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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-

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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

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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.

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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.

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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.

Most opponents of a tax cut are not actually in favour of raising taxes or keeping rates unchanged. They argue, rather, that the tax cut should come after the budget is balanced. However, the logic of this line of reasoning is flawed. It can be shown that, of the two policies that balance the budget at the same pace and cut taxes and spending, but differ only according to the timing of the cuts, the policy with the earlier cuts is less costly in present-value terms. This is because part of the tax cut is saved in an economy with relatively high real rates of interest and relatively low economic growth, thus compounding the value of early savings over time.

Those who feel uncomfortable accepting a tax cut are free to choose to return the funds to the government or to a charity at the nominal cost of writing a cheque.

THE POLITICAL CYCLE ARGUES FOR TAX CUTS NOW

The inclination for any government to effect policy change is greatest early in its mandate because resolve is high, the politicians are fresh, the civil service is receptive, and re-election concerns are well beyond the normal planning horizon. As time goes on, the natural tendency is to become less proactive, to protect the status quo, and to put forward a less politically risky agenda. As well, for taxpayers, "a tax-cut bird in the hand is always worth two in the bush."

Taking money out of the hands of the government forces bureaucrats to rank priorities and define core business services with the remaining funds, thus increasing the odds of a more efficient restructuring of spending patterns. As found in other restructured institutions, the greater the cost reductions, the greater the role for fundamental change in customer service delivery. Concern for the reaction of credit rating agencies to inadequate deficit reduction forces the government to fully and realistically fund the tax cut through expenditure reductions.

More money in private hands allows individuals to make spending and saving decisions, rather than leaving this to bureaucrats or politicians. Those who feel uncomfortable accepting a tax cut are free to choose to return the funds to the government or to a charity at the nominal cost of writing a cheque.

So, the critical reasons for cutting tax rates now are that the government promised to do it, the government can afford to do it, the cut will benefit economic growth and help the government do more with less, the early timing is appropriate, and personal choice is enhanced. The alternatives of maintaining or raising already excessively high tax rates have been soundly defeated by the electorate and public opinion.

Mark Mullins is chief economist at Midland Walwyn Capital Inc. and is one of the architects of the Common Sense Revolution.

EDITORIAL

BUILDING COMMON GROUND: THE POLICY OF CHOICE

BY DANIEL DRACHE

There is an urgent need to re-examine, in the most fundamental way, Canada's political and economic structures. The emergence of a modern Quebec — strong, assertive, and politically poised to leave Canada — has closed the door forever on Confederation as we have known it. To most English Canadians, the present impasse is still something of a mystery, something they didn't think could happen, and something they don't want to admit has happened.

This is not, however, the mood of English-speaking Canada. It desperately wants to believe that, somehow, Quebec will stay in Confederation and Canada will be saved. It doesn't want to confront the hard issue of what its relations with Quebec should be or tackle the larger question of the need to restructure the country with or without Quebec. This retreat from reality has now become part of the crisis of Confederation. Yet this political numbness, so much in evidence in many circles in English-speaking Canada, was predictable because English Canada has not found a way to rethink its collective future without embracing economic fundamentalism. Now it is paralyzed on two fronts: economic reform and the constitution. Why are these mega-issues on an irreversible collision course?

TURNING THE PUBLIC AGENDA ON ITS HEAD

Everywhere, governments are reviewing their social programs and fiscal priorities. Social expenditure is one of the largest responsibilities of provincial governments, and the elections of the Harris and Klein governments have triggered unprecedented changes to health and education programs, social services, and social assistance. Queen's Park and Edmonton have embraced an extreme version of the current rhetoric that says markets count more than the state. The result is that the country's social programs and the public sector are not being restored to a state of fiscal health, but are only subject to across-the-board blind cutting. The complication is that no government can make these kinds of mega-reductions on such short notice without impairing its own viability. Not surprisingly, this is exactly what is happening. At all levels, government is getting out of government.

Canada's political institutions have been strangled by an extreme form of economic liberalism that cannot deliver jobs, economic growth, or a recovery.

So far, the consequences have been dramatic. Canada's political institutions have been strangled by an extreme form of economic liberalism that cannot deliver jobs, economic

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