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The 1996 Federal Budget
Some Answers and Some Questions

By William B. P. Robson
and Kenneth J. Boessenkool

Since the March 1996 federal budget was notable for the absence of measures with major short-term impacts on federal finances or the Canadian economy, its aftermath is an apt time to reflect on some of Ottawa's longer-term fiscal conundrums. This note reviews a handful of the key challenges in light of the initiatives and information presented on March 6.

Deficits, Programs, and Intergenerational Transfers

In view of the growth in attention to the impact of fiscal policy on the relative welfare of different generations (see the Commentary by William Scarth on this site), a comment on this issue seems an appropriate leadoff.

Because of their impact on national saving and future wealth, government deficits are among the most important contributors to the poor prospects facing today's and tomorrow's young people. In that light, the government deserves some credit for having hit its deficit targets to date and for its good prospects (especially in light of the now familiar pessimistic economic forecast) for hitting its new target. Tempering that praise, however, is the unambitious nature of those targets in the first place: they fail to ensure a balanced budget during the life of the current Parliament. That the further modest measures announced in this budget will have no appreciable impact on the bottom line before the next election reinforces this concern.

Adding to concern about future wealth are the tax frictions involved when Ottawa is required, year after year, to tax far in excess of the programs it provides. The continued growth of interest payments suggests that, if the federal budget approaches balance around the turn of the century, Ottawa will be collecting more than $1.40 in taxes for every program dollar spent ($1.70 if cash transfers to other levels of government are excluded from federal programs). The slower the move toward surplus, and the smaller the eventual surplus, the longer this ratio will remain high, imposing unnecessary economic losses and incentives to move to the underground economy. There is also the risk that Canadians, already absorbing a large gap in what they pay and what they receive, may well lose patience if the gap persists over too long a period.

As far as intergenerational issues are concerned, however, there was other good news in the budget. The opening of debate over changes to the income support system for seniors (discussed further in the next section) signals overdue recognition that transfers along current lines cannot be maintained as the elderly portion of the population grows. In addition, the budget contained various other measures — more generous tax treatment of tuition expenses; larger RESP deductions; unlimited carryforwards of RRSP contributions; increased working income supplements — that incrementally reduce the overall tilt of fiscal policy against the young.

The Coming Changes to Elderly Benefits

The proposal to fold OAS, GIS, spouses' allowances, and the age and pension credits into a new elderly benefit in 2001 is a useful step forward. The debate over this and other potential changes promises to be long and difficult, however, not least because the projected savings are very modest and a long way off. While the proposal itself makes considerable sense, what actually happens in 2001 may well by quite different from what is envisioned in the budget.

Changing income support for the elderly inevitably involves unfairness to recipients: benefits are either taken away from those currently receiving them, or transitions create unfair situations where similarly situated people are treated differently. Having experimented with the former, using clawbacks, the federal government is now resorting to a system that promises rather acute versions of the latter. A quick reading of the proposal in the budget documents suggests that relatively well-off people reaching age 65 on January 1, 2001, may find themselves considerably worse off than their fellows who turned 65 one day earlier — a difference that, under the budget proposal, would persist for the rest of their lives.

A less problematic approach involves raising the eligibility age in small increments over long periods. It is to be hoped that the government will, in the course of the debate ahead, consider moves along these lines as well. The gains in life expectancy at age 65 that have occurred since the eligibility age for OAS was set at that age would justify a phased move to at least age 68. And money saved by raising the eligibility age could be used to mitigate unfairnesses arising from transitions to more targeted benefits such as that proposed in the budget.

The Hazards of Exploding Unemployment Insurance

A sleeper in recent federal budgets is the transformation in the UI account. Changes originally presented as allowing the account to run a surplus during booms (instead of fluctuating with the business cycle between balance and large deficits) have now produced an account headed toward the stratosphere. The budget projections suggest that the UI account will contain more than $12 billion by the end of fiscal year 1998/99. Roughly $5 billion annually — more than one-quarter — of UI revenues might at this point be thought of more as a deficit-reduction payroll tax than as anything like an insurance premium.

