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Assessing Nova Scotia's Fiscal Situation

Managing Social and Financial Debts

CCPA
CANADIAN CENTRE for POLICY ALTERNATIVES
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Introduction

Nova Scotia's fiscal situation is improving. Revenue is steadily increasing due to a growing economy. The recent balanced budgets are a welcome reprieve from the large deficits posted during the '90s. However, the Province still faces two major challenges: a large provincial debt and expenditure pressures resulting from years of insufficient investment in programs, services and infrastructure.

This report examines Nova Scotia's finances in the context of claims by the finance minister that Nova Scotians must accept another tough budget. In this paper we review government revenues and spending, the management of the provincial debt, and the sustainability of debt servicing costs. The premier is targeting the provincial debt, stating that the "centre piece" of the pending 2007-08 budget will be the allocation of more than $100 million to debt repayment.[1] At the core of this study is the question: should the Province be allocating increased revenue to debt repayment, or should the funds be put towards restoring programs and services?

Assessing Nova Scotia's Fiscal Situation

Government warnings of a tough budget are part of the annual run-up to the release of provincial budgets.[2] The message is usually the same – the Province's finances do not enable the government to make the investments in programs and services that citizens are demanding. The same government also makes the fiscal situation appear worse than it is by routinely under-estimating government revenue.

There have been exceptions to this dampening of expectations – often for budgets that precede a provincial election, such as the 2003-04 budget containing the Hamm government's income tax cut and the 2006-07 MacDonald government's pre-election budget.[3]

The provincial government's revenue forecasting record and its pre-budget musings make it difficult to clearly assess the Province's fiscal situation and the options available. This also stifles public debate as to how scarce resource should be allocated.

Revenues: Forecasts and the Democratic Process

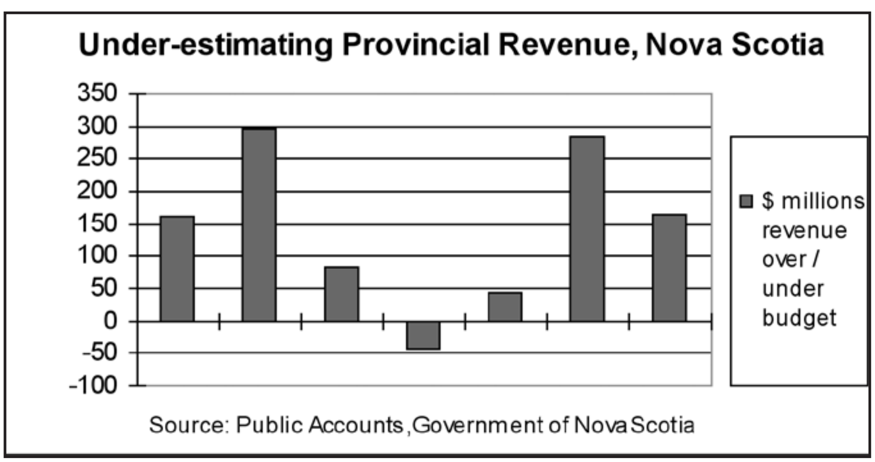
Provincial government revenues increased by just under $1.7 billion over the past 7 years, on average about $250 million (4.7%) annually, enabling the provincial government to make significant investments in programs. However, more than half (58%) of this increase was not budgeted due to the Province's tendency to under-estimate revenues. As a result just under $1 billion of the revenue increase was allocated by the provincial government outside the normal budget process (Figure 1). The Hamm government under-estimated revenue by $991 million between 1999-2000 and 2005-06 (Figure 1). The only exceptions to this pattern were in 2002-03 when revenues were over-estimated, and 2003-04 when actual revenue was within range of budget forecasts.

For the most part these unbudgeted revenues were allocated to programs and services such as health care, education and infrastructure. In other cases they were simply allocated, without public debate, to debt payments. On occasion, the spending of un-forecasted revenue has taken the form of pre-election spending.

Because the un-forecasted revenues are not included in the provincial budget they are not subject to public scrutiny and budget debates in the legislature. This provides the provincial government with significant funds to allocate to meet its priorities, but such priorities are not necessarily shared by Nova Scotia citizens. A basic principle of democratic accountability – particularly when a government does not receive a majority from the electorate – is that spending and taxation proposals be debated in the budget process.

