BC BUDGET 2017 ANALYSIS

Business Council of British Columbia
Est. 1966

FEBRUARY 23, 2017

BC BUDGET 2017: FISCAL STRENGTH PROMPTS TAX CUTS AND SPENDING INCREASES

HIGHLIGHTS

- BC Budget 2017 anticipates three more years of operating surpluses for the provincial government in the $250 to $300 million range.
- However, the new Budget builds in plenty of cushion which suggests the province will exceed its budget targets and realize even larger surpluses.
- Tuesday's document contained some tax relief for both individuals and businesses. The single largest measure is the halving of MSP premiums over the next couple of years for households with incomes below $120,000.
- For businesses, as advocated by the Business Council, PST is being removed from electricity. This is a welcome move, especially for energy intensive sectors selling products into competitive international markets. The small business tax rate is trimmed from 2.5% down to 2.0%. Business will also benefit from the MSP premium reduction.
- The most significant spending increases were channeled to the K-12 education system as well as to programs for families and individuals in need.
- Consistent with the Business Council's recommendation, government capital spending rises by $1 billion, with the funds going to build and refurbish infrastructure in the education and health sectors, and to improve transportation infrastructure.
- The additional capital outlays contribute to higher levels of tax-payer supported debt. Provincial debt, however, remains manageable and low by Canadian standards. The debt grows more slowly than the provincial economy, so the tax-payer supported debt to GDP ratio falls from 16.1% this year to 15.9% next year.

On February 21st, Finance Minister Mike de Jong introduced a pre-election budget consistent with the government's commitment to balancing the books, while also managing to deliver some targeted tax relief and spending increases. Critics will say these are simply pre-election perks, but we see it differently. Years of solid fiscal management coupled with stronger-than-anticipated economic growth provided the government some manoeuvring room. This led to decisions to cut MSP premiums, take steps to improve business competitiveness, and boost spending in a few key areas. The tax cuts will come in stages, and the immediate impact is not significant. The Finance Minister chose not to reduce personal income taxes, the corporate income tax, or to make any substantial changes to the PST. On the spending side, more funding is channeled to K-12 education and social programs for those in need. The government also pledged to hike funding for child care in the coming years but Budget 2017 did little in this area.

ECONOMIC SETTING AND OUTLOOK

Following a few years of above average economic growth (with BC topping the provincial growth charts), the economy is expected to downshift in 2017-18. Last year the BC economy expanded by a healthy 3.1%. But for 2017 the Economic Forecast Council foresees growth moderating to 2.3%, followed by 2.2% in 2018. This is due largely to housing market activity coming off the boil (notably in Metro Vancouver) and slower growth in retail sales. Turning to the outlook for exports, after a 9% gain in 2016 the picture is mixed, but on balance merchandise exports should provide a slightly bigger economic lift than last year.

The external setting is clouded with risk and uncertainty, but is not entirely unfavourable for BC. On the positive side, the giant American economy is expected to pick up and the Loonie should remain at a level that keeps BC's exports competitive in the US marketplace. The Forecast Council expects the US economy to expand by 2.3% this year, up from 2016's 1.6% pace.

The Trump administration's commitment to renegotiate NAFTA and the prospect of a cycle of US protectionism casts a shadow over global growth prospects. Canada is not President Trump's main concern, and therefore may be able to negotiate reasonably favourable terms in a re-worked NAFTA. The bigger risk is the potential for escalating trade wars that tip the global economy into recession.

Commodity prices have improved for many of BC's key exports, but overall the commodity picture is mixed. Unfortunately, a firmer pricing environment for lumber is likely to be offset by punitive penalty duties imposed by the US on lumber imports from BC, as the softwood lumber dispute returns with a vengeance. This scenario means mill shut downs and reduced harvests in the BC forest sector, as acknowledged by the Minister. Having already rebounded, the Budget anticipates a pullback in metallurgical coal prices this year.

A weaker Canadian dollar has helped to boost BC's exports. Forecast Council projections point to the dollar averaging 74.6 US cents in the coming year, a level sufficient to make BC exports competitive in the US marketplace. However, there is a wide range of projections for the dollar, ranging from 73 cents to 81 cents, depending in part on the trajectory of global oil prices. Furthermore, even if the dollar remains around 75 cents, additional growth in the currency-sensitive tourism and film and television sectors will be more modest than the big jumps seen following the Canadian dollar's steep slide in 2014 and early 2015. BC's exports to China have gathered steam lately and should make a modest contribution to overall export growth this year.

