

A Plan for Prosperity in Newfoundland and Labrador: Choosing the Right Frame for the Debate: Distribution, Development and Diversification

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Economic growth alone is not enough to ensure that we are getting closer to the world we want. Newfoundland and Labrador's own economic history is testament to that truism. Economic growth has to be directed and channelled to deliver prosperity along the dimensions we value. Markets don't create wonderful places to live; people do.

--*Delivering on the Promise of Prosperity*, p.12.

The transition of Newfoundland and Labrador to the status of a “have” province is a remarkable achievement. Indeed, it is clear that over the last decade and across a broad range of economic metrics—from real GDP growth to public investment, to declining public indebtedness, for example—a page has been turned in the history of the province's economic development. Yet for all this good fortune there remain a number of challenges going forward.

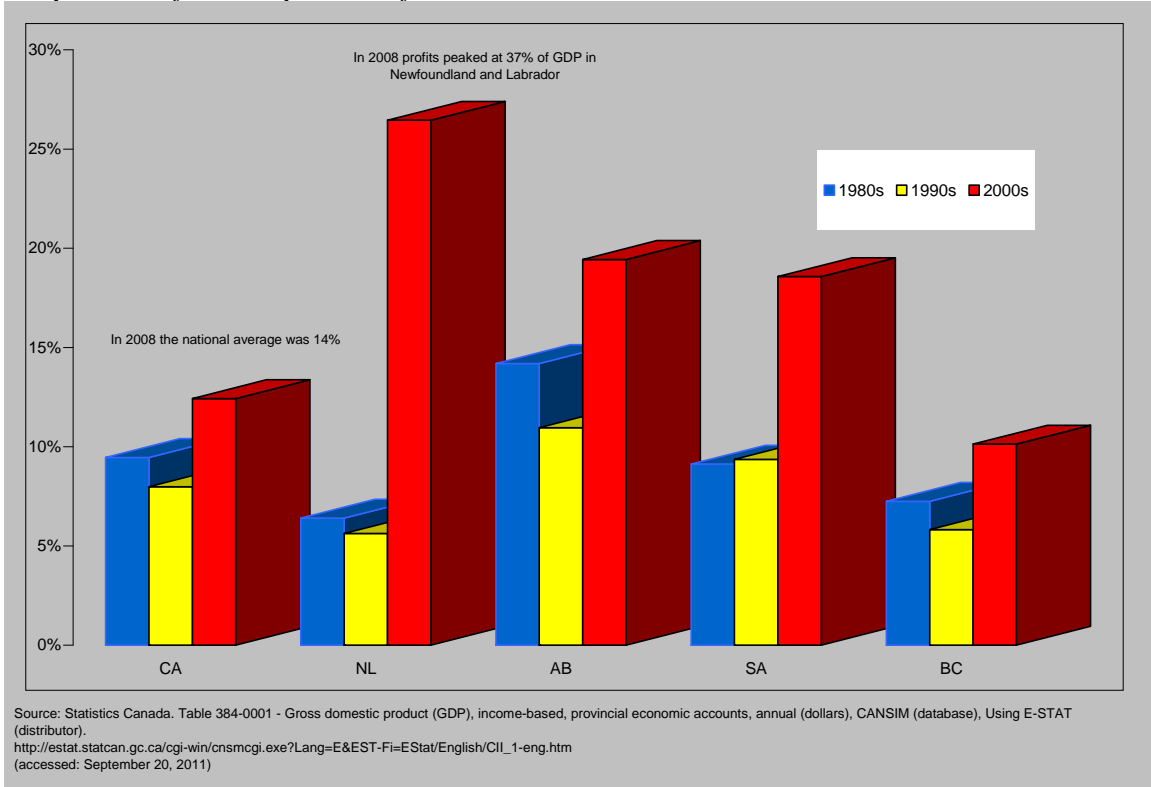
As part of a larger project being undertaken by Newfoundland and Labrador Federation of Labour this research note is principally concerned with the three interrelated issues of distribution, socio-economic development and diversification.¹

