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Austerity vs. Renewal

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What's at stake in the debate over Alberta's budget deficit

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Summary

Alberta's Official Opposition and other conservative critics have called for the repeal of recent tax increases and the adoption of a budgetary strategy aimed at eliminating Alberta's budget deficit on a short-term time scale, regardless of the state of the economy.

Such a strategy would, if implemented, have a devastating impact on Alberta's economic recovery. To wipe out the deficit and offset the revenue lost from repeal of the tax measures would require cuts amounting to $6.35 billion over a two-year period.

We estimate that the direct and indirect impact of such a strategy would be to reduce Alberta's GDP by more than $10 billion in 2017 – enough to wipe out the entire recovery of nominal GDP to 2014 levels projected in the provincial budget. It would have the effect of reducing Alberta's GDP by 3%.

The employment impact would be dramatic. The estimated direct impact on employment in the provincial government and in agencies solely dependent on transfer payments would be a loss of 22,000 jobs. This compares with the direct employment loss in oil and gas extraction between October 2014 and November 2015 (the most recent sector statistics available) of 27,000.

Indirect employment losses would push the total to 38,000.

Even these numbers understate the impact. The estimated direct employment impact of 22,000 does not take into account the impact of cuts through government purchases of goods and services and capital spending or their follow-on impact on agencies not solely dependent on transfer payments such as universities and colleges.

Austerity in the face of a recession has been discredited wherever it has been tried. To advocate such a strategy for Alberta flies in the face of the evidence and experience of the past decade around the world.

To implement such a strategy in Alberta in 2016 would literally usher in a second recession.

Alberta's economy today

Driven by the collapse of prices and continuing instability and uncertainty in world crude oil markets, Alberta is experiencing its most significant economic threat in more than a generation. Although, statistically, the decline in overall employment has not been as deep as it was in the so-called Great Recession of 2008 and 2009, the impact on the oil and gas industry has been substantially greater.

Between the peak and trough of the 2008-2010 recession, the oil and gas industry in Alberta lost just over 16,000 jobs. The most recent data from Statistics Canada show that since the employment peak in October 2014, Alberta has lost more than 27,000 jobs in oil and gas. So in the oil and gas sector specifically, the recession is deeper than was the case in the Great Recession. The downturn in the industry has already lasted longer than that caused by the Recession. In 2008-2009, the month-over-month downturn continued for 11 months; by contrast, the current month-over-month downturn is already at 12 months and counting. [1] The prospect that oil prices may remain "low for long" and that the current depressed and volatile pricing may signal a more prolonged period of structural adjustment in the sector adds to the concern.

Outside oil and gas, the impact has been significant, but not as great as that of the Recession. The economy outside the oil and gas sector has shed barely more than half the jobs since the fall of 2014 as it did in the Recession – 46,977 compared with 84,351 in the latest data for November 2015. And there are signs in the data that employment is turning the corner. Employment outside oil and gas was essentially stable between August and November of 2015.

The data suggest that the slide in economic activity may have bottomed out. But recovery is not yet established and its beginnings are extremely fragile.

The public policy response to the energy recession

One of the key factors in Alberta's favour as the economy begins to recover is that the national economic policy environment is favourable. The Bank of Canada is continuing with a low-interest-rate policy designed to add stimulus to the consumer and business investment sectors of the economy and to support the improved terms of trade for exporters created by the decline in the value of the Canadian dollar.[2]

Current Bank policy, however, is already at the limit of what monetary policy can expect to achieve. At the same time, continuing concerns are increasingly being

[1] Source: CANSIM 281-0063

[2] Bank of Canada, Monetary Policy Report, 20 January 2016

raised over the level of indebtedness of individual Canadians.[3] And the accumulation of cash on corporate balance sheets suggests that it is not the cost of capital standing in the way of business investment, rather it is a perceived lack of opportunity.[4]

This makes fiscal policy all the more important, because with monetary policy tools stretched to or beyond their effectiveness limit, fiscal policy is the only lever available to government to bridge the gap to a sustained economic recovery.

