



Business Council *of*
British Columbia

**Submission
to the
HST
Review Panel**

March 4, 2011



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SUBMISSION TO THE HST REVIEW PANEL

The Business Council of British Columbia is pleased to share our views with the Independent Panel reviewing the Harmonized Sales Tax (HST). We welcome the opportunity to outline some of the reasons why we believe the HST is “smart tax” policy and clearly preferable to the previous Provincial Sales Tax (PST) from an economic perspective. Virtually all credible studies show that the HST, like similar value-added taxes in place in other provinces, is positive for business investment and job creation, reduces tax compliance and administrative costs, and has little adverse effect on the economic welfare of consumers over the long-term. We don’t propose to cover the same ground as these existing studies. Instead, this submission puts particular emphasis on the role of the HST in strengthening British Columbia’s export base and in helping to develop a more productive and competitive economy – an economy that is able to grow jobs and wealth and fund government services.

Established in 1966, the Business Council is an association representing approximately 260 large and medium-sized enterprises active in British Columbia. Our members are drawn from all major sectors of the provincial economy, including forest products, mining, manufacturing, transportation, agri-food, telecommunications, information technology, financial services, energy, utilities, tourism, retail, construction, life sciences, engineering, healthcare, education and the professions.

1. Background and Economic Benefits

The Panel is familiar with the economic benefits of the HST and the reasons why leading economists and public finance scholars almost universally see value-added taxes such as the HST as an important element in the contemporary government revenue mix. Here, we



focus on a couple of significant reasons why the HST represents smart tax policy for British Columbia.¹

Under the HST system, sales taxes are removed from business inputs, including capital purchases. While eliminating sales tax on inputs improves competitiveness and supports exports in all jurisdictions that have value-added taxes, this feature of the HST deserves particular mention in the BC context.

Taxes on business inputs are an important factor shaping the economic environment for business activity. Although the PST was widely seen as a “consumption” tax, in reality it applied to both consumption and production. According to one recent estimate, 48% of PST revenues were actually derived from business inputs, amounting to about \$2.5 billion annually.² While the PST on inputs was paid in the first instance by businesses, it became embedded in the cost of domestically produced goods and services. Businesses then passed on this additional cost in the form of higher pre-tax prices charged to consumers. The shift to the HST has removed \$1.9 billion from the cost of producing goods and services in British Columbia, owing to the elimination of the PST previously levied on many business inputs.³ For BC exporters, the embedded cost attributable to the PST made them less competitive – or, in cases where prices are set in global markets, less profitable. In either case, the net result was a drag on capital investment and the jobs that typically accompany it.

In a recent paper prepared for the Business Council, Simon Fraser University economist and public finance scholar Jonathan Kesselman points to the positive impact of the HST on the export sector. Indeed, BC exporters are among the main beneficiaries of the elimination of the PST. Reducing input costs will enable more BC-based companies to succeed in the global marketplace; in some cases, it will also help BC businesses compete with imported

¹ See Jonathan Kesselman, “The Harmonized Sales Tax – Through an Economic Prism,” Policy Perspectives, Business Council of BC, (April 2010) for an overview of the economic benefits of the HST.

² Jonathan Kesselman, “Consumer Impacts of BC’s Harmonized Sales Tax” (January 2011), p.4. Study prepared for the Business Council of BC; available at www.bcbc.com.

³ The remaining \$600 million (the difference between \$2.5 billion and \$1.9 billion) is due to HST exemptions on items such as financial services and rental accommodation. While HST is not applied to these services, companies selling them are not eligible for input tax credits, so in practice they end up paying HST on their business inputs (and passing the cost on to consumers).



