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2010: BC Tax Advantage

Main Conclusions

- **British Columbia can create a tax advantage over all other provinces including Alberta by simply *maintaining* current per person spending, *acknowledging* more realistic revenue expectations, and *focusing* resources on a three-year tax relief plan.**
- **While British Columbia has made great strides in its tax competitiveness, more remains if the province is to achieve an advantage rather than simply be competitive.**
- **The province has enjoyed revenue excesses over budget totalling $10.6 billion over the last four years. In addition, year-end surplus have out-performed budget expectations by $7.8 billion over the last three years. Consequently, British Columbia has the resources for meaningful tax relief.**
- **2010 BC Tax Advantage: The Fiscal Plan**
  - Adjust revenues to more accurately reflect anticipated revenues;
  - Increase spending by $2.2 billion over the next three years in order to fully compensate for inflation and population growth;
  - Increase the forecast allowance to $3.4 billion to allow for a larger economic cushion.
- **5-Point Tax Relief Plan**
  - Eliminate the top three personal income tax rates and reduce the remaining top rate from 8.15 percent to 8.0 percent. Estimated cost: $5.5 billion;
  - Reduce corporate income tax rates to 8.0 percent from 12.0 percent. Estimated cost: $994 million;
  - Eliminate the financial corporate capital tax immediately. Estimated cost: $361 million;
  - Harmonize the provincial sales tax with the GST. Estimated cost: $0;
  - Increase the threshold for small business to $1 million from $400,000 over the three years. Estimated cost: $200 million;
  - Total estimated cost: $7.1 billion over three years (2008-09 to 2010-11).
- **2010 BC Tax Advantage Plan would result in a tax advantage for BC over all other Canadian provinces for personal income and business taxes.**
- **The plan would also strengthen economic incentives for work effort, savings, investment, risk-taking, and entrepreneurship, all vital to strengthening BC's already robust economy.**

Introduction

British Columbia, like its neighbours Alberta and Saskatchewan, is enjoying robust economic growth and prosperity. The province and its citizens are benefiting from relatively high rates of economic growth, low unemployment, solid job creation, and increasing investment. Most of the economic indicators show a bright future for British Columbia. The question for British Columbians is whether or not the province can do even better.

British Columbia is currently faced with an extraordinary opportunity. The province can create a tax advantage over all other provinces, including Alberta, by simply *maintaining* current per person spending, *acknowledging* more realistic revenue expectations, and *focusing* energy and resources on a three-year tax relief plan. The result would be a marked tax advantage for British Columbia in both personal and business taxes, which would improve the incentives for work, savings, investment, and entrepreneurship. (For more information on taxes and incentives please see Clemens, Veldhuis, and Palacios, 2007; Veldhuis and Clemens, 2006; and Karabegovic *et al.*, 2004.)

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Alberta is losing its way

Before analyzing the current opportunity facing British Columbia, it is important to understand the status quo in Alberta and how it has jeopardized the Alberta Advantage. The widely recognized Alberta Advantage has been based on lower competitive tax rates and smaller government compared to other provinces. For more than a decade, Alberta relied on this framework to guide its fiscal policies. The combination of low taxes, smaller government, and focused spending helped spur the country's leading economy. Fortunately for British Columbians, and unfortunately for Albertans, the province's focus on the Alberta Advantage has been eroded (see Clemens and Veldhuis, 2007), which has opened up an opportunity for British Columbia to create a tax advantage.

