BC SOLUTIONS BUDGET 2003

FEBRUARY 2003

CANADIAN CENTRE FOR POLICY ALTERNATIVES – BC OFFICE

2003 BC Solutions Budget

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Contents

BC Solutions Budget 2003

THIS YEAR'S CCPA *SOLUTIONS BUDGET* focuses on economic revival in BC. We look at long-term and short-term factors affecting BC's fortunes, and the resulting economic and fiscal context facing the province today. The centrepiece of this *Solutions Budget* presents an alternative fiscal plan that models what the 2001 to 2004 Budgets would look like had there been no tax cuts, no regressive tax increases, no spending cuts and modest spending increases.

A Long-term View of the BC Economy

BC is a small, resource-dependent economy heavily reliant on the export of basic commodities. We now have a more diversified economy than in the past, but this largely reflects the vitality of Greater Vancouver. Many observers have correctly noted that BC has two economies: the populous and diversified Lower Mainland area (plus the provincial capital of Victoria), and the rest of the province, where resource industries still rule, and changes in export markets and commodity prices have a great bearing on the fortunes of workers and communities.

BC's economy has been stagnating for two decades, a period that transcends the tenure of any particular government. There are two negative trends underlying BC's economic stagnation: a slowdown in private and public investment relative to GDP; and a shift in BC's trade balance from a surplus to a deficit. Both of these factors are rooted in BC's resource economy.

While trade and the resource sector will continue to be important for the province, we must increase the value created from BC's resource harvest, accelerate diversification, and seek to produce more at home of what we currently import. The role of the provincial government should be to facilitate this structural change, while protecting and helping communities through this transition.

The Government's Economic Strategy

The government's economic strategy—tax and spending cuts, privatization and deregulation, and the Olympics—is more of a leap of faith than a compelling plan for BC's future. In spite of all the rhetoric about "making BC open for business" there is no evidence that such strategies actually work—that they deliver the type of investment desired, or that they are worth the inevitable trade-offs in social and environmental protections.

Tax cuts have proved to be a disappointing economic stimulus. They have not paid for themselves, as was repeatedly promised during the election campaign. In spite of the tax cuts, BC went into recession in 2001 for the first time since 1982, and experienced slow growth in 2002, trailing the rest of the country. Even the government's own forecasts suggest that economic growth is not anticipated to boom in the short- to medium-term, nor is long-term investment, which tax cuts were also supposed to stimulate. But tax cuts have led to spending cuts that are causing hardship and increases in other, regressive taxes —this is the real price of the tax cuts.

Government fiscal plan:		
• Personal and corporate income tax cuts, introduced in 2001, worth over $2 billion; • Regressive tax increases (MSP premiums, sales taxes) worth $750 million in 2002/03; • $1.5 billion in spending cuts, introduced to cover the cost of tax cuts; • Record budget deficits; balanced budget by 2004/05.		
Impact on the BC Budget's bottom line:		
2002/03	2003/04	2004/05
$3.5 billion deficit	$1.4 billion deficit	$411 million surplus

The path not taken:		
• No tax cuts, no tax increases, no spending cuts; • Spending increases in health care and education in order to maintain 2001/02 services and employment levels; • Maintains all other public service funding levels—no welfare cuts, office closures, etc; • Much smaller deficits; balanced budget by 2004/05.		
Impact on the BC Budget's bottom line:		
2002/03	2003/04	2004/05
$1.3 billion deficit	$707 million deficit	$47 million surplus

The Path Not Taken: An Alternative Fiscal Scenario

This *Solutions Budget* constructs an alternative three-year fiscal scenario, which we call "the Path Not Taken." It shows what the BC Budget would look like had none of the recent tax cuts, tax increases, or spending cuts occurred, and small but necessary spending increases had been allowed. Had BC followed the Path Not Taken, the province would have better weathered the economic slowdown of 2001 to 2002, and still have balanced its budget by 2004/05. It shows that even with reasonable increases for expenditures over the three-year period, the deficit would have gradually reduced and provincial finances would even be in modest surplus by 2004/05. The accumulated debt under the Path Not Taken is less than under the government's three-year plan.

These numbers demonstrate that claims of an impending "structural deficit" were patently false, and were used to justify actions that most British Columbians find both radical and harmful. In other words, none of the pain we are seeing in the province due to expenditure cuts needed to happen.

A Made-in-BC Economic Strategy

Over the longer-term, BC needs to be much more creative in developing an investment strategy, and must seek a made-in-BC approach, not some off-the-shelf, one-size-fits-all imported one. It must address the growing gap between the "hinterland" and the Lower Mainland, and must seek to further diversify the BC economy. This means getting beyond the resource mindset that permeates the province's business culture. And it has to be a multifaceted strategy that moves BC up the value chain and promotes investment.

A number of key areas that should be considered:

- We need to use the tax system creatively—designing carrots and sticks that encourage investment, production and employment, and that reward the meeting of other social and environmental objectives—not give blank cheques via tax cuts to corporations.
- A public investment bank should be created to provide seed funding for new and innovative economic areas, where private sector financing is less likely to be forthcoming. Such a bank could also focus on innovative investments in the resource sector and alternative energy.
- We need a bold and comprehensive strategy for the resource sector based on adopting new environmentally-friendly technologies and moving up the value chain, thereby providing resource-dependent communities with both economic stability and environmental sustainability.
- Public investments and infrastructure development based on fundamental and existing needs should be prioritized. The emphasis should be on long-term care facilities, public transit, social housing and child care facilities—not Olympic circuses.

Economic growth is important but it has to be sustainable and equitable. BC is still a wealthy province, and is starting from a privileged position. But there is much work that desperately needs doing. Government cannot just sit on the sidelines; it must lead an economic strategy that is active and deliberate. The provincial government seems to understand this, but only when it comes to the Olympics. Budgets are about the choices we make—we need to remember that there are always alternatives.

Reviving the BC Economy

THIS YEAR, THE CCPA'S *SOLUTIONS BUDGET* looks at economic revival in BC. Over the past year and a half, radical changes have been implemented, allegedly to kick-start the BC economy. Based on neoliberal fundamentals—tax and spending cuts, deregulation and privatization—these changes are ongoing and are causing much pain and hardship. Many British Columbians, though they dislike this economic medicine, have come to accept this program as inevitable, and hopefully, good for them and the province in the long term.

The results so far, and reasonable forecasts of the future, however, do not provoke much optimism. At best, BC will post moderate, but not impressive, rates of economic growth over the next few years. No boom in private sector investment is on the horizon; indeed, the most plausible source of new investment is the public sector, should Vancouver-Whistler win its 2010 Olympic Games bid (although it is questionable whether this would be the best use of public funds).

