Chapter 3
Indicators of the Province's Financial Condition

Contents

Indicators of the Province’s Financial Condition

Background

3.1 In 1997, a research report published by the Canadian Institute of Chartered Accountants defined financial condition as a government’s “financial health as measured by sustainability, vulnerability and flexibility, looked at in the context of the overall economic and financial environment.”[1]

Scope

3.2 The purpose of this chapter is to provide readers with useful information about the Province’s financial condition using the CICA research report as a guideline.

3.3 Though many potential indicators of sustainability, vulnerability and flexibility were considered in preparing the research report, only ten indicators were found which were relevant, necessary, measurable and clear to users of government financial information. Of these, our Office has concluded that six can be considered meaningful in the context of the Province of New Brunswick. They are:

Sustainability
- *Net debt as a percentage of gross domestic product (GDP)*
- *Change in net debt and GDP*

Flexibility
- *Cost of servicing the public debt as a percentage of revenue*
- *Own source revenue as a percentage of GDP*

Vulnerability
- *Federal government transfers as a percentage of total revenue*
- *Foreign currency debt as a percentage of total debt for provincial purposes*

Restatement of financial results

3.4 In this chapter, our analysis uses restated figures for years prior to 1998. They were obtained from the Office of the Comptroller. These figures are restated for the effect of changes to accounting policies as explained in Note 2 to the financial statements of the Province.

1. Indicators of Government Financial Condition, 1997 published by the Canadian Institute of Chartered Accountants

3.5 The 1998 financial statement figures for revenue have been restated to show the accounting treatment recommended by our Office for the harmonized sales tax transitional payment. Expenditures have also been restated in the current year to recognize the impact of our recommended treatment of the Province's investment in New Brunswick Power Corporation. These issues are discussed in detail in chapter 2 of our Report.

3.6 Prior to 1998 sales tax paid by the Province was included in both its revenue and expenditure. However in 1998 revenue and expenditure no longer include these amounts.

Results in brief

3.7 In general, the five-year trends in sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved.

3.8 The two-year trend in flexibility is favourable. Indicators of sustainability and vulnerability during the same period suggest an unfavourable impact on the financial condition of the Province.

3.9 Much of the unfavourable impact on sustainability and vulnerability shown by the two-year trends can be attributed to proper recognition of the harmonized sales tax transitional payment and the investment in New Brunswick Power Corporation.

Sustainability

3.10 Sustainability is the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy.[1]

3.11 It is now well understood by the general public that increases in the cost of servicing the public debt can directly impact the quantity and quality of programs and services to which the public has access. Accordingly, many provinces - including New Brunswick - are striving to reduce their debt in order to ensure an optimum amount of funding is allocated to programs and services.

3.12 There are circumstances when governments may tolerate increases in their debt load. For example, when revenues are increasing, a higher cost of servicing the public debt might be tolerated without impacting existing programs and services. However, the ability to generate such revenues (e.g. through taxes, user fees or licenses) is closely linked to the performance of the economy.

3.13 Therefore, any growth in New Brunswick's debt must remain in line with growth in the economy to ensure that our Province can sustain its programs and services. If debt is growing faster than the economy, New

1. Indicators of Government Financial Condition, 1997 published by the Canadian Institute of Chartered Accountants

Brunswick will suffer reduced capacity for sustainability. Programs and services offered to the public may eventually suffer.

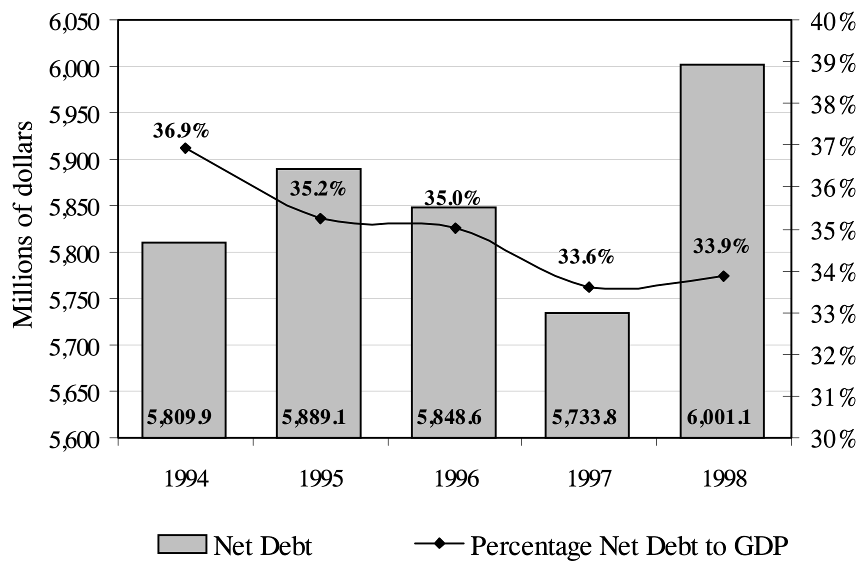
Net debt as a percentage of GDP as a measure of sustainability