The domestic side of the economy has been strong, underpinned by unusually robust job growth, rising in-migration, record low interest rates and borrowing costs, upbeat consumer spending and a hot housing market. While domestic conditions will remain reasonably healthy, the slowdown in the housing sector and the related ripple effects through the retail sector suggests an overall moderation in GDP and job growth. Our expectation, in line with that in Budget 2017, is that the housing sector will transition to a soft landing, supported by underlying fundamentals such as in-migration and continued employment growth. Housing market activity will remain brisk in some regions beyond Metro Vancouver.

An important plus for BC is the fact that Canadian interest rates will stay low. The Bank of Canada is expected to keep its overnight lending rate on hold at 0.50% through the

TABLE 1: **BUDGET 2017 ECONOMIC ASSUMPTIONS AND FORECASTS FOR BC** (ANNUAL PER CENT CHANGE UNLESS OTHERWISE INDICATED)

			FORECAST		
	2015	2016	2017	2018	2019
BC Real GDP (chained $2007)	3.3	3.0	2.1	2.1	2.0
BC Nominal GDP	3.8	4.7	4.1	4.0	3.9
Export Goods & Services (chained $2007)	2.8	0.9	1.4	1.3	1.8
Retail Sales	6.0	6.3	3.7	3.7	3.6
Housing Starts (000s of units)	31.4	41.8	30.0	27.5	27.0
Cdn 3-month T-bill (annual average %)	0.5	0.5	0.5	0.7	1.3
Cdn 10-year gov't bond (annual average %)	1.5	1.3	1.8	2.2	2.6
Canada Real GDP (chained $2007)	0.9	1.2	1.6	1.8	1.9
US Real GDP (chained $2009)	2.6	1.6	1.9	2.1	2.0
US Housing Starts (000s of units)	1,112	1,166	1,160	1,200	1,200
Real GDP Japan (chained Yen 2005)	1.2	0.8	0.6	0.7	1.0
Real GDP China (US$2005)	6.9	6.7	6.1	5.9	5.9

Source: 2017 BC Budget and Fiscal Plan.

end of 2017, if not later. Given the slowdown in BC's housing sector that is unfolding, continued low interest rates should serve to temper any declines in prices and overall market activity.

Employment growth is also poised to lose a step, following an unusually large 3.2% gain in 2016. This reflects not just slower overall economic growth but also the fact that last year's red-hot pace of job creation is not sustainable. This year, the number of people working in BC is projected to rise by 1.3%. In line with the pull back in housing and slower job creation, the growth of retail spending is also expected to dip from more than 6% in 2016 to something in the vicinity of 4% in each of the next two years.

The bottom line is that economic growth is set to moderate in BC, but not to the extent that the government will be unable to deliver on its fiscal plans. Our economy continues to diversify and has become more resilient.

TAX MEASURES

Tax cuts, or more precisely a mix of tax cuts, premium reductions and a broadening of sales tax exemptions, are a prominent feature of Budget 2017. In total, the Budget delivers $566 million in tax/premium relief in fiscal 2017-18. With most of these phased in over a number of years, the total amount of tax relief rises to $1.3 billion in 2018-19.

The single largest tax measure is the reduction in MSP premiums. As previously announced, the government is forgoing a previously planned 4% increase in premiums for 2017, and it's also trimming rates for those currently receiving premium assistance. The 2018 premium reductions also show up in fiscal 2017/18. Combined, these steps will add up to a decline in premiums of $318 million in 2017-18. This accounts for nearly half of the total tax reduction scheduled for the upcoming fiscal year.

On January 1, 2018 MSP premiums will be reduced by 50% for households with net incomes up to $120,000. This translates into a saving of $845 million for approximately 2 million BC households. A family of four with household income between $51,000 and $120,000 will save $900 annually.

Employers who pay MSP on behalf of employees – as do virtually all Business Council members – will benefit from the reduction in premiums. The amount of saving for employers will depend on how many employees are eligible for the premium reduction – and the extent to which overall employee pay may adjust over time in response to lower government-imposed payroll costs.