In the short-run, external factors, such as foreign markets for BC's exports and international commodity prices, greatly affect the performance of the provincial economy—in particular, the BC "hinterland"—irrespective of the government of the day. This needs to change. BC needs a compelling industrial strategy to make the province more resilient to the shifting winds of the global economy. The provincial government has a significant role to play in the long-run development of BC's economic future: what type of economic growth we have and how the bounty is shared.

In the next section, we take a longer term view of the BC economy, looking at trends over the past 40 years. We then hone in more closely on the economic and fiscal context in recent years, and how that has shaped the circumstances facing the province today. Large income tax cuts (accompanied by tax increases for MSP and sales) and large cuts in expenditures were a leap of faith that has undermined BC's fiscal situation.

The centrepiece of this year's *Solutions Budget* is an alternative scenario that shows what the BC Budget would look like had none of the recent tax cuts, tax increases and spending cuts occurred, and small but necessary spending increases had been allowed. This scenario—which we call the Path Not Taken—shows how BC could have been spared all of the hardship associated with spending cuts, while still meeting the government's three-year timetable for balancing the budget. We demonstrate how the government's spending cuts can and should be compassionately reconsidered. In the final section, we turn back to the longer-term challenges facing the province's economy. We set out the elements of a made-in-BC industrial development strategy aimed at increasing the value of BC's exports, and increasing public and private investment in the provincial economy.

PART 1

Beyond the Staples Economy

THIS SECTION TAKES A LONG VIEW of the BC economy over the past four decades (statistics from the BC economic accounts date since 1961). Many analyses are limited to the 1990s, but a fuller picture requires a longer time horizon, as many of the problems facing the BC economy have deeper roots.

BC's economic history is a classic case of what Canadian economic historian Harold Innis termed a "staples economy"—an economic development model driven by the extraction and export of unprocessed or semi-processed raw materials.

In 2003, BC remains a small, resource-dependent economy heavily reliant on the export of basic commodities. While it is true that BC now has a much more diversified economy than in the past, this largely reflects the vitality of Greater Vancouver. Many observers have correctly noted that BC has two economies: the populous and diversified Lower Mainland area (plus the provincial capital of Victoria), and the rest of the province, where resource industries still rule, and changes in export markets and commodity price swings have a great bearing on the fortunes of workers and communities.

BC has long lived the roller-coaster ride typical of staples economies. The good news is that the province has been experiencing less of these booms and busts—a feature of diversification and modernization of the economy. BC now has a substantial service sector that accounts for three-quarters of provincial GDP and employment. Services have experienced relatively stable year-to-year growth, carrying the BC economy at a time when goods-producing industries have been flat.[1]

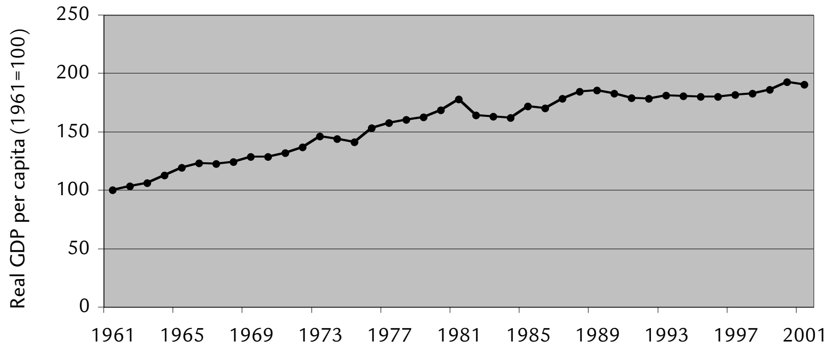
The bad news is the stagnation of the past two decades rooted in the resource sector. While many remember the 1990s as a weak decade in terms of economic performance, this actually reaches back to the 1980s, when there were only three good years of growth out of ten. In contrast, the 1960s and 1970s saw some bad years, but these were well outnumbered by the good.

Figure 1 shows BC's real GDP per capita—the total size of BC's economic product per person, after accounting for population growth and inflation—over the past 40 years in the form of an index (1961=100). The bulk of growth in real GDP per capita occurred in the first two decades. For the twenty-year period from 1961 to 1981, BC's real GDP per capita increased a total of 78%. But from 1981 to 2001, the total increase was a mere 7%.

This 20-year story of slowdown in the BC economy transcends the tenure of any particular government. It points to structural features of the economy that go much deeper than alleged government mismanagement. Socred governments, NDP governments and now a Liberal government have all presided over this period of relative stagnation in GDP growth.

A look at the components of GDP suggests two major areas of concern underlying the economic slowdown: a general decline in public and private investment; and a

Figure 1: Index of BC Real GDP Per Capita, 1961-2001 (1961=100)



Source: CCPA calculations based on BC Stats, BC Economic Accounts

shift in BC's net export performance from a trade surplus to a trade deficit. Both of these factors are connected to BC's resource economy.

The level of investment is a principal driver of economic growth and productivity. The upper line in Figure 2 shows two components of private sector investment as a percentage of GDP: investment in machinery and equipment; and investment in non-residential structures. Investment in residential structures is not included here. While residential construction does have a positive impact on the construction industry, the focus of Figure 2 is on growth and productivity enhancing capital investments.

Beginning in the early 1980s and continuing through the 1990s, there is a general decline in business investment as a share of GDP. By the 1990s, this amounts to a difference of around four percentage points of GDP compared to the 1960s and 1970s. Like trends in GDP growth, the investment slowdown is not just a 1990s story.

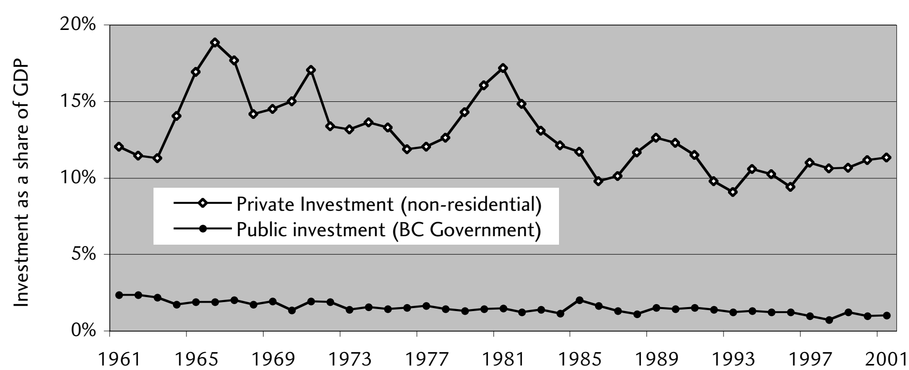
Nor has the public sector picked up the slack (the lower line in Figure 2). Although public sector investment is much smaller in magnitude than private sector investment, it has also been on a four-decade declining trend when expressed as a percentage of GDP. This has compounded the decline in private sector investment somewhat, although the overall investment slowdown has much more to do with the private sector.

