Sales Tax Reform:

An Updated Federal Proposal

October 14, 1994

Canada

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Department of Finance Canada
Ministère des Finances Canada

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AN UPDATED FEDERAL PROPOSAL

Building on the Finance Committee's report, the federal government has proposed a 12% integrated value-added tax aimed at achieving:

- fairness for consumers;
- simplicity for businesses;
- federal-provincial tax co-ordination; and
- reduced overlap and duplication.

The key features of the updated federal proposal are:

- a single, lower national sales tax rate;
- a common base;
- GST low income credit maintained at its current level;
- offsetting federal revenue measures;
- increased provincial tax policy flexibility; and
- a single administration.

The federal proposal was first discussed in June at the Finance Ministers' Meeting in Vancouver – at that time, the proposal was for an integrated sales tax at a 10% rate (6% provincial, 4% federal).

Provinces raised a number of concerns with the federal proposal, including:

- revenue shortfalls resulting from sales tax rate reductions and from the removal of tax on business inputs;
- the change in share of taxes paid directly by consumers and businesses;
- provincial commitments to no new taxes;
- broadening provincial sales tax bases;
- provincial tax policy flexibility; and
- identifying macroeconomic impacts.

Federal and provincial officials worked together over the summer and modified the Vancouver proposal to address concerns. These modifications include:

- a higher provincial sales tax rate of 7% (as compared to 6% under the Vancouver proposal) as well as a higher federal rate of 5% – resulting in less federal and provincial reliance on flat taxes to make up revenue shortfalls; and
- phasing in of full input tax credits (ITCs).

KEY FEATURES

Single Lower National Sales Tax Rate

The federal rate would be 5%.

Provinces would set their sales tax rates at 7%.

Common Base

The tax would apply to the current federal sales tax base which does not include goods such as basic groceries, prescription drugs and medical devices.

GST Low Income Credit Maintained at Current Level

The GST low income credit would be maintained at its current level, despite the federal rate reduction from 7% to 5%. This would ensure that low income Canadians would benefit from sales tax reform.

Offsetting Federal Revenue Measures

To compensate for the federal sales tax rate reduction, the federal government would introduce:

- a flat tax of less than 1% on personal taxable income; and
- offsetting measures in the area of excise taxes (e.g., excise taxes would be adjusted so that the price of goods such as alcohol, motor vehicle fuels and tobacco would not change).

Increased Provincial Tax Policy Flexibility

The federal government would provide participating provinces with added flexibility in the personal and corporate income tax fields. Specifically, the federal government would:

- agree to administer provincial flat taxes; and
- allow the deductibility of provincial payroll and capital taxes for federal corporate income tax purposes – up to a negotiated cap.

Single Administration

A single tax administration would administer both the federal and provincial components of the tax.

Higher Provincial Sales Tax Rate

Moving to a higher provincial sales tax rate (7% instead of 6% as proposed in Vancouver) reduces provincial revenue shortfalls.

Input Tax Credits (ITCs) Phased-in Over a Three-Year Period

Under a value-added tax, businesses recover taxes paid on their purchases through an ITC mechanism.

The federal government agreed to consider provincial requests for a partial ITC mechanism, as a transitional measure, to mitigate provincial fiscal impacts.

One approach would be for businesses to get 97% of their ITC entitlement in the first year of the tax, 98% in the second, 99% in the third, and 100% in following years.

Revenues arising from partial ITCs would be allocated to the provinces under a revenue-sharing formula.

ECONOMIC IMPACTS

Overall Impact on Taxpayers

Overall, Canadian families would experience almost no change in average tax burden:

- the tax burden of low- and modest-income Canadians would be reduced by 0.3% to 10.0%; and
- families with annual income above $50,000 would experience a minimal tax increase of 0.2%.

Macroeconomic Impacts

Gross Domestic Product (GDP)

Short Run

The proposal would result in an increase in real GDP in each of the first three years, ranging from 0.2% in year one to 0.6% in year three.

Long Run

All regions are expected to experience output gains.

Atlantic provinces would benefit the most because of the removal of high provincial sales taxes on intermediate inputs and capital goods.

