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A CHANGING COMPETITIVE LANDSCAPE FOR BC BUSINESS

Evidence continues to accumulate that the United States is headed for a full-scale recession. With more than 60% of BC merchandise exports shipped to the US, a faltering American economy will not leave British Columbia unscathed. Even worse is that the US downturn is being led by a collapse in homebuilding, resulting in disastrous conditions for the province's wood products sector. As our leading trading partner stumbles and credit markets remain unsettled, the outlook for the global economy is also being downgraded. All of this suggests tough times for much of BC's export sector and weaker growth for the economy as a whole in 2008.

Cycles in external economic conditions are not new. As the current US downturn unfolds, however, many businesses in BC are being buffeted by a number of other shifts in the competitive landscape. The overvalued Canadian dollar, rising electricity costs, the implementation of carbon constraints, labour shortages, and a thickening Canada-US border are all creating challenges for businesses in BC, especially those in trade-exposed industries.

A Soaring Loonie

One big change in the economic environment concerns the exchange rate. Since the start of 2007 the Canadian dollar has surged by more than 20% and is now trading slightly above parity with the US dollar. This follows a long period of even larger gains, to which many of our trade-exposed sectors are still adjusting. The unprecedented, multi-year rise in the Canadian dollar shows up in lower Canadian-dollar revenues for BC exporters shipping to the United States or selling commodities traded in global markets in US dollars. For BC's forest products sector, a one cent rise in the Loonie translates into a \$150 million drop in Canadian-dollar revenues. For mining, the comparable figure is a \$50 million fall in revenues every time the Loonie adds a cent.

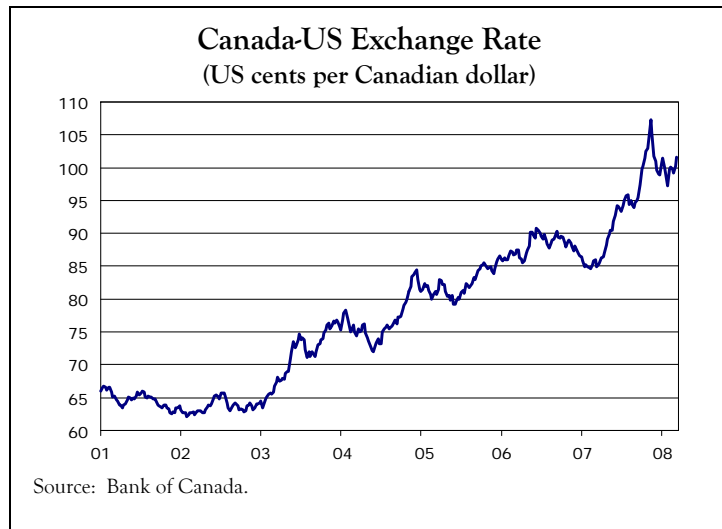
A new Statistics Canada study assesses the vulnerability of Canadian industries to a rising exchange rate. The analysis was based on comparing industries' export-dependence and then measuring the extent of their reliance on "imported inputs." It turns out that the Canadian industries whose bottom lines are most hurt by a rising exchange rate include wood and paper products, mining, oil and gas, transportation equipment, metal



manufacturing, machinery and equipment, chemicals, and clothing.¹ Taken together, these industries account for approximately two-thirds of British Columbia's export base.

A less talked about dimension of the appreciating currency is the impact on business costs more broadly. The rising Canadian dollar has increased business costs for a wide range of trade-exposed industries on this side of the border. According to the most

recent KPMG Competitive Alternatives report, which analyzes business costs in many different locations, the appreciation of the Canadian dollar has eliminated any cost advantage that Metro Vancouver (and by extension, BC) once enjoyed vis-à-vis American locations. When the Canadian dollar was at US\$0.85, the KPMG model found that business costs in BC (based on the average of 12 different industries) were three percentage points below the US benchmark. With the dollar now trading at \$US1.00, Metro Vancouver's business costs are approximately five percentage points higher than the US average. This puts the Lower Mainland's US dollar business costs ahead of Seattle's, which are four percentage points higher than the American benchmark. Recent and planned reductions in federal and BC corporate income tax rates should help trade-exposed industries deal with the strong currency, but for many BC businesses the benefits of lower taxes will be dwarfed by the impact of the soaring Loonie.²



