

Addressing Nova Scotia's Fiscal Challenge

*A report prepared by the
Nova Scotia Economic Advisory Panel*
for
Premier Darrell Dexter
Province of Nova Scotia

November 2009

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Panel of Economic Advisors Report to Premier Darrell Dexter
Province of Nova Scotia
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Written by members of the Nova Scotia Economic Advisory Panel:
Elizabeth Beale, Tim O'Neill, Lars Osberg, Donald J. Savoie

Contents

Summary	5
Assessing the Fiscal Challenges Facing the New Government	17
by Tim O’Neill	
Delivering on “Making Life More Affordable for Nova Scotia Families”—an Economic Perspective	49
by Lars Osberg	
Reviewing the Expenditure Budget: Lessons Learned	67
by Donald J. Savoie	
Shaping a Path for Growth and Prosperity in Nova Scotia	79
by Elizabeth Beale	

Summary

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Summary

It is now customary for newly elected governments to ask for an independent review of the books. Nova Scotia's newly elected NDP government was no exception and, within days of coming to office, it asked Deloitte to undertake a review and analysis of the province of Nova Scotia's current and future financial position. The government also decided to establish a panel of economic advisors with a mandate to provide advice on establishing "priorities with respect to the fiscal challenge identified by the external audit, to address the current economic recession taking realistic account of the province's fiscal condition, and to provide strategic objectives and options to dealing with the federal government and for dealing with other Atlantic governments." The panel decided to focus on the first two issues, convinced that they were the more important ones and knowing that answers to them would invariably shape the government's response to the issues of dealing with other governments.

Modern means of communication enabled panel members to share information, exchange views and data, and remain in constant communication with one another throughout the exercise. Different viewpoints were presented by all four members, but we share some common beliefs. For one thing, all four panel members see a positive role for government in society. For another, we are all firmly of the view that progressive government cannot be built on a mountain of debt.

As the reader will see, Nova Scotia is confronting important fiscal challenges. The panel offers no easy solution because none exists. While we see potential for economic growth in the province, we are concerned with a significant drop in projected revenues from offshore royalties and uncertainties around federal government transfer payments, particularly for health care, beyond the current cost-shared agreement that will shortly expire. As is well known, the recent recession has played havoc with government budgets throughout the western world; here too, Nova Scotia is no exception. It is against this backdrop that the panel undertook a review of the province's fiscal condition.

In carrying out the review, the panel was able to draw on a number of resources for data and support. We want to express our gratitude to provincial government officials, notably those in the Department of Finance and the Treasury Board for their willingness to share information and to answer numerous questions. In all our meetings and in dealing with all our requests for information, they demonstrated a high level of

professionalism. We also benefited from the work of Wade Locke at Memorial University and Mike McCracken of Informetrica. Locke prepared a paper on future revenue flows from equalization and from offshore energy, and McCracken reviewed the forecasting methods employed by the provincial finance department.

We also benefited greatly from Nova Scotians who made the effort to write to us or attend two focus sessions held in Halifax and Antigonish. The sessions proved extremely valuable to the panel, and they generated a number of ideas.

What We Heard

Individuals and organizations wrote to us to voice their opinions, and a number of Nova Scotians took the time to attend two focus sessions. We were fortunate in that we were able to hear from a cross-section of Nova Scotians, including the labour movement, the business community, volunteer groups, and representatives from the health and education sectors. We appreciated their contributions and we listened very carefully to what they had to say. They will see their input in the pages that follow.

The consultations were structured around the following four questions:

- Question 1: In your opinion, how important is it for the government of Nova Scotia to eliminate this deficit? If you agree that it should be eliminated, how quickly should this be done? If you think that it is not desirable to eliminate the deficit, how large a deficit is acceptable and for what period of time?
- Question 2: What measures are likely to be most effective in improving the fiscal position of the province? At what point should these measures be introduced?
- Question 3: What steps should the province take to introduce new programs or revamp existing programs in areas such as social assistance, education, health, tax reductions, and economic development?
- Question 4: A faster-growing economy in Nova Scotia could broaden the province's revenue base, thus improving its fiscal position. What immediate steps could the province take to improve its long-term economic prospects?

To be sure, many Nova Scotians are concerned about recent developments in the global economy and the state of the province's fiscal situation. They wrote or presented briefs to the panel or came to the two focus sessions armed with both ideas and a degree of optimism. It is not possible here to report in any detail what we heard from all the participants at the two gatherings and from those who wrote to us. However, we decided to present a summary, in point form, of the key points that were made:

- ▶ Some participants called on the government to articulate a vision and to promote “transformational change”—incremental change, one insisted, will not do.

- ▶ A number of participants focused their contributions on the high cost of delivering health care and education with the suggestion that measures should be introduced to limit growth in spending in these two sectors.
- ▶ Many stressed the need for greater accountability from those spending public funds. One participant insisted that “tax increases without accountability is unacceptable.”
- ▶ One participant cautioned the government against generating economic projections to 2012–13 because “we don’t know what the world economy will do.”
- ▶ Another suggested that the government should increase taxes on “things that contribute to poor health”; another urged increasing taxes “on very affluent people”; and still another suggested that the province “could occupy the 2 per cent HST that the federal government gave up.”
- ▶ There appeared to be consensus among the participants that the government should deal with the deficit problem over a three- to four-year period rather than to address it over the next 12 months or so. Indeed, no one recommended dealing with the deficit problem over the next 12 months.
- ▶ There is also consensus on the need to consult Nova Scotians widely in any effort to deal with the deficit and debt problem. A labour representative put it succinctly with the observation that the “government needs a plan that the public has brought into; otherwise, it will be thrown off course every time there is a protest against a proposed change.”
- ▶ There was, however, no consensus on how to address the deficit and debt problem. Some looked to tax increases, while others insisted that tax increases should be avoided, making the case that Nova Scotia needs to have competitive tax rates to prosper. A good number of the participants pointed to spending cuts provided they were carried out in an orderly fashion after consulting Nova Scotians.
- ▶ Some participants argued that the government should review how it delivers public services, insisting that important savings could be realized.
- ▶ Many participants stressed the importance of economic growth to deal with several public policy challenges, including the province’s deficit and debt problem.
- ▶ There was no shortage of ideas on how to promote economic growth, with most insisting that the government must play an active role. Some suggested measures to reduce the cost of doing business; others warned against a continuing depopulation of rural Nova Scotia; and still others stressed the importance of all facets of human resources development. Some urged the promotion of local markets, investing in the green economy, attracting new Canadians, placing new emphasis on Nova Scotia as a great place to live, and promoting greater coordination among the various federal and provincial economic development agencies.

What We Did

With limited time and limited resources, panel members decided to pursue in some detail four related issues and to divide up the work. Lars Osberg wrote a background paper on

an issue of considerable importance to the current government: Delivering on “Making Life More Affordable for Nova Scotia Families”—an Economic Perspective. Tim O’Neill wrote on Assessing the Fiscal Challenges Facing the New Government; Elizabeth Beale on Shaping a Path for Growth and Prosperity in Nova Scotia; and Donald J. Savoie on Reviewing the Expenditure Budget: Lessons Learned. All four papers are available on the government of Nova Scotia website.

Lars Osberg reminds the reader that the recently elected government pledged during the campaign to “make life more affordable” for Nova Scotia families. He maintains that pursuing an agenda of “affordability” need not be very costly and acknowledges that delivering a budget in the middle of a recession is no small challenge. Osberg reminds us that governments do much more than tax and spend, and he looked to “low-budget/off-budget” ways to promote affordability, help families meet family needs, and provide for tangible improvements in family well-being. He does not see much merit in selective sales tax exemptions, which he describes as economically inefficient as well as “very expensive and quickly forgotten.”

Osberg instead points to improved coordination of public service delivery, better regulation, and enhanced program delivery. As an example, he notes that well-functioning public transit is “a public service that saves private costs.” He maintains that “building public transit is sometimes an expensive and slow process, but it has long-run structural benefits and is particularly important for rural Nova Scotia.”

He argues that better coordination of services and “smarter” regulation are also important ways in which government can make life more affordable for Nova Scotia families, and he points to the need of young families for better integration of before-school and after-school child care. Osberg attaches a great deal of importance to *how* government delivers benefits to families and argues that policy innovation can enhance efficiency. He suggests, for example, that a review of labour standards legislation to provide for “unpaid family leave days to improve the security of family life” might provide significant benefits to employees, at little real cost to their employers.

Tim O’Neill explores in some detail the fiscal challenges confronting the government. He concludes that Nova Scotia is dealing with a structural deficit in the making, which he describes as a mismatch of the medium-term revenue and expenditure paths. He makes the case that even with a return to typical GDP growth levels for Nova Scotia, the province’s deficit will continue to grow if no changes to current taxes are made and recent expenditure growth trends continue.

O’Neill outlines a number of options for the government to consider in dealing with its fiscal challenges. He concludes that the government should not attempt to eliminate

the deficit by 2010–11, but that it should put in place measures to balance the books over the economic cycle. He considers possible tax cuts, tax increases, and spending cuts. He recommends that the government should look to both new tax measures and selected spending cuts as the way forward. More to the point, O’Neill maintains that “the only way to achieve fiscal balance by 2012–13 is either to cut spending significantly at some point over the next three years or to keep spending flat for a protracted period *and* combine that with material tax initiatives.” He insists that doing nothing about the fiscal difficulties confronting the province “is not an option for the government.”

Donald J. Savoie draws on the experiences of other governments to draw out lessons learned on how to review expenditure budgets. Governments will very often look to spending cuts as the way to deal with their fiscal challenges. Indeed, the federal and all provincial governments have launched program review exercises in recent years, and most, if not all, are planning new ones in the coming months. Few of the past exercises, however, have been able to live up to expectations.

The successful ones hold important lessons learned. Perhaps the single most important one is that citizens have to be part of the expenditure review process. They need to know that a problem exists before they are prepared to hear options. This calls for governments to lay out the facts on public finance as they are—no need for media spin specialists or costly communication strategies.

Savoie suggests that if expenditure reduction is the objective, the premier and Finance minister have to speak as one. The process to generate spending cuts should not allow for any end runs for ministers or others to appeal directly to the premier. To have any lasting impact, the process should go beyond across-the-board cuts, temporary hiring, or salary freezes and have a three- or four-year planning and implementation horizon. The process should involve relevant actors outside of government in the key sectors and also promote transparency in all things.

Elizabeth Beale provides a brief overview of the economic development challenges confronting Nova Scotia and outlines a number of suggestions for the way ahead. She calls for greater emphasis on growth and improving productivity, human resources development, and an improvement in the effectiveness of post-secondary education. Beale calls for improving the province’s business climate and recommends a review of province’s regulatory environment, improved infrastructure, and a sustained effort to improve coordination among the various economic development agencies.

Beale attaches a great deal of importance to workplace training and literacy as means of strengthening the Nova Scotia economy. She also calls on the government to redirect

its investments to new technology and skills development and for the development of new partnership arrangements between the different orders of government and with the business community and labour.

What We Recommend

The panel is of the view that Nova Scotia is on an unsustainable fiscal path and that difficult decisions are needed to change course. One can make the case that annual deficits can constitute good public policy and this fiscal year is an excellent case in point. Structural deficits, however, are never good public policy, and we believe that Nova Scotia is looking at one in the making. In addition, Nova Scotia's current debt level, at \$13 billion and growing, sends wrong messages, and the cost of servicing it—currently more than 10 per cent of total provincial government spending—crowds out government activities from sectors that it should be more active in, from education to social welfare to economic development.

The panel is also concerned about Ottawa's future funding for health care and equalization payments. The federal government has its own fiscal challenges, and if history is to be a guide (see circa 1995–97), one can easily speculate that federal transfer payments will be reduced in the years ahead. In addition, we know that offshore petroleum royalties will drop off significantly in the coming years.

What to do? The panel views the province's fiscal challenge not simply as a problem but also as an opportunity for the provincial government to reposition the province's public policy and program structure. Public institutions and government-funded institutions, organizations, and programs must be subjected to rigorous reviews from time to time, if only to ensure that they are efficiently run and meet current socio-economic circumstances and requirements. History reveals that there is a natural tendency on the part of many in public-sector activities to leave well enough alone and avoid fundamental policy and program reviews.

The panel accepts the recommendation of Tim O'Neill, one of its members, that "doing nothing is not an option for the government." We also agree that achieving fiscal balance by 2012–13 will require spending cuts and some tax initiatives.

Simply pointing to political will as the necessary ingredient to launch such reviews can never tell the whole story. Political will does not grow in a vacuum. As we already noted, citizens need to appreciate that a problem exists before they will consider options to solve it. On this point, we can do no better than once again quote a labour representative at one of the two focus sessions when he observed that the "government needs a plan that the public has brought into; otherwise it will be thrown off course every

time there is a protest against a proposed change.” In brief, any expenditure review exercise must be prepared in full consultation with Nova Scotians to have any chance of success. More to the point, it cannot be produced by a handful of politicians and senior public servants in a government boardroom in Halifax.

It is important to recognize that if federal transfers are reduced and if provincial tax rates are unchanged, the total revenue of the province of Nova Scotia will shrink over time as a percentage of provincial GDP. Hence, balancing the budget over the economic cycle means a diminishing role for the public sector in Nova Scotia unless the provincial government increases own-source tax revenue to offset the withdrawal of federal funds. It is also important to recognize that each Nova Scotia family is likely to be affected somewhat differently by the individual cuts to public services and the specific tax increases that will be necessary to reduce or eliminate the deficit over time. The fairness of the deficit reduction process as a whole depends on how these service cuts and tax increases add up in over-all impact on the distribution of income.

It is beyond the scope of the panel’s mandate to put forward detailed proposals for specific tax increases or spending cuts, or to propose the sale of certain government assets. The following are the panel’s recommendations for a broad approach to the fiscal management and economic development challenges facing Nova Scotia:

1. The government of Nova Scotia is looking at a substantial structural deficit, which means, even with a return to normal GDP growth, both year-over-year deficits and the long-term accumulated provincial debt will continue to grow if no action is taken. It is the panel’s view that the government of Nova Scotia should pursue both tax increases and spending cuts and promote an economic growth agenda to deal with the province’s deteriorating fiscal position.
2. The government should not attempt to eliminate the deficit by 2010–11, but adopt a more gradual fiscal strategy to avoid slowing the economic recovery and destabilizing needed public services. The panel recommends that the government aim to erase the deficit by fiscal year 2012–13 and urges the government to implement tax increases, introduce significant spending restraint measures, and focus more on economic growth to achieve this goal.
3. Among possible tax measures, the government should explore taking up the 2 per cent HST points that the federal government recently vacated, with appropriate protection for low-income families and individuals. The government should also consider an increase in personal income taxes.
4. The panel supports the province’s decision to rescind the balanced budget legislation and urges that it not replace it with another rigid fiscal rule.
5. A comprehensive consultation process should be put in place to enable Nova Scotians to understand the nature and scope of the problem.

6. To guide the government in addressing economic and policy challenges, the government should explore the option of establishing a Premier's Council on the Economy comprising leaders and key spokespersons for the business, labour, and voluntary sectors. The Council could be modelled on successful examples from the past in Ontario, Québec, and, more recently, Manitoba.
7. The government should explore "low-budget/off-budget" measures to deliver on its commitments to promote affordability in meeting family needs.
8. The government should review its public service delivery mechanism to promote better coordination and review labour standards to provide for unpaid family leave days.
9. The premier should launch a program review exercise that involves consultations with Nova Scotians. The review must be led with firm hands by the minister of Finance, with the premier's full support.
10. The program review exercise, to have any significant and lasting impact, should go beyond across-the-board cuts, temporary hiring, or salary freezes.
11. In launching a program review exercise, the government should establish a three- or four-year planning and implementation horizon. The purpose of a significant review exercise is to change the shape of the government's expenditure budget. This requires senior government officials to take the long view and to redesign their programs and operations.
12. The government should define a process to consult relevant actors in the key sectors of health care and education in search of more effective and efficient spending. These two departments have large expenditure budgets, and past attempts to reorient them have met with modest success. If the goal is to reorient the two sectors in any meaningful fashion, it is vitally important to involve representatives of the health care and education communities. That said, to have any chance of success, the rules of the consultation process have to be laid out at the very outset: given the province's fiscal situation, it should be made clear that the goal is to promote greater efficiency in the spending of public money in both sectors.
13. One measure to promote transparency would be to produce economic and fiscal forecasts every six months and ensure wide distribution with a view to encourage public discussion.
14. The government should encourage transparency in all things if it wishes to launch a meaningful program review exercise. A lack of transparency is quickly revealed and is all too often interpreted as masking a hidden agenda or special treatment for someone, some departments, or some communities.
15. A program review exercise should be guided by a series of questions for *all* departments to answer. The questions should, among other things, centre on affordability, impact on economic growth, fairness, and whether programs or policy goals can be achieved through other means.
16. The government should promote a stronger business climate in the province through strategic infrastructure investments, improvements in the regulatory environment, and more effective coordination of its economic development agencies.

17. The government should overhaul the province's economic development agenda by focussing on human resources development, including literacy, and on high-growth sectors and firms.
18. The government should focus its future economic development on strengthening the province's productivity performance and on developing a highly skilled and adaptable labour force.
19. Nova Scotia shares a public policy challenge with the other three Atlantic provinces: a serious vulnerability to changes in federal transfer payments. It is easy for one to speculate that there are rough waters ahead, given Ottawa's own deficit problem. The four Atlantic provinces have a much better chance of securing a proper hearing in Ottawa if they are able to develop a common strategy and speak with one voice on the future of federal transfer payments, particularly for health care.

Assessing the Fiscal Challenges Facing the New Government

A paper prepared for the
Nova Scotia Economic Advisory Panel

Tim O'Neill
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Assessing the Fiscal Challenges Facing the New Government

Introduction

The province of Nova Scotia is facing a significant shift in its fiscal fortunes. Current projections indicate that from a small surplus of \$20 million in fiscal year (FY) 2008–09, the new government will have to deal with a sharply rising deficit over the term of its mandate. **Based on the most up-to-date economic growth forecasts, if no policy changes are introduced, the deficit would exceed \$1.3 billion by FY 2012–13. Equally importantly, the province’s net debt/GDP ratio will, if no action is taken, rise from a level of just under 37 per cent in 2007–08 to over 44 per cent by 2012–13.**¹

The current cyclical downturn is partly to blame for the emerging fiscal challenges, but it accounts for only a portion of the projected run-up in the deficit. The cyclical component of the deficit will be dwarfed by its structural elements—a mismatch of the medium-term revenue and expenditure paths. Hence, it will not be possible to rely solely on a return to economic health—the provincial economy growing at its long-term trend rate—to restore fiscal health. Even when the economy is back on an even keel, maintenance of recent trends in expenditures, combined with a return to more normal growth in provincial revenues, will yield persistent deficits well beyond the end of the current mandate.

In this context, the new government will have to answer three fundamental questions:

1. Will it introduce policy measures to reduce/eliminate the deficit and, if so, over what time period?
2. Which policy measures—revenue and/or expenditure—will it introduce to deal with the fiscal challenges it faces?
3. What fiscal guideline or benchmark (e.g., deficit/surplus target, debt/GDP target, debt level target) will it establish to provide a clear direction for future policy?

This paper will begin by summarizing the best available information we have on the emerging fiscal challenges.² That section will also examine the fiscal impacts of a few

1. debt/GDP = the ratio of net debt to gross domestic product, expressed as a percentage.

2. Fiscal and GDP projections reported below are in current or nominal dollars. The rate of inflation, as measured by the GDP deflator, is projected to increase from 0 per cent in 2009 to 1.7 per cent in 2010 and

possible policy measures on the revenue and expenditure sides of the fiscal ledger. The report will then move on to consider possible answers to the three fundamental questions. Given the short time frame within which the panel is operating, it is not possible to offer more than broad options for the government to consider along with some guiding principles upon which it may wish to base its ultimate policy decisions.

Current and Projected Fiscal Situation

There are two publicly available projections on the emerging fiscal position of the province. The first is the Deloitte report *Province of Nova Scotia Financial Review* (August 2009). In the summary of projected operating results the report concludes, “Flat revenue growth and a reasonable allowance for inflation of expenses result in operating shortfalls into the future ... Nova Scotia is facing a projected annual deficit of \$1.3 billion by 2012–13 ...” Deloitte’s results are summarized in table 1. The flattening of revenues is the result not only of the current economic downturn and an initially sluggish recovery from it but also of the “completion of a period of extraordinary revenue growth.” The (non-recurring) extraordinary revenues of recent years have come, in large part, from offshore petroleum activities and from special equalization arrangements with the federal government. Over this same period, the report notes, expense growth, primarily in recurring programs, has tended to match the (extraordinary) revenue growth. Even assuming a slower pace of expense growth (5 per cent per year) than occurred over the last several years, the outcome is a sharp rise in the deficit from a projected \$51 million in 2009–10 to \$1.3 billion in 2012–13.

