BC Commentary

A QUARTERLY REVIEW OF PROVINCIAL SOCIAL AND ECONOMIC TRENDS
VOL. 6, NO. 3 • SUMMER/FALL 2003

Canadian Centre for
Policy Alternatives
BC Office

Waiting for a Miracle BC ECONOMIC AND FISCAL UPDATE

by Marc Lee

When economies achieve persistently high rates of growth and development, economists often refer to them as "miracles." For more than two years now, the BC government has attempted to engineer a miracle out of two decades of economic slowdown. Government is being downsized, reshaped by the tenets of free market fundamentalism—tax and spending cuts, deregulation, and privatization. Many British Columbians, though they dislike this economic medicine, have come to accept it as inevitable, and hopefully, good for them in the long-run.

The continuing sluggishness of the BC economy demonstrates that the good life is more than just a tax cut away. Despite pronouncing BC "open for business," economic growth and capital investment have been weak. The government is hedging its bets, however—if supply-side economics cannot do the trick, perhaps Olympic Keynesianism can (see accompanying article by Alan Greer).

BC by the Numbers

Because BC is a small, trade-dependent economy, the growth slowdown in the rest of Canada, the US and around the world is a significant constraint on provincial economic prospects. In particular, the end of a once-in-a-generation boom south of the border, and US trade actions in softwood lumber, have affected BC. Tourism has also dropped off since Sept. 11, 2001, although the situation is not as catastrophic as post-SARS Ontario.

Nonetheless, extravagant claims were made in favour of tax cuts more than two years ago, when they were considered a miracle cure for an ailing provincial economy. In spite of external conditions, a "successful" economic program should at least move BC up to the Canadian average, if not substantially exceed it. And concrete results on the domestic front should be evident. Sadly, by the government's own measures, the experiment has not had the desired results.

Economic Growth and Investment

After a slight decrease in BC's real GDP in 2001, economic growth in 2002 was a slow 1.8%, compared to growth of 3.4% for Canada as a whole (see Figure 1 on page 2). 2003 is not looking much better. At Budget time, the provincial government estimated that economic growth would reach 2.4% in 2003, but since then expectations have been revised downwards, with most forecasters estimating growth in the 1.5-2.0% range.

Many forecasters expect a return to modest growth in 2004 and beyond, in the 3% range of real GDP growth. But this is not exactly the stuff of miracles, and such forecasts reflect wishful sentiments—that things have got to get better some time—not hard data.

Investment is a key driver of future growth. When new investment expands rapidly, it creates new jobs with spillover effects to suppliers and to local businesses where earnings get spent. Moreover, new investment increases productivity through expenditures on new facilities, machinery and equipment. It is BC's slowdown in investment over the past two decades that manifests itself as sluggish economic growth, weak productivity gains, and a stagnant standard of living.

BC's investment performance continues to be disappointing in spite of the "new investment climate." As Figure 2 shows (see page 2), when viewed as a percentage of GDP, private capital expenditures are essentially flat. BC's best year on the investment front, both in terms of dollars and as a percentage of GDP, came in 2001—but this precedes the introduction of corporate tax cuts (which were supposed to stimulate investment).

New investment has been hottest in the residential sector. This creates jobs, but does little to enhance BC's productivity. Like the rest of Canada, low interest rates have fuelled a boom in construction of new buildings and a hot real estate market in general. Low interest rates also spurred a 15% jump in auto sales in 2002, though numbers are down for 2003.

Non-residential capital spending remains flat, particularly investment in machinery and equipment, and will be for the foreseeable future. The government continues to pin hopes of a revival on foreign investors rewarding BC for lowering corporate taxes, doing away with messy environmental and labour regulations, and selling off public assets.

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Wages and Employment

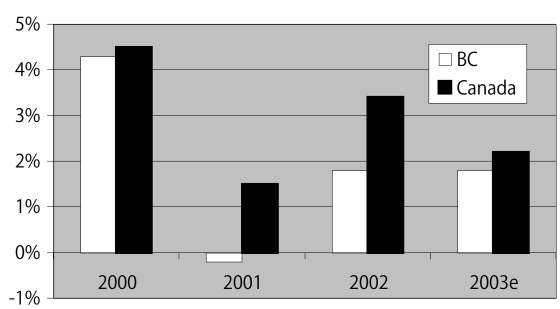
A strong economy increases provincial income through both gains in employment and in higher wages and salaries paid. These factors matter most for typical British Columbians. On both counts, BC's performance has been far from spectacular over the past few years.

