A Plan for Newfoundland & Labrador

NEWFOUNDLAND & LABRADOR employers' COUNCIL

2015 Position on Provincial Budget Priorities

A PLAN FOR SUSTAINABLE PROSPERITY:

2015 NL Employers' Council Position on Provincial Budget Priorities

The NL Employers' Council (NLEC) advocates for government policies that enhance the ability of employers to contribute to the economic growth and prosperity of Newfoundland & Labrador. The NLECs membership consists of the province's top employers, including companies from all major economic sectors. Collectively, they are responsible for more than half of all non-government jobs in Newfoundland Labrador (NL). The state of our province's finances is of great concern to our members. For two years in a row at the NLEC CEO Roundtable, an event gathering senior business leaders from the province's largest and most successful businesses, the number one issue for business leaders was the need to reduce government spending. Government's poor fiscal situation is a significant barrier to investment, innovation, and productivity.

It is not only the business community that would like to see reduced government spending. The citizens of the province also feel it is important. In August 2014 the NL Employers' Council commissioned Corporate Research Associates (CRA) to complete public opinion polling of the people of Newfoundland Labrador on business and public policy issues. Sixty-four percent of those surveyed said it was important to reduce government spending and 79% of people surveyed felt it was important to reduce provincial government debt.

2015 is not the first year the NL Employers' Council has asked government to curb spending. For the last five years this organization has been quite vocal about the fact that spending levels are unsustainable. The NLEC has been supportive of past efforts government has made to reduce spending and increase efficiency. Government's reductions in expenditures announced in 2013 budget together with public sector pension reform will have lasting positive implications for taxpayers, employers, and our provincial competitiveness. But these initiatives have not been nearly enough. This year, the NLEC will continue to ask government for many of the same things we have recommended in previous years: Reduce spending, reduce the size of the public sector, reorganize and reduce government programs to be more efficient and outcome oriented, develop a plan to pay down debt and save for the future. The difference between this year and previous years is that the current government finds themselves in the position, due to the recent decrease in the price of oil, of having ***no choice*** but to aggressively deal with the fiscal situation.

This is not a problem, it is an opportunity.

The people of the province want government to show courageous leadership. Tough decisions must be made to right the ship, and set our province up for long term economic success. Government must use this downturn as an opportunity to permanently reform spending in a necessary and meaningful way to levels that allow for much needed debt reduction and a plan to save for the future. This is an opportunity to make real and significant change for the next generation.

Competitiveness is key

The provincial government has stated that their goal in Budget 2015 is to ensure a vibrant economy over the long term. The key to long term economic success is to create a competitive business environment that will diversify our economy, attract increased investment and allow local businesses to thrive.

Newfoundland & Labrador has room to improve our competitive position. The Employers' Council recently commissioned the Conference Board of Canada (2015) to benchmark the economic environment in NL against peer jurisdictions. They found that, due to our resource boom, NL's competitiveness has come a long way in the last 15 years, but is still weak compared to our direct competitors. When comparing us against peer jurisdictions on the four competitive building blocks of innovation, investment, human capital and business policy environment, NL is falling behind. In fact, out of 32 benchmarking indicators used by the Conference Board, NL came in the bottom half of all peer jurisdictions in 20.

> "True competitiveness is measured by productivity. Productivity allows a nation to support high wages, attractive returns to capital, a strong currency – and with them, a high standard of living. What matters most is not exports per se or whether firms are domestic or foreign-owned, but the nature and productivity of the business activities taking place in a particular country."
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> —Dr. Michael Porter, Harvard professor and leading authority on competitive strategy. (World Economic Forum, 2003)

Laying the foundations for long term prosperity and economic diversification should be the focus of budget 2015 not just because it is the right thing to do, but because it is also what the general public wants. In their survey of Newfoundlanders and Labradorians in August 2014 Corporate Research Associates found that:

- 75% agree that business success in Newfoundland & Labrador will result in prosperity and increased quality of life for all of us.
- 83% believe that it is important that we have a competitive business environment compared to similar regions that are our direct competitors.
- 80% support government policy that encourages private sector business growth and investment in Newfoundland and Labrador.

