FRASER RESEARCH BULLETIN

November 2022

British Columbia's Growing Tax Competitiveness Problem

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Summary

- British Columbia faces significant tax competitiveness challenges with respect to the tax treatment of both businesses and individuals. This is a policy problem because competitive tax systems contribute to economic growth by helping jurisdictions attract business investment and skilled workers.

- British Columbia's tax treatment of businesses has long been uncompetitive. An inefficiently designed sales tax that taxes inputs to business production processes is the key reason for the province having the highest average level of tax on new investment in Canada.

- Recent policy changes in the United States have made the business tax environment in that country more attractive for investment, which puts a new source of competitive pressure on BC.

- Furthermore, in recent years, the province's tax competitiveness on personal income taxes for high-income individuals has become a new policy problem—on top of its longstanding business tax challenges.

- At 53.5 percent British Columbia now has the 4th highest top personal income tax rate in Canada or the United States. This is just 1.3 percentage points lower than in Newfoundland & Labrador, which at 54.8 percent has the highest personal income tax rate in either country.

- The added challenge of an uncompetitive personal income tax rate piled on top of the province's already uncompetitive business tax environment raises important questions about the overall competitiveness of the province's tax system. Policymakers should be concerned by British Columbia's tax path in recent years.

Introduction

British Columbia faces significant tax competitiveness challenges with respect to the tax treatment of both businesses and individuals. This is a policy problem because competitive tax systems contribute to economic growth by helping jurisdictions attract business investment and skilled workers.[1]

The province's lack of competitiveness on business taxation is longstanding and is primarily due to the fact that the provincial sales tax applies to a wide array of business inputs[2] that are not subject to sales taxes in most other provinces. More recently, federal and provincial changes to personal income taxes have left the province with income tax rates on high earners that are amongst the highest in North America.

This research bulletin illustrates British Columbia's tax competitiveness problems with respect to both individuals and business. The first section discusses the province's approach to business taxation and illustrates the extent of the province's business tax competitiveness problem. The next section discusses personal income taxes and shows how recent federal and provincial tax policy changes have undermined the province's competitiveness in this area for high income earners particularly. A brief conclusion follows.

BC's longstanding lack of business tax competitiveness

Tax policy can have a significant effect on business decisions; higher taxes can distort economic activity and slow economic growth. For example, tax rates influence choices about how many people to employ and what new machinery and equipment to purchase. Business taxes can also play a role in decisions about whether to open new businesses, whether to expand, or whether to continue operating. For these reasons, taxes on businesses can be amongst the most distortive and economically damaging. For instance, one often-cited recent study has identified the corporate income tax (CIT) as one of the most economically harmful components of Canada's tax mix (Ferede and Dahlby,2016).

British Columbia's tax treatment of businesses has long been uncompetitive. On the surface, the province's general corporate income tax rate is comparable to that in many other Canadian provinces. However, the CIT is just one of the ways in which businesses are taxed. More comprehensive measures illustrate the severity of BC's business tax competitiveness challenge. For example, Bazel, Mintz, and Thompson (2018) look specifically at the marginal effective tax rate (METR) and explain that it is a more complete measure that includes corporate income taxes, sales taxes applied to capital, and other taxes applied to capital purchases.

