

Mr. Martin's budget versus the alternative federal budget

WHAT IS A GOOD BUDGET?

A budget can be assessed on the basis of four broad criteria: the appropriateness of fiscal policy to the immediate economic circumstances; the contribution it makes to the longer-term growth of living standards; the impact on the social wage; and its effects on the efficiency and fairness of the tax system. Mr. Martin's 1999 budget can, from a progressive perspective, be judged to be very modestly positive, which makes it something of an exception to the dismal budgets of the past 20-odd years, which have been almost uniformly contradictory, and have cut deeply into both needed public investment and the social wage. However, the budget was "prudent" to a fault, and would have been much better if the minister of finance had more closely heeded the recommendations of the Canadian Centre for Policy Alternatives/Choices Alternative Federal Budget.

THE BUDGET AND MACROECONOMICS POLICY

Based on private sector forecasts, the budget anticipates real economic growth of just 2.0 percent in 1999 and 2.5 percent in 2000. This slowing of growth from 4 percent in 1997 and 3 percent in 1998 implies that the national unemployment rate will remain at or near 8 percent, the currently very high level of employment in precarious jobs will continue, and real wages will remain all but flat. Although partly insulated by the continuation of strong US growth and the recent depreciation of the dollar, the Canadian economy is clearly being affected by the still serious and deepening global economic crisis.

The government's basic response to changed international circumstances has been to "batten down the hatches"—that is, to loudly proclaim its commit-

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ment to rapid reduction of the debt as a share of GDP, to low inflation, and to "sound finance" generally in order to win the approval of "the markets." The budget aims to generate a large surplus in 1999-2000, the explicit \$3 billion contingency reserve, plus a hidden surplus of some \$6 billion, which will come from excessively pessimistic economic and revenue growth assumptions. Even on the basis of the forecast balanced budget, the debt is predicted to fall from 65.3 percent of GDP in 1998-99 to 63.7 percent of GDP in 1999-2000.

Recent budgets have greatly slowed growth and job creation by running very large operating surpluses (revenues minus program spending) of

about 5 percent of GDP. Mr. Martin did slightly reduce fiscal drag in this budget, mainly by allocating the 1998-99 surplus to last-minute spending initiatives, and by very modestly reducing taxes in 1999-2000. Program spending for 1998-99 will be 12.6 percent of GDP—0.9 percent of GDP higher than forecast in the 1998 budget, even though federal revenues as a share of GDP will likely come in "just" 0.7 percent of GDP higher than forecast last year. Program spending in the coming fiscal year will be 0.5 percent of GDP higher than forecast last year, and may come in higher still if Mr. Martin again decides to spend his hidden surplus at year-end rather than apply it to debt. Overall, the budget is very mildly stimulative in macroeconomic terms. At least it did not make things worse, and it is notable that the tiny recovery in program spending is the first that has taken place in a non-recession budget since the mid-1970s.

In contrast, the 1999 alternate federal budget (AFB) would have boosted federal program spending in 1999-2000 by an additional \$15 billion or about 1.7 percent of GDP compared with the actual budget, while leaving federal revenues unchanged as a share of GDP. (This is, in fact, an overstatement of the difference, since the actual budget shifted a major chunk of this year's program spending back into the last fiscal year.) Analysis by Informetrica Ltd. confirmed that the AFB would boost economic growth to 4 percent this year and to 3.5 percent next year. Because of faster growth and its impact on revenues, the budget would still remain in balance, and debt would fall even more rapidly. Most important, the stimulus to growth would have brought the national unemployment rate below 7 percent in 1999, and below 6 percent in 2000.

The core difference between the actual budget and the AFB in macroeconomic terms was that the AFB devoted the entire surplus to an immediate increase in program spending, plus the amount expected to arise as a dividend from the spending stimulus, while the actual budget runs a large hidden surplus of some \$9 billion. The cost of excessive "prudence" will be felt in terms of much slower growth and higher unemployment.

