Business Council of British Columbia

Priorities for the 2016 Federal Budget

FEBRUARY 2016

Business Council of British Columbia
Est. 1966

Suite 810
1050 West Pender Street
Vancouver BC V6E 3S7

Telephone: 604-684-3384
info@bcbc.com
www.bcbc.com

PRIORITIES FOR THE 2016 FEDERAL BUDGET

FEBRUARY 2016

The macro-economic challenge Canada is facing

Canada is being hit by both sluggish global growth and a widespread and significant downturn in oil and other commodity markets that is likely to persist for another 12 months, at least. The collapse of oil prices is especially daunting given the outsized role of the energy sector in driving economic activity in Canada in the decade leading up to 2014.[1] On current projections, the Canadian economy looks set to grow at a very muted pace this year and likely into 2017 as well – on the heels of a disappointing performance last year.[2]

The oil-rich provinces are going through a difficult, multi-year adjustment process that is far from having run its course. To a lesser extent the national economy is in the midst of a similar adjustment. Canada's terms of trade (the ratio of the prices of our exports to the prices of our imports) have weakened appreciably in the past two years. Together with the related depreciation of the Canadian dollar, this is depressing real incomes and purchasing power for households and businesses and crimping tax revenues for the public sector. Indeed, the Bank of Canada estimates that the oil slump alone is costing the national economy more than $50 billion per year in lost income, equivalent to $1,500 per person.[3] And this figure does not capture the negative impact on Canada from lower prices for many other commodities (e.g., natural gas, coal, metals, uranium, potash, etc.). The World's Bank's 2016 commodity market review summarizes the sharp declines in most commodity

[1] From 2010 to 2014, the energy sector, broadly defined, was responsible for approximately one quarter of Canadian merchandise exports and for ~35% of all non-residential business capital investment. Note that crude oil represents 75-80% of Canada's total energy exports.
[2] Based on the most recent published forecasts from TD Economics, BMO Capital Markets Economics, CIBC World Markets, and Capital Economics.
[3] Stephen Poloz, "Life After Liftoff," Bank of Canada, January 7, 2016.

prices since 2013. It foresees no meaningful turnaround in global commodity markets in 2016-17 (see Table 1).

Table 1[4] **U.S. Dollar Prices for Selected Commodity Products** (annual average)				
	2013	**2015**	**2016f**	**2017f**
Oil (bbl)	$104	$51	$37	$48
Natural gas (mmbtu)	$3.73	$2.61	$2.50	$3.00
Iron ore (mt)	$135.40	$55.80	$42	$44.10
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	$19

Monetary policy in Canada is currently far less potent than in normal times – interest rates have been at rock-bottom levels for a protracted period, and further minor cuts in the Bank of Canada's policy rate would do little to boost aggregate demand. The central bank continues to worry that consumers are taking on too much debt – a problem that would be compounded by further declines in interest rates and borrowing costs. Monetary policy, in short, is basically out of ammunition and has littles ability to offer additional support to a struggling economy.

Housing indicators in Canada are running at or near long-term structural peaks: homebuilding has been exceeding underlying demographic and demand growth for some time (although not dramatically so); urban housing prices are at or near record highs relative to both incomes and rents; the rate of homeownership has reached an all-time high; and investment in homebuilding and renovation is well above the long-term average measured as a share of GDP. Overall, residential investment spending is expected to contribute little if anything to GDP growth in Canada over 2016-17.

[4] World Bank, Commodity Markets Outlook, January 2016.

Following a steep drop in 2015, most forecasters also see business non-residential investment slipping again in 2016. The Bank of Canada's January 2016 business outlook survey indicates that the weakness in business capital spending is not restricted to the energy and mineral/metals sectors – it extends to other industries as well.[5] Weak global demand, the continued commodities slump, the extreme difficulty of building new energy and other linear infrastructure in Canada, and the erosion of Canadian competitiveness in the manufacturing sector over the last decade – all of these developments underscore the risk of an extended period of subdued business capital spending over the next few years.

