Nova Scotia

Fiscal Overview

NOVA SCOTIA

2006

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Minister of Finance

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Introduction

Nova Scotia's economy has done very well in recent years. More people are working, the economy is more diversified, and government revenues have kept pace with the growing cost of public programs and services.

The Province of Nova Scotia has played a role in this improvement, by promoting good fiscal management, fostering economic growth, and controlling spending. Government produced four balanced budgets in as many years and has introduced a number of measures to bring down the province's debt.

Government has also made a number of significant investments in long-term priorities such as education, health and health promotion, economic development, and provincial infrastructure such as roads and schools. These are designed to improve Nova Scotia's prospects over the long run.

Nova Scotians and others have taken notice of our positive trends. All three bond-rating agencies have recently given Nova Scotia a positive outlook, a precursor to a higher credit rating.

However, observers agree that it is very important for the Province of Nova Scotia to continue on its course of fiscal prudence. This includes

- containing spending
- promoting growth as appropriate in revenue sources, including encouraging the federal government to meet its fiscal obligations
- ensuring a competitive tax structure and reducing regulatory burden
- setting aside enough funds to maintain and build infrastructure
- promoting environmental sustainability
- continuing to reduce the government's debt load

Government must also develop realistic plans to help Nova Scotia adapt to broader changes in society and the economy, including

- a population that is aging and not growing
- lower economic growth than the national average

- population migration from rural to urban areas
- a changing employment environment, including a shortage of qualified workers in many sectors
- the ongoing shift from a resource economy to a service-based economy

These challenges cannot be addressed by the provincial government on its own. The Province of Nova Scotia must work in concert with a wide variety of partners to ensure that Nova Scotians can take advantage of opportunities that arise and can weather times of adversity. Other levels of government, research and learning institutions, and the private sector must be all part of this process.

Fiscal Overview 2006 outlines the province's economic and fiscal situation, based on the numbers and statistics produced for the province's December 2005 budget forecast update.[1] It is intended to provide a framework for planning, both inside and outside of government, for the 2006–2007 fiscal year and beyond.

1 Numbers are based on the *Province of Nova Scotia Budget Forecast Update*, as of December 14, 2005. Unless otherwise indicated, source numbers come from Nova Scotia Department of Finance and Statistics Canada.

Province of Nova Scotia—Economic Overview

Nova Scotia's challenge is to maintain continued economic growth in the face of changing local, national, and international conditions.

Growth has been steady over the last two decades, averaging 2.2 per cent each year, although in most years it has been below the Canadian average.

Strong economic growth from 1997 to 2002, with real growth in GDP averaging 4 per cent, has dropped somewhat in the last two years and is now forecast to be 1.6 per cent for 2005.

Nova Scotia's economy has experienced significant structural changes over the last 20 years. Economic activity has been shifting away from the production of goods to the production of services.

Fewer Nova Scotians are now working in traditional and resource industries such as fishing, mining, and ship building, and more earn their living from call centres, health care, construction, and scientific and technical jobs.

Despite these changes, economic results have been positive on many fronts in recent years.

Employment levels reached a record high in 2005, with a total of 443,100 workers employed in Nova Scotia last year. The employment rate has been above 58 per cent for the last two years. This is the highest employment-to-population ratio since the mid-1970s.

The service sector accounted for 100 per cent of the increase in employment in 2005. The biggest gains were in health care and social assistance, and wholesale and retail trade.

There was positive growth in both retail capital investment and manufacturing in 2005. Capital investment in non-residential building construction for 2005 was up more than 100 per cent for industrial construction and up 14.7 per cent for commercial construction.

Unemployment has also been at the lowest levels in decades, as the demand for labour (employment) has grown at a faster pace than the number of workers available (labour supply). Nova Scotia's overall unemployment rate stood at 8.4 per cent in 2005, compared to 8.8 per cent for 2004.

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However, there are a number of economic factors at play that have caused the recent reduction in the province's overall growth rate; and these will continue to pose challenges for the province.

The changing demographics of the province are very significant. The average age of the population is rising, and there are more elderly Nova Scotians. This translates into increased demands on health-care services and a reduction in the number of people in the active workforce.

