

# Lessons for Fiscal Reform from the Klein Era

*by Tegan Hill, Ben Eisen, and Milagros Palacios*



## Summary

■ Alberta is facing serious fiscal challenges, including a historic deficit and rapid debt accumulation that extend beyond the COVID shock. This is not the first time Alberta's finances have been in trouble. Today's situation has parallels to the early 1990s, when Alberta faced some of the largest deficits in its history.

■ In both instances, governments relied on high natural resource revenues to finance high spending and avoid large deficits. In both periods, once natural resource revenues dried up and could no longer support high spending, the province began to incur large deficits.

■ To tackle Alberta's deteriorating fiscal position in the early 1990s, the Klein government introduced swift, broad-based spending reductions. Real (inflation-adjusted) per-person program spending was reduced from \$11,040

(1992/93) to \$7,447 (1996/97)—a reduction of approximately \$3,600 per person. As a result, the Klein government quickly balanced the budget and reduced net debt—despite relatively low natural resource revenues over the period. These reforms set the stage for nearly a decade of fiscal stability.

■ Since the end of Klein reform era (1999/00), governments have routinely increased program spending beyond the level needed to account for inflation and population growth, and well beyond pace of revenue growth. In 2020/21, per-person program spending will reach an estimated \$13,644.

■ The Klein-era reform in the early 1990s introduced a distinct shift in fiscal policies and outcomes, which may present important lessons for Alberta today.

## Introduction

Alberta is facing serious fiscal challenges, including a historically large budget deficit and rapid debt accumulation. The COVID shock has contributed to the province's challenges, but it's only part of a much longer-running and larger-scale fiscal problem in Alberta. In fact, Alberta's fiscal position has been dramatically deteriorating for more than a decade.

Prior to the 2008/09 recession, Alberta held \$43.0 billion (inflation-adjusted) in net financial assets (2007/08) making it the only province whose financial assets exceeded its debts. Since then, spending growth and nearly uninterrupted deficits have eroded the province's fiscal position. By 2016/17, Alberta owed more in debt than it carried in financial assets. The provincial debt burden has grown every year since.

A recent report by the Parliamentary Budget Officer warned that Alberta's finances were unsustainable even prior to the effects of the COVID-related recession (PBO, 2018). Now, with the added impact of the recession and low oil prices, Alberta's net debt burden will reach an estimated \$63.5 billion in 2020/21 (Government of Alberta, 2020b).<sup>1</sup> Premier Jason Kenney has gone so far as to warn of a "great fiscal reckoning" (Government of Alberta, 2020a).

This is not the first time Alberta's finances have been in trouble. In fact, today's situation has some parallels to the early 1990s, when Alberta faced some of the largest deficits in its history. This paper compares the fiscal circumstances facing Alberta today to those that confronted the province in the 1990s and shows that the

province's fiscal challenges are in many respects as bad as or worse than those of the pre-Klein reform era. It also provides a discussion of the actions the Klein government took to eliminate the province's deficit and restore provincial finances to sustainability, which may provide lessons for policymakers today.

## Alberta's Fiscal Past: How Large Deficits Emerged in the Late 1980s and Early 1990s

In the early 1990s, Alberta faced severe fiscal challenges which are similar in many respects to those it faces today. Further, the causes of these problems are similar. In this section, we examine the years prior to the Klein reform era in the early 1990s<sup>2</sup> in order to compare them to the years that led up to the challenges we face today. All figures presented are inflation-adjusted (in 2020 \$) unless otherwise specified.

It is useful to begin in 1980, when Alberta's finances were in a relatively strong position (the province was in budgetary surplus and a net financial asset position). **Figure 1** shows the fiscal balance—i.e., budgetary surplus (positive values) or deficit (negative values) since 1980/81 (the Klein reform period is marked in orange). Of particular importance, note the string of nine consecutive budget deficits from 1985/86 to 1993/94.

How did this string of deficits emerge? In short, during the preceding years, the government relied on booming natural resource revenue to finance high spending and produce budget surpluses in most years. However, in 1986 the price of oil

