

SMART DEBT SPEAKING NOTES

Allan A Warrack

INTRODUCTION –

“Infrastructure” has emerged onto the public issues agenda, at last. There are concerns, particularly in Canadian major cities, about future quality and quantity of infrastructure available for provision of public services and as a platform for competitive business success. Edmonton aspires to be a “smart city” where urban liveability prevails.

Edmonton *must* tackle its growing infrastructure gap. Much existing infrastructure is at risk. New infrastructure is needed. The “why” is clear, what about the “how”?

Alberta is an urban province. Growth, both demographic and economic, is largely taking place in Alberta’s cities. About a third of each already is in metropolitan Edmonton and metropolitan Calgary. To be globally competitive, Edmontonians must be able to count on their physical and social infrastructure. Needed are large allocations of capital funding, and the need will be there for a protracted time period. Some are needed urgently. What are the options? Is there such a thing as “Smart Debt”, so it can be one tool (but far from the only tool) for meeting capital infrastructure requirements in Edmonton?

PUBLIC DEBT BACKGROUND –

Canada’s government debt became far too high by any measure, beginning with large deficits in the 1970s. Alberta’s government debt also became too high, but later (1980s). As accumulated interest on debt compounded, Canadians and Albertans “got the message” and helped to force a veer in Canadian public policy. So did Edmontonians. A (n over?) reaction to dangerously high public debt became a strong preference for *no debt* at all. The City of Edmonton embarked on a policy of gradual elimination of tax-supported debt. As debt at all levels became curbed, a regrettable result has been that infrastructure development is curbed resulting in yawning gaps that need to be filled. Welcome to 2004.

A question to be begged: why would debt be necessary in a province with oil prices of over \$35 (\$38.98 on 5 May 2004)/barrel and natural gas prices of over \$6 (\$6.26 on 5 May 2004)/mcf. Let alone in a province with burgeoning oil sands and forestry developments, presumably including accelerating royalty and stumpage payments from them to the owner-province. Or tax options issues: flat tax, sales tax, or high reliance on property taxes. Or what? What about Canadian charter cities, which could make more of these decisions for themselves?

These and other questions are exceedingly important, and should be taken as context for any discussion of “Smart Debt”. Smart Debt is discussed here as AN option, not as THE option. In reality, Smart Debt makes sense as part of an overall coherent financial plan for a city, even a pillar. A useful view of Smart Debt is akin to asset management. Like all assets, there is a need for careful and prudent management.

SMART DEBT – ONE OPTION? –

Speaker's Context (Scottish & stern Presbyterian background):

- I hate debt of any kind, and I don't have any
- But I *did* have debt, a house mortgage, and paid it off over time
- It has proven to be "Smart Debt"!

Society's Context (Edmonton city demographic & social character):

- Younger, vigorous & growing (a la age range of persons 30-50 years?)
- Like a younger, vigorous & growing family?
- But city sustains indefinitely, unlike individuals and families
- So city, like younger families, could have debt
- Such debt would "roll over" continuously through time
- Could such debt be "smart debt"?

Potential Gains:

- Public services – more available to the public, and sooner
- Productivity – time & cost savings facilitating more competitive business
- Equity – same rather than different era pay for the infrastructure improvements

Warning: The test of prudence must be higher in allocating and managing *public* funds, than one's own money. Public funds are in a *trust*, beyond the obligation of any individual. This warning is even more solemn when capital investments are made with borrowed money in the name of the taxpayer, incurring obligations for *future* taxpayers.

SMART DEBT (SD) – THE ELEMENTS –

A. Common Sense Principles –

1. **SD only** for **CAPITAL** purposes (physical, social?); but *not* all capital from debt.
 - Vital priority *needs* (not just wants); hardship to do without; hold to a *higher* standard of priority than ordinary operating budget allocations
 - *Urgent* timing; hardship if wait; again higher standard than regular
 - Priority and urgency denied unless borrowing, *no* real choice

Example: personal/family house mortgage

2. Affordability –

- (E)quity (1/4? - 1/3?) & **SD** (3/4? – 2/3?) proportions, like other down payments, common to householders (house down payments) or businesses (retained earnings)
- Incremental operating costs covered; some **SD** options reduce future operating costs, whilst others increase only slightly, but still others force major cost increases so entire (K + O) financial impacts must be incorporated into decision making
- Social equity; borrowing allows *same* people who benefit to be the ones that pay for **SD** amortization

3. **“Value” of K infrastructure exceeds SD + E –**

- **SD** amortization **fewer** years than expected useful life of **each** and every infrastructure item financed
- Cumulative **SD** lower than “value” of K portfolio of items, in each moment of time (budget cycle)
- Reliable “residual value” available after **SD** paid off, for each item

Example: Business may “profit” through borrowing, by a revenue yield on K (eg equipment) financed than the cost of borrowing plus a risk premium.

