

# Some Thoughts on the Upcoming Harmonized Sales Tax

Sal Guatieri, Senior Economist

Starting July 1, Ontario and British Columbia consumers will pay an extra 8% and 7%, respectively, on some goods and services when the provincial retail sales tax (PST) is harmonized with the 5% Federal Goods and Services Tax (GST). The resulting Harmonized Sales Tax (HST) has already been adopted in several other provinces. Over 140 countries, including 30 OECD countries except the United States, have some form of value-added tax system. Here is a rundown of the potential impact on Canada's economy.

From an economic efficiency standpoint, a value-added tax like the HST is a big improvement on the current retail sales tax system. Its major selling point is that most businesses will no longer pay retail taxes on inputs, such as materials, supplies, overhead and equipment. Companies will avoid paying multiple taxes through the supply chain by claiming input tax credits. These "hidden" retail sales taxes, which are ultimately borne by consumers, are estimated to cost \$4.5 billion a year in Ontario and \$2 billion in B.C.—equal to just over 2% of national business investment. Given competitive pressures and economic slack, businesses should ultimately pass a portion of the savings onto consumers, leading to lower retail prices than would otherwise be the case. This should improve each province's competitiveness and the nation's trade balance. Lower business costs, especially on capital equipment, will encourage investment (and employment), thus raising long-term potential growth. One study found that machinery and equipment investment rose 12% above trend levels in the years following the 1997 sales tax harmonization in three Atlantic Provinces.<sup>1</sup> Another study estimates that the HST (and other recent tax changes) will sharply increase Ontario's capital investment (and jobs) over the next decade.<sup>2</sup>

Businesses will save on the reduced costs of dealing with one sales tax system instead of two, and provincial tax collection will be more efficient.

After an initial spike higher, the HST should result in a modest temporary decline in Canadian inflation. Inflation initially averaged a half percentage point higher in the three Atlantic Provinces than in the other provinces in 1997, despite the fact that the provincial portion of the sales tax was reduced by about four percentage points (*Table 1*). But the increase in inflation was more than retraced in the subsequent two years, suggesting businesses passed along some of the tax savings. The Ontario government claims that, under the HST, 17% of consumer expenditures will now become subject to the 8% provincial tax. (The share of spending in B.C. that will be

**TABLE 1**  
**HST IMPACT ON INFLATION IN ATLANTIC PROVINCES**  
(y/y % chng)

CPI	1996	1997	1998	1999
New Brunswick	1.48	1.88	0.55	1.63
Newfoundland & Labrador	1.57	2.05	0.21	1.43
Nova Scotia	1.78	2.08	0.62	1.71
<b>Average</b>	<b>1.61</b>	<b>2.00</b>	<b>0.46</b>	<b>1.59</b>
Average of Other 7 Provinces	1.73	1.54	0.86	1.71
<b>Inflation Difference</b>	<b>-0.12</b>	<b>0.47</b>	<b>-0.40</b>	<b>-0.12</b>

subject to the 7% provincial tax is thought to be slightly higher). Based on Ontario and B.C.'s share of Canadian personal spending, the HST could raise national inflation by up to 0.4 percentage points in 2010 (the annualized impact is actually 0.7% but the HST will take effect at mid-year). Assuming businesses cut prices, the overall impact on inflation will be even less. The direct effect of the HST will drop out of the year-to-year inflation rate in July 2011. This, combined with lower retail prices, could subtract about a half percentage point from inflation in 2011. The HST will have no direct impact on the central bank's core inflation measure, though lower retail prices will depress it slightly. However, because the impact is likely to be transitory, it should have no meaningful effect on monetary policy.

Despite lower retail prices, consumers will pay more at the checkout counter for some items, as the HST will apply to a broader range of goods and services than the PST. In Ontario, some professional services (lawyer and accounting fees), personal services (haircuts), and a few goods like gasoline and heating fuels will cost 8% more on July 1. However, some items, like basic groceries, that are currently exempt from the PST and GST will continue to be excluded under the HST. Others (such as books, children's clothing, newspapers and prepared foods selling for \$4 or less) that are currently excluded from the PST but not the GST will continue to be excluded from the provincial portion of the HST. Since consumers will likely bring forward some purchases before July 1<sup>st</sup>, the HST should lift GDP growth somewhat in Q2 and reduce it in Q3.