Distribution

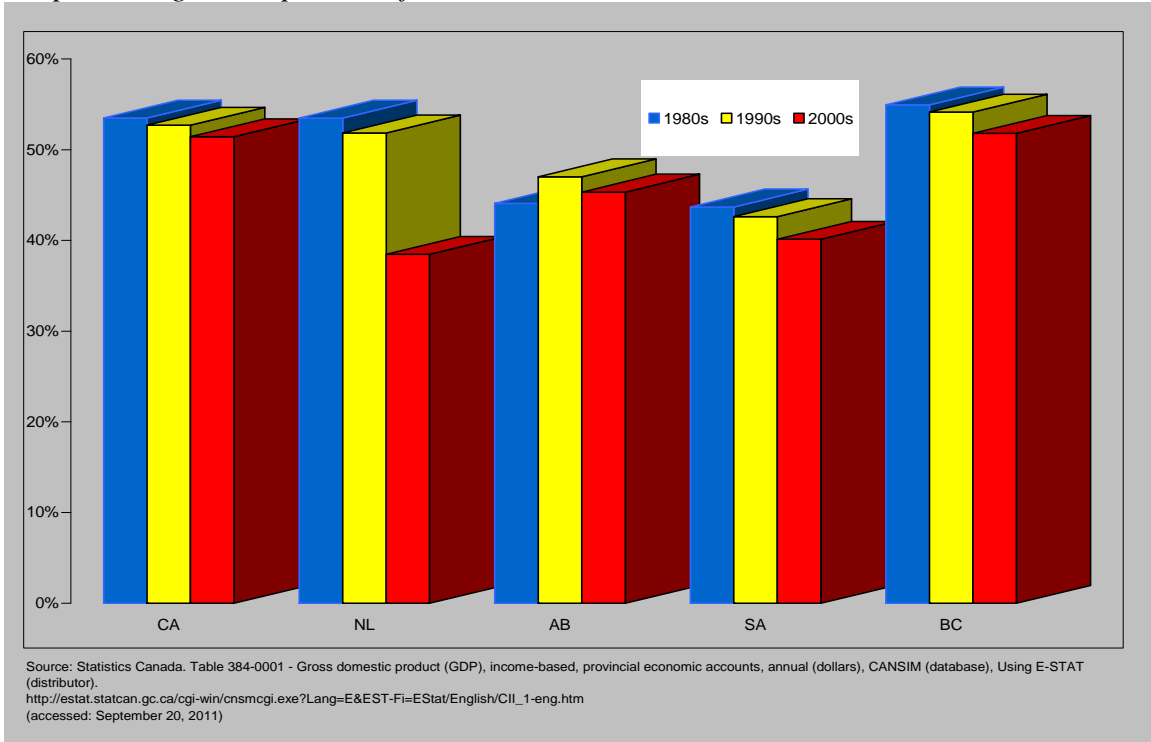
There are a number of different ways to look at the issue of inequality. In what follows I will look at two different aspects of income distribution. For purposes of clarity we can distinguish between the primary distribution of income as between profits and wages and the secondary distribution of income as between income earners. With regards to the primary distribution of income, Newfoundland and Labrador now leads Canada and the other resource intensive provinces in the degree of inequality in the primary distribution of income.

Looking at decadal averages of profits as a percent of GDP provides a sobering image (Graph 1 below). Profits as a percent of GDP peaked in 2008 at 37% of GDP. Even more sobering is that profits between 2000 and 2009 averaged over 25% of GDP. To give some perspective: the Canadian national average for the same period was already at a historical high of 13%. That makes the share of profits in provincial output over the last decade almost two times the national average and higher than any of the other resource intensive provinces.

