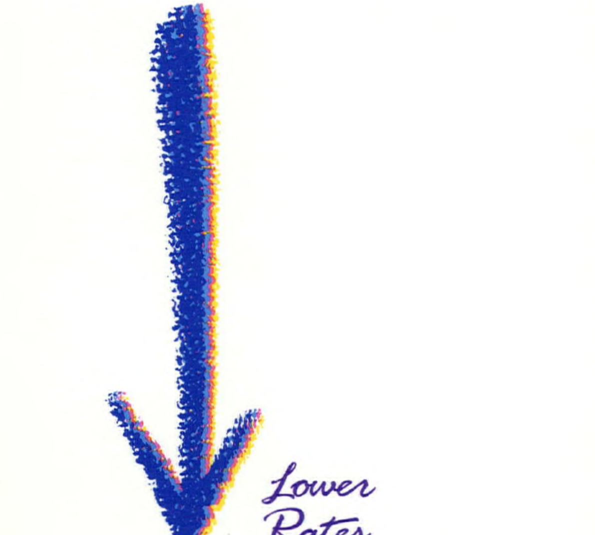
Tax Reform 1987

Sales Tax

June 18, 1987



Canada

Preface

Canada needs a fairer, more effective tax system.

We need it to ensure equitable sharing of the costs of public services vital to our economic, social and cultural well-being; and to strengthen our capacity to create jobs, opportunities and a better life for Canadians in a competitive world.

That is why the government is making important, comprehensive reforms in the nation's tax system. The first stage of reform, to the personal and corporate income tax, will be implemented in 1988. In stage two, the federal sales tax will be replaced by a better system, following further consultation with provincial governments and interested Canadians.

The cornerstone of comprehensive tax reform is a fairer tax system with lower tax rates on a broader tax base. Lower tax rates are the best incentive for Canadians to create economic benefits for themselves and for the nation. A broader tax base with fewer special tax breaks provides the means to bring down tax rates, ensures that taxpayers in similar circumstances will be taxed more equitably, and strengthens the foundation for further measures to reinforce social justice.

This booklet summarizes the changes the government proposes to make to the federal sales tax system and the direct benefits of these changes.

The Honourable Michael H. Wilson
Minister of Finance

Department of Finance Canada
Ministère des Finances Canada

Sales Tax Reform

The government is committed to replacing the current federal sales tax with a new system that will better support economic growth and job creation, increase the ability of Canadian businesses to compete at home and abroad, and improve tax fairness for individual Canadians and businesses.

What is Canada's Federal Sales Tax?

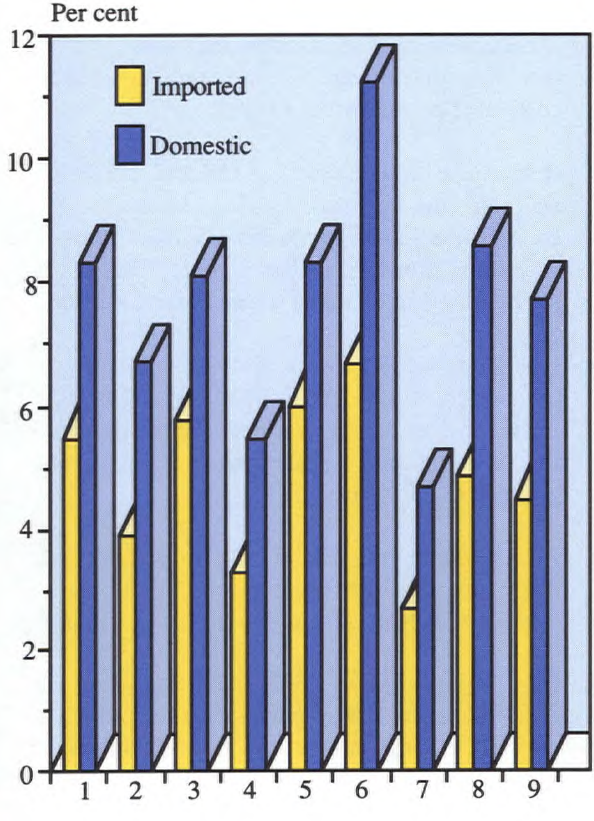
The current federal sales tax is also called "the manufacturers' sales tax." It is a tax applied to a manufacturer's sale price of goods produced in Canada and to the duty-paid value of imported goods. Because the tax is applied at the manufacturer's level, not the retail level, consumers may not even be aware that it exists. Yet it affects a large number of the goods Canadians purchase every time they shop.

