A REMARKABLE TURNAROUND WITH MORE WORK STILL TO DO

Thomas J. Courchene

Canada's fiscal performance during Paul Martin's tenure has improved dramatically, reducing its debt-to-GDP ratio by 20 percent, returning to budget balance and addressing the unfunded pension liabilities. Canadians are now reaping the benefits. Yet, important challenges are still to be addressed if Canada is to successfully face the new information and knowledge economy. Among other imperatives, Canada will have to offer competitive tax rates on mobile factors, shift to consumption taxes, and upgrade its human skills and capital. Moreover, Canada need to address the serious concerns raised by increasing vertical and horizontal fiscal imbalances and the fiscal needs of city-regions.

La performance fiscale du Canada s'est grandement améliorée sous le mandat de Paul Martin, comme en font foi la baisse de 20 p. 100 du rapport dette-PIB, le retour à l'équilibre budgétaire et l'effort de capitalisation des régimes de retraite. Les Canadiens en récoltent aujourd'hui les fruits. Mais il reste d'importants défis à relever dans la nouvelle économie de l'information et du savoir qui est la nôtre. Entre autres impératifs, le Canada devra offrir un taux d'impôt concurrentiel sur les facteurs mobiles, privilégier les taxes à la consommation, relever le niveau de ses compétences et de son capital humain. Surtout, il devra s'attaquer au problème grandissant du déséquilibre fiscal aussi bien vertical qu'horizontal, et répondre aux besoins fiscaux des cités-régions.

Earlier this year in my IRPP paper, ***Half-Way Home: Canada's Remarkable Fiscal Turnaround and the Paul Martin Legacy***, I reviewed Canada's fiscal performance in the context of focusing 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 after the recession in the 1990s. 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 will almost certainly be the only G7 country to run 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 (to 50 percent in 2001, from roughly 70 percent), the largest decline among G7 nations. Canada is still slightly above the G7 debt-to-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 and 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 1990s 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. Together, these initiatives played a key role in ensuring that Canada did not experience a recession, defined as two consecutive quarters of negative real income growth. Nor did the economic slowdown interrupt our string of successive budget surpluses, as many had predicted. So, plaudits to the

finance department and the finance committee on all counts.

In my recent book, *A State of Minds: Toward a Human Capital Future for Canadians*, I focused 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 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 the 21st century:

> *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 Canadian 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 compared with US rates: 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 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 offer are these: first, a charter of human-capital rights for our children; second, a reorganization of our government bureaucracies to make them consistent with the reality that, on the one hand, knowledge and human capital are now increasingly on the cutting edge of competitiveness and, on the other hand, that providing equality of opportunity for all Canadians to develop and enhance their human capital holds one of the keys to addressing the income-distribution and social-cohesion challenges of this new era.

In my view, these tax and social policy imperatives have a higher claim on our fiscal resources than does paying down our outstanding debt. Indeed, I remain wholly satisfied with the finance department's current approach to debt control (for example, the Enhanced Debt Reduction Plan). As already noted, this approach has reduced Canada's debt-to-GDP ratio more than that of any other G7 nation over the last half-dozen years and Canada will likely soon find its debt-to-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.

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There is, however, one issue that has arisen in this context that merits attention: The department of finance appears consistently and substantially to overachieve its deficit targets or its expected surpluses such that we 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, the department 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 department of finance. 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 was forecast. And in this regard, it is also important to note that the department relies on private sector forecasts for

the values of key economic variables: income, interest rates, inflation, etc. While the department 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 the department. Moreover, it is also the case that US private sector forecasters have underestimated the strength of the American boom. Given that likely US growth is a key variable in Canadian forecasts, if the former is underestimated so will the latter be. Hence, the ultimate problem may lie neither with the department 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. I begin with the old chestnut of federal-provincial fiscal relations and, later, federal-provincial-municipal relations.

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 (the fiscal interplay between the federal government and the provinces), the provinces are far more vulnerable than is Ottawa to the ongoing economic downturn. Led by British Columbia, several and perhaps a majority of provinces will surely run deficits this fiscal year. Indeed, in a Conference Board of Canada submission this year 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 highenergy-price scenarios. There is also growing concern relating to horizontal (or interprovincial) imbalances. At one end of the spectrum the Atlantic region is lobbying for a revised equalization program, while at the other end energy-rich Alberta is basking in its role as both a big spender and a tax haven. These imbalances are likely to become exacerbated as well. I deal briefly with each.

During the 1990s recession, aggregate (federal and provincial) deficits doubled, from $33 billion in 1989-90 to $66 billion in 1992-93. What was unprecedented about this spiralling deficit was that the provinces shouldered over $20 billion (or two-thirds) of the increase. Part of this was due to the operations of the "cap" on the Canada Assistance Plan (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 that put federal finances on a sustainable path, the fact is that a good deal of Ottawa's deficit progress came, initially at least, from a further "shifting the deficit" to the provinces via the cut in Canada Health and Social Transfers (CHST) cash transfers, to $11 billion from $18 billion.

