TD Bank Financial Group

TD Economics

Special Report

March 29, 2006

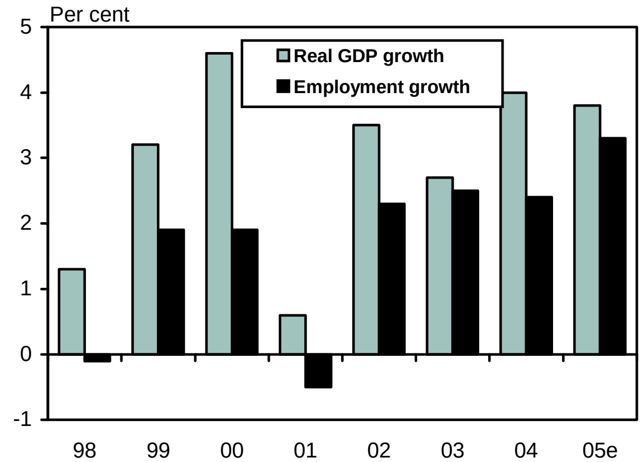
BRITISH COLUMBIA'S GOLDEN DECADE

Can this Period of Prosperity Take on a Longer Life?

The brisk growth recorded in British Columbia since 2002 has left little doubt that the province's long-awaited economic revival is well underway. The unemployment rate is at its lowest level in three decades, investment has picked up and housing activity is booming. What's more, with growth broadening across regions and industries and excitement mounting ahead of the 2010 Olympics, we believe that there is little stopping B.C.'s economy from recording a solid economic expansion and rising incomes through the end of the decade. For many British Columbians – especially those in the areas outside of the Lower Mainland that were hardest hit during the extended stagnation of 1995-2001 – it will be payback time.

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. No province in Canada has experienced a larger relative deterioration in recent history.

BRITISH COLUMBIA REAL GDP AND JOB GROWTH



Source: Statistics Canada / Haver Analytics, TD Economics

We see reason for optimism. Since being elected in 2001, the B.C. government has improved the competitive climate by eliminating the deficit, cutting taxes and red tape as well as improving the overall business climate. Currently, B.C. ranks in the top two or three among the provinces in most key economic indicators and is in top spot overall in those related to the infrastructure, the environment and health. It has the highest share of individuals with post-secondary education and the lowest high-school drop out rate among the provinces. Moreover, B.C. is stepping down some bold, new and innovative paths in order to improve the way it does business.

At the same time, however, we worry about some potential storm clouds once the Olympic torch burns out in

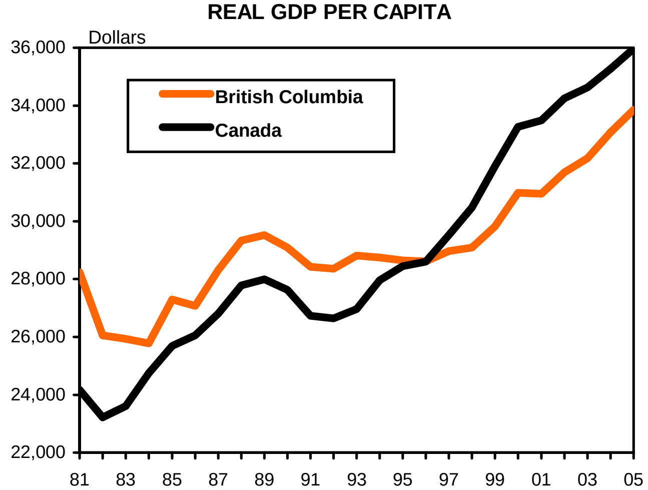
CONTENTS

2010. With the economy expected to run flat out over the next half decade, it is likely to be operating well beyond its capacity limits, resulting in escalating wages and costs. Add to this list the usual post-Olympic slowdown in spending, prospects for 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 another period of sub-par growth – while far from imminent – is real.

Complicating matters is the fact that the competitive threat from neighbouring Alberta – while hardly new – is almost certain to intensify. Despite B.C.'s progress on the policy front, Alberta is likely to flex its economic and fiscal muscles over the next few years, further solidifying its position as the most attractive and least-cost jurisdiction in which to do business. As a result, the province will become an even bigger magnet for individuals and companies.

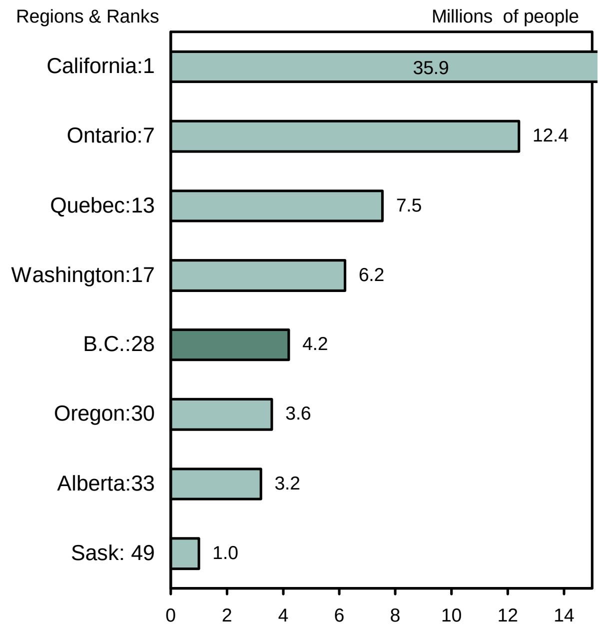
British Columbia is certainly not alone in facing longer-term challenges. Nor are all the risks that we've highlighted unique to B.C., namely that of an aging population. Regardless, it is critical that the players in the public and private sectors take action now to fend off any potential storm clouds, and in doing so, help to extend the recent economic gains. The province must not only continue down the road it has been travelling in recent years in its quest to raise the economy's long-term potential to grow, but it must run even faster. And, 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 preparation for the Olympics. Although the government has set a number of longer-term economic objectives – which we believe are achievable – we recommend formalizing a number of ambitious goals in a long-term growth and productivity agenda. That would provide a lens to which policy in key areas such as taxes, infrastructure and education can be viewed through.

REAL GDP PER CAPITA



Source: Statistics Canada, TD Economics

POPULATION IN SELECTED NORTH AMERICA'S REGIONS



Source: Statistics Canada, U.S. Census Bureau, TD Economics

Finally, one of the province's greatest challenges – its location between the Pacific Ocean and economic powerhouse Alberta – is its greatest opportunity. There is enormous potential for B.C. not only to strengthen its trade ties with Alberta, but more importantly, to leverage its position as a Gateway to Asia. This is perhaps the greatest hope to turn what the government has coined the Golden Decade into a Golden Century for British Columbia.

B.C. is no small player

Home to spectacular waterways, mountain ranges, woodlands, minerals, wildlife and other natural endowments, British Columbia is considered by many to be one of the most beautiful regions on the continent. In fact, with its above-average rainfall, almost two-thirds of the province is forest land, supported by its boreal climate. Major River systems include the Fraser, Columbia, Skeena and Peace Rivers.

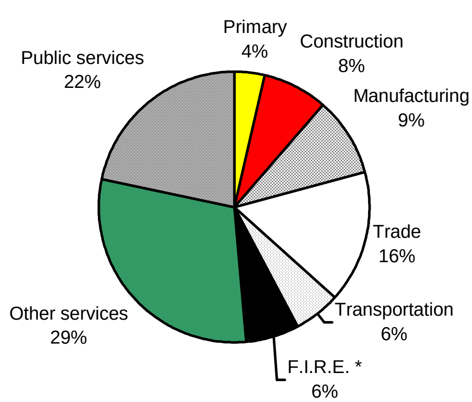
Over the years, the province has managed to protect its lush and clean environment while, at the same time, building up one of the largest economies in Canada. At $164 billion annually in economic output, B.C. accounts for about one-eighth of the Canadian total – or fourth highest among the provinces, after Ontario, Quebec and Alberta. And, on the North American landscape, B.C. is no small player either, ranking 28th and 30th among the 61 provinces and states in terms of population base and economic activity, respectively.

B.C. different than most

The combination of geography, climate and location sets the B.C. economy apart from many of its competitors in many respects. While certainly not an exhaustive list, here are some of the key differences that make B.C. unique:

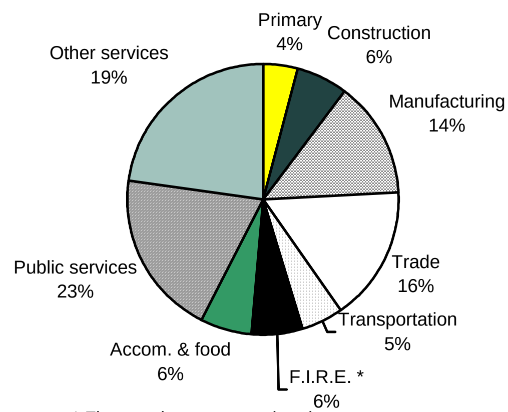
- *More resource dependent than average* – with upstream and downstream activities of forestry, mining, natural gas, coal, fishing and hydroelectricity making up 13.5 per cent of provincial GDP and 180,000 jobs, the resource sector leaves a large footprint in B.C.'s economic landscape.[1] Notably, the province is home to one of the largest forestry sectors in the world. While this resource orientation pales in comparison to a few provinces – notably the 25-per-cent shares recorded in Alberta, Newfoundland & Labrador and Saskatchewan – it is somewhat higher than the 11 per cent share recorded in the rest of Canada and twice the share of competing U.S. jurisdictions such as Oregon and Washington state.[2]

BRITISH COLUMBIA JOB MARKET- 2005



* Finance, insurance and real estate ;
Source: Statistics Canada / Haver Analytics

CANADA JOB MARKET- 2005



* Finance, insurance and real estate ;
Source: Statistics Canada / Haver Analytics

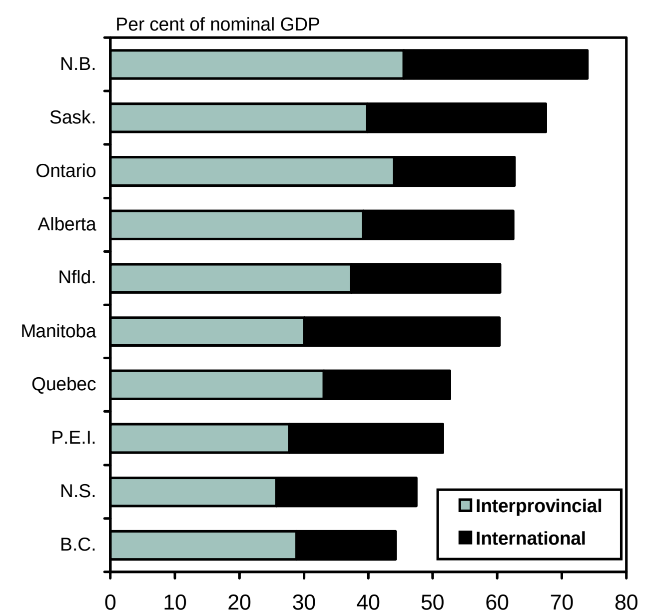
- *More driven by services* – British Columbia is home to the second largest service sector among the provinces (about three-quarters of GDP) and is in the same ballpark as competing U.S. states. The relatively high service share is largely attributed to the province's larger-than-average presence in health and social assistance care (212,000 jobs), education services (146,000 jobs), financial and real estate services (127,000 jobs), tourism (118,000 jobs) and transportation services (114,000 jobs).

- *Less reliant on manufacturing* – B.C. has among the smallest relative manufacturing sector (12 per cent of real GDP and 206,000 jobs) among the provinces. And, of this relatively small share, forest (wood and paper) products account for just under half of factory output and employment. Other major manufacturing industries include food manufacturing, machinery, fabricated metals and mineral products.

- *The least geared towards exports* – the province generates the smallest share of GDP through exports among the provinces. In British Columbia, combined international and inter-provincial exports comprise 43 per cent of provincial GDP, well below the 58 per cent share for Canada as a whole. Exports in B.C. are also heavily tilted towards two main sectors, with resources accounting for a striking three quarters of international goods exports while tourism dominates the service side. Although B.C.'s total inter-provincial trade flows are larger than average, this reflects significant imports from Alberta and Ontario. As a result, the province is actually running a trade deficit in goods and services with other provinces.

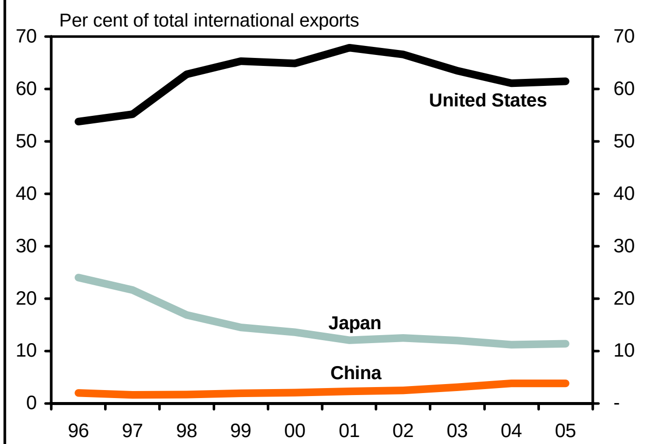
- *More tied to Asia and less to the United States* – the lower overall trade reliance conceals the fact that B.C.'s export sector is more diversified across foreign markets. In particular, in 2005, 11 of B.C. exports were destined for Japan and 4 per cent to China, well above the all-province average of 2 and 2 per cent, respectively. Nonetheless, the U.S. market (64 per cent) remains the province's largest export market.
- *More ethnically diverse* – British Columbia's close ties with Asia are reflected in the province's population base. In B.C., a nation-leading 21 per cent of the residents are visible minorities, a large share of who reside in the Greater Vancouver Area. There have been estimates that by 2017, more than 50 per cent of the residents of the GVA will be visible minorities.[3] Of this share, about half will be of Chinese descent. Moreover, Aboriginals make up a greater share of the population in the province (4.4 per cent) than in Canada (3.4 per cent). The bulk (96 per cent) of Aboriginal peoples in B.C. are North American Indian or Métis.
- *An older and more rapidly-aging population* – attracted by the warm climate, older individuals make up a larger share of the province's population than anywhere else in Canada. As a result, B.C. has among the highest median ages among the provinces (39 years old) and one that has risen more rapidly than in most other Canadian jurisdictions over the last decade.

