OTTAWA'S LOOMING FISCAL DIVIDEND

BY JOHN MCCALLUM

Under current policies and conservative economic assumptions, over the coming years federal government debt is set to decline sharply relative to the size of the economy. As this happens, it will become possible to have large tax cuts and/or increases in public services.

SIZE OF DIVIDEND

Here we focus on the size of the fiscal dividend in the years 2001-2 and 2006-7, which are (approximately) the final years of the mandates of this government and the next government. We use the figures from the last budget and assume base case growth of nominal GDP and government revenues equal to 4.0%. Debt charges are assumed constant to be at the level projected in the budget for 1999-2000 (since a balanced budget is projected for every year, the debt is assumed to be constant in nominal terms). Program spending is projected to grow at 3.3%, approximately equal to inflation plus population growth.

Under these assumptions, federal finances evolve as follows:

	1997/8	2001/2	2006/7
$Billion			
Revenue	147.5	172.6	210.0
Program spending	106.0	113.5	133.5
Debt charges	41.5	45.0	45.0
Contingency reserves	-	3.0	3.0
Fiscal dividend	-	11.1	28.5
Budget balance	0	0	0
Net debt	583.2	583.2	583.2
% of GDP			
Fiscal dividend	-	1.1	2.3
Net debt	68.1	58.1	47.8

Given the assumption that the government targets a balanced budget and that base case revenue and spending grow at the rates described above, the fiscal dividend emerges as the amount that becomes available to cut taxes and/or raise program spending to a level above the base case.

The numbers imply a fiscal dividend of some $11 billion, or 1.1% of GDP, by the end of the current mandate, rising to $28.5 billion, or 2.3% of GDP, by the end of the following mandate in 2006-7. To put these numbers in perspective, if all of the $28.5 billion were directed to lower personal income tax, it would be enough to cut tax rates by more than one-quarter. If it were all devoted to higher program spending, it would be enough to increase spending by about one-fifth.

A NOTE OF CAUTION

Over the past several years, the Finance Minister's job was to persuade Canadians to accept pain. In coming years, the job will be to persuade Canadians to limit the speed with which they absorb gains. Strangely enough, with the passing of an atmosphere of crisis, the latter job may prove more difficult than the former.

Certainly, however, it is essential to stress that the fiscal dividend cannot be spent in advance. To pre-spend the fiscal dividend is to invite a renewed upward spiral in the debt-to-GDP ratio, which would put at risk Canada's current record-low long-term interest rates. This in turn would remove the primary engine of the current economic expansion. With Canada's debt ratio second only to Italy's among G7 countries, we would become vulnerable to a loss of confidence on the part of Canadian and foreign investors. Recent events in Asia serve to underline the importance of this risk.

In the last election campaign, the NDP wanted higher taxes and higher spending, while Reform and the Conservatives wanted a smaller government and lower taxes. The Liberals were somewhere in between, and the Liberals got elected.

Some will argue that the assumptions underlying the last budget are too prudent, that we are probably heading for a sizeable surplus in 1997-98 rather than merely a balanced budget. That may well be so, in which case the debt ratio will come down faster than projected. On the other hand, one certainly cannot rule out the possibility of an economic downturn or an upward spike in interest rates at some point in the next 5-10 years. Consequently, I would argue that the amount of "cushioning" in the budget is appropriate.

HOW TO SPEND THE FISCAL DIVIDEND

Without forgetting the above cautions or *caveats*, I now turn to the question of how to spend the fiscal dividend or, as some would prefer to say, the putative fiscal dividend. In a democracy, the big decisions on this question are appropriately made by the citizens through their elected governments, not by economists. In the last election campaign, the NDP wanted higher taxes and higher spending, while Reform and the Conservatives wanted a smaller government and lower taxes. The Liberals were somewhere in between, and the Liberals got elected. That is how the central issue of "how to spend the fiscal dividend" gets answered, and appropriately so. Economists, however, do have modest contributions to make in this area, and I end with the following two points.

Over time, as the Canada-U.S. border becomes progressively less important, we are likely to experience an ongoing tension between pressures to equalize Canadian and U.S. taxes versus the desire of many Canadians to maintain a distinctive, and more expensive, social policy.

