

# Towards A Sustainable Fiscal Framework for Newfoundland and Labrador (SFF) [Paper 4]

Dr. D. May and Dr. W. Locke



## REPORT UNDER CONSTRUCTION

As has been shown, the provincial government has a fiscal problem! The problem is that our provincial government is on an unsustainable fiscal trajectory. We acknowledge this fact but have not explained it and do not intend to do so in this paper. Our position is that the problem is **solvable** with a strategy requiring resolve and commitment by all. Democratic leadership is needed for co-ordination rather than authoritarianism. Failure to act will imply a failure in responsible government at the provincial level. We argue that a strategy can be concocted using the principles and strategies that, for the most part, we have already agreed to or have accepted in the past.

### **Principles to be followed: (Don't Reinvent the Wheel)**

- **Consistent with Section 36.1 of Constitution Act of 1982**
  - “promoting equal opportunities for the well-being of Canadians”
  - “furthering economic development to reduce disparity in opportunities”
  - “providing essential public services of reasonable quality to all Canadians”
  
- **Consistent with Section 36.2**

*Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*
  
- **Consistent with Section 36 and argued by scholars is that the ultimate goal is maximizing the well-being of Canadians while considering the equality of opportunities.**
  - This general ultimate goal of promoting “well-being” was also recognized by the GNL under Brian Tobin when in 1998 it adopted the Strategic Social Plan (SSP).
  
- **Using Evidence-based decision-making**
  - Government action will be deemed necessary when there is evidence of a need for such intervention and any action (program/policy) will be adopted when

there is reasonable evidence that the action will ultimately result in the desired outcome of increasing social well-being.

- **Transparency and Accountability (Accepting)**
  - Evidence of successful outcomes will be subject of a “social audit” as suggested in the SSP and the details of which will be published and open to public scrutiny.
- **Fiscal Actions Towards Sustainability**
  - Some acceptable actions/strategies may result in losers as well as winners. Some losers will have been winners because of previous programs/policies. Both groups must be identified and the impacts on them.

## **A Vision (from the SSP(Strategic Social Plan of 19980)):**

“healthy, educated, self-reliant and prosperous people who feel empowered and supported for making full use of their innate potential and who are living in vibrant, supportive communities within sustainable regions”. To this we would add inclusiveness and considerations of equity while maintaining some of our current cultural values and embracing some new progressive values.

### **Objectives/Targets (to be chosen)**

The domains noted in the vision above and lead to **well-being** are documented in the GNL’s System of Community Accounts. Targets should be SMART, that is Specific, Measurable, Achievable, Relevant and Timed. An example of such a target is the Poverty Line set by the Government of Canada on August 21, 2018 using the MBM (Market Basket Measure) and reducing the poverty rate by 30% from the 2015 baseline by 2030 in alignment of the United Nations Sustainable Development Goals.

## **A Sustainable Fiscal Framework**

### **A Fiscal Plan**

**“The status quo is not sustainable! We must change the trajectory.”**

**The Trajectory:** A 4-5-year plan in which provincial government expenditures both public capital and public services per capita are targeted to levels comparable to those of **equalization-receiving** provinces. Consistent with Section 36.1 of our Constitution a Federal-Provincial Committee (FP S.36) would define the types of services deemed to be essential and set out **reasonable quality levels** of such services noting the impact on well-being of citizens. For example, the delivery of care to seniors and others in long-term care facilities.

With respect to **debt charges** as a % of revenues the target levels will be the average of that incurred by **equalization-receiving** provinces or about 6.5%.

## How?

*Certain policies and programs are optional choices while others seem to be essential (E) and generally agreed to. For example, dealing with efficiency and effectiveness in the delivery of health care services and those in education seem basic but whether or not we reduce expenditures in the provincial public sector by having a 4-day work week is optional (O).*

## Expenditures

- **4-Day Week for non-essential workers with a 15% reduction in pay. Similar to MB pensionable earnings are not affected.**
  - This policy was instituted in Manitoba (MB) in 1993 and called “Filmon Fridays”.
  - A review after 2 years concerning productivity levels, service delivery accessible levels and impacts on well-being of citizens and workers.
  - Optionally, after the review, to offer, as did Manitoba in 2002, a Voluntary Reduced Work Week (VRW). (O)
  
- **Workforce Attrition (O)**
  - Figure 6 clearly demonstrates that attrition in the GNL’s public sector has not substantially occurred. Fortunately for adjustment purposes, many individuals will be voluntarily retiring. Not replacing such individuals may not affect overall efficiency and the delivery of services but it may. Non-replacement is not always sensible. Replacement and redeployment of labour services must be undertaken considering the Essential Public Services
  
