NOVA SCOTIA
Department of Finance

Nova Scotia Tax Credit Review

Phase II Report

Nova Scotia Department of Finance
March 2001

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Introduction

In the 1998/99 fiscal year, $1.112 billion in revenue was raised by personal and corporate income taxes. This represents 24 percent of total provincial revenue for that year. During the 1998 tax year, the Province provided over $51 million in tax relief to businesses and individuals in the form of tax credits. The value of personal and corporate tax credits will grow to $69.5 million in the 1999 taxation year. If left unchanged, this growth will reach over $100 million in the next two years.

Phase I

In his 1999 Budget Address, the Minister of Finance committed to undertaking a complete review of all provincial tax credit programs with a view to determining the costs and benefits associated with each measure. Phase I of the review was completed and tabled by the Minister as part of the 2000 Budget. Tax credits included in the Phase I report were the:

- Equity Tax Credit
- Film Industry Tax Credit
- Investment Tax Credit for Manufacturing and Processing
- Research and Development Tax Credit
- ISO 9000/ISO14000 Tax Credits
- HST rebates for the MUSH sector (municipalities, universities, schools and hospitals), Non-Profit Organizations and Charities.

Further background information on the evaluation process and the economic impact models used in the evolution process can be found in Appendix A.

Small Business in Nova Scotia

Definition

There is no generally accepted definition of small business. Definitions are usually based on employment, sales, or assets of the company. Small businesses can be further classified as independent businesses, owner-operated or owner-managed, and incorporated or unincorporated. A commonly accepted definition, and one that will be used here, is to define small business as all companies with 50 or fewer employees.

Profile of Small Business in Nova Scotia's Economy

Most businesses in Nova Scotia (97.3 percent) can be classified as small business using the 50 employee criteria. Statistics Canada reports there are 49,945 business establishments in Nova Scotia as of October 2000. Of this number, 36,308 (72.7 percent) have four or fewer employees.

Small business employment is largely concentrated in the trade and service sectors as indicated in Table 1:

Table 1: Small Business Employment Ranked by SIC Industry Division

Small Business Industry	Employment	% of Total
Trade (Retail and Wholesale)	29,292	26.2
Business and Personal Services	21,354	19.1
Natural Resources	12,856	11.5
Construction	12,522	11.2
Accommodation, Food and Beverage	11,850	10.6
Finance, Insurance and Real Estate	9,615	8.6
Manufacturing	8,497	7.6
Transportation, Communication, Utilities	5,814	5.2
TOTAL	111,800	100.0

Source: Statistics Canada, Central Frame Database, Nova Scotia Establishments by NAICS Division by Employment, October 16, 2000.

Throughout the past decade, the importance of small business in terms of employment levels and business size as a generator of jobs and income for Nova Scotians has been outpacing that of large business.

Table 2: Employment and Payroll in Nova Scotia by Business Size 1992-1997

	Small Business	**Large Business**	**Nova Scotia(1)**	**% Small Business of Nova Scotia**
Employment: 1992 1997	 101,700 111,800	 238,200 228,900	 370,400 391,900	 27.5% 28.5%
Payroll ($millions): 1992 1997	 $2,034 $2,463	 $6,976 $6,899	 $10,180 $10,893	 20.0% 22.6%
Average Income: 1992 1997	 $20,000 $22,000	 $29,300 $30,100	 $27,480 $27,800	 72.8% 79.1%

Source: Employment Dynamics, Statistics Canada Small Business Surveys and Nova Scotia Statistical Review 1999, Nova Scotia Department of Finance: Note: (1) Total for all Nova Scotia including employment and payroll in sectors other than the business sector.

• In terms of the number of jobs, the small business sector accounted for 28.5 percent of jobs held by Nova Scotians in 1997 compared to 27.5 percent in 1992. Growth in large business employment declined over the same period. While large business employed the greatest number of Nova Scotians, small business has been an important factor in generating employment growth in the economy.
• The small business sector has increased its share of total Nova Scotia labour income from 20 percent in 1992 to 22.6 percent in 1997. Total payroll expenditures for large business decreased during the same time period.
• Average income in the small business sector is below average Nova Scotian labour income levels, but increased from 72.8 percent of the Nova Scotia average in 1992 to 79.1 percent in 1997. That wage levels are below the Nova Scotian average wage levels is probably due to a large number of single proprietorships and concentration in the Trade and Business and Personal Services sector, which are generally low wage industries.

In terms of Nova Scotia GDP (at Market Prices), it is estimated that the small business sector directly contributed approximately 12.2 percent to GDP in 1997 compared to 11.3 percent in 1992. Estimates are based upon small business labour income in relation to total Wages and Salaries and Supplementary labour Income in the PEA (Provincial Economic Accounts, Statistics Canada) and their total relationship to GDP. These estimates would also be higher since they do not include an estimate of small business corporate profit, which is a component in GDP estimates.

Small Business Rate Reduction

Introduction

The Nova Scotia Small Business Rate Reduction (otherwise referred to as the Small Business Rate) is 5 percent, which is 11 percentage points lower than the 16 percent General Corporate Income Tax (CIT) rate. This rate reduction is patterned on the federal Small Business Deduction, which reduces the federal CIT rate from 28 percent to 12 percent. In both cases the rate reduction is applied on the lower of three factors:

- Active Business Income earned in Canada;
- Corporate Taxable Income, and
- Annual Business Limit.

In most cases the Annual Business Limit is $200,000 which allows firms to claim the reduction on amounts as high as $200,000.

Both the federal and provincial rate reductions are restricted to Canadian Controlled Private Corporations (CCPCs). CCPCs includes firms that are not publicly traded on specified stock exchanges and are not controlled by non-residents or publicly traded corporations. The Annual Business Limit is also reduced for firms with an associated taxable capital above $10 million and eliminated at $15 million of taxable capital.

In the most recent federal Budget (February 2000) an additional benefit targeted at small business was introduced at the national level. Effective January 1, 2001, firms eligible for the federal Small Business Deduction will qualify for a rate reduction of 7% (28% down to 21%) on the next $100,000 of Corporate Taxable Income or Active Business Income above the Small Business Deduction $200,000 limit.

Rationale for the Small Business Rate

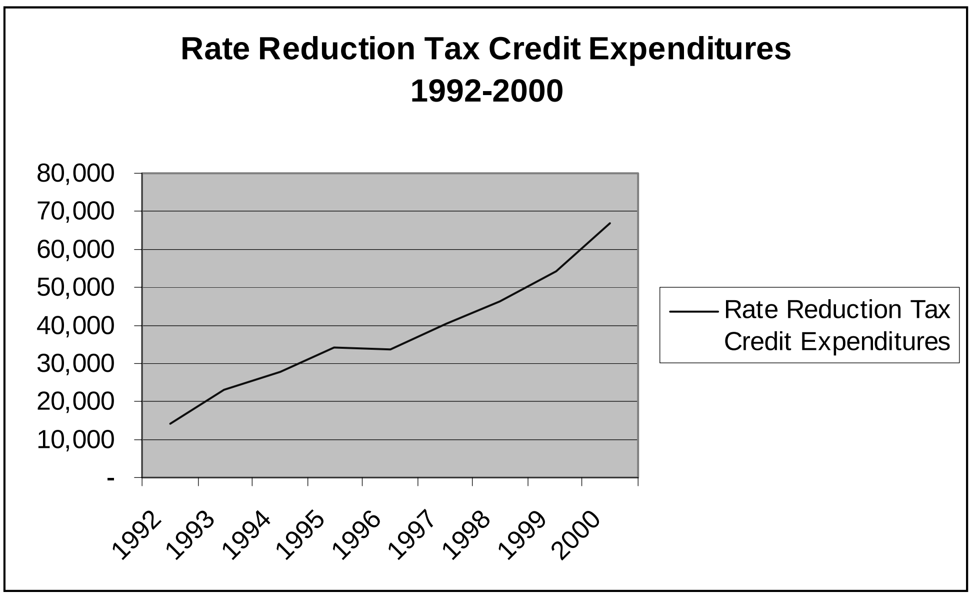
The Small Business Rate Reduction is intended to integrate the corporate and personal income tax systems by ensuring that salary from employment and dividend income from a small corporation are taxed at approximately the same rate. In Nova Scotia's case there is a slight over-integration with dividends from CCPCs taxed at a lower rate than are salary income and business income from unincorporated businesses. There are several other policy reasons for the reduced rate of taxation of small businesses.

Smaller firms are considered to have greater difficulty attracting both equity and debt financing because of the greater proportionate burden of the cost of issuing equity and the greater perceived risk of lending to small business. Smaller firms are considered to have less diversification of earnings and are therefore subject to greater swings in the earnings capacity to service fixed debt payments. Small firms are perceived as well to bear a greater proportionate burden of profit-insensitive taxes such as property and payroll taxes than do larger businesses.

Tax Expenditure Value

The tax expenditure value is the level of funding foregone by the province as a result of of a lower tax burden. In the case of the Nova Scotia Small Business Rate, the tax expenditure value is quite significant given the level of Corporate Income Tax collected annually. In Nova Scotia, approximately 30% of Corporate Taxable Income allocated to the province is taxed at the 5% rate. The expected cost of this lower rate in 1999 is estimated at $55.2 million ((30% X Total Corporate Taxable Income of $1,671,939,000) X 11% rate reduction)). With the growth in Corporate Taxable Income steadily rising, the cost increases to $67.8 million in 2000.

