Submission to British Columbia's Expert Panel on Business Taxation

Submitted to
the Expert Panel
on June 21, 2012

by Charles Lammam,
Milagros Palacios,
and Niels Veldhuis

Tax and Budget Policy Centre
Fraser Institute

Contact:

Charles Lammam
Associate Director, Tax and Budget Policy Centre
The Fraser Institute
4th Floor, 1770 Burrard Street
Vancouver, BC V6J 3G7
604.714.4544
charles.lammam@fraserinstitute.org
Twitter: @CharlesLammam

Executive Summary

The evidence from economic research indicates that tax rates affect people's behaviour. The most important conclusion is that high taxes contribute to lower rates of economic growth, reduced rates of personal income growth, lower rates of capital formation, and reduced entrepreneurship.

Research on taxation also finds that different taxes impose different costs on the economy. More specifically, production or capital-based taxes impose much higher costs on an economy than do less costly taxes such as consumption taxes. The Provincial Sales Tax (PST) was partly a consumption tax and partly a tax on production, so restoring the PST will again increase the cost of investing in BC and have an adverse impact on the province's competitiveness.

Provinces and countries are constantly competing for investment dollars, entrepreneurs, and skilled workers, so British Columbia must maintain a competitive tax system to ensure the province remains an attractive place to work and do business. This submission examines BC's performance relative to other provinces in three key areas of taxation (business taxes, property taxes, and personal income taxes) and provides recommendations for reform in each area. Our recommendations are summarized below.

To mitigate the negative effect on the provincial investment climate of restoring the PST, BC could:

- Introduce a complete sales tax exemption on all business inputs including machinery and equipment. Because sales taxes on capital goods are economically damaging taxes, this recommendation should be a high priority.

- Reduce the general corporate income tax rate to 8% from its current 10% rate through a phased-in reduction. This would give BC a marked advantage over other provinces and encourage business investment.

Another important business tax reform is to reduce the disincentive for small businesses to grow by increasing the threshold of income eligible for the preferential small business tax rate of 2.5% from $500,000 to $1 million.

When it comes to property taxes, BC appears to have a serious problem in its treatment of certain business classes as municipalities subsidize low residential rates with relatively high rates on business property. We offer two options to rectify this problem:

- Equalize property tax rates across business classes.

- Determine ranges of fairness and thresholds based on average property tax rates in municipalities for different major classes and require all tax rate changes to move toward this range.

To attract and retain highly skilled workers, BC should make the province's middle and top marginal income tax rates more competitive with Alberta. Specifically, BC should aim to gradually collapse its top three marginal rates (14.7%, 12.3%, and 10.5%) with the ultimate goal of moving toward a flat tax rate on personal income equal to the Alberta rate of 10%.

Respecting the Expert Panel's mandate that tax reforms be "within the province's balanced budget framework," we also provide options on how to pay for the recommended tax changes.

First, BC should refrain from increasing taxes that are highly economically damaging, such as personal and capital-based taxes, as it seeks to garner revenue for other tax reductions.

That said, the province could enact revenue neutral tax reform by broadening the tax base. While the ideal case would be to broaden the PST consumption base once it is re-implemented, this may not be politically feasible. Fortunately, other base-broadening options are available to create the fiscal room for pro-growth tax reform, including eliminating or significantly scaling back tax credits offered through the personal and corporate income tax systems.

A final option is to balance the budget first and enact aggressive pro-growth tax reform afterwards as revenues become available.

Introduction

Following the defeat of the harmonized sales tax (HST) in last year's provincial referendum, the government of British Columbia committed to restoring the provincial sales tax (PST). Unfortunately, the rebirth of the PST will strike a severe blow to the competitiveness of BC's investment climate and cause the province to lose out on the unrealized economic gains that the HST system would have encouraged.

However, the provincial government should be commended for creating the Expert Panel on Business Taxation to "identify other ways to maintain and improve BC's economic competitiveness, while respecting the referendum result to return to the [PST]."[1] We wish the members of the Panel well in their deliberations and thank them for the opportunity to present today.

The Fraser Institute is a non-profit, non-partisan research and education organization. It is fully independent from government and does not represent the interest of specific groups or individuals. The authors have therefore prepared this submission from an objective perspective. That is, our ultimate goal is to provide recommendations that will increase the general well-being of all British Columbians and the level of prosperity in the province.

Organization of the submission

The organization of this submission is designed to provide the Expert Panel with background knowledge about why taxes matter for BC's economic performance, the economic costs of different types of taxes, and a review of BC's performance relative to other provinces in key areas of taxation. The submission is divided into three main sections; a complete list of references is also provided. The first section discusses the impact of taxes on economic behaviour and how different taxes impose very different economic costs on society. The second section contains two major components: it first provides a brief overview of BC's performance on three important taxes (business, property, and personal income taxes) and later proposes recommendations that follow from the analysis for each area of taxation. The third and final section offers the Panel several options on how to pay for the proposed tax recommendations.

[1] See http://www.fin.gov.bc.ca/experts_panel_tax.htm#tor.

