Business Council *of* British Columbia

Preliminary Advice on the 2012 Provincial Budget

Submission to the Select Standing Committee on Finance and Government Services

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PRELIMINARY ADVICE ON THE 2012 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 2012 provincial budget.

By way of background, the Business Council, established in 1966, is an association representing more than 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 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 RISKS

More than two years into the recovery from the 2008-09 global and North American downturn, the outlook is for the BC economy to expand at a sub-par pace. While we expect positive growth over 2011-12, the external setting is clouded with an unusually high degree of uncertainty. It is important to underscore the challenges we face at this juncture in the economic cycle: a good part of BC's recovery to date has been based on a rebound in exports, but with the global economic backdrop weakening, this source of strength is in question, at least for the near term.

The serious fiscal challenges and non-trivial risk of sovereign default in Greece (and potentially other Euro-zone countries) are keeping financial markets on edge. With the Eurozone already struggling economically, any default will push the region back into recession and spread the associated financial turmoil to North America. While the situation in Europe is the biggest threat to the global economy, the ongoing malaise in the United States has a more direct impact on British Columbia. Most forecasters expect the US to grow at a very modest pace this year and through 2012-13. A soft labour market, continued difficulties in the housing sector, a shift towards higher saving as households repair balance sheets, and the prospect of fiscal consolidation all weigh on the outlook for growth. For planning purposes, we believe it is wise to assume that the US economy will expand by around 1.5% this year and next, rising to 2% or so in 2013. Normally, following a deep recession one would look for the US economy to gain momentum over the course of the expansion, but today the fundamentals are so poor that a protracted period of tepid growth seems likely.

Table 1

Global Growth Outlook

(annual % change in real GDP)

	2010	2011 (projections)	2012 (projections)
US	3.0	1.5	1.8
Euro zone	1.8	1.6	1.1
Japan	4.0	-0.5	2.3
China	10.3	9.5	9.0
UK	1.4	1.1	1.6
India	10.1	7.8	7.5
World	5.1	4.0	4.0

Source: IMF, World Economic Outlook, September 2011.

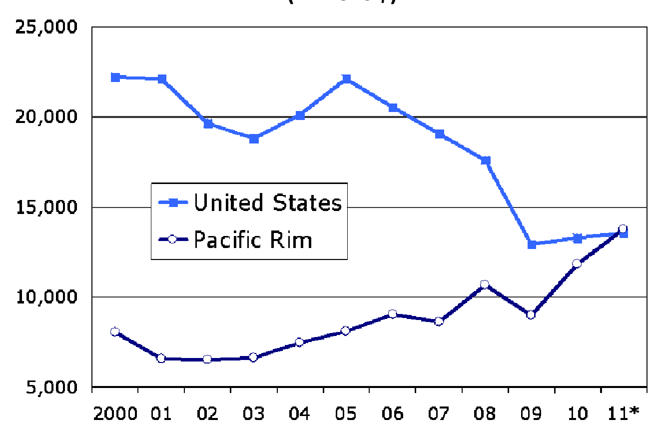
In Japan, the massive post-disaster rebuilding effort and rebound in auto and electronics manufacturing production promise to lift the economy in the final quarter of 2011 and into 2012. BC will benefit by supplying commodities and industrial raw materials for use in Japan's rebuilding and re-construction. Once the stimulus effect of re-construction wears off, however, Japan's longer-term structural issues (unfavourable demographics, high public debts) will push the country back to a slow-growth trajectory.

The main source of strength in the world economy continues to be found in China, India and other emerging markets. The dramatic shift in the geographic distribution of global economic influence is evidenced by the current outlook, which foresees most of emerging Asia growing between 6% and 9% in 2011 and 2012, while Europe and the US eke out gains of perhaps 1.5%. China is likely to remain the world's leading growth engine for some time. That said, a slower global economy and domestic credit restraints in the face of inflation worries will trim China's growth rate to around 9% next year. This pace, however, should still be sufficient to support further increases in BC's exports.

