

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

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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-

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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.

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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.

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In the course of this spending bonanza there isn't a single mention made of the fact that our tax system is increasingly uncompetitive with that of the U.S. where recently, for example, the capital gains tax rate has been cut to 20 percent. This compares to an effective rate of more than 40 percent in the trade union leaders' paradise and even 33 percent in Alberta.

Indeed, the central drawback of the budget is that it has failed to address the key issue we face, namely how big the government sector should be. Debt repayments aside, this question is equivalent to asking what is the total tax rate the average Canadian should be forced to bear. This is a question which, if not addressed directly, will be determined as a by-product of other discussions. It is not a question which should be determined by default; it should be asked and answered directly. At the moment, owing to the fact that a substantial number of low-income Canadians bear no significant tax burden, the average family pays nearly one-half of its income to government. While the federal government collects only 48 percent of this amount, as the senior level of government, the federal government ought to take the lead in addressing the issue.

What should be the tax rate faced by the average Canadian family? Evidently, it should be the ideal rate. That is the rate of tax that is in some way better than any other. What is the ideal rate of tax? Presumably it is the rate of tax that finances just the right level of government expenditure. If the tax rate were lower than this ideal rate, there would be too little government spending; if it is greater there would be too much. How can we de-

termine what this ideal rate of government spending is? This question is the subject of an extensive Fraser Institute paper which will be published later this spring.

The policies we actually followed produced very little change in the position of the bottom one-fifth of the population. In 1965, this group received 4.4 percent of the total income before tax, while by 1995 they were receiving only 5.7 percent after tax. This group, as well as everybody else, would have been much better off with a lower rate of total tax and the higher growth and output it would have produced.

Here I have the space to mention only two of the approaches which might be taken to answer this question. The first was adopted by Ludger Schuknecht and Vito Tanzi at the International Monetary Fund. In this approach, the authors analyzed 17 countries during the period 1870 to 1990. They treated government as a factor of societal production and asked the question, at what point does the addition of further govern-

ment to the society-wide production process lead to diminishing returns? Or, put another way, at what point does the addition of further government spending cease to produce any further improvement in the social and economic objectives which are presumably the intent of government spending to influence? I can do no better than to quote these two eminent government economists directly. They first conclude that "the expansion of public expenditure and the welfare state during the past three decades has yielded limited gains in terms of social objectives" (at 25). They go on to note that "most of the important social and economic gains can be achieved with a drastically lower level of public spending than what prevails today. Perhaps the level of public spending does not need to be much higher than, say, 30 per cent of GDP to achieve most of the important social and economic objectives that justify government interventions" (at 34).

A second approach to the question of the optimal size of government arises from the work of Gerald Scully, but actually has a root that goes back to the conjecture of Australian economist Colin Clark. Clark said, as early as the 1950s, that the maximum size of government should not exceed 25 percent of the GDP or else there would be a high price to pay in terms of foregone economic growth. The work of Scully for various countries suggests that the total tax rate ought not to exceed about 23 percent. Scully arrives at this result by asking the question, what tax rate will maximize the rate of economic growth. He approaches this question in three different ways and the answer he

provides is the average of the three. Two Fraser Institute economists, Joel Emes and Dexter Samida, have provided the calculation for Canada. Their conclusion is that the growth-maximizing size of government in Canada is 29.8 percent.

What is surprising is the extent to which we have endured a loss of output as a result of having operated government above the optimal level in the post-1965 period. According to the calculations done by Emes and Samida, the fact that we have had above-optimal tax rates since 1965 has cost us \$3.7 trillion in output. In more directly understandable terms, if we had had the optimal tax rate over the period, we would today have an average per capita income \$11,000 higher than we do. From the point of view of the lowest-income citizens in our country, this would have made quite a difference. The policies we actually followed produced very little change in the position of the bottom one-fifth of the population. In 1965, this group received 4.4 percent of the total income before tax, while by 1995 they were receiving only 5.7 percent after tax. This group, as well as everybody else, would have been much better off with a lower rate of total tax and the higher growth and output it would have produced.

The inevitable criticism of this result is that it ignores the fact that our national system of socialized medicine was introduced in 1970 and this surely was worth the additional cost. No other program of public expenditure is more widely supported by Canadians than our health care program. Without the expansion of the government sector, would this program have been

possible?