Total employment in BC fell from 2000 to 2001 by 0.3%, compared to 1.1% growth for Canada. Employment rebounded somewhat in 2002, with 1.6% growth, compared to a national rate of 2.2%. All of the growth in BC for 2002 was part-time employment. For the first seven months of 2003, however, employment was up 2.7% in BC over the same period in 2002, with stronger full-time employment growth, bringing us in line with national employment growth of 2.6%.

Because of a growing labour force, higher unemployment rates have prevailed over the past two years. From a two-decade low of 7.2% in 2000, the unemployment rate rose to 7.7% in 2001 and 8.5% in 2002. In 2003, the August unemployment rate was 8.7%, though the year-to-date average is better at 8.2%. And while unemployment rates are lower in Vancouver and Victoria, they remain stubbornly high in the Kootenays, the Cariboo and the North Coast.

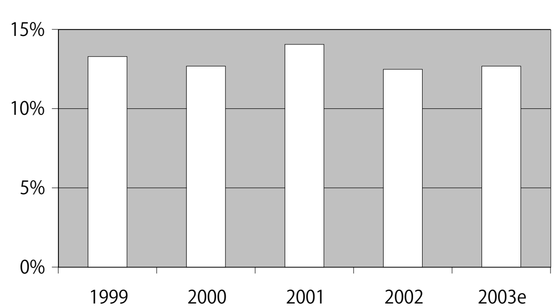
> **By the government's own measures, its economic experiment is not working.**

Figure 1: Economic Growth, BC and Canada



Note: 2003 is an average of two recent forecasts (1.7% from TD Bank and 1.9% from Royal Bank for BC; 2.0 from TD Bank and 2.3% from Royal Bank for Canada).
Sources: BC Economic Accounts, May 2003 release; TD Economics, Provincial Economic Outlook, July 30, 2003; RBC Financial Group, Provincial Outlook, July 2003.

Figure 2: BC Private Capital Investment as % of GDP



Note: 2003 estimates based on 3.9% nominal growth in GDP, and investment intentions as estimated by Statistics Canada.
Sources: BC Economic Accounts, May 2003 release; BC Financial and Economic Review 2003.

There are some employment gains that have not yet been tapped. Some 17% of small manufacturers cited a shortage of skilled labour in 2002, as did 5% of large manufacturers. This highlights the need for training and education funding to bridge the skills of workers with the needs of employers. Such spending would aid the longer-term skills shortage that is expected as baby boomers begin to retire. But the spending freeze in post-secondary education risks leaving this gap unmet.

The bottom line for workers has been falling wages, once inflation is accounted for. Real average wages for workers paid by the hour dropped to $16.02 per hour in 2002, from $16.24 in 2001 and $16.28 in 2000. However, BC still has the second highest real average wage in the country, and compares well to the national average of $15.44.

A Fiscal Drag

It is clear that with the exception of a few bright spots, BC's economy remains weak, and has not been kick-started by tax cuts. While economic performance is not dismal, there is little evidence of a boom on the horizon. But the tax cuts have had a significant impact on BC's public sector, in large part because tax cuts have not, as advertised, increased government revenues.

As the table on page 4 shows, personal income tax revenues fell by 29% from 2000/01 to 2002/03. Corporate income tax revenues also dropped significantly. Even by 2005/06, these revenues are not expected to reach pre-tax cut levels. The revenue shortfall has subsequently been partially offset by increases in regressive taxes (MSP premiums, sales tax, fuel tax and tobacco tax).

The current three-year fiscal plan shows a ratcheting downward of provincial tax revenues as a share of GDP to the 10.6% range (these figures do not include federal transfers or natural resource royalties and other smaller non-tax revenue sources, such as gaming). This permanently constrains the domestic tax base, and therefore the ability of the BC government to make needed expenditures. Instead, the government is going cap in hand to Ottawa, whether for new health care money, forest fire relief, softwood lumber compensation, Olympics facilities, or infrastructure improvements.

