



Business Council *of*
British Columbia

HST

Misconceptions

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Executive Summary

In place for three months now, British Columbia's new Harmonized Sales Tax continues to attract attention. Some of the public debate is focused on the economic consequences of the tax. This short brief addresses several of these economic concerns, with the goal of contributing to a more balanced and reasoned discussion. It is understandable that some people are unhappy with the HST, as consumers are now required to pay additional tax on items that were exempt from the former Provincial Sales Tax (PST). But many of the economic criticisms levelled against the HST are not well-founded and ignore evidence from other jurisdictions with valued-added consumption taxes.

Some critics of the tax believe the HST will undermine our economy. Yet none of Canada's leading economic forecasters believe that either British Columbia or Ontario – which has also instituted its own HST – will suffer economic harm as a result of the tax. In fact, a review of recent published forecasts shows that BC and Ontario are expected to have among the strongest economies in Canada over the next few years. There is no support among professional economists for the view that the HST will cause BC (or Ontario) to fall progressively further behind other provinces in the growth of total economic activity (GDP), employment, retail sales, or business investment.

A large body of research spanning many countries suggests that the reduction in business production costs associated with adopting a value-added consumption tax like the HST yields significant economic benefits over time. In particular, lower costs for capital equipment, construction materials, vehicles, computers, and many other “business inputs” give many companies a greater incentive to hire, to invest, and to expand their operations. A recent study by a leading Canadian economist estimates that the HST will generate an additional \$11 billion in private sector investment and spur the creation of more than 100,000 new jobs by 2020.

The small temporary up tick in inflation caused by the HST is not a major concern, especially in the current low inflation environment. Part of any inflation stemming from imposing tax on previously PST-exempt services should be offset by price reductions, as costs fall for most businesses due to the introduction of input tax credits under the new HST. Broadly speaking, pre-tax prices for both goods and services are expected to drop slightly under the HST. The effect will be greatest in industries in which the former PST on production inputs represented a non-trivial portion of overall business costs. It should be noted that in Canada, the GST had no lasting impact on underlying inflation.

A commonly heard complaint about the HST is that only “big business” will benefit from any cost reductions, even though input tax credits apply to all businesses, and despite the fact that the vast majority of enterprises in BC have fewer than 50 employees. In truth,



industries like manufacturing, construction and agriculture, which stand to gain from the HST, are heavily populated by small businesses. And, as a trade-dependent jurisdiction that exports more than \$50 billion of goods and services every year, with the HST in place British Columbia will become a more competitive location for export businesses across most of the industry sectors that underpin our prosperity.

A legitimate concern with any consumption tax is how it affects lower-income households. Under the HST, some basic consumer necessities (like rent and food) are exempt from the tax. In addition, the provincial government has established a system of HST tax credits to insulate lower-income households from any adverse economic impact. Moreover, in tandem with the HST, the government boosted the basic personal exemption – the amount individuals can earn before paying any provincial income tax – from \$9,373 to \$11,000, which disproportionately benefits those with low incomes. In fact, a significant number of low-income households in BC are expected to come out ahead with the HST. Nor should it be forgotten that on a cumulative basis, the BC government sharply reduced income taxes for all BC households over the period 2001-2010.

There are worries that the HST may lead to an expansion in the “underground economy” and/or spur the growth of government. Concern about the underground economy is understandable, but the critics overstate the case. For one thing, BC already has a sizable “shadow” economy, and the evidence from other Canadian provinces suggests the HST won’t spark a massive wave of new underground activity. Only a few areas of consumer spending (e.g., household services and home renovations) are susceptible to tax avoidance. Moreover, it’s important to recognize that with the HST, businesses in BC now have a stronger incentive to operate “above-ground,” as this is the only way they can qualify for tax credits on their inputs. Finally, international experience does not support the view that value-added consumption taxes stimulate the growth of “shadow” economies.

In terms of the size of government, in Canada public sector spending actually declined as a fraction of national income (GDP) in the years following the introduction of the GST at the federal level and the move to HST-type consumption taxes in several provinces. In other words, Canada’s own experience belies the claim that value-added taxes like the HST inevitably lead to an expanding public sector.



HST MISCONCEPTIONS

Misleading claims, misinformation and confusion about basic economics have characterized much of the debate over the province's unpopular Harmonized Sales Tax (HST). This short brief attempts to inject some balance into the often heated public discussion of the HST. In what follows, we address several concerns that have been expressed about the tax. Our attention is limited to the economic aspects of the tax; the political dimensions of the HST, and the manner of its introduction, are not the focus of our review, although we recognize that these are also matters of public interest.

