Business Council *of* British Columbia

Submission to the Select Standing Committee on Finance and Government Services in advance of the 2009 Provincial Budget

September 29, 2008

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SUBMISSION TO THE SELECT STANDING COMMITTEE ON FINANCE AND GOVERNMENT SERVICES IN ADVANCE OF THE 2009 PROVINCIAL BUDGET

The Business Council of British Columbia is pleased to provide this submission to the Standing Committee on Finance and Government Services summarizing our perspective and advice on the 2009 provincial budget due to be presented next February.

By way of background, the Business Council, established in 1966, is an association representing approximately 210 large and medium-sized enterprises engaged in business in British Columbia. The Council's members are active in all major sectors of the provincial economy, including forestry, mining, manufacturing, oil and gas, financial services, petro-chemicals, utilities, transportation, construction, telecommunications, information technology, hospitality and tourism, wholesale and retail trade, agri-food, life sciences, film and television production, healthcare, education and the professions. The corporate members and associations affiliated with the Business Council account for approximately one quarter of all jobs in British Columbia and for more than three quarters of the province's exports.

1. ECONOMIC SETTING AND OUTLOOK

British Columbia's economy is slowing after several years of solid growth. Recent data indicate that economic conditions have softened since the beginning of 2008. The continued US housing slump, the still unfolding global credit crisis, and the onset of recession-like conditions in Europe and Japan are all taking a toll on BC's exports, manufacturing shipments, and international visitor numbers. The deteriorating outlook, both globally and in North America, will result in slower economic growth for BC (and other provinces) both this year and next. The September 2008 quarterly report from the Ministry of Finance projects that real GDP will increase by 1.7% in 2008, down from 3.1%

last year, followed by a modest pick-up (to 2.3%) in 2009. The Ministry's revised forecast is generally in line with the Business Council's current assessment. However, the extraordinary financial turbulence gripping the United States and many other developed nations argues for adopting a cautious near-term outlook, as at this point the risks to the economy are tilted very much to the downside. The Ministry of Finance will need to carefully monitor economic and financial market developments in the months leading up to the 2009 provincial budget.

Of particular relevance to BC is the impact of the dramatic downturn in the US housing market on forestry – the province's largest export sector, responsible for about 40% of our total merchandise exports. While the United States so far has managed to avoid a technical recession, homebuilding has contracted at an unprecedented rate, accompanied by widespread declines in housing prices. Coupled with the high Canadian dollar and the imposition of export taxes on cross-border shipments of softwood lumber, the US housing implosion has created the worst economic conditions in 50 years for logging operators and lumber producers in British Columbia.

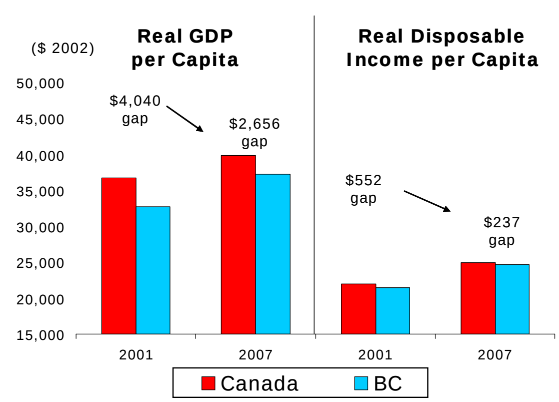
Indeed, the high Canadian dollar poses a challenge for many other trade-exposed BC industries, including pulp and paper, tourism, film production, mining, and many segments of secondary manufacturing. Since year-end 2006, the Loonie has moved up from 85 cents US to parity with the American dollar before falling back to 95-96 cents US by the end of the summer. A stronger domestic currency raises the US dollar cost of producing goods and services in Canada and makes it harder for many of BC firms to compete in the American market – the destination for almost two-thirds of the province's merchandise exports. The more than 50% increase in the Canada-US exchange rate since 2003 has fundamentally altered the competitive landscape for manufacturers and other export-oriented industries in British Columbia.