Figure 1:Small Business Rate Reduction Tax Credit Expenditures 1992-2000



Source: NS Department of Finance

The tax expenditure benefit is widely distributed across firms with the maximum benefit any individual firm can enjoy at the provincial level being $10,000 or 5% X $200,000. On average the number of firms utilizing the reduction is at least 5520 or $55.2 million divided by $10,000 maximum benefit (1999 values). In reality many more firms than this take advantage of the reduction since the benefit to individual firms is typically less than the maximum of $10,000.

Analysis

The Department is reviewing of the Nova Scotia business climate in order to obtain a better understanding of how it, and in particular the tax climate, compares with other jurisdictions. The small business rate reduction will be considered as part of that review.

In addition to taxation rates, the review will also encompass such issues as:

- Labour costs and markets
- Transportation infrastructure
- Capital costs
- Operating costs
- Availability of capital
- Regulatory environment
- Industrial capacity
- Knowledge capacity
- Lifestyle considerations

New Small Business Tax Deduction

Introduction

The New Small Business Tax Deduction came into effect April 18, 1986 and was designed to assist new small businesses during start-up. The tax deduction effectively eliminates the Nova Scotia Corporation Income Tax for the first two taxation years of a new small business incorporated after April 18, 1986 and three years for a new small business incorporated after April 24, 1992. Corporations must meet eligibility requirements and make application in each of the taxation years.

To receive the credit, the firm must be eligible for the Nova Scotia Corporate Income Tax small business tax rate and must not be:

- associated with another corporation(s);
- in a partnership or a joint venture with an ineligible corporation(s);
- a beneficiary of a trust where any beneficiary is ineligible;
- a previously active business with essentially the same owner(s) or related owner(s);
- a professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor;
- a business carrying on the same, or substantially the same, business activity as was carried on as a sole proprietorship, partnership or corporation.

NSB Tax Deduction Objectives

The New Small Business Tax Deduction is intended to assist Nova Scotia businesses during their start-up phase by providing the corporation with additional working capital. It is intended that this measure will increase the success rate of new small businesses and, in turn, increase employment and tax revenues in the long run.

Take-up Summary 1986-1999

Through the end of 1998, 1,773 small businesses had qualified for 2,585 certificates worth $7,083,986. Table 3 shows the number of certificates issued and the dollar value of the credits issued each year:

Table 3: Summary of Activity – New Small Business Tax Deduction - 1986-98

	# Certs			$ Credits			Total Certificates	Total Credits ($)
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3		
1986	5	0	0	22,513	-	-	5	22,513
1987	99	3	0	331,378	13,226	-	102	344,604
1988	126	77	0	435,009	438,585	-	203	873,594
1989	120	99	0	341,360	452,817	-	219	794,177
1990	114	99	0	333,728	473,265	-	213	806,993
1991	85	92	0	273,538	332,962	-	177	606,500
1992	89	76	0	193,137	232,914	-	165	426,051
1993	90	60	0	156,537	120,598	-	150	277,135
1994	109	80	2	164,916	159,451	7,290	191	331,657
1995	132	76	18	269,422	158,477	36,097	226	463,996
1996	123	122	72	252,789	250,481	187,147	317	690,417
1997	132	96	105	235,415	253,491	259,676	333	748,582
1998	100	103	81	203,324	250,171	244,272	284	697,767
	1324	983	278	3,213,066	3,136,438	734,482	2585	7,083,986

Source: NS Department of Finance

Table 4 classifies successful applicant companies by North American Industrial Classification System (NAICS) code.

Table 4: Activity by NAICS - New Small Business Tax Deduction - 1986-98

NAICS Code*	**NAICS Description**	**Total # Companies**	**NSB Recipients**	**All NS Companies**
11	Agriculture, Forestry, Fishing and Hunting	79	5%	11.7%
21	Mining and Oil and Gas Extraction	10	1%	0.3%
23	Construction	245	16%	11.8%
31	Manufacturing	67	4%	5.5%
41	Wholesale Trade	111	7%	6.2%
44	Retail Trade	236	16%	13.8%
48	Transportation and Warehousing	58	4%	5.2%

Table 4: Activity by NAICS - New Small Business Tax Deduction - 1986-98

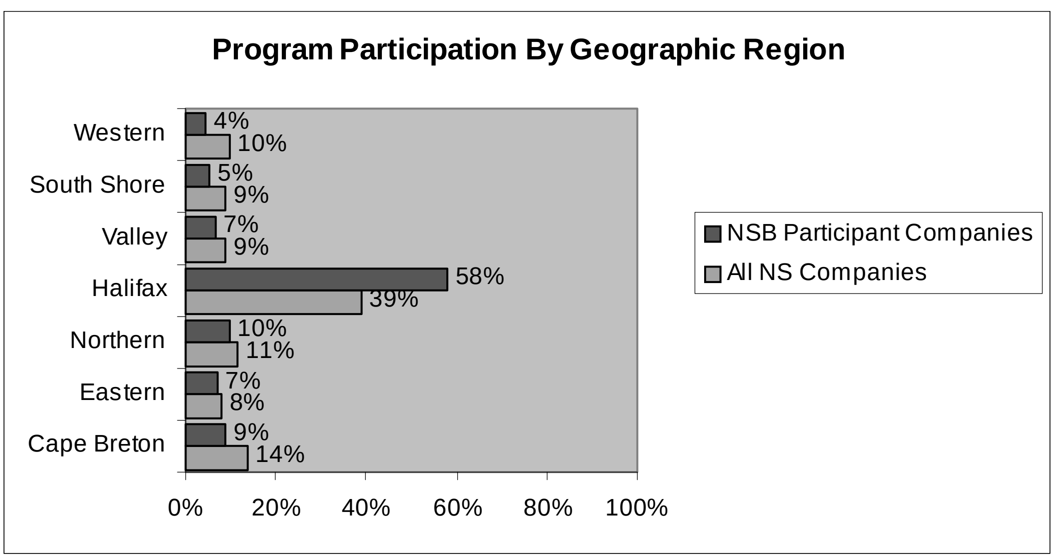
51	Information & Cultural Industries	3	0%	1.2%
52	Finance & Insurance	69	5%	4.5%
53	Real Estate & rental & leasing	52	3%	6.2%
54	Professional, Scientific, and Technical Services	235	15%	8.0%
56	Waste Management & Remediation services	9	1%	3.9%
61	Educational Services	17	1%	0.9%
71	Arts, entertainment and recreation	20	1%	1.9%
72	Accommodation and food services	78	5%	6.2%
81	Other Services	127	8%	9.4%
	Total	1520	100%	100%

*Source: NS Department of Finance; *Note: NAICS codes could not be determined for 79 firms*

Program participation is concentrated in the construction, retail, and professional services sectors. Professional services encompass a number of sub-categories including business and information technology consulting services.

The majority of tax credits have been issued to firms located in Halifax Regional Municipality (HRM). The following graph displays program participation by geographic region together with the geographic location of the NS small business population.

Figure 2:Program Participation By Geographic Area – NSB Tax Deduction, Based on Head office Location of Company - 1986-98



Source: NS Department of Finance

NSB Tax Deduction Analysis

The following studies have been completed to provide an analysis of the NSB Tax Deduction:

- Survey of Nova Scotia Small Business: to attain demographic and performance information on NS small businesses in general and tax deduction claimant companies in particular.

- Survival Rate Study: to determine whether corporations that have participated in the program have remained in operation longer than the population of corporations in general.

- Tax Policy: The NSB Tax Deduction Program was examined from a tax policy perspective.

- Program Administration: Department of Finance staff who administer the program were asked to provided feedback and suggestions on any possible alternations to the program.

Survey of Nova Scotia Small Business

The purpose of this survey was to provide the department with a better understanding of the small businesses sector in the Province and to determine the impact of the NSB Tax Deduction on recipient firms. Survey instruments were mailed to 2500 Nova Scotia small businesses. Appendix B contains details on the survey methodology and results.

Based on the results of the survey, the following key impacts of the tax credit were reported:

- Firms that received the NSB Deduction differ from the population of small business firms both in terms of geographic location and industry sector. Firms receiving the credit tend to be located within HRM and are more concentrated in the service sectors.
- Firms that received the credit were no more likely to report an increase in either full-time equivalent employees or pay roll expenditures. Claimant companies are almost twice as likely to report having only 1 employee than are non-claimant companies (25 percent compared with 14 percent).
- Firms that received the credit were slightly more likely to report an increase in profitability. This result was expected, however, because firms must be profitable to receive the credit.
- Respondents identified increased cash flow as the most significant benefit of the credit. Forty-one percent indicated it was of significant benefit and another 44 percent indicated it was somewhat of a benefit.
- 76 percent indicated that the credit did not affect their ability to attract investment.
- 49 percent indicated that the credit did not influence them to start their business earlier than otherwise; 38 percent indicated some or little influence.

