

NEWFOUNDLAND & LABRADOR BUDGET 2014

March 28, 2014

Easing up on the brakes

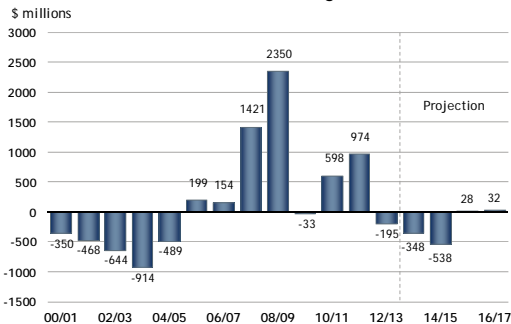
In the 2014 Newfoundland & Labrador budget, released yesterday, the government presented a plan to ease up on expenditure restraint while maintaining the return to budget surplus timeline in 2015/16. A better-than-expected outcome is now expected in 2013/14 and as a result, a lower deficit is projected for the upcoming fiscal year (at \$537.9 million versus \$651 million projected in budget 2013). The government intends to capitalize on this incremental improvement by boosting spending, in sharp contrast to last year's budget that saw a deterioration in the fiscal situation contribute to the plan to hold the line on expenditure growth. Despite the lift to the spending profile throughout the projection period, the government maintained a return to surplus in 2015/16, albeit a smaller one at \$28.5 million rising to \$32.3 million in 2016/17. Cumulatively, the surpluses in 2015/16 and 2016/17 of just under \$61 million are significantly lower than the \$230 million projected for only 2015/16 one year ago as the government shifts its focus to a "balanced outlook" directing funding to new initiatives to support various sectors of the province (instead of allocating larger sums to reduce the provincial debt).

Budget 2014 presented a number of new spending initiatives spread across various sectors of the province under the theme of "shared prosperity and a fair society". The government announced its intention to eliminate provincial student loans by transitioning to upfront grants that will not need to be re-paid, at a cost of \$50.6 million over 5 years. An additional \$39.8 million has been allocated to support the employment of under-represented groups, providing training for apprentices and encouraging new immigrants to settle and work in the province. The theme of supporting students was further evident with the government maintaining a tuition freeze at the province's universities and announcing that it will begin the process to implement universal full-day Kindergarten by September 2016. The largest new spending initiative in the Budget, however, was allocated towards advancing a major project in the province, with \$552.7 million as an equity investment in the province's energy company, Nalcor. The funds will support the development of the Muskrat Falls hydro-electric project and to "advance petroleum initiatives" in the oil and gas driven economy.

Expenditure savings drive an overall improvement in 2013/14

Broad based savings across expenditure categories are contributing to an overall improvement in the government's estimated deficit for 2013/14. At \$7.4 billion, total expenditures are projected to come in lower than the initial estimate, with \$248 million in savings largely a reflection of lower spending in program expenses, down 3.5% to \$6.6 billion. This comes after the government outlined a plan in Budget 2013 that focused on bringing expenditure growth back in line with revenue gains – a plan that appears to have yielded favourable results in 2013/14. Softer fiscal revenues are tempering the improvement however, with total revenues revised \$33 million lower than the initial Budget 2013 estimate to \$7.1 billion. In contrast to the fiscal challenges presented in last year's budget, offshore royalty revenues are expected to come in only mildly softer than projected (\$50 million lower to \$2.0 billion) with weaker taxation revenues (-3.5% to \$3.2 billion) partially offset by a rise in the Fees and Fines component of revenues and increased federal transfers. Collectively, the anticipated expenditure savings are sufficient to yield an overall improvement in the budget deficit in

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Source: Newfoundland & Labrador Ministry of Finance, RBC Economics Research

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2013/14, which is now pegged at \$348.7 million compared to a \$563.8 million deficit projected in Budget 2013.

Rebound in revenues in 2014/15...

For the upcoming 2014/15 fiscal year, total revenues are slated to rise by 3.3% to reach \$7.3 billion which is in sharp contrast to the outright revenue decline (-0.9%) that was projected one year ago. Oil production is expected to edge higher and, with help from a lower average exchange rate, offshore royalties are projected to surge to \$2.4 billion (+17.4%). Lower mining tax and royalties revenues, in part due to lower nickel production in the province (forecasted to fall by 36.2% to \$101 million) is expected to temper the overall gain in revenues, however. The introduction of new tax initiatives in Budget 2014, on net, is expected to lower taxation revenues in 2014/15. A reduction in the small business corporate income tax rate to 3% is projected to contribute to a 34% drop in corporate income tax revenues (to \$236 million). Providing a partial offset will be an increase in tobacco tax revenues, supported by a 3 cent per cigarette increase effective March 28, 2014 and a robust 7.8% gain in sales tax revenues. Revenues from non-provincial sources are expected to fall 4.4% to \$0.8 billion in part due to a \$34.9 million (6.7%) decrease in Federal Health Transfers.

Total revenues are projected to surge 10.9% in 2015/16 to \$8.1 billion before slowing significantly in 2016/17, rising by 1.6% to \$8.2 billion.

