Royal Commission on Renewing and Strengthening Our Place in Canada

The Fiscal Position of Newfoundland and Labrador

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<u>Executive Summary</u>

This assessment of the financial position of the province of Newfoundland and Labrador is divided into four main sections: (i) history and current state of public finance; (ii) relative economic and fiscal position; (iii) financial outlook; and (iv) financial issues and options.

The History and Current State of Public Finance

The review of the history and current state of public finance in Newfoundland and Labrador incorporates an overview of the fiscal position of the province dating back to Confederation. It includes an assessment of the key factors which have influenced budgetary results in recent years (highlighting elements of a non-recurring nature); an examination of the underlying deficit; a perspective on the relative magnitude and trends in the provincial debt including the impact which unfunded pension liabilities have on the overall debt profile of the province; as well as a review of the provincial credit rating and an assessment of the provincial budgetary position on a go-forward basis.

- **At the point of union** with Canada in 1949, Newfoundland and Labrador had a balanced budget, no debt and an accumulated cash surplus of $40 million. Since that time the province has recorded deficits in 51 of 54 years.

- While **budgetary deficits** ranged as high as 35 per cent of total revenues or seven per cent of GDP as recently as the early ’70s, they have declined significantly in relative terms in recent years. In 2001-02 the reported budgetary deficit of $47 million was equivalent to 1.2 per cent of revenues and 0.3 per cent of GDP. (The recent 2003-04 budgetary deficit ranges from 1.3 per cent to 4.0 per cent of GDP depending on the definition of the deficit.)

- The fiscal and economic history of the province reflects the **ongoing struggle** of a small population base, widely dispersed over a large geographic area, with a narrow, relatively weak economic base and inadequate or substandard infrastructure and public services – a province on a perpetual crusade to “catch up” with the rest of the country.

- The province encountered major **budgetary challenges** in the early 1990's, commencing with **"**a financial crisis**"** in 1990-91 when it recorded a deficit of $347 million – its largest reported budgetary deficit ever in absolute terms. Government responded to the deficit with a severe and far-reaching restraint program. By the mid-nineties, with the help of some non-recurring revenues, the annual deficit was virtually eliminated. With the 2003 budget, the deficit gap has again widened, yielding a "cash deficit of $213 million or $287 million on a "consolidated" basis including borrowings for various government entities.

- **Expenditure trends** over the past decade highlight the pronounced acceleration in health care spending (in keeping with the national trend). Near-term expenditure growth is accentuated by significant increases in public sector compensation. Debt service costs remain high at over 14 per cent of revenues fueled by ongoing requirements to fund deficits and pension obligations. Financial support through federal/provincial cost-sharing agreements is on the decline.

- Almost 60 per cent of the **total revenues** of Newfoundland and Labrador are now derived from provincial "own source" revenues while 40 per cent comes from federal sources (compared with a 50/50 split in the early '80s). Revenue growth in recent years has been dampened by: provincial tax reductions; the decline in the population of the province (10.5 per cent since 1992) and restraint in federal funding for health care and social services (CHST). Natural resource taxes and royalties had not figured prominently in the provincial revenue stream up to the 2002-03 budget. However, the actual revenues from this source for 2002-03 are now estimated at $88 million up from the budgeted level of $50 million. The budgeted gross revenues from these taxes and royalties are projected to rise to over $150 million in 2003-04. In future years, as these revenues continue to increase, they will be significantly offset by declines in equalization.

- Despite the ongoing **growth in expenditures and dampened revenue growth** in the late 1990s through to 2001-02, the reported budgetary deficit had been held to less than $50 million**.** The budgetary performance was facilitated by the combination of a series of "one time" or non-recurring revenue items and a budgetary smoothing strategy employed by government.

- **"One-time revenues"** contributed $217 million to narrowing the deficit gap in 2001-02. Similar types of revenues budgeted for 2002-03 totaled $232 million, in the absence of which, the 2002 budget would have projected a deficit of some $325 million. Unexpected growth in core provincial revenues during the year resulted in government deferring all but $80 million of the planned one-time revenues in 2002-03.

- **Unbudgeted expenditure obligations** related to hospital and school board operating deficits in 2000-01 and 2001-02 totaled $73 million and $22 million, respectively. Government has indicated it is making progress in this area and deficits are coming down. The 2003 budget for the first time highlighted the borrowing obligations of various government entities related to school construction, municipal financing and the "Rooms". This requirement increased government's consolidated deficit by $82 million in 2002-03 and by $74 million in the 2003-04 budget.

- In recent years, the trend in the underlying deficit of the province has been partially overshadowed by the **budget smoothing technique** used by government. At times when government has received significantly favourable revenue adjustments during the year, rather than record a high surplus, it has shifted certain revenues forward the subsequent year to lessen the impending deficit in that year.

- **Inconsistency in financial reporting** has generated confusion as to the "real" financial position of the province. In the past, the Government of Newfoundland and Labrador utilized two different accounting methods for its financial reporting. In 2001-02 for example, the "modified cash" basis of accounting used for budgetary reporting indicated a deficit of $47 million – while the "accrual" based accounting methodology, used in the audited public accounts, indicated a deficit of $473 million. In the 2003 budget, for the first time, government reported its budgetary position using three indicators; (i) the traditional "cash deficit" of $213 million; (ii) a consolidated deficit of $287 million (also a "cash" based approach); and (iii) the "accrual deficit" of $666 million.

- The **largest difference in the two basic accounting approaches**, cash vs. accrual, relates to the treatment of pension interest and the accrued pension costs. These net pension expenses totaled $186 million in 2001-02 and are projected at $302 million in 2003-04. These costs are included in accrual reporting but not government's customary cash-based budget reporting (no numbers have been provided by government for 2002-03).

- The historical review of the trend in **"total public sector debt"** reveals a significant escalation since the mid-seventies, to $7.9 billion at March 31, 2003. This is now budgeted to increase to $8.3 billion in 2003-04. Comparisons with the level of debt in other provinces have been made using the concept of **taxpayer-supported debt,** which excludes the self-sustaining debt of crown agencies such as provincial hydro electric corporations. By this measure, Newfoundland and Labrador has the second highest level of per capita debt ($13,000) among all the provinces (just behind Quebec) and the second highest debt to GDP ratio (second only to Nova Scotia).

- **Unfunded pension liabilities** of the Government of Newfoundland and Labrador total $3.4 billion, which adds a significant additional dimension to this province's debt profile. At an estimated $6,470 per capita, these liabilities in Newfoundland and Labrador are the highest of any province in Canada (Quebec is second highest at $4,990 per capita). This province's unfunded pension liabilities stand in stark contrast to the levels in the other Atlantic provinces; Nova Scotia for example, has unfunded pension liabilities of only $990 per capita while New Brunswick is even lower at $430 per capita.

- The combination of taxpayer-supported debt with the unfunded pension liabilities indicates that Newfoundland and Labrador has the **highest combined debt burden** of all the provinces at $19,500 per capita and the highest combined overall debt to GDP ratio of 66.7 per cent. Quebec has the next highest combined debt burden at $18,200 per capita and a debt to GDP ratio of 58.4 per cent.

- Despite its relatively high level, the current **debt to GDP ratio** in Newfoundland and Labrador reflects a significant improvement from the levels recorded in the last decade. In the last six years alone the combined debt to GDP ratio declined from 80.9 per cent to 66.7 per cent. (This ratio is one of the key indicators followed by the credit rating agencies.) Most provinces have also recorded improvements in this ratio in recent years and the Government of Canada also recorded progress with a reduction from 69.7 per cent in 1996-97 to 46.6 per cent in 2002-03.

- While Newfoundland and Labrador's **credit rating** has been upgraded somewhat by all three major credit rating agencies in the last five years, the province still ranks as the lowest among all Canadian provinces. The credit rating outlook overall remains stable with signs of encouragement noted in relation to major resource developments, improved debt ratios and stable federal transfers. The rating agencies also emphasize the importance of an ongoing commitment to fiscal balance.

- The **budgetary position in 2003** indicates a pronounced increase in the budgetary deficit which ranges from $213 million to $666 million by different measures. Real GDP growth of 8.2 per cent in 2002 contributed to strong growth in provincial source revenues in 2002-03, far exceeding budgetary expectations. However, in 2003-04, overall current account and related revenues are budgeted to increase by only 0.5 per cent while current account expenditures are up by 4.9 per cent.

- **Government terms its deficit "affordable"** and will target to eliminate it (the $287 million consolidated deficit) in four years, potentially at the rate of $75 million a year based on an expectation of strong provincial source revenue growth. The budget does not present a plan to achieve the deficit reduction, nor does it provide multi-year projections. The budget does not address the elimination of the $666 million consolidated accrual deficit.

- **The provincial public sector debt** is slated to increase by $450 million to $8.3 billion in 2003-04 – an increase of $1.8 billion since March 1999. In the five years ending March 31, 2004, total public sector debt is projected to have increased by $350 million a year.

- The budget presents a chart which shows a rapid run up in **revenues from offshore oil** to 2006-07. However, the chart does not reveal the entire story: (i) in the years to come the "net" revenue benefit to the province will be only 30 per cent to 40 per cent of the totals indicated due to equalization losses; and (ii) in the absence of new developments, these revenues are expected to begin to decline by 2011 and decline steeply thereafter.

- The examination of the province's fiscal position on a go-forward basis projects an **underlying consolidated deficit** in excess of $420 million, and upwards of $750 million on an accrual basis. This outlook assumes "one-time revenues" have been exhausted and incorporates the incremental borrowing commitments related to hospitals, schools and municipalities.

- The overall assessment, including the views of external analysts, portrays **mixed signals** with respect to the fiscal prospects for the province. From one perspective there is the relatively favourable budgetary report card as set by government, coupled with strong economic performance and a generally favourable assessment of the economic outlook. From another perspective, there is a more critical assessment of a deteriorating budgetary position, an "unsustainable" deficit and an "increasing" debt burden.

- Overall, Newfoundland and Labrador is confronting significant **budgetary challenges** in the near term. They are rooted in: (i) constrained revenue growth over the years; (ii) the depletion of one-time revenues; (iii) increased expenditure commitments, particularly related to public sector compensation and the escalation in health costs; and (iv) the workings of the equalization formula which substantially reduce the net benefit to the province from the increasing offshore oil revenues. The assessment illustrates the major inconsistencies between the expectations one might derive from the current economic trends as depicted by GDP growth, and the realities of the widening deficit gap and mounting debt load.

Relative Fiscal and Economic Position

Newfoundland and Labrador's fiscal and economic trends are compared with the fiscal and economic progress of the Government of Canada and the other provinces in order to place this province's performance in perspective as measured by a number of financial and economic indicators.

- **Canada** as a nation has achieved remarkable **economic and fiscal progress** in the last decade. It advanced from a recession and a record national deficit of $42 billion in the early 1990s to a favourable growth pattern and a consistent record of fiscal surpluses in the last six years. It has recently recorded the largest reduction in debt among the G7 countries and, in 2003, is projected to be the only G7 country in surplus.

- Newfoundland and Labrador's current **fiscal trend** is somewhat at variance with the national trend and that of most provinces. **All provinces** recorded large deficits in the early '90s, and then generally, including Newfoundland and Labrador, focused on restoring fiscal balance. By 2002-03, seven of the 10 provinces had budgeted for a surplus. While Newfoundland and Labrador progressed through to the mid-90s focused on fiscal balance and budgetary restraint like most provinces, it remains in a deficit position with a mounting underlying deficit trend. Over the past number of years, eight provinces have passed **balanced-budget legislation** – Newfoundland and Labrador and P.E.I. are the only provinces that have not done so. *It is recommended the Government of Newfoundland and Labrador introduce balanced budget legislation*.

- A review of the relative provincial **tax effort** indicates that Newfoundland and Labrador has the third highest overall tax effort. Examples of the relative tax rates show this province with: the second highest level of personal income tax, the highest fuel taxes, and mid-range sales taxes, tobacco taxes and corporate income taxes. The overall fiscal capacity of the province, however, is only 68.5 per cent of the national average, generally on a par with P.E.I., tied for the lowest for fiscal capacity amongst the provinces.

- **Provincial government expenditures** represent a relatively large component of the economy of Newfoundland and Labrador. At 30.9 per cent of GDP, it is the highest ratio among the provinces. This province's per capita expenditures exceeded the national average by more than 17 per cent in 2001-02. (It is noted that the decline in population has increased all of the per capita indicators for Newfoundland and Labrador.)

- Provincial government per capita **expenditures on health care** in Newfoundland and Labrador are the highest of any province, while government's **education** expenditures are above average and third highest. However, many other provinces have a greater proportion of funding for health and education provided through private sources, local government funding, fees and other sources (over and above provincial government funding).

- **Debt service costs** on Newfoundland and Labrador's funded debt rank third highest among the provinces as a percentage of revenues, and second highest on a per capita basis and as a percentage of GDP. The inclusion of interest costs on the unfunded pension liabilities makes the comparison even less favourable.

- A review of Newfoundland and Labrador's economic progress by **key indicators** at the end of 2001 indicates: i) the lowest per capita **personal income** (23.1 per cent below the national average); ii) the highest **unemployment** rate (more than double the national average; and, notwithstanding the impact of offshore oil production, iii) the second lowest **GDP** per capita (updated data for 2002 could change some of these indicators).

- Newfoundland and Labrador's **GDP growth** has exceeded the national average in three of the last five years, led by the increased value of oil production. However, the province lagged the national average GDP growth in the six years prior to the commencement of oil production in 1998. In the 10 years from 1991 to 2001 this province's **cumulative GDP growth** in real terms, was 14.8 per cent below the national average GDP growth. The province's GDP perspective reveals: (i) a relatively low economic base; (ii) a high degree of volatility; and (iii) recent growth dominated by increased oil production.

  Cumulatively, the province ranked second from the bottom of all provinces in GDP growth from 1991 to 2001.

- Strong **GDP growth** in Newfoundland and Labrador has not resulted in improved budgetary strength. Increased expenditure commitments and constrained revenue growth point to increased **budgetary deficits** for Newfoundland and Labrador in the near-term – at a time when GDP is expected to continue to climb and most provinces are targeting for fiscal balance.

- The current fiscal direction of Newfoundland and Labrador is not aligned with its near-term GDP growth prospects nor the expectations of many. A deteriorating budgetary position, increasing debt load, high tax burden with little prospect of reduction, combined with substantial ongoing unemployment and personal income disparities all serve to illustrate that Newfoundland and Labrador still has **a long way to go** to bring its overall relative position up to the Canadian average.

Financial Outlook for Newfoundland and Labrador

The overall financial outlook for Newfoundland and Labrador is examined in the context of its near-term fiscal situation and the potential impacts which major resource developments, particularly offshore oil are expected to have on the province's financial prospects given the existing public policy framework. This general outlook for the province is then reviewed in the context of the current economic and budgetary prospects of governments of Canada and the other provinces.

- The outlook is intended to be a broad based **assessment of trends and general indicators**. While specific trends and growth rates have been assumed for a number of key variables, obviously, there will be many unpredictable changes in such variables. In this regard the reader is urged not to focus on absolutes but to consider the nature of the key issues at play, the relationships between these issues, as well as general trends and orders of magnitude.

- The **potential revenue streams** from offshore oil production are widely expected to offer the largest incremental gains to the fiscal position of Newfoundland and

Labrador in the coming years. Also, the development of the White Rose project, as well as the development of the Voisey's Bay project and potentially a Lower Churchill hydro project are assumed to maintain positive momentum in such key revenue sources as sales tax, personal income tax and corporate income tax.

- The analysis of the potential revenues from offshore oil highlights a major **sensitivity to oil prices.** For example, gross annual provincial type revenues (e.g., royalties and corporate income tax) are projected to peak at over $800 million a year with a long-term price assumption of $24 U.S. a barrel. At $19 U.S. a barrel, gross provincial revenues could be 40 per cent less. While this highlights the sensitivity of gross provincial revenues to oil prices, it is noted that because of the equalization impact the net revenue change for the province is considerably less. ($24.00 U.S. has been used in the base case analysis.)

- There is a significant element of uncertainty surrounding the proportion of **provincial corporate income tax (CIT)** that will be attributed to and collected by this province. This is due to the multi-dimensioned nature of the oil companies. It is difficult to determine the extent to which their income will be attributed to this province as opposed to other jurisdictions. The companies operate in a number of different jurisdictions and have a wide range of projects ongoing with different levels of profitability. For the purpose of the analysis it has been assumed that this province will capture 25 per cent of the provincial type CIT.

- The projections of annual oil revenues using the planning assumptions as outlined in this analysis indicate a significant **"revenue bump"** which gains increasing prominence in the coming years, peaks around the years 2009-10, and then begins to decline significantly around 2011-12. The expected escalation is rapid, the peak is relatively short-lived, and the decline is steep.

- In the absence of revenue-offset protections, **equalization** would decline dollar for dollar as oil revenues increase. (In short, there would be no net revenue gain.) The **Atlantic Accord** provides time-limited protection through a rather complex two-phase formula. The degree of protection under this formula phases down in the coming years and expires completely by 2011. In addition, the province also has the option to choose the alternative revenue protection mechanism afforded by the **"generic solution"**. This alternative limits the loss of equalization to 70 cents on the dollar. It is difficult to predict which is the better formula in any given year, however, it has been assumed that the Atlantic Accord will be more favourable in the near-term but the generic solution will become the formula of choice as the Accord formula phases down (and before it expires in 2011).

- In the medium to long-term the revenue protection provisions of the **Atlantic Accord will no longer be operative**. Beyond the next few years, under existing arrangements, the province can only expect to retain a net amount equivalent to 30 per cent of its oil revenues under the generic solution (based on the assumption that this element of the fiscal arrangements is continued).

- **The oil revenue analysis highlights**: i) the rapid escalation in gross provincial oil revenues, the relatively short-lived "revenue bump" and the steep decline in revenues after the peak years; ii) the declining and time-limited protection of the Atlantic Accord which results in recourse to the 30 per cent protection of the generic solution after the next few years; and most importantly; iii) an effective net retention by the province of only 37.4 per cent of provincial type revenues from the existing projects.

- Contrary to a key objective of the Atlantic Accord, **Newfoundland and Labrador will not be the principal beneficiary of its offshore oil revenues**. When federal corporate income tax is included, the analysis of total government revenues concludes that Newfoundland and Labrador would be the net beneficiary of just 23.4 per cent of the total government revenues from offshore oil, while the Government of Canada's effective share is projected at 76.6 per cent.

- The **outlook for the overall budgetary position** of the province is assessed based on the oil revenue assumptions and projections outlined above. It starts from an underlying deficit position which is considered to be in the order of $400 million. This outlook is predicated upon a review of recent economic and fiscal experience as well as an analysis of revenue and expenditure trends. It assumes no change in tax policy or spending patterns.

- *The assessment concludes that the budgetary deficit is not self-correcting.* On a "go-forward" basis the **trends point to ongoing deficits in the order of $250 million to $500 million a year.** Public sector debt is projected to continue to escalate.

- The current **deficit trend is unsustainable**. A "status quo" fiscal policy stance will not see the deficit eliminated. *It is recommended that government firmly commit to the restoration of budgetary balance through a clearly articulated strategy that addresses both expenditure growth, and to the extent practical, revenue enhancement.*

- The fiscal outlook for Newfoundland and Labrador stands in **stark contrast** to that of the Government of Canada which is continuing its commitment to fiscal balance and to budget for an underlying surplus of $4-$5 billion in the coming years. Seven provinces are projecting balanced budgets in the coming years and the eighth, B.C., is targeting a balanced budget by 2004-05.

- The economic outlook for Newfoundland and Labrador continues to be quite favourable, led by the continuation of major resource projects. Unfortunately, **economic growth has not to this point become synonymous with fiscal strength for Newfoundland and Labrador.**

Financial Issues and Options

The foregoing analysis indicates that the Province of Newfoundland and Labrador is confronting major financial challenges which are not removed by the new oil revenues. The situation calls for a balanced, provincial/federal approach. It should encompass significant new fiscal and budgetary initiatives by the province and a renewal of revenue sharing arrangements with the Government of Canada particularly related to equalization and the Atlantic Accord.

- The **fiscal challenges** confronting the Province of Newfoundland and Labrador are centered around i) a significant budgetary deficit totaling $666 million (on an accrual basis); ii) a debt burden which, including unfunded liabilities, is $19,500 per capita (the highest in the country); iii) the third highest tax burden, iv) a population decline in excess of 10 per cent in the last 10 years; v) an inability to realize significant fiscal gains from its substantial offshore petroleum resources and vi) the withdrawal of the Government of Canada from key cost-shared funding arrangements.

- The **fiscal targets** for the foreseeable future should be focused on the fiscal fundamentals: i) balance the budget; ii) stop the escalation of debt and iii) stop the deterioration in the relative tax position. A reduction in the debt to GDP ratio, as well as the reduction in the deficit to GDP and the deficit to total revenue ratios could all be considered as potential fiscal targets. Some of these ratios are influenced by external forces and it is crucial that government not divert its focus from the fundamentals.

- There are **two dimensions** to confronting the fiscal challenges of Newfoundland and Labrador: A provincial dimension – based on fiscal management renewal and a fiscal recovery strategy. A federal dimension – incorporating revised equalization and resource revenue sharing arrangements and revitalized federal / provincial cost-shared agreements;

- *It is recommended that the provincial government make a firm commitment to a fiscal renewal plan which would include: i) a commitment to balance the budget within three to four years; ii) balanced budget legislation; iii) the transition to a single method of financial reporting; iv) the tabling of a three or four year rolling financial plan annually; and v) an expanded reporting scope to encompass key government agencies (implicit in iii) above).*

- *It is recommended that government's approach to balancing the budget encompass: i) a comprehensive, government-wide program review process; ii) a concentrated overhead reduction initiative; iii) a particular focus on programs where the cost of delivery exceeds the national average; iv) an effort to use the upcoming increase in retirements from the public service to accomplish cost-savings through attrition; v) increases in various fees and taxes (to the extent that the province's competitive position can be maintained); vii) an examination of* *the merits of privatizing various functions; and viii) signals from the top – a number of measures initiated at the highest level of government to signal commitment fiscal recovery.*

- The workings of the equalization formula continue to have a vital impact on the overall revenue base of the province. **The Standing Senate Committee on National Finance** recently conducted a detailed study on equalization and recommended that the formula be revised to restore the 10 **province standard** (and replace the existing five province standard). *This recommendation is consistent with the underlying principles of equalization and The Royal Commission should support it.*

- The Senate Committee acknowledged the **"exasperating predicament"** confronted by Newfoundland and Labrador and others, in seeing the revenue gains from offshore oil lost through reductions in equalization. It recommended that these issues be dealt with, not in the equalization formula per se, but through; i) an increase in the provincial share of entitlements under the Generic Solution and ii) a re-examination of the Atlantic Accord.

- There are a number of issues arising from **the Atlantic Accord** as currently structured: i) the proportionate level of revenue protection afforded is already declining, before peak oil revenues and economic and fiscal progress are attained; ii) the formula is only effective when revenues are rising, it is of no benefit when revenues are level or declining and, iii) the arrangements expire entirely in 2011.

- Future projections based on recent experience and current assumptions reveal that oil revenues are not projected to reach the point where equalization payments would be eliminated and 100 per cent of the resource revenues would flow to the province. Furthermore, oil revenues are not projected to be sustained at peak levels – a relatively **short-lived "revenue bump"** is projected.

- Beyond the early years the **generic solution** provides the only revenue protection but, i) it is limited to 30 per cent and, ii) it is not guaranteed beyond the term of the existing fiscal arrangements.

- Newfoundland and Labrador is **not the principal beneficiary** of offshore oil revenues. The province is expected to realize approximately 37 per cent of provincial-type oil revenues. A further revenue analysis which includes total government revenues (including federal corporate income tax) indicates the provincial net share will be in the order of 20 to 25 per cent of combined federal and provincial oil revenues .

- *It is recommended that the equalization formula be amended to restore the 10 province standard, that the equalization "floor" be retained, and that both the equalization and CHST programs be modified to incorporate reasonable accommodation for provinces experiencing significant declines in population.*

- *It is recommended that the Government of Newfoundland and Labrador and the Government of Canada enter into negotiations to amend the Atlantic Accord to ensure that the "principal beneficiary" objective is met through an increase in the proportion of net government revenues that will be retained by the province. Furthermore, the amended Accord should ensure that the province continues to receive a proportionately greater net share of provincial oil revenues as long as it remains below the Canadian average on key economic and fiscal measures.*

- *It is recommended that the Royal Commission support the revitalization of federal provincial cost-shared programs focused on rural development and infrastructure improvement.*

- *From a longer-term perspective, it is recommended that both orders of government give serious consideration to innovative means of revenue sharing whereby a portion of the revenues from non-renewable resources might be invested to reduce the provincial public sector debt and thereby reduce the highest provincial debt burden in the country for the lasting benefit of its future generations.*

Chapter 1

The History and Current State of Public Finance

An overview of the evolution of the financial position of the Province of Newfoundland and Labrador

Newfoundland has great and valuable natural resources of fish and minerals and timber and water power and soil. She has stout-hearted people of unsurpassed racial and national origins. She has joined in union with a great British nation. She has a Government that is moved by unshakeable faith in Newfoundland's destiny. The combination is irresistible. Greatness is her due, as surely as the sparks fly upward.

Hon. Gregory J. Power
Minister of Finance
Newfoundland and Labrador
Budget Speech, May 31, 1954

BUDGETARY HISTORY

Challenges, Progress and Deficits

When Newfoundland and Labrador joined Canada in 1949 it had a balanced budget and no debt. In the 1949 Budget Speech the Minister of Finance reported that *"our cash surplus on the day before Confederation was roundly $40,000,000."* The fiscal balance did not reveal the entire story of Canada's newest province.

Newfoundland and Labrador faced the gargantuan challenges of: i) a widely dispersed rural population distributed over a vast land mass; ii) inadequate health, education and social welfare services and facilities; iii) inadequate, and in some cases non-existent transportation and municipal infrastructure; iv) high unemployment and low personal incomes; and v) a narrow underdeveloped economy based primarily on seasonal, and cyclical resource-based industries.

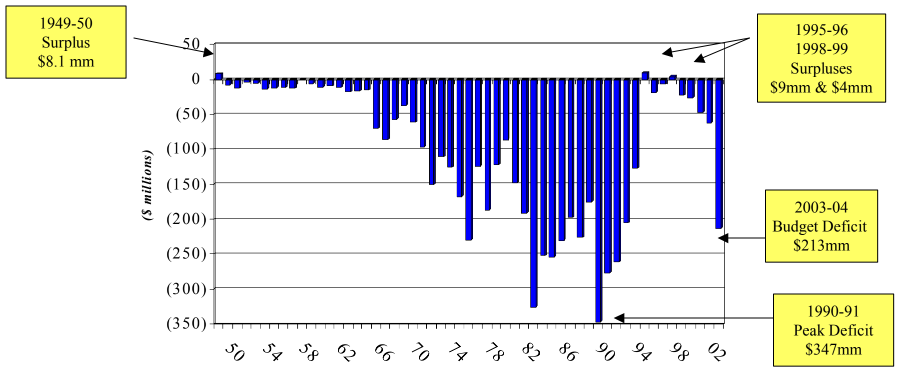
The unrelenting quest of the people of Newfoundland and Labrador to "catch up" with the rest of the nation in the level of quality and availability of public services has led to immense investments of public funds year after year by both the Government of Canada and the Government of Newfoundland and Labrador. While enormous progress has been achieved, the province still has a considerable distance to go in order to approach the national average in many key areas.

In many respects, the price of progress is reflected in the budgetary history and resulting debt profile of the province.

Since Confederation, the province's fiscal position can be characterized as a perpetual struggle with deficit financing. The budgetary chronology prepared for the Royal Commission by the provincial Department of Finance indicates that since joining Canada, Newfoundland and Labrador has recorded deficits in 51 of the 54 years, and is projected to record its 52nd deficit in 2003-04. A trend to increasing deficits has again emerged in recent years as illustrated in Chart 1-1:

Chart 1-1

Deficit / Surplus of Newfoundland & Labrador
1949-50 to 2003-04 Budget



(fiscal year ended March 31)

Source: Government of Newfoundland & Labrador, Department of Finance; Public Accounts 1949-50 to 2001-02 and Budget 2002 and Budget 2003. The projections for 2002-03 are based on the budgetary "Cash Deficit" to maintain comparability with prior years. See Note 1.

An analysis of the deficit in any one-year will reflect a number of specific policy initiatives, events or economic circumstances related to that particular year. However, an overall assessment of the expenditure and revenue trends over the years reveals a number of generally recurring elements:

a) **The need to "catch-up" in public services:** Since Confederation, Newfoundland and Labrador has been in a continuing struggle, first to provide for the most basic of services and then, to improve the level and quality of public services to the standards generally enjoyed by other Canadians. This applies to health care, social services, education, transportation and municipal infrastructure.

b) **The disproportionately high cost of servicing a small, dispersed population:** Newfoundland and Labrador comprises an area of over 400,000 square kilometers. It is seven times the size of Nova Scotia with only 55 per cent of the population. The remoteness of many communities, the large distances between communities, the lack of an efficient transportation network, coupled with a harsh climate, all add to the cost of providing public services.

c) **A limited revenue base**: The province's fiscal capacity was and remains significantly below the national average. From the 1970's to the turn of the century it generally remained 35 to 40 per cent below the national average. The province has one of the heaviest tax burdens in the country, at 113.8 per cent of the national average, yet it only generates approximately 60 per cent of its revenue requirements from provincial sources. Major natural resource developments, particularly hydro and mineral resources have not contributed significantly to the provincial revenue base.

d) **A narrow economic base**: Historically, the economy was characterized by low personal income, a high level of seasonality in employment and consistently high unemployment. The resultant pressures were manifested in relatively high social assistance payments as well as various types of industrial investment initiatives undertaken by governments (with limited success) to broaden and diversify the economy and attempt to generate employment. While the development of the offshore petroleum-related sector of the economy in the late 1980s and the 1990s was an important new dimension in broadening the economy, in many respects it simply helped offset the impact of the collapse of the groundfish resource which historically had been regarded as the backbone of the economy.

e) **A reduction in the proportion of federal funding**: Federal funding arrangements have changed over the years from various kinds of cost sharing formulae for social programs to per capita grants (CHST). In the last several years the growth in federal funding has not matched the growth in the cost of program delivery, particularly in relation to the cost of health care.

f) **An exposure to overall economic conditions**: While the timing and degree of impact varies, national and international economic trends understandably also play a significant role in the province's fiscal results. For example, rampant inflation and interest rate volatility was a key factor in the early 1980s. Also, the overall recession of the early 1990s was a contributing factor in the province's record deficit of $347 million in 1990-91.

Deficit Trends in Context

The deficits in the 1950's were generally in the range of $5 million to $15 million. This may seem small in today's terms but total provincial revenues for the full year in 1949-50 were less than $40 million and amounted to only $84 million by 1959-60. By the early 1970s, budgetary deficits were running in excess of $100 million a year. The peak annual deficit of $347 million was recorded in 1990-91.

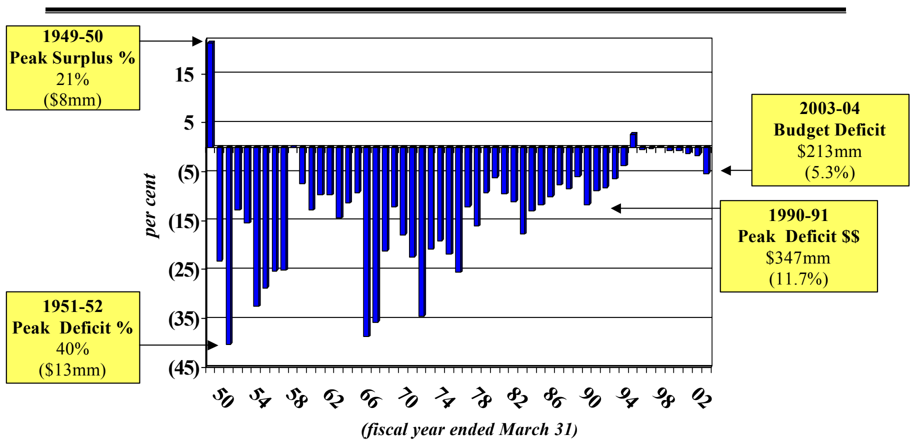
The annual deficits in current dollars, do not, of course, place the historic budgetary trends in a fair perspective.

A more relevant examination of budgetary trends reflects the respective budgetary deficits as a percentage of total revenues as illustrated in Chart 1-2:

Chart 1-2

Deficit/Surplus as a Percentage of Total Revenues

1949-50 to 2003-04 Budget



Source: Government of Newfoundland & Labrador, Department of Finance; Public Accounts 1949-50 to 2001-02 and Budget 2003 and calculations by author.

This analysis puts the deficit in context with the size of the budget. The deficits in the '50s, '60s, and early '70s appeared relatively small in current dollar terms; however, in percentage terms, they were quite significant – 35 per cent of total revenues as late as 1972-73.

In the last 20 years, while the deficits have hit their highest points in dollar terms, they have declined significantly in relation to the size of the overall budget**.** Most recently, the relative size of the deficit has increased.

The same can be said of the size of the provincial deficit in the context of the economy as illustrated in Table 1-1 below, which provides sample indicators at various points in the last six decades:

Table 1-1

Deficit in Context

Sample Indicators in Six Decades
'50s to '00s

Year	GDP ($millions)	Total Revenue ($ millions)	Deficit ($million)	Deficit/ Revenue	Deficit/ GDP
1951-52	N/A	33	**13**	**40.3%**	**N/A**
1961-62	540	94	**9**	**9.7%**	**1.7%**
1971-72	1,440	431	**97**	**22.4%**	**6.7%**
1981-82	5,150	1,552	**148**	**9.6%**	**2.9%**
1991-92	9,590	3,108	**276**	**8.9%**	**2.9%**
2001-02	13,760	3920	**47**	**1.2%**	**0.3%**
2003-04B	16,750p	4,048	**213**	**5.3%**	**1.3%**

Source: Government of Newfoundland & Labrador, Department of Finance; Public Accounts 1949-50 to 2001-02 and Budget 2003 & calculations by author. GDP for 2003 is projected by the author based on 7.4% nominal growth from 2002 estimate of $15.6 billion.

To maintain comparability, the above chart reflects the deficits in accordance with government's historic reporting practices. On this basis the relative size of deficits has declined significantly in the last 30 years, from levels over 20 per cent of total revenues and almost seven per cent of GDP recorded in the '70s down to the levels of 1.2 per cent of revenue and approximately 0.3 per cent of GDP in 2001-02. More recently, the numbers reflect an increase in the relative size of the deficit – to 5.3 per cent of revenues and 1.3 per cent of GDP in 2003-04 on the historic, modified cash basis of reporting.

Recent Budgetary Trends

While the historical financial perspective dating back to Confederation provides interesting background information, the financial results through the 1990's, and more particularly through the turn of the century, provide a more relevant picture for assessing the current state of public finance in the province.

Newfoundland and Labrador, along with most other provinces and the Government of Canada, was facing a bleak financial picture indeed at the outset of the 1990s.

1990-91 – "Financial Crisis"

In 1990-91 Newfoundland and Labrador incurred its highest deficit ever in dollar terms – $347 million. At that time, the Minister of Finance declared the situation to be a "financial crisis". In his 1991 budget speech he stated:

> *The costs of Government have escalated dramatically in recent years. Transfer payments are being seriously restricted by the financial problems of the Federal Government and by a national recession. The current economic downturn is limiting growth in our tax revenues. We face a financial crisis which, if left unchecked, would impair permanently our ability to maintain public services at acceptable levels.*
>
> *Perhaps the underlying reason for the financial crisis facing this and other governments in Canada today is the expectations of government that almost everyone seems to have…*
>
> *… It is not solely that our expectations of government are too high, but also that governments have not had the political courage to restrict current expenditures to the level of current revenues. Governments in Canada, including Newfoundland, have been living beyond their means and have allowed the public debt to increase year after year, rather than face the people with the grim reality that every increase in expenditure must ultimately be met by increased revenue from taxes.*[1]

A series of severe budgetary restraint measures, followed in successive budgets, which along with an improving economic environment, and some non-recurring adjustments, contributed to the elimination of the deficit by 1995-96.

<u>The Early ’90s - Budgetary Restraint</u>

In tackling the 1991 deficit, Newfoundland and Labrador embarked upon one of the most aggressive fiscal restraint programs ever undertaken in the history of the province. It included public service layoffs, wage freezes, hospital bed closures, reduced grants to community colleges, and the MUN School of Medicine, and government-wide program cuts and service reductions. The emphasis on fiscal restraint in Newfoundland and Labrador was in line with, and in some respects possibly more severe than, the budgetary stance taken by other provinces and the federal government at the time.

The continuing restraint program and the improving economy did much to improve the budgetary position through the early 1990s and in fact a surplus was recorded in 1995-96, (with the help of some “extraordinary”, or non-recurring revenues, which totaled some $93 million).

Notwithstanding the surplus reported in 1995-96, the Minister of Finance of the day emphasized that “an underlying deficit remains”. He called for further budgetary restraint. He highlighted the ongoing spending demands, particularly in the social program areas, in a time when the Government of Canada was cutting transfer payments for health care, post-secondary education and social assistance. Federal cash transfers for social programs were to decline by $110 million in 1996-97 and the amount of the

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[1] 1991 Budget, Newfoundland and Labrador, Hon. Hubert Kitchen, Minister of Finance, March 7, 1991, p.1.

decline was projected to total $160 million by 1997-98. The federal restraint program, which was focused on the eradication of the national deficit, was having a significant impact on the provinces.

<u>Throughout the '90s - Fiscal Recovery</u>

In committing itself to prudent financial management in 1996, Government began budgeting for an annual contingency reserve of $30 million to cover unforeseen requirements during the year. It also initiated a three-year financial planning process to build on the other elements of financial discipline. The three-year financial framework was announced in the 1997 Budget and it targeted a "sustainable balanced budget in 1999-2000".

In fact, a surplus of $4 million was recorded in 1998-99 and only modest deficits of $23 million and $26 million were recorded in 1999-2000 and 2000-01, respectively. Budgetary restraint, admittedly augmented by a series of one-time revenue arrangements, had reversed the negative trends apparent at the start of the decade.

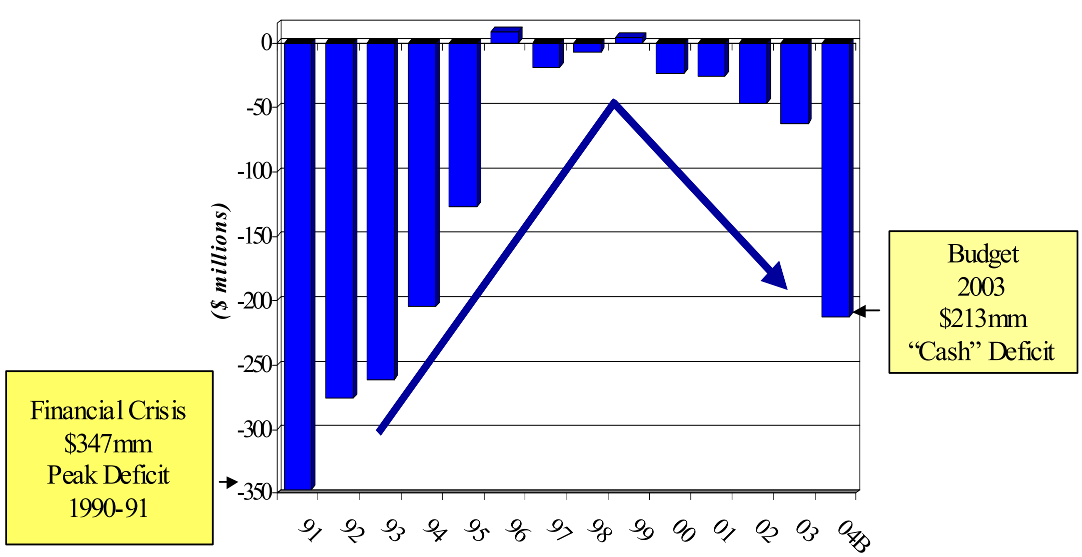
By 2001, the Minister of Finance was reporting upon "the best fiscal performance for any consecutive five-year period since the early 1960s."

<u>Chart 1-3</u>

Recent Budgetary Trends

Difficult start to '90s – then Positive Trend – then Increasing Deficits

(fiscal year ended March 31)



Source: Department of Finance; Public Accounts 1990-91 to 2001–02 and Budget 2003, based on government's modified "cash" method of reporting.

Today – Increasing Deficit Trend

A deficit of $47 million was recorded in 2001-02, and a deficit of $93 million was budgeted for 2002-03. However, in both cases the net position reflected significant "one-time" revenues. In fact, by 2002-03, excluding the budgeted one-time revenues, the budgetary deficit was trending toward $300 million. The three-year financial planning process was not continued beyond its initial cycle and the contingency reserve had been reduced from $30 million to $10 million.

The province recorded exceptionally strong growth in 2002 and by the March 2003 year end, government indicated that revenue growth resulting from favourable economic performance had reduced the 2002-03 budgetary deficit from $93 million to $62 million (based on its traditional method of reporting). Some of the one-time revenues budgeted for 2002-03 were deferred.

Nonetheless the budgetary outlook is for an increased deficit. The 2003 budget projected a deficit of $213 million for 2003-04 based on its previous reporting format. In addition government highlighted further borrowing requirements of $74 million for various government entities (school construction, municipal financing and a major heritage project) which brought the "consolidated deficit" to $287 million for 2003-04 (on a comparable basis the 2002-03 consolidated deficit was $143 million). It should be noted as well that there are at least $97 million in one-time revenues reflected in the new budget. Government has, however, indicated it plans to target deficit reduction of $75 million a year over the next four years, which it feels can likely be achieved through continuing revenue growth.

The return to rising deficits is the obvious outcome of ongoing expenditure growth combined with successive years of slower growth in core revenues. In the recent period of increasing deficits from 1999-00 to 2003-04, total revenues are budgeted to be up 13.5 per cent while total expenditures are up 18.8 per cent.

A review of the overall expenditure and revenue trends provides further insight into the elements contributing to the trend toward rising deficits.

