BRITISH COLUMBIA

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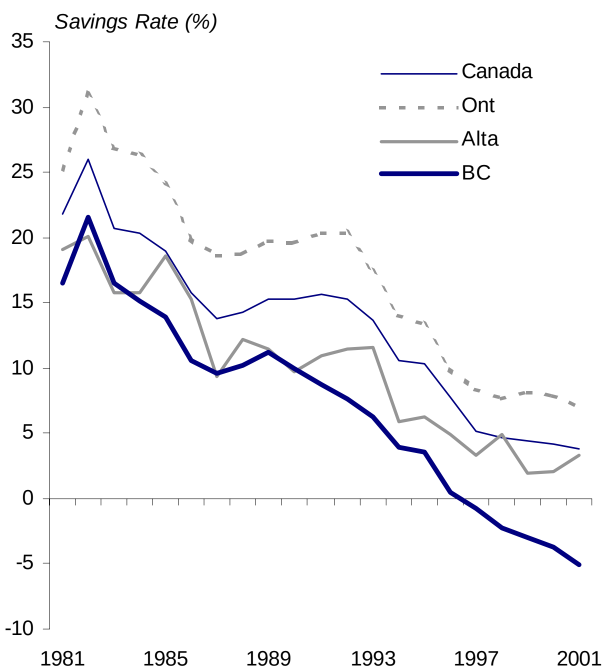
Have we become a spendthrift society?

BC's savings rate has fallen into the negatives, and there's no indication that the trend is about to reverse



BC's personal savings rate, which has declined steadily during the last two decades, remained in the red in 2001, falling to –5.2%. Last year was the fifth straight year in which the spending of individuals and unincorporated businesses has exceeded their after-tax income.

The savings rate has been trending down in all parts of the country, but BC and Saskatchewan are the only regions where the rate has fallen–and stayed–below zero. In the rest of the country, rates are well short of what they used to be, but have generally remained in the two to four percent range. Canada's savings rate was 3.5% last year. In Ontario, where the savings rate has historically been among the highest in country, the ratio of savings to after-tax income was 6.5% in 2001.

The decline in the savings rate raises some interesting questions. Why has the savings rate fallen so substantially during the last two decades? Are consumers here, and in the rest of Canada, becoming increasingly spendthrift? More importantly from BC's perspective, why is our savings rate persistently lower than in the rest of Canada, and will the fact that it has been negative for the last five years have serious consequences for the future state of the economy?

To answer those questions, it's necessary to first look at what the savings rate measures, and how it is calculated.

What is the savings rate and how is it calculated?

Economic accountants define four groups of transactors within the economy: the business, government and personal sectors, plus non-residents who buy and sell goods and services, and receive–or pay–transfers to residents. While savings rates are calculated for all four types of transactors, the one that is most commonly quoted is the personal savings rate. It shows the relationship between the amount that is saved or invested and the after-tax income received by the personal sector (which includes individuals, unincorporated businesses, and societies of individuals such as charitable organizations or trusteed pension plans).

After-tax personal income includes both earnings (such as wages and salaries, investment income, or income from operating an unincorporated business) and transfers (such as employment insurance, CPP or income assistance) from other sectors. Transfers primarily come from the government sector, but corporations and non-residents also make donations to individuals, charities and unincorporated businesses. Savings are simply calculated as the difference between total personal income (net of taxes and other payments to government) and expenditures on goods and services plus transfers to corporations and non-residents.

The savings rate should not be interpreted as an indicator of the value of assets held by the personal sector. Instead, it shows the relationship between current income and current expenditures. Income that is derived from the use of assets is included, but the value of those assets has no bearing on personal income or, by extension, on the savings rate. Similarly, changes in the value of assets such as stocks and bonds, housing and land, held by the personal sector are not included in personal income.

Why is the savings rate falling?

