

EVOLUTION OF THE NWT FISCAL FRAMEWORK, 2004-2008

ISSUE

The budgets for the 15th Legislative Assembly were consistent in their message that the GNWT was facing a fiscally unsustainable situation.

BACKGROUND

The GNWT is in a position where expenditure growth is forecast to exceed revenue growth unless measures are taken to counter the trend. This situation is not new and the underlying fiscal outlook has not changed substantively since Division on April 1, 1999.

Budgets presented during the 15th Legislative Assembly were consistent in their message that the GNWT's fiscal strategy must be sustainable. However, the GNWT needed to balance maintaining a sound fiscal situation with policies to advance the goal of developing a strong diverse economy. Throughout the 15th Legislative Assembly, the long-term structure of the Territorial Formula Financing arrangements, which form the majority of GNWT revenues, was uncertain and the GNWT was hopeful that a resource revenue sharing agreement was imminent. While the GNWT made some expenditure reductions, it chose not to undertake significant restructuring or reductions that would reduce the effectiveness or service levels of government programs until the longer term Territorial Formula Financing arrangements were established.

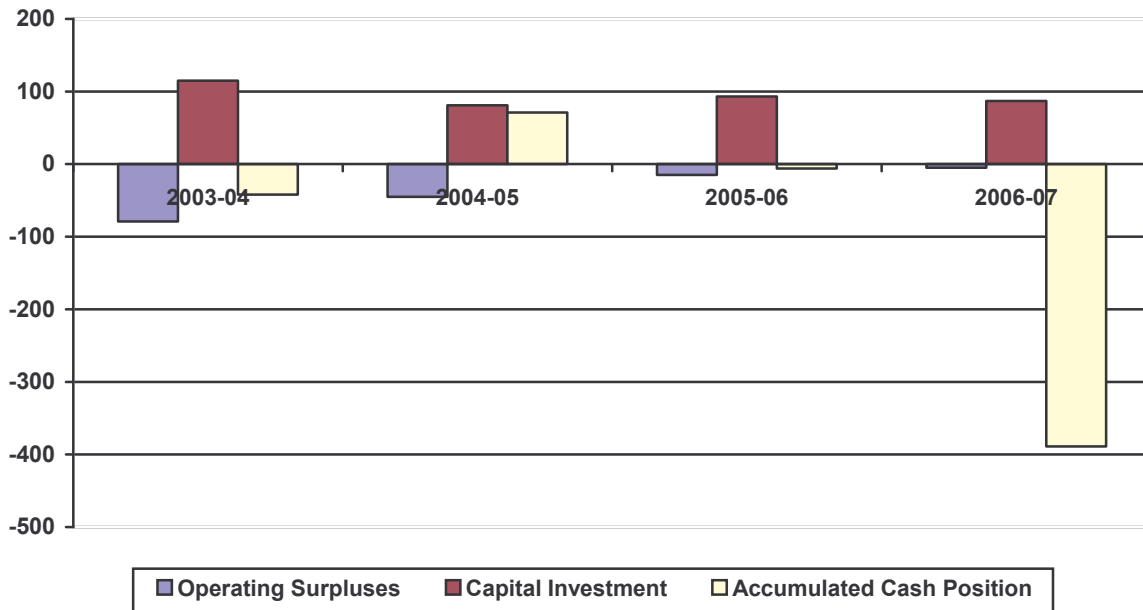
The following describes the fiscal situation at the time of each of the 15th Legislative Assembly budgets. Table 1 in the Appendix shows the evolution of the operating surpluses/deficits and cash position projected for each budget's planning period. From 2004-05 to 2007-08, it was clear that the GNWT had a structural deficit where expenditure growth was outpacing revenue growth, but each year, one-time revenues improved the situation and postponed the need for drastic action.

2004-05 Budget

At the outset of the 15th Legislative Assembly, it was clear that expenditure growth was outpacing revenue growth and the GNWT was forecasting operating deficits for the entire planning period to 2006-07, including exceeding the \$300 million debt limit by the end of the planning period. The situation was recognized as clearly unsustainable.

In response, the GNWT introduced a plan in the 2004-05 budget to cut spending by \$55 million over three years and to eliminate forecast operating deficits by 2006-07. Efforts continued both to restore the adequacy of Territorial Formula Financing arrangements and to negotiate devolution of non-renewable resources, including a resource revenue sharing agreement.

