Comments on "The GST Cut and Fiscal Imbalance" by Michael Smart and Richard Bird

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I only have comments on the paper by Michael Smart and Richard Bird. I enjoyed Charles McLure's paper, as I have enjoyed so many of his papers over the years, but I'm afraid I don't have anything to say about it.

I also enjoyed the Bird/Smart paper a good deal. Though I focus on where I think it needs elaboration or improvement, it makes an important contribution to discussion of what may be an emerging public policy issue. I look forward to reading subsequent versions.

The version of the paper discussants were sent was titled "The GST Cut and Fiscal Imbalance." My first comment is that I don't think the proposal—that Ottawa simultaneously cut both the GST and equivalent fiscal transfers while also taking measures to encourage the five provinces that continue to operate retail sales taxes (RTSs) to convert to some form of value-added tax—has much to do with fiscal imbalance. Fiscal responsibility, perhaps, but not fiscal imbalance.

In the current political vernacular, fiscal imbalance means the federal government has too much money and the provinces too little. In essence, therefore, fiscal imbalance is an argument about the federal surplus. The provinces would like most of it. Correcting the fiscal imbalance means moving money to the provinces. The Bird/Smart proposal quite explicitly does not do that.

At the heart of the fiscal imbalance story is the implication that the provinces spend money on activities with high marginal utility (health care and education, for example) while the federal government spends on activities with low marginal utility (sponsorships and Senators). With the federal government exercising squatter's rights in shared areas of taxation—and most are shared—the marginal cost of provincial taxation is too high for provinces to simply raises taxes to pay for their very high-value activities. If only the federal government would cease its wasteful expenditures and vacate tax room, the marginal cost of provincial taxation would fall to more reasonable levels and the provinces could proceed with their high-benefit spending.

My own view of fiscal imbalance is that there are too many examples of both levels of government spending on very low-marginal utility activities for it to be true. Both supported last summer's "Out Games," for instance, which may have been an ideological success but were a dismal financial failure. Both fund the home improvement shows that appear on the specialty TV channels—though why governments should fund entertainment programming that can be sold by cable companies is explained in no public economics textbook I have seen. Both still amply reward efficiency-reducing rent-seeking by industries, albeit somewhat less than they used. And so on and so on.

I naturally would not want the following to get back to my editor or readers at the *National Post* but there are also examples of the federal government engaging in high-marginal utility spending. New funding for the military will likely have a high foreign-policy payoff. Debt reduction may also be a wise investment. As Bev Dahlby argued in a book Christopher Ragan and I edited for the Institute for Research on Public Policy in 2003, it has a return on investment of something like 15 cents on the dollar, which is quite respectable. I expect improvements to border infrastructure also typically have a similarly high utility payoff. In sum, I doubt it could be demonstrated that provinces have cornered the federation's high-marginal benefit spending while the federal government specializes in its low-marginal benefit spending. Indeed, Bird and Smart suggest that extra spending on health care, the highest-profile provincial responsibility, has a negative return because it forestalls rationalization of health care supply.

Still, the debate around the fiscal imbalance has degenerated to such an extent that the political marker for Quebec seems to have been established at $3 billion: If a new federal-provincial agreement does not provide Quebec with $3 billion annually, then from my province's point of view the fisc will be deemed to be still out of balance. The Bird/Smart proposal obviously fails by this measure: It merely frees up tax room that would allow the provinces to replace the eliminated federal transfers.

Politically palatable or not, is the proposal a good idea? There are no welfare calculations in the paper and such calculations are difficult, in any case. But moving the provinces to broader-based, lower-rate consumption taxes does seem a good thing to do. When the GST was first being debated Andrew Coyne and I wrote a special insert in the *Financial Post* titled "A **G**enerally **S**ensible **T**ax." It was then and it probably still is now, even if attempting to tax services that previously had been untaxed has caused Canada's underground economy to grow. Doubtless there were increases in revenue from taxing activities that can be delivered for cash but, given the importance of the rule of law for all sorts of good social and economic outcomes, we should not be indifferent to measures that rewarded scofflaws. (Granted, not taxing a base because doing so will increase evasion involves hypocrisy; still, it may well be important to stick with those laws people will obey.)

The principal benefit of going to a GST-style tax is that it will reduce taxes on capital and thus make jurisdictions that take this step more attractive to investors, which will have implications for investment and labour productivity (though probably not for overall employment, despite the Bird/Smart draft's claim that sales tax reform is particularly important "in this era of global competitiveness when jobs are always to some degree on the edge of moving to Bangalore or Shanghai from Brampton or Winnipeg, Canada").

As noted, the proposal would improve fiscal accountability. Provinces would finance a greater share of their spending through their own taxes, rather than with federal transfers.

In his valedictory, George Washington advised Americans to avoid foreign entanglements. These days, most Canadian economists think Canadian governments should do a better job of avoiding domestic entanglements. Prime Minister Harper seems to agree. Bird/Smart concede (at p. 21) that they may be optimistic in thinking cleaner lines of accountability will help "reduce the endless blame-shifting game to which much Canadian fiscal federalism has been reduced in recent years." I'm sure they are right. Premiers running against prime ministers and vice versa is a Canadian tradition almost as old as Canada itself. Moreover, politicians providing benefits for client groups is simply the way politics is done in the modern world, indeed, is probably the way politics has always been done. A "watertight compartments" view of federalism would require politicians to stand aside when constituents came calling and direct them to politicians at the other level of government. I doubt most contemporary politicians are capable of standing up in Question Period and saying "No, we can't help. Go see the responsible person at the other level of government." When politicians do talk about respecting the constitutional division of powers they're usually told this is a cop-out. University professors, who, more than most Canadians, should be alert to questions of principle, have not been noticeably reluctant to take federal money over the last half decade, despite the fact that one of the most famous university professors in our history, Pierre Elliott Trudeau, argued in the 1950s that Ottawa should leave the universities alone since they did not fall within federal jurisdiction.