Chart 1

BC Exports: US and Pacific Rim Region

(millions $)



*Source: BC Stats *forecast based on export growth during first half of 2011*

Economic developments in China and other Asian markets are now one of the most important factors affecting the province's economic prospects. British Columbia's increasing commercial orientation to the Asia-Pacific region is well-documented and widely reported in the media. This year, BC is on course to export more to the Pacific Rim countries than to the United States. The Business Council believes the province's trade with China (and other Asian economies such as South Korea, India and Taiwan) will continue to expand over the next few years, as BC's overall commercial orientation becomes more aligned towards the wider Asian region.[1]

Canada, even though it has many advantages, will not escape the global slowdown unscathed. Indeed, the Canadian economy contracted (by an annualized 0.4%) in the second quarter of the year. Although this was a temporary setback, and a return to

[1] Jock Finlayson and Ken Peacock, "British Columbia in the Asian Century," Policy Perspectives, Business Council of BC (September 2011); available at www.bcbc.com.

positive growth is expected for the rest of 2011, the recent dip highlights the fragility of the recovery process. With debt-constrained consumers now pulling back and exports moderating, Canada is on track for real GDP growth of 2% this year; in 2012, growth may slip below 2%.

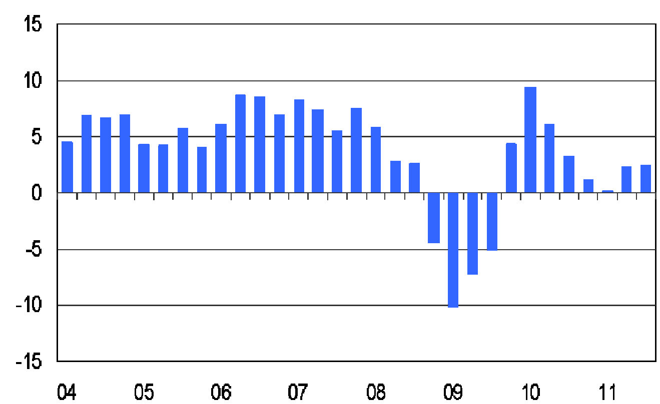
A Closer Look at the BC Picture

Table 2
BC Economic Forecast
(% change unless noted)

	2009	2010	2011 (forecasts)	2012 (forecasts)
Real GDP	-1.8	4.0	2.2	2.4
Employment	-2.1	1.7	1.1	1.5
Retail sales	-5.7	6.0	2.0	3.5
Housing starts (000s)	16.1	26.5	25.5	25.0

Source: Business Council, Statistics Canada for history.

Chart 2
BC Retail Sales, quarterly
(annual % change)



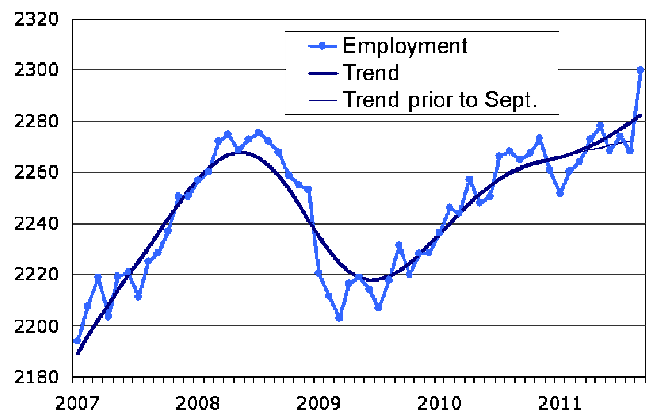
Source: Statistics Canada. *latest Q3, estimate based July data*

Conditions in the domestically-driven parts of the BC economy have been mixed in recent months. One source of strength has been construction. But even within this segment the situation varies across different industry sub-sectors. New home-building has leveled off and stayed flat for most of the past year; and this may persist in the lead up to the transition back to the Provincial Sales Tax (PST). Non-residential building activity, however, has been trending higher, and offers more hope as a near-term economic driver. A number of large projects related to energy, mining and other resource development and to the expansion of Gateway capacity should transition from the "planning stage" to the "building stage" over the next two years, delivering a welcome boost to both GDP and employment.

One area of economic activity that is dampening headline growth is consumer spending. Total retail sales in the province have barely inched ahead over the past year.

Employment concerns, sluggish growth in real incomes, high household debt and a constant barrage of negative economic news are all affecting consumer sentiment and causing many British Columbians to adopt a cautionary approach to spending. This pattern is likely to endure for at least the next two or three quarters.