- 59 percent indicated that the credit did not encourage them to hire more people at start-up than otherwise; 34 percent indicated employment at start-up was affected somewhat or little.
- 21 percent indicated that the credit had a significant benefit in enabling the company to purchase more equipment at start-up; 34 percent indicated the credit was of some benefit.
- 51 percent indicated that the credit was of some or significant benefit in allowing the firm to expand.
- 30 percent indicated that the credit helped to reduce debt during start-up; 44 percent indicated the credit was somewhat beneficial in this respect.

Business Location Decisions

- The majority (92 percent) of all firms surveyed said they did not compare investment opportunities in other areas before locating in Nova Scotia.
- "I live in Nova Scotia" was most often cited as the reason respondents chose to locate their business in Nova Scotia. "Proximity to market" and "quality of life" were most often cited as the second most influential reason for choosing Nova Scotia.
- Respondents who reported having 75-100 percent of sales to markets outside of Nova Scotia were more likely to have compared investment opportunities in other areas.

Survival Rates

The New Small Business Tax Deduction is designed to assist new small businesses during the start-up phase of the business life cycle. A principle measure of the program should be whether corporations that have received the tax credit have a higher survival rate than small business corporations generally.

Results

Each of the 14 groups of tax credit recipient companies incorporated from the years 1986 to 1999 performed better than the group of all corporations both in terms of average number of years in business and percentage of companies still in business.

Table 5: NSB Survival Rates

Year	All Corporations			NSB Recipients	
	% Still in Business (Nov 1, 2000)	Avg. # of Years in Business		% Still in Business (Nov 1, 2000)	Avg. # of Years in Business
1986	31%	10.1		54%	12.1
1987	29%	9.2		50%	10.8

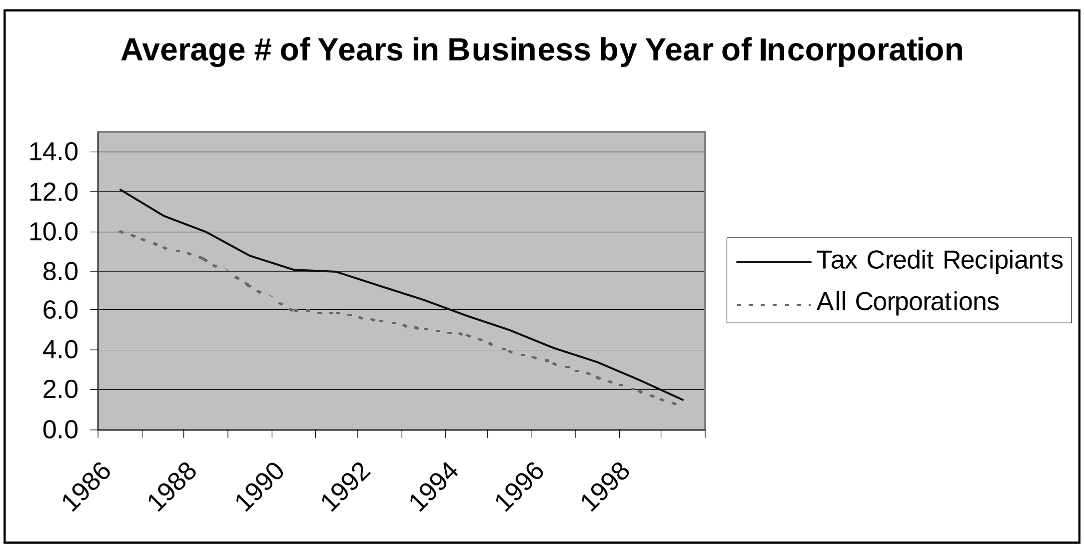
Table 5: NSB Survival Rates

1988	32%	8.7		53%	10.0
1989	33%	7.4		57%	8.8
1990	36%	6.1		52%	8.0
1991	42%	5.9		69%	7.9
1992	45%	5.5		67%	7.3
1993	50%	5.1		77%	6.6
1994	58%	4.8		83%	5.8
1995	59%	4.0		85%	5.0
1996	66%	3.4		88%	4.1
1997	73%	2.8		99%	3.4
1998	81%	2.0		100%	2.5
1999	88%	1.2		100%	1.5

Source: NS Department of Finance

For all years from 1986 to 1999, the tax deduction recipient groups were in business for a longer period of time, on average, than all corporations.

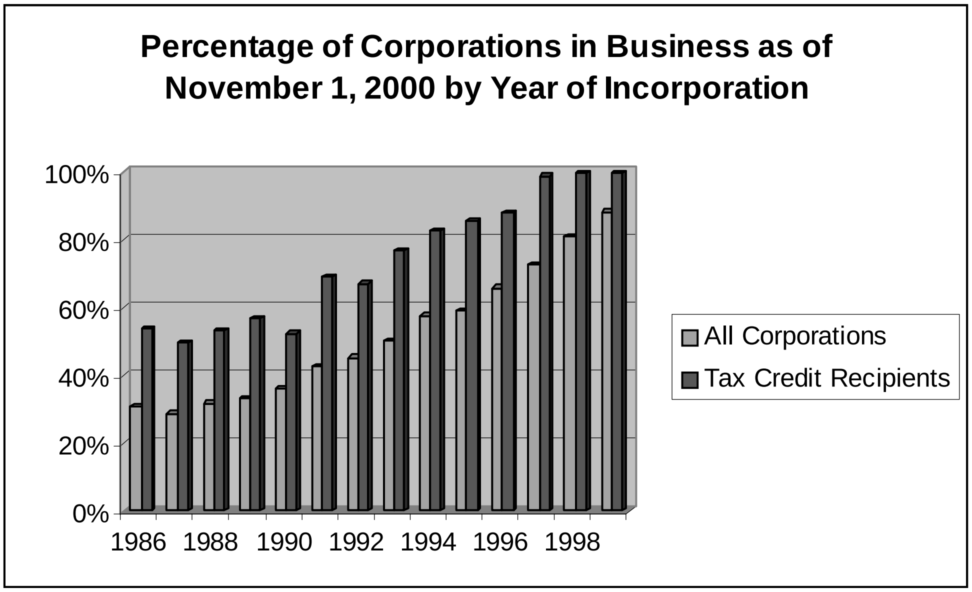
Figure 3: Average Number of Years in Business by Year of Incorporation



Source: NS Department of Finance

For each group of companies incorporated between 1986 and 1999, companies receiving the tax credit were more likely to still be in business as of November 1, 2000.

Figure 4: Percentage of Corporations in Business as of November 1, 2000 by Year of Incorporation.



Source: NS Department of Finance

It must be noted that the group of tax credit recipient companies are not a representative sample of the total population of incorporated companies and may differ from the total population in ways that would tend to increase their survival rates apart from the affect of the tax credit:

- Companies must be profitable to take advantage of the credit. The group of tax credit recipient companies would be more profitable on average than the entire population of companies and would tend to have a higher survival rate as a group, even in the absence of the tax credit.
- Tax credit recipients must be an *active business* as defined in the *Income Tax Act (Canada)* and must be a Canadian Controlled Private Corporation. The entire population of companies would include corporations that did not meet these criteria. This would include holding companies and single use corporations that would be more likely to cease operations for non-financial reasons.

Tax Policy Considerations

The NSB Tax Deduction, as it is currently designed, has several shortcomings when examined from a tax policy perspective.

First, the NSB Tax Deduction targets benefits to firms with the greatest profitability, and not necessarily to firms with the greatest capital needs. The more profitable a company, the greater the tax savings it will obtain under the program.

The tax deduction creates artificial imbalances among competing firms. The credit assists firms that are competing in markets with established firms that do not qualify for the deduction.

The tax credit is biased towards industry sectors that report profits relatively early in the business life cycle. Retail or wholesale companies, for example, with relatively low fixed costs generally report profits earlier than capital-intensive industry such as manufacturing. The credit is biased against industries with high capital requirements that have a proportionately greater amount of Capital Cost Allowance in the early years.

Comments from Program Administrators

The NSB Tax Credit is administered by the Department of Finance. Department staff were interviewed to obtain comments on the administration of the program and views on the effectiveness of the program. Comments include:

There is a large portion of “consultant corporations”. NSB Tax Deduction recipients are more concentrated in the professional service sector than the population of Nova Scotia business in general. These companies are usually single employee companies in which the owner/employee provides business services. These corporations are often formed for tax planning purposes and generally do not create additional employment apart from the owner/employee.

Some provinces require companies to claim all possible corporate deductions prior to calculating the NSB tax deduction. This is currently not required under Nova Scotia legislation.

It is possible under current legislation for a corporation to claim the NSB tax deduction while also receiving a refundable corporate tax credit such as the Film Tax Credit.

There are currently no time limits in place restricting when a corporation may apply for the tax credit.

