Policy Forum: Newfoundland and Labrador’s Debt Strategy—Waiting for a Saviour or Godot?

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P R É C I S
Lorsque le gouvernement de Terre-Neuve-et-Labrador est entré en fonctions à la fin de 2015, il a déclaré que le déficit prévu pour l’exercice en cours serait presque le double de celui prévu par le gouvernement précédent. Le nouveau gouvernement a ensuite adopté une position budgétaire très offensive dans son premier budget déposé en avril 2016. Cependant, à la suite de la démission de la ministre des Finances en juillet 2017, le gouvernement a semblé changer radicalement de stratégie en adoptant une réponse politique passive à l’aggravation du déficit. Alors qu’au cours des années suivantes le déficit annuel de Terre-Neuve-et-Labrador a diminué, sa dette nette et brute par habitant a grimpé en flèche et a atteint de nouveaux sommets par rapport à celle des autres provinces du Canada. Cet article présente une étude en profondeur de cette expansion et examine les probabilités de succès, à moyen et à long terme, de la stratégie budgétaire actuelle du gouvernement en réaction à l’aggravation de son problème d’endettement.

A B S T R A C T
When the government of Newfoundland and Labrador assumed office in late 2015, it declared that the expected deficit for the current fiscal year would be almost double that which was budgeted for by the predecessor government. The new government then adopted a very aggressive fiscal-policy stance in its first budget, tabled in April 2016. However, following the finance minister’s resignation in July 2017, the government seemed to dramatically change its strategy, adopting a passive policy response to the worsening deficit situation. While in subsequent years Newfoundland and Labrador’s annual deficit has fallen, its net and gross debt per capita have ballooned and reached new heights relative to Canada’s other provinces. This article presents an in-depth investigation of this expansion and examines the probabilities of success, in the medium and long term, of the government’s current fiscal strategy as a response to its deepening debt problem.

K E Y W O R D S: DEBT ■ DEFICIT ■ FISCAL PLANNING ■ NEWFOUNDLAND AND LABRADOR ■ FISCAL SUSTAINABILITY ■ PROVINCIAL DEBT

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INTRODUCTION

Budgetary deficits are recorded when a government’s explicit and implicit expenditures in any given year outstrip its revenues for that year.1 Debt accumulation is simple to understand: deficits that are not counterbalanced through the acquisition of financial assets or by budgetary surpluses in other years accumulate as government debt obligations. However, it is more difficult to determine whether public-sector debt accumulation is the manifestation of good government policy, designed to fund needed infrastructure, or a tangible demonstration of a fiscal crisis, requiring immediate and drastic government action. Alternatively, debt finance may simply reflect a short-term fiscal problem that can be addressed by a deliberate plan executed within a reasonable time frame.

Compounding any assessment of a government’s debt burden is the fact that there is not one universally accepted indicator of a fiscal crisis; rather, there are many indicators2 that can be used for this purpose. Additionally, there is no general agreement as to the precise threshold for any of those indicators at which a particular debt profile transforms from good public policy to a full-blown fiscal crisis. In

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1 Explicit expenditures—actual cash outlays incurred in the year under consideration—are illustrated by the hiring of public-sector employees and the purchase of software. Implicit expenditures, such as the interest costs associated with unfunded pension liabilities and other post-retirement employment benefits, are reported, under accrual-based budgeting, when the liability is incurred even though the associated payments may be made many years in the future. Implicit revenues are recorded when earned even if they are not received until later. For instance, on April 1, 2019, the government of Newfoundland and Labrador and the government of Canada, as part of their renegotiation of the Atlantic accord, reached an agreement that provided the province with a “new and guaranteed revenue stream that will deliver $2.5 billion to the province”: Newfoundland and Labrador, Executive Council, “Landmark Atlantic Accord Agreement Achieved,” News Release, April 1, 2019 (www.releases.gov.nl.ca/releases/2019/exec/0401n07.aspx). While this agreement would provide “fixed cash installments from 2019 until 2056,” the provincial treasury would actually receive $135 million in 2019; however, under accrual-based budgeting, the total of $2.5 billion was recorded as revenue and the treasury recorded a surplus of $1.9 billion: Newfoundland and Labrador, Department of Finance, 2019 Budget, Budget Speech, April 16, 2019, at 10 (www.gov.nl.ca/budget/2019/wp-content/uploads/sites/2/2019/04/Budget-Speech-2019.pdf).

2 These might include, for example, net debt per capita, net debt as a percentage of gross domestic product (GDP), and debt as a percentage of total revenue.
other words, it is important to appreciate that there is substantial subjectivity and interpretation associated with any analysis of the debt burden.

This article focuses on debt management in Newfoundland and Labrador. We begin with a description of the province’s fiscal context. We then present a comparative interprovincial assessment of fiscal indicators, which is followed by an evaluation of the specific factors that contribute to Newfoundland and Labrador’s fiscal circumstances. We discuss planning options for the way forward, and summarize our findings in a brief conclusion.

FISCAL CONTEXT

Newfoundland and Labrador is unique in ways that make it both amenable to and challenging for analysis of the evolution of its current net debt situation. Prior to offshore oil production in late 1997, the provincial government had reported only two small, cash-based budgetary surpluses since its Confederation with Canada in 1949. As shown in figure 1, another eight cash-based surpluses occurred between 1997-98 and 2018-19. In other words, in the nearly 70 years since Newfoundland (and Labrador) became a province of Canada, 85 percent of those years were characterized by deficits. These protracted deficits exacerbated Newfoundland and Labrador’s current debt problem.

Newfoundland entered Confederation with a pre-union surplus, recording $8.1 million as its first cash-based budgetary surplus in 1949-50, which at the time was equivalent to approximately $25 per capita and 4 percent of gross domestic product (GDP). However, over the next 28 years, Newfoundland reported only one other cash surplus (of $9.4 million in 1995-96). From 1949-50 to 1997-98, the provincial finances had accumulated cash deficits of $5.1 billion. Even though another small cash surplus of $3.8 million occurred in 1998-99, Newfoundland and Labrador’s best fiscal performance occurred between 2005-06 and 2011-12, inclusive; we refer to this period as “the seven golden years.”

