Newfoundland and Labrador Fiscal Review

By Hugh Mackenzie

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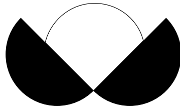

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Changes in provincial governments in Canada are almost invariably accompanied by questions about the financial circumstances left behind by the outgoing administration. The change of government in Newfoundland and Labrador in the fall of 2003 was no exception.

The first news release issued by Premier Danny Williams after his government was sworn in on November 6, 2003 announced a request for proposals for an independent review of the province's finances. The next day, Premier Williams commissioned the consulting firm of Pricewaterhouse Coopers (PWC) to conduct the review.

The PWC report was delivered to the government just before Christmas 2003. Helpfully titled (from the government's perspective) "Directions, Choices and Tough Choices" the report was released publicly on January 5, 2004 along with the Premier's "State of the Province" response.[1]

The report highlighted two principal conclusions: that the current year's budget introduced in May, 2003 by the previous government understated the deficit for the current year; and that the budget could not be brought into balance by the previous government's target year of 2007-8. Indeed, it forecast a dramatic and continuing deterioration in the fiscal situation that could not be reversed without draconian actions.

In his response, Premier Williams touched on all of the expected themes, from program cuts to public sector wage restraint. Since then, the government has been engaged in a consultative exercise, which is proceeding as if the only legitimate question is "How much do we have to cut in order to achieve financial stability?" as if the services on which the people of the province depend don't matter.

That is not the only question, of course. Faced with the same facts, we could just as easily be asking a different question: "What do we need to do to be able to afford the public services we need?"

The question matters. Because if you ask the wrong question, you will almost always get the wrong answer. Indeed, the most important issue facing Newfoundland and Labrador today is which question we should be asking.

The first step in addressing this fundamental issue is to get the facts straight. **PART ONE** examines the current and projected future fiscal

1 Pricewaterhouse Coopers, "Special Review of the Financial Condition of the Province of Newfoundland and Labrador: Directions, Choices and Tough Choices", December 22, 2003 referred to hereafter as the PWC report.

situation of the province of Newfoundland and Labrador as it has been presented to the public in the past few months. Does the province have a fiscal problem? And if so, how big a problem is it?

The second step is to identify with as much precision as possible what are the underlying causes of the problem. **PART TWO** looks above and behind the bottom line numbers to expose the key factors that contribute to NL's fiscal situation and prospects.

The third step is to focus on options for change that respond to the key factors that have been identified. If we were to find that increases in expenditures in NL were out of line with the experience in other jurisdictions, or that the compensation paid to public employees in NL were excessively generous relative to that of public employees in other provinces, that might point in the direction currently being suggested by the Government. On the other hand, a different set of underlying problems would point towards a different set of solutions. **PART THREE** develops an alternative package of proposals to address the key issues, and analyzes their likely impact on public services and NL's fiscal situation.

In summary, we find that:

- Newfoundland and Labrador does indeed face a fiscal problem over the next few years, although by no means as significant or as intractable as that forecast in the PWC report.

- Neither public spending nor public sector employees' compensation can legitimately be said to have caused the province's current fiscal problems.

- The primary cause of Newfoundland and Labrador's fiscal problems is a weakness in the province's revenue base. A revised, more realistic forecast of revenue and expenditure shows a persistent cash deficit of between $275 and $300 million a year. While this reveals a structural revenue shortfall, it is far less than the $714 million forecast for 2007-8 by PWC.

- This problem emerged in the early 1990s as the Government of Canada cut back on transfer payments to the provinces. The additional revenue generated by the offshore oil development boom in the late 1990s papered it over temporarily. It was exacerbated by the previous government's decision to get onto the national tax cut bandwagon.

- This problem was not caused by public sector employees' compensation increases, and imposing the wage freezes advocated by both the PWC report and the Premier cannot solve it.

- The chronic and unusually weak funded status of the province's pension plans for public employees contributes directly to the weakness of the government's financial position as presented on an accrual accounting basis. This weak funded status arises directly from the fact that, while public employees were contributing to the plan, prior governments were not. In effect, prior governments were borrowing from their employees' pension plans at zero interest. And with the new accounting rules, those chickens are coming home to roost.

- There is room to improve the province's revenue picture without making dramatic changes to tax levels in the province, and without putting tax levels in this province substantially out of line with tax levels in other similar jurisdictions.

- However, even with the best of efforts towards improving its "own-source" revenues, there can be no long-term answer to the fiscal questions facing NL without addressing declining Federal equalization payments and the related claw-back of oil industry revenue inherent in current fiscal arrangements.

PART ONE: THE FISCAL FACTS

The deficit for 2003-4

In its May, 2003 budget, the Grimes government planned for a deficit of $286 million in 2003-4 and forecast the elimination of the cash deficit by the year 2008.

The forecast deficit for 2003-4 held up reasonably well through the review by Pricewaterhouse Coopers (PWC). The principal variances from the budget projections for 2003-4 were a relatively minor $40 million increase in expenditures, balanced by an equal increase in estimated revenue; and the $220 million cost of buying back the provincial student loan program from the bank that had been managing it.

Its summary findings are presented in **TABLE 1**.[2]

The PWC report cites the $506.6 million cash deficit as evidence that the finances of the province are out of control. However, the additional $220 million attributable to the acquisition of the provincial student loan program is a one-time-only cost that is not a reasonable indicator of the province's longer-term financial situation. The underlying deficit for planning purposes is actually $286.6 million — exactly as forecast at budget time.

The report also cites an increase in the accrual deficit for 2003-4 from $665.9 million to $827.2 million. This increase is explained in part by an increase in the accrued interest and pension costs in Newfoundland and Labrador's under-funded public service pension plans, and in part by the report's recognition, for the first time, of the accrued liability for retirement health and life insurance benefits for public servants.

A substantial proportion of the change cited in the PWC report reflects not deterioration in the province's finances but a change in its accounting methodology. Regardless of the merits of the change, it is hardly reasonable to cite deterioration in the accrual balance resulting from an accounting change as indicative of a change in financial circumstances.

While the distinction between the accrual and cash balances of the Government of Newfoundland and Labrador may not have the dire implications suggested by the PWC report, it does expose an important feature of NL's financing — extensive reliance in the past on borrowing, without interest, from the various public service pension plans.

Cash vs. accrual accounting

Although budget planning in Newfoundland and Labrador has traditionally focused on the cash balance, the report pays particular attention to a second definition of the deficit, based on accounting on an accrual basis.

The cash balance compares the flow of revenue into and expenditures out of the government during the fiscal year. The cash deficit shows the amount that must be borrowed to finance the cash needs of the government during the year.

Accrual accounting compares the income and expenditure obligations accumulated during the year. Expenditures accrue as the obligation to pay

2 Source: PWC report, p. 11.

TABLE 1
Consolidated Accrual Budget
Original Budget and Projected Revised 2003-04

$ millions	Original Budget 2002-04	Projected Revised 2003-04	Variance positive / negative
Provincial own-source revenue and federal transfers	3,688.2	3,728.2	40.0
Expenditures, net of related revenue	3,900.9	3,940.9	(40.0)
Adjustment: Acquisition of student loan program		220.0	(220.0)
Cash balance — surplus / (deficit)	(212.7)	(432.7)	(220.0)
Borrowing requirements, other entities	73.9	73.9	
Budgetary Borrowing Requirements — all entities	(286.6)	(506.6)	(220.0)
Accrual adjustments			
Student aid receivable		(220.0)	
Bad debt expense — Student aid		55.0	
Pension interest and accrued pension cost, net of conributions	301.9	335.9	
Retirement benefits expense for health and life insurance		93.0	
Other amounts	54.5	44.0	
Other entities	24.1	21.4	
Adjustment for capital	(1.2)	(8.7)	
Accrual-based deficit — consolidated summary	(665.9)	(827.2)	

Source: Department of Finance and Treasury Board Secretariat

is incurred, whether or not any cash payment is required at the time. When an obligation to pay is incurred and the corresponding payment is made in the same year, there is no difference between the accrued expense and the cash expense. When an obligation arises in one year for a payment in a future year, the accrual expenditure will differ from the cash expenditure. In the current year, the accrual expenditure will exceed the cash expenditure. In a future year, when the cash actually flows, cash expenditure will exceed accrual expenditure.

