Business Alert

Business Council of British Columbia

March 24, 2016

Federal Budget Delivers on Liberal Campaign Commitments….But Little New for Business

In his inaugural budget, Finance Minister Bill Morneau ushered in a new era of higher federal spending and sizable deficits. In a shift from the Conservatives' focus on restraint and smaller government, the Liberals are loosening the purse strings and signaling a more activist approach in areas such as inequality, urban issues, social housing, and the environment. Budget 2016 delivers financial benefits to most families; provides incremental support to post-secondary students and the unemployed; earmarks significant new funding for First Nations; and promises to ramp up spending on infrastructure over the next decade.

In total, the Budget will offer a modest lift to Canada's economy, something we judge to be appropriate in the circumstances. While spending does rise considerably, the government opted to leave most taxes unchanged. As a result, deficits are now projected right through 2021, beginning with back-to-back $29 billion shortfalls in 2016-17 and 2017-18. In evaluating the stance of federal fiscal policy, it is important to take note of the current context: a Canadian economy that's still struggling to adjust to dramatically lower oil prices and a generalized downturn in global commodity markets. We should also take account of the federal government's solid baseline financial position. Even with a string of deficits, the federal debt/GDP ratio is projected to remain essentially flat over the next half decade.

Economic Setting

In addition to meeting their election promises, the Liberal Ministers involved in crafting the Budget were influenced by the generally sluggish macroeconomic environment. Global economic growth eased in 2015 to the slowest pace since 2008–2009, led by a downshifting of activity in many emerging markets, including China. Faced with tepid global growth and plummeting oil prices, Canada's economy has lost altitude, with real GDP advancing a meagre 1.2% in 2015, the worst showing since 2009. Nationally, job creation is anemic and the unemployment sits above 7%. Alberta, Saskatchewan and Newfoundland are all in recession. Business investment in Canada has been on a declining trend in after-inflation terms, while household debt stands at an all-time high measured against incomes. Housing markets are cooling across much of the country, and residential investment spending is unlikely to contribute much if anything to GDP growth over 2016-17. There are, in short, few growth drivers in the Canadian economy, apart from an improvement in "net trade" as non-energy exports have started to rebound.

The consensus of private sector economists points to real GDP growth of 1.4% in 2016, down from the 2.0% expected at the time of the fall 2015 economic update. Next year and in 2018, real GDP is projected to expand by 2.2%.

Table 1
Budget 2016 Economic Assumptions and Forecasts

		Forecast		
	2015	**2016**	**2017**	**2018**
Real GDP growth (% change)	1.2	1.4	2.2	2.2
Nominal GDP growth (% change)	0.7	2.4	4.6	4.3
Unemployment rate (%)	6.9	7.1	6.9	6.5
CPI inflation (%)	1.1	1.6	2.0	2.0
Cdn 3-mnth T-bill (ann. avg. %)	0.5	0.5	0.7	1.6
Cdn 10 year gov't bond (ann. avg. %)	1.5	1.6	2.3	2.0
Exchange rate (US cents/Cdn$)	78.3	72.1	75.9	79.1
Real US GDP growth (chained $2009)	2.4	2.3	2.4	2.4
WTI Crude oil price (US$ per barrel)	49	40	52	59

The main reason for Budget 2016's muted economic outlook is weak commodity markets, especially the collapse of oil prices. Current forecasts suggest that WTI[1] oil prices will average US$40 per barrel in 2016, rising to US$52/bbl in 2017. The Finance Minister has relied on less optimistic oil price forecasts – which is one reason why the government may beat its budget targets going forward.

The growth slowdown in China and other emerging markets is reverberating throughout the global economy and affecting Canada – directly through diminished trade, and indirectly via softer commodity prices. This situation is unlikely to change in the near-term. The IMF expects euro area growth to remain tepid over 2016-17. Significant risks persist in Europe, including high levels of sovereign debt, still-weak bank balance sheets, geopolitical uncertainty, and the effects of the ongoing refugee and migrant crisis.