During those years, revenues from offshore oil contributed to seven consecutive cash surpluses totalling $5.1 billion (with the largest, $2.2 billion, occurring in 2008-09), or an average annual cash surplus of $728 million. Unfortunately, the next seven years were a period

3 Net debt is equal to gross debt minus financial assets. Currently these assets include the historic costs associated with funding commitments relating to the Muskrat Falls project, an issue dealt with in more detail below.
4 According to Newfoundland’s first provincial budget, the cash surplus on March 31, 1949 was $41.4 million and the public debt was $81.5 million. Newfoundland, Department of Finance, 1950 Budget, Budget Speech, April 26, 1950, at 17-18.
5 While the province’s experience may not be of biblical proportions, Genesis 41:28 provides an apt analogy: “Seven years of great abundance are coming throughout the land of Egypt, but seven years of famine will follow them. Then all the abundance in Egypt will be forgotten, and the famine will ravage the land. The abundance in the land will not be remembered, because the famine that follows it will be so severe” (www.biblegateway.com/passage/?search=Genesis+41%3A15-38&version=NIV).
of fiscal famine: the cumulative cash deficit in 2012-13 to 2018-19 was $9.2 billion, the average annual cash deficit was $1.3 billion, and the cash deficit peaked at $2.6 billion in 2015-16, which was the highest in the province's history.

From 1994-95 onward, the government of Newfoundland and Labrador reported its public accounts on an accrual accounting basis. The first accrual-based surplus, $133 million, occurred in 1997-98. From 2005-06 to 2011-12 (the seven golden years), the province reported $5.7 billion in cumulative budget surpluses, resulting in an average annual surplus of $810 million and peaking at $2.4 billion.⁶ And from 2012-13 to 2018-19 (the years of fiscal famine), the provincial government faced accrual-based deficits, which totalled $6.4 billion, peaked at $2.2 billion in 2015-16, and averaged $910 million per annum.

Newfoundland and Labrador’s recent fiscal situation has been volatile, reflecting imprecise predictions of oil prices and uncertainty emanating from non-renewable

⁶ An accrual-based deficit of $33 million was reported in 2009-10.
resource markets. We illustrate this volatility by focusing on fiscal sustainability indicators analyzed for three distinct periods, with representative years that are a decade apart. Specifically, we consider

1. the current fiscal problem, represented by fiscal year 2018-19;
2. the seven golden years associated with offshore oil production and illustrated by fiscal year 2008-09; and
3. the earlier fiscal challenges prior to the full revenue impacts of offshore oil and reflected by fiscal year 1998-99.

NEWFOUNDLAND AND LABRADOR RELATIVE TO OTHER CANADIAN PROVINCES

Figure 2 indicates that in 2018-19 Newfoundland and Labrador's net debt per capita, at $29,340, was 64 percent higher than the average for all other provinces ($17,867). As well (but not shown in figure 2), this level of debt per capita was 77 percent higher than the average for the other three Atlantic provinces ($16,611) and exceeded the average for the next closest province, Ontario (at $23,633), by 24 percent.7

In 1998-99, before the full revenue impacts of oil development in Newfoundland and Labrador were realized,8 the province’s net debt per capita ($14,543) was 161 percent of the average for all other Canadian provinces ($9,022). The largest gap and the largest difference occurred in 2004-05, when the province’s net debt per capita ($22,976) was 248 percent of the average in the rest of Canada ($9,278). Although Newfoundland and Labrador’s net debt per capita increased by 7.1 percent between 1998-99 and 2008-09, the province’s relative position improved, falling from 161 percent to 152 percent of the average for all the other provinces. Newfoundland and Labrador’s net debt per capita in 1998-99 was the second-highest in Canada, surpassed by Quebec, at $17,295. However, with a subsequent increase of 88 percent between 2008-09 and 2018-19 (from $15,577 to $29,340), Newfoundland and Labrador has recorded the highest level of net debt per capita of any province. Therefore, by this measure, Newfoundland and Labrador’s fiscal position has deteriorated over the last 20 years.

As shown in figure 3, except for fiscal year 2008-09, when Newfoundland and Labrador posted the largest surplus per capita of any province (at $4,595), the province has recorded a higher deficit per capita, relative to the other provinces, over the last 20 years. It ranked highest (at $347) in 1998-99, and second-highest (at $1,050)

7 Our calculations are based on Canada, Department of Finance, Fiscal Reference Tables (www.fin.gc.ca/pub/trt-trf/index-eng.asp) and Statistics Canada table 17-10-0005-01, “Population Estimates on July 1st, by Age and Sex.”
8 Oil production commenced at the end of 1997, but the revenue flows to the provincial government were low in the first several years of production because of low profitability, and the threshold rates of return for the profit-sensitive royalties were not exceeded.
in 2018-19, behind Alberta (at $1,558). As well, from 1994-95 onward, Newfoundland and Labrador has experienced higher debt charges per capita than any other province. In both 1998-99 and 2018-19, the province’s debt cost per capita was $1,867, while the average for all the other provinces in those years was $812 and $803, respectively. The corresponding debt cost estimates for Newfoundland and Labrador and for all other provinces in 2008-09 were $1,456 and $694 per capita, respectively. Measured by the size of the per capita deficit, the situation in Newfoundland and Labrador has grown worse in recent years.

Surprisingly, despite having accumulated the highest net debt per capita of any province, in the last 20 years Newfoundland and Labrador simultaneously recorded the highest revenues per capita and its expenditures per capita surpassed those for all other Canadian provinces. By way of illustration,

- in 1998-99, Newfoundland and Labrador’s revenues per capita were 122 percent of the average for all other provinces, while its expenditures per capita were 127 percent of the average;
- in 2008-09, the province’s revenues per capita were 184 percent and its expenditures 132 percent of the average for the other provinces; and
- in 2018-19, the province’s revenues per capita were 126 percent and its expenditures 132 percent of the average for all other provinces.
Furthermore, for these periods, Newfoundland and Labrador’s per capita revenues and expenditures exceeded the levels in every other province, not just the average for all other provinces. In other words, in per capita terms, the province had more revenue to spend than other provinces, spent more than other provinces, and incurred more debt than other provinces.

