COMMISSION ON TAX COMPETITIVENESS

Improving British Columbia's Business Tax Competitiveness

NOVEMBER 15, 2016

ACKNOWLEDGMENT

Commission members would like to express their gratitude to B.C. Ministry of Finance staff, especially Richard Purnell, Senior Director, Tax Policy Branch, for his diligent work in support of the Commission, to Dan Perrin of Perrin, Thorau and Associates Ltd. who skillfully synthesized the Commission's perspectives in preparing the drafts of the report, and to Dr. Jack Mintz, Dr. Rhys Kesselman, and Dr. Kevin Milligan for the advice they provided.

November 15, 2016

Honourable Michael de Jong
Minister of Finance and House Leader
Room 153, Parliament Buildings
Victoria, BC V8V 1X4

Dear Minister,

We are pleased to submit to you the report of the Commission on Tax Competitiveness *"Improving British Columbia's Business Tax Competitiveness."*

The Commission members have experience in operating and growing businesses, and expertise in economics, business management and public policy. In fulfilling our mandate, we reviewed a substantial body of literature, data and detailed information about the structure and application of the tax system, sought advice from subject matter experts and received public input. The Commission is satisfied that work has resulted in a report that fairly and accurately reflects the effect of business taxation on B.C.'s competitive position and economic performance.

The Commission has unanimously concluded that B.C.'s economic performance and the standard of living of British Columbians can be improved through business tax reform. B.C. is facing challenges due to an aging population and a long history of under-investment in machinery and equipment. It is important that every opportunity be taken to encourage the investment needed for B.C.'s economy to grow and generate higher incomes for British Columbians. The Commission has made four recommendations which would, if implemented, have significant beneficial impacts, including improving the standard of living of British Columbians.

The Commission is well aware though, that there are other significant issues that also need to be addressed by government related to competitiveness and that business taxation is only one of many factors. The Commission is also aware of the need for fiscal prudence and balance in making public policy changes.

During our review, we received written submissions or oral presentations from 27 industry organizations, businesses and individuals, 59 responses on our website and conducted 12 meetings with stakeholder groups. The Commission would like to thank the many individuals and groups who have made submissions or presentations. Their thoughtful and insightful input added immeasurably to our understanding of these important issues.

Sincerely,

Bev Dahlby, PhD *Chair*	*Eric Patel*	*Mike Percy, PhD*	*Ratand Stephens*

Contents

Executive Summary *and* Recommendations

The Commission on Tax Competitiveness has been established and mandated by the B.C. Minister of Finance to review the competitiveness and economic performance impacts of business taxation. The Commission focused on the Provincial Sales Tax (PST), the Corporate Income Tax (CIT) and non-residential property taxation.[1]

CONTEXT

The B.C. economy is currently doing well compared to other Canadian provinces. That performance, though, is not spectacular by historical standards and future high levels of economic growth and standard of living improvements may be difficult to achieve.

Investment in B.C. has been, and continues to be, low. As a percent of Gross Domestic Product (GDP) B.C. investment in machinery and equipment is the third lowest in Canada. Investment per worker in B.C. is only three quarters of the OECD average and two thirds of the US average. Productivity growth has, similar to other OECD countries, slowed down considerably. That has held down disposable income in B.C.

B.C. Investment and Productivity Lags Holding Down Disposable Income

Like much of the rest of the world, B.C. is facing an aging demographic with the attendant increased demands on government services and reduced labour supply. On a global basis technology is rapidly evolving and disrupting industry after industry. These trends will challenge B.C.'s ability to fund desired government services with existing revenue sources.

It is therefore important that B.C. maintain and improve its competitive position and its ability to efficiently create economic activity and value added. There are many factors that affect competitiveness and economic performance, from global product market conditions to currency prices, from access to a skilled workforce to the availability of capital financing, and from government regulation to government-imposed costs such as fees and taxes, to name a few. Competitiveness is especially important for trade-exposed industries that produce commodities with prices that are set in world markets. Trade-exposed natural resource industries represent 70% of B.C. current exports.

Competitiveness also goes beyond those industries, affecting all industries to some extent. While tax is not always the most important factor determining competitiveness, public engagement has confirmed tax reform is among the top priorities for the B.C. business community.

1 The Terms of Reference explicitly preclude consideration of Carbon Tax or a return to the HST.

One focus for the Commission has been tax reform aimed at encouraging investment. Economic theory, confirmed by quantitative analysis, indicates that there is a direct and significant causal effect between increased investment and increased standard of living. That only makes sense, as investment in better and more efficient machinery and equipment and in intellectual property and new technologies allows workers to become more productive. The benefits of that productivity largely accrue to the workers in the form of higher wages, to companies in the form of higher profits and reinvestment, and to shareholders in the form of higher dividends. Higher incomes improve the standard of living.

> "B.C.'s economic future will depend upon our ability to attract investment and new economic activity."
>
> – B.C. CHAMBER OF COMMERCE

PST, CIT and non-residential property taxation all affect business investment, but they do so in different ways. Sales taxes increase the cost of capital goods being purchased. Income tax and property tax apply over the life of the investment. A widely used concept, the Marginal Effective Tax Rate (METR) allows these different effects on investment to be compared. It expresses the difference between pre- and after-tax investment returns (referred to as the Investment Tax Wedge) as a percentage of the pre-tax rate of return. The Commission has used METR, as well as the Investment Tax Wedge, in its consideration of investment effects.

Taxes Reduce Return on Investment, Reducing Incentive to Invest

B.C.'s economy-wide METR is 27.9% compared to 18.9% for the rest of Canada.[2] That represents a significant disincentive to invest in B.C. compared to other provinces and many other countries. About two thirds of the B.C. METR and Investment Tax Wedge are due to PST, with the remaining third due to CIT. Other provinces and countries that either have no sales tax (e.g. Alberta) or a value added tax[3] avoid the investment disincentives associated with retail sales taxes on machinery and equipment.

The Commission also considered the effect of taxes on operating costs. PST on operating expenditures made by businesses affects the ability of businesses to compete and overall economic performance.

Finally, business taxes affect economic efficiency by distorting decision-making when some items are taxable and some are not, and when the tax burden varies by location and industry. In addition, taxation imposes compliance costs on business and administrative costs on government that act as a drag on economic activity. These are often significant competitiveness issues.

2 The Investment Tax Wedge in B.C. is 1.8% compared with 1.2% for the rest of Canada. The METR and Investment Tax Wedge levels quoted do not include the effects of property taxes.

3 All other provinces except Saskatchewan and Manitoba and most OECD countries with the exception of the US.

PUBLIC ENGAGEMENT

The Commission invited input from the public through its website and invited interested groups to provide submissions and/or meet with the Commission. The Commission held 12 meetings with interested groups and received formal written submissions and/or oral presentations from 27 industry groups, businesses and individuals. In addition, the Commission received 59 responses to a survey on its website.

The clearest theme to emerge was that the most significant taxation issue facing B.C. businesses is the PST, particularly as it affects investment. There was a near unanimous view that the PST should be ultimately replaced by a value added tax and that, in the meantime, tax on machinery and equipment and certain business inputs should be eliminated.

In addition, there were many issues raised related to: property taxation in some municipalities; complexity and compliance issues related to PST; and issues related to CIT tax credits and the small business tax rate. There were also calls to postpone the planned cut to the general CIT tax rate in favour of more effective PST reform.

ANALYSIS

If one looked only at statutory tax rates and the total tax burden in B.C., one might conclude that B.C. is competitive. Delving more deeply into how tax is applied though, it becomes evident that there are issues that limit the competitiveness of B.C. businesses and hold down B.C.'s economic performance and standard of living. Each of the three taxes has distinct implications for competitiveness and economic performance.

PST

PST was found by the Commission to have the greatest negative effects in terms of the incentive to invest, operating costs and economic efficiency. PST reform has the potential to deliver significant increases in business investment, leading to standard of living enhancements.

Despite specific exemptions for production machinery and equipment[4], about 81% of spending on machinery and equipment is taxable under the PST compared to only 7% under the GST. Because of the PST, an investment in machinery and equipment in B.C. has to earn a rate of return that is 1.1 percentage points higher than in Alberta in order to provide an investor with the same after-tax rate of return. That is significant when real, risk adjusted rates of return are less than 4%[5]. PST on machinery and equipment generates about $640 million in provincial revenue.[6]

4 Applying only to the manufacturing, forestry, mining and oil and gas industries.
5 Statistics Canada data indicates the profit margins in non-financial industries averaged 7.1% for the period 2000 to 2014.
6 Source: Statistics Canada. Average Canadian corporate profits from 2000 to 2014 were 8.8%.

> **▸ *PST Reduces Investment, Increases Operating Costs, Imposes Compliance Costs and Market Distortions***

Although PST has exemptions for operating costs such as goods purchased for resale and goods incorporated in manufactured products, PST applies to about 20% of business inputs compared to 9% for GST. That results in an average tax rate of about 1.4% of all operating costs, representing 16% of corporate profit.

For certain industries the tax on specific inputs can have an even greater competitive impact. B.C. is the only jurisdiction that levies a sales tax on electricity and other sources of energy used by business, which puts B.C.'s energy intensive industries such as pulp and paper at a particular competitive disadvantage. Other inputs, such as telecommunication services and software are important in the digital economy and taxing them may hinder the organic growth rate of companies that could otherwise expand and create more jobs.

PST is complex and imposes high compliance costs. That is largely due to the many exemptions of products for use in specific circumstances, which are difficult to distinguish from taxable products or uses of products.[7] There are also many detailed rules that make compliance difficult or that defy common sense.[8] PST is applied to a relatively narrow range of goods and just a few services. That creates economic distortion, encourages tax avoidance and reduces the resiliency of the revenue stream to changing economic conditions. It is clear from stakeholder feedback that the sheer complexity of the PST creates a major burden on businesses, diverting management effort from more productive, potentially growth-creating activities.

CIT

The Commission found that, compared to PST, CIT has much less effect on business competitiveness and economic performance.

CIT creates a disincentive to invest that increases with the tax rate. Although B.C. has the lowest general CIT tax rate in Canada, the combined B.C. and federal tax rates are higher than average for the OECD. A reduction in the general B.C. tax rate would reduce the Investment Tax Wedge and METR. Government has promised a reduction from 11% to 10% by 2018. However, that reduction would only have about one third of the effect on investment as reducing PST on machinery and equipment with the same reduction in government revenue.

7 Examples range from the machinery and equipment exemptions to adult sized clothing purchased for children and school supplies.

8 For example a forklift operating in a plant may be exempt but if it also operates in the yard, it becomes taxable.

There are other issues related to the CIT. For example,

- Several industry-specific tax credits such as those related to the film industry create economic distortions. These credits can be difficult to change because of footloose industries and similar credits are offered in other jurisdictions.
- The Scientific Research and Experimental Development (SR&ED) tax credit is difficult to use and is not fully effective, but the B.C. credit uses the federal credit design, which is beyond B.C.'s ability to change unilaterally.
- The small business tax rate is meant to encourage small businesses to grow but there is little evidence it is effective. Conversely, it does provide significant benefits to many incorporated professions who never intend to grow their business but rather use retained earnings as a tax shelter. The small business rate also may create a disincentive to grow because of the "tax wall" growing businesses encounter at the small business threshold, although the economic impact does not seem to be significant.

All of these issues involve more than one Canadian jurisdiction and should be addressed in a multi-lateral context.

Property Taxation

The Commission found that the overall level of business property taxation in B.C. at both the provincial and local government level does not represent a competitiveness issue or a significant impediment to economic performance. Excessive property tax rates for large industrial properties in a few municipalities are a concern however. High property tax rates can have devastating effects on unprofitable plants. Also, the rates themselves and the uncertainty about future rates can have a chilling effect on investment when upgrading existing plants and developing new plants.

The Commission believes that uncertainty is the most concerning aspect of municipal property taxes on business property. While there are tools in the Community Charter and provincial programs that could help, there seems to be a need for an additional approach.

That approach could be a framework for taxation arrangements that would:

- Give taxpayers proposing to make significant new or upgrade investments the ability to trigger negotiations on a stream of future payments;
- Include effective dispute resolution; and
- Not require provincial government approval of the resulting agreement.

RECOMMENDATIONS

The Commission examined several options in order to find the best ways to improve business tax competitiveness and economic performance in both the short and long run. Based on that examination, the Commission is making four recommendations:

RECOMMENDATION 1 – *Full PST Exemption for Business Capital Expenditure*

The Commission recommends all capital expenditure by business be exempted from PST as soon as possible. The intention is to cover machinery and equipment as well as any other capital expenditure taxable under PST. This would be the single most effective short term tax reform measure to improve competitiveness. Government should choose to implement the exemption in a way that will be simplest for business and has the lowest compliance cost, even if that implies some tax leakage. The Commission strongly favours a point of sale exemption but lacks sufficient detailed information about the administrative issues and compliance costs involved to make a definitive recommendation.

RECOMMENDATION 2 – *PST Exemptions for Specific Business Inputs*

The Commission recommends that, to the extent that government has the fiscal capacity to do so in the short run, the following business inputs should be exempted, in this order of priority:

- Electricity and other energy;
- Software; and
- Telecommunications services.

RECOMMENDATION 3 – *Made-in-B.C. VAT*

The Commission recommends that in the long run B.C. implement a made-in-B.C. value added tax (VAT). That is the ultimate solution to all of the issues raised with the PST and would have the most impact on business competitiveness, economic performance and ultimately standard of living. Significant public engagement would be required to design a made-in-B.C. VAT and to make the final decision about whether to proceed.

> ***Made-in-B.C. VAT Addresses All PST Issues, PST Capital Spending Exemption is a First Step***

RECOMMENDATION 4 – *Industry-Municipal Investment Arrangements*

The Commission recommends that, in the short run, government introduce a mechanism for businesses contemplating significant incremental investment to trigger negotiations with a municipality for an arrangement that provides certainty about the contributions that will be provided to the municipality over the life of the investment.

TABLE 1 – *Cost of Recommendations*

	PST CAPITAL SPENDING EXEMPTIONS	***PST BUSINESS INPUT EXEMPTION***	***B.C. VAT***	***INDUSTRY – MUNICIPAL INVESTMENT ARRANGEMENTS***
Cost (millions)	Exemption for M&E $640	Electricity $160 Other energy $157 Software $50 Telecomm. $153 ***TOTAL $520***	Could be revenue neutral *(Estimated to be about a 5% tax rate)*	No provincial government cost
Timing	Short run	Short run	Long run	Short run

Although not required to provide revenue neutral recommendations, the Commission believes that if Recommendation 1 is implemented, consideration should be given to funding the cost in part by foregoing planned reductions to the CIT general and small business rates ($350 million). Consideration could also be given to eliminating some current consumer-oriented PST exemptions that put a heavy compliance burden on retailers or provide a disproportionate benefit to high income earners. If so, some of the revenue should be used to enhance the current PST tax credit for low income earners.

The Commission is also suggesting the following be considered:

- The various CIT tax credits (e.g. film and SR&ED) and small business tax rate issues be addressed in a multi-lateral context with the federal government and other provinces;
- The Ministry of Finance review and renew its commitment to the Taxpayer Service and Fairness Code and consider the PST administrative issues listed in the report as well as the suggested increase to the maximum PST commission paid to collectors; and
- Recommendations on property taxation in the 2012 Report of the Expert Panel on B.C.'s Business Tax Competitiveness be implemented.

Mandate of the Commission

The Commission on Tax Competitiveness was established on July 14, 2016 by the British Columbia Finance Minister with the release of Terms of Reference for the commission. The mandate of the Commission is:

> *"To advise the Province on how to modernize British Columbia's Provincial Sales Tax (PST) and other business taxes to drive business competitiveness and economic growth in British Columbia, while continuing to respect the results of the 2011 province-wide referendum to eliminate the harmonized sales tax."*

The mandate specifically precludes the Commission from recommending a return to the HST or addressing issues related to the Carbon Tax.

The Commission is required to:

- Put the issue of tax competitiveness in the context of demographic, economic and global changes affecting British Columbia,
- Identify tax competitiveness issues,
- Consider and evaluate alternatives,
- Make recommendations about the best options for PST and other tax reform to drive business competitiveness and economic growth, and
- Recommend measures that can be adopted in the short term and long term.

To fulfill this mandate, the Commission has set itself three questions to answer:

1. Are B.C.'s business taxes competitive?
2. Are business taxes in B.C. affecting its competitiveness and economic performance?
3. What are the best ways of improving B.C.'s business tax competitiveness in the short term and over the long run?

This report answers these questions by:

- Providing some context about the current fiscal and economic environment and future trends,
- Summarizing the feedback received from stakeholders,
- Reviewing how PST, corporate income tax and property taxation in B.C. affect competitiveness and economic performance,
- Setting out and evaluating tax reform options, and
- Providing the commission's conclusions and recommendations.

Context

This section provides background information and discussion that will help frame the rest of the paper, by:

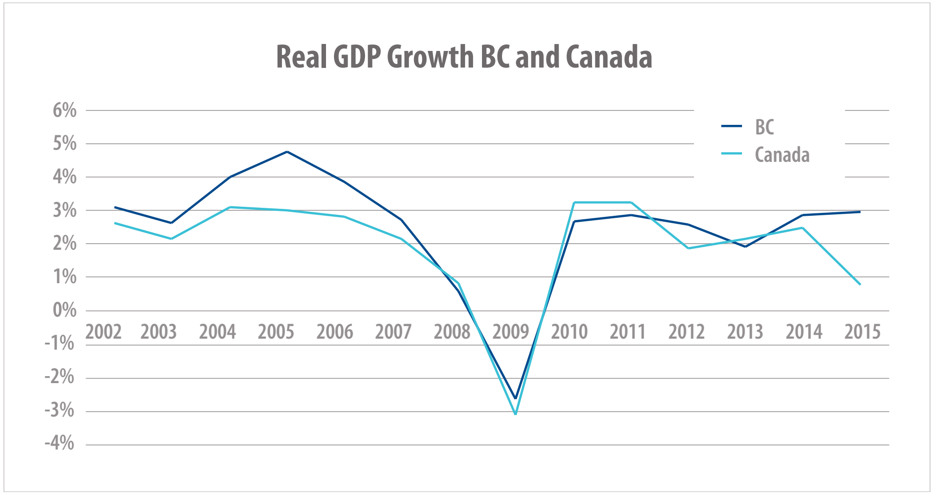
- Describing the fiscal and economic context;
- Outlining future trends that B.C. must address;
- Describing the results of the 2012 expert panel on B.C.'s tax competitiveness; and
- Defining competitiveness and putting business tax into the context of the range of factors affecting competitiveness.

B.C.'S CURRENT ECONOMIC AND FISCAL SITUATION

B.C.'s economic performance currently leads Canada in terms of growth in economic activity and growth in employment. In 2015 B.C. led Canadian provinces with a 3.0% rate of growth in real Gross Domestic Product (GDP) compared to the Canadian average of 1.1%, shown on Chart 1. In 2015, B.C.'s employment growth of 1.3% was second only to Manitoba, well above the Canadian average of 0.9%. In 2013, household disposable income per capita in B.C. was the third highest among the provinces, at $31,742, $878 above the Canadian average.

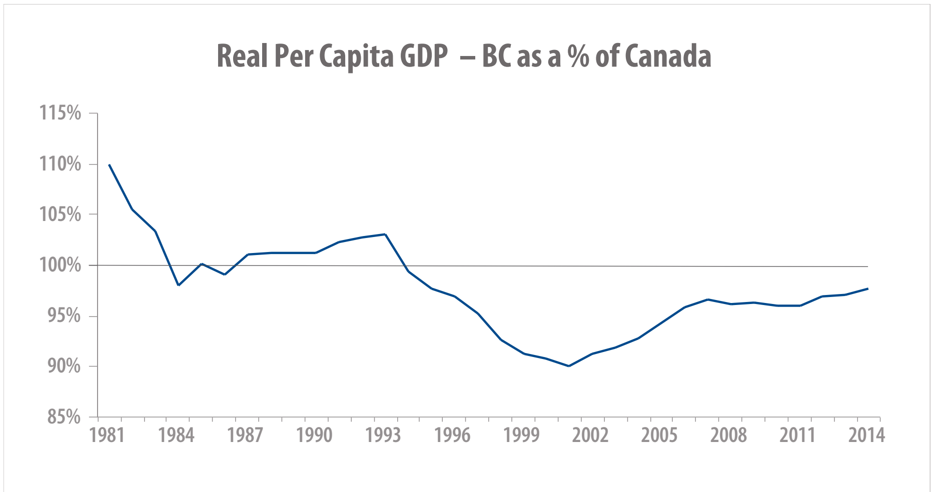
B.C. Leads Canadian GDP Growth, But the Population is Aging, Investment Lags and Productivity Growth Has Slowed

CHART 1[9]



9 Source: Statistics Canada

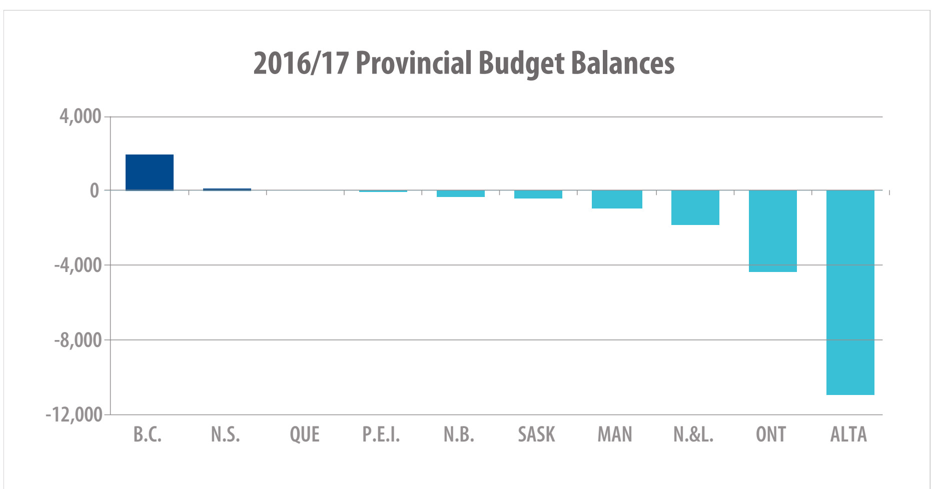
CHART 2[10]



However, those headlines must be interpreted with care. B.C.'s performance in 2015 seems especially good because Alberta and Saskatchewan have been hit hard by the drop in oil prices. Income inequality in B.C. is the third highest in Canada, after Alberta and Ontario.[11] Despite current GDP growth, B.C.'s average GDP per capita is below the Canadian average and has been since 1993 as indicated by Chart 2. In addition, there are future concerns, as outlined in the Future Trends Facing B.C. section below.

