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E-BRIEF

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FISCAL AND TAX POLICY

The Rock in a Hard Place: The Difficult Fiscal Challenges Facing Newfoundland and Labrador

by
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- Newfoundland and Labrador's current fiscal problems began in 2012/13 when the budget balance swung back into deficit and the net debt burden rose. The fiscal deterioration ramped up when the decline in oil prices beginning in late 2014 drastically reduced offshore royalty revenues accruing to the province. Large budgetary deficits had already opened before the negative impacts of the COVID-19 pandemic compounded the situation.
- Without strong corrective action, provincial finances appear to be set on an unsustainable track, with net debt to GDP reaching almost 60 percent by 2025 and interest payments eating over 14 percent of revenues.
- Program spending that is significantly and chronically in excess of other provinces constitutes by far the largest factor explaining the province's current fiscal challenges. Public-sector compensation costs – particularly in health and public administration – are major contributors to higher-than-average spending. Funding additional personnel costs, which are largely of indeterminate duration, with volatile annual resource revenues has created major fiscal risks for the province.
- A balanced budget fiscal projection incorporating adjustments focused on expenditure reductions would put provincial finances on a more sustainable track. The province needs to rapidly explain to the public the underlying causes of its fiscal difficulties, consult with labor and business on potential options, and then take action. The newly formed Economic Recovery Team can play a crucial role in this respect.

Newfoundland and Labrador's Fiscal Woes Have Been Building for Years

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

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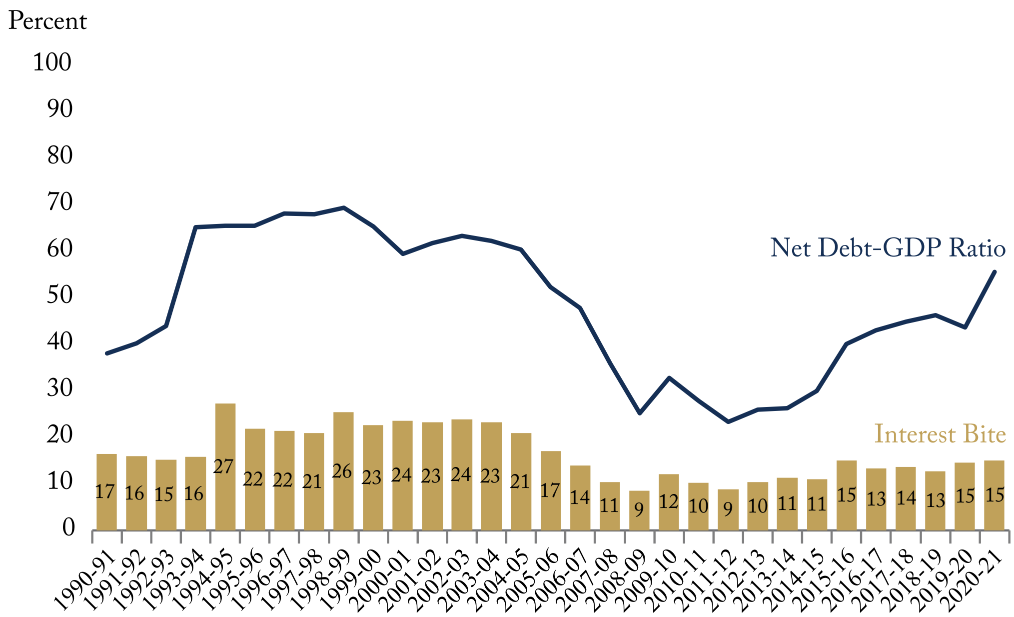
Figure 1: Newfoundland and Labrador Net-Debt-to-GDP Ratio & Ratio of Public Debt Charges to Total Revenue



Note: Calculation for interest payments/revenue for 2019/20 removes the one-time accounting entry of the $2.4 billion for the Atlantic Accord, the oil revenue-sharing agreement with the federal government. This also applies to calculations found in other figures. The debt figures from the Newfoundland and Labrador Budget and shown in figures and tables in this report 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. The Nalcor debt must in any case be addressed by Newfoundland and Labrador residents, likely through higher electricity prices and higher taxes. If taxes are used, then from the perspectives of the overall debt burden and credit rating, this debt should be added to the debt 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 the budget tables. Measurement of debt changed in 1994/95 so caution is in order in comparing figures pre-1994/95 with later figures.

Source: RBC Fiscal Tables and Fiscal Reference Tables for 1990-91 to 2018-19, and 2020 Budget to 2020-21.

its debt burden (net-debt-to-GDP ratio) down to a manageable 26.0 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 (see Figure 1).

This E-Brief identifies past trends with respect to Newfoundland and Labrador's expenditures and quantifies their contribution to the dire fiscal situation of the province. The decline in oil prices since 2015, which has also negatively affected other energy provinces, is not the only culprit for the province's fiscal problems. Excessive spending – especially relative to otherwise similar provinces in Atlantic Canada – is the key factor and fiscal projections show that expenditure reductions are essential to put the finances of the province back on a sustainable track.

The Economic Recovery Team chaired by Dame Moya Greene can help find ways to reduce program expenditures. The Team was appointed by the Premier October 22, 2020 and is to advise on economic and fiscal matters.

