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 reexamine, 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

continued on page 50

growth, or a recovery. In the aftermath of Ottawa's fiscal and social policy review, Canadians are told daily that less state now defines best practice. But, will any government have the resources to enforce national standards in health and social welfare programs? How will weaker provinces deliver provincially funded social policy? Which public authority is going to provide Canadians with the skills and resources to succeed in a world of intense international competition?

Ottawa has few answers of substance. Only the economic fundamentalists have a stock reply that everyone has to do more with less. Critically, this cliché does not apply to public authority. The anti-state crowd is wrong about the future of state policy in a borderless world. The best evidence shows that the state should provide innovative leadership because in the new era of global competition, economics and politics are more closely linked than ever. With the swings of the business cycle so pronounced, no government can afford to be a passive bystander, or to voluntarily give up more than it is getting in real benefits. So far, this pragmatic message has fallen on deaf ears. Ottawa and the provincial governments continue to "dream trade" and expect windfall benefits from the restless pursuit of foreign markets. In the meantime, the economic foundations of state policy continue to crumble.

A WEAKER ECONOMY

Less government, fewer taxes, weaker social programs, and impressive private wealth creation have not strengthened the economy where it matters. Canadians now face an unparalleled crisis in trying to cope with a massive reduction of federal funds from the social envelope. In the last decade, Canada has seen a persistent decline in its manufacturing industries, and a dramatic increase in part-time and casual employment, along with a decline in family incomes. Even government spending has not been anything close to excessive. In 1972-73, transfers to persons were equivalent to 5.1 percent of GDP. They fell back to 4.9 percent in 1989-90 before climbing back up to 6.1 percent as a result of the present economic crisis. Government spending has been modest but rising persistently. Our economic crisis is not, strictly speaking, due to an excessive "burden" of government. In 1995, Canada's deficit as a percentage of GDP was less than Germany's. If Canada wants to compete with its competitors, Ottawa should be spending more on jobs and social capital with the surplus funds — not less.

The intractable problem is that Canada has a mountain of debt because the economy is weak and interest rates are higher than they need be. The Bank of Canada's tight monetary policies under John Crow have left Canada awash in debt. When a country no longer generates the wealth it needs and governments no longer have an expanding revenue base, a vigorous public sector cannot be maintained for long. Services, public employees, and investment in the future are cut back or eliminated in whole or in part. The central issue is that there is a powerful link between the level of social spending and economic prosperity. Economists have devised sophisticated measures to study wealth creation in relationship to total factor productivity growth; that is, the individual contributions of labour, technology, and capital to a strong national performance.

The long-term productivity figures for Canada are particularly sobering in this respect. Canada's total factor productivity was one of the worst of all the G-7 countries. Between 1960 and 1973, total Canadian factor productivity bounced along at a respectable 2 percent per year. Since then, its rate of growth has declined in each period: from 1973 to 1979, it grew at only 0.8 percent; from 1979 to 1993, it showed zero productivity. No wonder, then, that the innovative capacity of the economy is stalled and, along with it, public policy.

Fifty years ago, the central challenge that faced Canadians was that their governments spent far too little money on social policy and far too much on promoting economic development for the banks and resource monopolies.

TOO MUCH OR TOO LITTLE GOVERNMENT?

Fifty years ago, the central challenge that faced Canadians was that their governments spent far too little money on social policy and far too much on promoting economic development for the banks and resource monopolies. There was none of the "burden of government" that haunts public policy makers today. The problem was the reverse — too little government, not too much. What bureaucracy there was, was ill-equipped and under-resourced to face the responsibilities of the modern state. Not surprisingly, modern welfare entitlements were rudimentary or non-existent and employment standards pitifully low. Canadians had a standard of living 40 percent less than that of their American counterparts. The state structure that grew up after World War II was a mixture of laissez-faire beliefs grafted onto a system of Keynesian welfare federalism that was intended to correct the economic distortions of resource-based development and weakly organized state institutions.

On the eve of the 21st century, Canada is beginning to resemble the Canada of 1900, with a bare-knuckle style of government facing a host of intractable challenges.

At the top of the list is the crisis in Canada-Quebec relations. Will a dramatically downsized federal government be able to withstand Quebec's demands for its own state? With government everywhere reduced to a second-order actor, will these new developments enable Canadians to address the global challenges before them? As family incomes decline further, more Canadians fall below the poverty line. Is this the best Canada can do? Is this what we want? If there is no viable concept of government in Canada, there will be no one to articulate English Canada's self-interest to build a common ground with Quebec.