Population growth in Nova Scotia has slowed. This is reducing the potential size of the workforce, just as the economy is shifting to labour-intensive service industries. Nova Scotia finds itself in competition with other provinces for workers of all kinds.

Nova Scotia's population has also been slowly moving from the rural to the urban areas, and in particular to the Halifax Regional Municipality (HRM). The municipality has seen strong growth, particularly in the higher-wage service industries. More rural residents are commuting to work in the city an hour or more each way.

Nova Scotia has reaped considerable benefits from natural resources such as offshore natural gas, which has been a major stimulus of economic activity in the last few years. The high price of natural gas has resulted in an increase in offshore revenues in 2005–2006.

However, if offshore revenues are to be a sustainable source of revenue into the next decade, new offshore developments will be required to replace the Sable Offshore Energy Project reserves. Future revenues will depend ultimately on the volume of natural gas available for sale, along with world energy prices.

Some economic factors are beyond the province's control, such as the United States deficit, currency exchange rates, and the growth of the Chinese economy.

Nova Scotia businesses are more involved in international trade, and the relatively high value of the Canadian dollar in 2005 was a key factor in a 4 per cent drop (January to November 2005) in Nova Scotia's international exports of merchandise goods.

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Current Economic Indicators

	Canada	Nova Scotia
Real GDP (2004/2003)	2.9	1.4
Employment (2005/2004)	1.4	0.2
Unemployment Rate (2005)	6.8	8.4
Consumer Price Index (2005/2004)	2.2	2.8
Retail Sales (YTD Nov 05/YTD Nov 04)	6.3	2.7
Labour Income (YTD Q3 05/YTD Q3 04)	5.0	5.3
Value of Building Permits (2005/2004)	9.3	5.6
Housing Starts – All Areas (2005/2004)	-3.4	1.2
Manufacturing Shipments (YTD Nov 05/YTD Nov 04)	3.4	6.1
Inter. Merchand. Exports of Goods (YTD Nov 05/YTD Nov 04)	4.8	-4.0

Economic shocks over the last two decades have taken a toll on the rural economy in Nova Scotia. Many communities have been affected by the collapse of the ground fishery and the closure of coal mines, steel mills, and military bases; some have rebounded with alternative activities.

Nova Scotia's fiscal plan must take all of these trends into consideration.

Continuation of the current trends of slower GDP, export, and employment growth may limit tax revenue growth over the next several years.

As well, structural changes in the economy are likely to put upward pressure on fiscal expenditures in the long run and challenge the province's capacity to meet the changing demand for public goods and services.

Province of Nova Scotia Revenues—Current Trends

Nova Scotia is forecasting total revenues for 2005–2006 of $6.552 billion, with $4.292 billion from provincial sources and $2.261 billion from federal sources.[2]

Since 1996–97, total annual provincial revenues have grown by approximately $2.3 billion, averaging growth of 4.9 per cent per year.

The main provincial sources are from personal income taxes (PIT), corporate income taxes (CIT), and harmonized sales taxes (HST). Other key revenues come from offshore royalties and motive fuel taxes and from revenues generated by government business entities (GBEs) such as the Nova Scotia Liquor Corporation.

These own-source revenues have grown over the last 10 years from 61.3 per cent of total revenues to 65.5 per cent, an increase of approximately $1.7 billion.

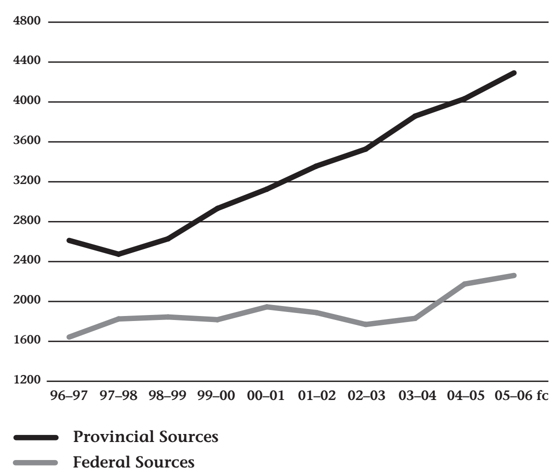
The $2.261 billion from federal sources this year is down from 38.6 per cent to 34.5 per cent of the province's annual revenues.