Some fiscal prudence in preparing budgets is to be expected, but consistently under-estimating revenues is undemocratic. Unexpected revenues are welcome, but Nova Scotians should also be concerned by the scale of funds that have been allocated at the discretion of the government without legislative scrutiny.

Figure 1



Federal transfers make up roughly 34% of total provincial revenue. At this time it is too early to fully assess the impact of the recently released 2007-08 federal budget. It appears that the budget does not provide the boost in transfers to Nova Scotia some had hoped for. The 2007 federal budget decreases equalization transfers, but total transfers, including dedicated funds, appear to maintain the overall level of federal transfers to Nova Scotia. Transfers to Nova Scotia have annually increased on average by 2.7% over the past 10 years and by 4.2% over the past 5 years.[4] Federal budget documents indicate that the total transfers to Nova Scotia will increase by 4.2% in 2007-08.[5]

The federal budget is provoking and will continue to provoke debate and scrutiny regarding equalization and federal transfers in general. A key concern is whether the federal budget becomes another means by which the provincial government underestimates revenue, rejects calls for program initiatives and allocates revenue increases, without public and legislative debate.

Unless provincial tax cuts and an economic slowdown undermine the provincial government's capacity to mange the provincial debt and provide the expenditures sought by Nova Scotians, the Province's revenue flow appears sustainable.

The finance minister's recent pessimistic musings appear to be more about dealing with the consequences of overly optimistic economic growth projections contained in the 2006-07 pre-election budget, than an indication of more fundamental changes to provincial revenue. The 2006-07 budget projected 3% real growth while it appears that growth for 2006 was significantly lower at about 2%.[6] This would not be the first time that the government has had to come to terms with the consequences of unaffordable pre-election budgets.[7]

Expenditure Pressures

Provincial and local governments in Nova Scotia continue to under-fund programs and services. In 2005-06 Nova Scotia and New Brunswick were essentially tied as the provinces that invested the least, on a per capita basis, in programs, of all provinces (Figure 2). For the past 15 years Nova Scotia has consistently invested among the least of all provinces, the majority of the time with the lowest level of program expenses and always spending less, on a per-capita basis, than the provincial and the Atlantic average.[8] Program expenditure in Nova Scotia increased less between 1990 and 2000 than in any other province (Figure 3).

This degree of consistent under-funding has curtailed anti-poverty initiatives, post-secondary education and economic infrastructure development, among many other programs and services.

Between 2000 and 2005, the Province increased programme funding (see Figure 4), although not nearly enough to bring per capita expenditures in line with other provinces. For example, local and provincial governments in Nova Scotia would need to invest an additional $500 million annually to

