VOLUME 4, NUMBER 3

JANUARY/FEBRUARY 1996

# CanadaWatch

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: THE HARRIS REVOLUTION IN ONTARIO

## SHORT-TERM PAIN FOR LONG-TERM GAIN: WILL IT WORK FOR MIKE HARRIS?

BY JAY KAUFMAN

Harris's neo-conservative revolution offers Ontarians short-term pain for long-term gain. According to the Common Sense Revolution (CSR), the gain is to be 725,000 jobs over five years, new investment, and renewed economic growth. Now, with the first installment of the CSR in hand, it is reasonable to ask whether the Harris government is likely to deliver on its economic promises.

The finance minister's fiscal and economic statement did three things. First, in addition to the earlier July spending reductions that were highlighted by a 21 percent cut in the social assistance rate, it announced deep multi-year funding reductions to the public sector. Second, it laid out multi-year deficit targets for a balanced budget in the fiscal year 2000-01. Third, it presented a set of economic assumptions and forecasts to underpin the province's fiscal plan for the next few years. What the statement did not assess were the risks to the economic forecast, except to say that its projections were conservative. Nor did it answer central questions about promised tax cuts: Will there be any, when, and how much? Despite hints of more to come, the statement assiduously avoided the issue of whether further expenditure reductions would be needed to meet the CSR's major tax-cut commitment on lowering personal income taxes.

### THE PAIN: TRANSFORMING ONTARIO'S PUBLIC SECTOR

Let us assess more carefully the impact of the spending reduction plan. Expenditure cuts now being implemented represent an 18.5 percent reduction in program spending from the level that existed when the Harris government took over. Cuts of this magnitude are by far the most severe in the history of public finance in Ontario and, in many instances, go well beyond anything attempted by the federal and other provincial governments, including Ralph Klein's Al-

*continued on page 46*

## WHY CUT TAXES NOW? WHY NOT?

BY MARK MULLINS

The current debate over Ontario fiscal policy seems to turn on the advisability of significant reductions in income tax rates, now that spending cuts are well in hand and the notion of continuing deficit reduction is generally accepted and underway.

On the left, the argument for no tax cuts starts and ends with a discussion of income distribution and notions of social equity and solidarity during times of government retrenchment. On the right, one hears the cry of no tax relief until balanced budgets are at hand. Both views are essentially arguments in support of the status quo, which was

*continued on page 48*

FEATURES



UNIVERSITÉ YORK UNIVERSITY

## SHORT-TERM PAIN FOR LONG-TERM GAIN *from page 45*

berta. And, unlike Alberta, which started its reduction program with the highest per capita spending in the country, the Harris government begins its task after Ontario has gone through three years of public sector restraint, the Social Contract, and per capita government spending that is among the lowest in the country. So even though it is difficult at this stage to be specific about the implications to the social and public-service fabric of the province that could flow from the November expenditure reduction program, we can be certain that the contraction in Ontario's public services is likely to be far more difficult and painful than it has been in other provinces.

The table below gives a sector breakdown of the November reduction plan. It demonstrates how deep, widespread, and protracted the cuts to the public sector will be. Almost the entire public sector is affected; the only areas that so far seem to have avoided the axe are some community health services and payments to physicians and lawyers. Funding reductions range from a one-year 9 percent spending cut to schools to a 48 percent cut in provincial municipal support over two years. Hospitals will be dealing with the fallout of the spending cuts for at least three years.

