

The Electoral Temptations of Natural Resource Revenues:
Towards a Theory on the Origins of Sovereign Wealth Funds in Canada

by

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Abstract

This thesis works towards establishing a theory on the origins of sovereign wealth funds in Canada and argues that despite claims that they are inter-generational savings vehicles, in practice these funds are a means to create near- and medium-term fiscal flexibility that benefits the electoral prospects of incumbent governments. In an era of global tax competition, electoral resistance to taxation, and growing demographic pressures on public expenditures, governments have turned to sovereign wealth funds to generate much needed revenues while avoiding tax increases more visible to their electorates. Alberta is this thesis' primary case study and illustrates the expected behaviour of sovereign wealth funds in Canada in the absence of strong governance structures, defined contribution rules, clearly articulated fund goals and strong fund connection to voters - four key elements present in widely recognized model funds like Norway and Alaska.

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Chapter 1: Introduction

The question of who is entitled to a nation's natural resource wealth is a foundational political question, moral issue and public policy challenge that political actors must grapple with. If one accepts that natural resource wealth belongs to all citizens, then how should that wealth be redistributed? To which generation does that wealth belong? Among political leaders who have taken a position on the matter, including provincial premiers in Canada, there is a broad rhetorical consensus that non-renewable resource wealth belongs not only to those alive today, but to future generations who will have to bear the economic, environmental and social consequences of resource depletion or obsolescence.

Once political leaders have established a normative perspective on non-renewable resource wealth belonging to future generations, they must then turn to the matter of choosing fiscal policies to capture that wealth and carry it forward into the future. They must weigh a variety of options including whether to invest in education and infrastructure to diversify the economy, pay down sovereign debt, provide royalties directly to citizens so that families can build generational wealth, or establish a sovereign wealth fund (SWF) to save and maximize future fiscal flexibility to make savings directly available to future generations. These decisions present partisan political actors with a difficult choice of whether or not to delay spending that could be politically beneficial in the near-term.

The question of how to utilize resource revenues is especially vexing for Canadian politicians who regularly face the judgement of voters. Democratic and nondemocratic governments face vastly different pressures when considering how to

transfer resource wealth. Authoritarian regimes often have greater flexibility in delaying consumption as the electoral pressures that face democratic governments are not as fierce. To date, authoritarian regimes have a record of creating more SWFs than democratic states. Existing evidence also suggests that, with few exceptions, authoritarian states have amassed larger funds than their democratic counterparts.

Of primary interest to this thesis is not why democratic governments create fewer SWFs than their nondemocratic peers, but rather, given the pressures facing provincial governments in Canada, why do they choose to adopt SWFs at all? And when these funds are created, what purpose do they serve? Investing in physical infrastructure or education programs in the near term could have the effect of diversifying an economy in the long run and strengthening the financial outlook for future generations while satisfying a government's current voters. Often, these investments are focused on near-term electoral gain rather than true economic diversification, but they seem to fit the "investing in the future" narrative that placates electorates more concerned with their personal financial futures. Democratic governments have also gained electoral traction by promising to pay down government debt so as not to burden future generations. This, in the view of many economists, is a form of savings that would indeed benefit future generations. So what explains the origins of SWFs in Canadian provinces? Why have these governments forgone the electoral benefits of spending today in favor of saving for tomorrow? And why have SWFs in Alberta, British Columbia, Northwest Territories and Saskatchewan failed to fulfil their initial promise? This thesis seeks to answer these questions.

The main contention of this thesis is that SWFs in Canada have been created

in response to both tax rate competition in a global race to the bottom since the rise of the neoliberal era, and a correlated increase in electoral opposition to tax increases at a time of dramatic demographic change. As natural resource extraction is one of the few revenue generating vehicles not directly exposed to foreign relocation, SWFs are attractive options for governments. They allow governments to challenge the immediate perception that they are 'taxing and spending', a charge that could prove electorally costly. Coupled with the emerging pressures of an aging population, provincial governments have turned to SWFs as an alternate means of revenue generation. In this context, this thesis will argue that these funds do not function as true savings vehicles. Instead, governments utilize these large pools of capital to finance welfare spending and tax reductions in an effort to buttress their electoral prospects. Provincial governments have frequently been unable to resist the lure of such riches at their disposal and have short-changed future generations.

The thesis will then draw upon evidence of increasing fiscal pressure facing Canada to emerging demographic changes, in particular an aging population, which is stressing public finances. Then, using historical tax data from the OECD countries, this thesis will argue that the emergence of SWFs in the industrialized world is a response to the decline in corporate income tax rates in the wake of the Thatcher/Reagan era of globalization (1980-present). Though there has been a corresponding decline in individual income tax rates, the thesis will focus on corporate rates to illustrate the phenomenon due to the complexities of comparing rates in progressive tax systems.

The theory on the origins of SWFs in Canada constitutes the original contribution this thesis makes to the literature on SWFs. Furthermore, it is one of the

few theories on the origins of the funds that addresses the phenomenon of funds being created at the sub-national level. This thesis will argue that there is a disconnect between Canadian SWF mandates and how they have functioned in practice. The evidence is clear that provincial governments frequently attempt to raid these funds or redirect their investment efforts to generate near term economic activity or dole out benefits to voters. Though the design of many funds has prevented governments from doing this, as was the case in Alaska when a plebiscite denied the government the right to raid the fund, democratically elected governments face great incentives, including electoral gain, to use SWFs for purposes other than their frequently stated purpose of saving for future generations.

Throughout this thesis, analysis is conducted from an institutional perspective. Though governments often behave in accordance with their perceptions of their electorates interests, voters themselves are not uniformly rational and a clear cognitive dissonance exists within Canadian electorates. The majority of voters simultaneously demand improved services and reduced tax rates, a position that is unquestionably irrational. Though this voter behavior is difficult to decipher, it can have an impact institutional behaviour, particularly in the case of publically visible taxes.

To support the foundational arguments on the origins of SWFs in Canada and their operation, this thesis will use Alberta as a case study. Though it is an outlier in terms of creation date, it is in fact a leading indicator of originating motives and how we would expect a SWF to function in Canada. The thesis will then examine five Canadian provinces and their adoption or consideration of SWFs. This exploration will provide both context for the lessons for Canada as well as additional supporting

evidence for the overarching theoretical perspective being developed within these pages. Coupled with the Norwegian and Alaskan funds, Alberta will serve as the basis of the key lessons for these other Canadian funds and those that could emerge in the future.

Defining Sovereign Wealth Funds

Broad agreement on the definition of SWFs has been elusive since Andrew Rozanov first coined the term in 2005. Governments often control pools of capital which they invest in markets for various purposes, including: pensions; insurance schemes; delayed investment; known and unforeseen liabilities; rainy day reserves; foreign aid and development; and various forms of economic stabilization. Monetary policy planners also manage significant foreign currency reserves and frequently invest these funds abroad to manage the money supply. These holdings exist at all levels of government, as well as arms-length independent governmental organizations such as public pension funds and central banks. Competing definitions of SWFs include various combinations of these purpose-driven vehicles, but there is no commonly accepted definition of SWFs that is applied consistently across the academic and professional literature.

The IMF International Working Group on Sovereign Wealth Funds, the body that arguably represents the form of consensus by national governments on the subject of the funds, which led the drafting of the Santiago Principles that serve as a voluntary rule set that guides the operation of SWFs, defines them as:

'special purpose investment funds or arrangements, owned by the general

government. Created by the general government for macroeconomic purposes, sovereign wealth funds hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The sovereign wealth funds are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports' (Al-Hassan, 2013, 3)

Though this definition reflects the scope of revenue sources SWFs are established with, it limits the definition to funds created by 'the general government for macroeconomic purposes'. This thesis will demonstrate that these funds are in fact often created at the subnational level and are frequently created for reasons other than macroeconomic planning. Beck and Fidora (2009, 354) note that this definition is "loosely defined as public investment vehicles that manage part of the (foreign assets) of national states". This definition is so encompassing that it could include the bulk of financial funds that are established by governments, including funds that benefit individuals. Such funds would not, in the assessment of this thesis, be considered sovereign as the flexibility of government to exercise discretion in the management and disbursement of those funds is severely limited. The absence of precision in the IMF construction illustrates both the challenge of reaching a meaningful definition and applying the definition for the purpose of academic inquiry.

Bortolotti and Miracky (2009) are closer to a definition that is suited to the purpose of this enquiry. They suggest that a SWF is an investment vehicle that meets five criteria:

- 1. It is owned directly by a sovereign government.*
- 2. It is managed independently of other state financial institutions.*
- 3. It does not have predominant explicit pension obligations.*
- 4. It invests in a diverse set of financial asset classes in pursuit of commercial returns.*
- 5. It has made a significant proportion of its publicly-reported investments internationally.*

Though this definition is more precise in articulating the concept of a sovereign government, it does not explicitly address the matter of subnational governments which are frequently excluded for the analysis of funds. This is a significant point of contention within the existing literature. Lenihan (2014, 230) argues that “subnational units within a federal system are often treated as ‘sovereigns’ under customary international law when acting in a commercial capacity, regardless of the motivation behind a particular commercial action”. However, a number of authors, including Bortolotti and Miracky, challenge this assertion.

For the purpose of this thesis, subnational governments are considered sovereign as they have functioned in the realm of international finance without the oversight or approval of the national government. SWFs should be considered unique from pension funds because they have the capacity to act solely in the long-term without any obligations. The two subnational cases that receive the most attention within these pages, Alaska and Alberta, are not only independent in the operations of their funds within a federal state, they are indicative of the type of competition that

occurs between jurisdictions within a federal state and are early examples of how one would expect such funds to behave within such a competitive environment. Further buttressing the case for their inclusion is the fact that both jurisdictions are members of the International Forum of Sovereign Wealth Funds (IFSWF) and recognized as sovereign wealth funds by leading institutions attempting to govern and monitor funds.

For the purposes of this thesis, the definition developed by the Sovereign Wealth Fund Institute (2017) will be used. The Institute's definition encompasses both subnational funds and is instructive in narrowing the nature of activity of such funds to those areas that are within the considerable discretion of sovereign jurisdictions.

A Sovereign Wealth Fund (SWF) is a state-owned investment fund or entity that is commonly established from balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, government transfer payments, fiscal surpluses, and/or receipts resulting from resources exports. The definition of sovereign wealth fund excludes, among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds (funded by employee/employer contributions), or assets managed for the benefit of individuals.

Funds under this definition will serve to inform the analysis of the global tax race to the bottom. Though the tax analysis focuses on the OECD, this thesis argues that

rates among its member countries have vast influence on global tax rates as the nations comprising the organization account for nearly 50% of global GDP.

Applying the Sovereign Wealth Fund Institute definition, there are four funds in Canada currently in operation: the Prosperity Fund in British Columbia, the Alberta Saving Heritage Trust Fund, the Quebec Generations Fund, and the Northwest Territories Heritage Fund. The definition also encompasses the defunct Saskatchewan Heritage Fund that was rolled up into that province's general revenues fund in the 1980s.

Overview of Sovereign Wealth Funds

There are two contradictory trends at work in the intersection between states and markets: privatization and increased investments in private markets. Since 1977, governments have earned more than US\$3 trillion dollars¹ from the sale of state owned assets (Megginson & Fotak, 2015, 734). This trend aligns with neoliberal economic theory that posits state-owned enterprises perform more poorly than those managed by the private sector. The sale of such assets can also be seen as a mechanism to offset reductions in tax revenues with the aim of balancing budgets. Counter to the trend of privatization, governments are increasingly active investors in global markets, holding US\$12.338 trillion in foreign exchange reserves at the end of 2012 (Megginson & Fotak, 735).

The decade of the 2000s saw dramatic growth in these foreign exchange reserve holdings in the wake of the Asian Financial Crisis and rise in the export

¹ Currency in this thesis is in Canadian dollars unless otherwise stated

strength of Southeast Asian nations, particularly China. Several scholars have highlighted the increase of these holdings as propelling an increase in the number of SWFs created during that period (Megginson & Fotak, 742). Though an increase in foreign exchange reserves is not a new explanation, the availability of this capital is undoubtedly part of the explanation for the adoption of the sovereign wealth fund model. A similar condition of sudden and dramatic balance of payments increases created the conditions for the uptake of the first modern SWFs in the Middle East in the middle half of the 20th Century.

Most scholars point to Kuwait as the first nation to have established a SWF in 1953 in the wake of dramatic oil revenue surpluses. However, the phenomenon arguably dates back to Texas nearly a century earlier, in 1854, where a fund based on surplus oil revenues was formed to finance public education. Today there are more than 80 SWFs with the majority of capital concentrated in the Middle East (oil) and Asia (trade surpluses). Only 3% of SWF holdings are managed by governments in the Americas. 59% of these funds are financed by oil and gas related revenues with other non-hydrocarbon commodities such as copper, diamonds, and phosphates, as well as non-commodity trade and budget surpluses account for the remainder of financing sources.

SWFs play an increasingly important role in the global financial system. Though a mere fraction of the US\$223 trillion in global wealth, the more than US\$8 trillion SWF influence on markets is projected to grow significantly over the next decade (Megginson & Fotak, 2015). Concerns over the potential for the funds to be used as a direct tool of political interference in foreign states has somewhat subsided since the 2008 financial crisis, when sovereign wealth funds injected much needed

liquidity into struggling American and European markets, but fear of a new mercantilist era lingers. In 2008, for example, a Chinese SWF bought US\$300 million in Costa Rican sovereign bonds. Costa Rica subsequently ended diplomatic relations with Taiwan and pivoted towards the mainland (Anderlini, 2008).

Given the potential implications of SWFs they have increased in public and academic profile in recent years. The bulk of the literature finds SWFs to be non-disruptive market actors. In fact, many authors have posited that such vehicles could strengthen the liberal order and help stabilize markets in the long-run by providing a significant injection of patient capital. SWFs are also potential activist investors who can opt to avoid holding equities or bonds in firms and countries that are deemed environmentally or socially wayward. The world's largest fund, the Norwegian Pension Fund Global, has divested itself of corporations that do not conform with their ethical guidelines.

Much of the existing scholarship accepts the standard economic theory on the utility of SWFs without great consideration. Though risk of political interference is frequently explored in the literature, political motivation in the design of SWFs is rarely considered as a driving force in their establishment. The existing literature on SWFs instead consists of three main areas of inquiry: fund objectives, governance, and investment practices.

Fund Objectives

The scholarship focuses a great deal of attention of the purpose of SWFs. The two primary objectives are economic stabilization and/or saving for the future. These aims can be achieved through a variety of fund objectives which include: investment

in domestic economic diversification; hedging against currency and commodity price fluctuations; and long-term investments for savings purposes.

