

Canada Watch

PRACTICAL AND AUTHORITATIVE ANALYSIS OF KEY NATIONAL ISSUES

a publication of the York University Centre for Public Law and Public Policy and the Robarts Centre for Canadian Studies of York University

SPECIAL ISSUE ON THE FISCAL DIVIDEND

FISCAL RELIEF?

BY DANIEL DRACHE

For this special issue of *Canada Watch*, we have asked some of Canada's leading "Think Tanks" consultants to comment on whether the 1998 budget is, in fact, as "good as it gets" now that Ottawa has a record fiscal surplus to spend. Don't hold your breathe that Martin's good-times budget gets a high grade from these experts. Think Tank experts on the Left as well as the Right are not in his corner cheering for good reason.

Despite their obvious ideological differences, what disturbs them is that there are few satisfactory answers in the budget documents to the important issues that matter: should government be spending more or be taxing less? Should it be looking to market-based solutions to reduce Canada's high unemployment or should it be doing more itself? Should it continue its rigid zero-deficit target, or do more to ensure that fiscal and social policy work together rather than against one another? Should it cut taxes for the middle and upper classes or should it make health, education, and the environment

top spending areas?

THE CORE ISSUES

Instead, Martin's budget assumes that Canada will be a narrow-gauge performer in the U.S. market relying on its embattled labour market to give Canadian business a competitive advantage in the global economy. Canadians are entitled to know the kinds of innovative measures the government is intending to rebuild the nation's social capital. Powerful integration pres-

ures from corporate restructuring and NAFTA continue to drive a wedge between Canada's rich and poor regions, and between new entrants entering the job market and the previous generation of job-holders.

Restoring the cuts to Canada's social programs should have been at the top of Martin's agenda. After all, social spending is the largest expenditure of the national government. More than one-half of all program spending in recent times involves cash payments to individuals or other levels of government. In

continued on page 42

BUDGET FAILS TO ADDRESS THE ISSUE OF THE IDEAL TAX RATE

BY MICHAEL A. WALKER

The federal budget package of 1998 deserves to be applauded for having delivered, as Paul Martin kept promising, a balanced budget and indeed budget surpluses. It would take a very careless person, particularly ignorant of recent fiscal history, not to note what an accomplishment this has been. I need to draw particular attention to this, since it may be easy to forget the good news when we get into the body of this article which discusses what the budget did not contain.

First, we need to remind ourselves that the federal government has been, on the whole, a reluctant budget balancer. By comparison with the ten provincial jurisdictions, the federal government was a laggard and was regularly the worst performer in the Fraser Institute Fiscal Performance index, which attempts to rank the federal and the provincial governments. Even as fiscal balance has been approached, the path has been quite differ-

continued on page 43

FEATURES

41

Fiscal Relief?
by Daniel Drache

41

Budget Fails to Address the Issue of the Ideal Tax Rate
by Michael A. Walker

45

How to Slay a Debt Monster
by Michael Mendelson

47

Ottawa's Looming Fiscal Dividend
by John McCallum

48

Paul Martin versus the Alternative: Grading the Budgets
by Jim Stanford

51

Canada's Fiscal Hydra: Paul Martin's Fight Is Not Over
by William B.P. Robson

52

Towards a Realistic Tax Policy
by Jonathan R. Kesselman

54

Income Distribution in Canada in the 1990s: the Offsetting Impact of the Government on Growing Market Inequality
by Andrew Sharpe

56

Canada's Competitive Challenge: the Budget and Beyond
by Jay Myers

1998, more than \$70 billion was spent in direct payments to people including the elderly, the unemployed, and the needy. Despite more than a decade of cutting back program spending, Canadians want better government, a new kind of state, and optimism for the future. So far, they have little grounds to be reassured.

LESS GOVERNMENT, MORE INEQUALITY

Canada's social programs are less able than ever to cope with the complex demands placed on them. Ottawa is spending less on education, health, and welfare than it did two decades ago. Federal program spending now amounts to about 14 percent of GDP, way down from what it was.

