

# FOUR MYTHS ABOUT ECONOMIC DIVERSIFICATION IN ALBERTA



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# Four Myths about Economic Diversification in Alberta

by Steve Lafleur, Ben Eisen, and Milagros Palacios



# Contents

Executive Summary / i

Introduction / 1

What Is “Diversification”? / 2

Myth #1: Alberta Is a “Petrostate” / 3

Myth #2: Economic Diversification Is Necessary  
for Stable Public Finances / 7

Myth #3: Top-Down Economic Diversification Efforts  
Are Self-Evidently Effective / 9

Myth #4: Diversification Is Inherently Good / 12

Conclusion / 13

References / 14

About the authors / 17

Acknowledgments / 18

Publishing Information / 19

About the Fraser Institute / 20

Purpose, Funding, and Independence / 21

Editorial Advisory Board / 22



# Executive Summary

Economic diversification is a frequent topic in Alberta's political discourse. This stems in part from a perception that Alberta's economy and public finances are overly reliant on natural resources, and that the government is well placed to implement top-down policies that would re-orient Alberta's economy towards other industries. In this study, we discuss four common myths about economic diversification.

The first myth is that Alberta's economy is a "petrostate"—in other words, that oil and gas production dominates economic activity and employment in the province to the point that the provincial economy is notably less diversified than other advanced, industrial economies. We follow Tombe and Mansell's 2016 paper, *If It Matters, Measure It: Unpacking Diversification in Canada*, by constructing a Herfindahl Index to show that employment and gross domestic product in Alberta are not unusually concentrated by Canadian standards. Because data is limited, it was not possible to compare Alberta directly to peer states or energy-producing countries. But Tombe and Mansell previously showed that Canada's economy is not unusually concentrated by the standards of other advanced industrial economies. Therefore, it is reasonable to claim that Alberta's economy is not unusually undiversified.

The second myth is that economic diversification is necessary to stabilize Alberta's public finances. While it is true that Alberta's public finances can be volatile, it is not the case that further economic diversification is required to reduce the volatility of public finances in Alberta. This can be addressed in several ways, but we highlight two. First, taxation in the province should focus on consumption rather than on more volatile sources of revenue. This can be achieved by orienting income taxes towards primarily taxing consumption, for instance. Second, the province should direct a portion of non-renewable resource revenue to the Heritage Fund, and using some of the earnings to pay a dividend to citizens. That could help limit the tendency for governments to increase program spending to unsustainable levels when there are large influxes of natural resources revenues.

Third, we explore the myth that top-down economic diversification efforts are inherently effective. However, building on Morton and McDonald's 2015 paper, *The Siren Song of Economic Diversification: Alberta's Legacy of Loss*, we show that despite the long history of economic diversification efforts in the province, they are not self-evidently effective.

Finally, we discuss the notion that economic diversification is inherently good. We argue that this is contradicted by one of the most basic tenets of economic theory: comparative

advantage. We point out that Alberta is one of the most prosperous jurisdictions on earth, so it is not clear that having a large natural-resource sector in any way undermines the provincial economy. In fact, as we note, many other highly successful economies from San Francisco to Germany specialize in particular economic sectors in which they have clear comparative advantages.

These four myths contribute to the narrative that top-down economic diversification is necessary for Alberta. We argue that these claims should be met with scepticism.

# Introduction

Diversification has long been a buzz word in Alberta politics. As a province with a large natural-resource industry that has been through a number of painful episodes resulting from fluctuations in global commodity prices, it is common for politicians to promise to reduce the province's reliance on natural resources. This has in many cases been paired with government-led attempts to bolster specific sectors of the economy, often with direct government investment in particular projects.

This study will show that the focus on top-down economic diversification is premised on a number of myths. First, the notion that Alberta's economy is unusually undiversified. While there is a sense in some quarters that Alberta is a "petrostate", like those seen in the Middle East, it is in fact diversified compared with other modern economies. Second, that a volatile economy means volatile government revenues and that leads to budgeting issues. This is a popular argument, often floated by politicians who do not have the wherewithal to appropriately budget for volatile revenues. The solution to this problem (volatile revenues resulting from a volatile economy) is better budget discipline, not a less volatile economy. Third, that top-down economic diversification efforts are effective despite little evidence of success from Alberta's history. Finally, the idea that economic diversification is inherently good. This ignores the benefits of economic specialization—which has helped make Alberta one of the most prosperous jurisdictions in the world.