Graph 1: Profits as a percent of GDP



Graph 2: Wages as a percent of GDP

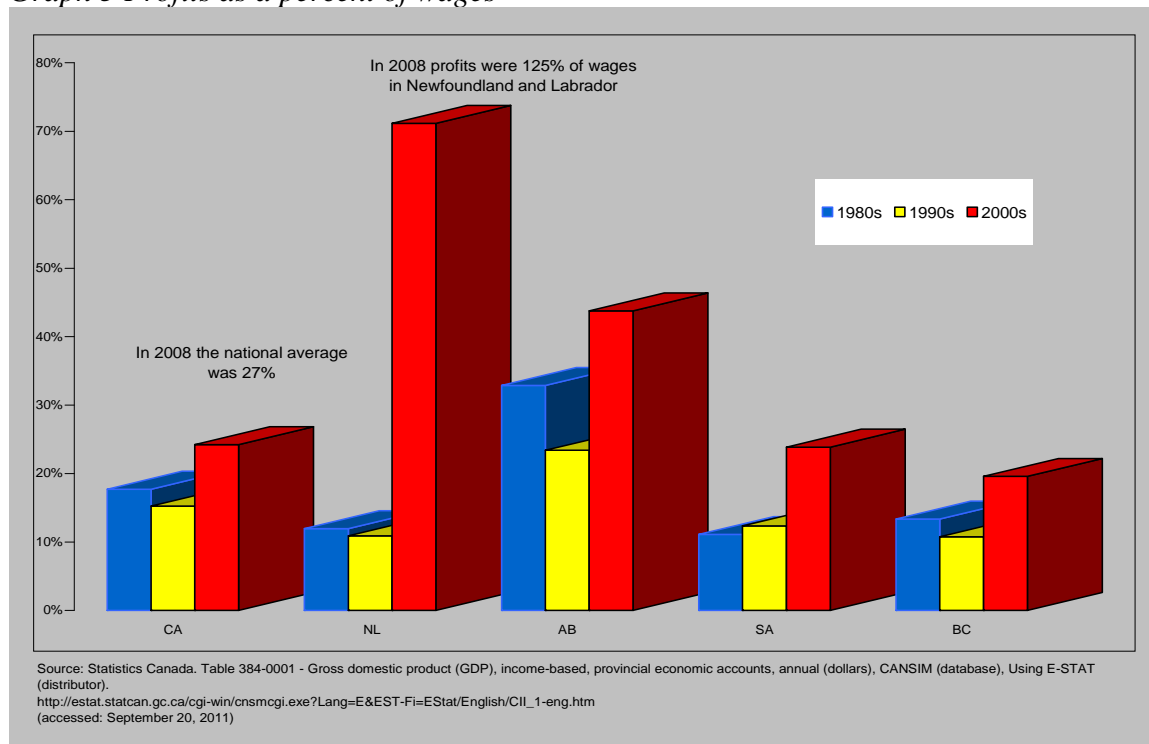


An alternative way of looking at the primary distribution of income is to examine wages as a share of GDP (see Graph 2 above). In the last thirty years wages (total compensation including benefits) have never been a lower share of provincial GDP. And once again Newfoundland and Labrador *leads* Canada and the other resource intensive provinces in the race to the bottom. The Canadian average of wages as a share of GDP between 2000 and 2009 was 51% whereas it was 38% over the same time frame in Newfoundland and Labrador.²

One of the sharpest ways to examine the primary distribution is to simply calculate profits as a percent of wages (graph 3 below). Profits as a percent of wages in Newfoundland and Labrador over the last decade have averaged over 70%. The national average for the same time period was around 25%. At the apex of the last economic cycle in 2008 profits as a percent of wages were at an unprecedented level of 125% whereas the Canadian national average was 27%. That is nearly 5 times the national average.

A simple way to think about the above observation is that in the rest of Canada, for every dollar that employers pay to workers (in wages, salaries, and benefits), they pay themselves 25 cents just for owning the company. In Newfoundland, they pay themselves over 70 cents for every dollar in labour income, just for owning the company. And in 2008, they actually paid themselves more, than they paid the workers. That is an unprecedented economic imbalance leaving Newfoundland and Labrador in the lead as the most regressive provincial jurisdiction in Canada.

Graph 3 Profits as a percent of wages



With respect to the primary distribution of income it is thus a robust finding that inequality has absolutely increased and at faster rate than with respect to national averages or with respect to the other resource intensive provinces.