Future Economic Growth Prospects are Bleak

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 (Drummond and Capeluck 2015). 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.[1]

There are other economic challenges. Offshore oil is expensive and without a sharp rebound in oil prices, will contribute little to the province's economy or fiscal coffers in the coming years. Several mega-projects have wrapped up so there will be little growth induced on that front in the future. In addition, large costs and further overruns at the Muskrat Falls project pose a threat to future growth since they imply a potentially large additional burden on households and businesses. (See Box 1).

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. It is interesting to contemplate what kind of economic and fiscal prospects the province might confront under the "status quo" and then, if that appears undesirable, examine in more detail the source of the problem and identify the actions required for a more favorable scenario.

It is assumed that real and nominal GDP will be $33.7 billion and $38.7 billion, respectively, in 2025, reflecting average annual growth rates of 0.2 and 1.8 percent from the 2019 base.[2] Own-source revenues are projected to be $7 billion in 2025/26. The great volatility in own-source revenues makes selection of a base fraught with uncertainty. Much of the volatility relates to offshore energy activity, not only for its direct contribution through royalties, but also through the lift it provides to other revenue sources.

1 Estimates provided by Canadian Institute for Health Information at one of the authors' request for provincial simulations.

2 Economic and fiscal projections are especially difficult for Newfoundland and Labrador because economic activity and revenues can be volatile. Two major sources of historical volatility are removed by assumption. It is assumed the province will not receive equalization through 2025/26. It is also assumed that oil prices do not recover sufficiently to permit a substantial contribution of the offshore to economic activity or provincial coffers.

A reference point for the economic projection is the 0.5 percent per annum estimate of long-term potential growth done by Drummond and Capeluck (2015). That is adjusted down over the next several years to reflect the probability that the pandemic will not just depress aggregate demand, but aggregate supply as well for many years (lower investment, lower immigration and weaker labour demand-supply matching).

Box 1: The Cost Impact of Muskrat Falls

The large cost overruns at the Muskrat Falls project will make the fiscal situation of Newfoundland and Labrador even more difficult in the years to come. Costs overruns rapidly piled up after the launch of the project in 2013. In 2017, the province appointed Justice Richard LeBlanc as head commissioner of a public enquiry into the project. The Commission's report made public in March 2020 makes it very clear that cost overruns (about $4B to date) should not have come as a surprise.

Justice LeBlanc's report also directs severe criticisms at elected and non-elected officials who 'sold' the project to citizens of Newfoundland and Labrador while failing in their duty to obtain and fully disclose adequate information about costs and risks. The obvious concerns identified by Justice LeBlanc also seem to have escaped the attention of federal decision-makers when the government of Prime Minister Harper decided in 2012 to extend the $5B loan guarantee requested by the province for the project.

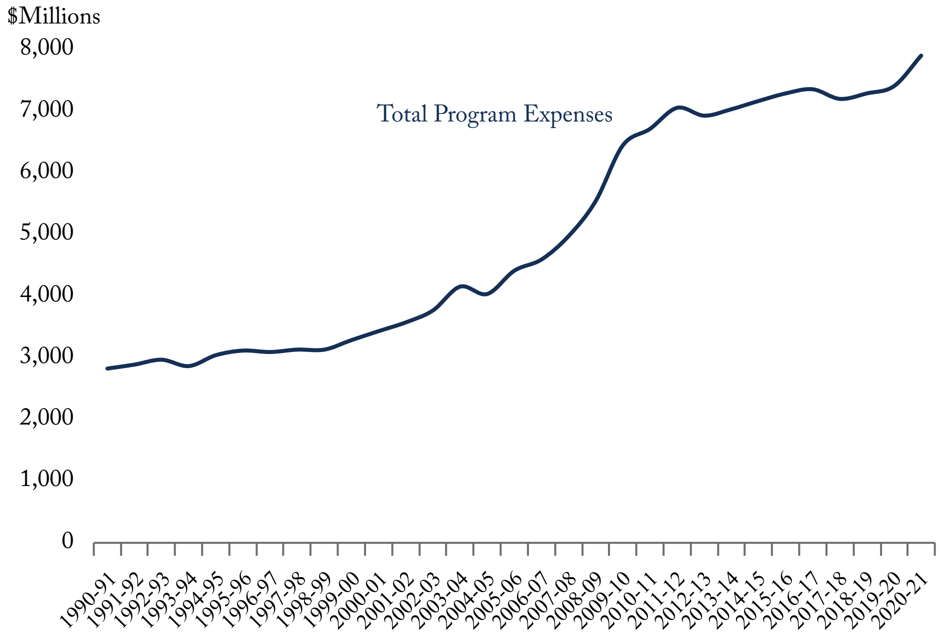
Federal support for the project has not wavered. As a matter of fact, the $5B federal loan guarantee for the Muskrat Falls project committed to under the government of Prime Minister Harper was increased to close to $8B under the government of Prime Minister Trudeau to cover additional borrowing by the province for the project.

Predictably, estimates now show that drastic measures such as hiking electricity rates from 13 to 24 cents per kilowatt-hour or imposing very large tax increases would eventually be required should Newfoundland and Labrador be left to service the large debt associated with the project on its own. Such an approach does not appear sustainable, nor fair to residents of the province, notably given the role of the federal government as an enabler to the launching of the project. The province can take action on its own to mitigate the impact on ratepayers by lowering the rate of return on its investment in the project. One can also expect the province to ask for a form of federal relief from the burden of that debt.

To arrive at the $7 billion own-source revenue projection for 2025/26 we focused on the 2018/19 revenue total of $6.6 billion. That figure includes $1.1 billion of offshore royalties.[3] We deducted $0.4 billion to lower the base to what it would have been with only $0.7 billion of royalties. We then applied an annual average growth rate of 1.7 percent. It must be considered that there are downside risks to achieving this revenue figure.