1. Why Taxes Matter

A province's tax system has a significant impact on the economic incentives faced by workers, investors, and businesses. It therefore plays a significant role in shaping a jurisdiction's economic success or failure.[2] A competitive tax system can help ensure BC remains an attractive place to work and do business in a world where provinces and countries are competing for investment dollars, entrepreneurs, and skilled workers.

We have enclosed a comprehensive review of the extensive evidence from academic research on the impact of taxes. Academic studies overwhelmingly conclude that tax rates do, in fact, influence individual and business behaviour when it comes to making decisions about working, investing, saving, and entrepreneurship.[3] The most important conclusion from the research is that high taxes contribute to lower rates of economic growth, reduced rates of personal income growth, lower rates of capital formation, and reduced entrepreneurship.

Since taxes change people's behaviour, they impose economic costs. However, some taxes impose greater costs on society than others. If British Columbians want a better standard of living—including more resources to pay for critical public services like health care and education—they will benefit from the least damaging types of taxes that are needed to raise the revenue the government spends.

This section explains how taxes affect people's behaviour and why the mix of taxes used to collect government revenue matters.

The impact of taxes on incentives and behaviour

Though economists differ on many issues, virtually all agree on a few basic concepts. One of the most important is that people respond to incentives. That is, people make decisions by comparing the costs with the benefits of a particular action. When either the costs or the benefits change, people's behaviour will also change. For instance, when the price of beef rises, consumers will likely purchase less beef, and substitute

---

[2] See Lammam et al. (2010a) for a discussion of other key policies that influence a province's economic success which include fiscal policy, government regulation, labour market policy, and transportation infrastructure.

[3] See Palacios and Harischandra (2008) for a comprehensive review of the economics research on the impact of taxes on economic behaviour.

with alternatives such as chicken. Similarly, when the price of a production input rises (such as the cork used in the wine industry), businesses will search for ways to compensate for the increased costs through substitution and innovation (like developing plastic alternatives to cork).

Taxes change the relative prices of goods, services, and inputs by making some things more expensive and others relatively less expensive. Since individuals and firms make decisions based on prices, taxes distort the behaviour of individuals, families, and businesses.

With taxation, governments have two basic choices:[4]

1. They can tax production (activities that increase economic output) through personal income taxes, corporate income and other business taxes, payroll taxes and taxes on interest, dividends, and capital gains.

2. They can tax consumption through general value-added sales taxes[5] or taxes on the consumption of specific goods such as excise taxes on alcohol and tobacco.

Taxes on production

To understand the impact of taxes on production and consumption, imagine a pile of goods in the middle of a town square. The pile is our gross domestic product (GDP), the value of all the goods and services produced within an economy. As individuals and businesses contribute to the pile, society has more and better goods and services available to it. For example, we get more advanced technologies, more powerful computers, products like Blackberries and iPhones, better health equipment such as MRI machines and CT scanners, and much more.

[4] Governments can also defer the tax bill by running deficits. But doing so does not make the debt go away; today's deficits are tomorrow's taxes. Since the increased debt that results from a deficit must one day be paid back, tax payers respond to deficits by increasing savings or paying down debt in anticipation of higher future taxes. See Law and Clemens (1998) for a detailed analysis of this phenomenon known as the Ricardian Equivalence Theorem.

[5] Value added sales taxes only tax the value added by the business selling the good or service. In other words, all inputs into the creation of a product and service are exempt from the tax. The federal Goods and Services Tax (GST) is one example of a value-added tax.

When governments tax production, they penalize the process through which individuals and businesses add to the pile of goods and services that make us better off. As a result, we get less investment, fewer goods and services produced, less innovation, and fewer technological improvements.

For example, personal income taxes decrease the take-home pay for workers and that affects the total number of hours they work, their overall work effort, the types of jobs they pursue, and whether they choose to be entrepreneurial. Personal income taxes also affect how much workers invest in their skills because they reduce the benefit that workers get from taking advanced training or education. Marginal tax rates on personal income are especially detrimental to people's incentives and are a critical determinant of economic behaviour since they directly affect the proportion of increased income that is left after taxes.

In Canada generally, and British Columbia specifically, personal income tax rates increase as an individual's income increases. Put differently, our personal income tax system is progressive. Yet a progressive personal income tax structure penalizes income growth. Think of taxes as "fines," such as those imposed on people who choose to drive above the speed limit. The more income one earns, the greater the rate of the fine (such as the progressive fines applied to those who speed). We have those progressive fines because we want to stop fast driving. While the intent of progressive taxes is not to stop faster income growth, they have that effect.[6]

Likewise, taxes on savings (i.e., personal income tax on interest, dividends, and capital gains) and taxes on capital (i.e., corporate income taxes) reduce the after-tax rate of return that investors receive, thereby discouraging savings and investment.[7] This can have significant adverse effects on productivity-enhancing investment, and ultimately wages. With decreased returns and less investment, both investors and workers lose.

Taxes on consumption

Let's return to our example of GDP as a pile of goods in the middle of a town square. When we tax consumption activity, we penalize people for taking goods off the pile. While the demand for goods and services is somewhat diminished by this

---

[6] See Palacios and Harischandra (2008) for a review of academic studies that show the destructive effect of high marginal personal income tax rates and a progressive income tax structure.