Large spending increases

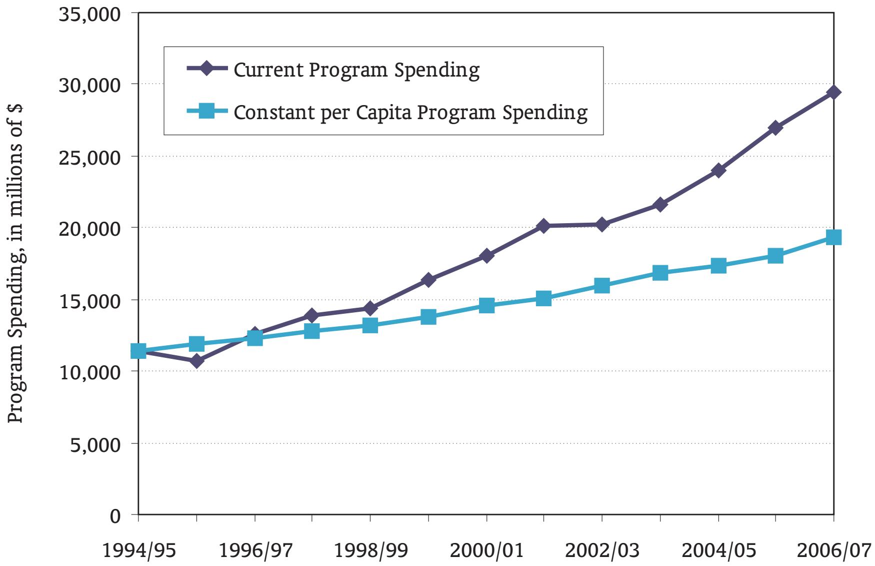
Figure 1 illustrates the Alberta government's program spending since 1994-95, the first year the province recorded a surplus after a decade of consistent budget deficits. In addition, figure 1 compares the level of program spending needed to compensate for inflation and population growth to the level of actual program spending. The results are dramatic and show the decline of the focus on the Alberta Advantage. The average growth in program spending required to compensate for inflation and population growth between 1994-95 and 2006-07 was 4.5 percent. But the Alberta government increased provincial program spending by an average of 8.4 percent, almost double the necessary growth rate. Put differently, between 1994-95 and 2006-07, the Alberta government increased program spending by more than $47.1 billion than was needed to compensate for inflation and population growth. This has resulted in an increase in inflation-adjusted per person spending from $7,074 in 1994-95 to $8,723 in 2006-07.

The situation in BC

British Columbia's current government has made tax competitiveness a key priority. The province maintains competitive rates for a number of key taxes. British Columbia

- has the lowest personal income tax rates for income under $108,000[2] ;
- has the third lowest statutory corporate income tax rate;
- is one of four provinces with no general corporate capital tax;
- is a relatively low user of the financial capital tax;
- is tied with Manitoba for the second lowest provincial sales tax rate (Alberta has no sales tax).

Figure 1: Program Spending versus Per Person Program Spending (inflation-adjusted), 1994/95-2006/07



Source: Statistics Canada, *Provincial Economic Accounts 2007*; Government of Alberta, Ministry of Finance, *Public Accounts* 1994-95 to 2006-07; calculations by the authors.

British Columbia has been competitive with its taxes since 2001, which has served the province and its citizens well. The province is experiencing a pronounced period of economic strength and prosperity. There are, however, remaining areas of taxation where the province is either not competitive or does not maintain an advantage:

- BC's top marginal tax rate (14.7 percent) is nearly 50 percent higher than Alberta's top rate (10.0 percent);
- BC's effective tax rate on capital investment[3] (31.6 percent) is the third highest in the country and well above Alberta's rate of 23.0 percent (figures based on Chen *et al.*, 2007, p. 11);
- BC is one of only 5 provinces that still maintains a non-integrated provincial sales tax that is applied to business inputs, which raises the cost of investment;
- The threshold for small business income ($400,000) is generally in line with most other provinces.

Table 1: Actual Versus Budgeted Revenues for the BC Provincial Government ($ Millions)

Fiscal Year	Estimate[1]	Actual[2]	Difference
2003-04	$26,000	$29,060	$3,060
2004-05	$30,492	$33,363	$2,871
2005-06	$34,476	$35,973	$1,497
2006-07	$35,364	$38,504	$3,140

[1]Estimate is included in the Public Accounts and based on the government's budget.
[2]The actual revenues for 2003-04 to 2005-06 were taken from the following year's Public Accounts based on revised actual numbers. The actual revenue for 2006-07 is based on the figure provided in the 2006-07 Public Account, which has not yet been revised.
Sources: BC Government, *Public Accounts*, 2003-04 to 2006-07.