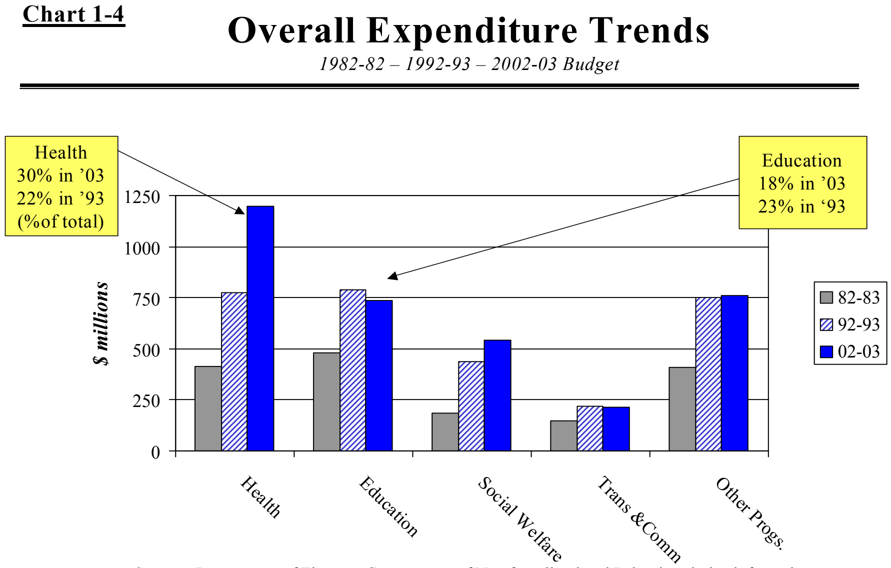
Expenditure Trends

The following review of expenditure and revenue trends was prepared based on historical data and the 2002 budget (prior to the release of the 2003 budget on March 27, 2003). In many respects the general trends evident up to and including the 2002-03 budget are still valid, and many of the detailed numbers have not been restated based on the 2003 budget. However, an effort has been made to update the data in those areas where the new budget provides significant additional information or would point to a different trend.

Total provincial government expenditures in the 2002-03 fiscal year were budgeted at almost $4.1 billion, with 30 per cent of the total attributable to health care and 18 per cent related to education. Total expenditures increased by $0.6 billion (17.3 per cent) from 1992-93 to the 2002-03 budget.

The dominant growth component is health care which accounts for over $0.4 billion or 70 per cent of the total increase in government spending since 1992-93:

Chart 1-4



Source: Department of Finance, Government of Newfoundland and Labrador, derived from the Public Accounts and the 2002-03 Budget Estimates with expenditures allocated on the basis of Functional Classifications developed by Statistics Canada.

Health surpassed education as the leading expenditure component in the provincial budget in 1994-95 and it was budgeted to exceed education by over 60 per cent in 2002-03. Expenditures on education, while ranking second in overall spending by the province, actually declined in the last decade

The major expenditure components reflect differing trends and pressures as outlined below:

i) Health Care

Provincial health care costs were budgeted at $1.2 billion in 2002-03, an increase of 54.5 per cent from the level recorded in 1992-93. This is generally reflective of the all provinces average increase of 51.6 per cent in the 10-year period to March 2002. This rate of growth in health care costs was more than triple the growth in this province's overall program spending of 16.1 per cent in the 10-year period.

The pronounced expenditure growth reflects: increased program delivery costs, increased drug costs, new and upgraded diagnostic services, increased demand for services, new medical procedures as well as substantial capital investment in upgrading, and in some cases replacing, health care buildings, facilities and equipment.

ii) Education

Education expenditures in 2002-03 were budgeted to total $735 million, down 6.6 per cent from the level recorded 10 years earlier, due primarily to declining student enrollment at the primary and secondary levels. Education spending declined from 22.8 per cent of the total budget in 1992-93 to 18.1 per cent in 2002-03. While student enrollment is down over 30 per cent in the last 10 years, teacher allocations and school board grants have not been reduced in direct proportion to the enrollment decline.

iii) Social Welfare

Social welfare costs were budgeted at $543 million in 2002-03, up 24.2 per cent in the 10-year period compared with the overall average increase of 16.1 per cent in total program spending. While case loads have declined in recent years, the cost increase is apparently attributable to program enhancements, increased rates and program delivery costs including personnel costs.

iv) Transportation and Communications

The 10-year comparison indicates a decline of 3.6 per cent to a budgeted level of $212 million in 2002-03. In the interim, the annual expenditures peaked at $271 million in 2000-01. Operating expenditures were actually up more than 10 per cent in the period; however, volatility in capital spending accounts for the decline. Gross capital expenditures in 2002-03 were budgeted to be $20 million below the 1992-93 level (and more than $50 million below 2000-01).

In addition to the expenditure trends by major program area, there are key broad based elements of expenditure growth which are having a significant impact on the overall budgetary trends:

i) Public Service Salaries and Benefits

The total public sector wage and salary bill for all groups is now estimated to be in excess of $2.0 billion. The recent round of negotiations provided for total compensation increases ranging from 15 per cent to more than 17 per cent over a three-year period. It is estimated that the full annualized cost of these increases exceeds $350 million. A significant part of this cost had been reflected in 2002-03, however, it is estimated that a further substantial increment of some $130-140 million remained to be incorporated in the 2003 budget. This has clearly been a key factor in the increased deficit for 2003-04. (The implementation of "pay equity" and a gender neutral job evaluation system has also increased the compensation costs in the last number of years with $50 million budgeted in health facilities for 2003-04.)

ii) <u>Debt Expenses</u>

Reduced interest rates have slowed the pace of escalation in debt service costs in the last 10 years. Maturing debt at double-digit interest rates has been replaced by new debt with interest rates in the five per cent to seven per cent range. However, in the 10 years up to March 31, 2003, incremental direct debt totaling $1.6 billion has been put on the books primarily to fund the annual deficits and significant non-budgetary pension contributions (see iii) below). Total debt expenses, capital and current, in 2003-04 are budgeted at $590 million, up 21 per cent from the 1992-93 expenditures.

iii) <u>Non-Budgetary Pension Contributions</u>

Since 1997-98 government has been making special annual contributions to the various public sector pension funds, over and above the budgetary contributions, to curtail the growth in its unfunded pension liability (discussed later in "Provincial Debt Trends"). In 2002-03 these contributions totaled $149 million. From a technical perspective, under government's traditional method of budgeting, these special pension contributions were not reflected in the budgetary cash deficit. (These liabilities are already fully reflected in the public accounts and these special contributions transform them from "unfunded" to "funded" liabilities.) However, these contributions are made from borrowed funds which are part of government's annual borrowing requirement. Funding these pension obligations through borrowings increases the direct debt of the province and the associated annual interest cost then becomes a budgetary expense. A total of $840 million has been borrowed to fund pension obligations over the last six years and this is estimated to have added in the order of $50 million to annual interest costs. A further $164 million will be borrowed for this purpose in 2003-04.

iv) <u>Reduced Capital Expenditures</u>

Annual capital program expenditures (exclusive of debt changes) have declined approximately 20 per cent in recent years. Gross expenditures on the provincial capital program averaged $300 million a year in the 10 years from 1982-83 to 1992-93 while in the most recent 10 year period, the annual average is in the order of $240 million. (The most notable decrease was in transportation and communications.) Gross capital expenditures in 2002-03 were budgeted at $225 million but the revised estimates in the 2003 budget indicated total expenditures of $206 million for the year.

Based on the foregoing, the dominant factors leading expenditure growth are: the incremental impact of the ongoing escalation of health care costs and public sector compensation arrangements. Furthermore, increasing deficits and additional non-budgeted borrowings for pensions continue to inflate Government's funded debt burden and exacerbate debt service costs.

Trends in Federal/Provincial Cost-Sharing Agreements

In relation to federal/provincial cost-sharing agreements there are really two areas for consideration: i) support for capital projects; and ii) support for traditional regional development cost-shared programs.

In recent years there has been a decline in both the level of **capital expenditures** in the province and the federal support for capital projects under cost-shared agreements. Through the 1990s, from 1989-90 to 1998-99, annual provincial capital expenditures totaled $285 million on average, and the annual federal contribution averaged $91 million (ranging from a low of $66 million in 1989-90 to a high of $133 million in 1992-93). This compares with the recent capital program which has declined to an average of $235 million over the past four years (1999-00 to 2002-03) with an annual average contribution of $63 million from the Government of Canada. This trend, in current dollars, highlights a decline of some 30 per cent in the aggregate revenue received from the Government of Canada for capital projects on an annual basis.

The results for 2002-03 as outlined in the 2003 budget indicate revenue receipts from the Government of Canada for capital projects totaled $48 million, short of the budgeted level of $68 million. The 2003 budget indicates an increase in federal revenue for capital projects to $98 million with the increase related to $25 million in one-time funding for medical equipment and budgeted funding support for various highway projects.

The most significant area of concern relates to the withdrawal of the Government of Canada from the traditional federal/provincial cost-sharing arrangements for regional development**.** A number of such agreements, highlighted by CEDA (the Canada-Newfoundland and Labrador Comprehensive Economic Development Agreement have expired or are about to expire. While the province budgeted for a one-year $20 million extension (70-30 cost-shared) in 2003, at this point there is no indication that the Government of Canada will agree. While the regional development challenges remain – failure to renew the agreements in this traditional area of federal/provincial co-operative funding creates a significant void in the ability to finance regional economic development initiatives.

Revenue Trends

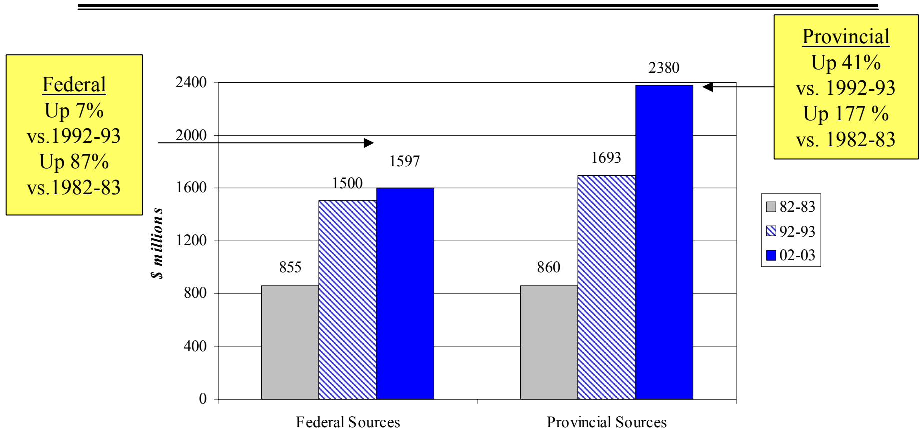
Gross revenues of the province totaled almost $4.0 billion in 2002-03; up 24.5 per cent from some $3.2 billion in 1992-93. The province's revenue profile is comprised of two components; provincial "own source" revenues, which accounted for 59.8 per cent in 2002-03 and federal transfers which amounted to 40.2 per cent of the total. This represents a significant change from the early 1980s when the revenue sources were almost evenly split at 50/50.

For the past several years the growth in federal transfers has lagged the rate of growth in provincial own source revenues as illustrated below:

Chart 1-5

Overall Revenue Trends

1982-83 – 1992-93 – 2002-03 Revised



Source: Government of Newfoundland and Labrador, Department of Finance Public Accounts and 2003 Budget & Annual Estimates

In the last 10 years alone, the growth in provincial source revenues has outpaced that of federal transfers by approximately 34 per cent.

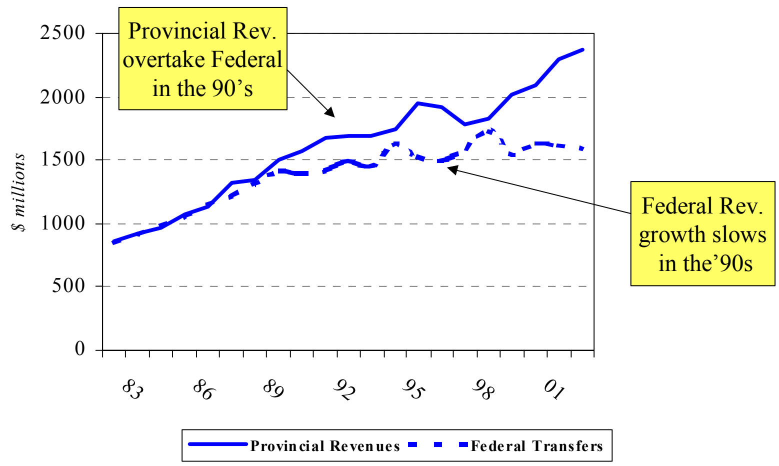
Chart 1-6 below illustrates more clearly, the differing trends in the growth from the two major revenue components.

Chart 1-6

Trends in Annual Revenues by Source

1982-83 to 2002-03

(year ended March 31)



Source: Government of Newfoundland and Labrador, Department of Finance Public Accounts and 2003 Budget & Annual Estimates

The rate of growth in the individual revenue components has varied significantly over the past 10 years. **Equalization**, which is the largest single component in the province's revenue base, increased by 29 per cent from $877 million in 1992-93 to the latest revised estimate of $1,132 million in 2002-03. Equalization constituted 27.5 per cent of the province's overall current and capital revenue base in 1992-93 and 25.9 per cent in 2002-03. It must be noted as well that the "equalization" payments in 2002-03 include over $200 million in offset payments under the Atlantic Accord, including payments in respect of the current year as well as prior year adjustments. (It is understood that a separate analysis of equalization has been prepared for the Commission.)

The Canada Health and Social Transfer **(CHST)** system of transfer payments to the provinces was introduced in 1996-97 to replace the previous federal funding arrangements under Established Programs Financing (EPF) and the Canada Assistance Plan (CAP). In 2002-03 CHST cash payments totaled $340 million, down more than 17 per cent from the combined cash payments of $411 million in 1992-93 under EPF and CAP. Clearly, the federal restraint on CHST payments has had a significant impact on the revenue growth from federal sources.

According to revised estimates, **equalization and CHST** combined, increased by 14.9 per cent as at March 31, 2003, compared with the combined entitlements received in 1992-93 under the predecessor arrangements. In the same period the province's gross annual revenues are estimated to have increased by 24.5 per cent as noted previously.

While there has been significant growth in individual revenue components (the most notable of which perhaps is provincial lottery revenues, which are up over $60 million, or 140 per cent in the last 10 years), the trends have varied significantly. From an overall perspective, analysis indicates that overall revenue growth in recent years has been dampened as a result of three key factors: i) provincial tax reductions; ii) population decline; and iii) CHST restraint:

i) **Tax Reductions: The Move to HST and Income Tax Reductions**

In 1997, government converted to the **Harmonized Sales Tax** in a policy move jointly with the Government of Canada and various other provinces. The provincial sales tax on consumer goods was effectively reduced from 12 per cent to eight per cent. As a result, 1997 provincial sales tax revenues were down $125.5 million or 22.3 per cent from the 1996 level (sales tax for the year totaled $436.3 million, down from $61.8 million). The initial impact was substantially offset by transitional grants from the Government of Canada.

The transitional grants, which totaled $349 million over four years, have been depleted since 2000-01 and the revenue base has been lowered. It is primarily for this reason that sales tax revenues increased only 10.1 per cent in 10 years – a period when per capita personal income increased by over 30 per cent. It is estimated that the net ongoing impact of the tax reduction on the tax base is in the order of $100 million to $120 million.

In addition, in 1999 government announced a three-phase program to **reduce personal income taxes** recognizing the general trends and the increasing tax competition. The first two phases were implemented in 2000 and 2001, and have an estimated annualized impact of $60 million to $80 million. The third phase of the reductions was deferred prior to the 2002 budget and remains deferred. (Other provinces have continued to proceed with tax reductions augmenting the competitive pressures.)

While these tax reductions help bring Newfoundland and Labrador's tax rates more in line with other provinces, and respond to the mounting competitive tax pressures, the combined dampening impact on the annual revenue base in the current economic environment is estimated in the order of $160 million to $200 million.

ii) **Population Decline**

The latest revised population estimates by the provincial Department of Finance indicate that Newfoundland and Labrador's population has declined by 61,000, or 10.5 per cent since 1992. In the 2003 budget, government indicated that the impact of the population decline on federal cash transfer payments for Equalization and CHST amounts to $140 million compared to the level that would have been paid had the population remained constant the past 10 years.

It should also be noted that, had the population remained constant, sales tax, personal income tax (PIT), and other consumer taxes such as the gasoline tax and tobacco tax would be higher today. It is difficult to estimate the out-migration impact on these revenue sources, however, an estimate based on collecting just 25 per cent of pro rata PIT and 50 per cent of pro rata revenues from other key **provincial tax sources** would indicate a further reduction in annual revenues of over $60 million.

Overall, therefore, it is estimated that the federal and provincial revenue base combined has been reduced by in excess of $200 million as a result of the population decline – which is primarily due to out-migration.

In addition, a further population decline of 16,000 or 3.1 per cent is projected over the next 10 years in the medium case forecast prepared by the provincial Department of Finance. This would lead to a similar dampening impact on future revenues.

iii) CHST Restraint

The federal government's expenditure restraint program has been felt by all provinces since the mid-1990s through the implementation of the CHST to replace previous funding arrangements (Established Program Financing – EPF and the Canada Assistance Plan – CAP).

The impact of the federal restraint on CHST has been a major source of contention between the Government of Canada and the provinces for the past several years. There has been an ongoing federal/provincial debate over the quantification of the size of the impact. The recent 2003 Budget of the province again reiterated this issue noting that:

> *… our federal cash transfers will be roughly the same in the coming year as they were in 1994-95, with the transfer in support of health expenditures actually $58 million lower.*[2]

Even after the Health Accord announced by the Government of Canada earlier in 2003, the provinces continue to emphasize the inadequacy of federal funding to meet the requirement in this area.

Natural Resource Taxes and Royalties are only now becoming a prominent feature of the province's revenue base. In 1992-93 this revenue source accounted for $17 million and by 2002-03 the budgeted revenues were just over $50 million – in a $4.0 billion budget. The province is on the threshold of an immense change in this area and this was evident as 2002-03 unfolded. With the increase in oil production and higher prices the revised estimate for 2002-03 came in at $88 million. The latest budget projects it will

[2] Budget 2003, Newfoundland and Labrador, Hon. Joan Marie Aylward, Minister of Finance, March 27, 2003.

increase to $153 million in 2003-04 – a significant change from the 2002 budgeted level of $51 million.

In the future, the net benefits to be realized by Newfoundland and Labrador will be contingent upon a range of issues including: the level of oil production, prices and profitability, and the extent to which the corresponding decline in equalization is offset (by the protections in Atlantic Accord and the generic solution discussed in Chapter 3). In addition to the direct revenues, it is likely that ongoing development in this sector will be a key element supporting growth in other key provincial source revenues.

Appendix B provides a summary of the trend in the various components of the annual revenue base in recent years. Equalization historically has been the largest single revenue source for the province. It has now begun to decline and this decline is expected to become much more pronounced as the oil related revenues increase in the coming years. (The outlook for oil revenues and equalization are dealt with in some detail in the fiscal outlook in Chapter 3.)

“One-Time” – Non-Core Revenues

Since the mid-1990s, the overall revenue trends, and accordingly, the trend in the net budgetary position of the province have been bolstered by a number of “one-time” revenues. The 2002-03 budget projected $232 million in such non-core revenues.

In the province’s fiscal history over the past 10 years, it was perhaps in the 1995 Budget speech that “one-time” revenues were first highlighted by the then-Minister of Finance. In that year one-time revenues in excess of $90 million were identified as being key to the province achieving a balanced budget for the first time in decades. The Minister at the time emphasized that balancing the budget should not be a “one-time event”. He noted that major challenges remained to be addressed and the need for ongoing restraint if substantial budgetary shortfalls were to be avoided in the future.

In succeeding years, however, notwithstanding fiscal restraint measures, “one-time” revenues have continued to figure prominently in the province’s budgetary position. In each of 1997-98 and 1998-99 they totaled $167 million and in 2001-02 they contributed a total of $217 million. Table 1-2 summarizes the budgetary impact since 1996-97 and includes the revised position for 2002-03 as well as the budget for 2003-04:

Table 1-2

"One-Time" – Non-Core Revenues
(1996-97 to 2003-04 Budget)

$ million

	96-97	97-98	98-99	99-00	00-01	01-02	02-03B	02-03R	03-04B
Term 29-Advance	50	40	40	-	-	-	-	-	-
HST Transition	-	127	127	63	32	-	-	-	-
CHST Supplements	-	-	-	35	69	-	-	-	42
Sinking Fund Recoveries	-	-	-	-	27	156	115	80	37
Hydro-Special Dividend	-	-	-	-	-	61	-		
Lab. Transportation Initiative – Trust Fund	-	-	-	-	-	-	97	-	-
NLHC/NLC Revenues	-	-	-	-	-	-	20	-	20
TOTAL	50	167	167	98	128	217	232	80	99

Source: Province of Newfoundland and Labrador Public Accounts and annual estimates.

One-time revenues of $232 million were budgeted in 2002-03. At the time that budget was prepared, it was expected that in the absence of such one-time revenues, the 2002 budget would have projected a deficit of $325 million. Fortunately, strong economic growth in 2002-03, along with various favourable revenue adjustments produced revenue growth beyond budgeted levels. Accordingly, government only drew upon $80 million of the planned one-time revenues in 2002-03, the balance was deferred to future years. A total of $99 million in one-time revenues is budgeted for 2003-04.

The nature of the one-time revenue sources has varied somewhat over the years, however, they all have one consistent characteristic – they are not sustainable as part of the ongoing annual revenue base. The most significant components in Table 1-4 are explained below:

i) Term 29 Advance

In the 1996 provincial budget, it was announced that the Government of Canada had agreed to an upfront advance on amounts payable under Term 29 of the Terms of Union with Canada. The amount appeared to be intended to cover the present value of the regular payments, $8 million per year, for the next 20 years. At the time, government explained that this arrangement enabled the province to avoid severe cuts in the health care sector in the 1996-97 fiscal year. The grants totaled $130 million and were paid out over three years ending in 1998-99. The regular Term 29 annual payments of $8 million per year, are to resume in 2016.

ii) <u>HST Transitional Grant</u>

The move to the Harmonized Sales Tax and the associated reduction in the retail sales tax from an effective rate of almost 20 per cent to 15 per cent had a significant impact on this major tax base. In recognition of the immediate reduction in revenues of approximately $125 million a year, the Government of Canada provided the transitional grants totaling $349 million. These grants were reflected commencing in 1997-98 and continued through the first four years the HST system was in effect. These transitional grants were fully utilized by the end of 2000-01.

iii) <u>CHST – Supplements</u>

In recognition of the significant challenges confronting the provinces in dealing with mounting health care costs, the Government of Canada provided special supplementary grants, on a non-recurring basis, which were spread over the 1999-00 and 2000-01 fiscal years. The 2003 Health Accord provided a total of $42 million in supplements in respect of 2003-04, 2004-05, and 2005-06. Provinces have the flexibility to draw down these funds as they require them. This province budgeted to draw down all $42 million in 2003-04. (Similar flexibility was provided under the new Health Accord with respect to the province's $25 million entitlement for diagnostic and medical equipment. The 2003 Budget indicates that these funds will all be drawn down in 2003-04 to finance new MRI equipment. Since this is a one-time revenue used to finance a one-time expenditure, it has not been reflected in Table 1-4.)

iv) <u>Sinking Fund Recoveries</u>

Regular contributions to sinking funds are made annually to retire certain components of the province's long-term debt. Over time these funds have generated earnings beyond the level required to retire the associated debt. In this regard, significant surpluses had accumulated over the years and in the late 1990s government began budgeting to recover a portion of the surplus to augment regular revenues and reduce the deficit.

Government has treated these funds as "flexible" revenues and actually deferred a portion of the budgeted recoveries at year-end in 2000, 2001 and 2002 in order to "smooth" the fiscal results. Government recovered $156 million in 2001-02 which significantly reduced the deficit in that year. In 2002-03, government budgeted to recover the entire balance of $115 million but only actually drew down $80 million. The balance was deferred. It now totals $37 million and is budgeted to augment revenues for the 2003-04 fiscal year.

v) Newfoundland and Labrador Hydro – Special Dividend

The province received its first dividend from Hydro in 1995-96 and at that time the Minister referred to it as a one-time revenue. However, since then it has become regular practice to budget for dividends from Hydro recently in the order of $50 million to $70 million. In many respects these ongoing dividends might now be considered part of core revenues.

In 2001-02 Hydro paid a special dividend to the province of $61 million, over and above the regular dividend. There is no basis to expect ongoing special dividends of this nature.

It should be noted also that the amount of the cash dividend received in a given year has not necessarily corresponded to the budgeted amount. As with sinking fund recoveries, Government has periodically deferred the receipt of these cash dividends to smooth its budgetary results.

In the last three years Hydro's dividends to the province, including the special dividend, have totaled approximately $250 million.

vi) Labrador Transportation Initiative Trust Fund

In the spring of 1997 the province signed an agreement with the Government of Canada whereby the federal government provided funding of $350 million in return for the province taking over responsibility for the Coastal Labrador Ferry Service. To the end of 2001-02, a total of $253 million had been expended from the fund. In 2002-03, the remaining balance in the fund of $97 million was budgeted to be transferred into the consolidated revenue fund and incorporated as part of the provincial revenue stream for the year. At year-end, 2002-03, government cancelled its plans to transfer these funds to provincial revenues and left the Trust Fund to be drawn down in the normal course.

vii) NLHC/NLC

For the past three years, and again in 2003, Government budgeted a recovery of $10 million from Newfoundland and Labrador Housing. To date it has deferred the recovery and treated it as a flexible revenue available to adjust the deficit. If and when it does recover this amount, it will be a one-time revenue. Similarly, it has budgeted for a one-time revenue recovery of $10 million from the Newfoundland Liquor Corporation.

In the several years up to and including the budget for 2003-04, the one-time revenues from a range of different sources have totaled in excess of $1 billion – with $99 million budgeted for the current fiscal year.

Financial Obligations – Beyond the Reported Budgetary Position

A further dimension of the province's fiscal position relates to the additional financial obligations of the province in respect of hospitals and school boards which had not been reflected in the provincial budget up to 2003.[3]

The Government of Newfoundland and Labrador is the principal funding source for the province's **hospital boards and school boards**. Periodically, the expenditures of these agencies exceed the funding provided by government in the regular budgetary process and deficits are incurred – despite considerable efforts on the part of government to encourage, or even demand, that these boards balance their books. For the most part, such deficits ultimately become financial obligations of the province which must be funded through the budgetary process. The recent operating deficits in that regard are summarized in Table 1-3:

Table 1-3

HEALTH AND SCHOOL BOARDS
OPERATING DEFICITS
For Fiscal Years Ended March 31

($ millions)

	2000	2001	2002
Operating Deficit *			
Hospital Boards	33.6	60.1	16.5
Health & Community Services Boards	4.6	11.6	3.1
School Boards	2.9	1.6	1.9
	41.1	73.3	21.5

* Net Deficit after non-sharable expenses

Source: Data extracted from the Report of the Auditor General for the Province of Newfoundland and Labrador for the year ended March 31, 2002.

Clearly, the most significant shortfalls have been in the health sector. Considerable efforts are underway by both the boards and government to eradicate these deficits, and important progress has been made.

[3] In addressing this issue an effort has been made not to complicate the analysis with a technical accounting debate on the relative merits of modified cash accounting as opposed to accrual accounting. An attempt has been made to assess these obligations within the spirit of the existing accounting structure.

In previous years, these obligations have not been reflected in the reported budgetary position on a regular basis. Notwithstanding arguments over accounting treatment, deficits of this nature have over the years eventually been funded by the province. It is reasonable, therefore, that they should be added to the deficit to reflect the overall position more completely.

While considerable progress has been made in addressing these deficits, it is not clear that they have yet been eradicated. However, on a go forward basis it has been assumed that the province and the hospital boards will be successful in eliminating these deficits and there will not be an incremental obligation.

In addition to government's obligations arising out of the board operating deficits outlined above, significant capital investments (approximately $30 million a year recently) related to **school construction** had not been reflected in the budget. These capital projects are funded through the Newfoundland and Labrador Education Investment Corporation.

Similarly, significant financial commitments in relation to "The Rooms" heritage project and the Newfoundland and Labrador Municipal Financing Corporation (NMFC) had not been reflected in the budget. The 2003 Budget represents a significant step forward in improving the budgetary reporting and disclosure in this regard. Borrowing requirements for these entities are summarized in Table 1-4.

Table 1-4

Borrowing Requirements
"Other Entities"
For the Fiscal year Ended March 31

	2002-03	**2003-04**
Newfoundland and Labrador Education Investment Corporation (School Construction)	31.8	30.5
Newfoundland and Labrador Heritage Corporation ("The Rooms")	17.6	13.0
NMFC	28.0	27.0
Other	4.1	3.4
	81.5	73.9

The budget explained that these requirements brought the consolidated budgetary deficit for 2003-04 up to $286.6 million compared with a revised deficit of $143.2 million in 2002-03 on the same basis (compared with the deficits of $212.7 million and $61.7 million respectively under the previous reporting method).

Budget Smoothing

The assessment of the underlying budgetary trends has been complicated in recent years by the budget smoothing technique government has employed and which merits a brief explanation.

During the course of each year, revenue forecasts and entitlements are revised periodically based on the receipt of updated economic data as well as revised projections from the Government of Canada. These adjustments can frequently be quite substantial (for both the current year and prior years), particularly in relation to major revenue components such as: equalization, CHST, sales tax, personal income tax and corporate income tax. The smoothing has occurred when, upon receipt of favourable news of revenue adjustments, government has deferred the receipt of other budgeted revenues. The Minister of Finance has explained the approach as follows:

> *The strategy we have utilized for several years in managing public finances is to shift revenues from high surpluses to years where we would otherwise have excessively high deficits. This smoothing of the peaks and valleys of our fiscal position has been a significant factor in creating the stability the province has enjoyed over the past five years.*[4]

The fiscal smoothing adjustments in recent years have been substantial and have in some cases included the prepaying of expenses as well as deferring revenues. Revenue smoothing adjustments in recent years are summarized below:

[4] Budget Speech 2001, Province of Newfoundland and Labrador, Hon. Joan Marie Alyward, Minister of Finance, March 22, 2001, p.5.

Table 1-5

Revenue Smoothing Adjustments[5]
Budgeted Revenue Deferred at Fiscal Year End

($ millions)

	96-97	97-98	98-99	99-00	00-01	01-02	02-03
Revenues Deferred:							
Hydro Dividends	15	30	52	76	68	7	-
Loan Guarantee Fees	8	8	-	8	8	-	-
Sinking Fund Recoveries	-	-	-	26	89	29	37
NLHC/GIPco Recoveries	-	-	-	13	12	13	10
NLC Recovery	-	-	-	-	10	10	10
Labrador Transportation Initiative Trust	-	-	-	-	-	-	97*
Total Deferred Revenues	**23**	**38**	**52**	**123**	**187**	**59**	**154**

*Government decided not to proceed with this transfer.

Source: Department of Finance annual estimates of revenue and expenditure and reports of the Auditor General of Newfoundland and Labrador and Budget 2003.

The 2000-01 fiscal year was the year of highest adjustments. Revised revenue projections late in the year provided favourable adjustments in excess of $200 million (mostly related to equalization and personal income tax). Had government taken no offsetting action, but recorded the favourable revenue adjustments and collected all of its other budgeted revenues, it would have recorded a surplus in the order of $160 million in 2000-01, after accommodating increased expenditures. Instead, government deferred receipt of revenues totaling approximately $190 million and brought net budgetary deficit for the year back to just slightly better than the budgeted deficit level of $35 million. The revenues deferred from 2000-01 were then budgeted for receipt in 2001-02 to help address the budgetary gap for that year.

Budget 2003 provided for similar adjustments at the 2002-03 year end. Revenues from provincial sources were up $176.9 million from the budgeted level. This, along with a number of other variances would have "transformed a $93.3 million budgeted deficit into a $94.4 million surplus". However, government decided not to withdraw $97 million from the Labrador Transportation Initiative Trust Fund, to defer one-time revenues of $57 million to 2003-04, and to contribute $2.1 million to the Memorial University Opportunity Fund. This eliminated the potential surplus and produced the reported "cash" deficit of $61.7 million.

[5] This analysis does not focus on the year-end expediting of expenditures because, while such measures could effectively adjust the net surplus or deficit from year to year, the author is of the view that, in some cases, a portion of such year-end expenditures could relate to commitments and obligations which arguably should have been included in the budgetary numbers. By way of example, there have been examples when year-end expenditures included funds to pay off hospital and school board deficits. It can be argued that such deficits appropriately belonged in the government deficit of prior periods.

Auditors General have repeatedly expressed concern over this practice of deferring revenues and recoveries, and prepaying expenses to smooth the financial results.

> *Specifically we are concerned about the way government can "adjust" its actual cash surplus or cash deficit through government decisions about which revenues or expenditures to include and when to include them. These concerns are not new and my office has reported on this in each of the past three years.*[6]

<u>The "Fiscal Stabilization Fund" Approach</u>

Wide, unpredictable and, in some respects, uncontrollable swings in revenue estimates present a challenging dimension to budgetary planning at the provincial government level. This challenge is not unique to Newfoundland and Labrador and other provinces also struggle with the potential fiscal volatility related to unexpected revenue revisions.

At least three provinces (New Brunswick, Manitoba and Saskatchewan) have established Fiscal Stabilization Funds (FSF) which provide some recourse to manage the swings. Unexpected revenues or windfall gains are collected, reported and allocated to the FSF when they arise. Then, as required, the fund is drawn down to facilitate budgetary balance. The bottom line effect may be the same as the smoothing technique but, the approach is clear and the reporting is more transparent. A reader of the financial results can clearly see the surplus or deficit, as well as the changes to the Stabilization Fund. The balance of the Fund and the movement up or down in a given year is clearly reported, as is the fiscal position after any changes in the fund.

Some other provinces employ variations of the budget smoothing practice. Manitoba used a mixture in its 2002 budget by drawing down its FSF as well as a special dividend from Manitoba Hydro. The Province of Quebec also drew down a $750 million reserve account to address its budgetary position in 2002. In its 2003 Budget, Alberta established a "Sustainability Fund" to smooth the effects of wide swings in resource revenues.

The revenue smoothing approach used by the province has raised questions from time to time as to the size of the "real deficit". These questions are compounded by the fact that: Newfoundland and Labrador is the only remaining province on a modified cash basis of accounting for reporting its budgetary position. All other provinces have moved to a form of accrual accounting. While the province has begun to address the issue in the 2003 budget, the matter is worthy of a brief explanation.

<u>"Inconsistent Reporting" – Budget vs Public Accounts</u>

Prior to the 2003 Budget the Government of Newfoundland and Labrador prepared its budget solely on a modified "cash basis" of accounting. However, the province prepares its Public Accounts and Consolidated Summary Financial Statements using an "accrual"

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[6] Report of the Auditor General for the year ended March 31, 2002, Province of Newfoundland and Labrador, dated October 28, 2002, p.23.

method of accounting. While it is not intended to divert the attention of the Royal Commission to a technical debate on the relative merits of different accounting policies, it is important that the Commission have an appreciation for the type of confusion which has been created by using two reporting practices.

This issue has been repeatedly highlighted by the Auditor General:

> *... the budgeting practices of government are significantly inconsistent with its financial reporting practices.*
>
> *The inconsistent reporting has resulted in much confusion and debate in the past as to what was government's "real" deficit or surplus in a particular year. The inconsistencies occur because of two things – first, the budget is prepared on a cash basis and therefore does not include significant accounting adjustments which are reflected in the Consolidated Summary Financial Statements and second, the budget does not include all government entities which are included in the Consolidated Summary Financial Statements.*[7]

The Auditor General explained that the Consolidated Summary Financial Statements are prepared by government in compliance with generally accepted accounting principles for governments and "are regarded as its primary financial report". While that may be so in the technical sense, in a practical sense, the annual budget and ongoing budgetary updates often have a higher public profile.

The fiscal picture is quite different depending on the report which one chooses to consider as illustrated in Table 1-6:

Table 1-6

(Deficit)/Surplus of Newfoundland and Labrador
Budget Reporting vs. Public Accounts Reporting
1998-99 to 2003-04 Budget

($ million)

	1998-99	**1999-00**	**2000-01**	**2001-02**	**2002-03**	**2003-04B** *
Budget Reports	3.8	(22.9)	(26.1)	(47.3)	(61.7)	(212.7)
Public Accounts	(187.1)	(269.0)	(349.7)	(473.1)	N/A	(666.0)

*The budgeted deficit of $212.7 million reflects the position on a basis comparable to the budgetary reporting practice of prior years.

Source: Department of Finance, Province of Newfoundland and Labrador, Public Accounts and Annual Estimates.

[7] Report of the Auditor General for the year ended March 31, 2002, Province of Newfoundland and Labrador, dated October 28, 2002, p.1

The huge differences in the deficits reported by government under the two different approaches underlines the basis for fiscal confusion. It must be emphasized that government does provide a reconciliation of the difference between the two reports in the Public Accounts. **In addition, for the first time ever, the 2003 budget contains a schedule which summarizes the budgetary position on the basis of full accrual accounting for comparison purposes.**

The 2003 budgetary deficit of $212.7 million, on its long-standing "cash" based budgetary reporting format, is reconciled to the full accrual deficit of $666 million by outlining the major adjustments. The most significant differences relate to: i) net pension costs ($301.9 million); ii) net expenses of various crown entities ($98.0 million); and iii) amortization of foreign exchange losses ($31.5 million). There are also a number of adjustments related to the treatment of capital assets which are effectively offsetting.

In addition, the 2003 Budget outlines a consolidated budgetary deficit of $286 million, which is the cash deficit plus the borrowing requirements of various crown entities as outlined previously. In short, the budget does appear to make a sincere effort to improve the disclosure but in so doing, with three different deficit numbers, it may have added to the confusion.

The additional reporting in the 2003 Budget is an indication of progress in that it articulates the differences and attempts to reconcile them. However, Government would be well advised to move away from using three deficit numbers. Government should be updating its overall approach to budgetary reporting to bring it in line with generally accepted accounting practices and more in line with other provinces. The focus should be on the avoidance of confusion with a single reporting format which provides full, clear and consistent disclosure of the province's fiscal position.

New standards and reporting practices continue to evolve in this area. In January 2003, the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants issued a New Reporting Model for senior governments following 10 years of work and consultation.

The new approach is intended to expand focus and the measurement of governments financial performance to five key indicators – a significant advancement beyond a narrow focus on annual surplus or deficit. The new model focuses on: i) governments' net debt position; ii) accumulated surplus/deficit position; iii) the annual surplus/deficit; iv) the change in net debt in the year; and v) cash flows in the year.

The new standards are effective for all years beginning on or after April 1, 2005. Some governments have indicated they will be implementing them earlier. *As the Government of Newfoundland and Labrador moves to modify its reporting practices, it should be encouraged to become proactive in updating its budgetary and financial reporting beyond the minimum requirements and be among the most progressive provinces in this area.*

PROVINCIAL DEBT TRENDS

The review of the provincial debt trends begins with an examination of **total public sector** debt, as reported by the province, which encompasses the debt of crown agencies as well as government's direct debt obligations. In addition, inter-provincial debt comparisons are provided on the basis of **"taxpayer supported debt"** (a concept used by financial analysts and credit rating agencies) which is intended to exclude debt of self-sustaining provincial crown agencies, which vary significantly from province to province, (particularly the provincial hydroelectric corporations).

The review also addresses the unfunded pension liability and endeavors to place it in perspective with the funded debt. It then compares the combined obligations with those of the other provinces.

Total Public Sector Debt

The unfortunate legacy of 50 years of budgetary shortfalls is the accumulation of a large provincial debt burden. As of March 31, 2003, the direct debt of the Government of Newfoundland and Labrador totaled $5.9 billion, crown corporation and other public sector debt (including Newfoundland and Labrador Hydro, Newfoundland Municipal Financing Corporation, and Newfoundland and Labrador Housing Corporation) amounted to $2.0 billion, yielding a total public sector debt of $7.9 billion.

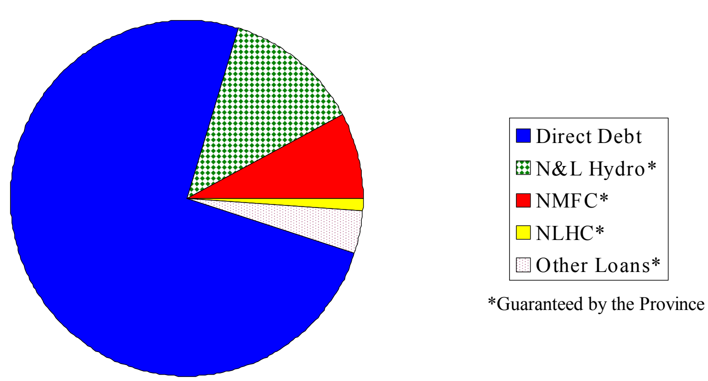
Chart 1-7

Total Public Sector Debt

Major Components as at March 31, 2003

(total net of sinking funds)

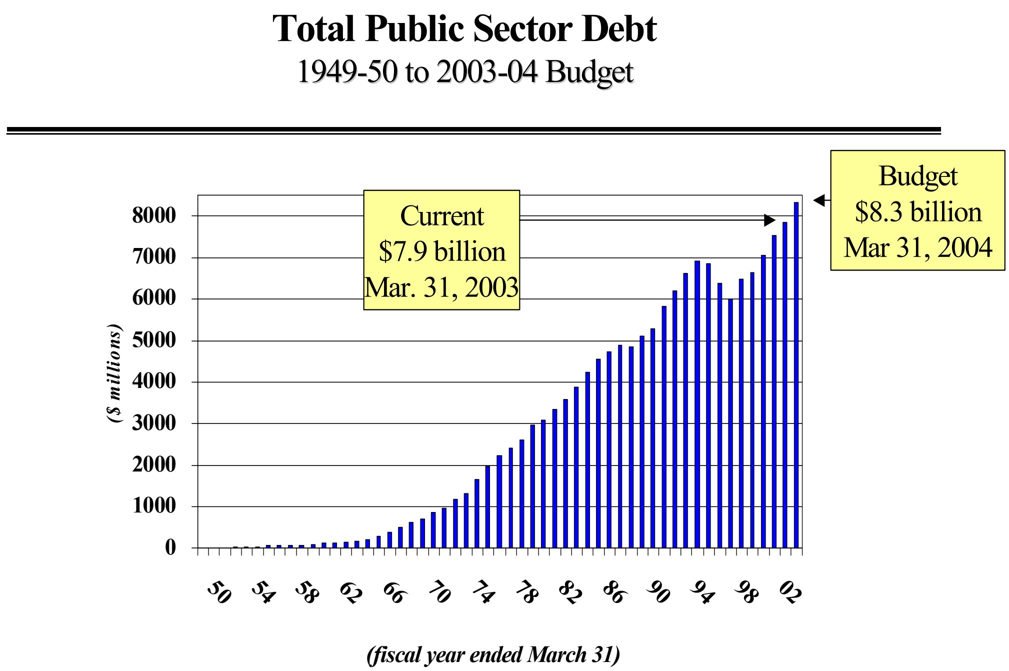
$7.9 billion



Source: Department of Finance, Province of Newfoundland and Labrador, Budget 2003 revised estimates for the year ended March 31, 2003

The historic debt trend of the province indicates a record of continually mounting indebtedness which advanced from an accumulated cash surplus in the order of $40 million at the time of Confederation, to $100 million in debt by the early 1960s. By 1970, the debt had increased to some $700 million and then to $3 billion by 1980. In the succeeding two decades, the public sector debt of Newfoundland and Labrador more than doubled to its current level of $7.9 billion.

