Canadian Manufacturers & Exporters BC

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# Provincial Pre-budget

# Submission

# To the Select Standing Committee on Finance and Government Services

***October, 2017***

# Contents

# 1 Introduction

Please accept this submission to the Select Standing Committee on Finance and Government Services on behalf of Canadian Manufacturers & Exporters.

Canadian Manufacturers & Exporters (CME) is Canada's largest trade and industry association, and the voice of manufacturing and global business in Canada.

Founded in 1871, CME represents more than 10,000 leading companies nationwide, and – through various initiatives, including the establishment of the Canadian Manufacturing Coalition – touches more than 100,000 companies from coast to coast, engaged in manufacturing, international trade, and service-related industries. More than 85 per cent of our members are small and medium-sized enterprises.

Collectively, CME's membership network accounts for an estimated 82 per cent of Canadian manufacturing production and 90 per cent of all goods and services exports.

Manufacturing makes a significant contribution to British Columbia's economy and the prosperity of its citizens, and is the third largest contributor to the provincial economy generating $45.8 billion in sales. More than 66 percent of the Province's exports are manufactured goods. Manufacturing provides well-paying, high-skilled employment opportunities to more than 170,000 people across the Province with wages that are 15% higher than the provincial average and totaled $11 billion in 2015.

This submission consists of three parts. An overview of the economic and budget issues of concern to the CME along with detailed analysis on two specific issues that CME would like the committee to consider.

# 2 Overview

This overview is prepared taking into account the September 11 provincial budget update along with other indications from the government about future direction. These indications were in both the party platform and in the pre-budget consultation document.

This September 11 budget update implemented a relatively stable and responsible approach to a new direction. Although CME has some concerns about these new directions there has been no 'jerking of the wheel' or abrupt measures that could surprise or create a significant negative impact for business in the short term. There are, however, still some issues that could create nervousness in the longer term.

The province has used relatively conservative analysis within its fiscal projections and there is a clear intent to account for any obvious risks in the economic forecast. However, there are two concerns that CME would like the government to consider in future projections. The first is the internal risk to the economy that could be created by increased taxation. The increased carbon tax in particular, when combined with other measures around pipelines and related projects may have a long term negative impact on revenues from energy related resource industries and from energy intensive industries. This could, in turn, cascade negatively on related government revenues.

The second issue to consider is the impact of future expenditures. The government has made commitments to significant expenditures to address a variety of social concerns. These include housing issues, education issues and child care issues. These are commitments that the government has not yet had time to budget appropriately. Once these initiatives have been analysed in terms of the cost they represent to the government, the revenue to pay for them might require increased taxation. This in turn would create a drag on economic growth.  This should be accounted for in economic projections.

There are some measures in within the budget that will have a positive economic impact for manufacturers. In particular, the CME would like to commend the government for maintaining the commitment to remove the PST on electricity for industry. This is a significant issue for high energy using manufacturers in trade exposed industries.

Other potentially positive measures include decreasing the MSP by half which will reduce costs for those businesses which pay the MSP for their employees. The reduction of the Small Business Income Tax is also a positive move.

CME is however concerned by other elements of the budget update. We have already mentioned that planned future expenditures could lead to tax increases. We are concerned about the ongoing, incremental increases in the cost of doing business. Government has already announced the increase of corporate income tax from 11% to 12% and the increase in the carbon tax by $5 per tonne per year for the next four years. Because government plans seem to require the need for greater revenue in the future the, worry is that these measures presage ongoing, incremental increases costs to business and the cumulative impact on competitiveness could be significant.

# 3 Pre-Budget Consultation Questions

The province raised three questions in pre-budget consultation document. The CME would like to address two of these questions.

## 3.1 What are your top priorities to make life more affordable in British Columbia

The Provincial Sales Tax (PST) has an important, but often hidden, impact on affordability because it generates costs at every stage of the production process that then get passed on to consumers.

The PST constitutes a significant disadvantage when compared to other jurisdictions. This is reflected in the rate at which BC's manufacturing industry invests in machinery and equipment. This rate is far lower than the rest of Canada, which in turn lags the investment rate in the rest of the OECD.

The PST is a tax on production while a Value-added Tax (VAT) is a tax on consumption. It adds tremendous operating costs compared to jurisdictions operating under a VAT. It is estimated that businesses pay $2.5 billion in PST on operating expenses. That represents 1.4% of all expenditures and 10% of profits. This only represents the direct cost. There are also complex reporting requirements and other hidden costs that are particularly challenging for smaller operations.

