



Business Council *of*
British Columbia

**Preliminary Advice on the
2010 Provincial Budget**

**Submission
to the
Select Standing
Committee
on Finance and
Government Services**

September 28, 2009



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British Columbia

**PRELIMINARY ADVICE ON THE 2010 PROVINCIAL BUDGET:
SUBMISSION TO THE SELECT STANDING COMMITTEE
ON FINANCE AND GOVERNMENT SERVICES**

The Business Council of British Columbia is pleased to provide this submission to the Select Standing Committee on Finance and Government Services, outlining our initial views and advice in respect of the 2010 provincial budget to be presented next March.

By way of background, the Business Council, established in 1966, is an association representing approximately 250 large and medium-sized enterprises. The Council's members are active in all major sectors of the provincial economy, including forestry, mining, manufacturing, oil and gas, chemicals, utilities, financial services, transportation, construction, telecommunications, information technology, hospitality and tourism, wholesale/retail, communications, agri-food, life sciences, film and television production, healthcare, education and the professions. Taken together, the corporate members and associations affiliated with the Business Council account for approximately one quarter of all jobs in British Columbia.

1. ECONOMIC OUTLOOK AND KEY CHALLENGES

After a difficult year, there is mounting evidence that the global economy has turned the corner and is now emerging from the steepest and longest downturn since the Great Depression. Several months ago, the economic news started to shift from bad to "less bad," and more recently it has improved further. Major industrial countries including Germany, France, Great Britain and Japan which were hard hit by the global recession are all growing again and helping to spark the recovery process. A key piece of the puzzle is the health of the financial system. Although it remains fragile after the traumas of the past year, conditions are considerably better than they were 6-12 months ago.



With the clouds lifting on the global economy, the debate has now shifted to the strength and shape (double-dip, U-shaped, V-shaped?) of the recovery. At this stage, most forecasters expect a relatively weak recovery, as it will take time to work through the fallout from the 2008-09 financial crisis and the first global recession in 60 years. An abundance of research shows that recoveries following recessions precipitated by severe financial distress are protracted, since it takes time to restore financial stability, write off bad loans, deal with bankruptcies and foreclosures, and ultimately restore confidence in the system. In its latest Global Financial Stability Report, the International Monetary Fund highlights the difficulty of restoring solid growth in the wake of economic downturns triggered by financial crises.

Some forecasters – albeit a minority – do anticipate a strong recovery. This optimistic group looks to history and notes that deep recessions tend to be followed by sharp rebounds. Such rebounds come as a surprise because just as people have resigned themselves to a lengthy downturn, things start to improve. Lending some support to this view, international agencies and banks recently have upgraded their outlooks for 2009 and 2010. An earlier and stronger-than-expected rebound, for example, has led the TD Bank to add nearly a full percentage point to its global growth projections for both 2009 and 2010. The RBC Financial Group has also revised up its forecasts for growth in 2009 and 2010 in its latest update.

One reason for optimism is the robust economic recovery taking shape in Asia. There the upturn actually took hold several months ago. The Asian NICs (Hong Kong, Singapore, Taiwan, and South Korea) collectively grew at an annualized rate of 18.6% in the second quarter, the second fastest pace in the past 25 years.¹ Several of these countries have enjoyed an unexpected boost in domestic demand and successfully implemented stimulus packages. China has also proven to be remarkably resilient, despite a slump in demand for its exports in the United States and other western economies. China's real GDP is now forecast to increase by at least 8% this year, with even stronger growth in store for 2010.

¹ TD Economics, Quarterly Economic Forecast, September 23, 2009.



