Business Alert

Business Council of British Columbia

February 17, 2016

The 2016 BC Budget: High Marks for Fiscal Management… But BC Must Do More to Improve Competitiveness

Highlights

- Budget 2016 foresees three more years of operating surpluses for the provincial government in the $600 to $700 million range. The budget is built around conservative revenue and growth assumptions, making it likely that the government's targets will be met or exceeded.
- The budget revamps MSP premiums, providing relief for single parents with children and, to a lesser extent, couples with children. But basic MSP rates go up 4% a year, meaning most businesses that pay these premiums for their employees will face higher operating costs.
- The government took steps to spur additional home construction by exempting new homes up to a value of $750,000 from the property transfer tax (PPT). A higher PPT rate will be levied on properties above $2 million. The province will start collecting data on foreign ownership of residential property.
- There were a few minor tax measures for business (extending tax credits for mining and providing PST exemptions to parts of the agriculture industry), but Budget 2016 contained little that will improve BC's competiveness or attract new business investment.
- That said, it is encouraging that, apart from MSP premiums, there were no other tax increases. The government is creating a Commission to review the overall competitiveness of BC's tax system, a welcome step that the Business Council has pushed for.
- Capital spending rises by more than $1 billion in fiscal 2016-17. As a result, taxpayer supported debt climbs – but the ratio of taxpayer-supported debt to GDP still edges lower over the next few years.
- The government will establish a BC Prosperity Fund that will see an unspecified amount of non-renewable resource revenue saved to help eliminate the province's debt over time and make investments in health care, education, transportation, social programs and other priorities.

Unveiled by Finance Minister Mike de Jong on the afternoon of February 16, Budget 2016 tells a generally upbeat story of British Columbia's economic performance and fiscal health. Economic and job growth are running above the national average, and BC is one of only two provinces expected to post a balanced operating budget (or surplus) both this year and in 2016-17.

Economic Setting and Outlook

Against the backdrop of slumping global commodity markets and a visibly sputtering Canadian economy, British Columbia's near-term prospects are surprisingly favourable. The Business Council's recent BC Economic Review and Outlook publication highlights some of the reasons why the province is doing better than Canada as a whole on several commonly-cited metrics – including economic growth, job creation, retail sales, and housing-related investment.[1]

One relevant factor is an expanding population. A number of other provinces are struggling with stagnant or shrinking populations, a demographic trend that tends to dampen the growth of economy-wide spending. At 1.2-1.3% per year, BC's population is rising faster than the national average, providing an ongoing source of additional demand for goods, services and housing. With Alberta in the midst of a severe downturn and British Columbia expected to lead the country in economic growth, we are likely to see a surge in interprovincial migration, which will further bolster population growth and overall economic activity in 2016-17.

A second reason for BC's comparatively strong economy is the sagging Canadian dollar. While the province is being hurt by low commodity prices, exports of both non-resource goods and tradable services are kicking into gear, aided by a Loonie that has lost almost one-third of its value against the US greenback in the last three years. British Columbia benefits more than most provinces from a depreciating currency, for three reasons: i) our large tourism and gateway sectors, ii) the relatively small share of imported inputs in the value of the output produced by BC's major export industries, and iii) diminished "leakage" of consumer spending to the United States via cross-border shopping and travel whenever the Loonie loses ground. The low dollar also appears to be attracting more foreign capital into the province.

As noted in Budget 2016, BC's hot housing markets are also adding to economic growth. The housing sector, especially in urban areas, is busy, supported by continued rock-bottom interest rates, a pick-up in job creation, and inflows of foreign money. Most provinces are projected to see a decline in residential investment spending in 2016-17, but that doesn't look to be in the cards for BC.