Attached to this pre-budget submission is a detailed position the CME has prepared on the PST (see Supplement B). Within it the CME has made recommendations that call for the province to transition to a Made in BC VAT. Transitioning could include short term steps including removing the tax on machinery and equipment and other business inputs. The CME recommendations echo those of the 2016 Commission on Tax Competitiveness.

## 3.2 What are your ideas, approaches and priorities for creating good jobs and to build a sustainable economy in every corner of the province?

Canadian Manufacturers & Exporters would like the BC government to reinvest carbon tax revenue in a BC SMART Green initiative that will help manufacturers become more environmentally sustainable and internationally competitive.

Such a program would be funded by the proposed increase to the carbon tax and would offer matching grants for companies to make an investment in improving environmental performance. Qualifying investments would include both assessment of existing baselines and capital projects.

The SMART Green program has been very successful in Ontario. Since October and for an expenditure of $3.5 million it has already generated $33 million in investment.

For a more detailed submission on the CME SMART Green program please see Supplement A.

# 4 Concluding Recommendations

Canadian Manufacturers & Exporters would like to make three broad recommendations to the Standing Committee on Finance.

1. Refrain from implementing ongoing, incremental increases to business taxes that render them non-competitive.
2. Implement stepped changes to the PST in the near term that reduce its impact on business inputs and hence business competitiveness and in the long term move to a ‘made-in-BC’ Value-added Tax
3. Implement a SMART Green program in BC that uses carbon tax dollars to incent industry to make capital investments that create efficiency and reduce environmental footprint.

# 5 Supplement A: A Smart Green Program for BC Manufacturers

## 5.1 Introduction

Like all manufacturers across Canada, BC manufacturers have worked hard to reduce emissions. Canada-wide, the sector has reduced CO2 emissions intensity by 30 per cent since 1990. BC has been a national leader because of the introduction of the carbon tax. In a 2015 study the Carbon Tax Centre found that:

> *The 12.9% decrease in British Columbia's per capita emissions in 2008-2013 compared to 2000-2007 was three-and-a-half times as pronounced as the 3.7% per capita decline for the rest of Canada. This suggests that the carbon tax caused emissions in the province to be appreciably less than they would have been, without the carbon tax.*

Tackling emissions however is becoming more challenging. The initial steps encouraged by the carbon tax were relatively easy and new measures will come at an increasing cost. This will significantly impact manufacturing as a trade-exposed industry that must compete worldwide.

As the province undertakes its plan to increase the carbon tax in British Columbia it must examine how this will impact on the competitiveness of the manufacturing industry. To minimize any harm to our economy, it must consider new policies that will assist industry to address these impacts and still meet or exceed the emissions targets.

CME released its landmark study Industrie 2030 in in October of 2017 and it noted:

> *Given the importance of technology adoption for the long-term competitiveness of Canadian manufacturing, for reducing the environmental footprint, and how far Canadian firms in general lag their competitors in this area, it is critical that government and the private sector work together to accelerate the adoption of a range of advanced manufacturing technologies.*

To help achieve this Industrie 2030 has stated that Canadian governments should:

> *Reinvest all federal and provincial carbon-pricing revenues back into offsetting the cost of purchasing new technologies and M&E.*

**RECOMMENDATION:**

That the BC Provincial Government implement a SMART Green program in British Columbia that provides matching grants to manufacturers to invest in technology and equipment to:

- improve environmental performance,
- mitigate costs associated with carbon reduction and
- improve competitiveness.

## 5.2 SMART Green Program Details

### 5.2.1 Background

In 2016, CME partnered with the Ontario government to develop a SMART Green Program that provides matching grants to manufacturers to invest in technology and equipment to address environmental issues. There are indications that the province of Alberta will implement a similar program.

A BC SMART Green Program would build off the Ontario model and be tailored to the specific needs of our BC manufacturing sector.

### 5.2.2 Program Objective

A BC SMART Green program would support investments in technology and process improvements by manufacturers which result in greenhouse gas emissions intensity reductions per unit of output, improved energy efficiency and improvements in productivity and competitiveness.

The SMART Green program would be open to all manufacturers in the form of non-repayable grants of 50% of eligible costs up to $500,000. The program would improve the competitiveness of the BC manufacturing supply chain by delivering value to eligible manufacturers. It would also contribute to BC's overall emissions reductions goals.