The trends in the secondary distribution of income (as between classes of workers) are equally troubling. So much so that there is now a growing recognition among economists that income inequality is in fact bad for business. Economists working for conservative organisations from the International Monetary Fund to the Conference Board of Canada have begun raising red flags about the emerging negative relationship between rising inequality, greater economic instability and potentially lower economic growth.³ Canada for example has fallen from 14th in terms of equality in the mid-1990s to 26th.⁴

In an article titled, “Canadian Income Inequality: Is Canada becoming more unequal?” published in the Conference Board’s *Hot Topic* series, the authors note that:

In Canada, only the fifth quintile—the group of richest Canadians—has increased its share of national income. All other quintile groups have lost share. This was particularly evident in the 1990s, when the income share for this top group jumped from 36.5 per cent in 1990 to 39.1 per cent in 2000.⁵

Following the research of Canadian Economist Armine Yalnizyan, they further note that:

[T]he richest 1 per cent of Canadians; that is, those whose income was higher than 99 per cent of Canadian tax filers. She found that this group—the 246,000 people whose average income was \$405,000—took home almost a third of all growth in incomes from 1998 to 2007, a decade that saw the fastest economic growth in this generation.

We do not as of yet have the same level of detail in the data to make a full analysis of the trends in the inequality of the distribution of income in Labrador and Newfoundland but there is nevertheless some evidence that inequality in market determined incomes is high in this province. We know for example that for the years 2000-2009 (despite a reduction in persons living with low incomes) that Newfoundland and Labrador had the highest percent of low income individuals in Canada.⁶ We also know that during the last recession (2007-2009) there was an increase of 2.1% in the rate of those in a low income situation in Newfoundland and Labrador.⁷ Given the increasing inequality in the primary distribution of income between profits and wages and the Canada wide trend in the increasing inequality in the secondary distribution of income there is reason to be concerned that Newfoundland and Labrador is not doing a good job at keeping the lid on inequality.

What has been fuelling the rising trends in the inequality in the distribution of income? In the case of Newfoundland and Labrador the answer is likely a combination of both *structural factors* and *public policy*.⁸ On the structural side we know that resource

intensive provinces tend to have greater disparities in the primary division of income between wages and profits (see the three graphs above). We also know that resource intensive provinces also tend to experience the economic cycle more severely than well diversified economies. Resource booms tend to draw down labour reserves and deliver revenue growth to the provinces in terms of royalties, corporate taxes and personal income taxes. Booms also decrease provincial expenditures on social programs like welfare. In the bust however the virtuous circle reverses: creating a vicious circle of causation.

The severity of the economic cycle in resource intensive provinces thus tends to have an adverse effect on both the provincial fiscal position and that of households particularly the less economically secure and mobile among households.

But the volatility of resource economies is not the whole story. Recall from the Graphs 1, 2, & 3 that Newfoundland and Labrador lead the other resource intensive provinces in the inequality of the distribution between profits and wages. Another structural factor is the quality of jobs. If an economy has a relatively large percent of low paying jobs and relatively few well and high paying jobs then income inequality between income earners will be high.

Public policy can also be an important driver of increasing income inequality. For example, to the extent that governments cut top marginal tax rates without providing offsetting transfers to low income workers it will increase after tax and transfer income inequality. If government labour market policy is too tilted in favour of employers then they will tend to encourage the growth of low skill and low paying jobs.

Sustainable economic development

Clearly the government of Newfoundland and Labrador cannot control commodity prices, the absolute size of ore deposits or the absolute size of oil reserves but it can within limits control tax policy; the evolution of the royalty regime; training and education; the attraction and retention rate of young families; investment in public infrastructure; and to some extent the direction and rapidity of economic diversification and the rate of exploration and development.

In order to have an adult conversation about public policy and socio-economic development it will require that citizens, particularly business leaders, disabuse themselves of the idea that the solution to public debt management and socio-economic development is further tax cuts, further deregulation, lax labour laws, a steady gruel of dubious direct and indirect subsidies, underinvestment in public infrastructure and services. Not only has this grab bag of public policies over the last thirty years led to higher inequality and put governments in the advanced capitalist zone in a more precarious fiscal position; it is rapidly proving itself to be a discredited economic paradigm.⁹

The Public Debt

Debt is of course a tool. No company, household or government operates without it. Businesses and households take on debt to finance large, long-lasting capital assets. Governments must do that, too. Any CEO who based their whole business strategy on "eliminating corporate debt" would be ousted by the shareholders within a year, because that's not the goal. The real questions are therefore two:

- What is a sustainable level of public debt?
- How should the debt financing and repayment burden be distributed?