At the outset, we should state up front that as economists and advocates for the business community, we support the HST. However, we take seriously a number of questions that have been raised about its economic rationale and consequences. And, we understand that many citizens are unlikely ever to embrace the idea of a broadly-based consumption tax, regardless of the arguments that may be advanced by economists and business analysts.

A Tax Shift

To begin with, let's be clear about the big picture. The HST, once fully implemented, will eliminate almost \$2 billion in taxes paid by businesses under the old provincial sales tax (PST). It also greatly lessens the complexity and compliance costs associated with the existence of two separate sales tax regimes in BC – the federal Goods and Services Tax and the PST. Having to comply with two different sets of tax rules, exemptions, and administrative requirements has imposed at least \$150 million in extra costs on British Columbia businesses every year. These costs disappear with the HST.

However, in net terms, the HST does result in an additional tax burden on consumers. This is because it involves a shift in tax from businesses activity (the production of goods and services) to consumption activity (the purchase of goods and services by BC residents). To say otherwise would be to ignore important reasons why most economists endorse the HST – namely, because it lowers business costs, makes it more attractive to invest in new equipment and other components of the capital stock, solves the problem of “tax cascading,”¹ and improves BC's competitiveness.

The 12% HST combines the pre-existing 5% Goods and Services Tax (GST) and the former 7% provincial PST into a single levy, with a (largely) common tax base. Contrary to what some believe, the HST has no effect on the amount of tax paid on most categories of consumer expenditures. The BC Ministry of Finance projects no change in taxes for

¹ Many items subject to the former PST at the point of final consumption also had PST “embedded” in their costs, because the BC companies that produced the goods/services were required to pay PST on many of their inputs. This is referred to as “tax cascading” and has the effect of increasing the total effective sales tax burden.



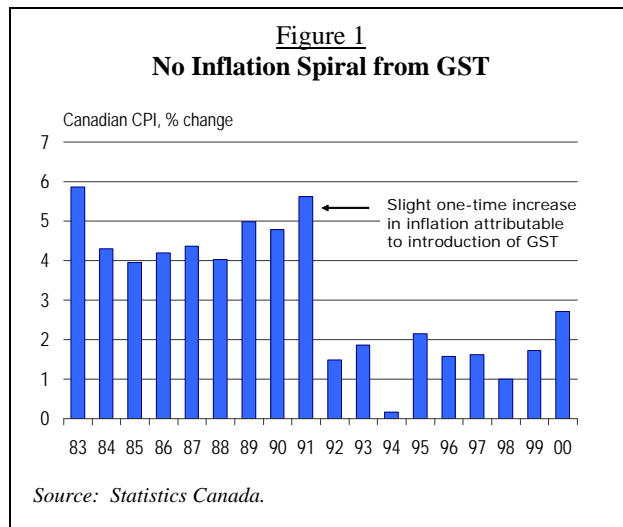
about 80% of total consumer spending; such items were already subject to the recently discarded PST (e.g., clothing, vehicles, legal services, and most consumer goods), are exempt from the provincial portion of the HST (e.g., motor fuel), or are not taxed at all under the full 12% HST (e.g., groceries, rent, medical services).

For consumers, the main difference with the HST is that the provincial portion of the tax now covers items such as haircuts, restaurant meals, dry-cleaning, and household services, which were exempt under the PST. Based on the public reaction, it is apparent that some people believe they must now pay another 12% on services that were not captured by the PST. This is incorrect: the GST already applied to virtually all of the items on which the HST is now levied.

Macroeconomic Considerations

Statements asserting that the HST is an economic calamity make no sense. To our knowledge, no credible economic forecaster believes the harmonized sales taxes now being implemented in Ontario and British Columbia will have serious negative economic repercussions. A scan of summer/fall 2010 forecasts from TD Bank, CIBC World Markets, the Conference Board, and Scotiabank shows that they all expect British Columbia (and Ontario) to basically match or even outperform Canada in the growth of gross domestic product (GDP), employment, and consumer expenditures over the next two years. If the HST were damaging in an overall economic sense, one would expect both BC and Ontario to fall progressively further behind the rest of Canada on key performance metrics – GDP growth, job creation, investment, housing starts, retail sales, etc. Few if any economic forecasters believe this will happen. Indeed, most are convinced the HST will produce economic gains for both British Columbia and Ontario over the medium- and long-term.