Analogy: Both government and business are “businesslike” when they make decisions prioritized according to risks profiles of their decision options.

B. Normative Analysis –

1. Sustainable Debt = 24-27% of GDP (a la CD Howe) {p. 51 of Taylor/Warrack/Baetz.}

- recommended level as sustainable/manageable level of public debt
- narrow tolerance band

2. Add Upper/Lower Bounds –

- political/economic philosophy
- rates of growth, economic/demographic
- interest rate levels
- counter-cyclical strategies

3. Quantify Upper/Lower Bounds

- Widen range of public policy options
- Upper Bound = about 40% (speaker’s judgment call)
- Lower Bound = about 15% (speaker’s judgment call)

C. Results –

1. **Federal** Gov’t – DEBT far too high for nearly two decades; now approaching the upper bound of **SD** and soon within normative range {see *visual*}; future Federal financial options becoming normal and flexible. *More funding for infrastructure has become affordable.*

2. **Alberta** Gov’t – DEBT far too high for a decade; now at lower bound of **SD**, but falling well below normative range {see *visual*}; future Provincial financial options already normal and flexible. *More funding for infrastructure is affordable.*

Note: AHF (Alberta Heritage Fund) perspective affects financial evaluations; if counted, Alberta is in a surplus position.

3. **Edmonton** City – DEBT policy reduced well below the normative range {see *visual*}; with infrastructure gaps accumulating; in 2003 City Council reversed debt reduction policy at \$50m/year for five years. Below normative **SD** range, *there is substantial room for public debt to be applied wisely.*

Note: Even as Edmonton borrowed new debt of \$50m, its debt/GDP continued to fall; the numerator increases less than \$50m because of continuing amortization of old debt, and the denominator continues to rise with vigorous economic growth.

D. SMART DEBT Conclusion

Public *debt capacity* is an asset. Competent, strategic and *smart* debt management, following common sense financial principles and norms, can harness debt options for enhancing public services and infrastructure. Defying debt can mean denying opportunities. Edmonton's decision to borrow for infrastructure purposes was *smart*, and Edmonton has capacity for significantly more smart debt.

APPENDIX – ITAC Minutes Excerpt (16 March 2004)

“ Debt Financing

At the same time that it advances new management techniques and implements new investment decision-making tools, the City's use of debt needs to stay 'smart' by adhering to stringent parameters. ITAC defines 'Smart Debt' as follows:

- the asset has an identifiable return to the City;
- it is more efficient to make the investment *now*, rather than later;
- the investment and debt incurred must be affordable; and
- it must have strategic value.

Recommendations

Based on this working definition of Smart Debt, ITAC offers several recommendations concerning debt financing of capital projects.

1. Debt should only be used where those who must repay the debt receive the benefit. That is, a debt-funded project should have long-term benefits to Edmontonians today and tomorrow; assuming debt for a project or initiative with a short lifespan is inappropriate.
2. Debt must not be used to cover operational shortfalls or to deliver services. Its use should be restricted to large-scale capital projects only that would otherwise remain unfunded or underfunded.
3. The City should consider incorporating Life Cycle Costing and Risk Assessment methodologies as part of the decision-making process to select infrastructure projects that are debt financed.
4. ITAC strongly recommends debt financing be applied to renewal, upgrading and expansion projects – and that the City seek an appropriate balance of rehabilitation and growth projects. The tendency to apply debt financing only to new growth projects should be resisted.
5. Debt levels incurred by the City should be sustainable, *i.e.*, within the City's fiscal capability. The current limit set is \$50 million annually over five years for a total of \$250 million by 2007. Edmonton has the capacity to borrow substantially more. This may be particularly appropriate now, when interest rates are low. Debt will help the City to meet growth pressures until new revenue tools are in place to address demand.
6. The time frame for decisions concerning debt financing should be expanded to cover a genuinely strategic time frame. This means not making decisions based on a three to five year planning horizon but at 20-year windows.

7. The debt incurred should be paid back within the lifespan of the asset.
8. ITAC recommends that the City explore other options besides debt financing. In addition to ensuring the most cost-effective management of existing infrastructure assets, the City could evaluate the appropriateness and applicability of other alternatives, such as creating utilities, Public-Private-Partnerships (P3s), and design-build-own-maintain (DBOM) contracting. These options should be entertained only with careful and objective analysis.

Desired outcomes

1. Develop a priority setting process for capital projects and debt financing that supports urban sustainability and that favours renewal and upgrading over expansion *i.e.*, rehabilitation over growth.
2. Use 'Smart Debt' and do not be constrained by fear of deficit financing.
3. Explore creative financing options to support the acquisition of necessary infrastructure."

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