



Publication

BUSINESS ALERT

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A CAUTIOUS BUDGET FOR UNCERTAIN TIMES

Just two days after the closing ceremonies for the 2010 Winter Olympics, Finance Minister Colin Hansen delivered a stay-the-course budget with little in the way of new spending or revenue measures. After the euphoria surrounding the Olympics, the Budget could be described as a bit of a ‘reality check’ as it reflects the difficult fiscal circumstances the government finds itself in. Like many other jurisdictions, BC is looking at sizable deficits as it struggles to get the public finances back on a sustainable footing in the wake of what many economists are now calling the ‘Great Recession’ of 2008-09. Last year saw both the global economy and the value of world trade contract for the first time in more than six decades. The onset of a synchronous recession caused government budgets across the world to plunge further into the red – and BC was no exception.

If there is a theme in the Budget, it is building on the momentum of the 2010 Games. But there is thin gruel in terms of new tourism-promotion measures, as the government opted for deficit reduction and directed most of the additional dollars available to health. From our perspective, Budget 2010 sets the right context for an anticipated economic recovery. It presents a solid plan to move the province back to a balanced budget but still manages to allocate some funding to new priorities (including full-day kindergarten, the 2010 Sports and Arts Legacy, and clean energy initiatives). It also confirms the government’s commitment to proceed with the HST.

Economic Outlook

On the economic front, the uncertainty that characterized the past 18 months has mostly passed. The Ministry of Finance, however, has adopted a very conservative view of the economic outlook, citing the risk of a ‘double-dip’ US recession. That said, the current economic setting is an improvement over the pessimism and worry that prevailed last year. The global economy is recovering, thanks in large part to strength in China and other emerging markets. Canada is benefiting from the accompanying upswing in commodity markets, as well as a return to positive growth in the United States. There has also been a fairly strong rebound in Canadian consumer spending and housing market activity, admittedly from the very low levels of 2009. However, there are significant risks around the strength of the recovery in both Europe and the US. Mindful of these risks, Budget 2010 is based on conservative economic assumptions.

For example, Minister Hansen assumes the US economy will grow 2.2% this year and 2.3% in 2011, whereas the private sector consensus is for American real GDP to advance by 2.9% and 3.1%, respectively. The Ministry of Finance worries that dark clouds are still hanging



over the US economy, including weak investment, cash-strapped consumers and a delayed recovery in the job market. To this we would add that the inevitable unwinding of massive fiscal stimulus and record low interest rates also pose a risk to the US outlook in 2011 and 2012. There is also a noticeable gap between the Budget forecast (2.0%) and the consensus outlook (2.6%) for Canadian economic growth in 2010. The Ministry of Finance expects the Canadian economy to strengthen in 2011 (2.4% real growth), but again the consensus outlook foresees a bigger jump to 3.2% growth.

Against a brighter but still uncertain external backdrop, Budget 2010 forecasts a 2.2% increase in British Columbia's real GDP in 2010 – less than the 2.9% growth expected by the independent Economic Forecast Council, and also below the Business Council's latest projection. This cautious forecast extends to other external economic factors. The Budget looks for a steady ramping up of short-term interest rates beginning mid 2010 and extending right through to 2014. While interest rates are clearly heading higher, an uninterrupted climb over a five-year period would be unusual, especially if Canadian economic growth turns out to be subdued, as the Budget assumes. Minister Hansen also sees a slow recovery for US housing starts. While the number of starts has edged higher over the past year, we agree with the Minister that there is little prospect of a marked turnaround in 2010 given the parlous state of US household finances and the excess supply of homes on the market.

The economic outlook embodied in Budget 2010 gives the government room to manage downside risks. But it also means there is some chance of an 'upside surprise' for 2010 and 2011, in which better than expected economic conditions allow the government to move more quickly back to a balanced budget.

