Business Alert

Business Council of British Columbia

April 22, 2015

Amid an Oil Price Collapse…
The Harper Government Delivers on its Balanced Budget Promise

Highlights

- As promised, the 2015-16 Budget is balanced. The government projects small surpluses through to 2019.
- The economic back drop is challenging as the drop in oil prices is weighing on economic growth and federal revenues. Real GDP growth is now projected to be 2.0% this year, whereas the September Fiscal Update foresaw growth of 2.6% in 2015.
- Budget 2015 had few surprises and felt like a pre-election document, as it delivered some targeted tax relief and reiterated many previously announced tax and spending initiatives.
- The Budget extends accelerated depreciation for eligible investments by manufacturers and reaffirms higher depreciation rates for LNG plants.
- There is also more tax relief for small businesses from a phased-in reduction in the small business income tax rate from 11% to 9%, in four increments starting next January.
- The government confirmed pre-budget speculation by enriching the Tax-Free Savings Account Program; the annual contribution limit rises from $5,500 to $10,000.
- The government is continuing with existing infrastructure funding commitments and is also investing a further $750 million over two years starting in 2017-18, and $1 billion per year thereafter, in a new Public Transit Fund.

The steep drop in the price of oil and related impact on federal finances prompted the Conservative government to delay bringing down the Budget. But despite a $6 billion hit to Ottawa's revenues, Finance Minister Joe Oliver was determined to meet the government's commitment to balance the operating budget by fiscal 2015-16, after seven years of red ink. Doing so required adding some modest amounts from asset sales and shrinking the contingency reserve, but in the end the government managed to erase last year's small deficit ($2 billion) and is forecasting a razor-thin $1.4 billion surplus for 2015-16.

The Budget has the distinct feel of a pre-election document. Notwithstanding a lack of fiscal maneuvering room, the government was able to propose a few new initiatives, with the associated financial price tag spread over several years. The Budget also re-confirmed a number of past spending and tax relief measures.

A Subdued Economic Setting

Budget 2015 is built around a consensus view that Canada's economy will grow by 2.0% (after inflation) this year, followed by a slightly stronger 2.2% advance in 2016. The

Table 1

Budget 2015 Economic Assumptions and Forecasts for Canada

(annual per cent change unless otherwise indicated)

		Forecast				
	2014	**2015**	**2016**	**2017**	**2018**	**2019**
Real GDP	2.5	2.0	2.2	2.3	2.2	2.0
GDP inflation	1.8	-0.4	2.6	2.3	2.1	2.1
Nominal GDP growth	4.4	1.6	4.9	4.7	4.3	4.2
Unemployment rate (%)	6.9	6.7	6.6	6.3	6.2	6.1
Cdn 3-month T-bill (%)	0.9	0.6	1.0	2.0	2.7	3.0
Cdn 10 year gov't bond (%)	2.2	1.7	2.5	3.2	3.7	3.9
US GDP growth	2.4	3.1	2.9	2.6	2.4	2.4

Source: 2015 Federal Budget, average of private sector forecasts.

effect of lower oil prices is starkly evident in the revised economic projections. As recently as last September, the government was confident the economy would expand by 2.6% in 2015. That has now been knocked down more than half a percentage point. In our view, the risk is that growth in Canada will underperform even this revised prediction. The decline in nominal GDP growth, which better captures the fall in oil and other commodity prices and is more closely aligned with tax revenue, has been even more dramatic. In September forecasters saw nominal GDP rising by 4.3% in 2015, but this has been revised down to a very sluggish 1.6%

As a net oil exporter, Canada has been hit hard by the oil price slump (and the related weakness in natural gas prices). In the second quarter of 2014 the value of Canada's crude oil exports stood at $100 billion, equivalent to 5.1% of nominal GDP. Oil exports have since tumbled to about $60 billion. While oil producing provinces have shouldered the brunt of the burden, the Bank of Canada estimates that oil's collapse will shave a full percentage point off of national GDP growth this year.[1] Incoming data for the first quarter point to an economy that has basically stalled.