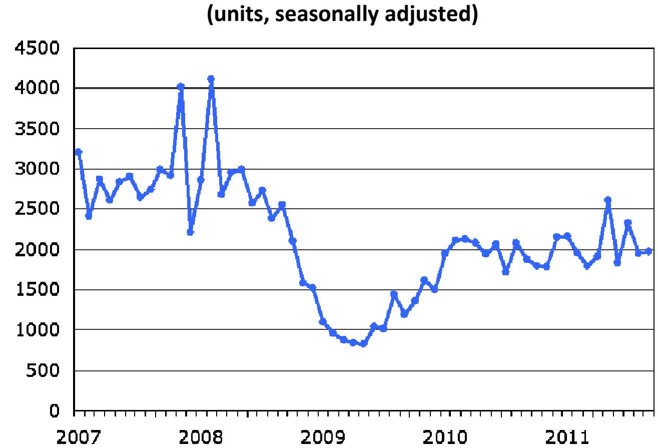
Chart 3
BC Employment
(thousands)



Source: Statistics Canada, BCBC for trend data. latest: September.

Notwithstanding September's sizable surge in employment – up by more than 30,000 – the BC labour market has been soft over the past year. While strong job gains in a single month need to be interpreted cautiously, the latest data does point to somewhat more buoyant job market conditions. Although we expect job creation to pick up, our current forecast calls for modest employment growth of 1.5% in 2012, measured on an annual basis.

Chart 4
BC Housing Starts
(units, seasonally adjusted)



Source: CMHC,BCBC for seasonal adjustment. latest September

The Business Council forecasts that the BC economy will expand by 2.2% in 2011, with a similar advance in 2012. Reflecting a less positive global backdrop and a notably lackluster US performance, this represents a downgrade to our previous 2012 forecast.

Summary and Risks

Adding it all up, global economic activity is set to moderate over the rest of 2011 and into 2012, weighed down by ongoing de-leveraging by households in some advanced economies and the winding up of fiscal stimulus programs across much of the developed world. For BC, this scenario translates into a rather muted short-term economic outlook. Consistent with our recent revisions, other private sector forecasters have scaled back their expectations for 2012, with most now predicting that British Columbia's real GDP will increase by 2.0-2.5% in 2012. The government's latest projection (in the September 2011 Fiscal and Economic Update) looks for growth of 2.0% this year and 2.3% in 2012 – closely aligned with our own assessment. We would note, however, that because of the financial uncertainty centered in Europe, most of the risk is on the downside.

2. PROVINCIAL FISCAL PLAN

With the onset of the Great Recession in 2008-09, the provincial budget was quickly pushed back into the red. Fueled by a return to operating deficits plus a substantial ramping up of capital spending, the provincial debt rose, with tax-payer supported debt on track to reach 18.4% of GDP in 2013-14, up by five percentage points from 2008. While the growing debt is of concern, BC still has the third lowest net public sector debt/GDP ratio among the ten provinces and enjoys a top-ranked credit rating. At this point, the Business Council believes the basic stance of fiscal policy should aim at preventing a further sustained increase in the debt/GDP ratio and safeguarding the province's enviable credit rating.

In this connection, we support the government's plan to eliminate the operating deficit by 2013-14, as outlined in the 2011 budget. As we have noted in previous submissions, the government deserves credit for its stewardship of the public finances in both good and tough economic times. Thanks to significant debt repayment, generally prudent management of program spending, and tax cuts prior 2009, the province was in a favourable position to weather the recent global downturn and financial crisis.

While we agree with the goal of returning to a balanced operating budget by 2013-14, there are a number of hurdles that may complicate this task. Undoubtedly the biggest comes from the requirement to return to the PST. As noted in the September update from the Ministry of Finance, moving from the HST to a re-instituted PST/GST system will result in a cumulative three-year financial loss of $2.3 billion. This figure includes $1.6 billion in 2011-12 to reimburse the federal government for HST transition funding, plus a $0.7 billion fiscal impact to reflect lower tax revenues under the PST, slower economic growth, and higher expenses from debt-servicing and PST administration costs. The net result is an overall fiscal gap estimated at approximately $460 million over the current budget planning cycle, relative to the projections built into the 2011 fiscal plan. On a $40 billion plus budget, it should be possible to eliminate this operating shortfall without large disruptions to the main areas of program activity.

