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THE HARMONIZED SALES TAX – THROUGH AN ECONOMIC PRISM

This issue of *Policy Perspectives* is guest authored by Jon Kesselman of Simon Fraser University. Recognized as one of Canada's leading public finance and tax policy experts, Dr. Kesselman outlines the economic benefits of the Harmonized Sales Tax which the BC government plans to introduce later this year. The Business Council is grateful to Dr. Kesselman for contributing this timely article.

Highlights:

- Economists use a number of criteria to assess tax policies, including simplicity, efficiency, and equity.
- The HST is clearly superior to the province’s existing Retail Sales Tax (RST) in terms of administrative simplicity and the cost of compliance, as it eliminates the need for BC businesses to collect, remit, and comply with the rules of two separate sales tax systems.
- The HST will produce efficiency benefits for the BC economy in three respects: “static efficiency” (how effectively the economy utilizes its existing stock of capital, labour, and raw materials); “dynamic efficiency” (how effectively the economy utilizes resources to expand production and consumption over time); and “trade competitiveness” (the impact of tax policy on the ability of BC firms to compete in external domestic and foreign markets).
- In terms of equity, the government’s proposed refundable tax credits ensure that low-income British Columbians will be shielded from any adverse impact on living costs associated with the introduction of the HST.
- Public acceptance of the HST has been hindered by the fact that it involves replacing the hidden portion of the RST (the portion paid by businesses) with a more visible tax.
- Experience with the federal Goods and Services Tax and with HST-type taxes adopted in Atlantic Canada confirms that businesses pass on to consumers most or all of the benefits associated with lower tax burdens, by reducing the prices of goods and services.
- In summary, converting BC’s retail sales tax to a value-added tax and packaging it with the federal GST in a new harmonized sales tax will have wide-ranging positive effects on the province’s economy.

From the time of Adam Smith to contemporary economic analysis, the three key criteria for assessing tax policies have been *efficiency*, *equity*, and *simplicity*. British Columbia's impending harmonized sales tax (HST) can be passed through the prism of those economic criteria to assess the desirability of this important tax reform. Amid all of the political and public furor, how does the HST measure up in purely economic terms? After assessing its economic spectrum, the HST beam will briefly be refracted through the prism again to assess it on the wavelength of public acceptance.

Simplicity

Simplicity refers to the complexity and operational cost of a tax to both taxpayers and to the government. Other things equal, a good tax should have minimal complexity and cost to operate. For indirect taxes like BC's retail sales tax (RST), the GST, and the HST, the ultimate taxpayer is essentially the consumer, but concerns over complexity and cost relate primarily to the businesses that must navigate and collect the taxes.

In terms of complexity, BC's current arrangement for sales taxes is among the worst in the world, shared only by several other Canadian provinces that retain a RST. No other country has both a national and sub-national sales taxes of such divergent kinds. Businesses—and also quasi-public organizations such as municipalities, universities, schools, and hospitals—must deal with the legislative and regulatory intricacies of two very different types of sales taxes simultaneously. With sales tax harmonization, BC entities will be rid of the retail sales tax's operational burdens. The provincial part of the HST follows almost all of the rules and regulations of the existing GST, with few exceptions, so that businesses and other collecting agents can dispense with all the complications of the RST. Similarly, the BC government can disband its division responsible for collecting and enforcing its RST, as both the provincial and federal parts of the HST will be collected jointly by the Canada Revenue Agency.

Elimination of BC's retail sales tax and its replacement by a component of a joint federal-provincial HST will yield major cost savings. First, harmonization will save the BC treasury—and ultimately BC taxpayers—the $30 million spent annually on public costs of collecting the RST. Additionally, the BC government will save another $50 million per year that it currently pays to businesses as partial compensation for their costs in collecting the RST. All of those savings translate to either a reduction in the deficit—and thus in future burdens on BC taxpayers—or an increase in the province's ability to fund valued public services such as education and health care.[1] Funds that are unnecessarily spent on collecting taxes are, from the public's perspective, simply money down the drain. Businesses and other BC entities now collecting the RST will save a further estimated $150 million per year in compliance costs. These savings reflect their no longer having to collect a separate provincial sales tax with the move to harmonization; after netting out

[1] The $1.6 billion that the federal government is paying BC to facilitate harmonization adds much more to the BC government's ability to maintain or expand public services and/or to avoid future tax increases.

their discontinued vendor compensation, business cost savings of $100 million per year will flow through as lower prices for consumers.