- **Essential Public Services Commissions (E)**
  - Health EPS Commission (E)

○

This Committee interacts with the FP S.36 Committee in helping to have input into reasonable quality of care in the health field. This Committee could set general health targets over a 5-year period. For example, the level of obesity would be reduced by 5%. It would therefore promote wellness and well as treating health issues both physical and mental. Given target levels of care and outcomes the issue becomes how is such care delivered in the most socially, cost-effective manner. Social Audit Reports would include Self-Reported Health Statistics as well as HALE data. It is assumed that primary care data would be integrated with Hospital data and long-term care data. Such data would be in the Community Accounts at the regional zone level and also at the community level.

A real problem with such committees is bureaucratic inbreeding of individuals associated with the current system. There would be 6 commissioners and a voting chair. One commissioner would be from the Province's current medical system but the Chair would be from elsewhere as would at least 4 commissioners.

#### ○ **Education EPS Commission (E)**

This commission would have the same structure as the previous committee.

In this case the committee might divide into pre-school, K-12 and post-secondary.

Once again, the Committee would strive to meet national and international knowledge and skill levels as a result of interacting with the FP S 36 committee. In today's global world international standards should be set.

For example, in Math and Composition we have certain OECD standards set out for 15 year-olds. Testing at year-end would be extended to other age groups.

Currently, there are no national or international outcome measures for many college or university students. At university, the standards in the same course may differ from professor to professor. Many professionally trained international students may be denied access to jobs in Canada because of questionable qualifications. Evidence-based decision-making dictates that hard data should exist as to the skill-levels possessed by individuals.

The public should be aware that student interests, institutional interests and public interests may not align. Transparency and objective validation is the best way to ensure that they do.

- **FP/BoC Fiscal Committee to co-ordinate sustainable responsible government and debt repayment. (E)**

This committee of 7 would be chaired by an ex-Federal Finance Minister or senior policy official such as David Dodge, Scott Clark, Don Drummond or Michael Horgan. There would be 3 provincial representatives and 3 federal representatives including a senior Bank of Canada official.

This Committee would interact with the other committees discussed above to make certain that the trajectory towards sustainable government was reasonable. In this regard, the committee would review evidence presented by the above committees that evidence for domain costs on a demographic basis (e.g. per 1000 pop) were reasonable with regard to the level and quality of services being delivered.

This committee would also review large infrastructure projects as to their contributing to net social well-being considering established cost-benefit criteria. In addition, the committee would receive and review reports from social audit committee on sectoral indicators of social well-being including poverty reduction.

The committee would review reports on economic well-being and development as well as tax fairness and public resource rent collection.

- **New Department of Employment Access and Enhancement**

An ongoing issue is the province's unbalanced approach to human capital allocation. On the one-hand "immigration" is often viewed as a demographic panacea to fiscal sustainability and economic development. Immigration is important but it is not a panacea and you must have employment (including self-employment) opportunities to attract people. On the other hand, although we invest a considerable amount of tax dollars on educating our young people, we do nothing to attempt to utilize that investment.

- **MUN**

- Like most organizations, MUN is somewhat self-interested. Its objectives may not necessarily correspond to those of the government. Its "stated" objectives might not correspond to its actual objectives as revealed by its expenditures and regulations.
- One way to proceed is to mimic the 3-Maritime Provinces' average of expenditures as a proportion of the total current expenditures after debt charges.

- Another rule might be to have a certain expenditure per Canadian resident and another for non-residents of Canada. A real problem with the first group is that many students will migrate. Does the Canadian government recognize this transfer issue?
- In any event, there will probably be substantial reductions in government transfers to the universities.
- The other side, the revenue side, is to let tuition fees move towards national levels. There will be a tendency to use student registration as the main yardstick for determining the Province's expenditures on MUN. This approach is wrong since education is only part of the complex services delivered by the university. It is true that the federal government is taking over more of the university funding related to research. As is the case with some private universities in the United States, the actual costs to the student depends on the student's income, the student's borrowing power and the household income of the student. Some poorer students may be fully subsidized. When considering the costs of education also note that the costs will be higher for those students who do not live at home.
- On the production side of delivering services. The pandemic has forced more academics into online teaching. Moving further along this innovation curve could easily involve new more cost-effective instruction models. These models might involve the use teaching assistants who hold discussion labs which video lectures can be produced by publishing companies.
- With respect to teaching, there is no independent evaluation of teaching effectiveness. Student evaluations are more directed to the subjective evaluation of the quality of service delivery rather the impact on the stock and quality of human capital.
- On the research side, the federal government has taken a much more active role in research funding including the use of research chairs. This role should be greatly expanded. At the present time, the funding of universities does not correspond to the weight of output delivery.
- In any event, cost/benefit analysis should be performed for each type of service noting that such analysis is different than economic impact analysis.