Table 1
Budget 2010 Economic Assumptions and Forecasts for British Columbia
(annual per cent change unless otherwise indicated)

			forecast		
	2008	2009	2010	2011	2012
BC Real GDP (chained \$2002)	0.0	-2.7	2.2	2.3	2.7
BC Nominal GDP	3.3	-5.0	4.5	4.7	5.0
Exports Goods & Serv. (chained \$2002)	-5.1	-6.5	2.2	2.1	3.5
Housing Starts (thousands of units)	34.3	16.1	20.5	23.6	25.8
Cdn 3-mnth T-bill (ann. avg. %)	2.4	0.3	0.5	2.2	3.4
Cdn 10 yr gov't bond (ann. avg. %)	3.6	3.3	3.7	4.2	4.6
Real GDP Canada (chained \$2002)	0.4	-2.6	2.0	2.4	2.6
Real GDP US (chained \$1996)	0.4	-2.4	-2.2	2.3	2.7
US Housing Starts (thousands of units)	900	552	640	800	928
Real GDP Japan (chained Yen 2000)	-1.2	5.1	1.1	1.0	1.8

Source: 2010 BC Budget and Fiscal Plan



Fiscal Plan

Budget 2010 reaffirms the government's commitment to balance the books by 2013-14 as originally outlined in the September 2009 Update. With the 2009-10 fiscal year almost over, the government projects a \$2.7 billion operating deficit for this year, similar to September. For 2010-11, the deficit is expected to shrink to \$1.7 billion (a figure which includes a relatively small forecast allowance of \$300 million). Usually we would view a \$300 million annual forecast allowance, which is just 7% of the budget, as too small in such an unsettled economic environment, but the prudent economic forecasts underpinning Budget 2010 provide a large additional cushion. The Budget also includes \$450 million in contingency funding to manage possible additional fiscal pressures in each of the next three years.

Together these three elements of Budget 2010 (contingency funding, forecast allowance and conservative forecasts) suggest the government should meet and probably exceed its fiscal targets. We believe the province will be back to an operating surplus sooner than the Minister is projecting.

<u>Table 2</u>					
BC Government Five Year Fiscal Plan					
(millions of dollars unless otherwise indicated)					
	09-10	10-11	11-12	12-13	13-14
Revenues	37,050	39,190	40,957	42,800	44,280
% change	-3.3	5.8	4.5	4.5	3.5
Expenditures	39,700	40,605	41,602	42,545	43,470
% change	3.8	2.3	2.5	2.3	2.2
Surplus/Deficit before forecast allowance	(2,650)	(1,415)	(645)	255	810
Forecast allowance	(125)	(300)	(300)	(400)	(400)
Surplus/Deficit	(2,775)	(1,715)	(945)	(145)	410
Taxpayer-supported capital spending	4,013	5,414	3,609	3,073	3,053
Total capital spending	7,270	8,159	6,528	6,058	5,914
Taxpayer-supported debt	29,093	33,748	36,720	38,329	39,618
(% of GDP)	15.5	17.2	17.9	17.8	17.5
<i>Source: 2010 BC Budget and Fiscal Plan.</i>					

In 2010-11, overall government revenues are set to grow 5.8% to reach \$39.2 billion. This represents an increase of \$520 million over what was expected in September 2009. A large portion of the additional revenue is from transition payments for the HST. With the upturn in certain commodity markets, coal and metal mining are providing more revenue than anticipated in the fall. On the other hand, personal and corporate income tax revenues and natural gas royalties are coming in below earlier projections.

The bad news is that with three years of significant operating deficits and a ramping up of capital spending, BC's debt is rising steeply. Taxpayer-supported debt as a share of GDP – the best measure of fiscal sustainability – is set to climb from 15.5% of GDP in 2009-10 to 17.9% by 2011-12 before declining slowly thereafter; in 2008, the debt/GDP ratio stood at 13.4%. While BC's debt burden is low compared to most other provinces, it is disconcerting to see the debt/GDP ratio rising at a time when the front-end of the baby-boom generation is starting to retire – a demographic trend that promises to put more pressure on government finances in the next 10-20 years. It is worth noting that when Moody's gave BC its AAA credit rating a few years ago, taxpayer-supported debt was



16.2% of GDP; this leads us to believe the province's credit rating is unlikely to be adversely affected by the large amounts of additional borrowing proposed in the Budget.

