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SPECIAL ISSUE ON THE FISCAL DIVIDEND

FISCAL RELIEF?

BY DANIEL DRACHE

For this special issue of *Canada Watch*, we have asked some of Canada's leading "Think Tanks" consultants to comment on whether the 1998 budget is, in fact, as "good as it gets" now that Ottawa has a record fiscal surplus to spend. Don't hold your breathe that Martin's good-times budget gets a high grade from these experts. Think Tank experts on the Left as well as the Right are not in his corner cheering for good reason.

Despite their obvious ideological differences, what disturbs them is that there are few satisfactory answers in the budget documents to the important issues that matter: should government be spending more or be taxing less? Should it be looking to market-based solutions to reduce Canada's high unemployment or should it be doing more itself? Should it continue its rigid zero-deficit target, or do more to ensure that fiscal and social policy work together rather than against one another? Should it cut taxes for the middle and upper classes or should it make health, education, and the environment top spending areas?

THE CORE ISSUES

Instead, Martin's budget assumes that Canada will be a narrow-gauge performer in the U.S. market relying on its embattled labour market to give Canadian business a competitive advantage in the global economy. Canadians are entitled to know the kinds of innovative measures the government is intending to rebuild the nation's social capital. Powerful integration pressures from corporate restructuring and NAFTA continue to drive a wedge between Canada's rich and poor regions, and between new entrants entering the job market and the previous generation of job-holders.

Restoring the cuts to Canada's social programs should have been at the top of Martin's agenda. After all, social spending is the largest expenditure of the national government. More than one-half of all program spending in recent times involves cash payments to individuals or other levels of government. In

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BUDGET FAILS TO ADDRESS THE ISSUE OF THE IDEAL TAX RATE

BY MICHAEL A. WALKER

The federal budget package of 1998 deserves to be applauded for having delivered, as Paul Martin kept promising, a balanced budget and indeed budget surpluses. It would take a very careless person, particularly ignorant of recent fiscal history, not to note what an accomplishment this has been. I need to draw particular attention to this, since it may be easy to forget the good news when we get into the body of this article which discusses what the budget did not contain.

First, we need to remind ourselves that the federal government has been, on the whole, a reluctant budget balancer. By comparison with the ten provincial jurisdictions, the federal government was a laggard and was regularly the worst performer in the Fraser Institute Fiscal Performance index, which attempts to rank the federal and the provincial governments. Even as fiscal balance has been approached, the path has been quite differ-

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1998, more than $70 billion was spent in direct payments to people including the elderly, the unemployed, and the needy. Despite more than a decade of cutting back program spending, Canadians want better government, a new kind of state, and optimism for the future. So far, they have little grounds to be reassured.

LESS GOVERNMENT, MORE INEQUALITY

Canada's social programs are less able than ever to cope with the complex demands placed on them. Ottawa is spending less on education, health, and welfare than it did two decades ago. Federal program spending now amounts to about 14 percent of GDP, way down from what it was.

Take another measure, that of capital spending: with the recovery, capital spending is actually slowing down rather than speeding up. StatsCan predicts an increase of about one-half of last year's gain. This demonstrates that there is less of a link between macro-policies and micro-investment decisions. Canada's manufacturing sector is turning in record profits from a cheap dollar and surging exports, but is spending precious little on reinvestment. So the increase in new spending is up by only 1 percent, despite all the tax breaks in this budget.

Over the next three years, Martin proposes to reduce federal taxes by $3 billion dollars and much of that is for upper-income earners. This is indeed an unlikely priority, because Canada's top marginal rates (51.6%) are similar to those of France, Germany, Italy, and Japan.

On the tax front, Martin is looking to cut taxes and bring relief to upper and middle classes. He predicts federal taxes will fall as government surpluses grow, and believes that the rich are the most needy and first in line for tax relief. Over the next three years, Martin proposes to reduce federal taxes by $3 billion dollars and much of that is for upper-income earners. This is indeed an unlikely priority, because Canada's top marginal rates (51.6%) are similar to those of France, Germany, Italy, and Japan.

By contrast, there is now a real problem of high marginal tax rates for people near the bottom. The Department of Finance calculates that those making between $25,000 and $40,000 can face a marginal tax rate of up to 70 percent because of the loss of so many federal and provincial income-tested credits and benefits. What has been taken away from these individuals is the GST tax credit, the child tax credit, and the proposed Senior's Benefit. This is why, in part, inequality and wage polarization are on the rise. Many core redistributive programs no longer exist and incomes now are set by market forces.

Finally, Martin has a lot of explaining to do with respect to what is happening to wages and profits. If once they used to move in tandem, they do so no longer. Since 1993, wages and salaries, the broadest measure including the non-unionized private sector, edged ahead by a mere 13.6 percent, while corporate pre-tax profits rose by 104%.

Canadians have a right to be sceptical about Canada's future based on non-inflationary expansion. Canada's growth has been fueled by a cheap Canadian dollar, lower interest rates, and the U.S. recovery. This kind of model requires governments to constantly do a lot of tightening to restrain the pace of economic growth.

Business share of total national income has surged and now is close to 10% of the national income. These figures are troubling, because they reveal that wages are increasingly downward flexible, and

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that income inequality is a permanent fixture of the Canadian scene as fewer workers succeed at the bargaining table. With more people working in non-unionized settings, wages reflect the highly competitive nature of these labour markets. One consequence is that the gender gap is back in full force. Forty percent of women in the service economy earn somewhere between $6.50 and $7.50 an hour, a paltry two-thirds of the national hourly wage of $9.30.

Canada is one step closer to a zero deficit, but no closer to having a healthy economy and a government capable of promoting national ends.

A HARD LANDING AHEAD?

Canadians have a right to be sceptical about Canada's future based on non-inflationary expansion. Canada's growth has been fueled by a cheap Canadian dollar, lower interest rates, and the U.S. recovery. This kind of model requires governments to constantly do a lot of tightening to restrain the pace of economic growth. This applies primarily to the labour market, where wages have to be racheted down. It means relying on the export sector to drive the economy where there are fewer and fewer people working at highly paid employment. It also requires de-taxing the middle and upper classes to ensure that investment spending does not falter.

Canada is one step closer to a zero deficit, but no closer to having a healthy economy and a government capable of promoting national ends. On the issue of governance, Martin gets a fat "F". He is no longer committed to reinventing the state, a former policy passion that he used to share with Lloyd Axworthy when he was the Minister of Human Resources Development.

Why then so little progress on the "big picture" questions?

The fact is that Martin's notion of economic renewal is still a mirror image of Mulroney's basic idea that Canada needs a massive devolution of Ottawa's powers to the provinces, a smaller role for government, and a large role for the private sector in the national affairs. What some *Canada Watch's* policy wonks object to is that Martin continues to treat deficit reduction as a technical problem for economists and government specialists. Here too Martin gets a low grade. Deficit reduction is all about politics, the choices to be made, and the different options open to the government depending on the way they conceive the defining elements of state policy.

