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# **Evolution or Extinction:**

## *Harmonization in a British Columbia that Works*

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A background report for a presentation  
by David Baxter at

**The Certified General Accountants of British Columbia**

**Countdown to the HST Conference**  
Vancouver, BC March 4, 2010

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By David Baxter, Ryan Berlin,  
and Andrew Ramlo

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## **Note from the authors**

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Currently there are a number of people advocating “no HST”; these people are advocates of the current PST+GST tax regime, a system of taxation that is both inequitable and inefficient. The exemptions to PST create the inequities: a person buying a coat or blanket to keep warm pays PST on their purchase, while a person enjoying a champagne and caviar dinner in a restaurant does not pay PST on theirs. After harmonization, equal tax rates will be charged on both purchases, thus making it a more equitable tax system. HST will also eliminate the waste associated with compliance and tax-cascading, and will remove barriers to growth in exports and productivity. The HST is better for British Columbia: it is more equitable and more efficient, it will promote exporting and, perhaps most importantly, it will promote investment in capital and productivity—issues that are becoming increasingly important as we collectively manage an economic and demographic future that will be much different from the past.

## I Introduction

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This report presents a general review of the dimensions of change that will characterize British Columbia's economy and demography in the coming years and some of the challenges and opportunities that such change will offer. In this context, the implications of the replacement of the Provincial Sales Tax plus Goods and Services Tax (PST+GST) with a Harmonized Sales Tax (HST) are highlighted. The coming changes will require the province to place a greater emphasis on productivity and exports, both as a result of our changing demography (a slowing in the growth of the province's labour supply in the face of increasing demand for the funding of social services) and due to industry-specific conditions (ranging from the supply consequences of the pine beetle to competition from US shale gas production). It also recognizes that the replacement of PST+GST with HST will have a differential impact across industry sectors.

In addition to broadly considering the economic implications for how different sectors may adjust to the changes brought about by harmonization, the restaurant and food services sector is used a specific example. The circumstances of the restaurant industry have been used for two reasons, primarily due to restaurant dining being a relatively common experience, so examples from this industry will be familiar to readers, but also due to the restaurant industry publishing a statement of how it sees itself being affected by harmonization.

Overall, the report points to the growing necessity for adaptive responses from both businesses and consumers to external changes—be they from demography, external economic conditions, or changes in our system of provincial taxation.

The report is organized into five major sections. The first examines the nature of the proposed changes to the expenditure tax system in the province and the general directions of its micro-economic impacts. The second and third sections consider how these directions may be of value to the province given its changing demographic and economic contexts. The fourth section presents a consideration of economic adaptation, something that will be required of all industries given the economic prospects of the province, be they long-term structural changes or short-term taxation changes. The final section, a supplement to the original report, explores issues of equity under both the PST+GST system and the HST system, as well as the potential impacts of HST on the market for newly-constructed housing units.

## II A Change from PST+GST to HST

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### 1. The Details

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It is essential to emphasize at the outset that the subject of interest is not the HST per se, but rather the HST as a replacement for the existing PST+GST taxation system. As such, the fundamental question, for both this paper and for businesses and consumers in the province, is not *HST or no HST?*, but rather *HST or PST+GST?*

The HST is to be a combination of the existing GST (currently at five percent) and a tax that replaces the PST (currently at seven percent), for a tax of 12 percent added to the purchase price of non-exempt and non-zero rated goods and services. The tax will be collected and remitted by vendors.

There are five major differences between PST+GST and HST:

**HST will reduce compliance costs.** The replacement of the two-tax PST+GST system with a single HST system will reduce compliance costs for those businesses currently collecting both PST and GST, as only one remittance form will be required. While this will not affect firms currently only remitting GST, it

will reduce costs for all firms currently remitting PST and GST. It is estimated that compliance costs for these firms will fall by \$150 to \$200 million per year.<sup>1</sup> Additionally, the provincial government will see administration costs fall by \$30 million per year.<sup>2</sup>

**HST will remove the PST tax-cascading effect.** As there are no input tax credits for the PST portion of the PST+GST tax (there are for the GST portion) the PST becomes an imbedded tax on non-exempt commodities purchased as inputs by firms and as final demand by consumers. Under HST, taxes paid on the purchases of inputs are credited (as input tax credits) against taxes collected on the sale of outputs (i.e. HST is a pure value-added tax). The replacement of PST+GST with HST will reduce input costs for all firms to the extent that they can claim input tax credits on the total HST paid on their purchases against the HST collected on their sales. The input cost savings to businesses resulting from the change to HST is estimated to be in the range of \$1.9 to \$2 billion per year.<sup>3</sup>

**HST will have a wider tax base than PST+GST.** The fact that some purchases are PST exempt creates the third difference between the two tax systems, as the HST will apply to all purchases currently subject to GST regardless of whether they are PST exempt, except in those circumstances where they are specifically exempt from HST or are zero-rated under the HST system. This means that the tax base for the HST will be wider than that for PST, and the same as it is for GST. Purchasers of goods and services that were previously PST-exempt but subject to GST will now pay a greater tax (12 percent rather than five percent) on HST-eligible products. To the extent that such purchasers are other firms selling goods and services that are subject to HST, the provision for input tax credits will offset the increased tax, and hence there will be no effective increase in costs for downstream firms. In the cases where purchasers represent not intermediate demand (other producers) but final demand (individuals and households as consumers), there will be an additional tax, above the GST already paid, of seven percent on the purchase of commodities (goods and services) that were previously PST-exempt.

**HST will impact services more than goods.** The fourth difference between the two tax systems also relates to the expansion of the tax base under the HST and results from the PST's differential treatment of goods and services. The PST applies almost entirely to the purchase of goods, with most services being exempt from PST but not GST. The absence of input tax credits under PST creates, at the margin, an implicit disincentive for firms to purchase goods as inputs. Under HST, all GST-taxed purchases, whether for goods or services, will be taxed and eligible for input tax credits. Further, this equality in the treatment of inputs means that the purchase of services will experience a greater impact from harmonization than goods, as in the latter case the HST of 12 percent will merely replace the PST+GST tax of 12 percent. As the HST provides for input tax credits for firms' purchases of goods and services, the increase in the price of services purchased due to the HST will be offset by credits against the HST collected on sales.

It is important to note in this context that HST, as with PST+GST, applies only to purchases from other firms. Thus, if a firm contracts with another firm for cleaning and janitorial services, it will pay HST on the services purchased, and deduct this from HST collected; if a firm has its own employees to do cleaning and janitorial work, it will not pay HST on these services and will not be able to deduct this amount from HST collected. Thus, while all firms will see costs decline as result of being able to claim HST input tax credits, those that purchase a significant portion of their inputs from other firms will have relatively large input tax credits compared to those who have a relatively low level of taxed inputs in relation to their outputs.

**Exports will be zero-rated under HST.** The final difference is that international exports (goods and services produced within the province but sold outside of Canada) will be zero-rated, meaning that while no tax is collected on export sales, the HST paid on inputs may be claimed, resulting in a refund to exporting firms.

1 Government of British Columbia and Business Council of British Columbia.

2 Government of British Columbia.

3 Government of British Columbia and Business Council of British Columbia.

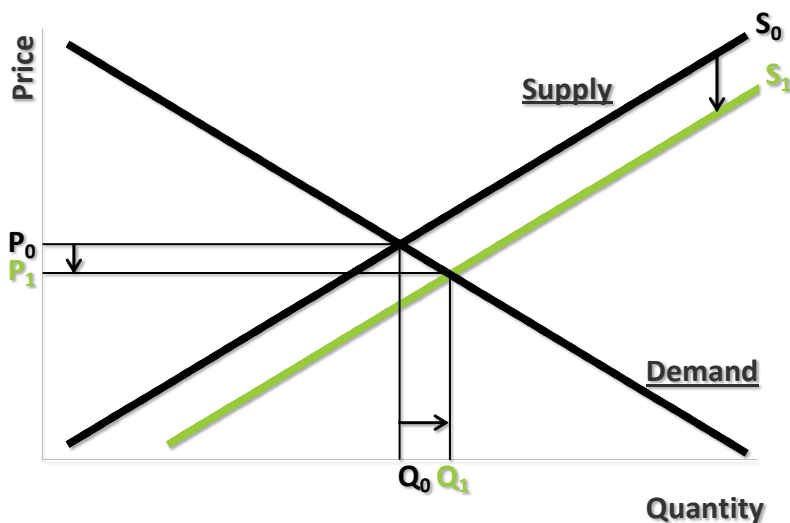
As the PST did not have an input tax credit system, harmonization will reduce costs for exporting firms. There are a few of other elements of the harmonization that should be mentioned. The first is that the Federal Government is providing \$1.6 billion to the Provincial Government to accommodate the shift from PST+GST to HST; while not an insignificant amount, given it is a one-time payment it is not considered in the following analysis. Further, not only are there a wide range of exemptions and zero-ratings for consumer goods and services under HST, there are also HST credits of \$230 for individuals with incomes up to \$20,000, and \$230 per family member for families with incomes up to \$25,000, paid quarterly with the GST credit. These added dimensions will make the analysis of the impact of HST a bit more complex, for while harmonization will cause price changes which are regularly measured for the calculation of the Consumer Price Index, household incomes and consumption patterns are not regularly measured and hence the rebate's impact on incomes and purchases will not be monitored as closely as prices.