Conclusions

• Recipient firms that responded to the survey were slightly more likely to report an increase in profitability than the overall survey respondents, but were no more likely to report an increase in either full-time equivalent employees or pay roll expenditures. The most important benefit of the deduction, as reported by recipient firms, was that it increased the level of working capital available to the corporation.
• As a group, NSB Tax Deduction recipients had higher survival rates than the population of firms incorporated from 1986-1999. The group of tax credit recipient companies are not a representative sample of the total population of incorporated companies and may differ from the total population in ways that would tend to increase their survival rates apart from the affect of the tax credit

- There is some indication the deduction may not have a strong incremental value. The majority (92 percent) of firms surveyed did not compare investment opportunities in other areas. “I live in Nova Scotia” was most often cited as the reason respondents chose to locate their business in Nova Scotia. “Proximity to market” and “quality of life” were most often cited as the second most influential reason for choosing Nova Scotia.
- NSB Tax Deduction has several shortcomings when examined from a tax policy perspective. The deduction favours corporations in particular sectors and provides the greatest benefit to the most profitable firms. The deduction provides an advantage to start-up firms over established firms competing in the same markets.

Policy Decisions
The New Small Business Tax Deduction program will continue. To maximize the benefits of the program and to target expenditures to corporations that will have the greatest impact on job creation, the following administrative changes will be made:
• The credit will be limited to corporations that have at least two employees, one of which cannot be related to a shareholder of the firm.
• As with other jurisdictions, applicants will be required to claim all possible corporate deductions and credits in the year prior to calculating the New Small Business Tax Deduction.
• A corporation that receives a refundable credit for a given tax year, will not be eligible for the New Small Business Tax Deduction.
• Corporations will have three years after the end of the taxation year to file an application in respect of that year.

Equity Tax Credit

Introduction

The Equity Tax Credit (ETC) program was introduced in 1994 and provides a 30% tax credit for investments in qualified Nova Scotia small businesses, co-operatives and Community Economic Development Investment Funds (CEDIF). The maximum annual tax credit is $9000 per individual. The ETC is non-refundable, but unused amounts may be carried forward seven years and back three years.

The Equity Tax Credit program has two principle components. The first component is the ‘General ETC’ program which applies to direct investments in corporations or co-operatives. This component is set to expire December 31, 2001. The second component, the CEDIF component, applies to investment in Community Economic Development Investment Funds. The CEDIF program is set to expire December 31, 2003.

Appendix C contains background information on the Equity Tax Credit program.

Equity Tax Credit Objectives

The Equity Tax credit program was introduced in the fall 1993 budget. The stated intent of the legislation was to 'create an important pool of venture capital for the province.' The budget speech identified a 'lack of available equity capital' as a primary impediment to the development of businesses in the province. Specifically, the aims of the Equity Tax Credit were as follows:

- To provide capital to small and medium-sized Nova Scotia companies.
- To encourage investment in Nova Scotia companies by Nova Scotians.
- To encourage Nova Scotia companies to seek equity investment.

Program Participation

From its inception in 1994 through to February 2000, 277 companies and 2,985 investors have participated in the Equity Tax Credit program. Participants have made $31.5 million dollars in investments and have received $9.0 million in credits.

Three CEDIFs were established in Nova Scotia during 1999. These funds raised $1.1 million of the $9 million raised under the ETC in 1999. For purposes of this review, the CEDIF program will be included with the general ETC program activity.

Table 6: Equity Tax Credit Program Activity 1994-99

Tax Year	# of Investors	# of Companies	Total Investments ($)	Total Credits ($)
1994	73	9	414,723	104,181
1995	176	26	1,633,515	484,616
1996	462	34	5,583,475	1,671,987
1997	895	63	8,131,342	2,374,153
1998	558	65	6,712,492	1,939,492
1999	821	80	9,003,883	2,483,479
Totals	2,985	277	31,479,430	9,057,908

Source: NS Department of Finance

Table 9 compares the industry sector ETC participants with the Nova Scotia companies in general:

Table 7: Activity by NAICS – Equity Tax Credit – 1994-2000

NAICS Code	**NAICS Description**	**% of ETC Participants**	**% of All NS Companies**
11	Agriculture, Forestry, Fishing and Hunting	12.6%	11.7%
21	Mining and Oil and Gas Extraction	3.0%	0.3%
23	Construction	1.9%	11.8%
31	Manufacturing	17.8%	5.5%
41	Wholesale Trade	5.9%	6.2%
44	Retail Trade	20.4%	13.8%
48	Transportation and Warehousing	0.4%	5.2%
51	Information & Cultural Industries	5.9%	1.2%
52	Finance & Insurance	2.2%	4.5%
53	Real Estate & rental & leasing	0.7%	6.2%
54	Professional, Scientific, and Technical Services	7.4%	8.0%
55	Management of Companies	1.5%	3.2%
56	Waste Management & Remediation services	2.6%	3.9%
61	Educational Services	1.5%	0.9%

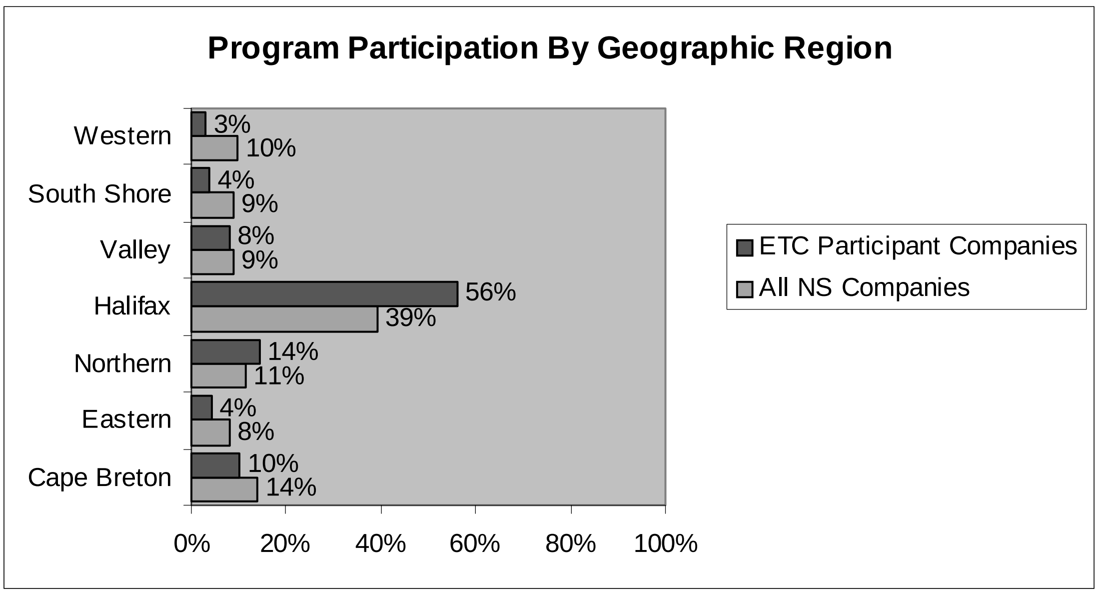
Table 7: Activity by NAICS – Equity Tax Credit – 1994-2000

71	Arts, entertainment and recreation	7.0%	1.9%
72	Accommodation and food services	7.8%	6.2%
81	Other Services	1.5%	9.4%

Source: NS Department of Finance

ETC participant firms tend to be more concentrated in the manufacturing and retail industries and less concentrated in construction industries than Nova Scotia companies in general.

Figure 5: Program Participation by Geographic Region



Source: NS Department of Finance

Geographically, 56 percent of participant firms are located in the Halifax Regional Municipality (HRM). Rural areas, however, are beginning to receive a higher percentage of investment. In 1999, 52.3% of ETC investments took place in areas outside HRM. The increase in share for 'rural' areas can be partly attributed to the establishment of three rural based CEDIFs, which raised a total of $1.1 million under the ETC program.

Analysis

The Equity Tax Credit program was reviewed as part of the Phase I report. It was recommended that the CEDIF program be extended to December 2003, but that recommendations on the general ETC program be postponed until Phase II so that more information could be incorporated into the Economic Impact Study. The original Economic Impact Study included the years 1994 through 1997. The 1998 and 1999 years have been added for the current study.

Survival Rates

The survival rate study completed for the Phase I report has been updated to include 1998-99 data. Of all companies using the equity tax credit between 1994 and 1999, 88% are still in business as of November 1, 2000. By comparison, 72% of all companies incorporated between 1994 and 1999 are still in business as of November 1, 2000.

These findings are consistent with the Phase I study which found a significant increase in the survival rates of participant firms.

Review of Phase I Studies

The Phase I report contained a study of the financial statements of 31 corporations that had been certified under the ETC in the 1994 to 1997 period. The following is a summary of the major findings of this study.

Revenues

- The average annual change in revenues was positive for ETC-certified corporations in all economic sectors. Overall, the corporations experienced an 89 percent increase in revenues for the year following the ETC-certified investment, and a further 33 percent increase in the second year.

Profitability

- The companies studied were not very profitable. In Year 0, the year of certification, the companies recorded an average loss of $25,309. This figure increased to $68,445 in Year 1. This number is somewhat skewed by the results of the two companies that lost a combined $1.7 million in year 1. In year 2, the companies reported a modest average profit of $3,405.
- Being new businesses, most firms participating in the ETC program are in the high-growth period of the corporation's life cycle. Firms in a high-growth period often cannot fund their growth exclusively through corporate earnings, and therefore must access funds through external sources, either through debt, equity or both. These firms commonly exhibit strong revenue growth but only modest profitability.