This program would support investments in technology and process improvements by manufacturers which result in GHG emissions intensity reductions and/or avoidance through upgrades to process/production equipment, deliver energy efficiency, and lead to productivity improvements, which in turn lead to lower GHG emissions on a per-production-unit basis.

### 5.2.3 Program Assessment Requirements and Funding Details

Project applications would include a current verification report demonstrating actual baseline GHG measurements. Companies without a current report could apply for SMART Green Assessment funding assistance to work with a Qualified Technical Service Provider (QTSP) who would conduct a verification audit of current GHG emissions and energy usage.

Based on our learnings in Ontario, the CME recommends applicants can receive 50% of eligible costs to a maximum of $25,000 for an assessment and $500,000 for a qualified capital project. These are the thresholds that will align with the Ontario program.

Given that CME already has the structure in place to deliver such programs, it’s estimated that program delivery cost would be in the range of five to eight percent.

### 5.2.4 Eligible Assessments and Projects

Manufacturers may apply for assessment funding to obtain GHG measurement and verification reports, conduct energy efficiency audits, or identify GHG and/or energy reduction opportunities. Typical eligible projects could include the following:

- Boiler Right Sizing and Load Management
- Advanced Boiler Controls
- High Efficiency Burners
- Feedwater Economizers
- Boiler Combustion Air Preheat
- Blowdown Heat Recovery
- Automated Blowdown Control
- Condensate Return
- Steam Trap Survey and Repair
- Minimize Deaerator Vent Losses
- Steam System Insulation
- Boiler Tune Up
- Reduced Furnace Openings (Air & Chain Curtains)
- Exhaust Gas Heat Recovery
- Oven/Kiln/Dryer/Furnace Insulation
- Lighting Retrofit
- Advanced Heating and Process Controls
- Optimize Combustion Air Compressor Heat Recovery
- Ventilation Optimization
- Ventilation Heat Recovery
- Automated Temperature Control
- Destratification Fans
- Warehouse Loading Dock Seals
- Minimize Door Openings
- Process Integration and PINCH Analysis
- Energy Management
- Solar Walls
- Reduce Boiler Steam Pressure
- Condensing Boiler
- Radiant Heaters
- Condensing Economizers
- Direct Contact Water Heaters
- Burn Digester Gas in Boilers High-efficiency Ovens & Dryers
- High-efficiency Furnaces
- Regenerative Thermal Oxidizers
- Process Heat Recovery
- Process Improvements (i.e. changing cleaning chemicals, set points, exhaust, moisture control, etc.)
- Steam Leak Repairs
- Improved Building Envelope
- High Efficiency Heating Units
- Gas Turbine Optimization
- Steam Turbine Optimization

## 5.3 SMART Green Program Experience

The CME's SMART program began with $25 million dollars allocated in the 2008 Ontario provincial budget. Since that time the program has evolved to include support from federal economic development agencies FedDev Ontario and FedNor.

To date, CME SMART Program, through various configurations, has administered funding to more than 1,400 projects in Ontario and delivered over $75 million in project support. This investment spurred a total investment of $300 million dollars.

### 5.3.1 SMART Green – Ontario

The latest program, SMART Green, launched October 31, 2016 to support manufacturers who emit less than 25,000 tonnes of GHGs per year. The program provides funding for assessments to identify what projects could be implemented. Funding was available for these assessments at 50% up to $30,000 and could be funded up to 100% of the costs should an eligible project be approved as a result of the assessment.

Capital project funding was available at 50% to a maximum of $500,000 per facility or up to $1,500,000 (capped) for multiple facilities/companies under one parent company.

Since November 1st (official opening of online applications), 81 applications have been received. Of these 81 applications, 43 applications were for assessments where companies had a consultant complete a walk-through of the facility to identify projects and/or complete a baseline of current emissions and 15 are approved capital projects.

Total value of assessments and projects approved to date: $3.5 million, applicants will invest in capital of over $33 million. This represents a significant ROI.

The program launched with 6-month pilot phase. With feedback received from the manufacturers and government, changes were implemented on July 4, 2017.

Changes include:

- Assessment funding amounts increased to 100% up to $30,000 for assessments.
- 50% up to $500,000 for capital projects – multi facility under one parent can have five facilities apply and $1,500,000 in funding
- Electricity projects will be considered
- CME estimates the revised program parameters will support up to 60 projects.