One of the primary design flaws identified in the literature is the melding of stabilization and long-term fiscal goals. This practice is problematic as each aim requires vastly different governance rules. Davis et al (2001, 15) argue that resource funds “should be integrated within the budget process to maintain a unified control of fiscal policy and to avoid problems in expenditure coordination”. He also notes that funds could be managed independently but in such cases monies to the fund should be approved through the budget process. This approach may work for stabilization funds where liquidity should be readily available to smooth out the impact of commodity price fluctuations, but this could have deleterious effects on savings funds. When the purpose of a fund is saving for the future, integrating such a fund within the normal fiscal process of a government creates considerably flexibility for spending for the purpose of electoral gain. This particular possibility is a core focus of inquiry of this thesis as it goes to the heart of fund design and operations. This feature was long present in the Alberta Heritage Fund which allowed elected political actors to regularly raid the fund for near-term economic gains.

In the context of achieving fund objectives, the literature focuses on the rules for dictating the timing of contributions or withdrawals from funds are difficult to establish (Davis, 2001). Barring constitutional constraints governing funds, rules are difficult to enforce as governments have considerable latitude in manipulating fund rules. Even in the case of constitutionally enshrined rules, governments have a wide array of fiscal options at their disposal which could be utilized in an effort to trigger conditions under which a withdrawal from a fund is allowed, for example; cutting taxes

to create a structural deficit.

An important question unanswered in the literature is why governments would choose to adopt SWFs over other fiscal and monetary tools states have at their disposal? Davis (2001) also identifies this problem and notes that policy objectives sought through resource funds for the purpose of stabilization, in particular, could be achieved through prudent medium-term fiscal policy via stable expenditure policies. When considering the constraints that governments place on themselves when creating SWFs, and the potential public backlash when breaking those constraints, the question of why democratic governments would adopt such is unanswered in the existing literature.

Governance

Governance, including transparency and the political motivations behind the funds investment practices, are of great interest to academics researching SWFs. The potential for political capture and the use of such funds for the purpose of statecraft is a topic that places funds in the context of great power debates. In this light, a great deal of the literature focuses on the potential national security implications of SWFs, with a focus on the motivations of non-democratic Gulf states and China's vast fund holdings.

In an effort to constrain the potential use of SWFs, the international community, through the International Monetary Fund, garnered international support for a ruleset that would govern their investment practices. Though voluntary, the 2008 Santiago Principles, shepherd by the IMF, established voluntary constraints on fund activity. The fact that the adopted rule set was not binding is indicative of the potential

power of these funds and broad unwillingness of states to meaningfully limit their sovereign discretion over the operation of such funds. Though this alone does not suggest that such funds would be used for nefarious purposes, it does indicate that governments are acutely aware of the potential power of these instruments and are unwilling to limit their potential future uses. There is no reason to believe that this desire to retain the right to use the funds for political purposes abroad does not extend to domestic considerations.

What is clear is that most countries have minimal controls that keep partisan actors from influencing the operations of SWFs or changing the rules that govern them. This is a central concern as it pertains to the ability of funds to meet their long-term objectives. Bernstein (2013, 220) notes that:

“sovereign wealth funds with greater involvement of political leaders in the management process are associated with investment strategies that seem to favor short-term economic policy goals in their respective countries at the expense of longer-term maximization of returns”

This phenomenon not only threatens fund objectives but has the potential to disrupt international markets. However, the literature broadly accepts that democratic states establish more transparent funds as “democracy promotes [SWF] institutionalization by its need for strong rule of law, voters trying to constrain opportunistic behaviors of politicians, and the free flow of information” (Wang & Quan, 2016, 383). This thesis challenges the extent to which voters constrain opportunistic behaviours in the operation of SWFs but agrees that the free flow of information in democratic states

likely has a positive effect on the institutionalization of funds, particularly around the willingness of governments to make withdrawals on the principal of existing funds.

Investment Practices

SWF's behaviour as investors is of great interest to the financial and legal literature. The implications of SWF managers serving as directors on the boards of private corporations, the stability of their investments, their investment decision practices, and implications for firms are all subjects of inquiry. The core question is whether states will act as profit maximizers or do other aims impact their decisions as investors?

The Literature on Fund Origins

Though unquestionably intriguing and influential financial vehicles, there is little research on the origins of SWFs. Monk (2010, 3) notes that there is "no accepted explanation of why countries set-up [SWFs] and when they do". The rationales for the creation of SWFs most commonly cited in the literature are stabilization of volatile resource revenues and saving non-renewable resource revenues for future generations. However, these aims are only rarely borne out in their operations.

The most apparent distinction on origins is between democratic and nondemocratic regimes. Bortolotti, et al (2014, 6), note that only four funds are from "western-style democracies" - Australia, Ireland, New Zealand and Norway.² There is some consensus surrounding the notion that democratic states face strong political

² This assessment does not consider sub-national funds

incentives to spend natural resource revenues within the fiscal year in which they are received. These incentives include buttressing support for the incumbent government through social spending or tax reductions and arguably include a wariness that saving such resources could benefit future opposition governments, delaying a potential return to power.

Van den Bremer, et al (2016, 114), articulate the generally accepted rationale for the creation of SWFs, which is “to smooth consumption of oil income across generations because oil reserves are finite and asset prices are volatile”. Though this is the most widely accepted theory, the conception is challenged by those who argue that their creation is better situated within statecraft and a nation's desire for political and economic autonomy. Another, more controversial theory is that SWFs are fiscal fads (Chwieroth, 2014).

Balin (2008, 4) identifies four principal reasons for sovereign wealth fund creation which reflect the classic normative purpose of SWFs within the literature:

1. *For the intergenerational transfer of wealth*
2. *To diversify a state's income to guard against shocks to comparative advantage*
3. *To increase return on assets held by a country's central bank reserves*
4. *To hedge against dollar-denominated reserve holdings*

This thesis challenges the notion that investments made by central banks for the purpose of currency stabilization, particularly independent banks in advanced economies, should be included in definition of SWFs as elected officials usually lack

formal operational control over monetary policy. However, this thesis acknowledges the impact of other factors on their creation.

Stabilization

Beck and Fidora (2009, 354) assert that the main driver of SWF adoption has “been linked to the accumulation of sizable foreign exchange reserves by emerging market economies”. They argue that in the wake of the 2008 financial crisis, SWFs should continue to grow as the conditions for the accumulation of surplus foreign exchange reserves remain largely unchanged. The role of these funds in mitigating the impact of ‘Dutch Disease’, which Bortolotti, et al (2015 ,8) describe as “an overheating of the local economy that could hurt the development of other, non-commodity, sectors”, is particularly important. This mitigation is achieved by investing currency amassed through significant trade surpluses abroad which prevents those monies from driving up inflation domestically.

Though funds continue to emerge, a substantial recovery in commodity prices has not been realized. Their assertion that surplus foreign exchange reserves is the driving force behind the creation of these funds does little to explain the adoption of such funds where these reserves are not present.

Davis (2001, 2) argues that funds do have a purpose in countries where there are limitations on the government’s ability to borrow. Funds also have the potential to constrain spending during commodity price booms and prevent substantial increases in social spending. The notion that SWFs could act as a constraint on government fiscal policy would be dependent on those funds being insulated from political interference with withdrawal triggers outside the influence of the state. These features

have been infrequently present in fund design outside model states like Norway and Alaska.

Saving for the Future

The primary motivation behind the most of the world's leading SWFs is saving for the future (Bishop, 2015). The moral proposition for such an endeavour is rooted in the notion that non-renewable resource wealth belongs not only to today's citizens but also to generations to come. As Bernstein (2013, 220) observes, "their investment charters usually state that the fund seeks to maximize financial returns for the benefit of long-term public policies". These funds are frequently named with such aims in mind, 'future fund', 'generations fund', 'heritage fund', etc.

Statecraft and Autonomy

Lenihan (2014, 243), rightly notes that SWFs represent more than the state as a passive institutional investor, they also present an opportunity to increase the "economic capabilities of the state". Amassing such large pools of mobile capital could allow states to exercise significant power over other nations by meddling in their markets. Conversely, Monk (2010, 1) argues that SWFs can serve as defensive tools that could allow states to "preserve local autonomy and state sovereignty by harnessing the power of finance". Both possibilities have garnered a great deal of attention within academia and international financial institutions.

Though the rise of SWFs is a relatively recent occurrence, the involvement of states in markets is not new. States have long held significant positions in markets through pension, insurance and other funds designed to meet fiduciary

responsibilities. Though many scholars note that states are taking a greater role in financial markets through SWFs, there is no exceptionally compelling reason to believe such behaviour will change within the confines of sovereign wealth funds.

As previously discussed, there is little evidence, outside of a few transactions involving China and ethical investment policies of a handful of investment boards, that SWFs have been used as a tool of statecraft. Fears over a new mercantilism were further allayed when funds were used to inject much needed liquidity into struggling markets during the 2008 financial crisis (Megginson & Fokat, 2015, 741)³. The 2008 case furthers Linihan's (2014) observation that SWFs may, in the long run, enhance independence among nations without being disruptive. The increasingly interwoven system of global markets may in fact be driving states into greater co-dependence. If this is the case, states would then be more inclined to make investments with such considerations in mind.

A Fiscal Fad

Chwioroth (2014) argues that the rise of SWFs represents a fashionable trend in global finance that is mimicked by governments as they grapple with the uncertainties of a resource-based economy. Though the awareness of such policy tools may have played a role in their adoption, reducing their existence to a matter of fiscal window dressing discounts considerable evidence pertaining to the intent of political actors in the creation of funds. If Chwioroth's theory is correct, one would have expected to see continued fund creation throughout all economic conditions,

³ In 2008, Gulf Sovereign Wealth Fund purchased more than \$60 billion worth of stock in American and European banks (Bortolotti, 2015. 8).

though this is not the case. In the wake of the 2008 financial crisis there was a prolonged period in which there were no funds created globally (see graph 1).

Timing of Fund Adoption

Within the confines of the main theories on the subject, there are various attempts to explain the timing of SWF adoption. Resource revenue windfalls, the Asian Financial Crisis and the 2008 Great Recession have all been cited as triggering events that drove increased adoption of funds.

Monk (2011) contends that there is academic consensus that the 1997 Asian Financial Crisis was a catalyst that prompted states to establish SWFs in order to insulate themselves from changes in demand for international reserves. More broadly, Monk observes that many emerging market economies opted to self-insure rather than rely on multinational development banks in times of crisis. A confounding factor driving origins of these funds is exchange rate volatility and a desire of governments to hedge against this potential vulnerability. Though this may have been a consideration in the development of some funds, it goes to this thesis's larger argument about the use of SWFs as near-term political tools of political convenience, and not a means of saving for future generations as most of these funds are billed. Further, if Monk's assertions are correct, then why has there not been a broader adoption of SWFs?

The second most frequently cited force in their creation is the high price of oil since the turn of the century, according to Megginson & Fotak (2015). Of 26 funds created since 2008, they identify the timing correlates with the discovery of a new natural resource or the reorganization of existing policies related to the territory's

resource base (736). The sudden increase in natural resource wealth is clearly a factor in the timing of fund adoption, though the presence of these revenues alone is not a sufficient answer as it does not address political choice. For example, why did Norway choose to divert North Sea oil revenues to a SWF when the United Kingdom did not?

Gaps in the Origins Literature: Electoral Motivation and Sub-national Funds

Lenihan (2014, 232) argues that “it is somewhat difficult to generalise about the composition and nature of countries with sovereign wealth funds”. This is true when placing SWFs in the context of a global financial actor. It is difficult to discern distinctions between those countries at the top of the international order which have adopted funds and those countries with less global influence. However, there is one political axiom upon which an understanding of the origins of SWFs can be built - the desire of governments to retain power.

The utility of SWFs to governments in the retention of domestic power is under-examined within the existing literature. A pool of relatively liquid capital holds the potential to temporarily increase a government's power and favorability among its population with relatively little near-term downside. In the case of Saudi Arabia during the Arab Spring, the government tapped its immense SWF to make financial payments to disaffected members of society to help keep factions opposed to the government from publically voicing dissent. The fund also helped the Saudi's to finance the repression of democratic activists in neighbouring Bahrain (Youngs, 2013). Though democratic governments require more sophisticated means of retaining popular support from their populations, capital from a SWF can finance

redistributive spending and temporarily bolster an economy, both measures which are known to increase support for incumbent governments. However, the literature only addresses the domestic potential of these funds in a cursory fashion.

The gaps in the existing analysis of the origins of SWFs comes from the debate being largely framed in the broader context of globalization. Without examining domestic political pressures facing the policymakers who have fashioned these funds, a complete picture of their origins remains elusive. The literature on the subject of sovereign wealth funds far too often considers the state to be a rational economic actor attempting to maximize returns. This approach ignores non-economic drivers of adoption, particularly voter preferences and the electoral impact of redistributive spending. This omission has prevented a fulsome analysis of incumbent choices in selecting policy tools in response to both economic and non-economic pressures. Though the literature discussed within this chapter is congruent with contemporary economic theory, the existing scholarship fails to incorporate the effect of demographic pressures, international tax competition and the pressures of electoral competition into the debate on the origins of SWFs. It is the aim of this thesis to situate the theory on the origins of SWFs within these pressures and to consider the subject from the perspective of democratic political actors in Canada.

This contention supports a main pillar of this thesis, which is that state economic power sought through SWFs primarily plays a domestic purpose. Though states could use SWFs as a means to exert power and influence over competing states, there is little incentive to embrace such risks when the primary motivation is domestic political stability. In fact, where investments decisions have exposed governments to substantial downside risk, those investments have been made

internally in an effort increase the economic condition of the fund's home state. As such, this thesis argues that the primary motivation behind the origins of SWFs is electoral advantage, not state power for the purposes of international projection, though both objectives share many similar behaviors.

Model Funds

Bortolotti (2014, 7) notes that, "the early pre-1980s stabilization funds often suffered from poor management and from the constant danger of politicians succumbing to the temptation to promote excessive domestic spending". Though the importance of governance structures and fund design has increased in the scholarly and industry literature, few states democratic states have built robust and sustainable SWFs that have achieved their stated aims⁴.

The first national fund to establish strong formal rules that placed real restrictions on potential political interference in fund operations was the Chilean Social and Economic Stabilization Fund in 1985 (7). Since its inception the World Bank has frequently touted the Chilean fund as a model to be used in the development of others as it clearly defines contribution and withdrawal rules. Since its inception, dozens of nations have built funds from which many lessons for other states natural resource management can be drawn, including the prominent case of Norway. However, sub-national SWFs successfully established decades before Chile and Norway designed theirs. Texas, for example, established a public school fund in

⁴ Though beyond the scope of this thesis, non-democratic authoritarian regimes likely have greater fiscal flexibility to delay spending as they do not face serious electoral challenges to their rule. They are also more likely to contemplate long-term factors in policy-making as many of the largest SWFs are controlled by hereditary monarchs and single-party states.

