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BC delivers fiscal 'dividend' ahead of May election

Highlights

- Ahead of a May 2017 general election, BC's budget delivered notable (if less immediate) tax relief and made some significant new spending and capital investments, all while keeping the budget balanced and the debt burden low.

- BC estimates a nearly $1.5 billion surplus for 2016-17 (0.6% of GDP), down from the $2.2 billion surplus last telegraphed but much better than plan. Revenue exploded higher, capturing stronger personal and corporate tax assessments and an outsized contribution from property transfer taxes. There's still $800 million in a forecast allowance/contingencies vote built into 2016-17, creating scope for an even larger surplus when the public accounts are released.

- Significant tax relief, a comedown in property transfer tax revenue and spending commitments imply smaller surpluses in future years. The budget projects surpluses of $295 million in 2017-18, $244 million in 2018-19 and $223 million in 2019-20—equivalent in each case to ~0.1% of GDP. Budget projections are insulated via four layers of prudence: forecast allowances of $250-350 million/year, annual contingencies of $300-400 million and conservative assumptions for real GDP growth and natural gas prices.

- A larger surplus and robust nominal GDP growth drove the taxpayer-supported debt-to-GDP ratio down a full percentage point to 16.1% in 2016-17. That ratio is slated to ease further to 15.9% in the coming fiscal year, remaining at or very near that level thereafter. BC envisions erasing its direct operating debt, which currently amounts to a little more than $5 billion, by 2020-21—marking the first time in 45 years the province would be free of operating debt. The taxpayer-supported interest bite was a scant 3.2% of revenue in 2016-17, and is seen holding below 4% through 2019-20.

- BC has raised almost $3.5 billion from debt capital markets in 2016-17, the majority sourced internationally. Capital spending is stepping up (including on education/health facilities, transit/transportation infrastructure and a variety of self-supported projects). As a result, $5.4 billion of gross funding needs have been telegraphed for 2017-18, rising beyond $7 billion/year in each of 2018-19 and 2019-20. Larger refinancing requirements are also part of the story, and after stripping out maturities, net bond issuance appears quite manageable. Moreover, as observed in years past, the actual level of gross/net bond supply could be lower than planned if the various levels of prudence are not required.

- The key plank of a tax relief plan is a 50% reduction in medical premiums effective January 2018. BC desires to fully eliminate medical premiums as its fiscal situation allows. Other tax relief measures included removing the provincial sales tax from electricity for businesses, a lower small business tax rate, a variety of new or enriched tax credits, and some additional measures that build on earlier efforts to bolster housing affordability/supply.

- Real GDP growth was rock-solid at an estimated 3% in 2016, but is seen running at 2.1% this year and next. As noted, assumed real GDP growth rates have been set below the consensus. Nominal GDP growth is likewise poised to moderate relative to 2016's brisk performance. The province assumes a 4% average annual growth clip for the coming three years.

- After jumping 33% higher in 2016, housing starts are expected to decline some 28% in 2017, with a further 10% cumulative reduction eyed over the subsequent two years. Lumber prices are projected to strengthen in calendar 2017 (SPF 2x4 at US$326), while the fiscal year assumption for natural gas is also higher at C$1.61/GJ for 2017-18. Trade protectionism, uncertain US fiscal policy and a fragile Europe are noted risks, as are potential softwood lumber duties.

BRITISH COLUMBIA • 2017 BUDGET

In what amounts to a pre-election budget, British Columbia is leveraging a diverse and growing economy *en route* to a fifth straight year of black ink in 2017-18. Notwithstanding notable tax relief (mostly via reduced health premiums) and a number of priority investments, there are balanced budgets extending out to 2019-20, insulated by multiple layers of prudence. Economic growth is set to moderate and the outlook is not without risks, with trade protectionism top of mind. But there's an enviable level of absolute and relative fiscal health in BC which we view as sufficient to maintain its position as the sole 'triple-A' rated province in the land. As it stands, BC's motto, *Splendor Sine Occasu*, which loosely translates to "splendor without diminishment", might just as reasonably be applied to the province's finances. However, we'll need to assess any potential change in government priorities and fiscal management principals following the spring election.