# 6 Supplement B - The Impact of the Provincial Sales Tax (PST) on BC´s Business Competitiveness

## 6.1 Introduction

Investment in new machinery, equipment and technology is perhaps the most important determinant of future success and growth in manufacturing. These investments are directly linked to improvements in productivity which, in turn, attracts new investment to BC and makes our manufacturers more innovative and competitive in domestic and global markets. On top of that, productivity growth is also tied to real wage gains and, therefore, to a higher standard of living for British Columbians.

Business investment is also critical to reversing the trend that has seen Canada's competitive position in manufacturing fall over the years as we lose ground both to emerging low-cost producers like China, as well as to advanced manufacturing leaders like Germany. The good news is that the rise of new and advanced technologies in manufacturing is changing how businesses operate, opening the door for exciting new innovations and growth opportunities for manufacturing in BC and across Canada.

Unfortunately, while Canada lags international standards when it comes to capital investment rates in manufacturing, investment rates in BC lag even the Canadian average. This has serious implications for the future of BC´s economy. While provincial economic growth is relatively strong today, that will not always be the case. In the short term, manufacturers will miss opportunities to invest in innovations and expand their businesses. In the longer term, lagging productivity will gradually erode BC's economic competitiveness, affecting prosperity and living standards across the province.

BC's tax structure is a major factor behind chronic private-sector underinvestment in machinery, equipment and technology. While corporate tax rates in the province are generally competitive – at least within Canada – the structure of the provincial sales tax (PST) is a major deterrent to manufacturing investment and puts the province at a significant competitive disadvantage.

Indeed, the BC Commission on Tax Competitiveness' 2016 paper Improving British Columbia's Business Tax Competitiveness notes that the structure of the PST is the primary reason behind lagging business investment in the province. The Commission recommends significant PST reform – a position strongly supported by Canadian Manufacturers & Exporters and its member companies.

## 6.2 Impact of the PST on BC Businesses

### 6.2.1 Background

In broad terms, there are two types of taxes that government levy – taxes on production and those on consumption. Production taxes include personal and corporate income taxes, while consumption taxes include the federal goods and services tax (GST) as well as harmonized sales taxes in other provinces. The PST is considered to be a tax on production because it taxes business inputs rather than value-added.

The BC provincial sales tax is the third lowest in Canada and there is no competitiveness issue associated with the rate itself. However, certain characteristics of the PST damage the business sector and, most importantly, act as a deterrent to investment in new machinery, equipment, technology and other capital.

### 6.2.2 Specific Impacts

In its 2016 study, the BC Commission on Tax Competitiveness identified four critical channels through which the PST negatively influences businesses in BC:

- It reduces the incentive to invest;
- Its complexity imposes compliance costs on business;
- Its relatively narrow tax base creates economic distortions between industries and a less stable and resilient source of government tax revenue; and
- It increases business operating costs.

#### *6.2.2.1 Business investment*

Capital investment is crucial for long-term economic development. However, BC has one of the highest overall tax rates on new investment when compared to the rest of Canada and indeed to other developed countries.

The main disadvantage arises because the PST is a tax on the production process – it is imposed on machines, equipment, materials, energy and other inputs. For the business sector in general, on average, 81 per cent of the purchase of machinery and equipment is taxable. By comparison, only 7 per cent is taxable under the GST. These taxes increase the cost to businesses of innovating, growing and remaining competitive. Moreover, while some machinery and equipment is exempt from the PST, these exemptions are narrow and their application is confusing.

For BC manufacturers, the PST adds approximately 5.5 per cent to the cost or purchasing new machinery and equipment. By comparison, they pay zero GST on those purchases. The result is that it is more expensive for BC businesses to buy new capital compared to most other provinces. The gap is most stark with neighbouring Alberta where businesses pay no sales tax on M&E expenditures. This gap creates a marked and avoidable disincentive for businesses to locate in the province.

The impact of the PST on capital investment in BC is both stark and demonstrable. Figure 2 illustrates that investment per worker in BC is not only behind the Canadian average, but also the OECD average. In addition, real non-residential investment, as well as real M&E investment (expressed as a percentage of GDP), in BC lag the national average.