Until recently, the drag on our economy stemming from sagging exports and a widening trade deficit was more than offset by buoyant domestic demand. Since 2005, economic growth in BC has been primarily driven by record levels of construction investment, robust consumer spending, a strong recovery in the mining sector, and a red-hot job market. According to the latest edition of the Major Projects Inventory, project investment remains at a high level across the province. However, more of these projects are now "planned" rather than under way. Two other economic mainstays, retail sales and residential housing activity (both starts and sales), are also slowing. With domestic demand losing momentum and exports falling, the pace of job creation has eased. Nonetheless, we expect the province to post a solid gain in employment (2.0-2.3%) in 2008. Disposable incomes are also continuing to rise, thanks to higher wages, a still tight labour market, and lower income taxes.

Economic Fundamentals: A Positive Trend

While the short-term outlook points to a period of subdued growth, it should not be overlooked that BC has staged an impressive economic rebound over the past several years. Table 1 below summarizes BC's record vis-à-vis Canada on key metrics commonly used to gauge economic success, over the period 2002 to 2007 inclusive. The data tells a story of a province undergoing an economic revival, as well as one that has benefited from an expanding global economy. During the six-year period covered, British Columbia outperformed Canada on both aggregate and per capita GDP growth, as well as job creation, incomes, and retail sales. This contrasts with the pattern of the 1990s, when the province generally lagged behind Canada on most economic performance measures. In recent years BC has enjoyed a remarkably strong job market, characterized by well above-average employment growth, a steadily falling unemployment

Figure 1
Progress Closing the "Prosperity Gap" with Canada



Source: Statistics Canada, Provincial Economic Accounts.

rate, and rising labour force participation. Also worth noting is that since 2002, BC has narrowed (but not eliminated) the gaps that had opened up with Canada over the preceding two decades on two basic indicators of economic well-being: output (GDP) per person, and after-tax income per person (Figure 1).

Table 1

Selected Economic Indicators, BC and Canada

	2002	2003	2004	2005	2006	2007	Avg. 2002-07
Real GDP growth, % change							
Canada	2.9	1.9	3.1	3.1	2.8	2.7	2.7
BC	3.6	2.3	3.7	4.5	3.3	3.1	3.4
Real GDP per capita growth, % change							
Canada	1.8	0.9	2.0	2.1	1.7	1.6	1.7
BC	2.7	1.4	2.5	3.1	1.9	1.7	2.2
Real personal disposable income growth, % change							
Canada	1.7	2.2	3.6	2.6	4.9	4.0	3.2
BC	1.3	1.9	4.2	3.6	6.5	4.5	3.6
Real personal disposable income per capita growth, % change							
Canada	0.6	1.3	2.6	1.6	3.8	3.0	2.1
BC	0.4	0.9	3.0	2.2	5.0	3.0	2.4
Employment growth, % change							
Canada	2.4	2.4	1.8	1.4	1.9	2.3	2.0
BC	2.2	2.5	2.4	3.3	3.1	3.2	2.8
Unemployment rate, %							
Canada	7.7	7.6	7.2	6.8	6.3	6.0	6.9
BC	8.5	8.0	7.2	5.9	4.8	4.2	6.4
Retail sales growth, % change							
Canada	6.3	3.6	4.7	5.6	6.4	5.8	5.4
BC	6.3	2.7	6.3	4.4	6.8	7.2	5.6

Source: Statistics Canada, Provincial Economic Accounts.