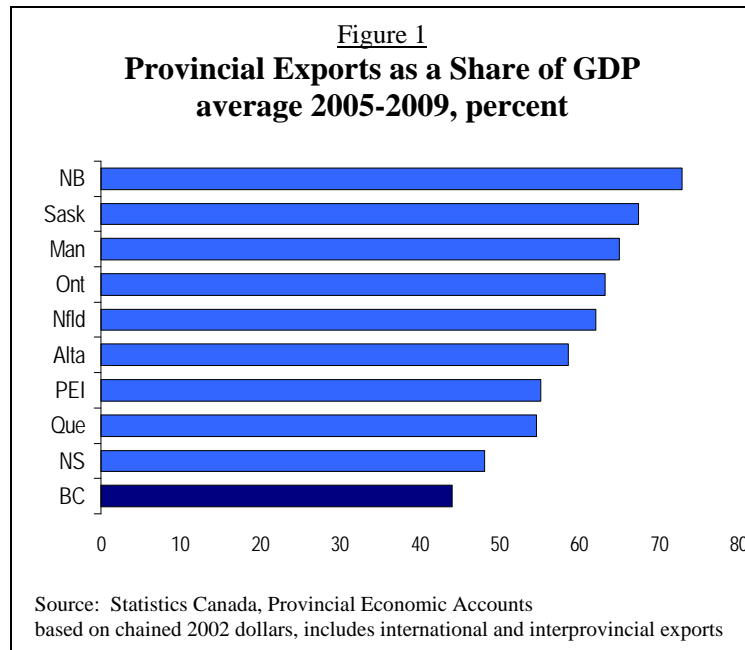
goods in the local market. Commodity-based exporters whose prices are set in the world markets should benefit from higher profits. In this connection, Professor Kesselman makes the point that the resulting tax saving should not be viewed as a “gift” to exporters, because companies involved in export business will put profits back into their operations by way of investment and additional jobs.

2. Building the Province’s Export Base

As a classic small open economy, BC’s prosperity depends heavily on the ability of local firms and entrepreneurs to do business outside of our borders. Selling BC-produced goods and services in external markets allows the province to finance purchases (imports) of consumer goods and services as well as many capital goods and sophisticated services. Exports sustain many communities across the province, and they also indirectly generate wealth in larger urban areas. Taxes generated through the production of exported products and services also support health care, education and other government-funded programs and services.

A striking feature of the BC economy is that, despite an abundance of natural resources, the province’s export sector is comparatively small. As illustrated in Figure 1, relative to the size of its economy, BC has the

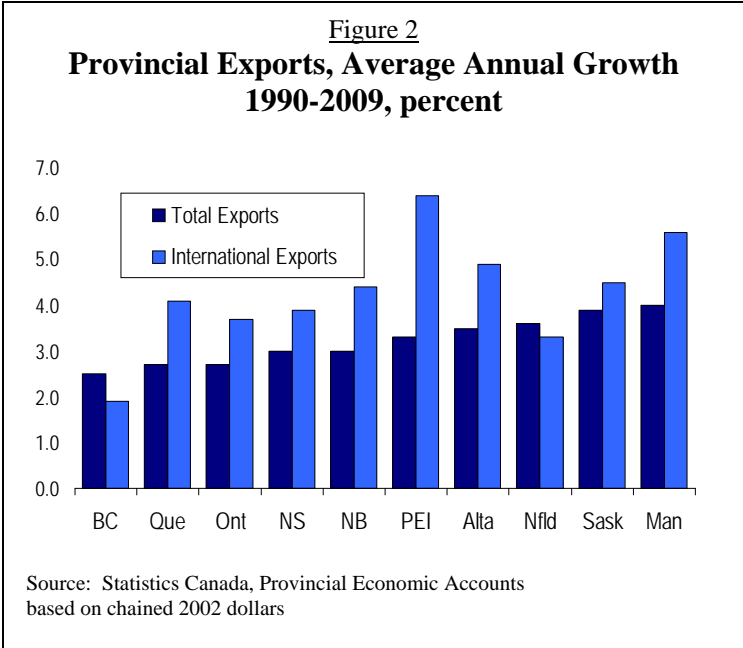
most limited “export base” among all provinces. Exports of goods and services amount to 44% of economic activity,⁴ whereas the comparable figures for Quebec, Ontario and Saskatchewan are 54%, 63% and 67% respectively.



⁴ The figure cited refers to exports of goods and services to other countries and to the rest of Canada.



In addition to “punching below its weight” in overall exports, a second fact to note is that BC’s export sector has grown quite modestly over the past two decades. Since 1990 the value of exports has risen, on average, by only 2.5% per year measured in real, inflation-adjusted terms. (Exports include interprovincial as well as international exports of goods and services.) This ranks as the weakest export expansion among all provinces. Although the gain in total exports is slightly behind Ontario and Quebec, the gap between BC and the other provinces is more pronounced when one looks at trade in international



markets. BC’s average growth of international exports over the same time period is an anemic 1.9% per year, half the pace recorded in almost every other province. Despite our strong orientation to the dynamic Asia Pacific region, British Columbia and Newfoundland were the only two provinces where the growth in international exports lagged the growth in interprovincial exports, further underscoring the need to bolster BC’s commercial position and presence in the international arena.