Figure 2.[1]

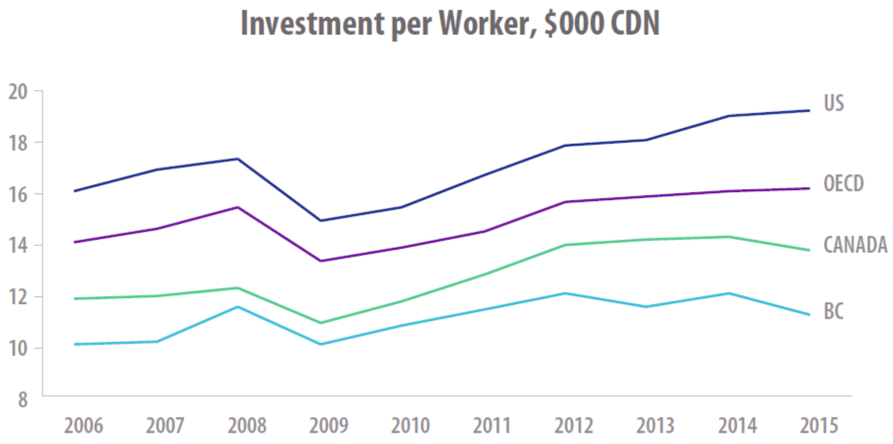
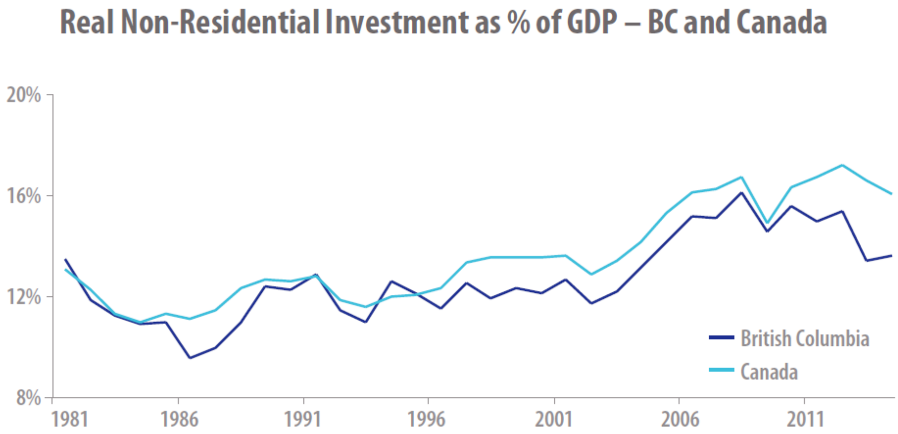
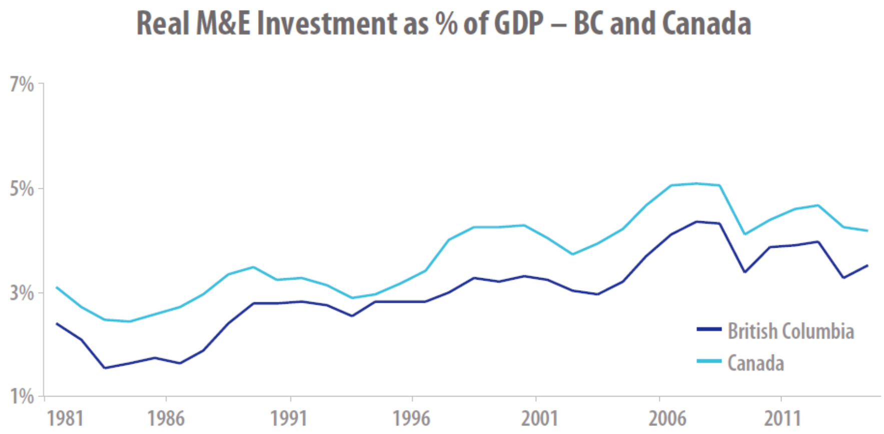



Figure 3.[2]




[1] Retrieved from Commission on Tax Competitiveness 2016.
[2] Retrieved from Commission on Tax Competitiveness 2016.

Figure 4.[3]




One of the main challenges with the PST is that BC is the only jurisdiction in Canada that levies a sales tax on electricity and other sources of energy used by businesses. This creates a significant disadvantage for energy-intensive, trade-exposed industries in the province, such as pulp and paper.

The provincial government has taken steps to address this challenge. In the February 2017 provincial budget, the government announced that the PST rate on electricity will be reduced from 7 per cent to 3.5 per cent in October 2017, and will be eliminated altogether in April 2019. The Ministry of Finance estimates this change will save SMEs about $50 million per year.

This initial measure will help to strengthen and improve BC´s business competitiveness. However, further steps are necessary in order to increase the investment rate.