Racking up surpluses

BC notched its fourth straight surplus in 2016-17. The outgoing year's surplus is now pegged at $1.458 billion or 0.6% of GDP. Although admittedly a step down from the surpluses flagged in the Q1 and Q2 updates (due to new spending commitments), the latest estimate is nonetheless a noted improvement over the original plan for a $264 million surplus. Moreover, it's a budget balance once again written in black ink at a time when the majority of Canada's provinces were still projecting budget shortfalls.

Relative to the budget plan, BC's larger 2016-17 surplus reflects robust revenue growth. Topline revenue vaulted $2.8 billion or almost 6% above target, driven by higher personal and corporate tax assessments, the beneficial impact of hearty consumer spending on sales tax revenue, alongside a significant increase in property transfer taxes (capturing an ultra-vibrant resale market and a move to levy an incremental tax on non-resident purchases). While a good chunk of the above-plan revenue went to the bottom line, including direct allocations to debt reduction and the BC Prosperity Fund, the province leveraged its fiscal good fortune to invest in some key priorities. Witness the $1.6 billion of above-plan spending for 2016-17, directed primarily to housing affordability initiatives, infrastructure projects and a number of front-line services, alongside unplanned wildfire/flood costs.

There's residual scope for improvement in the 2016-17 budget balance, given the $800 million buffer set aside in the form of a forecast allowance and spending contingencies (more on BC's prudence in a moment). So don't rule out a $2 billion-plus surplus for the 2016-17 fiscal year when all is said and done.

Looking ahead, BC is budgeting for a fifth straight surplus in 2017-18, and as in prior years, envisions nothing but balanced budget across the entire three-year forecast horizon. The coming year's official surplus is targeted at $295 million, with slightly smaller surpluses of $244 million and $223 million anticipated in 2018-19 and 2019-20 respectively. These positive budget balances average ~0.1% of GDP per year. So the forecasted surpluses aren't tremendously large, but as in years gone by, there's notable insulation built into the fiscal framework via:

- Sub-consensus economic forecasts — the planning assumption for 2017 real GDP growth, at 2.1%, has been set 0.2%-pts below the private sector average. Thereafter, the province discounts the consensus forecast by 0.1%-pts/year;
- Forecast allowance — as previously noted, there's a residual allowance of $350 million for 2016-17 and an equivalent cushion for 2017-18. While you always need to be careful with fiscal sensitivity analysis, the forecast allowance on its own would protect against at least a 1%-pt miss in 2017 nominal GDP growth (all else equal). These forecast allowances, which could also be used to offset unexpected costs, are set a little lower at $250 million in each of the two out-years of the fiscal plan. Consistent with our preferred approach, the annual forecast allowance is explicitly identified in the main fiscal tables and there's been a tendency in BC to allocated unused portions towards the fiscal bottom line (i.e., debt reduction), which is an approach we also strongly endorse;
- Contingencies vote — this is additional padding, worth $450 million in 2016-17, $400 million in 2017-18 and $300 million in both 2018-19 and 2019-20, available to offset unanticipated costs and/or to support priority initiatives;
- Below-consensus assumptions for the price of natural gas — once again, the natural gas price used for planning purposes is within the 20th percentile of private sector forecasts.

Lastly, we'd point out that economic growth and revenue assumptions built into the budget *do not* incorporate any incremental lift from prospective LNG development.

Tax relief and priority investments

The fiscal flexibility afforded of a wealthy/growing economy and structurally balanced budget is now being put to use. To wit, the budget outlined meaningful tax relief and a series of priority investments, meant to deliver some combination of extra tax-home pay, more affordable housing, improved education, better health care, enhanced service delivery for the needy, and/or lower costs for those living and doing business in British Columbia.