That said, it must be recognized that the slower global economy will make it harder to meet the government's balanced budget objective. Over the past year, an expanding export sector and higher resource prices have generated additional revenue for the province. Looking ahead, there is some concern that China's appetite for natural resources could gear down and, in turn, dampen global commodity markets. A more serious global slowdown would result in declining resource revenues, making it harder to reach the government's budget objectives. On present evidence, we judge it unlikely that natural gas royalties will deliver any near-term lift to the province's bottom line. Huge increases in North American supply resulting from the advent of new technologies for extracting shale gas and other tight gas deposits have pushed natural gas prices down to historically low levels since early-2010. The prevailing expectation in the market is that this low-price environment will continue for at least another couple of years.

Another challenge to balancing the budget stems from ongoing upward pressure on provincial spending. With its insatiable appetite for more resources, health care stands out in this regard. But there are also increasing demands on some other government programs and services, such as K–12 and post-secondary education, community social services, and income assistance. Public sector wage demands and unsettled union contracts also represent a risk to the fiscal plan. The plan assumes two-year agreements with a net-zero cost to employers in the provincial public sector. This mandate applies to all public sector contracts expiring between December 31, 2009 and December 31, 2011.

The Business Council supports the government's net-zero compensation policy, for three reasons. First, pubic sector employees received generous settlements in the previous round of bargaining, including one-time bonus payments and annual pay increases in the range of 3-4%. Second, many employees in the broadly defined public sector are paid more than private sector workers with similar qualifications and experience, particularly when account is taken of guaranteed pensions and other costly fringe benefits. Finally, private sector workers and small businesses in BC bore the brunt of the pain associated with the 2008-09 recession; people working in the public sector were shielded from the effects. It is therefore fair and appropriate to ask public sector employees to forego pay increases for a short period, as the government strives to get its finances on a sustainable footing and private sector workers and businesses struggle to put the impact of the 2008-09 recession behind them.

Finally, we suggest that the government retain the option to increase capital spending beyond the levels planned for 2012-13. While the province has made substantial investments in infrastructure over the past decade, there are additional investments that would produce positive economic returns. Such spending would also be beneficial if economic conditions deteriorate over the next year. While higher capital spending would add to the provincial debt, as noted earlier the province is in relatively good shape in this regard, and carefully selected infrastructure spending – e.g., transportation and energy infrastructure, post-secondary research and training facilities – could provide a measure of short-term economic support while strengthening the foundations for a more competitive and productive economy. At this point, we are not recommending that capital spending be increased in 2012-13 beyond the levels currently planned; rather, our recommendation is that, in developing the 2012 budget, the government should keep open the option of adjusting capital spending in case the incoming data show the economy slowing further or at risk of slipping back into recession.

3. TAX POLICY ISSUES

In light of the economic risks and budget challenges referenced above, the Business Council does not propose any major new revenue or expenditure items for the 2012 provincial budget. Instead, we recommend that the budget focus on deficit elimination and managing the return to the PST in an efficient and timely manner.

Returning to the PST

Concerns have been raised about the time required to reinstate the PST. While some observers have been critical of the 18 month-time frame posited by the government, one should not underestimate the complexity of restoring the former system – a point emphasized by the Independent Panel in its report earlier this year.[2] The province must rebuild an organization to administer and collect the PST. Most the public servants previously engaged in this work were transferred to the Canada Revenue Agency as part of the adoption of the HST. It is not clear how many of them will transfer back to a rebuilt provincial bureaucracy. The BC government also faces the task of implementing new computer systems. This is not simply a matter of "flipping a switch" and going back to the old system. The PST administrative software was an antiquated system that was repeatedly patched up to manage frequent adjustments and changes to the PST structure. If there is any hope of streamlining and improving PST collection and administration going forward, the province needs to put new systems in place.

[2] Independent Panel's Report, "HST or PST/GST? Its your Decision," (May 4,2011).

It should also be noted that businesses large and small across the province incurred significant costs to implement the HST and now face additional costs to revert back to the PST/GST. Many large companies report that they had to establish transition teams and spend millions of dollars over the course of many months to change IT systems. Reverting back to the PST will be equally complicated and time consuming.

