



Robert Hogue
Senior Economist
RBC Economics Research
(416-974-6192)
robert.hogue@rbc.com

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B.C. budget update

Provincial deficit jumps

While the budget update presented yesterday by the B.C. government was, at least in name, just an update to the plan it tabled in February, it had the look and feel (and new numbers) of a full-fledged budget. In the period since the initial February budget, the provincial economy (and that of the rest of the country) greatly deteriorated with the recession morphing into the worst downturn the province has known since 1982; natural gas prices going into a tailspin (reaching seven-year lows in August); corporate profits plummeting; and the labour market falling deeper into a slump. In short, the broad economic context has looked very little like that projected in February – the below-consensus growth assumption of -0.9% for 2009 at the time now appears overly optimistic. Since then, also, a provincial election has taken place and a major overhaul of the provincial sales tax has been announced. It was, thus, not entirely surprising that the B.C. government opted, at this juncture, to table what is essentially a brand new budget instead of the usual mid-year tweaking exercise.

In the event, the provincial government confirmed what it had warned about for weeks: a sharp drop in tax revenues, energy royalties and revenues from other natural resources will both significantly increase the deficit and stretch it longer than previously anticipated (the government announced in the August throne speech that it will suspend the balance-budget legislation for an extra two years to the end of the 2012-13 fiscal year). For 2009-10, the shortfall is now projected at \$2.8 billion, more than five times the \$495 million expected in the February budget. For 2010-11, the new deficit projection is \$1.7 billion compared with \$245 million previously. In the updated plan, the string of shortfalls is extended by two additional years: the province's books will see black ink again only by 2013-14 instead of 2011-12.

Total revenue estimates have been revised lower to \$37.6 billion, a reduction of \$1.2 billion (or 3.1%) in 2009-10 relative to the February budget or \$2.0 billion (5.0%) if the HST transition transfer from the federal government (\$750 million) is excluded (more on the HST below). This reflects significantly weaker personal and corporate taxes (down \$1.0 billion from the previous estimate), natural gas royalties (down \$492 million) and revenues from other natural resources (down \$561 million). For 2010-11, revenues are projected at \$38.8 billion, representing a downward adjustment of \$1.0 billion (2.5%) net of a \$374 million HST transfer. The new revenue profile now shows a year-over-year decline of 1.9% 2009-10 and a rise of 3.3% in 2010-11.

Meanwhile, expenses are revised higher to the tune of \$826 million this fiscal year (or 2.1%) to \$40.1 billion, primarily reflecting the run-up in direct costs of forest fires in the province (\$347 million), additional funding to service delivery agencies (\$362 million) and increased contingencies (including those related to the 2010 Winter Olympic and Paralympic Games; \$115 million). Rising expenses will be restrained by cuts in discretionary spending totaling \$454 million. Added to \$589 million in administrative savings identified in the February budget, the B.C. government intends to implement cuts amounting to 3.5% of total ministry spending in 2009-10. Next fiscal year, the expense estimate has been boosted by \$280 million (or 0.7%) net of discretionary and other savings to \$40.3 billion. The new expense profile now shows a year-over-year increase of 4.9% in 2009-10 and 0.5% in 2010-11. These compare to an average growth of 5.1% in the previous three years.

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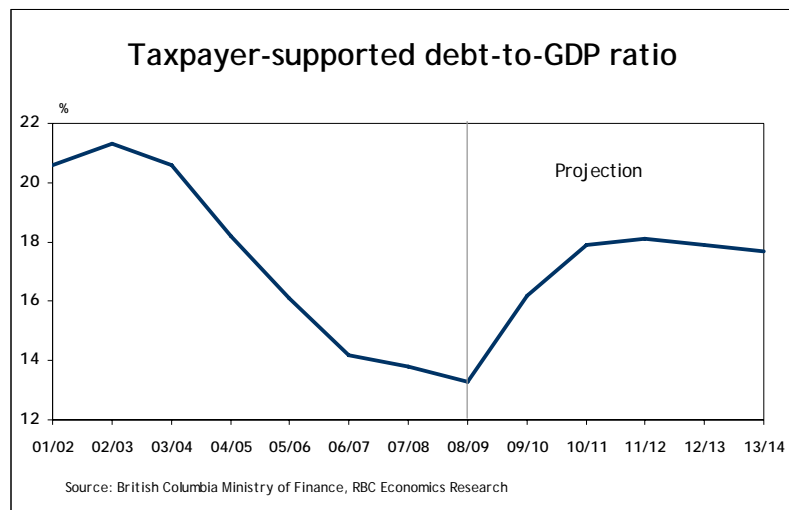
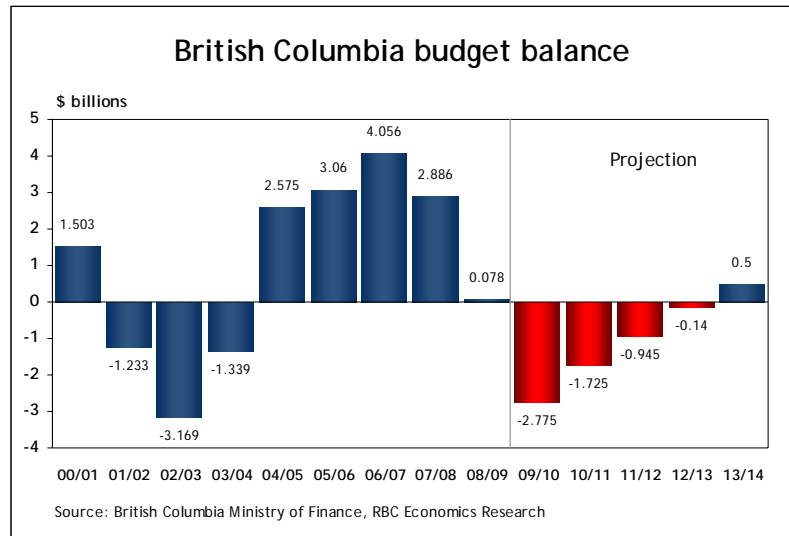
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Harmonized Sales Tax

