Fund and to reinforce the importance of adopting a longer-term commitment to savings. The Commission was struck by the comments of some experts that savings should become the next "fiscal anchor" for the province. At the same time, we understand that eliminating Alberta's deficits and debt was a captivating agenda for many Albertans, similar to their own personal goals of paying off credit card debt or eliminating their mortgages. In the case of savings, the reasons may not be as simple or compelling for some Albertans, particularly if, in the future, the province faces mounting pressure to spend additional funds on pressing priorities of the day rather than maintaining a disciplined approach to savings.

To address these concerns and help maintain Albertans' commitment to savings, the Commission suggests that a number of actions should be taken.

- As noted in Recommendation 3, establishing a significant target and reinforcing regular progress in achieving that target should foster greater interest in the Alberta Heritage Fund.
- The proposed role of the Premier's Council on Savings should include a prominent role in raising awareness about the Alberta Heritage Fund on an ongoing basis. This would include public meetings, annual reports, commission research, and regular advertising about the value of the fund.
- The provincial government should undertake the necessary steps to establish and consistently implement a comprehensive brand for the Alberta Heritage Fund. This would include not only a visual identity and appropriate descriptors for the Fund but also ongoing research to ensure that the brand is understood and matches Albertans' expectations for the Alberta Heritage Fund.
- Capital projects funded by the Alberta Heritage Capital Fund should be identified so that Albertans have a tangible product and result to attach to the use of provincial savings.
- Scholarships supported by the Alberta Heritage Fund should be clearly branded as one of the benefits of the Fund.
- In addition to promoting their own work, existing foundations such as the Alberta Heritage Foundation for Medical Research or Alberta Heritage Foundation for Science and Engineering Research should prominently promote the Alberta Heritage Fund as the source of their revenues.

In addition to these ideas, the Alberta Government should develop and implement a comprehensive strategy for raising awareness of the Alberta Heritage Fund on an ongoing basis.

The provincial government should also consider the value and appropriateness of periodic incentives as a way of maintaining support for the importance of longer term savings. While the Commission does not support the concept of dividends on an annual basis, the government should explore the effectiveness of incentives such as tax breaks if the province's fiscal position is better than expected.

## Ensuring a long-term commitment to saving

### Recommendation

# 16

**The provincial government should legislate a new approach to savings along with strict provisions for the Alberta Heritage Fund, the Alberta Heritage Capital Fund, and the Sustainability Fund. This legislation should remain in effect for at least ten years.**

The Commission feels strongly that Alberta must maintain a serious and disciplined commitment to savings. While we understand current spending demands and the need to respond to the pressures caused by a growing economy, there is a growing worry that Alberta is living beyond its means, particularly in the face of declining resource revenues and demographic trends. We simply cannot jeopardize the future of the province and future generations of Albertans while we spend today's prosperity.

For that reason, we recommend that the approach be specifically included in new legislation. We also believe that the approach should remain in effect for at least ten years. A high bar should be set before any future changes could be made in the basic components of this approach, including options such as a unanimous or super-majority vote in the Legislative Assembly, a referendum, or a public commission to seek the views of Albertans before any changes are made. While we do not wish to tie the hands of future governments unnecessarily, we also believe Albertans will not want a strong commitment to saving to be changed arbitrarily.

As is the case for most legislation, we understand that minor adjustments to the legislation may be necessary to refine the details and address unanticipated concerns. The government may also want to consider periodic reviews of the legislation within the ten year period to ensure that it continues to be effective in achieving the targets and objectives for the Alberta Heritage Fund.

### Recommendation

# 17

**The provincial government should report annually on its progress in achieving the \$100 billion target for the Alberta Heritage Fund.**

The Commission believes that setting a bold target for the Alberta Heritage Fund is essential to maintain fiscal discipline and to strengthen Albertans' resolve to save for the future. Just as the province reported annually on its progress in eliminating deficits and debt, the new "fiscal anchor" for the province should include annual reports on progress in achieving the \$100 billion target set for the Alberta Heritage Fund.

## Concluding comments

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As noted at the outset of our report, the Commission believes it is time to usher in a new era of savings now that Alberta has retired its debt. Alberta has been recognized around the world for its fiscal discipline and its ability to achieve goals that others might view as impossible. We now challenge the government and all Albertans to preserve Alberta's prosperity and make a \$100 billion Alberta Heritage Fund the next achievable goal.

