NEWFOUNDLAND & LABRADOR BUDGET 2016

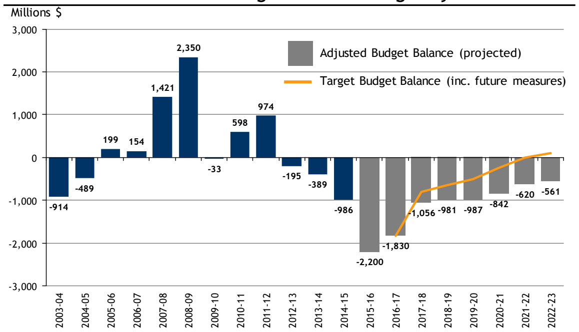
April 15, 2016

A step back from the brink

Overview

Newfoundland and Labrador's budget, released yesterday, reveals the gathering impact of low oil prices on the Province's revenues and the government's steps to address it. The budget was largely as expected with diminished revenues, caused by low oil royalties, only partly offset by measures to raise new revenues and restrain spending. Despite aggressive proposed action from the provincial government, a $1.8 billion projected deficit in 2016-17 gives way to still-large structural deficits through the 7-year forecast horizon. To close that distance the government intends to release a supplemental budget this fall which will detail the medium-term solutions needed to achieve their goal of budget balance by fiscal 2021-22. The concrete measures outlined in Budget 2016, while significant, are just the first steps towards a sustainable fiscal trajectory.

Newfoundland and Labrador government budgetary balance



Source: RBC Economics Research, Newfoundland and Labrador Department of Finance

Fiscal balance

In December 2015 the Newfoundland and Labrador government released its *2015 Fall Update* outlining a grim fiscal future for the province if nothing was done to accommodate the plunge in revenues. The austerity budget presented yesterday signals a course correction. The government expects the measures in this budget, along with those to be announced in a forthcoming *Fall Update,* to contain expenditures, boost revenues, and set the stage for a return to budget surplus over a 7-year horizon.

In the short-term however, the fiscal shortfall remains large. After revising the 2015-16 deficit upward to $2.2 billion (from $2.0 billion in the December update), the province is projecting a shortfall of $1.8 billion in 2016-17. This is down from the $2.4 billion expected in the *Fall Update* and lower than the government's estimated $2.7 billion 'business as usual' counterfactual deficit. This year's projected shortfall reflects a lower path of oil prices and royalties and new measures to contain costs and boost revenues. In 2016-17 offshore oil royalties are expected to generate $502 million, a far cry from an average of $2.1 billion from 2007-08 to 2014-15. Over the forecast horizon the government expects a gradual rise in oil prices (Brent recovering from US$40/bbl this year to $74/bbl in 2022-23) along with increasing oil production, both of which would be positive for oil royalties.

The recovery plan

The *Government Renewal Initiative* (GRI) was launched in January 2016 to find savings in the delivery of programs and services. This included tasking all government departments and agencies to identify ways to reduce their expenditures by up to 30% over three years. Decisions stemming from the GRI have resulted in $130 million in savings in fiscal 2016-17. Moreover, a line-by-line review of government budgets has resulted in a further savings of $113 million this fiscal year through eliminating vacant positions, reducing discretionary spending, and reviewing operating and programming expenses. The government estimates their total savings from cost-containing measures to be $243 million (the impact on the deficit is estimated to be $282 million thanks to adjustments for entities and accruals).

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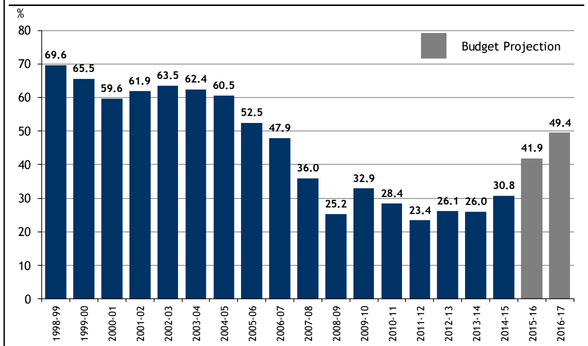
The larger component of the government's deficit reduction plan is substantial increases in taxes and fees. The budget details plans to raise personal income taxes rates for all brackets, increase the HST by 2 percentage points, introduce a temporary 16.5 cents per litre increase in the gasoline tax, and establish the Deficit Reduction Levy, a new temporary tax measure, of up to $900 annually per individual. Other revenue-enhancing measures include increased tobacco taxes and the modification or introduction of 350 fees. In all, new budgetary measures are expected to generate $647 million in new revenue in 2016-17 ($882 million on an annualized basis).