The HST does have negative short-term consequences for inflation, however. A detailed study by TD Bank economists estimates that the additional taxes on consumer purchases associated with the HST will lead to a 0.7 percentage point increase in the price level in BC, as defined by the all-items Consumer Price Index.² (Note that any upward pressure on inflation from the HST will come at a time when inflation overall is near a record low, thus mitigating its impact.) This is essentially a one-time effect; it does not translate into a higher ongoing annual rate of inflation. All of the



² TD Economics, “The Impact of Sales Tax Harmonization in Ontario and B.C. on Canadian Inflation” (September 18, 2009); available at td.com/economics.



Canadian forecasters we follow predict that BC's underlying inflation rate, post-HST, will remain in the range of 2% per year over the medium-term.

Of interest, when the federal government introduced the Goods and Services Tax as a replacement for the antiquated Manufacturers' Sales Tax in 1991, some worried that the GST might spark an inflationary upsurge, because the new tax applied to most items regularly purchased by Canadian households. As it turned out, inflation began to trend down not long after the GST came into effect, as depicted in Figure 1 on the previous page. By the late 1990s, Canada had gained a reputation as a country with low and fairly stable inflation. Far from triggering a destabilizing run-up in consumer prices, the period following the introduction of the GST coincided with a sustained decline in Canada's underlying rate of inflation. We are not suggesting the GST caused low inflation, only that instituting a broadly-based national consumption tax clearly did not cause a rise in trend inflation.

Lower Costs for Business = Wider Economic Benefits

As noted, the HST entails a shift in taxes paid from businesses to consumers, as a result of i) the elimination of the former provincial sales tax on goods and services purchased by BC companies to run their operations; and ii) the fact that certain items that were exempt from the PST are now subject to the full HST. However, from an economic perspective this is far from being the whole story.

To see why, it's important to realize that much of the PST which companies used to pay on their production "inputs" was embedded in prices charged to BC customers. For example, prior to the HST, retailers, car dealers, farmers, builders, restaurants, etc. had to pay PST on their purchases of computers, furniture/fixtures, office/restaurant supplies, equipment, construction materials, energy, and many other goods and services used to operate their businesses. These PST-related costs were incorporated into the selling prices seen by consumers. So while British Columbians may not have been aware of the PST paid on inputs, they experienced the effects via higher prices.

By removing sales tax from business inputs, the HST lowers the cost of producing goods and services in British Columbia. Lower production costs will translate into lower pre-tax prices for consumers. According to the aforementioned TD Bank study, pre-tax prices for goods and services sold in BC will fall, on average, by almost 1% as the business cost reductions arising from the HST are realized by firms.³ These price declines should offset a substantial portion (but not all) of the increase in tax paid by consumers due to the broadening of the sales tax base under the HST.

While economists agree that – in a competitive marketplace – most of the savings from lower business costs are shifted forward to consumers, there is public skepticism on this point. But consider what happens when the prices of business inputs change. When prices

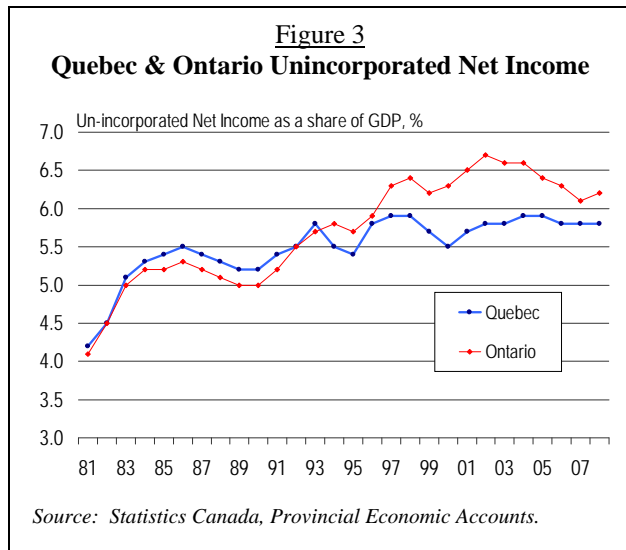
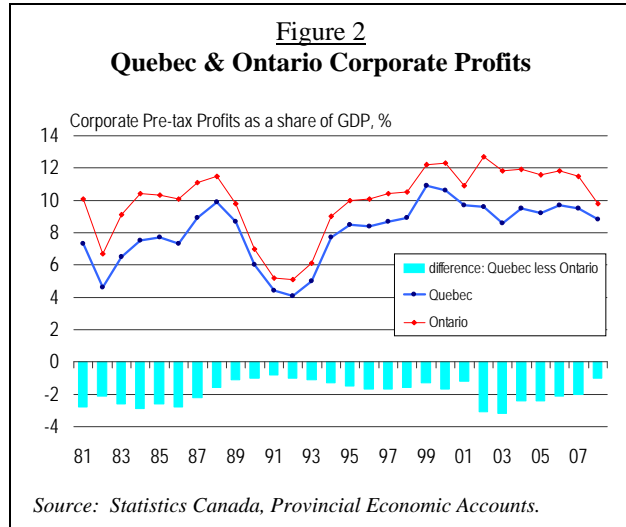
³ Ibid., p. 1.