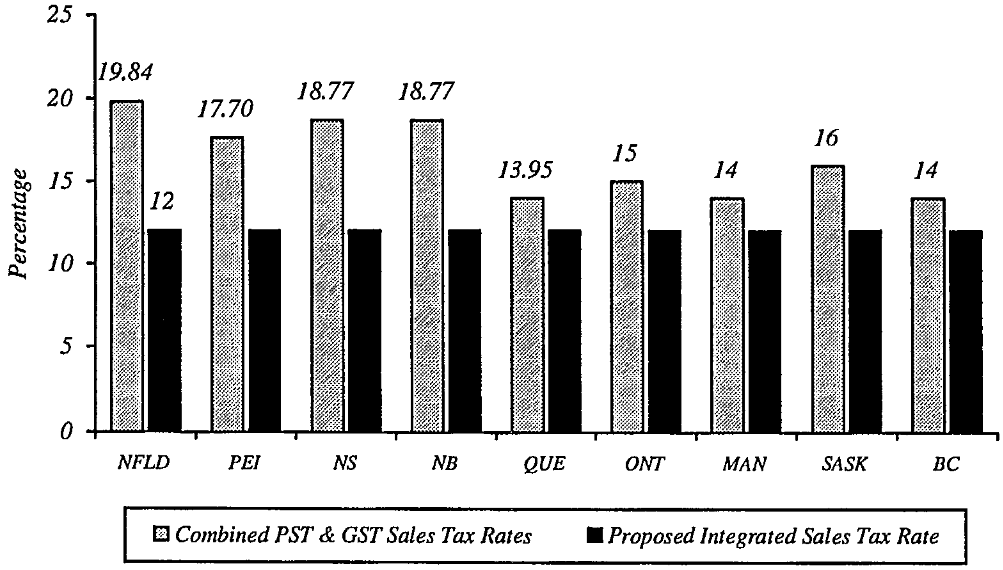
Consumer Price Index (CPI)

The proposal would lead to a reduction in the consumer price index.

It is estimated that, in the long run, the price level would be approximately 1% lower.

PROVINCIAL FISCAL IMPACTS AT 12%

Chart 1
Comparison of Current Combined Sales Tax Rates with Proposed Integrated Sales Tax Rates[1,2]



1. Alberta and the Territories are not included in the analysis since they currently do not have a sales tax.
2. Provincial sales taxes in Atlantic provinces and Quebec are calculated on top of GST.

Key Observations

- Under the proposed integrated sales tax, consumers in these provinces would benefit from significant sales tax rate reductions ranging from 2 to 8 percentage points.
- In most provinces, revenue shortfalls would arise from moving to a 7% provincial value-added tax rate and from removing the tax on business inputs.
- Since Atlantic provinces have a greater reliance on consumption taxes, their shortfalls would be a higher percentage of their own source revenue.
- Partial denial of ITCs in the first three years would provide additional transitional assistance in meeting provincial revenue shortfalls.

TAX INCIDENCE BY FAMILY INCOME LEVEL

Preliminary Estimates

Table 1
Tax Incidence by Family Income Level in Canada
12% Integrated Sales Tax with Fully Offsetting Flat Taxes[1], 1995

Family Income ($ thousands)	Number of Families (thousands)	Average Change in Total Tax ($)	Change in Total Tax (%)
0 - 10	638	-40	-10.0
10 - 20	2,199	-25	-1.7
20 - 30	1,792	-10	-0.3
30 - 40	1,707	-20	-0.3
40 - 50	1,356	5	0.0
50 - 75	2,414	30	0.2
75 - 100	1,164	55	0.2
100+	925	85	0.2
Total	12,194	5	0.1

1. Federal flat tax at 0.78% and fully offsetting provincial flat taxes.

Key Observations

Overall, Canadian families would experience almost no change in average tax burden:

- the tax burden of low- and modest-income Canadians would be reduced by 0.3% to 10.0%; and
- families with annual income above $50,000 would experience a minimal tax increase of 0.2%.

MACROECONOMIC IMPACTS

LONG-TERM IMPACT

The proposal would have significant long-term economic benefits, raising real GDP by 1.45%. These gains would come from:

- a more-efficient allocation of economic resources stemming from the broadening of the tax base and harmonization of rates;
- reduced administration costs for governments and compliance costs for businesses; and
- the elimination of provincial taxation of business inputs, in particular capital purchases, leading to higher investment and productivity.

All regions are expected to experience output gains. These range from 0.2% of GDP in Quebec to 3.8% in Atlantic Canada.