The stance of federal fiscal policy

As we see it, the above considerations suggest the upcoming federal budget should aim to provide incremental support to a near-stalled Canadian economy, and also include measures to facilitate the necessary economic adjustment process where possible. The former point has been widely discussed in the media and by elected officials, but the latter theme has received little attention. It should be noted that currency depreciation is doing much of the work to facilitate the adjustment process and support the Canadian export sector, but policy arguably could do more to help Canadians navigate through the adverse terms of trade shock and regional economic dislocations associated with plunging commodity prices. In particular, we believe there is a case for a measure of prudently calibrated "economic stimulus" in Budget 2016. This means going beyond the support to aggregate demand that will come from the operation of the automatic stabilizers built into the federal budget; it also calls for a dose of discretionary policy stimulus.

In our judgement, a federal budget deficit in the range of $25 billion in 2016-17 would not provoke undue alarm in the business community or the capital markets, assuming the government also committed to a credible plan to shrink the deficit over its mandate and to keep the debt/GDP ratio on a gentle downward track over the balance of the decade and

[5] Bank of Canada, Business Outlook Survey, Winter 2015-16, January 11, 2016.

beyond.[6] Given Canada's aging population, we believe it is appropriate to target a debt/GDP ratio of ~25% by the mid-2020s, down from ~31% today. Reaching that target is feasible even if the government runs budget deficits amounting to 1.0-1.5% of GDP for a year or two. However, the credibility of any government pledge gradually to lower the debt/GDP ratio will depend, in part, on the nature of the discretionary economic stimulus delivered in Budget 2016. This is where the topic of infrastructure enters the picture.

Investing in infrastructure

In the current environment of sub-par economic growth and record-low government borrowing costs, the option of stepped-up federal spending on infrastructure is generally supported by economists and much of the business community. The federal government has already pledged to lift infrastructure spending beyond the levels planned by the previous administration. We agree with this broad policy direction, but note that it is not without complications.

One challenge is timing. In many cases, the most worthy public sector capital projects may be those that require years to design and permit; transit and transportation infrastructure is a prime example. Major capital projects that involve significant public sector funding can produce economic benefits and improve Canadian productivity and competitiveness in the longer-term. But often they don't align well with the goal of providing near-term "stimulus" when the economy is weak.

Thus, it is also necessary to consider capital spending initiatives that can be undertaken in an expedited manner. Repairing and upgrading existing public sector assets makes sense, including roads and bridges as well as infrastructure assets in the education and health sectors. Across the country, universities, colleges and hospital facilities have built up tens of billions of dollars of "deferred maintenance" owing to a long history of insufficient

[6] We would note that two back to back years of deficits in the range of $20-25 billion would not raise the debt/GDP ratio: deficits of this size would amount to a little over 1% of nominal GDP, and even with a weak economy, nominal GDP growth in Canada is expected to exceed 2% per year over the 2016-18 period.

provincial capital funding to keep these assets in good working order and up-to-date. As a general point, asset rehabilitation and maintenance deserve a higher priority in public sector capital budgeting across all levels of government in Canada. An expanded federal infrastructure program should not overlook the benefits that can flow from the timely maintenance, repair and rehabilitation of existing physical assets.

In terms of new or "greenfield" infrastructure development, we believe that the highest priority should be given to investments in ports, roads, rail, and airports, as well as energy infrastructure projects that advance the goal of connecting Canadian energy resources to global markets. While we see a case for federal funding for selected municipal infrastructure projects, the qualifying projects should meet strict federal criteria for scale and contribute to economic growth and enhanced Canadian competitiveness. It is not the role of the national government to pay for municipal and community capital projects of a routine nature or that local governments would undertake anyway.

Capital investment beyond "bricks and mortar" should also be included in the mix – spending on IT would provide economic stimulus beyond the engineering and construction sectors that often benefit most directly from government capital spending. Investing in IT infrastructure can also produce longer-term gains in productivity and service quality. In this regard, we note that Canada's ailing health care system is woefully deficient in the use of inter-operable IT platforms, lacks modern digital infrastructure, and is relatively weak in data analytics – making it a potentially strong candidate for incremental infrastructure dollars.

