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VIEWPOINT

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SALES TAXES AND TAX COMPETITION

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At the start of its mandate, the sitting Quebec government envisioned a profound reform of the tax system in Quebec that would stimulate economic growth by minimizing the impact of the tax burden, but without reducing government revenues. The main recommendations of the Godbout Report which resulted from this initiative were never implemented, however, despite a favourable reception on the part of Finance Minister Carlos Leitão.

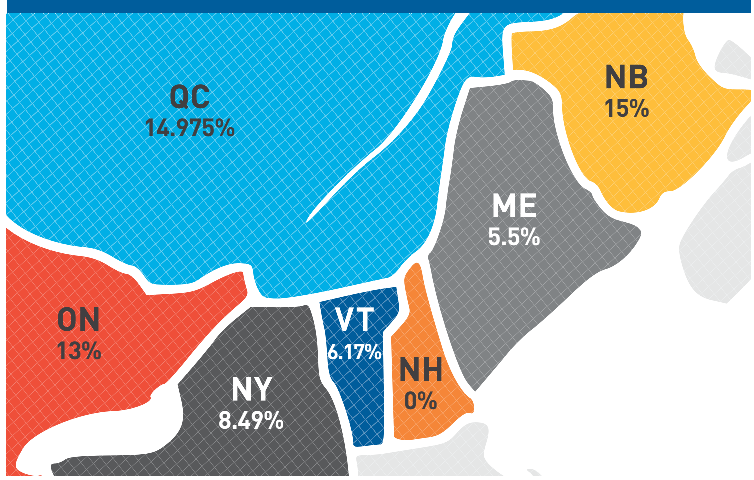
The proposed reform consisted of modifying the weights of different components of the tax system without altering the total amount of tax revenue collected by the government. By eliminating certain tax expenditures and increasing the rates of consumption taxes, mainly the Quebec sales tax but also specific taxes on tobacco, alcohol, fuel, and insurance, it would become possible to reduce personal and corporate income taxes.[1]

This kind of reform enjoys the support of many economists, who favour tax systems that do the least possible damage to economic activity.[2] Concretely, reducing personal income tax by one dollar increases the GDP by 72¢, whereas an equivalent reduction in the Quebec sales tax only increases GDP by 43¢.[3] Raising sales taxes in order to reduce income taxes thus stimulates the economy.

The logical explanation for this difference is that income tax penalizes work and investment, the motors of economic activity. By taxing consumption, it is income spent that is taxed, and taxpayers can avoid this to a certain extent by saving or by not purchasing taxed products, for instance by purchasing fresh foodstuffs rather than prepared meals.

Figure 1

Sales taxes in Quebec's tax competitors, 2016



Note: The sales tax rates include municipal sales taxes in Vermont (+ 0.17 percentage points) and in New York (+ 4.49 percentage points). For the Canadian provinces, the federal tax rate of 5% was included; these are therefore harmonized sales tax rates.
Sources: Scott Drenkard and Jared Walczak, "State and Local Sales Tax Rates, Midyear 2016," Fiscal Fact No. 515, Tax Foundation, July 2016; Canada Revenue Agency, GST/HST rates table, September 28, 2016.

However, the prospect of raising the sales tax elicited strong opposition from SMEs and retailers who fear they will no longer be able to compete if there is a Quebec sales tax hike.

THE ADVANTAGE OF SHOPPING ELSEWHERE

The Quebec sales tax represents an average burden of $2,061 a year per Quebecer aged 15 and over.[4] When many purchases are made over a short period, the weight of sales taxes can be a determining factor in the choice of store, and it becomes even more worthwhile to hunt for bargains online or in the United States.

This is the case during the holiday season. Last year, a financial institution estimated that each Quebecer would spend an average of around $1,060 in gifts, food, entertainment, and travel.[5] Included in this amount, sales taxes (GST and QST) represent $138.[6] Indeed, sales taxes are higher in Quebec than in neighbouring provinces and states, with a combined rate of 14.975%. Only New Brunswick has somewhat higher sales taxes, at 15%.