The standard rate of tax for most manufactured products is 12 per cent. Construction materials are taxed at a lower rate of 8 per cent while alcohol and tobacco products are taxed at a higher rate of 15 per cent.

A Badly Flawed Tax That Damages Our Economy

Every way the current federal sales tax is looked at, it is badly flawed and harmful to Canada's economic performance. It is hurting Canada's ability to grow and create jobs.

Effective Federal Sales Tax Rates on Selected Domestic and Imported Goods



1- Tires
2- Household furniture
3- Household appliances
4- Glassware and glass products
5- Televisions, radios, stereos
6- Office machines and equipment
7- Jewellery
8- Toys and game sets
9- Cosmetics

- It is the only sales tax in the world that discriminates in favour of imports and against domestic products. On average, the tax paid is one-third higher on domestic products than on imports (See chart).

- It results in double taxation on many products, driving up business and investment costs and prices to consumers.

- It imposes hidden taxes on exports, driving up their cost and making Canada less competitive in world markets. This burden represents more than 10 per cent of the profit margins of many Canadian exporters.

- It enables some manufacturers to structure their operations so as to avoid tax. This is unfair to competing producers and it makes the sales tax an unstable source of important government revenue.

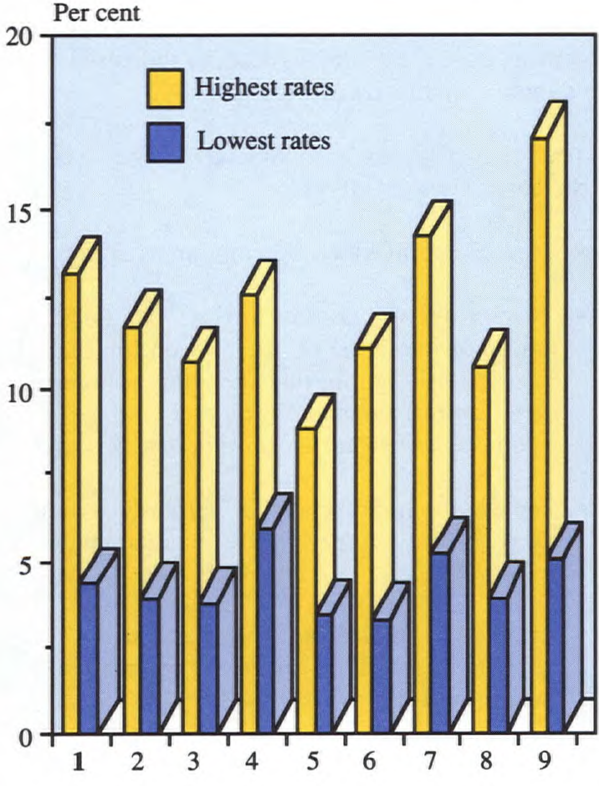
- It has widely different effects on prices, distorting consumer perceptions of the relative value of certain products (See chart).

- It is unfair to low-income individuals and families because they pay a larger proportion of their income in sales tax than do higher-income people.

- It is one of the most complex sales tax systems, causing compliance headaches and expense for taxpayers and costly administrative problems for the government.

- It applies to only about one-third of all goods and services, and so the tax on these items must be high to yield the revenue required to help pay for public programs.

Effective Federal Sales Tax Rates on Selected Domestically Produced Commodities



1- Auto parts
2- Household textiles
3- Kitchen utensils
4- Household appliances
5- Electric light bulbs, lamps
6- Office and stationery supplies
7- Sporting equipment
8- Blankets, bedsheets and towels
9- Cosmetics

A Better Sales Tax System: The Multi-Stage Sales Tax

The government will replace the current federal sales tax with a multi-stage sales tax applied on a broad base of goods and services. The new system will be similar in form to the sales tax systems now used in many leading industrial countries around the world.

