Newfoundland and Labrador
2017 Budget

Economics and Strategy

April 6, 2017

Return to surplus in 2022-23 based on reduction of expenses

Highlights

- The deficit for 2016-17 is estimated at $1.08 billion (3.6% of GDP), $580 million less than in the Fall Update.
- The deficit for 2017-18 is budgeted at $778 million (2.6% of GDP), $302 million less than the estimate for 2016-17. The improvement is due mostly to a $283-million reduction of expenses. As a percentage of GDP this deficit is less than that recently budgeted by Alberta.
- No new taxes or fee increases in Budget 2017.
- Return to surplus is projected for 2022-23 on the basis of revenue growth averaging 2.4% annually from 2017-18 to 2022-23 and of an expense decline of 0.6% on average from 2018-19 to 2022-23. The fiscal framework also embeds an oil-revenue risk adjustment of $50 million in 2018-19, rising in each of the following years out to 2022-23.
- Beginning June 1, the Temporary Gas Tax will be cut by 8.5 cents a litre. On December 1 it will be cut a further 4 cents a litre for a total decrease of 12.5 cents, a 75% reduction.
- Real GDP, estimated to have contracted 0.6% in 2016, is assumed to contract 3.8% in 2017 and stay more or less flat out to the planning horizon. Nominal GDP, estimated to have edged down 0.4% in 2016, is expected to grow 1.8% in 2017 and 3.0% on average from 2018 to 2021.
- Employment, after a 1.5% drop in 2016, is assumed to decline 1.9% in 2017 and to continue declining each year out to 2021. Population is projected to decline 0.5% on average each year from 2017 to 2021.
- The budget assumes Brent oil at US$56 a barrel in 2017-18, climbing to $62 in 2018-19 and $69 in 2019-20, then rising a more moderate $2 in each of the following three years. The Canadian dollar is projected at 75 cents US in 2017-18, 76 cents in 2018-19 and 2019-20 and 78 cents in 2020-21, then edging up 1 cent in each of the next two years.
- The Infrastructure Plan amounts to $3 billion over the next five years, of which $573 million in 2017-18.
- Net debt is assumed to grow from 47.6% of GDP at the end of fiscal 2016-17 to 50.8% at the end of the current fiscal year.
- Borrowing, which amounted to $2.9 billion in 2016-17, is projected at only $400 million in 2017-18. The reduction is mostly due to a cash drawdown of $1.9 billion. Also, in Budget 2017 the provincial government is investing $485 million in the equity of Nalcor Energy, a reduction of more than $800 million from last year. These equity investments are financial assets that need to be funded.

Newfoundland and Labrador 2017 Budget

NATIONAL BANK OF CANADA FINANCIAL MARKETS

2016-17

A year ago the 2016-17 deficit was budgeted at $1.83 billion. In the Fall Update it was $1.584 billion. Today it is estimated at $1.080 billion (3.6% of GDP — a tad higher than Alberta). This is quite an improvement over both the 2016 budget and the Fall Update. As can be seen from the table on page 4, the $750-million improvement over last year's budget stemmed mostly from higher-than-budgeted revenue (+$544 million, of which $460 million from offshore royalties). The price of Brent crude, assumed at US$40 a barrel last year's budget, came in somewhat above $50. Program expenses were $211 million under budget, a decrease partly offset by a $130-million increase in debt servicing. The remaining factor in the reduction of the deficit from last year's budget is the oil-revenue risk adjustment, which was set at $125 million in last year's budget but does not appear in today's financial statements for 2016-17.

2017-18 deficit pegged at $778 million

The deficit for fiscal 2017-18 is budgeted at $778 million, or 2.6% of GDP. This ratio is lower than that projected by Alberta in its budget of a few weeks ago. If this projection materializes, the deficit for 2017-18 will be down $302 million from than the current estimate for 2016-17.

This budgeted fiscal performance does not rely at all on new taxes or increases in fees. Neither does it rely on improvement in offshore royalties, which are expected rather to decline $81 million from the estimate for 2016-17. This may seem surprising given the assumed increase in the price of Brent crude; it reflects an anticipated natural decrease in crude output. Also to be factored in is the sole budget measure affecting revenue. The Temporary Gas Tax of 16.5 cents per litre introduced last year will be cut by 8.5 cents a litre on June 1. Next December 1 it will be cut a further 4 cents a litre for a total decrease of 12.5 cents, a 75% reduction.

