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THE GST IS A GOOD IDEA BUT AT A 5-PER-CENT RATE

The economic situation has clearly deteriorated since the Minister of Finance introduced his proposal for a 7-per-cent GST in the House last December 19. At that time, most economic forecasters would have accepted as a reasonable scenario the Department of Finances' view that 1991 would be a year of renewed healthy growth averaging around 3 per cent. Since that time, however, interest rates have gone up by more than a percentage point, and evidence is mounting that the economy is slowing more than anticipated. While the Canadian economy may not be entering a severe recession, it is certainly teetering on the brink of a mild one.

Forecasters currently expect real growth to only average around 2 per cent in 1991. Some forecasters expect the introduction of the GST at the beginning of 1991 to precipitate further weakness in output, perhaps even triggering a recession.

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They argue that it will do this in two ways. First, the GST will contribute to a pickup in inflation that will force the Bank of Canada to hike interest rates, putting the brake on economic activity. Second, the GST will take a bite out of the real income of consumers by transferring over $4 billion of indirect taxes on investment and exports to the personal sector. This will make consumers tighten their belt, squeezing growth in the short run.

A weakening economy and higher interest rates would also boost the budget deficit and make it very difficult for the government to take countercyclical action. Deficit reduction must remain the main objective of fiscal policy because of its importance from a long term structural point of view and the need to achieve a better balance between domestic and foreign savings and investment.

The very anticipation of the GST is already having a destabilizing impact on the collective bargaining climate and is impeding the ability of the Bank of Canada to counter inflation. Wage settlements have risen to over 6 per cent in the first quarter of 1991 from a 1989 average of above 5 per cent. Cost of living adjustment (COLA) clauses to protect against an upsurge of inflation are becoming increasingly prevalent in collective agreements. There is much misunderstanding of the likely impact of the GST on prices. Many union leaders talk as if they think the GST will result in a 7 per cent increase in prices, conveniently forgetting about the price reductions that will come from scrapping the Manufacturers' Sales Tax (MST).

While the year-over-year increase in the CPI can be expected to drop to below 4 per cent over the next few months as the effects on inflation of the sales tax increases in last year's budget disappear and the recent reductions in oil prices find their way through to consumer prices, the underlying trend of inflation will remain a concern and the Bank of Canada must remain vigilant.

The best way to cushion the economic and fiscal impact of the introduction of the GST is to introduce it at as low of a rate as possible so as minimize its impact on the price level. I thus recently proposed to the Senate Banking, Trade and Commerce Committee, which is conducting hearings on the GST legislation, that the GST should be introduced at a rate of 5 per cent and that appropriate consequential adjustments in the other elements in the GST package be made and fiscal actions be taken to preserve the deficit neutrality of the package.

A 5-per-cent GST would only add at most a marginal 1/4 per cent to the consumer price index. The risk that the GST might trigger a recession by setting off a price and interest rate spiral would be minimized.

There would be plenty of time later when the economy strengthens and inflation is under better control to increase the GST rate and to modify the other elements of the package accordingly.

A reduction is the GST rate to 5 per cent would cost $5.8 billion. This is a lot of money, but it could be financed without increasing the deficit by consequential adjustments to other components of the GST package and through additional fiscal actions. First, there are the consequential adjustments.

- The increase in the Sales Tax Credit could be limited to $45 per adult and $20 per child and the additional complicated credit based on earned income for singles could be eliminated, saving $400 million.

- The housing rebate could be abandoned, saving $0.5 billion. At a 5-per-cent rate the effective GST rate would be very close to the current effective MST rate on housing so no credit is necessary.

- Most of the costs of indexation would not be incurred as there would only be a marginal increase in the consumer price index. The savings would be $0.7 billion.

Second, there are the additional fiscal measures necessary to preserve the deficit neutrality of the GST package.

- A 10-per-cent corporate surtax could be imposed in addition to the existing surtax, adding 2.8 percentage points to the general business rate and raising $1.4 billion. This would compensate for the reduced sales tax burden falling on the corporate sector as result of the replacement of the MST by the GST. The corporate surtax could be dropped in the future when the economic climate improves sufficiently to allow an increase in the GST.

- The basic Personal Income Tax Surtax could be increased from 5 per cent to 8 per cent yielding $2 billion. This too would be a temporary measure that could be reversed when the timing is better for the GST to go up.

- An additional $900 million in expenditure reductions would have to be found to make the package deficit neutral.

Besides cushioning the impact of the GST on the economy and reducing the risk of stagflation, this 5-per-cent GST package would have a more favourable impact on income distribution than the government's 7-per-cent package. A problem with the government's proposal is that it does not fulfil the government's "commitment to ensure that families earning less than $30,000 are better off as a result of sales tax reform."

According to estimates that I made for a forthcoming Canadian Tax Journal article, 2.1 million or 46 per cent of the Canadian families (counting single individuals as families) earning less than $30,000 annually will actually pay higher taxes in 1991 as a result of the GST. These families will on average pay $20 more. While not a large sum, it runs counter to one of the key principles of fairness that the government specified for sales tax reform.

The proposed 5-per cent package is more consistent with the government's commitment to ensure that families earning less than $30,000 per year are better off as a result of sales tax reform. Under it some 2.7 million of the families earning less than $30,000 or 60 per cent would be better off and less than a third worse off.

The average Canadian family would also benefit. The average increase in tax burden would be only $232 under a 5-per-cent GST compared to $406 under a 7-per-cent GST. With less money taken out of their pockets, Canadian consumers could be expected not to cut back their spending as much.

In the longer run, the replacement of the outmoded MST with the technically superior GST will undeniably confer substantial benefits on the Canadian economy. Tax-induced distortions in production will be reduced and efficiency and competitiveness will be enhanced. It is only in the short run that the GST poses problems for the economy. But even these can be avoided if the GST is introduced at a 5-per-cent rate. Why create more problems than necessary when the economy is so clearly at a vulnerable stage of the cycle?