



Business Council *of*
British Columbia

**Preliminary Advice on the
2011 Provincial Budget**

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

October 15, 2010



Business Council of
British Columbia

**PRELIMINARY ADVICE ON THE 2011 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 2011 provincial budget to be presented next March.

By way of background, the Business Council, established in 1966, is an association representing approximately 260 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

More than a year into the recovery phase, the provincial economy has bounced back from the recession of 2008-09 and, on many measures, is in reasonably good shape. Having said that, the rebound which began in the immediate aftermath of the Great Recession has slowed, with the economy recently downshifting to a more tepid growth trajectory. As the government prepares its 2011 budget, the central issue is the strength of the economic expansion.



It is clear that external conditions have softened. Although still in the early stages of recovery, the global outlook is being scaled back. As many analysts anticipated, the financial crisis that accompanied the global downturn is weighing on the expansion. In the United States, the UK and a number of continental European countries, a multi-year process of de-leveraging is unfolding, after a dramatic build-up of debt over the preceding decade.¹ This de-leveraging promises to dampen economic growth in the affected nations in the years ahead. Unsettled conditions in several EU countries will likely keep financial markets on edge. Many European countries are moving to slash unsustainable budget deficits, which will subtract from economic growth in the short-term. In Canada, the federal government is about to embark on a similar path. And at some point the United States too will have to wrestle with its own huge fiscal deficits. While we believe the US will avoid a technical “double dip” in 2011, the US economy is poised to disappoint over the next 12 months. In fact, an increasing number of economists and market participants believe the US Federal Reserve will soon announce a second round of “quantitative easing,” in a bid to stimulate America’s faltering economy and fend off the threat of deflation.

Chart 1
Global Growth Eases in 2011
(annual % change in real GDP)

| | <u>2009</u> | <u>(projections)</u> | |
|-----------|-------------|----------------------|-------------|
| | | <u>2010</u> | <u>2011</u> |
| US | -2.6 | 2.6 | 2.3 |
| Euro zone | -4.1 | 1.7 | 1.5 |
| Japan | -5.2 | 2.8 | 1.5 |
| China | 9.1 | 10.5 | 9.6 |
| UK | -4.9 | 1.7 | 2.0 |
| India | 5.7 | 9.7 | 8.4 |
| World | -0.6 | 4.8 | 4.2 |

Source: IMF, October 2010.

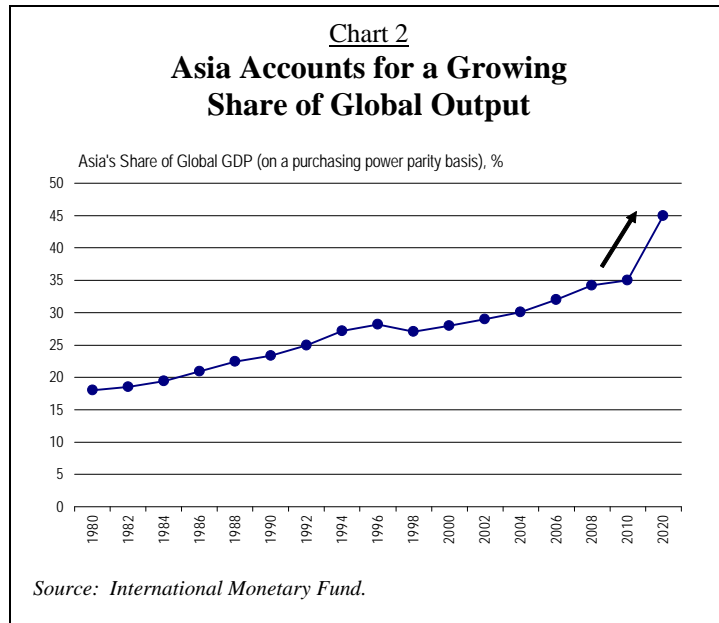
Even Canada, for all its advantages, is likely to experience a modest degree of de-leveraging, particularly by households (which are carrying a record high level of debt relative to income). With consumers pulling back and exports expected to slow, the Bank of Canada believes the Canadian economy is set to decelerate in 2011 (with real GDP growth slipping to perhaps 2%) before picking up slightly in 2012. On the export side, the super-charged Canadian dollar is emerging as a significant risk to the outlook.

¹ A useful discussion of the debt built-up can be found in the following McKinsey Global Institute report: Debt and de-leveraging: The global credit bubble and its economic consequences (January 2010).