As shown in table 1, the revenue impacts associated with oil royalties and associated corporate income taxes were the primary driver of Newfoundland and Labrador’s elevated revenues per capita. The highest direct impact of oil revenues on the provincial treasury occurred in 2011-12, when 43.2 percent of provincial revenues were accounted for by the sum of royalties ($5,323 per capita) and corporate income taxes from offshore oil activities ($116 per capita). As well, the Atlantic accords of 1985 and 2005 provided more than $5 billion to Newfoundland and Labrador. The peak impact for the 2005 agreement occurred in 2008-09. From that year onward, Newfoundland and Labrador no longer qualified for equalization; as a consequence, $2,254 per capita ($1.2 billion) in payments advanced under the 2005 accord could no longer be deferred and was recorded as revenue in the public accounts. As well, in 2008-09, the 1985 Atlantic accord transferred $1,088 per capita to the provincial treasury.

In the seven golden years (2005-06 to 2011-12), when cash surpluses totalled $5.1 billion and accrual-based surpluses totalled $5.7 billion, the 1985 and 2005 accords transferred $4.5 billion to the provincial treasury. Clearly, the negotiation
| Fiscal year | NL own revenues | Federal revenues |
|-------------|-----------------|-----------------|
|             | Oil royalties   | Corporate income tax, oil | Other | 1985 accord | 2005 accord | Equalization entitlements | Other |
| 1994-95     | 3,413           | 0                | 1,668 | 1,309 |            |               |         |
| 1995-96     | 3,833           | 0                | 1,607 | 1,164 |            |               |         |
| 1996-97     | 3,977           | 0                | 1,767 | 1,053 |            |               |         |
| 1997-98     | 1               | 0                | 1,829 | 1,837 |            |               |         |
| 1998-99     | 7               | 0                | 2,184 | 1,213 |            |               |         |
| 1999-00     | 45              | 0                | 1,986 | 1,052 |            |               |         |
| 2000-01     | 75              | 0                | 2,268 | 1,061 |            |               |         |
| 2001-02     | 59              | 0                | 2,042 | 1,033 |            |               |         |
| 2002-03     | 156             | 0                | 1,750 | 969   |            |               |         |
| 2003-04     | 245             | 90               | 1,415 | 1,165 |            |               |         |
| 2004-05     | 512             | 105              | 1,528 | 1,147 |            |               |         |
| 2005-06     | 1,035           | 219              | 1,674 | 1,355 |            |               |         |
| 2006-07     | 829             | 329              | 1,345 | 1,424 |            |               |         |
| 2007-08     | 3,446           | 342              | 1,604 |       |            |               |         |
| 2008-09     | 4,376           | 241              | 1,658 |       |            |               |         |
| 2009-10     | 4,105           | 370              | 2,090 |       |            |               |         |
| 2010-11     | 4,597           | 447              | 2,149 |       |            |               |         |
| 2011-12     | 5,323           | 116              | 2,016 |       |            |               |         |
| 2012-13     | 3,473           | 152              | 1,885 |       |            |               |         |
| 2013-14     | 4,031           | 159              | 1,935 |       |            |               |         |
| 2014-15     | 2,957           | 183              | 1,904 |       |            |               |         |
| 2015-16     | 973             | 160              | 2,003 |       |            |               |         |
| 2016-17     | 1,853           | 33               | 2,082 |       |            |               |         |
| 2017-18     | 1,785           | 0                | 2,239 |       |            |               |         |

Sources: Authors’ calculations based on Newfoundland and Labrador, Department of Finance, Public Accounts (St. John’s: Department of Finance, various years); and Statistics Canada table 17-10-0005-01, “Population Estimates on July 1st, by Age and Sex.”
of the Atlantic accord in 1985 and the revision of the accord in 2005 were significant factors affecting fiscal performance during that period.

Finally, it is interesting to note that in 2008-09, the accords and oil revenues combined accounted for 48.6 percent of provincial revenues. While revenue per capita has fallen in recent years, expenditures per capita have not. Consequently, the province's fiscal situation has not improved.

Newfoundland and Labrador’s net debt was equivalent to 199 percent of its total revenue in 2018-19, the same value as in 1998-99. The province’s relative position improved dramatically in 2008-09, when it was in the middle of all provinces with net debt equivalent to 92 percent of its total revenue. Newfoundland and Labrador, with net debt equivalent to 199 percent of its total revenue in both 1998-99 and 2018-19, was second only to Prince Edward Island (at 200 percent) in 1998-99 and to Ontario (at 220 percent) in 2018-19. When one considers the amount of additional revenue that would be required to offset net debt, it is clear that the province’s situation has not improved.

The interest bite\(^9\) for Newfoundland and Labrador outpaced the average for all other provinces in 1998-99 and 2018-19. Debt charges as a percentage of total revenue declined from 25.5 percent (or about $1 for every $4) in 1998-99 to 12.8 percent (about $0.50 for every $4) in 2018-19. In 2008-09, the province’s debt cost per dollar of revenue was in the middle of the pack, with the province allocating slightly more than $1 of every $12 to service its public debt. While the interest bite has been reduced, the province still has the highest cost of borrowing among the provinces, and the improvement is due primarily to the decrease in the overall cost of borrowing in Canada.\(^{10}\)

While per capita indicators reveal some of the burden of Newfoundland and Labrador’s net debt obligations, suggesting that the burden has become more severe both in absolute terms and relative to other provinces, converting these indicators into their GDP equivalents provides a slightly different perspective. Figure 4 illustrates how net debt as a percentage of GDP has evolved and how Newfoundland and Labrador performs relative to the other provinces.\(^{11}\) For every year except 2011-12 to 2014-15, Newfoundland and Labrador’s net debt as a percentage of GDP exceeded the average for all other provinces.

In 2017-18 and 1998-99, Newfoundland and Labrador’s debt obligations relative to its GDP (44.4 percent and 69.6 percent, respectively) exceeded the average

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9 The interest bite is the percentage of revenue needed to service the debt, or the amount of each dollar collected that goes to debt costs.

