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A New Fiscal Framework for British Columbia

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Summary

- British Columbia's provincial government finances have deteriorated rapidly in recent years. With large deficits and rapid debt accumulation forecasted in the years ahead, British Columbia is on track to become a high-debt province.
- This transformation in the health of BC's finances has been the result of a fundamental shift in the government's approach to government spending that began in 2017/18. Since that time, BC's government has increased spending at a much faster rate than occurred during a lengthy period of fiscal discipline that dates back to the turn of the century.
- This paper begins a process of outlining an alternative approach to public finances in British Columbia by establishing a fiscal framework to control expenditures to return to a balanced budget and begin saving rather than spending royalty revenues from natural gas.
- The implementation of the fiscal framework outlined in this paper would produce markedly different fiscal outcomes than those forecasted in the government's recent budget. By 2026/27, it would produce a balanced budget, in contrast to the government's projected $6.3 billion deficit. It would also result in the accumulation of $22.5 billion less debt over the next three years compared to the government's current plan. This framework would generate substantial deposits into a BC Prosperity Fund, allowing the fund to reach $3.7 billion by 2026/27.
- In the longer term, the implementation of the fiscal framework would create a range of policy options including tax relief, and explicit debt reduction.
- A fiscal framework based on spending restraint and saving rather than spending revenue from natural gas can prevent the rapid debt accumulation now forecasted in the years ahead, put provincial finances on a sounder footing for the long term, and ensure lasting benefits from natural resource royalties.

Introduction

In the middle of the 2010s, British Columbia's public finances were amongst the most-sound in Canada. In recent years, however, BC's provincial government finances have dramatically deteriorated. Following several large budget deficits with more of the same forecasted in the years ahead, BC is now on track to become a high-debt province.

This transformation in BC's fiscal position has primarily been the result of a fundamental shift in the provincial government's approach to government spending. Following a change in government in 2017/18, BC increased the rate of government spending growth substantially. The abandonment of spending restraint is the reason for the reemergence of large deficits.

The government's most recent budget clearly shows that if it continues on the current trajectory, large deficits will persist and the province's debt burden will increase in real-per-capita terms and relative to the size of the provincial economy. Further, debt interest costs will continue to rise. These results are forecasted despite the fact that non-renewable resource revenues have re-emerged as a meaningful source of government revenue.

This paper begins by outlining an alternative trajectory for government finances in the province by presenting a fiscal framework that would avoid the projected increase in debt in the coming years. It also proposes removing revenue from non-renewable resource revenue from the province's operating budget so that it can be saved as a financial asset, accruing ongoing earnings to produce a more reliable and permanent source of revenue.

The first section of the paper reviews the evidence of BC's deteriorating fiscal position and examines the causes of this deterioration. The second section presents an alternative fiscal framework for BC that would achieve a balanced operating budget in three years, create conditions for further improvements in the province's fiscal position, and begin a process of saving non-renewable resource revenue in the BC Prosperity Fund. A third section addresses possible next steps before a fourth brief section concludes.

British Columbia's current fiscal trajectory and its causes

Several recent analyses published by the Fraser Institute have documented British Columbia's recent fiscal deterioration as well as its causes in detail.[1] This section very briefly reviews the state of BC's finances.

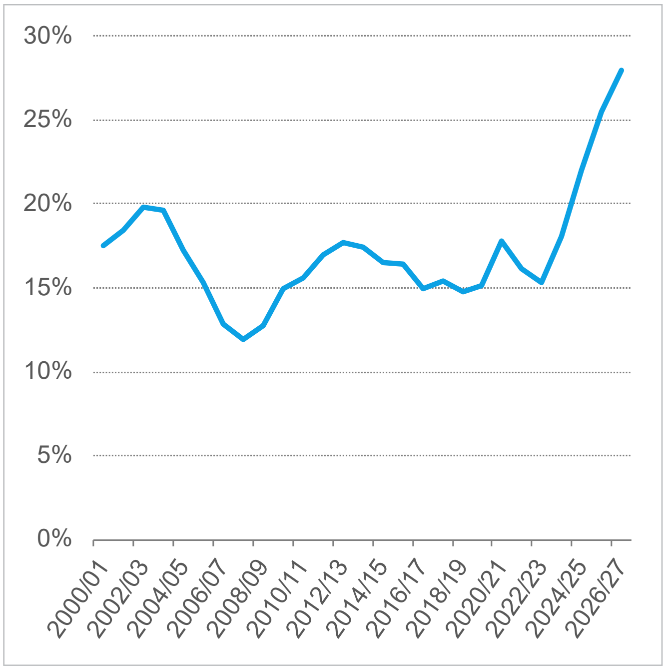
British Columbia's finances are deteriorating rapidly. The government's most recent budget estimated a $5.9 billion deficit for the 2023/24 fiscal year and projected a deficit of $7.9 billion for 2024/25 (British Columbia, Ministry of Finance, 2024).