The lone bright spot on the international economic horizon for Canada is the United States. America's huge $18 trillion economy has slowly gained traction, with the job market in particular showing impressive strength. Real GDP growth held steady at 2.4% last year, thanks to robust job creation, the ongoing housing recovery, and some gains in consumer spending. The US unemployment rate has dipped to 4.9% cent, versus more than 7% in Canada. The primary economic and fiscal risk facing Canada in 2016-17 is that the US economy slows unexpectedly.

Table 2
US Dollar Prices for Selected Commodity Prices
(annual average)

	2013	**2015**	**2016**	**2017**
Oil (bbl)	$104	$51	$37	$48
Natural gas	$3.73	$2.61	$2.50	$3.00
Iron ore (mt)	$135.4	$55.8	$42.0	$44.1
Aluminum (mt)	$1,847	$1,665	$1,550	$1,612
Copper (mt)	$7,332	$5,510	$5,000	%5,190
Nickel (mt)	$15,032	$11,863	$10,000	$10,801
Wheat (mt)	$312	$203	$185	$193
Phosphate (mt)	$148	$117	$120	$119

bbl=barrel; mmbtu=one million British thermal units; mt=metric ton
Source: World Bank, Commodity Market Outlook, January 2016.

[1] West Texas Intermediate crude oil.

Table 1 above summarizes the economic forecast underlying Budget 2016. The economic assumptions are very cautious, which means the deficits projected in the Budget may be higher than the amounts that eventually materialize.

Fiscal Plan and Key Budget Measures

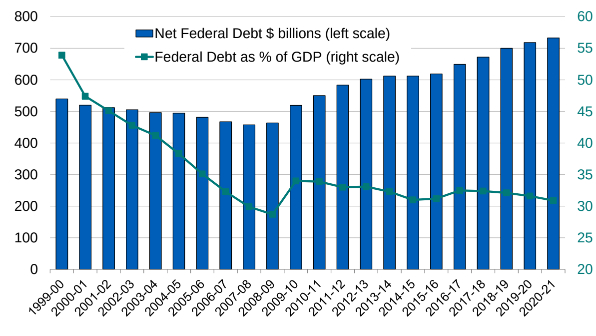
Budget 2016 outlines a plan to run operating deficits into the foreseeable future. The Liberal election platform envisaged a few years of deficits, albeit much smaller than those now being contemplated. According to the Budget, "in the current environment of sustained economic weakness and historically low interest rates, fiscal policy is the right policy lever to use to support long-term growth." Organizations such as the IMF, the OECD and the Bank of Canada have advanced similar arguments. The Business Council has also echoed these sentiments, particularly with respect to increasing spending on infrastructure.

In the coming fiscal year, the federal deficit jumps to $29.4 billion, up from a revised shortfall of $5.4 billion in 2015-16. The flow of red ink continues at ~$29 billion in 2017-18, with the deficit then falling to $14-15 billion by the end of the decade. Despite several years of operating deficits, the federal debt/GDP ratio remains in the 31-32% range. This reflects the modest size of the planned deficits relative to Canada's $2 trillion economy,[2] as well as the growth of nominal GDP over the forecast horizon.

Budgetary revenues actually decrease in the coming fiscal year, by $3.5 billion. Income tax cuts for the "middle class" are part of the reason, alongside weakness in corporate profits (and thus in corporate income tax collections) and a substantial drop in Crown corporation net income. Revenue growth picks up speed over the subsequent years of the fiscal plan.

Figure 1

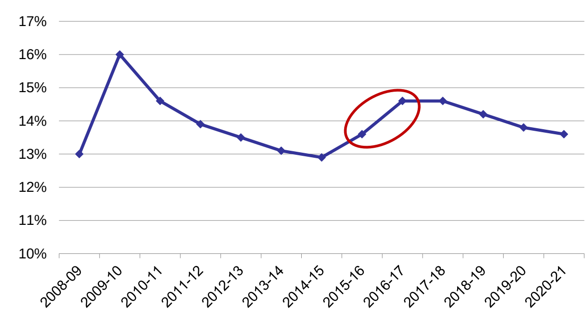
Federal Debt and Taxpayer Supported Debt-to-GDP Ratio



Source: Department of Finance and Budget 2016.