## 2. Micro-economic Adjustment

The changes brought about by the shift from the PST+GST system to the HST system will impose change to firms and consumers throughout the province—changes to which they will have to adapt. Micro-economic theory provides a framework for demonstrating the direction in which these adjustments will occur. For the purposes of analyzing the impact of this shift in sales taxes, it is necessary to assume that both the total tax revenue collected and consumers' disposable incomes remain constant.

Figure 1

### Industry Supply Curve Response to HST



The costs for all firms will fall to the degree that they can claim input tax credits on previously PST-taxed inputs as deductions from the tax they collect on sales. Further, the administrative cost of current PST-remitting firms will fall to the degree that their compliance costs fall, as they only have to collect and remit one tax which is calculated on the same base of goods and services as GST. As shown in Figure 1, the reduction in costs for all firms will result in their supply curves shifting down and to the right (from  $S_0$  to  $S_1$ ), with increased output at every price level. Considering only firms' cost structures, the result will be a decline in market prices (from  $P_0$  to  $P_1$ ) and an increase in the quantity purchased by consumers (from  $Q_0$  to  $Q_1$ ). Note that total revenue to firms, and the industry, may increase under such a

scenario, but it may also decline if the fall in prices offsets the increase in output. In either case, after market adjustment, firms will continue to earn normal profits.<sup>4</sup>

Increasing output to accommodate the increase in quantity demanded will require firms to purchase more inputs, including both goods and services, leading to an increase in both employment in the industry and in the demand for inputs from suppliers. As the HST will remove the implicit disincentive to purchase goods inputs that prevails under the current PST+GST system, the increase in inputs will, all else being equal, be greater for previously PST-eligible inputs (mainly goods) than the increase in PST-exempt inputs (services).

Firms and industries will also experience shifts in the markets in which they operate as a result of the

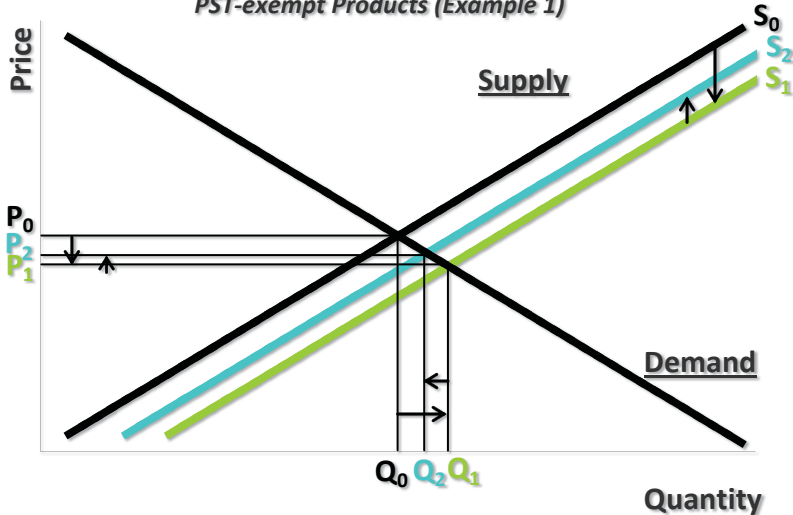
<sup>4</sup> Normal profits are the minimum profits required to attract and retain suppliers in a perfectly competitive market.

widening tax base to match that of the GST, with different shifts occurring for those products that were previously PST-exempt versus those which were not. In the case where products were previously PST-taxed, Figure 1 describes the effect of implementing harmonization: lower prices and increased output as a result of reduced input and compliance costs. There also may be a secondary effect whereby consumer demand shifts from goods whose prices had increased to substitutes whose prices decreased. The result of such cross elasticity of demand would be an increase in demand for goods that were previously subject to PST, and hence a marginal increase in prices and in output for those goods compared to the direct effect of harmonization.

Figure 2

**Industry Supply Curve Responses to HST**

*PST-exempt Products (Example 1)*



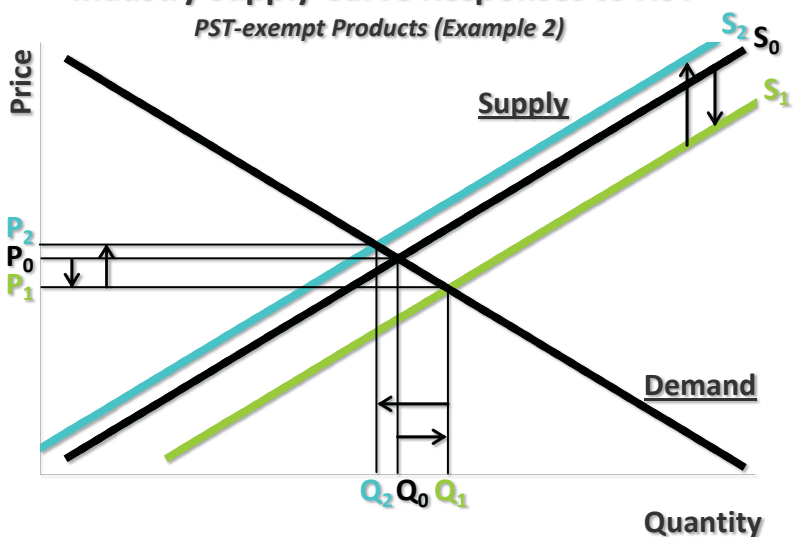
In the case of products that were previously PST-exempt, the HST shows up in firms' supply curves effectively as a cost of sales, and hence will shift their supply curves upward,<sup>5</sup> eroding some, all, or more than the savings from reduced input costs. This will mean that consumers will face higher prices, although some of the increase will be mitigated by the fall in prices that will result from firms' reduced input costs.

In some cases, firms may have significant input tax credits. In these instances firms' supply curves shift back part way, from  $S_1$  to  $S_2$  in Figure 2, causing the market price of output to rise back towards its pre-HST level, moving from  $P_1$  to  $P_2$ . This will be accompanied by a reduction in the quantity purchased from  $Q_1$  to  $Q_2$ . The effective impact from supply movements in this example would be that the shift to HST would still result in an increase in purchases and firms' output and a fall in prices, but the change would be less than it would have been if the output were previously subject to PST.

Figure 3

**Industry Supply Curve Responses to HST**

*PST-exempt Products (Example 2)*



In other cases, firms may have relatively small HST-taxed inputs and hence small input tax credits relative to the magnitude of the HST they collect on sales. In these situations, the upward shift in supply that results from the increased costs associated with the expansion of the tax base to include what were previously PST-exempt products may be larger than the initial downward shift of the supply curve that

results from the reduction in input costs for firms in that industry (the shift from  $S_1$  to  $S_2$  in Figure 3). The final price per unit output would be  $P_2$ , higher than the pre-HST price, and the level of purchases would be  $Q_2$ , lower than the pre-HST level. Note that revenue to the industry may fall under such a circumstance, but it may also rise if the increase in price offsets the decline in output. Again, in both situations, after market adjustment firms would continue to earn normal profits, and would have shifted some of the input

<sup>5</sup> As firms must collect the tax in order to sell their products, harmonization will effectively increase firms' costs while leaving consumer's demand curves initially unchanged. If the consumer had to remit the tax, then it result in a shifting in their demand curve. The same consequences, in terms of direction of changes in price and output, would result in both cases.



purchases from services goods.

In these examples, consumer demand for specific products has been held constant, an assumption that may not hold after HST is introduced. The falling prices in the industries selling previously PST-taxed output that are substitutes for previously PST-exempt products will result in a decline in the demand for the previously-exempt products and an increase for the now lower-priced, previously PST-taxed products. To some extent this shift will be offset by an income effect, whereby the fall in prices of previously PST-taxed products will free up some income that will be spent on the more expensive products that were previously PST-exempt. As well, the HST credits for individuals and families will have an effect on shifting incomes and, hence, demand.

Where all of this will settle cannot be precisely measured at this time, as it will be determined by the interaction of: **1)** firms' production functions; **2)** consumers' preference functions; and **3)** the degree to which products are substitutes. Overall, the experience with harmonization in other provinces was a modest decline in consumer prices (in the range of 0.8 percent), while TD Bank Financial Group anticipates a modest increase in prices (in the range of 0.8 percent) in British Columbia.<sup>6</sup> It is certain that there will be a decline in prices and an increase in output for some industries, and increased prices and a reduction in output for others. Overall, there will be a shift towards previously PST-taxed inputs (goods), as their effective cost will have decreased, all else being equal. While all firms will experience declining input costs to varying degrees, competition among firms will lead them back to earning normal profits in the long run, regardless of whether their total sales increase or decline.

Presuming total tax revenue collected by the government remains constant, then the effect of the change from PST+GST to HST will be a shifting in prices and production, with a generally neutral overall effect on aggregate prices. The removal of an imbedded tax that creates price distortions will reduce the price of not only products previously taxed under PST but also those (such as groceries) that are zero-rated under HST. Conversely it will increase the price of previously PST-exempt commodities that are not exempt or zero-rated under HST. As noted earlier, it is essential to consider not only the effect on prices but also on the quantity of goods and services purchased. The ultimate net effect of shifting prices will depend upon consumer preferences and firms' supply curves, with the shift from consuming fewer higher-priced goods to more lower-priced goods leaving consumers with the approximately same level of satisfaction after the implementation of HST as before (given unchanged incomes).

These firm- and industry-specific impacts have wider implications for the economy of British Columbia in three areas: productivity, exports, and the differential impacts on individual industries. Each topic is considered in the following sections.