3.14 Net debt is an accounting measure of the extent to which total liabilities of the Province exceed financial assets. The net debt of the Province increases with deficits and decreases when surpluses are experienced. The financial statements for 1998 indicate that net debt stands at $5,672.1 million - $137.8 million less than its 1994 level.

3.15 When the net debt is adjusted to reflect the impact of our Office's recommended accounting treatment for the harmonized sales tax transitional payment and the investment in New Brunswick Power Corporation, net debt is $6,001.1 million or $191.2 million greater than its 1994 level.

3.16 However, the New Brunswick economy has also grown. Exhibit 3.1 shows that the Province's net debt to GDP ratio *decreased* in the period 1994 to 1997 - showing the Province's increasing ability to sustain existing programs and services. In 1998, this ratio marginally increased over its 1997 level once the adjustments for the harmonized sales tax transitional payment and New Brunswick Power Corporation are considered.

Exhibit 3.1
Net debt as a percentage of GDP for the last five years [1]



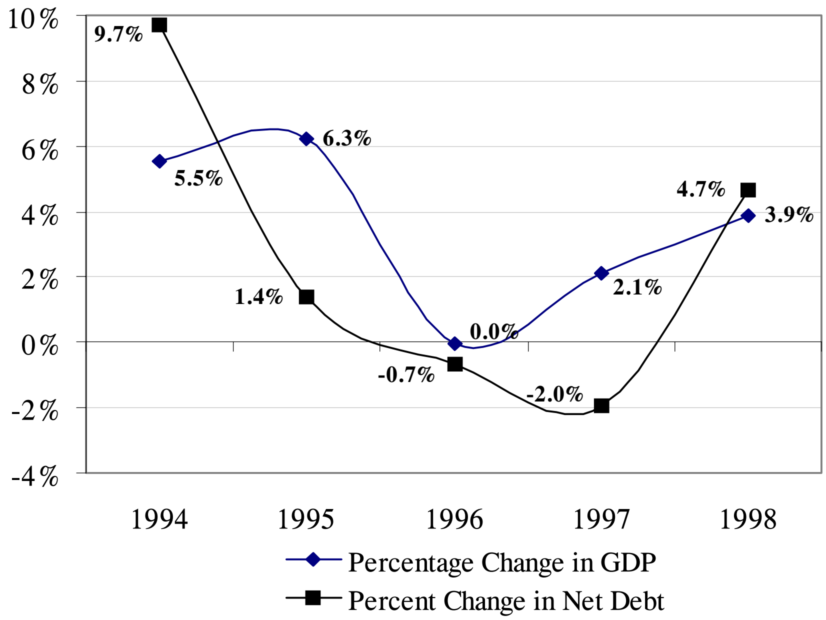
Change in net debt and GDP as a measure of sustainability

3.17 The Province can influence sustainability in two ways: by increasing surpluses (decreasing deficits) and by increasing growth in the economy. Though governments use various political, legislative and regulatory powers to stimulate the economy, the effect is neither guaranteed nor timely.

1. GDP information provided by N.B. Statistics Agency

3.18 The rate of growth in the surplus or deficit and their impact on net debt is much more controllable. Exhibit 3.2 shows that the Province has experienced economic growth in excess of growth in the net debt in three of the last five years. In 1998, growth in the net debt exceeded growth in the economy.

Exhibit 3.2
Change in net debt and GDP for the last five years[1]



Flexibility

3.19 Flexibility is the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden.[2]

3.20 Funding for programs and services is provided by either revenue or borrowing during the year. It is a useful measure of flexibility to know to what extent the Province is able to raise revenue from existing and potential sources should new commitments arise.