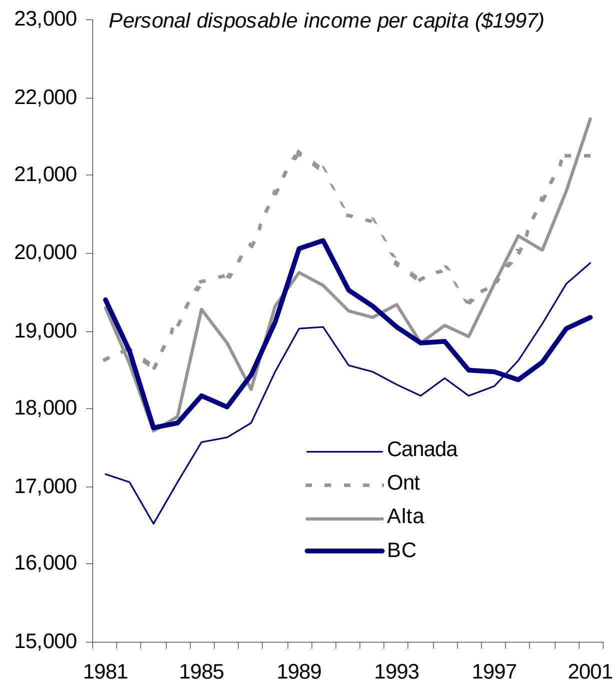
A decrease in the savings rate can be the result of either a drop in after-tax (disposable) income or an increase in spending, or a combination of both factors. So why have savings rates fallen in BC and in the rest of the country? In order to understand this phenomenon, we'll examine trends for each of the variables that are used to calculate the savings rate, starting with after-tax, or disposable income.

Personal disposable income in the province declined during most of the 1990s, falling below the national average

In real terms (after adjusting for inflation[1]) after-tax per capita[2] earnings of British Columbians have declined slightly during the last decade, while over the longer term the trend has been flat. The province, which started the 1980s with higher-than-average per capita earnings, fell below the national average in 1998, and has stayed there since. The disposable income of British Columbians is beginning to grow, but there is still a lot of lost ground to be regained.

In contrast, real per capita after-tax earnings in Alberta and Ontario advanced substantially during the latter part of the 1990s, showing strong growth over the longer term. The Canadian average has resumed an upward trend after stalling in the mid-1990s and has also advanced relative to 1981.

In 2001, the disposable income of British Columbians was lower than it had been 20 years earlier

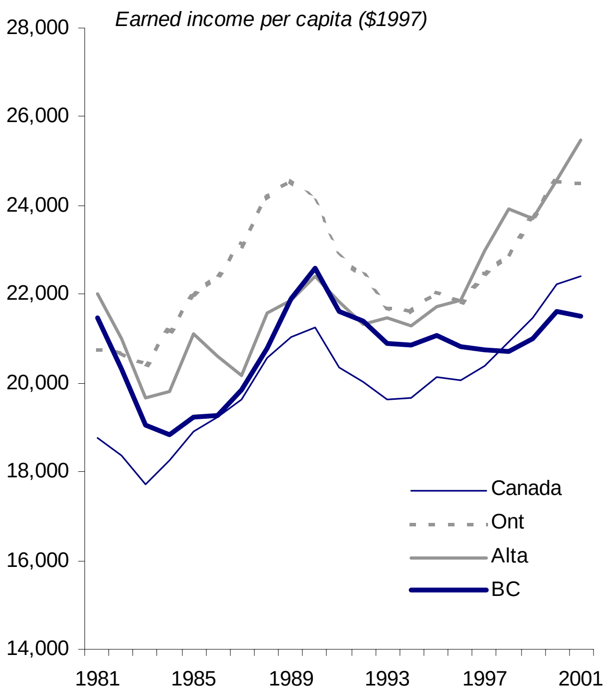


There are a couple of possible explanations for the contrast between BC's experience and what has happened in the rest of country. Personal disposable income is measured net of taxes, so BC's weaker performance could be due to slower-than-average income growth, or higher-than-average increases in taxes and other payments to government. The data suggests that the lacklustre growth in personal disposable income during the last decade has occurred because of a lack of income growth rather than higher taxes.

[1] Unless otherwise stated, all figures are in constant (1997) dollars. The constant dollar figures are calculated using the personal expenditure implicit price index.

[2] Because the levels of income and expenditure increase with the size of the population, the data quoted here is on a per capita basis. Changes in per capita income and expenditure thus reflect changes in behaviour rather than being population-driven.

