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Fiscal Balance, the GST, and Decentralization

An Opportunity for Reform

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Executive summary

Importance of federal fiscal transfers

In the most recent fiscal year (2005/06) the federal government provided the provinces with $42.3 billion in cash transfers, a little over 17.0% of the revenues raised independently by the provinces. The percentage of provincial revenues provided by federal transfers varies from a low of 10.4% in Alberta to a high of 58.7% in Newfoundland and Labrador. The four Atlantic Canadian provinces along with Manitoba have relatively high levels of dependence on federal cash transfers (30.2%–58.7%) compared to their total revenues. However, even the remaining five provinces that have relatively lower dependence upon transfers from the federal government still receive material amounts of their total revenues from the federal government (10.4%–17.9%).

Fiscal balance

Both the federal and provincial governments have experienced strong revenue growth since 1990/91. In fact, provincial governments have enjoyed stronger average revenue growth (2.5%) than the federal government (1.8%). The provincial governments, however, have had much larger spending increases, in part due to pressures in three of the largest programs provided by the provinces: health, education, and social assistance.

The nature of federal spending has also changed dramatically over the last ten years. The federal government has tended to neglect core areas of federal responsibility such as defence and transportation while increasingly involving itself in provincial areas of responsibility such as health, education, and social assistance. This blurring of responsibilities for raising revenues and providing or financing programs has had an impact on accountability.

Rebalancing Canada by making greater use of the GST

Canada faces an extraordinary opportunity to rebalance the federation, create clearer lines of accountability, and dramatically improve our tax system based on decentralization and greater use of the GST.

A 3-step plan for reform

Step 1: Eliminate transfers

The federal government should eliminate the Canada Health Transfer ($22.5 billion) and the Canada Social Transfer ($8.8 billion) to the provinces and territories as of the next fiscal year (2007/08). This would decrease federal spending by $31.3 billion in 2007/08.

Step 2: Reduce federal taxes

The federal government should concurrently reduce taxes. In addition, the taxes selected for reduction should be based largely on improving the country's tax system. Specifically, the federal government should focus the tax relief on improving the economic incentives to work, save, invest, and act entrepreneurially. Examples of these types of tax-relief measures would include reductions in middle- and upper-income personal income-tax rates and business taxes.

Step 3: Increase provincial taxes

The final step is for the provinces to increase their own taxes to compensate for the loss of revenues from the elimination of the CHT and CST cash transfers. The provinces should increase, or adopt, the least costly (most efficient) tax available, which is a GST-based provincial sales tax. The GST rates required to replace the revenues received from federal CHT and CST payments ranged from a low of 4.2% in Alberta to a little over 7.1% in Newfoundland and Labrador. This would result in greater use of the GST in aggregate but with no net tax increase for the country as a whole.

In addition, provinces with independent provincial sales taxes (PST) should harmonize their PST with the federal GST. Harmonization would mean one sales tax system for the country even though revenues would flow to two levels of government.

Major benefits for Canadians

The proposal to eliminate the federal CHT and CST coupled with reductions in federal taxes and increases in provincial taxes would yield a number of benefits. First, and perhaps most importantly, it would re-establish clearer lines of accountability and responsibility for critical areas such as health, education, and social assistance broadly defined. Second, it would markedly improve the country's tax system by increasing our reliance on efficient, low-cost, consumption taxes while reducing our use of less efficient, more costly, capital-based taxes. Third, it would reduce costs for businesses and individuals that file sales taxes since the number of reporting and administrative requirements would be cut in half. This proposal is a watershed rebalancing and improvement in the functioning of the Canadian federation.

Introduction

The debate over the fiscal balance between the provinces and Ottawa is as old as the country itself. Over the last decade however, this debate has taken on heightened interest as Ottawa enjoyed increasing surpluses while the provinces generally struggled to provide the bulk of government programs while balancing their financial books. In addition, the last decade or so has seen the federal government increasingly active in areas of sole provincial responsibility. As such, there is increasing recognition of the need for a rebalancing of the Canadian federation. There is also a simultaneous realization of the need for a better tax system in Canada that will promote and encourage diligence, savings, investment, and entrepreneurship. Canada enjoys an historic opportunity today to concurrently rebalance the federation, improve the country's tax system, and inject much needed accountability into government programs. [1]

The first section of this publication provides an overview of cash transfers from Ottawa to the provinces along with an analysis of the level of provincial dependence on federal cash transfers. The second section outlines the need for rebalancing within the federation based on greater accountability. The final section gives the recommendations for reform.

[1] One of the problems with both past and present debate and research on the fiscal imbalance is that they tend to discuss the federal government's largest transfers to the provinces, equalization and social transfers, in isolation from one another. This oversight often leads the authors to underestimate the effect of fiscal transfers from the federal government to the provinces. This study is part of a larger project that will examine the broader issue of fiscal flows and balance within Canada.

1 Components of fiscal cash transfers

In 2005/06, the federal government provided a total of $42.3 billion in cash to the provinces and territories. [1] This represents a little over 17.0% of the revenues raised independently by the provinces.

Figure 1 illustrates the composition of federal cash transfers. The Canada Health Transfer (CHT), which stood at $20.3 billion in 2005/06, represents nearly half (48.1%) of total federal government's cash transfers to the provinces. The next largest transfer is Equalization, which totalled $10.9 billion and represented a little over one-quarter (25.8%) of all cash transfers. [2] The Canada Social Transfer (CST) was the third largest envelope of federal cash transfers at $8.4 billion (2005/06). The CST is intended to aid provincial spending on post-secondary education and social assistance broadly defined. There are several other transfer programs but these three—Canada Health Transfer, Equalization, and the Canada Social Transfer—constitute the overwhelming majority (93.8%) of fiscal cash transfers to the provinces from the federal government.

Varying levels of provincial dependence

Some provinces rely on federal transfers more than others. Obviously the greater the percentage of a province's revenues is made up of federal transfers, the greater their dependence on federal transfers. Table 1 shows the percentage of each province's total revenue provided by federal cash transfers in 2005/06 and, thus, the degree of provincial dependence upon transfers.