- The benefits are expected to be the largest in Atlantic Canada, as this region presently has relatively high provincial sales taxes that impose significant costs for purchases of intermediate inputs and capital goods.
- Quebec has already achieved most of the benefits of a value-added tax while Alberta has none of the costs associated with a provincial sales tax.

SHORT-TERM IMPACT

The proposal would have overall positive economic impacts in the short- and medium-term – increases in real GDP would range from 0.2% in the first year to 0.6% in the third year.

This increase in GDP is primarily a result of some key positive impacts:

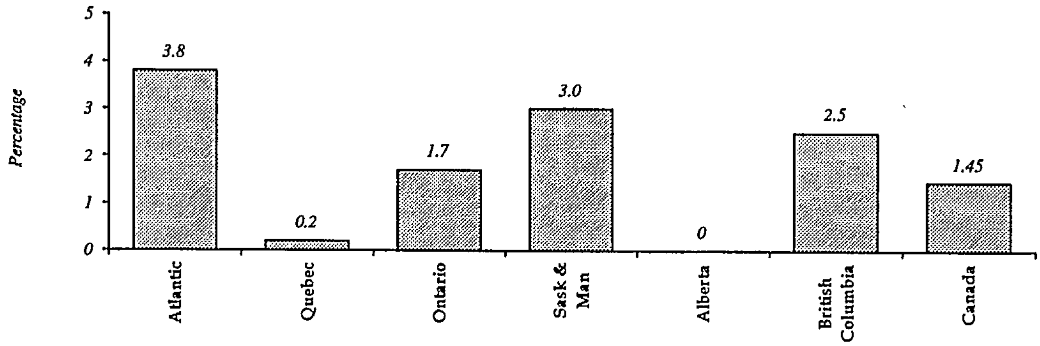
- higher exports – ranging from an increase of 0.2% in the first year to 0.7% in the third year – caused by the elimination of the provincial sales taxes on intermediate inputs and capital goods, enhancing the competitiveness of Canadian firms in international markets; and
- higher business investment rising from 1.3% in the first year to 3.3% in the third year as a result of the lower cost of capital goods.

CPI IMPACT

The proposal would reduce the overall level of consumption taxes, resulting in a reduction in the consumer price index level. The reduction in the CPI would begin with 0.1% in the first year and reach 1.0% in the long run, as costs to business decrease and productivity increases.

Preliminary Estimates

Chart 1
Long-Run Regional Output Gains
12% Integrated Sales Tax

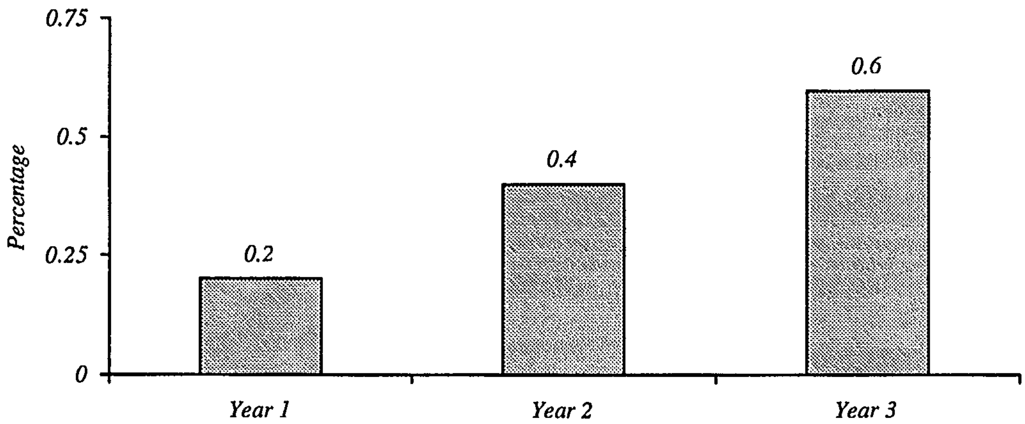


Key Observations

- All regions are expected to experience output gains from the federal proposal.
- In Alberta, gains would not arise because businesses do not currently incur any costs associated with a provincial sales tax, and hence no savings would result.
- Quebec has already achieved most of the benefits of a value added tax.
- Atlantic Canada would benefit most because of the removal of high provincial sales taxes on intermediate inputs and capital goods.

