NEWFOUNDLAND & LABRADOR BUDGET 2016

TD Economics

April 15, 2016

MIND THE FISCAL GAP

Highlights

- Budget 2016 is one centred on austerity, but the measures are justified as the province attempts to bring its spending more in line with shrinking revenues.
- The budget contains reasonable assumptions of modest improvement in oil prices. According to government estimates, the province will eke modest economic growth this year as oil production rebounds briefly before aging wells and slowing mining extraction lead to three years of contractions.
- Revenues are anticipated to expand 15.0% in FY2016-17 on a slew of revenue measures. The government is raising income taxes for all income levels, with sales and corporate taxes also up. Offshore oil royalties fell are expected to decline from $572 million to $485 million in FY2016-17.
- Largely reflecting increased spending on capital projects, program expenditure are forecast to rise 3.1% in FY2016-17. Expenditures will decline 2.6% the following year as effects of cost cutting measures manifest.
- A deficit of $1.8 billion (6.2% of GDP) in FY2016-17 is expected before declining to 3.5% of GDP the following year. The government is committed to a balanced budget by FY2021-22 but the details of how the gap will close have not yet been disclosed. Net debt-to-GDP will rise from 41.9% last year to 49.5% this year.

This was not a pleasant budget for Newfoundland & Labrador as its economy struggles to cope with an income shock related to the recent commodity price slump. Budget 2016 is a culmination of the government's attempts to set the province on a credible path towards budgetary balance while maintaining service levels amid dwindling offshore oil royalties. The result is a broad based increase in taxes and fees coupled with efficiency measures that will lead to a consolidation of public sector functions and tapering of government payrolls.

The numerous revenue measures will result in large increases in revenue over the next two fiscal years. But, these will not be enough to close the fiscal gap with additional measures expected in a supplementary budget this fall. These will aim to increase revenues while restraining expenditure growth, with the government committing to balancing the books by FY2021-22. Details on how this will be achieved are likely to be published in the fall supplemental-budget.

NEWFOUNDLAND AND LABRADOR ECONOMIC ASSUMPTIONS

[Per cent change unless otherwise noted]

	2015*	2016	2017	2018	2019
Real GDP	-2.3	1.0	-3.3	-3.4	-1.1
Nominal GDP	-10.1	-1.6	2.2	1.0	1.9
Unemployment rate (%)	12.8	12.8	15.2	18.3	19.8
Employment ('000s)	236.2	233.7	221.9	208.8	203.1
Real retail sales	1.8	-1.1	-2.3	-0.2	-0.9
Household income	1.7	0.5	-4.3	-2.5	1.4
Population ('000s)	527.8	527.1	523.3	517.2	513.6

Note: * - Estimate
Source: Newfoundland and Labrador Department of Finance.

Short lived output growth amid price stabilization

The government's near-term revenue projections are based on relatively conservative economic assumptions with nominal GDP projected to be little changed over the next two years.

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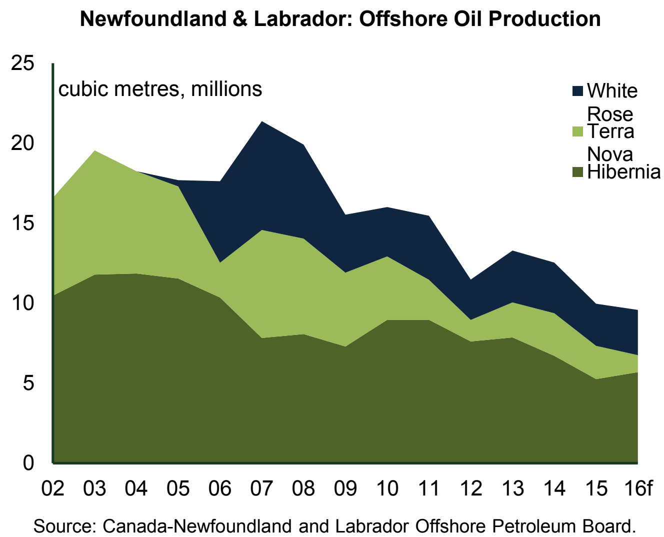

The oil price projections are fairly conservative. Brent is forecast at US$40 in FY2016-17 and will rise steadily to US$66 by FY2019-20.

After contracting 2.3% in 2015, the Newfoundland & Labrador economy is forecast to expand by 1.0% this year on expanded oil production and exports. Ongoing construction at the province's Muskrat Falls project offers an offset to investment from lower development activity at Hebron. However, while it is important to note that Muskrat activity will eventually be revenue generating, significant cost overruns have been experienced to date.

Beyond 2016, the economy is forecast to retreat 3.3% and 3.4% in 2017 and 2018. Ongoing offshore production declines, mines passing peak production, declines in capital investment, restricted public sector spending, and a resulting pullback in consumption will all contribute to a multi-year downturn in economic activity and employment. The province expects most indicators to remain below current levels through 2021 after adjusting for inflation. Rising unemployment, which the government projects will near 20% by the end of the decade will cause rapid outmigration, with population declining by nearly 3% through the end of the decade.

Despite the considerable contraction in real economic output, the nominal figures look better. Nominal GDP is anticipated to contract 1.6% in 2016, before advancing 2.2% and 1.0% over the next two years as commodity prices begin to gradually rebound.

