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# **Good Times, Good Decisions: Priorities for the 2001 Federal Budget**

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## Overview

It is a long time since the makers of federal fiscal policy have had such a promising environment to work in. The economy is expanding, and both the international environment and the domestic scene promise further gains. Government revenues are growing healthily, while small surpluses and stable interest rates are keeping interest costs in line.

In the run-up to the 2001 federal budget, it is only fair to note that we owe this benign environment largely to the good macroeconomic policies of the past several years. After bringing inflation down, monetary policy since the mid-1990s has promoted growth in line with a 2-percent inflation target. And fiscal policy, both federally and provincially, has reined in the unsustainable borrowing that was pushing up interest costs and taxes, setting the stage for declining debt and tax cuts.

Looking forward, the 2001 budget presents both a challenge and an opportunity. The challenge is to avoid taking the current benign economic environment for granted and abandoning the policies that produced it. The opportunity is to take advantage of a strong economy and a healthy fiscal position to build on recent gains, raising Canada's capacity to grow and create well-paying jobs, and ensuring that interest costs and taxes continue to fall in the years ahead.

## The Economic Outlook

The Canadian economy entered 2000 on a strong note and has, on the whole, continued to surprise observers with its buoyancy. Households and businesses are confident, consumption spending and investment are strong, and rising output has created enough jobs to bring unemployment down to levels not seen in a generation.

While this strong expansion has not yet pushed up measures of core inflation,<sup>1</sup> the slack that existed in the Canadian economy through the 1990s is rapidly disappearing, and may now be gone. Headline inflation has risen to the top of the Bank of Canada's 1-to-3 percent target band. The current pace of monetary expansion suggests that spending will grow fast enough through the rest of the year and into 2001 to put pressure on productive capacity.

This is a pleasant environment in which to make budgets. It is not, however, a time for a sizeable fiscal stimulus from the federal government.<sup>2</sup> Any additional impetus to spending and output from fiscal policy will be translated, not into higher output and employment, but into higher interest rates. The net result would be an economy that is no stronger, but interest costs for the federal government — indeed, for all governments and Canadians generally — that are more onerous.

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<sup>1</sup> Measures of "core inflation" typically strip out some of the consumer price index's more volatile components, such as food and energy, and often also adjust for the effects of consumption-tax changes.

<sup>2</sup> Evidence that changes in government budgets stimulate and depress the economy, as traditional Keynesian analysis predicts, has always been uneven. During the past decade in Canada, the rise and fall of deficits likely had effects on confidence and interest rates that overshadowed any direct effects on spending. Now that concern over unsustainable borrowing has eased, the effects predicted by traditional analysis may be stronger.

## The Fiscal Framework

With the economy now at or close to capacity, the major task of fiscal policy in the 2001 budget ought to be consolidating the progress made over the past few years. First, the federal government should run larger surpluses than it has to date. Second, it ought to subject spending to close scrutiny, increasing only programs that clearly promote long-term prosperity, and trimming those that do not. And third, it should take a more ambitious look at taxes, using the room the fiscal outlook provides to make Canadian taxes fairer and more supportive of growth.

### *Paying Down Debt*

In view of the benefits that stopping the growth of federal debt and starting to pay it down have already provided, it seems odd that the case for further debt reduction still needs reinforcing.

As the pressure of federal borrowing on interest rates has dissipated and the stock of debt has started to decline, annual net federal interest costs have fallen by more than \$6 billion.<sup>3</sup> This is a huge amount — equal, for example, to the annual cost of the expanded Child Benefit. Debt repayment on the expanded scale now possible could free up further billions over the next five years. Lower debt would not only provide near-term room for richer programs or deeper tax cuts. It would also prepare us for the more difficult years further ahead, when the labour force effects of the baby boomers' retirement and today's low birth rates will raise the ratio of nonworkers to workers, putting renewed, chronic pressure on government budgets.

