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Ready for Relief: There's More to a Lower GST than Meets the Eye

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The election platform that recently carried Prime Minister Stephen Harper into office featured a headline commitment to lowering the federal Goods and Services Tax (GST). A new Conservative government, the campaign promised, would lower the GST by one percentage point immediately, with another point to come off at some later time.

Now that the election is over and GST relief is front and centre in the new government's short list of priorities, some implications — for both consumers' wallets and government coffers — deserve attention. Canadians, having sadly little experience with tax relief, should look forward to small gains in their wallets in the countdown to the changeover, but should also be aware of the longer lasting impacts of lower shopping prices.

The immediate impact will be a small dollop of cash in most consumers' wallets — more than $300 per household available to be saved or spent — that otherwise would not have been there. In addition, however, a lower GST will push Statistics Canada's consumer price index (CPI) lower than otherwise. This will have long-lasting fiscal implications, because the CPI determines annual adjustments to the numerous thresholds and amounts of taxes and government benefits that Canadians pay and receive. As a result, for the government, the GST reduction will be a less costly fiscal policy than might be expected.

Waiting until the price is right

The timing matters, for both businesses and consumers. The Conservative campaign's promise of immediate tax relief almost certainly means that GST relief will be part of the spring budget legislation, expected in April or May 2006. The next question is whether the change will take immediate effect, as sales and excise tax changes often do, or at some later date, as occurred when the GST replaced the federal manufacturers' sales tax in 1991.

An overnight change would certainly disrupt business. The shock to transactions processing and record-keeping, and the programming changes in tens of thousands of individual sales management systems, would induce myriad local problems. On the other hand, businesses large and small know this change is coming at some point, and are preparing for it with cheerful assistance from software and systems vendors.

A defined future date for rate relief would be friendliest to planning and to the federal government's fiscal hopes. Businesses would have time to test their applications with revised tax parameters. The federal government's interest in delay is relatively mercenary: each month of a 7 percent GST, rather than 6 percent, represents more than $400 million in federal revenue, a hefty sum in the context of the new government's plan to reduce taxes and deliver numerous benefits under a no-deficits dictum.

Against this advantage, consumers would put off buying high-value goods, particularly durables, waiting for a lower tax on the sale. The concern is real, particularly in the case of high-value transactions — given a July 1 inauguration of tax relief. For example, few new home sales would close on June 30. In this scenario, however, retailers chasing sales in the face of slackening demand would discount prices in advance of the tax reduction.

One scenario and its implications

Suppose an early May budget announces GST reduction to take effect July 1, 2006. The announcement will itself trigger downward pressure on consumer durable prices in May and June, and when the July consumer price surveys are conducted, retail prices will clearly reveal its impact.

According to Statistics Canada, 63 percent of the all-items consumer basket is subject to GST. On the assumption that the rate cut feeds through into consumer prices, the arithmetic of backing out one percent of sales tax on that 63 percent produces a decline in headline CPI inflation of 0.6 percent. Less than complete or immediate pass through may occur in goods and services that have tax inclusive pricing, such as taxi fares, and for GST-exempt items, like most financial services, but competitive forces will tend to shift savings to consumers in these areas too.

Consumers at last will reap the rewards of the original, politically costly decision to make the GST visible at the sales counter. In a competitive market it will be difficult for suppliers or retailers to intercept the benefits of the sales tax reduction, and prices at the counter will decline. Hence, if the Bank of Canada is on track to deliver inflation at 2 percent when the change occurs, and stays the course while the GST cut is influencing the year-over-year change, the CPI will register a 1.4 percent increase between July 2006 and July 2007.

Federal legislation determines tax and transfer amounts and thresholds, and these will be affected by the path of headline CPI. The legislation specifies that indexed amounts, of which there are about four dozen, should increase by the average rate of inflation for the 12 months ended in September of the previous year.

The above scenario would see indexed amounts for 2007 grow by 0.1 percent less than otherwise, and for 2008 by 0.4 less, owing to the indexing formula's lagged impact on taxes and benefits. Future years will see growth return to 2 percent, assuming the Bank stays on target, but the levels will be lower because of the prior lower rate of growth.

Table 1: *Impact of a 1 percent GST Reduction on Federal Personal Taxes and Transfers*

Fiscal year	2007	2008	2009	2010
		Millions of dollars		
Higher PIT revenue	10.8	100.8	237.7	133.3
Lower transfers to persons	15.5	143.6	390.3	400.3
Combined impact on federal revenue	26.4	244.4	628.0	533.6

Source: Author's calculations, via Statistics Canada's Social Policy Simulation Database and Model, Release 14.0.

Because tax brackets and benefit amounts will grow by less than otherwise, the federal government will save money. The amount is small for fiscal 2007 and 2008, but climbs above $600 million for the next year, before dropping back as currently scheduled increases to the personal amounts supersede indexing's status quo impact on those amounts (Table 1). Such numbers are a small share of federal revenue and spending, and small relative to the more than $5 billion in annual savings consumers will derive from a lower GST, but not too small to notice in the course of medium-term budgeting.

Some might see the lower indexation of the child benefit — by about $30 a year less than otherwise — and Old Age Security payments — about $36 a year lower — as an unfair appropriation of GST relief from their recipients. But the episode highlights a natural consequence of indexing to a consumption-tax-inclusive CPI: that government transfer payments tend to insulate their recipients from changes in consumption taxes. Recipients of indexed transfers were protected from upward movements in consumer prices when the GST came in — indeed, beneficiaries of the refundable GST credit were initially overcompensated. Now, the same mechanism will work in reverse, just as lower indexation of thresholds will take back from taxpayers a small share of the benefits of a lower GST.

From a fiscal point of view, the net result is a modest offset to the more than $5 billion-a-year federal revenue cost of lower GST — a welcome development from the point of view of those who continue to hope for lower personal and business income taxes as a spur to Canadian competitiveness and economic growth.

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