Headlining things on the tax side, the budget announced a 50% reduction in Medical Services Plan (MSP) premiums for households with a net family income of up to $120K, effective January 2018. The income threshold for the MSP premium exemption is also being raised. These changes—worth $845 million/year once fully implemented—would mean an estimated two million British Columbians would no longer pay medical premiums (in addition to the two million or so that are already exempt). And this is deemed a "first step", with the province flagging its intention to fully eliminate MSP premiums as its fiscal situation permits.

In addition to lower medical premiums, the budget delivered tax relief in a host of other areas including, removing the provincial sales tax on electricity for business over two years (worth $82 million in year two) and cutting an already attractive small business corporate tax rate from 2.5% to 2% (worth roughly $70 million/year). There was a notably enriched tax credit for R&D, and new or more favourable tax treatment for training, book publishing, school-related purchases, volunteer firefighters and search & rescue volunteers. BC is halting the phase-out of preferential tax treatment for credit unions. Additionally, the government boosted the threshold for a first time homebuyers' exemption and made related threshold adjustments for the home owner grant phase-out. Those two measures are worth roughly $50 million, and can be viewed as part of a broader agenda to bolster housing affordability. Recall that BC had previously committed significant new funding for affordable rental units, and had also previously set aside financing for a new provincial home owner mortgage and equity partnership program.

In total, new tax measures add up to $566 million for the 2017-18 fiscal year, surpassing $1.3 billion come 2018-19. So while nominal growth is set to ease from last year's impressive clip, it's the significant tax relief delivered in the budget and a comedown from elevated levels for property transfer taxes that explains the tilt lower in total provincial revenue for 2017-18 and the slower growth thereafter.

Notwithstanding notable direct and indirect leverage to the housing market, we generally view BC's revenue mix is relatively well balanced/diverse. For 2017-18, taxation revenue is set to account for just over one half of total revenue. That includes property transfer tax revenue, which shot up through $2 billion in 2016-17 but is seen receding to $1.54 billion in 2017-18 (i.e., down roughly 25% from the outgoing year's exceptional level), as housing activity eases. More modest declines in housing starts and related property transfer tax revenue are penciled in for the following two years. Elsewhere, federal contributions are on the rise, accounting for an estimated ~16% of BC's revenue dollar. There's some exposure to natural resources, but fundamentally less reliance on these inherently volatile revenue streams than in Canada's three oil-producing provinces. The province expects to collect $2.3 billion in resource revenue in 2017-18, down more than 9% vs the outgoing year on lower proceeds from Crown land auctions/licenses/leases. While higher, natural gas royalties are slated to make up just $237 million or less than 0.5% of BC's $50.8 billion in total revenue for 2017-18.

Key commodity price assumptions and fiscal sensitivities include:

- Lumber (SPF 2x4) at US$326/thousand board feet in calendar 2017, declining to $318 in 2018 and $300 in 2019. A change of US$50 would be expected to have an annual fiscal impact of $75-100 million;
- Natural gas at C$1.61/GJ for 2017-18, averaging $1.53 and $1.73 in the two subsequent fiscal years. As noted, the province uses conservative price assumptions. Each 25¢ deviation in the average natural gas price vs budget would be expected to have a fiscal impact of $60-70 million/year;
- Housing starts are slated to fall 28% in 2017, with additional declines of 8% and 2% projected for the two subsequent years. Depending on property values, a 5% change in starts is estimated to impact property transfer taxes by $40-60 million/year.

All told, spending is slated to grow at an average annual rate of 1.7% over the three-year period ending in 2019-20, with new commitments geared to K-12 education, social assistance for vulnerable segments, mental health initiatives, rural economic development/environment and technology. The broader health care budget is slated for 3½% average annual growth over the coming three years, capturing some new commitments yes, but also keyed by previously negotiated wage increases.

Lower, flatter debt burden trajectory

If consistent budget surpluses weren't enough to distinguish British Columbia, consider the province's balance sheet. The favourable combination of a larger 2016-17 surplus and sturdy nominal GDP growth has put the debt burden on a lower trajectory than previously envisioned. The taxpayer-supported debt-to-GDP ratio is estimated to have declined by a full percentage point to 16.1% in 2016-17. (Given the potential for an even larger surplus, the outgoing year's debt burden could be lower still.)