2. PRIORITIES FOR BUDGET 2009

The September 2009 quarterly report from the Ministry of Finance forecasts a bigger surplus in 2008-09 compared with what had been anticipated at the time of the February budget ($1 billion, compared to $50 million).[1] It also predicts modestly larger surpluses over the following two years. The primary reason for this additional black ink is higher than expected revenues from natural gas (both royalties and revenue from the sale of Crown land leases). This revenue surprise underscores the benefits of having developed a significant

[1] These figures exclude forecast allowances.

upstream natural gas industry in BC – to say nothing of the potential that exists to further expand this high-value sector. Government revenues from the production of coal and base metals have also risen. Higher energy-and-mining related revenues are more than offsetting the decline in revenues from other sources which reflect a weaker economy (personal income tax, sales tax, and property transfer tax) as well as the fall-off in revenues owing to the severe problems afflicting the forest industry.

The government's disciplined approach to controlling expenditures has put the province in a favourable fiscal position to weather the current storms being generated by a slowing global economy, unsettled credit markets, and a shaky US banking system. With the exception of Health, Ministries continue to achieve their budget targets. Looking back, the government deserves credit for its excellent stewardship of the province's finances over the past several years. By meeting or (more often) exceeding all of its fiscal targets, the government has paid off much of the province's direct debt[2] and paved the way for a welcome decline in the net debt/GDP ratio. British Columbia's credit rating has been upgraded by all of the major rating agencies, as the burden of taxpayer-supported debt has dwindled from 23% of GDP in 2003 to 13.4% this year, the second lowest ratio among the ten provinces. This has happened even as the province has ramped up the level of capital spending. Budget surpluses and a shrinking debt/GDP burden have established a strong foundation for economic growth and business investment going forward.

Returning to the 2009 provincial budget, the Business Council recommends keeping the operating budget balanced and ensuring that the net or taxpayer-supported debt, measured as a share of GDP, remains among the lowest in Canada. We also believe it is important that government maintain its current capital spending program. According to the September 2008 quarterly report, planned capital outlays are slated to reach $6.2 billion this year, of which $2 billion represents investments by self-supporting commercial Crown Corporations and the rest spending by Ministries and other taxpayer-supported bodies. Substantial

[2] Direct debt consists of accumulated past operating deficits. It is distinguished from the portion of provincial debt which stems from borrowing undertaken to invest in infrastructure and other capital assets. Direct provincial debt has declined from $14.5 billion as of 2004-05 to an estimated $6.3 billion in the current (2008-09) fiscal year.

ongoing capital spending is necessary to meet the needs of our growing population and economy and to position the province to reap the benefits that will flow as Asia comes to occupy an ever larger place in the global economy. Home to two-thirds of the world's population and the source of 35% of global economic output, collectively the nations comprising East and South Asia are projected to account for at least 45% of all global economic activity by 2020. The transportation investments being made in BC under the umbrella of the Pacific Gateway strategy are essential to allowing our province – and indeed the rest of Canada – to capture the substantial economic benefits that are expected to result from the continued expansion of two-way trade and commerce between North America and Asia.

The Business Council strongly supports the province's strategy of using innovative public-private-partnerships (P3s) to accelerate the development of needed infrastructure and manage the risks borne by taxpayers. British Columbia is recognized as a North American leader in the use of P3s. Contrary to what is sometimes claimed, adopting P3 models for a limited number of capital projects has not caused the government to scrimp on public sector capital expenditures – indeed, the latest figures show that taxpayer-supported capital spending has almost doubled since 2004-05.

Tax Policy

To become one of the best places in North America to invest and do business, a small market economy like BC needs to embrace the concept of "smart taxation". Here too the government has accomplished a great deal. Since 2001, it has slashed personal and business taxes and made the tax system more supportive of investment, job creation and entrepreneurship. Today, British Columbia has competitive statutory income tax rates for both small and large companies; no general capital tax;[3] favourable tax provisions for venture capital, film production, international financial services, and mineral exploration; the second lowest top personal marginal tax rate in Canada; and the lowest personal income taxes in the country for individuals with incomes below $111,000. While the cost of doing

[3] The capital tax on financial institutions is being phased out over the next three years.

business for transportation and many trade-exposed industries will be pushed higher as a result of the recently enacted carbon tax, analysis undertaken by the Business Council suggests that offsetting cuts in business and personal taxes should be yield positive net results for almost all households and for many segments of business. That said, marginal effective tax rates on capital in BC remain high by the standards of OECD economies, mainly because the provincial sales tax (PST) is not based on a value-added model and thus acts to increase the cost of business purchases of a wide range of capital and other intermediate inputs.[4] To bolster BC's tax competitiveness, the government should be moving toward the adoption of a true value-added sales tax model in place of the existing provincial sales tax.

