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A PROFOUND TAX REFORM: THE IMPACT OF SALES TAX HARMONIZATION ON PRINCE EDWARD ISLAND'S COMPETITIVENESS†

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SUMMARY

Prince Edward Island's decision to harmonize its provincial sales tax with the federal GST next year will bring Canada's smallest province huge benefits; consumers and businesses will reap the rewards. While services will be taxed higher, the removal of PST on purchases of goods and services used in operations will keep more money in consumers' wallets as lower production costs cascade from business to the general public. Businesses, faced with a lower cost of capital, will have the chance to increase investments by around $560 million over seven years. Further, the HST regime's potentially more neutral treatment of economic activities will minimize distortions by promoting the efficient allocation of capital. By 2021, when the harmonization has been fully implemented, PEI's effective tax rate on new investments will have fallen by 18 points, making the island one of the most competitive economies in the OECD. Businesses of every size will gain enormously from the changes, as will Prince Edward Islanders themselves, in the form of more jobs, $380 million in additional wages and dramatically improved opportunities. This brief paper models the effects of the HST's gradual phase-in on all major sectors over the next seven years, and argues forcefully that PEI's course is the correct one — a major step toward the neutral corporate tax structure Canadian prosperity depends on.

† The authors wish to acknowledge the helpful comments of the anonymous referees.

INTRODUCTION

Prince Edward Island announced in its 2012 budget its plan to harmonize its provincial sales tax (PST) with the federal Goods and Services Tax (GST), effective April 1, 2013. By adopting a provincial HST that will be levied at a rate of nine percent (resulting in a federal-provincial rate of 14 percent, rather than the existing combined federal-provincial sales tax of 15.5 percent), PEI will remove most provincial sales taxes on capital and other goods and services used in business operations. The tax reform will lead to more investment as well as encouraging PEI businesses to compete in world markets by reducing their unit costs of production.

Joining its Atlantic neighbours, as well as Quebec and Ontario, PEI will achieve a more efficient and fair tax system that will improve its competitiveness. Instead of having the highest tax burden on investment in Canada and one of the highest in the world, PEI will have one of the lowest. Consumers will be treated more fairly as sales taxes will be more evenly applied across goods and services at a lower statutory rate. More importantly over time, the tax reform will result in higher incomes paid to workers and more jobs as businesses adopt technologically advanced capital that will raise output per worker.

We estimate that the sales tax harmonization, in combination with recent federal reductions in corporate taxes, will make PEI one of the most attractive locations for investments in North America and globally. The province's effective tax rate on new investment by medium and large companies will decline from the current 28.8 percent to 11.9 percent by 2014, and 10.7 percent by April 1, 2021 when sales tax harmonization is fully implemented.[1] With an astounding drop of 18.1 percentage points in its effective tax rate on new investments, PEI will move from having the fifth-highest to the fifth- lowest tax burden on new investments among all OECD countries.

With the creation of a much more tax-competitive environment for investment, businesses will be more willing to invest in PEI, and with greater investment will come more jobs and/or higher income paid to workers. By 2021, the effect of sales tax harmonization will be to increase the province's capital stock by more than $560 million, which is expected to translate into an increase of $380 million or 26 percent in employment incomes.

All business sectors in PEI will benefit from sales tax harmonization, particularly agriculture, construction, communications and other services including tourism, which will see their effective tax rates on new investment drop by 40 percent or more. The small business sector in PEI, with its relatively more intensive use of capital goods such as machinery and equipment to produce goods and services, will also benefit substantially from sales tax harmonization; the sector will see its effective tax rate on new investment decline by more than four-fifths, from 26.3 percent to 4.8 percent.

In short, sales tax harmonization will confer significant benefits on PEI's economy. Even though some particular business activities might not benefit directly or instantly from sales tax reform, the significant increase in business activity generated from a much better sales tax regime will help all sectors of the province's economy.

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[1] In the first five years, PEI will restrict certain input tax credits that would normally be claimed under the federal GST (see further discussion below). Within a further three years at the latest, the restrictions on input tax credit claims will be fully phased out so that the PEI sales tax will be fully harmonized with the federal GST.

This paper documents the impact of the government's HST plan on investment and labour income compared to the status quo of the existing PST. As sales tax harmonization will significantly reduce the tax cost of investment for all business sectors, it provides a special opportunity to reform PEI's corporate income tax structure so as to achieve a more neutral treatment among business activities that would be taxed at similar rates. We therefore provide some ideas on how corporate tax reform can be designed so as to enhance the positive impact of sales tax harmonization on PEI's business tax environment.