[7] See Clemens and Veldhuis (2003) for an explanation of who ultimately pays business taxes.

consumption tax, the people who produce the goods and services are not directly penalized.[8]

Since consumption taxes discourage people from consuming, they increase the incentive to save. Increased savings finances investments in machinery, equipment, new technologies, and research and development. These types of investments make workers more productive, which ultimately results in higher wages; they also result in a stronger economy with more job opportunities and better living standards.

In short, consumption taxes are less damaging to economic activity than other taxes like personal income and capital-based taxes. That's why economists across the political spectrum generally agree that the revenue to finance government spending should come mostly from consumption taxes rather than other more economically-damaging taxes.

The economic costs of different taxes

Numerous academic and government studies have estimated the economic cost of different types of taxes.[9] Recent calculations for Canada were published by the federal Department of Finance (see Canada, Department of Finance, 2004). The calculations are reproduced in figure 1 and show the long-term economic costs to society imposed by the country's main taxes.

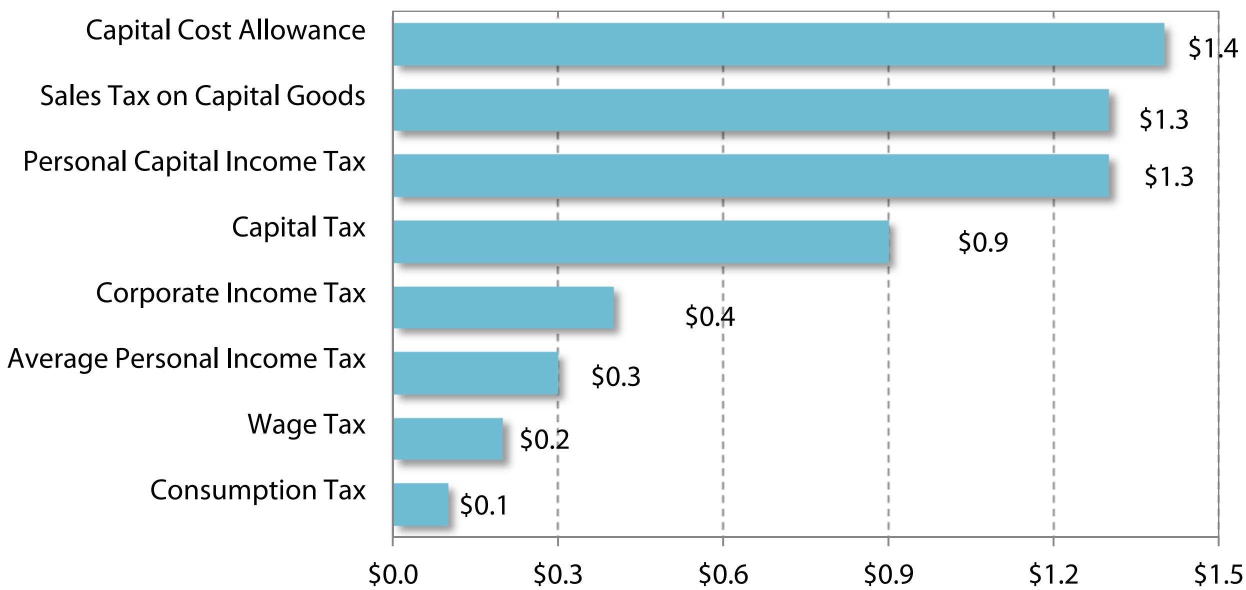
The Department of Finance study found that taxes on production—including sales taxes on capital goods purchased by businesses (the PST), personal income taxes on investment income, and corporate income taxes—impose substantially larger burdens on society than consumption taxes (the HST). Specifically, the study estimated the benefits of different types of tax cuts on economic well-being. For example, decreasing sales taxes on capital goods purchased by businesses (the PST) by $1.00 and imposing an offsetting $1.00 increase in consumption taxes (the HST) would result in a net increase of $1.20 ($1.30 - $0.10) in society's well-being (see figure 1). Unfortunately, this improvement in social welfare will be reversed when the PST is restored in BC next year.

---

[8] Sales taxes do indirectly affect the incentive to work because they reduce a worker's real wage rate by increasing the prices of consumer goods.

[9] See Clemens et al. (2007) for a complete literature review on marginal efficiency cost and marginal excess burden (MEB) calculations.

Figure 1: Gain in Economic Well-Being to Society Per Dollar of Tax Reduction



Source: Canada, Department of Finance (2004).
Notes:
(1) Revenue loss is assumed to be covered through "lump-sum" taxation. Welfare gains are calculated in dollars as the gain in economic well-being per dollar of tax reduction.
(2) The estimate for an increase in capital cost allowances (CCA) is for new capital only. Increasing CCA is not a tax reduction per se, but rather an increase in a deduction against corporate income taxes.

The PST will undo the giant leap forward in BC's tax mix

While the PST applied to many of the goods British Columbians purchase, it also applied to business inputs. Most critically, the PST applied to capital inputs such as machinery and equipment, which increased the cost of investing in plants, machinery, equipment, and new technologies like computers and software. The PST made it more expensive for businesses to invest, expand, upgrade, and innovate because it increased the cost of investment. As a result of the increased costs, the PST discouraged business investment.

