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Newfoundland and Labrador

Options for a Strong Economy

Diana Gibson and Greg Flanagan

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Summary

NEWFOUNDLAND AND LABRADOR (NL) has achieved considerable success in creating a vibrant economy with increasing prosperity. The province also faces challenges as it is increasingly resource driven and carries the legacy of being a have-not province. Like other resource dependent economies in Canada, NL is facing deficit budgets despite record levels of private investment. These challenges are all manifest in the 2014 and looming 2015 provincial budget debates.

This report looks carefully at the drivers of the deficit, the province's strengths and options for addressing sustainability. It begins with a big picture look at the province's fundamentals across a range of economic metrics. It then turns to the expense side, looking at expenses in comparative, historical and affordability contexts. Finally, the report examines the revenue side, looking at comparative tax structures across the country, affordability, and areas where NL has room to move.

On the fundamentals, between 2003 and 2013 NL's trends are strong across a range of economic measures: the rise in GDP; the fall in the provincial debt — both absolute and as a percentage of GDP; the rise in employment; the increase in tangible capital infrastructure; the positive climate for private investment; and in the overall dramatic rise in residential construction.

There are challenges, however. Recent oil price fluctuations are a good reminder of the risks associated with resource revenues. Additional challenges include NL's legacy of public underinvestment in social and physic-

al infrastructure, high unemployment, high poverty and outmigration, especially the population of working age.

Turning to expenditures, the report finds that provincial government expenditures have fallen from 30 per cent of GDP in the 1990s to 18 per cent in 2013. Compared to other provinces NL is square in the middle of the pack for spending to GDP. Delivering services in NL costs more due to: a much older population, difficult geography, more rural population, cost of living increases (resource booms are expensive), and higher rates of unemployment and poverty. NL needs to spend more than other provinces to offer citizens the same level of services. The report concludes that spending is not out of control.

This report and our 2013 report "Prosperity For All" both document the economic benefits of a strong public sector in the NL context. Resource revenues are volatile and oil and gas creates relatively few jobs. Public sector spending can create up to 20 times the jobs per dollar invested compared to oil and gas. Thus, given the persistent high unemployment in the province and legacy of poverty, public sector spending is a critical part of the economic stability and growth for the province as well as sharing the wealth.

Public spending is paid for by taxes. And, although under some circumstances tax cuts can also stimulate the economy and create jobs, a wide range of authorities have observed that public spending creates at least twice as many jobs per dollar as tax cuts.

On the revenue side the report illustrates that tax revenue as a per cent of GDP is quite low for NL compared to other provinces. If the province collected the percentage of GDP at the level of the Canadian average, it would have brought in over $3.5 billion instead of $3.1billion in 2012. In 2007 NL turned early surpluses into tax cuts, an action that proved to be short sighted as evidenced by subsequent deficits. The data reveals that the bulk of those income tax cuts went to the wealthy. Over a three-year period, the cumulative cost of combined personal and other tax cuts for Newfoundlanders and Labradorians exceeded three-quarters of a billion dollars.

NL's personal income taxes are lower and less progressive than in many other provinces. NL can ill afford this at the province, leading the nation in pre-tax market income inequality. By reinstating higher taxes at the top end with a fourth rate of 16.5 per cent, NL could gain revenues and restore some fairness, keeping rising and socially corrosive inequality in check.

Corporate profits make up a much bigger share of NL's GDP than most other provinces (twice the national average). On the flip side, a smaller portion goes to wages. There are other provinces with higher corporate tax rates and NL has room to move. NL should also consider a windfall profits tax such as Australia and Norway have. NL can ill afford to give away such a high portion of the economic growth.

In conclusion, this report illustrates that spending has not caused the deficits and spending cuts will only exacerbate existing vulnerabilities. The deficits are self-inflicted through short-sighted tax cuts and the failure to maximize revenues from the boom.

Cuts to spending should be avoided at this juncture for the following reasons:

- Now is the time to borrow with interest rates so low with NL having an infrastructure deficit.
- There is a strong need for social investment in NL due to the aging and highly rural population, legacy of poverty and rising cost of living.
- Unemployment remains high. Oil and gas is a low employment economic engine and the province needs to invest in jobs to share the wealth.
- A strong public sector helps the economy to weather the volatility of resource fluctuations.
- Resource booms are expensive and inflationary.
- The province needs to invest in building a future beyond fossil fuels.
- It is inappropriate for the province to borrow from the pension plan to finance the boom (Like Norway, instead the boom should be used to build long term pension security).
- Public sector cuts mean the loss of jobs that support local economies throughout NL.
- There are revenue options that would reduce inequality and strengthen the economy.

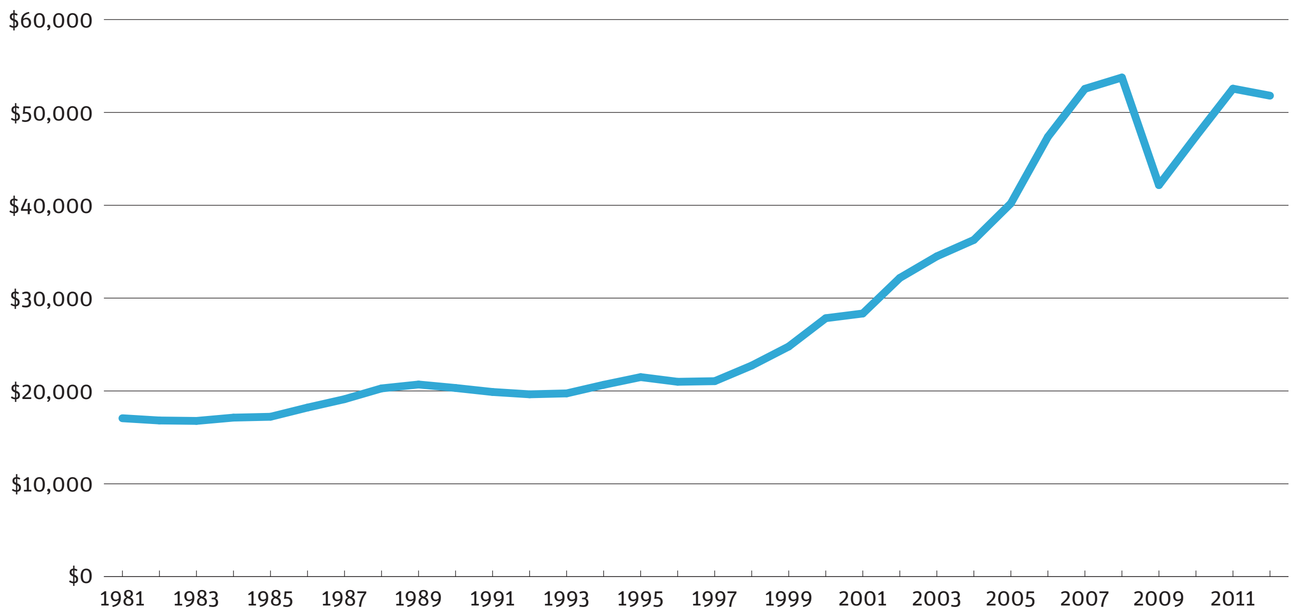
Introduction

NEWFOUNDLAND AND LABRADOR (NL) has achieved considerable success in creating a vibrant economy with increasing prosperity over the past decade. The evidence for this can be seen across a range of economic measures: the rise in GDP; the fall in the provincial debt — both absolute and as a percentage of GDP; the drop in unemployment; the increase in tangible capital infrastructure; the positive climate for private investment; and the rise in residential construction.

The province also faces challenges as its economy is currently highly resource-driven. Recent oil price fluctuations are a good reminder of the volatility associated with a reliance on resource revenues. Additional challenges include NL's very recent history as a less wealthy province, the legacy of underinvestment in social and physical infrastructure, as well as the province's geography and demographic makeup (for example, higher rural and aging populations). NL is an expensive place to deliver services. Another important concern for Newfoundlanders and Labradorians, after sharing poverty for so long, is how to share the prosperity.

These challenges are all manifest in debates over the budget. Not unlike other resource dependent economies in Canada, NL is facing budget deficits despite record levels of private capital investment coming into the province. There is a meme in the current government and media discussion of the deficit that spending is out of line. This drove the Dunderdale administration to cut 1,400 jobs in the 2014 budget. We documented the high costs borne across the economy from public sector job cuts in our 2013 report,

FIGURE 1 Newfoundland & Labrador Real ($2002) Gross Domestic Product (GDP) Per Capita



Source Statistics Canada, Table 384-0001 Gross domestic product (GDP), income-based, provincial economic accounts, annual ($1,000,000), Table 051-0001 Estimates of population, by age group and sex for July 11, Annual, Table 326-0021 Consumer Price Index (CPI), 2009 basket, annual (2002=100)

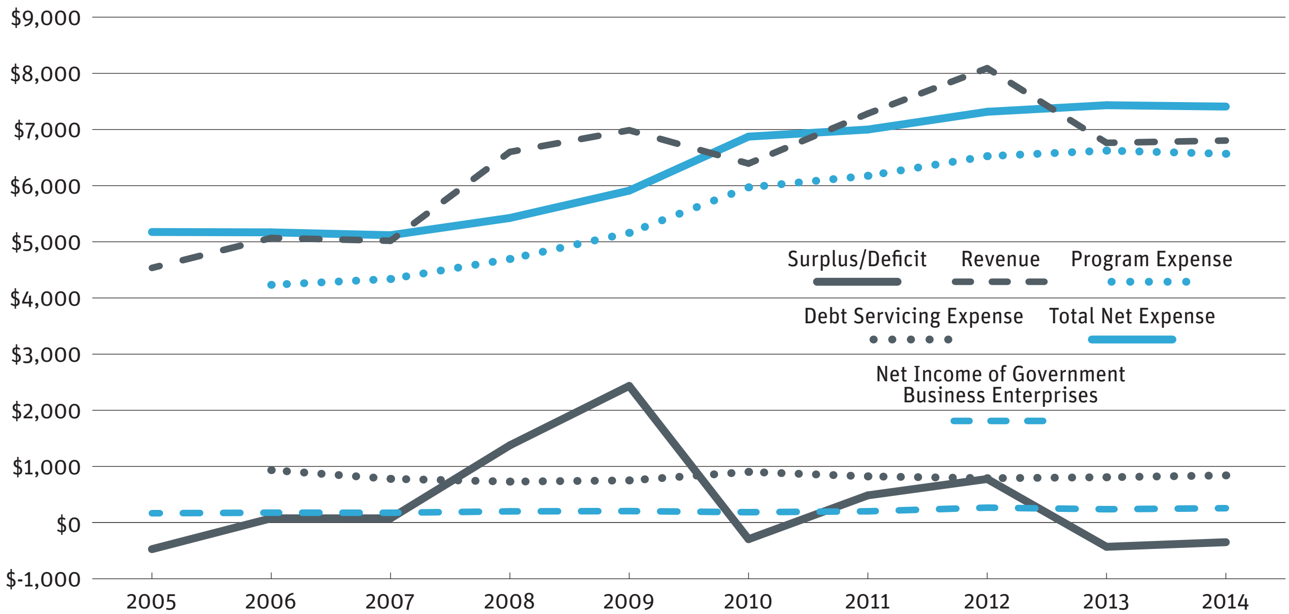
Prosperity for All.[1] Today, it is all the more critical that there be a factual and informed discussion that looks at the real drivers of the deficit and the revenue side of the budget. This report is a continuation of a broader conversation from 2013.