Figure 2

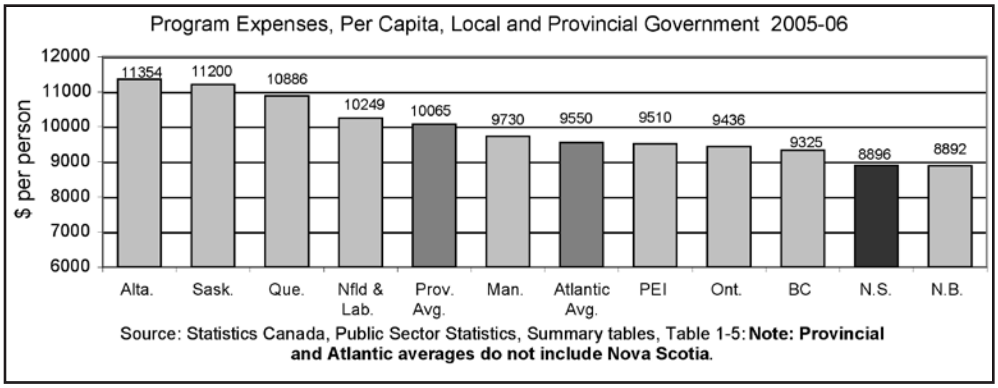


Figure 3

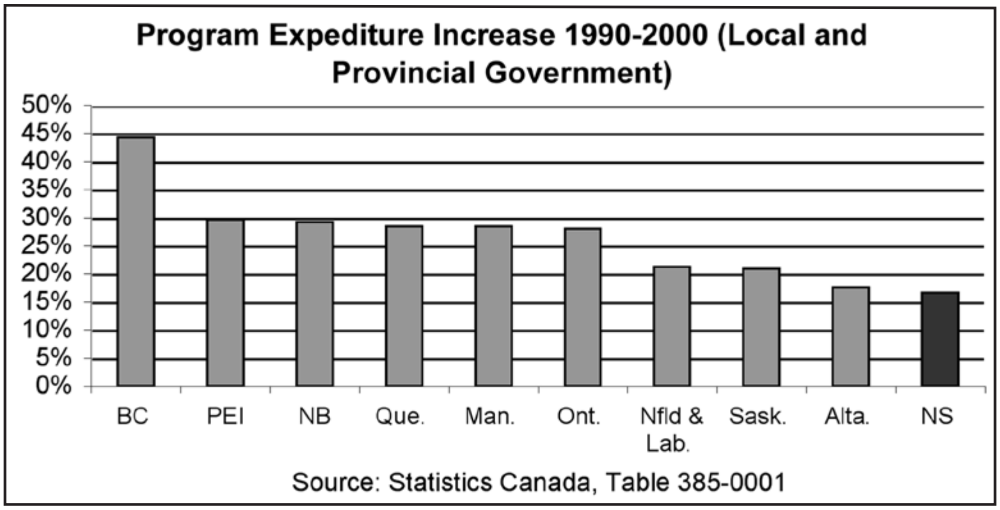
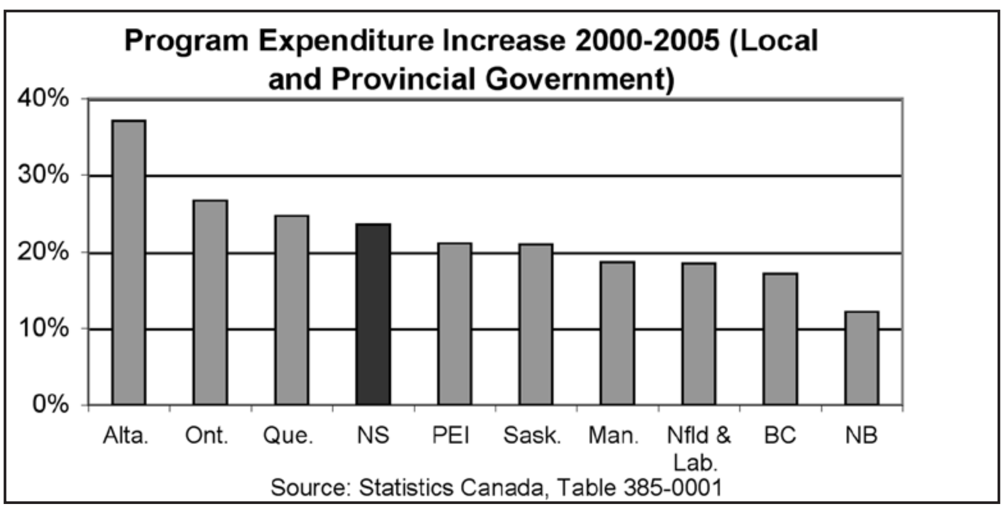