Cost of servicing the public debt as a percentage of revenue (or "interest-bite") as a measure of flexibility

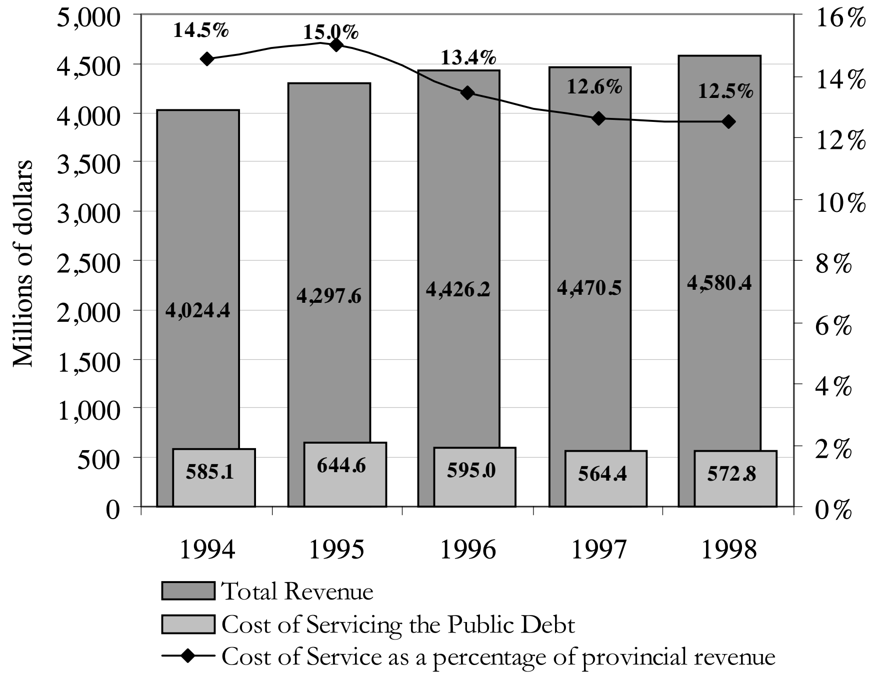
3.21 One of the most publicized factors which affects the flexibility of governments is the cost of servicing the public debt.

3.22 The cost of servicing the public debt is comprised mainly of interest on the funded debt of the Province. It also includes foreign exchange paid on interest and maturities during the year, the amortization of foreign exchange gains and losses, and the amortization of discounts and premiums which were incurred on the issuance of provincial debt. It does not include principal repayments on the funded debt of the Province.

1. GDP information provided by N.B. Statistics Agency
2. Indicators of Government Financial Condition, 1997 published by the Canadian Institute of Chartered Accountants

3.23 Exhibit 3.3 shows debt servicing costs as compared to total provincial revenue for the last five years.

Exhibit 3.3
Cost of servicing the public debt as a percentage of revenue for the last five years



3.24 This exhibit shows the cost of servicing the public debt increased in 1998 over 1997 but still remains $72 million lower than its 1995 peak of $645 million dollars. It also shows that the Province has decreased its overall "interest-bite" percentage from its 1994 level of 14.5% to its current level of 12.5%. This indicates that the Province has more of its total revenues available for current needs today than it did in 1994. This suggests increasing flexibility.

Own source revenue as a percentage of GDP as a measure of flexibility

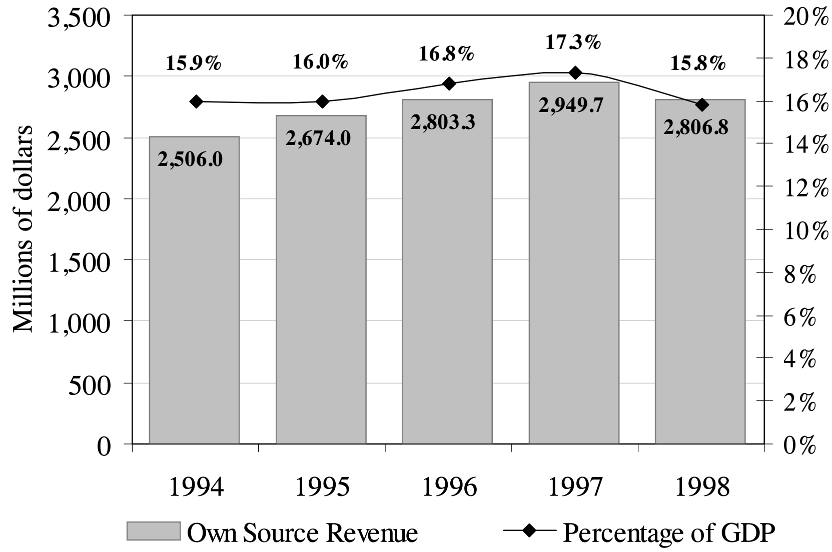
3.25 One could assume that any additional funding for new programs or services might not be possible from existing revenue sources. A reasonable alternative would be to raise revenue from new provincial sources. However, the Province is only able to extract a finite amount of dollars from the economy of New Brunswick before the economy begins to falter. Though the exact capacity of the economy to bear such a burden is not known, one can determine the relative increase or decrease over time.