Preliminary Estimates

Chart 2
Short-Run Impact on Real GDP
12% Integrated Sales Tax

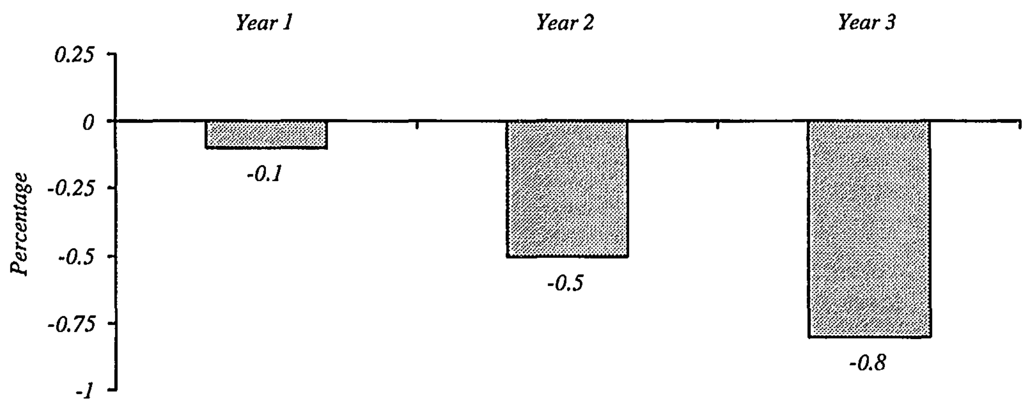


Key Observations

- The federal proposal would result in an increase in real GDP in each of the first three years ranging from 0.2% in year one to 0.6% in year three.

Preliminary Estimates

Chart 3
Short-Run Impact on CPI
12% Integrated Sales Tax

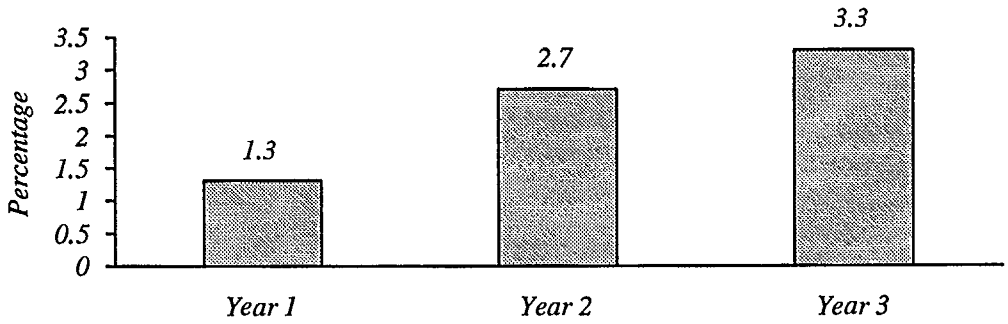


Key Observations

- The federal proposal would lead to a reduction in the consumer price index (CPI).
- The reduction in the price level would be phased in over time because of the partial denial of ITCs over the first three years.
- It is estimated that, in the long-run, the price level would be approximately 1% lower.

Preliminary Estimates

Chart 4
Short-Run Impact on Business Investment
12% Integrated Sales Tax



Key Observations

- The removal of the PST burden from business inputs would lead to increased investment and higher economic growth.

QUESTIONS AND ANSWERS

FACTS ABOUT THE FEDERAL PROPOSAL FOR SALES TAX REFORM

Finance Minister Paul Martin, at the October 14 meeting of federal, provincial and territorial finance ministers in Toronto, summarized the work done over the summer to address provincial concerns with respect to the federal proposal for sales tax reform originally presented at the June meeting of finance ministers in Vancouver. The following are key facts about the proposal.

Was the federal proposal developed in co-operation with the provinces?

- The federal proposal reflects extensive discussions with the provinces. The 7% provincial tax rate and the phase-in of ITCs specifically address concerns expressed by provinces during these discussions.

Why propose a single sales tax rate?

A single sales tax rate:

- greatly simplifies the operation of the tax for businesses and governments;
- simplifies the collection of provincial sales tax at the border; and
- facilitates tax-inclusive pricing.

Greatly Simplifies the Operation of the Tax for Businesses and Governments

A single rate across the country would remove the need for businesses and governments to deal with complex place of supply rules for interprovincial transactions.

- The integrated tax would operate in the same manner regardless of the province of origin or destination of a given supply.

A single rate system also facilitates the design of simplified accounting methods for small businesses.