### **III Productivity Matters**

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To the extent that HST paid on goods inputs including machinery, equipment and other previously PST-taxed goods can now be claimed as input tax credits, the PST disincentive to purchase goods inputs will be removed. On the margin this will mean higher business spending on goods inputs, including capital goods, which in turn will increase output per worker, thereby improving both productivity and wages for workers. While by definition increased spending on capital goods inputs relative to services (labour) will increase output per worker, fundamental productivity gains will occur only if the spending in the long-run is on capital goods and technology that expand firms' productive capacities.

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<sup>6</sup> Business Council of British Columbia, October 29 2009; TD Economics, September 18, 2009.

British Columbia's recent history has not revealed an ability to generate significant productivity growth:

“Overall, labour productivity in BC is below the Canadian average, and lower than in most other provinces. Lower-than-average productivity levels are observed in many industries in both the goods and service sectors. The situation is not improving, as productivity growth in BC industries has been relatively weak compared to other parts of Canada.

Business investment in machinery, equipment and structures, which could help boost productivity, has not been increasing as much as in other parts of the country, and this could be a contributing factor to the growing productivity gap. As well, BC's resource-based manufacturing sector has faced challenges that may have hampered productivity growth during the last ten years.

In order to close the productivity gap between BC and other parts of the country, it may be necessary for industries in both the goods and service sectors to invest in new capital equipment, adopt new technologies, and find ways to use existing labour and capital resources more efficiently. By doing this, they will help build the foundation for the long-term prosperity of the province. If they fail to do so, BC's potential for future economic growth may be reduced.”

*Labour Productivity: BC's Achilles Heel? BC Statistics, June 2008*

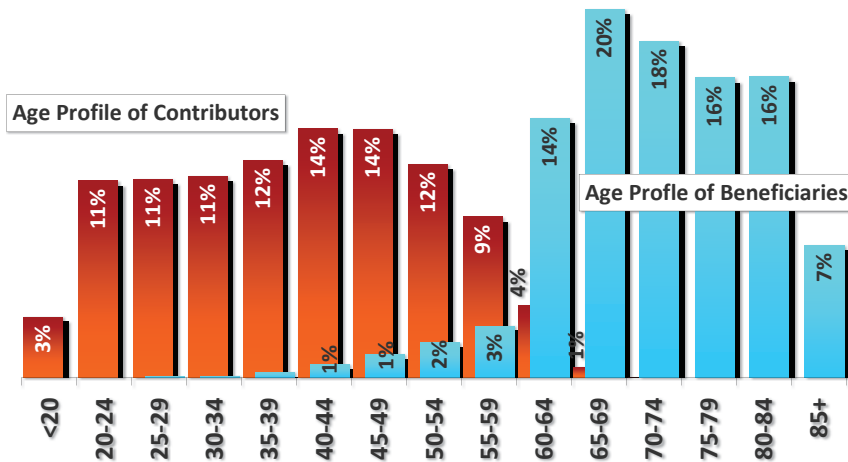
“British Columbia was the only province to experience a decrease in productivity between 2003 and 2008, posting an annual average decline of 0.1%.”

*Hours worked and labour productivity in the provinces and territories, Statistics Canada, January 2010.*

Regardless of history, British Columbia will be required to increase productivity in the future: to the extent that HST can assist it in doing so, it will make a valuable contribution to the economic well-being of the province. A future of productivity increases is not merely of concern to economists, but to all of us, as we will increasingly be compelled to rely on productivity to help us pay the bills for social programs such as health care and pensions. Demographic change in the coming years will simultaneously increase the demand for output from our economy and slow the ability of our economy to meet this demand, as the aging of the province's population will increase the demand for transfers to pay for health care and social services at the same time as it slows labour force growth.

Figure 4

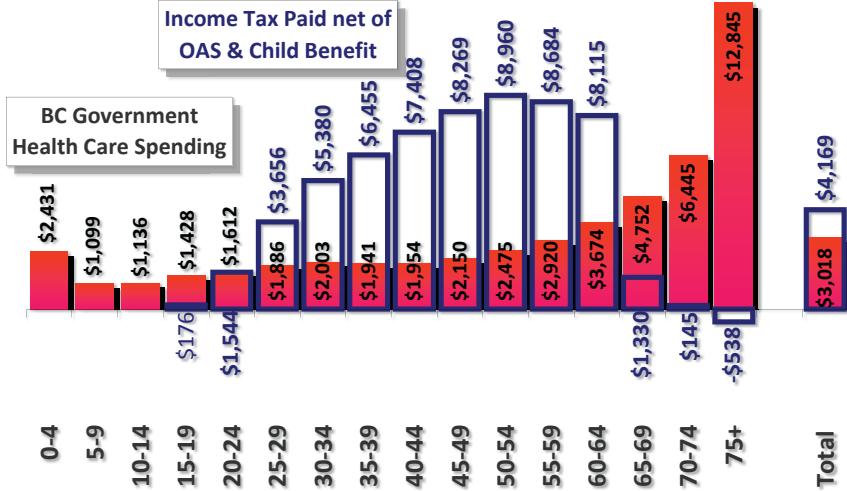
### Canada Pension Plan Contributors and Beneficiaries by Age, 2006



The reason demography matters so much is that spending on major social programs such as health care and pensions, as well as labour force participation and tax payment, follow strong lifecycle patterns. This is shown in Figure 4, which compares the age groups that contribute to the Canada Pension Plan and the age groups who receive benefits from it: 99 percent of the contributors are under the age of 65 and 91 percent of the beneficiaries are 65 and older.

A similar, but more complex, picture is shown in provincial government health care spending in British Columbia, as the beneficiaries and contributors are more evenly-spread across a wider range of age groups (Figure 5). Per capita age specific health care spending increases with age, the most notable being from age 40 onwards, with above-average per capita spending occurring in

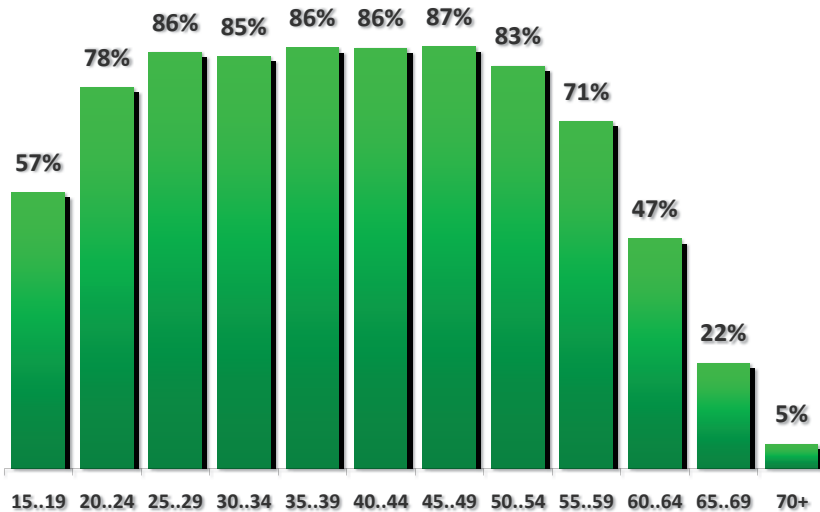
Figure 5 **2006 Per Capita Spending, British Columbia**



the 60-plus age groups. As only 12 percent of provincial health care spending is in the form of Medical Service Plan payments, contribution is here measured by net income taxes paid per capita in British Columbia. Per capita income tax contributions peak in the 50 to 54 age group, and then decline, with sharp declines after the 60 to 64 age group taking net income tax contributions to less than per capita health spending in the 65 and older age groups.

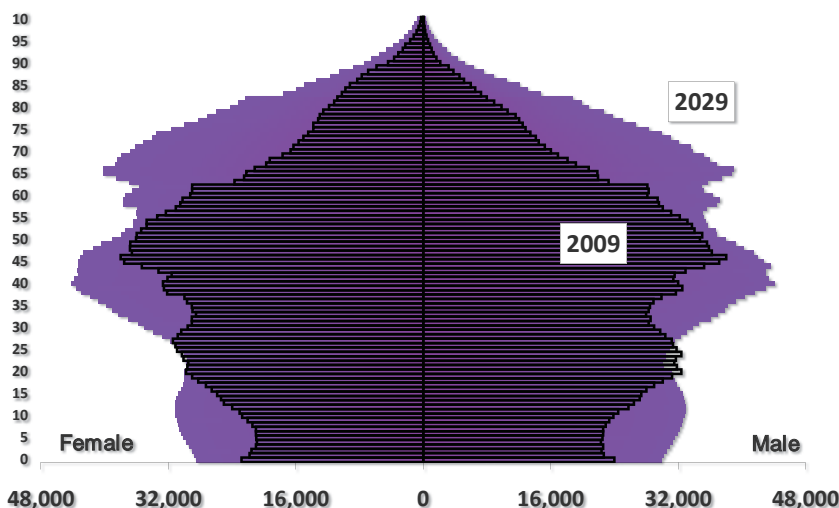
This pattern of per capita income tax paid by age group is reflective of an underlying pattern of age specific labour force participation, with labour force participation rates peaking in the 40 to 44 age group, with a significant rate of decline commencing in the 50 to 54 age group (Figure 6). By age 60 to 64, retirement reduces the labour force participation rate to 45 percent of the population, below the entry level 52 percent for the 15 to 19 age group and almost half of the 87 percent participation rate of the peak-participation 40 to 44 age group. The 36 percentage point drop in participation rates between the 50 to 54 age group and the 60 to 64 age group is larger than the 29 percent drop between the 60 to 64 and 70 to 74 age groups; freedom 55 is real, at least in terms of labour force participation.