Payroll

- The average annual change in payroll expenditures was positive for ETC-certified corporations in all economic sectors. Overall, the corporations doubled payroll expenditures in the period following certification, and increased payroll expenditures by 51 percent in Year 2.

Liquidity

- The corporations studied experienced an improvement in their financial ratios calculated in the two periods following certification (i.e., current ratio, debt-to-equity and total debt-to-asset ratio).

Survey

The Phase I report included a survey of all companies that had been certified under the program from 1994 to 1998. The survey of companies resulted in a 25 percent response rate. Overall, the results were positive towards the credit. The following is a summary of the major findings:

- 93 percent agreed that the ETC encouraged equity financing as opposed to debt, and for 89 percent it allowed the corporation to obtain equity financing that was otherwise unavailable.
- The majority of the companies surveyed, 75 percent, agreed they could not have started or expanded without the ETC.
- Overall 86 percent of respondents agreed that the ETC has had a positive effect on the corporation.

Economic Impact Analysis - Revised

An economic impact analysis using the Nova Scotia Input/Output (NSIO) was completed for the investment expenditures of companies certified from 1994-1999 and their ongoing annual operations associated with the ETC investment. The results are presented in the following table.

The net cost-benefit of the ETC for each year (in the table) is the difference between the cumulative total tax revenue foregone due to the ETC and the cumulative total tax revenue collected as generated by ETC investment.

The payback is the year in which the benefits related to the ETC investment (investment expenditures and their related ongoing annual operations) turn a positive cash flow for the provincial treasury.

The assumption of incrementally is critical to economic analysis of the ETC program. The impacts of the ETC program are assumed to be totally incremental. In other words, if the operation would have been undertaken anyway, without the ETC incentive, the ETC would have been a total cost without generating benefits of any kind to the province. It is noted that 75 per cent of respondents in a Department of Finance survey of companies involved in the ETC program indicated that they would not have started a company or expanded operations without the credit. This provides evidence that the ETC is significantly incremental.

Summary of Findings

- On a financial cost-benefit analysis basis, the ETC does not provide an immediate positive return to the provincial treasury, but this is to be expected with this type of program because the investment is considered to be 'seed' or start-up capital. In future years, the investment helps to generate ongoing economic impacts as long as the company survives.
- Payback analysis determines that the ETC investments made over the time period 1994-1999 will generate a positive cash flow to the provincial treasury by 2001. This payback is favorable and is consistent with commercial appraisals which use a five year payback as the basis for undertaking an investment.

Table 8: 1994 - 2001 Impact, Cost/Benefit and Payback Analysis of the Nova Scotia Equity Tax Credit

Indicator	1994	1995	1996	1997	1998	1999	2000	2001
Total Investment ($'000): Cumulative:	$414.7 $414.7	$1,633.5 $2,048.2	$5,583.4 $7,631.6	$8,131.3 $15,763	$6,130.0 $21,893	$9,004.0 $30,897	N/A $30,897	N/A $30,897
Total Employment (PYs): Cumulative:	12 12	44 56	176 232	436 668	706 1,374	905 2,278	663 2,941	663 3,604
Total Wages and Salaries ($'000): Cumulative	$300 $300	$1,107 $1,407	$5,078 $6,485	$10,931 $17,416	$17,719 $35,136	$22,701 $57,838	$16,638 $74,477	$16,638 $91,116
Provincial Gov't Revenue ($'000): Cumulative	$32 $32	$115 $147	$546 $694	$1,152 $1,847	$1,868 $3,716	$2,394 $6,110	$1,754 $7,865	$1,754 $9,620
(ETC) Foregone Revenue ($'000): Cumulative:	$104 $104	$484 $588	$1,672 $2,261	$2,374 $4,635	$1,939 $6,574	$2,483 $9,057	$0.00 $9,057	$0.00 $9,057

Table 8: 1994 - 2001 Impact, Cost/Benefit and Payback Analysis of the Nova Scotia Equity Tax Credit

Cost/Benefit/Payback to Provincial Government ($'000)	(-$72)	(-$441)	(-$1,567)	(-$2,788)	(-$2,858)	(-$2,948)	(-$1,192)	+$562

Source: NS Department of Finance; Note: Totals do not add exactly due to rounding.

Conclusions

The ETC studies conducted in the Phase I and Phase II program review indicate that the ETC program has had a positive impact on participating companies and has generated net revenues for the province:

- The survey results indicate that 93 percent of respondents agreed the ETC encouraged them to seek equity financing as opposed to debt; and 89 percent indicated it allowed them to obtain equity financing that was otherwise unavailable.
- Three quarters of respondents indicated that they would not have started or expanded their business without the ETC.
- Of all companies certified under the ETC between 1994 and 1999, 88% were still in business as of November 1, 2000. By comparison, 72% of all companies incorporated between 1994 and 1999 were still in business as of November 1, 2000.
- A study of 31 participant firms showed the majority of firms improved in terms of revenue, payroll expenditures, and liquidity ratios in the two years following certification.
- Payback analysis determines that the ETC investments made over the time period 1994-1999 will generate a positive cash flow to the provincial treasury by 2001. This payback is very favorable especially compared to commercial appraisals which use a five year payback as the basis for undertaking an investment.

Policy Decisions
• The General ETC program will be extended to December 31, 2003, the same end date as for the CEDIF program.

Labour-Sponsored Venture-Capital Corporation Tax Credit

Introduction

The Labour-Sponsored Venture-Capital Corporation (LSVCC) Tax Credit is a 15 personal tax credit for investments in provincially registered Labour-Sponsored Venture Capital Corporations. Individuals may receive a maximum provincial credit of $525 (based on a maximum investment of $3500) per year. Individuals may also receive a 15 percent federal tax credit up to a maximum $750 per year. The credit is not refundable and cannot be carried forward to future years.

A Labour-Sponsored Venture Capital Corporation (LSVCC) is a venture capital investment fund sponsored by a labour organization with the general aim to create employment by making capital available to small and medium sized businesses. Theoretically, LSVCCs differ from traditional venture capital funds in that LSVCCs have significant mandates apart from achieving the highest return for investors. Canadian governments have encouraged the development of these funds by providing individual tax credits for investments in LSVCCs.

Only investments in LSVCCs registered with the Nova Scotia Department of Finance are eligible for the tax credit. Appendix E contains a list of the five LSVCC currently registered with the Department.

Policy Rational for the LSVCC

The LSVCC Tax Credit legislation is contained in the *Equity Tax Credit Act*, which was introduced in the fall 1993 budget. The stated intent of the legislation was to 'create an important pool of venture capital for the province.' The budget speech identified a 'lack of available equity capital' as a primary impediment to the development of businesses in the province. Specifically, the aims of the LSVCC tax credit were as follows:

- To provide capital to small and medium-sized Nova Scotia companies.
- To encourage investment in Nova Scotia companies by Nova Scotians.
- To encourage Nova Scotia companies to seek equity investment.

Appendix D contains an overview report on venture capital activity in Nova Scotia.

Program Participation

The LSVCC program was started in 1994 and through 1999, approximately $7.5 million in tax credits have been claimed:

Table 9: Program Funds and Expenditures

Fiscal Year	Funds Raised (Net of Redemptions)	Tax Credit Expenditure
1994	3,449,257	690,486
1995	18,797,570	4,311,747
1996	5,970,217	1,179,559
1997	2,762,299	397,704
1998	3,911,432	483,874
1999	3,698,063	454,750
Total	$38,588,838	$7,518,120

Source: NS Dept of Finance

Nova Scotia registered funds have raised approximately $38.6 million in the province since 1994. The funds are required to place 60% of all funds raised in the province with Nova Scotia businesses. This results in a total minimum LSVCC pool of approximately $23.2 million (60 percent of $38.6 million) as of December 31, 1999.

Analysis

The LSVCC Tax Credit was introduced in the spring 1993 budget. The tax credit was intended to 'create an important pool of venture capital for the province.' In order to be successful, the LSVCC legislation had to achieve two objectives:

- First, the credit had to encourage the creation of a Nova Scotia pool of venture capital by motivating Nova Scotia residents to invest in provincially registered LSVCCs.

- Second, the LSVCCs had to reinvest these funds in Nova Scotia businesses.

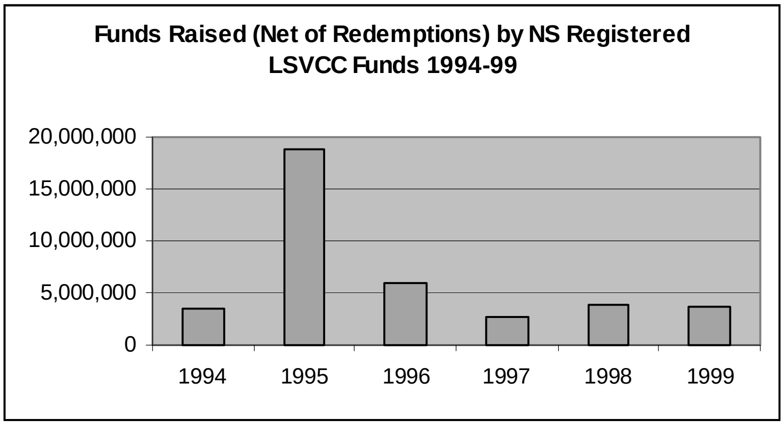
This analysis will therefore attempt to answer two questions:

- Has the LSVCC program been successful in creating a pool of venture capital for the province?
- Has this pool of funds been made available to Nova Scotia business?