An emerging pattern in federal fiscal policy, however, suggests insufficient appreciation of these benefits. In each of the past several fiscal years, large amounts have been spent in last-minute binges, and baseline spending has been rising sharply. Less than a year ago, the November 1999 fiscal update projected \$100 billion in potential surpluses over the six-year period from fiscal year 1999/2000 to 2004/05 (Canada 1999). Updating these figures in the light of the February 2000 budget, it appears that only \$37.5 billion of that potential surplus survived, with new spending accounting for some two-thirds of the difference (see table).<sup>4</sup>

It would set a much better precedent for the future, and help the prospects for yet lower interest costs in the years ahead, if this year's unneeded prudence cushions were not spent, but instead used to pay down additional debt.

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<sup>3</sup> Net interest is total interest paid minus the return on the federal government's financial assets. It corresponds more closely to the net debt figure than does the more widely publicized total interest cost.

<sup>4</sup> These totals treat increases in the Child Benefit as higher transfers. The 2000 Budget treats them as tax cuts, but this presentation is misleading. Many of the benefit's recipients do not pay personal income taxes, or have a tax liability that is smaller than the benefit. The benefit is a transfer payment, and ought to be shown as one (as in the gross figures on taxes and spending in the Public Accounts).

Summary of Federal Government Transactions, Fiscal Years 1999/00 to 2004/05							
	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	1999/00- 2004/05
	<i>\$ billions</i>						
<b>November 1999 Fiscal Update</b>							
Gross taxes and fees	165.6	172.7	180.9	188.4	196.5	205.5	1,109.6
Less gross program spending	(123.7)	(126.4)	(131.2)	(134.2)	(137.3)	(140.8)	(793.6)
Less net debt charges	(36.9)	(36.7)	(36.3)	(35.7)	(35.2)	(34.7)	(215.5)
Equals underlying balance	5.0	9.5	13.5	18.5	24.0	30.0	100.5
<b>February 2000 Budget</b>							
Gross taxes and fees	167.7	170.7	177.5	184.0	191.3	199.6	1,090.7
Less gross program spending	(127.8)	(130.5)	(137.7)	(142.1)	(146.2)	(150.9)	(835.2)
Less net debt charges	(36.9)	(37.2)	(36.8)	(36.2)	(35.7)	(35.2)	(218.0)
Equals underlying balance	3.0	3.0	3.0	5.7	9.4	13.4	37.5
<b>Change from 1999 Update to 2000 Budget</b>							
Gross taxes and fees	2.1	(2.0)	(3.4)	(4.4)	(5.1)	(5.9)	(18.9)
Gross program spending	4.1	4.0	6.6	7.8	9.0	10.1	41.6
Net debt charges	0.0	0.5	0.5	0.5	0.5	0.5	2.5
Underlying balance	(2.0)	(6.5)	(10.5)	(12.8)	(14.6)	(16.6)	(63.0)
Source: Robson 2000.							

### *Setting Program Priorities*

There is no doubt that much federal program spending provides Canadians with important benefits, and that cuts during the mid-1990s' fiscal retrenchment produced discontent. These facts, however, do not justify the across-the-board spending hikes that have occurred since the deficit disappeared.

Increased transfers to the provinces in support of health care, for example, provide only temporary relief. They do nothing to address the health system's chronic problems: consumer and provider choices insufficiently guided by medical evidence or resource constraints; and gaps in accountability when responsibility for financing is separate from responsibility for provision. New research, better data management, and new capital spending will help. In the long run, however, it is the provincial governments, which provide most publicly financed health services, that ought to raise the needed revenue. From this perspective, making room for provincial needs with federal tax cuts makes more sense than endlessly raising federal cash payments.

Space does not permit an extensive review of other federal programs. Looking over recent federal financial results, however, it is striking how widespread the spending increases are. Nearly every category of subsidies and discretionary transfer payments is up, as are payments to Crown corporations, while general operating costs in the first three months of fiscal year 2000/01 were 9 percent higher than a year earlier (Canada 2000). Looking ahead, moreover, it appears that substantially more regional development spending is on the way, and the reforms to employment insurance (EI) that trimmed benefits to frequent users may be rolled back.

Understandable though a rebound after the tough years of the mid-1990s may be, this spending shows

little of the careful prioritizing that Canadians have a right to expect from their governments. In the past, we at the C.D. Howe Institute have argued that federal fiscal initiatives ought to be subject to a straightforward two-part test (Robson, Mintz, and Poschmann 2000). How would this initiative affect future prosperity? And is it the federal government that should undertake it? Many federal subsidies do not meet this test, and we do not feel that substantially increased regional development spending or reversal of the EI reforms would meet it either.

