BC BUDGET 2018 ANALYSIS

Business Council *of* British Columbia
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MIXED REVIEWS FOR BUDGET 2018 — HIGHER BUSINESS TAXES PLUS ADDITIONAL SPENDING MEASURES

HIGHLIGHTS

- Finance Minister Carole James delivered a Budget that outlines a plan for three years of skinny surpluses. There is a fair amount of cushion built into the plan, which should allow the targets to be met.
- The Budget expands program spending in areas highlighted in the NDP's election platform. The new spending will help many low and middle income British Columbians. Notably, an estimated 86,000 families will receive new funding for daycare.
- The key tax change is a new Employer Health Tax (EHT) that will replace lost revenue when MSP premiums are eliminated and generate almost $2 billion in revenue for the government. Most large and mid-size BC employers will face escalating payroll costs once the EHT is in place.
- The government has introduced an unprecedented suite of measures intended to curb housing demand, particularly from non-residents, including a so-called Speculation Tax that is really an additional annual property tax on non-resident homeowners who do not pay any provincial income tax.
- The Additional Property Tax (previously called the Foreign Buyers' Tax) is also increased and its application expanded to capture several other urban regions.
- The Business Council is concerned that the Budget does little to improve BC's investment climate, nor does it acknowledge the province's lagging investment performance. Firms in BC are also looking carefully at the sweeping tax reform package recently adopted in the United States, which has sharply eroded any business tax advantage Canada may have enjoyed and made it more attractive for companies looking to invest in productive assets to do so south of the border rather than in our jurisdiction.
- Provincial capital spending on infrastructure is set to rise, which the Business Council supports.

INTRODUCTION

In her first full Budget, Finance Minister Carole James focused on social programs, housing issues and delivering relief for low and middle-income families. As part of this broader agenda, the Minister announced steps towards fulfilling the government's longer-term commitment to universal and affordable childcare and addressing serious housing affordability challenges. While many of the changes in the housing realm were anticipated, the scope and magnitude of the measures being taken to dampen housing demand leave little doubt that the NDP administration is taking dead aim at speculative activity and wants to greatly limit the role of non-resident buyers in residential real estate markets.

Incremental tax revenue from housing-related measures as well as a new employer payroll tax will provide the government with added revenues which, together with revenue growth from a still expanding economy, will give the government some manoeuvring room as it works to flesh out the NDP's ambitious agenda. While we are worried about the increased tax burden on employers amid a host of other tax, fee and regulatory cost increases for business, at least the government steered clear of further hiking personal and corporate income taxes. Particularly in light of far-reaching tax policy changes in the United States, now is not the time to be adding to the already heavy income tax burden in Canada.

TABLE 1: **BUDGET 2018 REVENUE MEASURES (MILLIONS OF DOLLARS)**

($millions)	2018/19	2019/20	2020/21
Eliminate Medical Services Plan premiums	-	(345)	(1,394)
Introduce employer health tax	463	1,850	1,922
Speculation tax with corresponding income tax credit	87	200	200
Increase and expand Additional Property Transfer Tax	35	40	40
Increase school tax on residential properties over $3 million	50	200	200
Increase property transfer tax on residential properties over $3 million	81	81	81
Enable online accomodation platforms to collect and remit PST	16	16	16
Increase tobacco tax rates	95	95	95
BC share of federal duty on cannabis	50	75	75
Other tax measures	3	17	18
Total Budget 2018 revenue measures	**880**	**2,229**	**1,253**

Source: 2018 BC Budget and Fiscal Plan.