The multi-stage tax has many advantages over the current system. It will:

- treat all businesses uniformly and fairly;
- prevent double taxation so that businesses and individuals do not pay tax on top of tax; this will ensure that there are no hidden taxes on consumer products and help promote investment and business activity;
- remove the unfair bias that currently favours imports that compete with Canadian-made products;
- remove the hidden tax from Canadian exports so that they can better compete in world markets;
- ensure that the tax is applied uniformly on products so that consumers can more accurately compare the relative value of different products or different brands of the same product;
- enable the government to significantly enrich and extend the refundable sales tax credit, to make the sales tax fairer by offsetting its impact on those in need.

How a Multi-Stage Sales Tax Works

The tax is levied on and collected from all businesses, **in stages,** as goods move from primary producers and processors to wholesalers, retailers and finally to consumers. The tax is imposed on the "value added" at each stage in the production-marketing chain. The tax to the consumer would be equivalent to that collected by a retail sales tax, but the way in which the tax is collected differs. The multi-stage sales tax is more effective than a retail sales tax in removing hidden taxes and therefore it would better promote economic growth and fairness to Canadian consumers and businesses.

The chart on page 9 illustrates how the multi-stage sales tax works - for example, for a piece of furniture such as a table. The tax rate, assumed in this example to be 8 per cent, is applied to the value added at each stage as the table is manufactured, distributed and sold. The arrows show how the tax paid at various stages is recovered as a tax credit at other stages.

Implementing the Multi-Stage Tax

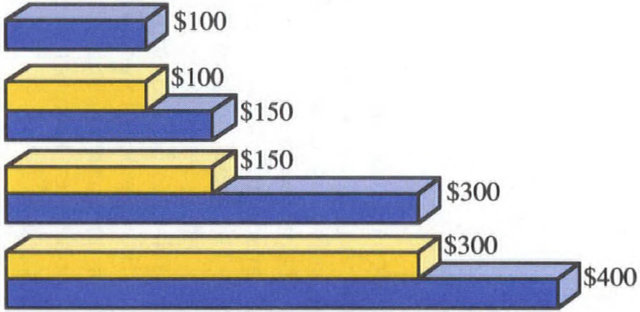
Three variants of a multi-stage sales tax are being considered. Any of the three would eliminate the distortions of the present system.

A **National Sales Tax** would combine the existing federal and provincial sales taxes into one national system. One joint system would maximize the economic benefits of sales tax reform and simplify compliance for taxpayers. The opportunity for a national system will be examined with provincial governments.

A **Goods and Services Tax,** which would operate only at the federal level, would apply to virtually all goods and services and would be relatively simple to comply with. No invoices would be necessary.

A **Value-Added Tax,** which would also operate only at the federal level, would require invoices but would provide greater flexibility to exempt some products from tax.

How the Multi-Stage Sales Tax Works



	Purchases	Sales (excluding tax)	Tax on sales	Input tax credit	Net liability
logger		$100	$8	-	$8
sawmill	$100	$150	$12	$8	$4
manufacturer	$150	$300	$24	$12	$12
retail	$300	$400	$32	$24	$8
				Total	$32

The tax charged by the vendor is assumed to be passed on.

The Sales Tax Base and the Sales Tax Credit

Three key issues have to be addressed in examining the multi-stage sales tax. The first is, which goods and services should be included in the base to which the tax will be applied. The second is the implications of the tax base for the rate at which the tax must be imposed to raise required revenues. The third is the size and design of the refundable sales tax credit.

These issues are important in deciding what goods should be included in the sales tax base. Before reaching any conclusions it is important to understand the factors that should be considered. These are illustrated below using food as a case in point. They apply equally to a number of other goods that usually are thought of as necessities.