Carbon Constraints

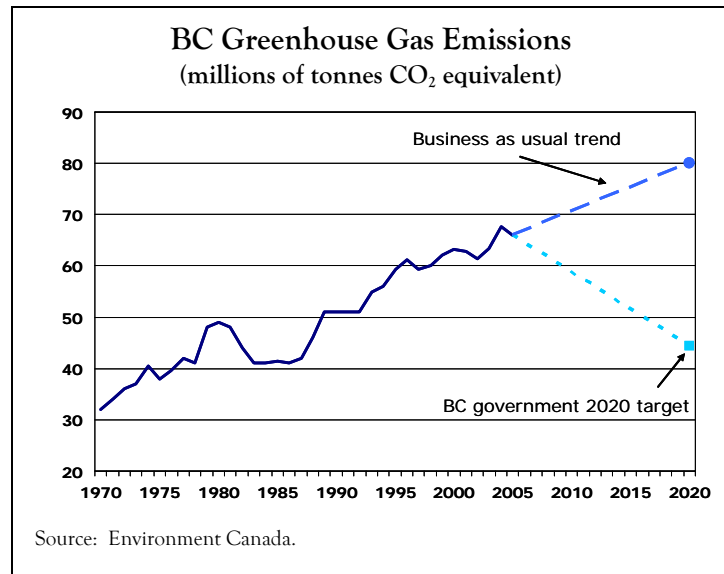
Another development that promises to affect the competitive environment for BC business stems from the provincial government's pledge to reduce greenhouse gas emissions (GHGs). In its 2007 Throne Speech, the government adopted a target to slash GHG emissions by one-third by 2020 - the most ambitious target of any jurisdiction in North America. The target was enshrined into law last fall. A key part of the government's plan to tackle GHG emissions is the introduction of a broadly-based carbon tax on fossil fuels consumed in the province, effective July 1, 2008. The tax will start at initial rate of \$10 per tonne of carbon dioxide equivalent emissions and then be ratcheted up in \$5 annual increments to reach \$30

¹ Z. Ghanem and P. Cross, "Loonie Tunes: Industry Exposure to the Rising Exchange Rate," Canadian Economic Observer (March 2008).

² Cost comparisons are from KPMG Competitive Alternatives, the online version is available at www.competitivealternatives.com. Note that the cited cost comparisons are based on the 2006 model with appropriate exchange rate adjustments. An updated version of the model will be released shortly.



per tonne by 2012.³ Initially, the tax will add 2.41 cents to the price of a litre of gasoline, rising to 7.2 cents per litre by 2012. For diesel fuel, the tax starts at 2.7 cents/litre in 2008 and climbs to 8.3 cents/litre by 2012. The carbon tax also applies to all other fossil fuels consumed in British Columbia, so businesses using natural gas (or coal) for heating and other industrial purposes will be paying more as well. It is estimated that more than three-fifths of the carbon tax will be paid by BC businesses, with the rest falling on households.⁴



The good news is that BC's carbon tax will be "revenue neutral", as all of the revenues raised from the tax are to be returned to businesses and households via cuts in other taxes. But the government's carbon tax "package" - the new tax on fossil fuels, coupled with lower business and personal income taxes - won't be revenue neutral for all industries. In particular, a number of sectors that rely on fossil fuels to run their operations and/or to ship their products to market stand to be disproportionately impacted - for example, lumber mills, pulp and paper producers, mining companies, pipelines, greenhouse growers, and manufacturers in industries ranging from chemicals to cement and food processing. Major export-oriented businesses in these sectors will pay millions of dollars in carbon taxes but receive little offset in the form of lower corporate taxes. And it must be remembered that few BC exporters will be able to pass on higher costs linked to the carbon tax to their ultimate customers.

