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March 10, 2011

The Honourable Colin Hansen
Minister of Finance and Deputy Premier
PO Box 9048
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Victoria BC V8W 9E2

Dear Minister:

Re: Considerations Regarding Harmonized Sales Tax

We are responding to the B.C. 2011 Budget request for submissions on the pros and cons of retaining the harmonized sales tax (HST) or reinstating a parallel provincial sales tax (PST) and goods and services tax (GST) system. Our observations focus on one aspect of the four on which input was sought, namely, the expected impact of each option on B.C. businesses and B.C. economic competitiveness.

In our view, the inescapable conclusion is that the HST is preferable from a business, government and general economic perspective. The PST embedded in prices had meant B.C. firm products were priced more highly than they needed to be and/or the firms' margins had been squeezed to remain competitive. This had left B.C. businesses less competitive, or with lower earnings, adversely affecting investment and growth prospects for these companies.

The HST enables B.C. businesses to pass through sales tax charged on inputs, instead of building it into the companies' cost structure, and to avoid double compliance costs of a federal and B.C. sales tax system. The significant majority of B.C. companies saved both previously hidden PST and $150 million in annual combined administrative compliance/filing costs. A return to a PST-plus-GST regime would see these benefits lost *and* an additional $30 million (and transition costs) would have to be found annually from taxpayers to cover the government's PST-related collection and compliance costs.

As the request was for fact-based input, our comments below refer to theoretical and empirical studies of sales and other taxes, and these taxes' impact on economic growth.

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- **Lower business taxes expand economic growth**

  In the mid-1990s, the federal government established the Technical Committee on Business Taxation, made up of tax experts from across the country, including Professor Nancy Olewiler, Department of Economics, Simon Fraser University. That committee reported in 1998 and the following conclusions may be instructive for the current assessment of an HST as compared to a PST plus GST regime for B.C.:

  > "As we reviewed each of the business taxes, it became clear to the Committee that the pursuit of one overall principle for business taxation – neutrality together with internationally competitive tax rates – is consistent with the aims of job creation and economic growth, simplification and fairness. With neutrality, the total tax paid on income earned from different business activities is similar so the decisions of businesses are largely unaffected by the tax system. Tax rates are kept as low and competitive as possible by being applied to the broadest possible base. …
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  > Neutrality encourages businesses and entrepreneurs to pursue profitable opportunities that will make Canada prosper, rather than to waste resources in an effort to reduce taxes. The efficiency of the Canadian economy would be improved. Moreover, with lower and more competitive tax rates, Canada would be a more attractive location for business, thereby creating employment and growth." *Technical Committee on Business Taxation Report, April 6, 1998, (http://www.fin.gc.ca/toc/1998/brie_-eng.asp#Brief)*

  Also of note, the report emphasized the need for a high degree of co-operation between federal and provincial governments as regards tax policy for the Technical Committee's recommendations to achieve their objectives, most importantly, improving the tax system to promote job creation and economic growth in an open economy. An unfinished area requiring federal and provincial co-operation is consumption taxes, namely, a move to a single value-added tax (VAT), with a broad base and lower combined federal-provincial rate, whose goal is neutrality of outcome among sellers and among buyers. That is why approaching 150 countries, including virtually all industrialized countries, have adopted a value-added tax, the lone major exception being the U.S., which is considering a VAT as a way to address its seriously indebted state.

  A VAT is particularly important in the case of economies that are seeking to expand exports as it removes all cascading sales taxes from intermediate steps of production. As emerging economies with lower labour cost structures have a natural price advantage, a value-added tax allows the higher-value-added goods and services supplied by firms in industrialized countries, such as Canada, to compete better in increasingly global markets.

- **Lower taxes on business investment improve productivity and standard of living**

  As tax revenues are used for infrastructure investment, delivering services, and distributing income more equitably, it is natural for there to be frequent discussion of the appropriate taxation of businesses and consumers. The types of tax chosen will influence spending and saving, and investment or underinvestment, affecting competitiveness and prosperity. B.C. businesses provide the jobs that enable most B.C. residents to earn wages and enjoy a good quality of life. More investment by B.C. businesses should contribute to improved salaries, job security and the high standard of living that most B.C. residents have come to expect. According to the Task Force on Competitiveness, Productivity and Economic Progress, ways to improve or maintain living standards are limited, with only one sure way in the long run – productivity enhancement:

  > "One way to improve living standards is to work more hours or use up more and more of our natural and physical resources. But this is limiting. We can find new workers from our population up to a point. But there are only so many hours in a day and days in a year. Natural resources are limited or become too costly to acquire and in addition their use can have adverse environmental consequences.
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  > The other way is to improve productivity. … Productivity measures how much value we create per unit of resources used – whether the resources are an hour of labour, an hour of machine time, a barrel of oil, or any other scarce resource. The value created is represented by how much money somebody will pay for the output – beyond the value of resources used. Productivity increases in one of two ways – greater efficiency in the use of inputs or greater value-added per unit of input*." Path to the 2020 Prosperity Agenda, Sixth Annual Report, November 2007, p. 29*

  As productivity improves, businesses should grow and employ more B.C. residents. The income and other taxes paid by the firms and their employees should exceed the taxes ostensibly "lost" by not subjecting intermediate inputs to PST. Note that under a PST, individuals pay tax on tax on domestically produced goods and services, increasing – albeit invisibly – the costs of what they buy anyway and in many cases giving price advantages to imported products and services from (and potentially jobs to) other countries.

- **Provincial sales taxes can discourage productivity-enhancing capital investment**

  Whether greater efficiency in the use of inputs or greater value-added per unit of input, the net dollar value created through greater productivity gets paid to workers and to shareholders, who are usually workers or former workers, or is re-invested. Provincial sales tax is applied to the amount paid by the user, including on investment capital and other productivity-enhancing equipment, increasing its cost, and discouraging its purchase and use. The GST and HST, on the other hand, are credited to businesses and the amount businesses pay for purchasing capital goods and services reduces the amount they owe the government from their sales. It is for this reason that many economists have pressed to change provincial sales taxes to value-added taxes, jointly applied with the GST to increase investment in capital and decrease costs for all firms already subject to PST (virtually all firms were already subject to GST, so incremental administrative costs of the provincial portion of the HST were expected to be minimal). Following on a conclusion of Alan Chow and Peter Dungan – "With the recent announcement that Ontario will harmonize its PST with the GST, capital expenditure in Ontario should increase in the long run." (Tax shift effects on the Canadian economy, Simon Fraser University, 2009 (http://www.sfu.ca/~acc8/ paper%202.pdf)) – capital spending by B.C. businesses, should the HST remain, can be expected to increase also.

By how much could capital spending increase? Research by federal Department of Finance economists Aled ab Iowerth and Jeff Danforth suggests that "a 10 percent reduction in the cost of capital (which is the effect of a reduction in marginal tax rates on business investment [including a reduction in consumption taxes]) can increase investment in machinery and equipment by 10 percent in Canada" ("Is Investment Not Sensitive to its User Cost? The Macro Evidence Revisited," Department of Finance, Working Paper 2004-05, Ottawa). Making the HST permanent would reduce taxes on capital spending, encouraging expenditure on capital investment to improve productivity and growth and, ideally, increase jobs.

The contrary – for example, the effect of the embedding of an estimated $1.9 billion in provincial sales taxes into the price of B.C.-produced goods and services – has also been found to be true. In "Assessing Ontario's Fiscal Competitiveness, A Report Prepared for the Institute for Competitiveness & Prosperity," (November 23, 2003), Duanjie Chen and Jack Mintz noted that "High effective tax rates on capital deter investments in new equipment and structures, and undermine the adoption of innovative techniques that are imbedded in new capital purchases. Recent economic studies have tended to show that a 10% increase in the cost of capital, due to higher taxes, will cause a long-run decline in capital stock in a range of 5% to 20% [Mintz, 1996]". A return to the PST and GST also would re-expose many firms to two sets of reporting and audit requirements.

- **B.C. as gateway to North America and Asia**

B.C. was traditionally dependent on resource industries and what manufacturing there was tended to be associated with these resources. Now, it has a vibrant, more diversified economy and can develop, in the right tax environment, into an even greater powerhouse. B.C.'s HST, coupled with its low corporate income tax, will combine to attract investment from other countries, but in particular from China, Hong Kong and other Asian countries that have deep pools of institutional and individual capital ready to be directed to external portfolio investment in politically and financially stable, business-friendly countries. B.C.'s strong relationships with Hong Kong and China, and possible conclusion of a double tax agreement between Canada and Hong Kong, would encourage cross-investment through Hong Kong to a market of over one billion Chinese for B.C.-based companies and, because the HST removes taxes from exports, for Hong-Kong or China-based companies wanting to serve the U.S. market from the closer time zones and delivery locations in B.C. Both inward and outward investment should help create sustainable jobs in the province.

While there are opportunities for administrative and other improvements to the GST and hence HST that should be pursued, on balance the evidence clearly suggests that the businesses, workforce and economy of B.C. will benefit from an HST as compared to a PST plus GST structure.

Yours sincerely,