Per capita earned income in BC is lower than it was at the beginning of the 1990s…



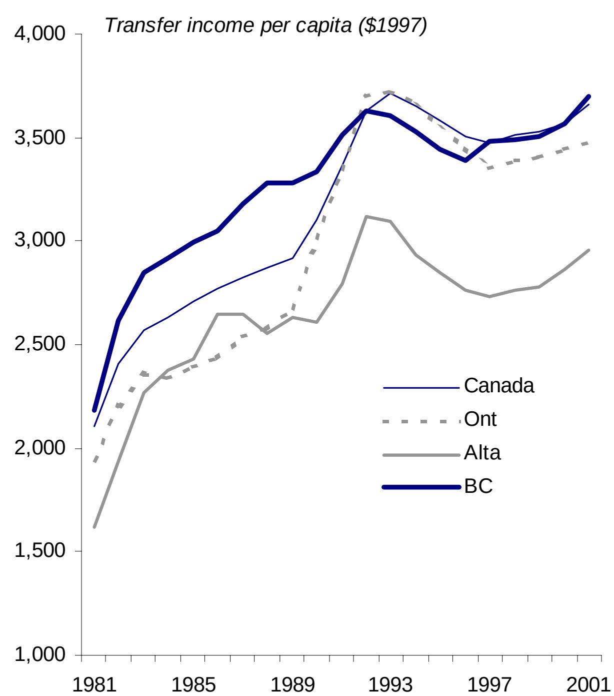
Per capita earned income has been falling and BC residents have become more dependent on transfers as a source of income

The 1990s were a period of slow growth that was mainly population-driven, and the per capita earnings of workers and owner-operators of unincorporated businesses reflect this fact. In real terms, there has been virtually no increase in per capita earned income since the early 1990s. In fact, per capita earnings are at the same level as in 1981. Other parts of the country experienced some ups and downs during the 1990s, but overall, earned income has been trending up in the rest of Canada.

At the same time, the degree to which BC residents depend on transfers as a source of income has been growing. In 2001, the average British Columbian received $3,695 per person in transfers from government, business and non-residents, a 70% increase over the $2,184 received in 1981. This was similar to what happened at the national level and in Ontario. In Alberta, per capita transfers increased 83% during the same period, but individuals and unincorporated businesses in that province remain less reliant on transfers than are other Canadians.

Thus, in contrast to what occurred in the two remaining "have" provinces, BC's income growth during the last decade was primarily fuelled by transfer payments. The fact that transfers have been the main vehicle for income growth in the personal sector underlines the intrinsic weakness of the economy during the 1990s. Earned income is more likely to grow when the economy is robust, as the demand for the services of labour and capital expands. Increases in transfers signal a greater dependence on income support systems such as employment insurance, social assistance, or pensions. This has an effect on the savings rate because people who are dependent on transfer income are more likely to be dissaving rather than saving.

…but transfer income has increased



Generally weak economic conditions are not the only reason why transfer payments may increase. Governments may use transfers such as child tax benefits or income supplements to promote social policy objectives such as income redistribution. However, while income redistribution may be desirable for social policy reasons, it can only stimulate economic growth through increased spending by households.

The greater dependence on transfer income in BC may reflect the composition of BC's population, which is somewhat older than the Canadian average. Seniors are less likely to be in the workforce, and more likely to depend on transfers as a source of income, than other citizens. In 2001, seniors made up 13.2% of the population, compared to 12.6% at the national level. In Ontario, 12.6% of the population was 65 or older. Alberta's population tends to be younger, with just 10.2% in the 65+ age group. In BC, pension payments (OAS, CPP and pensions to war veterans) accounted for 44% of all transfer payments in 2001.

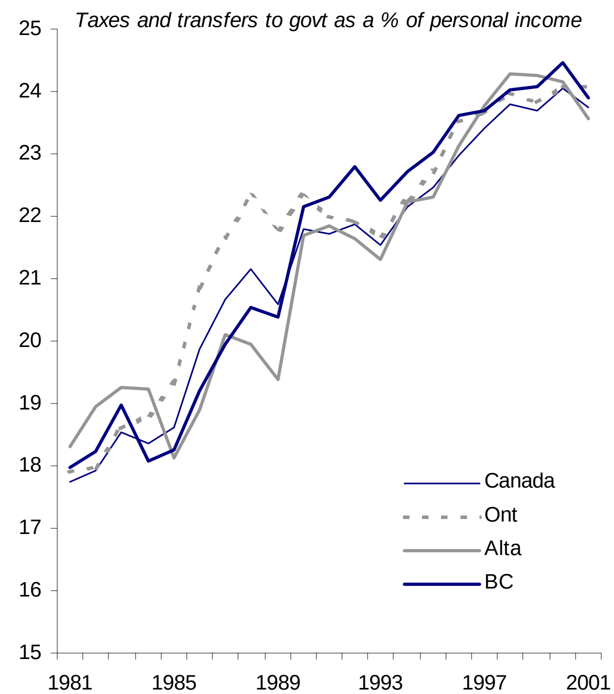
However, age structure alone does not explain all of the difference. Since 1981, per capita transfer income has increased at the same rate as the national average, but our growth in the population of seniors has been slower. The size of the senior population has expanded substantially more in Alberta (from 7.2% to 10.2%) than in BC (from 10.7% to 13.2%) since 1981. Ontario (+2.6 percentage points) and Canada (+3.0 points) have also seen their elderly population grow faster, relative to the total population, than in BC. This implies that an aging population is only one of the factors behind the trend.