TAX MEASURES

Budget 2018 includes several new tax measures. The most significant is a new Employer Health Tax (EHT), which the government intends to use to make up revenue lost from eliminating Medical Services Plan (MSP) premiums. While the tax is not entirely unexpected, the timing is surprising considering that the MSP Task Force, which the government established to consult and make recommendations on options for making up lost MSP revenue, has yet to deliver its final report. The Budget makes reference to an "interim" report from the Task Force as the basis for proceeding with the EHT as well as for eliminating remaining MSP premiums on January 1, 2020. But in its interim report, the Task Force actually suggested using a number of revenue sources to fill the MSP fiscal gap, rather than a single source. It also noted, specifically, that a payroll tax would be damaging to business competitiveness in BC. The government nonetheless chose to go down the payroll tax path, likely because it aligns with the NDP's agenda to make the overall tax system less regressive. Individuals currently pay roughly half of the $1.3 billion collected in MSP premiums (which were cut in half on January 1, 2018). Under the proposed EHT regime, businesses will provide all of the $1.9 billion in projected EHT revenue. As a result, the total tax burden on employers in B C will rise significantly (we estimate by perhaps $1 billion a year[1]), even as MSP premiums disappear.[2]

The new tax is structured to shield very small businesses, with the burden sharply tilted towards mid-sized and larger companies. Employers with payrolls under $500,000 are exempted. Those with payrolls over $1.5 million will face the maximum rate of 1.95% of total payroll. For firms with payrolls between $500,000 and $1.5 million, the tax rate is staged. In addition to generating more revenue than MSP premiums currently raise, the government is getting a one-time revenue lift in 2019-20. This is because the EHT comes into effect on January 1, 2019, while MSP premiums aren't eliminated until the following year. The resulting overlap yields an extra $1 billion in 2019-20. Larger employers and most Business Council members will pay substantially more under the new EHT scheme; and in 2019, many will also be paying MSP premiums as well.

The Budget announces some relief from the carbon tax for energy intensive exporters, as BC's tax rises from $30 per tonne to $35 on April 1st of this year and then marches steadily higher to $50 per tonne by April 2021. While some of the details are still forthcoming, the government will allow eligible BC facilities to apply for an incentive of up to 100% of the carbon tax they pay beyond $30, depending on the carbon efficiency of their industrial operations based on a yet to be specified global benchmark. The amount of the incentive under the program will depend on how BC firms' greenhouse gas production intensity compares with the benchmark, with the lowest emitters

[1] At present, many employers don't pay the MSP on behalf of their employees. However, even those that do will see payroll costs climb once the EHT is in place.
[2] Over time, a sizable share of the economic burden stemming from the EHT will be shifted to employees via wage and salary increases that are smaller than what would occur without the new tax.

receiving the largest incentives. The Business Council has long advocated for carbon tax relief for BC's trade exposed sectors and we are encouraged to see the government recognize that the tax is a serious competitive disadvantage for some local industries that sell their products in the global marketplace. We look forward to working with the government to determine the details of the plan and to ensure that current BC industrial production does not shift to other jurisdictions which have lower or zero carbon prices.

HOUSING

Housing was a prominent feature of Budget 2018. In her Budget speech, the Finance Minister referenced a 30-point plan to tackle the "housing affordability crisis". Included in this plan are tax measures intended to curb demand, notably from non-residents. There are also tax changes whose main purpose is to raise extra revenue.

In the first category is a new "Speculation" Tax on residential property. The name is misleading, as it is really an annual property tax targeting foreign and domestic home owners who don't pay income tax in British Columbia. It will also capture vacant properties. The tax will be levied only in larger urban centres (Metro Vancouver, the Fraser Valley, Capital and Nanaimo Regional districts). According to the Budget, the majority of homeowners will be exempt from the tax. Most home-owners will be eligible for an upfront exemption, as will those with long-term rental properties.

In 2018, the new tax will be set at 0.5% of the assessed value; in 2019, this rises to 2.0%. Once fully implemented, a property owner paying no BC income tax would face an extra $40,000 tax bill on a residence valued at $2 million. The specifics pertaining to rental requirements and other exemptions are still to be outlined, but like property taxes, the Speculation Tax is an annual levy. As such, it is likely to have a larger dampening effect on housing demand than the renamed Foreign Buyers' Tax, which is charged just once when the property is purchased.

Linking the liability for the new Speculation Tax to whether someone pays <u>BC</u> income tax is problematic, in our view. It would be better to use <u>Canadian</u> income tax paid as the determinant. There are many Canadians from other provinces who own properties in the affected urban areas of BC. Canadians are able to move freely within the country and to invest anywhere in the federation, and we believe they should also be able to own property on the same basis as residents of the province.