This report examines the overall economy, the level of debt, the long-term revenue and expenditure picture, and policy options for the province. First, the report begins with a brief overview of the economy. It then examines both expenditure and revenue trends in a historical and comparative context and takes into consideration the unique mix of challenges faced by the province at this juncture. Finally, the report lays out options for further improving the province's fiscal position. We look at the job and economic implications of both public spending cuts and alternatives to cuts.

Background on Newfoundland and Labrador's Economy

Newfoundland and Labrador is in a strong fiscal position, with exceptional economic growth before the global financial crisis, a quick rebound, and extraordinary growth in 2013. *Figure 1* illustrates the growth in real GDP

FIGURE 2 Newfoundland and Labrador Budget Revenue and Expenses, Actuals ($ Millions)



Source Newfoundland and Labrador Consolidated Statement of Operations — gross expense basis

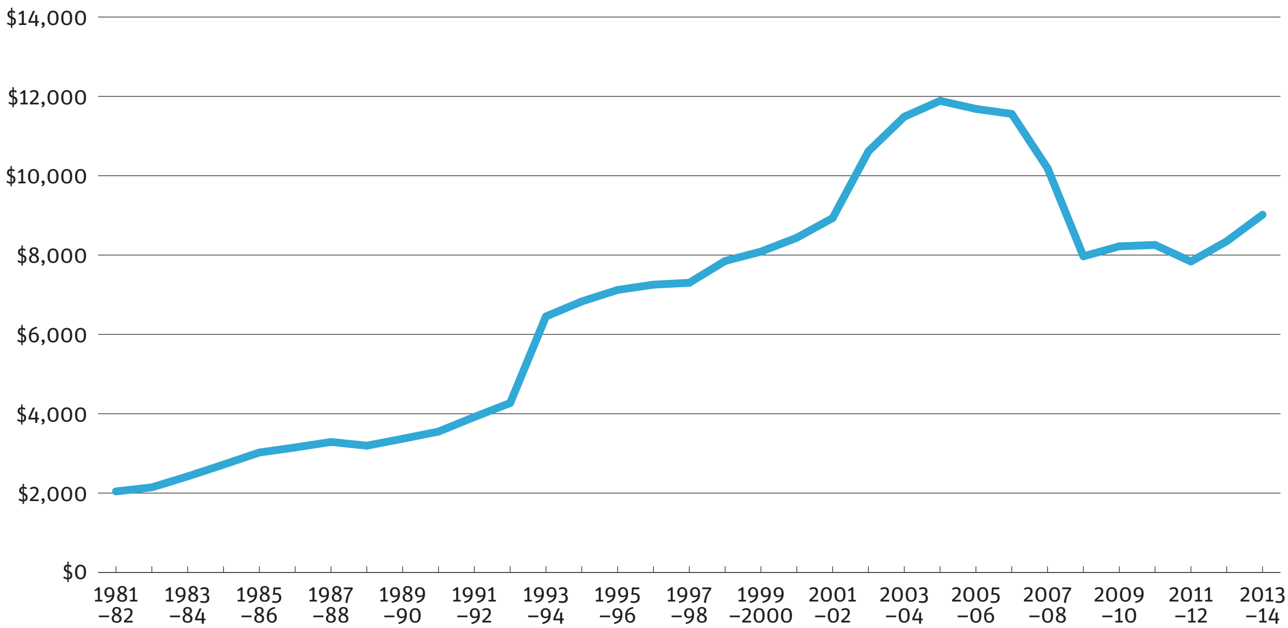
per capita.[2] Though relatively stagnant over the 1980s and 1990s, per capita GDP growth subsequently took off, rising over two and a half times by 2008 and surpassing the Canadian average. NL economic growth rate led the nation in 2013. Though moderating in pace, growth is expected to continue through 2015.[3]

The government appears to have managed the provincial public sector well during the province's rapid growth. NL weathered the Canada-wide recession of 2008/2009 that was compounded by financial instability around the world. We attribute this at least in part to a strong public sector, which has acted as a stabilizer.[4]

Fiscal Situation: The Big Picture

For most of the past decade, revenues have grown more than program spending (*Figure 2*), although revenue growth has slowed since the financial crisis. For most of those years the provincial government has seen surpluses while debt service costs and government enterprise income have been stable.

FIGURE 3 Newfoundland and Labrador Government Net Debt ($ Millions)



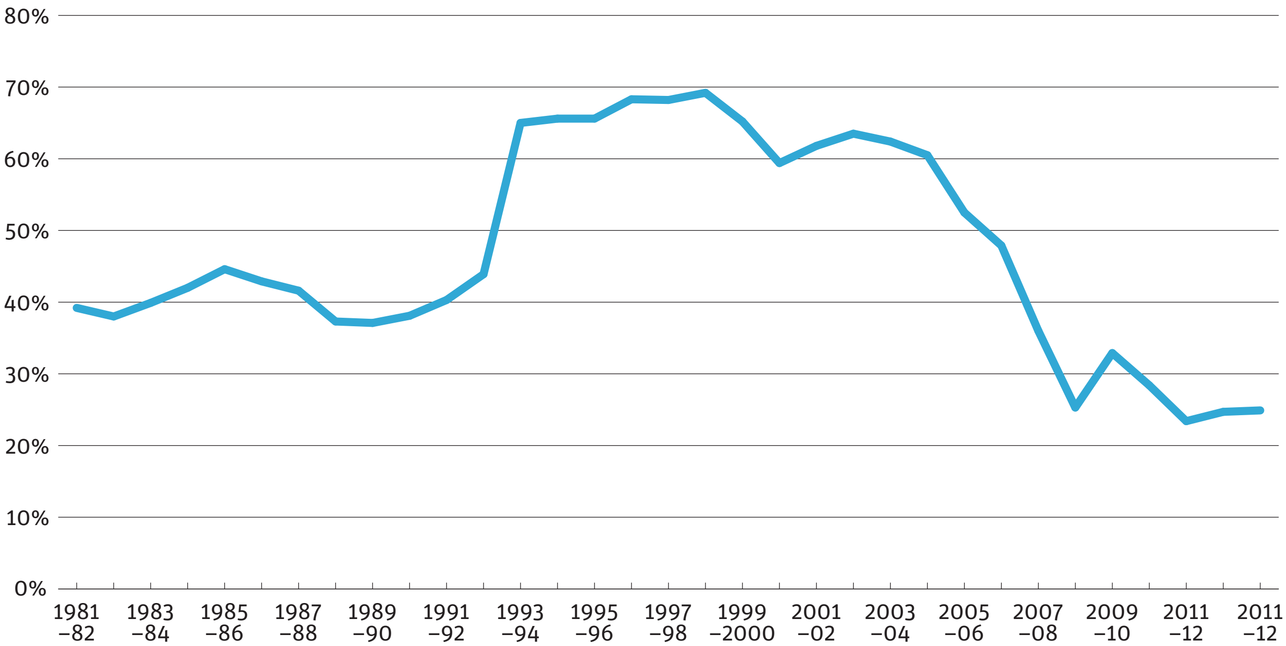
Source Newfoundland and Labrador Budget Estimates (various years)

Debt

The province's net debt is shown in *Figure 3*. Debt grew until 2006, much of it accumulated as the economy developed at a considerable pace and needed infrastructure to support expanding industries (e.g., oil) and to adjust away from contracting industries (e.g., fisheries). After 2006, the absolute debt decreased as revenues substantially exceeded expenditures; the past few years have seen absolute debt stabilize and increase slightly.

Net debt as a percentage of GDP (shown in *Figure 4*), is a better way to illustrate the positive direction that the provincial debt has taken, as well as the affordability of the debt load. The debt of NL was about 40 per cent of GDP during the 1980s, increasing to almost 70 per cent in the 1990s. During the 2000s, the debt-to-GDP ratio fell to a current low of less than 25 per cent — a rapid turnaround. Debt service costs have also fallen as a percentage of expenditures, freeing up revenues for other uses.

FIGURE 4 Newfoundand and Labrador Government Debt as a Percent of GDP



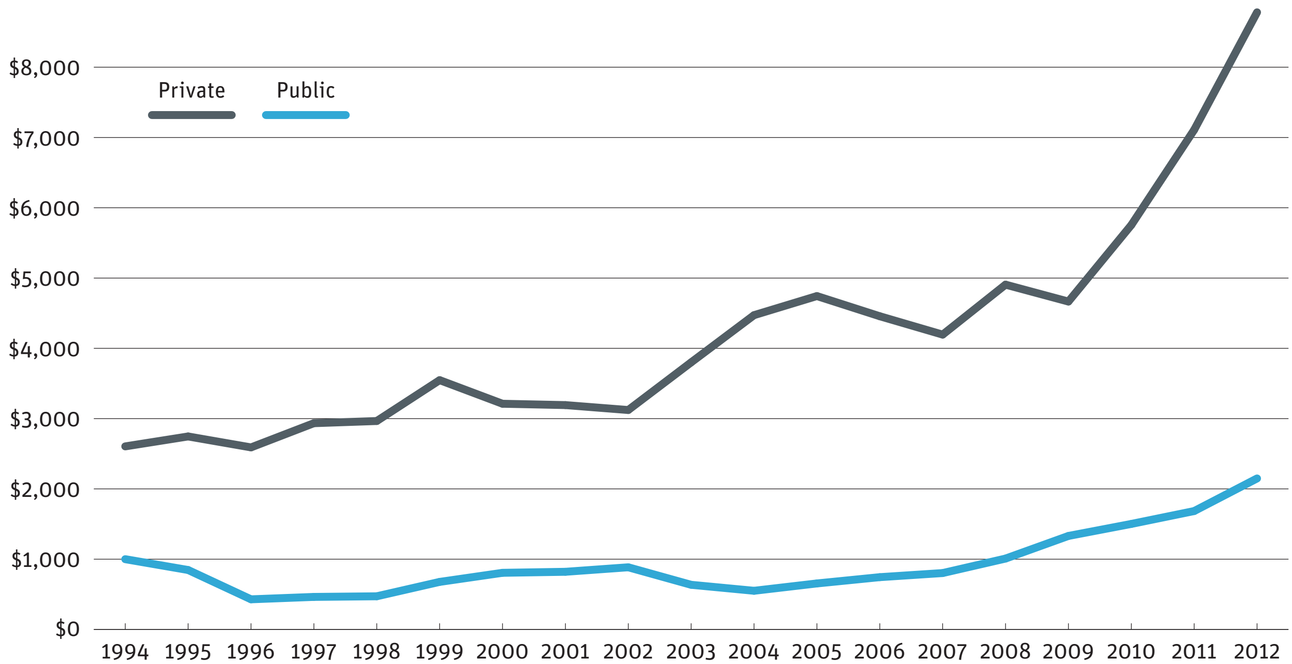
Source Royal Bank of Canada, Provincial Forecasts, Canadian Federal and Provincial Fiscal Tables http://www.rbc.com/economics/economic-reports/pdf/provincial-forecasts/prov_fiscal.pdf