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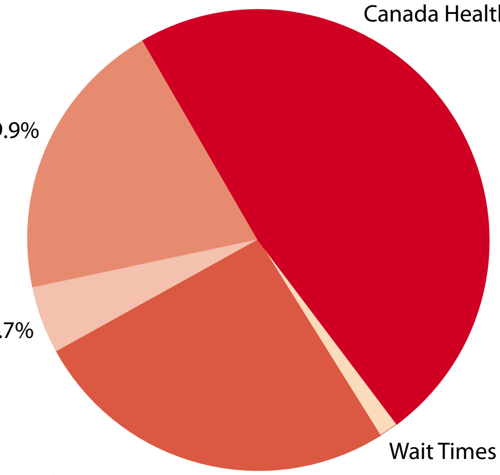
[1] This figure does not include tax-point transfers, which totaled $19.3 billion in 2005/06. In addition to the cash transfers it provided to the provinces, the federal government also gave $12.0 billion under the Canada Health Transfer (CHT) and $7.3 billion under the Canada Social Transfer (CST) as tax-point transfers. The federal government defines a "tax transfer" as "the federal government ceding some of its 'tax room' to provincial governments. Specifically, a tax transfer occurs when the federal government reduces its tax rates to allow provinces to raise their tax rates by an equivalent amount. With a tax transfer, the changes in federal and provincial tax rates offset one another and there is no net financial impact on the taxpayer. Tax transfers represent a growing source of revenue for provinces since they increase in value over time with growth in the economy" <http://www.fin.gc.ca/gloss/gloss-t_e.html#tax_transfer>. For further information, please see the website of the federal Finance Department, <www.fin.gc.ca/fin-eng.html>.

[2] Not all provinces receive equalization payments though all receive the Canada Health Transfer (CHT) and the Canada Social Transfer (CST).

Figure 1: Components of federal cash transfers (2005/06)



Source: Canada, Department of Finance, 2006b and 2006c.

The percentage of provincial revenues provided by federal transfers varies from a low of 10.4% in Alberta to a high of 58.7% in Newfoundland and Labrador. **[3]** The high level of dependence on federal cash transfers in Newfoundland and Labrador, even among those provinces that are highly dependent, is largely due to the effects of the Atlantic Offshore agreement, which is a one-time occurrence. In 2004/05, Newfoundland and Labrador's receipt of federal cash transfers constituted 40.1% of total revenues. However, even at this reduced rate Newfoundland and Labrador still has the highest level of reliance on federal cash transfers of any province.

In all, there are five provinces that have a relatively high reliance on the federal government for revenues: Newfoundland and Labrador, 58.7% (40.1% in 2004/05); Nova Scotia, 39.5% **[4]**; Prince Edward Island, 37.7%; New Brunswick, 35.8%; and Manitoba, 30.2%.

[3] There are a variety of reasons for the differing provincial levels of dependence on federal transfers. For example, provinces that are deemed to be eligible for equalization will obviously receive monies while those provinces deemed to be contributors are not eligible for payments. Related to the issue of equalization is the distribution of income across the country. Provinces that have higher income levels, on average, are able to collect more revenues compared to provinces with lower incomes, *ceteris paribus*. Yet another possible explanation is access to different types of revenues. Provinces in western Canada, for example, are currently enjoying strong revenue growth in part because of their ability to capitalize on their natural resource endowments and strong commodity prices for those resources.

[4] Nova Scotia also had an Atlantic Offshore agreement with the federal government that exempted offshore oil and gas revenues from equalization claw-backs; however, it had less impact on Nova Scotia's total provincial revenues than it did on those of Newfoundland and Labrador.

Table 1: Total Federal Government Transfers to the Provinces (2005-06) [1]

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL [2]
Total own-source revenues (in $ millions)										
	28,333	32,260	7,586	6,950	73,393	57,354	4,177	4,985	746	2,902
Total transfers from the federal government (in $ millions)										
	5,737	3,736	1,655	3,009	13,417	11,957	2,329	3,258	451	4,125
Total revenues (in $ millions)										
	34,070	35,997	9,241	9,959	86,811	69,311	6,507	8,243	1,196	7,027
Total transfers as a percentage of total provincial revenues										
	16.8%	10.4%	17.9%	30.2%	15.5%	17.3%	35.8%	39.5%	37.7%	58.7%
Own-source revenues as a percentage of total provincial revenues										
	83.2%	89.6%	82.1%	69.8%	84.5%	82.7%	64.2%	60.5%	62.4%	41.3%

Note 1: The data contained in this table relies on FMS provincial and territorial general government revenues and expenditures.

Note 2: There is a significant difference in the transfers from the federal government to Newfoundland from 2004/05 to 2005/06. The year-to-year difference in transfer revenues for Newfoundland from 2004/05 to 2005/06 can be attributed mainly to revenues related to the federal/provincial Atlantic offshore agreement, which was signed by the province in 2005. According to this agreement, the Government of Canada will provide the Government of Newfoundland and Labrador a payment of $2.0 billion. In 2004/05, the total federal transfers as a percentage of total provincial revenues in Newfoundland were 40.1%, markedly below the 58.7% recorded in 2005/06.

Source: Statistics Canada, Public Institutions Division, Financial Management System (FMS), 2006; calculations by the authors.

The remaining five provinces rely comparatively less on federal government transfers and more on their own sources of revenues. However, federal cash transfers to these five provinces still range from 10.4% in Alberta to 17.9% in Saskatchewan. In other words, even the provinces that have relatively lower dependence upon the federal government receive between 1 and 2 dollars out of every 10 from Ottawa.

Not just government-to-government transfers: redistribution through Employment Insurance

While outside the scope of this study, there are more than just government-to-government transfers affecting the provincial economies. For example, there is a strong redistributive component in the country's Employment Insurance (EI) program. Table 2 shows, by province, the value and percentage of contributions collected from, and benefits disbursed to, individuals for 2003, the latest year for which comparable data are available.