Table 1 Financial review projections of provincial operating results, 2009–10 to 2012–13 (\$ millions)

	2009–10	2010–11	2011–12	2012–13
Revenues	8,462	8,397	8,559	8,835
Expenses	8,513	9,113	9,634	10,136
Surplus (deficit)	(51)	(716)	(1,075)	(1,301)

Source: Deloitte, *Province of Nova Scotia Financial Review* (August 2009).

The Deloitte report also projects changes in the net debt of the province. Assuming no changes in policy other than the platform commitments of the new government, they forecasted the net debt to rise from \$12.9 billion in 2009–10 to \$16.6 billion in 2012–13.

2011, rising to 3.2 per cent by 2013, and averaging 1.8 per cent over the five years. In the subsequent five-year period, the inflation rate is projected to average 1.9 per cent per year.

Based on the (nominal) GDP forecasts being used by the Finance department in late August, this would imply a rise in debt/GDP from 37.5 per cent to 43.2 per cent over the same time period.

The second set of projections, the recent provincial budget, which updates the remainder of FY 2009–10, yields a similar picture of the province’s finances. It projects a deficit of \$592 million for this fiscal year, compared to the \$51 million deficit in the Deloitte report. All but about \$50 million of the difference is due to a higher level of program spending in 2009–10. However, there is a shift into the current fiscal year of \$341 billion of university funding. As a result, the deterioration in the deficit relative to the Deloitte projection is more in the order of \$200 million, of which three-quarters is spending related. The budget document also provides fiscal projections out to the end of the current mandate. These projections are used for the remainder of this paper.

In order to get a more complete picture of the dimensions of the province’s fiscal challenges, additional information was requested from the Finance department as well as from several external experts:

- an estimate of the split in the deficit projections between cyclical and structural components
- the impacts on the deficit and debt projections of possible policy-induced changes in expenditure and revenue paths
- an extension of the fiscal forecasts (revenues, expenses, deficit/surplus, and debt/GDP) beyond FY 2012–13.

We also examined the key economic assumptions underlying these projections, including those for GDP growth, inflation, and interest rates.

The longer the time period over which economic and fiscal projections are made, the greater is the uncertainty attached to the outcomes. For that reason, this paper will not include specific year-by-year estimates of the key variables such as deficit and debt levels beyond FY 2012–13. Instead, the fiscal assessment of the “out years” will be restricted to an examination of broad estimates of the key fiscal numbers.

In order to assess policy options for dealing with the fiscal challenges, there should be a *no-policy-action*, or *status quo*, projection. For that purpose the recent Nova Scotia budget projections were used. However, instead of assuming that the books are balanced in 2010–11, this paper assumes, similar to the Deloitte report, that program expenditures grow by 5 per cent per year from FY 2010–11 on, after growing 6.5 per cent in 2008–09 and a planned 7.2 per cent in 2009–10. The budget’s revenue projections to 2012–13 were used. The sensitivity of the projections to varying assumptions on revenue growth was also examined. The status quo projections are displayed in table 2.

TABLE 2 Status quo projections to 2012–13 (\$ millions)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
	(actual)	(actual)				
Revenues	8,523.4	8,494.4	8,411.8	8,455.8	8,633.7	8,891.7
Expenses						
Program	7,100.6	7,568.6	8,115.9	8,164.0	8,572.2	9,000.8
Other	1,032.4	952.4	978.1	1,073.2	1,174.5	1,291.1
Total	8,133.0	8,521.1	9,094.0	9,237.2	9,746.8	10,291.9
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	(712.9)	(1,081.7)	(1,368.8)
Net debt to GDP ratio	36.7%	35.4%	38.7%	40.5%	42.5%	44.3%
Net debt	12,114.8	12,323.5	13,492.7	14,558.9	15,745.2	17,207.1

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

Evaluating the assumptions

The key assumptions underlying the status quo projections were examined to assess whether those projections were unduly pessimistic or optimistic. The main concern was the revenue side of the fiscal forecasts. In the projections, total PIT (personal income tax) revenues are expected to decline slightly in 2009–10, by 0.5 per cent, before increasing in the three subsequent years by 2.7 per cent, 5.4 per cent, and 6.9 per cent, respectively. By contrast, nominal GDP (NGDP) is projected to rise by 0.2 per cent in 2009–10 before picking up to just over 3 per cent in the next two years and to 4.8 per cent in 2012–13.³ As a result, PIT growth is expected to significantly exceed that of NGDP (by 1.5 to 2 percentage points) once the economy has turned around. This is consistent with recent patterns up to 2008, when increases in PIT were at a materially higher rate than those of the economy.

The other major source of economy-related provincial revenue is the HST, which is projected to increase at a pace very close to that for NGDP. This too is consistent with recent history, in which HST growth rate (averaging 3.8 per cent from 2004–05 to 2008–09) was virtually equal to that of the economy (3.5 per cent over the same period). Two other own-source revenues—tobacco and motive fuel taxes—actually declined slightly in recent years. The former is projected to continue to fall gradually over the next four years, while fuel taxes are forecast to rise modestly. Corporate income tax (CIT) revenue

3. Nominal GDP refers to actual dollar values, not corrected for inflation.

displayed the volatility associated with a revenue source that is sensitive to swings in economic activity, rising strongly in the middle of the decade and then declining over the last two years as the economy slowed. Notwithstanding the continued weakness in the provincial economy in the near term, CIT revenues are forecast to rise steadily over the next four years.

The projections for the two major economy-related revenues (PIT and HST), which make up almost 60 per cent of provincial own-source revenues, appear to be very much in line with historical experience. The CIT projections are arguably a bit on the optimistic side, although their revenue share is modest enough not to make much of a difference to the overall provincial revenue forecast. Stated differently, the cyclically sensitive revenues are projected to respond to the downturn and recovery much as would be expected; this leads us to conclude that, appropriately, they can be used in a status quo forecast.

The continued weakness in revenue growth in the face of a return to a relatively robust economic environment is due, in large measure, to a significant downshift in offshore-related income and to a reversal of the pattern in federal transfers experienced over the last five to six years. For example, offshore royalties grew dramatically from \$24 million in 2003–04 to \$451 million in 2008–09. Due to both declining production volumes and falling natural gas prices, that revenue source is projected to decline over the mandate of the current government (an expectation shared by an outside expert on offshore oil and gas revenue forecasting).

Federal revenue, which grew at an average annual rate of over 8 per cent from 2003–04 to 2008–09, is anticipated to *decline* in the next two years (2010–11 and 2011–12) before rising slightly in 2012–13. This is on top of a decline in 2008–09 and a tiny increase in 2009–10. There are several components of that change. Equalization payments grew at an annual average rate of almost 6 per cent from 2005 to 2009, while the Canada Health Transfer and Canada Social Transfer increased at a 7 per cent pace. In addition, there were the added federal revenues from programs such as the Bill C-48 Infrastructure and Patient Wait Times Reduction funds. Not only do the special funds run out, but the extraordinary increases in equalization transfers will be replaced by a 20 per cent *reduction* in 2010–11, followed by increases in the two subsequent years that still leaves equalization revenues \$85 million lower than the 2009–10 level. In fact, Finance forecasts that equalization payments will not return to the current level until 2016–17. The Finance projections to 2012–13 are similar to those provided by an outside expert.

In short, the status quo revenue projections are consistent with recent historical experience and the anticipated pattern of improvement in the economic environment of

Nova Scotia. On the other hand, the 5 per cent expenditure growth assumption from 2010–11 onward could be optimistic given that, over the past five years, total program spending grew at an annual average rate of 7.4 per cent and in no year was growth below 6 per cent. The pattern was not the result of particularly rapid expenditure increases in only one or two areas. Health spending increased at a 6.9 per cent pace, while education and universities rose, on average, 7.1 per cent annually. Together these two categories account for 64 per cent of total provincial program spending. Community services, which makes up almost 12 per cent of the total, grew at a modest 3.2 per cent. However, all the other departments combined had an average annual growth rate of 11.6 per cent during the five-year period.

In all categories save community services, program spending grew at a substantially higher rate than would be sustainable over the long term. The clear implication is that the province was ratcheting up spending in line with extraordinary revenue growth. In fact, program spending grew at a *faster* pace than revenues over the five years. Hence, a 5 per cent growth rate for the status quo projections implies that the new government will, at a minimum, have to trim its expenditure growth to more closely match long-term trend growth in the economy (4.5 to 5 per cent). However, this will not be sufficient to balance the books.

Although not immediately apparent, there may be a hint of a silver lining in this record of overspending. As a significant share of it was in non-core program areas (the core areas are health, education, and community services), it might be easier to curtail or even reverse as part of an expenditure restraint effort. However, two caveats are necessary. Without a detailed examination of the expenditures of the “other departments”—which is beyond the scope of the panel’s work—it is difficult to know which program increases have become recurring and have, as a result, built up a constituency that will oppose cutbacks. Unfortunately, it is easier to introduce new measures than to eliminate existing ones. The second caveat is that two core programs, health and education, experienced spending growth rates well above the trend pace of revenue increases. Whatever restraint may be accomplished in the non-core areas, the expenditure patterns in health and education are not sustainable without permanently constraining other spending to below trend rates.

In the absence of material changes in spending and/or tax policy, sluggish growth in total revenues combined with steady growth in expenditures (even at a slower pace than in recent years) together generate a persistent and significant rise in the deficit over the mandate of the new government. From almost \$600 million in the current fiscal year, the deficit will exceed \$1.3 billion in 2012–13. Unfortunately, a return to solid economic

growth will not, by itself, make much of a dent in the fiscal problem that the government is facing. That is, the fiscal deterioration reflected in the status quo projections is due primarily to factors other than the economic downturn. As noted above, the protracted weakness in revenue growth is due to a downshift in two sources over which the government can exercise little or no control: federal transfers and offshore royalties. As a consequence, the deficit is structural rather than cyclical in nature.

Cyclical versus structural

With respect to the split between cyclical and structural components of the projected deficit, a brief description of the relevant concepts might prove useful. As an economy goes through its cyclical phases of downturns and upturns (decelerating and accelerating growth), there will be an automatic impact on governments' fiscal balances. If no changes in tax or expenditure policies are enacted, the fiscal balance will deteriorate during a downturn as tax revenues, particularly income and consumption/sales taxes, fall in response to rising unemployment and falling aggregate incomes. As well, some expenditures, such as income assistance and unemployment benefits, will increase in response to those same pressures. With declining revenues and rising expenditures, it is inevitable that fiscal surpluses will moderate or deficits will rise.

During the upturn phase in the economy, these patterns will work in reverse, especially as growth above trend occurs for a period. Deficits will decline or surpluses increase in the absence of policy changes. Hence adjustments in the fiscal balance that are purely a response to variations in aggregate economic activity are, logically, *cyclical* components.

If the measured or projected fiscal position of a government is adjusted to normalize for (eliminate empirically) the cyclical elements, the deficit or surplus that remains can be called the *structural* component. Stated another way, the fiscal position that persists when an economy is growing at its long-term trend is structural rather than cyclical. It has to be emphasized that the cyclical and structural components are estimated, not observed. A government can be running a structural surplus even if the overall balance is negative because the economy is in a (cyclical) downturn. During periods of strong economic growth a structural deficit can be "hidden" in a positive overall balance.

Estimates of the impact of the business cycle on Nova Scotia's own-source revenues over the next four years range from \$100 million to \$300 million.⁴ The primary revenue

4. The estimates were done by Finance and by a non-government organization. They should be treated as rough rather than precise estimates of the cyclical-structural split.

categories affected are corporate and personal income taxes [CIT & PIT], sales taxes [primarily HST] and capital taxes. That is, provincial government revenues are a cumulative \$100 million to \$300 million lower than they would have been if the economy had grown at a normal, or trend, rate. Using the baseline projection of a \$1.3 billion deficit in 2012–13, this means that the cyclical component of that deficit is somewhere between 8 per cent and 25 per cent. Even using the high estimate of the cyclical component yields the conclusion that **most of the deterioration in the fiscal balance over the mandate of the new government is structural**. Any deficits generated beyond 2012–13, when the economy is assumed to have returned to its trend growth path, would be entirely structural.

The implication for the government is clear. If it is to contemplate restoring fiscal balance it will have to introduce policy measures to increase the pace of revenue growth and/or reduce the rate of expenditure growth. It is simply not possible to achieve balance, even over successive mandates, by waiting for economic growth to do the job. The sharp move up in deficit levels and the consequent increase in debt/GDP is overwhelmingly structural in nature. The rising economic tide will help but much more will be required to lift the fiscal boat out of the choppy waters.

Risks to projections

There are three key *downside* risks to the fiscal outlook. First, economic recovery might prove more sluggish than assumed in the projections. There is still no shortage of pessimistic forecasters who feel that the economy will pick up only gradually for several years or that we will go through another downturn. For Nova Scotia, a weak US economy will hamper exports and adversely affect energy prices. The adverse impact on the Canadian economy would amplify the problem. This would delay the recovery of income (personal and corporate) and sales tax revenues and increase income assistance expenses, thus exacerbating the fiscal deterioration.

Second, with the federal government facing its own fiscal problems, the possibility of a downward adjustment in federal transfers to the province cannot be entirely ruled out. As noted above, the slowdown in federal payments to the province is already creating a significant fiscal hole. A repeat of the experience of the mid-1990s would deepen that hole.

Third, Nova Scotia experienced sub-par (i.e., below trend) economic growth in the 2003–08 period even as the national and most other regional economies had relatively robust levels of economic activity. If this were not an aberration but a signal of a structural shift down in economic performance, the long-term recovery of the economy

and of provincial revenues could be more subdued than projected. As the weakness was more evident in the middle of the decade than more recently, this is not likely a serious prospect.

However, there are *upside* risks as well. The economic recovery could well be faster and more extensive than many are currently anticipating. The unprecedented levels of fiscal and monetary stimulus being applied globally and, more importantly, in North America could well accelerate household and investment spending at a much faster pace than anticipated.

Two other positive risks with relatively low probabilities exist:

1. The federal government reverses the recent decisions on equalization and other transfers which will be adverse to the province's fiscal position from 2010–11 onward.
2. A combination of higher petroleum prices and, to date unforeseen, offshore natural gas deposits raise petroleum royalties well above projections.

Fiscal Impacts of Possible Policy Measures

In this section the measures being considered are not necessarily ones that the author is recommending. An assessment of each is provided in the following section of the report. The interest here is in what the size of the fiscal impacts would be under different possible measures.

Expenditure initiatives

On the *expenditures* side there is already a policy decision embedded in the status quo projections. That is, there is an implied commitment to cap total program expenditure growth at 5 per cent from FY 2010–11 to 2012–13. As we have already seen, such a policy approach does not prevent a sharp rise in the deficit and in debt/GDP over the next eight years.

Two other expenditure control measures were considered:

1. Cap expenditure growth at a lower rate (3 per cent annually).
2. Keep expenditures at whatever growth rate would be required to achieve fiscal balance by 2012–13.

If expense growth were constrained to 3 per cent over the next three fiscal years, there would be a significant positive impact on the deficit and debt/GDP (see table 3). The deficit in 2012–13 would be lower by just over \$500 million, and debt/GDP would be 2.5 percentage points lower. However, despite the dramatic difference that lowering the growth rate of expenditures can make, the province still would continue to move

farther from balance over its mandate and debt/GDP would continue to climb, albeit at a much slower pace.

TABLE 3 Policy Option 1: 3% expenditure growth (\$ millions)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
	actual	actual				
Revenues	8,523.4	8,494.4	8,411.8	8,455.8	8,633.7	8,891.7
Expenses						
Program	7,100.6	7,568.6	8,115.9	8,007.0	8,247.2	8,494.6
Other	1,032.4	952.4	978.1	1,073.2	1,166.7	1,266.6
Total	8,133.0	8,521.1	9,094.0	9,080.2	9,413.9	9,761.2
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	(555.8)	(748.8)	(838.1)
Net debt to GDP ratio	36.7%	35.4%	38.7%	40.1 %	41.1%	41.7%
Net debt	12,114.8	12,323.5	13,492.7	14,401.9	15,255.3	16,186.5

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

To achieve balance by 2012–13 entirely through expenditure-side measures implies one or more years of outright reductions in the level of expenditures or no growth in spending for the next three years. For example, to balance the books in FY 2010–11, as called for in the recent budget, requires a reduction in program expenditures in that year of about \$325 million, which represents a 4 per cent cut from 2009–10 levels (after adjusting for the shift of university funding into 2009–10). To maintain balance thereafter would require very modest growth in program expenditures for the next two years (see table 4).

TABLE 4 Nova Scotia budget 2009–10 (\$ millions)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
	actual	actual				
Revenues	8,523.4	8,494.4	8,411.8	8,455.8	8,633.7	8,891.7
Expenses						
Program	7,100.6	7,568.6	8,115.9	7,451.2	7,526.2	7,721.7
Other	1,032.4	952.4	978.1	1,073.2	1,138.9	1,201.3
Total	8,133.0	8,521.1	9,094.0	8,524.3	8,665.1	8,923.1
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	0.0	0.0	0.0
Net debt to GDP ratio	36.7%	35.4%	38.7%	38.6 %	37.6%	36.2%
Net debt	12,114.8	12,323.5	13,492.7	13,846.0	13,950.6	14,043.7

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

TABLE 5 Policy Option 2: Balance by 2012–13 (\$ millions)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
	actual	actual				
Revenues	8,523.4	8,494.4	8,411.8	8,455.8	8,633.7	8,891.7
Expenses						
Program	7,100.6	7,568.6	8,115.9	7,700.0	7,700.0	7,700.0
Other	1,032.4	952.4	978.1	1,073.2	1,151.3	1,223.1
Total	8,133.0	8,521.1	9,094.0	8,773.1	8,851.3	8,923.1
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	(248.8)	(186.2)	0.0
Net debt to GDP ratio	36.7%	35.4%	38.7%	39.3 %	38.8%	37.3%
Net debt	12,114.8	12,323.5	13,492.7	14,094.9	14,385.7	14,478.8

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

Another example involves keeping program expenditures constant at (adjusted) 2009–10 levels for the rest of the mandate (see table 5). While this does not exhaust all possible options (e.g., smaller cuts in several years), it is clear that relying entirely on expenditure restraint to balance the budget by the end of the government's mandate implies either outright program spending cuts in one or more years or virtually no growth over the entire period.

In none of the expenditures-only initiatives outlined above is there an implied assumption about whether growth caps (or an actual cut as in Budget 2009–10) would apply equally in all program categories. The issue of whether expenditure measures should be across the board or selective is addressed in the paper by Donald Savoie. This is simply an attempt to determine the fiscal outcomes of an average reduction in expenditure growth or levels.

Revenue initiatives

With respect to possible *revenue* measures, there is a range of possible initiatives. Provincial tax sources with the greatest potential to raise revenue sufficiently to make a dent in the fiscal hole include an across-the-board increase in the PIT and/or CIT, a targeted increase in PIT, an increase in the HST, and increases in tobacco and/or motive fuel taxes. Attempting to do projections of all the possible combinations of revenue measures would have been a daunting task. As a result, actual projections of the impact of only two specific measures were made, and then only for illustrative purposes. One is a two-percentage-point increase in the province's HST rate, the other a targeted increase in the PIT: an increase in the high income surtax to 17 per cent from the current 10 per cent.

A two-percentage-point increase in the HST rate generates about \$150 million additional revenue in the first year and then almost \$250 million in the two subsequent years. On the other hand, the seven percentage point increase in the PIT surtax raises only about \$25 million to \$30 million in additional revenue per year. The pros and cons of these and other revenue-raising initiatives are discussed in the next section. However, it is useful to look at a more generic projection to provide an estimate of the impact of combining revenue and expenditure policy measures.

Without being specific about the actual measures chosen, this paper considers the fiscal impact of initiating \$300 million of tax increases in 2010–11 and pairing that with expenditure restraint of 3 per cent program-spending growth starting in the same year. The result is displayed in table 6. Relative to the baseline projections, this policy approach dramatically lowers the deficit and debt/NGDP tracks, the former almost \$900 million

lower in 2012–13 and the latter five percentage points below the status quo outcome. In the final year of the mandate, the government will, however, still be faced with a sizeable \$500 million deficit. Note as well that the \$300 million in unspecified tax measures would generate revenue about one-third *larger* than that from a two-percentage-point hike in the HST.

TABLE 6 Policy Option 3: Tax increase of \$300 million + 3% spending growth (\$ millions)

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
	actual	actual				
Revenues	8,523.4	8,494.4	8,411.8	8,755.4	8,937.1	9,205.4
Expenses						
Program	7,100.6	7,568.6	8,115.9	8,008.0	8,248.0	8,495.0
Other	1,032.4	952.4	978.1	1,073.2	1,151.7	1,235.8
Total	8,133.0	8,521.1	9,094.0	9,081.2	9,399.8	9,730.8
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	(257.2)	(431.3)	(494.0)
Net debt to GDP ratio	36.7%	35.4%	38.7%	39.3 %	39.5%	39.2%
Net debt	12,114.8	12,323.5	13,492.7	14,103.3	14,639.2	15,226.3

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

An example of an option incorporating tax increases and spending restraint that does generate balance is provided in table 7. The \$300 million tax increase is combined with program spending maintained at 2009–10 levels for two years. Fiscal balance is achieved in 2011–12, and by 2012–13 expenditures begin to increase at a modest pace. This is essentially option 2 (table 5) modified to include a significant rise in taxes.