Private Sector Indicators

The private sector in NL has boomed as business optimism has driven large increases in the level of private investment in the province. *Figure 5* indicates the recent surge in private gross investment (capital and repair expenditures) with public investment expenditures shown for comparison.

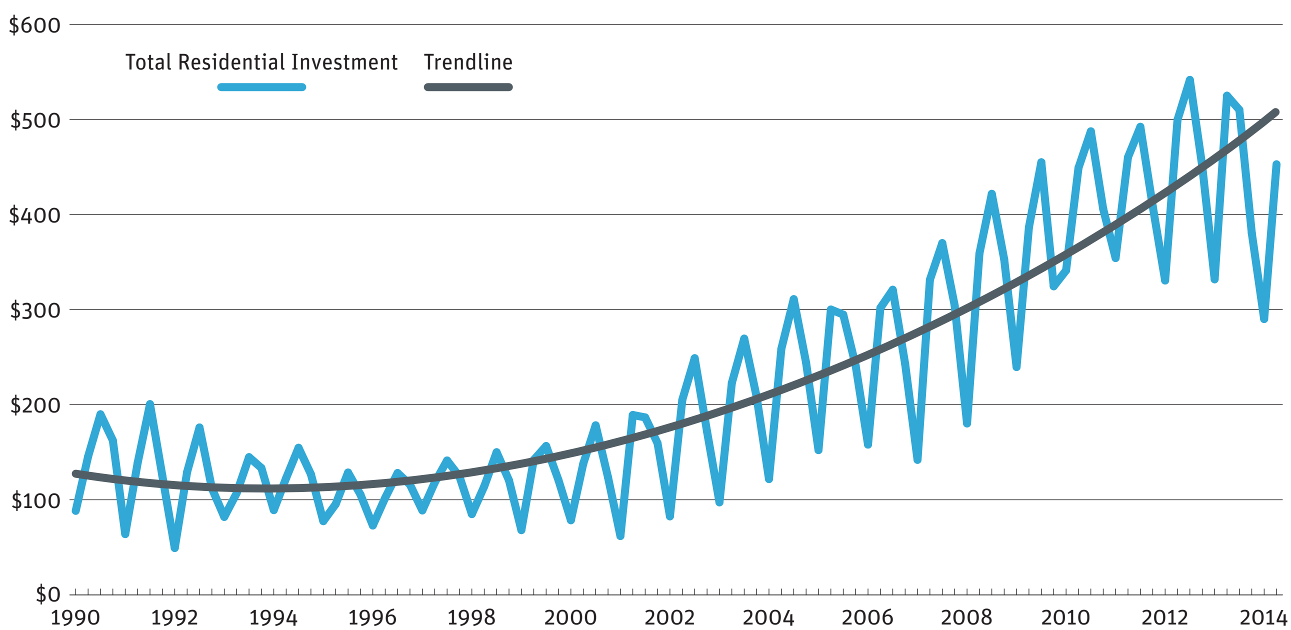
Residential construction is another common indicator of economic dynamism. NL had very 'flat' residential investment of over the 1990s, but the turn of the millennium saw that turn into considerable growth, only recently slowing and leveling off slightly. *Figure 6* shows residential construction roughly quadrupling since 2000, indicating confidence in economic prospects.

FIGURE 5 Newfoundland & Labrador Capital and Repair Expenditures Actual, Preliminary Actual and Intentions ($ Millions)



Source Statistics Canada. Table 032-0002 — Public and private investment, summary by province and territory, annual (dollars)

FIGURE 6 Newfoundland & Labrador Total Residential Investment (Per Quarter, $ Millions)



Source : Statistics Canada, Table 026-0013 – Residential values, by type of investment, quarterly (dollars)

Expenditures

THIS SECTION CONSIDERS public expenditures in Newfoundland and Labrador, how they compare to other jurisdictions, and how NL's unique characteristics drive the need for, and costs of, public services in the province.

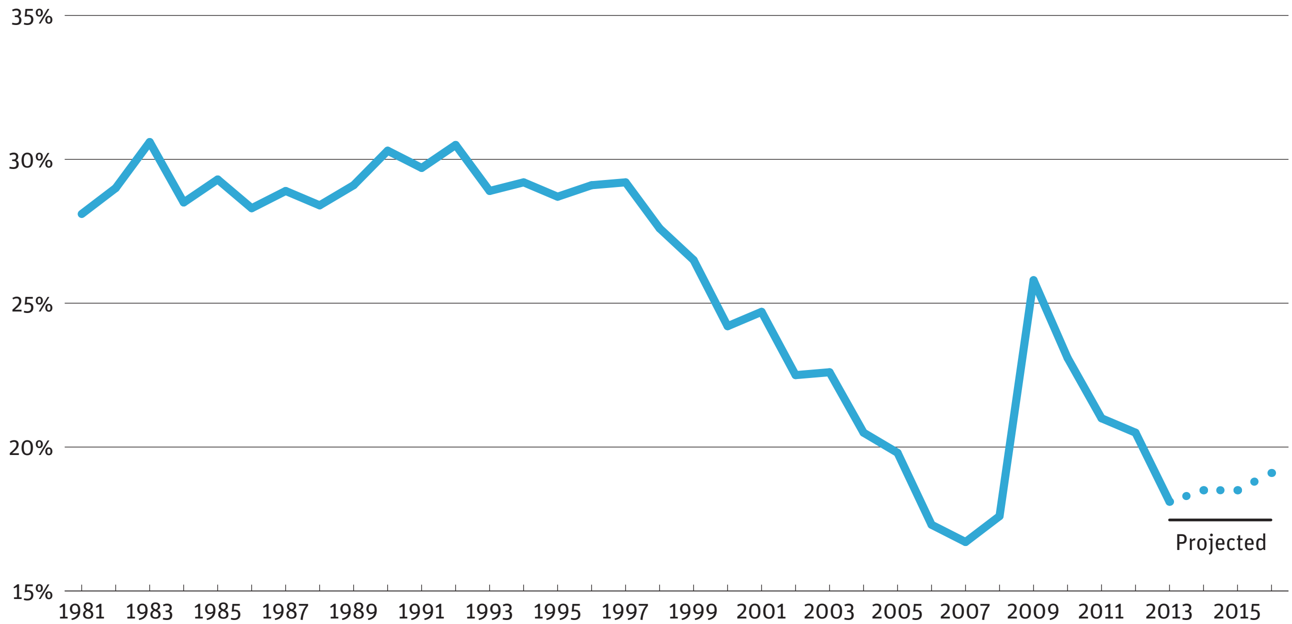
Much of the debate around public sector spending in NL has focused on per capita spending compared to other Canadian provinces. This limited measure tells us little about the appropriate level of public spending. This section will address both affordability and why NL is a uniquely expensive jurisdiction in which to deliver public services.

Spending Affordability

NL government expenditures as a share of GDP have been falling. *Figure 7* indicates that NL's program expenditures were approximately 30 per cent of provincial GDP through the 1980s and 1990s. Program expenditures then fell continuously to a low of 17 per cent in 2007/08 and now stand at approximately 18 per cent of GDP.[5] In short, government expenditures have not kept pace with the rapid growth of GDP.

Even in the Canadian context, NL is not a high spender on public services. Although provincial program spending is relatively high on a constant dollar, per capita basis compared to other provinces, it is not high when considered as a percentage of GDP. Looking at total spending to GDP, NL is middle of the pack — and that includes capital spending.[6]

FIGURE 7 Newfoundand and Labrador Government Program Expenses as a Percent of GDP



Source Data compiled by RBC Economic Research, Provincial Forecasts, January 21, 2013. http://www.rbc.com/economics/economic-reports/pdf/provincial-forecasts/prov_fiscal.pdf