### *6.2.2.2 Compliance costs*

Another profound disadvantage for BC´s businesses is the complexity of the PST which imposes high compliance costs on companies. The PST has many exemptions and exceptions depending on the type or specific use of the product at hand. In order to find out whether a product is taxable under the PST, retailers and purchasers need to determine for every single item what it is, how it will be used, who will use it and where it will be used. These are complex rules which make it difficult to determine if the tax has been collected and paid appropriately.

Unfortunately, as these compliance costs are concealed, it is difficult to estimate the real financial impact of this hidden tax. One BC manufacturer with revenues of approximately $30 million per year estimated that one individual spent half their working hours managing administration of the PST.

Machinery and equipment exemptions are an example of where the hidden costs create significant administrative challenges. The PST includes some exemptions for M&E purchases, but whether a product is exempt or not depends on the location and use of the item in question. Hand tools for example are not exempt yet are important

[3] Retrieved from Commission on Tax Competitiveness 2016.

to manufacturers. The Commission on Tax Competitiveness' 2016 study points out that a forklift used for products that are being processed is not subject to the tax. However, if the same forklift is used for products that are being transported outside of the plant, that would become subject to the tax and would no longer be considered exempt.

The effort companies spend to ensure they are not in contravention of the law imposes significant costs. This is particularly challenging for smaller enterprises which often lack the resources needed to absorb those costs. This compliance burden also acts as a disincentive to the establishment of new enterprises in the province.

#### *6.2.2.3 Economic distortions and fiscal volatility*

The PST is a tax with a relatively narrow base. While most spending on goods is subject to the tax, most services are exempt. Moreover, as described above, some goods are also tax-exempt depending on their nature and use. By comparison, the GST has a much broader base because most spending on goods and services is taxable.

The Commission on Tax Competitiveness 2016 study identified two primary ramifications of the narrow tax base of the PST. First, it leads to economic distortion between industries and businesses. Second, it leads to less fiscal stability for the provincial government.

The first of these arises because the PST acts as a disincentive to invest in certain industry sectors. Because PST coverage varies depending on the product and industry, so too does the intensity at which different industries are taxed. This creates a comparative advantage for those industries for which the relative tax burden is lower and can skew investment away from industries with a greater proportion of taxable products and services. Tax policy can be rightly be used as a way to influence investment or encourage industry growth, but it should not favour one industry over another – especially not in the absence of an explicit public policy goal.

The challenge to fiscal stability arises because a narrow tax base leads to less stable tax revenues and hence poses a risk to governments. A broad tax base tends to be less volatile and grows more or less in line with the health of the provincial economy. Conversely, a narrow tax base relies more heavily on generating revenue from isolated sources. If certain business sectors struggle, it could cause wider swings and greater unpredictability in provincial government revenues compared to a broader tax base.

This volatility s all the more a concern given the importance of the PST as a source of revenue. The PST generates about 25 per cent of all provincial government revenues for BC. Reducing volatility in such an important revenue source would improve the government's capacity for accurate budgeting and reliable long-term fiscal planning

#### *6.2.2.4 Business operating costs*

The final drawback to a PST is that it has a disproportionately heavy impact on business operating costs. According to the BC Commission on Tax Competitiveness, the PST applies to about 22 per cent of all business inputs in the province (not including machinery and equipment), compared to about 6 per cent for the GST.

As a result, businesses in the province pay about $2.5 billion in PST on their operating expenses, representing approximately 1.4 per cent of total expenditures. While this total may seem small, it accounts about 10 per cent of corporate profit.

For manufacturers, the PST impact on operating costs is relatively small because the sector benefits from a series of exemptions on inputs like raw materials, consumables and goods purchased for direct resale. All told, the PST adds about 0.5 per cent to the cost of doing business for BC manufacturers.

However, this does not tell the complete story. The PST has a significant impact on construction costs in the province; after accounting for exemptions, that sector pays an average PST rate of 4.4 per cent. In other words, to build new plants and facilities in the province requires manufacturers to pay a 4.4 per cent premium over neighbouring Alberta.

## 6.3 Comparing the PST to a Value-Added Tax

The PST harms business competitiveness in BC. It raises operating costs, imposes a high compliance burden, distorts economic incentives and, most importantly, creates a disincentive for businesses to invest in the province. This disincentive not only makes other jurisdictions more attractive to new investors, it also raises the cost of purchasing new machinery and equipment and is the primary reason why BC businesses chronically under-invest in capital compared to other provinces.

