Assessing Prince Edward Island's Fiscal Situation

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Introduction

Prince Edward Island, along with almost all other provinces, is being forced to reassess its fiscal situation. The public accounts released this past fall show a substantial increase in the deficit than was budgeted for 2002-2003. This deficit continues a trend that has occurred since the last budget surplus of 1999-2000 and is forecast to continue for 2003-2004. The provincial government has solicited input from Islanders on how the province should address PEI's fiscal situation. To assess PEI's financial position, it is necessary to examine the province's ability to carry the deficits in the context of long-term debt management. It is also important to examine how the province got into this position. This will provide insight into the reasons for the current fiscal challenges.

The province's financial management plan must be based on an assessment of the real fiscal situation. The plan should address the province's fiscal concerns while meeting the province's obligations to its citizens to provide investments in programs and infrastructure that support social and economic development. This paper places the current deficit in the context of the province's level of expenditure, its revenue raising capacity and its debt load. The primary objective is to contribute to a reasoned public debate on the fiscal issues facing PEI.

PEI's Current Revenue, Expenditure, and Deficit

Deficits are not inherently a cause for concern. Unexpected increases in expenditure may justifiably contribute to an unplanned deficit. Economic slowdowns can contribute to deficits, as revenues decrease due to less economic activity and expenditures rise due to increased demand on government services, as more citizens are left unemployed.

The current situation is causing particular concern because provincial governments are once again facing the level of deficits they thought they had left behind in the 1990s. All provinces, with the exception of Alberta, are facing deficits this year (3 provinces had to use their reserves from previous years to balance their books[1]). The provinces are dealing with a number of challenges including decreased revenue due to past income tax cuts; decreased federal investment in key areas such as health care and education; and disasters such as hurricanes, droughts and forest fires. The provinces are also facing slower overall economic growth.

PEI's finances have been hard hit by these factors. The province's consolidated public accounts for year-end 2002-03 show a deficit of $83.8 million. The deficit is the result of an overall decrease in revenue of 2.7%, a 2.87% increase in program expenditure and a 1.87% increase in total expenditure over year-end 2001-02 (Table 1).

Revenue

As shown by Table 1, overall revenue decreased by 2.7% between 2001-02 and 2002-03. Own-source revenues increased by slightly less than 7% ($40 million). But the largest component of this decrease was due to a drop of more than 16% in federal transfers. Federal transfers comprise 35% of the province's total revenue. The decrease in transfers resulted in $67 million decrease in revenue for PEI.

Expenditures

Program expenditures increased by almost $26 million (2.87%) – just slightly more than the rate of inflation of 2.71%. However a close examination shows that many departments actually decreased expenditures in 2002-03. The total of all expenditures, apart from those of the Department of Health and Social Services, in fact *decreased* by $16 million.

The major source of increased expenditures in PEI continues to be Health and Social Services with an increase of 11% or $42.6 million. Health and Social Services comprise 45% of the province's total program expenditure. PEI faces the same challenges as other provinces in coming to terms with health care expenditures in the context of insufficient federal funding, as noted by the Romanow Commission on Future of Health Care in Canada.[2]

For 2002-03 it is clear that the major contributors to the province's current deficit were the decrease in federal transfers and the increase in health expenditures. It is worth noting that more than 75% of the province's expenditures are allocated to three key areas – Health and Social Services (45%), Education (21%), and Transportation and Public Works (10%) – all areas that are essential to the long-term economic and social development of the province.

Provincial Debt

This is the third straight year that PEI has incurred a fiscal deficit. The deficit incurred in 2002-03 is higher than in the previous years. The $83.8 million deficit has contributed to a net debt of $1.165 billion in 2002-03. The level of provincial debt relative to the size of the economy (debt to GDP) gives us an indication of the province's ability to manage its debt load. As of March 2003 PEI's debt as a percent of GDP stood at 30.95%. In spite of the deficits incurred over the past 3 years the ratio has stayed stable.