[1] This research along with other publications on economic developments in the province are archived here: https://www.fraser-institute.org/categories/bc-prosperity.

Figure 1: Net Debt Per Capita (in 2024 dollars)

Sources: British Columbia, 2023; British Columbia, 2024; Finance Canada, 2023; Statistics Canada, 2024a; Statistics Canada, 2024b.

Figure 2: Net Debt, Percent of Gross Domestic Product



Sources: British Columbia, 2023; British Columbia, 2024; Finance Canada, 2023; Statistics Canada, 2024c.

These operating deficits are only a portion of the total debt that will be added to British Columbia's books. Once debt from capital expenditures is included, the province's net debt—a measure that deducts financial assets—is forecasted to reach $73.7 billion in 2023/24, which is also the highest level in real ($2024) per-person terms ($13,721) in BC's history. The budget forecasts net debt will increase by another $18.9 billion this year.

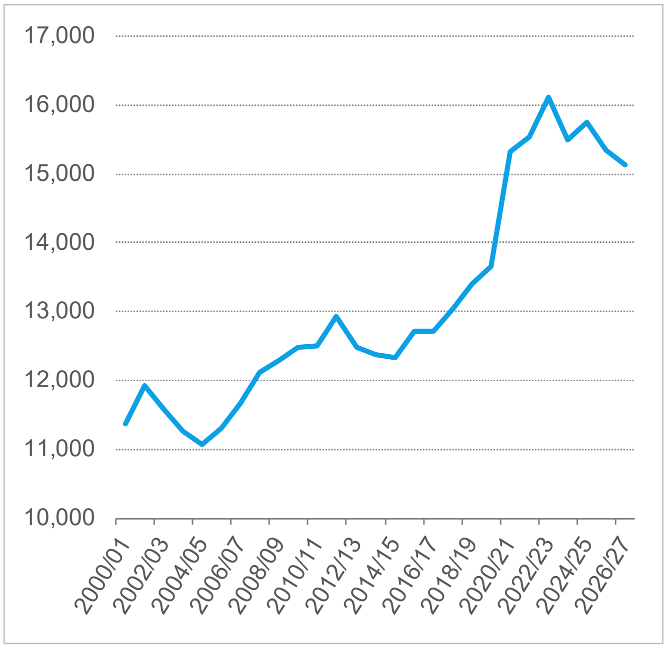
This, however, represents only the beginning of a rapid run-up in government debt that is projected for the coming years. The government's most recent forecast predicts that BC will increase its real (in $2024) per-person debt to reach $21,039 by 2026/27. That is an increase of $8,947 from 2022/23 levels. In total, British Columbia's net debt-to-GDP ratio is forecasted to climb from a recent low of 14.7 percent in 2018/19 to 28.0 percent at the end of the government's current fiscal plan in 2026/27. Figures 1 and 2 show the evolution of BC's net debt since the turn of the century in real ($2024) per-capita terms and as a share of GDP.

The impact of this increase in government debt will significantly affect the government's operating budget in the years ahead due to a rapid increase in debt service costs. Debt service payments are projected to more than double from $2.7 billion in 2022/23 to $5.7 billion by 2026/27 (British Columbia, Ministry of Finance, 2024).

