Notes for an Address

Opening Statement
to the
House of Commons
Standing Committee on Finance

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by

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April 30, 2002

Introduction

It is a privilege and a pleasure to be asked to appear before the House of Commons Standing Committee on Finance.

My statement begins with a series of congratulatory comments directed to Finance and to this Committee for commendable policies in the general fiscal area. I then turn to a discussion of some imperatives relating to debts, expenditures and taxes in the context of the New Economic Order. For the remainder of my opening comments the focus shifts to a series of issues and areas that deserve the attention of this Committee. Most obvious among these is the emergence of serious federal-provincial and interprovincial fiscal imbalances. This calls for the Finance Committee or some similarly constituted body to follow in the footsteps, twenty years later, of the *Parliamentary Task Force on Federal-Provincial Fiscal Arrangements*(generally referred to as the Breau Committee, after its Chair, Herb Breau). This is especially the case in the present time frame since Canada's so-called global city-regions are making a play to become more fully and more formally integrated into the federal-provincial negotiation game. Hence, a brief concluding section will be devoted to cities and their financing.

Plaudits for Canada's Fiscal Managers

In a recent paper (2002), I reviewed Canada's fiscal performance for a European University Institute conference in Florence which focussed on the debts, deficits and unfunded pension liabilities of G7 countries. On the deficit front, Canada was the first G7 nation to return to budget balance in the wake of the 1990s recession. And it now appears that the string of Canadian budget surpluses, begun in fiscal year 1997/98, will continue through to 2001-02 and beyond. No other G7 nation can claim five consecutive surpluses, and Canada may be joined by only one other G7 country in running a surplus this fiscal year.

While Canada ranked as one of the most indebted G7 nations (second only to Italy) in the mid-1990s, our debt-to-GDP ratio declined by nearly 20 percentage points since 1995 (from roughly 70% to 50% in 2001), the largest decline among G7 nations. Canada is still slightly above the G7 debt/GDP average, but we are converging quickly.

Another of our unsung accomplishments is that we have successfully addressed the unfunded pension liabilities of the CPP/QPP. Not only can no other G7 nation make such a claim, but for some of these nations the unfunded liabilities of public pensions are looming as enormous fiscal challenges.

Finally, we have been able to reap the rewards of putting our fiscal house in order. During the 1990's recession, our deficit and debt overhang was such that we were forced to *increase* selective taxes during the recession. Our return to fiscal flexibility has meant that during the current economic slowdown Canada was able to undertake a degree of discretionary fiscal stabilization that is historically unprecedented both in terms of magnitude and timing. The key stabilization initiatives were the huge income tax cuts (and, to a lesser degree the increase in health transfers to the provinces) that took effect on January 1, 2001. In the December 10, 2001 federal budget, Ottawa undertook further stimulus by postponing small-business tax installments for a six-month period. In tandem these initiatives played a key role in ensuring that Canada did not fall into recession, (defined as a two consecutive quarters of negative real income growth). Nor did the economic slowdown interrupt our string of successive budget surpluses, as many had predicted.

Plaudits to Finance and the Finance Committee on all counts!

Taxes, Debts and Deficits in the Information Age

In my recent book, *A State of Minds: Toward A Human Capital Future for Canadians* (2001), I focussed on the implications of globalization and the information revolution for citizens, for markets, for governments and, ultimately, for Canadian public policy. The bottom line is rather straightforward: the information era will privilege knowledge and human capital in much the same fashion as the Industrial Revolution privileged physical capital. Combining this perspective with the long-standing Canadian imperative of achieving both economic competitiveness and social cohesion led me to develop a one-sentence mission statement for century 21:

> Design a sustainable, socially inclusive and internationally competitive infrastructure that ensures equal opportunity for all Canadians to develop, to enhance and to employ in Canada their skills and human capital, thereby enabling them to become full citizens in the information-era Canadians and global societies.

Among the economic imperatives flowing from the mission statement (especially the “employ in Canada” component) is the necessity to ensure that our marginal tax rates on mobile factors (physical, financial and human capital) are competitive with those south of the border. In the 2000 federal budget and the October 2000 *Economic Statement*, we have made important progress in this area. It is still the case, however, that the top combined (federal plus provincial) marginal tax rates for personal income taxation remain too high vis-à-vis US rates, i.e.,high marginal tax rates on human capital (often referred to in this context as “talent”) are one of the factors fuelling the brain drain. More generally, as Canada becomes progressively integrated into North American (NAFTA) economic space, our system of taxation should shift away from income and toward consumption. Indeed, the export/import neutrality of value-added taxes makes the GST a critically important tax if we want to run a larger government sector than the Americans.

