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The University of Calgary is home to scholars in 16 faculties (offering more than 80 academic programs) and 36 Research Institutes and Centres including *The School of Public Policy*. Under the direction of Jack Mintz, Palmer Chair in Public Policy, and supported by more than 100 academics and researchers, the work of The School of Public Policy and its students contributes to a more meaningful and informed public debate on fiscal, social, energy, environmental and international issues to improve Canada's and Alberta's economic and social performance.

POLICY ADVICE TO ALBERTA'S NEW PREMIER

Jack Mintz, Ron Kneebone, Ted Morton and Jennifer Winter

On September 6th, 2014, members of the Progressive Conservative Party of Alberta elected Jim Prentice as leader of their party, and Premier of Alberta.

The School of Public Policy assembled its key thinkers in economic, taxation, energy and natural resource policy to provide unsolicited but important advice to Premier Prentice on some areas of policy that matter most to Alberta, and that will demand the Premier's attention as he takes office.

These are opinion pieces, are not peer reviewed, and reflect the views of their authors alone.

Tax Policy is Key to Maintaining the Alberta Advantage

Jack Mintz is Palmer Chair and Director at The School of Public Policy, University of Calgary

As Premier Jim Prentice takes the helm, he has many policy decisions before him. One of those is how Albertans get taxed.

Taxes are what oil the wheels of government. They are necessary to fund public services, like health and education, which, as expressed at the ballot box, are things we want. However, for every dollar of tax taken from our pockets, we have one less dollar to spend on our family's lifetime consumption. Taxes impose costs on the economy. Taxes today affect our children tomorrow. Tax policy matters.

While we are all used to the political debate about whether taxes should go up or down, the real job of thoughtful policy makers is to determine the right mix of taxes — the tax structure. Premier Prentice should make clear what vision he has with respect to the tax structure — without it, policy mistakes happen, and we can drift for years with a tax system that is unfair and hurts the economy.

For example, the Stelmach government eliminated the health care premium and cancelled an alcohol tax increase in 2008 while at the same time raising levies on resource investments. This approach was directly contrary to the approach adopted by jurisdictions around the world focused on growth and fairness.

Many governments have been reducing income taxes in favour of greater reliance on consumption-related levies. They have broadened tax bases and lowered tax rates so that people allocate resources in the economy according to their economic value instead of avoiding taxes. The tax bite, in many jurisdictions, has also been reduced for low-income citizens through refundable credits and exemptions. Governments have been especially good at improving the business tax structure to make it less distorting — especially in Canada.

If we are serious about the Alberta advantage, then it's time for an adult conversation about reducing corporate and personal income taxes, and increasing reliance on consumption-related levies. Tax structure issues cannot be avoided by the Premier. They come up all the time.

On the municipal front, Edmonton and Calgary are lobbying hard for new taxing powers beyond user fees and property taxes. Property taxes and user fees are relatively harmless in terms of their economic impact. They are tied to municipal services and cause little economic distortion. They are an appropriate tax for a municipality. On the other hand, a municipal personal and corporate income tax would impose heavier economic costs. Those are a bad idea. So is a municipal HST — the so-called “penny tax”. It is a non-starter due to its complexity. The new Premier will be faced with the decision as to whether municipalities need more tax room or should instead continue to rely on existing revenues. A new municipal tax is not a slam dunk and could do harm.

What about Alberta's flat income tax? Some argue that we should go back to a progressive tax, where higher income individuals pay more. Again, this is a bad idea that Prentice should resist. Given the exceptional reliance of the Alberta government on tax refugees from other parts of the country, higher marginal tax rates will make it harder to attract skilled labour and wouldn't raise much extra revenue. Instead, government could reduce the rate for lower and middle income Albertans, which would lead to a progressive rate structure. But, that would mean finding another source of revenue. Like a sales tax.

It would be as easy as taking up the federal reduction in the GST several years ago. Create an HST of seven per cent (the old federal rate) and take the extra two per cent for Alberta. That would allow Alberta to cut \$2 billion in personal income taxes for lower income earners through higher exemptions and tax credits. Given that temporary workers or visitors would pay about 10 per cent of sales taxes charged, Alberta would derive a new source of revenue to reduce taxes on its residents or spend on infrastructure.

A tax reform of this magnitude is difficult for any new Premier to undertake before an election. In the near term, incremental changes in sin taxes, user fees, environmental levies and property taxes can be used to support public services like health and education. The Premier should avoid painting himself into a corner by promising no tax increases, ruling out even the possibility of a tax reform that raises no new total revenues.