1854 which is now worth more than US\$37 billion. Alaska too is a model fund which has successfully grown for 41 years without significant political interference.

Norway

In 1969, Norway discovered petroleum reserves in the North Sea, leading to the establishment of Statoil, a state-run oil company. The Norwegian SWF, the Government Pension Fund Global, is now worth more than US\$922 Billion and widely recognized as a model fund on measures of governance, transparency and management (SWI, 2017). However, the country's initial oil boom and over reliance on petroleum income did not immediately precipitate good resource management. Classic Dutch Disease emerged in the late 1970s as petrodollars overheated the economy. The country's advanced manufacturing economy was severely damaged as the Labor Party accelerated government spending with oil revenues, greatly reducing Norway's export attractiveness during the 1980s. The economic shock led to several bank failures when prices collapsed (Bernstein, 2013).

Poelzer (2015, 6) points to the significant oil price crash of the late 1980s as the genesis of the fund with the government responding with two clear principles: proceed slowly with oil and gas development; and establish a fund to invest the new wealth. In order to stimulate the recovery of its manufacturing industry and to compete with global tax competition, Norway reduced its corporate tax rate from 50.8% to 28% in 1992, just two years after establishing its sovereign wealth fund.

The Norway Government Pension Fund Global was designed with two primary aims: to promote long-term savings and to protect the economy from the downside of the resource curse. Chambers (2012) notes that the risks from the sudden injection of

revenues from oil exports could “rapidly inflate domestic prices and the exchange rate, decrease international competitiveness, and result in de-industrialization”. The fund is mandated to:

“support long-term considerations in the government’s spending of petroleum revenues, as well as savings to finance pension expenditure under the National Insurance Scheme. Sound long-term management will help ensure that Norway’s petroleum wealth can benefit both current and future generations” (Norway, 2017).

Unique among large SWFs, Norway diverts all oil and gas revenues to their fund. These revenues come from taxes on oil producing firms and dividends from the state-owned oil company. The fund is mandated by the Ministry of Finance with the fund’s operations directly controlled by the Norges Bank, a subsidiary of the country’s central bank. A portion of the returns are directed to support government expenditures but these transfers are carefully pegged to the expected real rate of return (interest minus inflation) of the fund. This position gives Norway a substantially greater percentage of oil revenues than governments in the Americas where the private sector is the primary ownership actor in the development and extraction of petroleum resources.

The Norway Government Pension Fund Global is one of the most independent in the world. Its investment policy is directed by a board of experts who conform to guidelines established by the country’s’ democratically elected legislature and its fund managers are free from political interference with investment decisions

made within the non-partisan and highly independent confines of the country's central bank. As such, Norway has been given the highest ranking of any fund on a combined measure of structure, governance, transparency and responsible investing: 97% (Chambers, et al, 2012).

Today, the Norway's fund plays a significant role in both monetary and fiscal policy by reducing the impact of increasing commodity prices on the value of country's currency and stabilizing its budget (Taylor, et al, 2010). The fund's widely acknowledged role in the country's financial stability unquestionably constrains political actors from changing fund rules to benefit near-term political considerations. This constraint is strengthened by the fund's direct connection to the state's pensions obligations.

It is worth noting that the success of the fund cannot be attributed solely to design and management. Walter Galenson (1986) correctly observes that Norway's model of resource management was possible because it discovered its petroleum riches after the country had become one of the world's most prosperous and stable economies. This circumstance is exceptionally rare and has likely given the government both the fiscal space to delay spending and reduced public appetite for the oil revenues to be spent more rapidly.

Alaska

In 1969, the Government of Alaska was faced with a dramatic increase in revenues due to oil leases in Prudhoe Bay. The state budget of US\$172.8 million received a windfall of more than US\$900 million. The legislature went on a spending spree, investing in infrastructure and social projects highly visible to the state's

citizens. Bishop (2014) argues that this overspending made Alaskans aware of the effects of resource price volatility on welfare spending.

In 1976, eight years after first extraction of oil, Alaska established a SWF by a 2 to 1 margin in a public vote on constitutional amendment that required at least 25% of the royalty revenues from the Bay to be deposited in the Alaska Permanent Fund Corporation. The decision to amend the state's constitution to create the Permanent Fund may be the reason it has been insulated from political raids over the past 40 years, but the choice of ensuring the fund in such an ironclad fashion was one of practicality not foresight. An amendment was necessary because Alaska's constitution of 1959 forbid the establishment of dedicated funds. That amendment is as follows:

At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law (Alaska, 1976)

The first chairman of the Fund, Elmer Rasmuson, states that the goal of the Permanent Fund was “to place part of the one-time oil wealth beyond the reach of day-to-day government spending” (Bishop, 2014, 819). Notably, however, the income produced by the Permanent Fund was not specifically directed and left to the people's

representatives.

The legislature made two key decisions in deciding how the income from the fund would be used. First, it directed that income be directed to protecting the principal, essentially leaving income in the fund and increasing its size over time. Second it determined that citizens should receive a direct dividend from the fund. Then Governor Hammond argued that a direct payment would give “each citizen a personal stake in oil revenue and thus giving Alaskans an incentive to oppose [electorally motivated] spending and budgetary hyper-growth in general” (Bishop, 2014, 824). The decision to make regular universal payments from the fund’s earnings provides considerable explanation for the Permanent Fund’s longevity and protection from political raids. Christopher L. Griffin (2012) argues that the dividend checks the fund distributes annually have come to form part of the state's political community. In 2015, Alaskans each received a record US\$2,072 payout from the Permanent Fund. In fact, Bishop (2014, 830) observes that the disbursement is so popular that protecting it has become a powerful tool of incumbency with government warning that the opposition “wants to take Alaska’s [payments] to pay for more government”.

Of note is that management of the fund rests with a public corporation, though it is controlled by a board appointed by the Governor. The independent corporation is an additional accountability measure that protects the fund from partisan whims. The potential for abuse that could arise due to the Governor’s appointment power is undoubtedly tempered by the stake each Alaskan has in the fund’s management. Due to prudent management and the constitutional protection of the fund’s deposit rules, the Permanent Fund is now valued at more than US\$51 billion and served as a

model for other states looking to establish SWFs (SWF, 2017).

Features that Help Insulate Model Funds from Political Temptation

Despite the success of these funds, it is clear that they are not immune from the political pressures and temptations outlined in these pages. On several occasions in Alaska and Norway, political actors have suggested raiding their SWFs and extracting part of the principal to support near-term expenditure. As recently as 2015, Alaska Governor Bill Walker advocated to use the Permanent Fund to address the state's budget shortfall. However, in all cases of attempted political interference, the fund's designs and strong public opposition has protected them from political leaders who were tempted by their riches. The foundational features of model funds which provide protection from political interference, including those of Alaska and Norway, are:

1. Independent Fund Management

The investment decisions in both Norway and Alaska are free from political interference. Though Norway's model has distanced itself, arguably, in the most independent fashion possible - Alaska's is also well insulated from political interference by being a public corporation. This clear separation between a government's spending powers and the fund's investments protects the funds from being used domestically, which could threaten the long-term purpose of the fund.

2. Defined Contribution and Withdrawal Rules

Consistent contribution rules that cannot be manipulated by governments ensure that funds grow annually. Alaska achieved this through constitutional amendment while

Norway's government directs 100% of its petroleum revenues to their fund. This limits the ability of governments to manipulate the contribution conditions.

Withdrawal rules are also tightly controlled in both jurisdictions to ensure that governments cannot redirect the fund's earning or principal when economic or political conditions shift.

3. Clear and Stable Fund Objectives

A clear purpose constrains the political opportunism inherent with resource wealth revenue by increasing transparency and maximizing the potential of the fund by avoiding competing purposes.

4. Strong Fund Connections to Voters

SWF long-term stability benefits when the fund becomes part of the fabric of a state's political community. In Alaska, the direct payments from fund earnings to residents has achieved this while the connection to pension obligations has strengthened this bond in Norway. These connections between visible public benefit and the funds' success creates a political incentive for voters to pressure their elected politicians to protect the funds.

Conclusion

This chapter has introduced the primary questions this thesis is aiming to answer in developing of a theory on the origins of SWFs in Canada. The questions driving this effort are: why have governments in Canada adopted sovereign wealth funds given the electoral pressures facing them; what purpose do they serve; and what explains the disconnect between Canadian SWF mandates and objectives and

government's apparent inability to adhere to them? To establish the framework for answering these questions, this chapter has discussed the definition that will be used to ground the arguments in this thesis; reviewed the major themes that are currently the focus of SWF scholars; provided an overview of commonly accepted normative objectives SWFs in model funds, and engaged with the main theories on the origins of SWFs within the existing literature.

The chapter also discussed the existing gaps in the literature. To date, funds have largely been analysed in macroeconomic and geopolitical silos that assume states are rational economic actors seeking to maximize utility. This significant gap leaves several critical questions unanswered, including: why SWF mandates are ignored, why funds are frequently raided, and why other means of revenue generation are not utilized? The near total absence of consideration of revenue generation, including the use of such funds for domestic political gain makes cases like that of Alberta particularly difficult to decipher. The next chapter address these gaps in the literature and illustrates the pressures facing advanced democratic states which are causing them to turn to alternative sources of revenue to fund budgetary obligations and improve their electoral prospects. In later chapters, these concepts in the context of model funds including Norway and Alaska, will help provide an explanation for the political behaviour exhibited in the creation and operations of SWFs in Canada. This will be particularly informative with respect to Alberta, which despite being an early adopter of a SWF, has failed to achieve the same level of success as model funds.

Chapter 2: Pressures Driving The Adoption and Operation of Sovereign Wealth Funds in Canada

In their investigation of the impact of petroleum revenues on the government of Newfoundland and Labrador, Reid and Collins (2012, 10) draw upon Terry Lynn Karl's seminal work on the paradox of plenty. This discussion helps set the stage for this thesis' investigation into the pressures driving the creation of SWFs in Canada. Their inquiry is built on Karl's most pressing question in the management of resource wealth, "why have oil exporters apparently been unable to translate their fabulous windfalls into self-sustaining, equitable and stable development paths?". Karl's answer is:

Commodity led growth introduces changes in prevailing notions of property rights, the relative power of interest groups and organizations, and the role and character of the state vis-à-vis the market. These institutional changes subsequently define the revenue basis of the state, especially its tax structure. How these states collect and distribute taxes, in turn create incentives that pervasively influence the organization of political and economic life and shapes government preferences with respect to public policies. In this manner, long-term efficiency in the allocation of resources is either helped or hindered, and the diverse development trajectories of nations are initiated, modified, or sustained (10).

Reid and Collins then go on to note Karl's most important observation, "petro-states are built on what already exists" (11). This is a critical observation that leads this

thesis to examine the pressures facing governments in Canada as they consider whether to adopt a SWF as well as how such a fund should be designed and operated. With the exception of Quebec, all of Canada's SWFs have been adopted or considered during a time of peak resource pricing. Where they have been adopted they have operated in a broader political context where their management decisions have been shaped by political interest groups: primarily the incumbent government.

This thesis argues that the condition that exists in Canada which is driving the consideration and management of SWFs is an emerging crisis in public finances which is driven by rapidly shifting demographics, global tax competition and electoral resistance to taxation. These factors are making it difficult for governments to raise sufficient revenues to fund the services citizens demand. This phenomenon is hindering incumbent political parties ability to increase vote share through increased social spending. This thesis' main contention is that SWFs in Canada are a response to this emerging public finance crisis and serve primarily as vehicles to increase government revenues for near to medium term spending while preventing the need to raise taxes more visible to the voting population.

Other factors cannot be ignored in understanding the timing of SWF creation, including: the discovery, or increased value, of natural resources; fiscal shocks; as well as the increased awareness of SWFs as a public policy tool and the impact of new revenues on the economic life of state and its people, as Karl observes. However, these factors do not constitute the primary motivations for the creation of SWFs in Canada, rather it is the emerging fiscal crisis.

To support the theory of the fiscal crisis driving the adoption and operation of SWFs, this thesis will draw upon a wide variety of domestic and international

evidence. Though the theory is applied to the Canadian context, the thesis will draw upon lessons from the United States and Britain, the two leading nations in the adoption of neoliberal economics and electoral thought. Particularly in the area of electoral resistance to taxation, the United States and Britain have been global leaders. Prominent political consultants who have shepherded winning American presidential and British general election campaigns and have aggressively exported their ideology to other democracies, shaping their political debate further against taxation. These exporters of anti-tax ideology include James Carville, David Axelrod, Alistair Campbell and Stan Greenberg who have collectively advised political campaigns across the ideological spectrum in dozens of countries from Canada to Nigeria.

Demographics

Canada's demographics are shifting rapidly. In 1956, 7.7% of Canadians were 65 or older. By 2056, between 25% and 30% of Canadians will be with the ratio to working aged people being 1:2 (Statistics Canada, 2016). This dramatic shift has already begun to affect the balance sheets of governments in Canada. In 2002, Paul Pierson wrote:

The welfare state now faces a context of essentially permanent austerity. Changes in the global economy, the sharp slowdown in economic growth, the maturation of governmental commitments, and population ageing all generate considerable fiscal stress. There is little reason to expect these pressures to diminish over the next few decades. If anything, they are likely to intensify

(370).

Little did Pierson know that within the decade he was writing there would be a dramatic global recession that would further strain welfare states. As birth rates decline in Canada and people live longer, the country's public finances will face considerable pressure as workforce participation rates decline and demand for social safety programs increases. Health care in particular will face substantial pressure. Already, 60% of all hospital inpatient days are by those over 65 (Brown, 2014, 21). According to the C.D. Howe Institute, Canadian governments face a \$4.2 trillion expenditure liability over the next 50 years with the vast majority of this, \$3.9 trillion, related to health and elder care (Busby et al, 2014). Between 1979 and 2009, Canadian health care spending grew at an average rate of 7%, though since the great recession that figure has declined to 4% (IMF, 2014, 16). Whether that growth rate will remain at 4% is yet to be seen, but even 4% would draw Canada into the liability range predicted by C.D. Howe. Other age related costs such old age security will further taint government's fiscal outlooks across Canada.