Federal funding for health care and social programs, now provided through the Canada Health Transfer (CHT) and the Canada Social Transfer (CST), went through a period of decline between 1996 and 1999. This year they represent 13 per cent of total revenues, still below the proportion of federal transfers prior to 1996–97.

Revenues by Source

(Provincial = 65.5%; Federal = 34.5%)

($ millions)



2 Numbers are calculated based on total Nova Scotia revenues, including GBEs. Revenue projections reflect information available as of the December 14, 2005, budget forecast update.

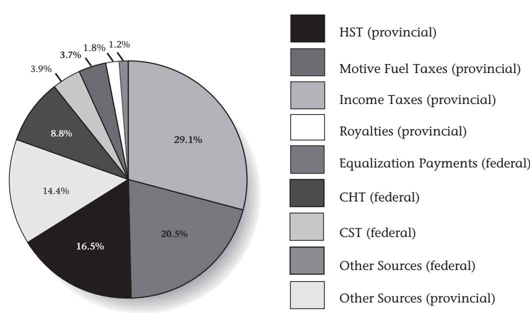
Nova Scotia's dependence on Equalization alone has decreased from 26.2 per cent of total revenues in 1996–97 to 20.5 per cent in 2005–2006. However, this year, Equalization is worth $1.343 billion, a very significant source of funding that could not realistically be replaced by other sources. The level of Equalization has been fixed for 2006–2007 at $1.38 billion.

A strong economy has led to growth in revenues generated from income taxes, from 25 per cent of total revenues in 1996–97 to 29.1 per cent in 2005–2006. Sales taxes have remained fairly constant at approximately 16 per cent of total revenues over this period.

Although the total dollar value of motive fuel excise taxes has grown from $199 million in 1996–97 to $244 million in 2005–2006, the relative importance of this revenue source has declined from 4.7 per cent of total revenues to 3.7 per cent over the same period.

The provincial/federal Offshore Offset Accord allows the province to keep 100 per cent of revenues generated from the offshore since agreements were signed in the 1980s. Nova Scotia received $830 million from the federal government in July 2005 to fulfil the terms of this agreement. The funds were immediately applied to the debt and will generate ongoing savings in debt-servicing costs.

Current Revenues by Source
(2005–2006: $6.552 billion)



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Revenue Challenges

Nova Scotia needs sufficient revenues to cover the cost of the programs and services that our citizens depend upon.

Slower growth in revenues overall, or a major drop in any one category, would jeopardize the province's ability to cover rising costs and make strategic long-term investments in infrastructure and the economy.

Although revenue growth has been positive in recent years, there are challenges associated with many revenue categories in Nova Scotia's budget.

Provincial tax revenues represent an important source of funds for Nova Scotia. Revenues from personal income taxes, corporate income taxes, and the HST make up almost 46 per cent. These can fluctuate widely from year to year due to a variety of economic and other factors.

Keeping pace with lower tax levels elsewhere will continue to be a challenge for Nova Scotia. Taxes that are too high can have a negative effect on the economy, dampening investment.

The province is limited in the extent to which taxes can be raised to generate more revenue. Competition is more global now, and companies and people prefer to locate in jurisdictions with favourable tax treatments.

Nova Scotia is also constrained in its ability to generate additional revenues from personal income taxes. The majority of Nova Scotia tax filers do not have the income levels of their counterparts in other regions of the country.

Roughly 66 per cent of Nova Scotia tax filers earn less than $30,000 a year; about 9 per cent of Nova Scotia's population bears 49 per cent of the personal income tax burden.

Nova Scotia had the third-highest provincial personal income tax rate for the middle and high income brackets in 2004 and has not been in a position to reduce personal income taxes in these categories in recent years.

Corporate income tax rates also remain at a relatively high level compared to other jurisdictions. In 2004, Nova Scotia had the second-highest provincial corporate income tax rate and the highest corporate income tax rate on manufacturers and processors.

This year, the province expects to generate $54 million from the tax on insurance, $20 million from the Corporations Capital Tax, and $55 million from the Tax on Large Corporations. Nova Scotia's 2005–2006 budget included a plan to decrease the rate of Capital Tax on Non-Financial Institutions over four years.