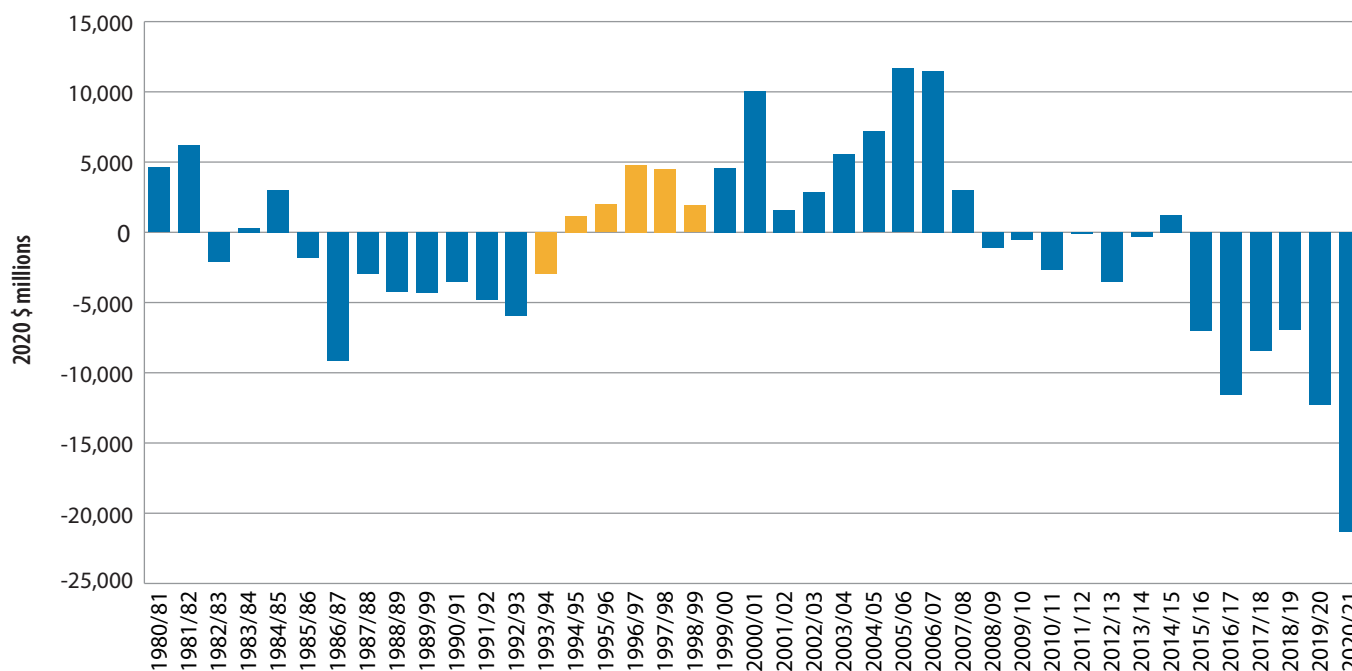
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1 Net financial debt is total debt minus financial assets, such as investments in the Heritage Fund. The term "net debt" is used to describe this concept throughout this bulletin.

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2 The Klein reform era is defined as the period of 1993/94 to 1998/99 for the purposes of this study. While Premier Ralph Klein's tenure lasted until 2006, there was a shift in the government's fiscal policy from about 1999/00 forward.

**Figure 1: Fiscal Balance, 1980/81 to 2020/21**



Note: Data are not fully comparable due mainly to various changes to accounting standards. Major breaks in the series include: 1990/91 to 1992/93: expense excludes change in unfunded pension liabilities; net financial debt/(assets) does include unfunded pension liabilities; 1993/94 to 2003/04: SUCH sector (school boards, universities and colleges, health entities) own-source revenue and expense, and assets and liabilities not included in numbers (grants to these entities are included in expense); 2004/05 to 2007/08: SUCH sector included on “net equity” basis (net revenue included in revenue; net assets included in assets); 2008/09 to 2018/19: SUCH sector included on “line-by-line” basis (revenue, expense, assets and liabilities reported in revenue, expense, assets and liabilities).

Sources: Canada, 2000, 2020; Alberta, 2020b; Statistics Canada, 2020c; BMO Economics, 2020; calculations by authors.

collapsed and there was no longer sufficient revenue to support the government’s high spending.

There was a particularly significant run-up of spending during the early 1980s. Real (inflation-adjusted) program spending (all operating spending minus debt servicing costs) jumped from approximately \$14.3 billion in 1978/79 to \$22.5 billion two years later (1980/81), and rose to \$32.5 billion by 1985/86 (Kneebone and Wilkins, 2018; Statistics Canada, 2020d).<sup>3</sup> In the