In 2008, prior to the financial crisis, the IMF projected that Canada would be in a position to weather the increases imposed on social spending by an aging population. However, the economic slowdown in the wake of the financial crisis, the deficit spending post-recession, and the Trudeau government's decision to run significant deficits, has eliminated the fiscal cushion that Canada once retained and has again exposed itself to long-term structural deficits if taxation levels are not increased (IMF, 2014, 16).

Canada is not alone in this demographic transition. The IMF estimates that

age related spending in G-7 countries will increase by an average of 4% by 2050 (Hauner, et al, 2008, 345). The G-20 may have to spend four times what they did in 2009 by 2040 on health care (Nazareth, 2014, 5). Theoretically, the public policy response would dictate that governments generate additional revenues by increasing taxation and reducing non-essential program spending. This approach, however, is constrained by the effects of reducing expenditures on an already slowing economy (Nazareth, 2014, 6) and the effects of global tax competition. Canada has already gone through a period of significant austerity in the wake of the fiscal pressures of the 1990s and can ill-afford either to raise taxes in highly competitive global market or to embark on further austerity.

Neoliberal Race to the Tax Bottom

This thesis, following the theoretical framework to understanding the normative dimensions of international tax competition of Dietsch and Rixen (2014), makes a distinction between de jure and de facto sovereignty. Though notionally states have retained a formal legal right to tax economic activity within their jurisdictions, the competitive forces that are shaping taxation decisions globally have effectively constrained the ability of states to set their own rates which would likely be in force barring such competition.

Dietsch & Rixen (2014, 152) articulate the primary motivation behind taxation, which is broadly, a means to address collective action problems. States, when fully sovereign, have a greater capacity to dictate the levels of taxation to finance intervention into the economy to address these collective action problems, such as environmental protections, law enforcement, public infrastructure, and the like. As we

will see later in this chapter, the absence of full sovereignty is not the only constraint to governments raising revenues, particularly in democratic states. However, the constraint of sovereignty is indeed the most significant force in a state's ability to dictate its own economic agenda and the degradation of that sovereignty through international tax competition is a significant force driving the creation of SWFs.

Until the 1980s, "domestic tax systems [were] essentially closed economies [though they] had an international dimension in that they potentially affected the amount of tax imposed on foreign source of income of non-residents, the interaction of domestic tax systems we relatively unimportant, given the limited mobility of capital" (OECD, 1998). However, the United Kingdom's decision to dramatically lower rates in 1984 is widely seen as the catalyst that triggered the global tax race to the bottom. In 1986, the United States, under the administration of Ronald Reagan following the precedent set by the Thatcher government, undertook a series of dramatic tax reforms that saw the effective tax rate on American firms and households rapidly decline. This period trend is reflected throughout the OECD. Overall tax revenues as a percentage of GDP in OECD countries fell nearly 10% in the wake of the Thatcher/Reagan rate reductions in the mid-1980s. With the exception of a brief correction during the economic boom of the late 1990s, the overall tax-to-GDP ratio in the OECD has been trending downward (2011). In the mid-1980s, many OECD countries had an effective top personal income tax rate that exceeded 70% (OECD, 2011). In 2016 the average top personal income tax rate of less than 40% (2011).

One of the dominate forces in the downward trend in global tax rates has been globalization. In 1998, the OECD published a report titled, *Harmful Tax Competition:*

An Emerging Global Issue. The report was mandated to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decision and the consequences for national tax bases”. The report notes that, “the liberalization and integration of markets have made capital more internationally mobile and significantly increased cross-border ownership of business, through both direct and portfolio investments. These pressures have encouraged a reduction in corporate income tax rates” (OECD, 2011). “Globalisation has also encouraged countries to continually assess their tax systems and public expenditures with a view to making adjustments where appropriate to improve the ‘fiscal climate’ for investment” (OECD, 1998) .

Countries have become more reliant international capital flows over the past three decades as economies have become more globalized and financial markets have played a greater role in propelling growth (Eroglu, 2015). This has placed countries in a catch-22. Though there is a need to bolster domestic spending to increase competitiveness, countries have gutted their corporate tax regimes to attract global capital which has limited their ability to make productivity enhancing investments and maintain a generous social welfare regime. Eroglu (2015, 39) argues that “countries have started to take international capital movements into consideration rather than national requirements while they are deciding on their tax policies”. In this context, the race to the bottom on tax competition is a self-reinforcing spiral in which countries lower rates to attract capital and their peers, having suffered losses during this process, lower rates to retain capital within their jurisdiction (Genschel, 2002)⁵.

⁵ Though tax rates are not the only determinate of capital flows they are a significant driver

Though there is broad consensus around the fact that rate reductions and base broadening had some beneficial effects in terms of promoting tax compliance, incentivising work and limiting the exercise of tax loopholes - international tax competition has had a negative effect on governments ability to raise revenues. It is clear that tax competition between states has driven down government revenues and constrained the ability of states to make investments in social welfare. In particular, the OECD notes that, “favorable regimes have been developed by some tax jurisdictions to attract profits and tax receipts (i.e. base shifting) away from countries where investment actually takes place” (OECD, 2011, 13).

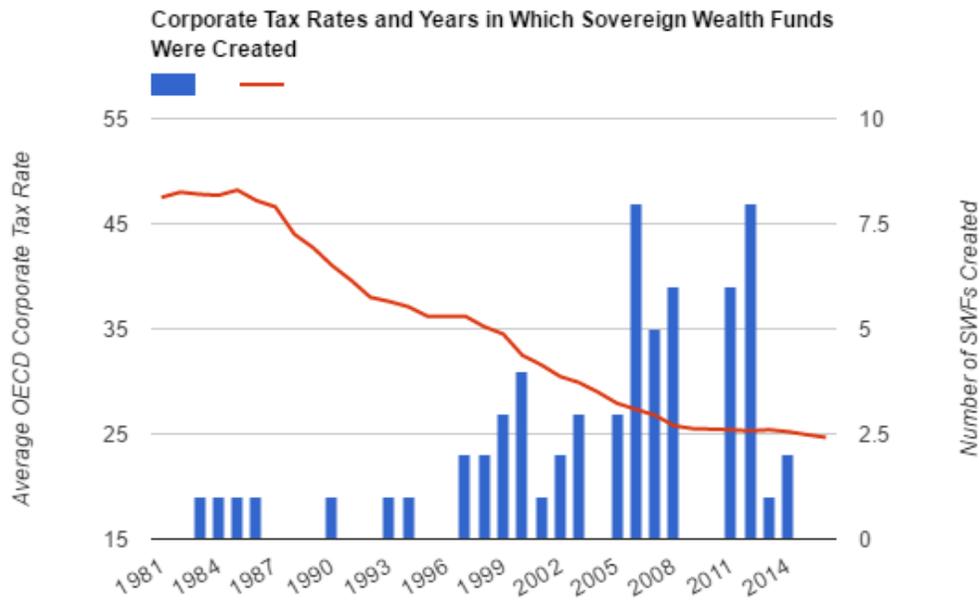
Dietsch and Rixen argue (2014, 154) that international tax competition can come about in several ways, including: “reducing tax rates or defining tax bases in favorable ways, fashioning preferential tax regimes for foreigners, or creating tax loopholes”, which could include bank secrecy and limited enforcement of tax laws. Losses due to tax evasion facilitated by this secrecy and lack of enforcement is estimated to be US\$155-255 billion annually. A wide range of scholarship on the subject of tax competition suggests that the phenomenon places the future of the welfare state in jeopardy as states come ever closer to bring their marginal tax rates on mobile capital to zero (Elkins, 2016).

As the “the interdependence of national tax regimes generates external effects that undermine the de facto sovereignty of states” (Dietsch & Rixen, 2014, 151), Canada has not been immune. The race to the tax bottom has played out across Canada at both the federal and provincial levels. Though there have been incidence of various taxes being increased from time to time, the overall trend has been markedly downward. Canada has experienced a similar trend. In 1995, tax revenue

as a percentage of GDP was 35.6%. By 2009, revenue had declined to 31.1% of GDP. In 2007, the government of Stephen Harper cut the corporate tax rate from 22% to 15%. Matt Fodor (2013) notes that, despite projections by then-Finance Minister Jim Flaherty, government revenues from corporate taxation fell from \$40 billion in 2007 to \$30 billion in 2010. The Harper government also cut the GST, a move that has lowered annual government revenues by some \$14 billion.

The current climate of global tax competition has led states towards the taxation of natural resources, as they are not a subject to interstate competition. There is a clear correlation between the adoption of SWFs and falling corporate tax rates (see graph 1). As tax competition continues to increase, it is likely that these non-mobile sources of capital will serve as revenues sources of governments in Canada and abroad with many choosing to create SWFs to capture these revenues.

Graph 1



Data from the OECD Tax Database & the Sovereign Wealth Fund Institute

Electoral Resistance to Taxation

Compounding the effects of international tax competition, and perhaps partially a product of it, is a resistance to taxation among voters in advanced democracies, particularly in the core constituencies of right and centre-right parties. As the driving force in the neoliberal race to the tax bottom over the past four decades, the tax resistance climate in the United States is most illustrative of the trends caused by this phenomenon. As in Canada, a number of US states have adopted or are now contemplating the creation of a SWF since the establishment of Alaska’s Permanent Fund in 1976⁶.

⁶ *Adopted prior to 1976:* Texas (1854, 1876), New Mexico (1898, 1973) and Wyoming (1974).

Outside of globally constrained corporate tax rates, which on average more than 60 percent of Americans believe firms pay ‘too little’, governments in the Western world face electorates leery of personal income tax increases. (Shaw and Gaffey, 2012, 584). From 1992 to 2011, the percentage of Americans who told public opinion researchers that “upper-income people” don’t pay enough income tax dropped nearly 20% (581), at a time when the top marginal rate continued to decline. In the wake of the Bush administration tax reductions in 2001 and 2003, there has been a modest decrease in the number of Americans who believe they pay too much tax, however, less than seven percent of Americans indicate they pay ‘too little’ tax (584). An even smaller number, less than three percent, believe that they pay ‘less than their fair share of taxes’. This suggests that public appetite for an increase in taxes among the largest population of American taxpayers is extremely low. Though the recent financial crisis may impact public opinion, Shaw and Gaffey (592) conclude that “observers should not expect the well-documented American reluctance to embrace redistribution to abate in the face of a prolonged recession”. This reluctance will force all levels of government in the United States to seek alternatives means of revenue generation.

Though most major parties have supported dramatic tax reduction in Canada and the United States in the neoliberal era, centre-right political parties in advanced democratic countries are more prone to garnering a significant base of their support

Adopted after 1976: Montana (1978), Alabama (1985), Louisiana (1986), North Dakota (2011), and West Virginia (2014). *Under consideration:* Pennsylvania and Ohio. With the exception of the Alaska and Texas funds, these funds have a long history of being undercapitalized and used for near-term budget shortfalls (see Saha and Muro, 2016). In particular, the Alabama fund “has been raided several times” (13).

from the portion of their electorates that favours lowering taxes⁷. In the United States, for example, the 2012 Republican candidate for president, Mitt Romney, received 66% of the vote from voters who believed that taxes were the biggest economic problem facing them. Though only 18% thought cutting taxes should be the highest priority of congress, these voters were overwhelmingly disposed to voting Republican (Bowman, et. al, 2016, 76). A strategy of targeting these voters has been at the centre of American political campaigns for decades, though these very voters represent a mystifying and politically dangerous contradiction - they want tax lowered, the deficit reduced and social programming like social security and medicare to be enhanced and protected. This places political actors in a position of having to choose between competing aims, most importantly between running long-term structural deficits while keeping tax rates low and continuing to fund popular social programming. However, as demographic changes take hold and international tax competition continues to strengthen, this path will continue to narrow.

Somewhat remarkable, two-thirds of Americans who believe income inequality was rising and viewed this with concern supported George W. Bush's administration proposal to repeal the estate tax - a levy that limits the intergenerational transfer of wealth (Campbell, 2010). And the number of Americans that support redistribution of wealth declined from 1973 to 2004 by 58% to 46% (Bowman et al, 2010, 34).

Squaring this with voters broadly expressed appetite for maintaining and strengthening. Heath et al note: "electors may feel that higher taxes and greater public spending are indeed what the country needs, but in the privacy of the polling

⁷ In Canada, it is worth noting, that with the exception of the Northwest Territories, sovereign wealth funds have been created by parties that draw support from the right of the political spectrum.

booth they may decide to follow their own self-interest” (Johnson, 2005, 406). This would help explain the disconnect between American public opinion polling that shows a preference for both increased social expenditures and lowered rates of taxation. Social welfare programs place politicians in vexing positions.

Ryan and Landon (1998) argue that, like some government spending, there are taxes that are not easily observed by voters, in particular hidden taxes and levies deducted at the source. On the opposite end of the visibility spectrum are consumption taxes that are levied frequently, which they note, continually re-enforces the presence of the tax. Where new taxation measures have succeeded, they have been regressive and frequently target low information voters. These taxes are largely focused on permits and fees as well as consumption taxes on sin products such as tobacco, alcohol and gasoline.

In a small number of cases, there have been broad consumption taxes adopted. Of note are the value-added taxes in Canada (1991) and Australia (1998). Even the introduction of these taxes can carry significant political consequence. Though the Liberal government of John Howard managed to retain power in the 1998 election, the party saw a nearly 8% swing in its share of the vote and lost the popular vote. In Canada, only two years after the introduction a national value-added tax, the Goods and Services Tax (GST), the reigning Conservative majority government suffered a stunning electoral defeat and was reduced to two seats in the House of Commons - even though the tax was effectively revenue neutral. The prevailing Liberals had promised to eliminate the tax but upon taking power they opted to retain it. Of course, the consequences of that action are difficult to assess given the post-1993 fracturing of the Conservative movement and subsequent effects on voting

patterns. Still, the Canadian result reflects empirical research on the effects of sales taxes that indicates such measures will “reduce both the incumbents vote percentage and probability of winning” elections in Canada. (Ryan and Landon, 1998, 42). For example, a political rebuke occurred in the 2008 Canadian federal election when Liberal leader Stephane Dion ran on the introduction of revenue neutral carbon-tax. The party was reduced to historically low seat totals.

Perhaps most concerning to governments is what Fodor (2013, 106) observes: that the neoliberal era in Canada has managed to “denigrate the positive role of government and separate the debate over taxes from the services they pay for”. He further argues that “elected officials are reluctant to openly campaign for tax increase to pay for improved public services” (2013, 110). What is still clear in this low-tax age is that citizens want service for themselves and their families without paying too much for them. This is supported by Johnson, et. al. (2005) who found that in Britain, incumbents increase their probability of losing power by increasing the effective tax rate.