Table 2: Employment Insurance (EI) contributions and benefits ($ millions) (2003) [1]

	Federal (total)	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL
Total EI Contributions	18,513	2,222	2,063	498	641	7,490	4,296	397	493	70	233
Share of Total Provincial Contributions		12.0%	11.1%	2.7%	3.5%	40.5%	23.2%	2.1%	2.7%	0.4%	1.3%
Regular EI Benefits	8,769	1,041	558	191	210	2,326	2,789	517	435	119	540
Other EI Benefits [2]	4,430	536	425	110	153	1,578	1,027	149	166	57	212
Total EI Benefits	13,199	1,577	982	301	363	3,904	3,816	667	601	175	752
Share of Total EI Benefits		11.9%	7.4%	2.3%	2.7%	29.6%	28.9%	5.1%	4.6%	1.3%	5.7%
Difference in Dollars		645	1,081	197	278	3,586	480	(270)	(108)	(105)	(519)
Difference in Percentage		0.1%	3.7%	0.4%	0.7%	10.9%	-5.7%	-2.9%	-1.9%	-1.0%	-4.4%

Note 1: 2004/05 EI benefits data is available, but the latest information available regarding contributions is 2003.

Note 2: Takes into account benefits payments under fishing, special (sickness, maternity, parental, compassionate), employment (section 25 of the Employment Insurance Act) and Work Sharing benefits. Dollar figures encompass Family Supplement top-ups paid.

Source: Canada, Human Resources and Skills Development, 2006; calculations by the authors.

Individuals in the three traditional wealthy ("have") provinces of British Columbia, Alberta, and Ontario along with Saskatchewan, Manitoba, and Quebec are aggregate net contributors to the EI program. That is, the federal government collects more revenues from workers (in total) from these provinces than it pays in benefits. On the other hand, the four Atlantic provinces all receive more benefits than the revenues collected. **[5]**

[5] Another way in which to examine the mix of revenues collected and benefits paid is by looking at the percentages of each. Again British Columbia, Alberta, and Ontario, the three traditional "have" provinces, along with the Prairie provinces of Manitoba and Saskatchewan contribute more proportionately than they receive in aggregate EI benefits. On the other hand, Quebec and the four Atlantic provinces all contribute less proportionately than they receive in aggregate EI benefits.

The Employment Insurance program is, therefore, an example of a federal program that transfers income to individuals but still acts to transfer income from a group of net contributing provinces to net recipient provinces. Such a redistributive program has important economic effects on both the individual recipients and the provinces that are net beneficiaries. **[6]**

Conclusion

In the most recent fiscal year (2005/06), the federal government provided the provinces with $42.3 billion in cash transfers, which represented a little over 17.0% of the revenues raised independently by the provinces. The percentage of provincial revenues provided by federal transfers varies from a low of 10.4% in Alberta to a high of 58.7% in Newfoundland and Labrador. The four Atlantic Canadian provinces along with Manitoba have relatively high levels of dependence on federal cash transfers (30.2$–58.7%) compared to their total revenues. However, even the remaining five provinces that rely comparatively less on federal government transfers still receive material amounts of their total revenues from the federal government (10.4% to 17.9%). In other words, even the provinces that have relatively lower dependence upon the federal government receive between 1 and 2 dollars out of every 10 from Ottawa.

[6] For a detailed analysis on the effects of (un)employment insurance, please see Grubel and Walker, 1978. For additional information, please see Kuhn and Riddell, 2006; Scarpetta, 1996; Christofides and McKenna, 1996; and Corak, 1993.

2 Rebalancing the federation

Much has been made over the last few years of "fiscal imbalance." Although this term has multiple meanings, most of the discussion has surrounded the large surpluses enjoyed by Ottawa at the same time that many provinces were struggling to finance programs such as health and education. [1] There are two core issues at the centre of the debate regarding fiscal imbalance: empirical evidence of its existence and accountability. The first issue is simply whether or not there is an imbalance between the revenues and spending responsibilities of the federal and provincial governments. The second issue is whether or not the separation of revenue raising and program provision reduces accountability.

Is there a fiscal imbalance?

Figure 2 illustrates the nominal net fiscal balance (surplus or deficit) for the federal government and all of the provincial and territorial governments (consolidated) between 1990/91 and 2005/06. [2] The federal government begins the period with an enormous deficit of $32.4 billion while the provinces had a much lower, collective deficit of $7.6 billion. In 1997/98, however, the federal government began operating in surplus while the provinces were still collectively struggling to balance their fiscal affairs. Specifically, in 1997/98, the federal government recorded a *surplus* of $4.5 billion while the provinces had a collective *deficit* of $3.3 billion.

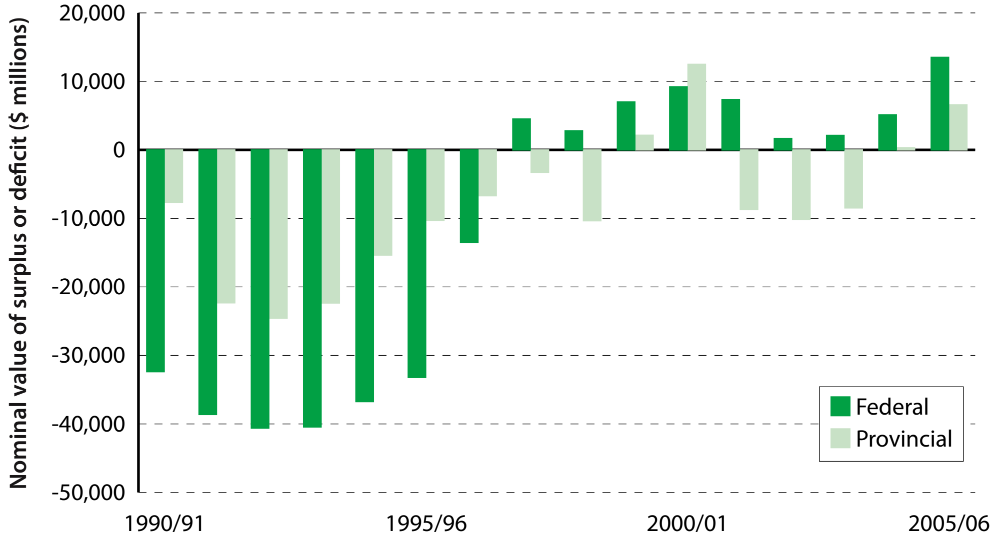
The provinces have collectively turned the fiscal corner and are now recording aggregate surpluses. In fact, Canada as a whole is experiencing quite strong fiscal performance: Statistics Canada recently reported that in 2005/06 all governments in Canada (federal, provincial, and local) recorded the second largest surplus ($26.0 billion) in the last 20 years (Statistics Canada, 2006). [3]