Table 1
PEI Revenue and Expenditure Consolidated

	2001-02	2002-03	2002-03 less 2001-02	% change
REVENUE				
Taxes	**459657**	**494536**	**34879**	**7.59%**
Licenses and Permits	16853	17934	1081	6.41%
Fees and Services	37366	36872	-494	-1.32%
Sales	32669	34885	2216	6.78%
Investment	13943	15228	1285	9.22%
Other Income	10563	14576	4013	37.99%
Government of Canada	410362	343352	-67010	-16.33%
Capital	589	2091	1502	255.01%
Sinking Fund Earnings	20674	17231	-3443	-16.65%
Govt. Business Enterprises	1373	324	-1049	-76.40%
Total Revenue	**1004049**	**977029**	**-27020**	**-2.69%**
EXPENDITURE				
Agriculture and Forestry	50842	35317	-15525	-30.54%
Attorney General	29853	30720	867	2.90%
Auditor General	1138	1019	-119	-10.46%
Community and Cultural affairs	20550	20728	178	0.87%
Development and Technology	60010	58979	-1031	-1.72%
Education	195093	198772	3679	1.89%
Executive Council	2918	2952	34	1.17%
Fisheries Aquaculture and Environment	9491	8397	-1094	-11.53%
Health and Social Services	375217	417901	42684	11.38%
Legislative Assembly	2922	3119	197	6.74%
Provincial Treasury	29169	35795	6626	22.72%
Public Service Commission	8755	5936	-2819	-32.20%
Tourism	18036	20148	2112	11.71%
Transportation and Public Works	101802	91984	-9818	-9.64%
Total Program Expenditure	**905796**	**931767**	**25971**	**2.87%**
Pension and Retirement Benefits	28430	25997	-2433	-8.56%
Interest Charges on Debt	107113	103075	-4038	-3.77%
Total Expenditure	**1041339**	**1060839**	**19500**	**1.87%**
Surplus (Deficit)	-37290	-83810		124.75%
Net Debt	1082069	1165879		7.75%
GDP (000)	3480000	3767000		8.25%
CPI(1992)	114.6	117.7		2.71%
GDP (real, in 000)	3169000	3348000		5.65%

Source: PEI Public Account 2002, Public Accounts

Table 2
PEI Debt to GDP

Year-end	1999-00	2000-01	2001-02	2002-03
Debt to GDP	31.83%	30.78%	31.09%	30.95%

Source: PEI Public Accounts and Statistics Canada

Prince Edward Island's debt to GDP ratio compares favourably with other Atlantic provinces. The ratio for PEI stands at about the average for all provinces other than Alberta (Figure 1).

The deficit for 2002-03 is not a cause for alarm. For the most part the causes for the deficit are beyond the control of the provincial government. The increased expenditures in Health and Social Services are essential to the well-being of Islanders and are needed investments in the province's future. The decrease in transfers apparently caught all provinces in Atlantic Canada by surprise. The current deficit is well within the government's ability to carry the debt, certainly within the short term. To maintain this situation the province would need to ensure that revenue is increased at the same rate as expenditures increase.

This situation would maintain a debt to GDP ratio of about 30-31%, but could also leave the province vulnerable to substantial slowdowns in economic growth. The current trend indicates that some caution is needed in long-term fiscal management. A fiscal plan is required that ensures sufficient funds are available to support the province's programs and services, and to invest in infrastructure, while limiting the long-term impacts of slower economic growth.

What are the Causes of PEI's Current Fiscal Situation?

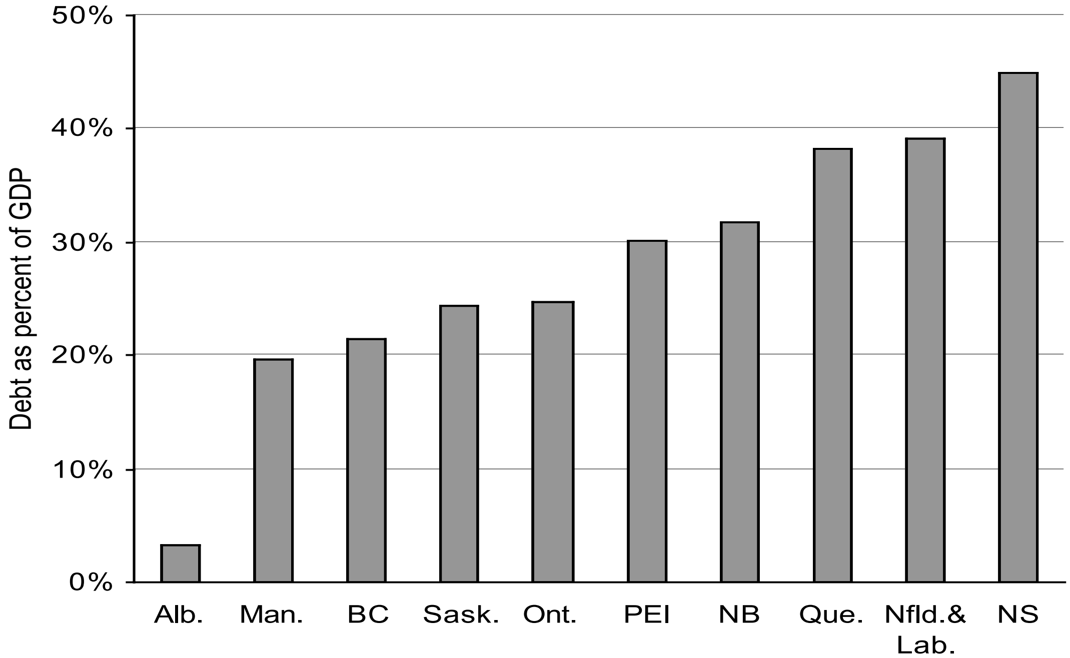
Over the last decade Canadian federal and provincial governments have chosen to address their fiscal challenges by cutting programs and services. Governments have depicted their fiscal problems as being the result of over-expenditure. But many of these same governments have followed-up on the decreases to expenditure by cutting revenue through income tax cuts.