THE BUDGET AND LONGER-TERM LIVING STANDARDS

As in previous Liberal budgets, the 1999 budget spoke to the importance of establishing a framework to promote longer-term economic growth through higher productivity. Aside from getting the macroeconomic fundamentals right, Mr. Martin stressed the importance of public investment in knowledge, skills, and innovation, further developing a major theme of the famous 1993 Liberal red book. His heart may be with "knowledge economy" public investment initiatives, but the budget speech also noted that tax cuts should be part of a productivity agenda, and the dollars went to tax cuts. The budget allocated very modest additional amounts to "creating, disseminating and commercializing knowledge"—\$116 million in 1998-99, \$198 million in 1999-2000, and somewhat more over the next two years—but it extended no new support for post-secondary education or training.

In recent months, the right has crusaded for tax cuts as the elixir that will deliver higher productivity growth, even though there is little evidence to indicate a connection. True, the low-tax United States has achieved higher productivity growth than Canada in the 1990s, but US productivity growth has generally been unimpressive compared with high-tax continental Europe. (The fastest rate of labour productivity growth in manufacturing among OECD countries in the 1990s was in the highest-tax jurisdiction, Sweden.) A recent survey of the literature on the respective

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contributions of public investment and tax cuts to long-term economic growth, by IMF staff economist Phil Gerson, found that well-targeted public investments are more growth enhancing than tax cuts. There are solid grounds to believe that this should be particularly the case in Canada, where the corporate sector has tended to underinvest in knowledge and in skills compared with the United States.

Going beyond macroeconomic stimulus to more structural, growth-oriented policies, the AFB proposed to boost federal spending in 1999-2000 on post-secondary education (\$1.5 billion); basic public infrastructure (\$1 billion); research programs across the federal government; and training. The AFB also proposed a training tax on employers, sector-based training councils, and a national capital investment fund—an arm's-length public investment bank financed through small compulsory deposits from financial institutions and mandated to extend loan and equity investments in support of community, sectoral, and regional development initiatives.

The key point is that the federal budget spoke at some length to the importance of public investment in building a knowledge-based economy but did very little that could reasonably be

expected to have a major impact on long-term prospects for economic growth and diversification. Nor did it do anything of significance to make economic growth environmentally sustainable. The AFB, again in sharp contrast, established a \$1 billion Canadian atmospheric fund, financed from a "green tax" program, to undertake necessary transition investments in areas such as building and equipment retrofits for greater energy efficiency.

THE BUDGET AND THE SOCIAL WAGE

In his previous budgets, Mr. Martin cut federal program spending by almost one-third as a share of the economy, from 16.6 percent of GDP in 1993-94, to 12.6 percent last year. Deep spending cuts eliminated the deficit to a much greater extent than either growth or tax increases, and the burden fell heavily on the social wage through cuts in transfers to the provinces for health and social assistance, and cuts to UI benefits. In the process, the federal government virtually abdicated its role as a major actor in terms of social policy and, indeed, the introduction of a single cash transfer to the provinces—the Canada health and social transfer (CHST)—signalled precisely that intent.

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resourced than its US counterpart. Total government taxes and other revenues in Canada reached about 43 percent of GDP, while the US figure has remained at 30 percent since the early 1970s.

Market-driven globalization has paradoxically created a larger state and also the need for a smarter one with more institutional capacity. As the global crisis has deepened and financial volatility increased, the Washington consensus model is in question and many of its former supporters have called for a re-examination of the framework. Its operative premise was that decentralized markets were highly efficient engines of growth and that the incentives of free market price signals could promote a virtuous cycle of individual, self-seeking behaviour that reflected the standards of neoclassical welfare economics. In a world of costless information, minimal transaction costs, and fully competitive markets, the price mechanism was alleged to reflect the true value to society of all the uses of its resources. From this perspective, all people have to do is follow the incentives that "full-price information signals provide."

RETHINKING THE FUNDAMENTALS

This minimalist conception of economic management has been marked by too much waste, too many unreachable targets, too little long-term public investment, and, too often, the unproductive use of the state's resources. Mr.