> *No economic model can fully capture the possible dampening effect on the economy of this kind of prolonged job insecurity among so many people.*

| Sector | 1995-96 Spending ($ millions) | Reduction $ | Reduction % | Time-frame |
|---|---|---|---|---|
| Municipalities[1] | 1,372 | 658 | 48 | 2 years |
| Schools | 4,444 | 400 | 9 | 1 year |
| Universities[2] | 1,829 | 280 | 15 | 1 year |
| Colleges[2] | 809 | 120 | 15 | 1 year |
| Hospitals | 7,243 | 1,307 | 18 | 3 years |
| Drug benefits[3] | 1,200 | 225 | 19 | 2 years |
| Agencies, boards, commissions[4] | 785 | 220 | 28 | 2 years |
| Other government grants[5] | 5,000 | 1,400 | 28 | 2 years |
| Business assistance government operations[6] | 4,300 | 1,427 | 33 | 2 years |

Note: The source for these figures is the DBRS Analysis of the Province of Ontario's Fiscal and Economic Statement (November 29, 1995).

1 Under the omnibus Bill 26, the *Savings and Restructuring Act, 1995*, municipalities are to be given extensive powers to introduce levies to help mitigate the impact of the cuts in provincial transfers.

2 Universities and colleges will be allowed to raise tuition fees up to 20 percent and 15 percent, respectively, to help offset these reductions.

3 Ontario's drug benefit program serves seniors and social assistance recipients. User charges and deductibles similar to those in other provinces are to replace the current no-cost features of the program.

4 Includes agencies such as the Ontario Arts Council, Ontario Science Centre, Science North, Art Gallery of Ontario, Royal Ontario Museum, and the Environmental Appeal Board.

5 Includes grants to sports, recreation, and cultural groups, environmental grants, and subsidies to GO Transit, among many others.

6 Reductions are to be achieved through streamlining operations, eliminating non-core government services, and privatization.

### DEEP JOB CUTS

We can also make an assessment of the impact of these spending reductions on public-sector jobs. The public-sector work force in Ontario is about 900,000 strong, roughly one job in four in the province. When the Rae government introduced the Social Contract, it estimated that the $2 billion it was trying to save by this measure would protect some


# CanadaWatch

PRACTICAL AND AUTHORITATIVE ANALYSIS OF KEY NATIONAL ISSUES





**Production**
WordsWorth Communications

*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, or write to
*Canada Watch*,
227 York Lanes, 4700 Keele St.,
North York, Ontario
M3J 1P3.



**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)





Printed in Canada

ISSN 1191-7733

20,000-40,000 public-sector jobs. Applying this arithmetic to the Harris expenditure reduction plan would mean that between 60,000 and 120,000 public-sector jobs are at risk. Within the Ontario government proper, which now accounts for less than 10 percent of public-sector jobs, it is estimated that more than 20,000 public servants, or about one-quarter of the work force, will face layoffs.

One can get a better sense of the economic significance of these potential job losses when one realizes that, at the peak of the last recession, the entire economy lost about 200,000 jobs in the two-year period 1990-91. In the current situation, the magnitude of the possible dislocations and the prospect that projected job growth over the next few years will barely keep up with the number of new entrants into the labour force, suggests that most of Ontario's 900,000 public-sector workers feel their jobs are at risk. No economic model can fully capture the possible dampening effect on the economy of this kind of prolonged job insecurity among so many people.

It is possible that, as Ontario's public-sector workers come out of the Social Contract and go into bargaining this spring, they will trade lower job losses for rollbacks in compensation. Such an outcome would certainly be less harmful to the economy than massive layoffs, and the financial losses among the public-sector workers would be somewhat offset if Harris followed through with promised tax cuts. But for employers to reach their financial targets with minimal layoffs, compensation reductions would have to be in the double digits, and these are unlikely to be given willingly, or without strife. If widespread wage reductions in the public sector were an intended outcome of the Harris government's fiscal strategy, they have chosen the most difficult and economically costly way to get there. It is unlikely that this point escaped the notice of decision makers, which suggests that the real fiscal agenda of the Harris government is as much about the deconstruction of the public sector as it is about managing the province's financial problems.