Although the global economy is emerging from its deepest postwar downturn, it may be premature to claim that the positive momentum has fully extended to the major industrial economies. In particular, as the American economy regains its footing and shifts to positive growth in the third quarter, Canadian forecasters are rightly cautious about a quick return to buoyant economic conditions stateside. Looking past the lift provided by inventory rebuilding and the stimulus flowing from large federal deficits and rock-bottom interest rates, a number of factors are likely to weigh on the US recovery in 2010. In this regard, a fundamental consideration is the wealth hit experienced by US consumers since mid-2006 – household net worth has dropped by \$12.5 trillion, representing about one-fifth of total household wealth, as housing prices have fallen roughly 30% and financial assets have also declined. American households are now increasing their net savings in a bid to repair balance sheets and re-build net worth. This process will almost certainly constrain the growth of consumer outlays over the next few years.

Another worry is the US labour market. Job growth stateside will probably resume in early 2010, but this will not stop the unemployment rate from breaching the 10% mark. There is also a widespread expectation that employment growth will remain muted as companies postpone hiring until they see convincing evidence of a sustained rebound. Sub-par job gains will keep incomes growing at a tepid pace through 2010 and limit the recovery in consumer spending.

Fortunately for BC, housing starts in the US appear to have bottomed and are showing tentative signs of improvement. New home sales are now rising, bringing inventories down to 7.5 months' supply from 12.4 months at the beginning of the year. Buyers are stepping into the market in greater numbers. Anecdotally, in San Diego, one of the hardest hit housing markets, some projects are sold out and there are waiting lists for homes. Overall, the evidence points to further gains in US home building in the coming months.

That said, the US housing sector still faces stiff headwinds and it will take a couple more years for starts to get back to the one million mark from their current level of 580,000 units. The good news for the BC forest sector is that, over time, American housing starts will gradually climb back to the demographically-driven rate of 1.4-1.5 million units



annually. But this won't happen overnight. At some point in the next 12-18 months, mortgage rates will begin to creep higher, impinging on affordability and sales. US builders also face competition from the still sizable inventory of existing homes, although here too the supply has dropped to 8.5 months from the recent average of 11 months. The Obama administration is studying whether to let the first time home buyers' \$8,000 tax credit expire at the end of November as scheduled. There is a chance that the tax credit may be extended through 2010.

Apart from the US economic situation, another factor shaping the external climate for British Columbia is the exchange rate. The Canadian dollar has emerged as a key risk clouding the outlook for BC. The Loonie is again rising in value against the US greenback, challenging the competitiveness of many Canadian export sectors – including lumber, pulp and paper, energy, tourism, and film production, all important industries in BC. After retreating below US 80 cents at the end of 2008/early 2009, the Loonie has jumped back above 90 cents and is currently trading at US 92 cents. Currency appreciation raises the cost of BC goods shipped to the US, a cost that is typically absorbed by exporters in the form of shrinking margins. A convincing recovery of the global economy is likely to prompt higher oil prices, possibly putting further upward pressure on the Canadian dollar over the next year. Of concern, a number of forecasters see the Canadian dollar trading at parity with the US currency some time in 2010.

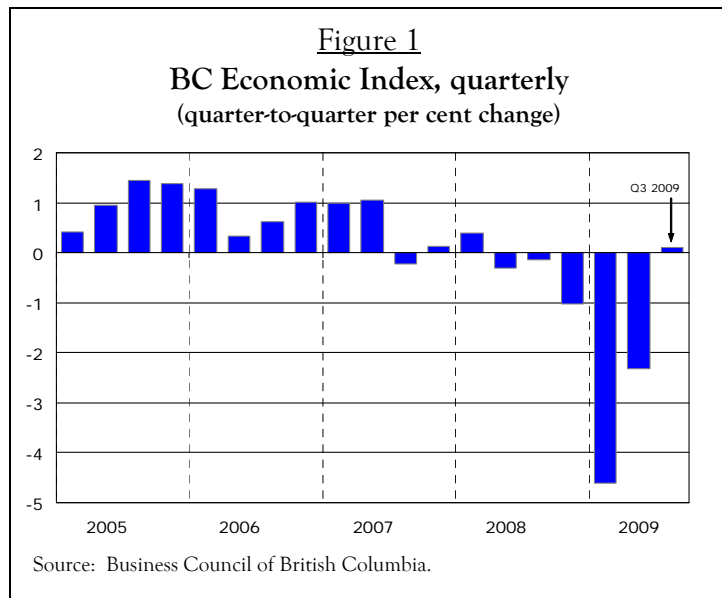
Tourism is one BC export sector that is directly affected by the currency. In addition to the recession, border security issues, and passport requirements, the stronger Canadian dollar continues to chip away at the number of US visitors travelling north. Not surprisingly, same-day American visits to BC have fallen off markedly and the number of US tourists coming for longer trips has also dwindled. The BC tourism industry's nervousness about the potential impact of the Harmonized Sales Tax must be understood against the backdrop of the significant business challenges the industry has been grappling with since the early part of the decade.