In the furtherance of a rational conversation where facts rather than emotions and ideology are the guide let us take up each of these questions in turn.

The first thing that needs to be addressed is the tendency of some economists to measure the public debt (or deficits) in pure dollar terms without reference to, for example, income.¹⁰ Making reference to absolute levels of public debt is both a meaningless and bogus practice as it does relate the level of debt to the level of income. The standard practice of economists is therefore to relate debt (or deficits) to annual GDP or revenue.

But even the standard practice is problematic. As Robert Shiller of Yale University has recently pointed out, measuring debt as a percent of *annual* GDP is an arbitrary and ultimately dubious measure.¹¹ Why not measure debt as a percent of quarterly GDP? In that case, the provincial public debt would be four times higher. Why not measure debt as a percent of GDP over ten or thirty years? Indeed, governments regularly sell public debt in bond issues that mature between ten and thirty years. When I bought my house the bank did not ask what my income would be this year but rather what it was likely to be for the next 20 years. Most of us finance the purchase of a home with debt and we view it (sometimes wrongly as it turns out) as an investment. However, unlike individuals, governments do not die; and unlike corporations, provinces and countries do not (normally) go out of business.¹² With all that in mind let us turn more directly to the provincial debt in Newfoundland and Labrador.

Unfortunately there is not a generally agreed threshold for debt to GDP ratios. The *conservative* scientific literature on the subject says that when public debt exceeds 90% of GDP economic growth is slowed by around one percent of the economic growth rate.¹³ Presently Newfoundland and Labrador's debt to GDP ratio for 2011 is estimated at around 27%.¹⁴ This puts Newfoundland and Labrador in the lower range of provincial debt to GDP ratios: in line with British Columbia and Manitoba and well below Quebec and Ontario.¹⁵ Since 2006, provincial debt has been reduced by over one-third and by over half as a share of provincial GDP. Even when the federal debt to GDP ratio is included, Newfoundland and Labrador's debt to GDP ratio is substantially below the conservative estimate of the 90% threshold. Further, not only is Newfoundland and Labrador's public debt not high by national or international standards but the estimate of 27% somewhat overstates the actual level of public debt as it includes such things as public loan guarantees unadjusted by default estimates.¹⁶

To attempt an answer to this question we need to return to Shiller's point that debt to GDP ratios can be expressed in different units of time. If for example, it were assumed that real GDP growth in the province would average 2.5% over the next ten years and that no further debt was added then by 2021 public debt as a percent of GDP would be around 20% of provincial GDP. Using the same assumptions, by 2031 the debt in the province would be 16% of GDP. Similarly, if we used the same assumption about GDP growth but let the debt remain at 26% of GDP, the province could add an additional 2 billion of debt between now and 2021. It must also be stressed that outside of offshore royalties, provincial revenues should continue to grow inline with the rest of the economy (for more on this see the section below).

As it stands there is not a public debt problem in Newfoundland and Labrador: at least if the scientific community is to be believed, if national and international comparisons have any relevance to the conversation, or if time matters.¹⁷

Diversification

By almost any measure the province is far too reliant on oil and gas revenues as a source of provincial revenue. While there is no agreed upon threshold among economists about what the percentage one sector should be in economic output or government revenues, we do know that one of the most effective risk mitigating investment practices is a diversified portfolio. The estimated offshore royalty revenues for 2011-2012 account for 40% of total provincial revenues.¹⁸ Clearly Newfoundland and Labrador is long in a non-renewable resource sector. One can debate the future about the short term and medium term path of royalty revenue but what can not be debated is the long term reality: non-renewable resources are just that. Finite is finite.