Taxes have increased, but only slightly more than in the rest of Canada

Despite slower-than-average growth in per capita personal income, taxes and other payments from the personal to the government sector remain close to the national average. They are lower, on a per capita basis ($6,023 in 2001) than in either Ontario ($6,738) or Alberta ($6,698), but that is largely because average earnings in those provinces are significantly higher than in BC or in the country as a whole. The Canadian average was $6,186.

Implicit tax rates have risen in all four jurisdictions, and despite differences at some points in time, the long-term trends have been very similar. The implicit tax rate in all three provinces was 24% of total personal income in 2001, which was equal to the national average. Taxes represented 18% of personal income in these jurisdictions in 1981.

Taxes and other payments to government accounted for nearly a quarter of personal income

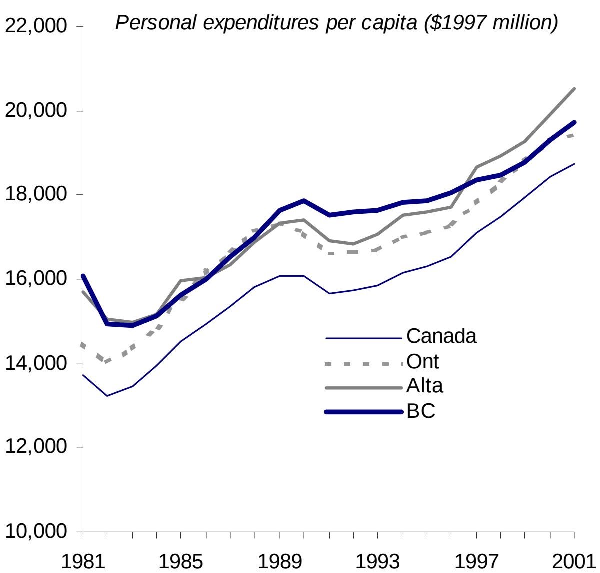


Despite the lack of income growth, spending by BC residents has continued to rise

Slower-than-average personal income growth, combined with a tax bill that has increased at the same rate as for the country as a whole, have left British Columbians no further ahead in 2001 than they were twenty years earlier. However, BC residents don't appear to have adjusted their spending habits correspondingly. They continue to spend more, per person, on goods and services than most other Canadians do, but the higher-than-average spending is not occurring across the board. A look at the components of personal expenditure shows some interesting trends. Spending on goods has been declining and BC residents now spend less, per capita, on these commodities than other Canadians do. However, purchases of services are well above the national average.

The high cost of housing in BC is part of the explanation for the province's above-average personal expenditures, since paid and imputed housing costs are included in personal expenditures[3]. However, even when rent is excluded from the total, per capita spending on services in BC remains above the national average. The difference is particularly noteworthy for transportation, accommodation and food services. This is partly because BC is an important tourist destination and it is not always possible to disentangle tourist expenditures made by people from outside the province from those made by locals. However, even after adjusting for the effect of tourism, this relationship holds.

Spending continues to rise even though after-tax income has stalled



A mild climate in coastal regions of the province, BC's natural beauty and an emphasis on physical fitness may encourage more spending on travel and recreation here than in other parts of the country. Alternatively, BC residents may simply be more fond of activities such as eating out. A survey of food expenditures found that in 1996, households in BC spent 32% of their food budget on restaurant meals. In Vancouver, restaurant meals ate up 37% of the weekly food budget. By comparison, Canadians as a whole allocated just 28% of their food budget on restaurant meals, as was the case in both Alberta and Ontario. More research would be required to adequately explain this phenomenon, but it appears that BC residents either pay more for services, or are more likely to purchase them, than other Canadians are.

