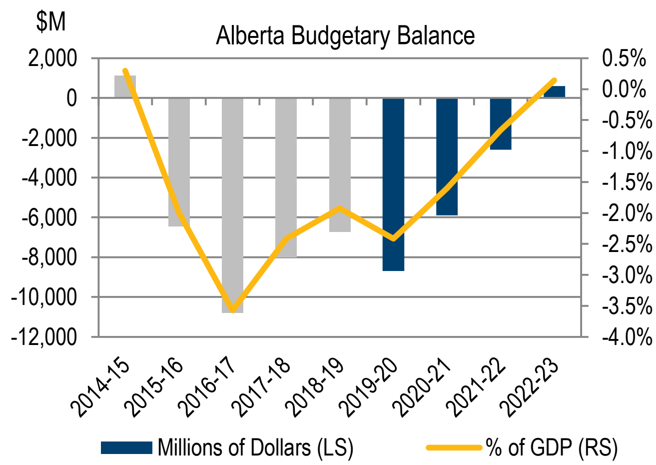
The Alberta Budget 2019: fiscal hawks in challenging economic times

Wednesday's televised pre-budget address from Premier Jason Kenney had already set the tone. Today's budget release marks the return to responsible fiscal management, which should be well received by investors. The objective is to balance the books in FY 2022-23, one year earlier than planned by the previous NDP government.

Alberta's high spending-per-capita was the province's Achilles heel flagged in the Mackinnon report released earlier this Fall. Therefore, the centerpiece of the UCP deficit-reduction plan is to improve the efficiency of each dollar spent. Program spending will be reduced by 2.8% over four years (from $48.2B in FY 2019-20 to $47.1B in FY 2022-23). The spending restraint proposed in this budget will come from various sources. First, many programs will be reformed, delivered through PPPs or eliminated. Second, over four years, the size of the public sector will be reduced by 7.7%. In FY 2022-23, this is expected to save close to $0.5B in compensation costs. This represents a 2.1% reduction relative to FY 2018-19 levels (total compensation in the public sector makes up more than half of the operating expenses annually). These savings will be achieved through attrition, reduction in the management-to-staff ratio, and a reduction in compensation costs in the post-secondary education sector. The UCP government is also looking forward to negotiate a new compensation agreement with doctors as the current one expires in March 2020. The budget assumes that physician compensation costs will remain at current levels ($5.3B in FY 2019-20, close to 10% of total expenses). Operating expenses for health care ($20.6B) and education ($13.3B), which make up more than half of total expenses, will be maintained at current levels or slightly reduced in the case of post-secondary education. Overall, we do not see an operational risk attached to this upcoming spending restraint considering that former Premier Ralph Klein was able to reduce public expenditures by 18% in the 1990s.

In our view, bending the spending curve is of high importance for two reasons. First, the current deficit is significant: $8.7B in FY 2019-20 (2.4% of GDP, see chart).It is also $1B above the status quo deficit estimate pegged in the Mackinnon report ($7.7B). Relative to GDP, Quebec had a smaller mountain to climb in FY 2014-15 and Ontario currently plans to eliminate a smaller shortfall over the same period of time.



Source: Alberta Government and LBS Econ. Res. and Strategy.

Second, the modest improvement in the outlook for the energy sector is insufficient to put the fiscal house in order, even if total revenue is projected to increase from $50.0B in FY 2019-20 to $57.5B in FY 2022-23. Key assumptions include a moderate increase in oil production, a modest uptick in WTI crude oil prices (from US$57/bbl in FY 2019-20 to US$63/bbl in FY 2022-23) and conservative estimates for the heavy-light oil differential. Another key assumption in the budget scenario is the gradual addition of pipeline infrastructure overtime: Enbridge Line 3 in 2021 and Trans Mountain and Keystone XL by 2023.

The budget also includes valuable stress test scenarios. For instance, there is a hypothetical "no market access" scenario in which the three expected pipelines are cancelled and lead to a $3B annual revenue loss for the province in FY 2022-23. The hypothetical global recession scenario is a notch more severe, lowering fiscal revenues by about $4.2B annually relative to the budget's basecase scenario. Inversely, the optimistic scenario in which WTI crude oil prices are about US$11/bbl higher overtime would add $5.8B in the coffers in FY 2022-23.

Overall, slightly better oil fundamentals in the budget scenario are expected to trickle down to improvements in population gains and consumer spending. Furthermore, the reduction in the general business tax rate from 12% to 8% over two and a half years, the enhancement of the capital cost allowance, the job creation tax cut and red tape reductions are part of the plan to improve private business investment. Capital energy investment is notably projected to pick up in 2020.This a determinant driver that usually brings positive second-order effects in other sectors of the economy.

The next steps

The pulse of Alberta's economy, measured by the Alberta Activity Index, has been weaker than usual in 2019 because of the mandatory oil curtailments and the modest outlook for oil prices. Earlier this week for instance, additional layoffs were unfortunately announced in the energy sector. Tough economic times require tough policy decisions. Inspired by the Mackinnon report, the UCP government says the Province cannot afford a higher public spending per capita than BC, Ontario and Quebec (almost $2,500 higher). Also, for a Province that was debt free not too long ago, spending close to $5M per day on debt servicing is not an acceptable status quo. The bottom line for bond investors is that the UCP government can restore Alberta's public finances, as long as the budget proposals are efficiently put into actions.

Because of blackout periods tied to the Spring elections and today's Budget, the Province of Alberta has higher borrowing requirements for FY 2019-20 relative to where it stood last year, and relative to other Provinces. This being said, Alberta's reliable access to international funding (a target of 30%-40% issuance in foreign markets), combined with the strong deficit hawk signal sent today will facilitate the issuance of bonds domestically and the continuous building of liquid benchmarks in the coming months. Borrowing requirements for FY 2019-20 are estimated at $15.1B with $3.095B completed. Borrowing requirements are projected to reach $15.3B in FY 2020-21 before declining to $12.3B in FY 2021-22. This reflects the reduction in new financing for the government's core operations. According to budget documents, the vast majority of the borrowing program will be completed using long-term debt ($12.2B in FY 2019-20).

Finally, the possibility that the minority federal Liberal government may need to lean on parties that are not in favour of pipeline expansions beyond Trans Mountain could raise the level of uncertainty with respect to federalism. Premier Jason Kenney evoked earlier this year the possibility of holding a referendum on equalization. Also, in his budget address, Finance Minister Travis Toews noted that Alberta's net fiscal contribution to the ROC averaged over $23B annually in the last five years. In this context, a new expert panel is expected to conduct public hearings and to put together a list of principles before year-end in order for Alberta to get what Premier Jason Kenney called a "fair deal" within the Confederation.

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