NEWFOUNDLAND AND LABRADOR, FROM AUSTERITY TO PROSPERITY – AND BACK TO AUSTERITY (?):

Planning to Avoid a Financial Crisis

BY DR WADE LOCKE

THE TWENTY-FOURTH IN A SERIES OF ARTICLES DEVELOPED FROM REGULAR PUBLIC FORUMS SPONSORED BY THE LESLIE HARRIS CENTRE OF REGIONAL POLICY AND DEVELOPMENT. MEMORIAL PRESENTS FEATURES SPEAKERS FROM MEMORIAL UNIVERSITY WHO ADDRESS ISSUES OF PUBLIC CONCERN IN THE PROVINCE.

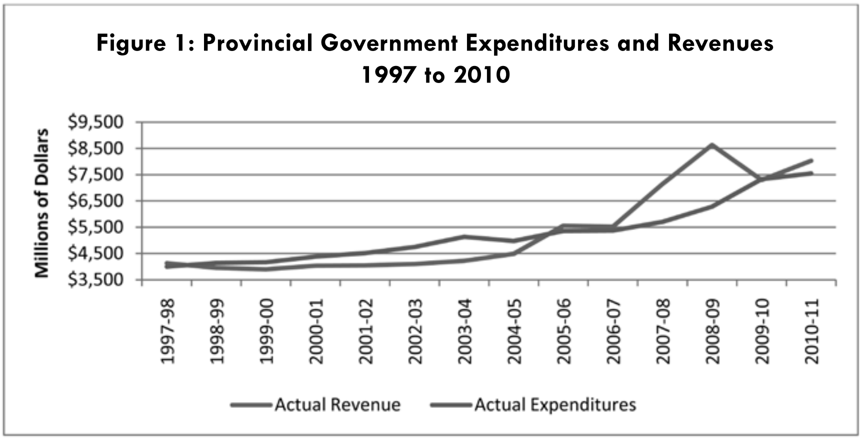
Over the last 15 years, Newfoundland and Labrador has been transformed from a relatively poor province, with little hope of things getting better in the medium to longer term, to one of the fastest growing and most affluent regions of the country. The economic transformation has been incredible. This is illustrated by the fact that from 1981 to 2010 Newfoundland and Labrador's Gross Domestic Product (GDP) per capita has increased by 550%, growing from $8,959 to $58,214. During the period prior to oil production, 1981-1997, per capita GDP more than doubled, rising from $8,959 to $19,119, but after oil production commenced in 1997, per capita GDP grew by a further 200% (increasing to $58,214 in 2010). Not only has Newfoundland and Labrador's economic activity grown in absolute terms, it has increased relative to the national average. Specifically, Newfoundland and Labrador's per capita GDP grew from 61.7% of the Canadian average in 1981 to 64.8% in 1997 to 122.2% in 2010, with a peak of 130% occurring in 2008. It is noteworthy that this turn-around in per capita GDP relative to the national average is the fastest improvement in the history of the country. In fact, the growth in economic activity from 1997 to 2010 has exceeded all other provinces.

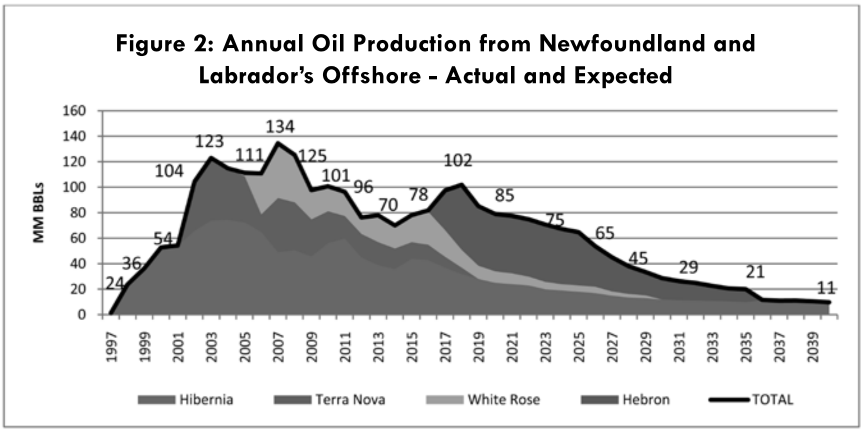
During the many austere years, Newfoundland and Labrador was one of the poorest provinces in Canada; dependent upon the presence of the equalization program to have the wherewithal to provide essential public services; burdened by massive debt, which peaked at almost $12 billion in fiscal year 2004-05; crippling out-migration (75,000 more people left the province than moved to it since 1990); and a declining population.[1] With the collapse of the cod stocks and the subsequent moratorium in 1992, there was little hope for improvement and the predictions for the province's economy and finances were dire. The public funds that were available had to be used sparingly, resulting in physical and social infrastructure with less than optimal investments; per capita debt levels that were the highest in the country; a credit rating that was below those experienced in all other provinces; public sector wage and hiring freezes; depressed public sector wages; and taxes that were some of the highest in the country. As if this were not bad enough, the province was characterized by unemployment rates that were the highest in the country; excessive levels of out-migration; and a population that consistently declined. Although the province's needs were great, the government's financial capacity was limited. Consequently, Newfoundland and Labrador ran deficits for every year from 1994 to 2004, with the exception of a small surplus recorded in 1997-98.

