BRITISH COLUMBIA BUDGET 2015

February 18, 2015

Budget surpluses and prudence prevail

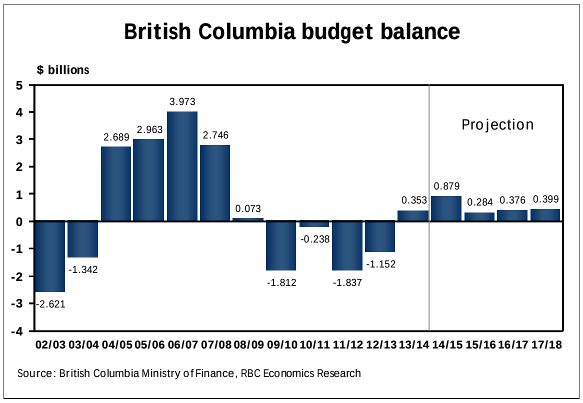
In a marked departure from the anticipation surrounding last year's budget (when the LNG tax rules were finally revealed), BC Finance Minister de Jong tabled a 2015 provincial budget that was largely void of prominent initiatives, instead choosing to preserve a path of balanced budgets with a renewed focus on "discipline and prudence". In the event, the government affirmed its enviable budgetary surplus position - possibly the only province to do so for the upcoming fiscal year - while reporting a better-than-expected fiscal performance for the current 2014/15 fiscal year. Caution remained on the agenda, however, as the government focused its efforts on implementing measures to ensure its fiscal health is maintained during its three-year plan. The inclusion of $2.1 billion in 'prudent budgetary measures' in Budget 2015 ($600 million allocated in 2015/16 and $750 million in each of the following two years) tempered the projected path of surpluses through to 2017/18, which if achieved, would mark six consecutive years of budget surpluses (British Columbia returned to a surplus position in 2013/14).

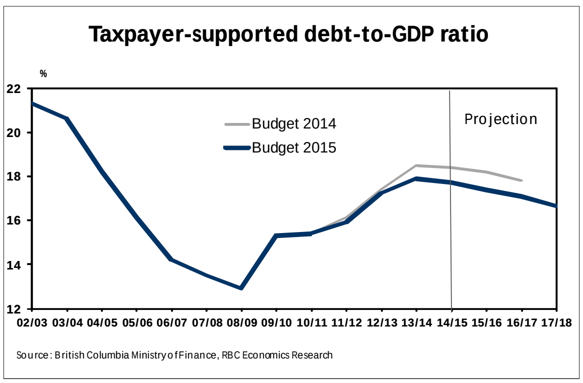
Beyond the inclusion of prudence measures, the budgetary outcomes presented were largely as expected: a $284 million surplus in the upcoming 2015/16 fiscal year, and surpluses of $376 million and $399 million in 2016/17 and 2017/18, respectively, round out the final years of the fiscal plan. The surprise in the documents was the better-than-expected outcome now anticipated for the fiscal year ending next month. The surplus was revised sharply higher to $879 million from $444 million projected in the second quarter update released in October and $184 million in the February 2014 budget.

The dominant theme of Budget 2015 was the degree of caution embedded in the fiscal plan with three layers of insurance built into the projections. First, the government maintained its common practice of including a forecast allowance to protect against unforeseen changes that may arise over the forecast horizon. These amounts were adjusted upwards in Budget 2015 by $25 million in each of 2015/16 and 2016/17 to $250 million and $350 million, respectively. The addition of 2017/18 to the fiscal plan came with $350 million in allocated forecast allowance funds.

The second measure to guard against uncertain developments was the inclusion of lower economic growth assumptions than that provided by the consensus of private forecasters. The latter expects real GDP growth in the province to average 2.7% over 2015 and 2016; however, the government used lower economic projections as the foundation for its fiscal plan, with growth expected to average a more modest 2.4% over the period. These compare with our own, more optimistic forecasts of 3.1% in 2015 and 2.8% in 2016.