Chart 1-8



Source: Government of Newfoundland & Labrador, Department of Finance; Public Accounts 1949-50 to 2001-02 and Budget 2003.

There was a brief dip in the debt trend in the late 1990s related to the large transitional payment for sales tax harmonization ($350 million) received from the Government of Canada which also coincided with the impact of favourable foreign exchange rates on foreign denominated debt as well as relatively good budgetary performance. This was a temporary situation. The ongoing debt trend quickly returned as the lower sales tax receipts exhausted the prepaid revenues.

In the four-year period ending March 31, 2003 total provincial public sector debt in Newfoundland and Labrador increased by $1.4 billion, or 21.5 per cent. In some respects, the escalation in public sector debt at an average of $350 million a year over the past four years provides a clearer indication of the province's fiscal trends than the different measures of the budgetary deficit outlined previously. The definite trend toward increasing public sector debt continues and it is budgeted to increase by some $450 million in the coming year to $8.3 billion by the end of 2003-04 fiscal year.

While clearly the chart reflects a rapid escalation, a comparative analysis is required to put the position in perspective.

Comparative Debt Position – "Taxpayer - Supported Debt"

"Taxpayer-supported debt" is a frequently used concept for comparison purposes and it excludes the hydro debt as noted previously. In Newfoundland and Labrador, this measure of debt totaled $6.6 billion as of March 31, 2002 and it was projected to increase to $6.9 billion by March 31, 2003 (according to calculations by DBRS, a Canadian-based credit rating agency). A comparison of the total debt levels of the various provinces showing the increase (based on the 2002-03 budgets) since 1992-93 is provided in Table 1-7:

Table 1-7

Taxpayer-Supported Debt
Provincial Comparison
2002-03 budget vs. 1992-93
($ millions)

Province	2002-03 budget	1992-93	Increase per cent
British Columbia	34,190	16,640	105.5
Alberta	--	18,220	(100.0)
Saskatchewan	8,410	10,380	(19.0)
Manitoba	9,620	9,000	6.9
Ontario	118,580	72,440	63.7
Quebec	98,710	60,350	63.6
New Brunswick	6,570	4,590	43.1
Nova Scotia	11,880	7,600	56.3
Prince Edward Island	1,080	700	54.3
Newfoundland & Labrador	6,930	5,100	35.9

Source: Data extracted from "The Canadian Federal and Provincial Governments – 2002 Overview" by DBRS (Dominion Bond Rating Service Limited) January 2003 and similar report by DBRS dated November 2001, and calculations by the author.

While Alberta and Saskatchewan have recorded reductions in debt from the 1992-93 level, Newfoundland and Labrador's increase of 35.9 per cent was the second lowest increase of the other seven provinces. British Columbia recorded the largest increase at 105.5 per cent. However, Newfoundland and Labrador was advancing from a relatively high base. Given the varying sizes of the provincial economies (and Ontario's debt load of $119 billion), "per capita debt" is a far more relevant basis of comparison than total debt outstanding.

Per Capita Debt Comparison

Provincial per capita debt has increased in all provinces, except Saskatchewan and Alberta since 1992-93 as outlined in Table 1-8:

Table 1-8

Taxpayer-Supported Debt – Per Capita
Provincial Comparison
2002-03 budget vs. 1992-93
($ millions)

Province	2002-03 budget	1992-93	Increase per cent
British Columbia	8,256	4,657	77.3
Alberta	--	6,820	(100.0)
Saskatchewan	8,396	10,308	(18.5)
Manitoba	8,364	8,047	3.9
Ontario	9,826	6,777	45.0
Quebec	13,240	8,423	57.2
New Brunswick	8,679	6,119	41.8
Nova Scotia	12,576	8,225	52.9
Prince Edward Island	7,729	5,280	46.4
Newfoundland & Labrador	13,026	8,798	48.1

Source: Data extracted from "The Canadian Federal and Provincial Governments – 2002 Overview by DBRS", January 2003 and November, 2001, Statistics Canada population statistics, and calculations by author.

While the most pronounced increase has occurred in B.C. with a 77.3 per cent growth, Quebec's per capita debt of $13,240 represents an increase of 57.2 per cent and places it at the highest level of taxpayer supported debt among the provinces. Newfoundland and Labrador is second highest with $13,026 per capita, an increase of 48.1 per cent.

Analysis of these numbers highlights the impact of population changes on per capita debt levels in Newfoundland and Labrador. In Table 1-7 the overall absolute increase in debt was 35.9 per cent, but, because of the population decline in the same period, the per capita debt in Table 1-8 actually increased by 48.1 per cent. (It must be noted that the numbers are based on the Statistics Canada population estimates as of July 2002. Should the numbers for Newfoundland and Labrador be revised downward as expected, the per capita burden would increase accordingly.)

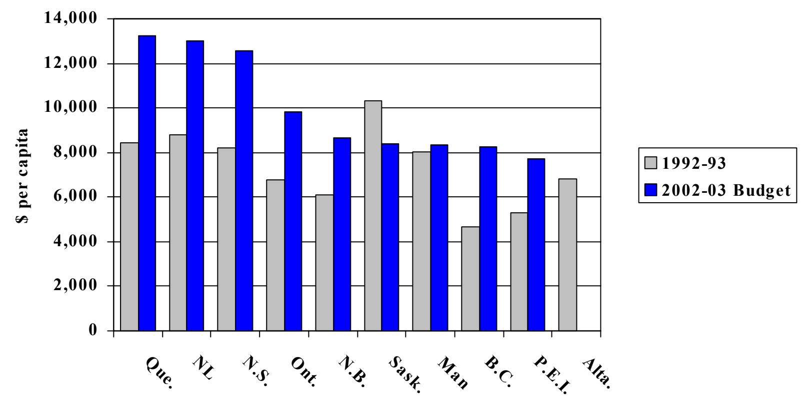
The opposite population impact is reflected in Ontario where the debt increased by 63.7 per cent but, since the population increased by 12.9 per cent, on a per capita basis, the increase in debt was only 45.0 per cent.

The relative ranking of the provinces as budgeted for March 31, 2003 is more clearly illustrated in Chart 1-9:

Chart 1-9

Taxpayer Supported Debt – Per Capita

Provincial Comparison



Source: Dominion Bond Rating Service, the Canadian Federal and Provincial Governments – 2002 Overview, dated November 2001 and January 2003. Base data extracted from source and extrapolated as required by author (based on unadjusted population data for Newfoundland and Labrador at 532,000 July 2002).

As noted previously, Newfoundland and Labrador has the second highest per capita debt, marginally behind Quebec. This province's taxpayer-supported debt per capita is projected to be 39.2 per cent above the all-province average as at March 31, 2003.

Debt to GDP Comparison

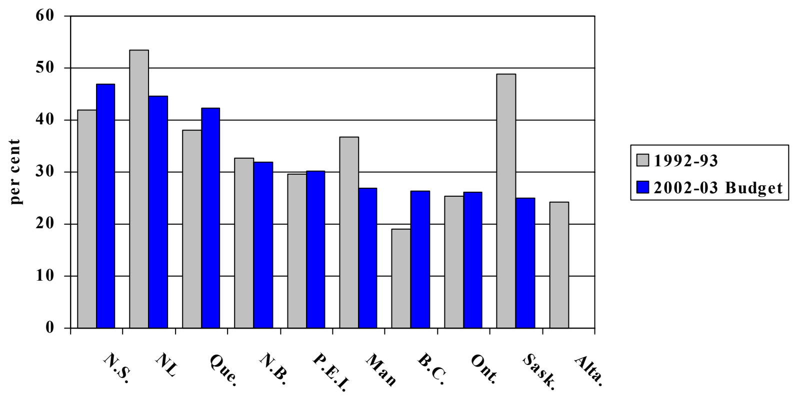
The taxpayer-supported debt to gross domestic product (GDP) ratio adds an important perspective to the increasing debt burdens relative to the size and economic growth trends of the Canadian provinces. A declining ratio is regarded as an important indicator of improving fiscal and economic strength.

In the last 10 years Newfoundland has recorded a significant improvement in this ratio, fueled in particular by the substantial impact of offshore oil development and production on the province's GDP. Taxpayer supported debt to GDP has improved from 53.4 per cent in 1992-93 to a projected 44.6 per cent in 2002-03.

Chart 1-10

Taxpayer-Supported Debt to GDP Ratio

Provincial Comparison



Source: Dominion Bond Rating Service, the Canadian Federal and Provincial governments, dated November 2001 and January 2003. Base data extracted from source and extrapolated as required by author.

Despite the significant progress in Newfoundland and Labrador, this province ranks second last among the provinces**.** Nova Scotia ranks tenth with a ratio of 47 per cent, a much less favourable ratio than the 42 per cent it recorded in 1992-93.

This analysis does not reveal the entire provincial debt picture. In addition to the funded debt of the provinces, there is another significant dimension of the debt profile – "Unfunded Pension Liabilities".

Unfunded Pension Liabilities

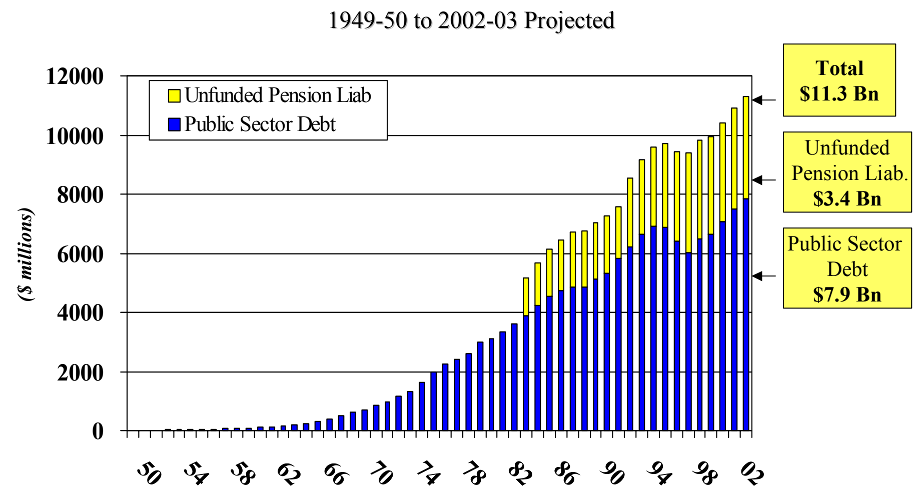
Newfoundland and Labrador has total unfunded pension liabilities estimated at approximately $3.4 billion as at March 31, 2002 which are fully reflected in the public accounts of the province.

Data is not yet available for the unfunded pension liability as of March 31, 2003. However, if it remained relatively unchanged at $3.4 billion, the combined debt, including public sector debt of $7.9 billion at March 31, 2003, would now total $11.3 billion.

The overall trend in these total public sector liabilities is reflected in Chart 1-11:

<u>**Chart 1-11**</u>

Total Public Sector Liabilities
Public Sector Debt + Unfunded Liabilities



Source: Government of Newfoundland & Labrador, Department of Finance, Public Accounts 1949-50 to 2001-02 and Budget 2003.
Note: Data unavailable for unfunded pension liabilities prior to 1984.

It is quite possible that in due course updated actuarial reports reflective of recent market trends, plan changes and wage movements will place the current unfunded liability and, accordingly the combined debt levels, higher than reflected in Chart 1-11.

These pension obligations constitute a major dimension of the provincial debt profile. While the province has initialed a number of actions to address pension funding in recent years, the ongoing challenge remains significant. (Appendix C provides additional background information on the nature of the pension liabilities and how they have evolved over the years.)

<u>Provincial Comparisons – Unfunded Pension Liabilities</u>

There is a wide variation in the pension funding status among the provinces; B.C. is fully funded; there are relatively small deficiencies in the Maritimes, and Quebec has a $37 billion deficiency.

Table 1-9

Unfunded Pension Liabilities

Provincial Comparison 2002-03 projected vs. 1992-93
($ millions)

Province	2002-03 projected	1992-93	Increase per cent
British Columbia	0	3,340	(100.0)
Alberta	4,830	4,770	1.3
Saskatchewan	4,030	3,030	33.0
Manitoba	3,190	1,620	96.9
Ontario	1,960	9,590	(79.6)
Quebec	37,220	29,550	26.0
New Brunswick	320	1,660	(80.7)
Nova Scotia	940	620	51.6
Prince Edward Island	240	340	(29.4)
Newfoundland & Labrador	3,440	2,360	45.8

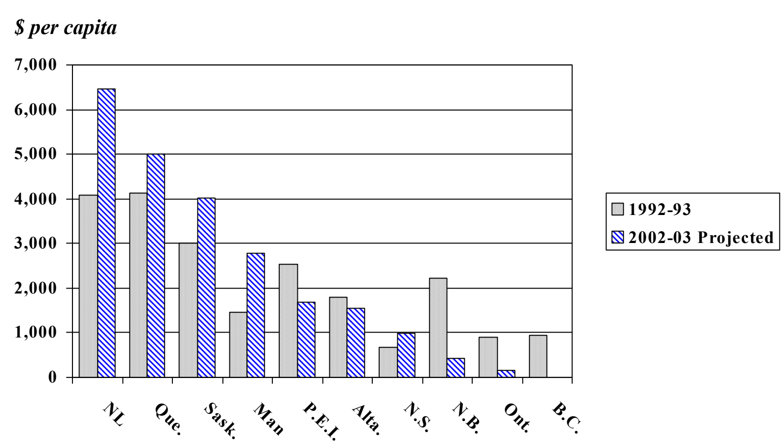
Source: Dominion Bond Rating Service, the Canadian Federal and Provincial Governments, dated November 2001 and January 2003.

As with the level of taxpayer-supported debt outstanding, the absolute numbers above do not tell the full story given the different size in the population base of the various provinces. The picture becomes much clearer when the unfunded liabilities are examined on a per capita basis as illustrated in Chart 1-12:

Chart 1-12

Unfunded Pension Liability – Per Capita

Provincial Comparison 1992-93 vs. 2002-03 Projected



Source: Dominion Bond Rating Service, the Canadian Federal and Provincial Governments, dated November 2001 & January 2003. Data extracted from source and extrapolated as required by author (based on unadjusted population data for Newfoundland and Labrador at 532,000 July 2002).

As of March 31, 2003, the projected unfunded pension obligations of Newfoundland and Labrador, at $6470 per capita were the highest of any province. The liabilities were almost 30 per cent higher than Quebec's $4,990 per capita. Newfoundland and Labrador also stands out in stark contrast to the position of the other Atlantic provinces. Nova Scotia, for example, which has the highest taxpayer-supported debt to GDP ratio of any province, has an unfunded pension liability of only $990 per capita, and New Brunswick's unfunded liability is even lower at $430 per capita.

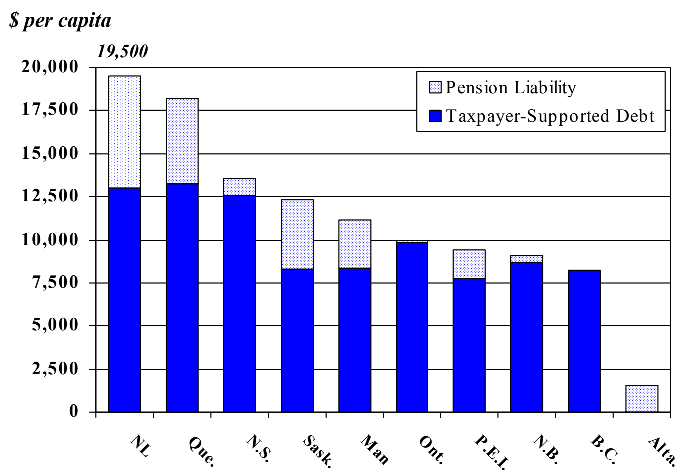
Combined Debt Obligations

The most comprehensive picture of Newfoundland and Labrador's overall debt position relative to the other provinces is portrayed in a comparison of the combined per capita taxpayer-supported debt and unfunded pension liabilities as depicted in Chart 1-13:

Chart 1-13

TS Debt + Pension Liability – Per Capita

Provincial Comparison 2002-03 projected



Source: Dominion Bond Rating Service, the Canadian Federal and Provincial Governments, dated January 2003. Data extracted from source and extrapolated as required by author (based on unadjusted population data for Newfoundland and Labrador at 532,000 July 2002).

Newfoundland and Labrador has the heaviest combined debt burden at $19,500 per capita while Quebec ranks second at $18,200. It is significant to note that while Nova Scotia's taxpayer-supported debt per capita exceeds that of Newfoundland and Labrador, its relatively low unfunded pension liability yields combined debt per capita which is 30 per cent below Newfoundland and Labrador:

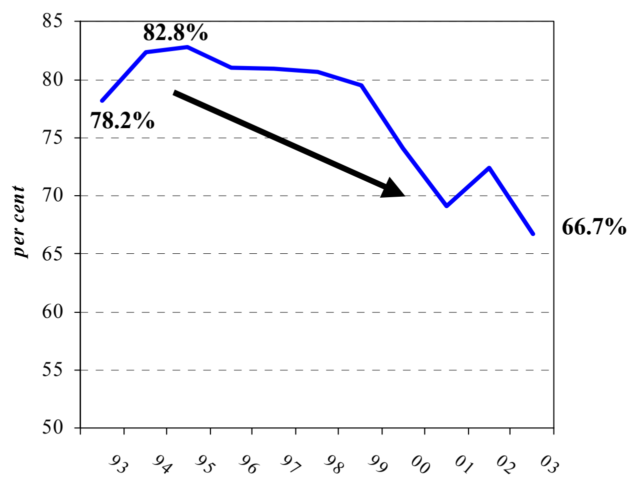
Combined Debt to GDP

The combined total of taxpayer-supported debt plus unfunded pension liabilities, "combined debt", is the basis for much of the analysis done by one of Canada's major credit rating agency, Dominion Bond Rating Service Limited (DBRS). By this measure, Newfoundland and Labrador's combined debt to GDP ratio increased from 78.2 per cent in 1992-93 to 82.8 per cent by 1994-95, and then declined to a projected level of 66.7 per cent by March 31, 2003:

Chart 1-14

Combined Debt to GDP Ratio

(fiscal years ended March 31)



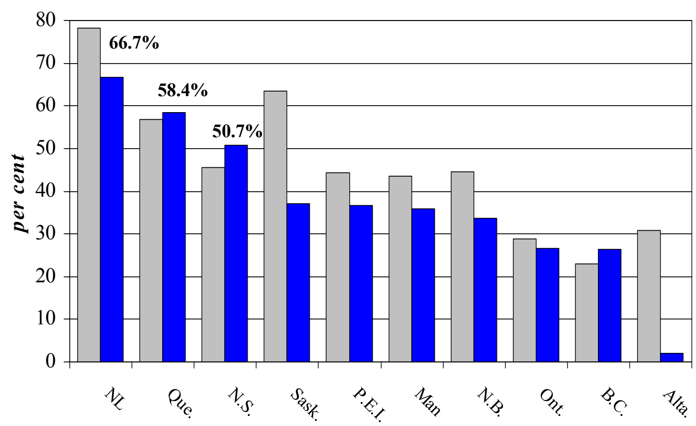
Source: Dominion Bond Rating Service, the Canadian Federal and Provincial governments, dated November 2001 and January 2003, Data extracted from source and extrapolated as required by the author.

Strong GDP growth in recent years, has more than offset the impact of increased debt on this ratio calculation. This favourable trend in the debt to GDP ratio is viewed very positively by the financial community and the credit rating agencies. The trend in the ratio in Newfoundland and Labrador is compared with the trend in other provinces in Chart 1-16:

Chart 1-15

Combined Debt + Pension Liability to GDP

Provincial Comparison: 1992-93 vs. 2002-03 projected



Source: Dominion Bond Rating Service, the Canadian Federal and Provincial governments, dated November 2001,and January 2003.

Notwithstanding the significant improvement in this key indicator of overall debt burden, at 66.7 per cent, Newfoundland and Labrador continues to hold the most unfavourable ratio of any Canadian province.

Federal Debt Trends[8]

The trend in the debt of the Government of Canada, as analyzed by DBRS is projecting net federal debt of $532.5 billion at the end of 2002-03, which is up 14.2 per cent from $466.2 billion in 1992-93. In that period, however, the total federal debt ran up to a high of $583.2 billion in 1996-97. The most significant recent trend, therefore, is the decline of 8.7 per cent in federal net debt in the last six years made possible by the successive budgetary surpluses recorded by the federal government. This contrasts with the 22.6 per cent increase in the combined debt of the Province of Newfoundland and Labrador in the same six-year period.

On a per capita basis, the federal net debt per capita amounted to $16,430 in 1992-93. It increased to $19,650 by 1996-97 and has since declined by 13.8 per cent to a projected level of $16,950 at the end of 2002-03. Newfoundland and Labrador's combined debt per capita is higher at a projected level of $19,500.

[8] Data extracted from "The Canadian Federal and Provincial Governments" – 2002 Overview and 2001 Overview dated January 2003 and November 2001, respectively.

The Government of Canada has also recorded a strong improvement in the key debt to GDP ratio in the last six years decreasing from 69.7 per cent in 1996-97 to a projected ratio of 46.6 per cent in 2002-03. This compares with this province's improvement from 80.9 per cent to 66.7 per cent in the same six-year period.

Foreign Exchange Exposure on Government Debt

In addition to the relative size of the outstanding debt, unhedged foreign currency exposure can add an element of risk to the overall debt burden. The decline in the value of the Canadian dollar relative to the United States dollar and other key international currencies in recent years, generated increased focus on the financial risks associated with non-Canadian dollar denominated debt.

While the proportion of this province's tax-supported debt denominated in foreign currencies exceeded 40 per cent in the early '90's, by 1999 it was down to 34.5 per cent and then to 27.6 per cent by March 2002. Most provinces have also reduced their foreign currency exposure in recent years as illustrated below:

Table 1-10

Percentage of Debt in Foreign Currency
Tax Supported Debt as at March 31

	2002 per cent	1999 per cent
Newfoundland & Labrador	27.6	34.5
Nova Scotia	25.4	48.8
Quebec	23.5	32.9
New Brunswick	19.0	22.4
Saskatchewan	15.2	17.9
Manitoba	5.9	22.0
British Columbia	5.6	6.8
Ontario	1.7	3.2
P.E.I.	0.0	0.0
Alberta	N/A	N/A
All Provinces	11.6	17.0
Federal Government	6.1	7.8

Source: DBRS, The Canadian, Federal and Provincial Governments – November 2001 and January 2003.

The vast majority of this province's foreign debt is payable in U.S. dollars, with a relatively minor balance in Swiss francs. Government is cognizant of the increasing currency exposure and in fact it has not borrowed in the U.S. capital markets since 1993.

The relative proportion of foreign debt in Newfoundland and Labrador's debt profile is declining but at 27.6 per cent, the exposure to currency fluctuations is regarded as significant. The provincial public accounts indicate that at March 31, 2002, the province had accumulated unamortized foreign exchange losses totaling $289 million. The foreign exchange sensitivity is also outlined in the Public Accounts – a one cent change in the foreign exchange rates at March 31, 2002 would result in an increase/decrease in foreign borrowings of $14.5 million. From an accounting perspective, an expense of $25 million was recorded in 2001-02 as "amortization of foreign exchange losses" in the public accounts. (While the numbers are not available for 2002-03, the 2003 budget projects amortization of $31.5 million for 2003-04.)

In its most recent rating assessment, Moody's Investor Sources noted that the foreign currency component of total public sector debt had declined "but is still substantial". They noted as well the partial hedge provided by the province's U.S. sinking funds.

With the increased volatility of exchange rates, this issue has gained prominence in recent years. Governments are being encouraged to: i) refrain from borrowing in foreign currencies; ii) consider hedging strategies for existing exposures; and iii) to amortize the mounting foreign exchange losses over the remaining life of the associated long-term debt. The recent strengthening of the Canadian dollar may well present government with an important opportunity to reduce or further hedge against its currency exposure.

At this point the Province appears to be moving in the right direction on this issue. The foreign debt is not coming down as quickly as in some other provinces because this Province tends to have a higher proportion of long-term debt and therefore "roll-overs" to Canadian currency do not occur as quickly.

Credit Rating Assessments

Regular credit rating assessments by the major credit rating agencies provide an objective perspective on both the debt profile, the fiscal performance and the general credit worthiness of the province on an ongoing basis.

There are three major credit rating agencies that rank the credit of the Province of Newfoundland and Labrador, as well as the other provinces and the Government of Canada: (i) Moody's Investor Services; (ii) Standard and Poors (S&P); and (iii) Dominion Bond Rating Service Limited (DBRS). The rating scales and categories vary and the agencies also vary somewhat in the emphasis they place on the respective financial and economic indicators. However, the agencies do tend to rank the provinces in roughly the same relative position.

This province's credit rating with all three agencies has improved somewhat since the early 1990s. The current ratings of the province are as follows:

Table 1-11

Credit Ratings
Province of Newfoundland and Labrador

Agency	Rating	Comment
Moody's	A3	Upgraded from Baa1 in May 2002
S&P	A-	Affirmed at A- in July 2002 (upgraded from BBB+ in November 1999)
DBRS	BBB	Confirmed in November 2002 (upgraded from BBB (low) in 1998).

Despite the improved economic performance and outlook and recent upgradings, Newfoundland and Labrador still ranks as the lowest among all Canadian provinces:

Chart 1-16

Comparative Credit Ratings

Canada and the Provinces

Jurisdiction	S& P	Moody's	DBRS
Canada:			
...Canadian $ Debt	AAA	Aaa	AAA
...Foreign $ Debt	AAA	Aaa	AA (high)
Alberta	AAA	Aaa	AAA
Ontario	AA	Aa2	AA
British Columbia	AA-	Aa2	AA (low)
Manitoba	AA-	Aa3	A
Saskatchewan	A+	Aa3	A
New Brunswick	AA-	A1	A
Quebec	A+	A1	A
Prince Edward Island	A	A2	A (low)
Nova Scotia	A-	A3	BBB (high)
Newfoundland & Labrador	A-	A3	BBB

Source: Government of Newfoundland and Labrador, Department of Finance, as of February 2003

Each agency has issued a report on Newfoundland and Labrador in the last 12 months and some of the main observations are noted below (the following commentaries are based on reports issued before the 2003 budget):

i) **<u>Moody's Investor Services</u>**

Moody's announced its upgrading of this province to A3 in May of 2002, simultaneously with the upgrading of P.E.I. from A3 to A2 and Saskatchewan from A1 to Aa3. In announcing the upgrades for Newfoundland and Labrador and P.E.I., Moody's stated:

> *The rating actions announced today for Newfoundland and Prince Edward Island reflect, primarily, our recognition that the federal government's improved fiscal position – acknowledged in last week's upgrade of federal government debt ratings – provides a more stable environment for federal-provincial fiscal transfers. This is especially important in our analysis of the fiscally weaker provinces*[9]

In its press release on October 21, 2002 following its yearly update on the province, which confirmed the A3 rating for Newfoundland and Labrador, Moody's highlighted "the province's improved debt ratios, brighter economic prospects and support received through federal fund transfers". That press release also commented favourably on the fiscal management of the province through the 1990s:

> *After reporting large deficits in the early 1990s due to sharp contractions in its economic performance and population resulting from the collapse of its fishing industry, the province has made a slow but steady recovery by committing itself to fiscal balance and progressively reducing its budget gap. Tighter budgetary control and renewed economic growth have cut down the province's debt load and provide the potential for further economic and credit improvement.*

Moody's was rather cautious with respect to the potential for further upgradings:

> *The chances of short-term credit quality improvements are modest, however, as the province continues to grapple with rising expenses and a 16 per cent unemployment rate. In addition, the province's use of non-recurring measures to enhance its short-term financial flexibility in response to current spending pressures is, in Moody's opinion, unsustainable. These circumstances limit the potential for further credit improvement.*[10]

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[9] Moody's Investor Services, announcement of rating actions related to the upgrading of Newfoundland and Labrador, Prince Edward Island and Saskatchewan, dated May 8, 2002.

[10] Moody's Investor Services, announcement coinciding with the rating agency's annual report on the province dated October 21, 2002.

Overall, Moody's provided a stable outlook for the province reflecting the "improved debt profile and brighter economic prospects". The agency noted that several large projects including offshore oil development, Voisey's Bay and the Lower Churchill could have a "large positive influence on the province's economy".

ii) **Standard & Poors**

Standard & Poors' (S&P) regular assessment in July of 2002 highlighted the province's solid economic performance in 2001, following three years in which GDP growth exceeded the national average and its promising medium-term economic outlook led by expected growth in the offshore oil sector. They cited "good" budgetary performance in the last several years, despite the return to "modest" deficits in fiscal 2002. S&P observed the province's financial challenges, related to low revenue growth and ongoing spending pressures in health care would likely "constrain financial flexibility".

The various oil projects, Voisey's Bay, call centers, and growth in tourism are among the factors highlighted in a generally favourable assessment of the economy. They cited "prudent fiscal planning during the past five years" as a contributing factor to the declining relative debt burden as meaning by various ratios.

The 2002-03 budgetary deficit was noted as was the increase in direct debt however, S&P viewed these as short-term situations:

> *Standard and Poors' views the deterioration in the fiscal position in fiscal 2002 and 2003 as cyclical and expects net tax – supported debt as a share of GDP – to begin to decline again in the medium term alongside the rebound in Newfoundland and Labrador's economy*[11]

S&P noted that Newfoundland and Labrador has the highest public sector pension burden of all provinces but emphasized government's ongoing priority to reduce the unfunded liability. Overall, S&P's outlook appears to be relatively positive.

> *The outlook reflects Standard and Poors' expectation that despite near term challenges to budgetary results, the province will remain committed to returning to a balanced budget after fiscal 2003, leading to a gradually declining debt burden in the medium term.*[12]

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[11] Standard and Poors, Canadian Ratings, Province of Newfoundland and Labrador, report dated July 9, 2002, p.5 and p.2, respectively.

[12] Standard and Poors, Canadian Ratings, Province of Newfoundland and Labrador, report dated July 9, 2002, p.5 and p.2, respectively.

iii) **<u>Dominion Bond Rating Service (DBRS)</u>**[13]

In its rating assessment of the strengths of Newfoundland and Labrador, DBRS designated the province as one of the growth leaders in Canada citing; "enhanced economic stability" from significant infrastructure development, and growth in value-added manufacturing, energy, tourism and customer-contact centers. It also flagged the reduced debt to GDP ratio, due to strong economic growth, as a significant positive feature along with, reduced personal and corporate taxes. In addition, it cited developments in the energy sector which have "greatly invigorated the region in recent years and continues to hold great promise". In this regard, increased production at Terra Nova, the development of White Rose and the possibility of a Lower Churchill project are all noted as positive factors for the economy.

DBRS suggested that the revenue projections in the 2002-03 budget were "very conservative". The agency explained that while economic growth is expected to impact positively on revenues and maintain the downward trend in the debt to GDP ratio, "opportunities for fiscal improvement are expected to remain limited in the near term as the province continues to match a large part of revenue growth with new spending."

While reduced debt burden (relative to GDP) is highlighted as a strength, the high debt level, "highest of all provinces relative to GDP" is also listed as a challenge. Other key challenges noted are: below average economic fundamentals, a volatile resource-based economy, declining population, and a high dependence on federal funding which "exposes the province to adverse changes in the funding formula and in the level of economic activity in the largest provinces."

Finally, DBRS echoes the comments of successive Auditors General of Newfoundland and Labrador on the accounting approach used by the province for budgetary purposes:

> *The Province continues to use cash accounting for budget purposes, instead of the modified accrual accounting approach used by all other provinces. This generally considerably understates the province's fiscal imbalance, reducing the incentives to improve fiscal results.*[14]

As was noted previously, the province has begun to address this latter issue with the expanded budgetary reporting and disclosure it included in the 2003 budget.

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[13] A synopsis prepared by the author of various comments contained in the "Credit Rating Report" on the Province of Newfoundland and Labrador, issued by Dominion Bond Rating Service Limited on November 19, 2002.

[14] Credit Rating Report on the Province of Newfoundland and Labrador, issued by Dominion Bond Rating Service Limited on November 19, 2002, p.2.

FISCAL POSITION IN 2003 – AN ASSESSMENT

The 2003 Budget

Clearly the financial position of the province at any point in time is not simply the result of the budgetary decisions in any one year. In many respects it is an amalgam of a vast array of public policy decisions integrated with the evolution of the federal/provincial fiscal frameworks over a long period of time. The Budget is, however, critically important in providing an up-to-date perspective on government's own assessment of its economic and financial position, its financial strategy, its financial plans and outlook, and its approach to fiscal management.

What the Budget says:

(a) The province experienced exceptional real GDP growth of 8.2 per cent led by increased oil production and high oil prices in 2002. The GDP outlook for 2003 is strong (5.4 per cent real growth), bolstered by significant capital investment in White Rose, and Voisey's Bay, and continued growth in employment is expected.

(b) Provincial source revenues were up strongly ($177 million from the budgeted level) in 2002-03 reflecting the economic strength, while federal revenues were below budget ($27 million). As a result of this net growth in core revenues, some planned one-time revenues were deferred. The Budget notes that provincial own-source revenues in 2003-04 are budgeted to be up $625 million over 1994-95. The Budget presents a chart showing the trend in offshore oil revenues rising from approximately $150 million at present to in excess of $650 million by 2006-07.

(c) The deficit in 2002-03 came in at $62 million – $31 million below budget on the province's historic "cash" based method of reporting. However, the deficit was $143 million when the borrowings for other government entities are included.

(d) The Budget focuses on improved accountability by expanding its reporting format to include three measures of the annual deficit. For 2003-04 the Budget projects a deficit of $213 million, based on historic "cash" reporting; $287 million based on including borrowings for other entities (a consolidated cash based reporting measure); and $666 million based on "accrual" accounting.

(e) Social programs are sustained. Taxes on tobacco are increased and liquor prices can be expected to increase – to generate approximately $10 million each in additional revenue. There are no further tax increases. Various new program expenditure initiatives are announced.

(f) The Budget targets the elimination of the deficit by 2007-08 based on the expectation of internal revenue growth from continuing strong economic performance. It notes this could be accomplished by a modest successive deficit reductions of $75 million a year.

(g) The Budget expresses concern over the Government of Canada's decision not to renew various cost sharing arrangements. It highlights the decline in various transfers. It emphasizes the impact of declining population on revenue transfers. It calls upon the federal government to renew and strengthen its financial commitment to the province.

It should be acknowledged that the Province has achieved its annual budgetary deficit targets in recent years and, in fact, has improved upon them. Year after year, significant favourable year-end adjustments have augmented the revenue stream to enhance the budgetary position. While this trend could be a factor which influences government's ongoing tolerance of budgetary deficits, it is worthy of note, of course, that at some point year-end revenue adjustments could prove to be unfavourable. It is also important to note that a narrow focus on the deficit as it has been reported, does not provide a complete picture of the province's unfolding financial position, particularly as it relates to the trend in the public sector debt.

What the Budget does not say

(a) The Budget speech does not address the mounting debt burden of the province. Total public sector debt will increase by some $450 million in the coming year, bringing it to $8.3 billion. The speech notes that the budgetary deficits have averaged $25 million a year in the seven years up to and including 2002-03. It does not state that with the 2003 budget, the funded public sector debt to the end of 2003-04 will have increased by $1.8 billion, or an average of more than $350 million a year since March 31, 1999. In fairness, the numbers are in the budgetary schedules but the unfolding debt situation is not addressed in the budgetary narrative.

(b) The Budget explains that current account revenues in 2003-04 will be up by $96 million from the previous year. It does not go on to explain that "related revenues" will be down by some $76 million yielding a net increase in combined current account and related revenues of just $20 million or 0.5 per cent. It is the relatively flat projections for combined current account and related revenues in 2003-04, set against gross current account expenditures which are budgeted to increase by 4.9 per cent which contributes to the widening deficit and which yield a deficit of over $100 million on current account. No plan to address the current account deficit is presented.

(c) The Budget sets out potential targets for deficit reduction of $75 million per year, for the next four years, but does not provide multi-year projections nor does it provide a plan as to how those targets would be achieved (other than a statement that they could be accomplished by revenue growth). It does not address the elimination of the accrual deficit. Even if the $75 million one-year deficit reduction targets were achieved, $366 million of the accrual deficit would remain.

(d) The chart presented in the Budget which illustrates the expected pronounced growth in offshore revenues does not explain that these are gross revenues before the impact of equalization reductions. It does not make it clear that beyond the very short term Newfoundland and Labrador's net gain will likely be in the range of 30 per cent to 40 per cent of these numbers. Beyond 2011, the current Atlantic Accord formula will have expired and the maximum provincial share would be limited to 30 per cent of provincial-type oil revenues. Furthermore the Budget does not indicate that, based on the resource development profile of these existing oil projects, these oil revenues would peak around 2010 and then decline steeply.

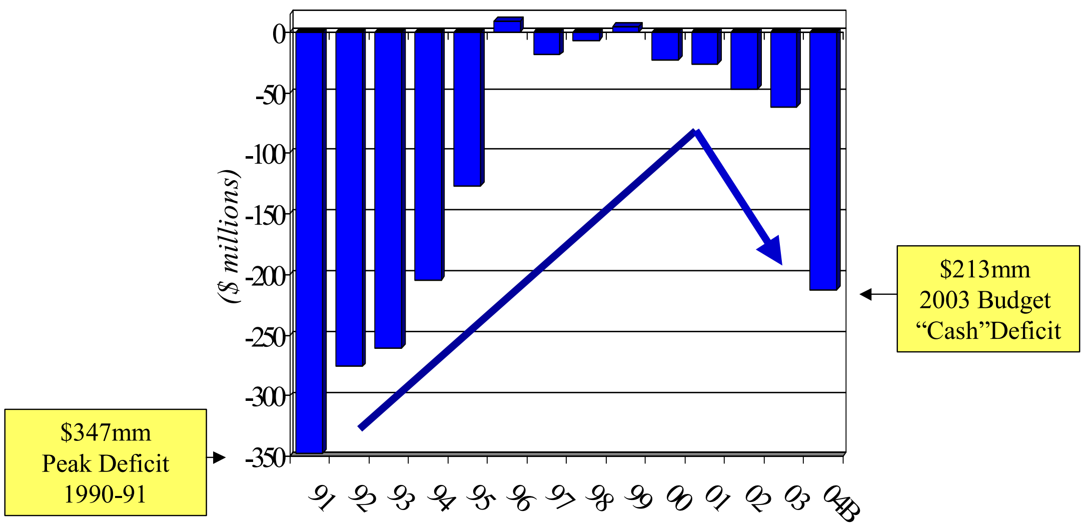
(e) Under government's expanded budgetary reporting approach in 2003, it included a reconciliation of budgetary requirements to an accrual basis of budgetary reporting (Statement III). This statement indicates that net pension interest and accrued costs are projected to total $302 million in 2003-04. Comparable figures are not provided for 2002-03. However, the projections for 2003-04 represent an increase of over $100 million from the net pension expense accrual recorded in the public accounts for 2001-02. The reasons for the significant increase are not clear from the budget, nor is there an update on the trends in the government's unfunded pension liability. *Since this was the first time this type of pension cost accrual information was provided with the budget, government may wish to expand its disclosure in the future*.

At first glance, the 2003 budgetary position of Newfoundland and Labrador represents a distinct contrast against the encouraging trend of financial recovery evident through much of the 1990s, after the financial crisis of 1990-91. The 2003 budgetary deficit of $213 million, or $287 million, or $666 million (depending on the accounting treatment preferred) represents a significant change of fiscal direction from the budgetary reports of the last several years. Even using the most modest "cash" deficit indicator, the traditional reporting method of the province, the new direction is pronounced.

Chart 1-17

Reported Deficit Trend

(fiscal year ended March 31)



Source: Department of Finance; Public Accounts 1990-91 to 2001-02 and Budget 2003

In many respects, the apparent change of direction should not come as a surprise as the seeds of a growing underlying deficit have been sown for some time.