INTERNATIONAL AND INTERPROVINCAL EXPORTS - 2004



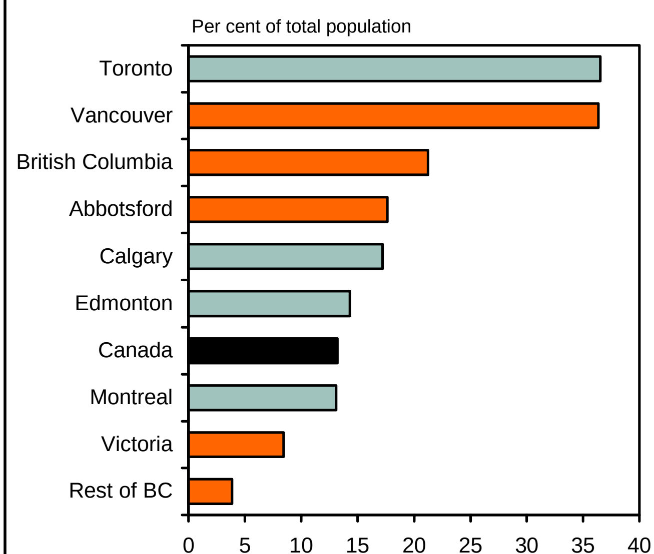
Source: Statistics Canada, TD Economics

BRITISH COLUMBIA EXPORTS MARKET



Source: Statistics Canada

VISIBLE MINORITIES IN SELECTED REGIONS - 2001



Source: Statistics Canada

B.C.'s economic base has shifted measurably

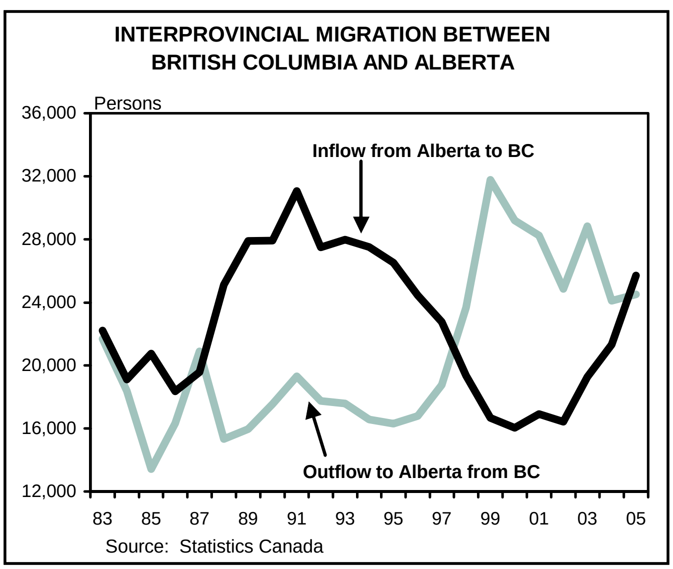
B.C.'s still-formidable presence on the resource front conceals the major swing of the pendulum towards its service sector over history. Indeed, in the mid-1800s, resources accounted for the bulk of economic activity in the province, as U.S. settlers were lured to the province in search of riches in gold, fishing, coal and forestry. Even as recently as the 1970s, direct and indirect activities of the resource sector accounted for more than one-quarter of all economic activity generated in the province – twice the current share. Since then, however, a series of developments has changed the economic mix in B.C. appreciably.

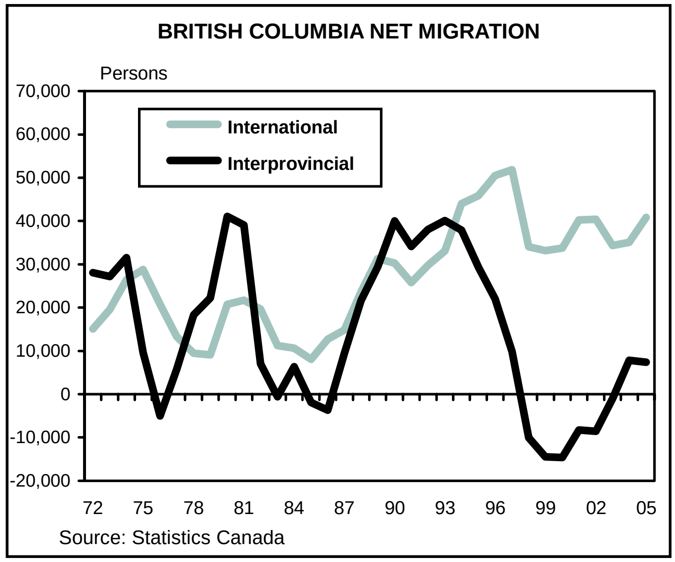
Resource decline resumes in 1980s, services flourish

The first was the global recession of the early 1980s, which dragged down both demand for – and the prices of – resources. Although commodity industries in the province would find their footing again in the latter part of the decade, they would continue to under-perform other areas in the B.C. economy in terms of growth. In particular, the mid-1980s was marked by a notable pickup in Asian interest in the region, as evidenced by rising immigration and in-bound investment flows. Both working-age individuals and those in search of retirement destinations from other parts of Canada also flocked to B.C. over the period. This influx fuelled rapid growth in housing, tourism and financial and real estate services, among others. It was also in 1986 that Vancouver hosted the world exposition, which intensified the favourable spotlight on the province even more. The head of momentum in housing and services would continue in full force into the early 1990s, helping B.C. to avert the devastating recession encountered elsewhere in North America.

Service sector continues to outperform resources in the 1990s

By the mid-1990s, the fortunes of B.C.'s overheated economy soured, leaving few of the province's industries immune. Perhaps the greatest catalyst for the downturn was the sizeable slowdown in in-bound investment and migration. First, flows from Asia waned, partly in response





to the fall from grace of Japan's economy and the impact of the Asian financial crisis in 1997-98. And, second, many residents of B.C. looked to the brighter economic pastures of Alberta. In fact, by 1998, B.C. had suffered a net loss of 15,000 individuals to Alberta, which marked a dramatic swing from the peak gain of 12,000 people in 1991. With population growth under pressure, homebuilding activity plunged, sending further shockwaves across the economy. Meanwhile, a number of structural barriers to growth in the province would become increasingly visible during the decade, including an increasingly uncompetitive tax system, rising budget deficits and cumbersome regulation.

The chilly winds would blow across the province's industrial landscape and rein in growth in the formerly high-flying service sector. Yet, real GDP and employment in most private-sector service industries in B.C. managed to expand moderately in the late 1990s. In particular, computer-related and other high-tech services emerged and American tourists and film producers headed to the province to take advantage of the low Canadian dollar at the time.

The same could not be said for the resource and goods-oriented trade sectors as the decade drew to a close. Japan's troubles encouraged B.C.'s companies to look for trade opportunities in the U.S. market – a bandwagon that other provinces had jumped on immediately following the signing of the Free Trade Agreement in the late 1980s. And, the vast potential of the natural gas industry also started to bear fruit, with the start-up of production at Lady Fern bound for the northeastern United States and the

The B.C. government's 2001 restructuring plan – benefits now being reaped

At the time the provincial Liberals got elected in May 2001, the economy was in the doldrums and the province was in deficit to the tune of $1.5-billion. In order to put fiscal and economic fortunes back on the right track, the government undertook a major review of ministries, departments and agencies and presented a 3-year restructuring plan in its 2002 budget. This exercise called for a 25-per-cent reduction in ministry spending – apart from health and education – over three years. At the same time, the government cut personal taxes and corporate income taxes deeply, the former by 25 per cent.

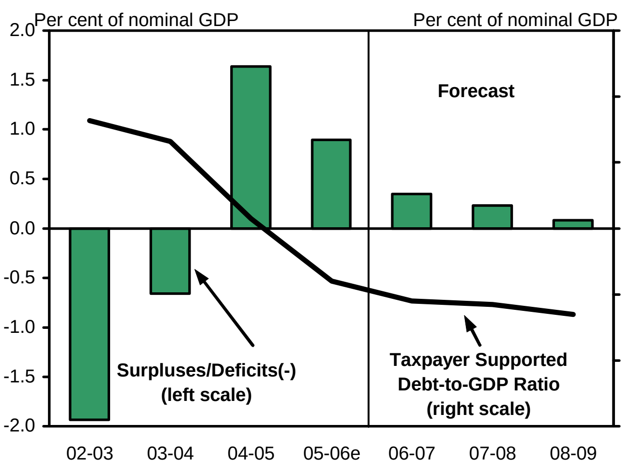
These restructuring moves delivered some difficult short-term medicine to British Columbia. However, a dramatic pickup in world economic growth and sharp rise in world commodity prices beginning in 2002 softened the blow, as both resource royalties and overall revenues came in well over plan. And, while much of the savings in lower priority areas was secured, the government was able to ease up on spending restraint to some extent.

At the end of the 3-year plan, the British Columbia government was able to claim victory in its battle with the deficit monster. In fact, a hefty surplus of $2.5 billion was registered in the fiscal year 2004-05, while the government is estimating another large surplus of $1.8 billion for the fiscal year ending on March 31st, 2006.

SELECTED TAX RATES IN BRITISH COLUMBIA			
	2001	2006	Diff.
Corporate income tax rate (%)	16.5	12.0	-4.5
Small business tax rate (%)	4.5	4.5	0.0
Small business threshold ($000)	200	400	200
Sales tax general rate (%)	7.0	7.0	0.0
Capital Tax rate (%)			
Non-financial	0.15	0.0	-0.15
Financial	1/3*	1/3*	0/0
Top personal inc. tax rate (%)	48.7	43.7	-5.0

*1% for financial institutions with net paid up capital equal to or less than $1 billion; 3% otherwise; Source: B.C. government

BRITISH COLUMBIA'S FISCAL POSITION



Source: B.C. government

In addition to cutting red tape and moving the books from red ink to black, the B.C. government has made the province more business-friendly by placing the debt-to-GDP ratio on a renewed downward track. Since the Liberals took office, the debt-to-GDP ratio has fallen from 21 to an estimated 16 per cent in fiscal 2005-06, which is the lowest among provinces besides debt-free Alberta. And, as shown in the table, the government has reduced the corporate income tax (CIT) rate by 4.5 percentage points since they took office, raised the small business income threshold by $200,000, provided enhanced tax credits for the film industry and eliminated sales tax on some business inputs – including machinery and equipment used in manufacturing and resource processing. As well, the capital tax was eliminated for all business sectors except financial services. We have more on this later.

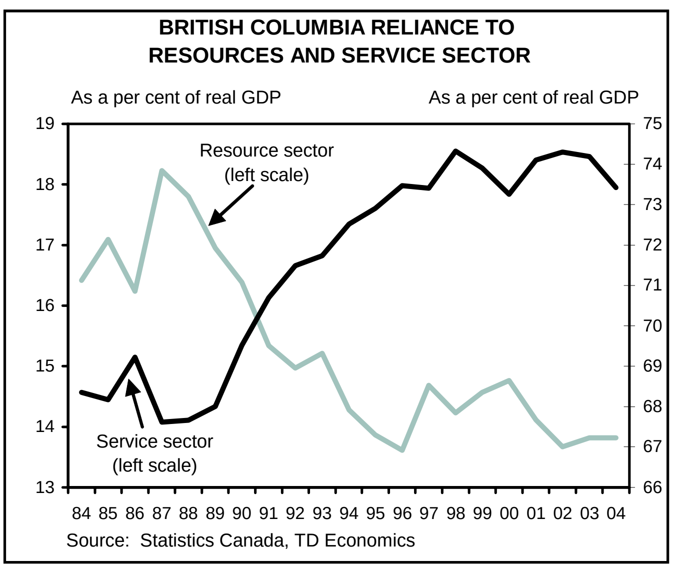
Income earners have not been left aside, as personal income tax dropped significantly as well. Notably, as a result of a 25 per cent reduction in B.C. personal income taxes, the top combined federal-provincial marginal income tax rate dropped from 48.7 to 43.7 per cent, the second lowest among the provinces. In addition, the province boasts the lowest marginal rates for low and modest income individuals. These efforts have left B.C. with one of the most competitive tax regimes in the country.

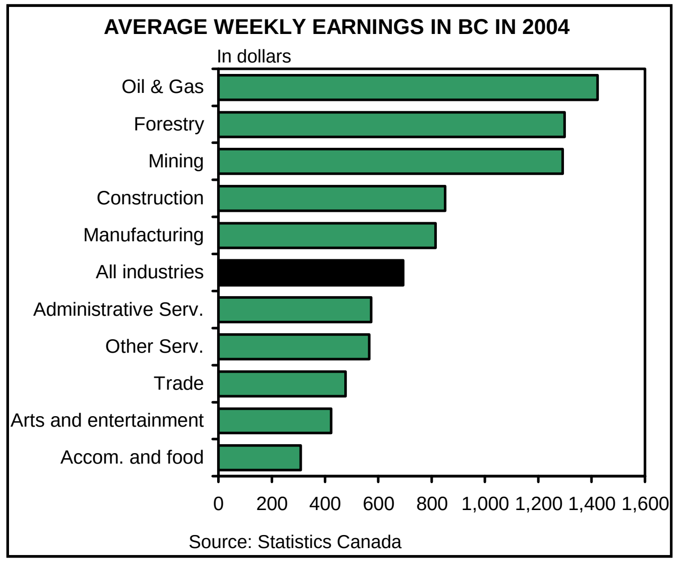
growth of natural gas drilling and production activity in northern British Columbia. But, even though the United States would comprise a growing share of B.C. exports, overall export growth would remain unspectacular. Forestry remained a weak spot, as the sector was not only forced to adjust to costs associated with the 1995 Forest Practices Code, but the implementation of a five-year softwood lumber agreement in 1996 would restrict the volume of Canadian lumber exports that could be shipped duty-free. And, just when the resource sector was starting to make strides penetrating the U.S. market in 2000-01, a further blow would strike. Notably, a combination of 9/11 and the implosion of the high-tech bubble would push the U.S. economy into recession, leaving the primary and manufacturing sectors limping along and also putting a damper on the advanced technology sector.

At the same time, the provincial economy would encounter a further major adjustment in 2001. Premier Gordon Campbell would be elected on a sweeping agenda to improve B.C.'s business climate (see text box on page 6). But, while subsequent moves to eliminate the deficit, lower taxes and trim red tape would be positive from a longer-term economic perspective, the accompanying cuts in public-sector spending in non-health, non-education areas that followed would yield a short-run negative impact on economic activity.

Resource share slide reversed since 2002

As we discuss in more detail later, with the period of restructuring behind it and commodity markets rebounding forcefully, the B.C. economy has taken flight since 2002. In view of the fact that commodity-oriented industries have been behind the charge, the slide in the resource sector's GDP share has halted at 13.5 per cent – albeit about half of its share in the early 1980s.





That being said, there is no question that the resource share's long-term decline has left an indelible mark on the province's economy. B.C.'s large resource players have always accounted for a disproportionate share of exporting, investing and research activities, not to mention the fact that they are among the highest value-added industries in the province. Consider that even after the events of the 1980s and 1990s, resources still account for one in ten direct jobs, a still-whopping 75 per cent of international goods exports, about 20 of the largest 100 companies and roughly one-quarter of annual investment flows.[4] Employment in the oil and gas, forestry and mining industries are also well paid, at above $1,000 per week. Moreover, resource companies pay above $4 billion annually in royalties as well as corporate income taxes, which is hardly chump change.

But, therein lies a problem. Although services industries in B.C. have risen up over the past two decades, they have managed to take up only some of the slack vacated by the prominent resource sector in terms of lost value-added. This contrasts with the experience of Alberta, where the value of oil and gas production and extraction has tumbled as a share of GDP over time. Yet, this decline in the relative share is the result of continued healthy growth in the oil and gas sector, but even more rapid expansion in other industries, including higher-value added resources and services.