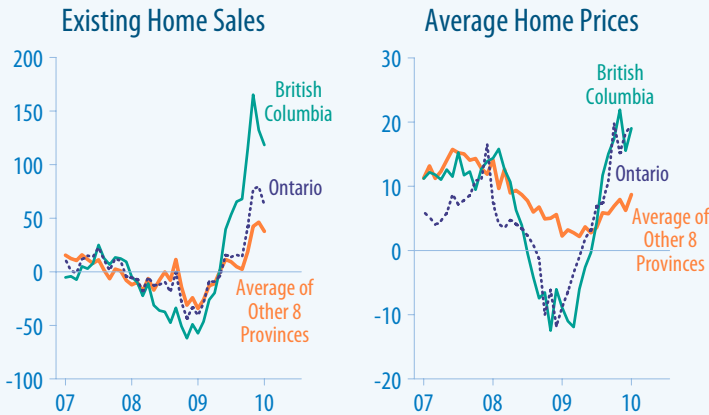
All else equal, the HST could reduce Canadian real personal spending by roughly 0.7% per annum; however, the actual impact will be much smaller because retail prices should decline modestly and governments will provide tax benefits to insulate many households from the tax. On January 1<sup>st</sup> 2010, the Ontario government reduced its lowest personal income tax bracket by one percentage point, benefitting all income earners. In addition, Ontario plans to issue temporary tax transition benefits to most households and permanent sales tax credits to lower income families. B.C. will provide annual tax credits to lower income families. Furthermore, to the extent that investment, employment and income should increase, consumer spending may be even less impacted by the HST.

The transitional benefits and permanent tax relief to households will cost the Ontario government \$10.6 billion over three years, while the additional revenue raised from the HST will amount to \$6.2 billion. The federal government will kick in \$4.3 billion of transfer payments to bridge the gap.

In the housing sector, although existing home sales and rents will be exempt from the HST, buyers will pay more for real estate services, including moving costs, home inspections and closing costs (such as legal fees, appraisals and surveys). Sellers will pay the HST on realtor commissions, coughing up an extra \$1,300 on the average-priced home in Ontario and \$2,000 in B.C. (assuming 5% commissions). Homeowners will face higher costs for utilities, such as heating and internet service. An Ontario

**CHART 1  
BEATING THE TAX?**

(y/y % chng)



household that budgets \$500 per month for utilities will pay an extra \$480 per year. Condo owners will pay several hundred dollars more per annum for maintenance fees, and renovators will pay more for labour services.

New homes priced up to \$400,000 in Ontario (and \$525,000 in B.C.) will effectively be shielded from the tax because of rebates that amount to 6% (5% in B.C.) and the likelihood that builders will reduce prices due to the elimination of the embedded PST on inputs (estimated at about 2%).<sup>3</sup> In Ontario, buyers will incur a flat tax of 8% on the amount paid in excess of \$400,000 (which is a major improvement from the original proposal). The buyer of a \$500,000 home will pay an extra \$16,000 (2% on the first \$400,000 plus 8% on \$100,000), though this would effectively be reduced to \$6,000 (or 1.2% of the sales price)

if the builder lowers prices by 2%. A million dollar new home would cost an additional \$36,000 after the price reduction. The higher cost of new homes should also lift resale prices. Recent rapid increases in home sales and prices in Ontario and B.C relative to other provinces suggest buyers may have already moved ahead of the HST (*Chart 1*). This behaviour could intensify in coming months, lifting prices temporarily higher.

**The Bottom Line:** Due to increased business savings, reduced retail prices and tax relief, the adoption of the HST in Ontario and British Columbia is not expected to have a negative short-term impact on the economy. Longer term, the HST will support capital spending and productivity, and increase Canada's reputation as a desirable place for companies to locate. The HST should result in temporary, modest downward pressure on core inflation, though this is unlikely to affect monetary policy.

<sup>1</sup> Michael Smart, C.D. Howe Institute, Commentary, *Lessons in Harmony: What Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax*. No. 253 July 2007.

<sup>2</sup> Mintz, Jack, University of Calgary, *Ontario's Bold Move To Create Jobs And Growth: Impact of the 2009 Ontario Budget and other Recent Tax Measures on Investment, Jobs, and Incomes*. The School of Public Policy, SPP Communiqué. Volume 1. Issue 4. November 2009.

<sup>3</sup> Frank A. Clayton, Altus Group, *New Housing Is Different: Implications for Sales Tax Harmonization on New Home Buyers in Ontario*. March 9, 2009.

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N.A., and BMO Capital Markets Limited.

TO U.S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U.S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd.

TO U.K. RESIDENTS: The contents hereof are not directed at investors located in the U.K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.