[1] The federal government outlined these problems in its *Budget Plan 2006* [Canada, Dep't of Finance, 2006a] as well as the supplementary document, *Restoring Fiscal Balance in Canada: Focusing on Priorities* [Canada, Dep't of Finance, 2006d].

[2] Please note that the data used throughout this section is based on Statistics Canada's Financial Management System (FMS) and will, therefore, deviate from the budget and public accounts data in certain circumstances.

[3] The size of the fiscal difference between the federal and provincial governments is best understood by comparing the aggregate fiscal balances of each since 1997/98. The federal government has experienced a cumulative surplus of $53.3 billion since 1997/98 while the provinces have incurred a cumulative deficit of $14.0 billion.

Figure 2: Federal and provincial fiscal balances (1990/91–2005/06)



Source: Statistics Canada, Public Institutions Division, Financial Management System 1999-2006.

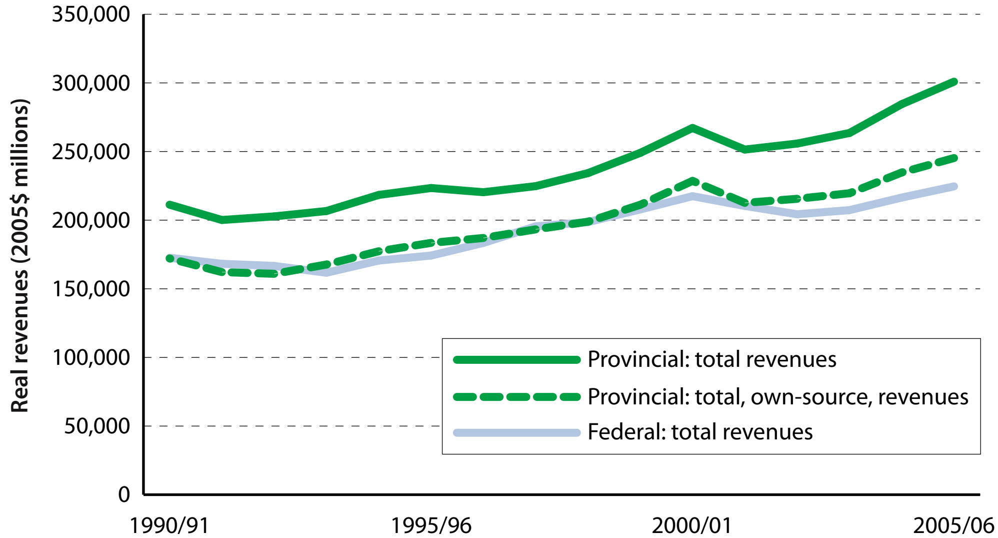
Comparing revenue and spending

One of the myths of the fiscal imbalance is that the provincial governments are not collecting enough revenues. Figure 3 illustrates the growth of inflation-adjusted (real) federal and provincial revenues between 1990/91 and 2005/06. Two series are presented for the provinces: total revenues and total own-source revenues. The more relevant statistic is own-source revenues, which exclude transfers from the federal government.

The federal government and the provinces begin the period with essentially the same amount of inflation-adjusted revenues: $172.6 billion (federal) compared to $172.1 billion (provinces). By 2005/06, cumulative own-source revenues for the provinces outweigh the revenues of the federal government by $20.7 billion. Real revenues for the federal government have grown, on average, 1.8% over the period while real own-source revenues for the provinces have grown at 2.5%. It is, therefore, quite difficult to argue that the provinces have lacked revenues compared to the federal government when discussing the fiscal imbalance.

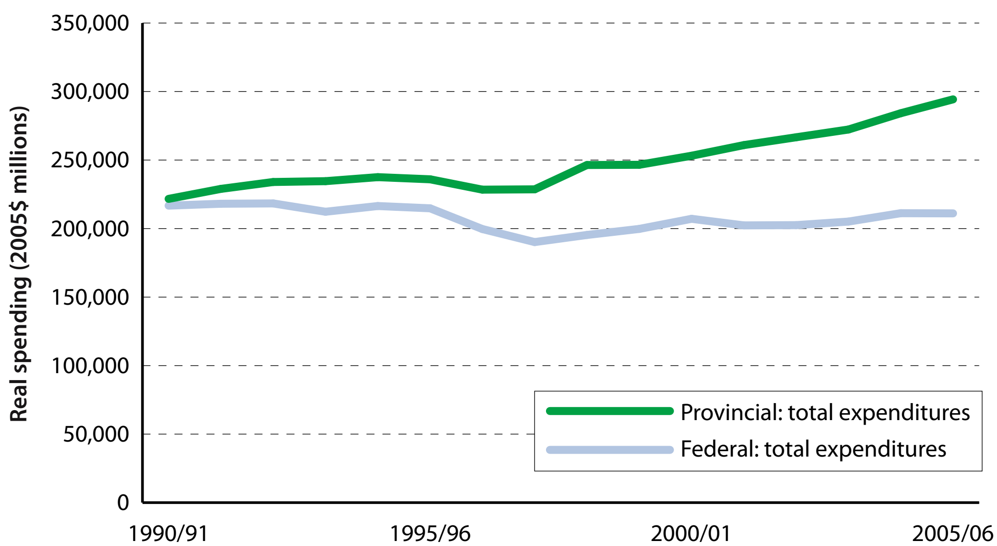
Much more telling and explanative of the current fiscal imbalance is the relative spending of the two levels of government as depicted in Figure 4, which illustrates inflation-adjusted spending by the federal and provincial governments between 1990/91 and 2005/06. In real terms, the federal government is spending slightly less in 2005/06 than it did in 1990/91. The provinces, on the other hand, are spending over $72.6 billion more (a growth of 32.8%) in 2005/06 in inflation-adjusted terms than they were in 1990/91. The provinces spent $4.9 billion more than the federal government in 1990/91; this difference has increased to over $83.2 billion in 2005/06.

