

The Potential Impacts of Sales Tax Harmonization on the Housing Sector in British Columbia

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EXECUTIVE SUMMARY

The Canadian Home Builders' Association of British Columbia approached Altus Group Economic Consulting to provide an analysis of the potential impacts of sales tax harmonization on B.C.'s housing sector and to provide options for the provincial government to pursue that would help mitigate these impacts.

The residential construction sector (new and renovation construction activities) represents a significant portion of investment activity in British Columbia. With the recently announced proposal for sales tax harmonization in B.C., this discussion comes at a critical time for this important sector.

The main finding of this report is that tax harmonization will not be revenue neutral with respect to housing investment. Harmonization will introduce sharply higher taxes on new housing and renovation investment, which will have far-reaching negative economic and equity implications for B.C..

New Housing Investment

- Harmonization will reduce new housing demand and thus the volume of new housing activity, which will be deleterious to economic activity and employment growth in B.C.;
- Some 57% of owners of newly-built homes in B.C. own homes valued over \$400,000. Thus, the vast majority of potential new home buyers will be subject to sharp tax increases once the new tax is implemented;
- B.C has a wide housing price distribution, with large variations in median price by area within the province. The sharp tax increases on homes priced above \$400,000 will introduce significant regional disparities. Generally, denser areas like Vancouver will shoulder the majority of the new tax burden. Effectively, this new tax will be a tax on density – running contrary to provincial efforts to promote more compact patterns of development;
- The median housing price in B.C. is \$437,575. A significant proportion of new home buyers in B.C. will not qualify for a full rebate under the proposed HST;
- Over half (approximately 60%) of owners of newly-built homes in B.C. that are valued over \$400,000 have total household incomes

below \$100,000. These households can be considered “middle class.” The new tax burden will be disproportionately borne by the middle class; and

- The additional tax on new housing through the proposed HST will further stress middle-income, middle-class families, who have already been battered by the rising cost of living and the current economic recession.

Based on the 2006 census findings for the number of newly-built, owner-occupied homes in B.C. by value, the introduction of the proposed tax would generate some \$165 million in additional revenues for the provincial government from new ownership housing alone – based on 2009 dollar values. This number is expected to increase dramatically to some \$298 million in 2019, due to the effects of normal housing price appreciation. In the absence of a formula to index the threshold values for the HST rebates, the tax burden on B.C.’s middle class will rise dramatically over time.

Renovation Investment

The proposed HST will also have significant impacts on the province’s renovation sector, including:

- Under the new proposed HST in B.C., the 7.0% of the provincial sales tax will be newly applied to the contractor’s labour and overhead costs, which accounted for approximately \$3.0 billion of investment by home owners and rental housing providers in B.C. in 2008;
- This will increase the tax burden on homeowners and rental housing investors by some \$212 million, based on 2008 dollars; and
- The aggregate provincial taxes levied on contractor renovations will rise from the existing \$104 million to \$316 million – a three-fold increase.

Tripling the sales tax rate on contractors’ renovations will have profound adverse consequences on the way renovation activity is performed and will create long-term negative effects on B.C.’s economy and the existing housing stock:

- Harmonization will reduce the volume of renovation activity by contractors, which will be deleterious to economic activity and employment growth in the province;

- Harmonization will shift contractor renovation activity into the “underground economy”, with a loss of existing income and sales tax revenues; and
- Harmonization may shift more renovation and repair jobs from contractor assignments to do-it-yourself projects. The lower renovation activity and a shift to do-it-yourself work could have longer-term negative consequences for the quality and maintenance of the existing housing stock.

To minimize potential negative impacts of the proposed HST in B.C., this report provides several policy ideas for the provincial government to consider, including:

- The threshold for full tax rebate eligibility on new housing must include a provision of indexation to the New Housing Price Index from Statistics Canada to ensure that it continues to reflect changes in housing prices, thereby protecting housing affordability over time;
- The threshold for full tax rebate eligibility in B.C. should be much higher than the proposed \$400,000, due to the relatively higher housing values in the province relative to the rest of Canada;
- The federal government initially based the GST/HST New Housing Rebate program on the concepts of fairness and minimizing market impacts. To be consistent with these, this report suggests the threshold for full rebate eligibility of B.C.’s HST be around \$890,000, which would be consistent with the threshold for full GST rebate eligibility in 1991 when the GST was first introduced; and
- To reduce the proposed HST’s potential impacts on residential renovation investment, the Province could reduce the rate of the HST applied to contractor renovations. For B.C., the tax rate for residential renovation contracts that would be considered revenue neutral is 2.3% for the provincial component of the proposed HST.

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INTRODUCTION

The Canadian Home Builders' Association of British Columbia approached Altus Group Economic Consulting to provide an analysis of the potential impacts of sales tax harmonization on the province's housing sector and to provide options for B.C. to pursue that would help mitigate these impacts.

The residential construction sector (new and renovation construction activities) represents a significant portion of investment activity in British Columbia. With the recently announced proposal for sales tax harmonization in the province, this discussion comes at a critical time for this important sector.

HARMONIZATION TAX BACKGROUND

The federal government introduced the Goods and Services Tax (GST), which is a value-added consumption tax, in 1991. Since the introduction of the GST, the federal government has pursued an objective to see provinces harmonize their own sales taxes with the GST into a Harmonized Sales Tax (HST). For the most part, Canadian provinces (with the exception of Alberta) levy consumption taxes. Several provinces have adopted a form of HST since the introduction of the GST including Newfoundland, Nova Scotia, PEI, New Brunswick, and Quebec.

According to the Canada Revenue Agency, a Harmonized Sales Tax (HST) is composed of the federal GST and the provincial sales tax, and applied generally to the same base of goods and services that are tabled under the GST. An HST follows the same general rules as the GST.