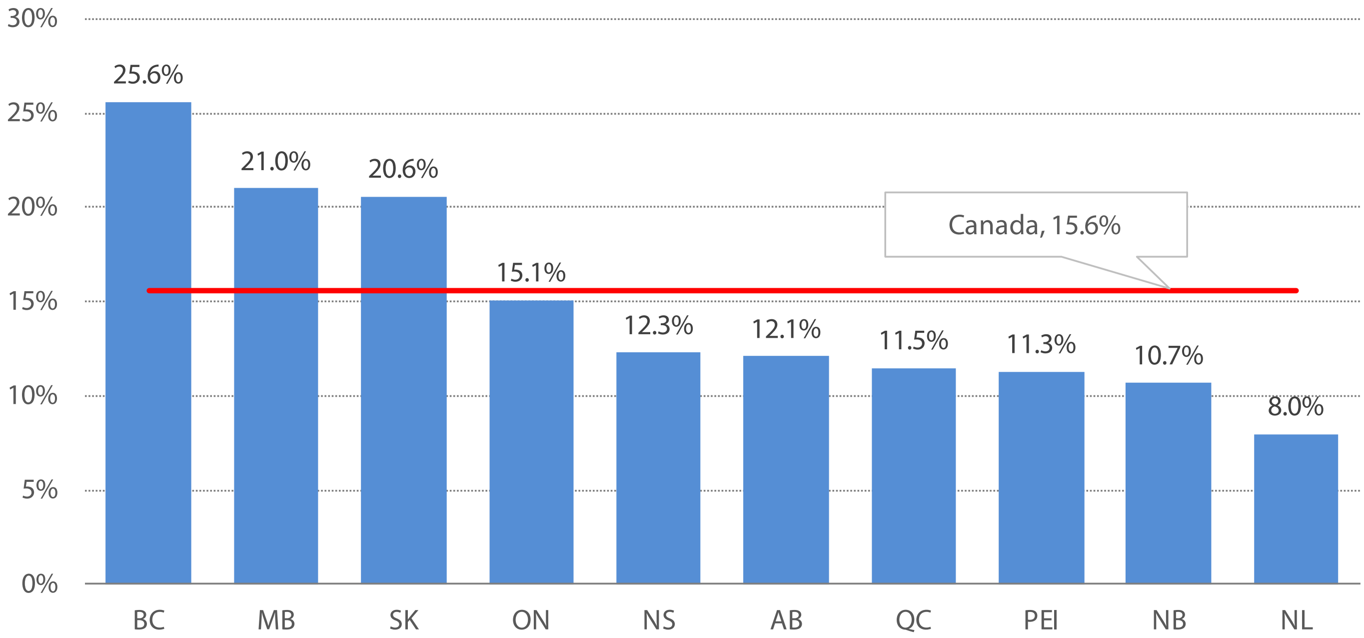
British Columbia performs poorly on this measure of business tax competitiveness. In fact, one recent analysis (Bazel and Mintz, 2021) showed that in 2020 BC had the highest METR in Canada. Figure 1 shows the METR in all Canadian provinces.

Figure 1 shows that in 2020 BC's METR was 25.6 percent. This is 4.6 percentage points higher than the next closest province, Manitoba. A comparison to the other large provinces is even more striking. The METRs in Quebec, Ontario, and Alberta ranged from a low of 11.5 percent to a high of 15.1 percent. This measure suggests

[1] For a more thorough overview of the research on this topic see Murphy, Clemens, and Veldhuis, 2013.

[2] Business inputs are goods and services that companies purchase and use in order to undertake their production activity.

Figure 1: Marginal Effective Tax Rates on New Investment by Province, 2020



Source: Bazel, Philip and Jack Mintz (2021).

BC faces a significant disadvantage compared to other Canadian provinces on business taxes.

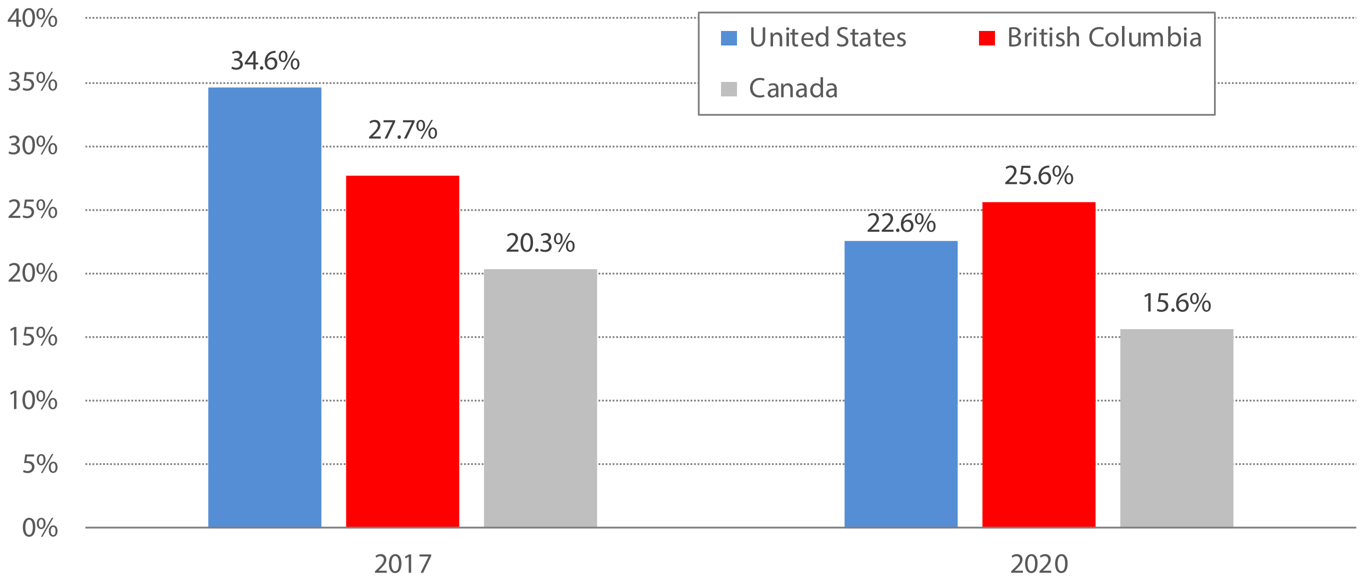
The primary reason that BC's average METR is unusually high stems from the province's use of a retail sales tax. The problem with this tax (the PST) is that it applies to capital purchases such as equipment or construction materials (Jackson and Eisen, 2019).