BC Economy – Better Days Ahead

Based on the most recent data, we believe the provincial economy has emerged from its deepest recession since 1982. Last year's (2008) slight contraction in economic activity was due almost entirely to a sharp downturn in provincial exports. While growth also slowed in other key segments of the economy, such as consumer spending, no other component of aggregate demand registered an outright contraction. But with domestic demand softening, last year's fall in exports was large enough to pull GDP growth into negative territory. Towards the end of 2008 and in early 2009, sentiment shifted quickly and the malaise spread to the domestic side of the economy. Job losses mounted and the unemployment rate doubled in a relatively short period of time. The provincial recession probably started in the second quarter of 2008, four or five months after the US recession began.

After five negative readings punctuated by a steep drop in the first quarter of 2009, however, the Business Council's quarterly

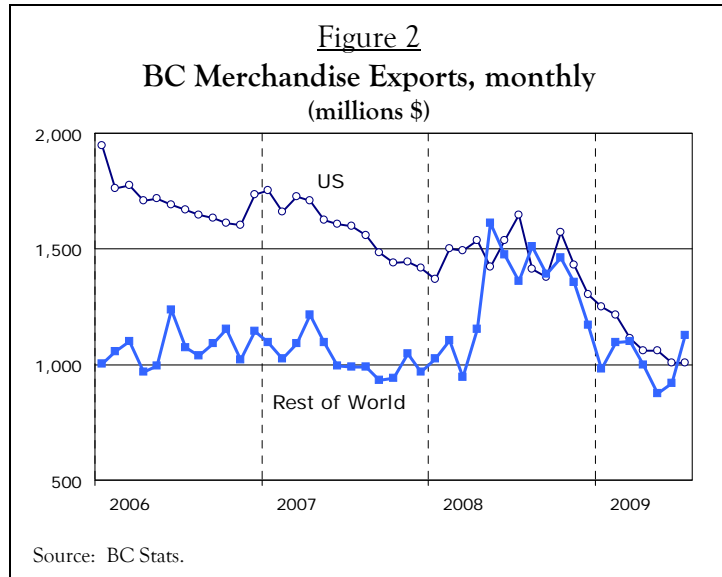


BC Economic Index turned positive in Q3 2009. This upturn is a promising sign, as the Index, which is designed to track current economic conditions, has a good track record of identifying turning points in the economic cycle. The latest reading of the BC Economic Index provides further evidence that the recession is over.