A BRITTLE GROWTH MODEL

In today's volatile world, Martin's model of economic growth is likely to prove painfully brittle. U.S. growth has been fueled by the irrepressible rise of the stock market there. If U.S. interest rates rise as they must and the growth bubble bursts, Canada will face yet another massive recession, more cuts in public spending, a shrinking tax base, higher taxes and, to be sure, the return of the deficit. This is why Martin owed it to Canadians to say, once and for all and without hedging, that Canada's fiscal and macro-economic problems do not stem from a big-spending mentality. Rather, our problems stem disproportionately from the government's made-in-Canada high-interest rate monetary policy.

In the 1990s, governments which still believe in the old dogmas—that markets are automatically better and the benefits from privatization are always positive—run the risk of making many more costly mistakes. This "heretical" view comes from Joseph Stiglitz, chief economist at the World Bank. He told his audience in a wide-ranging speech several months ago that macro-economic stability at any cost is simply the wrong target and that moderate inflation is not harmful.

More importantly, he admitted that zero-deficit targets are neither necessary nor sufficient either for longer-term development or for good macro-economic practice. He called past practices "misguided". Even deficits are "OK", "given the high returns to government investment in such crucial areas as primary education and physical infrastructure".

Stiglitz had a lot of other things to say had Canada's Department of Finance officials chosen to listen. They ought to, and before Canada finds itself in a vicious monetary cycle again. High interest rate policies are too costly, and Canada needs a thorough and critical policy review of the basics of good governance.

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IDEAL TAX RATE *from page 41*

ent than the one selected by fiscal conservatives such as Janice MacKinnon, the Finance Minister from Saskatchewan and one of the top fiscal performers in the country. The feds, over the period from 1993 to 1998, have relied to a very considerable extent on revenue increases (70 percent) and less so on spending cuts (30 percent) in reining in the deficit. The approach in most of the provinces has been just the opposite.

The difference between the two approaches is that the revenue path is one which assumes that the current level of spending is just fine and the only thing to be done is raise the level of government income to match it. This is, in effect, a status quo approach which leaves all of the important questions about the role of government and the consequent size of government unanswered—indeed, unasked.

The 1998 budget was true to this approach. Of a total of some $18 billion in spending increases and tax cuts which shall occur between now and 2000-01, only $4 billion is a real tax cut. The rest are either actual spending increases or targeted tax cuts—the so-called tax expenditures which deliver a tax cut only to those who spend their money in ways that the government thinks appropriate. The message is, while there are incipient surpluses which emerge from the growth in the economy and past program changes, government still knows best and will dispose of these surpluses largely by spending them directly or directing how they will be spent.

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In the course of this spending bonanza there isn't a single mention made of the fact that our tax system is increasingly uncompetitive with that of the U.S. where recently, for example, the capital gains tax rate has been cut to 20 percent. This compares to an effective rate of more than 40 percent in the trade union leaders' paradise and even 33 percent in Alberta.

Indeed, the central drawback of the budget is that it has failed to address the key issue we face, namely how big the government sector should be. Debt repayments aside, this question is equivalent to asking what is the total tax rate the average Canadian should be forced to bear. This is a question which, if not addressed directly, will be determined as a by-product of other discussions. It is not a question which should be determined by default; it should be asked and answered directly. At the moment, owing to the fact that a substantial number of low-income Canadians bear no significant tax burden, the average family pays nearly one-half of its income to government. While the federal government collects only 48 percent of this amount, as the senior level of government, the federal government ought to take the lead in addressing the issue.

What should be the tax rate faced by the average Canadian family? Evidently, it should be the ideal rate. That is the rate of tax that is in some way better than any other. What is the ideal rate of tax? Presumably it is the rate of tax that finances just the right level of government expenditure. If the tax rate were lower than this ideal rate, there would be too little government spending; if it is greater there would be too much. How can we determine what this ideal rate of government spending is? This question is the subject of an extensive Fraser Institute paper which will be published later this spring.

The policies we actually followed produced very little change in the position of the bottom one-fifth of the population. In 1965, this group received 4.4 percent of the total income before tax, while by 1995 they were receiving only 5.7 percent after tax. This group, as well as everybody else, would have been much better off with a lower rate of total tax and the higher growth and output it would have produced.

Here I have the space to mention only two of the approaches which might be taken to answer this question. The first was adopted by Ludger Schuknecht and Vito Tanzi at the International Monetary Fund. In this approach, the authors analyzed 17 countries during the period 1870 to 1990. They treated government as a factor of societal production and asked the question, at what point does the addition of further government to the society-wide production process lead to diminishing returns? Or, put another way, at what point does the addition of further government spending cease to produce any further improvement in the social and economic objectives which are presumably the intent of government spending to influence? I can do no better than to quote these two eminent government economists directly. They first conclude that "the expansion of public expenditure and the welfare state during the past three decades has yielded limited gains in terms of social objectives" (at 25). They go on to note that "most of the important social and economic gains can be achieved with a drastically lower level of public spending than what prevails today. Perhaps the level of public spending does not need to be much higher than, say, 30 per cent of GDP to achieve most of the important social and economic objectives that justify government interventions" (at 34).

A second approach to the question of the optimal size of government arises from the work of Gerald Scully, but actually has a root that goes back to the conjecture of Australian economist Colin Clark. Clark said, as early as the 1950s, that the maximum size of government should not exceed 25 percent of the GDP or else there would be a high price to pay in terms of foregone economic growth. The work of Scully for various countries suggests that the total tax rate ought not to exceed about 23 percent. Scully arrives at this result by asking the question, what tax rate will maximize the rate of economic growth. He approaches this question in three different ways and the answer he provides is the average of the three. Two Fraser Institute economists, Joel Emes and Dexter Samida, have provided the calculation for Canada. Their conclusion is that the growth-maximizing size of government in Canada is 29.8 percent.

What is surprising is the extent to which we have endured a loss of output as a result of having operated government above the optimal level in the post-1965 period. According to the calculations done by Emes and Samida, the fact that we have had above-optimal tax rates since 1965 has cost us $3.7 trillion in output. In more directly understandable terms, if we had had the optimal tax rate over the period, we would today have an average per capita income $11,000 higher than we do. From the point of view of the lowest-income citizens in our country, this would have made quite a difference. The policies we actually followed produced very little change in the position of the bottom one-fifth of the population. In 1965, this group received 4.4 percent of the total income before tax, while by 1995 they were receiving only 5.7 percent after tax. This group, as well as everybody else, would have been much better off with a lower rate of total tax and the higher growth and output it would have produced.

The inevitable criticism of this result is that it ignores the fact that our national system of socialized medicine was introduced in 1970 and this surely was worth the additional cost. No other program of public expenditure is more widely supported by Canadians than our health care program. Without the expansion of the government sector, would this program have been possible?