Some 40% of the government's PST revenues were derived from businesses buying the things they needed to produce goods and services (British Columbia, Ministry of Finance, 2010). In other words, 40% of British Columbia's old PST was a tax on production (business inputs) rather than consumption (final sales of goods and services).

BC's implementation of the HST in July 2010 significantly improved the province's tax mix. By reforming the province's sales tax to focus on final sales and not investment, BC markedly improved its competitiveness and reduced the cost of investing in the province.

Like the federal Goods and Services Tax (GST), the HST only taxes the value added by the business selling the good or service. In other words, all inputs into the creation of a product and service are exempt from the HST. This is the HST's greatest benefit. A return to the PST means that items purchased by businesses to produce those products and services will be subject to sales tax. This will again increase the cost of investing in BC and adversely affect the provincial investment climate, making BC a less attractive place for investors to set up operations or expand. This is why the Expert Panel's recommendations will be critical for British Columbians.

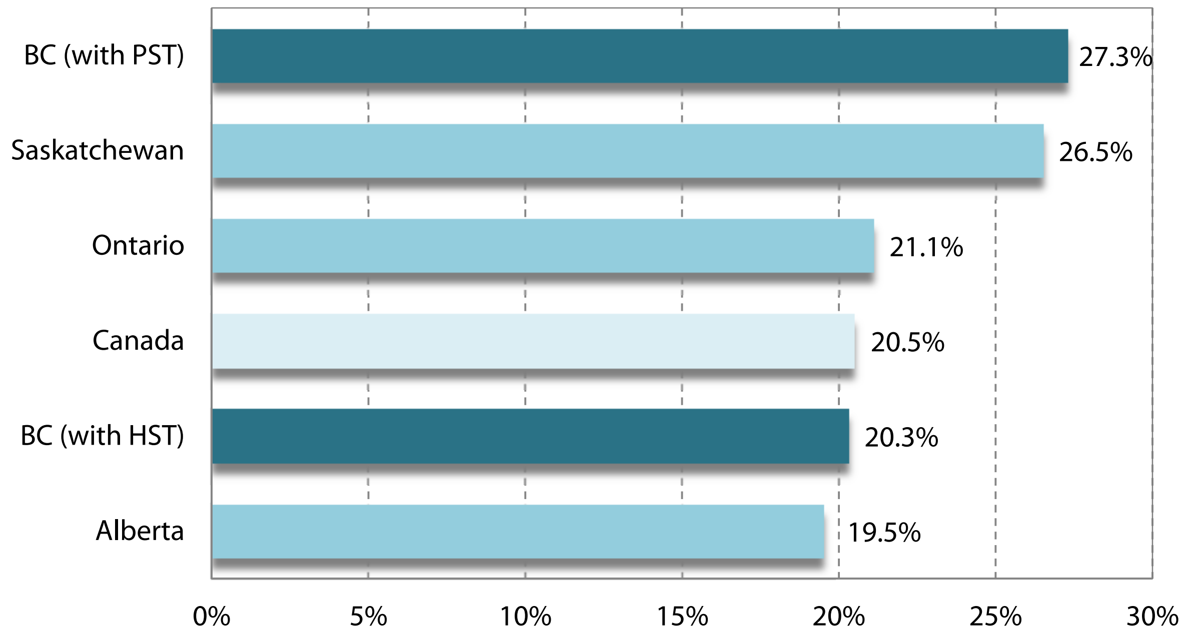
2. How BC Compares on Key Taxes

Over the last decade, BC has made tremendous progress in strengthening its provincial investment climate, in part through personal and business tax reform. While tax reform has served the province and its citizens well by helping usher in a period of economic growth and prosperity,[10] there are remaining areas of taxation where BC is either not competitive or does not maintain a significant advantage. Indeed, significantly more can be done to improve the competitiveness of BC's tax system and encourage individuals and businesses to undertake productive economic activities. Business tax reform in particular will be desperately needed in light of the restoration of the PST.

This section examines BC's performance relative to the other provinces in three key areas of taxation: business taxes, property taxes, and personal income taxes. Recommendations for reform are provided for each area.

[10] A 2008 study by one of Canada's leading economists, University of Alberta Professor Bev Dahlby, assessed the economic impacts of BC's 2001 tax cuts on production and found that the cuts had a profound impact on economic growth, and will continue to exert long-term positive effects that will benefit generations to come (Dahlby and Ferede, 2008).

Figure 2: Marginal Effective Tax Rate on Capital Investment in BC and Key Provincial Competitors, 2010



Sources: Chen and Mintz (2011); Mintz (2011); calculations by authors.
Note: The marginal effective tax rate (METR) is a comprehensive measure of a jurisdiction's business tax regime. The METR takes into account differing tax bases, the presence of tax credits, and other characteristics of provincial tax systems that are not readily apparent in a simple comparison of statutory tax rates.