3 Offshore royalties of $1.1 billion were recorded in 2018/19. They declined to $962 million in 2019/20 and are forecast at $533 million for 2020/21. To gross up the 2018/19 own-source revenue base for future growth, we deducted $400 million to ensure only $683 million of royalties is used in the base figure. After applying the growth rate of 1.7 percent per year, this means $769 million of offshore royalties is embedded in our 2025/26 revenue forecast. Substantially higher royalties should not be expected unless or until world oil prices rise, restoring the profitability of this relatively high-cost source of energy. A mix of demand and supply conditions surveyed by the Organization of the Petroleum Exporting Countries (2020) suggests that the world oil price may rise from the recent $50 U.S. (WTI at Cushing) range, but the increase should be expected to be modest. For example, Deloitte (2020) expects a WTI Cushing price of $62.25 by 2025. While Newfoundland and Labrador's offshore royalties should rise above this year's $0.5 billion mark, we have assumed only a modest recovery through 2025.

Figure 2: Program Spending 1990/91 to 2018/19



Source: 1990-91 to 2018-19 from Fiscal Reference Tables. 2019/20 and 2020/21 from 2020 Budget.

Reflecting no equalization,[4] the tight limits on growth in the Canada Health Transfer and Canada Social Transfer, and the declining population in Newfoundland and Labrador, total transfers from the federal government are projected to be $1.4 billion in 2025/26 (up modestly from the levels in 2018/19 and 2019/20 once the one-time entry for the $2.4 billion recorded for the Atlantic Accord, the 1985 oil revenue-sharing agreement with the federal government, is removed from the latter year).

Choosing a "status quo" growth rate for program spending is subjective as the government has considerable discretion here. We note the annual average growth rate of program spending from 2009/10 to 2019/20 was 1.4 percent (see Figure 2) and we project this rate of growth from the 2019/20 base to 2025/26.

4 The Finance Canada calculations for 2020/21 equalization (Finance Canada 2020-21 Equalization Workbooks) show Newfoundland and Labrador's average per capita fiscal capacity to be 1 percent higher than the national average. Consistent with the current equalization formula, the calculation includes 50 percent of royalties. This suggests Newfoundland and Labrador could receive equalization payments in the future should its per capita tax revenues fall short of national average growth. However, unless economic performance is well below the national pace the payments would not likely be large. Also, due to the lags built in the current formula, it could be several years before higher payments are triggered, and these will be limited by the overall fiscal capacity cap in the formula, which takes into account 100 percent of royalty revenues. Unless driven by changes to the equalization program, significant equalization for Newfoundland and Labrador would not likely leave the province in a better fiscal position because it would most likely reflect depressed own-source revenues as a result of weak economic performance.

Table 1: Fiscal Baseline and Projections to 2025/26

Budget Year	2018-19	2019-20(1)	2020-21(2)	2025-26 (Status quo)	2025-26 (Fiscal restraint)
	Actual and Projected from Budgets			Author Projection	
	($ millions unless noted)				
Own-source Revenues	6,645	5,879	5,647	7,025	7,025
Federal Transfers	1,182	3,678	1,482	1,400	1,400
Total Revenues	7,827	9,557	7,129	8,425	8,425
Program Spending	7,340	7,400	7,894	8,043	7,275
Interest on Public Debt	1040	1,043	1,073	1,200	1,150
Total Spending	8,379	8,443	8,967	9,243	8,425
Budget Balance	-553	1,114	-1,838	-818	0
Net Debt	15,378	14,400	16,441	23,000	20,000
Interest Payments/ Revenue (cents/$)	13.3	14.6	15.1	14.2	13.6
Net Debt-GDP (%)	46.3	42.1	55.7	59.4	51.6

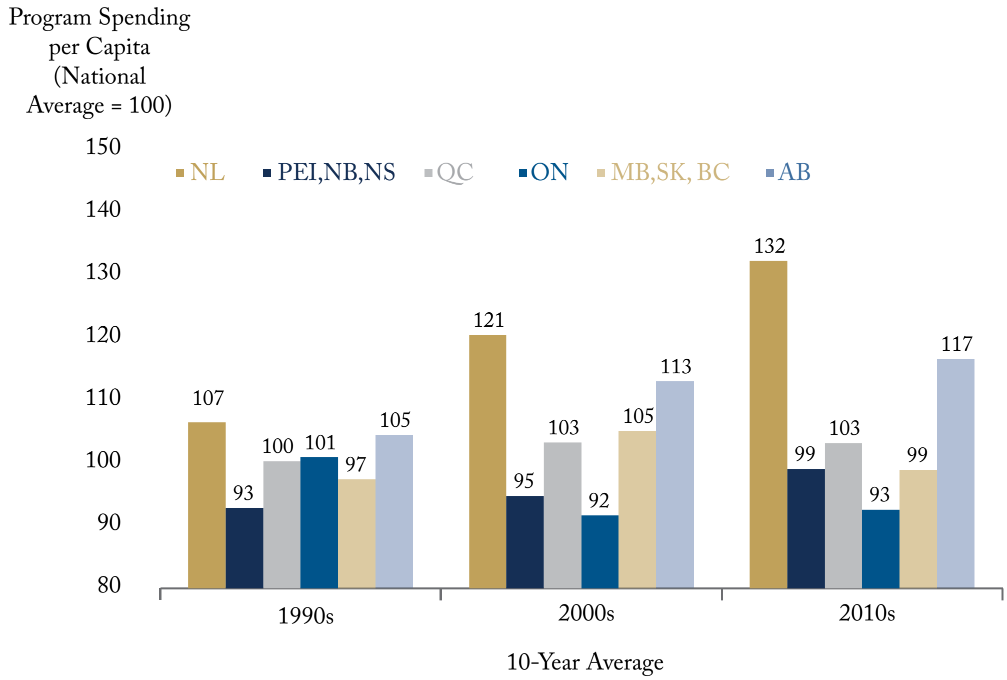
Notes and sources: (1) In 2019/20 $2.4 billion was recorded for the Atlantic Accord. To a large extent, this provided a one-time accrual accounting of the 38 years of benefit from the Accord. As such, only about $100 million of benefit is expected annually going forward. (2) Figures for 2020/21 are taken from the September 2020 Newfoundland and Labrador budget. Amounts do not include Muskrat Falls-related debt or future forecasts.