Figure 1: 2004-05 Budget Operating Surpluses, Capital Investment and Accumulated Cash Position (\$ Millions)



Subsequent to the 2004-05 budget, the federal government agreed not to rebase the 2004-05 tax effort adjustment factor in the Territorial Formula Financing Grant, adding \$48 million to the 2004-05 revenue projection. In September and October 2004, First Ministers' Meetings resulted in increased federal transfers under Territorial Formula Financing and health care. This added a further \$34 million to the 2004-05 revenue forecast and \$90 million in each of the 2005-06 to 2007-08 fiscal years. For the 2004-05 fiscal year, expenditures were \$14 million higher than estimated in the 2004-05 budget, primarily due to unexpected forest fire fighting costs. However, the increase in federal transfers turned the 2004-05 projected deficit of \$46 million into an operating surplus of \$44 million.

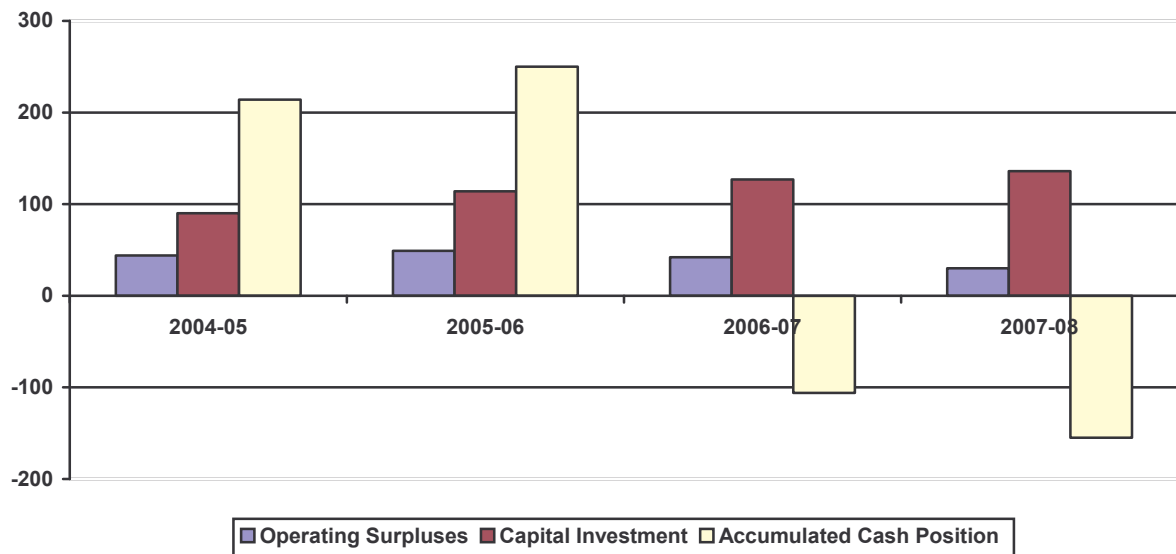
2005-06 Budget

Despite improvements in the GNWT fiscal situation since the 2004-05 budget, the 2005-06 budget made it clear that the uncertainty in revenues (particularly the Territorial Formula Financing arrangements) meant that the planning assumptions introduced in the 2004-05 budget would remain in place. As well, the *Fiscal Responsibility Policy* was introduced in the 2005-06 budget (see Appendix 2). The purpose of the *Policy* was to provide the guidelines for debt and deficit limits and create a coordinated strategy for responsible spending, borrowing and debt replacement. The *Fiscal Responsibility Policy* stipulates that the GNWT will not borrow to fund operating deficits. Further, no more than 50 per cent of the infrastructure investment may be funded through debt. At least 50 per cent must be financed through cash generated from operating surpluses.

The GNWT needed to generate sufficient operating surpluses to make necessary capital investments and it was clear that rising costs of delivering current program and service levels would result in postponement of further critical capital investments. Therefore, despite the increase in Territorial Formula Financing from the 2004 October First Ministers' Meeting, the GNWT continued to restrain expenditures in the 2005-06 budget. The \$16 million in new initiatives and \$20 million in forced growth were partially offset by \$26 million in expenditure reductions.

Based on these assumptions, operating surpluses were predicted for the entire planning period (2005-06 to 2007-08), including a \$49 million operating surplus for 2005-06.