3. Business Investment

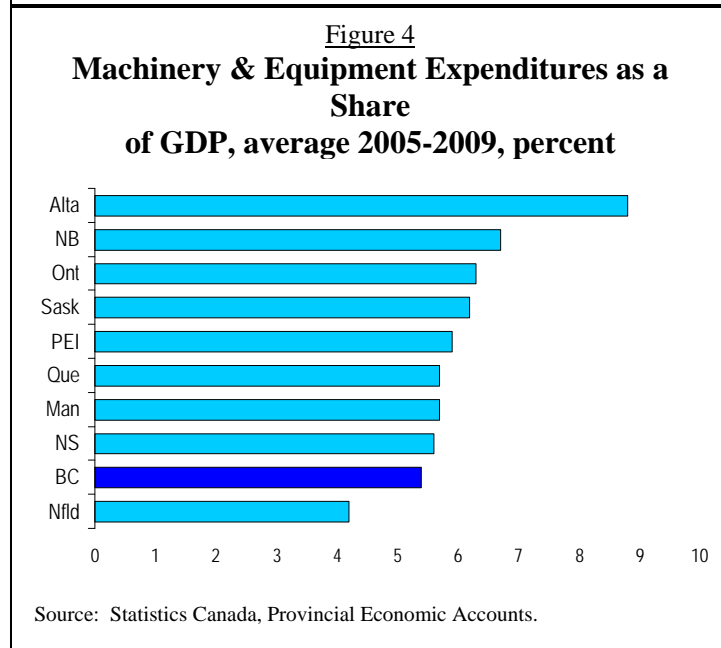
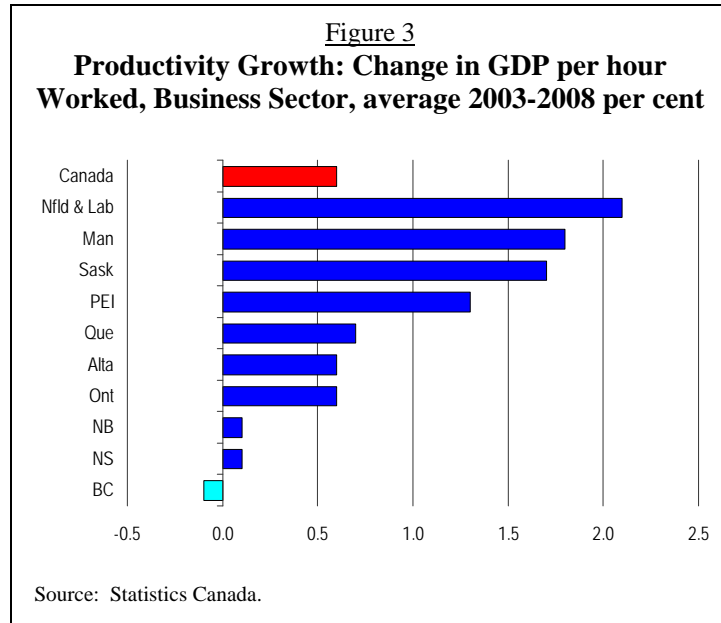
Removing taxes on business inputs means that BC companies no longer pay sales tax on capital equipment, new process technologies, vehicles, fixtures, legal services, building materials, and a host of other inputs used to operate and grow their businesses.⁵ Reducing the cost of capital inputs is important. For the individual firm, it strengthens the economic case for investing in machinery, equipment, new structures, advanced communications and

⁵ Under the PST system, certain types of machinery and equipment were exempted from tax for qualified companies in the manufacturing, mining and oil and gas sectors. Note that even with these exemptions, businesses operating in BC collectively paid \$2.4 billion in PST on capital and other inputs in 2009.



process technologies. A large body of Canadian research confirms that investments in machinery, equipment and advanced telecommunications and process technologies are a key driver of productivity improvements in the business sector.⁶ It is widely recognized that Canada’s productivity record is poor in relation to most other advanced countries. What is less often noted is that within Canada, BC stands out as a productivity laggard. Recent data show that BC’s business sector productivity actually declined in absolute terms over the 2003-2008 period, while productivity increased in all other provinces. It must be emphasized that boosting productivity is not a function

of men and women working longer hours; rather, it involves “working smarter” and ensuring that employees have access to appropriate tools, technologies, plant and equipment – in other words, that workers are able to draw on the advantages provided by an up-to-date and efficient capital stock.