For now, the main source of strength in the world economy will be China, India and other emerging markets. The dramatic shift in the geographic distribution of global economic dynamism was highlighted in the International Monetary Fund’s latest economic outlook, which foresees developing nations collectively growing by 6.4% in 2011 while the advanced economies as a group eke out a modest gain of 2.2%. Of particular relevance to Western Canada is the booming Chinese economy: the IMF believes it will grow by 10.5% this year and by 9.6% in 2011.²

China now ranks as the world’s second largest national economy; it is also the world’s biggest exporter and the leading consumer of several raw materials of which Canada is a substantial producer. A number of other Asian economies are presently growing above trend and are therefore at risk of spikes in inflation, adding another element of uncertainty to the near-term picture.



The ongoing shift in global growth patterns will be a key external factor affecting BC – and arguably all of Western Canada – over the next few years. Above-average economic growth in China and much of the rest of Asia will lift BC’s exports, while a muted recovery in the US promises to limit future gains in overall Canadian export sales. Shipments to the US now account for half of BC’s merchandise exports, down from two-thirds a few years ago. So in broad terms exports to the rest of the world and those to the US are now of roughly equal importance. Fortunately, BC is well positioned to benefit from the increasing clout of Asian markets in the global economy, both as a producer of goods in demand in Asia and as Canada’s gateway to the wider Asia-Pacific region. Exports destined for Asia, however, consist overwhelmingly of raw materials and resource

² IMF, World Economic Outlook: Recovery, Risk and Rebalancing (October 2010).

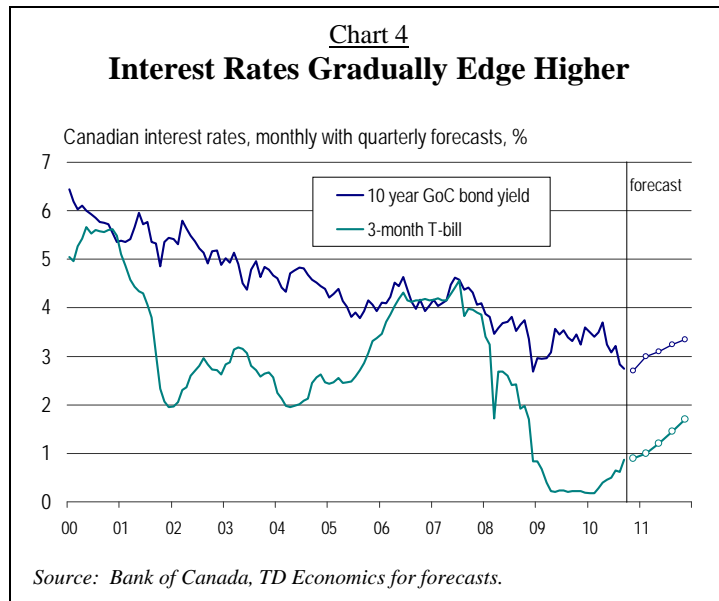
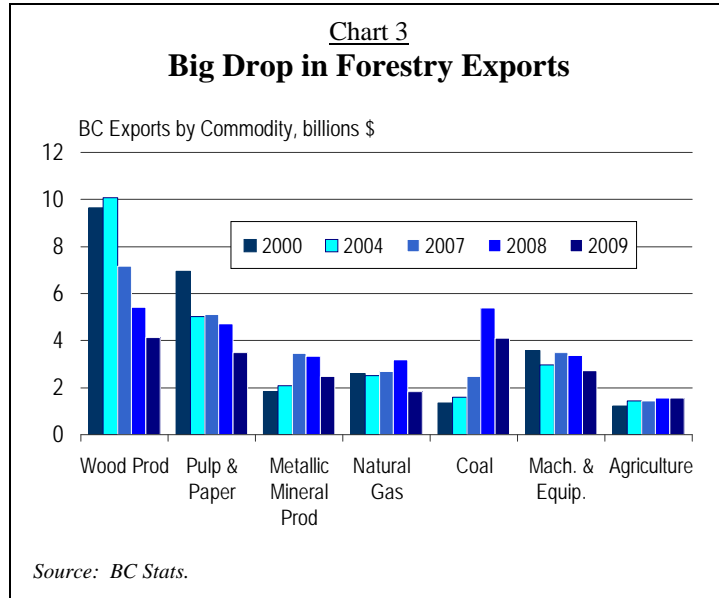


goods, meaning that a revival of BC's exports of more advanced and value-added manufactured products still depends heavily on the American market.