The reason for this rapid increase in debt is straightforward. Starting in 2017/18, following change in a government, British Columbia transformed its approach to the management of public expenditures. After an extended period of spending restraint during the first decade and a half of the twenty-first century, the government has substantially increased the rate of spending growth in recent years. Specifically, from 1999/2000 to 2016/17, inflation-adjusted per person government spending increased at an average annual rate of just 0.9 percent. Starting in 2017/18, however, following the election of John Horgan's New Democratic Party, British Columbia changed course and began a rapid period of increase in government spending. Figure 3 shows the sudden change in the rate of spending growth in the second half of the 2010s. Between 2017/18 and 2022/23, spending in BC increased at an average annual rate of 4.1 percent.

Several past studies have demonstrated that this spending growth is the reason for the expected run-up in government debt. Specifically, Eisen and Emes (2023) show that if the BC government had held real per person spending growth to the same level that prevailed during the period of fiscal restraint from 1999/2000 to 2016/17, the province would currently be running an operating surplus. Further, this analysis shows that this alternative level of spending

Figure 3: Real Per Person Spending, 2000/2001 to 2026/2027 (in 2024 dollars)



Sources: British Columbia, 2023; British Columbia, 2024; Finance Canada, 2023; Statistics Canada, 2024a; Statistics Canada, 2024c.

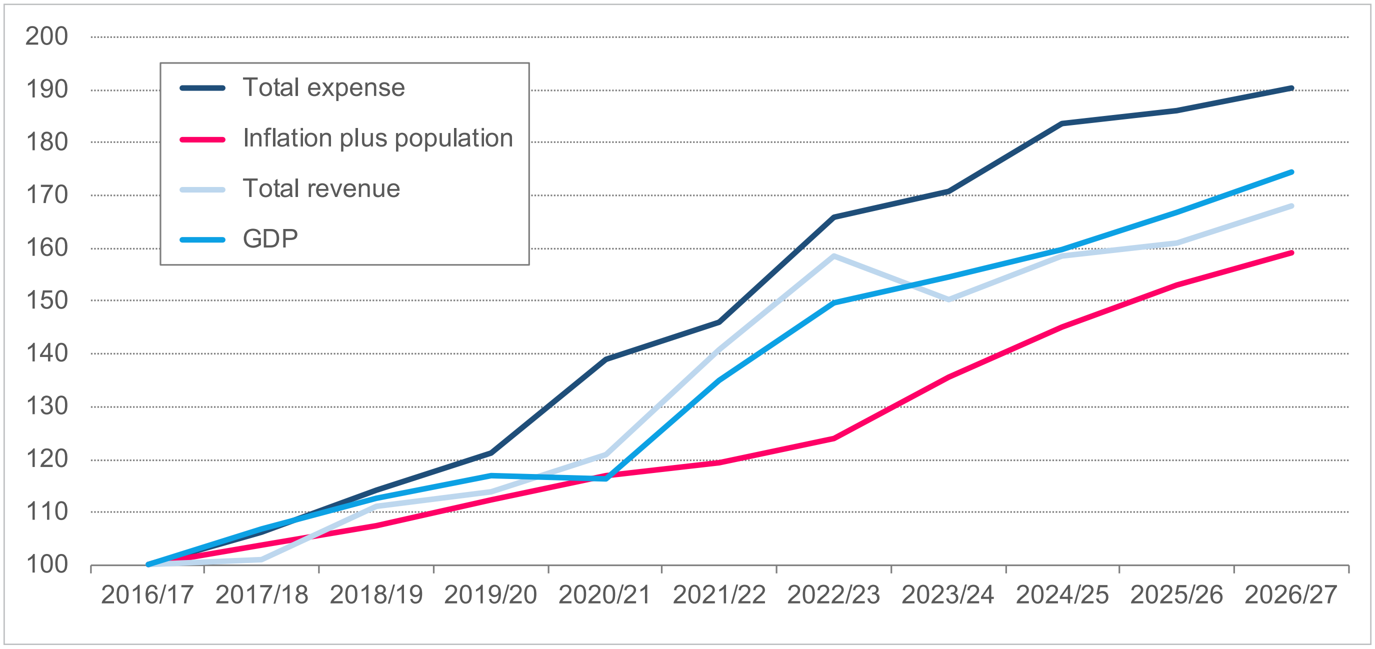
restraint would have been sufficient to avoid the large run-up in debt that the province is currently forecasting for the years ahead.

