FEDERAL BUDGET 2017 ANALYSIS

Business Council *of* British Columbia
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2017 FEDERAL BUDGET: LOTS OF WORDS, FEW NEW MEASURES

HIGHLIGHTS

- Budget 2017 projects annual federal government deficits right through to 2022.
- As a result, the federal debt grows, but the debt-to-GDP ratio remains stable in the 30-31% range.
- There are few new tax measures and none that will have significant economic implications.
- Instead this is largely a business as usual Budget that reiterates and follows through on the large number of commitments made in last year's Budget.
- There is a strong focus on innovation and investment in skills training.
- On balance, the Budget will provide a bit of additional fiscal stimulus, but not much beyond what was announced in Budget 2016 – and not enough to impact Canada's near-term economic growth profile.

Against a backdrop of a gradually strengthening Canadian economy, the Liberal government's 2017 Budget focuses on "helping the middle class" (repeated ad nauseam in the document) and spurring innovation. There are few significant tax measures and most of the spending commitments highlighted by Finance Minister Morneau reiterate previous promises or provide additional details on items announced earlier. A principal theme of this Budget is the need to improve Canada's lagging performance on private sector innovation, with the federal government directing funds to stimulate growth in six key innovation-based industry sectors and pledging to develop a handful of "super clusters" across Canada. Annual budget deficits continue for as far as the eye can see, as the Trudeau government seemingly backs away from any concern with returning to a balanced fiscal stance.

SOMEWHAT BRIGHTER ECONOMIC BACKDROP

Helped by a strengthening US economy, Canada's economy perked up in the second half of 2016. On the domestic front, hot housing markets and a pick-up in consumer spending have prompted most forecasters to revise their growth projections upwards in recent months. The job market has also been healthy, with year-over-year employment growth climbing to its highest pace since early 2013 (there are, however, concerns about the "quality" of the jobs being created). This modest forward momentum is expected to carry through to 2018. Despite recent improvements in US economic growth, Canada's non-energy goods exports have remained relatively flat — a sign of waning competitiveness.

There is still plenty of reason for caution. Despite the weak Canadian dollar, exports face ongoing competitiveness challenges as Canada grapples with a sharp decline in our share of the US import market. While many non-energy commodity prices have risen, oil prices have retreated recently. Budget 2017 assumes a slight recovery in oil prices, such that WTI crude averages US$54 per barrel in 2017 and $59 in 2018. The Canadian economy is still operating below potential, which is reflected in subdued wage growth. The overall picture suggests inflation remains contained, consistent with the consensus Budget forecasts of 2% CPI inflation in the years ahead. As with most other advanced economies, business investment remains a notable and persistent weak spot in Canada.

The consensus view of 14 Canadian forecasters points to economic growth (real GDP) of 1.9% in 2017 and 2.0% in 2018, up from last year's anemic 1.4% expansion. It is worth noting that the Department of Finance conducted its survey of forecasters in December of last year, a full three months ago. Since then the Canadian economic numbers have generally improved, which suggests the Budget is built around conservative growth projections. There are, however, significant risks to the outlook. Policy uncertainty attributable to the Trump Administration and the Republican-controlled US Congress is the biggest concern. In particular, there is a risk the new US Administration will implement protectionist trade measures while also slashing business and personal taxes and easing the regulatory burden on business — a policy agenda that could leave Canada at a marked competitive disadvantage in the North American context.

TABLE 1: **BUDGET 2017 ECONOMIC ASSUMPTIONS AND FORECASTS**

		FORECAST		
	2016	**2017**	**2018**	**2019**
Real GDP growth (% change)	1.4	1.9	2.0	1.7
Nominal GDP growth (% change)	2.0	4.1	4.0	3.5
Unemployment rate (%)	7.0	6.9	6.7	6.7
CPI Inflation (%)	1.5	2.0	2.0	1.9
Cdn 3-month T-bill (annual average %)	0.5	0.6	0.9	1.4
Cdn 10-year gov't bond (annual average %)	1.3	1.8	2.3	2.7
Exchange rate (US cents/Cdn$)	75.5	74.5	76.1	77.4
Real US GDP growth (chained $2009)	1.6	2.3	2.3	1.8
WTI Crude oil price (US$ per barrel)	43	54	59	56

Source: 2017 Federal Budget.

