Chapter 2
Indicators of the Province's Financial Condition

Contents

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Background

2.1 In 1997, a research report published by the Canadian Institute of Chartered Accountants (CICA) 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

2.2 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.

2.3 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 total 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*

Financial results used in analyses

2.4 In this chapter, our analyses are based on the current year financial statements as presented in the Public Accounts. These financial statements report a surplus for the year of $181.8 million. Prior year numbers used in our analyses may include restated figures obtained from the Office of the Comptroller.

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

2.5 The 31 March 2000 financial statement expenditure figures included $903.8 million relating to the capital cost of the Fredericton to Moncton highway. This transaction resulted in a one-time increase in expenditure and a corresponding increase in net debt of $903.8 million in 2000. The magnitude of this transaction has a significant impact on the analyses that follow.

Results in brief

2.6 In general, the indicators for the last eight years show that the Province of New Brunswick's financial condition has improved in sustainability, flexibility and vulnerability, with some deviations from this trend showing in 1999 and 2000. The indicators affected by these deviations showed a more positive result in 2001.

Sustainability

2.7 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]

2.8 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.

2.9 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.

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

2.11 Gross Domestic Product (GDP) is the total value of all goods and services produced in the province during a specific period. GDP is often used to measure the growth of the economy.

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

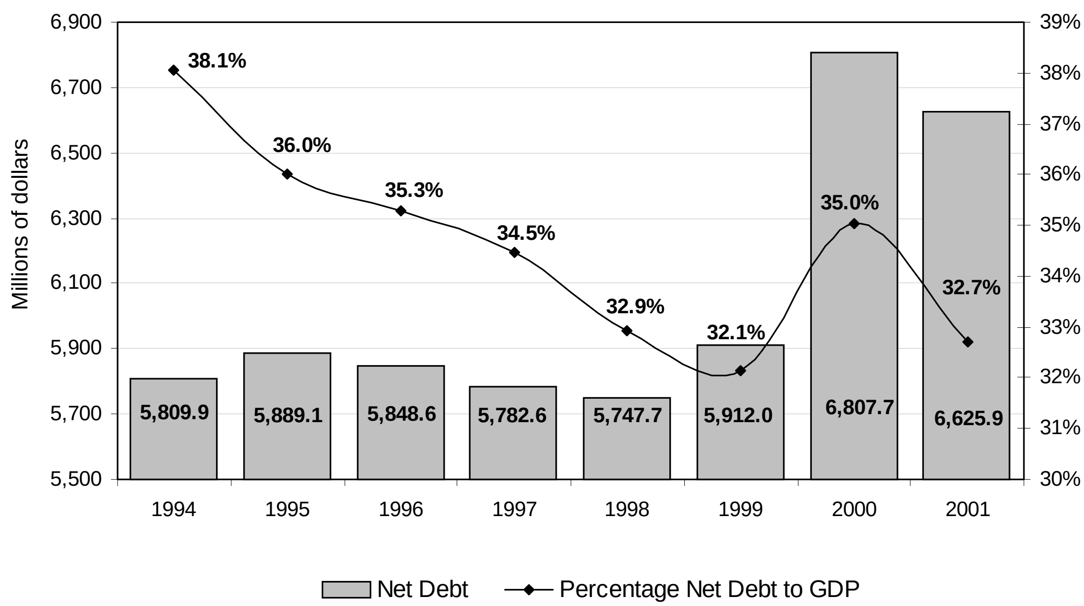
2.12 Net debt is an accounting measure of the extent to which total liabilities of the Province exceed financial assets. The net debt of the Province increases with deficits and decreases when surpluses are experienced. The financial statements for 2001 indicate that net debt

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

stands at $6,625.9 million - $816 million more than its level eight years ago, but $181.8 million less than in 2000.

2.13 The New Brunswick economy has also grown. Exhibit 2.1 shows that the Province's net debt to GDP ratio generally decreased (favourable) over the last eight years – showing the Province's increasing ability to sustain existing programs and services. The only exception to this trend came in the year 2000 as a result of recording the debt for the Fredericton to Moncton highway.