Program cuts go after the wrong target. The consequent underfunding of programs and services undermines provinces' social and economic development. At the same time, tax cuts undermine a government's ability to manage the province's finances and make needed investments. Managing PEI's financial challenges requires a fiscal plan that is based on the realities of the current situation and an examination of past fiscal policies.

Program Expenditure Trends

Program expenditures over the past 2 years were not out of line with the costs of maintaining the existing level of services. Expenditures have on average increased by 2.4% over the past 2 years (2001-02 and 2002-03), but have not kept pace

Figure 1
Provincial Debt as a Percentage of GDP, 2002-03



Source: TD Economics, Taxpayer-Supported Debt, January 2004

with the average rate of inflation (2.7%) over the same period. Overall the growth in expenditure did not come close to keeping pace with the average PEI rate of economic growth over the past 2 years (5.4 % nominal).

The experience of the past 2 years continues a trend that started in 1990. During the 1980s program expenditure relative to the size of the economy remained stable, but since 1990 it has decreased from 30% of GDP to 24% in 2002-03 (see Table 3). So, while the need for services and infrastructure continues to increase, financial support for such programs has not kept pace. The failure of program expenditures to keep pace with economic growth results in a strain on existing services and undermines the government's ability to make essential infrastructure investments. The investments needed to support a growing economy are delayed resulting in long-term pressures on expenditure.

Does Prince Edward Island Spend Too Much on Programs?

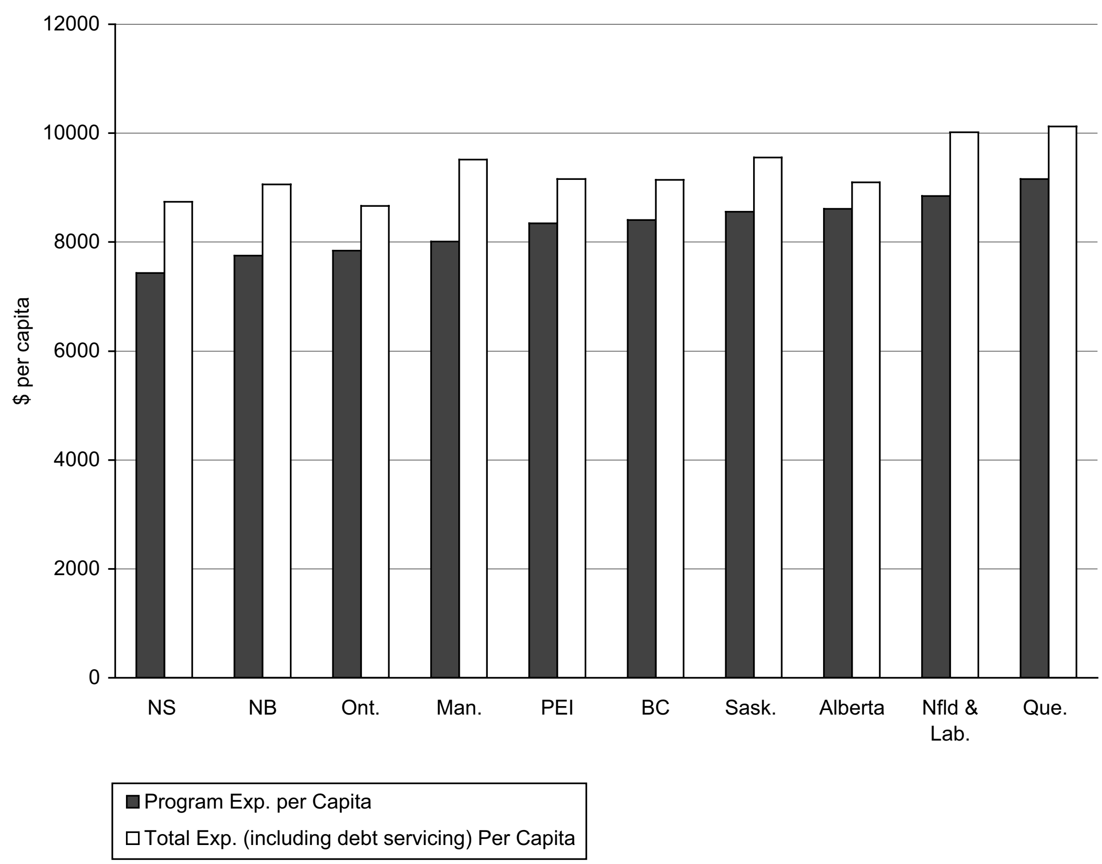
How does PEI's level of program expenditure compare to that of other provinces? Local governments operate under the jurisdiction of provincial governments and the division of responsi-

Table 3
Total PEI Program Expenditure as a Percentage of GDP (million $)

	GDP (nominal)	Program Expenditure	Program Expenditure
1981-82	1067	319	30%
1985-86	1445	437	30%
1990-91	2169	632	29%
1995-96	2662	669	25%
2000-01	3349	855	26%
2002-03	3748	884	24%

Source: Federal Dept. of Finance Fiscal Reference Tables and Statistics Canada Table 384-0013

Figure 2
Expenditures Per Capita, Local and Provincial Government, 2002-03



Source: Statistics Canada (385-0001)

bility between local and provincial governments varies between provinces. An accurate comparison across provinces of program expenditure requires an examination of provincial and local government expenditures in combination.