What this meant was that while Ottawa was able to achieve budget balance in 1997-98, early in the 1990s boom, the majority of the provinces achieved budget balance only in 2000-01, at the peak of the boom. Therefore, the provinces are far more vulnerable fiscally than is Ottawa to the ongoing economic slowdown. And, 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 overreach 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, both 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, welfare, education, the environment—almost everywhere but in the health sector because of the political power of the health constituency in every province.

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But this has prepared the jurisdictional landscape for Ottawa to now step in and spend money in these fiscally-starved areas, like 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 hand, 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 forthcoming federal-provincial fiscal tug of war.

On the interprovincial fiscal front, too, fiscal inequities are emerging. The shift from the old "tax on tax" approach of the personal income tax (PIT) system to the new "tax on base" or "tax on income" approach is leading to dramatic differences in top marginal tax rates in Canada. The highest marginal tax rates, in Newfoundland and Quebec, are at or near 20 percent, whereas Alberta's top rate is only 10 percent. These rate differentials reflect in part the fiscal ability of the various provinces to provide lower rates. They also reflect philosophical differences among 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 (and is!) great social policy, but it falls way short in terms of addressing international competitiveness concerns. To be fair, the October 2000 Economic Statement began 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 *vis-à-vis* the Americans, then you cut your rates! 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 percent 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. To begin with, 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 for 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 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 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 in which poorer provinces will not be able to provide reasonably comparable public services at reasonably comparable tax rates.

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Concerns related to both vertical and horizontal fiscal imbalances suggest that the finance committee think about 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.

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 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 that have benefited

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from direct access to generous federal infrastructure grants, Toronto and the others 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, 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 and 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 like federal-provincial fiscal committees. The model here is presumably the German city-provinces (Laender) of Berlin, Bremen and Hamburg.

The reports earlier this year from the TD Bank Financial Group 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 reports propose 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 piggybacked on provincial or federal collection systems). In the reports' view, providing tax room is preferable, on accountability and sustainability grounds, among others, to mounting a complex new set of transfers to the municipalities.

Former finance minister Paul Martin 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 first of the TD reports stresses the urgency of this challenge: *A Choice Between Investing in Canada's Cities or Disinvesting in Canada's Future*.

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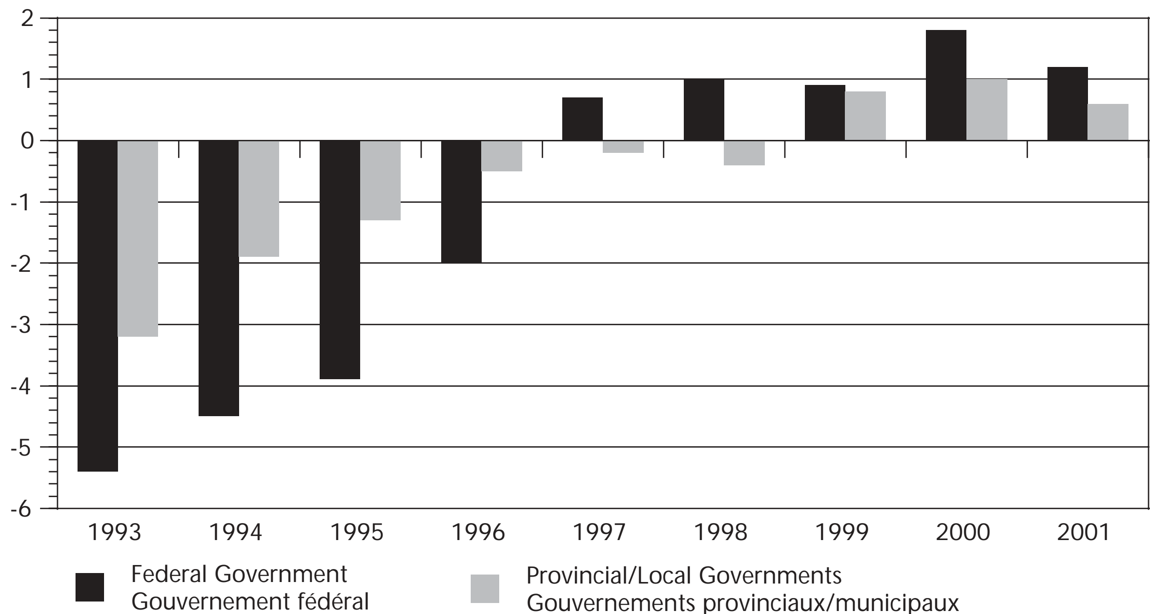
Federal and Provincial/Local Governments Budget Balance (as a percentage of GDP)

L'équilibre budgétaire des gouvernements fédéral et provinciaux/municipaux (en pourcentage du PIB)



Source: Statistics Canada/Statistique Canada.