- **Crown Corporations including expanded role for NALCOR & state equity in natural resource exploitation.**

Nalcor Energy has taken the approach of taking an equity position in oil and gas developments. This follows the Norwegian model developed by Norsk Hydro (later Statoil, later Equinor) and the Canada Hibernia Holding Corporation. While intuitively this resource development and exploitation strategy sounds reasonable, people at Nalcor Energy, specifically Jim Keating would be better able to articulate the benefits.

This approach leads one to question why isn't a state equity (state-owned enterprise (SOE)) used in other resource developments? The answer is that in the case of water power and hydroelectric generation it is and is used by our Province.

- **State Equity in Innovation and Industrial Development**

China in the last thirty years has remarkably reformed the nature of its State-Owned Enterprises or SOE's. Huawei is a good example of an innovative new firm engaged in international trade and being a dominant business force. It has perhaps engaged in questionable business practices, say, for example in the case of Nortel. Still, the company has engaged responded to market forces rather than older SOE's which responded to bureaucratic controls.

Both the Federal and Provincial Government have supported business development and innovation through grants and loans. There are three issues which may be of concern. Firstly, these funds may be an income transfer to upper income individuals. Secondly, some entrepreneurs may become "grantpreneurs". Thirdly, some successful local firms may "migrate" to larger growth centres. It may be useful to study the longer-term impacts of government transfers to these firm to determine the winners and the losers in a cost-benefit sense.

The question to be answered is, "Would it make sense for governments to take a passive equity stake in such companies following the Chinese government position?" It should be noted that Canada's BDC (Business Development Corporation) does have a venture capital arm which invests as does the Quebec government. All that is being suggested here is that this approach be investigated and assessed.

One last issue is the public and often-heard call for "diversification". Again, many individuals see economic diversification as the path to economic development when a downturn in the economy occurs. Two observations should be made. If the downturn is due to a slump in some staple commodity such as oil or fish then this is a natural occurrence when producing and exporting this type of product. Secondly, markets and the technological developments that occur in such markets naturally guide diversification. Government intervention simply uses scarce resources although it does provide employment for civil-servants. Our advice is that scarce resources devoted to diversification could be better employed to serve the public good.

## **Revenues: Taxation levels may be raised to support expenditures efforts above efficiency levels as set out previously. Trade-off competitiveness**

- There are several issues which should be addressed:
  - Firstly, the desire for provincial public goods and/or services may vary from province to province because of differences in tastes/preferences. For example, we may increase taxation in order to provide daycare spaces or to support long-term care beyond levels and quality currently supported by all province standards.
  - Secondly, in support of income equality and redistribution most of us would support the principle of poverty reduction. We showed the path towards accomplishing this objective in our CARE paper, “Promoting Tax Fairness ...” which was undertaken at the request of Tom Marshall.

As discussed in some of the CARE videos, the accepted manner developed by economists for example, in Canada, the USA, in Britain and by the OECD to define the percentage of the population in the middle class or living in poverty is to adopt an income approach and more specifically, use the “disposable” income approach for households. Disposable income is that income coming into households after transfers are added to market incomes and then most taxes, including income and labour taxes such as EI premiums are deducted. Although such income is shared amongst members of the household in the sense that all members live in the same house, not all households are the same size. This disposable income is “adjusted” to take account of differences in household sizes and then this adjusted income is attributed to each member of the household.

In August 2018, the Government of Canada adopted the Market Basket Measure (MBM) for defining the poverty threshold. The measure had been developed around 2001 as a result of a federal-provincial committee who tried to answer the question: how much disposable income would it take a family of 4 to provide the necessities of life and to be able to feel included in mainstream society. The resulting income can then be adjusted to consider a single individual. It is then relatively straight-forward to count the number of individuals or the proportion of the population of a province, community, or neighbourhood living below the MBM threshold or living in poverty. The results are shown for NL in its Community Accounts for all of its communities and most years up to 2017.



A major problem is that our income tax system designed in 1970 is based on an older concept of the family in which a head provided the main source of income, labour earnings and was responsible for dependents. Happily, this concept has evolved. However, our 1970's income tax base concept is inconsistent with how we measure poverty or the middle class. Is it time to convert to a more modern, updated concept of the family household? We believe that the answer is "yes". If we don't inject some consistency into our policy indicators we will continue to tax families into poverty.