Rather than focus on top-down efforts at diversification, the Government of Alberta should instead focus on creating an economic climate conducive to broad-based investment. In the penultimate section of this study, we will show that Alberta's improved tax competitiveness as a result of recent rate cuts has created a tax environment that encourages economic growth. A brief conclusion will follow.

## What Is “Diversification”?

Broadly speaking, economic diversification refers to the level of economic activity concentrated in particular sectors of the economy. A very undiversified economy would have a very high rate of activity in one particular economic sector. Extreme examples of this would be one-industry steel towns from the middle of the 19<sup>th</sup> Century or pre-modern fishing villages. By contrast, a diversified economy receives employment, business investment, and tax revenue from a broad array of economic sectors. “Diversification” is often used as a term to refer specifically to attempts to intentionally create a more diverse economy.

Today when people think about undiversified economies, they tend to think of “petrostates”. These are countries such as Saudi Arabia or Venezuela that rely heavily on their domestic oil and gas industries not only to create wealth, but also to fund large portions of government spending. These are countries where economic outcomes are heavily levered to resource prices.

This leads to the question of whether Alberta, like these contemporary “petrostates”, is in fact, an undiversified economy. We will turn to this question in the next section.

## Myth #1: Alberta Is a “Petrostate”

Politicians, activists, and pundits frequently discuss the idea of diversifying Alberta’s economy.<sup>1</sup> In the wake of the Global Financial Crisis, the Stelmach government put together an expert panel aimed at determining how to diversify the economy. “I want them to think big and provide an external perspective on our efforts to boost innovation, diversify the economy, enhance our quality of life, and sustain prosperity over the long-term,” Premier Ed Stelmach said (Government of Alberta, 2017). Similar thoughts have been expressed by subsequent premiers. As we will see below, the economy did diversify from where it was before the Financial Crisis—but this was not the result of any grand, top-down initiative.

The question of whether Alberta’s economy is diversified is not new. Indeed, Tombe and Mansell (2016) have investigated this question. Their approach was to construct a Herfindahl Index, which we use to measure concentration of employment and economic output.<sup>2</sup> Below we will update some of their findings in order to highlight that, contrary to perception, Alberta’s economy is not unusually undiversified compared with other advanced industrial economies.

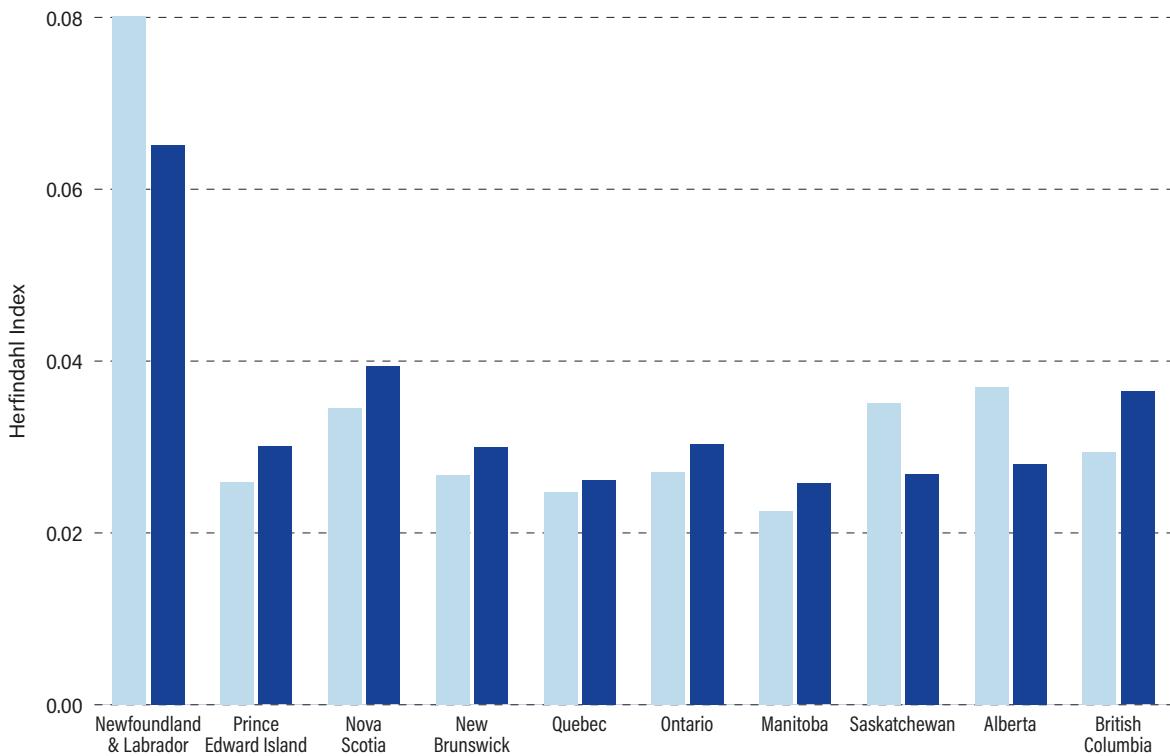
Because data is limited, it is difficult to compare Alberta directly to other countries. However, following Tombe and Mansell, we will show how Alberta compares to other provinces. Given that their work showed that Canada is relatively well diversified relative to other industrialized countries, Alberta’s level of diversification relative to other provinces gives us an indirect idea of how diversified Alberta’s economy is relative to the rest of the industrialized world.

