

### WILL IT BE DÉJÀ VU ALL OVER AGAIN?

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#### Summary

*The boom and bust in energy prices experienced recently has its parallels in the boom and bust of energy prices in the 1970s and 1980s. The earlier boom period saw the Government of Alberta struggle with restraining spending and so became heavily dependent on high energy prices. When in 1986 energy prices crashed the government suffered a string of large deficits that was followed by draconian cuts to spending. From 2000 to 2008 the government enjoyed another boom in energy prices and again found it difficult to restrain spending. The recent crash in energy prices threatens the government with repeating the earlier experience of deficits followed by dramatic spending cuts. As it prepares its 2009 budget the government has an opportunity to learn from the past and to quickly and decisively put its budget on a path toward a much smaller reliance on energy-related revenues.*

## INTRODUCTION

OPEC is attempting to reduce output to stabilize oil prices, a recession is coming on fast, housing markets are softening, and the Alberta government is suffering a fall in energy royalty income that threatens to produce a deficit for the first time in more than a decade. While these conditions describe the current economic situation, they also describe what was happening in the mid-1980s. In this note, we examine the parallels between the economic conditions of the 1980s and those of today, and review Alberta's response to the earlier episode. In so doing, our intention is to draw lessons from that earlier period that can be applied to the current economic situation.

Our message is simple: the recent boom and bust in energy prices has its parallels in the boom and bust of energy prices in the 1970s and 1980s. The earlier period saw Alberta struggle to restrain spending in an environment of booming revenues, allowing a sizeable "budget gap" to open between its spending obligations and its non-energy revenues — a gap it filled with energy-related revenues. This response, however, exposed the province to the risk of deficit if energy prices fell — as they did in 1986 to levels consistent with long-term trends. The government, slow to adjust to this new reality and failing to reduce the size of its budget gap, saw a rapid decline into debt and growing debt-servicing obligations, forcing it make draconian cuts to program spending until the budget gap finally became small enough that energy-related revenues could fill it.

From 2000 to 2008, Alberta again enjoyed an energy price boom, and once again the budget gap grew and became exposed to the risk of a correction in energy prices, which has occurred since mid-2008. Now, as it prepares its first budget following the bust in energy prices, the Alberta government has an opportunity to learn from the past and to put its budget *quickly* and *decisively* on a path toward much less reliance on energy-related revenues. To do otherwise invites a replay of the fiscal deterioration and draconian budget adjustments that followed the crash in energy prices in 1986.

In the next section, we describe the evolution of the Alberta government's finances through the 1970-1993 period of energy boom and bust. We then review the actions the government took after 1993 to re-establish its finances on a sustainable footing. We compare the current economic situation with that in 1987 and draw budgeting lessons from the earlier period. We conclude by discussing some options for the future.

### THE GOOD, BAD, AND THE UGLY: ALBERTA'S FINANCES FROM 1970 TO 1993

In the eight years prior to the first OPEC oil price shock in 1974, Alberta's resource revenues averaged \$290 million per year. The effect of the OPEC price shock, combined with the efforts of the Progressive Conservative government of Premier Peter Lougheed to negotiate a new royalty framework, contributed to a dramatic increase in resource revenues.<sup>1</sup> In the eight years following the first OPEC oil price shock, resource revenues averaged \$2.5 billion per year.<sup>2</sup> This rapid growth in resource revenues and the recognition of the need to save revenue generated by the sale of a non-renewable resource led to the creation of the Alberta Heritage Savings Trust Fund (AHSTF) in 1976.<sup>3</sup> The fund was established with a special appropriation of \$1.5 billion,

<sup>1</sup> Lougheed's renegotiation of energy royalties in 1972 caused considerable displeasure in the oil and gas industry, which had argued for the sanctity of royalty contracts signed in 1949; for a description and discussion, see G. Doern and G. Toner, *The Politics of Energy: The Development and Implementation of the NEP* (Toronto: Methuen, 1985). A similar reaction followed the changes to the royalty regime announced in 2008.

<sup>2</sup> The two revenue estimates in this paragraph are from P. Boothe, *The Growth of Government Spending in Alberta* (Toronto: Canadian Tax Foundation, 1995), table 2.1.