With a value-added tax such as the federal goods and services tax (which most provinces have incorporated into their own tax structures in the form of a Harmonized Sales Tax or HST), businesses can deduct from their taxes payable taxes levied on capital purchases. British Columbia does not enjoy this benefit; the disadvantages of a PST compared to an HST are substantial.

BC briefly moved to a harmonized value-added tax approach in 2009/10 but reversed course following a referendum in which voters rejected the change. The decision to pivot back to a PST meant that the cost of investing in the province increased dramatically. An estimate produced in 2013 found that BC's overall tax rate on new investment climbed from 16 percent to 27 percent (then and now the highest in the country) as a result of this single policy change (Lammam and MacIntyre, 2013). The decision to revert back to a PST is therefore the single greatest reason that the province has the highest average METR in Canada.

A second important contributor to BC's lack of business tax competitiveness is the province's Employer Health Tax (EHT). The EHT raises the cost for employers of adding more workers,

Figure 2: Marginal Effective Tax Rates on New Investment, Pre- and Post- US Federal Tax Reform



Sources: Bazel, Mintz, and Thompson, 2018; Bazel and Mintz, 2021.

which is a key input to production, further undermining the province's tax competitiveness (Ferede, 2020). Moreover, since some of the cost of the EHT is passed along to taxpayers, the tax reduces the take-home pay of taxpayers, which contributes to the personal income tax competitiveness problems that will be discussed in more detail below.

As noted earlier, BC's poor tax competitiveness within Canada is a longstanding problem. However, until recently, the province did enjoy a business tax advantage over many peer jurisdictions in the United States due not only to that country's high federal corporate income tax rate but to other dimensions of its federal tax policy that raised the METR for businesses in America. But relatively recent developments have substantially reduced BC's business tax advantage over competitors in the United States.

The 2018 Tax Cuts and Jobs Act in the United States dramatically reduced the tax burden on new investment in the US. Some key elements of the legislation were a 14 percentage point reduction in the CIT and an acceleration of capital investment deductions (Tax Policy Center, 2019).

Figure 2 illustrates how the tax policy changes in the United States have altered BC's competitive positioning relative to the US. It compares the average METR across the American states to BC and to the Canadian average.

Figure 2 shows that although BC had a much higher METR than the Canadian average in 2017 (for reasons discussed above), it was still lower than the American average by 6.9 percentage points. In 2020, as a result of the US tax policy changes, this advantage had been eroded to a 3-percentage-point disadvantage.

British Columbia's business tax environment is uncompetitive with respect to its effects on new investment. The province has the highest METR in Canada and in recent years has faced increased competitiveness challenges from the United States as a result of that country's major federal tax reform in 2018.

BC's lack of personal income tax competitiveness on high-income earners is a growing challenge

We have seen that BC's business tax competitiveness challenges are longstanding. In recent years, however, a new policy problem has emerged: the province's declining tax competitiveness on personal income taxes for high-income individuals.