Emergence of the Underlying Deficit

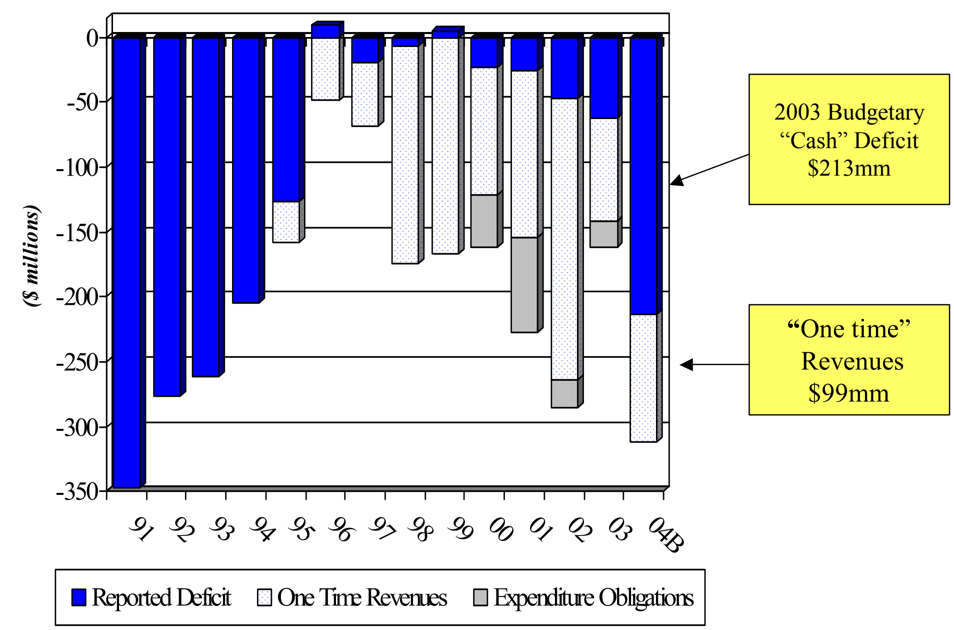
Overall, core-revenue growth had been constrained for a number of years but a large part of the impact had been temporarily offset by "one-time" revenues. Expenditure growth has been fueled by the rapid escalation in health costs augmented by the public sector salary settlements negotiated in 2001-02, the impact of which is only now fully reflected in the 2003-04 expenditure budgets. In addition, the operating deficits of health boards had not been budgeted over the years but they were nonetheless obligations of government. The underlying deficit trend, excluding one-time revenues and including just the expenditure obligations for hospital deficits in recent years illustrates the emergence of the mounting underlying deficit long before 2003:

Chart 1-18

Elements of Underlying Deficit

Impact of "one-time" revenues & key expenditure obligations

(fiscal year ended March 31)



Source: Department of Finance; Public Accounts 1990-91 to 2001-02 and Budget 2003

While this is an overly simplistic analysis it does indicate that the elements of a core deficit in excess of $150 million have existed for some time. (For comparative purposes with prior years, Chart 1-18 excludes the borrowings for "other entities" which totaled $81.5 million and $73.9 million in 2002-03 and the 2003-04 Budget respectively.)

The province recorded particularly strong and unexpected growth in its core revenues in 2002-03, due in large measure to its outstanding 8.2 per cent real growth in GDP. Core revenues were up $150 million over budget and this revenue growth is now reflected in the budgetary base for 2003. On a "go-forward" basis the underlying deficit has been examined on the following basis: (i) the "cash" deficit ($213 million) projected for 2003-04 is the base; (ii) "one-time" revenues in 2003-04 are excluded because they are of a non-recurring nature ($99 million); (iii) it is assumed as well that a portion of prior year adjustments from various revenue sources cannot be counted on as recurring in nature ($50 million); (iv) funding for other entities (which totaled almost $74 million in 2003-04) are assumed to total $60 million on a go-forward basis; and (v) it is assumed that there will be sufficient overall growth in core revenues to offset the general escalation in government expenditures. This analysis produces an underlying consolidated deficit of some $420 million as follows:

Table 1-12

The Underlying Deficit

Adjustments to establish a base for "go-forward " projections

		($ millions)
2003 Budget - Cash Deficit Forecast		**213**
"One-time Revenues" in 2003 Budget		
…Sinking Fund Recoveries	37	
…CHST Supplement	42	
…NLHC/NLC	**20**	
		99
Prior Year Adjustments in 2003 Budget		**312**
… Various Revenue Sources (est.)		**50**
Underlying "Cash" Deficit		**362**
Other Entities: ("go forward" assumptions)		
…N&L Education Investment Corp. (est.)	20	
…NMFC (est.)	27	
…Other (est.)	13	
		60
Underlying "Consolidated" Deficit		**422**

Source: Budget 2003 Newfoundland and Labrador and estimates by the author

On a full accrual basis of accounting, the go-forward deficit would appear to be in excess of $750 million. The most significant additional adjustments to the above projections would be related to net pension costs ($300 million) and foreign exchange amortization ($30 million).

Root Causes of the Deficit

It is legitimate to ask – What is the origin of the large underlying deficit projection for a province that actually recorded a budgetary surplus as recently as 1998-99? Once the short-term benefit of the one-time revenues, the revenue smoothing technique, and the pension issue are taken into account, and one reflects on the key revenue and expenditure trends previously outlined, the fundamental causes are readily apparent.

Revenues:

i) HST Implementation and PIT reduction: Effective reductions in the two major provincial revenue sources since 1997-98 reduced the annual revenue base by in the order of (estimated impact $160 to $200 million).

ii) Population Decline over the past 10 years which decreased entitlements from the two major federal revenue sources, equalization and CHST (some of these adjustments are only now being reflected). In addition, the population decline has detracted from the growth in provincial revenue sources such as personal income tax, sales tax, gasoline and tobacco taxes (estimated impact in the order of $200 million).

iii) Federal Restraint in transfers for social programs, particularly the CHST which has held federal cash transfers below the rate of escalation in the cost of program delivery and indeed below the levels received under predecessor transfer programs.

Expenditure:

i) Escalation in Health Care Costs associated with increased drug costs, service costs, increased demand, new diagnostic and other equipment, facilities upgrading, expansion and replacement.

ii) Salary and Wage Settlements over the past two to three years which are only now being fully reflected in the Budget.

iii) Relatively High Program Spending per capita which reflects the fact that as the population base has declined, program spending has not been reduced on a pro rata basis. Furthermore, new spending initiatives have been undertaken in successive budgets.

iv) Interest costs associated with funding the province's annual deficits and new borrowings to retire obligations associated with the $3.4 billion unfunded pension liabilities.

One-time revenues have clouded the underlying deficit and government has not launched a financial response or restraint program to address the increasing fiscal imbalance. A further root cause of the underlying deficit on an accrual basis, is the large unfunded pension liability. The origin of the pension funding issue dates back to the 1960s when public service pension plans were initially introduced without funding arrangements.

MIXED SIGNALS

The overall assessment of the financial position of the province that evolves from the foregoing analysis is somewhat at variance with what one might expect from the tone of government's reports on the specifics of the budgetary position of the province and the widespread favourable independent commentary on the performance of the economy.

Favourable Signals

From its perspective, government has characterized its current deficit position as "affordable". The budget states that government has "... *the best record of sound prudent fiscal management since Confederation, by any measure."*[15]

In some respects as well, the external assessment by the financial community has been positive. The province's credit rating was upgraded by one of the key credit rating agencies in May 2002 and declared stable by the other two since then.

In addition to signals implying financial strength, there have been successive reports of growing economic strength looking back to 2002, the Budget stated:

> *we should lead all provinces in 2002 with expected real GDP growth of 3.7 percent. This would mark the third time in five years that we top all provinces. It would be the fourth time that we exceeded the national average.*[16]

During 2002, the economic performance surpassed these expectations by a wide margin. The mounting economic strength of the province was heralded in successive publications by major banks and financial institutions throughout the year. For example; in July 2002, the Toronto-Dominion Bank ranked Newfoundland's ongoing economic performance at the top of all provinces:

> *…not only will rising crude oil production at the Terra Nova and Hibernia Offshore oil fields in 2002 likely fuel nation leading growth of 6.3 per cent in Newfoundland and Labrador in 2002, but the province is expected to remain on top of the leader board again next year. In 2003, with development gearing up at both the White Rose offshore oil project and Voisey's Bay nickel project, real GDP growth in the province is projected to reach a still-scorching 5.3 per cent.*[17]

The economic commentary became more and more positive as the year progressed:

> *"Energy and mineral development will leave Newfoundland and Labrador firmly atop the provincial growth charts this year and next".*[18]

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[15] Hon. Joan Marie Aylward, Minister of Finance, Province of Newfoundland and Labrador, Budget Speech 2003, p.39.
[16] Budget Speech 2002, Province of Newfoundland and Labrador, Hon. Joan Marie Aylward, March 21, 2002, p. 2.
[17] Provincial Economic Outlook", p.3, July 4, 2002, T.D. Economics, T.D. Bank Financial Group.
[18] "Energy Promises to Lead in 2003", CIBC World Markets Economics, Provincial Outlook, article by Warren Lovely and Leslie Preston, dated September 26, 2002.

Employment is increasing and reached a record high in 2002 and the ratio of debt to GDP has declined significantly in the last 10 years. These types of signals are extremely positive and suggest a very favourable outlook.

Cautionary Signals

Clearly, some of the underlying budgetary trends are not consistent with the tone of the economic outlook. The challenging elements in the fiscal equation have been acknowledged by various analysts that assess government finances on an ongoing basis. Just as they acknowledge the province's impressive GDP growth, driven by oil production, some have been very direct in their commentary on the fiscal position of Newfoundland and Labrador over the last couple of years.

The following are extracts from various external assessments of the 2002 Budget of Newfoundland and Labrador:

> ***TD Economics****: "The government will eventually have to deal with its structural deficit, hidden in part by its annual revenue smoothing technique. Only then can the government truly address its two biggest challenges – reducing the debt, and whittling down its high tax rates"*[19]
>
> ***Investment Dealers Association of Canada****: "…Newfoundland faces stringent financial conditions over the near term."*
>
> *"…with public debt on the rise, debt servicing has been a factor in total spending outpacing the rise in budgetary revenues for four straight years. The widening in the province's annual budget deficit is somewhat disappointing, given the unusually strong economic growth in this period that presented Newfoundland and Labrador an opportunity to place finances on firmer ground."*[20]

The 2003 Budget has been met with some mixed reviews. Scotia Economics summarized the Budget and characterized it as "… Adjusting to Prosperity".

> ***Scotia Economics: "****With its additional revenue, the Newfoundland and Labrador government has undertaken to reduce its consolidated financial requirement by $75 million annually between next year and FY07/08. This should at least restrain what has become one of the heaviest provincial burdens. Newfoundland's debt service continues to use nearly 15 cents of every revenue dollar, compared to a ten-province average that has moved down to about 12 cents."*[21]

The Bank of Montreal was more critical in its assessment of the 2003 Budget:

[19] "The 2002 Newfoundland and Labrador Budget", T.D. Bank Financial Group, article by Derek Burleton, Senior Economist, T.D. Economics, dated March 21, 2002.
[20] "Resources Development Brightens Mid-term Prospects", Investment Dealers Association of Canada, Provincial Perspectives, Newfoundland and Labrador, article by Stan Kumagai, Economist, Industry Relations and Representation, dated October 2002.
[21] "The Newfoundland and Labrador 2003/04 Budget … Adjusting to Prosperity", Scotiabank Group, Scotia Economics, article by Caroline Silsbury and Mary Webb, March 27, 2003.

> ***Bank of Montreal*** *… A deficit of $666 million, or 4.0 per cent of GDP, is simply not sustainable. When deficits hit four per cent of GDP in Alberta, Saskatchewan and Ontario in the early 1990s, governments there took drastic action to eliminate deficits and reduce debt. Further, their situations were less dire in that their debt levels were substantially below what that of Newfoundland is now.*
>
> *The Newfoundland government states that, for a few years, this size of deficit is manageable and, indeed, it would be if the debt were not so high and there were convincing evidence that deficits were headed sharply lower. Unfortunately, neither is the case.*
>
> *… Newfoundland's debt spiral must come to an end. Unfortunately, it is not easy to see how this will happen. With the highest debt levels and the highest personal income taxes in the country, the province cannot afford to either increase taxes to reduce the deficit nor cut taxes to stimulate the economy.*[22]

In its assessment of the 2003 Budget, the T.D. Bank Financial Group characterized the situation as "undeniably, … one of the most challenging fiscal environments among the provinces."

> *"**T.D. Economics** "…Although other regions in Canada are also feeling the heat to re-invest substantial amounts in health care and education, Newfoundland and Labrador must face these pressures while confronting a declining population base. Since federal transfers are calculated on a per capita basis, the total amount from Ottawa declines as the population shrinks, while the cost of public-service delivery per capita increases.*
>
> *Still, the Government of Newfoundland and Labrador must be careful not to risk reversing some of the significant fiscal progress it has achieved since the early 1990s. In fact, even if the government manages to post a balanced budget by fiscal 2007-08, the level of taxpayer-supported debt is likely to rise to $7.0 billion to $8.0 billion – almost twice the level recorded in fiscal 1997-98 – which would make the government increasingly vulnerable in the event of a sharp slow-down in economic growth, or a sharp increase in interest rates."*[23]

A Fiscal-Economic Conundrum

The people of Newfoundland and Labrador face a fiscal-economic conundrum. Recently reported "modest" deficits, combined with strong economic growth are contrasted against concerns about the widening deficit gap, the mounting debt burden and high tax rates.

[22] "Large Deficit in Newfoundland's 2003 Budget", Bank of Montreal, "Commentary", article by Tim O'Neill, Chief Economist, Economics Department, March 31,2003.

[23] The 2003 Newfoundland and Labrador Budget, T.D. Bank Financial Group, article by Derek Burleton and Mimi Curtis-Irving, dated March 27, 2003.

While much of the recent commentary naturally focuses on the 2003 budget, the fiscal challenges have evolved over a number of years.

The elements of the fiscal challenges confronting Newfoundland and Labrador are apparent from the foregoing review and analysis:

i) Revenue base constrained
- Population decline
- Important tax cuts in key revenue sources limited revenue growth
- Restraint on federal transfer payments
- Ongoing competitive pressures for further tax cuts

ii) One-time revenues depleted
- Sinking fund recoveries
- HST & Term 29 transitional payments

iii) Net revenue growth potential restrained
- Equalization losses increase as oil revenues grow
- Potential impact of future GDP growth largely diminished

iv) Expenditure requirements increasing:
- Ongoing pressures in health care costs
- Public sector compensation obligations
- Base expenditures not reduced in proportion to population (and revenue) decline

v) Debt burden increasing:
- Requirements to fund deficits
- Increased borrowing to fund long-standing and growing pension obligations

vi) Large underlying deficit

The analysis illustrates the significant inconsistencies between current economic trends as portrayed by GDP growth and the fiscal direction depicted by the widening deficit gap and escalating debt. The increased benefits of oil production are only beginning to be realized. But, in the absence of public policy changes, these benefits will be substantially diminished by the equalization impact (discussed in Chapter 3) with residual gains insufficient in themselves to eliminate the deficit or curb the escalation in debt.

Chapter 2

Relative Fiscal and Economic Position

A comparison of the fiscal position of Newfoundland and Labrador relative to the other provinces and the Government of Canada

... It is when we compare Newfoundland of today, after a dozen years of what for us has been phenomenal progress, with the rest of Canada that we are brought up by a short turn to the realization of the fact that we have a quarter century at best, and even a half century at worst, to go before we catch up with today's general average in Canada.[1.]

Hon. Edward S. Spencer
Minister of Finance
Newfoundland and Labrador
Budget Speech, June 22, 1960

WHERE DO WE STAND IN CANADA ?

The foregoing assessment of the evolution of the fiscal position of Newfoundland and Labrador provides substantial background information on the province's financial position on a stand-alone basis. However, with the exception of the comparative review of the debt position and credit ratings of all provinces, the analysis to this point begs the question – how does the province rank against the other provinces on key fiscal and economic criteria? This chapter will address this issue from a number of perspectives starting with a comparison of fiscal indicators and progressing to economic indicators.[24]

The analysis quickly shows that, as a nation, Canada has reported remarkable fiscal and economic success in the last decade. (This comparative analysis is, for the most part, based on the most recent comparative data available as of January 2003. However, it has been revised to reflect the February Federal Budget. Chapter 3 provides an updated comparative budgetary outlook for 2003-04 and beyond.)

Surplus/Deficit Comparison

Looking back 10 years to the 1993-94 fiscal year, all Canadian provinces recorded deficits. Newfoundland and Labrador's deficit was $205 million in that year, while Ontario recorded an enormous shortfall of $11.2 billion. In that year all provincial deficits together totaled $20.2 billion and the deficit of the Government of Canada amounted to over $42 billion:

[24] Comparative data used in this section are generally drawn from Statistics Canada and other third party sources that have endeavored to adjust the information to make it comparable among provinces. Accordingly, specific indicators in any year for any one jurisdiction may not correspond with individual published reports of that particular jurisdiction. The objective of this section is to provide an indication of relative position of the provinces as opposed to absolute numbers.

Table 2-1

Budgetary Surpluses & Deficits

Provincial & Federal Comparison

1993-94 to 2002-03 Revised

(millions)

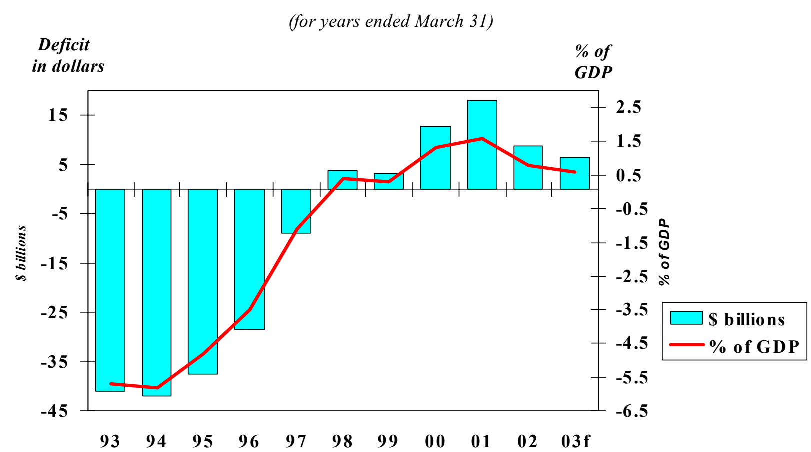
Govt.	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03R
NL.	**(205)**	**(127)**	**9**	**(19)**	**(7)**	**4**	**(23)**	**(26)**	**(47)**	**(62)**
P.E.I.	(71)	(1)	4	(4)	(7)	6	(5)	(12)	(15)	(8)
N.S.	(549)	(235)	(201)	(116)	(442)	(261)	(797)	147	(54)	14
N.B.	(266)	(68)	(51)	66	35	(165)	8	82	37	3
Que.	(4923)	(5821)	(3947)	(3212)	(2157)	126	7	427	22	0
Ont.	(11202)	(10129)	(8800)	(6905)	(3966)	(2002)	668	3325	375	524
Man.	(431)	(196)	157	91	76	31	11	41	63	4
Sask.	(272)	128	18	407	35	28	83	58	1	2
Alta.	(1384)	958	1132	2527	2639	1026	2717	6388	772	1819
B.C.	(899)	(228)	(317)	753	(167)	(1003)	40	1426	(1233)	(3800)
All Provs	**(20202)**	**(15719)**	**(11996)**	**(6412)**	**(3961)**	**(2210)**	**2709**	**11856**	**(79)**	**(1504)**
Federal	**(42012)**	**(37462)**	**(28617)**	**(8897)**	**3817**	**3112**	**12713**	**18148**	**8907**	**6400**

Source: *Department of Finance Canada, Fiscal Reference Tables, October 2002, Provincial and Territorial Governments Public Accounts and revised for 2002-03 based on 2003 Budgets.*

Federal Recovery: The recovery of the federal budgetary position was perhaps the most impressive of all Canadian governments. From 1993-94, when it recorded a peak deficit of $42 million, the Government of Canada progressed through successive years of fiscal restraint and deficit reduction until 1997-98 when it recorded a surplus of $3.8 billion. Since then the trend of surpluses has continued and the federal debt has been reduced by $46.7 billion.

Chart 2-1 **Federal Budgetary Balance**

Deficit/Surplus



Source: Government of Canada, Department of Finance (public accounts basis), Budget 2003, and TD Economics.

In his budget of February 18th, 2003, the federal Minister of Finance revised the projected 2002-03 surplus to $6.4 billion (up more than 80 per cent from the budgeted level of $3.5 billion). The federal Minister indicated that since 1995 Canada has recorded the largest reduction in net debt among the G-7 countries and it is now projected to be the only G-7 country in surplus in 2003. The improved fiscal results since 1993-94 have been accomplished primarily through government initiatives to achieve significant reduction in program spending as a percentage of GDP. In addition, the debt service costs has declined through a combination of reduced debt, lower interest costs and some accounting changes.

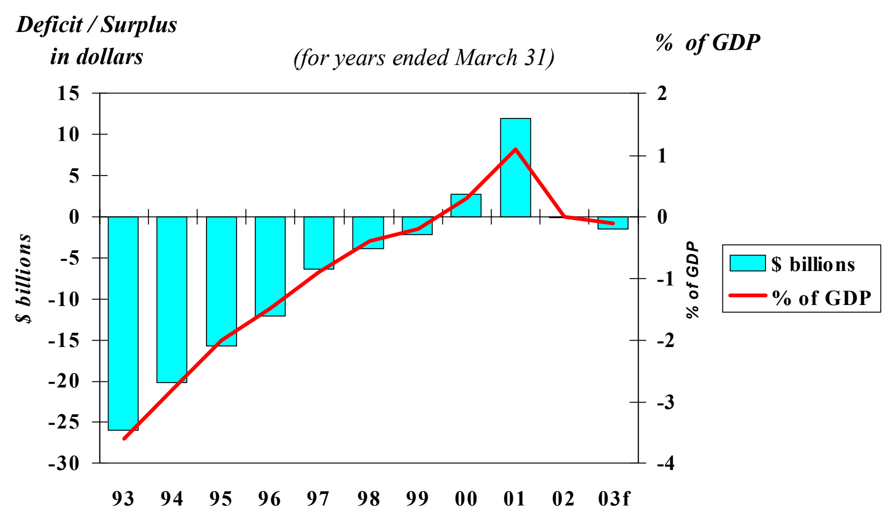
The Government of Canada is projecting balanced budgets for the next three years after providing for a $3 billion contingency reserve and a $1 billion to $2 billion fiscal prudence reserve each year. It has been suggested by many analysts that the Government of Canada is intentionally understating its projected fiscal position to reduce pressures to increase spending and cut taxes.

Provincial Recovery: Improving economic performance combined with a concentrated focus on fiscal discipline and repair generated improved financial performance in most provinces through the mid to late 1990s. The combined provincial deficits were progressively reduced in the years leading up to 1999-00 and 2000-01 when, in the aggregate, surpluses of $2.7 billion and $11.9 billion, respectively, were achieved:

Chart 2-2

All Provinces Budgetary Balance

Deficit/Surplus



Source: Government of Canada, Department of Finance, TD Economics, and provincial budgets.

Eight provinces recorded surpluses in 2000-01 – only Newfoundland and Labrador and P.E.I. registered deficits of $26 million and $12 million, respectively. (Newfoundland and Labrador could have recorded a surplus but chose to defer certain revenues to the following year.)

The economic slowdown in 2001-02 brought a change in direction in fiscal trends of the provinces and brought renewed emphasis on fiscal restraint in most provinces. The provinces moved from a combined surplus of $11.9 billion in the previous year, 2000-01, to a virtually balanced position overall in 2001-02.

The 2002-03 budgets reflected an aggregate provincial financial deficit of almost $3.8 billion – the increased deficit was driven by B.C.'s $4.4 billion deficit budget. While Newfoundland and P.E.I. budgeted for increased deficits, the remaining seven provinces produced balanced budgets for 2002-03. The revised estimates for 2002-03 now indicate that the combined net deficit for the provinces will be more in the order of $1.5 billion with significant improvements reported in Alberta, Ontario and B.C.

The relative order of magnitude of the provincial surpluses and deficits is illustrated by a comparison of the "Surplus and Deficit to GDP" ratios over the past 10 years:

Table 2-2

Surpluses & Deficits to GDP Ratio
Provincial & Federal Comparison
1993-94 to 2002-03 Projected

(percent)

Govt.	93-94	94-95	95-96	96-97	97-98	98-99	99-00	00-01	01-02	02-03P
NL.	**(2.1)**	**(1.2)**	**0.1**	**(0.2)**	**(0.1)**	**0.0**	**(0.2)**	**(0.2)**	**(0.3)**	**(0.4)**
P.E.I.	(2.9)	0.0	0.2	(0.1)	(0.2)	(0.2)	(0.2)	(0.4)	(0.4)	(0.2)
N.S.	(3.0)	(1.3)	(1.0)	(0.6)	(2.2)	(1.2)	(3.5)	0.6	(0.4)	0.0
N.B.	(1.8)	(0.5)	0.2	0.4	0.2	(0.9)	0.0	0.4	0.2	0.1
Que.	(3.0)	(3.4)	(2.2)	(1.8)	(1.1)	0.1	0.0	0.2	0.0	0.0
Ont.	(3.8)	(3.3)	(2.7)	(2.0)	(1.1)	(0.5)	0.2	0.8	0.1	0.1
Man.	(1.7)	(0.8)	0.6	0.3	0.3	0.1	0.0	0.1	0.1	0.0
Sask.	(1.2)	0.5	0.1	1.4	0.1	0.1	0.3	0.2	0.0	0.0
Alta.	(1.7)	1.1	1.2	2.6	2.5	1.0	2.3	4.5	0.5	1.3
B.C.	(1.0)	(0.2)	(0.3)	(0.4)	(0.1)	(0.9)	0.0	1.1	(1.5)	(2.8)
All Provs	(2.8)	(2.0)	(1.5)	(0.9)	(0.4)	(0.2)	0.3	1.1	0.0	(0.1)
Federal	(5.8)	(4.8)	(3.5)	(1.1)	0.4	0.3	1.3	1.6	0.8	0.6

Source: Department of Finance Canada, Fiscal Reference Tables, October 2002, Provincial and Territorial Governments Public Accounts, TD Bank Financial Group, TD Economics, Canadian and Provincial Governments Surpluses and Deficits, June 25, 2002, and revised estimates for 2002-03 based on 2003 budgets

The improving trend is evident in most provinces with the notable exceptions of British Columbia and, to a lesser extent, Prince Edward Island and Newfoundland and Labrador in 2002-03.

While the revised deficit in this province for 2002-03 at 0.4 per cent of projected GDP represented a marginal increase from the 2001-02 level, it was still a substantial improvement from the 2.1 per cent of GDP recorded in 1993-94. British Columbia on the other hand, with a revised deficit of 2.8 per cent of GDP in 2002-03 was an anomaly. B.C.'s deficit is directly attributable to large recent tax cuts. It has committed, and is required by legislation, to restore fiscal balance by 2004-05.

Exhibit 1 on the following page is a synopsis of the provincial budgets for the 2002-03 fiscal year, published by Scotiabank in September 2002. It not only provides a concise overview of the respective provincial budgets, it also highlights common elements running through many budgets – in particular a desire to reduce personal and corporate taxes but, in several cases, the necessity to postpone such action.

The summary indicates that three of the seven provinces with balanced budgets were recording deficits before drawdowns from their Fiscal Stabilization Funds (one other province, Quebec, utilized significant reserves to achieve fiscal balance in 2002-03).

EXHIBIT 1

PROVINCIAL BUDGET SYNOPSES: 2002-03

Newfoundland and Labrador's deficit is forecast to widen again this year, despite the postponement of the last stage of its PIT cut.

P.E.I. is also forecasting a larger deficit in FY02/03, even after deferring some highway investment to accommodate wage increases and higher health outlays.

Nova Scotia is on track to achieve its target of balanced books by FY02/03, after steadily reducing its deficit before unusual items from $322 million in FY99/00. Some tax relief is now anticipated in FY03/04.

New Brunswick expects a modest surplus for the seventh time in eight years. A drawdown from the Fiscal Stabilization Fund will allow further tax cuts and spending related to its Prosperity Plan released last February.

Quebec's November budget, to sustain growth, accelerated capital projects, enhanced corporate tax credits and provided assistance to QST credit recipients. Its March update confirmed a zero FY02/03 balance, while promoting biotechnology and innovation.

Ontario shifted gears to stay in the black, delaying planned personal, general, corporate and manufacturing income tax cuts from 2003 to 2004 and seeking increased sales and commercialization of government assets.

Manitoba, with $93 million from its Fiscal Stabilization Fund and a $75 million contribution from Manitoba Hydro's export profits, will maintain a small surplus in FY02/03 as it continues to chip away at its tax burden, and commits to substantial infrastructure projects.

Saskatchewan will retain a positive budget balance, aided by a streamlined government structure and a further draw down from its Fiscal Stabilization Fund. Spending is focused on health, education and infrastructure.

Alberta's forecast of a $724 million FY02/03 surplus incorporates a conservative oil and natural gas price forecast. The corporate tax cuts scheduled for April 2002 were slowed, and higher medical insurance premiums and tobacco taxes will help to fund hefty increases in health and education spending.

British Columbia, with major personal and corporate tax cuts in place, forecasts a record $4.4 billion FY02/03 deficit. To achieve balanced books by FY04/05, the new administration is maintaining health and education funding while reducing other program spending 25 per cent over the next three years. A retail sales tax increase combined with higher tobacco taxes and a 50 per cent hike in Medical Services Plan premiums will fund this year's compensation-driven rise in health outlays.

Source: Extracted from "Scotia Bank Provincial Forecast Update, September 2002". This Report was prepared by Scotia Economics as a resource for the clients of Scotia Bank and Scotia Capital. While the information is from sources believed reliable, neither the information nor the forecast shall be taken as a representation for which The Bank of Nova Scotia or Scotia Capital Inc. or any of their employees incur any responsibility.

Balanced Budget Legislation

The huge fiscal challenges confronted by governments in grappling with the deficits of the early to mid-nineties, gave rise to a movement in most provinces to reinforce fiscal discipline and the prudent management of public finances. Accordingly, eight provinces have introduced some form of balanced budget legislation in recent years. Exhibit II provides a very brief synopsis of the legislation in the provinces:

EXHIBIT II

PROVINCIAL BALANCED BUDGET LEGISLATION
BRIEF SYNOPSIS

Alberta's Fiscal Responsibility Act requires Alberta to budget for a surplus (called an economic cushion) of 3.5 per cent of budgeted revenues every year and the elimination of accumulated direct debt by 2025. (Legislation currently under review.)

Ontario's legislation introduced in 1998 imposes a legal obligation on government to balance the budget every year starting in 2001-02. Small deficits, less than one per cent, may be offset by corresponding surplus the next year. (Financial penalties are to be imposed on Ministers for failure to meet requirements) - Exceptions for disaster situations.

Manitoba's legislation introduced in 1995 requires balanced budgets starting in 1995-96. Penalties apply if deficits are incurred. Any deficit must be fully offset by a surplus in the next year. Up to certain limits surplus revenues must be placed in a Fiscal Stabilization Fund - Exceptions for disasters and a revenue decline of more than five per cent.

Nova Scotia's legislation was introduced in 1999 and requires a balanced budget by 2002-03 after which a deficit in one year must be offset by a surplus the next year.

British Columbia's government elected in 2001 introduced legislation requiring balanced budget by 2004-05. It imposes financial penalties on Ministers if fiscal targets are not achieved.

New Brunswick's Balanced Budget Act introduced in 1995 requires budgets for ordinary accounts (non-capital) to be balanced every four year period. Stated as an "objective", not a "requirement".

Saskatchewan's legislation requires balanced budgets every year. Transfers to and from the Fiscal Stabilization Fund are to be considered expenditures/revenues for the purposes of calculating the deficit.

Quebec's 1997 legislation requires balanced budgets each year but allows deficits in exceptional circumstances; severe recession or steep decline in fiscal transfers.

Source: Information extracted from "The Canadian Federal and Provincial Governments – 2002 Overview" by DBRS, dated January 2003, p.23 and "Report on Canadian Government Finances" TD Bank, TD Economics, dated October 2001.

In some cases the legislation goes beyond the annual budgetary balance and sets long-term deadlines for the elimination of debt. Manitoba, for example, requires the elimination of general purpose debt by 2035 and unfunded pension liability by 2040.

While it has been suggested that governments might be using creative accounting, deferrals and reserves to get around the legislation, it is not known whether this is the case. In any event, there is clearly a growing level of public intolerance for such tactics. The mere fact of "balanced budget" legislation underlines the overall public policy objective of balancing the books. *It is recommended the Government of Newfoundland and Labrador introduce balanced budget legislation.*

REVENUE COMPARISONS

A comparative review of revenues and expenditures adds further perspective to the relative fiscal standing of this province in Canada.

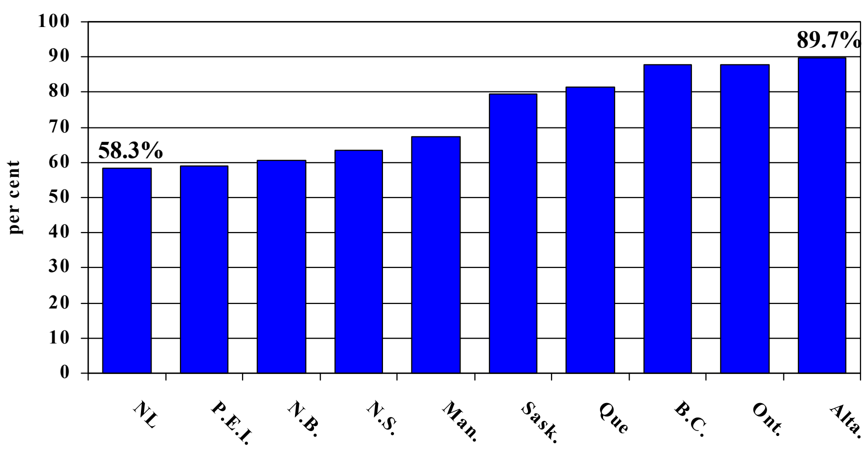
Review of Main Revenue Sources

In reviewing the main revenue sources of Newfoundland and Labrador compared to the other provinces, it is important to note that provincial "own source" revenues account for just over 58 per cent of total revenues. While this proportion has increased in the order of 10 percentage points in the last decade, it still ranks with the lowest of all Canadian provinces in terms of its ability to generate revenues from provincial sources.

Chart 2-4 **Provincial Source Revenues vs. Total Revenues**

As percentage of total revenues

for year ended March 31, 2002)



Source: Government of Canada, Department of Finance and provincial Public Accounts.

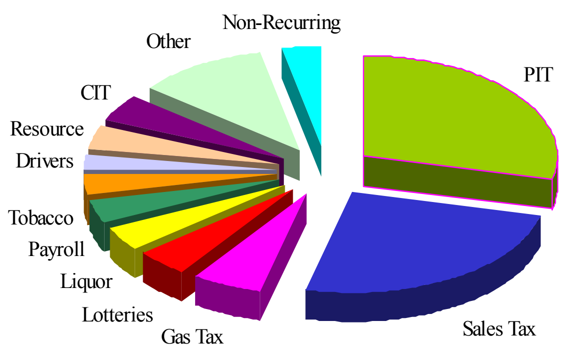
The main "provincial source revenues" for the Government of Newfoundland and Labrador historically have been sales tax and personal income tax (PIT). In total these two sources accounted for $1,265 million, or 53.9 per cent of all provincial revenues in the 2002-03. (The actual revenues from these two sources combined were up $92 million above the budget in 2002-03.) Chart 2-5 illustrates the breakdown of the provincial source revenue base:

Chart 2-5

Provincial Revenue Sources

Newfoundland & Labrador

(for year ended March 31, 2003)



Sources		
	Bud	***Act***
PIT	611	***671***
Sales Tax	562	***594***
Gas Tax	133	***135***
Lotteries	106	***106***
Liquor	103	***93***
Payroll Tax	84	***84***
Tobacco Tax	81	***80***
CIT	58	***109***
Drivers License	55	***56***
Natural Res.	51	***88***
Other	197	***251***
Non-Recurring	232	***80***
	2273	***2347***

Source: Government of Newfoundland and Labrador, Department of Finance, annual estimates.

There were significant variances, mostly favourable, in provincial revenues in 2002-03. While approximately 10 per cent of the 2002-03 budgeted provincial source revenues were of the non-recurring, "one-time" nature referred to in Chapter 1, strong growth (totaling $177 million) in core provincial revenues lead to the deferral of the majority of these one timers.

In addition to unexpected growth in PIT and sales tax, revenues from natural resource royalties and taxation came in at $88 million, up from the budgeted level of $50 million. This revenue component can be expected to increase dramatically in the coming years. Corporate income taxes (CIT) were budgeted at $50 million but at year end 2002-03 totaled $109 million.

This background on the relative significance of the various revenue components for this province is meant to add some perspective to the inter-provincial comparison which follows.

Comparative Tax Effort

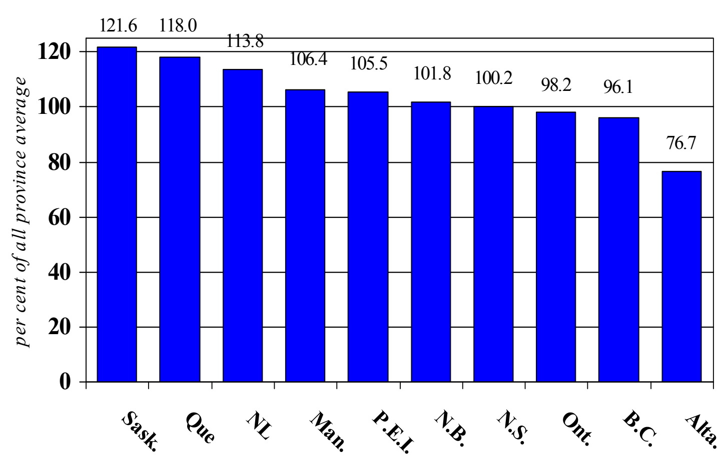
There is a wide variation in tax policies and structures across the country.

While some of the common elements of the provincial tax systems will be compared individually, one of the more revealing overall indicators of the weight of taxation in this province relative to the other provinces is the comparison of "tax effort". This analysis indicates Newfoundland and Labrador has the third highest tax effort at 113.8 per cent of the national average, behind Saskatchewan and Quebec. Alberta, not surprisingly, has the lowest tax effort at 76.7 per cent of the national average.

Chart 2-6

Comparative Tax Effort

Estimated for year ended March 31, 2003



Source: Provincial Department of Finance, derived from the federal third equalization estimate 2002-03 , February 2003.

Comparative Tax Levels

The more prominent taxation instruments in all Canadian provinces include: i) personal income tax, ii) sales tax, iii) fuel taxes, iv) corporate income taxes, and v) tobacco tax. A brief comparison of the rates in each case is outlined below (provincial budgets were being introduced with tax changes as this was being finalized accordingly - the 2003 budget changes are not reflected in all cases):

i) **Personal Income Tax (PIT)**: This is the largest provincial own source tax base in Newfoundland and Labrador and it generated $671 million in 2002-03. This province's PIT rates are generally the second highest in Canada, second only to Quebec. On a combined basis (federal and provincial PIT) for the top marginal tax rate, Newfoundland and Labrador is the highest at 48.64 per cent, just above Quebec at 48.22 per cent. This compares with Alberta which has the lowest top marginal rate at 39 per cent and B.C. which is next at 43.7 per cent.

The following summary of comparative tax rates provides an indication of the provincial income tax rates applicable in 2002 in the various provinces grouped by three categories; low income (generally $0 to $30,000); middle income (generally $30,000 to $60,000) and high income (generally over $60,000):

Table 2-3

Provincial Income Tax Comparison – 2002

Summary Indication of Tax Rates [25]

Provinces	**Low $0-30,000**	**Middle $30-60,000**	**Over $60,000**	**Surtaxes**
NL	10.6	16.2	18.0	nine per cent of basic provincial tax (BPT) over $7,032
Nova Scotia	9.8	15.0	16.7	10 per cent of BPT over $10,000
P.E.I.	9.8	13.8	16.7	10 per cent of BPT over $5,200
New Brunswick	9.7	14.8	16.5-17.8	-
Quebec*	N/A	N/A	N/A	N/A
Ontario	6.1	9.2	11.2	20 per cent of BPT over $3,747, 36 per cent of BPT over $4727 minus tax reduction
Manitoba	10.9	14.9	17.4	-
Saskatchewan	11.3	13.0	15.0	-
Alberta	10.0	10.0	10.0	-
B.C.	6.1	9.2	11.7-14.7	-

*Quebec's rates are not available on a comparable basis but it is believed they yield an effective rate higher than NL on most tax brackets.

Source: Provincial Department of Finance (note: the rate categories do not exactly correspond among provinces.)

The above table indicates that Newfoundland and Labrador ranks among the highest of the provinces for each tax bracket.

ii) **Sales Tax**: The second largest provincial own source revenue yielded $594 million in 2002-03. The Retail Sales Tax rate in Newfoundland and Labrador was 12 per cent until 1997-98 when the sales tax harmonization agreement with the Government of Canada brought in the combined HST rate of 15 per cent. This reduced the effective provincial sales tax rate to eight per cent, albeit on a broader base. Nova Scotia and New Brunswick moved to the 15 per cent HST rate at the same time. Accordingly, this province's sales tax rate today is generally in line with the median of Canadian provinces. P.E.I. did not convert to the HST and still retains its 10 per cent rate which is the highest in the country. (P.E.I.'s rate is calculated after GST is added and effectively compounds to 10.7 per cent).

[25] This table was compiled by the author from information obtained from provincial government websites. The rate categories do not correspond exactly between provinces and the table and is believed to provide a reasonable indication of the relative rates intended to provide a general indication of corporate rates as opposed to a detailed accurate comparison.

Table 2-4

Federal and Provincial Sales Tax Rates
Federal and Provincial Comparison
(percentage)

	G.S.T.	Provincial[1.]	H.S.T.	Total
P.E.I.	7.0	10.0	N/A	17.7
Newfoundland and Labrador	-	-	15.0	15.0
New Brunswick	-	-	15.0	15.0
Nova Scotia	-	-	15.0	15.0
Quebec	7.0	7.5	N/A	15.0
Ontario	7.0	8.0	N/A	15.0
British Columbia	7.0	7.5	N/A	14.5
Manitoba	7.0	7.0	N/A	14.0
Saskatchewan	7.0	6.0	N/A	13.0
Alberta	7.0	0.0	N/A	7.0

[1.] Reflects the general rate: Some provinces have different rates for liquor, meals and accommodation.

