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Tax Impact of BC's HST Debate on Investment and Competitiveness

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SUMMARY

If voters kill British Columbia's Harmonized Sales Tax (HST) in a June referendum, the province's economy will suffer in the long run. A rejection will spur the rebirth of the provincial retail sales tax, leading to steep increases in the marginal effective tax rates on capital and costs and a corresponding dip in investment and job creation. Should voters decide to keep the HST, BC will reduce the tax by two points over the next three years and raise the corporate income tax rate to bridge the revenue gap. This will also negatively impact corporate competitiveness, but since the government has indicated that the hike will be temporary, retaining the HST is the best option for BC's economy.

[1] I thank Duanjie Chen for assistance in evaluating the tax impacts. I appreciate comments received from three reviewers.

In the past week, I received a number of requests regarding the tax impact of British Columbia's recent Harmonized Sales Tax (HST) announcement on competitiveness and in comparison to the readoption of the retail sales tax (RST) if the referendum succeeds. Below, I provide an evaluation regarding a new HST proposal in terms of its impact on BC's cost competitiveness in comparison to the existing system and one in which the HST is replaced by a RST.

The BC proposal to reduce the HST rate by two points and raise the corporate income tax rate by two points is far less harmful to the province's economy than readopting the provincial retail sales tax. If the new package helps convince BC voters to reject the referendum to extinguish the HST, then this will be quite important to BC's competitiveness.

BC Premier Christy Clark's government has introduced a potentially dramatic tax reform. Should the referendum fail to extinguish the HST, BC will reduce its part of the HST rate from seven percent to six percent on July 1, 2012 and by a further point on July 1 2014. The government estimates that each family will see a reduction in sales tax payments equal to $470, more than offsetting the estimated increase of $350 in sales taxes after replacing the retail sales tax.

Given the revenue cost of reducing the HST rate, the BC government is raising the corporate income tax rate from 10 to 12 percent for large companies on January 1, 2012. The small business corporate income tax elimination planned for April 1, 2012 is postponed indefinitely. BC will also slightly increase tobacco taxes and provide a one-time payment in $175 for each child and senior (the payment to be covered by contingency funds).

The tax impact of reducing the HST and raising the corporate income tax is to reduce the marginal tax rate on labour but increase it for capital. This is a worrying policy development since BC will shift from a tax with less economic cost (the HST) to one that is more harmful to the economy (the corporate tax).[2] Nonetheless, the short-run impact of the proposal will have only a slight negative impact on BC's cost competitiveness. Over the long run, the higher corporate tax rate will reduce capital investment, impair technological adaptation and hurt productivity. It will be important for BC to reduce the corporate rate back to 10 percent as soon as the budget balances.

The table below provides estimated marginal effective tax rates on capital and labour for BC for the current sales and corporate tax system, the proposed tax reform announced last week if the HST is maintained and the impact if BC returns to provincial RST.

The marginal effective tax rate on capital is the annualized value of corporate income, capital and sales taxes on business purchases as a proportion of the pre-tax rate of return on capital. The marginal effective tax rate on labour is the weighted average of personal taxes, employer and employee payroll taxes and sales taxes as portion of the pre-tax cost of labour faced by BC businesses when providing additional hours of work to workers.[3] I also compute the marginal tax rate on the cost of doing business – this is an aggregation of taxes on capital and labour, using the assumption that 30 percent of labour taxes are shifted forward in negotiated labour costs.

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[2] See B. Dahlby and E. Ferede, "What Does it Cost to Raise a Dollar of Tax Revenue," *C.D. Howe Institute Commentary*, No. 324, C.D. Howe Institute, Toronto, March, 2011. The marginal cost of raising one dollar of corporate income tax revenues in BC is estimated to be $11.64, the highest of any tax.

[3] Marginal tax rates on labour are averaged over wage distributions for BC businesses. A fuller explanation of all these tax rate measures is provided in Duanjie Chen and Jack Mintz, "Federal-Provincial Business Tax Reforms: A Growth Agenda with Competitive Rates and Neutral Treatment of Business Activities," *SPP Research Papers*, Vol. 4, Issue 1, School of Public Policy, University of Calgary, January, 2011.

Marginal Effective Tax Rates (METR) on Capital, Labour and Costs in British Columbia under Various Tax Packages (in percentages)

	Current System (HST at 12% and Corporate Income Tax Rate 10%)	HST at 10% and Corporate Income Tax Rate at 12%	RST at 7%, GST at 5% and Corporate Income tax rate at 12%
METR on Capital (large companies)	20.0	21.5	28.8
METR on Labour	41.7	40.6	41.4
METR on Costs	18.5	18.6	21.8

Reducing the HST rate from 12 to 10 percent will lower the marginal effective tax rate on labour by about 1.1 percentage points since workers will have greater purchasing power to buy goods and services with lower tax-inclusive consumer prices. The reduction in labour taxes will have some beneficial impact in encouraging employment and labour supply, although economic studies do show that labour taxes are not as distortionary as taxes on mobile capital.