EFFECTIVE TAX RATES ON NEW INVESTMENTS

To understand how sales tax reform will affect PEI's competitiveness, we measure the impact of sales taxes on the cost of capital faced by businesses. One measure to assess the impact of taxes on investment decisions is the effective tax rate on new investments: the marginal effective tax rate (METR) on capital.[2] In deciding how much investment to undertake, a business will choose to invest in projects so long as the after-tax rate of return on capital is high enough to attract financing from international financial markets. When maximizing the value of their shareholders' equity, businesses will invest in capital until the marginal return on it is equal to its cost. The marginal investment project, therefore, is a project that earns an after-tax rate of return on capital that is just equal to the cost of raising capital from international financial markets.

Suppose a project earns a before-tax rate of return on capital equal to 10 percent, net of inflation and risk. With an effective tax rate of 50 percent, the after-tax rate of return on capital will be five percent. If that rate of return is just sufficient to attract international investor capital (prior to the payment of any personal taxes), then the new investment project will be undertaken by the business. Thus, any reduction in the effective tax rate on new investments will make more projects attractive for business investment. For example, if the required after-tax rate of return on capital were five percent (net of inflation and risk), with an effective tax rate of 20 percent, any project with a before-tax rate of return on capital at least equal to 6.25 percent (i.e., 20% = (6.25% - 5%)/6.25%) would be acceptable.

In the analysis below, the effective tax rate on new investments is calculated as the annualized value of taxes paid by a business as a proportion of the before-tax rate of return on capital. Capital taxes and sales taxes on capital purchases are included; property taxes are not. Effective tax rates on new investments are estimated by asset and industry for non-financial sectors, excluding non-renewable resource companies (oil, gas, and mining). For international competitiveness, most of the focus is on medium- and large-sized companies that raise capital from international markets, but the analysis also considers the impact of sales tax harmonization on small Canadian privately owned companies that are eligible for small business tax treatment (basically, companies with an asset size less than $15 million).

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[2] The METR on capital — also referred to here as the effective tax rate on new investment — has been used for policy analysis since the concept was initially developed in R. Boadway, N. Bruce, and J. Mintz, "Taxation, Inflation and the Effective Marginal Tax Rate on Capital in Canada," *Canadian Journal of Economics* 17 (1, 1984): 62-79; and M. King and D. Fullerton, *The Taxation of Income from Capital* (Chicago: University of Chicago Press, 1984).

SPECIFIC FEATURES TO THE REFORM

As specified in the Memorandum of Agreement between the federal and the PEI governments,[3] under the harmonized sales tax (HST), the provincial sales tax (PST) rate will be reduced from 10 percent to nine percent. As a result, the HST rate will be 14 percent rather than the current combined GST/PST rate of 15.5 percent, which is a result of applying the existing 10 percent PST on top of the five percent GST.

PEI will also adopt certain point-of-sale rebates that will apply to heating oil, children's clothing and footwear and rebates to low- and modest-income households.

The agreement also includes a clause on a temporary denial of allowable business input tax credits for a select list of items within the GST/HST legislation.[4] Assuming PEI will follow Ontario's practices,[5] this temporary denial of input tax credits on limited business inputs will affect mainly the "other services" sector ranging from professional and management services to entertainment and accommodation and food. For PEI businesses, most PST on capital goods will be relieved with the introduction of the HST on April 1, 2013 — the existing effective PST rate[6] on machinery will decline from its current rate of 6.2 percent to 0.4 percent and be removed entirely by 2021 — while the current effective five percent PST rate on structures will largely be eliminated.

The effect of adopting the HST will be to eliminate the sales tax on capital goods purchases, which will lower the sales tax burden on consumer goods and services. It is self-evident that the sales tax on consumer goods will drop, given that PEI will lower its sales tax rate from 10.5 to nine percent. Services, on the other hand, will be taxed more highly since they are exempt from PST but will be taxed under HST. However, the removal of PST on goods and services used in operations will reduce consumer prices for both goods and services that, to various degrees, all use inputs taxable under PST.[7] Therefore, the overall impact of adopting the HST in PEI on consumer prices would be the removal of the cascading effect of PST embedded in the current consumer prices.

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[3] Refer to the Memorandum of Agreement Concerning a Canada-Prince Edward Island Comprehensive Integrated Tax Co-ordination Agreement, May 2012.

[4] In the Memorandum of Agreement, Clause 10(c) says: "Prince Edward Island may temporarily deny for a period of up to five years all or a portion of allowable business input tax credits ("ITCs") based on a select list of items to be determined by Prince Edward Island (not to apply beyond the items subject to the current ITC denials under the GST/HST legislation). Following this period, full ITCs will be phased in, in equal annual proportions, over a period of up to three years. Prince Edward Island would advance the timeline for the phase-in of full ITCs should fiscal circumstances allow."