Finally, the economic information presented in Budget 2016 attests that British Columbia's diversified industrial and export base has made our economy resilient, which is especially welcome at a time of weak commodity markets. The province's traditional resource-based export engines (forestry, mining and energy), along with the large gateway transportation sector, remain critically important to our prosperity, of course. But today BC also has competitive strengths as well as future growth opportunities in several other areas, including tourism; some segments of advanced manufacturing; the high technology sector; agri-food and seafood production (now a $3.5 billion export business); educational services (some of which are "exported" through the presence of foreign students in local institutions); engineering, architecture and design; and film, digital animation and other parts of the "creative economy." A diverse economy lessens the impact of downturns that may occur in one or two specific industries.

[1] Jock Finlayson and Ken Peacock, "BC's Growth Story Remains Intact…Despite an Uninspiring Global Backdrop," BC Economic Review and Outlook, Business Council of BC, February 2016, available at www.bcbc.com.

Table 1

Budget 2016 Economic Assumptions and Forecasts for British Columbia

(annual per cent change unless otherwise indicated)

			Forecast		
	2014	**2015**	**2016**	**2017**	**2018**
BC Real GDP (chained $2007)	3.2	2.4	2.4	2.3	2.3
Business Council Real GDP forecast (chained $2007)	*3.2*	*2.6*	*2.8*	*3.0*	*na*
BC Nominal GDP	4.7	3.3	4.0	4.3	4.3
Exports Goods & Serv. (chained $2007)	2.7	0.3	1.5	2.2	2.4
Retail Sales	5.6	6.5	4.3	3.7	3.6
Housing Starts (000s of units)	28.3	31.4	29.4	28.0	27.0
Cdn 3-mnth T-bill (ann. avg. %)	0.9	0.5	0.5	1.1	1.7
Cdn 10 year gov't bond (ann. avg. %)	2.2	1.5	1.8	2.5	3.4
Real GDP Canada (chained $2007)	2.5	1.2	1.4	1.9	2.1
Real GDP US (chained $2009)	2.4	2.4	2.2	2.3	2.3
US Housing Starts (000s of units)	1,003	1,111	1,100	1,100	1,100
Real GDP Japan (chained Yen 2005)	-0.1	0.6	0.8	0.4	1.0
Real GDP China (US$ 2005)	7.4	6.9	6.2	6.1	6.1

Source: 2016 BC Budget and Fiscal Plan and Business Council, Economic Review and Outlook (February 2016).

Add it all up, and we expect the BC economy to grow faster than the 2.4% pace projected by Minister de Jong – by 2.8% (after inflation) this year, rising to 3% in 2017, enough to put British Columbia at the top of the provincial rankings. By comparison, the Canadian economy will struggle to expand by 1.5% over the next two years, pulled down by recessions in the main oil-exporting provinces (Alberta, Saskatchewan and Newfoundland and Labrador). The Business Council's forecast, unlike the government's, assumes that one major LNG project moves forward by the last quarter of 2016. Economic growth will be slower, although still respectable, if LNG investment in the province remains on hold.

Table 1 above summarizes the economic forecast underlying Budget 2016, as well as the Business Council's (slightly more optimistic) GDP growth projections.

Fiscal Plan and Key Budget Measures

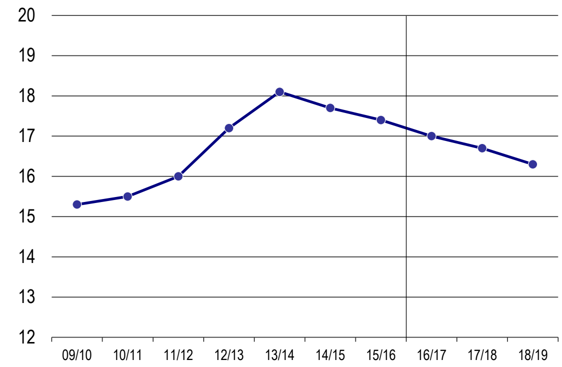
The BC Liberal government is committed to avoiding budget deficits. For 2015-16 and the following three years, it plans to run modest operating surpluses, in the range of $600-700 million. These surplus projections include an annual forecast allowance of $350 million for the period 2016-17 through 2018-19. The government may beat its fiscal targets if the economy continues to grow. At a time when most other provinces are facing persistent budget shortfalls, British Columbia stands out both for its strong fiscal position and for the government's disciplined management of spending.