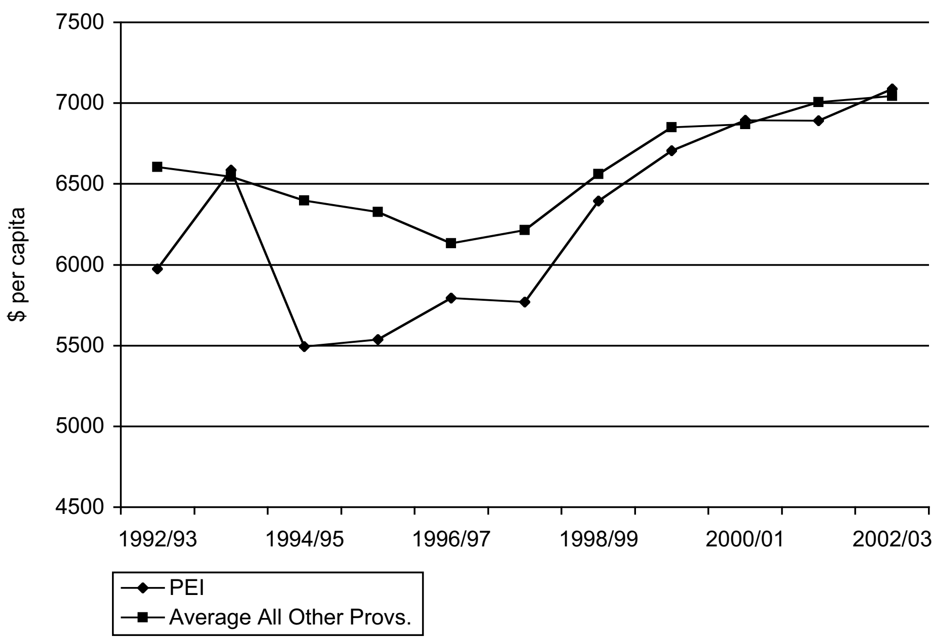
PEI's per capita program expenditure of $8,343 in 2002-03 is at about the average of all other provinces (6th position). Bit, over the past decade PEI has tended to spend less per capita than the average of all other provinces. Over the past 5 years it has spent the least or second least of all provinces. When we include debt servicing PEI moves from 6th place to 5th in terms of total expenditure per capita in 2002-03.

Figure 3 compares Prince Edward Island's real per capita program expenditure (adjusted for inflation) to the average of all other provinces. Overall the data confirm the trend towards decreased expenditures during the 1990s and an increase in per capita expenditure as provinces are forced to make up for cuts to expenditure during the middle of the decade. PEI was substantially below the average of all other provinces during the period 1995 to 1998 and this was followed by increases. The recent increases in per capita spending are indicative of the expenditure pressures faced after years of insufficient investment in programs, services and infrastructure. The province will find it difficult to decrease expenditures as it has been spending too little on services for some time and is only now beginning to catch up.

Program Expenditure and the Provincial Economy

Program expenditure accounts for about 25% of provincial GDP. Provincial government expenditure plays a greater role in the PEI economy than in any other province (Figure 4). Government operations in a province with a relatively

Figure 3
Local and Provincial Real Per Capita Program Expenditure, PEI and Average of All Other Provinces



Source: Authors' calculations based on Statistics Canada, Tables 385-0001 and 384-0013 small population and economy provide specific challenges. PEI is less able to achieve the same economies of scale as other provinces in the provision of services.

