A NEW FISCAL FRAMEWORK FOR ALBERTA

Alberta 2003 Budget

Making Alberta Even Better

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A New Fiscal Framework for Alberta

Budget 2003 implements a new fiscal framework for Alberta. The *Financial Statutes Amendment Act, 2003* legislates this new framework through amendments to the *Fiscal Responsibility Act*, the *Financial Administration Act* and the *Government Accountability Act*.

FINANCIAL MANAGEMENT COMMISSION

"We believe the province has an opportunity to build on its strengths and, once again, lead the rest of the country in thoughtful and sound financial management."

Financial Management Commission
July 8, 2002

Alberta has a well-earned reputation as the fiscal leader in Canada. Since 1993, we have made the difficult decisions that were needed to restore fiscal balance. Nine years of deficits and increasing debt have been replaced by nine years of surpluses and debt repayment. Alberta has returned to a position of fiscal strength. Alberta has by far the lowest debt load per person of any provincial government in Canada and is the only provincial government with financial assets that exceed liabilities.

Alberta's fiscal strength provides the flexibility to adjust our fiscal policies and re-focus our priorities. Last year, the government appointed a Financial Management Commission to consult with Albertans on how to enhance the province's fiscal policies and strategies. The Commission submitted its report, *Moving from Good to Great*, on July 8, 2002.

The Commission reported that, while the government has been effective in balancing the books and repaying debt, other issues also needed to be addressed. Albertans were concerned that the existing fiscal framework did not adequately manage the ups and downs in energy revenue. They did not want capital spending to continue to be tied to swings in oil and natural gas prices. School boards, post-secondary institutions, health authorities, local governments and other partners wanted firmer commitments to ongoing funding so they could plan more effectively.

"This new fiscal framework, which provides predictability, sustainability and discipline, will prepare Alberta now for the challenges that lie ahead."

Pat Nelson
Minister of Finance
September 26, 2002

The government's response to the Commission's Report was released on September 26, 2002. The response is included at the end of this chapter. The government accepted 22 of the Commission's 25 recommendations, several with modifications, and set out an implementation schedule for the accepted recommendations.

Budget 2003 implements significant changes to the fiscal framework that will bring more sustainability to fiscal planning, and more predictability and continued discipline to operating and capital spending. Work is underway by the Canadian Public Sector Accounting Board to update recommendations on the government reporting entity. Depending upon the results of this work, the government reporting entity may expand by Budget 2006 to include some entities in the education and health sectors.

SUSTAINABLE AND PREDICTABLE OPERATING SPENDING

A new Alberta Sustainability Fund is being established to protect ongoing operating spending from volatile revenue and the costs of emergencies and disasters.

Alberta Sustainability Fund

- Receives resource revenue above $3.5 billion.
- Funds shortfall if resource revenue under $3.5 billion.
- Resource revenue above $3.5 billion can be used to offset in-year shortfalls in other revenue.
- Can be used to pay for emergencies and disasters.
- Can be used to pay for assistance under the *Natural Gas Price Protection Act*.
- Balanced budget requirement adjusted for transfers to and from the Fund.
- Fund cannot be drawn down below zero.
- First priority for year-end surpluses until Fund reaches $2.5 billion.

STABILIZING RESOURCE REVENUE

Resource revenue available for spending will be fixed at $3.5 billion per year.

As recommended by the Financial Management Commission, non-renewable resource revenue will now be fixed at $3.5 billion per year for fiscal policy purposes. This is about the average of actual non-renewable resource revenue from 1981-82 to 2001-02, excluding the unprecedented spike in 2000-01. If resource revenue over the previous three years averages less than $3.5 billion, budgeted resource revenue will be reduced to that lower amount.

Non-renewable resource revenue above $3.5 billion (or the three-year average) will be deposited in the Alberta Sustainability Fund and will not be available for budgeted spending. If non-renewable resource revenue is less than $3.5 billion, the shortfall can be withdrawn from the Sustainability Fund to maintain planned spending.