Efficiency

Economic efficiency is a measure of how effectively an economy uses its resources to satisfy human needs. Three distinct aspects of efficiency are assessed separately for the HST. First is "static" efficiency, which gauges how effectively the economy utilizes its *existing* stocks of resources, including capital, labour, and raw materials. Second is "dynamic" efficiency, which gauges how effectively the economy uses its resources to expand production and consumption over time. Third is the "trade competitiveness" of the BC economy in its relations to the rest of Canada and foreign economies. Taxes can distort all of these dimensions of efficiency and thereby reduce people's well-being; good tax policy consists of formulating taxes so as to inflict the minimal efficiency costs while collecting the requisite revenues. Of these three efficiency aspects, economists consider dynamic efficiency gains to be the most important for sales tax harmonization.

Static Efficiency

First consider the static dimension of the efficiency impacts of harmonization. The current RST applies not only at the stage of final sales to consumers but also to many inputs purchased by firms in the course of their business. Thus the RST entails most goods and services being taxed multiple times in their production and distribution—a process called "tax cascading." Consequently, items currently subject to the BC sales tax of 7 percent have taxes embedded in their costs, which yields effective tax rates[2] exceeding 7 percent. These additional RST burdens are hidden from the final consumer, who sees only the 7 percent BC tax added at the point of purchase. Moreover, the goods and services currently exempt from BC sales tax actually bear positive effective tax rates rather than their nominal 0 percent rate. The result of tax cascading is that taxable items bear effective tax rates that are variable rather than a uniform 7 percent; this distorts consumers' choices and the efficient allocation of economic resources.

The HST is like the GST in adopting a <u>value-added tax</u> (VAT) structure. With a VAT, tax cascading is eliminated by providing each firm a rebate (formally called an input tax credit) for the taxes that it pays on purchases of all inputs used in its business. These rebates apply to the firm's sales tax payments on purchases of capital, materials, intermediate goods, services, and energy inputs. Consequently, the provincial portion of the HST applied at a 7 percent rate yields an actual final effective tax rate of 7 percent for consumers, not the higher and varying rates that arise with the RST. Moreover, items that are exempt (or more technically called "zero-rated") from the HST will bear an effective tax rate of 0 percent rather than the current higher rate from embedded taxes. The broader coverage of the HST and the more uniform effective tax rates for covered items will make for a less distorting tax system, in which consumers make their choices based on the

[2] As distinct from the statutory or nominal sales tax rate, the effective tax rate equals an item's statutory rate plus the taxes embedded in its production and distribution (expressed as a percent of its sale price).

relative costs of various goods rather than the biases of variable effective tax rates. As a result, the economy's resources will be more efficiently allocated to meet consumer wants.

Dynamic Efficiency

Second consider the dynamic dimension of the efficiency impacts of sales tax harmonization. An economy grows over time in productive capacity, employment, and real wages through the investment of capital in new and more technologically advanced machinery and equipment. Various kinds of taxes on business—including corporate income tax, property tax, and sales tax—raise the effective cost of and therefore reduce the rate of investment. Despite some exemptions for business, BC's RST nevertheless imposes a $1.9 billion annual burden on business inputs including investment goods, which represents nearly 40 percent of the tax's $5 billion in annual revenues. Because of this tax burden, BC businesses have reduced their rate of investment, contributing to the provincial economy's long-time lagging productivity growth.[3]

The scale of this RST-induced deterrent to business investment in BC—which would be totally eliminated by sales tax harmonization—can be measured. The "marginal effective tax rate" or METR gauges the total tax-induced burden on incremental investment. The total METR for the BC economy was projected by Finance Canada to be 32.9 percent in 2011 with the existing RST and with the scheduled rate of corporate income tax. Full abolition of the BC corporate income tax would have reduced this METR by 8.4 percentage points—or more than one quarter. Harmonization of the BC RST was estimated to reduce the METR by 8.1 percentage points, nearly equivalent to complete abolition of the provincial corporate tax.[4] Thus, the HST will be a major stimulus to business investment in forthcoming years and raise both employment and earnings growth.[5] In fact, provincial sales tax harmonization was ranked by a panel of non-partisan experts as foremost among potential policy initiatives to improve the Canadian economy's long-run performance.[6]

