Business Council of British Columbia

Business Alert

March 30, 2012

2012 Federal Budget: Fiscal Restraint with New Policy Directions

Reflecting the precarious nature of the economic recovery, Finance Minister Jim Flaherty delivered a budget with few new tax measures, a moderate amount of spending restraint, and a plan to return to fiscal balance over the medium term. From our perspective it is a prudent budget that trims spending sufficiently to balance the books by mid-decade, while not tapping on the fiscal brakes too hard. While the federal workforce will be reduced, overall the level of restraint is such that critics will be hard pressed to claim that it will undermine the economic recovery.

The federal government is targeting returning to surplus by 2015-16, keeping the same timeline as outlined in last year's budget. The deficit in 2014-15, however, is smaller than expected, meaning the budget will essentially be in balance one year earlier. The good news on the fiscal front is that the projected deficits over the next few years are declining more quickly than anticipated in the fall update, with most of the improvement due to cost savings rather than upside surprises on the revenue side.

While the broad fiscal aspects of the budget are largely status quo, Budget 2012 sets in motion a number of policy changes designed to improve innovation and productivity, support and expedite resource development, address skill shortages and manage escalating liabilities linked to Canada's aging population.

The Economic Setting

Budget 2012 assumes that the Canadian economy will grow 2.1% this year and strengthen slightly to 2.4% in 2013. In comparative terms, Canada has enjoyed a fairly healthy economic recovery, and continues to lead most G-7 countries on key economic metrics including GDP growth and job growth.

In an absolute sense, however, we would note that real GDP growth of 2.1% this year is very modest, especially for a period of economic recovery. Softer growth generally translates into slower revenue gains, but as discussed below, the federal government is projecting fairly brisk revenue growth over the next five years.

As the Minister noted, the consensus view among economists sees the US economy continuing to gradually strengthen and assumes an orderly albeit protracted resolution to the European debt crisis. The European sovereign debt and banking crisis remains a significant downside risk to the outlook, although near-term concerns have diminished over the past few months.

In recognition of the downside risks, the government has opted to adjust the private sector consensus forecast for the level of nominal GDP down by $20 billion over the period of the fiscal plan out to 2016, which translates into a $3 billion reduction in projected revenues (or a $3 billion forecast cushion) each year.

Table 1
Budget 2012 Economic Assumptions and Forecasts for Canada
(annual per cent change unless otherwise indicated)

		forecast				
	2011	**2012**	**2013**	**2014**	**2015**	**2016**
Real GDP	2.5	2.1	2.4	2.4	2.4	2.2
GDP inflation	3.3	2.4	2.0	2.1	2.0	2.0
Nominal GDP growth	5.8	4.6	4.4	4.6	4.4	4.2
Unemployment rate	7.4	7.5	7.2	6.9	6.7	6.6
Cdn 3-month treasury bill	0.9	0.9	1.3	2.2	3.3	3.9
Cdn 10 year gov't bond	2.8	2.2	2.8	3.6	4.3	4.5
US GDP growth	1.7	2.3	2.4	2.8	2.9	2.8

Source: 2012 Federal Budget.

Moderate Spending Restraint

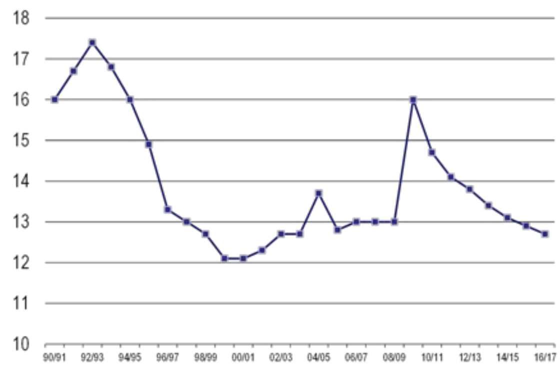
After a fair amount of media speculation in the days leading up to the Budget that deep spending cuts were forthcoming, the reality is somewhat different. Budget 2012 does contain spending cuts, but they are actually quite modest and need to be put in context. To begin with, all spending cuts are restricted to what is termed the "review base" which is departmental spending, or direct program spending excluding major transfers to provinces and to persons. In other words, funding for social programs, health care and provincial equalization, along with old age pensions and Employment Insurance, was protected. As a result, all spending reductions referenced in the Budget are confined to a base of $75 billion, out of a total federal program spending of more than $240 billion.

A second consideration is that the reductions are not across-the-board cuts. Rather they are based on the results of the government's review of departmental spending and are concentrated in areas where the greatest scope for reducing spending was identified. The reductions are also phased in over time. In 2012-13 departmental spending will be trimmed just $1.5 billion. The following year reductions rise to $3 billion, and by 2014-15 the cumulative savings will amount to $5.2 billion. For individual departments the reductions range from a low of just a 1.1% (Veterans Affairs) to a high of 16.8% (in the Department of Finance). While these are meaningful reductions, judged against total federal outlays they amount to only 1.9% of all expenditures. Moreover, they represent just 0.2% of Canadian GDP, so any fiscal drag attributable to the Budget will be minimal.