Take another measure, that of capital spending: with the recovery, capital spending is actually slowing down rather than speeding up. StatsCan predicts an increase of about one-half of last year's gain. This demonstrates that there is less of a link between macro-policies and micro-investment decisions. Canada's manufacturing sector is turning in record profits from a cheap dollar and surging exports, but is spending precious little on reinvestment. So the increase in new spending is up

by only 1 percent, despite all the tax breaks in this budget.

Over the next three years, Martin proposes to reduce federal taxes by \$3 billion dollars and much of that is for upper-income earners. This is indeed an unlikely priority, because Canada's top marginal rates (51.6%) are similar to those of France, Germany, Italy, and Japan.

On the tax front, Martin is looking to cut taxes and bring relief to upper and middle classes. He predicts federal taxes will fall as government surpluses grow, and believes that the rich are the most needy and first in line for tax relief. Over the next three

years, Martin proposes to reduce federal taxes by \$3 billion dollars and much of that is for upper-income earners. This is indeed an unlikely priority, because Canada's top marginal rates (51.6%) are similar to those of France, Germany, Italy, and Japan.

By contrast, there is now a real problem of high marginal tax rates for people near the bottom. The Department of Finance calculates that those making between \$25,000 and \$40,000 can face a marginal tax rate of up to 70 percent because of the loss of so many federal and provincial income-tested credits and benefits. What has been taken away from these individuals is the GST tax credit, the child tax credit, and the proposed Senior's Benefit. This is why, in part, inequality and wage polarization are on the rise. Many core redistributive programs no longer exist and incomes now are set by market forces.

Finally, Martin has a lot of explaining to do with respect to what is happening to wages and profits. If once they used to move in tandem, they do so no longer. Since 1993, wages and salaries, the broadest measure including the non-

unionized private sector, edged ahead by a mere 13.6 percent, while corporate pre-tax profits rose by 104%.

Canadians have a right to be sceptical about Canada's future based on non-inflationary expansion. Canada's growth has been fueled by a cheap Canadian dollar, lower interest rates, and the U.S. recovery. This kind of model requires governments to constantly do a lot of tightening to restrain the pace of economic growth.

Business share of total national income has surged and now is close to 10% of the national income. These figures are troubling, because they reveal that wages are increasingly downward flexible, and

Canada Watch

Practical and authoritative analysis of key national issues

EDITORS-IN-CHIEF

Daniel Drache, *Robarts Centre for Canadian Studies, York University*

Patrick Monahan, *Osgoode Hall Law School, York University*

MANAGING EDITOR

Vladislav Tumor

BUSINESS MANAGER

Daniel Kumer

COLUMNISTS IN THIS ISSUE

Daniel Drache
Michael A. Walker
Michael Mendelson
John McCallum
Jim Stanford
William B.P. Robson
Jonathan R. Kesselman
Andrew Sharpe
Jayson Myers

Canada Watch is produced jointly by The York University Centre for Public Law and Public Policy, and The Robarts Centre for Canadian Studies of York University.

For information, call (416) 736-5499, fax (416) 736-5739, write to *Canada Watch*, 227 York Lanes, 4700 Keele St., North York, Ontario M3J 1P3, or visit us at www.yorku.ca/faculty/osgoode/canwatch/cwhome.htm.

SUBSCRIPTION INFORMATION

Canada Watch is published six times per year.

Annual subscription rates

Institutions\$75.00
Individuals\$35.00
Students\$20.00
(Outside Canada add \$10.00)

© 1998 Centre for Public Law and Public Policy; the Robarts Centre for Canadian Studies

Printed in Canada

ISSN 1191-7733

that income inequality is a permanent fixture of the Canadian scene as fewer workers succeed at the bargaining table. With more people working in non-unionized settings, wages reflect the highly competitive nature of these labour markets. One consequence is that the gender gap is back in full force. Forty percent of women in the service economy earn somewhere between \$6.50 and \$7.50 an hour, a paltry two-thirds of the national hourly wage of \$9.30.

Canada is one step closer to a zero deficit, but no closer to having a healthy economy and a government capable of promoting national ends.

A HARD LANDING AHEAD?