Finally, Budget 2015 incorporated a "contingencies vote allocation" that sets aside $1.15 billion in funds to "help manage unexpected pressures and fund priority initiatives". This budgetary measure is expected to pro-





Budget assumptions

	2014	2015	2016
Real GDP growth (%)			
Budget 2015 planning assumption	2.2	2.3	2.4
Private sector average*	2.3	2.6	2.8
Nominal GDP growth (%)			
Budget 2015 planning assumption	3.9	3.8	4.3
Private sector average*	4.1	4.1	4.8

* BC Economic Forecast Council survey (updated January 2015)

Source: BC Ministry of Finance, RBC Economics Research

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tect the fiscal plan from unforeseen costs that may arise as well as account for the impact that external events may have on estimates built into the budget plan. In the absence of these above prudent budgetary measures, the budget profile would show surpluses of $884 million, $1.13 billion and $1.15 billion in each year of the 2015/16 – 2017/18 projection period.

Budget 2015 highlights

The presence of revenue boosting initiatives for 2014/15 in last year's budget – notably a personal income tax increase for incomes greater than $150K – resulted in a stronger-than-expected starting point for total revenues in 2015/16. No such new initiatives are included in this year's budget and total revenues are slated to rise by a modest 1.3% in 2015/16 to $46.4 billion. Declines in both personal and corporate income tax revenues are expected to be offset by solid gains across 'other revenue' components. Rising population growth in the province is expected to support a rise in Health and Social Transfers from the Federal government. In contrast, price weakness is expected to weigh on natural gas royalties, which are forecast to plunge 36.5% to $344 million in 2015/16, although this will follow a stronger-than-expected $542 million in 2014/15 (23% above the initial Budget 2014 projection of $441 million thanks to higher-than-assumed natural gas prices at the start of the fiscal year). A modest recovery is expected in this revenue source through the projection period; however, the level is expected to remain below the 2014/15 level. Notably, the projection does not incorporate any prospective boost to revenues resulting from the two-tiered LNG income tax introduced in Budget 2014.

Beyond the subdued increase anticipated in 2015/16, revenues are slated to rise 2.8% to $47.6 billion in 2016/17 (compared to 2.7% to $46.0 billion in Budget 2014) supported by a 2.9% rise in taxation revenues (accounts for 50% of total revenues). The addition of 2017/18 to the fiscal plan shows revenues rising by 2.0% to $48.6 billion that year.

Expenditures

On the other side of the ledger, total expenditures are projected to rise 2.2% to $45.8 billion in 2015/16. A 2.8% increase in health spending (which makes up nearly 30% of total expenditures) accounts for the bulk of the increase with education (up 1.9%) and social spending (up 2.5%) also representing significant spending items. Public debt charges are slated to rise 4.0% in 2015/16 at the fastest pace of increase since 2011/12. In contrast to previous budgets, the 'expenditure management' targets have been removed ($76 million in savings lapsed in 2014/15 following a $30 million allocation in 2013/14).

Expenditure Profile

Expenditure growth is expected to be contained to an average of 2.2% over the three-year fiscal plan with softer spending in the final year tempering increases of 2.2% and 2.3% in 2015/16 and 2016/17, respectively. The predominant driver of spending growth is expected to be health, rising by 2.8% and 3.0% in each of the outer years, respectively. The budget also allocates a share of funds to compensation increases resulting from the 2014 Economic Stability Mandate. This is in contrast to last year's budget where funding for the collective agreements was positioned within the Contingencies vote allocation. To date, two thirds of public sector unionized employees have reached settlements under the 2014 Mandate and the provision for additional funds in the upcoming fiscal year reflects the expectation for "modest wage increases". Notably in Budget 2015, expenditure savings resulting from the comprehensive Core Review were absent compared to Budget 2014's fiscal plan that allocated $50 million in savings over the 2015/16 to 2016/17 period. Despite this exclusion, the respective paths of revenue and expenditure growth along with a significant degree of prudence built into the fiscal plan leaves BC in the enviable position of likely achieving its surplus targets through the projection period.