The differences between cash accounting and accrual accounting arise from differences in the timing of obligations and payments in three key areas: minor year-end variances; major projects that take more than a year to complete; and obligations for retirement benefits and pensions that accrue during employment.

The original budget estimated the accrual-based deficit at $665.9 million. Of the $379.6 million difference between the cash deficit and

the accrual deficit, 79.5% — $301.9 million — was attributable to the unfunded liability in the pension plans for Newfoundland and Labrador's public employees. The PWC analysis increased the accrued liability in the public employees' pension system to $335.9 million and recognized a new accrued liability of $93.7 million for retirement benefits for public employees.

According to the PWC report, the accrual deficit of $827.2 million is the real indicator of the state of the province's finances. PWC asserts that: "the accrual deficit is THE DEFICIT" [emphasis in original].[3] Although the report refers repeatedly to the accrual deficit in its analysis, it does not go as far as to suggest that the government's objective should be to eliminate it. Why? Because the reality is more complicated than is suggested by the total accrual deficit.

The difference between the accrual and cash deficits for 2003-4 is attributable in part to transitory factors such as changes in currency values and the timing of program and capital expenditures. The two largest components of the difference — and the only ones with long-term significance — are the increased unfunded liability for pensions and for retiree benefits.

Post-retirement benefits have been included in the accrual balance reported by PWC in accordance with Public Service Accounting Board standards. Those standards, in turn, reflect changes within the past ten years in the standards for corporate accounting in the private sector. While it is appropriate to include these liabilities on public balance sheets to reflect properly the government's future obligations, it is not clear how the annual accrual of these liabilities should affect public budgeting. Unlike pensions, post-retirement benefits are not normally funded in advance. Consequently, budgeting for an accrual balance would require the government to run a persistent surplus on a cash basis.

The accrual in the unfunded liability for public employees' pensions is a different matter. Until relatively recently, many Governments in Canada operated pension plans for their employees on a modified pay-as-you-go basis, paying little attention to their funded status and providing for benefits as they become payable. Over the past 25 years, most governments have brought their pension plans for public employees within the framework for pension administration, governance and funding required for private sector employee pension plans. As a result, in most provinces unfunded liabilities in public sector pensions have declined substantially.

The Royal Commission on Newfoundland and Labrador's Place in Canada reported in the summer of 2003 that Newfoundland and Labrador is in a class by itself when it comes to unfunded liabilities for public service pensions. Newfoundland and Labrador has by far the largest unfunded pension liability per capita of any province in Canada. The only province that even approaches the level in NL is the Province of Quebec.[4]

Under-funding relative to legislative standards

TABLE 2
Unfunded pension liabilities — 2002-3

	$ million	$ per capita
Newfoundland and Labrador	3,440	6,620
PEI	240	1,742
Nova Scotia	940	1,004
New Brunswick	320	426
Quebec	37,220	4,971
Ontario	1,960	160
Manitoba	3,190	2,743
Saskatchewan	4,030	4,051
Alberta	4,830	1,532
British Columbia	-	-

3 PWC report, p. 18.

4 Norris, Dave "The Fiscal Position of Newfoundland and Labrador", study for the Royal Commission on Renewing and Strengthening Our Place In Canada, March 2003, p. 36.

amounts to borrowing from pension plans at zero interest. While the province has begun to fund its public service pension plans on a more conventional basis, in prior years it did not. In prior years, public employees made their contributions to the pension fund; the province allowed its required contributions to accumulate, with interest, as unfunded liabilities. In effect, in the past NL has been borrowing from its public service pension plans — at an interest rate of 0%.

In recent years, the province has been contributing more to the pension plan than its share of the benefits currently being earned by its employees. However, this additional contribution covers only a portion of the interest on the unfunded pension liability. In effect, a portion of the unfunded liability generates interest represented by the special payments; the remainder continues as an interest-free loan from the plan to the province.

On a cash basis, the cost of this interest-free loan never appears in the province's accounts. Each year, interest on the unfunded liability (representing the interest on the province's implicit loan from the pension plan) results in the unfunded liability growing — the interest cost is simply converted into more debt and never appears as a cost. On an accrual basis, the interest on the unfunded liability, together with any additional accrued unfunded liability, is included as an expense.[5]

The significance of unfunded pension liabilities in the net debt of the province, and the importance of the interest on those unfunded liabilities in the reconciliation of the cash and accrual deficits makes the financial status of the province's public sector pension plans an important element of the financial status of the entire provincial government.

It also raises important questions about the suggestion currently being made that public employees should be expected to accept wage freezes to assist the province in addressing the accrual deficit. If the province's employees were to contribute their wage increases towards deficit reduction, they would in effect be paying the province's share of the costs of their pensions, as well as their own share — in perpetuity. The unfairness of that expectation, under the circumstances, is transparent.

Projected financial balances to 2007-8

In addition to reviewing the current year's fiscal situation, PWC was asked to evaluate the previous government's announced intention to balance the budget, on a cash basis, by 2007-8.

The PWC report concludes that it will not be possible to balance the budget on a cash basis by 2007-8, and that the deficit will in fact continue to increase in each year until then and beyond. PWC's projections show the cash deficit reaching $710.8 million by 2007-8, with the accrual deficit reaching $1,155.9 million in that year.

PWC's detailed projections for the years 2003-4 to 2007-8 are shown in **TABLE 3**.[6]

If these projections are taken at face value, they set out a financial scenario for the province that is clearly not sustainable. They show both net debt, and the accrual deficit increasing as a share of GDP; and debt servicing costs increasing as a share of provincial revenue.

In fact, however, the projections in the PWC report will tend to overstate the seriousness of Newfoundland and Labrador's fiscal situation, for four reasons: they are based on economic assumptions which are materially more pessimistic than those of the major Canadian chartered banks; they reflect worst-case estimates of revenue from offshore oil, net of federal government equalization transfers; they forecast federal government

5 Details of the pension funding shortfall and its implications for Newfoundland and Labrador's finances are discussed in Appendix I.

6 Source: PWC report, p. 12.

TABLE 3
Projected consolidated accrual deficit, cash deficit and net deficit — PWC report

$ million Accrual	2001-2	2002-3	2003-4 Revised	2004-5	2005-6	2006-7	2007-8
Revenue	4,046.5	4,102.0	4,352.4	4,207.9	4,221.6	4,392.5	4,516.4
Expenditure	4,514.3	4,792.8	5,179.6	5,196.8	5,334.9	5,516.0	5,672.3
Accrual balance	(467.8)	(690.8)	(827.2)	(988.9)	(1,113.3)	(1,123.5)	(1,155.9)
Net Debt			11,587.3	12,574.7	13,630.6	14,695.4	15,796.3
Cash balance	(47.3)	(36.3)	(506.6)	(601.6)	(672.8)	(665.4)	(710.8)

transfers for purposes other than equalization at substantially below even worst-case estimates; and they assume that there is no room for the provincial government to improve its revenue picture by using additional revenue generated from its own sources.[7]

A more-realistic projection to 2007-8

The alternative projection is based on four key assumptions.

1. Projections for real and nominal economic growth are based on the most current projections from the major Canadian chartered banks for years in which such forecasts are available, and on rates consistent with those projections and prior economic performance for years beyond the end of their forecast periods. Average wages and salaries are assumed to increase at the rate of increase in the consumer price index. Forecasts for personal income, personal disposable income and employment are the same as those used in the PWC projections.

The key assumptions are summarized in **TABLE 4**.

2. Expenditures are assumed to increase at the same rate as the Consumer Price Index for program and capital areas other than health. Health expenditures are assumed to increase at 5% per year.

3. Offshore oil revenue is assumed to increase according to the same forecast as used in the PWC report. No allowance is made in the main forecast for oil prices or exchange rates more favourable than those in the Department of Finance forecast.

4. Transfers from the federal government for purposes other than equalization and health are assumed to increase at the rate of increase of the CPI. Health transfers are assumed to increase at 7.3% per year, the increase to which the federal government is currently committed. No allowance is made for any potential further improvement in the federal government's position on health funding.

The equalization system is assumed to remain unchanged. No allowance is made in the main forecast for either an improvement in the overall equalization formula or to address the equalization claw-back problem faced by NL.