The simple truth is that Canada is dying, not because it is inevitable, nor because Quebec and Canada have reached the point of no return. Even if Quebeckers are no longer won over by moderate options, the roots of the present crisis are much deeper and more difficult to untangle. Strident appeals to national unity are not likely to breathe new life into Canada's political and economic system. Far from it. What is happening is that tugging at one thread now causes the rest of the body politic to unravel more quickly. What then is our best hope in the face of a dysfunctional federation?

FINDING THE COMMON GROUND: THE NEED FOR PLAN C

Getting out of the present cul-de-sac requires demolishing old psychological barriers and stereotypes. Canada can no longer afford to live in a world of legal and political fictions. Even if history cannot be undone, a country's institutional arrangements can be made or unmade, revised or overhauled when the old order has to give way to the new. This means finding out how the federation has to be reorganized so that it functions as a country no longer at war with itself. Stock-taking has many elements, but four critical areas of state policy are key:

The 1982 Constitution made provincial rights the keystone of Canadian federalism and this has changed the theory and practice of Canadian federalism at Quebec's expense.

The 1982 Constitution

The 1982 Constitution made provincial rights the keystone of Canadian federalism and this has changed the theory and practice of Canadian federalism at Quebec's expense. Should we continue with the 1982 settlement? Or do key provisions that deny Quebec's bi-national status need to be scrapped? Do we want a country in which provincial premiers, never elected on constitutional issues, become the principal gatekeepers of the Constitution?

A New Partnership with Quebec

If Confederation collapses, it will be due to the fact that two national entities cannot live within a set of uni-national political structures. At a minimum, Canadians need to know more about any new kind of partnership before they decide whether a new relationship is feasible and possible. Is there a need for a new social and political union? What does economic partnership entail with respect to the core issues such as NAFTA, debt and deficit, social policy, and citizenship? Political partnership is a second phase. What kinds of political models of partnership are on offer? Which, if any, suit both our needs?

Social Policy

Canada's social programs have long been the cement of modern confederation. Government must provide the people with the means and resources to make decisions about the present and the future. Preserving our social cohesion in a globalized economy is the keystone of society. What new principles, practices, and values will improve the social well-being of the majority? What kinds of policies are needed to enable Canadians and Quebeckers to address their growing social deficit?

North American Integration

In 1988, Canada signed the Free Trade Agreement and later joined NAFTA to create

continued on page 52

THE ECONOMIC RATIONALE FOR THE ONTARIO WELFARE REDUCTIONS

BY JACK CARR

The current social assistance system in Ontario involves two programs: General Welfare Assistance (GWA) is for shorter-term cases, such as employable singles and families and those experiencing temporary ill health, and is delivered primarily by municipalities; *Family Benefits Act* (FBA) allowances are paid to specific categories of people such as sole-support parents, persons with disabilities, those permanently unemployed for medical reasons, and the aged.

On October 1, 1995, the Ontario government reduced welfare rates. The FBA rates for all recipients, other than the disabled, permanently unemployed, and aged, were reduced by 21.6 percent. For this welfare reduction to be properly assessed, it must be placed in the appropriate historical context. A single employable individual received $202 per month in GWA benefits at the end of 1980, and $663 per month at the end of 1994. On October 1, 1995, the same individual received $520 per month. Clearly, individuals received more social assistance in October 1995 than they did in 1980. However, this increase in income from social assistance does *not* mean that individuals are better off in 1995 than they were in 1980; prices of goods and services have increased from 1980 to 1995.

The table below presents social assistance rates in real terms, after adjusting for the effects of a changing price level, and measures all social assistance rates in terms of June 1995 dollars. The Consumer Price Index is used to arrive at the real rates. For ease of comparison, real social assistance rates for 1981 are set at 100. The number in any year in the table can be interpreted as the level of real social assistance expressed as a percentage of the 1980 level. For example, the index number of 125 for single employable individuals in 1984 means that real social assistance rates in 1984 were 125 percent of their level in 1980. In other words, real social assistance rates increased 25 percent from 1980 to 1984 for single employable individuals.

The table shows the trend in real social assistance rates in Ontario since 1980. For *all* seven cases, real social assistance rates increased from 1980 to the early 1990s. In 1994, in all seven cases, real welfare rates were anywhere between 46 percent and 69 percent higher than they were in 1980. Real Ontario welfare rates increased *substantially* from 1980 to 1994. Welfare recipients in 1994 were *substantially* better off in 1994 than they were in 1980.