We expect overall export growth to moderate in 2011, as many of BC's export-oriented industries face headwinds in the second leg of recovery. Prices for lumber, natural gas and other commodities of interest to BC will probably not increase appreciably in 2011. At the same time, the Canadian dollar has essentially reached parity vis-à-vis the US greenback, owing to its recent surge. A year ago the Loonie was trading below US 90 cents; in the early spring of 2009 it was as low as US 80 cents. Looking ahead we expect

persistent volatility in currency markets as many countries try to engineer devaluations to re-kindle their export sectors.

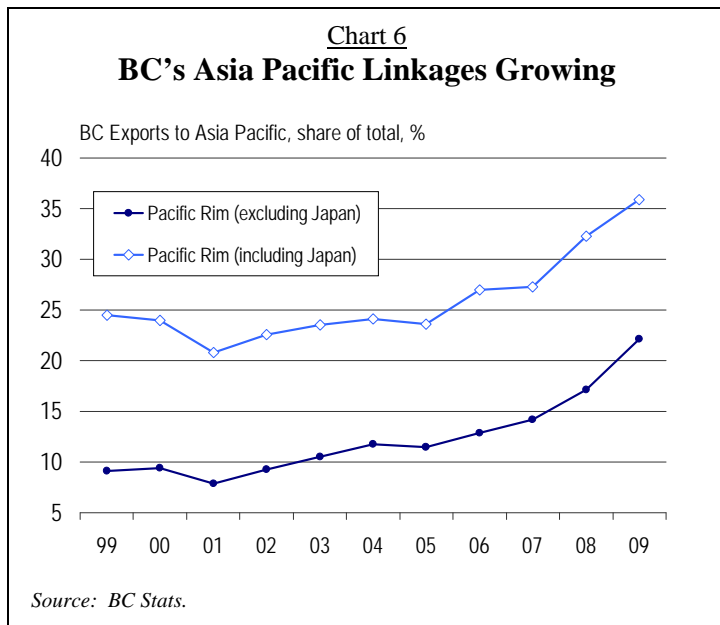
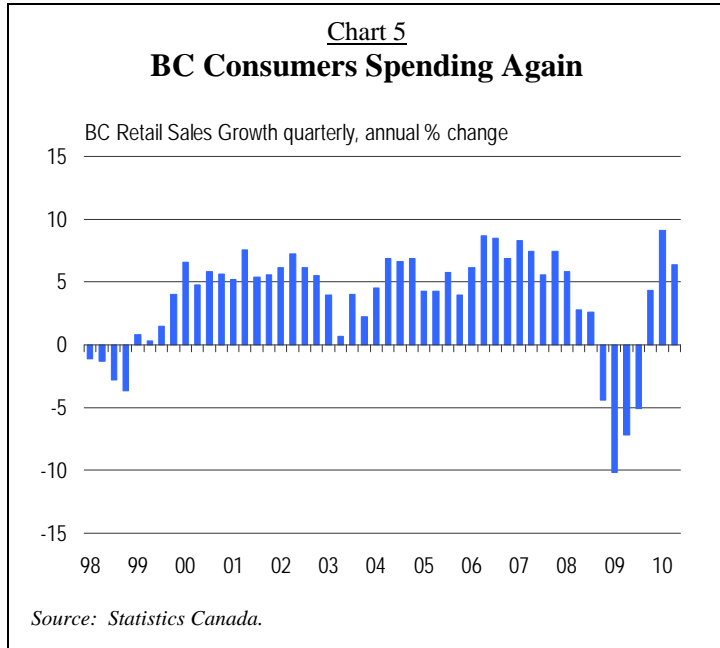
Tourism is one of the sectors directly affected by the currency. In addition to the recession, border security issues, and passport requirements, the stronger Canadian dollar continues to chip away at the number of US visitors travelling north. Not surprisingly, same-day American visits to BC have fallen 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 for several years.

With Canadian GDP and employment growth expected to disappoint in the coming quarters, most forecasters believe the Bank of Canada will shift to a holding pattern, meaning interest rates will remain low well into next year. This is an important consideration, given the soaring debt burdens carried by Canadian households. Weak income and wage growth coupled with higher interest rates a couple of years from now could strain the finances of many households, especially in “urban” BC where housing prices are the highest – and affordability the lowest – in Canada.



