

A PAUL MARTIN, SR., BUDGET



Paul Martin's tax cuts move in the right direction, but too slowly for a country rapidly integrating into a globalizing information economy. The further expansion of the Canada Child Tax Benefit does continue the very sensible specialization in which Ottawa takes fiscal responsibility for Canada's children and seniors while the provinces cater to the needs of the work force. But Mr. Martin's failure to make a meaningful dent in either the top marginal or corporate tax rates means that the job of cutting taxes to promote wealth creation will fall to the provinces, especially the "have" provinces. The result will likely be divergent provincial economic fortunes, and calls from the "have-not" provinces for Ottawa to play an increasing redistributive role.

Thomas J. Courchene

Les réductions d'impôts qu'annonce Paul Martin nous engagent certes sur la bonne voie. Mais le rythme reste trop lent, pour un pays qui doit s'intégrer rapidement à une économie de l'information, en voie de mondialisation. L'accent mis sur la Prestation nationale pour enfants poursuit la saine spécialisation déjà amorcée : le fédéral assume sur le plan fiscal la responsabilité des enfants et des personnes âgées, pendant que les provinces pourvoient aux besoins de la main-d'œuvre. Toutefois, l'incapacité de M. Martin de diminuer de manière significative le taux marginal d'imposition ou l'impôt des entreprises aura pour effet de laisser aux provinces — surtout les plus riches — la responsabilité de couper les impôts pour stimuler la croissance économique. Les finances des provinces risquent d'en être affectées de manière très variable, et les moins nanties d'entre elles exigeront probablement du gouvernement fédéral qu'il assume un rôle plus important dans la redistribution des ressources.

With his reputation as Canada's deficit tamer fully secure, in his 2000 budget Paul Martin again dons the legacy mantle, this time as tax cutter — or as pay-back man. Though his tax cuts are part of a five-year agenda, and many are back-loaded, this label is surely appropriate. On the personal tax side he reworks the Tories' 1987-88 tax reform by altering the three features which, even in the context of 1988, were deemed either inappropriate or temporary. The first and by far the boldest initiative is to fully index the tax system. He does this in an intriguing way. Specifically, Mr. Martin increases the personal and spousal exemptions as well as the threshold levels for the middle- and upper-income brackets to levels that (roughly) would have prevailed had the 1988 tax system been fully indexed from the outset. Then he fully indexes these new levels. While almost all of the budget provisions were telegraphed well in advance of the budget, full indexing was a surprise and a most welcome one. Note, however, that the two provinces that, pre-budget, signaled their intentions in terms of rate and bracket flexibility (Alberta in its budget and Saskatchewan in the form of a blue-ribbon private sector task force) both

embraced full indexation and along the way challenged Ottawa to follow suit. Thus, the provinces may well have been the catalyst for federal indexation.

Mr. Martin's second re-working of 1988 reduces the middle-income tax rate from 26 per cent to 23 per cent. Recall that this was also on the Tory agenda in the late 1980s: Part of the GST initiative was to reduce this middle income tax rate. The Tories ended up reneging on this commitment, but Paul Martin delivers it. This was long overdue and, again, most welcome. And, finally, he removes the Tories' five per cent high-income surcharge, having removed their three per cent surcharge in a previous budget.

On the business side, the federal corporate tax rate will fall from 28 per cent to 21 per cent, capital gains can be rolled over tax-free from one small business to another, the capital gains inclusion rate falls from three-quarters to two-thirds and stock options are made compatible with US tax practice (Note that these latter two initiatives, although corporation- or business-related, are really personal tax measures).

All in all, on the tax side Mr. Martin's handiwork looks like an election budget in search of an election. My con-

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cern, however, is that the tax-reduction provisions that are actually proposed in the two-year budget cycle, as distinct from what is in the five-year plan, tend to focus on restoring vertical equity within a more or less closed-economy conception of Canada. It is this vision of the two-year budget proposals that prompted the Paul Martin, Sr., title for my comments — a vision that embraces a generous social conscience in the context of the comfortable international niche within which Canada found itself in Mr. Martin, Sr.’s era. As one perceptive commentator noted, backloading both the corporate tax cuts and phase-out of the high-income surcharge places these initiatives on “government time” rather than on “Internet time.” Phrased differently, the legislated initiatives are ideally suited to Paul Martin, Sr.’s time frame, not to the on-going dynamism and creative destruction associated with globalization and the knowledge /information revolution.

Before addressing this globalization challenge, and the resulting implications for the federal-provincial tax and fiscal interface, I shall touch briefly on two expenditure components of the budget, which also impact the federal-provincial nexus. The first of these is the significant enhancement in the Canada Child Tax Benefit — from \$1,805 for the first child to \$2,265 as of July 1, 2001 and, eventually to \$2,400 under the five-year plan. This represents a further evolution in the *de facto* division of powers in the federation. Essentially, Ottawa is taking increased responsibility for the income support of Canada’s children. If one links this with Ottawa’s already central role for the elderly, the provinces are left with the responsibility for their working-age populations. This amounts to a creative, non-constitutional, disentanglement of responsibilities in the social policy area, one that was initially recommended by the provinces in their impressive 1995 *Report To Premiers*, prepared by the provincial and territorial Ministerial Council on Social Policy Renewal and Reform.