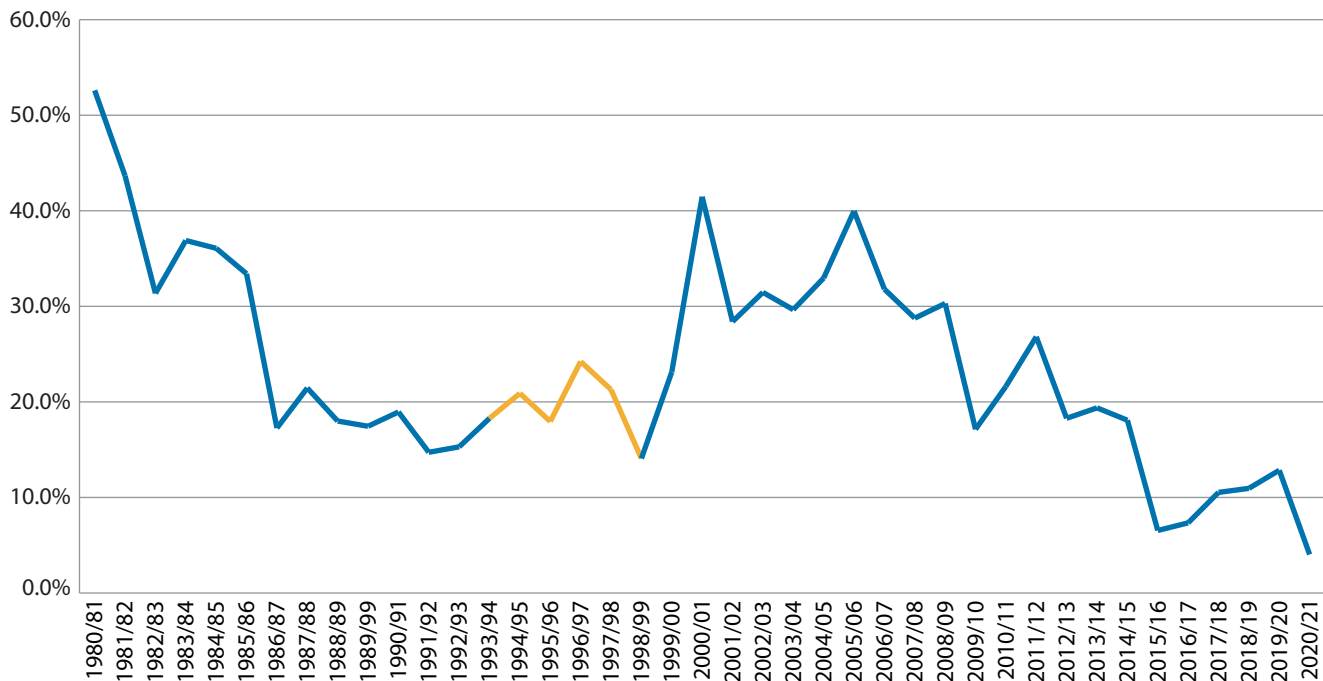
first half of the 1980s, real (inflation-adjusted) program spending grew by 32.5 percent while real revenue grew by just 6.7 percent.

High spending growth relative to revenue growth set the stage for deficits when natural resource revenues eventually fell. As shown in **figure 2** (Klein reform period is marked in orange), in 1980/81, natural resource revenue

from 1980 onwards and include some changes in accounting overtime. For this reason, the data presented in Kneebone and Wilkins is slightly different than data included in the remainder of this bulletin. Nonetheless, it follows the same trend and is useful to show the spike in spending in the early 1980s.

<sup>3</sup> Kneebone and Wilkins (2018) reconstruct provincial financial data prior to 1980 using the Public Accounts. Data used elsewhere in this bulletin is from the Fiscal Reference Tables, which includes data

**Figure 2: Natural Resource Revenue as Share of Total Revenue, 1980/81 to 2020/21**



Sources: Canada, 2000, 2020; Alberta, 2020b; calculations by authors.