However, according to CD Howe Institute, Nova Scotia fares well (third overall) in comparison to all other provinces in relation to marginal effective tax rates on capital for large- and medium-sized corporations. This is due to input tax credits provided to businesses through the HST system.

While Nova Scotia's dependence on federal revenues overall has dropped somewhat in recent years, federal sources continue to be essential to Nova Scotia's ability to offer programs and services at levels comparable to other provinces.

Atlantic Canada Business Tax Rates, 2005

	Nova Scotia	New Brunswick	PEI	Newfoundland and Labrador
General Income Tax	16%	13%	16%	14%
Small Business Income Tax	5%	3%	7.5%	5%
Large Corporations Tax (Capital Tax)	0.275%	0.3%	Nil	Nil
Corporations Capital Tax	4%	3%	5%	4%

Sources such as the Canada Health Transfer and the Canada Social Transfer, which are scheduled to grow marginally in the next few years, are not sufficient to keep pace with current—or indeed future—costs in health care and higher education.

The results of this underfunding are clearly evident in a number of sectors. For example, the erosion of federal funding for higher education has forced Nova Scotia universities to generate more of their revenues from tuition. Students now face the highest tuitions in Canada.

The ongoing importance of Equalization from the federal government should not be understated. A federal review of the program now under way could mean changes to the Equalization formula. Any potential drop in Equalization funding would pose severe fiscal challenges for Nova Scotia, reducing the province's ability to fund core services.

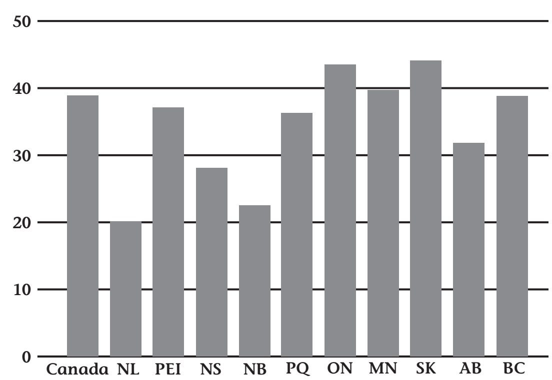
Nova Scotia is currently benefitting from higher offshore royalty revenues, primarily due to the higher price of natural gas of late. Such revenues may fluctuate with changes in the price of fuel and, over the long run, are affected by the volume of natural gas produced in the offshore fields.

Finally, Nova Scotia has chosen to reduce some sources of revenue for social policy reasons. For example, revenues from gaming, which had been increasing, will decrease over the next couple of years as the Nova Scotia Gaming Strategy is fully implemented.

Marginal Effective Tax Rates on Capital

Large and Medium-sized Corporations

(Per cent)



Source: C.D. Howe Institute

Province of Nova Scotia Expenses—Current Trends

Nova Scotia's total net program expenses in 2005–2006 will be $5.566 billion. This is 55.4 per cent higher than 10 years before, when total expenditures were $3.582 billion.[3]

Spending has been growing at a rate of 5 per cent a year, compared to a 4.9 per cent growth of annual revenues.

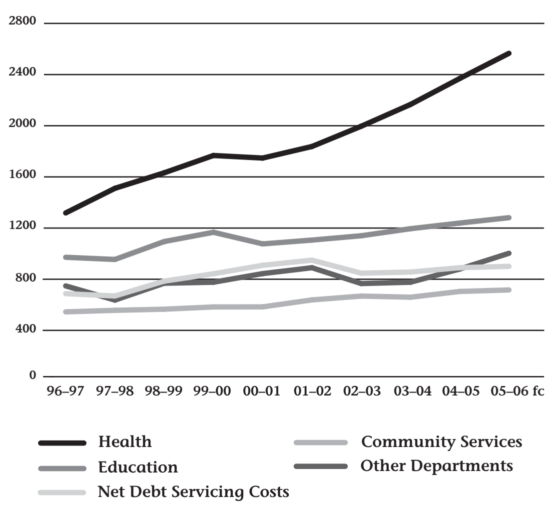
Total expenses for 2005–2006, including net debt-servicing costs, are forecast to be $6.467 billion. Adding accounting adjustments for pension valuations brings total expenses to $6.519 billion for the year.

