The 2018 BC Budget: Unprecedented Housing Policies, ICBC's Financial Challenge and a Whole Lot More

In this budget, the NDP government outlines several policies to make life more affordable to many British Columbians. To finance unprecedented plans for housing affordability and child care, the NDP government intends to rely on new and higher taxes. Over three years, the budget includes more than $5B in both new spending and tax measures, significant amounts relative to the $54B annual budget. With so many moving parts ahead, it is difficult for us to assess if it will even out perfectly. The budget says it will.

Indeed, this fiscal outlook shows a balanced budget for the next three years. As stated in the September 2017 budget update, bond investors will definitively applaud the intention of Finance Minister Carole James to keep the fiscal house in order. The debt-to-NGDP ratio (15.2% in FY 2017-18) and debt-to-revenue ratio (84.3% in FY 2017-18) were both significantly revised down since last September. Given this positive development, the current financial position of the Province should stay solid (BC is the only Province with a triple-A rating), unless an unexpected negative development occurs. Acknowledging risks to the outlook and the fragile financial position of the provincial auto insurance crown corporation (ICBC), the budget appropriately includes larger contingencies and forecast allowances than before.

BC's housing market enters uncharted territory?

The 2018 BC budget introduces a 30-point plan for housing affordability, far beyond anything that has been done in the past by a provincial government. In January 2018, the average resale price of a residential unit was $1.025M in the Greater Vancouver area, up 26% from 3 years prior. The average rent in Vancouver rose by an annual 5% over the last 3 years to $1,300 per month. Many aspects of the 30-point housing plan caught our attention:

1-The foreign tax rate on residential resale transactions in Metro Vancouver increases to 20% starting today, clearly stating that 15% was insufficient. Furthermore, the 20% foreign tax also applies to the Fraser Valley, Central Okanagan and some parts of Vancouver Island (Victoria and Nanaimo).

2-As we highlighted in our *Provincial Monitor* report last week (available at www.vmbl.ca), the budget introduces a new speculation tax targeting foreign and domestic speculators who don't pay taxes in BC. Those who leave their units sitting vacant will pay a small 0.5% tax rate based on the assessed property value in 2018. The tax rate will increase to 2.0% in 2019. It remains to be determined if this vacant home tax will be enough to convince absentee homeowners to sell their units. An annual 2% tax burden is not much if home prices continue to appreciate at a decent pace (home prices rose by 8% annually on average during the last 15 years).

3- Increases in school and property transfer tax rates applied on homes over $3M are likely to weigh down Vancouver's high-end market.

4-The Province is appropriately taxing the sharing economy, asking, for instance, Airbnb to collect the 8% provincial sales tax.

5-Reinforcement of audits to crack down on loopholes: developers will need to report information about the assignment of pre-sale condo purchases to the Province. The objective is to reduce tax evasion in pre-sale condo flipping and hidden ownership.

6-Enhanced rental assistance for low-income families and seniors. In fact, the budget does not include a $400 annual rental subsidy for everyone as proposed last year.

7-$6B to build 34K affordable housing units over 10 years.

Altogether, the BC's housing market is likely to go through an important adjustment period. Our take is that this 30-point plan is likely to: deteriorate the relative cost of owning versus renting, increase supply on the resale market, put back some buyers on the sidelines, curb home prices appreciation and lead homebuilders to be more prudent. In the budget documents, the Treasury Board Staff forecasts housing starts at 32K units in 2018, down from a record-high 43.6K in 2017. If this projected 27% decline turns out to be accurate, it would essentially match the downturn in residential construction registered during the housing market slowdown of 1995 (-31%).

ICBC's financial turnaround required

Besides the BC's housing sector adjustment that is about to occur, a key risk to the fiscal outlook is ICBC's financial situation. ICBC forecasts a record loss of $1.3B for FY 2017-18. As such, the net income from crown corporations was revised down by a significant $884M compared to the *Second Quarter Report*. Without this financial deterioration, the surplus for FY 2017-18, now estimated at $246M, would've been substantially higher. The 2018 budget proposes reforming ICBC's insurance product such as limits on insurance payments, measures to reduce vehicle crashes, higher premiums for bad drivers, etc. The NDP government estimates that this insurance product reform will eventually improve ICBC's net income by $1.0B in FY 2020-21. In our opinion, this expected turnaround of ICBC's financial position needs to work as planned in order to prevent upward pressures on the Province's public debt and borrowing requirements.

Major improvement in affordable child care

In addition to housing policies, lowering the cost of child care for families is another way to make life more affordable. Costing $1B over the next 3 years, the budget includes a new child care fee reduction program and a new affordable child care benefit. Although it is not specifically mentioned in the main budget document, an improved child care policy is likely to increase the female labour force participation and employment rates in the long run. For instance, various studies have showed that the low-fee childcare program in the Province of Quebec allowed more mothers to enter the workforce. The participation rate of women aged 25-54 years old stands around 86% in Quebec, compared to 82% for many other provinces including BC. With a public-funded childcare program, the fiscal return of each dollar spent could turn out to be slightly above 1$ for the federal and provincial governments. In summary, it is a sound public policy improving economic potential.