One strategy to this long term eventuality is to raise the sense of insecurity among citizens and demand "austerity now" in order to pay off the public debt before the royalty revenues run dry.¹⁹ The hysterics of this solution to the side, it does not answer the quintessential question of what comes after oil? In absence of a plan to wean the province off its reliance on offshore oil and gas royalties a program of austerity now will only bring forward the gloom of tomorrow in which a different future was not planned.

That is to say, proponents of austerity simply assume that nothing comes after oil (or indeed develops during its decline) and that the province will eventually have to simply live with a 40% reduction provincially sourced revenue. Moreover, they also seem to believe that there is nothing that can be done to change the pace of offshore royalty revenue declines. That remains to be seen. Exploration and development is undoubtedly a complicated affair but it far from true that governments must sit back and passively watch the decline of the sector. Indeed, government involvement was essential to the development of sector in the first place.

Clearly the only way forward is to diversify the provincial economy and reduce the importance of natural resources in the economy of tomorrow. That is not to say resources

both renewable and non renewable will not be an important part of our future economy but they should only be part of that economy. In many respects the history of economic development in the province has been one long cycle of boom, bust and ruin. The only way to break that cycle is develop a modern diversified economy with high skilled and good paying jobs. That is going to mean finding ways to channel more of the wealth created in this province back into the development of the type of economy we want to have in 30 years. In the second phase of this research project, this subject will be one of the major themes investigated.

Key to any diversification strategy is both a growth in the province's population and change in the demographic profile of the population. That is to say Newfoundland and Labrador needs to increase the size of its population and decrease the median age of its population.²⁰

The province is already expected to have a labour shortage of 77,000 workers over the next 8 years.²¹ Attracting this number of workers is a major challenge. It is a challenge made all that more difficult because in the minds of settled Canadians Newfoundland and Labrador is still a peripheral economic region. Moreover, for many new Canadians it is the major metropolitan centres which have tended to capture their imaginations. Therefore, any economic diversification strategy will have to initially be focussed on the attraction of new immigrants and the retention of working families from Newfoundland and Labrador.

Despite the significant challenges facing Newfoundland and Labrador going forward the good news is that given the history of Canada every single province in this country as had to eventually face these challenges directly: We are, therefore not short of analyses and ideas about how to avoid the classic staples trap or how to move the surpluses generated in one sector in order to diversify economy. Nor are we short of analyses and ideas about how to attract and retain workers, be they from within or without Canada and Newfoundland and Labrador.

More specifically in terms of the primary and secondary distribution of income between wages and profits some obvious areas for improvement are:

- The corporate tax regime and or royalty regime.
- Review top marginal personal income tax rates
- Specific measures to help Nfld workers wrest a larger share of the wealth they produce via minimum wage increases, stronger minimum standards legislation and enforcement, and stronger collective bargaining legislation.
- Pro-active training/education/social development policies which are well integrated and serve to help everyone participate in the economy.

With respect to development some obvious areas for improvement are:

- Pro-active sector strategies to foster value-added developments (not just resource extraction) – e.g., requiring resource producers to locate secondary activities in Nfld.
- The strategic use of public capital in investment ventures (e.g., the new energy Crown corporation, and the NLFL's proposal to do the same in mining)
- Recognize the public sector as a driver of growth in its own right (top quality health care and education are important industries, not a "drain" on society)
- Investment in top-quality infrastructure (physical & social) to lubricate diversifying investments

It is an exciting and brave project that the Newfoundland and Labrador Federation has taken on and it is in the best tradition of democratic practice that it has sought to do so in the furtherance of a disciplined and informed public dialogue on the socio-economic future of the province. We look forward to helping contribute to this dialogue as this project unfolds.

¹ As this note is part of a larger research project for the NLFL every attempt has been made to ensure that the supporting documents are available to the general public and its members. Outside of the Statistics Canada data all the data can be found in the documents referenced *inter alia*. Similarly where possible we have made a concerted effort to ensure that the economic literature cited in this research note can be directly downloaded from, or read on, the internet. We would encourage readers to take some time with the document and explore the many sources referenced

² More study is needed on this subject. My suspicion is that it is not just wage repression that is responsible for the low level of wages in output but also the high percent of low paying jobs in the economy. The two are of course connected: it is the low skill, low wage trap.