Exhibit 2.1
Net debt as a percentage of GDP[1] for the last eight years



Change in net debt and GDP as a measure of sustainability

2.14 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.

2.15 The rate of growth in the surplus or deficit and their impact on net debt is much more controllable. Exhibit 2.2 shows that the Province has experienced economic growth in excess of growth in the net debt (favourable) since 1994, with the exception of the year 2000. The deviation in the year 2000 resulted from the effects of the Fredericton to Moncton highway.

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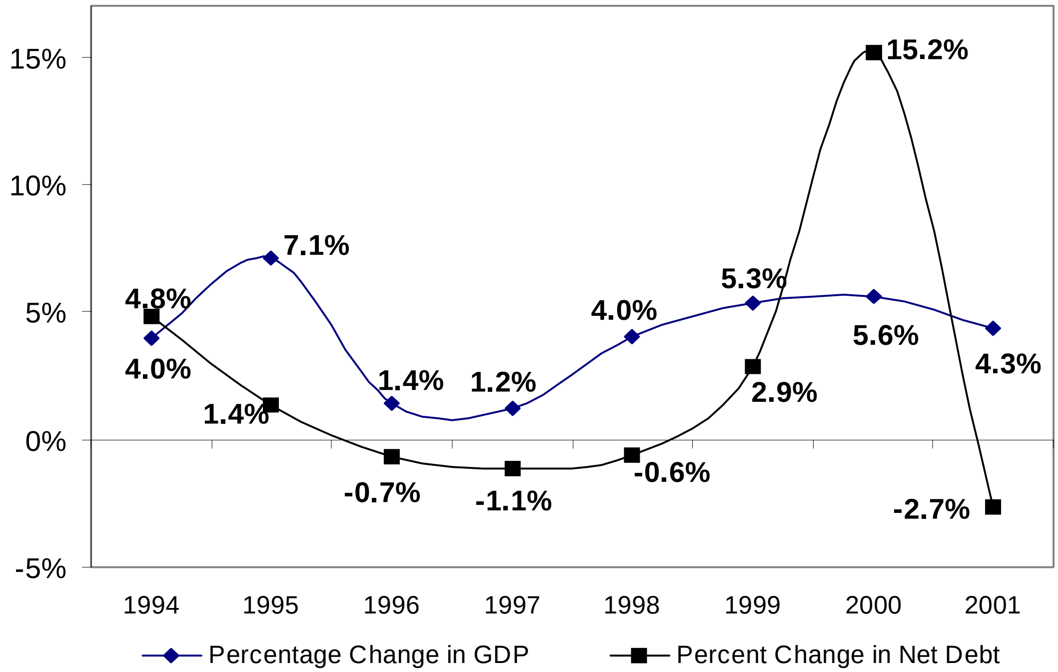
1. GDP information provided by NB. Department of Finance. Actual GDP for 1994-1999; estimated for 2000; forecast for 2001.

Exhibit 2.2
Change in net debt and GDP[1] for the last eight years



Flexibility

2.16 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]

2.17 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.

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

2.18 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.

