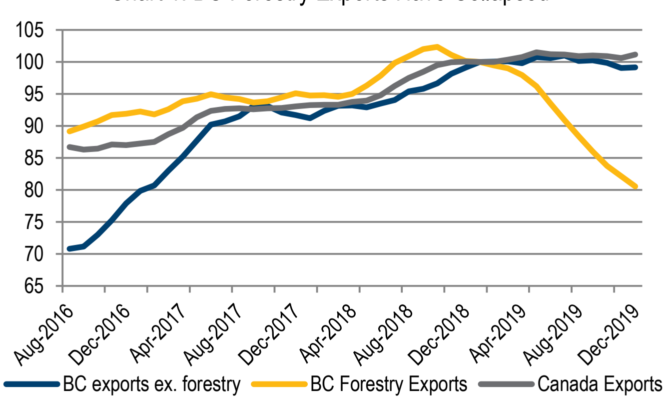
The 2020 British Columbia Budget: Fiscal Resilience In A Challenging Environment

Forestry Struggles but Tech Thrives

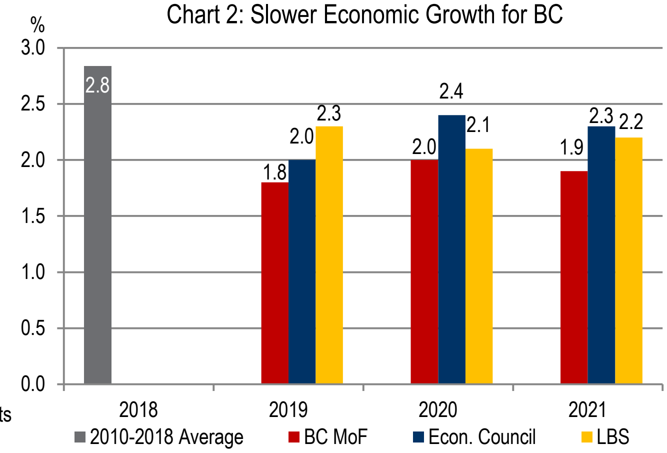
BC Finance Minister Carole James delivered the third budget of the NDP minority government yesterday. Headwinds, both domestic and global, are affecting the province's economic and fiscal outlook presented in the 2020 Budget. First, international trade tensions weigh down on BC's export sector. Last year, exports to the U.S. (representing half of the Province's total exports) fell by 2.8%; exports to non-U.S. destinations declined by 9.8%. This underperformance was caused in part by the limited supply of timber and lower lumber and pulp prices. Exports of forestry and building material products plunged by almost 20% in 2019, affecting many regional economies (chart 1). Similar to forests revenues, natural gas royalties were revised down in FY 2019-20 due to the increased utilization of credits and lower natural gas production. Fortunately, the economic momentum is positive in urban centers, due notably to the vibrant tech sector located in Vancouver, Victoria and Kelowna. Housing market activity in these three cities also surpassed expectations lately. This led to higher-than-expected property transfer tax revenue relative to the first fiscal update. Altogether, the surplus for FY 2019-20 was ultimately revised down to $203M (0.1% of GDP) from the original $274M figure pegged in Budget 2019.

Chart 1: BC Forestry Exports Have Collapsed



Notes: Shown as a 12-month moving-average. Indexed to January 2019=100.
Source: Statistics Canada, LBS Econ. Res. and Strategy Calculations.

Chart 2: Slower Economic Growth for BC

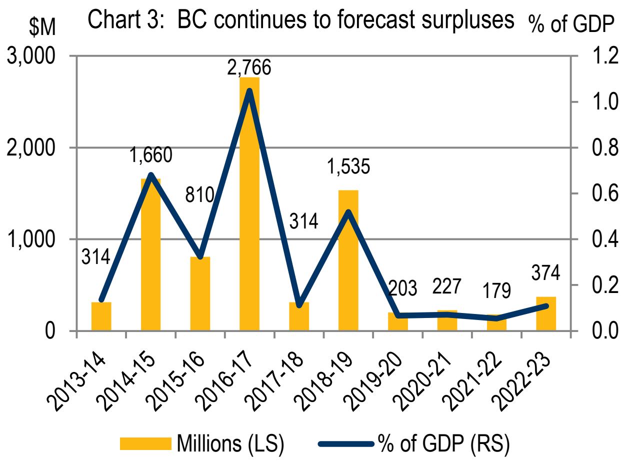


Source: BC Budget 2020, Statistics Canada and LBS Econ. Res. and Strategy.

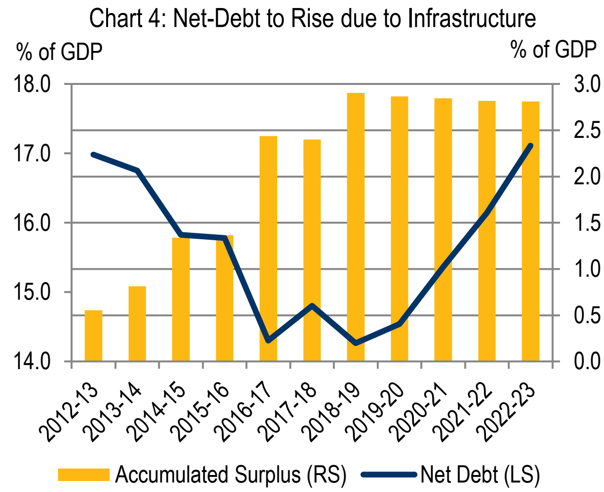
Balanced budget shielded by enhanced fiscal prudence

As investors have been used to in previous releases, the BC government continues to forecast balanced budgets over the next three years. In Budget 2020, very modest surpluses averaging 0.1% of GDP are projected (chart 3). The 3-year outlook relies on a steady real GDP growth performance in 2020 and 2021 relative to 2019. However, close-to-2% real GDP growth definitively marks a sub-par performance relative to what we have observed over the last decade (chart 2).

