



Weighing the Advantages and Disadvantages of a Harmonized Sales Tax for Prince Edward Island

The PEI Government will surely revisit the HST issue, particularly in light of Ontario's recent decision to harmonize its retail sales tax with the GST.

A recent survey has provided valuable member input for the GCACC to develop a formal policy position to present to the Provincial Government.

Guest opinion submitted by Keith Wornell, LexEcon Group, at the request of the Policy Committee of the Greater Charlottetown Area Chamber of Commerce

Most significant public policy issues are complex and contentious - a harmonized sales tax for PEI will be no exception. Impacts, advantages and disadvantages will differ for government, the business sector, primary industries, consumers, families and individuals. However, the change is worthy of implementation if the overall provincial economy is significantly stronger and if there are acceptable compensations to those who may be negatively affected.

The fiscal impact on the Provincial Government: In the short term, the PEI government will collect less revenue under HST than it does now from PST. The actual amount will depend on the interaction of a lower provincial tax rate applied to an expanded range of taxed goods and services. Currently, the HST rate in the harmonized provinces is 13%, consisting of 8% provincial and 5% GST.

A rough estimate of the net revenue loss can be determined by looking at the compensation the Federal Government paid to the 3 Atlantic provinces. They received \$961 million over four years, or \$437 per capita. They reduced their PSTs by approximately 3.8% when harmonization took place.¹ Had PEI also harmonized its PST with the GST in 1997, it would have received approximately \$30 million. Escalated by GDP growth, this would be approximately \$52 million in 2009 (paid over 4 years) to compensate the Provincial treasury for revenue losses under harmonization. ***Clearly, the first requirement for harmonization is an agreement with the Federal Government to ensure provincial fiscal neutrality.***

In per capita terms, this amount approximates the \$4.3 billion the Ontario Government will receive in Federal transfers to accompany 'harmonization'. However, the Ontario money is not required to compensate the Province, since there won't be a reduction in Provincial revenues because Ontario's portion of the harmonized tax will be the same as its current PST rate of

¹ Dividing the \$437 per capita by the rate reduction of 3.8% gives \$115 per capita for each percent reduction in rate.

8%. The Federal compensation to Ontario will be used to fund grants to Ontario residents. In fact, in a few years Ontario will probably receive more revenue under harmonization than it would have received if it had continued with a PST.

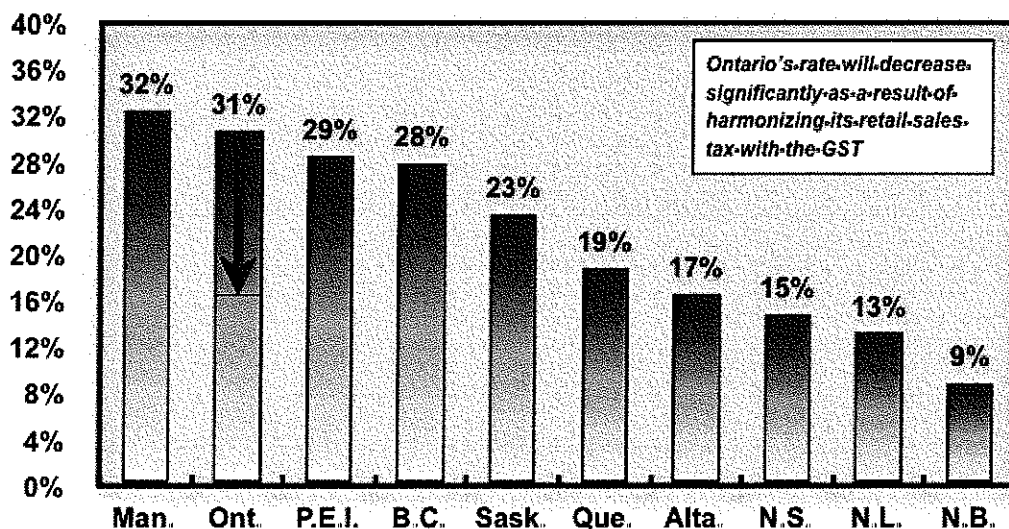
The federal compensation to the Atlantic provinces was transitional and phased in over four years, based on the premise that provincial revenues would return to pre-HST trends over that period. Investment and productivity were expected to increase under the HST, leading to additional economic growth and increased provincial revenues. This indeed did occur, and there is retrospective evidence to support this (Smart, 2007).