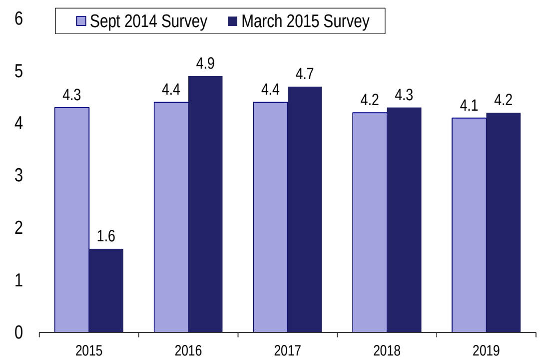
While energy and non-energy commodity prices have been soft, there is some positive news on the external front. The global economy is expected to improve, albeit just slightly, over 2014, and then to advance again in 2016. Most data suggest the US economy continues to strengthen, albeit the picture is clouded by a disappointing first quarter. And monetary policy – in Canada and globally – remains exceptionally accommodative, which is supporting economic activity.

Encouragingly, Canada's non-energy exports have shown signs of life. After languishing in both 2012 and 2013, real Canadian exports rose by almost 7% last year, mainly on the back of rebounding US demand. The depreciation of the Canadian dollar is helping by improving the competitive position of Canadian firms on a North American basis.

[1] Real GDP. Bank of Canada, Monetary Policy Report, April 2015.

Nominal GDP Growth Forecasts

per cent



Source: 2015 Federal Budget, consensus of private sector forecasts

Because oil is Canada's biggest export category and the oil and gas industry is the leading source of business investment in the country, lower crude oil prices pinch the incomes of Canadian households and firms via a few different channels: job losses in the high-paying energy sector, and in the industries that supply the oil patch; falling revenues and profits for energy producers and their suppliers; and reduced royalties and taxes for governments. Many Canadians are shareholders of firms in the energy sector (through direct investments as well as via mutual funds, registered pension plans, etc.), so plunging oil prices have also affected household wealth. These negative impacts are somewhat offset by gains for households and for non-energy firms flowing from lower gasoline and other energy-related prices.

While some of the risks that have overshadowed the Canadian economy in recent years have dissipated, forecasters are concerned about high levels of Canadian household debt, softer global commodity markets, and slower growth in emerging economies. On the upside, the decline in the Canadian dollar will boost net exports and support stronger economic growth in the next two years.

Budget 2015 includes smaller fiscal cushions than in the past. Relative to the consensus view, the Finance Minister adjusted the nominal GDP projection for 2015 down by just $7 billion (it was reduced by $20 billion last year) and included a tiny $1 billion contingency reserve (versus $3 billion in 2014-15) to provide a bit of protection against potential downside revenue surprises.

Fiscal Outlook

Budget 2015 confirms the Harper government's plan to return to balance by 2015-16. The updated figures show that last fiscal year the deficit came in at $2 billion. For the upcoming fiscal year the plan calls for a slim surplus of $1.4 billion (which does not include the $1 billion contingency). Subsequent years are expected to see slightly larger but still relatively small surpluses. Departmental expenditures have been restrained through government-wide reviews of spending and operating budget freezes. Despite spending restraint, federal transfers to individuals and other levels of government continue to climb, going up by a combined $9 billion this year. Total program spending is slated to increase from $254 billion to $263 billion in 2015-16, a 3.4% rise.

On the revenue side, despite falling oil prices, federal government revenue is projected to reach $290 billion in 2015-16, up $11 billion, or 3.9%, from the previous year. The main area of weakness is corporate income tax collections, dampened by dwindling profits in the energy sector. All

Table 2

Canadian Government Financial Position

(billions of dollars unless otherwise indicated)

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Revenues	279.3	290.3	302.4	313.3	326.1	339.6
% change	2.8	3.9	4.2	3.6	4.1	4.1
Program expenses	254.6	263.2	274.3	282.7	293.0	302.6
% change	2.4	3.4	4.2	3.1	3.6	3.3
Public Debt Charges	26.7	25.7	26.4	28.0	30.5	32.1
Total Expenses	281.3	288.9	300.7	310.7	323.5	334.7
% change	1.6	2.7	4.1	3.3	4.1	3.5
Budgetary Balance	-2	1.4	1.7	2.6	2.6	4.8
Federal Debt	616.0	617.0	615.3	612.6	610.1	605.2
% of GDP	31.2	30.8	29.3	27.9	26.7	25.5

Source: 2015 Federal Budget.

other major revenue sources are slated to grow in 2015-16. Personal income tax collections are poised to increase by 2.6% to $134.2 billion in 2015–16, with stronger increases (~5%) on tap in later years if the fiscal plan is realized. The more modest increase this year reflects the tax relief measures for families announced last fall. The wide-ranging effect of tumbling oil prices is underscored by the fact that, compared to the Fall Update, projected federal revenues are now lower over the entire forecast horizon.