<sup>3</sup> Saving non-renewable resource revenue for the benefit of future generations of Albertans was one of three goals identified for the AHSTF upon its establishment. The other goals were to provide benefits to the current generation of Albertans and to diversify the provincial economy. It is interesting to note that the government of the time was concerned with the effect that rapidly growing resource revenues were having on expectations for still further increases in program spending. Based on interviews conducted with policymakers in power at this time, Boothe (*The Growth of Government Spending in Alberta*) reports a consensus among them that diverting resource royalties to the AHSTF would be effective at taming such expectations.

and the Alberta government committed to add to it 30% of future resource revenues collected.<sup>4</sup>

By the end of the 1970s, the second OPEC oil price shock had allowed the province to enjoy high levels of resource revenues that enabled it to keep tax rates low and to put in place a strategy for saving a significant portion of those revenues. It was perhaps for that reason that, in 1978 the provincial treasurer, noting satisfaction with low levels of taxation, high levels of government services, and on-going budget surpluses, could afford to raise the possibility of increasing the share of resource revenues committed to the AHSTF.<sup>5</sup>

Alberta's rosy budgetary picture of the 1970s came to an end with the 1980 National Energy Program (NEP)<sup>6</sup> and a deep North America-wide recession that began in 1982. The recession slowed the economy and the NEP not only slowed the growth in resource revenues but prompted the provincial government to increase spending in the form of support to the energy industry.<sup>7</sup> The effects of these events on Alberta's budget surplus were mitigated by the decision in 1982 to divert the investment income earned by the AHSTF to general revenues and to reduce from 30% to 15% the portion of resource revenues deposited in the AHSTF. These two fiscal adjustments — which were envisioned to last only for two fiscal years, but proved to have a longer life — plus a renegotiation of some aspects of the NEP caused resource revenues to recover and enabled the provincial government to remain in budgetary surplus until 1985.

Despite the difficult times experienced in the early 1980s, expectations for high oil prices for the foreseeable future remained. Indeed, the petroleum boom of the 1970s was never seen as a transitory, short-lived boom that would be followed by an inevitable bust, but as establishing a permanently higher growth path for the Alberta economy.<sup>8</sup> Signs that this optimism was unfounded soon became apparent. High and rapidly increasing world oil prices after 1978 had resulted in reduced demand for oil and, after 1981, prices began to moderate. The weakening demand for oil in the early 1980s was due to the recession that struck the industrialized oil-consuming nations, energy conservation by consumers, and the substitution by consuming countries away from oil to coal and nuclear energy.<sup>9</sup> Global oil consumption fell from 56 million barrels of oil per day in 1979 to under 45 million barrels of oil per day in 1983.<sup>10</sup> From 1982 to 1985, OPEC attempted to stem the reduction in world oil prices, but it failed to enforce the production quotas it imposed on its members, and by 1985 the world price of oil stood at just under US\$25 per barrel. Saudi Arabia through this period was the “swing producer,” cutting its production to stem the falling prices that were caused in part by other OPEC members' exceeding their production quotas. By August 1985, Saudi Arabia decided it had had enough of this situation, and by early 1986 it had more than doubled its oil production.<sup>11</sup> By mid-1986, the world price of oil fell to a low of US\$10 per barrel, and from 1986 to 1998 hovered around US\$15 per barrel. Not surprisingly, Alberta's revenues took a catastrophic hit.

<sup>4</sup> By the end of fiscal year 1981/82, the AHSTF had received \$8.3 billion of resource revenues and had earned \$2.65 billion in investment income. Despite \$1.3 billion of spending on capital projects, the AHSTF was valued, at cost, at \$9.7 billion in 1982. After adjusting for inflation (using the Alberta all-items consumer price index), this amount would have grown to \$22.5 billion in 2008. At the end of fiscal year 2007/08, however, the AHSTF was valued, at cost, at just \$16.4 billion, so its real value had been allowed to fall quite considerably over time. See Alberta, Finance and Enterprise, *Alberta Heritage Savings Trust Fund Annual Report, 2007-2008* (Edmonton, 2008).

<sup>5</sup> M. Leitch, *Budget Address* (Edmonton, 17 March 1978).

<sup>6</sup> As a result of the NEP, through a series of negotiated settlements between Alberta and the federal government, the price of “old oil” (oil discovered prior to 1980) was set as a percentage of the world price; the price of “new oil” was allowed to rise to the world price in an agreement signed in 1983.