Source: "Tax Bites" Canadian Federation of Independent Business, dated March 2002.

iii) **Fuel Taxes**: Gasoline and diesel fuel taxes are the third largest source of provincial taxation revenue for Newfoundland and Labrador and generated $135 million in 2002-03. This province has the highest fuel taxes in the country as illustrated below:

Table 2-5

Fuel Taxes - 2003
Interprovincial Comparison
(¢/litre)

Province	Gasoline*	Diesel*
Newfoundland and Labrador	16.5	16.5
Quebec	15.2	16.2
Nova Scotia	15.5	15.4
Saskatchewan	15.0	15.0
New Brunswick (2003 Budget)	14.5	16.9
Ontario	14.7	14.3
B.C. (2003 Budget)	14.5	15.0
P.E.I.	14.0	13.5
Manitoba	11.5	10.9
Alberta	9.0	9.0

*Automotive fuels only

Source: Canadian Federation of Independent Business "Tax Bites"- March 2002 adjusted to reflect increases in the 2003 budgets of New Brunswick and B.C.

iv) **Tobacco Taxes**: Tobacco taxes have been one of the most prominent areas of tax rate increase in recent years. In this province these taxes raised $80 million in 2002-03. The 2003 budget increased the tax rate by $3.00 per carton to generate an extra $11 million a year. Newfoundland and Labrador's new tax rate of $30.00 per carton is fourth highest among the provinces. (The rankings change often in this source as new budgets are released.)

Table 2-6

Tobacco Taxes – 2003
Interprovincial Comparison
($ per Carton of 200 Cigarettes)

Province	Tax
British Columbia	34.00
Alberta	32.00
Saskatchewan	32.00
Newfoundland & Labrador (Budget of 2003)	30.00
P.E.I. (Budget 2003)	29.90
Manitoba	29.00
New Brunswick (Budget 2003)	28.50
Nova Scotia	26.04
Quebec	18.10
Ontario	17.20

Source: Province of Newfoundland and Labrador Department of Finance with revisions based on the New Brunswick, B.C., and Newfoundland and Labrador 2003 budgets.

v) **Corporate Income Tax Rates (CIT)**: The relative ranking of the provinces and the rate structure varies considerably depending on the income level. Saskatchewan and P.E.I. have the highest overall CIT rates. Newfoundland and Labrador's rates fall generally in the middle as outlined below:

Table 2-7

Corporate Income Tax (CIT) 2003
Interprovincial Comparison
(percentage)

	Income Levels		
	<$200,000	**$200,000 to $300,000**	**>$300,000**
Saskatchewan	6.00	6.00	17.00
P.E.I.	7.50	16.00	16.00
Nova Scotia	5.00	16.00	16.00
Manitoba	5.00	5.00	16.00
Newfoundland & Labrador*	5.00	14.00	14.00
New Brunswick (Budget 2003)	3.00	3.00**	13.00
Ontario	5.50	5.50	12.50
Quebec	8.90	8.90	8.90
B.C.	4.50	4.50**	13.50
Alberta	4.50	4.50	13.50

* Budget 2003 announced that the threshold would be increased for the small business tax from $200,000 to $300,000 over four years.
** Rates applicable up to $400,000 income.

Source: Canadian Federation of Independent Business "Tax Bites" dated February 2003 (ranges can vary somewhat among provinces).

The tax strategy varies amongst the provinces. New Brunswick has launched a major budgetary thrust with the lowest tax rates (3.0 per cent) for small to medium sized businesses. Quebec, with a single rate across the board, has the highest tax on small business and the lowest tax on large business. (The lowest tax on large business of course is a conscious move by Quebec to entice large business to choose Quebec.)

This is becoming an increasingly competitive element of the tax system as provinces are cutting CIT rates as incentives to spur business activity. Some provinces are expanding the application of the small business rates to more companies by increasing the threshold before the higher rate becomes applicable. (The comparison above is generally based on 2002 data and the new budgets for 2003-04 may provide further changes.)

vi) **Payroll Tax/Health Insurance Premium:** Newfoundland and Labrador has a payroll tax which generates approximately $84 million in revenue annually and is generally based on two per cent of payroll for companies with payrolls in excess of $600,000. Three other provinces impose a similar tax; Quebec (2.7 per cent to 4.3 per cent); Manitoba (2.2 per cent to 4.3 per cent) and Ontario (two per cent). In the case of Ontario, the tax is called an "Employer Health Tax".

> B.C. and Alberta do not have payroll taxes but they collect "Health Insurance Premiums". Annual premiums in the case of B.C. total $864 for a single person and $1,728 for a family. In the case of Alberta the premiums are $528 and $1,058, respectively.

The general trends in the type of taxation measures implemented in Canada recently, as well as the competitive pressures are evident from Exhibit III which provides a brief synopsis of the major revenue measures in the 2002 provincial budgets:

EXHIBIT III

TRENDS IN PROVINCIAL REVENUE MEASURES: FY02/03

Newfoundland and Labrador deferred the final stage of its three-year PIT reduction and raised tobacco taxes by $5/carton.

P.E.I. hiked tobacco taxes by $5/carton and its gasoline tax by one cent/litre.

Nova Scotia extended its Large Corporations Capital Tax from March 2002 to March 2004, increased fuel taxes by two cents/litre and tobacco taxes by $5/carton. Higher fees and user charges will raise an additional $26.7 million.

New Brunswick widened its low-income PIT reduction for 2002 and 2003. In July 2002 and January 2003, the general CIT rate will fall from 16 per cent to 14.5 per cent to 13 per cent, and for small business, the rate will drop from 4.0 per cent to 3.5 per cent to 3.0 per cent as the threshold rises from $300,000 to $350,000 to $400,000. Tobacco taxes rose $5/carton in June.

Quebec's November Budget indexed social assistance for 2002 and enhanced tax assistance for resource regions and e-commerce. From 2003 to 2007, its two corporate capital taxes will be roughly halved. Tobacco taxes jumped by $2.50/carton. The March update expanded aid for biotech and enriched low-income/family tax credits.

Ontario deferred planned PIT, general and manufacturing CIT and property tax cuts from 2003 to 2004. For small business, the scheduled tax rate cut from six per cent to 5.5 per cent and the higher ceiling will proceed next year and low-income PIT relief was enriched. Tobacco taxes were raised $5/carton.

Manitoba lifted tobacco taxes by $9.80/carton and eliminated the Learning Tax Credit. However, it increased PIT credits by three per cent for 2002 and lowered the education property tax by 10 per cent. The Equity Tax Credit was extended three years, a Mineral Exploration Tax Credit was introduced and scheduled PIT/CIT cuts will proceed.

Saskatchewan hiked liquor taxes from seven per cent to 10 per cent and tobacco taxes by $14.80/carton. Planned PIT cuts will go ahead in 2002 and 2003 with indexation in 2004. The corporate capital tax ceiling was raised and the 15 per cent fuel tax on ethanol sold in blended fuel was eliminated.

Alberta uncapped school property taxes and raised tobacco taxes $18/carton and medical insurance premiums 30 per cent. CIT cuts from April 1, 2002, were scaled back – the general rate fell from 13.5 per cent to 13 per cent and the small business rate fell from five per cent to 4.5 per cent alongside a higher threshold.

B.C. lifted tobacco taxes $8/carton, medical insurance premiums 50 per cent, and the sales tax 0.5 per cent to 7.5 per cent. This created an offset of roughly $750 million to the more than $2.1 billion of tax relief from tax cuts announced in 2001.

Source: Extracted from "Scotia Bank Provincial Forecast Update, September 2002". This report was prepared by Scotia Economics as a resource for the clients of Scotiabank and Scotia Capital. While the information is from sources believed reliable, neither the information nor the forecast shall be taken as a representation for which The Bank of Nova Scotia or Scotia Capital Inc. or any of their employees incur any responsibility.

Comparative Fiscal Capacity

The term "fiscal capacity" is commonly used in evaluating the revenue generating capability of a particular province compared to other provinces or the national average:

> *Fiscal capacity matters to governments because this measures the ability of a province, relative to other provinces, to generate the revenues necessary to fund the full range of programs and services we deliver, as well as provide capital infrastructure and service provincial debt.*[26]

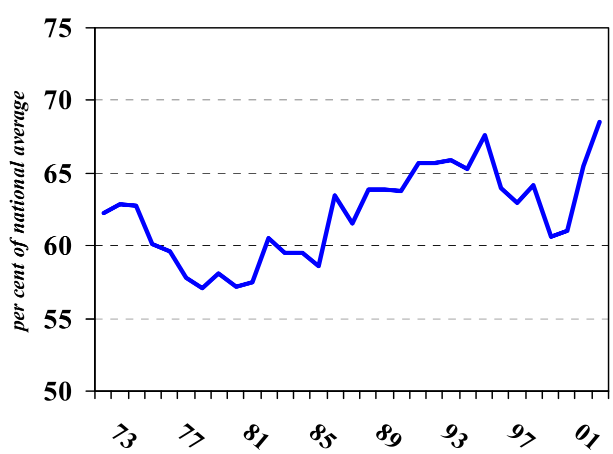
For decades, the fiscal capacity of Newfoundland and Labrador has generally been ranked the lowest of Canadian provinces – a dubious distinction which, in a few years, it has traded with Prince Edward Island in exchange for second last place.

Historically, over the past 30 years, this province's relative fiscal capacity has generally moved in the range of 57 per cent to 66 per cent of the national average. It hit 67.6 per cent in 1995-96 during the peak of Hibernia construction. It subsequently dropped back to 63.0 per cent in 1997-98 and 60.6 per cent in 1999-00. Most recently it has improved and in the February 2003 estimates of the Government of Canada it was at its highest point ever – 68.5 per cent – driven by the nation leading economic growth in 2002. The historic trend is illustrated in Chart 2-7:

Chart 2-7

NL Fiscal Capacity
1973 -2003

(fiscal years ended March 31)



Source: Department of Finance, Government of Newfoundland & Labrador, extracted from information provided by the federal Department of Finance for the Equalization Program, February 2003.

[26] Premier Roger Grimes' Presentation to Standing Senate Committee on National Finance, October 18, 2001, p.5.

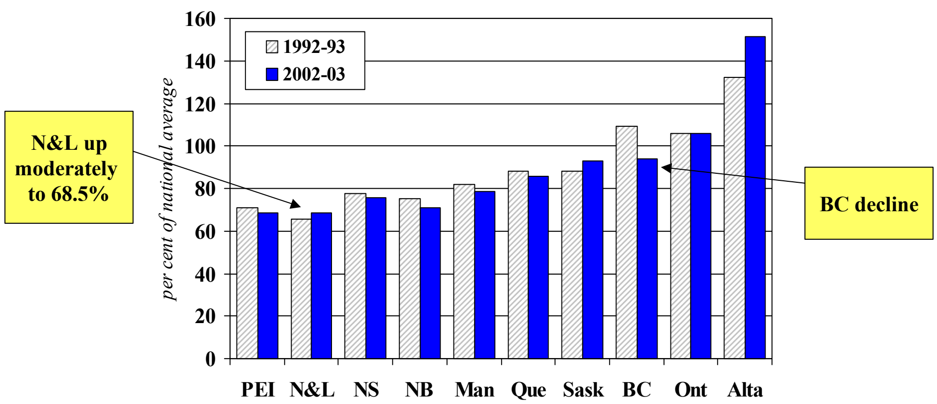
As Chart 2-7 indicates, there has been a distinct upturn in the last two years.

A comparison with the trends in fiscal capacity of all provinces over the last 10 years indicates an improvement in Newfoundland and Labrador's relative position from 65.7 per cent to 68.5 per cent:

Chart 2-8

Provincial Fiscal Capacity Comparison

1992-93 vs. 2002-03 projected



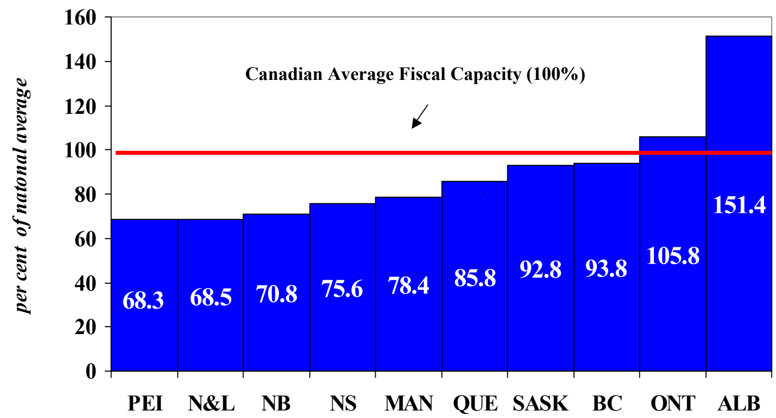
Source: Department of Finance, Government of Newfoundland & Labrador, extracted from information provided by the federal Department of Finance for the Equalization Program, updated for February 2003 estimates.

While Alberta continued to improve and Ontario was steady, the most pronounced change occurred in British Columbia. B.C. declined from a fiscal capacity of 109.4 per cent in 1992-93 to 93.8 per cent this year – 6.2 per cent below the national average. The current ranking showing the percentage of fiscal capacity is illustrated in Chart 2-9:

Chart 2-9

Provincial Fiscal Capacity (percentage)

For year ended March 31, 2003



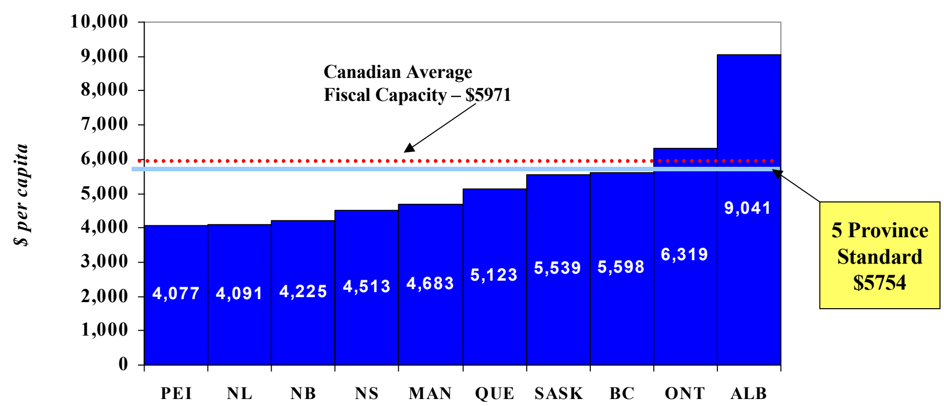
Source: Department of Finance, Government of Newfoundland & Labrador, extracted from information provided by the federal Department of Finance for the Equalization Program, updated for February 2003 estimates.

In dollar terms, the February 2003 estimate of Newfoundland and Labrador's fiscal capacity is $4,091 per capita for 2002-03, compared with the national average of $5,971 per capita. The per capita fiscal capacity of the provinces is illustrated in Chart 2-10:

Chart 2- 10

Provincial Fiscal Capacity (per capita)

For the year ended March 31, 2003



Source: Department of Finance, Government of Newfoundland & Labrador, extracted from information provided by the federal Department of Finance for the Equalization Program, updated for February 2003 estimates.

Under the equalization formula, Newfoundland and Labrador (and others) receive equalization transfer payments on a per capita basis to bring it up to a five-province standard level. In 2002-03 this standard is now estimated (February 2003 estimates) at $5,754 per capita -- 96.4 per cent of the Canadian average. There is a strong view held by most provinces and recently supported by the report of the Standing Senate Committee on National Finance in March of 2002, that the basis of the formula be moved to the national average. In many respects the five-province standard is not consistent with the stated objectives of the equalization program. Such a change would likely increase Newfoundland and Labrador's annual equalization entitlement by in the order of $110 million to $120 million based on the 2002-03 estimates. *It is recommended that the Royal Commission also support the return to the 10 province standard.*

With the offshore petroleum developments and surge in GDP in recent years, and Newfoundland and Labrador's relative fiscal capacity has begun to increase but it still remains at close to the bottom of the ranking of Canadian provinces, just marginally above P.E.I.

It is expected that the ongoing increase in resource revenues will result in this province surpassing 70 per cent of the Canadian average fiscal capacity in the current fiscal year.

EXPENDITURE COMPARISON

Overall Provincial Government Expenditures

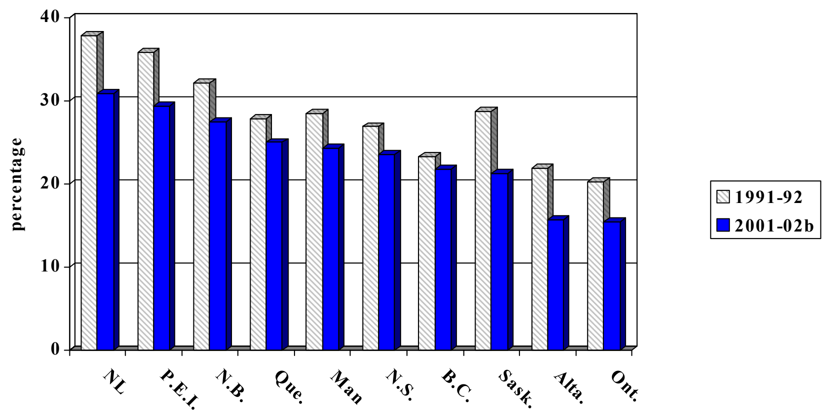
Annual provincial government expenditures in Newfoundland and Labrador totaled over $4.2 billion in 2001-02 which was equivalent to 30.9 per cent of GDP, down from 37.8 per cent in 1991-92. Nevertheless, relative to GDP, government expenditures in this province rank with the highest of all provinces (the recent strong growth in GDP in this province may have altered the order somewhat).

<u>**Chart 2-11**</u>

Provincial Government Expenditures to GDP

Expenditures as a percentage of GDP

(for years ended March 31)



Source: Statistics Canada , Provincial Government Revenue and Expenditure – Estimates and actual data CANSIM II table 385-0002.

This ratio reflects the interaction of a number of factors. Firstly, it is an indication of a proportionately high level of provincial government expenditures. Secondly, it also reflects the relative size of the economy – Alberta ranks lowest on this ratio due to its significant GDP relative to other provinces – Newfoundland and Labrador on the other hand has a proportionately small GDP. Thirdly, and far less obviously, it reflects different financial structures in different provincial jurisdictions. (As the analysis will subsequently illustrate, this is particularly the case in education and health care funding where local taxation and private funding play a greater role in some provinces.)

In the period from 1991-92 to 2001-02 total government expenditures in Newfoundland and Labrador increased by 17.2 per cent, substantially less than the all-province average growth of 28.9 per cent. However, in that same period, the population of Newfoundland and Labrador decreased by 8.3 per cent, the largest decline of any province, while the aggregate population of the country increased by 10.7 per cent. (These per capita calculations are based on Statistics Canada population estimates issued in 2002 which may be revised downward for Newfoundland and Labrador based on the latest census data.)

It is important, therefore, to put these expenditure patterns in perspective with population trends. On a per capita basis, provincial government expenditures in Newfoundland and Labrador increased by 27.7 per cent in the 10-year period, which actually outpaced the 16.4 per cent increase in the all-province average.

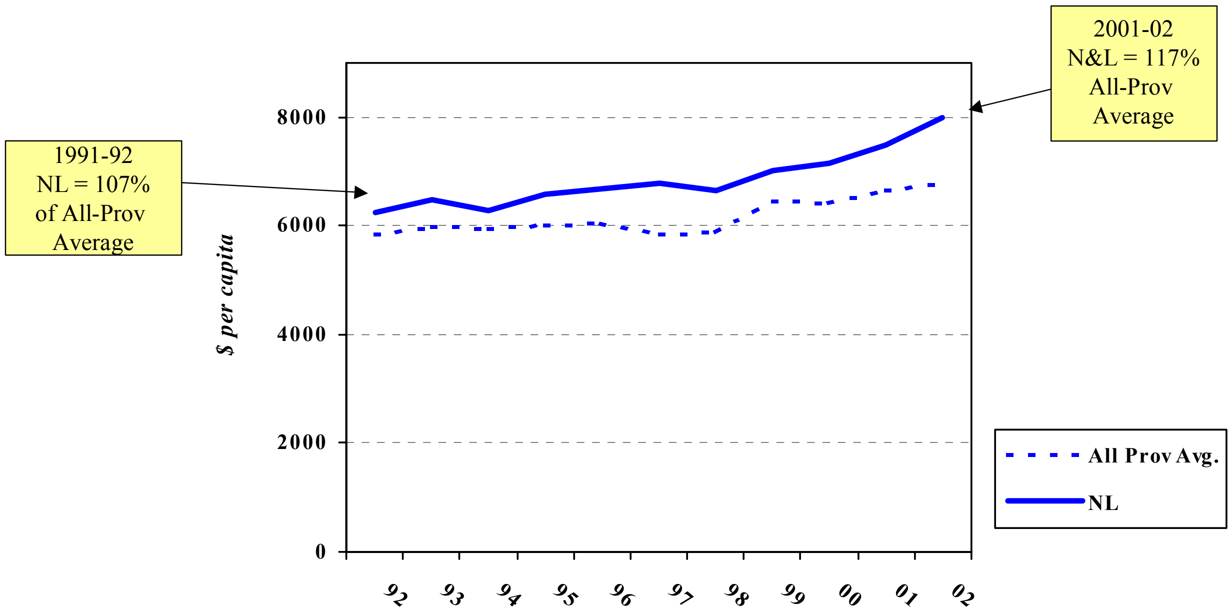
As Chart 2-12 illustrates, this province's per capita expenditures exceeded the national average by approximately 7 per cent in 1991-92 but by 2001-02, the gap had widened to more than 17 per cent above the national average:

Chart 2-12

Total Government Expenditures – Per Capita

NL vs. All Provinces 1991-92 to 2001-02

(fiscal years ended March 31)



Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador.

Major Expenditure Components

Any analysis of provincial government expenditures in Canada clearly indicates a high concentration of spending in the social programs. There is considerable variation in the nature of individual programs, the cost of delivery and the relative levels of priority assigned in the various provinces. However, on average; health, education and social services account for approximately two-thirds of overall government expenditures in all provinces.

Health Care Expenditure

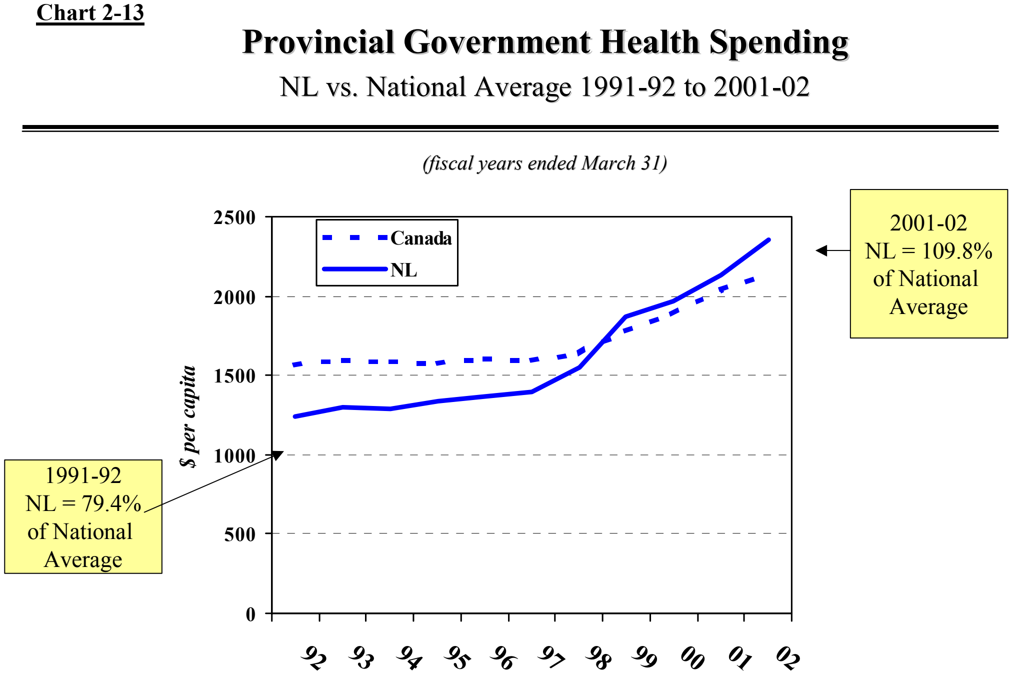
In the mid-1990s health care moved to the number one expenditure component of the provincial budget in Newfoundland and Labrador. At that time, it surpassed education which had been the largest expenditure category throughout the 1980s. The rapid escalation in health care costs, combined with the impact of declining student enrollment account for the significant change in the relative weighing of budgetary allocations in Newfoundland and Labrador.

The Canadian Institute for Health Information indicates that health expenditures in Canada have grown by 30 per cent since 1997 in "real terms", significantly surpassing the estimated 20 per cent real growth in the in the national economy in the same period**.**

Provincial Government Health Expenditures

In 1991-92 provincial government spending on health care per capita in Newfoundland and Labrador was 20.6 per cent below the national average. However, by 1998-99 this province had surpassed the national average, and by 2001-02, it was 9.8 per cent above the national average:

Chart 2-13



Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador.

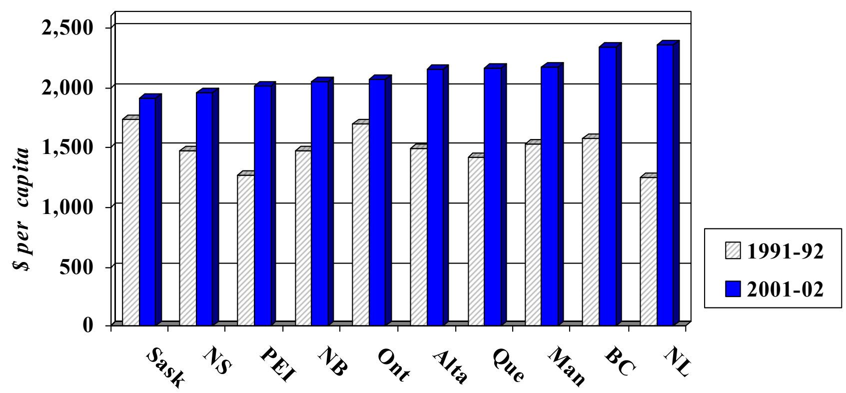
Of course all per capita comparisons over time are influenced by population changes – a major decline in this province and growth in most others.

Since 1991-92, Newfoundland and Labrador has moved from being the province with the lowest provincial government spending per capita on health care, to the highest in 2001-02**,** (marginally above British Columbia) as illustrated below:

Chart 2-14

Provincial Government Health Care Spending

Per capita expenditures 1991-92 & 2001-02



Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador.

The above analysis reflects provincial government expenditures only and does not include the private sector component.

The above data is derived from the federal Department of Finance and Statistics Canada. Other data sources use somewhat different basis of calculation, and while the order of various provinces differs, Newfoundland and Labrador still ranks highest. The latest report of the Canadian Institute for Health Information (CIHI) released on December 18, 2002 states:

> *In 2000, the latest year that age sex adjusted data is available, adjusted provincial government health spending per capita was highest in Newfoundland ($2,379) and Alberta ($2,242), followed by Manitoba ($2,196), British Columbia ($2,191), Ontario ($2,068), Saskatchewan ($1,915), Quebec ($1,906), New Brunswick ($1,890), Nova Scotia ($1,812), and Prince Edward Island ($1,793).*[27]

The CIHI notes that "expenditures per capita varies among the provinces and is much higher in the territories than in the provinces, reflecting the higher costs of servicing large geographic areas with relatively small populations." Similarly, the demographics of Newfoundland and Labrador is undoubtedly a factor in the explanation of why Newfoundland and Labrador costs are high on a relative basis.

[27] Canadian Institute for Health Information Press Release, December 18, 2002.

Private Sector Health Expenditures

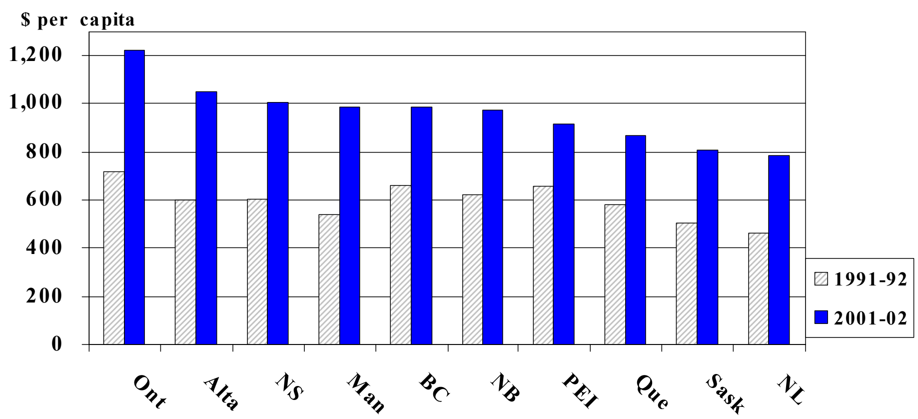
The CIHI provides an additional dimension to the provincial comparison through an analysis of private sector health expenditures. This analysis covers health care spending by households and private insurance firms.

Nationally, the private sector share of health expenditures amounts to just over $30 billion and accounts for 29-30 per cent of total expenditures on health care. Newfoundland and Labrador ranks last among the provinces in private sector spending on health at $786 per capita while Ontario ranks highest at $1,226 per capita:

Chart 2-15

Private Sector Health Care Spending

Per capita spending by province 1991-92 & 2001-02



Source: National Health Expenditure Database, Health Expenditures by Source of Finance, 1975-2002, Canadian Institute for Health Information (CIHI).

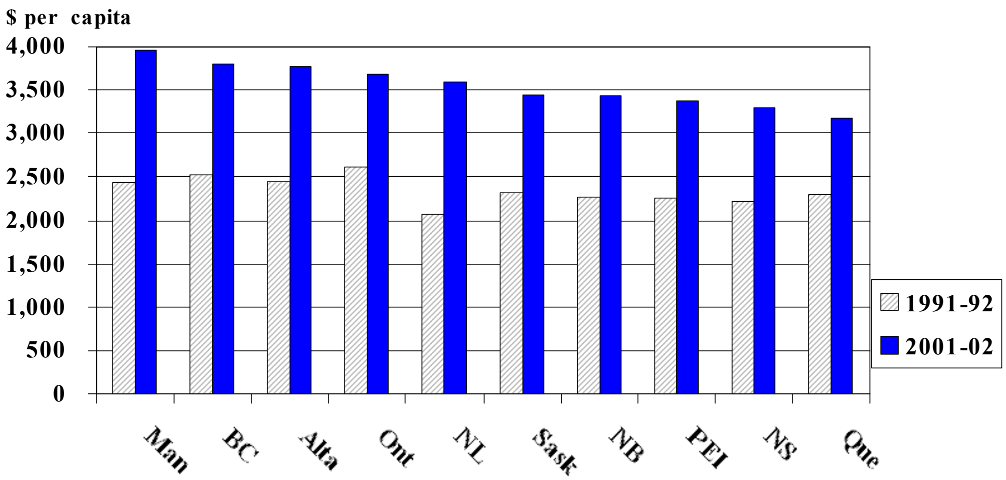
Total Health Care Spending – Public and Private

On a combined basis, public and private spending, the CIHI analysis indicates that Manitoba leads all the provinces, in total expenditures on health at $3,955[28.] per capita, while **Newfoundland and Labrador ranks fifth at $3,587 per capita**. Quebec ranks tenth at $3,182 per capita as illustrated in Chart 2-16:

[28] The data in Charts 2-15, 2-16, and 2-17 are based on data extracted from the CIHI National Health Expenditure Database, and are computed on a somewhat different basis, and therefore do not tie-in with earlier charts which were based on data initially sourced from the Department of Finance of the Government of Canada. While the previous charts focus on provincial spending, these charts reflect CIHI's computation of private sector funding as well as government funding. Accordingly, they are helpful in placing the public vs. private expenditure components in context.

Chart 2-16

Total (public & private) Health Care Spending
Per capita spending by province 1991-92 & 2001-02

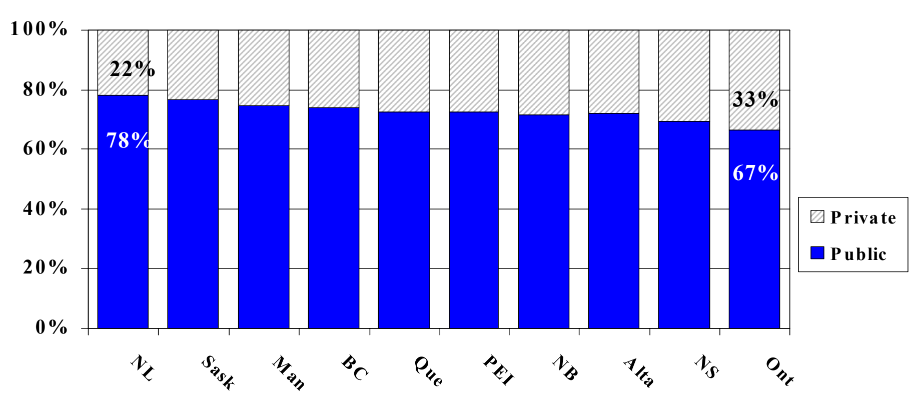


Source: National Health Expenditure Database, Health Expenditures by Source of Finance, 1975-2002, Canadian Institute for Health Information (CIHI).

Despite the highest public sector expenditures on health per capita, the lowest private sector component places overall per capita expenditures on health in Newfoundland and Labrador roughly in the middle of the range for all provinces. Chart 2-17 which follows illustrates the variation in the split of public/private sector funding for health care across the country.

Chart 2-17

Sources of Health Care Financing
% Public Funding vs. % Private Funding (2002 forecast)



Source: Base data extracted from the National Health Expenditure Database, Health Expenditures by Source of Finance, 1975-2002, Canadian Institute for Health Information (CIHI).

Education

In the decades following confederation, enrollment in primary and secondary education in Newfoundland and Labrador increased quite significantly. From 1952-53 (the earliest year that statistics are readily available) up to the peak year of 1971-72, enrollment increased from 87,800 to 162,800, or 85 per cent. This growth in enrollment at the elementary and secondary levels coupled with increased emphasis on improved quality and access to post-secondary education resulted in education becoming the largest expenditure component in the provincial budget by the late 1960s – a ranking which it held until the mid-1990s.

Elementary and primary student enrollment in the province has now been in decline for three decades. From 1971-72, to 2001-02 it dropped by almost 76,000 down to 86,900 – a decline of 47 per cent from the peak level of the early '70s. This enrollment decline, coupled with the significant escalation in health care costs, explain why education dropped to the number two rank in the budgetary spending program in the mid-90s.

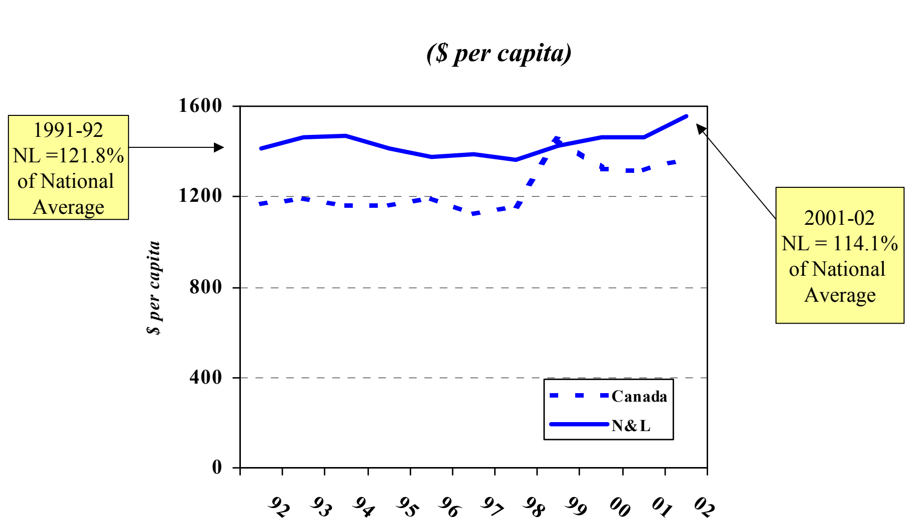
Provincial Government Education Expenditures

Newfoundland and Labrador's per capita government expenditures on education have generally exceeded the Canadian average for several years. At $1,559 per capita in 2001-02, this province exceeded the Canadian average by 14.1 per cent as illustrated in Chart 2-19 below:

Chart 2-19

Provincial Government Education Spending

NL vs. All-provinces average 1991-92 to 2001-2002



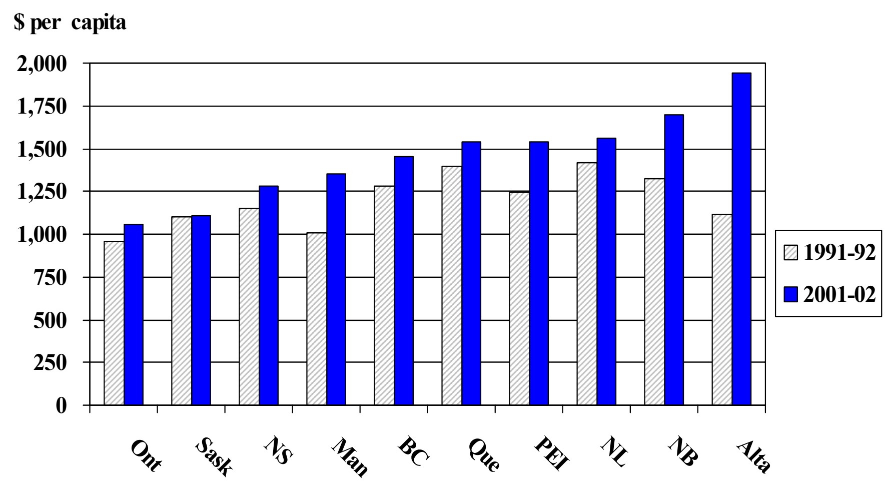
Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador.

In 2001-02 Newfoundland and Labrador ranked third highest in per capita education spending by provincial governments, behind New Brunswick and Alberta:

Chart 2-20

Provincial Government Education Spending

Per capita expenditures 1991-92 & 2001-02



Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador

Varying Sources of Education Funding

As with health, a narrow analysis of provincial government spending on education does not tell the full story. The funding arrangements for education vary significantly among provinces. Many provinces, including Ontario, Saskatchewan and Manitoba, augment the funding for education through local governments and local school taxation authorities. In this regard, Newfoundland and Labrador, New Brunswick and P.E.I. are the only provinces which do not augment provincial government expenditures with funding from local government sources. In all provinces there is also a component of funding provided by fees and other sources, as well as direct federal funding for certain programs.

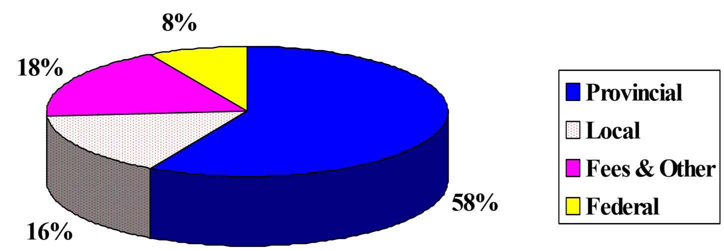
On average, across all provinces, only 58 per cent of the funding for education comes directly from provincial governments as illustrated in Chart 2-21:

Chart 2-21

Sources of Education Financing - All of Canada

Provincial, Local and Federal Governments, Fees & Other Sources

1999-2000



Source: Statistics Canada, CANSIM II, tables 478-0004, 478-0005, 478-0007 and 478-0015
Expenditures on Education, Provinces and Territories

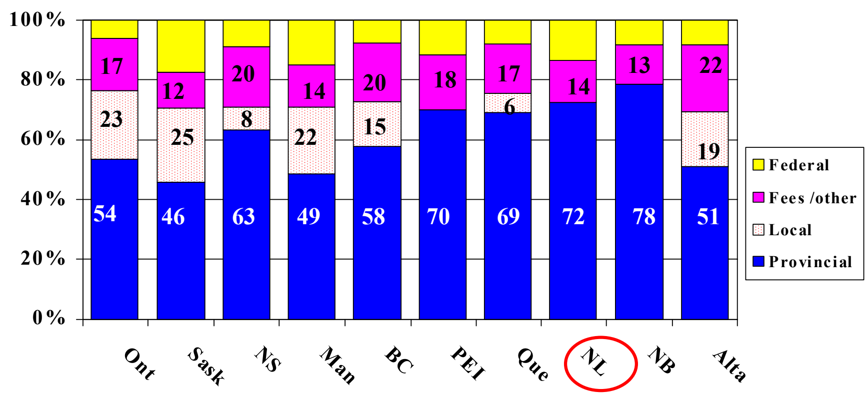
According to Statistics Canada, in 1999-2000, 72.3 per cent of the total expenditures for education in Newfoundland and Labrador were provided directly by the province. There was no local government funding and direct federal funding through various programs accounted for 13.3 per cent while fees and other sources provided the remaining 14.4 per cent.

In contrast, Ontario, which by the earlier analysis had the lowest provincial government expenditure per capita, only sourced 54 per cent of its educational financing from the province, a further 23 per cent was provided by local governments. The variation in the sources of education funding across the country is illustrated in Chart 2-22 below (the provinces are presented in the same order as the chart on provincial government funding per capita):

Chart 2-22

Sources of Education Financing by Province

1999-2000 Percentage Split by Source



Source: Statistics Canada, CANSIM II, tables 478-0004, 478-0005, 478-0007 and 478-0015 Expenditures on Education, Provinces and Territories.

While the earlier analysis of provincial government spending on education indicated that Ontario was by far the lowest of all provinces ($1,056 per capita) in 2001-02, that funding was augmented by over 40 per cent through local funding sources (assuming a continuation of the levels provided in 1999-2000). Accordingly, provincial and local sources would have provided in the order of $1,500 per capita in Ontario in 2001-02 to a highly urbanized population which was in line with the $1,559 per capita provided in Newfoundland with its highly dispersed rural population base.