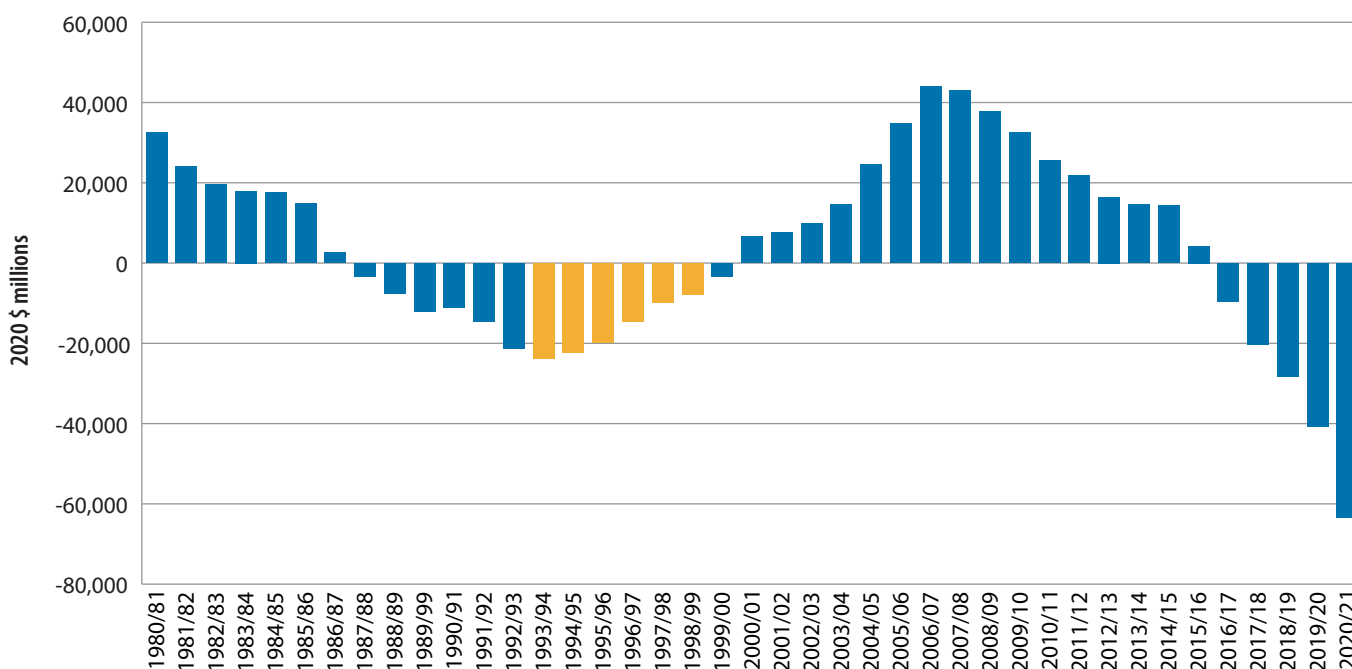
accounted for more than half (52.6 percent) of all of Alberta’s revenues. Changes in commodity prices in subsequent years, however, produced a dramatic reduction in natural resource revenues. By 1986/87, natural resource revenue represented 17.3 percent of all revenue. Program spending was not sufficiently reduced to reflect lower revenues after the oil price collapse in 1986. In other words, despite the fact that natural resource revenues could no longer support high spending, the government continued to spend at high levels.

As a result, Alberta went from frequently recording surpluses in the early 1980s to a \$9.2 billion deficit in 1986/87 (figure 1). For perspective, the deficit to GDP ratio in 1986/87 was 6.8 percent, the largest in provincial history at that time. This would be the second of nine consecutive deficits.

Primarily as a result of these deficits, Alberta’s fiscal position deteriorated rapidly in the 1980s and early 1990s. **Figure 3** illustrates this fact by showing the evolution of Alberta’s net financial position; again, the Klein reform period is marked in orange. As noted, at the start of the 1980s, Alberta was in a net financial asset position. By 1987/88 the province’s net assets were depleted and the province entered a net debt position, which would peak at \$23.8 billion in 1993/94. This represents a deterioration of \$56.3 billion (again, in 2020 dollars) in the province’s net financial position over just 14 years (from 1980/81 to 1993/94).

In summary, throughout the early 1980s, Alberta relied on high natural resource revenues to largely maintain budget surpluses. When resource revenues declined, large deficits emerged and the province’s fiscal position deteriorated quickly. The origins of Alberta’s fiscal

**Figure 3: Net Financial Assets, 1980/81 to 2020/21**



Note: Data are not fully comparable due mainly to various changes to accounting standards. See note to figure 1 for major breaks in the series.

Sources: Canada, 2000, 2020; Alberta, 2020b; Statistics Canada, 2020c; BMO Economics, 2020; calculations by authors.

challenges today, to which we will now turn, are reminiscent of this history.

## How We Got Here: Alberta's Fiscal Challenges Today

We have seen that in the 1980s, an over-reliance on natural resource revenues led to a rapid deterioration in the province's fiscal position when those revenues declined. This is exactly what has happened again over the past 15 years.

In the years following the Klein reforms of the early and mid-1990s, including Klein's later years as premier, a new era of rapid spending growth took hold in Edmonton. As natural resource revenues climbed during the late 1990s and early 2000s, the Klein government and its successors quickly increased spending.

As Figure 2 shows, natural resource revenues climbed quickly beginning in 1999/00. They would peak at 41.5 percent of total revenue in 2000/01. Although there were years of higher and lower natural resource revenue in between, generally speaking natural resource revenue remained high in Alberta until 2008/09, at which point it constituted 30.3 percent of government revenue.

During these years of high natural resource revenues, the late Klein government and its successors repeated the policy decisions of the 1980s and early 1990s by increasing spending quickly.

Since 1999/00, real (inflation-adjusted) program spending has increased by 134.0 percent, while revenues increased by 30.0 percent. There were notable spikes in program spending in certain years. For example, in real terms



program spending jumped from \$38.0 billion (2006/07) to \$43.8 billion in 2007/08 (a 15.3 percent increase), and spiked again during the 2008/09 financial crisis. It remained at its elevated recession level and in fact increased in subsequent years.