In order to assess Alberta’s level of economic diversification, Tombe and Mansell employed a two-step process. First, they showed that Canada is relatively well diversified when compared to other OECD countries—both in terms of employment concentration and GDP concentration. The second step (which we update here) is to show that relative to other provinces, Alberta’s economy, as figure 1a shows, is not unusually concentrated in any given industry. In fact, Alberta in 2020 was the fourth most diversified provincial economy in Canada as measured by GDP concentration—more diversified than Ontario or British Columbia.

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1. For example, a search of *Alberta Views* magazine’s website returns five articles since 2010 that use the term “petrostate” in relation to Alberta.

2. Specifically, the Herfindahl Index is a measure of the size of individual industries in relation to the overall economy and is a indicator of the level of diversification of the economy. Larger values mean that economic activity is concentrated in a relatively small number of industries. See Tombe and Mansell, 2016 for more details on their methodology, which we have replicated.

Figure 1a: Normalized Herfindahl Index of nominal GDP, by province, 2019  and 2020 

Note: The Herfindahl Index was calculated across 20 sectors.

Sources: Statistics Canada, 2021b: table 36-10-0400-01; calculations by authors.

In addition to being relatively well diversified compared to other provinces, Alberta has also become more diversified over time. As figure 1b shows, in the middle of the last decade, Alberta did indeed see a period of heavy concentration of economic output in oil and gas. However, this concentration did not persist as the period of major investment was short-lived. Nominal GDP concentration in the province has been on a noticeable downturn starting with the Global Financial Crisis.

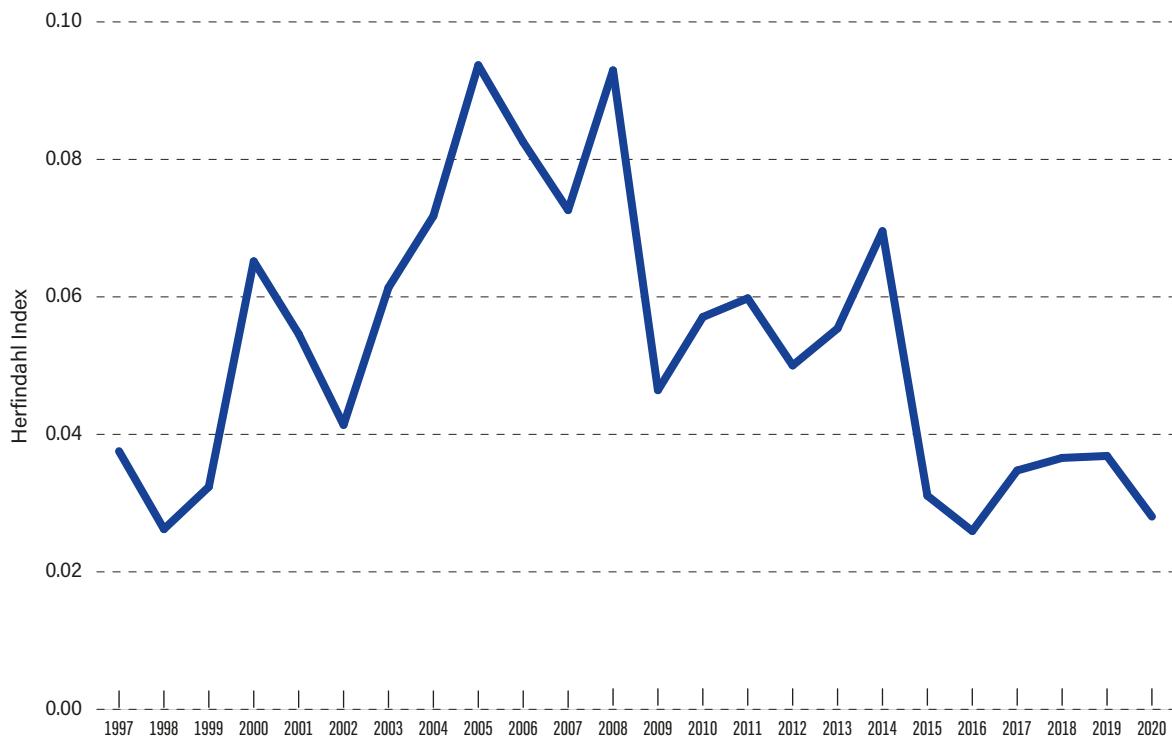
When looking at employment concentration (figure 2a), Alberta is even more diversified than other provinces.<sup>3</sup> In fact, by that measure Alberta has the most diversified economy in Canada. Interestingly, fellow oil-producing jurisdiction Saskatchewan registered as the second most diversified provincial economy on this metric.