Business taxes

The most comprehensive measure of a jurisdiction's business tax regime is what is called the Marginal Effective Tax Rate (METR) on capital investment. The METR takes into account differing tax bases, the presence of tax credits, and other characteristics of provincial tax systems that are not readily apparent in a simple comparison of statutory tax rates.[11] Specifically, the METR measures the tax wedge between the pre-tax and after-tax rate of return on incremental business investment; it accounts for corporate income taxes, capital taxes, depreciation and inventory cost

[11] Statutory tax rates are the rates specified by the tax code which can, and often do, differ from the effective tax rates, the rates people actually pay.

deductions, and sales taxes imposed on business inputs.[12] The calculation of METRs is an onerous and complex process. Thankfully, a recent report by Duanjie Chen and University of Calgary professor Jack Mintz provides us with some Canadian estimates (Chen and Mintz, 2011).

Figure 2 presents the effective tax rates on capital for businesses in BC and our key provincial competitors in 2010, the most recent year for which comparable data is available. With the HST, BC's METR in 2010 is roughly in line with the Canadian average and neighbouring Alberta. However, now consider the impact of restoring the PST on the overall tax rate. We estimate that moving from the HST to PST will increase the overall rate from 20.3% to 27.3% and result in BC having one of the highest overall tax rates on investment among the provinces (Chen and Mintz, 2011; Mintz, 2011; calculations by the authors). When compared to our key competitors, BC's METR with the PST will not only surpass other western provinces (Alberta and Saskatchewan), but it will also far exceed the Canadian average.

But all is not lost. The BC government can pursue other options to mitigate the damaging impact of restoring the PST on the METR. We outline some of these options below.

Business tax recommendations

Introduce a complete sales tax exemption on all business inputs

BC could offset the negative effect of restoring the PST on the provincial investment climate if it introduced a complete sales tax exemption on all business inputs including machinery, equipment, and technology. Something similar was attempted back in 2001 but the province limited the exemption by narrowly interpreting the types of machinery and equipment, and manufacturing companies, that qualified (Wang, 2004). Indeed, the exemption was not available to most businesses and resulted in an administrative disaster which eventually deterred many companies from seeking eligibility. Because sales taxes on capital goods (such as machinery and equipment) are among the most economically damaging types of taxes, this recommendation should be high priority in light of the return to the PST.

[12] See Chen (2000) for a detailed explanation of how METRs are calculated and why they matter for capital allocation.

Reduce the general corporate income tax rate

Moving back to the PST will significantly increase BC's effective tax rate on investment and reducing the general corporate income tax rate would help mitigate the increase. A phased-in reduction of the general corporate tax rate to 8% from its current 10% rate would provide BC with a marked advantage over all other provinces, giving it the lowest rate within Canada. More importantly, it would encourage business investment and development in the province, which will ultimately translate into a more flourishing economy with increased job opportunities for British Columbians.

Reduce the disincentive for small businesses to grow

There is increasing concern regarding the negative effects of the small business preferential tax rate on business development and growth (see, for example, Clemens and Veldhuis, 2005). While a lower small business income tax rate may appear favourable, the large gap between the small (2.5%) and general rate (10%) acts as a significant barrier, or disincentive, for small businesses to grow and expand beyond $500,000 (the income threshold for the preferential 2.5% rate). Ideally, the business tax system wouldn't discriminate based on firm size and would levy the same rate for all businesses. However, a more practical option is to increase the threshold of income eligible for the small business tax rate (2.5%) from $500,000 to $1 million. Increasing the threshold for eligible income would mitigate the disincentive for small businesses to grow and develop, and thus allow British Columbians to reap the benefits of having an industrial landscape containing larger and more productive firms.

Property taxes

Property taxes are also key components of the province's competitiveness and the Expert Panel has identified this as an area for possible reform. When it comes to property taxes, BC appears to have a serious business climate problem in its treatment of certain business classes. The latest and most comprehensive research in the area of property taxes was undertaken by Dr. Robert Bish in an important 2004 study entitled *Property Taxes on Business and Industrial Property in British Columbia* (see Bish, 2004). The complete study is enclosed.

Since 1984, British Columbia has allowed municipalities discretion in setting property taxes for different classes of property; in 2004 BC had nine different classes of property, four of which are for businesses. Unfortunately, municipal councils have used this discretion to subsidize low residential rates with relatively high rates on business property. This has damaged the business climate in many municipalities.

Bish's (2004) comparative analysis of the treatment of business classes of property relative to residential ones in BC revealed that business property has been taxed at much higher rates than residential property. In 2003, the median residential tax rate in BC was 1.2% compared to 4.9% for major industry, resulting in a ratio of 4.0. The median ratios for other business classes were 4.6 for utilities, 2.9 for light industry, and 2.3 for other business (Bish, 2004).[13] The higher the ratio, the greater the subsidy from business to residential property tax payers.

Most provinces, with the exception of Alberta and Ontario, put all business properties into one class and set required or maximum ratios between rates on different property classes. In these provinces, the ratios of business to residential rates are quite small. For example, in Saskatchewan it is 1.4 for commerce and industry, and 1.0 for utilities. In Manitoba it is 1.4 for business, 1.1 for pipelines, and 0.6 for railroads.