This section has briefly reviewed the current state of BC's finances, the significant debt growth anticipated in the years ahead, and the resulting rising interest costs. Further, it has shown that the cause of these developments has been the growth in spending since 2016/17.

An alternative fiscal framework for BC

In recent years, BC has operated without a clear fiscal framework. As figure 4 shows, spending has increased faster than revenue, inflation plus

Figure 4: Index of Total Expense, Inflation, Population, and Total Revenue (2016/17=100)



Sources: British Columbia, 2023; British Columbia, 2024; Finance Canada, 2023; Statistics Canada, 2024a; Statistics Canada, 2024b.

population, and the rate of provincial economic growth.

The province has also not had a clearly defined framework with respect to managing the deficit or debt burden. The province has not articulated clear goals with respect to its budget balance, nor has it established any fiscal anchors that will restrict its debt accumulation in the future.

Finally, it has not demonstrated a framework for treating revenues from non-renewable resources differently from tax revenue. This has reemerged as an important issue in British Columbia with revenues from natural gas expected to climb in the years ahead. Natural gas revenues were estimated at $2.3 billion in 2022/23 and are expected to be $1.4 billion in 2026/27.

There is extensive literature on the advantages of distinguishing between non-renewable resource revenue and general tax revenue. We will not review that literature here. However, the underlying public management principle is that revenue from non-renewable resources represents the depletion of an asset. Therefore, instead of being spent as current revenue, it should be saved for the future in a fund that can generate earnings to provide an ongoing source of revenue over time.[2]

[2] For an overview of the literature on this topic, see Hill, Emes, and Clemens (2021).

The BC government has expressed that it understands and supports this principle by creating the BC Prosperity Fund, which was intended to be a vehicle for saving some Liquefied Natural gas (LNG) revenues for future use. However, the perpetuation of budget deficits and the inclusion of natural gas revenues in annual operating revenue in the recent budget shows that the government has not yet begun a process of separating non-renewable resource revenue from tax revenue.

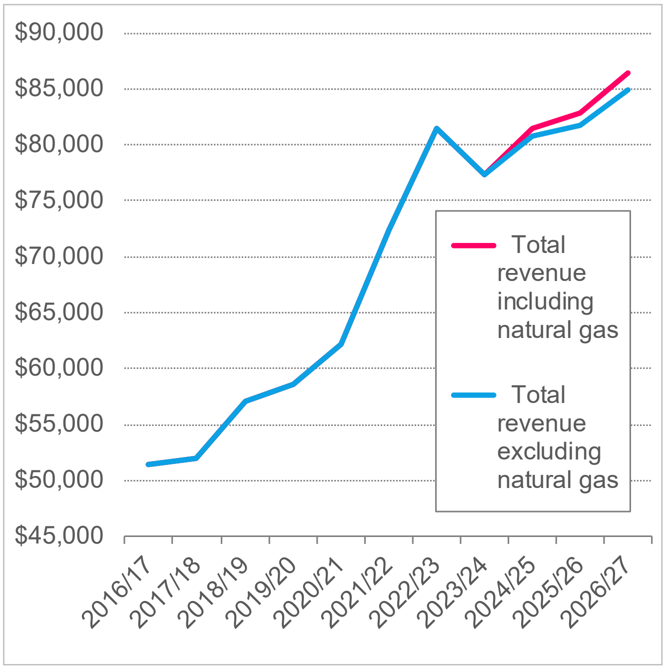
This section proposes a fiscal framework to help structure spending decisions in BC in the coming years, aiming to achieve a balanced budget, control expenditures, and save non-renewable resource revenues to produce a financial asset that can generate more predictable and stable future revenue. The framework includes two parts: removing natural gas royalties from general revenues and saving them in the BC Prosperity Fund, and limiting future spending growth (after a brief period of reduction) to the rate of inflation plus population growth to help ensure future balanced budgets and improve the sustainability of provincial finances. We will now examine these components in turn.