10 The average yield on long-term (10+ years) government bonds declined from 9.29 percent in June 1994 to 1.7 percent in June 2019. See CANSIM series V122487, “Government of Canada Marketable Bonds—Average Yield—Over 10 Years.”

11 At the time of writing, nominal provincial GDP data were available from Statistics Canada up to and including 2017; therefore, the corresponding data for the 2017-18 fiscal year are the data for the last year discussed for the GDP indicators.
reported for all other provinces (30.2 percent and 29.4 percent, respectively). However, in 2008-09—one of the seven golden years—the province ranked in the middle of the other provinces. Even with the relative improvement brought about by enhanced oil revenues in 2008-09, Newfoundland and Labrador’s debt obligations in that year (25.2 percent of GDP) still surpassed the average for the rest of Canada (20.8 percent). While the relative position of the province by this measure appears to be slightly better than its position based on per capita data, the situation has clearly deteriorated in recent years, even controlling for GDP.

Newfoundland and Labrador’s deficit as a percentage of GDP (2.8 percent in 2017-18 and 1.7 percent in 1998-99) exceeded the average for all other provinces (0.3 percent) and was larger than the percentage reported for every other province in those years. Interestingly, for 2008-09, the province reported a surplus equivalent to 7.4 percent of GDP, which was the largest of any province reported between 1994-95 and 2017-18.12

FIGURE 4 Net Debt as a Percentage of GDP, Newfoundland and Labrador Compared to the Average for All Other Canadian Provinces, 1994-95 to 2017-18

GDP = gross domestic product.

Sources: Authors’ calculations based on Canada, Department of Finance, Fiscal Reference Tables (www.fin.gc.ca/pub/rrr-trf/index-eng.asp); and Statistics Canada table 36-10-0222-01, “Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual.”

12 Our calculations based on Canada, Department of Finance, Fiscal Reference Tables, supra note 7, and Statistics Canada table 36-10-0222-01, “Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual.”
Newfoundland and Labrador’s debt cost as a percentage of GDP in 1998-99 (8.9 percent) and 2017-18 (3.0 percent) exceeded the average for all other provinces (2.6 percent and 1.4 percent, respectively). In 2008-09, Newfoundland and Labrador, with debt costs as a percentage of GDP at 2.4 percent, was the third-highest province, behind New Brunswick (3.4 percent) and Quebec (2.6 percent). The fiscal position of the province is seen as getting worse when this indicator is utilized as well.

**SPECIFIC DRIVERS OF THE PROVINCE’S FISCAL CIRCUMSTANCES**

Having provided some perspective on Newfoundland and Labrador’s debt performance relative to that of other Canadian provinces, we will now analyze the components and drivers of the province’s debt. The most recent public accounts provide data up to 2017-18 and report $14.7 billion in net debt for the province, made up of $22.5 billion in liabilities offset partially by $7.9 billion in financial assets (see figures 5, 6, and 7).

The province’s 2019 budget reported that net debt was estimated to rise to $15.4 billion in 2018-19 and fall back to $13.8 billion in 2019-20. The forecasted decline in net debt is the result of the renegotiation of the Atlantic accord between the government of Newfoundland and Labrador and the government of Canada in April 2019. Specifically, this agreement provided the province with a “new and guaranteed revenue stream that will deliver $2.5 billion to the province.” Using accrual-based accounting, the province applied the $2.5 billion in future revenues to its current budget. This enabled the government to report an expected surplus of $1.9 billion in 2019-20; however, according to the Dominion Bond Rating Service (DBRS), without this additional revenue source, the province would have recorded a deficit of $577 million.

Despite this good fortune bestowed on the province, Newfoundland and Labrador’s fiscal position has not changed. In a recent interview, the minister of finance, Tom Osborne, noted that the government’s deficit reduction plan aims to return the province to surplus by 2022-23, but he indicated that he “won’t sacrifice services in order to get there.” Of course, that position has direct implications for the province’s willingness to cut expenditures in order to alleviate its fiscal problems; in another interview, the minister “acknowledged that government spending is still

13 Newfoundland and Labrador, 2019 Budget, supra note 1.
14 Newfoundland and Labrador, Executive Council, News Release, supra note 1.
15 Michael Connors, “No New Credit Rating Downgrade, but Tom Osborne ‘Won’t Sacrifice Services’ To Get to Surplus,” NTV, September 26, 2019 (http://ntv.ca/no-new-credit-rating-downgrade-but-tom-osborne-wont-sacrifice-services-to-get-to-surplus/).
16 Ibid.
The government’s optimism appears to centre on the hope that the oil industry will expand and generate sufficient revenues to mitigate the province’s fiscal difficulties, so that no adjustment to expenditures will be needed. This will allow the government to kick the can down the road one more time.

As shown in figure 5, from 1994-95 to 2017-18, the province’s liabilities increased by 145 percent (from $9.2 billion to $22.5 billion), but its financial assets increased by 229 percent (from $2.4 billion to $7.9 billion). Consequently, net debt (liabilities minus financial assets) increased by 115 percent (from $6.8 billion to $14.7 billion). As well, despite the recent improvement resulting from the $2.5 billion in additional Atlantic accord monies, net debt has been growing since 2011-12, driven by new bond issues in response to large deficits.

Except for the most recent period, post-retirement employment benefits have made up a large share of the province’s outstanding liabilities (see figure 6). In 2006-07, these liabilities amounted to $3.3 billion, or 25.1 percent of provincial liabilities; by 2015-16, they had more than doubled, increasing to $7.4 billion and

FIGURE 5  Financial Assets, Liabilities, and Net Debt, Newfoundland and Labrador, 1994-95 to 2019-20

Sources: Newfoundland and Labrador, Department of Finance, Public Accounts (St. John’s: Department of Finance, various years); and Newfoundland and Labrador, Department of Finance, 2019 Budget, April 16, 2019.