## Appendix 1: List of submissions

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### Official submissions:

Canadian Taxpayers Federation  
The Institute for Public Sector Accountability  
McCarthy Tétrault LLP  
C.D. Howe Institute  
Canadian Federation of Independent Business  
Calgary Chamber of Commerce  
Canada West Foundation  
Canadian Pension Plan Investment Board

### Stakeholder Roundtable Participants:

Roger Gibbins,	President & CEO	Canada West Foundation
Scott Henning,	Alberta Director	Canadian Taxpayers Federation
Ken Kobly,	President & CEO	Alberta Chambers of Commerce
John Carpenter,	Executive Director & CEO	Certified General Accountants of Alberta
Heather Douglas,	President & CEO	Calgary Chamber of Commerce
Brian Elder,	President	Venture Capital Association of Alberta
Ricardo Acuna,	Executive Director	Parkland Institute
Ken Boessenkool,	President	Sidicus Consulting Ltd.
Bob Ascah,	Vice-President	Government Relations - ATB Financial
Paul Darby,	Chief Economist	The Conference Board of Canada
Dr. Jacques Magnan	Interim President & CEO	Alberta Heritage Foundation for Medical Research
Ron Triffo,	Chair	Alberta Ingenuity
Gil McGowan,	President	Alberta Federation of Labour
Rick Hersack,	Vice-President Public Affairs	Edmonton Chamber of Commerce
Brett Gartner,	Senior Economist	Canada West Foundation

### Experts' Day Participants:

Dr. Ron Kneebone,	University of Calgary
Dr. Herb Emery,	University of Calgary
Dr. Randall Morck,	University of Alberta
Dr. Roger Smith,	University of Alberta
Al O'Brien,	University of Alberta
Bob Kamp,	TELUS Corporation
Robert D. Brown	–
Dr. Larry Kotlikoff,	Boston University
Dr. Mel McMillan,	University of Alberta
Dr. Jean-Francois Wen,	University of Calgary
Dr. Michael Smart,	University of Toronto
Dr. Richard Bird,	University of Toronto

## Appendix 2: References

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- Boothe, P. 2006. PowerPoint Presentation on Alberta's Fiscal Future, Calgary.
- Chawla, R. and T. Wannell. 2005. Spenders and Savers. *Perspectives on Labour and Income*. Vol. 6 No. 3 (March):5-13.
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- Emery, Herb. 2007. *The Future of the Alberta Heritage Fund*. Paper presented to the Financial Investment and Planning Advisory Commission.
- Gibbins, R. and R. Roach. (eds.) 2006. *Seizing Today and Tomorrow. An Investment Strategy for Alberta's Future*. Canada West Foundation, Calgary.
- Kneebone, R. 2006. The Government of Alberta's Fiscal Future: Possibilities and Pitfalls. Paper No. 16 of the Alberta Energy Futures Project, Institute for Sustainable Energy, Environment and Economy, University of Calgary.
- Kneebone, R. 2007. *Managing Non-Renewable Resource Revenues: The Savings Decision*. Paper presented to the Financial Investment and Planning Advisory Commission.
- Smart, Michael. 2007. *Capital budgeting and fiscal rules: A public economics perspective*. Paper presented to the Financial Investment and Planning Advisory Commission.

# Appendix 3: Funds and Endowments

Update market values to reflect as of September 30, 2007

Fund	Market Value as of 09/30/07 (\$M)	Year Established	Spending Rule	Investment Policy Creation Responsibility	Investment Policy Approval	Investment Responsibility
Alberta Heritage Savings Trust Fund	16,089	1976	All realized income is transferred to the GRF	Treasury Management Division	Minister of Finance	AIMCo
Alberta Heritage Medical Research Endowment Fund	1,616	1980	As requested by the AHFMR. Fund value cannot go below \$300M	Treasury Management Division	Minister of Finance	AIMCo
Alberta Heritage Science and Engineering Research Endowment Fund	881	2000	4.5% of 3yr average market value	Treasury Management Division	Minister of Finance	AIMCo
Alberta Heritage Scholarship Fund	860	1980	As needed annually per scholarship requirements	Treasury Management Division	Minister of Finance	AIMCo
Access to the Future Fund	1,030* *Included in AHSTF total	2005	4.5% of principal annually	Treasury Management Division	Minister of Finance	AIMCo
Sustainability Fund	7,794	2003	\$2.5B must be maintained for disaster relief, natural gas rebates, First Nations settlements, unexpected declines in resource revenues. Funds in excess of \$2.5B can be used for other balance sheet improvements	Treasury Management Division	Minister of Finance	AIMCo
Capital Account	6,640	2003	As budgeted for capital projects	Treasury Management Division	Minister of Finance	AIMCo
Debt Retirement Account	1,975	2005	Funds disbursed as provincial debt matures	Treasury Management Division	Minister of Finance	AIMCo
Cancer Prevention Legacy Fund	496	2006	Minister of Health determines annually	Treasury Management Division	Minister of Finance	AIMCo
Energy Innovation Fund	200	2007	5 Ministry Advisory Board oversees spending	Treasury Management Division	Minister of Finance	AIMCo
General Revenue Fund	2,731	N/A	N/A	N/A	N/A	AIMCo