Figure 2: 2005-06 Budget Operating Surpluses, Capital Investment and Accumulated Cash Position (\$ Millions)



2006-07 Budget

One-time events (\$36 million decrease in corporate income tax entitlements resulting from a prior year capital loss and the accrual of a \$23 million liability for the Giant Mine remediation) turned the 2004-05 projected surplus into a \$17 million deficit and reduced the 2005-06 surplus to \$18 million.

The 2006-07 budget was built around conservative revenue forecasts because of fiscal uncertainty surrounding the new Territorial Formula Financing arrangements, devolution, and the request for an increase to the borrowing limit. The conservative revenue forecasts meant that an operating deficit was forecast by 2008-09 and the borrowing limit was forecast to be reached by 2007-08.

The 2006-07 budget included \$41 million in funding for new initiatives and \$55 million to address the increased costs of existing programs and services, which were only partially offset by \$23 million in expenditure reductions.

Despite the expenditure increases, the budget continued the fiscal strategy of the 2004-05 and 2005-06 budgets by adhering to the *Fiscal Responsibility Policy*.

Figure 3: 2006-07 Budget Operating Surpluses, Capital Investment and Accumulated Cash Position (\$ Millions)

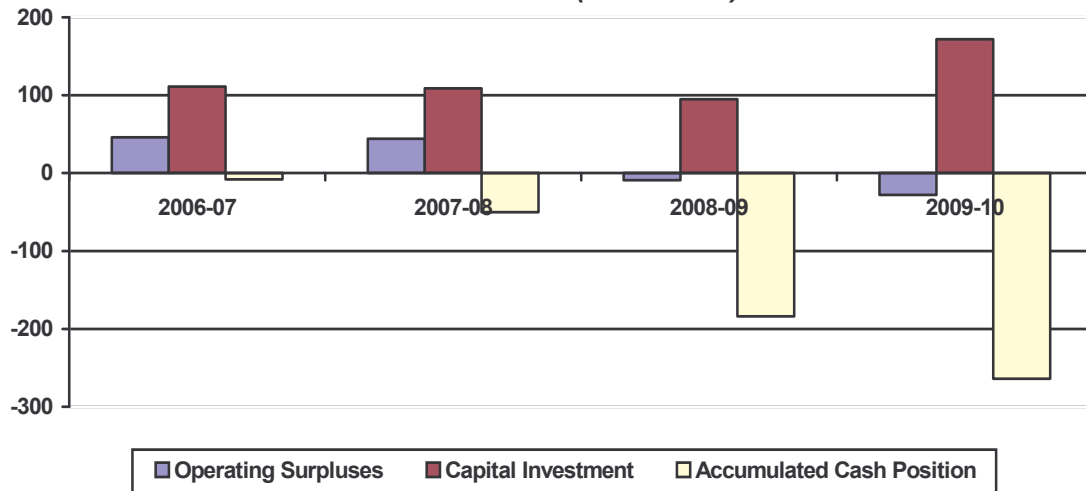


2007-08 Budget

The actual 2005-06 operating surplus was \$20 million higher than estimated in the 2006-07 budget due to \$17 million more in revenues and \$8 million less in expenditures. Increases in revenues projected for the 2006-07 fiscal year, partially offset by \$60 million more in expenditures (mainly due to infrastructure contribution carry-overs) increased the 2006-07 operating surplus \$15 million.

At the time of the NWT 2007-08 budget, the federal government had not announced new Territorial Formula Financing arrangements but had established a floor amount for the 2007-08 Grant. Although a \$44 million operating surplus was estimated for 2007-08, operating deficits were forecast for the remainder of the planning period as expenditure growth was expected to outpace revenue growth. This meant that capital investment would need to be curtailed if the *Fiscal Responsibility Policy* was to be adhered to.

Figure 4: 2007-08 Budget Operating Surpluses, Capital Investment and Accumulated Cash Position (\$ Millions)



The federal 2007-08 budget, released after the NWT 2007-08 budget, established new Territorial Formula Financing arrangements that added \$24 million to the 2007-08 Grant's Gross Expenditure Base and a one-time payment of \$54.4 million to compensate the NWT for a refund of corporate income tax that would have been a prior year adjustment under the previous Territorial Formula Financing arrangements. However, this additional revenue was partially offset by further write-downs of corporate income tax after the 2007-08 budget of \$32 million in 2006-07 and \$50 million in 2007-08.