Although UI premiums are often termed "job killers," their biggest impact is more likely a wage-depressing one. Among the various taxes that the federal government might have deployed to chip $5 billion off the deficit, UI premiums may be one of the less damaging to growth and job creation. But this relentless growth in the UI account raises some awkward questions about the future.

The two most obvious choices the federal government has are both unattractive. It can reduce UI premiums, which would mean — for a given level of non-UI spending — accepting a higher deficit or looking for another, possibly more damaging, tax to fill the gap. Or it could boost UI benefits, not a course most economists would recommend for improving the functioning of Canada's labor market. A third choice, then, would be for the government simply to absorb the surplus in the UI account into the rest of the budget, maintaining UI's considerable benefits for the bottom line further into the future.

Aside from well-founded opposition from labor and business groups, who will object to this perversion of an insurance program, this option also runs into a constitutional obstacle in that the federal and provincial governments are prohibited from taxing each other. UI premiums have not fallen afoul of this prohibition in the past, since they were part of a social insurance program. If a large part of UI revenue becomes, in effect, simply part of the regular federal budget, then British Columbia, Alberta, and Ontario — provinces that are chronic losers from the UI program — may decide to challenge the legality of the deduction on behalf of their own employees. The federal government's moves on this front will bear close watching.

The Fiscal and Political Baggage of the CHST

For those concerned that political difficulties might derail the rolling of old Established Programs Financing and Canada Assistance Plan transfers into the new Canada Health and Social Transfer, and pre-empt the associated budgetary savings, the budget provides some reassurance. The government has decided to move toward a more equal distribution, with a five-year funding regime that will reduce by half the disparities in per capita entitlements (tax points and cash considered together) under the CHST. When cash, rather than overall entitlements, is focused on, however, the appearance of a fairer distribution among provinces fades. It seems likely that this plan will be challenged by both the provinces who will lose relative to the current system and by those — British Columbia, Alberta, and Ontario — who will continue to do relatively worse.

The commitment to an $11 billion cash floor, which will be praised by those concerned about provincial behavior in social programs, promises to bring at least two types of future headache.

First, because tax points were allowed to "crowd out" cash transfers over the past five years, the government has realized an annual contribution to the deficit in the range of $2 to $3 billion above and beyond reductions in the ceiling placed on total entitlements. A floor value for the cash component of the CHST will wipe out this annual contribution and result in a dollar-for-dollar increase in the deficit when the floor is hit. This effect will be tempered by the fact that the $11 billion dollar floor is in nominal dollars, so the contribution will still fall in real terms by the value of inflation.

Second, the prospect of guaranteed federal involvement in programs under provincial jurisdiction will dishearten those who were hoping for a more decentralized federation. The $11 billion floor ensures that the federal government will continue to attempt to call the shots on key aspects of provincial welfare, education, and health policies. In this respect, while no movement to date has been made in the 1995 budget commitment to develop "a set of shared principles and objectives that could underlie the new transfer," this new floor for the CHST will reinvigorate calls for further centralized standards for these programs. Given the political frictions and lack of accountability in the delivery of health, postsecondary education, and welfare programs under the current system — and in view of the marginal contribution that federal funds will be making to the total cost of these programs to provincial governments — these calls should be placed on hold.

A Charitable Last Word

Although not as economically or fiscally significant as the items already covered in this note, the budget's proposals for more generous tax treatment of charitable donations deserves mention. The retrenchment of governments is going to be a fact of life for some time to come. Nonprofit groups will play a larger role in many service areas — often to good effect, since nonprofit groups tend to be less wasteful of resources and better targeters of their services. The inadequate recognition of the contributions of this sector in the tax treatment of charitable donations, especially by contrast with the far more generous treatment given political donations, has been criticized both by the nonprofit sector itself and by many tax experts. One would hope that individuals and businesses will respond by increasing their support of key organizations serving areas from which governments are withdrawing.