New Brunswick's Deficit and Debt Problem: Root Cause and Solution

by

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1. Brief Economic Background of New Brunswick

New Brunswick has the second lowest median family income in Canada. Its unemployment rates are usually above the Canadian average and are significantly higher than the Western provinces. As a result, New Brunswick has suffered out-migration of its young, the most dynamic section of its population, for many years. The long term consequence of this is that the median age of New Brunswick's population is 2 years above the Canadian average. In New Brunswick there are twice as many 50-year olds as 5-year olds, and the aging of the baby boomers will hit New Brunswick harder than any other province.

And yet, despite these adverse fundamentals, New Brunswick isn't exactly a basket case.

Yes, it receives about $1.7 billion in equalization payments from the Federal government. *But until recently, our fiscal house was in pretty good shape.* As shown in Figure 1, New Brunswick's debt/GDP ratio had been falling since 1985, and by 2008 it was in the middle of the pack of provinces. [Note: comparative data ends in 2008 as Stats Canada changes its accounting methodology. Beyond 2008, we rely on the province's public accounts to track the debt and deficit.]

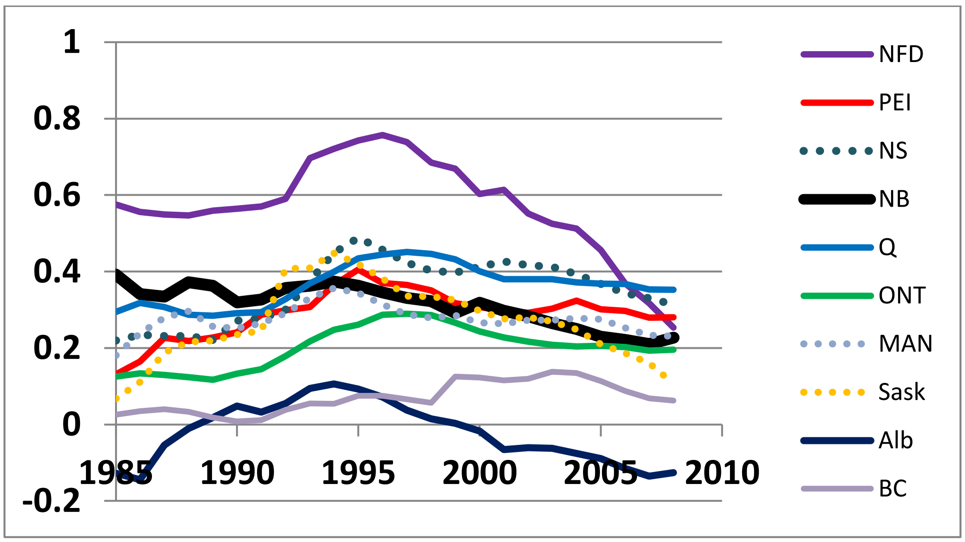

Figure 1: Debt to GDP ratios of Canadian Provinces

However, the good performance of New Brunswick changes dramatically after 2008. The chart below shows New Brunswick's annual deficit. Notice the dramatic deterioration in 2009-10!

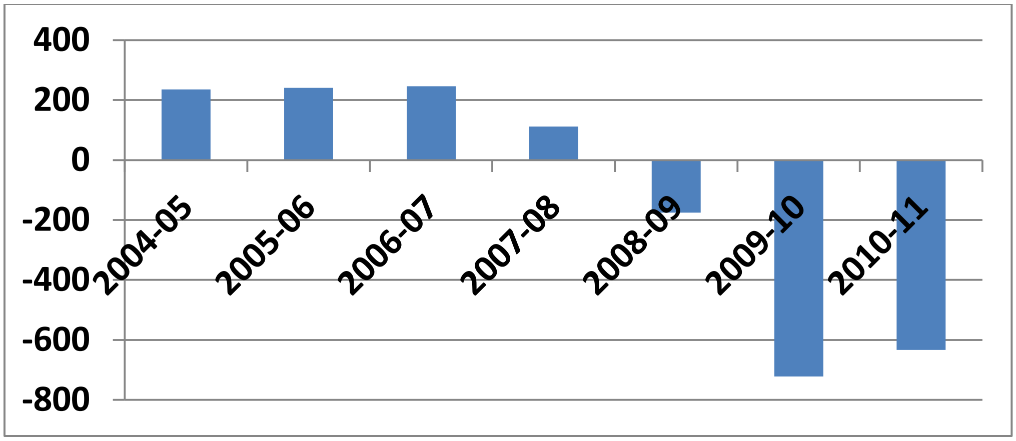

Figure 2: Recent Surplus/Deficit Situation of New Brunswick

2. How Bad Was It?

In 2009-10 and 2010-11, New Brunswick had the second biggest deficit in Canada as a proportion of GDP. While the deficits were BIG, the increase in net debt was even bigger. In 2009-10 the deficit was $722 million, but the increase in Net Debt was $970 million. In 2010-11 the deficit fell slightly to $633 million, but the Net Debt increased by more, by a whopping $1,009. That's about a 10% increase in one year!