The investment decline translates into a productivity performance that is somewhat lagging other provinces. BC produced about $35 of income for every hour worked in 2001, slightly behind the Canadian average. Ontario creates about $2 more income per hour worked than BC, while Alberta (the highest in Canada) creates about $4 more income per hour than BC. [2] This is a reversal from the early 1980s, when BC was Canada's productivity leader.

A Statistics Canada study broke down the productivity numbers by industry, accounting for the shares of particular industries in the overall economy.[3] Interestingly, it found that BC's productivity gap vis-à-vis Ontario is mostly accounted for by the different industrial mix. In "like" industries, productivity levels are very similar, but Ontario's economy is characterized more by high value manufacturing, and less by natural resources, relative to BC's.

Alberta, of course, demonstrates that it is possible to have a prosperous resource economy. Indeed, Alberta is even more resource dependent than BC. But its situation is unique, shaped by substantial oil and gas exports to the US. While BC does produce some oil and gas, our international exports are dominated by wood, pulp and

Figure 2: Public and Private Investment as a Share of GDP, 1961-2001



Source: CCPA calculations based on BC Stats, BC Economic Accounts

This 20-year story of slowdown in the BC economy transcends the tenure of any particular government. It points to structural features of the economy that go much deeper than any alleged government mismanagement.

paper products, which together accounted for almost half of our $30.8 billion of exports in 2001. BC will never have the same oil and gas endowment as Alberta. Comparisons to Alberta often presume that BC could replicate Alberta's economic performance by lowering taxes, but low taxes are the consequence of a boom in oil and gas exports that reap windfall revenues for government—not their source.

The BC economy as a whole is less reliant on resources as a share of GDP than in the past, but when it comes to exports, resources are dominant. Adding together all resource sectors—forestry, agriculture, fish products, minerals and energy—some 77.8% of BC exports are from natural resources. Fortunately, BC has made some gains. In 1992, the share of exports from natural resources was 86.4%. And within the sub-categories of resource products, value-added exports have gained ground. For instance, value-added wood products now comprise 3.1% of total exports, up from 1.8% in 1992.[4] While it is notable that BC has diversified its export base and is adding more value to its exports in certain areas, basic commodity exports still comprise the lion's share of exports.

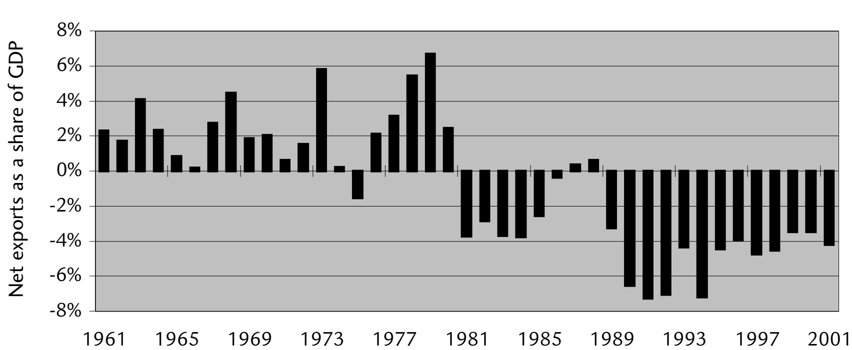
Where this becomes particularly problematic is when BC's overall trade position is considered—both international and interprovincial. Figure 3 shows that through the 1960s and 1970s BC had a consistent trade surplus (exports in excess of imports) averaging 2.4% of GDP. This began to reverse in the 1980s. From 1981 to 2001, BC had a trade deficit averaging 3.8% of its GDP, a large and troubling turnaround.

The biggest factor behind the trade deficit is a steady increase in imports from other countries relative to GDP, while BC's exports to other countries have remained relatively steady at around 30% of GDP. BC still maintains a small surplus on *international* trade, but this is more than offset by a large deficit on *interprovincial* trade.

The roots of the problem go back to the composition of BC trade: we are still a "staples" economy that tends to export raw materials and commodities, while importing manufactured goods and capital equipment. Whereas Ontario has weaned itself from natural resources in favour of manufactured goods, BC continues to follow a development strategy more common to the Third World than the First. Exporting natural resources has certainly been a successful strategy historically for BC, but international competition and changing technology make this less effective than it used to be. It is time to make a break.

While trade and the resource sector will continue to be important for the province, we must increase the value created from BC's resource harvest, accelerate diversification, and seek to produce more at home of what we currently import. The role of the provincial government should be to facilitate this structural change, while protecting and helping communities through this transition. Ways to do this are considered later in this *Solutions Budget*.

Figure 3: BC Net Exports (International and Interprovincial) as % of GDP, 1961-2001



Source: CCPA calculations based on BC Stats, BC Economic Accounts

PART 2

BC's Current Fiscal Situation

WHILE THE LONGER-TERM DYNAMICS described above are important to understanding the broader context of the BC economy, there are some particularly pressing short-term issues that are affecting economic growth, and as a consequence, the provincial budget and fiscal situation.

The most recent revisions to the provincial economic accounts marked down BC's economic performance in 2001. The latest Statistics Canada data show that after strong growth of 4.3% in 2000, real GDP declined by 0.2% in 2001, the first actual recession for the province since 1982. BC was the only province to experience a recession in 2001. Recent estimates suggest that BC will trail most other provinces in 2002 (preliminary estimates will be published in the spring) and in 2003. Real GDP growth in 2002 is estimated at 1.9%. The outlook for 2003 and 2004 from the Finance Minister's Economic Forecast Council calls for slight improvements each year, with average projected real GDP growth of 2.7% and 3.3% respectively.

In contrast, the Canadian economy overall has fared better than anyone imagined a year ago. While the US economy has been flat since early 2001, Canada escaped a recession and recovered strongly through 2002. The Canadian economy has now outperformed the US economy for four consecutive years (1999 through 2002) and is forecast to do so again in 2003. Low interest rates have been a key ingredient in spurring consumer spending on big ticket items, such as cars and homes. This has also been the case for BC, with a notable construction and real estate boom, although the economy overall has been held back by external factors.

The main area of uncertainty for BC has to do with activities south of the border. Of particular concern is the ongoing dispute over softwood lumber—whether there will be a resolution this year, and if so, on what terms. Overall, the US is now the destination for 70% of the value of BC exports—$21.4 billion in 2001. In 1991, the US was the destination for only 44% of BC exports. After being sideswiped by the Asian Crisis in the late-1990s, BC exporters turned their attention to the US market, caught the tail end of the boom, but are now being squeezed between an overall US and global slowdown and specific trade harassment by the US over softwood lumber.