Wealth of revenues

Because of its strong economy and sound fiscal policies, for four straight years the BC government has recorded much higher revenues than budgeted. Table 1 summarizes the budgeted revenues for this period versus the actual amounts received. In total, the provincial government has received $10.6 billion in excess of budget expectations over the last four years. In fact, the $3.1 billion excess recorded for 2006-07 is the largest to date and indicates the strength of BC's fiscal situation.

As important as the size of the excess revenues is their nature. Contrary to popular opinion, commodities were not the sole source of the larger than expected revenues. In fact, the unexpected revenues were mainly derived from strong personal and corporate income tax revenues. Table 2 summarizes the difference between budgeted revenues and actual revenues for 2006-07 for a number of

Table 2: Actual Versus Budgeted Revenues, by Category, 2006-07 ($ Millions)

Revenue Category	Estimate	Actual	Difference
Personal income tax	$5,850	$6,908	$1,058
Corporate income tax	1,341	1,540	199
Provincial sales tax[1]	4,331	4,673	342
Property taxes	1,632	1,623	-9
MSP premiums	$1,404	$1,493	$89
Contributions from the federal government	5,040	5,383	343
Natural resource revenues	4,802	3,942	-860
Net contributions from Crown Corporations	1,544	1,941	397

[1]The provincial sales tax is formally referred to as the "social service tax" in budget documents.
Source: BC Government, Ministry of Finance, *Public Accounts 2006-07*, pp. 100 and 101.

significant government revenue sources.

The largest positive difference occurred with respect to personal income tax revenues, which exceeded expectations by nearly $1.1 billion. Corporate income tax revenues also exceeded budget expectations by almost $200 million. Ironically, given the public perception, natural resource revenues actually fell short of expectations by $860 million.

Personal and corporate income tax revenues are important over the long-term, too. For the four years included in table 1 (2003-04 to 2006-07), personal income tax receipts exceeded budget expectations by a total of $1.6 billion. In the same four-year period, corporate income tax revenues exceeded forecasts by $791 million. On the other hand, natural resource revenues were actually below budget expectations by some $166 million.[4]

Table 3: BC Provincial Government's Actual versus Budgeted Fiscal Balance ($ Millions)

Fiscal Year	Estimate[1]	Actual[2]	Difference
2003-04	-$2,300	-$1,275	$1,025
2004-05	$100	$2,696	$2,596
2005-06	$1,300	$3,090	$1,790
2006-07	$600	$4,056	$3,456

[1]Estimate is included in the Public Accounts and based on the government's budget.
[2]The actual fiscal balances (surplus/deficit) for 2003-04 to 2005-06 were taken from the following year's Public Accounts based on revised actual numbers. The fiscal balance for 2006-07 is based on the figure provided in the 2006-07 Public Account, which has not yet been revised.
Sources: BC Government, *Public Accounts*, 2003-04 to 2006-07.

Year-end surpluses: more outperformance

The British Columbia government has also recorded much larger year-end surpluses over the last four years than budgeted. Table 3 compares the budgeted year-end fiscal balance (surplus-deficit) against the actual for the last four years. In total, the BC government has enjoyed cumulative surpluses in excess of the budgeted amount of $7.8 billion over the last three years.[5] In fact, the year-end surplus for 2006 of $4.1 billion (versus a budgeted amount of $600 million) is the largest to date.

British Columbia is currently enjoying both larger than expected revenues and surpluses due to broad-based economic strength. These extra revenues mean that British Columbia has the resources available to implement meaningful and sizeable tax relief in order to create a BC Tax Advantage without jeopardizing current spending plans.