Are we a spendthrift society…

After-tax incomes in BC have been stagnant, largely because earned income has stalled. Despite this, we are spending more than we used to on goods and services. This is the reason why BC now has a negative savings rate.

BC is not the only province where the savings rate is dropping. The same overall trend has been observed throughout the country although the savings rate has stayed positive in most regions. But is the long-run decline in the savings rate really an indicator of increasingly spendthrift behaviour, or is it simply a due to the way in which it is measured?

…or is the plummeting savings rate merely a statistical construct?

It has been argued that the long-term decline in the savings rate is really just a statistical construct because some types of income, which are becoming increasingly important, are excluded from this measure. Transfer income is only included in personal income if it is paid from the current earnings of another sector. For example, social assistance payments are made by the government to individuals, using money from tax revenues received in that year. Similarly, corporations that write off bad debts owed by individuals are making an implicit transfer of income to the personal sector.

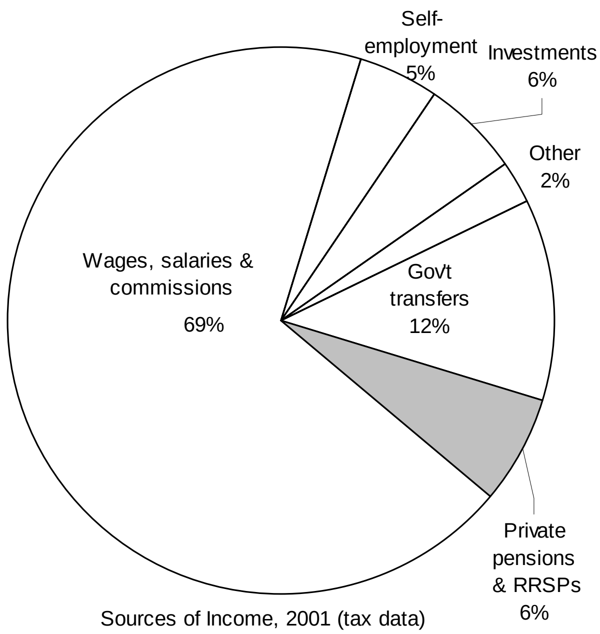
Income from private pension plans and RRSPs is not included

Some types of income, such as benefits from private pension plans and income from RRSPs, are not derived from the current economic activity of individuals, businesses, governments or nonresidents. Instead, they represent income that is based on drawing down accumulated assets that have been built up in previous years. As such, the transfer is not included in personal income. Personal income thus understates the actual spend-

[3] In fact, personal income includes an estimate of the imputed rental income on owner occupied housing, but since this estimate also shows up as an expenditure, the savings rate is not affected.

ing power of British Columbians since they can finance purchases by divesting themselves of assets that have been accumulated in the past.

Private pension plans and RRSP benefits accounted for about 6% of the income of BC taxfilers in 2001



Private pension plans and RRSPs accounted for 6% of the income reported by taxfilers in 2001

Benefits from private pension plans and RRSPs accounted for a relatively small, but still significant, share (6%) of the total income of BC taxfilers in 2001. The national average was also 6%, with income from these sources accounting for a similar percentage of the total in most provinces. Alberta (4%) was the only province where private pensions and RRSPs represented a substantially lower share of total personal income.

If BC residents depend more on private pension plans and RRSP benefits as a source of income than residents of other provinces do, this might help explain the lower savings rate and per capita income observed in this province. It would be reasonable to assume that this is the case, since the province has a large population of seniors. However, tax data for 2001 suggest that the situation in BC is similar to that in the rest of the country, so it is unlikely that this explains BC's low savings rate.

