SUBMISSION TO THE SELECT STANDING COMMITTEE ON FINANCE AND GOVERNMENT SERVICES IN ADVANCE OF THE 2022 PROVINCIAL BUDGET

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Business Council *of* British Columbia
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The Business Council of British Columbia is pleased to provide this submission to the Select Standing Committee on Finance and Government Services, outlining our views and advice on the 2022 provincial budget.

The Business Council, established in 1966, is an association that currently represents more than 250 large and medium-sized enterprises with assets and operations in B.C. The Council's members are active in all major sectors of the provincial economy, including forestry, mining, manufacturing, oil and gas, renewable energy, chemicals, utilities, financial services, transportation, construction, telecommunications, information technology, hospitality and tourism, wholesale/retail, communications, agri-food, life sciences, film production, healthcare, education and the professions (including legal, accounting/advisory and engineering). Taken together, the corporate members and the associations affiliated with the Business Council account for approximately one quarter of all private sector payroll jobs in British Columbia.

1. Economic Outlook

B.C.'s solid economic rebound is expected to continue over the next couple of years. Our expectation of 5.8% real GDP growth in 2021 is close to the Ministry of Finance's 6% forecast, as reported in the First Quarterly Update. For 2022, BCBC projects 4% real GDP growth while the province expects a 4.8% expansion.

Whatever the nuances, the economy looks to be on a growth path for the next two years. The province's resilient export sector and ongoing work on large capital projects tempered the COVID-driven downturn in 2020. These sectors also provided a boost early in the recovery process. International tourism/air travel remains a notable weak spot, but here too we anticipate improved conditions next year.

British Columbia recorded the smallest real GDP contraction among the major Canadian provinces in 2020. The downturn was less severe here in part because the "upstream economy" (natural resources, manufacturing, utilities, and construction) continued to operate. And, as noted above, the construction of large capital projects has been a positive economic factor throughout the pandemic.

Exports are contributing to B.C.'s robust recovery

Year-to-date international merchandise exports are up 36%, led by a 50% rise in exports to the U.S. Exports of services are also rebounding. Film and television production is up sharply, and activity in both technology services and professional services has surged. Apart from air transportation, other Gateway transportation services, including trucking, are also recovering after a temporary drop in the spring and early summer of 2020.

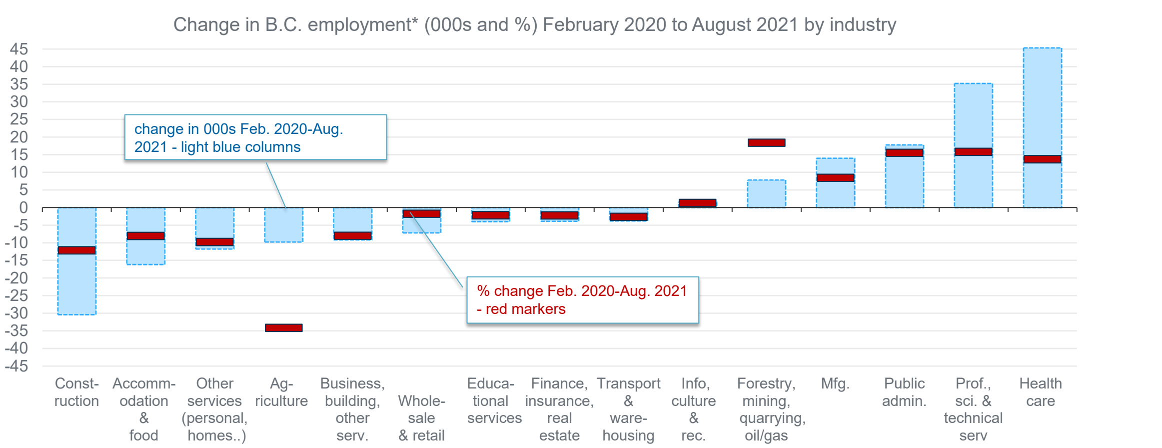
Healthy and growing export industries are vital to B.C.'s prosperity. Selling B.C. goods and services beyond the small domestic market brings widespread economic benefits, including by providing externally generated income to pay for imports. Access to larger markets also allows more B.C. companies to scale and increases the incentives for our businesses to innovate and become more productive.