for lumber, steel or cement climb, the cost of building a home or commercial building goes up; when the prices of these materials drops, construction costs typically decline.

It takes time for these kinds of adjustments to occur, but economic research finds that the domestic selling prices of goods and services do respond when input costs shift.

The HST means lower costs for businesses in a large majority of the industries that make up BC's economy. The magnitude of the cost reductions varies across sectors – e.g., industries that are more labour-intensive will see smaller decreases than those that are relatively capital-intensive. Academic studies confirm that in the provinces which harmonized their sales taxes in the late 1990s, most of the savings to business from eliminating taxes on inputs were shifted forward to consumers, in the form of lower (pre-tax) prices.⁴ An Ontario government study finds that up to 90% of the cost savings realized by Ontario businesses from removing the previous sales tax on inputs will be passed through to consumers within three years.⁵



Note that if this were not the case, and businesses simply pocketed any cost reductions, there should have been a permanent increase in business profitability in jurisdictions which adopted HST-like consumption taxes in the 1990s. However, there is no evidence of any unusual rise in long-term business profitability in provinces with HST-type taxes. Figures 2 and 3 show pre-tax profits for both corporations and unincorporated businesses in Quebec and Ontario, measured as a percentage of each province's gross domestic product.

⁴ Michael Smart and Richard Bird, "The Economic Incidence of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence From Canadian Experience," *Canadian Public Policy*, 2009; Jack Mintz, *British Columbia's Harmonized Sales Tax*, University of Calgary, School of Public Policy Briefing Paper, 2010 (www.fin.gov.bc.ca/Mintz_report.pdf).

⁵ Ontario Ministry of Finance, "Ontario's Tax Plan for Jobs and Growth: Technical Paper on How the Tax Changes Affect People (June 2010).



Recall that Quebec followed the federal lead and replaced its provincial sales tax with a new VAT in 1991, at which point businesses there qualified for tax credits on many of their production inputs; Ontario did not harmonize, and stayed with its retail sales tax (similar to our PST).

Post-1991, business profits in the two provinces tracked closely. There was a cyclical jump in profits in the early 1990s, but the data show no tendency for Quebec businesses – whether corporations or smaller unincorporated entities – to reap unusually high profits post-1991. Of interest, after the 1991-92 recession corporate profits actually recovered more quickly in Ontario, and businesses there remained more profitable overall, even though Ontario did not harmonize its sales tax. This supports the view that a large portion of the cost reductions for Quebec businesses from the shift to a value-added consumption tax was passed on to Quebec consumers.⁶ Such an outcome is not at all surprising: in a market economy, high profits tend to invite market entry by new suppliers, which in turn acts to dampen profitability – a story told in any undergraduate economics textbook. Both economic logic and empirical evidence point in the same direction: consumers here will benefit from reductions in costs for British Columbia companies as sales tax is eliminated from business inputs under the HST.

That said, BC consumers will not of course directly gain from lower prices for goods and services that are exported. But thanks to lower production costs from sales tax harmonization, companies operating here should be better placed to compete in the international (and interprovincial) marketplace.⁷ With the HST, thousands of BC businesses in export-oriented and import-competing sectors will be more competitive and thus in a stronger position to invest and create/sustain employment in the province. This is critical to our prosperity: BC is a small jurisdiction that exports more than \$50 billion worth of goods and services every year. By strengthening the competitive foundations for all of our traded industries, the HST is expected to yield substantial economic gains. One prominent Canadian economist predicts the HST will stimulate \$11 billion in additional business investment and more than 100,000 incremental jobs in BC over the next decade.⁸

Large vs. Small Business

Some politicians and media pundits are fond of proclaiming that only “big business” will enjoy the lower costs ushered in by the HST. This view rests on a poor understanding of the province’s business community and industrial structure. The vast majority of companies in British Columbia are “small” – defined as having fewer than 50 employees (see Table 1). Most exporting firms are also small. All businesses, irrespective of size or industry sector, purchase and make use of inputs that were previously subject to the PST

⁶ Note that cost reductions accruing to export-oriented companies in Quebec would not directly flow through to local consumers via lower pre-tax prices.