The people of this province know that creating a competitive business environment NOW is the only way to ensure that our children's generation will, at a minimum, enjoy the same level of prosperity as we do today. Increased private sector investment, business growth and employment will lead to increased government revenues long term. While considering what programs and services are important to the people of the province as part of the pre-budget process, government must evaluate every decision through the lens of not only what people want now, but how it will impact our long term competitive position.

How did we get here?

In a time when NL has experienced unprecedented revenues, expenditures have increased so rapidly that the province has still barely been able to balance the books. The province has run a deficit in four out of the last six years, using up all of the cash reserves generated during peak oil production. While government made some headway in reducing net debt bringing it from a high of $12 billion to $8 billion, debt resumed its assent in 2012-13 and is expected to reach $10.4 billion by March 2015, with deficits projected for the next five years.

Provincial expenses have grown from $5.1-billion (2001) to $7.7-billion (2013) which represents an increase of 51 per cent. According to a recent report by the Canadian Federation of Independent Business (Hammond & Bourgeois, 2015) from 2003 to 2014, real operating spending by the provincial government increased by 29.7 per cent while the population grew by 1.6 per cent. The study also indicated that government's 2014 operating spending was $1.6 billion more than it would be if it had been held in line with inflation and population growth. Had government held the line on spending while times were good, they would not be in a position of needing to cut $1 billion from the budget in 2015 when oil prices dropped significantly due to global market forces.

The Auditor General, multiple think tanks and business organizations (including the NLEC) have raised the alarm bells about government's spending on multiple occasions. According to our Auditor General in early 2014, government spent about 40 per cent more per person than any other province in Canada and the province would have to cut $2.3 billion from its budget to reach the national average of spending per person (The Canadian Press, 2014).

Government attributes much of the increased spending to an infrastructure deficit throughout Newfoundland and Labrador, which required them to make historic levels of investment. However, despite an increase in infrastructure spending, according to the Conference Board of Canada (2015) government's investment in infrastructure in NL is still the lowest as a percentage of GDP in the country.

Where the real problem lies is in government's program spending. We have the *highest* per-capita expenditures on programs and services in the country. These costs have grown dramatically over the last decade and have ballooned since the recession. Newfoundland & Labrador spent $13,300 per person on program and service delivery in 2013-14 - the all-provincial average was $8,917 (Conference Board of Canada, 2015). Spending continued at a level of $13,200 per person in 2014-15.

It is not surprising that our program spending is so high, when you consider the size of our public service. The Fraser Institute reported that between 2007- 2011 NL had the highest average provincial and local government employment as a percentage of total employment of any jurisdiction in North America, at 26% (Karabegović, Gabler, & Veldhuis, 2012). The Conference Board of Canada demonstrated that while the province has had one of the highest ratios of public administration employees per resident for decades, this already-high rate has also experienced the fastest growth in the country. In 2013, the province's public sector employed over 27.4 workers for every 1,000 residents, up from 19.6 in 1997, which was already the second highest in the country. Meanwhile, the rates were mostly stable in the other provinces, with several provinces even reducing public sector employment ratios.

Salaries and employee benefits represented 49 per cent of government operating spending in 2014 and according to the CFIB, inflation-adjusted spending on salaries and employee benefits increased by 61 per cent between 2003 and 2014. A recent study by the Atlantic Institute for Market Studies (Eisen & Fantauzzo, 2014) found that if public sector employment rates matched the national average in Newfoundland and Labrador, it would have reduced the province's wage bill by **$880 million** in the 2012-13 fiscal year – nearly our entire deficit for last year.

Pension and post retirement benefits provided to our large public sector are also driving the province into debt. Unfunded public sector pension liabilities account for the bulk of Newfoundland Labrador's net debt. The Conference Board states that: "Public sector employment has risen "tremendously" in recent years, and combined with the impacts of an aging population, public sector pension demands are set to increase even further." In fact, they are expected to account for 85% of all debt by 2016-17 and are the second highest of any province in the country.