2010: BC Tax Advantage

The wealth of revenues that the BC government is enjoying, coupled with the loss of focus in Alberta, have combined to create a real opportunity for British Columbia to create a lasting tax advantage over the rest of the country. If undertaken systematically and in a focused manner, the tax cuts proposed below would result in a tax

Table 4: 2010 BC Tax Advantage Fiscal Plan

	2007-08 (Current year)	2008-09	2009-10	2010-11	Cumulative (2008-09 to 2010-11)
Revised revenues	$40,710	$41,233	$42,545	$43,898	$127,676
Revised spending	$36,240	$37,386	$38,619	$39,860	$115,865
Forecast allowance	$750	$1,000	$1,100	$1,250	$3,350
Available balance	$3,720	$2,847	$2,826	$2,788	$8,461
TAX RELIEF					
1) Personal income taxes		$1,725	$1,838	$1,940	$5,503
2) Corporate income tax rate		$209	$328	$457	$994
3) Corporate capital tax		$115	$120	$126	$361
4) PST harmonization		$0	$0	$0	$0
5) Small business threshold		$33	$67	$103	$203
Total tax cuts		$2,082	$2,353	$2,626	$7,061
Available balance post-tax relief		$765	$473	$162	$1,400

Sources: BC Government, Ministry of Finance (2007, 2005a, 2005b); BC Government, *Public Accounts* 2003-04 to 2006-07; calculations by the authors.

advantage for the province by 2010 and significantly improve the economic incentives in BC for work, savings, investment, and entrepreneurship.

Table 4 summarizes the fiscal plan proposed for the next three years; implementing it would result in the 2010 BC Tax Advantage.

Details of the fiscal model

Revenues: The 2010: BC Tax Advantage plan adjusts revenues to reflect a more accurate expectation of future revenues, given the consistent surpluses recorded over the last 4 years. Specifically, the revenue growth rates for 2007-08 to 2009-10 as detailed in the 2007 provincial budget were applied to the actual revenue figure for last year (2006-07) of $38.5 billion. This resulted in a revenue estimate for 2007-08 (current year) of $40.7 billion rather than the budgeted amount of $37.4 billion.

Expenses: The 2010: BC Tax Advantage plan shows an increase in spending over the three-year period to ensure that per person spending, adjusted for inflation, remains constant. This results in an additional $2.2 billion in spending over the three-year period over and above the spending plans announced by the provincial government in the 2007 *Budget*.[6]

Forecast Allowance: The 2010: BC Tax Advantage plan increases the forecast allowance to $3.4 billion over the 2008-09 to 2010-11 period, which provides a larger cushion against any unforeseen variances in either revenues or expenses.

These changes (increasing revenue estimates, increasing spending in order to ensure constant per capita spending levels adjusted for inflation, and increasing the forecast allowance) result in a total cumulative budgetary surplus of $8.5 billion over the next 3 years.

Tax relief proposal: 5-point plan for the 2010 BC Tax Advantage

A $7.1 billion tax relief program is outlined below; it represents 83.5 percent of the available $8.5 billion surplus. This tax relief plan would not only improve the economic incentives critical to BC's success in the future but would also create a tax advantage for BC compared to the rest of the country. The plan has five main areas of tax relief.

1) Personal Income Tax

The largest component of the tax relief plan (77.9 percent of the total tax relief) relates to personal income taxes. The plan eliminates the top three statutory personal income tax rates (leaving only two rates) in year one (2008-09). In addition, it decreases the remaining top rate from 8.15 percent to 8.0 percent, also in year one. These two changes are estimated to cost $5.5 billion over the three-year period. The result of these changes is that British Columbia would have the lowest personal income tax rates in Canada for all income earners.[7] Such changes would dramatically improve the incentives in BC for not only professional and skilled labour, but also unskilled labour, to make an effort, take risks, and behave in entrepreneurial ways. In particular, however, the tax changes are aimed at attracting and retaining professional and skilled Canadians in order to promote business development, entrepreneurship, and innovation.[8]

2) *Corporate Income Tax*: Another component of the tax relief plan would see the statutory rate of corporate income tax reduced from 12.0 percent to 8.0 percent over the three-year period. The estimated total cumulative cost is $994 million. An 8.0 percent corporate income tax rate would provide BC with a marked advantage over all other provinces on these tax rates. This reduction would cut the cost, and therefore would promote and encourage, investment and development in the province.