While the details will not emerge until the federal budget is tabled, the Federal Government is expected to table an expansionary budget designed to support economic recovery. Having faced down critics calling for a "hell or high water" balancing of the budget has a mandate to use the fiscal policy levers available to it to stimulate the economy, to invest in renewed public infrastructure and to support economic diversification.

Budgetary implications for Alberta

A general economic slowdown of this magnitude would have a noticeable impact on provincial government finances under any circumstances. In Alberta, that impact is substantially magnified by the provincial government's dependence on revenue from the oil and gas industry to support its ongoing operations.

The following table drawn from data in the October 2015 Budget highlights the implications for Alberta of the downturn in the oil and gas sector.

[3] For example, "Canada's household debt burden hits record high in third quarter", Globe and Mail, 14 December 2015.

[4] For example, "Canadian corporate cash hoard rises to $630 billion in first quarter", Financial Post, 19 June 2013.

Revenue and expenditure -- Alberta Budget October 2015

	2014-15	2015-16	2016-17	2017-18
Program	47,644	49,128	50,208	51,018
Interest	722	778	919	1,267
TOTAL EXPENDITURE	48,366	49,906	51,127	52,285
Taxation	21,436	22,099	23,121	23,803
Royalties	8,948	2,768	3,412	4,365
Transfers	5,982	6,984	7,288	7,559
Investment income	3,113	2,820	2,564	2,512
Enterprises	2,665	2,736	2,822	3,003
Premiums Fees Licences	3,564	3,687	3,734	3,854
Other	3,773	2,694	2,769	2,823
TOTAL REVENUE	49,481	43,788	45,710	47,919
Balance	1,115	-6,118	-5,417	-4,366

It shows an abrupt swing in the budgetary balance from a small surplus of $1.1 billion in 2014-15 to a deficit of $6.1 billion in 2015-16.

The numbers also reveal clearly the underlying cause for the fiscal swing – a decline of nearly $6.2 billion in provincial revenue from resource sector royalties. With program spending having grown by only 1.5% between 2014-15 and 2015-16, the swing in Alberta's fiscal balance is almost entirely attributable to a decline in revenue in general and in resource sector royalties in particular.

Alberta's October 2015 budget

The budget tabled by the Government of Alberta in October 2015 is fully consistent with the themes that are emerging at the national level. The government has adopted an approach to fiscal policy that balances the need to increase revenue against the need to maintain services that support those affected by the downturn and to add stimulus to the economy against the headwinds created by the turmoil in the oil and gas sector.

Response to Alberta's changed fiscal circumstances

As might be expected, the Budget's acknowledgement of an expected deficit of $6.1 billion has generated an overheated political response. It has been attributed to the recently-elected NDP government, when it is clear that it is entirely attributable to a decline in resource sector revenue driven by the collapse in crude oil prices that began in October 2014. It has been blamed on public spending, when the data show clearly that it is the revenue side of the budget that is responsible for the growth in the deficit.

Opponents have had fun with figures in demonstrating the substantial percentage increase in the province's debt forecast in the budget – conveniently ignoring that any increase in the debt would look large because Alberta essentially had no net debt going into the current downturn.

Much has been made of credit rating changes announced by the major bond rating agencies. Some perspective would be helpful, however. Standard and Poors both reduced Alberta's credit rating from their highest rating to their second-highest rating – still second only in Canada to the Federal Government. DBRS and Moody's changed their official outlook to negative, while maintaining their rating at the top Aaa level. These changes will have no material impact on Alberta's cost of borrowing and merely reflect the reality that Alberta's economy is in recession and the budget is suffering as a result.[5]

More disturbing has been the response of the Official Opposition, cheered on by conservative critics of the government, calling for an overriding commitment to balancing the provincial budget in the short term through massive cuts in expenditures.