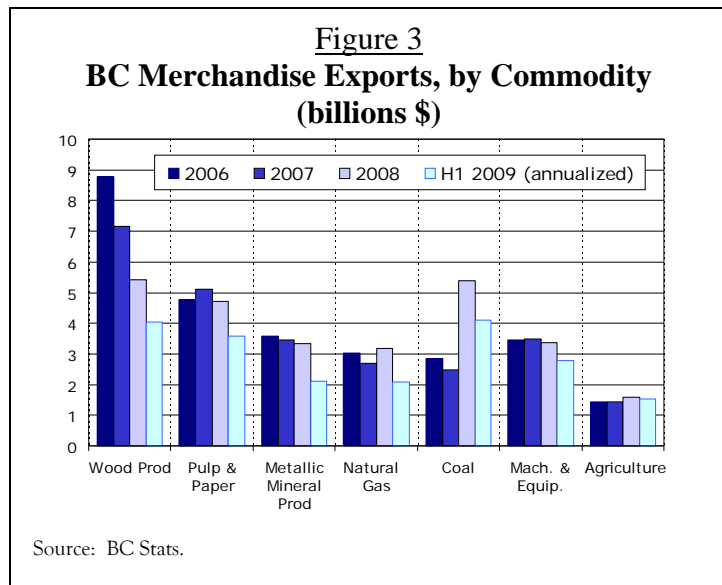
For BC, as for many other jurisdictions, the critical question now is how strong the recovery will be. A big piece of the puzzle lies in exports and commodity prices. Just as the collapse in trade volumes and commodity prices pulled BC's economy down, a rebound in trade flows and firmer commodity prices should provide a boost. The outlook for BC's exports over the next 1-2 years is modestly positive. There has already been an



upturn in export sales in recent months. As shown in Figure 2, the value of exports to the “rest of the world” is where the largest gains have been made, reflecting the fact that Asia is recovering and purchasing more raw materials as economies in that region step up production.



Our optimism about developing Asia’s ability to support export growth, however, is tempered somewhat by the outlook for the US. The American economy, like Canada’s is beginning to grow again, but as noted above consumer spending will be crimped by wealth declines and a second wave of mortgage resets which come due in the first half of 2010.



As evident in Figure 2, most of the decline in BC’s exports over the past 18 months is attributable to the drop in shipments to the US. US bound exports are now half of what they were at the outset of 2006 – which speaks to the magnitude of the US downturn generally and the collapse in housing starts and natural gas prices in particular. In order for a strong expansion to take hold in BC, the value of US-bound exports will have to grow.

Shipments to the US now account for half of the province’s merchandise exports. So in broad terms exports to the rest of the world and those to the US are of now equal importance. This pattern underscores the ongoing realignment of global economic activity

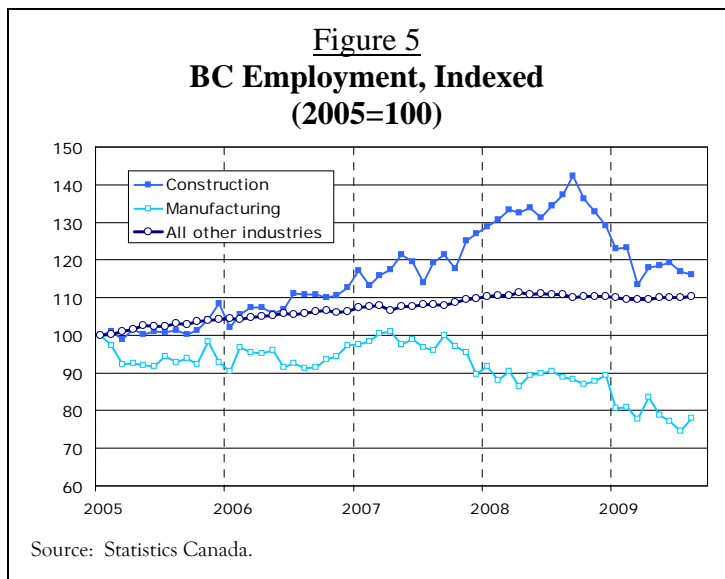
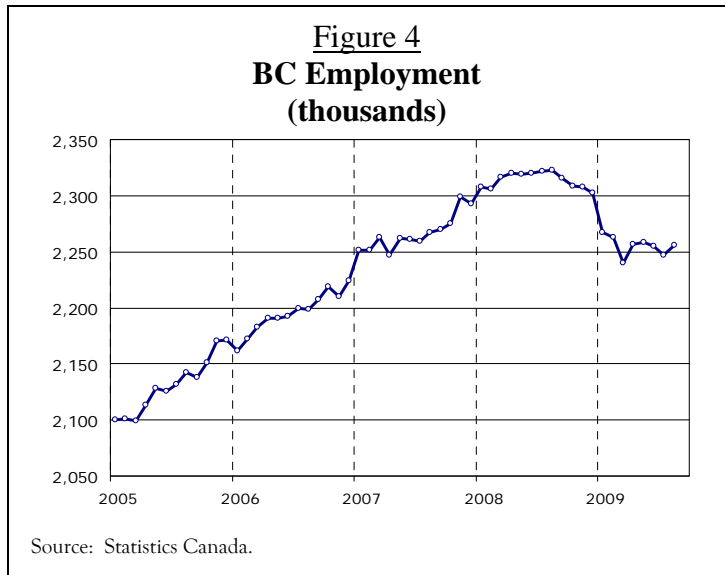