Apart from the carbon tax, the BC government is still working out details for the eventual introduction of absolute GHG emissions "caps" as part of the Western Climate Initiative (WCI).⁵ The caps are expected to cover "large" emitting industries such as oil and gas, forestry, mining, cement, aluminum, and some other segments of manufacturing. Once the WCI deliberations are completed, the adoption of emission reduction obligations is likely to lead to higher operating costs for several major BC industries, including some in the struggling manufacturing sector.

³ There are six different greenhouse gases, but common practice is to convert the emissions from all of them into volumes of carbon-equivalent emissions.

⁴ Some BC businesses will pass on the cost of a rising carbon tax to consumers. However, exporters will find it harder to pass on these costs than businesses that sell mainly in the domestic market.

⁵ The WCI participants include BC, Manitoba, California, Washington, Oregon, Arizona, New Mexico, Utah, and Montana.

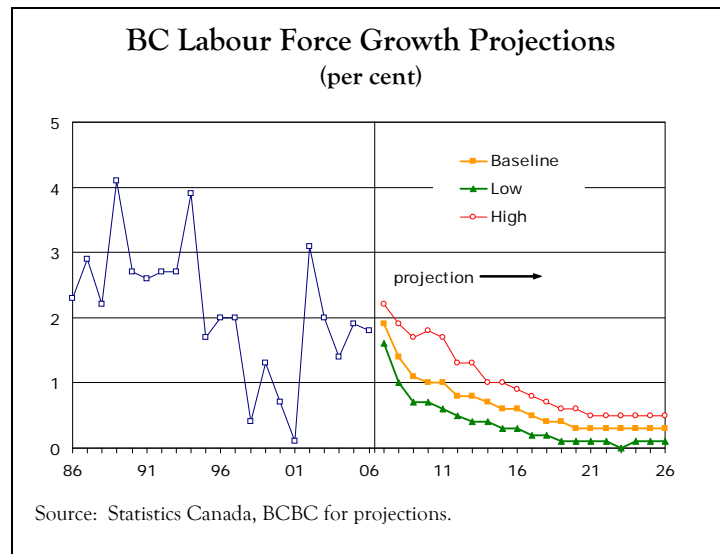


Electricity Costs

Low cost electricity has long been a competitive advantage for BC, one that has assisted in attracting investment in industries such as mining, pulp and paper, chemicals, and other parts of manufacturing. This too may soon change as a result of the provincial government’s revised Energy Plan, released last year, coupled with the need to expand and refurbish BC’s aging electricity generation and transmission systems. The 2007 Energy Plan calls for BC to become self-sufficient in electrical power by 2016, a goal that increases the need to build new domestic capacity in order to reduce the demand for imported power. The Energy Plan features ambitious energy conservation objectives. It also signals that the province, as a matter of policy, intends to steer clear of new thermal power generation (even though thermal sources are the lowest-cost options for electrical energy). The government’s preference for “green” power may be justified on environmental grounds, but it will translate into higher electricity costs for businesses and households. Recent reports from BC Hydro point to a 25% increase in power rates over the next three or four years.

Labour Shortages

Also bearing down on the business community are growing labour shortages. After several years of robust economic growth, BC’s unemployment rate has dropped to a record low. A lack of qualified workers is already limiting the ability of some firms to expand. Skill shortages first emerged in health care, construction and high technology, but they are now spreading to other industries. Hiring difficulties



for BC employers have been aggravated by the ongoing construction boom and the red-hot economy in next-door Alberta. Looking ahead, the labour force growth rate is projected to slow significantly as population aging leads to a steady rise in the number of retirements. This demographic trend promises to re-shape labour markets right across the country. One consequence will be upward pressure on compensation costs. Over the past few years, average annual wage gains in BC have gone from 1.5-2.0% to 3.0-5.5%.



