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Global Economics

5 September 2009

Online at <https://mpra.ub.uni-muenchen.de/59021/>
MPRA Paper No. 59021, posted 01 Oct 2014 19:17 UTC

Global Economics Ltd.



**The Conservative GST Cut Has Catalyzed
Sales Tax Harmonization**

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Global Economics Policy Paper 2009-1

September 5, 2009

Abstract:

Some economists have attacked the two-percentage point cut in the GST to 5 per cent proposed by the Conservatives in the January 2006 Canadian federal election. The main reason for this is that many economists believe that, if money was available for tax cuts, it would make more sense to use it to lower income taxes than the GST. This is because the personal income tax is, in theory, a relatively inefficient tax that penalizes savings. In practice, however, the income tax does not penalize savings as much because of the prevalence and widespread use of tax deductible savings plans and a new Tax-Free Savings Plan that can be used as an additional way to shelter interest income and that make the income tax more like a more efficient consumption tax. A neglected additional advantage of the GST cuts is that the lower GST rate they establish made it easier to achieve an agreement to harmonize provincial sales taxes with the GST, which is what happened in Ontario and British Columbia (although B.C. subsequently backed out). A lower 5-per-cent GST rate is becoming an accepted fiscal fact of Canadian life and is unlikely to be reversed.

JEL Classification Codes: H21– Efficiency – Optimal Taxation; H25 – Business Taxes and Subsidies; H71– State and Local Taxation, Subsidies, and Revenue; H77 – Intergovernmental Relations • Federalism • Secession

Keywords: Goods and Sales Tax (GST), provincial sales tax, harmonization

The two-percentage point cut in the GST to 5 per cent has been very controversial ever since it was proposed by the Conservatives (2006) in the January 2006 election. And the controversy has continued to rage even after the proposed cuts were introduced in two one-percentage-point stages, the first coming January 1, 2007 and the second January 1, 2008.

Some economists have been particularly virulent in attacking the cuts. During the 2006 campaign, one practitioner of the dismal profession, who not surprisingly got the most press coverage, was quoted in a CBC (2005) story as saying that the idea was "Stupid, stupid, stupid, stupid, stupid." Then, a survey of 20 economists done by the Globe and Mail in October 2007 revealed an uncharacteristic agreement that it would be better for the country to reduce other taxes than the GST (Grant, 2007,pA2). This apparent consensus is all more surprising given that the polled economists came from such ideologically non-kindred organizations as the Fraser Institute, the Canadian Auto Workers, Canadian Manufacturers & Exporters, Bank of Montreal and the Halifax-based Atlantic Institute for Market Studies.

The main reason that economists opposed the GST reductions is that they believe that, if money was available for tax cuts, it would make more sense to use it to lower income taxes than the GST. This is because the personal income tax is, in theory, a relatively inefficient tax that penalizes savings. It does this by double taxing savings -- once when the income is initially earned and again when interest is paid. In contrast, the GST is widely regarded to be a much more efficient tax, only taxing consumer expenditures once.

That is the theory. In practice, the income tax does not penalize savings as much because of the prevalence and widespread use of tax deductible savings plans like RRSPs and RPPs. And now there is the new Tax-Free Savings Plan (TFSP) that can be used as an additional way to shelter interest income.

A few economists, myself included, took issue with the apparent conventional wisdom in the profession against the GST cuts. This included most notably Jon Kesselman (2006; 2007), who made a very strong case for the GST cuts on the grounds that it would reduce distortions between taxable and non-taxable goods and services, including those produced in the underground economy, and that it would facilitate the harmonization of the GST with the retail sales taxes in the provinces that have not yet harmonized. Michael Smart and Richard Bird (2006) also leaned towards the pro-GST-cut camp, arguing that the reduction in the GST could usefully be packaged as part of a broader reform if it was accompanied by a reduction in transfers to provinces and provincial harmonization and compensating tax increases. In their view, this would lead to a better balanced federation and improvements in efficiency resulting from the elimination of taxes on business inputs, including investment.

