



# Publication

## BUSINESS ALERT

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### SEPTEMBER BUDGET UPDATE SIGNALS CHALLENGING ECONOMIC TIMES

September's Budget Update underscores the damage that has been done to British Columbia's economy and public finances by the global recession that began last autumn and continued through the first half of 2009. In Europe, North America, Japan, and much of the developing world, policy-makers are grappling with the worst economic slump in six decades. For the first time since the 1930s, the world economy is expected to shrink this year. The American economy - which still accounts for more than one-fifth of global output - has been contracting for 18 straight months, making the 2008-09 downturn the longest postwar US recession.

Closer to home, communities, workers and businesses here in BC are feeling the effects of the protracted American recession, dismally low US housing starts, a steep drop in world trade, and the lingering consequences of last year's severe credit crunch. The results are starkly evident in the data presented in the Budget Update.

#### Economic Picture

British Columbia's real GDP is now forecast to shrink by 2.9% this year, significantly worse than the 0.9% drop projected in February. More strikingly, nominal GDP is forecast to decline by 5.0% - an unprecedented fall that does much to explain the sustained downward pressure on provincial revenue. So far in 2009, BC's international export shipments are down 18% compared to 2008. Housing starts for the full year are expected to tumble by 60%. According to the Budget Update, retail sales for the year are on course to come in 6.1% lower than in 2008.

The government is banking on a modest recovery in 2010, with further gains in 2011. The main components of the economic outlook underlying the Budget Update are summarized in Table 1. Overall, the economic assumptions used by Finance Minister Colin Hansen strike us as realistic and, for 2010 at least, possibly on the conservative side. Recent data out of the US suggest a return to positive growth over the second half of 2009, while in Asia (ex-Japan) the incipient economic recovery looks to have stronger momentum than analysts were anticipating even two months ago.



**Table 1**  
**Economic Outlook**

Annual percent change unless otherwise indicated	2009	2010	2011	2012	2013
Real GDP	-2.9	1.9	2.7	2.7	2.8
Nominal GDP	-5.0	3.5	5.0	5.1	4.9
Personal income growth	-1.0	2.1	3.8	4.5	4.5
Pre-tax corporate profit growth	-36.4	7.3	5.4	8.2	7.7
Natural gas:					
Price (\$Cdn/gj; plant inlet)	\$3.51	\$5.09	\$5.78	\$6.24	\$6.68
% change in volumes	2.1%	0.9%	20.9%	12.8%	1.8%
Lumber prices SPF (\$US/000 mbf, cal year)	\$176	\$200	\$238	\$288	\$300

Source: September Budget Update - 2009/10 to 2011/12.

### **Fiscal Outlook**

Turning to the fiscal situation, in retrospect it is fair to say the government badly misjudged the severity of the economic downturn and its impact on the province's budget. But then so too did most private sector forecasters (regardless of what some of them may claim today). Eight months ago, few analysts understood either the magnitude or the consequences of the near-breakdown of the world financial system last fall, still less how the credit crunch that started in the US and the UK would come to engulf continental Europe, Canada, and even parts of Asia.

From the government's perspective, the net result has been a noticeable drop in several components of provincial revenue. Specifically, the September Budget Update reports that personal income tax revenues in 2009-10 will be down \$881 million relative to what had been assumed in February; corporate income taxes will be \$120 million lower; consumption taxes will be off by \$290 million<sup>1</sup>; and total direct resource-related receipts will be \$1.05 billion<sup>2</sup> less than the province was banking on just eight months ago. Adding to the province's near-term fiscal woes are skyrocketing costs for fighting forest fires (up \$347 million) and additional social assistance expenses attributable to higher welfare caseloads (\$113 million more in 2009-10).

<sup>1</sup> Consisting of provincial sales tax (down \$240 million), fuel tax (down \$41 million), and hotel tax (down \$8 million), compared to the amounts included in the February 2009 Budget.

<sup>2</sup> Consisting of natural gas royalties (down \$492 million), forest revenues (down \$222 million), and other energy, metals and natural resources (down \$339 million).



Lest it be thought that the problem of disappearing revenues is unique to BC, it is worth noting that own-source revenues for the 50 US states combined through the first five months of 2009 were down 20% from the corresponding period in 2008.<sup>3</sup> And several other provinces as well as the Canadian government have also experienced a significant erosion of their revenues.