The economic well-being of welfare recipients improved from 1980 to 1994, not only in an absolute but also in a relative sense. Data reported in Statistics Canada *Family Income* (#13-208) show that average Ontario family real income increased 2.5 percent from 1980 to 1993. Although the average Ontario family real

continued on page 52

BUILDING COMMON GROUND: THE POLICY OF CHOICE

from page 51

a continental common market with the United States and Mexico. These agreements are no longer about trade, but about reorganizing state policy on a continental footing. Eight years later, no government has made a major assessment of this fundamental change in economic and social orientation of the Canadian federation. Canadians need a full-scale study of the costs and benefits of trade liberalization. Has trade liberalization worked to Canada's advantage? To Quebec's? What new problems have emerged? How should this conditioning framework be adjusted to address these new realities?

It is only by having full answers to these critical issues that reconfederating Canada will happen. Plan C is the third option — finding common ground that is acceptable to both English Canada and Quebec. Is investing in such a national effort not worth one last try?

In the coming days, all of us will have to choose. If not, complex events inevitably chart their own course.

Daniel Drache is director of the Robarts Centre for Canadian Studies and professor of political economy at York University.

THE ECONOMIC RATIONALE

from page 51

income increased slightly from 1980 to the early 1990s, social assistance real income increased substantially during the same period.

The table shows that even after the cuts in social assistance rates in October 1995, real social assistance rates are still significantly higher now than they were in 1980. In the seven cases, real social assistance rates are anywhere between 18 and 43 percent higher in October 1995 than they were in 1980. Considering only the cases of the non-disabled, real social assistance rates are 18 to 29 percent higher in October 1995 than they were in 1980.

The welfare reductions of October 1995 have returned real welfare rates back to the levels that existed in the mid-1980s.

From a historical perspective, real welfare rates are higher in October 1995 than they were in 1980, and are currently at about the same level as they were in the mid-to late-1980s. The welfare reductions of October 1995 have returned real welfare rates back to the levels that existed in the mid-1980s.

ADVERSE INCENTIVE EFFECTS OF INCREASED WELFARE RATES

The table shows that welfare rates increased substantially from 1980 to 1994. Increases in welfare rates can have adverse incentive effects. Consider the case of employable low-income individuals who, because of bad economic times, receive social assistance. Individuals compare incomes from various options. As social assistance rates increase and, as a result, income from social assistance increases relative to the income that could be earned in the labour market (or, equivalently, if labour market income falls relative to social assistance income), there is an increased incentive for individuals to stay on social assistance and not participate in the labour market. This incentive exists even when economic conditions improve and jobs become more plentiful. High welfare rates relative to labour market income can, thus, result in a "welfare trap."

A significant increase in social assistance rates will lead to a reduction in labour force participation rates and an increase in social assistance cases. When individuals stay out of the labour force and become welfare dependent, this has negative economic consequences for the economy, for the following two reasons.

First, if employable individuals stay out of the labour force and on social assistance, there are fewer people engaged in productive labour market activity and, as a result, total output is reduced. Second, if fewer working individuals have to support more individuals on social assistance, tax rates on working individuals and businesses will increase. Higher tax rates will themselves cause individuals to want to reduce their work effort, and will provide an incentive for business to seek alternative, lower-tax jurisdictions in which to operate.

Firms today are very mobile; with the North American Free Trade Agreement (NAFTA), Ontario firms can locate their plants in the United States or Mexico and still sell their goods duty-free in the Ontario market.

What is crucial to the work-versus-welfare decision is the income level obtained on welfare compared to the income level obtained from work.

If firms leave Ontario for a lower-tax environment, this will result in lower levels of employment, output, and economic well-being for the average Ontario resident.

In 1981, the total Ontario social assistance caseload was 197,491 (a total of 379,771 beneficiaries). By 1994, the total number of cases was 673,010 and the total number of dependents stood at 1,329,415. This dramatic increase in cases and beneficiaries cannot be explained solely by population growth. From 1981 to 1994, the Ontario population grew by 24 percent, while the total caseload increased by 240 percent and total number of beneficiaries increased by 250 percent. In 1981, total beneficiaries represented 4.3 percent of the Ontario population but, by 1994, they represented 12.1 percent. By 1994, approximately one out of eight Ontario residents was on social assistance.

This increase in social assistance cases cannot be explained solely by the economic recession. The Ontario and Canadian economies were in recession at the beginning of the 1980s. As a consequence, one would expect higher welfare caseloads during these recession years. The Ontario and Canadian economies exhibited substantial growth in the period from December 1982 to March 1990.