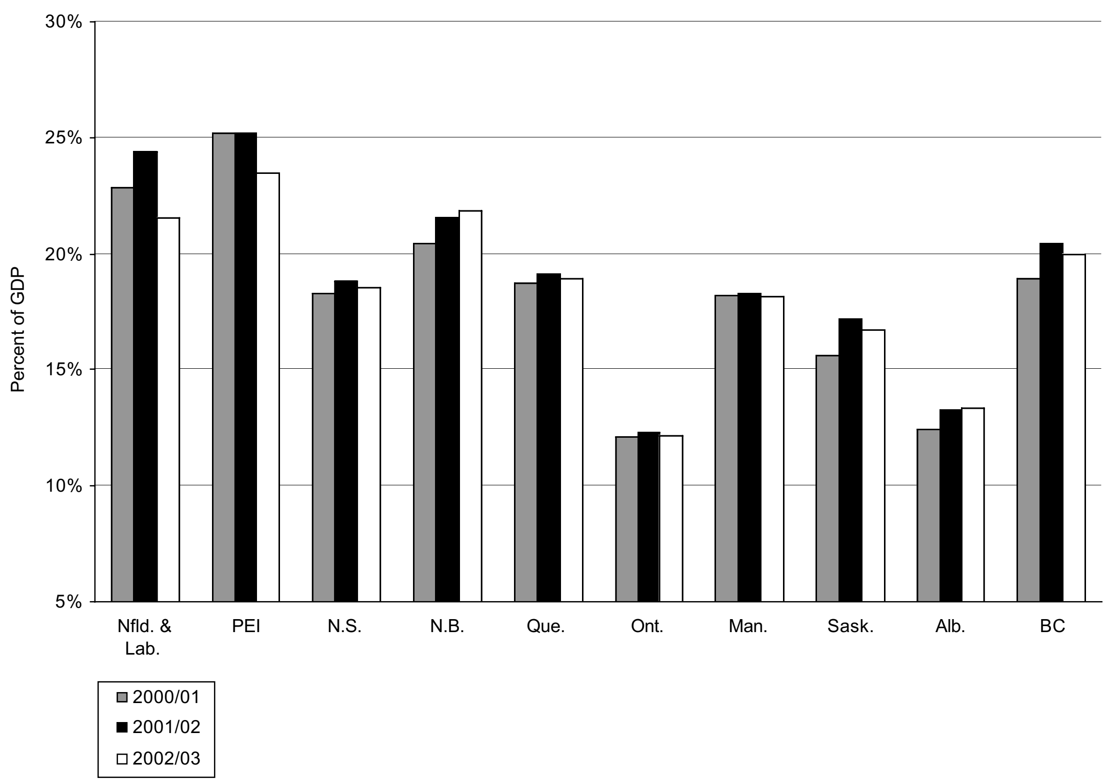
This has implications for attempts by the provincial government to address its fiscal challenges. Resolving the problems through major cuts to program expenditures will have significant negative social and economic impacts. Such cuts would slow economic growth and result in decreased government revenue, further exacerbating the current financial difficulties. These cuts would also have a negative impact on communities by decreasing the economic activity that results from public sector workers spending money in their communities.

Program cuts would decrease the overall standard of living by undermining services provided to communities and businesses, and to individuals in need of support. The cuts would place undue hardship on the most vulnerable citizens – such as low income households, children and youth and Islanders suffering from ill health.

Revenue: Federal Transfers

The provincial government derives revenue from two major sources: transfers from the federal government and own-source revenue derived within the provincial economy. The PEI government has had decreasing revenue to work with relative to the size of its economy and the demands

Figure 4
Program Expenditure as a Percentage of GDP

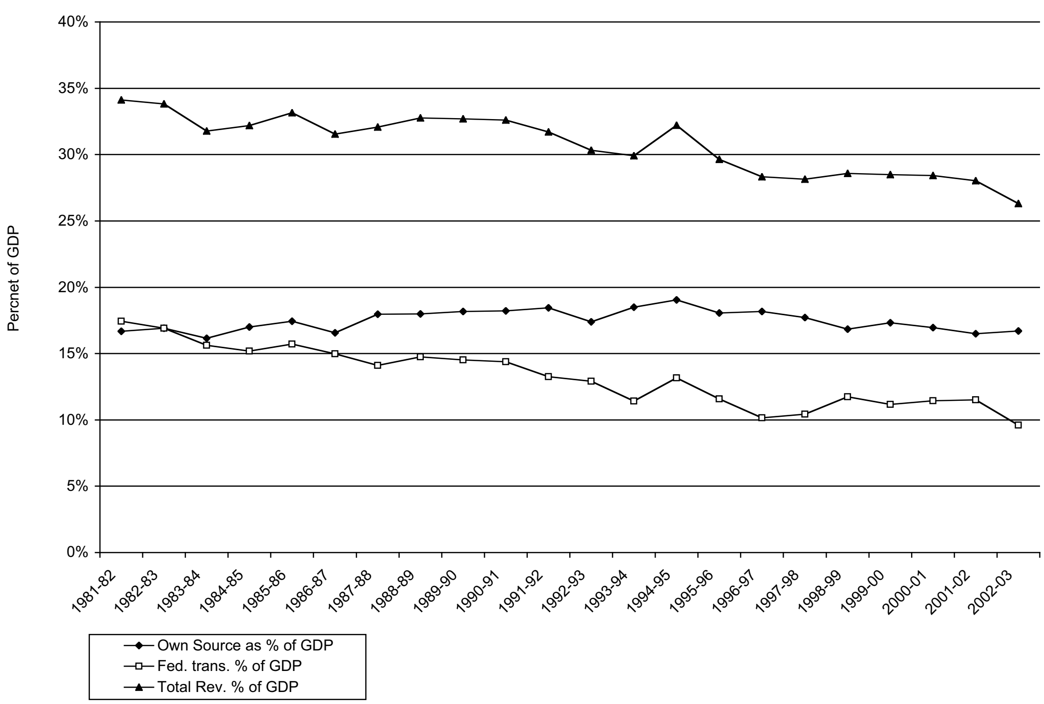


Source: Authors' calculations based on Federal Department of Finance, Fiscal Reference Tables and Statistics Canada on services. Total revenue as a portion of GDP has decreased since 1981 from 34% to 26% of GDP in 2001-02. This is primarily due to the decrease in federal transfers.