and trade patterns. One plus from this shift is that BC is relatively well positioned to benefit from the growing clout of Asian demand in the global economy. Exports destined to Asia, however, consist overwhelmingly of raw materials and resource goods, meaning that a recovery for exports more advanced and value-added manufactured products still depends on the American market.

On the domestic side of the BC economy the sharp fall in housing starts in the past year and slowing business investment have taken a toll on jobs and activity in the construction sector. Home building and non-residential construction were major drivers of economic growth in the previous 5-6 years.

But housing starts have plummeted from 3,000 per month to just 1,000 since last fall. Not surprisingly, the downdraft in starts was accompanied by sizable job losses in the construction sector and sagging retail sales in sectors like home furnishings and appliances.

Home building is now showing signs life. Low mortgage rates and some price corrections have improved affordability and spurred housing sales. In response builders are cautiously starting some new projects.





Consistent with other jurisdictions across North America personal consumption in BC went from underpinning robust provincial growth to barely advancing at all over the second half of 2008 and during the early months of this year. In fact, retail sales (which form a big part of overall consumption) declined by nearly 10% year-over-year in the first half of 2009. Slower job growth will dampen consumer spending in the near term, but BC is not facing the kind of hangover in the housing and financial sectors that is plaguing the United States. For this reason, we are more optimistic about consumption growth in BC.

Summary and Risks

Adding it all up, we believe the global economy could surprise on the upside in the next year. Conditions are set to improve in the US, but the global turnaround will be driven in large part by Asia and other emerging markets. As we move through the remainder of 2009, the provincial economy should continue to gather strength. Pronounced weakness in the first half of the 2009 will cap growth for the full year at around minus 2%, but in 2010 we now see real GDP expanding by as much as 3%. This represents an upgrade from the Business Council's June 2009 forecast. And it paints a happier picture than the modest 1.9% real GDP growth projected for next year in the September Budget Update. The 2010 Olympics will provide a welcome, albeit short-lived, lift to economic activity in early 2010. Longer term benefits related to Olympic exposure and investment will take time to materialize and are difficult to quantify.

2. PRIORITIES FOR BUDGET 2010

The government deserves good marks for its prudent management of British Columbia's public finances over the period 2001 to 2008. Thanks to significant debt repayment and sizable tax cuts (both personal and corporate), the province was in a favourable position to weather the recent global downturn and the shockwaves which the 2008-09 financial crisis continues to send through parts of the economy.

Taxpayer-supported debt, which is the best metric for gauging long-term fiscal sustainability, declined steadily as a share of British Columbia's GDP from a peak of 21.3% in 2003 to 13.3% GDP as of last March. Surplus budgets and a shrinking debt/GDP



ratio contributed to a positive climate for economic and business growth in the period prior to the recent recession.