The LSVCC Capital Pool

The following graph displays annual LSVCC pool contributions from 1994-99:

Figure 6: Funds Raised by NS Registered LSVCC Funds 1994-99



Source: NS Department of Finance

Amounts raised under the LSVCC Tax Credit Program are dependent on two factors: the marketing intentions of the registered LSVCC funds and market conditions that affect the ability of those funds to sell their products in Nova Scotia.

LSVCCs generally focus on either raising new capital or reinvesting existing capital. For example, Working Ventures was very aggressive raising capital from 1994 to 1996. The fund reduced its marketing efforts in Nova Scotia in 1997 and 1998 and focussed on reinvesting existing equity. The fund has recently increased its marketing efforts.

Several factors have affected the attractiveness of LSVCC products. The federal and provincial tax credit rates were reduced from 20% to 15% in 1996 and the holding period extended from five to eight years. Increases in the foreign content allowance for RRSPs has reduced an important benefit of LSVCC shares.

All of these factors considered it is unlikely that program activity will return to 1995-96 levels. If current trends continue, funds will rise between $3 million and $4 million per year, which would result in an annual pool contribution between $1.8 and $2.4 million.

Has the LSVCC Tax Credit program been successful in creating a pool of venture capital for Nova Scotia businesses?

The LSVCC program has created a venture capital pool of at least $23.2 million for Nova Scotia. This is an average contribution of about $3.9 million per year. Approximately 73 percent of these funds were raised between 1994 and 1996. At the current level of activity, the program will contribute between $1.8 million and $2.4 million annually to the provincial venture capital pool.

The LSVCC model has been effective for raising venture capital nationally and in Nova Scotia.

Reinvestment Activity

The Nova Scotia LSVCC tax credit is intended to encourage investment in Nova Scotia business. In order to ensure that the majority of funds raised in Nova Scotia are reinvested in Nova Scotia, registered funds must meet specific reinvestment requirements in order to maintain their registration and avoid penalties. The reinvestment criteria are as follows:

- **80%** of the equity capital raised in the Nova Scotia must be invested in eligible business entities or reserves within **3 years**.
- **60%** of the equity capital raised in the Nova Scotia must be invested in eligible business entities within **4 years**.

The following table provides sales and reinvestment activities for the provincially registered funds:

Table 10: LSVCC Reinvestment Activity

Fund	Gross Sales through 1999	Reinvestments through December 2000
Working Ventures	$14.1 million	$4,535,000
Canadian Medical Discoveries	$13.9 million	$6,550,000
Retrocom Growth Fund	$1.1 million	Nil
Triax Growth Fund	$7.5 million	$3,500,000
Canadian Science & Growth	$2.0 million	$1,250,000
TOTAL	$38.6 million	$15,835,000

Source: NS Department of Finance

The LSVCCs have reinvested approximately 41 percent of all funds raised and 68 percent of the $23.2 million provincial pool.

The $15.8 million in investments have been made in seven different companies for an average placement of about $2.3 million. Two investments were start-ups and account for $2.8 million. The seven companies represent a variety of economic sectors including biomedical, software engineering, new media, and manufacturing. Six of the companies are located in HRM. One company is located in Sydney. Appendix F includes details on the investments.

The investment activity of the funds is consistent with the industry nationally: the funds have made large investments in a limited number of companies in high value-added industries.

As discussed in the background report in Appendix D, venture capital investment activity needs to be distinguished from other forms of investment activity including economic development investment. The 1993 budget speech does not make such a distinction, though the speech does seem to refer to what can be described as 'economic development capital' activity.

From an economic development capital perspective, the LSVCC program has had the following drawbacks:

- The LSVCCs have not invested in a wide range of Nova Scotia companies.
- Investments have been limited to urban centres.

Has the LSVCC Tax Credit program been successful in making venture capital available to Nova Scotia business? The answer to this question depends on the evaluation criteria used and the evaluation criteria depends on the specific kind of investment activity the program is meant to encourage:

- If the program is meant to encourage *venture capital activity*, it can be concluded that registered LSVCC have undertaken investment projects in the province that are consistent with activity in other parts of the country, although on a much smaller scale.
- If the program is meant to encourage *economic development capital activity*, it can be concluded that the program has not been successful in making capital available to a wide range of Nova Scotia businesses.

Regardless of the specific kind of investment activity the program is intended to encourage, the provincially registered LSVCCs have been slow to reinvest funds, and this has considerably reduced the benefit of the program to the government.

On average, it takes the LSVCCs three and a half years to reinvest funds raised in the province. Since most venture capital investments are made with long-term growth in mind, it may be an additional four or five years before the investment begins to show significant returns in the form of corporate tax revenue and employment expenditures. Given these two factors, it may be close to a decade before the government realizes any benefit from the tax expenditure.

While the provincially registered LSVCC funds have expressed a commitment to meeting pacing requirements, the Nova Scotia pacing requirements are among the most lenient in the country. Most provinces require registered LSVCCs to reinvested funds within two years.

Comments From Public Consultations

In preparing this report, the Department consulted with provincially registered LSVCC funds, local venture capitalists, and local tax practitioners. The aim of these consultations was to obtain a better understanding of venture capital activity in Nova Scotia, expected future directions, and the appropriate role of government in this process. The following is a synopsis of these comments:

Venture Capital Activity in Nova Scotia

- Nova Scotia is gaining a national profile in the venture capital community. This is largely attributable to the favorable economic performance of the Halifax area in recent years. Venture capitalists invest where opportunities are available, and the economic success of the Halifax area has attracted investors.
- An important recent development is the establishment of several local venture capital funds. This local presence will raise the profile of the province and help put venture capital 'on the ground' in Nova Scotia.
- Participants were generally optimistic about the future of venture capital in Nova Scotia and expect the recent positive developments to continue. A frequent comment is that 'good' projects are receiving financing.
- Participants commented that "all the trends were good" for venture capital in Nova Scotia, and that patience was required to allow the industry develop.

Challenges Facing the Venture Capital Industry

- Capital formation is a principal challenge facing the industry. Institutional investors largely left venture capital in the late 1980's, which was a principal rationale for the creation of LSVCC funds. Capital raised from the general public will remain important until institutional investors return to the market. All things being equal, most venture capitalists would prefer to work with institutional investors.

Challenges Unique to Nova Scotia

- The venture capital industry in Canada tends to favour later stage investment. Although there are many Nova Scotia entrepreneurs developing promising products and technologies, they are often unable to obtain the seed capital required to prove the commercial viability of their ideas to potential investors.
- The sizes of venture capital deals are not significantly smaller in Nova Scotia than in the rest of the country.

Table 11: Average Venture Capital Deal Size 1997-1999

	Atlantic Canada	Ontario & Quebec	All Venture Capital Investments
1997	1.29	1.93	1.96
1998	1.17	1.48	1.54
1999	2.44	2.74	2.75

Source: Canadian Venture Capital Association (CVCA)

- Since the region has a smaller number of companies than can absorb this level of investment, there is less venture capital activity in the region.
- Participants commented that a venture capital fund needs at least $20-30 million in assets in order to invest in a variety of projects and to provide follow-up financing. In the

Atlantic Region it is difficult to raise these funds from the general public. It is even more difficult when several funds are competing for investment dollars. It has been suggested that capital formation issues need to be addressed on a regional as opposed to a provincial basis.
• Venture capital in Nova Scotia is hampered by a relative shortage of management talent available to run emerging companies. Venture capitalists often face a challenge in creating management teams for the companies in which they have invested.

Specific Commitments from the LSVCCs

• The LSVCC funds stressed that venture capital has made significant advances in the province since the early 1990's and an elimination of the provincial LSVCC tax credit would be a major set-back to this development.
• The LSVCC funds noted that the recent increase in LSVCC investment activity is attributable to an increase in the number of suitable investment opportunities.

The Role of Government

• Participants generally indicated that government should not attempt to influence venture capital activity in the province, but conceded that in the absence of institutional investors, personal tax credits may be necessary to promote capital formation.
• Venture capitalists need the freedom to invest in the geographic areas and economic sectors that offer the greatest return on investment. Government involvement cannot have 'strings attached' with respect to regional economic initiatives or other economic development priorities.
• Government programs must be tailored to the stage of investment the program is attempting to stimulate. For example, at the seed stage, it was suggested that direct funding to incubators is the most effective way of assisting entrepreneurs in commercializing their products. To promote expansion stage development, government should encourage venture capital formation through personal tax credits, but should allow venture capitalists to make investment decisions.
• Participants indicated that competition among venture capital funds is healthy for the industry, but stressed that the government should not confer special advantages on any one fund by way of start-up assistance.