FIGURE 1: **CANADA REAL GDP GROWTH, %**

f = forecast

Sources: Statistics Canada; 2017 Federal Budget for forecasts.

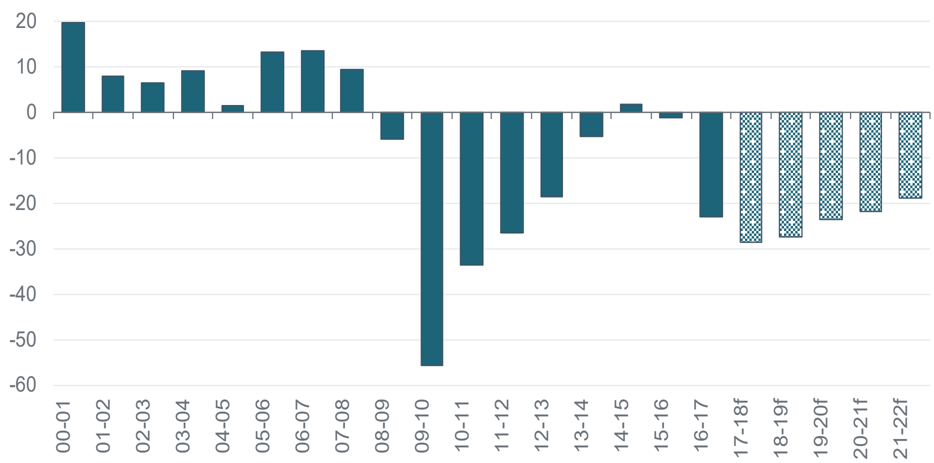
FISCAL PLAN: RED INK AHEAD

Turning briefly to the current fiscal year, the federal government is on target to post a $23 billion deficit for the 12 months ending March 31, 2017. This is a smaller shortfall than the $29.4 billion deficit originally anticipated in Budget 2016.

The new Budget envisages sizable deficits through the planning horizon, to 2022. In the upcoming 2017/18 fiscal year, the deficit is projected at $28.5 billion, after which it falls slowly to reach $18.8 billion five years out. These planned deficits are slightly larger than expected in last year's Budget, resulting in an additional $6.4 billion cumulative shortfall through 2021/22.

Some context on the deficit is warranted. Ottawa's deficit for the coming fiscal year amounts to 1.4% of Canadian GDP. We deem this to be a manageable amount, especially when contrasted against many other advanced economies where national government deficits are running 3-4% of GDP. To the extent we have a concern about federal

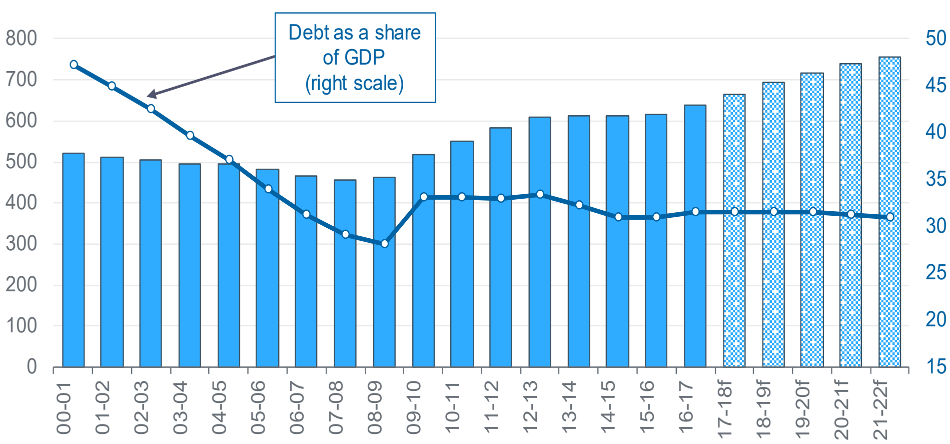
FIGURE 2: **FEDERAL DEFICIT, BILLIONS $**



f = forecast

Sources: Fiscal Reference Tables and 2017 Federal Budget for projections.