The answer to this question is interesting. During 1995, the latest year for which we have complete, reliable figures, health care absorbed about 10.5 percent of the national income. This is 63.9 billion inflation-adjusted dollars. If we had pursued the growth-maximizing tax rate over the period, GDP would have been $936 billion. Total current spending on health care of $63.9 billion is 6.8 percent of that higher GDP level. Coincidentally, this is just six-tenths of a percent more than the U.S. spends on their government health care programs, MediCare and MedicAid. It is probably not necessary to note that the U.S. government taxes only 33 percent of its total GDP—very close to the optimal rate for Canada.

[E]arly indications are that we are returning to the spend-and-tax policies which got us into trouble in the first place.

Another objection is that 1971 brought a great expansion of the parameters of the Unemployment Insurance system. Without the expansion in the size of government, the higher cost associated with this extension of federal program spending would not have been possible. In this case, the response has already been provided by the current government. Program parameters for what is now Employment Insurance have been rolled back to their pre-1972 level because of the malevolent effects, and in due course the outlays on this program will return to more manageable levels—indeed, they have already begun to do so while the payroll tax to support them remains at its peak levels.

It appears that we have everything to gain and very little to lose by moving to the optimal tax rate. The crucial discussion which was absent from the budget and its treatment of the emerging fiscal reality is, how does the proposed plan affect the achievement of the optimal tax rate? This and the corresponding size of the government sector is the key to solving our persistent unemployment problem and the slow growth which perennially plagues our regions.

There is also a practical reason for decrying the absence of discussion of the optimal size of government. That is the fact that it leaves us without a clear fiscal target of the sort which the balanced budget trajectory provided. By setting out his fiscal targets clearly in advance, then meeting them successively, and finally beating them, Paul Martin had a very positive effect on expectations in Canada. This sense of fiscal direction and clarity has been lost and the early indications are that we are returning to the spend-and-tax policies which got us into trouble in the first place.

Michael A. Walker is Executive Director of the Fraser Institute.

NOTES

G. Scully, *Tax Rates, Tax Revenues and Economic Growth* (NCPA Policy Report No. 98, National Center for Policy Analysis, 1991).

V. Tanzi & L. Schuknecht, *Growth of Government and Reform of the State in Industrial Countries*, International Monetary Fund Working Paper 130, 1995.

HOW TO SLAY A DEBT MONSTER

BY MICHAEL MENDELSON

Several weeks before the 1998 Budget, the Caledon Institute of Social Policy released a study on the federal debt, *To Pay or Not To Pay.*[1] This study reported the results of a model projecting federal finances over the next decade, under a number of different scenarios. The model showed that under any reasonable set of assumptions the burden of debt in Canada, as measured by the ratio of federal government debt to the Gross Domestic Product (GDP), would decline rapidly, reaching historically low levels by the end of the ten-year projection period.

Figure 1 ("Federal debt versus GDP") shows the model's most recent projections for the next decade, using the new estimates provided in the federal government's 1998 Budget and assuming no policy changes other than those announced in the Budget. As can be seen, federal government debt compared to GDP is still projected to be on a swift downward path. There is a simple explanation for the debt burden falling so quickly: with budgets that are balanced or in surplus, the debt stays the same or falls in nominal terms while GDP grows in nominal terms. Consequently, the ratio of debt to GDP declines rapidly due to the combined effects of a constant or increasing numerator and an increasing denominator.

Those who advocate accelerated repayment of the debt seldom bother to tell us how much payoff there would be were their advice to be followed. In Figure 2 ("Effect of an extra $2B debt repayment") below, we show the change in debt-to-GDP ratios which would result from each additional $2 billion in repayment of debt, assuming that there is no other effect on the economy. Were the additional $2 billion paid against the debt by decreasing spending beginning in 1998-99, and continuing the decrease throughout the projection period so that this is not a once-only reduction (and also taking into account the resulting reduced payments on the public debt), the grand result would be an additional reduction in the debt-to-GDP ratio of 2.80 percentage points by the year 2008-09. In contrast, the reduction due to economic growth over the same period would be approximately 40 percentage points.

Making additional payments against the debt would have very little effect on the total long-run debt burden because of the magnitude of the amounts involved. With a debt of $583 billion and a GDP of $846 billion, $2 billion is not going to make a lot of difference in the debt-to-GDP ratio. The same can be said about the opposite alternative, i.e., spending more money. Increasing spending by $2 billion results in an additional 2.80 percentage points of debt burden by the year 2008-09, but due to economic growth the debt burden still falls to 27.6 percent of GDP by 2008-09.

So, we should not be asking how quickly we can reduce our debt burden. Rather, the logical question we should be asking is: What is the most advantageous path for debt reduction given the best quantitative estimates available?

To answer this question, the trade-offs need to be considered. What would we lose by cutting more money out of

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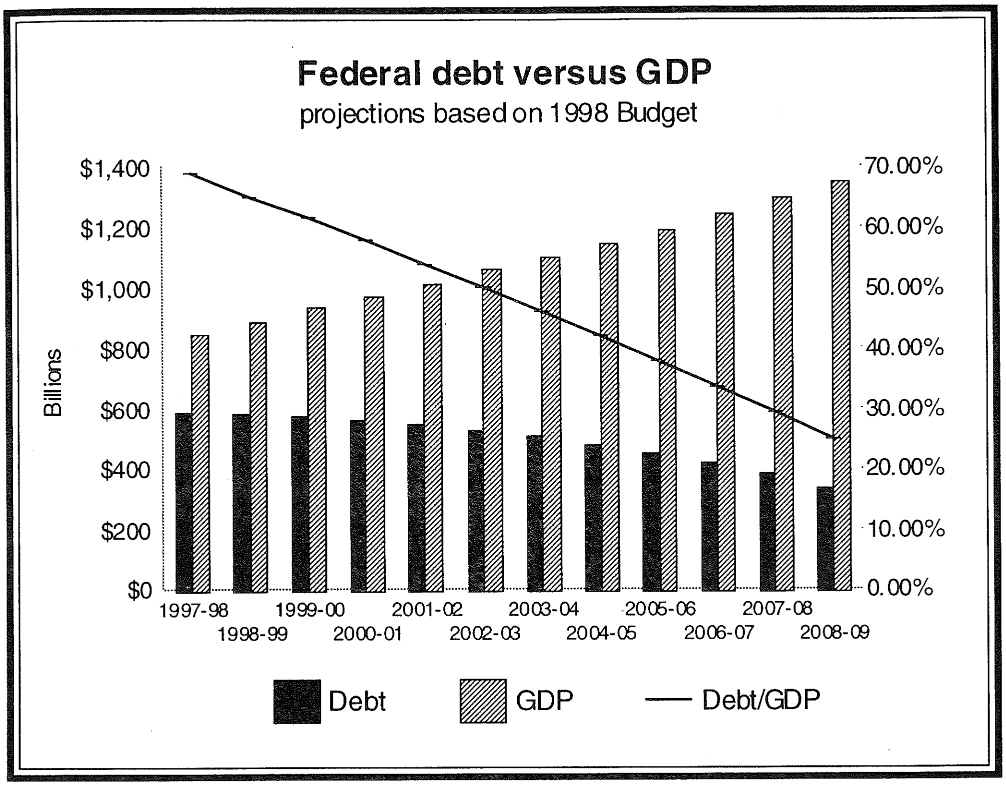
federal spending (or increasing taxes), and would it be worth the additional reduction in debt burden that it would buy? On the other hand, what could we gain by spending a little more money now, and would it be worth bearing with the added debt burden that would result? These are questions of judgment and are not subject to quantitative estimate; however, it is hard to see how anyone would propose that a few more percentage points in debt reduction is worth the tremendous costs to Canada of more cuts in funding of public programs. Indeed, it seems to me that the positive gains from spending a little more money right now—for example, to reduce substantially the depth of poverty among families with children and provide more support in early childhood development—would be easily worth the additional few points in debt burden, since debt burdens still would fall rapidly.