## Appendix 4: Technical Appendix on Sustainable Fiscal Policy

Governments, like families or businesses, face budget constraints. The discounted value of a government's current and future revenues has to equal the discounted value of its current and future program expenditures. A government's fiscal policy will be sustainable if it can maintain the same tax to total output ratio and the same program spending to total output ratio over time. We will define the fiscal gap as the difference between the province's program spending and its tax (and other own-source) revenues.

In Alberta, this difference between what we spend and the taxes that we levy on ourselves is covered by the province's resource revenues, the investment income from the province's financial assets, and its annual transfer from the federal government. The province can sustain this fiscal gap if the income from these three sources is maintained over time relative to the size of the total economy. Whether or not Alberta's current fiscal policy is sustainable depends on how fast resource revenues, federal transfers, and net investment income will grow in the future. If the growth rates of these three sources of revenue do not keep pace with the growth of the rest of the Alberta economy, then the current fiscal policy will not be sustainable.

Given this perspective, the province's sustainable fiscal gap can be calculated using the following equation:

$$SFG = \left( \frac{r-n-\rho}{r-\theta} \right) \frac{RR}{Y} + (r-n-\rho) \frac{NFA}{Y} + \left( \frac{r-n-\rho}{r-v} \right) \frac{FT}{Y}$$

where:

- SFG is the sustainable fiscal gap—the gap between the province's program spending and tax revenues—expressed as a proportion of Gross Provincial Product
- RR is the current level of resource revenues received by the provincial government
- NFA is the provincial government's net financial assets
- FT is the current level of federal transfers to the provincial government
- Y is current total output (Gross Provincial Product)
- r is the real rate of return on net financial assets
- n is the population growth rate
- $\rho$  is the rate of productivity growth
- $\theta$  is the rate at which real resource revenues are expected to increase or decline in the future
- v is the rate at which real federal transfers are expected to increase or decline in the future

Total provincial output grows at the sum of the population and productivity growth rates,  $n + \rho$ . If the provincial government did not have any financial assets (or debt) and it did not receive any federal transfers, then the fraction of its annual resource revenues that could be used to finance the fiscal gap would be given by the coefficient on the first term on the right hand side of the above equation  $\frac{r-n-\rho}{r-\theta}$ . If resource revenues grew at the same rate as the economy's total output,  $= n + \rho$ , then all of the resource revenues could be used to finance the fiscal gap without requiring tax increases or spending cuts in the future. However, if resource revenues grow more slowly than total provincial output, then only a fraction of the resource revenues can be used to finance current spending. The remainder has to be saved to provide future investment income. The second term in the equation indicates how much of the fiscal gap can be sustained because the government receives investment income from its current financial assets. The third term indicates how much of the fiscal gap can be sustained because the provincial government receives transfers from the federal government, given that these transfers grow at the rate  $v$  in the future.

Calculating the province's sustainable fiscal gap requires assumptions about the real rate of return on the province's financial assets, the population and productivity growth rates, the rate of increase in federal transfers to the province, and most crucially, the rate of increase or decline resource revenues. Table A1 shows the sustainable fiscal gap for three alternative scenarios about future long-term trends in resource revenues, based on the assumption that the province will be able to earn a real rate of return of 4.5 percent on its financial investments, that the population will grow at 2.0 percent per year, that productivity will grow at 1.5 percent per year, and that federal transfers will grow at the same rate as the population.

In the base case scenario, with resource revenues declining at 3 percent per year, the province's sustainable fiscal gap is 1.3 percent of Gross Provincial Product. In 2006-07, the fiscal gap was 4.2 percent of Gross Provincial Product. This implies that the current fiscal policy is unsustainable and that a fiscal adjustment—expenditure cuts and or tax rate increases—equal to 2.9 percent of Gross Provincial Product would be required in order to move to sustainable rates of expenditure and taxation. An immediate fiscal adjustment of this magnitude—\$7.1 billion or \$2067 per capita—would be very large and potentially very disruptive and the Commission is not recommending the government undertake such a drastic measure. However, these calculations indicate that the province needs to adopt a more disciplined fiscal policy, restraining spending and/or increasing its tax effort, in future years. Increasing saving is part and parcel of adopting a disciplined fiscal policy, which will help to reduce the magnitude of the fiscal adjustments that the province will have to make in the future.