In terms of new initiatives, the centerpiece of this budget update is the move to the Harmonized Sales Tax (HST) – a move that had been pre-announced on July 23. Following in the footsteps of three Atlantic Provinces (in place since 1997), Quebec (which has had its own version since the early 1990s) and Ontario (scheduled for July 1, 2010), the B.C. government will replace its provincial sales tax (and several other taxes and levies) on July 1, 2010, with a value-added tax that will be blended with the GST. The PST rate of 7% will be maintained for the provincial portion of the HST for a combined rate of 12% (including the 5% GST), the lowest among HST provinces. The GST’s tax base will be modified slightly for the provincial portion of the HST, as the provincial government will offer point-of-sales rebates on certain items (including motor fuels, books, children clothing and footwear, children car seats, diapers and feminine hygiene products), which are currently exempt from the PST. To help the transition to the HST, the federal government will transfer \$1.6 billion to the province over three years (\$750 million in 2009-10, \$374 million in 2010-11 and \$475 million in 2011-12).

This overhaul of the sales tax system will be accompanied by other tax measures aimed at offsetting any adverse impact on individuals, businesses and organizations. Chief among them will be a 17% increase in the basic personal income tax credit to \$11,000 effective January 1, 2010. There will also be credits for low income families, rebates on residential energy and partial rebates on new housing. Considering all related tax relief and rebates (although excluding the federal transfer), the net fiscal impact of harmonization on the B.C. government’s books relative to the current system is expected to be nil when fully implemented. However, the inclusion of the transition money from Ottawa would result in a revenue increase of \$1.6 billion over three years.



Conservative assumptions

While the global financial and economic situation appears to be turning a corner, risks of further turbulence will remain. In this context, the B.C. government’s cautious approach to budgeting in this update should reduce the risk of more bad surprises in the near term. Of note is the re-introduction of a forecast allowance of \$250 million in each of the next three fiscal years, providing some cushion. There is also much prudence embedded in the economic projections where provincial real GDP is forecast to contract by 2.9% in 2009 and to grow modestly by 1.9% in 2010, both more conservative than our June forecast of -1.9% and 2.9%, respectively. The new natural gas price assumptions (C\$3.51/GJ in 2009-10 and C\$5.09/GJ in 2010-11) represent significant downward revisions – down 40% and 18% this fiscal year and next, respectively – from the earlier estimates. Similar downgrades have been made to softwood lumber assumptions. The bottom line is that the sharp deterioration in the budget situation is likely fully captured by this update.

Debt rises

The larger deficits in the coming years will necessarily result in higher provincial debt levels than previously projected. Taxpayer-supported debt is now expected to climb from \$26.4 billion (or 13.3% of GDP) in 2008-09 to \$37.3 billion (18.1%)



by 2011-12, a rise of 41% in three years. This compares to the earlier projection of \$34.1 billion by 2011-12. However, even after the increase, the debt/GDP ratio will remain well below the recent peak of more than 21% registered earlier this decade and still rank as one of the lowest among provinces.

British Columbia's fiscal plan

\$ billions			Feb.	Sept. update		
	Actual		Budget	Budget	Plan	Plan
	<u>07/08</u>	<u>08/09</u>	<u>09/10</u>	<u>09/10</u>	<u>10/11</u>	<u>11/12</u>
Revenue	39.8	38.3	38.8	37.6	38.8	41.1
Expense	36.5	38.3	39.3	40.1	40.3	41.8
Negotiating framework incentive	-0.004	-0.002				
Climate action dividend	-0.4	0.02				
Surplus (before fcst allowance)	2.9	0.078	-0.495	-2.525	-1.475	-0.695
Forecast allowance		0	0	-0.25	-0.25	-0.25
Surplus	2.89	0.078	-0.495	-2.775	-1.725	-0.945
Total capital spending	5.0	5.5	6.9	7.4	7.7	6.5

Source: British Columbia Ministry of Finance, RBC Economics Research