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REDUCING PERSONAL INCOME TAX OR THE GST: PROS AND CONS

Philippe Bergevin
Philippe Le Goff
Economics Division

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The tax system has a fundamental impact on a society's economic activity and performance, since it influences matters such as labour supply, household savings, and companies' business decisions (production, employment, investment). While it is utopian to seek to eliminate taxes completely, a good tax mix can be a central element of an economic policy that supports a country's or a government's prosperity.

Since a key issue in the last federal election campaign was whether to reduce the rate of the goods and services tax (GST) – a consumption tax – or cut personal income tax (IT), it may be helpful to consider various elements of the optimal tax mix in Canada. Referring to recent economic literature, this paper attempts to summarize the main pros and cons of changes in the two tax instruments with respect to eight factors. The analysis highlights certain theoretical concepts and some empirical results discussed in the economic literature.

CONSUMPTION, SAVINGS AND INVESTMENT

One of the major differences between personal IT and consumption taxes (CT) is that the latter do not apply to savings and hence do not influence an individual's decision whether to consume now or to save now and consume later. IT, however, takes away a large share of the gains realized by saving (interest income, dividends); it thus makes immediate consumption more attractive and discourages saving. In a country with an aging population, favouring a tax system that discourages saving may not be the best solution – which suggests that a reduction in IT might be preferable.

Furthermore, saving encourages investment and thus promotes the purchase of new equipment and technologies, along with growth in research and development (R&D) activities. These forms of investment are the cornerstone of a more productive and prosperous economy. All in all, CT encourage capital accumulation in an economy, since by definition they apply to income only when it is spent.

On the other hand, a number of aspects of the tax system, such as registered retirement savings plans (RRSPs), allow taxpayers to grow at least part of their savings sheltered from IT. Such programs reduce the effective impact of a change in the tax system that would raise CT or cut IT.

As well, CT have a narrower tax base. If the government wanted to keep its level of revenue constant, any change in personal income tax rates would have to be offset by a proportionally larger inverse change in the GST rate.

Thus, though there is wide agreement that raising the GST would encourage individuals to save, there is no consensus among specialists regarding the real impact of such a move.

LABOUR EFFORT

Compared to consumption taxes such as the GST, IT is reputed to have negative effects on labour effort and to be less conducive to economic growth. Nevertheless, it is primarily the progressive nature of taxes on labour income, rather than the tax base *per se*, that is said to be demotivating for workers and likely to discourage additional work that would earn additional income.

In this regard, a new tax mix that slightly reduced the GST rate would not affect labour supply differently than would a cut in the lowest personal income tax rate, in so far as the progressive nature of taxation would not be radically altered.

ECONOMIC EFFICIENCY

A tax is judged to be more efficient when it imposes fewer distortions on the allocation of resources in an economy. As noted above, IT produces distortions in the choice of whether to consume now or later, and it also affects labour supply. IT is also discriminatory, since it does not apply uniformly to all classes of assets. The favourable tax treatment, for example, on the purchase of a residence increases demand for one asset at the expense of others. The issue is balancing the efficiency losses stemming from these distortions and the potential gains from such measures, in this instance the benefits of becoming a property owner.

The debate on efficiency is also ideological, since it pits the free market against interventionism. Nevertheless, viewed from the limited perspective of economic efficiency, CT are superior to IT, since they reduce distortions in the economy.

FAIRNESS

CT are deemed regressive since they have a proportionally greater effect on low-income people, who consume a larger share of their disposable income. In Canada, the regressive nature of the GST is attenuated by a tax credit based on income and household size, and by not taxing basic food products and residential rents.

The main argument put forward for reducing the GST rate in terms of fairness is that it would benefit everyone, even those who pay no income tax. However, the impact on households' purchasing power will depend on their consumption of taxable goods and will create a wealth effect that will vary according to discretionary income. One thing is clear: households with higher discretionary income will see their purchasing power increase more, simply because they have the ability to consume more.

THE UNDERGROUND ECONOMY AND TAX POLICY

Empirical data make it increasingly clear that high income taxes and consumption taxes promote development of the underground economy. It has also been shown that the introduction of the GST in 1991 caused the underground economy to grow.(1) Indeed, most people have at some time been offered the option of paying cash to save on "taxes," allowing the merchant to avoid declaring income that is taxed at a higher rate than total CT.

Even though the presence of CT may encourage buying some services (home renovations, child care, catering) and goods (cigarettes) under the table, the underground economy is said to be in general 2.5 times more sensitive to changes in personal IT than to changes in CT such as the GST.(2) This ratio changes over time, particularly according to the economic situation and tax rates.