While an $11 billion fiscal dividend in 2001-2 sounds like a lot of money, it is only about 13% of projected revenues from personal income tax. So even if the government wanted to devote the whole dividend

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to a general income tax cut (which it doesn't), the best it could manage would be a 13% cut by the end of its mandate. The general conclusion is that there is not enough money for significant general tax cuts within the mandate of the present government—unless the government elected to further reduce program spending (which it isn't planning on doing). On the other hand, if our projections hold up, there will be much more money available in the next mandate, enough to produce a substantial tax cut as well as selective increases in program spending.

Suppose a decision were made to cut taxes by $x billion. Would it be better to cut income tax or Employment Insurance premiums? Lower EI premiums have the advantage that they would favour mainly people with relatively low incomes and that they are a "tax on jobs" (although the long-run impact on jobs is relatively modest to the extent that the incidence of the lower premiums falls on the employee rather than the employer). On the other hand, the fact that the burden of social security payments is lower in Canada than in any other G7 country, while Canada's personal income tax burden is the highest of all the G7 countries, is an argument for income tax reduction. Over time, as the Canada-U.S. border becomes progressively less important, we are likely to experience an ongoing tension between pressures to equalize Canadian and U.S. taxes versus the desire of many Canadians to maintain a distinctive, and more expensive, social policy.

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PAUL MARTIN VERSUS THE ALTERNATIVE: GRADING THE BUDGETS

BY JIM STANFORD

Finance Minister Paul Martin was not the only one to table a 1998 budget in Ottawa this past February. Two weeks before Martin brought down his historic balanced budget, the fourth annual Alternative Federal Budget was also released to reporters and parliamentarians. Sponsored by an alliance of over 50 national community, social, and labour organizations, the Alternative Federal Budget (AFB) has shown that it is possible to combine fiscal responsibility with social responsibility. Here are the grades that we might give to Paul Martin's latest effort, with corresponding comparisons to the AFB's rather different approach. The following table provides a quick comparison of the two budgets on several key indicators.

A Tale of Two Budgets: Paul Martin versus the Alternative (1998-99 fiscal year)

	Paul Martin's Official Budget	Alternative Federal Budget
Revenues ($billion)	$151 billion	$160.2 billion
Revenues (% GDP)	16.9%	17.8%
Program Spending ($billion)	$104.5 billion	$118.7 billion
Change from 1997-98 ($billion)	-$1.5 billion	+$12.7 billion
Debt Service Payments	$43.5 billion	$41.5 billion
Surplus/Deficit ($billion)	$3 billion surplus[1]	balanced budget
GDP Growth (nominal, %)	4.1%	6.0%
Net Debt (% GDP)	65.4%	65.0%

1. Assumes contingency fund not required.

ALLOCATING THE FISCAL DIVIDEND: "D"

A great debate has occurred in Canada since economists first concluded that the federal deficit was poised for quick extinction. With years of red ink soon to be replaced by large and growing annual surpluses, how should the government spend the money? Three broad options were presented: repay some of the accumulated debt, cut taxes, or rebuild the public programs (such as education and health care) that have been so damaged by spending cuts at the federal and lower levels.

Being good Liberals, Paul Martin and his government positioned themselves near the middle of this "triangle" of options: they would spend one-half on social programs, one-quarter on tax cuts, and one-quarter on debt repayment. Not surprisingly, this formula was not dissimilar from the preferences that Canadians themselves were revealing to pollsters. For example, the most recent national survey (conducted by Michael Marzolini for the federal Liberal party) suggested that Canadians would divide $100 of fiscal dividend as follows: $44 for social programs, $34 for debt repayment, and $22 for tax cuts. Other polls have produced similar findings.

In practice, however, Martin's budget has strayed far from both public opinion and his own formula (see figure). He cut taxes by $1.5 billion in the 1998-99 fiscal year, but he pays for this by *cutting* program spending by the same amount. The full fiscal surplus—which in practice will likely exceed $8 billion—is thus devoted to debt repayment. In contrast, the AFB allocates *all* of the latent surplus to the reconstruction of public programs. The AFB includes a major "tax relief" package for low- and middle-income households, but these are offset by higher taxes on well-off households and the business sector.

DEBT REDUCTION: "B-"

By slashing public programs, Paul Martin eliminated the deficit far faster than even his own supporters expected. And he now plans to use the bulk of coming surpluses to reduce the outstanding accumulated debt. This is winning him high marks for fiscal prudence from the financial community.

In practice, however, Martin is not achieving as rapid a pace of debt reduction as is possible—and indeed his own debt reduction timetable falls behind what is projected for the AFB, even though the AFB sets aside no funds for actual debt repayment. How is this?