⁶ Aled ab Iorwerth, “Machines and the Economics of Growth,” Department of Finance Working Paper (March 2005); Andrew Sharpe and Jean-Francois Arsenault, The Canada-US Investment Gap: An Update, Centre for the Study of Livings Standards, Ottawa (February 2008).



While the reasons for BC's decidedly mediocre productivity record are multifaceted and complex, part of the explanation lies in relatively low levels of investment in machinery, equipment and advanced process technologies. The available data indicate that investment in machinery and equipment is generally at the low end of the provincial spectrum. For this reason, any policy that reduces the cost of capital and encourages investment in machinery, equipment, and advanced communications and process technologies is welcome – indeed, we believe a stepped-up pace of investment in these areas will be critical to assuring BC's future prosperity.

3. Impact on the Provincial Budget

In this section we offer a few high-level comments on the HST's impact on the provincial budget, focusing on fiscal policy issues that have not received much attention to date in the debate over the HST. The points below are motivated by a concern over longer-term impacts and the overall stability and growth of tax revenue, rather than on the particular details around near-term budgetary balances.

When thinking about the budgetary implications of the HST and its role as a provider of government revenue, it is useful to keep in mind the industrial structure of the provincial economy. Like all advanced economies, BC is becoming more services oriented. Personal expenditures on services have grown at an average annual rate of 6.4% over the past two decades (based on nominal increases which reflect the tax base), while spending on goods has increased by 4.9% on average. Since spending on services will probably continue to grow more rapidly than spending on goods, it makes sense to retain the broader tax base of the HST, instead of reverting to the narrower base of the former PST. The HST includes the consumption of most services, whereas the PST's tax base was skewed heavily towards goods – which represent a diminishing share of overall consumer outlays. Not only is there no sound economic or tax policy rationale for imposing a “consumption” tax on goods while exempting services, but a strong case exists for maintaining a broad, well-diversified tax base. The narrower the tax base, the higher the rate of tax required to raise a given amount of revenue, and the more that tax policy will end up distorting the economic decisions made by businesses and consumers.



A related issue is the inter-temporal stability of tax revenue. Sales taxes provide a steady and predictable source of revenue for any jurisdiction, including BC.⁷ Both corporate and personal income taxes experience large fluctuations over the business cycle, whereas consumption taxes generally don't. In fiscal 2009-2010, for instance, provincial corporate tax revenue collected by the BC government plunged 35% from the previous year, while revenues from personal income taxes dropped 9%. In comparison, sales tax revenues dipped by only 3.8%. In the BC context, revenues from natural resource industries and from Crown corporations are also quite volatile – significantly more so than revenues from consumption-based taxes.⁸ While the former PST also generated a fairly predictable flow of tax dollars, the broader tax base under the HST promises greater revenue stability, in part because spending on services does not fluctuate as much as spending on goods. In the 2009 recession, for example, nominal consumer outlays for durable, semi-durable and non-durable goods declined by 6.1%, 3.4% and 1.3%, respectively. On the other hand, spending on services continued to grow (albeit more slowly than prior to 2009), rising by 6.1%. While these points may seem minor, and the issue of revenue stability is perhaps less visible than the need to repay \$1.6 billion to Ottawa in the event that the HST is rescinded, from a long-term perspective good public policy should seek to fashion a stable and reliable tax base to enable future governments to effectively manage the province's finances.

3. Additional Comments

Critics of the HST often suggest that any benefits which it provides to businesses come at the expense of individuals and families. While the impact of the HST on households is not the focus of this submission, a few comments on this topic are warranted. In particular, we want to draw the Panel's attention to the recent analysis by Professor Jonathan Kesselman. One significant conclusion emerging from his review of BC's experience is that while the

⁷ Robert Carroll and Alan D. Viard, "Value Added Tax: Concepts and Unresolved Issues," Tax Notes (March 1, 2010); Alan J. Auerbach, "The Choice Between Income and Consumption Taxes: A Primer," Institutional Foundations of Public Finance: Economic and Legal Perspectives, Volume 13 (2008).

⁸ In BC, resource-related revenues fell by 30% between 2008-2009 and 2009-2010.



HST does involve a tax shift to consumers, it is not nearly as large as many people seem to believe. The reasons for this are twofold.