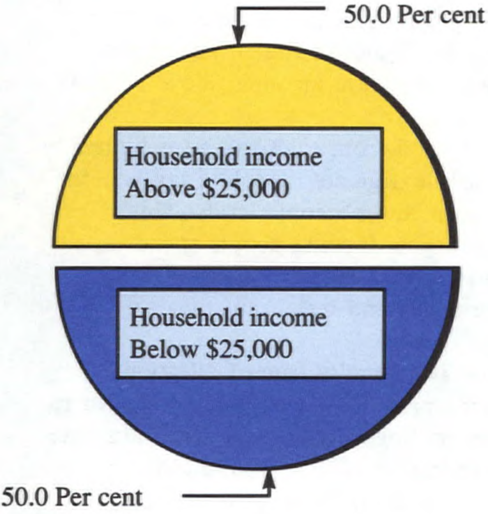
Even though food is taxed in many other countries and some foods are now taxed in Canada, taxing food is understandably an emotional and controversial issue. Its sensitivity reflects our Canadian tradition of concern for those in need. The prevailing view among Canadians has long been that exempting food from tax is required to help shield low-income families from the disproportionate burden of sales taxes. An important question, however, is whether or not an exemption is the best means to achieve this result.

Let's look at the facts on food.

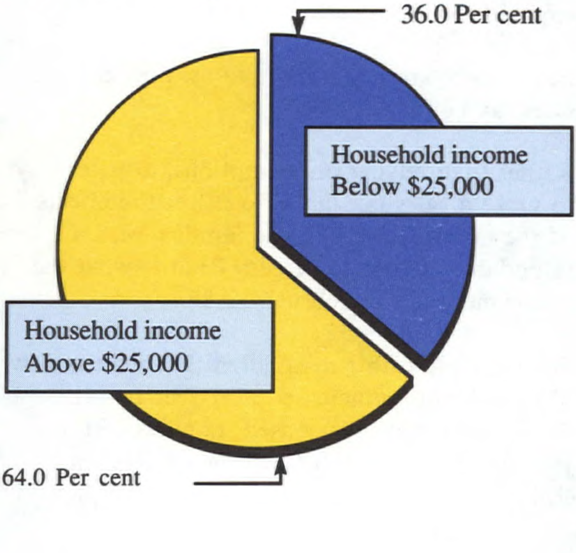
In 1982, the last year for which detailed figures are available, statistics show that households with incomes below $25,000 accounted for

Higher-Income Households Spend More on Food Than Lower-Income Households

Population



Food consumption



almost half of all Canadian households, but they purchased less than 36 per cent of food consumed in Canada. The other half of all households, with incomes greater than $25,000, purchased more than 64 per cent of food consumed in Canada (See chart). In other words, 64 per cent of the tax savings from exempting food goes to the 50 per cent of households who have incomes above $25,000.

Exempting food from sales tax gives higher-income people a greater absolute tax benefit than those at lower-income levels. This is because higher-income people spend more on food and, in particular, more on expensive foods and restaurant meals.

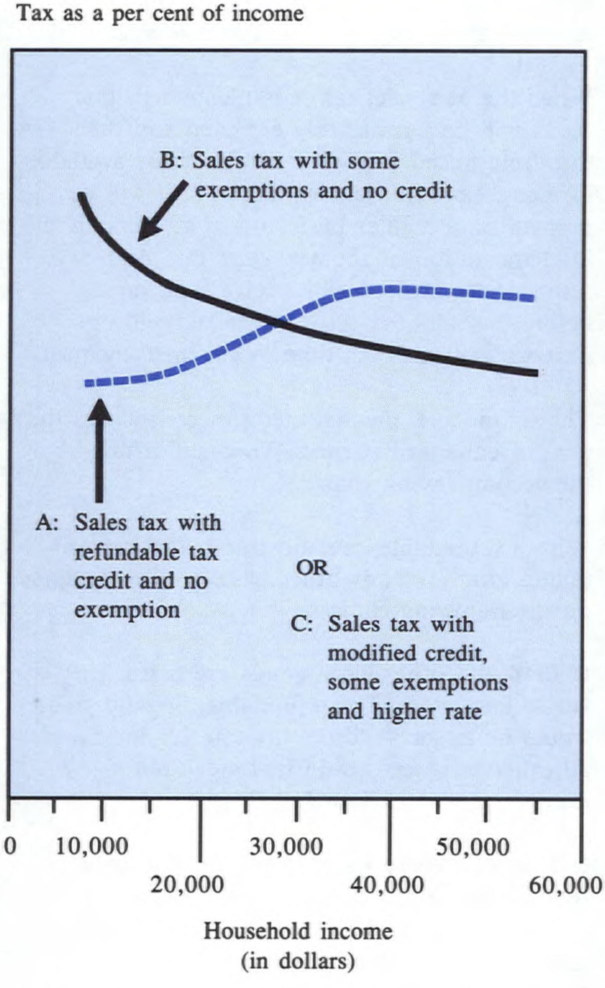
This result is generally true of all goods. Exemptions provide greater relative benefit to lower-income households but greater absolute benefits to higher-income households. Exemptions lead to higher tax rates on everything else, including other things bought by low-income households, to raise the revenue required to fund public programs.