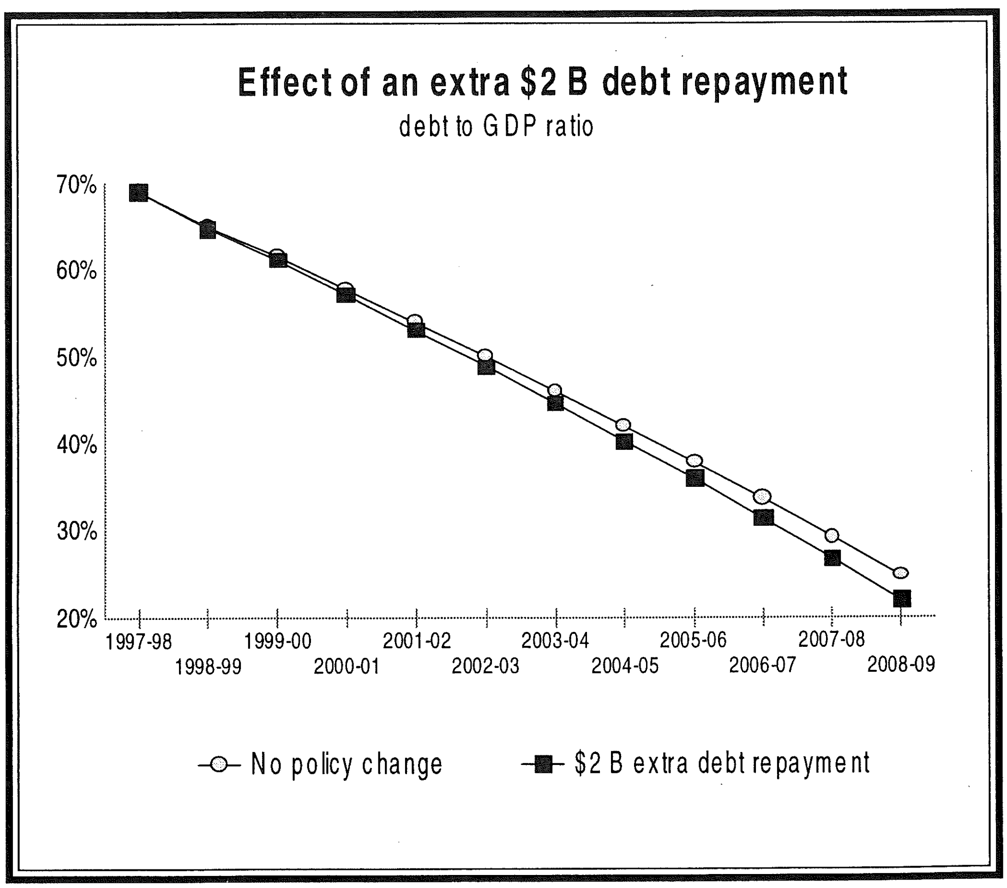
In short, the way to slay the debt monster is through achieving fiscal conditions that allow the debt burden to decline due to economic growth. This we have done in Canada. We have done it so thoroughly that we now have some additional fiscal room to consider new spending or tax cuts without prejudicing the struggle against the debt.

Michael Mendelson is a Senior Scholar with the Caledon Institute of Social Policy.

NOTES

1. See M. Mendelson, *To Pay Or Not To Pay: Should The Federal Government "Pay Down" Its Debt?* (Ottawa: The Caledon Institute of Social Policy, January 1, 1998), www.caledoninst.org, for a detailed description of the model discussed here.





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.

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

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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.

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CANADA'S FISCAL HYDRA: PAUL MARTIN'S FIGHT IS NOT OVER

BY WILLIAM B.P. ROBSON

Having brought down a budget that showed federal revenues and spending in balance, not only this fiscal year, but over the next two, Finance Minister Paul Martin is being hailed as the slayer of Canada's deficit dragon. Sadly, however, the Minister cannot put away his sword. The monster he has been battling is no dragon; it is a hydra that grows new heads even as it loses old ones.

As Mr. Martin struggled with mounting debt and interest payments, another threat to Canadian living standards—high taxes that discourage work and saving—arose in its place. Worse, as he turns to battle that threat, yet another—targeted transfers that, through clawbacks, compound the damage of high taxes for low and middle-income Canadians—is growing in destructive power.

> *The growth of Ottawa's debt burden over the past 25 years has driven a $5,500 wedge between what a Canadian family of four pays in taxes every year and the services and benefits it gets in return.*

If governments do not stop taxing and clawing back more of every additional dollar Canadians earn, the resulting erosion of work and saving may nurture a new federal deficit problem. Like Hercules fighting the hydra, Mr. Martin needs to ensure that each victory provides, not a short respite before the next attack, but a permanent gain.

A HEAD OFF: DEBT

Growing debt was a threat Mr. Martin came to office ready to fight. The growth of Ottawa's debt burden over the past 25 years has driven a $5,500 wedge between what a Canadian family of four pays in taxes every year and the services and benefits it gets in return.

During the 1980s, Mr. Martin's predecessors tried to play down this threat, keeping taxes in line with program costs and borrowing to pay interest. But borrowing to pay interest is the mark of a bad credit risk, which drives up the price lenders demand. And the bigger the debt is, the more increases in the cost of borrowing hurt.

So Mr. Martin picked up his sword. Now, he has not only cut federal borrowing to zero but, thanks to deliberately understated economic and fiscal assumptions, he has set the federal budget on a course to pay down debt with budget surpluses over the next few years.

A HEAD ATTACKING: TAXES

Now that the hydra's deficit head is gone, its second head, taxes, looms large. Taxes in Canada are way up over the past 25 years, and personal income taxes in particular have risen relentlessly. Average income taxes on each dollar Canadians earn are up by about one-third. And the typical marginal tax rate—the share of each *additional* dollar earned taken by tax—is up by even more.