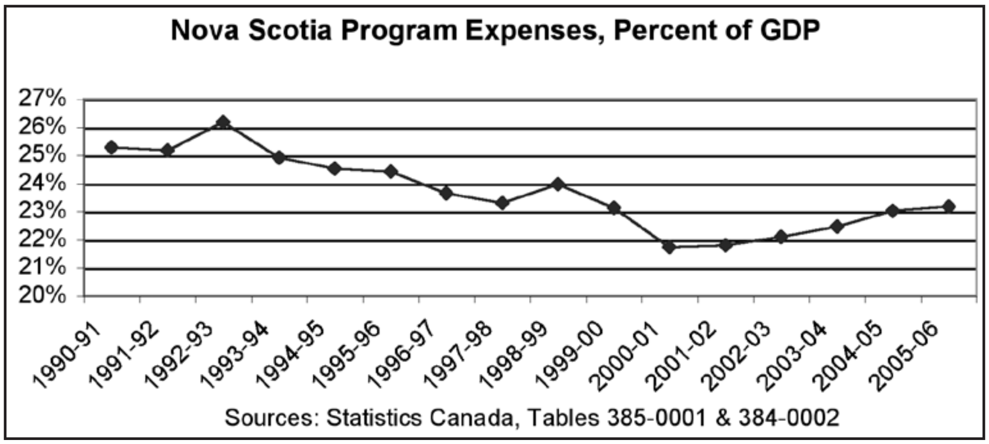
Figure 4



reach the average per capita expenditures of the other Atlantic provinces, and in the range of an additional $1 billion annually just to reach the average per capita level of expenditure of all other provinces.[9]

Provincial fiscal polices of the 1990s led to expenditure pressures – pent-up demands for basic government services to support social and economic development. The consequences of continued under-funding are easy to identify. Most of us are familiar with the state of disrepair of roads and the consequence of having the highest tuition fees in the country. Demand for food bank services is increasing. Affordable housing and women's programs and services are not adequately supported. Income assistance benefits continue to decline in terms of purchasing power for single people, people with disabilities and single parents.[10] The prevalence of household poverty and children living in poverty in Nova Scotia is too high.[11]

Figure 5



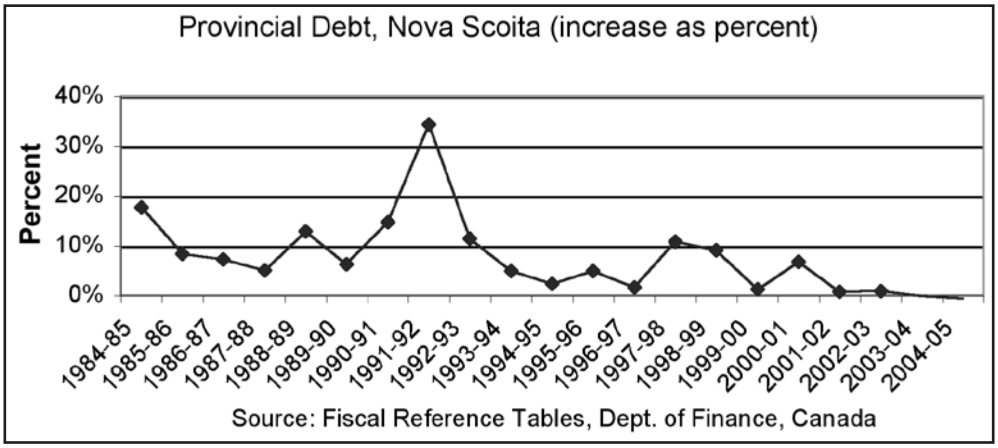
Provincial program expenditures have also been decreasing as a portion of overall economic activity – from 25% of GDP in 1993 to 23% in 2005 (see Figure 5).[12] Not keeping pace with economic growth undermines governments' capacity to, for example, establish and enforce environmental and health and safety standards. It undermines the ability of the provincial government to promote the transition to a more environmentally sustainable economy.

The data indicate that Nova Scotia will continue to face expenditure pressures. Even with the increased spending the Province is still well behind the other provinces in terms of per capita spending on social and economic development.

Putting the Provincial Debt in Perspective

Managing the provincial debt, while addressing the need for increased program investment, remains the key challenge for the government of Nova Scotia. The debt continues to be high, both in historical terms and in comparison to other provinces.

Figure 6



During the '90s the provincial debt grew at an unsustainable pace. Between 1988-89 and 1993-94 it increased by 51%. In 2001-02 it stabilized and has not increased over the past 3 years (see Figure 6). The net direct debt currently stands at $12.2 billion.[13]

The level of debt relative to the size of the economy (debt to GDP) is the best indicator of a government's capacity to manage its debt load. As the provincial GDP increases so does the Province's capacity to raise own-source revenue and its ability to finance the debt. Nova Scotia has among the highest ratios of debt relative to the size of the provincial economy (see Figure 7).

