



November 2006

## Softwood Sellout

**How BC Bowed to the US and Got Saddled  
with the Softwood Lumber Agreement**

by Ben Parfitt



In July, Canada and the United States announced they had reached an agreement to end their longstanding dispute over the alleged subsidization of US-bound Canadian softwood lumber. Since then, much attention has focussed on the role played by negotiators and elected leaders on both sides of the border in ending the bitter dispute.

Comparatively little has been said, however, about how the deal, which passed first reading in the Canadian House of Commons in September, will hurt specific provinces. Or how individual provinces, in an effort to appease the powerful US softwood lumber lobby, may have tied the hands of their respective forest industries and forestry-dependent communities by making premature changes to provincial forest policies.

This document addresses some of the major impacts that the Softwood Lumber Agreement will have on BC's forest industry and the province's forest-dependent communities.

## The Softwood Dispute at a Glance

The latest softwood lumber dispute between the US and Canada began in August 2001, when the US announced that Canadian softwood lumber producers would pay duties on all US-bound lumber. Two months later, the penalties were increased. In five years, the US received more than \$5 billion in countervailing and anti-dumping duties. The duties came after a previous five-year softwood lumber agreement between the two countries ended.

At the heart of the dispute were US allegations that stumpage fees charged by BC and other Canadian provinces to companies logging publicly-owned timber were too low, and thus constituted a subsidy.

Despite subsequent rulings by trade panels convened under the North American Free Trade Agreement and the World Trade Organization that were generally favourable to Canada's position that its forest industry was not subsidized, the Canadian and US governments agreed in April 2006 to a framework agreement to end the dispute.

Under the new agreement, \$4 billion of the \$5 billion-plus in duties paid by Canadian companies will be returned, with the US keeping the rest. The agreement calls for export taxes to be paid on US-bound shipments of Canadian softwood lumber once prices fall below a certain level and/or exports exceed certain thresholds or quotas.

These restrictions on unfettered market access came despite significant changes to provincial forest policies, changes that may not have had to be made in light of the trade panel rulings, and despite a growing number of legal victories that generally went Canada's way. Had Canada simply stayed the course, it is likely that a clear legal and trade victory would have resulted – a far preferable outcome for Canada than the terms of the new agreement.

The Softwood Lumber Agreement covers a wide range of lumber products that BC companies typically sell to buyers in the US (and elsewhere) and that were valued at \$10.6 billion in 2005. Under the deal, BC companies making such products will be penalized with export taxes as high as 15 per cent if average prices fall below a certain threshold or in the event that Canadian lumber shipments to the US exceed certain levels. In practice, the penalties will deny Canadian producers open access to US markets and will shield US producers from Canadian competition.

This paper also looks at the role that the BC government itself played in the outcome of the agreement, in particular forest policy changes the Province made in an attempt to appease the US lumber lobby. Sadly, none of the changes were necessary. Various trade panels convened to look at the dispute between the two countries essentially ruled that no subsidies existed in Canada or that if they did they could not be quantified.

The end result is that BC is hamstrung by both the self-imposed policy changes and by the Softwood Lumber Agreement itself.

Make no mistake, this is a bad deal for BC. It discourages value-added output at a time when BC needs to improve on its sorry record in generating more jobs and higher prices from the forest products we manufacture. And it encourages further shipments of raw, unprocessed logs from the province. Many rural communities – highly dependent for their social and economic wellbeing on the forest industry – will be hurt by this deal along with the provincial economy as a whole. Here are seven reasons why.

# Seven Ways BC Has Sold Out

## 1. An End to Milling Requirements

BC responded to the US softwood lumber lobby's concerns about alleged subsidies by implementing far-reaching forest policy reforms. One of the more significant reforms effectively removed "appurtenancy" provisions from forest tenure agreements, meaning that companies awarded publicly-owned timber are no longer required to operate mills in specific communities. Successive provincial governments had until then used the provisions to ensure that sawmills and pulp mills were operated in certain communities, bringing much-needed jobs to outlying regions.

This fundamental change in forest policy had its origins in a December 2001 document prepared by the Revenue Branch of BC's Ministry of Forests. The document signaled that BC was considering fundamental changes to its forest policies in an attempt to address "real or perceived" concerns on the part of the powerful US softwood lumber lobby about alleged "trade distortions" in the province's timber market.<sup>1</sup> The document would later serve as the basis for negotiations between BC and Washington over how BC would adjust its timber-pricing regime to alleviate US concerns. Ironically, virtually all of the changes that were subsequently enacted by the provincial government from 2002 onward do not appear to have been necessary. Various international trade panels that were called upon to review the dispute found that no subsidies existed, or that if they did they could not be quantified. In other words US "perceptions" were not reality.