FIGURE 8 Provincial Government Program Expenses as a Percent of GDP 2013/14

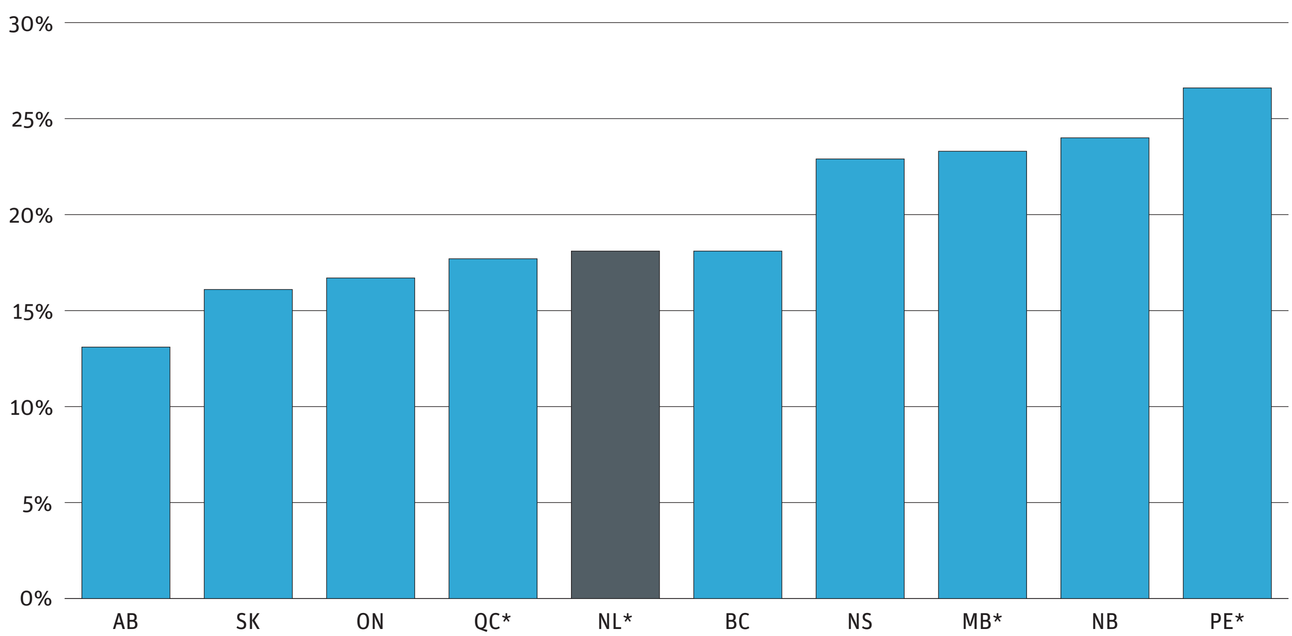


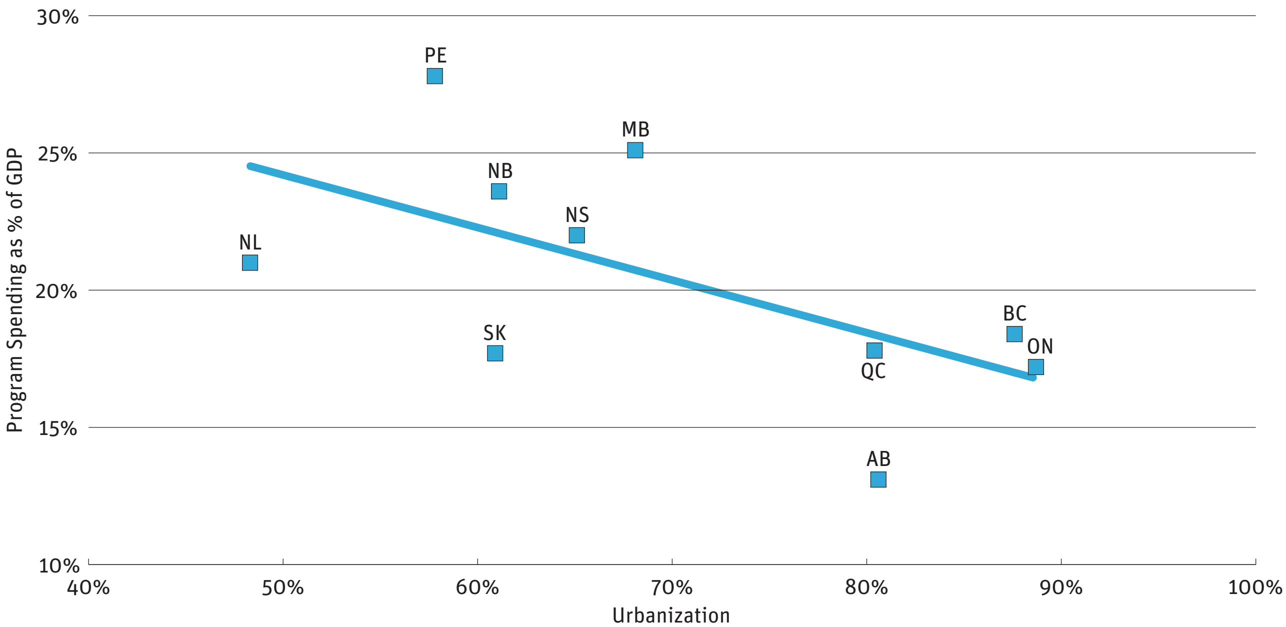
Figure 8 compares NL with other Canadian provinces, showing each province's total public program expenditures as a percentage of its GDP. NL is lower on this metric than the other Atlantic provinces, as well as Manitoba. And although the province spends more relative to GDP than Alberta, B.C., Ontario, and Quebec, NL faces some very different and more costly circumstances than these highly urbanized provinces.

Newfoundland Costs More

Inter-provincial comparators are complicated by differences in history, geography, demographics, density, and many other factors that do not figure into overall per capita spending data. On each of these criteria, NL is not directly comparable to other provinces. The following factors, among others, make it more costly to deliver the same services in NL.

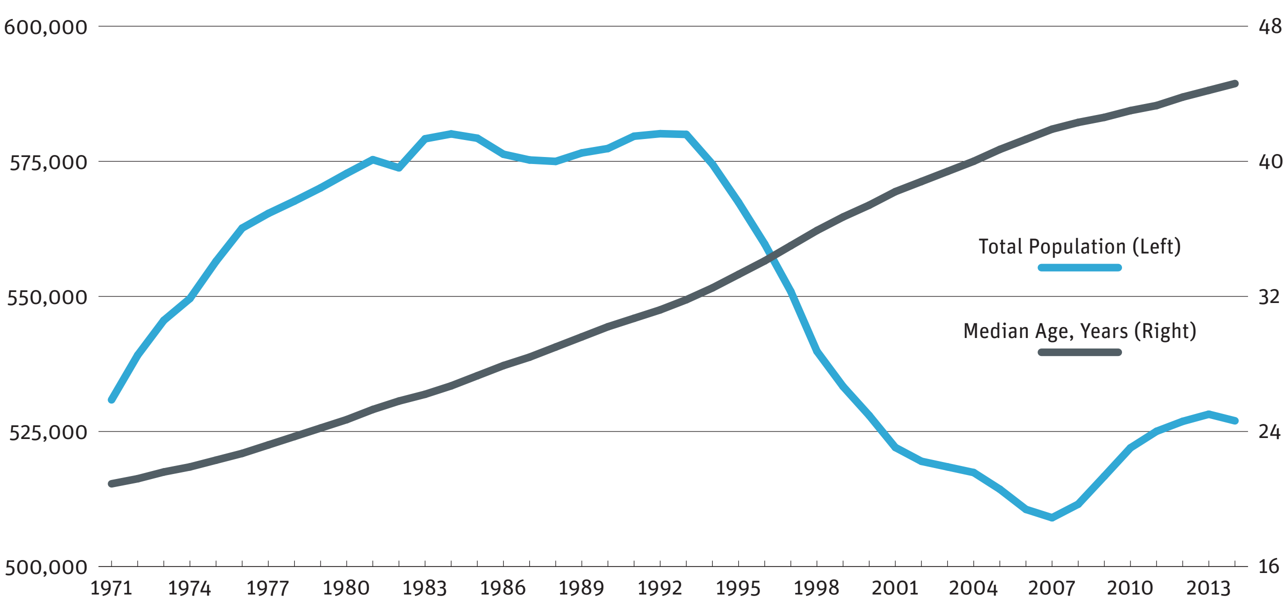
- *A highly rural population. Figure 9* shows comparative data for the provinces for the rate of spending compared to rate of urbanization. It illustrates that NL has the lowest rate of urbanization of all the provinces. It also illustrates that, generally, a higher rate of urbanization correlates with a lower rate of public spending as a percent of GDP.
- *Difficult geography.* NL has very difficult geography. A significant portion of the rural population is located in remote regions that are difficult to access.
- *Aging population and changing demographics.* NL lost population from the mid-1990s to the mid-2000s, mostly in the younger age group. Although the population is now on the rebound, it has left an aging demographic that has higher costs for health care and other services (*Figure 10*).
- *Higher than average growth in cost of living.* The cost of living is growing faster on average in NL than in other provinces (see *Table 1*).
- *Resource booms are expensive.* Both to attract and to keep investment in resource extraction, the government must spend. A resource boom demands social infrastructure such as education, training, and health care as well as physical infrastructure such as roads and ports that need to be built, expanded, or maintained. This is not cheap.

FIGURE 9 Program Spending Vs. Urbanization, 2011



Source Per cent of the population living outside a census metropolitan area (CMA) or census agglomeration (CA), Statistics Canada, Focus on Geography Series, 2011 Census.

FIGURE 10 Newfoundland and Labrador, Total Population and Median Age



Source Statistics Canada, Cansim table 051-0001. Estimates of population, by age group and sex for July 1, Canada, provinces and territories.

TABLE 1 Inflation: Consumer Price Index Comparisons, NL and Canada

CPI All Items	2008	2009	2010	2011	2012	2013
NL	2.9	0.3	2.4	3.4	2.1	1.7
Canada	2.3	0.3	1.8	2.9	1.5	0.9

Source Statistics Canada Cansim table 326-0021. Consumer Price Index, by province.

- *Unemployment and poverty rates are high.* As of September 2014, NL had the highest seasonally-adjusted unemployment rate of all provinces. NL also lags the national average on 8 out of 11 indicators of poverty.

Given these drivers, it costs more per capita to deliver the same level of services in Newfoundland and Labrador than it does in other provinces.

Infrastructure Spending

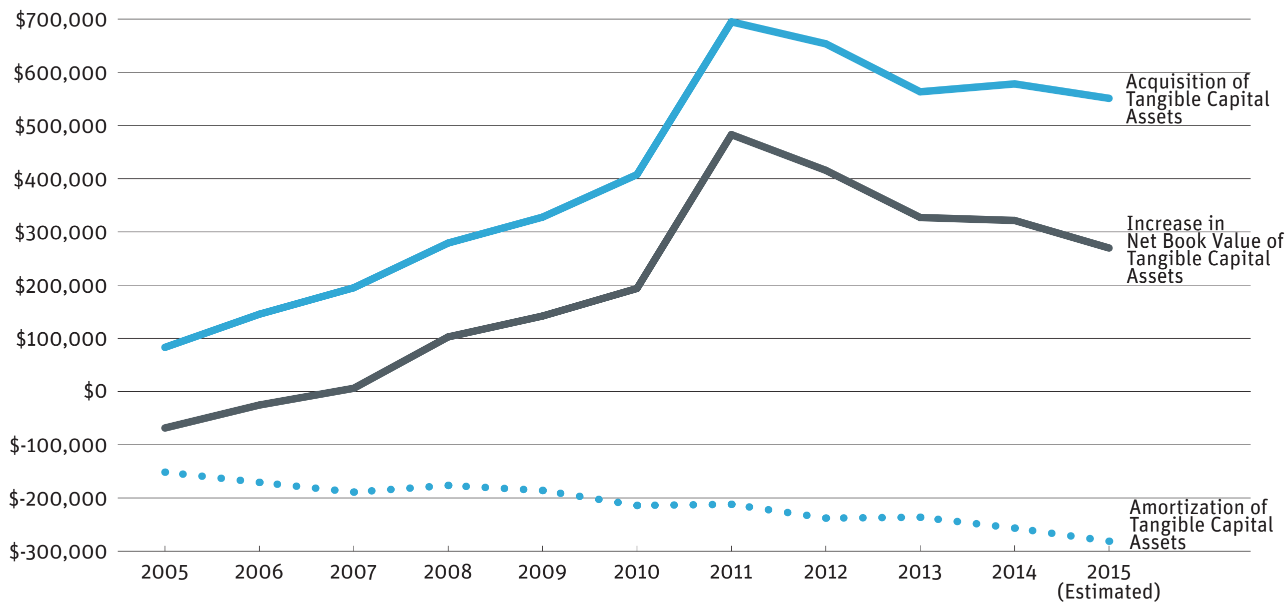
As mentioned earlier, resource booms aren't cheap. Infrastructure needs are high. This is exacerbated in NL by the decades of underinvestment before the boom and the legacy of an infrastructure deficit.

