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Slicing the Pie: Federal Assistance for Provincial Sales Tax reform

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Few tax changes offer as much economic promise as replacing provincial retail sales taxes (RST) with a value added tax like the federal Goods and Services Tax (GST). There are clear economic benefits from harmonization with the GST tax base, such as lower compliance costs, more interprovincial trade, lower costs for consumers (Smart 2007), and a lower effective tax rate on new business investment (Chen et al. 2007).

The federal GST is a value-added tax that allows businesses to claim a tax credit against the GST they pay on purchases. In contrast, a provincial RST does not allow businesses to claim these input tax credits, increases their costs as a result and, therefore, the final price to consumers. In moving to a Harmonized Sales Tax (HST), a province eliminates its RST and instead collects a share of the GST. Newfoundland and Labrador, Nova Scotia and New Brunswick moved to the HST, which is applied to the same tax base as the federal GST, in 1997.[1]

Five provinces still levy an independent RST: British Columbia, Manitoba, Saskatchewan, Ontario and Prince Edward Island. Why have these provinces not reformed their harmful RSTs? One of the major reasons is the political pressure expected to arise from potentially placing a more visible tax on consumers, and which may apply to more goods and services than an RST. The other is uncertainty over the fiscal cost of changing to a tax base like the GST's (Blagrave 2005).

The federal government is urging the remaining RST provinces to harmonize, en route to improving Canada's tax competitiveness. Ottawa may provide some funding to provinces to soften the fiscal and political blow of shifting the apparent incidence of sales taxes — from business purchases to a more visible

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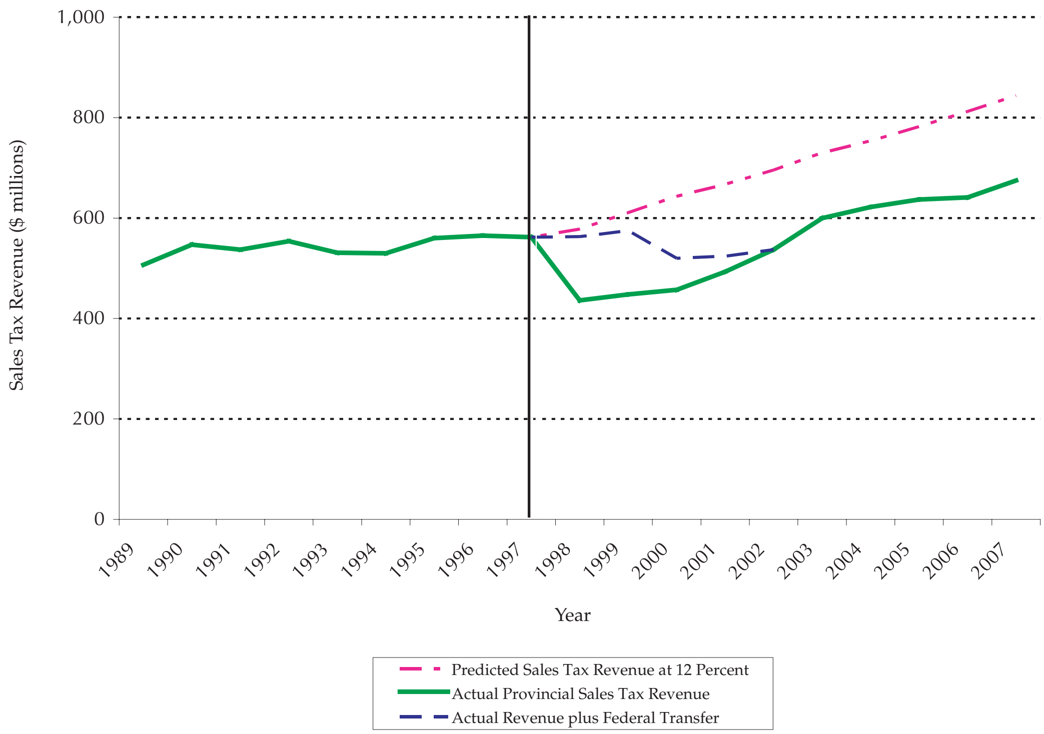
1 Quebec largely harmonized its tax base with the GST in the 1990s, and is not included in this study. Likewise, other provinces can levy a value-added tax without harmonizing administration of the tax with the GST.