For projecting public debt charges, it is necessary to infer an average effective interest rate on public debt, defined crudely for our purposes as interest payments divided by net debt. In recent years, the effective interest rate has fluctuated between 6.4 and 7.2 percent, reflecting the very long-term structure of the province's debt. This will come down as new debt attracts much lower interest rates. Recent provincial issues have had yields between 1.75 and 2.85 percent. In the "status quo" scenario, about one-third of the debt accumulated by 2025/26 is added post-2020/21, so a good deal of the total debt will carry the much lower interest rates. In the "status quo," the effective interest rate is assumed to be just slightly above 5 percent by 2025/26; in the alternative scenario with a balanced budget the effective interest rate is a bit higher as a lower portion of the 2025/26 debt is accumulated post-2020/21.

With these assumptions, the "status quo" fiscal projection is shown in Table 1.

Several features of the "status quo" project must be considered troubling. First, we predict a large deficit of $0.8 billion for 2025/26. Second, the debt burden is expected to be 59.4 percent. This would be the province's highest debt burden since the early 2000s. Third, 14.2 cents of every revenue dollar would be eaten by debt

Figure 3: Program Spending by Province Relative to the All-Province Average



Source: Fiscal reference tables published by Finance Canada in October 2019 and quarterly population numbers from Statistics Canada. Territories are not included in calculation of national average.

charges. This is money going to cover past consumption and not available for current and future needs such as health and education. Furthermore, it must be considered that this is by no means a "worst case" scenario. Economic growth and, hence, revenues could be weaker. The strains of dealing with Muskrat Falls could be more evidenced. Interest rates could rise, putting more pressure on public debt charges.

Relatively High Program Spending and Compensation the Main Factor behind Newfoundland and Labrador's Fiscal Problems

Newfoundland and Labrador's program spending per capita was not always well above the all-province average as shown in Figure 3. In the early 1990s, it was at the national average. Starting in the mid-1990s, the province allowed its program spending to grow much faster than did other provinces. In the 2000s, program spending in Newfoundland and Labrador was on average 20.5 percent higher than the provincial average. Newfoundland and Labrador budgets between 2008 and 2011 included projected annual spending increases in excess of 12 percent on average, which materialized slower than budgeted (Robson and Omran 2020). Nonetheless as a result, for the nine years to 2018/19, the gap with spending in other provinces reached 32.3 percent on average. For the last 15 years, spending in Newfoundland and Labrador has in fact exceeded that of Alberta, the richest province in the country.

The case is often made that Newfoundland and Labrador's government per capita spending is high of necessity given its relatively small and older population. Yet, although they have a higher population density, to a large degree these characteristics are shared by the other Atlantic provinces. Combined program spending per capita in New Brunswick, Nova Scotia and Prince Edward Island is the all-province average.

Of particular concern is the further ramp-up in spending after 2008 where Newfoundland and Labrador began long-term spending commitments that would only be prudent if high offshore revenues would be permanent. This massively increased the province's exposure to the financial mismatch between largely permanent spending on the one hand and highly volatile offshore resource revenues on the other hand.

It is easy to calculate, for example, that had Newfoundland and Labrador limited its excess annual program spending compared with the Maritimes (NS, NB, PEI) at 15 percent (about the level prior to 2005), the province would have saved more than $10 billion, before interest costs, cumulatively from 2000 through 2017/18. Taking interest savings into the account, the province would have been essentially debt free by 2015 before being hit by the decline in oil prices. Other oil producing provinces, most notably Alberta, are now also facing greatly reduced revenues. Their much lower debt levels as of 2015 put them in a much stronger position to withstand the oil shock.

Past overspending on programs is also more important than the cost of Muskrat Falls project discussed above in Box 1 in terms of explaining the current difficult fiscal situation of the province.