On the social cohesion front, the challenge is to upgrade the skills and human capital of the lower half of our labour force. As Lester Thurow (1993,5) has noted in this connection: “If capital is borrowable, raw materials are buyable and technology is copyable, what are you left with if you want to run a high-wage economy? Only skills, there isn’t anything else.” The principal imperative that flows from the mission statement in this regard is the “democratization” of the opportunity to access the fruits of information and human capital. Among the specific suggestions I proffer are i) a bill/charter of human-capital rights for our children, and ii) a reorganization of our government bureaucracies to make them consistent with the reality that knowledge and human capital are now increasingly on the cutting edge of competitiveness on the one hand, and also with the reality that providing equality of opportunity for all Canadians to develop and enhance their human capital will hold one of the keys to addressing the income-distribution and social-cohesion challenges of this new era on the other.

In my view, these tax and social policy imperatives have a higher claim on our fiscal resources that does paying down our outstanding debt. Indeed, I remain wholly satisfied with Finance’s existing approach to debt control (e.g. the *Enhanced Debt Reduction Plan*). As already noted, this approach has reduced Canada’s debt/GDP ratio more than that of any other G7 nation over the last half-dozen years and Canada will likely soon find its debt/GDP ratio to be below the G7 average. Ensuring budget balance in the context of a growing economy ensures a continuously falling debt-to-GDP ratio.

There is, however, one issue that has arisen in this context, namely that Finance appears consistently and substantially to over-achieve its deficit targets or its expected surpluses such that we do end up paying down our outstanding debt when that was not the intention. In fiscal 2000-01, for example, the debt paydown was over $17 billion, the largest in our history. In the December 10, 2001 budget, Finance forecast a zero budget deficit for fiscal year 2001-02. But more recent data (although less than six months after the budget) suggest that revenues are running well beyond expectations, so that there may well again be a double-digit surplus. At one level, this reduces the information content of federal budgets and may serve, on the surface at least, to reduce the accountability of the Finance Department. However, it is important to recall that one of the key factors at play here is that the economy has been performing much better than it was forecast to perform. And in this regard, it is also important to note that Finance relies on *private sector forecasts* for the values of key economic variables – income, interest rates, inflation, etc. While Finance then adds a bit of prudence and contingency here and there, the fact remains that the principal cause of the underestimation of federal fiscal balance is, by and large, the result of projections coming from the private sector, not from Finance. Moreover, it is also the case that US private sector forecasters have also underestimated the strength of the American boom. Given that likely US growth is a key variable in Canadian forecasts, if the former are underestimated so will the latter be. Hence, the ultimate problem may lie neither with Finance nor with Canadian private forecasters but, rather, with US private sector forecasters and forecasts.

For the remainder of these comments, I want to highlight some issues that will impinge on Canada's fiscal and economic fortunes and that are, therefore, appropriate to raise before the Committee even though they probably would not qualify as standard fare. I begin with the old chestnut--federal-provincial fiscal relations and, later, federal-provincial-municipal relations.

Federal-Provincial and Inter-Provincial Fiscal Imbalances

While the federal government is well launched in a direction consistent with putting its fiscal house in order, this is not the case for the other governments in the federation. In terms of vertical fiscal balance (i.e. the fiscal interplay between the federal government and the provinces), the provinces are far more vulnerable than is Ottawa to the on-going economic downturn. Led by British Columbia, several and perhaps a majority of provinces will surely run deficits in this fiscal year. Indeed, in a Conference Board of Canada submission (2002) prepared for Quebec's *Commission on Fiscal Imbalance* (often referred to as the Séguin Commission, after its Chair, Yves Séguin), the budgetary projections are that, under the assumption that the current revenue and program structures are maintained, Quebec would post recurring deficits averaging $3 billion each year until 2019-20 while the federal government would achieve ever-greater surpluses eventually reaching $90 billion in 2019-20 (and cumulatively roughly adequate to retire the existing federal outstanding debt). And presumably Quebec is not an outlier among the provinces in this regard, with the possible exception of Alberta in high-energy-price scenarios. There is also growing concern relating to horizontal (or inter-provincial) imbalances. At one end of the spectrum the Atlantic region is lobbying for a revised equalization program while at the other end Alberta is basking is its role as both a big spender and a tax haven. This imbalance is likely to become exacerbated as well. I deal briefly with each.