Figure 2

Federal Program Spending as Share of GDP



Source: Federal Budget 2016.

Total program spending climbs to $291 billion in 2016-17, up $20 billion from the previous year. Spending increases are spread across many different program areas. In total, the new spending measures in Budget 2016 amount to $11.5 billion.

[2] Around 1.5% of GDP in 2016-17 and the following year, dropping to roughly 0.5% of GDP by 2020-21.

Importantly, some of the incremental spending will be hard-wired into Ottawa's budget base[3], adding to the fiscal pressures on the government down the line. Unlike money for infrastructure or one-time boosts to the budgets of particular Ministries, this kind of spending is less about "economic stimulus" and more about expanding programs and therefore the size of government. We see a risk that the government's shotgun approach to spending increases could lay the foundations for structural deficits beyond the period covered by the fiscal plan.

The accompanying box lists a number of the spending commitments and other key measures included in Budget 2016.

How will all of this affect the Canadian economy? Leading private sector forecasters estimate that the new spending and tax measures together with the plan for bigger deficits will boost real GDP growth by between two and five tenths of a percentage point in each of 2016 and 2017.[4] This counts as a modest dose of "stimulus" for an economy that has some slack and is still adjusting to the terms of trade shock caused by lower oil and other commodity prices.

Some Key Budget Measures

- Budget 2016 confirms the previously announced reduction of the middle income bracket tax rate (from 22% to 20.5%) on incomes between $45,282 and $90,563, and the establishment of a new, higher tax bracket (33%) on incomes above $200,000. The net impact of these two measures is negative for the government's bottom line.
- Budget 2016 provides details on phase one of the revised ten-year infrastructure program, amounting to $4 billion of additional spending in 2016-17 (compared to what the previous government was planning) and $7.4 billion more in 2017-18.
- $8.4 billion over five years to support programs and new investments to improve the socio-economic well-being of First Nations peoples and communities.
- The government is revamping support for families with children, through the new Canada Child Benefit and the disbanding of three related programs introduced by the previous government. The result is greater financial support to low- and moderate-income families and less for higher-income families.
- Income splitting for families is eliminated (this has a positive impact on the government's bottom line).
- The children's fitness and arts credits are eliminated; a new school supply credit for teachers is introduced.
- Employment Insurance (EI) program: the waiting period for EI is reduced; accumulated hours of work requirements are relaxed for new entrants; there is a longer benefit period for EI recipients in some resource dependent regions; EI premiums fall from $1.88 to $1.66 in 2017. These various changes come at a net cost to the federal government of ~$600 million in 2016-17.
- Canada Student Grant is increased; higher income threshold for re-paying Canada Student Loans.
- Guaranteed Income Supplement is increased; OAS eligibility age is rolled back to 65.
- $2 billion over three years to modernize and improve infrastructure and research/training facilities at universities and colleges.
- $1 billion over four years to support the clean tech sector.
- $800 million over four years to support "innovation clusters," with more details to follow.
- Accelerated capital cost allowances will be available for investments in electrical energy storage and electric vehicle charging. Plus, $62 million is being allocated to expand infrastructure for alternative fuel vehicles.
- $50 million over two years for tourism marketing through Destination Canada.

<u>Putting a BC Lens on Budget 2016</u>

British Columbia will certainly see some benefits from a number of the measures listed on Box 1. This includes the revamping of federal support for families with children (the New Canada Child Benefit will increase support for low- and middle-income families with children, at the expense of more affluent

[3] An example is the increased Guaranteed Income Supplement for low-income seniors.