Nevertheless, the changes were made. And for the most part they were made specifically with US allegations in mind. For example, the 2001 Revenue Branch document said that appurtenancy clauses "hamper[ed] both the movement of logs within the province and the operating decisions of mills and processors." To do away with any perceived trade distortions that might result from such requirements, BC proposed "eliminating" appurtenancy provisions. "This," the provincial government said, "will help foster the growth of competitive log markets and permit entry to/exit from the industry."<sup>2</sup>

Appurtenancy was subsequently scrapped through the introduction of new provincial legislation. Only under limited exceptions may BC tie awards of forest tenures to desired social outcomes. The exceptions are for mills producing items other than "softwood lumber products" as defined in Annex 1A of the Softwood Lumber Agreement (hereafter referred to either as the agreement or SLA).<sup>3</sup>

For example, BC recently awarded a forest tenure to Ainsworth Lumber Co. Ltd. and stipulated that in return for the tenure the company was required to build a new mill. But the product the company will manufacture is Oriented Strand Board, or OSB, a sheathing product not covered under the SLA. The province was explicit in saying that it would award the tenure to a company submitting plans to "construct or expand a timber-processing facility that produces something other than dimensional softwood lumber" – an obvious nod to the SLA.<sup>4</sup>

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## 2. An End to Guaranteed Wood Supplies for Value-Added Mills

Historically, BC has had two forest tenure types. The first involves long-term, generally renewable licences awarded to one company. The licences are either area-based (to defined lands) or volume-based (to set amounts of timber). The other tenure type is that secured by an individual or company through a bidding process or timber auction. Until recently, such auctions were of two types:

- Under a straight competitive bidding process, timber was auctioned, with the highest bidder winning the rights to log. A percentage of timber sold this way was limited to bids by small, independent mills and was referred to as a “partitioned” supply (more on this in the following section).
- A second pool of timber was also available for bidding, but the bids were restricted to manufacturers of value-added wood products. This included a wide range of companies producing everything from finger-jointed boards (long boards created by gluing shorter pieces of wood end-to-end) to high-end products such as window frames, furniture and musical instruments. Under such auctions, companies were required to submit “bid proposals” that essentially identified the kind of product to be made, how many jobs would be generated in the process, and where.

The US lumber lobby alleged – and never proved – that by limiting the number of companies or individuals that could bid on publicly-owned timber, BC was effectively subsidizing the price of timber by not subjecting it to full market forces. In response, BC proposed in December 2001 to “terminate” the dual bid proposal process and base “all future [timber] awards . . . solely on price.”<sup>5</sup>

The bid proposal program was subsequently scrapped, with the end result that value-added manufacturers no longer have access to a separate pool of wood and must now compete directly in the “open” market. The problem is that serious questions remain about how open the market is, and whether value-added mill owners can compete on an equal footing with big lumber producers and other large consumers of logs.

### 3. An End to Wood for Small, Independent Mills

Under the straight competitive bidding process for timber noted previously, BC helped to ensure that small, independent mills gained access to some timber that other companies were restricted from bidding on. This block of timber was referred to as a “partitioned” supply.

The idea was that independent mills that depended on the auction process for their timber supply were at a competitive disadvantage. Larger companies, whose timber needs were met primarily through long-term forest tenures, could afford to pay higher prices for auctioned logs because at the end of the day the average prices they paid were still comparatively low. Smaller mills, on the other hand, paid a high cost for everything.

Under the SLA, designating log supplies to small, independent mills appears to be over. Under proposals submitted to US trade officials early in 2002, BC indicated that it would “eliminate” all “non-price criteria” for log auctions.<sup>6</sup> In effect, every company would be free to bid for whatever timber was available, with small companies competing directly with large companies for their log needs.

Further indication of the intention to eliminate the partitioned log supply – also known as Category 2 sales – is noted in the minutes of a recent BC Timber Sales Advisory Committee meeting. BC Timber Sales, an arm of the provincial Ministry of Forests, administers all log auctions in the province. Minutes of the committee’s June 8, 2006 meeting note that Dave Peterson, the ministry’s assistant deputy minister in charge of BC Timber Sales, told members of the committee that the Ministry was continuing on its course of “phasing out” Category 2 sales.<sup>7</sup>

### 4. Rising Raw Log Exports

Raw log exports from BC have climbed sharply in recent years, and will likely continue to do so under the SLA.