<sup>7</sup> Provincial support for the industry included a \$5.4 billion program, introduced in 1982, of royalty reductions and grants designed to increase the flow of revenue to the industry. In the same year, the federal government supplemented this effort with its own \$2 billion assistance plan; see Doern and Toner, *The Politics of Energy*, pp. 114-115. Measured in 2008 dollars, these two support programs were worth \$17.2 billion, an amount considerably larger than the bailout offered to GM and Chrysler by the federal and Ontario governments in late 2008.

<sup>8</sup> As noted by R. Mansell, “Fiscal Restructuring in Alberta: An Overview,” in *A Government Reinvented: A Study of Alberta's Deficit Elimination Program*, edited by C.J. Bruce, R.D. Kneebone, and K.J. McKenzie (Toronto: Oxford University Press, 1997).

<sup>9</sup> See F.J. Al-Chalabi, “The World Oil Price Collapse of 1986: Causes and Implications for the Future of OPEC,” in *After the Oil Price Collapse: OPEC, the United States and the World Oil Market*, edited by W.L. Kohl (Baltimore: Johns Hopkins University Press, 1991).

<sup>10</sup> E. Krapels, “The Fundamentals of the World Oil Market of the 1980s,” in *After the Oil Price Collapse*.

<sup>11</sup> H. Askari, “Saudi Arabia's Oil Policy: Its Motivations and Impacts,” in *After the Oil Price Collapse*.

Prior to 1986, the province's most pressing concern was the depletion of its resource base, but high oil prices were expected to solve that problem by finally making the exploitation of the vast northern oil sands economically feasible. With the collapse of oil prices in 1986 and a corresponding 47% decline (in real terms) in the Canadian dollar price of oil, however, Albertans and their provincial government had to deal with a new economic reality. A 63% loss in resource revenues and a 30% loss in total revenues devastated the provincial budget for fiscal year 1986/87. Premier Don Getty, newly elected in 1986, noted that he had "inherited an economy and budget based on \$40 oil — and the price of oil was \$13."<sup>12</sup> The government's immediate response was to grab more revenue. With the fiscal year 1986/87 budget, the government completely abandoned its efforts to save non-renewable resource revenues and now diverted all investment income earned by the now-moribund AHSTF into general revenues.

On the expenditure side, however, the government largely behaved as if it expected the good times associated with high oil prices to return at any time. Indeed, Premier Getty remarked that trying to control spending after the prolonged period of strong revenue growth was akin to "turning the Queen Mary."<sup>13</sup> As a consequence, and despite the grab of additional revenues, the budget plunged into deficit and would remain there for the next nine fiscal years. By the end of fiscal year 1993/94, the provincial government had moved from a net asset position of \$12.6 billion in 1985 to a net debt position of \$8.3 billion — a \$21 billion loss in wealth.<sup>14</sup>

Despite evidence that the world market for oil had adjusted in a way that should warrant caution, Alberta's budgeting choices during the late 1980s and early 1990s reflected the earlier assumption that prices would resume their upward trend, an ill-founded optimism that would have serious consequences. As it turned out, world oil prices peaked in real (constant purchasing power) terms in 1983 and would not recover to that level until 2005.

The 1980s proved to be a disastrous decade for provincial budget-makers. The government's heavy dependence on royalty income and its reluctance either to cut those expenditures or to raise tax rates immediately following the loss in energy royalties allowed its strong balance sheet to become awash in red ink. Steadily increasing servicing costs on the growing debt made the inevitable fiscal adjustment larger and more painful the longer the province waited to make that adjustment. The reality that Alberta had been living through a transitory boom took a remarkably long time to sink in, and it was only after eight years that the inevitable adjustments were made to put the province's finances back on the road to fiscal rectitude.<sup>15</sup>

## GETTING BACK ON TRACK

Concern over the long string of deficits that followed the collapse of oil prices in 1986 provided the focus of the provincial election campaign in summer 1993, which was fought over how to respond to the extraordinarily rapid accumulation of debt that had occurred over the previous nine years. All three major political parties supported taking strong steps to eliminate the deficit, and both the Liberal and Progressive Conservative parties advocated deep cuts to government spending in order to achieve it. The Progressive Conservatives, under new leader Ralph Klein, were elected to a majority government in June 1993 on a platform of a 20% cut to spending.