However, the PST accounts for about one quarter of all provincial government revenues; it cannot simply be eliminated. The most obvious practical alternatives, then, are either to reform the tax or to replace it with a value-added tax (VAT). This adds another complication; a failed attempt to introduce a harmonized sales tax in the province has left many reluctant to pursue reform. Indeed, the BC Tax Commission’s mandate in its study on improving tax competitiveness explicitly forbade recommending a return to the HST.

In advance of specific recommendations, it is important to understand the key differences between a VAT and the current PST. It is also instructional to review the economic evidence in provinces where a VAT has been introduced and to examine the reasons why the attempt to introduce such a tax (in the form of the HST) in BC was a failure.

### 6.3.1 Key Differences

BC is one of only three provinces that levy a PST. All other provinces have introduced the HST, except for Alberta, which has no provincial sales tax, and Quebec which administers its own VAT (the Quebec Sales Tax).

There are several important differences between these taxes that lead to different impacts on firms' competitiveness. The most crucial distinctions revolve around how the tax is levied and the correspondent tax base. VATs only tax the value added at each stage of production. Every time a transaction takes place, the VAT is assessed and collected. The seller has to collect and remit the VAT to the government and charges the tax amount to the buyer. The tax is only paid on the gross margin of each transaction since sellers are able to deduct the previous paid tax if the buyer is not the end consumer. The end result is that under a VAT, inputs purchased for the creation of a product or service are free from the tax.

This is the critical distinction between a value-added tax and the PST. For the PST, business inputs are subject to the tax and cannot be rebated. This leads to the cascading effect where an item has the same tax levied on it multiple times.

Laurin and Poschmann (2011) point out that provincial retail sales taxes like the one in British Columbia are particularly harmful because they tax business inputs that are used in the production process including machinery, equipment and technology. In contrast, the HST exempts products for capital input. As noted earlier, the PST applies to about 20% of business inputs compared to 9% for GST. However, most importantly, 81% of spending on machinery and equipment is taxable under the PST compared to only 7% under the GST. This represents a significant competitive disadvantage for businesses located in BC.

Kesselman (2010) illustrates the beneficial outcomes of an HST model for BC. He states shows that it would improve tax simplicity, economic efficiency, and equity. Nevertheless, he also notes that a few "losers" will emerge since some businesses that were exempt under the narrow PST would be taxed under an HST. However, the overall outcome will be positive since BC would gain competitiveness, have more investment and therefore increased employment as well as higher wages.

### 6.3.2 Benefits of a VAT

There is ample evidence in the economic literature demonstrating the benefits of a VAT over a retail sales tax. Some of the specific studies are surveyed below:

Bird and Smart (2009) estimated that investment in machinery and equipment rose 12.1% annually above trend levels in the years following the 1997 sales-tax reform in provinces that introduced the HST. In order to control for other determinants that influence consumer price inflation such as economic or monetary factors they made a comparison to provinces that did not undergo the tax reform. They concluded that overall consumer prices fell in provinces that introduced the HST, in spite of increases in some sectors (like clothing).

Chen and Mintz (2011) demonstrated that the introduction of the HST in 2010 significantly increased BCs tax competitiveness. They estimated that the HST introduction together with a cut in the corporate income tax led to a reduction in the marginal effective rate of taxation by more than 9% from its level of 29.5% in 2009. Smart (2007) estimated the effects of introducing the HST in the Atlantic Provinces. His research noted that the PST in that region was particularly high on business inputs and concluded that HST reform led to significant increases in machinery and equipment investment.

Dahlby and Ferede (2012) estimated the potential growth for BC if the HST had remained in place. They found that economic growth would have increased by 1.3 per cent, partly due to an increase in investment. Their results indicate that after only five years, per capita output would have been 6% higher and, in the long run, total output would have been 25 per cent higher.

Mintz (2010) illustrated that the HST would have significantly increased BCs competitiveness. He estimated that the HST would have brought BCs tax rate on each additional dollar of new business investment below the Canadian and OECD average by 2018.

He further estimated that, by 2020, sales tax harmonization would have increased provincial capital investment and created more than 100.000 jobs. He also pointed out that small businesses benefit from a sales tax reform and the elimination of the tax on input would cut the burden for these businesses on new investment by more than a half.

Dahlby and Ferede (2009) used panel data for Canadian provinces between the years 1977 and 2006 in their tax study. Their findings indicated that there are potentially large increases in growth and investment when provinces switch from a retail sales tax to a harmonized sales tax with the federal GST.

