Discussion

Don Drummond

Robin Boadway notes that, as the Department of Finance is notoriously closed to public scrutiny, one must rely upon "a reasonable presumption that David Dodge was in the thick of things" on major public policy initiatives during the 1980s and 1990s. Since David Dodge was my boss for much of that period, I can vouch for the reasonableness of this presumption. Many a civil servant has pondered whether change always happened on David's watch because he was given assignments where reforms were sought, or because David was invariably an agent of change himself. My answer is that both factors were at play. Certainly, with the introduction of the Goods and Services Tax (GST) and the efforts to stabilize the country's public debt burden, David was at the top of his game and on a mission. Nothing could or did stop him. Much has been written about the difficulty in persuading the politicians of the day to act. Much less is known, however, about the often more difficult battles David fought and won to bring along his fellow civil servants.

Boadway focuses on four nation-shaping shifts in public policy during David's tenure at Finance: the Canada-U.S. Free Trade Agreement (FTA), followed by the North American Free Trade Agreement (NAFTA); the GST; stabilization of the national debt; and reform of the system of retirement savings. It is interesting that three of the four arose out of a sense of crisis. While the public did not perceive that the Federal Sales Tax (FST) was in the throes of crisis, that was certainly the perception within Finance. The narrow tax base on manufacturing activity was projected to decline, and the base was rapidly being eroded through court decisions that forced further exemptions. At a minimum, it was perceived that the tax would need to be shifted to the wholesale level. By the mid-1990s, Canadians came to perceive that the country's public finances were on the verge of collapse. David used to say that it was as if we were standing on a thin breakwater and we could smell the salt water crashing towards us. At the time, the actuary for the Canada/Quebec pension plans (CPP/QPP) released projections showing that the funds would not meet entitlements unless contribution rates were sharply increased or other major reforms introduced. Only the FTA and NAFTA arose out of a calmer situation of attempting to improve upon a status quo that may have been strained but that was not necessarily broken. The examples yield some interesting yet depressing insights on the conditions under which reforms can be enacted in Canada. A prerequisite would appear to be the perception of crisis: we don't like to fix what isn't obviously broken.

Boadway observes correctly that the shift from the FST to the GST cannot be considered a complete success, because we still have five provinces levying retail sales taxes that heavily tax business inputs, including capital, and do not exempt exports. Indeed, as the Department of Finance calculations show, these remaining taxes are a major reason why Canada's taxation of capital is one of the highest in the world. It is interesting that one of the reasons the five provinces have not shifted to a value-added tax is the reluctance of their politicians to explain a simple economic concept. The public generally believes that the sales tax revenue from inputs is absorbed by businesses, yet prices will go up when the tax is applied to a range of goods and mostly services that are exempt from the retail sales taxes. So a value-added tax is perceived as being a shift in tax burden away from businesses towards households. This perception persists, despite strong evidence from the introduction of both the GST and the Harmonized Sales Tax in three Atlantic provinces that businesses pass on the savings from removing the tax on their inputs.

The manner in which cuts were made to departmental spending under the program review implemented in the 1995 and 1996 budgets is of interest for much more than just the savings extracted. It was perhaps the first time that every dollar of federal spending had been reviewed from a comprehensive framework. One of the core questions was whether the federal government was the appropriate agent to be delivering the good or service. Was it a pure public good, or should some cost recovery apply? From the answers to these questions came reforms such as shifting from owning, operating, or subsidizing the transportation system to focusing on policy and regulatory responsibilities, moving to farm-income stabilization instead of subsidization, and a 60 per cent reduction in business subsidies over three years. Another principle was giving the departments input on how cuts would be enacted to their budgets. Previously, the central agencies tended to decide not only the magnitude of the cuts but also where the savings would be extracted. The opportunity to provide input was important in achieving a degree of buy-in from deputy ministers and produced a more efficient allocation of the savings than would have been achieved from a totally top-down exercise. The intent was that such principles would guide an ongoing process of internal audit. That legacy has been disappointing, however. While the principles survived and indeed were refined somewhat in the 2003 budget, there has been little by way of continuous audit, and many of the subsequent spending-restraint exercises have tended to lapse into cutting across the board with little discrimination.

Boadway notes with disappointment that the major transfers to individuals were not cut during the program review. It is worth pausing on why, as a bridge to the subsequent discussion of reforms to retirement-income programs. Finance Minister Paul Martin proposed to income-test Old Age Security (OAS), only to back down. This was due in part to effective lobbying by seniors. But it also reflected a policy conundrum for which no satisfactory solution was found. The desire remained to provide relatively generous benefits at low incomes. With this condition, extracting significant savings meant applying a fairly sharp recovery rate (or "clawback rate," as it was called in those days) just above a threshold. Yet a sharp recovery rate gave a very high marginal effective tax rate and dulled incentives for private savings. The internal struggles on policy design went back and forth: raise the clawback and get savings, but kill incentives or lower the clawback to restore incentives but lose the savings. At Finance, the younger people in particular faced a rude awakening to the finances of the sexes. There was little appreciation of how many senior women prized even a modest OAS cheque as their only direct source of income. The political retreat was ultimately somewhat of a relief to the bureaucrats.

One must understand the experience with the OAS to appreciate the approach to the next file that came up—reforming the CPP and QPP. Many options were open to stabilize the funding: cut benefits, raise the age of entitlements, raise contribution rates, and so on. After the experience with the OAS, the politicians had little appetite to take on the seniors again. It is not surprising, therefore, that the thrust was focused on higher contribution rates. Essentially, anyone over 50 at the time of the reforms broke even between their lifetime contributions and benefits. Those over 50 received a net subsidy. And those under 50 paid in more than they would ever receive. A young person would face a combined employer-employee contribution rate for CPP of 9.9 per cent for a benefit that is worth about 5.5 per cent of their wages. The residual was of course required to make up for the previous underfunding. Boadway could have drawn on this experience in his discussion of intergenerational accounting.