Specific Recommendations from Public Consultations

• Until institutional investors return to the market, there will be a need for personal tax credits.
• Government should explore ways to encourage provincial pension funds to invest in provincial venture capital funds.
• The venture capital industry is growing in Nova Scotia, and the government should be careful not to implement any measure that may disrupt this development.
• Companies have different capital requirements at different stages of their development, and government programs must be designed to address these unique needs. For exam-

ple, at the seed stage, it was suggested that direct funding to incubators is the most effective way of assisting entrepreneurs in commercializing their technology or product.

Conclusions

- The LSVCC model has been effective for raising venture capital nationally and in Nova Scotia. The registered LSVCCs have reinvested funds raised in the kind of projects undertaken in other parts of the country, although on a much smaller scale.
- The LSVCC funds have failed to make capital available to a wide range of Nova Scotia companies. However, this may not be an appropriate criterion for measuring the success of the program.
- The funds have been slow to reinvest funds raised. This can be partly attributed to the Nova Scotia pacing requirements, which are among the most patient in the country.
- Venture capital activity in Nova Scotia has increased substantially in the past few years. The province is gaining a national reputation as a technology center and is attracting venture capital from outside the region. Local venture capitalists are confident these trends will continue. A frequent comment is that 'good' projects are receiving financing.
- Local venture capitalists indicate that personal tax credits are required to ensure new venture capital is available. They stress that private fund managers must be free to make investment decisions and that government should not impose an economic development mandate.
- Companies have different capital requirements at different stages of their development, and government programs must be designed to address these unique needs.

Policy Decisions
• The LSVCC Tax Credit will be sunset as of December 31, 2003. The program will be evaluated before this date to determine whether it should be extended.
• Pacing requirements will be amended: registered LSVCCs will have to reinvest 60 per cent of funds raised in the province in eligible businesses within two years instead of the current four years.

HST Rebate: New Housing Rebate

Introduction

The New Housing Rebate was introduced in 1997 as part of the Harmonized Sales Tax (HST). The rebate was intended to replace the First Time Home Buyer's rebate offered under the former Health Services Tax. The New Housing Rebate is equivalent to 18.75 percent of the provincial HST owing (or 1.5 percentage points of the 8 percent tax) on new housing construction, to a maximum of $2,250 per unit. This maximum per unit rebate is reached at a new house price of $150,000. All new houses are eligible for the credit, regardless of price.

The rebate applies to new home construction or substantial renovations (90 percent or more) performed by the owner or a contractor. The credit may be assigned to the builder, but the ultimate beneficiary is the final purchaser. The provincial HST rebate applies to the same types of housing expenditures as the federal GST rebate.

Objectives

The New Housing Rebate has two basic objectives.

The first is economic: to neutralize the effects of implementing the HST on the price of new housing. The HST on housing construction represented an added cost for consumers. A temporary measure was needed to ensure that residential housing starts were not unduly affected before the market had a chance to adjust to the changes.

The second is social: to make home ownership more affordable for moderate-income families.

Program Activity

The former First Time Home Buyers' Rebate cost $3,997,902 in 1995-96 and $9,252,348 in 1996-97. The dramatic increase in 1996-97 can be attributed to the fact that potential home buyers were aware the program was ending, but there had been no announcement on a replacement program. This prompted many home buyers to accelerate their purchasing decisions.

The cost for the New Housing Rebate is as follows:

- $2,442,442 in 1997. Since the credit was introduced in April 1997, the 1997 figure includes data from April 1 to December 31, 1997.
- $4,150,222 in 1998.

The number of maximum claims ($2,250 per unit) is only 13.5 percent of the total number of claims indicating that the majority (86.5 percent) of claims were for housing less than $150,000.

Analysis

This analysis will attempt to evaluate the economic and social policy objectives for the New Housing Rebate outlined above.

Economic Policy Objective

The New Housing Rebate was introduced in part to help neutralize the effects of the implementation of the HST on the price of new housing by effectively lowering the price paid for housing by a maximum of $2,250 per unit. It was assumed that the additional cost to the builder would negatively impact the housing starts in the province. The rate of housing starts over a given period of time depend on a variety of factors in addition the price of housing. These factors include demographic and economic factors:

- Demographics: Individuals have different housing needs at different points in their lives. As a given generation ages, their demands for housing will influence the rate of housing starts. A change in the number of housing starts can often be attributed to an unusually large or small age group entering the housing market. Demographic trends indicate that the growth rate of source population (15+) in Nova Scotia is decreasing over the medium term suggesting that the number of first-time home buyers (target population in the low-to-middle income bracket) will decline.
- Economic Conditions: Empirical studies conducted by Canada Mortgage and Housing Corporation (CMHC) suggest that market conditions other than price have an influence on new house construction. Their studies have found that mortgage rates and personal income growth are the two most significant determinants of construction demand.

Studies have also found that home buyers are more concerned with the monthly mortgage payment costs than the overall price of the home. Based on this assumption, under the fifty percent pass-through scenario on which the rebate is based and with a 4.5 percent increase in house prices due to the HST, monthly mortgage payments would increase by the same amount as if mortgage interest rates increased 0.5 percent. On a 25-year mortgage of $100,000, the monthly payment increase would be between $29.12 on a one-year term and $34.20 on a five-year term.

The following table displays housing start activity (single-detached and semi-detached) in Canada and Nova Scotia from 1988 to 1999:

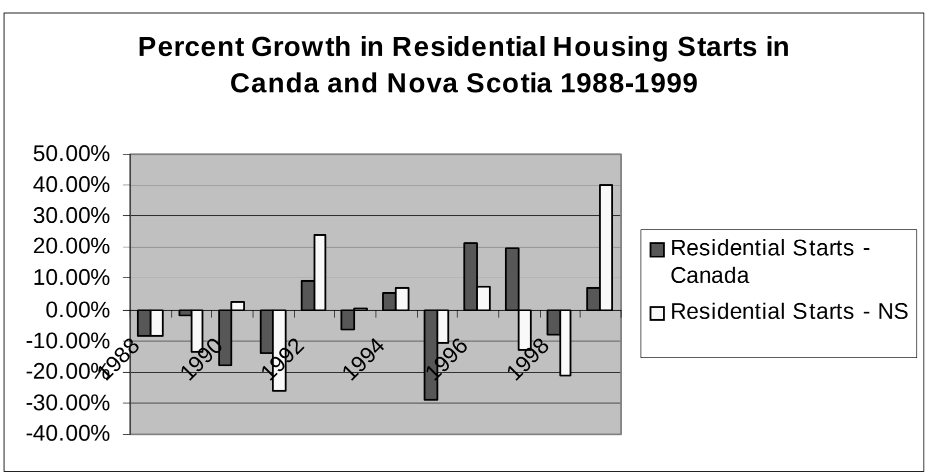
Table 12: Single-Detached and Semi-Detached Housing Starts for Nova Scotia and Canada 1988-99

Year	Residential Housing Starts Nova Scotia	Residential Housing Starts Canada
1988	4,444	136,093
1989	3,846	133,492
1990	3,949	109,866
1991	2,905	95,602
1992	3,605	103,165
1993	3,622	96,540
1994	3,876	101,628
1995	3,457	71,961
1996	3,725	87,301
1997	3,242	104,571
1998	2,547	96,474
1999	3,565	103,282

Source: CMHC Quarterly Housing Starts

The growth rate in residential housing starts in Nova Scotia generally corresponds with activity nationally. The average annual growth rate in single-detached and semi-detached housing starts was -1 percent in Nova Scotia compared to -2 percent nationally from 1988-1999.The following graph displays the annual growth rates in residential housing for Canada and Nova Scotia from 1988-1999.

Figure 7: Annual Growth in Residential Housing Starts in Canada and NS 1988-99



Housing starts declined in Nova Scotia by 13 percent from 1996 to 1997 and by 21.4 percent from 1997 to 1998. Housing starts nationally increased during this period. The 1997 housing numbers were negatively affected by a surge in housing starts in 1996 that occurred after the announcement of the elimination of the First Time Home Buyers Rebate, but before the announcement of the new HST rebate. Potential homeowners accelerated their purchasing decisions in order to be eligible for the First Time Home Buyer's rebate under the Health Services Tax. There were 2,515 starts alone in the second and third quarters of 1996.

Provincial single-detached and semi-detached housing starts increased 40 percent from 1998 to 1999. This growth rate exceeded the 7.1 percent growth rate nationally during the same period.

Social Policy Objective

In addition to economic considerations, the New Housing Rebate is intended to make homeownership affordable for moderate-income families. The federal and provincial rebates have had the positive social benefit of providing many families with a down payment for their first home.

Homeownership is generally perceived as having positive social impacts. Home ownership, among other things, encourages stability: stable communities, stable work forces, stable tax bases. Home ownership provides greater commitment to communities as homeowners have a greater stake in the long-term value of the community.

Tax Policy Considerations

The rebate is currently available to all home builders regardless of the cost of the home. The relative value of the credit to the home builder decreases as the price of the home increases. For example, on a $150,000 home, the rebate represents 1.5 per cent of the purchase price. On a $250,000 home, the maximum rebate represents less than one per cent of the purchase price. In the context of scarce resources, fairness and equity would suggest that the government should assist those families that most need financial help to become homeowners.