The new premier proclaimed that Alberta had a spending problem, not a revenue problem, so that the elimination of the deficit would come from cuts to spending, not from increases in tax rates. Since the

<sup>12</sup> Quoted in Boothe, *The Growth of Government Spending in Alberta*, p. 94.

<sup>13</sup> *Ibid.*, p. 92.

<sup>14</sup> Alberta, *Budget 2001, The Future: Meeting Priorities, Sharing Benefits* (Edmonton, April 24, 2001).

<sup>15</sup> A painfully slow response to a new fiscal reality is not unique to Alberta. For a detailed examination of how Canadian provincial and federal governments failed in the 1980s to respond to economic conditions that caused a rapid accumulation of debt, see R. Kneebone and J. Chung, "Where Did the Debt Come From?" in *Is the Debt War Over?*, edited by C. Ragan and W. Watson (Montreal: Institute for Research on Public Policy, 2004). The authors argue that the slow response was the reason for the need to introduce large cuts to federal and provincial spending programs in the 1990s.

deficit was then equal to 20% of expenditures, a dramatic cut in program spending was required. The new government's first budget called for a deep and speedily implemented 20% cut in spending, to be completed by the end of fiscal year 1995/96 and, in fact, the government kept its promise to eliminate the deficit through cuts in program expenditures. Relative to values at the end of 1992/93, real per capita program expenditures fell by 31% by the end of 1996/97, eliminating the deficit.<sup>16</sup> The price of adjustment, however, was high: cuts to spending on public health care, for example, were accompanied by the closure of hospitals.

While cuts to program spending were the most public of the new government's efforts to regain control of its finances, they were not the only measures taken. The *process* of budgeting in Alberta would also change in the 1990s. Important in that period were the easily identified and understood target of a zero deficit, an unwavering dedication to meeting that target by both the premier and the treasurer, and the speed with which it was accomplished.<sup>17</sup> Most important of all, however, were legislative changes that allowed the government to build credibility by systematically meeting pre-announced deficit targets on the way to the goal of a zero deficit, and to manage a long-standing budgeting problem: the volatility of its revenues.

The strategy of announcing long-term fiscal targets as a way of imposing discipline on annual budgeting exercises proved highly successful. With the elimination of the deficit in 1995, the government introduced a new long-term fiscal target: debt elimination. In exactly the same way as Premier Lougheed's government had tried to restrain expectations for new spending by formally committing to a savings target, the Klein government used long-term fiscal commitments to bind annual budgeting efforts and force them to constrain spending even in the face of rapidly growing resource royalties. The target of debt elimination was met during fiscal year 1999/2000. A new long-term fiscal target has not yet been announced, although a government-appointed panel, the Alberta Financial Investment and Planning Advisory Commission, recently recommended building a savings fund to \$100 billion by 2030.<sup>18</sup>

## LESSONS FROM THE PAST

The precipitous fall in oil prices since the summer of 2008 closely resembles the context of the great oil price collapse of the 1980s (see Figure 1). In the earlier period, prices increased quickly over the six-year period 1979-1985 before falling by 47% in 1986. In the most recent period, prices increased quickly for eight years (2000-2008) before falling even more steeply — by 70% from July to December 2008. In the earlier period, Alberta suffered the loss of 63% of its non-renewable resource revenues; in its November 2008 fiscal update, the government reports that, in fiscal year 2008/09, it expects to receive \$4.3 billion, or 23%, less in resource revenues than it anticipated it would receive just three months earlier. The bleeding is not expected to stop in fiscal year 2009/10.<sup>19</sup>

<sup>16</sup> In fact, the deficit was eliminated by the end of fiscal year 1995/96, although the program of spending cuts continued nonetheless. For data on the size of the spending cuts by ministry and year, see C.J. Bruce, R.D. Kneebone, and K.J. McKenzie, "Introduction," in *A Government Reinvented*.