Figure 2b does show that the level of employment concentration has been on an up-trend in Alberta but, nevertheless, the province remains no less diversified in terms of employment concentration than Canada's other provinces by this metric. In other words, Alberta is a typically diversified modern economy.

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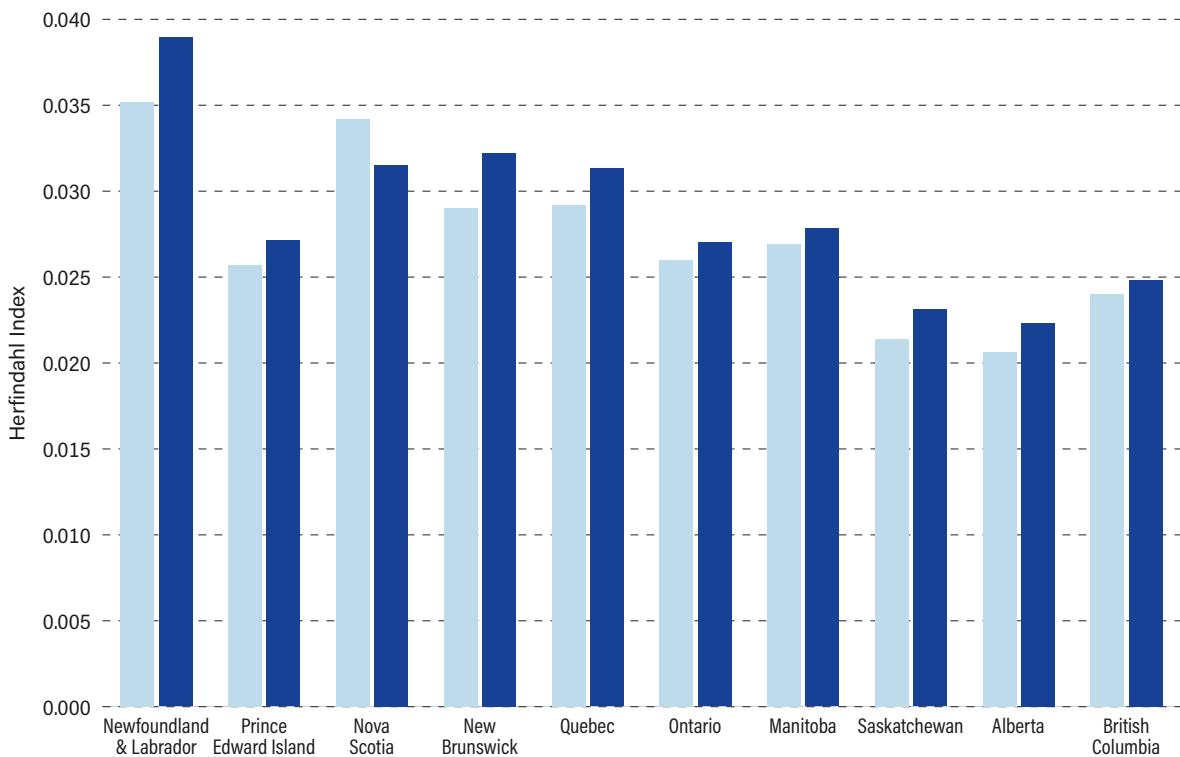
3. This could be due to the oil and gas sector having a relatively low labour-to-capital ratio.