The province’s domestic economy has fared relatively well over the past year, boosted by a hefty dose of fiscal stimulus and record low interest rates that spurred a temporary rebound in home sales and home-building. It is fair to say that domestic demand has been quite resilient in the face of the world-wide downturn. But the recovery in domestic demand has now slowed. Home sales have fallen sharply, pointing to a more subdued pace of home



construction in the coming quarters. And a recent drop in the Business Council’s quarterly BC Economic Index is further evidence that economic growth is decelerating.

As with so many elements of this recovery process, there are concerns about the underlying strength of the provincial labour market. While the job market in Canada and in BC is healthier than in the United States, the rise in overall employment masks the fact that private sector hiring has been relatively weak. The most recent Statistics Canada employment report did show an oversized gain in the number of private sector employees, which may be an early

| | <u>2008</u> | <u>2009</u> | <u>2010f</u> | <u>2011f</u> |
|---------------------------|-------------|-------------|--------------|--------------|
| Real GDP | 0.0 | -2.3 | 3.3 | 2.5 |
| Employment | 2.1 | -2.4 | 1.9 | 1.7 |
| Retail sales | 1.5 | -4.4 | 5.2 | 4.7 |
| Corporate profits | 3.6 | -30.0 | 20.0 | 10.0 |
| Housing starts (units) | 34,200 | 16,100 | 23,800 | 20,000 |

Source: Business Council, Statistics Canada for history.

indication that private sector hiring is gaining traction. Continued slack in the labour market is evidenced by an unemployment rate at 7.6%.

Following an unusual outright decline in consumer spending in 2009 (when retail sales fell by 4.4%), spending in BC stores has bounced back but is still below pre-recession trends. Data from the past few months suggest some of the momentum in consumer spending has subsided, in part reflecting softer retail outlays on items relating to home purchases. However, the retail marketplace is in better shape today than it was in 2009.

Summary and Risks

Adding it all up, global economic activity is set to moderate in 2011, weighed down by ongoing balance sheet repair by households in some advanced economies and initial efforts to tackle ballooning government budget deficits. This scenario points to a rather subdued near-term economic outlook for British Columbia. Private sector forecasts have been scaled back for 2011, with most economists now expecting British Columbia’s real GDP to increase by 2.0-2.5%. Independent forecasts and the government’s latest projection (in the



September Update) are now closely aligned. The provincial Ministry of Finance's call for 2.2% real GDP growth for 2011 is generally consistent with our current assessment.

2. PROVINCIAL FISCAL PLAN

As we have noted in previous submissions, the government deserves solid marks for its past management of British Columbia's public finances. Thanks to significant debt repayment and sizable tax cuts (both personal and corporate) in the years before 2009, the province was in a good position to weather the recent global downturn and financial crisis. Taxpayer-supported debt, which is the best metric for assessing long-term fiscal sustainability, declined as a share of GDP from 21.3% in 2003 to 13.4% of GDP in fiscal 2008/09. Surplus budgets, lower taxes, and a falling debt/GDP ratio contributed to a positive climate for economic and business activity prior to the recent recession.

With the onset of the Great Recession, the province was pushed back into deficit. Driven by a return to operating deficits plus substantial capital spending, net debt is again growing faster than the economy,³ and is projected to peak at 18.1% of GDP in 2011/12. While the rising debt is unfortunate, BC still has the third lowest public debt/GDP ratio among the ten provinces and enjoys a top-flight credit rating. At this point, we believe fiscal policy should aim at preventing a sustained increase in the debt/GDP ratio and at restoring balanced operating budgets as soon as practical. In this regard, we are encouraged that, according to the September Update, the government seems to be on track to beat the deficit target for 2010/11 which was established in the 2010 budget.

The Business Council is comfortable with the fiscal plan outlined in the 2010 budget, and we do not propose any major new revenue or expenditure items for the 2011 budget. Instead, we recommend that the forthcoming budget focus on deficit elimination and that the province eschew major new multi-year spending commitments. That said, the government may wish to retain the option to boost capital spending beyond the levels planned for 2011/12, in case economic conditions deteriorate over the next few months. [At present, the fiscal plan envisages that capital outlays will drop from \$8.2 billion this

³ As measured by nominal or current dollar gross domestic product.



year to \$6.5 billion in 2011/12.] While higher capital spending would add to the provincial debt, carefully selected infrastructure spending – e.g., transportation and energy infrastructure, university research facilities – can provide a measure of short-term economic stimulus and help to lay the foundations for a more competitive and productive economy.