Taking a longer view, moreover, casts doubt on the wisdom of building further increases into baseline program spending in the 2001 budget. As noted already, the Canadian economy is likely at or close to capacity, and the longer-term outlook is for slower trend growth as demographic changes slow and ultimately stall the growth of the labour force. Canada's fiscal capacity to carry sizeable new federal commitments may shrink in the years ahead, setting us up for a fresh round of disappointment as recently established federal programs are chopped again.

### *Reforming Taxes*

Turning to taxation, the tone of recent statements about the need to scale back the tax hikes that occurred during the fiscal consolidation is encouraging. Contrasts in the performance of the provinces, as well as international experience, support the view that high personal and corporate tax rates hold back growth and that lower tax rates would improve the prospects for long-term prosperity.

The reindexation of the personal income tax system for inflation in the 2000 budget was a commendable step, slowing the automatic increase in taxes generated by growth in nominal incomes.<sup>5</sup> Other federal tax changes to date, however, have consisted largely of piecemeal reductions in rates and the publication of a vague and leisurely timetable for more of the same. It would be better to take advantage of the current period of fiscal flexibility to undertake more fundamental improvements in Canadian taxes.

On the personal income tax front, it bears repeating that Canada's high marginal effective tax rates bite at low levels of income.<sup>6</sup> As another presenter to this committee has noted more than once, Canada does not so much tax the rich as it taxes those trying to become richer.<sup>7</sup> Making work and saving more rewarding, and making Canada a more attractive place to earn a living, will require further raising of thresholds and cutting of the rates that apply to all incomes. The current environment also offers a chance to make the tax treatment of families with children fairer: a universal deduction or credit would recognize the fact that all such families face nondiscretionary costs, regardless of income level or

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<sup>5</sup> As long as thresholds are fixed in real terms (as they now are with indexation to inflation), however, increases in real incomes will continue to push up overall tax rates.

<sup>6</sup> To pick a stark example — though by no means a worst-case one — in 2001, a one-earner family with two children under age seven in Ontario will see more than 70 cents of each additional dollar it earns in the range from around \$28,000 to \$30,000 taken by governments in various taxes and clawbacks.

<sup>7</sup> David Laidler makes this point in his brief.

division of paid work among parents.

On the business tax side, Canadian taxes stand out for two adverse features (Mintz 2000; Chen 2000). Overall marginal effective rates on new investment are higher than in other countries with which Canada competes for capital investment. And marginal effective rates on new investment differ considerably from sector to sector and by size of firm. Eliminating the corporate income surtax and establishing an accelerated, more ambitious, and more comprehensive schedule for cutting the general federal corporate income tax rate would address both problems. By improving Canada's attractiveness as a place to invest, we could raise the economy's capacity to grow and create well-paying jobs over time.<sup>8</sup> And by making the tax burden more uniform across sectors, we would make opportunity, rather than taxation, a more important determinant of Canada's future industrial development.

### **Good Times, Good Decisions**

With the Canadian economy near capacity, the federal government needs to take a long view in framing the 2001 budget.

Accelerating the pace of debt reduction would further lower interest costs, and provide flexibility in the years ahead when the economic cycle and demographic changes make the fiscal environment more difficult. Rather than allowing temporarily flush revenues to boost spending across the board, setting Canadians up for disappointment later, the government needs to give priority to programs with reliable long-term payoffs that it is uniquely well placed to deliver. And seizing the opportunity to reform Canadian taxes to encourage work, saving, and investment could raise Canada's capacity to produce in the future.

A well-framed 2001 budget would take advantage of Canada's current strong economy and buoyant fiscal position with measures to sustain growth and healthy government finances in the years ahead.

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<sup>8</sup> Because capital investment flows more easily across international borders as time goes by and the number of countries that both compete for and supply investment is growing, the cost of such tax cuts in terms of revenue foregone is far less than "static" estimates that allow for no behavioural response suggest.

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