[5] Under the Ontario HST scheme, restrictions on certain input tax credits for specific inputs apply during a transition period. Large businesses (those with sales in excess of $10 million) and financial institutions will temporarily be unable to claim input tax credits for energy (except where purchased by farmers or used to produce goods for sale), telecommunications services (other than Internet access and certain toll-free numbers), road vehicles weighing less than 3,000 kilograms (and parts and certain services), and certain hospitality costs. The restrictions apply for five years and are then phased out over the following three years.

[6] The effective PST rates quoted here are based on statistics on PST revenue collected from the purchase of capital goods categorized according to the capital cost allowance (CCA) classification under the corporate income tax system. Therefore, they are not directly related to the legal concept but to actual tax collection under PST.

[7] It is estimated that at least 90 percent of retail sales taxes are shifted forward in higher consumer prices. See J. R. Kesselman, "Consumer Impacts of BC's Harmonized Sales Tax: Tax Grab or Pass-Through?," *Canadian Public Policy, Vol. 337, No. 2, 2011, 139-162*, for an analysis of the BC sales tax changes and M. Smart, "Lessons in Harmony: What Experience in Atlantic Canada Shows about the Benefits of the Harmonized Sales Tax," *Commentary*, No. 253, C. D. Howe Institute, Toronto, 2007, for the Atlantic sales tax reforms in Newfoundland & Labrador, Nova Scotia and New Brunswick.

Before proceeding with various effective tax rate simulations, it is noteworthy that PEI's corporate income tax is levied at a rate of 16 percent in general but only one percent for small business, the largest differential between large and small corporations among all provinces. This distorting corporate tax rate structure (i.e., an excessively high rate for business in general and an extremely low rate for small business) is unusual, to say the least. To mitigate the impact of the high general corporate income tax rate, PEI also provides a 10 percent investment tax credit for investments in manufacturing and processing assets, which is in addition to the 10 percent federal Atlantic investment tax credit[8], administers several tax free zones[9] and provides a number of tax rebated programs[10]. All these tax incentives further erode the corporate income tax base, increase tax distortions and complicate tax administration and compliance.

HOW DOES SALES TAX HARMONIZATION AFFECT PEI'S RANKING IN TAX COMPETITIVENESS?

As shown in Table 1, complete sales tax harmonization (i.e., with the input tax credit system fully implemented) will reduce the marginal effective tax rate on investment in PEI from 28.8 percent to 10.7 percent, based on the legislated 2014 corporate income tax structure at federal and provincial levels.[11] This reduction in the effective tax rate on new investments will raise PEI's tax competitiveness ranking among the 10 Canadian provinces from its current bottom (10th) position (i.e., with the highest effective tax rate among the 10 provinces) to the top third (i.e., with the third-lowest effective tax rate on new investment). Table 1 also presents the assessment of PEI's tax competitive ranking among the 34 OECD member countries, which indicates that PEI's tax competitiveness ranking among the 44 jurisdictions will be sharply shifted from the bottom fifth (with the fifth-highest effective tax rate) to the top fifth (with the fifth-lowest effective tax rate)[12].

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[8] The federal Atlantic investment tax credit is provided at a rate of 10 percent for qualifying resource and manufacturing investments in machinery and structures. The existing federal credit is being phased out for oil, gas and mining investments, but these sectors are not included in this analysis as the industries are not significant in PEI.

[9] The most notable of such free zones is at Slemon Park that has a focus on the aerospace industry.

[10] See http://www.gov.pe.ca/newsroom/index.php?number=news&dept=&newsnumber=3897&lang=E

[11] By 2014, the federal and provincial governments will be phasing out temporary fast write-offs for manufacturing and processing assets.

[12] For more details on this ranking, refer to Table 5 in D. Chen and J. Mintz, "The 2012 Corporate Tax Competitiveness Ranking: A Canadian Good News Story," School of Public Policy, *SPP Research Paper*, Vol 5, Issue 25, August 2012.

TABLE 1: EFFECTIVE TAX RATE ON NEW INVESTMENTS FOR CANADIAN PROVINCES, CROSS-BORDER RANKING

	Effective Tax Rate on New Investments 2014	Cross-border Ranking (1 implies highest effective tax rate)	
		Among Canadian Provinces	Among OECD Countries & Canadian Provinces**
British Columbia	27.7	1	5
B.C. (2012)	*17.0*	*(6)*	*(28)*
Manitoba	27.1	2	6
Saskatchewan	25.2	3	11
Ontario	19.8	4	19
Alberta	17.9	5	22
Quebec	16.9	6	28
Newfoundland	11.2	7	39
PEI	10.7/11.9*	8	40
PEI (2012)	*28.8*	*(1)*	*(5)*
Nova Scotia	7.7	9	41
New Brunswick	4.6	10	44

