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A Note on Business Tax Competitiveness in British Columbia

It's slightly more than one year since BC scrapped the Harmonized Sales Tax (HST) and returned to the former Provincial Sales Tax (PST) as the main tax on "consumption" in British Columbia. Now is therefore an opportune time to step back and assess the broader business tax structure and its impact on BC's attractiveness as a place to invest and do business. This issue of Policy Perspectives considers several features of the tax system that impinge on business investment, expansion, and job creation. We do not examine the taxes paid by households – the focus here is on taxes that apply to enterprises and business activity.

What is a Competitive Tax System?

Competitiveness is a much discussed but somewhat elusive economic concept that defies simple measurement. The World Economic Forum (WEF) defines it as "the set of institutions, policies and factors that determine the level of productivity of a country."[1] Productivity matters because it largely determines the material standard of living of any jurisdiction. In its annual Global Competitiveness Report, the WEF produces data on what it classifies as the "12 pillars of competitiveness," covering more than 100 countries.[2] An individual country's ranking relative to its peers is a weighted average of its performance across the various pillars.

Of interest, the WEF does not treat the tax system as a distinct "pillar;" instead, taxes are judged to be important insofar as they influence competitiveness through their impact on the 12 pillars. For example, the design of the tax system (and the overall tax burden) may affect the level and composition of private sector innovation; investments in infrastructure, technology, and skills training; and business strategy and sophistication. In a real-world commercial context, taxes help to shape the decisions that companies make about where, when and how much to invest; what specific assets to build or acquire; the capital structure (i.e., the mix of debt and equity on a firm's balance sheet); the production process (the use of inputs, including capital, labour and technology); and whether to take the risks involved in trying to expand a business.

The globalization of economic activity and the progressive liberalization of trade and capital markets have increased the competitive pressure on both companies and countries/regions. One sign of this is the growing importance of foreign investment in national and regional economies. Among the advanced OECD economies as a group, the stock of outward

[1] WEF, Global Competitiveness Report, 2011-12.

[2] The 12 "pillars" are: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development and sophistication, technological readiness, market size, business sophistication, and innovation.

foreign direct investment almost quadruped between 1990 and 2010, rising from 10% to 39% of GDP over the period. Increasingly, investors – and the companies they invest in – want to maximize their post-tax returns and are inclined to consider multiple locations when looking to deploy capital. These trends have significant implications for the design of tax policy, particularly in small jurisdictions like British Columbia that rely on external sources of finance for a substantial portion of private sector investment.

Corporate Income Tax

The good news is that British Columbia maintains a competitive income tax structure for the business sector. Statutory corporate tax rates (CITs) on business profits/net earnings are very reasonable by North American standards. And the applicable small business income tax rate is exceptionally low – BC charges only 2.5%, on top of the 11% rate set by the federal government. Table 1 provides the details on general business income tax rates for the ten provinces as well as the relevant federal government rate.

In thinking about the corporate income tax, it is helpful to look beyond statutory tax rates and consider how various tax credits, deductions and incentives may affect the actual amount of tax paid by businesses. One way to get a handle on this is to compute the average "effective corporate tax rate" on business income. For most companies that reach the point where the lower preferential small business tax rate no longer applies, the effective tax rate will differ from the statutory rate because of the role of tax deductions, credits, exemptions, incentives and other tax provisions.

Table 1
Federal/Provincial Tax Rates for General Corporations*
(January 1, 2014)

Basic federal rate	15.0%
British Columbia	11.0%
Alberta	10.0%
Saskatchewan**	10.2%
Manitoba	12.0%
Ontario**	11.5%
Quebec	11.9%
New Brunswick	12.0%
Nova Scotia	16.0%
Prince Edward Island	16.0%
Newfoundland**	14.0%