In another alternative examined, a higher level of tax increases is combined with 3 per cent program spending restraint. In effect, it is assumed that by 2011–12 total revenue growth will have increased sufficiently to match the growth rate of GDP. Given the fiscal hole created by lower federal transfers and falling offshore revenues, this would imply a hike in provincial taxes in one or more of the key areas listed above sufficient to fill this hole. The projections from this option are in table 8. As can be seen, even with tax increases totalling \$550 million over the next three fiscal years and 3 per cent spending growth constraint, the budget is still not balanced by 2012–13. On the other hand, the deficit is down to \$230 million and debt/NGDP is starting to decline.

TABLE 7 Policy Option 4: Tax increase of \$300 million + flat spending (\$ millions)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	actual	actual				
Revenues	8,523.4	8,494.4	8,411.8	8,755.4	8,937.1	9,205.4
Expenses						
Program	7,100.6	7,568.6	8,115.9	7,800.0	7,830.0	8,030.0
Other	1,032.4	952.4	978.1	1,073.2	1,141.3	1,203.9
Total	8,133.0	8,521.1	9,094.0	8,873.1	8,971.3	9,234.0
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	(49.2)	(2.8)	2.8
Net debt to GDP ratio	36.7%	35.4%	38.7%	38.7 %	37.8%	36.3%
Net debt	12,114.8	12,323.5	13,492.7	13,895.3	14,002.7	14,093.0

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

TABLE 8 Policy Option 5: Tax increase of \$550 million + 3% spending growth (\$ millions)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	actual	actual				
Revenues	8,523.4	8,494.4	8,411.8	8,755.4	9,037.1	9,464.4
Expenses						
Program	7,100.6	7,568.6	8,115.9	8,008.0	8,248.0	8,495.0
Other	1,032.4	952.4	978.1	1,073.2	1,151.7	1,230.8
Total	8,133.0	8,521.1	9,094.0	9,081.2	9,399.7	9,725.8
Consolidation adjustments	28.6	46.4	90.2	68.5	31.4	31.4
Surplus (deficit)	418.9	19.7	(592.1)	(257.2)	(331.3)	(230.0)
Net debt to GDP ratio	36.7%	35.4%	38.7%	39.3%	39.2%	38.3%
Net debt	12,114.8	12,323.5	13,492.7	14,103.3	14,539.2	14,862.3

Note: Minor discrepancies in some totals result from rounding (to \$0.1 million) from original calculations.

The message from the above projections is quite clear. If the new government commits to an elimination of the deficit, it will not be able to do so over the life of the current mandate simply by damping down the pace of program spending growth.

Significant tax measures, alone or in combination with constrained spending growth, will not do the trick either. **The only way to achieve fiscal balance by 2012–13 is either to cut spending significantly at some point over the next three years or to keep spending flat for a protracted period *and* combine that with material tax initiatives.** The 4 per cent program spending cut in 2010–11 envisaged in the recent 2009–10 budget is one example of the former approach. Alternatively, if flat expenditures are combined with major tax initiatives, the deficit would be eliminated in 2012–13.

The government may well choose to make progress toward fiscal balance over the next three years without actually achieving it during this mandate. This, in fact, is the path some governments have already chosen or are likely to opt for in upcoming budgets. For example, the federal government has indicated an intention to re-achieve a balanced budget by 2015. The key issue will be whether the Nova Scotia government will have laid an adequate foundation for eventually reaching balance. In that case, the focus shifts from the fiscal projections for the period to 2012–13 to a longer-term perspective. As noted already, the uncertainty associated with even a three- to four-year forecast horizon makes a formal extension of the projections beyond the next three years a dubious venture. However, it is possible to make some reasonable guesstimates of the *range* of potential outcomes in the period after 2012–13.

Starting with the status quo projection (i.e., the no-policy-change option), the most optimistic projection would leave the province with a deficit in the range of \$1.5 billion to \$2 billion by 2016–17. The key assumptions here are that revenues (other than offshore-related) grow at the rate of growth in the economy, that offshore revenues peak later than current forecasts, and that program expenditures grow at 5 per cent. More pessimistic assumptions about revenue growth would yield a deficit closer to \$3 billion. In both cases, debt/GDP continues to rise, reaching almost 60 per cent in the most pessimistic forecast.

Clearly, doing nothing about the fiscal challenges facing the province is not an option for the government. What is the outcome if the government does move aggressively to begin reducing the structural deficit it faces? Two examples will help illustrate the longer-term consequences. The first involves balancing by the end of the current mandate, the other moving the deficit below the current-year level without achieving balance by 2012–13.

The first example involves extending the fiscal outlook for policy option 4: \$300-million tax initiative in 2010–11 and spending held at 2009–10 level for two years. In this case, the government has the option of allowing spending to grow at the pace of revenues and maintain balance or grow spending at a slower pace and allow modest surpluses to

emerge. The key issue, then, is the expected rate of growth in revenues. This, in part, is influenced by policy choices regarding additional tax initiatives of the sort discussed above in policy option 5. The actual income and offshore revenue growth, as well as federal transfer payments, will play a significant role in determining the scope for spending available to the province in the next mandate period.

The other illustrative example extends policy option 3, in which the deficit declines to just under \$500 million by 2012–13 and debt/GDP stabilizes around 39 per cent. In this instance, to balance the budget during the 2013–2017 period requires that the government maintain program spending growth well below the rate of increase in revenues and/or adopt even more aggressive tax measures to push revenue growth materially higher than GDP growth. Even under optimistic revenue assumptions (growth at or close to GDP growth), the deficit will start to rise again if the government allows program spending to increase at the rate of growth in the economy after 2012–13.

The clear implication of this brief consideration of the “out years” is that ***if the government commits itself to pursuing a policy path that will lead to a balanced budget, the sooner it achieves that aim, the sooner the province can resume more conventional (i.e., trend) growth in program spending.*** Obviously, the government will have to weigh the benefits of a speedy return to fiscal balance against the costs of the spending restraint and tax increase initiatives it will have to undertake. We now turn to consideration of this issue.

To this point the discussion has been entirely about what the fiscal consequences would be of various expenditure and revenue initiatives that might be considered by the new government. There is no implied recommendation for any of those hypothetical undertakings. The next section provides a brief assessment of each of them before moving on, in the final section, to suggest some guiding principles for the government to consider as it evaluates its options for dealing with the fiscal challenges ahead.

Assessment of Expenditure and Revenue Initiatives

Spending restraint

The single biggest argument in favour of spending restraint—lower growth rates or outright cuts—is that the government has virtually complete control over how much and where to allocate its revenues. Economic activity levels have a very modest impact on provincial spending; income assistance programs will fluctuate somewhat with changes in GDP growth rates, but the effect on the overall budget is small. The government cannot absent itself from health care and education expenditures, but it can choose

explicitly to vary the quantity and quality of the services provided in the two largest components of provincial budgets. Although bound in the short term by contracts with public servants, it can also adjust the number of people to which the contracts apply.

The single biggest challenge with spending restraint is that it not only affects particular (sometimes widespread) interests and hence has political consequences, but if done unwisely it can generate adverse economic and social consequences that will have to be repaired later on, often at a cost greater than the original fiscal savings. That is one of the arguments in favour of the more deliberate expenditure review processes that Donald Savoie outlines in his paper.

However, it is clear from the foregoing examination of own-source revenue initiatives that they cannot, on their own, resolve the looming structural deficit. Much of the effort, in fact, will have to come from reducing the growth rate in expenditures. Dr. Savoie outlines the problems with “across-the-board” restraint measures, suggesting that a more selective approach will be required if the restraint is to be long-lasting in its impacts.

It is often argued that a government can make significant inroads on a deficit by eliminating “waste.” A somewhat more sophisticated version of that theme is one we heard at the focus sessions held to get the views of a cross-section of Nova Scotians. Several participants argued that the government should be looking for increased efficiencies in the delivery of services. There are, no doubt, modest savings to be had from adjustments in the existing mechanisms used for providing health, education, and other public services. But it is almost always the case that the search for waste or inefficiency bears little fiscal fruit. The low-hanging varieties have typically been “harvested” in previous attempts at cost cutting.

Arguably the single biggest challenge facing provincial governments in Canada (in fact most governments globally) is the pace of growth in health-care expenditures. In Nova Scotia, the average growth rate in that sector has been approximately 7 per cent over the past 5 years, while revenue growth (excluding extraordinary items) has been 4.5–5 per cent over the same period. This pattern is similar in all the other provinces. The consequence is that other areas of spending get slowly but inexorably squeezed. The capacity for new initiatives, however worthwhile, is also constrained. Even if the aging (for some, the preferred phrase is “chronologically maturing”) of the population does not prove to be the fiscal bombshell that many observers project, the current pattern of health-care costs cannot continue indefinitely without wrenching adjustments in other areas of public services. There is not sufficient time for the panel to contemplate even a high-level assessment of options for reining in health-sector costs. However, such an

assessment should be near (or at) the top of the new government's to-do list of long-range issues.

In fact, a comprehensive *review* of expenditures in all areas provides an excellent opportunity for considering significant *reforms* in key categories of public services. That is, it can open up the discussion of the effectiveness and efficiency with which critical services in health and education in particular are delivered. The fact that spending growth in both has been significantly higher than overall economic—and hence long-term revenue—growth implies that some structural, cost-saving initiatives will eventually have to be found. The alternative is to face the inevitable shrinking in the share of spending going to programs other than health and education.

Revenue measures

The HST is the largest of the consumption taxes, generating about 14 per cent of total provincial revenues; hence, it is a major potential source of additional revenue. The federal government has reduced the federal GST in recent years by two percentage points, and several provincial governments have considered occupying the vacated tax “space.” For most economists, consumption taxes are preferable to personal income taxes for at least two reasons. First, taxing consumption tends to discourage household spending and encourage saving, which, it is argued, is a positive outcome in the context of the falling savings rates observed in most advanced economies. From a tax collection efficiency perspective, consumption taxes cannot be (legally) avoided in the way that income taxes can be. In a deficit-fighting context, an arguable benefit of raising the HST rate would be that the burden of reducing the deficit is broadly shared by taxpayers.

Apart from being highly unpopular politically, one of the main disadvantages of a hike in the HST is that consumption taxes tend to be regressive, taking a proportionately larger share of the incomes of lower-income individuals and families. This may be offset, in part at least, by raising the low-income tax credit and/or lowering the high marginal effective tax rates that low-income people face through claw-back of benefits when their earned income rises. While such mitigating measures also reduce the net impact of the rate hike, they also make a potentially significant source of additional revenue more palatable, not only (marginally) from a political perspective but from an equity perspective as well.

The other revenue measure explicitly examined was an increase in the high-income surtax from 10 per cent to 17 per cent. One argument for considering it is that there may be concern that the burden of deficit reduction be shared by everyone. If low-income families are adversely affected by an HST hike, and public sector workers might have to

face job losses or wage restraint, high income individuals, it may be argued, should bear some of the added pain as well. It has the added advantage of being a politically popular tax hike—except, of course, among those subject to the hike.

The major disadvantage of an increase in the surtax of the size examined here is that it simply does not generate much additional revenue because the tax base upon which it draws is so small. That is, despite any political appeal it might have it has limited fiscal heft. Another argument put forward is that “soaking the rich” discourages high-income earners from coming to the province and may even discourage companies from locating here. While anecdotal evidence is sometimes offered to bolster such an argument, there is little empirical support for the general claim that *modest* increases in the top PIT rates affect individual or corporate location decisions.

Among the other revenue-generating measures to be considered, two merit specific mention. The CIT is not likely to be a significant source of revenue for dealing with the deficit. Business taxes generate only 4 per cent of total provincial revenues. As well, if there is a tax category where competition with other jurisdictions is relevant to location decisions, it is corporate taxes. While the empirical evidence is mixed regarding the *size* of the impact, the *direction* of the influence on business decisions is clear: higher relative rates would tend to discourage investment in the rate-hiking jurisdiction. In any event, for the next several years, the impact of the recession will continue to be felt in this tax category as firms carry forward losses from the current weak economic environment.

Another area of potential tax changes is the broad PIT, which generates about 22 per cent of provincial revenues, compared to 14 per cent from the HST. Across-the-board increases in PIT could yield a larger increase in revenues to reduce the deficit. Which increase would be more unpopular politically is likely a toss-up, but the economic arguments for and against raising the HST apply in reverse here. Raising the PIT will lower disposable (after-tax) income and will tend to reduce savings. On the other hand, the progressivity of the PIT structure means that there will not be a disproportionate burden on low-income individuals and families. A variation on the PIT increase theme is an option chosen several years ago by the Liberal government in Ontario to introduce an income-based (and hence, progressive) health tax. The argument used was that, as health expenditures were rising faster than any other category of provincial spending, Ontarians ought to be prepared to pay more for those public services through an addition to their existing income tax payments (including the income surtax).

Several participants at one of the focus sessions suggested that the government consider tax *reductions* to encourage spending (household and business) and job creation. Although not stated at the sessions, one of the arguments in support of tax cuts as a

deficit reduction measure is that by generating spending, jobs, and income, they can be self-financing. That is, the extra income generated will eventually raise tax revenues sufficiently to offset the initial decline.

Without getting overly technical, the analytical foundation for the position is that tax cutting, whether personal or corporate, causes changes in behaviour that raise productivity and long-term economic growth. Personal tax cuts induce greater work effort and directly raise labour productivity. Business tax cuts, especially those that tax capital rather than business income, encourage investment, which increases productivity.

The empirical foundations for the PIT-productivity link are weak, although a recent OECD study suggests that personal income tax levels and the progressivity of rates do have an impact on the individual decision to choose entrepreneurship and, through that mechanism, have an influence on long-term growth. With respect to business taxes generally, the evidence is a bit more mixed, although the main source of empirical disagreement is over the *size* of the impact on investment spending of changes in tax rates. The OECD study does suggest that “[economic] growth is higher when the corporate income tax is lower.” The one tax area that makes no sense is the capital tax, as it tends to generate little revenue and taxes the base for investment, a company’s capital.

In making choices about what tax measures to use and the size of the changes in each, the government has to consider not only the impact on its short-term fiscal position but also the longer-term implications for economic growth and development. It is well beyond the scope of the panel’s work to assess specific tax initiatives to any greater extent than the above discussion and that included in the paper by Elizabeth Beale. However, there is already an ongoing internal effort within the Finance department to analyse tax policy in the province. Halifax Regional Municipality is also engaged in a substantial debate on the fairness and efficiency of municipal taxation.

The goals for tax policy essential to any structural reforms that the government might contemplate include fiscal responsibility, equity and fairness, economic efficiency, long-term growth and rising living standards, and sustainability. The interactions between levels and types of taxation must also be carefully considered. The government must build on the current work on tax reform within Nova Scotia, as that will be a critical counterpart to an examination of possible spending reforms. In short, there is both an opportunity and an urgency to consider major reforms to current expenditure patterns and to the tax structure in the province.

To this point, this paper has examined the fiscal situation that the province can expect to face. The fiscal outcomes of a few broad policy options—including maintaining the status quo—have been projected along with a high-level assessment of their pros and

cons. The general conclusion reached from this is that *if* the new government is unwilling to allow the deficit and debt/GDP to balloon during its current mandate and beyond, it will have to introduce significant expenditure constraint and tax enhancement.

We move on to provide guidance to the government in answering the three questions posed at the outset of the report: Should it plan to reduce/eliminate the looming deficit and, if so, how quickly? Which policy measures should it use? What fiscal guideline(s) should it put in place to direct future policy?

Considering the Three Questions

At one of the focus sessions, there was a sharp division between those who felt the government had to commit to eliminating the deficit and those argued that, while a deficit is undesirable, the government should not feel an urgent necessity to deal with it soon. Some even suggested that it could wait until a second mandate to plan how to reduce it.

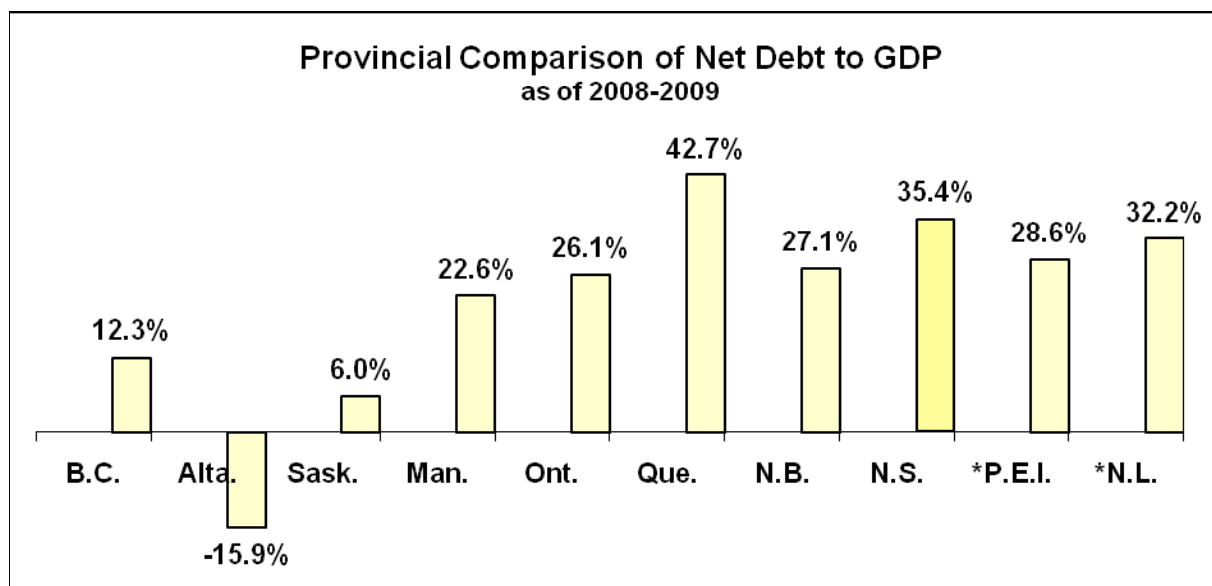
However, the government cannot allow the deficit to increase as rapidly as is projected in the status quo policy case. On the other hand, it should not attempt to eliminate it by 2010–11 as contemplated in its campaign platform and explicitly spelled out in its recent budget. Even if the government were to choose not to aim to achieve balance by the end of the current mandate, it would have to spell out a credible plan to achieve balance not much later than that.

Reduce or eliminate?

The fundamental argument against allowing a *significant* deficit to persist or, worse, to continue to rise indefinitely is that the increase in debt-servicing costs inexorably squeezes a government's capacity to deliver the programs—existing or new—that society has deemed important. In addition, at some point the rising debt/GDP reaches a level at which lenders become increasingly reluctant to take on the government's debt and demand higher interest rates to cover the perceived increase in the risk of holding that government's paper. We saw this, for example, in the mid-1990s in Canada (federal) and Sweden. The episode and the mind-set change it engendered are discussed in Donald Savoie's paper. Finally, the fiscal squeeze renders the jurisdiction more vulnerable to a material change in economic circumstances such as a recession or a sharp rise in interest rates.

Sub-national governments—provinces, states, municipalities—are more vulnerable than national governments, as they do not have the range of policy tools, especially monetary policy, available to the latter. The smaller the entity, the more susceptible it is to external factors beyond its control. Nova Scotia would certainly fit that description and

hence has less scope to allow its fiscal position to deteriorate. Nova Scotia's debt/GDP is already at the upper range of levels observed across the country. While nobody knows how significant an impact the recession will have on other jurisdictions or how they will deal with the fiscal consequences, starting out near the top of the debt/GDP league tables is not the most desirable situation.



Sources: Statistics Canada for nominal GDP (release date 2009-4-27); Provincial Public Accounts for 2008–2009 for Nova Scotia debt/GDP estimate (Department of Finance for September 2009 budget).

* Prince Edward Island and Newfoundland and Labrador have not yet released 2008–09 Public Accounts; therefore, 2008 GDP has been factored against 2007–08 net debt for these provinces.