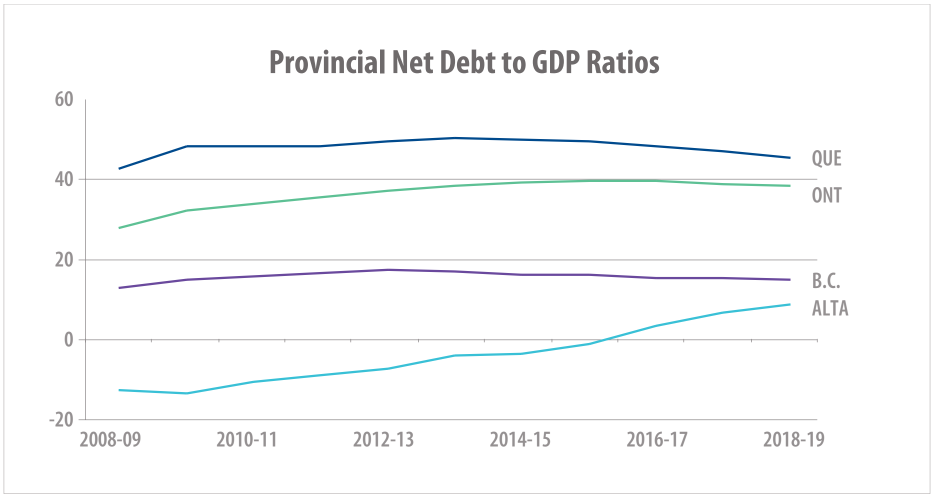
The B.C. government is in a relatively strong fiscal position. Following the recession in 2009, the province had four years of deficits, but B.C. is the only province to have consistent surpluses since that point as shown on Chart 3. B.C. has consistently had the third lowest level of net provincial public sector debt per capita behind Alberta and Saskatchewan and budget forecasts suggest that the gap between B.C. and Alberta will close further over the next two years, as indicated on Chart 4.

CHART 3[12]



10 Source: Statistics Canada
11 Source: Statistics Canada
12 Source: *"Canadian Federal and Provincial Fiscal Tables"*, Royal Bank of Canada, September, 2016

CHART 4[13]



The 2016 B.C. budget estimated total provincial revenue would be $48.1 billion from a wide variety of revenue sources. Of that revenue, 51% or $24.3 million will come from taxation revenue, as shown by Chart 5.

The provincial government levies nine taxes of general application. Together personal and corporate income tax account for about 45% of tax revenue, sales and excise taxes (PST, fuel tax, carbon tax and tobacco tax) account for 38% of tax revenue and property tax accounts for 10%.

B.C.'s set of taxes is similar to those applied by provinces across Canada. All provinces apply income taxes, all but Alberta have a retail sales tax or a value added tax, and all tax real property. Some also have payroll taxes, which B.C. does not have. Only three provinces (B.C., Alberta and Quebec) currently have carbon taxes.[14]

How does B.C. tax revenue as a whole compare with other jurisdictions and does the overall level of taxation affect B.C.'s business competitiveness? If the B.C. government took a significantly higher proportion of GDP in the form of tax revenue than other jurisdictions, that would affect B.C.'s economy in comparison to other provinces.

13 Source: Statistics Canada and *"Canadian Federal and Provincial Fiscal Tables"*, Royal Bank of Canada, September, 2016

14 Ontario and Quebec are adopting cap and trade programs which will effectively put a price on greenhouse gas emissions and the federal government has indicated it will require all Provinces to establish at least a minimum effective carbon price by 2018.

CHART 5[15]

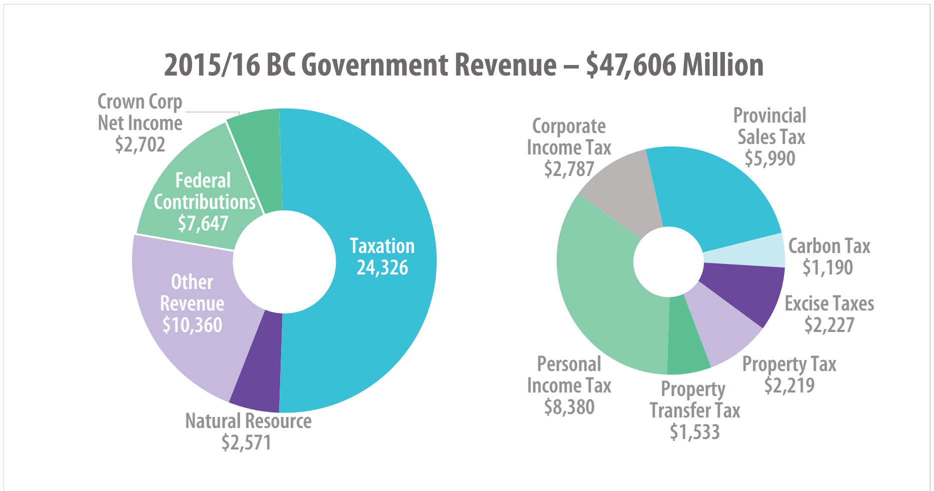
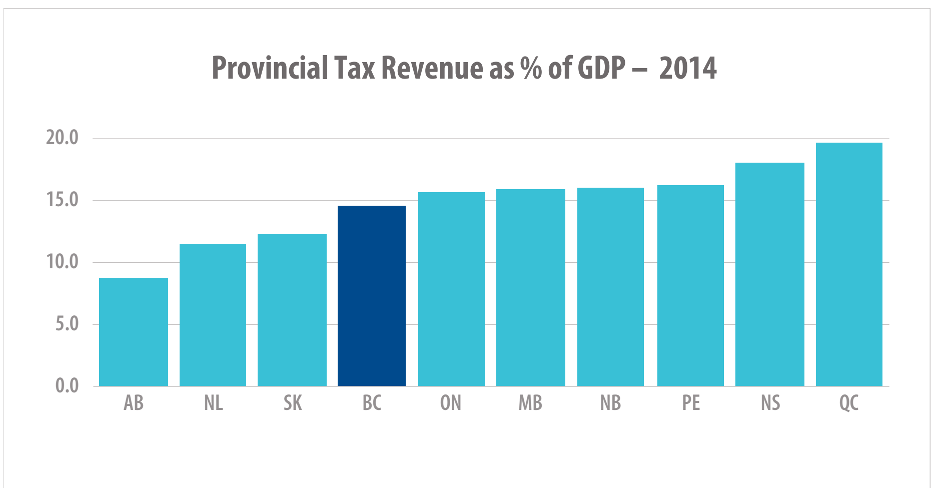


Chart 6 compares 2014 tax revenues as a percent of GDP across the provinces. It shows that B.C. taxes represent about 14.5% of B.C.'s GDP. That is the 4th lowest in Canada, suggesting B.C. is about middle of the pack, but the three lower provinces all had high levels of oil and gas royalties. In any event, B.C.'s overall level of taxation is competitive in the Canadian context.

CHART 6[16]



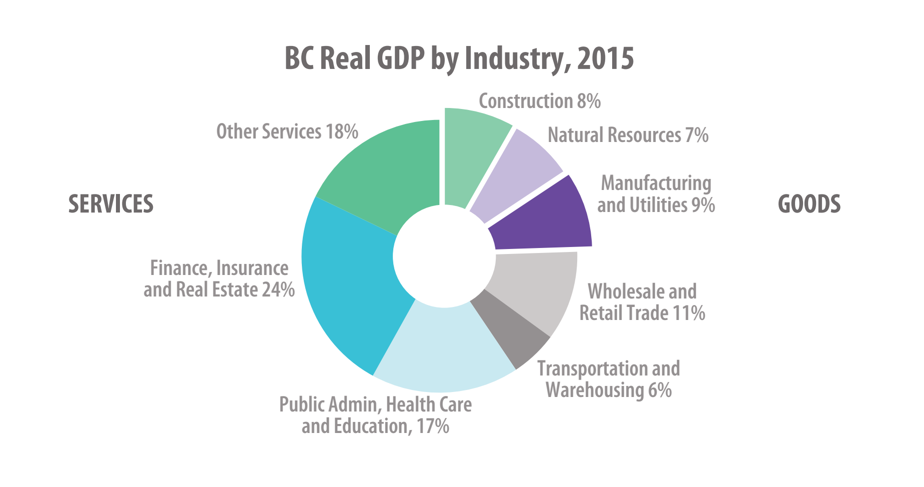
15 Source: B.C. Ministry of Finance
16 Source: Statistics Canada

B.C.'S ECONOMIC STRUCTURE

B.C.'s economy is often thought of as resource-based, focused on forestry, mining, natural gas and oil, most of which is exported. In fact, Chart 7 shows that natural resources only account for 7% of GDP whereas services account for 75% of GDP. Services account for an even greater proportion of employment, at 80% in 2015.

The largest sector in B.C. is real estate, representing 18.3% of provincial GDP in 2015.[17] Since 2001, real estate has grown at an average annual rate of 3.9%, second only to construction, the largest goods-producing sector, which has grown at a 4.2% average annual rate. The real estate market, especially residential housing in the Lower Mainland, is a major driver of the B.C. economy through the increase in the value of the assets, real estate commissions and construction activity.

CHART 7[18]



Advanced technology industries have been growing in B.C., especially in urban areas. To capture this, B.C. Statistics has defined a B.C. High Tech industry comprised of some specific elements of the more traditional industry groupings used to measure GDP.[19] The High Tech sector accounted for 7% of B.C.'s GDP and, with 92,700 employees, 4.6% of employment in 2014, larger than the natural resource extraction sector. It has grown faster than the overall economy over the past decade. Average weekly earnings in the sector are 68% higher than the provincial average.

17 The large size of the real estate sector is due to the fact that, to meet international statistical standards, Statistics Canada includes "imputed rent" from owner occupied residential real property in GDP representing the housing services accruing to owners from property ownership. Even before the recent rapid increase in Lower Mainland real estate prices, real estate was the largest sector and real estate and related activities have grown more rapidly than the rest of the economy over the past five years.

18 Source: Statistics Canada

19 Profile of the British Columbia Technology Sector, 2015 Edition

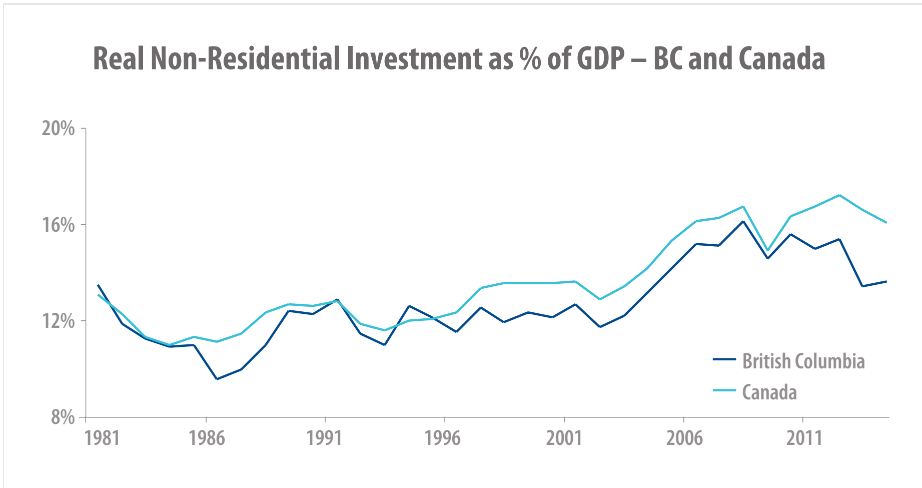
“Technology has become a transformative force in the B.C. economy” – B.C. TECH ASSOCIATION

The High Tech industry is a labour-intensive industry, relying heavily on skilled employees. High Tech industry exports represent about 3.1% of B.C.'s exports, of which three-quarters were service exports. Those exports are not standardized commodities but rather goods and services provided in a market where product differentiation and innovation is the objective.

At 7% of provincial GDP, natural resource extraction (mining, quarrying, oil and gas extraction, forestry and logging) remains important and is a driver of other industries including manufacturing and services such as finance, professional and management services which support B.C.'s natural resource industries. Natural resource extraction is especially important in rural B.C.. However, since 2001 natural resources have grown at an average annual rate of 1.1%, considerably less than the overall economy.

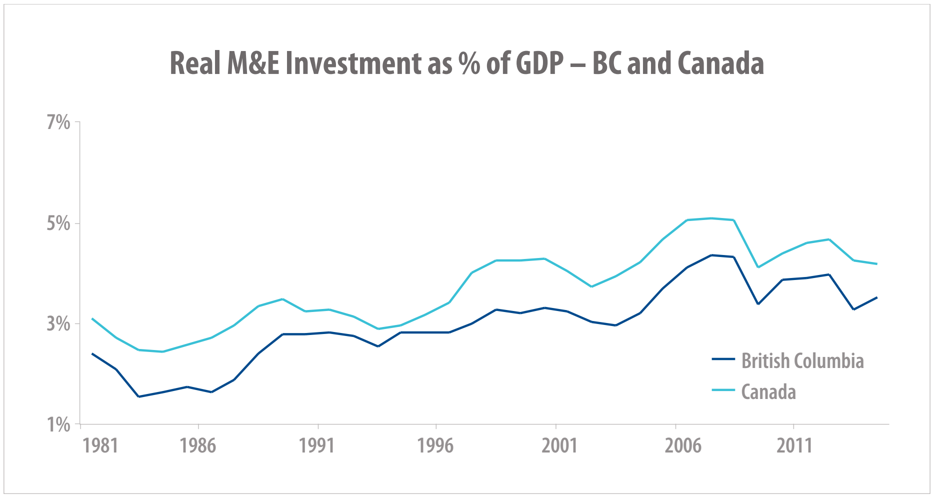
Natural resource extraction is capital intensive, depending heavily on machinery and equipment. A relatively high proportion of its production is exported on world commodity markets where B.C. is a small player with no influence over market prices. Natural resources represent 70% of B.C.'s exports.

CHART 8a[20]



20 Source: Statistics Canada

CHART 8b[21]



Capital investment is a key to future economic growth regardless of the industrial sector. Investment provides the machinery, equipment and buildings needed to allow for the efficient production of goods and services. As shown by Charts 8a and 8b, since 1981 B.C.'s non-residential capital investment as a percent of GDP is lower than for Canada as a whole, and the gap has widened since the 2009 recession. Even more importantly, B.C. has lagged significantly in machinery and equipment investment.

CHART 9[22]

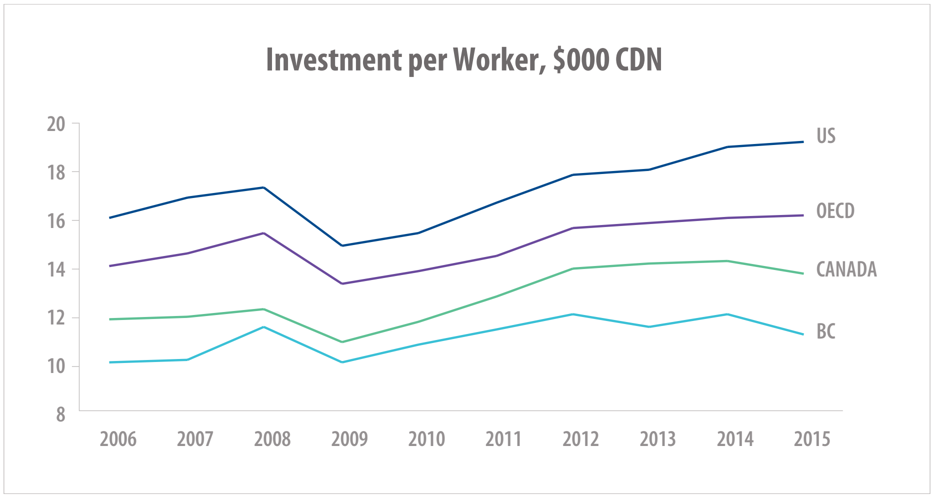


Chart 9 shows that B.C. lags the US, OECD and the rest of Canada in terms of investment per worker at 73% of the OECD average and only 64% of the US average over the 2006 to 2015 period. Under-investment in B.C. has serious implications for labour productivity, wage and salaries and the standard of living in the province. The Commission believes this issue, if left unaddressed, will have serious long-term implications for B.C.'s economy and the well-being of its citizens.

21 Source: Statistics Canada

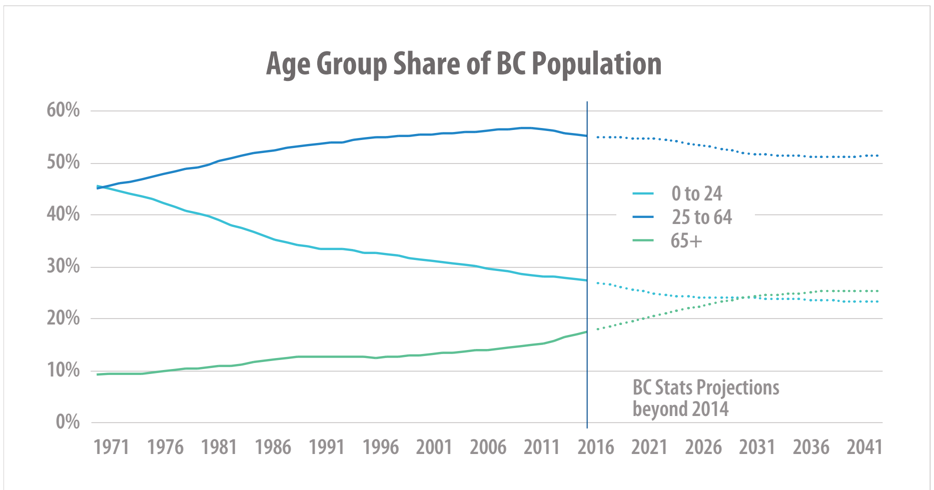
22 Source: B. Dachis, W. Robinson and A. Jacobs ," A Crisis of Capital: Canadian Workers Need More Tools, Buildings and Equipment" C.D. Howe Institute, e-Brief, 2015, Table 1a

Aging Population

Most developed countries and others, including China, have been facing aging populations for the past couple of decades and Canada is not an exception. In 2013, about 15% of Canada's population was over 65 years of age. Currently in B.C. the proportion of people older than 65 is slightly higher than the Canadian average (16%) and it is expected to increase to 25% by 2032, as shown by Chart 10.

That demographic shift will increase health care and other government service costs, creating fiscal pressure. The ability to generate government revenue while having the least impact on economic performance will be important in every Canadian jurisdiction, including B.C..

CHART 10[23]



Technological Advances

Technological advances, such as robotics, self-driving vehicles and smart equipment connected to the internet, will likely disrupt many industries in the coming decades. Businesses that are unable or unwilling to keep up with these innovations will not be able to compete in global or domestic markets. In many sectors, digitization will require continued investment in capital goods, particularly electronic equipment and software systems. In other "new economy" sectors, the emphasis will be on investment behind skilled workers and intellectual property development. However, investment in machinery and equipment and other forms of capital will continue to be a key source of productivity improvements. With business investment lagging in B.C. as indicated above, there is a concern about business' ability to innovate and compete.

23 Source: B.C. Stats

Open Economy

There has been a long-term trend toward free trade and Canada has recently negotiated some important trade deals, such as the Canada European Trade Agreement, the Canada Korean Trade Agreement and the Trans Pacific Partnership, although there is uncertainty about when and if the deals will be ratified. B.C. will continue to have many trade opportunities if it maintains a competitive cost structure and is nimble, innovative and resilient. However, B.C. businesses face both opportunities and threats whether trade continues to become increasingly open or protectionist forces in some countries begin to reduce openness.

Real Estate Issues

Lower Mainland real estate values pose a significant risk to the overall B.C. economy. If there is a major correction it will have significant detrimental impacts throughout the entire economy. B.C.'s high real estate prices also directly impact B.C.'s competitive position, increasing costs and making it difficult to attract skilled labour. That means that it is doubly important that other competitiveness factors, such as taxation be highly competitive.

> "The single biggest determinant of our per capita income and our ability to raise wages and living standards is our productivity… Countries that are innovative and able to adapt to shifts in the global economy will see high productivity and thus a superior standard of living." – B.C. CHAMBER OF COMMERCE

These future trends are affecting not only B.C. but most developed countries and all of Canada and the US. Nevertheless, B.C.'s future standard of living depends on economic growth to generate increased income and to produce the tax revenue needed to cover increased service costs and lower tax revenue growth resulting from aging population. Any improvement to B.C.'s competitiveness and ability to generate economic growth will benefit the people of the province as it grapples with these and other issues into the future.

RECENT TAX COMPETITIVENESS POLICY CHANGES

Tax competitiveness is not a new concept. Every B.C. budget makes tax changes that affect provincial business competitiveness, usually with the direct intention of improving economic performance. Since 2000, there have been over 35 significant tax measures introduced in B.C. that affect tax competitiveness. In addition, there have been regular minor changes to PST exemptions.

Perhaps the most significant tax competitiveness measure was the introduction of the HST in 2010, which was reversed with the reinstatement of the PST in 2013, following a referendum on the issue in 2011. When the re-establishment of the PST was being prepared, the Minister of Finance instituted an Expert Panel on B.C.'s Tax Competitiveness. The Panel found:

> ***2012 Panel Recommended M&E Exemption Leading Eventually to a Made-in-B.C. VAT***

Modern machinery and equipment, including cutting edge computing and communications technology, are tools that B.C. workers must have in order to compete in Canada and with the rest of the world. Increasing B.C. businesses' investment in modern equipment, and especially in advanced technologies, is a necessary and critical element to achieving higher productivity and better incomes. After the PST is re-introduced, B.C.'s taxes on new investment will become the highest among all the provinces.

As a result, the Panel said:

- The Panel's key recommendation is to introduce a refundable investment tax credit equal to the PST paid on machinery and equipment, claimable over two years.
- The investment tax credit will keep B.C.'s effective tax rate on new investment competitive with those in other Canadian provinces.
- Other recommendations concerning the PST will make the PST fairer in its distribution, more neutral in its application across industries, simpler to administer and easier to comply with.
- The Panel recommends that the B.C. Government should work with local governments to ensure B.C.'s property taxes remain competitive.

The Panel also urged the government to consider implementing a made-in-B.C. value added tax in the future, but only after extensive consultations with stakeholders.

Summary of 2016 Public Engagement

The Commission received formal written submissions and/or oral presentations from 27 industry groups, businesses and individuals and held 12 meetings with various groups. In addition, the Commission received 59 responses to a survey on its website.

The information provided was crucial for the completion of this assignment. A list of those providing input is in Appendix A and a summary of the input provided is in Appendix B.

There were six main themes that the Commission heard from multiple sources:

1. The PST investment disincentive is the single most important business tax competitiveness issue.
2. The best option for short term business tax reform is to exempt machinery and equipment and energy from the PST.
3. The PST is inordinately complex and PST administration is difficult to work with, placing a significant compliance burden on businesses, both retailers who collect the tax and purchasers who pay the tax.
4. The best long term measure to improve business competitiveness and reduce administrative complexity would be to replace the PST with a value added tax.

> "If the B.C. government were to implement only one change to our system of taxation, jettisoning the PST in favour of a Value Added Tax would have the greatest impact on fueling growth in our province."
>
> – B.C. CHAMBER OF COMMERCE

5. The CIT is not a priority for tax reform or a significant competitiveness issue and the planned general tax reduction should be postponed in favour of PST reform. There is no such consensus about the small business rate, which some would like decreased while others would like reformed and increased.
6. Extraordinarily high rates for some property classes in some municipalities create uncertainty and can be a significant local problem which should be addressed.

Evaluation Criteria

The Commission's Terms of Reference specifically require that the Commission's work include:

> *Evaluation of the impacts of the identified options on business competitiveness, business investment, economic growth, tax policy principles, provincial revenues, and British Columbians;*

This section summarizes the specific criteria the Commission has chosen. The Commission is applying eleven criteria in total, divided into two groups: Competitiveness and Economic Performance (including business competitiveness, business investment, economic growth and British Columbians) and Tax Policy Principles (including effects on provincial revenues). The Commission is aware that income and wealth inequality have become prominent public concerns around the world, and it is an important issue in B.C.. Tax policy should ensure that the fruits of economic growth are distributed throughout the society.