The alternative forecast estimates revenue for each year following 2003-4 on a line-by-line basis,

7 The PWC assumptions and their implications for the report's financial projections are reviewed in Appendix III.

TABLE 4
Economic assumptions for alternative projection

	Alternative 2003	2004	2005	2006	2007	2008
Nominal GDP	8.3%	5.0%	4.2%	4.2%	4.1%	4.4%
Real GDP	4.3%	4.3%	2.6%	2.3%	2.3%	2.3%
GDP Deflator	4.0%	0.7%	1.6%	1.9%	1.8%	2.1%
CPI	3.2%	1.7%	1.9%	1.9%	1.8%	2.1%
Personal Income	4.5%	3.5%	3.5%	4.7%	3.3%	3.9%
Disposable Income	4.2%	3.5%	3.6%	4.8%	3.3%	3.9%
Employment	2.2%	1.6%	0.6%	2.0%	0.7%	1.4%

using assumptions appropriate to the revenue item being forecast. The escalation factors used are presented in Appendix IV.

Expenditures are forecast based on the assumptions outlined above. Cash debt service charges are calculated by applying the assumed interest rate to the prior year's deficit, and adding the resulting cost to the deficit for the prior year.

Our alternative forecast of revenue, expenditure and the deficit on a cash basis is presented in **TABLE 5**, together with the PWC forecast for the cash deficit.

Whereas the PWC forecast for the cash deficit rises in every year, reaching $710 million in 2007-8, our projections show a deficit of approximately $280 million, which is relatively stable throughout the forecast period.

These projections are based on widely accepted forecasts of economic growth and conservative assumptions about the key revenue factors of offshore oil revenues and federal government transfers.

Conclusions from the analysis

Nothing that the provincial government can do at this point can change Newfoundland and Labrador from a have-not province into an economic powerhouse, hopes for offshore oil and hydro and mineral development notwithstanding. As a result, the residents of this province can expect higher taxes, lower public services spending; and a substantially greater dependency on transfers from the federal government than in wealthier provinces, for the foreseeable future.

To suggest otherwise: to suggest that NL can have lower taxes, a balanced budget, better public services, fully funded public service pension plans and a reduced dependency on the federal government, all at the same time, is a fantasy.

Previous governments' refusal to come to terms with this reality has left Newfoundland and Labrador a persistent cash deficit and a high level of public debt, relative to the size of its economy and its population. The public debt float understates the size of the debt load because it does not reflect the interest-free loan from public sector pension plans implicit in the under-funded status of those plans.

NL's fiscal problems are not outrageous, or catastrophic, demanding draconian measures in response. They are problems which are within the province's capacity to address today, and which could be ameliorated significantly in the future

TABLE 5
Alternative projection of revenue, expenditure and deficit

$million	2001-2	2002-3	2003-4	2004-5	2005-6	2006-7	2007-8
Cash							
General Revenue	3,370.9	3,606.8	3,916.1	4,034.1	4,157.6	4,295.4	4,423.1
Revenue Related to Current		300.2					
Revenue Related to Capital		82.3	132.2	134.5	137.1	139.6	142.3
Total Revenue		3,989.3	4,048.3	4,168.6	4,294.7	4,435.1	4,565.4
Program Spending	3,685.0	3,258.6	3,461.3	3,562.1	3,670.0	3,781.5	3,897.1
Capital Expenditure		207.2	243.3	247.6	252.3	257.0	261.8
Debt Charges and Financing		559.8	556.6	572.6	588.6	604.8	620.4
Total Expenditure		4,025.6	4,261.2	4,382.2	4,510.9	4,643.2	4,779.3
Government balance		(36.3)	(212.9)	(213.6)	(216.2)	(208.2)	(214.0)
Other entitites borrowing			73.9	75.0	75.0	75.0	75.0
FORECAST BALANCE			(286.8)	(288.6)	(291.2)	(283.2)	(289.0)
Post-budget adjustments			(293.7)				
PWC Cash Balance Forecast			(506.6)	(601.6)	(672.8)	(665.4)	(710.8)

with relatively modest changes in federal-provincial fiscal arrangements.

NL has two significant fiscal problems. Its cash deficit, which drives the governments growing need to borrow from public markets; and the under-funding of its public service pension plans, which drives the growth in the accrual deficit and the total debt of the province.

The cash deficit of the province is not escalating and out of control, as suggested by the PWC projections, but it is large and persistent.

The difference between the conclusions implied by the PWC projections and our alternative projections is significant. Rather than a broad and sweeping, massive, intractable problem, NL has a structural gap between revenue and expenditures that amounts to approximately 7% of provincial revenue, or about 1.7% of GDP.

The under-funded status of public service pensions will not sink NL's finances overnight, but it is a problem that needs to be addressed in a way that does not short-change current needs.

PART TWO looks at the options available to address these problems.

PART TWO: UNDERLYING FACTORS AND ROOM FOR CHANGE

The commentary in the PWC report, together with the official response from the Premier, suggests that Newfoundland and Labrador's spending and taxation levels are wildly out of step with Canadian provincial norms. They go on to assert that there is no scope for NL to do anything in response to its fiscal dilemma other than impose massive cuts on program spending to bring it into line with revenue.

For the most part, however, while most key measures of government revenue and expenditure for NL are above the Canadian average, these measures are not out of step with those of other Canadian "have-not" provinces. Indeed, when the true outliers — Ontario and Alberta — are taken out of the comparison, NL is very close to the Canadian main stream.

On two measures, per capita program spending and per capita transfers from the federal government, Newfoundland and Labrador ranks highest in Canada.

In expenditures relative to GDP, Newfoundland and Labrador ranks second, behind PEI and just ahead of New Brunswick.

Over time, Newfoundland and Labrador's expenditures have declined as a share of GDP, and the ratio has declined more quickly for NL than for Canadian provincial governments as a group.

Two sets of comparisons are particularly interesting for their implications for potential solutions to NL's fiscal problems.

A comparison of Newfoundland and Labrador's "own-source" revenue — that is, revenue raised from NL taxpayers rather than from federal government transfers — with other provinces reveals that while NL's own-source revenue as a share of GDP was above the national average for provincial governments in 2002-3, it is below the average of the other provinces, excluding Ontario and Alberta.

The results are summarized in **TABLE 6**.

Newfoundland and Labrador's own-source revenue is approximately 2.3% of GDP below the average own-source revenue to GDP ratio for the rest of Canada excluding Ontario and Alberta. This suggests that there is some room for NL to increase taxes without putting the province out of

CHART 1
Expenditures and GDP 2002-3 All Provinces

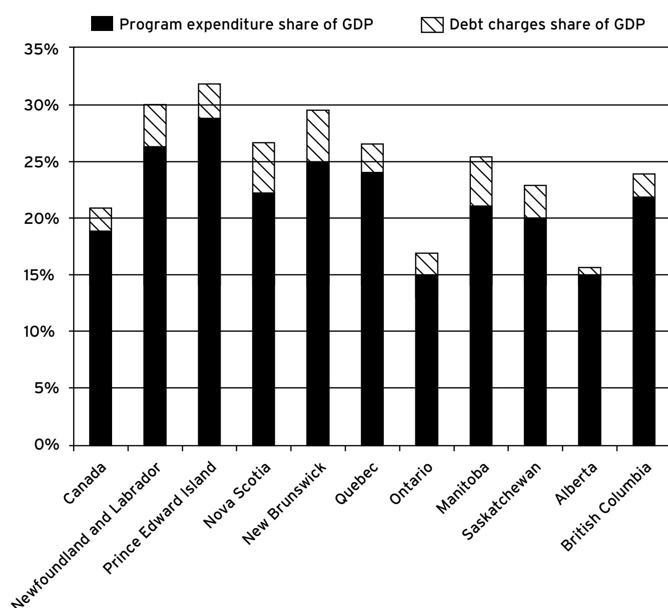


CHART 2

Expenditure and GDP Provincial governments

Newfoundland and Labrador and All Canada 1989-90 to 2002-3

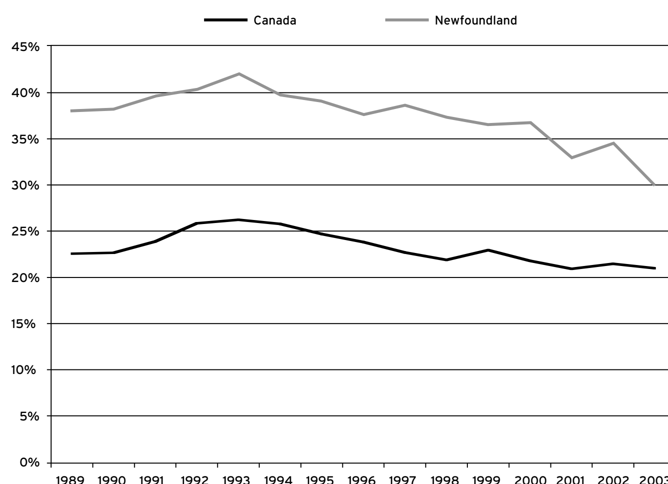


TABLE 6

Own-Source Revenue and GDP, Provincial Governments, 2002-3

Canada	17.2%
Newfoundland and Labrador	17.8%
Prince Edward Island	20.2%
Nova Scotia	18.9%
New Brunswick	19.4%
Quebec	21.7%
Ontario	14.7%
Manitoba	18.9%
Saskatchewan	19.7%
Alberta	15.2%
British Columbia	18.1%
Other provinces average excluding Ontario and Alberta	19.3%
Other provinces, GDP weighted	20.1%
Other provinces, population weighted	20.1%

line with comparable jurisdictions in Canada.