Finally, we urge the federal government to consider the vital role of the private sector when thinking about infrastructure policy and project selection. By some estimates, there are $50-60 billion in planned/proposed energy-related infrastructure investments on the books in Canada today, encompassing oil and gas pipelines, LNG facilities, and capital projects in the electricity sector.[7] Realizing even a portion of this very substantial private sector infrastructure opportunity would support economic growth and – more importantly – enable the Canadian energy sector to access growing global markets for all types of energy.

Building a more productive and competitive Canadian economy

In our view, Budget 2016 should help to lay the foundations for a more productive and competitive Canada. Apart from investing in infrastructure projects with a high economic payoff, this calls for a renewed focus on smart tax policy, the development of new measures to accelerate business innovation and the diffusion of advanced technologies, effective talent-attraction and retention strategies, and a commitment to ensure that Canada is part of evolving global trade agreements.

Smart tax policy:

After a decade of mounting complexity driven by a plethora of mostly small-scale tax changes, it is time for federal policy-makers to step back and re-assess the design and effectiveness of the overall business tax system in Canada. We support the federal government's stated intention to review the existing suite of tax expenditures, special preferences and boutique tax credits.[8] Smart business tax policy is underpinned by a commitment to relatively low statutory tax rates coupled with a broad tax base. It is also important that Canada establish a business tax regime that encourages firms to invest in machinery, equipment, advanced process technologies, up-to-date facilities, new software and other productive assets that drive productivity growth – the essential requirement for rising real incomes over time. Of concern, Canada continues to lag well behind the United States and a number of other OECD countries in "investment per worker (Table 2)."[9] Smart

[7] There are also planned/proposed/possible non-energy private sector infrastructure projects in sectors such as telecommunications that should not be overlooked when policy-makers are thinking about opportunities to accelerate infrastructure investment in Canada.
[8] As indicated in the 2015 election platform published by the Liberal Party of Canada.
[9] As documented in B. Dachlis, W. Robson and A. Jacobs, "A Crisis of Capital: Canadian Workers Need More Tools, Buildings and Equipment," C.D. Howe Institute, E-brief, December 16, 2015.

tax policy can assist in narrowing this gap. The evidence points to a clear negative relationship between marginal effective tax rates on business capital investment and the amount of investment per worker.[10] Although many of the biggest distortions in the Canadian business tax regime are at the provincial/local government levels, the federal government can take the lead in developing and advocating for pro-growth business tax policies that are aligned with the objective of stimulating productive business investment. This should include steps to narrow the current sizable differentials between small and medium/larger businesses in the applicable federal/provincial income tax rates. Canada is one of the few advanced countries that levies much higher tax rates on business income as companies grow beyond the small firm category.[11] The existing system of small business tax preferences distorts business behaviour and penalizes entrepreneurial ambition and company growth.

Table 2
Investment Per Worker, Canada, 2014
(relative to the US and to OECD average)

	Relative to US	**Relative to OECD Avg**
Canada	75%	88%
Manitoba	70%	82%
BC	63%	74%
Ontario	42%	49%

Source: C.D. Howe Institute.

Finally, Canada also needs broadly competitive personal taxes, including for entrepreneurs and skilled professional and technical employees. We are concerned that the recent introduction of a new, higher federal tax bracket, in tandem with relatively heavy personal income tax burdens in many provinces, has pushed top personal marginal tax rates beyond the 50% mark across much of the country. There is a risk that escalating personal taxes, especially at a time when the Canadian currency is under sustained downward pressure, will trigger a renewed “brain drain” of talent to the United States and other jurisdictions that have lower taxes and highly dynamic business sectors.

[10] Ibid, p. 4, and the sources cited therein.
[11] In British Columbia, the combined federal/provincial tax rate on small business income is 13.5% and will soon drop to 11.5% based on the election platform of the federal Liberal Party. In comparison, the general business income tax rate in BC stands at 26.0%.