Figure 1b: Normalized Herfindahl Index of nominal GDP, Alberta, 1997–2020



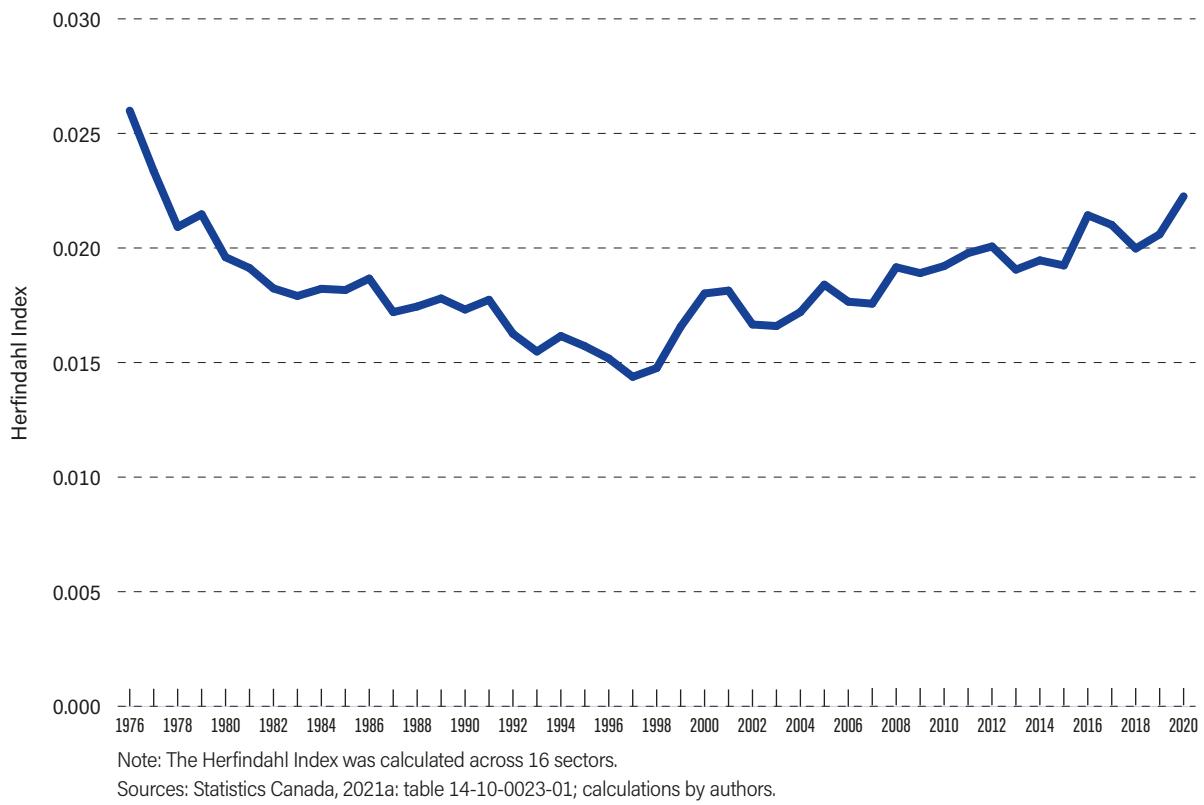
Note: The Herfindahl Index was calculated across 20 sectors.  
Sources: Statistics Canada, 2021b; table 36-10-0400-01; calculations by authors.

Figure 2a: Normalized Herfindahl Index of employment, by province, 2019 ■ and 2020 ■



Note: The Herfindahl Index was calculated across 16 sectors.  
Sources: Statistics Canada, 2021a; table 14-10-0023-01; calculations by authors.

Figure 2b: Normalized Herfindahl Index of employment, Alberta, 1976–2020



In summary, Canada's economy is reasonably diversified and Alberta's economy is not noticeably undiversified compared to other Canadian provinces. While the data does not allow for an apples-to-apples comparison of Alberta to other countries or other peer jurisdictions (for instance, to Texas or North Dakota), the data presented here strongly suggests that Alberta does not have an unusually undiversified economy. But that has not prevented politicians from attempting top-down economic diversification schemes, as we will see in the next section.

## Myth #2: Economic Diversification Is Necessary for Stable Public Finances

Discussions of economic diversification tend to intensify during recessions, when large deficits coincide with large declines in non-renewable resource revenues (NRR). Because governments tend to use non-renewable resource revenues for day-to-day spending rather than saving portions for future use, and since NRR is very volatile, they tend to use NRR to finance high levels of expenditures during good times that turn into large deficits when NRR declines.