CHART 3 shows the same information, broken down among sources of revenue.

It suggests that, while NL's consumption taxes and sales, rental and investments as a share of revenue are at or above national norms, there is some room to move in income taxes (corporate and personal) and in health, payroll and social security taxes.

CHART 4 shows how own-source revenue in Newfoundland and Labrador has changed as a share of GDP since 1989, compared with the same data for Canada.

In both Canadian provinces as a group and in NL in particular, own-source revenue has declined as a share of GDP since 1989. However, the decline has been substantially more rapid in NL than in Canada as a whole.

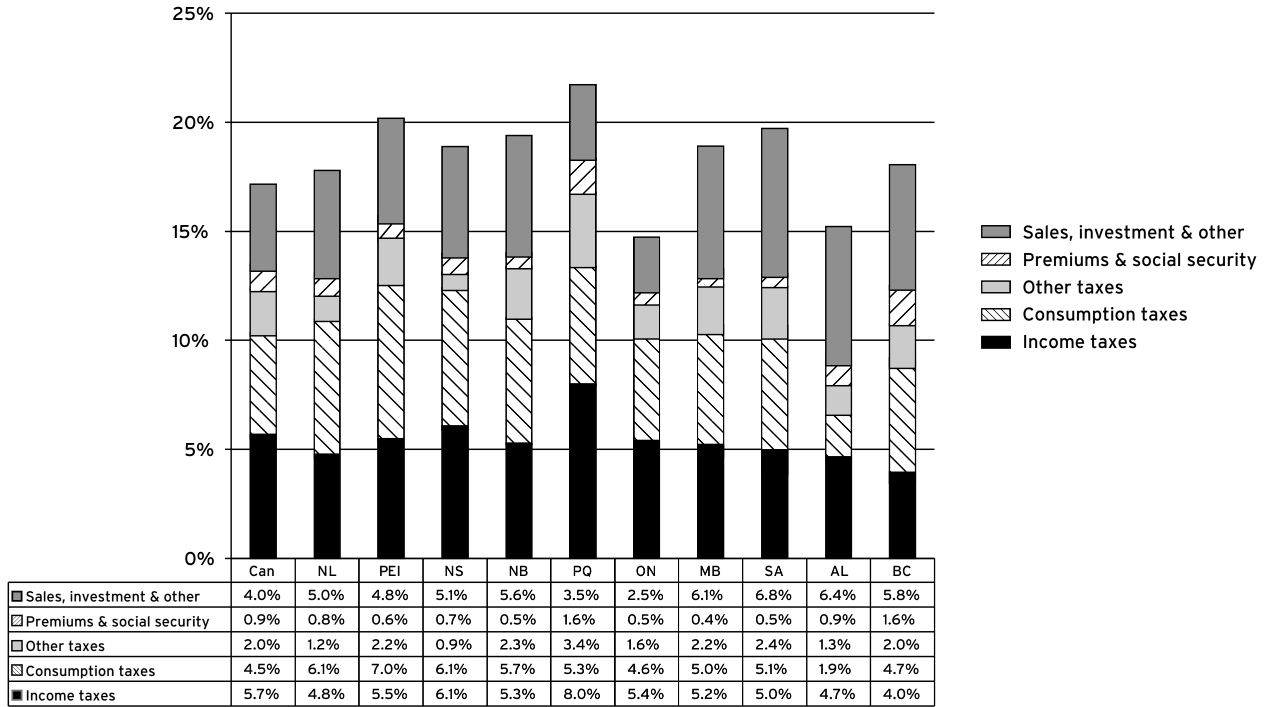
Contrary to the expectation created by public comment on the PWC report, expenditures have not increased relative to GDP. In fact, the expenditure share of GDP has declined more rapidly in NL than it has among provincial governments in Canada as a group.

The data on own-source revenue as a share of GDP also highlight the impact of Ontario on national averages of provincial government measures. After a decade of expenditure and tax cuts, Ontario and Alberta are outliers on the low end in both expenditure and own-source revenue as a share of GDP. Including Ontario or Alberta in any national or sub-national average has the effect of making the average unrepresentative of other Canadian jurisdictions.

This has important implications for the federal system of equalization payments. The equalization formula is based on revenue raised from a basket of taxes at the average rate in the five wealthiest provinces, not including Alberta. With Ontario as a low-tax outlier included in the calculation, the revenue from the basket of taxes is

CHART 3

Own-source revenue as share of GDP 2002-3, All provinces



	Can	NL	PEI	NS	NB	PQ	ON	MB	SA	AL	BC
Sales, investment & other	4.0%	5.0%	4.8%	5.1%	5.6%	3.5%	2.5%	6.1%	6.8%	6.4%	5.8%
Premiums & social security	0.9%	0.8%	0.6%	0.7%	0.5%	1.6%	0.5%	0.4%	0.5%	0.9%	1.6%
Other taxes	2.0%	1.2%	2.2%	0.9%	2.3%	3.4%	1.6%	2.2%	2.4%	1.3%	2.0%
Consumption taxes	4.5%	6.1%	7.0%	6.1%	5.7%	5.3%	4.6%	5.0%	5.1%	1.9%	4.7%
Income taxes	5.7%	4.8%	5.5%	6.1%	5.3%	8.0%	5.4%	5.2%	5.0%	4.7%	4.0%

reduced and the amount generated by the equalization system goes down.

Finally, a comparison of provincial public sector wages with private sector wages over the past five years shows that public sector wages have not played an independent role in Newfoundland and Labrador's fiscal problems. A 12-month moving average of wages in the provincial public sector compared with the Newfoundland and Labrador industrial composite, with January 1998=100 shows growth in provincial public sector wages lagging general wage growth in Newfoundland and Labrador.[8]

Conclusions from Part Two

1. Interprovincial and time series comparisons do not support the contention that Newfoundland and Labrador's fiscal problems are the result of excessive spending. Program spending in NL is high, whether measured on a per capita basis or as a share of GDP, but not out of line with Canada's

8 Source: Statistics Canada CANSIM Table #281-0026 Average weekly wages and salaries, including overtime

CHART 4

Own-source revenues and GDP Provincial governments

Newfoundland and Labrador and All Canada 1989-90 to 2002-3

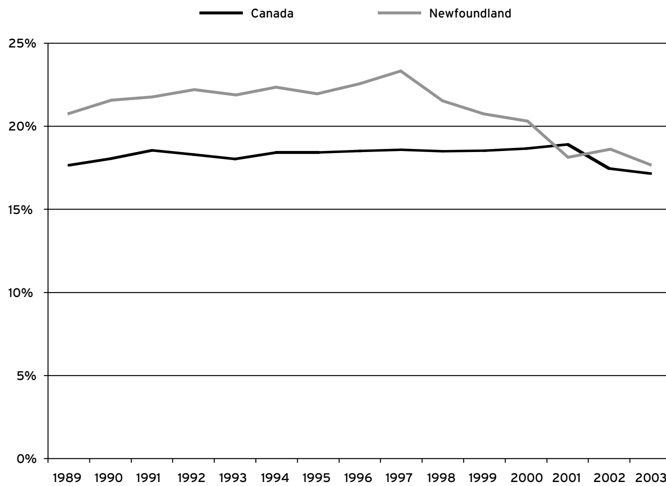
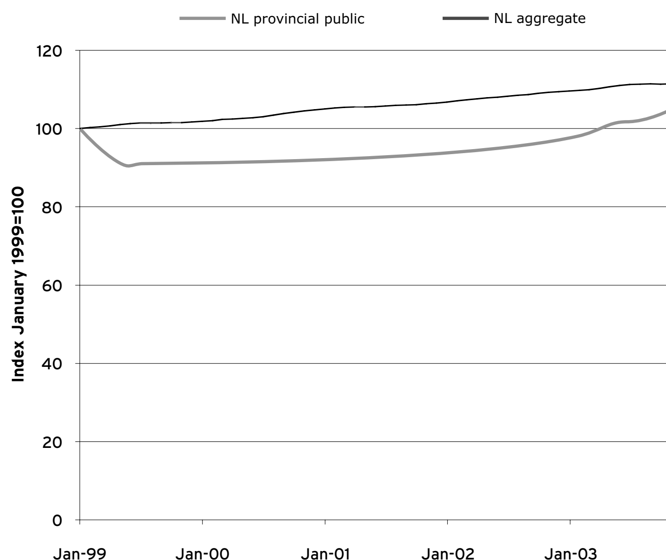