Following the introduction of a two-tier liquefied natural gas tax regime in Budget 2014 and the release of further details this past October, references to the potentially transformative nascent liquefied natural gas (LNG) industry were limited in Budget 2015. The government announced $31 million in support for the mining industry and the ongoing development of LNG; however, also noted that deterioration in global economic conditions could affect the timing of final investment decisions in the development of the LNG sector.

Instead the government introduced only a handful of initiatives predominantly targeting tax credits including, but not limited to:

- Eliminate temporary PIT rate of 16.8% on individual incomes over 150K effective January 2016
- Enhance British Columbia tax reduction credit effective January 2015
- Introduced Children's Fitness Equipment tax credit
- Extended BC training tax credit until the end of 2017

Taxpayer-supported capital spending is projected to rise by 2.6% to $3.7 billion in 2015/16. This follows a downwardly revised capital spend in 2014/15 of $3.6 billion (9.8% lower than projected in Budget 2014) resulting predominantly from project scheduling changes. Fewer than half of the components of tax-payer capital spending are slated to rise in 2015/16 with the largest components – Health and Education – both projected to decline (by 2.1% and 1.2%, respectively). A projected 13.6% jump in spending by the BC

Transportation Financing Authority and a 35.2% surge in BC Transit spending will be sufficient for capital spending to rise on a year-over-year basis in 2015/16. A sharp decline in the latter, however, is expected to contribute to a slight 0.1% decline in taxpayer-supported capital spending in 2016/17 before a 14.1% drop in 2017/18 is expected.

The taxpayer-supported debt profile was lowered, in part reflecting better outcomes in 2014/15 (larger surplus, lower capital spending). Taxpayer-supported debt is now projected to rise from $42.3 billion in 2014/15 to $44.7 billion by 2017/18. As a share of GDP, taxpayer-supported debt is expected to gradually decline from a peak of 17.9% in 2013/14 to 16.6% in 2017/18, thereby representing a 0.4 percentage point annual improvement relative to the profile presented in Budget 2014.

Borrowing Requirements

The budget documents show total borrowing requirements of $14.0 billion over the fiscal plan, with $11.5 to be allocated for capital spending and $2.5 billion to be directed to retire maturing debt over the next three years. In 2015/16, provincial borrowing is expected to be $4.9 billion ($4.6 billion in new borrowing and $0.3 billion in direct borrowing by Crown corporations and agencies), representing a decline from $5.5 billion in 2014/15 as new borrowing is projected to drop by 10.7%.

Conservative assumptions

A foundation of conservative economic assumptions is embedded in the fiscal plan in addition to the allocation of ‘uncertainty’ funds. The government assumes that real GDP in the province will grow by 2.3% in 2015, 2.4% in 2016 and 2.3% in 2017. This is markedly weaker than the private sector consensus forecasts (2.6%, 2.8% and 2.7%, respectively) and our own forecast of 3.1% in 2015 and 2.8% in 2016. The net-oil consuming position of the province along with strengthening US demand for the province’s merchandise exports sets up for overall economic activity in the province to accelerate over the forecast horizon; however, the degree of caution embedded in the fiscal plan does provide some degree of protection should downside risks materialize that could derail the province on its track of posting consecutive budget surpluses.

British Columbia's fiscal plan

$ billions	Actual	Forecast	Estimate	Plan	Plan
	13/14	14/15	15/16	16/17	17/18
Total revenues	43.7	45.8	46.4	47.6	48.6
Total expenses	43.4	44.8	45.8	46.9	47.9
Program spending	40.9	42.3	43.2	44.1	44.9
Interest on public debt	2.5	2.5	2.6	2.9	3.0
Surplus (before fcst allowance)	0.353	0.979	0.534	0.726	0.749
Forecast allowance	0	-0.100	-0.250	-0.350	-0.350
Surplus	0.353	0.879	0.284	0.376	0.399
Total capital spending	5.7	6.2	6.2	6.3	6.1