BRITISH COLUMBIA'S GOLDEN DECADE

Can this Period of Prosperity Take on a Longer Life?

Executive Summary

British Columbia's "Golden Decade" is now in full swing, with the unemployment rate plumbing the depths at its lowest level in three decades, investment picking up and housing activity booming. What's more, with the expansion broadening across regions and industries and excitement building in the run-up to the 2010 Olympics, we believe that there is little stopping B.C.'s economy from recording solid growth and brisk income gains through the end of the decade.

For many British Columbians, this buoyant period will represent payback time for the period of economic stagnation suffered in the late 1990s. But, even more importantly, it will raise hopes that the much longer slide in prosperity is finally behind the province. In 1981, total provincial income in real per-capita terms in B.C. was 17 per cent *above* the national average. Today, it stands 6 per cent *below,* leaving British Columbia in 36th position among the 61 provinces and U.S. states (or 50th spot on a nominal basis). There has been a direct hit to residents' wallets, with real per-capita after-tax income going from 13 per cent above the Canadian average to 2 per cent below over the 1981-2004 period.

Relative decline accompanied by low productivity

In order to shed light on what has contributed to B.C.'s relative long-term decline in prosperity, we decomposed the change in real per-capita provincial income into its four components: demographics (i.e., working age population as a share of total population), the employment rate (i.e., employment as a share of working-age population), work intensity (i.e., total hours worked per employee) and productivity (i.e., real GDP per hour worked). Unquestionably, the biggest culprit behind this relative deterioration was productivity. While there has been much talk about Canada's disgraceful showing on this front since 1981, British Columbia's annual productivity growth has run a full percentage point below that of Canada over the period. It may be reasonably concluded that the shift in jobs away from the highly-paid, productive resource sector to lower value-added service employment over the past quarter century has been a notable impediment to productivity in British Columbia. However, the province's productivity performance across most sectors has been inferior to those posted in the rest of Canada and in the United States, with forestry being a notable exception.

Strong growth expected through 2010

The B.C. economy is expected to record a number of new milestones before 2010, including a new record low annual unemployment rate of 4.5 per cent. But, even though the province should benefit from a cyclical rebound in real output per hour worked over the next few years, we don't expect to see a meaningful narrowing in relative productivity levels between B.C. and competing jurisdictions. As such, this area is likely to remain the Achilles Heel of an otherwise impressive economic scorecard.

At the same time, we are concerned that a number of potential storm clouds could move in once the Olympic torch is put out in 2010. And, here, we're not just talking about a slowdown in tourism activity that is certain to follow the 2010 Games. Rather, we are referring to a number of other downside risks that, if they materialize, could jeopardize the continuation of healthy gains in the first half of the next decade. With the economy likely to operate well beyond its capacity limits over the next few years, cost pressures could escalate. The booming construction sector, which has been generating one of every four jobs over the past four years, will probably lose momentum by 2010 as the housing cycle inevitably turns. Add to that the likelihood of a beetle-related decline in harvesting and timber processing activity after 2012 and an easing in labour force growth as the first wave of baby boomers turn 65 years and the risk of a period of sub-par growth – while far from imminent – is real.

Alberta to flex its muscles

Complicating matters is the fact that the competitive threat from Alberta – Canada's unrivalled economic tiger – is almost certain to intensify over the next several years. Armed with massive surpluses, no debt and already-low tax rates, Alberta is expected to continue to take steps to solidify its position as a magnet for investment and immigration. This was reinforced in last week's 2006 Alberta budget, where the province announced further measures aimed at addressing its vulnerabilities.

B.C. on the right track

British Columbia is certainly not alone in facing longer-term challenges. For example, Central Canada's heavily manufacturing-oriented economies are facing enormous pressures resulting from a combination of a high loonie, lofty energy prices, and increased competition from Asia. Nor are all the risks that we've highlighted unique to B.C., namely that of an aging population. Regardless, it is critical that the players in the public and private sectors take action now to fend off any potential storm clouds, and in doing so, help to extend the recent economic gains. **First,** we believe that the province is already on the right track in its quest to raise the capacity of the provincial economy to both grow and innovate. However, it must accelerate these efforts. And, **second,** it must respond to Alberta's competitive threat. This task will not be easy given that much of the attention in the province over the next few years will be placed on meeting the day-to-day challenges that arise from a booming economy and, to a lesser extent, preparation for the Olympics.

The good news is that if there is one province up to the task it's British Columbia. Supported by the progress made since the early part of this decade, B.C. now occupies the second or third place among the provinces in terms of most economic and social measures – including fiscal position and tax competitiveness – and is the outright leader in the environment. Above all, international surveys almost invariably place Vancouver at the top of the list in terms of overall quality of life. These strengths provide an excellent foundation on which to build on.