Figure 6 **2008 Labour Force Participation Rates, BC**



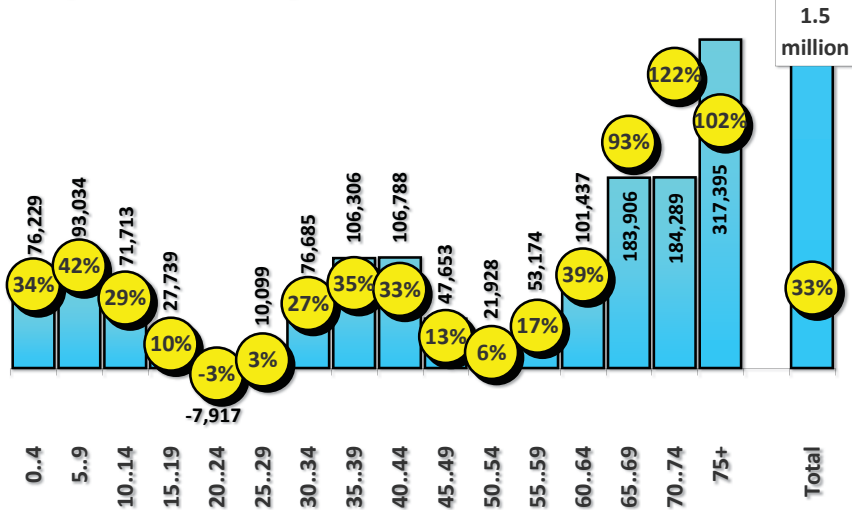
What makes all of these age specific patterns relevant in the context of changing economic and demographic trends, is the aging that the province's population will undergo over the next two decades: birthdays will dramatically increase the share of the population that is in the older age groups, where health care spending and pension income are greatest and tax contributions and labour force participation are low. The cumulative result of four decades of a below the replacement level birth rate following a two-decade baby boom from 1946 to 1965, the province's current population age profile has a distinct shrub-like shape (Figure 7). The bulge between the ages of 44 and 63 in the 2009 age profile that accounts for 30 percent of the population represents BC's post-World War II baby boom generation, with fewer people in each age group both before and after them.

Figure 7 **Population Age Profile, British Columbia**



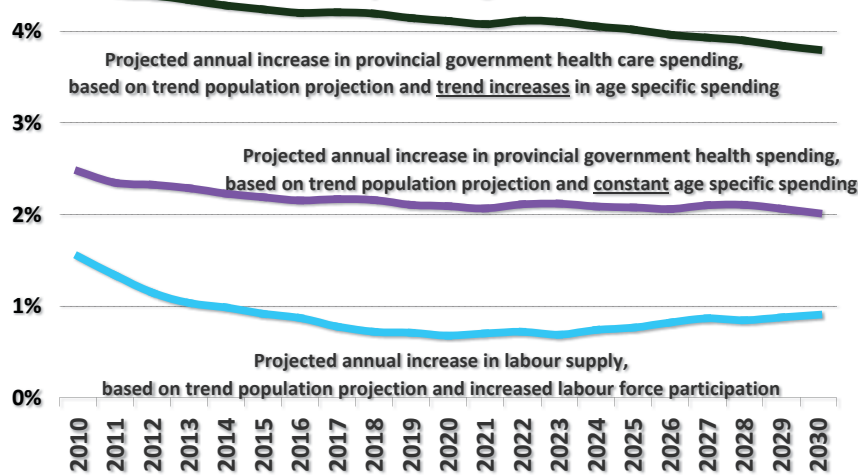
The aging of the province's current population

Figure 8  
**Population Change, British Columbia, 2009 to 2029**



will shift the age profile upwards, bringing rapid growth to the older age groups over the coming decades (Figure 8). Because the age profile of the migrant population is distinctly young, to the extent that the province is able to attract and retain migrants it will be able to increase its younger population while this overall aging occurs. A trends-based projection of the province's population over the next two decades indicates an increase of 16 percent in the prime 20 to 59 labour force participation age groups (without migration, the number of people in these age groups would decline by 16 percent), which compares to an 85 percent increase in the 60-plus population.

Figure 9  
**Annual Change in Labour Force & Health Care Spending**



If labour force participation rates continue to increase over the coming years then, given this underlying demographic change, the labour force in the province would increase at an annual rate in the range of one percent per year over the next two decades (Figure 9). With the same population growth, and if real (i.e. constant-dollar) age specific health care spending continues to increase at the rate observed over the past fifteen years, total provincial government health care spending will increase in the range of four percent per year; if age specific health care spending remains constant at its current level, total health care spending would increase at just over two percent per year. This means that there would be a one to three percent gap between the growth that is required of the economy to fund health care spending and the

growth of the labour supply contribution to it.

Only through increasing productivity can the gap between rapidly-increasing funding requirements and a slowly-growing labour force be narrowed or eliminated—even with increased net in-migration and increases in labour force participation the labour force will increase at only one-quarter to one-half of the rate of growth in health care spending.

It is the awareness of the need for productivity increases that led the former governor of the Bank of Canada, David Dodge, to comment in June of 2007 that “aging is no longer an abstract issue for policy-makers,” cautioning that Canada needs a productivity miracle to avoid a demographic torpedo to the economy. In February 2010, the Office of the Federal Parliamentary Budget Officer published a report that projected a decline in potential GDP growth in Canada that will be “a function of the projected decline in the growth of trend labour input, which reflects slower growth of the working-age population and a decline in the trend employment rate associated with the shifting age composition of the workforce. This

reduction in potential GDP growth will constrain the pace of government revenue growth going forward.”<sup>7</sup>

British Columbia will require increased productivity in the future. Replacing the PST+GST, and its implicit disincentive to purchase goods and to invest in capita, with HST is a necessary step towards increasing productivity.

## **IV Exporting Matters**

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The shift from PST+GST to HST will also, all other things equal, support an increase in the exports from the province of British Columbia. In the interprovincial context, the provision of HST input tax credits for purchases of what were PST-taxed inputs will reduce the cost structure of firms selling to other provinces, making these firms more competitive relative to their counterparts in other provinces. In the international export context, the zero-rated tax status of goods and services exported from the province means that exporting firms can effectively claim a rebate of HST paid on input goods and services, thereby improving their competitive position in the province’s international export markets.

As a small economy with a relatively narrow resource endowment, British Columbia is reliant on other regions to provide it with a wide range of goods and services that cannot be produced in the province. Some of these imports are required because we do not have the resources to produce them (citrus fruits, bauxite) and others because scale economies in manufacturing mean that they cannot reasonably be produced here (cell phones, pacemakers). The extent to which we must import goods and services compels us to trade with other regions:

“What a country really gains from trade is the ability to import things it wants. Exports are not an objective in and of themselves; the need to export is a burden that a country must bear because its import suppliers are crass enough to demand payment.”

*Paul Krugman, 2008 Nobelist in Economics*<sup>8</sup>

Trade is how we get the all of the goods and services that we cannot realistically or efficiently make for ourselves. To get the things that we want but cannot produce, we must make things that others want and cannot produce so that they will, directly or indirectly, swap them for what we want. Imports drain money from the economy, so we must bring into the economy enough money to pay for them or see our economy shrink. The overwhelming supply of money to do so comes from exports (sales of our output to people outside of the province).<sup>9</sup>

British Columbia’s export picture has changed significantly over the past decades, and will continue to change in the coming ones; in terms of providing us with the means of paying for imports, the historical direction of change does not create much optimism. Considering trade data taken from balance of payments tabulations shows that we have, since the end of the early-1990s recession, been able to generally manage a balance in our total trade in services (international and interprovincial), being in a net surplus position in the range of one percent over the past decade (Figure 10). This pattern has been generally achieved by service exports increasing at about the same rate as service imports.

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<sup>7</sup> *Estimating Potential GDP and the Government’s Structural Budget Balance*, [http://www2.parl.gc.ca/Sites/PBO-DPB/documents/Potential\\_CABB\\_EN.pdf](http://www2.parl.gc.ca/Sites/PBO-DPB/documents/Potential_CABB_EN.pdf).

<sup>8</sup> Krugman, Paul, 1997. in *Pop Internationalism*, Cambridge, MIT Press.

<sup>9</sup> Krugman appropriately links the source of money to pay for imports as being exports, although in the short run this revenue source can be supplemented by inward investment and borrowing (in the long run these cannot continue as the outflow of yield and debt payments ultimately drains money out of the economy, witness Greece); by inward flows of yield and debt repayment (which requires trade surpluses in earlier periods); by transfers (such as pension income); and by the charity of people living in other places.