Employment has recovered, but…

The overall level of employment in B.C. has recovered from the 2020 COVID-induced shock. In comparison to other provinces, B.C. has done well on this high-level metric. But the overall picture masks variations across industry sectors and some occupational groups.

In fact, employment remains below pre-pandemic levels in nine of 15 broad B.C. industry sectors. The "recovery" in total employment is attributable to gains in just six industries and is heavily concentrated in just a handful. Manufacturing, professional, scientific and technical services, and forestry and mining have all seen strong job gains since February 2020. The number of people working in health care and public administration is also up sharply, which is consistent with the 9.5% jump in public sector employment more generally. A healthy economy requires a healthy private sector rather than an endlessly expanding public sector. Provincial policymakers must make this a central guidepost in framing next year's budget and B.C.'s post-pandemic economic plan.

FIGURE 1: EMPLOYMENT DOWN IN MOST INDUSTRIES SINCE FEBRUARY 2020 WHILE A FEW HAVE SEEN GAINS



*aged 15 and over, seasonally adjusted.   Source: Statistics Canada, Labour Force Survey. Table: 14-10-0355-01.

Labour scarcity is a growing concern across a widening array of industries. B.C. has the highest job vacancy rate in the country. Recorded job vacancy rates are very high in the accommodation services sector (11.6% in Q2), foodservices (9.5%), construction (7.4%), and data processing and hosting services (7.4%). In part, this reflects the impact of government income support programs introduced to address COVID: the availability of unusually generous debt-financed income support has dampened labour force participation, at least temporarily. But it's also the case that many workers have shifted from sectors that experienced pandemic-related closures and disruptions to other industries/occupations, while others have left the workforce (advancing retirement, childcare responsibilities) amid COVID. Strong economy-wide demand for digital skills and related experience is also evident in the labour market.

Economic risks

In the short-term, the biggest risk to the economic outlook is the path of the virus and spread of new variants – both within the province and globally. Uneven vaccination rates across countries and – notably – U.S. states mean monitoring and border restrictions will complicate and hinder the recovery in international travel.

Inflation also poses a risk. If consumer inflation remains outside of the Bank of Canada's 1-3% target range (it currently sits at 4.1%), the Bank will be prompted to respond and hike its trend setting interest rate sooner than markets now expect. In the B.C. context, where household debt burdens are higher than elsewhere in the country, even small increases in borrowing and debt-servicing costs will crimp consumer spending and likely have a negative impact on the real estate/housing sector.

From a medium-term perspective, we also see risk around future levels of business investment and the prospects for growth/improvements in prosperity, given the shifting competitive landscape and Canada's (including B.C.'s) waning attractiveness for private sector capital spending and new industrial and infrastructure projects in the natural resource and manufacturing sectors that comprise the core of the economy's export base. In this respect, it is important for policymakers to recognize that private sector investment and business growth will be hampered by uncompetitive elements in B.C.'s overall tax regime, including higher capital and business operating costs imposed by the PST, the design and operation of the province's carbon pricing system (which fails to match the levels of protection provided to export-focused industries by other jurisdictions that have embraced aggressive carbon pricing), and punitive income tax rates on the most highly skilled workers and entrepreneurs.

2. Fiscal Setting and Policy Directions

The three-year fiscal plan outlined in Budget 2021 last spring was prudent given the circumstances. At the time, we noted that it contained a sizable fiscal “cushion” in the form of prudent growth forecasts, a forecast allowance and several billion dollars in contingency funding. This was a sensible approach amid the uncertainties stemming from the pandemic.

The province’s First Quarterly Report indicates the operating deficit for fiscal 2021-22 is now projected to be well below $5 billion, versus the $9.7 billion anticipated in Budget 2021. The nearly halving of the deficit is due to the economic recovery and resulting stronger-than-expected revenue growth, largely from personal and corporate income taxes and higher federal government cash transfers. There is also the $1 billion forecast allowance that likely will not be needed, suggesting the actual 2021-22 deficit may come in closer to $4 billion.

Considering the strong upside revenue surprise, we recommend that the province update its fiscal plan and target eliminating the operating deficit by 2023-24.

Balancing the books by then is attainable but will require prudent financial management. Large upside revenue surprises are unlikely to recur. The very unusual 11% jump in nominal GDP (which is loosely correlated with provincial revenues) in 2021 will certainly not be repeated. In 2022, we expect nominal GDP growth to come in near 5%. The government will need to guard against building in permanent additional expenditure commitments in the years ahead as provincial revenue growth moderates.