That said, the province continues to borrow significant sums to fund capital spending and infrastructure projects (see below).

Figure 1

Taxpayer Supported Debt-to-GDP Ratio

per cent



Source: 2016 BC Budget and Fiscal Plan.

Taxpayer-supported debt[2] is slated to climb by just under $2.5 billion by 2018-19. However, measured relative to the size of the economy (GDP), taxpayer-supported debt is slowly shrinking in BC (Figure 1). Within Canada, British Columbia maintains the third lowest level of overall public debt as a share of GDP.

Total government spending is forecast to increase by 2.7% a year from 2015-16 through 2018-19. Adjusted for inflation and population growth, this equates to an approximate freeze (or a slight drop) in program outlays on a real, per person basis. In dollar terms, the Ministry of Health accounts for three quarters of the rise in aggregate Ministry expenditures, with smaller increases planned for the Ministries of Children and Family Development, Social Development and Social Innovation, Education, and Advanced Education.

The Liberal government has earmarked $100 million from this year's budget surplus to establish a new Prosperity Fund – although there are no additional dedicated allocations to the Fund over the fiscal plan. Building a large Prosperity Fund hinges on the potential development of an LNG industry. For now, the budget documents note that the Fund will be used to "help eliminate" the province's debt over time, "make investments in health care, education, transportation, family supports and other priorities…,"and "preserve a share of today's prosperity for future generations." The Business Council has supported the idea of a dedicated "savings vehicle" based on setting aside a share of revenues derived from the development of British Columbia's non-renewable resource wealth. Our concept for how such a fund would be financed and operate was informed in part by the experiences of jurisdictions like Norway and Alaska. At this point, it is unclear to what extent the Prosperity Fund as envisaged by the government will align with the proposal that was advanced as part of the Business Council's Agenda for Shared Prosperity project back in 2012-13.

Turning to the revenue side of the budget, government tax and other receipts are projected to grow by almost 7% between 2015-16 and 2018-19. But the overall revenue gain conceals considerable variation across different revenue sources (see Figure 2). While taxation revenues are predicted to increase by ~$1.7 billion over the fiscal plan, natural resource revenues will fall further, reflecting weak commodity

[2] Under the province's accounting rules, taxpayer-supported debt includes all past operating deficits (direct debt) as well as debt incurred to finance taxpayer-supported capital spending. It excludes the debt of self-supporting Crown corporations like BC Hydro.

Table 2

BC Government Three Year Fiscal Plan

(millions of dollars unless otherwise indicated)

	2014/15	2015/16	2016/17	2017/18	2018/19
Revenues	46,122	46,992	48,066	49,034	50,141
% change	5.5	1.9	2.3	2.0	2.3
Expenditures	(44,439)	(46,365)	(47,452)	(48,397)	(49,418)
% change	2.4	4.3	2.3	2.0	2.1
Allocation to the BC Prosperity Fund	-	(100)	-	-	-
Surplus before the BC Prosperity Fund	1,683	527	614	637	723
BC Prosperity Fund	-	100	-	-	-
Forecast Allowance	-	(250)	(350)	(350)	(350)
Surplus	1,683	377	264	287	373
Taxpayer-supported debt	41,880	42,709	43,227	44,242	45,089
(% of GDP)	17.7	17.4	17.0	16.7	16.3

Source: 2016 BC Budget and Fiscal Plan.

markets. Net revenues flowing to the treasury from the profits of commercial Crown corporations are expected to jump in 2016-17 and then stay roughly flat through 2018-19. Budget 2016 includes no new revenues from LNG, in keeping with the Finance Minister's cautious approach to forecasting.

Budget 2016 features relatively few new spending measures or consequential tax policy changes.