Figure 1a: *The Atlantic Experience: Newfoundland and Labrador*



tax on consumers — as was hinted at in the 2007 federal budget. While federal support is likely necessary for some provinces, there remains the question of how big a slice, if anything, is needed to get provinces to harmonize.

Harmonization Experience: The Fiscal Costs Revisited

In 1996, to encourage the provinces to harmonize their tax base with the GST, the federal government offered to compensate for some of the difference between (i) what the provinces would have raised from their RSTs, had they kept rates the same, and (ii) the actual revenues of a provincial HST at 8 percent.

Sales tax revenues fell in the provinces that harmonized their RST in April of 1997 (see figures 1a, 1b and 1c). This was because these three provinces cut their RST rates by approximately one-third. Nova Scotia and New Brunswick had statutory RST rates of 11 percent while Newfoundland and Labrador had a statutory rate of 12 percent. The provincial component of the HST is now 8 percent (the federal component is now, of course, the 5 percent GST).

But what if those provinces had maintained their existing 11 or 12 percent rates in the course of harmonization? Estimating the fiscal costs of harmonization alone requires a projection of provincial revenues based on these previous sales tax rates.[2] The three provinces received a total $961 million in transfers from the

2 I use personal consumption growth after 1997 in each province to predict provincial HST revenue at the pre-harmonization sales tax rate, with the last year of the pre-harmonization sales tax revenues as the base year. These three provinces had consumption growth below the national average since 1998, whereas their GDP growth was higher than the national average. In this ...

