2015 NEWFOUNDLAND AND LABRADOR BUDGET

TD Economics

April 30, 2015

LONGER PATH BACK TO BALANCE

Highlights

- Newfoundland and Labrador has not been immune to movements in commodity prices, which have affected royalty revenues, creating a fiscal gap. As a result, the budget deficit is expected to reach a sizeable $1.1 billion in fiscal 2015-2016, or about 3.3% of GDP. Budget balance will not be achieved until 2020-21, five years later than previously anticipated.
- To close this gap, the province will rely largely on revenue measures, including an increase in the provincial HST to a combined 15%, alongside higher income and corporate tax rates. Expenditure growth will be slowed by reductions in government employment, as well as efficiencies.
- Investment in the crown energy corporation is expected to continue, pushing overall 2015-16 borrowing to $2 billion.
- The government has presented a path back to balance. Oil prices play an important role in the budget plan, and so represent a key risk to be monitored.

Newfoundland and Labrador has not been immune to the effects of falling commodity prices. Despite government expenditures in fiscal 2014-15 coming in below target, lower-than-expected revenues resulted in a larger deficit than anticipated. The ongoing oil-related disruption to government finances has pushed the province off its previous budget path. As a result, the province has introduced a Five-Year Fiscal Recovery Plan, with a balanced budget now targeted for the 2020-21 fiscal year, five years later than envisioned in last year's provincial budget. To achieve the target, Newfoundland and Labrador will employ both revenue and expenditure tools, including tax increases and reduced government employment.

Expanded taxation to help government revenues

The drop in commodity prices since the summer of 2014 has resulted in offshore royalties coming in $800 million lower than originally expected in fiscal 2014-15, pushing overall government revenues below target. Lower offshore royalty revenues more than offset higher than expected tax and fee revenues.

To help fill the revenue shortfall going forward, the province will introduce a number of changes to the tax system. The most visible will be a 2 percentage point increase in the provincial portion of the HST, bringing the overall

NEWFOUNDLAND AND LABRADOR FISCAL POSITION
[C$ millions, unless otherwise noted]

	2015 Budget				
Fiscal Year	**14-15****	**15-16**	**16-17**	**17-18**	**20-21**
Revenues*	**6,965**	**6,976**	**7,480**	**7,836**	**8,627**
% change	--	0.2%	7.2%	4.8%	--
Expenditures	**7,889**	**8,069**	**8,369**	**8,325**	**8,540**
% change	--	2.3%	3.7%	-0.5%	--
Debt Service Costs	807	888	951	997	1,002
% change	--	10.0%	7.1%	4.8%	--
Program Expenses	7,082	7,181	7,418	7,328	7,538
% change	--	1.4%	3.3%	-1.2%	--
Surplus (+)/Deficit (-)	**-924**	**-1,093**	**-889**	**-490**	**87**
% of GDP	-2.6%	-3.3%	-2.6%	-1.4%	0.0%
Net Debt	**10,259**	**11,528**	**12,488**	**13,049**	**13,104**
% of GDP	29.2%	35.0%	36.1%	37.2%	31.7%

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

Source: Newfoundland and Labrador Department of Finance

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NEWFOUNDLAND AND LABRADOR ECONOMIC ASSUMPTIONS [Per cent change unless otherwise noted]					
	2014*	2015	2016	2017	2018
Real GDP	-1.9	-0.3	-1.6	-1.6	-0.6
Nominal GDP	-2.1	-6.2	5.1	1.3	2.6
Unemployment rate (%)	11.9	12.4	13.1	13.0	13.3
Employment ('000s)	238.6	234.9	228.3	226.7	222.8
Real retail sales	1.8	-1.1	-2.3	-0.2	-0.9
Household income	4.9	0.2	0.1	2.2	0.7
Population ('000s)	527.0	526.2	524.1	521.9	520.6

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

rate to 15% from January 1st, 2016. Income taxes will also increase for higher earners, with new, higher rates for those making more than $125K per year, starting in July of this year. As well, the financial corporations capital tax rate will rise to 5% (from 4%), effective immediately.

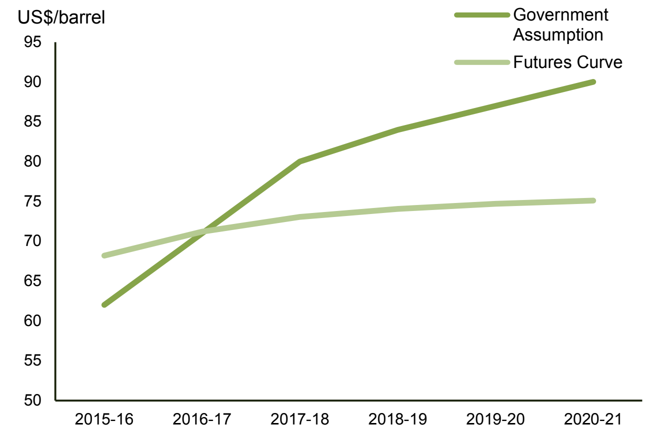
To mitigate the impact of a higher HST on lower-income individuals, the provincial HST credit, and income threshold, will be increased, with nearly 130K families to be eligible. The net result of these changes is an expected increase in government revenue of $122 million in fiscal 2015-16, rising to around $250 million in subsequent years.