A 2005 survey of Canadians found that the majority did not feel they were receiving fair value for their taxes. 73% stated they are taxed too high (Bricker & Wright, 2005). Though social spending increases an incumbent’s electoral advantage in Canadian elections - sales tax increases led to a lowered incumbent vote percentage. The most visible taxes (sales, gasoline taxes, and direct taxes on persons) have the largest systematic political costs (Ryan & Landon, 1998, 47).

Zelenak (2009, 382) claims that politicians have considerable flexibility in the implementation of tax policy due to the ‘low salience’ of tax policy among the voting public. However, this thesis argues that this is only the case where the tax is less

visible. Income and consumption taxes, as well as fees, which contribute significantly to the revenue stream of most advanced democratic governments, are not of 'low salience' among voters. SWFs, on the other hand, are low salience. Zelenak's most important point is the notion that the tax debate is easily manipulated for political gain. As such, it is an area of debate which most political actors avoid. This notion is reinforced by Ryan and Landon (1998, 47) who observe:

“Governments that want to reduce the probability of their defeat or raise their percentage of the vote are likely to reduce their reliance on broad-based visible taxes (such as sales taxes and income taxes) and concentrate on raising revenues from less visible revenue source such as natural resource royalties, corporate taxes, and user fees”.

Social Spending and Electoral Outcomes

Given that options for increasing revenues are so constrained, a logical question arises: why is government not content with reducing its size to an expenditure level that is within their means? The answer lays in the evidence that suggests both broad social welfare spending and target-localized expenditures by governments have a positive electoral return for incumbent governments. Moreover, the evidence is abundantly clear that political actors believe this to be a core axiom of political survival as incumbent spending patterns in the United States, Canada and Europe all demonstrate a concentration of expenditure in constituencies that are electorally competitive. This motivating belief underpins the need for governments to raise revenues in order to finance such activity in support of improving their political

fortunes.

Voters hold governing parties to account for the state of the economy. Keynesian counter-cyclical spending by incumbent parties has been demonstrated to improve economic conditions in the near-term, an outcome that has historically improved electoral fortunes of parties in power. Shin (2016) studied 197 lower chamber elections in OECD countries that took place between 1980 and 2013. He finds that social spending generates vote share gains to incumbent parties, but these gains become more limited as taxation increases. Wang & Quan (2016, 383) note that “leaders in democracies, facing competitive political elections and the frequent prospect of being voted out of office, often have short time horizons, and are frequently inclined to manipulate policies to maximize electoral fortunes”. This helps us partially explain the relative absence of sovereign wealth funds in advanced democratic states. Political actors in democratic states favor fiscal flexibility over the constraints of institutional rules that attempt to govern sovereign wealth vehicles.

Further supporting the argument that government spending improves electoral outcomes for incumbent parties is evidence that indicates such spending does not need personally to affect a voter to have an impact on ballot box behavior. Connections in their communities to those impacted by government spending or hearing of such spending through news outlets is sufficient, find Kriner and Reeves (2012). They also observe that, in the United States, voters reward presidential candidates for spending their party undertakes in local constituencies. Similarly, spending on goods and services significantly improves a government’s electoral prospects in Canada (Ryan and Landon, 1998, 106). Government spending on goods and services is shown to reduce both “reduce the probability of incumbent defeat and

the percentage of the vote going to the opposition” (Ryan and Landon, 1998, 47).

Of note, voter groups respond to various spending choices in divergent ways. In the United States, Lazarus and Reilly (2010) find that Democratic voters are more likely to reward incumbents who spend directly on goods and services. Republicans, on the other hand, are more likely to reward finance based interventions such as loan guarantees for local firms and measures designed to support private enterprise. This research is consistent with the difference in party political philosophy in the United States, Canada and most advanced democratic states.

From graft prone developing countries to the halls of the United States Congress, pork-barrel spending, as vote buying through government expenditure is colloquially known, is perceived by most lay observers to be widespread. Generally, those observers would be correct. Tavits (2009) finds that even in Nordic countries, a region with a reputation of not being prone to localism, there is considerable evidence to suggest that governments utilize pork-barrel spending as an electoral strategy.

Conclusion

This chapter discusses the three primary pressures driving the adoption of SWFs in Canada: the neoliberal race to the tax bottom; electoral resistance to taxation; and the perceived association between social spending and electoral outcomes. These factors are made substantially more potent by growing demographic challenges impacting Canadian government’s spending obligations. In response, we have seen that governments are more likely to generate revenues from sources less visible to their electorates and free from global tax competition. Non-mobile, electorally distant natural resource extraction is an obvious target for this type

of taxation.

In supporting the arguments within this chapter, the United States is identified as an important leading indicator of the three trends as its neoliberal political ideology of small government and continually lower rates has been widely exported to other Western democracies, including Canada. Alberta, as we will see, was also an early adopter of these neoliberal governing values. However, this ideological perspective has not dislodged the clear perception among political actors in that province that redistributive spending and tax reductions can improve vote share. As the old adage goes, 'the aim of every first-term government is to get a second'. This presents a sticky paradox with which governments have to grapple: how to maintain spending and tax reductions while avoiding the need to raise taxes visible to their electorates. In this context, the three pressures set-out within this chapter will help unpack the Alberta case and illuminate why its SWF has fallen far short of its original promise. The pressures will also help us explain the origins and operating decisions of other Canadian funds in chapter four.

Chapter 3: Alberta Savings Heritage Trust Fund

Alberta is endowed with a reserve of hydrocarbon resources of which most other provinces and states can only dream. The province has been the beneficiary of great petroleum fortune over the past 40 years which has benefitted government coffers to the tune of more than \$200 billion in non-renewable resource revenues

(Finance Alberta). Albertans have benefited greatly from this resource windfall, enjoying high quality public services while paying the lowest tax rates in Canada for more than 50 years. Lou Hyndman, a former Albertan treasurer, has noted that Albertans pay far less than citizens of other provinces for their programs. In 1982, for example, resource revenues subsidised more than half the cost of provincial services (Smith, 2016).

Though Alberta's finances have benefited from their natural resources, they have also faced structural deficits during times of commodity price downturns and the spending choices of their leaders which have frequently been fueled by petroleum. Like many of their resource rich peers, Alberta's governments have had to manage the potential risks associated with Dutch Disease and plan for a future where oil could be depleted or become obsolete, depriving its economy of a significant source of strength. In an attempt to manage these risks, the province adopted a SWF in 1976 - the Alberta Saving Heritage Trust Fund (Heritage Fund). However, the Heritage Fund has not lived up to its lofty aims of diversifying the economy, stabilizing resource revenues and saving for future generations. When compared to similar funds like Norway's Government Pension Fund Global - which was inspired by the Alberta model - the Heritage Fund falls far short of its potential. Today the fund has little more than \$19 billion while Norway's, which did not receive its first payment until 1996, is valued at more than US\$900 billion. Why is it that the Heritage Fund has failed to live up to the vision set out by Premier Peter Lougheed in 1976?

The previous chapter laid out the forces that are driving the adoption and operation of sovereign wealth funds in Canada. Alberta should be viewed as being a jurisdiction in which these forces were felt early, long before other provinces and

territories. Within the Canadian federal system, Alberta has long positioned itself as a low-tax jurisdiction, boasting the lowest personal and corporate tax rates in Canada. As such, the province has significantly less fiscal room in which to maneuver when commodity price fluctuation and demographic related spending pressures confronted a succession of Progressive Conservative governments from Lougheed to Klein to Prentice. The province's fiscally conservative electorate, which embraced low tax and minimal governments in the infancy of the neoliberal era, further pushed the government of Alberta to rely on the resource revenues to exact electoral advantage. As such, the Alberta case embodies the fiscal forces and electoral behaviors that have faced other Canadian provincial governments since Canada's first SWF was established in 1976, and holds a number of key lessons that should be considered by other SWFs in Canada.

Unique among a political class saturated in law degrees, Peter Lougheed received an MBA from Harvard University prior to seeking the leadership of Alberta's Progressive Conservative Party. It is possible that his time at one of the world's preeminent business schools exposed him to alternative public policy ideas and unconventional approaches to managing sovereign wealth. In 1976, Lougheed's government established the Alberta Savings Heritage Trust Fund, Canada's first SWF, with an initial injection of \$1.5 billion. Its original aim was to save 30% of the province's natural resource royalty revenues.

Lougheed identified three primary objectives of the Heritage Fund: to save for the future, to strengthen or diversify the economy, and to improve the quality of life of Albertans (Finance Alberta, 2016). Lougheed rose in the Alberta Legislature to introduce the bill that would create the fund and addressed its key aims:

“1...a future source of revenue, either through the income flowing from the fund or from the fund itself, as resource revenue declines in the years and decades ahead

2. To reduce the debt load that may at some future time, perhaps not too far away, be required by the citizens of this province for capital projects of a budgetary nature

3...to improve the quality of life in this province, to do some special things that no other province is able to do, so the quality of life here become even better and certainly compares well with other parts of Canada

4... to strengthen and diversify the economy of this province... it is fairly clear to forecast that for Alberta in the mid-1980s, oil and gas as both a source of revenue and job-creating part of our economy in a conventional sense will have passed its peak” (Mumey & Ostermann, 1990, 30)

Though there were obvious competing tensions between the fund’s focus on Albertans present material conditions and future generations, Lougheed emphasized the importance of the savings aspect of the fund, pitching its creation in strong moral terms. He stated in 1976, “are we prepared as a province to put aside substantial sums of current revenues from the sale of non replaceable crude oil production, put it aside for our children and for our grandchildren and not make it available for current revenue needs; to use it someday ... when some of the wells may have gone dry...” (30). Due in no small part to this core moral argument, the Alberta Heritage Savings Trust Fund Act became law.

Fund Governance & Objectives

As early as 1980, discussions at economic conferences in Alberta were focused on the soft governance of the Heritage Fund. Pratt and Tupper question the independence of the Select Standing Committee charged with overseeing the Heritage Fund as it is controlled by government MLAs (Smith, 1980). Though the investment decisions are formally at arms length, oversight to this day remains in the hands of a committee controlled by government MLAs. Although the Heritage Fund is widely recognized as having improved its governance over time, in its formative years control of fund asset allocation, contribution, and withdrawal rules were not well separated from the government of the day, and were directed by the Minister of Finance.

The original fund was separated into three divisions: (1) a Capital Projects Division, (2) an Alberta Investment Division, and (3) a Canada Investment Division. These divisions represented a broad government vision that extended well beyond long-term savings into politically motivated investment activity (Hoffman, 1996). The organization of the investment divisions demonstrates that the Heritage Fund was never truly about saving for the future. You do not protect savings by investing in the very economy that is vulnerable to the shocks from which you are looking to protect future generations. Though the fund may have helped economic diversification through investments in medical research and the petrochemical industry, areas of the economy which grew over time, there were also significant failures. Investments in the now defunct NovAtel Inc. and Magnesium Company of Canada cost Albertans hundreds of millions of dollars (Canadian Press, 2009). The significant domestic

losses illustrate the risk involved in investing fund capital domestically. Had Alberta constructed a more balanced fund portfolio with greater international exposure it may have grown at a more substantial pace in first decade of operation.

Though the early operation of the fund demonstrated considerable focus on saving for the future, there were clear tensions between the competing aims of the fund. In the 1970s and early 1980s, \$1.9 billion was lent to other provinces. The Government of Alberta secured a healthy interest rate of 12.5% and provinces received a lower interest rate than would have been available to them through traditional lenders (Finance Alberta, 2016). However, these loans were issued domestically, again exposing the province to political pressures that would not have been faced if the investments had been made in global equity markets. The decision to make loans to other provinces should be seen as an act of fund politicisation, one that illuminates an early appetite to utilize the capital within the fund to improve the public standing of the government of the day at the expense of prudent long-term investing.

Compounding the natural tension within fund objectives was the lack of political conviction within Lougheed himself. As oil price began to decline in the early 1980s, he approved a reduction in fund contributions from 30% of resource revenues to 15%. At the same time, two new divisions were added to the Heritage Fund: the Commercial Investment Division and an Energy Investment Division. A Cash and Marketable Securities Portfolio was also created under the auspices of the fund's management, further complicating the funds operations and making it more challenging to understand investment motivations.

In 1985, Peter Lougheed left provincial politics. His departure coincides with

the beginning of an extended period during which no revenues were diverted to the Heritage Fund (Wilson, 2012). In the late 1980s, with the Government of Alberta facing rising deficits, the fund began making investments in projects that would have otherwise been funded through the government's budget. These investments included parks, libraries and forest preservation. The Alberta Department of Finance describes these projects as an effort to "diversify the economy and meet the needs of growing population" (Finance Alberta, 2016). One would traditionally expect that an increase in population would bring greater government revenues, but the government of the day, unwilling to levy new taxes, borrowed from the future.

For nearly a decade no deposits were made into the Heritage Fund, prompting the legislature to change the contribution rules in 1996 to state that "a percentage of the non-renewable resource revenue received in each fiscal year shall be transferred from the General Revenue Fund to the Heritage Fund in accordance with this Act, but only if the transfer is authorized by a Special Act" (Alberta Finance, 2016). Though a symbolic effort to restart contributions, the Act left the decision to transfer revenue to the whim of the government. The Act also calls for the Minister of Finance to "inflation proof" the Heritage Fund so that it retains its capital value in real terms.

11(1) Subject to subsections (2) and (3), for the fiscal year 1999-2000 and subsequent fiscal years, the Minister of Finance shall retain from the income of the Heritage Fund and allocate to the endowment portfolio as soon as convenient after the end of each fiscal year an amount equal to the value of the total equity of the Heritage Fund as recorded in the financial statements of the Heritage Fund for March 31 of the fiscal year multiplied by the percentage increase, if any, for that fiscal year in

the Canadian gross domestic product price index specified by the Minister of Finance.

Though the Minister was directed by the Act to inflation proof the fund, this practice did not begin until 2006 as the Act also allows for delays in implementation if the provincial budget is in deficit (Murphy and Clemens, 2013). This provision allows for near total control over the decision to transfer revenues into the Heritage Fund as the decision to run a deficit is entirely at the discretion of the government itself. Five years from 2000 and 2011 saw the entire net income of the Heritage Fund transferred to general revenues. If the Heritage Fund had been continually inflation proofed, all deposits remaining the same, it would be worth more than \$27 billion today⁸.

In 2007, another public show of reform was undertaken with the creation of the Alberta Investment Management Corporation (AIMCo). The Management Corporation now manages a globally oriented fund with a diverse asset mix, however, investment principles and guidelines remain vulnerable to meddling by the government of the day. The fund's Statement of Investment Policies and Guidelines (SIP&G) is crafted, as well as the responsibility for fund management - through AIMCo - rest with the Minister of Finance (Alberta, 2016). In the province of Alberta, the Minister of Finance also serves as President of the Treasury Board which circumvents another potential oversight vehicle that exists in other governments.