As the government seeks to balance its budget, provincial expenditures will be reduced to conform to the revenue picture. As a result, provincial budget cuts are a drag on economic growth this year and next.

BC's deficit hit $3.2 billion in 2002/03. This is easily the largest deficit in BC history, besting the $2.3 billion deficit posted by the outgoing Socred government in 1991/92 (although the Socred deficit was larger as a share of GDP). While overall debt levels are still in manageable territory, there is a

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Managing the Cost of Olympic Gold

By Alan Greer

photo: Joshua Berson

Vancouver has won the opportunity to host the world at the 2010 Winter Olympic and Paralympic Games. The widespread (though not universal) display of triumphant joy by supporters underscores the main reason for hosting the Games – pride and enjoyment. But the cost-benefit analysis I co-authored of the 2010 Winter Games indicated clearly that these benefits will come at a financial cost – some $1.2 billion (net present value in 2010). And, that cost could get higher.

Our study also noted that the Games could pose significant social and environmental costs. For the most part, Bid proponents have committed to take steps to mitigate or address these issues. Many will watch closely to ensure that these commitments are met.

The weakest of the pro-Olympic arguments has been that the "economic stimulus" before, during and after the Games will substantially boost the provincial economy, so much so that increased tax revenues will fully cover the provincial government's costs. There is no basis to believe that the economic stimulus will be that great, that sustained and especially that it would be enough to fill the hole in the provincial treasury.

Is our view controversial? Certainly the Premier and the Board of Trade have restated their firm belief in the miraculous economic healing powers of the Games (they have been transformed from tax-cutting supply-siders to born-again Keynesians). They cite billions in economic activity and hundreds of thousands of jobs based on a consultant's economic impact study.

A careful review, however, shows the impact study provides no indication of net return, and even its rosy scenarios do not envision increased tax revenues to offset costs.

Regardless, the Games are coming. Whether they're worth having is now a moot point. But, it is worth considering what can be done to make the best of the opportunity and obligations the 2010 Games present. Enthusiasm should not blind anyone to the serious risks that the next seven years present. So what should we do to make the best of the Games?

The federal and provincial governments should ensure effective and accountable governance for the Vancouver Organizing Committee for the Olympic Games with full transparency in all financial matters. The Organizing Committee should be subject to the same freedom of information rules as government agencies. This can help to reduce the possibility of conflict of interest and financial impropriety that have tainted many Olympics (including both the Calgary and Montreal Games).

The governments and the Organizing Committee should set aside economic impact models as a tool for justifying Olympic projects. That approach makes all spending appear good – and would perversely make a cost overrun (more economic activity) appear better than an on-budget project. Instead, they should return to conventional benefit-cost tools incorporated within the provincial government's own Capital Asset Management Framework. Done right, a benefit-cost evaluation lays bare the tradeoffs between project options – the pros and cons – and identifies the net gains or losses for each.

Governments and the Organizing Committee should define exactly what the minimal requirements of hosting the Games are – which venues, with what capacity and features, and what transportation are minimally needed for 2010. Closer review may show that the Sea-to-Sky highway does not require such extensive upgrades. Costs of mitigating social and environmental impacts should also be included. This baseline budget – plain vanilla Games – should anchor all financial decisions.

There may be a case for spending more than plain-vanilla on a particular project. It may be wise, for example, to build in additional features to a facility so that it can be converted after 2010 to be more useful. But warning lights should go off whenever someone argues for an enhancement based on it being a "legacy" or an opportunity to "show the world." Each case should be judged by whether the additional benefits warrant the additional costs.

And each enhanced spending decision should face the same ruthless cost-cutting scrutiny that healthcare, child services, education and all other government services must face. Elaborate torch displays must compete for scarce dollars with seismic upgrades of elementary schools.