The reality is that current program and service spending is being financed by one time revenues that will not always exist. One third of Newfoundland & Labrador's revenue is completely dependent on commodities, the prices of which are volatile. "Spending up" when times are good has created an expectation of program and service delivery and an inflated civil service with salaries and benefits that are not sustainable when commodity prices decrease. The recent drop in oil prices has clearly demonstrated to the public that budgeting provincial spending on the high end of these volatile prices is not sustainable. Government must use Budget 2015 as an opportunity to take a long term view to spending and responsibly balance program spending on what citizens want today with investments into our province's future.

Reform spending and return to surplus as soon as possible

While spending reform should be well thought out, given our growing provincial debt and the cost of servicing it, it is important that NL return to surplus budgets as soon as possible. To plan for five years to return to surplus is simply too long.

Some special interest groups have raised concern about the economic spill-over effects of constraining government spending. The actual overall economic impact of cutting provincial expenditures to balance the budget, however, would be less impactful than these few special interest groups have suggested. The NL Employers' Council recently asked the Fraser Institute to calculate the impact of spending cuts to the overall provincial economy. They estimated that a $1 billion cut from provincial expenditures represents roughly 2.8 percent of provincial GDP of $35.8 billion, based on the most recent data available (2013). Depending on what multiplier assumptions are made to account for economic spin off of cuts in the public service, the net economic effects range from roughly 1.4% (less than the spending cut) to a maximum of 4.5% of the provincial economy. While a reduction of the provincial economy by 4.5% in one year would not be advisable, if these cuts are implemented over three years, the effective reduction is substantially less. The Fraser Institute analysis illustrates that while some short term pain may be felt from expenditure reform, it will not devastate our province, particularly given the optimistic outlook of future development projects and a rebound in commodities prices long term.

Government must seize this opportunity for meaningful spending reform as quickly as possible. In the 1990s many governments across the country acted decisively to enact spending reductions to bring government expenditures in line with revenues and achieve balanced budgets within two to four years including the Federal Liberals and the Ontario, Saskatchewan and Alberta provincial governments. Such actions, while difficult in the short term, lead to better results in the medium and long term, including balanced budgets, declining debt, lower interest costs, and a more prosperous economy that contributed significantly to Canada's outstanding economic performance from 1997 to 2007 (Veldhuis, Palacios, & and Lammam, 2012).

Recommendation #1: Budget 2015 should target a return to surplus budgets and debt reduction by 2018.

The framework for permanent and meaningful spending reform

Continue to invest in infrastructure

Capital investments are just that – investments. They will provide returns to our economy that will pay dividends for years to come. High levels of strategic government investment in infrastructure can support the economy by allowing goods to move more efficiently to markets (in the case of transportation investments), or by strengthening human capital with better access to health and education institutions. Utilities, including electricity, water, and sewage, all support business activities, making it less costly to open a plant in a location where these services are available. An extensive telecommunications network connects people between communities and with the world, ensuring businesses have access to all information required to make decisions, and to coordinate logistical needs in a timely manner.

While government has increased infrastructure spending significantly it still has kept pace with peer jurisdictions. Newfoundland and Labrador ranked 8 out of the 10 provinces on government investment in fixed capital as a share of GDP, and as of 2012 Newfoundland and Labrador's average age of its public infrastructure was 16.7 years, second oldest of any province in the country.

The mix of spending in this province is not aligned with creating a competitive environment that will generate further prosperity for the next generation. The Conference Board has said that these lower levels of government investment in infrastructure have put the province at a disadvantage. If government capital investment in Newfoundland and Labrador as a proportion of GDP had matched the national average over 2004-2013, the province would have invested an additional $145 million per year. This would have amounted to $1.5 billion of additional investment.

If the true goal is sustained prosperity and continued economic success, in the long term, resources should be reallocated away from other less productive expenditures that do not provide the economic benefit and towards infrastructure. Infrastructure investment decisions should, however, be made in a strategic manner to grow the economy. The decision to invest in a hospital or school in a region may not always be the best decision if perhaps better health or education outcomes could be achieved by investment in transportation infrastructure, technology or improved program delivery.