The government is also increasing what it is now calling the Additional Property Transfer tax (previously called the Foreign Buyers' Tax) rate from 15% to 20% and broadening its application to the Capital Regional District, the Fraser Valley, the Regional District of Nanaimo and the Central Okanagan. The way this change is being introduced also prompts concern. When the Foreign Buyers' Tax was first adopted, many transactions, particularly pre-sales of new homes, were caught up in the transition period. These foreign buyers had signed contracts but the transactions had not closed. When the tax was implemented before the foreign buyers had taken possession, some purchasers were faced with an unexpected and sizable additional tax bill; in certain cases, the affected buyers no longer wanted to proceed with the purchase. The same concern will arise from expanding the geographic application of the tax. We are perplexed as to why the government would not exempt presale properties and other sales contracts that were signed but not yet closed as of the day of the budget. Doing so would be a fairer approach to all parties involved.

The Budget also contains other housing-related tax measures intended more to raise revenue than to curb demand. The province is increasing the provincial school property tax on high value homes. The new tax applies to the portion of assessed value in excess of $3 million, at a rate of 0.2%, with the rate rising to 0.4% on the portion of assessed value over $4 million. The government may discover that there are some households with high value properties (long-term residents in areas where real estate prices have soared) who may have modest incomes (e.g., retirees). Such people won't be pleased with the higher school property tax. Additional revenue is also being raised via an increased property transfer tax rate (5%) on the sales of properties valued over $3 million.

Finally, the government is taking steps to collect more information, close loopholes and toughen tax enforcement and compliance activity around real estate transactions. We fully support these long overdue steps.

Budget 2018 heralds a substantial increase in total public sector capital spending. It rises from $6.8 billion this fiscal year to $9.2 billion in 2018-19.

Continuing with the housing theme, but shifting to the supply side, the government has announced significant investments to expand the supply of affordable rental housing. Specifically, $1.6 billion is committed over three years for operating and capital funding to build and maintain more affordable housing units. Considering the tight rental market and escalating rents in many parts of the province, we support these measures.

CHILDCARE

The government took notable steps toward its longer-term goal of providing affordable universal childcare. Budget 2018 earmarks more than $1 billion for this over the next three years. The most substantial item is an affordable child care benefit that will reduce the cost of child care for 86,000 low- and moderate-income families by 2020-21. A complementary child care fee reduction program will provide increased funding to licensed service providers to reduce fees by up to $350 per month. The Business Council has advocated for improved access and more affordable child care and we support these initiatives, which (so far) have been introduced in a fiscally manageable manner. Looking further ahead, we believe government's focus should be on assisting low and moderate-income families with children rather than on establishing a costly "universal" program.

CAPITAL SPENDING

Budget 2018 heralds a substantial increase in total public sector capital spending. It rises from $6.8 billion this fiscal year to $9.2 billion in 2018-19. In subsequent years the figure falls a bit but remains above $8 billion. Additional investment in roads, bridges, hydro projects, schools, hospitals, and other infrastructure is essential to efficiently deliver services and support growth and prosperity. The Business Council has advocated for increased capital spending on infrastructure for the past few years.

Capital spending for transportation investments jumps from $1.1 billion this year to $1.5 billion in the next fiscal year and then to $1.9 billion in 2019-20, largely due to additional investment in transit infrastructure and the replacement of the Pattullo Bridge. Unfortunately, there is nothing in Budget 2018 about the George Massey Tunnel replacement project, other than $44 million presumably to cover the costs of cancelling the project and cleaning up the preliminary stages of construction. The Massey Tunnel is a heavily congested corridor. In our view, it urgently needs to be upgraded to keep goods and people moving around and through the region in a timely manner.

FISCAL OUTLOOK

Budget 2018 is focused on enhancing social programs. As noted above, it includes some sizable expenditure increases. At the same time, the aggregate tax burden will rise, enabling the government to deliver thin surpluses over the fiscal plan.