Having said that, there is no need for the government to push the panic button. Even the situation described in the worst of the projections examined—status quo policy—is not a looming catastrophe, at least within the next four years. Debt/GDP rises to a level (44 per cent) that is not without precedent in the province. The level of deficit in 2012–13, at about 4 per cent of GDP, has also been seen in the past in the province and in other Canadian jurisdictions—and may be seen elsewhere again over the next several years. Hence, it is the view of the panel that **the new government does *not* need to eliminate the emerging deficit in the FY 2010–11 budget.**

However, doing little or nothing during this mandate is not an option either. The rapid escalation in the deficit and debt/GDP, especially after the impacts of the economic downturn have faded, is a clear indication of a significant structural problem that will have to be addressed with a sense of urgency. The consideration of expenditure restraint

and revenue enhancement measures should already be underway and a plan formulated before the budget comes down in 2010. The execution of the plan will have to begin in that budget. As described in Donald Savoie's piece, the expenditure review process will not be completed quickly, but commitments to a pace of expenditure restraint along with some specific elements of it will have to be included in that budget.

With respect to a choice between reduction and elimination, the latter is the appropriate target. In the current circumstances, the focus should be on the policy changes required to eventually achieve balance. Anything less ambitious, such as a small but persistent deficit, implies acceptance of a perpetual structural deficit for which no legitimate economic rationale exists. What can happen is that the (sustained) deficit target is treated not as the minimum fiscal discipline but as the norm or, worse, the maximum that can or should be achieved.

Over what time period?

If fiscal balance is to be the interim target, how fast should the government plan to move toward it? Unfortunately there is no widely acknowledged rule of thumb. However, a few simple strategic principles can be offered:

- The commitments have to be clearly articulated and the mechanisms for achieving them have to be credible; promising more than any reasonable analysis suggests is possible sets the government up for failure. If anything, the government should aim to under-promise and over-deliver rather than the reverse.
- The time frame also has to be credible. It has to be long enough so that the specific measures adopted, however painful, can be reasonably expected to work and short enough that the government cannot be accused of putting off the inevitable.
- The time frame has to be constructed to fit the current and expected circumstances. A deficit and debt/GDP anticipated to rise materially in the absence of policy initiatives implies a need to move aggressively as soon as possible and aim for balance not long after the end of the current mandate.
- Whatever plan is devised, it must have a set of annual targets that display credible movement toward the goal of balancing.

Committing to balance by the end of the government's mandate should be given serious consideration. As noted above in the discussion of the "out years," the less aggressive the government is over the next three fiscal years, the more constrained will be its capacity to spend in later years or the more substantial will its tax measures have to be. If the aim were to balance the province's books no later than when the upturn phase of the economic cycle reaches its peak, the endpoint would be set about FY 2012–13. That is when, in the current Finance economic forecast, GDP growth reaches its peak

over the next eight years. This target year would be (broadly) consistent with an attempt to balance the budget over the cycle, a guideline to which we return below.

Expenditure restraint or tax increases, or both?

The issue of whether the deficit elimination program ought to rely primarily on expenditure restraint or on tax increases cannot be addressed without reference to the context in which Nova Scotia finds itself. First, the province is currently in the upper end of the range of PIT rates (second highest province in Canada in 2008) and of PIT and HST tax effort (second highest in taxes as a share of GDP). It may well be that some provinces will have to raise their tax effort in response to deteriorating fiscal positions, but if the province is concerned about its comparative tax position it cannot rely on that happening. It is worth repeating that there is scant evidence of personal income tax competition being relevant to individual or company location decisions. However, the province may not want wish to risk being branded the highest tax jurisdiction in Canada.

The fact that the NDP is perceived by some, rightly or not, to be a “tax (more) and spend (more)” political party might create added pressure to avoid instituting policy measures that appear to confirm the first half of that stereotype. The fact that a number of Western Canadian NDP governments have amply displayed fiscally conservative behaviour could help blunt if not obliterate the stereotype. Unfortunately, the new government is also “new” in not having a track record in the province on which to rely.

If the projections outlined above are a reasonable depiction of the oncoming fiscal challenge, **the government must contemplate using significant tax measures along with expenditure restraint to achieve fiscal balance.** They can be delayed to a later budget or scaled down from the ones used in the projections. This will give the province time to see what is happening in other jurisdictions and to establish more firmly its fiscal bona fides. However, the downside to delay is that the fiscal hole will be deeper and/or the spending restraint will need to be more pronounced.

In any event, there is no question that any credible effort to significantly reduce or to eliminate the deficit will require significant expenditure restraint (program spending growth close to 0 per cent annually for a couple of years) whatever revenue initiatives are incorporated into the total package. If holding spending essentially constant for two years is deemed unworkable or inappropriate, the fiscal plan will have to include one budget that calls for program expenditures to be cut. However, the cut would not have to be as dramatic as that proposed in the current budget projection.

What fiscal guideline(s)?

The Province of Nova Scotia has a fiscal policy *rule* intended to provide a framework within which to set fiscal policy. The Provincial Finance Act calls for the government to balance its budget each year and, if it runs a deficit in a particular year, to eliminate the deficit in the following fiscal year. Under most of the scenarios discussed above, this does not happen. There is therefore a question: Should the Province of Nova Scotia continue to have a formal fiscal target or rule, and if so, what should that be? The two main types of target typically used for long-term guidance are fiscal balance and debt/GDP.

Between a fiscal balance (i.e., deficit/surplus) rule and a debt/GDP rule, the more analytically appealing one for economists is the latter. Debt is the accumulation of past deficits (net of surpluses) and debt/GDP indicates the underlying affordability of that debt—the fiscal capacity to service the debt. In that sense it is analogous to the debt/income position of households or corporations, which reveals the fundamental financial viability of the entity. Whether a government, company, or household spends more than its income in any given year is far less important than whether it can sustain the cost of servicing the increase in debt that results from the deficit. Having said that, it is also not feasible for a household or business to indefinitely run a deficit in its operations. Hence, persistent fiscal deficits are not sustainable either.

There is no agreed upon *optimal* debt/GDP level that can be set as a target for all governments to aim for. There is a broad range within which there may be a *preferred* debt/GDP. Most analysts would agree that a number above 50 per cent, especially if it is rising, is too high. There is no clear low end to the range, although a number around 20 per cent would be widely regarded as more than acceptable. The problem, then, with choosing a debt/GDP level as *the* target is that the choice of a specific number offers considerable latitude. This suggests that, in the adoption of fiscal rules of conduct, debt/GDP can be a key guidepost but not the *primary* fiscal target.

There are two key elements to the determination of a target debt/GDP. The first is the fiscal capacity of the government to finance its liabilities in the future. This includes liabilities to which the government is already committed and those that will emerge for demographic and other reasons over succeeding decades. The second, related, issue is the fiscal burden that will be imposed on future generations both to service the debt and to pay for current and future commitments. In this regard, the steady decline in the ratio of the working-age to the retired population raises issues of intergenerational equity. Put another way, the baby-boomers caused the run-up in the debt, and the generations that follow, though smaller in number, will be saddled with much of the burden of servicing

the debt and of the cost of ongoing programs—health and public pensions—from which the retired baby-boomers will disproportionately benefit.

These considerations point to a desirable debt/GDP at the low end of the (broad) “acceptable” range. The government could set 25 to 30 per cent as the target, a figure that many economists would regard as reasonable from the perspective of providing both a cushion against unforeseen cyclical problems *and* ample fiscal room to deal with looming contingent liabilities. Some have even argued that an emphasis on lowering the intergenerational transfer of the fiscal burden implies the need for an even lower target range, such as 15 to 20 per cent. Even if a debt/GDP target were to be set by the province, the timeline for achieving it need not be—in fact, should not be—the next three to four years. The debt/GDP level will drift down over time simply because of economic growth so long as the deficit is not rising faster than the economy. With fiscal balance or surpluses it will decline that much faster.

If the objective is to set a target that is transparent, easily understood, and a consistently clear indicator of the degree of fiscal discipline being exercised, then fiscal balance is the appropriate one to use. That is, within some time period, the government should have a specific level of deficit or surplus at which it will aim. Policy will be designed so as to maximize the probability that the target will be reached under a set of assumptions about the performance of the macroeconomy. The time period may be a year or a number of years; the target may be zero balance or a deficit or a surplus of specified size.

In recent years, it has been common for national and sub-national governments to set a target of annual balanced budgets. Many jurisdictions (including Nova Scotia) have legally mandated them. There are several problems with this particular fiscal rule. First, they tend to be procyclical in their impact. When the economy is strong and (cyclical) surpluses would normally emerge, the surpluses are spent, thus reinforcing the economic expansion. This is precisely what appears to have happened in Nova Scotia over the last five to six years. In a downturn, revenues decline and governments have to either increase taxes or reduce spending to maintain the budget balance. By so doing, government actions add to the economic weakness.

Governments, faced with weakening revenues, almost invariably search for ways to skirt the balanced-budget rule they legislated. The more severe the downturn, the more likely it is that the government will effectively ignore the fiscal rule in place. That is why we have seen a number of governments change or ignore such legislation in the recent economic downturn. This reduces the credibility of the rule and invites scepticism, even cynicism, about the government's fiscal management.

A third problem is that strict adherence to the rule can cause systemic distortions in the fiscal forecasting process. One of the main conclusions of recent analyses of federal fiscal forecasting is that the injunction never to allow the government to run a deficit caused federal Finance to build (quite properly, given the rule) enough conservatism into the forecast process (understating revenues and overstating expenditures) that surpluses were virtually guaranteed under almost any circumstance (including during the near recession in Canada in 2001).⁵ This added to the scepticism about fiscal management at the federal level, especially about the “hiding of surpluses” from the opposition in Parliament.

Several arguments can be put forward in favour of an annual balanced budget target. First, it provides an unequivocal fiscal anchor for the government. There is no ambiguity about the minimum target in each budget year or about whether it has been achieved at the end of that year. Second, the no-deficit target is very easy to explain to the public, and it appears to have more widespread acceptance than would have been the case 15 years ago. Finally, for many policy analysts the key reason for retaining the rule is that, so long as the target is met or exceeded, it is a guarantee against a return to the “bad old days” of persistent and (often) rising deficits. In particular, it prevents structural deficits.

Fundamentally, though, there is no economic rationale for perpetually balanced budgets, although there may be debatable political economy arguments in their favour.

The appropriate conclusion to draw from this is that the Nova Scotia government was correct in its decision to scrap the balanced budget rule. The rule might not have caused the over-spending pattern of recent years, but it did nothing to discourage it either. An adherence to it in the current fiscal and economic circumstances would require draconian policy measures. The issue then becomes what guideline should replace it. The term “guideline” is used deliberately here to indicate that the adoption of hard-and-fast fiscal rules (i.e., legislated requirements) is not the most effective way to proceed. However, the government does need some kind of fiscal anchor to establish a transparent framework for budget policy. This is especially important given that it has decided to formally rescind the balanced-budget legislation.

As argued above, the government should, at a minimum, set a fiscal year deadline for balancing the budget, with intermediate year targets as well. The government should consider going further to set a guideline of balancing over the economic cycle. This was the “rule” argued for by Keynes in the 1930s. Governments would run deficits in recessions and surpluses in booms, aiming for zero balance on average over the full

5. Tim O’Neill, *Review of Canadian Federal Fiscal Forecasting* (Ottawa: Department of Finance, June 2005).

cycle. If governments aim to balance over the economic cycle, their activities help dampen the size of the upturns and downturns; in other words, the activities are counter-cyclical. In fact, in contemporary advanced economies, the combination of personal income tax, consumption tax, and income support structures are automatically counter-cyclical. By following a rule of balancing over the cycle, the government could passively allow a deficit to occur during periods of weak economic activity and a surplus when the economy strengthened.

There are significant challenges with adopting a formal *rule* of balancing over the economic cycle. On the technical side, adoption of the rule requires that it be possible, when unanticipated fiscal changes (primarily in revenues) occur, to determine which changes are driven by cyclical factors and should be ignored and which are caused by structural factors to which adjustment will be necessary. In effect, targeting a cyclically adjusted balanced budget involves considerable judgment about the causes of discrete and unexpected changes in revenue and about the proximity of the economy to its long-term full employment level of activity. As well, because economic cycles are not of uniform length, it is not possible to set out, in advance, the period over which fiscal projections ought to be made, targets set and monitored, and success determined.

Despite these technical challenges, several countries have adopted either balance or a small surplus over the cycle as their key fiscal target. For example, the UK government in the late 1990s established the so-called “golden rule” as its operating policy. Over the cycle, deficit financing would be allowed only for public investment expenditures. Hence, for the ongoing operations of the government, the budget was to be balanced over the economic cycle. At about the same time, Australia set a balanced budget over the cycle as its fiscal strategy. In Sweden and New Zealand, the governments targeted small surpluses (2 per cent of GDP in Sweden) as the primary fiscal goal.

The political economy problem is that governments have a political cycle that is of relatively specific length and is shorter than most of the economic cycles of the last 50–60 years. This creates an added challenge for monitoring and measuring fiscal success. As well, we have seen in a number of jurisdictions with balanced-budget rules, there is a strong incentive to cheat on the rule, especially when faced with difficult fiscal choices. There is a similar inclination to violate even a less-constraining rule such as the balance-over-the-cycle one. This occurred in the UK in the middle of this decade when the definition of public investment was bent to fit a deteriorating fiscal position occasioned by program spending choices. An OECD study several years ago noted that “allowance for the business cycle may ... come at the expense of simplicity and transparency ... [and] may make the fiscal framework less binding and reduce its credibility.”

A variation on the balance over the cycle that may be more transparent and easier to make operational is for the government to establish a more-or-less fixed program-spending growth rate. If, for example, the long-term trend in nominal GDP growth is 4.5 per cent (2.5 per cent real growth plus 2 per cent expected inflation), the government could set that as the annual target for program spending increases irrespective of the current pace of actual growth in the economy and hence in revenue. In a booming or robust economy, there would tend to be budget surpluses, and in downturns or recessions, deficits would emerge. There would be something close to balance over the economic cycle without there being a formal setting of such as the fiscal target.

Several caveats are in order, though. The trend growth rate in the economy is an estimate, not an observed fact. The estimate relies on historical data patterns that can vary for both cyclical and structural reasons. If a break in the pattern does occur, it can be some time before it is clear what the primary cause of the change was. If it is cyclical, the original pattern will return, and no change in the spending growth rate will be required. A structural adjustment implies that the trend growth rate of the economy has increased or decreased and the spending growth target will have to be adjusted accordingly.

Second, the implicit assumption above is that revenue growth will match the trend GDP growth rate. As we saw in the projections, that might not be the case when key external revenue sources moderate or decline (e.g., equalization and offshore royalties) and there is no offsetting adjustment in own-source revenue rates. In that case, the government is forced to either increase taxes or reduce the rate of spending on a permanent basis.

It is for these reasons that it would not be appropriate for the Government of Nova Scotia to replace one legislated fiscal rule with another one. However, the notion of broadly aiming to achieve balance by the time the economy hits its peak growth rate and to run surpluses during the period of robust economic performance might prove a useful framework for guiding fiscal policy over the short-to-medium term. This would be consistent with balancing over the cycle. It could help to establish credible fiscal discipline without locking the government into a fixed rule that will be difficult to make operational.

In sum, there is no need for the government to rush to immediately balance the budget in order to conform to the Provincial Finance Act. However, the government cannot avoid making a number of difficult decisions and implementing painful policy measures by the 2010–11 budget. There will have to be an unequivocal commitment to eliminating the structural deficit within a three- to four-year time frame starting in FY 2010–11. By that time the economy will be in full recovery and the

government will, if the structural deficit is gone, have surpluses to work with. Debt/GDP will already be heading downward. Both of these outcomes will help establish a well-earned reputation for fiscal discipline.

**Delivering on
“Making Life More Affordable for
Nova Scotia Families”
—an Economic Perspective**

A paper prepared for the
Nova Scotia Economic Advisory Panel

Lars Osberg

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Delivering on “Making Life More Affordable for Nova Scotia Families”—an Economic Perspective

Summary

Nova Scotia’s newly elected government pledged during the election campaign to “make life more affordable” for Nova Scotia families. The specific policy most associated with this pledge was the promise to rebate the provincial portion of the HST on home electricity consumption. However, once this promise has been honoured, what is the next step? What is the more general meaning of this commitment and what can be done to deliver on it, given the actual economic constraints likely to face the Nova Scotia government over the period 2009 to 2013?

Because many dimensions of provincial government policy affect family economic well-being, this paper argues that “improving affordability” should be interpreted broadly as “providing tangible material benefits.” A benefit gained in one aspect of life frees up resources that can be spent elsewhere, and small improvements in government services can sometimes help families avoid major expenses. Hence, provincial government policies that help families earn an additional dollar, or save on their current spending, or save time and aggravation, all can be seen as helping to make life more “affordable.”

The context for this paper is the constrained budget situation of the Province of Nova Scotia, for the period 2009 to 2013. As the Deloitte report has documented, the impact of the current recession on the incomes and consumer spending of Nova Scotians implies lower tax revenues that, by itself, would have meant that the Government of Nova Scotia will face extreme difficulties in balancing the provincial budget. In addition, program spending—especially health care costs—has been increasing at a rate greater than the sustainable rate of increase of the tax base. This means that Nova Scotia has to restrain program spending, or increase tax rates, or both, if it is to avoid structural budget deficits when the recession does eventually end. Although transitory increases in equalization and royalty revenues in recent years have masked the province’s structural deficit, the new government’s commitment to budget balance implies that revenue is not available to deliver tax expenditure or transfer benefits to large numbers of Nova Scotia families—at least not in magnitudes that would be large enough to be noticeable.

Governments, however, do much more than just “tax and spend.” The Government of Nova Scotia also delivers services—particularly in health care and education—which Nova Scotia families depend on. Because the value of these services is a significant fraction of the total resources available to most Nova Scotia families, improvements in

their coordination and efficiency can have noticeable impacts on family well-being. Families have to balance both a time budget and a cash budget—the “time crunch” facing families implies that if government can deliver coordinated services in a way that more effectively meets family time needs, tangible improvements in family well-being can be substantial. The paper therefore focuses on the low-budget/off-budget ways in which government can deliver on affordability—by providing tangible benefits through improved service coordination, better regulation, and enhanced program delivery.

Affordability for families depends on both the expenditures and the revenues that families have, so section 3 examines the probability of tangible increases in family incomes over the 2009–13 period. Average hourly wages after inflation have not changed much in Nova Scotia in many years. The most important factor in family income trends has been changes in hours worked. Declining unemployment in the recovery phase of the recession—though perhaps delayed as late as 2011–13—will be the key driver of household money income trends.

Although more affluent families also benefit from the public services discussed in the paper, promises about affordability are not very salient for people at the top of the income distribution who have substantial discretionary income. For them, affordability is not really a top-of-mind problem. Affordability is also not to be confused with an anti-poverty agenda. Poor people need cash transfers, and they also need training and counselling and a much more targeted policy design than discussed here. The target population for this paper is instead the large number of middle- and low-income families who have to watch their spending carefully—60 per cent of Nova Scotia families have total pre-tax annual incomes less than \$72,500 per year. The paper starts with a vignette—Bob and Mary and their two children—to illustrate some key themes.

“Making life more affordable” is one thing, but getting any political credit for it is a very different issue, for any government. The strength and duration of public perceptions of tangible improvements in economic well-being depend on how visible a change is, how many people it affects, how quickly it becomes taken for granted, and how many other potential policy initiatives are precluded by the resources it absorbs. Selective sales tax exemptions (i.e., tax expenditures), are a very expensive, and quickly forgotten, way for governments to try to deliver tangible material benefits to voters.

Bob and Mary and Tyler and Natasha: A Vignette

Bob and Mary and their two children, Tyler (6) and Natasha (4), typically have an early start to their busy day. For Bob to get to work on time by 8:30, he first has to drop Natasha and Tyler at the babysitter's. Mary works in the other direction and has to be at

work by 8 AM, but she usually gets off work a little earlier in the afternoon, so she is in charge of the afternoon pickup (unless she has to work late). Most mornings they manage to get the kids out the door by 7:30 and get them home around 5, but their daily schedule would be impossible if they didn't each have a car.

Bus service out where they live is poor, and the nearest stop is a mile away, so they need their two cars. With the hectic rush of day to day, they have little time to read newspapers or watch the TV news, but they are both concerned about the environment their kids will inherit. However, although they do worry a bit about the air pollution of Mary's old clunker, their main concern is whether it will last another winter, and how they will afford to replace it. They both also worry about whether Natasha and Tyler would be better off if they could afford licensed daycare for both of them, but there just isn't enough money coming in to pay for better daycare, and for car costs and groceries and the mortgage and everything else.

Bob is currently paid \$18.00 per hour, which puts him at almost exactly the average weekly wage in Nova Scotia.⁶ His annual income before tax is generally around \$36,000. Mary's job as a receptionist brings in \$24,000 a year⁷. They are certainly not "poor," and they know that many families have to get by with less than they have, but they also have to watch their own spending carefully.

If better bus service could enable them to get by with one car, they figure the savings would be about \$6,000 per year in expenditure (counting insurance, depreciation, and repairs, as well as gasoline) minus the cost of a bus pass (\$840), for a net saving of about \$5,100, which would be close to 10 per cent of post-tax family income.