Simplifies the Collection of Provincial Sales Tax at the Border

- All imports could be taxed at the combined rate, whether the goods are imported directly into the province of destination or shipped through other provinces.

Facilitates Tax-Inclusive Pricing

- National catalogues could advertise the same tax-inclusive prices across the country.

Why reduce the federal sales tax rate?

A lower federal rate facilitates participation by all provinces.

In the context of sales tax integration, achieving a lower tax rate:

- reduces the impact of broadening the tax base to items that are not taxed under current provincial retail sales taxes – e.g., the tax on children's clothing would go to 12%, instead of 14% or more without a rate reduction; and

- provides consumers with significant sales tax rate reductions – while they would pay tax on more goods and services, it would be at a lower rate.

What are the benefits for consumers under the federal proposal?

- Consumers would benefit from significant sales tax rate reductions – from a reduction of approximately 2 points in Quebec to almost 8 points in Newfoundland.

- In addition, the removal of provincial sales taxes from business inputs would result in price reductions for consumers in the short to medium term.

Despite its lower sales tax rate, the government proposes to maintain the GST Credit at its current level. Why?

- Maintaining the GST low-income credit at its current level, despite the sales tax rate reduction, ensures that low-income Canadians would be better off.

Is the federal proposal fair to low-income Canadians?

- Yes. The combination of a lower sales tax rate, the flat tax on personal income and the GST low income credit maintained at its current level would reduce the overall tax burden of low income Canadians.

What are the benefits for businesses under the federal proposal?

- Under this proposal, businesses would no longer have to deal with federal and provincial sales tax systems – they would make their sales tax remittances to a single tax administration.
- The removal of provincial sales taxes from business inputs would make Canadian businesses more competitive.
- This proposal would also reduce compliance costs for businesses by facilitating a simpler, integrated sales tax with a single rate.
- An integrated sales tax with a single rate also facilitates the design of small business simplification measures.

Would the tax burden of Canadian businesses increase under the partial ITC mechanism?

- The overall sales tax burden of Canadian businesses would be reduced.
- The three-year transitional measure would recognize the need for provinces to reduce their reliance on tax from business inputs.

Does the federal proposal involve tax savings for businesses and, if so, would the tax burden be shifted to individuals?

- Taxing business inputs results in higher consumer prices. Under this proposal, tax would be removed from business inputs, which would result in price reductions for consumers in the short to medium term.

What would be the base of the new tax?

- The tax would apply to a broad base of goods and services, but <u>not</u> to basic groceries, prescription drugs and medical devices. A broad base would ensure that the tax remains simple to administer for businesses and governments. It would also allow for a lower combined sales tax rate.

Why introduce a flat tax?

- A flat tax would make up the revenues lost because of the reduction of the federal sales tax rate. It would also make the tax system more progressive in a manner that minimizes increases in marginal income tax rates.

Are there other offsetting measures to compensate for the federal rate reduction?

- Excise taxes would be adjusted so that the price of goods such as alcohol, tobacco, and motor vehicle fuels remains the same, despite the federal sales tax rate reduction.

- Those revenues, together with revenues from the flat tax, would offset the shortfall from the federal sales tax reduction.

Why would the federal government provide provinces which participate in its proposal with added flexibility in the personal and corporate income tax fields?

- This additional flexibility recognizes that participating provinces may want to have access to more revenue sources in order to offset revenue shortfalls resulting from sales tax integration at a single lower rate.

Are efficiency gains and lower collection costs possible under the federal proposal?

- Yes, a single tax rate and base, common operating rules and a single administration allow for a significant reduction in overlap and duplication, resulting in greater efficiency.

What is the overall impact of the proposal on taxpayers?

Under the proposal, the federal sales tax rate would be reduced with an offsetting increase in personal income tax – a flat tax on taxable income would be introduced. Overall, Canadian families would experience almost no change in tax burden:

- the tax burden of low- and modest-income Canadians would be reduced by 0.3% to 10%; and

- families with annual income above $50,000 would experience a minimal tax increase of 0.2%.

What would be the economic impact of the proposal?

- The proposal would have overall positive impacts in the short- and medium-term – increases in GDP would range from 0.2% in the first year to 0.6% in the third year. This increase in GDP results mainly from increased exports and higher business investment. In addition, the proposal would lead to a reduction in the consumer price index.

- In the long run, all regions would experience output gains – the overall impact on the Canadian economy would be 1.45% in increased output.