TABLE 2 – *Evaluation Criteria*

COMPETITIVENESS AND ECONOMIC PERFORMANCE	
Business Competitiveness	Impact on business costs generally and the incentive to invest
Business Investment	Impact on investment
Economic Growth	Impact on GDP growth, employment, wages and salaries, income
Economic Efficiency	Impact on the ability of the economy to produce value added
British Columbians	Impact on the current and future standard of living
TAX POLICY PRINCIPLES	
Fairness	Who pays the tax and does it improve or reduce the fairness of the tax system? Are similar taxpayers treated the same (horizontal equity)? Are taxes on individuals progressive (vertical equity)?
Transparency	Is the amount of tax more or less visible and understandable to taxpayers?
Compliance and Administrative Cost	Does the tax measure make it more or less costly to comply with the requirements of the tax system? Who does the compliance burden fall upon? How does the measure affect government administration cost?
Provincial Revenue Impact	Estimated impact on provincial revenues; short term and long term
Stability and Predictability	Will government revenue be more or less volatile? Will future revenues be easier or harder to predict?
Implementation	Is it feasible to make this change quickly or will it take longer to design and implement? Are transition provisions required?

Competitiveness and Economic Performance

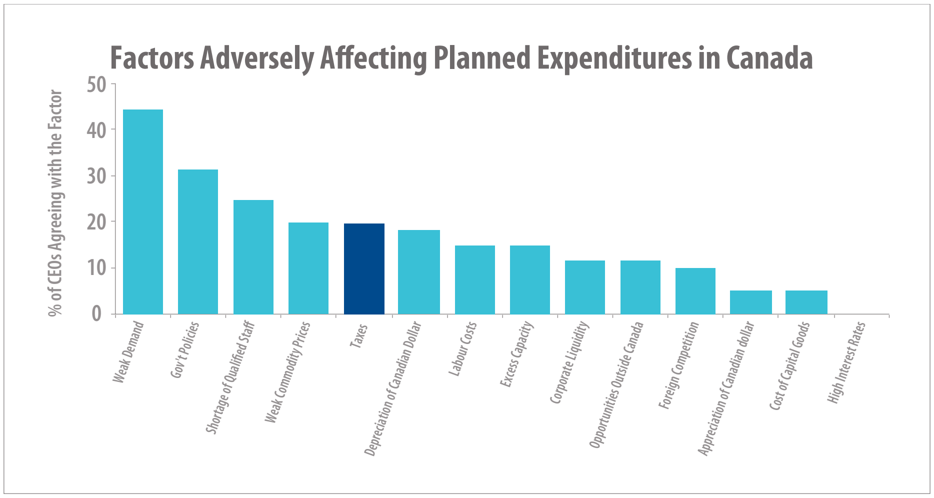
The following describes how business competitiveness, business investment and economic performance relate to each other and how competitiveness and economic performance have been evaluated by the Commission.

WHAT IS COMPETITIVENESS?

The Commission's Terms of Reference make it clear that its mandate goes beyond making businesses more "tax rate competitive" to enhancing B.C.'s economic performance. Improving competitiveness and economic performance will directly benefit British Columbians through more jobs and higher wages. Increased economic activity will also increase government revenue helping to address the demographic shifts and other future trends that B.C. is facing, including external macro-economic factors, industry dynamics, individual business decisions, and government policies. The B.C. Government has a series of initiatives underway to address various aspects of competitiveness, ranging from red tape reduction to infrastructure investment. The relative importance of these factors can vary from industry to industry and, in some cases from business to business but they all have an effect on economic performance.

Taxation is rarely the most important competitiveness factor to businesses, but surveys of small and larger businesses consistently indicate that tax is one of the top ten factors that affect performance, as indicated on Chart 11. The Commission's survey on the website also showed that respondents consider PST and its complexity important, as discussed in Appendix B.

CHART 11[24]

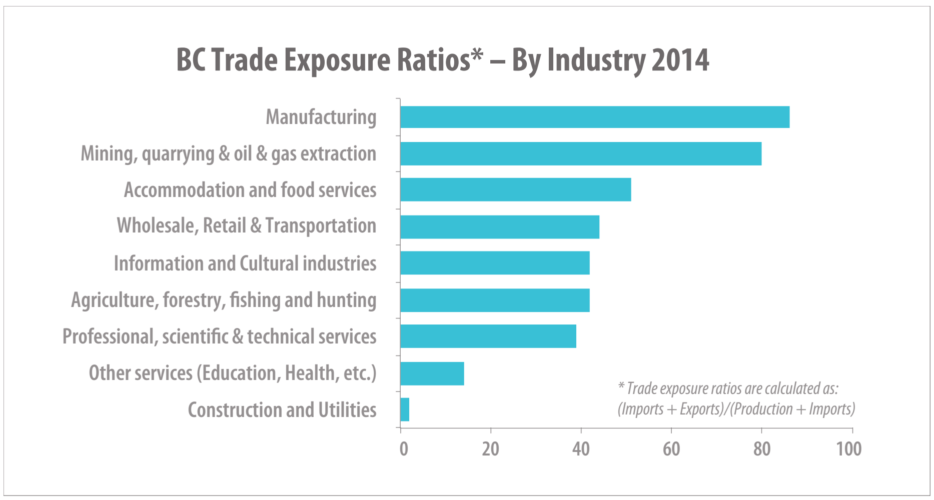


24 Source: Conference Board of Canada, Index of Business Confidence Database, Q2, 2016

Business taxation is also one of the factors that government has the most direct control over. That is why this Commission has been struck and asked to focus on business taxes. The Commission was asked to focus particularly on the PST because it is well known to affect competitiveness. The Commission is also looking specifically at the corporate income tax and the property tax, but the terms of reference specifically asked the Commission not to consider Carbon Tax, which has been reviewed separately.

Competitiveness pressures are often greatest for trade-exposed industries, low margin businesses, those that export commodity products and those that compete against products imported from another jurisdiction. Chart 12 shows trade exposure for several important B.C. industries. Several of the most trade-exposed industries, such as mining and oil and gas extraction operate in global commodity markets and thus have little or no influence over the price of their product. Trade in service industries, not traditionally thought of as trade-exposed, has accelerated in recent years and is increasingly important.

CHART 12[25]



25 Source: Statistics Canada

TAXATION AND ECONOMIC EFFICIENCY

Taxes change the incentives and the decisions made by individuals and businesses about what to buy and sell, how much to work, how many people to employ and what investments to make. The degree to which a tax measure increases or decreases distortions in the allocation of land, labour and capital and reduces income generating opportunities is a measure of the efficiency loss from taxation. Fewer and smaller distortions means that there will be less drag on the economy's ability to produce value added, leading to improved economic performance.

Some taxes distort decisions more than others and impose greater economic losses in raising revenues. Taxes that are imposed on tax-sensitive, or relatively narrow,[26] tax bases create larger efficiency losses. High tax rates may reward aggressive tax planning to reduce taxes, encourage the underground economy, and induce highly paid, highly skilled individuals to move to lower tax jurisdictions and reduce the likelihood a business will locate new activity in the jurisdiction. For these reasons the economic efficiency impact of tax reform options is used as an evaluation criteria.

CHART 13[27]

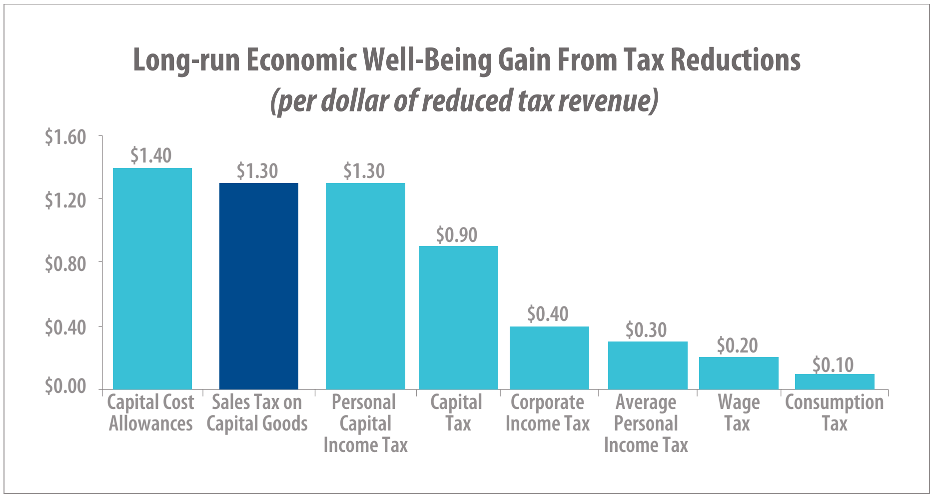


Chart 13 ranks the gains from various potential business tax reform in terms of improvements in public well-being. It suggests that the most effective tax reform within provincial government jurisdiction is a reduction of sales tax on capital goods.

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26 The breadth of a sales tax base refers to the proportion of consumer expenditure that is subject to tax. The PST tax base is relatively narrow because although most spending on goods is subject to tax, most spending on services is not subject to tax. The GST tax base is broader because most spending on goods and services is subject to tax. However, both tax bases are narrower than the broadest possible tax base under which all spending is subject to tax.

27 Source: M. Baylor and L. Beausejour "Taxation and Economic Efficiency: Results from a Canadian CGE Model", Department of Finance, Working Paper 2004-10, November 2004, Table 4, page 16. *http://www.fin.gc.ca/taxexp-depfisc/2004/TaxExp04_e.pdf*, p. 71

MEASURING THE EFFECT OF TAXES ON BUSINESS INVESTMENT

As noted above, competitiveness and economic performance are affected by taxes because taxes increase the cost of production and the cost of investment. The effect of taxes on production costs is relatively easy to measure but measuring the effect of taxes on the incentive to invest is less straightforward. The reason measurement of the effect is a challenge is that taxes affect business investment in two distinct ways:

- By increasing the cost of the capital goods that comprise the investment, and
- By taxing the return on the investment throughout its life.

Taxes increase the cost of capital goods when the goods are taxable. Retail sales taxes like the PST often tax some or all machinery and equipment, which is a significant part of capital expenditure. In addition, embedded sales tax that accumulates in construction of buildings and facilities also increases the cost of capital. When the cost of capital increases, that means that an investment must earn a higher pre-tax rate of return in order for it to be worthwhile.

All investment is made in the anticipation of future earnings, whether it is sustaining investment to renew existing plant and equipment, investment needed to meet regulatory requirements, investment to create new production capacity or investment to increase productivity by adopting improved technology. Taxes that apply throughout the life of the investment and reduce those profits include income taxes, which tax profits from the investment and property taxes. Taxes that apply throughout the life of an investment also increase the pre-tax rate of return required of an investment.

The problem is, how can one compare the impact on investment of one set of taxes with another set of taxes? The starting point is that income taxes, property taxes and sales taxes on capital goods all increase the pre-tax rate of return needed to provide an investor with enough profit to make the investment worthwhile. The gap between the pre-tax rate of return on an investment and the after-tax rate of return the investor requires is known as the "Investment Tax Wedge".

> ***B.C.'s Effective Tax on Investment is One of the Highest in the OECD, Largely Due to PST***

Higher sales tax rates on capital goods and higher corporate income tax rates and higher property taxes all increase the size of the Investment Tax Wedge. Thus, the tax wedge provides a way to measure and compare the effects of changing the various taxes. The Investment Tax Wedge in B.C. is 1.8% compared with an Investment Tax Wedge of 1.2% for the rest of Canada.

A related measure that is often used is the Marginal Effective Tax Rate (METR). It presents the Investment Tax Wedge as a percentage of the pre-tax rate of return. METR is a widely used measure of the combined effect of tax on the incentive to invest across different sectors, both within and between jurisdictions.[28]

METR is a ratio of two usually single digit percentages that often gives rates in the 20% to 40% range. It is useful for side-to-side comparisons but should not be interpreted as a "tax rate on the return on investment". For some, the Investment Tax Wedge is easier to understand because it is the impact of taxes on the required return from investment. For this reason, the Commission presents both the METR and Investment Tax Wedge on investments.

CHART 14[29]

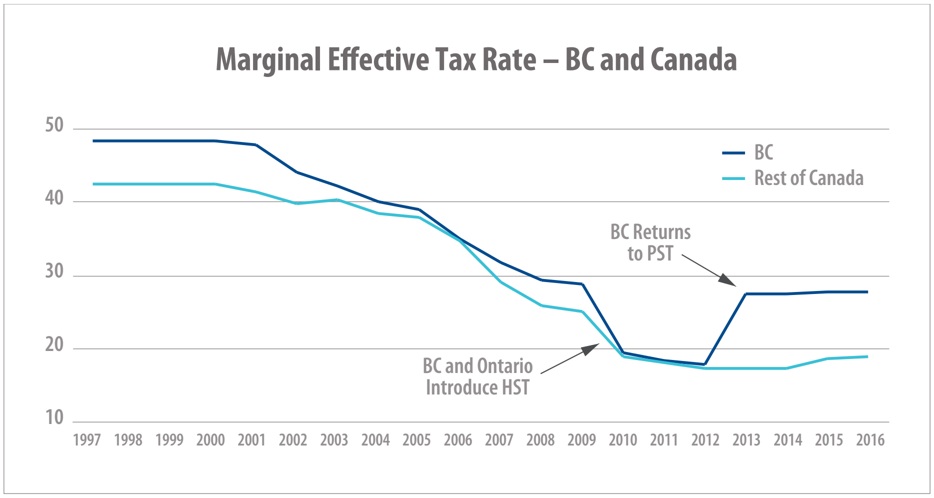


Chart 14 shows that since 1997, the METR has declined in B.C. and the rest of Canada as the result of reductions in federal and provincial CIT rates. METR in B.C. and the rest of Canada dropped significantly in 2010 when B.C. and Ontario replaced retail sales taxes with the HST, which no longer imposed taxes on most capital goods purchased by business.

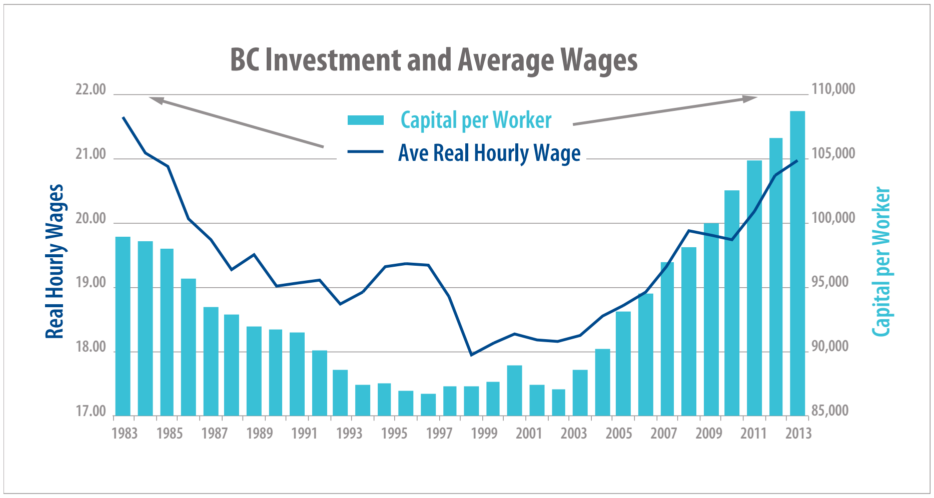
The point is that the higher the Investment Tax Wedge and METR, the lower the amount of investment, all else being equal. This has been substantiated by a large body of published econometric analysis in Canada and other countries.[30]

28 See Appendix C.
29 Source: Commission calculation
30 See Appendix C.

Not only is the link between METR and investment well established, so too is the fact that reductions in METR lead to increases in wages by increasing investment. As detailed in Appendix C, investment is directly and strongly linked to wage rates. B.C.'s history of under-investment has held down wages of B.C. workers, as demonstrated by Chart 15. Average real wage rates have declined in the province as the average amount of capital declined from 1983 to 2003 and increased since then as capital per worker increased.

> ***B.C.'s Under-Investment Has Held Wages of B.C. Workers Down***

CHART 15[31]



31 Source: Statistics Canada

PST Review

DESCRIPTION

The PST contributes about 25% of provincial tax revenues as shown by Chart 5. As Milligan[32] has argued, B.C. needs a significant amount of sales tax revenues to finance current and projected spending. Not having a sales tax is not an option. The question is – what type of sales tax should B.C. have?

The PST is a retail sales tax on most goods and some services. The tax applies to sales of taxable goods and services in B.C. and to taxable goods and services acquired out-of-province for use in B.C.. Most PST is collected and remitted by retailers at the point of sale. The general tax rate is currently 7%. Businesses in B.C. pay about $3.1 billion in PST, representing about 48% of the total $6.4 billion total PST collected. Of this, PST on business operating costs is about $2.5 million and PST on machinery and equipment is about $640 million.

The PST tax base is relatively narrow because it includes only a small proportion of services. Consumption of services is more than half of purchases, which is the broadest possible sales tax base.

The tax base was originally limited to "tangible personal property" or goods other than "real property." Over the decades it has been broadened to include a few specific services, such as legal services and telecommunications services, but most services remain untaxed. Within the class of tangible personal property, PST has a considerable number of exemptions. Some exemptions apply to business inputs such as raw material transformed into another product through manufacturing, goods purchased solely for resale and certain types of machinery and equipment used in certain places for certain purposes. There are a number of exemptions that apply primarily to consumers, ranging from broad exemptions for food and medical expenses to more specific exemptions for school supplies, restaurant meals, children's clothing and bicycles.[33]

In Canada, only B.C., Saskatchewan and Manitoba currently have retail sales taxes. All other provinces have either no sales tax (Alberta) or a value added tax. While Ontario and the Atlantic provinces have the HST which is "harmonized" with the GST, Quebec has its own, made-in-Quebec value added tax known as the QST. The US and Canada are the only major world economies that use retail sales taxes. Most other countries have a value added tax.

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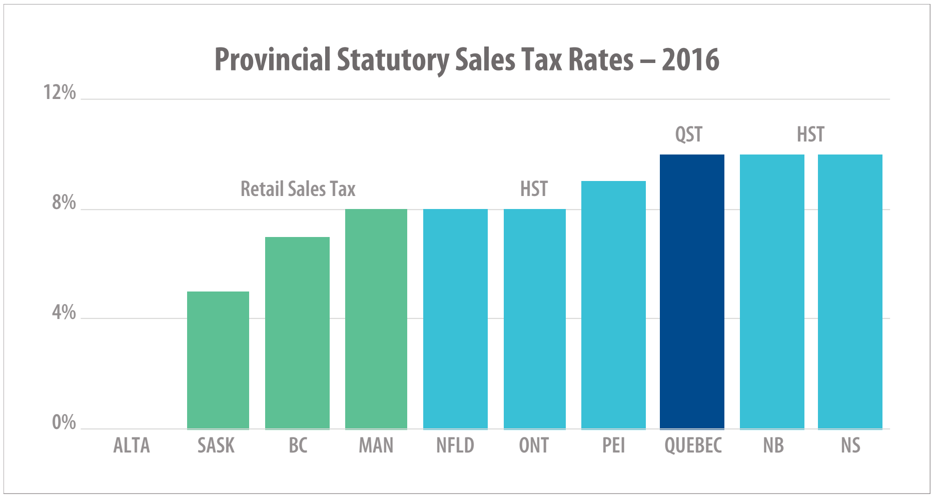
32 Milligan, Kevin (2016) "Fiscal Options for Building a Prosperous British Columbia", paper commissioned by the British Columbia Business Council, July 2016. *http://www.bcbc.com/publications/2016/commissioned-paper-fiscal-options-for-building-a-prosperous-british-columbia-by-kevin-milligan*

33 See Appendix C, Table C.1 for a list of items not taxed and the resulting benefit received by income group.

CHART 16[34]



The B.C. 7% statutory sales tax rate is the third lowest in Canada and the tax rate itself is not a competitiveness issue. However, as discussed below, PST does affect competitiveness and economic performance in four important ways:

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

Impact of PST on Capital Cost

Table 3 sets out the amount of PST and GST paid in B.C. on purchases of machinery and equipment and the average tax rate (total taxes divided by total spending on taxable and non-taxable costs) by industry. The tax burden varies considerably across industries.

34 Source: B.C. Ministry of Finance

TABLE 3 – *PST and GST Paid on Machinery and Equipment in 2016*

	MACHINERY & EQUIPMENT			
	GST (Millions)	Average GST Rate	PST (Millions)	Average PST Rate
GOODS SECTOR				
Agriculture, fishing and hunting	-	0.0%	6	3.1%
Natural Resource Sector	-	0.0%	84	5.8%
Utilities	-	0.0%	25	6.9%
Construction	-	0.0%	61	6.8%
Manufacturing	-	0.0%	44	5.5%
TOTAL GOODS SECTOR	**-**	**0.0%**	**221**	**5.9%**
SERVICES SECTOR				
Wholesale and Retail Trade Services	-	0.0%	76	6.9%
Transportation and Warehousing Services	1	0.0%	81	5.3%
Financial and Real Estate Services	31	1.7%	57	3.1%
Social Services Sector	6	1.1%	37	6.6%
Other Services and Non-Profit Housing	1	0.1%	106	6.9%
Knowledge-Based Industry Sector	-	0.0%	12	7.0%
Accommodation and Food Services	2	0.6%	19	7.0%
Government Sector	-	0.0%	30	4.9%
TOTAL SERVICES SECTOR	**41**	**0.5%**	**418**	**5.5%**
TOTAL	**41**	**0.0%**	**639**	**5.6%**

Prepared by B.C. Ministry of Finance

There are PST exemptions for certain machinery and equipment used in the manufacturing, forestry, mining and oil and gas industries, as well as specific exemptions for many specific items used in agriculture, aquaculture and fishing. Judging by the average tax rates, the exemptions for agriculture, aquaculture and fishing are more effective than the exemptions for manufacturing, mining, and oil and gas extraction. The exemptions cover only about 20% of machinery and equipment expenditures in the manufacturing and natural resource industries.

In other industries, most machinery and equipment is subject to PST, as shown by average tax rates close to the 7% statutory rate. In comparison, under the GST most machinery and equipment is not taxed.[35]

PST on machinery and equipment totals $639 million. That represents an average tax rate of 5.6% of those capital costs. Under the PST, 81% of the cost of machinery and equipment is taxable, compared to 7% of those costs under GST.

35 Except in the financial services and social services industries, where many services are exempt from GST and therefore input tax credits are not fully provided for those industries.

Charts 17a and 17b show that the Investment Tax Wedge and METR on machinery and equipment in B.C. is meaningfully higher than in the Alberta, Ontario and Quebec. Because of the PST, an investment in machinery and equipment in B.C. has to earn a risk adjusted real rate of return that is 1.1 percentage points higher than in Alberta in order to provide an investor with the same after-tax rate of return.