It is regrettable that the province has been pushed back into deficit due to the onset of an unexpected global recession. According to the September Budget Update the government will post a record deficit of \$2.8 billion in 2009-10 and continue to run deficits for the following three years. The Business Council believes a return to operating deficits is the right decision given the extent and swiftness of the global downturn. All across the developed world jurisdictions have seen their fiscal positions erode and budget deficits soar. However, it is disconcerting that BC's net debt/GDP ratio will be rising just as the front-end of the baby-boom is starting to retire. Going forward, it is important that the government meet the fiscal targets outlined in the September Budget Update and maintain a credible commitment to balance the operating budget by the end of its term.

Harmonized Sales Tax

Amid these challenging economic times the government opted to advance the agenda of tax reform by unveiling a proposal to replace the Provincial Sales Tax with a Harmonized Sales Tax integrated with the federal GST. This decision was motivated by Ontario's announcement that it intends to adopt the HST in 2010. While the BC government's move caught many by surprise, we believe that introducing the HST is an important step toward building a more productive and competitive BC economy.

From a macro perspective, there are many reasons why shifting to a value-added sales tax like the HST makes sense. Most significantly, it will remove all current PST from business inputs -- intermediate inputs as well as capital purchases. While the PST is often viewed as a "consumption" tax, the reality is that it is really a "hybrid" tax that applies to elements of both consumption and production. Approximately 40% of PST revenue is paid by businesses on a wide variety of inputs. This represents additional costs to produce goods and services in BC, in the range of \$2 billion annually. Under the proposed HST, the PST on inputs is removed, as the 7% provincial portion will be credited along with the 5% GST for all goods and services purchased for business operations.



Economists recognize that taxes on capital and other intermediate inputs have long-lasting negative effects, notably by raising the cost of private sector investment in machinery, equipment, technology, vehicles, construction materials and other components of the capital stock, which in turn hampers productivity and dampens wages. So eliminating the retail sales tax is sound economic policy. As the C.D. Howe Institute has observed, with a value-added tax such as the proposed HST,

“...construction investment would increase, as would business spending on machinery and equipment. The reason is that the tax burden on business capital investment would drop significantly. Labour productivity would improve, and with it workers’ wages.”²

A recent study from the Organization for Economic Cooperation and Development (OECD) underscores the long-term economic benefits of removing sales tax from business inputs. Drawing on previous Canadian research, the study estimates that reducing consumption taxes on business inputs by the equivalent of 1% of GDP would yield a 3.1% increase in the level of Canadian GDP. This result reflects a higher after-tax marginal product from the acquisition and deployment of new capital, which in turn “raises savings and investment and leads to a higher capital stock, hence greater output, income and wealth.” Moreover, over time a higher marginal product on capital also “stimulates labour supply, because the real wage rises along with the capital stock.”³ In contrast, a pure or value-added consumption tax is far less damaging to long-term productivity, output and income. Specifically, the OECD estimates that reducing a value-added consumption tax by the equivalent of 1% of GDP has relatively little impact on the level of Canadian GDP.⁴

² F. Poschmann, “Sales Tax Reform: The Time is Right,” C.D. Howe Institute e-brief, March 20, 2009.

³ A. Bibbee, “Tax Reform for Efficiency and Fairness in Canada,” OECD Economics Department Working Paper No. 631, August 2008, pp. 10-12.

⁴ *Ibid.*, p. 12. A recent in-depth treatment of the impact of different types of taxes on economic performance, based on state-of-the art research and international experience, can be found in A. Johnson et al, “Taxation and Economic Growth,” OECD Economics Department Working Paper No. 620, August 2008.