The Ontario government announced in its 2009 Budget proposed tax reforms, which include the elimination of the Ontario Retail Sales Tax (RST) and the adoption of a value-added tax harmonized with the federal GST – Ontario refers to this proposed new tax as the Ontario Single Sales Tax (SST).

To keep the cost of capital investment competitive, the B.C. government recently announced its intention to replace its existing 7% provincial sales tax with an HST.

There are reasonable grounds to believe that the remaining provinces (with the exception of Alberta that levies no provincial sales tax at present) will

take Ontario and B.C.'s recent decisions to heart and begin looking seriously at the possibility of harmonizing sales taxes.

- Firstly, Ontario and B.C. could expect to improve their competitive business environment considerably through the elimination of their existing provincial sales taxes, which currently imposes inefficiencies on production through taxation of machinery and equipment investment. With the two recent announcements, Manitoba and Saskatchewan remain the only two provinces with no comprehensive consumption tax that covers a broad range of goods and services at the provincial level. These provinces may need to consider a similar move to stay competitive. Under pressure, Manitoba's Ministry of Finance has recently suggested they are potentially considering the move.
- Secondly, in these current fiscally-difficult times, provinces may be admiring the \$4.3 billion in incentive payments promised by the federal government to Ontario and \$1.6 billion to B.C. as a result of their recent decisions to pursue harmonization.

While the proposed tax reform measures in Ontario and B.C. are said to be "revenue neutral" (i.e., generally raising the same amount of provincial tax as their predecessors), they are unequivocally not revenue neutral in the important area of housing investment. The proposed Ontario SST of some 13% (8% provincial and 5% federal), and the proposed B.C. HST of some 12% (7% provincial and 5% federal), would apply to the final price all new homes and renovations.

At present, only the federal GST is applied to purchases of new homes and renovations (with partial rebates in certain circumstances). There is a provincial retail sales tax (RST) component for both. RST is charged to building materials used in new home construction and renovation, and thus are embedded in the final price. However, the labour cost and overhead components of residential renovation investment are generally not taxed under the current RST in Ontario and B.C.

There is a significant risk that moving to a harmonized sales tax (which could unintentionally increase tax on housing investment) will impose undue harm on the housing sector:

- Housing investment (new housing construction and renovation activity) involves the formation of capital assets;
- Taxing new housing investment creates both equity and efficiency distortions. It also discourages investment in housing by individuals; and
- Taxes on renovation activity in particular can cause significant amounts of activity to move into the “underground economy”, ultimately leading to lost tax revenue for governments as well as warranty and other protection issues for homeowners.

To mitigate these risks, the federal government provides partial GST rebates for new housing investment in certain circumstances. In provinces that have adopted an HST, a similar tax and rebate structure is used. The following summarizes the treatment of housing investment under the federal GST:

- The GST was introduced in 1991 to replace the largely hidden Manufacturers Sales Tax (MST). The tax was introduced at 7% in 1991 and later reduced to 6% and 5% in 2007 and 2008 respectively;
- Partial rebates are applied to residential investment. The New Housing Rebate (NHR) provides a refund of 36% of the GST paid on new homes and substantial renovations priced below \$350,000. The rebate is phased out for new homes priced between \$350,000 and \$450,000. There is no rebate for homes above \$450,000;
- The federal government provides a rebate on the GST paid for “substantial renovations” which are defined as:

the renovation or alteration of a building to such an extent that all or substantially all of the building that existed immediately before the renovation or alteration was begun, other than the foundation, external walls, interior supporting walls, floors, roof and staircases, has been removed or replaced where, after completion of the renovation or alteration, the building is, or forms part of, a residential complex.¹

Residential renovation investment accounts for spending of some \$53 billion annually in Canada and in reality, a tiny percentage of this investment qualifies for the GST rebate; and

- The federal government introduced the New Residential Rental Property Rebate (NRRPR) in 2000 with enhancements in 2006 and 2008. The NRRPR provides rebates for qualifying rental units on a

similar basis to the NHR (i.e., rebates of up to 36% of the GST paid, and thresholds of \$350,000 and \$450,000 respectively.) The thresholds apply to each qualifying unit within a multi-unit structure.

Ontario also introduced the concept of rebates for new housing investment in the proposed Ontario SST, albeit on a much more limited basis than the federal rebates:

- Ontario proposes to provide a 75% rebate for the provincial portion of the SST on homes sold below \$400,000. For homes priced at \$400,000 and above, the Province proposes a flat rebate of \$24,000 per home. The 75% rebate (which is equivalent to 6 percentage points of the 8% provincial portion of the proposed HST) was determined based on research by CMHC suggesting that the embedded RST in new housing was approximately 2% (based on 8% RST applied to the building materials used);
- In the case of rental accommodation (purpose-built rental or other newly-built dwellings purchased for the purposes of rental) the same rebate rules apply based on the price or value of the rental dwelling; and
- Ontario's proposal provides a rebate for "substantial renovations" on the same basis as the GST.

PROPOSED HST IN B.C.

The recently announced HST in B.C. will replace the current 7% provincial sales tax. Some details of the proposed HST and rebate structure include:

- The proposed B.C. HST would take effect on July 1, 2010, and amount to a 12% HST on a broad array of goods and services, including all new homes sold in B.C. The HST is to be composed of a 7% provincial portion and a 5% federal portion;
- For homes priced below \$400,000, buyers will be eligible for a tax rebate of some 71.4% of the provincial portion of the tax paid – or the equivalent of 5 percentage points of the provincial portion of the HST;
- The effective tax rate, for the provincial portion of the HST, for homes under \$400,000 is 2%;

- The provincial government has said that currently approximately 2% of the price of a home is “embedded PST” – that is, embedded taxes that were paid in building materials and other provincially taxable inputs into the construction process. On this basis, the Province claims that buyers of homes priced under \$400,000 will be more or less revenue neutral, as the price of the home will go down by the 2% (once the PST is no longer embedded) and then up by 2% with the new tax;
- Homes priced over \$400,000 are taxed at a rate of 7% with a flat rebate of \$20,000 per home;
- Essentially, homes priced over \$400,000 will face effective tax rates for the provincial component that are higher than 2% - thus will not be revenue neutral to the current situation (of 2% embedded tax); and
- There is no proposed rebate for spending on residential renovations

B.C HOUSING MARKET OVERVIEW

MOST NEWLY-BUILT, OWNER OCCUPIED HOMES IN THE PROVINCE ARE VALUED ABOVE \$400,000

Figure 1 describes the distribution of newly-built owner-occupied homes (defined as homes built between 2001 and 2006) in B.C., based on data from the 2006 Census:

Figure 1

Distribution of Newly-Built, Owner-Occupied Housing By Value British Columbia

Total Home Sales by Price Range ¹						
	Total			Single-Detached		
	% Distribution			% Distribution		
Under \$75,000	2.0%			1.7%		
\$75,000 to \$99,999	0.6%			0.7%		
\$100,000 to \$124,999	0.8%			0.8%		
\$125,000 to \$149,999	0.9%			0.7%		
\$150,000 to \$174,999	1.5%			1.2%		
\$175,000 to \$199,999	1.6%			1.1%		
\$200,000 to \$224,999	2.6%			1.6%		
\$225,000 to \$249,999	2.4%			1.2%		
\$250,000 to \$274,999	5.7%			3.2%		
\$275,000 to \$299,999	3.5%			2.3%		
\$300,000 to \$349,999	12.8%			9.8%		
\$350,000 to \$399,999	8.4%			8.0%		
\$400,000 to \$499,999	18.1%	18.1%		19.5%	19.5%	
\$500,000 to \$749,999	23.9%	23.9%		27.9%	27.9%	
\$750,000 to \$999,999	7.9%		57.2%	10.1%		67.8%
\$1,000,000 or more	7.2%	15.2%		10.3%	20.4%	

¹ Adjusted to 2009 dollars based on the New Housing Price Index

Source: Altus Group Economic Consulting based on data from Statistics Canada, the 2006 Census

- Some 57% of owners of newly-built homes in B.C. own homes valued at \$400,000 and above. This is much higher than the proportion in Ontario. Just under a quarter of newly-built homes in B.C. are valued between \$500,000 to \$750,000;
- The share of single-detached homes with value of \$400,000 or above is even higher, accounting for 68% of newly-built, owner-occupied single-detached homes in B.C. More than a quarter of newly-built, owner-occupied single-detached homes in the province are valued between \$500,000 to \$750,000; and
- Under the proposed HST, a significant number of new home buyers in B.C., therefore, will not qualify for a full tax rebate.

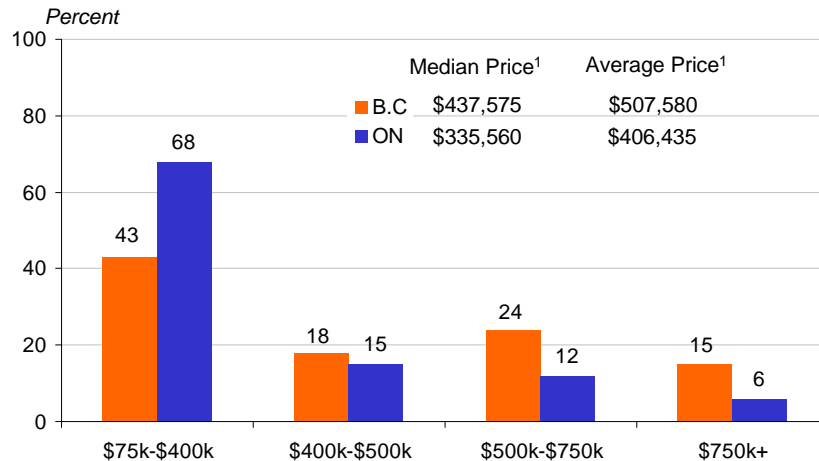
B.C.'S HOUSING MARKET HAS A WIDER PRICE RANGE

The housing price distribution in B.C. is wider than in Ontario (Figure 2):

- The majority (68%) of newly-built, owner-occupied housing units are valued under \$400,000 in Ontario, significantly higher than in B.C. The housing price distribution in Ontario is skewed to the left (i.e. housing price is concentration at low price levels);

Figure 2

Distribution of Newly-Built, Owner-Occupied Housing By Value, British Columbia and Ontario¹



¹ Adjusted to 2009 dollars based on the New Housing Price Index.

Source: Altus Group Economic Consulting based on data from Statistics Canada the 2006 Census

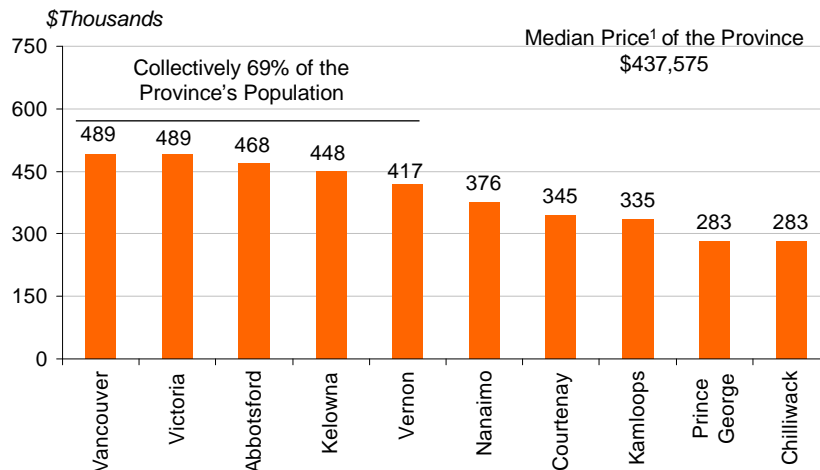
- British Columbia, on the other hand, has a wider housing price distribution than Ontario – more than half of the newly-built, owner occupied housing units are priced above \$400,000 and fairly evenly distributed among the three high price categories;
- The median housing price in B.C. is some 30% higher than in Ontario – half of the newly-built housing units in B.C. are valued above \$437,575. As a result, a significant proportion of new home buyers (approximately 57%) in the province will not qualify for a full rebate under the proposed HST tax; and
- The average housing price in B.C. is about 25% higher than in Ontario – on average, it costs residents in B.C. approximately \$507,580 to purchase a house. This is also significantly higher than the proposed HST new housing rebate threshold.

MOST HOMES IN B.C.'S LARGEST URBAN CENTRES ARE PRICED ABOVE \$400,000

Figure 3 illustrates the median newly-built, owner-occupied housing values in each of the 10 largest metropolitan areas (by population) in B.C.:

Figure 3

Median Values¹ of Newly-Built, Owner-Occupied Housing, the Largest 10 Urban Centres by Population in British Columbia



¹ Adjusted to 2009 dollars based on the New Housing Price Index.

Source: Altus Group Economic Consulting based on data from Statistics Canada the 2006 Census

- These 10 housing markets, together, represented approximately 82% of the province's new housing market during the 2001-2006 period;
- Vancouver and Victoria, the two largest new housing markets in B.C., have the highest median new housing price, about \$489,000. Another three urban centres in the province have a median new housing price above \$400,000 – Kelowna, Abbotsford and Vernon;
- These five urban centres, which have a median new housing price above \$400,000, accounted for 72% of the province's new housing market during the 2001-2006 period;
- This shows that half of the new homes in these markets are priced well above the proposed HST new housing rebate threshold. As a result, the vast majority of new home buyers in these markets will not qualify for a full tax rebate, and thus, will be subject to higher taxes;
- Median prices in other smaller urban centres are relatively lower compared to those five – Prince George and Chilliwack have the lowest median new housing prices among the largest 10 urban centres in the province; and
- Due to these price and market size differences, a disproportionate share of the additional sales tax burden will be carried by new home

buyers in the largest urban centres of the province under the proposed HST.

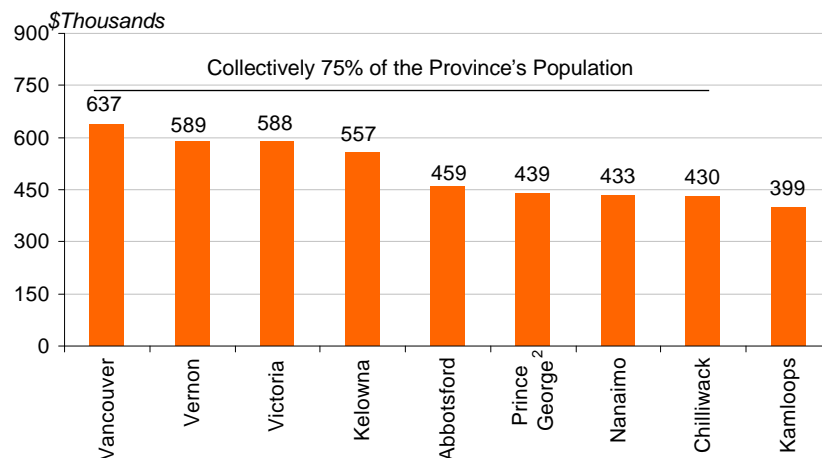
RECENT MARKET DATA CONFIRM THAT A SIGNIFICANT PROPORTION OF B.C.'S NEW HOUSING UNITS ARE VALUED ABOVE \$400,000

The more recent actual sale prices of new housing units in some largest urban centres in B.C. confirm that a large share of the province's new housing market is priced above \$400,000.

Figure 4 illustrates median values of newly completed and absorbed single- and semi-detached homes in the largest nine urban centres in B.C.:

Figure 4

Median Values¹ of Newly Completed and Absorbed Single- and Semi-Detached Homes, the Largest 9 Urban Centres by Population in British Columbia



¹ Based on median absorbed price in May 2009 from CMHC.

² The latest data available for Prince George is from March 2009.

Source: Altus Group Economic Consulting based on data from CMHC and Statistics Canada, the 2006 Census

- With the exception of Kamloops, all of the other 8 largest urban centres have an median price of newly-built single- and semi-detached homes well above \$400,000; and
- Typically, a large share of occupants of single- and semi-detached homes comprises couples with children. This implies that those families will be the hardest hit by the proposed HST tax. This will further strain the household finances of those families and may force

some families to live in smaller houses, which may be inadequate in size.

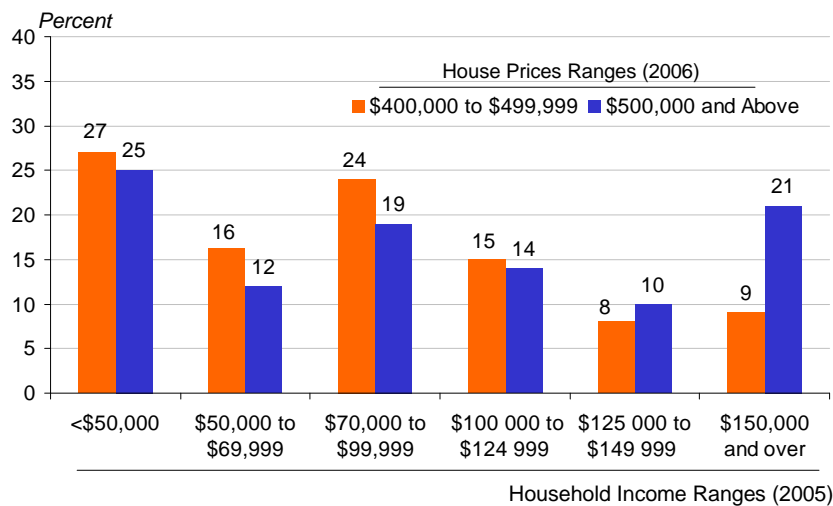
MANY HOUSES OVER \$400,000 IN B.C. ARE HOMES FOR TYPICAL FAMILIES

Homes over \$400,000 are not exclusively owned by very wealthy residents in B.C.:

- Among owners of newly-built homes in the province that are valued at \$400,000 and above, a significant number of households could be classified economically as “middle class” or below;
- Some 39% of owners of newly-built homes in B.C. that are valued at \$400,000 and above have total family incomes of \$70,000 or less;
- The share is even higher for newly-built homes valued between \$400,000 and \$500,000 – about 44 % of owners of those homes have total family incomes of \$70,000 or less (Figure 5);
- Over half (approximately 60%) of owners of newly-built homes in B.C. that are valued at \$400,000 or above have total household incomes below \$100,000;

Figure 5

Distribution of \$400,000 and up Homes in British Columbia by Average Household Income, 2006



Source: Altus Group Economic Consulting based on data from Statistics Canada the 2006 Census

- Households with incomes in these ranges (below \$100,000 and certainly below \$70,000) are solidly middle-class. Households in these categories with two incomes are generally well below the highest tax brackets in B.C.;
- As an illustration, such a household could be composed of a forestry-sector worker (average annual earnings \$45,000) and an elementary school teacher (average annual earnings \$51,000). This is the demographic that will be asked to bear the additional tax hit in B.C. under the proposed tax; and
- The additional tax on new housing through the proposed HST will further stress these middle-income, middle-class families, who have already been battered by the rising cost of living and the current economic recession.

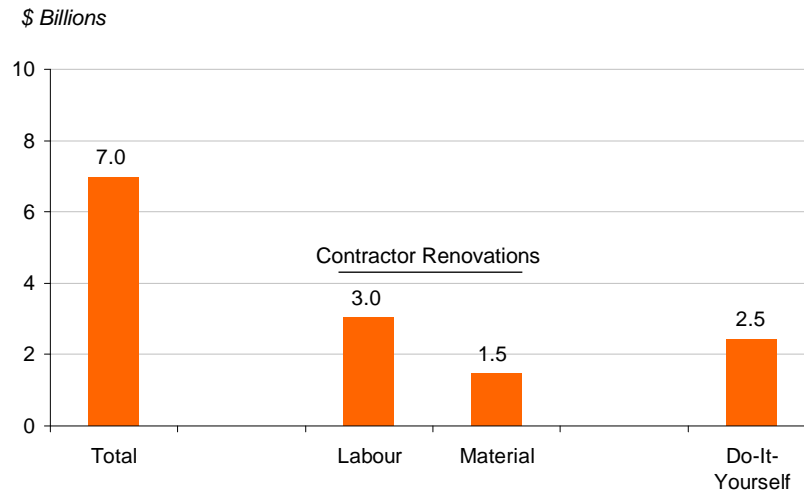
B. C. RESIDENTIAL RENOVATION MARKET OVERVIEW

In 2008, total household investment in home repairs and renovations totalled just under \$7 billion in B.C., representing some 13% of total residential renovation investment in Canada (Figure 6):

- Of the \$7 billion, approximately \$4.5 billion was spent through contractor renovations (i.e. repairs and renovations are done through a contractor). The remaining \$2.5 billion is accounted for by the “do-it-yourself” (DIY) sector (i.e. repairs and renovations done by homeowners themselves with materials purchased, generally, from retail stores);

Figure 6

Annual Investment in Residential Repair and Renovation, British Columbia¹



¹ Based on total spending in 2008.

Source: Altus Group Economic Consulting based on data from Statistics Canada

- Investment in residential renovation through contractors can be further divided into the labour/overhead component and the materials component. On average, the labour/overhead component accounts for about two-thirds of total repair and renovation investment through renovation contractors, according to Statistics Canada. The cost of materials accounts for the rest;
- Current provincial sales taxes in B.C. apply only to goods and certain services. Home repair and renovation services are not considered taxable services for the purposes of provincial sales tax in either B.C. or Ontario;
- Contractors pay provincial sales taxes on building materials used to renovate their clients' homes, which are passed on to their clients in the final price of the contract. Although these passed-on sales taxes are generally not itemized, provincial sales taxes ultimately account for some 2.3% of the final contract price for homeowners in B.C.; and
- The HST proposals in B.C. will eventually increase the effective tax rate on contractor renovations to 7% on virtually all contractor renovations.

POTENTIAL IMPACTS OF THE PROPOSED HST ON B.C.'S NEW HOUSING MARKET

THE PROPOSED HST WOULD GENERATE \$165 MILLION IN ADDITIONAL TAX REVENUES

Figure 7 illustrates the potential impacts of the proposed HST on B.C.'s new housing market, including:

Figure 7

Distribution and Proposed BC HST Impact on Newly-Built, Owner-Occupied Housing By Value British Columbia

	Total Home Sales by Price Range ¹				Additional ² Tax Collection by Price Range			
	Total		Single-Detached		Total		Single-Detached	
	% Distribution		% Distribution		\$ Millions		\$ Millions	
Under \$75,000	2.0%		1.7%		-		-	
\$75,000 to \$99,999	0.6%		0.7%		-		-	
\$100,000 to \$124,999	0.8%		0.8%		-		-	
\$125,000 to \$149,999	0.9%		0.7%		-		-	
\$150,000 to \$174,999	1.5%		1.2%		-		-	
\$175,000 to \$199,999	1.6%	42.8%	1.1%	32.2%	-	-	-	-
\$200,000 to \$224,999	2.6%		1.6%		-	-	-	-
\$225,000 to \$249,999	2.4%		1.2%		-	-	-	-
\$250,000 to \$274,999	5.7%		3.2%		-	-	-	-
\$275,000 to \$299,999	3.5%		2.3%		-	-	-	-
\$300,000 to \$349,999	12.8%		9.8%		-		-	
\$350,000 to \$399,999	8.4%		8.0%		-		-	
\$400,000 to \$499,999	18.1%	57.2%	19.5%	67.8%	9.9	165.3	5.5	
\$500,000 to \$749,999	23.9%		27.9%		56.1	33.2		
\$750,000 to \$999,999	7.9%		10.1%		37.8	24.4		
\$1,000,000 or more	7.2%		10.3%		61.5	44.6		

¹ Adjusted to 2009 dollars based on the New Housing Price Index

² Value of provincial portion of HST net of rebate, relative to 2% assumed embedded existing PST

Source: Altus Group Economic Consulting based on data from Statistics Canada, the 2006 Census

- Based on the 2006 census findings for the number of newly-built, owner-occupied homes in B.C. by value, the introduction of the proposed tax would generate some \$165 million in additional revenues for the provincial government from new ownership housing alone – based on 2009 dollar values;
- A vast majority of this new tax burden will be placed upon new home buyers of single-detached homes, primarily because this housing segment represents a large share of the province's housing market and has a relative higher valuation compared to the provincial average; and
- The federal government reduced the rate of GST from 7% to 5% over the course of two cuts over two years recently, as a measure to reduce

the cost of living for average Canadians. The proposed HST in B.C. on new housing would weaken the federal government's efforts by increasing housing expenses for average families in the province.

THE ADDITIONAL TAX REVENUES FROM THE PROPOSED HST WILL INCREASE DRAMATICALLY DURING THE NEXT DECADE

The additional tax revenues from the proposed HST for the provincial budget will grow during the next decade, due to appreciation in housing price:

- Based on the New Housing Price Index of B.C. from Statistics Canada, the growth rate of the new home price in the province is estimated to be about 30% for the period of 1998-2008;
- By applying this rate to the 2009 new housing price in the province, this report provides an estimate of the potential new housing price in 2019;
- Based on this estimate and the 2006 census findings for the number of newly-built, owner-occupied homes, the potential additional tax revenues from the proposed HST in 2019 would be \$298 million;
- The impact of the proposed HST on the province's new housing market will increase by 81% over the next decade, as a direct result of housing price appreciation; and
- To reduce potential impacts of housing price appreciation, the provincial government can index the threshold for changes in home prices.

LONG-TERM IMPACTS ON THE PROVINCE'S ECONOMY AND SOCIAL DEVELOPMENT

The proposed HST will unequivocally push up the cost of new housing for homebuyers in B.C. Housing has no exceptions from the laws of economics and higher costs for homebuyers will mean reduced new housing demand. As a result of HST, B.C. can expect lower volume of new housing activity on a trend basis going forward. This will be deleterious to economic activity and employment growth in the province.

A recent CMHC studyⁱⁱ estimates the incremental effects of a policy-led drop in housing starts on the economy. The study found that a drop in housing

starts of as little as 10,000 units from the annual trend leads to demonstrable negative economic effects, such as:

- A reduction of some \$3.3 billion in economic production across a broad array of industries, including a loss of \$727 million in manufacturing output. Further production impacts are likely created through the induced round;
- The loss of some 19,300 jobs (person years of employment), again across a broad array of sectors. Additional job loss is likely through the induced round;
- A decrease of some \$1.3 billion in household income, related to the employment loss; and
- A decline of some \$56 million in indirect tax revenue for governments and likely much more in terms of direct tax revenue loss, due to lower sales tax collected from sales of new housing.

The proposed HST will increase the cost of new housing to new home buyers, which in turn will cause a reduction in demand and lower housing starts. The magnitude of the impact on housing starts ultimately will be governed by supply and demand. According to the modelling in this report, some 57% of the new housing market will immediately face higher costs through HST and this proportion is set to rise significantly over the next decade as more and more new home buyers fail to qualify for a full rebate. Given these large components of the market facing direct impacts, it would be reasonable to expect an impact on demand of several thousand units a year on a trend basis.

The sharp tax increases on homes priced above \$400,000 will also introduce significant regional disparity in the new tax burden and could have long-term impacts on B.C.'s economic development:

- The B.C. government has various provincial policies in place to promote higher urban density development related to environmental objectives, including:
 - The provincial government is committed to reduce provincial greenhouse gas emissions by 33 percent by 2020.ⁱⁱⁱ To achieve such a target, the B.C. Climate Action Team (CAT) suggests that the government should “create a regulatory regime that encourages compact, smart community development”^{iv};

- *The Provincial Transit Plan*, announced in January 2008 states that one of its key objectives is to “support increased population and employment densities near transit hubs and along transit corridors, changing urban forms, which will further decrease greenhouse gas emissions”^v;
- Under the proposed HST, denser areas like Vancouver will generally shoulder the majority of the new tax burden, primarily due to higher housing values;
- This disparity in tax burden will also lead to denser areas like Vancouver seeing the greatest negative impact on new housing demand; and
- Effectively, this new tax will be a tax on density – running contrary to provincial efforts to promote more compact patterns of development.