Save, don't spend natural resource revenues

There are multiple reasons to treat revenues from non-renewable resources differently from tax revenue. First, these revenue sources are generally much more volatile than tax revenue and so a reliance on them as a source of general revenues for the budget is risky and uncertain particularly for multi-year planning. Second, unlike tax bases non-renewable resources are depleted over time. It is therefore prudent to consider saving royalties as the transformation of a one-time asset into more diversified set of financial assets that, rather than being drawn down and spent, can generate investment revenue to provide an ongoing benefit for the province.

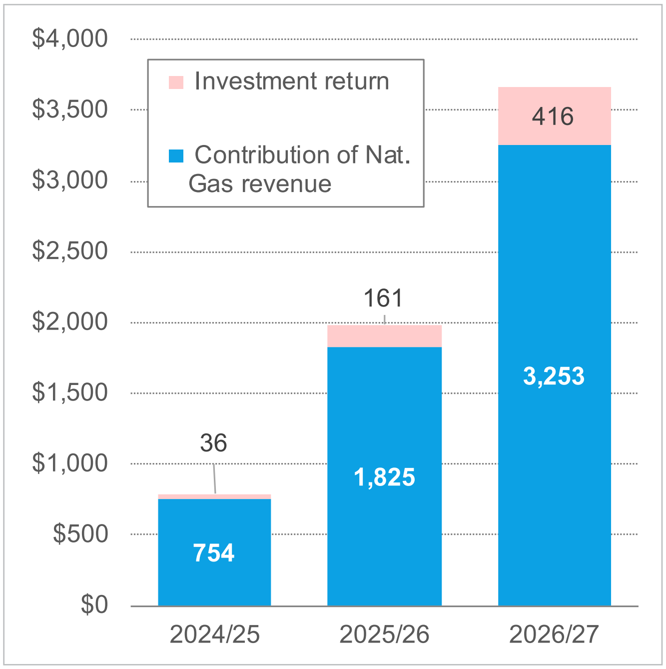
This issue has become particularly pertinent in BC due to the increase in revenue from natural gas in recent years. Natural gas revenues averaged just $161 million per year from 2015/16 to 2020/21. These revenues surged to $920 million in 2021/22 and $2.3 billion in 2022/23. From 2024/25 to 2026/27 the government forecasts a further $3.3 billion in revenues. Natural gas may be a substantial source of government revenue in the years ahead and it would be prudent to establish a mechanism for separating these revenues from general tax revenue. To this end, the fiscal framework presented here diverts all revenue into the BC Prosperity Fund, created under Premier Christy Clark in 2013 (BC Government News: Office of the Premier, 2013). There are valid arguments to be made for many different rates/shares of saving non-renewable resource revenue. We here propose diverting all natural gas revenue to a prosperity fund on the basis that they are non-renewable resources that theoretically belong equally to current and future British Columbians. Other savings rates could be selected, and would require slight modifications to this framework and model.

Figure 5: Total Revenue With and Without Natural Gas Revenue ($ Millions)



Sources: British Columbia, 2023; British Columbia, 2024.

Figure 6: BC Prosperity Fund Value at the End of Each Year ($ Millions)



Note: Investment return is based on the 10-year average return in the Alberta Heritage Savings Trust Fund.

Sources: Alberta, 2023; British Columbia, 2024.

The recent budget forecasts that natural gas revenues will be $754 million this year, rising to $1.1 billion next year and $1.4 billion in 2026/27. Cumulatively, the change proposed here would remove $3.3 billion from the government's operating budget in the next three years. In the final year, it would remove 1.7 percent of expected revenue from the government's operating budget.

Figure 5 shows how this change would alter the trajectory of government revenue over the next three years. Instead of the currently projected average revenue growth of 3.8 percent, average government operating revenue growth over the next three years would be 3.2 percent.

Instead of remaining in general revenue, under this fiscal framework natural gas revenue would be placed in a BC Prosperity Fund. This would eventually generate a steady stream of revenue to benefit British Columbians that could provide funds for the provision of public services and/or to maintain lower taxes. Over the course of three years, assuming no withdrawals from the fund, the contributions to this fund would total $3.3 billion plus an additional $416 million in investment income. Figure 6 illustrates the new contributions and fund value resulting from this framework over the next three years.