The notion that Alberta's government revenues are volatile in part because of swings in resource revenues isn't new.<sup>4</sup> Indeed, it has been a frequent topic of discussion among academics, politicians, and activists. It is such a ubiquitous topic in discussions of Alberta's public finance that there is a colloquial term for it: the "resource revenue rollercoaster". However, while this has historically been a problem with government budgeting in Alberta, economic diversification is not required to smooth budget volatility. There are a number of ways to do so.

The first is focusing taxation on less volatile sources of revenue. For instance, consumption. This can be done through taxing consumption directly. The most obvious example is a sales tax. However, personal income taxes can also be designed to primarily tax consumption.<sup>5</sup> This leaves out people who do not pay income taxes, such as tourists, but a personal income-tax system can nevertheless be designed to focus primarily on consumption. But focusing the tax system on consumption rather than investment can help smooth fluctuations in government revenue without harming economic growth.<sup>6</sup>

The second is contributing a portion of non-renewable resource revenue to a sovereign wealth fund, such as Alberta's Heritage Fund. By diverting a portion of natural resource revenues to an investment fund that pays out a portion of the revenue either to directly fund a portion of government expenditures or as taxable dividends to individuals, a sovereign wealth fund can help stabilize volatility in public finances.<sup>7</sup> This was part of the original vision of the Heritage Fund, though regular contributions ended decades ago. One proposal, based on the Government of Alaska's Permanent Fund, is to allocate a

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4. For instance, Landon and Smith (2010) wrote about the topic in 2010, and it was cited as an issue by the Alberta government's Blue Ribbon Panel on Alberta's Finances (2019).

5. For a more detailed explanation, see Mintz, 2017.

6. See *Ferede and Dahlby, 2016* for a discussion of the economic impacts of major tax categories.

7. For a detailed and thorough discussion, see Hill, Emes, and Lafleur, 2021.

fixed percentage of annual non-renewable resource revenue to the Heritage Fund, using some of the resulting earnings to protect the value of the fund from inflation, and paying annual dividends from the fund to the general public in order both to smooth resource revenue volatility and to prevent the government from using large windfalls to increase program spending to unsustainable levels during periods of elevated resource revenues.<sup>8</sup>

In summary, while economic diversification is often implied to be a solution for volatile government revenues, further diversification is not the only way to reduce volatility in provincial finances. This can be achieved by regular contributions to the Heritage Fund, focusing the tax system more on consumption, or both.

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8. See Hill, Emes, and Lafleur, 2021 for details.

## Myth #3: Top-Down Economic Diversification Efforts Are Self-Evidently Effective

Alberta has a long history of efforts at top-down economic diversification that have been well covered by the existing literature. For instance, Morton and McDonald (2015) exhaustively surveyed provincial diversification up to 2015. This section will merely summarize the existing literature on diversification efforts to provide context, and will then discuss post-2015 developments.

Morton and McDonald trace the history of efforts at top-down diversification back to Premier Lougheed in the early 1970s. In 1972 the Lougheed government created two Crown corporations: the Alberta Agricultural Development Corporation and the Alberta Opportunity Company. This kicked off a period during which the provincial government took equity stakes in energy and materials companies, then outright purchased a commercial airline. In subsequent years, provincial diversification efforts ranged from losing hundreds of millions of dollars on a telephone company to qualified successes such as purchasing shares of the Bank of Alberta, which went on to become part of Canadian Western Bank.<sup>9</sup>

In recent history, successive governments have implicitly conceded that large-scale attempts at top-down reorganization of the economy won't work. The most prominent recent diversification efforts centered on partial upgrading of petroleum products (the Sturgeon upgrader) and spurring petrochemical investment.<sup>10</sup> Given that both of those efforts are centered on petroleum production, it doesn't appear that either of the last two Alberta governments believes that it is possible or advisable to forgo Alberta's comparative advantage in energy in favour of an aggressive shift into new to Alberta industries.