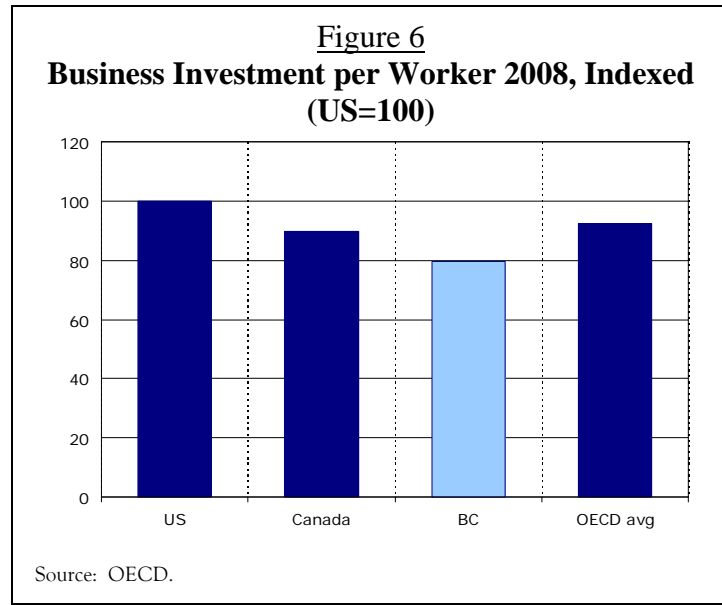


For British Columbia, establishing a policy framework that stimulates investment is especially important because of the province's lacklustre performance in investment per worker (as shown in the accompanying chart). Moving to a value added consumption tax is probably the single best thing the province can do to encourage investment and ensure an up to date capital stock.

Another benefit of harmonization is reduced compliance costs and greater administrative simplicity. Under the current system of different and administratively

unconnected BC and federal sales taxes, businesses have to remit separately to the federal and provincial governments and ensure they are in compliance with two sets of tax rules (including a litany of exemptions in the case of the PST). Administrative costs should be far lower once the proposed HST is implemented.

In general, with the HST the province will adopt the same tax base as the federal GST. However, BC has announced that it will provide "point of sale" rebates and tax credits for the provincial portion of the HST for certain purchases. The government also intends to provide partial rebates for the provincial portion of the HST paid by charities, eligible non-profit organizations, and various public sector bodies (hospitals, universities, school boards, local governments). The Business Council recommends that the province take steps to minimize any extra costs for public sector bodies under the HST. We are particularly concerned that the HST not lead to substantially higher costs for universities and colleges, at a time when enrolment is growing and the need for a well-educated workforce has never been greater.





A key feature of shifting from a retail to a value-added sales tax is that the tax base is broadened so that many items – especially services – that now are exempt from the PST (but that are covered by the GST) become subject to the full combined 12% HST. Consumers will pay an additional 7% on purchases of services and some goods that previously were untaxed by the PST. But contrary to what many believe, the net result is not to raise the cost of these items to the final consumer by 7%. The reason is that the prices of most goods and services sold in the BC market will fall as the costs imposed on businesses by the PST disappear. A recent report from TD Economics indicates that adopting the HST will lead to a small (0.7%) permanent increase in the Consumer Price Index.⁵ Again, experience in Quebec and the Atlantic provinces indicates that the reduced sales tax on business inputs was indeed passed on (and surprisingly quickly) to domestic consumers in the form of lower (pre-tax) prices.⁶ This outcome is not surprising in a competitive marketplace; while the retail sales taxes imposed on business inputs are hidden from consumers, the businesses that pay these taxes naturally will seek to pass the costs on to consumers.

Consumption taxes are sometimes criticized for being “regressive” by disproportionately affecting lower income households. To address this legitimate concern, the provincial government intends to provide a refundable HST credit which will be paid quarterly along with the existing GST credit and carbon tax credit to lower income individuals.

Although the Business Council supports the HST, we recognize that a few industry sectors have concerns about how the tax may affect their businesses.

One is homebuilding. The government plans to structure the HST so that new homes up to \$400,000 in value will bear no more tax under the HST than they do with the current system in which builders pay PST on construction materials (and some other inputs). For new homes priced over \$400,000, the province will provide a flat rebate of around \$20,000. While these are positive steps, under the HST net costs will be higher for some

⁵ TD Economics, “The Impact of Sales Tax Harmonization in Ontario and BC on Canadian Inflation,” September 18, 2009.