New Spending and Tax Measures

There are very few new spending or tax measures in Budget 2010, and most of the items referenced in the document were previously announced.

- Further details are provided on transition and mitigation measures related to the adoption of the Harmonized Sales Tax on July 1, 2010. The Business Council strongly supports replacing the existing Provincial Sales Tax with the HST, as this will significantly improve BC's competitive position, reduce costs for BC businesses, and assist in boosting productivity in the years ahead.
- The government is establishing an advisory group – in which the Business Council will be participating – to review concerns over the fairness and economic impact of industrial (class four) property taxes. This is an important issue for a number of industry sectors.
- A residential property tax deferral program is being introduced for home-owners with children under 18 facing financial hardship.
- The International Financial Activity program, which offers tax refunds in respect of BC corporate income tax for certain qualifying activities, is being expanded to include digital media and publishing, clean technology, and certified carbon trading.
- In response to competitive pressures from Ontario and Quebec, BC is enhancing existing incentives for film production and new media. In addition, the province will introduce a new digital media tax credit set at 17.5% of qualifying labour costs.
- Medical Service Plan premiums will rise in January 2011.
- In keeping with the government's commitments to reduce greenhouse gas emissions and spur the development of 'clean' energy, \$35 million is allocated to a revived Live Smart BC and another \$100 million is set aside for clean energy development.
- The Minister re-iterated that there is no money in the operating budget to pay for increases in public sector compensation over the next three years. The government is sticking with its 'net-zero' negotiating framework as it works to achieve new collective agreements with public sector employees in 2010 and 2011.

Capital Plan

An accelerated pace of capital spending counts as the government's main contribution to ongoing efforts to stimulate the economy after almost two years of recession. Total capital spending is pegged at more than \$20 billion over the next three years (2010-11 to 2012-13). In 2010-11, capital outlays rise by 12% to reach \$8.1 billion, on the heels of a hefty increase in 2009-10. The level of capital spending is expected to fall in the latter two years of the revised three-year fiscal plan.



Conclusion

Budget 2010 must be judged in context. While the economy is gaining traction there is still a fair amount of uncertainty about the path ahead. The deep recession of 2008-09 resulted in large revenue reductions, leaving the government with little fiscal room. We applaud the fact that Minister Hansen is determined to avoid a 'structural deficit' and has outlined a realistic and achievable plan to eliminate the deficit. The overall debt load is rising, although this should be seen in relation to the size of the economy. On this basis the debt remains manageable and BC is in good shape relative to other provinces. Moreover, much of the additional debt is for infrastructure, which should provide benefits for years to come. However, the government needs to focus on limiting the increase in the debt/GDP ratio and establishing a framework to reduce the debt burden over time.

While many were looking for more, we believe the Budget is consistent with the Liberal government's record of generally sound stewardship of the province's finances. Although the Budget lacked bold new measures, it is important to remember that the HST was announced just last summer and is yet to be implemented. Arguably, this is the most significant and beneficial tax reform in BC in many generations.

Finally, we re-iterate the Business Council's concern over the implications of BC's escalating carbon tax, which is slated to increase again on July 1, 2010 to the equivalent of \$20 per ton of carbon dioxide emissions. When the government introduced the carbon tax in 2008, it may have believed that other jurisdictions would soon follow. But that has not happened: BC is still the only jurisdiction in North America with an economy-wide carbon tax, which is a tax on the use of most types of energy. For most businesses, a made-in-BC carbon tax means a made-in-BC competitive disadvantage, as it leads to an ever-rising cost for the energy they need to transport goods, heat buildings, operate plants and factories, and run vehicles and equipment. In our view, the government would be well-advised to freeze the carbon tax at its current level (\$15 per ton) and reassess whether a steadily rising made-in-BC carbon tax really makes sense in the light of changing economic circumstances.

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