All in all, the budgeted improvement in total revenue is a mere $19 million (+0.3%) despite an expected $133-million gain in sales tax revenue (2017-18 being the first full year of the 2-percentage-point increase in the provincial sales tax) and an expected $115-million increase in revenue from corporate income tax (also increased last year).

The budgeted improvement in the deficit therefore comes mainly from $283 million in expense reduction, budgeted to be achieved by:

- Implementing a zero-based budgeting approach (budgeted saving: $65 million).
- Reviewing expenditures of agencies, boards and commissions (budgeted saving: $42 million).
- Eliminating duplication and streamlining management structures within departments, agencies, boards and commissions to make them more efficient and focused (saving: $31 million).
- Annualizing the effect of actions implemented in 2016-17 (saving: $68 million).
- Net saving of $77 million from actuarial calculations and other accrual adjustments.

Crude production expected to rise in late 2017

According to Statistics Canada, Newfoundland real GDP declined in 2014 and 2015. According to the economic projections published with Budget 2017, real GDP declined 0.7% in 2016 and will decline a further 3.8% in 2017. It then remains basically flat over the following four years. So over those four years, the economy will not recoup any of the ground lost in the last three years and this year. Employment also declined over the last three years and is expected to decline again this year and over the next four years. These declines are greater than the decline of the labour force, meaning that the unemployment rate, the highest in Canada in 2016 at 13.4%, will continue to rise in the foreseeable future. Household income is projected to decline this year and next.

Real GDP contraction will be exacerbated this year by an expected 9.1% decrease in capital investment as major projects move toward completion. Capital investment is forecast to decline another 20% next year and to continue declining out to the planning horizon. Furthermore, the government acknowledges that last year's increases in a number of taxes, projected to bring in $860 million of new revenue over a full year, are an additional drag on economic growth.

Under these conditions it may seem surprising that the fiscal framework projects a budgetary surplus by 2022-23 on the basis of a 2.4% average annual increase in government revenue from 2018-19 to 2022-23. This increase cannot come from higher household disposable income or retail sales. The explanation must be that oil royalties will be boosted by the startup of production of the Hebron site in late 2017. Add to that an assumed increase in the price of Brent crude, from a projected US$56 in 2017-18 to $62 in 2018-19 and $69 in 2019-20. Surely it is higher oil production and prices that are behind the assumption that nominal GDP will grow, unlike real GDP, and with it government revenue. The projected nominal GDP growth rates are 1.8% in 2017, 3.2% in 2018 and 4.5% in 2019. Oil royalties are projected to largely exceed $1.2 billion a year beginning in 2018-19, compared to the $882 million budgeted for 2017-18.

Newfoundland and Labrador 2017 Budget

Let's hope the forecasts for oil prices and production will materialize, given the sensitivity of royalties to their fluctuation (and of course the fact that the share of oil royalties in government revenue was still 13.1% in 2016-17). For instance, a US$1 drop in the price is assumed to reduce royalties by about $26 million. It must be said, however, that the fiscal framework has some padding against a shortfall of oil price gains, in the form of an oil-revenue risk adjustment amounting to $50 million in 2018-19 and rising in each of the four subsequent fiscal years.

Spending cuts out to the planning horizon

Fortunately the strategy for a return to balanced budgets is not based solely on recovery of oil prices and production, far from it. Total expenses are projected to grow 2.3% in 2018-19, but then to decline an average 0.6% annually over the following four years. This means of course that program spending will not track CPI growth, even after adjustment for an average 0.5% annual decrease in population out to the planning horizon.

Since expenses include debt servicing, an increase in debt or in interest rates could bring pressure to cut program expenses even further if the government wants nonetheless to maintain its fiscal target.

Infrastructure investment (federal and provincial) is another element of the government's strategy. Over this year and the next four, this is planned to amount to $3 billion, of which $573 million in 2017-18. According to the government, the infrastructure plan will deliver an average 4,900 full-time-equivalent jobs annually for the next five years.

Debt and borrowing

In Newfoundland as elsewhere, budget deficits combined with signifiant capital investment usually bring an increase in net debt. Net debt is assumed to grow $1 billion over the current fiscal year, from 47.6% of GDP at the end of fiscal 2016-17 to 50.8% at the end of 2017-18.