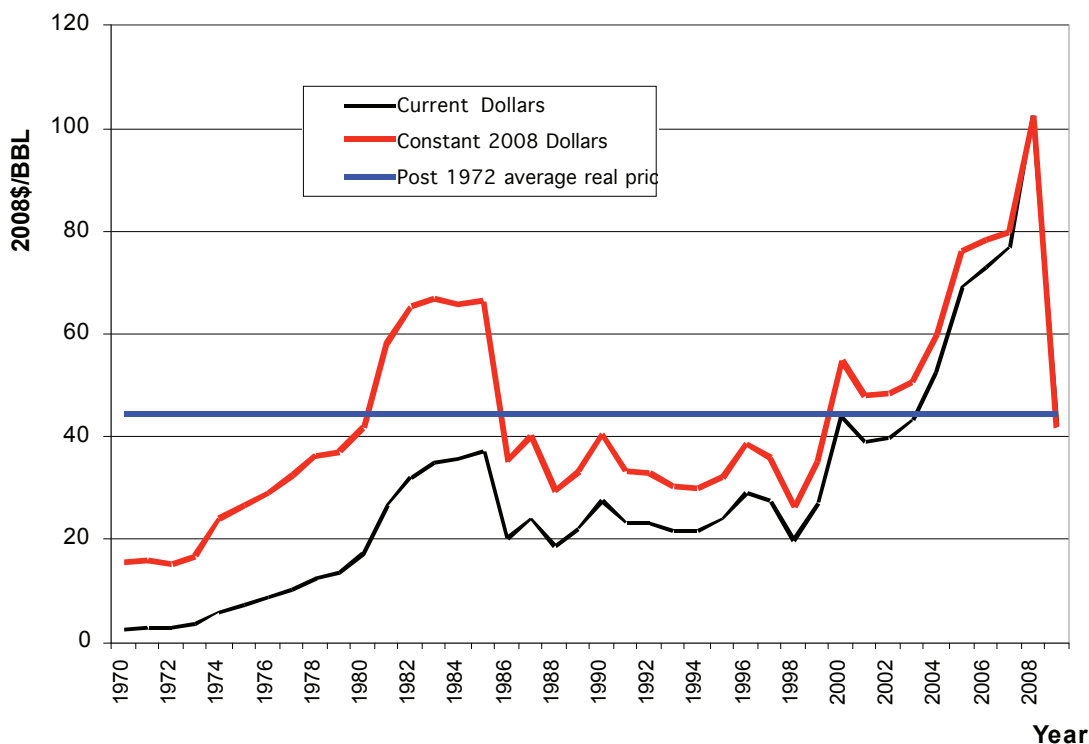
<sup>17</sup> R.D. Kneebone and K.J. McKenzie ("The Process Behind Institutional Reform," in *A Government Reinvented*) report the results of interviews conducted with Premier Klein, six cabinet ministers, seven MLAs, thirteen senior civil servants, and twenty-one representatives of school boards, colleges, universities, health authorities, and social service agencies. Interviewees were consistent in identifying the commitment to the zero-deficit target and the unswerving commitment to spending cuts as instrumental in minimizing opposition and easing their implementation.

<sup>18</sup> Alberta, *Alberta Financial Investment and Planning Advisory Commission* (Edmonton, December 2007).

<sup>19</sup> In fact, the value for the price of oil shown in Figure 1 for 2008 is the average for the whole year, and hides the price peak of an average of \$138 in July and the fall to \$41 in December; see MJ Ervin Associates, online at <http://www.mjervin.com/subscriptions/crdweekly09.htm>. Moreover, the figure uses the average of the observations of the oil price for the first seven weeks of 2009 (\$43.78) to represent what might be observed during the whole of the year, which, if it holds, would hover just above the price that prevailed in the disastrous 1980s.



**FIGURE 1 : Price of Crude Oil, Edmonton Par, 1970 to 2009**



Sources: Current dollar prices are from Natural Resources Canada, available online at <http://www2.nrcan.ca> (1970-2002); and from M.J. Ervin and Associates, available online at [http://www.mjervin.com/other\\_resources.htm](http://www.mjervin.com/other_resources.htm) (2003-2009). To convert to real 2008 dollars, we used the GDP implicit price deflator for Canada, from Statistics Canada, CANSIM database, series v1997756.

Following the crash in energy prices in 1986, the Alberta government appear to have based its budgetary policies on the expectation that oil prices would return to higher levels following a “hockey stick” pattern — staying level for a short while but increasing steadily thereafter. This assumption proved correct, but the blade of the hockey stick proved to be much longer than anticipated, and it took 20 years for real oil prices to return to their levels of 1985. By the time oil prices started to climb, the province’s finances were in shambles.