> *Rather than cutting tax rates, leaving Canadians a larger share of each additional dollar they earn, the February budget introduced complex geared-to-income adjustments to the basic personal credit and the 3-percent surtax that actually* increased *marginal tax rates on low- and middle-income Canadians.*

What makes this head a threat to living standards is that taxes do more than simply transfer purchasing power from some people to others. They also reduce the rewards from work and investment, tipping people out of the labour force and discouraging saving. When the rewards of escaping taxes are high, moreover, people emigrate, move into the underground economy, or shuffle their assets into less taxable forms. In short, raising a dollar in tax imposes additional costs, beyond the dollar taken out of someone's pocket, on living standards.

Marginal personal tax rates for many Canadians are now so high that estimates of this additional damage exceed 40 cents per dollar of revenue. Even worse, this damage may not just lower living standards now, but impair their future growth, imposing massive losses when we look a decade or more ahead. Taxes that discourage saving and investments in education and skills training likely cause heavy collateral damage to growth, and personal income taxes score badly on both counts.

Unfortunately, Mr. Martin's initial thrusts at this threat have been off the mark. Rather than cutting tax rates, leaving Canadians a larger share of each additional dollar they earn, the February budget introduced complex geared-to-income adjustments to the basic personal credit and the 3-percent surtax that actually *increased* marginal tax rates on low- and middle-income Canadians. It is becoming common for people earning between 20,000 and 40,000 annually to lose more than half of every additional dollar to governments—marginal effective tax rates that are higher than those facing Canada's top income earners, and that send a strong negative message to younger, less skilled or less experienced workers about the merits of working, saving, and upgrading their skills.

A HEAD GROWING: PROGRAMS

Even as Mr. Martin becomes more adept in taking on taxes, he risks nurturing a third head that could yet cost him the fight. Like taxes, many government programs look at first simply like a transfer of purchasing power from one person to another. Also like taxes, however, many programs—such as welfare benefits for employable people that exceed what their recipients can make working—impose additional costs that compound the damage of the taxes that pay for them.

Several federal transfers, such as the Child Tax Benefit and transfers to the elderly, already contain clawbacks that increase the effective marginal tax rates faced by low- and middle-income Canadians, cutting the share of every addi-

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CANADA'S FISCAL HYDRA *from page 49*

tional dollar earned that they keep. And as the government looks for new politically popular spending programs and for new ways to save money on old ones, the number of such transfers is growing.

Canadians cannot look forward either to continued increases in living standards or to continued fiscal balance, if government policy is tilted so strongly against work and saving.

The most ominous prospect on this front is the Seniors Benefit that is due to replace existing elderly benefits in 2001. As proposed, this program will impose a 20-percent clawback —over and above regular income taxes—on other income over $26,000, sharply increasing many Canadians' effective marginal tax rates when they turn 65. The result will be less work, as more people retire early, and less saving, thanks to lower earnings and punitive tax rates on retirement income. The proposal is unpopular and may yet change. But some obvious sweeteners—enriching the benefit for the worst off or extending the clawback range—could *increase* the number of people facing 60-percent-plus effective marginal tax rates after age 65.

Canadians cannot look forward either to continued increases in living standards or to continued fiscal balance, if government policy is tilted so strongly against work and saving.

A LABOUR OF HERCULES

Vanquishing a hydra requires more than cutting off one head after another. As Hercules discovered, it requires making sure that heads, once removed, do not grow back.

By balancing the budget, Mr. Martin has cut off one head of the hydra. Two other heads, however, taxes and clawed-back transfers, have gained strength and are on the attack. The growing hostility of Canada's tax and transfer system to work and saving threatens to further erode Ottawa's tax base and boost demand for its transfer payments. If it does, the old threat of deficits and mounting debt may yet return.

Only by leaving more of each additional dollar earned in the hands of those who earned it can Mr. Martin defeat the fiscal hydra, and finally earn the right to put away his sword.

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TOWARDS A REALISTIC TAX POLICY

BY JONATHAN R. KESSELMAN

The 1998 federal budget cut income tax rates for all taxpayers except those at upper incomes. In excluding higher earners from the tax cuts, the Finance Minister stated that the priority must be relief for middle- and low-income Canadians. As a result, the high-income surtax was left in place, and abolition of the general surtax was phased out between incomes of $50,000 to $65,000 so as to yield no cuts at higher incomes.

Cutting tax rates for upper earners poses obvious political difficulties, even for right-of-centre parties.

One could argue that cuts in the top marginal tax rate are a priority for the next federal budget. Such cuts can be justified to improve incentives, enhance economic efficiency, and augment job creation. While this change is not the end-all for tax reform, it is a pressing need that can be achieved at modest, if any, revenue cost.

Top-bracket taxpayers are relatively small as a group but are highly influential in the economy's overall performance. They face marginal tax rates exceeding 50 percent in all provinces except Alberta, which has a top rate of 46 percent. B.C. has the highest combined federal-provincial top marginal tax rate, at 54 percent.

Cutting tax rates for upper earners poses obvious political difficulties, even for right-of-centre parties. In the last B.C. election campaign, the Liberals proposed a 15-percent cut in provincial income taxes but, remarkably, they would have left the top marginal tax rate unchanged. Ontario's Tory income tax cuts are being offset in part by a new surcharge on those at higher incomes, which will still leave the top marginal rate at nearly 50 percent when fully implemented.

Economic analysis for Canada and the U.S. has found the costs of imposing high marginal tax rates to be large. With B.C.'s surtaxes, for example, the loss of valued economic activity has been estimated at $65 for each extra dollar of tax revenue; for Quebec's surtax the figure is over $70. Using plausible assumptions about behaviour, total tax revenues might actually be increased by cuts in the top-bracket marginal rates.

These strong results can be explained by individuals' actions to curtail their taxable incomes when confronted with high tax rates. They will reduce their work effort, substitute untaxed production of home services for taxed market work, take more compensation in untaxed fringe benefits, decline promotions, postpone the sale of appreciated assets, invest in legal tax shelters (including home equity), and find ways to evade taxes.

Clearly, no one benefits if tax rates are set so high that revenue is actually decreased. Even short of such rates, the cost to the economy in reduced supply of productive labour and capital services and entrepreneurial activity is high. Employment is reduced for other individuals at more modest wage and skill levels, which in turn reduces the income and sales taxes that they pay. Hence, any modest gains in income tax from high rates imposed on top earners may be more than offset by reduced revenues from taxes on other economic actors.

> *[Politicians] are captives of rhetoric about "tax equity", which in common usage assumes that ever-higher tax rates on upper earners is necessarily equitable. But if those higher rates do not produce greater revenues, or if they do so only at great cost to the economy, we are all victims of the rhetoric.*

High tax rates on upper incomes further discourage the location and expansion of business in Canada as opposed to lower-taxed locales. Canada becomes less attractive to potential immigrants with special skills, business acumen, and high wealth. Much of the fuss over the proposed new reporting rules for foreign assets would not have arisen if Canadian tax rates were lower (the U.S. already has more stringent reporting requirements).