If Tyler's public school were able to offer playground supervision before and after school, they could save the cost of paying a babysitter for him—about \$40 weekly, which adds up to about \$1,600 over the school year. They would love it if Natasha could have full-day daycare, but the difference in cost would be more than \$300 per month. As well, both Bob and Mary worry every day that their babysitter has been a little undependable in the past and there is always a chance that she will be suddenly unable to take Tyler and Natasha, for some random reason, on any given day.

6. The average weekly earnings (including overtime) of all Nova Scotia employees was \$728.31 in Jan–Apr 2009 (see Statistics Canada, CANSIM tables 281-0023 and 281-0026). At \$18 per hour, 40 hours work per week yields \$720.

7. The average hourly wage for "Receptionists and Switchboard Operators" in Colchester/Cumberland, Nova Scotia is \$13.15. At 35 hours per week, the annual pre-tax salary is \$23,933. See <<http://www.labourmarketinformation.ca>>.

Where Does the Money Go?

If the Government of Nova Scotia could choose which parts of the cost of living to reduce, what would make the biggest difference for most Nova Scotia families?

Table 1 Distribution of consumption expenditures (%)

Market basket method, poverty line (four-person family), Nova Scotia, 2006*						
	Income (\$/y)	Food (%)	Clothing (%)	Shelter (%)	Transport (%)	Other (%)
Rural	29,211	26.6	9.0	25.4	13.8	25.3
<30K	29,487	26.3	8.9	26.1	13.6	25.1
30K–100K	27,277	28.5	9.6	29.0	5.9	27.1
Halifax	29,073	26.0	9.0	34.4	5.8	24.9
Cape Breton	26,360	28.8	9.9	28.6	5.1	27.6
Consumer Price Index, Canada**						
Canada	100%	17.0	5.4	26.6	19.9	31.1

*HRSDC, Appendix G, Low Income in Canada: 2000–2006 Using the Market Basket Measure (October 2008).

** Statistics Canada, Table 1: The Consumer Price Index, major components and special aggregates, Canada, not seasonally adjusted, [online] <<http://www.statcan.gc.ca/pub/62-001-x/2008012/t031-eng.htm>>.

Table 1 presents two calculations of the distribution of consumption expenditures, across commodity classes. Their differences reflect their origins. The top part of the table is derived from a calculation of the minimum expenditures necessary for a subsistence budget of a family of four, as used by HRSDC to motivate a budget-based measure of the “poverty line.” The bottom line reports the components of the Consumer Price Index, which is intended to measure changes in the consumer prices facing all households. The two differ because high-income households do most of consumer spending, and their spending patterns therefore dominate total consumption expenditures. The weighting of commodities appropriate for the CPI therefore reflects the substantial discretionary income of upper-income groups, which is available to be spent on recreation, education and reading, etc. However, as the table shows, expenditures on food, clothing, and shelter dominate the budgets of low-income Nova Scotia families.⁸

8. The fact that the percentage of income spent on food, clothing and shelter falls as family incomes rise has been called “Engel’s Law” and is the basic relationship underpinning the calculation by Statistics Canada of the “Low Income Cut-Off” (LICO). On a Canada-wide basis, the differences between the poverty line calculated by a LICO and by Market Basket methodology are not large, but the omission of transportation from the LICO means that it underestimates the extent of rural poverty, which is particularly important in Nova Scotia.

The poverty-line calculations of table 1 embed the reasonable assumption that if food is a necessity of life, people also need some transportation to get to and from the grocery store (or to get to work or to access public services). The lack of any available public transit, with the consequent necessity of running a car, is the reason why the minimum cost of living is estimated by HRSDC to be *higher* in rural and small-town Nova Scotia than in Halifax.

As table 1 shows, food and shelter are the main expenditure items for middle- to low-income families. These goods are, for the most part, provided by the private sector and already largely exempt from provincial taxation. A provincial government in Canada has limited direct policy levers on most of the cost of living of families.

Transportation costs are, however, an area in which provincial policies can have a major impact. The availability of public transit makes a huge difference to family cost of living if transit can substitute for automobile ownership, even if it only makes the second car unnecessary. Rural and small-town Nova Scotia is currently almost entirely without public transit. Subsidizing fares and expanding access is only part of the issue. Equally important is convenience of use—the frequency of service and the coverage of transit destinations. Transit use also has an important positive-feedback-loop aspect in that more riders make more frequent service and a better route network feasible, which makes transit use more convenient, which in turn tends to increase usage, and so on. And when more people use public transit, there are important ancillary public benefits in reduced air pollution and CO₂ emissions, fewer traffic injuries and fatalities and associated health care costs, reduced traffic congestion, and decreased demands for public investment in roads, bridges, parking, etc.

Policy example 1: Public transit—a public service that saves private costs

The convenience, frequency, and cost of service of public transit availability are important to the private budgets of the Nova Scotia families who either do not have automobiles or who would like to operate with fewer automobiles. Building public transit systems is sometimes an expensive and slow process, but it has long-run structural benefits and is particularly important for rural Nova Scotia.

In addition, government is not powerless to affect the cost of car ownership. The cost of auto insurance is a significant budget item for many families. NDP governments have shown their willingness in other provinces to use a variety of strategies—from public auto insurance to regulation and negotiation with the private sector—to drive down auto insurance costs, thereby helping family finances without necessarily directly impinging on the province's budgeted spending.

Policy example 2: Car insurance—better regulation to reduce private costs

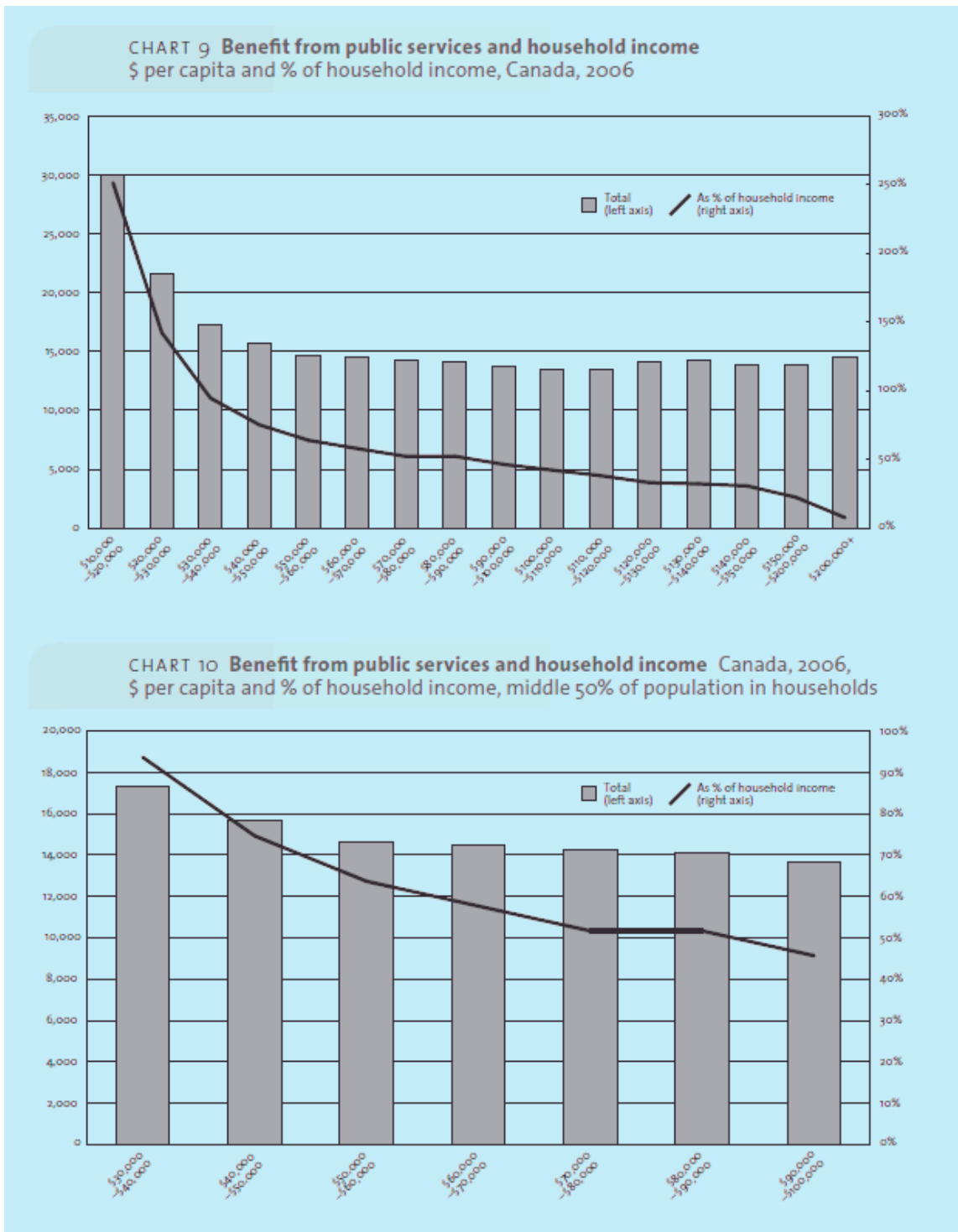
Given the necessity for many families of running a car, the cost of auto insurance is a highly visible and important component of the cost of living, particularly in rural Nova Scotia. There are complex issues involved, but government has numerous potential policy levers because it sets the legislative framework for the assessment and processing of liability, regulates industry participants directly, and can plausibly suggest that public auto insurance is a feasible alternative if negotiation with current private-sector participants does not yield satisfactory results.

In general, regulation primarily has costs and benefits that impinge directly on firms and individuals, without any corresponding line item in the provincial budget. This does not mean that regulation is either costless or devoid of benefits—just that the costs and benefits are harder to quantify. “Smart regulation” should recognize both the costs to the private sector of compliance and any savings (e.g., in reduced use of litigation and ensuing court costs).

How Does Government Make the Biggest Difference?

In 2007, the median (i.e., the mid-point) of after-tax incomes of Nova Scotia families was \$54,200,⁹ but the money income of families is a very incomplete guide to their command over resources. In all developed economies, families benefit from the provision of government services, most importantly in health care and education.

9. Statistics Canada, CANSIM v25742705: Nova Scotia, economic families, two persons or more.



Charts 9 and 10 are taken from MacKenzie and Shillington (2009:16) and illustrate the average incidence of government spending, by income class in Canada in 2006.¹⁰

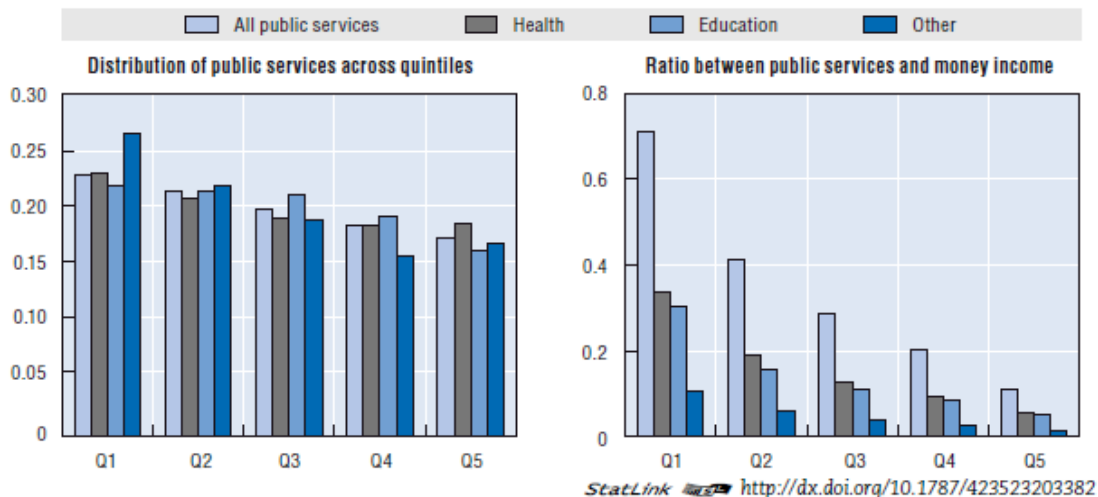
10. Note that chart and figure numbers are from original sources and bear no relationship to other figures in this paper.

Figure 9.6 shows the average importance of public services in OECD nations, as a fraction of household income for each quintile, or fifth, of the income distribution (i.e., Q1 is the poorest 20 per cent, Q5 the richest 20 per cent of households). It is taken from the OECD (2008), to illustrate the fact that the redistributive pattern of public services in Canada is much the same as in other countries.¹¹

Government spending on the provision of in-kind services in health care and education does not vary hugely in dollar amount across most income classes because it is primarily composed of per-person costs. This implies that such spending is a much greater proportion of income for low-income households than for upper-income groups. At the very bottom of the income distribution some households also get transfer payments, but most Canadians pay their taxes in order to get government services. These services benefit all income classes, but they matter most for middle-income and lower-income families, who cannot afford to purchase private-sector alternatives.

Figure 9.6. Importance of public services in household income across the distribution, OECD average

Estimates based on grouped data, around 2000



Public services in health care and education replace the expenditures that families would otherwise have to make, and they also impact directly on the time budget of families—the inescapable reality that all our activities have to fit into a 24-hour day. In Nova Scotia, as in the rest of Canada, hourly wages have not on average changed much, after inflation, in many years. Increases in household money income have therefore only

11. Hugh Mackenzie and Richard Shillington, *Canada's Quiet Bargain: The Benefits of Public Spending* (Toronto: Canadian Centre for Policy Alternatives, 2009); OECD *Growing Unequal?: Income Distribution and Poverty in OECD Countries* (Paris: OECD, 2008), [online] <<http://lysander.sourceoecd.org/vl=727957/cl=47/nw=1/rpsv/ij/oecdthemes/99980088/v2008n3/s1/p11>>.

been possible because families have increased their hours of paid work, but the cost has been less time available to do everything else. In balancing both their money budget and their time budget, families with young children often find time even scarcer than money. This time crunch implies that if government can deliver coordinated services in a way that more effectively matches family time needs, tangible improvements in family well-being can be substantial.

For example, in jurisdictions that offer parents a seamless coordination of daycare and school, parents can drop their children off at daycare centres attached to their school. When daycare and school are administratively integrated, parents can meet their work schedules secure in the knowledge that their children will be taken care of before and after school.

Why doesn't this now happen in Nova Scotia?

The barriers to coordination of services are at least as much institutional as financial, partly the product of turf protection in different ministries and the “it's always been this way” mindset, and partly the embedded economic interests of existing child-care providers

Policy example 3: Before-school and after-school child care—better integrated public policy to improve family life

In Nova Scotia, the lack of integration between school and child care before official school hours, at noon, and after school is remarkable. For decades now, most mothers have had paid jobs and have not been at home at noon or at 3:15 PM, waiting patiently for their children to come home from school. The cost, quality, and uncertainty of child care are a huge headache for young families, who are now left largely on their own to find solutions.

Child care also involves unpredictable illnesses and other events. A parent who stays home from work may risk dismissal, and leaving a sick child alone at home is sometimes the only alternative. Employers do have a legitimate interest in the dependability of their employees, but workers also have a legitimate interest in not being put in a situation where they can be accused of child neglect. Since labour standards legislation in Canada is a provincial jurisdiction, provincial governments can establish minimum employment standards—such as a minimum number of unpaid family leave days—that would enable parents to take some days off to care for sick children, without risking dismissal.

Policy example 4: Labour standards legislation—unpaid family leave days to improve the security of family life

Unpaid family leave days would not just be a highly visible symbol of the government's commitment to making life better for Nova Scotia families; they would also offer workers a greater sense of job security. The costs to employers would be small—few workers can afford to take unpaid days off unnecessarily— and the financial cost to government would be nil. Even if most employers already make reasonable accommodations for the family circumstances of their employees, there is both a symbolism and a peace of mind to having a right to unpaid family leave.

What Change in Family Incomes Is Likely by 2013?

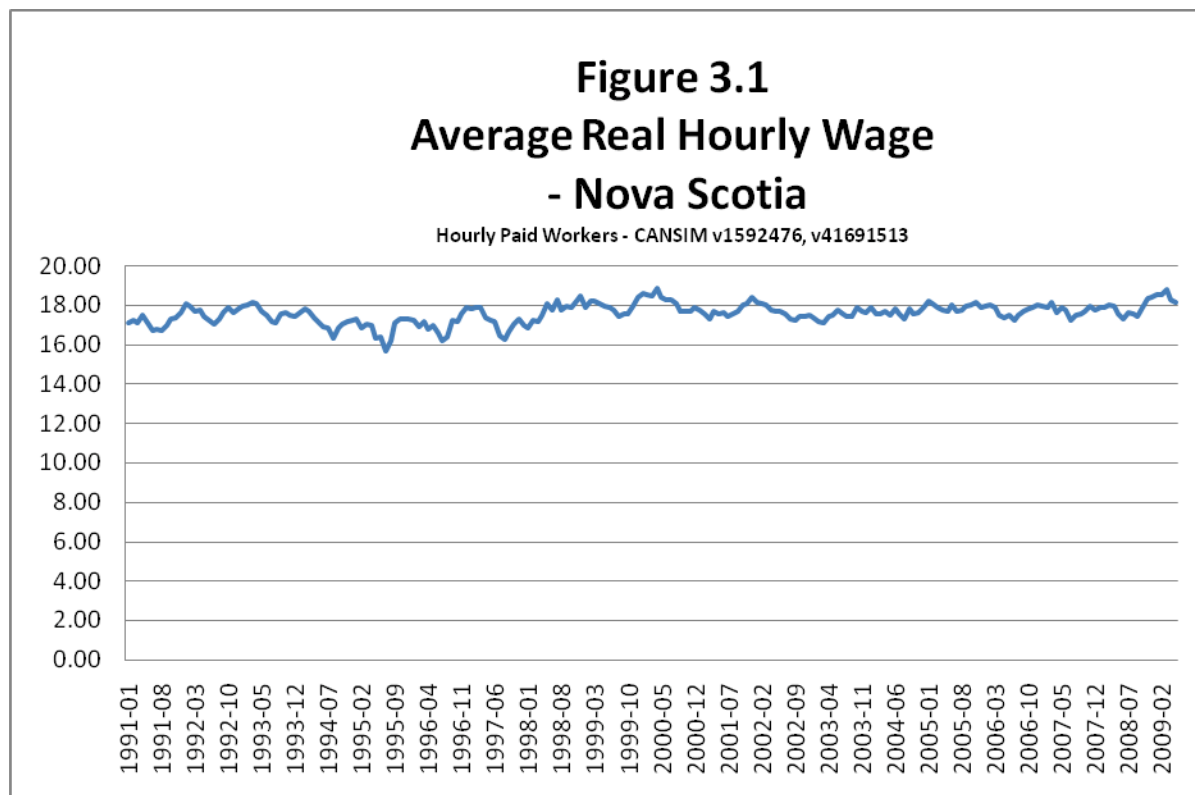
The average hourly wage in Nova Scotia has not changed much in the past twenty years, measuring in 2009 dollars after accounting for inflation, as figure 3.1 illustrates.¹²

Although in the long term one can hope to improve this sorry trend through better training and education, it has not happened yet and it would be rash to expect much change in the life of this government. If hourly wages are roughly constant, the only way that family earnings can increase is if more hours of work are supplied to the paid labour market as more people get jobs.¹³

The key driver of employment growth will be the strength of recovery from the recession. Although the Bank of Canada is now (August 2009) forecasting resumed growth in the balance of 2009, this is “recovery” only in the technical sense that growth in GDP is no longer negative. Every month, the normal increase of productivity and labour force means that GDP has to grow, just to prevent unemployment from rising. When aggregate GDP growth falls short of the trend rate of growth in productivity and labour force (about 2.2 per cent for Nova Scotia), the economy is no longer in a classic recession, but unemployment will continue to rise. With continued weakness in the US and broader global economies, robust growth in employment in Nova Scotia will likely have to wait for some time.

12. From Statistics Canada, CANSIM v1592476: Nova Scotia, including overtime, industrial aggregate excluding unclassified businesses; v41691513: Nova Scotia, all-items (2002=100). There is nothing unusual about Nova Scotia; a similar figure could be presented for any Canadian province.

13. There is not much trend at all in average hours per job. See CANSIM v2766747: Nova Scotia, average actual hours (worked in reference week, main job), hours, total.



Any Nova Scotia government has to face clearly the fact that even if it succeeds completely in its promises of structural creation of jobs, the business cycle produces swings in employment in Nova Scotia that are an order of magnitude greater in size. In the early 1990s recession, employment fell by roughly 20,000 from its peak of 385,300 in 1990 to the trough in 1993, a decline of 4.9 per cent. These lost jobs were not fully replaced until 1998.¹⁴ The current recession is, so far, milder in employment impacts, but its impact on labour markets is also far from over.

How should tangible benefits be delivered?