As Figure 8 indicates the provincial debt to GDP ratio peeked in 1999-2000 and has been steadily declining, from 48.7% to its current rate of about 38%. The declining ratio reflects a steadily growing economy and a series of balanced budgets. With moderate growth assumptions but no debt payments, the debt to GDP ratio will decline to about 33% within 4 years (Figure 8).

The main cost of high debt is the interest payments required to service the debt. Paying interest on the debt costs the government "12 cents of every dollar available to spend."[14] While this is not insignificant, it is useful to put it in historical perspective.

Debt servicing costs relative to total revenue are at their lowest point in more than 22 years (Figure 9). At their highest point in 1995 debt charges absorbed 18% of every dollar in revenue raised by the Province. Since

Figure 7

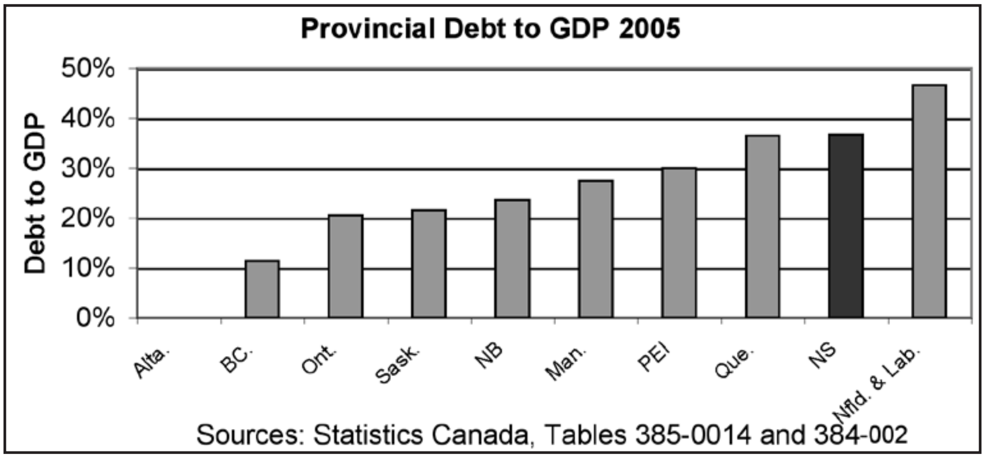
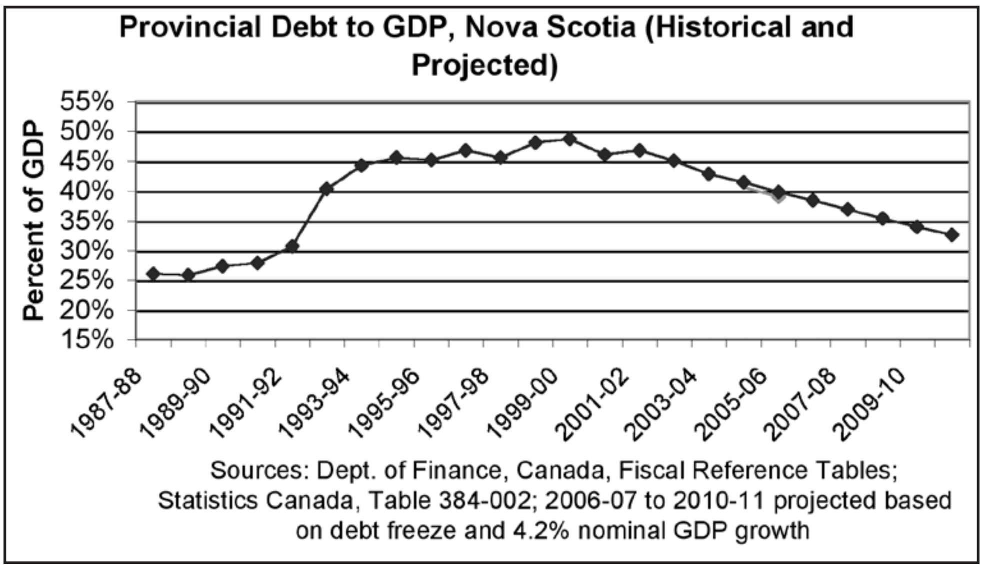