Then came oil! Its impact on the economy and the provincial treasury was great. More than 30% of provincial government revenues were coming from oil royalties and at peak, 40% of the province's economic activity could be traced to oil and gas activities. For the first time in its history, the province has run or is expected to run consecutively fiscal surpluses.[2] As of 2008-09, Newfoundland and Labrador no longer needed equalization and its fiscal circumstances have improved substantially, primarily driven by increased resource revenues flowing to the provincial treasury. The changed circumstances offered the province the

1 Between 1993 and 2008, population fell from 580,819 people to 506,193. This has increased slightly to 508,410 people in the second quarter of 2011.

2 For six of the last seven years, the province has recorded a fiscal surplus. To mitigate the negative impacts of the 2009 recession, the provincial government increased expenditures on infrastructure, resulting in a small deficit of $33 million in fiscal year 2009-10.





revenues and expenditures have doubled; expenditures grew by 4.6% per annum while revenues grew by 4.7% per annum, enabling the provincial government to run multi-year surpluses.

Unfortunately, non-renewable natural resources accounted for the majority of the new-found prosperity and these will eventually run out. Furthermore, while the provincial treasury will have received $5 billion in cash payments under the 1985 and 2005 Accords, 2011-12 will be the last year for these programs. In 2011-12, the provincial government is entitled to receive $540 million as a result of the 1985 Atlantic Accord.

As shown in Figure 2, Newfoundland and Labrador oil production, from the three operating projects and the one project in development,[3] peaked at 134 million barrels in 2007. By June 30, 2011, the cumulative production from the offshore has surpassed 1.2 billion barrels. The value of output produced to the end of 2010 was $75 billion and, depending on the price of oil, the exchange rate and the assumed rate of inflation,[4] the value of oil that remains to be produced is in the range of $160 to $180 billion. Finally, production from the existing fields operating in the offshore are now in decline.

To date, the Newfoundland and Labrador treasury has received in excess of $10 billion royalties. While, as illustrated in Figure 3 (p. 41), the treasury can expect to receive another $42 billion in royalties, the average royalty payments will increase in the short term, but decline dramatically in the medium term. In particular,

possibility of a new beginning, an improved outlook, and a confidence for the future.

Given the improved fiscal circumstances, the pent-up demand was released. The provincial government turned its attention to addressing physical and social infrastructure deficits, providing elevated wages to its public servants and a comprehensive suite of public services for its constituents. There was a sense of entitlement. People who had shouldered the burden in hard times were now expecting to share in benefits associated with the province's good fortune. With the ebullience of good times, no one stopped to ask: what now?

Although there was some money paid on the debt (e.g., the $2 billion upfront payment from the 2005 Atlantic Accord was used to offset the unfunded liabilities associated with the teachers' pension fund), it was still at unacceptable and unsustainable levels ($8.7 B in Budget 2011-12). As well, public expenditures grew at levels that could not be sustained unless revenues continue to grow at unbelievable and unexpected levels. As illustrated in Figure 1, from 1998-98 to 2011-12,

3 The three operating projects are Hibernia with an estimated 1.4 billion barrels of recoverable reserves, Terra Nova with slightly more than 400 million barrels, and White Rose (and North Amethyst) with almost 375 million barrels. The project in development is Hebron and it is expected to produce more than 600 million barrels over its productive life.