3.26 Exhibit 3.4 shows the extent to which the Province has removed dollars from the provincial economy through tax dollars and user fees/licenses during the last five years.

3.27 This exhibit shows that the dollars extracted by the Province from the New Brunswick economy as a percentage of GDP gradually increased from 1994 to 1997. This indicates a decrease in flexibility. However, in

1997-98 this trend in Provincial own-source revenue reversed and own-source revenue now stands at 15.8% of New Brunswick GDP.

Exhibit 3.4
Own source revenue as a percentage of GDP for the last five years [1]



Vulnerability

3.28 Vulnerability is the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence, both domestic and international.[2]

3.29 Funding for programs and services can only come from two sources: revenue or borrowing.

Federal government transfers as a percentage of total revenue as a measure of vulnerability

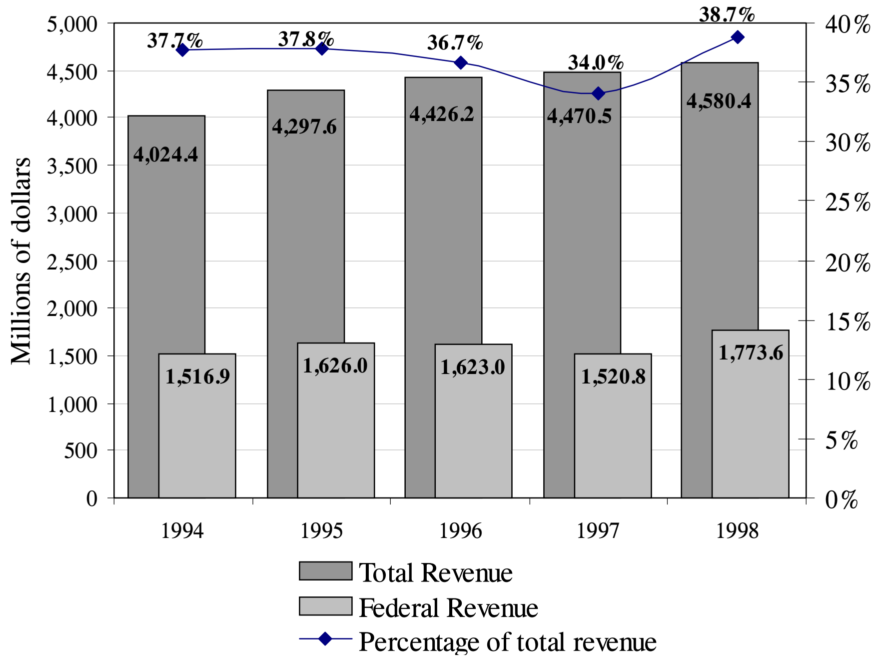
3.30 In 1997-98, almost 39% of the Province's total revenue came from federal transfers. This is significant because revenue from federal sources is not considered to be as controllable as revenue generated in the Province.

3.31 Own-source revenue is more controllable because the government can directly impact the amount generated using tax legislation as well as implementation or adjustment of user-fees/licensing rates. Federal transfers are subject to very different variables - few of which are under the jurisdiction of the provincial government. Federal fiscal policy decisions can severely impact provincial governments by determining the amount and timing of future transfers.

3.32 Increasing New Brunswick's reliance on federal transfers will leave the Province more vulnerable to variables outside of its control. Exhibit 3.5 details the Province's reliance on federal transfers over the last five years.

1. GDP information provided by N. B. Statistics Agency
2. Indicators of Government Financial Condition, 1997 published by the Canadian Institute of Chartered Accountants

Exhibit 3.5
Federal government transfers as a percentage of total revenue for the last five years



3.33 This exhibit demonstrates that approximately 39 cents of each dollar of revenue received by the Province comes from the federal government. Though small fluctuations have occurred over the last five years, this ratio has not significantly changed since 1994 - indicating no real change in the vulnerability of the Province to the fiscal policy decisions of the federal government.

3.34 In the above exhibit, both total revenue and federal revenue have been increased by $121.0 million to reflect our Office's recommended treatment of the harmonized sales tax transitional payment.