⁷ It is sometimes forgotten that BC exports \$15-20 billion worth of goods and services to other provinces every year, on top of exports to other countries. All BC exporters, including those who sell in other provinces, will benefit from the removal of PST from production inputs.

⁸ Jack Mintz, op. cit.



(e.g., equipment, office supplies, construction materials, computers, vehicles, furniture/fixtures, energy, legal services, and so on). And, while large companies obviously spend more in absolute dollars on production inputs, the reality is that BC does not have very many big companies. In some instances the HST should produce proportionately greater savings for smaller enterprises. Small business representatives often point to tight operating margins and the inability of smaller firms to absorb additional costs (including costs imposed by governments). For many of these companies, the HST should provide a welcome cash flow boost, by enabling them to recover sales taxes paid on inputs previously subject to PST.

<u>Table 1</u> Breakdown of Businesses in British Columbia, 2008	
	<u>Number of Businesses</u>
Total businesses with paid employees	175,000
Businesses with less than 50 employees	168,000
Businesses with 50 or more employees	7,000

Source: BC Stats using data supplied by Statistics Canada.

Four examples of BC industry sectors that stand to experience reductions in production costs under the HST are manufacturing, high technology, construction and agri-food. These sectors are heavily populated by small firms: the average manufacturer in the province has fewer than 100 paid workers; the typical advanced technology firm fewer than 10; the average construction company fewer than 30; and a majority of BC’s agricultural producers maintain payrolls of under 20. Simply put, the argument that small businesses won’t gain from the HST is false. And, we can’t help but point out that those who espouse this opinion never bother to cite any statistical data or research-based evidence to back up their claims.

Impact on Lower-Income Households

An important issue highlighted by some HST critics is that the tax may hurt poorer households. A legitimate concern with any kind of consumption tax is that lower-income families spend a bigger portion of their disposable incomes on consumer “necessities”. This is why certain “necessities” (like groceries, rent and medical services) are exempt from the HST. It also explains why the provincial government decided to provide HST tax credits for lower-income households, just as Ottawa did when the GST was adopted almost two decades ago.

Under the HST, low-income individuals will receive an HST tax credit of up to \$230 per year, while four-person households with low incomes will qualify for up to \$960 in tax credits. The tax credits are phased out for individuals with incomes above \$20,000 and for families with incomes above \$25,000. A couple with two children will receive \$920 in tax credits up to an income of \$25,000, and qualify for partial credits up to \$43,000. In all, about 1.1 million British Columbians will benefit from HST tax credits.

Is the protection being afforded to lower-income households sufficient? We estimate the HST credits are enough to cover \$3,285 in annual spending on previously PST-exempt



services and restaurant meals for a single individual, and \$13,140 in such spending for a four-person household. This should offset the extra tax on purchases of newly HST-covered items for most lower-income households. Dr. Jon Kesselman, the Canada Research Chair in Public Finance at Simon Fraser University, calculates that many low-income British Columbians will actually come out ahead with the HST.⁹ If it turns out that he is wrong, the government can address the situation by enriching the HST tax credits to better shield less affluent households.

Finally, critics overlook the fact that, in tandem with the HST, the BC government boosted the basic personal tax exemption – the amount individuals can earn before paying any provincial income tax – from \$9,373 to \$11,000. This provides a further saving for all taxpayers – and a proportionately greater one for those with relatively low incomes. Moreover, it should not be forgotten that over the 2001-2010 period, the provincial government sharply reduced personal income taxes for all British Columbians, including those with low and moderate incomes.

Vulnerable Sectors: Homebuilding and Restaurants

The decision to levy the HST on new homes has sparked concern. Previously, the 5% federal GST applied to new home construction and renovation, but the provincial PST did not. With the HST, only new homes (not re-sales of existing homes) priced over \$525,000 will incur additional tax, as the province has set this as the threshold for applying the HST. Admittedly, a sizable proportion of new homes in “urban” British Columbia are priced above \$525,000, so there will be an impact on costs for these properties.