³ For the IMF series of articles on the subject see:

<http://www.imf.org/external/pubs/ft/fandd/2011/09/index.htm>

For the Conference Board study on Canada see:

“Canadian Income Inequality: Is Canada becoming more unequal?”

<http://www.conferenceboard.ca/hcp/hot-topics/canInequality.aspx#ftn11-ref>

On the international scene see:

“World Income Inequality: Is the world becoming more unequal?”

<http://www.conferenceboard.ca/hcp/hot-topics/worldInequality.aspx>

⁴ Armine Yalnizyan (2011), “Inequality is bad for business,” *Canadian Business*.

<http://www.canadianbusiness.com/article/39123--inequality-is-bad-for-business>

⁵ <http://www.conferenceboard.ca/hcp/hot-topics/canInequality.aspx#ftn11-ref>

⁶ Ibid.

⁷ Ibid.

⁸ Obviously the two are not so easily separated. An economy’s structure is the result of public policy.

⁹ Paul Krugman recently had this to say:

When I look at a lot of what prominent economists have been writing in response to the ongoing economic crisis, I see no sign of intellectual discomfort, no sense that a disaster their models made no allowance for is troubling them; I see only blithe invention of stories to rationalize the disaster in a way that supports their side of the partisan divide.

<http://krugman.blogs.nytimes.com/2011/09/27/does-economics-still-progress/>

¹⁰ Wade Locke, (June, 2011) “A Prosperity Plan for Newfoundland and Labrador: Defining the Realities and Framing the Debate” presentation given at the Harris Centre, Memorial University (p.18).

http://www.mun.ca/harriscentre/policy/memorialpresents/2011c/Wade_Locke_presentation.pdf

¹¹ Robert J. Shiller (2011) “Debt and Delusion.” comment at *Project Syndicate*.

<http://www.project-syndicate.org/commentary/shiller78/English>

¹² From what I understand Newfoundland and Labrador the country did go out of business on March 31 of 1949 and restructured as the province of Newfoundland. Later in 2001 the province would re-rebrand itself Newfoundland and Labrador.

¹³ Carmen M. Reinhart and Kenneth S. Rogoff (2010), “Growth in a Time of Debt,” prepared for the *American Economic Review Papers and Proceedings*.

<http://www.nber.org/papers/w15639>

See Robert Shiller’s (2011) critique of Reinhart and Rogoff (above).

¹⁴ Estimate based on the Department of Finance’s estimate of 3% GDP growth for 2011.

<http://www.economics.gov.nl.ca/frcstGDP.asp>

The estimates for total public debt contained in the 2011 2012 budget can be found on page 275 of the *Estimates*:

<http://www.budget.gov.nl.ca/budget2011/estimates/estimates2011.pdf>

¹⁵ See the various provincial 2010-2011 budgets for confirmation of this fact.

¹⁶ This is standard practice but it is nonetheless a very conservative practice. It assumes that all the student loans that the province has guaranteed, for example, will go into default for the full value of the loans. Not a very optimistic outlook for NL’s university graduates.

¹⁷ Japan for example has a public debt in excess of 200% of GDP and still manages to have large subscriptions to their 10 year bond issuances at well below 2%, with their 30 year rate at 2%. Obviously Newfoundland and Labrador are not comparable to Japan for any number of reasons. Most obviously, NFL no longer issues their own currency. The point is that the debt to GDP ratio is not in and of itself a good measure debt sustainability or the likely path of future financing costs.

For those interested taking a tour of current international bond rates see:

<http://www.bloomberg.com/markets/rates-bonds/government-bonds/us/>

¹⁸ Calculated from the *Estimates* as a percent of total *provincially* sourced revenue.

¹⁹ This is the strategy Wade Locke plumbs for in “A Prosperity Plan for Newfoundland and Labrador: Defining the Realities and Framing the Debate.” See endnote # 10.

²⁰ Population growth can be a significant driver of GDP growth in and of itself.

²¹ “Meeting Future Job Demands” September 16th 2011.

<http://www.thetelegram.com/Business/2011-09-16/article-2750051/Meeting-future-job-demands/1>