In an attempt to bring public oversight over the operation of the fund, an all-party legislative committee is responsible for reviewing the performance of the Heritage Fund, assessing whether its mission is being fulfilled, and approving the

⁸ Calculated using 2006 deposit rules and Statistics Canada reporting of inflation from 1996 to 2017

Annual Report (The Standing Committee on the Alberta Heritage Savings Trust Fund) (Alberta, 2016). However, the committee is heavily influenced by the government of day, which appoints the majority of its members; 6 of the 9 members are from the government bench. Even if the committee were truly independent, the power of this oversight function pales in comparison to the authority of the Minister of Finance in directing the operation of the fund.

Within the fund, the government has established an Alberta Growth Mandate. The current guiding principles of the Mandate, which were set by the Department of Finance and AIMCo, are (Alberta, 2016):

- a . Create jobs in Alberta
- b . Build new infrastructure in Alberta
- c . Diversify Alberta's economy
- d . Support Alberta's growth
- e . Connect Alberta's companies to export markets
- f . Develop subject matter expertise within Alberta

To date, two investments have been driven by the mandate, totalling \$48 million: one in renewable energy and the other in pumping services for unconventional natural gas and light oil (Alberta, 2016). Although these investments have been relatively small, it is an indication that fund governance structures have not constrained the political temptation that the Heritage Fund's capital represents. Given the rise of populist protectionist rhetoric in Western democracies, the political gains of touting an 'Alberta Growth Mandate' may be too much for a government to pass up.

Further diminishing the potential of resource revenues being directed to the fund was a 2012 decision by Premier Ed Stelmach's government to invest nearly \$10 billion into a Sustainability Fund that was designed to buttress the budget in times of commodity price downturns. This demonstrates that the only practical check on the Heritage Fund's operations has long been internal party debates over the Heritage Fund's future. Since its creation, government MLAs have advocated for diverting resource revenues to the General Revenue Fund to create a surplus rather than directing those revenues toward long-term savings (Smith, 1980).

Public Opinion

It is a well accepted political axiom in democracies that public opinion shapes government behaviour. Public opinion has long been a driving force in shaping the fiscal decisions of Alberta governments. The Government of Alberta has frequently surveyed Albertans on their views towards both taxation and the Heritage Fund. The response to the finding is instructive and helps us explain both public policy behaviors with respect to the management of the fund overtime and the electoral pressures that were facing the governments of Alberta. What is most vexing about public opinion, according to research conducted by the Government of Alberta is that "Albertans strongly support keeping the Heritage Fund, yet Albertans offer little support for increased investment in the Heritage Fund. Why this baffling, puzzling paradox?" (Alberta, 2008).

In 1995, the Government of Alberta asked citizens to voice their opinions on the future of the Heritage Fund through a survey titled, "Can We Interest You in an \$11 Billion Decision?". Fifty thousand Albertans were overwhelmingly in favor of

keeping the fund and called for “generating better returns on long-term investments” (Finance Alberta, 2016). In 1996, the Alberta Heritage Savings Trust Fund Act was updated in response to the survey. The funds uses were restricted and future governments were banned from using the Heritage Fund for direct economic development and social investment. However, this action was not a constitutional change or mechanism requiring a plebiscite to seek public consent for changes to fund governance rules. Future governments could easily grant themselves the ability to raid the fund for whatever purpose they deemed a political necessity at the time. What is important here is that the government chose to protect the fund’s principal while avoiding structuring the fund in such away that obligated the government to direct a fixed portion of resource revenues to it.

Helping us understand why fund contributions were not a priority is a 2001 survey, “It’s Your Money”, a somewhat suggestive title that left out allusion to consideration of future generations. In it, they were asked about their fiscal priorities once the debt was retired. 34% of respondents indicated that they wanted to allocate monies that were then going towards interest payments to a budget savings plan, such as a SWF (Finance Alberta, 2016). This option fell far behind tax reduction and increased program spending, which 73% and 44% of Albertans respectively, indicated was their preferred use of the revenue (2016). The “It’s Your Money” survey also asked about spending revenue from one-time windfalls, like high oil revenues. 52% wanted to save those funds for the future, 57% were in favour of tax rebates and 29% supported one-time spending (Finance Alberta, 2016).

As the Heritage Fund’s Growth has slowed and contributions have become infrequent, there is increasing evidence that Albertans have lost interest in the

Heritage Fund, or at the very least have lost confidence in government action rising to the level of the rhetoric around saving for the future. Recent public consultations on the future of the Heritage Fund have been sparsely attended (Sarrazin, 2012). Among those attending consultations, many advocate for revenues generated through non-renewable resources be spent to address more immediate priorities like health care and education. At a meeting in 2012, PC MLA Maureen Kubinec stated, “the task of (the government) is to find the balance between what a certain segment of the population thinks we need to spend it on and (the other) segment of the population that thinks we need to save” (Sarrazin, 2012). The consultations are indicative of how one would expect a democratic government to respond to competing voter priorities. However, government action indicates that those wanting spending have won out through most of the history of the Heritage Fund. Future generations, who do not yet have a voice, have not found one in an Alberta government to date.

Electoral Campaigns

The 2012 Report by the Alberta Premier’s Council on Economic Growth observes, “when the energy sector is booming, provincial revenues increase substantially. The public expects to share in the general affluence, and we put pressure on our legislators to increase spending” (Alberta, 2011). This has been abundantly clear in the decisions of Albertan governments in electoral campaigns. Though there have been campaigns that include cuts to government, key priorities like healthcare and education have seen perpetual increases in spending.

Alberta’s governments have long behaved in a fashion that would suggest that the province’s leaders have little interest in truly establishing a fund that respects

future generations. Successive premiers, including the recently elected New Democrat Rachel Notley, have all but ignored the lessons of other jurisdictions that have successfully protected funds from political interference. In 1986, members of the Standing Committee of the legislature proclaimed that there were no similar funds in North America (Smith, 1991, 139), when in fact, there were at least five. However, rather than being the exception to the rule, Alberta governments have behaved in a fashion consistent with the theory advocated here on why a Canadian province would establish a SWF and how such a fund would operate.

Spending to gain electoral advantage is not unique to Alberta, though the province has some shining examples of it. In 2004, when Alberta eliminated its debt, then Premier Ralph Klein doled out cash payments to every Albertan in the form of a one-time payment of \$400. Klein referred to the payments as a 'prosperity bonus', a reward for the 'fiscal constraint' Albertans had shown when the debt was being reduced - the media dubbed them "Ralph Bucks" (Fawcett, 2016). The motivation to spend to curry favour among the electorate is deeply rooted in democratic states. Even though politicians are often acutely aware of the choices they are making in the moment, they frequently choose short-term gain over long-term fiscal prudence. Ralph Klein himself noted, in a 2006 open letter in the Calgary Herald, "If we do not save a sufficient portion of these oil and gas revenues, history proves that much of it will be dissipated on non-essential expenditures and we will not have much to show for it 10 years or so from now" (Fawcett, 2016). Klein's open letter ignored the impact of his decision to dole out Ralph Bucks.

In the 2012 provincial campaign, the PC party, fighting off a strong challenge from the newly created Wildrose Party which had unified the Albertan far right,

promised more than \$5.8 billion in new spending over four years to make capital and other investments in health care and education (Flanagan, 2014). The dissonance between a desire for low taxes and expanded social services was apparently lost on Tory voters who returned the party to power with another sizable majority.

The Heritage Fund & Political Choices

Natural resource dependence has been the cause of dramatic swings in the revenues of the Government of Alberta. In 2006 natural resources accounted for 40% of the government revenues. By 2010, two years after the financial crisis and collapse of commodity prices, those resources represented just 19% of revenues (Fraser Institute, 2015). Since the inception of the Fund, \$39.2 billion has siphoned from the Heritage Fund to bolster the government's balance sheet (Alberta, 2016). Since 1976, Alberta's natural resources have generated more than enough revenues to sufficiently capitalize the Heritage Fund to save for the future and maintain a stabilization reserve. Instead, Mike Priaro (2013) correctly notes that the relative value of the Heritage Fund has declined since 1987, the year contributions to the fund first ceased. As of 2013, the real value of the fund had contracted by 33%. Despite the waning size of the Heritage Fund, successive premiers have refused to revisit Alberta's long standing regressive flat-tax system. This decision, as Mike Priaro (2013) notes, has led the continued reliance on "unstable and unpredictable non-renewable resource revenues to fund critical programs like health, education and infrastructure". In lieu of adopting a sustainable fiscal policy, Alberta governments have relied on resource revenues and opposed calls to draw upon some of the wealthiest and least taxed Canadians to contribute to the future prosperity of their

province.

In the period 1978 to 1981, natural resource revenue comprised more than 50% of total provincial government revenues - by 1986 that number was 25% (McMillan and Warrack, 1993, 14). From 1970 to 1986, Alberta non-natural resource revenue was consistently below that of the provincial average. Taylor, et al (2010, 28) argue that “the Alberta Heritage Fund is an example of a well conceived permanent fund that was halted and therefore has not achieved its original intentions”. The cessation of deposits into the Heritage Fund coincide with a dramatic decline in energy price in the mid-1980s. Between 1985 and 1986, decreased demand for petroleum reduced government royalty revenues by more than \$3 billion. This ushered in a period of structural deficits in Alberta that would last through to the end of the century. Despite years of high oil prices and savings potential, McMillan and Warrack observed that “the [Alberta] did not have sufficient flexibility on the expenditure side to address the problem of the deficit” (1993, 14). The 1993 election campaign would foreshadow future political debates in Alberta in which tax increases would be treated as a third rail and both major parties contending for power, the Liberals and the Progressive Conservatives, would propose spending cuts as the solution for addressing the province’s structural deficit. During that campaign, newly elected Progressive Conservative Premier Ralph Klein promised to cut provincial spending by 20% by 1997 - a target he reached a year early. On a per capita basis, cuts were actually 28% (Kneebone, 2002). However, during the period of 1993 to 1997, health spending grew by 8% and education by 4%, suggesting that even Alberta was not immune to the demographic forces of aging and population growth (2002). Throughout this period, no deposits were made to the Heritage Fund and its

earnings were directed to funding tax reductions and social expenditures.

Kneebone (2002) observes that boom and bust commodity cycles are reflected in government debt and spending trends . The unique feature of the Klein years was that his government used increases in resource revenues to finance tax reduction measures. Kneebone further argues that a policy of accumulating assets “would seem to be a sensible one given the budgetary implications of demographic changes that are on the horizon. One can envision a rapid accumulation of assets that can be used to finance the increase in health care expenditures without the need for increases in tax rates or cuts to spending” (2002, 15). In the latter Klein years, and in those that followed, the fiscal constraint of the 1990s was not even apparent.

Mark Milke, an analyst with the Fraser Institute, argues that spending in Alberta grew by more than \$2,002 per person (inflation adjusted) between 2004/2005 and 2013/2014, far more than the rate of inflation and population growth demanded (Milke, 2015). During that 10 year period the Government of Alberta collected more than \$100 billion in resource revenue. As Milke notes, depositing just 25% of these resources would have led to more than \$25 billion in contributions to the Heritage Fund (2015). Between 2005/06 and 2012/13, the Government of Alberta spend \$300.5 billion on program spending during which time the province deposited a mere \$4.1 billion into the Heritage Fund. Another analysis by Milke concludes that of these funds, \$41 billion was beyond that necessary to keep pace with population growth and inflation (2015, 6). These monies could have been used to make contributions to the Heritage Fund. The rate of spending suggests that Alberta’s PC government was attempting to bolster their electoral prospects through spending on social services. This is consistent with the theoretical expectations laid out in chapter two.

The near-term program spending that the government engaged in during the past two decades in Alberta is a clear political statement that current citizens were being prioritized over future generations and that the vast majority of royalty revenues belonged to the present day consumer of government services. The Heritage Fund's current size of \$18 billion is far short of what the fund should be, even if contributions would have been halted in their entirety when Lougheed left office. "The Heritage Fund has suffered from poor stewardship for most of its history", Murphy and Clemens (2013, 5) aptly note. They present the operation of the Heritage Fund as betrayal of the founding vision of the investment vehicle, when in fact, there is little evidence that the operation of the fund has been carried out contrary to Lougheed's founding vision.. Alberta's political leaders have frequently ignored the Heritage Fund's moral purpose and have drawn upon it in service of other spending priorities, almost always under the guise of one budget crisis or another - mostly of the government's own making.

The choice to wed provincial finances to the commodity boom and bust cycle continues today. No contributions are being made into the Heritage Fund while Alberta public spending per capita was the lowest in the country in 2015 - by a considerable margin. Government expenditures were a mere 13 percent of GDP, compared to the next lowest at 17% (Saskatchewan) and the provincial average of 22%, yet Alberta was still running a deficit (Hussey, 2015). Not exercising the fiscal flexibility available to the government today will surely place tomorrow's Albertans in greater financial limbo.

The Heritage Fund in the Context of Model Funds

The conservative Edmonton Sun notes that the current size of the Heritage Saving Trust Funds is a “great embarrassment”, going on to claim that Alberta “should be one of the world’s brightest beacons of fiscal responsibility.” The editorial correctly observes that “[Alberta has] been blessed with riches most other provinces, states and countries can only dream of” (Graham, 2014). Though the concept was widely heralded by public policy activists, both conservative and liberal, the Heritage Fund is now widely seen as falling far short of the expectations laid out by Lougheed in 1976. The body of literature on Alberta’s Heritage Fund is an echo chamber of regret and historical revisionism. Both scholarly and news articles present a similar case: Alberta has squandered decades of high oil prices, stole from the future by raiding its resource fund to fund near-term social spending and tax reductions. If only the fund had followed its original rules, or adopted Alaska’s. Better yet, had Alberta adopted the Norway model, the province would be awash in cash with the ability to both save for the future and weather swings in commodity prices. Energy resources make up 25% of both Alberta and Norway’s economies, however, in the midst of the 2014 collapse in oil price Alberta deficits hovered around \$10 billion while Norway was able to continue its level of expenditure without debt financing - even running a precautionary surplus of \$8.5 billion (Poelzer, 2015, 1).

As this thesis has demonstrated, the political choices of the province’s political leaders - to favor near-term spending for electoral gain over saving from the future - is the core reason why Alberta has failed to parlay great oil riches into sustainable, long-term gains within its Heritage Fund. What could have been done to prevent this

plunder? Would the adoption of lessons from model sovereign wealth funds have insulated the Heritage Fund from the political interference it has been subject to for over 40 years?