A smaller than expected deficit and continued rock bottom borrowing costs have led to a significant downward adjustment in the projected net debt/GDP ratio for 2021-22, from 22.8% to 19.6%. This is a positive development. BCBC believes it is important to keep the net debt/GDP ratio under 25% (and preferably closer to 20%) going forward, in order to avoid a scenario where rising debt-servicing costs unduly constrain the government’s fiscal flexibility or make it difficult and costly to respond to future shocks.

Related, we believe the province should gradually wind down temporary COVID-related economic, business and social supports over the next year, assuming the virus is brought, and remains, under control. Among the industries hit hardest by the COVID shock, tourism and travel stands out. This sector may require continued financial support even as the province scales back business assistance programs introduced in 2020.

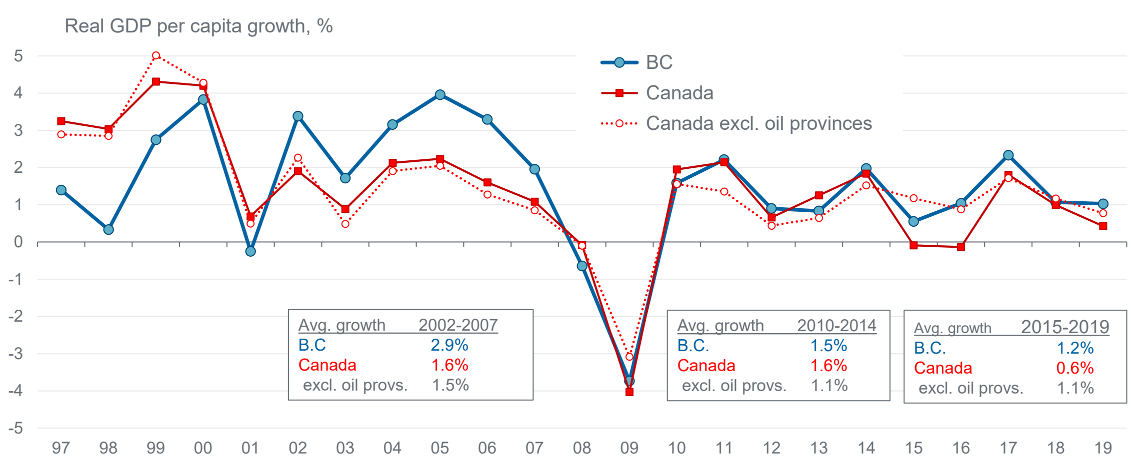
The Business Council advises caution in establishing a new mandatory sickness benefit in 2022, as the government has promised. While a majority of BCBC members provide income support to employees suffering temporary illness, many small and mid-sized B.C. businesses do not. Labour costs are already increasing due to worker shortages, higher CPP premiums, expected hikes in EI premiums (after 2022), and escalating non-wage benefit costs. We also see a risk of higher WorkSafeBC premiums over the medium term. A new mandatory sickness benefit should be set at a level that recognizes the other factors and trends impacting overall private sector labour costs. We see no case for the province to go beyond the parameters of the sickness benefit that will be established by the federal government in 2022.

3. Medium-Term Economic Challenges

As the COVID-19 crisis recedes, BCBC believes the province should focus on strengthening the foundations for prosperity and family well-being. Ultimately, this means prioritizing the growth of real GDP per person – the single most important measure of living standards.

While the B.C. economy grew faster than the Canadian average in the years leading up to 2020, gains in real GDP per person have been decidedly modest. Much of B.C.'s economic growth has come from a rising population and expanding workforce. Overall real GDP growth averaged 2.8% over the 2015-2019 period. But growth in real GDP <u>per capita</u> averaged just 1.2% over the same period. This means the resources available for each person in the province across the public, private, and not-for-profit sectors grew by an average of just 1.2% over the past five years. This is down from the average 1.5% growth earlier in the decade.

FIGURE 2: B.C. (SLIGHTLY) OUTPERFORMED CANADA IN PER CAPITA GROWTH OVER PAST DECADE



Source: Statistics Canada. Table: 36-10-0222-01 and 17-10-0005-01. chained 2012 dollars

Fostering a healthier and more sustainable economic growth model should be rooted in growing per person output through increased productivity. This entails fostering more export capable businesses, scaling more B.C. companies, developing a more innovative economy, and supporting the development of a flexible and highly skilled workforce.