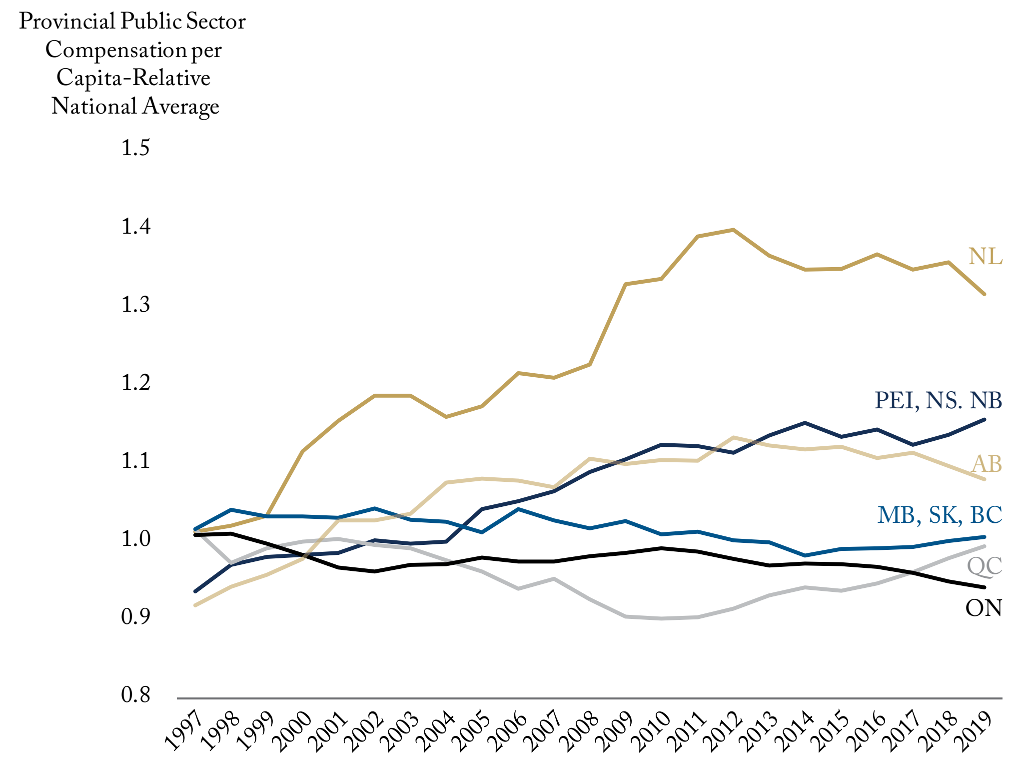
Program spending that reached more than 130 percent of the provincial average has reflected higher levels of total compensation for Newfoundland and Labrador public-sector employees. Figure 4 compiles the main sectors of provincial public-sector compensation costs (divided by total population): elementary, secondary and college education sector employees; healthcare sector employees; and provincial public-service employees.[5] Total compensation (which includes the value of non-wage benefits) is expressed in terms of provincial per capita costs relative to the national average. That is, a province with costs at the provincial average would have a cost of 1. Total compensation costs per capita in Newfoundland and Labrador reached a peak of 40 percent higher than the national average in 2012. That is now down to 32 percent higher as of 2019 and is still much higher than compensation costs in the rest of Atlantic Canada (which faces similar demographic-driven demands for programs) or in Alberta (which also faced an oil-price-induced demand boom for employees until 2014).

What makes up the much higher growth in employee compensation in Newfoundland and Labrador compared to the demographically similar provinces of Atlantic Canada (Figure 5)? Healthcare worker compensation per capita in Newfoundland and Labrador between 1997 and 2019 grew by 332 percent. In the rest of Atlantic Canada, healthcare worker compensation per capita grew at 284 percent, compared to 228 percent across Canada as a whole. Direct provincial government employees also saw an increase in their total compensation costs per capita of 255 percent compared to 230 percent in the rest of Atlantic Canada, and a 197 percent increase nationally. In contrast, compensation per capita for educators has grown at a slower rate in Newfoundland and Labrador relative to the rest of Atlantic Canada.

The gap in total public-sector compensation costs per capita in these categories between Newfoundland and Labrador and the rest of Atlantic Canada was less than $200 per person in the late 1990s. It then grew in 2013 to a public-sector pay premium of over $1,300 per Newfoundland and Labrador resident. The gap held at around $1,100 for a few years and then declined in 2019 to $877.

5 This analysis does not include Crown corporation employees or university employees.

Figure 4: Provincial Public-Sector Compensation per Capita, Relative to National Average of Main Sectors