With tax cuts/investments leading to smaller surpluses ahead, capital spending slated to rise and economic growth likewise due to moderate, the rate of decline in the debt-to-GDP ratio is expected to slow from here. BC puts its key debt ratio at 15.9% for 2017-18, holding at or very near that level thereafter. For the full three-year period covering 2016-17 to 2018-19, the debt-to-GDP and debt-to-revenue profiles compare favourably to the fiscal plan set down a year ago, albeit with an altered long-term trajectory. Meantime, the taxpayer-supported interest bite, while slated to increase somewhat, is extremely manageable at less than 4% of annual revenue through 2019-20.

The budget also flagged the potential for BC to wipe out its remaining operating debt by 2020-21—marking the first time in 45 years the province would be free of operating debt. (BC's direct operating debt is estimated at $5.2 billion for 2016-17, falling to $1.1 billion by 2019-20. This is not to be confused with the trajectory for the broader, taxpayer-supported debt measure, which today stands at ~$42 billion and is seen rising to just over $47 billion in three years' time, driven higher by notable capital investment.)

Thus, BC remains positioned as a low debt jurisdiction by Canadian provincial standards, which goes a long way towards explaining the superior credit rating of its long-term debt. Following downgrades to Alberta and Saskatchewan, BC is the sole remaining 'triple-A' province, having earned that top-notch rating from S&P, Moody's and Fitch. (DBRS currently rates the province 'AA(high)', and has previously expressed a desire for a further, sustained reduction in the debt-to-GDP ratio before taking the rating all the way to the top.)

Larger capital spending & refi needs drive increased issuance

Gross borrowing requirements are ending 2016-17 some $1 billion below the original budget plan, capturing the larger surplus and lighter-than-planned capital spending. As it stands, the province has raised almost $3.5 billion from debt capital markets since April 2016. That includes $1.5 billion in public benchmark bonds in the Canadian dollar market and the equivalent of $1.8 billion raised via a variety of international trades.

The smaller projected surplus for 2017-18, combined with notably larger capital requirements and increased refinancing activity, implies a non-trivial increase in gross funding needs ahead.

As per the budget, there's an unprecedented $13.7 billion in taxpayer-supported infrastructure spending earmarked over the three-year fiscal plan for hospitals, schools, public transit and the like. The province intends to finance $9.5 billion of that amount via new debt. Then there's $10.8 billion over three years in capital spending at self-supported commercial Crowns, highlighted by power projects and transportation infrastructure, which is expected to require an incremental $6.7 billion of new borrowing. (The inclusion of the George Massey Tunnel Replacement Project helps explain incremental self-supported funding needs, relative to last year's budget.)

In light of this capital build-out, BC is telegraphing $5.4 billion in gross borrowing for the coming fiscal year, with larger, $7 billion-plus programs following in both 2018-19 and 2019-20. We caution that gross funding needs are based on conservative budget forecasts, and could therefore be overstated should the economy perform as expected and underlying spending ultimately line up with plan. Moreover, strip out maturities and the stock of outstanding BC bonds would see more moderate growth, running at what we'd deem very manageable levels. So while we could see gross bond issuance pick up in the years ahead, the absolute and relative supply outlook is still fairly constructive for a BC credit that boasts some of the strongest fiscal metrics and the very best credit ratings in the provincial sector.

Our attention now turns to the provincial election, scheduled for May 9.