Overall, growth in program spending has routinely exceeded what would be needed to account for the effect of inflation and population growth. Real (inflation-adjusted) spending increased from \$8,731 per person (1999/00) to a projected \$13,644 per person (2020/21).

The years from 1999/00 to 2008/09 particularly followed the same policy trajectory as their predecessors in the 1980s, by using high levels of natural resource revenue to fund rapid spending growth. As in the early 1980s, natural resource revenues helped to prevent the emergence of large deficits despite high spending.

However, history would repeat itself as natural resource revenues began a dramatic and prolonged decline as a share of total revenue in recent years. As shown in figure 2, natural resource revenues fell from 40.0 percent of all revenue in 2005/06 to 12.8 percent in 2019/20. The government's projections in a recent fiscal update suggest another significant drop this year, to 4.0 percent.

Once again due to large spending increases in the preceding years, large budget deficits emerged when natural resource revenues fell. As shown in figure 1, Alberta returned to deficit spending in 2008/09, which would begin a string of 12 deficits in 13 years. Following another collapse in natural resource revenues starting in 2015/16, the deficits became much larger and have exceeded \$6.9 billion every year since. Relative to the size of the provincial economy, these deficits have ranged from 1.9 percent to 6.9 percent of Alberta's gross domestic product.

Predictably, the province's net financial asset position began to steadily deteriorate in the next years (figure 3). By 2016/17 the province lost its debt-free status. More recently, the net debt burden has quickly begun to climb. It will reach an estimated \$63.5 billion in 2020/21. The debt-to-GDP ratio is expected to reach 20.6 percent this year (2020/21) and rise to 25.1 percent by 2022/23.

As we have seen, the circumstances under which deficits emerged in the pre-Klein era and those that have emerged today have some similar causes. In both instances, during periods of high natural resource revenues, governments spent freely while relying on those resource revenues to prevent the emergence of large deficits. In both cases, when resource prices fell Alberta's government found itself at spending levels that it could no longer maintain without large budget deficits.

Given the historical parallels in how these two situations emerged, there is value in considering how the fiscal problems in the 1990s were addressed. We will now briefly turn to discuss this issue, to compare it to the policy response to date in Alberta, and then to consider possible lessons from the 1990s that may be useful to policymakers today.

### Contrasting Fiscal Policy and Outcomes During the Klein Reform Era

The similarities between pre-Klein era and more recent years are stark. Overreliance on natural resource revenues, high spending, and routine deficits were responsible for the debt accumulation that arose in both periods.

In the 1990s, the newly elected government of Premier Ralph Klein undertook a substantial reform of government spending to try to address

the deficit and growing debt. The Klein-era reform in the early 1990s introduced a distinct shift in fiscal policies and outcomes, which may present important lessons for Alberta today.

To balance the budget and eventually pay down debt, governments generally have two options: reduce spending or increase revenues (or some combination of both). The chosen fiscal adjustment can then be made quickly or slowly, and in a targeted or broad-based manner. The Klein government was elected on its explicit commitment to balance the budget through swift, broad-based spending reductions.

The decision to reduce spending, as opposed to increase taxes, was made with recognition for the negative effect raising taxes could have on the economy (Alberta, 1994: 256).<sup>4</sup> It was also made with consideration for the source of Alberta's fiscal challenges, as summarized by Alberta Treasurer Jim Dinning:

For years, governments in Canada have been living beyond their means. Governments have put off paying bills until tomorrow in the mistaken belief that revenue will catch up to spending. Overspending, not lack of revenue, is the problem. And every delay in fixing this problem increases the amount of debt and makes the solution more painful.  
(Dinning, 1995: 7)

To reduce spending, the Klein government focused on identifying waste, prioritizing spending, and restructuring government while improving efficiency in delivering programs and

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4 This assertion is supported by a large body of research that shows that spending reductions are a less economically damaging way to control deficits than tax increases. For example, see Alesina et al. (2014).

services to Albertans. The government prioritized speed, requiring each department and agency to “justify its existence” and set out clear objectives over a three-year horizon including a plan for spending reductions, and report quarterly on its progress (Klein, 1994). This requirement for rapid spending reductions forced all ministries to fundamentally rethink their business models rather than attempting to reduce spending gradually over time through incremental steps.

These reforms quickly reduced the size of Alberta's government. Public sector employment shrank by 14.1 percent from 1993 to 1997 (Veldhuis, et al.: 2011),<sup>5</sup> compensation was reduced for remaining provincial government employees, and many services were contracted to nongovernmental agencies. As a share of the economy, the size of government was reduced from 21.2 percent (1992/93) to 13.1 percent by end of the Klein reform period in 1998/99.<sup>6</sup>

As a result, spending was reduced across ministries, including social services, health, and education which collectively accounted for nearly two-thirds of total program spending (1992/93). In Klein's first budget (1993/94) nominal program spending was cut by \$757 million, or 4.7 percent. The following year (1994/95) program spending was reduced further by nearly \$1.7 billion, or 10.7 percent. In 1995/96 it was reduced by \$1.1 billion or 7.9 percent. Overall, the Klein government reduced spending by 21.6 percent (\$3.5 billion) over three budgets.

