Doing the Right Thing for the Right Reason

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The title of my presentation is "Doing the Right Thing for the Right Reason". I read the Smart-Bird paper and noted the heavy emphasis on addressing the fiscal imbalance issue, so this is one of the issues that I want to talk about. I'm going to briefly talk about the proposal, but focus most of my attention on the issue of horizontal imbalance that this might create and then say something on the issue of vertical fiscal imbalance, fiscal incentives and the sales tax.

I can't be highly critical of this proposal because, in fact, I proposed much the same thing in 2005 in a paper published by the C.D. Howe Institute. Before there was a cut in the GST by the federal government, I suggested that the federal government reduce its GST to 5 points, allowing the five provinces with RSTs to switch to revenue-neutral VATs of about 8 percent in Ontario. And this tax reform proposal would approximately lead to the same direct sales tax burden on families in provinces that levy the RSTs.

The essential problem then is that even though Ontario and Quebec levy approximately the same tax rate, the proximate tax burden on families is considerably higher in Quebec than in Ontario because a big chunk of the retail sales tax base is on business inputs. To switch to the VAT base, which is something like what the QST is, there would be an immediate apparent increase in the sales tax burden on families in Ontario. This, of course, as we know, is highly unpopular and a political non-starter. So the idea of implementing this through a simultaneous cut in the federal GST makes it possible for the provinces to switch to the VAT base, but not have any net or proximate increase in the burden that is in fact levied on families.

The motivation for this is one that has been aptly described by Michael. We want to replace this highly distortionary RST that taxes business inputs with a less distortionary tax. I did some back-of-the-envelope calculations that the efficiency gains here might be around the order of $6 billion. It might have a net cost to the federal treasury of $7 billion, but it would be worthwhile as long as the public cost of funds to the federal government was less than $1.67. I'm hoping that all the detailed work that Michael's going to do is either going to show that my back-of-the-envelope calculations are right or wrong. So I'm awaiting his results.

Those are some of the things that I highlighted in my brief analysis. But I also suggested that we shouldn't just stop at this GST reform; we should also think about harmonizing or transferring tax bases in the excise tax area. The federal government and the provinces co-occupy the major excise taxes, and this creates a lot of problems with transparency and accountability. And they also create negative fiscal externalities when one level of government raises the tax base, especially when they levy per-unit taxes. It shrinks the tax base for both levels of government; it causes a revenue loss for the other level of government. It can lead to bad or misinformed tax policies because they don't take into account that there are vertical fiscal externalities.

Some of these excise taxes are associated with public-expenditure externalities – alcohol and tobacco products affect health care costs, a provincial responsibility; the use of streets and highways is related in at least some degree to fuel consumption. So there is some argument that this is perhaps a more appropriate field of taxation for the provincial governments. So I would suggest that, in addition to the sales tax, this kind of reform, where the federal government reduces the GST in order to allow the provinces to have more room to adopt a value-added tax base, should also be extended to the excise tax area.

In terms of equalization, I want to suggest that we should try to avoid the problems that were created in 1977 when we had the tax-point transfer. The problems of the tax-point transfer have been highlighted in those recent reports by the advisory committee on fiscal federalism that reported last year and by the Expert Panel on Equalization. I think one of the ways we could address this issue is by renaming our equalization program the Reasonable Comparability Program because the constitution says nothing about equalizing fiscal capacity or having the same fiscal capacity. It says the provinces should have reasonably comparable fiscal capacity. And if we have a reasonably comparable fiscal capacity formula, that takes care of all these kinds of issues when we transfer tax room from one level of government to the other. So I would say we don't need to address this question of trying to equalize these tax-point transfers.

Now you might say, this is all fine because you're from Alberta; you don't have a sales tax. This tax cut by the federal government is in fact going to make you better off by 2 percentage points on your hard-earned dollars. But for those of you who don't know, I've been a long-time advocate that in Alberta, we should have a sales tax, or at least consumption taxes, so I'm for sales taxes not just because this sales tax cut might be personally advantageous to me.

But the issue that I'd like to really focus on is the question of fiscal incentives and whether this addresses the fiscal imbalance question. In the paper that Michael wrote in 2005 under the same C.D. Howe conference as from where my paper emerged, he identified three generic problems that occur in federations with complex and overlapping tax structures: the bailout problem, the fiscal illusion problem and the common pool problem. The question is, would this transfer of sales tax room and a cut in CHT and CST address these problems.

One of the very interesting figures that Michael had in his presentation is a chart that shows how the CHT and CST have been ratcheted up budget after budget as the federal government tries to respond, I guess, to provincial and voter interest in having more money transferred to the provinces, suggesting that there is a bailout problem – that is, the provinces try to get more and more money from the federal government based on need to spend money, especially in the health care area. I think this is a very interesting and potentially important problem.

The question is, do we have a bailout problem? I don't know the answer to that. But if we look at these trends and these grants over a longer period of time, not just since 1996, we don't see the kind of ratcheting up that I would expect a bailout scenario would involve. If you had a bailout mechanism going on, the provinces would go into deficit, the federal government would come in with high levels of grants, maybe the deficit would come down for a while, then, of course, they jack the deficit back up to get more grants – and you'd see a ratcheting up of the federal transfers. Of course, simply plotting these things won't really answer this question. But it doesn't jump out at you and say, "Look, we have this ratcheting up; there must be a bailout problem." I'd like to see the econometricians get to work on this and see if there really *is* a bailout problem emerging.

Does equalization address the fiscal illusion problem? The CHT and CST are lump-sum, or block grants – they're fixed in amount. The provinces are responsible for funding the marginal expenditures on health care, education and welfare – in other words, if they want to spend an extra dollar on health care, they have to raise an extra dollar in taxes. So there's not really – at least at the level of the people who are having to raise the money – an illusion problem. These are not matching grants, etc. From that perspective, I don't think they contribute to what I would regard as a fiscal illusion. There may be other distortions that lead to that, but I don't think they contribute to a fiscal illusion.

Finally, do we have a common pool problem, and does this proposal address that? The common pool problem arises, I think, because the median voter in a province may see the tax price – that is, what they have to pay to get an extra dollar of services – as being lower at the federal level than at the provincial level. Why? Because – and here, all taxes are broadly proportional to income, if we think of it that way – if the province's average provincial income is lower than the average national income, the tax price that any voter in that province sees is lower from the federal government than from the provincial government. They'll see that they can get their services cheaper if they get money from the federal government than from the provincial government. Also, this tax price will depend on the marginal cost of funds for provinces versus the federal government. Provinces may have more elastic, tax-sensitive bases than the federal government, again contributing to higher tax prices at the provincial level than the federal level.

This issue that voters are going to want to get money from the level of government where they can get it at the cheapest cost to them – and the median voter will try to do this – if this is what's driving the determination of grants, I don't think this transfer of sales tax room is going to interfere with that mechanism. It's not going to change ratios of average incomes across the country. It's not going to change the marginal cost of funds for, I would say, the two highest-cost source of funds, which would probably be the corporate income tax and personal income tax.

Again, although I applaud this proposal, I think we need to make sure we support it for the right reason. I think the right reason is it will help to improve the efficiency of our tax system. It's good from that perspective. And we should also think about a similar exchange of tax fields in the excise area. We shouldn't even start to think about equalizing these tax transfers. But I don't think the transfer of sales tax room and the reduction in CHT and CST would really address the alleged fiscal imbalance issue.