* small business income tax rates are lower

** these provinces levy a lower corporate tax rate for income derived from manufacturing and processing

Source: KPMG

Table 2 provides one set of recent estimates of the average effective corporate income tax rate in four industry sectors: food processing, aerospace, R&D intensive companies, and corporate services. The data are taken from a KPMG analysis done for the BC government's Jobs and Investment Board.[3] As shown, BC is quite well positioned based on this particular concept of corporate tax competitiveness and scores particularly well vis-à-vis many US jurisdictions. The KPMG study notes that the computed effective income tax rates ignore discretionary incentives and other targeted tax measures that some jurisdictions use to attract business activity. Only statutory tax

[3] Global 360: Attracting Investment in an Increasingly Competitive World, Final Report of the BC Jobs and Investment Board, 2014, Appendix 2.

Table 2
Estimated Effective Corporate Tax Rates in Selected Industry Sectors*

	Food processing	Aerospace	R&D Industry**	Corporate Services***
BC	22.2%	14.4%	0%	20.4%
Alberta	22.2%	15.9%	-16.6%	24.6%
Manitoba	11.3%	15.3%	-37.1%	26.6%
Ontario	22.9%	18.1%	0%	24.7%
Quebec	20.4%	17.9%	-21.7%	17.1%
Seattle, WA	26.1%	27.3%	18.6%	34.6%
Portland, OR	31.1%	33.7%	25.8%	41.2%
San Diego, CA	32.6%	33.2%	18.7%	40.4%

* negative numbers mean the refundable tax credits are greater than the taxes that would otherwise be paid and where the tax rules allow the difference to be remitted to the firm

** based on three R&D intensive sectors

*** based on two corporate service sectors

Source: KPMG analysis for the BC Jobs and Investment Board.

provisions – i.e., tax rates, capital cost allowances, and generally available credits and deductions – were included in the analysis. Many American states use targeted tax incentives (as well as direct, firm-specific subsidies) in an effort to lure business investment and to “close deals.” British Columbia tends to eschew such fiscal tools. This means that a given company considering an investment opportunity in BC versus American locations is unlikely to actually face the effective US corporate tax rates reported in Table 2.

Marginal Effective Tax Rates

We also consider a different and – as seen by economists, a more accurate – measure of tax competitiveness for the business sector: the marginal effective tax rate (METR). The METR seeks to capture the impact of a variety of taxes and tax rules on a marginal or incremental dollar of capital investment, and then to relate this to the cost of capital for business firms. The focus is not just on the taxes that are paid once an enterprise begins to generate sales revenue and profits; METR calculations also consider the up-front costs of making an investment – including financing costs, and the cost of taxes on both materials and services used to construct facilities and the purchase of equipment and other inputs needed to start a business. Most METR estimates capture the effects of statutory income tax rates; the impact of deductions, credits, generally available tax incentives, depreciation rules, and other factors which influence the amount of income tax companies pay; capital taxes; sales taxes on building materials, equipment, and other business inputs; and certain commodity taxes (e.g., on fuel). Business property taxes are also counted in some METR computations.

Under the METR method for determining the tax burden on an incremental dollar invested, taxes affect not just the after-tax revenues and profits received by firms, but also the cost of undertaking a particular investment. As an example, BC’s current sales tax, the PST, increases the cost to companies that invest in or otherwise purchase some forms of capital, such as equipment, vehicles, and communications technologies. The PST also pushes up the cost of construction and building materials that companies purchase when undertaking improvements or expansions of their facilities and operations. On the other hand, tax allowances (such as capital cost allowances or investment tax credits) and generally available tax credits (such as for R&D) can reduce the cost of an investment, thereby making it more attractive. Ideally, a comprehensive METR calculation should also incorporate information on inflation, interest rates, the extent of leverage on the firm's balance sheet, the rules governing the treatment of inventory, and assumptions concerning the actual "economic life" of different types of assets.[4] Regardless of what's included in the measure, METRs differ across industries and types of assets acquired by firms. However, the basic METR methodology makes it possible to compute an "average" METR for the entire business sector as a summary indicator of a jurisdiction's tax-related competitiveness from the perspective of profit-seeking enterprises.