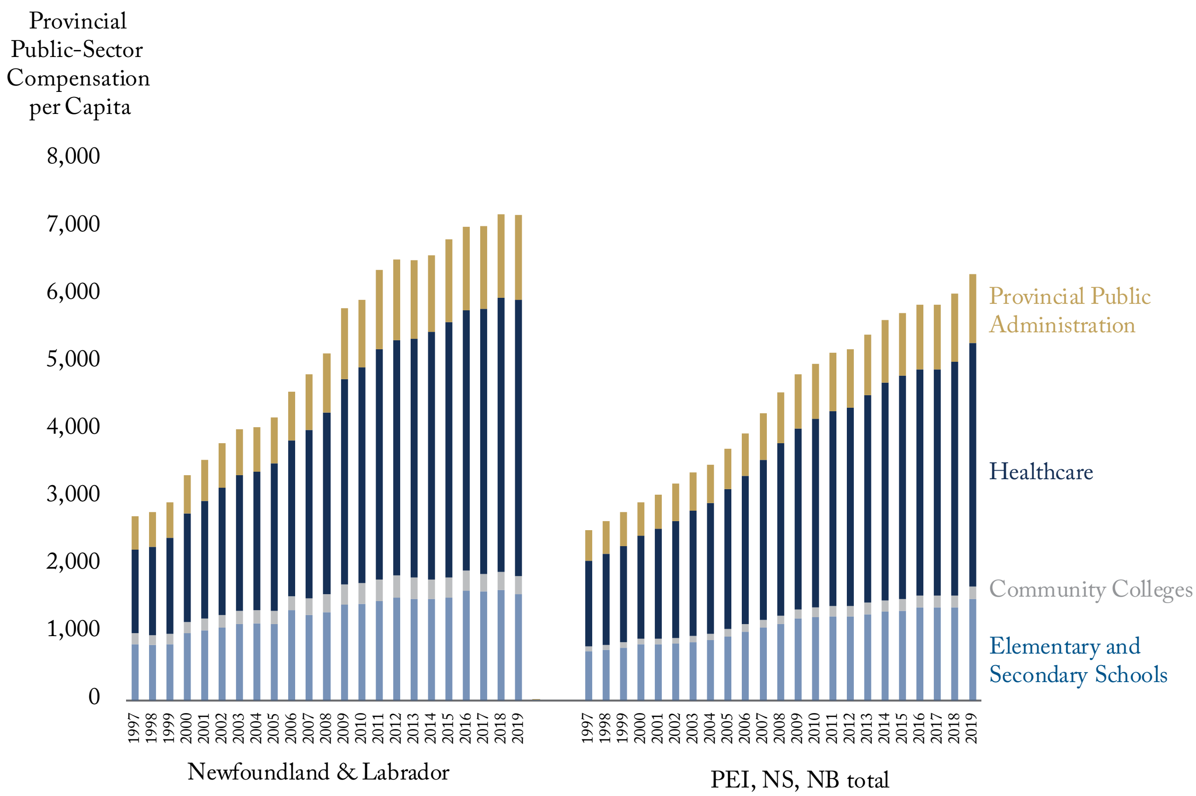
Note: Provincial public-sector components include elementary and secondary schools, community colleges, healthcare, and provincial public administration. This analysis does not include Crown corporation employees or university employees.

Source: Statistics Canada Table 36-10-0489-01.

Two clear conclusions can be drawn from the above analysis. The first is that to put its finances back on a sustainable track, Newfoundland and Labrador will have to bring its program spending down much closer to levels in other provinces. The second is that containment of total compensation for provincial public-sector employees will have to be a big part of the plan to reduce spending.

We calculate that total compensation costs per Newfoundland and Labrador public employees was 16 percent higher than those 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. Bringing provincial public-sector compensation per capita in Newfoundland and Labrador closer to the provincial average within five years will require measures to reduce the number of employees and measures to limit compensation per employee.

Figure 5: Provincial Public-Sector Compensation per Capita – Main Components, 1997-2019



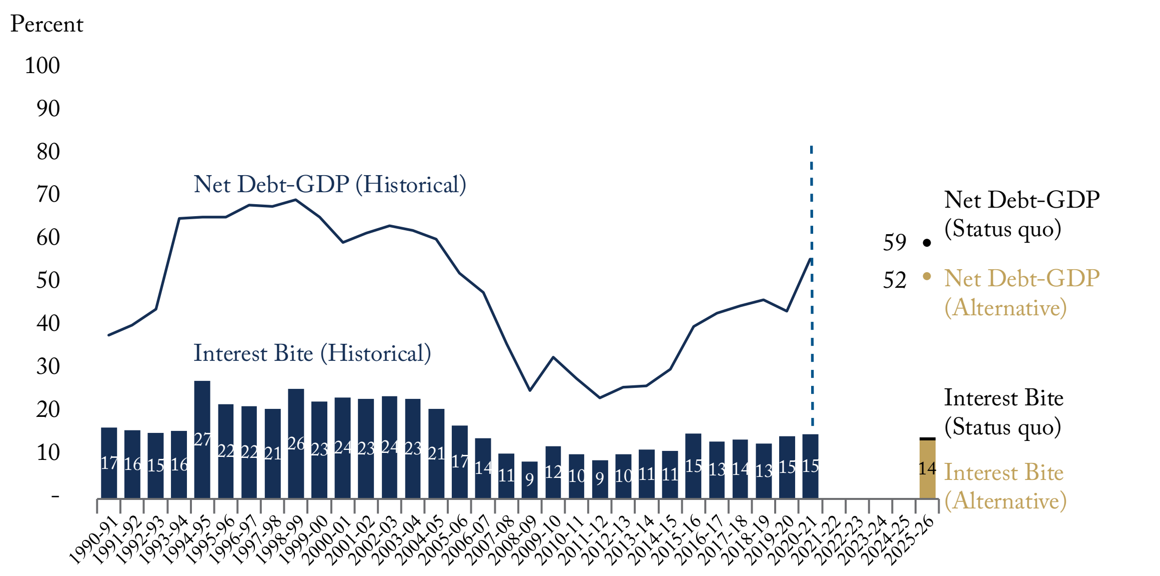
Note: Provincial public-sector components are: elementary and secondary schools, community colleges and CEGEPs, healthcare, and provincial public administration.

Source: Statistics Canada Table 36-10-0489-01.

A Balanced Budget Scenario for Newfoundland and Labrador is Hard, but Doable

The above analysis points to Newfoundland and Labrador's fiscal challenge being mainly the result of high program spending. This background does suggest that the focus of fiscal consolidation should be on lowering spending. Further, there is evidence that fiscal austerity based on spending reduction is less negative for economic performance than tax increases. For example, Alesina et al. (2019) conclude that "we find that spending-based plans are remarkably less costly than tax-based plans." Asset sales can certainly be part of the mix. But asset sales tend to produce one-time fiscal gains while Newfoundland and Labrador faces a longer-term, structural fiscal problem. And some asset sales jeopardize associated revenue flows. Finally, some tax increases

Figure 6: Net-Debt-GDP Ratio and Interest Bite Showcasing Status-quo (blue) and New (Gold) Scenarios



Note: See Figure 1.