Why can't politicians appreciate these economic truths and moderate the top tax rates? They are captives of rhetoric about "tax equity", which in common usage assumes that ever-higher tax rates on upper earners is necessarily equitable. But if those higher rates do not produce greater revenues, or if they do so only at great cost to the economy, we are all victims of the rhetoric.

A desirable target for top marginal tax rates would be in the low 40-percent range. This could be achieved by elimination of all federal surtaxes on upper incomes, combined with elimination of the high-income surtax rates applied in several provinces. These moves would place Canada in the company of other major Western economies.

The top U.S. marginal tax rate is 39.6 percent, though this arises only for taxable incomes above US$264,000 or about CDN$370,000, five times the threshold for top rates in Canada. (Most states also impose an income tax but at much lower rates than the Canadian provincial taxes.) In Britain the top marginal income tax rate is 40 percent. New Zealand cut its top rate from 66 to 33 percent, with beneficial effects on productivity and real wages.

Even egalitarian, heavily-taxed Sweden has come to appreciate the damaging effects of high tax rates. Its top marginal rate on labour earnings is now down to 51 percent, and capital incomes face a flat tax rate of just 30 percent. Germany's plans to cut its top tax rate from 53 to 39 percent were scuttled last year by the Social Democratic opposition on the grounds of "tax equity".

For those concerned about the loss of equity from reducing the top tax rate, the response is two-fold. First, since taxing at very high rates may generate little if any incremental revenue, the loss of equity would be more symbolic than substantive. Second, if there were much revenue loss, other taxes could be applied to those at upper income and wealth levels—such as taxes on higher-valued homes, cars, and estates—with significantly less damage to the economy.

The inevitable losers from excessive marginal tax rates on those at upper incomes are in fact the most disadvantaged members of society. They remain unemployed, underemployed, or underpaid in an economy that cannot generate enough jobs. Many of the well-off who are targeted by high tax rates can shift their capital, consumption, and businesses off-shore or even emigrate.

> *High marginal tax rates also cause upper earners to press the political process for special tax preferences. Moderating top tax rates would enhance the ability of governments to apply a broadly based income tax. Hence, reducing high tax rates may itself be a prerequisite to more fundamental tax reforms to accompany the broader tax cuts that will become feasible in the coming years.*

The burden of high tax rates on managerial, professional, and technical workers is transferred partially into higher prices for the goods and services they produce. Cutting those tax rates will increase their productive supply and thereby yield price cuts that benefit consumers at all income levels. Lower dental and legal fees, for example, will be welcomed by moderate-income families.

High marginal tax rates also cause upper earners to press the political process for special tax preferences. Moderating top tax rates would enhance the ability of governments to apply a broadly based income tax. Hence, reducing high tax rates may itself be a prerequisite to more fundamental tax reforms to accompany the broader tax cuts that will become feasible in the coming years.

Indeed, the federal Liberals could take a leaf from the B.C. NDP government's recent budget. That budget will cut the provincial upper-income surtax such that the total top marginal tax rate will fall from its current 54 percent to 49.9 percent within three years. The cited rationale was a need to facilitate the hiring of managerial and technical workers for new-economy industries.

At last we may be entering an era where taxation policy can transcend political ideology and populist politics to recognize the economic imperatives for a growing and prosperous economy.

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INCOME DISTRIBUTION IN CANADA IN THE 1990S: THE OFFSETTING IMPACT OF GOVERNMENT ON GROWING MARKET INEQUALITY

BY ANDREW SHARPE

Canada, unlike the United States, experienced in the first half of the 1990s no significant rise in the inequality of the distribution of income after tax, arguably the most relevant income measure since it gauges disparities in command over private goods and services. Like the United States, Canada did, however, experience a rise in income inequality before transfers. The divergence between trends in the distribution of income after tax and income before transfers is explained by changes in the relative importance of government transfers and income taxes. This article examines the offsetting impact of government on the growing market inequality of the period.

AVERAGE AGGREGATE INCOME TRENDS

An examination of income and income distribution trends in Canada in the first half of the1990s must look at three definitions of income: income before transfers, total money income, and income after tax. All three measures show that Canadian families became worse off in the first half of the 1990s. Real income before transfers fell 7.1 percent, income after tax 5.4 percent, and total money income 4.8 percent.[1] The larger decline in income before transfers meant that transfer payments increased in relative importance, rising from 9.9 percent of money income in 1989 to 12.1 percent in 1995. The slightly larger decline in income after tax compared to total money income meant that income tax increased as a proportion of money income-from 19.3 percent to 19.8 percent.

The overall declines registered in all three measures of real average family income were experienced by all income quintiles, although the relative severity of the fall varied by income measure and quintile, as is discussed below.

INCOME BEFORE TRANSFERS

Table 1 shows trends in income before transfers or market income (including both employment and investment income). While all quintiles experienced falls in income between 1989 and 1995, the lower the income quintile, the larger the magnitude of the decline. Income for families in the bottom quintile fell 20.2 percent, compared to only 2.8 percent in the top quintile. These divergent trends led to increased income inequality, with the share of the bottom quintile declining to 3.3 percent of total income before transfers from 3.8 percent, and that of the top quintile rising from 42.0 percent to 43.9 percent. The Gini coefficient rose 7.8 percent while the ratio of the average income of the top quintile to that of the bottom quintile rose 21.8 percent from 11.1 to 13.5.

The rise of market inequality in the 1990s reflects both cyclical and structural factors. Sharpe and Zyblock[2] found that about one-third of the rise in market family income inequality has been due to poor macroeconomic performance. High unemployment increases inequality because the burden of unemployment is disproportionately borne by persons in the bottom quintiles. The remaining two-thirds is related to poorly understood structural factors such as technological change favouring the skilled over the unskilled, and increased international trade.

TOTAL MONEY INCOME

The increase in inequality was much less for total money income than for income before transfers because of the growing importance of transfer payments (Table 2). The Gini coefficient for total money income increased only 3.3 percent in the 1989-95 period while the ratio of the average income of the top to bottom quintiles rose 6.8 percent from 5.9 to 6.3.

For the bottom quintile, the proportion of money income accounted for by transfers rose from 51.0 percent in 1989 to 59.0 percent in 1995. But this development reflected not so much large increases in transfers (in fact up only 6.3 percent), as the absolute decline in the quintile's market income. Transfers did increase significantly in absolute terms as well as relative terms for the second and middle quintiles. The former saw transfers jump 27.2 percent, with their share in money income rising from 18.7 percent to 26.0 percent. The latter experienced a 31.1 percent increase, with the share going from 9.4 percent to 13.0 percent.