[5] Standard and Poors – "Standard and Poor's has downgraded Alberta's credit rating on concerns of weak budgetary performances and rising debt burden.The credit rating agency dropped the province's rating one notch from AAA to AA+ while still stating it expects the province's credit liquidity to be exceptional in the next two years.", Edmonton Journal, 18 December 2015.
DBRS – "The DBRS report released Thursday maintains the agency's triple-A credit rating for Alberta, but altered its trend to negative from stable because of high debt and sub-$30 US oil prices that have battered the provincial economy.", Edmonton Journal, 21 January 2016
Moody's – "Moody's Investors Service today changed the outlook to negative from stable on the Province of Alberta's long term debt ratings, and affirmed the Aaa and (P)Aaa ratings. At the same time, Moody´s changed to negative from stable the outlook for both Alberta Capital Finance Corporation (ACFA) and ATB Financial (ATB) and affirmed the Aaa ratings of both institutions. The short-term P-1 ratings of the Province of Alberta and ATB Financial remain unchanged.", Moody's Investor Service News Release, 18 January 2016

Fiscal policy and economic recovery

The fact that Alberta's budget deficit is attributable to deteriorating revenue reflects the fact that government revenue serves as an automatic stabilizer in the economic cycle. When government revenue declines during a recession, the excess of expenditure over revenue is a source of economic stimulus, working against the recession. By the same token, when government revenue growth accelerates during an economic expansion, the surplus of revenue over expenditures works against the expansion, moderating economic growth. So when the economy weakens and revenue drops, as has been the case in Alberta in 2015, the resultant excess of expenditure over revenue serves to stimulate the economy against the downturn.

Austerity measures -- fiscal actions aimed at reducing or eliminating a cyclical deficit -- have the effect of offsetting or even negating this stabilizing effect.[6] Introducing austerity into a recession will inevitably make the recession deeper and longer-lasting. As a result, governments' priority ranking as between balancing the budget and encouraging economic recovery matters.

So too does the mix of policy instruments chosen to address fiscal imbalance. Both expenditure and revenue changes have multiplier or knock-on effects on general economic activity. A reduction in expenditures has both direct or immediate and indirect or secondary negative effects. Lower government expenditure results directly in less wage and salary income in the economy and/or less expenditure in the economy on goods and services. That reduced wage and salary income and goods and services spending, in turn, leads to less consumer spending on goods and services and reduced income for the businesses whose success depends on goods and services spending as individuals and businesses react to the change in government spending. These direct and indirect effects combine to produce a multiplier for expenditure cuts between 1.5 and 2.5, depending on the nature of the expenditure being cut. An average expenditure multiplier effect of 2 means that, for example, for every dollar of expenditure cut, economic activity is reduced by two dollars; or that for every job cut through restraint, an additional job is lost elsewhere in the economy.

Tax changes have a corresponding impact, but one which is weaker than that of expenditure changes because it consists entirely of indirect effects. Changes in taxes do not change economic activity directly; they affect economic activity only to the extent that they change the actions of consumers and businesses. An increase in taxes will lead indirectly to lower spending on goods and services, and therefore to a reduced level of economic activity. But because tax changes have no direct economic impact, their total impact is much lower. As a result, the impact multipliers for tax changes are generally much lower than those for

[6] By the same token, tax cuts at the peak of an economic cycle will tend to bolster economic activity precisely at the time when the economy needs cooling off.

expenditure changes. While the multiplier associated with a tax increase will vary depending on the tax being cut – the indirect effects of more regressive taxes tend to be greater than those of more progressive taxes – tax multipliers are generally less than one.[7]

The analysis that follows is based on multipliers of 2.0 for expenditures; 0.6 for income tax; and 0.8 for other taxes. For expenditures, I assume that 100% of the direct impact and 75% of the indirect impact is in the Alberta economy. For income and other taxes, where the entire impact is indirect, I assume that 50% of the indirect impact is in Alberta. This results in multipliers of 1.75 for expenditures; 0.3 for income tax and 0.4 for other taxes.