Spending plans by the government, and the authorities and agencies that the government funds, will be sustainable and predictable since they are based on sustainable and predictable resource revenue. This does not mean abandoning spending discipline; it simply means eliminating the up and down swings in spending that have been driven by the up and down swings in resource revenue. Spending cuts will not be needed if resource revenue falls unexpectedly, but there will also no longer be spikes of ‘one-time’ spending due to resource revenue windfalls. Both the peaks and valleys of ongoing operating spending will be smoothed.

STABILIZING OTHER REVENUE

To provide additional predictability to spending plans, the Alberta Sustainability Fund will also be used to help stabilize revenues other than resource revenue. Other revenues can also swing unexpectedly, as evidenced by the large loss in investment income last year when stock markets fell sharply.

If there is a shortfall in revenue other than resource revenue during the year, any resource revenue that year above $3.5 billion can be used to offset the shortfall. As a result, declines in other revenue will not require in-year spending cuts unless total actual revenue is less than budgeted revenue for fiscal policy purposes (revenue using $3.5 billion of resource revenue). Cash available from year-end surpluses in other revenues will be deposited in the Sustainability Fund to help pay for shortfalls in resource revenue in that year or future years.

IN-YEAR SPENDING INCREASES

Contingency Allowance for in-year spending increases fixed at 1% of budgeted revenue. Does not increase if in-year revenue increases.

Disasters and emergencies funded from Sustainability Fund, not Contingency Allowance.

The Alberta Sustainability Fund will also be used to address volatility and unpredictability in spending. Disasters and emergencies, such as droughts and forest fires, can require large unbudgeted government payments during the year. Under the new framework, funds can be transferred from the Sustainability Fund, if needed, to help pay for the costs of disasters and emergencies. In those years of exceptionally high natural gas prices, the Sustainability Fund can also be used to fund assistance under the *Natural Gas Price Protection Act*.

Other in-year spending increases, or revenue reduction initiatives, can be funded from the Contingency Allowance that must be set aside in the budget as part of the Economic Cushion. The new fiscal framework sets the Contingency Allowance at a minimum of 1% of budgeted revenue for fiscal policy purposes. As in the previous fiscal framework, 'net-budgeted' spending increases that are offset by revenue received for that specific purpose will not be charged to the Contingency Allowance.

Sustainable and predictable spending means more than just preventing, if possible, in-year cuts in spending plans. It also means that in-year spending increases must be limited to avoid creating unrealistic spending expectations for future years. The new framework eliminates the '75%/25%' rule that allowed the government to spend up to 25% of any in-year revenue increases. The Contingency Allowance will now remain capped at the budgeted amount even if revenue increases during the year. This new limit on the funds available in-year for non-emergency initiatives increases budgetary discipline and the importance of three-year planning.

SUSTAINABLE AND PREDICTABLE CAPITAL SPENDING

The Alberta Sustainability Fund will help bring more predictability to both operating and capital spending. Other fundamental changes are also being made to the way the government manages and accounts for capital spending to end stop-and-go funding for infrastructure projects.

New Capital Framework

- Three-year capital plan.
- Carry-over of unexpended capital investment funding.
- Income statement on an expense basis with amortization of capital assets. Capital assets brought onto balance sheet.
- Alternative financing proposals to be reviewed by a private sector advisory committee.
- Capital Account.
- Balanced budget requirement adjusted for transfers from the Capital Account.

THREE-YEAR CAPITAL PLAN

Three-year capital plan sets out government commitments, including funding for major projects deferred in 2001.

Beginning in Budget 2003, a rolling three-year capital plan will set out the government's commitment to capital funding. The capital plan includes:

- infrastructure projects and purchases of equipment by school boards, post-secondary institutions, health authorities, municipalities, and other local authorities and organizations, and
- capital investment in government-owned infrastructure, equipment and inventories, and operating funding to rehabilitate government infrastructure.

The capital plan includes major projects that were deferred in the fall of 2001 and have not yet been funded.

CARRY-OVER OF UNEXPENDED CAPITAL FUNDING

Capital funding appropriated for government-owned projects that is not expended, due to bad weather for example, can now be carried over to the next fiscal year. This will help ensure that capital plan commitments are met. Previously, those dollars could be reinstated only if there was room within the next year's fiscal plan.