Smaller contribution from offshore revenues offset by higher taxes

NEWFOUNDLAND AND LABRADOR FISCAL POSITION

[C$ millions, unless otherwise noted]

	2016 Budget				
Fiscal Year	**15-16**	**16-17**	**17-18**	**18-19**	**21-22**
Revenues*	**5,894**	**6,776**	**7,410**	**7,659**	**8,097**
% change	--	15.0%	9.3%	3.4%	--
Expenditures	**8,094**	**8,481**	**8,341**	**8,516**	**8,592**
% change	--	4.8%	-1.7%	2.1%	--
Debt Service Costs	818	982	1,034	1,125	1,229
% change	--	20.1%	5.2%	8.9%	--
Program Expenses	7,276	7,499	7,307	7,390	7,363
% change	--	3.1%	-2.6%	1.1%	--
Surplus (+)/Deficit (-)	**-2,200**	**-1,705**	**-931**	**-856**	**-495**
Revenue Risk Adjustment		-125	-125	-125	-125
Adjusted Surplus		**-1,830**	**-1,056**	**-981**	**-620**
% of GDP	-7.3%	-5.7%	-3.1%	-2.8%	-1.5%
Deficit Target	-2,200	-1,830	-800	-650	0

* Includes net income of Government Business Enterprises. ** Estimate

Source: Newfoundland and Labrador Department of Finance

Revenues are projected to total $6.8 billion during FY2016-17, an increase of 15.0% over last year. This will happen despite the anticipated decline in offshore oil royalties. Royalties are expected to fall from $572 million last year to $485 million this year, making up just 8.9% of total revenues -- less than a third of their peak level in FY2008-09.

To help bridge the gap created by declining royalties the government presented a slew of permanent and temporary tax measures. Among the permanent tax measures:

- Personal income taxes will be raised for all income levels. This will provide an additional $204 million (see table on next page for details)
- The HST will be increased 2 percentage points to 15%, raising an additional $111 million annually
- The Insurance Companies tax will increase by 1 percentage point, increasing revenues annually of $16.9 million
- Effective January 1, 2016, the Financial Corporations Capital Tax Rate and the general corporate income tax rate, will increase 1 per cent and the Manufacturing and Processing Profits Tax Credit will be eliminated, generating additional annual revenues of $31.8 million

The budget plan also included several temporary tax measures, including:

- A Deficit Reduction Levy of up to $900 annually, depending on taxable income will be implemented. Individuals with a taxable income of $20,000 or less will be exempt. That levy will come into effect July 1, 2016. Revenue from the temporary tax will be $74.8 million in 2016-17, annualizing to $126 million. This

NEWFOUNDLAND AND LABRADOR Income Tax Changes			
	2016 Budget		
Income Brackets	Current	2016	2017
$0-$35,148	7.7	8.2	8.7
$35,149-$70,295	12.5	13.5	14.5
$70,296-$125,500	13.3	14.55	15.8
$125,501-$175,700	14.3	15.8	17.3
Over $175,700	15.3	16.8	18.3

temporary tax will be phased out starting in 2018

- The gasoline tax will be increase by 16.5 cents per litre starting on June 2, 2016. Taxes on diesel fuels will increase 1.8 cents per litre. This will generate an additional $142.8 million in revenues annually

Limited expenditure growth focuses on diversification

Despite the difficult financial situation the government faces, it has allocated new funds for targeted, strategic investments. Core services - namely education and health care - were large priorities. Highlights include:

- Investment in infrastructure, including transportation, health care, schools and housing at a cost of $570 million
- Implementation of full day kindergarten in September 2016 and hiring 142 new teachers at a cost of $13 million
- Approximately $3.5 million will be provided for seniors requiring enhanced care
- An additional $8.5 million is to be invested in the continued design and planning of the new Western Memorial Regional Hospital

Importantly, the government made a significant effort to reduce spending through a line-by-line evaluation. This process is projected to cut $243.3 million from spending this fiscal year. Reductions were made on an efficiency basis, with a goal of insulating core programs. However, no areas were spared, with education and health care expenditures set to be reduced by a combined $99.7 million, and cuts impacting most areas of government.

As a result of the measures the government will trim payrolls. Budget 2016 announced the elimination of 450 full-time equivalents in the governments agencies, boards, and commissions, with another 200 positions cut from core government.

Despite these measures, expenditures are expected to rise by 4.6% in FY2016-17 as the province injects $551 million in additional natural resource capital spending for its infrastructure projects which are suffering cost overruns.

Deficits are the new norm

Despite the large increase in revenues the adjusted fiscal gap will shrink only slightly to $1.8 billion (6.2% of GDP) in FY2016-17 before moderating to 3.5% the following fiscal year. The government has committed to balancing the budget by FY2021-22, with net debt swelling from 41.2% last year to 49.5% this year. Net debt is expected to crest above 50% of GDP next year.

Bottom line

The Newfoundland & Labrador government is facing a very grim reality. The highly-commodity levered provincial economy is suffering from an income shock leading to a sharp decline in revenues, which has put it increasingly at odds with its spending. This mismatch is further accentuated by an aging population which utilizes more provincial services, and outmigration of working-age individuals.

Budget 2016 outlines some important and necessary steps to address this gap. A combination of permanent as well as temporary tax measures coupled with spending restraint is a starting point in a very long journey towards fiscal balance. Details about how the government will achieve this have not yet been disclosed, potentially posing a credibility risk for the government. There are also potential downside risks from the ongoing infrastructure projects which could require additional capital injection if overruns continue. These are only partly offset by the relatively conservative economic assumptions.

The rating agencies have already downgraded provincial debt earlier this year with the onus now squarely on the government to convince investors that their plan to achieve budgetary balance is sound and remains on track.

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We reserve judgement until more details are made available, something that will likely take place in the supplemental-budget this fall.