Social Services

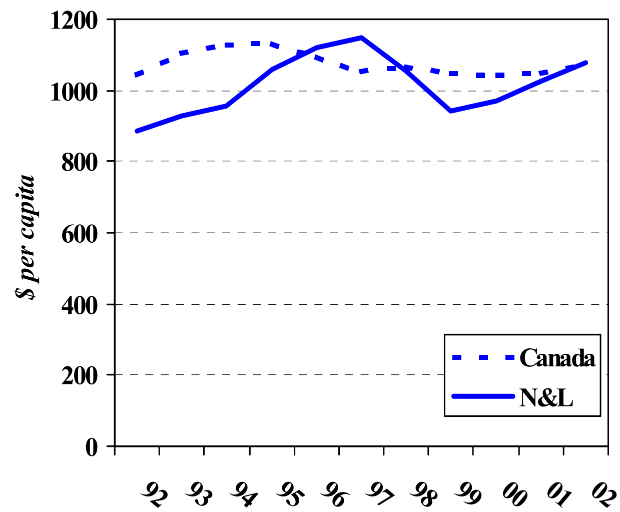
In 1991-92 Newfoundland and Labrador's per capita expenditures on social services were more than 15 per cent below the national average. However, this relative position has changed over the past decade. In the mid '90s, per capita spending in Newfoundland and Labrador actually exceeded the national average possibly due to the far reaching impacts of the closure of the groundfish fishery. By 2001-02 the rate of expenditure in this province was virtually in line with the Canadian average:

Chart 2-23

Provincial Government Social Services Spending

NL vs the National Average 1991-92 to 2001-02

(fiscal years ended March 31)



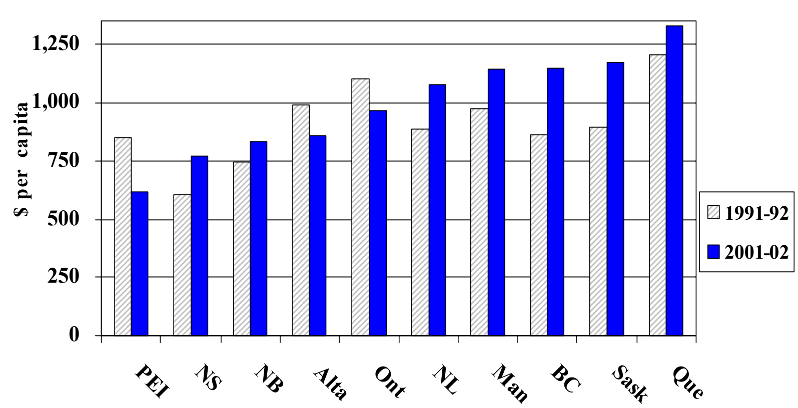
Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador.

On a relative basis compared to the other provinces, Newfoundland and Labrador ranks close to the middle in per capita spending. (The population decline in Newfoundland and Labrador may well have influenced these statistics in various ways.) The statistics indicate that Prince Edward Island recorded the lowest per capita spending in 2001-02 while Quebec had the highest level of expenditures in this sector:

Chart 2-24

Comparative Social Services Spending

Per Capita 1991-92 & 2001-02



Source: Computed by author from Statistics Canada, Population Data and Federal Fiscal Arrangements data supplied by the Department of Finance of the Province of Newfoundland and Labrador.

Debt Service Costs

An analysis of debt service costs adds further dimension to the relative significance of the debt burden and places the ongoing expenditure requirements to service the debt in context with government's program spending requirements.

At the time of union with Canada in 1949, Newfoundland and Labrador had no debt and no debt service costs. Over the years as the debt accumulated, the related debt service cost, or interest burden, increased accordingly. By 1960, 3.5 per cent of government's revenues were dedicated to cover debt service costs. By 1970 and 1980, the debt service ratio had increased to 9 per cent and 13.7 per cent respectively. The cost escalation in the interest burden was related to the mounting level of debt, as well as the run up in interest rates. Spiraling interest rates of the early 1980s combined with significant deficits to push the debt service ratio to the 17-18 per cent range by the late 1980s.

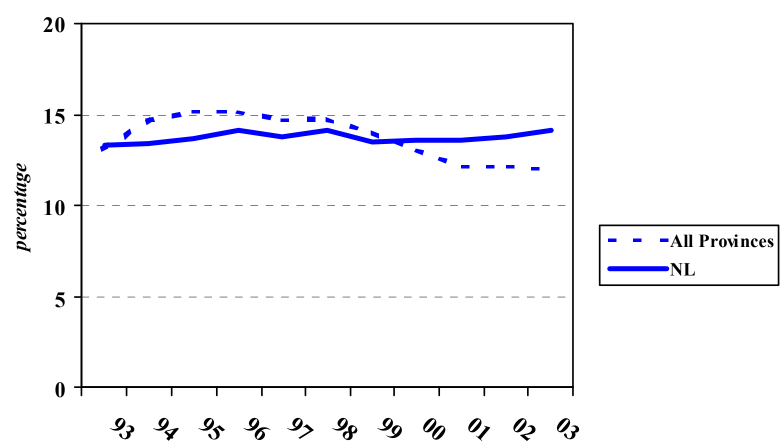
The subsequent decline in interest rates and the moderation in the deficit through the mid-nineties combined to bring the debt service ratio down to its current range of 14 to 15 per cent. In the 2003 budget, debt expenses of a current account nature total just over $550 million, or 14.1 per cent of current and related revenues. When expenses of a capital nature are added ($38 million) combined debt expenses for the coming year amount to approximately $590 million. This equates to 14.6 per cent of the overall revenue budget for the coming year.

The recent trend in debt service costs is illustrated by the ratio of "net interest costs to total revenues" as calculated by the Dominion Bond Rating Service and illustrated in Chart 2-25:

Chart 2-25

Ratio of Net Interest Costs to Total Revenues

NL vs. All provinces 1992-93 to 2002-03



Source: Dominion Bond Rating Service, The Canadian and Provincial Governments – 2001 Overview dated November 2001 and 2002 Overview, dated January 2003.

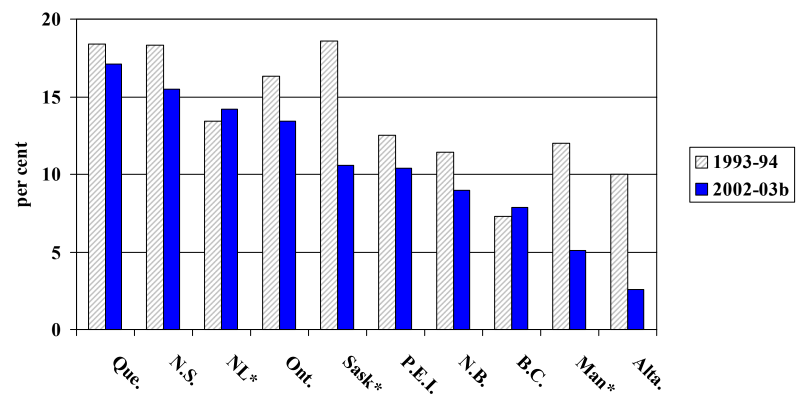
This shows Newfoundland and Labrador's average of 14.2 per cent in 2002-03 is trending above the all-province average of 12.1 per cent. This chart presents this province's position according to its "cash" basis of budgeting. On an "accrual" basis, which is more in line with the other provinces, DBRS estimated the ratio to be 20.8 per cent in 2000-01 (the most recent data available).

Chart 2-26 provides a provincial comparison of interest costs to total revenues. This chart indicates that Quebec is in the worst position of the provinces with the highest ratio of 17.1 per cent, Nova Scotia is next at 15.5 per cent, while Newfoundland and Labrador is the third highest.

Chart 2-26

Ratio of Interest Cost to Total Revenues

Provincial Comparison 1993-94 & 2002-03 Budget



Excludes interest charges accrued on unfunded pension liabilities for N&L, Manitoba and Saskatchewan

Source: Dominion Bond Rating Service, The Canadian Federal and Provincial Governments—2002 Overview, dated January 2003.

Chart 2-26 also indicates that only Newfoundland and Labrador and British Columbia recorded an increase in this ratio since 1993-94 – all other provinces reflected declines – in some cases quite significant. While debt levels have increased in most provinces, low interest rates have played a large part in bringing down these ratios. Other provinces generally have a higher level of floating rate debt than does Newfoundland and Labrador and therefore they have benefited more from the rate declines.

It is significant to note that Newfoundland and Labrador's unfunded pension obligations of $3.4 billion carry an annual implicit interest cost in the order of $240 million. This clouds a fair comparison with some of the provinces which are fully funded or have minimal unfunded liabilities (e.g. Nova Scotia and New Brunswick).

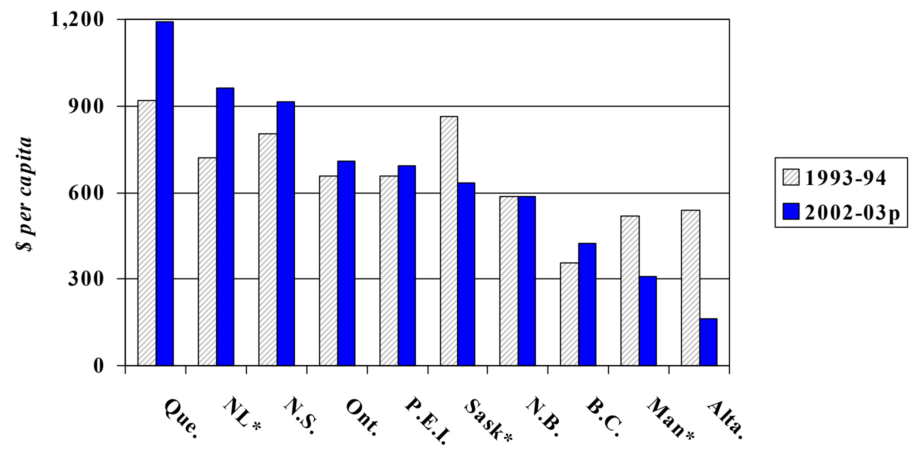
On a per capita basis, (exclusive of pension liability interest) Newfoundland and Labrador's interest costs are the second highest as illustrated in Chart 2-27.

Chart 2-27

Interest Cost – Per Capita

Provincial Comparison 1993-94 & 2002-03 Budget

(for years ended March 31)



***Excludes interest accrued on unfunded pension liabilities**

Source: Dominion Bond Rating Service, the Canadian Federal and Provincial Governments, dated November 2001, and Jan 2003 extracted from source and extrapolated as required by author.

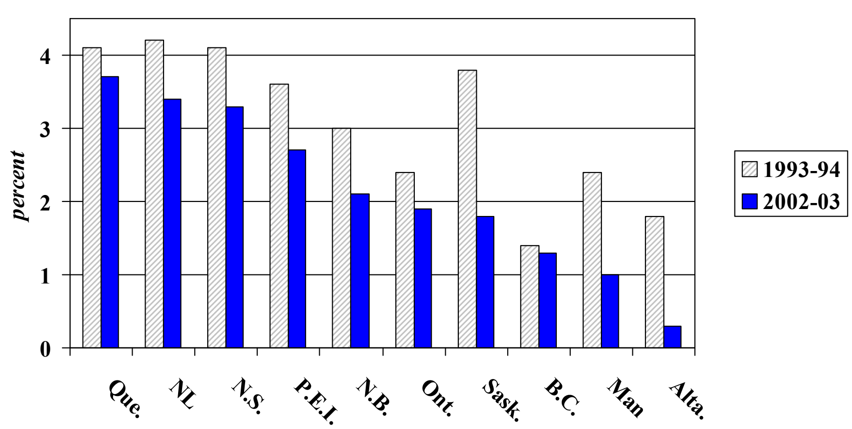
In the overall context of the economy, a comparison of the annual interest cost to GDP again shows Newfoundland and Labrador's relative interest burden is the second highest in Canada.

Chart 2-28

Interest Cost to GDP

Provincial Comparison 1993-94 versus 2002-03 Budget

(for years ended March 31)



Source: Dominion Bond Rating Service, the Canadian Federal and Provincial Governments, dated November 2001, and Jan 2003. Data extracted from source and extrapolated as required by author.

The foregoing analysis deals with the interest obligations of the province on the funded debt of government. As was noted in the earlier examination of the provincial debt profile, Newfoundland and Labrador's ranking on debt-related indicators, becomes much less favourable when the weight of the unfunded pension liabilities is taken into account.

ECONOMIC COMPARISONS

Has Newfoundland and Labrador "closed the gap" in its relative economic ranking with other provinces? Clearly, gains have been made in some areas in respect of growth from the base position but, other provinces have progressed as well. Accordingly, on a relative basis, a substantial degree of economic disparity remains and is quite evident in inter-provincial comparisons of key economic indicators. The following review assesses the trends over the last 20 years.

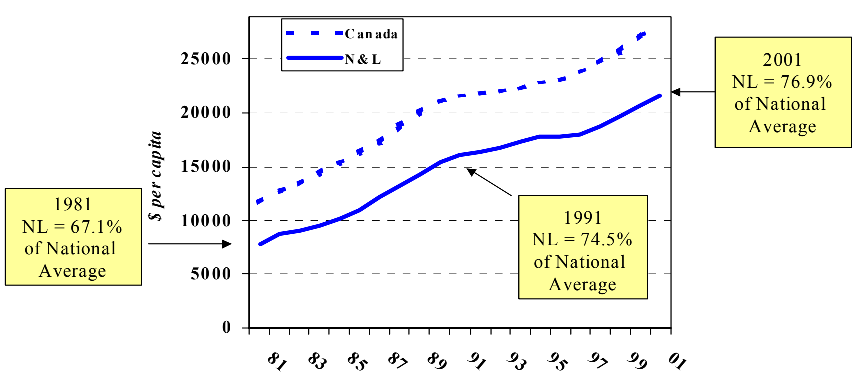
Personal Income

Newfoundland and Labrador still ranks last among the provinces in terms of per capita personal income with average per capita income of $21,588 in 2001 – 23.1 per cent, or approximately $6,500 below the national average.

Nonetheless some progress has been recorded in the last 20 years. In 1981, this province's per capita income was just 67.1 per cent of the national average. By 1991, it had climbed to 74.5 per cent. Accordingly, the personal income gap had been reduced by 7.4 per cent. There was additional progress in the next 10 years, but it was less pronounced with a further 2.4 per cent reduction in the province's income disparity relative to the national average:

Chart 2-29

Personal Income – Per Capita
NL vs. National Average 1981 - 2001

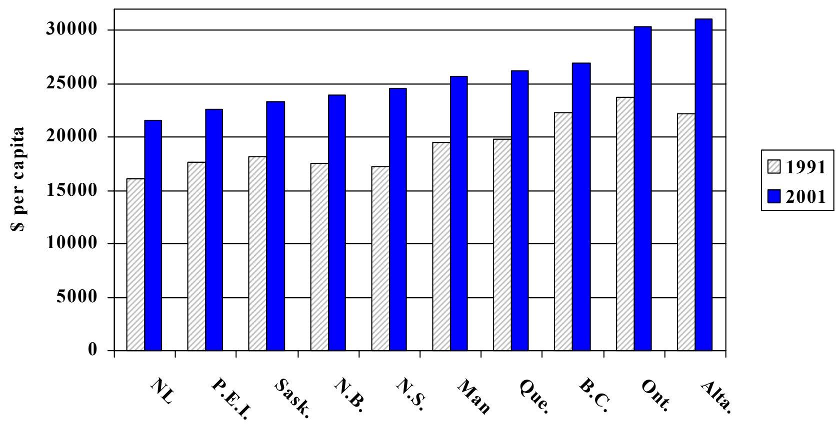


Source: Statistics Canada, Provincial Economic Accounts, Catalogue 13-213.

The rate of progress has varied relative to the income level of different provinces over the past 20 years, but this province's overall last place ranking has not changed:

Chart 2-30

Personal Income – per Capita
Provincial Comparison 1991 and 2001



Source: Statistics Canada, Provincial Economic Accounts, Catalogue 13-213.

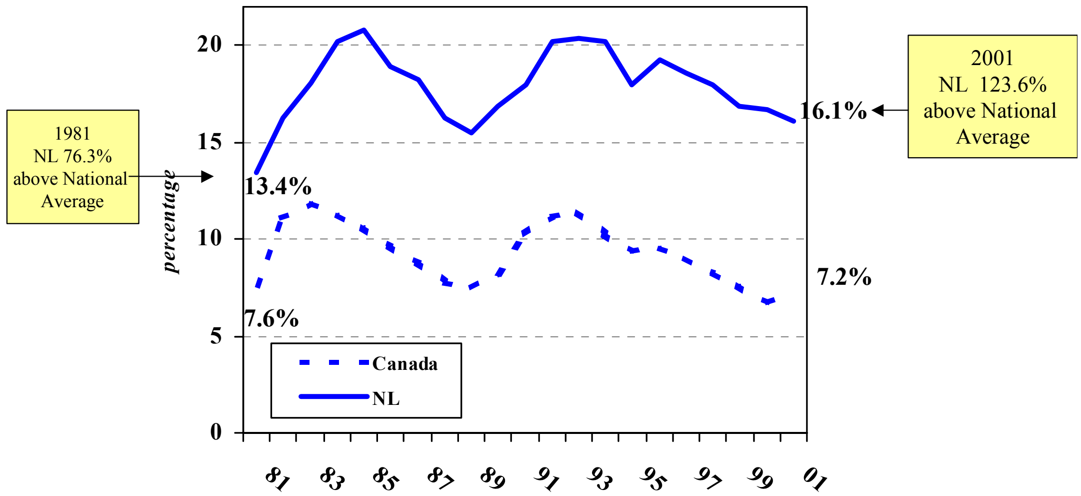
Unemployment

The unemployment rate in Newfoundland and Labrador remains the highest of any Canadian province. It averaged 16.1 per cent in 2001, substantially above the next highest province, Prince Edward Island at 11.9 per cent, and more than doubled the Canadian average of 7.2 per cent in that year. Furthermore, the relative disparity has not been reduced in the last 20 years as illustrated in Chart 2-31 below:

Chart 2-31

Unemployment Rate

NL vs. National Average 1981 -2001



Source: Statistics Canada, Provincial Economic Accounts, Catalogue 13-213

***Note**: In December 2002 the National rate was 7.5% and the NL rate was 18.5%*

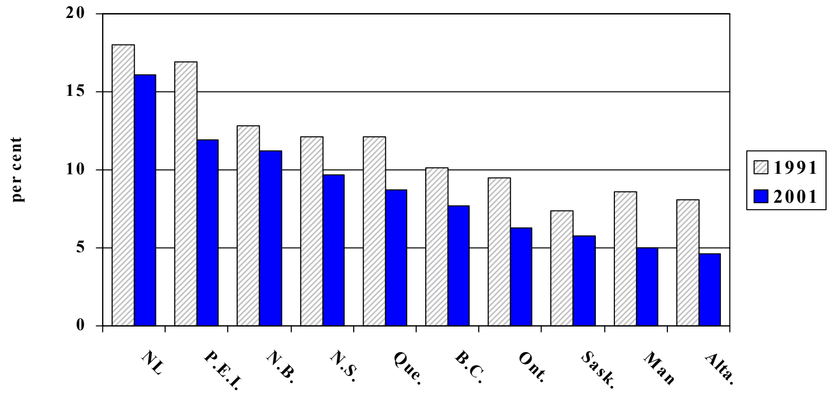
In 1981 and 1991 the spread between the unemployment rate in Newfoundland and Labrador and the national average was 76.3 per cent and 74.8 per cent, respectively – by 2001 the gap had increased to 123.6 per cent. (In 2002, the national rate averaged 7.7 per cent and this province's rate was 16.9 per cent.)

On the positive side, it is important to note that the actual number of people employed in the province has increased, notwithstanding the decline in population. In 1981, there were 186,000 people employed, while in 2001 the number employed had increased (13.4 per cent) to 211,000, despite the population decline. The increase in the employment rate is attributable to an increased participation rate which moved from 53.5 per cent in 1981 to 57.3 per cent in 2001. Even at this level, Newfoundland and Labrador remains the lowest in Canada and compares with the national average participation rate of 66.0 per cent. (Further gains were made in 2002 when the level of employment in Newfoundland and Labrador increased by 3,000 to 214,000. Employment gains were recorded across Canada with an overall increase of 560,000 jobs in 2002.)

A comparison with the trends in the unemployment rates in other provinces again highlights the extent of this province's last place ranking in employment:

Chart 2-32

Unemployment Rate
Provincial Comparison 1991-2001



Source: Statistics Canada, Provincial Economic Accounts, Catalogue 13-213.

As the above chart indicates, in recent years practically every province has made more progress than Newfoundland and Labrador in reducing unemployment rates from the recessionary highs of the early 1990s. The rates in Ontario, Quebec and Manitoba came down more than three percentage points in the last 10 years while the P.E.I. rate dropped five points. The rate in Newfoundland and Labrador dropped less than two percentage points.

GDP - Per Capita

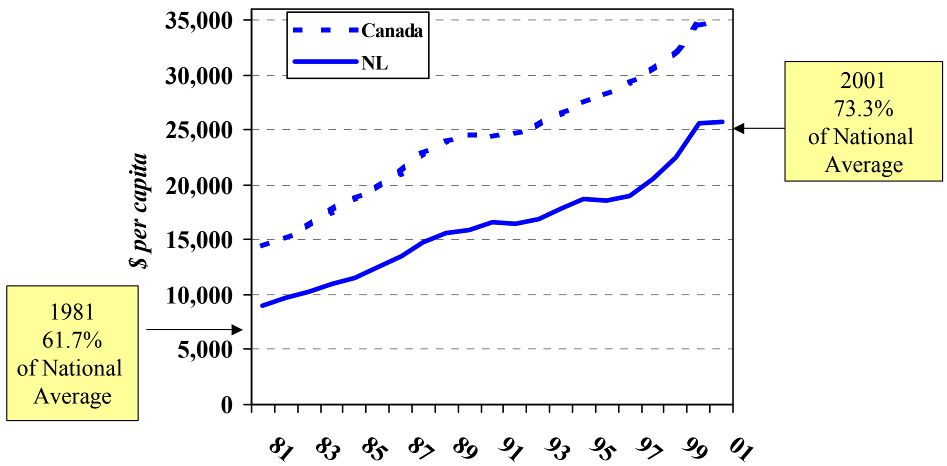
Over the 20-year period from 1981 to 2001, the accumulated growth in the province's Gross Domestic Product (GDP), at market prices, totaled 167 per cent – from $5.1 billion to $13.8 billion. In the same period, the growth in Canada's national GDP outpaced this province's performance with an accumulated growth of 203 per cent.

The trends in GDP per capita indicate that Newfoundland and Labrador has advanced from 61.7 per cent of the national average in 1981 to 73.3 per cent in 2001. Again, population trends are a factor in this indicator. The national population increased by 25.2 per cent (from 24.8 million to 31.1 million in the period), while this province's population declined by 7.7 per cent in the same period (from 575,000 to 534,000).

Chart 2-33

GDP – Per Capita

NL vs. National Average 1981 - 2001



Source: Statistics Canada, Provincial Economic Accounts, Catalogue 13-213

The GDP gap was reduced by 11.6 per cent from 1981 to 2001, with over half of the gain realized by 1991. While the gap was actually widening again in 1996, the commencement of oil production in late 1997 was largely instrumental in restoring the favorable trend.

Population Impact on GDP per Capita

The changes in population have had a material impact on the per capita GDP calculations for both the province and the national average as illustrated in the following table for the 10-year period 1991-2001:

Table 2-7

GDP at Market Prices and Per Capita
Newfoundland and Labrador vs. Canada

GDP at Market Prices:

	1991	2001	Increase
		($ Billion)	
Canada	685.4	1,092.2	59.4 per cent
Newfoundland and Labrador	9.6	13.8	43.5 per cent

GDP per Capita:

	1991	2001	Increase
Canada	24,450	35,141	43.7 per cent
Newfoundland and Labrador	16,529	25,770	55.9 per cent

Table 2-7 shows the impact of the national population changes which transforms the 10-year growth in the aggregate value of the national economy from 59.4 per cent overall to a per capita growth of 43.7 per cent.

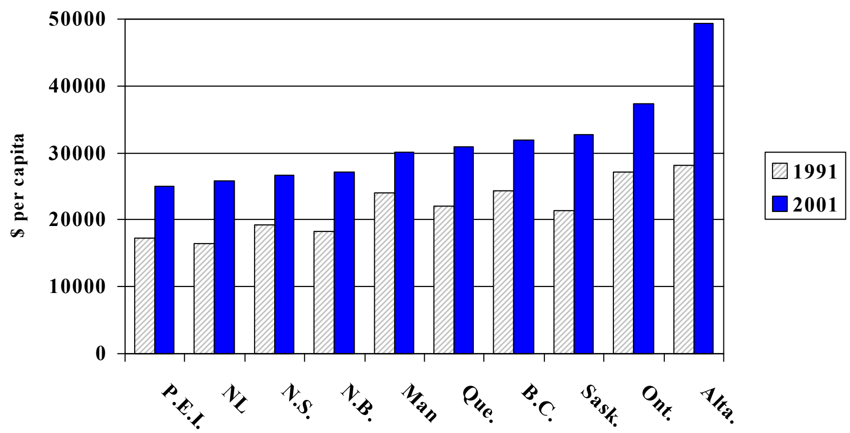
In the case of Newfoundland and Labrador, the population impact is almost reversed. While the aggregate value of the economy grew by 43.8 per cent, the reduced population base effectively increased the growth in per capita GDP to 55.9 per cent.

An inter-provincial comparison of GDP per capita indicates little change in the relative position of this province over the 20 years leading up to 2001. Newfoundland and Labrador remains in ninth position, marginally ahead of P.E.I.:

Chart 2-34

GDP – per Capita

Provincial Comparison 1991 & 2001



Source: Statistics Canada, Provincial Economic Accounts, Catalogue 13-213.

The strong GDP growth recently recorded by Newfoundland and Labrador may have produced an improvement in this province's ranking relative to the maritime provinces in 2002. (These statistics will be released later in 2003.)

GDP-Growth Trends

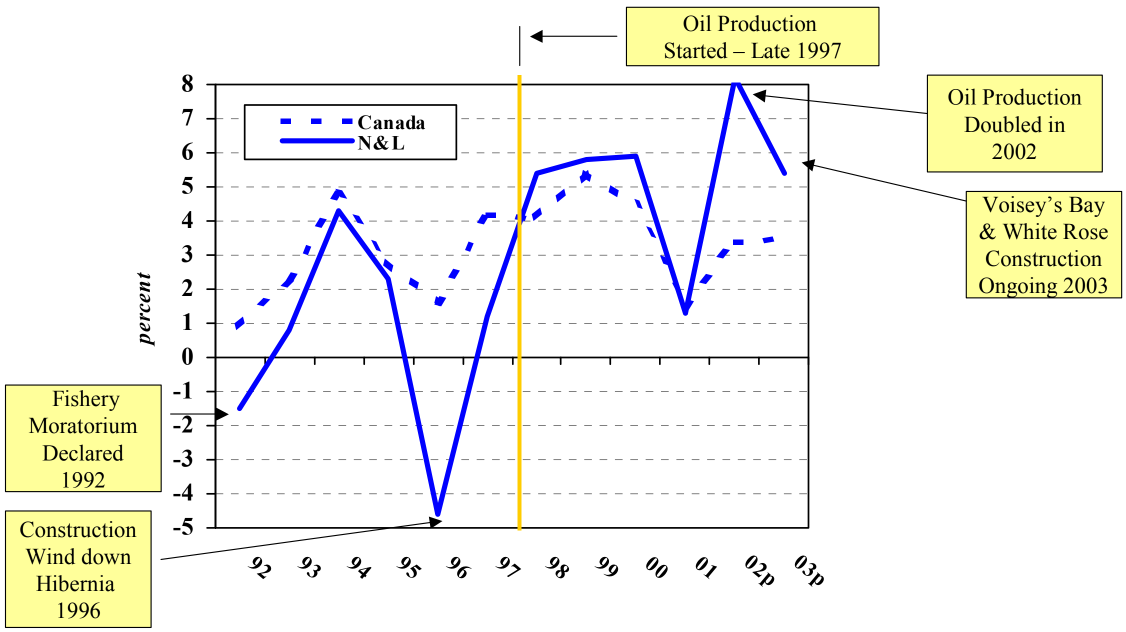
Various economic analyses have shown Newfoundland and Labrador leading the nation in "real" GDP growth in recent years. However, in assessing this province's economic performance, it is important to note: i) the relatively **low base** from which the growth is measured; ii) the high degree of **volatility** in recent years; and iii) the sizeable impact which the growth in **petroleum production** has had on these growth rates, and which is not necessarily representative of many aspects of the provincial economy.

A comparison of the yearly movements in real GDP highlights the volatility of the Newfoundland and Labrador economy relative to the Canadian economy:

<u>**Chart 2-35**</u>

Real GDP Growth – Volatility

NL vs . National GDP Growth – 1992 to 2003 projected



Source: Statistics Canada, and Departments of Finance, Government of Newfoundland and Labrador and Government of Canada.

In the six years prior to 1998, the first full year of oil production, GDP growth in this province was below the national average. The recent boost in GDP value from oil production has been the key factor leading the pace of economic growth since 1998. With oil production in 2002 approximately double the 2001 output, it clearly was the main force driving last year's GDP growth (which ultimately totaled 8.2 per cent in real terms).

The significant increase in the GDP performance in recent years often overshadows the relatively weak economic base the province is building upon and the disappointing performance of the early to mid-nineties as the province adjusted to the collapse of the groundfish fishery.

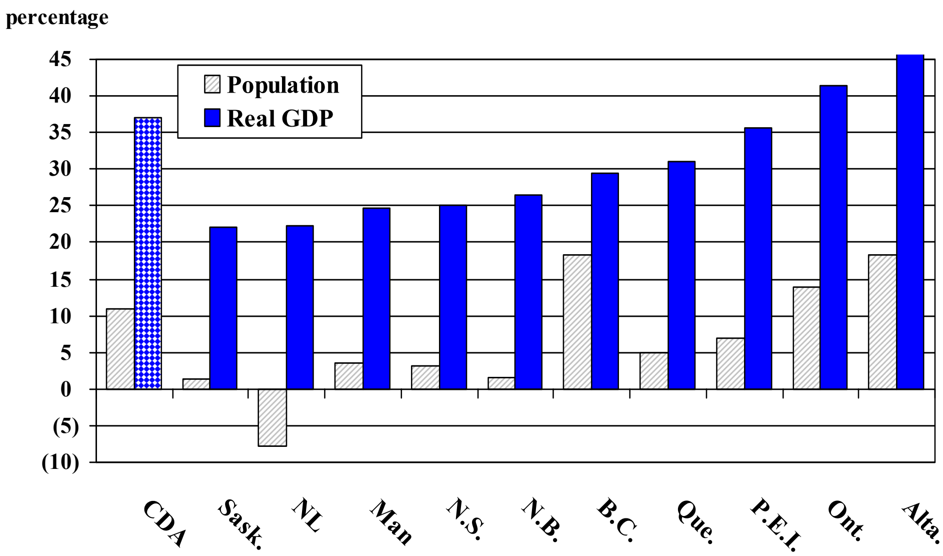
Over the 10-year period from 1991 to 2001, the national economy grew by 37.1 per cent in real terms. In the same period Newfoundland and Labrador significantly lagged the national growth with accumulated real GDP growth of only 22.3 per cent – 14.8 per cent below the national GDP growth.

A further examination of Newfoundland and Labrador's relative performance over the last 10 years indicates this province ranked second from the bottom of all the provinces in cumulative economic growth from 1991 to 2001 (Saskatchewan was marginally lower):

Chart 2-36

Population & Real GDP Growth

Comparison of Cumulative Growth 1991-2001 (1991 base)



Source: Statistics Canada, Government of Newfoundland and Labrador Department of Finance, Economics & Statistics Branch. Data extrapolated from source and extrapolated as required by author.

Chart 2-36 indicates, with the possible exception of British Columbia**,** the strongest rates of growth were generally recorded in the provinces with the strongest population growth**.** While Newfoundland and Labrador has recently recorded strong growth, it comes from a weak base and still has a long way to go. The economic growth challenge for this province is clearly compounded by the decline in population.

GDP Trends vs. Fiscal Trends

It is often assumed that strong economic growth as measured by GDP is synonymous with strong fiscal or budgetary performance. While this is true in some economies, it is not axiomatic. Favorable economic trends and industrial expansion can support improved fiscal results but the nature of the economic performance, the financial base and the fiscal framework are vitally important as well.

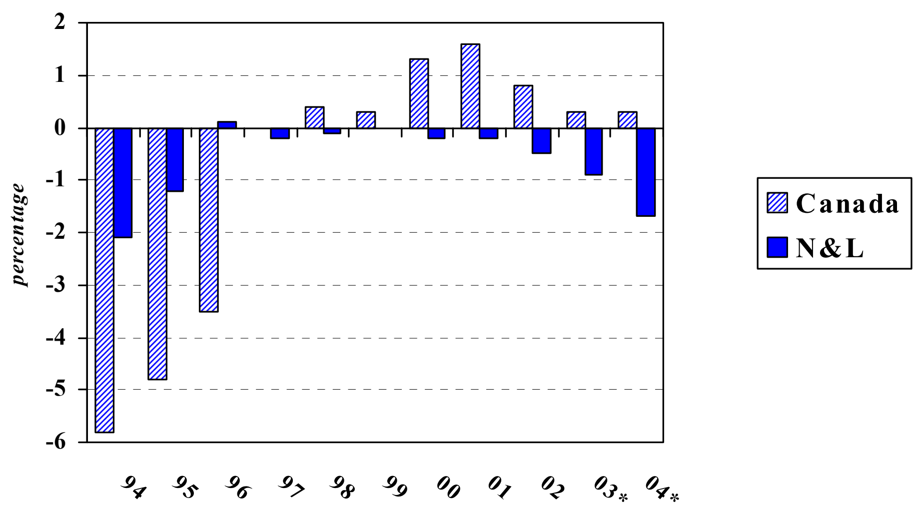
In recent years **Canada** has experienced favorable economic performance overall and is currently leading the G7 nations. The federal government has focused on a broad-based strategy to eliminate the deficit through expenditure restraint, revenue preservation, and the reduction of the debt. The huge federal deficits of the past have been eliminated. In 1993-94, the federal deficit totaled $42 billion, which amounted to 5.8 per cent of GDP. By 2000-01 the position had steadily improved to a surplus of $18.1 million, or 1.6 per cent of GDP. National economic and fiscal trends are both running on a generally favourable trend and the Government of Canada is continuing to record surpluses.

Newfoundland and Labrador started out on the same track as the Government of Canada in the early 1990s with a far reaching budgetary restraint program and, it made considerable fiscal progress through the early to mid-nineties.

Ironically, it had accomplished this when provincial GDP growth was consistently below the national average. Ironically as well, in the last three or four years as the relative GDP performance of the province has improved, budgetary deficit has been increasing. Chart 2-37 illustrates how the trend in the fiscal performance relative to GDP in Newfoundland and Labrador is moving in a different direction from that of the Government of Canada:

Chart 2-37

Trend in Surplus (Deficit) as a percentage of GDP
NL vs. Canada 193-94 to 2003-04



Source:TD Economics and Departments of Finance, Budget 2003 Newfoundland & Labrador and calculation by author.
Note: *NL in 2002-03 and 2003-04 reflects the "consolidated" cash deficit prior years are just the cash deficit.

A number of factors should be noted in relation to the provincial trend:

i) **Oil-driven GDP growth** does not produce a proportionate increase in overall net provincial revenues. The revenue impact is positive, but not to the extent that the GDP growth might imply.

ii) **Core revenue growth has been constrained** in recent years by the combination of reductions related to HST, PIT, out-migration and the population decline and federal restraint on transfer payments. In many respects it has taken strong growth in various provincial source revenues, driven by the recent pace of economic activity to lessen the impact of these factors.

iii) **Increased expenditure obligations** highlighted by the escalation of health care costs, increases in public sector compensation, new program spending initiatives and the ongoing weight of the significant and increasing debt burden.

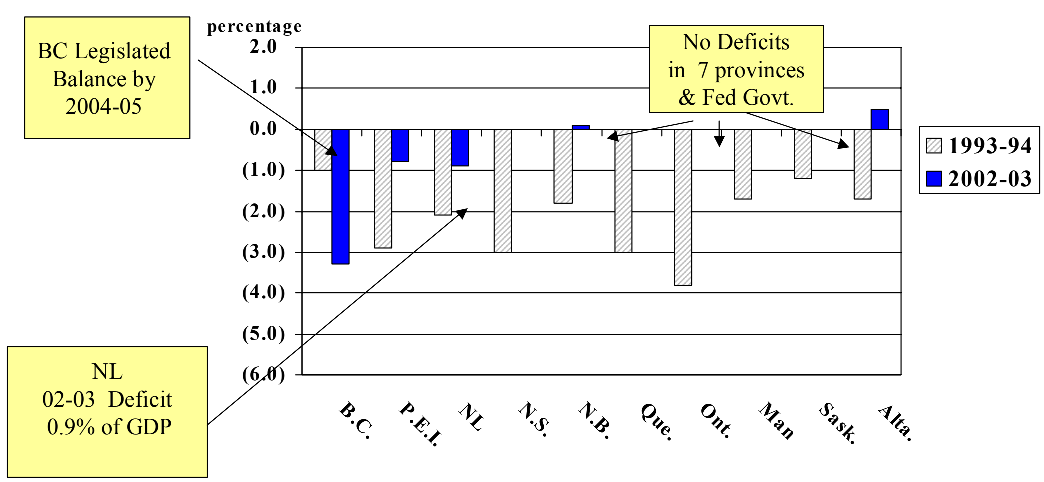
While real GDP growth in 2002 climbed to an impressive 8.2 per cent in Newfoundland and Labrador, the consolidated deficit increased to 0.9 per cent of GDP. In contrast Government of Canada recorded GDP growth of 3.3 per cent but had a fiscal surplus.

Deficits in the order of one per cent to three per cent of GDP were the norm in the early 1990s. Apart from Newfoundland and Labrador, only two provinces, B.C. and P.E.I., were budgeting for deficits in 2002 as illustrated in Chart 2-38. B.C., which budgeted for a $4.4 billion deficit in 2002-03, is now budgeting to cut its deficit to $2.3 billion in 2003-04 and is required by legislation to balance its budget in 2004-05.

In 2002-03 seven provinces budgeted for a fiscal balance (and a similar picture has subsequently unfolded for 2003-04).

<u>**Chart 2-38**</u>

Surplus (Deficit) as a percentage of GDP
Provincial Comparison 1993-94 to 2002-03



Source:TD Economics and Budget 2003, Newfoundland & Labrador and calculations by the author.

Three provinces (New Brunswick, Saskatchewan and Manitoba) budgeted to achieve fiscal balance by drawing on their Fiscal Stabilization Funds and at least one other (Quebec) has drawn down on various reserves to eliminate its deficit. This raises the specter of explicit or implicit underlying deficits in seven of the 10 provinces. Unfortunately, unlike some of the other provinces, Newfoundland and Labrador does not have any “rainy day” funds to draw upon and its one-time revenues have been depleted. After the delivery of the provincial budgets for 2003-04, the picture has not changed. (A comparative fiscal outlook reflecting the recent round of provincial budgets is provided in Chapter 3, Exhibit V.)

After 54 years of confederation, **Newfoundland and Labrador still has a long way to go** to catch up with most other provinces in Canada. Its budgetary deficit has increased in recent years while others are focused on fiscal balance. Its combined debt burden is the highest of all provinces and continues to escalate with no prospect of reduction. While others are cutting taxes, Newfoundland and Labrador’s tax effort ranks with the highest and it currently has little practical flexibility to reduce it. Despite favourable, oil-driven GDP performance in recent years, the economic disparity as measured by a number of key indicators remains -- underlined by its ongoing tenth place ranking in personal income and unemployment.

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Chapter 3

Financial Outlook for Newfoundland and Labrador

A perspective on the Fiscal Prospects
given the current policy environment

Now that our offshore oil industry is poised to generate significant revenues it is more important than ever for mechanisms to be put in place to ensure the Province will be the principal fiscal beneficiary of this industry over the longer term. This is the most practical way for the Province to get access to the financial resources necessary to grow and diversify our economy so we can close the disparity gaps that persist between us and the rest of the country.

Hon. Joan Marie Aylward
Minister of Finance and
President of Treasury Board
Budget Speech 2003
March 27, 2003

Financial Outlook - Perceptions

Newfoundland and Labrador is in the midst of a period of strong economic growth with significant petroleum production coming on stream in recent years and more to come in the near future. This recent progress combined with other major new developments just starting or on the horizon, Voisey's Bay and a potential Lower Churchill development, produce a sense of optimism in the financial outlook for the province. One of the most significant factors in this perception is the expectation that as petroleum production accelerates, the province will benefit significantly through increased revenues.

Context of Financial Outlook

It must be emphasized at the outset that the projections provided in this document are not to be regarded as definitive or predictive as to the actual financial results in any one year**.** Rather, the analysis is intended to show that the relationship of key issues and the potential trends which could emerge based on certain types of planning assumptions applied to various key variables. It is recognized that there can be a wide variation of opinion on the various assumptions and in many respects nobody knows the exact mixture of circumstances that will actually unfold.

Before reviewing the overall financial outlook for the province, it is pertinent to examine the potential impact of revenues from offshore oil.

ASSESSING THE POTENTIAL REVENUE IMPACT OF OFFSHORE OIL

The continuing development and expansion of the offshore petroleum sector is expected to be a very significant factor in provincial revenue growth in the near term. A broad range of possibilities could unfold depending on: i) the price of oil; ii) the pace of development of existing discoveries; iii) the mode of development; iv) the level of reserves and recovery rates; v) the nature and extent of new discoveries; and vi) in the longer term, the feasibility of gas production.

The basic fiscal outlook is predicated on the potential revenues from the three existing active projects (Hibernia, Terra Nova and White Rose) and revenue streams have been projected for the full life cycle of these projects to 2023.

Basic Assumptions

The provincial revenue streams include both royalties and corporate income tax from the companies involved in the oil production. The base case for the projection of potential revenues assumes:

i) an oil price of $28 U.S. in 2003 and an average of $24 U.S. throughout the subsequent years of the analysis;

ii) the continuation of the existing royalty regime;

iii) 25 per cent of the projected provincial corporate income tax (CIT) will be attributed to and retained by this province. (This is difficult to predict with accuracy due to the multi-jurisdictional nature of the activities of the large oil companies, the variation in the profitability of their activities and their diverse range of businesses.);

iv) revenue stream projections (which encompass royalties and CIT) are in constant dollars in accordance with base case data provided by the provincial Department of Finance.