The majority of Nova Scotia's spending covers health and social services—primarily through the departments of Health, Education, and Community Services—along with debt-servicing costs.

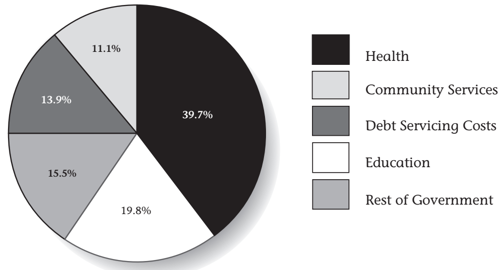
The remainder of government programs account for about 15.5 per cent of total spending. Key spending includes provincial roads, economic development, the justice system, natural resources, and the environment.

Any reductions in spending will have a direct impact on the people who use government programs and services.

Spending Trends
($ millions)



Total Spending
(2005–2006: $6.467 billion)



3 Expenses as of December 14, 2005, budget forecast update

Health and Health Care Spending

Health care has been the fastest-growing segment of the budget, averaging annual increases of 7.8 per cent since 1996–97, almost 3 per cent higher than average revenue growth.

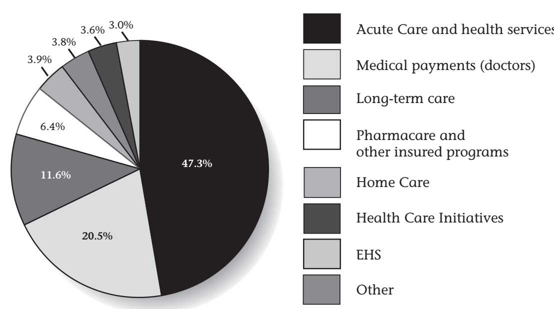
For 2005–2006, health care expenses represent some $2.566 billion. This is almost 40 per cent of total expenses, and 46 per cent of net program expenses. Health expenses have almost doubled from $1.319 billion in 1996–97 and increased by more than $500 million in the last three years alone.[4]

Of the total cost for health care, almost 48 per cent goes to running hospitals, including nursing and other staff. Just over 20 per cent goes to paying physicians. The remaining 30 per cent is divided up among long-term care, Pharmacare, home care, emergency services, and other health services.

The costs of all of these categories have been increasing steadily each year. From 1996 to 2006 costs have changed as follows:

- The cost of running hospitals has gone up from $729 million to $1.211 billion (from 55 per cent of total health expenses down to 48 per cent).
- Payments to physicians increased from $268 million to $525 million per year, consistently just over 20 per cent of total expenses.
- Long-term care has escalated from approximately $104 million to $296 million, rising from 7.9 per cent to 11.6 per cent of the total.
- Pharmacare and other insured services have escalated from $55 million to $163 million, a proportional share increase from 4.2 per cent to 6.4 per cent.
- Spending for home care has stayed at approximately 4 per cent, but the net dollar value has increased from $57 million to $100 million.

Health Spending
(2005–2006: $2.566 billion)



4 While prior period figures have been restated to reflect changes in accounting policy standards over the years, there could be minor differences in the composition of the balances.

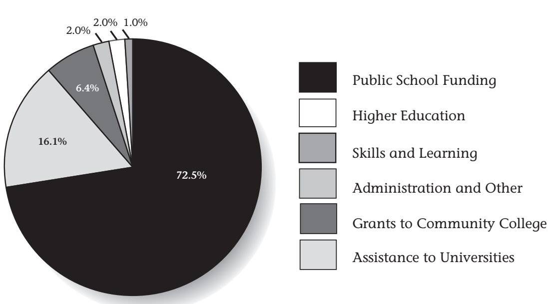
Education Spending

Education (including P–12 and colleges and universities) is Nova Scotia's second-largest annual program expense, accounting for 19.8 per cent of net expenses—or close to $1.3 billion annually (2005–2006).

While the dollar value of program spending on education has increased by some $300 million since 1996–97, spending on education as a percentage of total provincial spending has slipped from 22.8 per cent to 19.8 per cent.