So at least a few of us can claim that we argued that the GST cuts could make it easier to achieve an agreement to harmonize taxes. And, lo and behold, that is exactly what is happening. Ontario and British Columbia have both entered into agreements with the

Federal Government to harmonize their provincial sales taxes with the GST, establishing a Harmonized Sales Tax (HST) like in the Atlantic provinces.¹ This should serve to convince most economists, including even those who were most critical, that the GST cuts were not just good politics, but good tax policy.

It's hard to believe that Ontario and British Columbia would have agreed to harmonize their sales taxes with the GST if the aggregate rate would not have been reduced by the cuts. While the compensation for transition costs paid to the provinces (\$4 billion to Ontario and \$1.6 billion to B.C.) made harmonization more financially attractive, particularly given the large deficits the provinces were facing, and will also help pay for tax reductions and other benefits to make the HST more palatable to taxpayers, the lower overall rates (13 per cent in Ontario and 12 per cent in B.C.) were clearly what made the HST a political possibility. Even at these significantly lower rates the governments of Ontario and British Columbia are still taking heavy flack from those opposed to the HST who erroneously attempt to portray harmonization as nothing more than a disguised tax grab.

After Ontario and British Columbia come on board, the HST (including the TVQ in Quebec, which harmonizes the GST with the provincial tax rather than vice versa) will extend to seven provinces. This will leave only PEI, Saskatchewan and Manitoba out. And maybe not Manitoba for long as it is considering joining up as well.

By the way, a common misperception is that Jean Chrétien's Liberals promised to eliminate the GST in their famous 1993 Redbook. In fact, they promised to transform the GST into a HST generating the same revenue. And they pointed to their success in negotiating a HST with Newfoundland, Nova Scotia, and New Brunswick as constituting "significant progress" in keeping their campaign promise.² The Conservative Government's further progress in producing an HST could thus be viewed, perhaps ironically, from a longer-term perspective as bipartisan cooperation in reforming Canada's system of sales taxation. And it took the much decried Conservative GST cut to make it possible.

The existence of separate, uncoordinated, federal and provincial sales taxes in the provinces from Ontario west and Prince Edward Island has long been considered by tax experts to be a grave structural deficiency in Canada's system of taxation. The existence of two taxes on theoretically what should be the same base has added to the complexity of the sales tax system and has increased administrative and compliance costs. And last, but not least, there is the taxation of business inputs by provincial sales taxes. The Federal Department of Finance (2007, p.79) estimated that sales taxes in provinces with their own sales tax raised the Marginal Effective Tax Rate on new business investment by 7 percentage points. And it argued that harmonizing the sales tax in these provinces with the GST would be "the single most important action that these provinces could take to improve their provincial and Canada's overall tax competitiveness."

While opposition politicians may be still criticizing the Conservative GST cuts, a lower 5-per-cent GST rate is becoming an accepted fiscal fact of Canadian life. Unlike his

predecessor, the new Liberal Leader Michael Ignatieff is not proposing to reverse the GST cut and jack the rate back to 7 per cent.³ And neither are any economists. If cutting the GST was such bad policy, you'd think that it would be the first tax people would propose to increase now that money is going to be needed to reduce the deficit once the recession is over. But I suspect it may be the last, given its political notoriety and the past battles and promises it evokes.

Notes

1. Jonathan Rhys Kesselman (2009) has most strongly made the case for the HST in B.C., putting forward persuasively all the arguments in its favour and debunking those of its opponents. In a more recent paper, he and Peter Spiro (2014) provided a devastating criticism of the main argument against the GST reduction, namely that a shift away from the GST will reduce economic efficiency.
2. Liberal Party of Canada (1993, p.22) and (1996, p.17).
3. While in December 2008, Michael Ignatieff said "I'm not going to take a GST hike off the table". His current position, according to CBC, is that "A Liberal government would eliminate the \$52-billion federal deficit 'hole' created by Stephen Harper's Conservatives without raising Canadians' taxes," but that he "refused to give details of how he planned to do it." (CBC News, 2009).

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