Finally, it should be underscored that outright spending cuts are not part of the plan. With transfers to provinces and individuals and spending on many other social programs protected (or increasing), total program spending rises in each of the next three years. The rate of increase in total spending, however, is kept below nominal GDP growth, so that by 2014-15 the ratio of program spending to GDP falls back to where it stood (13.1%) prior to the 2008-09 recession.

Program Expenditures as a Share of GDP

per cent



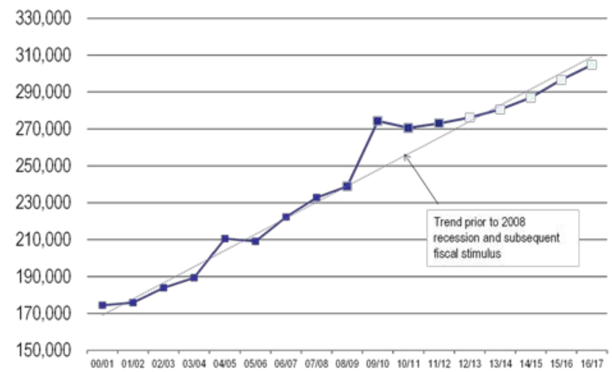
Source: Fiscal Reference Tables and 2012 Federal Budget.

Having said that, the number of federal government employees will be trimmed by 19,200 positions, which amounts to 4.8% of the public service. While cutting staff is challenging, the pending cuts are much smaller than the 14% headcount reduction undertaken in the mid-1990s. And this time around a greater share of the job losses are likely to come via attrition. Federal employee pension contribution rates will be increased so that there is an equal contribution by employees and the employer. Finally, beginning in 2013 the normal age of retirement for all new federal employees will rise to 65 from 60.

The cost of financing public debt has fallen over the past decade and has been stable over the past few years. In 2011-12 the government will spend $31 billion on public debt charges. A decade ago, debt financing charges amounted to nearly $40 billion. Low debt servicing costs are a significant factor behind the government's ability to return to a balanced budget in a timely manner without making much more stringent spending cuts. While low interest rates are the primary reason debt service costs remain low, prudent fiscal management and Canada's top-notch credit rating are also important factors.

Total Federal Spending

millions $



Source: RBC Fiscal Reference Tables and 2012 Federal Budget

Revenue Picture

Based on year-to-date results, federal revenues are projected to expand by 4.6% in 2011-12. Over the remainder of the forecast period, revenue growth is projected to reach an annual average rate of 4.7%. Of interest, between 2002 and 2008, a period of robust economic growth, average revenue growth was also 4.7%.

One of the main drivers behind the government's expectation of solid revenue gains is the assumption that personal income growth will boost personal income tax collections in the years ahead. Corporate income tax revenues also grow steadily over the course of the fiscal plan, underscoring the point that lower corporate tax rates don't necessarily lead to reduced revenues. The federal government now obtains more revenues from business income taxes than from the GST.

Table 2
Canadian Government Financial Position
(billions of dollars unless otherwise indicated)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Revenues	248	255	270.4	285.5	300	312.5
% change	4.6	2.8	6.0	5.6	5.1	4.2
Expenditures	241.9	245.3	249.4	253.9	261.7	268.6
% change	1.0	1.4	1.7	1.8	3.1	2.6
Public Debt Charges	31	30.8	31.1	33	34.9	36.1
Total Expenses	272.9	276.1	280.6	286.9	296.6	304.7
% change	0.9	1.2	1.6	2.2	3.4	2.7
Budgetary Balance	-24.9	-21.1	-10.2	-1.3	3.4	7.8
Federal Debt	581.3	602.4	612.5	613.9	610.4	602.6
% of GDP	33.9	34.4	33.2	31.6	30.1	28.5

Source: 2012 Federal Budget.

Debt and the Deficit

The government pledges to return to a budget surplus by 2015-16, but there's a good chance it will reach this target one or even two years earlier. In contrast to most other advanced countries, Canada is in the enviable position of being able to return to balanced budgets within a few years with only modest spending restraint.

The debt will increase for a few more years and the debt-to-GDP ratio will climb to a manageable peak of 34.4% in 2012-13. After that, the debt-to-GDP ratio falls to 28.5%, where it was prior to the recession.

Tax Measures

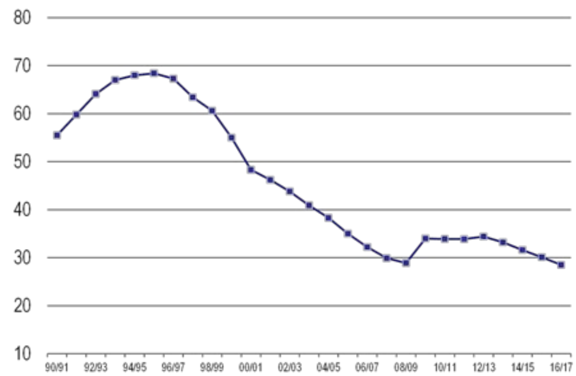
As noted at the outset, the Budget is very thin on new tax measures. One of the more substantial changes is the move to limit future increases in EI premiums to 5 cents per $100 of insurable earnings until the EI operating account is balanced. As a result, over the forecast period EI premiums rise from $1.78 in 2011-12 to $1.95 by 2016-17. While restricting the increment of annual increases provides certainty and stability for business, the coming cumulative increase still represents a significant jump in employers' payroll costs.