Public school enrolment has declined, from 163,941 in 1996–97 to 148,514 in 2003–2004, and is projected to decline further, to 133,273 in the 2006–2007 budget year.

Education Spending
(2005–2006: $1.281 billion)



Overall funding for education increased by 3.4 per cent or $41.9 million from 2004–2005 to 2005–2006. The increase primarily covers the Learning for Life initiative designed to enhance public school education, and funding for universities under a Memorandum of Understanding that will keep tuition increases capped at 3.9 per cent per year.

Debt Servicing

Net debt-servicing costs have increased by over $200 million since 1996–97 and are forecast to be $900 million for 2005–2006. This is due to the rise in the level of debt plus the inclusion of interest on unfunded pension liabilities and other post-retirement benefits ($113 million in 2005–2006.) However, net debt-servicing costs as a percentage of total net spending have declined from 16.1 per cent to 13.9 per cent.

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Community Services

Funding for Community Services represents government's fourth-largest program expense, at $716 million for 2005–2006. This has grown by $171 million since 1996–97, or 31 per cent, although the share of total spending on Community Services has declined from 13 per cent to 11 per cent.

Spending Challenges

Nova Scotia's spending capacity is limited by its formal commitments to balance its budget and reduce its debt over time. Legislation has been passed to formalize these commitments, which includes a Debt Management Plan.

These controls are designed to prevent per capita debt levels from rising and to bring down the level of debt over time. They are also intended to ensure that government spending commitments for current and future years will match the revenues available or projected.

However, certain cost pressures continue to pose challenges. The increase in health-care costs from 30 per cent to 40 per cent of total net expenses since 1996–97 has placed a significant strain on provincial finances and has reduced funding available for other priorities.

Growth in health-care costs is not expected to abate in the near future and, unless action is taken, can be anticipated to grow at approximately 8 per cent per annum in years to come.

Nova Scotia's total revenue growth has been less than 5 per cent, and federal funding for health is growing at only 6 per cent. Obviously this trend is a great challenge for Nova Scotia, as it is for all provinces.

The aging population demographic, wage settlements, drug costs, and increased demand for more and more sophisticated services will keep pressure on the government to maintain and enhance health services. The challenge will be to keep spending growth down while protecting the services that people need.

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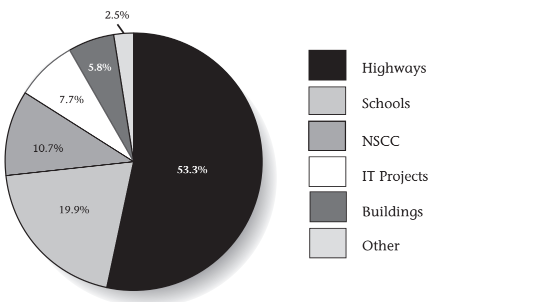
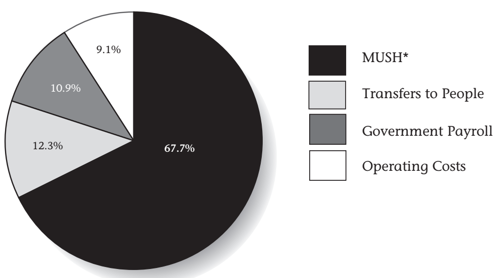
Tangible Capital Asset Spending

(2005–2006: $280 million)



Sector Spending

(2005–2006: $5.56 billion)



* Municipalities, universities, schools and hospitals

There will be a need for more investment in education and training to strengthen Nova Scotia's competitive capacity as represented in our human capital. Well-educated and trained people are necessary for economic growth.

Wages and salaries are the largest component of the province's total expenses across the public service. These compensate health-care providers, educators, and other public servants. Wages and salaries account for approximately 64 per cent of all program spending; and for every 1 per cent increase, government expenses goes up by approximately $35 million.

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The rising costs of energy, the implications of global warming, and the sustainability of our natural resources will challenge Nova Scotians in the years ahead.

Besides the increasing costs of health care, general wage pressures, and the need to invest in environmental sustainability, the provincial government is facing pressures for improved infrastructure, higher energy costs, and ever-present demand for public services.