Now, the real price of oil is back to its post-1972 average level.<sup>20</sup> If the current price level reflects, more or less, the long-term level, then movement above that level — such as occurred from 1979 to 1985 and again from 1999 to mid-2008 — should be considered a short-term deviation.<sup>21</sup> Premier Getty’s famous quote about inheriting an economy and budget based on \$40 oil when the price turned out to be \$13 highlights how the Alberta budget and economy treated the extremely high prices of the late 1970s and early 1980s as a permanent condition. But the quote also misrepresents the nature of Alberta’s difficulty after 1986: it did not have a revenue problem, but a spending problem. In constant-purchasing-power terms, a barrel of oil after 1986 was worth more than at any time between the end of World War II and 1973, and as much as a barrel of oil from 1974 to 1978. So, from a long-run perspective, the oil prices observed during the mid-1970s were, in effect, permanent. What proved to be transitory were the high prices observed from 1979 to 1985. Thus, the source of the

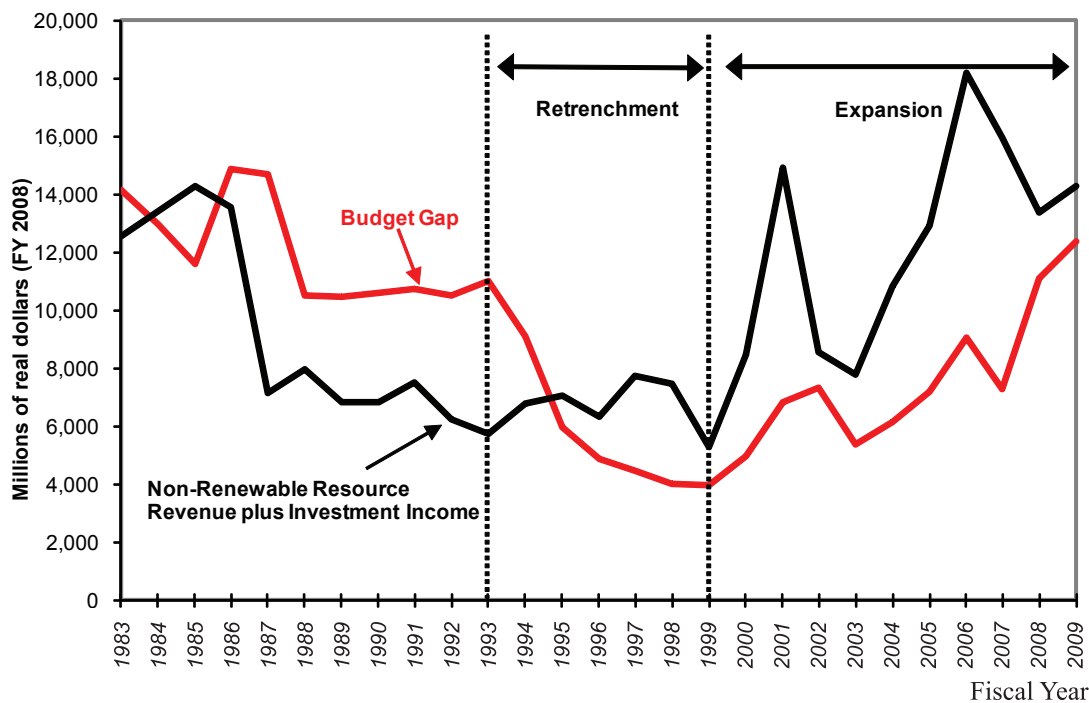
<sup>20</sup> As reported in “Plumbing the Depths,” *The Economist*, 4 December 2008.

<sup>21</sup> Our focus on the price of oil reflects two considerations. First, the price of oil will determine the viability of plans to develop Alberta’s non-conventional oil resources, and the development of these resources, particularly the oil sands, will determine Alberta’s economic future and will be the major source of government energy revenues. Second, natural gas prices traditionally have tracked changes in oil prices quite closely.

Alberta government's fiscal problems was its belief that the level attained after a rapid escalation in price was sustainable.

Figure 2 illustrates how the provincial budget responded to the 1987 crash in energy prices. The boom of the late 1970s and early 1980s enabled the government to afford a large "budget gap" equal to nearly \$13 billion (measured in real 2008 dollars). We define this gap as the difference between the amount the government spent on programs and the amount it collected in revenue from all sources except revenue gained from energy royalties and investment income spun off by the government's savings funds.<sup>22</sup> The gap of \$11.8 billion in fiscal year 1984/85, for example, indicates the government was spending \$11.8 billion more than it collected by way of non-energy-related revenues and investment income. Clearly, such a gap results in a budget deficit unless something fills it, which, in 1984/85, was the \$14.3 billion of energy-related revenues that the government enjoyed; indeed, when measured in 2008 dollars, Alberta had a \$2.5 billion surplus that year.