3. COMPETITIVENESS, HUMAN CAPITAL AND INNOVATION

Over the medium-term, the Business Council believes it is important that the province continue to advance three priorities highlighted in our Outlook 2020 project: enhanced competitiveness, improvements in human capital, and fostering a more innovative and productive economy.

Like most other jurisdictions, BC is grappling with a rapidly changing global economic context. While growth in emerging markets is creating new opportunities for some Canadian businesses, the rise of China, India and other low-cost global suppliers is having a dramatic effect across a range of Canadian manufacturing and service industries. The continued ascent of the Loonie poses a challenge to many of our exporters. Although BC has made significant progress in building a stronger economy, other jurisdictions are not standing still. Competitiveness is an overarching priority that requires sustained attention by policy-makers at all levels. For BC, a central goal should be to attract more high-value business investment, particularly in knowledge-intensive sectors and in industries that produce tradable goods and services. A closely related goal is to attract and retain talented and educated people.

The presence of a skilled and adaptable workforce is essential to our prosperity. Policy-makers, employers and educators must continue to focus on strengthening the province’s “human capital base” by maintaining an excellent post-secondary education system, creating a positive environment for research and commercialization, and targeting immigrants with in-demand skills. According to experts on early childhood development, the introduction of all-day kindergarten is another measure that should pay economic and social dividends over time. Given demographic trends, the coming baby-boom retirement



wave, and the pace of technical change, longer-term investments in human capital may need to be complemented with a greater capacity to re-train and re-tool mature workers – both to equip them with marketable skills and to encourage their continued attachment to the work force.

Infrastructure is another broad area that is linked to competitiveness. The government has done a commendable job investing in many forms of infrastructure from public transit to highways, port infrastructure and post-secondary education and research. Investments to date have improved capacity and efficiency in moving goods and people through and within the province. Still, as BC's economy and population grow, and as commercial linkages with Asia intensify, there will be a need for additional infrastructure investments. Developing the Asia Pacific Gateway is critical to the province future and warrants additional attention, particularly with respect to developing the Northwest Transportation Corridor. Further expansion of capacity at the Port of Prince Rupert will help the province capture a greater share of the growing volume of trade between North America and the Asia Pacific. We also believe there is an opportunity to invest in the Prince George airport to further enhance its role as a cargo hub with Asia.

There are two additional policy areas that are linked to improving BC's competitiveness that also need to be addressed. One is the duplication and complexity that arise from the existence of separate federal and provincial environmental review processes. From a business investment and project development perspective, it is imperative that these dual processes are streamlined and combined into a single, high-quality review. At present, even after clearing a detailed and comprehensive provincial assessment, many projects are then subject to a cumbersome federal review, which greatly increases the time and costs for projects in sectors such as energy, mining, transportation, and utilities.

The second policy area that deserves brief mention is open skies. The Business Council has long advocated the liberalization of Canadian air policy to expand the number of direct international connections for passengers as well as cargo between BC and other markets. While this is an area of federal responsibility, government and the private sector in BC



need to keep up the pressure on Ottawa to modernize Canada's increasingly outmoded air policy regime.

Finally, we wish to touch on two principal findings from the Business Council's Outlook 2020 project that wrapped up earlier in the year.

The first is the importance of nurturing innovation as a means to advance BC's economic prosperity. Innovation is about putting ideas to work to create economic value. It is not limited to the high technology industry, nor does innovation apply to the private sector alone. As the forces of global competition, demographic change and the imperative of higher productivity bear down on our businesses, employees and public institutions, BC must strive to become a "province of innovators."

At the national level, the Coalition for Action on Innovation in Canada recently produced a ten point plan aimed at making Canada a global leader in innovation.⁴ We recommend that all Committee members review their report. The Coalition's plan calls, *inter alia*, for a review of the role of the tax system in driving innovation; for new measures to expand the pool of risk capital available to finance the growth of innovative firms through the funding cycle; for improvements in Canada's intellectual property regime; for closer and more effective linkages between business and academia; for a stepped-up effort to recruit the best and brightest to come to Canada; and for governments and public bodies to become early adopters of innovative, home-grown products and services. Many of the ideas in the Coalition's report have a provincial dimension and are relevant in the context of provincial policy and action.