FIGURE 3: **FEDERAL DEBT (ACCUMULATED DEFICITS), BILLIONS $**



f = forecast

Sources: Fiscal Reference Tables and 2017 Federal Budget for projections.

finances, it is that there appears to be little worry about the risk of an economic downturn or a shock that could quickly push the deficit much higher. Budget 2017 makes no reference to debt reduction or firm debt management targets. Over the planning horizon, the string of annual deficits means the accumulated public debt is set to climb from $637 billion in 2016/17 to $757 billion in 2021/22. The debt-to-GDP ratio remains in the 30-31% range, but this overlooks the risk that an intervening recession could leave Ottawa in a considerably worse financial situation. Nothing is being done by the government to plan for the proverbial rainy day.

NO NEW TAX MEASURES OF SIGNIFICANCE

Rumours of changes to capital gains taxes turned out to be unfounded. The new Budget contains no new tax measures of significance, with the government instead focusing on combating tax evasion and chipping away at what it deems to be "tax loopholes". The government is boosting funding for the Canada Revenue Agency by $524 million over five years to stem tax evasion and avoidance. The government — optimistically, in our view — believes this will result in the CRA collecting an additional $2.5 billion in revenue over the same time frame. Given the brighter but still fragile economic setting and the competitive challenges facing Canada, we are relieved that taxes were not increased. Higher taxes on households, businesses and investors would run contrary to the government's professed commitment to making Canada one of the world's most innovative and prosperous nations.

There were a few minor tax adjustments. Citing evidence that it has been ineffective in encouraging the use of public transit, Budget 2017 eliminates the Public Transit Tax Credit. The Investment Tax Credit for Child Care Spaces is also repealed.

Relevant to the BC oil and gas sector is the proposed modification of tax treatment for exploratory drilling. Expenses associated with successful oil and gas discovery wells will now be deducted gradually over time, rather than being immediately deductible as exploration expenses. Unsuccessful exploration drilling expenses will still be immediately deductible.

TABLE 2: **FEDERAL GOVERNMENT FISCAL PLAN**
(BILLIONS OF DOLLARS UNLESS OTHERWISE INDICATED)

			FORECAST				
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Revenues	295.5	292.1	304.7	315.6	327.7	340.3	356.0
% change	*4.6*	*-1.2*	*4.3*	*3.6*	*3.8*	*3.8*	*4.6*
Program Expenses	270.8	290.9	305.4	313.7	319.8	328.6	338.5
% change	*6.7*	*7.4*	*5.0*	*2.7*	*1.9*	*2.8*	*3.0*
Public Debt Charges	25.6	24.3	24.7	26.3	28.3	30.4	33.3
% change	*-3.8*	*-5.1*	*1.6*	*6.5*	*7.6*	*7.4*	*9.5*
Total Expenses	296.4	315.1	330.2	340.0	348.1	359.0	371.8
% change	*5.7*	*6.3*	*4.8*	*3.0*	*2.4*	*3.1*	*3.6*
Adjustment for risk	-	-	-3.0	-3.0	-3.0	-3.0	-3.0
Budgetary Balance	-1.0	-23.0	-28.5	-27.4	-23.4	-21.7	-18.8
Federal Debt	616.0	637.1	665.5	692.9	716.3	738.1	756.9
Per cent of GDP							
Budgetary BAlance	0.0	-1.1	-1.4	-1.2	-1.0	-0.9	-0.8
Federal Debt	31.0	31.5	31.6	31.6	31.5	31.3	30.9

Source: 2017 Federal Budget

For consumers, excise duties on alcohol will be increased by 2%, effective immediately. The Budget also proposes to amend the definition of a taxi business to make ride-sharing businesses (such as Uber) subject to the same GST/HST rules as taxi operators.

Canadian employers are now looking at higher EI premiums, but not until 2018. For 2017, as previously announced, EI premiums have been trimmed to $1.63 per $100 of insurable earnings, down from $1.88 the previous year. The lower premium was based on the estimated seven-year break even rate for the EI Account, but projections now point to a shortfall in the Account due to a softer economic outlook and the enrichment of EI benefits for maternity and caregiver leave announced in Budget 2017. As a result, EI premiums will be bumped up by the maximum permitted increase of 5 cents, to $1.68, next year.

BUDGET LARGELY REITERATES PREVIOUSLY PLANNED SPENDING

Although program spending does rise by 5.0% in fiscal 2017/18, our read is that the majority of the spending increases flow from the government moving ahead on previous/existing commitments. The Budget provides an indication of the status of measures unveiled last year. It shows that progress for most of the major categories is broadly on track. The big exception is the nearly $4 billion in infrastructure spending, for which only 50% to 75% of the planned projects are on track.