The cumulative increase in tax revenue resulting from new measures announced in the Budget totals $794 million initially rising to over $2 billion once all of the changes are in effect. Business will bear the burden of providing the vast majority of additional revenue, mainly due to the new Employer Health Tax. A substantial contribution also comes from taxing expensive residential properties – via both transactions and annual property taxes – at a

TABLE 2: **BC GOVERNMENT THREE YEAR FISCAL PLAN**
(MILLIONS OF DOLLARS UNLESS OTHERWISE INDICATED)

			FORECAST		
	2016/17	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Revenue	51,459	52,069	54,193	57,559	58,646
% change	*8.1*	*1.2*	*4.1*	*6.2*	*1.9*
Expenditures	48,722	51,818	53,624	56,778	57,762
% change	*4.1*	*6.4*	*3.5*	*5.9*	*1.7*
Forecast Allowance	-	100	350	500	600
Surplus	2,737	151	219	281	284
Taxpayer-supported debt	41,506	43,680	45,198	47,554	50,257
% of GDP	*15.7*	*15.6*	*15.5*	*15.7*	*15.9*

Source: 2018 BC Budget and Fiscal Plan.

higher rate. Combined, these new taxes generate around $280 million annually. Non-resident property owners are expected to contribute another $240 million annually through the Speculation Tax and a higher Additional Property Transfer tax.

In the current fiscal year, additional spending in priority areas — housing affordability, child care, healthcare, education and training — amounts to another $1 billion. In the subsequent two years another $1.7 billion and $2.7 billion are allocated to these areas. The increment is significantly larger in 2020-21 because the government is budgeting over $1 billion in the final year of the fiscal plan to address case loads and higher employee compensation. This is prudent, as most public sector collective agreements expire in the next 18 months and the government is sure to face higher compensation costs going forward. It should be noted that the new EHT will also apply to public sector organizations, including the BC government and other employers in the broad provincial public sector, all of whom will see their labour costs increase once the EHT is in effect.

Minister James says the new revenue measures and higher revenues from existing taxes and other revenue streams will be sufficient to allow the government to deliver on the policy agenda outlined in the NDP's 2017 election platform. The Minister projects operating surpluses in the $200 to $300 million range over the three year fiscal plan. As has become common practice, the Budget includes a forecast allowance of $350 million next year and $500 million in each of the following two years. There is also other money set aside as contingencies and unallocated funds. Add in the fact that the Budget is built around cautious economic growth forecasts, and it is quite conceivable the government could end up out-performing its fiscal targets in the next 1-2 years.

TABLE 3: **BUDGET 2018 ECONOMIC ASSUMPTIONS AND FORECASTS**
(ANNUAL PER CENT CHANGE UNLESS OTHERWISE INDICATED)

		FORECAST			
	2017	**2018**	**2019**	**2020**	**2021**
BC Real GDP (chained $2007)	3.4	2.3	2.0	2.0	2.0
BC Nominal GDP	5.9	4.4	4.0	3.9	3.9
BC Export Goods & Services (chained $2007)	2.1	2.6	1.4	1.5	1.6
BC Retail Sales	9.5	4.3	3.8	3.7	3.7
BC Housing Starts (000s of units)	43.7	32.0	30.0	29.5	29.5
Cdn 3-month T-bill (annual average %)	0.7	1.3	2.1	2.4	2.7
Cdn 10-year gov't bond (annual average %)	1.8	2.3	2.8	3.1	3.4
Canada Real GDP (chained $2007)	2.9	1.8	1.7	1.7	1.7
US Real GDP (chained $2009)	2.3	2.4	2.1	1.9	1.9
US Housing Starts (000s of units)	1,202	1,200	1,200	1,200	1,200
Real GDP Japan (chained Yen 2011)	1.7	1.2	0.9	0.8	0.8
Real GDP China (US$2010)	6.9	6.3	6.0	5.8	5.8

Source: 2018 BC Budget and Fiscal Plan.