Implications of the Official Opposition's Fiscal Austerity

In the 2015 election campaign, the platform of the Wild Rose Party was based on a plan to balance the provincial budget in 2017-18.[8] Although the Official Opposition has not released a formal position as an alternative to the October 2015 budget, it has not signaled any change in that position.[9] The campaign

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[7] In general, higher income is associated with higher savings and a greater tendency to consume imported goods and services. As a result, a larger proportion of the economic benefit (of a tax cut) or cost (of a tax increase) is absorbed by changes in savings and imports for taxes that are more related to income. This, in turn, will tend to moderate the macroeconomic impact of the change.

[8] Wild Rose Platform "Standing up for Albertans – Five Priorities", Election 2015; priority number one "Low Taxes, Balanced Budgets and a Savings Plan".

[9] See the following representative statements from the Official Opposition:

"Standing up for low taxes, balanced budgets and a savings plan"
https://d3n8a8pro7vhmx.cloudfront.net/wildrose/pages/223/attachments/original/1429486536/Balanced_Budgets_apr19.pdf?1429486536

"Moody's negative outlook shows urgency to limit borrowing and constrain spending"
http://www.wildrose.ca/news_release_moody_s_negative_outlook_shows_urgency_to_limit_borrowing_and_constrain_spending

"NDP follows Wildrose call for senior management pay freeze, time to freeze salaries across government"
http://www.wildrose.ca/ndp_follows_wildrose_call_for_senior_management_pay_freeze_time_to_freeze_salaries_across_government

"Budget 2015: Risky economics, record debt, higher taxes, higher spending"
http://www.wildrose.ca/budget_2015_risky_economics_recod_debt_higher_taxes_higher_spending

"Provincial budget must serve Albertans, not ideological interests"
http://www.wildrose.ca/provincial_budget_must_serve_albertans_not_ideological_interests

"With no plan or budget, NDP bring in record $9.1 billion shortfall"
http://www.wildrose.ca/with_no_plan_or_budget_ndp_bring_in_record_9_1_billion_shortfall

platform addressed the budget deficit entirely on the expenditure side, calling for the repeal of the revenue measures introduced by the outgoing Conservative government and proposing no revenue changes in its own plan. Since the election, the Official Opposition has opposed all of the revenue increases proposed and implemented by the Alberta Government.

Based on the two-year forecasts of revenue and expenditure tabled with the provincial budget, the budget framework implied by the Opposition position would be as summarized in the following table:

Revenue and expenditure -- Alberta Budget October 2015

	2014-15	2015-16	2016-17	2017-18
Program	47,644	49,128	50,208	51,018
Interest	722	778	919	1,267
TOTAL EXPENDITURE	48,366	49,906	51,127	52,285
Taxation	21,436	22,099	23,121	23,803
Royalties	8,948	2,768	3,412	4,365
Transfers	5,982	6,984	7,288	7,559
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Other	3,773	2,694	2,769	2,823
TOTAL REVENUE	49,481	43,788	45,710	47,919
Balance	1,115	-6,118	-5,417	-4,366
Allow for				
Revenue increases				
PIT		450	906	942
CIT		250	450	468
Fuel		530	550	561
Locomotive		5	10	10
Total		1,235	1,916	1,981
Adjusted balance	1,115	-7,353	-7,333	-6,347

Taking the projections in the budget as a starting point and adding back the revenue measures the Opposition is committed to repealing, a commitment to eliminating the deficit in 2017-18 would require a full reversal of a deficit of $6.35 billion between 2015-16 and 2017-18 – in a single budgetary year.

The estimated macroeconomic multiplier impacts of such a plan are summarized in the following table.

Multiplier impacts (All figures except percentages in $ million)

Official Opposition Deficit Plan	***2014-15***	***2015-16***	***2016-17***	***2017-18***
Surplus (+) / Deficit (-)	1,115	-7,353	-7,333	-6,347
Summary budget actions				
Expenditure measures	-	-	6,347	-
Income tax measures	-	-	-700	-656
Other revenue measures	-	-	-535	-25
Macroeconomic impact				
Expenditures, multiplier = 1.75	-	-	-11,108	-
Income tax, multiplier = -0.3	-	-	210	197
Other revenue measures, multiplier = -0.4	-	-	214	10
TOTAL Macro Impact	-	-	-10,684	207