Competitive Efficiency

The third dimension of efficiency relates to the impacts of taxes on an economy's competitiveness in trade. For British Columbia businesses, competitiveness with respect to

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[3] BC Progress Board, *Productivity Drivers in British Columbia: Strategic Areas for Improvement*, report prepared by the Centre for the Study of Living Standards (Vancouver: 2008); see also the studies on investment impacts of taxation cited in Jack M. Mintz, "Ontario's Bold Move To Create Jobs and Growth: Impact of the 2009 Ontario Budget and Other Recent Tax Measures on Investment, Jobs, and Incomes," *SPP Communiqué*, 1:4 (The School of Public Policy, University of Calgary: November 2009).

[4] These figures are taken from Jonathan R. Kesselman, "GST Harmonization Strategies," *Canadian Tax Highlights*, 15:5 (May 2007).

[5] Evidence that this occurred in the harmonizing Atlantic provinces appears in Michael Smart and Richard M Bird, "The Impact on Investment of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from the Canadian Experience," *National Tax Journal*, 62:4 (December 2009).

[6] This panel's recommendations are recorded in Jeremy Leonard, Christopher Regan, and France St-Hilaire, eds., *A Canadian Priorities Agenda: Policy Choices To Improve Economic and Social Well-Being* (Montreal: Institute for Research on Public Policy); another top ranking for sales tax harmonization appears in BC Progress Board, *Investment in British Columbia: Current Realities and the Way Forward*, report prepared by the Centre for the Study of Living Standards (Vancouver: 2008).

other provincial economies as well as foreign markets is relevant. The existing RST applied to business inputs raises the costs of production and makes BC businesses less competitive both domestically and internationally. Harmonizing the RST removes this cost burden on businesses and thus makes their products more competitive in other Canadian and foreign markets, resulting in greater sales and higher employment and wages for BC workers. Moreover, the fact that Ontario had already announced it would harmonize its sales tax with the GST placed compelling pressures on the BC government to follow suit. Without harmonization by BC, businesses here would face additional barriers in competing for sales with businesses in the much larger Ontario economy. Additionally, Ontario's harmonization move would tend to increase the Canadian dollar exchange rate, further hindering BC businesses in international sales.

Equity

In tax policy analysis the concept of equity has two principal dimensions: horizontal and vertical. Horizontal equity is the principle that individuals with the same income or "ability to pay" should be subject to the same tax burdens. A sales tax system such as the RST with varying effective tax rates on various goods and services—due to both the capricious effects of tax cascading and the exemption of some goods and services—violates this standard of equity. Individuals with the same income may pay significantly different amounts of RST based on differing preferences and patterns of consumption, since one may spend more than the other on items bearing higher effective tax rates. Clearly, sales tax harmonization will reduce the variation of effective tax rates across the full range of goods and services, thus improving the system's horizontal equity.

Vertical equity is the principle that individuals with higher incomes or "ability to pay" should in fact pay more in taxes than those with lower incomes or "ability to pay." Some notions of vertical equity state that those with higher incomes should pay not only more taxes but a higher proportion of their incomes in tax—a concept called "progressivity." Sales taxes of any kind (whether the RST, GST, or HST) are inherently regressive, a situation in which the proportion of incomes paid in tax actually declines with income level. Sales tax regressivity results mainly from the fact that higher earners tend to save a higher proportion and spend a lower proportion of their incomes, thus bearing a lower proportionate burden of sales taxes. This regressive pattern can be partially offset by exempting goods and services that loom largest in the budgets of lower earners, and by providing refundable tax credits for those at lower incomes.

