The GST Cut is not so Stupid

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Abstract:
This paper argues that the two-percentage point cut in the GST to 5 per cent proposed by the Conservatives in the January 2006 Canadian federal election and implemented in the 2007 budget was not "stupid" as suggested by many economists. To the contrary, it fortuitously turned out to provide needed fiscal stimulus of a particularly potent type just as the economy turned down. It also had a progressive impact on the incidence of the tax system. And finally the lower rate would make it easier to harmonize the GST with provincial sales tax.

JEL Classification Codes: H21– Efficiency – Optimal Taxation; H25 – Business Taxes and Subsidies; E62 – Fiscal Policy; H77 – Intergovernmental Relations • Federalism • Secession.

Keywords: Goods and Sales Tax (GST), tax cut stimulus, income distribution impact of GST cuts, harmonization of sales tax

As promised in the last election, Prime Minister Stephen Harper's Conservative Government introduced a second one-percentage-point reduction in the GST to 5 per cent effective January 1, 2008 (Conservative Party of Canada, 2006). Ever since the proposal to cut the GST was released in the platform, it has come under attack from economists. During the campaign, one practitioner of the dismal profession was quoted in a CBC story (2005) as saying that the idea was "Stupid, stupid, stupid, stupid." Moreover, a survey of 20 economists done by the *Globe and Mail* last October revealed an uncharacteristic agreement that it would be better for the country to reduce other taxes than the GST (Grant, 2007, p.A2) This 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.

These articles presenting the assembled wisdom of the economics profession provided the basis for the Leader of the Opposition Stéphane Dion's claim in a speech last October in London that "there is scarcely an economist on the planet who believes that taking another point off the GST is better than cutting income taxes." (Dion, 2007). Based on his interpretation of the economists' criticisms, he went on to present four reasons why a GST cut would be a mistake:

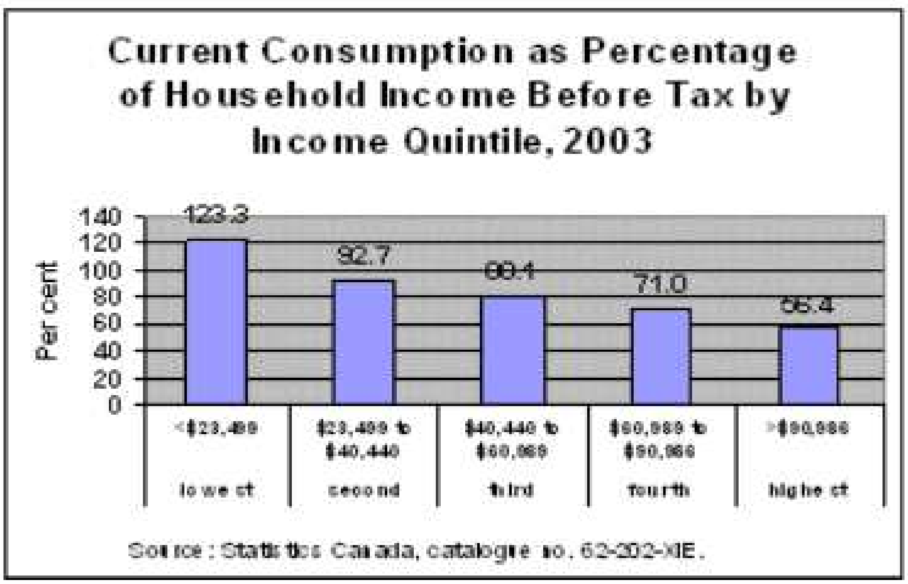
> First, compared with income tax cuts, a GST cut does nothing to improve our competitiveness in the world economy. Our consumption taxes in Canada are already quite low. In fact, compared with other OECD countries, our consumption taxes are among the lowest.
>
> Second, a GST cut does little to improve the fairness of our tax system. We already have a GST tax credit that helps individuals and families with low and modest incomes offset all or a significant part of the GST.
>
> Third, a GST cut does little to improve our productivity and to move our economy forward. Why? Because it does not give Canadians the choice to spend or save. To benefit, they must spend. This is the wrong direction when we have inflationary pressures and record low savings rates. Giving that we have an ageing population, we need more savings to create a more productive economy that will support the growing number of seniors in Canada. The bottom line is that a GST cut does not generate investment, nor does it do much to create jobs and improve our standard of living.
>
> Fourth, reducing the GST from 6% to 5% is an irresponsible use of the government budget. It will cost $6-billion per year or a massive $30-billion over five years. (Dion, 2007)