Given these trends, it may not come as a big surprise then that business investment in B.C. has lagged behind Canada as a whole over the past two decades. B.C.'s export performance, too, has trailed, both internationally and inter-provincially. In fact, B.C. is the only province among the big four in Canada that is running a growing combined shortfall in trade in international and inter-provincial goods and services. And, the struggles of the resource sector have resulted in a shrinking number of head offices, although this trend has been partly owing to consolidation in the resource sector. On a per-capita basis, B.C. now stands fourth in the number of major head offices, after Alberta, Ontario and Quebec.[5]

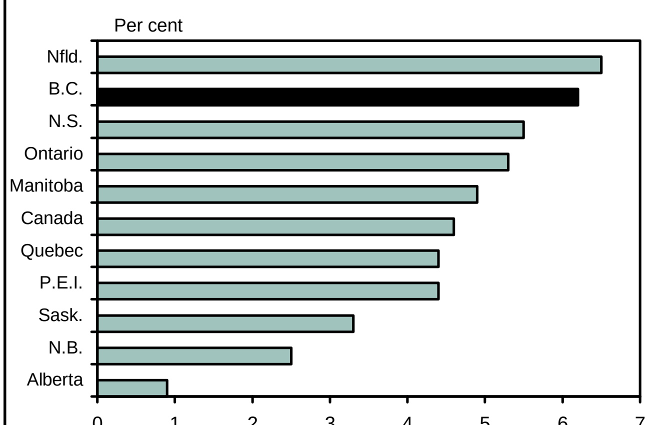
As importantly, these developments have fuelled major changes in the nature of B.C.'s labour market. With much of the job creation in lower-wage service industries, B.C. is home to the highest relative proportion of workers earning the minimum wage (6.2 per cent), although some of this gap over the national average of 4.6 per cent can certainly be attributed to the fact that B.C.'s minimum wage ($8.00) is $0.50-$1.00 higher than in other provinces.[6] Lastly, the movement away from the highly-unionized resource sector to services has been a primary factor driving private-sector unionization rates in B.C. from 36 per cent in 1981 to 22 per cent in 2004, the sharpest drop recorded among the provinces.[7]

Relative standard of living has declined

The decline in the resource sectors' share of output and employment has also coincided with the most sobering of trends and one that best captures B.C.'s long-term woes – the province's relative slippage in standard of living (SOL) over the past two decades. One commonly-used measure of prosperity is real GDP per capita. Between 1981 and 2004, real GDP per capita grew by a paltry 0.8 per cent per year in British Columbia, less than one-half the 1.8-per-cent annual gain recorded for Canada as a whole. As a result, B.C.'s real per-capita GDP, which stood 17 per cent above the national average in 1981, had sagged to 6 per cent *below* by 2004. Worse still, on a North American basis, B.C.'s ranking in terms of per-capita real GDP slumped to 36th among the 61 provinces and U.S. states (or an even weaker 50th spot on a nominal basis). In terms of real personal disposable income per capita, the trend has not been much better, with B.C, moving from a 13 per cent advantage to a 2 per cent disadvantage vis-à-vis Canada.

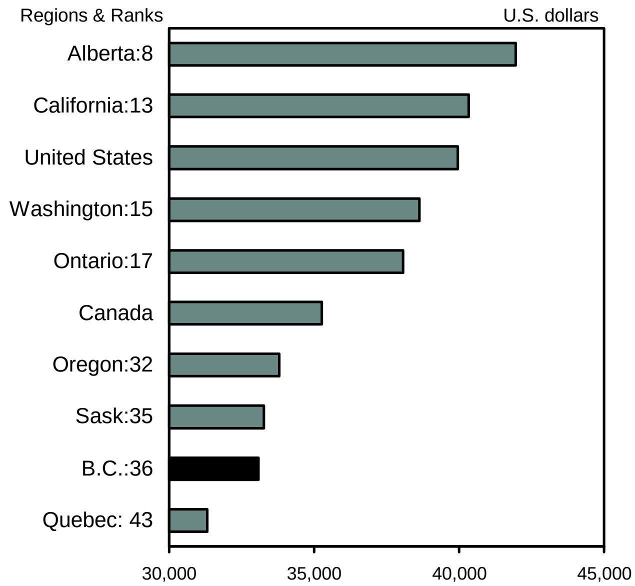
To better understand what has contributed to B.C.'s trailing prosperity performance, it is useful to decompose the change in real GDP per capita into four components: demographics (i.e., working age population as a share of total population), employment rate (i.e., employment as a share of working-age population), work intensity (i.e., total hours worked per employee) and labour productivity

SHARE OF EMPLOYEES WORKING FOR MINIMUM WAGE OR LESS - 2004

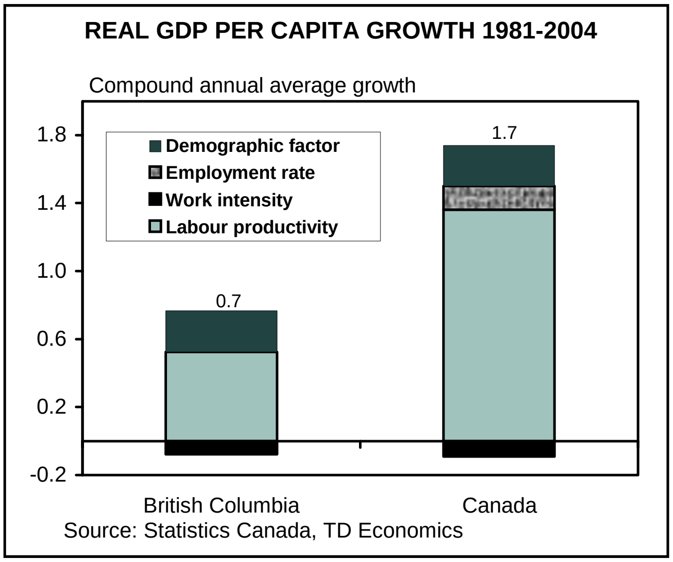


Source: Perspectives on Labour and Income, September 2005, Statistics Canada

REAL GDP PER CAPITA IN SELECTED REGIONS



Source: Statistics Canada, U.S. Bureau of Economic Analysis, TD Economics



(i.e., real GDP per hour worked). In order to arrive at the cumulative change, you simply add up changes to these four components. We summarize the results in the accompanying chart. Notice that both work intensity (-0.1 percentage points per year) and the demographic factor (+0.2 percentage points per year) affected real per-capita GDP growth equally in both B.C. and nationally. In contrast, while the Canadian living standard benefited from an increase in the employment rate (+0.1 percentage points annually), B.C.'s rate was stagnant over the period.

Still, by far the biggest culprit behind the province's trailing prosperity showing in the 1981-2004 period was weaker productivity growth. In fact, B.C.'s productivity gains have lagged behind Canada's by almost one full percentage point per year. Interestingly, while it may be reasonably concluded that the shift in economic mix from higher-value-added resources to low value-added services over time has been a major driver of B.C.'s poor productivity showing, but tells only part of the story. Even holding the mix constant by comparing relative performance by sector with those of other provinces, B.C.'s productivity was lower than Canada's in most areas, including resources, high-wage services, construction and manufacturing.[8] This is not to say that all sectors have not stacked up well – the province's forestry industry, following its upheaval of the 1990s, has emerged more competitive than average.

Urbanization trend notable in British Columbia

Not all regions of the province have borne the brunt of B.C.'s economic challenges equally. The last couple of decades have represented the tale of two economies, where resource-based communities have grown slowly or declined while the larger, more services-based regions have flourished. And, while this trend of urbanization has been observed widely across Canada, few regions in Canada have matched the extent to which it has taken place in B.C.

To better illustrate this point, consider the province's eight economic development regions:

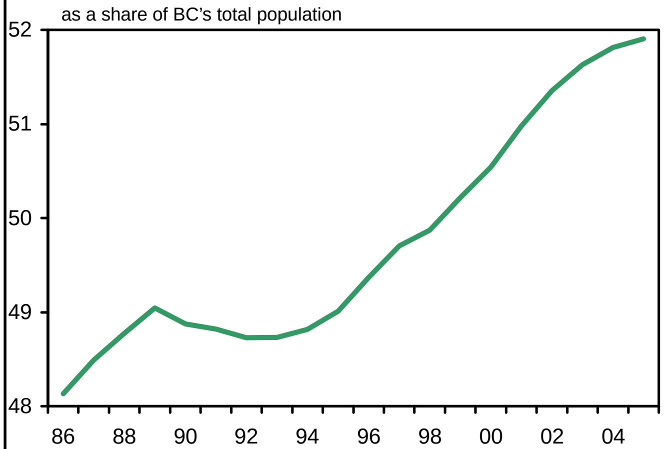
- The largest region is the Lower Mainland, which comprises Greater Vancouver, the Fraser Valley, the Sunshine Coast and Squamish-Lillooet. This region is the business, financial and transportation hub, and accounts for more than half of the province's entire population and economic activity. Employment is well diversified across service industries, manufacturing and construction. Primary industries, which are found largely in areas south of Greater Vancouver, round-out the mix.

POPULATION OF BRITISH COLUMBIA

	Population (persons)	Population annual avg. % change	
	Jul-05	02-05	91-05
Vanc. Island and Coast	**740,268**	**0.8**	**1.3**
Capital RD	345,756	0.4	1.0
Nanaimo RD	**139,231**	1.3	2.3
Lower Mainland-Southwest	**2,536,007**	**1.5**	**2.2**
Fraser Valley RD	263,191	1.5	2.4
Greater Vancouver RD	2,208,333	1.6	2.2
Sunshine Coast RD	28,923	2.0	2.1
Squamish-Lillooet RD	35,560	0.7	3.0
Thompson - Okanagan	**505,620**	**1.1**	**1.8**
Thompson-Nicola RD	124,605	0.1	1.3
Central Okanagan RD	167,542	2.1	2.7
Kootenay	**146,279**	**-0.8**	**0.7**
Cariboo	**159,334**	**-1.3**	**0.6**
North Coast	**59,301**	**-2.4**	**-0.4**
Nechako	**42,303**	**-1.0**	**0.6**
Northeast	**65,410**	**0.8**	**0.8**
BRITISH COLUMBIA	**4,254,522**	1.1	1.6
CANADA	**32,270,507**	1.0	0.9

RD: Regional District
Source: Statistics Canada, TD Economics

VANCOUVER CMA POPULATION



Source: Statistics Canada, TD Economics

- The next biggest urban centre in B.C. is the Capital region, which is located on the southern part of Vancouver Island. This region, combined with other communities on the Island, is home base to nearly one of five B.C. residents. Public services and tourism account for a large share of jobs on the Island. At the same time, the forestry industry has also been a major employer in communities north of the capital region. Service industries aimed at the large share of retired individuals on the Island also form a major backbone of this economy.
- About one in eight British Columbians live in the Thompson Okanagan region in B.C.'s interior. The hubs of this region include the communities of Kelowna, Kamloops, Penticton and Vernon. This region benefits from its attractiveness as a destination for both tourism and retirees. In addition, there are significant contributions from forestry, base metal mining, agriculture, hydroelectricity and manufacturing as well as a small but growing technology sector.
- Most other regions remain largely resource based. The Kootenay region, which borders on Alberta in the south, is rich in coal, mining, hydroelectric power and forest products. In addition to these industries, the Northeast region has an abundance of natural gas. The Cariboo region in central B.C. has Prince George at its epicenter, and is driven by a large forestry sector. Fishing, transportation services and forestry are vital to the north coast region, which includes Prince Rupert, Kitimat and the Queen Charlotte Islands.

The relative economic mix of the major regions, along with their records on population growth, are shown in the accompanying tables. In general, regions that are home to more diverse economies are magnets for migration and tend to be less resource-oriented – notably, the Lower Mainland and the Thompson-Okanagan – have grown at a more rapid rate. Vancouver Island has turned in a mixed performance, as growth in the larger urban areas (i.e., Victoria, Nanaimo and Comox/Courtenay) has been offset by weakness elsewhere.

Statistics Canada has defined the combined area of B.C.'s Lower Mainland and South Vancouver Island as one of Canada's four large urban conglomerations. With 2.7 million people at last count, this region ranks third behind Ontario's Golden Horseshoe (6.7 million), the Greater Montreal Region (3.7 million) and ahead of the Calgary-Edmonton Corridor (2.2 million). Interestingly, B.C.'s urban region accounts for a larger share of provincial population (about 69 per cent) than the Golden Horseshoe and the Greater Montreal Region, and a notch below the Calgary-Edmonton Corridor (72 per cent).

Golden decade underway

The late 1990s slump now seems like a distant memory. Since 2002, economic growth in B.C. has accelerated, running at a brisk annual rate of 3.5 per cent on average – one

INDUSTRIAL STRUCTURE OF EMPLOYMENT -2004 *

	Lower Mainland	Vanc. Island	Rest of BC	BC
All industries	**100**	**100**	**100**	**100**
Goods-producing sector	**18.8**	**18.0**	**28.9**	**20.9**
Agriculture	1.6	1.6	2.5	1.8
Forestry, fish., mining, oil and gas	0.5	2.7	4.4	1.7
Utilities	0.4	0.1	0.8	0.4
Construction	6.5	6.8	8.0	6.9
Manufacturing	9.8	6.6	13.6	10.1
Services-producing sector	**81.2**	**82.0**	**71.1**	**79.1**
Trade	15.5	16.0	15.4	15.6
Transportation	5.9	4.6	5.9	5.7
F.I.R.E.	7.5	5.1	4.2	6.4
Profess. and techn. serv.	8.7	5.4	3.8	7.0
Business and building serv.	4.0	4.0	3.9	4.0
Info., culture and recr.	5.8	4.9	4.6	5.4
Accom. and food services	8.0	10.8	8.2	8.5
Public Services	21.3	26.7	20.4	22.0
Other services	4.5	4.5	4.7	4.5

* per cent of total employment ; F.I.R.E.: Fin., Ins. & Real Estate
Source: Statistics Canada, TD Economics

of the strongest showings among all provinces and competing U.S. states. And, while a rebound in labour productivity growth remains elusive, a record low jobless rate has helped to propel a meaningful rebound in real after-tax income per capita. Population growth has picked up, partly on the back of a rebound in inter-provincial immigration. But, most telling is the fact that with commodity markets strengthening across the board, few industries and regions have been left behind in the recovery. This is evidenced by a decline in jobless rates in every region of the province over the past four years.

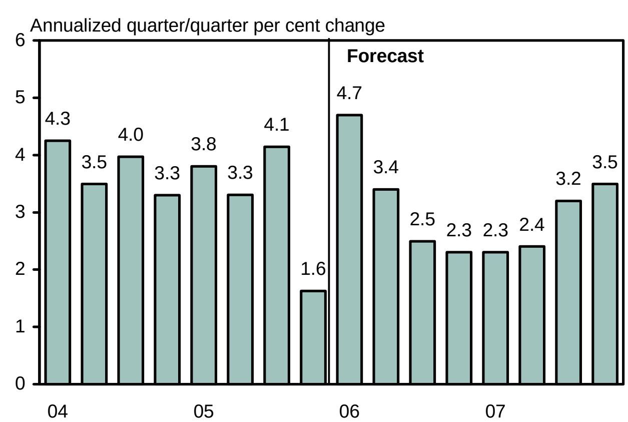
What's more, armed with this head of steam, we expect B.C.'s economic locomotive to remain on the fast track over the next few years, with real GDP growth advancing by 3.5 per cent on average and outperforming the Canadian average through 2010. We present our 5-year look ahead for real GDP, job markets and other key indicators in the tables.

A moderate slowdown in 2006 and 2007

This is not to say that the road ahead will be completely free of obstacles. In our view, the single greatest uncertainty facing the B.C. economy at the moment is the U.S. economy, where a robust expansion over the past few years is vulnerable to a number of imbalances, including sizeable fiscal and trade deficits. Even more importantly, an overheated U.S. housing market has triggered an unsustainable increase in home prices south of the border, which has fuelled much of the expansion in consumer spending over the past few years.

In our view, the probability of an outright U.S. reces-

U.S. REAL GROSS DOMESTIC PRODUCT (GDP)



F: Forecast by TD Economics as at March 2006
Source: U.S. Bureau of Economic Analysis/Haver Analytics

Olympic Games to Provide Large Boost in 2010

Predicting the direct benefits of hosting an Olympic Games is no easy task. A study carried out in 2002 by Intervistas Consulting suggests that the Olympics will generate $2.1 billion (in constant 2002 dollars) over the period 2003-15 in capital construction activities, operating and tourism expenditures.[9] By adding indirect and induced benefits, this estimate jumps to $3.3 billion. In terms of employment, the Games could generate 77,000 new jobs over the same period. The accommodation and food, recreation services, retail and wholesale trade and construction industries will get the lion's share of the benefits.