A general framework to advance productivity growth should be based on a broadly-based business growth strategy. Government should examine all policies that accelerate the diffusion of technology and advanced management techniques across the economy. Investing to grow a few small industry sub-sectors won't have much impact on economy-wide productivity levels or growth rates.

Business investment is perhaps the most critical driver of productivity growth. Policy changes that encourage more capital investment would support the adoption of new technologies and systems. Workers with newer and more capital are more productive. Unfortunately, this is an area where Canada (and B.C.) lag. A recent study by the C.D. Howe Institute documented the low and declining levels of capital investment per worker in Canada:

> "The gap between gross investment per potential US worker and the equivalent Canadian figure in the second quarter of 2021 was $11,700. That is a lot of money – it represents a significant shortening of the replacement and upgrade cycle for a piece of capital equipment such as a truck or an excavator, a major upgrade of health and safety in a workplace, or a complete replacement of many office workers' entire information and communications technology."[1]

B.C. has done better than Canada in overall capital investment per worker in recent years, but this is mainly due to a few very large projects. For machinery and equipment investment more specifically, the B.C. situation mirrors that in Canada. A central challenge for government is setting a policy environment to encourage stronger business investment, help ensure B.C. has an up-to-date capital stock and is on the pathway to building a digital and data-enabled economy. This calls for smart tax and regulatory policies that make B.C. a preferred place to deploy capital and grow business across multiple sectors.

An agenda to achieve stronger per capita GDP growth should also recognize the benefits of scaling businesses. Larger firms are much more likely to export. They also tend to be more productive and pay higher wages (because they are more productive) than smaller businesses.

[1] C.D. Howe Institute, "Declining Vital Signs: Canada's Investment Crisis," (Sept. 2021) William B. P. Robson and Miles Wu, p.4.

According to the province's 2020 Small Business Profile:

- Only 2% of businesses (8,700) in B.C. are considered "large" – that is they have 50 or more employees. Parenthetically, it is noted that other jurisdictions define "large" businesses as those with 1,000, 500 or 100 employees; B.C. is unusual in setting the bar for "large" firms at such a low level.
- Large businesses, as defined by the province, pay higher wages on average - the annual wage gap between small and large businesses in B.C. is about $8,800.
- In B.C. there are there are almost 6,200 small businesses that export, but this is just 6% of all goods-producing small firms.
- There are only 1,000 large firms in B.C. that export internationally. But these companies account for two-thirds of the value of international exports (and small firms the remaining one-third).

The presence of a robust, diverse and vibrant export sector populated by competitive and dynamic businesses delivers widespread economic benefits. Competing in international markets provides powerful incentives. Firms must continually improve and become more productive to succeed in export markets. For growing companies, selling into external markets allows them to benefit from economies of scale and become more productive. The higher productivity of larger firms (including those that also export) is reflected in the higher average wages (and non-wage benefits) provided by larger firms. It is also worth noting that in addition to direct job creation and paying higher wages, large exporters also purchase a vast array of inputs (services and products) from other local companies in communities across B.C.

Talent, skill, and qualified workers are scarce resources, and will become more so as the labour market adjusts during this recovery phase. Government will need to support the PSE sector to ensure B.C. continues to have a well-educated workforce; build out work-integrated-learning across the education system; and create a framework to encourage and support micro-credentialing as a way to facilitate re-skilling and upgrading.

Eroding competitiveness slows prosperity growth

For some time, the Business Council has been concerned about B.C.'s competitive position within North America and the impact on business growth of higher taxes, a steadily increasing regulatory burden and potential changes to policies and legislation in the areas of labour and employment standards, project assessments, environmental permitting, and climate change. The cumulative effect of policy and regulatory changes in these areas is especially problematic for industries operating on the land base or engaged in manufacturing, where First Nations claims, permitting and other environmental rules, and rising energy costs pose challenges for existing operations and make it increasingly difficult for many companies to justify making incremental capital investments in the province. The deteriorating competitive position runs counter to encouraging capital investment and the scaling of businesses.