Under the agreement, logs – unlike lumber – are not subject to export caps or export taxes.<sup>8</sup> This is a very curious aspect of the SLA, in that the entire dispute rested on US allegations that Canadian provinces subsidized the forest industry by undervaluing the raw resource: trees.

If Canadian softwood lumber producers are somehow subsidized because provincial governments fail to charge sufficient stumpage or timber-cutting fees, how can it be that logs – the first raw “product” created from a felled tree – are not viewed as being subsidized, but lumber products – created from a log – are?

The vast majority of logs currently exported from BC are from private forestlands where stumpage fees do not apply, but more and more are coming from public forestlands. The concern is that such exports may increase.

First, many Coastal sawmills remain vulnerable to closure. As mills decline in number, there will be more pressure to push logs onto export markets. Why? Historically, raw log exports have only been allowed if it can be demonstrated that the logs are in “excess” of what local mills need. As more mills close in an environment in which appurtenancy clauses no longer apply, it will be easier to argue that logs are in excess of milling capacity and therefore should be available for sale to out-of-country buyers.

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Second, there will be some economic logic in doing this. Companies making softwood lumber and shipping it to the US may be subject to export taxes as high as 15 per cent. But raw logs are not subject to such taxes. The third reason that log exports may rise in the months and years ahead involves the extremely large logging increases in the Interior in response to the mountain pine beetle outbreak.

## **5. Incur More Costs, Pay More Taxes**

Under the SLA, Canadian softwood manufacturers pay export taxes on a range of US-bound products once certain price benchmarks or export thresholds are reached.

The taxes apply to a broad range of items listed in Annex 1A of the SLA, not just straight lumber, and they apply equally to products of lower and higher value. This has consequences for a significant segment of BC's value-added wood product industry.

For example, a 15 per cent tax applies as equally to a standard two-by-four as to a finger-jointed board. Finger-jointed boards begin as several smaller boards that are cut in a zigzag pattern on their ends, glued and pressed together to form longer and very strong boards. They retail for about 13 per cent more than a standard two-by-four.

Under the agreement such extra work is "rewarded" with a higher tax bill even though the subsidy, if it exists, ought to apply to the stumpage price paid for the first raw material in the production chain – the tree from which the log and later the lumber is derived. This reality may prove a further disincentive to value-added manufacturing in BC, something that would exacerbate a troubling trend in BC toward producing less, not more, value-added products.

This is cause for concern. BC already has an unenviable record in this arena. A 2003 study, for example, found that our forest industry produced about 31 cents worth of value-added or secondary wood products for every dollar of lumber produced. In Ontario as well as Quebec, the corresponding figure was \$1.50 in value-added output for every dollar's worth of lumber.<sup>9</sup>

If BC really wanted to see more value-added manufacturing, it would implement a new stumpage and taxation regime under which stumpage would be high on low-value products like logs, but progressively decline as products moved higher up the value chain from lumber, to structural beams, to wooden furniture.<sup>10</sup> Instead, BC's policies and the SLA result in a tax regime that does the reverse – charging more the higher up the value chain one goes.

Adding to the value-added industry's woes, there has been a history in years past of firms in the sector paying two sets of duties. As reported by the Canadian Centre for Policy Alternatives in 2005, value-added manufacturers in BC complained that during the years when the US collected some \$5 billion in countervailing and anti-dumping duties, lumber makers here in Canada often charged them a "duty in" cost for their raw materials.<sup>11</sup> In other words, if a local value-added mill wanted the same board that a US customer might otherwise take, it paid a price equal to what a US buyer would pay *plus* the duty that the BC lumber maker would pay were it selling its product in the US. The net effect was that value-added mill owners first paid a "duty" to the local lumber maker and then a second and even higher duty if their remanufactured product was sent to the US.

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## 6. No Caps on Wood Waste

In a set of proposed forest policy changes developed by the BC government and presented to US trade officials in 2002, the province said it would abandon rules known as utilization standards that required forest companies to remove all or most of the wood from logging sites.

It is far from clear – because the document containing the proposed changes fails to make a convincing case – exactly *why* requiring a company to remove all logs from a tract of harvested forestland constitutes a subsidy, since it actually costs a company more money to remove all logs: expensive equipment must be employed; higher energy costs are a certainty; and more labour is required whenever log loading and transporting activities increase.