Canadians have a right to be sceptical about Canada's future based on non-inflationary expansion. Canada's growth has been fueled by a cheap Canadian dollar, lower interest rates, and the U.S. recovery. This kind of model requires governments to constantly do a lot of tightening to restrain the pace of economic growth. This applies primarily to the labour market, where wages have to be ratched down. It means relying on the export sector to drive the economy where there are fewer and fewer people working at highly paid employment. It also requires de-taxing the middle and upper classes to ensure that investment spending does not falter.

Canada is one step closer to a zero deficit, but no closer to having a healthy economy and a government capable of promoting national ends. On

the issue of governance, Martin gets a fat "F". He is no longer committed to reinventing the state, a former policy passion that he used to share with Lloyd Axworthy when he was the Minister of Human Resources Development.

Why then so little progress on the "big picture" questions?

The fact is that Martin's notion of economic renewal is still a mirror image of Mulroney's basic idea that Canada needs a massive devolution of Ottawa's powers to the provinces, a smaller role for government, and a large role for the private sector in the national affairs. What some *Canada Watch's* policy wonks object to is that Martin continues to treat deficit reduction as a technical problem for economists and government specialists. Here too Martin gets a low grade. Deficit reduction is all about politics, the choices to be made, and the different options open to the government depending on the way they conceive the defining elements of state policy.


A BRITTLE GROWTH MODEL

In today's volatile world, Martin's model of economic growth is likely to prove painfully brittle. U.S. growth has been fueled by the irrepressible rise of the stock market there. If U.S. interest rates rise as they must and the growth bubble bursts, Canada will face yet another massive recession, more cuts in public spending, a shrinking tax base, higher taxes and, to be sure, the return of the deficit. This is why Martin owed it to Canadians to say, once and for all and without hedging, that Canada's fiscal and macro-economic problems do not stem from a big-spending mentality. Rather, our problems stem disproportionately from

the government's made-in-Canada high-interest rate monetary policy.

In the 1990s, governments which still believe in the old dogmas—that markets are automatically better and the benefits from privatization are always positive—run the risk of making many more costly mistakes. This "heretical" view comes from Joseph Stiglitz, chief economist at the World Bank. He told his audience in a wide-ranging speech several months ago that macro-economic stability at any cost is simply the wrong target and that moderate inflation is not harmful.

More importantly, he admitted that zero-deficit targets are neither necessary nor sufficient either for longer-term development or for good macro-economic practice. He called past practices "misguided". Even deficits are "OK", "given the high returns to government investment in such crucial areas as primary education and physical infrastructure".

Stiglitz had a lot of other things to say had Canada's Department of Finance officials chosen to listen. They ought to, and before Canada finds itself in a vicious monetary cycle again. High interest rate policies are too costly, and Canada needs a thorough and critical policy review of the basics of good governance. 

Daniel Drache is Director of the Robarts Centre for Canadian Studies and Professor of Political Economy at York University.

IDEAL TAX RATE *from* *page 41*

ent than the one selected by fiscal conservatives such as Janice MacKinnon, the Finance Minister from Saskatchewan and one of the top fiscal performers in the country. The feds, over the period from 1993 to 1998, have relied to a very considerable extent on revenue increases (70 percent) and less so on spending cuts (30 percent) in reining in the deficit. The approach in most of the provinces has been just the opposite.

The difference between the two approaches is that the revenue path is one which assumes that the current level of spending is just fine and the only thing to be done is raise the level of government income to match it. This is, in effect, a status quo approach which leaves all of the important questions about the role of government and the consequent size of government unanswered—indeed, unasked.

The 1998 budget was true to this approach. Of a total of some \$18 billion in spending increases and tax cuts which shall occur between now and 2000-01, only \$4 billion is a real tax cut. The rest are either actual spending increases or targeted tax cuts—the so-called tax expenditures which deliver a tax cut only to those who spend their money in ways that the government thinks appropriate. The message is, while there are incipient surpluses which emerge from the growth in the economy and past program changes, government still knows best and will dispose of these surpluses largely by spending them directly or directing how they will be spent.

continued on page 44