Figure 10  
**Total Services Trade, British Columbia, 1981-2008**

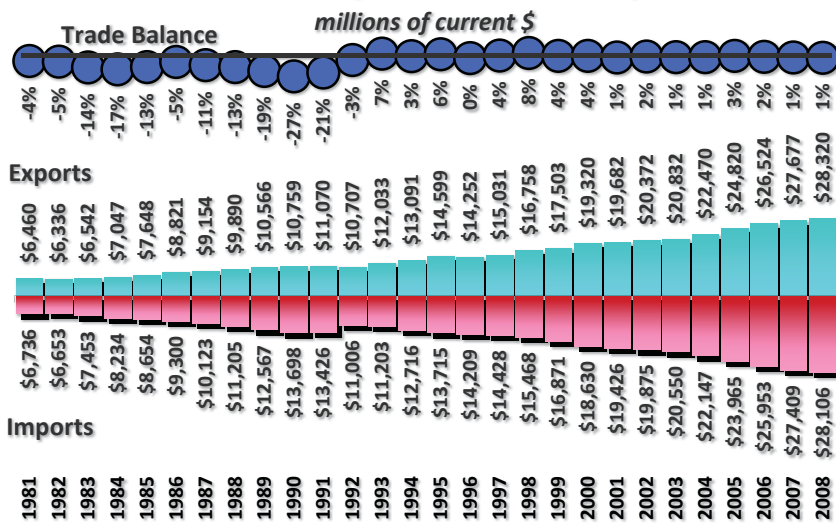


Figure 11  
**Total Goods Trade, British Columbia, 1981-2008**

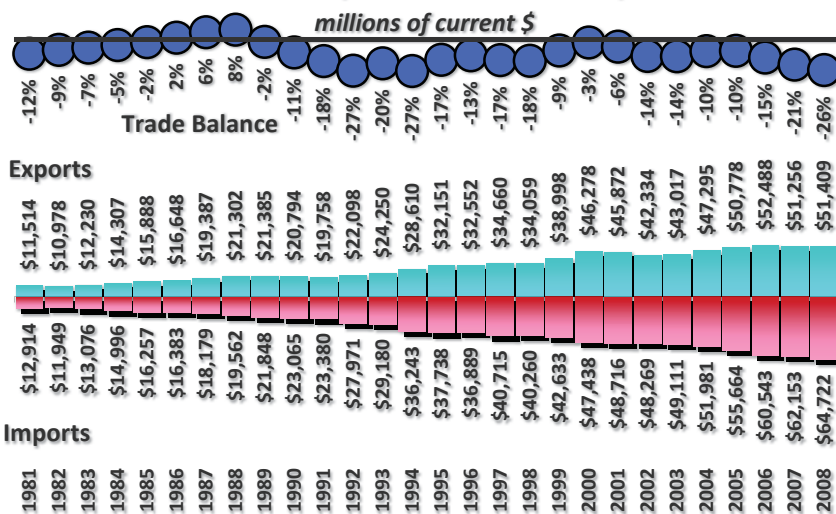
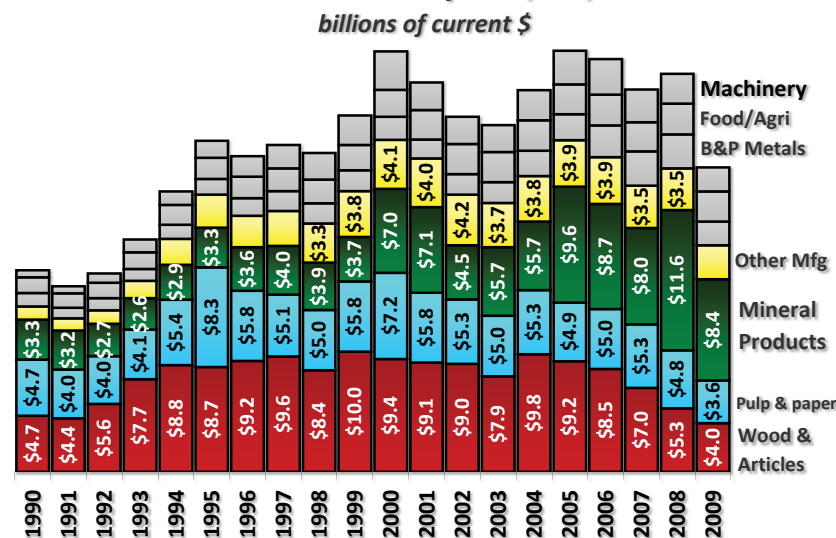


Figure 12  
**International Goods Exports, BC, 1990-2009**



Such a pattern has not been often observed with respect to our trade in goods, as we have consistently run a merchandise trade deficit since the early-1990s recession (Figure 11). Between 1990 and 2000, although a merchandise trade deficit prevailed, it generally narrowed as goods exports grew faster than goods imports; since then, however, merchandise exports have grown much more slowly than imports. In fact, since 2005 merchandise exports have essentially not grown at all while merchandise imports have continued to. As our exports in goods are almost twice that of our exports in services this merchandise trade deficit is of significant long-run concern because it will ultimately mean that we will not be able to afford some of the goods and services that we can not efficiently produce here.

While it will be some months before 2009 data on total trade in goods and services for British Columbia will be available, the 2009 data on international merchandise trade from a customs basis—which does not precisely match balance of payment data and does not include services or interprovincial trade—highlights a number of concerns about the future of BC’s exports (Figure 12).

Total international merchandise exports from the province in 2009 were down 24 percent from 2008, with declines recorded in every major commodity group except food and agricultural products. While this drop in 2009 may be understandable given the major recession in the United States, these data show a disturbing long-term pattern: exports of most commodity groups achieved their peaks some years ago and have been declining or static ever since. International exports of wood and wood products have been below their 1999 current dollar peak of \$10 billion consistently over the past decade. In addition, exports of paper and pulp products peaked in 1995, exports of machinery and equipment peaked in 2000, and exports of other manufactured products not shown elsewhere on the chart peaked in 2002. Exports of food and agricultural products have not increased,

remaining relatively constant in the \$2.5 billion range since 2001. This leaves two sectors, base metals and their products and mineral products—primarily mining (including coal) and natural gas—as sectors which grew during the past decade excluding the past year.

British Columbia remains a natural resource dependent province, with merchandise exports (accounting for two-thirds of total exports) dominated by the products of forests, mines, and wells. The forest-based industries have been in decline for a decade, and their future prospects are not rosy: the effects of the mountain pine beetle and the associated fire hazard will impact supply at the same time that increased competition from Russia—particularly in dimensioned lumber—and other countries increases. The US housing market is a long way from recovery and will likely never attain the volume of new construction recorded in the 2004 to 2006 period. While China is a strongly growing market, it is much closer to other suppliers and requires lumber dimensions that are not standard for BC mills; other external changes for the forest industry include Brazil's rapid expansion of pulp exports and the changes in the wood pellet market as a result of the EU's 2020 targets for renewable energy. Finally, wider background issues, ranging from e-books and digital newspapers to climate change concerns, will bring longer-term fundamental change to the province's forest-based industries.

The natural gas industry has recently been touted as the replacement for the province's forest industry, as natural gas sales have, over the past decade, helped offset the decline in forest-based product sales.<sup>10</sup> While the near-term future for this industry, singularly dependent on sales to the United States, will be reasonably healthy, it too faces long-term challenges, specifically from the rapid expansion of shale gas exploration and production in the United States: the US Energy Information Agency is projecting a 2.6 percent per year decline in natural gas imports over the next three decades.

The province's exporters, be they of natural resources, manufactured products, or services, are facing, and will continue to face, dramatic changes in both supply and demand sides of their markets. As the tax-cascading effect of PST will be eliminated by harmonization, the competitive position of inter-provincial exporters will be improved. To the extent that BC's exports are zero-rated for HST—with exporters claiming tax credits for HST paid on inputs—harmonization will shift exporters' costs downwards, making them better able to compete in international markets. The increasing exports that will result will help to pay for the growing list of goods and services that British Columbians must import. In this respect, HST is better for British Columbia's economy than PST+GST.

## V Evolving Matters

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As consumers, workers, and firms we all will face significant changes in the future—including those specifically associated with harmonization and those associated with the broader and deeper changes in the province's demography and economy—and we will all have to figure out how to respond to these changes. Conceptually, there appears at first glance to be two alternative models of responding to change. The first is the *creative destruction* model, which holds that destruction is inherent in economic competition as established firms and institutions are so committed to historical technology and practice that they do not respond to change and hence fail, being replaced by new firms who realize the advantages of contemporary innovations as they leverage them into a competitive advantage.<sup>11</sup>

An alternative model of response to change is that of *continuous adaptation*, where firms and institutions embrace innovation, transforming themselves—usually in response to change, but often to create it. Such firms are not destroyed and replaced, but rather adapt and remain. This process is reflected in Charles

<sup>10</sup> According to the 2006 Census, there were 78,625 workers in the forest industry and 13,440 workers in oil, gas, and coal industries in BC.

<sup>11</sup> Although its antecedents lie with 18<sup>th</sup> and 19<sup>th</sup> century European social scientists, in the economic context creative destruction is associated with Joseph Schumpeter and his 1942 text, *Capitalism, Socialism and Democracy*.

Darwin's comments on survival: "It is not the strongest species that survive, nor the most intelligent, but the ones most responsive to change."

In economics, neither model is the rule, as both are found in historical observations of how firms have adapted to change, with some "established" firms blown away by change, replaced by new "contemporary" firms, who, perhaps in their turn, will be replaced by another generation of firms in the next business cycle. In other cases, established firms continually shake themselves up, reinventing themselves over and over to such a degree that, in the fullness of time, they become indistinguishable from new contemporary firms.

All firms and consumers in British Columbia will have to respond to the changes that the shift from PST+GST to HST will bring. The nature of the change will range from declines in the prices of goods and services previously subject to PST to increases in the prices of goods and services which were previously PST-exempt. There has been much discussion of the "hardships" firms at this latter end of spectrum will face, so much so that it has been suggested that in spite of the overall benefits to consumers, business, and the economy, there should be no shift to the value-added HST and that we should remain with the tax-cascading PST+GST system. It is useful to close this brief review with a consideration of responses to change that might be open to firms. The restaurant industry and the shift from PST+GST to HST are used as an example of how the alternative processes of creative destruction and continuous adaptation will chart business and consumer response to the wider range of changes that participants will experience over the coming year.