Alberta's current taxation policies are doing a disservice to future generations. How? Because Alberta spends rather than saves its non-renewable resource revenues, thus taking fiscal capacity from future voters who will pay higher taxes to cover their current needs. Future voters don't determine today's public decisions, but will be left holding the bag if Albertans leave large unfunded liabilities in pensions and health care to be covered by them. The Premier is one person to remind today's voters that they have an obligation to future generations. We must save our resource revenues.

Tax policy may not excite many people. But tax policy matters. I sincerely hope Premier Prentice spends time, effort and political capital to ensure we get tax policy right. The Alberta Advantage depends on it.

Advice to the Premier: The Budget

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Maybe we should start with something very basic. The government of Alberta represents the collective interests of Albertans. It is through their government that Albertans pool a significant fraction of their incomes so that they can enjoy a system of health care, schools, roads, etc. Every four years or so, they elect fellow Albertans to represent their interests in making decisions about how much they should pay in taxes and how their pooled incomes should be spent. After four years, Albertans evaluate how well their interests have been represented. They do so by casting their votes in favour of incumbents, or in favour of someone they think might do a better job. That's democracy.

For democracy to work well, citizens need to be able to fairly and easily evaluate how well their elected officials have represented their interests. If citizens cannot be fair in their assessments because the information required is too complicated to understand, then democracy will not work in the way we hope. Citizens will perhaps vote against those who have in fact done well, or vote for those who have in fact represented them poorly.

When they attempt to determine how good a job their elected officials are doing, citizens tend to rely on indicators they can easily measure: the amount of taxes paid, the amount and manner in which they are spent, and the balance between the two. This is not always fair to elected representatives. Recessions — which are largely beyond the control of governments to either predict or end — cause spending on programs like social assistance to increase and cause tax revenues to fall, and so create the appearance of poor fiscal management. On the other hand, an economic boom — again, well beyond the control of governments to either promote or predict — will give governments the appearance of being wise and careful managers of the public purse, when in fact this assessment may not be warranted.

The trick to fairly assessing the fiscal management skills of our elected representatives is to calculate at what level spending and taxation would have been had the economy been enjoying “normal” economic conditions; that is, if the economy were in neither a recession nor a boom. Such an assessment lifts off the shoulders of elected representatives the blame for higher spending and higher deficits caused by recession, while also preventing elected representatives from taking credit for the lower spending and large surpluses that result during booms. The method for calculating these measures — what are known as cyclically adjusted budgets — is well known to economists. The OECD and the IMF regularly publish such estimates for countries around the world using a well-established methodology. In Canada, the federal Department of Finance provides similar calculations for the federal government, and the Congressional Budget Office does the same for the U.S. government.

Canadian provincial governments have not, and do not, provide their citizens with such a measure of their fiscal management skills. Although the methodology is relatively straightforward, private-sector and academic economists find it difficult to provide such estimates because provincial governments do not make the necessary data on their finances easily accessible, or they fail to present their budget information in a manner that allows it to be compared over time. Statistics Canada once provided data useful for this purpose, but has not done so since 2009. Researchers at The School of Public Policy are working toward filling this knowledge gap and will, in the coming months, publish their results. We will be sharing our data and our methods so that others, including Alberta Treasury Board and Finance, can evaluate our efforts. We hope the government will use this approach to enable Albertans to more accurately and fairly assess the efforts of their elected representatives.

Producing estimates of the province’s cyclically adjusted budget is, however, just the first of two steps required to provide Albertans with a useful way of judging the performance of their government. The second is that the government, in consultation with Albertans, needs to establish long-term goals for levels of taxes and spending, and clarify what its plans are for the Heritage Fund. Identifying targets they hope to achieve 10, 20 or more years into the future has always proven a useful way for governments to maintain their focus and fiscal discipline. Most importantly, it is also a useful and simple metric by which voters can assess their government: Has it taken steps to achieve the goals we expect to achieve in 10 or 20 years, or has it moved us further from those goals?

Providing citizens with clear and easily understood measures of performance should be a priority of any government. Democracy works well and citizens become engaged in the democratic process when such measures are available. The changes that we are suggesting the Alberta government make to its budgeting approach are not difficult to implement and they would enable voters to more easily assess government performance. Good leadership encourages, rather than fears, such assessments.

The North West-Sturgeon Upgrader: Good Money After Bad?