As with the other Atlantic Provinces and in other regions of Canada, federal transfers have played an important role in sustaining programs and services at a level comparable to those provided in the rest of the country. The size of these transfers, relative to the size of the provincial economies and relative to overall revenue, has decreased in all Atlantic provinces. These decreases relate to the longer term challenge of adequate federal funding of programs and to the broader issues of regional inequalities within Canada. In PEI the transfers have decreased from just over 50% of PEI total revenue in 1981-82 to 36.5% in 2002-03.

The decrease in transfers corresponds with a general restructuring of federal government activities initiated during the 1990s. The resulting cuts have seriously curtailed the fiscal capacity of almost all provinces and especially the Atlantic provinces and their ability to provide supports for their citizens. In 2003 the situation in PEI, and other provinces, was exacerbated by a decrease in federal transfers due to an adjustment to reflect changes in provincial population.

Figure 5
PEI Provincial Government Revenue as a Percentage of GDP



Source: Authors' calculations based on Fiscal Reference Tables,

Table 4
Federal Cash Transfers to PEI ($ millions)

	1981-82	1991-92	2002-03
Total Revenue	364	707	986
Federal Cash Transfers	186	312	360
Federal Transfers as % of Total Revenue	51.1%	44.1%	36.5%

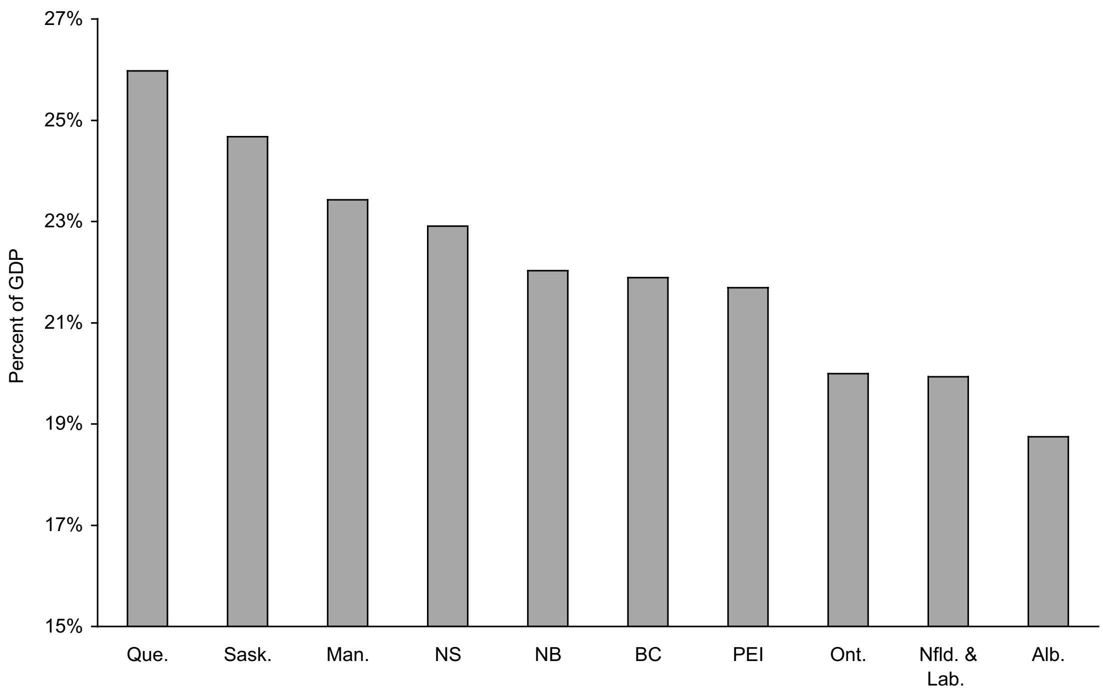
Source: Federal Department of Finance, Fiscal Reference Tables, based on PEI Public Accounts

Own-source Revenue: Is the PEI Economy Over Taxed?

While federal transfers have decreased, provincial own-source revenue as a portion of GDP has remained fairly stable. The provincial government's own source revenue as a portion of GDP has decreased somewhat from 18% of GDP in the mid 1990s to the current level of 17%.