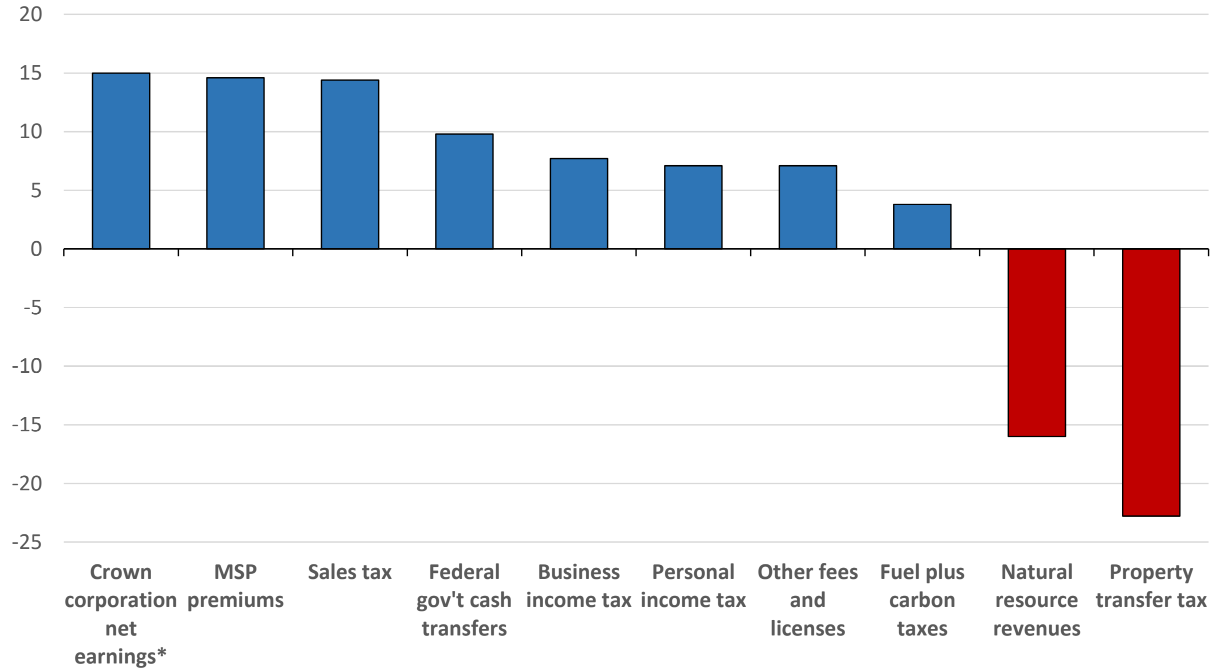
In terms of incremental spending, the government is setting aside $355 million over five years to fund the construction of ~2,000 units of affordable housing for low- and moderate-income families. An additional $673 million is provided over three years to support families and individuals in need, including disabled persons. There is $75 million to enable small rural communities in BC to reinvigorate and diversify their economies. Budget 2016 confirms the province's earlier commitment to establish a $100 million BC Tech Fund to stimulate venture capital investment in technology firms. The Industry Training Authority gets another $8 million over three years to expand trades training for youth. It should be noted that Ministry and agency budgets are adjusted higher to account for increased wage/benefit costs stemming from the Economic Stability Dividend and Economic Stability Mandate adopted by the government a few years ago.

Turning to taxation and other revenue measures, changes to the existing system of Medical Services Plan premiums will reduce the cost burden on low-income households and families with children, beginning in 2017. The amount allocated to MSP premium assistance is also being raised. However, the basic MSP premium is set to rise by 4% a year over the fiscal plan. It is sometimes overlooked that employers pay a majority of all MSP premiums collected by the province.

Figure 2

Projected Increase/Decrease in Provincial Revenue, Selected Source

(% change, 2015-16 to 2018-19)



* Total reflects BC Hydro, ICBC, BC Lottery Corporation, the Liquor Distribution Branch, Transportation Investment Corporation, Columbia Power Corporation, BC Railway Company, the Columbia Basin Trust power projects.

This means that as premiums move higher, payroll costs for the employer community will continue to increase.