Just paying interest on the debt cost us $643 million in 2010-11. The interest costs increased by $26 million in one year – at a time when interest rates were at historic lows. Debt Service payments are now New Brunswick's fourth biggest expenditure. It absorbs nearly 50 cents of every dollar we pay in provincial income tax.

This is especially worrying for four reasons. First, the Federal government intends to cut the growth of transfer payments, and these are about 40% of our revenues! Second, there is ongoing weakness in the world economy. We know Europe – the biggest economy in the world – is going into a recession. Third, we know that interest rates will increase eventually. And fourth, New Brunswick, with its aging baby boomers, faces more difficult demographic issues than other provinces.

3. What Went Wrong?

A prime suspect, one blamed by the Liberal government of Shawn Graham, was the world financial meltdown in 2008 and the ongoing recession since. It is relatively easy to calculate the impact of the recession on the province's finances. First, we need to estimate the impact on economic activity. Then we need to translate this into an impact on revenues and spending.

It turns out that the growth rate of real GDP for New Brunswick mirrors very closely that for Canada as a whole. The Bank of Canada publishes data on the output gap for Canada, so we have a reasonably good, well-respected, estimate for the impact on economic activity. Given this proportionate output gap, we can estimate upper bounds on the impact on revenues and spending.

To do this, take New Brunswick's *entire* own-source revenue and *decrease* it by the percentage of the output gap. In addition, take New Brunswick's *entire* social spending and *increase* it by the output gap. Finally, let's take 2011 numbers as the base for our calculations, so as to get the biggest possible effect. The resulting *upper bound* estimates for the effect of the recession on New Brunswick's current account position are contained in Table 1 below. These calculations suggest that the deficit in 2008-09 was mostly because of the recession. But subsequent deficits are much too big, and the effect of the recession much too small.

Table 1: Impact of the Recession

	2008-09	**2009-10**	**2010-11**
Budget Deficit	**-$176**	**-$722**	**-$633**
Impact of recession	**-$141**	**-$90**	**-$42**

So, what happened? What unbalanced New Brunswick's Budget?

4. Tax Cuts in New Brunswick

The Liberal government of Shawn Graham introduced sweeping tax reductions both for businesses and individuals.

The corporate and personal income tax reductions were phased in beginning March 2009. In the 2009-10 year, personal income tax reductions cost $143 million in lost revenue (source: information from the March 17, 2009 Budget). By 2010-11, they cost $247 million in lost revenue (source: Edwards and Hill, CCPA, 2011). The corporate income tax was cut from 12% to 10%, at a cost of $28 million.

In addition, in 2005 the previous Conservative government of Bernard Lord had initiated a gradual phase out of the Large Corporation Capital Tax. By 2010 it had completely disappeared, costing $45 million compared to 2005 levels.

These three tax cuts alone amount to **$320 million in lost revenue**.

Ruggeri and Bourgeios (2010, and 2011) denounce the Graham tax changes as being: regressive, unsustainable, and ineffective. Let's unpack this unholy trinity. First, consider the regressive nature of the personal income tax cuts.

Table 2: Personal Income Tax Rates in New Brunswick		
Income Tax Brackets	**2008 tax rates**	**Current rates**
0 - $35,707	10.12%	9.1%
$35,708 - $71,415	15.48%	12.1%
$71,416 - $116,105	16.8%	12.4%
$116,106 and over	17.95%	14.3%

Referring to Table 2, notice that the biggest tax cuts were enjoyed by the richest individuals. Someone earning $30,000 a year gained $306 in net income. But for someone earning $150,000 a year, the gain in net income is $4,474. So, those earning 5 times more, received a tax break 15 times bigger! This is what is known as a regressive tax policy. Consider next why those tax cuts are ineffective and unsustainable.

5. Ineffective and Unsustainable Tax Cuts

In 2010 election, the Liberals campaigned on an economic policy of having the lowest taxes in the region to "stimulate growth, to generate revenue, to pay for the services we need." Unfortunately, there are THREE problems with this strategy. I'll deal with them in increasing order of severity.