Figure 8

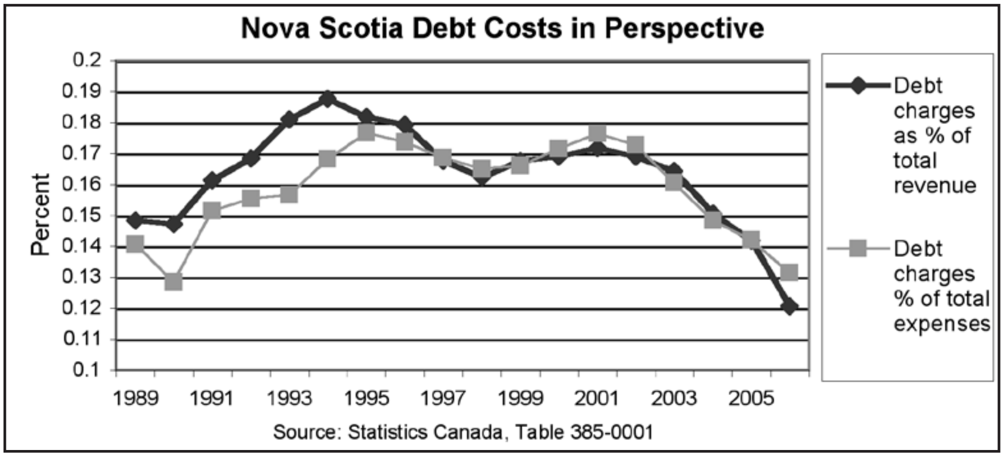


2001, benefiting from a stabilized debt and low interest rates, the portion of debt interest charges to total revenue has been declining to the current level of 12%. The cost of debt charges relative to total expenditures has also been declining and is at the lowest level since 1990 (Figure 9 and Table 1).

We can also measure the Province's capacity to manage the current debt by comparing debt charges to the size of the provincial economy (GDP). Debt costs relative to GDP are also at the lowest level in more than 15 years, declining from a high of 5.3% in 1995 to the current level of 3.5% (Table 1).

The numbers indicate that rather than being high and beyond the means of the Province, debt servicing costs are low by historical standards,

Figure 9



providing further evidence that the current debt is manageable. Low interest rates and a steadily growing economy will continue to contribute to the relatively lower interest costs. The provincial department of finance has been taking advantage of low interest rates in its debt management strategy and the provincial fiscal situation should benefit in the form of low debt charges for the foreseeable future.

Table 1

Debt Servicing Costs in Perspective, Nova Scotia								
	1989	1990	1995	2000	2001	2003	2005	2006
Debt costs % total revenue	14.8%	14.7%	18.2%	16.9%	17.2%	16.4%	14.2%	12.1%
Debt costs % total expenses	14.1%	12.8%	17.7%	17.1%	17.6%	16.1%	14.2%	13.1%
Debt costs % GDP	4.1%	4.1%	5.3%	4.8%	4.7%	4.2%	3.8%	3.5%
Sources: Statistics Canada, Tables 385-0001 and 384-0002								

Conclusion and Fiscal Policy Options

Nova Scotia's finances are in better shape than they have been in more than a decade. For the most part the improved situation is due to the avoidance of the high deficits experienced during the '90s, the stabilization of the provincial debt, low interest rates, and steady economic and revenue growth.

Revenue Forecasting

Nova Scotians should be sceptical of dire pre-budget warnings. For much of the past 7 years the provincial government has under-estimated revenues and made the fiscal situation look worse than it really is. Pessimistic forecasts not only dampen expectations but also provide governments with significant discretionary spending to be allocated with little or no public or legislative input.

Policy objective

- The provincial government needs to establish more transparent and accurate revenue projections in the development of budgets.

Payments on the provincial debt?

To some degree the Province's fiscal caution is understandable. It has little room to manoeuvre as it contends with social and financial debt accumulated during the 1990s. Nova Scotians are paying the price for past provincial fiscal polices that did not raise sufficient revenue, and for past Federal policies that cut federal transfers. Together, these cuts to revenue allowed the debt to grow at an unsustainable rate.