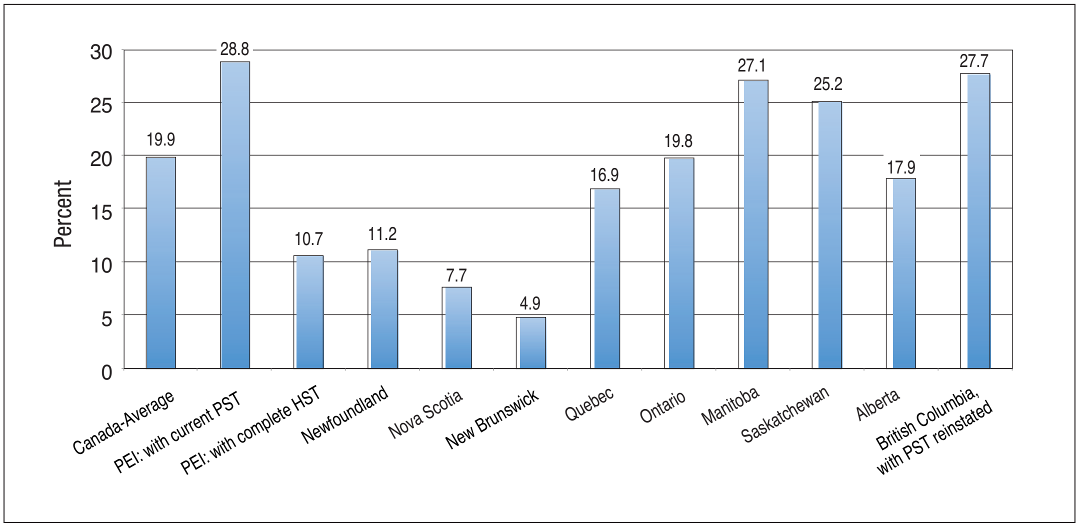
* The lower number indicates the fully implemented HST while the higher one is associated with the planned temporary denial of input tax credit for certain business inputs.

** Refer to Table 5 in Chen and Mintz, "The 2012 Corporate Tax Competitiveness Ranking: A Canadian Good News Story," The School of Public Policy, *SPP Research Paper*, Vol 5, Issue 25, August 2012.

Source: Tax and Economic Growth Program, The School of Public Policy, University of Calgary.

Figure 1 further illustrates this major change by comparing the two PEI effective tax rates on new investment — one with the current PST and the other with the HST — with those among the other 10 provinces. The 18-percentage-point drop in its effective tax rate on new investment fundamentally advances PEI's tax competitiveness within Canada and among industrialized countries.

FIGURE 1: EFFECTIVE TAX RATE ON NEW INVESTMENT (IN PERCENT): PRINCE EDWARD ISLAND VS. OTHER PROVINCES, 2014



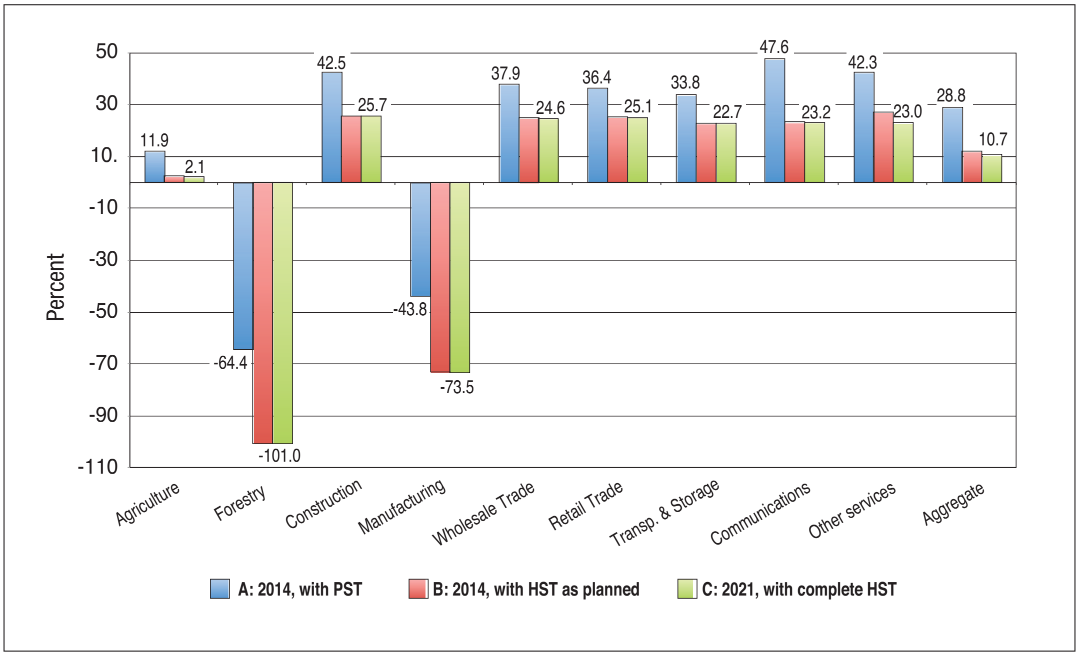
Source: Tax and Economic Growth Program, The School of Public Policy, University of Calgary.