The bulk of these benefits will be accrued in 2004-08, when much of the construction activity is completed, and in 2010, which will mark the peak of tourism activity. It is important to note that these Olympic-related estimates do not factor in the indirect benefits of rising consumer and business confidence, which could lead to a greater-than-expected kick to economic momentum leading up to and just after the event. But, while not insignificant, these gains need to be taken in context. For example, the expected benefits in 2010 of $2.3 billion from tourism and other spending represent only 1.5 per cent of real GDP. Put another way, the Olympics will represent one of many important influences on the B.C. economy over the next 5 years.

Lastly, there has been some concern that rising wages and costs-overruns could lead to higher government debt and taxes in the future, akin to the experience in Montreal's hosting of the Games in 1976. The province of Quebec has indeed used a share of tobacco tax revenues for 30 years in order to pay this debt, which will be finally eliminated by September 2006. So far in BC, the Vancouver Organizing Committee (VANOC) stated last February that infrastructure costs have already gone up 23 per cent since the $580 million original estimate was presented. However, the provincial government appears to have taken considerable action to insure the province's coffers against this risk. Notably, the government's 2006 budget has set aside $131.5 million in unused Olympic contingency. Further, VANOC has managed to offset some of these higher-than-expected costs by higher advertising revenues from sponsors and by reconfiguring some venues and other installations to achieve cost savings.

Vancouver and Victoria housing markets flash bubble signs

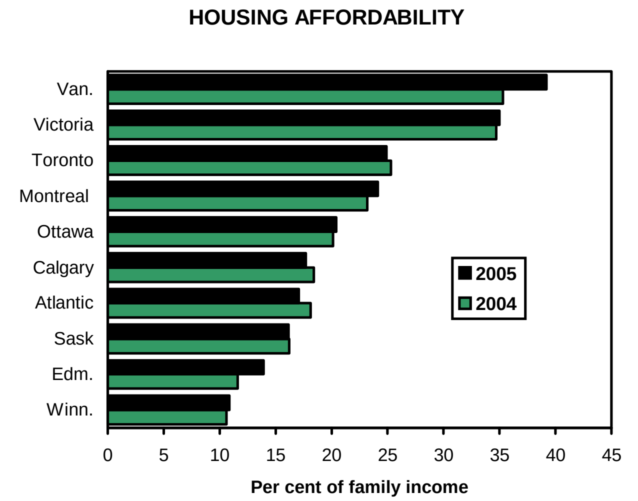
The rapid ascension of housing prices has caught a lot of attention recently. Since 2002, the appreciation in resale home prices has been close to 10 per cent per year in British Columbia. This major upswing has raised many questions among homeowners, potential homebuyers and homebuilders: Will house prices tumble like in the mid-1990s or worse, like high-flying technology stocks did back in the year 2000?

TD Economics publishes the *Housing Bubble Watch*, a quarterly report in which we look at whether the strength in home price appreciation is fully supported by economic fundamentals. We have stressed for some time that the risks of a housing bubble are more elevated in Vancouver's and Victoria's housing market compared to other Canadian cities. In our view, the strong economic fundamentals in place in B.C. can justify *some* of the home price appreciation observed in Vancouver in Victoria over the last few years. However, it cannot warrant *all* of it.

This view is supported by a string of indicators. For example, the 4-per-cent increase in personal disposable income observed in 2004 fell short of the 12-per-cent surge observed in resale home prices. During the same year, Alberta's home price appreciation of 6.5 per cent was backed up by a 6.2 per cent rise in personal disposable income. But, it does not stop there. Indeed, there are good reasons to be concerned with affordability. First, the percentage of household income needed to service ownership costs in Vancouver and Victoria (about 40 per cent) is at least twice that observed in other Canadian cities. Further, the Demographia International Housing Affordability Survey released earlier this year showed that not only is Vancouver the most unaffordable city in Canada for housing, but it ranks 15th worst in the world.[10] Lastly, despite much lower interest rates now, affordability has deteriorated to the same sky-high level that it stood at in both 1989 and 1995 – years that marked the beginning of home price corrections in the province.

Another indicator that reveals frothy conditions is the price/earnings ratio, which measures the price of a benchmark property in relation to its expected future cash flow, i.e. the imputed rent yielded by the property. This ratio has surged in Vancouver – notably the condo segment – recently, reflecting both home-price increases and weakening rents in the depressed rental market. What that tells us is that prices may have risen faster than what the underlying earnings of that property could generate, potentially implying some overvaluation.

Some analysts have suggested that Vancouver's successful bid for the 2010 Olympics could justify this "premium" in the market. However, this raises the question

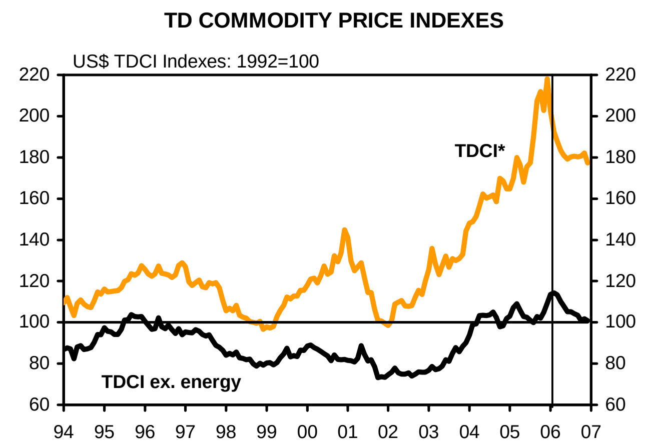


Source: Royal LePage, Statistics Canada, TD Economics

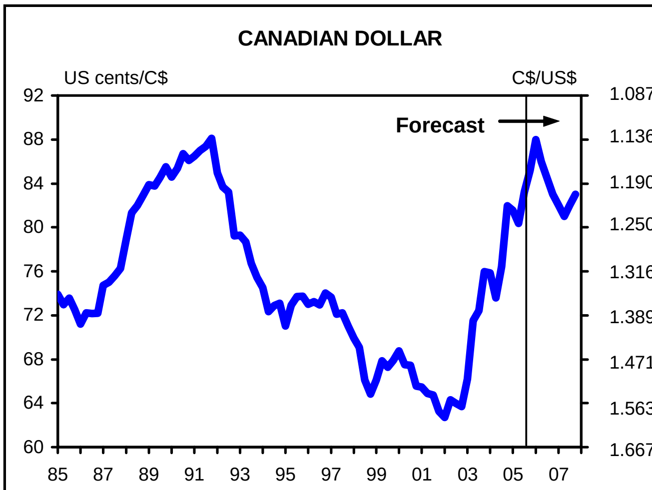
of what happens once the Games are over? Housing prices fell in Sydney Australia in the aftermath of the 2002 Olympics.

Under such circumstances, the probability of a "hard landing" becomes even higher. Further, while this argument could hold for some time in Vancouver, it totally fails to explain large home price gains in other parts of the province. A dwindling supply of land could also fundamentally justify some of the outsized price growth for single-detached homes in heavily populated urban areas. Then, there is little justification for the double-digit pace of condo price growth beyond speculation, suggesting that multiple properties may be at the heart of a potential housing bubble in Vancouver. It is unreasonable to expect condos to have much of a premium for land shortages since municipal planners can always allow for greater densification. Furthermore, this segment of the market is more at risk since many new condo units that have sprouted up are "shoe box". Since these housing projects cater mostly to young first time buyers and appeal less broadly to other types of potential buyers, these units could be viewed as an inferior housing type once they come up for resale in the existing home market in the next several years.

While we have shown evidence of a speculative bubble in the two largest cities of British Columbia, this does not imply that a major correction is going to happen tomorrow. In fact, our base case is that housing prices will continued to grow on a trend basis through the end of the decade, albeit at a much reduced pace. As a result, B.C. will remain home to the most expensive housing markets in the country.



* Index of 18 Canadian resource commodity prices
Actual data to February 2006; F: Forecast by TD Economics as at March 2006;



Last actual: Q4-2005; Forecast by TD Economics as at March 2006
Source: Bank of Canada

sion is quite low (i.e., 15-20 per cent), given the fact that inflation south of the border has remained low and stable. Nonetheless, we do expect the rate of expansion south of the border to slow measurably in the second half of 2006 and into 2007. In particular, even if housing prices don't crash but experience a mild decline, as we expect, U.S. consumers will slow their pace of spending. This, in turn, will have knock-on effects for economies across North America and the world. Meanwhile, weaker demand growth globally is projected to trigger a pull-back in world commodity prices, with the price of West Texas Intermediate Crude slipping to US$45-50 per barrel by early 2007. Prices of base metals are expected to follow suit, dropping by about 20-25 per cent on average over the next 12-18 months. Gold and natural gas prices, however, are likely to buck the general downtrend, with the former trading in the range of US$525-600 per ounce while the latter, which recently fell to around US$6 per MMBtu, is expected to hold close to the US$7-8 range in 2006 and 2007.

The impact of the U.S. mid-cycle slowdown will not be lost on the B.C. economy. At the same time, the province is well-positioned to absorb these impacts over the next few years:

- Much of the negative impact from a weaker U.S. performance on B.C. export demand will be offset by ongoing strength in Asian developing markets and a continued pickup in the Japanese economy.
- Corporate balance sheets are in their best shape in a generation.
- Interest rates and inflation are expected to remain low and stable, which will continue to support housing market activity and keep household debt-service costs under wraps.
- The Canadian dollar is likely to pull back from its recent 14-year high of 88 U.S. cents to 83 U.S. cents by year-end, providing some offsetting positive influence for the province's exporters.
- With the outlook for budget surpluses and a low and declining debt-to-GDP ratio, the B.C. government's fiscal position will allow it to weather most economic shocks.

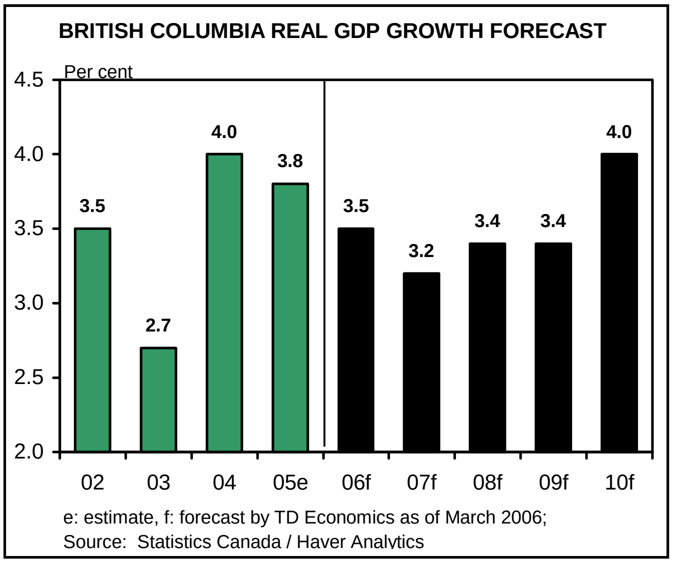
Above all, investment will remain relatively well insulated. While declining profits in the resource sector will likely result in some marginal projects being shelved, price

BRITISH COLUMBIA ECONOMIC FORECAST

Annual Per Cent Change

	2004	2005e	2006	2007	2008	2009	2010	06-10 *
Real GDP	4.0	3.8	3.5	3.2	3.4	3.4	4.0	3.5
Population	1.1	1.4	1.5	1.5	1.5	1.4	1.4	1.5
Employment	2.4	3.3	2.2	2.0	2.0	2.0	2.4	2.1
Unemployment Rate	7.2	5.9	5.7	5.5	5.2	5.0	4.5	5.2

e: Estimate; *Annual average; Forecast by TD Economics as at March 2006; Source: Statistics Canada



declines won't be significant enough to derail many of the big projects already announced in both the resource and non-resource sectors. And, public capital spending on key transportation projects and the 2010 Olympic Games will forge ahead regardless.

B.C. housing markets will continue to percolate

Another risk facing the economic outlook over the next few years is domestic in nature – that being the likelihood of a major correction in B.C.'s housing markets, which have been showing signs of froth. Indeed, as we point out in the text box on page 12, among the major Canadian markets, Vancouver and Victoria have been showing more signs of a speculative bubble than other markets. Still, major disruptions in housing activity are normally caused by an economic shock, such as a sharp spike in interest rates, unemployment or a rapid turnaround in in-migration flows, none of which appear to be on the medium-term horizon. As such, we see the rate of increase in home prices slackening significantly from their recent ferocious pace, but not retrenching either. And, as we show in the chart to the right, with markets in Vancouver and Victoria expected to outperform most other CMA's, the hefty positive gap in housing prices between these two markets and the national average is only likely to widen further by 2010.

Growth to pick up some steam again in 2008

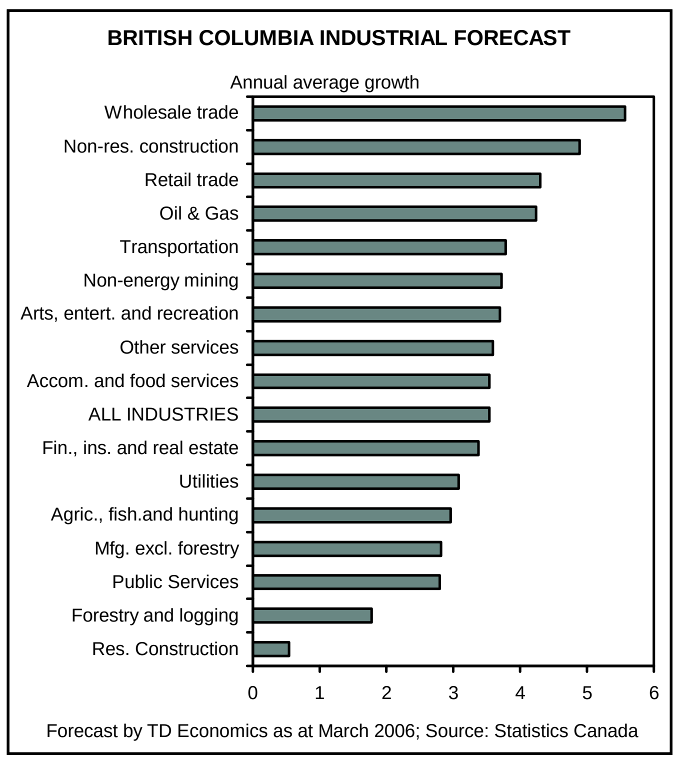
Adding everything up, economic growth in B.C. is expected to lose only a modicum of strength in the 2006-07 period, with real GDP gains and job creation holding at annual rates of above 3 and 2 per cent, respectively. Thereafter, economic growth in the province is likely to ramp up again beginning in 2008, as the U.S. economy emerges from its mid-cycle slowdown, Asian economies continue to chug along, and conditions in world commodity markets firm. And, as discussed in the text box below, the hosting of the Olympic Games in Vancouver in 2010 is likely to provide an added fillip to economic growth later in the decade. Put simply, a mild "U-shaped" growth profile is the most likely for the 2006-10 period.

Industrial outlook 2006-10

Over the past two years, the goods sector has led the way with robust growth of more than 5 per cent, although the service sector has not been that far behind. We expect services-related industries to return on top in the 2006-10 period, with annual growth averaging 3.6 per cent compared to a respectable 3.0 per cent per year for the goods sector. The accompanying table on page 17 also presents output growth by industry through 2010.