Accelerating innovation:

We endorse the government's commitment to step up investments in both basic and applied research, as well as consider other initiatives to encourage the commercialization of new ideas and technologies and spur the growth of innovative companies in Canada. The Business Council recommends that the government re-visit the proposals developed by the Expert Panel on Federal Support to Research and Development.[12] Among other things, the Panel advocated the expansion of ***direct*** R&D funding mechanisms and a greater focus on attracting global mandates from multinational firms – especially in innovation-based sectors. To compete and win in today's information-intensive economy, Canada also needs excellent broadband infrastructure, up-to-date regulatory frameworks to encourage long-term private sector investment in digital infrastructure and services, and a workforce with the right digital skills. Ongoing federal government policy attention and leadership will be needed to make Canada a global leader in the shift to a digital economy.

There is also a role for the national government in strengthening areas of post-education education and research that contribute disproportionately to higher productivity and business growth. In this regard, we recommend that the federal government further increase its support for graduate post-secondary programs in STEM disciplines[13] and other fields closely associated with economic innovation.

Talent attraction and retention:

Canada should set a goal to be a global leader in overall workforce skills and capabilities. Achieving this will require greater collaboration between higher education institutions and the business and non-profit sectors, more use of innovative work-integrated learning models, and a re-tooling of immigration policy to keep Canada well positioned to attract global talent. The federal immigration system remains plagued by unacceptable processing delays and excessive red tape – weaknesses that complicate efforts to recruit highly-

[12] Expert Panel on Federal Support to Research and Development, Innovation Canada: A Call to Action, October 2011.
[13] Sciences, technology, engineering, and mathematics.

qualified people from other countries and make it harder for companies to grow and create wealth and jobs. It is clear that significantly more resources must be deployed to streamline administrative review and approval processes for all categories of immigration – permanent and temporary.

As the government considers changes to federal immigration programs, we believe the highest priority should continue to be given to economic immigrants with the skills to grow the economy and enable more Canadian-based enterprises and academic institutions to succeed. We also urge the government to work with the provinces to improve existing systems for foreign credential recognition.

Policy-makers need to recognize that Canada will benefit if employers are able to access temporary foreign workers to help meet labour market needs in selected areas and sectors. This includes agricultural workers, skilled trades and other workers with hard-to-find technical qualifications, workers with skills to help advance large industrial and infrastructure projects outside of populated urban centres, and researchers seeking to come to Canada on a temporary basis or with a view to transitioning to permanent status after a period of time.

Finally, we urge the federal government to accelerate efforts to reduce barriers to labour mobility through the Agreement on Internal Trade and also by pressing the provinces and professional licensing and occupational certification bodies to commit to the vision of a single, seamless Canadian labour market for individuals in all lines of work.

Trade agreements:

The Business Council supports the Canada-Europe Comprehensive Economic and Trade Agreement, and we also favour Canadian participation in the proposed Trans-Pacific Partnership agreement. In both cases, Canada would have more to lose than to gain if we chose not to be part of these major global trade and investment accords. Canada is a small, relatively slow-growing and aging economy that accounts for ~2% of global output. In the long run, our prosperity hinges on accessing foreign markets for goods and services and ensuring that Canadian businesses are linked into evolving international supply chains.

Conclusion

Budget 2016 is being developed at a difficult time for Canada. The world economy remains unsettled and unusually risk-prone, the prices for many of Canada's leading export goods have fallen sharply, and the efficacy of monetary policy is under critical scrutiny after a long period of record low interest rates. Looking further ahead, Canada faces long-term economic and fiscal challenges stemming from population aging, a secular slow-down in workforce growth, lagging productivity, and the ongoing forces of globalization which appear to be concentrating wealth and high-value economic activity in a handful of jurisdictions. With a strong political mandate, the new federal government is in a position to define an economic policy agenda that responds to these domestic and global trends and helps to strengthen the country's growth potential and while also improving the prosperity of Canadians.

*****