The next largest tax measure is the five-year extension of the Scientific Research and Experimental Development (SRED) tax credit. In the upcoming fiscal year, this will save businesses with eligible R&D expenditures $96 million, rising to $175 million in fiscal 2018/19. To be clear, this represents an extension of an existing tax incentive, not an enrichment. BC's SRED program has been in place for many years and builds on a larger federal tax credit. While extending the SRED is welcome and supports research and innovation, Budget 2017 essentially maintains the status quo in this area.

Another tax measure that helps business is the half point reduction in the small business income tax rate from 2.5% to 2.0%, effective April 1, 2017. This step comes with a fiscal price tag of $68 million in 2017-18 and $72 million the following year. We wonder about the wisdom of using this fiscal room to further reduce an already very low tax rate. The gap between the small business rate and the general corporate BC tax rate of 11% provides a disincentive for companies to grow past the $500,000 revenue threshold. It also confers disproportionate benefits on incorporated professionals rather than growth-oriented entrepreneurs. Considering most small businesses don't export, invest in innovation, or grow over time, a low small business tax rate does little to build a more productive and competitive economy.

With the removal of PST from business purchases of electricity, Budget 2017 delivers some welcome tax relief for all businesses. This step also directly addresses competitiveness challenges in the natural resource and manufacturing sectors by lowering operating costs. On October 1st, the PST rate levied on electricity is halved to 3.5%, resulting in a $41 million saving this fiscal year. For the next full fiscal

On January 1, 2018 MSP premiums will be reduced by 50% for households with net incomes up to $120,000. This translates into a saving of $845 million for approximately 2 million BC households.

year, the tax saving climbs to $82 million. The PST on electricity is not fully phased out until April 2019, at which point the saving is expected to be $164 million.

BC is the only jurisdiction in North America to impose a sales tax on electricity consumption, although residential users are exempt. The Business Council advocated for the removal of PST on electricity purchased by business and is pleased with the announcement. Rising electricity prices and the highest carbon tax in North America have worked to undermine the competitive position of a number of energy intensive export industries in BC (e.g., wood production, pulp and paper, mining and mineral processing, metal fabrication, and food processing).

We do, however, have one concern. In Budget 2013, the government increased the corporate income tax rate one percentage point, from 10% to 11%, with a promise to return it to 10% when fiscal circumstances permitted. The Business Council felt it made sense to keep the CIT rate at 11% and to use the resulting fiscal room to pay for more targeted and effective tax relief. Phasing out the PST on electricity is an important move toward a more competitive business tax regime. However, we note that a one percentage point cut in the CIT represents a savings for business in the $250 to $300 million range. When fully implemented, the saving from eliminating PST on electricity for the business sector will be roughly $160 million. So in terms of overall government-imposed costs on mid-sized and large companies, the reality is that BC will be in a less competitive position in 2019 than we were in 2013.

The new Budget shows that BC's net debt remains manageable and relatively low by Canadian standards...

SPENDING ANNOUNCEMENTS

Budget 2017 provides significant investment in key program areas, reflecting the government's commitment to expand social support, improve education and spur economic development.

Healthcare spending rises $875 million next year. Much of this will be absorbed by scheduled wage increases rather than by expanded or improved services. On average, the health budget is set to rise by 3.6% in each of the next three years. This is below the expected 4% annual increase in federal government cash transfers to BC in respect of health care under the new agreement recently concluded by the two governments.

The Ministry of Education will see $740 million in additional funding over the next three years. This is intended to fund enrolment growth, enhance rural education, and meet higher compensation costs.

To support families and individuals in need, Budget 2017 provides an additional $796 million over three years, with most of this going to persons with disabilities and for income assistance and services for children and youth.

OVERALL FISCAL POSITION

Budget 2017 represents a milestone - for the first time, BC government expenditures are projected to surpass the $50 billion mark. It also marks the fifth consecutive balanced budget under the BC Liberals. The government deserves praise for its disciplined management of the operating budget.