Above average (i.e. more than 4% per year)

Non-residential construction (4.9%) – The next few years will see significant Olympic venue and related construction, the Gateway infrastructure program, and expanded private sector investment in buildings, ports and pipelines to satisfy growing demands. Among these projects include $600 million for the construction and reno-



vation of sports facilities and Olympic villages, a $1.8 billion Richmond-Airport-Vancouver (RAV) light rapid transit line, a $565 million expansion of the Vancouver Convention and Exhibition Centre, and a $600 million Sea-to-Sky highway project. A new container-handling facility at the Prince Rupert port will also support growth, starting in the second half of 2007. There are also plans to build a $4 billion pipeline from Alberta to Kitimat in northwestern B.C. Lastly, in January 2006, the province announced a $3 billion plan to enhance the province's transportation network, including a new Pitt River Bridge that will connect Maple Ridge and New Westminster, new perimeter roads on the north and south sides of the Fraser River, and the twinning of the Port Mann Bridge. Although non-residential activity will remain robust through the forecast period, some slowdown in growth is expected in 2008 and 2009 when many of the Olympic projects are completed.

Wholesale and Retail Trade (4.9%) – Consumer spending is likely to remain strong in an environment of solid job creation, low interest rates and rising incomes. A moderate simmering down in auto sales from last year's eye-popping levels is expected to be more than counterbalanced by continued strong demand for household furnishings, other discretionary items and services. In addition to benefitting from healthy demand from retailers, wholesalers will receive support from continued strong levels of business spending.

Oil and gas (4.2%) – While oil and gas prices are not expected to return to the highs reached last year, the overall price environment is likely to remain favourable. As a result, B.C.'s natural gas industry – the country's second largest after Alberta – is poised for continued rapid growth, as activity continues to tap some of the still-lofty reserves in the north-east. Onshore, the Bowser, Winona, Nechako basins all have potential. Moreover, coal-bed gas exploration could lead to output over the medium term. We have not assumed that the huge offshore reserves near the Queen Charlotte Islands and off Tofino start to get exploited over the medium term forecast period. While the provincial government has shown some interest in permitting off-shore exploration, the federal government remains wary, due to potential environmental impacts.

Mountain Pine Beetle to bite into growth

After facing major disputes on softwood lumber, B.C. lumber producers will encounter the greatest of all challenges. The pine beetle infestation, which covers a huge part of B.C. forests, has darkened the long-term prospects of this vital industry. The beetle has been around for decades, but has been normally killed off by cold winters. However, with warmer temperatures, infestation has materialized. Indeed, the volume of forested land infested in cubic metres jumped from 2.5 million in 1998 to 283 million in 2004. In order to control them, it would take -25 degree Celcius weather in the early fall or late spring or -40 degrees Celcius in the winter, which is highly unlikely.

The B.C. Ministry of Finance projects that 80 per cent of the provincial lodgepole pine inventory could be destroyed by 2013, and these trees make up more than one half of the Interior's annual harvest. This has led to a 27 per cent increase in the total allowable cut for the three north-central BC timber supply areas most affected by the pine beetle. In the short run, the epidemic is expected to raise production, as timber harvest levels are increased to use dead trees before they decay and lose their commercial value. This short-term rise will be followed by a significant reduction in the cut in the next decade as the epidemic runs its course and the trees reach the end of their economic usefulness.

The B.C. and federal governments have joined forces to try and mitigate the impact of the problem. In September 2005, the federal government agreed to set aside a combined $100 million over three years, building on the B.C. government's promise to allocate some $214 million. These funds will be used for research into new products for infested wood, controlling the spread, economic development and diversification planning. Further federal assistance to help deal with the fallout stemming from the pine beetle may be forthcoming. In addition to lumber production, other possible uses of beetle wood include supply for oriented strandboard (OSB), heating fuel pellets and power co-generation facilities. Two new OSB plants will likely get built in Prince George and in Quesnel.

Average (3.0-4.0 per cent)

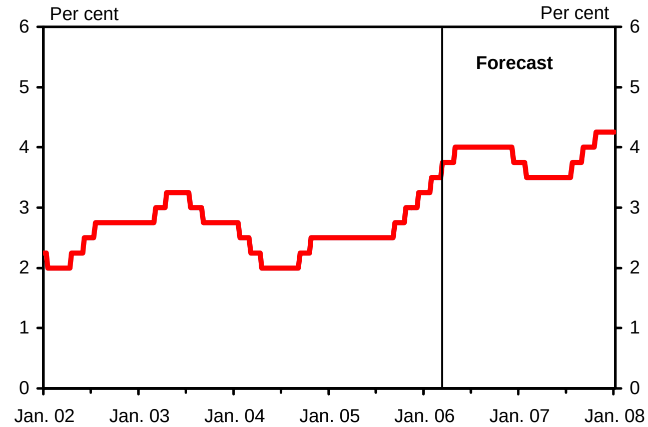
Transportation services (3.9%) – While the slowdown in U.S. growth will take some steam out of transportation services in 2006 and 2007, the benefits of rising trade activity with Asia will take up the slack. The longer-term outlook for this industry is also bright, supported by a number of investments that will gear up over the next few years. These include seaport and airport expansions, the construction of energy pipelines and a planned liquified natural gas terminal. Although Vancouver will remain a major transportation hub, these investments will further elevate the province's northern communities, including Prince Rupert and Kitimat, to important centres of transportation activity.

Non-energy mining (3.7%) – This sector, which has sprung back to life since 2004, is expected to turn in a respectable performance over the next few years. Still, producers will face varying market conditons, as prices for copper, zinc and molybdenum are projected to pull-back by 20-25 per cent over the next few years while gold and natural gas prices remain firm. Over the longer haul, ongoing rapid growth in China will continue to provide significant export opportunities for B.C.'s metallurgical coal and metals industries.

Tourism-related services (3.5%) – The tourism sector is expected to advance only modestly over the next few years. Although a healthy domestic economy and increased traffic from China and other Asian countries will continue to provide support to tourism travel, visits from the U.S. will likely be constrained by a combination of a weak greenback, still-lofty pump prices, and the effects of slower U.S. economic growth. Moreover, the province's cruise ship industry continues to face growing competition from the Port of Seattle, while the likely implementation of new security plans by 2008 – which will require every U.S. traveler to show a passport to enter Canada – will deliver an added challenge. However, the longer-term prospects for B.C.'s tourism industry remain positive. The hosting of the 2010 Olympics will not only be a major driver of growth in that year, but will provide an opportunity to once again showcase the region for the benefit of future years. The industry recently received a major boost when Travel and Leisure Magazine ranked Vancouver Island number one among Islands in continental North America.[11]

Other private services (3.6%) – Among this large mix of industries, private education services will remain a particular source of strength, owing in part to rising demand, particularly from foreign students, for schools providing english as a second language (ESL). Moreover, businesses in the high-tech sector are expected to remain on a solid recovery from the throes of the 2001 downturn. The television and film production industry bounced back strongly in 2005 from a poor showing in 2004. Still, in view of the elevated level of the Canadian dollar and rising competition from other North American jurisdictions, this industry is projected to follow a moderate growth track over the next few years. On the plus side, the provincial government has extended the tax credit for film and video productions to 2008.

BANK OF CANADA OVERNIGHT TARGET RATE

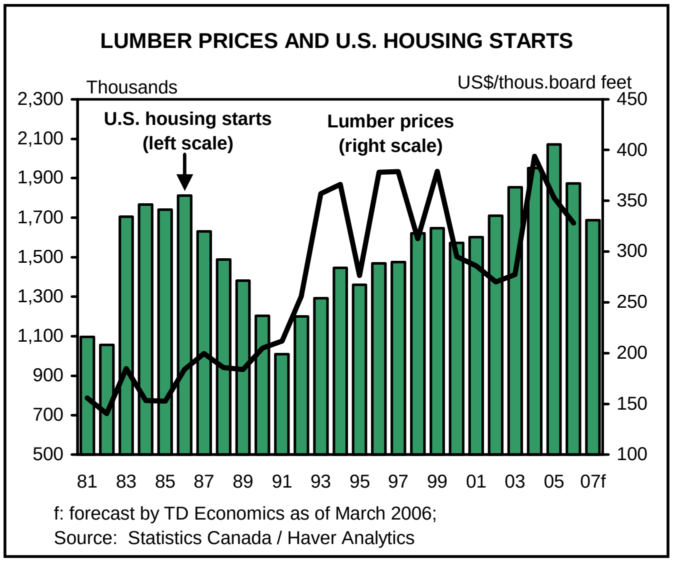


Actual data to Mar. 22, 2006; Forecast by TD Economics as at Mar. 2006
Source: Bank of Canada

Finance, Insurance, Real Estate and Leasing (3.4%) – These industries will grow at a respectable clip in line with the domestic economy as a whole. That being said, there is expected to be rebalancing in growth within the sector, as slower advances in activity related to a more modest upward trend in housing are offset by increased activities on the non-residential side. Indeed, with profit growth expected to taper off in B.C. as commodity prices pull back, this may create opportunities for additional lending activity. A major barrier to expansion in the finance sector will continue to be the provincial capital tax imposed on financial institutions, which is among the most punishing in North America.

Below Average (under 3.0 per cent)

Public services (2.8%) – In its 2006 budget, the B.C. government announced moderate growth in health-care and education outlays, while keeping overall spending on a moderate upward track. On the education side, the province has embarked on a multi-year plan to create 25,000 new spaces by 2010 at the post-secondary level. As usual, health spending pressures will continue to dominate the agenda. In our forecast, we have assumed growth in private delivery under a single public-payer model. Recently, the Premier carried out a four-country European tour to



learn about alternative methods of delivering health. This trip came on the heels of the 2006 Speech from the Throne, which elevated dialogue on health-care delivery to a higher priority.

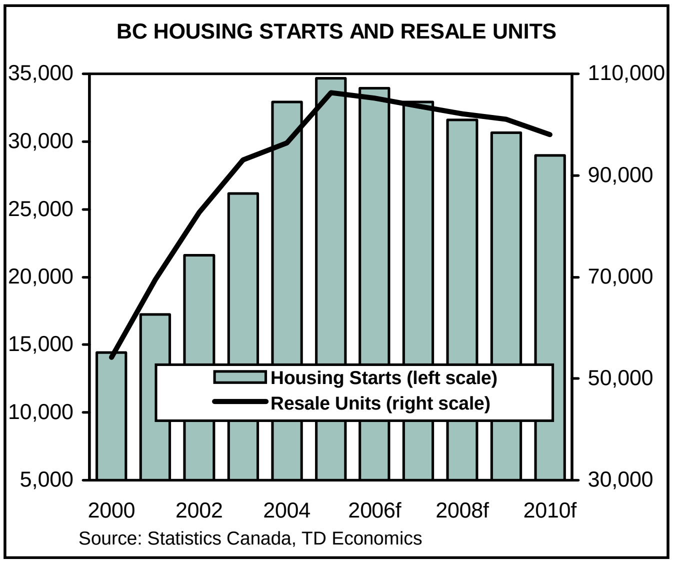
Manufacturing excluding forestry (2.8%) – This sector has adjusted reasonably well to the 35-per-cent run-up in the currency since 2002, helped by brisk growth in demand from the U.S. and Asian export markets. Although our forecast of a reversal in the value of the Canadian dollar toward the 82-83 U.S. cent mark and some further reprieve in energy prices will provide some support to manufacturers, prospects for a slowdown in the pace of U.S. expansion later this year and in 2007 will constrain growth in this area. In this tougher demand environment, manufacturers in B.C. are unlikely to let up in their recent efforts to raise productivity, which will continue to be achieved partly by outsourcing supply chains to Asia.

Forestry (1.8%) – A sharp slowdown in both homebuilding and overall import demand south of the border is expected to weigh on prices and output growth in B.C.'s forestry sector later this year and in 2007. Nonetheless, we still expect the lumber industry to expand over the medium term. First, lumber producers in the interior are likely to further accelerate harvests of beetle-infested wood (see text box on page 15). Second – and on a more upbeat note – the imposition of U.S. duties on the Canadian lumber industry since 2001 has spurred ongoing efforts to raise efficiency, which should continue to stand B.C.'s producers in good stead during a period of more difficult U.S. market conditions. We have not factored any final resolution to the U.S. softwood lumber dispute into the forecast, and continue to assume that U.S. duties will remain at a combined rate of 10.8 per cent, which is down from their peak of 27 per cent. It seems likely that any final agreement would include a new export tax on Canadian shipments south of the border and some sharing of the $5 billion in duties that have been collected by the U.S. government. Within the pulp industry, there have

BRITISH COLUMBIA INDUSTRIAL FORECAST
Annual Per Cent Change in Real GDP

	2005e	2006	2007	2008	2009	2010	2006-10 *
ALL INDUSTRIES	**3.8**	**3.5**	**3.2**	**3.4**	**3.6**	**4.0**	**3.5**
Goods	**4.1**	**3.3**	**3.2**	**3.4**	**3.1**	**2.1**	**3.0**
Forestry and logging	1.5	2.1	2.0	1.8	1.6	1.4	1.8
Agriculture, fishing and hunting	4.5	3.0	3.0	2.9	2.9	2.9	3.0
Oil & Gas	4.5	3.5	4.2	5.0	4.5	4.0	4.2
Non-energy mining	3.5	4.9	3.5	2.9	3.7	3.6	3.7
Utilities	3.4	2.9	2.9	2.9	3.2	3.5	3.1
Residential construction	4.0	2.0	2.0	0.0	-0.5	-0.8	0.5
Non-res. construction	6.9	6.3	6.7	7.1	5.1	-0.7	4.9
Manufacturing excl. forestry	3.9	2.6	2.5	3.0	3.0	3.0	2.8
Services	**3.6**	**3.5**	**3.1**	**3.2**	**3.4**	**4.6**	**3.6**
Wholesale trade	7.5	6.0	4.8	4.8	5.2	7.0	5.6
Retail trade	5.4	4.1	3.5	3.7	3.9	6.3	4.3
Transportation	3.3	3.0	2.8	3.4	3.8	6.3	3.9
F.I.R.E.	3.8	3.6	3.2	3.2	3.3	3.6	3.4
Arts, entertainment and recreation	2.7	2.6	2.4	2.5	3.0	8.0	3.7
Accommodation and food services	3.0	2.3	2.3	2.3	3.2	7.6	3.5
Public Services	2.2	3.0	2.7	2.7	2.7	2.9	2.8
Other services	3.2	3.0	2.8	3.2	3.5	5.4	3.6

*Annual average; Forecast by TD Economics as at March 2006; Source: Statistics Canada



been significant efforts recently to rationalize operations in the wake of high energy prices and the Canadian dollar's strength. This restructuring trend is expected to continue over the near term, especially in view of the outlook for weaker U.S.econonic growth. On the plus side, China will continue to be a major market for B.C. pulp, as the nation relies on imports to meet growing pulp needs.

Residential Construction (0.5%) – Housing starts in B.C. surged to 34,700 starts in 2005, which is more than twice the level when the new housing market was in the doldrums back in the early 2000s. Strong population gains and a buoyant job market will continue to propel demand for new homes. At the same time, however, shortages of land, labour and equipment in the larger markets will likely curtail growth on the supply side. Altogether, look for homebuilding activity to remain elevated, but to pull back towards a more sustainable level of about 30,000 units per year decade's end.

Lower Mainland will outperform in 2006-10

With growth in the resource sector likely to come off the boil to some extent and service-sector activity to jump into the driver's seat, we expect to see some shift in economic momentum over the next few years back to the major urban regions of Lower Mainland, most notably the Greater Vancouver Area. Still, the divergence in performances will not come close to that in the 1990s, as capital investments in the resource, transportation and tourism sectors drive economic activity in B.C.'s interior and northern communities. As such, look for employment to grow by just over 2 per cent in the Lower Mainland over the next 5 years, a notch above the still-healthy growth rates of 1.5-2 per cent rates posted in Vancouver Island and the other regions of the province.