On the other hand, borrowing, which amounted to $2.9 billion in 2016-17, is budgeted at only $400 million in 2017-18. The reduction is due mostly to a $1.9 billion drawdown on cash this year. Also, in Budget 2017 the government is investing $485 million in the equity of Nalcor Energy, a reduction of more than $800 million from last year. These equity investments are financial assets that need to be funded.

Marc Pinsonneault

Newfoundland and Labrador
2017 Budget

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Newfoundland & Labrador

$000,000	Budget 2016/17	Forecast 2016/17	Budget 2017/18	Outlook 2018/19	2019/20	2020/21	2021/22	2022/23
Fiscal Revenue	6,368	6,872	6,898					
Provincial tax sources	4,205	4,680	4,806					
Personal Income Tax	1,524	1,603	1,626					
Sales Tax	1,171	1,105	1,238					
Corporate Income Tax	223	227	342					
Offshore Royalties	502	962	882					
Mining Tax and Royalties	53	57	37					
Other Taxes	*732*	*726*	*681*					
Other Provincial Sources	978	969	835					
Government of Canada	1,185	1,224	1,256					
Net Income of Government Business Enterprises	408	448	441					
Total Gross Revenue	**6,776**	**7,320**	**7,339**	**7,711**	**7,996**	**7,959**	**8,172**	**8,282**
Program Expenses	7,499	7,288	7,004					
Debt Servicing	982	1,112	1,112					
Total Gross Expenses	**8,481**	**8,400**	**8,116**	**8,305**	**8,258**	**8,188**	**8,124**	**8,118**
Consolidated surplus (deficit) before adjustment	**(1,705)**	**(1,080)**	**(778)**	**(594)**	**(262)**	**(229)**	**48**	**164**
Revenue risk adjustment	(125)	-	-	(50)	(80)	(95)	(120)	(140)
Adjusted surplus (deficit)	**(1,830)**	**(1,080)**	**(778)**	**(644)**	**(342)**	**(324)**	**(72)**	**24**
Surplus (deficit) - target	**(1,830)**	**(1,830)**	**(800)**	**(650)**	**(500)**	**(250)**	**-**	**100**
as a % of revenue	-27.0%	-14.8%	-10.6%	-8.4%	-4.3%	-4.1%	-0.9%	0.3%
Debt servicing as a % of revenue	14.5%	15.2%	15.2%					
Offshore Royalties as a % of revenue	7.4%	13.1%	12.0%					
Net Debt and Total Debt								
Net Debt, beginning of period	**12,633**	**12,654**	**14,251**					
+ Deficit (surplus)	1,830	1,080	778					
+ Acquisition of Tangible Capital Assets	485	785	479					
- Amortization of Tangible Capital Assets	286	267	275					
= Net Debt - End of period	**14,662**	**14,251**	**15,234**					
of which: Borrowings net of Sinking Funds	11,171	10,493	10,847					
Unfunded Pension and Retirement Benefits Liability	2,408	2,776	2,840					
Deferred Pension payments - Promissory note	4,381	4,381	4,317					
Other financial liabilities less financial assets	(3,298)	(6,246)	(5,706)					
Net debt - End of period as a % of GDP	48.9%	47.6%	50.8%					
Debt, beginning of period	**15,889**	**16,403**	**20,498**					
Debt retirement, T-Bills and sinking funds	(998)	(1,407)	(46)					
Borrowings	3,400	2,925	400					
Increase in Promissary note issuance	1,814	1,814	-					
Increase (decrease) in promissary notes	(323)	(36)	(65)					
Increase (decrease) in unfunded pension liability	(1,595)	721	65					
Increase (decrease) in post-retirement benefits liability	(226)	78	89					
Debt, end of period	**17,960**	**20,498**	**20,940**					

Var. in borrowing

Borrowing 2016/17	**2,925**
+ Var. in deficit	(303)
+ Var. in capital inv.	(305)
+ Var. inv. In GBE	(364)
+ Var. in other items	335
- Net draw on cash	(1,888)
= Borrowing 2017/18	**400**

Source: Budget documents of Newfoundland & Labrador Ministry of Finance.

Newfoundland and Labrador 2017 Budget

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca