

What Should Be the Federal Government's Agenda?

By Jack M. Mintz

Noises coming out of Ottawa suggest that the federal government is embarking on a new social policy agenda – increased public expenditures on a variety of programs, including day care, social housing and income supplements, without any reference to productivity, debt reduction or tax cuts. In fact, some new dedicated taxes for transportation and health care are being suggested as new less-than-innovative policies foisted on our beleaguered taxpayers.

In the meantime, the Minister of Finance, John Martin (or is it Paul Manley?), is trying to lower expectations by reminding the public – and, more importantly, the rest of the government – there is not that much money in the bank to spend. At best, the surplus will be in the \$3-to-\$4 billion range, which is a paltry sum to pay for the cost of any major programs.

All this leads to an interesting dynamic in Ottawa as the leadership battle within the natural governing party intensifies. Will Ottawa be able to show movement on a new agenda? If so, what should that agenda be?

Let's begin with a review of the most important economic and fiscal changes that have occurred in the past decade and then look at what the federal government should be doing in the months ahead.

Economic Changes

In the past decade, we have seen a number of important changes to the Canadian economy.

Canada's standard of living has slipped relative to many other countries. From 1989-99, Canada had one of the lowest growth rates in per capita GDP of all OECD countries. Although we have recently fared better, Canada witnessed several countries leapfrog over it, including Ireland, once a very poor cousin.

Part of the concern about our low productivity is that investment in Canada has been too little. Foreign direct investment declined as a share of FDI to the rest of North America. Canadian companies are becoming North American or global corporations with increasing outbound investment to the rest of world. However, capital formation in Canada remains relatively slow. The dollar has been on a steady downward trend against its US counterpart.

With so many Canadian companies now conducting the largest share of their business in the United States, while listing on US stock exchanges, many companies are increasingly looking to the US for new business. In fact, a growing number of companies that were once Canadian-based are moving to the US – Nova Chemical, TrizecHahn and IPSCO are examples of Canadian companies that have left.

Thus, our economic relations with the United States are becoming increasingly important. Can Canadian companies compete in North America or do they have to hop over the border to be competitive? Keeping the border frictionless is a Canadian priority. For the United States, after September 11, security is of utmost concern.

A further trend is the aging of our society with a flattening out in growth of the work force that supports the elderly. Although the full effects of these demographic changes won't be felt until 2020, they are nonetheless important today as the current middle-age working population needs to save sufficient resources for their retirement needs.

Fiscal Changes

The singular problem faced by governments in the 1990s was the need to deal with an overwhelming debt and large deficits built up over a decade and half. Total government expenditures, about 40 percent of gross domestic product in 1980, increased to as much as 50 percent of GDP by 1994.

Then, fiscal retrenchment became the order of the day in the mid-1990s, at a time when economic growth was anemic. Program expenditures in many areas were cut back as public debt charges increased. Taxes were raised to cover deficits – government revenues as a proportion of GDP rose from 36 percent to 42 percent of GDP.

Since the mid-1990s the debt burden has declined, though it still remains over 75 percent of GDP. Public expenditures have declined to about 42 percent of GDP, reflecting falling debt charges and static expenditures. Even though taxes have been cut, especially income taxes, governments take more out of the economy in terms of revenue than ever before – close to 43 percent of GDP and almost 10 points more than is the case in the United States, our most important trading partner.

The fiscal problems facing Canada have lessened substantially, though there is much more work to be done. Specifically, our fiscal policies fail to support productivity and make it difficult for Canadians to provide resources for retirement, relying more than ever on a dwindling working population.

Specifically, Canada's fiscal policies contribute to an undermining of our productivity. High personal and business taxes relative to other jurisdictions reduce the incentive for investments in technology and for high paying jobs to be created in Canada. Further, high tax rates on lower-income Canadians deter them from improving their own standard of living since better incomes are substantially taxed back by governments through various taxes and income-tested benefit schemes.

As I estimated in my book, *Most Favored Nation*, taxes, net of public subsidies for infrastructure, research and development, education, health care and social security benefits, are almost 40 percent higher than in the United States as a proportion of business costs. Even with the tax cuts being still implemented in the coming four-to-five years, Canadian fiscal policies still will be at a 30 percent disadvantage relative to the United States.

Further, unfunded liabilities, including government debt, health care and pensions, net of the value of tax revenues from RRSPs and pension withdrawals, amount to close to \$2 trillion. Such a large debt liability implies, according to OECD calculations, that Canadian government revenue as a percentage of GDP will have to rise to as much as 53 percent by 2040, about 15 points higher than will be the case in the United States. We have a productivity problem today and it will become even greater in the future given demographic trends.

The Federal Government's Agenda

Then what should be the federal government's agenda? Certainly, from my analysis, the pressing needs are related to improving our productivity and making sure that Canadians can support the elderly when they retire. A higher standard of living will be a basis for greater support of public services and other amenities enjoyed by Canadians. No poor country has a first-class infrastructure, health and education system – these are affordable for richer countries.

Some might believe that we have gone a long way to correct our fiscal mismanagement of earlier years. I disagree. We have may have gone on a diet and lost some weight, but now is not the time to give up and risk becoming obese. Public debt remains too high. Our tax system is full of inequities, induced in part by the need for governments to raise revenue. Many of our public-expenditure priorities are being neglected, while some expenditures of questionable value to Canadians are still funded.

So, what are the policies that are most useful now over the next decade that would support a productivity agenda and deal with the oncoming demographic pressures?

My first priority would be to continue reducing debt. In my view, we should try to reduce total government debt to less than 25 percent of GDP by 2015, which would help reduce the overall unfunded liabilities left to the next generation.