Fiscal Outlook for 2008-09 and Beyond if No Action Taken

The GNWT's budgetary balance is currently positive. The operating surplus in 2006-07 was \$87 million, and an operating surplus is expected in 2007-08. However, for accounting purposes, the GNWT recorded the \$50 million *Northern Housing Trust* in the 2006-07 fiscal year, despite the fact that \$33 million of the associated expenditures would occur in 2007-08 and 2008-09. Consequently, for planning purposes the 2006-07 surplus was overstated by \$33 million and the 2007-08 and 2008-09 surpluses are understated by \$17 million each.

The overall fiscal position of the GNWT remains unchanged from the last four budgets: revenues are projected to grow more slowly than expenditures. (Total revenues are projected to increase by an average of 3.9 per cent per year between 2006-07 and 2011-12, excluding \$58 million in one-time trusts included in 2006-07 revenues while expenditures, without mitigation, are projected to grow by an average 5.9 per cent per year.)

The key difference between the 2004-05 to 2007-08 budget forecasts and the current 2008-09 outlook is that the structure of Territorial Formula Financing is

established in legislation until 2013 and it is clear that even if a devolution agreement were signed immediately, resource revenues would probably not flow to the NWT before the end of the current planning period. Therefore, while the structural problem of expenditure growth exceeding revenue growth over the medium term is unchanged, the uncertainty about future revenues is considerably less – the possibility for additional Territorial Formula Financing revenues, beyond those already included in the new arrangements, is unlikely.

If no corrective action is taken, the \$35 million operating deficit projected for 2008-09 would grow to an annual deficit of \$104 million in 2011-12, the accumulated cash position will be a deficit of \$527 million and the GNWT will exceed its borrowing limit of \$500 million by 2011-12.

The goals of the proposed fiscal strategy continue to be to ensure a sustainable long-term fiscal position while providing the flexibility to invest in strategic priorities and support economic development and communities by investing in infrastructure. This is to be achieved by bringing projected growth rates of revenues and expenditures into line and by adhering to the *Fiscal Responsibility Policy*.

Figure 5: Fiscal Outlook for 2008-09 to 2011-12 Planning Period if No Action is Taken (\$ Millions)