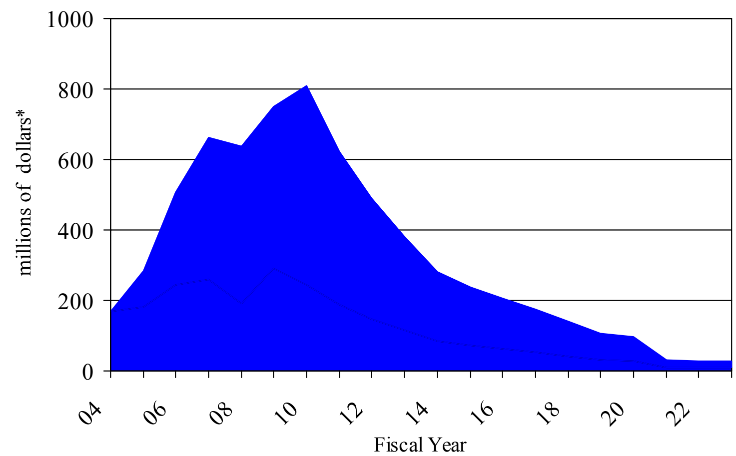
v) equalization offset payments under the Atlantic Accord and the application of the "generic solution" under the equalization formula are based on the assumed continuation of the existing policies. (The projected annual benefits to the province from these payments are also based on projections from the provincial Department of Finance. While equalization payments generally can be influenced by a number of external factors, it has been assumed that there will be no significant changes in the relationships amongst these external variables – an "other things being equal" assumption has been used to facilitate the analysis).

Potential Revenue Streams – Royalties and CIT

Against this background, the potential revenue streams from royalties and provincial corporate tax to Newfoundland and Labrador is as outlined below (before the equalization impact):

Chart 3-1. **Provincial Offshore Oil Revenues**

Provincial Royalties and Corporate Income Tax



Source: Projections based on the existing projects (Hibernia, Terra Nova and White Rose). Data extracted from projections provided by the provincial Department of Finance.
***Note:** Constant dollars adjusted for inflation.

Under these assumptions combined annual provincial royalty and tax revenues are projected to escalate rapidly in the coming years and peak in 2009-10 at over $800 million. It must be emphasized that these are "gross" revenues, before the decline in equalization is reflected. The most significant aspects of the projections are:

i) the rapid run up in revenues leading up to 2009-10;

ii) the relative short-lived period that annual revenues remain at the peak level;

iii) the rather dramatic decline in revenues which commences around 2011-12.

The significant bump in the revenue stream encompasses the peak revenue generating years for Hibernia, Terra Nova and White Rose. By 2011-12, it is projected that revenues from all three projects would be declining.

It can be argued that subsequent discoveries or major additional developments could dramatically change the shape of this profile. At this stage, however, presentations to the Royal Commission have not provided any basis to support a substantially different revenue profile. Current indications suggest that while subsequent oil developments and discoveries may occur in the future they will likely be significantly less lucrative than the aggregate of the three existing active projects. There is also considerable ongoing uncertainty as to the feasibility of offshore gas development and in any event, it would be well into the future. Accordingly, it is not factored into the revenue analysis. It is in this context that it is felt that an analysis of the three existing projects provides a reasonable basis for understanding the revenue implications of oil for the province in the foreseeable future. While ultimately the shape of the oil revenue bump could be less pointed at the peak, it is nonetheless expected that there will be a significant "revenue bump" and it will be of a relatively limited duration.

Oil Price Sensitivity

It is important to emphasize that the projected revenue streams are highly sensitive to assumptions – one of the most significant is the price of oil. The base case is predicated on a long-term average price of $24.00 U.S. ("constant") per barrel. (A price of $28.00 U.S. is assumed for 2003 only.)

The uncertainty of the outlook for oil prices is underlined by the volatility in recent weeks and months. In March of 2002, oil prices were in the order of $22.00 to $24.00 U.S. a barrel. By the end of 2002 they had run up to the area of $30.00. By the end of February of 2003, with the looming threat of war with Iraq, prices approached $40.00. Following the outbreak of war in March the price dropped below $26.00 U.S. While the current price is in the order of $30.00 U.S., many expect that it will return to the long-term base case assumption of $24.00 U.S. a barrel, or lower, by the end of 2003.

Gross provincial taxes and royalties are very sensitive to oil prices. Sensitivity analysis indicates that a $5.00 U.S. drop in the average price of oil could impact the gross provincial revenues by in the order of 40 per cent -- over $300 million in the peak year. From this province's perspective, this sensitivity is considerably reduced at present since the province's net share is substantially diminished by the equalization impact discussed below.

Net Revenue Growth – Net of the Equalization Impact

The straight application of the equalization formula, absent any offset provisions, would see Newfoundland and Labrador effectively lose one dollar in equalization payments for every one dollar it derived from its offshore oil and gas resources. It is understood that the Royal Commission initiated a separate equalization study so this analysis will not attempt to duplicate it. However, an attempt will be made to illustrate the workings of the formula in relation to these crucial revenues.

The Atlantic Accord signed by the Government of Canada and the Government of Newfoundland and Labrador in 1985, established the basis for joint management and revenue sharing in respect of the offshore oil and gas resources. One of the main purposes articulated in the Accord (stipulated in clause 2(c)) is:

> *to recognize the right of Newfoundland and Labrador to be the principal beneficiaries of the oil and gas off its shores, consistent with the requirement for a strong and united Canada;*

Accordingly, revenue offset provisions were incorporated in the Accord which were intended to protect the province against sharp downturns in equalization entitlements.

These revenue protections included in the Atlantic Accord were intended to provide protection from large equalization losses as a result of rapid economic growth. The formula is complex and it provides two tiers of protection. Its scope in relation to potential equalization declines is very broad and is not confined to revenue changes related to the offshore. Accordingly, it can in some circumstances provide substantial, short-term protection of the revenue base, particularly as revenues are rising rapidly – as they are expected to do in the next few years. It is significant, however, that:

i) under the formula the level of protection declines over time and with the increase in the fiscal capacity of the province. (The maximum protection was available in the first four years the formula was activated. That period has passed and the level of protection is now declining);

ii) the Atlantic Accord equalization protection is time limited -- it expires in 2011.

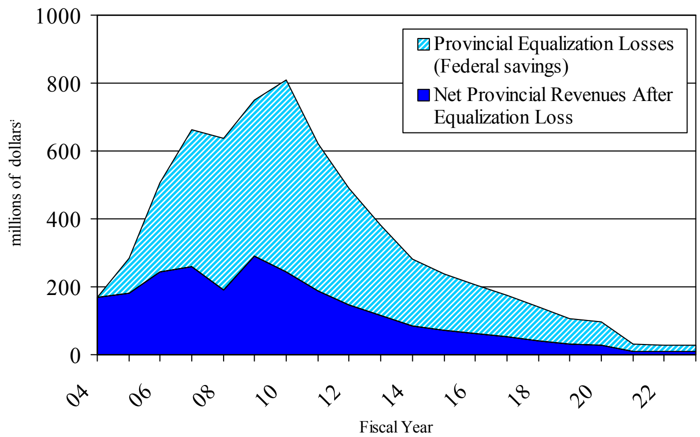
Alternative arrangements called the "generic solution" were also implemented by the Government of Canada to ensure that regardless of the technical workings of the other formulae, the effective loss of offshore revenues through the equalization decline would not exceed 70 per cent. This offset formula is less complex than the provisions in the Accord. The province must select which option it wishes to follow each year, prior to December 31st. The timing of this election is a matter of concern to the province since the potential revenue impact can vary quite substantially at different points during the year with the movement of key variables. Often there is insufficient hard financial data available to ensure the appropriate choice is being made in December.

In the base case analysis, the Atlantic Accord is assumed to be the most beneficial of the two formulae in the majority of the early years. By 2009-10, it appears the generic solution will be most beneficial. Beyond 2011-12 it is assumed that the generic solution (the 30 per cent protection) will continue to be available and therefore would be the operative, and only form of revenue protection.

The base case analysis indicates that while, in the aggregate, the net annual "provincial-type revenues" from offshore oil projects peak at some $810 million (with $24 U.S. oil prices), in that year, 2009-10, it is projected that Newfoundland and Labrador's share would be in the order of $240 million to $250 million. The actual timing of the peak and the net provincial share could vary with the application of the formula (the peak in provincial net share could be in the order of $250 million to $300 million and not correspond with the timing of the overall peak in revenues). Nevertheless, for the vast majority of the production cycle, the province's net revenue benefit would be substantially less than the peak level. The net benefit to the province is considerably diminished due to the significant equalization losses as illustrated in Chart 3-2 below:

Chart 3-2 **Provincial Offshore Oil Revenues**

Before and After Equalization Losses



Source: Projections based on the existing projects (Hibernia, Terra Nova and White Rose). Data extracted from projections provided by the provincial Department of Finance.

***Note:** Constant dollars adjusted for inflation.

In contrast, the net annual benefit to the federal treasury from the "provincial" oil revenue stream is estimated to peak at over $550 million in 2009-10 – through its equalization savings. **Over the life of these projects it is projected that the Government of Canada will realize a net financial benefit of some $4.2 billion (in 2002 dollars) through equalization savings compared to a net gain of $2.5 billion for the province. This is an overall split of 62.7 per cent federal and 37.3 per cent provincial**. (It must be emphasized that this is the net effective sharing of provincial royalties and taxes, it does not reflect the federal income tax benefit to the Government of Canada.)

It is important to note that the provincial share is relatively larger in the early years, when revenues are rising and the Atlantic Accord is operative. In fact, the province is expected to be the net beneficiary of virtually all the royalties and provincial corporate income tax available in the very short term as a result of the workings of the Accord. The relative and net sharing of revenues is projected to change significantly in subsequent years as an increasing proportion of oil revenues will effectively be offset through equalization declines. Commencing in 2009-10, and into the future, it is assumed the generic solution would apply with a 70 per cent federal and 30 per cent provincial split in the net "provincial type" revenues. (The Atlantic Accord formula will have phased down and expired in 2011).

The foregoing analysis illustrates a number of key issues:

i) the rapid escalation of provincial oil revenues, the steep decline in revenues following the peak years and the resulting unsustained nature of the revenue "bump";

ii) the short-lived nature of the equalization protection afforded by the Atlantic Accord;

iii) the generic solution will be the main source of oil revenue protection for much of the life of the current projects but it will only provide 30 per cent protection;

iv) *the net revenue "upside" to the province is severely limited by the existing sharing arrangements. In the absence of changes to the existing revenue sharing arrangements, Newfoundland and Labrador will clearly not be the "principal beneficiary" of the offshore oil revenues.*

OVERALL SHARING OF TOTAL GOVERNMENT REVENUES

While the foregoing analysis has only focused on provincial royalties and provincial corporate income tax, the total pool of government revenues from offshore oil resources also includes federal corporate income tax (CIT). The financial model for the $24.00 U.S. oil base case, projects potential federal CIT revenues of $8.0 billion over the life of the three projects. Given that with CIT revenues generally, both the flow and the rate of retention or capture by governments, are difficult to predict, a more conservative assumption of $4.0 billion in federal CIT is used for illustrative purposes (a 50 per cent capture rate). Also, it has been assumed that only 25 per cent of the provincial CIT would ultimately be attributed to and captured by Newfoundland and Labrador (other portions could well be reflected in other jurisdictions). On this basis the overall federal/provincial split in government revenues is summarized in Table 3-1:

Table 3-1

Overall Sharing of Total Government Revenues

Federal and Provincial Government Revenues from Offshore Oil

(billions of constant dollars)

	Newfoundland and Labrador	Canada	Total
Royalties	5.7	-	5.7
Provincial Corporate Income Tax	1.0	-	1.0
Federal Corporate Income Tax	-	4.0	4.0
	6.7	4.0	10.7
Equalization Impact	(4.2)	4.2	-
	2.5	8.2	10.7
Overall Revenue Split	**23.4 per cent**	**76.6 per cent**	100.0 per cent

In this base case analysis for the three projects, the combined government revenues would total $10.7 billion – the province would realize 23.4 per cent of the total and the net benefit to the Government of Canada would amount to $10.7 billion, or 76.6 per cent**.**

It is acknowledged that the Government of Canada provided vital financial support at the outset of the Hibernia project and there have been important economic benefits to Newfoundland and Labrador. It is clear, however, that the overall long-term outlook for revenue sharing indicates that the net revenue gains to the province as a result of offshore oil taxes and royalties will pale in significance to the financial benefits to the Government of Canada. **The revenue analysis concludes that the Government of Canada is the "principal beneficiary" of future offshore oil revenues.**

OVERALL FISCAL OUTLOOK FOR THE PROVINCE

The financial outlook of the province has been assessed in the context of: i) underlying deficit position in the order of $400 million (on a consolidated basis) as outlined in Chapter 1; ii) a continuation of a high level of resource development activity, including the development of White Rose and the Voisey's Bay project; iii) ongoing growth trends in major provincial source revenues (particularly sales tax PIT and CIT); iv) stable tax policy; v) a rapid escalation in provincial royalty and CIT revenues from offshore oil production; vi) the counter balancing impact of the existing equalization formula and related offset provisions; and vii) ongoing government expenditure patterns.

One of the objectives of this analysis is to gain some insight as to whether or not the provincial deficit challenge might be self-correcting in the near term.

Approach

One approach to assessing the outlook is to prepare a detailed multi-year forecast based on line-by-line assumptions on key variables. Clearly the array of components to be addressed on both the expenditure and revenue side could lead to significant differences of opinion on the appropriate assumptions to use (from the rate of growth in tax revenues, to the future rate of escalation in wages, health care and education costs, to mention just a few of the high profile variables). The budgetary sensitivity to many such assumptions is quite significant and it is obvious that even modest differences on a range of assumptions can produce significantly different forecast results.

In view of the wide-ranging sensitivities and given that government does not publish multi-year projections, it was decided to take an alternative approach. This approach examines the fiscal outlook based on the current budgetary direction and recent "macro" budgetary trends (as opposed to a line-by-line build-up of a budgetary forecast based on micro assumptions).

Assessment

In essence this approach is meant to address the question: "What is the overall fiscal outlook for the province given (i) recent budgetary trends; (ii) the current economic trends; (iii) the continuation of existing taxation policies, including the expected net impact of oil revenues; and (iv) the continuation of existing spending policies and patterns? The outlook therefore reflects the following:

(i) Recent budgetary trends

Recent budgetary trends show the province on a course of increasing deficits as outlined in Chapter 1, with the 2003-04 budgetary deficit double the prior year's level. On a "go forward" basis, this year's consolidated cash deficit of $287 million, is more in the order of $400 million when one-time revenues and prior year revenue adjustments are excluded. (The underlying accrual deficit is likely in excess of $700 million.) The total public sector debt has increased by an average of $350 million a year over the past four years with an increase of $450 million projected for 2003-04.

(ii) Economic trends

Overall economic trends as measured by GDP and other indicators reflect a very strong performance in recent years. This province has led the nation in economic growth in three of the last five years. Ongoing resource developments point to a continuation of strong economic growth. Ironically, in this period of particularly strong economic growth the fiscal deficit of the province has escalated substantially. Clearly, economic growth does not automatically produce budgetary strength – in fact, Newfoundland and Labrador's recent budgetary trends are in the opposite direction. Obviously, the expenditure and revenue policies of government play a pivotal role in determining the fiscal direction.

(iii) Revenue Trends

The 2003 budget indicates that annual provincial own-source revenues will see an increase in 2003-04 of over $625 million (40 per cent) when compared to 1994-95. It is significant that in that same period federal revenues were relatively flat, therefore, total overall budgetary revenues only increased by $660 million. Equalization of course is declining. Even including the offset payments under the Atlantic Accord, budgeted equalization revenues in 2003-04 are down almost $100 million from the level recorded in 2000-01. This is attributable to a number of factors some of which reflect the positive economic trends in the province. Nonetheless, it underlines the necessity to examine the overall revenue picture when analyzing revenue trends. It is also relevant to consider that the ongoing population decline continues to have a dampening impact on the revenue base.

While total revenues are budgeted to have increased by $660 million since 1994-95, annual expenditures during that same timeframe are budgeted to have increased by $745 million (exclusive of the borrowings for "other entities") and the deficit, measured on the traditional cash basis, increased by some $85 million, up two-thirds from the 1994-95 level. Accordingly while provincial revenue growth is vitally important, it must be assessed in the larger context of: a) the overall revenue growth, particularly as it relates to lackluster federal revenue growth trends; and b) ongoing provincial expenditure growth patterns. Notwithstanding the exceptional economic performance of recent years and significant growth in provincial source revenues, expenditures have outpaced the overall revenue growth and the deficit has increased.

The modest growth in overall revenues is highlighted in the 2003-04 budget for current account. Provincial current account and related revenues are up some $69 million while federal revenues are down $49 million. Therefore, current account revenues in this fiscal year are up only $20 million (0.5 per cent). Gross current account expenditures on the other hand are up $186 million (4.9 per cent). Together these trends have produced a budgetary deficit in excess of $100 million on current account (compared to a current account surplus of almost $65 million recorded in 2002-03).

Clearly oil revenues are becoming an increasingly important dimension of the provincial revenue profile. It is particularly significant to note that the revenue base for 2003-04 described above already includes over $150 million in oil related revenues. The full net benefit of these revenues is expected to flow directly to the province this year due to the various revenue protection mechanisms (short-term as they are) of the Atlantic Accord. In short, the province is already receiving a significant portion of the net revenues it can expect to realize from offshore oil on an annual basis. Therefore, based on the revenue analysis outlined earlier, the net oil revenue upside to the province in the coming years is likely in the order of $100 million to $150 million - important but a far cry from the projected growth in total offshore oil revenues.

Even with the increased oil revenues this year, and with the ongoing economic growth, total revenues are budgeted to be up only 1.8 per cent from 2002-03.

As a final point on revenue trends, it is anticipated that increased CHST funding will augment revenues in the coming years. However, this must be considered in the context of the continuing escalation in health care costs. While incremental funding in this area will be important to help offset mounting health care costs (and prevent the further escalation in budgetary pressures), it is not envisaged that there would be sufficient additional CHST funding to contribute to deficit reduction.

iv) Expenditure trends

Previously (in (iii) above) it was noted that gross expenditures will have increased by $745 million in the period from 1994-95 to the end of the current fiscal year, 2003-04. It is significant to note that the rate of escalation in expenditures has been most pronounced in the last four years. In the period from 1994-95 to 1999-2000, gross expenditures increased by $73 million, or approximately $15 million per year. More recently from 1999-2000 to 2003-04 total expenditures will have increased by $672 million - $168 million a year (an average of 4.4 per cent a year in a four-year timeframe when revenues are projected to have increased by an average of 3.2 per cent). Total expenditures in 2003-04 are budgeted to increase by 5.5 per cent - triple the 1.8 per cent rate of increase budgeted for total revenues. Expenditure growth in recent years has repeatedly outpaced revenue growth.

Conclusions

Assessing the prospects for the provincial budgetary position against this background yields the following conclusions:

i) The "go-forward" deficit should be evaluated from a base starting point of an underlying consolidated cash deficit in excess of $400 million.

ii) Strong industrial development activity will contribute to favourable revenue growth from various provincial sources. But, the overall revenue growth rate will likely be less impressive. This is evidenced by the experience of recent years when despite outstanding GDP growth, total revenue growth failed to keep abreast of expenditure growth. This was underlined in the 2003 budget which includes significant oil revenues but an overall revenue growth of only 1.8 per cent.

iii) There is an incremental upside in oil revenues (beyond the amounts already in the base) but, due to the workings of the Atlantic Accord and the generic solution, it is likely limited to the $100-150 million range in the peak years.

iv) Expenditure growth has outpaced revenue growth. Current spending patterns indicate a continuation of the average expenditure growth trend (4.4 per cent) of the last four years would add more than $180 million a year and in five years would yield an increase in the annual expenditure base of over $900 million (not compounded).

v) If the ongoing expenditure pattern continues, then coupled with the underlying $400 million deficit, the increased annual revenue requirement in five years would be $1.3 billion (not compounded). Accordingly, an average increase of $260 million a year in total revenues would be required to eliminate the deficit in five years (a steady revenue growth rate of 6.5 per cent compared to the average growth in the last four years of 3.5 per cent). There does not appear to be a current basis for such an optimistic revenue growth assumption. A revenue growth rate in the next five years of 3.5 per cent (almost double the 2003-04 growth) would generate an increase in the revenue base of $700 million by year five. If it were assumed that by that time, there might also be an additional $150 million in net oil revenues, the total annual revenue base would be up $850 million from the 2003-04 budgeted level. This would still yield a budgetary shortfall of some $450 million if the current spending patterns continue. (On a similar basis, an annual revenue growth assumption of 4.5 per cent plus the oil revenues would point to a future budgetary deficit in the order of $250 million).

The bottom line is that it is not reasonable to assume that the current budgetary deficit position will be self-correcting over the next five years, given current revenue trends and a continuation of Government's current spending practices. Even with an improvement in revenue growth trends, the analysis points to ongoing budgetary deficits in the order of $250 million to $500 million. This type of deficit trend is not sustainable. Such a trend, with a continuation of existing pension funding requirements would lead to annual increases in the total public sector debt in the order of $400 million to $650 million.

It must be emphasized this analysis is predicated on an assumed continuation of existing spending patterns and a judgment on reasonable revenue trends given recent experience. It is <u>not</u> meant to suggest that the deficit is entrenched and cannot be remedied. The deficit can be eliminated in a reasonable time frame. However, a "status quo" fiscal stance will not provide the solution – it requires a new policy direction. *The province's fiscal position requires firm commitment on the part of government with a clearly articulated broad-based strategy to restore budgetary balance.*

Fiscal Outlook in Perspective:

Newfoundland and Labrador – Ongoing Deficits

The fiscal outlook for Newfoundland and Labrador indicates that in the absence of major policy change, the budgetary deficit which increased substantially in 2003-04, is likely to range in the area of $250 million to $500 million (on a consolidated cash basis) in the coming years. If this were to be allowed to happen, the provincial public sector debt would continue to increase significantly to fund the successive budgetary deficits and pension obligations.

The oil revenues are expected to produce a significant, but relatively short-lived, "bump" in the annual provincial revenue stream, and these revenues could well be on the decline in less than 10 years. The significant benefit of offshore oil revenues will be considerably reduced in the coming years by the equalization impact and the absence of a reasonable and sustained offset arrangement, (despite the stated intent of the Atlantic Accord). The current provisions of the Atlantic Accord and the generic solution are not sufficient to ensure that Newfoundland and Labrador becomes the principal beneficiary of its offshore oil revenues.

It must be emphasized that these projections are based on the assumption "status quo" fiscal policy environment with no changes in tax policy and no new expenditure reduction initiatives or restraint programs**.** A firm response from government can improve this fiscal outlook.

Canada – Continuing Strong Performance

The financial outlook for Newfoundland and Labrador, as with its recent fiscal history, portrays a stark contrast with the financial outlook for the Government of Canada. On

October 30, 2002 the federal Minister of Finance in announcing very favorable fiscal results for the fiscal year ended March 31, 2002 stated:

> *We realized a surplus of $8.9 billion, every single penny of which went to reduce Canada's debt. This is our fifth consecutive budget surplus, the first time this has happened in my lifetime. Moreover, Canada is the only G-7 country expected to achieve a surplus this year.*[29]

The $8.9 billion was up significantly from the budgeted level of $1.5 billion. In that same statement the Minister explained that Canada has *"the most rapidly growing economy of the G-7 countries and that our debt to GDP ratio has declined from its peak of 71 per cent in 1995-96 to 49 per cent, the largest decline recorded by any G-7 country in the same period."*

On February 18, 2003, the federal Minister delivered the Government of Canada's sixth consecutive balanced budget and also committed to fiscal balance "next year and beyond". He reiterated the overall financial strategy as follows:

> *Keeping a balanced budget, cutting debt and getting the best value for money are a constant challenge and a constant imperative. These are the bedrock of our fiscal and economic strategy... Canadians remember well the sacrifices that were made to set our country on the right track in the mid-1990's. We will not turn back.* [30]

In the new federal budget, the Government of Canada confirmed the financial policy shift to "full accrual accounting". It indicated that on the full accrual basis, and before the measures introduced in the budget, it was projecting surpluses of $8.8 billion and $11.5 billion respectively for 2003-04 and 2004-05.

The budgetary measures, particularly the spending plans, brought the surpluses back to an even balance in both years. This balance is after the provision of a $3 billion contingency reserve each year plus an "additional degree of economic prudence" of $1 billion in 2003-04 and $2 billion in 2004-05. It might be argued, therefore, that the Government of Canada has an "underlying surplus" of $4 billion to $5 billion in its budget for the next two years.

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[29] Hon. John Manley, presentation to the House of Commons Standing Committee on Finance, October 30, 2002, p.12.

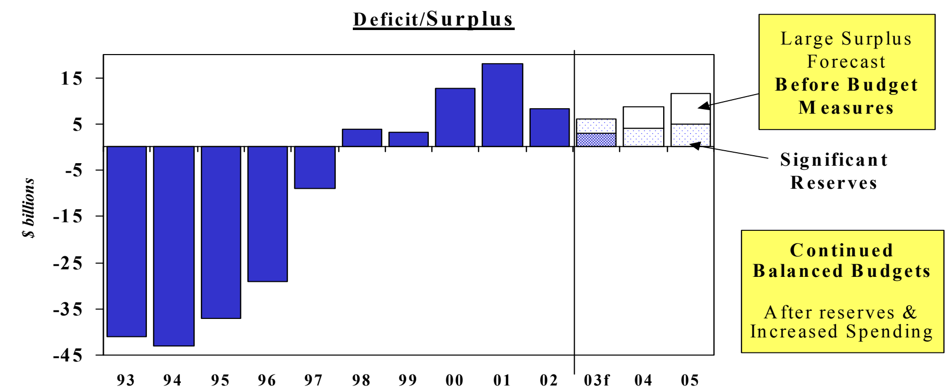
[30] Budget Speech 2003, Hon. John Manley, Minister of Finance, Government of Canada, February 18, 2003, p.5.

Chart 3-7

Government of Canada Surplus Outlook

Outlook in Context with Historical Performance

(for years ended March 31)



Source: Government of Canada Department of Finance; Public Accounts 1992-93 to 2000-01, and Budget 2003 dated February 18, 2003.

The budget indicated economic outlook for the nation for 2003 is for real growth of 3.3 per cent and 3.5 per cent growth in 2004.

The Government of Canada's approach to budgeting has been characterized as conservative by a number of private sector observers, because the actual results have consistently exceeded the budgetary targets. In early January 2003 for example, before the 2003 budget, the Conference Board of Canada indicated that the budgetary outlook for each of fiscal 2003 and 2004 would be some $8 billion more favourable each year than the Minister had indicated on his October statement. This was subsequently confirmed to be the case in the February budget.

Provincial Outlook – Most Targeting Fiscal Balance

It is important to recall the earlier section of this document that indicated seven provinces have balanced budget legislation in effect for 2003-04. The eighth province, British Columbia, has legislation which requires it to produce a balanced budget by 2004-05. It is also relevant to note that while seven provinces produced balanced or surplus budgets in 2002-03, four provinces did so by dipping into their "rainy day funds" or fiscal reserves which had been established from prior years' surpluses.

In addition to the varying economic circumstances within individual provinces, there are common factors which continue to influence the budgetary strategy of most provinces:

i) the rapid escalation of health care costs and the extent to which the Government of Canada will provide new funding support in response to the Romanow Commission;

ii) the ongoing desire in most provinces to cut key taxes (particularly PIT and CIT) to improve the competitive environment – in many cases this is a desire to proceed with previously announced tax cuts that were deferred last year due to budgetary pressures; and

iii) a focus on expenditure restraint to preserve fiscal balance and the avoidance of tax increases (except on tobacco, liquor and gasoline).

While there is limited multi-year forecast data available, the following overview by province provides a brief insight into the near-term fiscal outlook of the respective provinces:

EXHIBIT IV

PROVINCIAL BUDGETARY OUTLOOK – 2003-04

Alberta – Budgetary Surpluses: The 2002 budget targeted a surplus of $0.7 billion but at year-end the surplus had climbed to $1.8 billion (due to increased oil and gas revenues). The 2003 budget calls for a surplus of $1.1 billion for 2003-04 from operations and projects continuing surpluses in 2004-05 and 2005-06. Alberta is setting up a "Sustainability Fund" to smooth out volatile resource revenues.

Ontario – Budgetary Surplus: Ontario recorded a surplus of $0.5 billion in 2002-03 and has again budgeted for a surplus of $0.3 billion in 2003-04. It is projecting a balanced position for 2004-05 (after providing for a $1 billion contingency reserve each year). It is also proceeding with its planned series of cuts to personal and corporate income taxes.

New Brunswick – Balanced Budget: The New Brunswick budget for 2003-04 was released early in December of 2002. It reiterated the commitment to fiscal balance and at $7.5 million was the "fourth consecutive budgetary surplus". The budget was balanced by drawing down $104.2 million from the province's "Fiscal Stabilization Fund". The budget provided some reductions in CIT and PIT and increases in tobacco and fuel taxes.

Nova Scotia – Balanced Budget: Nova Scotia balanced its budget in 2002-03 for the first time in 40 years and budgeted for a balanced position in 2003-04. It is also proceeding with its commitment to cut personal income taxes by 10 per cent. (Despite the budgetary balance by its reporting format, its debt increased by $84 million in 2002-03 and is budgeted to rise $118 million in 2003-04.)

Quebec – Balanced Budget: Budgetary surpluses were recorded in 1998-1999 to 2000-2001. A balanced budget was achieved in 2001-02 and again in 2002-03, (with some movement of revenues from year to year). The Government of Quebec tabled its 2003 budget on March 11, 2003 and projected balanced budgets for the next two fiscal years. With strong revenue growth in 2003-04, it is setting up a reserve fund of some $800 million (otherwise it would be targeting a surplus of $800 million). It is then projecting that it will draw down some $500 million from the fund in fiscal 2004-05 to balance the budget in that year (planned revenue smoothing continues).

Manitoba – Balanced Budget: Manitoba publishes a Medium Term Fiscal Framework with its budget, which runs for an additional three years beyond the budget year. In accordance with its balanced budget legislation, the province is projecting surpluses of $10 million a year out to 2005/06. It is projecting drawing down on its "Fiscal Stabilization Fund" in 2003-04 and 2004-05 with amounts of $96 million and $53 million respectively, but projecting it will contribute $56 million to the fund in 2005-06 from its operating results.

Saskatchewan – Balanced Budget: The 2003 budget was its 10th consecutive balanced budget and it provided tax cuts for small business. The province did not draw on the Fiscal Stabilization Fund as it had planned in 2002-03, but projects it will have to draw $400 million and $100 million, respectively, to balance the books in the next two years. It also proceeded with further corporate and personal income tax cuts.

British Columbia – Reduced Deficit – Targeting Balance 04/05: British Columbia had the largest budgetary deficit by far in 2002-03 at $4.4 billion, but is now projecting the actual will come in at $3.8 billion. Government has committed itself by legislation to a balanced position by 2004-05. The new B.C. budget targets a reduction in the deficit to $2.3 million for 2003-04 including a contingency or forecast allowance of $500 million. BC has also reaffirmed its commitment to produce a balanced budget in 2004-05 and is proceeding with an aggressive cost cutting strategy to accomplish it.

P.E.I. – Ongoing Deficits Possible: P.E.I. recorded a deficit of $8 million in 2002-03 and has now budgeted for an $11 million deficit in 2003-04. The province has high tax rates, and ongoing pressure for tax reductions. While it is budgeting for a deficit, P.E.I.'s debt/GDP ratio remains the lowest among the Atlantic provinces and Quebec.

Newfoundland and Labrador – Significant Deficit Increase: The consolidated cash deficit is projected to increase to $287 million in 2003-04, up from $143 million in 2002-03. On an accrual basis of accounting, the 2003 budgetary deficit is $667 million. The province has targeted elimination of this cash-based deficit by 2007-08 based on assumed revenue growth.

GDP Growth and Budgetary Strength - - Not Synonymous

The foregoing overview of the near term fiscal prospects for the Government of Canada and the provinces indicates a continuing surplus position for the national budget and balanced budgets for 7 of the other 9 provinces. This is also consistent with the balanced budget legislation of these provinces. Most provinces and the Government of Canada have come a long way in deficit reduction and elimination since the early 1990's when deficits in the order of 2 to 3 per cent of GDP were not uncommon.

B.C. is targeting to reduce its huge deficit from the actual level of $3.8 billion in 2002-03 to $2.3 billion in 2003-04 and has a legislated requirement for fiscal balance by 2004-05. At least three provinces will balance their budgets this year by drawing down on their "Fiscal Stabilization Funds". In its 2003 budget P.E.I. adopted full accrual accounting and budgeted for a deficit of $11 million, or 0.3 per cent of GDP.

For Newfoundland and Labrador, in the absence of new major budgetary initiatives to address expenditure growth and/or measures to enhance revenues, the fiscal trends point to ongoing deficits and an escalation in its debt burden. The fiscal outlook for the province indicates that the problem is not self-correcting – even with its favourable industrial development environment.

The prospect of ongoing large deficits in Newfoundland and Labrador remains "inconsistent" with the trend in most provinces and the national government. It is also "out of sync" with the general perception which might be expected in relation to the province's strong economic performance as measured by GDP.

The unfortunate conclusion of this economic and budgetary analysis is that nation leading growth in GDP and budgetary strength are not synonymous. Newfoundland and Labrador's GDP growth is inflated by oil production which does not produce corresponding net revenue growth and fiscal strength. Having recorded outstanding GDP growth over the past five years, this province confronts the prospect of ongoing deficits at a time when most provinces and the country as a whole are reporting balanced budgets or surpluses. The situation requires a focused, clearly articulated fiscal response strategy by the Government of Newfoundland and Labrador to restore and sustain budgetary balance.

Chapter 4

FINANCIAL ISSUES AND OPTIONS

The Financial Challenges confronting the province in the near-term and the types of options available to address them

We've been paying for the groceries by taking out a second, third and fourth mortgage on the house – a house in desperate need of repair. ...more of the same will result in one of two things. The house will either collapse around us or eventually be seized by the banks. In either case, the kids move out.

Hon. Neil J. LeBlanc,
Minister of Finance, Nova Scotia
Budget Speech, April 4, 2002

"...governments at all levels must constantly re-invent themselves"

Hon. John Manley,
Minister of Finance, Canada,
The Economic and Fiscal Update, October 30, 2002

FISCAL CHALLENGES

The significant fiscal challenges confronting Newfoundland and Labrador are readily evident, and in fact, are recurring themes throughout the foregoing fiscal review and outlook:

- Significant budgetary deficit;
- Mounting debt burden;
- Heavy tax burden;
- Ongoing population decline;
- Limited access to offshore oil revenues; and
- Withdrawal of the Government of Canada from key cost-shared arrangements.

Significant Budgetary Deficit

Newfoundland and Labrador's budgetary deficit has increased to $287 million or 1.7 per cent of GDP in 2003-04 ($666 million or four per cent of GDP on an accrual basis) at a time when the Government of Canada and most provinces have reported fiscal balance. The core of the deficit is rooted in constrained growth in revenues and ongoing expenditure pressures in the last several years.

Revenue growth has been slowed by: (i) a decline in population which is estimated to have removed in excess of $200 million from the annual revenue base in federal transfer and provincial own-source revenues; (ii) the move to HST in concert with the Government of Canada and certain other provinces, combined with a partial implementation of planned PIT reductions which dampened the annual revenue base by an estimated $150 million to $200 million; (iii) federal restraint on social transfer payments, particularly CHST grants, to the extent that transfers in 2003-04 are substantially below the 1994-95 level.

In the aggregate, these issues alone have impaired core revenue growth to the extent of some $400 million to $500 million**.** "One-time" revenues have partially offset or delayed the impact of these revenue constraints on the net budgetary position, but, these revenues will be virtually exhausted by the end of 2003-04.

Expenditure growth in Newfoundland and Labrador, like all provinces, has been dominated by pressures in health care in recent years. In this sector expenditures were up over 54 per cent in the 10-year period from 1992-93 to 2002-03. While this rate of growth is in line with the national trend, it is more than triple the growth of government's overall program spending in the same period. Health expenditures in total were up over $350 million in the five years ended March 31, 2003. In addition, in the last two years significant compensation agreements with the provincial public sector employees have added in excess of $350 million to the annual expenditure budget. While it is recognized that there is an overlap in these expenditure components, on a combined basis they likely constitute incremental expenditure pressures of some $500 million beyond the base level five years ago.

Debt service costs constitute a significant ongoing obligation and a huge constraint on fiscal flexibility. Despite significant reductions in interest rates in recent years, debt service costs total in the order of $590 million annually, or 14.6 per cent of total revenues.

The financial outlook indicates that with a “status quo” policy environment, the budgetary deficits on a “go-forward” basis could well be in the range of $250 million to $500 million. Unfortunately, the budgetary shortfall does not appear to be self-correcting, even with the increased revenues from the province’s non-renewable offshore oil resources.

Mounting Debt Burden

The provincial public sector debt totaled $7.9 billion at March 31, 2003, and is budgeted to increase by $450 million to more than $8.3 billion in the current fiscal year. This level of funded debt, combined with unfunded pension obligations in excess of $3.4 billion, yields a projected combined debt burden approaching $12 billion by March 31, 2004.

The comparative indicator of “taxpayer supported debt” per capita indicates that Newfoundland and Labrador is second highest among the provinces in funded debt. At a projected level of $13,000 per capita as of March 31, 2003, it is approximately 39 per cent above the all-province average. However, this province has by far the largest unfunded pension liability on a relative basis (about $6,500 per capita) which, combined with the funded debt obligations (taxpayer supported debt) yields the highest combined per capita debt burden of any province at $19,500 per capita.

The financial outlook indicates that, in the absence of a new fiscal policy response from government, the province’s direct debt load could continue to increase by $450 million or more a year in the coming years, with the ongoing requirements to fund deficits and retire pension obligations.

Heavy Tax Burden

Newfoundland and Labrador has the third highest combined tax burden according to the comparative tax effort index of the Government of Canada – 13.8 per cent above the national average while the neighboring provinces of Nova Scotia and New Brunswick are just slightly above the national average at 0.2 per cent and 1.8 per cent, respectively. The tax burden also needs to be considered in the context of the unemployment rate, which is the highest in Canada, at double the national average, and the per capita income which is the lowest, at 23 per cent below the national average.

The challenge of the high tax burden is being exacerbated each year as successive budgets in other provinces reduce key provincial taxes – particularly personal income tax and corporate income taxes. In line with a competitive trend across the country, Nova Scotia and New Brunswick both provided tax reduction measures in their recent budgets. Newfoundland and Labrador did not, and in fact, previously announced personal income tax reduction measures remain deferred. With the ongoing trend, this province's already troublesome relative tax position could continue to become less competitive each year.

Ongoing Population Decline

The provincial population is now estimated to have declined by over 60,000 people, more than 10 per cent in the 10 years from 1992 to 2002 – A problem of a nature and magnitude encountered by no other province. (The national population is estimated to have increased by more than 10 per cent in the same period)

The impact goes beyond the decline in revenues previously estimated at over $200 million. It effectively means that the proportionate cost of providing public services and infrastructure has increased significantly. Costs of providing government services don't go down proportionately when the population declines – 10 per cent of the roads don't close when 10 per cent of the people leave. Per capita costs rise. Further population declines are projected in the coming years.

Conversely other parts of the country have enjoyed population growth. They have benefited from revenue gains (direct and indirect) but have not necessarily had pro rata cost increases. The net result of these divergent population trends of course, is that per capita expenditures and indeed per capita debt have continued to become proportionately higher in Newfoundland and Labrador relative to other parts of the country. This challenge is made all the more troublesome by virtue of the dispersed, rural population base which is more costly to serve in many respects than urban centers.

Limited access to offshore oil revenues

Gross revenues from the important offshore oil projects are already increasing substantially and could run up from the 2003 budgeted level of more than $150 million to over $800 million by 2009-10. However, current projections indicate that these resources will produce a relatively short-lived "revenue bump" which will begin to decline steeply by 2011-12.

It is acknowledged that offset payments (under the Atlantic Accord) could provide the province with a favourable percentage of the total revenues in the early years. But, these are the years of relatively low overall revenues due to the project investment recovery nature of the government royalty and regimes. By the time the combined current projects reach peak revenues in 2009-10, the province's net annual share will have declined to 30 per cent of provincial type revenues. (The Government of Canada will effectively realize a net gain equivalent to 70 per cent of the provincial type revenues plus its federal corporate income tax.) Accordingly, current trends indicate that the vast majority of the net benefits from provincial-type revenues are projected to flow to the Government of Canada through reduced equalization expenditures.

The bottom line of the multi-year future projections suggests that these non-renewable oil resources could well be depleted in the years ahead and not contribute to a material lasting improvement in the financial position or fiscal flexibility of the province.

It should be noted as well that under the formulae, the relative benefits of the Atlantic Accord are already declining and the revenue arrangements in the Accord will expire by 2011. The generic solution, which provides the 30 per cent protection, is part of the federal/provincial fiscal arrangements, which are subject to negotiation and renewal every five years – at this point even the existing formula is not guaranteed beyond the current term.

Withdrawal of the Government of Canada from Traditional Cost-Shared Programs

In addition to the challenge which federal spending restraint on social transfers has presented to the growth in core revenues, the failure to renew traditional regional economic development cost-sharing agreements has presented a further dimension to the range of fiscal challenges confronting the province.

For decades, the Government of Canada has joined with the Government of Newfoundland and Labrador in successive cost-shared agreements – most recently through the Canada –Newfoundland and Labrador Comprehensive Development Agreement (CEDA) and a range of initiatives undertaken in cooperation with ACOA. These have provided a vitally important boost to the rural economy. While important progress has been achieved, much remains to be done to strengthen and diversify the economic base. The Government of Canada's withdrawal from this area of funding is creating a major void in the support for investment in regional economic development – additional pressure on the province's fiscal position.