Some claim that the priority in fiscal policy should be to pay down the provincial debt. Since 2001, the Province's capacity to manage the debt has been steadily improving. This paper shows that there is no urgent need to use revenue increases to make debt payments. The provincial debt has stabilized.

The Province is set to generate small budget surpluses for the foreseeable future. The government of Nova Scotia's debt management strategy allocates surplus funds remaining at the end of a fiscal year to debt payments. Is it better to invest the surplus in education, poverty reduction, transport and environmental protection, or should the surplus be allocated to debt repayment?

A payment of, for example, $50 million on a net debt (the portion of total debt on which interest is charged) of $9.9 billion would reduce annual interest payments from $830 million to $826 million, a reduction of about $4 million or 0.4%. Given the need to address Nova Scotia's social and infrastructure debt after years of under-funding, a far better investment in terms of return and addressing citizen's needs would be to allocate funds to programs, services and infrastructure. For example, $37 million can provide 900 new or renovated affordable homes in Nova Scotia[16].

Allowing the debt to GDP ratio to fall over time, because the economy is growing while the debt level is stable, decreases the proportion of total revenue going to debt servicing. In 2000-01 net debt servicing costs comprised about 17.2% of total revenue. In 2005-06 the proportion of total revenue dropped to 12.1% (Figure 9 and Table 1)

Were Nova Scotia in the same revenue position as, for example, Alberta, dept repayment would make sense. But, given the minimal fiscal benefits of such payments and the need to address expenditure pressures, debt payments would do more harm than good to the social and economic well being of the province.

Policy objective

- Revenue forecasts should not be systematically biased towards generating unanticipated surpluses that will be allocated to the debt. The only debt repayment, in the foreseeable future, should be upon receipt of significant windfalls such as the revenue from the Offshore Agreement. Surplus funds remaining at year end should be reallocated to priority

Is there an optimal level of debt?

In thinking about their own family finances, most people would find a policy of zero debt to be unreasonable, since it would rule out car loans and home mortgages – assets which yield benefits well into the future. As well, they realize that it is the level of *debt relative to income* that is the key issue. A car loan of $30,000 would be a crushing burden to someone on a $10,000 income, but is quite manageable for someone making $100,000.

Although the province of Nova Scotia measures its public debts in billions, while its citizens typically measure their private debts in thousands, the same basic principles apply. In both cases acquiring debt to purchase long-term assets can make sense, and it is the debt to GDP ratio that determines whether that debt is manageable. Of course, when either households or governments acquire debts, they have to be paid for sooner or later – but should we pay the debt down sooner or should we pay later?

What is the optimal level of the debt/GDP ratio? Paying down the current provincial debt represents a decision that today's taxpayers should pay a bit more now in debt servicing – which means that future taxpayers will have to pay a bit less. In debt management policy, there is an unavoidable trade-off between the interests of today's taxpayers and those of tomorrow's taxpayers. If the debt-financed capital assets yield benefits for future citizens, future generations should absorb at least part of the cost. As well, if the economy is growing, future generations will have a higher income from which to pay debt servicing costs. Nevertheless, some balance between the interests of current and future citizens must be struck – what should it be?

There is no consensus among economists on this issue. In an informal poll of economists at a recent conference[15] on Canada's debt, participants were asked to specify their own estimate of the optimal long-run debt/GDP ratio for combined federal and provincial debt. None of the 20 respondents was willing to suggest an optimal ratio less than 20% or greater than 50%. However, the two most frequently specified ranges (by 30% of respondents in each case) were right at the edges of this band—20 to 25% and 46 to 50%. Although the average response was almost exactly in the middle (35.7%), that average clearly masks a significant divergence of opinion.

Economists would all agree that a continuing rise in the debt / GDP ratio is not sustainable. However, once the debt ratio has been stabilized they – like citizens in general – have a range of values about the optimal level. Some would argue for a rapid pay-down, while others would emphasize attending to the pressing needs of the present. Fundamentally, finding the balance is the legitimate domain of the political process.

(Reprinted from "Maintaining Investments in Nova Scotians, Alternative Provincial Budget 2005-06" CCPA-NS, 2006.)

areas such as poverty alleviation, transportation, environmental protection and post-secondary education.