4 The price scenario used for this calculation was taken from the publicly available July 1, 2011, oil price forecast from GLJ Consultants www.gljpc.com, an exchange rate at par and a 2% annual inflation rate.

the annual royalties for 1996-2000 averaged $18 million per year, which increased to $218 million per annum during 2001-2005 and to $2.4 billion per year in the most recent five-year period ending in 2010. For the next five-year period, 2011-15, the provincial government is expected to receive $2.5 billion per annum, after which average annual provincial royalties will fall off significantly – $1.8 billion in 2016-2020, $1.4 billion in 2012-2025 and $0.9 billion in 2026-2030.[5]

Figure 3: Provincial Offshore Royalties - Actual and Estimated

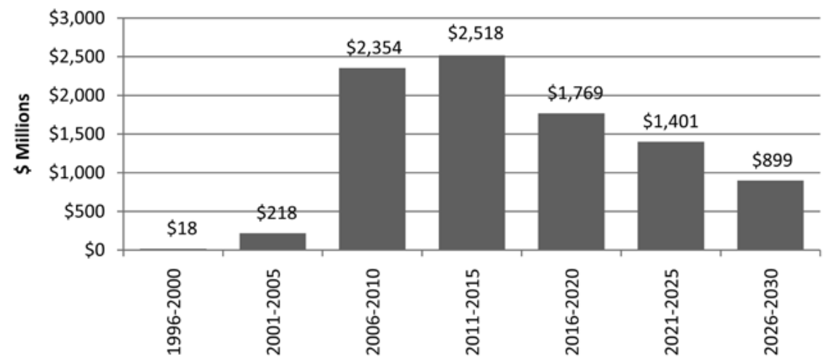
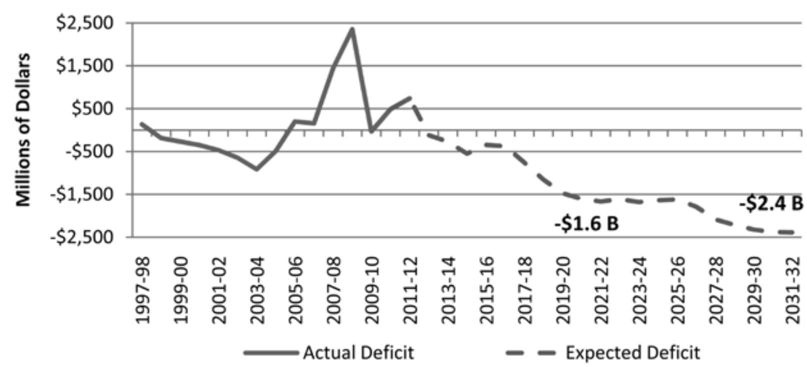


Figure 4: Actual and Expected Provincial Deficits



The annual fall-off of $1.6 billion in oil royalties and the $500 million in Atlantic Accord payments will not be offset by other revenue sources such as mining projects, other energy developments[6] or other provincial developments in the next 20 to 25 years. Even assuming no real growth in expenditures, the province is estimated to run deficits in the next five years in the range of $330 million per year. By 2020-21, the annual provincial deficit could reach $1.6 billion and grow to $2.4 billion by 2030-31. At this rate, provincial debt will double within 10 to 12 years.[7]

These economic circumstances are such that the provincial government will have to deal with these fiscal realities sooner rather than later; especially since expectations and entitlements are now built into the system. Whether the timeframe for action is five or ten years, taking no action will make the situation unmanageable within a relatively short period of time. Hence, Newfoundland and Labrador needs to plan to bring its expenditures back in line with the anticipated revenues. This should involve broad-based consultations to define expenditure needs and priorities. It should also include a realignment of expenditure to enable a Heritage Fund and a formal debt reduction strategy that will see debt reduced to a manageable level.[8] We need to plan for the future by recognizing the constraints that we are expected to face; deal with them realistically; define our priorities and move forward with a plan for sustainable expenditures and debt levels. Newfoundland and Labrador does not need to face a financial crisis, but we do have to plan to avoid one! NQ

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5 It is important to appreciate that if higher prices were to prevail than those used in this analysis, provincial royalties will be larger than indicated in Figure 2, but the pattern illustrated would be similar. That is, in the medium term, provincial royalties expected from the offshore will fall dramatically.
6 For instance, the development of the Muskrat Falls development will add between $100 and $200 million per annum to the provincial treasury in the next 25 years, before debt associated with the project is paid off.
7 Although higher prices than were assumed in this analysis will improve the situation, the deficit and debt problems will still persist. With higher prices, it may take another five years before debt actually doubles.

8 A manageable level of debt for Newfoundland and Labrador could be in the $4 to $6 billion range.