There are a few risks to the relatively rosy fiscal outlook. Operating losses at ICBC directly impacted the government's bottom line in this Budget and created some budgeting challenges. In fiscal 2018-19 the government plans on covering $684 million in losses at ICBC, after factoring in recently announced product reforms and other changes at ICBC that are expected to save the company $392 million next year. If these estimated savings are not realized, larger-than-expected losses at ICBC will cut into the government's very modest operating surplus. There is also some uncertainty around a number of the new tax measures related to housing. The Speculation Tax is designed to curb demand from non-residents. Coupled with the higher (and geographically expanded) Additional Property Tax, it could prove to be more effective than expected, which would diminish revenues. Many public sector contracts, including with teachers, nurses and other health care workers, are up for re-negotiation in 2019. While the government has earmarked some funds to cover higher compensation costs, settlements could run higher than anticipated.

With this budget, provincial taxpayer supported debt increases to $50.3 billion by the end of the fiscal plan. With small surpluses for the operating budget expected, this increase is due entirely to capital spending. The taxpayer supported debt-to-GDP ratio inches up from 15.6% today to 15.9% by 2020-21. BC's debt load remains low in a Canadian context.

ECONOMIC BACKDROP

The government came to power with the economy on a solid footing, underscored by the fact that BC has led all provinces in economic growth in two the past three years and has posted exceptionally strong job growth for a couple of years. The outlook is for economic growth to downshift, but remain healthy and supported by solid fundamentals such as ongoing employment increases, gains in consumer activity, and an expanding population.

The Budget is built around an economic growth forecast of 2.3% in 2018, down noticeably from the 2015-17 period. As has also become common practice, this is two-tenths of a percentage point lower than the consensus growth projection provided by the Economic Forecast Council. Adopting a somewhat more conservative economic forecast provides a further cushion to help the province meet its fiscal targets.

Here we do offer a word of caution. Forecast Council members prepared their projections in advance of the policy changes announced in this Budget. The multiple and substantial measures to dampen foreign demand for housing and the new EHT do introduce elements of uncertainty. The policy changes in Budget 2018 could have a larger impact than intended, notably on business confidence and housing market activity, which in turn would impact overall economic and job growth in the coming years. However, as noted, the Budget seems to anticipate as much, as it projects significant declines in GDP and job growth as well as housing starts and growth in retail sales over 2018-20, compared to the previous two years.

CONCLUSION

Budget 2018 reflects the government's intention to ramp up social programs and provide greater support for low and middle income families. From the Business Council's perspective, a fiscal plan that balances the operating budget and keeps provincial debt levels manageable at this point in the economic cycle makes sense. With the economy in decent shape and the unemployment rate falling below 5%, this is not a time to be running deficits. Having said that, we note that if the government was not "double dipping" by having the MSP premiums overlap with the new Employer Health Tax for a year, the operating budget might have shown a return to a deficit at some point in the next two years.

Of greater concern is that the Budget does little to improve BC's investment climate, nor does it acknowledge the province's lagging investment performance. The Business Council has long been worried about the long-term consequences of weak capital formation in the province. BC businesses aren't investing enough in machinery, equipment, advanced process technologies, intellectual property products, and other assets that make our enterprises and workers more productive. Like Canada, British Columbia is losing ground to the United States on competitiveness, capital formation and business attraction, owing in part to higher taxes, increased regulation, and rising carbon and energy prices on our side of the border, at a time when the U.S. is moving in a different opposite direction.

In sum, with this Budget the government took steps towards advancing some of its key campaign promises, particularly those related to child care and housing affordability. Many British Columbians will be supportive of the housing plan, enhanced support for childcare, measures to improve education and the steps taken to provide some financial relief to low and middle income working families. On the other hand, many BC businesses will be scrambling to adjust to significantly higher payroll costs. Firms in BC are also looking carefully at the sweeping tax reform package recently adopted in the United States, which has sharply eroded any business tax advantage Canada may have enjoyed and made it more attractive for companies looking to invest in productive assets to do so south of the border rather than in our jurisdiction. Canadian policy-makers, including those in BC, cannot afford to ignore the shifting competitive landscape facing our economy and buffeting our business climate.

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