CHART 5

Newfoundland and Labrador Provincial public sector wages vs. NL aggregate

1998-2003 – 12-month moving average



other "have not" provinces.

2. The clear indication from the data is that what sets NL apart from other provinces, as a group, is the decline in its own-source revenue as a share of GDP during the 1990s. NL's own-source revenue as a share of GDP is 2.3% below the provincial weighted average, excluding Ontario and Alberta.

3. The current equalization system, which is heavily weighted towards tax rates in Ontario, biases equalization payments downwards, placing additional pressure on NL's transfer payment revenue.

4. Newfoundland and Labrador relies more heavily on interest free borrowing from its public sector pension plans than any other provincial government — substantially more than any province other than Quebec.

5. Average wages and salaries in provincial public administration in Newfoundland and Labrador have lagged private sector wages in NL, the Consumer Price Index, and provincial public sector wages across Canada since 1992.

PART THREE: AN ALTERNATIVE STRATEGY FOR FISCAL RENEWAL

A strategy for fiscal renewal that is based on exaggerated or misleading information cannot succeed. Neither can a strategy that does not focus on the underlying causes of the fiscal problem.

The debate over Newfoundland and Labrador's fiscal situation and what to do with it is misplaced, on both grounds. The deficit situation facing NL is being characterized as a crisis that is spiraling out of control. It is claimed that the cash deficit has jumped from $286 million to $506 million this year, and that it will continue to increase indefinitely, rising above $800 million by fiscal year 2007-8. In fact, when one-time-only factors are accounted for, the deficit this year is still forecast to be the $286 million originally forecast in the spring budget. And far from spiraling out of control, a more reasoned and realistic set of assumptions suggests that the deficit will stabilize in the future at about $280 million.

A deficit that is stable at $280 million a year is still a major problem, but it is not a crisis that is spiraling out of control.

With respect to cause, it is suggested that NL's budget problems are the result of excessive spending on programs in general, and on prior years' wage settlements with public sector workers in particular. It is also asserted that NL has reached an absolute maximum in own-source revenue generation, precluding a revenue-based strategy for recovery. None of these things is true. NL public sector workers' pay increases cannot legitimately be described as excessive, either in relation to those of other workers in Newfoundland and Labrador, or in relation to the pay increases granted to public sector workers in other parts of Canada.

Indeed, a comparative analysis with other jurisdictions in Canada in 2002-3 and over time indicates that NL's own-source revenue was below that of other similar provinces as a share of GDP in 2002-3, and that the own-source revenue share of GDP had declined much more rapidly in NL in the 1990s than in all provinces in Canada as a group. The data clearly indicate that a revenue-side response to the fiscal situation is both warranted and practical.

The message in the numbers is reinforced by the changing political climate across Canada. It is evident that the tax cut mania that swept the provinces from Ontario west in the mid-to-late 1990s and that struck the federal government in the year 2000 has run out of steam. In Ontario, where the notion of deep tax cuts got its start in Canada, tax cuts have been rolled back, and popular sentiment is actually pushing the Liberal government to increase taxes still further and run budget deficits in the short term rather than allow a revenue shortfall to dictate program cuts.

At the federal level, we are heading into an election in which tax cuts are not on the agenda for debate.

There ***are*** important fiscal problems facing Newfoundland and Labrador.

- Sufficient additional revenue must be generated to wipe out a persistent structural deficit.
- The fiscal distortion created by the fact that the government has in effect borrowed billions of

TABLE 7
Federal Department of Finance projection of Newfoundland and Labrador's tax cut costs

Tax cuts $million	2003-04	2004-05	2005-06	2006-07	2007-08
Personal Income	(54.5)	(58.2)	(62.1)	(66.3)	(70.8)
Corporate Income	-	-	-		
Other	(93.0)	(102.2)	(111.2)	(120.9)	(131.5)
TOTAL	(147.6)	(160.4)	(173.3)	(187.2)	(202.3)

dollars from its public service pension plans, at zero interest, must be addressed.

- The problems with Canada's fiscal equalization system are of urgent concern. The current formula falls far short of the original goal of ensuring that all citizens of Canada, regardless of their province of residence, should have the benefit of adequate levels of public services with reasonable levels of taxation. In addition, as it is currently structured, the offset of offshore oil revenues against equalization payments results in NL receiving far less than half the benefit from those resources.

The facts point to solutions; the current combination of ideology and political expedience do not.

Revenue recovery

Although Newfoundland and Labrador has a reputation as a high-tax jurisdiction, provincial own-source revenue as a share of GDP is 2.3 percentage points below the average for the other provinces, excluding Alberta and Ontario. The fact that NL's own-source revenue generation is running behind that of its economic peers in Canada suggests that there is some potential for revenue recovery in this province.

The 2.3 percentage points of GDP by which NL's own-source revenue share lags that of its peers represents a potential revenue gain of more than $390 million in 2004-5. So clearly, there is more than enough fiscal room available to address a structural deficit of $280 million.

Three areas of potential change suggest themselves.

First, in what under the circumstances can only be described as fiscal folly, the previous government decided in the late 1990s to get into the Canadian tax cut contest.

According to data prepared by the Federal Department of Finance, tax cuts in Newfoundland and Labrador introduced in the late 1990s have reduced NL's 2004-5 revenue potential by $160 million. **TABLE 7** reproduces the Finance data for NL.[9]

Clearly, those tax cuts were unaffordable, and should be rescinded.

Second, Newfoundland and Labrador's payroll tax contains loopholes and exemptions that will cost the provincial treasury an estimated $50 million in 2004-5. The most important of these loopholes is the exemption from the tax for the first $600,000 in payroll. The payroll tax in NL is the component of the system that generates revenue from employers in recognition of the value of universal medicare in reducing what would otherwise be employment costs.

Medicare provides employers in Canada with a substantial competitive advantage. In the

9 Department of Finance, Ottawa, unpublished spreadsheet, October 2002.

TABLE 8
Estimated revenue from eliminating payroll tax exemption

$ million	2003-04	2004-05	2005-06	2006-07	2007-08
Payroll potential — no exemption	136.4	140.6	144.7	149.9	154.0
Payroll actual	88.0	91.4	95.0	98.7	102.6
Revenue gain	48.4	49.2	49.7	51.2	51.5

United States, coverage comparable to that provided publicly in Canada adds approximately $US 7,000 a year to payroll costs. A payroll tax of 2%, which adds only $2.00 a working day — $500 per year — to payroll costs for the average employee in Newfoundland and Labrador is a modest revenue expectation for such a substantial benefit.

Although the payroll tax exemption is touted as a benefit to small business, as a measure to assist small business it is very badly targeted. It applies to all businesses, both large and small. It applies to many settings that would not fit most people's definition of a small business worthy of government assistance. For example, corporations established by professional practices as income splitting devices qualify for the exemption. Individuals employing caregivers are exempt, regardless of their ability to pay. And it is worth noting that a $600,000 exemption means that an employer with 24 employees earning the average industrial wage in Newfoundland and Labrador would be fully exempt.

The overall argument against the exemptions — that every employer benefits from the existence of public medicare, and every employer should pay something towards that benefit — is compelling.