**FIGURE 2 : Retrenchment and Expansion**



Sources: Alberta, *Budget*, various years; and authors' calculations. To convert to real 2008 dollars, we used the all-items CPI for Alberta, from Statistics Canada, CANSIM database, series v41692327.

Following the collapse of oil prices in 1986, the province responded by cutting the size of its fiscal gap, but not by nearly enough to yield a balanced budget. Energy-related revenues were well below what was required to fill the fiscal gap, and the government fell into deficit. By 1993, with little having been done to bring the fiscal gap in line with the new lower level of energy-related revenues, the province's net asset position had been completely wiped out and it was now the owner of a considerable amount of debt.

<sup>22</sup> The Alberta Financial Investment and Planning Advisory Commission refers to what it calls the government's "fiscal gap": the difference between provincial spending and the taxes paid by Albertans. The Commission's fiscal gap is filled by resource revenues, net investment income, and transfers from the federal government to the Alberta government. Our "budget gap" differs from the Commission's "fiscal gap" only by the amount of federal government transfers. It is worth noting that our measure of the "budget gap," while intended to identify the reliance of the government on energy-related revenues, is not a precise measure of that reliance, because personal and corporate income taxes also rise and fall with energy prices and many provincial expenditure programs are sensitive to the health of the energy sector.

The election of the Klein government and the introduction of a no-deficit fiscal rule forced a realignment of spending that more closely matched the revenues the province was collecting from non-energy sources. That is, the provincial government dramatically reduced the size of its budget gap so that it fell below the persistently low level of energy-related revenues. In this way, it moved into a budget surplus in fiscal year 1994/95 and began to retire debt. By 1999, the budget gap had been reduced sufficiently that energy-related revenues, generated with oil prices averaging just \$35 per barrel (in real 2008 dollars), were able to fill it and even enable the government to maintain budget surpluses. It seemed as though the government had established a fiscal regime that would be sustainable over the long term. This, however, was not to last.

Energy prices and energy-related revenues turned around starting in 2000. By July 2008, the price of oil in real dollar terms had increased fourfold to \$138 per barrel and energy-related revenues had increased from \$5.3 billion in fiscal year 1998/99 to an estimated \$14.3 billion in 2008/09. Perhaps not coincidentally, Figure 2 shows that the size of the budget gap also grew over this period. Indeed, after 1999, there is a disconcertingly close relationship between the size and movements in the budget gap and the size and movements in energy-related revenues. From fiscal year 2003/04 through 2007/08, the government budgeted to spend 64% of the resource revenues it expected to collect; thus, as energy revenues increased, so did spending. Government estimates show that, by the end of 2008/09, the budget gap will have widened once more to where it was before the spending cuts introduced by the Klein government starting in 1994 — the effort to reduce dependence on a volatile revenue source will have completely unravelled.

## THINKING ABOUT THE FUTURE AND CONCLUDING COMMENTS

Since the early 1970s, Alberta has enjoyed access to huge revenues earned on the sale of non-renewable resources. Unfortunately, however, the size of the bounty cannot be known with any degree of certainty, and this makes budgeting challenging.

Twice since 1970 — in 1987 and again since the second half of 2008 — Alberta has had to deal with a precipitous fall in energy prices and resource revenues. In the earlier period, the government allowed its budget to become heavily dependent on energy-related revenues — a notoriously uncertain revenue source. In so doing, the province adopted a high-risk budgeting strategy that would demand painful adjustments to government spending or tax rates should energy-related revenues suffer a precipitous decline. When that decline came in 1987, the government made the inevitable adjustment worse by delaying its implementation until 1994. For six years, from fiscal years 1987/88 to 1992/93, the province chose not to reduce the size of its budget gap to match the new, lower level of energy-related revenues; by that time, draconian cuts to government spending were required to re-establish fiscal probity.