Warren Lovely & Marc Pinsonneault

British Columbia

$000,000	Budget 2016/17	Update 2016/17	Budget 2017/18	Plan 2018/19	Plan 2019/20	Percentage change 2017/18	2018/19	2019/20
Taxation revenue	24,304	26,910	26,804	27,622	28,429	-0.4%	3.1%	2.9%
Resource revenue	2,347	2,562	2,320	2,230	2,187	-9.4%	-3.9%	-1.9%
Other revenue	10,405	10,674	10,482	9,862	9,818	-1.8%	-5.9%	-0.4%
Other federal transfers	8,008	8,080	8,317	8,407	8,650	2.9%	1.1%	2.9%
Commercial Crown corporation net income	3,002	2,664	2,915	3,075	2,961	9.4%	5.5%	-3.7%
Total revenue	**48,066**	**50,890**	**50,838**	**51,196**	**52,045**	-0.1%	0.7%	1.7%
Program spending	44,417	46,101	47,127	47,650	48,402	2.2%	1.1%	1.6%
Contingencies	400	450	400	300	300			
Debt servicing costs	2,635	2,531	2,666	2,752	2,870	5.3%	3.2%	4.3%
Total spending	**47,452**	**49,082**	**50,193**	**50,702**	**51,572**	2.3%	1.0%	1.7%
Forecast allowance	(350)	(350)	(350)	(250)	(250)			
Surplus	**264**	**1,458**	**295**	**244**	**223**			
Provincial Debt Changes								
Deficit (surplus) before forecast allowance	(614)	(1,808)	(645)	(494)	(473)			
Taxpayer-supported capital spending	4,251	4,123	4,804	4,491	4,398			
Self-supported capital investments	3,108	2,855	3,278	3,572	3,985			
Commercial Crown corp. retained earnings	861	106	489	609	514			
Amortization, taxpayer-supported capital investments	(2,256)	(2,139)	(2,239)	(2,248)	(2,311)			
Other items	(2,950)	(1,763)	(2,531)	(2,445)	(2,067)			
Increase in total provincial debt	**2,400**	**1,374**	**3,121**	**3,670**	**4,231**			
Total provincial debt	**67,690**	**66,666**	**69,787**	**73,457**	**77,688**	4.7%	5.3%	5.8%
Provincial government direct operating	**6,215**	**5,167**	**3,609**	**2,350**	**1,066**	-30.2%	-34.9%	-54.6%
Other taxpayer-supported (mainly capital)	**37,012**	**36,860**	**39,693**	**42,834**	**46,135**	7.7%	7.9%	7.7%
Self-supported	**24,113**	**24,289**	**26,135**	**28,023**	**30,237**	7.6%	7.2%	7.9%
Forecast Allowance	**350**	**350**	**350**	**250**	**250**			
Total provincial debt / GDP	26.6%	25.5%	25.6%	25.9%	26.4%			
Taxpayer-supported	17.0%	16.1%	15.9%	15.9%	16.0%			
Capital Spending	**7,359**	**6,978**	**8,082**	**8,063**	**8,383**	15.8%	-0.2%	4.0%
Taxpayer-supported capital spending	4,251	4,123	4,804	4,491	4,398			
Self-supported	3,108	2,855	3,278	3,572	3,985			
Gross Borrowing Requirements	**4,525**	**3,518**	**5,368**	**7,169**	**7,355**			
Operatins deficit (surplus)	(264)	(1,458)	(295)	(244)	(223)			
Capital spending	7,359	6,978	8,083	8,063	8,383			
Refinancing requirements	2,341	2,367	2,756	3,870	3,148			
Other financing sources	(4,911)	(4,369)	(5,176)	(4,520)	(3,953)			
Large program expenses								
Education	12,476	12,637	13,124	13,324	13,441	3.9%	1.5%	0.9%
Health services	19,638	19,719	20,629	21,114	21,697	4.6%	2.4%	2.8%
Subtotal	32,114	32,356	33,753	34,438	35,138	4.3%	2.0%	2.0%
Other program expenses	12,303	13,745	13,374	13,212	13,264	-2.7%	-1.2%	0.4%
Total education / total expenses	26.3%	25.7%	26.1%	26.3%	26.1%			
Health services / total expenses	41.4%	40.2%	41.1%	41.6%	42.1%			
Debt servicing costs / total expenses	5.6%	5.2%	5.3%	5.4%	5.6%			

Source: Budget documents, British Columbia Ministry of Finance

BRITISH COLUMBIA • 2017 BUDGET

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