Fiscal Balance, the GST, and Decentralization

by Jason Clemens, Niels Veldhuis & Milagros Palacios

Readers of *Fraser Forum* will know that the authors have long argued for substantive tax relief aimed primarily at improving incentives for work, savings, investment, and entrepreneurship (Clemens *et al.*, 2006b). They will further know that we were not enamoured of the federal government's decision to reduce the GST. However, the reduction in the federal GST rate has opened the opportunity for fundamental decentralization based on *greater* use of the GST, which would simultaneously improve the country's tax system. A recent study by the authors, which is the first chapter of a forthcoming book examining fiscal transfers and equalization, outlines a plan by which the federal government can actually use its decision to reduce the GST to fundamentally deal with these two important issues: tax efficiency and fiscal balance. This article summarizes the three recommendations in our study *Fiscal Balance, the GST, and Decentralization: An Opportunity for Reform*.

Reducing federal spending and taxes

The study's first recommendation is that the federal government eliminate transfer payments to the provinces for health and social programs, which are expected to total $31.3 billion in the 2007-08 fiscal year (see also Harris and Manning, 2005a, 2005b, and 2006). Specifically, the federal government should eliminate the Canada Health Transfer ($22.5 billion in 2007-08) and the Canada Social Transfer ($8.8 billion in 2007-08).

The plan also recommends that the federal government concurrently reduce taxes by the same amount ($31.3 billion). The current federal government has already committed itself to a further 1-percentage point reduction in the GST, which is estimated to cost approximately $5.2 billion (Department of Finance, 2006, p. 65). That still allows for over $26 billion (2007-08) in incentive-based tax relief, which should include reductions in marginal personal income tax rates for middle- and upper-income earners, reductions in corporate income tax rates, and the outright elimination of the capital gains tax (for a more thorough discussion, see Veldhuis and Clemens, 2006).

Increase provincial taxes

Reductions in both federal spending and taxes mean there is an opportunity for genuine and lasting decentralization to the provinces. The final recommendation is for the provinces to increase their own taxes to the extent required to compensate for the loss of federal transfers for health and social programs. Such decentralization would mean that all provinces would be more responsible for raising the revenues needed to provide these programs.[1] It would also mean less interference by Ottawa and more flexibility for the provinces to experiment with how best to provide these programs.

The study strongly recommends that the provinces increase their use of provincial sales taxes based on a GST model rather than increasing other taxes such as personal income taxes or business taxes. This would mean that the four provinces (Quebec, Nova Scotia, New Brunswick, and Newfoundland) that have an existing provincial GST would have to increase their current rates. The five provinces that maintain an independent provincial sales tax (BC, Saskatchewan, Manitoba, Ontario, and PEI) would need to adopt a provincial GST. Even Alberta, the lone sales tax hold-out, should introduce a provincial GST.

Table 1 outlines the expected rates of provincial GST needed to compensate



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for the loss of federal transfers. Note that these rates do not include current sales tax revenue. In other words, the GST rates in the table would be in addition to existing sales tax rates.[2] The provincial GST rates range from a low of 4.2 percent in Alberta to a high of 7.1 percent in Newfoundland and Labrador.

The rates in the table are considered a worst-case scenario since the greater flexibility afforded the provincial governments coupled with more direct accountability to citizens should force provincial governments to develop better and more cost effective ways to deliver social programs. This was certainly the case in the mid-1990s with the decentralization of the provision of welfare, which was reformed under the previous Liberal government (see Schafer *et al.*, 2001).

Table 1: Expected Provincial GST Rates Required to Compensate for the Loss of CHT/CST Revenues

Province	Provincial GST Rate (%)
Newfoundland	7.1
PEI	6.7
Nova Scotia	6.7
New Brunswick	7.0
Quebec	6.4
Ontario	5.6
Manitoba	6.9
Saskatchewan	7.0
Alberta	4.2
BC	6.0

Source: Clemens *et al.*, 2006a.

Principal benefits

Two principal benefits arise from this decentralization proposal. First, there would be a marked change in the country's tax mix. Canada would dramatically move away from its relatively heavy reliance on economically damaging taxes, such as personal income and business taxes, towards greater use of more efficient consumption taxes such as the GST. The overall tax burden would not increase, but the mix of taxes used would be altered.

Beyond this efficiency consideration, this plan also addresses the competitive concern that Canada is an outlier in the industrialized world in terms of our reliance on damaging personal income and business taxes. Canadian governments collect 46 percent of their revenue in income and profit taxes compared to an average of 34 percent among industrialized countries. The changes outlined in this plan would bring Canada more in line with our competitors.

The second main benefit that will emerge from this set of reforms is meaningful decentralization from the federal government to the provinces in financing and delivering some of the country's most cherished social programs. The reforms would require the provinces to both raise the necessary revenues to pay for these programs and be directly and solely responsible for their performance. It would eliminate the ambiguity that currently exists in Canada in terms of what level of government is actually responsible for health and social programs.

Conclusion

Canada has an opportunity to simultaneously deal with the current fiscal imbalance between Ottawa and the provinces while improving the country's tax system by introducing greater accountability in program provision through decentralization. The reforms outlined would provide benefits to all Canadians through a better tax system and greater flexibility for the provinces to experiment and innovate in the delivery of social programs.

Notes

[1]This plan does not include eliminating the equalization program.

[2]Provinces with independent sales taxes (PST) should convert these to a GST similar to the federal GST as part of the reform process. Harmonization would reduce compliance costs for business and individuals and, more importantly, eliminate the sales tax (PST) on business inputs.

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