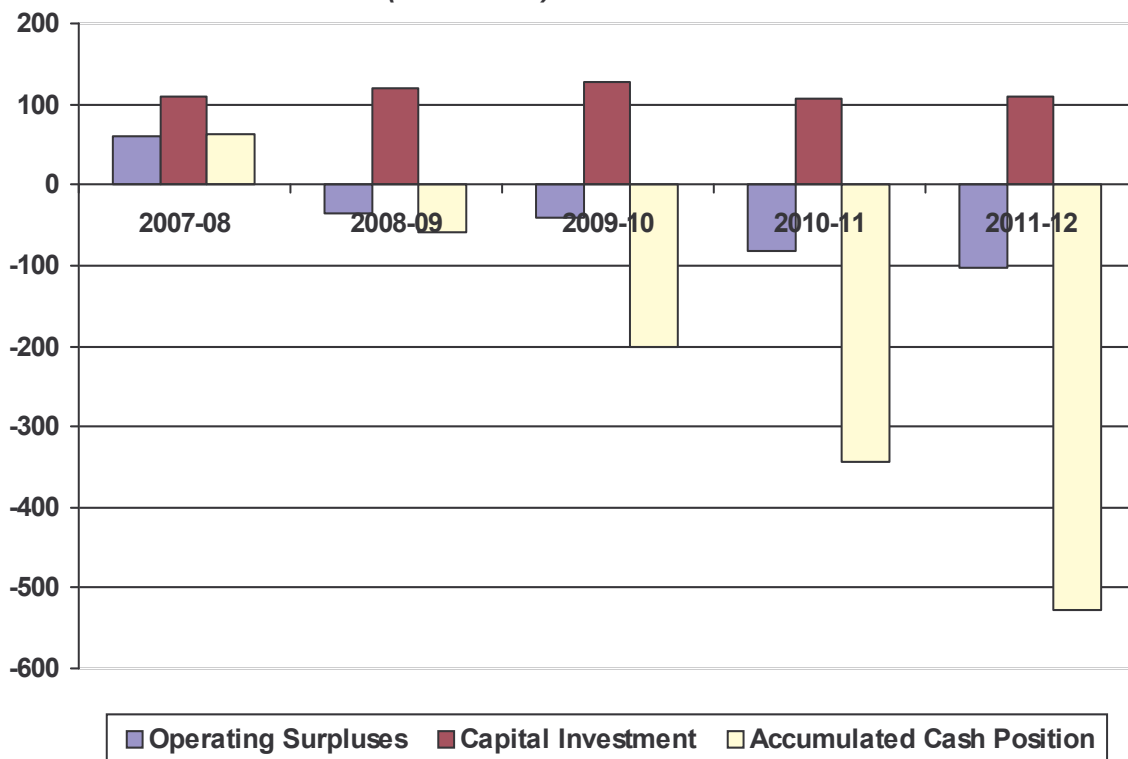


Table 1
15th Legislative Assembly Budget Fiscal Frameworks (2004-05 to 2007-08)
(\$ Millions)

2004-05 Budget	2003-04	2004-05	2005-06	2006-07			
Operating Surpluses	-79	-45	-15	-5			
Capital Investment	115	81	93	87			
Accumulated Cash Position	-42	71	-6	-389			
2005-06 Budget	2003-04 Actual	2004-05	2005-06	2006-07	2007-08		
Operating Surpluses	-65	44	49	42	30		
Capital Investment	84	90	114	127	136		
Accumulated Cash Position	25	214	250	-106	-155		
2006-07 Budget	2003-04 Actual	2004-05 Actual	2005-06	2006-07	2007-08	2008-09	
Operating Surpluses	-65	-17	18	31	23	-22	
Capital Investment	84	81	106	111	128	160	
Accumulated Cash Position	25	255	258	-79	-160	-331	
2007-08 Budget	2003-04 Actual	2004-05 Actual	2005-06 Actual	2006-07	2007-08	2008-09	2009-10
Operating Surpluses	-65	-17	36	46	44	-9	-28
Capital Investment	84	81	106	111	109	95	172
Accumulated Cash Position	25	255	347	-8	-50	-184	-264

Sources: 2004-05 to 2007-08 GNWT Budget Addresses

FISCAL RESPONSIBILITY POLICY

The GNWT's *Fiscal Responsibility Policy* was introduced in the 2005-06 budget as the cornerstone of the GNWT fiscal strategy. The *Fiscal Responsibility Policy* provides the guidelines for debt and deficit limits and includes accountability measures to make the GNWT's financial management transparent and open to public scrutiny. The *Policy* framework creates a coordinated strategy for responsible spending, borrowing and debt repayment.

Under the *Fiscal Responsibility Policy*, the GNWT will only borrow for infrastructure investments, self-liquidating investments, and repayable loan programs. Total GNWT debt will be considered affordable as long as debt-servicing payments (principal and interest) are no greater than 5 per cent of total revenues. (Debt includes lines of credit with banks, long-term debentures, bond issues and mortgages and capital leases but does not include loan guarantees, trade payables and obligations to employees, operating leases, and multi-year contracts for goods and services not yet received.) If debt servicing payments exceed 5 per cent of total revenues, then operating surpluses must be generated in the following two years to permit principal repayments that will decrease the debt servicing payments to 5 per cent by the third year. The GNWT will be accountable for its debt management by adopting performance criteria to ensure that total debt does not exceed the GNWT's ability to repay it.

Significant fiscal strategy guidelines included in the *Policy* are as follows:

- Operating surpluses will be maintained at a level sufficient to provide the cash required to finance 50 per cent of capital investment and meet debt servicing payments. A maximum 50 per cent of capital investments will be funded with long-term debt. The GNWT will need operating surpluses to fund capital investments.
- The GNWT will borrow for infrastructure (capital and capital leases), self-liquidating investments (those that generate direct savings or new or increased revenue streams) and repayable loan programs but not for operating purposes.
- Infrastructure debt will be repaid within 20 years, or over the useful life of the asset, if less.
- Debt for self-liquidating investments will be repaid through the new revenues generated from the investment.
- Repayable loan program debt will be repaid from cash generated from the loan recipient repayments plus interest.
- The GNWT will be accountable for its fiscal stewardship through established debt management performance that is realistic and achievable and through performance criteria identified by financial policy.

The performance criteria used to measure the debt management results are: debt to revenue ratio, debt per capita, debt servicing costs (interest) as a per cent of revenue, net debt as a per cent of GDP, and net debt per capita.