Vertical imbalance

During the 1990's recession, aggregate (federal and provincial) deficits doubled-- from $33 billion in 1989/90 to 66 billion in 1992/93 (Courchene, 2002). What was unprecedented about this spiralling deficit was that the provinces shouldered over $20 billion (or 2/3) of the increase. Part of this was due to the operations of the "cap" on CAP as well as the series of freezes and cuts to federal transfers for the Established Programs. While we can all celebrate

Ottawa's 1995 budget, which put federal finances on a sustainable path, the fact is that a good deal of Ottawa's deficit progress came, initially at least, from "shifting the deficit" to the provinces via the cut in CHST cash transfers from $18 billion to $11 billion. What this meant is that while Ottawa was able to achieve budget balance in 1997/98 (i.e. early on in the 1990s boom), the majority of the provinces achieved budget balance only in 2000/01 (i.e. at the peak of the boom). Therefore, the provinces are far more vulnerable fiscally than is Ottawa to the on-going economic slowdown. Thus, while Ottawa's focus can continue to be on "managing the surplus", the majority of the provinces must still be pre-occupied with "wrestling deficits to the ground." With several and perhaps a majority of provinces facing fiscal deficits, this is bound to lead to a call for re-balancing the fiscal underpinnings of the federation, a call that was being routed through the Romanow and Kirby reports but will now take a more direct route given the recent rosy surpluses forecast at the federal level.

There is a related vertical imbalance issue, one that translates into the over-reach of the federal spending power into areas of provincial jurisdiction. While Ottawa's cuts were, arguably, viewed as being directed to the health sector, the provinces have by and large *not* reduced outlays on health. Indeed, all provinces have *increased* health expenditures since 1995 in absolute terms and as a percentage of total provincial expenditures. Rather, the transfer-tightening process has resulted in the provinces' cutting their expenditures on municipalities, on welfare, on education, on the environment, i.e. almost everywhere but in the health sector because of the political power of the health constituency in every province. But this has prepared the jurisdictional landscape for Ottawa to now step in and spend money in these "fiscally-starved" areas, e.g. millennium scholarships, homelessness and soon, perhaps, direct municipal transfers from Ottawa (see below), In other words, by fiscally squeezing the provinces, Ottawa can now use the combination of its superior fiscal position on the one hand and the federal spending power on the other to do an end run around provincial jurisdictional responsibilities. This may play well in the eyes of many Canadians, but it will surely trigger dramatic responses from the provinces on a variety of fronts. The Séguin Report's call for the transfer of all GST revenues to the provinces promises to be only the opening volley in the federal-provincial fiscal tug of war.

Horizontal imbalance

On the interprovincial fiscal front, fiscal inequities are also emerging. The shift from the old "tax on tax" approach to the personal income tax (PIT) system to the new "tax on base" or "tax on income" approach is leading to rather dramatic differences in top marginal tax rates in Canada. The highest marginal tax rates in Newfoundland and Quebec are at or near 20% whereas Alberta's top rate is only 10%. These rate differentials reflect in part the fiscal ability of the various provinces to provide lower rates. They also reflect philosophical differences across provinces.

Arguably, there is a further important factor at play here. The 2000 federal budget approached tax reduction largely from a *social policy* rather than a *competitiveness* standpoint. Most of the cuts were geared to low and middle income Canadians. This may be great social policy, but it falls way short in terms of addressing international competitiveness concerns. To be fair, the October 2000 *Economic Statement* did begin to focus on decreasing the high tax rates on mobile factors. Nonetheless, Ottawa has implicitly sent the following message to the provinces: if you want to have overall personal and corporate taxes more competitive north-south, then you cut your rates! And on the corporate side Ontario has cut its corporate tax rates in half, with Alberta following. On the personal tax front, Alberta has accomplished this by its opting for a 10% single-rate tax (with *no* other provinces able to match this, but several attempting to follow suit).