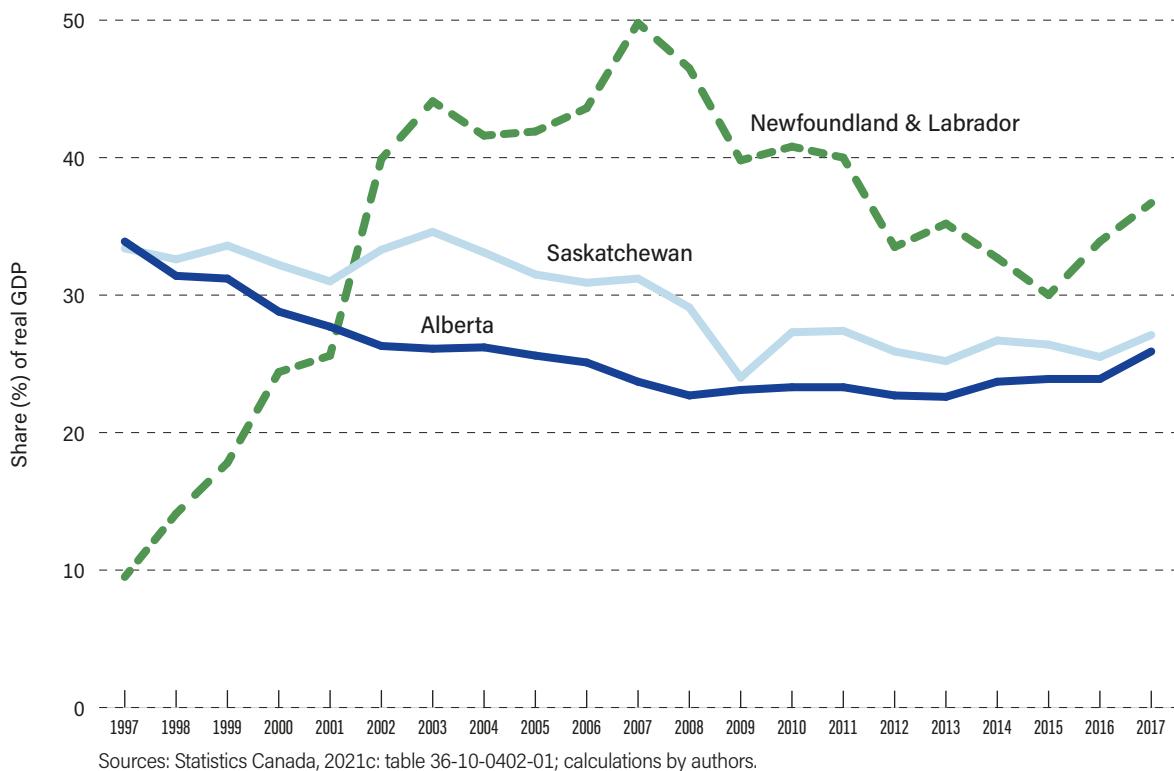
While Morton and McDonald did label some of Alberta's diversification efforts qualified successes, it is important to realize that none of the projects they catalogued contributed substantially to the overall level of economic diversification in the province.

9. The Alberta Heritage Savings Trust Fund played a role in many of the province's diversification efforts. For instance, the Heritage Fund was used to finance the bank that would go on to become Canadian Western Bank. However, this changed during the Klein years when the provincial government changed the Heritage Fund's mandate to maximize returns on investment, rendering it a less convenient political vehicle for top-down diversification efforts.

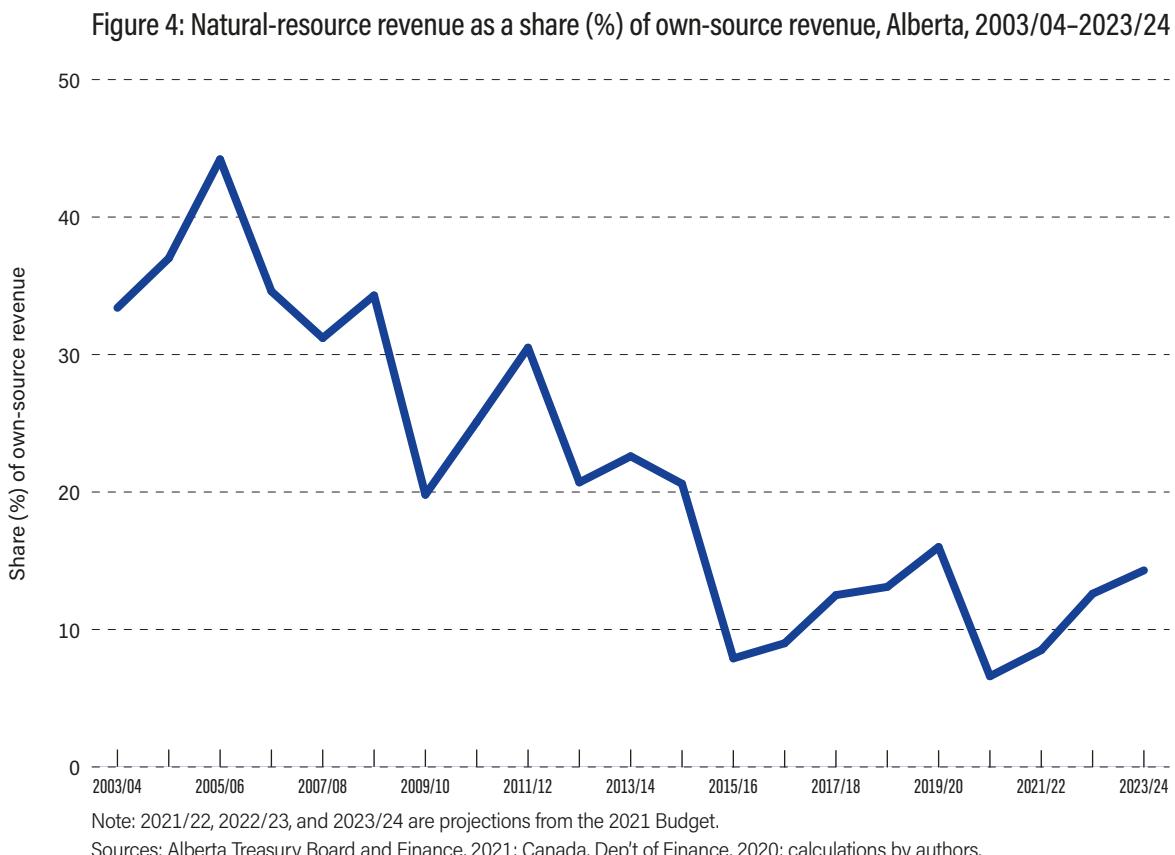
10. Both the Notley and Kenney governments have allocated billions of dollars of incentives to attract petrochemical investments. See CBC Edmonton, 2019 and CBC Calgary, 2020 for details.