CHART 17a[36,37]

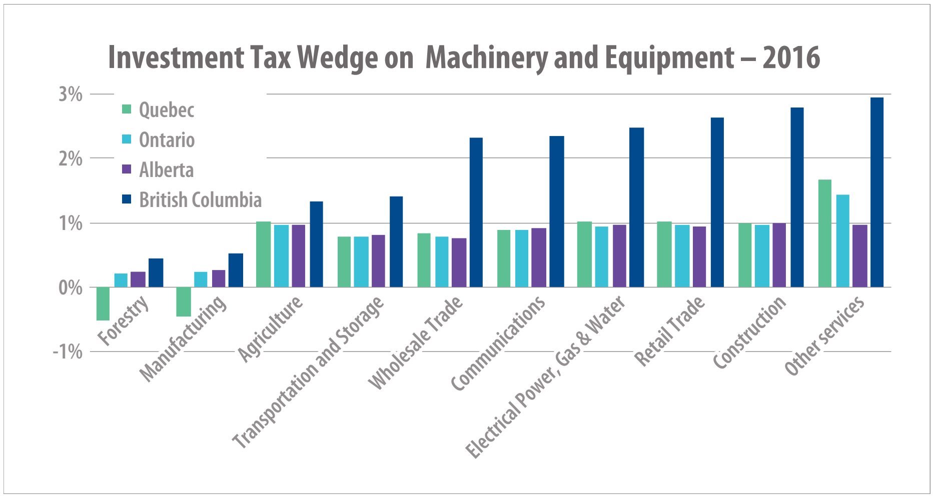
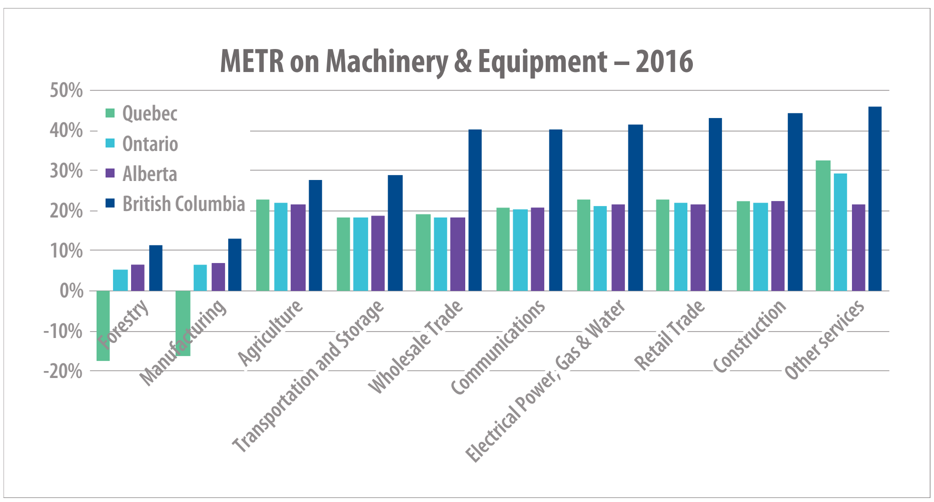


CHART 17b[38]



The charts show forestry, manufacturing and agriculture, have relatively low Investment Tax Wedges in every province, including B.C., due to advantageous CIT provisions, such as accelerated depreciation, and, in B.C., PST exemptions for certain machinery and equipment. Although B.C.'s tax wedge is higher for every industry, the problem is more acute for the service and construction industries where rates of return would have to be 1.5% to 2% higher in B.C. to earn the same after tax rate of return as in other provinces.

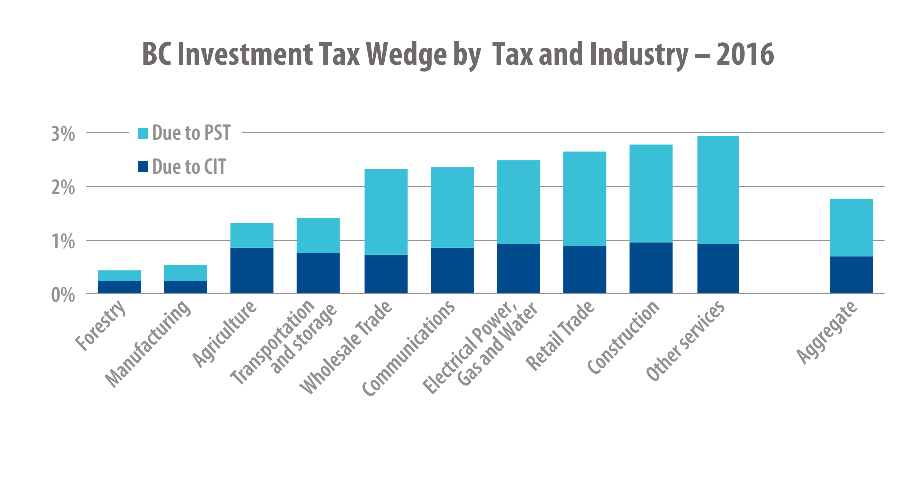
36 Source: Commission calculations

37 Quebec has such advantageous measures to encourage investment in machinery and equipment in forestry and manufacturing that the "tax" paid is negative, providing a subsidy.

38 Source: Commission calculations

Ontario, Quebec and Alberta all have either no sales tax or a value added tax and CIT tax rates that are higher than the B.C. rate. That means that all of the relative B.C. disadvantage is the result of PST on machinery and equipment, which accounts for 60% of the Investment Tax Wedge, as illustrated by Chart 18.

CHART 18[39]



Impact of PST on Operating Cost

Businesses pay about $2.5 billion PST on operating costs, representing about 1.4% of business expenditure. This is the Cost Tax Wedge. Businesses also paid about 0.4% under GST.[40] While a 1.4% Cost Tax Wedge may seem small, it represents about 10% of corporate profit in B.C..

Most businesses in B.C. have operating costs that are about 1.4% higher than competitors would in an HST province with a 7% statutory tax rate because 22% of business inputs are subject to PST while only 6% of business inputs are subject to GST. That represents a significant cost difference when profit margins are measured in single digits, as they are in many Canadian industries.[41]

In spite of the PST exemptions for raw materials, consumables and goods purchased solely for resale, the Cost Tax Wedge indicates that there is a considerable amount of PST paid on goods and services purchased by businesses that are not exempt, coupled with the embedded PST that builds up in business inputs. As Table 4 shows, the impact varies considerably by industry, depending on the extent that inputs used are exempt or taxable under the PST and GST. Particularly significant is the 4.4% average rate paid by the construction industry, which becomes embedded in the costs of all B.C. structures. It is also notable that several growing service sectors have higher average PST costs on business inputs than most goods-producing sectors.

39 Source: Commission calculations

40 Note that the statutory PST tax rate is 7% while the GST rate is 5%. If the GST rate were 7% the Cost Tax Wedge would have been 0.42% assuming no changes in behavior.

41 Statistics Canada. Table 180-0003 – Financial and taxation statistics for enterprises, by North American Industry Classification System (NAICS), annual.

TABLE 4 – *PST and GST Paid on Business Inputs in 2016 By Industry*

BUSINESS INPUTS (EXCLUDING MACHINERY AND EQUIPMENT)				
	GST (Millions)	Average GST Rate	PST (Millions)	Average PST Rate
GOODS SECTOR				
Agriculture, fishing and hunting	-	0.0%	19	0.6%
Natural Resource Sector	-	0.0%	120	1.0%
Utilities	-	0.0%	8	0.6%
Construction	-	0.0%	949	4.4%
Manufacturing	-	0.0%	162	0.5%
TOTAL GOODS SECTOR	-	**0.0%**	**1,257**	**1.8%**
SERVICES SECTOR				
Wholesale and Retail Trade Services	-	0.0%	110	0.8%
Transportation and Warehousing Services	11	0.1%	183	1.3%
Financial and Real Estate Services	506	2.3%	172	0.8%
Social Services Sector	152	3.7%	80	1.9%
Other Services and Non-Profit Housing	17	0.1%	267	1.5%
Knowledge-Based Industry Sector	2	0.0%	94	1.5%
Accommodation and Food Services	42	1.0%	84	2.0%
Government Sector	46	0.2%	204	0.9%
TOTAL SERVICES SECTOR	**775**	**0.7%**	**1,194**	**1.1%**
TOTAL	**775**	**0.0%**	**2,451**	**1.4%**

Prepared by B.C. Ministry of Finance

There are some items used directly in the production process that are not exempt under the PST, as shown in Table 5. One of the most significant for some industries is energy. For the cement and pulp and paper industries, and any manufacturing process that uses electricity, coal, natural gas or other source of energy, the PST on the energy component can be significant as they compete internationally in commodity markets and margins are thin. B.C. seems to be the only jurisdiction, at least in North America, in which energy costs are subject to retail sales tax.

> "As B.C. electricity generation is overwhelmingly produced by abundant clean sources currently in surplus, the effect of imposing PST on electricity prices works against the carbon tax, discouraging further electrification." – THE ASSOCIATION OF MAJOR POWER CUSTOMERS

TABLE 5 – *PST Paid on Business Inputs by Commodity*

	PST ON BUSINESS INPUTS*2016
	($ millions)
Building materials for construction industry	691
Other materials	541
Other services	296
Services related to repair or maintenance of property	210
Electricity	160
Other energy	157
Telecommunications	153
Legal Services	99
Office supplies	76
Software	50
Other Professional services	18
TOTAL	***2,451***

**Excluding machinery and equipment*

Prepared by B.C. Ministry of Finance

Compliance Cost Implications

There are significant compliance costs for businesses associated with the PST. Machinery and equipment exemptions impose some of the highest compliance costs on retailers and purchasers as they try to determine for each individual item whether it qualifies based on what it is, who will be using it, how it will be used and where it will be used. Every retail store faces compliance issues related to whether the items they sell are taxable or exempt, and whether they can claim a credit for items returned. Costs are imposed on retailers by administrative requirements related to exemptions, such as documenting who purchases items of adult-sized clothing for children or goods shipped to out-of-province purchasers. Complex rules make it difficult for retailers and purchasers alike to determine if they have collected and paid the right amount of tax.

> "The complexity of the tax system itself acts as a tax on entrepreneurship."
>
> – FOUNDER OF SYNERGY ENTERPRISES

PST COMPLIANCE COST EXAMPLES

Machinery and Equipment Exemptions – these exemptions often depend on the use and location of an item. A forklift used to load materials for processing may be exempt, but if that forklift is used to load items for transportation outside of the plant, it would no longer be exempt, and the owner would be expected to self-assess and pay the PST.

Real Property Contractors – generally contractors installing items to a building or other real property pay tax on goods purchased and do not charge PST to customers. If they mistakenly do not pay PST on the purchase and charge PST on the sale, they will be required upon audit to pay the PST on purchase, effectively doubling the taxes paid.

Mixed Inventory – when a vendor, like an auto repair shop, both sells a product and uses the same product in the business, such as lubricants, they must pay PST when purchasing for their own use but not pay when purchasing for resale. In practice, it is difficult or impossible to not make mistakes, leading to penalties on audit.

Mixed contracts – Mixed contracts are contracts for the provision of multiple interconnected goods, services and real property as a single supply for a single price. Because of the narrow PST tax base vendors must tease out of the agreement which goods and services are subject to PST and which are not. Vendors must also determine the fair market value of the taxable goods and services in order to collect the correct amount of tax. In practice, it is difficult to not make mistakes, leading to potential penalties and interest on audit.

"In 2009, Synergy launched a cleaning product line, SoapX, for specific use in restaurants and other food service facilities. After our first $10,000 in sales, we found the administrative barriers in registering, tracking and reporting on PST exhaustive and time-consuming. This on top of the normal hurdles in launching a food-service cleaning product line was enough for our team to decide to sell the business to a cleaning company, who is now in Australia. When people asked us why we decided not to pursue the line, our answer was "getting a cleaning product line through the regulations is really tough, but trying to manage PST on top that felt impossible". In the four businesses I have owned and operated in B.C., I have avoided exploring product sales any further, due to fear of PST and its administrative burdens."
– FOUNDER SYNERGY ENTERPRISES

"In comparison to Federal GST, PST requirements are too difficult for small businesses to navigate and must be simplified. Aspiring entrepreneurs … may have particular difficulty accessing resources to navigate requirements efficiently (i.e., access to technology, mentors and consultants)." – SMALL BUSINESS ROUNDTABLE

Compliance costs are a hidden cost that affects economic performance. Jurisdictions with fewer specific exemptions face lower compliance costs. Compliance costs are especially burdensome on small businesses that lack the resources to handle complex, time-consuming administrative procedures, stifling growth in one of the economy's main jobs growth engines.

The Commission received very clear and consistent feedback from most public consultation respondents about PST complexity. The Commission believes that, as a general rule, competitiveness will be enhanced by favouring simplicity over trying to prevent all "tax leakage", in the design of tax regulations.

> "Small businesses are very sensitive to the overall tax burden, and any changes to the tax system should be clearly communicated, with adequate time for consultation to fully understand and implement any required changes." – SMALL BUSINESS ROUNDTABLE

A broad-based tax with few specific exemptions would reduce compliance costs. Care needs to be taken in examining alternatives to ensure that compliance costs are not inadvertently or unnecessarily increased.

Implications of a Narrow Tax Base

There are two issues associated with the fact that PST has a relatively narrow tax base, an economic efficiency issue and a fiscal stability issue.

The economic efficiency implications of a narrow tax base are due to the distortions and competitive disadvantages created by treating industries differently depending upon their product mix. Non-taxable products and services have an advantage over taxable ones, which can feed through and affect their ability to compete outside the jurisdiction. For example, accounting and related professional consulting services are not taxed, but a similar professional service, legal services is taxed. The result is that some legal business is instead given to other professionals or sent to law firms out-of-province. Value added taxes generally have relatively broad tax bases and are less distortionary.

A narrow tax base carries with it an important fiscal risk, in the sense that if the untaxed part of consumption grows faster than the taxable part of consumption, tax revenue will not keep up with economic growth. As government service demands associated with an aging population continue to grow, it is important that tax revenues grow to accommodate those service demands. In addition, a broad tax base may provide an opportunity to reduce tax rates, reducing the incentive to avoid taxes.

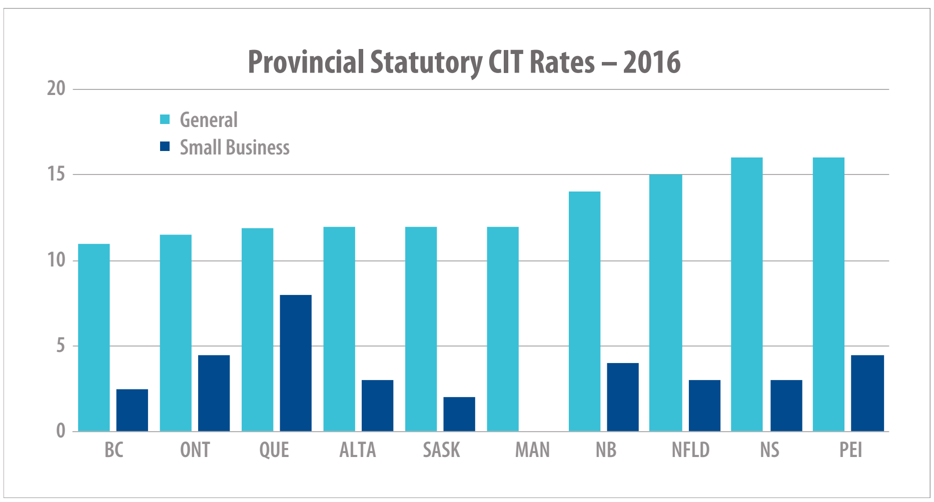
CIT Review

The B.C. CIT is an income tax on all corporations that have a permanent establishment in B.C..[42] Under a Tax Collection Agreement between the B.C. and federal governments, the B.C. CIT uses the federal tax base and applies B.C. tax rates to that base. In addition, B.C. has several tax credits that apply in specific circumstances. The federal government administers the tax on behalf of the provincial government, except for some tax credits which are administered directly. All provinces except Alberta and Quebec have a similar arrangement. Income that is earned by corporations in more than one province is allocated, in most cases, based on the share of the corporation's wage and sales in those provinces where it has a permanent establishment.

The general federal CIT tax rate is 15% and Canadian-controlled private corporations (CCPCs) are eligible for the "small business rate" of 10.5% on the first $500,000 of active business income if their "taxable capital" does not exceed $10 million. Taxable income above $500,000 is taxed at the general rate and the small business deduction is reduced as taxable capital increases from $10 million to $15 million.

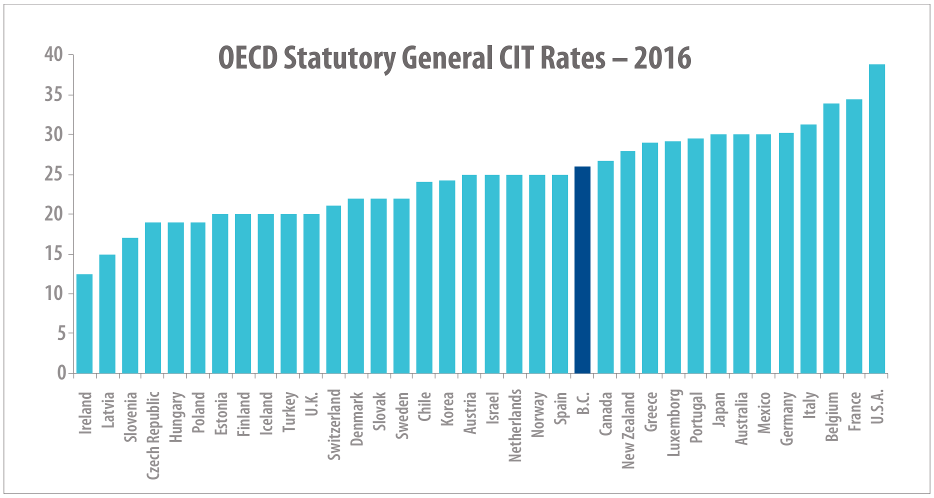
As shown in Chart 19a, the general CIT rate in B.C., at 11%, is the lowest general provincial CIT rate in Canada, resulting in a combined federal and provincial statutory rate of 26%. The small business rate in B.C. at 2.5% is in the middle of the pack and results in a combined federal and provincial small business rate of 13%. Both small business and general rates are scheduled to be reduced by a further 1% within the next two years.

CHART 19a[43]



42 The business income of unincorporated businesses is taxed under the personal income tax.
43 Source: B.C. Ministry of Finance

CHART 19b[44]



From a narrow Canadian perspective, B.C. has a competitive general corporate tax rate. However, individual firms and industries in B.C. are in competition for investment in different countries around the world. The after-tax returns on investments in B.C. have to be competitive with pulp and paper projects in Finland, with copper mining projects in Chile, and with LNG projects in Australia, to cite a few examples. Chart 19b puts those rates into an international context, with B.C., at 26%, slightly above the average for the OECD countries, at 24.6%. There is no simple answer to the question: Is B.C.'s corporate tax rate competitive? A more meaningful question is: How would changes in B.C.'s corporate taxes affect investment, employment, wage and salaries, and tax revenues?

A starting point in answering this question is to recognize that corporate tax bases, and especially provincial tax bases, are highly sensitive to CIT. The higher the statutory CIT rate that a government levies the greater the incentive to use various inter-company financial mechanisms to shift profits to other jurisdictions, thereby eroding the corporate income tax base.

Econometric studies by Mintz and Smart[45] and the Department of Finance Canada[46] indicate that differences in statutory tax rates results in base shifting across provincial boundaries. As a result, provincial corporate income tax bases are much more sensitive to tax rates than the personal income tax bases or the sales tax bases. A higher tax rate erodes the corporate tax base in B.C. because in the short run it creates incentives to shift corporate profits to other provinces or countries and because it reduces investment in machinery and equipment and other forms of business capital that generate corporate profits in the medium-to-long-term. As a consequence of these distortions in investment and financing decisions, raising an additional dollar of corporate tax revenue costs the private sector in B.C. $4.09 in terms of foregone income.[47] As other studies have indicated, the corporate taxes are "high cost" sources of tax revenues.[48]

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44 Source: OECD, 2016

45 J. Mintz, and M. Smart (2004). "Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada." *Journal of public Economics*, 88, 1149-1168

46 Department of Finance Canada, (2015) "Interprovincial Tax Planning by Corporate Groups in Canada: A Review of the Evidence" *Tax Expenditures and Evaluations* 2014, Ottawa.

47 Computations based on the econometric model in E. Ferede and B. Dahlby "The Costliest Tax of All: Raising Revenue through Corporate Tax Hikes Can Be Counter-Productive for the Provinces" *SPP Research Papers* 9 (11)

48 OECD (2010), *Tax Policy Reform and Economic Growth*, OECD Publishing. *http://dx.doi.org/10.1787/9789264091085-en*

As discussed above, the corporate income tax also affects the Investment Tax Wedge and METR because the tax applies to profits earned as the result of investments over their useful life. CIT is responsible for 40% of the Investment Tax Wedge and PST is responsible for 60%. Eliminating PST on machinery and equipment would almost eliminate the PST portion of the Investment Tax Wedge. Reducing the general CIT rate from 11% to 10%, with the current PST in place, would only reduce the tax wedge on machinery and equipment from 1.77% to 1.73%.

While CIT Rates Affect Investment,PST Reform Increases Investment More

CIT Tax Credits

B.C. provides a refundable 33% tax credit for the B.C. labour costs of film, television and digital media, on top of federal tax credits that vary between 16% and 25% of Canadian labour costs. These credits are estimated to cost the province $493 million in 2015/16. The justification for these tax measures is that these are footloose industries that would not be as significant in B.C. without the tax credits, given that other jurisdictions offer tax credits that are at least as generous. On the other hand, many argue that the value of the Canadian dollar is at least as important a factor in attracting activity in these industries at present. Lester[49] conducted a benefit-cost analysis of the federal and provincial tax credits for foreign location production and concluded that Canadians would be better off with the elimination of the tax credits because the economic benefit from increased foreign film production was less than the cost of the credits. He estimated that the elimination of the tax credits would reduce the foreign location shooting industry in Canada by about a third. A unilateral reduction or elimination of these credits in B.C. would only result in significant losses in activity and jobs, at least in the short run. A coordinated review of the federal and provincial film tax credits should be undertaken to see if these tax expenditures are generating net positive benefits for Canadians.

B.C. provides an SR&ED tax credit of 10% of qualified expenditures in B.C., which is refundable for Canadian-controlled private corporations up to an expenditure limit of $3,000,000. This credit is administered by the Canada Revenue Agency and is on top of the federal 35% refundable tax credit for Canadian-controlled private corporations and 15% credit for large firms. The cost of the B.C. credit is $131 million in 2015-16. The SR&ED tax credits have been criticized for the complexity of application procedures and the uncertainty concerning acceptance and expenditure coverage. The Commission recognizes this credit provides a meaningful incentive to innovation in B.C.. However, given its high compliance and administrative costs relative to the amounts of funding provided to small businesses that apply for the SR&ED tax credits, the cost effectiveness of the credits for small businesses has been questioned.[50] One simplification reform, recommended by the 2011 Jenkins Panel Report on innovation in Canada[51], is to base the tax credit for small business on labour costs. Again, it would be best to consider changing this credit in a multi-lateral context so there is one, simpler and more effective, Canada-wide model.

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49 J. Lester (2013) "Tax Credits for Foreign Location Shooting of Films: No Net Benefit for Canada" *Canadian Public Policy* 39, 451-472.

50 J. Lester "Benefit-Cost Analysis of R & D Support Programs." *Canadian Tax Journal*, 2011, : 60 (4): 793-836.

51 Government of Canada. 2011. Innovation Canada: A Call to Action, Review of Federal Support to Research and Development – Expert Panel Report. Ottawa: Industry Canada.