While many forecasters are calling for stronger growth in the US in 2003, there is much uncertainty. Among the factors are:

- Corporate and consumer debt levels in the US are at record high levels. Together they amount to 200% of US disposable income;[5]
- A massive and growing trade deficit of about 4% of US GDP;
- An impending war against Iraq; and,
- Heightened restrictions for security purposes.

The strength of BC's economic growth has a direct connection to the bottom line of the provincial budget. Figure 4 shows BC's surpluses and deficits from 1991/92 to 2002/03 as bars, with a line showing annual growth rates of real GDP. Years of slower growth generally translate into larger deficits, as revenues to the Treasury grow at a slower pace than expenditures. But when growth picks up, there is a strong positive benefit to the budget's bottom line. The only exception is in the most recent years, due to the lost revenues from tax cuts.

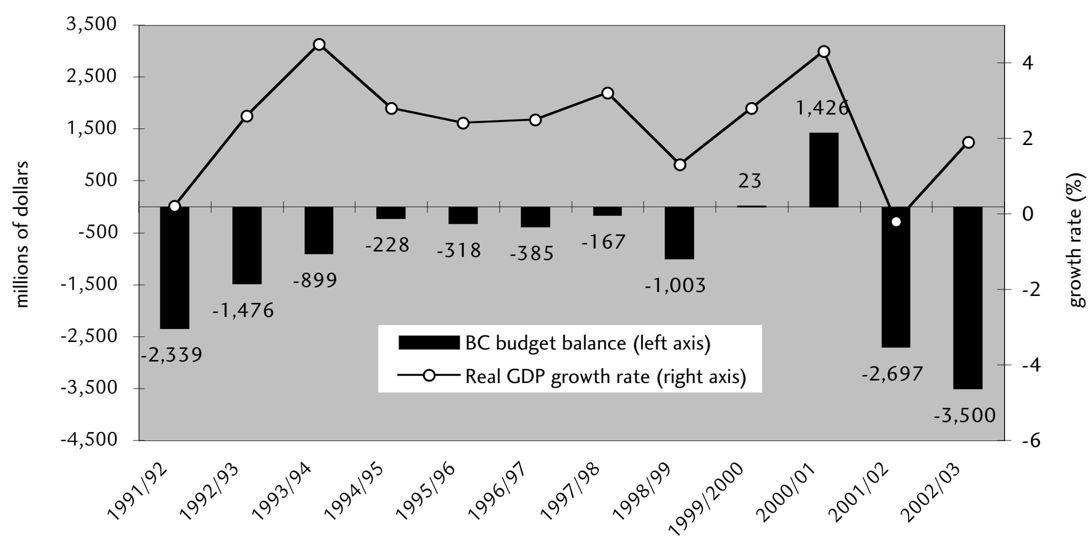
The figure shows that moderate growth in the early- to mid-1990s helped shrink a then-record deficit of $2.3

BC was the only province to experience a recession in 2001. Recent estimates suggest that BC will trail most other provinces in 2002 and 2003.

billion in 1991/92 over the next few years. While much was made of the string of deficits in the mid-1990s in the mainstream media, these were all very small as a percentage of GDP. A growth slowdown in 1998 associated with the Asian Crisis increased the deficit to $1 billion, but a resumption of growth in 1999 and 2000 led to surpluses—a modest surplus of $23 million in the 1999/00 fiscal year and a record surplus of $1.4 billion in 2000/01 (about $1 billion of this latter figure is connected to windfall electricity and energy exports).

The budget balance again turned to deficit in 2001/02, and the 2002/03 projected deficit of $3.5 billion is scheduled to be the largest in provincial history (the government estimates a $4 billion deficit but this includes a $500 million "forecast allowance"). However, in addition to a cyclical component connected to BC's 2001 recession and slow growth in 2002, these deficits are much larger as a result of BC's tax cuts. The next section attempts to sort out the cyclical component of the deficit from the structural deficit that arose from the tax cuts.

Figure 4: BC Budget Balance and Real GDP Growth



Notes: The figure for 2002/03 is the latest estimate from the Second Quarter report. The government's official estimate is $4 billion, but this includes a $500 million "forecast allowance." The figure for 2001/02 reflects the underling deficit prior to an accounting adjustment of $1.464 billion.

GDP growth rates are for calendar years, not fiscal years. For example, the budget figure for 2000/01 fiscal year is matched to the GDP growth rate for the 2000 calendar year. GDP growth for 2002 is the most recent average estimate.

Sources: BC Ministry of Finance, Financial and Economic Review 2002; Ministry of Finance Second Quarter Report, 2002; BC Economic Accounts; Minister of Finance's Economic Forecast Council.

PART 3

The Path Not Taken

An Alternative Budget Scenario

IN THE 2002 BUDGET, the BC government laid out a three-year plan for provincial finances. This plan maintains the high profile personal and corporate tax cuts, valued at some $2.3 billion. It also included selected regressive tax *increases* for MSP premiums, sales taxes and the tobacco tax, and spending cuts of $1.5 billion (a cut to the direct public sector of $1.9 billion less an increase in health care of just over $400 million) phased-in over the three-year plan. These latter measures, if there is to be no reconsideration of the tax cuts, are required to meet the government's balanced budget target date of 2004/05.[6]

The accompanying table considers the "path not taken"—what BC's fiscal situation would have been had there been no tax cuts (or regressive tax increases) or spending cuts. It contrasts the government's three-year plan with a continuation of the pre-tax cut status quo, plus a modest increase in spending.

The left half of the table reproduces the final, audited numbers for the 2001/02 fiscal year, plus the three-year fiscal plan tabled in the February 2002 Budget, modified by new information made available in the Ministry of Finance First and Second Quarter Reports. In 2001/02, the deficit was $1.23 billion, although the underlying deficit was much worse—about $2.7 billion—because of the inclusion of a $1.46 billion one-time accounting adjustment related to the treatment of public pension plans.

For the 2002/03 fiscal year, the projected deficit is $3.5 billion. Over the next two fiscal years, if all goes according to plan, the deficit will fall to $1.36 billion in 2003/04, and there will be a surplus of $411 million by 2004/05.[7] If this is the case, the government will be cutting spending by much more than necessary to balance the budget; this means that some of the spending cuts should be scaled back in the 2003 Budget.

In addition, there is good reason to believe that this fiscal forecast is geared, in Paul Martin fashion, to ensure that actual numbers will exceed projections. The government's revenue projections seem to be greatly understated, particularly the revenue drop from 2001/02 to 2002/03 for personal and corporate income tax cuts. Most of the personal income tax cut was phased in for the 2001/02 fiscal year, and 2001 was also a recession year. Even with the second installment of tax cuts, it is hard to see how personal income tax revenues could drop by $1.1 billion when the economy is growing moderately. Similarly, corporate income tax revenues are projected to fall by almost $900 million, in excess of the forgone revenues due to tax cuts. When the final totals are published, the 2002/03 fiscal year will in all likelihood close with a deficit substantially smaller than $3.5 billion.

