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Publication

BUSINESS ALERT

July 28, 2009

BC GOVERNMENT OPTS FOR HARMONIZED SALES TAX

In what is arguably the most important provincial tax reform measure in a generation, the BC government has announced that it will harmonize the provincial sales tax (PST) with the federal Goods and Services Tax (GST), effective July 1, 2010. For anyone keen to see a more productive and globally competitive BC economy, this is welcome news. Canadian public finance experts have long called for precisely this kind of tax change. And for nearly a decade, the Business Council has advocated moving away from the PST towards a "value-added" sales tax as a means to bolster the province's long-term economic performance.

From a policy perspective, there are several reasons why overhauling the sales tax makes sense. Most significantly, the HST will remove all current provincial sales tax from business inputs -- intermediate inputs as well as capital purchases. While the PST is often viewed as a "consumption" tax, the reality is that it applies to elements of both consumption and production. Approximately 40% of the PST revenue collected by Victoria is paid by businesses on a wide variety of inputs used in producing goods and services. This represents additional costs for BC businesses of some $2 billion annually. A tax on business inputs raises the cost of capital, is distortionary, and favours some sectors over others because firms rely on purchased inputs to varying degrees. Under the proposed HST, the provincial sales tax now paid on inputs is effectively eliminated, as the 7% provincial portion will be credited along with the 5% GST for all goods and services purchased for business operations.

In general, the HST will see the province adopt the same tax base as the federal GST. However, BC plans to provide "point of sale" rebates and tax credits for the provincial portion of the HST on certain purchases, including:

- gasoline and diesel motor fuels;
- books;
- children's clothing, footwear, car-seats, and diapers; and,
- feminine hygiene products.

The province also intends to provide rebates for the provincial portion of the HST paid by charities, eligible non-profit organizations, and various public sector bodies (hospitals, universities, school boards, local governments). Further details on the tax treatment of these non-profit institutions will be forthcoming over the next several months.

Economic Policy Considerations

Economists agree that taxes on capital and other intermediate inputs have negative effects, notably they raise the cost of investing in machinery, equipment, technology, vehicles, construction materials and other components of the capital stock, which in turn hampers productivity and dampens wages. So getting rid of BC's retail sales tax qualifies as sound economic policy. As the C.D. Howe Institute has observed, with a value-added tax such as the proposed HST

> "…construction investment would increase, as would business spending on machinery and equipment. The reason is that the tax burden on business capital investment would drop significantly. Labour productivity would improve, and with it workers' wages."[1]

In this context, it is important to consider the impact of different types of taxes on the marginal, or incremental, investment decision. Estimates show that BC's marginal effective tax rate (METR) on capital, defined as the additional tax on an incremental dollar of income generated from a new investment, stood at 31.6% in 2007, which is above the national average and the third highest in Canada. Strikingly, the PST accounts for nearly one-third of the overall METR. For this reason, a recent paper prepared for the BC Progress Board by Canadian productivity expert Andrew Sharpe concluded that "[h]armonizing the PST with the federal GST would do more to stimulate investment in the province than the complete abolition of the corporate income tax…"[2] By shifting to the HST, British Columbia can anticipate billions of dollars of additional business investment and faster renewal of the private sector capital stock.

Experience in Atlantic Canada[3] confirms that replacing a retail sales tax with a value-added levy like the HST paves the way for a sizable jump in business investment. University of Toronto economist Michael Smart found that annual investment in machinery and equipment and other components of the capital stock rose by 12% above trend levels in the years following the 1997 sales-tax reform.[4] BC can look forward to similar gains. A higher rate of investment will lead to stronger economic growth, increased productivity, more exports, and higher wages for private sector workers.

Another benefit of harmonization is that it will lower compliance costs and allow for greater administrative simplicity. Under the current system of different and administratively disconnected BC and federal sales taxes, businesses have to remit separately to the federal and provincial governments and ensure they are in compliance with two sets of tax rules

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[1] F. Poschmann, "Sales Tax Reform: The Time is Right," C.D. Howe Institute e-brief, March 20, 2009.
[2] Andrew Sharpe, Jean-Francois Arsenault and Peter Harrison, "Investment in British Columbia: Current Realities and the Way Forward," BC Progress Board (December 12, 2008), p.30.
[3] Nova Scotia, New Brunswick and Newfoundland have all integrated their sales taxes with the GST.
[4] Michael Smart, "Lessons in Harmony: What the Experience in the Atlantic Provinces Show About the Benefits of a Harmonized Sales Tax," CD Howe Institute, July 2007, p.1.

(including a litany of exemptions in the case of the PST). Administrative costs should be far lower once the proposed HST is implemented.

Impact on Consumers and Vulnerable Industry Sectors

A key feature of shifting from a retail sales tax to a value-added sales tax is that the tax base is broadened as many items – especially services – that now are exempt from the PST (but that are covered by the GST) become subject to the combined 12% HST. Consumers will pay an additional 7% on purchases of services and some goods that presently are untaxed by the PST. But contrary to what many may believe, the net result is not to increase the tax-inclusive cost of these items to the final consumer by 7%. The reason is that the prices of most goods and services sold in the BC market will fall as the costs imposed on businesses by the imposition of PST on inputs disappear. Experience in Quebec and the Atlantic provinces indicates that the reduced sales tax on business inputs was passed on (and surprisingly quickly) to domestic consumers in the form of lower (pre-tax) prices.[5] This outcome is not surprising in a competitive marketplace; while the retail sales taxes charged on business inputs are hidden from consumers, the businesses that incur these taxes naturally seek to pass the associated costs on to consumers.