Governments have important choices to make in *how* benefits are delivered to families. Cutting a family's taxes by a dollar by exempting some commodity from tax or giving each family a tax credit of a dollar or sending them a cheque for a dollar are all different ways of delivering a dollar's financial benefit. But they are not equivalent types of public policy.

14. See Statistics Canada, CANSIM v2341593. The government has pledged to "create 2,200 secure jobs by rewarding investment in Nova Scotia companies, including those in key sectors like forestry," but there were 465,600 people employed in Nova Scotia in June 2009, so this pledge amounts to about 0.47 per cent of employment. See CANSIM v2711663: Nova Scotia, employment (persons), total, all industries, both sexes 15 years and over.

To take, for example, the issue of funeral expenses, it would be possible for the province of Nova Scotia to assist families by a) sending a cheque to all bereaved families to help with funeral expenses or b) providing a refundable tax credit to all bereaved families of a fixed amount or c) exempting funeral expenses from the provincial portion of HST. Even if one assumes that the cost to government is the same, in total, the impact on families is very different.

Suppose, for example, that *on average* the foregone revenue of exempting funeral expenses from sales tax is \$2,000. If a fixed dollar amount (\$2,000) is paid as either a refundable tax credit or as a grant, it is a larger proportion of the income of low- and middle-income households, so the assistance it provides has a bigger impact for the less affluent (although there is some benefit for all families). But exempting an expenditure from sales tax means that the more you spend, the more you benefit. The *average* tax benefit of \$2,000 is an average over lavish and modest funerals. It reflects the fact that the dollar value of the tax exemption benefit is least for low-income families who cannot afford a lavish funeral and greatest for the upper-income households that can afford to spend a lot. By providing lavish benefits for those who can afford to spend a lot and meagre benefits for those for whom every dollar matters, selective commodity tax exemptions have a regressive impact on the income distribution, which is a major reason why economists who care about equity dislike sales tax exemptions as a way to deliver fiscal benefits.

Economists who care about efficiency tend to dislike selective sales tax exemptions for a number of reasons. If some expenditures are taxed and some are not, the tax may shift spending decisions at the margin. Even bereaved families have to think about how much to spend on funeral costs and how much to retain to spend on the continuing needs of surviving family members. Would it, for example, be wise for government to bias spending decisions against providing for the needs of survivors if funeral expenses are made exempt from HST while HST is still payable on the cost of replacing the roof of the family home?

As well, in a value-added tax system, each exemption built into the system adds to complexity of administration and creates, over time, its own layers of precedence, litigation, and jurisprudence on the ambiguities of interpretation. For example, would the bar bill at a wake, or wakes, qualify for a funeral cost HST exemption? What qualifies as religiously valid funeral expenses?

The more sales tax exemptions are built into the system, the more difficult it then becomes to resist further claims for recognition, and the more holes that are created in a tax base, the less tax revenue it can produce. Governments must then either accept a

deeper long-run structural deficit problem or raise taxes on the activities and expenditures still subject to tax (which increases the severity of tax-induced misallocation of resources).

The open-ended nature of sales tax exemptions is also a crucial reason why they are a very poor policy instrument for enabling families to have the necessities of life. Spending \$5,000 on a funeral might, for example, be necessary, but spending \$500,000 on a mausoleum is hard to justify as being necessary. Nevertheless, a general exemption of funeral expenses from HST would apply to both equally. Similarly, although some clothing is in a general sense necessary, it is impossible in practice to distinguish between the particular items of clothing that are necessary and those that are not. Exempting all clothing from HST would raise the question of exactly what public purpose is served by exempting mink coats from sales tax, but where and how would one draw the line between necessary and unnecessary types of coat?

In societies where both equity and efficiency are valued (e.g., the Scandinavian countries), the policy model is to ensure that all citizens have sufficient income to purchase necessities—by providing cash transfers or refundable tax credits—but to make very few exemptions and keep the tax base as broad as possible (which means that Scandinavians can keep the tax rate as low as possible to deliver public services).¹⁵ If, on the other hand, the policy model adopted is an endless series of exemptions from tax, the ensuing erosion of the tax base would necessarily imply significant revenue loss (and a greater structural deficit) and/or increased tax rates on the remaining tax base, which would also maximize the inefficiencies induced by the tax system.

In recent years economists have paid increasing attention to the psychology of economic decision making and the ways in which behaviour deviates from the “perfect rationality” model that used to be dominant. There is a good deal of evidence, for example, that people do not necessarily remember all economic benefits equally or value them equivalently. The difference between subjective perceptions and objective measurements arises partly because some prices are highly visible and frequently encountered while other prices might be infrequently encountered and hard to calculate.¹⁶

15. As Lindert has argued, it is this emphasis on efficiency in the tax system that has enabled Scandinavian countries to deliver both equity and efficiency: incomes that are both high on average and relatively equally distributed. See P.H. Lindert, *Why the Welfare State Looks Like a Free Lunch*, Working Paper 9869 (Cambridge, MA: National Bureau of Economic Research, 2003), [online] <<http://www.nber.org/papers/w9869>>.

16. Motorists are, for example, highly conscious of minor variations in gasoline prices, since they have to purchase gas frequently and prices are on public display. Despite its importance for the total cost of car ownership, however, very few drivers know what their vehicle depreciation costs are—indeed, depreciation and interest costs are bundled together for those who lease their cars.

Numbers that are infrequently encountered and complex are hard to remember, and this matters for the political economy of tax policy because governments do not get any political credit for benefits that have been forgotten. Conversely, tax increases that are buried deep enough in complexity can be hard to spot, and some changes to the details of income tax rates (e.g., a graduated surtax on income tax payable) can be made to appear highly complex.

If people were completely rational, their behaviour and attitudes would also be unaffected by “framing”: whether a glass is described as being half full or half empty would not matter because everyone would know that the same amount is implied either way. But, in fact, framing does matter, a lot, to perceptions of taxation and spending. Habituation and “reference dependency” also matter. A tax that has been in place for some time becomes taken for granted and is soon the frame of reference for judging the fairness of subsequent tax decisions. When, for example, a GST that was once 7 per cent becomes 5 per cent, all further discussion of taxation starts from the new reference point.

For a Nova Scotia government that faces a severe cyclical budget deficit and a difficult, but manageable, structural deficit problem, the implication is that selective tax exemptions yield only transitory political benefit to incumbent governments, but they are “the gift that keeps on taking,” as their ongoing impact on the tax base accentuates the long-run structural deficit problems of the province. To take a concrete example, although few now notice that Nova Scotia rebates the provincial portion of HST on printed books, this tax exemption continues to do its own little bit, year in and year out, to increasing the deficit and debt of the province.

Conclusion: How To Deliver on “Affordability”

This paper has presented four illustrative examples of how a new government can deliver tangible improvements in the economic well-being of Nova Scotia families:

- ▶ Policy example 1: Public transit—a public service that saves private costs
- ▶ Policy example 2: Car insurance—better regulation that can reduce private costs
- ▶ Policy example 3: Before-school and after-school child care—better integrated public policy to improve family life
- ▶ Policy example 4: Labour standards legislation—unpaid family leave days to improve the security of family life

The choice of these examples was motivated by the context: a severe constraint on provincial government finances. When governments attempt to deliver economic benefits to families by transfer payments or tax cuts, each dollar in benefits to family budgets corresponds exactly to a dollar withdrawn from the provincial government budget. But

marginal expansions in public services, or better co-ordination of public services, do not have the same “dollar for dollar” arithmetic. If such policies can enable family-life strategies that were previously not possible, the benefits to families can be considerably greater than the financial costs to government—as the public transit and child care examples tried to illustrate.

The car insurance and labour standards examples were intended to make the point that better regulation can provide significant benefits to families. In these examples, the private sector bears the financial costs of compliance, so a complete analysis must compare the size of benefits to families with costs of compliance to firms, but from the provincial government’s point of view, this is an off-budget policy choice.

The basic message of the paper is therefore positive—that options are available to enable a newly elected government to help make life more affordable for Nova Scotia families, even in our current tough times. The paper also noted some of the reasons why targeted HST exemptions are, on grounds of both equity and efficiency, ineffective ways of helping to “Make Life More Affordable for Nova Scotia Families.”

Reviewing the Expenditure Budget: Lessons Learned

A paper prepared for the
Nova Scotia Economic Advisory Panel

Donald J. Savoie

October 2009

Reviewing the Expenditure Budget: Lessons Learned

A number of governments have been struggling with stubborn deficits for much of the past 50 years, or since the arrival of the era of modern government. Leaving aside the federal government and some provincial governments (circa 1997–2006), things have been no different in Canada. Deficits have made a comeback recently, and there is every indication that they will be here for the foreseeable future. This is true for both Ottawa and the provinces, including those that have had healthy balance sheets in the recent past. Modern governments long ago put an end to the Gladstone formula for public budgeting. Former British prime minister William Gladstone laid down in simple terms how governments should shape their expenditure budgets. He wrote: “New wants are always coming forward, but where ... provision is made for those new wants [it] ought to be counterbalanced by new economies.” He added that governments should be certain to “make each year pay its own expense.”¹⁷

The recent economic downturn has made the management of public finances everywhere in Anglo-American democracies difficult. Suddenly, governments are confronting a perfect storm scenario: falling revenues, no economic growth, and strong pressure on the spending side. Stimulus spending may well be the right policy prescription to kick start a sluggish economy, but it can play havoc with public finance over the medium and long terms.

What to do? There are six ways to deal with stubborn deficits: raise taxes; cut spending; sell government assets; introduce or increase user fees, or download responsibilities to a different order of government, the private sector, or volunteer associations; and stimulate economic growth to generate more revenues. It will be recalled that the federal government relied heavily on the latter in its 1995–97 efforts to deal with its “deficit and debt” problem.

It only takes a moment’s reflection to appreciate that it is not easy for governments to pursue a deficit-cutting strategy. If it were, more governments would have done it more often. Politicians, for the most part, do not run for office to cut spending, increase taxes, or take things away from citizens. Many see a positive role for government in society, and pursuing a positive role, much more often than not, requires new spending.

17. Quoted in Donald J. Savoie, *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press, 1990), 15.

I marvel at people who say that what is truly needed to cut spending is political will. Here, I am thinking of academics, journalists, and even public servants. I have not, however, seen many academics generating the necessary will to cut redundant university programs. The point is that political will does not come easily when one has to take things away from citizens or staff. It is much too easy for non-politicians to say that all that is needed to get a government's fiscal house in order is for the politicians to exhibit political will. It is never that easy because political will can never be generated in a vacuum.

Provincial governments are all confronting difficult fiscal challenges, and Nova Scotia is certainly no exception. The Deloitte financial review outlines in stark terms the scope of the challenge at hand: both federal transfers and own-source revenues are falling while expenditures are going up. Lars Osberg, in a background paper for this panel, went to the heart of the matter when he wrote, "Nova Scotia has to restrain program spending or increase tax rates, or both, if it is to avoid structural budget deficits when the recession does eventually end."¹⁸

The purpose of this paper is to focus on the government's expenditure budget. It draws on lessons learned from elsewhere to take stock of measures designed to reduce government spending. To be sure, there has been no shortage of efforts over the past 30 years or so. However, precious few of them have lived up to expectations. Nova Scotia is again no exception.

The provincial government launched an ambitious program review exercise in the fall of 1999. The province was confronting a difficult fiscal challenge at the time, and the government of the day turned to a Voluntary Planning task force led by Allan Shaw to lead a program review. The task force urged both structural changes in the expenditure budget and a change in the province's political culture. It made 29 recommendations, including a call for a new program decision process to review all government activities.

The government's 2000 budget reported on the results. Some spending cuts were made, but they hardly constituted a "complete from-start-to-finish housecleaning of programs."¹⁹ The government announced the closure of its bookstore, the sale of a golf course, and turning over management of three resorts to private sector management. It also declared its willingness to consider privatizing all retail liquor sales.

18. Lars Osberg, "Delivering on 'Making Life More Affordable for Nova Scotia Families'—an Economic Perspective" (Halifax, August 2009), 1. A paper prepared for the Economic Advisory Panel.

19. For an overview of program review efforts in Nova Scotia and other provinces, see *Living Within Our Means* (Halifax: Government of Nova Scotia, undated).

The government also decided that in future all new activities should be funded from existing departmental budgets, and it enacted balanced budget legislation. Government officials now report that the legislation has had some positive impact in imposing discipline on the spending side.²⁰ However, the program review exercise did not live up to expectations and in the end only generated modest spending cuts. The flow of natural gas royalties enabled the government to put off making tough decisions, and the government's program structure and machinery of government look much like they did in 1999. However, Nova Scotia is hardly alone in not meeting expectations from program review exercises.

Other Provinces

All provincial governments have launched program review exercises in recent years, and most, if not all, are planning new ones in the coming months to cope with a growing deficit and debt problem. This is true for traditionally *have* provinces, including Alberta, Ontario, and British Columbia. Alberta, which has had an impressive series of budget surpluses in recent years, is today confronting a \$7 billion deficit, its biggest ever. The government announced that it would be making spending cuts in the near future.²¹

All review exercises invariably pledge to “review programs or activities,” “prioritize” programs,” “examine governance in key sectors” . . . and the list goes on. The great majority are looking to the high cost sectors—health and education—for spending cuts. Others are freezing salaries (of both politicians and public servants in one case), and still others are slowing down the staffing of vacant positions. Recent exercises have also established spending-cut targets (e.g., in the case of British Columbia, \$1.9 billion over three years), others have pledged to manage overhead costs better (e.g., Manitoba), and still others have established cabinet committees to lead a program review exercise (e.g., New Brunswick).

Time will tell if these efforts are any more successful than earlier ones. There are early signs that not all is well with the exercises. In response to public pressure, New Brunswick, for example, has pulled back on its decision to discontinue some ferry services and has also backed away from announced cuts to the education budget.

Where provincial governments have met some success in arresting the growth in government spending, they had little choice. It will be recalled that Ottawa downloaded to the provinces spending cuts in its 1995–97 program review exercise. A number of

20. Consultations with various Nova Scotia government officials (Halifax, August 2009).

21. “Alberta deficit soars on natural gas bust,” *Globe and Mail* (August 27, 2009), B1 and B4.

provincial governments, including Nova Scotia, were by the late 1990s confronting a fiscal crisis. Spending restraint measures, if not actual spending cuts, were introduced in every province and in many sectors to deal with cuts in federal transfers to the provinces.

Program Review Exercises Elsewhere

Some students of public spending point to two program review exercises as the gold standard for success: the UK (circa 1980–87) and Ottawa (1995–97). Margaret Thatcher led a sustained effort to cut government spending, employing a variety of means to get the job done. The Chrétien government also launched a high-profile program review exercise in 1995 that lasted four years. Both exercises met with some notable successes.

The UK experience

Thatcher instructed her most senior public servants to cut the size of the civil service. By the time she left office, she had reduced the civil service from 733,000 positions to 569,000, a 22 per cent reduction. She sold a number of crown or state corporations, struck new public-private partnership arrangements to deliver public services, and eliminated a number of government programs and activities.²² No one is suggesting that Thatcher did not deliver on her commitment to cut government down to size.

Before long, government representatives from many Anglo-American democracies went to Britain to see first-hand how a successful program review exercise was successfully implemented. They soon discovered, however, that only some lessons learned in Britain could apply in other jurisdictions. For one thing, Thatcher was a committed political ideologue firmly determined to define a new role for government; as she said, “this lady is not for turning.” If political will is a requirement for a successful program review, Thatcher had it.

But here, too, political will did not surface in a vacuum. There was an important force at play in Britain that is now all too often overlooked. Britain was confronting a serious fiscal crisis, which reached a boiling point in the mid-1970s when senior government officials insisted that they had no choice but to turn to the IMF for a loan. In 1976, the British government needed a £5.3 billion standby credit to keep operating. The IMF agreed, on the condition that the government cut £1.0 billion from its expenditure budget. Britain, a founding member of the IMF, had long believed that the loan program was for less-developed countries, not for itself. Going to the IMF with cap in hand drove home the point, with a sense of urgency, that the country needed to get its fiscal house in order.

22. See, among others, Donald J. Savoie, *Thatcher, Reagan, Mulroney: In Search of a New Bureaucracy* (Pittsburgh: University of Pittsburgh Press, 1994).

British voters expected politicians to take the lead in getting the country's public finances under control, and Thatcher answered the call.

The Canadian experience

Ottawa also undertook a high-profile program review exercise in 1995–97, and much has been written of late about its success. We are informed, for example, that Britain is currently looking at the exercise as it prepares to confront yet another fiscal crisis.²³ To be sure, the review did meet with some success. Here are the facts: 47,000 public service and military positions were eliminated, and the annual deficit (\$42 billion in 1993) was eliminated. The government claimed that it was able to reduce spending by 20 per cent.²⁴ Achieving those spending cuts was no small achievement.

Several factors explain the review's relative success.²⁵ History now reports that the prime minister and the minister of Finance made sure that there was no light between them. They were always on the same page, and the prime minister made it clear to *all* ministers that he would not tolerate end runs. He explained that a program review process had been put in place to deal with a very difficult situation and everyone would be playing by the same rules. He would not allow special cases or special pleadings to himself or his office. Some ministers did attempt end runs around the process, but they were all turned down. This is an important lesson learned for any program review exercise.

The prime minister also built the review process around key ministers and senior public servants. They made the process work, and everyone in government knew that they enjoyed the full support of the prime minister. Ministers were selected so that they represented both the regions and important spending departments. They also had excellent communication skills in cabinet and with Canadians. Brian Tobin, a member of the review committee and an accomplished public speaker, criss-crossed the country, outlining the scope of the country's fiscal crisis. His task, and that of his cabinet colleagues, was to ready Canadians for the difficult decisions the government was about to deliver.

23. See, for example, Neil Reynolds, "Britain takes a cue from Canada's deficit slayers," *Globe & Mail* (August 7, 2009).

24. Peter Aucoin and Donald J. Savoie (eds), *Managing Strategic Change* (Ottawa: Canadian Centre for Management Development, 1998).

25. I write "relative" success for two reasons. First, a good part of the spending cuts were simply downloaded to other orders of government or to community groups (airports, for example). One doubts whether provincial governments saw much success in Ottawa's program review exercises circa 1995–97.

Perhaps the most dramatic event, however, came just before the program review exercise was launched—the Mexican currency crisis. In late 1994, as the peso went into a free fall, Mexico experienced a major downturn in its economic fortunes following a 20-year period of progress. Given its high accumulated government debt, Canada then became the focus of scrutiny by international financial markets. In early January 1995, the *Wall Street Journal* described the Canadian dollar as a “basket case.” The *Journal* ran an editorial on January 12, 1995, entitled “Bankrupt Canada?” and declared that “Mexico isn’t the only US neighbour flirting with the financial abyss.” It went on to argue that “if dramatic action isn’t taken in the next month’s federal budget, it’s not inconceivable that Canada could hit the debt wall and have to call in the International Monetary Fund to stabilize its falling currency.” This editorial had a major effect on those in the cabinet still hesitant to accept the general expenditure stance advocated by Finance; indeed, the deputy minister of Finance, David Dodge, later described it as a “seminal event” in the politics of the 1995 budget.²⁶ Suddenly, the appetite to launch new activities was lost, and the willingness of those, including the prime minister, to cut spending was considerably strengthened. The *Wall Street Journal* article had a similar impact in Canada as the IMF loan had in Britain several years earlier. Canadian decision makers bought into the argument that the government had to put its fiscal house in order.

The Chrétien government insisted that Canadians were fully supportive of spending cuts and pointed to government sponsored public opinion surveys to make the case.²⁷ However, other polls were not as clear. In the immediate aftermath of the first phase of the government’s program review exercise (1995–97), EKOS published a public opinion survey that suggests that Canadians were of two minds on spending cuts and that they supported increased spending in several sectors.

Although the 1995–97 program review exercise did generate important spending cuts, we need to highlight a number of issues. First, contrary to what is generally believed, the review did rely on across-the-board cuts. In the first phase of the program review, it was agreed that cuts would be divided into three categories: large, being 25 per cent in the case of some departments; substantial, being 15 per cent in the case of others; and 5 per cent in the case of still others. The approach was described as “rough and ready” and government officials felt that there was no alternative. There was little time available to undertake an in-depth review of government spending. Spending cuts were needed for the next budget, so there was no time for elaborate evaluation studies.

26. See footnote 8.

27. See, among others, Donald J. Savoie, *Governing from the Centre: The Concentration of Power in Canadian Politics* (Toronto: University of Toronto Press, 1999).

In phase II of the program review, the government simply reverted to a straight across-the-board cut of 3.5 per cent to be applied to all departments and agencies. This ran counter to the government's statement in its 1995 budget that "blind cuts are bad cuts." The program review exercise came to a close in 1998–99.