Table 3 reports the average business sector METRs for 2013 for the ten provinces, Canada and a few other countries, based on the analytical model pioneered by Canadian economist Jack Mintz – who is recognized as a leading global expert in the field of public finance.[5] Using this particular METR methodology, BC has experienced a sharp erosion of its competitive position vis-à-vis other jurisdictions – in fact, we now have the heaviest business tax burden in Canada according to an all-in METR calculation. The decline in BC's tax competitiveness since 2011-12 is almost wholly due to the return of the PST, which has boosted the sales taxes that companies must pay on a wide range of business inputs.

Table 3
Average (All-Industry) Marginal Effective Tax Rates, Selected Jurisdictions, 2013

US (national average)*	35.3%
British Columbia (Note – it was 17.8% in 2012)	27.5%
Manitoba	26.2%
Australia	25.9%
UK	25.9%
Germany	24.4%
Saskatchewan	24.3%
Canada (national average)	18.6%
Ontario	18.2%
Alberta	17.0%
Quebec	15.2%

* actual METRs vary by state

Source: J. Mintz and D. Chen, School of Public Policy, University of Calgary, November 2013.

The three Canadian provinces with the highest average METRs are BC, Manitoba and Saskatchewan. As it happens, the tax systems of all of these provinces share one attribute: "The common feature…is having a conventional retail sales tax, which is not based on value added and, hence, is not refundable when it is applicable to [business purchases of] capital inputs such as building materials, machinery and equipment as well as intermediate goods…"[6]

[4] The economic life of an asset typically differs from the deprecation rate used for accounting purposes.
[5] D. Chen and J. Mintz, "2013 Annual Global Tax Competitiveness Ranking: Corporate Tax Policy at A Cross-roads," School of Public Policy, University of Calgary, SPP Research Papers, Volume 6, Issue 35, November 2013.
[6] Ibid., p. 20.

Other Elements of the Business Tax Environment

The consultative and analytical work done by the BC Jobs and Investment Board highlighted several aspects of the tax structure that bear on the province's appeal as an investment location. Three are briefly noted below: the PST (already discussed), the carbon tax, and business taxes in the municipal domain.

PST: As already noted, the re-establishment of the PST has pushed up the METRs for most industry sectors in BC. Overall, the PST has raised the total cost of producing goods and services in the province by well over $1 billion per year, compared to the situation that prevailed under the previous HST system. According to estimates provided by the Expert Panel on BC's Business Tax Competitiveness, the return of the PST has resulted in a marked increase in average METRs across a host of industry sectors, with some of the biggest increases occurring in communications, construction, professional services, transportation, resources, and manufacturing.[7]

Carbon tax: BC is unique in North America in having legislated a broadly-applied tax based on the carbon content of fossil fuel products consumed by businesses and households. The carbon tax generates roughly $1.2 billion in annual revenue, of which around half is paid by businesses.[8] A portion of the carbon tax revenue raised from businesses is "returned" to the business sector via lower corporate and small business income tax rates (and a higher income threshold for applying the preferential small business tax).[9] However, in net terms the carbon tax has increased the tax burden on the business community. Moreover, as noted by the Jobs and Investment Board, the carbon tax is a significant competitive issue, "especially for energy-intensive, trade-exposed industries" that are disproportionately hit by the escalating energy costs for which BC's carbon tax is partly responsible.[10] In fact, the Jobs and Investment Board recommended that the government "modify" the carbon tax so as to enhance the competitiveness of BC's natural gas, mining and transportation sectors.

Municipal taxation of business: In common with other provinces and states, in BC local governments also impose various taxes on the business sector, of which the most important is property tax. Municipal taxation has become a higher-profile concern for the business community in the past decade or so. In practice, the main problems stem from the province's complex property tax

[7] Report of the Expert Panel on BC's Business Tax Competitiveness, August 2012, p. 20.