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5 Public-sector employment is broadly defined and includes both provincial and local government employment as well as positions in universities, hospitals, and school boards.

6 Size of government is measured as total provincial government spending as a percentage of provincial GDP.

During the Klein reforms, real per-person spending shrank dramatically. **Figure 4** shows per-person program spending since 1980/81. The Klein reform period is marked in orange. As shown, per-person program spending was reduced from \$11,040 (1992/93) to \$7,447 (1996/97) following three years of marked spending reductions. That is a reduction of approximately \$3,600 per person.<sup>7</sup>

As a result of a marked reduction in spending, the government balanced the budget in 1994/95, two years earlier than originally planned.<sup>8</sup>

<sup>7</sup> It is again worth noting that in the later years of Klein, per-person program spending began to increase following an increase in natural resource revenues. By the last year of Klein’s tenure per-person spending reached \$11,100 (2006/07).

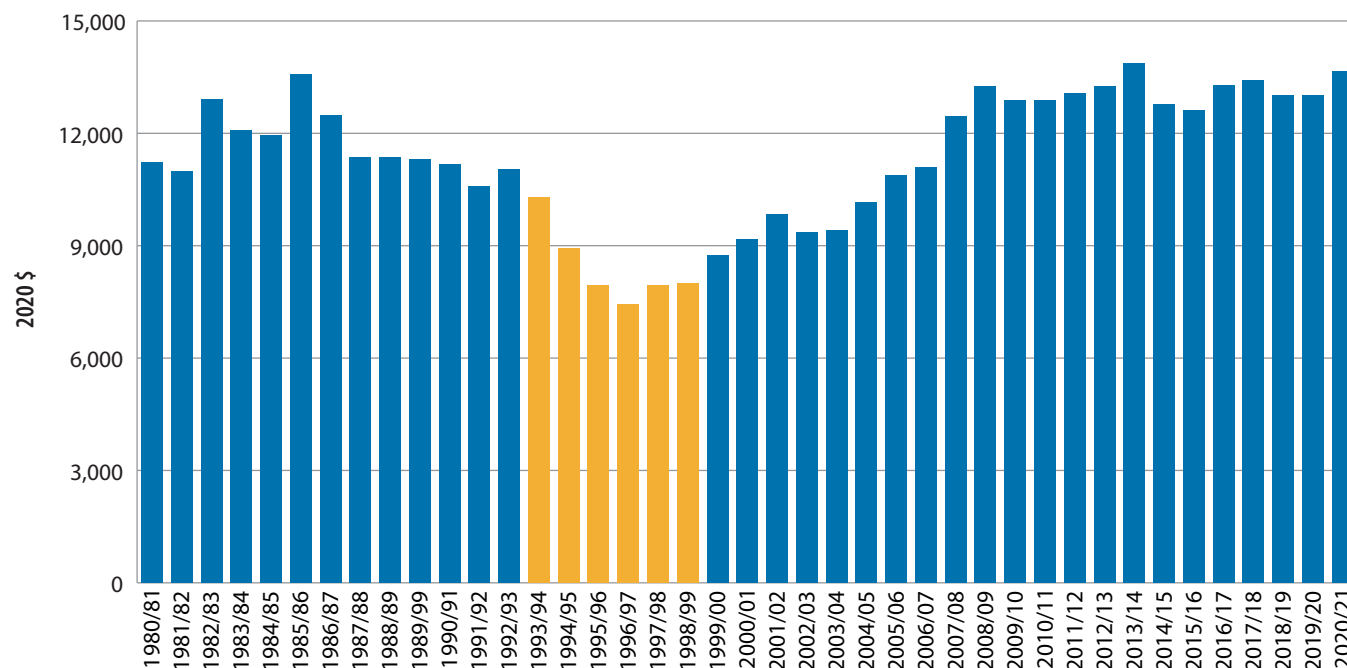
<sup>8</sup> Many opponents of spending reductions warned that such action would have a negative effect on the economy. On the contrary, however, spending

One important dimension of the Klein deficit reduction effort was that it was focused entirely on spending reductions instead of tax rate increases, or even rapid revenue growth. In fact, the fiscal consolidation was successful despite reductions in federal transfers in the mid-1990s.<sup>9</sup>

reform paved the way for tax cuts and, correspondingly, strong economic performance over the Klein-era. For more information, see Clemens et al. (2017).