⁶ See Michael Smart, “Lessons in Harmony: What the Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax,” CD Howe Institute, July 2007.



categories of new homes – including many single family homes. Given the high cost of new housing in urban British Columbia, the government should consider additional measures to mitigate the impact of the HST. Instituting a higher threshold beyond \$400,000 and a bigger rebate, linked to housing price differentials in regional markets, is one idea. Exempting new houses from some or all of the Property Transfer Tax would also ease the burden. We urge government to carefully consider these suggestions. We also recommend the introduction of a transitional grandfathering provision for sales contracts reached prior to the implementation of the HST so that home buyers are not faced with unanticipated costs for projects that are already under way.

The tourism and hospitality sector has also voiced concern that the HST will be an added cost for visitors. There is no simple fix to the issues in this sector. It must be noted that in committing to reduce the small business income tax rate to zero by 2012, the province has taken a significant step that will benefit many small and mid-sized tourism and hospitality businesses. We recommend that the province continue to work with the Council of Tourism Associations to explore measures that can assist tourism operators by lowering government-imposed costs, fees and regulatory requirements.

3. OTHER ISSUES

Beyond the HST, there are other areas where provincial action is needed to strengthen BC's competitiveness and foster economic development.

One is the business property tax. Province-wide, the average property tax ratio (the tax rate on business properties relative to the residential class rate) has risen since 1990. Most property tax is collected by municipalities, although regional authorities and the provincial government⁷ also levy property taxes. Among the various classes of business, the steepest property tax burdens are imposed on Major Industry and Utilities. Academic studies show that BC's business property tax system hinders both greenfield industrial investment and

⁷ The province levies property tax on residential and business properties for school purposes.



re-investment in existing manufacturing facilities. It is particularly damaging to capital-intensive industries like pulp and paper, lumber manufacturing, chemicals, and mining.⁸

As we have noted in previous submissions to this Committee, BC has the most anti-competitive business property tax regime in Canada: 1) there is an unusually large number of business property classes; 2) municipal governments are free to set their own tax rates and ratios and to shift the property tax burden onto specific types of business; and 3) there is no administrative appeal mechanism to review the fairness of local decisions. The evidence shows that some (but certainly not all) municipalities in BC today impose property tax burdens on major industry that are punitive and among the highest in North America. The BC Competition Council drew attention to this issue in its 2006 report. We acknowledge the government's moves to lighten the provincial portion of industrial property tax over the past year. Looking ahead, we recommend that the province put some limits on the ability of municipalities to set property tax rates on major industry. This could be done by establishing a single province-wide rate for all class four properties, or by legislating "fairness ranges" to control the tax rates that municipalities can charge to different types of property.

A final issue that warrants brief mention concerns fees imposed on businesses holding waste discharge permits from the BC Ministry of Environment. Research by the Business Council and several of our members indicates that such fees are significantly higher in BC than in other provinces. In addition, in BC the fees are based on the maximum limits prescribed in the permit, not on the actual amount discharged. We urge the Ministry of Environment to immediately modify its discharge permit fee system so that fees are based on actual volumes discharged. Not only would this regulatory change produce a cost saving for many permitted facilities, but it would also provide a stronger incentive to minimize emissions. We also recommend that the Ministries of Environment and Small Business, Technology Economic Development jointly complete a review of waste permit fees across Canada in order to benchmark British Columbia's performance. If, as we

⁸ 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).



expect, this review finds that BC is out of line with other provinces, the government should take steps to reduce the permit fees charged here.

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The Business Council appreciates the opportunity to share our preliminary advice on the 2010 budget with the Legislative Standing Committee on Finance and Government Services. We intend to develop a follow-up submission later in the fall.