Conclusion: Lots of moving parts in the spending and revenue columns

This budget proposes several progressive public policies. The intended boost in affordable housing supply and childcare support will partly be financed by $500M in annual new revenues coming from taxes on expensive homes and empty housing units. This being said, the largest tax measure is the new payroll health tax for businesses, expected to be effective in January 2019 and to generate almost $2B per year in new revenues. Employers with payroll over $1.5M will pay a 1.95% tax rate on their total payroll. Although BC's economic momentum has been very strong lately, a payroll tax could harm employment and economic growth. Furthermore, it will likely erode BC's companies' competitiveness further (Corporate Canada just lost its tax advantage relative to the US due to the passage of Trump's tax reform bill into law). Altogether, several policies announced in this budget may leave some bond investors with question marks. Bond investors will need to closely monitor fiscal update releases in order to find out if the additional tax revenue will fully compensate for housing and child care initiatives. Finally, it will be important to keep an eye on future developments at ICBC. Altogether, these dynamics will determine the future path of the province's public debt and borrowing requirements.

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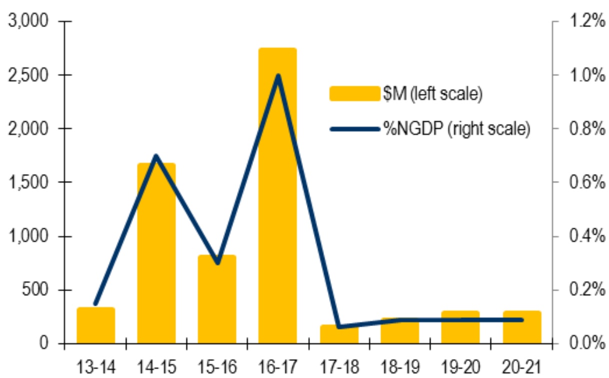
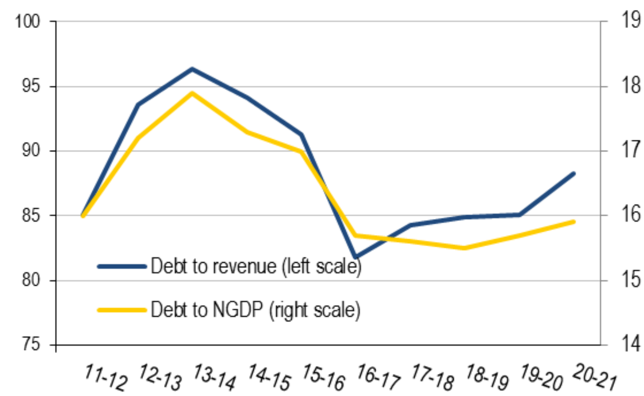
British Columbia Budgetary Balance



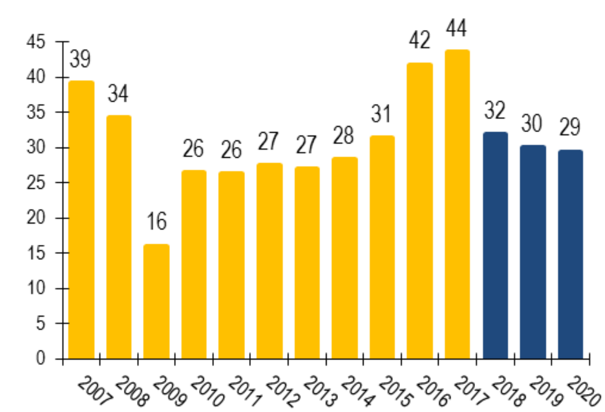
Source: BC Budget 2018

British Columbia Taxpayer-Supported Debt Ratios (%)



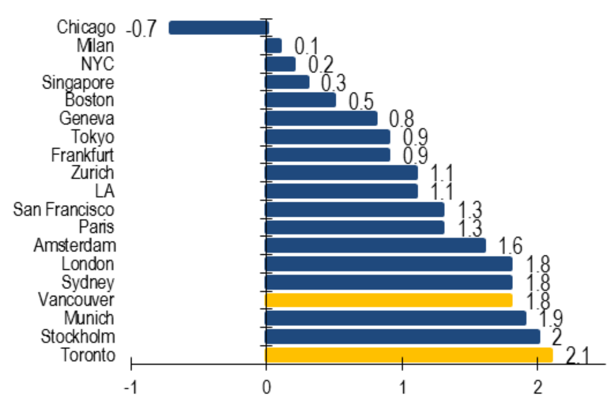
Source: BC Budget 2018

British Columbia : Housing Starts (units in 000s)



Source: BC Budget 2018

UBS Global Real Estate Bubble Index



Source: UBS; above 1.5 = bubble risk; 0.5 to 1.5 = overvalued; -0.5 to +0.5 = fair-valued; -1.5 to -0.5= undervalued.

British Columbia : Key Fiscal Sensitivities for FY 2018-19*		
	Increases of	**Annual Fiscal Impact $M**
Nominal GDP	1%	$150-$250
Lumber prices (US$/000 board feet)	$50	$150 -$200
Natural gas prices (Cdn$/GJ)	25 cents	$30 -$50
Exchange rate (US$/CAD)	1 cent	-$25 to -$50
Interest rates	1%	around -$82
Debt	$500 million	-$14 to -$16

* change in the entire fiscal-year average; Source : The 2018 British Columbia budget

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