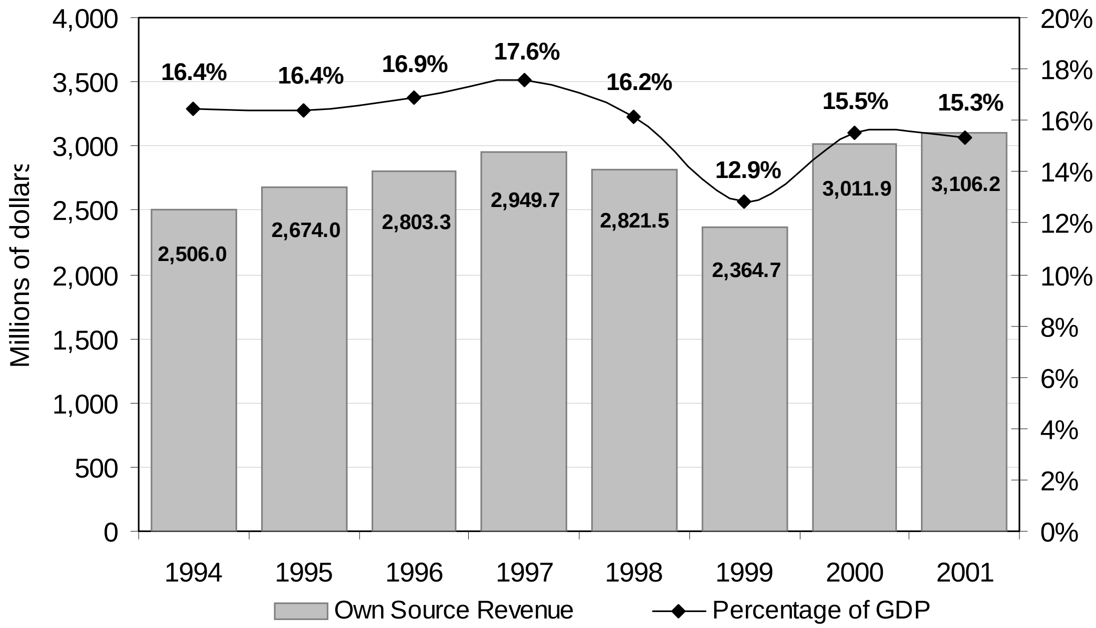
2.19 Exhibit 2.3 shows the extent to which the Province has removed dollars from the provincial economy through taxes and user fees/licenses

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

during the last eight years. This exhibit shows that the dollars extracted by the Province from the New Brunswick economy as a percent of GDP gradually decreased (favourable) in this time frame, and this is particularly true since 1997. This indicates an increase in flexibility.

2.20 The large reduction in own-source revenue in 1999 was due to a $450 million one-time write-down in the Province's investment in the New Brunswick Power Corporation.

Exhibit 2.3
Own source revenue as a percentage of GDP[1] for the last eight years



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

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

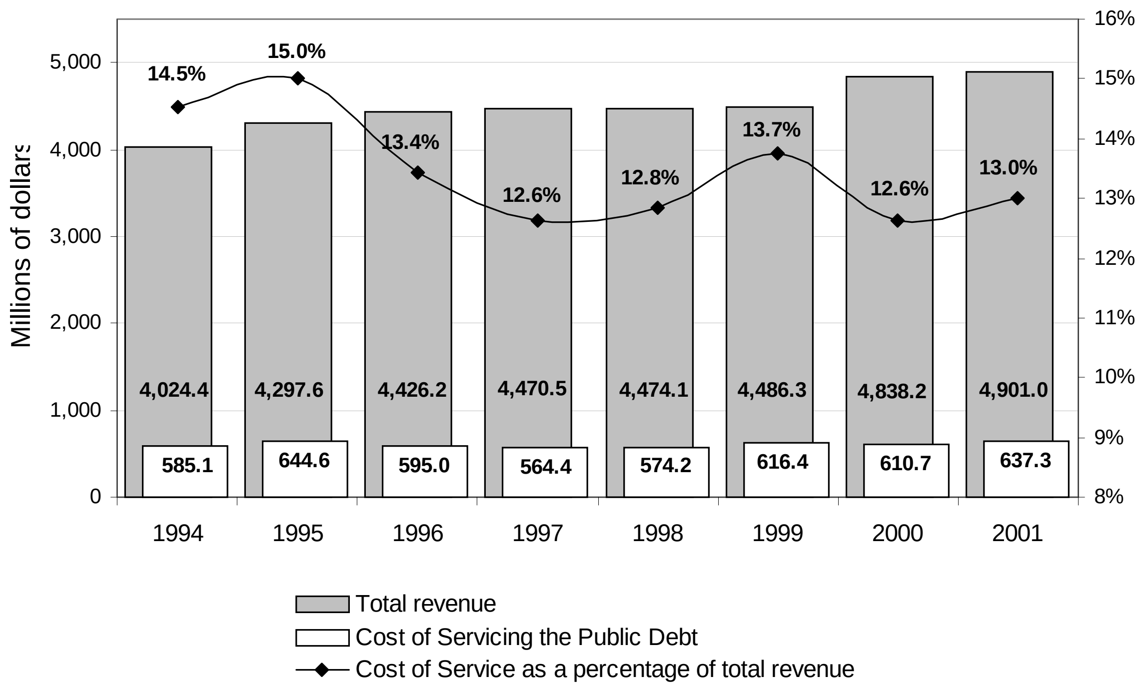
2.22 The cost of servicing the public debt is comprised mainly of interest on the funded debt of the Province. It also includes foreign exchange paid on interest and maturities during the year, the amortization of foreign exchange gains and losses, and the amortization of discounts and premiums which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