Assuming a 9.5 percent investment return,[3] a $3.7 billion Prosperity Fund would already be sufficient to generate $347 million in annual revenue by 2027/28. Of course, this development should be viewed as the starting point in the development of a much larger savings fund. At the time of its creation, Premier Clark suggested that the fund could one day rise to $100 billion. It is impossible to predict how global energy markets, and therefore this fund would evolve. However, the creation of this framework would ensure that any substantial resource revenue from a prolonged natural gas boom is set aside as a source of revenue for future generations, and not simply spent on current day-to-day expenditures.

There would be many implementation and design choices involved in the creation of a successful Prosperity Fund. The BC government would, for example, need to determine how long to allow interest generated within the fund to be reinvested in order to help build up the fund in its early years before beginning to withdraw interest earnings as a source of revenue for the operating budget. One approach to making these determinations would be to stipulate a minimum inflation-indexed principal for the fund that would have to be reached before withdrawals could be undertaken.

A greater implementation challenge would be establishing guardrails to limit the ability of future governments to abide by the rules related from the fund and to make required deposits. The history of Alberta's Heritage Fund, which has seen governments repeatedly fail to abide by the plans created at the fund's founding in the 1970s, illustrates the significance of this challenge. The most promising strategy for ensuring the long-term success of a Prosperity Fund in BC would be to make use of constitutional provisions to protect its governing rules rather than relying on simple legislation which can be overturned by simple legislation.

Addressing these design and implementation challenges would be necessary for the long-term success of a Prosperity Fund in British Columbia, but a complete discussion of them is beyond the scope of this paper. For a detailed discussion of these issues and particularly the value of constitutional protection of fund rules beyond simple legislation, see Hill, Emes, and Clemens (2021).

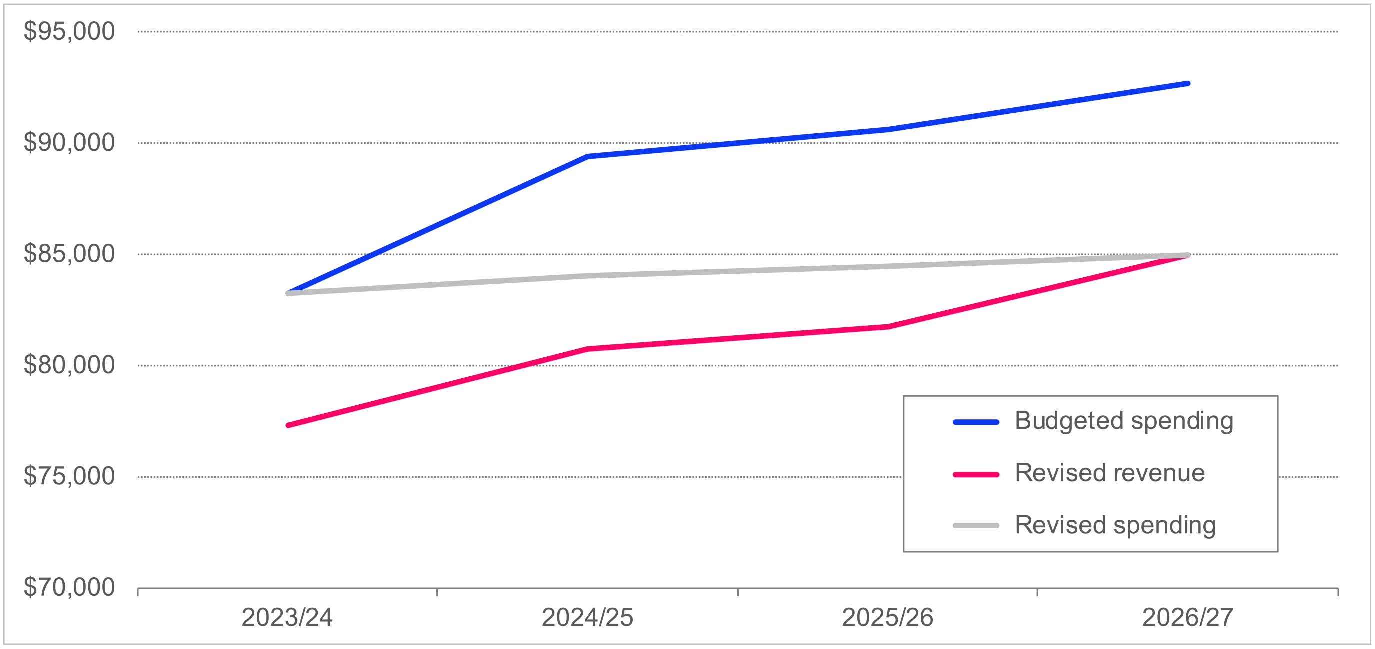
Balance the budget and then restrain future spending growth to inflation plus population growth