The government's response to the sagging economy and dwindling revenues involves a mix of: 1) restraint on selected program and administrative expenses, 2) higher capital outlays in 2009-10 and 2010-11, and 3) a decision to run operating deficits for the next four years. The latter will require a further amendment to the *Balanced Budget and Ministerial Accountability Act* (previously amended in February).

Table 2 summarizes the fiscal plan laid out in the Budget Update. For the current year the government is projecting a record high operating deficit of \$2.8 billion – almost six times bigger than the \$495 million shortfall acknowledged in February.<sup>4</sup> This is followed by \$1.7 billion of red ink in 2010-11, \$945 million in 2011-12 and \$140 million in 2012-13. All of these deficit numbers include a \$250 million forecast allowance – an amount that we judge too small to provide much wriggle room in the event that economic conditions turn out to be less favourable than anticipated.

As a share of the province's economy, this year's deficit is pegged at slightly less than 2% of GDP. In today's world of soaring public sector deficits, 2% of GDP counts as a modest fiscal shortfall.

(\$ millions)	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Revenue	38,328	37,608	38,845	41,072	42,920	44,630
Total Expense	38,250	40,133	40,320	41,767	42,810	43,880
Surplus (Deficit) before forecast allowance	78	(2,525)	(1,475)	(695)	110	750
Forecast Allowance	-	(250)	(250)	(250)	(250)	(250)
Surplus (Deficit)	78	(2,775)	(1,725)	(945)	(140)	500
Total capital expenditures	5,540	7,434	7,687	6,544	6,574	5,740
Total Taxpayer-supported debt	26,446	30,593	34,894	37,279	38,613	39,993

*Source: September Budget Update - 2009/10 to 2011/12.*

<sup>3</sup> The Nelson Rockefeller Institute of Government, State Revenue Report (July 2009).

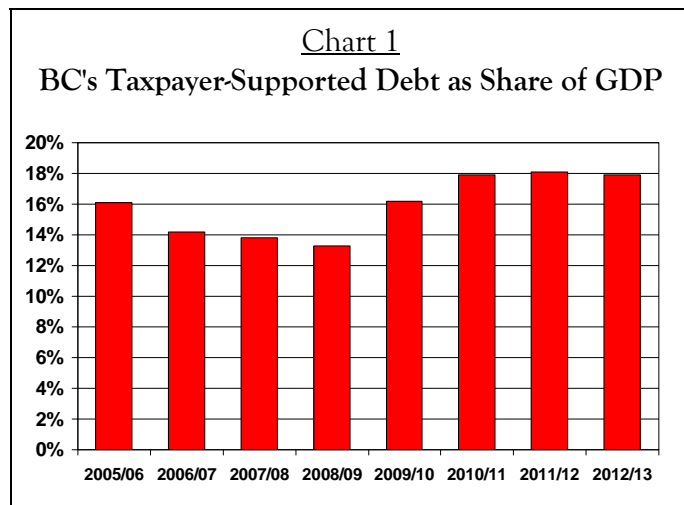
<sup>4</sup> The deficit this year would be \$750 million higher were it not for the fact that the province is allocating this amount from the \$1.6 billion that BC will receive from the federal government as part of moving to a harmonized sales tax regime.



While in his speech the Minister put considerable emphasis on the need for restraint, in fact total direct Ministry spending is set to climb by \$1.1 billion this year, with the lion's share of the increase directed to health services and smaller amounts to education and social services. Health care also absorbs the bulk of spending hikes in the next two years, as the health budget expands by 18% over three years. **By 2011-12, health care will account for 51% of direct spending by all provincial Ministries combined.**<sup>5</sup> In other words, half of the dollars used to fund the core activities of government will be allocated to provide health services. One wonders when (not if) 60% of the budget will be needed to pay for health care.

To support aggregate demand in the midst of a downturn, the province is ramping up capital expenditures. These rise by almost \$2 billion to \$7.4 billion in 2009-10, and are then increased further to \$7.7 billion next year. In our view, a stepped-up pace of public sector capital investment is a wise policy given the slack that exists in the economy, the underutilized resources in the construction sector, and the ongoing need to upgrade and expand infrastructure and other public assets.