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Paul has finally got the message. Without a strong regulatory role for government, market forces know few limits. The difficult issue that no amount of economic theorizing can adequately explain is why market signals malfunction and produce suboptimal results. Even when high-quality training and day care are indispensable to the optimal functioning of market forces, the private sector fails to respond and invest in these strategic goods. The record of decentralized market approaches in the area of social intervention has been, to state the obvious, a failure. Political systems are attractive, efficient, and indispensable when they can generate a consensus that social intervention is needed and markets can be organized in more effective ways when the state is present rather than absent.

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will support the Martin budget of a "definite maybe." They are increasingly resistant to the idea that tax cuts are the answer and the recent experience in Ontario has demonstrated that public opinion wants an end to the chaos in schools and hospitals.

Public opinion has sided with the argument that, in a globalized economy, there are few advantages to having a smaller state presence when all governments are having to confront a range of intractable distributional issues. The very idea of a strong public has moved from the edge of the envelope and is now a fundamental concern both for international organizations such as the World Bank and many national governments. Shifting priorities from cutting to spending initiatives calls for reinvesting in the social market side of the economy. Even in Anglo-Saxon economies, the state is back. And this time, anyway, Mr. Paul is not out of step. ♦

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The centrepiece of this year's budget was, of course, an \$11.5 billion reinvestment in health care transfers. However, despite headline multiyear numbers and a one-off distribution of last year's surplus funds, the cash floor of the annual CHST transfer increases by only \$2.5 billion, and the federal share of public spending on health rises insignificantly. While a welcome injection in the context of the immediate crisis, the

budget did not address the heart of the problem—the declining federal share of both public and total spending on health care. In contrast, the AFB, in line with the proposals of the Canadian Health Coalition, set a schedule to increase the federal share to 25 percent to re-establish the federal government as the guardian of medicare and a major player in the future evolution of a growing public system.

Beyond a tiny addition to the Canada child tax benefit, the budget did almost nothing to alleviate growing poverty and income insecurity. In contrast, the AFB re-established a separate transfer to the provinces for social assistance and social support services, with almost \$3 billion of new funding as the basis for setting national stand-

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FISCAL PROBLEMS AND DISTRIBUTIONAL INEQUITIES

During the next decade and a half, the changed environment of chronic federal fiscal problems sapped the strength of the transfer programs. Ottawa repeatedly scaled back the formula governing growth in total EPF entitlements, which meant that the cash component (the difference between a slowly growing total and a more rapidly growing tax component) stagnated in aggregate and fell in provinces with more robust economies. Then the 1990 "cap on CAP" put a ceiling on welfare-related transfers to the three richest provinces. And when EPF and CAP payments were rolled together into the CHST in 1995, total cash transfers to the provinces dropped by one-quarter over two years, and the disparity among per-person cash payments to each province widened to the point where the transfers to the most favoured province (Quebec) were half again as large as those to the least favoured (Alberta).

Although the dwindling amount of cash in these transfers began to prompt speculation about when they would fade from the scene completely, it was not only their shrinking size, but also their ever-more-skewed distribution, that gave these transfers a deathly hue by the mid-1990s. The provinces that contribute disproportionately to federal coffers—Alberta, Ontario, and British Columbia—were getting steadily less. Since Canada already has a \$9.5 billion-a-year equalization program that addresses the "horizontal imbalance" between the different provinces' revenue-raising capacities by topping up the budgets of the less well off, the CHST's tilt toward these same recipient provinces was undermining political support for transfers in the provinces whose citizens provided the bulk of the money.

Now that a budget surplus has given Ottawa room to increase the size of the CHST and reduce the disparities in cash payments to different provinces, federal-provincial transfers are back from the grave. Provinces are celebrating by pouring new money into health care and cutting taxes.

The pressure for more social spending—especially in health, where there is literally no limit to the demand for services provided free at the point of consumption—will still be strongest at the provincial level. But it makes no more sense now than it ever did for provincial governments to become more and more dependent on transfers from Ottawa to finance their programs.