Addressing the Challenges

In many respects the overall weight of the challenges outlined above were reflected in the 2003 budget and some of the analysis which followed it. TD Economics offered some suggestions as to an approach it felt government might wish to consider:

> *…Down the road, the government might consider legislating firm multi-year deficit-reduction targets to ensure that it eliminates its deficit by fiscal 2007-08. Moreover, efforts to re-allocate government spending from areas of low priority would help to free up some much-needed fiscal room to address areas of high priority.* [31]

The BMO Financial Group also analyzed the significant financial challenges explained previously. It then concluded with a summary of its view of types of alternatives available to government:

> *Given its fiscal predicament, policymakers in the province may have to consider a number of difficult initiatives, including: some form of expenditure controls, negotiations with the federal government to amend the equalization formula to enable the province to keep a larger share of its oil revenues; and, potentially, re-negotiation of public sector pension agreements so as to reduce its pension liabilities.* [32]

It is perhaps not difficult to identify a consensus on the nature of the various fiscal and economic challenges confronting Newfoundland and Labrador. The overriding challenge of course is the need to develop a response to these issues which is both constructive and realistic and can accelerate the pace of the province's progress -- an approach which will narrow, and eventually close the gaps between Newfoundland and Labrador and most other provinces on so many economic and fiscal measures.

The requisite fiscal targets which emerge from the analysis are perhaps as obvious as the challenges. They are rooted in the need for focus on three fundamentals; the deficit, the debt and the tax burden. The ultimate difficulty centers around the nature of the options available to address the fiscal issue.

FISCAL TARGETS

Given the magnitude of the fiscal challenges confronting the province as previously outlined, regardless of the indicators and measures selected, there should be three fundamental nea- term fiscal targets – in fact they are fiscal imperatives:

(i) Balance the Budget.

(ii) Stop the escalation of debt.

(iii) Stop the deterioration in the relative tax position.

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[31] "The 2003 Newfoundland and Labrador Budget", T.D. Bank Financial Group, article by Derek Burleton and Mimi Curtis Irving, dated March 2003.

[32] Large Deficit in Newfoundland 2003 Budget", Bank of Montreal, "Commentary", article by Tim O'Neill, Chief Economist, Economics Department, March 31, 2003.

Reducing the debt burden, reducing the tax burden and improving the capital infrastructure and services available to the people are also important indisputable goals for Newfoundland and Labrador to advance from the "bottom of the ladder" of Canadian provinces. However, from a fiscal perspective, the first order of business must be to achieve fiscal balance – eliminate the deficit and stop the growth in debt and at least "hold" our own in relative tax standing.

The challenges are significant and likely beyond the potential of being practically overcome in a year or two. However, the initial focus period should be short enough to maintain government's commitment and accountability**.** The objective should be the restoration of fiscal balance and debt stability within the period of a normal government mandate – four years. This is consistent with the timeframe suggested in the 2003 budget. The ultimate objective should be to eliminate the full accrual deficit of $666 million.

The short-term targets must focus on the relative tax position and measures being taken by other provinces to enhance their relative tax positions – particularly in the areas of personal and corporate income tax. Government's fiscal targets need to ensure: (i) that there is no further deterioration in its relative tax standing; and (ii) in the longer-term begin to reduce the gap. Failure to address these objectives will potentially fuel the forces of out-migration and be a deterrent to the corporate investment so necessary for economic progress.

For the longer term, balancing the budget, capping the debt and "holding our own" on taxes is not enough. Such a strategy, while important would clearly not be considered "moving up from the bottom of the Canadian ladder". Government should then set its sights on preserving the budgetary balance, closing the tax gaps and reducing the overall debt position.

Financial Ratios

While the prime targets and the principle focus should be on: (i) deficit elimination; (ii) debt control; and (iii) preservation/enhancement of its relative tax position, government may wish to consider additional targets based on improving the province's relative fiscal position as measured by key indicators.

At the outset, it is noted that a range of targets based on a number of ratios could prove to be misleading or distracting from the required fiscal focus. For example, targets based on GDP can yield distorted results given the huge impacts of oil revenues. Similarly, targets based on per capita measures can lead to distortions based on divergent population trends.

The **"**debt to GDP ratio**"** is frequently used as a key reference point for evaluating overall fiscal and economic progress and it is one of the more commonly used reference points by the credit rating agencies. Yet a key element of the ratio, GDP, is outside government's direct control. Furthermore, GDP improvement does not automatically yield proportionate fiscal gains, particularly when the economic growth is attributable to oil revenues.

Newfoundland and Labrador's ratio (combined taxpayer supported debt plus unfunded liabilities) at March 31, 2003 was projected by DBRS to total 66.7 per cent, which is down from over 80 per cent in the last five years. But at this level this province remains more than double the all-provinces' average of 32.0 per cent (as estimated by DBRS).

It is good to see this province's ratio decline over the past five years. The improvement is driven primarily by the oil related GDP growth as in the same period the provincial public sector debt increased by $1.8 billion, a major ongoing fiscal challenge. In many respects GDP growth will continue to be driven by resource development – particularly oil production and oil prices. While volatility can be expected, there should be substantial growth in GDP in the coming years and this ratio could continue to improve.

In addressing the debt to GDP ratio government's fiscal focus should be on the debt component. Ongoing GDP growth coupled with a "hold the line" strategy on debt could produce a significant improvement in the debt to GDP in coming years. This could significantly reduce the gap in this province relative to the next highest provinces – Quebec is currently second at 58.4 per cent and Nova Scotia at 50.7 per cent by DBRS estimates.)

Newfoundland and Labrador could consider targets which would i) maintain the continuing decline in combined debt to GDP ratio and ii) reduce the gap of almost 35 per cent between this province's ratio at March 31, 2003 and the all-province average.

Other financial ratios used in establishing fiscal targets include; the "Deficit to GDP" (currently estimated at 1.7 per cent based on the consolidated cash deficit of 2003-04) and the "Deficit to total revenues" (currently estimated at 7.0 per cent based on the budgeted consolidated cash deficit of 2003-04). Again, the focus needs to be on the fiscal fundamentals – eliminate the deficit in four years and thereby bring both ratios to zero.

A BALANCED APPROACH – TWO DIMENSIONS

The fiscal targets appear distant from today's realities. The fiscal challenges are significant and they have evolved over a long period of time. They are rooted in issues within the province as well as in areas of national policy

The potential components of an approach to improve the financial prospects for Newfoundland and Labrador should include a combination of shared objectives and firm commitments by both the Government of Newfoundland and Labrador and the Government of Canada. Accordingly, the analysis points to two fundamental dimensions of lasting fiscal progress for Newfoundland and Labrador:

The Provincial Dimension:

i) **Fiscal Management Renewal** which incorporates uniform up-to-date and consistent budgeting and accounting methods, balanced budget legislation and rolling multi-year financial projections.

ii) **Fiscal Recovery Strategy** based on a firm commitment to balance the budget leading to a clear plan with new budgetary measures focused on the elimination of the deficit within the next four years.

The Federal Dimension:

i) **Renewed Oil Revenue Sharing and Fiscal Transfer Arrangements** to ensure that the province is the true "principal beneficiary" from its non-renewable offshore oil revenues (through amendments to the Atlantic Accord); to revert to the 10 province standard for calculating equalization and to provide reasonable accommodation within the equalization and CHST programs for significant population declines.

ii) **Revitalized Federal/Provincial Agreements** including ongoing infrastructure development and upgrading, as well as a renewal of financial support for regional economic development.

(The CHST arrangements were revised somewhat during the course of the preparation of this analysis. The details and impact of the new arrangements were unfolding as this report was being finalized; accordingly no assessment has been provided. Nonetheless it is clear that the arrangements should be modified to provide reasonable accommodation in the event of significant population declines.)

The combination of a focused provincial fiscal strategy, combined with revitalized resource revenue sharing, equalization and federal funding arrangements would enable Newfoundland and Labrador to achieve its fundamental fiscal targets in the coming years and begin to advance from its historically unfavourable ranking on so many economic and fiscal indicators.

THE PROVINCIAL DIMENSION

Fiscal Management Renewal

In recent years, the provincial government has been criticized by the Auditor General and others for its various reporting methods and the difficulties they present in terms of comprehensive disclosure, performance measurement and accountability. Furthermore the themes of accountability, transparency, fiscal balance and progress to the adoption of new accounting standards are all prevalent throughout most recent provincial budgets as well as the 2003 budget of the Government of Canada.

It is against this backgound that it is recommended the Government of Newfoundland and Labrador consider launching a full-scale fiscal management renewal strategy which would include:

i) *The transition to a single method of reporting* based on the accrual method of accounting as recommended by the Auditor General and the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants. It should discontinue the modified cash basis of budgetary reporting.

ii) *A commitment to balance the budget within four years* – a focused period to introduce the necessary policy changes to eradicate the underlying deficit.

iii) *The introduction of "balanced budget legislation*"**,** following an assessment of the practices and experience of the eight provinces that already have such legislation in place. The specifics of the legislation may not be as important as the establishment of the overriding principles to reinforce the commitment to fiscal responsibility.

iv) *The tabling of a rolling three or four year financial plan annually***,** which would clearly reflect the full and ongoing fiscal impact of multi-year trends and obligations such as phased tax changes, multi-year collective agreements, and place the short-term impact of one-time expenditures and revenues in the appropriate perspective.

v) *The expansion of the scope of budgetary reporting* (implicit in (i) above) to encompass the entire financial position of key agencies including the deficits, if any, of hospitals and school boards.

Such a revitalized approach to financial management would enhance accountability, bring clear focus and facilitate the ongoing evaluation of this province's progress relative to the other provinces. It should no longer be necessary to ask "What is the real financial position of the province?"

Elements of Fiscal Recovery

In many respects, the "fiscal management renewal" represents the easiest element of the equation. The identification of the appropriate collection of measures and policy initiatives to tackle the deficit i.e. the "fiscal recovery strategy" is clearly the most difficult.

Eliminating an underlying deficit of some $400 million (or more than $700 million on an accrual basis), presents an enormous challenge in the short-term. While there is important revenue momentum fuelled by offshore oil production which will narrow the deficit gap somewhat in the coming years, the net gain to contribute to deficit reduction will be significantly diminished by the equalization impact. Further important policy initiatives are required.

There is no obvious or easy combination of expenditure reductions which would yield annualized cost savings in the order of $300 million to $400 million per year**.** Neither is there a range of palatable taxation options to generate new revenues of that magnitude.

The magnitude of the budgetary challenge extends far beyond what some might consider the obvious first areas for attention: cuts in government travel, entertainment, advertising, consulting, reductions on overtime and reductions in grants to business and private agencies. These areas are undoubtedly being addressed on an ongoing basis and further cuts should form part of a comprehensive fiscal recovery strategy. However, even significant cuts in these areas only scratch the surface of the fiscal challenge.

In Newfoundland and Labrador, as in most Canadian provinces, some 60 per cent of program spending relates to the salaries and benefits of public employees in some form or another.

Furthermore, the "social sector" component of the budget, which encompasses Health and Community Services, education and youth services and public safety and security, accounts for 71 per cent of the entire budget. The "general government" and the "resource" sectors together account for just over 15 per cent with the balance allocated to debt costs. It follows, therefore, that a substantial expenditure reduction program would likely touch many of the most sensitive social program areas. In that regard it should be noted that the entire resource sector accounts for only 4.4 per cent of budgetary expenditures.

Expenditure Review

Over the years, Newfoundland and Labrador has had considerable experience in assessing the types of harsh measures required to eradicate a substantial deficit. In 1991, the array of measures instituted to address the unprecedented $347 million deficit included:

- Government-wide reductions in salary and operating budgets, wage freezes, deferrals of negotiated increases and reopening collective agreements to achieve savings;
- Layoffs of 1,300 permanent, 350 part-time and 350 seasonal employees (10 per cent reduction in management and executive positions);
- Rationalization of health care including the closure of 360 acute care hospital beds;
- Reduced funding for community colleges, institutions and institutional schools and frozen grants for school boards;

- Discontinuation of MCP coverage of various procedures and services;
- Freeze or reduction in funding of most government agencies as well as a reduction or elimination of a range of programs;
- Reduction in the numbers of police officers;
- Reduced funding for the MUN Faculty of Medicine;
- Reduced ferry services;
- Non-reinstatement of teaching positions eliminated by declining enrollment;

Following the implementation of these measures in the early nineties, Government proceeded with an ongoing process of program review and continuing restraint through to the mid to late-nineties.

The population decline has added a complex and troublesome facet to the fiscal challenge. As the Government of Newfoundland and Labrador assesses its place in Canada, it must address the fact that over 10 per cent of the population has moved elsewhere in the last 10 years. The province's revenue base and, to a degree, its economic base, have been impacted accordingly. Just as a business must downsize its operations if its resource is depleted or its customer-base declines, government must contemplate further downsizing its programs and overhead structure to correspond appropriately to its reduced population and sustainable revenue base – a grim reality, of a proportion that no other province has been compelled to confront. It is noted, however, that in the current budget for fiscal 2003-04, government's total expenditures are budgeted to increase by 5.5 per cent while its total revenues are budgeted to be up only 1.8 per cent. Clearly the expenditure growth pattern requires attention.

The expenditure sensitivities are obvious from a simple review of the province's annual estimates. However, it is not constructive to list an arbitrary range of expenditure reduction options in isolation of an indepth assessment of how program delivery might be modified to achieve the overall policy objectives, at less cost with least disruption.

An effective budgetary renewal strategy will require input from all departments and agencies encompassing a comprehensive analytical review; prioritizing programs and services; revised organization structures and program delivery methods to meet the service objectives more efficiently and at a lower cost. It should not be a "slash and burn strategy". Some of the important changes will require considerable thought, others may take two or three years to implement fully, and may require upfront one-time costs. Clearly, the strategy will need to be planned and communicated properly.

Particular focus should be centred on overhead reductions, areas where the cost of program delivery appears relatively high compared to other provinces and, of course, those areas which, following an up-to-date careful review in the current environment, are deemed to have declined in relative priority.

A common thread in many government restraint programs is the "signal from the top" -- a high profile reduction in government overhead, departmental reorganization, consolidation and a reduction in the size of Cabinet. In this regard it is noted that in recent years there has been considerable downsizing in the size of the cabinet (and departmental consolidation) in Saskatchewan, New Brunswick and Nova Scotia as they addressed their budgetary challenges.

The overriding objective of course is to secure fiscal progress in a manner which is not retrogressive to the province's place in Canada – a difficult tug-o-war.

The practical options to generate significant increases in provincial taxation are no more palatable than the major expenditure options.

Revenue Review

There are a number of taxation options theoretically available to government to address the fiscal shortfall. They are termed theoretical because given the ongoing serious concerns over the existing tax burden: (i) the wisdom of making such changes is questionable at best; and (ii) there is a diminishing return element that comes into play and the full mathematical calculation of a rate change is not always realized. In a practical sense, therefore, the scope for new revenue measures is far more limited than might first appear from a simple list of alternatives. As with the theoretical expenditure options the sensitivity to changes in the main tax sources is obvious from a simple examination of the annual revenue estimates which accompany the budget.

Such an examination clearly indicates that to get the largest revenue gains, the province would need to increase the sales tax and/or personal income tax. Such taxation measures, or any major thrust to increase revenues through higher levels of taxation might well be considered ill-advised at best, and counter productive at worst for a number of reasons:

(i) the province already has the third highest overall tax burden in the country, 13.8 per cent above the national average;

(ii) rather than reverse out-migration pressures, such measures would provide further disincentives to stay in the province or return (the higher level of taxation has been cited as one of the reasons for some people leaving);

(iii) there is ongoing intense competition amongst the provinces to reduce tax rates (except for tobacco, gasoline and liquor);

(iv) tax rates in Canada generally (and Newfoundland and Labrador is among the highest) are considered to be high in relation to the U.S.A.

(v) the heavy tax burden in Newfoundland and Labrador is considered to be a negative, and high risk factor by credit rating agencies and financial analysts.

(vi) increased tax rates would effectively take more money out of a relatively small, private sector, which is struggling to grow, to support public sector expenditures.

A major budgetary thrust to eliminate the deficit through a strategy focused primarily on tax increases would clearly be quite troublesome. It should be noted, however, that ongoing modest adjustments in the range of fees and consumption taxes can be justified to maintain the various elements of the revenue base and prevent erosion by inflation. Other provinces often proceed with a limited package of such adjustments, with the tobacco tax increases being the most popular in recent years. All of the foregoing points to a need for a fiscal strategy which encompasses significant measures exclusive of major provincial tax increases.

Approach to Fiscal Recovery

The ultimate challenge of a provincial budgetary renewal strategy is to develop a plan which advances the fiscal stability objectives but, avoids seriously disruptive retrenchment and retrogressive measures.

It is beyond the scope of this study to suggest a list of specific measures. However any approach to budgetary reassessment should include the following key elements:

i) *A comprehensive government-wide program review* (including government agencies) to evaluate the effectiveness of the various programs, to reassess relative priorities, and to reduce/eliminate programs of low priority;

ii) *A concentrated overhead reduction initiative aimed at reducing the overhead costs* of government in recognition of the population decline of over 10 per cent in the last decade (and which is ongoing);

iii) *A thorough assessment of those program areas where the cost of program delivery exceeds the national average* and where the differential continues to grow. While it is to be expected that some of the differential will be attributed to demographic factors, the analysis should examine the potential areas where the method of program delivery might be modified and the cost structure reduced;

iv) *Maximize the attrition opportunity*. It is understood that the age profile of the public service indicates that a significant number of public servants will be retiring in the next three to five years. This could present a crucial opportunity to implement the cost reductions in a way that is less harsh than would otherwise be the case;

v) *An assessment of the cost escalation associated with all the public sector pension plans***.** This would include a review of the benefit trends, the rate of escalation in the unfunded liability, and a reassessment of the province's funding strategy to determine if modifications are required;

vi) *Consideration should be given to regular increase in various fees and certain taxes to preserve the revenue base on a go-forward basis.* But, in so far as possible, increase in sales tax, personal tax and corporate income taxes should be avoided;

vii) *The potential merits of privatizing various functions* currently provided by government and its crown agencies should be examined. In this regard it may be instructive to explore the experience of other provinces and any successes that have been recorded to date in this generally sensitive area;

viii) *Leadership from the top* - a demonstration of commitment to the process through high profile expenditure reductions by the Premier and cabinet members.

The fiscal challenges confronting the province are not self-correcting and there are no easy or magic solutions. *Nevertheless, it is recommended that the provincial government firmly commit to the elimination of the deficit and develop a clear broad-based plan which reflects the input of all of its departments and agencies.*

The provincial government must seize the challenge of restoring budgetary balance. In many respects, however, this challenge will be a struggle to preserve the status quo in terms of program delivery and the economic well-being of the people of Newfoundland and Labrador. In order for the province to make meaningful progress in improving its relative position within Canada, and reduce long-standing fiscal and economic disparity gaps, action by the Government of Canada is required.

THE FEDERAL DIMENSION

The Equalization/Resource Revenue Challenge

It is understood that the Royal Commission has initiated a separate study on equalization. Accordingly, the following commentary does not attempt to analyse or address the basic principles nor the technical workings of the formula. It is intended as a general commentary on the net result of the existing equalization structure and some key recommendations that have been put forth for consideration.

In many respects, rightly or wrongly, the equalization formula is the “lightning rod” for fiscal frustration in Newfoundland and Labrador. The province has derived an enormous benefit from equalization over the years. Yet this province has one of the highest tax burdens in Canada. It is continuing to struggle to bring services and infrastructure up to the Canadian norm. It has a crippling debt burden. It continues to experience severe unemployment and income disparities. Yet, it is on the threshold of a steep decline in equalization entitlements.

The Standing Senate Committee on National Finance recently conducted a detailed review on "The Effectiveness of and Possible Improvements to the present Equalization Policy". In its report dated March 2002, it examined a number of options to change the formula including: i) the move to a less complex "macro formula" based on a single variable; ii) modifications to accommodate the different costs of program delivery in various provinces and iii) the removal of non-renewable natural resource revenues from the formula. The Committee rejected each of these options. It explained that in some cases there was profound disagreement among provinces and noted as well that some of the proposals considered could potentially give rise to new divisive inequities.

The Senate Committee did recommend one very important change in the formula -- *It recommended that the Government of Canada move from the present five-province standard to restore the 10-province standard in determining entitlements under the equalization program*. Such a change is considered to be more consistent with the overall objectives of enabling the provinces to provide comparable levels of services at reasonably comparable levels of taxation.

The Senate Committee also recommended that the "equalization floor" be retained to provide temporary protection to equalization recipient provinces against a potential significant downturn in equalization payments in any year relative to the levels paid in the prior year. This element of the program is particularly important to this province in providing incremental short-term protection against a dramatic decline in equalization payments as oil revenues escalate. *Both recommendations, the restoration of the 10-province standard and the floor preservation, are well founded and this report recommends they be adopted.*

There is an additional matter in relation to Newfoundland and Labrador, beyond the general application of the equalization floor as discussed by the Senate Committee. It relates to this province's significant population decline and the impact it has on both equalization and CHST entitlements. These entitlements are calculated on a per capita basis and therefore decline proportionately if the population declines. This can result in sudden changes in entitlements and retroactive recoveries of prior year "overpayments" based on revised population estimates. *It is recommended that the equalization program as well as the CHST be amended to provide reasonable accommodation to enable provinces to adjust to significant population declines.*

The Senate Committee struggled with the perplexing problems that the existing equalization formula presents in terms of negating the revenue gains from offshore oil production. It concluded that the issues must be addressed but that the focus should shift from the equalization formula per se. In his preface to the Committee's report, the Chairman of the Senate Committee stated:

> *We acknowledge the exasperating predicament of less wealthy provinces that have begun to reap the benefits from the development of offshore petroleum resources only to see their revenue gains lost by reductions in federal equalization payments. We believe this problem must be addressed within the Offshore Accord – with affected provinces, or through existing or new programs*

– not through changes to the Equalization formula, which would create a new set of problems.[33]

[33] "The Effectiveness of and Possible Improvements to the Present Equalization Policy", Report of the Standing Committee on National Defence, dated March 2002; Chairman's Preface, page 1.

The Committee's reluctance to pursue this issue in the context of the broader equalization formula is clearly understandable. This is particularly so, given the complexity of the equalization formula and the multiple consequences of attempting to revise it to address this issue. Nevertheless, the Senate Committee proceeded beyond the general formula discussion to make made two key recommendations on the issue.

> Recommendation #7.*"The government change the Generic Solution so as to increase the share of a province's entitlements that are protected when its non-renewable natural resource revenues increase."*

> Recommendation #8.*"The Government should undertake an evaluation of the equalization provision of the Atlantic accords to determine if they have met the intent for which they were designed."*[34]

While revising the overall equalization formula per se represents opening a fiscal Pandora's box, a revised Atlantic Accord offers the potential for a more focused, conceptually valid strategy. It would be working within principals that are already clearly established and understood.

The analysis outlined earlier in this report further underlines the need for the reassessment as recommended by the Senate Committee:

i) The Atlantic Accord provides significant payments to offset the impact of equalization declines in the early years of oil production, when oil revenues are relatively low and just beginning to escalate. The protection diminishes before peak revenues are reached;

ii) The Atlantic Accord formula is only of benefit when the overall resource revenue are rising. (It is of no benefit when revenues are level or declining);

iii) The period of maximum revenue percentage protection under the various phases of the Atlantic Accord formulae has passed and the relative levels of revenue protection afforded by the Accord will now begin to decline. This is occurring well before Newfoundland and Labrador has recorded meaningful fiscal progress and well before the peak annual revenues from the existing oil projects has been attained;

iv) The revenue protection arrangements afforded by the Atlantic Accord expire in 2011**;**

v) A sharp escalation in oil revenues is projected with a peak in 2009-10, but below the level that would eliminate the provincial entitlement to equalization. At peak production levels it is anticipated that the maximum net gain to the province would be 30 per cent of the net provincial type revenues under the generic solution;

[34] "The Effectiveness of and Possible Improvements to the Present Equalization Policy", Report of the Standing Committee on National Finance, dated March 2002,page 26.

vi) Oil revenues are not projected to be sustained at the peak level. They are projected to decline steeply following the attainment of the peak revenues. Subsequent developments could occur in future years but indications are that the subsequent revenue stream will fall well short of the peak levels expected by 2009-10. In essence the analysis suggests that, in the most likely case, there will be a significant but, relatively short-lived "revenue bump".

vii) Each year, by December 31, the province must select which revenue formula (the Atlantic Accord or the generic solution) to apply for that year. At that time of the year it does not generally have access to sufficient information to ensure it is making the appropriate selection;

viii) By 2007-08, or sooner, the generic solution which provides only 30 per cent net revenue protection is likely to be more beneficial to the province than the Atlantic Accord. Beyond 2010-11, the expiration of the Atlantic Accord formula, it would be the only from of revenue protection – assuming it is continued;

ix) The availability of the generic solution is not guaranteed beyond the regular five year renewal of the fiscal arrangements;

x) It is projected that this province's net overall revenue benefit from the existing projects will in the order of 37 per cent of provincial-type royalties and taxes. (The analysis reflects the benefit of the Atlantic Accord in the early years – then 30 per cent generic solution for the balance, i.e. the majority, of the production periods); and

xi) When federal corporate income tax is included in the total government revenue stream from the existing offshore oil projects, the federal government effectively will be the net beneficiary of 75 to 80 per cent of the government revenues and the province will only receive 20-25 per cent.

The analysis clearly indicates that with the current revenue sharing arrangements Newfoundland and Labrador is not the principal beneficiary of the revenues from the development of it offshore petroleum resources -- the Government of Canada is.

<u>Approach to the Federal Dimension:</u>

In many respects, the essence of an approach to the federal dimension of the key fiscal challenges confronting Newfoundland and Labrador, was effectively set out by the Senate Committee on National Finance.

The framework for an approach, including the key recommendations of the Senate Committee, as well as other issues arising from the analysis may be summarized as follows:

i) *The Equalization Formula should be revised to restore the 10-province standard for the determination of equalization entitlements. The equalization floor should be retained to protect against the potential significant decline in annual equalization payments in any one year. Both equalization and CHST should also be modified to incorporate reasonable accommodation for significant population declines;*

ii) *The Generic Solution* should be reassessed in the context of providing a greater percentage of protection of a province's entitlements when its non-renewable (oil) resource revenues increase. (*Given the challenges that such an approach might present within the complexities of the equalization formula, it may be most appropriate to achieve this objective through an amended Atlantic Accord*);

iii) *The Atlantic Accord* revenue offset formulas should be renegotiated by the federal and provincial governments to update them and to reflect adherence to the fundamental principle that Newfoundland and Labrador will be the "principal beneficiary" of its offshore petroleum resources. The time frames within the Accord should be extended to encompass, more appropriately, the pace of development and revenue generation pattern of the current developments – based on actual experience and updated projections. The arrangements within the revised Accord should not expire based on arbitrary dates. Rather the formula should be structured such that the Province continues to receive a proportionately higher share of provincial oil revenues as long as it remains below the Canadian average on key economic and fiscal measures;

iv) *Cost-shared Programs and Support for Infrastructure Development* should be revitalized. The restoration of federal support for regional development to previous levels is important if the province is to hold its own in supporting traditional rural economic development initiatives. Significant additional investment is required if Newfoundland and Labrador is to continue to bring its provincial infrastructure up to the standards enjoyed elsewhere in the country.

A LONG TERM INVESTMENT – DEBT REDUCTION CONCEPT

It is difficult to envisage the prospect of reducing the disproportionately high debt burden of the province at a time when it is continuing to rise and the deficit challenges remains to be resolved.

Offshore oil resources are part of the province's heritage but they are non-renewable resources. Once depleted, these resources will have been removed from the inventory of provincial assets available to benefit future generations. However, in time, with improved sharing arrangements, the dedication of oil revenues to debt reduction would be one way that the exploitation of these non-renewable resources could be invested for the lasting benefit of future generations.

This province's overall combined debt burden (tax payer supported debt and unfunded pension liabilities) at $19,500 per capita is 74.5 per cent above the all-province average per capita debt of $11,200. Yet the prospect of channeling oil revenues to provincial debt reduction does not appear to be a realistic option in the current fiscal environment with the existing revenue sharing framework. *However, in a revised policy framework, both orders of government should give serious consideration to -- a revenue sharing arrangement that would facilitate the investment of at least part of the proceeds from the non-renewable resource exploitation, to reduce the highest debt burden in the country for the long-term benefit of future generations.*

APPENDIX “A”

TERMS OF REFERENCE

INDEPENDENT ASSESSMENT AND ADVICE ON THE CURRENT STATE AND PROSPECTS FOR THE PROVINCE’S FISCAL POSITION

ROYAL COMMISSION ON RENEWING AND STRENGTHENING OUR PLACE IN CANADA
TERMS OF REFERENCE FOR EXTERNAL STUDY

Independent Assessment of and Advice on the Current State of and Prospects for the Province's Fiscal Position

General
The Royal Commission on Renewing and Strengthening our Place in Canada is initiating a number of research activities and projects as one of the means of obtaining input on matters relevant to its mandate. It is the intent of the Royal Commission that all research be conducted in the spirit of Royal Commission's own Terms of Reference, a copy of which is attached. Further guidance on how research is intended to help fulfill the Commission's mandate is summarized in the Commission's document "Research Principles and Policy."

Purpose
The purpose of this paper is to provide the Royal Commission with an assessment of the state and history of this Province's finances and the overall financial prospects for the Province together with advice on policy options for the province. The paper should strive to provide a balanced assessment that places the current financial position and outlook of the Province in perspective relative to the other provinces and the Government of Canada. Its main tasks are to identify the major financial challenges facing the province and to provide advice on the fiscal options available to the Province to address those challenges. The paper should cover the following main items:

A. OVERVIEW OF THE HISTORY AND CURRENT STATE OF PUBLIC FINANCE

A synopsis of the Historical Overview on Public Finance prepared for the Royal Commission by the provincial Department of Finance, together with an assessment of the Province's current financial position.

This section should cover such items as:

1. A review of the budgetary position and how it has evolved. Highlight key factors influencing the overall position including ongoing expenditure pressures, and changing revenue patterns (e.g., the revenue impact of out migration).

2. A review of the historical trend in the overall debt position of the province relative to other provinces; any issues with respect to currency exposure; key points to note in the recent credit rating assessments; and the extent to which unfunded liabilities are being addressed; (NB: the future debt position will be addressed in a subsequent section).

3. An examination of the various "non-core" budgetary issues that appear to have influenced the net financial position of the province in recent years, including such issues as; i) Term 29 Award; ii) Sales Tax/GST Transitional Assistance; iii) dividends from crown agencies; iv) recoveries of sinking fund surpluses; and v) Labrador Transportation Initiative. Also, an examination of any key areas of financial exposure not reflected in the budgetary position e.g. hospital deficits.

4. An assessment of the financial position of the Province, on a "go-forward" basis. In this regard the paper will quantify significant revenue and expenditure items of a non-recurring nature, as well as significant recent expenditure commitments (e.g. wage settlements) and revenue reductions that may not be fully reflected in historical data. A restated base case financial position will be provided to facilitate future analyses and comparisons.

5. A review of any inconsistencies between the basic "go-forward" financial position of Newfoundland and Labrador and the implicit or expected financial trends of the Province, given the ongoing growth in GDP and the reported budgetary position.

B. RELATIVE FISCAL POSITION

A comparison of the fiscal position of Newfoundland and Labrador relative to the other provinces and the Government of Canada.

This section should cover such items as:

6. A comparison of the overall surplus/deficit position of Newfoundland and Labrador with the other provinces and Canada - the current position as well as the trends in recent years.

7. Comparative levels of taxation and fiscal capacity.

8. Comparative levels of expenditure on various public services e.g. health care, and education.

9. Comparative levels of debt per capita, relative debt servicing costs and credit ratings.

10. Comparative economic indicators; per capita income, unemployment.

11. Comparative GDP per capita and GDP growth trends.

12. A comparison of the relative trends in the GDP position with the trends in the relative fiscal position.

13. An overall assessment of the relative pace of fiscal and economic progress in

Newfoundland and Labrador in recent years.

C. FINANCIAL OUTLOOK

An assessment of the financial outlook for Newfoundland and Labrador given its existing base position (as restated) and the existing fiscal framework.

This section should cover such items as:

14. A list of key mid-range, macro assumptions which form the basis of the projections - no tax increases, no service reductions or changes to fiscal arrangements, realistic population trends and most likely industrial development scenarios (White Rose, Voisey's Bay, Lower Churchill? Ben Nevis?).

15. An assessment of the financial prospects for Newfoundland and Labrador, including the projected order of magnitude of the surplus/deficit for the next several years. Highlight key changes, if any, in expected expenditure patterns as well as the projected impact of resource revenues.

16. The projected borrowing requirements and outlook for the trend in the overall debt position of the province.

17. A comparison of projections for Newfoundland and Labrador with those of the Government of Canada (and other provinces if available), to place this province's fiscal outlook in perspective.

18. An overall summary assessment of the fiscal outlook for Newfoundland and Labrador. An examination of the relationship (similarity or contrast) between the trend in the GDP position and the projected trend in the relative fiscal position.

D. FINANCIAL ISSUES AND OPTIONS

An assessment of the major financial challenges confronting Newfoundland and Labrador in the near term and the types of options available to address them.

This section should include:

19. The magnitude of the fiscal challenges confronting the province related to: slow revenue growth, ongoing expenditure pressures, deficit trends, mounting debt and out-migration.

20. Discussion of the types of fiscal targets that the province should consider (e.g., debt-to-revenue ratio, or budgetary deficit as a percentage of revenue or GDP) with rationales and a timeframe for achieving these targets.

21. The types of options; service reductions, user fees, and tax increases which could be considered in order to balance the budget and set the province on a course to fiscal progress.

22. A comparison of the trends and pace of fiscal progress in Newfoundland & Labrador in recent years with the trends and pace of progress in the financial position of the Government of Canada in recent years.

23. Discussion of options to modify the arrangements for federal-transfers to the provincial government (e.g., equalization, CHST).

24. Potential components of a "balanced approach" to securing the financial future of Newfoundland.

APPENDIX "B"

SUMMARY OF CURRENT AND RELATED REVENUES

1997-98 TO 2003-04 BUDGET

Appendix B.

Newfoundland & Labrador

Current and Related Revenues

1997-98 to 2003-04 Budget

($ millions)

	03-04B	02-03R	01-02R	00-01R	99-00R	98-99R	97-98R
PROVINCIAL:							
Taxation:							
Personal Income Tax	703.0	671.4	611.8	620.9	605.0	545.0	544.0
Sales Tax	597.2	594.0	535.1	489.1	467.2	457.0	445.0
Gasoline Tax	138.0	134.7	130.0	125.0	125.5	121.5	119.0
Payroll Tax	88.0	83.8	81.5	76.5	71.7	68.5	69.6
Tobacco Tax	90.5	79.5	65.5	65.5	65.1	64.0	67.0
Corporate Income Tax	123.4	109.2	54.7	74.8	83.4	82.7	78.1
Natural Resource Taxes & Royalties	153.2	87.5	47.5	60.8	36.0	29.8	26.4
Other	39.4	38.1	34.4	33.2	32.2	30.2	28.3
	1,932.8	1,798.2	1,560.5	1,545.8	1,486.1	1,398.7	1,377.4
General Revenues:							
Newfoundland Liquor Corporation	113.0	93.0	90.0	90.0	96.0	81.2	81.3
Lottery Revenues	108.0	106.0	102.0	95.3	99.3	87.0	78.0
Vehicle & Drivers Licences	55.0	56.3	54.5	53.0	52.0	49.5	50.5
Registry of Deeds Companies & Securities	18.0	18.1	14.9	14.0	12.3	11.9	11.5
Fines & Forfeitures	6.1	5.8	5.3	5.1	5.2	5.7	6.3
Labrador Transportation Initiative	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	27.0	41.1	49.4	33.3	27.0	24.7	30.9
	327.1	320.3	316.1	290.7	291.8	260.0	258.5
Expenditure Programs - Related Rev's							
Recoveries - Sinking Fund Surpluses	37.0	80.6	156.1	36.1	10.4	10.2	11.7
Interest Income	1.7	3.1	4.8	6.8	6.0	13.4	15.9
Other (including Hydro Dividends??)	118.2	145.3	195.9	138.5	145.0	91.0	91.2
	156.9	229.0	356.8	181.4	161.4	114.6	118.8
TOTAL: PROVINCIAL REV'S	**2,416.8**	2,347.5	2,233.4	2,017.9	1,939.3	1,773.3	1,754.7
GOVERNMENT OF CANADA:							
Fiscal Transfer Payments:							
Equalization Payments	1,028.9	1,131.9	1,162.4	1,153.2	1,070.9	1,165.3	995.7
Canada Health & Social Transfer (CHST)	397.7	339.7	331.0	338.7	290.2	275.2	280.0
Sales Tax Transitional Assistance	0.0	0.0	0.0	31.0	63.0	127.0	127.0
Term 29 Award	0.0	0.0	0.0	0.0	0.0	40.0	40.0
Canada Assistance Plan (CAP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PUITTA	0.0	0.0	0.0	0.0	0.0	0.0	(0.7)
Statutory Subsidies	1.7	1.7	1.8	1.8	1.8	1.8	1.8
	1,428.3	1,473.3	1,495.2	1,524.7	1,425.9	1,609.3	1,443.8
Cost Shared Programs:	**71.1**	75.3	81.1	67.5	65.5	60.9	53.9
TOTAL: GOVT OF CANADA REV'S:	**1,499.4**	1,548.6	1,576.3	1,592.2	1,491.4	1,670.2	1,497.7
TOTAL CURRENT & RELATED REV'S	**3,916.3**	3,896.1	3,809.7	3,610.1	3,430.7	3,443.5	3,252.4

Source: Province of Newfoundland and Labrador Annual Estimates 1997-98 to 2003-04 and Budget 2003-04.

(Based on the revised estimates contained in the respective budget documents for the following year, except 2003-04 which reflects the initial budget estimates.)

<u>APPENDIX “C”</u>

<u>UNFUNDED PENSION LIABILITIES</u>

<u>BACKGROUND INFORMATION</u>

Background on Pension Liabilities

The province currently has four defined benefit pension plans with 16,500 pensioners and over 32,000 active members. The plans relate to: public service employees, the teachers, the uniformed service employees and the M.H.A.s.

Prior to 1980 there was no pension fund. All pension contributions from teachers and employees were paid into the consolidated revenue fund as general revenue. Payments to pensioners were disbursed as an annual expense with no accounting for the significant and growing financial obligations associated with past and current service.

The province's "Pooled Pension Fund" was only established in 1980 and initially it was based solely on the contributions from employees and teachers through payroll deduction – an important first step, but far from the long-term solution to the issue.

In 1991 a government appointed Commission of Inquiry on Pensions recommended that significant and immediate steps be taken to address the situation. As a result, in recent years, Government has instituted a number of measures including: i) increased contribution rates for both employers and employees; ii) reduction/elimination of some of the more generous benefits; and iii) significant special contributions to the pension funds over and above regular budgetary allocations, aimed at improving the funding level of the plans.

As at March 31, 2002 the net unfunded liabilities of the respective plans were as follows:

Table C-1:

Unfunded Pension Liabilities
Government Pension Plans

($ millions)

Plan	**Net Unfunded Liability**	**% Unfunded**
Public Service Pension Plan	1,456	53.0%
Teachers Pension Plan	1,706	65.3%
Uniformed Services Pension	190	88.0%
M.H.A. Pension Plan	40	74.1%
	3,392	60.2%

Source: Public Accounts of the Province of Newfoundland and Labrador for the year ended March 31, 2002.

In the case of the **public service pension plan**, Government began making special contributions of $30 million in 1997-98, which have increased over the years to the level of $60 million committed for 2003-04. Government has committed to continue these special payments until the unfunded liability is extinguished.

The funding deficiency of the **teachers' pension plan** is more serious. As recently as 1998 it was projected that in the absence of significant action, the fund's assets would be depleted by 2003 or 2004. The matter was addressed in the collective agreement negotiated with the teachers in 1998-99 and Government committed to make special payments of up to $815 million plus interest over a 14 year period.

By the late 1990s the **uniformed services plan and the M.H.A.s plan** were depleted of funds. Commencing in 2001-02 government committed to make special payments of $20 million and $7.5 million respectively to the plans for five years.

The recent pattern of **special pension funding** arrangements may be summarized as follows:

Table C-2:

Special Payments to Pension Funds
Government's Pension Plans

	97-98	98-99	99-00	00-01	01-02	02-03	03-04P
Public Service Pension Plan	30	30	40	40	40	45	60
Teachers Pension Plan		166	166	76	76	76	76
Uniformed Services Pension Plan	-	-	-	-	20	20	20
MHA Pension Plan	-	-	-	-	8	8	8
	30	196	204	116	144	149	164

P = Projected

Source: Public Accounts of the Province of Newfoundland and the Auditor General's Report for the year ended March 31, 2002.

Accounting for Pension Obligations

Since 1997-98 Government has made **special contributions** totaling about $840 million to the pension funds. These contributions have been **"non-budgetary"** and are not reflected in the annual budgetary deficit. The full unfunded pension liability is clearly recorded as a separate component of government's "Total Liabilities" in the audited Consolidated Statement of Financial Position of the province. Since government is borrowing the funds to make these special payments, the net effect is to reduce the unfunded liability (or more correctly – to contain the growth in the unfunded liability) and increase government's "Borrowings". In effect, it moves debt from one category of liability to another on the province's balance sheet.

The interest on the unfunded liability highlights a budgetary accounting issue**.** The implicit annual interest on the unfunded liability was estimated at $242 million in 2001-02 and recorded as an expense in the public accounts. This implicit interest cost was partially offset by the amount by which government's pension contributions during the year exceeded the current service cost ($56 million). Accordingly, a net expense of $186 million overall is reflected in the Public Accounts. These amounts had not been reflected in the provincial budget prior to 2003-04. This is one of the largest areas of difference between the reporting method utilized in preparing the public accounts and that used in the budget over the years. For the first time ever, the 2003 budget included a reconciliation to the accrual method of accounting which incorporated the projected net pension cost accrual. It projected the net pension cost accrual adjustment, including projected interest on the unfunded liabilities, will total $302 million for 2003-04.

Overall, long-term pension liabilities reflect a number of factors including; the employee population base, the benefit structure, wage inflation, interest rate trends and financial market returns. Even with the significant special contributions in recent years, the net unfunded liability of the plans has not declined and, based on recent trends, it is likely that the unfunded obligations are continuing to grow.