The new carry-over rule applies only to capital investment in government-owned projects. For projects being constructed by local authorities, the government's capital grants can continue to be fully advanced in the year the grants are budgeted even if there are construction delays.

NEW CAPITAL ACCOUNTING POLICY

Fiscal reporting moves to the new PSAB standard of amortizing capital.

The government will move this year to the new Public Sector Accounting Board (PSAB) standard of amortizing capital for fiscal reporting. This is similar to the standard that has been used for many years by the private sector. This change affects only government-owned capital assets. Capital grants to local authorities will continue to be charged to expense on the income statement.

Previously, while the annual amortization (depreciation) cost of government-owned capital projects was reported in expense, the government's bottom line was adjusted to put government capital costs on a pay-as-you-go basis. The full cost of a capital project was charged to the bottom line as it was constructed.

Government capital assets added to balance sheet.

In the new reporting model, government-owned capital assets will be added to the government's balance sheet and will be charged to the bottom line over their useful lives through amortization expense.

The cost of constructing or purchasing a government-owned capital asset will no longer immediately affect the bottom line. It will become a balance sheet transaction that can be financed by reducing a financial asset, such as cash, or by adding a financial liability, such as a capital lease or a loan. Neither transaction will affect the government's net assets. Thus, borrowing for capital purposes will be excluded from the legislated accumulated debt repayment plan.

ALTERNATIVE FINANCING

Alternative financing will be used for some capital projects.

For some major capital projects, the government will use alternative financing arrangements, such as public-private partnerships (P3s), debt financing and capital leases. The use of alternative financing will be assessed on a project-by-project basis. A business case will be required that demonstrates that alternative financing of the project makes sense, considering all private sector costs including financing costs. All proposals will have to be reviewed by a private sector Advisory Committee on Alternative Capital Financing. The Committee will report to Treasury Board on the proposals it reviews.

Alternative financing will also be used for some capital projects of regional health authorities, school boards and post-secondary institutions, subject to review by the Advisory Committee on Alternative Capital Financing and approval by the government.

CAPITAL ACCOUNT

Capital Account will prefund future-year capital projects.

A Capital Account has been created to provide an additional source of financing for government-owned capital projects, capital grants to local authorities and other infrastructure support. Funds allocated to the Capital Account in one year can be used to fund capital projects in future years.

THE OVERALL FISCAL FRAMEWORK

The new fiscal framework will result in significant changes to the government's fiscal management and financial reporting.

ECONOMIC CUSHION

The Alberta Sustainability Fund will provide protection against declines in revenue and the cost of emergencies and disasters. As a result, the Economic Cushion no longer needs to be as large as previously required. The minimum size of the budgeted Economic Cushion has been reduced from 3.5% of revenue to 1% of revenue for fiscal policy purposes (revenue using $3.5 billion of non-renewable resource revenue). This is the Contingency Allowance for in-year spending increases or revenue reduction initiatives.

In addition, the cushion must include any net positive amount required for the combined total of:

- the retained earnings of funds and agencies, and
- cash required for the capital plan that is not already provided for elsewhere in the fiscal plan.

The net earnings of funds and agencies are included in the government's consolidated results. If this income is retained by the funds and agencies, it is not available to fund other government spending. Therefore, it must be set aside in the cushion.

The cash required for capital investment in government-owned projects will be provided through a combination of current-year revenue, the Capital Account and alternative financing mechanisms (which will require cash in future years for principal repayments). Since amortization, which is included in expense, is a non-cash item, the revenue allocated to amortization provides cash for capital investment. The net book value of any capital asset disposals also provides cash. The cushion is required to include any other current-year revenue needed to fund government-owned capital projects.

Economic Cushion reduced to about $250 million per year.

As a result of these changes, the minimum Economic Cushion has been reduced from about $750 million to about $250 million for the next three years. The Economic Cushion in the budget may be larger than the minimum requirement. If so, the extra amount will be included in the Contingency Allowance.