As populations continue to move, demands for services in the urban centres will increase while facilities in the rural areas must also be maintained.

Roads, bridges, ports, rail systems, mass transit, and municipal services all play a part in the economic development of the province. Spending in these areas is needed to maintain and grow our economy.

The Department of Transportation and Public Works estimates that Nova Scotia has an infrastructure deficit of approximately $9.6 billion. Addressing this deficit over a 20-year time horizon would require around $700 million per year.

However, the Province of Nova Scotia currently spends $318 million per year on capital improvements, including $280 million in the Tangible Capital Assets program and $38 million for buildings, equipment, and other capital costs in district health authorities.

Controlling costs will continue to be very important for government to meet these challenges in the years ahead.

Province of Nova Scotia—Debt Management Trends

The Province of Nova Scotia has taken a number of steps to slow the growth of Nova Scotia's debt in recent years, including legislation governing balanced budgets and debt management.

The government's adoption of a more disciplined fiscal management system has resulted in four consecutive balanced budgets, and the 2004–2005 surplus was the highest yet at $165.3 million.

Nova Scotia's net direct debt (NDD) at March 31, 2005, was $12.308 billion. Although this is approximately $3.72 billion higher than in March 31, 1997, $1.865 billion of the increase can be attributed to the adoption of generally accepted accounting principles (GAAP).

These accounting changes require government to report all of its liabilities in its calculation of debt. In recent years, government added to the debt those charges related to the sale of Sydney Steel Corporation and Nova Scotia Resources Limited, as well as the addition of assets for P–3 school capital leases.

Net direct debt went down in 2004–2005 for the first time in many years as government produced a surplus higher than its capital spending costs.[5]

Government has announced plans to increase capital investment in infrastructure—highways, schools, and other buildings—this fiscal year and next. As a result, even though balanced budgets continue, net direct debt is not scheduled to go down until 2007–2008.

5 Surplus was greater than the change in net book value of tangible capital assets.

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As a result of this good management, the province's credit rating has been upgraded by all three major bond-rating agencies, which changed their outlook on the province's credit rating from stable to positive. Such trends provide Nova Scotia with more favourable terms when borrowing.

The Offshore Offset Agreement brought $830 million from the Government of Canada in July 2005. These funds were immediately applied to paying down debt, and this will translate into lower debt-servicing costs.

Debt Management—Challenges

Nova Scotia has taken a number of significant steps in managing the debt in recent years, slowing its growth and even seeing the first drop in net direct debt in recent memory.

However, these efforts must be sustained over many years to see any significant reductions in the overall debt load and to further improve key debt indicators such as net direct debt per capita.

In basic terms, Nova Scotia would need to generate $250 million in surpluses annually (after accounting for capital spending) for 50 years to retire our debt. There is a long way to go.

It is positive that debt-servicing costs have dropped as a proportion of the total budget in the last few years. However, paying interest on the debt still costs the government in the range of $900 million a year—14 cents of every dollar we have to spend. It would be preferable to be able to apply these funds to program costs, such as health, education, and social services.

Although the province has been successful at lowering debt-servicing costs through a variety of means, these costs are influenced by factors that may be beyond the province's control, including interest rates and the value of the Canadian dollar.

Conclusion

Nova Scotia has performed well of late, and the fiscal picture is good. The budget is balanced, surpluses are being generated, and there is a plan in place to reduce the debt.

However, although expenses have been growing at almost the same pace as revenues, health-care expenses have been growing at a much faster rate. The rapidly growing health spending takes money away from other priority areas such as education, community services, and other government programs.

In addition, all government programs are facing normal increases in operating costs, such as the higher wages, fuel prices, and changing technology, that put pressure on the government budget.

At the same time, the province is facing some possible challenges on the revenue side. A number of revenue sources depend on growth in the economy and therefore are at risk of dropping if growth slows.

There are no windfall revenues expected from any source, and potential changes in programs like Equalization could cause serious problems for Nova Scotia.

These factors will affect the province's ability to deliver government programs and services and make positive changes such as reducing taxes.

The Province of Nova Scotia must continue with a prudent approach to fiscal planning and ensure that the provincial budget responds to the changing fiscal environment each year.