Figure 3: Federal and provincial real revenues (1990/91–2005/06)



Source: Statistics Canada, Public Institutions Division, Financial Management System 1999-2006; calculations by the authors.

Figure 4: Federal and provincial real spending (1990/91–2005/06)



Source: Statistics Canada, Public Institutions Division, Financial Management System 1999-2006; calculations by the authors.

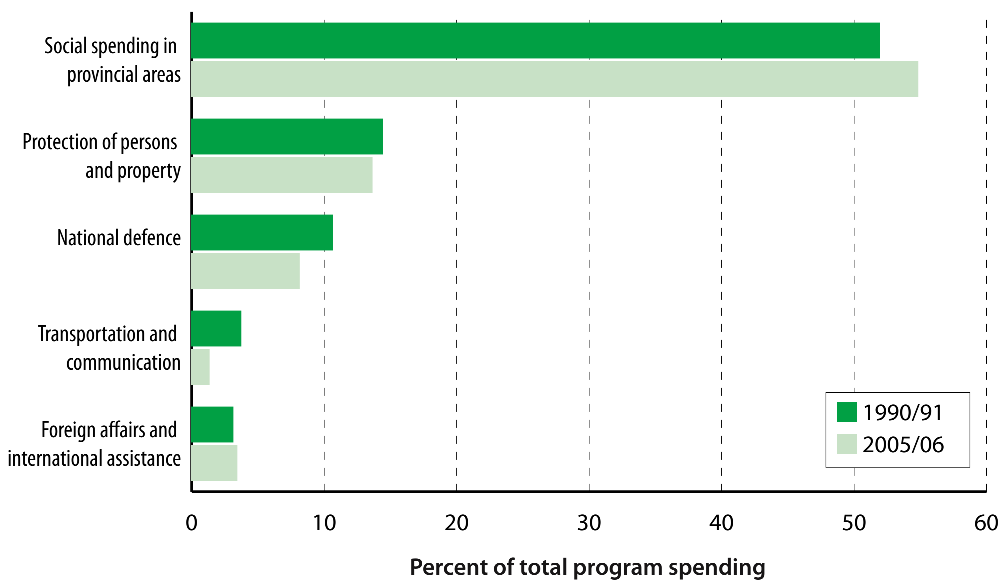
It is quite clear that one of the driving forces behind the current fiscal imbalance is the difference in spending growth over the last decade and a half. Part of the explanation for these differences is the rather large increases in spending on health, education, and social assistance by the provincial governments.

Of equal importance, however, and critical to the debate on fiscal imbalance, is the nature of federal spending. Figure 5 depicts growth in a selected number of federal spending categories between 1990/91 and 2005/06. The figures are presented as a percentage of total program spending rather than total spending to reflect the dramatic changes in debt-service costs at the federal level. [4]

Between 1990/91 and 2005/06, a number of key areas of federal responsibility such as the protection of people and property (including national defence) and transportation and communication infrastructure have all declined as a percentage of total federal program spending. Other areas, such as foreign affairs, have essentially stagnated. This has occurred while the federal government dramatically increased its funding of provincial

[4] The federal government has enjoyed a marked decline in the dollar cost and percentage of spending allocated to debt servicing costs. Debt servicing costs peaked in 1996/97 at $44.9 billion, 27.1% of total expenditures. They have since declined to $32.0 billion in 2005/06, 15.2% of total expenditures.

Figure 5: Selected areas of federal spending as a percentage of total program spending (1990/91 and 2005/06)



Note: Social Spending in provincial areas includes both direct spending on health, education, and social assistance as defined by Statistics Canada (FMS) as well as the CHT and CST, which are dedicated transfers.
Source: Statistics Canada, Public Institutions Division, FMS 1999-2006; calculations by authors.

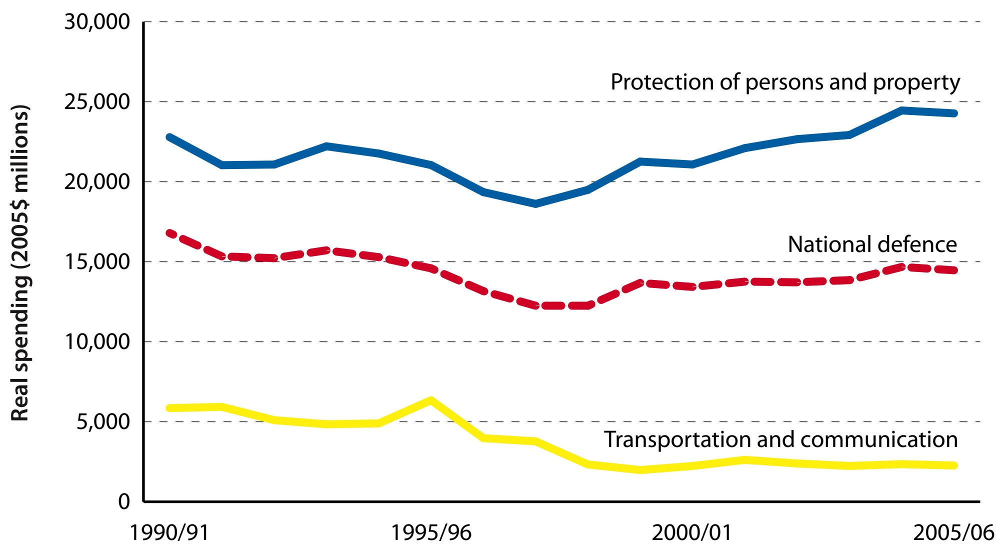
areas of responsibility such as health, education, and social assistance through its transfer programs (CHT and CST) as well as a number of direct spending programs.