The new budget foresees small annual surpluses (less than $300 million) over the 2017-18/2019-20 period. However, there is a fair amount of prudence built into the revised fiscal plan. To start with, there is an annual forecast allowance,[1] which provides a cushion against weaker-than-expected growth and related revenue shortfalls. In addition, and as has been common practice for many years now, the Ministry of Finance has adopted what we view as conservative economic assumptions. This expands the size of the annual fiscal cushion. Finally, the new fiscal plan includes a sizable "Contingencies" vote allocation of $400 million in fiscal 2017-18 and $300 million in the subsequent two fiscal years, to manage unexpected spending pressures. Add it all up, and we believe the government may be able to report better than projected fiscal results going forward, so long as the economy continues to post at least moderate growth.

The new Budget shows that BC's net debt remains manageable and relatively low by Canadian standards, at about 16% of GDP over the three-year fiscal planning horizon. The dollar amount of debt continues to increase due to borrowing to fund ongoing capital spending. However, the figures for what the province

[1] $350 million in 2017-18, and $250 million in each of the following two years.

TABLE 2: **BC GOVERNMENT THREE YEAR FISCAL PLAN**
(MILLIONS OF DOLLARS UNLESS OTHERWISE INDICATED)

			FORECAST		
	2015/16	2016/17	2017/18	2018/19	2019/20
Revenue	47,606	50,890	50,838	51,196	52,045
% change	*3.2*	*6.9*	*-0.1*	*0.7*	*1.7*
Expense	46,876	49,082	50,193	50,702	51,572
% change	*5.5*	*4.7*	*2.3*	*1.0*	*1.7*
Forecast Allowance	-	350	350	250	250
Surplus	730	1,458	295	244	233
Taxpayer-supported debt	42,727	42,027	43,302	45,184	47,201
% of GDP	*17.1*	*16.1*	*15.9*	*15.9*	*16.0*

Source: 2017 BC Budget and Fiscal Plan.

labels "taxpayer-supported" debt exclude the debts incurred by some Crown Corporations, notably BC Hydro, whose debt has risen steeply (by some $10 billion) since 2010. Recent reports from credit rating agencies have pointed to BC Hydro's growing debt as a trend that could eventually trigger a reassessment of the government's vaunted triple A rating.

A NOTE ON CAPITAL SPENDING

Total capital spending is slated to rise from nearly $7 billion in fiscal 2016-17 to around $8 billion in each of the next three years. The Business Council has long urged higher capital spending to pay for both new infrastructure and to accelerate asset refurbishment at a time of record low borrowing costs. We believe there is room to further ramp up capital spending in the next budget.

Both taxpayer supported capital spending (health facilities, schools, transit, and housing) and self-supported capital spending undertaken mostly by provincial Crowns rise next year. As the Budget notes, taxpayer supported capital spending totals $13.7 billion over the next three years, which is the highest level ever. Current plans outlined in Budget 2017 envisage an additional $1.7 billion in capital outlays over what had been planned in Budget 2016, in part because the province is effectively leveraging contributions from the federal government under the Strategic Investment Fund.

CONCLUDING THOUGHTS

Budget 2017 is a good news budget. While it falls shy of being a "something-for-everyone" document, it does announce some useful tax/premium reductions along with increased spending in a number of high priority areas. It also extends the province's track record of sound fiscal management. Apart from the risk stemming from the high debt load of certain Crown corporations, Tuesday's budget reinforces BC's top notch credit rating.

Looking ahead, the province still has work to do to lay the foundations for a more productive, competitive and innovative economy. Specifically, government still needs to act on the outstanding recommendations of the Commission on Tax Competitiveness, which was tasked with developing a blueprint for a modern, investment-friendly BC business tax regime. This will entail additional PST reform.

Another priority is to boost funding for post-secondary education and research, with a particular focus on STEM disciplines, the IT sector, and health. There is also a convincing case for expanding child care and early childhood development programs, ideally via a targeted approach that directs public funding to low- and middle-income households with young children. Finally, BC's growing population and our place as Canada's gateway to the Asia Pacific mean we must continue to develop new and refurbish existing transportation infrastructure. Government has already made substantial investments in this domain, but more will need to be done to increase and improve public transit services as well road networks in the lower mainland.

AUTHORED BY

Ken Peacock
Chief Economist and Vice President

Jock Finlayson
Executive Vice President and Chief Policy Officer