Address British Columbia's vulnerabilities …

The greatest threat from Alberta is on the cost front. Despite progress by the B.C. government in lowering taxes since 2001, the gap with Alberta remains sizeable, and promises to get even larger over the next few years. It is unrealistic that the B.C. government would be able to eliminate the gap in tax rates that exists across the board over the next 5-10 years. Hence, we would encourage the government to focus on those taxes that generate the best bang for the buck in terms of economic growth – namely, those on income, savings and capital.

The most pressing tax challenge confronting B.C. is on the business side, where marginal effective rates not only stand well above those of Alberta counterpart, but are among the highest in Canada. This has been a major factor behind the small and declining number of head offices and weaker investment performance in B.C. compared to other jurisdictions, including Alberta, over the past few decades. Action on this front would involve further lowering corporate income tax rates and moving to fully exempt business inputs from the sales tax. In addition, in contrast to Alberta, which has no capital tax, the B.C. government continues to levy punitive capital taxes on financial institutions. The presence of this tax may go a way in explaining why B.C.'s financial sector – one of the province's largest employers and wealth generators – has been losing ground on its competitors.

The business-cost differential between B.C. and Alberta is exacerbated by B.C.'s considerably higher regulatory burden, despite the progress made by the government in cutting red tape over the past few years. Going forward, the government has committed to zero increase in regulation over the next four years. However, it may want to set a more ambitious target.

…and better leverage its competitive strengths

As B.C. forges ahead with addressing its vulnerabilities, it can springboard off its comparative strengths.

Highly-educated labour force

For one, B.C. is home to the most highly-educated workforce in Canada, as measured by the share of working-age individuals holding a post-secondary degree, diploma or certificate. It also has the lowest drop out rate in Canada. And, with B.C.'s larger population shares of New

Canadians, Aboriginals and older individuals – groups that have relatively low labour-market participation rates – there is an enormous opportunity to build on this advantage in the future. Agreements that have been reached with First Nations' communities are a step in the right direction, as they will allow projects to proceed and, at the same time, improve the economic well being of Aboriginal peoples. In addition to public investments in education, training and other skills-related programs, the private sector must take a major role in this area by opening its pocket book and adding flexibility to work arrangements. It is important that B.C. be mindful of the fact that other jurisdictions have elevated education to the top of their priority list, and are backing that up with hefty increases in funding for education and skills development.

Given that new Canadians and Aboriginal groups tend to have a higher-than-average incidence of low income, one of the major challenges for the B.C. and federal governments is to improve safeguards against the low-income trap. Working to lower extraordinarily high marginal effective tax rates on market income as individuals move from welfare to work, supporting affordable housing initiatives, increasing accessibility to education, and reducing barriers for new immigrants to enter into the labour market should all be high up on the needs list.

World-class infrastructure

B.C. benefits from one of the best systems of roads, highways and other public infrastructure in the world, which reflects in part the province's well-funded and regional-based planning approach. However, the province must be careful not to let its competitive edge in infrastructure erode in the future, as other jurisdictions ramp up efforts to close their infrastructure gaps. On the plus side, British Columbia has become a North American leader in innovative approaches to finance and manage public infrastructure, including the use of public-private partnerships (P3s). Continued effective use of P3s along with traditional procurement methods would stand the province in good stead.

Location, location, location

Paradoxically, one of British Columbia's biggest challenges – its location next to Alberta – is also one of its greatest opportunities. B.C. would do well by further strengthening trade and cooperation with Alberta to better leverage the economic boom that is expected to continue in the oil patch. But, even more importantly, there are tremendous benefits to be reaped – in terms of boosting two-way trade ties in resource and non-resource industries and opening the door to increased immigration of skilled workers – by establishing closer links with Asia Pacific. On the bright side, the B.C. and federal governments have promised to inject significant amounts into new port and transportation capacity over the next few years in order to reduce bottlenecks. However, we share concerns of some others that both governments may not be moving quickly enough – nor are they being bold enough – to truly realize the dream of becoming the North American Gateway to Asia.

Bottom Line

The goal should be nothing short of restoring B.C. to its place as one of the highest income jurisdictions in the world with a quality of life that is second to none. By leveraging their relative strengths, keeping their eyes squarely focused on competition outside its borders, and thinking big on building the province as a Gateway for Asia, the public and private sectors in British Columbia can transform the Golden Decade into a Golden Century.

Derek Burleton, AVP & Senior Economist
416-982-2514

Sébastien Lavoie, Economist
416-944-5730