INDEXATION OF THRESHOLDS TO CHANGE IN HOME PRICES

The Government of Canada has already acknowledged the importance of indexation of thresholds to changes in home prices, when they promised to adjust the thresholds periodically. However, the government still has not carried through with it, in part, due to fiscal and political constraints:

- When the GST was introduced, the federal government committed to adjust the thresholds “at least every two years” to ensure that they continued to reflect changes in housing prices, thereby protecting housing affordability over time, in all parts of Canada;
- However, the federal government never delivered on their promises. The \$350,000-\$450,000 thresholds have remained unchanged since the GST was introduced;
- Statistics Canada’s New Housing Price Index shows that new housing prices have risen some 55% between 1991 and 2009. As a result of the normal advancement of housing prices through the process of inflation, a significantly larger share of new homes sold in Canada do not qualify for the full 36% New Housing Rebate than was the case in 1991; and
- Current thresholds, if properly indexed to the change in the New Housing Price Index since 1991, would be some \$540,000 and \$700,000 respectively for the upper and lower rebate thresholds.

The B.C. government has not committed to indexation under the proposed HST. As a result, the tax burden on new home buyers from the proposed HST will increase considerably during the next decade, as house prices rise making fewer new housing units eligible for a full tax rebate over time:

- New home prices advanced in B.C. some 30% in the period of 1998-2008 – an annual average of 2.6% per year; and
- Assuming a similar rate of house price increases going forward, the additional HST tax burden will rise to some \$298 million by 2019, **an increase of 81% over the next decade** – due mostly to the effect of a larger proportion of homebuyers not qualifying for a full rebate.

POTENTIAL IMPACTS OF THE PROPOSED HST ON B.C.'S RESIDENTIAL RENOVATION MARKET

Generally, contractor renovations in Canada are subject to the GST. To mitigate some negative effects of the GST on the renovation sector, the Government of Canada includes “substantial renovations” within the eligibility for the GST/HST New Housing Rebate program. As such, the owner of a residential complex that has been substantially renovated is eligible for the rebate program as though it were a newly constructed residential complex^{vi}.

However, this is unlikely to amount to much relief for the vast majority of homeowners undertaking repair and renovation investment. In order to be eligible for the GST rebate, the Canada Revenue Agency requires that “at least 90% of the building that existed before the renovation began must be renovated to some minimum degree”^{vii}.

This type of renovation work is extremely rare and only accounts for a marginal part of the renovation sector in the province. An overwhelming majority of contractor renovations are still subject to the GST. Since the proposed HST will be harmonized with the GST, the new tax will further increase the costs of contractor renovations for B.C. homeowners.

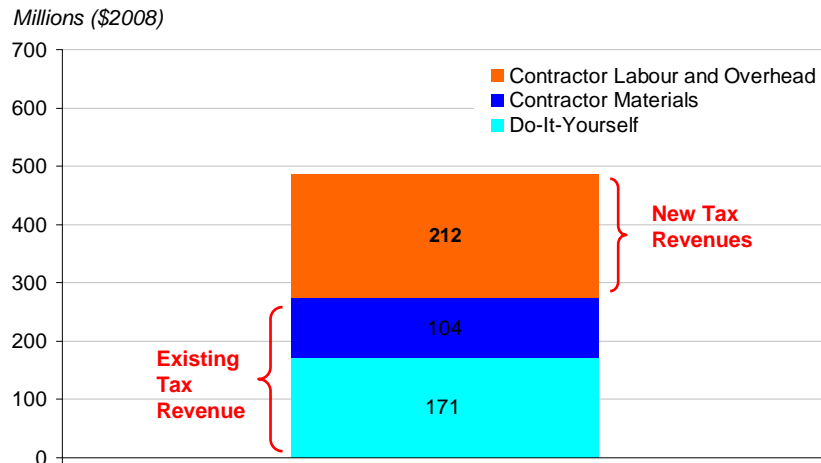
THE PROPOSED HST WILL COLLECT ADDITIONAL \$212 MILLION IN TAX REVENUES FROM CONTRACTOR RENOVATIONS

Under the new proposed HST in B.C., the 7.0% of the provincial sales tax will be newly applied to the contractor’s labour and overhead costs, which was

approximately \$3.0 billion in 2008. This will increase the tax burden on homeowners and rental housing investors by some \$212 million (Figure 8). The aggregate taxes levied on contractor renovations will rise from the existing \$104 million to \$316 million – a three-fold increase.

Figure 8

Potential Provincial Government Revenues¹ Under the Proposed HST in British Columbia



¹ Based on the data of Household Spending on Home Repair and Renovation in 2008.

Source: Altus Group Economic Consulting based on data from Statistics Canada

In terms of tax rates, the proposed HST will have the following rate implications for renovations:

- For homeowners doing their own work, a 7% tax rate – no change; and
- For contractor renovations – a rise from the existing effective PST tax rate of about 2.3% to 7% on the total value of contractor renovations.

THE INCREASED TAXATION ON CONTRACTOR RENOVATIONS WILL HAVE LONG-TERM NEGATIVE EFFECTS ON THE PROVINCE'S ECONOMY AND THE EXISTING HOUSING STOCK

Residential renovation activity is an important component of residential investment in B.C., contributing \$7 billion annually to the province's economy. Any tax measures that either unduly discourage renovation activity or push it into the underground economy will ultimately have

deleterious effects on the quality and functionality of the existing housing stock.