HOW WILL THE SALES TAX HARMONIZATION AFFECT PEI'S INDUSTRIES?

Sales tax reform provides significant benefits to individual industries as well. By removing sales taxes on business inputs, each sector will face a lower cost of capital and thereby be able to invest more in capital. Further, the economic benefits from a potentially more neutral treatment of business activities will reduce tax distortions in the allocation of capital, so that scarce resources shall be put to better economic use. Specifically, if tax burdens are similar across business activities, businesses allocate capital according to the most desirable economic opportunities without being influenced by the tax system.

Figure 2 presents three effective tax rate simulations, based on the 2014 corporate income tax structure in the transition from the current PST to the HST: (A) the 2014 corporate income tax structure with the current PST, (B) the 2014 corporate income tax structure with the initial HST implementation (i.e., including the restriction of claims for some input tax credits for HST paid on the purchase of certain capital goods), and (C) full implementation of the complete HST by 2021 (a tax base similar to the federal GST).

FIGURE 2: EFFECTIVE TAX RATE ON NEW INVESTMENT BY LARGE AND MEDIUM CORPORATIONS, PRINCE EDWARD ISLAND, VARIOUS TAX SCENARIOS



Source: Tax and Economic Growth Program, The School of Public Policy, University of Calgary.

The effect of sales tax reform is to reduce substantially the effective tax rate on new investment for all industries. The most highly taxed sectors (communications, construction and other services including tourism) will see their effective tax rates drop the most compared to other highly taxed sectors (wholesale trade, retail trade and transportation and storage). Further, the differences in effective tax rates across these highly taxed sectors are substantially reduced when the HST is adopted.

The other group of beneficiaries includes the manufacturing, forestry and agricultural industries. The existing corporate income tax structure provides excessive tax support to these industries through the (federal) Atlantic investment tax credit and the provincial investment tax credit (which does not apply to the agricultural industry). As a result, these industries enjoy a rather low (e.g., agricultural industry) and even negative METR (i.e., forestry and manufacturing). They also enjoy the PST exemption for the main assets used in their production (i.e., manufacturing and processing assets). However, the PST levied on other asset classes also used by these industries offsets about 40 percent of the tax support associated with the federal and provincial investment tax credits.[13] With the adoption of the HST, the substantial tax advantage for manufacturing and forestry over other industries will be more fully realized, as indicated by the significant reduction in the METRs for these industries.

Table 2 compares the effective tax rates on new investment with PST (Case A) with those with HST (Case C). The table also presents the difference in effective tax rates between Cases A and C, expressed as percentage points. It shows that the adoption of the HST after full implementation will provide significant benefits to all industries. Taking the effective tax rate differences in percentage points between the case with the existing PST (Case A) and that with full HST (Case C), the forestry industry appears to benefit the most from sales tax harmonization (with a effective tax rate reduction of 36.6 percentage points), followed by manufacturing (29.7 points), communication (24.4 points), "other services" (19.4 points) and construction (16.8 points) industries.

TABLE 2: EFFECTIVE TAX RATES ON NEW INVESTMENT BY LARGE AND MEDIUM CORPORATIONS, PEI, VARIOUS TAX SCENARIOS

	Agriculture	Forestry	Constr.	Manuf	Whole -sale	Retail Trade	Trans & Storage	Comm.	Other services	Aggregate
A: 2014, with PST	11.9	-64.4	42.5	-43.8	37.9	36.4	33.8	47.6	42.3	28.8
B: 2014, with HST as planned	2.4	-100.9	25.7	-73.3	24.9	25.4	22.8	23.2	27.2	11.9
C: Full HST	2.1	-101.0	25.7	-73.5	24.6	25.1	22.7	23.2	23.0	10.7
Rate reduction from Case A to C (percentage points)	9.8	36.6	16.8	29.7	13.3	11.3	11.1	24.4	19.4	18.2