The wild card in these numbers is how much new money the federal government will inject into provincial health care systems in the 2003 Federal Budget. If the federal government meets the Romanow Commission

Table 1: The Path Not Taken

	GOVERNMENT FISCAL PLAN				PATH NOT TAKEN			
	2001/02	2002/03	2003/04	2004/05	2001/02	2002/03	2003/04	2004/05
	MILLIONS OF DOLLARS				MILLIONS OF DOLLARS			
CONSOLIDATED REVENUE FUND								
REVENUES								
TAXATION								
Personal Income Tax	5,375	4,254	5,109	5,449	6,415	6,652	6,965	7,376
Corporate Income Tax	1,522	664	989	1,070	1,770	1,835	1,922	2,035
Sales Tax	3,535	3,812	4,039	4,245	3,510	3,640	3,811	4,036
Other taxation revenue	3,220	3,227	3,178	3,265	3,220	3,339	3,496	3,702
Total taxation revenues	13,652	11,957	13,315	14,029	14,915	15,467	16,194	17,149
NATURAL RESOURCES								
Oil, gas and minerals	1,352	1,352	1,523	1,538	1,352	1,352	1,523	1,538
Forests	1,253	1,120	1,071	1,109	1,253	1,120	1,071	1,109
Columbia River Treaty	360	90	165	185	360	90	165	185
Water and other	287	261	293	297	287	261	293	297
Total natural resource revenue	3,252	2,823	3,052	3,129	3,252	2,823	3,052	3,129
MSP PREMIUMS	955	1,327	1,342	1,353	925	938	950	964
OTHER REVENUE	974	851	922	969	974	851	922	969
GOVERNMENT ENTERPRISES	1,437	1,483	1,429	1,412	1,437	1,483	1,429	1,412
FEDERAL TRANSFERS	2,855	3,485	3,570	3,660	2,855	3,485	3,570	3,660
TOTAL REVENUES	**23,125**	**21,926**	**23,630**	**24,552**	**24,358**	**25,047**	**26,117**	**27,283**
EXPENDITURES								
Health	9,964	10,380	10,374	10,378	9,964	10,380	10,899	11,253
Education	6,862	6,871	6,871	6,871	6,862	7,034	7,209	7,390
Social services	3,369	3,197	2,784	2,368	3,369	3,706	3,500	3,369
Debt service	798	920	1,085	1,182	798	850	900	950
Other	4,262	3,932	3,821	3,329	4,262	4,262	4,262	4,262
TOTAL EXPENDITURES	**25,255**	**25,300**	**24,935**	**24,128**	**25,255**	**26,232**	**26,770**	**27,224**
NET BALANCE ON CROWN CORPORATIONS	**(567)**	**(126)**	**(53)**	**(13)**	**(567)**	**(126)**	**(53)**	**(13)**
ACCOUNTING ADJUSTMENTS	**1,464**				**1,464**			
SURPLUS (DEFICIT)	**(1,233)**	**(3,500)**	**(1,358)**	**411**	**0**	**(1,311)**	**(707)**	**47**

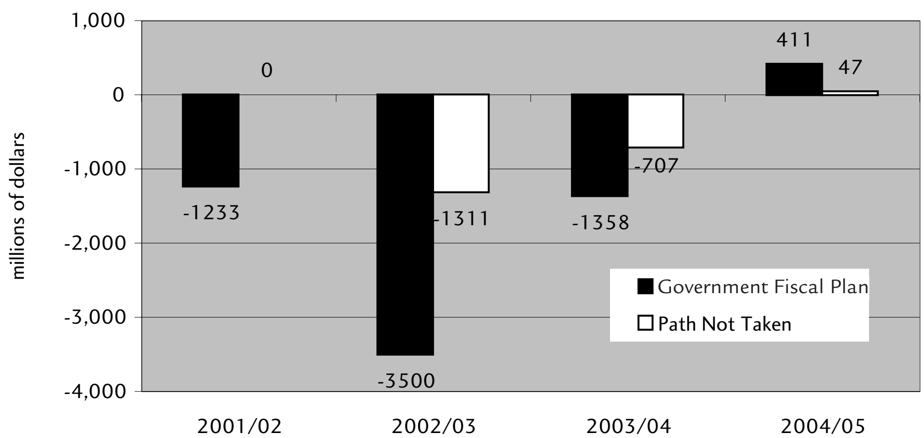
Notes and Sources: See next page.

target of $3.5 billion, this would mean an additional infusion for BC of approximately $450 million. While this is a reasonable assumption of the minimum federal contribution, because of uncertainty due to funding in subsequent years, and about whether strings will be attached requiring new spending, we do not include an estimate of new health care money in the table. It is certain, however, that BC will benefit from new federal dollars, a fact that improves the overall budget situation.

On the right side of the table, the Path Not Taken scenario takes the government's 2001/02 figures as a baseline, then adds back revenues lost due to the tax cuts. But recognizing the small stimulus from the tax cuts, we reduce the figure accordingly (based on revenue sensitivities in the BC Budget). The net impact is an increase in tax revenues of $1.3 billion relative to the actual 2001/02 figures in the government's fiscal plan. For subsequent years, tax revenues in the Path Not Taken are based on projected nominal GDP growth (revenue figures are in nominal, not real terms) from the Finance Minister's Economic Forecast Council, adjusted to reflect the different fiscal impact of the Path Not Taken approach (based on Informetrica's fiscal impact model). In addition, MSP revenues are reduced to pre-fee hike levels, and are assumed to rise in accordance with trend growth rates over the past decade. Natural resource royalties, revenue from government enterprises, federal government transfers and other revenues are all duplicated from the government's three-year plan.

On the expenditure side, the Path Not Taken also begins with the final numbers for 2001/02 as a baseline. It accepts the government's health care increase for 2002/03, then assumes growth in health care expenditures of 5% in 2003/04, rising to $11.25 billion in 2004/05 (this

Figure 5: BC Budget Balance – Government Fiscal Plan vs. CCPA's Path Not Taken



Sources for Table 1 and Figure 5

Notes: For the government fiscal plan numbers: 2001/02 are actual figures; 2002/03 are estimates based on Ministry of Finance Second Quarter Report; 2003/04 and 2004/05 are based on 2002 Budget three-year fiscal plan, with revised numbers from First Quarter Report. Federal equalization contributions for 03/04 and 04/05 have been raised due to new information from federal government.

