Sales Tax Harmonization in Manitoba:
What it would mean for households, businesses and public finances

Manitoba Finance

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This paper examines the implications of harmonizing Manitoba's sales tax with the federal Goods and Services Tax and what the impacts would mean for Manitobans, businesses, and provincial finances.

BACKGROUND

A Harmonized Sales Tax (HST) is a provincial sales tax applied largely on the same terms as the federal Good and Services Tax (GST) and administered alongside the GST by the Canada Revenue Agency (CRA).

The GST and the HST are value-added taxes, which means that they ultimately apply only on sales to the final domestic purchaser. In contrast, retail sales taxes (RSTs) apply on many intermediate business inputs.

The federal Minister of Finance has called on RST provinces to harmonize, stating that sales tax harmonization "is the single most important step provinces with RSTs could take to improve the competitiveness of Canadian businesses."

This latest call to harmonize is backed by a federal offer of one-time financial assistance. Recent harmonization agreements with Ontario and British Columbia define the current offer: one-time transitional assistance; the option to restrict certain of the Input Tax Credits available to larger businesses for up to eight years; the option to permit certain point-of-sale exemptions that go beyond federal GST exemptions; federal administration of the HST at no cost to the Province; and a best-efforts offer to hire Provincial employees affected by HST.

In 1997, three Atlantic Provinces responded to an offer of federal transitional assistance and harmonized with the GST, receiving four years of federal payments to fully offset the fiscal impact of introducing an HST for those four years. Quebec has had a value-added sales tax (QST) since 1991. Alberta has no sales tax. In 2009, both Ontario and BC responded to the offer of federal assistance and announced that they would harmonize effective July 1, 2010. This leaves Saskatchewan, Manitoba and Prince Edward Island as the RST provinces.

For Manitoba, the one-time federal assistance would be worth $344 million if the provincial sales tax was harmonized in 2010.

MANITOBA'S RETAIL SALES TAX COMPARED TO AN HST

On July 1, 1967, Manitoba introduced a Retail Sales Tax. It is applied on most goods and on some services. Since May 4, 1987, the RST rate has been 7%.

There are two types of sales tax systems in Canada:

- A Retail Sales Tax (RST) applies to a broad base of goods but only a few services. Much of the revenue – 41% in Manitoba – comes from RST on business inputs. Until the 1990s, all governments in Canada (except Alberta, which has no sales tax) used this system, although the tax base (the list of items subject to tax) varied widely.

- A Value-Added Tax (VAT) applies to a broader base that includes most services as well as goods, but, with minor exceptions, does not apply to business inputs. The federal GST is a VAT, and so are the Quebec Sales Tax (QST) and the HST in Newfoundland and Labrador, Nova Scotia, New Brunswick and, prospectively, in British Columbia and Ontario. Most countries in the world impose VATs. The U.S., where most states and many local governments impose RSTs, is an exception.

Under Manitoba's RST system, sales tax applies on some inputs purchased by businesses and is therefore built into the cost paid by final consumers, even though these "embedded" taxes are not visible to consumers. For example, furniture manufacturers do not pay RST on goods purchased for resale or on items like moulds that are consumed during the production process, but they do purchase these goods from companies that pay RST on things such as energy, office supplies and accounting services. Although the furniture company pays no explicit RST on goods for resale, it does pay sales taxes embedded in the prices paid for those goods. Those embedded RST costs are included in the total costs paid by the furniture maker and are passed on in the final price charged to furniture buyers. So not only does the final consumer pay 7% RST on the furniture, he or she also pays the RST hidden in the purchase price. Therefore, RST is embedded in the cost charged to consumers for many goods and services. This is referred to as *"tax cascading."* The *effective* tax rate, therefore, is higher than 7%. How much higher depends on the specific good or service.

RST is also hidden in the prices of consumer purchases that are nominally exempt from RST. For example, Manitoba RST is embedded into the purchase price of a new house, even though no RST is charged explicitly to the new home buyer.

Although embedded RST is significant, it should not be overstated. It is estimated that harmonization would save Manitoba businesses $510 million in sales tax. Even if that entire amount is embedded in the prices charged to customers (both local and export), that is still less than 1.5% of the value of all final goods and services produced in Manitoba.

Under a VAT system, businesses pay sales tax on their inputs, but receive offsetting Input Tax Credits (ITCs) when they sell their product further up the production/distribution chain. For example, if a house builder paid $5,000 of VAT on building supplies, this would be offset by $5,000 of ITCs. The final purchaser would pay VAT on the purchase price of the house, but the nominal tax rate would be the effective tax rate – there is little or no embedded tax under a VAT system (with some exceptions such as financial services).

Furthermore, a VAT applies broadly to most non-essential goods and services and so does not bias purchase decisions in favour of services. For example, Manitoba RST provides a disincentive for Manitobans to buy exercise equipment, which is subject to RST, and an incentive to instead pay for gym memberships, which are exempt from RST. Thus, value-added taxes have less of a distorting effect on a purchaser's decisions than retail sales taxes.

An advantage for business of harmonization is the need to comply with only one sales tax system instead of two. Under the HST, the federal and provincial sales taxes are collected and administered together using a single set of rules (although some deviations are allowed). On the other hand, provinces not harmonized are required to maintain separate tax administration and collection operations. The administration of Manitoba's RST system costs the Province about $12 million annually.

Although there are clearly some benefits from adopting a harmonized value-added tax the benefits are not universal, as will be discussed below.

IMPACT ON CONSUMERS

Consumers currently pay about $892 million in Manitoba RST. Under an HST, because of the broader base of goods and services subject to sales tax, that amount would increase by $405 million.

Table 1
Distribution of Manitoba Sales Tax Revenue

$ millions	**RST**	**HST**	**Difference**
Consumers	892	1,297	405
Business	670	160	(510)
Government spending	85	56	(29)
Total Revenue	1,647	1,513	(134)
Share of Total:			
Consumers	54%	86%	
Business	41%	10%	
Government spending	5%	4%	
Total Revenue	100%	100%	

Source: Manitoba Finance

Table 1 shows that Manitoba collects $1,647 million in RST and would collect $1,513 million in HST for a loss of $134 million (before considering any of the offsets and adjustments discussed below). Consumers pay 54% of RST but would pay 86% of HST – an increase of $405 million (+45%). Business pays 41% of RST but this would fall to 10% (mostly in financial services) for a reduction of $510 million (-76%). There is also a small reduction in sales taxes paid by the government sector. Government can reduce the impact on consumers, but at the expense of a greater impact on its own revenue.

Some of these additional sales tax costs for consumers would be mitigated by price reductions resulting from the elimination of embedded taxes. However, such reductions are not as visible as is the addition of tax to things previously exempt. Attachment A provides a fairly comprehensive list of goods and services currently exempt from RST that would be subject to HST. The most significant items for the average household are listed in Table 2. (Note: these estimates are based on average household income of $63,300 in Manitoba in 2007.)

Table 2
Major Household Expenditures Exempt from Manitoba RST but Taxable Under HST

	Average Spending	**HST**
Vehicle fuels	$2,300	$161
Entertainment	$900	$63
Home heating	$500	$35
Personal services (hair care, etc.)	$430	$30

Source: Manitoba Finance

To some extent, the cost of the items in Table 2 could decrease under an HST because of the elimination of embedded RST, partly offsetting the HST shown.

HST on the sale of new houses would also be very large and visible (sales of previously occupied homes are non-taxable). HST at 7% on a $250,000 home would be $17,500. The real increase in sales tax paid under an HST may be exaggerated somewhat because under the Manitoba RST, there is embedded sales tax built into the price of the house, estimated to be equal to 3.5% of the price, or $8,750 on a $250,000 house. Even if all input tax savings to homebuilders were passed on to purchasers through lower new home prices, the increased sales taxes on a new home under an HST would still be significant – $8,750 on a $250,000 house. This amount does not include new costs associated with the application of an HST to the closing costs on the sale, such as real estate commissions, legal fees and surveyor fees. HST on $8,000 of such fees would be $560. Under Manitoba's RST, only the legal fees are taxable. These additional taxes on closing costs under an HST would also apply to the resale of homes.

An HST would also put upward pressure on residential rents. Although residential rents are not taxable under either Manitoba's RST or an HST, landlords would not qualify for input tax credits on their business costs under an HST because they are considered the final purchasers (see the explanation on page 9 for the consequences to a business that sells HST exempt goods and services). The expanded sales tax base under HST therefore would mean higher sales tax costs for landlords on the maintenance and operation of rental properties. These additional costs would likely mean higher rents for residential tenants.

CONSUMER OFFSETS

Under an HST in Manitoba, consumers would pay $405 million more in provincial sales tax. The federal government and all HST provinces provide several forms of offsets to reduce the cost of GST/HST for households. These fall into three categories: point-of-sale exemptions, rebates for new housing, and low-income tax credits. Each of these offsets have a significant cost and would have a major impact on Manitoba revenue and expenditures.

Point-of-sale exemptions (benefiting all households)

Under an HST, provinces can deviate from the federal GST base by exempting items that together do not exceed 5% of the HST revenue. Accordingly, Manitoba could provide point-of-sale exemptions worth approximately $75 million.

With a $75 million limit on the point-of-sale exemptions permitted, choices would have to be made to determine which goods or services currently exempted from Manitoba RST would continue to remain exempt under an HST. For example, BC and Ontario will provide exemptions for books, children's clothing and footwear, children's car seats and car booster seats, diapers, and feminine hygiene products under an HST. If Manitoba paralleled these exemptions, the revenue loss would be $19 million. Under an HST, the cost of maintaining Manitoba's RST exemption on home heating would be $17 million. The combined revenue loss from these exemptions would be $36 million.

Under the 5% deviation limit, BC will exempt fuel sold at the pump. Manitoba, however, would be unable to make a similar exemption because the $80 million cost of offering such an exemption in Manitoba exceeds the 5% base deviation allowed by the federal government. Manitoba consumers would face $80 million in new sales tax costs on fuel.

It is important to note that this paper's analysis of the impact of an HST on Manitoba assumes only $36 million in point-of-sale exemptions (out of the $75 million permitted under the current federal harmonization offer). If Manitoba were to offer more point-of-sale exemptions, the cost to the Province would increase accordingly.

New housing rebate

The federal government and all HST provinces provide rebates of a portion of the GST/HST on new house purchases, which reduces the effective tax rate. The federal rebate is 36% of the GST on sales up to $350,000, with a reduced rebate for new houses valued between $350,000 and $450,000. New homes costing at least $450,000 get no rebate. In Ontario and BC, the rebate will be 75% and 71.4%, respectively, of HST on the first $400,000 and $525,000, respectively, of new house prices.

The rebates do not apply to the closing costs (real estate commissions, surveyor fees, etc.), which are subject to HST on purchases of new and used houses.

Since the current effective RST rate on new housing in Manitoba is estimated to be 3.5%, a 50% rebate would leave most new home buyers neither better nor worse off. The cost-neutral rebate levels in Ontario and BC are higher because the current embedded RST is lower – about 2% – in those provinces. Offering a 50% new home rebate would cost Manitoba $40 million.

Low-income tax credit

Some provinces with an HST, and the federal government, offer a tax credit to offset the impact of the GST/HST on low-income households. Manitoba could offer an HST Credit, similar to the GST Credit, to offset the additional sales tax for low-income households. Currently, Manitoba provides $68 million through the Family Tax Benefit (FTB, a non-refundable personal income tax credit) and another $42 million through the Personal Tax Credit (PTC, a refundable personal income tax credit) to low- and middle-income Manitobans. The FTB and PTC could be redirected as a single HST Credit that would be more generous in order to offset increased sales tax paid by lower-income households. Table 3 summarizes the financial parameters assuming an incremental cost of $57 million.

Table 3
Financing a New HST Credit
($ millions)

Redirected Family Tax Benefit	68
Redirected Personal Tax Credit	42
New funds	57
Total value of HST Credit	167

Source: Manitoba Finance

The HST Credit financed as in Table 3 would be sufficient to fully offset the tax for low-income households up to about $35,000 or $40,000 (depending on whether there are children), leaving higher-income households still paying more tax.

Consumer Offsets in Total

Table 4 summarizes the provincial cost of providing point-of-sale exemptions and an HST credit to consumers. These measures would cost a total of $133 million. This does not mean that each household would experience zero net impact – many lower-income households could be better off while many with higher incomes could be worse off.

Table 4 **Summary of Basic Consumer Offsets: Impact on Manitoba Revenue** ($ millions)	
Point of sale rebates and exemptions (benefits all households)	
Home heating exemption	17
New housing rebate @ 50%	40
Children's clothing, footwear exemption	11
Books	6
Other exemptions*	2
Subtotal	76
HST Tax Credit (benefits low-income households)	
HST Credit for low-income households**	57
Total (rebates, exemptions & credit)	**133**

* Other exemptions could include children's car seats and car booster seats, diapers and feminine hygiene products.
** $57 million is the incremental cost.
Source: Manitoba Finance

For more information on the impact of a Manitoba HST and an HST Tax Credit for sample households, please refer to Attachment B: Overall Impact of Harmonization on Sample Households.

Further offsets to assist middle-income households would add to the overall cost of harmonization to the Province. For example, a reduction in the first bracket personal income tax rate by 0.5% would cost $41 million.

While the offsets outlined above would cost $133 million, they are still less extensive than other offsets being implemented in Ontario and BC. Paralleling those offsets would increase the cost for Manitoba to harmonize.

IMPACT ON BUSINESS

Businesses would save under an HST in two main ways: input tax credits would reduce the amount of provincial sales tax payable, and their compliance costs would decrease from no longer having to deal with two tax administrations.

Businesses in Manitoba currently pay $670 million in Manitoba sales tax. Input tax credits would not be available for all sectors under an HST. The net savings to business would be $510 million.

The savings to Ontario businesses from a single administration were estimated at $500 million a year. This implies savings for Manitoba businesses of $40 million a year.

However, it should be noted that Manitoba has taken other important steps to reduce red tape and simplify the administration of RST, such as adopting a common Business Number with the CRA, reducing the frequency of filing for small business, introducing on-line filing and payment (TAXcess), reducing RST regulations by 44%, and eliminating registration and collection requirements for small home-based business.

Exempt versus zero-rated

Consumers do not pay GST/HST on a limited but important range of goods and services such as health-care services and groceries. However, there are two different methods of making items tax-free at the point of sale: they can be exempt or they can be zero-rated.

Exempt means no GST/HST is charged on a sale but the business is *not* entitled to input tax credits. In such cases, the financial impact on the service provider is likely to be passed on to the consumer in the form of higher prices. Examples of exempt services include financial services, residential rents, daycare services, legal aid services, most health and dental services, and most educational services.

Zero-rated means no GST/HST is charged on a sale but the vendor *is* entitled to input tax credits. Thus, there is no sales tax embedded in the price. Examples of zero-rated supplies include exports, groceries, prescription drugs, medical devices, agricultural products, and transportation services.

Sectoral Impacts

Ontario and BC are offering partial input tax credits only for the first eight years in order to phase-in some of the fiscal implications of harmonization. Input tax credits would be restricted for large businesses with annual sales over $10 million and financial institutions. For these companies, inputs tax credits would not be available for five years, and then phased-in over three years on: natural gas, motor vehicles under 3,000 kgs., motor fuels, telecommunications, electricity (except for farming and the production of goods), and meals and entertainment. Adopting the same approach in Manitoba would generate an estimated $60 million to $70 million in additional Manitoba revenue for the first five years after harmonization.

Since 1992, Manitoba has provided the 10% Manufacturing Investment Tax Credit (MITC) for manufacturers, a corporation income tax credit which more than offsets Manitoba’s 7% RST. Under an HST, input tax credits would replace the need for the MITC. Accordingly, under harmonization the MITC would be redundant and Manitoba corporation income tax revenue would increase by $20 million in the short term (as MITC credits earned but unused in prior years continue to get used up) and $28 million annually in the medium and long term.

Businesses which would begin applying provincial sales tax under HST

Some businesses provide services that are currently exempt from RST. While they would have to start charging a provincial sales tax to their customers, they would also benefit since they would no longer have to pay sales tax on their own purchases. For example, health and sports club memberships and fees are exempt from RST and subject to HST, but the equipment purchased by the clubs would no longer be subject to provincial sales tax.

Businesses which would continue to apply provincial sales tax under HST

Many businesses such as retailers would continue to charge consumers Manitoba sales tax on the same basis as before, but would benefit from not having to pay sales tax on their business inputs. While consumers would not experience any change in sales taxes charged under an HST in such businesses, the businesses themselves would benefit from input tax credits (no longer paying sales tax on inputs).

Businesses which would not qualify for input tax credits under HST

Some businesses would be worse off under harmonization because they provide exempt services and are therefore ineligible to claim input tax credits. They would pay more sales tax due to the expanded base of taxable items. Examples include: financial services, residential landlords, daycare services, private personal care homes and most non-institutional health and dental service providers.

Financial services are RST exempt but goods purchased as inputs in the provision of financial services are taxable. Under an HST, financial services are an exempt supply and financial service providers are not eligible for input tax credits. Since the HST base is broader than the RST base, more business inputs, particularly services, would be subject to provincial sales tax.

Financial services is broadly defined and includes most domestic transactions that involve financial instruments such as debt securities, equity securities, insurance policies, options, and guarantees. Financial institutions affected include banks, trust companies, traders or dealers in financial instruments, insurance companies, credit unions, and investment plans. Manitoba is home to the head offices of some major firms in this sector.

HST applies to the sale and rental of commercial real estate, including land and buildings. It also applies to the purchase of new buildings. As with new housing, HST on new commercial structures would be partly offset by the elimination of embedded RST.

Under an HST, medical services (for example, a physician in private practice) are an exempt supply. This means medical service providers (such as doctors) are not eligible to claim input tax credits on HST paid on their inputs. Since medical fees are regulated, the HST cannot be passed on to the users or purchasers of the medical services unless the regulated fees are adjusted. According to the Canadian Medical Association, the average cost of the 5% GST per medical doctor in Canada is about $1,000. Proportionately, a 7% Manitoba HST would equal about $1,400 per physician.

Other medical services not covered by provincial health care plans (optometry, dentistry, etc.) would also be affected in the same way, and practitioners in these fields would be expected to increase their fees. This could have cost implications for private health-care premiums and employer-provided health-care benefits.

Professional Services under an HST

Some but not all professional fees are subject to RST: legal, accounting, engineering design, security and private investigations and architectural design. A more comprehensive list of professional services is taxable under an HST, but professionals are eligible to claim input tax credits on HST paid.

Summary of Sectoral Impacts

The impact of an HST varies by sector. The following sectors would experience the largest savings under an HST (assuming full implementation without restrictions on Input Tax Credits):

- construction: $267 million, or 52% of total business savings
- manufacturing: $69 million (after replacing the Manufacturing Investment Tax Credit with an HST, the net tax savings to manufacturing would be $49 million in the short-term and $41 million in the medium and long term. See page 8)
- retail and wholesale trade: $64 million
- transportation and warehousing: $39 million
- farming: $18 million

Under harmonization, the health-care and social assistance sector would see its provincial sales taxes increase by $9 million and the finance, insurance, real estate, rental and leasing sector would see its provincial sales tax increase by $37 million.

For a more complete listing, see Attachment C: Manitoba Sales Tax Paid by Businesses.

Table 5 summarizes the estimated impact of HST on businesses, including the compliance cost savings ($40 million), the impact of partial input tax credits for up to eight years after harmonization ($65 million), and the impact of replacing the Manufacturing Investment Tax Credit.

Table 5 **Impact of a Manitoba HST on Businesses** ($ millions – ignores inflation and tax base growth)		
	Short Term	Medium & Long Term
Less sales tax paid by businesses	(510)	(510)
Lower compliance costs	(40)	(40)
Partial business input tax credits	65	nil
Replace Manufacturing tax credit	20	28
Net impact	(465)	(522)

Source: Manitoba Finance

Impact on Prices

Sales tax savings on business inputs can be:

- passed on to consumers as lower prices
- passed on to labour as higher wages
- reinvested in capital improvements or working capital
- retained as profits

A July 2007 report by Michael Smart on the impact of HST in the Atlantic Provinces concluded that overall consumer prices fell 0.3%, but rose somewhat for shelter, clothing and footwear, while investments in machinery and equipment experienced a short-run increase greater than 10%. These results, though empirical, should be interpreted cautiously because the adoption of HST in Atlantic Canada entailed not only a shift in tax bases but also a significant reduction in the average provincial sales tax rate from 12% to 8%. ("Lessons in Harmony: What Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax," C.D. Howe Institute)

On September 18, 2009, TD Bank released a special report, *The Impact of Sales Tax Harmonization in Ontario and B.C. on Canadian Inflation*. The study looked at the impact of harmonization on prices when the sales tax rate in a province is not reduced but the base is reduced for businesses and broadened for consumers. The study concluded that while the majority of business cost savings would be passed on to consumers, resulting in a 0.8% reduction in pre-tax prices, the effective tax rate on consumption would increase by 1.5 percentage points, resulting in a net permanent impact on prices of +0.7% in both Ontario and BC, and +0.4% nationally.

The TD Bank study is not necessarily an indicator of the impact on prices under a Manitoba HST. Compared to Ontario and BC, Manitoba's RST applies to a broader range of business inputs, suggesting the cost savings available to be passed on to consumers would result in a reduction in pre-tax prices that is greater than 0.8%. On the other hand, the Manitoba RST base is more closely aligned to the GST base on taxable goods and services than both Ontario and BC, suggesting that the effective tax rate on consumption would increase by less than 1.5 percentage points under a Manitoba HST. Combined, these two factors suggest that the price impact under a Manitoba HST would be less than what the TD study estimates for Ontario and BC.

Prices faced by consumers would likely rise in the short term as tax costs are shifted to consumers, but economic research suggests prices may eventually decrease by up to 1% as savings to business are passed on to consumers in the longer run.

TAX COMPETITIVENESS

Before examining the implications of an HST for business tax competitiveness, it is worth noting that our main trading partner, the United States, applies a welter of RSTs at the state and local level and does not have a VAT, like an HST.

There are various tools available to measure the business tax competitiveness of a jurisdiction. One tool that has been emphasized by proponents of sales tax harmonization is Marginal Effective Tax Rates (METRs).

According to the CD Howe Institute’s *2009 Federal-Provincial Tax Competitiveness Report*, harmonization would reduce Ontario’s METR on new business investment from 34% to 19% (this includes corporate income tax rate reductions announced together with harmonization). In BC, the improvement would be from 30% to 19%. In Manitoba, the current METR is 31% and would fall to about 19% under harmonization. If Manitoba does not harmonize, its METR would fall to 27% due to the elimination of the general capital tax by the end of 2010, but the weighted national average will fall from 28% to 19%, and so the extent by which Manitoba exceeds the national average will increase.

Although Manitoba’s overall METR is above average, the *2009 Federal-Provincial Tax Competitiveness Report* reports that Manitoba’s METR for manufacturing in 2009 is only 5.1% – less than one-third of the national average of 17.5%. In fact, the only provinces with a lower manufacturing METR are the Atlantic provinces, which benefit from the federal government’s Atlantic Investment Tax Credit. This is significant since manufacturing is one of the sectors most reliant on being competitive in export markets. It is also the largest sector in Manitoba, accounting for 12% of both GDP and employment, and so its competitive position is especially important.

Forestry is smaller, but regionally very important and, like manufacturing, highly exposed to competition in export markets. According to the *Tax Competitiveness Report*, Manitoba’s METR for forestry is 4.9% – less than half the national average of 10.8% and much lower than in any province west of Quebec.

The limits of METRs analysis are well understood. As economist Robin Boadway has explained: “METRs capture the effects of taxation on one margin alone, and that is the decision to invest in some capital assets. They do not capture the incentive for firms to hire labour (including the substitution of labour for capital), to innovate, to invest in knowledge, to train workers, or to engage in risky enterprises . . . . METRs also do not differentiate among industries according to their capital intensity, and therefore according to the magnitude of the distortion that may occur." (*Canadian Tax Journal*, 2007, Vol. 55, no. 1, p. 129)

A more comprehensive way assess tax competitiveness is to calculate all the taxes that would actually be paid by a sample company with specific characteristics. This is the approach used by KPMG in *Competitive Alternatives 2008 – Special Report: Focus on Tax*. This report compares business taxes in 102 cities in 10 countries. The results show Manitoba in a favourable light when compared to other countries. Most notably:

- Winnipeg has the 20th-lowest Total Effective Tax Rate (TETR) out of 102 cities;
- Winnipeg has the third-lowest effective Corporate Income Tax (CIT) rate out of 102 cities;
- most strikingly, Winnipeg has a lower effective CIT rate and a lower TETR than 58 out of 59 US cities in the study (only San Juan, Puerto Rico had a lower rate).

These results are more consistent with the observed positive performance of the Manitoba economy.

A similar approach is used in the Manufacturing Competitiveness Model maintained by Manitoba Finance (see *The Manitoba Advantage* budget paper in any Budget). The model simulates start-up, operating, financial and tax costs over a 20 year period for a manufacturing firm with revenue of $45 million and 220 employees. The company is assumed to be a Canadian-Controlled Private Corporation. The following charts were derived from the model.

Chart 1
Manitoba Manufacturing Competitiveness Model

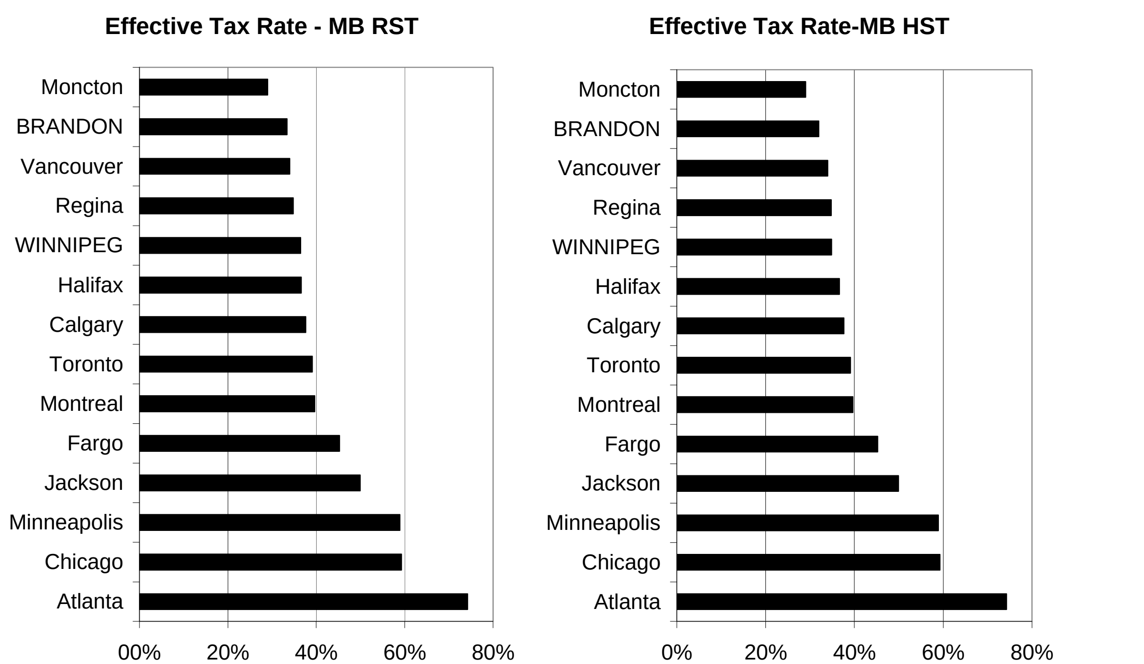


Chart 1 shows the effective overall tax rate for each of 14 Canadian and US cities, including Winnipeg and Brandon. The effective tax rate includes all relevant taxes, including payroll and local property taxes. The model incorporates the impact of switching from an RST to an HST in Vancouver and Toronto, including the associated corporate income tax changes in Ontario. The only difference between the two panels of Chart 1 is whether the existing RST or a new HST is assumed for the Manitoba cities. The panel on the left shows that, under the current RST, Brandon has the second-lowest effective tax rate while Winnipeg is fifth-lowest. The panel on the right shows that adoption of an HST to replace the existing Manufacturing Investment Tax Credit would reduce the effective tax rate somewhat – from 33.4% to 32.0% for Brandon and from 36.5% to 34.0% for Winnipeg – but not by enough to improve the rank of either relative to other cities.

Chart 2
Manitoba Manufacturing Competitiveness Model

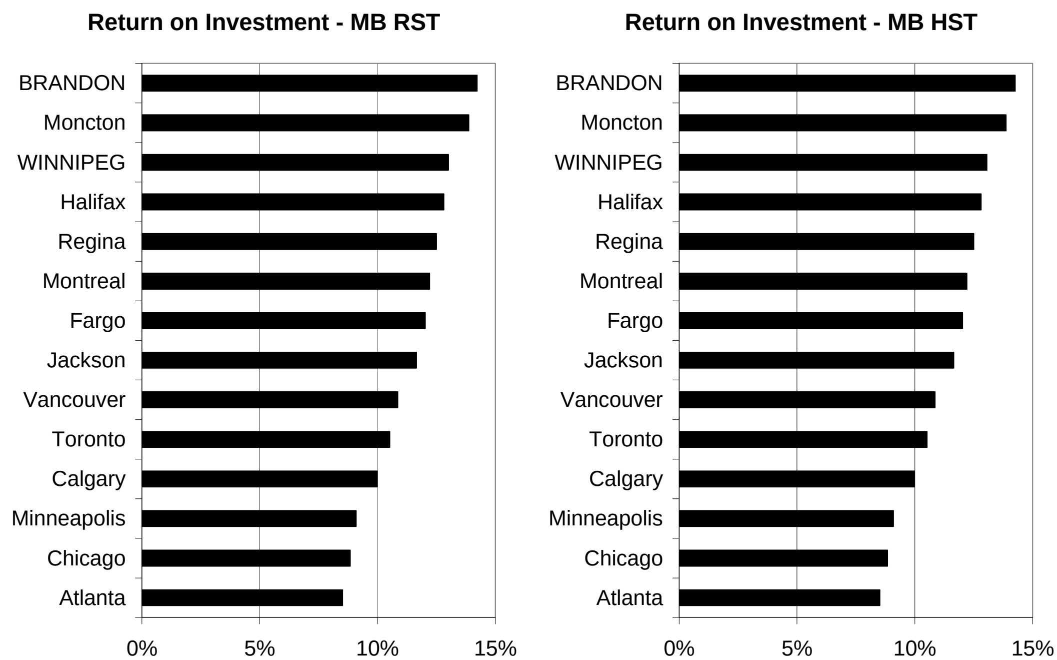


Chart 2 shows the return on investment (measured as Internal Rate of Return) when all taxes and costs are taken into account. Brandon and Winnipeg rank in the top three whether Manitoba keeps the RST or adopts an HST. For both cities the improvement in ROI is only one-tenth of one percent.

A similar sort of analysis is also available for the mining industry. PriceWaterhouse-Coopers recently released *Canadian Mining Taxation – 2009,* a study which compares the tax burden on a hypothetical mining operation in each of 11 Canadian provinces and territories. According to PWC, Manitoba has the second-lowest tax burden on mining at 19.0% (the range is from 17.0% to 28.4%).

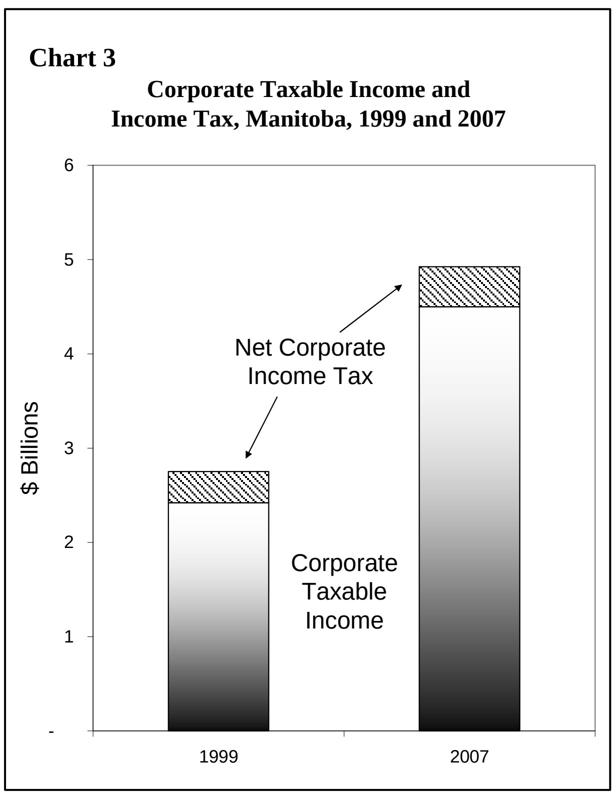
This overview of tax competitiveness measures suggests that no single measure of taxes should be relied upon to gauge the potential impact of sales tax harmonization. The METRs measure undoubtedly has some value, and two of Manitoba's most export-oriented sectors – manufacturing and forestry – have very low METRs. However, it would be wrong to infer from the overall METR that Manitoba's economy is performing below average since the opposite is true. In 2008, Manitoba led all provinces with a 12.6% increase in business capital investment. From 2000 to 2008, business investment in non-residential construction grew 87%, the strongest growth among provinces. Manitoba is also weathering the current recession better than most provinces.

Tax measures which capture the taxes actually paid by manufacturing businesses agree with the METRs measure that Manitoba has a competitive manufacturing environment and that harmonization, as a replacement for the existing Manufacturing Investment Tax Credit, would have a very modest benefit. In particular, it would not improve Manitoba's competitiveness ranking by even one rank.

Attachment C shows the potential savings to sectors from harmonization, grouped according to whether they are more or less exposed to export competition. It is notable that over half the savings to business accrue to one sector – construction – that is essentially non-traded. Of course, to the extent that these savings result in lower cost buildings, other sectors would benefit indirectly. Nevertheless, a large part of the savings to business will not directly or significantly improve the competitive position of the export sector.

In the end, it is important to look at all the taxes and costs faced by businesses when comparing jurisdictions. Focusing on harmonization ignores past efforts in Manitoba to provide significant business tax relief (over $400 million) in other ways over the last decade, especially for manufacturers and exporters. The main initiatives are as follows:

- eliminating the general corporation capital tax by the end of 2010;
- eliminating the small business income tax by December 2010;
- doubling the threshold of eligibility for the small business rate;
- reducing the general corporation income tax rate from 17% to 12%;
- increasing the R&D Tax Credit from 15% to 20%;
- making the Manufacturing Investment Tax Credit 70% refundable; and
- increasing the Health and Education Levy exemption threshold from $1 million to $1.25 million.



It is worth emphasizing the magnitude of the corporation income tax reductions. As shown in Chart 3, between 1999 and 2007 (the last year for which final data are available) corporate taxable income in Manitoba increased by $2.1 billion while Manitoba taxes on that income rose by only $93 million. Put another way, Manitoba businesses kept 95.6% of their income gains over the period (ignoring federal taxes, although they also went down). On top of this, the phase-out of the corporation capital tax is removing more than $100 million of tax from corporations. Accordingly, the after-tax income available for re-investment by Manitoba businesses has increased significantly. (The numbers above include both general corporation and small business income taxes. Net tax is gross tax minus tax credits.)

IMPACT ON PROVINCIAL FINANCES

In addition to the impact of an HST on business and consumers in Manitoba, including offsets discussed above, the following factors are also taken into account and built into an estimate of the fiscal impact of harmonization on the Province.

Impact on Public Sector Bodies: Municipalities, Universities, School Divisions and Hospitals (MUSH); Charities and Non-profit Organizations

HST provinces provide rebates to public sector bodies (municipalities, universities, schools, hospitals, charities and non-profit organizations) to ensure each sector is subject to the same overall amount of provincial sales tax on their non-commercial activities as before harmonization. Ontario and BC have decided to use “burden neutral” rebate levels. Manitoba could also adopt “burden neutral” HST rebates for each public sector at an estimated cost of $114 million.

Transitional Assistance

Ontario will receive transitional assistance of $4.3 billion and BC will receive $1.6 billion. For Manitoba, the one-time federal assistance would be worth about $344 million. This is less than the full-year cost to Manitoba of over $400 million once harmonization would be fully implemented after eight years.

The federal offer does not recognize the impact on provincial revenues varies widely, in part because of large differences in the existing RST bases, and in part because differences in economic structure give rise to differences in the amount of revenue that the HST generates in each province. Both factors increase the cost of harmonizing in Manitoba relative to other provinces – i.e. Manitoba generates more than other provinces from the RST base, and would generate less than other provinces from the HST base.

Net Fiscal Impacts

Table 6 details the estimated impact on Manitoba finances. It is important to note that this is just one example of how harmonization in Manitoba might be designed. It does not represent a decision of the Government of Manitoba, but is presented to illustrate the relative impact of the main features that are typically part of harmonization, including changes in the tax base, offsets, consequential changes and one-time federal compensation.

The highlights are as follows:

- Because the reduced tax on business inputs is greater than the increased tax paid by households, HST revenue is less than RST revenue by $134 million in the first year.

- For only the five years after implementation, limited restrictions on input tax credits that larger companies can claim (as in Quebec, Ontario and BC) would raise revenue by $65 million in year one, improving the net revenue reduction to $70 million.