Figure 6 illustrates the inflation-adjusted spending in three key federal areas of responsibility (protection of persons and property, national defence, and transportation and communications) over the same time period. The trend line for both national defence and transportation and communications is decidedly negative while real expenditures on the protection of people and their property is essentially flat. These trends exist within a framework that has seen federal spending on provincial areas of responsibility such as healthcare and education increase markedly.

Conclusion

Both the federal and provincial governments have experienced strong revenue growth over the period examined. The provincial governments, however, have had much larger spending increases, in part due to pressures in three of the largest programs provided by the provinces: health, education, and social assistance. This can be best seen by the stable and indeed rising surpluses of the federal government compared to much tighter fiscal balances for the provinces in a period when provincial revenue growth was stronger than the federal government. In addition, it is critical to note the changing nature of federal spending as outlined above. Over the course of the period examined, the federal government tended to neglect core areas of federal responsibility while increasingly involving itself in provincial areas of responsibility.

Figure 6: Selected areas of federal spending (1990/91–2005/06)



Source: Statistics Canada, Public Institutions Division, Financial Management System 1999-2006; calculations by the authors.

Accountability: A critical component of reform

Those who believe that the "fiscal imbalance" is a serious problem that must be addressed commonly propose that the federal government increase its transfer payments to the provinces, particularly, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST). [5] Simply increasing the CHT and CST would, however, retain the federal government's role in these provincial areas of responsibility. The recent federal document *Restoring Fiscal Balance in Canada* clearly acknowledged that K-12 education, health, municipalities, social assistance, and social services were exclusive areas of provincial jurisdiction [Canada, Dep't of Finance, 2006d: 20]. This is an important recognition by the federal government and offers a genuine opportunity for reform.

A key principle to be applied in evaluating reform should be accountability. That is, how transparent and understandable is both the financing and provision of services. Currently, both the federal and provincial governments collect revenues to support these programs. The federal government then transfers monies to the provinces to assist in financing the provision of these programs, often with conditions. The provinces then directly provide the programs.

A far more accountable system is to remove the federal government from this activity in order to have one level of government responsible for both the raising of revenues (taxes) and the provision of programs and services. This improves accountability since there is no longer confusion or ambiguity about responsibilities. The provinces would be required to raise necessary revenues and then provide high-value services. [6] An additional benefit would be that the provinces would be freer to experiment in how best to provide the goods and services demanded by their citizens than is currently the case due to conditions imposed by the federal government. Welfare and K-12 education are two excellent examples of areas that benefit from provincial autonomy and experimentation. [7]

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[5] The high-profile expert panel appointed by the Council of the Federation—a provincial body—recommended large-scale increases in both equalization as well as the CHT/CST. See Council of the Federation, 2006.

[6] Please note that "provide" does not necessary mean provision of services by the public sector. Rather, it refers to a general provision through financing, regulating, contracting, or direct provision of goods and services to citizens.

[7] For more on welfare and K-12 education reform, please see Faguet and Sanchez, 2006; Harris and Manning, 2005b; Hepburn and Robson, 2002; Schafer et al., 2001; Hepburn, 2001; Richards and Poschmann, 2000; Karlsen, 1999; Richards, 1997; and Boessenkool, 1997.

3 A plan to decentralize by making greater use of the GST

A plan for genuine decentralization, unlike the calls to increase federal transfers to the provinces, requires that the federal government reduce its taxes so that provinces can simultaneously increase theirs, with no net tax increase. Such a reform means that provinces raise more of their revenues from their own sources and rely less on the federal government for transfers. A critical decision is what type of taxes the federal government should reduce and what types of taxes the provinces should increase.

Changing the tax mix

There is widespread agreement amongst economists that the reductions in consumption taxes, such as the GST are the least productive tax cuts available [Veldhuis and Clemens, 2006]. Indeed, a recent study by the federal Department of Finance [Baylor and Beausejour, 2004] confirm the small benefits garnered from a cut in consumption taxes such as the GST compared with other types of tax relief. Figure 7 gives estimates of "welfare gains" or benefits from different types of tax cuts.