[4] See CIBC Economics, "2016 Canadian Federal Budget," March 22, 2016; and TD Economics, "2016 Federal Budget," March 22, 2016. The Department

Table 3

Federal Government Fiscal Plan

(C$ billions)

	2015/16	2016/17	2017/18	2018/19	2019/20
Revenues	291.2	287.7	302.0	315.3	329.3
Expenditures	296.6	317.1	331.0	338.0	347.0
Program Spending	270.9	291.4	304.6	308.7	314.2
Public Debt Charges	25.7	25.7	26.4	29.4	32.8
Budgetary Balance	*-5.4*	*-29.4*	*-29.0*	*-22.8*	*-17.7*
Net Federal Debt*	619	649	678	700	718

Source: 2016 Federal Budget. * Rounded to nearest whole number

families); phase one of Ottawa's ten-year infrastructure program; the additional federal funding earmarked for First Nations communities; the $1 billion set aside to bolster the clean tech industry; and the $2 billion that Ottawa is allocating to improve infrastructure and research and training facilities at Canadian post-secondary institutions (a step that the Business Council had recommended). Also of interest is the extra money allotted for tourism marketing and the government's decision to provide $32 million to the BC-based Centre for Drug Research and Development.

On the tax side, the previously announced reduction in the "middle" federal income tax rate will help many BC households, although the new, higher federal tax bracket (33%), starting at $200,000, may make it harder for BC employers to attract and retain senior-level managerial, technical and professional talent. Fortunately, the government left intact the previous administration's decision to allow accelerated depreciation for certain investments made in LNG facilities.

Thankfully, Budget 2016 steered clear of additional tax hikes, including on capital gains income and stock options. The rumor mill had hinted at policy changes in these areas, but the government wisely demurred. That said, the Finance Minister is pledging to launch a review of existing "tax expenditures" and tax preferences, which could have implications for a wide range of targeted tax benefits now available to individuals, entrepreneurs, and companies. The Liberals have re-considered their election pledge to further reduce the preferential small business income tax rate. Instead, the rate will stay at 10.5%, which compares to the basic federal corporate tax rate of 15% for companies that don't qualify as "small." There is no economic logic for imposing significantly lower tax rates on small business – unless policy-makers believe it is sensible to incent companies not to grow, and/or want to encourage self-

of Finance claims a somewhat bigger lift to real GDP from the measures in Budget 2016, in the range of 0.5-1.0% in 2016 and the following year.

employed professionals who effectively earn salary-like incomes to incorporate in order to lighten their tax burden.

Overall, Budget 2016, together with the tax and spending measures announced by the Trudeau government late last year, should have a small positive effect on BC's economic performance over the next 2-3 years.

Final Thoughts

There is more to come as the new Liberal government fleshes out its economic policy agenda. Work continues on phase two of the ten-year infrastructure plan, which hopefully will feature a stronger focus on infrastructure that enables trade and contributes to increased productivity and competitiveness. The government has also promised to unveil a new innovation strategy by the end of 2016.

While we support the decision to run bigger budget deficits for the next two years, the extra $100 billion plus in debt that the Liberals are on track to accumulate by the end of the decade does give us pause. What if a US recession intercedes, or interest rates defy market expectations and rise significantly by 2018? Canada's triple-A credit rating could be in jeopardy if external events do not unfold as the Finance Minister assumes. A faster return to balanced budgets would lessen Ottawa's fiscal risks over the medium-term.

The new budget heralds important changes in the structure of benefits for families with children, the employment insurance system, federal programs touching aboriginal people, and income transfers to seniors. Government spending will increase as a fraction of GDP. Reversing the staged increases in the eligibility age for Old Age Security enacted by the Harper government deviates from the prevailing trend across the developed world and is ill-advised given Canada's aging population. Already, the cost of "elderly benefits" in the federal budget is rising by $4-5 billion every year.

Finally, it must be said that there is not much in the new Budget to excite the broad business community. Indeed, taken as a whole, Budget 2016 seems to downplay the role of enterprises and entrepreneurs in driving economic and job growth, wealth creation, and innovation. This is a puzzling oversight, one that may reflect the emergence of a "state-centric" view of how a modern economy operates among those who now occupy the corridors of power in Ottawa.

*****

Jock Finlayson
Executive Vice President and Chief Policy Officer

Ken Peacock
Chief Economist and Vice President