Third, Newfoundland and Labrador's corporate income tax rates are well below the Atlantic Canadian norm. In Nova Scotia and New Brunswick, the corporate tax rate is 16%. In NL, the rates are 14% for general business activities and 5% for manufacturing and processing activities. NL is the only province in Canada where the manufacturing and processing tax rate is the same as the small business tax rate.

This kind of tax preference is unwarranted, for a number of reasons.

1. For businesses that are already located in NL, the preferential tax is simply a windfall that has no impact on economic activity; it simply reduces the revenue available to the province for public services.

2. Much of the activity classified as manufacturing and processing currently drawn to the province locates in NL for reasons other than tax rates — most notably resources, both physical and human. For businesses like Inco, for example, the tax rate differential is irrelevant to the basic investment decision.

3. Deep preferences for manufacturing and processing industries run against the trend in Canadian tax reform, with governments increasingly recognizing that industries that will never qualify for this tax preference are going to be providing much of the job growth in the future.

4. The evidence suggests that tax rates are not prime determinants of business location decisions; that other factors are far more important. This makes concessionary tax treatment a post-decision windfall rather than a location decision driver.

5. Business leaders are increasingly coming to

the view that the quality of public services offered in a jurisdiction is an important determinant in business location both because of their direct impact on business efficiency and profitability and because of their impact on the quality of life of their employees. The most obvious indicator of this trend is the role being played by leading corporate research groups and local business organizations in pressing for increased funding for urban services in Canada.

Moving to the New Brunswick / Nova Scotia standard for corporate tax rates would generate an estimated $65 million in additional revenue in 2004-5.[10]

These three proposed changes alone would be sufficient to eliminate NL's current structural deficit and provide additional revenue to improve public service pension funding and for in-year contingencies.

TABLE 9 presents the four-year fiscal outlook, on a cash basis, with the new revenue measures in place. In this revised outlook, payroll tax exemptions are eliminated as of January 1, 2005; recent personal income tax cuts are rolled back effective July 1, 2004; other tax cuts are rolled back effective April 1, 2005; and corporate taxes are harmonized with Nova Scotia and New Brunswick rates as of January 1, 2005.

Even with these revenue increases, Newfoundland and Labrador's own-source revenue as a share of GDP would still be below the 2002-3 average for seven peer provinces.

10 This estimate assumes that 25% of NL's corporate tax revenue for sources other than offshore oil comes from manufacturing and processing; 50% from general corporate activity; and 25% from small business taxation. Corporate tax revenue excluding oil is estimated by using 1999-2000 revenue as a base, adjusted to reflect general economic growth. No additional revenue is attributed to estimate oil-related corporate tax because of its impact on equalization.

The accrual balance and public service pension funding

The discrepancy between the accrual deficit and the cash deficit is attributable to two main items: interest on the unfunded liability in NL's public service pension plans; and the accrued liability for retiree benefits. Because retiree benefits are not typically funded in advance, NL will likely follow the practice of private sector corporations and allow the retiree benefits liability to accumulate on its books. That number will indicate the size of this potential future liability, without any expectation that cash surpluses will be accumulated to offset it.

The unfunded pension liability is a different matter. Since the expectation for private sector pension plans is that they will be fully funded, NL's unfunded pension liability will continue to be treated by rating agencies as if it is part of the provincial debt, accumulating interest by increasing the amount of debt outstanding.

In 2002-3, as noted above, interest on the unfunded liability plus the province's share of the current-year benefit accrual was $337 million. The province's contributions to the plan totaled $242.7 million. $66.8 million for NL's share of benefit accrual and $175.9 million that could be attributed to interest on the unfunded liability. In this framework, $94.3 million in interest on the unfunded liability remained unpaid.

The province's objective should be to put its pension plans onto a solid financial footing so that these plans do not act as a hidden detractor from the province's fiscal health. NL should follow the strategy adopted by most other provinces when confronted with this problem. The unfunded liability debt should be converted into interest-bearing debt, by issuing interest-bearing debentures. This process should proceed only in step with the province's ability to pay the cash interest required.

Equalization reform

The Canadian approach to fiscal equalization was a casualty of the federal governments efforts

TABLE 9
Alternative proposal Revenue and Expenditure

	2003-4	2004-5	2005-6	2006-7	2007-8
Cash					
General Revenue	3,916.1	4,034.1	4,157.6	4,295.4	4,423.1
Revenue Related to Current	-	-	-	-	-
Revenue Related to Capital	132.2	134.5	137.1	139.6	142.3
Total Revenue	4,048.3	4,168.6	4,294.7	4,435.1	4,565.4
Program Spending	3,461.3	3,562.1	3,670.0	3,781.5	3,897.1
Capital Expenditure	243.3	247.6	252.3	257.0	261.8
Debt Charges and Financing	556.6	572.6	588.6	604.8	620.4
Total Expenditure	4,261.2	4,382.2	4,510.9	4,643.2	4,779.3
Government balance	(212.9)	(213.6)	(216.2)	(208.2)	(214.0)
Other entitites borrowing	73.9	75.0	75.0	75.0	75.0
BALANCE BEFORE REVENUE MEASURES	(286.8)	(288.6)	(291.2)	(283.2)	(289.0)
Post-budget adjustments	(293.7)	-	-	-	-
Cash deficit 2003-4 and PWC forecast	(506.6)	(601.6)	(672.8)	(665.4)	(710.8)
New revenue measures	-	-	-	-	-
PIT	-	43.6	62.1	66.3	70.8
CIT	-	16.7	69.5	72.4	75.4
Payroll	-	12.3	49.7	51.2	51.5
Other	-	-	102.2	111.2	120.9
TOTAL REVENUE MEASURES	-	72.6	283.5	301.0	318.5
BALANCE AFTER REVENUE MEASURES	-	(216.0)	(7.7)	17.8	29.6

to bring its deficit under control in the 1990s. Although it chose its targets for cuts for their efficiency in reducing expenditure and their political sale-ability, virtually every element of the federal government's deficit reduction strategy in the 1990s had a negative impact on provincial governments — an impact that was relatively greater for the "have-not" provinces than for the "have" provinces.

Most of the federal expenditure cuts were in transfers to provincial governments. Equalization payments to provincial governments were cut. Previously, equalization payments had been based an equalization standard calculated as the population-weighted average of the fiscal capacities of all ten provinces. Fiscal capacity was and is measured by calculating the amount that would be raised from a group of taxes levied at national average tax rates. Provinces that could raise less than the weighted average revenue from that

group of taxes received the difference between the equalization standard and their actual measured fiscal capacity.

In the federal government's drive to cut transfer payments, the ten-province standard was replaced by a five-province standard. The five-province standard is the weighted average of five "middle-income" provinces — all provinces other than the four Atlantic Provinces and Alberta.

A move back to the 10-province standard would increase federal government equalization payments by approximately $3.4 billion, of which Newfoundland and Labrador's share would be just over $100 million.

But the formal fiscal equalization program represented only a portion of the federal government's direct and indirect equalization programming before the cuts of the 1990s were implemented.

The largest federal-provincial transfer — the Canada Assistance Plan — had an element of equalization built into the design of the program. As a result, provinces received different per-capita CAP transfers in rough relation to their need for the fiscal assistance.

The 1995 Federal Budget, which kicked off the federal government's drive to eliminate its deficit, eliminated the Canada Assistance Plan, and replaced it with the Canada Health and Social Transfer. The CHST was smaller in total than the programs it replaced. In addition, it eliminated the component of equalization that had been built into the design of the CAP. CHST entitlements are based on population.

The third major indirect component of federal equalization — Unemployment Insurance — was also cut back dramatically as it was transformed into the current Employment Insurance system. This change had a double impact on Newfoundland and Labrador. First, total EI benefits were much lower than the corresponding benefits under UI. Second, the design of the program was changed so as to reduce NL's share of total program benefits.

These changes in turn affected Newfoundland and Labrador in two ways. First, incomes were reduced, thereby reducing provincial revenue. Second, many of those whose benefits were either reduced or eliminated in the program change were forced to rely on social assistance to survive — social assistance that, courtesy of the elimination of CAP, was no longer cost shared with the federal government.

Finally, as NL began to benefit from offshore oil development activity, the design of the equalization formula began to work against NL.