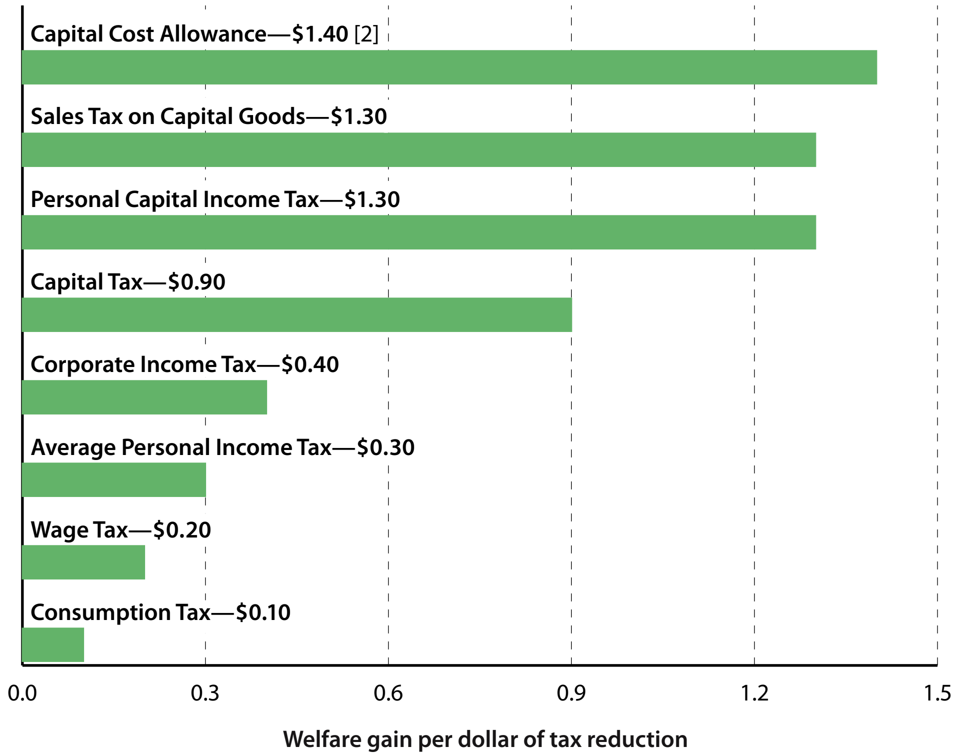
Baylor and Beausejour estimated the benefits of a $1 reduction in consumption taxes such as the GST at $0.10. [1] This compares poorly with the level of benefits available from the same size of tax cut ($1) but in different forms. For example, reductions in personal income taxes generated benefits of $0.30. The tax relief that generated the largest benefits were those that reduced taxes on capital: capital cost allowance or more commonly depreciation allowances ($1.40), sales taxes on capital goods or business inputs ($1.30), and corporate capital taxes ($0.90).

The benefits of different types of tax cuts are based on incentive effects. For instance, personal income tax and capital-based taxes influence the decision of individuals to work, save, invest, and undertake entrepreneurial activities. A reduction in this kind of taxes, therefore, encourages these activities. [2] On the other hand, reductions in consumption taxes such as the GST make current consumption less expensive and, thus,

[1] Benefits of different types of tax cuts were calculated by assuming that any revenue loss was offset by a non-distortionary "lump-sum" tax increase. In other words, tax changes are revenue neutral. The lump-sum tax does not distort individual and firm behaviour by altering the incentives to work, save, invest, or undertake risk.

[2] For a comprehensive review of the literature on taxes and incentives, please see Clemens and Veldhuis, 2005.

Figure 7: Estimated welfare gains from various tax reductions [1]



Note 1: Revenue loss is assumed to be recovered through "lump-sum" taxation. Welfare gains are calculated as the gain in economic well-being per dollar of tax reduction.

Note 2: The estimate for an increase in capital cost allowances (CCA) is for new capital only.Increasing CCA is not a tax reduction per se but rather an increase in a deduction against corporate income taxes.

Source: Baylor and Beausejour, 2004.

do not improve the incentives to save and invest. It is these pronounced differences in incentives that result in large differences in the benefits provided by different tax cuts.

International competitiveness must also be considered as a reason to move towards greater use of consumption taxes. Canada is already one of the heaviest users among developed countries of income and profit taxes, two of the more distortionary and, thus, costly types of taxes. In fact, Canada had the fourth highest reliance on these types of taxes in 2003, the latest year for which data is available. **[3]** A reduction in the GST means that Canada will actually rely proportionately more on profit and income taxes and less on consumption taxes. This will push Canada even further out on the fringes of the other OECD countries in terms of the structure of our tax burden.

[3] For further information and the specific data, please see Veldhuis and Clemens, 2006: 19.

Rebalancing Canada by making greater use of the GST

There are clearly benefits to using consumption taxes like the GST relatively more and using the more distortionary, high-cost taxes, such as capital-based taxes, less. The challenge is how Canada as a federation can use the GST more when the federal government has just implemented a reduction in the tax and has committed itself to an additional reduction over the next four years. The confluence of the federal government's decision to reduce the GST, the need for decentralization, and the advisability of greater reliance on consumption taxes offers the country a unique opportunity to achieve all three simultaneously.

A 3-step plan for reform [4]

Step 1: Eliminate transfers

The first step is for the federal government to eliminate the Canada Health Transfer ($22.5 billion in 2007/08) and the Canada Social Transfer ($8.8 billion in 2007/08) [Canada, Dep't of Finance, 2006d: 136]. **[5]** The elimination of these two transfer programs, which support provinces in providing services in provincial areas of responsibility would result in a decrease in federal spending of $31.3 billion in 2007/08.

Step 2: Reduce federal taxes

The second step is to concurrently reduce federal taxes. The tax reduction should aim (1) to allow provinces to increase their own taxes as needed to compensate for the loss of CHT and CST transfers, and (2) to improve the country's tax system by increasing its efficiency and competitiveness through greater reliance on consumption taxes.

As discussed, part of that reduction in federal taxes would be needed to accommodate the additional reduction of 1-percentage point in the GST that the federal government has already committed itself to. **[6]** The approximate cost of the additional

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[4] There are a number of similarities between the proposal contained in this chapter for rebalancing the federation, installing more accountability in government, and improving the tax system and those in a study by Boothe and Hermanutz [1999] and, more recently, in a study by Professors Smart and Bird [2006].

[5] The Canada Strong and Free series by former Ontario Premier Mike Harris and former Leader of the Opposition Preston Manning have called for such a change for nearly two years. The three-volume series on this issue offers a wealth of reasoning and explanation as to the benefits of such a change.

[6] In an ideal world, the already implemented GST reduction from 7% to 6% would be undone and the planned additional reduction of 1-percentage point foregone in order to allow for even more aggressive reductions in personal income taxes and business taxes. For the purposes of this study, however, we have assumed as given the already implemented GST reduction as well as the planned additional reduction.