As discussed above, BC's current fiscal challenges are the result of a change in the government's approach to public spending in the mid 2010s that abandoned spending restraint and begun a process of rapid spending growth. Neither this growth nor the fiscal outcomes it has created with respect to deficits and debt have been constrained by a meaningful fiscal anchor, framework, or guardrails.

The framework suggested here proposes repairing this dimension of BC's finances by limiting the growth of spending in the future

[3] This is the average annual return over the last 10 years in Alberta's Heritage Savings Trust Fund (Alberta, 2023).

Figure 7: Budgeted Spending and Revised Spending and Revenue ($ Millions)



Sources: British Columbia, 2024; Statistics Canada, 2024a; Statistics Canada, 2024b.

to the pace of inflation plus population growth. This would allow spending to evolve with the needs of a larger population and higher prices while helping ensure the sustainability of government finances by holding spending growth below the level of revenue growth. This would occur naturally unless revenue growth were below inflation plus population, which would be historically unusual. Average revenue growth has exceeded average inflation plus population growth over the past 20 years.

Establishing this spending guideline immediately, however, would require a lengthy period of budget deficits in BC due to rapid spending growth in recent years. Real ($2024) per capita spending increased by 18.0 percent from 2019/20 to 2023/24. Implementing a brief period of real per capita spending reductions to return to pre-pandemic levels before applying the inflation-plus-population rule would expedite a return to budget balance and help prevent rapid debt growth in the years ahead.

Returning to pre-COVID (2019/20) spending levels would not require significant nominal spending cuts. In 2023/24, nominal program spending in BC is estimated to have been $85.0 billion. A nominal spending freeze at this level through 2026/27 would be sufficient to bring spending almost precisely in line with real per capita spending levels from 2019/20 if they had grown by population plus inflation ($79.3 billion). For perspective, this would still leave BC with historically high spending levels, and would leave per capita spending meaningfully higher than current levels in Alberta and Ontario.

This level of fiscal restraint would bring British Columbia to a balanced budget in 2026/27, even with non-renewable resource revenues removed from operating revenues. Excluding non-renewable resource revenue ($1.4 billion), total revenues in BC would be $85.0 billion in 2026/27. At present, the government's plan calls for total spending to be $92.7 billion, producing a deficit of $6.3 billion.

Figure 7 compares the government's current spending plan to the three-year nominal spending freeze described here. It also shows the adjusted revenue forecast in the preceding section, with resource revenue from natural gas removed from the operating budget. Together, the data in figure 7 show us that a nominal program spending freeze for three years—that returned the province to pre-COVID spending levels—would be sufficient to balance the provincial operating budget while also devoting all natural gas revenue to a BC prosperity fund rather than general revenues to finance day to day spending. The graph shows an increase in total spending in the scenario with frozen program spending because interest costs are projected to increase over the next three years.

By returning to pre-COVID real per-person spending levels, the BC government can balance the budget by the end of its current fiscal plan. In the process, it would reduce the amount of new net debt generated during this period by approximately $22.4 billion. We estimate that this reduction in debt, in turn, would reduce debt service costs by $719 million over the next three years, with further savings in all additional years.

In subsequent years, the fiscal framework outlined here would restrict the government to holding further spending increases to the rate of population growth plus inflation. This would allow the government to adjust to these cost pressures while also putting in place an anchor on spending that would help ensure balanced budgets in the years ahead. These topics are discussed in the next section.