Alberta, where there is also flexibility on property tax rates and ratios, has higher residential rates and lower business rates than BC. As a result, the median ratios of business to residential tax rates in Alberta are less than 1.5. Ontario has provincially-designated "ranges of fairness," resulting in business to residential ratios of 0.6 to 1.1.

Bish (2004) also found that US states maintain a more balanced property tax regime with median ratios of urban commercial and industry-to-residential property tax rates of 2.0 and 1.6, respectively.

Property tax recommendations

Provide a framework for pro-investment property tax reform

In terms of property tax reform, we suggest that tax rates be equalized across property classes. Businesses are becoming more mobile, so municipalities must be aware of the effects of discriminatory property taxation. High property taxes may affect the location decisions of new businesses and whether existing businesses will stay open or move to friendlier jurisdictions. For this reason, the government may consider combining the number of business classes into one class. Another option is for the

---

[13] Major industry includes land and buildings of major industrial properties such as lumber and pulp mills, mining operations, ship building, and loading terminals. Light Industry includes property used or held for extracting, manufacturing, or transporting products. Other business includes property used for offices, retail, warehousing, hotels and motels, and property that doesn't fall into other classes. See http://www.sbr.gov.bc.ca/business/property_taxes/rural_property_tax/Tax_rates/key.htm#CAT for more details.

provincial government to determine ranges of fairness and thresholds based on average property tax rates in the municipalities for different major classes, and require all tax rate changes to move toward this range of fairness.

Personal income taxes

While the Expert Panel's focus is on business taxation, personal income taxes are also an important component of BC's overall investment climate and competitiveness (Lammam et al., 2010a). Competitive personal income tax rates enable the province to better retain and attract high-skilled professionals as well as promote entrepreneurship and innovation in BC.[14]

When compared to our closest provincial competitor, Alberta, BC's personal income tax system does not bode well for the investment climate. For instance, while BC maintains five separate tax brackets, Alberta levies a single tax rate on all personal income earned beyond the provincial exemption. This means BC's tax system is much more complex and progressive, which causes substantially more economic distortions.

It is also concerning that BC's middle and upper marginal tax rates are uncompetitive relative to Alberta. That is, BC's highest three marginal tax rates (14.7%, 12.3%, and 10.5%) all exceed Alberta's top rate, which is 10% for all income beyond $17,282. Most concerning, however, is the large difference in top marginal rates between BC and Alberta. A highly skilled professional earning $150,000 will pay a provincial marginal tax rate of 14.7% working in BC, but only 10% working in Alberta. BC's rate is nearly 50% higher than that levied in neighbouring Alberta. The reality is that BC is competing with Alberta for scarce, highly qualified labour and a higher tax rate, among other considerations, affects the decisions of workers to stay in or come to the province.

Personal income tax recommendations

Make personal taxes on high skilled workers more competitive

To attract and retain highly skilled workers, BC should make the province's middle and top marginal income tax rates more competitive with Alberta. Specifically, BC should aim to gradually collapse its top three marginal rates (14.7%, 12.3%, and

[14] Interestingly, two consecutive federal governments—one Liberal, the other Conservative—have, in their economic plans, emphasized the need to reduce personal income tax rates in Canada to make the country more competitive internationally (see Canada, Department of Finance, 2005: 131; Canada, Department of Finance, 2006: 46).

10.5%) with the ultimate goal of moving toward a flat tax rate on personal income equal to the Alberta rate of 10%. Reducing BC's middle and top marginal rates would harness the productive energies of skilled workers, business owners, and entrepreneurs.

More significantly, a longer-term goal for BC should be to move to an integrated approach to business and personal income taxation by instituting an overall flat tax. Under a flat tax, all sources of income, capital gains, business income, wages and salaries, and interest income are taxed at one rate. In addition, all savings and investment are exempt from the tax which gives businesses incentives to increase investment and encourages individuals to work, save, and take entrepreneurial risks.[15] University of Stanford Professor Alvin Rabushka calculated that BC could introduce a flat tax at less than 8% and collect the same amount of revenue as it currently does (Rabushka and Veldhuis, 2008).

3. How to Pay for Tax Relief

We understand that the Expert Panel and provincial government are operating under fiscal constraints. And we respect the view that "tax reforms or other recommendations must be fiscally neutral and sustainable for the province within the province's balanced budget framework." With that in mind, we provide three general options to pay for the tax reforms outlined above. The principle that guides our recommendations is that tax reform is an ongoing issue that should be approached from a longer term perspective and changes in other provinces should be factored into BC's ultimate plan. We hope the Panel adopts this view.

Refrain from increasing taxes that are highly economically damaging

BC should refrain from increasing taxes to garner revenue for other tax reductions. As our earlier discussion of taxes explained, this approach has widespread and damaging consequences, particularly if the tax increase is on personal income or capital-based taxes. Unfortunately, the provincial government signaled in its 2012 budget that higher taxes might be an option. Critically, the government has proposed a "provisional" one percentage point increase to the general corporate income tax rate in 2014/15.