<sup>9</sup> As was the case in other provinces, the reduction in federal transfers during this period contributed to Alberta’s need for, and decision to, implement significant and swift spending reductions. In addition, such reform—specifically, the replacement of Canada Assistance Plan (CAP) and the Established Program Financing (EPF) with a new block transfer known as the Canada Social Transfer (renamed the Canada Health and Social Transfer)—allowed for potential innovation and improved performance through experimentation based on the increased flexibility and autonomy accorded by the federal government. For more information, see Veldhuis et al. (2011).

**Figure 4: Per-Person Program Spending, 1980/81 to 2020/21**



Note: Data are not fully comparable due mainly to various changes to accounting standards. See note to figure 1 for major breaks in the series.

Sources: Canada, 2000, 2020; Alberta, 2020b; Statistics Canada, 2020b, 2020c; BMO Economics, 2020; calculations by authors.



Further, the Klein government reached a balanced budget despite relatively low natural resource revenues compared to pre-reform and in the years following reform. Returning to figure 2, natural resource revenue comprised between 18 to 21 percent of all government revenues over the three years of marked spending reductions, which was markedly lower than prior and immediately succeeding years. It remained relatively flat during the entire reform period.

Put simply, the Klein government was able to quickly balance the budget without reliance on growing natural resource revenues. In fact, the Klein consolidation was achieved with no revenue growth whatsoever, as real (inflation-adjusted) revenue actually declined by less than 1 percent during the reform era.

The fiscal outcomes ushered in by the Klein reform era would significantly outlive the reform period itself. The Klein era reforms started a string of budgetary surpluses that would last for 14 years (figure 1). As a result, net debt (figure 3) was reduced. In fact, the province achieved “debt free” status in 2000/01 and enjoyed a net financial asset position for many years following. Specifically, net debt was reduced from \$23.8 billion in 1993/94 to a net financial position of \$44.0 billion in 2006/07.

At the same time, a combination of budget surpluses and declining interest rates meant fewer tax dollars were being diverted to paying interest on debt (figure 5). The Klein reform period is marked in orange. Specifically, the province went from spending nearly 11 percent of all government revenue on debt-interest payments at its peak (1995/96) to spending effectively nothing on debt-interest payments (2006/07). In other words, after balancing the budget and paying down debt, the province could focus its

spending on delivering programs and services to Albertans rather than servicing its debt. Figure 5 illustrates the evolution of debt interest payments over time.

In sum, the Klein government quickly and successfully balanced the budget and reduced net debt—despite relatively low natural resource revenues—through marked spending reductions. These reforms set the stage for nearly a decade of fiscal stability in the province.

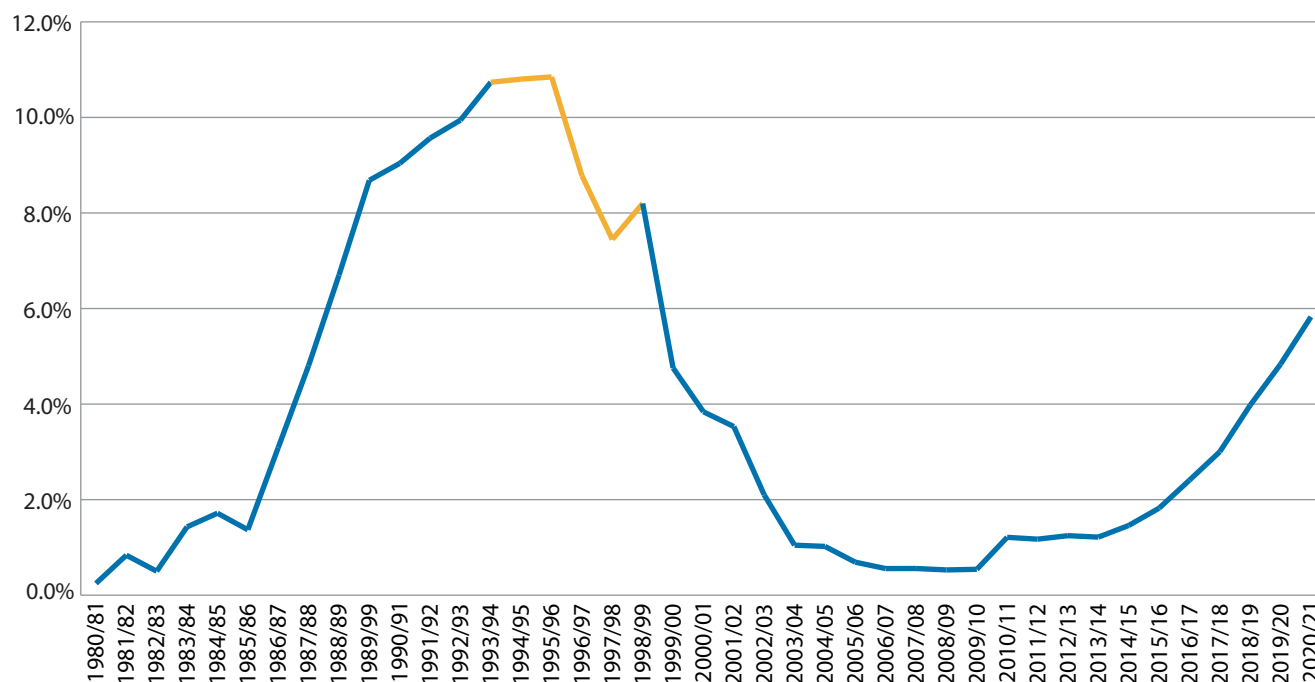
### Fiscal Policy Approach Since 2015/16