Austerity impacts on Alberta's Growth Rate	***2014-15***	***2015-16***	***2016-17***	***2017-18***
Official Opposition	0.00%	0.00%	-3.11%	0.06%
Forecast Nominal GDP growth rate (calendar year)	-	-9.4%	4.0%	6.3%
Estimated net growth rate	-	-9.4%	0.9%	6.4%
Estimated GDP without Opposition measures (calendar years)	364,544	330,277	343,488	365,128
Estimated GDP with Opposition measures (calendar years)	364,544	330,277	333,215	354,396

The effect of a $6.35 billion cut in expenditures, offset by the positive effect of repealing the 2015-16 budget's increases in personal and corporate income taxes and fuel taxes, would be to reduce the level of economic activity in the province by $10.7 billion during 2016-17 and would result in provincial GDP $10.7 billion lower in 2017 than is currently projected.

Without austerity, Alberta's GDP is projected to recover in 2017 to roughly its nominal level in 2014 -- $365 billion. Austerity on the scale implied by the official opposition's budgetary positions would literally wipe out that recovery, leaving Alberta with a level of GDP just over $10 billion lower than its 2014 level.

Employment impact

The expenditure cut of $6.35 billion as of fiscal year 2017-18 represents a cut of approximately 12.4% relative to projected program expenditures (excluding interest) for that year.

Because the Official Opposition has given no indication as to where it would impose the cuts necessary to balance the provincial budget, there is no direct measure available of the employment impact. We can, however, estimate the impact from available public sector employment data by looking narrowly at the impact on employment in the provincial public service and the associated spin-offs.

Using the most recent available data (for 2011), employment in the broader provincial public service excluding postsecondary education (local school boards, health and social services and general provincial government employment) is approximately 180,000. A 12.4% cut – assuming that cuts are imposed proportionally across the public service -- would translate to a direct loss of over 22,000 jobs. Taking into account the indirect impact of these job cuts – 0.75 indirect jobs for each direct job lost – the estimated total job impact would be 38,000.

This figure is extremely conservative, for two reasons. First, it assumes that cuts in operating funding for colleges and universities, which unlike other parts of the public service have non-government sources of funding, would have no impact. Second, it takes no account of the employment impact of cuts to the 40% of the provincial budget that is not accounted for by direct wages and salaries and transfers to other entities.

Even this conservative estimate of the employment impact, however, puts the impact of budget austerity into sharp relief.

Direct employment impacts in context

	Impact on direct provincial government employment	% of Alberta employment	% of resource sector loss
Opposition	-22,000	-1.1%	80%

Alberta employment data, November 2015		*Source*
Employment total	*1,978,976*	*CANSIM 281-0063*
Mining, Quarrying, Oil & Gas Employment	*108,985*	*CANSIM 281-0063*
Change in resource sector employment October 2014 to November 2015	*27,054*	*CANSIM 282-0028*

The estimated direct impact on provincial government employment alone – ignoring the impact on the other 40% of the provincial budget and spill-over effects on postsecondary education – would be to reduce total employment in Alberta by 22,000 or 1.1%.

To put that into perspective, the direct employment loss in the oil and gas extraction sector between peak employment in October 2014 (approximately 136,000) and November 2015 (approximately 109,000) comes to 27,000.

Austerity on the scale imagined by the Official Opposition would literally usher in a second recession.

Alberta's economy, fiscal policy and deficit financing

One direct implication of this analysis is that a focus on deficit reduction as an overriding goal of economic policy in Alberta's current economic circumstances is completely wrong-headed. Measures taken to reduce the deficit in the face of a major economic recession – especially measures to reduce the deficit by cutting back on public expenditures – will act as a drag on Alberta's economy precisely when public sector stimulus is needed to offset the current weakness in the private sector economy.