Figure 1b: *The Atlantic Experience: Nova Scotia*

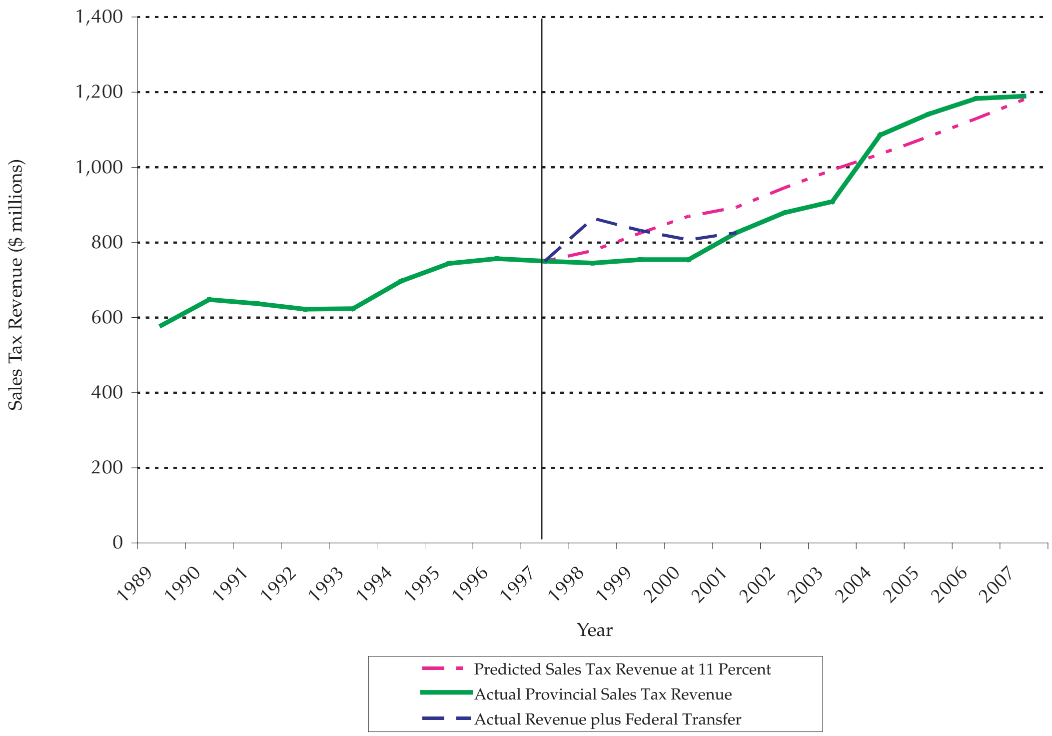
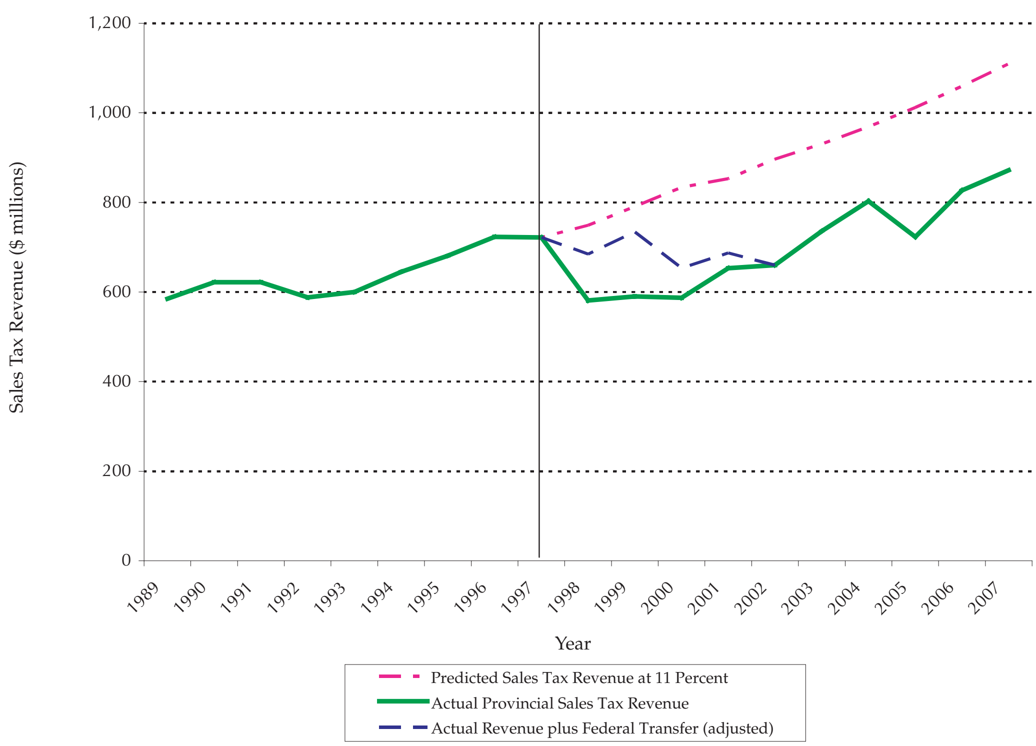


Figure 1c: *The Atlantic Experience: New Brunswick*



Sources: Provincial public accounts, author's calculations.

federal government during the 1997/98 — 2000/01 period. These transfers compensated, in approximate terms, for the difference between the sales tax revenues at the two different rates. In fact, had these provinces applied an HST at the pre-harmonization tax rates, federal assistance would have been largely unnecessary.