ALLOCATION OF YEAR-END SURPLUSES

Previously, cash available from 75% of the budgeted Economic Cushion was allocated primarily to debt repayment. This was after adjusting for the cash retained by government funds and agencies and other cash requirements. As a result of the smaller cushion in the new fiscal framework, there will be no budgeted debt repayment from the cushion.

The allocation of year-end surpluses (the final Economic Cushion) will also change. As with the budget, cash available from year-end surpluses was previously allocated to primarily debt repayment. Because of the large surpluses in recent years, more cash was available for debt repayment than there was maturing debt that could be paid off. A Debt Retirement Account was established in the General Revenue Fund to invest the extra cash until debt matured.

The new fiscal framework expands the potential uses of year-end surpluses. The government will now have three savings accounts for annual surpluses dedicated to specific fiscal needs:

- The Debt Retirement Account will continue to save funds allocated for accumulated debt repayment until debt matures and can be paid off. Sufficient funds were in the account at March 31, 2003 to pay off debt maturing in 2003-04 and part of 2004-05.
- The Alberta Sustainability Fund will fund potential budget shortfalls in future years due to weak resource revenue or other revenue, or the costs of disasters and emergencies.
- The Capital Account will fund capital spending in future years.

In 2002-03, the $1.41 billion in cash available from the forecast surplus was divided as follows:

- $500 million to the Debt Retirement Account, and
- $910 million to the Capital Account.

Sustainability Fund is the first priority for annual surpluses until the Fund balance reaches $2.5 billion.

Beginning in 2003-04, the Sustainability Fund will be the first priority for year-end surpluses until the balance of the Fund reaches $2.5 billion. This should protect against two consecutive years of weak energy revenue, or one year of both weak energy revenue and a major disaster. Cash from accrued 2002-03 natural gas royalties that will not be received until the first quarter of 2003-04 will be allocated to the Sustainability Fund.

After the Sustainability Fund reaches a balance of at least $2.5 billion, extra cash from year-end surpluses can be once again allocated to debt repayment, the Capital Account or other improvements to the government's balance sheet. The money could not be used for operating spending since that would affect the government's bottom line.

FINANCIAL REPORTING

Since 1996-97, annual deficits have been against the law in Alberta. In accordance with Canadian generally accepted accounting principles (GAAP) for governments, the government's bottom line is consolidated, including the results of all the government's funds and agencies.

The only exception has been the exclusion of the annual change in the government's share of unfunded pension obligations, which are being eliminated under a separate legislated plan, from the government's expense and bottom line in determining compliance with the balanced budget rules in the *Fiscal Responsibility Act*. This means that the government has reported two bottom lines – the fully consolidated Net Results of Operations and the Results for Fiscal Policy Purposes after excluding changes in pension obligations.

Fully consolidated results will continue to be reported. However, the new fiscal framework requires additional adjustments in determining the Results for Fiscal Policy Purposes.

Balanced budgets remain the law, after adjusting for transfers to and from the Sustainability Fund and the Capital Account.

The Alberta Sustainability Fund and the Capital Account are designed to increase the sustainability and predictability of government operating and capital spending. The government's bottom line will be adjusted to match the stabilizing objectives of these accounts. The Results for Fiscal Policy Purposes will adjust for:

- revenue transfers in and out of the Alberta Sustainability Fund, and
- transfers from both the Alberta Sustainability Fund and the Capital Account to pay expenses authorized by the amended *Fiscal Responsibility Act*.

Since neither account will be allowed to go into debt, withdrawals from these accounts will have been prefunded from prior years' surpluses. Thus, while the Net Results of Operations could be negative in a future year, due to weak resource revenue or major disasters for example, any such negative results would have been prefunded in prior years. This will be reflected in the Results for Fiscal Policy Purposes, which by law must be balanced each year.

The government will be forced to adjust to new realities if low resource revenue persists over the medium term and the Sustainability Fund is drawn down to zero.