Recommendation #2: Spending reform must include a shift in spending towards strategic infrastructure investments and away from program and services.

Reorganize program delivery and reduce the size of the public service

Newfoundland & Labrador simply cannot afford, and does not need to have, the largest public service in North America. It is the private sector, not the public sector that creates wealth. Many policy think tanks and economists have demonstrated clearly that a larger public sector leads to poorer outcomes in the labour market, reduced productivity, and poorer economic performance (Di Matteo, 2013). The public service does not need to administer every program and service that citizen's demand.

Government must use Budget 2015 to reorganize program and service delivery and reduce the size of our public sector to be more efficient and outcome focused. This does not mean cutting a percentage off the top for the sake of cutting costs. Across the board cuts to the public service are not an effective means to reduce expenditures. A long term approach needs to be taken to reorganizing and reducing the public service to permanently sustainable levels that are in line with the Canadian average. Government must look at each program or service to make sure that program spending is efficient but effective at meeting expected and targeted outcomes. Are taxpayers getting the return on their investment that they expect? If not, then the program should be reengineered to be delivered more efficiently, or eliminated altogether. In some cases, this may also mean that certain programs or services receive an *increased* investment or additional staffing, depending on its ability to efficiently meet desired outcomes or create opportunities for cost savings in other areas. As an example, investments in technology in order to more efficiently deliver programs and services could provide cost savings from a staffing perspective.

This will not be achieved by sticking with the old ideas. Innovative solutions to providing government services more efficiently, including productivity focused goal setting, increased outsourcing to the private sector, regionalization of programs and services and performance based incentives for government employees should all be considered.

Recommendation #3: Spending reform must include a reorganization of program and service delivery and a reduction of the size of the public service to sustainable levels in line with the Canadian average.

Increased Outsourcing and Privatization

Privatization of government services has resulted in considerable cost savings in other jurisdictions. Alberta Transportation and Utilities began to implement outsourcing in 1996 and realized a cost saving immediately (Bucyk & Lali, 2005). Over the next five years they developed a strategy for tenders and by the year 2000, their cost per km went from $5117 to $3705 - a 28% reduction. This had a total **annual** cost reduction of **$26.4 million**. In addition, $45 million was also raised from the sale of the maintenance facilities previously owned by the government. The Alberta Government also saved approximately $800,000 in grants that were paid out annually to the municipalities, in-lieu-of taxes for the maintenance facilities. Eighty percent of the public sector workers affected became employed with the various contractors in the private sector.

Recommendation #4: Reorganization and reduction of the size of the public service must include increased outsourcing and privatization of relevant government programs and services to the private sector, as has been successful in other jurisdictions.

IMPROVE OUTCOMES IN GOVERNMENT PROGRAM AND SERVICE DELIVERY

As of January 2015, 37.7 per cent of the provincial budget went to the health care sector and 20.5 per cent to education, including post-secondary education. Health and Education are two primary examples of the need for structural reform in the way programs and services are delivered by the NL government to be more outcome focused.

Health care spending has increased tremendously in recent years. NL has the highest health care spending per capita of any province in Canada (Conference Board of Canada, 2015). Education spending is another area that has experienced exponential growth in recent years. When comparing education spending per student (full-time equivalent) in public elementary and secondary schools across the country, NL's spending was the fastest growing in the country over the five year period 2007-08 to 2010-11. NL had the third highest spending in the country in 2010-11, and it grew 20 per cent higher in 2013-14 (Conference Board, 2015). This is despite the fact that between 2001-02 and 2011-12 the number of students dropped from 87,000 to 67,800 — the largest decrease on a percentage basis of any province in the country (Neven Van Pelt & Emes, 2015).

Health and education are two of the most important services provided by government. No one would argue with these levels of spending if it were clear that citizens of NL were receiving the desired outcomes from these important services. The reality is that under the current model of delivery, taxpayers are not receiving a return on their investment.