After the 1997 reforms, per capita investment rose over 11% in the harmonized provinces compared to the non-harmonized provinces. In addition, total investment in machinery and equipment increased by over 12% annually above the level prior to the 1997 reforms. If the other Atlantic provinces were asked today if they would do it again, it is most likely the answer would be a resounding yes.

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Marginal Effective Tax Rate on New Business Investment, 2012



Source: Adapted from Federal 2008 Budget

The Marginal Effective Tax Rate (METR) is a useful measure of the total tax burden placed on businesses because it includes all income, capital and sales taxes paid by businesses. METR analysis allows for comparison of diverse tax regimes on a consistent basis. (NS Finance)

Impact on the Island business sector: Impacts would differ, depending on the type of business. Most businesses would benefit by being able to deduct sales tax on business inputs, while some that specialize in services will pay more tax (it is estimated that currently at least a third of provincial sales tax revenue is collected from taxing business inputs). However, overall, the average business will pay less tax. This will lead to additional capital investment, enhanced competitiveness and business expansions.

The estimated impact on overall consumer prices is estimated to be minimal, as prices adjust to reflect the lower business tax burden. The experience of the other Atlantic Provinces provides evidence that prices will in fact reflect the expansion of input tax credits (Smart 2007).

Businesses will also have measurable administrative savings as they will only have to deal with one tax administration.

Impact on Primary Industries: This is very difficult to assess given the many current exemptions for agriculture, fishing and aquaculture under the PST. Regardless of these exemptions, the Report of the Commission on the Future of Agriculture and Agri-Food on Prince Edward Island stated -

“The PEI agri-food sector partners should work with the provincial government to review tax policy as it relates to the sector. Particular consideration should be given to eliminating the competitive disadvantage to PEI agriculture created by adoption of the Harmonized Sales Tax (HST) in other Canadian provinces.”

The competitive disadvantage referred to is the inability to deduct provincial sales tax on purchases made for business operations.

Impact on Consumers (individuals and families): The downside of harmonization is with this group and it is the essence of the political dilemma. Despite the strong evidence that the HST would enhance overall economic opportunities in the province, it is individuals who vote, and they may perceive a shift in tax burden from business to consumers as too big a price to pay for a better future. They are unlikely to support the HST unless they can be convinced that their future economic well being will be jeopardized by continuing with an ‘un-harmonized’ PST.

But as many analysts have pointed out, there are relatively easy-to-implement mechanisms to compensate low income individuals and families for negative effects of introducing the HST (e.g. sales tax credits, grants, exemptions, zero ratings, the personal income tax system etc.). There are obvious areas of concern such as children’s clothing and footwear, home heating, new home construction - all of which, in whole or in part, would have to be addressed. **So, a second requirement of an agreement with the Federal Government is the flexibility to have ‘made for PEI’ provision, and, if necessary, the additional fiscal resources to ease the impact on low income families.**

In Conclusion: The upside of a harmonized sales tax, to government and the business and primary sectors, is all about administrative efficiencies, removal of barriers to capital investment, growing the economy, remaining competitive in a very competitive world, protecting employment and raising family incomes.

All the major industrialized countries, with the exception of the US, have implemented value added tax systems, a fact in itself which should convince policy makers of the inherent economic advantages of harmonization. However, again, the issue is complex, emotional and contentious. In the final analysis, the Provincial Government has to weigh the advantages of positive economic stimulation against negative distributional effects. As the tide continues in favor of harmonization, this weighing of advantages and disadvantages should come sooner rather than later.

Keith Wornell is an economist and former Secretary to the Council of Maritime Premiers. His public service in PEI included Deputy Provincial Treasurer, Deputy Minister of Health and Social Services, Deputy Minister of Education, Secretary to the Treasury Board and Secretary to Executive Council. Keith resides in Charlottetown and operates a public policy consulting business, LexEcon Inc.