There are challenges here for both the federal and the provincial government since the province's income tax must follow the federal tax bases but not its rates under our current tax agreements.

A note of caution and that is, economists have acknowledged as has been discussed already that economic well-being is based on consumption and not income. Work is already occurring in this area but more data should be collected. The implication is that those income comes from cash may and should find themselves paying higher taxes. Another change associated with this approach is to concentrate on overall consumption patterns at the international level.

- Income inequality in NL is far less than in the United States and even less than in Canada generally. Real inflation-adjusted incomes for households adjusted for size have risen over the two decades between 1997 and 2016. Much of this remarkable increase has been due to the direct and indirect impacts surrounding oil development and production. What, to us, is equally surprising is how many of these same households are not net contributors to the federal or provincial governments. In 2019, about one-half of these households received more in transfers than they pay in taxes both direct and indirect. In 2020 this fraction will no doubt have grown due to the pandemic and heavy federal borrowing to finance transfers to counter the negative economic impacts of the economic slowdown and the major retraction in many of our industrial and occupational labour markets. While the public generally supports such measures, we wonder if taxes are too low for the many households who have standards of living above the poverty line. We acknowledge tax/expenditure competition amongst provinces and also acknowledge that the call for taxing the super-rich is more relevant in much of the United States or Britain than it is in Canada.

We would argue that a study is needed that examines households who are net recipients with the idea of a MTR (Minimum Tax Rate) on household members who adjusted disposable income is above the poverty threshold. The MTR rate might itself be graduated. (O)

- The pandemic as noted earlier has exposed a number of fault lines, for example, in the quality of care provided in long-term facilities. In general, we have found that the negative labour-market and any associated negative income impacts caused by the pandemic are best handled primarily by the federal government although these areas are primarily the responsibility of the provinces.

The federal government has been moving in the direction of taking responsibility for poverty reduction for example through the Canada Child Benefit and the Guaranteed Income Supplement for Seniors. In addition, there is the GST/HST credit and its supplementation under COVID-19 programs. We would suggest that the Federal Government take over all anti-poverty transfer programs over the next 5 years. The non-income assistance offered to families through social services could still be in place for further study. Provincial anti-poverty programs would be discontinued permitting more co-ordinated and effective targeting. Funds saved by this realignment might be redirected towards assuming greater responsibility for long-term care under fed/prov. consultation. (O)

- Muskrat Falls.

A legitimate concern is that **if** the province is committed to holding residential electricity rates at current levels then the money must come elsewhere to meet the debt charges and additional operating costs. The dream is that Ottawa will provide funding. One might argue that some funding, about \$200 million each fiscal year, is being provided by Ottawa over the medium term through the 2019 altered Atlantic Accord. If the province has to accept these charges as part of its expenses then they would crowd out other essential service expenditures. As noted earlier, the “benefits” of spending money on this large infrastructure project has already had a “multiplier” stimulative impact on the provincial economy through wages and salaries and business profits which would also have an immediate impact on government revenues. Naturally, one also has to consider the increase in benefits as a result of hydro-electric consumption.

The argument is made that residents cannot afford any increase in current rates even though they are often below those that exist in other cities such as Halifax or provinces such as Saskatchewan and are currently below the Canadian average. In our view, this argument has some merit for households below the MBM poverty line. This issue could be handled in two ways. Firstly, the MBM could be updated to account for these charges and as already suggested the federal government would be responsible for some modernized tax/transfer system discussed earlier. An alternative would be for Nalcor to directly cover such costs from its profits in its subsidiary, Nalcor Energy.

As for other residents who are not in this category, for those in the lower middle income range they could be charged the average Canadian rate, presently around

17.4 cents/kwh while Nalcor Energy covering any shortfall. All other household would be charged the full recovery rate. Another possibility would be to keep the option for the households in poverty and charge all other households at the full rate but adjust the basic amount that households can deduct when calculating their income taxes. (0)

○ Property Taxes: (0)

It has been documented that some households do not pay property taxes. It is suggested that a minimum provincial property tax on all housing including vacation/seasonal housing be instituted but that houses paying above this minimum rate at the municipal level not be subject to this rate. Any household whose members are below the MBM would not pay property tax and any household which by virtue of the property tax would fall below the MBM poverty line would have that portion taking below the poverty line forgiven.

Property taxes on second homes, vacant land and vacation property would pay property taxes at 1.25 times the normal rate.