There are two distinct ways the government is creating capital in NL. One is money transferred to Nalcor for energy development in the form of equity purchases. The other is direct capital spending to pay for schools, roads, and other public infrastructure.

In terms of physical infrastructure, Newfoundland has budgeted for a continued high level of capital investment in the 2014 budget. Given that NL underinvested in lean years, this is a positive direction.

The government of Alberta learned the hard way that a booming economy is an expensive time to build infrastructure. Alberta did not make counter-cyclical spending on infrastructure before the boom heated up. As a result of its focus on deficits and cost cutting during the Klein era, Alberta entered the boom years with a large physical and social infrastructure deficit: close to $7 billion in 2006.[7] Clear indicators of this deficit were everywhere — for example, costly nursing shortages and long emergency room wait times in the public health sector. On the capital cost side, Alberta paid a high premium for waiting to build infrastructure as the construction cost index ramped up into the boom. Thus, the province paid an almost 30 per

FIGURE 11 Newfoundland and Labrador Capital (Tangible) Expenditures



cent premium for the infrastructure it built. This cost Alberta between $3 billion and $4.8 billion.

NL needs to keep an eye on private investment and the construction cost index. Engaging in high levels of public sector capital investment at the same time as high levels of private sector capital investment will drive up costs for both sectors. NL has record levels of private capital investment on the books while housing starts have also ramped up. Muskrat Falls has already seen cost escalation and the province would not want to be a driver of further escalation due to poor planning.

Staging public and private sector investments would create construction jobs over the longer term rather than as one large, expensive boom. This would also help support NL's laudable goal of attracting younger workers and encouraging Newfoundlanders and Labradorians to return home. It would allow NL to provide cost predictability for its public investments as well as private investors, keeping developments more affordable for both parties. The continued high unemployment rate indicates that there is still room to move on this front but ongoing planning is needed.

Benefits of Public Spending and Employment

Increases or cuts in public sector spending have ramifications across the economy. In the 2013 budget analysis we discussed the employment and GDP multipliers for different types of spending and the impacts those have in the private sector. We identified that the NL government was at a crossroads and that there were alternatives to the cuts. The government chose to cut 1,400 public sector jobs in the 2014 budget.

The government and mainstream media focus a great deal of attention on the costs of public spending, while often overlooking the benefits. Public sector spending and employment provide benefits to workers, their families and communities, both directly and indirectly.

Direct Effects

The direct effects of government program spending are clear: increased access to public services and programs as well as more quality public sector jobs. Spending creates jobs and services directly, both inside and outside of government, in education, health care, construction, administrative, professional and consulting services, and other sectors.

Indirect Effects

Government spending also creates jobs indirectly, in industries that supply goods and services to enable the "direct effect" workers to do their jobs, e.g., in manufacturing, transportation, warehousing, and retail sectors.

Induced Effects

Workers employed directly by government, and those employed indirectly by industries supplying government, spend most of their money on local goods and services. This spending induces higher levels of employment in other sectors of the economy — retail, food services, hospitality, and much more. This stimulates both jobs and economic activity across a range of local private sector businesses.

It is due to the indirect and induced effects that the public sector can be a great stabilizer to help the economy weather external shocks and fluctuations. This is particularly the case for a resource driven economy subject to periodic volatility.

Our 2013 budget analysis illustrated that public spending can create substantial amounts of employment compared to other sectors per dollar invested. Public sector spending creates up to 20 times more jobs per dollar invested than oil and gas extraction.[8] Indeed the oil and gas industry creates fewer jobs per dollar spent than almost any other industry in Newfoundland. Allowing excess profit and resource rents to stay in the hands of resource extraction companies is not a cost-effective way to boost employment.

Of course public spending in the long run is paid for by taxes. Tax reductions can also create jobs, by leaving resources in the private sector to be spent with the resultant indirect and induced effects. However, in reality tax cuts have a relatively small impact on jobs due to leakage outside the province and its communities. A wide range of authorities have observed that government spending creates at least twice as many jobs as do tax cuts.[9]

Job Losses from the Cuts

On the flip side of public spending are the impacts of public sector cuts. Just like public spending, public sector cuts will have direct, indirect and induced impacts. Cutbacks create unemployment directly, and also in a wide range of industries in the private sector. The Royal Bank of Canada (RBC) reported on the continuing economic drag created by the public sector cuts in its September 2014 economic update.[10]

In NL, unemployment has been a major problem for a long time, and much public policy discussion has focused on how governments can create jobs. With the economic boom being driven by oil and gas, employment has not grown in parallel with GDP. With unemployment remaining high, public sector spending is critical to both stabilize the economy and maintain employment.

Inequality in a Resource Boom

In our 2013 analysis, we highlighted that NL needs to keep an eye on the risk of rising inequality that can accompany resource wealth, otherwise known as the paradox of plenty. Alberta is a textbook case: it is home to both some of the country's richest rich and most intense poverty.

Newfoundland has the highest inequality in market income in the nation. This inequality is mitigated by the tax and transfer system and NL is not the most unequal in post-tax-and-transfer income.[11] Research such as that found in *The Spirit Level* by Richard Wilkinson and Kate Pickett has clearly shown that inequality is bad for the well-being of all. Other research has shown that it is also bad for the economy.[12]

NL would be well advised to focus on mitigating the risks and downsides of a resource boom through progressive tax structures as well as social infrastructure spending. The analysis in this report documents that maximizing revenues and reinstating social spending is critical in this context.

Revenues

Tax Revenues in Context

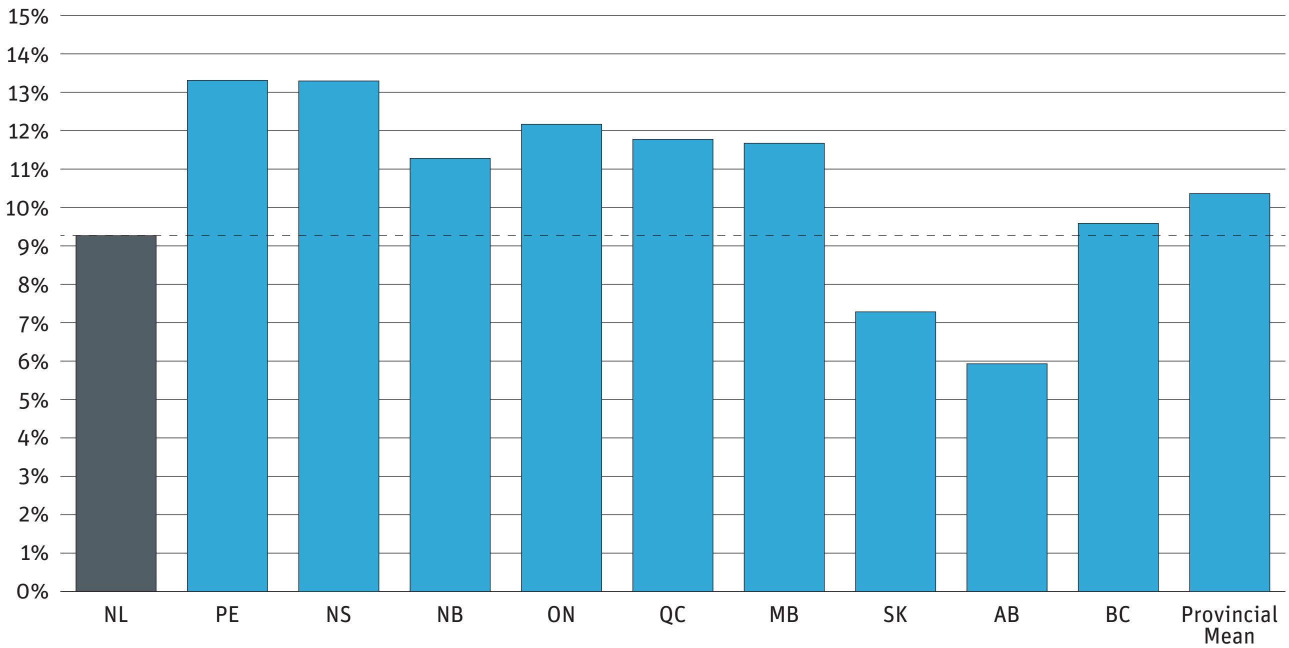
Tax revenue as a percentage of GDP is quite low in NL compared to other provinces. *Figure 12* compares the total tax revenue of each province in Canada collected in 2012. That year, NL tax revenue as a percentage of GDP was lower than all provinces except Alberta and Saskatchewan (both finance government spending with royalties from the sale of natural resources to a much greater extent than others).

There is considerable room for NL to increase taxes. If the province collected the percentage of GDP at the level of the Canadian average, it would have brought in over $3.5 billion in 2012. As it stands, NL collected $3.1 billion.[13] Just by moving to the average ratio of revenue to GDP of the other provinces, NL could have realized $400 million more in revenue.

Figure 12 compares total taxes collected. These include personal income tax (PIT), corporate sales tax, sales tax, capital tax, property, fuel and gasoline, carbon, liquor and tobacco taxes, etc. *Figure 13* compares revenues obtained from personal income tax only.