*The issues now are fairness and what is most beneficial to the economy.*

## TAXES AND DEFICITS

The tax cut on personal incomes is the political and economic centrepiece of the CSR. Its ultimate value to the taxpayer, which has never been openly stated by the government, will partly depend on the growth in personal incomes over the next few years. But if implemented roughly in line with the CSR, it would likely put $5-6 billion back into the hands of taxpayers. Early on, despite the support it got from Ontario voters, this tax move was roundly criticized as misguided for the damage it would cause to Ontario's social fabric and the prospects for economic growth and jobs. Today, many of the same commentators maintain that, with the spending decisions now being made, the tax cut is essential to counter the economic damage of the government's actions on expenditures. The issues now are fairness and what is most beneficial to the economy.

Whatever one's view of the tax cut, the real question is whether it can be accomplished within the budget deficit targets presented in the November statement. Rating agencies, such as Standard & Poor's, have publicly made it clear that if the government abandons its deficit-reduction plan, the provincial credit rating would be downgraded. Faced with a stark choice between sticking to the deficit targets to preserve its "double A" rating or going ahead with a tax cut, it is likely the government will opt for the former because a downgrade to a "single A" rating — apart from exacerbating the province's borrowing problems — will be a powerful symbol of failure of the Harris plan.

In its analysis of the November statement, the Dominion Bond Rating Service concluded that the spending cuts provided sufficient flexibility for at least the first stage of the tax cut on personal incomes to proceed. But this is true only if the economic assumptions of the government's fiscal plan hold, and the federal government resists the temptation to further reduce transfers to the provinces. As for implementing the tax promise, it is likely that $2-3 billion, or 5-10 percent, of further reductions in program expenditures would be needed to fully finance a 30 percent tax cut over the next three years while preserving deficit targets. If this course of action is chosen — and one strongly hopes it will not be — the additional fiscal drag on the economy will be substantially greater and more prolonged than forecasters are currently predicting.

## THE GAINS: JOBS, INVESTMENT, AND GROWTH

The proclaimed goal of the CSR was to restore fiscal and economic health to Ontario. How does it fare?

### Jobs

The Harris government has made a commitment to create more than 725,000 new jobs by the end of the decade. According to the November statement forecasts, the number of new jobs to be created is likely to be about 60 percent of that number, which translates to high rates of unemployment in Ontario throughout the rest of the 1990s with no relief from the cost pressures that unemployment exerts on government finances, especially programs like social assistance.

### Investment

The November statement indicates only a modest pace of improvement. Housing starts are to be up after a disastrous year, but will reach their 1992 level only in 1997. At this same point, non-residential construction will still be well below the 1992 level of investment. Despite improved company balance sheets and stronger profit positions, the rate of increase in new investment in machinery and equipment, essential to strong long-term economic growth, is projected to steadily decline over the next few years, falling from 17.4 percent in 1995 to 8.5 percent in 1997.

### Growth

With some measure of a tax cut factored in, the provincial economic forecasters see real GDP in 1996 rising slightly over the projected 1995 level of 2.1 percent, but moving up to 3.1 percent in 1997 and staying around that level for the remainder of the decade. If accurate, despite massive and painful restructuring of Ontario's economy and its public sector through the CSR, the average rate of growth for the next five years will remain well below that of the past four decades. In nominal terms (which is what matters for provincial revenues), and because of extremely low inflation,

*continued on page 48*

## SHORT-TERM PAIN *from page 47*

growth is expected to remain below 5 percent, which means there will be a tight lid on natural revenue growth.

### THE TIGHTENING SCREWS

The finance minister presented these economic indicators as prudent assumptions for fiscal planning purposes. Unfortunately, since November, largely on the strength of government austerity, the consensus forecast on Canada's economy has been moving steadily downward, to the point where economic growth for 1996 is now being projected at between 1.5 and 2.0 percent, placing the consensus forecast well below that of the Ontario government. For 1997, some economists, such as James Frank of the Conference Board of Canada, are scaling back their predictions for growth in Canada to about 2 percent, which would pull Ontario's projected growth rate a full percentage point lower than the 3.1 percent guiding provincial fiscal planning. There are also indications of weakness in the American economy that, by negatively affecting exports, would erode the single most important source of Ontario's recent economic growth.