2.23 Exhibit 2.4 shows debt servicing costs as compared to total provincial revenue for the last eight years.

1. GDP information provided by N. B. Department of Finance.

2.24 This exhibit shows the cost of servicing the public debt increased in 2001 over 2000 by $26.6 million to $637.3 million. It also shows that the Province has increased its overall "interest-bite" percentage from its 2000 level of 12.6% to its current level of 13.0%. However, this level is lower than the peak of 15.0% in 1995. The exhibit indicates that, on a percentage basis, the Province has more of its total revenues available for current needs today than it did eight years ago.

Exhibit 2.4
Cost of servicing the public debt as a percentage of total revenue for the last eight years



Vulnerability

2.25 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.[1]

2.26 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

2.27 In 2001, 36.6% 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.

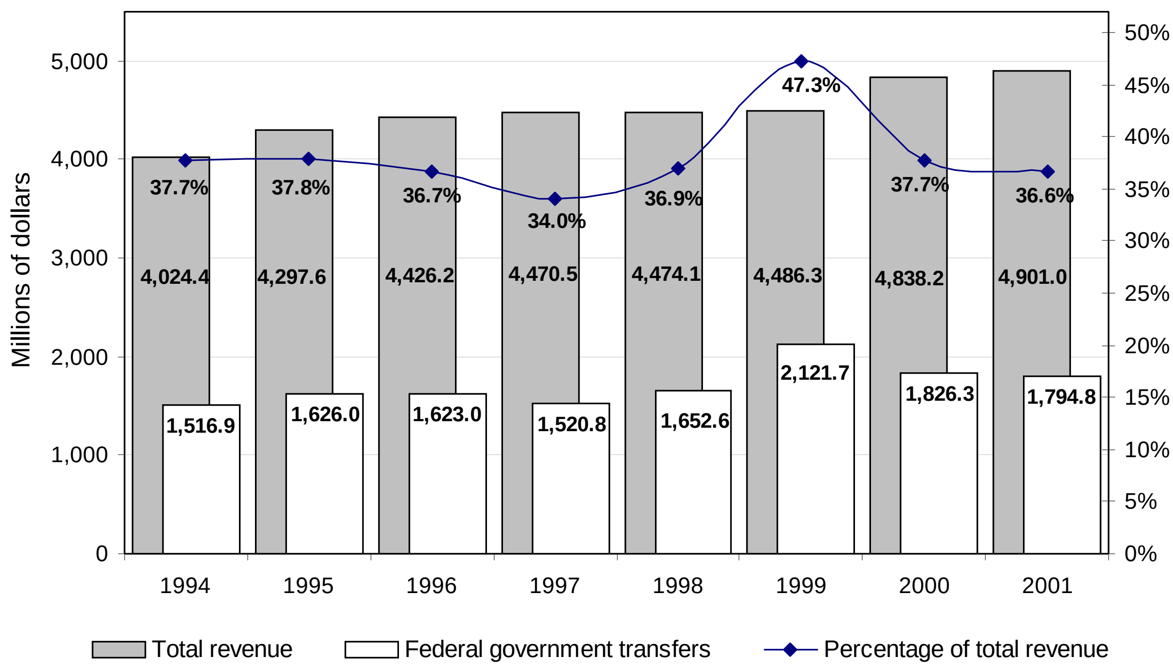
2.28 Own-source revenue is more controllable because the government can directly impact the amount generated using tax legislation as well as implementation or adjustment of user-fees/licensing rates. Federal

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

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.