GHOSTS OF THE PAST

If the past is any guide, however, what now looks new will soon begin to look old again. Ottawa still has a commanding position in raising personal and corporate income taxes, and the pressure for more social spending—especially in health, where there is literally no limit to the demand for services provided free at the point of consumption—will still be strongest at the provincial level. But it makes no more sense now than it ever did for provincial governments to become more and more dependent on transfers from Ottawa to finance their programs. Recycling the resources that go into hospitals, schools, and income support through Ottawa does not make citizens any healthier, smarter or wealthier—in fact, the reverse is more often the case, because the recycling blunts accountability, and injects addi-

tional political tension into a provincial service-delivery job that is already overwhelmingly complicated.

As Ottawa's surplus continues to grow, therefore, Canada's leaders should remember how transfers of tax room have eased the vertical imbalance between federal and provincial fiscal powers and responsibilities in the past. Provincial governments are going to need more resources and management flexibility in social programs over time. While a bigger CHST can deliver the former, only further transfers of taxing power from Ottawa to the provinces can deliver both. Without it, annual bickering over new money and the friction of federal-provincial overlap will soon spoil the party. Federal tax cuts may be the best way to keep our future festivities free from the ghosts of the past. ♦

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ards and raising social assistance incomes to 60 percent of the poverty line immediately. The AFB also redirected the large UI fund surplus to UI benefits, rebuilding a program that now provides benefits to less than one in three of the unemployed. In short, the actual budget called an end to the cuts, but did very little to provide an assured funding base for the social wage.

THE BUDGET AND TAX FAIRNESS

Building on last year's initiatives, the budget adjusted the amount of income that can be earned free of tax, offsetting some of the recent impact of deindexation of the tax system to low inflation, and completed the elimination of the 3 percent federal surtax. In combination, the two budgets delivered a very mod-

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estly progressive federal tax reduction in percentage terms, with an average full-time worker getting a 5 percent tax cut (\$300), high-income earners (\$100,000 plus) getting about 3 percent (\$800), and low-income earners (\$20,000) getting a tax saving of about 9 percent (\$200). In dollar terms, the savings from the elimination of the 3 percent surtax on high-income earners in the 1999 budget were large. Taxpayers earning more than \$250,000—the top 0.4 percent—will save an average of \$3,673 per year, and those earning between \$150,000 and \$250,000 will receive an average of \$1,127. Mr. Martin resisted the call from the right for immediate, large, across-the-board, personal and corporate income tax cuts, but he has done little to increase the progressivity of the tax system. His “balanced” approach—which has resulted in significant tax cuts for very high-income earners—must be set in the context of rapidly growing income inequality in Canada. Those earning \$100,000 and more were, after all, the only group to experience rising real pre-tax incomes in Canada in the 1990s.

The AFB, yet again in sharp contrast to the actual budget, maintained the federal tax share of GDP, but introduced a tax on large wealth transfers between generations (additional revenues of \$3 billion per year), introduced higher fed-

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eral tax brackets of 32 percent and 34 percent for those earning more than \$100,000 and \$150,000, respectively, and closed some particularly unproductive corporate and personal tax loopholes. The proceeds were used to significantly increase tax credits for low-income households, with an additional \$2,000 per child directed to households with incomes of less than \$26,000. This progressive tax redistribution, combined with the AFB's improvements to social assistance, would cut the child poverty rate in half.

CONCLUSION

Mr. Martin's budget has been almost universally described as “modest” and “prudent.” It is essentially a “stay-the-course” budget, tailored to the new realities of a post-deficit fiscal world. The best that can be said is that it moves us—

ever so slightly—forward rather than backward in terms of dealing with such key issues as unemployment and precarious employment, long-term growth, environmental sustainability, social justice, and tax fairness. The progressive alternative, the AFB, would have represented a much bolder and decisive step forward, but it would not have meant returning to deficit financing. The price of “prudence” is higher unemployment, higher child poverty, and reduced living standards in the longer run.

More than ever, the choices cemented in federal budgets need to be thoroughly assessed and debated by progressives, or we may come to believe, with the Liberal government, that small gestures count for a lot, and that occasional doses of progressive rhetoric can compensate for doing very little in practice. ♦

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