

Now's the Time to Put GST On Groceries

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Former minister of finance Michael Wilson recently announced a list of “technical amendments” to the goods and services tax, deemed necessary due to some anomalies in the existing rules determining which goods are GST-free and which goods are taxed. Don Mazankowski, as the new minister of finance should change the GST to allow no exemptions, not even for basic groceries.

The four criteria economists use in evaluating a tax are efficiency, administration costs, compliance costs, and equity. On each of these grounds, exempting foods—or any other item—from the GST constitutes bad policy.

A tax is efficient if it does not lead people to produce or consume one product rather than another simply for a tax advantage. Exempting some items from the tax changes relative prices and, therefore, leads to inefficient patterns of production and consumption.

Though economists rarely downplay the importance of economic efficiency, it seems unlikely that exempting food from the GST leads to a significant reallocation of consumption from other goods to food. After all, people can only eat so much. The argument against exempting food is, therefore, based on the other three criteria.

Exempting food means large administrative costs because a distinction is made between non-taxable “basic groceries” and taxable “snack food”. In the average grocery store, there are thousands of items and each one must ultimately receive one of these two labels. Such labeling is costly and arbitrary.

Salted peanuts, for example, are snack food, but unsalted ones are basic groceries. A single muffin is a snack, but a package of six is basic groceries. How much salt is required for peanuts to be considered snacks? Why is the crucial number of muffins six, rather than four or 14? How many civil servants occupy their time with this arbitrary list of foodstuffs? One per item? One per six-pack? Who knows? But any number is a waste of resources.

A second administrative problem is that GST exemptions give individuals the incentive to evade the tax. I don't know if there is truth to the story of the Ottawa dry-cleaner who no longer sells cleaning services but, instead, sells expensive GST-free potatoes and throws dry-cleaning in for free. I don't even know whether such a scheme would be legal, but legality is beside the point. Exemptions to the GST encourage a waste of resources as individuals try to evade it. Furthermore, creative schemes for GST evasion are sure to be followed by a barrage of tax amendments to fill the GST loopholes. More waste.

Exemptions also hike the compliance cost of the GST. We have all heard reports of shopkeepers complaining about the complications of calculating the amount of GST to remit to the government. With an ideal GST, which applies to all newly produced goods and services at the same rate, the computation is simple—apply the tax to the difference between sales revenue and non-labour costs.

The numbers for sales revenue and non-labor costs are figures that a firm must, in any event, compute for income-tax purposes and for annual reports to shareholders. Thus, with an exemption-free GST, the calculations would, indeed, be trivial. In New Zealand, where an exemption-free GST was introduced in September 1986, accountants have been loudest in favour of the GST.

Things get very messy in a world of GST exemptions, since both revenues and non-labor costs include transactions of some goods which are GST-free and other goods on which the GST is paid. A firm must, therefore, arrive at measures of revenues and non-labour costs that exclude all GST-free items. For a firm which produces several goods from a large number of inputs, even a small number of GST exemptions can make the accountant's job a nightmare.

This is why the GST should be changed to apply to all newly produced goods and services at the same rate, with no exemptions. We would be better off if the dry-cleaner could devote his considerable skills to dry-cleaning rather than to tax avoidance, and if the government did not have to match wits with the private sector by filling tax loopholes. We would be better off if the civil servants now measuring salt content in peanuts were doing something constructive, and if completing a tax form were not an obstacle to running a business.

The alleged benefit of exempting basic groceries is that it makes the tax system more equitable. Since low-income families spend a larger share of their income on food than do high-income families, applying the GST to food appears to impose a heavier burden on the poor than

on the rich. The benefit is illusory, however, because it ignores the extra tax revenue that must be raised to offset the tax revenue lost by exempting food.

By applying the GST to all food items, we can make low-income families better off. This is because high-income families spend more on food—in absolute number of dollars—than low-income families. The government should, therefore, broaden the scope of the GST to include food and return the resulting increase in tax revenue equally to all individuals, independent of their income. Since the rich spend more on food than the poor, the poor would be better off as they would receive a payment in excess of their GST payments on groceries.

This would make the GST more progressive, as well as eliminating the significant resource costs discussed above. And it would be simple because the structure is already in place—the existing GST tax credit.

Mazankowski should take a bold first step as the new minister of finance. By changing the GST to be exemption-free, he would send a signal to Canada that the finance portfolio is still in capable hands. But if the government continues to ignore the logic of making the GST exemption-free, Canada will have a costly and arbitrary tax. We will all suffer.