Far from being an economic evil as portrayed by conservative critics, deficit financing is essential in an economic downturn. Indeed, the recent emergence and persistence of a fiscal deficit in Alberta is an indicator that the province's fiscal policy is doing exactly what it is intended to do – provide economic stimulus at a time when both the consumer and business sectors have been weakened by the chaos in the global crude oil market. Even in normal economic times, the case for pursuing balanced budget as an overriding budget planning goal is weak, because it ignores the role that measured reliance on deficit financing can play in funding long-lived, productive improvements in economic infrastructure. In the current economic environment, deficit fixation is destructive and counter-productive.

Alberta's finances in perspective.

Alberta's current fiscal circumstances are by no means an indicator that the province's public services spending is out of control or dramatically out of step with that of other Canadian provinces. In fact, Alberta's spending as a share of GDP is the lowest in Canada; its taxation as a share of GDP is by far the lowest.

Measured on a per-capita basis, Alberta's spending ranks 5th out of the ten provinces; taxation ranks 9th.

Alberta vs. Canadian provinces, 2012

	Tax % GDP	#	Exp % GDP	#	Exp/cap	#	Tax/capita	#
Newfoundland and Labrador	11%	8	23%	6	13,926	1	7,042	3
Prince Edward Island	16%	2	30%	1	11,435	4	5,914	6
Nova Scotia	14%	3	26%	4	10,486	8	5,769	8
New Brunswick	13%	5	26%	3	10,937	6	5,295	10
Quebec	17%	1	27%	2	11,761	3	7,533	1
Ontario	12%	6	18%	8	9,335	9	6,061	4
Manitoba	13%	4	23%	5	10,829	7	6,029	5
Saskatchewan	10%	9	17%	9	12,692	2	7,306	2
Alberta	7%	10	14%	10	11,138	5	5,620	9
British Columbia	12%	7	19%	7	9,155	10	5,780	7

Sources
GDP CANSIM 384-0038
Tax and Exp CANSIM 385-0034
Population CANSIM 051-0026

Conclusion

The central premise behind the fiscal austerity policies advocated by conservatives is that a budgetary deficit is, in and of itself, a threat to Alberta's economy and that, therefore, measures aimed at eliminating the deficit should be the government's overriding priority.

This premise is incorrect. Policies of austerity in response to recession-driven deterioration in government fiscal balances have been widely discredited. Such policies have been blamed for the slow and halting recovery from recession in most of the EU. The IMF and even conservative commentators in Canada cautioned against the previous Federal Government's determination to balance the budget on a fixed time schedule in light of the slower than expected economic recovery and the additional impact of the crude oil price shock, whereas the abandonment of that goal by the current Federal Government has been welcomed, even in conservative business circles.

Indeed, the decision by the Federal Government to stimulate the economy rather than pursue a balanced budget in a minority parliament in 2009 is credited with accelerating Canada's recovery from the Great Recession. Similarly, the policy of fiscal entrenchment embraced by the Harper Government in 2012 is responsible in part for the double-dip recession that hit Canada in 2013 and the early part of 2014 – before the oil price collapse.

Policies of austerity work against economic recovery precisely when the economy needs stimulus to offset weak demand in the private sector. The emergence and persistence of a budgetary deficit in Alberta in the current recession is a clear indication that the province's fiscal system is doing its job – adding stimulus to the economy at a time when the private economy is weak.

This analysis demonstrates in concrete terms the negative impact of government austerity policies implemented in the face of a deep recession as is reflected in the 2015 election platform and subsequent positions of the Official Opposition in Alberta. Such policies will further suppress economic growth in an environment in in 2015-16 in which the economy is already expected to shrink by 9.4%.

It also points to the self-defeating nature of austerity policies. The fiscal drag from austerity (3% lower GDP) by 2017-18 will itself result in lower provincial revenue of roughly $1.5 billion, enough to push the budget further into deficit.

The analysis also points to another of the critical choices presented to Albertans by the Official Opposition in the Legislature -- whether to focus on revenue or expenditures in the effort to repair the province's fiscal balances. This analysis makes it clear not only that the macroeconomic outcomes are better if the focus is on revenue rather than expenditures, but also that Alberta has considerable room to move on the revenue side relative to other Canadian jurisdictions.