Because oil revenues are included in the calculation of the province's fiscal capacity for equalization purposes, the normal operation of the equalization formula would result in "have-not" provinces like Newfoundland and Labrador and Nova Scotia losing one dollar of equalization payments for every dollar of additional revenue received from offshore oil.

Special arrangements limit the extent of the equalization claw-back.

The so-called generic solution limits the extent of the equalization claw-back to 70% of the revenue generated from tax bases, which are unique to a single province — where, in effect, the provincial tax rate will automatically be the national average tax rate.

In addition, Nova Scotia and Newfoundland and Labrador have each negotiated separate agreements with the federal government to limit the equalization impact from offshore gas and offshore oil, respectively. The Accord that covers Newfoundland's offshore oil was developed in 1985, and provides for offsets against equalization claw-backs over a phase-in period after oil production reaches 15 million barrels. That level was reached in fiscal year 1999-2000.

TABLE 10
Offset Entitlements

Year	Accord entitlement
2001-2	$50.6 million
2002-3	$183.9 million
2003-4	$178.8 million
2004-5	$108.8 million

According to the Federal Department of Finance[11] Newfoundland's offset entitlements under its Accord as set out in the February 2004 estimates are as shown in **TABLE 10**.

The fact that these payments have already begun to decline highlights the problems with the link between equalization and oil revenues raised earlier in this report.

The projections of oil revenues and equalization impacts in this report are based on a study conducted for the Royal Commission in 2003 by consultant Dave Norris. The projections assume that Newfoundland and Labrador will use the combination of its Accord rights and the generic solution safeguard to maximize its revenue.

However, the Norris study shows clearly the imbalance between federal and provincial revenues from offshore oil even with these safeguards.

His analysis of the three offshore oil projects that have been committed to date shows that the Government of Canada receives more than ¾ of the revenue from offshore oil, once the equalization offset is taken into account.

TABLE 11 summarizes the results.[12]

Canada's equalization system is no longer achieving its intended purpose. Flaws in its design clearly work against the interests of Newfoundland and Labrador. The stakes for this province are very high. Indeed, the stakes for NL in equalization design are far higher than the stakes in the debate over health care financing.

TABLE 11
Overall sharing of total government revenues
Federal and provincial government revenues from offshore oil (billions of constant dollars)

	NL	Canada	Total
Royalties	5.7		5.7
Provincial CIT	1.0		1.0
Federal CIT		4.0	4.0
TOTAL	6.7	4.0	10.7
Equalization offset	(4.2)	4.2	
Net revenue	2.5	8.2	10.7
Share of total	23.4%	76.6%	100.0%

To illustrate the point, an increase of $3.5 billion in the CHST would generate less than $60 million in additional revenue for Newfoundland and Labrador. But the increase of $3.5 billion in equalization that would result from a return to the ten-province standard would generate double that amount of additional revenue. And a change in the treatment of resource revenues would generate even more.

With all of the focus on the CHST transfer, equalization has disappeared from the national political agenda. The shift to per capita grants in the CHST removed the equalization component of established programs funding. That should have triggered a greater emphasis on the equalization program. Instead, the opposite has happened, creating substantial fiscal problems in all of the have-not provinces.

Newfoundland and Labrador needs to work as hard to find allies to pressure the federal government on equalization as the larger provinces have with respect to health care funding.

11 "Federal Transfers to Provinces and Territories", Department of Finance, Canada, February 2004, http://www.fin.gc.ca/FEDPROV/nae.html.

12 Norris, Dave "The Fiscal Position of Newfoundland and Labrador", study for the Royal Commission on Renewing and Strengthening Our Place In Canada, March 2003, p. 113.

CONCLUSIONS

The debate over fiscal options in Newfoundland and Labrador is being driven relentlessly towards an all-too-familiar "solution": public services cutbacks and sacrifices by public sector workers.

Newfoundlanders and Labradoreans are being told that the province's deficit has skyrocketed in the past year, and that it is trending upwards and out of control; that there is no room to alleviate the situation on the revenue side of the equation; and that in the circumstances, the only fair option is to freeze the wages of public sector workers and cut services.

None of these things is true.

Newfoundland and Labrador does have a persistent structural deficit. But it has not skyrocketed this year. This year's deficit increased only because of a one-time-only expense incurred because a bank pulled out of the student loan program. And the deficit is not rising out of control. More reasonable projections suggest that the deficit will stabilize at about $280 million a year.

While taxes in Newfoundland and Labrador are above the Canadian average, there is still room for the province to increase its own-source revenue — more than enough to address NL's immediate fiscal problems. This paper recommends a package of tax cut roll-backs and loophole closures that would still leave own-source revenue in NL below that of the average province, excluding Ontario and Alberta.

Acknowledging that, in these circumstances, fairness is a political rather than a logical term, it is stretching the idea of fairness to suggest that it is fair and appropriate for public employees to be expected to bear the price alone of solving this province's fiscal problems. Public service wages and salaries did not create these problems. They result from factors beyond the control of any group in Newfoundland and Labrador society. The cost of solving these problems should be shared by every citizen of the province, through the tax system.

Perhaps the most egregious suggestion is that public employees should give up wage increases to enable the provincial government to catch up for its history of under-funding public employees' pensions. To suggest that a wage freeze is necessary to enable the government to meet its past pension obligations is, in effect, to tell public employees who have been contributing their share of the cost of their pensions for all of these years that they now have to pay the employer's half as well. It is important for the province's fiscal health to deal with the massive under-funding of public employees' pension plans. But again, the costs of that adjustment should be shared generally in society.

Finally, one inescapable conclusion is that there can be no long-term solution to Newfoundland and Labrador's problems of fiscal capacity without substantial repair of Canada's fiscal equalization system. A campaign for reform of that system should be the government's number one priority in federal-provincial relations. For the Atlantic Provinces in particular, equalization reform is a far more important issue than health care financing reform. Newfoundland and Labrador should be taking the lead in the fight to get that issue onto the national political agenda.

APPENDICES

Appendix I — Pension Funding and the Accrual Deficit

The auditor's pension footnote in the 2002-3 public accounts illustrates the impact of under-funding on the accrual balance.

TABLE 12 summarizes the funded status of the four major public service pension plans as of the end of fiscal year 2002-3.

The total unfunded liability of $4,359.3 million represents the extent of the Province's zero-interest loan from the pension plans for its employees and shows up on the books of the province as part of NL's net debt.

The pension expense for 2002-3, as presented in the Public Accounts is shown in **TABLE 13**.

The figure of $270.2 million for interest expense represents the interest cost of carrying the unfunded pension liability. Note that the province's pension contribution for the period covered NL's share of the benefits earned in 2002-3 plus approximately 65% of the interest on the unfunded pension liability and therefore makes no contribution towards reducing the liability. This means that even with the special payments, the unfunded pension liability continues to increase.

Appendix II — Assumptions behind the PWC projections

A number of the assumptions behind the PWC projections raise questions about the weight that should be placed on those projections. Three areas are of particular concern.

Expenditure growth. The projections assume a 3% annual increase in expenditures on program and capital. A projection methodology that distinguishes between health, with its greater cost pressures, and other expenditure areas would provide more reliable estimates of future expenditure patterns.

TABLE 12
Province of Newfoundland and Labrador Public Service Pension Plans Funded Status as of 31 March 2003

Plan	Estimated Accrued Benefit Obligation	Fund Assets	Funded Ratio
Public Service Pension Plan	3,319.9	1,332.3	40.1%
Teachers' Pension Plan	2,778.4	643.6	23.2%
Uniformed Services Pension	223.9	30.8	13.8%
MHA Pension Plan	55.7	11.6	20.8%
Total	$6,377.9	$2,018.3	31.6%

Source: Public Accounts 2002-3, Vol. I, p. 18; calculation of funded ratio added.

TABLE 13
Pension Expense for 2002-3

Plan	Province's Share of Pension Benefits Earned for the Period ($ mil)	Pension Interest Expense on the Unfunded Liability ($ mil)	Province's Current Period Pension Contributions ($ mil)	Current Period Amortization of Experience Changes ($ mil)	Plan Amendments ($ mil)	Unfunded Portion of Current Period Pension change ($ mil)
Public Service Pension Plan	49.8	102.1	(105.3)	(190.8)	181.0	36.8
Teachers' Pension Plan	14.4	149.7	(107.6)	16.1	62.3	134.9
Uniformed Services Pension	1.7	14.8	(21.9)	0.7	-	(4.7)
MHA Pension Plan	0.9	3.6	(7.9)	0.8	-	(2.6)
Total	$66.8	$270.2	($242.7)	($173.2)	$243.3	$164.4

Source: Public Accounts 2002-3, Vol. I, p. 18.