The answer to this question is interesting. During 1995, the latest year for which we have complete, reliable figures, health care absorbed about 10.5 percent of the national income. This is 63.9 billion inflation-adjusted dollars. If we had pursued the growth-maximizing tax rate over the period, GDP would have been \$936 billion. Total current spending on health care of \$63.9 billion is 6.8 percent of that higher GDP level. Coincidentally, this is just six-tenths of a percent more than the U.S. spends on their government health care programs, Medicare and Medicaid. It is probably not necessary to note that the U.S. government taxes only 33 percent of its total GDP—very close to the optimal rate for Canada.

[E]arly indications are that we are returning to the spend-and-tax policies which got us into trouble in the first place.

Another objection is that 1971 brought a great expansion of the parameters of the Unemployment Insurance system. Without the expansion in the size of government, the higher cost associated with this extension of federal program spending would not have been possible. In this case, the response has already been provided by the current government. Program parameters for what is now Employment Insurance have been rolled back to their pre-1972 level because of the malevolent effects, and in due course the outlays on this pro-

gram will return to more manageable levels—indeed, they have already begun to do so while the payroll tax to support them remains at its peak levels.

It appears that we have everything to gain and very little to lose by moving to the optimal tax rate. The crucial discussion which was absent from the budget and its treatment of the emerging fiscal reality is, how does the proposed plan affect the achievement of the optimal tax rate? This and the corresponding size of the government sector is the key to solving our persistent unemployment problem and the slow growth which perennially plagues our regions.

There is also a practical reason for decrying the absence of discussion of the optimal size of government. That is the fact that it leaves us without a clear fiscal target of the sort which the balanced budget trajectory provided. By setting out his fiscal targets clearly in advance, then meeting them successively, and finally beating them, Paul Martin had a very positive effect on expectations in Canada. This sense of fiscal direction and clarity has been lost and the early indications are that we are returning to the spend-and-tax policies which got us into trouble in the first place. 🍁

Michael A. Walker is Executive Director of the Fraser Institute.

NOTES

G. Scully, *Tax Rates, Tax Revenues and Economic Growth* (NCPA Policy Report No. 98, National Center for Policy Analysis, 1991).

V. Tanzi & L. Schuknecht, *Growth of Government and Reform of the State in Industrial Countries*, International Monetary Fund Working Paper 130, 1995.

HOW TO SLAY A DEBT MONSTER

BY MICHAEL MENDELSON

Several weeks before the 1998 Budget, the Caledon Institute of Social Policy released a study on the federal debt, *To Pay or Not To Pay*.¹ This study reported the results of a model projecting federal finances over the next decade, under a number of different scenarios. The model showed that under any reasonable set of assumptions the burden of debt in Canada, as measured by the ratio of federal government debt to the Gross Domestic Product (GDP), would decline rapidly, reaching historically low levels by the end of the ten-year projection period.

Figure 1 (“Federal debt versus GDP”) shows the model’s most recent projections for the next decade, using the new estimates provided in the federal government’s 1998 Budget and assuming no policy changes other than those announced in the Budget. As can be seen, federal government debt compared to GDP is still projected to be on a swift downward path. There is a simple explanation for the debt burden falling so quickly: with budgets that are balanced or in surplus, the debt stays the same or falls in nominal terms while GDP grows in nominal terms. Consequently, the ratio of debt to GDP declines rapidly due to the combined effects of a constant or increasing numerator and an increasing denominator.

Those who advocate accelerated repayment of the debt seldom bother to tell us how much payoff there would be were their advice to be followed. In Figure 2 (“Effect of an extra \$2B debt repayment”) below, we show the change in debt-to-GDP ratios which would result from each additional \$2 billion in repayment of debt, assuming that there is no

other effect on the economy. Were the additional \$2 billion paid against the debt by decreasing spending beginning in 1998-99, and continuing the decrease throughout the projection period so that this is not a once-only reduction (and also taking into account the resulting reduced payments on the public debt), the grand result would be an additional reduction in the debt-to-GDP ratio of 2.80 percentage points by the year 2008-09. In contrast, the reduction due to economic growth over the same period would be approximately 40 percentage points.

Making additional payments against the debt would have very little effect on the total long-run debt burden because of the magnitude of the amounts involved. With a debt of \$583 billion and a GDP of \$846 billion, \$2 billion is not going to make a lot of difference in the debt-to-GDP ratio. The same can be said about the opposite alternative, i.e., spending more money. Increasing spending by \$2 billion results in an additional 2.80 percentage points of debt burden by the year 2008-09, but due to economic growth the debt burden still falls to 27.6 percent of GDP by 2008-09.

So, we should not be asking how quickly we can reduce our debt burden. Rather, the logical question we should be asking is: What is the most advantageous path for debt reduction given the best quantitative estimates available?

To answer this question, the trade-offs need to be considered. What would we lose by cutting more money out of

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