Consumption taxes are sometimes criticized for being "regressive" by disproportionately affecting lower income households. To address this legitimate concern, the provincial government intends to provide a refundable HST credit which will be paid quarterly along with the existing GST credit and carbon tax credit to lower income individuals. To maintain the value of the HST credit over time, the province should consider indexing it to the rate of consumer price inflation.

Two sectors that are worried about the proposed HST are homebuilding and the restaurant industry.

The government is taking steps to blunt the effect of the HST on the homebuilding industry and thus on the price of new housing. It plans to structure the HST so that new homes up to $400,000 will bear no more tax under the HST than they do with the current system (in which builders pay PST on construction materials and some other inputs like tools and equipment). For new homes priced over $400,000, the province will provide a flat rebate of around $20,000. While more details are necessary to make a full evaluation, it appears that under the HST net costs will be higher for more expensive categories of new homes. Given the high cost of housing in urban British Columbia, the government may want to consider additional measures to mitigate the impact of the HST on housing costs. Instituting a higher threshold above $400,000 could be one way to ease the burden.

For the restaurant and foodservices industry, the economic picture is much more difficult. At present, food purchased in BC restaurants is subject to the GST but not the PST,

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[5] See Smart, op. cit., for a complete discussion.

whereas food purchased in grocery stores faces neither of these taxes. The industry fears that imposing additional sales tax on restaurant meals will depress business. This is a legitimate concern: the HST means higher tax-inclusive prices for restaurant meals, even after taking into account that restaurant operators will gain access to input tax credits for sales tax paid on many of their inputs, just as they do now with the federal GST.[6] Post-HST, it will become relatively more expensive to eat out than to dine at home, which at the margin should lower demand for restaurant meals. That said, experience with the GST suggests that after an initial adjustment to the new tax regime, spending on restaurant meals eventually returns to its trend growth rate (roughly in line with nominal GDP).

Why Now?

The timing of the BC government's announcement in large part reflects Ontario's decision – in late March – to replace its provincial sales tax with a harmonized tax regime by July 2010. With Ontario taking this step, the only provinces left with separate retail sales taxes are BC, Saskatchewan, Manitoba and PEI.[7] Ontario has commenced negotiations with the Canada Revenue Agency (CRA) over the rules and administrative arrangements needed to establish a harmonized sales tax in that province. By moving forward now, BC can join that process and benefit from the work that Ontario and the CRA have already done.

Some commentators have questioned whether BC should harmonize at a time of economic recession. However, the HST will not be in place for another year, by which time the Business Council believes the economy will have returned to a growth path. Moreover, arguably now is a good time to focus on ways to fortify the foundations for BC's long-term prosperity. Replacing the PST with a value-added-sales tax tied to the federal GST is the single best thing the province can do to promote investment, exports, and productivity; encourage the growth of higher-paying jobs; and reduce administrative and compliance costs for business. The HST system should position British Columbia for a more robust and sustained economic recovery once the current downturn is behind us.

The HST will have an impact on the tax-inclusive prices paid by BC consumers, but to a lesser degree than most expect. Businesses that sell in the domestic market will see costs fall as the PST is removed from inputs. The benefits of these cost reductions will flow through to consumers in the form of lower (pre-tax) prices. Experience in Quebec, Atlantic Canada and other jurisdictions that have adopted broadly-based value-added consumption taxes in place of retail sales taxes strongly validates the view that cost savings for businesses are passed on to consumers. It is worth noting that in the years following the implementation of the federal GST, Canada's inflation rate trended steadily lower, confounding critics who claimed the new tax would be inflationary.

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[6] In Ontario, which recently announced a move to a harmonized system, the provincial sales tax already applies to restaurant meals so it was not an issue there.

[7] Alberta does not maintain a provincial sales tax.

Over time, the broader tax base established by the HST is likely to translate into increased revenues for the province (in part thanks to faster economic growth and higher productivity). In addition, the government has signalled that it plans to temporarily delay the provision of input tax credits (ITCs) for certain purchases by "large" businesses with taxable sales in excess of $10 million. Details at this point are scant, and the Business Council intends to work to persuade policy-makers to ensure that all BC businesses have full access to ITCs as quickly at possible.

Of interest, the province is also in line to receive $1.6 billion in transitional funding from the federal government, which has long sought to encourage the provinces to integrate their sales taxes with the GST as a way to improve the functioning of the Canadian economic union. Finally, once the HST is in place BC expects to save $30 million per year as responsibility for administering the tax is assumed by the CRA.

While a few industry sectors will be disadvantaged by the HST, overall the new sales tax regime is expected to have positive economic results. Economists have long observed that in terms of consumption taxes, retail sales taxes like the PST are markedly inferior to value-added taxes because they have a narrower tax base, are more distortionary, and are more susceptible to evasion. As SFU economist and public finance scholar Jon Kesselman has written, "in addition to gains in economic efficiency and investment growth, harmonization reduces complexity for consumers, compliance costs for business, and tax collection costs for governments."[8]

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[8] J. Kesselman, "GST Harmonization Strategies," Canadian Tax Highlights, May 2007.