There is another, albeit related way to view this increase in the CCTB, namely as a creative way for Ottawa to play a larger role in the welfare area now that 50 per cent cost-sharing under the Canada Assistance Plan is history. There is a huge difference, however. Transfers under CAP went through the provinces whereas the CCTB deals directly with citizens, thereby enhancing Ottawa’s presence in the lives of Canadians. And

while Ottawa has proven on more than one occasion that it can unilaterally alter cash transfers to the provinces, it is not likely to renege on these refundable tax credits to children.

The most controversial feature of this budget, at least in terms of the general public and the provinces, is the \$2.5 billion supposedly once-and-for-all increase in CHST cash transfers (which, intriguingly, the budget allocated to both health and post-secondary education, arguably buttressing the above view that the CCTB is a substitute for the notional welfare component of the CHST). Were the provinces to take all of this money into next year’s finances (rather than spreading it over four years, as in the budget’s notional allocation), this would total about \$17 billion, not far off the roughly \$18 billion peak in cash transfers prior to the implementation of the 1995 CHST budget. Nonetheless, it is clear to everyone that the Liberals will follow through with more on the health front in next year’s budget, especially if it is the *real* election budget. In the interim, I view this once-and-for-all infusion as salutary. We need a societal dialogue with respect to the evolution of our health care system. All that we are lacking now is an appropriate forum within which these debates and discussions can take place. With the Prime Minister’s refusal to hold a first ministers’ conference on health, preferring the health ministers to meet first, the stage may well be set for this public dialogue.

What eventually happens on the health front is very relevant to the following discussion of the tax side, since a reworking of the health envelope could easily put key aspects of the five-year tax plan in jeopardy and, in particular, could make it exceedingly difficult to move the proposed cuts forward in time. With his “come hell or high water” approach to deficits cuts, Mr. Martin surely has credibility in following through on multi-year commitments. But it seems unlikely that he will be around as finance minister to see the five-year plan through to its implementation.

Returning to the tax side, my assessment is that our competitive position in North America, for both attracting and keeping enterprise and talent, required much more in the way of immediate tax relief at the top end of the tax spectrum. Perhaps we should be thankful that the budget went as far as it did. After all, in Martin’s November 2, 1999

Economic and Fiscal Update, both corporate tax reduction and removal of the surcharge were low on his proposed agenda. And the stock option provision was not even on the radar screen. Moreover, the intended allocation of the fiscal surplus was clearly tilted toward the expenditure side, quite unlike the dominance of tax cuts in the actual budget. Still, the timid decrease in corporate tax rates from 28 per cent to 27 per cent on January 1, 2000, will leave Canada well above all of its G7 partners in terms of tax rates in the fast-growing services sector. This is surprising since corporate tax cuts are not very expensive in terms of foregone tax dollars. (If Ireland is an example, tax cuts could even increase corporate tax revenues). Moreover, that everyone knows Canada eventually has to get its corporate rates down to competitive levels argues strongly for a first-mover advantage. But this would have been clearly off-side with the overall low-and-middle-income approach that drove the 2000 budget.

The failure to remove the high-income surtax immediately, let alone decrease the top marginal rate, underscores the social-policy — as distinct from wealth-creation — perspective underpinning the budget. What Mr. Martin's caution effectively does is transfer responsibility for wealth creation to those provinces whose economic futures are in jeopardy unless top marginal rates come down. Indeed, Alberta is clearly leading the way here, with its 11 per cent flat tax. (As an aside: The result of the reduction in the federal middle income tax rate from 26 per cent to 23 per cent will mean that the existing Alberta tax system would have delivered a lower marginal tax rate to middle-income Albertans than they will pay under the 11 per cent flat tax. This is also true for lower-income Albertans but it is offset by the doubling of the personal and spousal tax credits. Musings out of Alberta in the wake of the federal budget are in the direction of lowering the flat tax to 10 per cent to assuage middle-income Albertans.) Assuming for discussion purposes that Alberta maintains its 11 per cent rate, after the elimination of the federal surcharge the top marginal rate for Albertans will be 40 per cent (11 per cent plus 29 per cent), since Alberta has also abolished its surcharges. Indeed, it may well be that Alberta's 11 per cent flat tax provided a signal to Ottawa that selected provinces would follow Alberta, so

that it could leave the top federal rate untouched. Pressure will now shift to Ontario, whose top marginal rate, because of the health care surcharge, is above the 40 per cent Alberta rate. If Ontario moves here, as I assume it must since its industry is more footloose than Alberta's, Quebec will then have to fall in line, as it has to a degree with its recent budget's reduction in its top marginal rates. But not all provinces will follow suit — some cannot afford to fiscally, some will not on ideological grounds, and some may not feel that lower top marginal rates are warranted economically.