The average fair market value of a new home, based on the 1998 rebate claims, was approximately $124,000. A new housing rebate threshold of $100,000 for first-time home buyers would ensure that those families most in need would receive the benefit.

This measure would not reduce the total amount of housing starts, since families who need the rebate as a down payment would still receive it. Most individuals buying their second home use existing equity for their down payment.

Conclusions

- Provincial housing starts were down in 1997 and 1998, but exceed the national average in 1999.
- The rebate has had the positive social benefit of providing home buyers with a down payment for their house.
- The incremental impact of the credit on a family's decision making process decrease as the cost of the house increases. In the context of scarce resources, fairness and equity would suggest that the government should assist those families that most need financial help to become homeowners.
- A new housing rebate threshold of $100,000 for first-time home buyers would ensure that those families most in need would receive the benefit.

Policy Decisions
The HST New Housing Rebate will be amended as follows:.
• The maximum rebate claim is reduced to $1,500 ($100,000 purchase price).
• The rebate will be limited to first-time home buyers.
• The new rules will start on January 1, 2002. Transitional rules will be developed to ensure individuals buying new homes during the current construction period will not be affected.

HST Rebate: Persons with Disabilities Rebate

Introduction

The HST Rebate for Persons with Disabilities was introduced in April 1998 to replace similar tax relief provided under the health services tax (PST). The rebate applies to purchases of vehicles for people with disabilities that prevent them from using their legs.

The HST rebate is 100 percent of the provincial portion of the HST, or 8 percent. The maximum rebate is $3,000, reached when the vehicle costs $37,500. Vehicles with a purchase price above this amount are still eligible for the maximum rebate.

The federal government offers a GST rebate on the cost of auxiliary driving controls and wheelchair lifts attached to specially equipped vehicles. The GST rebate does not apply to the full purchase price of the vehicle, but there is maximum amount that an individual can claim.

Objectives

Arguments supporting the HST Rebate for Persons with Disabilities are based primarily on the principle of fairness. People with disabilities pay more for personal transportation. Auxiliary driving controls and wheelchair lifts can cost up to $10,000. Personal transportation is a basic requirement for access to employment opportunities and public services. The tax rebate reduces some of the additional costs people with disabilities incur to pursue activities that are available to other citizens.

Although the rebate does not fully reimburse individuals for the added costs of specially equipped vehicles, the intent of this program was to rebate only the HST on such purchases.

Program Activity

When the tax measure was introduced, the government projected that the annual cost of the rebate be about $200,000. The actual annual costs for this program is:

- $224,432 for 1997-98
- $166,018 for 1998-99
- $150,368 for 1999-00

Conclusion

- The costs of the HST Rebate for Persons with Disabilities has not exceeded projected program costs.

• Arguments supporting the HST Rebate for Persons with Disabilities are based primarily on the principle of fairness. People with disabilities pay more for personal transportation.

Policy Decisions
• The HST Rebate for Persons with Disabilities will be continued.

HST Rebate: Printed Book Rebate

Introduction

The HST Printed Book Rebate offers a 100 percent point-of-sale rebate of the provincial portion of the HST, or 8 percent. The rebate applies to the purchase of printed books, audio recordings of printed books, printed versions of scriptures of any religion, and periodicals that have less than 5 percent of the total printed space dedicated to advertising. There is no limit on the amount of the HST rebate.

The rebate was introduced in 1998 to replace similar tax relief provided under the health services tax (PST). The HST rebate rules are essentially the same as the former PST rules, except that the PST provided an exemption from tax as opposed to a tax rebate. The end result for the purchaser is the same: the individual pays no provincial sales tax on the purchase of qualified products.

The HST Printed Book Rebate definition of printed book is slightly different from the definition under the former PST. Some notable exceptions are:

- The HST definition includes unbound printed books and road maps, and
- The HST definition excludes newspapers, atlases and coloring books.

Since the HST Printed Book Rebate is a tax rebate, the supplier is required to offset the rebate given to purchasers against their tax owing to the Canada Customs and Revenue Agency (CCRA) on all of their taxable sales. This means that the supplier must track sales of printed books in order to have its point-of-sale rebate claim approved. This increases the administration burden when compared with an up-front exemption.

Objectives

The HST Printed Book Rebate was intended to replace similar tax relief provided under the PST.

Program Activity

The government projected that the HST Printed Book Rebate would cost about $5 million each year. Since the HST rebate is a point-of-sale rebate, there is very little administrative data because the tax return filed by a HST registrant does not require that they provide details regarding their point-of-sale rebate claim. The cost of the rebate must be estimated using relevant economic data.

The HST Printed Book Rebate cost about $5.02 million in 1998. The costs of this rebate are in line with original estimates.

Conclusion

The costs of the HST Printed Book Rebate has not exceeded projected program costs.

Policy Decisions
• The HST Rebate for Printed Book Rebate will be continued.

HST Rebate: Volunteer and Municipal Fire Department Rebate

Introduction

The province introduced the Volunteer and Municipal Fire Department Rebate in 1998. The rebate is available to volunteer fire departments and municipalities on the purchase of fire fighting vehicles and heavy equipment. The rebate was intended to replace special tax relief provided under the former health services tax (PST).

The Volunteer and Municipal Fire Department Rebate is designed to top-up the existing Public Sector Body Rebates that volunteer fire departments (50 percent rebate) and municipalities (57.14 percent rebate) qualify for under the HST. When the Public Sector Body Rebates are combined with the provincial HST rebate, volunteer fire departments and municipalities effectively receive a 100 percent rebate.

Volunteer fire departments receive a 50 per cent rebate on the provincial portion of the HST paid, to a maximum of $7,400. Municipalities receive a 42.86 per cent rebate on the provincial portion of the HST paid, to a maximum of $6,343.28. These maximum rebate amounts are reached on the purchase eligible equipment of $185,000. Vehicles with a purchase price above this amount are still eligible for the maximum rebate.

Objectives

The primary rationale for the Volunteer and Municipal Fire Department Rebate is that tax relief should be provided for purchases of emergency vehicle equipment. Volunteer and municipal fire departments provide a vital public service. A sales tax on this equipment would serve as a disincentive to volunteer fire departments purchasing new equipment.

Program Activity

The government projected that the Volunteer and Municipal Fire Department Rebate would cost about $500,000 each year. The rebate actually cost:

- $17,025 for 1997-98
- $36,373 for 1998-99
- $126,177 for 1999-00

Annual tax rebate costs for this program tend to vary because purchases of new fire fighting equipment represent a significant capital investment that is not incurred by volunteer and municipal fire departments on an annual basis.

Conclusion

The costs of the Volunteer and Municipal Fire Department Rebate has not exceeded projected program costs.

Policy Decisions
• The Volunteer and Municipal Fire Department Rebate will be continued.
• The existing Sales Tax Act Regulations will be amended to correct an error in the existing erratum.

General Comments

Annual Tax Credit Reviews & Tax Credit Expenditure Reports

In 1998-1999, Nova Scotia tax credit expenditures were approximately $120 million, and this number is expected to increase significantly over the next few years. Given the magnitude of these expenditures, it is important that the Department of Finance periodically determine the effectiveness of tax credit programs and report tax credit expenditures on an annual basis.

The following are specific recommendations on the creation of periodic tax credit review and tax expenditure reporting function:

- A tax credit expenditure summary report should be completed each spring.
- Given the time required to complete a proper analysis, a limited number of tax credit programs should be reviewed periodically. Programs approaching sunset should be reviewed to determine if the tax credit expenditure is still warranted. The Department should attempt to evaluate all programs within four years of the initiation of the program and before programs are set to expire.
- Existing tax credit programs should be examined in order to identify opportunities to incorporate data gathering in the application process. For new programs, administration procedures should be designed with intent to evaluate the program in future periods.

Related Issues

This report represents the completion of Phase II of the Nova Scotia Tax Credit Review. Some tax credit reviews are ongoing. The film industry tax credit is being reviewed and an independent business climate review is under way to provide government with a broader understanding of the business climate in this province compared to other jurisdictions. Other tax-credit-related incentives, which have not been included in either Phase I or II of the review, will be studied in 2001-02.

Film Industry Review

The film industry tax credit was evaluated as part of Phase I of the Nova Scotia Tax Credit Review. At that time it was decided that there would be continued work on both the equity tax credit program (which has been included in this report) and the film industry tax credit. A separate process to review the film industry in the province is now under way and the results of this work are expected by March 2002. The program is set to expire on December 31, 2002 and the study will attempt to provide an understanding of the costs and benefits associated with the provincial film industry.

Business Climate Review

The department is reviewing the Nova Scotia business climate in order to gain a better understanding of how Nova Scotia's business climate compares to that of other jurisdictions.

The study will determine the total cost of doing business in Nova Scotia (with particular emphasis on taxation) and will compare it to the total cost in other jurisdictions. Taxation considerations will include both personal and corporate taxation. The study will include an analysis of:

- Taxation rates
- Labour costs and markets
- Transportation infrastructure
- Capital costs
- Operating costs
- Availability of capital
- Regulatory environment
- Industrial capacity
- Knowledge capacity
- Lifestyle considerations

Small Business Tax Reduction

The small business rate reduction will be reviewed as part of the business climate report.