However, HST critics exaggerate the impact, by failing to acknowledge that the business cost reductions from eliminating the PST will be passed on to home buyers. Many inputs used to construct a home were subject to PST, and the sales tax paid by homebuilders was included in the price charged to buyers. If builders no longer have to pay 7% in tax on construction materials or tools or equipment or vehicles, this effectively means a 7% price reduction for these items when used by builders in their business activity. The BC Ministry of Finance calculates that the “embedded PST” in a new house is equivalent to between 2% and 3% of the final selling price.¹⁰ So, while the HST will result in additional taxes on new homes priced above \$525,000, the extra net cost for buyers of such homes will not amount to the full 7%, as is often claimed. Moreover, with the HST in place, the cost to build less expensive homes (those priced below \$525,000) will be lower, as the embedded PST is eliminated. Thus, prices for these homes should fall.

We acknowledge that the HST does present a challenge for BC’s restaurant and foodservices industry, for three reasons. First, under the PST, restaurant meals were not

⁹ Jon Kesselman, “The Harmonized Sales Tax – Through an Economic Prism,” Policy Perspectives, Business Council of British Columbia (April 2010), p. 6 (www.bcbc.com/Documents/ppv17n2.pdf).

¹⁰ Labour costs, which are an important component of the overall cost of building a home, were not subject to the PST. This helps to explain why removing PST from construction-related inputs will not lead to a larger drop in the final price of a new home.



subject to provincial sales tax (though they did attract the GST)¹¹; now, the full 12% HST applies to restaurant meals. Second, food bought in grocery stores is tax-free, so the disparity between the price of meals consumed in restaurants and meals prepared at home has widened. Third, because the restaurant industry's two biggest cost items are labour and food, neither of which qualifies for HST input tax credits, restaurants will see little reduction in their own costs under the new tax regime.

Taken together, these factors mean that consumers will pay higher tax-inclusive prices for restaurant meals (although not for alcohol). In this situation, and as noted by the Canadian Restaurant and Foodservices Association, at the margin consumers are expected to reallocate their household "food budgets" toward grocery stores and home-prepared meals, and away from restaurant meals. This is almost certain to translate into a drop in total restaurant sales post-HST, as restaurant industry representatives have stated.

Nationally, restaurant sales did decline when the GST was introduced in 1991, so we understand why the industry is worried the same thing will happen here. However, some perspective is necessary. In Canada, the drop in restaurant business proved to be temporary, as restaurant receipts subsequently rebounded. Between 1991 and 1997, per capita restaurant sales in Canada rose by one-quarter.¹² In addition, the evidence we have seen indicates that the restaurant industries in Quebec and Atlantic Canada were able to adjust to the adoption of harmonized sales taxes in those jurisdictions and have continued to see their sales volumes increase over time.

What About the Underground Economy?

An interesting issue posed by the HST is whether it may lead to a bigger underground economy, as more consumers opt to pay cash for services – e.g., home renovation, landscaping, etc. – in order to avoid the tax. One difficulty with this argument is that if someone is willing to operate in the "shadow economy" to avoid a 12% sales tax, presumably many of these people were already doing so to escape the GST – which applies to the same range of goods/services. However, a higher consumption tax rate obviously creates a greater incentive to pay cash for services, and some consumers undoubtedly will make this choice. So on this basis, one might anticipate an increase in "underground" transactions post-HST.

However, it is important to realize that a contrary economic force is also at work: with the HST, small businesses and self-employed service providers actually have a stronger incentive to operate "above ground," as this is the only way they can claim HST input tax credits for taxes paid on their own purchases of supplies, vehicles, equipment and other business inputs. The HST also reduces reporting and administrative costs for all businesses, which should support the goal of enhanced tax compliance.

¹¹ Note that provincial sales tax did apply to alcohol purchased in restaurants.

¹² Statistics Canada, Restaurant, Caterer and Tavern Statistics, CANSIM Table no. 355-0002 for data on restaurant receipts. Statistics Canada annual population estimates for Canada.



We have been unable to find evidence, either from Statistics Canada or published academic sources, which indicates that the size of the “shadow” economy expanded in the provinces which fully or partially harmonized their sales taxes with the federal GST in the 1990s. But we do believe the risk of a growing “shadow” economy is something that warrants careful monitoring by BC policy-makers going forward.

A few vocal HST critics have tried to draw a link between Greece’s recent economic woes and the fact that it has a value-added tax (VAT) similar to the HST. This is a very weak argument. All European countries levy broadly-based value-added taxes, yet only a few –

Greece, Spain, Ireland and Portugal – are presently facing severe financial challenges. Moreover, a number of European countries with VAT rates as high as or higher than in Greece actually have relatively small “shadow” economies, as shown in Table 2. The Netherlands, for example, has a VAT rate that matches Greece’s, but its “shadow” economy is only 40% as large. Germany’s VAT rate is also equal to Greece’s but its underground economy is estimated to be less than two-thirds as large. Denmark, Finland and France have VAT rates higher than Greece’s with much smaller underground economies.¹³ In truth, Greece’s well-advertised economic problems stem from decades of fiscal mismanagement, weak public institutions, and a deeply rooted history of tax avoidance; they have little to do with the particular design of its national value-added tax.