**Table A1: The Sustainable Fiscal Gap**

Scenarios	Optimistic	Base Case	Pessimistic
Projected Rate of Change in Total Real Resource Revenues	$\theta = 0.00$	$\theta = -0.03$	$\theta = -0.10$
Per Capita Value (In Canadian \$)	1.7%	1.3%	1.0%

Other parameter values:  $r = 0.045$ ,  $n = 0.02$ ,  $\rho = 0.015$ ,  $v = 0.02$ .

These calculations are based on assumptions about long-term trends in key variables and there is a great deal of uncertainty about the future course of the economy. However, even under the optimistic scenario of constant real resource revenues, the sustainable fiscal gap would be 1.7 percent of Gross Provincial Product, substantially below the current fiscal gap of 4.2 percent of Gross Provincial Product. Indeed, resource revenues would have to grow by 3.1 percent per year for the current fiscal gap to be sustainable in the future. The likelihood that resource revenues will continue to grow at 3.1 percent per year over the long-term is extremely remote. While acknowledging that alternative assumptions about future trends in key economic variables may affect the size of the sustainable fiscal gap, the Commission has concluded that the current gap between spending and taxes is not sustainable in the long term and that a major fiscal adjustment (through tax rate increases and/or spending restraints) will be needed in future decades.

Table A2 indicates the magnitudes of the fiscal adjustments that will be required in the future to achieve a sustainable fiscal policy under alternative increases in our current savings rate out of resource revenues.

**Table A2: The Fiscal Adjustment Required to Attain a Sustainable Fiscal Policy as a Proportion of Gross Provincial Product (with No Demographic Impact)**

Years in the Future	No Charge in Current Tax and Expenditure Rates	Increase in the Annual Savings Rate as Proportion of Total Revenues		
		0.05 <sup>a</sup>	0.10 <sup>b</sup>	0.15 <sup>c</sup>
10	0.032	0.024	0.017	0.009
15	0.034	0.026	0.018	0.010
20	0.036	0.027	0.019	0.010

<sup>a</sup> Equivalent to a \$1.89 billion increase in savings in 2007-08.  
<sup>b</sup> Equivalent to a \$3.78 billion increase in savings in 2007-08.  
<sup>c</sup> Equivalent to a \$5.67 billion increase in savings in 2007-08.

The fiscal adjustment is the tax increase and/or the expenditure reduction, expressed as a proportion of provincial Gross Provincial Product, that would be required to achieve a sustainable fiscal policy in a given year in the future. The table indicates that, if there are no changes to the province’s fiscal policies, a fiscal adjustment of 3.2 percent of Gross Provincial Product will be required in ten years to achieve a sustainable fiscal policy compared to the fiscal adjustment of 2.9 percent of Gross Provincial Product today. This fiscal adjustment would require an eventual 25 percent cut in spending and/or a 40 percent increase in taxes and other own source revenues when the resource revenues are no longer forthcoming. This would amount to a \$2,364 per capita cut in spending or an equivalent increase in taxes. If the fiscal adjustment is delayed, the magnitude of the fiscal adjustment that will be eventually required increases. In 20 years, it will be 3.6 percent of Gross Provincial Product. After 20 years, the situation only gets worse. For example, in 40 years, the fiscal adjustment that would be required would be equal to 4.3 percent of Gross Provincial Product.

Increasing the savings rate now will help to smooth the transition to a sustainable fiscal policy. If the province decided to increase its savings rate by 5 percent of current total revenues, it would reduce the required fiscal adjustments to 2.4 percent in 10 years, or 2.7 percent in 20 years. To achieve a net increase in savings of 5 percent of total revenues, the province would have to slow spending or increase taxes by 0.8 percent of Gross Provincial Product or \$1.89 billion in 2007-08. Table A2 also shows that if we increased the savings rate by 15 percent of total revenues, the province would be close to a sustainable fiscal policy. However, this would require a very large and potentially very disruptive fiscal adjustment of \$5.67 billion in 2007-08. An immediate adjustment of this magnitude is not recommended by the Commission.