As a two-handed economist,[1] I can't resist putting forward the counter-arguments against these points and disturbing the professional harmony reigning among my colleagues.

Concerning the first point, while it is true that Canada's consumption taxes are lower than in Europe, they are much higher than in the United States where there is no federal sales tax and states sales taxes are lower. According to the OECD(2006, p.25), the United

States had the lowest consumption taxes in the industrialized world, which in 2004 amounted to less than 2.1 per cent of GDP or less than half the 5 per cent of GDP recorded in Canada. This large difference is much more important for our competitive position, particularly taking into consideration the possibility of cross-border shopping. In addition, it is generally agreed among economists that sales tax directly affect the price level, which is a critical determinant of wages. And everyone agrees that wages are important for our competitive position.

With respect to point two on the fairness of the tax system, it is important to note that data on family expenditures show that consumer expenditures fall quite dramatically as a proportion of income as income rises (see Chart). This is because low income people have to spend a much higher proportion of their income just to get by. Consequently, the tax savings from a cut in GST are progressive, meaning that they account for a larger proportion of income for low income earners than for high, even though the tax rate is the same for everybody.



In addition, it must be recognized that in the 1990s the GST credit, which was introduced to shield low income people from the full brunt of the GST, was not fully indexed to inflation until the year 2000 (only being indexed to increases in the consumer price index above 2 per cent during that period) and that as a result its value was severely eroded for low-income families. A recent study done by Statistics Canada staff (2007) quantified the extent of this erosion and concluded that the 2007 cut in the GST rate was just sufficient to restore the average amount of GST paid by families, net of the credit, to 1999 levels. The study showed that "the reduction of the rate meant that families who made less than $35,000 paid similar amounts of GST in 2007, net of the credit, as they did in 1992 while families who made more than $35,000 paid more GST in 2007 than they did in 1992." So in effect, the recent cuts in the GST rate can be viewed as improving the fairness of the tax system by restoring the originally intended degree of support provided by the GST credit to those with low income.

The third point made by Mr. Dion is also not as telling as it may seem. In theory, consumption taxes are better than income taxes because they do not favour consumption over savings. This is because an income tax taxes savings twice – once when the income is earned, and again when interest on the savings is earned, whereas a consumption tax is only levied when goods or services are purchased. An income tax thus tends to favour consumption over savings and distorts the incentive to save and invest. Consequently, it is always better to reduce the income tax than a consumption tax if the objective is to encourage savings and investment and to improve productivity. However, while this is the theory, in practice, the actual Canadian income tax incorporates deductions for savings for pensions and RRSPs which make it resemble a consumption tax as much as a true income tax. This reduces the extent of the productivity-enhancing effect of income tax reductions compared to GST cuts.

The factual part of Mr. Dion's fourth point is, of course, true. A one-percentage-point reduction in the GST rate will indeed cost $6 billion per year and $30 billion over 5 years. And a two-percentage-point cut costs $12 billion per year or $60 billion. But whether or not it is "irresponsible" is, of course, a matter of judgement.

This is about as far as we can take these points. Upon closer examination, they certainly don't appear to be convincing enough to justify the consensus among economists against the GST cut, which is invoked to support the Liberal Leader's position. And there are still additional, perhaps more telling, points that need to be considered.

Most importantly, when the policy of GST cuts was formulated, it wasn't intended to be an important part of a stimulus package designed to counter an economic slowdown. But now with the United States possibly slipping into a recession and a $168 billion fiscal stimulus package being debated south of the border, it's important to ask the question of how good the Conservative Government's GST cut will be in boosting the economy.

First, it is useful to recall that the introduction of the GST by the former Conservative Government of Prime Minister Brian Mulroney was very disruptive to the economy, contributing to the last recession. While it was estimated by the Government at the time that the replacement of the old Manufacturers' Sales Tax by the GST would only result in a 1.25 per cent increase in consumer prices, there still was a substantial pick-up in wage increases in the period prior to the GST's introduction that contributed to rising inflation, perhaps because of confusion over whether inflation would be boosted by the full 7-percent GST rate. This led the Bank of Canada to sharply raise interest rates, which precipitated an economic slowdown that sent the unemployment rate soaring to over 11 per cent in 1992. This painful experience suggests that changes in indirect taxes and the GST in particular can have very significant impacts on the economy because of the way they directly affect prices and interact with monetary policy.

Evidence, albeit dated, on the greater relative impact on the economy of reductions in sales taxes compared to income taxes was provided at a seminar held at the Department of Finance in 1979 where nine econometric modeling groups compared the responses of their models to nine standard shocks including a $1 billion sales tax and income tax cut (Fiscal Policy Division, 1979). The results show that for four out of the seven models that did the simulation the impact of the sales tax cut was significantly larger and was only significantly smaller for two of the models. And in the models where the impact was smaller it wasn't assumed that the full amount of the tax reduction was passed on in lower prices, which reduced the impact of the cut. A key assumption behind the larger impacts for the sales tax cut was that the money supply was exogenous due to the policy of specifying a target for money supply growth in effect at the time so that the price reduction would result in lower interest rates. While the current policy approach of inflation targeting is not exactly the same, it would also tend to reinforce the impact of sales tax cuts on output.

Returning now to the current situation, it is the opposite from 1991. This time the GST is being cut just as the economy is beginning to slow rather than being increased. The timing of the cut hence couldn't be better. At a time when the Americans are now playing catch up and trying to rush a stimulus package through Congress to get more money in the hands of consumers to counter an anticipated recession, the Canadian Government is in the preferred position of already having introduced large tax cuts, including a cut in the GST rate from 7 to 5 per cent, which has lowered the price level by around one per cent and will give the Bank of Canada some additional room on the monetary front if it will only decide to use it. While the Canadian Government can't credibly take any credit for its great foresight in anticipating the slowdown and for the timeliness of its tax cuts, at least it can take comfort from the fact that its fiscal policy is turning out to be appropriate from the point of view of stabilization policy.

There is also an additional point in favour of the GST cuts that is worth noting. The provinces from Ontario west and Prince Edward Island too have continued to tax business inputs through their provincial sales taxes. The Federal Department of Finance estimates that sales taxes in these provinces raise the Marginal Effective Tax Rate on new business investment by 7 percentage points. And it argues 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." (Department of Finance, 2007, p.79) In my view, the GST cuts could make it easier to achieve an agreement to harmonize taxes. The lower Federal rate should mitigate provincial concerns about imposing taxes on sensitive goods like children's clothes and books and it would make the overall consolidated rate less visibly burdensome, thus making an agreement more politically palatable.

Hopefully, one final thing should be clear to everyone by now, including even the economists who dumped upon the GST cuts and Liberal Leader Stéphane Dion who said he would considering rescinding them if elected (CTV News, 2007) It is that what would really be stupid to do now, given the threat to Canada of stagflationary pressures from the United States, would be to reverse the Government's policy and hoist the GST back to 7 per cent. In spite of what economists have said, the GST cut is turning out to be not so stupid.

Note

1. President Harry S. Truman once lamented that he needed a one-handed economist so that he would not have to put up with economic advice premised with, "On the one hand….And on the other hand...." But on the other hand, maybe being a two-handed economist is not so bad if the one handed-economists aren't correctly interpreting the whole picture.

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