INNOVATION...EVERYWHERE

The new buzz word in Ottawa economic policy circles these days is innovation. All three parts of the first chapter of the Budget, in varying degrees, are focused on innovation. The Budget outlines the rudiments of a new Innovation and Skills Plan, which targets six key sectors judged to have strong innovation-driven growth potential: advanced manufacturing, agri-food, clean technology, digital industries, health/bio sciences and "clean resources". How these were chosen is unclear, as is whether these particular sectors truly represent Canada's best prospects for future growth. Governments, including in Ottawa, have an uninspiring record of identifying tomorrow's growth stars.

Building skills and promoting life-long learning is a central feature of the Trudeau government's emerging innovation strategy. The government plans on investing an additional $1.8 billion over six years to expand current Labour Market Development Agreements with the provinces. There are a host of generally small-scale initiatives relating to skills and human capital development, including support for students and adult learners, additional funding to support skills development and training for indigenous peoples, and money to promote work-integrated learning. Budget 2017 also promises incremental funding for the previously announced Global Skills Strategy and the Temporary Foreign Worker program – both being measures we strongly support.

The most significant innovation announcement is $950 million over five years to nurture the establishment of a small number of business-led “super clusters”. Of this, $800 million was set aside in Budget 2016, with another $150 million to be reallocated from funds previously earmarked for public transit and green infrastructure. Competition for the “super-cluster” funding will launch in 2017. The Business Council will be collaborating with our industry and academic partners to determine how BC can best compete for a portion of the monies Ottawa will be doling out for cluster development.

Budget 2017 also proposes to establish the Impact Canada Fund, which will help focus and accelerate efforts towards “solving Canada’s big challenges.” Initial efforts will be in two streams. The clean technology stream will see $75 million over two years to help rural and remote communities reduce reliance on diesel as a power source. There is also $300 million (over 11 years) to support the Smart Cities Challenge. Whether this will prove to be money well spent is uncertain; count us doubtful.

OTHER ITEMS TO BENEFIT BC

Budget 2016 announced $3.4 billion over four years to fund improvements to public transit infrastructure. This Budget directs another $20.1 billion over 11 years, using bilateral agreements with the provinces to fund new urban transit networks and extensions. BC is apparently in line to receive $2.7 billion of this. The Vancouver Broadway line is identified as one of the projects that will be supported.

In support of efforts to build a clean economy, Budget 2017 confirms $21.9 billion for green infrastructure and other initiatives that will support the implementation of a Pan-Canadian Framework on climate change. Budget 2017 also proposes investing $21.9 billion over 11 years to support social infrastructure.

The Budget builds on and expands on the government’s commitment to provide better support for Canadian families. In addition to the $500 million directed towards early leaning and child care in Budget 2016, this year’s Budget commits a further $7 billion over 10 years to create more affordable child care spaces across the country. Some of these will be developed in BC.

New funding, some of which will flow to BC, is allotted to an expanded housing strategy, which includes $11.2 billion (over 11 years) to build and renew the stock of affordable housing. Budget 2017 also adds $4 billion on top of last year’s $8.4 billion (over five years) to advance reconciliation and provide investments in education, infrastructure, training and other programs targeted to improving the quality of life for Indigenous peoples.

As part of a broader global skills strategy, to facilitate faster access to top talent the government is setting a goal to process visas and work permits for skilled individuals within two weeks – an initiative welcomed and supported by the Business Council. The Budget also commits funding to help attract global talent into Canada’s universities. Independent organizations, such as Mitacs, will receive new money to support collaborative industry-academic research projects.

CONCLUDING THOUGHTS

Budget 2017 will provide a bit of added fiscal stimulus but have little impact on Canada’s near-term economic growth prospects. Much of the spending profiled in the new Budget represents re-announcements (or updating) of previous commitments. Long time frames of a decade or more also make it difficult to know how program funds will be spread and sequenced in areas such as infrastructure, housing affordability, subsidized child care, and innovation.

Essentially this Budget is a stay-the-course effort, which reflects the era of heightened uncertainty we are all operating in. Innovation, skills training and support for the middle class are themes that dominate Budget 2017 and are likely to remain front-and-centre as the Trudeau government moves into the second half of its mandate.

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