Discussion: Summary of results and next steps

This section of this study has presented a fiscal framework for British Columbia with two key components. The first of these is saving rather than spending non-renewable resource revenue from natural gas. The second is returning to pre-COVID real per person spending levels over a three-year period and holding spending growth to the rate of inflation plus population change in subsequent years. The following table provides an overview of some important points of comparison with respect to fiscal outcomes under the framework proposed above compared to the status quo.

Table 1 shows several benefits to British Columbians over the next three years from the implementation of this fiscal framework. This period of deficit reduction, however, should be viewed as the beginning of the process of building a sustainable fiscal framework rather than

Table 1: Results of Smaller Spending Increases and Creation of a Prosperity Fund										
	Surplus/(deficit)		Net debt		Debt charges		Prosperity Fund value, end of year		Net debt to GDP	
	Budget	Revised	Budget	Revised	Budget	Revised	Budget	Revised	Budget	Revised
2023/24	-5,914	-5,914	73,728	73,728	3,300	3,300	0	0	18.1%	18.1%
2024/25	-7,911	-3,270	92,611	87,180	4,105	4,105	0	790	22.0%	20.7%
2025/26	-7,773	-2,700	112,056	99,566	4,815	4,533	0	1,986	25.5%	22.6%
2026/27	-6,288	3	128,789	106,339	5,676	5,043	0	3,669	28.0%	23.1%

Sources: British Columbia, 2023; British Columbia, 2024; Finance Canada, 2023; Statistics Canada, 2024a; Statistics Canada, 2024b.

the end. The long-term benefits would result only if the government is successful at continuing to hold spending growth to the rate of inflation plus population over the long term in subsequent years.

Provided that operating revenue growth from other sources keeps pace with inflation plus population, this framework would keep the province in a balanced operating budget while continuing to build a robust BC Prosperity Fund that could eventually become a substantial source of reliable revenue for the province.

Furthermore, to the extent economic growth and other factors caused revenue growth to outstrip population growth plus inflation, this would create operating surpluses that can create new fiscal options. One of these options is to use surpluses to pay off provincial debt. British Columbia's nominal debt burden and debt-to-GDP ratio have increased in recent years and will increase further in the next few years even with the adoption of the fiscal framework described above. In the long term, reducing the province's debt-to-GDP ratio is the key indicator of progress in this area; however, using operating surpluses for explicit deficit reduction can accelerate progress toward this goal.

Another option is the introduction of pro-growth tax policy changes, such as reversing the numerous tax increases implemented in recent years. Due to personal and corporate income tax hikes in recent years, BC has become less tax competitive relative to other Canadian provinces as well as nearby US jurisdictions with whom we trade and compete; personal income tax and corporate income tax reductions can help reverse these trends and contribute to productivity and economic growth.

This paper does not weigh the merits of various options, of which the above list is not comprehensive. Instead, we note that the adoption of the fiscal framework described in the preceding sections would create immediate fiscal benefits shown in Table 1 and would also create, in subsequent years, numerous options for reducing the debt burden on British Columbians and/or providing pro-growth tax relief while benefiting increasingly over time from the interest flowing from a growing BC Prosperity Fund. Through the adoption of a fiscal framework based on spending restraint and saving resource revenue for the future, BC's provincial government can reverse the fiscal deterioration of recent years, move provincial finances in the direction of sustainability and create opportunities for growth-enhancing policy reform.

Conclusion

British Columbia's fiscal position is deteriorating rapidly. In this paper, we provide a new fiscal framework designed to halt this trend. This framework has two key components: The first is to save rather than spend natural gas resource revenue so that these resources can be invested in financial assets that provide a stream of earnings for future residents. The second is to return spending to pre-COVID levels and then restrain spending growth to the rate of inflation plus population change in subsequent years.

We show that this approach can produce a balanced budget in three years while producing a range of options for additional benefits such as debt relief or tax reductions in the years ahead. We have also shown that this approach would produce a fiscal benefit for British Columbians immediately which would grow over time, in the form of reduced debt interest payments as well as a stream of new revenue from a growing prosperity fund to which natural gas revenues would be directed. The adoption of this framework would represent a transformation in the province's approach to fiscal policy and would reverse the trajectory of debt accumulation and deterioration of public finances that the province has been on in recent years.

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