Business Council of British Columbia

Business Alert

March 22, 2013

2013 Federal Budget: Following Through, Fiscal Restraint and Some New Funding for Priority Areas

Against a backdrop of softer economic conditions, Finance Minister Jim Flaherty tabled a budget still centered around achieving the Conservative government's 2015-16 balanced budget target. To meet that objective, the Budget imposes meaningful but not draconian spending restraint. In turn, this left little capacity for much in the way of new spending or tax relief. The Budget does, however, direct additional funding to a few priority areas such as skills training and infrastructure investment.

The Economic Setting

Budget 2013 anticipates real economic growth of 1.6% this year, followed by a stronger 2.5% in 2014. In comparative terms, Canada has enjoyed a solid economic recovery, and continues to lead G-7 countries on several key metrics, including job growth.

We would note, however, that real GDP growth of 1.6% for 2013 is modest. Perhaps even more noteworthy is the fact that nominal GDP (which includes inflation) is projected to increase by just 3.3% in 2013, as the general rate of price inflation is tracking well below 2%. The current low inflation/slow growth environment is challenging from a budgeting perspective, as it tends to weigh on government revenues.

Part of the reason for slower growth in Canada is that the economic expansion south of the border remains subdued. The consensus view among forecasters is that the giant US economy will grow by 1.9% this year, little changed from 2012. The domestic side of the Canadian economy has weakened as retail spending and the housing sector have slowed. The euro area sovereign debt crisis remains a downside risk to the outlook. Most economists believe it will take a number of years for the necessary fiscal and structural adjustments to take place in Europe, and there is still a small risk that the euro-zone could unravel.

Recognizing that the economic environment is uncertain, the government opted to retain the $20 billion downward adjustment to the private sector consensus projection for nominal GDP. This prudent decision translates into a $3 billion reduction in projected revenues each year over the revised fiscal plan.

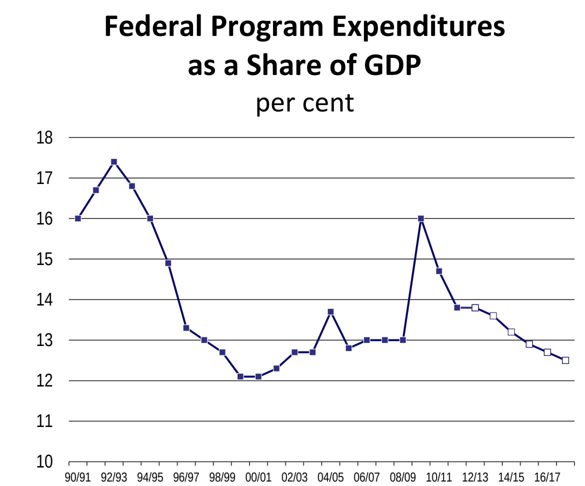
Spending Restraint Continues

While the Budget contains a fair number of new spending initiatives, most are small scale, and total program spending stays virtually flat in the upcoming fiscal year. This means that measured in inflation-adjusted per capita terms, spending will decline this year and next as well. Thereafter, federal program expenditures rise at a pace roughly consistent with inflation and population growth.

Ottawa's spending cuts, however, are far from drastic in a macroeconomic sense. Looking at the underlying details shows that the restraint is mainly achieved by pruning government operating expenses; in contrast, transfers to persons and to other levels of government continue to increase. This mirrors the approach adopted in Budget 2012. For the upcoming fiscal year, the government plans on reducing its direct operating expenses by $4 billion and by a further $2.5 billion in 2014-15.

Some of these savings come via what the Budget describes as "common sense improvements" to public administration and service delivery. These include reducing travel, consolidating and standardizing software procurement, and, expanding the use of electronic publishing.

The cost of financing the public debt has fallen over the past decade, mainly thanks to rock bottom interest rates. But debt charges are projected to rise slightly to $29.7 billion this year and to $30.2 billion the following year. A decade ago, Ottawa's debt financing charges amounted to nearly $40 billion. Low debt servicing costs are facilitating the return to a balanced budget.



Source: Fiscal Reference Tables and 2013 Federal Budget.