There are a number of changes and improvements the government could make to the PST system, while keeping its commitment to return to the PST largely as it existed prior to the switch to the harmonized system. The justification for doing so is to mitigate the negative economic and financial impact on BC businesses from re-establishing the PST. Here, it is important that all legislators understand the longer-term economic implications of the decision made by voters in the recent public referendum. Reverting to the PST will result in British Columbia having a sales or consumption tax system that discourages investment and makes it harder for businesses to be competitive nationally and internationally. This is primarily because local companies, including the tens of thousands which operate in "trade-exposed" sectors[3], will have embedded PST in their cost structures for the production of goods and services. Once the PST is restored, the "marginal effective tax rate" on private sector capital investment in the province will rise by approximately one-third.[4] This tax increase on enterprises engaged in producing goods and services in British Columbia will do lasting damage to capital formation, productivity, and the ability of BC companies in many sectors to succeed in national and international markets. With the political argument over the HST now settled, we hope that legislators will recognize the challenges that returning to the PST are likely to pose to British Columbia's long-term competitive position.

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[3] That is, they sell their goods/services in export markets and/or compete against imports in the local market.

[4] The marginal effective tax rate is a measure of the tax on new investment. It is a comprehensive measure of the tax burden on capital formation that includes statutory business taxes, tax preferences and incentives, capital taxes, and sales tax paid on business inputs. See Jack Mintz, "British Columbia's Harmonized Sales Tax," School of Public Policy Briefings Papers, Volume 3, Number 4 (March 2010).

The choice made by BC voters was motivated in part by concerns about the impact of the HST on consumers. Re-establishing the PST arguably will address these concerns. This leaves open the question of how restoring the PST might be done in a way that addresses some of the negative consequences for business and industry. In this regard, we believe the government should be looking at both short- and medium-term policy changes to modernize and streamline the PST. These fall in two categories: administrative improvements; and modifications to the PST exemptions.

Beginning with administrative improvements, the BC government's traditional approach to PST assessments and audits created needless headaches and raised costs for local businesses through:

- Lengthy delays in resolution, due to changing interpretations.
- A rigid process that encourages litigation, not negotiation.
- Practices that discourage open discussion with senior officials.
- Lack of timeliness on rulings and assessment files.
- Approaches to audits that fail to consider overall return on investment.

As part of re-establishing the PST, we recommend that the province:

- Clarify the rules for scope of application of the PST and eligibility for exemptions, with a view to minimizing future disputes over interpretation.
- Revise the statute of limitations for assessments for prior tax years, from four years to three.
- Adopt risk-based approaches to audits, using sampling techniques, in order to improve returns on investment in terms of incremental revenue-potential versus costs.
- Encourage negotiation in audits, as is done federally and in other provinces, to lessen the need for litigation.
- Enact legislation prescribing maximum timeframes for appeals to provide greater certainty as to when businesses can seek legal remedies.

- Remove the Minister from the appeal process, and direct appeals instead to a Commission or Appeals Branch, as is done in Manitoba, Saskatchewan, PEI, and Ontario (prior to the latter's adoption of the HST in 2010).
- Examine opportunities to avoid duplication with the federal government by determining whether it is feasible to devolve administration of the PST to the Canada Revenue Agency on BC's behalf.

Turning to PST exemptions and the structure of the tax base itself, historically the BC government took a narrow and inconsistent view of eligibility for existing exemptions permitted by way of the certificate exemption system, particularly in the case of production machinery & equipment. For example:

- Under the PST, manufacturers were eligible for the production machinery & equipment exemption, but other companies/industry sectors purchasing machinery and equipment were not.
- Hydro-electricity producers were deemed to be manufacturers for the purposes of the exemption, whereas telecommunications providers and some other utilities were not.
- Software and IT-development costs for systems used within businesses were not considered to fall within the definition of production machinery and equipment.

The intent of the production machinery & equipment exemption was two-fold: to reduce the cost for manufacturers of significant capital purchases used directly in their production processes, thereby stimulating investment and job-creation; and to reduce "double-taxation" or cascading tax for consumers, by preventing a tax element from being included in a major cost of the manufacturer, and subsequently taxed again when the product is sold.