While we appreciate that it is easy to have 20-20 hindsight on these matters, we nonetheless find it difficult to understand how Alberta could have allowed its budget gap to remain so unresponsive for so long to the evidence that energy prices would not soon return to pre-1987 levels. The inevitable fiscal adjustment — measured in closed hospitals and deteriorating public infrastructure — was considerably more painful than was necessary had action been taken earlier.

Now, the government is preparing to table its first budget since the most recent precipitous fall in energy prices. It has the opportunity to learn from the past and avoid the consequences of its earlier mistakes. The painful adjustments in the form of draconian spending cuts in the mid-1990s had their origins in two earlier budgeting choices. The first was the decision to adopt the high-risk strategy of allowing the budget to become heavily dependent on a volatile source of revenue. The second was the failure to act quickly when collapsing energy prices exposed the consequences of the first choice. It is unfortunate that, during the latest energy price boom, the government repeated the first budgeting mistake. It would be doubly unfortunate if the province



were to repeat the second mistake and risk a rapid dissipation of financial assets and, eventually, the need to implement spending cuts of the kind it made in the mid-1990s.

The province now has an opportunity to take the all-important first step of putting in place a plan to quickly reduce its budget gap to a level appropriate to what is likely to be the long-term outlook for resource-related revenues. The choices it must make are not easy — they involve consideration of both spending cuts and tax increases. In considering spending cuts, the government needs to distinguish between spending on infrastructure that is conducive to long-term economic growth and spending on less strategic areas. Consideration of tax increases need to be similarly strategic; some are less harmful to long-term growth than others.<sup>23</sup> However difficult are these choices, we stress that they will not become easier with time. On the contrary, the experience following the 1987 fall in energy prices shows that delaying the adjustment could result in the rapid accumulation of debt and debt-servicing costs, requiring a more painful adjustment than if the government acts sooner. Notably, our recommendation requires a commitment on the part of the Alberta government to save during boom periods of energy price cycles and, therefore, dovetails with a key recommendation of the Alberta Financial Investment and Planning Advisory Commission that the government commit to a long-term savings target.

In urging Alberta to put in place a credible plan for reducing its reliance on energy-related revenues, we recognize how tempting it is to do little and wait for high energy prices to return. Indeed, our urging is, in part, due to worrying signs that the current government is leaning toward that choice. Energy minister Mel Knight reportedly believes that continuing demand from countries such as China and India will cause oil prices — and thus the provincial economy — to recover faster than they did following the wrenching oil slump of the mid-1980s.<sup>24</sup> Such expectations, of a quick rebound in oil prices, fuelled the province's fiscal crisis after the first precipitous fall in energy prices.

We also recognize that it is difficult to know what the price of energy will be over the long term, and we stress that we do not criticize the Alberta government for erring in its energy price forecasts. Rather, we criticize it for allowing its budget to become so heavily dependent on volatile energy-related revenues — that is a high-risk budgeting strategy; it has been tried before and has failed, with dire consequences. It is a mistake the Alberta government must recognize and take steps to avoid as quickly as possible.

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<sup>23</sup> Tax increases could include eliminating health care premiums, effective 1 January 2009, at an estimated cost of \$1 billion in provincial revenues.

<sup>24</sup> “A Sticky Ending for the Tar Sands,” *The Economist*, 15 January 2009.

## About the Authors

Ron Kneebone has published research dealing with issues pertaining to government finances, the political economy of government deficit and debt reduction, the history of government fiscal and monetary relations in Canada, and the characteristics of Canadian federal, provincial and municipal fiscal policy choices. He recently participated in the deliberations of the Alberta Financial Investment and Planning Advisory Committee.

Herb Emery received his BA (Honours) in economics from Queen's University in 1988 and PhD in economics from the University of British Columbia in 1993. He has taught at the University of Calgary since 1993 and is now the Svare Professor in Health Economics which is a joint appointment between the Department of Economics and the Department of Community Health Sciences in the Faculty of Medicine. Dr. Emery's current research includes “The Rise of Public Health Insurance Before 1930,” “The Sustainability and Reform of Public Health Care in Canada”, and “Western Canadian Economic Development.”

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For media inquiries, please contact Betty Rice, Associate Director of Communications and Educational Programming, by telephone at 403-220-2103 or on e-mail at [bwrice@ucalgary.ca](mailto:bwrice@ucalgary.ca). Our web site, [www.ucalgary.ca/policystudies](http://www.ucalgary.ca/policystudies), contains more information about The School's events, publications, and staff.

## **Development**

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