First, low taxes are neither necessary nor sufficient to generate growth. Historically, Canada experienced its highest growth in the 1950s when tax rates were much higher than they are now. Furthermore, high tax countries such as Sweden and Denmark have enjoyed faster long term growth than many other developed countries, such as the UK or the US, that have lower tax rates.

These examples concern sovereign countries. However, in a federation such as Canada, it is always possible to hope that business will relocate from neighbouring provinces in search of lower tax rates. This type of "beggar-thy-neighbour" policy rarely works, since the neighbours inevitably retaliate with tax reductions of their own. The end result is a "race to the bottom" where all jurisdictions lose the precious tax revenue required to provide public services. This is the second problem with the strategy.

The third problem is that, even if the low tax strategy did generate growth without causing retaliation, it could *not* generate extra revenue. To prevent "beggar-thy-neighbour" policies, the

Canadian federation has an important failsafe built into it. In particular, equalization payments are designed so that when the tax base of a recipient province grows faster than the rest of Canada, equalization payments fall dollar for dollar. If a recipient province had lower tax rates than the Canadian average, and as a result grew faster than the Canadian average, equalization payments would decrease by more than that province's own tax revenue would increase.

It is this failsafe aspect that makes the tax cuts unsustainable. The tax cuts have unbalanced the budget, and the only way to rebalance it is to restore the tax revenues or cut government program spending.

6. The Option of Cutting Public Spending

Most spending cuts, like tax cuts, are regressive. It is usually the poor that benefit most from government spending. Furthermore, cuts in spending will be difficult and painful to achieve for the simple reason that 80% of New Brunswick's spending is on health, education, social security, and interest payments on the provincial debt. One would expect school boards to resist spending cuts, especially the ones experiencing increased enrollment. And who wants worse health care or worse education?

Of course, there are some spending cuts that would not be regressive. It is certainly possible to eliminate subsidies to the biggest, most powerful, wealthiest corporations. These take many forms, from subsidizing electricity and gas rates, to low stumpage fees. While it is true that the wood industry is currently in crisis mode, the long run future of the province won't be assisted by forever subsidising declining industries.

Other non-regressive spending cuts could be achieved by eliminating sweetheart public-private-partnership deals for the politically well connected that line private pockets at the expense of the public purse. (See the auditor general's 2011 report, volume 3, chapter 2.)

7. Conclusion

Certain right-wing free market advocates – whether they be termed 'neoliberals' or 'neoconservatives' – seek to shrink the public sector. So far, the tried and true method is to promise the electorate tax cuts. When implemented, these generate deficits and increasing debt. When severe enough, the public is coerced into accepting reductions in public services.

The deficits and rising debt create a crisis atmosphere and governments may be tempted to seek solutions through desperate measures. They may, for example, be tempted to approve a shale gas industry and risk severe environmental degradation; or they may be tempted to try to sell off assets such as their crown corporations (NB Power and NB liquor).

That is the real danger of struggling with structural deficits caused by tax cuts.

In section 4 of this note I showed that the province of New Brunswick could have an additional **$320 million** in revenue simply by restoring taxes to the levels experienced in 2005. In fact, this understates the potential tax revenue available to the government. In Oct 2007, the Federal government gave the provinces more "tax room" by reducing HST by 2 percentage points. In New Brunswick, each percentage point brings in around $130 million. So, if New Brunswick increased HST by 2 percentage points, back to 2007 levels, and bringing us into line with our neighbours in Nova Scotia, we'd have another **$260 million**.

In other words, restoring the full panoply of taxes that were in effect in 2005 would yield an additional **$580 million** in revenue. Life was good in 2005. At that time the province ran a surplus and was paying down its debt. And think of what else could be done with that kind of additional revenue. A universal child care program, along the lines of that in Quebec, could be implemented at a cost of around $140 million. Lack of affordable childcare is the single biggest obstacle to rejoining the workforce. A catastrophic drug coverage plan along the lines of Nova Scotia could be implemented at a cost of around $50 million. New Brunswick is one of only two provinces without such a plan. We could implement a fight against illiteracy. We could implement a means-tested dental program. We could reduce university tuition fees by 10% and attract students from across the country. *And still have money left over to pay down the provincial debt.*

As a final remark, if the province had not embarked on the folly of tax cuts, and had been able to keep its debt level at 2008 levels, the interest payments on the provincial debt would be **$100 million** a year less than they currently are. Moreover, we are not out of the woods yet. While the projected deficit for 2012-13 has been reduced to $183 million by the Alward Conservatives, the increase in net debt is still a whopping $739 million. Inexorably, the interest payments on our debt are absorbing more and more of our resources.

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