Sales tax harmonization raises the issue of whether the provincial portion of the HST will be more burdensome at lower incomes and more regressive *than the existing RST*. (Harmonization will leave unchanged the federal portion of the HST, which is simply the existing GST and thus imposes no distributional impact.) TD Bank economists have estimated that sales tax harmonization will raise the overall consumer price level (including tax) by just 0.7 of one percent in BC.[7] Whether individuals at lower incomes

[7] TD Bank Financial Group, "The Impact of Sales Tax Harmonization in Ontario and B.C. on Canadian Inflation," *TD Economics Special Report* (Toronto: September 18, 2009); this estimate assumes full pass-

will be more or less affected than those at higher incomes hinges upon two offsetting effects. First, goods and services that will be exempt or zero-rated from the BC part of the HST (such as rents, groceries, home energy, children's clothing and footwear) or are already taxed at the same 7 percent rate (household supplies, furnishings, adults' clothing and footwear) take a disproportionately large share of lower-income households' budgets; thus the impact on their cost of living will likely be less than 0.7 of 1 percent.[8] But secondly, those at lower incomes spend a higher proportion (often all) of their incomes than those at higher incomes, so that the HST's price level impact will strike them relatively more heavily. No one has estimated which of these two effects dominates, so whether sales tax harmonization actually increases or decreases regressivity at low and moderate incomes is unknown.

Notable in gauging the impact of the HST on those at low and moderate incomes is the provision by BC of new refundable tax credits to accompany harmonization. Credits of up to $230 per person per year will be paid, with the credits phased out for individuals with incomes above $20,000 and families with incomes above $25,000 at 4 percent of income exceeding those thresholds. Thus, for example, a couple with two children will receive $920 of credits at incomes up to $25,000 and partial credits at incomes up to $43,400. Some critics have asserted that these credits are too stingy and should be enlarged or phased out more slowly with incomes.[9] However, note that an estimated 1.1 million British Columbians—or nearly one-quarter of the population—will benefit from the credits. In addition, individuals at very low incomes will be net gainers from harmonization. For example, an individual earning $15,000 per year who spends all of his or her after-tax income (about $13,500) will face $95 in increased costs (assuming that the full 0.7 of one percent impact applies) while receiving a credit of $230—thus pocketing a net gain of $135 per year. Thus, even if the overall impact of harmonization were slightly regressive, individuals and families at lower incomes will be fully insulated from the impact or even over-compensated.

Acceptability

Sales tax harmonization fulfills all of the standard economic criteria for good tax policy with flying colours. However, harmonization has been woefully deficient in BC with respect to another, non-economic, criterion: public acceptability. In part public distress over BC's harmonization exercise reflects a predictable fear of any complex tax change. It also reflects opposition groups' ability to muster resistance based on misconceptions. In many ways, the current experience is similar to the public's upset over implementation of the GST in 1991. The GST was thought to be a totally new tax, whereas it replaced a federal manufacturers' sales tax; similarly, the HST is simply a reformulation of the existing provincial sales tax and not a new tax per se. The GST was thought to be a tax

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through to consumers of the reduced burden of business taxes (a later note provides the result without this assumption) and was made prior to BC's announcement of an increase in its HST rebate for new housing.

[8] A small offsetting factor is that the HST will raise the cost of cigarettes, which play a relatively larger role in the budgets of lower-income than higher-income households.

[9] For example, see Marc Lee, "BC and the HST," *The Progressive Economics Forum*, posted July 27, 2009 [updated] http://www.progressive-economics.ca/2009/07/27/bc-and-the-hst/

grab by the federal government, whereas in fact it generated roughly the same net revenues as the tax it replaced. Similarly, the HST will not bring the BC treasury any more net revenues than the discontinued RST. Rather, the HST collects the same total amount but rather at different points in the production, distribution, and retailing stream.

Also like the GST experience, sales tax harmonization converts a hidden tax into a highly visible tax. The old federal manufacturers' sales tax was applied at the level of the manufacturer or wholesaler or, in a few areas, at the point of final sale. Very few people outside of business were aware of this federal tax of 13.5 percent on covered goods and a few services. Similarly, very few people outside of business are aware of the large part of total RST in BC that is paid directly by businesses on their inputs and thus gets embedded in the final prices that consumers pay. Converting a hidden tax to a highly visible tax may be very good policy in terms of its economic effects, but it is hardly a popular move. People apparently like not knowing how much they are paying in taxes.