Small Business Rate

Small business in B.C. has a reduced federal and provincial CIT rate. The rationale for having a lower small business rate is that small businesses typically have a significantly higher cost of financing than larger businesses and in many cases have no access to capital financing at all. The lower small business rate allows small businesses to build up retained earnings to be used to finance future growth. However, every small business can accumulate retained earnings, whether the business is trying to grow or not. For example, professionals and other individual high-income earners can use the low small business CIT rate to effectively create a low-tax retirement fund, with no intention of ever growing their business beyond the small business threshold.[52]

In addition, the difference between the combined federal and provincial small business and the general rates (doubling from 13% to 26%) creates a "tax wall" for businesses that exceed the small business threshold, discouraging rather than encouraging growth[53]. Studies by Dachis and Lester[54] and Department of Finance[55] have shown that there is an abnormal number or "bunching" of small businesses at the limits to the small business deduction proving some evidence in support of this concept. However, the number of businesses bunched at the threshold is small, suggesting that there is not much economic significance to this effect.

Quebec has recently made some changes to try to focus the small business rate on businesses that are more likely to grow and the federal government is reviewing tax expenditures, which likely includes the federal small business rate. Note that the B.C. small business rate uses the federal small business rate mechanism and is integrated with the federal structure, although B.C. does set its own rate. Any unilateral change by B.C. regarding who receives the benefit of the small business rate would add complexity and compliance burden to the CIT.

Conclusion

In conclusion, although the CIT affects investment and creates incentives for profit shifting, B.C.'s statutory rate is the lowest among Canadian provinces and close to the OECD average. The PST on machinery and equipment is a much more significant deterrent for investment than the CIT.

There are concerns over the cost effectiveness and design of some tax credit programs and the small business rate, but in each case the issue would be better dealt with multi-laterally with the federal government and other provincial governments. While the Commission believes that these issues should be addressed, this can most effectively be done in a coordinated federal/provincial context, not by unilateral provincial action. The latter would likely only increase the complexity burden on business and render B.C. less tax competitive.

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52 Government of Canada. 2011. Innovation Canada: A Call to Action, Review of Federal Support to Research and Development – Expert Panel Report. Ottawa: Industry Canada.

53 See Chen and Mintz (2011) on the increase in the METR on investment as a small business increases its investment.

54 B. Dachis and J. Lester (2015) "Small Business Preferences as a Barrier to Growth: Not so Tall After All" CD Howe Commentary, No 426.

55 Department of Finance Canada (2014) "Taxation of Small Business in Canada" Tax Expenditures and Evaluations 2013, Ottawa.

Property Tax Review

Property taxes are generally levied as assessed value times a tax rate. Real property in B.C. is assessed for property tax purposes by the B.C. Assessment Authority. The overarching principle of the property assessment system is annual market value assessment, except for certain types of property for which market values are difficult to determine, such as major industrial facilities like pulp mills and linear property like pipelines.

Tax rates are set by taxing authorities, of which there are many in B.C.. The provincial government is a major taxing authority, levying school property tax on all taxable properties and rural area tax on properties outside of organized municipalities. Many of the remaining taxing authorities are related to local government, including municipalities, regional districts and various types of local areas established for specific purpose, such as building local infrastructure or promoting businesses in a specific neighborhood.

All property in B.C. is classed into one of nine property classes:

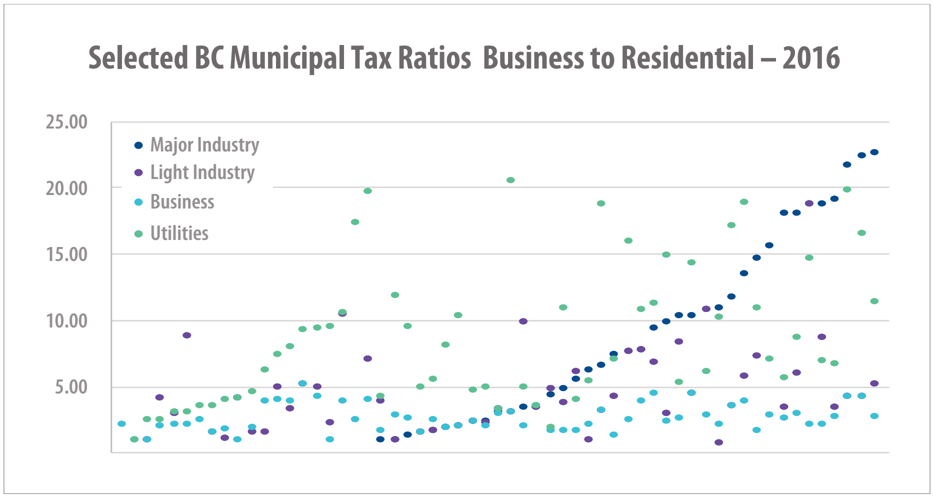
- CLASS 1 – Residential
- CLASS 2 – Utilities
- CLASS 3 – Supportive Housing
- CLASS 4 – Major Industry
- CLASS 5 – Light Industry
- CLASS 6 – Business Other (Commercial)
- CLASS 7 – Managed Forest Land
- CLASS 8 – Recreational Property, Non-profit Organization
- CLASS 9 – Farm

Of these classes, Classes 2, 4, 5 and 6 all deal with business property. Property classes exist because of different assessment methodologies (Class 2 and 4) or different tax rates (e.g. Classes 3, 7, 8 and 9 generally have lower or zero tax rates).

The provincial government generally sets its tax rates each year based on inflation in the previous year and new construction. It sets rural tax rates that generally apply across the province, residential school tax rates that vary by school district and non-residential school tax rates that are the same across the entire province.

Importantly, municipalities have full autonomy to set different property tax rates for each property class without restriction, except for some port and utilities class property. As a result, tax rates and the relationship among the rates for different classes varies widely across the province. As Chart 20 indicates, both Utilities and Major Industry properties are taxed in some municipalities at rates that are more than 20 times the residential tax rate. Light Industry tax rates also vary considerably but not to the same extent as Utilities and Major Industry. Business Other tax rates vary in a narrower band, typically 1 to 5 times the residential tax rate.

CHART 20[56]



It is difficult to compare property classes across provinces because of the differences in the assessment and tax systems. However, what evidence there is suggests that neither the level of provincial business property taxes in B.C. or the level of total property taxes levied on business is a competitiveness issue. Overall B.C. property taxes seem to be relatively low.[57]

Excessive Rates in Some Municipalities Create Investment Uncertainty

The flexibility given to local governments to set whatever level of property taxes they choose results in competitiveness issues in some municipalities at some times. The issue is more acute in relation to Class 2 Utilities and Class 4 Major Industry.[58] High tax rates and uncertainty about future tax rates have an impact on the province as a whole because they create a disincentive to invest or reinvest in facilities, leading to reduced employment opportunities and provincial income tax revenues. In addition, higher municipal business property taxes, which are deductible under the CIT, reduce provincial revenues. In effect, high tax rates and the risk premium associated with potential high tax rates increase the Investment Tax Wedge and the METR for those investments.

Two provincial initiatives have been implemented to partially address this issue for some specific properties. Limits have been placed on property tax ratios related to Utilities Class property, which includes railways, pipelines, and telephone lines and some port property, because of significant provincial interests in encouraging investment in these properties. There were unintended consequences in both cases, including "ceiling" tax rates becoming the "floor" with the result that more municipalities increased than decreased tax rates. Chart 21 shows what happened to utilities class tax rates after limits were imposed in the mid-1990s to encourage railway investment.

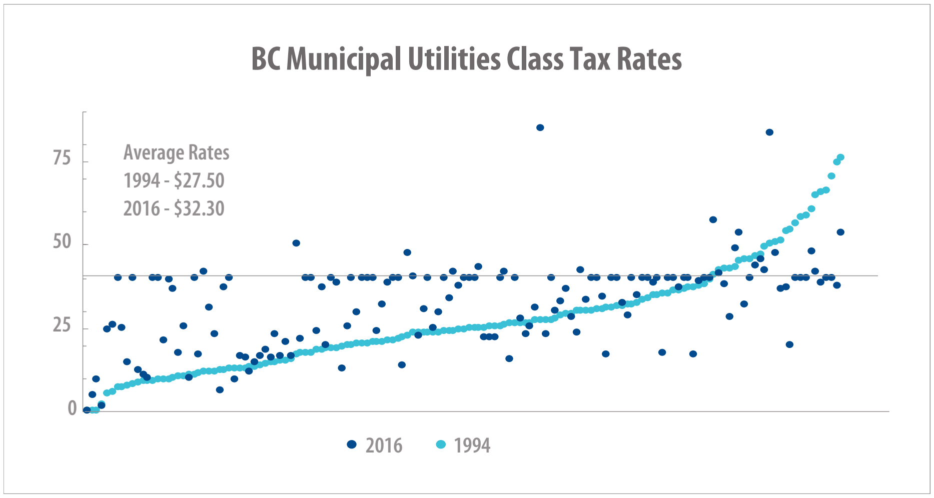
56 Source: B.C. Ministry of Community, Sport and Cultural Development – the tax ratios for a given municipality are vertically in line.

57 H. Kitchen and E. Slack (2012) "Property Taxes and Competitiveness in British Columbia" A report prepared for the B.C. Expert Panel on Business Tax Competitiveness and A. Found, P. Tomlinson and B. Dachis (2015) "Business Tax Burdens in Canada's Major Cities: The 2015 Report Card" *CD Howe E-Brief*, November.

58 See Union of British Columbia Municipalities and B.C. Ministry of Community, Sport and Cultural Development, Major Industrial Property Taxation Impacts, January, 2011

Many low rate municipalities increased rates to the limit and a few decreased rates because of the limit. Some municipalities remain above the limit because of exceptions.

CHART 21[59]



The problem of high property tax rates can be especially acute for unprofitable businesses with large embedded infrastructure investments, however there are measures available to help address issues related to high property tax rates. There is a provincial program, Community Transition Services, that is able to help communities faced by downsizing of large employers, especially in natural resource industries. In addition, the *Community Charter* provides a tool known as Revitalization Tax Exemptions that municipalities can use in such cases and also in cases where a property taxpayer is planning incremental investment. The provision provides authority to exempt land or improvements or both, from the municipal portion of property value taxes for the purposes of encouraging various types of economic, social or environmental revitalization within a community.

Conclusion

The Commission notes that most municipalities' business property tax rates do not represent a significant competitiveness issue and are unlikely to do so in the future. Nevertheless, throughout the past three decades there have always been a few municipalities with extremely high rates for at least one non-residential property class. That causes investment uncertainty and creates an investment disincentive. A fundamental change to the way municipal property taxes are managed would create a significant amount of disruption, with attendant costs. In addition, the experience from the railway and port property tax limitations is that there can easily be unintended consequences that undermine the effectiveness of measures to limit business property tax rates. Therefore, the benefits of a fundamental change need to outweigh the costs such a change would impose.

59 Source: B.C. Ministry of Community, Sport and Cultural Development – the tax ratios for a given municipality are vertically in line.

Options Design and Evaluation

The review of the PST, CIT and PT above indicates that all three taxes can affect business competitiveness and economic performance. The Commission has concluded that the PST in its current form is the highest priority for reform because it has the greatest impact of the three taxes on business competitiveness and economic performance province-wide. The following sets out a range of PST reform options, an option to replace the PST with a B.C. VAT and options related to CIT and PT.

PST REFORM OPTIONS

As discussed above, PST affects business competitiveness and economic performance because:

- PST on machinery, equipment and other capital goods is a disincentive to invest;
- PST on other business inputs increases ongoing expenses for businesses;
- PST has a relatively narrow tax base, which distorts consumption decisions between taxable and non-taxable goods reducing economic efficiency; and,
- PST's extensive set of exemptions adds complexity and increases compliance burdens.

The following options are organized according to these four effects.

OPTION PST I – *Expand Existing M&E Exemptions*

Under this option, the four existing machinery and equipment exemptions for the manufacturing, forestry, mining and oil and gas industries would each be simplified and broadened so that they are easier to administer and comply with. The result would be that a greater proportion of the machinery and equipment purchased by these four industries is exempt.

This option would reduce the disincentive to invest in the four targeted industries, all of which are trade-exposed, capital intensive industries which would benefit from the change. However, it would do nothing for all of the other industries that also require capital investment, do nothing to reduce the distortions that arise from the fact that the current exemptions apply to only some purchases in some industries, and limit the impact of the option on economic performance. Because the exemptions would still draw difficult distinctions between items that are exempt in some situations and not exempt in others, considerable compliance and administrative costs would remain. The option is expected to reduce revenue by $129 million in a full year if exemption covers 100% of the machinery and equipment for those industries. The option could be introduced and implemented in the short term.

OPTION PST II – ***Full Business Capital Expenditure Exemption***

This option would provide a full exemption for machinery and equipment and all other capital goods purchased by business.

Eliminating PST on capital expenditure would reduce the disincentive to invest across the entire business sector, reducing METR on machinery and equipment from 33.7% to 24.9% and reducing the tax wedge between the pre-tax rate of return and the after-tax rate of return from 1.77% to 1.11%. It would have the effect of increasing fairness between economic sectors and reducing economic distortion associated with the current exemption. It should be noted, that the option would not remove all PST from capital expenditures, since any tax embedded in the cost of capital goods would remain.

PST Capital Spending Exemption Single Most Effective Investment Tax Measure

Modelling indicates that a lower METR on machinery and equipment would increase investment and result in higher wage and salary income of about $1.1 billion per year, which would generate about $100 million in additional tax revenues. The amount of PST revenue foregone would be about $640 million per year for the machinery and equipment which would make up most of the exemption, once fully implemented. The cost would be partially offset in the medium term by the increased revenues arising from higher personal income.

The impact of this option on compliance and administration costs and the timing of implementation depend on the way this option is implemented. There are three sub-options representing three different implementation approaches. The Commission feels that for the purpose of implementing this option, care should be taken to keep complexity and compliance burden to a minimum, erring on the side of simplicity even if that implies tax leakage may be somewhat higher.

Sub-option (a) – Point of Sale PST Exemption. Under this sub-option, all businesses would be eligible for an exemption from PST on capital goods at the time of purchase. In practice, this would require:

- The registration of all businesses to identify who qualifies for the exemption or the use of an existing business registration, such as GST registration; and
- The definition of exactly what qualifies as machinery and equipment and what does not qualify.

Both of these requirements could result in a compliance and administrative burden. Many businesses are not currently registered for PST. The compliance burden would be reduced if GST registration can be used to identify businesses, but if not thousands of additional businesses would be required to register for PST.

Defining capital goods would likely require detailed lists of goods that are exempt from PST when purchased by businesses. This would put considerable compliance burden on retailers in determining, product by product, whether it is or is not exempt. When in doubt, the PST would be charged and the purchaser would need to seek a refund (as is currently the case). When a point of sale exemption is granted, it would likely need to be supported by a signed certificate to protect the retailer.

This option could be implemented in the medium-term, since it would take time to develop the needed regulations and manuals, to provide the needed training and to enable vendors to change their systems to accommodate the exemptions. It would have the advantage of providing the tax relief to businesses at the time of purchase in many cases.

Sub-option (b) – PST Refund System. Under this option, PST would be paid at point of sale but businesses would be able to apply for refunds of PST paid on qualifying products. It would require registration of businesses for refund purposes and the same requirements as sub-option (a) to define exactly what qualifies and what does not. The main differences between the two sub-options are that the compliance cost burden would shift from vendors to purchasers and government administrators. Rather than instant tax relief under the point of sale sub-option, refunds would delay the timing of tax relief, affecting businesses' cash flow. This sub-option would take about the same length of time to implement as sub-option (a).

Sub-option (c) – Refundable Income Tax Credit. Under this option, businesses would be able to apply for a tax credit on their income tax return, based on the increase in capital assets in specified Capital Cost Allowance (CCA) classes in B.C.[60] That is information that is already required to be collected for income tax purposes.

The increases to B.C. assets in the following CCA classes would qualify for the tax credit:

- CLASS 8 – Miscellaneous furniture and equipment
- CLASS 10 – Computer hardware and associated software, and some vehicles
- CLASS 10.1 – Vehicles with cost > $30,000
- CLASS 38 – Power-operated, movable equipment used for excavating, moving, placing, or compacting earth, rock, concrete, or asphalt
- CLASS 43 – Manufacturing machinery and equipment
- CLASS 46 – Data network equipment and associated software
- CLASS 50 – Computer hardware and associated software not included in class 10

60 See *http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtng/cptl/dprcbl-eng.html*

Asset purchases in the following CCA classes would not qualify for the tax credit:

- **CLASSES 1, 3 AND 6** – Buildings and their components
- **CLASS 12** – Consumable items
- **CLASS 29** – Machinery and equipment purchased before 2016

This tax credit would be available under both CIT for incorporated businesses and PIT for unincorporated businesses. The advantage is that there would be no definition of capital goods or machinery and equipment required, since the federal asset classes would be used and no registration of businesses would be needed. There would be some additional complexity because assets purchased and used in B.C. would have to be tracked separately for businesses operating in more than one province. The tax relief would also be delayed until the tax return is assessed affecting businesses' cash flow but the amount of the tax credit could be reflected in installment payments for businesses that have taxable income, mitigating this effect somewhat.

In 2000 a non-refundable investment tax credit was introduced but it was ineffective because it denied tax relief to businesses without taxable income and tax payable, often those businesses most in need of the tax relief to encourage the investments needed to make them profitable and able to grow. For this reason the tax credit should be refundable.

Sub-options (b) and (c) could be phased-in incrementally by providing partial tax relief of a percentage of the tax paid instead of the full amount to phase-in the exemption if it is unaffordable in one year.[61]

OPTION PST III – *Specific Additional Business Input Exemptions*

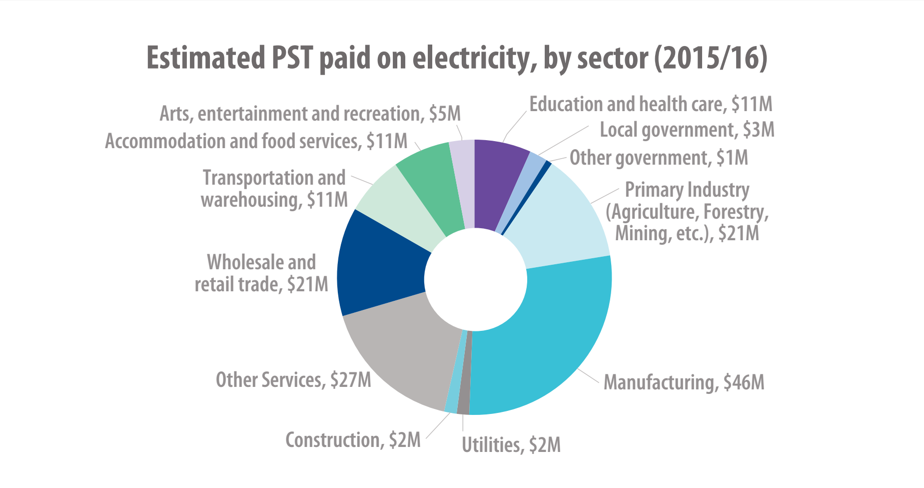
This option would add exemptions for some specific business expenses that particularly affect business competitiveness. There are many business inputs that are taxed under the PST ranging from stationary supplies to legal services. Except for some machinery and equipment and goods purchased for resale or to be manufactured into other goods and some industry specific exemptions (e.g. for agriculture), most goods and the services that are taxed under the PST are taxable when purchased by businesses.

> "B.C. is the only jurisdiction to apply a sales tax to electricity for processing across competing pulp and paper regions in North America"
>
> – PULP & PAPER COALITION

61 If a partial refund or tax credit were given, the issue of how to deal with the existing exemptions for manufacturing, forestry, mining and oil and gas would arise. Those exemptions could be eliminated or, alternatively the refund or tax credit could only be provided to other industries, perhaps combined with option PST I, expanding the existing exemptions. For the tax credit, another alternative would be to require businesses receiving a PST M&E exemption to deduct the amount of the exemption received from the amount of the tax credit.

Based on public consultations, the Commission believes that the priority exemption areas are electricity and other energy, software and telecommunications services. Retail sales taxation of business use of electricity and natural gas is unique to B.C. and is a significant business expense in some industries, such as pulp and paper, creating a significant disadvantage against international competition that does not face such a tax. In that industry, the PST on electricity alone represents 1.8% of total costs, and net margins are often less than that. Thus PST on electricity can often be the difference between profit and loss for these companies. Software purchases are in the nature of productivity enhancing investments, even if the cost isn't capitalized, and are similar in that respect to the machinery and equipment exemption issue. Telecommunications is crucial in the digital age and is an important business input that should not be discouraged through higher cost due to PST.

CHART 22[62]



These exemptions would all enhance business competitiveness and economic performance to some extent. The impact would be felt by some industries more than others, particularly those industries currently most negatively impacted by the tax on these inputs.

Exemptions for energy would be relatively simple to implement with low compliance costs because there are few vendors and it is relatively easy to identify business users. Software and telecommunications services exemptions would require defining the products and distinguishing between business and non-business users, perhaps requiring use certificates, similar to machinery and equipment exemptions. The exemption would reduce revenue by $160 million for electricity, $157 million for other energy, $153 million for telecommunications services and $50 million for software for a total of $520 million. These exemptions could be introduced quickly.

62 Source: B.C. Ministry of Finance

OPTION PST IV – *Full Business Input Exemption*

This option would, similar to full capital investment exemption (Option PST II), provide a full exemption for business inputs. It would enhance competitiveness and economic performance by reducing business costs across all industries. The option would also reduce the disincentive to invest by eliminating embedded tax as well as direct tax on all forms of capital.

Eliminating PST on all capital expenditure and other business inputs would reduce the disincentive to invest across the entire business sector, reducing the aggregate METR on investment from 27.9% to 18.0%. That would consequently increase the capital-labour ratio by 4.12% in the medium term. Because of the added investment, modelling indicates that the average real wage rate would increase by about 1.90%, resulting in a $2.5 billion per year increase in wage and salary income in B.C..

As with the capital investment option, this could be implemented in different ways. It could be a point of sale exemption or a refund system.[63] All purchases by business would be exempt, so compared to the capital goods exemption, defining and complying with this exemption would be relatively straightforward. The main compliance issue would be determining whether the purchaser is actually a business entity doing business in B.C. or not. The difference between the point of sale and refund implementation options is whether the vendor (point of sale exemption) or the tax administrators and purchasers would need to determine business eligibility. In both cases, all businesses would have to be registered and identified appropriately on invoices.

A refund system would be very similar to the input tax credit under an invoice-based value added tax. In fact, with a full business exemption, the PST would effectively become a value added tax with a relatively narrow tax base.

This option would reduce revenues by about $3.1 billion. It would be a medium to long term option.

63 The income tax implementation option is less feasible for a full business input exemption because there is no convenient income tax account similar to CCA that would include just taxable expenditures in B.C. and therefore would provide a basis for a tax credit.

MADE-IN-B.C. VAT OPTION

This option is to implement a made-in-B.C. value added tax that reflects the values and priorities of B.C. citizens, as Quebec has done. A B.C. VAT would address all three of the issues identified with the PST: investment disincentive; increase in business costs; and, distortions and compliance costs due to the narrow tax base.

A made-in-B.C. value added tax that would remove the taxes on capital goods and other business inputs would increase incentives to invest to the same degree as Option PST IV and would result in a similar increase in real wages and salaries, $2.5 billion per year. Some of these gains in real incomes would result from lower prices of some consumer goods as businesses pass on cost reductions from the elimination of the embedded tax under the PST.[64]

There are essentially two types of value added tax: invoice based value added tax, which is the type of VAT used in almost every country that has a VAT; and accounts-based VAT, which is used only in Japan at present. While an accounts-based VAT with the broadest possible tax base is the simplest form of VAT, there is public resistance to taxing items like basic groceries or medical services in Canada. Once significant exemptions such as these are introduced, the accounts-based tax becomes effectively the same as the invoiced-based VAT in terms of complexity. That fact together with concerns about transparency and the fact that the accounts-based approach is not widely used and therefore riskier to implement, have convinced the Commission to only consider an invoice-based VAT.