Economic growth. The projections are based on economic forecasts prepared by the Government of Newfoundland and Labrador, which are appreciably more pessimistic about the near-term future than are the published forecasts of the major chartered banks in Canada.

For periods covered by both NL Government and bank forecasts, the comparative projections are as shown in **TABLE 14**.[16]

Offshore oil revenues and federal equalization payments. The projections use Government of Newfoundland estimates of revenue from royalties and corporate income taxes from the oil fields currently in operation.[17]

The projections are based on the same assumptions about oil prices and the Canada-US exchange rates as are used in the general economic forecast. Given current economic conditions, these assumptions will inevitably lead to a conservative estimate of oil revenue.

According to these projections, NL's gross

16 Source: Department of Finance, Government of Newfoundland and Labrador; bank economics department web sites, CIBC, RBC, BNS, BMO & TD

17 The projection of revenues and equalization offsets developed for the Royal Commission in the summer of 2003 were used, without change, in the PWC report. Data in this table are derived from chart appearing in Norris, Roayl Commission, p. 111.

TABLE 14
Economic forecasts

	Newfoundland and Labrador			Banks		
	2003	2004	2005	2003	2004	2005
Real GDP	4.3%	2.1%	1.5%	4.3%	2.6%	2.3%
Nominal GDP	14.4%	-1.9%	2.9%	8.3%	5.0%	4.2%
CPI	3.2%	1.7%	1.9%	3.0%	1.7%	1.5%
Employment	2.2%	1.6%	0.6%	1.7%	1.1%	1.2%

TABLE 15
Offshore oil revenue, gross and net of equalization losses relative to 2003-04

$ million	2003-04	2004-05	2005-06	2006-07	2007-08
Net Revenue	160	180	250	250	250
Gross Revenue	160	200	320	335	410
Equalization losses	-	20	70	85	160

revenue from offshore oil in 2007-8 will be $492 million, with a net benefit after equalization claw-back of $244 million. This conclusion is based on the assumption that the current claw-back formula remains unchanged, and that Newfoundland and Labrador's share of total benefits from offshore oil will drop substantially below the 50% share, which theoretically underlies the federal-provincial agreement on revenue sharing.

While this forecast may be consistent with its conservative economic assumptions and the letter of the current agreement, it amounts to at best a conservative estimate of offshore revenue potential.

The CHST transfer. While the PWC report does not comment explicitly on the CHST transfer, it is possible using the report's estimates of total federal transfers as a share of provincial revenue and the equalization transfers implicit in its estimates of net revenue from offshore oil to calculate the CHST transfer implicitly assumed in the projections.

Equalization estimates are calculated by using the 2003-4 equalization payment numbers as a base, and subtracting from that amount in each subsequent year the amount of the equalization claw-back implicit in the forecast of oil revenues used in the report. This calculation is based on the Department of Finance forecast that gross oil-related revenues will increase from $160 million in 2003-4 to $492 million in 2007-8 and that net oil-related revenues (after allowing for equalization claw-back) will never exceed $250 million.

The total of federal transfers is the NL Department of Finance estimate referred to in the PWC report.[18] Other federal transfers are assumed to increase at the rate of increase in the Consumer Price Index.

These two calculations imply an assumption that CHST transfers will remain constant, and that transfers for purposes other than the CHST and equalization will be eliminated.

There is no basis for either of these assumptions. The February 2003 accord commits the government to an annual increase in health transfers of 7.3% through to 2008. For Newfoundland and Labrador, that would imply an increase in CHST transfers to more than $525 million from their current level of approximately $400 million, even if no further progress were made by the provincial premiers in their efforts to get the federal government to increase its commitment to health care funding.

18 PWC Report, p. 41.

TABLE 16
Federal Transfers Implicit in PWC Projections

$ million	2003-4	2007-8
Equalization	1,028.9	780.6
Health	399.4	399.4
Other	71.1	-
TOTAL	1,499.4	1,180.0

The federal government has given no indication that it intends to reduce its transfers for purposes other than equalization and health. Quite the contrary. Indications are that renewed federal government interest in urban issues and education will result in higher, not lower, federal transfers for these purposes.

These two assumptions alone underestimate a worst-case estimate of federal transfers to NL of approximately $200 million.

Appendix III — Escalation factors used in alternative projection

See **TABLE 17**.

Appendix IV — Options for equalization reform

A study for the Royal Commission, Queen's University (Kingston) economist and federal-provincial relations expert Robin Boadway reviewed the current approach to equalization and its treatment of resource revenues.[19]

His study raises a number of equalization issues:

1. **Timing and volatility.** Because equalization is based on current year fiscal capacity and population, the payments are subject both to year-to-year fluctuations and to frequent adjustments. The result is that equalization payments are both uncertain at the time of budget preparation and volatile.

Changing to a moving average ending prior to the start of the fiscal year would make payments both more certain and more stable, eliminating the unpleasant in-year "surprises" that can arise from the current system.

2. **Five-province vs. ten-province as the standard.** As noted above, the five-province standard delivers substantially less funding to provincial governments than would the former ten-province standard. From the perspective of Newfoundland and Labrador, the five-province standard means that Alberta's resource revenues do not count in determining the national standard, while NL's count against its provincial entitlement.

3. **Defining tax bases.** While comparing some tax bases is relatively straightforward — corporate and personal income, for example — others pose difficulties for comparability. In some cases — sales taxes, for example — the resulting distortions are essentially random. In others — property taxes, for example, Boadway notes that "[the procedure used for comparing tax bases] yields lower entitlements for provinces where the market value of real estate properties is relatively low."[20] This distortion works directly against Newfoundland and Labrador, with its relatively low real estate values.

4. **Treatment of resources.** As Boadway points out, "While resource developments are fully equalized for the have-not provinces, they are not equalized at all for the have-provinces, except indirectly through the general revenue financing of Equalization payments. In fact, since Alberta is outside the five-province standard, their vast resource revenues are completely unequalized, even indirectly. … It seems fundamentally unfair that a province like Alberta can retain the full proceeds of its vast oil and gas revenues, while have-not provinces like Newfoundland and Labrador are taxed back at very high rates …"[21]

A return to the ten-province standard would help with the resource revenue problem, to some extent. However, the analysis by Norris suggests the need for a fairness rule that overrides the

19 Broadway, Robin "Options for Fiscal Federalism", study for the Roayl Commission on Renewing and Strengthening Our Place in Canada, March 2003.

20 Broadway, p. 255.

21 Broadway, p. 269.

details of equalization. For example, a requirement could be added that, in combination, federal and provincial taxes and royalties and equalization offsets could not result in a province's share of revenue from a unique resource development falling below 50%.

Another issue in equalization design is the use of weighted average tax rates in determining the fiscal capacity standard. Dramatic reductions in the tax rates of large provinces, as has happened recently in both Ontario and British Columbia, will tend to drive the weighted average down, thus reducing potential entitlements for all provinces.

The have-not provinces are thus faced with a double-edged attack on their fiscal systems. On one hand, they find themselves under political and economic pressure to reduce their tax rates in competition with those jurisdictions, which are lowering their tax rates. And on the other hand, those same tax rate reductions have the effect of driving down their equalization entitlements.

TABLE 17

Increase factors for alternative projection

Taxes	
PIT	Personal Income
Sales	Disposable Income
Gasoline	Real GDP
Payroll	Personal Income
Tobacco	Real GDP
CIT excluding oil	Nominal GDP
Natural resources taxes & royalties non-oil	Nominal GDP
Other taxes	Nominal GDP
General Revenues	
Liquor	Disposable Income
Lottery	Disposable Income
Vehicle and Drivers Licences	Nominal GDP
Deeds, Companies & Securities	Nominal GDP
Fines & Forfeitures	Nominal GDP
Other	Nominal GDP
Expenditure Related	
Sinking Fund Surpluses	Flat
Interest Income	Flat
Other	Expenditure
Federal Tansfers	
Equalization	Equalization
CHST	Health
Sales Tax Transitional	Flat
Statutory Subsidies	Flat
Cost Shared Programs	Other Federal