Harmonization in the Rest of Canada

The experience of harmonization in the East is an important precedent for other provinces that still levy a non-harmonized RST. Some of these provinces have publicly demanded a similar amount of money to consider harmonizing (Wood 2008). To be sure, politicians in these provinces would face political pressure from their electorates at the prospect of shifting a tax on business inputs that, is invisible to them, to one that is highly visible. Furthermore, consumers could face paying sales tax on previously exempt items: many provinces have exempted certain goods and services from the RST that are not exempt or zero-rated under the GST.[3]

The highest political hurdle for provincial leaders is the shift in the observed tax burden to final consumers. The increase in observable sales taxes paid by consumers would range from 18 percent in Manitoba to 77 percent in British Columbia, with Ontario and Saskatchewan both seeing a 40 percent increase relative to the existing RST; meanwhile sales taxes paid by businesses would fall by approximately 70 percent.[4] But overall, after-tax consumer prices would likely decrease in most harmonizing provinces, albeit with some increase for food and shelter, as was seen in the Atlantic Provinces (Smart 2007). Among the visible impacts: the non-harmonized provinces exempt new residential construction and fuel from their RSTs, but the GST applies to these items.

Using the method described in Box 1, I estimate that Manitoba, Saskatchewan, Ontario and Prince Edward Island would see a shortfall in revenues if their HST rates were to equal their current RST rates (Table 1 shows the difference in revenue projections).[5] Ontario would see a small drop in revenues from 2008 to 2011. British Columbia, by contrast, would raise more revenue if they applied an HST with the same base as the GST at the province's current rate of 7 percent.

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footnote 2 cont'd

... model, sales tax revenues grow considerably faster after 1997 at the higher, original tax rate, a performance that reflects its application to a broader personal consumption tax base than under the narrowly applied RST. The federal transfers for New Brunswick are adjusted to match the formula for federal compensation as the public accounts report a lump-sum transfer in 1999 with only a nominal transfer in the prior year.

3 Businesses can claim input tax credits for HST/GST paid on supplies or services used producing zero-rated goods or services.

4 As measured by the difference in total estimated RST and HST receipts from consumers and businesses.

5 Smart (2007) estimates that an Ontario HST would have raised $121 million less than the existing RST in 2002; however, GST revenues have grown faster than RST revenues in Ontario and a switch to an HST is now likely to be revenue positive by 2012. The positive revenues from the fourth year are ignored in the calculation of the federal transfer.

Box I: *Harmonization in the Rest of Canada — Methodology*

Projections of RST and hypothetical HST revenues for British Columbia, Manitoba, Saskatchewan, Ontario and Prince Edward Island are shown in Table 1. National and provincial consumption growth is projected to 2012 using the Department of Finance 2007 Fall Update projections of future economic growth. GST and RST revenues from all goods and services are available from Statistics Canada's Input-Output tables. Tax revenues from specific commodities that grew faster (slower) than the total sales tax from 1997 to 2004 are projected to grow faster (slower) than total sales tax revenues from 2005 to 2012. An estimate of how much each province would hypothetically collect in HST revenues is based on a pro-rated share of GST revenues from each commodity in each province at the current provincial retail sales tax rate. For example, the province of Ontario would collect 8/5ths of the federal GST collected within the province from goods and services that incur GST. Expected federal transfers are based on the same formula as that which Ottawa applied in 1997, where the full difference between HST and RST revenues is provided for the first two years, one-half for the third year and one-quarter for the fourth year, reported in 2008 dollars. (Domingue and Soucy 2000). Tobacco, fuel and alcohol excise taxes are excluded, but the RST component of tobacco and alcohol sales is included in provinces where this applies and provinces are assumed to collect HST on fuel sales in addition to their fuel excise taxes.

Using the same federal compensation formula applied in 1997, Saskatchewan would receive $281 million, Manitoba $536 million, Ontario $248 million and Prince Edward Island $11 million.[6] The transfers to Manitoba and Saskatchewan would be approximately $450 and $285 per capita, respectively, over four years. Moving towards a fully harmonized sales tax system would have national economic benefits, such as a likely increase in inter-provincial trade. This suggests the possibility of some reform benefits spilling over provincial boundaries, and therefore supports the case for the federal government to compensate provinces for a little more than just the fiscal costs of reform.