Some Significant Policy and Regulatory Changes

As was clearly signaled in advance, the Budget announces steps to ensure that social programs remain sustainable in light of growing demographic pressures. The Economic Action Plan proposes to gradually increase the age of eligibility for Old Age Security and Guaranteed Income Supplement benefits from 65 to 67. Here the optimal word is "gradual." The changes will not start until April 2023, and then will be phased in over a six year period to ensure people have adequate time to plan. People over the age of 54 today won't be affected by the move to a later OAS eligibility age.

Debt-to-GDP Ratio

per cent



Source: Federal Fiscal Tables and 2102 Federal Budget.

Beginning in July 2013, individuals will also have the option to voluntarily defer their OAS pension for up to five years. This sensible change is intended to provide more flexibility for individuals who wish to keep working past the "normal" retirement age. Those who take up this option will receive an actuarially adjusted higher pension at a later date.

Budget 2012 introduces a number of policy changes intended to enhance competitiveness and support economic development. Perhaps the most significant for BC is the long awaited and welcome commitment to streamline the review processes for major economic projects. The government plans to introduce legislative changes to shift to a "one project, one review" model that includes clearly defined time lines. The Business Council has long advocated such reforms to the federal environmental assessment regime. With an abundance of resource development and infrastructure projects on the books, this is an important change for BC. Ottawa's intention is to focus its resources on projects where the environmental impact may be the greatest. The Budget includes $165 million over two years to renew the Major Projects Management Office and to support stepped up consultations with Aboriginal peoples. Some of this funding will also be devoted to supporting responsible energy development, e.g., improving pipeline safety, enhancing existing tanker inspections, and implementing appropriate legislative and regulatory frameworks related to oil spills and emergency preparedness.

Another notable policy focus in the Budget is labour markets and skills training. The government is keen to build a more flexible and responsive immigration system to assist in addressing escalating skill shortages – a key issue in BC and Western Canada generally. To ensure immigrants are ready to work and can be successful in the labour market, the government pledges to improve the assessment of education credentials and to reform the federal skilled worker points system to reflect the need for younger workers with Canadian experience and better language skills. The government also will introduce a new stream to facilitate the entry of skilled tradespersons.

Two specific changes target regional skill shortages: (i) the government plans to focus on and expand the economic immigration streams within the Provincial Nominee program; and (ii) it promises to enhance the responsiveness of the Temporary Foreign Worker program and reduce the processing burden on employers who use it.

Supporting Innovation and R&D

Another theme of Budget 2012 is the need for a new approach to supporting innovation in Canada. Budget 2012 announces $1.1 billion over 5 years to support "direct" programs aimed at fostering innovation and commercialization. (Much of this money is obtained by modifying the existing SR&ED program.) In recognition of the financing challenges many innovative early-stage companies face, the Budget provides $500 million for venture capital. The Scientific Research and Experimental Development (SR&ED) tax credit program which supports business R&D will be altered and streamlined. The government proposes to narrow the base of eligible expenditures in SR&ED by removing capital. Other expenses including wages/salaries, material and overhead expenses, are still eligible for the tax credits. It should be noted that there are mixed views on these changes within the business community.

The theme of innovation features prominently in the Budget. The government plans on spending $440 million over six years to establish Centres of Excellence for Commercialization and Research. The Budget also announced the launch of a new Western Innovation Program, which will provide financial support to innovative small and medium-sized companies in the western provinces.

Concluding Thoughts

Overall the Budget is balanced and appropriate for the economic times. And although much of it was focused on restraint there are still a significant number of positive measures for BC. One is the planned streamlining of the regulatory review processes for new projects. Extending the mineral exploration tax credit for one year is good news for BC. The Business Council also applauds the proposed changes to immigration and temporary foreign worker policies, which should help to address mounting skill shortages.

With respect to innovation, which BC needs to foster, the new Regional Innovation Program to be operated under Western Diversification may hold promise, and the additional funding for forest sector innovation and market development is welcome.

Funding to renew the Canadian Coast Guard fleet (and $101 million over the next five years to restore and modernize the Esquimalt Graving Dock) will support economic activity in the province. The investment of $330 million to improve water infrastructure in First Nations communities is also a positive initiative.

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Jock Finlayson, Executive Vice President and Chief Policy Officer (Jock.Finlayson@bcbc.com)
Ken Peacock, Chief Economist and Vice President (Ken.Peacock@bcbc.com)