To ensure it achieved its balanced budget target, the government took a few steps to bolster its near-term finances. Asset sales will generate an additional $1 billion this year. Smaller contingencies also help. Over the next five years, as noted, the annual contingency allowance is trimmed from $3 billion to $1 billion, which effectively puts another $2 billion directly into revenues each year.

With the budget returning to balance, the stock of federal debt will no longer be growing. More importantly, the debt/GDP ratio will be gently falling, reaching approximately 25% by the end of the decade, versus 31% today.

New Tax Measures

Even with tight fiscal circumstances, the federal government did work in a few new tax breaks, some of which reinforce the pre-election tone of the Budget. Starting with business related measures, a welcome decision is the proposal to grant manufacturers a ten year accelerated capital cost allowance for eligible investments in machinery and equipment. This extends a similar CCA for manufacturing that was introduced in 2007 and was due to expire at the end of 2015. Budget 2015 also confirms the government's intention to provide accelerated capital cost allowance treatment for investments in LNG facilities. This will allow businesses to more quickly recover the cost of their initial capital investments and thus support the development of an LNG industry in British Columbia.

The Budget delivers tax relief to small businesses with a phased-in reduction in the small business income tax rate from 11% to 9%, in four steps starting next January. This move reinforces the existing problematic bias in Canada's business tax regime that encourages firms to "stay small" rather than grow.

Employment Insurance (EI) premiums are to be frozen for the next two years (the basic premium is $1.88 per $100 of ensured earnings), before dropping to ~$1.49 in 2017 as the government shifts to a seven-year "break-even" policy for managing the EI Account. Lower premiums will boost income for households and also support job creation in the business sector.

Also on the personal tax side, the government confirmed pre-budget speculation by enriching the Tax-Free Savings Account Program, with the annual contribution limit rising from $5,500 to $10,000 effective this year. The Budget also provides seniors with a break by relaxing the minimum withdrawal requirements in respect of Registered Retirement Income Funds.

Spending Measures

The government is continuing with existing infrastructure funding commitments and is also investing $750 million over two years starting in 2017-18, and $1 billion per year thereafter, in a new Public Transit Fund. Amid the need for more transit funding in the lower mainland this is welcome news, but after the funds are spread across the country the amounts available for BC will be small.

Budget 2015 earmarks additional multi-year funding for the Canada Foundation for Innovation and for the university and health research granting councils – good news for BC universities and research institutions. The allocation of $42 million over five years to expand the work of the Trade Commissioner Services is also a positive step.

Budget 2015 sets aside $86 million over two years to support for the Forest Innovation Program and the Expanding Market Opportunities Program, which are designed to help forest companies adopt emerging technologies and develop new markets for Canadian wood products. Finally, the Business Council is pleased that the government has found $65 million over four years to support the development of partnerships between employers and post-secondary institutions.

Conclusion

The fact that many of the items in the Budget were well publicized in advance tends to make the whole exercise somewhat anti-climactic. As a pre-election document, the Budget delivered on the government's promise to balance the budget. Although the downturn in oil prices took a bite out of revenues, the government managed to find some additional savings and also engineered a few revenue injections that enabled it to announce a handful of tax breaks and new spending commitments. As always, context and relative comparisons are important. In this regard Canada's fiscal picture is healthy by the standards of other advanced economies. The federal government deserves credit for its stewardship of the country's finances in a world of relatively slow growth, weak oil prices and generally unsettled global economic conditions.

Looking ahead, the Business Council believes there is further work to be done to develop a more productive, innovative and globally competitive Canadian economy. In particular, the federal government should continue to re-tool the tax system to support investment and business growth, further boost its investments in post-secondary education and research, and ensure that Canada has the up-to-date infrastructure required to succeed as a trading nation within the context of a rapidly-changing 21st century global economy.

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Jock Finlayson
Executive Vice President
and Chief Policy Officer

Ken Peacock
Chief Economist
and Vice President