Finally, Dungan et al. (2008) show that a VAT would encourage investment, reduce compliance costs and stimulate GDP growth.4

### 6.3.3 The HST Experience in BC

A VAT is a demonstrably superior tax structure when compared to a retail sales tax. However, after a referendum in 2011, BC abandoned the HST and reverted to the PST. It is important to understand why this reversal occurred.

The primary advantage of the HST is that it frees business inputs from the tax. However, as Bird (2012) points out, citizens and consumers may not appreciate that advantage. Their perception was that the HST effectively shifted the tax burden from businesses to consumers. This, however, is untrue since, at the end of the day, business taxes are almost always shifted to the consumer in the form of higher prices.

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[4] The study has been conducted for a made-in Ontario value added tax (VAT) and is likely to have the same effect in other provinces.

Another issue behind the failure of the HST was that it created a broader tax base. Some services, like haircuts, were PST-exempt, but became subject to tax the HST. These additions to the tax base were highly visible to the public, whereas declines in other areas, like car prices for example, were much less noticeable.

Robertson (2012) compares the introduction of the HST in Ontario and British Columbia. He argued that the announcement of the intent to shift to the HST on July 23, 2009 was an example of poor implementation. The government did not signal in advance that it was considering the introduction of an HST. It had, in fact, indicated the opposite. Conversely, the government in Ontario implemented measures to address many of the issues they knew would arise. This allowed Ontario to defuse some of the anger among the broader consumer base.

In sum, it is clear that communication problems during the introduction and implementation phase led to the failure of the HST in BC. The government did not signal its intentions to introduce the HST; it did not effectively communicate the benefits of the change; and it did not adequately assuage the concerns of BC consumers.

## 6.4 Recommendations

Given the disadvantages of the PST in its current form, the demonstrable superiority of a VAT, and ongoing public resistance to re-introducing the HST, what are the practical alternatives for reform? How can the tax structure in BC be improved so as to encourage business investment – and thus improve long-term economic competitiveness in the province – without triggering a public backlash or adversely impacting the government’s capacity to provide goods and services?

### 6.4.1 Short term

In the short term the best option would be to exempt all business inputs from the PST. This would be a bold signal and have an immediate positive effect as it would reduce the tax burden across all industries, and spur investment and growth.

If this is not feasible then an alternative would be to exempt only investment in machinery, equipment and technology from the PST. This would still have an immediate impact on business investment. According to the Commission of Tax Competitiveness 2016, eliminating the PST on all capital expenditures and other business inputs would reduce lead to an increase in investment in BC and raise the average real wage in the province by 1.9 per cent.

In either of these cases the most important consideration is to ensure the process is not further complicated. It has already been noted that the current system of exemptions creates an administrative challenge for industry. In implementing further exemptions it is important that government attempt to simplify the processes for all exemptions as opposed to adding a new layer of complication.

The downside however, is that these options would lead to a reduction in tax revenue for the government. In addition, Dungan et al. (2008) points out that a system with many exemptions on business inputs leads to higher complexity and monitoring costs. For these reasons, a PST exemption for business inputs is not a long-term solution.

### 6.4.2 Long term

Ultimately, the best way to increase investment and strengthen BCs business competitiveness is to introduce a value-added tax. The benefits of so doing have already been discussed, above. Moreover, a VAT could be structure in such a way as to be revenue-neutral for the provincial government.

As the re-introduction of the HST is unlikely even in the long run, we support the proposal made by the Commission on Tax Competitiveness: a made-in-BC value-added tax.

Before implementing such an initiative, however, it is imperative that the government closely consult with the public and develop a tax that reflects the values and priorities of British Columbians. As much as possible a new VAT should mirror the processes of the GST to ease the complications of having to deal with dual processes on these two layers of taxation. These priorities – including the identification of specific exemptions – would lead to a system more palatable to the general public and help ensure the long-term success of the tax reform.

## 6.5 Conclusion

The PST imposes a significant barrier on doing business in BC. High compliance costs, the narrow tax base and high operating costs are among the disadvantages of the tax. Most concerning, however, is the impact of the PST on business investment. If no improvements are made, the disincentives created by the PST will continue to erode long-term economic competitiveness in the province.

However, these impacts can be averted through PST reform. In the short term, there are a number of changes that can be made to the PST to relieve the businesses tax burden – especially on investment. In the longer term, however, a VAT is the clear solution. Value-added taxes are demonstrably superior to, and more economically efficient than, retail sales taxes. A carefully-designed VAT – one developed in close consultation with BC businesses and the general public – creates the best chance for improving business investment in the province and ensuring the long-term health of the provincial economy.

# Appendix

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