The potential of higher business taxes will prove especially damaging to BC's economy. They will create policy uncertainty during already uncertain economic times

[15] See Clemens (2008) for a detailed analysis of the case for a flat tax.

and degrade BC's investment climate when improvements are desperately needed to counteract the blow from restoring the PST next year.

Enact revenue neutral tax reform by broadening the tax base

The government could broaden the tax base to create the fiscal capacity for some of the tax reforms outlined in the previous section. While the ideal case would be to broaden the PST consumption base once it is re-implemented (by removing special exemptions on certain goods and services), this may not be politically feasible. Fortunately, other base-broadening options are available to create the fiscal room for pro-growth tax reform. To gain revenue in the least economically damaging manner, the government can either eliminate or significantly scale back tax credits offered through the personal and business tax systems. Doing so would provide the added benefit of simplifying the tax code.

The provincial government currently offers a litany of tax credits that narrow the tax base, which means a higher tax rate is required to raise the same amount of revenue. Many of these tax credits have questionable economic value, while others reward activities that would have still been undertaken in the absence of the tax credits. They also unfairly provide special benefits or privileges to certain individuals or businesses at the expense of others. Rather than further distort the tax system with special privileges to some groups, a more effective approach is to reduce tax rates more broadly to benefit all British Columbians

Table 1 presents an itemized list of personal income tax credits and their cost to government in terms of foregone revenue in 2012/13. Table 2 presents this data for corporate income tax credits. The cost of all (refundable and non-refundable) personal income tax credits is expected to total $791.1 million in lost revenue in 2012/13 (table 1) while the cost of all corporate income tax credits is expected to total $542.5 million in the same year (table 2). The combined cost all personal and corporate income tax credits is over $1.3 billion for the current fiscal year.

Tax reform offers the opportunity to rationalize, either by reducing or outright eliminating, some of these tax credits and other special treatments in exchange for lower marginal tax rates. By expanding the tax base through the reduction or elimination of these special privileges, lower tax rates can be introduced that raise the same amount of revenue. For perspective, a two percentage point reduction in BC's general corporate income tax rate would cost the government approximately $453

Table 1: Personal Income Tax Credits, Non-Refundable and Refundable, 2012/13 (in millions)

Non-Refundable Credits	
Political Contributions	1.3
Logging	1.0
Employee Share Ownership	0.2
Employee Venture Capital	2.0
BC Mining Flow-through Share	0.0
Children Fitness & Arts	9.0
Medical Expense	0.3
Foreign	33.0
Total NR credits	46.8
BC Tax Reduction	112.0
Total NR Credits and BC Tax Reduction	**158.8**
Refundable Credits	
Low Income Climate Action	190.0
Sales	13.3
BC HST	315.0
Equity Venture Capital	28.0
Training (Employers & Employees)	20.0
First-Time New Home Buyer Housing	24.0
BC Seniors Home Renovation	27.0
Mining Exploration	0.5
Mutual Funds Refunds	10.0
Family Bonus program	4.5
Total Refundable Credits	**632.3**
Total Personal Income Credits	**791.1**

Source: British Columbia, Ministry of Finance (2012b).

million in lost revenue which is still less than the total of all corporate income tax credits ($543 million).[16]

[16] This estimate for the lost revenue of a two percentage point reduction in the general corporate tax rate is a static one that does not account for dynamic behavioural changes that would result from a lower rate. In 2012/13, the BC government expects total corporate tax revenues to be $2,266 million. If we assume all the revenues are from the general rate, then two percentage points of 10% would equal roughly $453.2 million.

Table 2: Corporate Income Tax Credits, Non-refundable and Refundable, 2012/13 (in millions)

Non-Refundable Credits	
Logging Tax	10.8
Scientific Research & Experimental Development	69.3
Manufacturing & Processing	1.1
Venture Capital	2.2
Total NR Credits	**83.4**
Refundable Credits	
Film and TV Production	70.0
Production services	217.4
Scientific Research & Experimental Development	79.2
Digital Interactive Media	37.9
Mining Exploration	39.5
Capital Gains	1.0
Training Credit	11.9
Book Publishing	2.2
Total Refundable Credits	**459.1**
Total Corporate Income Credits	**542.5**

Source: British Columbia, Ministry of Finance (2012b).

Balance the budget first, enact pro-growth tax reform afterwards

This option places a balanced budget as the first priority for the government. With recent deficits and increased government debt, there is a real risk that BC's future economic growth could be dampened (Kumar and Woo, 2010; Reinhart and Rogoff, 2010). However, once the budget is balanced and revenues become available, the government could enact more aggressive tax reforms to significantly improve BC's investment climate.

References

Bish, Robert (2004). Property Taxes on Business and Industrial Property in British Columbia. The Fraser Institute. http://www.fraserinstitute.org/publicationdisplay.aspx?id=13324&terms=property+taxes+on+business.

British Columbia, Ministry of Finance (2010). *Budget and Fiscal Plan: 2010/11–2012/13.* Government of British Columbia. http://www.bcbudget.gov.bc.ca/2010/bfp/2010_Budget_Fiscal_Plan.pdf.

British Columbia, Ministry of Finance (2012a). *Budget and Fiscal Plan 2012/13–2014/15*. http://www.bcbudget.gov.bc.ca/2012/bfp/2012_Budget_Fiscal_Plan.pdf.