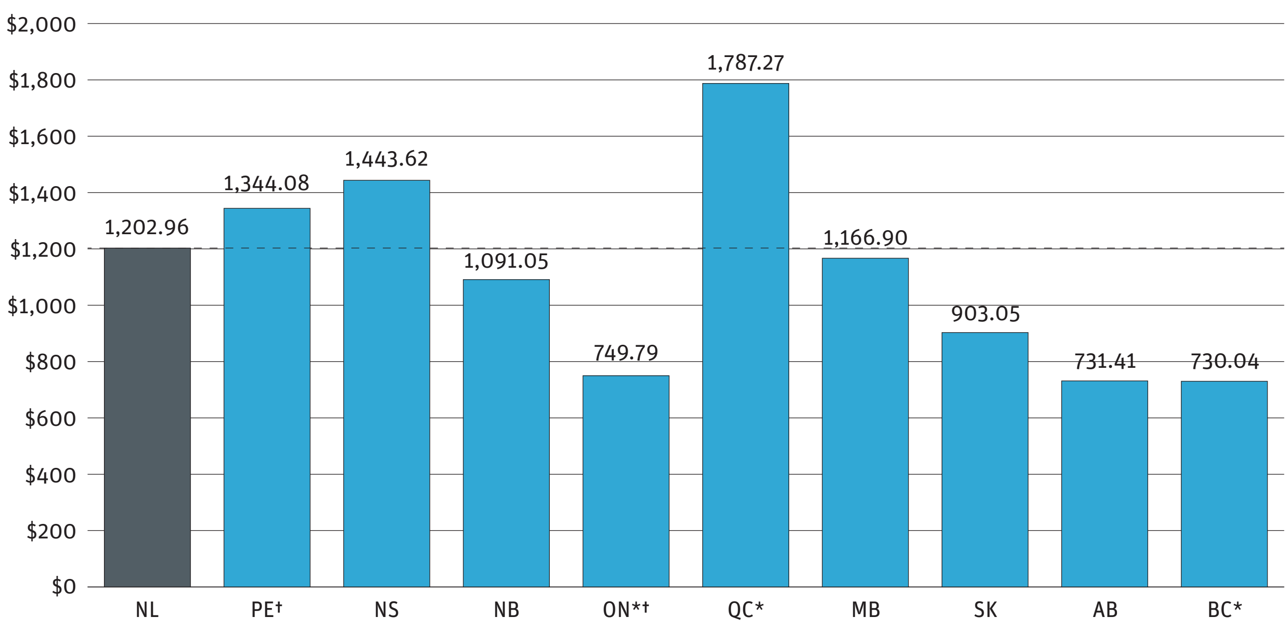
The analysis presented in *Figure 14* shows how much PIT revenue NL could generate if it applied the tax structures of other provinces to its tax base. For example, using the tax rate brackets of Prince Edward Island, Nova Scotia, or Quebec would create more government revenue than the current NL personal income tax structure. On the other hand, if NL used the tax rate schemes of other provinces less PIT revenue would be generated for NL.

FIGURE 12 Total Tax Revenue as a Percent of Provincial GDP (2012)



Source Total Tax revenue, provincial budget documents; Gross Domestic Product, expenditure based Statistics Canada, Cansim Table 384-0038.

FIGURE 13 Comparison of Possible Newfoundland Revenue Based On Other 2014 Provincial Personal Income Tax Rates, Estimated From Individual Newfoundland and Labrador Tax Filers, 2012 Personal Income ($ Millions)[14]



* Also collect a health care premium. † Include surcharges on provincial tax paid

Source Individual Newfondland and Labrador tax filers, 2012 personal income and Statistics Canada, CANSIM, table 111-0008 Neighbourhood income and demographics, taxfilers and dependents with income by total income, sex and age group, annual.

TABLE 2 Federal and Provincial Personal Income Tax Rates, Brackets and Surtaxes For 2014

	Personal Basic Amount	Tax Brackets						Surtax Rates and Threshold
Fed.	$11,138	**15%**	**22%**	**26%**	**29%**			
		Up to $43,953	43,954–87,907	87,908–136,270	136,271 and over			
BC	$9,869	**5.06%**	**7.7%**	**10.5%**	**12.29%**	**14.7%**	**16.8%**	
		Up to $37,606	37,607–75,213	75,214–86,354	86,355–104,858	104,859–150,000	$150,001 and over	
AB	$17,787	**10.00%**						
		All income						
SK	$15,378	**11%**	**13%**	**15%**				
		Up to $43,292	43,293–123,692	123,693 and over				
MB	$9,134	**10.80%**	**12.75%**	**17.4%**				
		Up to $31,000	31,001–67,000	67,001 and over				
ON	$9,670	**5.05%**	**9.15%**	**11.16%**	**12.16%**	**13.16%**		20%: $4,331
		Up to $40,120	40,121–80,242	80,243–150,000	150,001–220,000	220,001 and over		36%: $5,543
QC	$11,195	**16.00%**	**20%**	**24%**	**25.75%**			
		Up to $41,495	41,496–82,985	82,986–100,970	100,971 and over			
NB	$9,472	**9.68%**	**14.82%**	**16.52%**	**17.84%**			
		Up to $39,305	39,306–78,609	78,610–127,802	127,803 and over			
NS	$8,481	**8.79%**	**14.95%**	**16.67%**	**17.5%**	**21%**		
		Up to $29,590	29,591–59,180	59,181–93,000	93,001–150,000	150,001 and over		
PE	$7,708	**9.80%**	**13.8%**	**16.7%**				10%: 12,500
		Up to $31,984	31,985–63,969	63,970 and over				
NL	$8,578	**7.70%**	**12.5%**	**13.3%**				
		Up to $34,254	34,255–68,508	68,509 and over				

The various tax structures of each province are compared in *Table 2*. All provinces, except for Alberta and Ontario, have higher top marginal tax rates than NL. Therefore, one approach for NL to increase personal tax revenue would be to increase tax rates in the current top brackets, and/or add a new tax bracket on the highest incomes. This would increase both revenues and the progressivity of the tax system, making it fairer. This approach is appropriate in NL where the oil and gas industry has increased the number of high-income earners, exacerbating inequality.

Foregone Revenues

NL is foregoing revenues in a number of ways; first, through recent tax cuts and second by not having the right tax mix to capture revenues that may otherwise leave the province.

With regard to tax cuts, the province's February 2013 pre-budget consultation document states that $500 million of the deficit was due to tax cuts.[14] Though a reduction in taxes for lower income NL citizens can be positive in terms of their ability to participate more in the local economy, the same is not true for tax breaks for high-income individuals; their marginal propensity to spend locally is much less.

The tax cuts in 2007 were heavily in favour of the top income brackets. Effective July 1, 2007, the following reductions were made to the province's personal income tax rates:

- Tax on the first income tax bracket was reduced from 10.57 to 8.7 per cent;
- Tax on the second bracket was reduced from 16.16 to 13.8 per cent;
- Tax on the third bracket was reduced from 18.02 to 16.5 per cent; and
- The 9 per cent surtax imposed upon middle and high-income earners was eliminated.

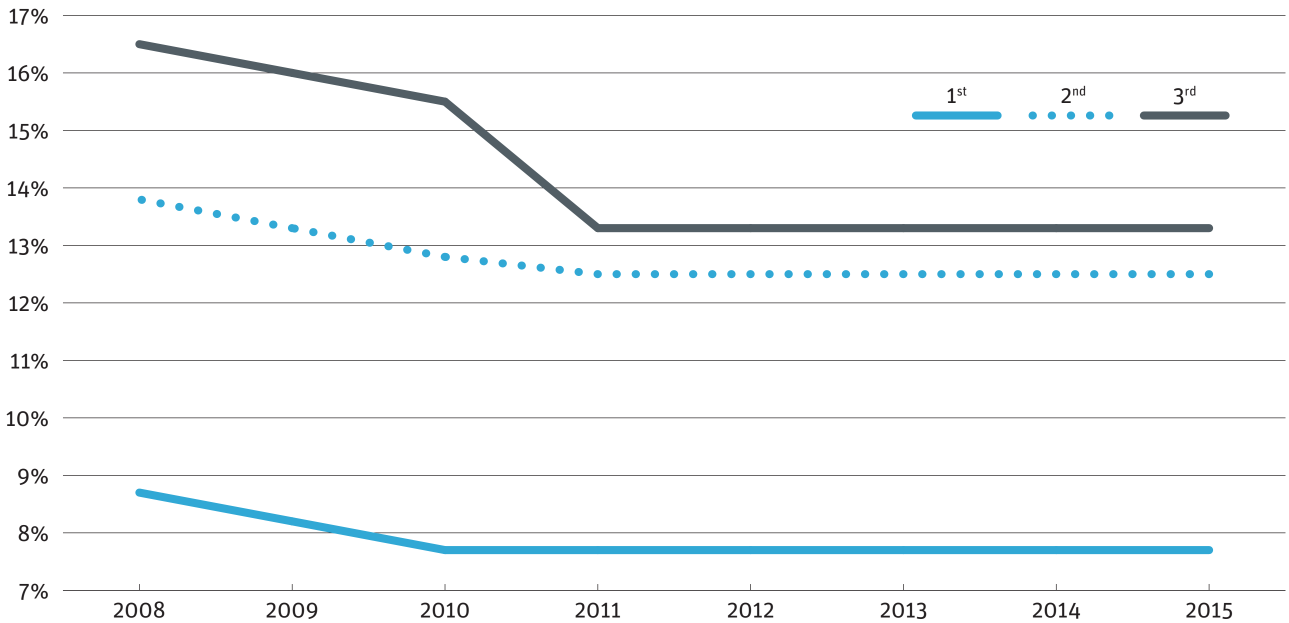
The 2010 budget had further tax cuts for second and third tax brackets:

- Those in the bracket between $31,278 and $62,556 per year saw a rate cut of 0.3 per cent; and
- Those with incomes above that bracket saw their rate cut by 2.2 percentage points.

By 2013 tax rates were 7.7 per cent for the first $31,984 of taxable income 8.7 per cent on the next $31,985 and 13.3 per cent for taxable income of $63,970 and over.