Feeding “Big Government”

A final concern highlighted by some observers is that the HST may pave the way for “bigger” government and lead to an ever-rising overall tax burden. We have some sympathy for this view. In response, we offer two thoughts.

First, eliminating the PST and replacing it with the harmonized sales tax is revenue-neutral to the BC government – no increase is projected in the total tax revenues collected by Victoria, nor in the size of BC’s public sector relative to that of the province’s economy. And, while it is true that a future government could raise the provincial portion of the 12% HST, ultimately this is a matter of political choice. After all, the federal Conservative government has trimmed the GST rate on two occasions since 2006, taking it from 7% to

Table 2
Value-Added Tax Rates and Size of Underground Economy, Selected Countries, 2007

	<u>VAT Rate</u>	<u>Underground Economy % of official GDP</u>
Denmark	25.0%	14.8%
Finland	22.0%	14.5%
France	19.6%	11.7%
Germany	19.0%	14.7%
Greece	19.0%	25.1%
Netherlands	19.0%	10.1%
UK	18.0%	13.7%
Spain	16.0%	19.3%
Canada		
Federal only	5.0%	12.6%
Ontario, 2010	13.0%	NA
BC, 2010	12.0%	NA

Source: VAT rates, PricewaterhouseCoopers; underground economy estimates from Professor Friedrich Schneider, Department of Economics, University of Linz, Austria (www.econ.jku.at/Schneider).

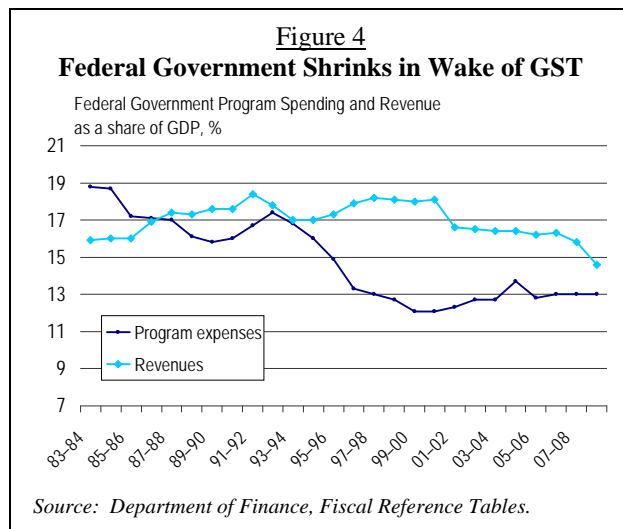
¹³ Ibid., p. 25.



5%. It is conceivable that the BC government could decide to lower the provincial portion of the HST rate once the province’s budget is back in balance.

Second, in Canada the period during which the federal and some provincial governments implemented value-added consumption taxes was followed by a shrinking rather than an expanding public sector. Ottawa legislated the GST in 1991 and Quebec the related Quebec Sales Tax, while the three biggest Maritime provinces established harmonized sales taxes in 1997. According to some local critics, this shift to broadly-based consumption taxes should have led to a big expansion in the size (and cost) of government. Instead, the opposite occurred: both federal and combined federal-provincial government spending diminished as a share of the economy.

Total public sector outlays in Canada peaked at about 50% of GDP in the first half of the 1990s; by 2007 the figure had dropped to a little over 40% of GDP. As depicted in Figure 4, federal government expenditures fell significantly as a percentage of GDP between the mid-1990s and 2007-08; federal revenues also decreased as a share of GDP. The fear that the HST will spur the growth of government is belied by Canada’s own experience.



Timing of the Benefits

This section is not about a misconception per se but rather about trying to clarify some confusion around competing findings regarding the timing and economic benefits expected to flow from the HST. In a study done for the provincial government earlier this year, Jack Mintz concludes that the HST alone will be “responsible for an \$11.5 billion increase in capital stock and an increase of 113,000 jobs by the end of the coming decade.”¹⁴ Importantly this analysis examines the impact of the tax in a BC context, taking account of the specific design of the HST as implemented here (e.g., the fact that energy is exempt).