Tripling the sales tax rate on contractors' renovations will have profound adverse consequences on the way renovation activity is performed and ultimately on the amount of tax revenue collected from the GST/HST and income taxes:

- Harmonization will reduce the volume of renovation activity by contractors, due to higher cost. This will lower economic activity and employment in the province;
- Harmonization will shift contractor renovation activity into the underground economy, with a loss of existing income and sales tax revenues for federal and provincial governments; and
- Harmonization may shift more renovation and repair jobs from contractor assignments to do-it-yourself projects, often undertaken by homeowners who are not as well trained as professional contractors to do this kind of work. The lower renovation activity and a shift to do-it-yourself work could have longer-term negative consequences for the quality of the existing housing stock.

RECOMMENDATIONS

To minimize potential negative impacts of the proposed HST in B.C., this report brings several policy ideas forward for the provincial government's consideration, including:

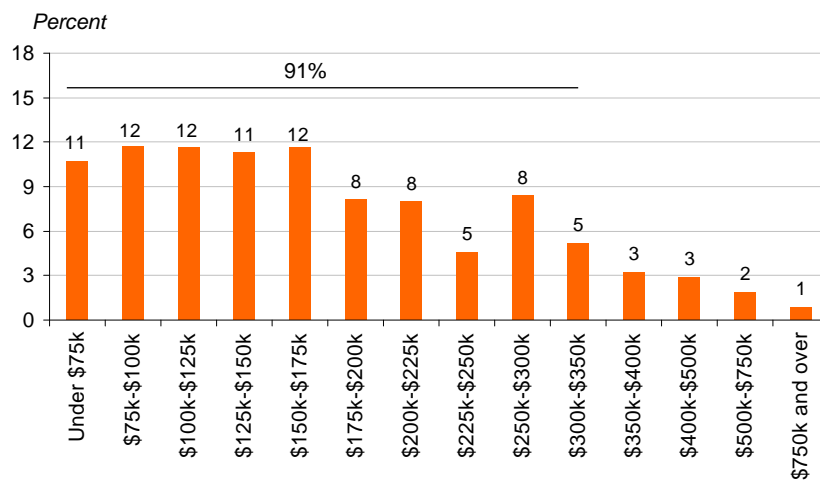
- The threshold of the tax rebate on new housing must have indexation to the New Housing Price Index from Statistics Canada to ensure that it continues to reflect changes in housing prices, thereby protecting housing affordability over time. This will keep the real cost of the new HST to homebuyers of new housing units in B.C. at current levels;
- The threshold of the proposed HST in B.C. has to be more than \$400,000 just to be comparable to the Ontario's proposal. The \$400,000 threshold in the B.C.'s proposal is too low compared to the Ontario's – about 68% of newly-built, owner occupied homes are below \$400,000 in Ontario vs. just 43% in B.C. To make the tax rebate affect a similar share of the new housing market in B.C., the threshold should be

approximately \$500,000 – about 61% of the newly-built, owner occupied housing units in the province will be below this threshold;

- However, even \$500,000 is not an appropriate benchmark for the tax rebate threshold. When the GST was introduced in 1991, the federal government set the thresholds at \$350,000 and \$450,000. The lower threshold of \$350,000 covered about 91% of newly-built, owner-occupied housing units during the 1986-1991 period (Figure 9);
- In effect, the GST tax was exempted for virtually all new housing units when it was initially introduced. The initial intention of the federal government was to avoid both creating any additional cost for buyers of new homes and causing any housing market distortion;
- However, when introducing the HST, the provincial governments in Ontario and B.C. only aim to shield a much smaller proportion of new housing market from potential negative effects of the new tax, leaving a substantial share of the new housing market vulnerable;
- The federal government initially based the GST/HST New Housing Rebate program on the concepts of fairness and minimizing market impacts and to be consistent with these, the threshold should be around \$890,000, based on the 2006 census data in B.C.;

Figure 9

Distribution of Newly-Built, Owner-Occupied Housing By Value, Canada, 1986-1991



Source: Altus Group Economic Consulting based on data from Statistics Canada the 1991 Census

- To reduce the proposed HST's potential impacts on the residential renovation sector in B.C., the Province should consider reducing the rate of the HST applied to contractor renovations. The Province can calculate a fair and revenue-neutral tax rate on legitimate contractor renovations and then apply that tax to all legitimate contractor renovations. Operationally, this rebate can be handled as a point of sale lower tax rate applicable to qualifying contracts, or it can be handled as a refundable tax credit for homeowners;
- For B.C., the tax value for residential renovation contracts should be 2.3% for the provincial component of the proposed HST; and
- This rate equals the current effective tax rate in B.C. and so would keep provincial taxation of this important component of residential renovation revenue neutral, and would avoid diverting more renovation activity into the underground economy.

ⁱ Canada Revenue Agency, "Substantial Renovation and the GST/HST New Housing Rebate", *GST/HST Technical Information Bulletin*, January 2005.

ⁱⁱ Altus Group Economic Consulting, *Economic Impacts of Residential Construction*, prepared for Canada Mortgage and Housing Corporation, February 2009.

ⁱⁱⁱ The B.C. Climate Action Team, *Meeting British Columbia's Targets*, July 2008.

^{iv} Ibid.

^v The Ministry of Transportation, *The Provincial Transit Plan*, January 2008.

^{vi} Canada Revenue Agency, "Substantial Renovation and the GST/HST New Housing Rebate", *GST/HST Technical Information Bulletin*, January 2005.

^{vii} Ibid.