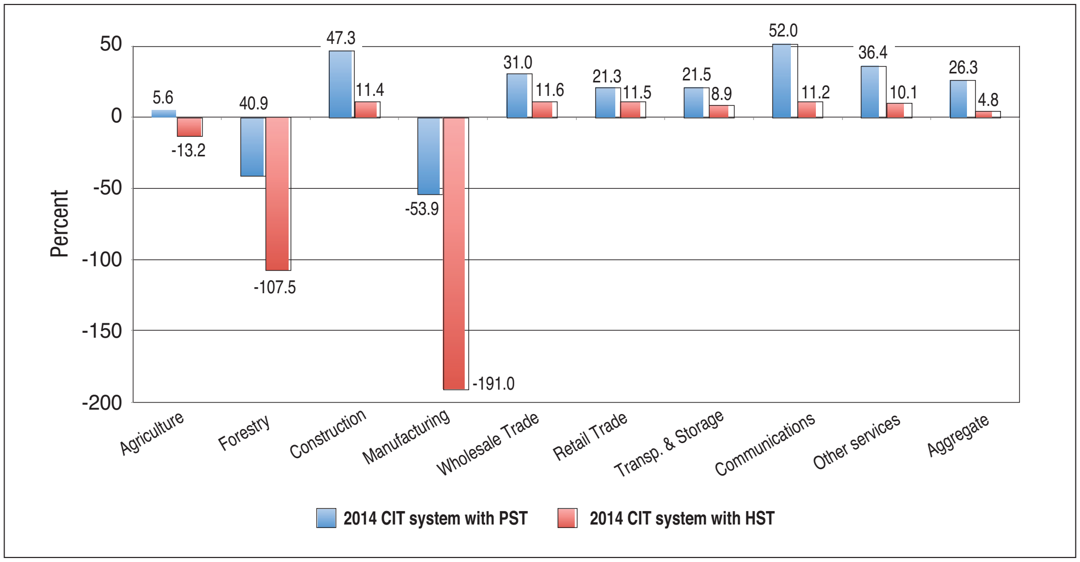
Source: Tax and Economic Growth Program, The School of Public Policy, University of Calgary.

[13] Without the federal and provincial investment tax credits, forestry and manufacturing industries would be taxed at rates similar to other industries.

BENEFITS TO SMALL BUSINESS

Large and medium businesses will not be the only beneficiaries of PEI's tax reform; small businesses will also benefit. The effective tax rate on new investment for small businesses will decline substantially, since they are even more intensive users of machinery and equipment in production than are large businesses. As Figure 3 shows, the effective tax rate on new small business investment, based on the corporate income tax structure of 2014, declines sharply from 26.3 percent, which is associated with the existing PST, to 4.8 percent due to sales tax harmonization. As the PEI corporate income tax rate on small business income is only one percent, most of the remaining tax on small businesses is the federal corporate tax, levied at 11 percent.[14]

FIGURE 3: EFFECTIVE TAX RATE ON NEW SMALL BUSINESS INVESTMENT BY INDUSTRY 2014 CORPORATE INCOME TAX SYSTEM, WITH PST VS. HST



Source: Tax and Economic Growth Program, The School of Public Policy, University of Calgary.

ECONOMIC IMPLICATIONS OF GREATER INVESTMENT IN PEI

Prince Edward Island's sales tax harmonization will have a profound impact on the economy, promoting private capital investment and providing an opportunity for the private sector to create jobs and pay higher compensation to workers. The reduction in taxes on business capital inputs ultimately will benefit employees as businesses invest in capital and new technologies. Businesses, in any event, do not pay taxes, but pass the tax burden on to customers through higher prices (thus reducing the purchasing power of household income), and to investors through reduced return to capital and to employees with lower employment compensation. In a

[14] Note that the small business tax rates that we refer to apply to "active" business income up to a threshold ($500,000 at the federal level and PEI. Active income above the thresholds and income from financial investments (passive income) are subject to the general corporate income tax rate.

small open economy such as that of PEI, investors do not bear taxes on capital investment, since owners of capital can choose to invest in jurisdictions with a higher net-of-corporate tax return on capital. Costs cannot be passed on to export prices of most goods and services, since international markets determine the prices of these goods and services. Therefore, any taxes on business costs are borne by fixed factors through higher domestic prices or lower real wages paid to workers. Recent economic studies suggest that taxes on investments by larger companies tend to fall on workers, who are either paid less compensation or face higher domestic prices on consumer goods they purchase.[15]

A large number of studies have been undertaken to estimate the sensitivity of capital investment to changes in the tax-inclusive cost of capital. One such study estimates that a 10 percent increase in the cost of capital reduces investment by seven percent.[16] That is, a 10 percent increase (decrease) in the cost of capital causes the capital stock to decline (rise) by seven percent.[17]

The effect of additional capital is to increase income paid to workers either in the form of higher wages, more hiring or both. Using a specific formulation accounting for the substitutability of capital and labour and increased output due to competitiveness, we can derive the change in labour income in relation to the change in investment as being 0.67.

Based on Statistics Canada's data for capital stock and the latest PEI input-output table (2008), and by applying the aforementioned changes in the tax-inclusive cost of capital resulting from sales tax harmonization on capital demand, we estimate that the investment impact of sales tax harmonization will be to increase private sector capital stock by $560 million within seven years, with roughly 60 percent of the adjustment taking place within four years.[18] This substantial increase in capital investment will generate $380 million, or an increment of 26 percent in total current private sector employment income. This significant increase in employment income results in either more jobs, or higher average annual earnings, or most likely some combination of both, within the business sector,[19] which will in turn become a powerful driving force for economic growth in PEI.