It is important to note at the outset that firms producing previously PST-eligible products will not be made better, or worse, off by harmonization. Yes, their input costs will decline by the elimination of tax-cascading, and compliance costs will fall, but, as they compete with each other they will expand output, leading to a fall in prices, and hence will continue to earn normal profits. Similarly, firms producing previously PST-exempt products will have higher costs, and hence lower output, but they too, after adjustment, will be earning normal profits. The question for these firms, and the industry they are in, is how the adjustment to lower output occurs.

The innovation and entrepreneurial spirit of restaurateurs, as well as the ease of entry and exit into and from the industry, results in a sector where responding to change is a daily activity. For example, recently a fairly formal, fine-dining restaurant (rated \$\$\$\$ in cost) found that business was, in the words of its owner, just not good enough, and folded its napkins for the last time. Within weeks it was replaced by a casual dining restaurant (rated \$\$\$ in cost) which, at least at this point, is thriving. At first glance, this seems to be a poster case for the creative destruction model, with the casual newcomer having a better business model for the location than the formal diner. Digging deeper into the detail, however, it turns out that it is actually an example of continuous adaptation, as the owner of both establishments is the same person (as are many of the staff) who transformed his business to follow a better model for the site and the times.

While considering this industry, it is important to note that it is not the only one that will have to respond to change, nor will it be the one that faces the largest or most varied changes: the forest industry, for example, will have to respond to e-books, the pine beetle, an aging workforce, a shift in markets from imperial to metric, Russian investment in export of dimensioned lumber rather than raw logs, uncertain US demand, and more—all in addition to the move to HST. The reasons for selecting the restaurant industry as an example are: **1)** restaurant dining is a common experience, so examples from this industry will be familiar to readers; and **2)** the restaurant industry has published a statement of how it sees itself being affected by harmonization, thus providing a foundation for discussing consumer and producer responses to change.



The Canadian Restaurant and Food Services Association (CRFA) has not been reserved in its opinion of the effects of the shift from PST+GST to HST:

“While many business groups are applauding this move, an HST in B.C. will have a devastating impact for the province’s 12,000 restaurants, bars and caterers. Here’s why:

At present, restaurant meals are only subject to the 5% GST (no PST). Starting next July, your customers will be forced to pay more than double the current tax whenever they order a meal from your restaurant.

As if a 12% tax isn’t enough of a disincentive to dine out, customers will find comparable products at grocery stores even more attractive once the HST is in place. That’s because the HST is applied on the GST tax base, which treats food differently depending on where it is purchased. If you sell a pizza, you will have to charge your customers HST – but frozen pizzas sold at the grocery store will be HST-free.

The last time a new tax was added to restaurant meals – the 7% GST in 1991 – food service sales across Canada dropped by more than 10%. According to Ernst and Young, nearly three-quarters of this drop – 7.3% – was due to the GST.

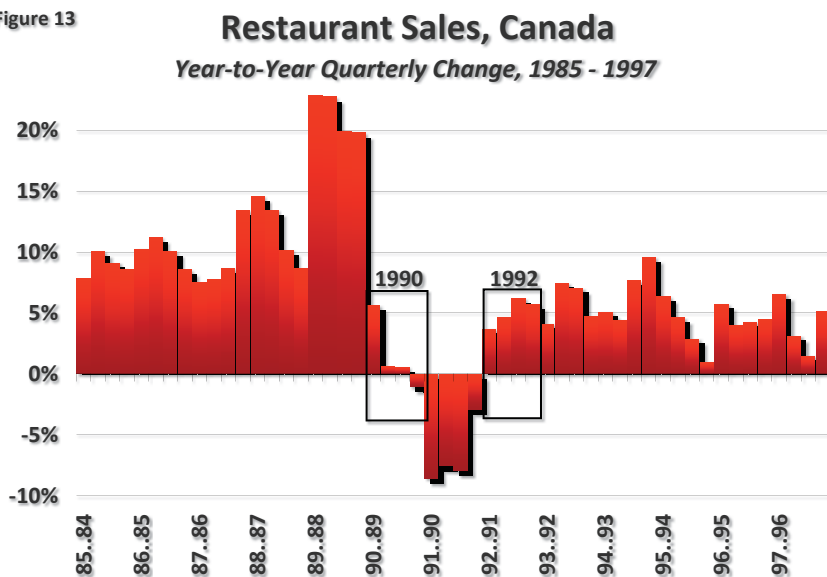
When you add it all up, an additional 7% tax on meals will cost the industry \$750 million each year in lost sales, according to CRFA’s econometric model. That’s an annual loss of 7.5% or nearly \$50,000 for the average restaurant in the province.

Many are touting input tax credits as an upside to tax harmonization, but food service operators will not benefit from input tax credits in the same way as other businesses. The largest costs for food service operators, labour and food, are not eligible for these credits.”

*Canadian Restaurant and Food Services Association, February 14, 2010.<sup>12</sup>*

This suggests that the restaurant industry sees itself falling into the second example of vendors of previously PST-exempt products, in that they are asserting that the increase in costs introduced by harmonization—as represented by the HST that they must collect in order to sell products and services—will be greater than the reduction in costs that they will achieve as a result of being able to claim HST input tax credits. The result of this, in their eyes, will be higher prices to consumers and less spent by consumers (in aggregate) than under the PST+GST system.

Figure 13



There are three elements to the restaurant industry’s opinion: **1)** based on the experience of 1991, the introduction of value-added taxes “devastate” restaurants; **2)** food from grocery stores is a direct substitute for “comparable products” from restaurants; and **3)** the level of sales, rather than levels of profit, matters to firms in the industry.

The CRFA has cited the introduction of the GST in January of 1991 as a precedent for their anticipation of the impact of HST on their industry. Therefore, it is useful to examine the data to place the decline in restaurant sales during this period in their full context. What such an examination shows it that the restaurant industry in Canada was not “devastated” by the GST: according to Statistics

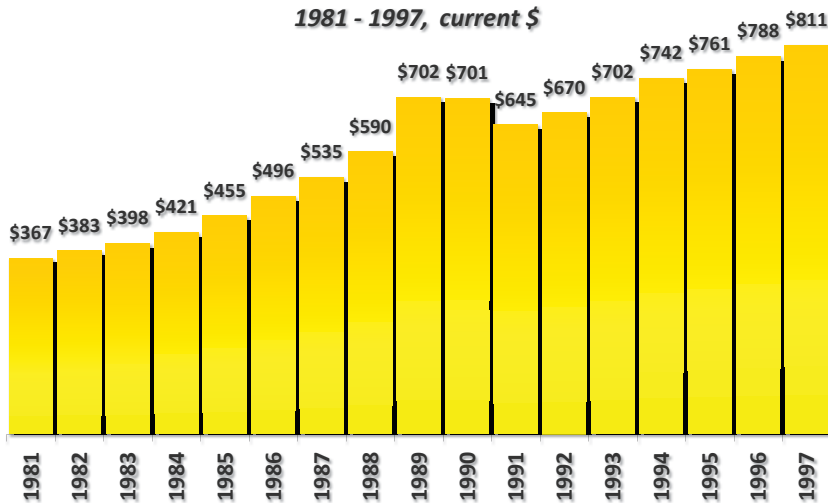
<sup>12</sup> [http://www.crfa.ca/news/2009/bcs\\_hst\\_bad\\_news\\_for\\_restaurants\\_consumers.asp](http://www.crfa.ca/news/2009/bcs_hst_bad_news_for_restaurants_consumers.asp)

Canada, restaurant sales dropped by 6.8 percent between 1991 and 1990, and then increased by 5.1 percent between 1991 and 1992 and by 6.0 percent between 1992 and 1993 (Figure 13).<sup>13</sup> Far from being devastated, the restaurant industry was establishing record sales levels by the fourth quarter of 1992, within two years of the introduction of GST.

It is also essential to note that restaurant sales had started to decline one full quarter (the third quarter of 1990) before the introduction of GST, and had shown essentially no growth in either the second or third quarter of 1990. Even the first quarter growth in 1990 was the smallest increase recorded in the four years leading up to it. The most dramatic change shown in the data on restaurant sales during this period is not the decline of 6.8 percent in 1991, but rather the 20-plus percent increase in sales between 1988 and 1989.

Figure 14

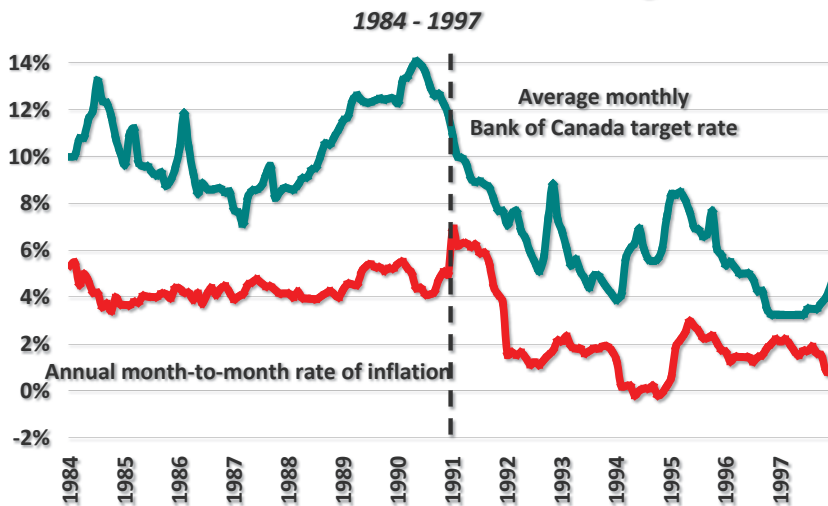
**Annual Restaurant Sales Per Capita, Canada,  
1981 - 1997, current \$**



The rapid growth in restaurant sales between 1988 and 1989 contributed to the decline two years later. When viewed on a per capita current-dollar basis, 1989's sales were far above the trend in sales, with the \$702 per person sales in 1989 being 19 percent above 1988's \$590 per capita sales (Figure 14). This represents the largest year-to-year increase recorded in the 1981 to 1997 data series on restaurant sales published by Statistics Canada, far out of line with the annual average increase of five percent. The reason for this rapid increase was inflation, both directly in prices and indirectly in the inflationary environment that prevailed at the time (Figure 15).