Source: See Figure 1.

may eventually be in order.[6] But, given the findings of Alesina et al. on the economic cost of tax increases, we do not see how tax hikes could constitute the bulk of the urgently needed fiscal consolidation effort.

To secure a better fiscal future, we produce a scenario chosen for illustration that produces a balanced budget by 2025/26 (see the last column of Table 1). Reflecting the discussion on spending, we assumed that the province makes all the changes required to shift from the "status quo" to a balanced budget through lower program spending (plus the induced benefit of lower deficits in reducing public debt charges). For the reasons discussed above, higher taxes do not play a role in the drive to a balanced budget in this scenario. Further, we assume the balance is achieved in a straight line over six years from this year's deficit of $1.8 billion (Figure 6).

The alternative scenario is much more favourable than the "status quo." By design, a large deficit becomes a balanced budget by 2025/26. The debt burden in 2025/26 is 51.6 percent instead of 59.4 percent. But the 51.6 percent would be higher than any debt burden from 2006/07 through 2019/20. Interest payments would take 13.6 cents of every revenue dollar instead of 14.2 cents. Almost one-seventh of all the province's spending would be eaten up by covering the payments on previous debt. That still would seriously constrain the ability to deliver present and future services.

6 Tombe (2018) estimates that "tax effort" in Newfoundland and Labrador is slightly above the national average but below that in Manitoba, Quebec and the 3 Maritime Provinces. This supports the notion there may be some room for tax increases to play a limited role in fiscal consolidation in Newfoundland and Labrador.

The key parameter in the alternative is the inferred level of program spending in 2025/26, $7.3 billion. That is more than $0.6 billion less than 2020/21 spending of around $7.9 billion. The 2020/21 spending is inflated by pandemic-related measures, so we focus instead on the $7.4 billion level of spending for 2019/20. From that base and given the declining population, hitting program spending of $7.3 billion in 2025/26 would mean holding program spending constant in per capita terms at the 2019/20 base.

Another perspective on the inferred level of program spending in 2025/26 is that the $7.3 billion would take program spending back to where it was in the mid-2010s. The level of real spending would be 22 percent lower in 2025/26 than in the mid-2010s.

Comparing Newfoundland and Labrador's Fiscal Challenge to Other Provinces

It is interesting to compare these calculations to the same sort of exercise done at the beginning of the Commission on the Reform of Ontario's Public Services. Conducted over 2011 and early 2012, the objective the Commission was restraining program spending sufficiently to balance Ontario's budget by 2017/18. In a similar exercise as conducted here, the Commission calculated program spending could only grow around 0.8 percent per annum (a per capita cut of 0.4 percent), with some sectors needing to reduce total spending by more than 2 percent.[7]

In 2019, the "MacKinnon Panel on Alberta's Finances" estimated that in order to balance Alberta's budget in 2023/24, program spending would need to be cut 1.2 percent from the level of 2018/19, meaning annual average decreases of 0.3 percent.

Newfoundland and Labrador's challenge as set out here (flat per capita spending from a 2019/20 base) is less severe in per capita terms than the calculations done for Ontario and Alberta. To a considerable degree this is, however, due to the expectation of population decline in Newfoundland and Labrador and that presents its own challenges as the absolute size of the public service would need to shrink to reflect the shrinking "client base."

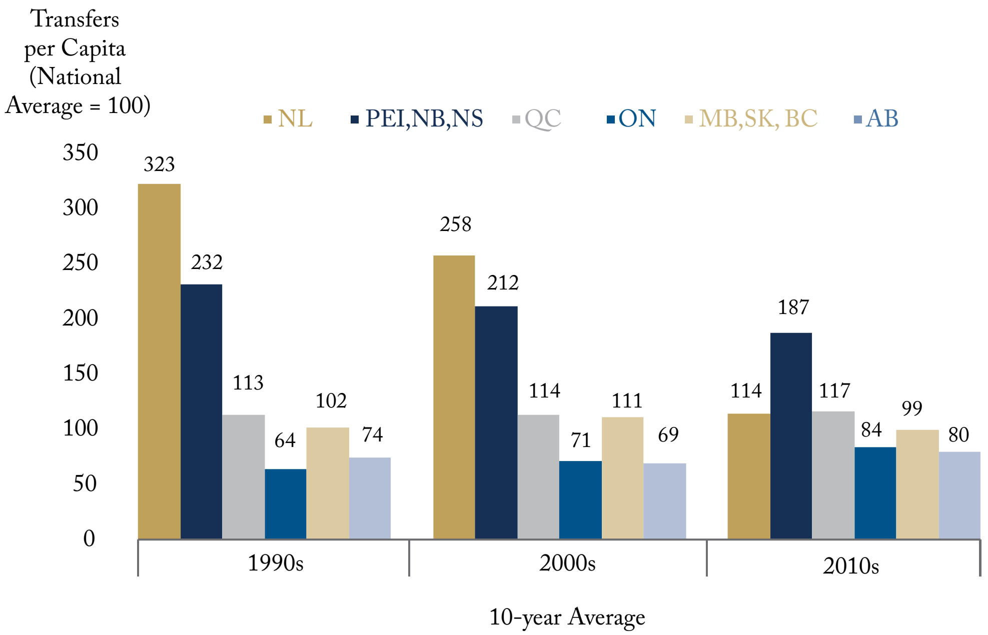
The reports for other provinces and the exercise here for Newfoundland and Labrador focus on the goal of balancing the budget, but while a balanced budget in Ontario would have produced a debt ratio of 37 percent in the target year, 2017-18, the debt ratio when Newfoundland and Labrador hits a balanced budget would be 51.6 percent, 40 percent higher. That high debt burden for Newfoundland and Labrador suggests a balanced budget by 2025/26 is an interim target. Only additional fiscal restraint could bring the debt burden down further.