Would a B.C. VAT be just the HST in disguise? It is true that the HST in B.C. was an invoice-based value added tax, as is the GST. However, the different design choices made-in-B.C. could mean that it would be significantly different than the GST or HST. Quebec has chosen to implement its own, made-in-Quebec value added tax, the QST which differs from the HST and GST.

B.C. VAT addresses all PST issues, could differ significantly from GST, would have a lower revenue neutral tax rate

The Commission feels strongly that any introduction of a B.C. VAT would require an extensive public consultation process to determine exactly how it should be made in B.C.. Therefore, the Commission is not proposing design parameters in this option. However, it may be useful to note some of the features that could be included in the detailed design:

64 See J. Kesselman (2011) Canadian Public Policy 37, 139-162 on the effect of the introduction of the HST on consumer prices in B.C..

- ***General tax rate*** – a tax rate could be chosen to generate more revenue than the PST, be revenue neutral or generate lower revenue. As shown in Table 6, the Commission estimates that, if the machinery and equipment exemption and certain specific business input exemptions are implemented in the short term and a B.C. VAT is implemented after a few years with made in B.C. exemptions that have a total cost of $1.0 billion, the revenue-neutral tax rate would be about 5%;
- ***Tax base*** – British Columbians could pick the tax base that best fits their needs. This would be different from the HST, where provinces can only deviate from the federal GST base by up to 5%. The made-in-B.C. tax base could include some items that are exempt under GST and exclude some things that are taxable under GST. Exemptions[65] could be granted in three different ways:
  - » A full exemption would mean that the purchaser pays no tax but the seller cannot claim input tax credits, so that suppliers of exempt goods and services would need to pro-rate input tax credits based on the proportion of sales that are exempt.
  - » Zero-rated items mean that the good or service would be taxable but with a zero tax rate, so that the seller is eligible to claim input tax credits, removing the imbedded GST that would otherwise be hidden in the price.
  - » Some goods could be given a lower tax rate, similar to zero-rating but not reducing the rate all the way to zero. That could be useful, for example, where an industry competes with another industry that is zero-rated and has products that could be substituted for the first industry. For example, restaurants feel that they would suffer more than other industries when their products are added to the tax base because groceries, a substitute, are zero-rated.
  - » In designing the tax base, consideration should be given to how exemptions would affect families at different levels of income. As shown in Table C.1 in Appendix C, many of the current PST exemptions provide the greatest benefits to higher income earners. Taxing those items and providing a targeted income tax credit to low income earners would help to make the tax more progressive.
- ***Tax Rate*** – some goods and services could be taxed at a rate higher than the general rate. Currently privately sold used vehicles are taxed at 12% to level the playing field for motor dealers because used vehicles sold privately are GST exempt. B.C. could choose to include them in the tax base and set a higher rate, as is done now.

65 Like PST, exemptions of specific items that can be difficult to distinguish or that are exempted only when purchased by certain buyers (like school supplies or purchased of adult-sized clothing for children) would impose high compliance costs under a B.C. VAT and should be avoided to the extent possible.

EXAMPLE OF A MADE-IN-BC VAT

This is an example only. The Commission feels strongly that a BC VAT should be designed based on extensive public engagement, but an example is provided to help give a sense of some possible design parameters of a BC VAT. This example is shown in terms of differences from the GST.

BC Specific Exemptions (no tax but vendors do not qualify for input tax credits)

- Bicycles, bicycle parts and accessories
- Appliance repair (to encourage repair rather than replace)
- Sports safety helmets

BC Specific Zero-rated Items (no tax and vendors qualify for input tax credits)

- Landline telephone services
- Reading materials
- Basic cable
- Motor fuel that is taxed under the Motor Fuel Tax Act
- Renewable energy generation equipment and installation

BC Specific Additions to the Tax Base

- Used vehicles sold privately
- Snack food and sugary drinks sold as groceries

Tax Rates in Addition to General Rate

- Used vehicles, boats and aircraft, sold privately – GST rate plus general rate
- Restaurant meals – 2.5% to reflect competition with zero-rated groceries
- Liquor – 10% as at present
- Manufactured homes – lower rate to reflect competition with pre-owned real estate
- Hotel rooms – general rate + 1% or more, depending on municipality

Input Tax Credits

- Start at something less than 100%, say 75% increasing to 100% over 5 years to keep the revenue-neutral tax rate as low as possible

> "A "made-in-B.C." VAT would also give the province full control over the tax base the rate the tax is levied at. The government could choose to exempt some goods or services, an option that was not available under the HST."
>
> – BUSINESS COUNCIL OF B.C.

- *Input tax credits* – businesses receive input tax credits for tax they have paid under an invoice-based VAT. If necessary, it would be possible to provide only partial input tax credits, at least initially, to reduce the revenue-neutral tax rate. That would reduce the economic benefits of the tax but could be implemented if needed to reflect the values and priorities of British Columbians.
- *Definitions, "border" rules and other administrative provisions* – while value added taxes generally have lower compliance burdens than retail sales taxes, the devil is in the details. B.C. would have the ability to set its own rules, but unless there is a compelling reason not to do so, adopting the same definitions and rules used under GST will help to preserve the compliance cost savings associated with introducing a B.C. VAT.
- *Enhanced personal income tax credit* – another feature that should be associated with a B.C. VAT would be an enhanced B.C. VAT personal income tax credit to offset the impact of the expanded tax base on individuals, especially low income families. This is a necessary feature to ensure that the overall impact of the tax change is not to make taxation in B.C. regressive. It would ensure that the tax relief is delivered to the families that need it.

TABLE 6 – *Revenue Neutral Tax Rate Estimate*

	REVENUES ($MILLIONS)
Current PST Revenue	***6,400***
Short-Term Measures	
Exempt machinery and equipment	***-639***
Exempt energy	***-317***
Exempt software and telecommunication services	***-203***
Revenues After Short-Term Measures implemented	***5,241***
Revenues if B.C. introduces a 7% VAT that adopts GST tax base	***8,000***
Made-in-B.C. VAT Exemptions	***-1,000***
Made-In -B.C. VAT - 7% rate	***7,000***
Revenue for each 1% of the Tax Rate	***1,000***
Revenue Neutral Tax Rate	***5.2%***
Revenues Required ($5,241) divided by Revenue for each 1% Rate ($1,000)	

Prepared by B.C. Ministry of Finance

A B.C. VAT would be simpler and have a lower compliance burden than the PST, provided that detailed exemptions of products that are difficult to distinguish or are exempt for some uses and not for others are avoided. Businesses would still have to comply with two different sales taxes, the GST and B.C. VAT. The extent of the compliance burden associated with that will depend on exactly what choices are made in the detailed design of the tax.

The specific impacts of a B.C. VAT would depend on the final design of the tax, including the impact on GDP, prices, employment and consumers. Studies indicate that the reduction in embedded tax will flow through to a large part to reduce consumer prices over time, offsetting increased taxes paid by consumer on the broader tax base.[66]

A B.C. VAT would be a long term option, because of the consultations that would be required before a decision was made to proceed and because it would take time to develop the needed legislation, regulations, administrative systems, preparations by businesses, training and negotiations with other governments to ensure that the tax works effectively with the GST and provinces that have adopted the HST.

PST SUMMARY

In summary, the Commission believes that the best short term option for reforming the PST is the exemption of capital goods. There are options for implementing such an exemption and the principle in choosing an implementation approach should be to simplify and reduce complexity, and if necessary err on the side of simplicity even if it means a certain amount of tax leakage. The Commission recognizes the complexity of administration and burden placed on vendors associated with a point of sale exemption but leans to a simplicity-based principle because of the reduction in complexity and cash flow benefits for purchasers.

Exempting some business inputs would also be beneficial in the short term, providing immediate relief to some industries and facilitating growth in others. Exempting all business inputs would effectively make the PST a narrow value added tax and for that reason it would be prohibitively expensive in terms of foregone revenue.

The Commission believes that the ultimate solution to the issues associated with the PST is to replace it with a made-in-B.C. VAT that recognizes the priorities and values of British Columbians. This represents a long term solution to issues of business tax competitiveness. Exemption of capital goods and certain business inputs in the interim would be a beneficial step towards a B.C. VAT.

The objective of improving competitiveness is to improve the B.C. standard of living and PST reform has the potential to deliver significant improvements to the wages and salaries of British Columbians.

66 See J. Kesselman (2011) Canadian Public Policy 37, 139-162 on the effect of the introduction of the HST on consumer prices in B.C.

CIT OPTIONS

While B.C.'s general statutory CIT rate is lowest among the provinces in Canada at 26%, from an international perspective it is about the average for OECD countries. However, the marginal effective tax rate on investment is a better measure of the overall impact of the tax system on incentives to investment, and from this perspective B.C. has a competitiveness issue. Among the provinces, B.C. has the second highest, after Manitoba, METR on investment. Among the 92 countries in the Bazel and Mintz study[67], only Japan, France and the United States had higher marginal effective tax rates on investment in 2015.

The question is "What is the best way of reducing the tax impediments to investments in B.C.?" Below we consider two options for addressing the tax competitiveness issue through reductions to the corporate tax rates in B.C..

OPTION CIT I – *Reduce the General CIT Tax Rate*

A one percentage point reduction in B.C.'s general CIT rate from 11% to 10% would reduce aggregate METR from 27.9% to 27.3% and the aggregate tax wedge on rate of return on investment from 1.35% to 1.31%. It would reduce provincial tax CIT revenues by more than $250 million.

Such a reduction in the aggregate METR would increase the incentive to invest in B.C.. Modelling indicates that the resulting increase in labour productivity would increase wages and salaries in B.C. by $151 million per year. While lowering the corporate income tax rate provides a net benefit to British Columbians through a more competitive tax system and ultimately higher standard of living, this option is not as cost-effective as the elimination of PST on all machinery and equipment (PST Option II). The gain in wages and salaries per dollar of tax revenue foregone is $0.60 with the CIT rate cut, whereas it is $1.77 with the elimination of the PST on machinery and equipment. In other words, eliminating the PST on machinery and equipment provides three times as much "bang for the buck" as reducing the CIT rate from 11% to 10%. This ranking of the options is consistent with a federal Department of Finance study which indicated that a reduction in sales taxes on capital goods would generate net benefits per dollar of revenue foregone 3.7 times as large as a reduction in the statutory corporate tax rate[68]. It is also consistent with the advice that the Commission received during our public engagements with business organizations, who indicated that reducing the PST on business inputs was a higher priority than lowering the general corporate income tax rate.

OPTION CIT II – *Reduce the Small Business CIT Tax Rate*

This option is to proceed with the currently planned reduction in B.C.'s small business rate in 2017, from 2.5% to 1.5%. That would reduce provincial tax revenues by more than $100 million.

Concerns have been raised by the OECD[69] in its most recent report on Canada that the small business rate is not a cost effective way of promoting the growth of innovative new businesses.

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67 P. Bazel and J. Mintz (forthcoming) "2015 Tax Competitive Report: Canada is Losing its Attractiveness" SPP Research Paper.

68 M. Baylor and L. Beausejour "Taxation and Economic Efficiency: Results from a Canadian CGE Model", Department of Finance, Working Paper 2004-10, November 2004, Table 4, page 16.

69 OECD (2016), OECD Economic Surveys: Canada, OECD Publishing, Paris. *http://dx.doi.org/10.1787/eco_surveys-can-2016-en*

The Commission strongly suggests that these issues be addressed by government but they should be addressed in a multi-lateral context, involving other provincial governments and the federal government so that unilateral changes do not affect competitiveness across Canada, and in the case of the small business rate, that the issue be fundamentally addressed through the design of the federal CIT.

OPTION CIT III – *Leave the Small Business Rate Unchanged*

This option would forego the planned reduction in the small business tax rate from 2.5% to 1.5% in 2017 and leave the rate unchanged, at least in the short run.

Reducing the small business rate was suggested by several respondents in the public engagement as a mechanism to promote the small business sector, which is responsible for a majority of jobs and GDP in B.C.. However, it would not have any material effect on the Investment Tax Wedge or METR and it would increase the height of the tax wall encountered by businesses that exceed the small business threshold. The small business rate has not been effective in increasing the number of medium-sized and large businesses in B.C.. A further reduction in the rate seems unlikely to change that.

A reduction in the small business rate would cut provincial tax revenue by more than $100 million. The Commission believes that revenue could be better used to partially fund other business tax reform measures that would have a much more significant competitiveness and economic performance impact.

CIT Summary

Based upon the analysis of these three options, the Commission feels that neither the general CIT rate cut or the small business rate cut planned over the next two years should go ahead because PST reform with a similar cost would have a far greater benefit.

While the corporate income tax affects investment, the provincial statutory rate is the lowest among Canadian provinces and slightly higher than the OECD average. As such, the general CIT rate is less of a competitiveness concern at present. The impact of the PST on the incentive to invest in machinery and equipment is much more significant. Eliminating the PST on machinery and equipment is a more cost-effective way of improving economic performance and generating additional income for British Columbians than reducing the general CIT rate. In the public engagement the Commission consistently heard that PST should be the priority over CIT and the Business Council of B.C. suggested that the proposed reduction to CIT rates should be foregone in favour of PST reform.

Concerns have been raised about whether the small business rate and some of the major corporate tax credits are cost effective in promoting employment and the growth of innovative new businesses. The Commission strongly suggests that these issues be addressed by government but they should be addressed in a multi-lateral context, involving other provincial governments and the federal government.

PROPERTY TAX OPTIONS

Property taxation in B.C. is complicated compared to many other jurisdictions because of the different taxing authorities, subtle differences in property tax bases and the fact that there are nine property classes, all of which often have different tax rates. B.C. also has an assessment system based largely on market value that provides a fair, transparent and rigorous basis for determining the tax base, a strong advantage of the B.C. system.

By far the biggest competitiveness concern related to property tax arises because local governments have the full discretion to set different property tax rates for each class of property and some local governments have chosen to impose excessive property taxes on major industrial and/or utilities properties. Perhaps the most damaging aspect of this practice is the uncertainty about what the future level of property tax will be, especially when a major investment is made in a location with few or no other properties in a particular property class. High tax rates and the potential for future high tax rates affect the rate of return required by a company before making an investment, effectively increasing the tax wedge.

Two options are proposed as ways to address this issue:

OPTION PT I – *Cap Non-Residential Property Tax Ratios*

One approach to reducing uncertainty related to new investments, and preventing unreasonable non-residential property tax rates, would be to limit non-residential property tax rates as a proportion of residential property tax rates.

This option would have the following features:

- A maximum would be set for the ratio of non-residential property tax rates to residential property taxes. That is, non-residential property tax rate would not be allowed to be more than X times higher than the residential property tax rate in any municipality;[70]
- Local governments that have ratios currently exceeding the limit would be required to reduce the ratio for each class that exceeds the limit annually over a reasonable period of time; and
- The provincial government could provide compensation to some local governments to facilitate the transition, as was done with the port property tax rate limits, recognizing that this would effectively be rewarding behaviours that in the past put the interests of local residents over the provincial interest in economic performance.[71]

As noted in the property tax discussion above, it is expected that the ceiling represented by the limit would likely become a floor in most cases. For example, where the rate for one property class exceeds the limit but the other rates do not, municipalities can be expected to mitigate the impact on residential rates by raising all non-residential rates to the limit. Even local governments where all tax ratios are less than the limit may feel that the limit represents an acceptable ratio and move the tax rate up to the limit.

70 The Commission is not proposing a specific limit.

71 Note that the provincial government would benefit from reduced property tax rates, as property taxes are deductible for income tax purposes.

Another unintended consequence of limited property tax ratios may arise because assessed values for properties assessed using market values may move in different directions from properties assessed using different methods, such a Major Industry and Utilities Class properties. If, as has happened in the Lower Mainland, residential values increase rapidly then residential property tax rates will fall. If, at the same time, major industry and utility properties have stable or falling assessed values due to depreciation and the ratio is already at the limit, major industry tax rates will be reduced significantly, shifting the tax burden from business to residents even if business was already reasonably taxed.

The opposite situation could also be true. In a case of falling residential assessed values and stable major industry and utility values, the tax burden would shift to those non-residential taxpayers, unless the local government chose to let the ratio fall.

Implementing this option would represent a fundamental change in the way that local governments deal with fiscal management, requiring a complete change in mindset and decision-making. It would reduce local government fiscal flexibility substantially and may encounter significant local government resistance.

OPTION PT II – *Industry - Municipal Investment Arrangements*

A second approach to reducing the impact of property tax uncertainty on major investments is to create a framework within which companies planning major investments could negotiate with municipal governments for a predictable stream of payments to the municipality over the life of the investment, instead of an unpredictable property tax.[72] While municipalities have authority under the *Community Charter* to exempt property from municipal tax for revitalization, that is fully at the discretion of the municipality and a full exemption may not be required or desirable.

This option would have three features:

- It would provide a legal framework within which a taxpayer and local government can reach an arrangement about the future payments related to the property in question;
- It would have a mechanism setting out the circumstances under which a taxpayer could trigger negotiations with a local government; and
- It would provide a dispute resolution mechanism to ensure that the parties ultimately arrive at an arrangement.

72 These payments would not be property tax payments per se, because they would not be calculated using the standard assessed value times tax rate formula.

A precedent for this sort of arrangement exists in the arrangement reached between Pacific Northwest LNG and the municipality of Port Edward. There is the potential for similar arrangements to be reached for other LNG plants, with provincial government approval and specific enabling legislation for each agreement. This option would provide a general framework that could be extended to major investments in various industries, but without case-by-case provincial government involvement.

Industry-Municipal Tax Arrangements Triggered by Industry Could Significantly Reduce Investment Uncertainty

The arrangements themselves could be pre-determined streams of payments that are established in advance or they could be payments that depend on certain factors such as inflation, commodity prices, services provided by the local government or other factors. There could be considerable flexibility given to the parties in designing a basis for future payments that is a reasonable compromise given the interests of both parties.

The trigger mechanism suggested is based on the premise that the taxpayer must be proposing an incremental investment, that is an investment in an existing or new facility, of at least a threshold amount. The LNG facilities range from about $1 billion to tens of billions of dollars. However, there are likely to be significant investment opportunities that could make an important contribution provincially and locally when investments involve much lower total capital costs.

The dispute resolution mechanism should be some form of binding arbitration to ensure that an arrangement is ultimately achieved. Final offer arbitration, where each party is required to submit a final offer and the arbitrator must choose one or the other, has great promise for encouraging the parties to reach an agreement or at least narrow their differences substantially before the arbitrator decides. It should be noted that both parties will benefit from incremental investment in most cases, which should make reaching a mutually beneficial arrangement through direct negotiation possible in many cases.

Negotiations will have a cost for both parties, so this approach should be limited to investment that is significant enough to make that cost worthwhile. Hopefully those costs will also encourage quick resolutions in many cases. Toward that end, it might be useful for the province, in consultation with industry and the Union of B.C. Municipalities to develop some template arrangements that could form the basis for rapid resolution in certain situations.

What about cases where there is other existing property in a property class where incremental investment is proposed? In the case of port property limitations, where property tax rates were limited for some but not all properties in a property class, an unintended consequence was that some municipalities increased the tax rate on other properties in the class to make up lost revenue. That is not expected to happen in this case, since the result will be incremental revenue for the local government, not a loss of revenue. However, it would still be important to review the results after a measure such as this has been in effect for a few years to ensure that unintended consequences are mitigated and the legal framework, incremental investment threshold and dispute resolution mechanism are all working well.

This option would not have any direct provincial government revenue impact and could be implemented relatively quickly, although it would require provincial legislation.

PT Summary

Several public engagement respondents raised the issue of municipal tax rates for some classes being excessive, and the impact that can have on future investment, especially for major industrial facilities. A solution often proposed was to cap non-residential tax rates or ratios.

The Commission understands that there may be significant unintended consequences to such a measure and that it would be difficult to implement. That is why it has developed a more targeted approach that would resolve the issue at least for significant investments. Given likely local government objections to a cap on residential/commercial property tax rates, a targeted framework seem more likely to be successful.

COMPARING OPTIONS

As discussed above, the Commission has identified 11 evaluation criteria to apply to the options. The most important points related to these criteria are discussed in the sections describing the options. Table 7 below summarizes the effect of each option under each evaluation criterion. Appendix C provides additional evaluation discussion.