17 “DBRS Maintains NL Credit Rating, but Outlook Remains Challenging for Province,” VOCM, September 26, 2019 (https://vocm.com/2019/09/26/dbrs-credit-rating-nl/).
FIGURE 6 Composition of Liabilities, Newfoundland and Labrador, 1994-95 to 2019-20

| Fiscal year | Borrowings | Unfunded pension liabilities | Group health and life insurance | Other liabilities |
|-------------|------------|------------------------------|---------------------------------|------------------|
| 1994-95     |            |                              |                                 |                  |
| 1995-96     |            |                              |                                 |                  |
| 1996-97     |            |                              |                                 |                  |
| 1997-98     |            |                              |                                 |                  |
| 1998-99     |            |                              |                                 |                  |
| 1999-00     |            |                              |                                 |                  |
| 2000-01     |            |                              |                                 |                  |
| 2001-02     |            |                              |                                 |                  |
| 2002-03     |            |                              |                                 |                  |
| 2003-04     |            |                              |                                 |                  |
| 2004-05     |            |                              |                                 |                  |
| 2005-06     |            |                              |                                 |                  |
| 2006-07     |            |                              |                                 |                  |
| 2007-08     |            |                              |                                 |                  |
| 2008-09     |            |                              |                                 |                  |
| 2009-10     |            |                              |                                 |                  |
| 2010-11     |            |                              |                                 |                  |
| 2011-12     |            |                              |                                 |                  |
| 2012-13     |            |                              |                                 |                  |
| 2013-14     |            |                              |                                 |                  |
| 2014-15     |            |                              |                                 |                  |
| 2015-16     |            |                              |                                 |                  |
| 2016-17     |            |                              |                                 |                  |
| 2017-18     |            |                              |                                 |                  |
| 2018-19     |            |                              |                                 |                  |
| 2019-20     |            |                              |                                 |                  |

Sources: Newfoundland and Labrador, Department of Finance, Public Accounts (St. John’s: Department of Finance, various years); and Newfoundland and Labrador, Department of Finance, 2019 Budget, April 16, 2019.

representing 45.5 percent of total provincial liabilities. In the 2019-20 budget, these liabilities are expected to increase to $8.0 billion. The rate of growth has slowed, in part because of a change in the governance structure of provincially funded pension plans and the issuance of a promissory note, which effectively committed the province to converting its post-retirement employment benefit liabilities into explicit debenture debt outside the pension funds, or to pay a fixed amount each year from general revenue.18

It is also worth noting that a large portion of the province’s financial assets results from equity in government business enterprises (GBE), which increased from $0.6 billion, or 24.4 percent of financial assets, in 1994-95 to $5.1 billion, or 65.4 percent, in 2017-18 (see figure 7). As well, a significant amount of GBE equity is made up of equity in Nalcor Energy, in general, and the Muskrat Falls project in particular. Since Muskrat Falls is not yet operational and has experienced significant

18 In 2014-15, the province and its unions changed the governance structure of its pensions and established joint and equal participation in the sponsorship and management of the Public Service Pension Plan; it also committed to a promissory note to pay off the unfunded pension liability at the time over a 30-year period. A similar arrangement was made with the Teachers’ Pension Plan in the following year.
cost overruns, the price of electricity within the province, in the absence of a mitigation plan, is expected to double; however, the provincial government has committed to developing a mitigation plan that will avoid this result.

At the time of writing, the details of the mitigation plan are not known, but it could have significant consequences for the net debt situation of the province. If the price received by Nalcor Energy is not consistent with the equity value, that value will have to decrease and provincial net debt will increase correspondingly. This issue is dealt with in more detail below.

**THE WAY FORWARD**

As noted above, the provincial government has forecasted a return to surplus in 2022-23; however, it is unlikely that this goal will be achieved within that time frame. Our skepticism emanates from a couple of observations. First, the provincial economy is returning to more normal levels of economic activity, rather than being bolstered by activities associated with large construction projects such as Muskrat Falls or development of the Hebron offshore oil field. Second, the province’s population is aging rapidly and shrinking in absolute size. The demographic effects are expected to be manifested through two routes: (1) many baby boomers are now retiring or...
will be retiring over the next decade; and (2) a continued increase in net outmigration is anticipated as people leave the province in search of employment and improvement of their personal circumstances.

There are negative forces affecting the province’s fiscal balance, even with the recent assistance from the federal government associated with adjustments to the Atlantic accord. As shown in the public accounts, on the expenditure side of the budget, health-care expenditures are the largest component of provincial expenditures, and these will be strongly influenced by demographics. Public-sector salaries are also a large component of expenditures, and these costs are obviously determined by the number of people on the provincial payroll and their compensation rates, including fringe benefits. The number of public-sector workers per 1,000 in Newfoundland and Labrador’s population is well above the Canadian average. The rates of compensation on a weekly level have been consistent with the all-province average, but well above regional levels. Compensation commitments for public-sector workers occur not only during their working lives, but also after retirement until death or the death of the worker’s spouse. Our investigation reveals that these future costs can be effectively transferred to the next generation. The question is whether the shrinking population will have the income or the borrowing capacity to fund these financial obligations when they become due. At the time of the 2008 financial crisis associated with housing debt in the United States, we saw that a solution for individual homeowners was to default on their mortgages and move. A more equitable or moral solution perhaps is to prepare now for the future.

The paradox is that Newfoundland and Labrador, with the highest revenue per capita of any province, is also the province with the highest gross (and potentially net) debt per capita. It is helpful to consider the issues and associated evidence in more detail.

First, we consider the elephant in the room—demographics. Figure 8 provides a picture of the province’s demographic profile in 2016. The predominance of baby boomers stands out. The so-called echo, which is often seen in other population profiles, is entirely absent, perhaps because of outmigration. Newfoundland and Labrador has a very low fertility rate; in 2017, at 1.33, it was the lowest rate of any province and well below the replacement rate of 2.11 children (for a representative woman aged 15-49). The rate can be expected to fall further as the province’s economy deteriorates. Our forecast is that the number of deaths in 2019 will exceed 5,000 while the number of births will be less than 4,000; therefore, the province’s population will experience a further natural decline. As well, a loss of construction jobs and perhaps future attrition in the public sector could result in an increase in interprovincial outmigration, which would probably not be offset by an increase

19 Newfoundland and Labrador, Public Accounts 2017-18 (St. John’s: Department of Finance, 2018).

20 Newfoundland, Department of Finance (www.gov.nl.ca/fin/economics/pop-projections/).
in international immigration. In summary, the province’s population is declining, and we believe that this trend can be expected to accelerate.