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(1) Peter S. Spiro, "Evidence of a post-GST increase in the underground economy," *Canadian Tax Journal*, Vol. 41, No. 2, 1993.

(2) David E. A. Giles and Lindsay M. Tedds, "Taxes and the underground economy," Canadian Tax Paper 106, Canadian Tax Foundation, 2002.

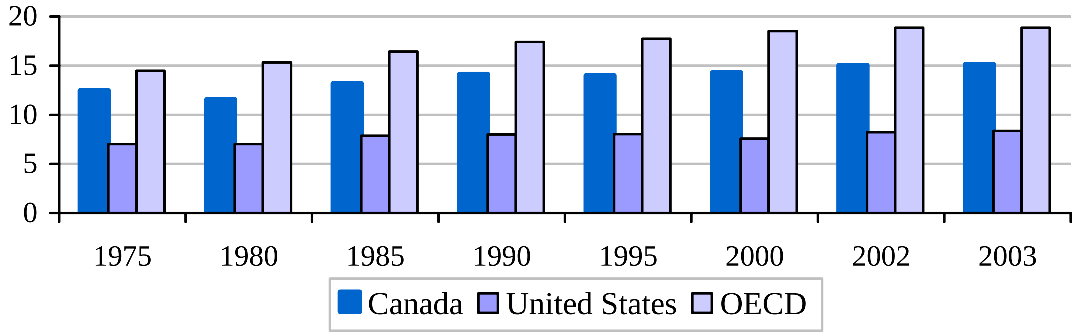
INTERNATIONAL COMPETITIVENESS

Any change in the tax structure must take into account the key role international trade plays in Canada's economy, which is very highly integrated with the world economy, in particular the economy of the United States. Too great a gap between Canada's tax structure and that of its only bordering neighbour could lead to problems. For example, increasing the already high level of CT in Canada could cause some people to make more of their purchases in the United States. On the other hand, a tax structure geared more to CT is favourable to exporters: lower taxes on salaries and no GST on exports mean exported goods are taxed less and that exporters are more competitive on foreign markets.

It may also be noted that Canada's comparatively higher IT is one of the factors behind the brain drain to the United States.

VAT(3)/GST and other sales taxes(4) have experienced sustained growth in the countries of the Organisation for Economic Co-operation and Development (OECD) in recent decades, though their contribution to total tax revenues appears to have stabilized in the last few years (Figure 1). These CT now represent 19% of all OECD governments' tax revenues, compared to 14% in 1975.(5) All the OECD countries except the United States now have some type of value added tax.

Figure 1 – General Consumption Taxes
(% of all tax revenues)



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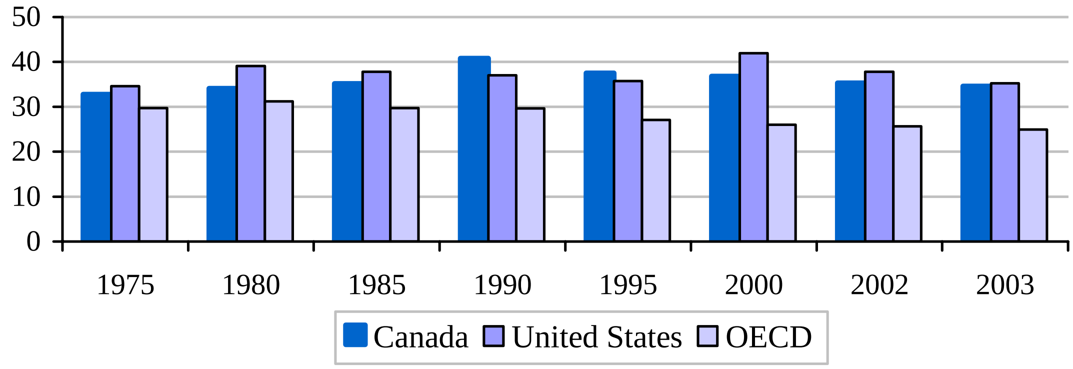
(3) Value added tax. This tax applies at every step of the economic process and not only to the final sale.

(4) VAT/GST and other sales taxes are part of the category *general consumption taxes*, according to the OECD nomenclature. This category includes all CT that apply to most, if not all, goods and services, and excludes other more specific forms of CT such as excise tax (e.g., on tobacco) or customs duties. In this section, the definition of general consumption taxes is used for purposes of international comparison.

(5) Unweighted average of the 30 OECD countries. The most recent data available are from 2003 (OECD Tax Data Base).

The percentage of tax revenues from personal IT has declined slightly within the OECD member countries, especially since the early 1990s (Figure 2). On average, Canada and the United States rely less on CT and more on personal IT than the average of OECD countries. This divergence is even more marked in the case of the United States.

