DIVIDEND *from page 47*

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.

John McCallum is Chief Economist with the Royal Bank of Canada.

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?

The debt burden is most appropriately measured as a share of GDP. The real burden of a debt (like a household mortgage) depends on the income of the debtor. By growing nominal GDP at a faster pace (thanks to lower interest rates, rebuilt public programs, and a tolerance for moderately higher inflation), the AFB actually reduces the debt faster as a share of GDP, even though the dollar value of debt does not fall.

Financiers love Martin not because they were ever genuinely worried about government default, but rather because his fiscal strategy ensures continued small government, low inflation, and big capital gains for existing bondholders (since bond prices will rise as the stock of outstanding debt is reduced).

In contrast, by continuing to endorse the slow-growth, low-inflation economic strategy of the Bank of Canada, Martin ensures that nominal GDP will continue to expand quite slowly—thus making the task of debt reduction all the more painful. Financiers love Martin not because they were ever genuinely worried about government default, but rather because his fiscal strategy ensures continued small government, low inflation, and big capital gains for existing bondholders (since bond prices will rise as the stock of outstanding debt is reduced).

SUPPORT FOR PUBLIC PROGRAMS: "D"

Incredibly, despite the attainment of a balanced budget two years ahead of schedule and the imminent appearance of a large federal surplus, Paul Martin actually *cut* federal program spending for 1998 by another $1.5 billion. Program spending will thus fall to just over 11% of Canada's GDP—its lowest level since the conclusion of World War II, and notably smaller than similar figures for the U.S. Federal programs have thus retreated dramatically to levels not seen since before the introduction of the big-ticket social policy items (public pensions, medicare, modern UI, etc.) that defined Canada as a supposedly "kinder, gentler" place. For how long can we accept the myth that our society is still a "generous" one?

Even if Paul Martin followed his own 50:25:25 surplus allocation rule (which he is ignoring), federal program spending would at best stabilize at a much smaller share of our economy (see table on this page). One can almost feel sympathy for the efforts of Preston Manning to portray the Liberals as "big spenders": this is an impossible task for even the nimblest spin-doctor, so tight-fisted is this government.

To be sure, federal program budgets could have been even smaller. Program spending for fiscal 1997 would have totaled at least $3 billion *under* Martin's budget (due mainly to plummeting EI payouts). So Martin retroactively padded his budget with some modest new initiatives, including a phony one-time "payment" into the Millenium Scholarship Fund (money that won't even be released for at least 2 years). Perhaps a "truer" conservative would have locked the lower budgets in place and thus attacked the debt even more aggressively.

In contrast, the AFB would start to gradually rebuild federal program spending—to some 13% of GDP in the current fiscal year, and more thereafter. The spending programs contained in the AFB look large by current Ottawa standards (providing major funding for pharmacare, student grants, job-creation, and revamped transfers to the provinces, totaling over $12 billion in new spending for fiscal 1998). But in reality the AFB would only *partially* offset the historic cuts overseen by Martin.

DESIGN OF TAX CUTS: "B+"

In one respect, Paul Martin still differs from his even-more-conservative adversaries, the relatively progressive orientation of his tax policy. The bulk of the $1.5 billion in tax relief offered by his budget is targeted nicely at lower- and middle-income households—additional funding for the Child Tax Benefit, an increase in the basic personal exemption, and a targeted elimination of the 3% surtax. This contrasts sharply with the general income tax cuts recently implemented by several provinces (an approach which disproportionately concentrates the benefits of a tax cut among high-income earners).

[T]he fact that Martin financed his tax cuts with further spending cuts greatly undermines what would otherwise have been a progressive initiative.

Some of Martin's tax cuts are less progressive (and hence drag down his grade in this category). For example, he reduced the capital tax on large banks (hardly the neediest constituency in Canadian society today) and expanded RESP credits—a program which overwhelmingly benefits high-income families. The level of funding provided to the child tax benefit has been sharply criticized as inadequate. And the fact that Martin financed his tax cuts with further spending cuts greatly undermines what would otherwise have been a progressive

continued on page 50

MISSING THE MARK: PAUL MARTIN AND HIS TARGETS, 1994-98 ($BILLION)

FISCAL YEARS	BUDGETED DEFICIT	ACTUAL DEFICIT	DIFFERENCE
1994	39.7	37.5	+2.2
1995	32.7	28.6	+4.1
1996	24.3	8.9	+15.4
1997	17.0	0	+17.0
1998	0	(8 to 10 surplus)	+8 to 10
TOTAL			+47 to 49

initiative.