For the Path Not Taken scenario: Tax revenue uses a 2001 baseline but without the tax cuts. This adds $1.1 billion in personal income tax revenues and $248 million in corporate income tax revenues. To account for the small stimulus provided by the tax cuts, based on revenue sensitivities from the 2002 Budget, $75 million in PIT revenues, and $25 million in sales tax revenues, are subtracted. "Other taxation revenue" includes other corporate taxes, such as the capital tax, that have been rolled back. Subsequent years assume growth in revenues based on nominal GDP growth (as forecast by the Finance Minister's Economic Forecast Council), adjusted for the impact of fiscal changes according to Informetrica's fiscal impact model. These numbers are: for 2002, 3.7%; for 2003, 4.7%; for 2004, 5.9%. MSP is taken from 2001 Second Quarter Report (last report before announcement of MSP increases), then assumed to increase according to recent historical trend. Other revenue numbers are same as government three-year plan. Health care expenditures assume a 5% increase in 03/04, rising to $11,253 in 2004/05 (based on anticipated $873 million shortfall by 04/05 according to Hospital Employees' Union estimates). Education expenditures assumed to increase 2.5% per year; debt service assumed to increase by $50 million per year, which is consistent with lower provincial debt under this scenario. Social services expenditures assumed to increase by 10% in 02/03 due to a weak economy, then decline back to 01/02 levels by 04/05. All other expenditures are assumed constant over the three-year period.

Sources: CCPA calculations based on BC Budget 2002; Ministry of Finance 2002/03 First and Second Quarter Reports; Finance Minister's Economic Forecast Council.

These numbers demonstrate that government claims of an underlying "structural deficit" were patently false, and were used to justify actions that most British Columbians find both radical and harmful. In other words, none of the pain we are seeing in the province needed to happen—indeed, spending increases were possible.

covers an estimated $873 million shortfall in funds, as estimated by the Hospital Employees' Union). Education expenditures are assumed to increase by 2.5% per year, the amount required to fund salary increases and inflation. Social services expenditures are assumed to increase in 2002/03 due to the state of the economy, then revert back to 2001/02 levels by 2004/05 as the economy recovers. Debt service costs are lower in the Path Not Taken due to lower accumulated deficits. Other expenditures are maintained at their 2001/02 levels.

Had BC followed the Path Not Taken, the provincial budget would have been balanced in 2001/02, albeit on a technicality—the underlying deficit would have been $1.46 billion, reflecting the public pensions accounting adjustment. In the absence of this accounting adjustment, the 2001 recession would have led to a large deficit for the 2001/02 fiscal year. Attempting to maintain a balanced budget during a recession would have been foolish.

For 2002/03 to 2004/05, the Path Not Taken illustrates that the government could have weathered the storm of 2001 to 2002, and still have balanced its budget by 2004/05. It shows that even with reasonable increases for expenditures over the three-year period, the deficit would have been gradually reduced and provincial finances would even be in modest surplus by 2004/05. This is due to the natural increase in revenues attributable to economic growth.

These numbers also demonstrate that government claims of an underlying "structural deficit" were patently false, and were used to justify actions that most British Columbians find both radical and harmful. In other words, none of the pain we are seeing in the province due to expenditure cuts (to pay for the government's tax cuts) needed to happen—indeed, spending increases were possible.

Large deficits in 2001/02 to 2003/04 push up BC's debt-to-GDP ratio. Fortunately, the province's overall debt situation is still in decent shape relative to other provinces. What is troubling is that these deficits financed tax cuts rather than real investments that will benefit the province in the long-run. There is an opportunity cost to these political choices, reflected in higher levels of public debt and larger annual debt service costs.

PART 4

Evaluating the Government's Economic Strategy

THE PROVINCIAL GOVERNMENT'S economic strategy has three main planks: personal and corporate tax cuts (funded by spending cuts and selected tax increases); deregulation and privatization; and the Olympics. With the exception of the Olympics, this platform is based on making BC "open for business" by getting government "out of the way."

The Olympics are an interesting counterpoint to the "small government" agenda. In this case—a two-week party for global elites—the provincial government is prepared to turn on the spending taps. A large increase in public spending would indeed provide a short-term economic boost, although the Olympics would distort the priorities for spending, and push forward projects that are not necessarily at the top of the public's list. Olympics projects may also be low-productivity ones. For instance, the economic benefit from building luge runs and speed skating ovals is not likely to be very high. The ongoing operating costs of running these facilities after the Olympics may make them a net drain to the Treasury.

The centrepiece of the government's strategy is clearly tax cuts. However, so far the tax cuts have been disappointing in terms of performance. Tax cuts have not paid for themselves, as was repeatedly promised during the election campaign. In spite of the tax cuts, BC went into recession in 2001 and experienced slow growth in 2002. Even the government's own forecasts suggest that economic growth is not anticipated to boom in the short- to medium-term, nor is long-term investment, which tax cuts were also supposed to stimulate.[8]

The skewed distribution of the tax cuts muted their economic stimulus. For example, half of the total tax cut went to the top 13% of taxpayers that make more than $60,000 per year.[9] People with high incomes are less likely to spend their tax cut in BC, preferring imported goods, vacations abroad and financial market investments. There have also been tax increases—higher sales taxes, MSP premiums, and tobacco taxes—totaling half the value of the personal income tax cut. But these latter taxes are regressive—people with low and modest incomes take a bigger hit as a share of their incomes. Taken together, changes in the tax system effectively redistribute the tax load from upper-income earners to modest- and middle-income earners.

Moreover, as the CCPA noted in a recent paper entitled *Bleeding the Hinterland*, on a regional basis, not much of the tax cut actually made it to places where help is most needed. Most of the income tax cuts stayed in the very southwest corner of BC—in the Lower Mainland and Victoria—with only 29% of the tax cut pie thinly

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spread across the rest of the province. The big winner of the tax cut derby was Greater Vancouver, already the wealthiest part of the province. With 51% of the province's population, the Greater Vancouver Regional District got 58% of the total tax cut. Most places outside the GVRD got a share of the tax cut that was much less than their share of the population.[10]

The sweeping cuts to BC's public services are the real price of tax cuts. While the spending cuts were announced one year ago, many office closures and service reductions are only just starting to happen—and they are scheduled to intensify over the next two years, as the government seeks to re-balance the budget by chopping public spending. Closures of Ministry offices, courthouses, schools and health care facilities are also disproportionately hurting smaller communities, and are coming at the worst possible time. In many communities in BC, the public sector is the number one or two employer. The loss of income from public sector jobs compounds losses in resource sectors, and threatens to accelerate the depopulation of the "hinterland."

Together, the tax and spending cuts are making a bad situation worse in rural BC. And at present, the biggest economic development initiative in the government's arsenal is the Olympics, which if successful, will largely confine any public spending and economic spin-offs to the Vancouver-Whistler area. BC's Hinterland will be forced to watch from the sidelines.