The second priority would be use the interest savings from debt reduction to provide further tax cuts, letting that government revenue fall to less than 40 percent of GDP. One can think of these tax cuts as dividends paid to Canadians for good fiscal performance.

The third priority is to undertake a review of public expenditures at all levels of government to make sure that the programs are operated efficiently and effectively, with some programs eliminated so that more funding could be directed to critical areas requiring government support. Reallocations of resources from inefficient uses to priority areas would enable governments to grow less than the economy, providing for further tax cuts.

Let me particularly turn to federal expenditure priorities in this regard. The federal government has a number of important responsibilities and these should be well funded.

For one thing, there are those services at the federal level that are “pure” public goods that benefit all Canadians. These include defence, law and order, security and health testing. These services are essential for the conduct of the economy. Certainly, after years of constrained expenditures, the federal government may need to increase the amounts spent in this area to make sure that services are properly funded.

For another, the federal government is also responsible for international relations and the economic union within Canada. Unlike foreign policy, the government has expended very little effort on economic union issues, yet we know that a number of internal barriers to trade remain in place, undermining our east-west economic integration. Immigration services – some of which are downloaded to lower levels of government without compensation – are critical to Canada. The federal government is responsible for treaties, including tax treaties, some of which need more resources to implement them.

Thirdly, the federal government provides mixed private-public services at the national level that are important for the Canadian economy, such as border infrastructure, national transportation grids and communication infrastructure and regulation. Although one could let the private sector have a bigger role in the delivery of these services, a federal role is essential in some of the infrastructure areas.

Finally, the federal government is responsible for certain transfer programs to people or provinces that administer the programs – old age security, unemployment insurance, equalization, post-secondary education and the Canada Health and Social Transfer. Aboriginal policy is also a federal responsibility, one in which government has failed miserably so far despite the \$8 billion spent on services for our Native people.

These are important priorities that should be a focus for the federal government. Yet, I have not made mention of other current or proposed federal programs like regional development, job creation grants, social housing, municipal funding, childcare and primary and secondary education.

Why have I not mentioned these other possible agenda items? The answer is fairly simple. I believe the federal government should focus on its core responsibilities, avoid ineffective programs like regional development and job creation grants, and not expand into areas that are more effectively administered by the provinces.

As one example, I refer to Employment (unemployment) insurance, a federal constitutional responsibility. Employment insurance is not a well-designed program in Canada. It is not well integrated with provincial social assistance and workers’ compensation programs. There is no experience rating to deter overuse of the program, unlike the case of workers’ compensation programs. Further, a large surplus continues, creating demands for greater benefits to be paid out (like long-term parental care or training programs). The 1994 reforms have pretty well been unravelled in 2000 so the EI system continues to operate at high administrative and economic costs. Significant effort should be made to improve the system rather than

embarking on new programs. The program should adhere more closely to insurance principles – risk-sharing with incentives built in to reduce overuse. The program should be balanced so that premiums cover the benefits paid out. And, the federal government could provide a base and allow provinces to run an alternative or supplementary system that would be integrated with other provincial services.

As another example, I believe that federal intrusion in municipal funding is a mistake. Municipalities differ substantially across the provinces in terms of their responsibilities and resource needs. They also are creatures of the provinces and any mayor, worth a grain of salt, would love to do an end run around the provincial premier to get funding from the federal government. Further, the federal government would find it very difficult to balance the needs of different municipalities. When caught with the municipal responsibilities, as in Brazil, a federal government becomes stuck in quicksand with little way out except to throw increasing amounts at the municipalities to establish fairness without regard to priorities.

Where the federal government does fund provincial programs, like health care, it should be providing some flexibility for provincial experimentation so that Canadians can learn what reforms might improve the system or not. Many of the social programs that started in Canada, including health care, began with a province. Why not allow the provinces to introduce some reforms on an experimental basis, like public health provider competition and incentive-based financing, to see if the services are improved over time. The federal government could fund some initiatives if they wish.

Therefore, the federal government, in my view, should focus on some of its current responsibilities and improve public service delivery rather than get distracted with programs that are better delivered at the provincial government.

Back to the Productivity Agenda

What about the productivity agenda? Has the federal government run out of innovative ideas? The current thrust – greater public financial support for research and post-secondary education– has perhaps come to a dead-end in terms of new ideas. As many countries have found, simply throwing money at research does not result in high levels of productivity because other factors play an important role in making sure that research gets converted into productivity gains. Creation of ideas is not enough – one must have adoption.

While the adoption of ideas partly depends on having a robust research and education infrastructure, considerable effort must be made at the commercialization and development of products that provide large payoffs to a country. Further, ideas come out of nowhere and it is very difficult for government to predict which ideas might work best.

Often, therefore, an environment that supports research and its adoption is most important for innovation and productivity.

One particular imbalance in Canada is in the tax system itself. Although the research and development tax credit, one of the most generous in the world, reduces the costs of hiring researchers and paying for research infrastructure for a company, taxes remain relatively high on those operations and people responsible for the adoption of technologies. Productivity is not achieved if government simply reduces the cost of creating ideas, then highly taxes those who adopt them.

For this reason, we get back to the tax-cut agenda. Canadian personal and business taxes, still high in a number of areas, erode our productivity. We still need to address a number of tax issues, especially where taxes are barriers to growth – high marginal tax rates for low and middle income Canadians, high taxes on investment and savings and high EI payroll taxes.

Thus, I come to the conclusion that the federal agenda should be focussing on its core responsibilities, cutting debt and cutting taxes where inappropriately high.

This is quite contrary to noises coming from Ottawa. The primary ideas – new social programs and dedicated taxes – will fail to address the standard of living and demographic issues facing Canada. Instead,

the federal government should focus on productivity – its own, as well as others’ – and avoid being distracted in a number of new, questionable ventures.