For companies not operating on the land-base or involved in manufacturing, the province's competitive position is stronger; this includes film and television production, the advanced technology sector, finance, tourism (pre-COVID), and professional, scientific and technical services. While these sectors do not face the same permitting and regulatory complexities and costs as traded-goods industries, they have seen the tax burden climb in recent years and face increasing challenges attracting and retaining talent. On top of housing costs that are among the highest in the world relative to incomes, policymakers should recognize that high personal income tax rates also make it harder to attract highly skill individuals to jobs in the lower mainland and some other urban regions of B.C.

It is worth recapping the more notable business tax increases in recent years:

- On January 1, 2019 the Employer Health Tax came into effect. The new tax raises approximately $1.8 billion, with all of the revenue coming from the subset of employer organizations with annual payrolls over $500,000. For businesses operating in B.C., this was the biggest payroll tax hike in history.
- The corporate income tax rate was increased by one percentage point in 2013 and then by an additional percentage point in 2017.
- The carbon tax has climbed steadily, now sits at $45/ton and is scheduled to rise to $50 on April 1, 2022 – on the way to at least $170 by 2030 based on the federal government's current carbon pricing policy.
- Employers are also facing a myriad of other rising costs including additional expense related to COVID, rising EI premiums, and pending sick day coverage.

For the natural resource and manufacturing sectors, higher taxes are part of the story of diminished competitiveness. However, the mounting regulatory burden – and the prospect of more to come – is also adding to the cost and complexity of doing business in the province.

4. Recommendations for Budget 2022

Below we outline our main recommendations for Budget 2022. They are mostly framed around increasing real GDP per capita, through stronger productivity and real wage growth. We are sensitive to the fiscal impacts and the costs of the recommendations. Each of the items comes with some cost or foregone revenue. But we judge these to be generally modest, especially to the extent they do produce stronger per capita growth, higher wages and improved prosperity.

Establish a B.C. Prosperity and Productivity Commission – the new independent agency would monitor B.C.'s performance on productivity and living standards and evaluate/advise on reforms that could increase productivity and wages. The agency would help ensure that policies and new regulatory provisions are viewed through a productivity/prosperity lens. It would bring an institutions-based approach to addressing productivity/economic, environmental and community well-being issues. It would advise on changes that support scaling up businesses, growing the export sector, increasing productivity, and nurturing stronger real wage growth. The agency could also advise on medium and longer-term fiscal challenges such as rising program costs flowing from an aging population.

Modest tax changes to support productivity and wage growth. As the economy continues to recover from pandemic-induced shock, the Business Council recommends Budget 2022 introduce several tax changes to be phased in over the next 1-3 years, with the goal of making B.C.'s tax structure more investment-friendly and supportive of productivity growth.

- **Reduce the penalty for business scaling by graduating the CIT rate between small/large companies**. B.C. has two rates of corporate income tax – the general rate and the lower small business rate. The small business rate is 2% and applies to business income up to a limit of $500,000. Income over this limit is taxed at the general 12% provincial CIT rate. The large increase in the tax rate on business income over the threshold is a disincentive to growing. Eliminating the large one-time jump in the business tax in favour of graduated increases would support firms scaling up. Rather than jumping from 2% to 12% after $500,000, the rise to 12% could be phased in over several increments at higher income thresholds. This shift would likely have a small revenue impact for the government but would substantially re-align B.C.'s business tax towards a more growth supporting tax framework.
- **Broaden PST exemptions for business investment in machinery/equipment**. In keeping with a productivity enhancing growth agenda, the government should encourage and support capital investment, particularly new technology and equipment for workers. To support capital investment in the province's

export focused resource and manufacturing sectors, business purchases of machinery and equipment have long been exempted from the PST. The government's recent move to exempt business purchases of electricity from the PST also helped lower input costs for large exporters (and also provided a small tax cut for businesses more generally).

Broadening the current suite of machinery and equipment PST exemptions to other sectors is "low hanging fruit" among a broad range of policy options to support productivity growth. B.C. currently has the most punitive tax regimes in Canada for new capital investment, based on estimates of the average "marginal effective tax rate". Providing more widespread PST exemptions for capital spending on technology and other equipment would reduce the overall tax burden on investment and promote higher rates of capital per worker – a key to boosting productivity and real wages.

We also recommend extending PST exemptions to the province's trucking industry for purchases of new heavy-duty commercial vehicles to speed fleet modernization and reduce carbon emissions from the commercial road transportation industry.