The return of multi-year operating deficits coupled with higher capital outlays means that the days of a shrinking public debt burden are over. Instead, as depicted in the accompanying chart, taxpayer-supported debt<sup>6</sup> is projected to grow from 13.3% of GDP in March 2009 to 18.1% by March 2012. By then, servicing the expanding net debt will require 5.1 cents of every



revenue dollar, up from 4.2 cents today. Although British Columbia remains in a strong financial position relative to other provinces, it is disconcerting that the debt burden will be rising at a time when the baby-boom retirement wave is about to begin – a demographic development that is sure to heighten the fiscal pressure on government going forward.

### Budget Initiatives

The Budget Update included several initiatives of note to the business community.

- The government is raising the personal income tax credit from \$9,373 to \$11,000 in 2010. This will deliver a well-timed tax saving for BC households and also help

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<sup>5</sup> September Budget Update, p. 11.

<sup>6</sup> Taxpayer-supported debt is total provincial debt minus the debts carried by certain financial self-supporting commercial Crown Corporations (the main ones are BC Hydro, BC Transmission Corporation, and the Transportation Investment Corporation established to develop the new Port Mann Bridge).



consumers adjust to the proposed Harmonized Sales Tax slated to come into effect next July.

- BC's small business income tax rate will be reduced to zero from 2.5% in 2012. In addition, the small business income threshold is increased from \$400,000 to \$500,000 effective in 2010. These changes promise to make BC an even more attractive jurisdiction for small businesses.
- The basic training tax credit for eligible apprentices, which is paid to employers, doubles from \$2,000 to \$4,000.
- The mining flow-through tax credit is extended to the end of 2010.
- Expiry dates for the province's film tax credits are removed.
- Less welcome is the news that Medical Services Plan premiums are being increased by 6% effective January 1, 2010. As most companies pay these premiums on behalf of their employees, this amounts to a higher payroll tax for BC employers.<sup>7</sup>
- Beginning January 1, 2010, ethanol and biodiesel will be subject to the province's carbon tax.

The Budget Update reiterated the government's commitment to replace the Provincial Sales Tax with a Harmonized Sales Tax that is integrated with the federal Goods and Services Tax, resulting in a single HST rate of 12% charged on purchases of most goods and services. In this connection, the Finance Minister outlined a number of measures linked to the HST:

- BC will provide rebates of 75% of the provincial portion of the HST for organizations that now receive federal GST rebates, and 57% of the provincial portion of the HST for registered charities and certain non-profit entities that qualify for GST rebates. The province is continuing to work on determining rebates for other public sector bodies (universities, colleges, health authorities, school districts).
- The province has decided to provide rebates for the provincial portion of the HST on energy purchased for residential use. This will reduce the impact of the HST on consumers by approximately \$200 million per year.
- As part of the implementation of the HST, the Innovative Clean Energy levy will be repealed, saving households and firms \$25 million per year.<sup>8</sup>

There is broad support for the HST across most of the province's business community and within the Business Council's membership. Replacing the existing PST and GST with a single, value-added consumption tax will stimulate investment, productivity and exports; make BC more competitive; and reduce administrative and compliance costs for taxpayers. Once the HST is fully implemented, the marginal effective tax rate on new capital investment will drop by ten percentage points - by any standard, this represents a big boost to BC's competitiveness.

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<sup>7</sup> The increase translates into \$36 more per individual and \$72 more per family.

<sup>8</sup> The government has stated that it will continue to operate the Innovative Clean Energy Fund using other funding sources.



However, the Business Council recognizes that a few sectors may be disadvantaged by this major and somewhat unexpected change in tax policy. In this regard, we believe it is important for the government work with these industries over the coming months to devise measures that can help to mitigate any adverse effects which the HST may have on their businesses.

While the economic situation has deteriorated markedly since the beginning of the year, the September Budget Update presents a revised and more realistic picture of the province's finances and what lies ahead. The government has chosen a balanced fiscal approach by increasing capital spending, preserving core programs, and keeping a tight rein on program and administrative costs. As a small open economy, BC's prosperity depends on the health of the external markets with which we do business. Overall, the province seems to be reasonably well positioned for a return to growth as the global economy stabilizes and then begins to expand again.

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