3) *Financial Corporate Capital Tax*
Immediately eliminating the financial corporate capital tax in its entirety in 2008-09 would result in an estimated total cumulative cost of $361.0 million. (This estimate does not include the incentive program initiated in the federal 2007 *Budget* to help eliminate provincial capital taxes.[9] It is, therefore an overestimate of the actual revenue losses.) By eliminating the financial capital tax, British Columbia would join Alberta as the only other Canadian jurisdiction to have completely eliminated this particularly costly and damaging tax. (For more information on the serious economic costs of capital taxes, see McQuillan and Cochrane, 1996; and Clemens *et al.*, 2002.)

4) *Provincial Sales Tax*
The provincial sales tax should be harmonized with the federal goods and services tax (GST) in order to a) exclude business inputs from taxation and b) eliminate the two tax bases used for sales taxes. The act of excluding business inputs from taxation would reduce the cost of investment and thus encourage it. In fact, the federal department of finance estimates that the marginal effective tax rate on capital in British Columbia would be reduced from 30.2 percent to 21.5 percent through sales tax harmonization.[10] The second benefit from harmonization is that it would reduce compliance costs on businesses by reducing the paperwork and related efforts to one system instead of two (see Smart, 2007). The reform could be implemented in a revenue neutral manner.[11]

5) *Small Business Threshold*
The tax relief plan calls for a dramatic increase in the threshold for income eligible for the small business tax rate (4.5 percent) from $400,000 to $1 million over 3 years. This dramatic change in tax policy for small business is estimated to cost a little over $200 million over 3 years.[12] However, this change would create a significant advantage for small businesses in British Columbia. One problem with the preferential tax rate for small business income is that it creates a large barrier to small business growth and development since as small businesses grow they potentially face a much higher corporate income tax rate (see Clemens and Veldhuis, 2005). By increasing the threshold for eligible income, this effect would be mitigated.

The cumulative cost of these five tax changes is $7.1 billion over 3 years. Implementing these tax measures would create a marked and substantial tax advantage for BC over the other Canadian provinces, including Alberta, for both personal and business taxes. These measures would improve the incentives for work, savings, investment, and entrepreneurship—all bedrocks of a strong and robust economy.

Overall, if each of these changes is implemented, the province can still expect surpluses of $765 million (2008-09), $473 million (2009-10), and $162 million (2010-11). Put differently, a cumulative surplus of $1.4 billion exists for British Columbia over the three-year period after allowing for $2.2 billion increases in spending over the *Budget 2007* amounts, an increased financial cushion for unforeseen events, and $7.1 billion in personal and business tax relief.

Cautious estimates

The fiscal plan outlined above is a restrained one. The plan increases spending to fully accommodate for inflation and population growth. It increases the forecast allowance for any unforeseen variances. In addition, research has consistently shown that incentive-based tax relief is less costly in revenue loss than forecasts predict. That is because the improved incentives promote economic activities such as diligence, investment, and entrepreneurship that expand the tax base. The increase in the size of the tax base means that revenues are larger than forecast even though the tax rate has decreased (see Clemens, Veldhuis, and Palacios, 2007; and Mankiw and Weinzierl, 2006). These effects were not included in the costing of the proposed tax cuts.

Building on past success

British Columbia has already benefited enormously from the large-scale, incentive-based tax relief begun in 2001.[13] The provincial government provided critical personal income and business tax relief that dramatically improved economic incentives. The central theme of the 2001 tax cut was personal income tax relief. A two-stage, 25 percent, across-the-board personal income tax relief package was implemented over two years. Three major business tax relief measures were also announced: 1) a reduction in the corporate income tax rate from 16.5 percent to 13.5 percent, 2) a phase-out of the non-financial corporate capital tax, and (3) the exemption of production machinery and equipment[14] from the provincial sales tax. A number of other, smaller tax changes were also announced at the time. These changes partially explain the revitalization of BC's economy over the last six years: GDP has grown, employment has increased, and investments have been attracted to the province. One indicator of BC's success has been its jump from a dead last ranking in its investment climate in 2000 and 2001, to third place in 2002, to surpassing Ontario in 2004 to secure its place as the second best investment climate in Canada. (For further information on provincial investment climates see Clemens, 2002; Karabegovic *et al.*, 2004; and, Clemens *et al.*, 2007.)