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[15] See W. Arumlampalam, M.P. Devereux, and G. Maffini (2008), "The Direct Incidence of Corporate Income Tax On Wages," Working Paper 07/08, 2nd version (Oxford: Oxford University, Centre for Business Taxation, 2008); for the United States, see K.A. Hassett and A. Mathur (2006), "Taxes and Wages," Working Paper (Washington D.C.: American Enterprise Institute, 2006); and for Germany, see N. Aus dem Moore, T. Kasten, and C. Schmidt, "Do Wages Rise when Corporate Tax Rates Fall? Difference-in-Differences Analyses of the German Business Tax Reform 2000" (Berlin: Rheinisch-Westfäliches Institut für Wirtschaftsforschung, 2009).

[16] Canada, Department of Finance, "Corporate Income Taxes and Investment: Evidence from the 2001-04 Rate Reductions," *Tax Expenditures and Evaluation* (Ottawa: Department of Finance, 2007).

[17] These estimates assume that production takes place with constant shares of value added paid to employees and owners of capital (a Cobb-Douglas production function). Within this framework, a lower cost of capital causes capital demand to replace labour, which is more than offset by improved competitive demand (greater output) for products and services. The substitutability of capital for labour reduces the demand effect for labour by a third.

[18] The University of Toronto Focus model estimates that most of the response will take place in seven years, with 62 percent taking place within four years (information provided by T. Wilson).

[19] By "business sector," we mean the total economy excluding the public sector, which includes educational services (with NAICS code 61), health care and social assistance services (62) and public administration sectors (91).

OPPORTUNITY TO REFORM THE CORPORATE INCOME TAX STRUCTURE

As mentioned earlier, the corporate income tax structure in PEI is unusually beneficial to small businesses, in that PEI has the highest general income tax rate (16 percent, the same as that in Nova Scotia) in the nation for large and medium firms, while having the second lowest rate (one percent, following the zero rate in Manitoba) for small business. It also provides a 10 percent investment tax credit for manufacturing and processing activities in addition to the 10 percent federal Atlantic investment tax credit for manufacturing and processing activities. The corporate income tax structure results in excessive tax distortions with forestry and manufacturing activities (and a few other selective business sectors and companies enjoying preferential tax treatments[20]) far less taxed than other investments. Small businesses are taxed at a substantially lower level.

These distortions in PEI's corporate income tax result in a non-neutral treatment of business activities. Substantial variation arises in the taxation of industries and assets, thereby distorting economic decisions made by businesses. A non-neutral tax system results in an inappropriate allocation of capital across business activities, resulting in low-rate-of-return investments crowding out more profitable ones. The economic cost of these distortions has been documented in several studies over the years for many jurisdictions.[21] Further, the breaks for small businesses impair their growth, since greater profitability leads to much higher levels of taxation.[22]

TABLE 3: EFFECTIVE TAX RATE ON NEW INVESTMENTS WITH CORPORATE INCOME TAX AND SALES TAX REFORMS BY INDUSTRY AND BY FIRM SIZE

	Agriculture	Forestry	Constr.	Manuf.	Whole -sale	Retail Trade	Trans & Storage	Comm.	Other services	Aggregate
For Large and Medium Firms										
With the 2014 corporate tax rates	2.1	-101.0	25.7	-73.5	24.6	25.1	22.7	23.2	23.0	10.7
With a 10% corporate rate & no provincial investment tax credit	-4.5	-33.4	20.4	-24.7	19.4	19.9	17.9	18.2	18.1	10.2
For Small Firms										
With the 2014 corporate tax rates	-13.2	-107.5	11.4	-191.0	11.6	11.5	8.9	11.2	10.1	4.8
With a 4% corporate rate & no provincial investment tax credit	-10.0	-39.6	14.3	-44.4	14.5	14.4	11.2	14.1	12.7	9.6
Reference: The 2014 corporate tax rates with PST										
For Large and Medium Firms	11.9	-64.4	42.5	-43.8	37.9	36.4	33.8	47.6	42.3	28.8
For Small Firms	5.6	-40.9	47.3	-53.9	31.0	21.3	21.5	52.0	36.4	26.3

[20] Refer to paragraph 1 on page 4 and footnotes 9 and 10 for details. Our METR calculation does not include these preferential tax treatments targeting only a few selective business sectors and companies.

[21] See the Technical Committee on Business Taxation, *Report,* Department of Finance, Ottawa, 1997.

[22] See D. Chen and J. Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth," School of Public Policy, *SPP Research Paper*, Vol 4, Issue7, May 2011.