[8] 2014 BC budget, pp. 64-66.

[9] The government misleadingly claims that, as part of its "revenue-neutral" carbon tax policy, the revenues derived from the carbon tax are also being used to finance a variety of other tax measures that benefit business in BC, including the film and digital media tax credits, the training tax credit, and the scientific research and development tax credit. The problem with this claim is that these tax incentives were conceived, introduced and thus notionally funded **prior to the adoption of the carbon tax in 2008**. It should also be noted that the two-point reduction in the provincial corporate income tax rate announced at the time of the carbon tax was partially reversed with the government's decision to hike the CIT rate from 10% to 11% in the 2013 BC budget.

[10] Global 360: Attracting Investment in an Increasingly Competitive World, Final Report of the BC Jobs and Investment Board, 2014, p. 9.

system (consisting of nine classes) and the fact that municipal governments have essentially unfettered scope to set tax rates and ratios between property classes with no oversight or control by the provincial government. This has led to a situation where, in some communities, local governments are levying an unfair and manifestly disproportionate share of the property tax burden on certain classes of business – notably capital-intensive resource and manufacturing industries (class four) and utilities (class six). As a result, we see punitively high tax rates on capital-intensive facilities in certain BC communities, coupled with enormous variation across municipalities in the property tax burden born by different industries (and often by similar companies in the same industry depending on where their operations are located). A more general problem with the current local government property tax regime in British Columbia is that non-residential business property tax rates tend to be higher here than in other provinces when compared to the prevailing residential property tax rates. In aggregate, municipalities in BC have used the flexibility afforded to them by provincial legislation to shift a bigger portion of the property tax burden on to the business sector (and less on to the household sector) than is typically the case elsewhere in Canada.[11] Arguably, this detracts from BC's competitiveness relative to many other jurisdictions.

Conclusion

In some ways, BC is not badly positioned when it comes to the competitiveness of the tax system as it applies to business. Statutory corporate tax rates are quite low – and for small businesses, very low. The carbon tax has increased the tax-inclusive cost of energy for business, but this has been mitigated through a slight reduction in business income tax rates (although it must be noted that energy-intensive industries in BC have been put at a net competitive disadvantage owing to the government's carbon tax policy). The province maintains a handful of tax incentive programs aimed at particular sectors that have helped to attract capital and employment. Municipal property tax remains an area of concern for some Business Council members, but the problems are concentrated in a minority of communities and primarily affect a limited number of industry sectors.

All of that said, there is no denying that the shift back to the PST has fundamentally altered the competitive landscape. Put bluntly, the PST in its existing form has made it more difficult to attract private sector capital to BC. With the PST back in place, the average marginal effective tax rate on business has climbed sharply and BC has ended up with the highest average METR burden in the country. As the Expert Panel observed, companies in BC now face "a significant additional cost on investments" to build, expand and run their operations, which in turn "make[s] it harder for them to remain competitive and preserve and create jobs" in the province.[12]

Looking beyond the realm of taxation, British Columbia does enjoy some non-tax competitive advantages – among them a relatively healthy fiscal position, abundant natural resources, decent infrastructure, a

[11] As noted by the report of the Expert Panel on BC's Business Tax Competitiveness (p. 52).

[12] Ibid.

high quality post-secondary education system, and a favorable geographic position facing the dynamic Pacific Rim region. But there are non-tax competitive disadvantages as well, such as high land and housing costs in urban areas, exceptionally complex and costly regulatory processes for resource-based industries and infrastructure providers, steadily rising costs in the municipal government sector, escalating energy costs, and intense competition from other Western provinces for skilled labour. All in all, BC cannot afford to ignore tax competitiveness as an important factor shaping the environment for private sector investment, job creation and growth. As part of our ongoing work on strengthening competitiveness, in the coming months the Business Council will be advancing specific ideas to improve the tax structure for business and industry in the province.

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and Chief Policy Officer