...will be exceeded by accelerating expenditures, thereby keeping the province in the red

Total expenditures are slated to rise 5.7% in 2014/15 to \$7.8 billion. Program expenses are estimated to jump 5.9% to \$7.0 billion with debt servicing costs growing at a more subdued 3.9% pace to \$0.87 billion. The anticipated increase in program expenses reflects a \$130 million spending boost within the General Government Sector and Legislative Branch to \$1.9 billion with nearly half of the new funding allocated for Transportation and Works. As a result of new spending initiatives, the Social Sector branch will see the largest spending lift, rising by \$258 million from 2013/14 with broad based increases across departments. Health and community services will see a \$114 million increase to just under \$3 billion while \$77 million in increased spending is planned for the Education sector at \$0.9 billion. Beyond 2014/15, expenditure growth is set to slow although the expenditure profile has been upwardly revised from the plan presented in Budget 2013. Program expenditures are projected to rise 2.5% in 2015/16 compared to an outright 0.9% *decline* previously planned. The addition of 2016/17 to the fiscal plan shows program expenditure growth slowing by more than half to 1.2% to reach \$7.2 billion. Overall, total expenditures (including debt servicing expenses) are slated to rise by 2.9% and 1.6%, respectively, in 2015/16 and 2016/17.

Return to surplus by 2015/16 maintained but with a lower balance

There is a notable shift in the expenditure profile in Budget 2014 compared to the budget plan presented one year ago. Total expenditures are projected to grow, on average, by 3.4% through the projection period which marks a sharp contrast from the 0.1% growth planned previously. On the revenue side of the ledger, total revenues were initially set to fall (-0.9%) in 2014/15; however, softer revenue growth in 2015/16 will shift the overall profile down slightly (5.2% average annual growth compared to 5.9% previously). As a result, the budget balance in 2015/16 is set to come in at \$28.5 million which is smaller than the \$230 million surplus initially planned. The province expects to maintain a small \$32.3 million surplus the following year.

Capital spending

Capital expenditures are expected to be \$1.15 billion in 2014/15, a 5.2% increase from the estimated \$1.1 billion in 2013/14. Capital spending allocated to Education is projected to rise by more than half (57%) to \$108 million while a 13% jump in Health and Community Services together will account for 25% of capital account expenditures. Natural resources will continue to make up the largest share of investment at \$562 million, an increase of 3.8% from 2013/14.

Net debt to rise further

With the introduction of the 10-year Sustainability Plan last year, the government aims to bring the province to “long-term fiscal sustainability” by reducing net debt per capita to the average for all provinces within 10 years. Nonetheless, net debt is set to jump by 8% by March 31, 2014, to \$9.0 billion, and by 9% to \$9.8 billion by March 31, 2015 on account of the province running a deficit as well as a further increase in the acquisition of tangible capital assets. As outlined in Budget 2014, net debt continues to grow as a result of increases to unfunded pension and other post-retirement liabilities. By 2016/17, the government expects this component to account for \$9 billion (85%) of net debt and in Budget 2014, the government affirmed its longer-term commitment to review the sustainability of these costs going forward.

Borrowing requirements

The government is set to borrow funds to finance its operations for the first time since 2005. Of the \$1 billion in required borrowing, \$372 million will be allocated for debt retirement.

Lackluster growth throughout forecast horizon

After a rebound in crude oil production fuelled the province to the top of the provincial growth rankings in 2013, the government forecasts economic growth to slow significantly from 5.9% in 2013 to 0.5% in 2014. This is lower than RBC's forecast for 1.5%

growth. In the outer years of the fiscal plan, economic activity is projected to slow considerably with real GDP remaining unchanged in 2015 and declining by 4.2% in 2016. The government expects capital investment to fall by 22% in 2016 following years of elevated levels of investment supported by the advancement of major projects in the province, including the Hebron offshore oil field and the development of Muskrat Falls hydro-electric project. While the commencement of crude oil production at the former is expected to provide a boost to economic growth, the province is faced with lackluster real GDP growth prospects in the near-term. As has been seen in the past, this volatility in the oil and gas sector along with changes in the timelines of major projects could impact economic growth and present a challenge to the province maintaining the small projected surpluses. The government remains committed, however, to its 10-year Sustainability Plan to diversify its revenue sources and has displayed its commitment to holding the line on expenditure growth as needed. As well, the economic assumptions embedded in the budget projections are conservative and provide a degree of prudence in the outlook.

Newfoundland & Labrador fiscal plan

(\$ millions)	Actual	Estimates	Revised	Estimates	Projection	
	<u>2012/13</u>	<u>2013/14</u>	<u>2013/14</u>	<u>2014/15</u>	<u>2015/16</u>	<u>2016/17</u>
Total revenues	7,506	7,093	7,060	7,291	8,082	8,212
Fiscal revenue	7,265	6,842	6,803	7,027		
Net income of government business enterprises	241	250	257	264		
Total expenditures	7,701	7,656	7,408	7,829	8,054	8,180
Program expenses	6,921	6,809	6,567	6,955	7,127	7,210
Debt servicing expenses	780	848	841	874	927	970
Surplus/(Deficit)	-195	-564	-348	-538	28	32

Source: Newfoundland & Labrador Ministry of Finance, RBC Economics Research

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