

vendor can claim an input tax credit for the GST paid on goods and services used in the production and distribution chain. Suppliers of zero-rated items (for example, basic groceries, prescription drugs) will be able to claim an input tax credit. Suppliers of exempt goods and services (including day-care services, most domestic financial services, and most educational, medical and dental services), on the other hand, will not.

## **B. Approach to the Committee's Study**

Many economists have suggested that the proposed shift from the FST to the GST should provide certain long-term benefits to the Canadian economy. Economic efficiency should be enhanced as a result of an improved allocation of resources. Business investment should be stimulated as the cost of capital is lowered. Over time, economic growth is expected to increase as the positive results of the reform of the tax regime take effect. Both the manufacturing sector and exports should become more competitive and imports will no longer be accorded an unnecessary competitive advantage.

This having been stated, the real challenge in ensuring that benefits emerge from tax reform is to manage the transition from the existing FST to the GST. As the Conference Board of Canada aptly noted in its brief to the Committee, the anticipated two-year transition period will be unduly prolonged if business and labour react adversely to the initial price effect of the change in tax regime. The Board stated that "if wages start to accelerate and interest rates are raised in response, the gains from a more efficient tax system will take longer to realize" and "if manufacturers try to increase profit margins when removing the 13.5 per cent FST and adding the 7 per cent GST, this, too, will be more inflationary than necessary and lead to interest rate increases which will delay the adjustment process."

It was precisely to ensure that the transition from the FST to the GST would take place smoothly and in a relatively short period of time that the Committee undertook a study of the effects of the proposed tax change on consumer prices. A number of pertinent questions were of interest. Would manufacturers, wholesalers, distributors and retailers pass on the tax savings realized through the replacement of the FST by the GST? Would these potential savings be difficult to ascertain? What price effects would be experienced in various economic sectors? What would be the overall direct price effect of the tax switch? What would be the response of organized labour to the predicted increase in the price level? If labour was successful in achieving sizeable wage gains as a result of the initial price effect of the GST, how would the monetary authorities respond?