Conclusion

British Columbia is enjoying a period of economic prosperity, but even more could be on the horizon. With comparatively little effort—in fact by simply recognizing the current reality of the level of the province's revenues, maintaining current per person spending, and focusing on tax relief—BC's government can deliver a clear tax advantage for the province over the rest of the country by 2010. The 2010 BC Tax Advantage would serve all British Columbians well; it would deliver heightened prosperity through improved incentives for diligence, savings, investment, and entrepreneurship. The current prosperity may be just the beginning of an historic period in the province's economic development.

Notes

1 Figure 1 includes data on program spending only, rather than total spending, which includes debt-servicing charges. The reason for the focus on program spending is that Alberta has eliminated its net debt and thus substantially reduced its debt charges. All other Canadian provinces continue to carry net debt and thus maintain much higher debt servicing charges. A comparison of program spending alone, therefore, offers a better comparison of each province's spending levels.

2 This statement is from the 2007 provincial budget but has not been validated by the authors.

3 This is an aggregated calculation of the various taxes imposed on new capital investment, such as the corporate income tax and provincial sales taxes if they are not harmonized with the GST.

4 Even if the large difference between forecasted natural resource revenues and the actual amount received in 2006-07 (-$860 million) were excluded, the total unexpected surplus from natural resource revenues would be slightly less than $700 million, which is less than half of the amount recorded in personal income tax revenues.

5 The total variance is $8.9 billion over the last four years. However,

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the variance in the first year (2003-04) was a smaller deficit than anticipated ($1.3 billion versus $2.3 billion) and should not therefore be included as a "surplus."

6 The fiscal plan presented extends the spending horizon for the provincial government out to 2010-11, one year more than the current budget. The assumption behind this extended spending is that per capita spending based on government assumptions regarding inflation and population growth will be constant.

7 The top rate of 8.0 percent would also match the corporate income tax rate of 8.0 percent, thus eliminating any advantage from altering the nature of income from personal to corporate.

8 An additional recommended change not included in the fiscal plan is that the threshold for the top rate (8.0 percent) be increased from roughly $35,000 currently to $50,000 over the three-year period. This change would be implemented if revenues respond as anticipated to the improved incentives (see discussion below).

9 The federal *Budget 2007* included a new incentive for provincial governments to eliminate their corporate capital taxes. Specifically, the federal government offered provinces the amount of federal income tax gained through the elimination or reduction of their capital taxes. Provincial capital tax costs are deductible against federal income taxes. Thus, the reduction of provincial capital taxes actually increases federal revenues. This incentive program, which is in effect between 2007 and 2011, reduces the revenue losses provinces would experience by eliminating or reducing their capital taxes. For more information, see the federal *Budget 2007*, p. 237.

10 This estimate was derived through conversations with representatives from the federal Department of Finance. It is based on marginal effective tax rates for 2011, given all current information. The specific change estimate for British Columbia is a decline of 8.7 percentage points on the marginal effective tax rate.

11 Revenue neutrality means that the government would receive neither more nor less revenue as a result of the change in the provincial sales tax. Rather, the government would set the new harmonized provincial sales tax rate at a level that would enable it to collect the same amount of revenue as it currently receives.

12 This estimate was calculated using the $10 million forecasted cost of increasing the small business threshold to $400,000 from $300,000 presented in the 2005 September *Budget Update*. The estimate was adjusted for the growth in the underlying tax base. In addition, a 50 percent buffer was added to the baseline estimate. (Several inquiries directed to the BC Ministry of Finance to obtain more complete and accurate estimates went unanswered.)

13 The BC government has subsequently delivered two additional tax relief measures focused on improving incentives. In 2005, the provincial government reduced corporate income tax rates from 13.5 percent to 12.0 percent. In addition, the 2007 *Budget* implemented a two-stage, 10 percent tax cut for incomes under $100,000 starting January 1, 2007.

14 The exemption was limited, not broad-based. Importantly, a 2004 study by the Canadian Tax Foundation found that BC "seems to be limiting the exemption by narrowly interpreting its key aspects." The exemption's limited scope has resulted in a limited incentive effect regarding investment in machinery and equipment.

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