At the risk of stating the obvious, phase I was more ambitious, more comprehensive, and more successful than phase II. Several factors contributed to its success:

1. A process was established to guide the review. The process saw the establishment of a special committee of senior ministers. The committee met every week, and there was "buy in" from committee members. As a result, the minister of Finance was not left on his own to sell proposed spending cuts inside the system.
2. The process was also guided by six questions against which programs were assessed. All departments and agencies had to answer the questions:
 - Does the program area or activity continue to serve a public interest?
 - Is there a legitimate and necessary role for government in this program area or activity?
 - Is the current role of the federal government appropriate, or is the program a candidate for realignment with the provinces?
 - What activities or programs should or could be transferred in whole or in part to the private or voluntary sector?
 - If the program or activity continues, how could its efficiency be improved?
 - Is the resultant package of programs and activities affordable within the fiscal restraint? If not, what programs or activities should be abandoned? [I note that this became the key question.]
3. The prime minister's commitment to play by the program review rules and to tolerate no attempt by any minister to bypass the process and to appeal directly to him proved to be an important ingredient to the success of the review exercise.
4. The government adopted a three-year period for the implementation of decisions. In the past, expenditure cutting exercises had usually required implementation within a matter of months, which led departments to focus on areas where quick results were possible rather than on expenditures of low effectiveness. The three-year horizon used for program review made it possible for managers to take a longer view and to plan a redesign of their operations in conjunction with budget reductions.
5. Finally, there was a shift in public opinion in seeing the merits of spending cuts. The crisis-like atmosphere of the program review (phase I, 1995–97) explains in no small measure why the government was able to reach agreement quickly with 15 of the 16 public sector unions on layoffs and wage restraint.²⁸

28. The government failed to reach an agreement with the Public Service Alliance and later turned to legislation to secure concessions.

Though Ottawa's 1995–97 program review exercise (phase I) was successful, we should highlight a number of issues. First, Ottawa was able to download some of its important spending cuts to the provinces through its transfer payments for health care, social services, and economic development. This alone explains why several provincial governments, including Nova Scotia, came face-to-face with a difficult fiscal problem by the late 1990s. Second, Ottawa was also able to shift some of its responsibilities and their expenditure budgets to third parties. I am thinking here, for example, of airports and ports. These facilities still exist and they still employ a large staff. However, users now assume the cost of operating them, not the Department of Transport. Third, while person years were cut from the federal government (between 45,000 and 50,000 positions were eliminated), we witnessed a sharp increase in consultants working in departments and agencies. Today, more than 50 per cent of cabinet documents and Treasury Board submissions in Ottawa are prepared by outside consultants.

Lessons Learned for Nova Scotia

The most important lessons learned for Nova Scotia:

1. *Nova Scotians have to be part of any expenditure review process.* The government should not assume that it can turn over responsibility to reshape its expenditure budget to a handful of ministers and senior public servants. Nova Scotians need to be informed of the province's fiscal situation and the options to address it.

One can easily speculate that if Nova Scotians were asked today if the provincial expenditure budget should be cut back, the answer may well be yes. But this is where the consensus would end. The medical community would say cut, but cut elsewhere. Representatives would make the case that their budgets are already stretched to the limits and the province's aging population will place still more pressure on the health-care system. The education community would make a similar observation, insisting that it holds the key to future economic growth.

If, as many public policy specialists state, economic development begins with people, then they would argue that what is needed are *more* initiatives to promote human resources development, *not less*. The same argument applies to all sectors in which the hand of government is present.

It does not end there. The public service will likely tell politicians not to cut in the bureaucracy because that will only be able to generate small saving—"nickels and dimes stuff." Public servants will make the case that what is needed are cuts in programs or eliminating activities out in the regions that are no longer necessary. Politicians representing those regions will invariably put up a good fight as they seek to represent their constituencies as best they can.

All this makes the point that a successful program and expenditure review requires, above all, the support of Nova Scotians. They must all see the merit of putting shoulder to the wheel to get the province's fiscal house in order. It has to be a

collective exercise to have any chance of success. The IMF crisis in Britain and the *Wall Street Journal* article, in the case of Canada, paved the way for governments to take charge and deal with a growing deficit and debt problem. Citizens accepted that something had to be done, and politicians were able to draw on this support to make substantial spending cuts. But the British and Canadian governments were also able to communicate effectively with citizens in outlining the challenges and in laying down what needed to be done.

The Deloitte financial review and material provided by the Department of Finance make it clear that Nova Scotia has to put its fiscal house in order. There are a variety of reasons for this, and finger pointing will not help the situation or convince Nova Scotians that something should be done.

What is needed is a communication plan with a clear, simple, and straightforward message on the state of the province's public finance. The government should lay the facts down as they are—no need for media spin specialists or costly communication strategies prepared by consultants. Every effort should be made to make this a non-partisan process; hence the need to avoid finger pointing.

Once Nova Scotians gain an understanding of the situation, it will be easier for the government to speak to the collective challenge at hand. It will also be easier to speak to inefficiencies in *all* sectors, not just in somebody else's. *More to the point, it is hardly possible to overstate the point that there must be recognition by Nova Scotians that a problem exists before they will be prepared to hear options.*

2. *The premier, the minister of Finance, and others on the “guardians” sides of government must act as one.* Once a process has been established to review the expenditure budget, the premier should make it clear that *no end runs by anyone* will be tolerated.

The review process should be guided by the most senior politicians and public servants. On the political side, both traditional guardians of the public purse (i.e., Finance and the Treasury Board) and spenders (particularly large-spending departments) should be directly involved. There should also be representatives from the regions, and it is important to have one or two first-rate communicators on board. Similarly, it is important to have senior public servants from both central agencies and large-spending departments directly involved in the process. The process should be allowed to explore all potential savings, including how programs and services are delivered at the provincial and local levels.

3. *The process, to have any significant and lasting impact, should go beyond across-the-board cuts, temporary hiring, or salary freezes.* These measures may have some merit in slowing down government spending over the short term, but they do not change the expenditure budget over the medium term.
4. *In launching a program review exercise, the government should establish a three- or four-year planning and implementation horizon.* The purpose of a significant review exercise is to change the shape of the government's expenditure budget. This requires cabinet and senior government managers to take the long view and to redesign their programs and operations. Anything less than a three-year horizon will only generate quick spending cuts with very modest lasting impact.

5. *The government should define a process to consult relevant actors in the key sectors of health care and education.* These two departments have large expenditure budgets, and past attempts to reorient them have met with modest success.

If the goal is to reorient the two sectors in any meaningful fashion, it is vitally important to involve representatives of the health care and education communities. They know the strengths and weaknesses of their sectors and where savings can be realized. It will be important, however, to lay the ground rules at the outset: the goals are to rationalize the infrastructure and services, not create new ones, and to identify new efficiencies, not add to their expenditure budgets.

If, as many public policy analysts have argued in recent years, governments will not be able to finance the status quo in health care over the medium and longer terms, it is best for the sector to make the necessary decisions today than several years down the road when financial conditions could force the hand of government to introduce indiscriminate spending cuts. It is important to note that the government only has indirect control over much of the health care and education sectors. That said, the government established the size of the expenditure envelopes and is free to introduce accountability requirements.

6. *The government should encourage transparency in all things* if it wishes to launch a meaningful program review exercise. Successful program reviews have all promoted transparency *in the numbers, in relations between central agencies and line departments, in relations with politicians and public servants, and in relations between the government and all interested parties, the media, and citizens.* A lack of transparency is quickly revealed and is all too often interpreted as masking a hidden agenda or special treatment for someone, some departments, or some communities. Transparency also serves to avoid surprises. Surprises to politicians, interested parties, and citizens will invariably hurt a program review exercise.
7. *A program review exercise should be guided by a transparent process that is shaped by a series of questions that all departments must answer. The questions should, among other considerations, centre on affordability, impact on economic growth, fairness, and whether programs or policy goals be achieved through other means.*

Shaping a Path for Growth and Prosperity in Nova Scotia

A paper prepared for the
Nova Scotia Economic Advisory Panel

Elizabeth Beale

November 2009

Shaping a Path for Growth and Prosperity in Nova Scotia

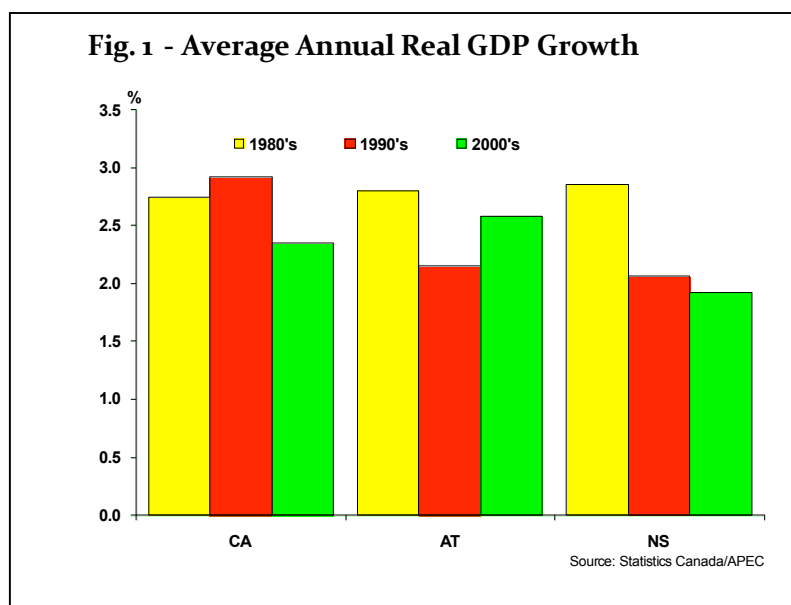
Over the past year, the attention of governments in Canada has been riveted on the recession. Horizons have narrowed as policy makers have sought to redress the worst effects of the economic downturn through short-term stimulus spending. Concerns with competitiveness and productivity growth have taken a back seat to more immediate priorities to create jobs and protect individuals and firms.

There is now ample evidence to suggest that many of the changes observed in the province's economy over the past year go well beyond the bounds of a cyclical downturn. Despite the slump in global trade flows over the past year, the broader process of globalization—the rise of global supply chains and the increased dominance of Asian markets—continues unabated. Even with a mild recession to date in Nova Scotia, the effects of these changes continue to be felt in the province as local industries are restructured and jobs and investment are lost. As we come to the end of this recession, our attention must quickly return to the longer-term opportunities and challenges facing the province.

What does the future hold for Nova Scotia? Certainly there are many positive examples of successful adaptation to new global realities by both companies and individuals in the province. But at the same time, the slowdown in economic growth over this decade and lack of any new large-scale investment projects on the horizon are cause for concern. Where are new opportunities likely to emerge for the province over the next few years? What steps can government take to enhance the climate for growth and prosperity in the province?

A brief retrospective on Nova Scotia's economy is a good starting place for this discussion. Nova Scotia enjoyed a strong period of growth starting in the 1980s, a decade in which nominal GDP growth matched national performance. Inward flows of foreign direct investment played a key role, adding value to the province's resource industries and bringing non-indigenous industries to the province. Federal spending helped: the expansion of federal regional development programs throughout the 1970s and into the early '80s, although subject to much criticism for wasteful spending, led to some new industries and key infrastructure initiatives that remain in place today. The Canada-US free-trade agreement mid-decade was also crucial, although with a small share of its output in manufacturing compared to many other provinces, Nova Scotia had less to gain from the reduction in trade barriers into its leading market. Nevertheless, exports

diversified and trade intensity—trade as a share of GDP—increased throughout this period.



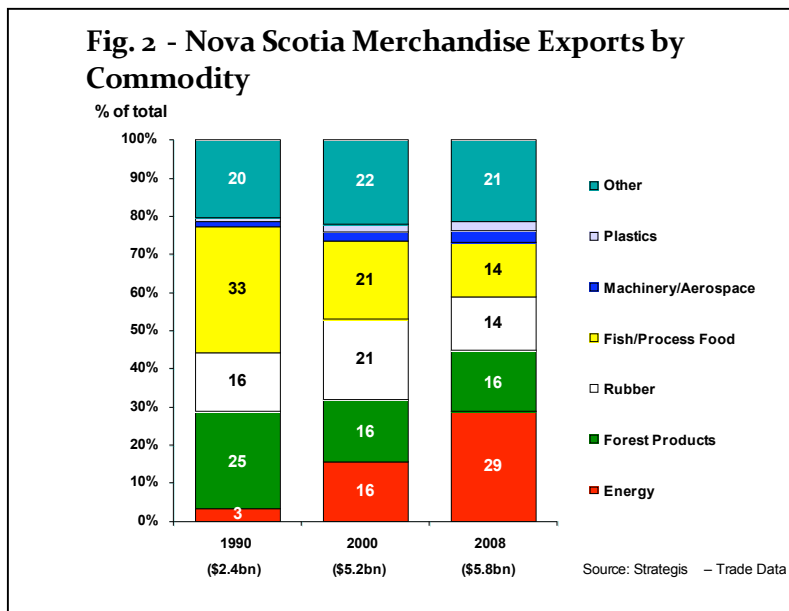
The prolonged recession of the early 1990s had a profound impact on Nova Scotia's economy and set in motion a process of industrial restructuring that is continuing to be felt in the province. Increased competition from low-wage producers elsewhere in the world began to undermine the competitiveness of Nova Scotia's resource processing industries. Resource endowments also changed: the most notable example was the decline in cod stocks, which led to the cod moratorium in 1992, eliminating a product source for one of Nova Scotia's leading commodity exports. Older industrial regions around the province were also on the wane. Between 1990 and 1993, employment in the province fell by 7.2 per cent and did not regain its previous peak for more than seven years, almost twice as long as the recovery process at national level.

Employment losses were greatest in communities beyond the reach of Halifax's urban core—those in which resource industries were the backbone of employment. This contributed to a steady loss of population, from rural to urban areas and from Nova Scotia to elsewhere in Canada. Nova Scotia's experience in industry restructuring is certainly not unique; a similar process has been underway in most advanced economies. However, the concentration of economic activity in these industries ensured that restructuring had a much greater impact in Nova Scotia (and the rest of Atlantic Canada), compared to provinces where larger urban areas provided a stabilizing influence.

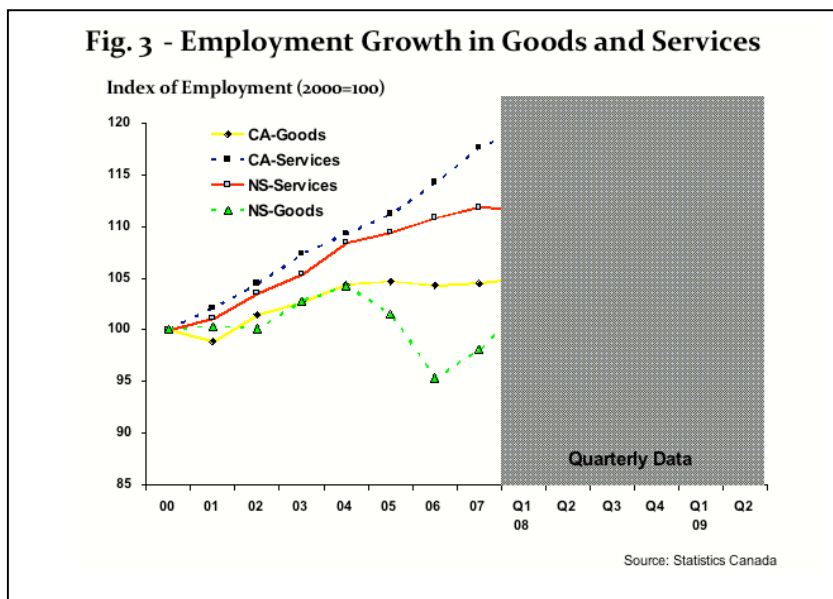
Restructuring also has a positive side. Reduced seasonality and industry consolidation increased economies of scale. A number of Nova Scotian companies embraced new technologies and advanced manufacturing processes, emerging from the recession in an

altered, but much improved, competitive position. Investment in a new industry— offshore gas—also helped to bring Nova Scotia back to growth in the mid-late 1990s. However, changes to federal programs during this period were less accommodating. Federal subsidies continued to flow to Cape Breton until the mid 2000s to help the island adjust to the decline and eventual closure of its coal and steel industry in 2001. Elsewhere in Atlantic Canada, the federal government had substantially reduced its commitment to regional development programs by the early 1990s. Other actions by the federal government as it sought to contain its own growing deficit in the late 1990s—such as changes to EI program (which reduced access and benefits for seasonal workers) and cuts in provincial transfers, direct federal employment, and defence spending—reinforced this trend. With a high dependence on federal spending, Nova Scotia’s vulnerability to these changes was underscored during this period.

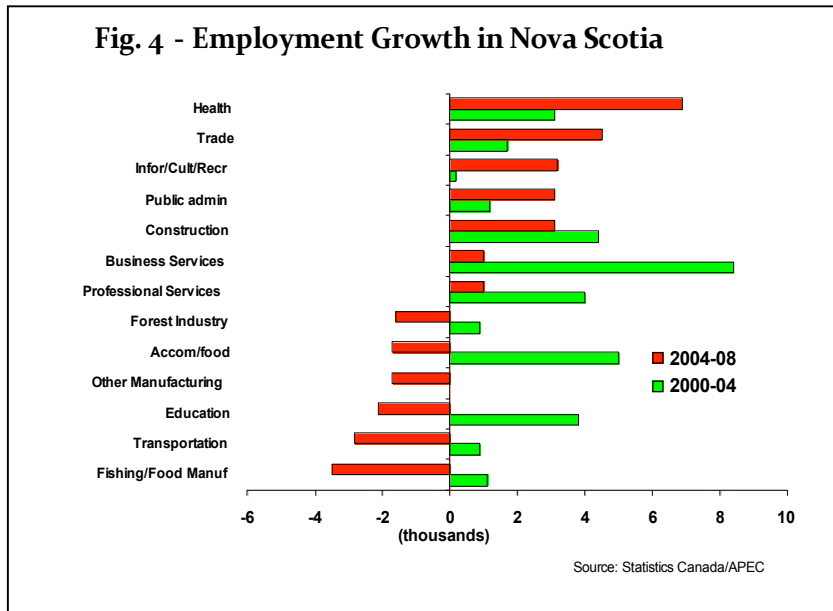
In this decade, economic restructuring has intensified and spread to other industries. The Maritime lumber industry, for example, had benefited in the 1990s from growing US demand and exclusion from the Softwood Lumber Agreement. By 2004, output in the wood-products sector had begun to decline, affected by factors such as a drop in US housing starts, competition from lower-cost producers and new products (i.e. non-wood building products), and an appreciating Canadian dollar. Non-energy exports to the US in key sectors such as forestry are now at a decade low. Even with the expansion of natural gas exports, now the province’s leading export, Nova Scotia’s trade intensity ratio has fallen back to the same level as in 1981: 0.54. In comparison, Canada’s international trade intensity, which was on a par with Nova Scotia’s in 1981, has risen to 0.67.



Similar pressures have slowed the flow of foreign investment to the province. The number of foreign firms establishing new (greenfield) operations in Atlantic Canada has dropped since 2000, with the exception of several financial services firms that established back-office operations in Halifax in late 2006 and 2007. There have also been a number of disinvestments by foreign firms with manufacturers (e.g., Trentonworks) and several call centres closing their operations. Call centres accounted for 30 per cent of Nova Scotia's net employment growth in services between 2000 and 2006, with many firms attracted to the province by the availability of provincial labour subsidies. However, the industry is now in decline across North America as lower-cost competitors have emerged in other English-speaking countries and as on-line support has replaced telephone-based services. With tight margins generally across this industry, and few stranded assets, firms have been quick to shift their operations elsewhere: employment has fallen by at least 20 per cent since its peak in 2006.

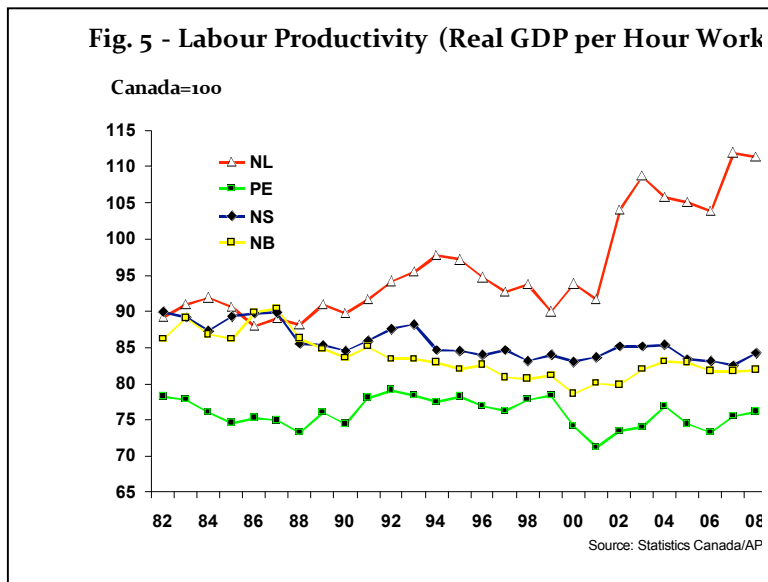


Certainly not all shifts in economic structure have been negative for Nova Scotia. The service sector has grown steadily and now accounts for 76 per cent of GDP and over 80 per cent of employment. Government's share of employment in the services is about 30 per cent, while the balance reflects a range of services to business and consumers. Defence services are particularly important to the province, with 12 per cent of all Canada's military personnel—19,000 in total—employed in Nova Scotia. Defence spending is also a catalyst for growth in other sectors such as advanced manufacturing (aerospace and shipbuilding), as well as marine and transportation services.