The Alberta Capital Finance Authority, formerly the Alberta Municipal Financing Corporation, is a government agency that borrows money in financial markets on behalf of municipalities and other local authorities. Under Canadian accounting standards, any borrowings by regional health authorities, school boards and post-secondary institutions from the Authority that can only be repaid from future government grants must be charged to government expense as the loan is advanced. In contrast, if those authorities borrow directly from non-government sources, government expense includes only grants for principal repayment and interest costs. The government’s Results for Fiscal Policy Purposes will treat borrowing from the Authority the same as other borrowing. Adjustments will be made in calculating both expense and the bottom line, in a manner similar to the adjustments for pension obligations.

RESPONSE TO THE FINANCIAL MANAGEMENT COMMISSION REPORT

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COMMISSION RECOMMENDATION	GOVERNMENT RESPONSE
1. The Alberta Heritage Savings Trust Fund should be retained, strengthened, allowed to grow and renamed the "Alberta Heritage Fund" with four new purposes: • To stabilize the impact of volatile resource revenues on the province's budget • To manage the orderly pay down of existing debt as it comes due • To address the backlog of deferred capital projects in the short term • To serve as a transition to the time when resource revenues decline and as an integral part of the province's strategy for achieving a sustainable economic vision for the future.	Accepted in principle. A sustainability fund will be established. Further consultation with Albertans on the Heritage Fund will determine the future role of the Heritage Fund. Implement in Budget 2003.
2. To provide stable and predictable funding, the Commission recommends that all non-renewable resource revenues should go into the renewed Alberta Heritage Fund on an annual basis. All year-end surpluses should also go into the Heritage Fund. A fixed and sustainable amount of resource revenues should be drawn out each year to support the government's budget. The fixed amount should be set at the lesser of $3.5 billion or the average of resource revenues for the previous three years.	Accepted in principle. A sustainability fund will be established. Further consultation with Albertans on the Heritage Fund will determine the future role of the Heritage Fund. The recommendation will be supplemented by: • adding any payments required under the Natural Gas Price Protection Act to the $3.5 billion transfer for budget purposes, • providing an exemption from contingency allowance spending limits for emergencies and disasters, and • allowing in-year increases in resource revenue to be used to offset in-year declines in other revenue. Implement in Budget 2003.
3. The renewed Alberta Heritage Fund should provide the vehicle for managing the orderly pay down of existing debt as it comes due. That means the bulk of Alberta's accumulated debt will be repaid by 2005-06.	Accepted in principle. A sustainability fund will be established. Further consultation with Albertans on the Heritage Fund will determine the future role of the Heritage Fund. Implement in Budget 2003.

COMMISSION RECOMMENDATION	GOVERNMENT RESPONSE
4. A portion of the province's annual budget should be allocated for capital spending. The amount should not be less than 0.9% of the average of the provincial GDP for the previous two years.	Accepted in principle. Government will review the determination of an appropriate benchmark for capital spending. Implement in Budget 2003.
5. Government should prepare a three to five year plan for capital and infrastructure projects and include that plan as part of its annual budget. Changes should be made to existing legislation to allow funding for specific approved capital projects to be carried over from one year to the next.	Accepted. Begin implementation in Budget 2003 with full implementation in Budget 2004.
6. In the same way that debt must be repaid, so must government commitments of spending be honoured. Funds in the renewed Alberta Heritage Fund should be allocated to address the current backlog of previously committed capital projects in a planned and orderly way.	Not accepted. The government does not agree that the Heritage Fund should be used to fund deferred capital projects. Funding for deferred capital projects will be addressed in the three to five year capital plan.
7. Government should produce and publish the list of committed but deferred capital projects along with its annual budget and report each year on the status of those projects.	Accepted. Deferred projects will be included in the capital plan that will be published under recommendation 5. Begin implementation in Budget 2003 with full implementation in Budget 2004.
8. Government and government-funded entities should be allowed to enter into alternative funding arrangements for capital projects under specific conditions and with appropriate guidelines in place.	Accepted. The government will develop appropriate guidelines and conditions for alternative funding arrangements.
9. All capital project proposals should include a business plan that clearly outlines the funding model and cost implications including operating costs, amortization, and debt repayment if applicable. Government should have the option of funding approved projects over a longer term or paying the full cost of the project in a given fiscal year.	Accepted. The government will develop appropriate business case criteria for capital projects.