Originally, 20% of the Fund was intended to be invested in capital projects within the province for the purpose of diversifying the economy. In 2009, Lougheed told the Canadian Press that the size of the fund was, “distressing to me because when I left government in 1985 the fund was of a similar value”. Lougheed also asserted that the fund’s investments led to a “highly successful diversification of [the Albertan Economy]” (2009). Though this claim is dubious, the problem of competing fund aims is not. Until 1996, the Heritage Fund had both near and long-term goals which conflicted with each other and muddled management and withdrawal decisions. Had the Heritage Fund been created under an alternative set of rules, its present value could have been considerably higher. Murphy and Clemens point to Alaska as an ideal model of revenue fund governance (2013). The Alaska Permanent Fund, established in 1976, the same year as the Heritage Fund, was created via state constitutional amendment which mandated the 25% of resource revenues be allocated to the savings fund. The Permanent Fund also has a clear mandate through which citizen can hold their elected officials to account. Perhaps the most effective protective feature of the Permanent Fund are the payments the fund makes to Alaskans in the form of an annual dividend. Since its inception, the Permanent Fund has paid out \$19.2 billion (46 percent of total earnings) while contributions to governments operations have been limited to \$424 million (Murphy & Clemens, 2013, 6).

The Norway case is even more rigid and requires that all resource revenue be

deposited into the state's Government Pension Fund Global. As a result of the requirement to save all resource revenues, the fund has amassed holding of more than US\$900 billion since its founding in 1990. Has Alberta followed this model, it could have had in excess of \$150 billion in its fund today.

In order for the Heritage Fund to have functioned as a true long-term savings vehicle, it would require both the commitment of successive governments, the support of Albertans and rules to foster and maintain these conditions. As this paper's theory of SWF creation and operation argues, these requisites for success are extraordinary difficult to come by as the forces within a democracy are not conducive to accumulating capital for the benefit of future generations.

Future Expectations

In 2014, then Finance Minister Doug Horner announced the establishment of an 'Alberta Future Fund' to receive \$200 million a year in capital injections to be used for large-scale project funding. However, the move did not represent new savings as the source of funds was identified as the Alberta Heritage Savings Trust Fund (Fawcett, 2014). In 2015, merely a year after the start of a substantial downturn in oil prices, then Premier Jim Prentice warned Albertans that they should expect cuts to basic services as a result of reduced government revenues (Nam, 2015). The recently elected NDP government has also committed to continued investments in priority spending areas such as healthcare and education. Through all political parties there is a clear commitment to doing so at the expense of increasing long-term savings.

Recent developments continue the tradition of protecting the Heritage Fund's principal but avoiding regular and meaningful contributions. Alberta Budget 2016 ran

a deficit of \$6.5 billion dollars though it did not draw on the Heritage Fund to balance the books. Premier Notley told the legislature, “the Heritage Trust Fund is a legacy that is very important...that builds value for future generations...playing around with that is something that one would have to be very, very careful with - and so the idea of having it fund operational or specific capital projects is not something that I think aligns with the values of Albertans” (Wood, 2015). Though if the current Government of Alberta is so intent of preserving the fund in a way that reflects the “values of Albertans, than why hasn’t the government taken steps to legally protect the fund from being used as an instrument of social spending or set defined levels of annual contribution? Leaving the door open to dip into the fund in the future further buttresses this thesis’ theory that governments are not inclined to enshrine protections that would prevent them from using the fund to placate an electorate. What will be telling moving forward is how the fund is used later in the NDP government’s mandate.

Like many scholars and commentators who have criticised the Heritage Fund for not living up to its original promise, Kevin Nam (2015) argues that Alberta would have considerably more savings in the fund if the province had stuck to the original rules governing the fund. He cites former Premier Lougheed who claims that the fund would be worth \$100 billion if the original contribution plan had not been changed by subsequent governments. This rose coloured perspective obscures the fact that the Heritage Fund’s original design did not commit governments to leaving fund savings untouched. Lougheed also fails to consider changes to the contribution structure that were made while he was still premier, when in 1982, he reduced the percentage of resource revenues that were directed to the Heritage Fund from 30% to 15%.

Opting not to help secure Alberta's future through regular and sizable contributions to the Heritage Fund ignores much of the government's own advice. A report of the economic advisors to Premier Ed Stelmach in 2012 recommends, "we must plan for the eventuality that oil sands production will almost certainly be displaced at some point in the future by lower-cost and/or lower-emission alternatives. We may have heavy oil to sell, but few or no profitable markets wishing to buy" (Alberta, 2011, 6). To achieve this, the report made three recommendations to ensure adequate investment in the future:

(1) stop directing money received from the sale of non-renewable energy assets into the General Revenue Fund, (2) finance current expenditures using current revenue. Determine the level of public services desired by Albertans and align revenue to pay for them, and (3) restore the stabilization fund to a level appropriate to withstand future cyclic drops in revenue (2011, 94).

The report goes on to warn, "if we continue on this path, someday we will have to explain to our children why we've spent their inheritance on today's needs" (94). However, this warning is followed by a call for investment into maximizing the exploitation of existing resources and diversifying the economy to lay the foundation for long-term job creations, profitability and growth for this generation and generations to come. The underlying problem with this approach is that it has been tried before. Alberta's record of attempting to diversify its economy is checkered at best. Provincial governments have pointed to jurisdictions where growth has been stimulated by diversification, like Texas, but they have not succeeded in replicating that growth on

an economy-wide scale.

Ironically, one of the primary recommendations of the economic advisors was the creation of another fund. The report recommended creating a “Shaping the Future Fund...to make strategic investment in firms, projects, and infrastructure” (2011, 102). It would appear that such a fund would divert revenue from the sale of non-renewable energy assets to finance near-term expenditures. Through this is done under the guise of investing in the future, it has the practical effect of borrowing from the future. Though such investments are often prudent and deliver benefits to Albertans, the correct moral action would be to save one-time revenues for the future and finance diversification efforts within the current tax base. Taking this action would require an Albertan government that was not seized by the political temptation of resource wealth and was committed to its promise to protect future generations from the side-effect of resource dependence.

Conclusion

This chapter provided a number of critical lessons for other Canadian SWFs which could help them avoid the pitfalls that have limited the Heritage Fund’s potential. As we will see, other provinces are not immune from forces of the global race to the tax bottom, electoral resistance to taxation, the perceived need for spending to improve electoral gains, and the emerging demographic challenges - all factors which have driven fund decision-making in Alberta. The choices made to spend in the near-term, retain extremely flexible deposit and withdrawal rules, and consistently leave the Heritage Fund’s objectives opaque, are lessons that those considering or operating such vehicles should heed. The electoral temptations of

natural resource wealth are frequently too much for democratic governments to ignore. The lessons that the Alberta case provides were long available to its own leaders. Numerous model funds were known, even to Lougheed. As we will see in the following chapter; like Alberta, other Canadian provinces may be ignoring the lessons of model funds by political choice.

Chapter 4: Sovereign Wealth Funds in Canada

Canada is endowed with an abundance of natural resources. The old adage of hewers of wood and drawers of water has expanded to include a vast array of hydrocarbon and mineral resources which has propelled Canada into a position as one of the world's largest economies. Its immense natural resource wealth is not confined to Alberta. From natural gas and timber in British Columbia to the mineral riches in Ontario's Ring of Fire, to New Brunswick's offshore petroleum, the country is brimming with natural resource wealth that could benefit Canadians for generations to come. However, the vast majority of resource revenues currently benefit this generation of Canadians.

Government expenditures in Canada have outpaced inflation from 1991 to 2012 by more than half a percentage point as demographic changes have strained public finances. This phenomenon has increased both the federal and provincial government's reliance on resource revenues to delivery services to Canadians and minimize public debt (Busby et al, 2014). As natural resource revenue from land

extraction falls within the jurisdiction of provinces, the federal government has never seriously contemplated the creation of a SWF. However, since 2006 three SWFs have been adopted at the provincial and territorial level by British Columbia, the Northwest Territories and Quebec. Two more have considered their adoption: Newfoundland and Saskatchewan.

In each of the cases of adoption and rejection, the same forces have been at play. Each decision has been rooted in maintaining substantial control and flexibility by the government of the day in determining investment strategy as well as contribution and withdrawal rules. Where funds have been created, the functioning of those funds has clearly been aimed at increasing the electoral prospects of the incumbent government and maximizing near-term fiscal flexibility. This has been achieved through low contribution rates (Northwest Territories), delayed or selective sourcing of contributions (British Columbia), or targeting fund spending to increase fiscal space in the provincial budgets (Quebec).

The following analysis of the five Canadian provincial and territorial SWFs will demonstrate that each meets this thesis' primary expectations that decisions regarding the functioning of SWFs are responsive to electorates that are anti-tax and their policies and practices seek to bolster the electoral prospects of the incumbent government.

Quebec

Quebec highlights the near-term tax motivation that is inherent in the creation of SWFs in advanced democratic states. The fund is mandated exclusively to pay down the provincial debt so as not to burden future generations (Quebec, 2017).

Contribution rules have frequently been adjusted by the government since the creation of the Generations Fund in 2006. Though some economists would argue that paying down the debt, which currently stand as \$207 billion, is a form of saving for the future, this thesis argues that such payments are designed to create additional spending flexibility for the current government. In fact, future generations are paying for the spending choices of past and present generations by drawing upon funds that could be earning returns and awaiting those who are not yet part of Quebec's political community and who will not retroactively have a voice to shape today's decisions.

The Generations Fund currently contains \$8.5 billion and is expected to be worth \$22.9 billion by 2020-21. It has reduced the debt-to-gdp ratio by 5.5%, according to an analysis conducted by the National Bank of Canada (2016). Such a reduction represents hundreds of millions of dollars in reduced debt service payments, giving the government additional fiscal space to spend on high profile social programming. In 2016, the provincial government announced that it would divert its surplus to the Generations Fund. The fiscal space that debt service reduction creates will likely help support additional tax reductions and increased education and infrastructure spending, two highly visible areas of expenditure that Premier Couillard has championed (Canadian Press, 2016., National Bank, 2016).

The Generations Fund is managed by the Caisse de dépôt et placement du Québec, the investment organization that also controls the provincial pension fund. Though it is a long-standing institution with strict investment policies, rules pertaining to the management of the Generations Fund resides with the Quebec Minister of Finance.

By reducing the debt it frees up funds that would otherwise go towards debt

service payments. Placing surplus revenue into the Generations Fund also has the effect of retaining fiscal space in the near-term which could be devote to additional social spending. As surpluses are in part dependent upon the government's own budgets, they can be reduced and increased in response to the electoral standing of the government. If a government is enjoying a period of popularity it can delay spending by banking surpluses in the Generations Fund. If a government is facing an electoral threat or looming election it can then increase spending by reducing the surplus without running a deficit - an action that could erode voter support.

Northwest Territories

The United States Geological Survey estimates that the Arctic could contain 30% of the earth's undiscovered gas reserves, with the Mackenzie Delta and Beaufort Sea alone potentially holding 55 trillion cubic feet (Taylor, et al, 2010, 3). As the effects of climate change puts this wealth within reach, the Northwest Territories spent the bulk of last decade considering how to manage the potentially dramatic increase in resource revenues to come. In 2013, the government announced the creation of a Heritage Fund to save for the future.

The Heritage Fund originally received a mere 5% of the Territory's share of resource revenues (Wohlberg, 2014). This funding level raised public concern that the Fund will be insufficiently capitalized to serve future generations - 45% of the revenues go to paying down the debt and near-term social and infrastructure spending (2014). Though the Government of the Northwest Territories faced political pressure to dramatically increase contribution to its Heritage Fund, and in 2015 increased the contribution rate to 25%. It is a case where citizens took an active role

in advocating for delayed investment of non-renewable resource revenue against the government's self-interest of directing those revenue for near term political gain. The Northwest Territories Finance Minister has stated that increasing the contribution rate would be politically difficult, noting "there are some folks who would like to see us spend all the money because we need it today - we can use it all tomorrow. The idea of putting it all into the Heritage Fund would not have support, I don't think, from anybody because we have all these other needs we're trying to meet" (2014).

The design of the Heritage Fund leaves doubt that even the paltry amount of money that is currently under management will be untouched by political actors. The administration of the Heritage Fund is the responsibility of the Financial Management Board's Secretary who is appointed by the Minister of Finance and the government is allowed to withdraw up to 5% of the fund's principal annually. This direct patronage linkage creates uncertainty as to whether or not the fund's objective to "maximize the long-term growth in the Northwest Territories Heritage Fund while avoiding undue risk" will be met (NWT, 2014). Even if the Fund avoids being raided, it will have to be particularly effective in executing its mandate if it is ever to having a meaningful impact on the lives of the Territory's citizens. The fund is currently worth less than \$2 million.

British Columbia

The province of British Columbia estimates that its land contains 2.933 trillion cubic feet of natural gas (BC Liberals, 2015). The government estimates that industry could be as large as \$1 trillion dollars over 30 years. One project alone, Pacific NorthWest LNG, could generate tax and royalty revenues of \$8.6 billion over 25

years. The 2013 BC Liberal platform committed to placing \$100 billion in a sovereign wealth fund, the BC Prosperity Fund (BC Liberals, 2013). Though independent analysis suggests this ideal scenario is unlikely to materialize, the province still has the potential to capture tens of billions in royalties and corporate taxes on LNG producers over the next 30 years (Lee, 2014).

Anticipating new resource revenues from liquid natural gas (LNG), Premier Christy Clark announced plans to establish a British Columbia Prosperity Fund in her party's 2013 Campaign Platform. The decision was taken at the height of natural gas prices and in the midst of a flurry of planned investment into extraction and distribution of liquid natural gas. Within a year of the announcement, however, LNG prices collapsed. The anticipated revenues to the fund have yet to materialize.

Much like Quebec, the government of Christy Clark promised to use revenues from the fund to eliminate the provincial debt. Unlike Quebec, however, the province's debt levels were not a subject of concern among economists and leading financial institutions. Furthermore, the British Columbia Liberals did not promote their fund as a potential intergenerational savings vehicle. Freeing up fiscal space for additional program spending would appear to be the fund's motive in absence of more substantive economic aims.

The motivation to create the fund was clearly one of political optics and a desire to follow through on the 2013 campaign promise. The Prosperity Fund was created in the 2016 Budget Implementation Act with its revenue source identified as general revenue surpluses, not LNG royalties (Legislative Assembly of British Columbia, 2014). This source of funds is extremely revealing. Though the Government argued that it did not want to wait until LNG projects had been

established to kick-start the important fund, it could have diverted royalties from existing natural gas projects. British Columbia produced nearly 45 billion cubic litres of natural gas in 2014 generating over \$500 million in royalties (Lee, 2014). It is likely that the incumbent government did not want to divert \$500 million in potential social spending to the sovereign wealth fund with a general election less than a year away. The province's finance minister, Mike de Jong, essentially stated as much when he remarked that current and future investments outside of LNG will "accrue from the anticipated surplus...it's arbitrary to that extent" (Hunter, 2016).