A second conclusion from Outlook 2020 is that BC is well-positioned to strengthen its position as an exporter of tradable services – everything from education, engineering and financial services to transportation/logistics, communications, design and other creative services. The province should develop a strategy to build on its role as a producer/exporter

⁴ [An Action Plan for Prosperity](#), report of the Coalition for Action on Innovation in Canada, (October 2010); see www.actioninnovation.ca



of knowledge-based services, and we recommend that this become an explicit focus of provincial economic development policy and programming going forward.

Recommendations Concerning Tax Policy

In this submission we do not propose to revisit the economic and business implications of the Harmonized Sales Tax. As Committee members know, the Business Council has produced a number of reports touching on the HST and explaining why we believe it represents smart tax policy for a 21st century BC economy. There is near-unanimous agreement among economists that the HST is an important step forward in fashioning a more competitive economy and improving the environment for private sector investment in plant, equipment, machinery, technology and other elements of the capital stock. Attached to this submission is a paper entitled “HST Misconceptions,” in which we address a number of economic-related concerns that have been raised by critics of the HST. We would invite Committee members to review that paper and follow up with Business Council staff if there are any questions.

The future of the HST is uncertain, as British Columbians will decide its fate in a public referendum next September. Adopting the HST was a significant – and, for most industry sectors, very positive – change to the business environment. Our members are concerned about the disruption, costs and pronounced business uncertainty that are likely to result if the tax is rescinded. The province’s reputation as a place to invest, to do business and to build wealth will suffer if the HST is dismantled. There is also the immediate cost from potentially having to return \$1.6 billion to Ottawa. Returning to the former PST would have serious negative implications for BC’s competitive position and darken the outlook for future investment and job growth in the province.

The Business Council acknowledges legitimate concerns about the impact of the HST in a few business sectors – notably foodservices, tourism, and parts of the homebuilding industry. Unlike Ontario, where the previous PST was levied on restaurant meals, British Columbians have had to adjust to a noticeable tax impact on restaurant food. The cost of new homes priced above \$525,000 is expected to rise with the HST in place. In the event



that British Columbians choose to keep the HST, it may be worth exploring options to help mitigate adverse effects on vulnerable industries.

Another area of tax policy that directly impacts BC's competitiveness is the design of the property tax system, especially as it pertains to major industry (class four). This is an important issue for many sectors, including resource-based industries and related manufacturing, which play a pivotal role in supplying the exports that underpin BC's prosperity. As we have noted in previous submissions to this Committee, from the vantage point of business and industry British Columbia has the worst property tax regime in Canada. An unusually large number of business property classes, coupled with the fact that municipal governments are free to set tax rates and ratios without regard to considerations of fairness or the quantum of municipal services actually consumed by different property classes, combine to make BC unique in Canada when it comes to property tax. The absence of an administrative appeal mechanism to review the fairness of local decisions compounds the problems in this field. There is compelling evidence that some (but certainly not all) municipalities in BC have imposed property tax burdens on major export-oriented industries that are both punitive and among the highest in North America.⁵

We acknowledge the government's moves to lighten the provincial portion of industrial property tax, as well as the current review of industrial (class four) property taxation, in which the Business Council is participating. At this stage the Steering Committee appointed last spring by the Minister of Community and Rural Development is still working on its final report. In our view, a meaningful solution will not be achieved unless the province is prepared to legislate restrictions on the ability of municipalities to set property tax rates on major industry (as is the case in several other provinces). Looking further ahead, we believe it is also necessary to address glaring discrepancies in local property taxation as applied to utilities and to the general business class, something that is not being entertained as part of the government's current review.

⁵ 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).



The Business Council understands that there are solid policy arguments for using a broadly-based carbon tax to assist in the gradual transition to a low-carbon economy. However, the current “made in BC” tax, while well-designed in many respects, raises the cost of doing business here relative to other Canadian and US locations. It also undercuts the competitive position of a number of our export-oriented industries, without – from what we can see – doing much to reduce greenhouse gas emissions or to spur new investment and business activity. We recommend that the government freeze the carbon tax at its 2010 level (\$20 per ton of carbon dioxide equivalent emissions), instead of increasing it as planned next July, so that the gap between BC and competing North American jurisdictions in the cost of fossil fuel-based energy does not continue to widen. Because the carbon tax is part of revenue-neutral package of offsetting tax measures, instituting a one-year freeze would have implications for planned future changes in personal and business income tax rates.

* * * * *

The Business Council appreciates the opportunity to share our preliminary advice on the 2011 budget with the Legislative Standing Committee on Finance and Government Services. We may develop a follow-up submission to the Minister of Finance later in the year.

* * * * *