To preserve a balanced budget, the government has no choice but to taper off the pace of increase in program expenditures. The latter are projected to rise by 2.6% on average each year, virtually matching the 2.7% annual average revenue growth forecast. In both cases, these figures are below the pace registered during the last 10 years (4.1% for spending and 4.6% for revenues).



Note: FY 2019-20 results are from the Third Quarterly Report.
Source: Government of British Columbia.



Source: Government of British Columbia and LBS Econ. Res. and Strategy

Given the elevated degree of global uncertainty, the level of prudence incorporated into the 2020 Budget has been adjusted. For FY 2020-21, the BC government put aside a fiscal buffer of $900M (1.5% of revenues), compared to $700M expected in Budget 2019. The fiscal buffer is composed of a $300M forecast allowance and a $600M contingencies allocation. Also, the BC Ministry of Finance's GDP growth forecasts are 0.4ppt below the *Economic Forecast Council* in both 2020 and 2021, close to our most recent forecasts (chart 2). The conservative economic assumptions used in the 2020 budget, set before the coronavirus outbreak started in the Chinese city of Wuhan, will likely turn out to be a good choice for the government. China real GDP growth in 2020 could turn out to be approximately 1ppt lower than the 5.9% figure used by the BC Ministry of Finance. Overall, the multiple layers of prudence built up in this budget will facilitate the materialization of the fiscal targets.

Targeted spending measures partially financed by a higher top marginal tax rate

Given the elevated degree of global uncertainty, the timing is obviously not optimal to announce a major makeover of spending programs and tax rates. Thus, the 2020 budget mostly builds on existing programs. For instance, the *Child Opportunity Benefit* announced in the 2019 budget will become effective in October 2020, improving the disposable income of families. The complete elimination of Medial Services Plan (MSP) premiums occurred on January 1st 2020, costing $2.7B in taxation revenues relative to FY 2016-17. The health care sector will receive an additional $1.0B over three years. In education, the single most important measure consists of a $339M additional spending in the K-12 education system. Finally, the government will offer a little more financing for the construction of affordable housing (+$45M in FY 2022-23) and homelessness initiatives (+50M over three years).

The biggest single modification on the tax side relates to the announced increase in the top personal income tax rate. Effective January 1st 2020, taxable income over $220,000 will be subject to a 20.5% tax rate, up from 16.8%. The government expects to collect $216M from this single measure in FY 2020-21.

Capital Spending Leads to Higher Borrowing Requirements, Improvement at ICBC

The operating surpluses projected in the 2020 budget will not prevent debt and borrowing requirements from increasing. They are projected to increase consistently during the next three years to reach almost $10B in FY 2022-23, relative to $5.7B in FY 2019-20. Capital requirements for the infrastructure plan are important. Similar to what we observed in 2019-20, the province could tap more into international markets than in previous years to conduct its financing operations. However, it is important for investors to note that BC's use of internal financing sources and changes in short-term borrowing could lower the province's long-term borrowing requirements. Finally, the net debt-to-GDP is forecast to rise from 14.5% in FY 2019-20 to 17.1% in FY 2022-23 (chart 4). Given the lower for longer era of interest rates, it is not a risky proposition for the BC government to modestly increase its (low) public debt burden to invest in infrastructure. In fact, BC's AAA-rating could also benefit from the progress achieved at the Insurance Crown Corporation of British Columbia (ICBC). Indeed, the financial woes at ICBC could be almost over as the large deficits (sometimes over $1B) observed in recent years have been almost completely eliminated. ICBC's deficit for FY 2019-20 is now estimated at $91M, slightly up from the $50M Budget 2019 estimate. Even though an $86M surplus is projected for FY 2020-21, it is still being flagged as a "key risk" to the fiscal outlook by the Province.

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Budget and Fiscal Plan
($ billions)

	2019-20	2020-21	2021-22	2022-23
Total Revenue	**59.3**	**60.6**	**62.4**	**64.2**
% change	3.8	2.1	2.9	3.0
Total Expenditure	**58.8**	**60.1**	**61.9**	**63.5**
% change	5.8	2.1	3.0	2.7
Forecast allowance	0.3	0.3	0.3	0.3
Budgetary Balance	**0.20**	**0.23**	**0.18**	**0.37**
% of GDP	0.1	0.1	0.1	0.1
Net Debt	44.5	48.9	53.3	58.7
% of Nominal GDP	14.5	15.4	16.1	17.1
Accumulated Surplus	8.8	9.0	9.3	9.6
% of Nominal GDP	2.9	2.8	2.8	2.8
Taxpayer-supported Debt	44.6	49.2	53.9	58.6
% of Nominal GDP	14.6	15.5	16.3	17.1
Gross Borrowing Requirements	7.1	8.6	9.6	10.0
Of Which: Capital Requirements	9.5	10.5	10.6	11.5

Note: Other financing sources and operating surplus reduce gross borrowing requirements.
Source: BC Budget 2020 and LBS Economic Research and Strategy.

Key Fiscal Sensitivities for FY 2020-21*

	Increases of	Annual Fiscal Impact $M
Nominal GDP	1%	$150-$250
Lumber prices (US$/000 board feet)	$50	$125 -$150
Natural gas prices (Cdn$/GJ)	25 cents	$30-$40
Exchange rate (US$/CAD)	1 cent	-$25 to -$50
Interest rates	1%	around -$134
Debt	$500 million	-$11 to -$12

* change in the entire fiscal-year average; Source : BC Budget 2020.