An earlier study that garnered some attention found that a harmonized tax in Ontario would have a small negative impact on economic growth for three years with positive benefits thereafter, and cause a modest decline in employment for five years before a positive impact on jobs became evident. This study, prepared for the C.D. Howe Institute in 2008, was coauthored by Jack Mintz.¹⁵ The media reported on the short-term negative

¹⁴ Jack Mintz, “British Columbia’s Harmonized Sales Tax: A Giant Leap in the Province’s Competitiveness,” University of Calgary SPP Briefing Paper, Volume 3, Issue 4 (March 2010) p.2.

¹⁵ Peter Dungan, Jack Mintz, Finn Poschmann, Thomas Wilson, “Growth-Oriented Sales Tax Reform for Ontario,” C.D. Howe Institute (September 2008).



impacts in the Ontario context and questioned how the two studies on the HST by the same author could have seemingly contradictory results.

A closer examination, however, reveals that although the two studies are broadly similar, with both finding long-term benefits from the HST, a number of significant differences limit the usefulness of short-term comparisons. There are two main reasons why the 2008 study reported a short-term loss in output and employment for Ontario. One is that the model used posits that it takes longer for business investment and exports to respond to the HST, whereas consumer spending – and to a lesser extent housing -- are dampened immediately after the tax change is introduced.

Intuitively, it seems plausible that the HST will have a negative effect on consumption that initially outweighs the slower-to-materialize benefits to business investment and exports; this is one of the reasons we have maintained that the benefits of shifting from the PST to the HST will take time to be realized. Even so, any diminished consumer spending won't be as large with the HST in BC as was suggested in the hypothetical Ontario study.

One key difference is that the introduction of the HST here was accompanied by HST rebates for low income households, as well as modest income tax cut for all income levels. These measures will offset some of the additional costs to consumers arising from the HST. While the Ontario government also provided tax relief and cash refunds to its citizens, the 2008 modeling exercise did not incorporate any of these measures. Another significant departure from the Ontario study is that in BC, the HST does not apply to gasoline or to energy used in home heating. Because energy is a sizable part of household budgets, this too means that the average BC household will not be affected to the extent assumed in the Ontario study.

The second factor driving the short-term negative result of the HST in Ontario comes via the rise in the consumer price index. The Ontario study presumes that because of a slight rise in the CPI due to the HST, workers seek higher wages, which in turn inhibits employment growth. It further assumes that in the face of higher wages and the accompanying upward price pressures, the Bank of Canada raises interest rates, which also works to suppress demand.

Current economic conditions differ from those posited in the Ontario study, which assumed the Bank of Canada would raise interest rates to combat any upward wage and price pressures linked to the HST. At the time this was probably a prudent assumption, given generally robust economic conditions over the 2006 to 2008 era. Today, however, in the wake of the Great Recession, Canada is facing relatively high unemployment, a slowing economy and virtually no threat of inflation.

A final factor to note is the actual tax rate. In BC, the provincial portion of the HST is 7%, but it was modeled as 7.5% in the 2008 Ontario study. While the difference may seem small, it actually has a significant impact. In the Ontario study, the authors compare a few different scenarios, one being a provincial tax rate of 7% rather than 7.5%. Under the 7% scenario, economic output (GDP) does not fall, and the negative impact on employment in the early post-HST years disappears. This implies that the difference between BC's 7% rate and the 7.5% rate modeled in Ontario is material.



When the differences between the Ontario simulation study and the HST as actually implemented in British Columbia are considered, there is reason to believe there will be little if any negative short-term effect on GDP or employment here. The only caveat relates to the HST-sensitive restaurant and housing sectors. If spending in restaurants drops off and consumers delay undertaking renovations and buying new homes, employment could slip in these sectors in the initial aftermath of the HST.

Evaluating the economic consequences of any tax change is complex. It will take time for the benefits of the HST to show up. In the meantime, the HST is not likely to have much of an impact on overall employment or output in the short-term. Looking further ahead, the HST will reduce the cost of all business inputs and enhance BC's competitiveness and productivity. And stronger productivity gains will lay the essential foundations for higher wages and an improvement in overall prosperity.

Conclusion

Concerns over the economic implications of the HST have helped to fuel public opposition to the tax, although they are not the only factor at play in the ongoing debate. As discussed above, most of these concerns are unfounded, exaggerated, or reflect an incorrect reading of the evidence on the economic consequences of value-added taxes. Loud arguments against the HST have also tended to drown out the solid economic policy rationale that lies behind the BC government's decision to adopt the tax. In fact, there are compelling reasons to believe the HST will deliver significant long-run benefits to our economy in areas such as job creation, investment, productivity, export competitiveness, and a reduced tax compliance burden for British Columbia businesses.