Figure 9 shows that Newfoundland and Labrador suffered a rapid population decline from around 1992, the beginning of the fishing moratoria, until around 2007. During the seven golden years, there was a period of population growth, stimulated by increases in oil prices and royalties and in corporate profits, along with increased employment in the public and construction sectors. After 2012-13, as the construction of some larger projects began to wind down, so naturally did employment, and the population began to fall.

As shown in figure 9, the population estimate for 2019 is 521,542, a drop of almost 4,062 from 2018. A recent (August 2019) population projection made by the province’s Department of Finance also has the population declining over the next decade, using the low-growth scenario predicted in the budget, but the decline is far slower than that in our prediction and in Statistics Canada’s. The trend line shown in figure 9 suggests that population growth in the medium term can be difficult to predict. However, given the province’s very low fertility rate and the large presence of older baby boomers, there is some consensus that the population will fall below 500,000 in the next decade or two.

Figure 10 shows the sources of revenue for the government of Newfoundland and Labrador from 1994-95 to 2017-18, as reported in the public accounts. Historically, personal income tax has represented the single most important source of

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FIGURE 8 Age Cohorts by Gender, Newfoundland and Labrador, 2016

Source: Compiled by Newfoundland and Labrador, Department of Finance, Community Accounts Unit, based on information provided from Statistics Canada, 2016 Census of Population.

21 Special tabulations provided by the Labour Statistics Division of Statistics Canada.
FIGURE 9  Population Estimates and Projections, Newfoundland and Labrador, 1986-2038

Notes: The fast-aging scenario contains the following assumptions at the Canada level: the total fertility rate reaches 1.40 children per woman in 2042-43 and remains constant thereafter; life expectancy at birth reaches 88.0 years for males and 91.3 years for females in 2067-68; interprovincial migration is based on the trends observed between 1991-92 and 2016-17; the immigration rate reaches 0.65 percent in 2042-43 and remains constant thereafter; the annual number of non-permanent residents reaches 1,080,910 in 2043 and remains constant thereafter; the net emigration rate reaches 0.18 percent in 2042-43 and remains constant thereafter.

The slow-aging scenario contains the following assumptions at the Canada level: the total fertility rate reaches 1.79 children per woman in 2042-43 and remains constant thereafter; life expectancy at birth reaches 85.6 years for males and 88.8 years for females in 2067-68; interprovincial migration is based on the trends observed between 1991-92 and 2016-17; the immigration rate reaches 1.08 percent in 2042-43 and remains constant thereafter; the annual number of non-permanent residents reaches 1,944,400 in 2043 and remains constant thereafter; the net emigration rate reaches 0.13 percent in 2042-43 and remains constant thereafter.

Sources: Newfoundland and Labrador, Department of Finance, Economic and Project Analysis Division; and Statistics Canada: for 1986-2019, table 17-10-0005-01, “Population Estimates on July 1st, by Age and Sex”; for 2020-2038, table 17-10-0057-01, “Projected Population, by Projection Scenario, Age and Sex, as of July 1 (× 1,000)."
Two factors give cause for concern with respect to the prediction of provincial revenues over the medium term. First, as illustrated in figure 11, the number of jobs in the construction industry is falling and perhaps returning to historical levels. In the peak year, 2015, employment in this industry represented just over 14 percent of total employment in the province.22 The jobs in electric power engineering construction are associated with the Muskrat Falls hydroelectric dam and the Labrador to Newfoundland transmission line. These jobs pay well, but both projects are nearing completion. As they come to an end over the next two years, some workers will likely move out of the province while others may remain and take lower-paying jobs (if these are available).

The second factor of concern is the aging population. Figures 12 and 13 help to illustrate the potential problem. Figure 12 shows the average levels of provincial revenues; in 2017-18, it contributed just over 20 percent of total revenues. Two factors give cause for concern with respect to the prediction of provincial revenues over the medium term. First, as illustrated in figure 11, the number of jobs in the construction industry is falling and perhaps returning to historical levels. In the peak year, 2015, employment in this industry represented just over 14 percent of total employment in the province.22 The jobs in electric power engineering construction are associated with the Muskrat Falls hydroelectric dam and the Labrador to Newfoundland transmission line. These jobs pay well, but both projects are nearing completion. As they come to an end over the next two years, some workers will likely move out of the province while others may remain and take lower-paying jobs (if these are available).

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22 Statistics Canada table 36-10-0480-01, “Labour Productivity and Related Measures by Business Sector Industry and by Non-Commercial Activity Consistent with the Industry Accounts.”
income tax payable by age group for selected years between 2000 and 2018. The pattern is expected and may be reassuring, given the large increase between 2016 and 2018 for individuals in their prime earning years (ages 40-59). However, we note the sharp drop in average taxes payable for the 65-69 cohort compared to the 60-64 cohort; our estimate shows a decrease from $4,850 to $2,320 (not quite 50 percent). Figure 13 illustrates the demographic wave. Currently, the largest age cohort is the group of individuals aged 60-64. Many of these individuals are expected to retire in the next five years, and the vast majority will have retired by the end of the next decade. Increased efficiencies and technological change, along with increased competition for a dwindling core-age labour force, suggest that Newfoundland and Labrador will have a relatively smaller population of wage earners in the near term.

The other side of the treasury coin is that individuals receive transfers from government. However (as shown in figure 14), the bulk of the transfer burden, primarily for older adults (aged 65+), falls on the federal government, with payments through the Canada Pension Plan, old age security (OAS), and the guaranteed income supplement (GIS). Income support transfers by the provincial government basically disappear for those aged 65+ in the presence of the federal transfers of OAS and GIS, as do workers’ compensation payments for retirees.
FIGURE 12  Average Provincial Income Tax Payable by Age Cohort, Newfoundland and Labrador, Selected Years, 2000-2018

Tax payable ($)

Source: Simulations using Statistics Canada, Social Policy Simulation Database and Model (SPSD/M), v. 27.1, September 2019.