On the other hand, BC is making its corporate income tax system less competitive, especially given the increase in the corporate income tax rate on large businesses. The marginal effective tax rate on capital will rise by 1.5 percentage points with a 2-point increase in the corporate income tax rate. The effect of raising corporate taxes in the long run is to reduce capital investment and the adoption of new technologies (which are typically part of new vintages of capital).

Overall, the effect of the proposed changes announced last week by the BC government on cost competitiveness is remarkably small in the short run, given our shifting assumptions (30 percent pass-through of labour taxes). The marginal effective tax rate on costs rises by 0.1 percentage points from 18.5 to 18.6 percent. The proposed changes will favour labour-intensive industries that benefit most from reductions in taxes on labour (and lower wage costs). However, capital-intensive industries will be worse off.

If the referendum results in the end of the HST, the effect of shifting back to the retail sales tax will have a very negative impact on competitiveness. The marginal effective tax rate on capital rises to 28.8 percent and the marginal effective tax rate on costs rises to 21.8 percent from 18.5 percent. As documented elsewhere, this will hurt investment and jobs quite dramatically.[4]

BC Finance Minister Kevin Falcon indicated that the corporate tax rate hike will be temporary — the rate would be reduced to 10 percent when fiscally possible. I do think that it is important for BC to return to the 10 percent corporate rate as quickly as possible when the budget balances. Otherwise, it will be disadvantaged compared to Ontario, Alberta and some other provinces for investment. Further, the revenue increase will likely be eroded as large BC businesses shift profits to jurisdictions with lower corporate income tax rates.

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[4] Jack Mintz, "British Columbia's Harmonized Sales Tax: A Giant Leap in the Province's Competitiveness," *SPP Briefing Papers*, Vol. 3, Issue 4, School of Public Policy, University of Calgary, March, 2010. Although my estimated investment and job impacts are larger than that of the BC panel that evaluated the tax reform, the difference is primarily related to the higher sales tax on capital goods that has been estimated from input-output analysis in the Canadian METR model for each province.

Not moving ahead with the planned reduction in the small business tax rate has an ambiguous impact on competitiveness. Although the reduction in small business corporate rates can reduce the cost of investment, it increases a "taxation wall" that impedes small business growth. Further, small business corporate reductions make it easier for those owners who use the corporate form of business organization to avoid paying personal taxes on income shifted into the small corporation.[5] For this reason, it is advisable that the BC government re-evaluate its small business tax incentives to make them more growth-friendly and less costly in revenue terms.

Overall, the BC government's proposed changes to the HST would not hurt competitiveness in the near term, although a quick reversal of the corporate tax hike on large companies is highly advisable for future growth.

[5] These concerns regarding current structure of small business tax incentives is discussed by Duanjie Chen and Jack Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth," *SPP Research Papers*, Vol. 4, Issue 7, The School of Public Policy, University of Calgary, May 2011.

About the Author

Dr. Jack Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of *International Tax and Public Finance* and the *Canadian Tax Journal*, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to Canadian Business and the National Post, and has frequently published articles in other print media.

Dr. Mintz presently serves on several boards including Brookfield Asset Management, Imperial Oil Limited, Morneau Shepell, and Royal Ontario Museum. He was also appointed by the Federal Minister of Finance to the Economic Advisory Council to advise on economic planning and served as research director for the Federal-Provincial Minister's Working Group on Retirement Income Research.

Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business from 1989-2007 and Department of Economics at Queen's University, Kingston, 1978-1989. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the C.D. Howe Institute from 1999-2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; Chair of the federal government's Technical Committee on Business Taxation in 1996 and 1997; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993-1995. He was founding Editor-in-Chief of *International Tax and Public Finance*, published by Kluwer Academic Publishers from 1994-2001, and recently chaired the Alberta Financial and Investment Policy Advisory Commission reporting to the Alberta Minister of Finance.

In 2002, Dr. Mintz's book, *Most Favored Nation: A Framework for Smart Economic Policy*, was winner of the Purvis Prize for best book in economic policy and runner-up for Donner Prize for best book in public policy.

Dr. Mintz has consulted widely with the World Bank, the International Monetary Fund, the Organization for Economic Co-operation and Development, the governments of Canada, Alberta, New Brunswick, Ontario, and Saskatchewan, and various businesses and nonprofit organizations.