Some of the consequent implications are already evident. Although the personal income tax system is currently in gradual transition to a "tax-on-income" from a "tax-on-tax" system, in which provincial taxes are levied as a straight percentage of federal taxes, some of the budget's provisions, most notably indexing and the reduction of the middle rate from 26 per cent to 24 per cent, will be in place on July 1 of this year. But for this year the system is still on the old tax-on-tax footing, so that absent provincial initiatives, the federal tax cuts also imply provincial tax cuts, unless provinces decide to increase the rate they apply to federal taxes.

Several provinces will presumably allow these federal tax cuts to flow through and reduce their own revenues. But some provinces have already signalled that they want to maintain their revenues. As I understand the situation, the Canada Customs and Revenue Agency (the replacement for Revenue Canada) will be accommodative to these provinces. In effect, a version of tax-on-income will be put in place on July 1, 2000. Suppose a province has a 50 per cent tax rate under the tax-on-tax system. Under tax-on-income, this would convert to a rate structure of 8.5 per cent, 12 per cent and 14.5 per cent across the three brackets (i.e., one-half of the three federal rates, 17 per cent, 24 per cent and 29 per cent). At this point, nothing has really changed. However, again as I understand it, the CCRA has indicated it would be willing to implement and withhold a targeted surcharge, presumably an increase in the provincial middle income tax rate to 13 per cent (i.e. one half of the former 26 per cent rate). This would maintain a province's revenues, although it would have to enact a discretionary tax increase to do so, not an enviable task on the political front.

Setting this complication aside, which only affects the current tax year in any event, my

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guess is that the result of rate and bracket flexibility at the provincial level will be a divergence in growth prospects across provinces. To be sure, marginal tax rates have long differed across provinces. What is different now is the heightened mobility for both enterprises and talent alike, which will surely increase as the US engages in a further round of tax cuts. In effect, Toronto, Calgary and perhaps Vancouver and Montreal will progressively become the focal points for Canadian talent and human capital, perhaps only as a positioning stage toward a move toward more friendly tax climates south of the border. Admittedly, this is conjecture. But what is certainly true is that the advent of tax-on-base will usher in a period in which the provinces' new rate and bracket structures embody quite different income-distributional and growth implications.

By focussing its immediate tax cuts on low- and middle-income Canadians and on small corporations, Ottawa is inviting selected provinces to embark on a wealth-creation approach to their tax systems. The result, I think, will be to force Ottawa even more into an income-redistributional frame of mind. The on-going concern over health funding is not just about health — for several provinces it is first and foremost a fiscal issue. Complicating all of this, although not related to the budget, per se, is that if oil prices stay near \$30 per barrel for any length of time several provinces will demand that Alberta's tax base be brought back into the equalization formula. The fact that the two recent federal CHST cash infusions have been allocated on a per capita basis (and not in line with the value of their CHST-related tax points) will only add fuel to the demands of the have-not provinces. Under this scenario, it seems more or less inevitable that Ottawa will be drawn into the middle of the interprovincial revenue-distribution issue — which likely will appear first in terms of the level of the equalization ceiling, but will eventually transcend this.

For Ottawa to increasingly play a redistribution role across all fronts, leaving key allocation or wealth-creating aspects to the provinces, is admittedly a viable approach to governance. But along the way it also means more powerful "have" provinces and greater economic asymmetry within the federation. To be sure, the existence of the *Agreement on Internal Trade* on the economic union front and of *A Framework to Improve the Social Union for Canadians* on the social union front means that we can now han-

dle greater asymmetry. Still, my guess is that ultimately this will not sit well with Ottawa.

But the problem is of Ottawa's own making, since in both the timing and the scope of its tax measures it paid precious little attention to Canada's viability in the geo-economics of NAFTA and the open borders of the Internet and knowledge era.

In closing, however, I do not want to fall into the trap of having the best be the enemy of the good. Paul Martin has delivered impressively on the tax-reduction front. The budget certainly makes our tax system more equitable domestically and it is a sound foundation on which to build a more competitive tax system internationally. As noted, this ensures that the 2000 budget fits exceedingly well into the times and the philosophy of Paul Martin, Sr. However, to make it a legacy budget for Paul Martin, Jr., one that goes on to reflect his times and his philosophy — or at least his competitiveness rhetoric, requires not only quick action on the unfinished five-year agenda but also further initiatives on the tax front that will make Canada an inviting place to start and grow enterprises that will provide attractive employment in Canada for our home-grown talent and human capital.

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The end of economics?

Maybe the discipline [economics] has come down with nothing more than a bad case of diminishing returns. Perhaps as much light as will ever be shone on the inexhaustibly complex behaviour of economic actors has by now been cast, and it is futile to hope for more. Of course, it will always be possible to gather extra data, looking for finer and finer detail — hence the trend towards specialization in the universities. But this will not, you might argue, render the big picture any more faithfully, or bring general economic laws any better into focus. Indeed it may make the big picture harder to see, until the search for general laws is called off altogether.

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