FIGURE 13  Distribution of Population by Age Cohort, Newfoundland and Labrador, Selected Years, 2000-2018

Number of individuals

Source: Simulations using Statistics Canada, Social Policy Simulation Database and Model (SPSD/M), v. 27.1, September 2019.
Given the employment and demographic trends outlined above, the question is whether the provincial government can alter the cards it is dealt in terms of personal income taxes. The brief answer is, “Probably not.” The province’s current personal income tax rates are generally in line with those in other provinces. Moreover, the provincial government has promised not to raise taxes. The challenge for the government may be to keep wealthier taxpayers in the province, since this group is often the most mobile.

It should also be noted that many workers in the provincial public sector effectively have their base wages frozen, except for step increases, until 2020 as part of “no-layoff” agreements with public sector unions. In conclusion, the most likely medium-term scenario is that personal income tax revenues will fall.

Sales taxes are the second most important source of tax revenue for the provincial government. Figure 15 shows the general upward movement of both personal income tax and sales tax revenues in the 2010–2017 period. This trend began with the recovery after the 2008 financial crisis, followed by some tax increases. Sales taxes in Newfoundland and Labrador, like income taxes, are now in line with those in the other Atlantic provinces. Further increases seem unlikely in the short run, given regional harmonization of tax rates and political promises. It is interesting to note that Newfoundland and Labrador’s Department of Finance has estimated that future revenues from these two tax sources are not expected to be quite as high as the recent historical levels. Our instinct is that these two sources of revenue will decline in nominal and real (inflation-adjusted) terms. At the same time, we acknowledge that it is extremely difficult, if not impossible, to predict revenues beyond a
Planning for debt sustainability therefore requires prudent, longer-term, risk management.

With respect to personal taxes, another observation is interesting and relevant. While most of us acknowledge and complain about the wide variety of personal taxes that we pay, we tend to be less aware of the transfers we receive. Our simulations using Statistics Canada's SPSD/M 27.1 program estimate that for 2019 just over one-half (50.5 percent) of all households in Newfoundland and Labrador are net contributors to the federal and provincial governments. Our calculations include all direct taxes, such as personal income taxes, and all indirect commodity taxes, such as general sales taxes and gasoline taxes. The percentage of net contributors varies by family type; for example, about 8.7 percent of single elderly individuals are net contributors, compared to 80.5 percent of married non-elderly individuals with no children living at home. The top 5 percent of households in the province, by total income, will contribute about 27.4 percent of all direct taxes in 2019. Whether or not the tax burden could be increased is a value judgment. However, there is likely to be resistance to any proposal to raise taxes, as evidenced by the current concern

Sources: For actual revenues, Newfoundland and Labrador, Department of Finance, Public Accounts (St. John's: Department of Finance, various years); for forecasted revenues, Newfoundland and Labrador, Department of Finance, Estimates (St. John's: Department of Finance, 2019).

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23 Social Policy Simulation Database and Model.
over an increase in household electricity rates to assist in covering the costs associated with the Muskrat Falls project.

The great hope on the revenue side lies with potential oil royalties. The rationale for such hope can be seen in figures 16 and 17. From 2005-06 to 2012-13, oil prices and production levels were high, and the jewel in the Exxon-Mobil crown, Hibernia, had unexpectedly reached payout (that is, the consortium had recovered its asset costs associated with the offshore platform). With relatively low operating costs per barrel and high prices in US dollars for Brent oil, profits and royalties were high. Forecasting oil royalties can be a risky business. While the general discussion revolves around demand and supply, evoking images of competitive market forces, non-competitive and geopolitical forces also play a formative role, as does rapidly changing technology. One only has to consider the change in market prices in September 2019.

The prospect of substantial oil field development in the years ahead appears promising. Oil fields in the region are often in deeper water, implying higher production costs and risk. The question is, if new viable discoveries are made, when will these fields come into production, and how much will the oil be worth on the market over their lifetime? The Canadian picture has become more complicated with the changes to the regulatory environment enacted by Bill C-69. In our view, it is unlikely that new development and production (excluding the White-Rose extension, the development of which is under way), will occur before 2030. This perspective seems to be consistent with that of the federal and provincial governments, as reflected in federal gap funding to be made available under a revised Atlantic accord.

Could royalty rates be increased for existing projects? We think not, given that these rates are set before development occurs and, when the government is not the primary developer, are subject to international competitive forces. Because of changing technology with respect to production and development, as well as the potential for falling prices, supply-side stakeholders have become and will continue to be more cost-conscious. The implication is that there will be a reduction in the economic benefits to the province during the development stage—for example, through new construction jobs or more business for local suppliers—compared to projects undertaken in the recent past.

In conclusion, on the revenue side of the government’s future financial statements, there is not much room for manoeuvring with respect to the province’s own revenue sources in the medium term. Given our earlier observations on the aging population, the winding down of large resource-development projects, and out-migration, we are in accord with projections that traditional revenue sources might decline. However, we acknowledge the adjusted revenue inflow from the federal government through the Atlantic accord. The issue is the rate and duration of

24 Bill C-69, An Act To Enact the Impact Assessment Act and the Canadian Energy Regulator Act, To Amend the Navigation Protection Act and To Make Consequential Amendments to Other Acts, SC 2019, c. 28, royal assent June 21, 2019.
revenue loss. By our estimation, a number of factors could accelerate the decline around 2022—though we reiterate our caution about the reliability of predictions extending beyond the next three or four years. The variability is evident from figure 18.

On the expenditure side, figure 18 shows that provincial government expenditures have remained remarkably constant in current-dollar terms since about 2014. A conjecture is that expenditures rose when revenues rose (primarily owing to increased oil production).

Perhaps, then, it is easy to understand why some might believe that oil revenues could be the solution to the province’s fiscal problems. However, as we have explained earlier in this article, the underlying causes of the present debt situation are complex and thus not amenable to an easy remedy. Moreover, there is public resistance to a reduction in expenditures, in nominal dollars.