High and uncompetitive PIT rates for high earners are problematic for multiple reasons. First, high marginal PIT rates can have a negative effect on economic growth because of the behavioural responses they trigger. Specifically, higher income taxes create disincentives for work and productivity, which slows the rate of economic growth. These behavioural changes can also reduce the size of the tax base upon which various taxes are employed which can partially or entirely offset the revenue gains that would otherwise accrue from a higher rate.

Second, just as jurisdictions compete for capital in a globalized world they also compete for highly skilled and mobile workers. Tax policies that increase the overall income tax rate and reduce the take-home pay of these workers more than is the case in other jurisdictions can have an adverse effect on the incentives for highly skilled workers to locate or stay in a given jurisdiction.

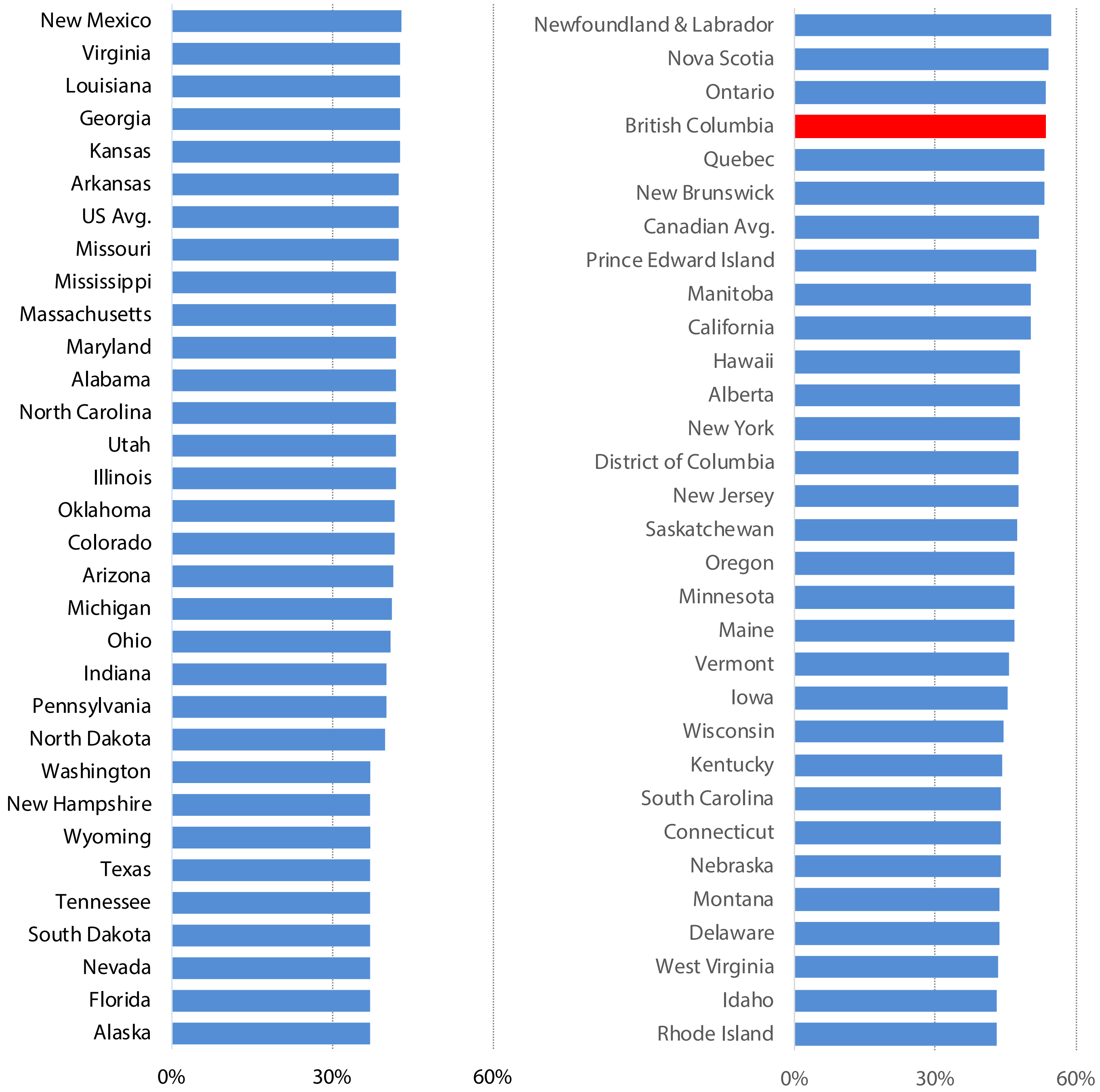
One indicator of personal tax competitiveness is a jurisdiction's top marginal personal income tax rate. Recent empirical research has established a negative link between high marginal personal income tax rates and entrepreneurship in Canada. One recent study found that a 1.0 percentage point increase in the top statutory PIT rate was associated with a reduction in the "business entry" rate—a common measure of entrepreneurship (Ferede, 2018).