Despite recent progress on the tax front, BC policy-makers need to be alert to tax changes being made by other jurisdictions. British Columbia continues to face stiff competition for talent and for new business investment from Alberta, the western US states, and offshore jurisdictions, particularly in sectors like high technology, research, tradable services, advanced manufacturing, and the location of high-value corporate functions. In addition, BC lags behind other provinces in machinery and equipment (M&E) investment per employee. This matters because M&E investment embodies advances in technology and is a key determinant of increases in productivity. That British Columbia has long underperformed Canada in M&E investment helps to explain the province's poor record on productivity growth.[5]

The consultation document issued by the Ministry of Finance in September indicates that there is scope for tax reductions in the 2009 budget. Below we list a number of suggestions for tax relief.

[4] For an up to date discussion of the impact of provincial sales taxes on marginal effective tax rates, see Duanjie Chen and Jack Mintz, Limited Horizons: The 2008 Report on Federal and Provincial Budgetary Tax Policies (C.D. Howe Institute, July 2008).

[5] For a recent review, see A. Sharpe and J. Arsenault, ICT Investment and Productivity: A Provincial Perspective (Ottawa: Centre for the Study of Living Standards, September 2008).

Manufacturing Sector

Large segments of Canadian manufacturing are under severe economic pressure due to the strong Canadian dollar, rising energy and other input costs, the thickening Canada-US border, and intense offshore competition. Secondary manufacturing in BC is feeling the same pain as manufacturers in central Canada. Manufacturing is a vital part of the BC economy. The value of manufacturing shipments will reach $48 billion this year. Some 205,000 British Columbians work in manufacturing-related jobs – jobs which on average pay higher wages than most other sectors. Increasingly, experts agree that the survival of manufacturing in Canada (and BC) will require a stepped up pace of investments aimed at boosting productivity.

- To support manufacturing and encourage greater value-added production in British Columbia, we recommend that the government introduce a "refundable plant modernization[6]" tax credit designed to spur investment by manufacturers in productivity-enhancing equipment and technologies. The tax credit would be applied toward new investments in Capital Cost Allowance asset class 43; and eligible companies should be able to carry the credit forward.

Carbon tax

Under the carbon tax shift policy which the province introduced earlier this year, a new levy has been imposed on the domestic consumption of fossil fuels, with offsetting reductions in personal and business taxes. The carbon levy is expected to rise gradually over time. Business Council analysis shows that approximately two-thirds of the carbon tax will be paid by businesses, while a similar proportion of the accompanying tax cuts will be directed to individuals and households. Our rough calculations indicate that BC's escalating carbon tax will impose $500-$600 million in extra costs on "trade-exposed" industries over the next three years (plus at least $100 million of additional costs on the commercial transportation sector by 2010). Most of these "carbon-intensive" industries won't be able to pass on higher

[6] A refundable tax credit would be beneficial to eligible businesses regardless of whether they are profitable or in a loss-making position.

fossil fuel costs to their customers. Moreover, because other North American jurisdictions haven't legislated their own carbon taxes (and aren't likely to), many manufacturers and other energy-intensive businesses operating in British Columbia will be put a competitive disadvantage as the province's carbon tax rises over time.