As well, the major public-sector unions have negotiated an agreement with the provincial government in which general wages do not increase in return for no layoffs. The agreement is in place until 2020. The result is that real wages adjusted for inflation are falling. Economic theory would predict that, at some point, it will be difficult to attract new entrants into the labour force if wages in other jurisdictions are increasing. The number of provincial civil servants per 1,000 residents is

FIGURE 16  Royalty Payments to the Government of Newfoundland and Labrador—Actual, 1994-95 to 2017-18, and Forecasted, 2018-19 to 2019-20

Sources: For actual payments, Newfoundland and Labrador, Department of Finance, Public Accounts (St. John’s: Department of Finance, various years); for forecasted payments, Newfoundland and Labrador, Department of Finance, Estimates (St. John’s: Department of Finance, 2019).
higher than is generally the case in other provinces and, in particular, in the neighbouring provinces of New Brunswick and Nova Scotia. The average weekly wages for Newfoundland and Labrador's civil servants are also higher.

A common justification for Newfoundland and Labrador’s higher provincial expenditures is that the province has a large rural population that is very spread out. This observation is true, but then so is it true for many other provinces in Canada. To our knowledge, interprovincial cost comparisons have not been carried out specifically for rural areas. The general public may find Newfoundland and Labrador’s current expenditure pattern acceptable, since government jobs pay well and there is an urgent need for secure employment in rural areas, where traditional jobs in fishing, fish processing, and logging are in decline. To the extent that the government provides employment opportunities, the argument goes, it may help to slow population decline through outmigration and aging.

The number of individuals in electoral constituencies tends to be lower in rural areas than in urban areas, and correspondingly, the number of voters per rural member of the provincial legislature is relatively low. That fact, coupled with few newcomers in these communities, leads to fewer degrees of separation between the local politician and her or his constituents. Bluntly put, it is hard to close beds in a local hospital when those who need beds may be relatives, friends, or neighbours.

Sources: For actual data, Newfoundland and Labrador, Department of Finance, Public Accounts (St. John’s: Department of Finance, various years); for forecasted data, Newfoundland and Labrador, Department of Finance, Estimates (St. John’s: Department of Finance, 2019).
The politician is therefore faced with conflicting priorities. Fiscal realities and economic efficiency may play second fiddle to sociopolitical considerations. Often, rural communities are defined by the presence of a school or a community health centre.

The above observations do not solve the fiscal sustainability problem, but they may help to explain the province’s procrastination in dealing with it. While kicking the can down the road may not be the best solution from an economic perspective, it may be the only solution from a political perspective.

The new entrant into the fiscal room is the Muskrat Falls hydroelectric project. The problems associated with this project are not unique to the province, but they are representative of its history. While the final construction costs associated with Muskrat Falls can be estimated, the future revenues cannot. Even in the short run, the revenues from users are unlikely to cover the legally required cash outlays. Is the

25 In our opinion, it was probably these considerations that caused the current government to abandon its previous proactive, deficit-reducing strategy when the former finance minister, Cathy Bennett, resigned in July 2017; the government adopted a new, passive approach under the current finance minister, Tom Osborne.
project sustainable? It may be, with an infusion of cash from investors or from a saviour.

Normally, any analysis of fiscal sustainability involves invoking GDP, such as the debt-to-GDP ratio. While such an approach may have loose validity when the factors of production and associated incomes are internally held, and perhaps the debt is also, the Newfoundland and Labrador economy does not fit this traditional mould. The economy is very open, with natural resource exports playing a large role in final goods output. Specifically, over the past couple of decades, oil production has been of increasing importance, but has fallen off since 2008. Moreover, oil royalty regimes are determined before development projects are approved. The implication is that the provincial government has little ability to alter the capture of incomes generated by oil sales. In a similar manner, justifying public goods expenditures by reference to percentages of GDP, rather than population, makes little sense in a situation where much of the economic output is generated by capital-intensive natural resource industries predominantly owned by non-residents.

CONCLUSION

In summary, while Newfoundland and Labrador's future looks bright if the province's natural resources and the associated rents are properly managed, the coming decade will be a challenge. There is a fiscal deficit gap to be dealt with. The government's current strategy seems to be “steady as she goes,” combined with warnings about future expenditure reductions and the promise of future balanced budgets. For the reasons outlined in this article, we believe that the government's objectives will be very difficult to achieve over the next decade. Another part of the current strategy is the implicit understanding that the federal government will produce an innovative intervention. Such interventions are not new to the province, nor to the former dominion. The prospect of default on the debt of the Dominion of Newfoundland during the Great Depression in November 1932 resulted in the establishment of a commission of government in 1934, in which seven members were representatives of the British government and three were from Newfoundland. The commission's mandate was to govern in such a way as to produce a sustainable and efficient public sector. A second intervention occurred after the declaration of a northern cod moratorium by the federal government in July 1992. The northern cod adjustment and replacement program was instituted to provide income support to processors and fish harvesters who lost income because of the moratorium. The federal government's guarantee on bonds issued to finance the Muskrat Falls project, as well as its recent infusion of front-end funding to the province under the Atlantic accord, contributes, we believe, to a general understanding of a federal backstop, or a saviour, should fiscal unsustainability become a reality. In such event, the question is whether the federal government would impose conditions on the provincial government in exchange for its financial support. Our casual belief is that there would be no explicit conditions. One confounding observation is that currently the revenue per capita of the government of Newfoundland and Labrador is
the highest of any province; thus, Newfoundland and Labrador is a “have” province and consequently denied access to equalization funds under current arrangements.

Our final thought is that the province’s fiscal situation may not be sustainable in the medium term. The government’s current strategy is to maintain expenditures, in nominal terms, as well as the existing tax structure, while looking to Ottawa for medium-term assistance (as evidenced by recent adjustments to the Atlantic accord). As we have noted, history has demonstrated the success of this strategy. What history has not previously shown is Newfoundland and Labrador as the richest “have” province in Canada. In the longer term, the belief is that the province’s saviour is to be found in its recent past experience and the hope of its future repetition with major oil discoveries and high oil prices. Without a saviour, the path is clear: Another year older and deeper in debt. Rather than waiting for Godot, who never arrives, the province hopes that its fiscal saviour will come soon.