Figure 15

**Inflation and the Bank of Canada Target Rate  
1984 - 1997**



From early 1987 on, the Bank of Canada had been concerned about the prevailing, persistently-high level of inflation (in the four percent per year range). By early 1988 the Bank acted, aggressively increasing interest rates on a monthly basis to 12.6 percent in the second quarter of 1989 and, when inflation persisted, to a high of 14.1 percent in the second quarter of 1990. This resulted in a dramatic increase in the value of the Canadian dollar compared to the US dollar, extremely high real interest rates (evidenced by the spread between the Bank rate and inflation in 1989 and 1990), a dramatic decline in exports to the US, and, in the middle of 1990, a recession.

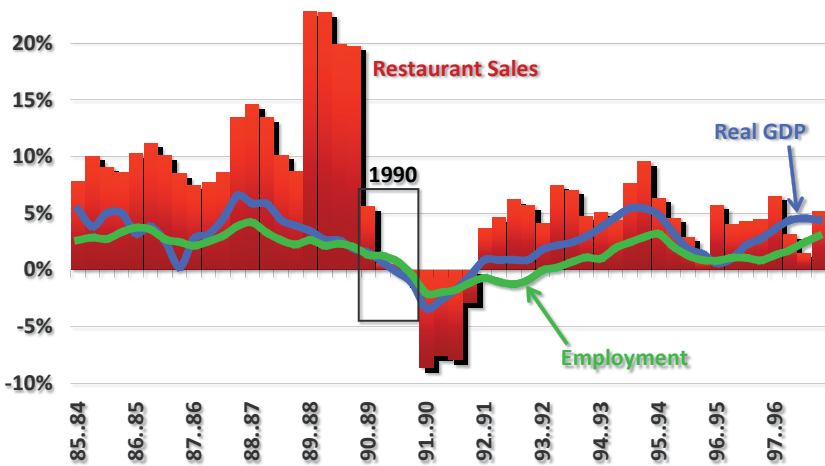
The direction of change in restaurant sales in this period almost precisely followed that of the national economy, which in this case was into a decline in 1990, with real GDP declining

in the second quarter of that year and continuing to decline until the first quarter of 1992 (Figure 16, next page). Employment in Canada followed GDP, starting to decline in the third quarter of 1990, with 308,000 people losing their jobs between March 1990 and March of 1991. Restaurant sales also began their decline

<sup>13</sup> Statistics Canada, CANSIM table 355-002, www.statcan.gc.ca, accessed February 22, 2010

Figure 16

**Restaurant Sales, Real GDP, & Employment, Canada**  
Year-to-Year Quarterly Change, 1985 - 1997



in the third quarter of 1990 following GDP and before the introduction of GST.

The Bank drove inflation down to the two percent target level by the beginning of 1992, and both nominal and real rates of interest fell back to relatively low levels, helping to end the recession in that year. While restaurant sales also started to increase in 1992, employment continued to decline for another full year.

The Ernst & Young report cited by the CRFA is not posted to their website, so it is not possible to determine how it was concluded that 73 percent of the decline in restaurant sales in 1991 was attributable to GST during a period when the country was in a recession, real and nominal interest rates were at very high levels,

high gas prices and a strong dollar prevailed, and restaurant sales were flat to declining for three quarters before the introduction of the GST in an industry that had expanded by twenty percent just a year earlier. One can conclude, however, that while 1991 was difficult for restaurants—as it was for all of us—it was over by 1992. A one-year decline in sales after a record increase, followed by new record levels only one year later, does not necessarily fit with everyone’s definition of “devastation”.

While an interesting historical discussion, at a fundamental level this is not relevant in the context of assessing the economic consequences of change, as the well-being of firms and industries is not determined by sales, but by profits (a decline in total sales no more means devastation than an increase in sales means an economic windfall). Profit maximization, not revenue maximization, is the goal of private business owners, as firms keep their eyes on the bottom line, not the top one. Thus, before asserting that falling sales means “devastation” for the restaurant industry, it is necessary to argue that firms cannot reduce their costs in the face of falling sales. Recent evidence suggests that restaurants can:

“Burger King Corp is taking a page from its bigger rival McDonald’s Corp’s playbook and replacing its \$1 double cheeseburger with a \$1 double burger with one, rather than two, slices of cheese.”  
*Reuters, February 17, 2010*

Without data describing the effects of the introduction of GST on the profits of restaurants, adjusted for the impact of the recession and potential inflationary expansion during 1989 (and the previous years), it is not possible to draw any meaningful conclusions from this experience regarding the impact of harmonization. We are therefore compelled to fall back again on the theoretical micro-economic model presented earlier, which, if we accept the CRFA suggestion that the increase in costs implicit in the collection of HST on previously PST-exempt restaurant meals will be larger than the reduction in costs that will result from HST input credits (including those on beer, wine, and liquor), indicates that restaurants will face lesser sales of, and consumers will face higher prices for, the same products.

To the extent this true, restaurants are going to have to respond to changing circumstances, just as the forest industry, the natural gas industry, and all of the other industries in the province will have to respond to changing circumstances, whatever their source. The analytical question is what model of response to change will restaurants decide to follow: creative destruction or continuous adaptation? To see what their options might be, it is useful to consider what their customers will be doing in the face of these changes. In the face of rising prices, customers will adapt—to some extent by switching to cheaper substitutes.

The CRFA website implies that the substitute will be food from grocery stores—but consumer behaviour suggests that it is much more complex than a less than seven percent tax (as they will have some input tax credits) on restaurant pizzas sending people flocking to the frozen foods sections of supermarkets. The range of options for consumers is much wider: yes, they can reduce dining out by substituting food from grocery stores, but they can also continue to dine out at the same restaurants but move down menu by up to seven percent, or by moving down market to restaurants that are up to seven percent cheaper.

In each of these options, the degree to which consumers can substitute one commodity for another will be crucial to determining the impact on the restaurant industry. Clearly, consumers do not see preparing their own food at home as a perfect substitute to dining out, as a couple of examples from Vancouver indicates. The first is the ever-popular fusion hot dog stands that sell gourmet hotdogs in the \$5-\$7 per hotdog range on the streets of downtown. Lineups for these hotdogs can be half an hour to order and one quarter of an hour more before they are delivered. Interestingly, one stand is situated just 50 meters from a major grocery store, where all of the ingredients for the same dog can be purchased for less than half the price. Similarly—to use the pizza example from the CRFA—a popular social house in Kitsilano sells pizzas for \$13, while across the street the supermarket sells them frozen for, again, less than half the price. Clearly in both of these examples, the restaurants are selling a lot more than food: they are selling time, convenience, experience, entertainment, romance, acknowledgement, and a whole lot more along with their food. The value of the difference to consumers is indicated by the price difference between the food in the store and the food in the restaurants—restaurants sell the sizzle as well as the steak.

But diners have a much wider choice than going across the street from the restaurant to the grocery store to substitute store food for restaurant food: they can also substitute cheaper restaurant food for more expensive restaurant food. To the extent that dining out remains an activity that people wish to engage in, the face of changing prices, they will change how they do so. Even those who have favourite restaurants that they always go to will not be immune to the increase in costs for the same menu item. Those who value eating in their favourite restaurants will continue to go to them, adapting by moving down menu (as they have been doing since the beginning of the 2009 recession). This means ordering prosecco rather than champagne, tap water rather than bottled water, salad rather than oysters, chicken rather than the steak, or maybe sharing a dessert.

If it is not possible, or not accepted, or not encouraged to move down menu in the favourite restaurant, then customers will follow another path to substitution: moving down market by going to another restaurant that is, effectively, up to seven percent cheaper. Moving down market will be represented as being part of the spirit of adventure of finding “new” restaurants, as customers shift from fine dining to bistro, from bistro to neighbourhood restaurant, from the place with the double-shot latte with sprinkles to the one with large double-doubles.

Consumers can and will adapt to the changes the HST will bring—some will adapt by moving down market and others may adjust their spending patterns so that they can continue to enjoy the same dining experience. Restaurateurs will also adapt, but they have the opportunity to influence consumers’ choices. If existing restaurants make it a pleasure and an adventure to move down menu, then fewer customers will decide to stay home or go down the street to a less expensive restaurant. Adaptive restaurants will focus on profits and product margins, not on total sales and prices: they will ease their clients down menu, providing options to switch from the eight-ounce steak to the six-ounce; they will provide innovative wine and beverage lists that are effectively up to seven percent cheaper to the customer; and they will look to all of the other opportunities to retain and attract customers while increasing their margins.