In a high-profile move, the government has revamped the Property Transfer Tax regime, by establishing a higher tax rate (3%) on all residential real estate transactions above $2 million,[3] and allowing a full exemption from the PPT for purchases of newly constructed homes up to $750,000 in value (provided the purchaser is a Canadian citizen or permanent resident).[4] In a positive move, the mining exportation tax credit is extended. We also support the decision to expand the Small Business Venture Tax Credit. The agricultural sector will benefit from minor changes to the list of exemptions under the Provincial Sales Tax and a new "farmers' food tax credit."

Finally, the government is creating a Commission on Tax Competitiveness to review the competitiveness of the business tax system and report back to the Minister of Finance and the Legislative Standing Committee on Finance by the fall. The Commission's mandate will preclude consideration of returning to the former HST regime. Establishing the Commission is in line with a recommendation made in the Business Council's pre-budget submission.

[3] The basic PPT rate is 1% on the first $200,000 and 2% between $200,000 and $2 million.

[4] There is a partial PPT exemption up to $800,000.

Capital Spending Plan

Budget 2016 plans for government capital spending to rise to $7.36 billion in fiscal 2016-17, a sizable increase (18%) from the updated forecast of $6.23 billion for 2015-16. The capital budget goes to refurbishing and building new physical assets in K-to-12 education, the post-secondary sector, healthcare, social housing, energy and transportation. With interest rates and government borrowing costs at all-time lows, the Business Council agrees it is an opportune time to step up capital spending. In the last two years of the fiscal plan, the government plans to reduce capital spending levels to $6.5 billion and $6.76 billion. If the federal government proceeds with a large-scale infrastructure program, BC may need to revisit its three-year capital plan in order to effectively access and leverage the growing amounts of federal funding directed to this area.

Close to 60% of public sector capital spending is supported by taxpayers. The other 40% is deemed to be "self-supporting" because it is funded and financed by revenue-generating Crown corporations. BC Hydro accounts for around 90% of all self-supported capital spending in the province.

Future Priorities

At this juncture, we believe a primary challenge for the BC government is to take advantage of a broadly supportive macro-economic and fiscal picture by designing and implementing polices to improve competitiveness and make the province a more attractive location for new investment – particularly outside of the over-heated housing and real estate sectors. Among other things, this requires streamlining and modernizing regulatory frameworks and systems, investing in education, skills, and infrastructure, and reforming features of BC's tax system that inhibit capital formation, new investment and business growth. Of concern, business non-residential investment has been lagging in the province for some time and, like Canada as a whole, British Columbia underperforms international peer jurisdictions in the capital invested per working person, as documented by the C.D. Howe Institute (Table 3). Addressing this problem calls for overhauling the current sales tax system, reforming municipal property taxation, and a stronger political commitment to keeping a lid on fees, energy-based taxes, and other non-tax levies that are not sensitive to business profitability.

Table 3
Investment Per Worker, Canada, 2014
(relative to the US and to OECD average)

	Relative to US	Relative to OECD Avg
Canada	75%	88%
Alberta	224%	263%
Manitoba	70%	82%
BC	63%	74%
Ontario	42%	49%

Source: C.D. Howe Institute.

More specifically, it is important that the government take concrete action to reduce BC's high marginal effective tax rate on new capital formation – an area where we rank near the bottom in North America. A high effective tax rate on new capital spending acts as a significant barrier to non-residential investment and hinders the growth of established businesses.[5]

Looking ahead, the Business Council's biggest concern is that investments in machinery, equipment, up-to-date factories and production facilities, infrastructure, advanced process technologies, post-secondary education, and innovation will be insufficient to lay a foundation for the productivity growth necessary to deliver rising real wages and incomes for British Columbia residents over time. Finding ways to boost productivity and build a more competitive economy is where policy-makers need to be directing their attention in the next few years.

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[5] The marginal effective tax rate includes statutory income taxes on business profits as well as the impact of sales taxes on inputs, investment tax credits, and other features of the business taxation regime. See D. Chen and J. Mintz, The 2014 Global Competitiveness Tax Report, University of Calgary.