As shown in Table 3, despite the sales tax harmonization, tax distortions associated with PEI's corporate income tax system among industries and different-sized corporations remain largely in place. For example, within the group of large and medium firms, the effective tax rate on new investments for manufacturing industry (-73.5 percent) is over 84 percentage points below the weighted average of effective tax rates on new investments for all large and medium firms (10.7 percent). The counterpart for small business is almost 200 percentage points (i.e., -191 percent vs. 4.8 percent).

Within each industry, the gap in effective tax rates between the large (and medium) and small firms ranges from 7 percentage points (forestry) to 118 percentage points (manufacturing).

PEI could realize significant improvements in productivity by evening out tax burdens on business activities. For example, the corporate income tax rate for medium and large businesses could be reduced from 16 to 10 percent, following past reforms in New Brunswick, British Columbia and Alberta. The small business tax rate could also be raised to a higher level, reducing the tax hurdle a small business faces when trying to grow. Accompanied by tax rate reductions, targeted tax preferences for manufacturing and processing businesses and other highly selective business sectors and companies could also be removed.

With the significant benefits of the HST, PEI is in strong position to undertake corporate tax reform that would improve competitiveness and achieve a more level playing field, while implementing fully sales tax harmonization in the next several years.

As shown in Table 3, with a lower corporate income tax rate of 10 percent and no provincial investment tax credit for manufacturing and processing activities, the effective tax rate on new investment for large and medium firms will be lowered for all sectors except manufacturing and forestry industries. Despite this change, manufacturing and forestry industries will continue to benefit from the federal Atlantic investment tax credit and relatively more generous tax depreciation allowances compared to other industries. The overall result is that PEI will be able to maintain its third-lowest effective tax rate with a business tax structure that is more neutral and productivity-improving.

For small businesses, the corporate income tax rate could be set to at least match the modest rate of four percent in the Atlantic provinces.[23] As shown in Figure 3, raising the corporate income tax rate for small business from the current one percent to four percent, and simultaneously eliminating the provincial investment tax credit for manufacturing and processing assets, will not impact negatively on capital investment by small business. With sales tax harmonization, the marginal effective tax rate for small business will drop from the current 26 percent to 10 percent, which is over a 60 percent reduction in the tax cost of capital investment for small business in PEI.

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[23] In principle, there is no particular argument to match small business rates since small businesses or their profits are not particularly mobile — their location depends on the residence of the owner. The corporate income tax rates for small business in the four Atlantic provinces are: one percent in PEI, 4.5 percent in New Brunswick and four percent in both Nova Scotia and Newfoundland and Labrador.

CONCLUSIONS

The government of PEI has announced the adoption of the HST at a rate of nine percent, to take effect April 1, 2013. The federal-provincial HST rate of 14 percent is a 1.5- percentage-point reduction in the combined federal-provincial sales tax rate of 15.5 percent under the existing provincial sales tax system.

Sales tax harmonization in PEI will significantly reduce the effective tax rate on new investment, shifting PEI from having the highest tax burden on new investment in Canada to the fifth-lowest among OECD economies. All sectors will benefit from the adoption of the HST in PEI, including small and large firms. As a result of PEI's harmonization of its retail sales tax with the federal GST, the province will realize an increase in private sector investment of about $560 million within seven years. Labour in the private sector will benefit from the sharp increase in investment by earning an additional $380 million in employment income, which is roughly a quarter more than current employment income levels.

In summary, the sales tax reform is a win-win for the people of PEI. Taking the opportunity provided by sales tax harmonization to further reform the corporate income tax structure would help advance the province's overall tax competitiveness even further while improving tax neutrality.

About the Authors

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The James S. & Barbara A. Palmer Chair in Public Policy

Jack M. Mintz was appointed the Palmer Chair in Public Policy at the University of Calgary in January 2008.

Widely published in the field of public economics, he was touted in a 2004 UK magazine publication as one of the world's most influential tax experts. He serves as an Associate Editor of *International Tax and Public Finance* and the *Canadian Tax Journal*, and is a research fellow of CESifo, Munich, Germany, and the Centre for Business Taxation Institute, Oxford University. He is a regular contributor to the National Post, and has frequently published articles in other print media.

Dr. Mintz presently serves on several boards including Brookfield Asset Management, Imperial Oil Limited, Morneau Shepell, and the Social Sciences and Humanities Research Council. He was also appointed by the Federal Minister of Finance to the Economic Advisory Council to advise on economic planning and served as research director for the Federal-Provincial Minister's Working Group on Retirement Income Research.

Dr. Mintz has consulted widely with the World Bank, the International Monetary Fund, the Organization for Economic Co-operation and Development, the governments of Canada, Alberta, New Brunswick, Ontario, and Saskatchewan, and various businesses and non-profit organizations.

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