In yet another respect, BC's sales tax harmonization is much like the GST experience. Once people were told that the GST was simply replacing a hidden tax on business, they expressed doubts that removal of that burden on business would flow through to lower final prices at the consumer level. Similarly, harmonization opponents widely express skepticism that the $1.9 billion of reduced taxes on business inputs will flow through to the benefit of consumers.[10] HST critics assert that harmonization is not just shifting the point of collecting taxes but also shifting the actual net burden of the taxes from businesses to consumers. Yet, the real-world evidence on tax incidence supports the finding that most of the reduced burdens on business will in fact flow to lower prices for consumers. This outcome was confirmed in the 1997 harmonization of sales taxes with the GST by the three larger Atlantic provinces.[11] It has also been confirmed in experience from other jurisdictions with analogous types of tax reforms that reduce taxes on business. In France, more than 75 percent of the tax relief flowed to reduce prices within four months of the tax change in competitive product markets; even in a less competitive market such as new cars, over half of the relief went to consumers.[12]

Public upset over the HST could be calmed over time by packaging it—and the federal GST that it contains—in a different way. Almost all countries that operate a similar value-added tax require that the listed or tagged prices of covered goods and services be expressed in "tax-inclusive" terms. In contrast, BC's impending HST, like the existing GST (and the RSTs of Canadian provinces and US states), uses "tax-extra" pricing for the great majority of covered items. With the GST a few items—such as taxi rides and gasoline—are required to register tax-inclusive prices on their meters. Almost all other

[10] If none of the tax savings to business flowed through, the TD Bank economists estimated that the impact on BC's consumer price level would be 1.5 percent rather than the 0.7 of one percent with full flow-through. This figure is still quite moderate, and even under this extreme assumption the previously cited $15,000 earner would still be a net gainer (by nearly $30 per year) after receiving refundable credits.
[11] Michael Smart and Richard M. Bird, "The Economic Incidence of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience," *Canadian Public Policy*, 35:1 (March 2009).
[12] Clément Carbonnier, "Who Pays Sales Taxes? Evidence from French VAT Reforms, 1987-1999," *Journal of Public Economics*, 91:5-6 (June 2007).

goods and services employ tax-extra pricing except for a few vendors that choose to post in tax-inclusive terms. Without legislative obligation to use tax-inclusive pricing, the great majority of vendors choose to post the apparently more appealing tax-extra prices. Requiring tax-inclusive pricing would blunt public resistance to the HST and also ease consumers' understanding of the "true" cost of any item before facing cash-register shock as commonly occurs with tax-extra pricing.[13] A good place for BC to start with requiring tax-inclusive pricing would be restaurant meals, since they will be newly covered by HST and will otherwise provoke continual resentment over the "new" tax.

Summation

Converting BC's retail sales tax to a value-added tax format and packaging it with the federal GST in a new harmonized sales tax makes for indisputably desirable economic outcomes. The colours emerging from the economic prism are all lovely: harmonization will improve tax simplicity, economic efficiency, and equity. Some losers will arise in sectors that have enjoyed a tax-preferred status for many years, such as restaurants and home construction. But overall British Columbians will gain through a more competitive business sector yielding, over time, more investment, increased employment, and better-paying jobs. Economists who specialize in taxation are virtually unanimous that the HST is a highly desirable tax reform; even economists who quibble over possible distributional impacts concede the economic merits of harmonization.[14] The retail sales tax is a dying breed and survives in only a few jurisdictions around the world (a few Canadian provinces and most US states); all the rest of the world has long ago shifted to the value-added tax format embodied in the GST and the HST. Can the opponents of harmonization credibly argue for retaining BC's antiquated, inefficient, complex, and unfair RST?[15] The adage that "an old tax is a good tax" may contain political insight—but it offers scant economic wisdom.

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[13] Related constitutional and technical issues are assessed in David M. Sherman, "Policy Forum: Tax-Included Pricing for HST—Are We There Yet?" *Canadian Tax Journal*, 57:4 (2009). Note that even with tax-inclusive pricing, the sales receipt would break out the HST component, which is both desirable for consumer-voter awareness of taxes and necessary for input tax credit claims by business purchasers.

[14] For example, see Marc Lee, op. cit., who states "in principle a harmonized tax is indeed a good idea" and proceeds to cite benefits such as streamlined tax administration and improved economic efficiency.

[15] And how would opponents replace the $1.6 billion federal transfer that BC is receiving to aid the process: through higher taxes on the BC public (and which taxes) or through cuts to public services (and which services)? Surprisingly, harmonization opponents have remained silent on this point. This sum is equivalent to a one-year hike of 2.25 percentage points in BC's current RST.