Factors behind the growth of transfers include the growth of the 65 and over population, which increased old age security and C/QPP payments, and higher unemployment, which increased social assistance payments. Despite the cyclical downturn, unemployment insurance payments did not increase in the 1990s because of cuts to the UI system. Thus it was not increased generosity of social programs that accounted for rising transfers in the first half of the 1990s, but rather demographic developments and the larger welfare payments made necessary by high unemployment.

INCOME AFTER TAX

The increase in inequality for income after tax in the 1990s was even less than for the other two income measures as taxes increases hit high-income Canadians proportionally harder than low-income Canadians (Table 3). The Gini coefficient rose only 1.4 percent and the ratio of average income between the top and bottom quintiles actually fell 2.0 percent from 4.9 in 1989 to 4.8 in 1995. Income taxes for the top quintile rose from 24.8 percent of money income in 1989 to 26.1 percent in 1995. In contrast, for the bottom two quintiles, they fell-from 3.6 percent to 2.7 percent for the lowest quintile and from 12.2 percent to 11.0 percent for the second quintile.

CONCLUSION

Government transfer and tax policies have greatly dampened the inequalities of market income distribution. In 1995, they reduced the average income ratio between the top and bottom quintiles from a factor of 13.5 for income before transfers to a factor of 4.8 for income after tax, that is by 2.8 times. The Gini coefficient for income after tax was 69.6 percent of that for income before transfer. In the first half of the 1990s, these policies played an increasingly important role in constraining the growth of inequality. In 1989, for example, the ratio of the average income of the top and bottom quintiles only fell from 11.1 to 4.9 as one moved from income before transfers to income after tax, or by 2.3 times, while the Gini coefficient for income after tax was 74.1 percent of that for income before transfers.

In the last several years, to

attain the objective of a balanced budget, governments have dramatically cut transfer payments. For example, in 1995 the Ontario government slashed welfare payments and in 1996 the federal government again reduced the generosity of employment insurance. For 1995, the impact of these measures on income distribution was still relatively small, but by 1996 and 1997 it was becoming much more important. Preliminary data for 1996 indeed show a significant increase in income inequality because of the cuts to welfare in Ontario, given the concentration of social assistance recipients in the bottom quintile. If recent trends continue, it appears that the dampening effect of government transfer and tax policy on rising market income inequality will be less, with the result that income inequality as measured by income after tax, the most important indicator, will increase.

But current government cuts to transfers do not have to continue. Their rationale, namely to improve government's fiscal position, is no longer justified given the elimination of the deficit by the federal government and by most provincial governments. Even Ontario and Quebec will balance their budgets by the 2000-01 fiscal year at the latest. A strong case can be made that a priority for the use of fiscal dividend should be increased transfers and tax cuts targeted to low-income Canadians to offset growing market income inequalities and ensure a certain stability in the distribution of income after tax (or even greater equality).

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Table 1: Average Family Income Before Transfers in Canada, 1989 and 1995

	Share of Total		1995$		
	1989	1995	1989	1995	% Change
Lowest	3.8	3.3	$9,914	$7,907	-20.2
Second	11.5	10.4	30,035	25,191	-16.1
Third	17.9	17.2	46,735	41,826	-10.5
Fourth	24.9	25.3	65,056	61,404	-5.6
Highest	42.0	43.9	109,666	106,579	-2.8
Total	100.0	100.0	52,281	48,581	-7.1
Gini Coeff.	0.397	0.428			7.8
Q5/Q1	11.1	13.5			21.6

Table 2: Average Total Money Income for Families in Canada, 1989 and 1995

	Share of Total		1995$		
	1989	1995	1989	1995	% Change
Lowest	6.6	6.4	19,146	17,722	-7.4
Second	12.6	12.1	36,557	33,484	-8.4
Third	17.8	17.5	51,693	48,326	-6.5
Fourth	23.8	24.0	69,187	66,221	-4.3
Highest	39.1	40.0	113,542	110,465	-2.7
Total	100.0	100.0	58,025	55,244	-4.8
Gini coeff.	0.330	0.341			3.3
Q5/Q1	5.9	6.3			6.8

Table 3: Average Income After Tax for Families in Canada, 1989 and 1995

	Share of Total		1995$		
	1989	1995	1989	1995	% Change
Lowest	7.6	7.7	17,837	17,058	-4.4
Second	13.6	13.4	31,791	29,410	-7.5
Third	18.2	18.0	42,612	39,903	-6.4
Fourth	23.6	23.7	55,274	52,405	-5.2
Highest	37.0	37.3	86,627	82,646	-4.6
Total	100.0	100.0	46,828	44,284	-5.4
Gini coeff.	0.294	0.298			1.4
Q5/Q1	4.9	4.8			-2.0

Source: Income after tax, distributions by size in Canada, 1995, cat. 13-210, Statistics Canada, May 1997.

1. All rates of change in this article refer to real or inflation-adjusted figures.

2. See A. Sharpe & M. Zyblock, "Macroeconomic Performance and Income Distribution in Canada" (1997) 8(2) North American Journal of Economics & Finance 167.

CANADA'S COMPETITIVE CHALLENGE: THE BUDGET AND BEYOND

BY JAYSON MYERS

Finance Minister Paul Martin stole the headlines in his last budget when he announced the elimination of the federal deficit. But, government budgets and fiscal policy are about more than keeping public sector finances in order. They set the course for economic growth-and they should be judged with respect to how well they respond to the key challenges and opportunities facing the Canadian economy.

Nine years prior to the FTA, back in 1980, Canadian manufacturers exported 25% of what they produced. Almost 73% of the manufactured goods purchased in Canada were made here. Today, nine years after the FTA, 62% of Canada's manufacturing production is being exported, approximately 53% of it into or through the United States. Meanwhile, the domestic market share of Canadian manufacturers has fallen to 38%.

From the point of view of Canadian industry, and especially Canadian exporters, the most important challenge that companies face today is maintaining and enhancing their competitive position in international markets. It's a matter of ensuring that the right product or service is delivered at the right price and at the right time to customers in Canada and around the world. And, it is also a question of attracting and retaining investment and product mandates in this country as other jurisdictions focus their attention on improving fiscal conditions, reducing tax rates, and ensuring a business climate that promotes productive investment, technological development, and job creation as an integral part of their fiscal strategies.

Competitiveness issues have gained prominence as Canadian industry has become increasingly integrated in the North American economy in the aftermath of the Canada-U.S. Free Trade Agreement. Nine years prior to the FTA, back in 1980, Canadian manufacturers exported 25% of what they produced. Almost 73% of the manufactured goods purchased in Canada were made here. Today, nine years after the FTA, 62% of Canada's manufacturing production is being exported, approximately 53% of it into or through the United States. Meanwhile, the domestic market share of Canadian manufacturers has fallen to 38%.