British Columbia's top combined federal/provincial PIT rate has increased significantly over the past decades due to both federal and provincial tax policy changes. In 2016, the federal government created a new top income tax bracket which increased every province's top PIT rate by four percentage points. Further, in recent years the provincial government has increased the top provincial marginal PIT rate from 14.7 percent to 20.5 percent. Combined, these changes have increased the top marginal PIT rate in BC by 9.8 percentage points since 2015, from 43.7 percent to 53.5 percent. Although all Canadians provinces have seen an increase in their combined provincial/federal top PIT rate, British Columbia has experienced the largest increase of any province.

Figure 3 shows the effect of these changes on BC's tax competitiveness with respect to its top combined federal/provincial or federal/state marginal personal tax rate in North America by comparing the ten provinces to the 50 states and Washington DC.

At 53.5 percent British Columbia now has the 4th highest top personal income tax rate in Canada or the United States. This is just 1.3 per-

Figure 3: Top Combined Marginal Personal Income Tax Rates in Canadian Provinces and US States, 2022



Notes:
(1) Personal income tax rates include surtaxes where applicable.
(2) The federal personal income tax rate is lower in Quebec because of the Quebec abatement, which is applied because Quebec has opted out of various federal programs. For more information, see https://www.fin.gc.ca/fedprov/altpay-eng.asp.
(3) For US states, local income taxes are excluded.
(4) Country averages reflect simple averages and not provincial or state population weighted averages.

Sources: Vermeer and Loughead, 2022; York, 2022; CRA, 2022; Revenu Quebec, 2022.

centage points lower than in Newfoundland & Labrador, which at 54.8 percent has the highest personal income tax rate in either country.

The average top combined federal/state marginal PIT rate in the United States is 42.4 percent. This is 11.1 percentage points lower than in British Columbia. BC's neighbouring states Alaska and Washington have top marginal PIT rates that are 16.5 percentage points lower than BC's since neither has a state-level PIT.

These data show that in addition to British Columbia's longstanding lack of business tax competitiveness, the province is also now uncompetitive on its top marginal personal income tax rate. The combined 9.8 percentage point increase in the top combined rate is due to increases at the provincial and federal levels, and is the largest increase in Canada.[3]

Conclusion

Primarily due to an economically inefficient provincial sales tax that taxes inputs to production, British Columbia has a longstanding business tax competitiveness problem. The province has the highest average marginal effective tax rate on new investment in Canada. Further, like all Canadian provinces, BC's competitiveness advantage relative to American jurisdictions has been significantly eroded by recent tax reform in that country.

Until relatively recently, British Columbia had a relatively competitive personal income tax system, particularly on its marginal tax rate for high-income individuals. This has changed in recent years. We have shown that due to federal and provincial tax increases, British Columbia now has the 4th highest top marginal tax rate in Canada and the United States.

The added challenge of an uncompetitive personal income tax rate piled on top of the province's already uncompetitive business tax environment raises important questions about the overall competitiveness of the province's tax system. Policymakers should be concerned by British Columbia's tax path in recent years.

[3] Unfortunately, recent evidence suggests that these competitiveness-reducing upper income PIT increases have likely done little to increase the revenue available to governments to deliver services to British Columbians. An analysis of the 2016 federal PIT increase showed that due to reductions in the size of the tax base, there was a minimal net combined increase in federal and provincial revenues (Smart and Uguccioni, 2019). Given that the elasticity of taxable income tends to rise as marginal rates increase and is also generally higher at the provincial than that federal level, it is reasonable to assume that similar results would hold for an analysis of recent provincial tax increases.

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ISSN 2291-8620

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Acknowledgments

The authors wish to thank the anonymous reviewers for their suggestions and feedback. Any remaining errors or oversights are the sole responsibility of the authors.

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