In its discussion of the issue, the Province told US trade officials that it proposed to "eliminate" utilization standards and went on to say:

*These requirements may force [forest] tenure holders to utilize uneconomic timber or logs. Under this proposal, tenure holders will be free to make commercial decisions with respect to utilization subject to meeting forest management objectives for bio-diversity, forest health, silviculture, reforestation and fire management.<sup>12</sup>*



While it is unclear how strict utilization standards constitute a subsidy, what is certain is that relaxing such standards benefited various BC forest companies. Soon after the government set the industry on a more “commercial” footing by dropping its earlier and stringent no-waste policies, more and more usable wood started to be left on the ground rather than being hauled to market. Never mind that in the hands of other companies this “waste” wood might have been turned into wood products, generating much-needed jobs in resource communities.

## 7. A Market That Isn't a Market

The most significant forest policy change that BC implemented in response to US trade concerns was the move to a “market-based” timber pricing system.

Even though separate trade panels convened under the North American Free Trade Agreement and the World Trade Organization were unable to conclude that subsidies existed under BC's old administered timber-pricing system, or if they did by how much, the pricing changes were made.

To make the changes, the BC government took back a portion of the timber allocated to forest companies under long-term renewable forest tenures and reallocated that wood, primarily but not exclusively to log auctions.<sup>13</sup> The government contended that the only criteria for accessing wood through such auctions would be price. Whoever bid the highest would get access to whatever timber was placed for sale. The idea was that such reforms would create more of a market-based pricing system.

The companies affected by the timber take-back were compensated by the Province, which set aside \$200 million for such purposes. It is doubtful, however, that the companies actually lost the wood. For one thing, in BC's Interior, government-approved logging rates have skyrocketed by millions of cubic metres in the past few years in order to clear-cut beetle-killed trees. Moreover, the companies that lost the wood or their proxies are free to enter auctions to compete for whatever logs are put up for sale. In addition, because the same companies held large amounts of timber under secure forest tenure agreements and because they also



owned and operated the bulk of the primary mills, they had de facto control of the market anyway. Simply put, there were and remain few domestic outlets to whom to sell logs. For example, more than three out of every four logs currently run through BC sawmills are controlled by just 10 companies.<sup>14</sup> One company – Western Forest Products – directly controls one out of every two logs coming off of public forestlands on the Coast, while three companies – Canadian Forest Products, Tolko, and West Fraser – control the bulk of sawmill output in the Interior.

Control of forest tenures and of manufacturing capacity regularly triggers complaints from lumber remanufacturers and value-added producers. These companies contend that the result is an unequal playing field in which the larger companies and their proxies effectively control the allegedly market-based auctions.

Furthermore, market-based pricing “reforms” have failed to do what the US lobby ostensibly wanted – create higher log prices for Canadian exporters, thus weakening their competitive position. On the Coast, where market-based pricing was first introduced, the average price paid for logs (which includes both stumpage paid for tenured wood supplies and in log auctions) has actually declined, and dramatically so, in recent years. In fiscal year 2003/2004, the average price paid was \$19.37 per cubic metre. One year later it stood at \$14.16, and in 2005/2006 it dropped to \$7.68.<sup>15</sup> The market-based pricing system will be implemented in the Interior over the coming few years. Similar declines may well occur there, due in large measure to the added volumes of timber being logged in response to the mountain pine beetle infestation.

It is extremely difficult to say with any certainty what such declines mean, however. A cursory review of successful BC Timber Sales bids shows that the prices companies pay in auctions are far higher than the average stumpage prices noted above. This is because the Province insists on a minimum payment known as “upset stumpage” to cover all the costs the government incurs before and after an auctioned block is logged, including reforestation costs. Companies then submit a bonus bid over and above the upset rate. When the upset rate and the bonus bid are combined, the final stumpage paid for auctioned wood is very high compared to the stumpage fee associated with a company’s tenured wood supply. However, what we don’t see in the “lower” stumpage fee for tenured wood is what the company pays in pre- and post-logging costs.

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These complexities, however, may not even enter the equation when US lumber lobbyists attempt to convince US officials about the alleged ongoing “subsidization” of Canadian softwood lumber. They will simply focus on the downward trend as “evidence” of a problem. Never mind that housing starts may be declining, international markets may be oversupplied, or operating conditions changing – all of which individually or collectively would depress prices. Only time will tell whether the US lumber lobby resumes its efforts to re-impose duties on Canadian softwood lumber shipments entering the US market. But history strongly suggests it will. And if it succeeds in convincing its government to act, the US is free to cancel the current deal in as little as two years, after which it can slap another set of punitive duties on US-bound shipments of Canadian softwood lumber. Further highlighting the precarious position that BC is in as a result of the SLA, the US government is also free to cancel the agreement immediately if it feels that Canada has not complied with the terms of the agreement. And also, under an anti-circumvention clause in the SLA, the US government has a veto over changes in Canadian forest policies – a staggering concession of policy-making sovereignty.