The federal and provincial governments should reconsider setting aside a "legacy fund" where $110 million is placed in a trust in 2010 to sustain money-losing facilities indefinitely after the Games. It was honest of the Bid Corporation to identify this obligation. But, such a fund provides a "free-pass" around the gauntlet of annual budget appropriations that other public facilities face. It will be hard for communities that have lost a school, hospital, or courthouse to understand why ski jumps or luge tracks get guaranteed operating subsidies after the Games have come and gone.

Undoubtedly, the provincial government will be under considerable pressure to make sure that the rest of the province (outside the Lower Mainland, Squamish and Whistler area) should share in the Olympic bounty. But, the Olympic construction boom cannot be moved, nor can we expect many tourists to explore far afield from Vancouver or Whistler in February. The Olympics themselves are not the best way to address equity between different regions of the province.

By all means the government should take advantage of the profile provided by the Olympics to showcase BC and its businesses. But any campaign should be grounded in the reality that February is not a good time to showcase most of BC,

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large annual cost in interest payments to finance deficits that are largely the result of the tax cuts.

For 2003/04, the estimated deficit in the BC Budget is $1.8 billion after rolling in a $500 million forecast allowance. Fairly conservative projections about revenues, plus new federal money for health care, suggest that the final number will come in lower than $1.8 billion. However, if lower projections for BC's economic growth in 2003 are correct—and the real cost of fighting forest fires continues to rise—this will worsen the underlying fiscal picture, and could lead to either a larger deficit than anticipated or new spending cuts.

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BC has paid a high price for the experiment of the past two years: higher debt and interest payments on that debt, large reductions in the civil service and fewer public programs. Some might argue that this was a price worth paying if the payoff of a resurgent economy had materialized. Unfortunately, many British Columbians are still waiting for a miracle.

The fact of the matter is that no country or region has become a "miracle" by aspiring towards a free market ideal. Whether in the US, Canada or European countries during their development phase, or the East Asian economies of the post-World War II era, governments have intervened through trade and industrial policies, prioritizing education, supporting research and development, and building infrastructure to shape market forces to their liking. If BC wants to be a "miracle" economy, it needs to learn this lesson quickly.

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BC Tax Revenues, 1999/00 to 2005/06

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
					I Three year planning framework		I
	millions of dollars						
personal income	5,825	5,963	5,366	4,216	4,722	5,027	5,337
corporate income	943	1,054	1,522	645	755	873	929
sales	3,355	3,625	3,552	3,816	3,995	4,224	4,430
capital	460	459	395	190	101	99	97
MSP premiums	867	894	954	1,385	1,410	1,425	1,442
other tax revenue	3,145	3,182	3,255	3,498	3,768	3,876	3,945
total tax revenues (incl. MSP)	14,595	15,177	15,044	13,750	14,751	15,524	16,180
tax revenues as share of GDP	12.1%	11.7%	11.5%	10.2%	10.6%	10.6%	10.5%

Note: Figures are based on BC Budget 2003. Nominal GDP for 2003/04 estimated at 3.8%, for 2004/05 and 2005/06 at 5%.
"Other tax revenue" includes fuel, tobacco, property and other taxes.
Source: BC Budget 2003; GDP figures from BC Economic Accounts, May 2003.

The tax cuts simply are not paying for themselves. Personal income tax revenues fell by 29% from 2000/01 to 2002/03. Corporate income tax revenues also dropped significantly. Even by 2005/06, these revenues are not expected to reach pre-tax cut levels.

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and that Vancouver itself may appear darker and wetter than we'd like the world to picture it.

Finally, the provincial and federal governments should get on with managing their real economic responsibilities. An economic strategy based solely on the Olympics neglects many important sectors in BC (natural resources, high tech, financial services), redirects transportation investment away from key goods movement routes in the Lower Mainland and places too much emphasis on one event seven years out.

There is a real risk that government in Victoria will become pre-occupied with the Olympics initiatives. Cabinet meeting agendas will refocus on the feel-good of the Winter Games, to the neglect of the many serious problems facing British Columbia over the next decade. If so, that could be the biggest cost of the Games.

Alan Greer is an economic consultant in Vancouver and co-author of Olympic Costs and Benefits *with Marvin Shaffer and Celine Mauboules, published by the CCPA in February 2003.*

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