Expenditures to be contained, but cuts will be limited

On the expenditure front, the provincial government has decided to avoid what it refers to as "precipitous cuts" in expenditures, preferring to rely on revenue tools to help close the fiscal gap. While government expenditures are anticipated to grow modestly in the near term, some cost containment is being pursued. The size of the civil service is to be reduced by roughly 1400 positions over the coming years, largely through attrition. Improved cost management, operational improvements, and changes to delivery models are also expected to help constrain expenditure growth.

Beyond program expenditures, sizeable investment in Nalcor, the provincially-owned energy corporation, are planned. Coming on top of the cumulative $1.6 billion (approximately) that has been invested to date, the government will continue to invest in Nalcor through fiscal 2017-18, at which point investment will have totaled $3.1 billion. Investment is focused on the Muskrat Falls hydroelectric generation project, with potential for funding future projects in the oil and gas sector. It is expected that all of these funds will be returned to the province via dividends by 2025-26, with dividend payouts continuing thereafter.

GOVERNMENT OIL PRICE ASSUMPTION MAY BE OPTIMISTIC IN LATER YEARS



Source: Newfoundland and Labrador Department of Finance, Bloomberg.
Note: futures prices as of 29 April, 2015

Economic outlook

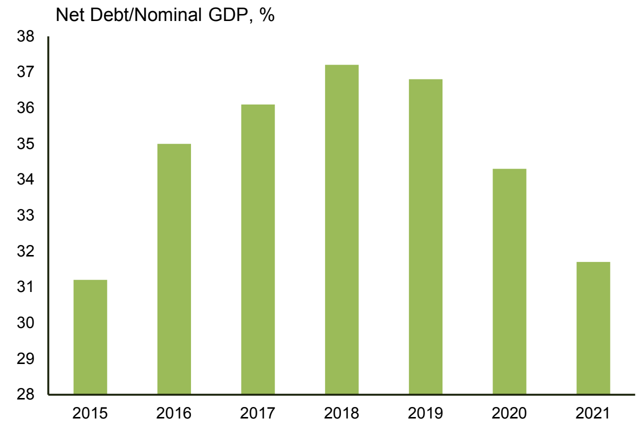
The provincial growth outlook has been adjusted to reflect the new outlook for commodity prices. Real GDP is expected to decline over the next four years, with GDP effectively unchanged from its current level by the end of 2019. In contrast, nominal growth is expected to recover in 2016 as the government expects crude oil prices to accelerate steadily over this time. Nominal growth will take time to translate meaningfully in the broader economy, as employment, household income, and retail sales are all expected to remain weak over the forecast horizon.

Just as crude oil has had a key role in the current economic situation, it is also the major risk to the economic and fiscal outlook. The government anticipates a rapid increase in crude oil prices to more than US$80/barrel by the 2017-18 fiscal year and $90/barrel by 2020-21, which is considerably higher than futures markets currently expect in the outer years. In the short term however, the budget assumptions are more cautious than the market, which may provide some fiscal space via higher royalty rates. We note that the oil market's track record in predicting future prices is weak at best.

Newfoundland to continue borrowing

Newfoundland and Labrador anticipates total financing needs for 2015-16 of $2 billion, resulting from the budget deficit and planned infrastructure investment, as well as further investment in Nalcor. While the 2015-16 fiscal year will see the peak in borrowing, the government plans to issue debt in the following three years, resulting in total borrowing of around $4.9 billion. Of the borrowing, around $1.5 billion is earmarked for Nalcor, $2.0 billion for infrastructure

NET DEBT/GDP EXPECTED TO PEAK IN 2018



Source: Newfoundland and Labrador Department of Finance.

investment, and the remainder for operating expenses and pension obligations.

Although net government debt is expected to increase rapidly, the debt expense is likely to remain manageable. The province expects this expense to remain near its current level of around 2.5% of GDP, although it will rise somewhat as a share of gross revenue. Newfoundland and Labrador remains well positioned on both metrics, which are anticipated to remain well below their mid-1990s highs.

Bottom line

The Government of Newfoundland and Labrador faces a difficult economic outlook, as the province is buffeted by weak commodity prices. While balancing the budget has been delayed, today's budget presents a clear longer-term roadmap back to black ink that maintains government investment in the province. To get to a zero deficit, at least one side of the ledger has to move, and in this case, revenues will fill the gap via tax increases. Although these increases will be felt by residents of the province, offsetting measures should help reduce the impact on lower income earners. Much of the outlook for the province hinges on the path of future oil prices. Should the government's anticipated recovery in these prices not materialize, further fiscal adjustments will be needed.

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