All primary residences whose sale price or transfer price is above \$250K but below \$500K shall have ½ of the capital gains subject to an “income” tax payable in equal annual instalments over 10 years. Any primary residence whose value on transfer or sale is above \$500K will be subject to a 100% capital gains income payable in equal annual instalments over 10 years. All non-primary residence property should be subject to a 100% capital gains as income.

○ Resource Rents (0)

While the royalty rates associated with the production and sale of quite complex and consistent with other jurisdictions such as Norway and China, the Government of Newfoundland and Labrador has taken an equity position in such development, the same is often not true of some of the other resources. In fact, many of these resources have traded off resource rents for jobs or other income associated with development or production. With the looking decline in our population and the probability in some occupations of labour market shortages there is less of a need for such trade-offs. Accordingly, it is recommended that the government consider the possibilities of resource rent collection on new developments and enterprises. Such developments would extend to the fisheries where the rents are often encapsulated in the value of a license being sold. While such capital gains in the value of a harvesting license may be passed from one resident to another this is not necessarily the case.

In the case of the province’s equity position in a resource such as hydro-electric generation in such cases where the resource is sold to residents then the resource

should be sold by a Nalcor enterprise at “cost” without a return on equity but including any capital cost allowances.

## Methodological Issues:

Evidence-based decision making requires evidence. The idea of widely treating individuals using a “vaccine” to treat COVID-19 that includes never-tested ingredients or ingredients used to treat other illnesses seems likely to end badly. Yet, we often take the approach above with respect to government policies or programs. The scientific methodology used to evaluate an economic treatment or medical treatment has some common features that were well-established during the 19<sup>th</sup> Century.

Carrying out such evaluations requires technical expertise and knowledge which may not normally exist in smaller provincial governments.

In any event, as with any study, scientific methodology requires that any analysis be subject to review and scrutiny which implies that any program and data used to produce results should be available upon request. In short, the results should be replicable. That standard is the one followed in this paper.

## Social Well-Being Accounts and Social Audit Commission (E)

We have tried to stress that the ultimate goal of any government policy or program should be to maximize the long-term well-being of society. This is a difficult goal to achieve but it does lead us to focus on “outcomes” and the subjective and objective indicators that may be associated not only with well-being but also with those domains that determine well-being. The framework that we would follow has already been established by the Government of Newfoundland and Labrador and has generally followed and advanced by the OECD in its work on this subject. The Community Accounts produced by the Newfoundland and Labrador Statistics Agency follows this framework which was started in 1998 and is to our knowledge, the only system that takes a community up approach to the provincial and then national/international level. The first and only Social Audit publication, entitled “From The ground Up” and published in 2003 did not present any findings of a social audit performed on some policy or program. Instead, using provincial data it presented a prototype of how to use indicators to describe the social landscape at the province-wide level. In medicine, it would be similar to reporting the number of active COVID-

19 cases. This is always a useful exercise in order to determine if social action is necessary.

## Summary Remarks

This paper has argued that the Government of Newfoundland and Labrador has a serious structural fiscal problem which implies that it may not be able to meet its debt charges or financial essential public services. A paradox arises as to why should this situation occur when this government is the most well-off of all the provinces in Canada with respect to its own-sourced revenue capabilities or at least, this was the case before the severe drop in oil prices. We also argue that, while this drop in oil prices has aggravated the fiscal situation the structural problem existed well before this fall. The paradox can be explained by several factors creating ideal conditions for this storm including volatile commodity prices, wage rigidities, and cost over-runs in infrastructure projects along with other factors. The solution we argue can be sensibly handled. However, the increased standard of living that we have enjoyed resulting from a fiscal imbalance of expenditures being greater than revenues and this imbalance being financed by a run-up of the provincial debt must now be addressed by a decrease in our consumption or standard of living to pay off the debt and associated charges. We would argue that the real challenge is not so much associated with the economic factors as it is with the political factors. Governments are elected and mostly follow the will of the general electorate. Failure to manage an economic problem may simply be a lack of support of cabinet actions by caucus members who in turn depend on support from their constituents. The political challenge then is to obtain the support of the general populace for policies and programs that will result in economic and social losses. Moreover, these losses will be greater for some households than others. Some programs to mitigate these losses for the poorest of families are possible. Innovative restructuring of our essential services might in fact increase social well-being. The failure to manage the problem ourselves because of political forces is understandable but it does signal a failure of responsible and independent government if we are forced yet again, to depend on others thereby effectively generating regressive transfers at the provincial level.