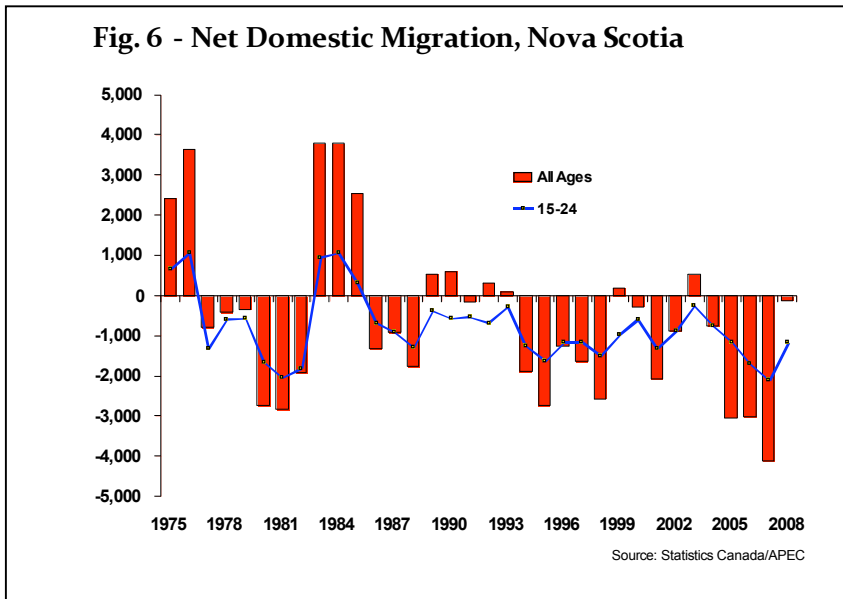
Nova Scotia also has a small but growing share of activity in some high-knowledge, high-value-added goods and services, including plastics and electronic equipment, biomedical equipment and services, and telecommunications and computer system design. The common factor behind the success of individual firms in these diverse fields is their capacity for innovation, both in their use and development of new technologies and the ongoing investment in the skills of their workers. For the most part, however, individual firm success has not triggered the development of broader industry clusters in which the interconnectedness of firms might fuel further firm/product specialization and growth. As a result, Nova Scotia's share of activity in high-knowledge industries is well below par, and most of the employment growth in this decade has taken place in lower-value-added, and hence lower-wage, services.

What have been the implications of these trends for Nova Scotia's economy? Two decades of continuous restructuring in major industries compounded by recent losses in other sectors have certainly taken a toll on the province's economy. Over the last two decades, labour productivity per worker has strengthened against the Canadian average, in part due to reduced seasonality (i.e., an increase in hours worked). However, labour productivity per hour worked has not appreciably improved. That ratio has remained well below the Canadian average, currently at 0.84.

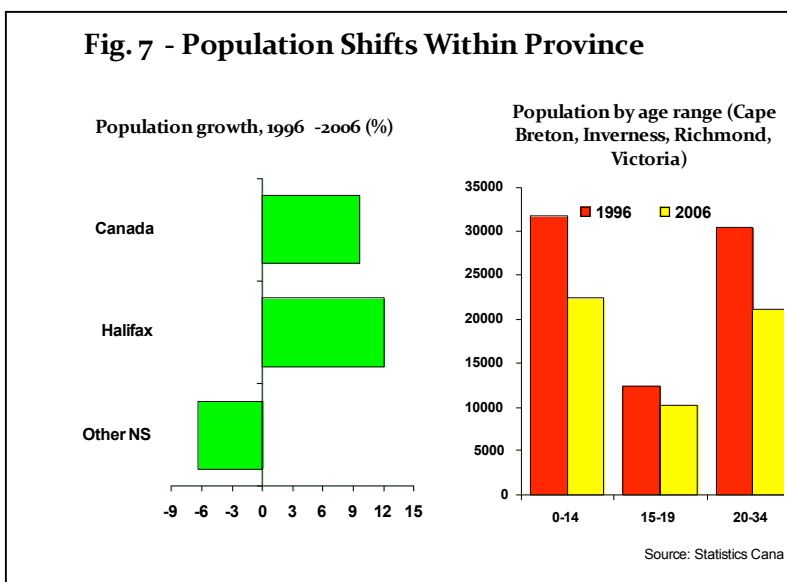


As the discussion has revealed, Nova Scotia's productivity gap reflects a broad range of factors, including lower levels of investment in structures, machinery and equipment, and human capital, and an industry mix that includes a high proportion of small firms and low-value-added products as well as limited capacity for innovation. The consequences of this for the average Nova Scotian are evident: weekly earnings have remained well below the national average, although this varies considerably across occupations and industries. When such results are coupled with sluggish growth and limited employment opportunities, it is hardly surprising that there has been a sustained outmigration over the past two decades, particularly of young Nova Scotians.

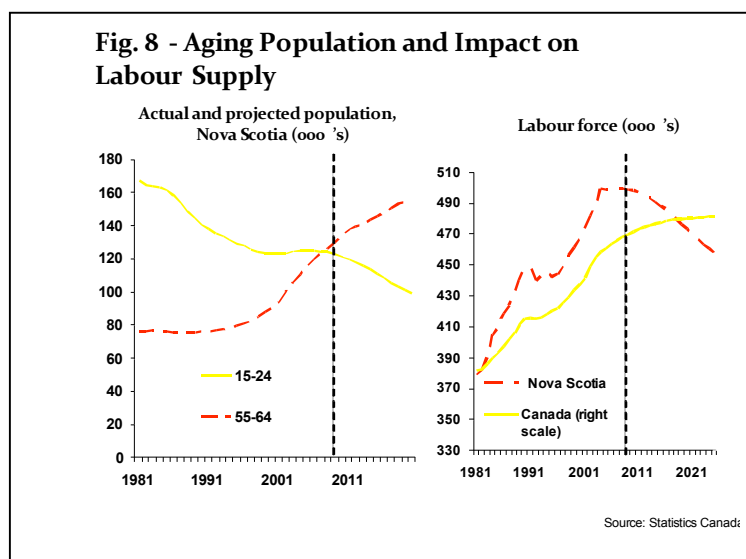
In anticipating how Nova Scotia's economy might continue to evolve over the next few years, there are a number of considerations to which one might wish to pay particular attention. The first of these is the growing importance of urbanization. Even though Nova Scotia is still one of the most rural provinces in Canada, it is steadily urbanizing, with population concentrating around metropolitan Halifax. The city currently encompasses 42 per cent of the province's population and 46 per cent of its labour force, although its reach extends well beyond this. Approximately 60 per cent of the province's population lives within a one-hour drive of the city boundaries.



Halifax is drawing population not only from rural Nova Scotia but also from other provinces, particularly the rest of Atlantic Canada. It has the largest immigrant concentration in Atlantic Canada and a rapidly increasing 55+ age group attracted to health, cultural, and recreational services. Even though employment growth has slowed overall since 2004, professional and business services have continued to expand, reflecting the leverage Halifax now exerts not only in Nova Scotia but also in Atlantic Canada. Up until now, it has been Canada’s largest cities that have benefited most from growth. But high costs and other constraints may now temper that trend and leave room for second-tier cities to grow faster.



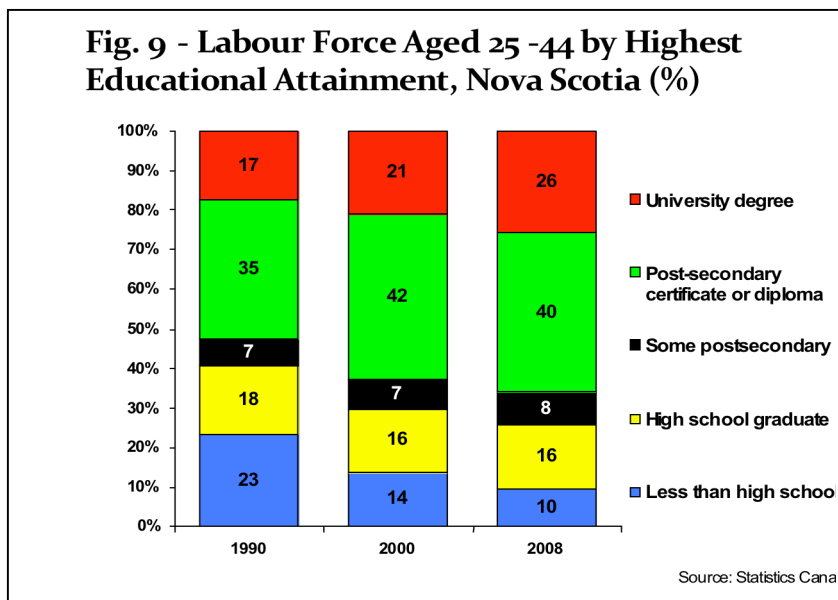
A second consideration is the rapidly aging population and its impact on the labour force. The drop in the birth rate and steady outmigration of young people are already having a big impact on the demographic profile of Nova Scotia. This year, the number of young people coming into the labour force (the 15–24 age group) is projected to be just slightly below the number of baby boomers moving to retirement (the 55–64 age group). However, looking ahead, the gap widens quickly and will certainly exacerbate labour shortages already in evidence in some occupations and industries. On the upside, the retirement of a large cohort of baby boomers is leaving plenty of room for young people to enter the workforce, even in a slow-growing economy. Employers are also much more likely to accommodate older workers than in the past. The downside for employers is the upward pressure on wages, and the increasing costs and inefficiencies associated with lengthy recruitment processes and unfilled positions. APEC surveys, and indeed the discussion that took place at the focus groups held in conjunction with this panel confirm that labour scarcity and skills shortages are now a dominant concern of business and indeed all employers.²⁹



A final consideration is the growing importance of human capital to the evolution of Nova Scotia's economy. If innovation is the principal source of productivity growth, either through the development of new products and services or through the use of new technologies, then it is the skills and competencies of individual workers that will enhance or hold back that process of innovation. Nova Scotia does reasonably well in providing access to post-secondary education for young people, either through

29. See, for example, David Chaundy, "Corporate leaders are optimistic, despite increasing competitive pressures," *Progress* (September 2008).

universities or through the expansion currently underway in its community college system. Even with the outmigration of many university and college graduates to faster-growing parts of Canada, the proportion of the labour force with advanced credentials is steadily expanding. However, Nova Scotian firms rank low in their commitment to training. In addition, many individuals lack the basic skills or credentials to undertake further training. The consequence of this is significant for the province: an estimated 38 per cent of Nova Scotia’s population has prose literacy below level 3, the minimum level deemed necessary to cope with the increasing demands of the knowledge and information economy.³⁰



Meeting the Challenges

What steps can this government take to address the challenges that have been identified in this narrative? The suggestions that follow take into account internal and external constraints such as Nova Scotia’s fiscal position and the continued uncertainty in the US and global economy as well as recognizing that Nova Scotia has limited policy autonomy in many key areas central to its economic future. However, even within these limitations, there is room for policy experimentation and novel approaches, either to improve outcomes within an existing framework or to expand in some new areas.

30. International Adult Literacy and Skills Survey, 2003.

1. Committing to growth

The overarching requirement is for government to embrace a strategic focus that coalesces its policies and programs around the dual objectives of increasing growth and productivity. The interpretation that has been offered in this paper points to the consequences of two decades of slow growth and limited productivity improvements in terms of low incomes, poor returns to capital, and weak employment growth. Unless this situation can be arrested, Nova Scotia runs the risk of slipping further behind other provinces, making it even more difficult for the province to recover from its current fiscal challenges or provide an environment which might attract new investment and people.³¹

There are many ways in which this commitment could be developed and implemented across government departments and agencies. Selective program elements could include initiatives such as easing the regulatory burden and improving regulatory effectiveness for a priority industry; trade promotion to a new market; or the adoption of a broader innovation strategy that focuses on science and technology enhancement across the economy. The choice of programs should target the potential for the largest gains, with an eye to both immediate and longer-term challenges. Whatever mix of initiatives is chosen, this has to be led by the premier, with clear targets in terms of measurable goals and objectives and a fully accountable reporting mechanism.

What are the advantages of placing this at the forefront of government's agenda? It clearly communicates to the public that the status quo is not sustainable and helps to build support for program reform. Most importantly, it imposes a discipline on government spending against the inevitable pressures that fall on cabinet to provide compensation or short-term assistance, particularly if accompanied by a program review exercise, as laid out by fellow panel member Donald Savoie in his paper "Reviewing the Expenditure Budget: Lessons Learned." The establishment of priorities also helps others to understand the government's agenda, notably the federal government, which can be expected to be a strong supporter of efforts to improve productivity.

A key element of the growth commitment should be the recognition that Halifax will continue to strengthen its position within the provincial economy and that the prospects for Nova Scotia are now inextricably linked to the success of its largest urban area. What strategies could be adopted to ensure that Halifax maximizes its potential? Given the ongoing trend toward urbanization, this could be more a matter of "do no harm."

31. Stronger growth clearly confers fiscal benefits: a one- percentage-point increase in nominal GDP is estimated to increase provincial own-source revenues in Nova Scotia by \$53 million.

However, the province could use its influence to encourage municipalities to adopt a more efficient and less distortionary property-tax system.

In the adoption of this growth commitment, there are clearly implications for existing government programs aimed at attracting or retaining industry. Productivity growth should clearly take priority over job creation. It is increasingly evident that job creation focusing on recruiting employers attracted to Nova Scotia's low-cost advantage confers limited long-term benefits either in terms of income growth or spin-off to other sectors. Jobs all too frequently disappear as labour subsidies run out and cost-sensitive employers move on to the next low-cost jurisdiction. Well-intentioned efforts to spread jobs around the province can also limit the capacity to build synergies amongst firms. However, redirecting incentives towards productivity enhancement, such as investment in new technologies or skills development, can be a hard sell for government, as it may consolidate support in successful firms (or regions) and offer limited benefits in terms of new job growth.

Similar complications arise with respect to the sectors where productivity gains might be greatest. Manufacturing and resource firms in Nova Scotia already benefit from a federal (Atlantic) investment tax credit that places Nova Scotia's marginal effective tax rates on capital among the lowest among Canadian provinces. A new provincial manufacturing and processing investment credit will confer additional benefits, effective January 2010. Can the focus on the manufacturing sector be justified in terms of long-term growth potential and productivity gains? The province could benefit more from reaching a broader group of firms, either through raising the small-business threshold in line with (most) other provinces or speeding up the commitment to reduce capital taxes.

In resolving these issues, it is essential to build partnerships within and outside government. Provincial economic development agencies in particular have to be solidly behind the growth commitment, and that might require new approaches to improve coordination and reduce overlap. The need for an improved partnership also extends to the federal government, as well as to business and labour. One mechanism worthy of investigation is the Strategic Partnership Council in Newfoundland and Labrador, which includes equal representation from the provincial government, labour, and business and has been effective on building support for new initiatives that focus on the economic development of that province.

2. Building human capital

The generally high level of educational qualifications in Nova Scotia should not negate the importance of continuing to develop the province's human capital to strengthen productivity performance, and there are two areas particularly deserving of attention:

Literacy

Better literacy skills confer benefits on individuals by enhancing employment and earnings and thus helping to reduce inequality in the labour force. Improved literacy also strengthens the ability of firms to adopt new technologies, contributing to enhanced productivity. The province is well aware that the quality of Nova Scotia's future labour supply will depend in large part on the skills of its young people and has taken steps over a number of years to improve educational outcomes across all school boards and to reduce the number of high school drop-outs.

However, the province faces an unmet challenge on adult literacy. There are 27,000 Nova Scotians in the 25–44 age group who have not completed high school, and there are many others who have crossed this threshold, yet nevertheless lack essential core competencies. These are individuals who can face significant roadblocks to acquiring new skills, particularly where they lose their jobs due to industrial restructuring. There is no consistent approach to deliver programs to this group; school boards spend a tiny fraction of their budgets—less than 1 per cent—on adult literacy, and although there are many community-based literacy programs across the province, these cover only a fraction of the needs within this group.

There is clear evidence to suggest that the net benefits to the economy from literacy training are considerable. One Canadian study estimates that improving literacy results in a significant improvement in GDP, with net benefits exceeding costs by a factor of six over a ten-year period.³² Basic adult education should be a top priority for the province, a way to improve equity as well as increasing labour force participation and the mobility of workers within the labour force. Furthermore, there may be scope to direct resources to new programs in this area under the transfer of federal training funds to the province.

Universities

Nova Scotia is in a unique position among Canadian provinces. For a province with a population of under a million, it has a large number of universities—11 in total—and the highest concentration of undergraduate enrolment in Canada. Nova Scotia has clearly

32. S. Murray et al., *Addressing Canada's Literacy Challenges: A Cost/Benefit Analysis* (DataAngel Policy Research, 2009).

benefited from the presence of universities around the province, well beyond their principal contribution of providing new graduates. Universities are centres for innovation, bringing highly qualified staff and new ideas to the communities in which they are placed. They also provide an important platform for industry, through research partnerships, commercialization, and technology transfer.

Funding for Nova Scotia's universities has increased rapidly in the last two years, largely due to a three-year agreement established in 2008 that provides additional resources in lieu of tuition increases to allow fees in Nova Scotia to converge to the national average. Nova Scotia students also receive a tuition bursary. However, these funding increases are occurring at a time when university enrolment is dropping due in large part to the decline in the 15–19 age group. Enrolment peaked at just over 44,000 in 2004–05 and had fallen to 41,700 in 2008–09. Although the recession has temporarily arrested the decline this year, enrolment could drop to 37,000 by 2014–15.³³ To date, there has not been any significant rationalization of university programs or facilities in the province.

The rapid increase in funding at a time when enrolments have dropped and provincial budgets are constrained points to the need to open up discussion on the relationship between the province and the universities. This relationship is a complex one, and certainly one does not want to undermine the capacity of the province's universities to be leaders in the economic transformation of the province. However, within the framework of the current agreement, the province could take a more directional role in ensuring that program planning meets provincial development goals, improving outcomes in terms of number of graduates and qualifications, strengthening the links between university and industry, coordinating program delivery with colleges and other PSE providers, and containing costs.

3. Improving the business climate

It is often assumed that tax competitiveness is the dominant concern of business when it comes to location decisions. In this regard, the tax review currently underway in the province is a useful exercise if for no other reason than to ensure that Nova Scotia is not an outlier, particularly with respect to taxes on investment.³⁴

33. Preliminary data for 2009–10 indicate a 1.5 per cent increase in full-time undergraduate enrolment at Nova Scotia universities. In Canada, full-time undergraduate enrolment is up by 4.1 per cent. Enrolment projections are based on the trend for 2004–05 to 2008–09.

34. For discussion on the link between lower corporate income taxes and growth, see Gareth D. Myles, *Economic Growth and the Role of Taxation: Disaggregated Data*. (OECD: Economics Department Working Papers No. 715, June 2009).

However, other factors that could have a greater influence on business investment include the availability of infrastructure. Improving the regional transportation system is particularly important, given the need to move goods (and people) considerable distances between Nova Scotia and markets around the world. Although there are typically cost advantages for marine shippers, thin transportation corridors in most other modes push up costs. From this perspective, it is essential that the Gateway strategy move quickly on priorities to reduce shipping costs and transit times, thus improving productivity across the transportation system.

The regulatory environment also has a direct bearing on business costs. The cost of compliance has been growing as governments seek to meet the needs for increased regulatory protection in areas such as health and safety, environment, and labour standards. This places a greater urgency on improving regulatory effectiveness. Significant benefits on this front could come from greater harmonization of the regulatory regime within Atlantic Canada (or between neighbouring provinces), allowing business access to a larger market at a lower cost. Harmonization through initiatives such as single business registry, common labour standards, full transferability and standardization of apprenticeship programs, and common security regulations could also set the stage for a more comprehensive approach to eliminate barriers to internal trade within the region.

It is appropriate to conclude this paper by returning to the central theme—the need to build a stronger foundation for growth and prosperity in Nova Scotia. We have moved well beyond the era when Canada's poorer regions could expect preferential treatment from the federal government as protection against the adverse effects of economic change. A new era has emerged in which provinces are required to take greater control over their own destiny. This means that Nova Scotia must adopt a much more disciplined and strategic approach in order to take advantage of the opportunities now emerging in the global economy. The success of this government will be determined by its willingness to make the tough policy choices that can move us along this path.