Does the provincial government generate sufficient revenue relative to the size of the provincial economy? Is the PEI economy over-taxed? Comparing PEI's efforts with those of other provinces provides a measure of the province's effectiveness in raising revenue from the provincial economy. In 2002-03 PEI local and provincial governments derived revenue equivalent to 21.7% of the provincial GDP (Figure 6). This is only

Figure 6
Own-source Revenue (Local and Provincial) as a Percentage of GDP, 2003-03



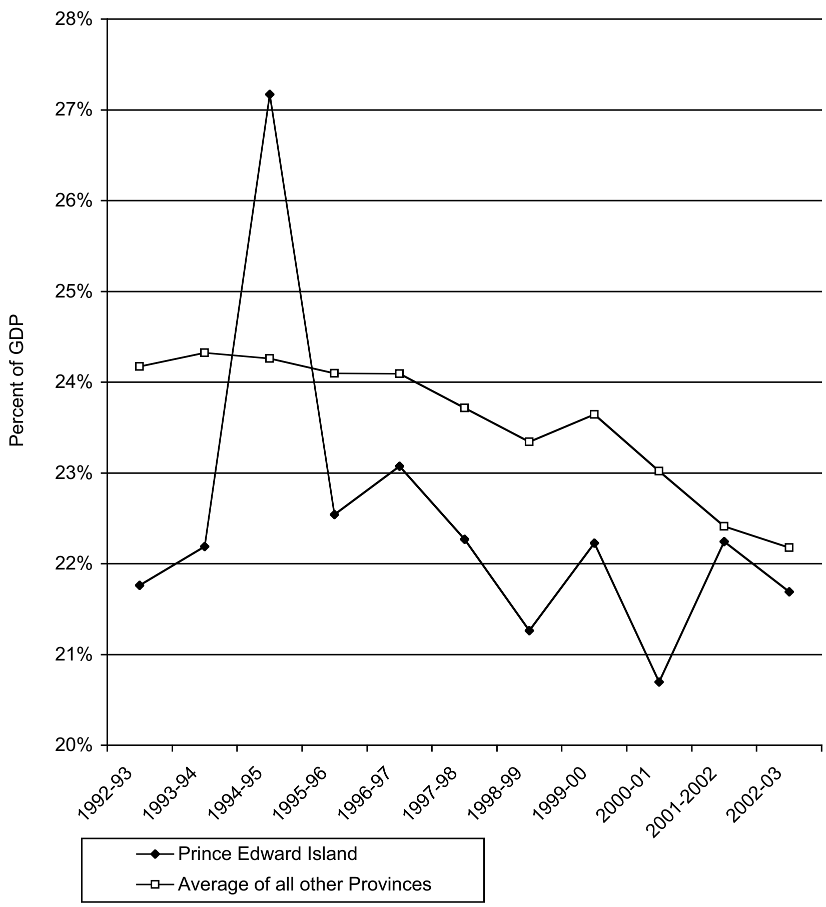
Source: Authors' calculations based on Statistics Canada Tables 385-0001 and 384-0013

0.5% less than the 22.2% average of the other provinces. Had the province generated revenue at the average of the other provinces it would have resulted in $18 million in additional revenue for 2002-03 – significant but certainly not enough to resolve the province's fiscal problems.

Such ratios can fluctuate over time and can therefore be somewhat misleading given changes in, and the structures of, provincial economies. A longer term view can provide us with further insight into the determinants of the province's current fiscal challenges. Figure 7 presents PEI local and provincial own-source revenue relative to GDP compared to the average of the other provinces over the past decade.

Over the past decade PEI has consistently generated less revenue as a portion of the economy than the average of the other provinces. The exception to this is in 1994-95 when the province's finances were hard hit by an economic slowdown causing GDP to stagnate (this accounts for the blip in Figure 7). The average difference over the past 11 years between the provincial average across Canada and the PEI rate has been just over 1%.

Figure 7
Own-source Revenue as a Percentage of GDP, Local and Provincial, PEI and Average of Other Provinces



Source: Authors' calculations based on Statistics Canada, Tables 385-0001 and 384-0013

In 7 of the past 11 years PEI generated less than the average provincial rate of own-source revenue to GDP of the other Atlantic provinces.

The revenue to GDP data show that the Prince Edward Island economy is not over taxed relative to other provinces. The rate over the past decade in fact suggests that there is some room to increase PEI's tax effort. The ability to generate increased revenue is somewhat limited in the short term by the general trend (see Figure 7) in the other provinces towards a decreasing ratio of revenue to GDP. On the other hand the current deficits faced by many provinces suggest that further tax cuts will be limited as provinces are forced to address the consequences of previous tax cuts and the need to invest in services and infrastructure after years of underfunding.

While federal transfers have decreased relative to PEI's total revenue and to the size of its economy, the province's fiscal capacity is still very reliant upon federal funding, as exemplified by the effects of the recalculation of transfers in 2003. Insufficient transfers will continue to limit the province's revenues. Pending increases in health transfers, estimated to be $9 million, will have little impact.[3]

All governments need to look at ways to effectively generate sufficient revenue to support social and economic investments. Our examination of the province's revenues indicates that any tax cuts would further undermine PEI's fiscal situation.