*If the emerging consensus on sharply lower rates of growth is right, Mr. Harris is confronting a deepening fiscal crisis that may carry the thorns of a political one as well.*

If the emerging consensus on sharply lower rates of growth is right, Mr. Harris is confronting a deepening fiscal crisis that may carry the thorns of a political one as well. A much preferred and less damaging course would have been a fiscal strategy that focused on jobs while preserving the province's revenue base and steadily bringing the budget into balance.

Ironically, like the Rae government before it, Harris's Tories have in their first budget outings constructed a fiscal box for themselves that will drive their fate for the remainder of this mandate. There are initial signs that the fiscal and economic screws on this box are tightening. Without continuing growth in the United States to pump Ontario's exports and sustained lower interest rates to strengthen consumer demand, these signs of deteriorating economic prospects will become a certainty. Unlike his predecessor, perhaps the new premier will get lucky and the economy will turn to a more positive note. If the premier gets the fiscal room he needs to meet his deficit targets and follow through on the bulk of his tax cuts, it will be the "hands on the economic throttle" in Washington and at the Bank of Canada, rather than the Harris Revolution, that will largely have been responsible.

*Jay Kaufman was deputy minister of finance in the former NDP government of Ontario.*

## WHY CUT TAXES NOW? WHY NOT? *from page 45*

widely recognized by taxpayers as unacceptable before the June 8 provincial election. Let me be more specific by listing, in no particular order, the key arguments in favour of a tax rate cut now.

### THE 30 PERCENT TAX RATE CUT

The government committed to a significant tax cut; people voted for the party on that basis, and it is fundamentally undemocratic not to meet this campaign promise that was mandated by Ontarians. It is also politically dangerous, given the continuing mood of mistrust between elected officials and the electorate.

According to figures released with the government's November economic statement, one can infer that there is roughly $2 billion in fiscal room for a fiscal tax cut in 1996. At the same time, the deficit is projected to fall from $11.2 billion in the prior fiscal year to $8.2 billion. Success at cutting taxes and the deficit at the same time hinges on two factors: significant spending reductions and a modicum of economic growth, both of which are likely.

### TAX RATES ARE TOO HIGH

The top marginal rate of income tax in Ontario is now over 53 percent, the second highest in North America, and it begins to bite for those at gross income levels just under $68,000. The impact of having government as the majority shareholder in each top marginal dollar earned means that fewer marginal dollars of income are generated. Tax rates affect the return to human capital, the incentive to work and invest, labour cost competitiveness, and productivity. Lower tax rates will improve the economy's efficiency by reducing the tax distortion of those factors.

Real disposable income will rise, thus increasing consumption, and the portion of income saved will add to the economy's capital stock. Reliance on foreign savings will also diminish due to a more favourable domestic savings-investment balance. A faster-growing economy is more likely to create higher employment in the private sector. The improvement to business confidence from lower taxes and deficit control may also be a contributor to faster economic growth through corporate investment.

Despite the popular myth that above-average income earners do not pay their way, deduction at source, few significant tax shelters, and a progressive income tax system result in the tax burden rising sharply with income. High tax rates encourage tax avoidance through growth in the underground economy and weaken political support for redistribution policies.

### THE STRUCTURE OF THE TAX CUT IS EQUITABLE

The tax cut will benefit all working Ontarians and increase the incentives for those currently unemployed, or outside the labour force, to become employed. Tax increases through the 1980s hit middle- and upper-income earners disproportionately as rates and progressivity increased. The tax cut will push many individuals below the two-income tax surcharge thresholds. As well, the proposed Fair Share Health Care levy, which is steeply progressive and begins at a gross income of $50,000, ensures that proportional benefits are pushed back into the hands of the middle-class taxpayer. In sum, the net tax cut increases progressivity at the same time that rates are lowered for everyone.