Over time, broadening the PM&E exemption to include other capital-intensive operations within industries like forestry, mining, transportation, technology, energy and telecommunications, and to other significant business-input costs like software and IT-development, would help to stimulate investment, innovation, productivity and job-creation, as well as reduce costs for consumers. Thus, the Business Council recommends that the government develop a medium-term strategy to mitigate the economic and competitive damage that will be done by re-creating the former PST system by:

- Expanding eligibility for the production machinery & equipment exemption beyond manufacturers, to include other capital-intensive producers of taxable services, such as transportation, energy and telecommunications.
- Broadening the PM&E exemption to include the purchase of software and IT-development used by producers of taxable goods and services. There is a strong economic policy rationale for this step, as a large body of research shows that investing in software and IT products and services is critical to increasing business sector productivity.[5]
- Extending the PM&E exemption to include the purchase of services used in the production of taxable goods and services.

We recognize there is unlikely to be scope in the 2012 budget to modify the system of PST exemptions along the lines suggested above. But our recommendations, if implemented over time, would go a long way toward developing an economic climate that supports productivity-enhancing business investment, a stepped-up pace of innovation, and the creation of more good-paying jobs for British Columbians.

Industrial Property Taxes

From the business perspective, the current industrial property tax system in BC undermines competitiveness, is inequitable, and discourages capital investment because

[5] For a review of the literature, see Andrew Sharpe and Jean-Francois Arsenault, "ICT Investment and Productivity: A Provincial Perspective," Centre for the Study of Living Standards, Research Report 2008-06, available on line at www.csls.ca/reports/csls2008-6.pdf. Also see Andrew Sharpe and Ricardo de Avillez, "Canada-US ICT Investment in 2009: The ICT Investment Per Worker Gap Widens," Centre for the Study of Living Standards, Research Report 2010-08, available on line at www.csls.ca/reports/csls2010-08.pdf.

of high rates and the very large discrepancy between industrial property tax rates and residential tax rates that have evolved in some municipalities. As Professor Robert Bish notes in his paper on BC property taxes, "British Columbia's municipalities have more discretion to set different property tax rates on different classes of property than any other jurisdiction in Canada."[6] The unfettered ability to set tax rates coupled with an unusually large number (nine) of property classes has allowed property taxes to be raised more quickly on a particular property type.

The business community believes there is ample evidence that there is a problem with BC's property tax system. Academic research points to significant inequities and identifies concerns about competitiveness and the high rate of industrial property taxes deterring investment. In its 2006 report the BC Competition Council concluded that to ensure consistency and establish a competitive level of property tax for major industry, "municipalities must reduce the tax burden on the major industry sector particularly where the ratio of industry versus residential rates is high."[7]

The February 9, 2010 Throne Speech identified the need to "make property taxes more conducive to investment while assuring local government services are fairly provided for all taxpayers." Shortly thereafter the government launched a joint review of major industrial property assessment and taxation that included the province, UBCM, and industry. To date, however, the process has not resulted in any recommendations or changes in the municipal taxation system.

The Business Council recognizes that as part of the review, research and analysis evaluating the impact of property taxes on investment is ongoing. Other than this research, however, little has been done to advance the process. The Council believes the

[6] Robert Bish, "Property Taxes on Business and Industrial Property in British Columbia: Comparisons and Business Climate Observations." (October 2003).
[7] BC Competition Council, 'Enhancing the Competitiveness of British Columbia," (June 2006).

province needs to refocus efforts to make changes that will address inequities within the industrial property tax system in the province. A balanced property tax regime is a key ingredient in ensuring that BC has a diversified economy and a competitive business climate.

As a final note, the Business Council strongly supports the review of business tax competitiveness that was announced as part of the BC Jobs Plan. The review is especially important now that the province will be returning to the PST and will need to focus on measures that reduce BC's marginal effective tax rate and improve the property tax regime. Implementing changes that will foster business investment and in turn support productivity growth is important in order to sustain BC prosperity. While we do not wish to preempt the review, we do note that second to eliminating sales tax on capital goods (which is what the HST does for now), there is evidence that corporate income tax cuts result in some of the biggest productivity increases relative to revenue reduction and comparatively small revenue impacts.[8]

The Business Council appreciates the opportunity to share our preliminary advice on the 2012 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.

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[8] Conference Board of Canada, "Accelerate Business Tax Reform to Boost Canadian Competitiveness," (August 2008).