Provincial economy to reach new milestones by 2010

By the time the Olympic torch is lit in Vancouver, B.C. will have reached a number of new milestones:

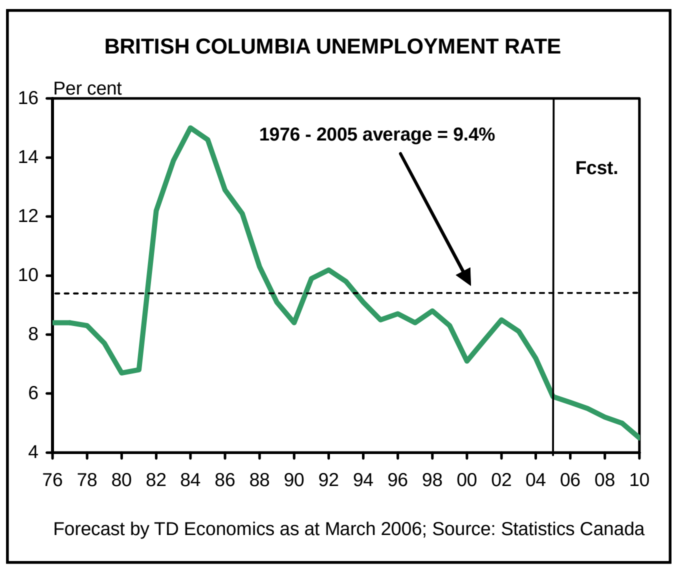
- With the B.C. economy growing well above its long-term potential rate, the province's unemployment rate is expected to slip to a new record annual low of 4.5 per cent by 2010.
- At 4.5 per cent by 2010, the annual increase in average hourly earnings will climbed to twice the average posted since 1991.
- Average housing prices in Vancouver and Victoria will have reached roughly $550,000 and $440,000, respectively.
- Look for real GDP per capita to gain 2.0 per cent per year on average to 2010 – above its long-term average of 0.8 per cent per year. Nonetheless, B.C.'s prosperity gap with the rest of Canada is projected to remain a

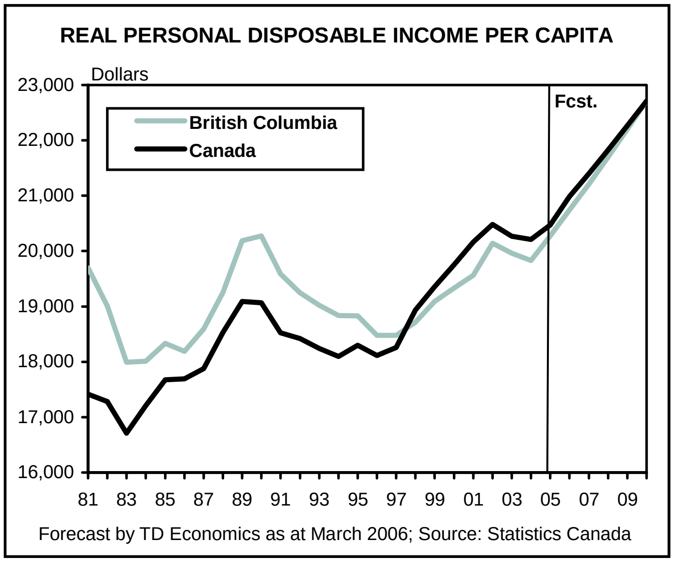
EMPLOYMENT GROWTH IN SELECTED REGIONS

Annual average growth

	B.C.	Vanc. Island	Mainland Southwest	Rest of BC
1996-2005	1.8	1.4	2.2	1.1
2006-2010f	2.1	1.9	2.4	1.5

Forecast by TD Economics as of March 2006 ;
Source: Statistics Canada





(negative) 6 per cent.

- On a particularly positive note, real PDI per capita is poised to grow by 2.3 per cent per year in 2006-10, well above its long-term average of only 0.1 per cent and in line with its showing during the 1985-1990 boom period. By 2010, we expect that the gap in per-capita personal disposable income with that of Canada will be virtually eliminated.

In 2001, the government formed the B.C. Progress Board, tasked with benchmarking the province's economic performance with other jurisdictions and with providing advice on how to improve its showing. The Board has set three core economic goals for 2010 – notably, targeting 1st or 2nd in Canada in each of growth in real GDP per capita, real PDI per capita, and the employment rate.[12] The province has seen its position improve on these metrics, reaching third, third and fifth, respectively, among the provinces in 2004. We expect that the Progress Board's longer-term goals will be reached even before the Olympic year 2010, although some room has been left through the setting of single-year targets rather than those over a period of time. In addition, the Board has established a goal to be 1st in Canada in environment quality and health outcomes and 1st or 2nd in social conditions. In our view, these are also achievable objectives, particularly the first two, where the province already ranks number 1.

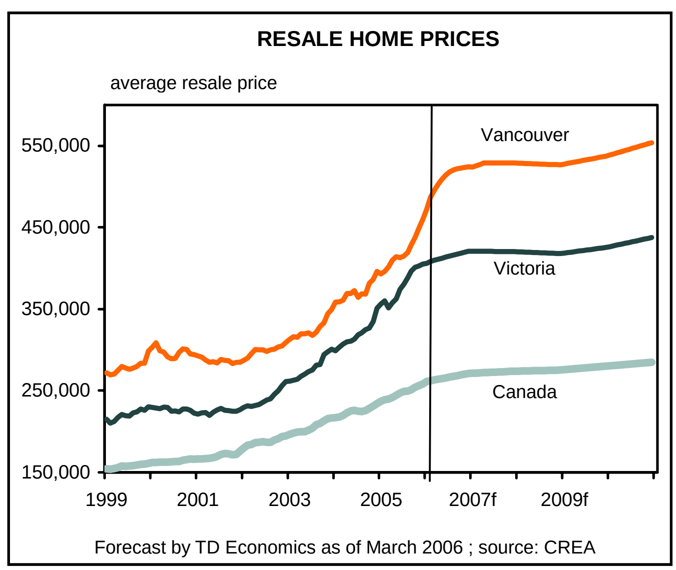
Less clear, however, is whether the province's improved showing will be accompanied by a long-awaited acceleration in productivity gains. Although the province is expected to benefit from a cyclical rebound in real output per hour worked over the next few years, we don't expect to see a meaningful narrowing in relative productivity levels between B.C. and competing jurisdictions. Despite record profitability and the falling cost of U.S. made technologies in the wake of a rising Canadian dollar, business investment in machinery and equipment has increased only moderately since 2003. In fact, the recent 2006 investment intentions survey showed B.C. machinery and equipment investment up only slightly in nominal terms for the year ahead.[13] As such, the productivity area is likely to remain the Achilles Heel of the province's otherwise impressive economic scorecard.

Some storm clouds loom post-2010

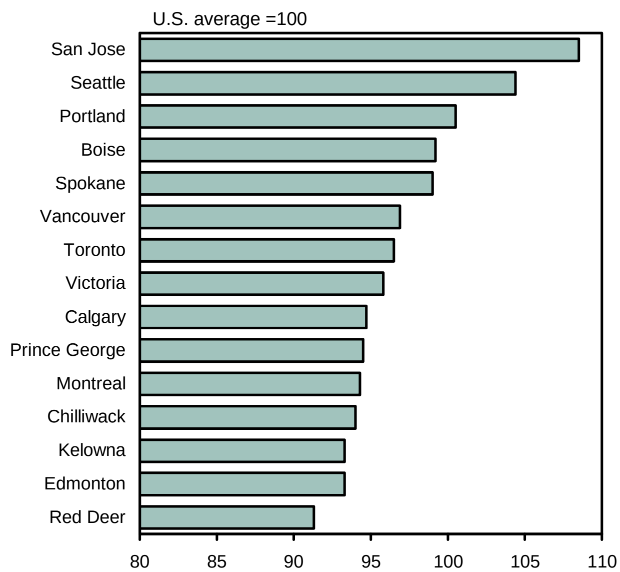
British Columbia's economic picture becomes cloudier after the burning Olympic torch is extinguished in 2010. And, here, we're not just talking about a slowdown in spending and tourism activity that is certain to follow the Olympic Games. It is reasonable to expect that those impacts should be relatively short-lived and not substantial enough to lead to a major economic downturn. Rather, we are referring to a number of other downside risks that are lurking around the corner that could cast a pall on B.C.'s economic expansion. We count five in particular.

Risk 1: a housing bubble

As we discuss on page 12, there have been emerging signs of late that a speculative-driven bubble has begun to take root in B.C.'s key markets of Vancouver and Victoria. Despite these warning signals, we also argued that don't see any meaningful slowdown in housing activity taking



BUSINESS COSTS
Overall Operating Cost Index



Source: KPMG 's guide to international business costs", 2006 Edition.

place in light of the continued strength in population, job creation and confidence. At the same time, however, the housing market, which is cyclical in nature, may be ripe for a significant slowdown beyond 2010. And, with one of every four jobs over the past four years generated within the construction industry, this could have signigicant negative repurcussions on the province's economy.

Risk 2: depleting timber stocks

With lumber harvests in the interior continuing to accelerate over the next several years as a result of the pine beetle infestation in the interior, the impact of declining timber stocks will only be truly felt further down the road. The B.C. and federal governments have been working together to assist lumber producers and communities to cope with the crisis. However, large structural adjustments may be required that could take several years and ripple across B.C.'s economy.

Risk 3: rising wages and prices

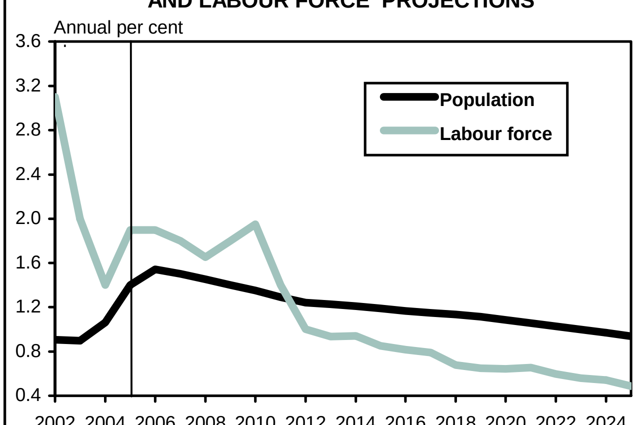
We are concerned about an unsustainable build-up in wages and prices over the next half decade, which could erode the province's cost competitiveness and ultimately trigger a downward adjustment post-2010. Labour shortages, which are already evident across some major industries, are expected to only worsen over the next few years, as unemployment rates continue to drop. Continued healthy migration to the west from the weaker economic regions of Central and Atlantic Canada is expected to provide some support to job markets. Still, with Alberta also in dire need of additional workers, especially as a number of oil sands projects ramp up in 2007 and 2008, competition for labour will probably intensify. Moreover, rising wages that are not offset by productivity increases raise the risk of a escalating inflation. While a moderate pull-back in commodity prices over the next few years could take some pressure off of materials prices, the reprieve is likely to be modest in an economy operating above full capacity.

Vancouver, which stands dead last in terms of cost competitiveness among urban centres in Canada, has already seen its cost edge over U.S. competitors largely disappear as a result of the strength in the Canadian dollar since 2003.[14] Rapid wage and price increases would lead to a further deterioration in the city's competitive position.

Risk 4: bear market returns to commodity prices

We share in the general view held by many analysts that resource prices will remain relatively high over the next few years. This outcome is far from assured, however. There are upside risks to longer-term commodity supply forecasts, given the fact that the current high price environment has triggered considerable new interest in exploration and development since 2003. And, current demand forecasts may be overestimating the impact of consumption from developing markets. Although we don't expect to see any significant movement to alternative energy sources and away from conventional fuels such as

BRITISH COLUMBIA POPULATION AND LABOUR FORCE PROJECTIONS



Population forecast by Statistics Canada;
Labour force forecast by TD Economics; Source: Statistics Canada

gasoline and natural gas over the next several years, we can't rule out a shift sometime in the next decade.

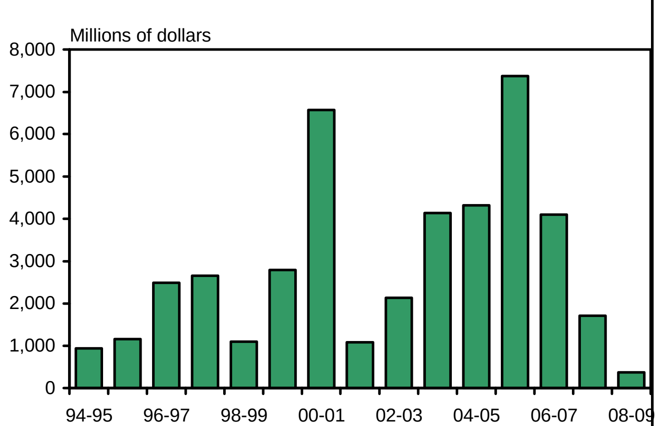
Risk 5: slowing workforce growth

Gains in British Columbia's labour force appear set to taper off beginning in the early part of the next decade. For one, net migration to the province could moderate sharply, particularly in the event of an economic slowdown. Even more importantly, the effects of an aging population are poised to dampen labour force growth. It has been estimated that the number of individuals in the 15-24 age cohort in B.C. (representing the inflows into the labour force) will peak in 2007 while those in the 55-64 age category (the outflows of people nearing in on retirement) will climb steadily until 2021.[15] As a result, growth in British Columbia's labour pool is on track to slow from its current trend rate of about 1.5-2 per cent to under 1 per cent by 2015 and then to a mere 0.5 per cent by 2020. On a brighter note, supported by faster projected immigration, labour force growth in B.C. is expected to outperform that of Canada as a whole.

Alberta will continue to flex its muscles

If these five risks we've highlighted weren't formidable enough, B.C. is also likely to face a challenge that is not new, but one that is likely to intensify – namely, the competitive threat from Alberta. We have argued in a previous TD Economics report that Alberta and its urban powerhouse, the Calgary-Edmonton Corridor, stand out as the only jurisdiction to enjoy a Canadian-style standard of living with a U.S.-style level of income.[16] The province continues to face many growth-related challenges, partly stemming from its low tax burden and extremely attractive business climate. However, armed with no debt, big surpluses as far as the eye can see, and billions of dollars set aside in a number of funds, Alberta will continue to take steps to address its check list of challenges, including its infrastructure and education systems, and solidify its position as a magnet for investment and immigration. Accordingly, the competitive bar that B.C. is only going to rise several rungs over the next decade.

ALBERTA'S BUDGET BALANCE



Source: Alberta government

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.

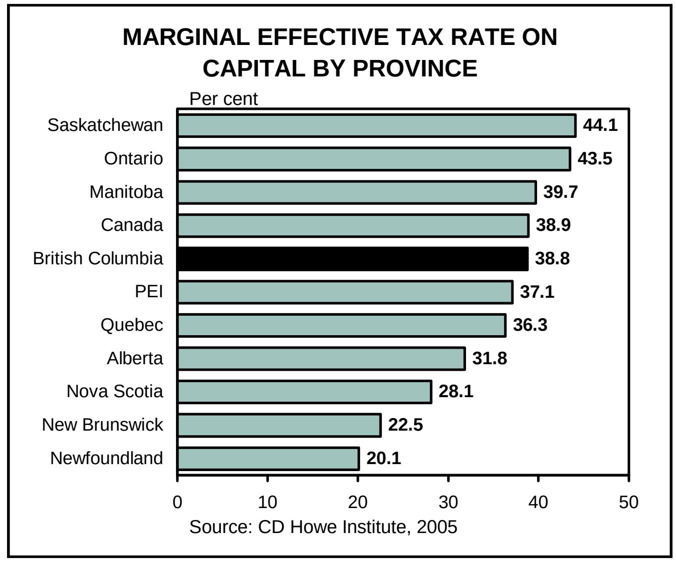
Regardless, it is critical that British Columbians take action now to fend off any potential storm clouds, and in doing so, help to extend the recent economic gains. **First,** we believe that the province is already on the right track in its quest to raise the capacity of the provincial economy to both grow and innovate. However, it must accelerate these efforts. And, **second,** it must respond to Alberta's competitive threat.