Most importantly, the government's strategy is more of a leap of faith than a compelling plan for BC's future. In spite of all the rhetoric about "making BC open for business" there is no evidence that such strategies actually work—that they deliver the type of investment desired, and that they are worth the inevitable trade-offs in social and environmental protections. The next section goes into more detail about an alternative industrial strategy that addresses the long-term problems raised in the first part of the *Solutions Budget*.

PART 5

A Made-in-BC Industrial Strategy

AMONG THE BAD IMPORTS TO BC in recent years is the belief that "small government" is necessary for the province's "competitiveness" as an investment location. While it is clear that there has been an investment slowdown, particularly in the resource sector, and that sustained higher levels of capital investment are required, this view hangs a lot on investors responding positively to BC's current commitment to downsizing.

For example, BC needs more capital investment in the resource sector, but we have to recognize that there are limits to the resource base. New investment must focus not on greater throughput—more cutting and more timber processed—but on adding more value to a sustainable resource harvest. The type of investment matters a great deal, and by reducing regulations that protect the environment and workers in resource communities, we may simply attract the wrong kind of investment.

BC needs to be much more creative in developing an investment strategy, and must seek a made-in-BC approach, not some off-the-shelf, one-size-fits-all imported one. BC's problem is that exporting resource commodities and importing manufactured goods is a bad trade strategy. The way out is not to get government out of the way—by cutting taxes, deregulating and privatizing to attract foreign investment—but rather, by finding ways that government can lead the charge. BC policy makers need to think outside the neoliberal box, as all successful nations and regions have had to do.

A made-in-BC strategy must address the growing gap between the "hinterland" and the Lower Mainland. It must seek to further diversify the BC economy, particularly with regard to manufacturing. This means getting beyond the resource mindset that permeates the province's business culture. And it has to be a multifaceted strategy that moves BC up the value chain and promotes investment.

We need to use all the tools at our disposal to promote investment, production and employment in BC. Certainly, a province has more challenges in this regard than does a national government. BC cannot control interest rates, the exchange rate, trade policy or other broad framework laws. But provincial governments are far from helpless and still have policy levers at their disposal should they wish to exercise them. Below we comment on a number of key areas that should be considered: tax system changes; the creation of a public investment bank; a revitalized resource policy; and public infrastructure and investments.

Tax Incentives not Tax Cuts

The problem with corporate tax cuts is that they are a blank cheque—corporations benefit without necessarily committing to new investment or employment. Whether they do so in the end requires a leap of faith. Instead, we need to use the tax system creatively to provide carrots and sticks that create the incentives for investment, production and employment, and that reward the meeting of other social and environmental objectives. The only tax cut implemented by the provincial government that was not a blank cheque was the elimination of the sales tax on machinery and equipment. In this case, only those companies making investments in machinery and equipment benefit from the tax cut.

In principle, there is no reason why the tax system should not reward companies that meet provincial objectives with lower taxes, but it should also ensure that companies that do not meet these objectives pay higher taxes. The system should provide a range of tax credits that would make BC a low tax jurisdiction relative to others in North America—but only for those companies that are willing to meet provincial economic, social and environmental objectives.

Overall, changes to the corporate tax structure should be revenue-neutral. This can be accomplished by engaging in some other measures to broaden the corporate tax base and by rolling back some or all of the corporate tax cuts.

A Public Investment Bank

BC needs to channel resources into the real economy rather than getting caught up in the whirlwind of speculation that characterizes financial markets. We propose the establishment of a public investment bank, funded by a portion of resource royalties, export taxes on low value-added commodities, and interest-earning investments from governments, pension funds and individuals. Funding from the public investment bank would then be allocated to smaller "development councils" that would finance projects in particular sectors as well as projects in regions or communities.

A public investment bank would act as a provider of seed funding for new and innovative economic areas, where private sector financing is less likely to be abundant (if there at all), as well as focusing on the revitalization of the resource sector. Funding recipients would include new Crown corporations, cooperatives, worker-owned enterprises, communities, First Nations and other non-profit entities, in addition to traditional businesses—anyone with a solid business plan would be welcome.

A theme of sustainable development should be front-and-centre for the new entity. It could provide funding support for projects in sustainable agriculture; sustainable forestry; recycling facilities; investments in resource efficiency; development and purchase of environmental technologies and green power sources. There is a clear connection between these areas and an aggressive provincial strategy related to the implementation of the Kyoto Accord, now that it has been ratified by the federal government.

There are, of course, many lessons to be learned from the experience of programs at the national and regional levels. The federal Technology Partnerships Canada program is an interesting model to consider in the design of a new public investment bank, as it is consistent with Canada's international trade obligations, and based a model of conditional repayment of funds based on commercial success.

Public investments can also face major pitfalls. A number of issues related to objectives, planning and accountability emerged in the context of the Fast Ferries project. A review of the Fast Ferry project by the Auditor General of BC found that significant breakdowns in governance and project management occurred on the project. No business case was prepared, the likelihood of exporting the end result was not examined in any detail, the project proceeded before sufficient analysis and information were available, and the project was rushed along. The corporation established to build the ferries, Catamaran Ferries International, was a subsidiary of the buyer, BC Ferries Corporation, both of which were under the guidance of a common CEO. Boards of directors for both corporations did not have sufficient information to do their jobs, and in any event were often bypassed by decisions made outside the corporations by elected officials. In the end, an approved $210 million to build three ferries ballooned to an estimated $463 million, delivery dates were around three years behind schedule, and the final product did not meet some of its original objectives.[11]

This type of governance disaster tarnishes efforts by governments to engage in industrial development. However, as the AG report comments,

> *[T]he idea of using Crown corporations to deliver publicly provided services of a commercial nature is sound. Properly applied, such an administrative mechanism can be more cost-effective that direct service provision by government because it gives more room for the application of business practices. However, BC Ferries has not been allowed to apply these practices in an organized and consistent way.*[12]

Accountability, governance and clear objectives are essential ingredients to a successful public investment program. The case of the Fast Ferries should not be generalized to the public sector as a whole, any more than the cases of Enron, Tyco and Bre-X can be generalized to the private sector.

The system should provide a range of tax credits that would make BC a low tax jurisdiction relative to others in North America—but only for those companies that are willing to meet provincial economic, social and environmental objectives.

Resource Sector Strategy

BC's resource sector needs a bold and comprehensive investment strategy. The resource sector was plagued throughout the 1990s by a lack of investment. Forest companies, for example, invested just enough to counter the depreciation of their aging machinery. Opportunities to become more efficient and productive in pulp and to move up the value chain in solid wood have been foregone, leaving the industry in an uncompetitive and unstable position compared to forest companies elsewhere in Canada and abroad.

The focus of an investment strategy should be to adopt new environmentally-friendly technologies and move up the value chain, thereby providing resource-dependent communities with both economic stability and environmental sustainability. The provincial government can play a role in encouraging and facilitating investment—from many places and in different forms—to move the resource sector towards a more viable *and* responsible position, and to capture emerging markets for eco-friendly resource products. This strategy should challenge BC's resource corporations to enter into a new social contract with British Columbians.