This is inappropriate policy on Ottawa's part. For starters, Ottawa is abandoning its leadership role if it turns over the responsibility for ensuring competitive tax rates for mobile factors to the provinces. Ottawa might counter that maintaining high top marginal rates is necessary to ensure that the personal income tax (PIT) remains progressive. If Ottawa were to flatten the top end and if the provinces were then to follow Alberta's lead in implementing flat taxes, the result would be that the PIT would lose much of its progressivity. I have some sympathy with this position. But then the obvious solution should be a uniform lowering of *all* federal tax rates to create flexibility and tax room for the provinces to mount their flat taxes. Most likely, however, the majority of provinces would choose to have progressive rates, as they have now.

These concerns aside, the manner in which provinces' PIT tax rates are evolving makes it likely that the "have" provinces will end up with lower PIT rates than the have-not provinces, the implications of which may be an internal "brain drain". Moreover, the rather dramatic cuts in the tax rates of the largest provinces have significantly reduced the equalization "standard", one result of which has already been alluded to, namely the repeated calls for rethinking and reworking equalization because the status quo is leading to scenarios where poorer provinces will not be able to provide reasonably comparable public services at reasonably comparable tax rates.

Concerns related to both vertical and horizontal fiscal imbalances suggest that the Finance Committee ought to give some thought to addressing these potential imbalances in a comprehensive way. The obvious precedent here is the *Parliamentary Task Force on Federal-Provincial Fiscal Arrangements* of the early 1980s. Addressing intergovernmental fiscal arrangements in a comprehensive way is important for yet another reason – the movement by Canada's municipalities to become more fully and more formally integrated into federal-provincial political and fiscal forums. To this I now turn.

Global City Regions and Canadian Federalism

Progressively, the principal motors of the New Economic Order are "global city-regions." These city-regions are emerging as dynamic export platforms, as creative centres of human capital and research concentrations, and as key competitive nodes in the global networking of economic activity. And cities generally also find themselves in the front line of implementing many federal policies. More to the point, Canada's global city-regions (Montreal, Toronto and Vancouver among perhaps others) find themselves going head-to-head competitively with US global city-regions. Unlike these US cities which have benefited from direct access to generous federal infrastructure grants, Toronto *et al* have no direct access to federal infrastructure funding, since they are the creatures of their respective provinces and, therefore, have no direct entrée to Ottawa. One obvious solution is for the provinces to provide these needed infrastructure monies directly to their cities or, alternatively, to transfer greater taxing powers to these cities. Should neither of these occur, however, then the cities will surely collectively approach Ottawa and lobby for direct access to infrastructure and other funds. Indeed, this has already begun via groups such as the C5 (which includes the mayors of Vancouver, Calgary, Winnipeg, Toronto and Montreal), the Federation of Canadian Municipalities, the Canadian Urban Institute, the Canada West Foundation, among others. Along similar lines, the city of Toronto has recently enacted a "charter," replete with demands for designated powers, for flexible financing and for representation in existing fora (e.g., federal-provincial fiscal committees). The model here is presumably the German city-provinces (Laender) of Berlin, Bremen and Hamburg.

The recent report from the TD Bank Financial Group (2002) calling for greater fiscal and financial independence for Canada's cities provides yet further impetus for an increased role for cities. Among other recommendations, the TD report proposes that other levels of government reduce their taxes (especially excises and sales taxes) in order to provide tax room for the cities to impose their own taxes (hopefully piggy-backed on provincial or federal collection systems). In the report's view, providing tax room is preferable on accountability and sustainability grounds, among others, to mounting a complex new set of transfers to the municipalities. Finance Minister Paul Martin has indicated his willingness to take a sympathetic view of the cities' concerns. Thus, it is not much of a leap to suggest that at some point the Finance Committee will have to grapple with this issue of ensuring that Canada's global city-regions are internationally competitive. The title of the TD report stresses the urgency of this challenge–*A Choice Between Investing In Canada's Cities Or Disinvesting in Canada's Future.*

Conclusion

In my appearance before this Committee last year I devoted more attention to north-south integration within NAFTA economic space. Part of this integration included support for a North American monetary union or common currency modelled along the lines of the Euro. The events of September 11, 2001 have made creative mechanisms and instruments to enhance trade even more important. Should Committee members wish, I will be happy to answer questions on NAFTA integration as well as on those issues dealt with in the above analysis.

Thank you for your attention.

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