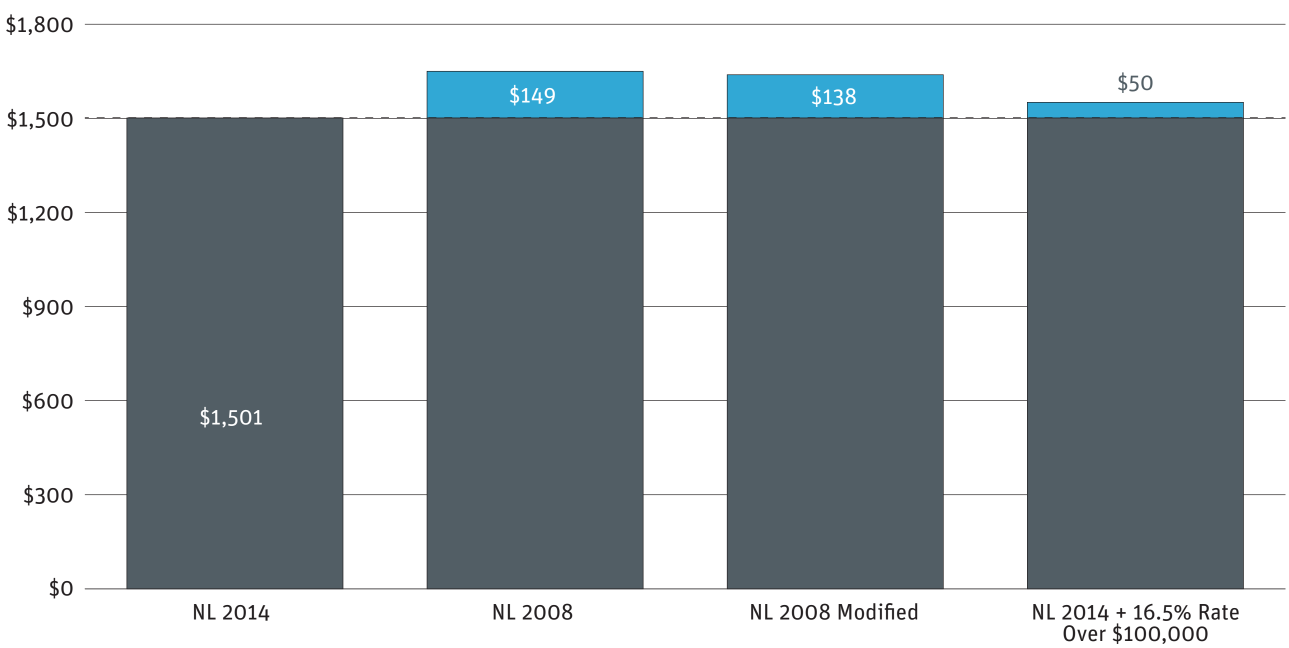
Figure 14 illustrates this history of tax reductions showing the greater decline in the two higher income classes.

FIGURE 14 Newfoundland & Labrador Personal Income Tax Rates



Source Provincial Government budget and estimates documents (various years)

FIGURE 15 Comparison of Possible Newfoundland PIT Revenue Based on Various NL Tax Rates Estimated From Individual Newfoundland and Labrador Tax Filers, 2012 Personal Income ($ Millions)



Other tax reductions included a tax break to seniors by changing the age amount from $3,681 to $5,000 and a change in the small business tax, cut from 5 to 4 per cent effective April 1, 2010. The government has announced additional changes including lowering the rate of 4% to 3%, effective July 1, 2014, and a new credit for corporations, the Newfoundland and Labrador small business venture capital tax credit.

According to the government's Budget 2012 estimates, over a three-year period, the cumulative cost of combined personal and other tax cuts for Newfoundlanders and Labradorians exceeded three-quarters of a billion dollars.[15]

The 2008 personal income tax rates had a greater tax burden on those with higher incomes, therefore taxes were more fairly distributed. If the 2008 tax regime was reinstated PIT tax revenue could increase by an estimated $149 million. Subsequent tax rate reductions were greatest in the third bracket (highest income class). If a fourth tax rate of 16.5 per cent is added for those earning, for example, greater than $100,000, while keeping the lower rates at the current 2014 values, would result in increased revenues of $50 million and make NL's tax regime more progressive. Implementing a fourth tax bracket would increase revenues, make the tax system fairer and bring NL into line with other provinces.

Corporate Taxes

Table 3 illustrates trends in revenues and expenses in offshore oil and gas for NL and NS in based on industry data from the Canadian Association of Petroleum Producers (CAPP).[16] The table reveals that the offshore sector made before-tax net revenues of over $2 billion in 2013, the bulk of which was from production in NL. To account for initial capital investments, the final column includes total revenue and expenses for the period 1985 to 2010, and reveals a before tax net revenue of almost $50 billion.

It is worth noting that the sector is heavily foreign owned (e.g., 90 per cent for Hebron). Thus, a low tax or rent capture model is unlikely to stimulate jobs or investment as much of those revenues will leave not just the province but the country.[17] These companies are not operating on tight margins; ExxonMobil, one of the key investors in the Hebron project, announced earnings of over $30 billion in its global operations in 2013.[18]

It is beyond the scope of this study to analyze how effectively the government is capturing rent from the resource sector. There are indications that oil and gas revenues are not being maximized on that front, though this

TABLE 3 Revenues and Expenditures, Offshore Oil and Gas

($ Millions)	2011	2012	2013	Total 1995–2013
Eastern Offshore Value of Producer Sales (NL and Nova Scotia)	11,261	8,449	9,626	113,502
Net Cash Expenditures Offshore NL	5,477	5,664	7,185	50,976
Net Cash Expenditures Offshore Nova Scotia	500	247	299	13,390
Revenues After Expenditures	5,284	2,538	2,142	49,136

Source Canadian Association of Petroleum Producers Statistical Tables 4.12a, 4.13a, 4.24a

is subject to an ongoing debate.[19] The Norwegians realized over five times the value Canadians received per barrel of oil by charging the oil companies higher taxes and investing equity ownership in production. Norway has a savings fund approaching a trillion dollars. The Norwegian government has maximized revenue and used it to secure the retirement future of its citizens while Newfoundland has instead borrowed against its citizens retirement future to fund economic expansion and lower taxes.

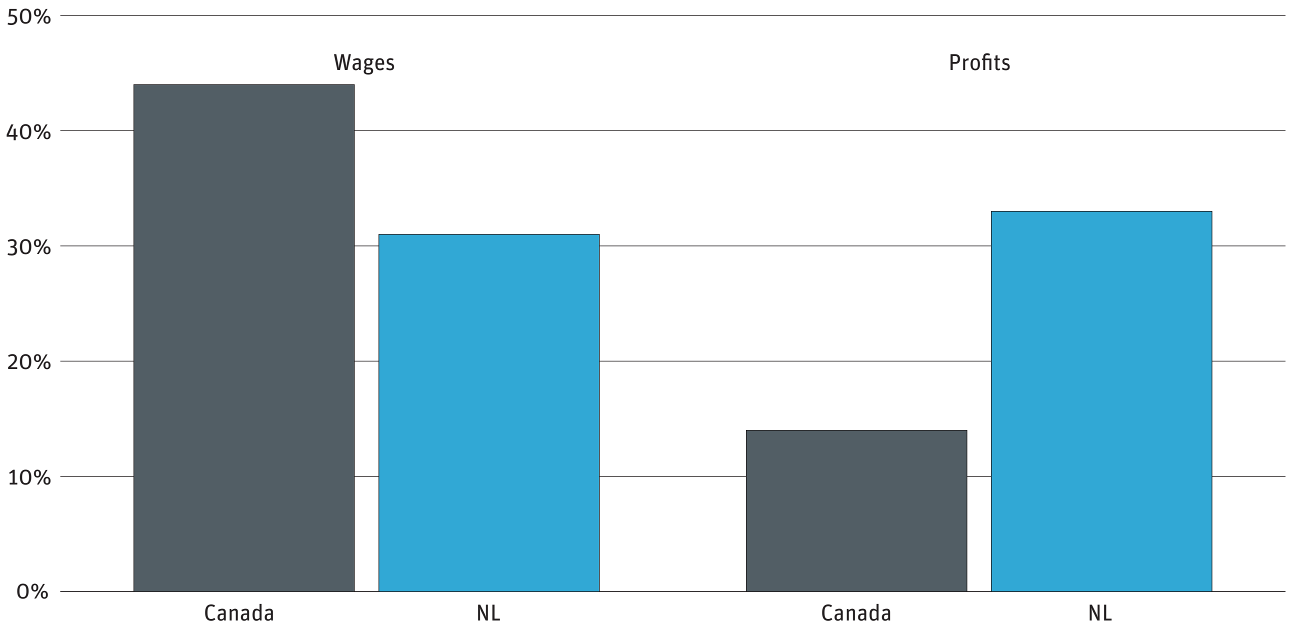
Mining is no different in terms of the ownership profile and there are risks of profits leaving the province and the nation from that sector as well.

Given the high rate of net profit in the offshore sector shown in the table, it is not surprising that corporate profits have been capturing a disproportionately high share of GDP. The tax and royalty structures in NL have been much less effective than those of other provinces at capturing these profits, as shown in *Figure 16*. It also shows, for contrast, how this compares to the share of NL's economy that goes to wages.

Deficit projections show that the province can ill afford to give away revenue. Corporate taxes are important instruments to capture excess profits in the case of a capital intensive, resource extraction industry that is majority foreign owned. For NL to maximize the benefits of the industry to local citizens, higher corporate taxes and a tax on excess profits need to be considered.

Table 4 details the comparative corporate tax rates for the provinces and territories as of September 30, 2014. As can be seen, higher cost regions like PEI and the territories have higher corporate tax rates than NL. It is also worth noting that BC raised its corporate tax rate in 2014. A case could be made for NL to have amongst, if not the highest corporate tax rate in the nation due to the foreign ownership of its resource sector. With a low tax rate for small businesses, this tax would hit only larger corporations and could be an important instrument in keeping profits from leaking out of the country.

FIGURE 16 Profits and Wage Shares as Percent of GDP, 2013: Canada Vs. Newfoundland and Labrador



Source CANSIM Table 384-0037 GDP, income-based, provincial and territorial, annual (dollars×1,000,000)

TABLE 4 Comparative Corporate Tax Rates, 2014

Province or Territory	Lower Rate	Higher Rate
NL	4% (3%)*	14%
NS	3%	16%
PE	4.5%	16%
NB	4.5%	12%
QC	8%	11.9%
ON	4.5%	11.5%
MB	nil	12%
SK	2%	12%
AB	3%	10%
BC	2.5%	11%
YT	4%	15%
NT	4%	11.5%
NU	4%	12%

Source Canadian Tax Highlights Volume 22, Number 9, September 2014 ©2014, Canadian Tax Foundation
* Effective July 1 2015, new rate will apply to small business

The federal government has been cutting the corporate tax rate consistently, opening up room for NL. The general federal corporate income tax rate was cut from 28 per cent in 2000 to 15 per cent in 2012. This means that the combined federal rate for NL was 29 per cent as of 2012. For comparison, in January 2012, the combined federal and state corporate tax rate across the United States averaged 39.2 per cent. Canada currently maintains the lowest corporate tax rates among G8 countries.[20]

Another instrument effective at capturing extraordinary profits from foreign corporations is a special tax on those profits. It is not uncommon for jurisdictions with large multinational firms making high profits to implement an extraordinary profits tax. Often referred to as a 'tax on unearned income' or a 'windfall profits tax,' the tax ensures that the province and citizens share in the windfall if commodity prices suddenly make for higher than anticipated profit margins.