Ted Morton is Executive Fellow at The School of Public Policy, University of Calgary

In government policy, as in life, the path to hell is often paved with good intentions. And so it is with Alberta's bitumen royalty-in-kind program, or BRIK. What started off as a low-cost, low-risk initiative to incentivize more upgrading of bitumen in Alberta has turned into the multi-billion-dollar North West-Sturgeon upgrader — a project that will leave Alberta taxpayers holding the bag if it doesn't fly.

It began innocently in the first year of the Stelmach government. Oil prices were soaring. Billions of dollars were going into new oilsands production. But unless new upgraders were built in Alberta, the growing volumes of bitumen would all be shipped south. But no one was going to invest billions of dollars in a standalone “merchant” upgrader in Alberta unless it came with an ironclad guarantee of at least a 30-year supply of bitumen. Enter BRIK.

First proposed in 2007, BRIK would require bitumen producers to give the government of Alberta a portion of their bitumen in lieu of paying royalties. Armed with its own stream of bitumen, the government could, in turn, sign contracts with prospective merchant upgraders to guarantee the long-term supply needed to attract investors. Risk to the government would be minimal, since it was merely acting as a middleman — collecting bitumen from existing producers and selling it for the same market price to new upgraders.

Prior to the 2008 recession, BRIK appeared poised to achieve all these objectives. Five upgraders were being built or expanded and another six were planned. These projects represented over \$100 billion in capital investment and would have added three-million barrels a day of upgrading capacity — more than tripling the current capacity. The area east of Edmonton began to be called “Upgrader Alley” in anticipation of a Houston-like refinery row.

Edmonton's euphoria was short-lived. When the 2008 financial collapse hit, oil prices plunged and investment dried up. Only three of the five upgraders under construction in 2008 were completed, and five others were either cancelled or postponed. It became apparent that BRIK by itself was not going to build any new upgraders.

Eager to keep one of the premier's signature commitments, the Stelmach government proceeded to sweeten the deal to keep a remaining project afloat: North West Upgrading's refinery in Sturgeon County. Under this new scenario, rather than simply selling the bitumen to North West, the province now committed to retain ownership of the bitumen, pay North West a processing fee or “toll” for upgrading it, and would then sell the upgraded product into the market.

Construction costs were now estimated to be \$5.7 billion (up from \$4 billion). Eighty per cent of the capital costs would be borrowed, with payment on these bonds effectively guaranteed by the government's 30-year “take-or-pay” tolling contract. This new arrangement effectively transferred the risk of upgrading to the government — a liability estimated to cost \$19 billion dollars in tolls over the 30-year contract.

The financial risk of upgrading depends on three factors: the capital cost of building the upgrader; the costs of operating it; and the “spread” between the price of bitumen and the price of the refined products. The wider the spread, the greater the opportunity for profit. The narrower the spread, the greater the risk of loss. If your all-in upgrading costs are greater than the spread, you lose money.

Capital construction costs are another risk variable. The higher the costs, the higher the processing toll. By 2011, capital costs for the North West upgrader were estimated at \$5.7 billion, with a guarantee that any cost overruns above \$6.5 billion could not be added to the processing toll. North West executives repeatedly emphasized how this cap on capital costs minimized the government’s risk. This cap was confirmed in the report from the all-party legislative committee in May 2013. Five months later in October, then-premier Alison Redford participated in the official groundbreaking ceremony. There were smiles all around.

Not so now. Two months later, in a quiet announcement just days before Christmas, the government announced that cost overruns had driven the total construction costs to \$8.5 billion, and the expected completion date was extended 12 months to 2017. In addition, the province would now loan North West \$300 million to help with interim financing. The original \$6.5 billion cap was nowhere mentioned.

What would this 50 per cent cost increase mean for the government of Alberta’s toll payments? That was quietly announced six months later. The province is now on the hook for \$26 billion in processing payments — up from \$19 billion — which translates into a processing cost of \$63 a barrel, making it even less likely that the investment will ever break even. And that’s assuming that there are no more cost overruns and that the plant actually operates the way it is supposed to — two rather optimistic assumptions.

A final complication is the additional demand that proceeding with construction will put on Alberta’s already constrained labour market. Building the upgrader will increase labour costs for other oilsands projects, thereby decreasing royalties and taxes paid to the province. The energy consulting firm IHS-CERA concluded that “the province creates more jobs and benefit by NOT upgrading bitumen.”

Suffice it to say that this project has taken on an inertia of its own, with a lack of effective oversight and due diligence. After five different energy ministers and three — now four — different premiers, it’s time to blow the whistle. Stop the game, do a thorough review — informed by some independent, outside expertise — and decide whether it’s time to fish or cut bait.