NL has the least healthy population of any province in Canada, according to the Conference Board of Canada's annual report card which gave NL a D minus (Conference Board of Canada, 2015). Some would argue that because Newfoundland and Labrador also has the oldest population in Canada and aging demographics require more resources. However, a Canadian Institute for Health Information report found that the aging of the population is only a modest cost driver, expected to be responsible for 0.9 per cent of the health-care spending increase nationally in 2014 – less than the growth attributed to natural population growth plus inflation (Canadian Institute for Health Information, 2014). Livio Di Matteo, an economics professor at Lakehead University in Thunder Bay attributes the difference in spending simply to the *ability* to pay due to resource revenues (Grant, 2014).

Our education outcomes are also among the worst in the country. NLs student skills scored a D in the Conference Board's Education and Skills report card. In contrast, British Columbia has some of the lowest levels of education spending in the country, but amongst the highest outcomes – earning a B in the same report. In addition to elementary and secondary education, NL also does not seem to be achieving outcomes within the university system. NL scored a D in the Conference Board report on university completions, and continues to graduate the least amount of university students of all competitors – despite a tuition freeze and significant investment in university education by the province.

Health and education outcomes in this province need to improve. Government must look at fundamental changes to how we spend money within our health care and education systems, along with every other program and service delivered by government. Government systems should be proactive and centered on the outcome for the citizen, not on the institutions and practitioners within the system. Careful examination of spending should include consideration of different models of delivery and reengineering of work processes to be outcome oriented. Access to and quality of services can be enhanced despite the need to restrain spending.

Recommendation #5: Spending reform must include a focus on improving outcomes within government program and service delivery.

Focus on Immigration

NL has the fastest aging population and the lowest rate of in-migration of all of our competitors. The Conference Board of Canada's long-term economic forecast (2014) predicts that if nothing is done, 30 percent of the population will be 65 or older by 2035. Not only will skill shortages worsen, our aging and shrinking population will squeeze the working age population economically, socially and fiscally.

The attraction and retention of immigrants has traditionally been a challenge for our province. Implementing solutions to successfully increase immigration in Newfoundland and Labrador will require resources within the Department of Advanced Education and Skills (AES) to be re-allocated towards its immigration responsibilities.

There is a strong need to narrow the scope of the labour market initiatives of the Department of AES and provide fewer, more focused programs that meet the needs of employers. In a study commissioned by the NL Business Coalition in 2013, the majority of surveyed industry respondents were not very familiar with most of the current initiatives. Employers also feel the majority of programs had a great deal of red tape in terms of applications, a lengthy waiting period, and elaborate reporting requirements. Priorities for employers included immigration followed by a youth strategy and apprenticeship programs for those relevant industries, up-skilling workers, and providing greater education-employment alignment. Online resources and wage subsidies have potential but need improvements, and supply-side initiatives such as the Career Work Centres and other stop-gap measures that result in people taking jobs that don't suit their aptitudes or skill sets were viewed as low priorities. Efforts to deal with supply of labour will only work if driven directly by employers needs.

Recommendation #6: Budget 2015 must narrow the scope of the labour market initiatives currently offered by government by redirecting resources away from low priority labour market initiatives and towards immigration as the number one priority.

Develop a plan to save for the future

Budget 2015 should lay out a long term plan to not only live within our means today, but also to save for the future.

The Impact of Different Types of Taxes on Economic Growth

In today's global economy with increased mobility of capital and labour, setting the right tax mix is extremely important to a jurisdictions' economic success. In an OECD study (Johansson, 2008) on the design of tax structures that promote economic growth, a ranking of taxes confirmed results from earlier studies regarding the impact of different types of taxes on GDP:

Corporate taxes are found to be the most harmful for growth, followed by personal income taxes, and then consumption taxes.

Recurrent taxes on immovable residential property appear to have the least impact because they have less effect on decisions to supply labour, to invest in human capital, to produce, invest and innovate. Taxes on financial and capital transactions are highly distortionary.

Broadening the base of consumption taxes is a better way of increasing revenue than rate increases, because a broad base improves efficiency while a high rate encourages growth of a shadow economy.