As figure 3 shows, the contribution of the Mining, Oil, and Gas sector to the economy fluctuates enormously over time. Saskatchewan and Newfoundland & Labrador have also seen substantial variation in the contribution of the Mining, Oil, and Gas sector, highlighting the fact that fluctuations in oil & gas investment swamp the effects of spending a few billion dollars on a diversification project. Short of fundamentally reorienting the economy towards a different economic sector, it is hard to see how top-down diversification efforts would really change the composition of the economy.

Figure 3: The mining, oil and gas sector's share (%) of (real) GDP in Alberta, Saskatchewan, and Newfoundland & Labrador, 1997–2017



Finally, figure 4 shows that natural resource revenue as a share of own-source government revenue in Alberta declined markedly even when oil and gas activity was growing rapidly in the mid-2000s to mid-2010s. Even with those investments happening, the provincial economy diversified.



## Myth #4: Diversification Is Inherently Good

Underlying the push for top-down diversification is the notion that economic diversification is inherently good. While it may seem obvious, it isn't. In fact, economic theory suggests that jurisdictions ought to pursue their comparative advantage rather than intentionally diversifying their economies.<sup>11</sup> And, indeed, Alberta has been among the wealthiest jurisdictions on earth for decades while specializing in oil production.

Specialization allows for a jurisdiction to focus on goods and services that it can produce and sell efficiently. Diverting capital and labour from those industries can reduce productivity, unless there happens to be a more efficient use of resources that market participants have not yet identified. The notion that governments could consistently allocate capital more efficiently than private markets is dubious. Moreover, while the notion that governments are good at making these determinations underlies the case for top-down diversification, it is usually an unspoken assumption rather than an argument supported by evidence. It is folk wisdom that simply goes unchallenged.

Many of the most successful economies on earth are highly specialized. Metropolitan areas such as San Francisco and Toronto specialize in technology or finance, while countries such as Germany and Japan specialize in advanced manufacturing. And these jurisdictions are all very wealthy as a result. This is an important consideration as global oil-and-gas prices increase. While it is beyond the scope of this paper to estimate future resource demand, there is no reason to believe that governments are better able to make investment decisions than private firms.

Given that there is no theoretical reason to believe that economic diversification is inherently good, and given that governments are not good capital allocators, we should view calls for top-down diversification with scepticism.

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11. This was well known to early economists such as Adam Smith and David Ricardo, and remains a pillar of contemporary economic theory. Indeed, liberal economist Paul Krugman won a Nobel Prize for his work on gains from trade (Krugman, 2008).

## Conclusion

The need to diversify Alberta's economy is an evergreen talking point. But rarely is this claim examined critically. And, equally as important, politicians and advocates often ignore the lack of success that previous efforts at top-down economic diversification have achieved. Here we have explored four myths that commonly appear in debates about economic diversification in Alberta. In broad strokes, we have argued that Alberta's economy is more diversified than commonly understood, and that top-down efforts to further diversify the economy should be met with scepticism.

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