TABLE 7 – *Options Evaluation Summary*

	PST REFORM OPTIONS				
	Expand Existing M&E Exemptions	***Full Business Capital Exemption***	***Exempt Specific Bus. Inputs***	***Exempt all Business Inputs***	***B.C. VAT***
OPTION	**PST I**	**PST II**	**PST III**	**PST IV**	**B.C. VAT**
Description	Simplify and expand M&E exemptions for the existing four industries (manufacturing, forestry, mining, oil & gas)	Exempt capital spending by POS exemption, refund or a refundable CIT tax credit	Exempt specific business input items from PST – energy, software, telecommunications	Exempt all business purchases, by POS exemption or a refund system	A tax similar to the GST, with rates & exemptions made in BC, after extensive consultations
EVALUATION CRITERIA					
Business Competitiveness, including growth and investment	Encourages investment in specific industries, leading to limited increased investment, economic performance and standard of living	Encourages investment generally leading to some economic growth due to increased investment	Reduces business costs, affecting some industries more than others -> some economic growth	Encourages investment and reduces costs for all businesses, improving economic performance and standard of living	Would eliminate competitive disadvantage due to tax on business inputs
Investment and Cost Tax Wedges	No impact generally, reduce slightly for affected industries	Reduces M&E investment tax wedge from 1.77% to 1.11%	Reduces cost tax wedge	Reduces cost tax wedge and aggregate investment tax wedge from 1.35% to 0.77%	Reduces cost tax wedge and aggregate investment tax wedge from 1.35% to 0.77%
Economic Efficiency	Would increase inter-industry distortions already caused by the existing partial exemption	Would reduce distortion caused by current partial exemption	Would reduce some distortion caused by current partial exemption	Would eliminate distortions due to treating different industries differently	Would reduce distortion caused by current partial taxation of business inputs and narrow base
Fairness	Does not improve fairness	Improves fairness by putting more businesses and more investment in exempt category	Improves fairness by exempting more business inputs	Improves fairness by exempting more business inputs	Improves fairness by exempting more business inputs and subjecting more consumption to tax
Compliance and Administrative Cost	Somewhat simpler but still complex	Higher compliance costs with a wider range of exemptions	Increased exemptions, some of which will increase compliance cost and gov't admin	Simplifies some complex exemptions but adds compliance and admin burden due to POS or refund	Lower than for PST, but not as low as GST. Gov't admin cost will increase substantially
Fiscal Stability and Predictability	No significant impact	No significant impact	No significant impact	No significant impact	Improves fiscal stability due to broader base
Transparency	No significant impact	Reduces embedded taxes	Reduces embedded taxes	Eliminates most embedded taxes	Eliminates most embedded taxes
Provincial Revenue Impact	About $129 million	About $640 million for the M&E component of the exemption	Energy $317 million Software $50 million Telecommunications $153 million Total $520 million	About $3.1 billion, including M&E	Could be higher, lower or revenue neutral, depending on general rate chosen and design details – revenue neutral rate about 5%
British Columbians	Slightly better off due to income arising from investment generating economic growth	Better off due to income arising from investment generating economic growth	Slightly better off due to income arising from improved competitiveness generating economic growth	Significantly better off due to income arising from investment generating economic growth	Significantly better off due to income arising from investment generating economic growth
Implementation	Could be done relatively quickly	POS exemption and refund system would take longer than CIT tax credit	Could be done relatively quickly	Would require significant lead time to implement	Would require considerable lead time to prepare, long term option

TABLE 7 – *Options Evaluation Summary*

	CIT OPTIONS			PT OPTIONS	
	Decrease the General Tax Rate	**Reduce the Small Business Rate**	**Leave the Small Business Tax Rate Unchanged**	**Cap Business Property Tax Rates**	**Industry Municipal Investment Arrangements**
OPTION	**CIT I**	**CIT II**	**CIT III**	**PT I**	**PT II**
Description	Reduce the general tax rate from 11% to 10%	Reduce the small business rate from 2.5% to 1.5%	Leave the Small Business Rate Unchanged at 2.5%	A limit would be set on all business tax ratios, implemented over a reasonable period	Taxpayers making significant incremental investment negotiate payments with local governments
EVALUATION CRITERIA					
Business Competitiveness, including growth and investment	Would improve tax competitiveness slightly, enhancing economic performance slightly	Would not affect businesss competitiveness or materially improve economic performance	Would not increase the tax wall when the small business threshold is exceeded and would enable bigger improvements through PST reform	Encourages investment leading to improved economic performance and standard of living	Would facilitate some new investment, improving economic performance and standard of living
Investment and Cost Tax Wedges	Reduces aggregate investment tax wedge from 1.35% to 1.31%	No change from present	No change from present	Reduces, but not quantifiable	Reduces, but not quantifiable
Economic Efficiency	Improves economic efficiency somewhat	Difficult to assess	Economic efficiency unchanged	Would reduce distortion due to tax rates varying geographically and across property classes	Limited positive Impact
Fairness	Difficult to assess	Difficult to assess	Difficult to assess	Reduces unfair industrial PT increases	Reduces unfair industrial PT increases
Compliance and Administrative Cost	No Impact	No Impact	No Impact	No Impact	Cost associated with negotiations, reduced cost of assessment
Fiscal Stability and Predictability	No Impact	No impact	No impact	No Impact	Increase predictability and stability slightly but reduces flexibility
Transparency	No Impact	No impact	No impact	No Impact	No Impact
Provincial Revenue Impact	Reduce revenue by more than $250 million	Reduce revenue by more than $100 million	No Change from present	Limited positive impact	Limited positive impact
British Columbians	Somewhat better off due to income arising from investment generating economic growth	Increases incomes in the small business sector	Enables PST reform with significant impact	Some gains due to effect of increased investment	Some gains due to effect of increased investment
Implementation	Could be implemented quickly	Could be implemented quickly	Could be implemented quickly	Phased-in over a significant period, but could be introduced in the short-term	Could be implemented quickly

Conclusion and Recommendations

The Commission has posed three questions that get at the essence of our mandate:

1. Are B.C.'s business taxes competitive?
2. Are business taxes in B.C. affecting its competitiveness and economic performance?
3. What are the best ways of improving B.C.'s business tax competitiveness in the short term and over the long run?

ARE B.C.'S BUSINESS TAXES COMPETITIVE?

In terms of statutory tax rates and total business tax burden, B.C. is generally competitive compared to jurisdictions with which B.C. businesses compete.

Delving more deeply into how tax is applied in B.C., there are issues that limit the competitiveness of B.C. businesses and reduce B.C.'s economic performance and standard of living. These represent opportunities for improving B.C.'s competitiveness.

B.C.'s PST is the tax with the greatest negative impact on business competitiveness. By taxing business inputs, particularly capital investment and because of its complexity, the PST acts as a drag on the engine of economic activity. PST can create a disincentive to invest in the machinery, equipment and other capital needed to expand, to keep operating costs down and to keep up with the rapid pace of disruptive technological change.

> ***PST, CIT and Property Tax Could All be Improved but PST has the Greatest Impact***

Many Canadian jurisdictions and most of the rest of the world, other than the state governments in the US, have taxes that do not create the same kind of drag on their economies.

Income taxes also act as a disincentive to invest and Canada's general corporate income tax rate is slightly above the OECD average. However, B.C.'s general CIT rate is the lowest provincial rate in Canada. Gains in competitiveness and economic performance could be achieved by cutting the CIT tax rate. However, the impact of cutting the CIT would be much less than the impact of cutting PST on capital expenditure with the same fiscal cost, and several business groups have suggested that the CIT rate remain the same in favour of PST reform.

Property tax needs to be looked at in terms of provincial and local government implications, as both levels of government levy the tax. Provincial property taxes on business are reasonable compared to other jurisdictions and compared to the level of taxes applied to residential property. However, local governments have full autonomy in setting tax rates for each property tax, including the four property classes that apply to businesses. Some local governments have excessively taxed non-residential property to keep residential taxes low. That has affected investment throughout the province because of the uncertainty about future property taxes, especially for major industrial facilities. In that sense, property tax can be a significant competitiveness issue, but it is localized in nature and of lower priority than PST reform.

ARE BUSINESS TAXES IN B.C. AFFECTING ITS COMPETITIVENESS AND ECONOMIC PERFORMANCE?

The Commission recognizes that business taxes are only one factor affecting competitiveness and the importance of business taxes as a competitiveness factor varies from industry to industry. Nevertheless, the Commission has concluded that the overall effect of the competitiveness issues identified can be significant, particularly for trade-exposed, low-margin industries, and that addressing them would improve the ability of many B.C. industries to compete on world markets and at home, resulting in better economic performance, higher wages and salaries and improvements in the standard of living.

RECOMMENDATIONS

What are the best ways of improving B.C.'s business tax competitiveness in the short term and over the long run? The Commission believes the following are the best options, in order of priority:

RECOMMENDATION 1 – *Full PST Exemption for Business Capital Expenditure*

The Commission recommends all capital expenditure by business be exempted from PST as soon as possible. The intention is to cover machinery and equipment as well as any other capital expenditure taxable under PST. The Commission believes that it is feasible to do this in the short run and that it is the single most effective business tax measure that government could quickly implement to improve competitiveness and economic performance.

> ***Capital Spending Exemption Would Increase Wages by $1.1 Billion Due to Investment***

There are three different ways that this could be implemented. Government should choose the implementation option that will be simplest for business and has the lowest compliance cost, even if that implies some tax leakage. The Commission strongly favours a point of sale exemption, but lacks sufficient information about the administrative issues and compliance costs involved to make a definitive recommendation.

RECOMMENDATION 2 – *PST Exemptions for Certain Business Inputs*

The Commission recommends that, to the extent that government has the fiscal capacity to do so in the short run, the following business inputs should be exempted from PST, in this order of priority:

- Electricity and other energy;
- Software; and
- Telecommunications services.

There are many business inputs that are subject to PST and affect business competitiveness but the Commission believes these three areas should be addressed first. Energy use by business is not taxed under any other retail sales taxes or value added taxes, putting energy-intensive industries at a particular competitive disadvantage. Software is a particularly complex area under the PST generating significant compliance issues, especially in the knowledge-based sector. Both software and telecommunications services are crucial in the digital economy across virtually all industries.

RECOMMENDATION 3 – *Made-in-B.C. VAT*

The Commission recommends that in the long run B.C. move to develop and implement a made-in-B.C. value added tax. That would provide a comprehensive solution to all of the issues raised by the PST and would have the most impact on business competitiveness, economic performance and ultimately standard of living.

Significant public engagement would be required to design a made-in-B.C. VAT and to make the final decision about whether to proceed. Therefore, the Commission is not making recommendations about the details of features of the tax such as tax rates, tax base, input tax credits and a refundable personal income tax credit for lower income households. The flexibility to make these decisions unfettered by requirements set by the federal government is a significant benefit to a made-in-B.C. VAT.

However, care should be taken not to let the specific decisions taken erode the gains made by moving from the complex PST with its high compliance burden to a simpler value added tax. Where possible, definitions and rules established for GST should be adopted to minimize compliance cost. Care should also be taken to ensure tax exemptions introduced are not regressive in nature by benefitting high income earners most.

RECOMMENDATION 4 – *Industry- Municipal Investment Arrangements*

The Commission recommends that, in the short run, government introduce a framework for businesses contemplating significant incremental investments, designed to require local government to negotiate arrangements that provide certainty around the property taxes that will be charged by local governments over the life of the investment. This is similar to the opportunity provided to some LNG proponents to bring certainty to their future local government property taxes.

Funding

The Commission is not required by its mandate to submit revenue neutral recommendations. However, the Commission and many of those providing input to the Commission feel that the way any changes are funded is important. Therefore, the Commission suggests:

1. If RECOMMENDATION 1 is adopted, serious consideration be given to cancelling or deferring the proposed cuts to the CIT general and small business rates (Options CIT II and III). Together this would save more than $350 million, compared to the expected cost of eliminating PST on capital expenditures of about $640 million. That would fund over 50% of the cost of that option. While reducing the general CIT tax rates would have had a positive economic impact, the PST changes will have a much larger impact. Additionally, not reducing the small business rate will keep the tax wall at the small business threshold from growing.

> “The Business Council believes the province should keep the CIT at 11% and use the fiscal room . . . to help fund tax relief for business in other areas, such as eliminating the PST on electricity and providing PST exemptions on machinery and equipment” – BUSINESS COUNCIL OF B.C.

2. An option for funding some of the remaining costs of RECOMMENDATION 1 and some of the costs of RECOMMENDATION 2 would be to eliminate some consumer-oriented PST exemptions. The Commission did not include broadening the PST tax base in its options because the total competitiveness and economic performance benefits from eliminating a few specific exemptions would be small and the Commission believes that it would not make much sense to significantly broaden the tax base without also moving to a value added tax at the same time.

However, some PST exemptions could be removed as a funding option. If so, the Commission suggests that the first consideration be eliminating exemptions that have high compliance burdens. Some of that revenue could be used to enhance the PST Tax Credit under the personal income tax and the remainder to fund business tax reductions. Care should be taken in making products that are currently exempt, and have a close, non-taxable substitute, taxable. Exemptions that are regressive (provide a higher benefit to high income earners) are candidates for elimination.

OTHER ISSUES

1. *CIT Issues* – As discussed in the CIT Review section, there are issues related to the small business tax rate, tax credits that target specific industries (such as the film-related tax credits) and the SR&ED tax credit. All of these could be improved but there are limits to what can be accomplished by a single province moving unilaterally. The Commission urges the province to engage the federal and other provincial governments on a multi-lateral basis to address the CIT concerns raised in this report.

2. *PST administration* – Although the Commission heard that this issue has improved in recent years, several commentators noted that, in addition to the complexity and compliance burden imposed by PST, they also experience difficulties in dealing with government. There is a Taxpayer Fairness and Service Code in place that was introduced about a decade ago and last updated in 2012. Some taxpayers feel that service has deteriorated and the intent of the code is not followed to the same extent it once was when first implemented. The Commission suggests that consideration be given to reviewing the Code and undertaking a process to renew the Ministry of Finance's commitment to taxpayer fairness and service.

3. *Border Rules* – Some groups providing input have suggested that B.C. change the way that it administers PST for businesses temporarily bringing goods, especially machinery and equipment, into the province. The issue is especially acute in Northeast B.C. as Alberta oil and gas service contractors bid for work in B.C. during the current period of low oil prices, but it is of general concern. Saskatchewan has adopted a set of rules that, similar to workers' compensation programs, makes businesses who hire the contractors liable for the sales tax if the contractors do not pay it together with other measures to ensure appropriate sales taxes are paid. This issue would be largely addressed by exempting machinery and equipment from PST. If that recommendation is not implemented, the Commission suggests that the Ministry of Finance give serious consideration to adopting similar rules to Saskatchewan.

4. *PST Administrative Issues* – public engagement has revealed several administrative issues related to PST, outlined in Appendix B which do not appear to be consistent with common sense and the principles of the tax, including B.C. tax when manufacturers install products out of province and double taxation of real property contractors who enter into special agreements. The Commission suggests that these issues be reviewed by the Ministry of Finance.

5. Several respondents noted that the maximum commission paid to PST collectors for their role in administering the tax is $198 per month and has been for many years. Given the complexity of the PST for many retailers, the Commission suggests that this maximum commission may be inadequate and should be reviewed.

6. The Report of the Expert Panel on B.C.'s Business Tax Competitiveness issued in 2012 included several recommendations[72] related to property taxation that would have had the effect of the government and local governments working collaboratively to reduce issues with excessive tax rates in some municipalities. Only one of those recommendations was implemented. The Commission suggests that the Ministry of Finance and Ministry of Community, Sport and Cultural Development consider implementing the recommendations now.

> "Increase the "commission" maximum from $198 to $1,000 for small businesses. The rate could stay at 6.6 percent of PST payable, but consideration should be given to lifting the maximum commission amount."
>
> – SMALL BUSINESS ROUNDTABLE

72 Report of the Expert Panel on B.C.'s Business Tax Competitiveness, August 2012, recommendations 24 to 29. *http://www.fin.gov.bc.ca/docs/Final%20Report%20as%20of%20September%2014,%202012.pdf*

APPENDIX A – *List of Participants*

The Commission encouraged submissions from, and met in-person with, a wide variety of stakeholders including British Columbians, B.C. businesses, major industry groups, think tanks, academics and others. Submissions were accepted until September 30, 2016.

The Commission received formal written submissions and/or oral presentations from 27 industry groups, businesses and individuals and held 12 meetings with various groups:

1. Association for Mineral Exploration
2. Association of Major Power Consumers
3. BC Chamber of Commerce
4. BC LNG Alliance
5. BC Pulp and Paper Coalition
6. BC Tech Association
7. BC Trucking Association
8. Business Council of British Columbia (BCBC)
9. Canadian Association of Petroleum Producers
10. Canadian Centre for Policy Alternatives
11. Canadian Energy Pipeline Association
12. Canadian Federation of Independent Business (CFIB)
13. Catalyst Paper Corporation
14. Central 1 Credit Union
15. David Douglas Robertson, EY Law LLP
16. Deloitte
17. Fraser Institute
18. Insurance Bureau of Canada
19. Kevin Milligan, Vancouver School of Economics
20. Mining Association of British Columbia
21. Northeast B.C. Resource Municipalities Coalition
22. Restaurants Canada
23. Small Business Roundtable
24. Tax Executives Institute, Inc.
25. Teck Resources Limited
26. Telus
27. Union of British Columbia Municipalities (UBCM)

The Commission also received 59 responses to a survey on its website. The majority of survey responses were from small business owners (52%) and individual citizens (21%).

APPENDIX B – *Summary of Feedback Received*

PROVINCIAL SALES TAX RELIEF

Feedback on the PST was remarkably consistent. Many stakeholders identified the PST as the biggest tax challenge to business competitiveness in the province and provided various recommendations for improving the PST.

Machinery and Equipment (M&E)

The PST on machinery and equipment (M&E) was identified as a critical problem. Multiple stakeholders noted that B.C. lags the rest of Canada in expenditures on machinery and equipment, and suggested that the PST may be contributing to this problem. The PST on M&E makes it costlier for B.C. firms to invest in capital upgrades. Stakeholders, including BCBC, the Chamber of Commerce and CFIB, widely agreed that eliminating the PST on M&E would remove an important barrier to capital investment, helping B.C. firms better compete in the global economy. When compared with other tax measures, stakeholders placed a high priority on removing PST on M&E.

Targeting Specific Business Inputs

After M&E, some stakeholders indicated competitiveness concerns with levying the PST on other business inputs. The second most common concern heard by the Commission was PST paid on electricity. This concern is particularly acute for highly energy intensive and trade-exposed businesses, for which electricity costs are a significant share of total business costs. Given these concerns, along with the fact that B.C.'s hydroelectricity is a low-carbon form of energy, some stakeholders questioned whether levying PST on electricity continues to be good public policy.

Beyond electricity, the Commission heard that government should target PST exemptions toward business investments that would lead to the greatest improvement in productivity and competitiveness. Some examples identified by stakeholders include software, telecommunications services and expenses related to research and development and intellectual property.

Made-In-B.C. Value-Added Tax

Most stakeholder groups indicated that replacing the PST with a made-in-B.C. value-added tax (VAT) would largely eliminate the competitiveness concerns with the current PST, including concerns with the PST on M&E and other business inputs and competitiveness issues that affect border communities who face unique competitiveness issues with neighbouring jurisdictions.

No stakeholders that met with the Commission indicated that replacing the PST with a made-in-B.C. VAT would negatively affect business competitiveness. However, some stakeholders, including Restaurants Canada, raised concerns that a made-in-B.C.-VAT could affect competitiveness for some industries if the tax base were expanded to include the full set of goods and services taxed under the GST.

The CFIB indicated that the small businesses they represent are generally not in favor of increasing other business taxes to pay for a PST reduction on business inputs. However, the Commission heard broad support for forgoing the current planned corporate income tax rate reduction from 11% to 10% in favor of reducing PST on business inputs.

PST Complexity

Complexity of the PST system was a significant concern expressed by most industry groups and others that met with or made written submissions to the Commission.

The Commission heard numerous examples of areas where the PST is very difficult to understand and comply with. Here are a few examples.

- *Production Machinery and Equipment (PM&E) Exemption* – PM&E is exempt from PST, but there are various limits to the types of machinery and equipment that are exempt. These limitations are very complex, as they often depend on an item's use, its location and even details about how the item was purchased/produced. Manufacturing and other primary industries spend significant efforts ensuring they comply and government spends significant resources auditing compliance.
- *Real Property Contractors (special arrangements)* – The Commission heard that many real property contractors have difficulty determining when they should pay PST on materials they purchase to complete their projects, versus when they should claim an exemption and instead bill their customers for the PST. Generally, contractors should pay PST on materials, and not charge their customers. However, if they and their customer choose to have a special agreement, the contractor becomes exempt and the customer taxable, resulting in the tax treatment varying by customer. If an error is made, government will deny the exemption and require the contractor to pay the appropriate amount of PST. However, at this point, the contractor has likely already billed their customer and it would be difficult to recoup the PST paid. The result is that businesses will be out of pocket the PST they are required to pay and government will collect PST twice on the same materials, unless the customer applies for a refund.
- *Real Property Contractors (installing products outside B.C.)* – The Commission heard complaints about the treatment of PST when B.C. manufacturers install their own products outside the province. Currently, businesses are allowed a refund of PST paid on the materials used to make products installed outside the province, but only if the jurisdiction where the product is being installed levies a similar retail sales tax as B.C.. The refund removes much of the imbedded PST on the product, allowing B.C. businesses to compete. However, if the other jurisdiction levies no sales tax or has a GST/HST style valued added tax, there is no refund provided. This policy is confusing, appears very random, and puts B.C. businesses at a competitive disadvantage.
- *Mixed contracts* – many contracts can be for the provision of multiple interconnected goods, services and real property as a single supply for a single price. Because of the narrow PST tax base vendors must tease out of the agreement which goods and services are subject to PST and which are not and they must also determine the fair market value of the taxable goods and services in order to collect the correct amount of tax. In practice, it is difficult to not make mistakes, leading to potential penalties and interest on audit.
- *Mixed Inventory* – Some businesses both sell a product and use the same product in their business. In that case, they are required to pay the PST on the product that they will use themselves when they purchase it but not on the product that they are purchasing solely for resale. They are then required to charge the customer PST for the product sold to them but not charge the customer PST for product used in providing a service. For example, a garage might both sell lubricant and use lubricant in servicing vehicles. The problem is that at the time of

purchase it is almost impossible for businesses to know if they will use some products themselves or if they will resell the products to their customers. If a business makes a mistake and charges customers PST on goods used in providing the service but does not pay PST when the goods are purchased, they are subject to having to pay the unpaid PST plus penalties upon audit.

While the administrative complexity of the PST is a concern for all businesses, it is particularly concerning to small businesses. Large companies can hire tax experts who focus on the PST and other taxes full-time. However, small business owners are often left to navigate the complex PST rules on their own. The Commission heard that this can be a daunting task, sometimes even leading business owners to abandon opportunities due to the tax complexity that would be involved. Stakeholders requested that the government consider the impact on small businesses when considering measures to reduce the complexity of the PST.

The Commission also heard that the complexities inherent in the PST contribute to a strained relationship between PST administrators monitoring compliance and businesses trying to comply. While administering the PST is difficult for both government and businesses, the Commission heard that businesses have difficulty dealing with government and sometimes feel they are being treated with suspicion when under audit.

In probing stakeholders for solutions to the many PST complexities it was clear to the Commission that the solutions are often not easy. However, it was widely acknowledged that many of the issues raised would automatically go away if B.C. were to adopt a made-in-B.C. value added tax.

PROPERTY TAX

While the Commission heard that the PST was by far the top priority for the business community, concerns with business property taxation were also identified. While overall the Commission heard that property taxes are not out of line with other jurisdictions, two key concerns were highlighted.

- *Tax Ratios* – Property tax rates levied on businesses tend to be much higher than the rates that apply to residential property. For example, it was brought to the Commissions attention that business rates are often 5 to 10 higher than the residential rate, and in some municipalities industry can be even higher reaching 15 to 20 times the residential rates or more. These situations tended to occur in locations where a particular major industry forms a substantial part of a community's economy and property tax base.
- *Uncertainty* – Because each municipality has the ability to set its own property tax rates and can change the rates at any time, the uncertainty around what future rates will be makes it difficult for businesses to manage the risks over the long term.

A common recommendation made to the Commission to address these issues is to put caps on the business-to-residential tax rate ratios, or implement tax rate "fairness ranges." Rules would then be put in place for communities falling outside the cap/ranges to become compliant over a period of time.

In exploring solutions to the above issues the Commission also heard from communities through input provided by UBCM. This input was very helpful in understanding the complexity around municipal property taxation and some of the issues to be aware of when exploring solutions. Issues to consider include:

- *Historical context* – What is the history of taxation in a region and does that history provide context for the current rate setting structure? For example, the resource industry in B.C. (in particular forestry and related industries) has been in decline in recent years. What may be considered very reasonable property taxation rates in normal economic times may appear less reasonable during a depressed economic period when an industry is struggling to adapt.
- *Interactions between rates, assessed values and revenues* – For example, it is common for municipalities to lower the residential tax rates as residential property values rise to prevent property taxes from rising at the same pace as house values. Likewise, industrial property values are not determined based on fair market value but instead are calculated using a complex formula whereby depreciation reduces assessed values over time. Combining these two results, it is easy to see how the major industry to residential property tax ratio could rise significantly over time even when there has been little change in the amount of tax paid by the various taxpayers over that same period.
- *The role of municipalities* – Municipalities provide a wide range of services to businesses and individuals in their communities and are well positioned to understand the individual needs of their constituents. Property taxes form the primary funding mechanism for financing these services.

CORPORATE INCOME TAX

Currently, B.C. has the lowest general corporate income tax rate and third lowest small business rate in Canada. The majority of stakeholders who met with the Commission or made written submissions did not identify corporate income tax as a major competitiveness concern. However, some within the small business community, including the Small Business Roundtable, indicated that small businesses would benefit from continued reductions to the small business rate.

Other stakeholders highlighted the gap between the small business rate and general rate and questioned its rationale. They indicated that the gap could act as a disincentive to growth and suggested the government re-examine the effectiveness of the small business rate.

The Business Council of British Columbia and others recommended that the government not follow through with the planned general corporate income tax rate reduction from 11% to 10% but instead use the money to fund PST improvements.