Adjacent American states are much less greedy,[7] as shown in Figure 1. It must be pointed out that even though 45 American states have sales taxes, they do not exceed 10% in any of them. For purposes of illustration, sales taxes included in purchases in Plattsburgh, New York equivalent to C$1,060 would amount to C$78, while they would amount to C$57 in Burlington, Vermont.

In addition to tax competition from our neighbours, retailing in Quebec is also faced with the growing phenomenon of online shopping, in which sales taxes are not systematically collected. In 2012, Revenue Quebec estimated that $165 million in Quebec sales taxes were not collected in the context of electronic commerce with suppliers located outside Canada, and another $300 million for purchases in other provinces.[8]

Indeed, online retailers do more business where sales taxes are the highest. Thus, a one-percentage-point increase in the sales tax leads to an increase of nearly 2% in online purchases.[9]

UPDATING THE GODBOUT REPORT?

In theory, an increase in consumption taxes, including the Quebec sales tax, accompanied by a personal income tax reduction, would stimulate the economy. Tax competition, however, limits the capacity to raise sales taxes given their already high level in Quebec compared to its neighbours. Yet in the Godbout Report, increasing the rates of consumption taxes was an essential component that generated $2.7 billion of new tax revenue, allowing income taxes to then be reduced.[10]

The Godbout Report proposal was neutral in terms of tax revenue because any net reduction in revenues collected would have deepened the deficit that prevailed at the time when it was released. Now that Quebec's public finances are back in balance and that the government is managing to record a modest surplus, there is room to go a little further. It would be possible to reduce the tax burden of individuals in order to stimulate economic growth, all while leaving aside the proposed hike in consumption taxes. The economy, consumers, and retailers in Quebec would all be better off.

REFERENCES

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3. Quebec Taxation Review Committee, *op. cit.*, endnote 1, p. 44.
4. Statistics Canada, CANSIM Table 051-0001: Estimates of population, by age group and sex for July 1st, Canada, provinces and territories, 2015; Quebec Finance Department, *2015-2016 Public Accounts—Volume 1: Consolidated Financial Statements of the Gouvernement du Québec*, October 2016, p. 170.
5. Denis-Martin Chabot, "Les achats de Noël : qui dépense le plus?" *Radio-Canada*, December 26, 2015. The month of December is particularly good for jewellery stores, toy stores, and appliance stores. See Jane Lin, "Christmas Shopping: A Provincial Perspective," Analytical Document No. 034, Statistics Canada, December 2005.
6. The calculation of sales taxes assumes that Quebecers are prudent in their estimates and that sales taxes are included in their anticipated spending.
7. The rates indicated for the American states take into account a weighting of local taxes in addition to state taxes, in order to reflect an average for each state. Total sales taxes in the city of Chicago, for example, amount to 10.25%, but the state of Illinois as a whole remains at 8.65%. Scott Drenkard and Jared Walczak, "State and Local Sales Tax Rates, Midyear 2016," Fiscal Fact No. 515, Tax Foundation, July 2016; MyTaxIllinois, Tax Rate Finder, December 2016.
8. Quebec Taxation Review Committee, *op. cit.*, endnote 1, p. 179, cited in Mathieu Bédard, "The Dilemma of Taxing Online Purchases," Economic Note, MEI, November 2015, p. 1.
9. Liran Einav *et al.*, "Sales Taxes and Internet Commerce," *American Economic Review*, Vol. 104, No. 1, 2014, pp. 1-26; Yu Jeffray Hu and Zhulei Tang, "The Impact of Sales Tax on Internet and Catalog Sales: Evidence from a Natural Experiment," *International Journal of Industrial Organization*, Vol. 32, January 2014, p. 85.
10. Quebec Taxation Review Committee, *op. cit.*, endnote 1, pp. 53, 64-67. In this $2.7 billion, the increase of the QST by 1.025 percentage points is accompanied by increases in specific taxes on insurance, tobacco, alcohol, and fuel.

This *Viewpoint* was prepared by **Youri Chassin**, Economist and Research Director at the Montreal Economic Institute. *The MEI's **Taxation Series** aims to shine a light on the fiscal policies of governments and to study their effect on economic growth and the standard of living of citizens.*

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