But if there are fewer exemptions, how can the sales tax be fair?

Rather than relying on exemptions, a better way to make a sales tax fair is to offset the effects of the tax for lower-income families with a refundable income tax credit. That is what the government did in February 1986.

For a couple with two children the credit is now $150 and will be increased next year to $210. When the credit is increased, families with net income of up to $16,000 will be eligible for full credits.

Illustration of Refundable Sales Tax Credit and Exemptions



Note: Lines A, B and C are drawn to yield the same revenues, net of the credit.

The credit will be reduced by $5 for every $100 of family net income over $16,000.

The existing credit is refundable. That means all low-income Canadians get it, even if they do not earn enough income to pay tax. All that is required to qualify is to file a tax return.

When the new sales tax is implemented, this credit will be significantly enriched and the threshold raised so that it will be made available to many more households. As well, it will be prepaid on a regular basis and in advance of the implementation of the new sales tax. As a result, those in need will receive a payment before the sales tax takes effect and will not have to wait until tax time to get their cheques.

The refundable, prepaid credit, accomplishes the goal of enhanced fairness. This is illustrated by the accompanying chart.

With a refundable, prepaid credit, the issue of taxing food - or any other basic good - depends on the following choices.

If food and other basic goods are taxed, they would cost more. The refundable, prepaid credit would be larger. And the tax rate for food and all other products would be lower than if necessities were excluded.

If food and other basic goods are not taxed, their prices would be lower. The refundable, prepaid credit would not be as great. And, to raise the same amount of revenue, the tax rate for all other products would be higher.

Stage Two – Sales Tax Reform

Sales tax reform will take time to implement, both to determine which variant of the multi-stage sales tax should be implemented and to allow for a smooth adjustment to a totally new system. The new sales tax, with an enhanced refundable sales tax credit available to more families, will be introduced in stage two of tax reform.

When the new sales tax system is implemented, further important changes will be made to the personal income tax system. Tax brackets will be adjusted to further reduce income tax paid by middle-income earners. And the 3-per-cent surtax will be removed for all taxpayers.

Interim Measures

Until the new sales tax system can be put in place, the government is proposing a number of interim changes to the existing federal sales tax. These measures will remove some of the major competitive distortions that now exist and reduce opportunities for tax avoidance. Together with increased revenue resulting from corporate tax reform, the measures will raise additional revenues to finance personal income tax reform. The measures include:

- moving the point of tax for certain products to the wholesale level to reduce the competitive advantage of imported goods;
- moving the point of tax from manufacturers to related marketing companies to reduce opportunities for unfair tax avoidance;

- extending the sales tax to telecommunications services at a rate of 10 per cent; the basic service charge for a private residential line will be exempt from this 10-per-cent tax;

- increasing the rate of tax on Cable and Pay TV from 8 per cent to 10 per cent;

- deleting paint and wallpaper from the list of construction materials taxable at the rate of 8 per cent; as a result, they will be subject to the general sales tax rate of 12 per cent;

- advancing the time of payment for businesses remitting federal sales taxes and excise taxes.

Protection for Low-Income Canadians

To protect low-income households against the impact of these interim measures, **the refundable sales tax credit for low-income Canadians with net incomes up to $16,000 will be increased from $50 to $70 for adults and from $25 to $35 for children.**

Comprehensive Reform: Comprehensive Improvement

A new sales tax system, together with reform of the personal and corporate income tax systems, will give Canada and Canadians a fairer and simpler tax system. The reformed system will help build a stronger, more competitive economy that will support growth, jobs and opportunities for Canadians in the years to come.