The value of housing and other capital assets owned by individuals is not reflected in the data

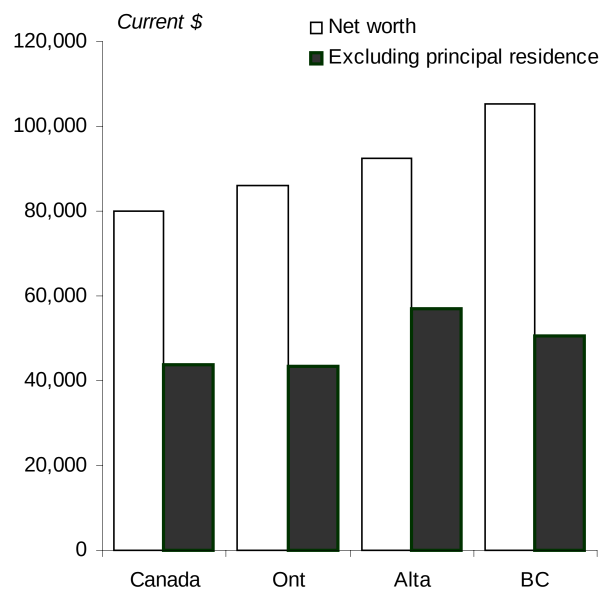
If the value of stocks and bonds, housing and land or other assets held by individuals increases, the capital gain will not be reflected in personal income until the asset is sold and the proceeds are invested. At that point, any interest or dividend income generated by those investments would be counted. From a practical perspective, what this means is that, if individuals are investing more of their money in housing, mutual funds, or other instruments which appreciate in value, the savings rate will not fully reflect the current financial position of the personal sector.

Personal income is not intended to be a measure of wealth, and from an economic accounting perspective, the value of assets held by individuals has already been counted in the sector's savings in the year in which the income used to purchase them was earned. For example, in the case of a house purchase, the portion of yearly mortgage payments that goes toward paying down the principal is treated as savings, while the interest payment is counted as an expense.

With the high cost of housing in this province, an enormous amount of capital is invested in residential structures, which don't necessarily generate an income stream, rather than in investments that pay dividends or interest. The low savings rate is less cause for concern if it is occurring simply because people are spending more on housing here than in other parts of the country. However, housing alone does not account for the difference between BC and other provinces.

Similarly, an increasing number of people are choosing to invest their savings in RRSPs, mutual funds or stocks rather than in interest-bearing accounts. Those who do so can realize capital gains as the value of their holdings changes with fluctuations in the stock market. These capital gains are not reflected in the savings rate since they will not be realized until the funds are liquidated. This means that when the stock market is rising, the savings rate does not capture the potential buying power of individuals who could liquidate their assets to finance their purchases. On the other side of the coin, losses incurred during bear markets also have no effect on the rate. The volatility of real estate and stock market holdings means that unrealized capital gains may be no guarantee of future buying power.

The net worth of British Columbians is higher than in the rest of the country, mainly due to the cost of housing in the province



British Columbians are wealthier than other Canadians

A 1999 survey of financial security indicates that BC residents are wealthier, in terms of their assets, than other Canadians are. On a per capita basis, the net worth (value of assets net of debt) of British Columbians was about $105,000 in that year, well above the $80,000 average for the country as a whole. Ontario ($86,000) and Alberta ($92,000) residents also had substantially lower net worth. The difference, however, is less marked when housing is excluded from the total. Net worth in BC remains above the national average, but lower than in Alberta.

Is the decline in the savings rate cause for concern?

It could be argued that, since residents of the province have more assets than other Canadians do, they can more easily afford to spend more than they earn in a given year. In other words, we can afford to be spendthrifts. Even if spending is financed by drawing down the value of assets, it stimulates the economy and helps create jobs. There is little doubt that consumer spending boosted BC's economy during the late 1990s, and may well have kept the province from slipping into a recession in some years.

Furthermore, a substantial number of British Columbians must rely on income from savings or pensions to finance their expenditures since they are elderly and therefore no longer in the work force. Finally, if migrants from other provinces or other countries are spending their savings or of living off the value of assets that they acquired elsewhere, it would appear that we are spending more than we earn, but the situation is not as bleak as it might seem.

Despite all this, a negative savings rate may still be cause for concern, particularly if it persists over the longer run. To a certain extent, the savings rate can be viewed as an indicator of the current ability of British Columbians to accumulate new assets. If we continue to finance a growing share of today's expenditures using savings accumulated in the past, or through capital appreciation, there may come a point when that behaviour will no longer be sustainable. That does not bode well for the future ability of individuals to stimulate growth in the economy by providing needed capital to corporations that will employ British Columbians.

Whether or not the behaviour of individuals can, or should be, changed is a matter that is open to debate. But the long-term effect of their behaviour on BC's potential for growth could be significant.