Nevertheless, the AFB's tax relief proposals were not entirely dissimilar from Martin's, although they were financed with new taxes on well-off households and businesses, rather than through further spending cutbacks. The AFB provided close to $10 billion in targeted tax relief, concentrated in the child tax benefit (which increased by $4.4 billion in 1998), the elimination of the 3% surtax, and lower tax rates for low-income taxpayers. The AFB showed that tax relief can be provided to working-class and low-income Canadians, but without undermining the revenue base of the public programs which are just as important to those same households.

HONESTY IN BUDGETING: "F"

One of the most worrying legacies of Paul Martin has been the deliberate and manipulative design of federal budgets for ideological purposes. Of course, every budget is a political document. But it should still be expected to provide a more-or-less accurate description of the state of government finances. This is no longer the case for our federal government. Its budgets have been so distorted with "contingency funds", deliberately conservative assumptions, program spending that isn't actually spent, and other accounting gimmicks, that they now completely fail to reflect the government's true fiscal situation.

Federal budgets are now written in code. They present one message to Canadians: first, that historic spending cutbacks were inevitable, and now that surpluses are actually very small so don't expect much in new social spending. But they portray another message to the Bay Street analysts and anyone else who is handy with a computer spreadsheet—those who can look behind the misleading assumptions of the official budget to see the true picture. That's why Martin has become such a hero on Bay Street: even his historically conservative budgets were in fact far *more* conservative than they appeared to be.

His 1997 budget overshot its deficit target by an incredible $17 billion. His first five budgets will have overshot their targets by a cumulative total of close to $50 billion (see table). This has come as no surprise to the financial community. But in retrospect it makes one wonder whether the government indeed "had no choice" but to cut annual program spending by $14 billion over the previous four years. If any corporation missed its own profit forecasts by such a margin, even in a positive direction, it would face sharp criticism from the financial analysts and traders who demand accurate and timely information. But in the case of government, despite its new "corporate" mode of functioning, this deliberate duplicity is encouraged.

The 1998 budget gives us more of the same. In theory, it is a "balanced" budget. The only "surplus" will arise if the $3 billion contingency fund is not needed. But in practice, the government will certainly run a huge surplus of $8 billion or more (see table on this page).

We can only hope that Canadians will learn from this past experience: when Paul Martin says there are no funds available to pay for health care, higher education, child poverty initiatives, or other essential services, he is quite simply lying. The charade of "fiscal necessity" has been removed from the budget-cutting process once and for all. When governments fail to act on the pressing social and economic issues of our time—health care, job creation, poverty, access to education—it is because they are *choosing* not to act. Canadians should hold them accountable for those choices.

SURPLUS BY STEALTH: PAUL MARTIN'S HIDDEN 1998 SURPLUS

AMOUNT	SOURCE
$3.0 billion	Contingency fund
$0.8 billion	"Prudent" growth assumption
$1.0 to $2.0 billion?	Revenue growth too slow (even under prudent growth)
$0.8 billion	"Prudent" interest rate assumption
$1.0 to $1.5 billion?	Debt service too high (even under prudent interest rate)
$1.0 to $1.5 billion?	EI benefits too low
$8 to $10 billion?	**TOTAL**

OVERALL GRADE: D+

This was supposed to be Paul Martin's "good news" budget. After almost 30 years, the red ink had finally stopped. The tough medicine had been swallowed. It was time for Canadians to take their reward.

But Martin's first post-deficit budget portends a still-grim future for most Canadians. It downsizes the real functions of government and the public sector even further. It leaves government smaller and defensive, and leaves most Canadians less protected against the dictates of a lean, mean, increasingly business-dominated economy. It accepts sluggish, tightly-constrained, unbalanced economic growth—the result of high interest rates and Bay Street's phobia of inflation—as a given. And the only big rewards are those being handed out to the financial community: debt repayment, rising bond yields, and a growing conviction that activist government is indeed a thing of the past (deficit or no deficit).

The deficit was a phony, but powerful, excuse for the unprecedented attack on public programs and services that has dominated Canadian politics in the 1990s. Now that the deficit is a thing of the past, perhaps Canadians will be more willing to look at the alternative.

Jim Stanford is an economist with the Canadian Auto Workers and Co-Chair, Macro & Fiscal Policy, Alternative Federal Budget.