Assessing Fiscal Options for PEI

A strategy to resolve Prince Edward Island's fiscal challenges must address the real causes of the current situation. This review of PEI's provincial finances presents a number of findings. The deficit for 2002-03 was the result of decreased federal transfers and was not caused by excessive increases in expenditure. The province's financial picture is by no means in a state of crisis. The deficit is well within the province's debt carrying capacity.

PEI is not the only province facing financial difficulties and the recent deficits are to a considerable degree the result of factors beyond the government's immediate control. As with other provinces, PEI finds itself having to make up for decreased federal funding for crucial programs. Health care and post-secondary education funding have become challenges for all provinces. A key part of any strategy must be to work with other provinces, and the federal government, to develop adequate levels of sustainable funding for social programs. But there are also a number of internal factors that have contributed to PEI's fiscal situation.

Expenditure

PEI spent less, per capita, on programs than most other provinces for much of the 1990s. Current program spending is more in line with that of other provinces. Recent pressures on expenditures indicate that PEI is now paying the price for insufficient program spending during the past decade. Program expenditure must grow by at least the rate of inflation if the province is to avoid further deterioration of programs. The long-term social and economic development of the province depends upon the provision of effective public services and infrastructure. Recent studies by Statistics Canada confirm that public infrastructure investments in decrease business costs and increase overall productivity.[4]

Own-source Revenue

On the revenue side the province also raised less in own-source revenue than other provinces for much of the past decade. This has limited the province's ability to provide a similar level of services to those available to Canadians living in other provinces. Two factors are clear: the province does not spend too much on programs, nor is the provincial economy over taxed. PEI must work to generate sufficient revenue to sustain effective social and economic programs. A fiscal management strategy should examine ways to increase own-source revenues, as a portion of the economy, to at least the same level as the average of the other provinces.

Debt Management

PEI needs to develop a realistic fiscal strategy that supports social and economic development while managing its long-term debt obligations.

If expenditure, revenue and GDP continue to grow over the next 5 years at the same rate as the average increases over the past 5 years PEI's debt to GDP will grow only marginally (Table 5). While the current deficit can be carried without jeopardizing the province's fiscal position, over the long term the current level of debt relative to GDP could leave the province vulnerable to the effects of slower economic growth and changes in debt servicing costs due to fluctuations in interest rates.

To limit its vulnerability to dips in economic growth, the province should seek to maintain an average target debt to GDP ratio over the course of a business cycle. During periods of strong economic growth the ratio should decrease, while during periods of slower economic growth it would be inclined to increase. The setting of the rate should be tied to a broader public debate on the level of public services that Islanders desire and their willingness to financially support such services. The development of the strategy needs to occur in the context of a discussion with all Canadians as to the role of social programs in our future.

Public policy over the past decade has been dominated by an agenda of cutting programs and taxes. This agenda does not reflect the aspirations of Canadians. Polls repeatedly show that rather than cutting taxes and programs, Canadians want their governments to invest in programs. Governments in Canada need to promote the public interest and genuinely value social programs. Public programs and services develop communities, promote health and welfare, support opportunities for individuals and communities and protect the environment. Ultimately they make provinces and communities desirable places to live, work and invest.

Table 5
Projected Debt to GDP Ratios ($ millions)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Total Revenue	977	1027	1079	1134	1192	1253
Total Expenditure	1061	1114	1170	1228	1290	1354
Surplus (deficit)	-84	-87	-91	-94	-98	-101
Net Debt	1166	1253	1344	1438	1535	1637
GDP	3767	3993	4233	4487	4756	5041
Debt/GDP	31.0%	31.4%	31.7%	32.0%	32.3%	32.5%

Assumptions: Annual growth at the average rate of increase over the past five years, expenditure (5%), revenue (5.1%) and nominal GDP (6%).

Endnotes

1 Ibbitson, John (2004/) *Globe and Mail*/ January 4, 2004. Available on line at http://www.globeandmail.com/servlet/story/RTGAM.20040109.uibbi0109ibox/BNPrint/National/, accessed February 5, 2004.

2 *Building on Values: The Future of Health Care in Canada* (2002) http://www.hc-sc.gc.ca/english/care/romanow/index1.html, accessed February 5, 2004.

3 *Atlantic Report*, (Fall 2003), Atlantic Provinces Economic Council. Halifax., p. 9.

4 See Harchaoui, Tarek M. and Faouzi Tarkhani. 2003. /Public C//apital and its C//ontribution to the P//roductivity P//erformance of the Canadian Business S//ector./ Statistics Canada: Ottawa and Harchaoui, Tarek M., Faouzi Tarkhani and Paul Warren. 2003. /Public infrastructure in //Canada//: //Where do we stand?/ Ottawa: Statistics Canada.