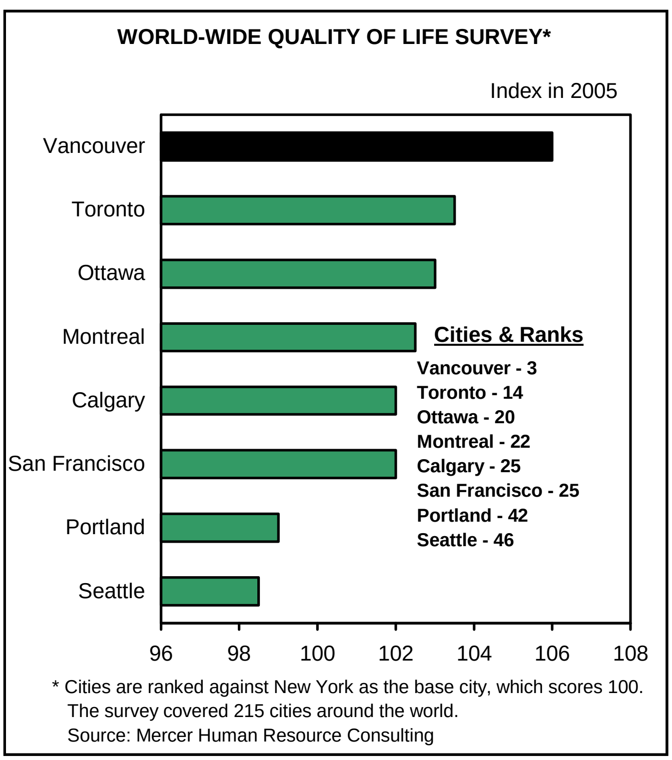
This will be no easy feat, in light of the fact that the attention of policy-makers will be squarely fixed on meeting the day-to-day challenges that arise from the current economic boom along with preparation for the 2010 Olympics. However, taking time out over the next few years to bask in success without continuing to move forward could be costly down the road. And, nobody can sit idly by. Governments have a primary role in improving the overall backdrop for investment, while the private sector must step up in response to these incentives.

Happily, if there is one province that is well-positioned to overcome these tall challenges, it's British Columbia. Supported by the progress made since the early part of this decade, B.C. currently stands high up in the leaderboard in most economic and social areas.[17] Furthermore, by many counts, it enjoys a competitive edge over provinces, even powerhouse Alberta, in the key areas of education, infrastructure delivery and environment. The Conference Board of Canada ranked B.C. first in terms of health outcomes.[18] And, perhaps most importantly, B.C.'s largest city – Vancouver – comes out on top in international surveys of quality of life, and is highly regarded for its tolerance and diversity.[19] Hence, the province's overriding goal should be to maintain a competitive advantage in these areas, while attempting as best it can to respond to Alberta's moves to improve its cost position. Better still, by following this recipe, B.C. is almost guaranteed to improve its relative standing on the North American landscape.

Undeniably, Alberta has a major advantage over B.C. and other provinces in terms of available public resources. But, while there may be calls for the B.C. government to reduce its debt over the next few years, we would argue that a greater priority should be placed on maintaining fiscal flexibility to respond to, say, tax reductions by Alberta. Not only is B.C's net debt relatively low as a share of GDP (16 per cent in fiscal 2005-06), this ratio will continue to drop as long as the province continues to balance its operating budget. Besides, there is a solid argument that some form of debt is optimal. This is because as some of the benefits of long-term public capital are spread out over generations, so too should the costs be spread out. B.C. can also free up additional public resources by continuing to pursue newer ways of doing business, such as using P3s and other innovative service delivery mechanisms. This is another area where it continues to lead the way in Canada.

Lastly, some solace can be taken from the B.C. government's 2006 Speech from the Throne, which stated "the comfortable curse of complacency is not a path for long-term prosperity. It is the dead-end route of inevitable decline." But, while the government has acknowledged the potential cost of resting on its laurels, little was said about where it wants to take the economy past 2010. We do hope to see specifics emerge in future speeches and budgets, perhaps as part of a long-term growth and productivity agenda.





Tax bar to come down further, care of Alberta

British Columbia has worked hard to improve its tax standing since the Campbell government was elected in 2001 (see text box on page 6). And, in its 2005 Fall Budget update and February 2006 Budget, it wielded the tax axe again, trimming corporate income taxes and promising to match the move by Ottawa to reduce dividend taxes once the initiative is enacted into federal law. Still, there is plenty of unfinished business on the tax side. Indeed, as we show in the accompanying table, the tax gap with Alberta remains sizeable in virtually all areas.

On the plus side, B.C. now boasts the lowest personal income tax (PIT) rates for the bottom two tiers of income earners (i.e., less than $60,000 per year). But, while B.C. has moved into second place in terms of top marginal PIT rate – a rate which is a key driver in attracting skilled mi-

TAX RATES AND KEY ECONOMIC INDICATORS IN SELECTED JURISDICTIONS			
	B.C.	Alberta	Canada**
Corporate income tax rate (%)	12.0	10.0	13.7
Small business tax rate (%)	4.5	3.0	4.5
Small business threshold ($000)	400	400	360
Sales tax general rate (%)	7.0	0.0	7.1
Capital Tax rate (%)			
Non-financial	0.0	0.0	0.3
Financial	1/3*	0.0	2.7
Top personal inc. tax rate (%)	43.7	39.0	45.9
Participation rate (%)	65.6	72.7	67.2
Unemployment rate (%)	5.9	4.0	6.8
Real GDP per capita ($)	33,072	41,956	35,266

*1% for financial institutions with net paid up capital equal to or less than $1 billion; 3% otherwise; **unweighted prov. average

Source: B.C. government, Statistics Canada

grants – the differential with Alberta remains significant. An even bigger challenge is found on the business side. Despite the recent cuts to corporate income taxes, the marginal effective tax on capital in B.C. (a broader measure of business taxation that combines the impacts of income taxes, capital taxes, depreciation allowances and payroll taxes) stood at 38.8 per cent in 2005, which is the fourth *highest* among the provinces and well above rates in competing U.S. states of Washington and Oregon.[20] In Alberta, the comparable figure in was 31.8 per cent, and that was before the province cut corporate income tax (CIT) rates by a further 2 percentage points in its 2006 budget.

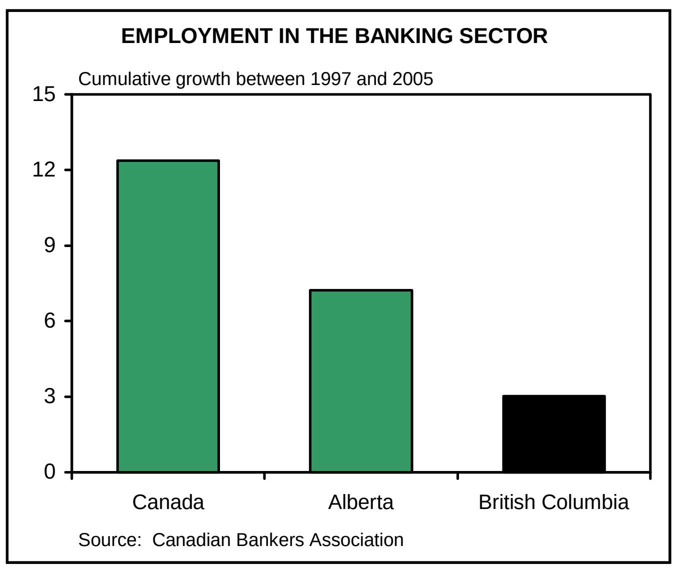
While far from the only culprit, the higher capital tax burden in B.C. is a factor behind this notable gap with Alberta, not to mention with that of other provinces. Alberta levies no tax on capital. In contrast, B.C. has eliminated its capital tax on non-financial institutions, but continues to place a punishing tax on the capital of financial institutions. The rate is 1 per cent for institutions with capital of less than $1 billion, and 3 per cent for those with capital greater than $1 billion. Even among the other provinces who levy capital taxes, such as Ontario and Quebec, the comparable rates on financial institutions are a fraction of the level in B.C. Moreover, Ontario has plans to phase out its capital tax entirely by 2010.

What's more, look for Alberta to continue to trim tax rates further in upcoming budgets, potentially opening up the gap even further. The province, which last week announced a reduction in its general CIT rate to 10 per cent, is on record as promising to lower it to 8 per cent. Some observers have speculated that Alberta may even be considering eliminating its corporate and/or personal income taxes altogether, since annual collections are roughly the same as its vast surplus. We don't see this likely. However, other reductions could be in store, notably to health premiums.

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. In contrast, the large relative gap in the sales tax burden should be a lower priority, since this is a more efficient form of taxation.

Although we would encourage keeping income-tax rates on a downward trajectory, there are two relatively "low hanging fruits" that should be addressed to improve the competitiveness of B.C.'s tax system. One move would be to extend the sales tax exemption to all business inputs, which would remove one major barrier to growth. Another is to eliminate its capital tax on the financial sector, which would not cost much in terms of foregone revenues but go a long way to help to encourage expansion in one of the economy's largest industries. Indeed, new hiring in British Columbia's financial services sector has underperformed both Alberta's and Canada as a whole in recent years.

Municipal governments need to follow suit in improving their tax competitiveness. In British Columbia, there are major inequities in property tax systems, where com-



mercial rates are at least double those of residential properties. In Vancouver, this ratio is more than four times, among the worst disparities in all of North America. This differential has contributed to flight of businesses from Vancouver to outlying areas. In addition, some municipalities levy extremely high property taxes on industrial property, which hurts the competitiveness of industries like pulp and paper and other heavy manufacturing sectors.

Regulatory burden needs to fall further

B.C.'s Liberal government has made important strides in balancing considerable reductions in the province's sizeable regulatory burden with the need to protect the environment, safety and health. Indeed, the former B.C. Ministry of Small Business and Revenue (now Ministry of Economic Development) reported that its 2001 commitment to reduce regulatory requirements by one-third over three years was exceeded.[21] Still, B.C.'s higher business cost position vis-à-vis Alberta continues to reflect a larger overall regulatory burden. Indeed, a recent Fraser Institute study that compared provincial investment climates placed B.C. seventh on this front, its worst showing among the various categories examined. Alberta, in contrast, ranked first in this area.[22] The gap remains quite wide based on differences in areas such as employment standards and environmental permitting and the regulatory regimes governing land use.

Moving forward, the B.C. government has committed to no increase in regulation over the next four years.[23] However, the province may want to set its goal higher, through increased efforts aimed at reducing and preventing regulatory overlap and duplication across levels of government. In particular, land use regulation remains broad and complex, requiring consideration of impacts on natural resources, crown land tenures, tourism, biodiversity and relationships with First Nations. Moreover, land use is among the most multi-jurisdictional policy areas, raising the potential for competing levels of government to use separate reviews for economic development projects, which in turn makes approvals costly and slow. In a 2005 report, the B.C. Progress Board recommended that a comprehensive review of land use regulation be conducted to build on work currently underway.[24]

A major challenge in B.C. relative to most other provinces is the greater need to balance new development with aboriginal rights. This fact was reinforced by a 2004 Supreme Court of Canada decision that confirmed the duty of federal and provincial governments to consult aboriginal communities about activities that could infringe on their rights and title, even if such claims had not been proven in court. In recent years, the provincial government and the private sector have been making significant strides in reaching agreements with First Nations. These deals, which have been partly spurred by the increased appetite on the part of the First Nations communities to become more involved in economic development, have allowed projects to proceed and at the same time, improved the economic wellbeing of Aboriginal peoples. We hope to see continued success on this front.

REGULATORY BURDEN

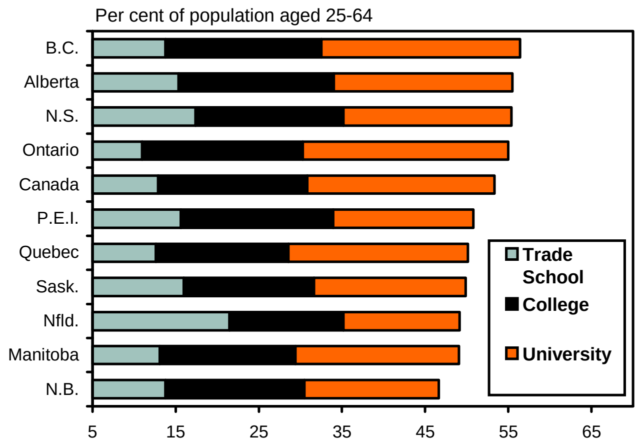
*GDP excludes government activity ;
Source: Jones and al. (2005), Statistics Canada

Maintain advantage in education

British Columbia stacks up very well against other provinces on the education front. According to figures from Statistics Canada:

- B.C. has the highest share of its working-age population holding a university degree, college diploma or trade certification, at 58 per cent. Alberta ranks second, although its university share is considerably lower than that of B.C. This partly reflects high education attainment of immigrants, of which four in ten have received a university degree alone.
- The province has the lowest high-school drop out rate. Alberta is second highest.
- And, while B.C. has a slightly lower share of graduating high school students going on to PSE (ranking 4th

POST-SECONDARY EDUCATIONAL ATTAINMENT* IN 2001



*Completion of either Trade School, College or University
Source: Statistics Canada

in Canada), Alberta places last in this area.

- On the funding side, BC also is in good shape. It ranks second behind Alberta in support for K-12 education. And, on total funding per student, including tuition, public funding and donations, B.C. is well above the Canadian average and also outscores Alberta.

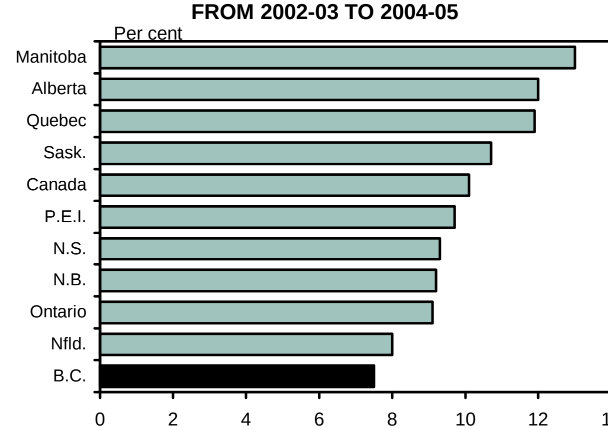
British Columbia needs to maintain a competitive advantage in this all-important area. Yet, a number of other provinces have elevated education to the top of their priority list and are backing that up with significant financial injections. Further, after freezing tuition fees, several have allowed fees to rise significantly, recognizing the high private returns to holding a post-secondary degree. As a result, funding per student is poised to advance substantially in provinces such as Alberta and Ontario.

In recent B.C. budgets, the need to enhance PSE has also featured largely, as the province moves to increase the number of spaces by 25,000 by 2010. This has been supplemented by other measures in this year's budget, including a $30 million per year training tax credit and allocated another $40 million to the Industry Training Authority to expand apprenticeships. At the same time, however, the province announced that it would keep gains in operating budgets constant in real terms or about 2 per cent per year. What's more, even though tuition fees are not particularly high in B.C. – ranking in the middle of the pack among Canada's provinces – the government has capped increases in tuition at inflation over the next few years. Particular focus should be given to continuing to increase the number of science and engineering degrees, where B.C. places fifth among the provinces, whereas Alberta is at the top of the pack.