British Columbia, Ministry of Finance (2012b). Special Data Request. Received on June 13, 2012 by email.

Canada, Department of Finance (2004). *Tax Expenditures and Evaluations 2004*. http://www.fin.gc.ca/taxexp-depfisc/2004/TaxExp04_e.pdf.

Canada, Department of Finance (2005). *A Plan for Growth and Prosperity. Government of Canada*. http://www.fin.gc.ca/ec2005/agenda/agc2005e.pdf.

Canada, Department of Finance (2006). *Advantage Canada: Building a Strong Economy for Canadians*. Government of Canada. http://www.fin.gc.ca/ec2006/pdf/plane.pdf.

Canada, Department of Finance (2010). *Tax Expenditures and Evaluations 2010*. http://www.fin.gc.ca/taxexp-depfisc/2010/TEE2010_eng.pdf.

Chen, Duanjie (2000). *The Marginal Effective Tax Rate: The Only Rate That Matters in Capital Allocation*. Backgrounder. C.D. Howe Institute. http://www.cdhowe.org/pdf/chen.pdf.

Chen, Duanjie, and Jack Mintz (2011). *Federal-Provincial Business Tax Reforms: A Growth Agenda with Competitive Rates and a Neutral Treatment of Business Activities*. The School of Public Policy Research Papers. Vol. 4, issue 1 (January). http://policyschool.ucalgary.ca/sites/default/files/research/fed-prov-tax-reform-1a_0.pdf

Clemens, Jason (ed.) (2008). *The Impact and Cost of Taxation in Canada: The Case for Flat Tax Reform*. The Fraser Institute. http://www.fraserinstitute.org/research-news/display.aspx?id=13518.

Clemens, Jason and Niels Veldhuis (2003). Who Pays Business Taxes? *Fraser Forum* (October: 30-31). http://www.fraserinstitute.org/research-news/research/display.aspx?id=13257.

Clemens, Jason, and Niels Veldhuis (2005). *Growing Small Businesses in Canada: Removing the Tax Barrier*. The Fraser Institute. http://www.fraserinstitute.org/publicationdisplay.aspx?pageid=16041&id=13081&ekfxmen_noscript=1&ekfxmensel=e0fa05764_34_2147483650.

Clemens, Jason, Niels Veldhuis, and Milagros Palacios (2007). *Tax Efficiency: Not All Taxes Are Created Equal*. The Fraser Institute. http://www.fraserinstitute.org/publicationdisplay.aspx?id=13462&terms=taxes+not+created+equal.

Dahlby, Bev, and Ergete Ferede (2008). *Assessing British Columbia's Incentive-Based Tax Cuts*. Studies in Economic Prosperity. Number 5 (February). The Fraser Institute. http://www.fraserinstitute.org/research-news/display.aspx?id=12822.

Kerr, Heather, Ken McKenzie, and Jack Mintz (ed.) (2012). *Tax Policy in Canada*. Canadian Tax Foundation.

Kumar, Manmohan S., and Jaejoon Woo (2010). *Public Debt and Growth*. IMF Working Paper WP/10/174. International Monetary Fund. http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf.

Reinhart, Carmen M., and Kenneth Rogoff (2010). *Growth in a Time of Debt*. NBER Working Paper 15639. National Bureau of Economic Research.

Lammam, Charles, Alex Gainer, and Niels Veldhuis (2010a). *Canadian Provincial Investment Climate—2010 Report*. The Fraser Institute. http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/canadian-provincial-investment-climate-2010.pdf.

Lammam, Charles, Niels Veldhuis, and Milagros Palacios (2010b). *Countering the Myths Surrounding British Columbia's Harmonized Sales Tax*. The Fraser Institute. http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/Countering-the-Myths-surrounding-HST.pdf

Law, Marc, and Jason Clemens (1998). The Ricardian Equivalence Theorem: Back to the Future? *Fraser Forum* (February). http://oldfraser.lexi.net/publications/forum/1998/february/terminology.html

Mintz, Jack (2011). *Tax Impact of BC's HST Debate on Investment and Competitiveness*. The School of Public Policy Communiqué. Vol. 3, issue 1 (May). http://policyschool.ucalgary.ca/sites/default/files/research/tax-impact-bchst-communique-c.pdf

Palacios, Milagros, and Kumi Harischandra (2008). The Impact of Taxes on Economic Behavior. In Jason Clemens (ed.), *The Impact and Cost of Taxation in Canada: The Case for Flat Tax Reform*. (The Fraser Institute): 3-31. http://www.fraserinstitute.org/research-news/display.aspx?id=13518.

Rabushka, Alvin, and Niels Veldhuis (2008). A Flat Tax for Canada. In Jason Clemens (ed.), *The Impact and Cost of Taxation in Canada: The Case for Flat Tax Reform* (The Fraser Institute): 145-186. http://www.fraserinstitute.org/research-news/display.aspx?id=13518.

Wang, Jeanette (2004). PST: Production Machinery. *Canadian Tax Highlights* 12, 9 (September). Canada Tax Foundation.