World markets today demand world class business practices. Canadian industry has to invest in cost-efficient, high-quality processes, in product innovation and the development of new markets, in their people and in new technologies in order to ensure customer success. Yet Canadian companies are lagging behind competitors from other countries when it comes to productivity improvement and innovation.

Relatively high corporate tax rates put Canada at a disadvantage when it comes to attracting and retaining direct investment, while high personal tax rates are encouraging an exodus of skilled Canadians to the United States.

The Alliance of Manufacturers & Exporters Canada surveyed its 3,500 corporate members late last year in order to determine their priorities with regard to competitiveness issues. Three issues stand out in the survey results:

1. Relatively high corporate tax rates put Canada at a disadvantage when it comes to attracting and retaining direct investment, while high personal tax rates are encouraging an exodus of skilled Canadians to the United States. Over 84% of members indicated in the survey that tax reduction should be a priority for the federal government; 65% say that high taxes are a significant impediment to inward investment and economic growth;

2. The need to keep up with the rapid pace of technological change and continue to innovate in order to service new markets and maintain profit margins in the face of more intense competition. As more open markets have intensified competition in international as well as domestic markets, Canadian companies have had to rely more and more on innovation, not only to increase operating efficiencies and lower unit production costs, but to differentiate themselves from their competitors through new design, the development of new products, innovative customer service, and the development of niche markets; and

3. Their ability to identify, recruit, and retain employees with the skills required by modern manufacturing and exporting businesses. About 31% of members reported difficulties in finding skilled workers last year. The five skills in greatest demand were in the fields of marketing, engineering, design, software development, and manufacturing management.

Even more of a challenge for Canadian companies is their capacity to retain skilled personnel in the face of a low Canadian dollar and relatively high personal tax rates that have made employment prospects in U.S. companies far more attractive than many Canadian firms can afford.

The federal budget was generally well received by Canadian industry, not only because of Ottawa's achievement in eliminating the deficit, but because the budget signals that targeted tax reductions, innovation, and education are also priorities for the Finance minister and the Chretien government. It's still fair to say, however, that there is a great deal of skepticism about the ability of the government to follow through with meaningful measures that will contribute to the capacity of Canadian businesses to compete for investment or sales in international markets. My overall grade for the government in putting together a budget that addresses the issues by competitiveness is a "B". Here's why.

[T]he release in April of the recommendations of the technical working group on corporate tax reform chaired by Jack Mintz are a disappointing combination of average tax rate reductions across all sectors of Canadian business and reductions in tax credits and allowances—including Canada's research and development tax credits—now enjoyed primarily by Canadian manufacturing and resource processing industries. The net effect of the Mintz recommendations would penalize rather than encourage investment and competitiveness of the one sector responsible for most of the innovation, export development, and over the past five years, for a large part of the job creation, in the Canadian economy.

The limited tax changes announced in the budget were aimed almost exclusively at personal taxes; but, they did little to encourage skilled personnel to remain in Canada or to make it easier for Canadian companies to fill the current skills gap affecting almost every sector of industry. Targeted tax changes were introduced, setting a precedent for corporate tax reforms in future budgets. However, the release in April of the recommendations of the technical working group on corporate tax reform chaired by Jack Mintz are a disappointing combination of average tax rate reductions across all sectors of Canadian business and reductions in tax credits and allowances-including Canada's research and development tax credits—now enjoyed primarily by Canadian manufacturing and resource processing industries. The net effect of the Mintz recommendations would penalize rather than encourage investment and competitiveness of the one sector responsible for most of the innovation, export development, and over the past five years, for a large part of the job creation, in the Canadian economy. The Mintz report has been tabled for discussion and does not (I hope) reflect the priorities of the Finance Department itself. It will set the stage for discussion and for tax reforms in future budgets.

Nevertheless, from industry's point of view, the issue of tax reform is an urgent one. In addition to real concerns over the impact of the tax changes recommended by Mintz, there is a general sense of disappointment that the government is still not in a position either to make corporate tax reform a priority issue or to be able to prioritize or even analyze those reforms with respect to their impact on the economy as a whole.

The government increased funding for its popular Industrial Research Assistance Program, but the amount of additional financing is limited by the fiscal constraints Ottawa continues to face. Meanwhile,

The government's Millennium Scholarship Fund, while acknowledging the problems of skill shortages and youth unemployment, does not and cannot deal with the more substantive issues of institutional restructuring, subject content, and admissions into relatively more expensive engineering and technical programs that have to be addressed in order to close the skills gaps that are widening across Canadian industry.

the future of other programs in support of innovation, including the R&D tax credit system, has not been assured. The increasing complexity of interpretation under the R&D tax credit system has, in any event, significantly increased the cost of using the program for small and medium-sized companies.

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From industry's perspective, the budget shows that the federal government may have its priorities rights. But, it is still not clear that the government has a consistent strategy or the appropriate programs in place to encourage Canadian businesses to make the investments in people, technology, and new market development that are required in order to boost productivity growth and ultimately improve the competitive performance of the Canadian economy. Any business will tell you that it is important not only to cut costs but also to reinvest in order to grow. That is a lesson that Ottawa has to take to heart as Canadians respond to the competitive pressures of a global economy.

Jayson Myers is Senior Vice President of the Alliance of Manufacturers & Exporters of Canada.

The Robarts Centre For Canadian Studies Awarded Grant To Establish A Summer Institute for the Canadianist Community in Latin America

The International Academic Relations Division of the Department of Foreign Affairs and International Trade has announced that, for the next three years, it will support a Canadian Studies Summer Institute for Latin American Scholars at the Robarts Centre for Canadian Studies in collaboration with the International Council for Canadian Studies.

This is a major award that provides Latin American scholars with a unique opportunity to work with leading Canadian specialists at York on a range of public policy issues and academic concerns. Half of the time will be spent in seminars and the other half in meetings with different groups and organizations from business, government, social movements, and cultural communities. Excursions to the Toronto region are also part of the program.

The aim of the Institute is to enable participants to acquire a first-hand knowledge of Canada, culturally and socially, as well as a deeper academic understanding of their areas of expertise by attending workshops and lectures conducted by leading York scholars

The participants will be drawn from recipients of the Canadian Government Faculty Research and Faculty Enhancement grants awarded each year by DFAIT. These awards enable Latin American Canadianists to come to Canada to do research and develop projects to further their scholarship on Canada and the hemisphere. It is anticipated that there will be 20-25 participants for the eight-day Institute.

The Robarts Centre will be cooperating with the Canadian Studies Associations and Centres from Mexico, Brazil, Argentina, Uruguay, Cuba, Spain, and Chile in the organization of the Institute. The Institute is another York initiative to develop strong hemispheric ties with leading academics and researchers. The Summer Institute will create a distinctive forum to examine issues particular to the hemisphere.

It is likely that the first Summer School will be held in 1999, but as yet there is no final decision in this regard.

The Summer Institute gives the York University community the uncommon opportunity to meet young scholars who might then participate in other York teaching and research programs.

For additional information, please contact:

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