The CPP/QPP system was patched together in the late 1990s, but much is left to be done on the overall pension system in Canada. Few new companies offer either defined benefit or contribution plans to their employees. And within the defined plans there has been a marked shift towards defined contribution. Many of the employer-sponsored plans are in serious actuarial deficiencies at this time. We are rapidly moving towards a regime where the only people with defined plans will be civil servants, politicians, and some in the financial services industry. There has been much more talk than action on pension portability for the many workers who shift jobs. The courts have rendered unclear the ownership of surpluses in company pension plans. Tax rules limit the creation of pension surpluses and hence there is little cushion against market downturns.

Despite decades of efforts to encourage individuals to save for their retirement, savings remain inadequate for most. And the need to save for children's post-secondary education postpones the beginning of asset accumulation for retirement. The time has come for some more big thinking on Canada's pension system. This might include contemplating an expansion of the CPP/QPP beyond a 25 per cent replacement ratio and lifting the cap on the earnings base.

Boadway is certainly correct in that few of the structural reforms in the Mintz report have been enacted. It should be noted, however, that the general corporate tax rate has gone from 28 per cent at the time (with a surtax) down to 15 per cent. As well, the federal capital tax, arguably the most economically destructive tax of all, has been eliminated. It has also been eliminated or is being phased out in several provinces, although the capital tax remains on financial institutions in some provinces. Several of the provinces are moving their general corporate tax rate to 10 per cent, so the combined federal-provincial rate will soon be 25 per cent in some jurisdictions. This is a very competitive international rate. Of course, as Boadway comments, it is unfortunate that the prospect of rate cuts was not used as cover to address any corporate losses from the base broadening and other reforms that Mintz et al. recommended.

Canada's extremely high marginal effective personal income tax rates should be identified as one of the remaining public policy challenges. By this, I refer to how much of the last dollar earned is kept after taxes and the recovery of a host of social benefits. Most think of the top marginal rate when this subject is raised. Yet high income earners face among the lowest marginal rates in Canada. The highest rates are typically faced by people trying to exit welfare by working. Between the direct recovery of welfare payments and the loss of a host of in-kind benefits such as subsidized housing, many people would be worse off exiting welfare for paid employment. Families with children typically face marginal effective tax rates of at least 60 per cent up to the middle-income level. Particularly high tax-back rates are associated with the Canada Child Tax Benefit, the low-income GST credit, and the Guaranteed Income Supplement. Various efforts to address this problem, such as the Working Income Tax Benefit (WITB), to a large extent just shift the income level at which the marginal rates spike. These high marginal rates dull the incentives to work, save, and invest. Unfortunately, and this is likely why the problem hasn't been addressed, it is very expensive to do anything about it. A minimum of $10 billion a year would be required to make even a dent. Instead, the GST rate was cut by 2 percentage points. That is a shame, because the $12 billion annual revenue loss could have made a real difference if it had been applied to bring marginal income tax rates down.

A review of Boadway's remaining policy challenges reveals a common theme of governments nibbling away at problems rather than implementing the bold reforms they once enacted with initiatives such as the FTA, the GST, and the program review. Instead, bit by bit, we move towards a better personal income tax base by reducing the capital gains inclusion rate, correcting the overtaxation of dividends, raising RRSP contribution limits, introducing new savings vehicles for post-secondary education, and the latest, the Tax-Free Savings Account (TFSA). It isn't a consumption tax base yet, but it is inching there. Similarly, it has been recognized that much of the effort to assist families with the cost of post-secondary education is regressive—hence, the Canada Student Grant Program in the last budget.

Most economists would support the notion of blowing up the hodgepodge of support programs now in place for post-secondary education and starting over with a fundamental reform. Many advocate an income-contingent loan program. Yet here again, as with the tax incidence of retail sales taxes, economists have failed to register their message. Students are vociferous opponents of income-contingent loans. They shut down Lloyd Axworthy when he proposed it, and they jumped all over Bob Rae when he was thinking about it during Ontario's review of post-secondary education. The main objection is that they don't like the prospect of either having to pay back the loan quickly (if they earn a lot) or of having it hang over their heads for a long time (if their earnings are low). It would seem they do not understand discount rates.

Clearly, Boadway favours a stronger element of income redistribution in post-secondary education support. Here, I would defend a point that David Dodge often raised: it can't always be about income redistribution; the tax system should recognize legitimate expenses of families regardless of their incomes. And that is something to be kept in mind.

Boadway also seems to favour greater redistribution across provinces through the equalization program itself but also by introducing equalization features into other programs. But how much equalization can a country afford in the modern, globalized economy where being competitive is paramount? Can all jurisdictions achieve that competitiveness if the federal government is taking a large portion of their resources to make transfers to other provinces? The nature of the economy has changed dramatically since the equalization program started, with the removal of tariff barriers and much more north-south trade than east-west. These changes may point to less overall redistribution.

Finally, I would argue that a major challenge is that we no longer have a fiscal anchor. It used to be reducing the public debt burden. But it has been brought down substantially, and economists have not reached a consensus on where the "optimal" end point is. For want of anything better, the fiscal anchor has become balancing the budget. This has led to inefficiencies. Any initiative, whether it be new spending or a tax cut, is deemed satisfactory as long as it doesn't push the jurisdiction into a deficit. There isn't the rigorous application of principles such as those used in the program review to ensure value for money. There is little concept of scarce resources, so new initiatives are not tested against each other or against existing programs. It will be a shame to see Canadian governments go back into deficits after the hard work David Dodge applied to get them out. But perhaps it will restore a dose of discipline.