To help industry cope with a gradually rising carbon tax, the Business Council recommends that government implement measures to mitigate the negative impact of the tax on trade-exposed and other vulnerable industry sectors. Some suggestions:

- Institute a refundable tax credit to spur investment in energy-efficiency and carbon-reducing equipment and technologies that would apply to a select group of industries judged to be especially exposed to the carbon tax.[7]
- Establish a rebate program to accelerate the retrofitting of large commercial vehicles with proven energy-efficiency technologies.
- Consider carbon tax offset mechanisms to assist BC businesses in trade-exposed industries that are in a loss-making position (and therefore won't benefit from lower corporate income tax rates). One idea is a PST offset on purchases of hydroelectricity and other forms of energy.

Innovation and Commercialization

British Columbia's long-term prosperity depends on building a more innovative and diversified economy. While the province has made progress in developing a competitive advanced technology sector, on at least some measures our high technology industries appear to have fallen short of reaching their full potential.[8] Other jurisdictions in North America and elsewhere have made aggressive use of tax policy and other policy instruments

[7] This can be accomplished by limiting the tax credit to investments in certain types of assets that qualify for capital cost allowances under the federal Income Tax Act.

[8] The share of the province's GDP accounted for by what BC Stats defines as high technology industries has increased by less than half of one percentage point since 1997. Moreover, BC lags behind Ontario, Quebec, Alberta and a majority of American states in the size of the high technology sector relative to provincial/state GDP.

to stimulate innovation, commercialization and the growth of advanced technology industries. British Columbia can learn from their experience.

- BC should examine the tax exemption for commercialization introduced earlier this year by Ontario. In its 2008 budget, Ontario announced a ten-year holiday from provincial income tax for companies formed to commercialize intellectual property developed by qualifying Canadian universities, colleges, and research institutions. The BC government should determine whether a similar measure makes sense for our province.
- The province should look at further broadening the scope of the *International Financial Activities Act* (which provides an exemption from BC corporate income tax for certain international financial activities and for life sciences activities that lead to the granting of patents), to capture additional types of business activity (e.g., software development leading to patents, mining finance, etc).

Skilled Workers

In its 2006 report, the BC Competition Council[9] argued that lowering personal income tax rates for individuals earning between $70,000 and $150,000 would make it easier for BC employers to attract and retain the skilled knowledge workers on which competitive success increasingly rests.

- The Business Council recommends that government increase the income threshold at which the highest provincial personal tax rate applies to $150,000.[10] The annual cost of this proposal is estimated at $40 million.

Medium Term Tax Reforms

Looking beyond Budget 2009, we believe the province must do more to foster economic diversification and accelerate the growth of export-capable industries in areas like advanced technology, health-related products, secondary manufacturing, financial services, and other

[9] Report of the BC Competition Council (June 2006).
[10] At present, the top provincial tax rates applies on incomes above $97,636.

tradable services. In particular, over time the government should further reduce marginal effective tax rates on new business investment, which remain higher than in a number of other provinces and many OECD jurisdictions.[11] Effective tax rates differ from statutory business income tax rates because they take into account the impacts of taxes on production inputs, capital taxes, capital cost allowances, and other provisions that affect the after-tax returns on private sector investment in fixed capital. Reducing marginal effective tax rates would stimulate investment in new machinery, equipment and technologies – precisely the kinds of investments that many academic studies have shown are critical to raising business sector productivity.

- Reducing marginal tax rates on capital investment can be accomplished in two main ways: 1) lowering BC's corporate income tax rate; and 2) reducing sales taxes on business inputs, either by further extending the current list of exempted inputs or, preferably, shifting to a value-added consumption tax model.

The business community has long been concerned about the unfairness of the current property tax regime in British Columbia. Province-wide, the average property tax ratio (the tax rate on business properties relative to the residential class rate) has risen from 2.5 to 3.7 since 1990. Among the various classes of business, the heaviest property tax burdens are imposed on Major Industry, Light Industry and Utilities. There is compelling evidence that BC's business property tax system discourages investment and acts as a competitive handicap, particularly for capital-intensive industries.[12] The existing system is unwieldy and economically counterproductive because of the large number of property classes, the absence of an appeal mechanism, and the fact that municipal governments are free to set tax rates and ratios without any limits – and can (and do) arbitrarily shift the tax burden onto specific types of business.