## Conclusion

The Softwood Lumber Agreement is a bad deal. Combined with forest policy changes that the BC government made in a failed attempt to appease the softwood lobby, it harms the province's ability to generate much-needed jobs in resource-dependent communities. Before it is too late, political leaders should seek to block its final passage into law.

As landlord and overseer of public forestlands in BC, the provincial government owes a duty to the public to explain how it intends to maximize social benefits from publicly-owned resources in the years ahead. If its hands are tied by recent forest policy changes and the SLA, making it difficult if not impossible for the Province to enact new laws and regulations that will improve job prospects and community stability, the government should state so publicly. And it should do so now, in order that resource-dependent communities can embark on much-needed economic diversification initiatives.

If forced to live under the terms of the SLA, the Province can take five steps that would not contravene the SLA and that might help stimulate job prospects in BC's forest sector.

## Five Steps Forward

1. The province should immediately complete and publish forest industry competition reviews in both the Interior and on the Coast. At present, an enormous amount of manufacturing horsepower is concentrated in the hands of a few very large companies. The same companies also hold the lion's share of forest tenures, meaning they wield a great deal of power in a limited, competitive marketplace for logs. If such reviews show there is an unacceptable level of concentration, the Province should use powers at its disposal to reallocate forest tenures and create a more diversified, level playing field.

2. The Province should immediately review whether the current volume of wood placed for auction is sufficient to ensure that all potential entrants have equal access to timber. The government is fully aware of complaints from lumber remanufacturers, value-added producers and small, independent sawmills: that they lack access to sufficient volumes of wood fibre, and that when auctions are held they find themselves at a disadvantage when they compete with companies holding sizeable forest tenures. The review should include analysis of where log auctions should occur in order to maximize social benefits as well as how timber or logs could be readied for sale to ensure the highest dollar return to the Province.

3. The Province should immediately channel a portion of stumpage fees to resource-dependent, rural communities to assist in economic diversification initiatives. The money to do so is easily found in the millions of dollars in additional stumpage revenues currently being generated as a result of the harvesting of beetle-attacked trees.

4. The Province should move quickly to award new forest tenures to companies that build new mills. Under the SLA there are numerous wood products excluded from the agreement, including wood trusses, I-Joist beams, pallets, garage doors, edge-glued products, and completed window and doorframes. This means they are not subject to export caps or export taxes. These are all higher-value products, much in demand, which could generate new, much-needed jobs in BC.

5. Too much dependence on one market is bound to create problems. With its large population and physical proximity to Canada, the US is a natural destination point for manufactured products from BC and other Canadian provinces. However, other markets such as China are growing by leaps and bounds. The BC government should step up marketing efforts with forest companies, and in particular value-added manufacturers, to ensure that as much as possible our export markets are being diversified.

## Notes

<sup>1</sup> Province of British Columbia 2001.

<sup>2</sup> Ibid.

<sup>3</sup> Government of Canada. Government of the United States. 2006.

<sup>4</sup> Province of British Columbia 2006a.

<sup>5</sup> Province of British Columbia 2001.

<sup>6</sup> Ibid.

<sup>7</sup> Province of British Columbia 2006b.

<sup>8</sup> Government of Canada. Government of the United States. 2006.

<sup>9</sup> Woodbridge, Peter, 2003.

<sup>10</sup> Parfitt, Ben, 2005.

<sup>11</sup> Ibid.

<sup>12</sup> Province of British Columbia 2001.

<sup>13</sup> Province of British Columbia 2003.

<sup>14</sup> Parfitt, Ben, 2005.

<sup>15</sup> Province of British Columbia 2004, 2005, 2006.

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### ACKNOWLEDGEMENTS

The author would like to thank Bruce Campbell, Shannon Daub, Seth Klein and Scott Sinclair for their helpful feedback on this report.

ISBN: 0-88627-487-7

Any errors and the opinions presented in this paper are those of the author, and do not necessarily reflect the views of the Canadian Centre for Policy Alternatives.

The CCPA would like to thank the following organizations for their financial contributions to this work: the BC Government and Service Employees' Union, the Pulp, Paper and Woodworkers of Canada, the Endswell Fund of Tides Canada Foundation, and the Communications, Energy and Paperworkers Union.

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