As we have seen, the fiscal circumstances leading up to the pre-Klein fiscal challenges and those facing Alberta today are remarkably similar. The policy response, however, has been markedly different. To date, Alberta governments of various political stripes have taken a consistently passive approach to deficit control or reduction since large deficits emerged in 2015/16.

More specifically, since the collapse in oil prices in 2014/15, real program spending has grown by 15.6 percent, while real revenues have declined by 23.6 percent. This trend is not simply a result of the pandemic and related recession. From 2014/15 to 2019/20, prior to the full effect of the COVID shock, real program spending increased by 8.9 percent, while real revenues declined by 13.7 percent.

As in the late 1980s and early 1990s, the rate of spending growth was not reduced to reflect lower revenues. Instead, while Edmonton has generally slowed the pace of spending growth in the period since 2008/09 it has not taken active action to reduce spending to bring it closer in line with the reality of significantly reduced revenues in the province. As described above, the result has been continuous large budget deficits, rapid debt accumulation, and as shown in figure 5,

Figure 5: Interest Payments as a Share of Total Revenue, 1980/81 to 2020/21



Sources: Canada, 2000, 2020; Alberta, 2020b; calculations by authors.

increased debt-interest payments. In 2020/21, debt-interest payments are projected to consume nearly six percent of all government revenue.

In short, Alberta’s policy approach to the large deficits that have emerged since 2015/16 has been similar to that of Alberta’s governments in the late 1980s and early 1990s. No government has yet undertaken an ambitious deficit reduction strategy. We will now turn to examine lessons from the Klein era that may be applicable today, if and when a government in Edmonton chooses to embark upon a more active approach to deficit reduction.

## Lessons from the 1990s

Alberta is still coping with the impact of the COVID-19 pandemic and recession. Hopefully, however, the crisis will soon be over, at which

point the Kenney government may wish to revisit its campaign promise to eliminate the deficit and put the province’s finances back on the path to sustainability. If it chooses to move forward with a concerted effort for fiscal consolidation, the government can draw lessons from the Klein reform era. Some of these include:

- **Don’t hope, act.** A key feature of the Klein reforms was that they relied on factors within the government’s control (specifically, program spending) to eliminate the deficit rather than hoping for help from external factors. Most importantly, the Klein effort at deficit reduction did not rely on or benefit from significant increases in natural resource revenues.

- **Think broadly, target as needed.** The Klein government ordered each ministry to justify their existence and achieve significant, rapid cuts. This forced them to re-examine their

business models entirely. The composition of spending reductions would undoubtedly look different today, however, the same principal should be applied: assess the efficiency and efficacy of all areas of current spending and target as appropriate.

■ **Go fast, not slow.** The Klein government did not take a gradualist approach to spending and deficit reduction. It reduced program spending by 21.6 percent over three budgets and eliminated the deficit in two years.

■ **Interest costs matter.** As the Klein reforms were implemented and the government began running surpluses, coinciding with a period of falling interest rates, debt-interest payments as a share of revenue fell from a high of approximately 11 percent to nearly zero. Currently, Alberta is headed in the other direction, having quickly moved from almost zero to six percent. By moving to balance quickly, Alberta's government today can help slow or can stop the rise of interest costs.

### Conclusion

Alberta is repeating many of the fiscal mistakes of the pre-Klein era (1980/81 to 1992/93), including over-reliance on natural resource revenues and high spending, which led to persistent deficits and rapid debt accumulation when resource revenues dried up. The Klein government's reforms in the mid-1990s can offer important lessons on how we can confront similar challenges today. Specifically, swift spending reductions should be considered as a means to quickly balance the budget, reduce Alberta's debt accumulation and restore stability to the provincial finances. To avoid repeating the cycle, Alberta would do well to find ways to control its spending and reduce its over-reliance on natural resource revenues over the long term.

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