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[11] Jack Mintz, 2007 Tax Competitiveness Report, C.D. Howe Institute, Commentary (September 2007); Duane Chen, Jack Mintz and Andrey Tarasov, Federal and Provincial Tax Reforms: Let's Get Back on Track, C.D. Howe Institute, Backgrounder (July 2007). .

[12] Robert Bish, "Property Tax on Business and Industrial Property in British Columbia: Comparisons and Business Climate Observations," University of Victoria School of Public Administration, Working paper #11 (October 2003).

- As an initial step, we recommend that the province move to legislate maximum ratios between municipal property taxes on residential as compared to various classes of business property. This would put some limits on the ability of local governments to shift the property tax burden on to local business and industry.

Spending Proposals

This year, the provincial government will spend close to $38 billion, up from $30.6 billion in 2004-05. In broad terms, the Business Council sees no evidence that the overall level of provincial program spending is insufficient to deliver the services that British Columbians want and expect. Undoubtedly, there is room within a budget fast approaching $40 billion to reallocate resources to higher priority areas by spending less on ineffective programs and activities and by continuing to search for efficiencies in the design, management and delivery of services.

There are two areas of spending where we wish to offer specific comments.

The first is *post-secondary education*. A well-educated population and work force is critical to developing and maintaining a prosperous economy. In this regard, the scope and caliber of post-secondary education and training programs are especially important. British Columbia has a well-developed system of public post-secondary institutions that play a key role in providing the skills and talents that employers need. Many of these institutions also produce new knowledge and innovative technologies that can help to build successful local businesses. The province's universities, colleges and institutes require a stable framework of public funding coupled with a strong ongoing government commitment to support excellence in research and to facilitate the attraction and retention of top talent.

- The Business Council recommends that the province provide predictable multi-year funding envelopes to all public post-secondary institutions.
- We also recommend that the province increase funding for programs designed to attract top-flight international graduate students to BC. Recruiting world class

graduate and post-graduate students will help to build the knowledge economy, particularly in fields where academic-industry partnerships exist or can be developed.

Finally, the Business Council recognizes that government has a central role to play in dealing with the *social challenges facing many of our communities* – notably homelessness, substance abuse, mental health challenges, and low levels of literacy. We commend the government for the initiatives it has launched in all of these areas. Going forward, we are persuaded that additional public resources will be required to address BC's most pressing social problems.

3. CONCLUSION

The economic landscape in which British Columbia operates has shifted over the past decade. Among the most obvious trends re-shaping the economic environment for BC businesses and workers are the expanding role of Asia in the global economy; continued rapid growth of international trade and investment; advances in information and communications technologies; the emergence of new competitors for some of our biggest industries (e.g., pulp and paper, wood products, agri-food, electronics, tourism, film); higher energy costs; and mounting concerns over climate change and other environmental issues.

The province is adapting to these new realities. As a small open economy, British Columbia must be competitive on a global – and, especially, a North American – scale if we hope to achieve a high and rising standard of living. Although the province has been enjoying an extended economic upswing, there has been a significant cyclical component to the post-2002 expansion. British Columbia has reaped gains from strong growth in Asia and high prices for energy, metals and some other commodities. The province has also benefited from a long period of relatively low interest rates, which helped to fuel high levels of residential and non-residential investment, both of which are expected to ease within the next few years. Unfortunately, the short-term economic outlook for BC is clouded by the weakening global economy, the US housing slump, the high Canadian dollar, and the unsettled state of financial markets. In this setting, the challenge for government is to stay the course with sound fiscal management and continue to focus on ways to strengthen the foundations for long-term prosperity.

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The Business Council appreciates the opportunity to appear before the Legislative Standing Committee on Finance and Government Services.