Importantly, my estimate contemplates neither provincial compensation for personal rebates nor a narrowing of the GST base. If provinces elect to exempt more goods and services than does the GST, net revenue from harmonization may change, but there is no national benefit from such changes that would justify a federal subsidy. If provinces decided to tax a narrower base than does the GST, the resulting revenue shortfall would not be something Ottawa should compensate for — that would amount to subsidizing a distortion. Rather, the federal government might be justified in providing funding for a larger personal sales tax credit to offset possible increases in costs for lower income Canadians.

What Needs to be Done?

British Columbia could face no trade-off between ceding provincial autonomy in tax setting and the need to raise revenues. The other RST-levying provinces, however, would need a federal incentive to harmonize their RSTs with the GST.

6 This is likely the minimum amount that should be given, as the previous formula was predicated on provinces reducing their sales tax rates.

Table 1: *The Fiscal Costs — Projected RST and HST Revenues by Province, 2009-2012*

	(2008 $ millions)			
	British Columbia — 7% RST			
	2009	**2010**	**2011**	**2012**
Projected RST/Revenues*	5,342	5,555	5,806	6,225
Projected HST Revenues+	6,423	6,787	7,191	7,791
Difference Between HST and RST	1,081	1,232	1,385	1,567
Four-Year Fund (2009-2012)				0
	Saskatchewan — 5% RST			
	2009	**2010**	**2011**	**2012**
Projected RST/Revenues*	859	890	926	969
Projected HST Revenues+	764	787	813	842
Difference Between HST and RST	-95	-103	-114	-127
Four-Year Fund (2009–2012)				286
	Manitoba — 7% RST			
	2009	**2010**	**2011**	**2012**
Projected RST/Revenues*	1,449	1,495	1,550	1,614
Projected HST Revenues+	1,269	1,305	1,343	1,385
Difference Between HST and RST	-179	-191	-207	-229
Four-Year Fund (2009–2012)				531
	Ontario — 8% RST			
	2009	**2010**	**2011**	**2012**
Projected RST/Revenues*	19,174	20,311	21,469	22,699
Projected HST Revenues+	19,025	20,212	21,468	22,846
Difference Between HST and RST	-149	-99	-1	147
Four-Year Fund (2009–2012)				248
	Prince Edward Island — 10% RST			
	2009	**2010**	**2011**	**2012**
Projected RST/Revenues*	213	223	235	248
Projected HST Revenues+	209	219	230	243
Difference Between HST and RST	-3	-4	-4	-5
Four-Year Fund (2009–2012)				11

* Using existing RST base

+ Provincial component only; existing GST base

Sources: Statistics Canada Input-Output Tables, Public Accounts, Authors Calculations

The federal government could pursue a number of strategies to help provinces harmonize. Ottawa can:

- Provide at least $1 billion in total funding to the provinces to compensate for just the fiscal costs of harmonization.
- Provide funding to lower the provincial component of the HST, akin to the bargain struck with the Atlantic Provinces. This is a more defensible proposition than providing funding to compensate the provinces for exemptions from the tax base.

- Fund larger low-income sales tax credits provided through the tax system. This could help address the political considerations of moving to an HST, without the drawbacks of narrowing the tax base.

In summary, the federal government should provide transitional financial assistance to some provinces to convince them to improve their provincial sales taxes. While a value-added tax does move visible taxes from businesses to consumers, there is evidence from Atlantic Canada that businesses reduce prices in line with their tax reductions, resulting in savings for consumers. Some provinces (not all) would see reduced government revenues by switching tax bases from the retail sales tax to the GST's value-added tax base, while keeping their sales tax rates the same. Further federal funding might be justified to reduce the provincial component of the HST or to enhance sales tax credits, but not to narrow the tax base.

There will be substantial economic benefits from harmonizing the remaining provincial sales taxes with the GST; namely, improving Canada's tax structure and strengthening Canada's economic union.

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