Figure 2 – Personal Income Tax
(% of all tax revenues)



In Canada, the federal GST rate is 7% (at the time of writing), while the provincial rate ranges from 0% for Alberta to 10% for Prince Edward Island. On average, the combined federal-provincial rate is approximately 14%,(6) below the average of 17.8% for the OECD countries, but well above the average level of sales tax in the United States.(7) For personal IT, the average rate in Canada is 17.8%, as against 16.5% in the United States and 14.3%(8) on average in the OECD countries. These countries make up for this lower taxation by social security premiums that are, on average, higher.

STABILITY OF GOVERNMENT REVENUES

To ensure the stability of its tax revenues, a government will diversify its sources of taxation to avoid being dependent on any particular tax base. It will also seek to broaden its tax bases as much as possible and avoid over-reliance on the less stable components, such as capital gains and income from higher tax brackets.

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(6) Unweighted average of the effective consumption tax rate in the various provinces, 2004.

(7) The rate of sales tax varies by state and locality. The unweighted average of effective rates is approximately 7.4% for the maximum state/local rate (Washington Department of Revenue, 2004).

(8) Average rates for a single person with no dependants (OECD Tax Data Base).

In general, from one fiscal year to the next, changes in net GST revenues are closely linked to changes in consumption. There is also a fairly constant relationship between personal income and personal income tax revenues, but this pattern is more visible over longer periods.

U.S. studies,(9) using a number of measures of variance of tax bases, have concluded that consumption constitutes a more stable tax base than income and benefits do. A study of the volatility of tax bases in Canada and in 14 OECD countries conducted by the authors of this paper tends to confirm this finding. Over the last 40 years, the tax base on which personal IT relied was more volatile than that of CT. However, the volatility of both tax bases appears to diminish with time, to the point where the difference between the two becomes somewhat marginal. In light of these results, lowering the GST rate rather than making an equivalent reduction in personal IT would have the effect of slightly increasing the volatility of government tax revenues.

ADMINISTRATIVE COSTS

The costs to the government of administering taxes and the costs of compliance for taxpayers, although unavoidable, are considered by the economic literature as economic losses, in the sense that they are not used for financing public services, nor do they contribute to national production.

The collection of consumption and income taxes and the resources required for ensuring compliance with the tax laws and regulations cost a lot of money. In 2004-2005,(10) the Canada Revenue Agency (CRA) collected $305 billion in tax revenues. To do so, it mobilized a workforce of 27,384 full-time equivalents (FTEs), at a cost of $2 billion; to this figure must be added the spending on CRA and call centres administration, which came to more than $800 million.

However, Canada's tax administration is among the most efficient in terms of costs versus revenues. The tax administration ratio(11) was under 1% in 2004-2005. It should be noted that Canada's tax system is based on self-assessment and voluntary compliance in filing

(9) Americans for Fair Taxation, *A Fair Tax White Paper – The stability of the Fair Tax as a principal source of federal revenues*, http://www.fairtax.org/pdfs/stability_of_FairTax.pdf.

(10) Canada Revenue Agency, *2004-2005 Performance Report*.

(11) Administrative cost per dollar of income tax collected.

returns, registration and payment. The private sector, individuals and businesses therefore assume a large share of the cost of the tax system by filing their own income tax returns and collecting GST/HST [Harmonized Sales Tax]. In this regard, Kesselman(12) believes that the threshold of annual sales above which small businesses must register with the CRA for the GST should be raised considerably above the current level of $30,000. Doing so would make life easier for small businesses and reduce the private and public costs of compliance and administration.

A change in the GST rate would not reduce what it costs the government to collect the tax, but would in the short term increase businesses' costs of collecting it (reprogramming cash registers, revising forms, etc.). A change in personal income tax rates or an adjustment to the basic personal exemption would be simpler to implement and less costly in the short term.

CONCLUSION

The findings reviewed in this document do not lead to any absolute or definitive conclusions. While a consumption tax offers some advantages in terms of economic effectiveness, compliance levels and stability of government revenues, income tax is less regressive and probably easier to administer.

The difficulty in making a clear choice between these two proposals stems from the fact that the two modes of taxation are fundamentally similar, even though they differ in their current forms, and the fact that the proposed changes are, all in all, small ones. Also, regardless of its taxation preference, the government must keep the tax base as broad as possible, and this limits the scope of possible reforms. The international context also imposes limits on the changes possible in the tax system. Finally, minor adjustments to the tax mix, as proposed, may well have a negligible impact on the Canadian economy.

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(12) Jonathan Kesselman, "Cutting the GST," *The Globe and Mail* [Toronto], 13 December 2005.