Tax exemptions or reduced statutory corporate tax rates for small firms may be much less effective in raising productivity than a generalized reduction in the overall statutory corporate tax rate. Lowering statutory corporate rates will lead to particularly large productivity gains in firms that are dynamic and profitable, and can make the largest contributions to GDP growth.

High top marginal rates of personal income tax can reduce productivity growth by reducing entrepreneurial activity.

Taxes on labour can have adverse effects on labour utilization by affecting both labour supply and labour demand. Lower taxes bring down labour costs and firms respond by increasing labour demand.

Lower corporate and labour taxes may encourage inbound foreign direct investment, which in turn is found to increase productivity of local firms. Multinational enterprises are attracted by tax systems that are stable and predictable, and are administered in an efficient and transparent manner.

Generally, most taxes would benefit from a combination of base broadening and rate reduction, versus rate increases.

The Conference Board of Canada study (2015) found that many of NLs comparator jurisdictions with non-renewable resource based economies, including Norway, Texas, North Dakota, Alberta and Saskatchewan have already created, or are in the process of creating, a Sovereign Wealth Fund. Such a fund sets aside a portion of resource revenues for future use, whether to avoid deficits during economic downturns or to be saved for future generations. Such funds protect competitor jurisdictions from fluctuations in resource prices and will allow future generations in those jurisdictions to benefit from the same quality of life from the resource long after the resource is depleted.

When it comes to managing our province's finances, as long as we have resource revenue, establishing a sovereign wealth fund should be the ultimate goal. The current downturn provides government with the opportunity to lay the groundwork for establishment of a sovereign wealth fund within the next mandate through meaningful spending reform.

Recommendation #8: Budget 2015 should target the creation of, and contribution to, a sovereign wealth fund by 2018.

Tax or fee increases to private citizens and businesses are not the solution

Some will argue that revenue generation through tax or fee increases is the solution to current fiscal challenges; however no type of tax increase is without negative economic implications (see bar at left).

Business costs such as payroll, transportation and utility costs are exceptionally high in Newfoundland Labrador. We need to ensure we remain competitive on taxation if we are to attract investment and allow local businesses to compete globally and expand. According to the Conference Board of Canada study, NL has the second highest Statutory Labour Cost of all provinces. Given the high portion of the total taxes paid by businesses in NL that are attributed to labour costs, even a small increase in the corporate tax rate or sales tax would quickly make NL uncompetitive on total tax rate as compared to competing jurisdictions.

Everyone is feeling the strain of the low price of oil. While some special interest groups continue to call for increased corporate taxation, it will not benefit our province to increase costs to businesses while they are also suffering financially. Based on Corporate Research Associates August 2014 public opinion polling, the general public understands the importance of this issue. Sixty-one percent those surveyed felt it was important to **DECREASE** tax rates to businesses to encourage investment, jobs and wage growth. Government has themselves said that this drop in oil revenues is a "short term" problem. It would be unfair to the taxpayers of this province to remedy a short term situation (which was largely created by increasing levels of program spending to unsustainable levels) with a *permanent* increase in taxation and a permanent decrease in our competitiveness.

Recommendation #9: Government must hold the line on tax levels and instead ensure that taxpayers dollars are being spent in the most efficient and prudent manner possible.

CONCLUSION:

The time to act in creating a competitive future is now. Government must use Budget 2015 as an opportunity to meaningfully reform spending and processes within government in order to return to surplus within three years. Government must also publicly commit to a plan to constrain spending growth in the future to levels that allow for debt reduction and savings through the establishment of a Sovereign Wealth Fund. Spending reform must include a shift toward infrastructure and away from program and services. Government does not need to deliver all the programs and services that it currently delivers. Increased outsourcing and privatization of programs and services will provide significant cost savings to government, and rationalization of programs and services must occur. Particular attention should be paid to healthcare, education, and the Department of AES to ensure improved outcomes for citizens. Tax increases to private citizens and businesses should not be considered until government can ensure that taxpayers dollars are being spent in the most efficient and prudent manner possible.

Budget 2015 is not a problem; it is an opportunity for this government to show courageous leadership in shaping economic success for the province and its citizens for years to come.

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