In our 2013 budget analysis we described examples from other jurisdictions (Australia and Norway) for capturing windfall profits. The appropriate type of tax for capturing windfall or excess profits in NL needs more research and debate. Certainly the province needs to closely examine the tax mix in order to ensure that natural resource wealth is captured and shared fairly with the province and citizens of NL and corporate profits are a more balanced percentage of GDP.

Oil Price Volatility and its Implications

With so much of government revenues currently reliant on the resource sector, in particular offshore oil, the recent fall in oil prices has sparked significant debate in NL.

The most recent budget projections were based on continued high prices; the 2014 budget assumed oil prices at US$105 per barrel (and an exchange rate just above US$0.91 per Canadian dollar). At present, the effects of falling oil prices are mitigated slightly by a falling Canadian dollar and the expansion of oil transport networks across North America, but there will still be a notable impact on the deficit projections.

The average oil price for the year is likely to be lower than what the government projected. Economists have calculated that every U.S. dollar less in the price of oil (averaged over the year) will mean $20 million to $30 million less in annual government revenues.[21] However, budgeting should not be done based on short-term reactions to fluctuations in commodity prices.

It is still uncertain where oil prices will settle in the long term after the current volatility. For instance, looking several years out, the markets have kept pricing around the same level in Canadian dollars as one or two years ago.[22]

The impact of the oil price fluctuations on the deficit is a clear indication of the importance of shifting to more reliable revenues such as taxes for funding operational expenses.

Conclusions

THIS REPORT HAS detailed the strong economic position NL is in and the unique challenges it faces. The data confirms that it continues to cost NL more to deliver the same services as other provinces, meaning that spending per capita will be higher for equivalent levels of public services. It also details how the levels of spending are affordable by measures of spending to GDP and that the province is actually a relatively low spender by that measure.

Other indicators of economic strength remain strong including personal income tax revenue, capital investment, retail sales and housing starts. However, despite the economic strength, NL has seen deficits in the past two fiscal years and is projected to also see a deficit in the current year — one potentially exacerbated by the recent fall in global oil prices.

This report is an update of our 2013 report "Prosperity For All" in which we illustrate that the deficits are not driven by spending increases. They are so far the result of temporary shocks, both self-inflicted and external. The most important shock so far has been a self-inflicted fiscal shock: the government has cut its own revenues. Personal income tax rates have been cut, disproportionately for those with higher incomes. At the same time, the government has been unwilling to adequately tax the extraordinary profits going to large corporations in the extractive sector, particularly those in the oil industry. Together, these decisions have contributed to two successive deficits. This is exacerbated by the external shock coming from softening oil prices, which is only slightly mitigated by the change in Canadian dollar value.

The argument for a continuing campaign of public sector job and spending cuts in the face of today's pressures is a weak one and politically-motivated. This is a good time to take pause. Rather than exacerbating cuts that could hamper future growth, NL should be investing in the public sector, especially as reasonable funding options exist. Debt-financed public expenditure may be prudent given the low interest rates still prevalent after the financial crisis. This is especially the case since both the Muskrat Falls investment and the Hebron oil field will be complete and generating revenues (in the form of return on equity for Muskrat and royalty payments for Hebron) by 2017.

Investing in public sector jobs and programs can be a source of economic strength in volatile times. A strong public sector can be a job creator, which is much needed given NL's persistent high unemployment. It can also act as an economic stabilizer and an engine for economic diversification.

As our 2013 report, "Prosperity For All," pointed out, the direct employment effects of public spending are some of the largest across a variety of major economic sectors (for a given amount of investment). The initial job creation also has knock-on effects as jobs are created in firms that supply the public sector and elsewhere across the economy as those newly-employed go out and spend their earnings. Given the current size of the public sector and the few jobs created by oil and gas extraction, strengthening the former is one of the best ways to encourage job growth. This is all the more so the case because jobs in the public sector are often good jobs: jobs that pay decent wages, offer benefits, observe health and safety standards and promote stable communities.

Cutting spending during a time of uncertainty would decrease the number of good jobs as well as the capacity to create more of them, it would shrink the public sector's ability to stabilize private sector volatility and it would leave the province with fewer options to pursue a diversified future, one less dependent on resource extraction.

That is the low road the government is increasingly taking — one that risks shortchanging the Newfoundlanders and Labradorians of long-term, stable prosperity in favour of short-term gains for a few. Yet there is still time to take the high road. This would require recognizing that the capacity to raise revenues needs to be bolstered and that volatility in commodity markets can be counteracted by public spending to produce stability and lay the foundation for widely-shared gains. It requires, above all, the courage to invest in the province, its people and its future.

Notes

1 Diana Gibson and Greg Flanagan, *Prosperity for All: An Alternative Economic Path for Newfoundland and Labrador* (CCPA, 2013).

2 We acknowledge the limitations of GDP per capita as a measure of well-being, but use it here as a measure of the growth in wealth of the province for context. The report addresses the issues of how this GDP is captured and redistributed.

3 Scotiabank, Global Economics, June 27, 2014 "Provincial Trends." Recent discoveries in the Flemish Basin have been a game changer for NL, reversing projections for production to decline in the near future. Susan R. Eaton "Discoveries Breathe New Life In Newfoundland." American Association of Petroleum Geologists. http://www.aapg.org/publications/news/explorer/details/articleid/8055/discoveries-breathe-new-life-in-newfoundland#sthash.CiwkiKiR.dpuf. Accessed November 2014.

4 For a discussion of spending as a stabilizing force, see Alex Himelfarb, Jordan Himelfarb "Tax Is Not a Four-Letter Word: A Different Take on Taxes in Canada." Wilfrid Laurier Univ. Press, Nov 8, 2013.

5 A province's accounting and reporting practices may have changed over time and historical comparisons need to be treated with some caution.

6 Based on the public accounts of provincial and federal governments. Due to differences in accounting and reporting practices, figures are not strictly comparable between provinces.

7 Parkland Institute, *Unpacking Alberta's infrastructure spending: Real increases have been moderate,* February 23, 2011.

8 Gibson and Flanagan, supra note 1.

9 Gibson and Flanagan, supra note 1. For a discussion of the higher GDP public spending compared to tax cuts see: Congressional Budget Office, "Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from January 2012 Through March 2012" Table 2 (CBO, May 2012), www.cbo.gov/sites/default/files/cbofiles/attachments/05-25-Impact_of_ARRA.pdf; Mark Zandi, "A Second Quick Boost From Government Could Spark Recovery" Testimony before the U.S. House Committee on Small Business on July 24, 2008 (Moody's Economy.com), www.economy.com/mark-zandi/documents/Small%20Business_7_24_08.pdf; Organization for Economic Cooperation and Development, "OECD Economic Outlook Interim Report" Ch. 3, www.oecd.org/economy/outlook/42421337.pdf; and Oliver Blanchard and Daniel Leigh, "Growth Forecast Errors and Fiscal Multipliers," International Monetary Fund, Working Paper No. 13/1, January 03, 2013.

10 Gerard Walsh, "Newfoundland and Labrador Economic Outlook," RBC, September 2014.

11 Andrew Sharpe and Evan Capeluck, CSLS Research Report 2012, *The Impact of Redistribution on Income Inequality in Canada and the Provinces*, 1981–2010, September 2012.

12 Richard Wilkinson and Kate Pickett, *The Spirit Level: Why Inequality Makes Societies Stronger* (New York: Bloomsbury Press, 2010).

13 Province of Newfoundland and Labrador, Schedule 10, Revenue by Source, for the year ended 31 March 2012.

14 Government of Newfoundland and Labrador, *2013 Pre-Budget Consultations*.

15 Government of Newfoundland and Labrador, Budget Speech: People and Prosperity, Responsible Investments for a Secure Future." April 24, 2012.

16 Canadian Association of Petroleum Producers, "Statistical Handbook for Canada's Upstream Petroleum Industry," Technical Reports, November 2011. Note: Data is combined for the two provinces in the CAPP tables and not available for the individual provinces.

17 Data on foreign ownership in this section is based on a review of shareholder information from Bloomberg as analyzed by Nikki Skuce, published in "Who Benefits? An Investigation of Foreign Investment in the Tar Sands," ForestEthics Advocacy, May 2012.

18 Press Release, Jan 30, 2014, "Exxon Mobil Corporation Announces Estimated Fourth Quarter 2013 Results" http://news.exxonmobil.com/press-release/exxon-mobil-corporation-announces-estimated-fourth-quarter-2013-results

19 Jack Mintz and Duanjie Chen, "Taxing Canada's Cash Co: Tax and Royalty Burdens in Oil and Gas Investments, *SPP Briefing Papers*, Volume 3, Issue 3, University of Calgary School of Public Policy, February 2010, www.policyschool.ca. See also Wade Locke, "Do oil and gas royalties subsidize investment, Memorial University, August 2010.

20 PricewaterhouseCooper (PwC), the World Bank and the International Finance Corp, "Paying Taxes 2013." Note: Undercutting U.S. taxes only results in more money to the U.S. Treasury as the U.S. mandates minimum tax payment even for corporations paying taxes in other jurisdictions. Thus, the difference between Canada's tax rate and the U.S. rate actually gets paid by the corporation to the U.S. Treasury. See Erin Weir, "The Treasury Transfer Effect," *Behind the Numbers: Economic Facts, Figures, and Analysis* 10, No.7 Canadian Centre for Policy Alternatives, 2009.

21 Economist Wade Locke estimates $20–25 million in October 2 CBC interview: http://www.cbc.ca/news/canada/newfoundland-labrador/slump-in-oil-prices-may-slam-provincial-budget-wade-locke-1.2784179; $30 million is what the NL Finance Minister is saying, eg: http://www.theglobeandmail.com/news/national/crude-oils-fall-raises-budget-concerns-in-newfoundland-and-labrador/article21471065/

22 See Andrew Leach, "The loonie, oil's crash, and why this isn't anything like 2008" *Macleans*, November 8, 2014, http://www.macleans.ca/economy/economicanalysis/the-loonie-oils-crash-and-why-this-isnt-anything-like-2008/

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