Table 6
Fiscal Impact of Harmonization
($ millions)

	Year 1	**Year 2**	**Year 3**	**Year 4**
Gross change in sales tax revenue	(134)	(148)	(174)	(197)
Restricted Input Tax Credits for business*	65	68	72	75
Net change in sales tax revenue	(70)	(80)	(102)	(122)
Rebates/Exemptions				
New housing (for new home buyers)	(40)	(50)	(53)	(56)
MUSH, Charities, Non-profit Organizations	(114)	(121)	(126)	(133)
Books (exempt)	(6)	(6)	(7)	(7)
Children's clothing (exempt)	(11)	(11)	(11)	(11)
Home heating (exempt)	(17)	(17)	(17)	(17)
Other point-of-sale exemptions**	(2)	(2)	(2)	(2)
Total Rebates/Exemptions	(190)	(207)	(216)	(226)
Low-income HST Credit	(57)	(58)	(59)	(60)
Replace Manufacturing Inv. Tax Credit	20	21	22	23
MB Finance administration savings	12	12	12	13
Fiscal Impact before federal assistance	(285)	(312)	(343)	(372)
One-time federal assistance	285	59	nil	nil
Net Fiscal Impact	nil	(253)	(343)	(372)

* After five years, restricted Input Tax Credits would be phased out over the next three years.
Note: Year 1 is based on data for 2010.
** Other exemptions are children's car seats and car booster seats, diapers and feminine hygiene products. Approximately $39 million in additional point-of-sale exemptions could be provided under the 5% deviation from the GST base permitted by the federal government.
Source: Manitoba Finance

- Adopting Manitoba tax-neutral rebates and point-of-sale exemptions similar to Ontario and BC would cost $190 million.
- A low-income credit that would completely offset the impact of HST for low-income households would cost $57 million.
- The Manufacturing Investment Tax Credit offsets RST and could be replaced for a net saving of $20 million.
- Administrative savings in Manitoba Finance would be about $12 million.
- The total fiscal impact before any federal assistance would be a loss of $285 million in year one.
- One-time federal compensation would be worth $344 million. This would entirely offset the loss in the first year only. After year two, with the one-time compensation used up, the net loss would be over $300 million annually.
- Once input tax credits for businesses are no longer restricted (after year eight), the annual fiscal cost to the Province would be at least $400 million. For example, if restricted ITCs were eliminated in year four in the table below, the net annual fiscal cost to Manitoba would be -$447 million (-$372 million and $75 million in restricted input tax credits for business).

Revenue Flexibility

The federal government already controls the personal and corporate income tax bases, that is, it determines how taxable income is to be calculated. With harmonization, the federal government would also determine the sales tax base (with limited exceptions). As a result, taxes bases from which Manitoba derives 75% of its own-source revenue would be controlled by the federal government. Manitoba would only retain control over tax credits and rebates.

Under the federal-provincial HST memorandum of agreement with Ontario and BC, the federal government can make changes to the HST base impacting up to 1% of provincial HST revenue ($15 million under a Manitoba HST) without consulting HST provinces. Also, under the federal-provincial HST MOA, provinces agree not to increase or decrease the provincial HST rate for two years after implementation.

WHAT WE HAVE HEARD FROM MANITOBANS

Since media coverage of the federal invitation to harmonize began, the Province has received, formally and informally, a significant expression of views on the HST from individuals, businesses and other organizations.

Correspondence from individual citizens and municipal governments has been almost uniformly opposed to an HST.

Some organizations in the not-for-profit and charitable sectors have expressed strong concerns about the potential negative impacts of an HST on their operations.

Many businesses and business associations, particularly in the financial, restaurant/food service, real estate and small business sectors, have expressed their opposition to harmonization. This includes some businesses represented by organizations that have expressed support for harmonization.

Even where businesses and business associations have expressed support for harmonization, all but one have made their support conditional on the provision of exemptions/rebates for their sector or on the implementation of offsetting tax reductions. For example, the Winnipeg Chamber of Commerce has publicly advocated for harmonization if it is accompanied by a long list of offsetting exemptions, tax credits and tax reductions, the cost of which would far exceed the basic offset package assumed in this analysis.

This pattern is consistent with the recent harmonization experiences in BC and Ontario, where strong and continuing business lobbies have resulted in the announcement of additional exemptions beyond those initially announced. Although such offsets would dilute the stated advantages of harmonization, they have not generally been taken into consideration by analyses that have been presented to support harmonization.

POSITION OF THE MANITOBA GOVERNMENT

The Global Economic Context

The call to harmonize provincial retail sales taxes with the federal GST comes at a time when a global recession has created a situation of economic uncertainty across Canada. <u>Manitoba recognizes that the pace of the global economic recovery continues to be slow and that any decision to harmonize must be considered with particular attention to this economic reality.</u>

The Impact on Consumers

A key conclusion of this analysis is that Manitoba consumers would face $405 million in additional sales tax costs under an HST as the sales tax burden shifts from businesses to consumers. The Province is concerned about the potential impact that this increased sales tax burden could have on Manitoban's resilient consumer confidence. A recent survey found that, despite the slow pace of the global economic recovery, consumer confidence in Manitoba is growing, rising to levels not seen in several years (Prairie Research Associates, October 29, 2009).

Manitoba does not support harmonization at this time because of the potential risk to the economic recovery and the burden it would place on Manitoba families at a time of economic uncertainty.

The Impact on Businesses

A key conclusion of this analysis is that, although the impact on business varies greatly by sector, harmonization can have some positive overall benefits for the economy, particularly for exporters. However, the analysis finds that the competitiveness gains, particularly for those sectors exposed to export competition, are very modest:

- It notes that the relative tax competitiveness ranking of Manitoba manufacturers against other competing cities would not improve with an HST.
- A very large part of the savings to business would not directly or significantly improve the competitive position of the export sector.
- Sales taxes in the US are imposed as RSTs rather than as value added taxes like the HST.

Manitoba notes that sales tax harmonization is just one dimension of overall tax competitiveness and must be considered in the context of other tax measures. It is important to remember that over the past decade, Manitoba has announced more than $400 million in tax relief for Manitoba businesses. This includes reducing the capital tax on non-financial institutions and eliminating it at the end of 2010, increasing the R&D Tax Credit, reducing the general corporate income tax rate from 17% to 12%, and completely eliminating income tax for small business in 2010.

The Province believes Manitoba business can continue to be supported with tax relief that does not burden consumers with the increased costs of an HST. Manitoba Finance will continue to monitor and evaluate the implementation of the HST in other provinces over the eight-year implementation period.