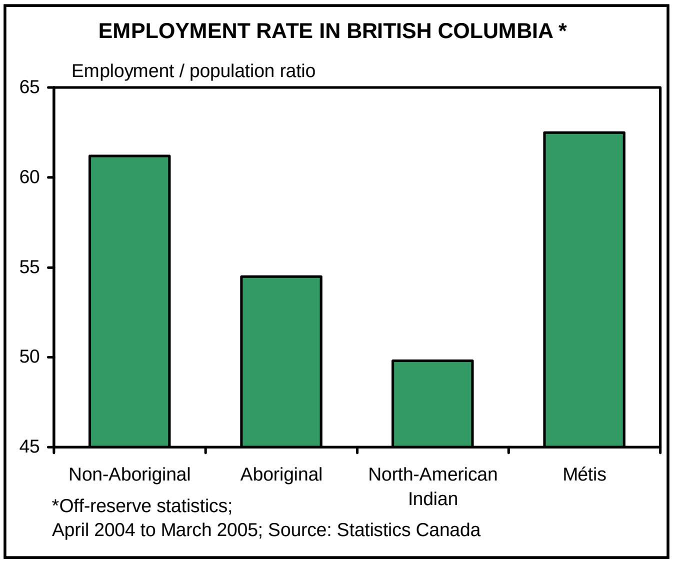
Another area within skills development that B.C. currently enjoys a comparative advantage is in opportunities to integrate the province's larger populations of Aboriginals, new Canadians and older workers into the workforce. The first two groups, in particular, have markedly lower labour market outcomes than non-Aboriginals. Happily, progress is being made in reducing the gap in both education and labour force participation rates of Aboriginals, partly through major joint investments made by the federal and provincial governments in job training and ESL programs. This momentum must not let up in the future. Moreover, the private sector needs to become more involved. B.C. businesses continue to lag behind the national average in spending on job training. Private sector efforts to establish more flexible work arrangements in order to pave the way for older workers to remain in the workforce will also go a long way in addressing the challenge of an aging population. At the same time, B.C. should follow a number of other provinces – namely, Alberta and Ontario – in abolishing mandatory retirement at age 65 years.

Virtual education is an area of competitive strength that B.C. can further build on.[25] This year, the government will introduce a virtual school to provide B.C. students with a new option for learning. Supported by Network B.C., the school will offe a full range of courses and free on-line tutoring that will especially benefit students in rural communities. This plan is consistent with and will support the government's recent goal to bring broadband internet ac-

HIGH SCHOOL DROP OUT RATE* FROM 2002-03 TO 2004-05



* Per cent of population that have not completed high school nor working toward completion. Source: Statistics Canada



cess to remote communities, including First Nations reserves.

Innovative use of P3s build advantage in infrastructure

B.C. benefits from arguably the best system of roads, highways and public infrastructure among the provinces. This favourable position partly reflects regional planning in the lower mainland, which brings together the region's 21 municipalities together to jointly plan and fund infrastructure. In addition to establishing the Greater Vancouver Regional District (GVRD) – which was established to deliver essential utilities like drinking water and sewage – the Greater Vancouver Transportation Authority (GVTA or Trans Link) was set up to lay out policies and directions for the buses, light rail, trolleys, commuter rail and ferry services. Moreover, while public funding of transportation in most other Canadian urban regions is funded largely through general property tax collections, the GVTA has a broader mix of revenues at its disposal, including a share of provincial gasoline excise tax that is collected in the region. This has the benefit of increasing the reliability of revenue flows and facilitating long-term project planning.

Admittedly, the regional structure in Vancouver region is not perfect. For example, recently, the province launched a review of the GVTA's governance structure in an attempt to address some inherent weaknesses. Still, the structure marks a big leap forward from the fragmented approach applied in other large urban regions, including the GTA. Consider the Edmonton area, where there are 22 municipalities. While efforts to better cooperate have been ramped up in recent years, cities in that region continue to largely go it alone with respect to infrastructure planning and development.

In light of growing deficits in the mid-to-late 1990s, government funding for public infrastructure has fallen behind over the past decade, slipping as a share of GDP. And, although this has mirrored the trend observed in Canada as a whole, other jurisdictions have been stepping up with significant new funding in order to address their significant cumulative infrastructure gaps.

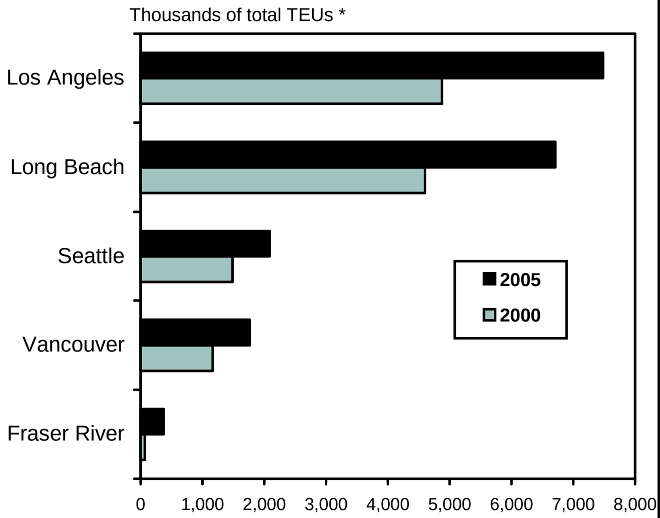
In B.C.'s case, the largest single challenge on this front is in the area of transportation infrastructure, where capacity bottlenecks have worsened at ports and along the Canada-U.S. border. Backlogs at the Port of Vancouver have caused lost market share to other ports, including those at Seattle, Long Beach and Tacoma in the United States. Even Port of Halifax has started to benefit from diverted shipments through the Panama Canal. In order to address this issue, the B.C. government has announced its Gateway Strategy, which includes funding to expand the Port of Vancouver, a commitment to construct a new container port at Prince Rupert, and initiatives to expand and improve road and rail systems. The federal government has also pledged some $590 million to support Gateway-related infrastructure investment going forward, recogniz-

STATUS OF PPP PROJECTS
VALUE FOR MONEY

PROJECT	Life-cycle cost savings	% of project cost
Sierra Yoyo Desan Resource Road	Completed 3 months ahead of schedule	
Acedemic Ambulatory Care Centre	$17 million	15%
Abbotsford Regional Hospital and Cancer Centre	$39 million	10%
Britannna Mine Water Treatment Plant	$10 million	30%
Sea to Sky Highway Improvement Project	Value for Money Report under development	
William R. Bennett Bridge	$25 million	16%
Richmond-Airport-Vancouver Rapid Transit	Value for Money Report under development	
Kicking Horse Canyon	Value for Money Report under development	

Source: Partnerships British Columbia: November 2005

PORT ACTIVITY ON THE WEST COAST



* Twenty-foot equivalent units ; Source: Ports of Los Angeles, Long Beach, Seattle, Vancouver and Fraser River

ing that increased access to Asian markets will benefit all of Canada.

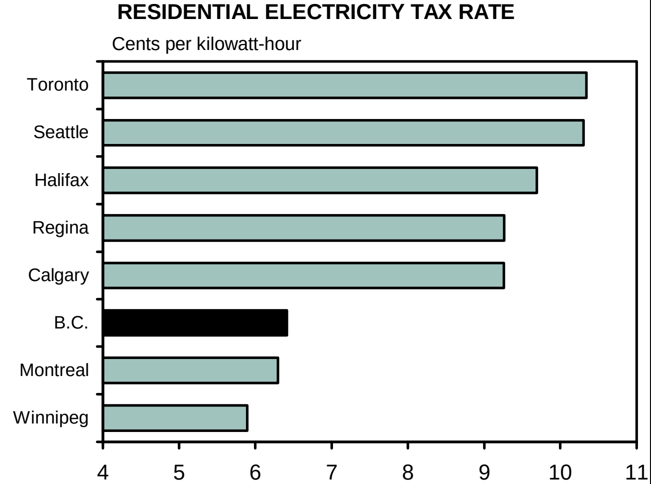
Another area of growing vulnerability is electricity. B.C. experiences annual gyrations in power output given that output from its hydro-based system is highly dependent on water levels. Moreover, the utility has taken advantage of power inter-connections with Alberta andneighbouring U.S. states to increase trade, maximize electricity resources and raise profitability in recent years. That said, although the province systematically ran a surplus in trade of power with other provinces and U.S. states, this is no longer the case. But, while some of the answer lies in investing in new sources – including biomass, wind power, new hydro, and perhaps new natural gas or coal-fired power plants – a good part of the overall solution rests in improved demand-side management. The Smart Program encourages power use during non-peak times. However, there needs to be more effort to bring power prices closer to the actual marginal cost of incremental production. While businesses may see this as a hit to short-run competitiveness, it would prevent much larger increases in power prices down the road.

In order to meet these major infrastructure needs in light of ongoing budget constraints, B.C. has been forging ahead with innovative ways of doing business, such as embarking on public-private-partnerships (P3s). More specifically, the B.C. government has been entering into contracts with private sector parties to undertake many of the aspects of infrastructure development and delivery that the government traditionally has carried out itself, including financing and managing capital projects. A number of projects have come to fruition – such as the Sea-to-Sky Highway upgrade and the new Richmond-Airport-Vancouver Transit Line – or are in the procurement stage. We believe that the B.C. government is a leader in North America in this regard, owing in part to the strength of its model and its rigorous approach to assessing which is the best route to take between traditional procurement or a P3. Ongoing success in adopting the P3 model should continue to pay handsome dividends going forward.

Assist those falling between the cracks

British Columbia has a relatively high share of its residents earning little or no income. At last count in 2003, about 19 per cent of British Columbian families had after-tax incomes below the low income cut-off level – a proportion that has been edging down on a trend basis but remains the highest among the provinces.[26] The poverty challenge has been accentuated by weak income gains over the past two decades and the shift towards a lower-wage service economy. Moreover, high accommodation prices in the two largest centres of Vancouver and Victoria is another important factor to consider. In fact, Vancouver has the highest share of residents with an affordability problem (i.e., those spending at least 30 of their pre-tax income on shelter) among Canadian urban centres. This financial hardship is undeniably a major contributor to B.C.'s worse-than-average rate of violent crime and nation-leading rate of property crime.

RESIDENTIAL ELECTRICITY TAX RATE



Source: BC Hydro

PER CENT OF ALL HOUSEHOLDS EXPERIENCING AFFORDABILITY PROBLEMS IN 2000

	30% or more spent on shelter	50% or more spent on shelter
Canada	**24.1**	**10.6**
CMA	25.9	11.3
Non-CMA	20.9	9.2
Vancouver	31.4	14.5
Calgary	22.9	8.9
Edmonton	22.4	9.2
Regina	21.0	9.4
Winnipeg	20.7	8.4
Toronto	29.1	12.3
Ottawa	21.4	9.2
Montreal	26.1	12.2
Halifax	24.7	11.5

Source: Statistics Canada, TD Economics

Governments have been chipping away at that this formidable challenge in recent years. A tripartite agreement was formed to deal with the related problems of poverty and drug use on Vancouver's East Side, with some degree of success. The province has also redesigned its Welfare to Work Program in order to strengthen it, although the jury remains out on how effective the new program will be.

One of the major challenges for the B.C. and federal government is to improve safeguards against the low-income trap. Increasing accessibility to education for low-income earners and removing barriers for new immigrants to BC to enter into the labour market are high on the needs list. As importantly, provincial and federal programs that aim to help low-income people but actually create disincentives to seek higher market income and save for retirement need to be adjusted. In particular, social benefits are scaled back as market income rises, resulting in marginal tax rates that can exceed 80 per cent at some low income levels.

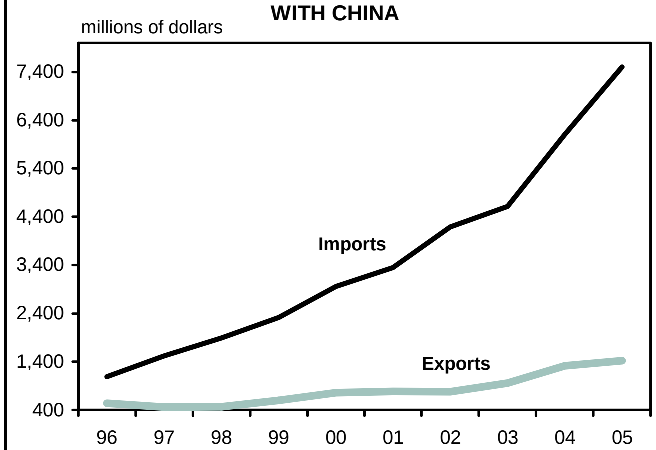
As we discussed in a 2003 TD Economics report, *Affordable Housing – In Search of a New Paradigm* – the ultimate solution to dealing with the housing affordability problem is to raise market incomes at the low end of the spectrum.[27] In the meantime, subsidies can form part of the solution, with capital grants (rather than tax incentives) the most efficient form of assistance to stimulate the creation of new supply. Indeed, the cost-sharing affordable housing agreement currently in existence between British Columbia and the federal government is set on capital grants. But, continuing to remove market imperfections, such as existing rent regulations in the province, could also help to stimulate new supply.

B.C.'s golden opportunity

Paradoxically, one of British Columbia's most daunting challenges – its location next to Alberta – is also one its greatest opportunities. B.C. would do well by strengthening trade and cooperative ties with Alberta to take advantage of rising economic activity in that province in the future. But, even more importantly, there are tremendous benefits to be reaped – in terms of boosting two-way trade in resource and non-resource sectors and opening the doors to increased immigration of skilled workers – by establishing closer bonds with its rapidly-growing counterparts in Asia-Pacific.

We have already discussed some of the initiatives underway by both the B.C. and federa governments to leverage this strength of location, notably the Province's Gateway Strategy. Yet, we share the concerns of some others that both governments may be missing out on this golden opportunity. Case in point is the Port of Vancouver, where the port's planned expansion was recently delayed by more than a year so the federal government could carry out more environmental studies.[28] This setback is on top of last year's truck strike, which lasted a few months. Furthermore, the plan for Prince Rupert raises the question as to whether the province is maximizing the potential for

BRITISH COLUMBIA TWO-WAY TRADE WITH CHINA



Source: Statistics Canada

growth. Prince Rupert is being built to handle two million TEU's (twenty-foot equivalent container units), but land is available for twice that size. There are legitimate concerns that the current plan is a quick fix rather than an example of strategic long-term thinking.

There is a need to think big on trade in services and human capital as well. Recently, the number of direct flights to and from India, China and other Pacific nations was increased, while China awarded Canada approved destination status. Both of these developments will open the doors to new opportunities for B.C.'s tourism industry. And, given that China is also the biggest source of foreign students to Canada's education sector, there is considerable potential to lure more Asian students, many of whom will opt to stay in the province.[29] B.C. will need to focus its sights, partly through aggressive marketing and branding in the Asian region. There may be opportunities to partner with other Canadian provinces in these efforts, since many jurisdictions in this country have launched their own campaigns, resulting in a fragmented approach.

B.C. and Alberta have many common interests and often adopt similar stances vis-à-vis the federal government on issues ranging from trade and transportation policy to environmental regulation. In recent years, B.C. and Alberta have made a high level political commitment to pursue cooperative agreements and to harmonize policy in a number of areas, including labour markets. Alberta's desire to send crude oil and natural gas to energy-hungry Asia through a newly-planned pipeline from Edmonton to B.C.'s Kitimat further highlights their joint interests on this front. Soon, the two governments will announce a bilateral trade agreement that builds on but goes beyond the existing pan-Canadian Internal Trade Agreement. Ongoing progress on these matters will be of mutual benefit to both jurisdictions.

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 B.C.'s relative strengths, keeping their eyes squarely focused on competitors outside its borders and thinking big on building the province as a Gateway for Asia, the public and private sectors in British Columbia can turn the Golden Decade into a Golden Century.

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