The more the restaurant helps customers make the adjustment, creating a price structure and process by which the customer can move down menu without losing face, the greater the retention of current

customers. For these innovators, harmonization can be the grain of sand irritant that the oyster (restaurant) makes into a pearl, as it will be an incentive to transform. Watch for the innovators bringing in a greater range of special moderately-priced prix-fixe tasting menus which customers cannot directly cost from the a la carte menu, thus affording the restaurant larger margins and the customer a way to move down menu. Watch for a shrinking or an elimination of the free bread and tea, smaller portion sizes, more appetizers and fewer entrée menus, and a shrinking of menu items to reduce costs and inventories. Harmonization will also provide a strong incentive for firms to reduce costs (that second slice of cheese did not benefit Burger King's bottom line) and increase productivity. An important first step for this industry in adapting would be to stop telling people that it will be much more expensive to dine out and that they will find eating at home much cheaper; a better strategy would be to encourage them to dine out more and make the commitment that restaurants will continue to provide an affordable, and pleasurable, experience.

In conclusion, the response to the changes coming to the restaurant industry due to the harmonization of the PST+GST system will provide some guidance to firms in other industries who will be facing their own changing markets. First, respond to your customers' needs: if Chinese firms want their lumber sawn to metric rather than imperial dimensions, do it. Second, look for ways you can increase the productivity of your workers (something that HST will provide an impetus to do). Third, look for export opportunities (also something that HST will encourage). Fourth, do not focus on sales, but on profits, looking at opportunities to change costs in the face of changing demand. And remember Darwin—change is going to happen, and it will be the ones most responsive to change who will survive.

## **VI Supplement: Equity and Residential Construction**

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Subsequent to the publication of the preceding report, we received a number of requests for elaboration on two specific topics: **1)** the inequity associated with the PST+GST system; and **2)** the differential impact of HST on industry sectors (specifically on the residential construction industry). While these topics are not central to the discussion presented above, there was sufficient interest expressed in them to warrant some elaboration.

**1) The inequity of PST+GST compared to HST.** The purpose of purchase-based taxation systems is to collect revenue; from an economic perspective they should, with explicit exceptions, treat all purchases the same way (i.e. no exempt purchases and the same tax rate for all purchases). Such neutrality raises revenue while respecting that rights of consumers to make their own decisions regarding what they wish to purchase. In this context the exceptions to neutrality exist where social policy specifically and explicitly intends to override consumer sovereignty in order to either suppress the consumption of some goods and services (for example, the additional “sin taxes” on tobacco and alcohol) or encourage the consumption of others (the perennial exemption of children’s clothing from excise taxes).

Intentionally or not, pursuing social policy by using non-neutral revenue collection systems creates inequity, as it treats those who purchase disproportionate shares of exempt items differently from those whose purchases are predominantly taxed items. To the extent that inequity is the intention of social policy, it may be acceptable. However, to the extent that inequity is not desired but rather an accidental and unintended consequence, it should not be accepted, and the tax system should be restructured to remove any inequities.

For all of the opinions expressed and words written about harmonization in British Columbia, there has been little said about the inequity of the PST+GST system. It is a system where the purchase of clothes and bedding to keep warm is taxed more than fine dining; where the purchase of a modest kitchen table and a pot to cook supper in is taxed more than the purchase of a new million dollar house. The PST is an inefficient and inequitable artefact of the past; harmonization is forcing us to look at each of the exemptions that have long-prevailed under PST (by default rather than by explicit choice) and justify them or eliminate them to produce a more equitable system. As HST will have significantly fewer exemptions than PST+GST, it will be a more equitable way of raising revenue.

**2) Residential construction.** As the removal of tax inequities will necessarily focus on the removal of exemptions under HST, there will be industry-specific patterns of adjustment. One particular sector of interest for readers is the adjustment pattern that will be adopted in the residential construction industry. As the purchase of newly-constructed housing units was previously exempt from PST but subject to GST, harmonization will bring an additional tax of seven percent applied to the total pre-GST purchase price of new homes. In this regard, the residential construction industry’s response has been similar to that of restaurant industry as it seeks to preserve its tax-exempt status. The provincial government has in turn responded by agreeing to rebate five percent of the first \$525,000 of the purchase price of any new home in BC, equivalent to a maximum rebate of \$26,250.

Residential construction will now benefit to the extent that there will be an estimated two percent reduction in the costs of building new homes, as construction firms will be able to claim input tax credits at each stage of construction, thus removing the PST tax-cascading effect that embeds PST into the final selling price. Including these savings, Table 1 shows that the impact of harmonization on the purchase price of new homes at or below the \$525,000 threshold will be zero: the partial HST rebate and the removal of the embedded PST would just offset the additional tax on the final purchase price of the new home.

**Table 1**

Potential Impact of HST on New Home Purchases					
Before Harmonization					
Purchase Price	\$400,000	Purchase Price	\$525,000	Purchase Price	\$650,000
GST (5%)	\$20,000	GST (5%)	\$26,250	GST (5%)	\$32,500
<b>Total Outlay</b>	<b>\$420,000</b>	<b>Total Outlay</b>	<b>\$551,250</b>	<b>Total Outlay</b>	<b>\$682,500</b>
After Harmonization					
Purchase Price	\$400,000	Purchase Price	\$525,000	Purchase Price	\$650,000
BC HST (7%)	\$28,000	BC HST (7%)	\$36,750	BC HST (7%)	\$45,500
New Housing Rebate (5%)	\$20,000	New Housing Rebate (5%)	\$26,250	New Housing Rebate (5%)	\$26,250
Embedded PST (2%)	\$8,000	Embedded PST (2%)	\$10,500	Embedded PST (2%)	\$13,000
GST (5%)	\$20,000	GST (5%)	\$26,250	GST (5%)	\$32,500
<b>Total Outlay</b>	<b>\$420,000</b>	<b>Total Outlay</b>	<b>\$551,250</b>	<b>Total Outlay</b>	<b>\$688,750</b>
<b>Impact of HST</b>	<b>0.0%</b>	<b>Impact of HST</b>	<b>0.0%</b>	<b>Impact of HST</b>	<b>0.9%</b>

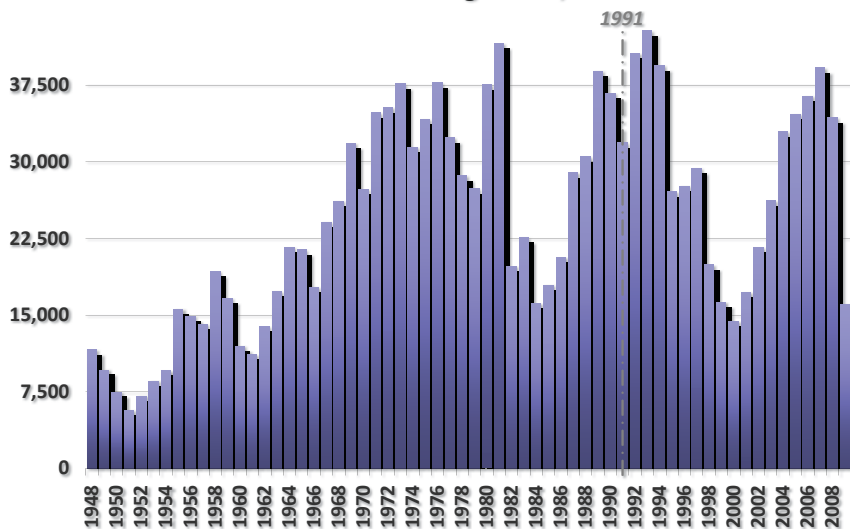
**Table 2**

Potential Impact of HST on New Home Purchases	
Purchase Price	Price Impact
\$525,000 & under	0.0%
\$600,000	0.6%
\$700,000	1.2%
\$800,000	1.6%
\$900,000	2.0%
\$1,000,000	2.3%

All else being equal, purchasers of new homes priced above \$525,000 could incur additional costs as a result of harmonization. For example, consider the purchase of a newly-constructed residential property at a sales price of \$650,000: harmonization will result in an additional seven percent (\$45,500) being added to the final sale price, an amount reduced by the HST rebate (equal to \$26,250) and the removal of imbedded PST costs (equivalent to \$13,000), resulting in a net increase of \$6,250. Thus, at this particular price point a purchaser's total outlay on a new home would be greater by under one percent after harmonization than before. Table 2 shows the potential price impacts of HST on new homes at various price points up to \$1 million. While under one percent on the purchase of a new home at \$650,000, HST could add up to 2.3 percent to the purchase price of a million dollar home.

So there you have it: all else being equal, the transition to HST would have no impact on homes priced at \$525,000 or less, with a potential price increase of under one percent on purchases in the range of \$650,000, and up to 2.3 percent for those at a million dollars.

**Figure 17 British Columbia Housing Starts, 1948 - 2009**



Source: Statistics Canada, CMHC

As with restaurant dining, housing consumers have choices in how to respond to this increased cost: they can move down menu or down market, purchasing a new home at a slightly lower price point, either by level of finish or square footage; they can move further down the street where the units may be less expensive; or they can delay purchasing a new home in order to save some extra money for the home they want. On the supply side, residential builders will help them not only by sharpening their pencils, but by paying less for land as an input to the construction process. All residential builders, just like restaurateurs, will focus not on the top line (sale price), but on the bottom line (profit), and they will adapt and thrive just as they did in 1992 and 1993, when, within two years of the application of

GST to new residential construction, housing starts in British Columbia peaked; a peak that was not even surpassed in the flurry of building activity in 2007 (Figure 17).

The discussion of the exemptions already provided to the residential construction industry, and those still sought, must be placed in the wider context of the entire excise tax system and in the efficiency and equity associated with how tax revenues are raised. Under HST there is no debate with respect to efficiency: it is a more efficient and less wasteful tax system than PST+GST. Additionally, it will be a more equitable tax system.