Other Factors

Two other developments relevant to BC's competitiveness also warrant brief mention. The first is the oft-mentioned "thickening" of the Canada-US border. In recent years, businesses on both sides of the 49th parallel have expressed concern over the rising costs and delays associated with moving goods and people across the border. Among the most commonly cited problems are long border wait times; the application by US authorities of direct fees on cross-border commerce; inadequate staffing at



border crossing points; onerous inspection requirements; a failure to tap the full potential of trusted shipper and traveller programs; and the impact of the US Western Hemisphere Travel Initiative (WHTI) on cross-border tourism.⁶ Through the Security and Prosperity Partnership of North America, governments are working on these issues, aided by input from the North American Competitiveness Council. However, progress has been slow, and the evidence suggests that doing business across the Canada-US border has been getting more costly and difficult, not less. Anything that makes it more complicated and expensive to move goods and/or people across the border works against the success of trade-exposed industries in British Columbia.

The final issue is the high cost of oil. By mid-March, the price of crude surged to a record high of US\$110 per barrel. The rapid and steady ascent of oil prices over the past few years has resulted in much higher transportation costs. While it is true that many other jurisdictions are also confronted with the same high oil prices, a number of BC's most important export goods are energy intensive and must be transported long distances to market. In the wood products industry, for example, logs are first cut and hauled out of the forest to mills. Once processed, wood products are then shipped from the interior, northern and coastal regions of BC to often distant external markets. Although its location provides the province with the advantage of being Canada's Pacific Gateway, it also means that our exporters are geographically remote from most of the largest markets in North America. As such, higher oil prices lead to comparatively high shipping costs for many BC producers relative to their North American competitors.

⁶ For a valuable and timely review, see the recent joint report by The Canadian Chamber of Commerce and The US Chamber of Commerce, Finding the Balance: Reducing Border Costs While Strengthening Security (February 2008).



Conclusion

British Columbia's economy has been growing at a healthy clip since 2002. During this period, government has taken steps to improve the province's competitive position by lowering taxes; streamlining and modernizing regulations; boosting public investment in research, infrastructure and skills development; and stepping up efforts to attract qualified workers to BC. Despite these positive measures, the economic environment is changing in ways that pose significant challenges for businesses and workers in the province. As discussed above, a number of trends are chipping away at British Columbia's relative attractiveness as a business and investment location. The problems are particularly visible in export-oriented industries, which are most exposed to the winds of global competition and have been significantly affected by the rising Canadian dollar.

There are signs that recent shifts in the competitive environment are starting to take a toll on business in British Columbia. The lumber industry is grappling with the worst business conditions in half a century. Capacity utilization rates have been falling across a swath of trade-exposed industry sectors.⁷ The value of BC's international exports is expected to shrink again in 2008, marking the third consecutive year of dwindling merchandise export receipts. Statistics Canada's just released 2008 Investment Intentions Survey forecasts that, outside of the oil and gas and mining industries, non-residential construction investment is also set to decline. Also of note is that planned investment in machinery and equipment is expected to grow at a slower pace than in the previous three years.⁸

The message from an assessment of the trends reviewed in this short paper is straightforward: although the province has been experiencing a multi-year economic upswing, the foundations for a globally competitive export sector are under pressure. Strengthening the competitiveness of British Columbia's trade-exposed industries should be at the top of the list of the BC government's priorities. Among other things, policy-makers should:

- avoid loading more costs onto export industries;
- consider tax incentives to stimulate new investments in machinery, equipment and technologies as a way to make firms more productive;
- examine the scope for other tax measures to offset the impact of proposed carbon taxes and escalating electricity costs; and,
- continue to work on expanding and modernizing transportation and other key infrastructure that allows BC companies to connect with external markets.

⁷ Statistics Canada, "The Daily" (March 13, 2008).

⁸ Statistics Canada, Public and Private Investment in Canada, Intentions 2008.