First, for the majority of consumer spending, the sales tax rate has not actually changed – i.e., the introduction of the HST did not affect the rate of sales tax for about 80% of all consumer outlays. The second reason is that in a competitive economic environment, businesses pass the savings on input taxes through to consumers, as is clear from the experiences of other Canadian jurisdictions with HST-type sales taxes.

In his recent paper, Kesselman, concludes that since July 2010 BC businesses “have in fact passed through to consumers large amounts of their tax savings with the HST.” He also determines that the overall impact of the HST on “prices including taxes paid by consumers is very modest”⁹ Kesselman estimates that, as a result of the HST, the average BC consumer is spending just one additional dollar for every \$165 in overall outlays on goods and services. Importantly, there are HST-related cost savings for several categories of consumer spending (albeit higher tax-inclusive costs in other areas). Just six months after implementation, Kesselman finds that a surprisingly large fraction of the reduced business costs flowing from the HST have been passed through to domestic consumers. This finding is mirrored in the recent experience in Ontario, and it is also consistent with the evidence from other provinces which previously moved to fully or largely harmonize their sales taxes with the federal Good and Services Tax.¹⁰

Another point made in Kesselman’s paper on the impact of the HST on consumers is that low-income households are actually better off under the HST than they were with the PST/GST structure. The tax credits available to low- and modest-income households are the main reason for this. It also turns out that the price reductions resulting from the flow-through of tax savings to BC firms are greatest in areas where low-income households spend proportionally more of their budgets than higher-income households. So contrary to what is sometimes alleged, the HST is less regressive than the old sales tax structure.

⁹ Kesselman, (January 2011).

¹⁰ See Michael Smart, “Lessons in Harmony: What Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax,” C.D. Howe Institute (July 2007).



Another point that we urge the Panel to consider in preparing its report is the cost to businesses of having to return to the dual PST/GST system. Apart from a significantly higher administrative and compliance burden from reverting to two distinct sales tax systems, there would be costs associated with requiring many tens of thousands of BC businesses to reprogram accounting, billing and invoicing systems. We are aware of some larger companies that spent several million dollars converting to the HST system. If the province returns to the PST structure, they will be forced to spend millions more converting their systems again. Many of our member companies have indicated that because the PST/GST structure was more complicated than the HST, it will be more difficult to return to the dual tax structure.

This is not simply a matter of “undoing” the switch to the HST. Although we do not have any firm estimates, it is safe to say that the economy-wide costs associated with another conversion/administrative overhaul of sales taxes in BC would add up to multiple hundreds of millions of dollars for the business sector as a whole. On top of this is the damage likely to be done to British Columbia’s reputation as a place to invest and do business if the existing (and fairly new) sales tax regime is thrown out and the previous system is restored in its place. Such a wrenching change to a key part of the overall business tax structure is sure to be viewed in a very negative light by investors and companies outside of the province. From our perspective, it would be very unfortunate to incur all of these negative economic consequences to reinstate an antiquated tax regime that will dampen investment, impose higher costs on most businesses (including virtually all exporters), and lead to weaker employment and productivity growth over the medium term.

4. Conclusion

When the provincial government announced its intention to harmonize the provincial sales tax with the federal GST, the Business Council characterized it as “the most important provincial tax reform measure in a generation.” From our perspective this assessment remains accurate. If the goal is to build a more productive and globally competitive British Columbia economy, the HST has a vital role to play.



A reality that has seldom been mentioned in the HST debate is that the provincial government actually has relatively few policy levers available to attract investment, foster the growth of high-paying private sector jobs, and enhance BC's competitiveness. The design of the consumption tax regime is one area where the province has the capacity to shape the economic environment in a positive way. The HST, arguably, is the single most important step the province can take to directly make our exporters more competitive and stimulate capital investment. Given BC's underperformance in both of these areas, we believe it is particularly important that the HST remains in place.

Finally, although the Panel is not explicitly seeking input on strategies to retain the HST, we wish to highlight a suggestion first advanced by Professor Kesselman to reduce the HST by one percentage point. A one-point reduction in the provincial portion of the HST – bringing the overall tax rate to 11% – would essentially eliminate any price impact from the HST on domestic consumers; that is, on average BC households, in their economic role as consumers, would not be adversely affected by the shift from the PST to the HST. A lower tax rate may also have the further benefit of lessening any remaining consumer antipathy toward the tax.