OTHER ISSUES

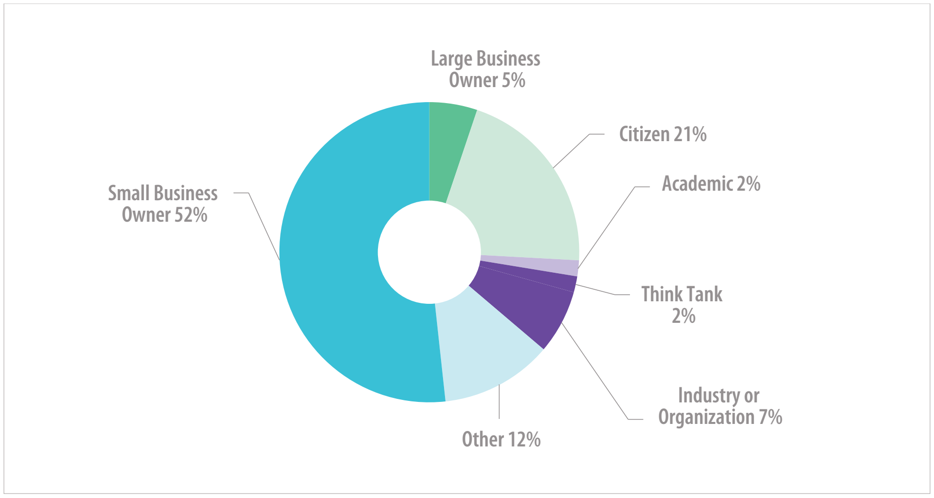
Through its public engagement the Commission received various other recommendations from industry groups, businesses, individuals and other stakeholders. These recommendations have been included in the Commission's analysis and deliberations in coming to its recommendations for improving business competitiveness in B.C.. When the Commission received a recommendation that was outside its mandate, that recommendation was forwarded to the B.C. Ministry of Finance. A few notable recommendations that have not been discussed above are noted below.

1. *MSP Premiums* – The Commission heard that MSP premiums need to be reformed. The current administrative system is inefficient and expensive. A better system would be to administer premiums through the income tax system.
2. *Broader tax review needed* – It was noted that a broader tax review that encompasses more than just businesses taxes was necessary, with a particular focus on fairness and the impact of the tax system on individuals.

ONLINE FEEDBACK

In addition to discussions with stakeholders, the Commission also received feedback through an online survey available on the Commission website. There were 59 responses to the survey, the majority of which was provided by small business owners (52%) and individual citizens (21%), as shown on Chart B.1.

CHART B.1

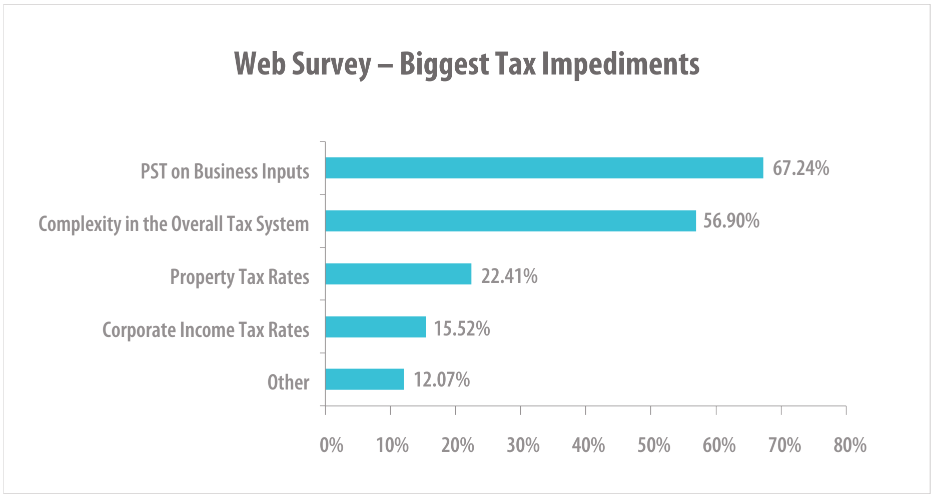


Online feedback was consistent with feedback received from industry groups and other stakeholders who met with the Commission of made formal written submissions. The feedback focused on two main themes:

- Reducing PST on business inputs, and
- Reducing the complexity of the tax system

When asked, *"What do you find to be the biggest tax impediments to business growth in B.C.,"* two thirds of respondents identified PST on business inputs and more than half identified the complexity of the overall tax system as important tax issues, as shown in Chart B.2.

CHART B.2



Online feedback tended to focus on the following recommendations:

- Simplify the tax system's administrative rules and regulations, especially the PST rules. Current rules are too complex and are drag on economic growth.
- Eliminate the PST and replace it with a made-in-B.C. value added tax or go back to the HST.
- Reduce businesses taxes generally.

APPENDIX C – *Evaluating the Impact of Tax Options*

Improving business tax competitiveness is not an end in itself, but the means to improving the standard of living of B.C. residents. Improving business tax competitiveness, by reducing the taxation of capital goods and other intermediate inputs used by business, will increase private sector investment and the adoption of new technologies and innovations. Labour productivity will increase, resulting in higher wages and salaries for B.C. workers.

The marginal effective tax rate on investment (METR) is a widely-used measure of business tax competitiveness. Econometric studies have shown that a lower METR on investment increases investment.[73] As a result, the machinery and equipment and other forms of capital that workers operate with increases over time, leading to improvements in labour productivity and higher wage rates. The linkage between a lower METR and higher average wage rates is shown in the following charts.

CHART C.1[74]

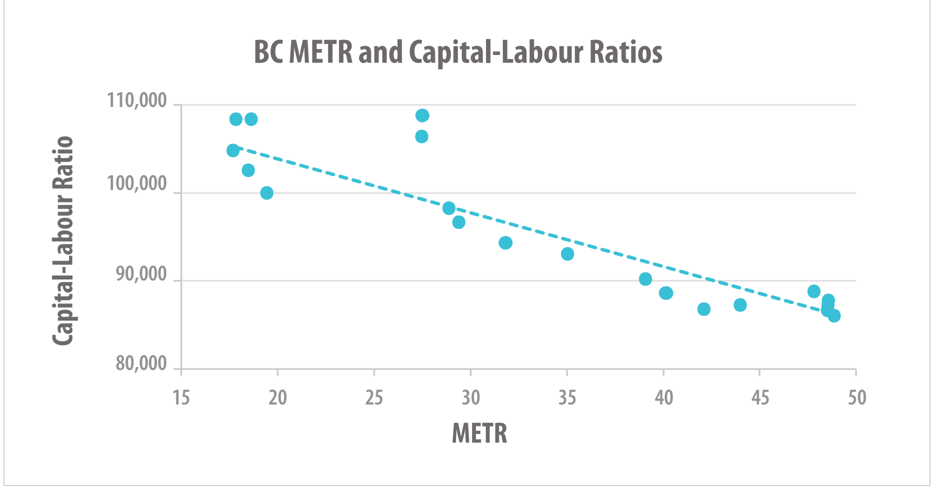


Chart C.1 shows that when the METR in B.C. is lower, the ratio of the total private sector capital to labour is higher. This increase in the capital-labour ratio results from the increase in business investment that occurs over time because a reduction in the METR increases incentives to invest in machinery and equipment, structures and other forms of capital that increase labour productivity.

73 See K. Hassett, and R.G. Hubbard (2002) "Tax Policy and Business Investment." Handbook of Public Economics 3, 1293-1343 and B. Dahlby and K. Hassett (forthcoming) "The Economic Effects of the Corporate Tax: "A Review of the Recent Literature", presented at Reforming the Corporate Tax in a Changing World: A Conference on the 20th Anniversary of the Report of the Technical Committee on Business Taxation, Toronto, June 15,

74 Source: Statistics Canada.

CHART C.2[75]

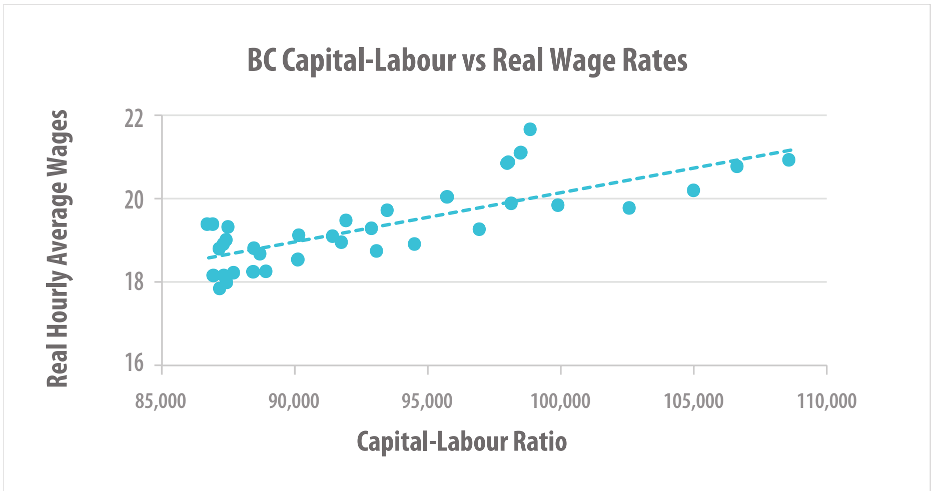


Chart C.2 shows that the average hourly real wage rate in B.C. is higher when the capital-labour ratio is higher because workers' productivity is higher when the amount of capital that they have to work with is higher. The relationships between METR, the capital-labour ratio, and the real average wage rate that are reflected in these charts are confirmed in a recent econometric study based on Canadian data by McKenzie and Ferede[76]. They found that a 10 percent reduction in the METR increases the capital-labour ratio by 1.16 percent and a 10 percent increase a provincial economy's capital-labour ratio increases the average real wage rate in the province by between 2.45 percent and 6.45 percent. Combining these estimates implies that lowering the METR on investment, either by reducing the PST on capital expenditures or by reducing the general CIT rate, will increase workers' average wage rates.

The McKenzie and Ferede econometric results are consistent with the findings of another recent Canadian econometric study by Ebrahimi and Vaillancourt[77], which found that a one percentage point reduction in the provincial CIT rate increases the average hourly wage rate by 0.55% to 0.88%. Assuming a 37.5-hour work week and 52 weeks of work, the income of a worker earning the average wage rate would increase by between $254 and $390 per year. The results of these econometric studies are consistent with econometric studies from other countries which indicate that workers benefit through higher wages and salaries when corporate income tax rates are reduced. Conversely, these studies indicate that a substantial share of the burden of a corporate tax is borne by workers through lower real wage and salaries.

75 Source: Statistics Canada.

76 K. McKenzie and E. Ferede (2016) "The Incidence of Corporate Income Tax on Wages: Insights from the Literature and Evidence from Canadian Provinces" paper presented at Reforming the Corporate Tax in a Changing World: A Conference on the 20th Anniversary of the Report of the Technical Committee on Business Taxation, Toronto, June 15.

77 P. Ebrahimi and F. Vaillancourt (2016). "The Effect of Corporate Income and Payroll Taxes on the Wages of Canadian Workers". Fraser Institute, *https://www.fraserinstitute.org/studies/the-effect-of-corporate-income-and-payroll-taxes-on-the-wages-of-canadian-workers*

OPTION PST I – *Expand Existing M&E Exemptions*

Under this option, the exemptions for the manufacturing, forestry, mining and oil and gas industries would be broadened to eliminate the PST on all machinery and equipment. These measures would reduce the METR on machinery and equipment in forestry from 11.2% to 8.6% and the investment tax wedge from 0.44% to 0.0.33%. In manufacturing, this measure would reduce the METR from 13.2% to 10.3% and the investment tax wedge from 0.53% to 0.40%. (The impact on METRs and tax wedges for the mining and oil and gas sectors were not available at the time this report was prepared.) The total amount of revenue foregone with the expansion of the PST exemptions for machinery and equipment for these four sectors would be $129 million per year.

The reductions in the METRs and Investment Tax Wedges with this option would increase the incentive to invest in machinery and equipment in these four industries, but industry-specific estimates of the responsiveness of investment to these tax parameters are not available and therefore it is not possible to estimate of the gains from these measures. While the investment impacts might be relatively large, because these are trade-exposed, capital intensive industries, these measures would do nothing for all of the other industries that also require capital investment, doing nothing to reduce the distortions that arise from the fact that the current exemptions apply to only some purchases in some industries, as well as limiting the impact of the option on economic performance. These exemptions would still require difficult distinctions to be made between items that are exempt in some situations and not exempt in others, and therefore considerable compliance and administrative costs would remain.

OPTION PST II – *Full Business Capital Expenditure Exemption*

This option would provide a full exemption for machinery and equipment and other capital goods purchased by all businesses. Eliminating PST on capital expenditure would reduce the disincentive to invest across the entire business sector, reducing the average METR on machinery and equipment from 33.7% to 24.2% and reducing the investment tax wedge between the pre-tax rate of return and the after-tax rate of return from 1.77% to 1.11%. The amount of PST revenue foregone would be about $640 million in a full year once fully implemented.

The McKenzie and Ferede econometric models enables us to estimate the impact on wages and salaries in B.C. from this measure. Eliminating the taxation of machinery and equipment under the PST will reduce the aggregate METR from 27.9% to 23.4% or by 16.1%. Their econometric results imply that this would increase the capital-labour ratio by 1.87% in the medium term and the average real wage rate would increase by between 0.60% and 1.21%. We adopt their base case estimate of a 0.86% increase in wage rate. In 2015, total labour compensation in B.C. was $131.4 billion, and a 0.86% increase in wage rates implies a $1.1 billion per year increase in wage and salary income in B.C.. As result of the increase in wage and salary incomes, the provincial government would receive an additional $113 million in tax revenues and the federal government will receive $170 million more in tax revenues.

In summary, removing the PST from all machinery and equipment purchased by business will increase private sector investment and the adoption of new technologies and innovations. Labour productivity will increase, resulting in higher wages and salaries of about $1.1 billion per year for B.C. workers.

OPTION PST III – *Specific Additional Business Input Exemptions*

This option would provide PST exemptions for business purchases of electricity and other energy, software and telecommunications services. Retail sales taxation of business use of electricity and natural gas is unique to B.C. and is a significant business input in some industries, such as pulp and paper, creating a distortionary competitiveness impact. Software purchases are in the nature of productivity enhancing investments, even if the cost isn't capitalized, and is similar in that respect to the machinery and equipment exemption issue. Telecommunications is crucial in the digital age and is an important business input that should not be discouraged through higher cost due to PST.

These exemptions would all enhance business competitiveness and economic performance, but the Commission was not able to obtain an estimate of the benefits from this measure which might vary widely across industries. In total, the foregone revenue from this option $520 million per year.

OPTION PST IV – *Full Business Input Exemption*

This option would provide a full exemption for business expenditures on capital, including machinery and equipment, and other business inputs. It would enhance competitiveness and economic performance by reducing business costs across all industries. The option would also reduce the disincentive to invest by eliminating embedded tax in capital goods as well as direct tax on machinery and equipment.

Eliminating PST on capital expenditure would reduce the disincentive to invest across the entire business sector, reducing the aggregate METR on investment from 27.9% to 18.0% or by 35%. The amount of PST revenue foregone would be about $3.1 billion a year once fully implemented.

The McKenzie and Ferede econometric model can be used to estimate the impact on wages and salaries in B.C. from this measure. The 35% reduction in the aggregate METR would increase the capital-labour ratio would increase by 4.12% in the medium term and the average real wage rate would increase by between 1.32% and 2.65%. We will use their base case estimate of a 1.90% increase in wage rate. In 2015, total labour compensation in B.C. was $131.4 billion. Thus a 1.90% increase in wage rates implies a $2.5 billion per year increase in wage and salary income in B.C..

In summary, removing the PST from all business inputs would directly lower the cost of machinery and equipment purchased by business and the embedded tax on other capital inputs such as structures. This will increase private sector investment and labour productivity, resulting in higher wages and salaries of about $2.5 billion per year for B.C. workers.

Made-in-B.C. VAT Option

A made-in-B.C. value added tax which would remove the taxes on capital goods and other business inputs which would increase incentives to invest as in Option PST IV and result in a similar increase in wages and salaries, $2.5 billion per year.

Under a B.C. VAT, the government, after extensive consultations with the public, would have to decide on the which consumer items would be taxed, which would be zero rated, and which would be exempt. Broadening the tax base from the current narrow PST base would help to generate additional revenues that could be used to offset the reduction in revenues from removing the sales taxes on business inputs. As Milligan[78] has shown, B.C. needs a significant amount of sales tax revenues to finance current and projected spending. Not having a sales tax is not an option.

In deciding what goods and services to tax, that are not currently taxed under the PST, the government would have to consider the effects of taxing, or not taxing, certain items on different income groups to ensure a fair and equitable distribution of the total tax burden.

Table C.1 can provide some guidance concerning the fairness of *not taxing* certain items. It shows the benefit of some of the most significant PST exemptions for five different income groups based on their after-tax incomes. In many cases, the exemption confers a larger per person benefit for those who are better off and indicates the exemption is regressive.

For example, exempting restaurant meals provides an average per person benefit of $80.41 to the 20% of households in B.C. with the highest after-tax incomes, but only $41.22 to the 20 percent of households with the lowest incomes. Many of the PST exemptions provide greater benefits to individuals in the higher income groups than those with lower incomes. In total, the 20% of households with the highest incomes get 35% of benefits from the PST exemptions while the 20% of households with the lowest income only get 10% of the benefits. Providing greater tax breaks to those who are better off is usually considered unfair because of the regressive effect.

The table also shows that some exemptions, such as electricity for the principal residence, provide a per person benefit that is similar across the income groups. In such cases, taxing the item and providing a refundable tax credit for low income groups would make the tax system more progress. There are a few exemptions, such as the landline telephones, that provide larger per person benefits to the low income groups and zero-rating the item in these cases could be justified on the basis of making the tax system more progressive, but it would distort consumer choices between land line services and cell phone services. Again, it might be better to tax such items and compensate lower income households through a larger refundable sales tax credit.

78 Milligan, Kevin (2016) "Fiscal Options for Building a Prosperous British Columbia", paper commission by the British Columbia Business Council, July 2016. *http://www.bcbc.com/publications/2016/commissioned-paper-fiscal-options-for-building-a-prosperous-british-columbia-by-kevin-milligan*

TABLE C.1 – *The Distribution of the Benefit from PST Exemptions by Income Group*

	B.C. HOUSEHOLDS				
Average Annual PST Savings Per Person in each Household from Exempting the Following Items* from PST	***1st Quintile***	***2nd Quintile***	***3rd Quintile***	***4th Quintile***	***5th Quintile***
	After-Tax Income ($0 - $26,268)	***After-Tax Income ($26,269 - $47,104)***	***After-Tax Income ($47,105 - $69,722)***	***After-Tax Income ($69,723- $100,919)***	***After-Tax Income ($100,920+)***
ENTERTAINMENT					
Restaurant Meals	$41.22	$53.52	$76.13	$79.92	$80.41
Entertainment Services (movie theatres, sports, arts, etc.)	$26.14	$29.93	$26.17	$23.11	$23.52
Use of Recreation Facilities (Includes day camps)	$8.57	$11.81	$10.69	$16.92	$21.89
Reading Materials (books, magazines, newspapers, etc.)	$4.11	$3.83	$6.10	$4.64	$4.44
CHILDREN					
Bicycles, Bike Parts and Accessories	$2.18	$2.30	$1.57	$2.45	$8.59
Textbooks and School Supplies	$4.70	$2.55	$4.15	$2.28	$4.88
TRANSPORTATION					
Gasoline and other fuels	$42.20	$49.00	$57.63	$68.93	$71.25
Airplane Travel	$22.08	$21.58	$24.78	$26.37	$44.90
Inter-City Passenger Service	$3.18	$1.93	$2.59	$4.08	$4.07
Taxi Services	$2.79	$3.06	$2.64	$2.60	$2.74
HOME UTILITIES					
Electricity for Principal Accomodation	$29.66	$27.78	$26.98	$26.42	$30.97
Natural Gas for Principal Accomodation	$14.29	$14.77	$20.42	$19.03	$22.05
Other Fuel for Principal Accomodation	$2.12	$2.01	$2.06	$1.68	$1.23
Landline telephone services	$12.92	$11.41	$9.21	$8.68	$8.15
MISCELLANEOUS					
Personal Care Services (including hair grooming)	$11.01	$14.33	$14.52	$14.63	$20.80
Repairs and Maintenance for Owned Living Quarters	$12.87	$11.19	$19.46	$19.44	$15.43
Veterinary Services	$4.63	$11.78	$7.55	$8.53	$14.22
Unions/Professional Association Dues	$0.73	$3.17	$6.62	$9.26	$13.80
Horticultural services, snow and garbage removal	$2.50	$5.29	$3.34	$5.35	$7.95
Non-prescribed medicines and pharmaceutical products	$23.40	$9.28	$8.02	$7.19	$7.63
Photographic services	$3.13	$2.22	$2.99	$2.84	$4.82
Clothing Services (Dry Cleaning, Tailoring, Rentals, etc.)	$3.48	$3.46	$1.80	$0.92	$2.60
Home security services	$0.66	$1.75	$1.48	$1.75	$1.98
NUMBER OF PERSONS IN HOUSEHOLD	***1.43***	***1.92***	***2.41***	***2.88***	***3.53***
TAX SAVINGS PER HOUSEHOLD	***$398.00***	***$572.00***	***$812.00***	***$1,028.00***	***$1,477***

**This list is not an exhaustive list of items exempt from the PST. Estimates are derived using expenditure data from the Survey of Household Spending.*
Source: B.C. Ministry of Finance

OPTION CIT I – *Reduce the General CIT Tax Rate*

A one percentage point reduction in B.C.'s general CIT rate from 11% to 10% would reduce aggregate METR from 27.9% to 27.3% and the aggregate tax wedge on rate of return on investment from 1.35% to 1.31%. It would reduce provincial tax CIT revenues by $250 million.

Based on the McKenzie and Ferede econometric model, the reduction in the aggregate METR would increase the incentive to invest in B.C.. The resulting increase in labour productivity would increase wages and salaries in B.C. by $151 million per year. While lowering the corporate income tax rate provides a net benefit to British Columbians through a more competitive tax system and ultimately higher standard of living, this option is not as cost-effective as the elimination of PST on all machinery and equipment (PST Option II). The gain in wages and salaries per dollar of tax revenue foregone is 0.60 with the CIT rate cut, whereas it is 1.77 with the elimination of the PST on machinery and equipment. In other words, the eliminating the PST on machinery and equipment provides three times the "bang for the buck" as reducing the CIT rate from 11% to 10%. This ranking of the options is consistent with a federal Department of Finance study which indicated that a reduction in sales taxes on capital goods would generate net benefits per dollar of revenue foregone 3.7 times as large as a reduction in the statutory corporate tax rate[79].

79 M. Baylor and L. Beausejour "Taxation and Economic Efficiency: Results from a Canadian CGE Model", Department of Finance, Working Paper 2004-10, November 2004, Table 4, page 16.

APPENDIX D – *Acronyms Used*

CIT .... Corporate Income Tax

GST .... Goods and Services Tax

HST .... Harmonized Sales Tax

METR............ Marginal Effective Tax Rate
– see Measuring the Effect of Taxes on Business Investment

OECD .... Organization for Economic Co-operation and Development

POS .... Point of Sale

PST.............. Provincial Sales Tax

PT .... Property Tax

SR&ED........... Scientific Research and Experimental Development (Tax Credit)

VAT.............. Value Added Tax

Notes: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1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016