2.29 Increasing New Brunswick's reliance on federal transfers will leave the Province more vulnerable to variables outside of its own control. Exhibit 2.5 details the Province's reliance on federal transfers over the last eight years.

Exhibit 2.5
Federal government transfers as a percentage of total revenue for the last eight years



2.30 This exhibit demonstrates that approximately 37 cents of each dollar of revenue received by the Province comes from the federal government. Though a significant fluctuation occurred in 1999, the trend has been generally stable. In 1997 the province's position was more favourable at 34%.

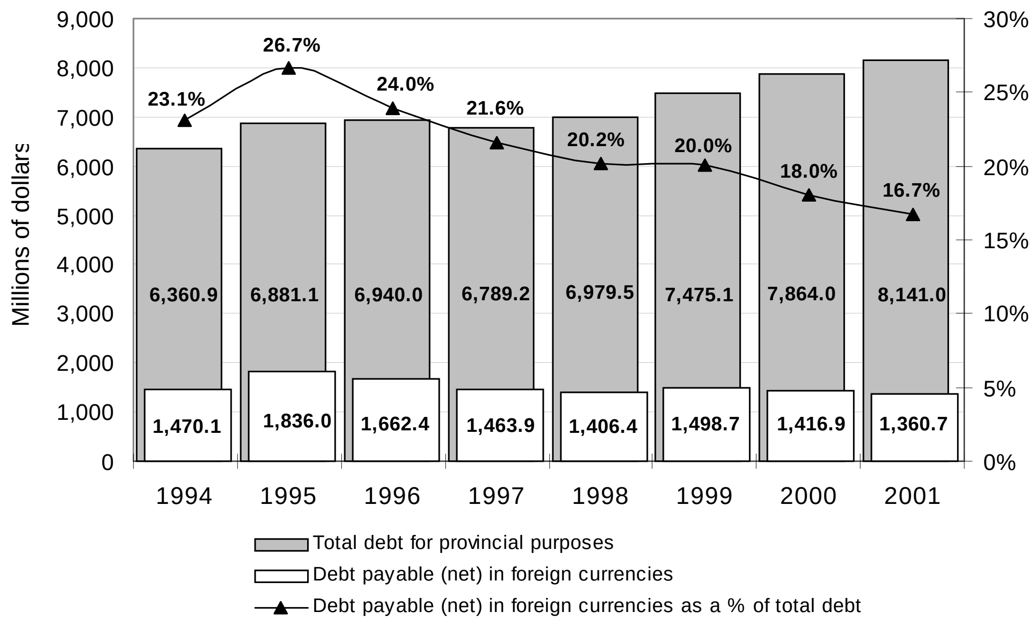
Foreign currency debt as a percentage of total debt for provincial purposes as a measure of vulnerability

2.31 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.

2.32 Exhibit 2.6 shows the relationship of foreign currency debt to total debt for provincial purposes over the last eight 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 allows 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).

Exhibit 2.6
Exposure to foreign currency risk for the last eight years



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

2.34 The above exhibit demonstrates that the Province's vulnerability to foreign currency risk has experienced continuous decline (favourable) since its 1995 peak of 26.7% to the 2001 level of 16.7%.

Summary

2.35 In general, over the last eight years, the indicators of sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved. The only exception to this trend is the percentage of total revenue received from federal government transfers, which has remained relatively stable over the last eight years.