Although I tend to agree that shared responsibility leads to harmfully muddled accountability, a couple of arguments supporting muddled-ness might at least be mentioned. The first is that if some taxes cause especial harm when imposed on a sub-national basis there may be efficiency gains, even despite muddling, from having the federal government raise and then redistribute them. A second is that monopoly in jurisdictions may be unsatisfactory. The possibility that another level of government will intervene in a policy area if it is being mishandled by the constitutionally responsible level of government may be an effective discipline on bad government. (On the other hand, if the "bad" government in question is that some politician is departing from type and saying "No," such competition may end up being ruinous.) In the 1990s Canadians evidently wanted their governments to spend more on health care. It might have been better had their provincial governments raised taxes to do so, but Ottawa's decision to divert substantial moneys to the provinces for this purpose did at least get done what Canadians seemed to want done.

Let me close with a few comments about some public-choice aspects of this proposal.

The first is that it strikes me as strange that in a paper stressing the importance of clean lines of accountability and at least water-resistant compartments Bird/Smart seem to suggest that the federal government should play a lead role in coordinating or even coercing the tax reforms of the five provinces that currently retain retail sales taxes. Who are the major beneficiaries of tax reform? Surely, the five provinces in question. If they are imposing (p. 7) "half or more of the so-called 'retail' sales tax" on intermediate business sales and investment, that presumably is mainly hurtful to investment within their own territories. Ontario's hidden tax on capital must mainly hurt Ontario. In the spoken version of the paper Michael Smart referred to externalities of one kind or another emanating from provincial decisions. I'd bet these are relatively small compared to the overall harm inefficient taxation does to the province that imposes it. The provinces who suffer the most harm from the remaining retail sales taxes are the provinces that still have them.

The interesting public choice questions, then, are: Why do they still have them? Why did they not take advantage of previous opportunities—in 1991, when the GST came in, and in 1997, when the HST was introduced—to do away with them? And what has now changed so that in 2007 or 2008 they will go ahead with reforms they have so far neglected for 15 years? Provincial premiers presumably are presented with possible reforms on an almost daily basis, almost all of which they perceive as involving some political risk. What over the years has caused them to decide not to invest their political capital in sales tax reform? One obvious possibility is that the example of what happened to the government that brought in the GST itself—it went from 169 seats to two in just five years—is seared into their memory. It is easy for academics to urge politicians to take risks but in the real world of politics risks can have real, sometimes career-ending consequences.

One thing that has changed recently is that the Conservatives' GST rate reduction may provide cover for provincial reform. The once and perhaps future reduction of the GST means that the question of indirect taxation, including what are the best forms of indirect taxation, is effectively on the policy table again. And a five per cent rather than seven per cent rate makes the GST slightly warmer and cuddlier, so people may now be willing to consider replacing the PST with something like it. Perhaps the time really is right for sales tax reform. (Bird/Smart refer to the "unpopular" GST (p.5). I wonder if the GST is still as unpopular as it was.)

Even so, it may be a hard sell. We economists are convinced that consumption taxes are better than income taxes (subject to the proviso, as Jonathan Kesselman has emphasized, that Canadian income taxes are not far from being consumption taxes). But consumers, who outnumber us substantially, are not. The line we are taking with this reform is that it is important to get business taxes down and consumer taxes up. In many respects, political debates are more sensible now than they were 25 years ago—possibly because so many more of us are in higher tax brackets—but my suspicion is we have not yet come so far that the idea that we should lighten taxes on business in order to raise taxes on consumers will be popular. It plays well on the 19th floor in Toronto's financial district, where our workshop took place, but my bet is it doesn't play in Peterborough.

Our natural economists' rebuttal—that consumers are not rational to resist this change because they already pay the indirect taxes imposed on business—may not actually help the public debate. If businesses simply pass taxes along, people will say, who really cares where the tax's legal incidence falls? We economists understand that businesses pass taxes along by investing less in the jurisdiction imposing the tax but getting that wrinkle across assumes a high level of sophistication for a political debate. At one or two places in the paper there are expressions of at least mild exasperation at the irrationality of

Canadians who seem not to understand: that “provincial money” and “federal money” come from the same place; that exempting groceries and other favoured items creates substantial costs and inefficiencies; that the GST tax credit makes up for possible distributional difficulties with a single-rate consumption tax; and so on. I don’t know whether ordinary Canadians are rationally ill-informed about the economics of taxation but they certainly are ill-informed and yet they obviously play a key role in the political debate.

If politicians are to spend political capital undertaking the proposed reform, we need to give them good arguments that will help persuade those who will lose from the change that they should not oppose it to the last man standing. Or, if the losers are unpersuadable and can’t be compensated, we should at least convince those whose opinion is malleable that there is a substantial gain overall. My own view is that in this effort a good anecdote is worth a thousand regressions. In the question period, Charles McLure offered the example of Intel, which decided to build a $1 billion chip plant in New Mexico because it didn’t want to pay California construction taxes. This single anecdote obviously does not say anything conclusive about the net welfare effects of California’s tax system, but if careful analysis of the sort Bird and Smart are attempting has indeed satisfied us that the welfare effects of our current system are negative and reform is therefore justified, a vivid example is more likely to win the public debate than even the most robust econometric results.