Revenue Picture

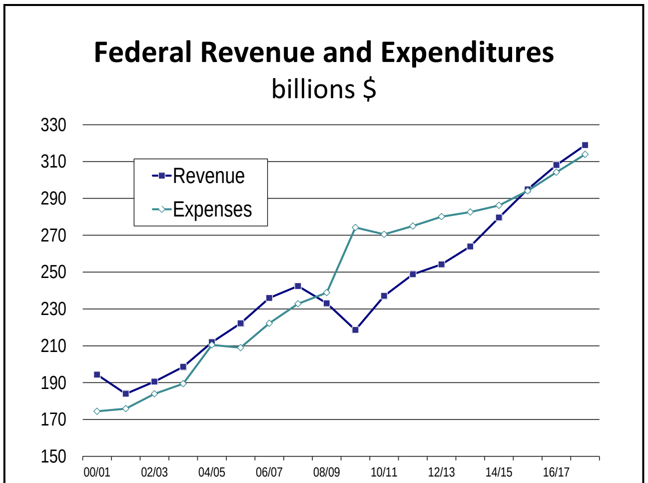
For the current fiscal year (2012-13), federal revenues are slated to rise by 2.2%. This is somewhat lower than the 2.8% increase assumed in last year's Budget, due largely to weaker-than-expected economic growth. In the 2012 Budget nominal GDP was forecast to grow 4.6% in 2012, but it actually came in at 3.1% (with much of the difference attributable to lower inflation). We draw attention to this not to question the accuracy of the new Budget's forecasts, but

Table 1
Budget 2013 Economic Assumptions and Forecasts for Canada
(annual per cent change unless otherwise indicated)

		forecast				
	2012	**2013**	**2014**	**2015**	**2016**	**2017**
Real GDP	1.8	1.6	2.5	2.6	2.4	2.3
GDP inflation	1.3	1.7	2.1	2.0	2.0	2.0
Nominal GDP growth	3.1	3.3	4.7	4.7	4.4	4.3
Unemployment rate (%)	7.2	7.1	6.9	6.7	6.5	6.4
Cdn 3-month T-bill (%)	1.0	1.0	1.3	2.2	3.3	3.8
Cdn 10 year gov't bond (%)	1.9	2.1	2.8	3.5	4.1	4.6
US GDP growth	2.2	1.9	2.9	3.1	3.0	2.8

Source: 2013 Federal Budget.

rather to highlight the fact that for several years now, GDP growth and inflation have both been lower than economists anticipated. A protracted period of subpar economic growth and very low inflation poses a risk to medium-term fiscal planning.



Source: RBC Fiscal Reference Tables and 2013 Federal Budget.

For the coming fiscal year (2013-14), federal revenues are expected to climb by 3.8%, underpinned by nominal GDP growth of 3.3%. The following year revenue growth is assumed to pick up to a 5.9% pace. For the next two fiscal years the gap between revenue growth and expenditure growth is sizable, allowing the government to eliminate the deficit by 2015-16. Of interest, between 2002 and 2008, a period of robust economic growth, federal revenue grew by an average of 4.7%. We see some risk that Ottawa's updated revenue forecasts will prove to be too optimistic.

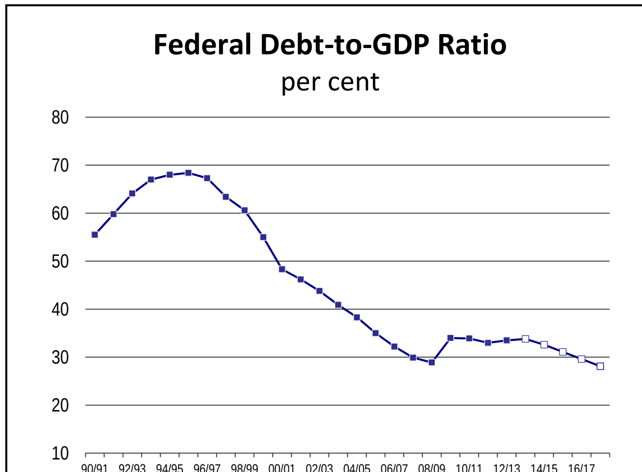
Personal income tax is assumed to increase by 4.7% next year, rising to 5.4% over the rest of the projection period. Corporate income tax revenues also expand at an average rate of 5.5% over the fiscal plan.

The strong projected increases in income tax revenue are not just based on higher labour income and corporate profits, but also reflect the government's plan to close various "loopholes" and step up tax enforcement/compliance.

Deficit and Debt

The government pledges to return to a small budget surplus by 2015-16. As noted, attaining this goal depends on continued spending restraint and solid revenue gains. The good news is that Canada remains in a favourable fiscal position compared to many other advanced countries in terms of both the level of public debt and its growth trajectory.

As shown in Table 2, the federal debt rises this year and next before starting to decline. The debt-to-GDP ratio, however, starts to fall as soon as next year, owing to shrinking deficits and ongoing expansion in the size of the national economy (nominal GDP).



Source: Federal Fiscal Tables and 2013 Federal Budget.