The Impact on Provincial Finances

This analysis finds that the HST would be a net cost to the Province of more than $400 million annually, once fully implemented, assuming there is a basic package of exemptions and offsets to cushion the impact on Manitobans. As such, it would be the single most costly tax measure undertaken in decades in Manitoba. Further, this annual cost to Manitoba would exceed the amount of one-time federal compensation that would be available to Manitoba.

Given the negative impact of the global recession on Manitoba finances, the Province believes it would be imprudent to undertake the costs of implementing an HST in the current context.

Attachment A

MANITOBA RST-EXEMPT GOODS AND SERVICES SUBJECT TO HST

Goods

- New housing *(partially offset by a rebate)*
- Gasoline and diesel fuel
- Home heating products (electricity, natural gas, wood)
- Children's clothing and footwear *(exempt under HST in ON and BC)*
- Books *(exempt under HST in ON and BC)*
- Feminine hygiene products *(exempt under HST in ON and BC)*
- Vegetable and fruit plants, seeds and trees
- Organic fertilizers and topsoil
- Smoking cessation products

Services

- Personal services
    - hairdressing
    - manicures and pedicures
    - skin care
    - tanning
    - tattooing
    - piercing
    - hair removal/augmentation
    - cosmetic procedures
    - spa services
- Construction services to real property (land and houses excluding mechanical/electrical systems)
    - Excavation, basements, foundation, piles and waterproofing
    - Concrete and asphalt work
    - Roofing and shingling including vents
    - Eaves troughs, soffits and fascia
    - Stucco, siding, plastering and other exterior finishing
    - Fencing and decks
    - Insulation
    - Masonry work
    - Drywall and paneling
    - Painting (interior/exterior homes/garages/fences)
    - Doors and windows including hardware and millwork
    - Flooring
    - Framing
- Real estate agency fees
- Funeral services
- Postal services

- Investment services, (portfolio management fees), financial planning, tax/estate planning
- Transportation (taxi, bus, rail, air, courier and delivery)
- Moving and storage
- Parking
- Entertainment services (admission to theatre, movies, circus, fairs, sporting events, concerts, parks, zoos)

Attachment B

OVERALL IMPACT OF HARMONIZATION ON SAMPLE HOUSEHOLDS

The following table shows the estimated impact of an HST on various family profiles, taking into account the embedded or indirect RST paid currently as well as the point-of-sale exemptions listed above, a new housing rebate and a low-income credit. Note that the exemptions and the rebate are implicit in columns C and D, and are not shown explicitly.

Column D shows that the approximate gross increase in sales tax would range from $60 at an income of $15,000 to $340 at $85,000 income. For a near-average income of $60,000, the increase is $240. Column H shows that the HST Credit would fully offset the extra tax at lower incomes. For high-income households there would be a significant increase in tax. For example, a single taxpayer at $85,000 would pay an extra $340 a year in sales tax.

Note that this analysis assumes that consumers get the full benefit of price reductions that result if businesses pass along the savings from the removal of embedded sales tax, (that is, the HST is compared to Column B, “Total RST” rather than Column A, “Direct RST”).

Table B1
Impact of HST on Households, Including Offsets

	Manitoba Sales Tax Paid				HST Credit			
	Direct RST	**Total RST**	**HST**	**Increase Due to HST**	**HST Credit**	**Loss of FTB & PTC**	**Net Benefit**	**Change in Sales Tax after HST Credit**
	A	B	C	D=C - B	E	F	G=E - F	H=D - G
Single @ $15,000	$154	$205	$265	$60	$230	($122)	$108	($48)
Single @ $20,000	$205	$273	$353	$80	$180	($29)	$151	($71)
Single @ $30,000	$308	$410	$530	$120	$80	$0	$80	$40
Single Parent @$30,000	$400	$532	$652	$120	$460	($244)	$216	($96)
One-Earner Family of 4 @ $40,000	$865	$1,150	$1,310	$160	$810	($694)	$116	$44
One-Earner Family of 4 @ $60,000	$1,169	$1,555	$1,795	$240	$610	($457)	$153	$87
Two-Earner Family of 4 @ $60,000	$1,169	$1,555	$1,795	$240	$685	($609)	$76	$164
Two-Earner Family of 5 @ $75,000	$1,563	$2,079	$2,379	$300	$0	$0	$0	$300
Graduate @ $50,000	$515	$685	$885	$200	$0	$0	$0	$200
Single @ $85,000	$873	$1,161	$1,501	$340	$0	$0	$0	$340
Single @ $110,000	$1,130	$1,502	$1942	$440	$0	$0	$0	$440

Source: Manitoba Finance

Attachment C

MANITOBA SALES TAX PAID BY BUSINESSES

	Tax Paid		
	HST*	**RST**	**Difference**
	($ millions)		
Sectors which compete more in export markets			
Manufacturing **	$0	$69	-$69
Transportation and Warehousing	12	51	-39
Wholesale Trade	0	30	-30
Information and Cultural Industries	3	23	-20
Professional, Scientific and Technical Services	0	19	-19
Crop and Animal Production	0	18	-18
Accommodation and Food Services	0	13	-13
Mining and Oil and Gas Extraction	0	11	-11
Utilities	3	9	-6
Forestry and Logging	0	2	-2
Fishing, Hunting and Trapping	0	1	-1
Support Activities for Agriculture and Forestry	0	1	-1
Sectors which compete less in export markets			
Construction	$0	$267	-$267
Retail Trade	0	34	-34
Other Services (except Public Administration)	0	13	-13
Admin. and Support, Waste Mgmt & Remediation	0	8	-8
Arts, Entertainment and Recreation	4	7	-3
Educational Services	0	1	-1
Health Care and Social Assistance	27	18	+9
Finance, Insurance, Real Estate, Rental and Leasing	111	74	+37
Total paid by businesses	$160	$670	-$510

"Sectors which compete more in export markets" are those for which exports exceed 25% of total supply.

* The HST column does not reflect the temporary restriction of Input Tax Credits on selected items for larger businesses. See page 6.

** After replacing the Manufacturing Investment Tax Credit with an HST, the net tax savings to manufacturing would be $49 million in the short-term and $41 million in the medium and long term. See page 6.

Sources: Manitoba Finance and Manitoba Bureau of Statistics

Sources

Much of the analysis in this paper is based on taxation and related data available internally in Manitoba Finance. For household impacts, the Statistics Canada *Survey of Household Spending in 2007* was also used. Business and sectoral impacts are based on Statistics Canada *Input-Output Tables*. Where needed, numbers were projected forward based on economic forecasts for Manitoba from the Conference Board of Canada.