Foreign currency debt as a percentage of total debt for provincial purposes as a measure of vulnerability

3.35 When borrowing is required, there are choices to be made by the Province. For instance, if the Province chooses to issue its debt in a foreign currency instead of Canadian dollars, the Province will assume the risk of foreign exchange fluctuations. Such fluctuations can increase or decrease the amount ultimately payable in Canadian dollars for interest, and later, redemption of foreign currency debt.

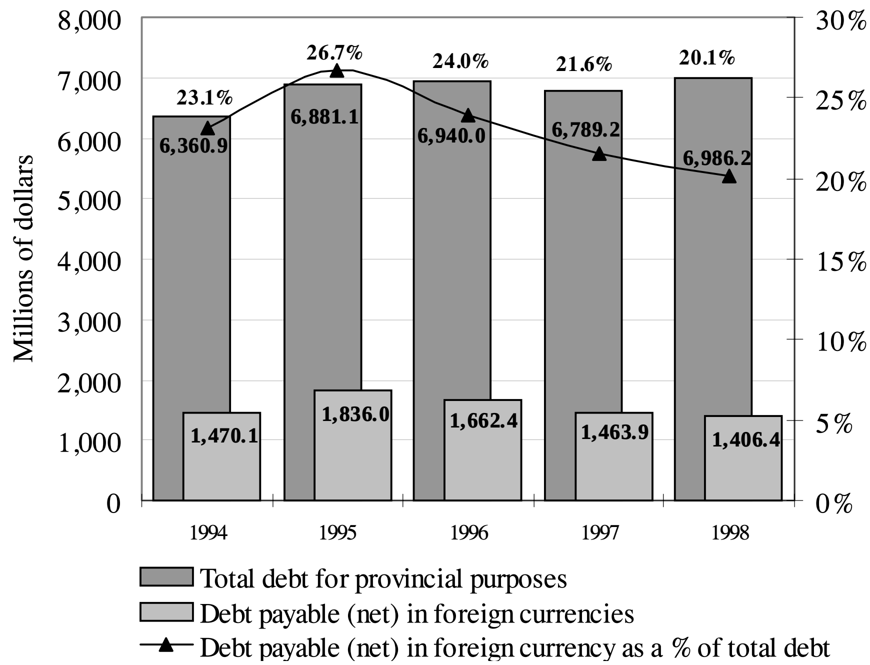
3.36 Exhibit 3.6 shows the relationship of foreign currency debt to total debt for provincial purposes over the last five years. The Province has several alternatives to reduce (hedge) the risk associated with debt repayable in foreign currencies:

- purchasing assets denominated in foreign currencies for the Province's sinking fund;
- entering into debt swap agreements which allow repayment of the debt in Canadian dollars; and

- entering into forward contracts (which allow the Province to purchase foreign currency at a stipulated price on a specified future date).

3.37 The exhibit reflects the Province's exposure to foreign currency risk after eliminating the effect of hedges against foreign currency fluctuations.

Exhibit 3.6
Exposure to foreign currency risk for the last five years



3.38 The above exhibit demonstrates that the Province's vulnerability to foreign currency risk has declined slightly for three consecutive years. In addition, the overall exposure has decreased from its 1994 level of 23.1%.

Summary

3.39 Exhibit 3.7 summarizes the financial indicators used in the chapter and outlines the impact of the two and five-year trends on the financial condition of the Province.

3.40 In general, the five-year trends in sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved.

3.41 The two-year trends for three of the six financial indicators shown below suggest an unfavourable impact on the financial condition. Much of this impact is attributable to the required adjustments to the harmonized sales tax transitional payment and the provincial investment in New Brunswick Power Corporation to comply with generally accepted accounting principles. To properly recognize the harmonized sales tax transitional payment an additional $121.0 million in federal source revenue has been recorded in our analysis of 1998. To properly recognize the investment in New Brunswick Power Corporation, $450.0 million of expenditure has been recorded.

Exhibit 3.7
Summary of financial indicators

Financial Indicator	1998	Impact on Financial Condition of the Province: 2 year trend	Impact on Financial Condition of the Province: 5 year trend
Sustainability			
Net debt as a percentage of GDP	33.9%	Unfavourable	Favourable
Change in net debt and GDP	4.7%/3.9%	Unfavourable	Favourable
Flexibility			
Cost of servicing the public debt as a percentage of revenue	12.5%	Favourable	Favourable
Own source revenue as a percentage of GDP	15.8%	Favourable	No significant change
Vulnerability			
Federal government transfers as a percentage of total revenue	38.7%	Unfavourable	No significant change
Foreign currency debt as a percentage of total debt	20.1%	Favourable	Favourable