Advice to the New Premier: Reform Alberta's Emissions-Reduction Policy

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Behind opposition to oil pipelines and the oilsands is a perceived lack of an effective climate-change policy in Alberta. This is arguably a fair assessment; Alberta introduced a climate-change strategy in 2002, updated it in 2008, and has since ignored it as an issue. Regardless of where you stand — in support of market access for oil and natural gas, or concerned about the environmental consequences of increased development — this is an issue that should be ignored no longer.

The new premier will have much on his plate. To clarify what needs to be done on the climate file, let me present some advice based on the consensus view of academic economists. First, provide clear emissions-reduction goals. Second, scrap the well-intentioned but limited and inefficient set of existing policies and replace them with a broad-based emissions tax. Third, regularly and transparently measure and monitor progress.

The current emissions targets are far from clear. The goals in the 2008 climate-change strategy were to reduce emissions by 20 million tonnes relative to “business as usual” (BAU) by 2010, and by 50 million tonnes by 2020. However, the report gives no indication of what the business-as-usual emissions would be; one must go back to the 2002 climate-change strategy to find them. Interestingly, the 2020 emissions target changed between 2002 and 2008; the 2002 report states a goal of a 60-million-tonne reduction compared to the 50-million-tonne reduction in the 2008 report. There is no indication if the change in target is due to a change in the BAU projection, or if it was made for another reason. In addition, the legislated emissions-reduction goal is “reduction by December 31, 2020 of specified gas emissions relative to Gross Domestic Product to an amount that is equal to or less than 50 per cent of 1990 levels.” It is possible to achieve an emissions-intensity goal but not achieve the absolute reduction in emissions, and the two goals create confusion over what constitutes success. There is clearly room for improvement in describing the policy goals in Alberta's climate-change strategy.

Whatever the goal, a broad-based (and appropriately set) emissions tax is the most effective and least costly way to reduce emissions. It increases the cost of emissions for all users — not just some — requiring them to take into account the negative consequences of fossil fuel use. Alberta's current emissions-reduction regulation is distinctly second best: the Specified Gas Emitters Regulation (SGER) requires firms whose facilities emit over 100,000 tonnes of CO₂-equivalent per year to reduce the facilities' emission intensity by 12 per cent relative to their baseline emissions. Firms can either reduce emissions, purchase carbon offsets, or pay \$15 per tonne for emissions not abated. The SGER is Alberta's only regulation requiring emissions reduction.

Based on data from Environment Canada, facilities covered by SGER account for approximately 49 per cent of Alberta's emissions. Between 2008 and 2012, emissions reductions attributed to SGER by the Alberta government total 36.4 million tonnes. However, total emissions over the same period were 1,205 million tonnes, which means SGER has only reduced emissions by three per cent relative to business as usual. Not only does the current policy arbitrarily tax some firms and not others, it has done relatively little to reduce emissions.

Changing the regulation to a broad-based tax will turn it into a fair and efficient policy, with no special treatment, and is likely easier to administer. An additional benefit is that the revenues from the tax can be used to reduce other taxes, as well as to potentially reduce revenue volatility in Alberta.

As shown above, evaluating the effectiveness of SGER is straightforward. It is just as easy to evaluate whether Alberta is on track (or not) in reaching its emissions-reduction goals (assuming there are clear goals, of course). Environment Canada produces an annual report on emissions by province. Given readily available emissions data, there is no excuse for a six-year wait to evaluate the effectiveness of the 2008 strategy.

However, not all of the parts of the strategy are measurable. For example, it is extremely difficult to determine emissions avoided from energy-efficiency initiatives (such as credits for new furnaces) because emissions in the absence of the policy are unobserved. A revised “strategy” should not focus on attributing emissions-reductions to separate policies, but should instead provide clear goals and policy initiatives for reaching those goals. Effective reporting would involve reporting progress in meeting the goals and the costs associated with the various policy options, and whether policies such as the tax need to be strengthened to meet the stated goals.

Alberta is six years away from the next milestone in its emissions-reduction plan. The new premier should take action to show that he is serious about meeting the goal, and to ensure that we meet the stated commitments. The most effective way to do this is to set a clear goal, implement a broad-based emissions tax to reach the goal, and report on Alberta’s progress in reducing emissions.



THE SCHOOL OF PUBLIC POLICY

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Jack M. Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of *International Tax and Public Finance* and the *Canadian Tax Journal*, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to the National Post, and has frequently published articles in other print media.

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