Ultimately, the province's objective should be to eliminate PST on business purchases of all types of machinery and equipment, software, vehicles, digital tools, and telecommunications and data services – and to extend these exemptions to all industry sectors. Removing sales tax from these inputs would stimulate investment in up-to-date capital equipment and the digital and other communications-related technologies that are fundamental to driving productivity gains and improved operational performance at the enterprise and industry levels.

- **Refrain from further increases in personal income tax (PIT) rates and raise the income threshold at which B.C.'s highest PIT rate now applies.** Talent attraction and retention is an essential part of building a more productive and dynamic B.C. economy. Punitive personal income tax rates in Canada and B.C. are undermining the ability of employers to attract high skill individuals. Steep housing prices in the lower mainland make the challenge even greater. In the post-COVID world, B.C. policy makers need to recognize that it is simpler and potentially more appealing for talented people to work from remote locations, including those with more sensible tax regimes.

  High skill individuals are well-compensated, and for them top marginal tax rates matter. Here B.C. is moving in the wrong direction and has gone from having a relatively low top marginal tax rate to one of the highest in North

America. On January 1, 2018, B.C.'s top marginal tax rate was hiked from 14.7% to 16.8%. Then Budget 2020 introduced a further increase to 20.5%. The result is that B.C.'s combined federal-provincial top marginal tax rate is 53.5%. In comparison, Alberta's top combined rate sits at 48%. And in Alberta the top rate does not apply until incomes reach $315,000 while B.C.'s top rate kicks in at $220,000. Top tax rates are far lower in most American states, including our Cascadia neighbor Washington state.

We recommend that B.C. lift the income threshold for the province's top tax rate from $220,000 to $320,000. Setting a somewhat higher income threshold for B.C.'s top tax rate is unlikely to have a material impact on the government's overall revenues.

- **Address the punitive amount of carbon tax paid by energy intensive exporters**. B.C. exporters pay hundreds of millions in carbon tax while competitors in other North American jurisdictions pay little to nothing for their emissions. It is imperative that B.C. quickly realign its carbon pricing policy to address this discrepancy that is putting B.C.'s wealth generating export industries at a significant competitive disadvantage. The way the tax is currently structured, with little or no financial relief for exporters and for local manufacturers that must compete with untaxed imports, also deters capital investment, which readily flows to lower cost jurisdictions.

  At a minimum, the Business Council submits that the province should afford similar protection to B.C. exporters and manufacturers as provided in the federal carbon pricing framework. Other Canadian jurisdictions that have implemented carbon pricing (such as Quebec and Alberta) have taken measures to shield their energy-intensive export industries. The Business Council supports carbon pricing but is concerned that if B.C.'s manufacturers and natural resource producers are left to bear the full cost of the rising carbon tax, they will be put at a growing economic disadvantage relative to other provinces and U.S. states. We therefore recommend that the government urgently develop and implement a robust system of cost and tax offsets to protect the competitiveness of B.C.'s export industries as the carbon tax moves higher.

Additional recommendations to boost per capita growth, prosperity and wages:

- Open (or permit expansions of) 6-7 mines by 2025 to take advantage of the positive global minerals/metals cycle. From a medium and longer-term perspective, the growth in world-wide demand for electric vehicles and carbon-free electricity will increase the need for copper and many other minerals. B.C. should embrace and promote the reality that copper and other minerals mined and processed here are lower carbon than comparable products in other jurisdictions (mostly because of B.C.'s carbon free hydro electricity).

- Nurture innovation-driven sectors where B.C. has existing commercial strengths and can accelerate business and employment growth. This includes agri-tech; bio-pharmaceutical manufacturing; AR/VR. All of these small sectors would benefit from recommendations in the 2020 *Putting Innovation to Work* report by former Innovation Commissioner Dr. Alan Winter.
- Leverage the presence of Canada's Digital Supercluster in Vancouver to grow more digitally-enabled B.C. businesses and build commercial strengths in specific sub-segments of the emerging digital economy.

5. Concluding Thoughts

The B.C. economy is recovering, and the province's finances are in comparatively good shape. There are still weak spots and risks but in general the provincial economy has fared reasonably well considering the circumstances.

As the government shifts attention from managing the pandemic and related fallout to building a more prosperous British Columbia, it will need to establish a policy environment that attracts investment and encourages business to grow. We encourage government to view policy changes through the lens of improving productivity and real per capita GDP growth.

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