Beyond the initiatives contained in the budget, the government intends to announce additional measures in its *Fall Update* to be released later this year. Guidance from the Province suggests that these measures could include replacing the Public Tendering Act, reviewing the government's real estate portfolio, finding efficiencies in health care delivery and increased partnering with the non-profit and private sector. Down the road, the government also plans to create a Diversified Wealth Fund once the budget returns to balance.

Newfoundland and Labrador net debt-to-GDP ratio



Source: RBC Economics Research, Newfoundland and Labrador Department of Finance

Infrastructure and Nalcor

Despite this year's large deficit, the government will be investing a further $1.3 billion in Nalcor, the province's energy crown corporation, bringing the Province's total investment in it to $3.6 billion. These investments are related to the Muskrat Falls project which is now significantly behind schedule and is expected to face cost overruns. The government aims to trim down Nalcor's expenses and has signalled that putting the project back on track is a priority. The government also intends to invest $570 million in infrastructure this year in part to foster economic growth and leverage federal funding.

Borrowing and net debt

The Province intends to borrow $3.4 billion during fiscal 2016-17 and since January it has secured just under $2 billion in long-term financing. According to government fiscal targets, if the province meets its deficit reduction goals and achieves a budget balance in 2021-22, the next 7 years will require $8.2 billion in new debt. This would take net debt to $16.5 billion by March 2023, compared with its 2015-16 level of $12.6 billion. While this net debt level is substantially lower than the bleak outlook detailed in December's *Fall Update* (net debt of $22.9 billion by 2020-21), it also assumes that deficit reduction goals are met thanks to as-yet unannounced measures.

Commentary

Facing a baseline deficit of $2.7 billion this year if nothing is done, Newfoundland and Labrador's government plans to take aggressive action to reduce its budgetary shortfall. Measures in the 2016 budget aim to reduce the deficit by one-third relative to that baseline in the first fiscal year alone. This is a good start, but the government is not out of the woods yet. Despite the host of austerity measures proposed in this budget, the province is on track for half-billion dollar structural deficits through 2022-23. Closing the gap will require both further government action, and for forecasts of the economy, oil prices and oil production to materialize within the tolerances of the budget's $125-million annual risk adjustment. Moreover, planned fiscal retrenchment is coming amid a grim outlook for the provincial economy. Total investment spending is forecast to decline going forward as a number of major projects head for completion, low commodity prices are impacting the outlook for natural resource development, and the province has seen mounting job losses. The upshot is that according to budget projections, between 2015 and 2020 the province's unemployment rate will rise to nearly 20%, the economy will contract by 7% in real terms, and total employment will decline by 15%.

Table 1: Budget Summary (millions of dollars)

	Revised	Projection						
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Budgetary Revenues	**5,894**	**6,776**	**7,410**	**7,659**	**7,737**	**7,872**	**8,097**	**8,245**
Program Expenses	7,276	7,499	7,307	7,390	7,433	7,407	7,363	7,398
Public Debt Charges	818	982	1,034	1,125	1,167	1,182	1,229	1,283
Total Expenses	**8,094**	**8,481**	**8,341**	**8,515**	**8,599**	**8,589**	**8,592**	**8,681**
Adjustment for Risk		-125	-125	-125	-125	-125	-125	-125
Adjusted Budgetary Balance	**-2,200**	**-1,830**	**-1,056**	**-981**	**-987**	**-842**	**-620**	**-561**
Target Budgetary Balance		-1,830	-800	-650	-500	-250	0	100

Source: Newfoundland and Labrador Department of Finance

Table 2: Economic Assumptions

Year-over-year % change	Projection						
	2016	2017	2018	2019	2020	2021	2022
2016-17 Budget							
Real GDP growth	1.0	-3.3	-3.4	-1.1	-0.6	1.4	0.2
CPI	2.2	2.0	2.2	2.2	2.0	1.8	1.7
Nominal GDP growth	-1.6	2.2	1.0	1.9	2.3	3.4	1.5
Unemployment Rate*	12.8	15.2	18.3	19.8	19.5	18.9	18.2
Oil Price (USD$/bbl, brent basis)**	40	52	60	66	69	72	74
RBC Economics							
Real GDP growth	-0.1	-0.8					
CPI	1.7	2.4					
Nominal GDP growth	-1.1	5.2					
Unemployment Rate*	13.4	14.5					
Oil Price (USD$/bbl, WTI basis)*	40	57					

*Average level, **Average level, fiscal year

Source: RBC Economics Research, Newfoundland and Labrador Department of Finance