But a new approach also involves looking for alternatives to the present industrial and investment structure. Policy makers must be reminded that there are other potential investment players besides the large corporate sector who can develop natural resources and create wealth and stability for resource-dependent communities. Communities themselves, co-operatives, workers, the small business sector, First Nations bands, and public enterprises can all be vehicles to put new investment into motion, and are frequently less willing to compromise the long-term ecological integrity of BC's natural systems or the health of the people of the province. Ultimately, the more options a government has to choose from with respect to managing its resources, the more bargaining power it has with each entity wanting a piece of the action.

Communities themselves, co-operatives, workers, the small business sector, First Nations bands, and public enterprises can all be vehicles to put new investment into motion, and are frequently less willing to compromise the long-term ecological integrity of natural systems or the health of the people of BC.

In order to increase investment in value-added wood products, the provincial government should:

- ban the export of raw logs from Crown land;
- provide tax credits to forest companies investing in value-added production, with the revenue coming from increased stumpage rates;
- increase the number and size of tenures for communities and First Nations; and
- make more wood available to small firms wanting to manufacture value-added products by reforming the Small Business Forest Enterprise Program and establishing more log yards.

For reasons of social justice and putting an end to uncertainty in BC, the provincial and federal governments should:

- negotiate interim agreements with First Nations people and, as part of treaty settlements, provide them with resources to develop forestry plans and market ecologically-friendly forest products.

In order to generate a sustainable flow of capital from non-renewable resources, the provincial government should:

- establish a trust fund by pooling a portion of resource royalties and taxes from oil, gas, coal and other mining operations, with the capital used for economic development projects within the province; and
- amend the *Mines Act* so that companies developing a non-renewable resource must pay a community transition bond, to be used by the community and workers for transition once the project is completed.

This list is far from exhaustive. These and other policy ideas are elaborated upon in Dale Marshall's *Re-Capturing the Wealth*, published by the CCPA in July 2001. All are hopeful and realizable policies that together form a compelling investment strategy to reinvigorate BC's resource sector.

Public Infrastructure and Investment

Public investments and infrastructure development based on existing needs should be prioritized with the same zeal now being given to the Olympics. Government cuts are leading to under-investment in the infrastructure needed for economic growth. If we are to have a stable economic base to underpin a more diversified economy, we need to make the necessary investments.

Much of this comes down to choices. Is adding new lanes to the Vancouver-Whistler highway a bigger priority than fixing the dangerous stretch of Trans-Canada Highway from Sicamous to the Alberta border? Should we construct a long-term care facility or a speed-skating oval? Previous CCPA publications have gone into great detail about priorities for new public investment. In broad strokes, key investment areas include:

Post-secondary education and apprenticeships—With a skills shortage looming, organized labour and businesses both recognize the need to ensure BC has the skills base needed for the future. BC has made gains over the past decade with respect to post-secondary participation, but tuition hikes and frozen budgets put these gains at risk. If the government is truly interested in boosting long-term rates of economic growth, there is no better place to start than education. Investments in education are vital to attracting business investment.

Transportation infrastructure and public transit— A rapid build-out of public transit in cities, along the lines common in Europe, should be a high priority. There are many inter-city transportation needs in the Interior that have been identified.

Social infrastructure—A number of public investments in areas such as social housing and child care facilities are required to meet existing needs. Progressive health care reform that includes long-term and continuing care facilities, community health centres, and addiction services should also be a top priority, for reasons of social justice *and* economic competitiveness.

A More Compassionate Approach

THE GOOD NEWS is that, increasingly, there is a recognition that we need a vibrant public sector. Recent debacles featuring top US corporations, such as Enron, Tyco, WorldCom and Arthur Anderson, have lifted the veil on the supposedly hyper-efficient private sector that was so revered in the 1990s. This is not just a US story, either—Livent, Bre-X and YBM Magnex are among the highest profile Canadian examples in recent years of companies who practiced "aggressive accounting."

None of this means the government should be making toasters or DVD players. But a large number of essential areas—education, health, water, energy, and environmental protection, to name but the most vital—must be kept public so that they meet the needs of local people, not the demands for higher profits from distant shareholders. The public sector also has a major role to play in the revitalization of BC's economy—a task it cannot accomplish by leaving matters to "the market."

This *Solutions Budget* shows that the pain and hardship imposed by spending cuts did not need to happen. BC could have balanced its budget within the government's specified timeframe, and still supported services that people want and need. The tax cuts represent a failed economic experiment, and it is time the government recognize this and change course to find a more compassionate approach. Moreover, tax cuts were a lost opportunity to put in motion a long-term development strategy to get BC beyond its legacy as a staples economy.

Economic growth is important, but it has to be sustainable and equitable. BC is still a wealthy province, and is starting from a privileged position. But there is much work that desperately needs doing. Government cannot just sit on the sidelines; it must lead an economic strategy that is active and deliberate. The provincial government seems to understand this, but only when it comes to the Olympics. Budgets are about the choices we make—we need to remember that there are always alternatives.

Notes

1. Lillian Hallin. 1998. "British Columbia's Changing Industrial Structure" in *Business Indicators*, BC Stats, November.

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3. John Baldwin, Jean-Pierre Maynard, David Sabourin and Danielle Zeitsma. 2001. "Differences in Interprovincial Productivity Levels". Statistics Canada, Analytical Studies Branch Research paper series, no. 180, catalogue #11F0019, December.

4. BC Stats. 2002. *Exports (BC Origin) 1992-2001*.

5. Randall Wray. 2002. "The Perfect Fiscal Storm". Center for Full Employment and Price Stability, Policy Note 02/05.

6. For an analysis of the relative impacts of these changes on people in BC, see Sylvia Fuller and Lindsay Stephens. 2002. *Cost Shift: How British Columbians are Paying for Their Tax Cut*, CCPA, July. Also, visit www.costshift.ca to calculate what remains of your tax cut.

7. This latter number differs somewhat from the projected surplus of $93 million in the First Quarter Report. No re-evaluation of the three-year plan is made in the Second Quarter Report, but new information is provided about larger equalization transfers from the federal government.

8. Marc Lee. 2002. "Where's the Beef in BC's Fiscal Plan?" CCPA Behind the Numbers, February 28.

9. Marc Lee. 2001. "The Great BC Tax Cut Giveaway" in *BC Commentary*, CCPA. Summer.

10. Marc Lee. 2003. *Bleeding the Hinterland: A Regional Analysis of BC's Tax and Spending Cuts*. CCPA. January.

11. Auditor General of British Columbia. 1999. *A Review of the Fast Ferry Project: Governance and Risk Management*. Victoria, BC. November.

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