The Role of the Federal Government

Health and social transfers combined with equalization related payments comprise the bulk of federal transfers to provinces. Since 2014, all provinces have received the same level of per capita health and social transfers. Equalization payments are made to cover the difference between the measured fiscal capacity of a province and the program standard for the year. Prince Edward Island, New Brunswick, Nova Scotia, Quebec and Manitoba

7 The Commission's analysis of spending components led to the following recommendations to adhere to that total spending constraint: Healthcare – plus 2.5 percent; Education (primary and secondary) – plus 1.0 percent; Post-secondary (excluding training) – plus 1.5 percent; Social services – plus 0.5 percent; All other programs – minus 2.4 percent.

Figure 7: Federal Transfers Per Capita



Sources: Fiscal reference tables published by Finance Canada in October 2019 and quarterly population numbers from Statistics Canada. Territories are not included in calculation of national average.

have been in receipt of equalization payments each year. Ontario, Saskatchewan and British Columbia have received payments for some years during the period, while Newfoundland and Labrador received equalization or offset payments until 2012. The results in Figure 7 are thus predictable, with levels under 100 for non-equalization receiving provinces and highest for the equalization receiving provinces with the lowest fiscal capacity.[8]

A look at the numbers for Newfoundland and Labrador demonstrates that the deterioration of the fiscal situation of the province occurred despite levels of federal financial support to that province being much higher than those provided to other provinces for decades before 2012. In the period between 1990 and 2012, federal transfers to Newfoundland and Labrador were in fact about 40 percent higher on a per capita basis than those received by the Maritime provinces, in large part because of equalization offset payments under the Atlantic Accord (1985) and a subsequent arrangement (2005) that totalled about $5 billion over the period. There appears to be a correlation between the large equalization offset payments made to Newfoundland and Labrador as result of the 2005 arrangement and the increases in provincial program spending to unsustainable levels in the following years. Newfoundland and Labrador ceased to receive offset or equalization payments in 2012. It

8 While not shown separately, transfer numbers for equalization-receiving Manitoba are in line with the relative fiscal capacity of that province; that is, lower than those of the Maritime provinces and higher than those of Quebec.

may become eligible again for equalization payments should oil prices remain low and its overall revenues fall below the program fiscal capacity cap. The fiscal projections shown above assume this does not happen before 2026.

In the current situation, it may be in fact appropriate for the federal government to continue to provide exceptional support to provinces so that they can both respond to the pandemic and continue to deliver core services. As long as this support is time-limited and provided on comparable terms to all regions of the country, this should neither discourage responsible fiscal management on the part of provinces nor fuel interregional tensions. This would help Newfoundland and Labrador in the short term. That said, all governments in Canada will have to face tough fiscal decisions in the years ahead to put their finances back into shape. Maintaining a principled approach to fiscal arrangements remains essential to the continued effectiveness of Canada's decentralized fiscal structure.

The situation with respect to the Muskrat Falls project deserves special consideration. It is likely that the project would not have gone ahead without the loan guarantee provided by the federal government. Also, as explained above, the cost overruns have pushed the debt related to the project to a level such that it appears unrealistic to expect electricity ratepayers in the province to bear it alone. As discussed above, the province should reduce the rate of return it is demanding from its investment in the project while the federal government should consider assuming financial responsibility for a portion of the Muskrat Falls project debt. Any such federal relief should be contingent on strong actions on the part of the province to bring its spending significantly closer to that of other provinces. Formal conditionality for federal relief could be restricted to the performance of Nalcor, such as in reducing costs, or could extend to broader provincial actions.

Looking forward

Newfoundland and Labrador has structural economic and fiscal problems that will not go away with recovery from the 2020 woes from the pandemic and collapsing oil prices. The province needs to strengthen its economic growth prospects. The Economic Recovery Team will no doubt look at that. 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. But that must be considered as only an interim goal since it would still leave the province vulnerable to its high debt.

Most of the fiscal effort must come from spending that the province allowed to grow higher than other provinces, such as in the rest of Atlantic Canada, on the assumption of ever high offshore revenues. 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, labor 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 and could potentially result in legal challenges. 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. 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. A limited contribution could likely be made from various excise taxes and user fees. 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.

If average annual surpluses of $1.0 billion were recorded 2026/27 to 2030/31 and nominal GDP growth averaged 1.5 percent per annum, the debt burden would continue to decline from the 51.6 percent shown in Table 1 for 2025/26 to 35.9 percent in 2030/31. This would take the debt burden back to where it was in 2007/08. If the average effective interest rate on public debt continued to decline, interest charges would go from the 13.6 cents on the revenue dollar in 2025/26 to under 10 cents by 2030/31. Such implications for the long-term emphasize the point made at the outset: the issues before Newfoundland and Labrador go well beyond ensuring economic recovery. And they go beyond the province itself.

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