Intelligence MEMOS

From: Don Drummond and Louis Lévesque

To: Newfoundland and Labrador Taxpayers

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Re: **The Newfoundland and Labrador Fiscal Morass**

Newfoundland and Labrador's fiscal balance is sharply deteriorating this year. But a structural fiscal problem was well engrained prior to the pandemic and latest plunge in oil prices. After bringing its debt burden (net debt-to-GDP ratio) down to a manageable 26 percent by 2012/13, there was a sharp deterioration, bringing the ratio to 56 percent by 2020/21.

Despite low interest rates in Canada, 15 cents of every revenue dollar were going to service the public debt in 2020/21. In our new C.D. Howe Institute E-Brief we examine past expenditure trends, quantify their contribution to the dire fiscal situation and outline a scenario to escape.

The decline in oil prices since 2015 is not the only culprit in the provincial plight. Excessive spending – especially relative to otherwise similar provinces in Atlantic Canada – is the key factor and fiscal projections show that reductions are essential to put the finances of the province back on a sustainable track.

Our debt figures do not include the debt associated with Muskrat Falls that is on the books of a provincially owned Crown corporation, Nalcor. The provincial debt only includes the equity investments made by the province into Nalcor for the project. If, however, taxes are used instead of electricity rates to resolve Muskrat Falls debt, then this debt should be added to the figures reported by the government. As such, the effective net and gross debt burdens of Newfoundland and Labrador should be considered much higher than reported in Finance Department budget tables.

The long-run potential economic growth rate of Newfoundland and Labrador has been estimated at only 0.5 percent, a full percentage point below the national average. A key factor behind the dismal economic prospects is a declining and ageing population, hence a labour force declining at a significant pace.

The bleak prospects reflect some degree of circularity as the weak economy is undoubtedly partly to blame for the population losses. The decline in the labour force slows revenue growth while the ageing population puts upward pressure on healthcare costs. Ageing is adding 1.2 percentage points per annum to healthcare costs in Newfoundland and Labrador compared to a national average of 0.9 percentage points.

The combination of the pandemic and the plunge in oil prices is expected to lower real GDP in 2020 by 6.5 to 10.9 percent (the range in private-sector forecasts) and nominal GDP by 8.8 to 17.1 percent.

The province has structural economic and fiscal problems that will not go away with recovery from the 2020 woes from the pandemic and collapsing oil prices.

To put its finances back on a sustainable track, Newfoundland and Labrador will have to bring its program spending per capita down much closer to levels in other provinces. Containment of total compensation for provincial public-sector employees will have to be a big part of the plan to reduce spending. Provincial compensation costs per public employee were 16 percent higher than in the rest of Atlantic Canada over the period 1997 to 2019. It would be difficult to close that gap over the time frame of a fiscal framework and will require measures to reduce the number of employees and measures to limit compensation.

As soon as the economy recovers from the pandemic, it must embark upon fiscal correction to eliminate its chronic deficits and, more importantly, to reduce its debt burden. A goal of balancing the budget by 2025/26 is ambitious, but seemingly feasible given the high level of government spending in the province.

The province needs to put the basic facts before the public and explain the need for action. It needs to sit down with key stakeholders, labour unions, businesses and other civil society actors, to discuss its plan of action.

The focus on spending restraint and specifically provincial public-sector compensation will elicit negative reactions from public-sector unions. Transparency and due process will be key to creating public support for difficult decisions while demonstrating an appropriate degree of deference to the rights of employees to negotiate work conditions.

It will be difficult to squeeze more tax dollars from the people and companies of the province. But the tax burden is not low in absolute terms and relative to some other jurisdictions. Care would need to be taken to minimize the economic damage. That suggests broad-based consumption taxes, such as the HST. The federal government should also step forward to assist with resolving the Muskrat Falls imbroglio. As well, privatizations and sales of assets will likely need to be identified with the aim of creating a pool of money that can be used to lower ongoing debt service payments.

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