Table 2

Canadian Government Financial Position

(billions of dollars unless otherwise indicated)

	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Revenues	248.8	254.2	263.9	279.6	294.9	308.1	318.9
% change	4.9	2.2	3.8	5.9	5.5	4.5	3.5
Program Expenditures	244	251	252.9	256	262.6	270.4	278.1
% change	1.8	2.9	0.8	1.2	2.6	3.0	2.8
Public Debt Charges	31	29	29.7	30.2	31.5	33.8	35.7
Total Expenses	275	280.1	282.6	286.2	294.1	304.2	313.9
% change	1.7	1.9	0.9	1.3	2.8	3.4	3.2
Budgetary Balance	-26.2	-25.9	-18.7	-6.6	0.8	3.9	5.1
Federal Debt	582.2	608.7	627.4	634	633.2	629.3	624.2
% of GDP	33.0	33.5	33.8	32.6	31.1	29.6	28.1

Source: 2013 Federal Budget.

Tax Measures

In an environment of slow growth and with a near-term balanced budget target, it is not surprising that Budget 2013 is thin on major new tax measures. But there are a few worth noting.

- The Budget extends the 15% Mineral Exploration Tax Credit for one year, which is good news for the province's mining industry.
- The hiring tax credit for small business is also retained for another year.
- To support the hard-pressed manufacturing sector, the temporary accelerated capital cost allowance for investment in machinery and equipment is extended for an additional two years and will also apply to investments in clean energy generation and conservation equipment. These moves will benefit manufacturers, resource companies and the clean energy sector in BC.
- On a related matter, the Business Council is concerned that the federal government did not take the opportunity to signal that LNG plants built in BC would be classified as manufacturing and processing facilities for tax purposes. We will continue to press the federal government to revisit this issue.
- Customs tariffs: The government is eliminating preferential tariff treatment for goods imported from a large number of developing countries. As a result, tariffs will increase on a wide range of imported goods – particularly consumer products.
- Tax loopholes: Minister Flaherty announced several measures to eliminate purported tax "loopholes" in areas such as tax loss trading, life insurance products, labour sponsored venture capital corporations, and non-resident trusts. Once fully implemented, these measures will increase annual

federal tax collections by several hundred million dollars.

Other Items of Interest to BC

Budget 2013 contains a number of announcements that should be positive for British Columbia.

One is the planned overhaul of federal support for skills training, mainly via a new Canada Job Grant (the details of which are not yet worked out). Skill shortages are a growing concern for employers, and we agree that Ottawa's existing Labour Market Agreements with the provinces have produced disappointing results. Over time, the federal government will need to direct more funding to training and post-secondary education to further strengthen the country's human capital base.

Budget 2013 proposes $92 million over two years to fund forestry innovation and market development. Presumably, BC will be a significant beneficiary. There is also new money to support the aquaculture, aerospace and other defense-related industry sectors.

Investments in economic and security initiatives to implement Canada's commitments under the Canada-US Beyond the Border Action Plan are also welcome. Although the framework was previously announced, the follow through with plans to upgrade border infrastructure, implement a system to submit shipments data electronically, and enhance trusted trader and traveler programs should help to streamline border crossings and reduce costly wait times.

A BC specific initiative that will be funded is a pilot project at the Port of Prince Rupert that aims to improve cargo perimeter security and advance the concept of "cleared once, accepted twice."

Budget 2013 announces a new Building Canada plan that will provide $53 billion in new and existing funding over 10 years ($47 billion is new) to develop and upgrade provincial and municipal infrastructure. This is a major step, one that we applaud. Many municipalities and First Nations communities in BC should be in a position to benefit from this significant federal commitment.

The government is providing new funding to support advanced research and to foster business innovation, including by supporting incubator and accelerator organizations in the advanced technology sector. This announcement has been well received by the local technology community. Budget 2013 also allocates additional funding to the Canadian Foundation for Innovation, Sustainable Development Technology Canada, and Genome Canada. Some of this new money will stimulate and enable incremental research, commercialization and business activity here in BC.

Finally, Ottawa is providing $54 million over two years to ensure that First Nations land claims can be addressed more quickly.

Concluding Thoughts

Overall Budget 2013 takes a balanced approach that we judge to be appropriate for the economic times. Although there is a continued focus on restraint in aid of the goal of deficit reduction, the government managed to direct new funding to skills training, infrastructure, research and innovation. The planned overhaul of federal policy around workforce skills training will depend on yet-to-be reached agreements with the provinces -- and on more Canadian employers being willing to step up their own direct support for training.

Importantly, Budget 2013 preserves Canada's fiscal advantages and competitive overall tax environment; it also maintains stability in the system of federal-provincial transfers. The Business Council is pleased that the new Budget re-iterates the federal government's intention to pursue international trade and economic agreements with the European Union, Japan, and India, and to ensure that Canada is part of the evolving architecture of the Trans-Pacific Partnership.

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