Table 3: CHT and CST cash transfers to the provinces (2005/06) ($millions)

	Federal (Total) [1]	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL
Canada Health Transfer [2]	20,310	2,805	1,776	698	777	7,624	5,013	497	619	91	341
Canada Social Transfer [2]	8,415	1,188	682	303	329	3,105	2,122	210	262	39	144
Wait Times Reduction [3]	625	82	63	19	23	243	147	15	18	3	10
Total CHT/CST Cash Transfers	29,350	4,075	2,521	1,020	1,129	10,972	7,282	722	899	133	495

Note 1: Transfers to the Territories are included in the federal total but not delineated.

Note 2: This table only includes cash transfers for the CHT and CST; there are also tax point transfers.

Note 3: The Wait Times Reduction transfer is not an ongoing program and is unique to 2004/05 and 2005/06.

Source: Canada, Department of Finance, 2006c.

reduction in the GST is $5.2 billion [Canada, Dep't of Finance, 2006a: 65]. Total federal spending on the CHT/CST program is forecast to reach $31.3 billion for 2007/08. The elimination of the CHT and CST could finance the entirety of the GST tax reduction (1-percentage point) plus an additional $26.1 billion in federal tax relief in 2007/08 alone.

This would allow for large-scale reductions in personal income taxes as well as business taxes, which would improve the efficiency of the tax system, its competitiveness, and the incentives for productive behaviour such as diligence, savings, investment, and entrepreneurship. **[7]**

Step 3: Increase provincial taxes

The final step is for the provinces to increase their own taxes to compensate for the loss of revenues from the elimination of the CHT and CST cash transfers. The provinces should increase, or adopt, the least costly (most efficient) tax available, which is a GST-based provincial sales tax. At this time, only four provinces (Quebec, New Brunswick, Nova Scotia, and Newfoundland and Labrador) have GST-type sales taxes. Five provinces have an independent provincial sales tax (PST) and Alberta has no provincial sales tax at all.

The provincial GST rates would have to be sufficient to raise the amount of revenue lost from the elimination of the CHT and CST. Table 3 contains CHT and CST cash transfer values by province for 2005/06. Using the Social Policy Simulation

[7] For a discussion of prioritized tax relief, please see Veldhuis and Clemens, 2006; Caranci and Drummond, 2005; Chen and Mintz, 2004; Kesselman, 2004; Gentry and Hubbard, 2000; and Mintz and Wilson, 2000.

Demonstration Model (SPSD/M), a tax model from Statistics Canada, we calculated estimates of provincial GST rates required to compensate the provinces for the elimination of the CHT and CST. [8] The GST rates required to replace the revenues received from federal CHT and CST payments ranged from a low of 4.2% in Alberta to a little over 7.1% in Newfoundland and Labrador [Table 4]. [9] The non-weighted average for the ten provinces is 6.4%. [10]

Convert PST to GST (Harmonization)

There is another issue arising from the implementation of GST-based sales taxes in the provinces. To date, only three of the four provinces that have GST-type sales taxes (New Brunswick, Nova Scotia, and Newfoundland and Labrador) have harmonized their systems with the federal GST. Quebec's GST-based system is independent of the federal GST [Treff and Perry, 2006: 58]. Those provinces with independent provincial sales taxes (PST) should convert these to a GST similar to the federal GST as part of this reform process.

There are a number of reasons why harmonization makes economic sense. One, it reduces compliance costs for businesses and individuals that must file sales taxes since they would need to report only one tax. Two, it restructures the provincial sales taxes to exclude business inputs, which is a major flaw in the current tax system. [11]

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[8] The assumptions and calculations underlying the simulation results were prepared by the authors and the responsibility for the use and interpretation of these data is entirely theirs.

[9] Note that it is possible that provinces would not have to replace the entirety of the monies lost through the elimination of the CHT and CST payments due to the increased flexibility and autonomy accorded them in the design and delivery of the underlying social programs. Note also that these calculations do not consider enhancement of the existing GST tax credit, which mitigates the effect of the GST on lower-income families by providing direct payments. It is certainly possible that some, if not all, of the provinces would enhance existing credits or implement new programs to further mitigate the effects of a higher GST.

[10] If a standard provincial GST rate (estimated to be 6.4%) were implemented, there would be some provinces (Ontario, Alberta, and British Columbia) that would raise more money than required to cover the loss of revenues emanating from the elimination of the CHT and CST cash transfers. Alternatively, there would also be provinces (the remaining seven) that would raise insufficient revenues from a standardized GST to cover the revenue loss; they would be in a deficit. Some experts have recommended that this surplus-and-deficit situation resulting from a standardized provincial GST rate be dealt with under the auspices of equalization [Harris and Manning, 2005a, 2005b, and 2006].

[11] The federal government outlined possible reform strategies in *Towards Replacing the Goods and Services Tax* [Canada, Dep't of Finance, 1996].

Table 4: Expected provincial GST rates required to compensate for the loss of CHT and CST revenues

	Provincial GST Rate		Provincial GST Rate
British Columbia	6.0%	**Quebec**	6.4%
Alberta	4.2%	**New Brunswick**	7.0%
Saskatchewan	7.0%	**Nova Scotia**	6.7%
Manitoba	6.9%	**Prince Edward Island**	6.7%
Ontario	5.6%	**Newfoundland**	7.1%

Note: The rates included in this table are in addition to the existing provincial sales tax rates.

Sources: Statistics Canada, Socio-economic Analysis and Modeling Division, 2006; calculations by the authors.

Major benefits for Canadians

The proposal to eliminate the federal CHT and CST coupled with reductions in federal taxes and increases in provincial taxes would yield a number of benefits. First, and perhaps most importantly, it would re-establish clearer lines of accountability and responsibility for critical areas such as health, education, and social assistance broadly defined. Second, it would markedly improve the country's tax system by increasing our reliance on efficient, low-cost, consumption taxes while reducing our use of less efficient, more costly, capital-based taxes. Third, it would reduce costs for businesses and individuals that file sales taxes since the number of reporting and administrative requirements would be cut in half. This proposal is a watershed rebalancing and improvement in the functioning of the Canadian federation.

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