Taxation

The Province's financial reality has forced the government to take a pragmatic approach to fiscal policy. When the provincial government has embarked on fiscally conservative initiatives such as the 2003-04 10% income tax cut, it has been forced to backtrack, as it did when it reversed the tax cuts. Cutting taxes decreases the revenue that the Province relies on to manage the fiscal debt and address the expenditure pressures it faces. Given the challenges faced in both of these areas, tax cuts are simply not affordable.

New Brunswick is the only province that invests less than Nova Scotia on a pre-capita basis (Figure 2). The previous government of New Brunswick was proud of the fact that the province had the lowest levels of corporate taxation in the Atlantic region. This dubious record has caught up to the province. The province's newly elected government, confronted with this situation, has rejected the low service, low taxation route and opted for fiscal policies that increase revenue for social and economic development. According to New Brunswick's finance minister, "We all enjoy lower taxes, but when the level of taxation is insufficient to ensure the continued provision of essential public services, it needs to be addressed."[17] New Brunswick's recent budget included spending increases, investments in pubic infrastructure, and significant tax and debt increases.

Nova Scotia finds itself facing some of the same expenditure pressures as its neighbour, but Nova Scotia does not have the option of significant debt increases, given its already high debt load. When faced with budget shortfalls and deficits due to, for example, slower economic growth, the provincial government should consider increasing revenue through taxation, rather than cuts to program expenditure.

Such tax increases should be focused on ability to pay. Upper income citizens and large corporations have the greatest ability to pay and have been the major beneficiaries of the growing economy and federal tax cuts. The impact of tax increases on these wealthy households and prosperous businesses would be negligible given that the provincial government would be moving into the taxation room vacated by the federal government through tax cuts. Polling indicates that there is broad public support for such initiatives. In a recent Environics Research poll, 76% of Atlantic Canadians supported "Increasing taxes on wealthier Canadians to pay for programs that benefit the rest of the population…," while overall 70% of Canadians interviewed agreed with the statement.[18] The support is based not only on reasons of fiscal prudence, but also on the need to address poverty and growing inequality in our country.

Policy Options

- When faced with budget short falls and deficits the provincial government should not focus on expenditure cuts. Rather it should focus on maintaining the revenue need to support programs through increasing taxation of upper income earners and large corporations.

- A provincial government debt reduction strategy should be based on increasing revenue, rather then redirecting funds from programs and services. Revenue could be raised by increasing taxation on individuals and businesses most benefiting from the growing economy and the unequally distributed wealth it is producing.

Governments often depict budgets and the management of public finances as a process in which there are few options. This paper indicates otherwise. Budgets are about choices – choices that have an impact on all citizens, from the taxes we pay to the services we receive. In a healthy democracy citizens need to be aware of the real fiscal circumstances and options so they can participate in making the decisions that effect their lives.

Endnotes

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8 See CCPA-NS (2006). "Maintaining Investments in Nova Scotians," Halifax: Canadian Centre for Policy Alternatives – Nova Scotia. See in particular pages 9 to 12 and Figures 1 and 2. http://policyalternatives.ca/documents/Nova_Scotia_Pubs/2006/Maintaining_Investment_in_Nova_Scotians.pdf accessed March 18, 2007.

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13 Nova Scotia Department of Finance (2007), "Nova Scotia Fiscal Overview: 2007" (page 18).

14 Nova Scotia Department of Finance (2007). "Nova Scotia Fiscal Overview: 2007" (page 22).

15 C. Ragan and W. Watson (2004). *Is the Debt War Over*? Montreal: Institute for Research on Public Policy.

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18 In a recent poll by Environics Canada, 76% of Atlantic Canadians agreed with "*Increasing taxes on wealthier Canadians to pay for programs that benefit the rest of the population…"* Source: Canadian Centre for Policy Alternatives, "What Can Governments Do About Canada's Growing Gap: Canadian Attitudes Towards Income Inequality" (March 2007). http://policyalternatives.ca/documents/National_Office_Pubs/2007/What_Can_Governments_Do.pdf (accessed March 20, 2007).