COMMISSION RECOMMENDATION	GOVERNMENT RESPONSE
10. Standardized methods for estimating and reporting on deferred maintenance and utilization, functional obsolescence, and efficiency of facilities should be established and communicated. Government and its funded agencies should use these tools in their planning and reporting.	Accepted. The government will develop standardized methods.
11. The province should develop a plan for addressing deferred maintenance over the next five years. Funding for deferred maintenance should be identified as a component of the province's annual budget.	Accepted in principle. It is expected that it will take more than five years to address all deferred maintenance. Begin implementation in Budget 2004 with full implementation in Budget 2005.
12. Government should clearly articulate a strategic plan for achieving a sustainable economic vision for the province. The government's business plan should be refocused as a strategic plan to achieve the vision and to provide criteria for setting priorities and making budget decisions.	Accepted. Begin implementation in Budget 2003 with full implementation in Budget 2004.
13. The current business planning process should be strengthened by requiring all government ministries, organizations and agencies to focus on measuring their decisions against strategic goals linked to the government's strategic plan. Activities and operational matters should be left for internal operational plans.	Accepted. Begin implementation in Budget 2003 with full implementation in Budget 2004.
14. Standing Policy Committees should be given increased responsibility for gathering information from various stakeholder organizations and providing this input to the budgeting process.	Accepted. Begin implementation in Budget 2003 with full implementation in Budget 2004.
15. There should be regular reviews, including benefit-cost assessments, of all major government programs, policies and delivery mechanisms. The number of government departments and agencies should be reviewed.	Accepted. The government will continue with regular reviews.

COMMISSION RECOMMENDATION	GOVERNMENT RESPONSE
16. The government should explore various incentives to encourage ministries and government-funded agencies to manage their budgets and assets more efficiently.	Accepted. The government will continue to explore incentives.
17. The government should undertake a review and risk analysis of all the major components of its expenses and revenues, including its dependent boards and agencies, with a view to developing a comprehensive, cost effective risk mitigation strategy.	Accepted. The government has already begun work to develop a framework to assess an enterprise risk model for government.
18. The government should not be involved in public sector salary negotiations where it is not a signatory to the collective agreement.	Not accepted. As a general rule, the government is not involved in public sector salary negotiations. However, the government has an obligation to take appropriate action to ensure public safety.
19. Government should play a more direct role in establishing a framework for public sector salary negotiations through a mechanism for sharing information with various employer groups including health authorities and school boards. This would include providing guidance on the province's ability to meet new fixed costs on a sustainable basis and on competitive salaries and benefit levels on other provinces and jurisdictions.	Not accepted. The government provides general fiscal direction and information to publicly funded organizations through its business planning and budget processes.
20. To supplement the government's reporting regime, the government should consider adding the publication of a quarterly and an annual financial summary of the highlights limited to a few pages of material and presented in a simplified, easily readable, plain language format.	Accepted. Implement in 2003-04.

COMMISSION RECOMMENDATION	GOVERNMENT RESPONSE
21. The Government should continue to work with the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants in the development of the government entity reporting proposal. Government-funded entities should be consolidated into the government's accounts and financial statements unless there is a compelling case why a specific entity should be excluded.	Accepted in principle pending PSAB recommendations. Implement by Budget 2006.
22. The government should continue working with PSAB in the development of the standard regarding the capitalization and amortization of assets and it should adopt the standard when it is developed.	Accepted in principle pending PSAB recommendations. Implement in Budget 2003.
23. The government should work closely with the Office of the Auditor General with the objective of having an audit opinion without reservations based on generally accepted accounting principles (GAAP) and not on a "disclosed basis" of accounting.	Accepted. Implement by Budget 2006, pending PSAB recommendations discussed in Recommendations 21 and 22.
24. The Government should signal its intent to move forward with a new fiscal framework and use the balance of the current fiscal year to prepare for the transition.	Accepted.
25. In five years or less, the government should establish a new Commission to provide an external review of government's fiscal situation and its fiscal framework.	Accepted.