The creation of the Prosperity Fund was likely a medium-term political consideration by the Clark government that anticipated an additional term in office faced with growing demographic pressures. British Columbia, like all other Canadian provinces, is facing stark demographic changes that will not only increase the cost of healthcare and other related social services but decrease the tax base as baby boomers enter their retirement years (Busby, et al, 2014). Though the British Columbia government has fared far better than other provincial governments in managing the growth of healthcare spending, its tax base will grow at a substantially slower pace as demographic changes continue to accelerate and put downward pressure on GDP growth. This, Busby et al, note, "will further reduce the ability of British Columbia to accommodate growth in future healthcare costs (2014, 2). The C.D. Howe Institute projects that healthcare spending in British Columbia as a percentage of GDP will rise from 7.6% in 2014 to 11% in 2035 (Busby et al, 2014, 5).

Lee (2014) estimates that, once operational, the LNG income tax will generate \$200 to \$400 million annually for the provincial government coffers. This is largely due to lower prices and the choices of the provinces political leaders. If these

revenues are captured by the Prosperity Fund, the province could use the revenues for a variety of long-term economic initiatives and save for the benefit of future generations. In practice, the fund's revenues, if they are ever substantial, will not reach future generations. Instead, British Columbia's governments are likely to prioritize near-term consumption in an effort to bolster their electoral prospects by leveraging the Prosperity Fund in an attempt to retain power.

Saskatchewan

Saskatchewan benefits from an abundance of potash, a key mineral in the production of fertilizers, as well as a substantial reserve of petroleum and uranium. In 1978, in the midst of high oil prices and on the heels of its neighbour Alberta creating a sovereign wealth fund, Saskatchewan established a Heritage Fund of its own. It was mandated to pursue economic development, aid in fiscal stabilization, and save for the future. It received an initial deposit of \$465 million and was legislated to receive 100% of the provinces resource revenues. However, as McKinnon observes (2013, 3), "there were few formal controls on spending, and, by 1982 most of the fund's assets were committed to Crown corporations and assets". This is due in large part to then Premier Grant Devine's decision to remove rules governing how much of the fund could be invested in provincial development (Wilson et al, 2012, 4). In 1992, facing a \$600 million deficit, NDP Premier Roy Romanow abandoned the fund and transferred its remaining capital into consolidated revenues.

In the wake of the commodity collapse of the late 1980s, as with Alberta, the decade that followed saw significant cuts in government spending as both provinces abandoned the Heritage Fund approach and included almost all resource revenues in

their annual budgets (Wilson et al, 2012) - a practice that left them vulnerable to price shocks. As prices recovered through the 2000s, the Saskatchewan government began using the windfall to create higher level of baseline social spending. Revenues grew by 7.7% a year between 2003 and 2010 (Globe and Mail, 2011) with a nearly corresponding increase in government spending at 6% annually (Wilson et al, 2012). In 2009, when resource revenue fell by almost 60%, the province was once again thrown into fiscal disarray. This pattern was repeated as the government of Brad Wall continued spending increases during the recovery of the early 2010s by removing income tax on families making less than \$45,000 and reducing corporate income taxes. When prices corrected once again in 2014, the government faced a deficit in excess of \$1 billion.

The cycle of increasing spending followed by commodity price declines has been compounded since 1991 through decisions by both conservative and New Democratic governments to lower taxation and royalties on the natural resource sector instead of saving those resources for economic stabilization or the benefit for future generations (Warnock, 2011).

In 2013, in response to public criticism over the government's management of natural resource revenues, Saskatchewan Premier Brad Wall commissioned a report on the possibility of establishing a Futures Fund for the province (McKinnon, 2013). Though Wall agreed with the recommendations of the report, the subsequent collapse in commodity prices and a \$1 billion provincial deficit put off the adoption of a sovereign wealth fund in the province as the government focused on near-term fiscal stability. Wall may have missed an opportunity to establish a fund during a period of high commodity prices earlier in his government's tenure. Now, faced with a billion

dollar deficit, the political imperative within his conservative party to avoid raising taxes or cutting services makes this a difficult time to propose delaying spending by creating a SWF.

Last year, Premier Wall announced that he would capitalize a Growth and Financial Security Fund up to \$500 million, though only when oil prices reached US\$75 per barrel. This falls far short of the Futures Fund recommendations of 2013. The province will continue to face the boom and bust commodity cycle and in the absence of sound natural resource management policy will perpetually be faced with budgetary crises in the wake of declining prices. These periods of collective pain will only intensify as its population ages. Healthcare spending was 38% of the provincial budget in 1991. By 2014 it was 43% with that figure expected to continue to grow, as spending in healthcare as a percentage of GDP is forecast to double in the next 50 years (Busby et al, 2014).

Newfoundland

Outside of Alberta, Newfoundland is the province that most clearly meets the benchmarks established by the existing literature on the origins of SWFs. Government revenues doubled between 2003 and 2010, but Premier Danny Williams neither secured those gains for the benefit of future Newfoundlanders, nor did he take measure to prevent an overheating of the provincial economy during the petroleum windfall (Marland, 2010). Even though his government ran several surpluses and temporarily ended the provinces 'have not' status, Newfoundland has now returned to deficit in the wake of the commodity price correction of 2014. By 2016 the province had a \$2.2 billion deficit - a remarkable sum considering the government serves a

population of a little over 500,000.

Since 1997, three offshore oil well projects have been brought online off the coast of Newfoundland and Labrador, generating billions of dollars in royalties. Its case is highly instructive for this thesis' attempt to understand the political forces that drive the adoption of SWFs in Canada. The bulk of the existing research suggests that discovery of offshore resources would lead the government of Newfoundland and Labrador to establish a SWF for the purpose of macroeconomic stabilization or intergenerational savings. The fact that a fund was not set up illustrates the desire of the government to spend for near-term electoral gain, an expectation that is in line with the arguments put forth in this thesis.

In the mid-2000s, as much as 30% of the province's revenues came from royalties, and by 2011 this had grown to 37.6%. Russell Williams argues that "most of the money went into increased spending and tax cuts" (Freeman, 2015). Between 2008 and 2012, the government increased public sector salaries by 21.5% and spent more than \$1 billion on new infrastructure projects (Reid & Collins, 2012, 19). Total expenditures from 2002 to 2012 rose from \$4 billion to \$8 billion. Reid and Collins note that oil royalties were used to "eliminate political opposition" (19).

Alex Marland (2010) argues that Premier Williams employed a kind of regional populism that pitted his government against the federal government on issues pertaining to control over national resource revenues and transfer payments. Williams was particularly effective in turning the Harper government into a political enemy of the province after Ottawa decided not to uphold a previous federal Liberal decision to exclude oil royalties from the Atlantic Accord. Part of the decision not to establish a SWF in Newfoundland could be the governance structure for the management of

offshore resources. In 1985, the federal and provincial governments established the Canada-Newfoundland Offshore Petroleum Board to jointly manage these resources. From this perspective, it could be argued that the premier would have been placed at a disadvantage if the province had adopted a SWF that the federal government could then point to as a highly visible example of Newfoundland's improved fiscal condition. However, given that the province has the most dramatic demographic crisis in Canada and its population is stagnating without the benefits of sustained immigration enjoyed by British Columbia, Ontario and Quebec - not establishing a SWF was a lost opportunity.

Lessons for Canada

Canada's natural resource exports stand as a comparative advantage in an era where advanced economies have passed the peak demographic window for growth. Serving the growing markets of Asia, Africa and Latin America can sustain the Canadian economy and help increase government revenues to help address the challenges posed by an aging population. However, as natural resource prices are volatile and demand uncertain, governments across Canada must act prudently to select public policies that will both smooth the boom and bust cycle and save for the future when the benefits of those resources may no longer be available.

In his report to the Premier of Saskatchewan, Peter McKinnon (2013, i) notes that "the advantages that come with non-renewable resource wealth are accompanied by risk of excessive reliance, unsustainable spending commitments, and waste". To date, the advantages have been overshadowed by the poorly managed risk of natural resource revenues. Imagine a scenario in which

Saskatchewan retained its fund and continued to divert 100 percent of natural resource revenue to it? Or an Alberta Heritage Fund that followed its original contribution rules of 25%? Both provinces would have funds in excess of \$100 billion and would be positioned to weather the budgetary pressures of lowered commodity prices while preserving the fund's principal for future generations. If the funds that exist in Canada today are going to fulfil their promises for tomorrow, then the governments that manage them must learn the lessons of model funds and other Canadian experiences.

The political use of government savings vehicle receives only cursory examination in the literature, though the potential for this use is frequently referenced. Gouett (2016) notes that, "without clear rules or transparent accounting...political rivals become worried that the ruling party will be able to maintain support through higher public expenditures". This concern while in opposition has been an opportunity seized by the founding governments of SWFs in Quebec, British Columbia, Saskatchewan and Alberta. Such funds hold great potential, however, without appropriate controls they are frequently used as vehicles to enhance the electoral prospects of the government of the day.

The lessons that should guide SWF creation and operation are not new, nor are they unknown. Poor fund design is politically driven to create the space required to utilize fund capital for electoral gains. To avoid this, Revenue Watch (2014) makes six recommendations to ensure SWFs contribute to strong natural management and avoid political manipulation:

1. *Set clear fund objective(s) (e.g., saving for future generations;*

stabilizing the budget; earmarking natural resource revenue for development priorities).

2. Establish fiscal rules—for deposit and withdrawal—that align with the objective(s).

3. Establish investment rules (e.g., a maximum of 20 percent can be invested in equities) that align with the objective(s).

4. Clarify a division of responsibilities between the ultimate authority over the fund, the fund manager, the day-to-day operational manager, and the different offices within the operational manager, and set and enforce ethical and conflict of interest standards.

5. Require regular and extensive disclosures of key information (e.g., a list of specific investments; names of fund managers) and audits.

6. Establish strong independent oversight bodies to monitor fund behavior and enforce the rules.

A seventh should be added: establish meaningful public linkages to the fund within a given political community. The case studies of Alaska and Norway, and the absence of this feature in Alberta, are a clear indication that embedding a fund in the government's political community is an important cornerstone of a fund's long-term success.

This thesis argues that the key lessons from the Canadian experience and model funds globally are to establish: (1) clear fund purposes, (2) clearly defined withdrawal and contribution rules, (3) independent governance, and (4) connection to the political community.

McKinnon (2013, 7) rightly argues that, “the successful creation of a [SWF], and its endurance over generations and centuries as distinct from political cycles, requires bipartisan support and social consensus that it is the right thing to do”. To do this governments must clearly articulate the purpose of funds. If a fund is for stabilization, it should be solely for this end. Competing priorities, as the Alberta and original Saskatchewan case clearly illustrate, creates opportunities for both political abuse and poor portfolio management.

As Gouett (2016) notes “the potential effectiveness of [SWFs has] been undermined by frequent changes to deposit and withdrawal rules, as well as deviations from their intended purposes”. In addition to a clear purpose, funds should have clearly defined rules that dictate withdrawal scenarios. A stabilization fund could use a commodity floor price or the government’s deficit exceeding a certain percentage of the province’s budget as a trigger for withdrawal. A savings, conversely, could inflation proof itself and protect the fund principle from withdrawal with clear rules for the expenditure the earnings until such time as the funds source of revenue has been depleted or has become obsolete. Conversely, deposits should be a fixed percentage of clearly identified revenues. Government control over the deposit amounts or conditions, as seen in Quebec, increases the likelihood of capturing such funds for political purposes.

Canada’s SWFs should also be independently managed. As provinces do not have central banks to which they can vest the responsibility for fund management, they should create independent organizations that are completely free from political interference. This could include measures such as one-term limits for board members and executives, bipartisan approval of manager appointments and public oversight

bodies.

Perhaps most importantly, SWFs should be engrained within the political community. If Canadians are committed to holding governments to their commitment to future generations, they need to apply levels of political pressure that would lead to the redesign of Canadian SWFs to ensure they reach their tremendous social potential. To foster this pressure, funds should have a clear connection to citizens to bolster broad public support. As is the case with Alaska, a transfer of a portion of the fund's earnings to individuals could serve this purpose, or it could be tied to future government obligations like pensions or health care. With a clear purpose, the connection that the public feels to a fund will spur them to temper their political leaders' use of it for partisan gain.

If the four principles are adopted, SWFs in Canada have the potential to serve as extraordinarily prudent tools of fiscal policy. However, if the four principles articulated in this chapter are present at the time of a funds creation, it is unclear if incumbent governments would be inclined to adopt such funds given that they would have to forgo the opportunity to spend the resource revenue in the near-term.

Conclusions

The principles of sound SWF management are not new, nor are they unknown. Governments know full well how to design funds that are protected from political interference and support sustainable resource development while avoiding Dutch Disease. However, Canada's SWFs have largely avoided adopting the principles that underpin sound management and avoid political raid. This thesis argues that this is not an accidental occurrence.

Canadian SWFs have been designed either to buttress near-term social spending or made to be easily raided when incumbent government's face electoral challenge. This is a function of a diminishing number of options to increase revenues through traditional means. Governments across Canada are increasingly bound by a global tax race to the bottom, demographic pressures, and electoral resistance to taxation.

SWFs are created to establish flexibility through delayed spending. If resource revenues were transferred into general revenues to be spent in the fiscal year in which they were collected, governments would face pressure to lower tax rates or establish higher than normal spending patterns. This scenario would limit their ability to spend without going into deficit when economic circumstance or political forces prompted them to increase spending on social welfare to protect their electoral prospects.

Worth watching is an apparent appetite for deficit spending in service of economic growth and social spending. The growing federal deficit is indicative of the public changing appetite for investment but not for tax increases (Graves, 2017). This trend is new and it is unclear if it will extend to an acceptance of increased personal income tax rates over time.

Until such time as public attitudes towards taxation shift and demographic pressures ease, this thesis expects that a greater number of Canadian provinces will adopt SWFs as the forces detailed within these pages continue to strengthen. How these funds are structured will reveal a great deal about their originating motives. Given the experiences of Alaska and Alberta, one would anticipate governments attempting to avoid the constraints on the use of capital contained within model

SWFs. As demonstrated by almost all the Canadian cases, future adopters will likely seek soft governing arrangements that leave such funds open to speedy rule changes if the political or economic winds change.

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