

**Federal and Provincial
Fiscal Policy Challenges**

**Mike McCracken
Informetrica Limited**

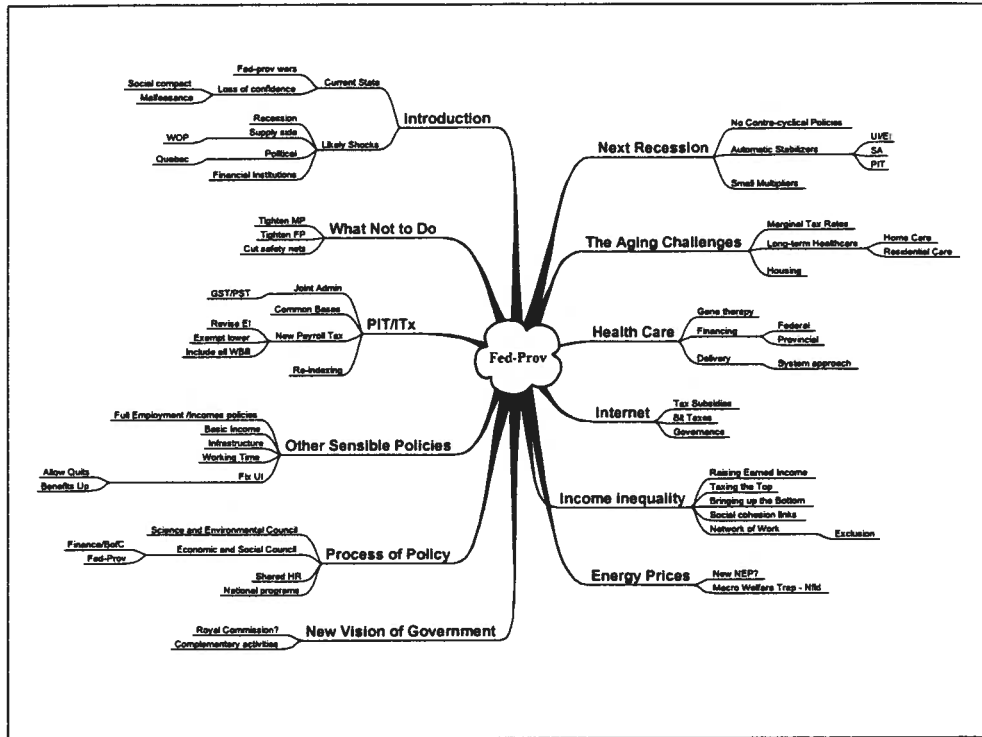
Treasury Board Seminar
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The focus of my remarks is on the changes in fiscal policy effectiveness, partly due to fed-prov changes. The situation is such that there will be a deeper and longer recession than would have been the case without the major structural changes in the last two decades. .

The main concern I have is that failure of fiscal policy will further destroy the public confidence in our shared institutions, including governments at all levels. How do we reverse it?

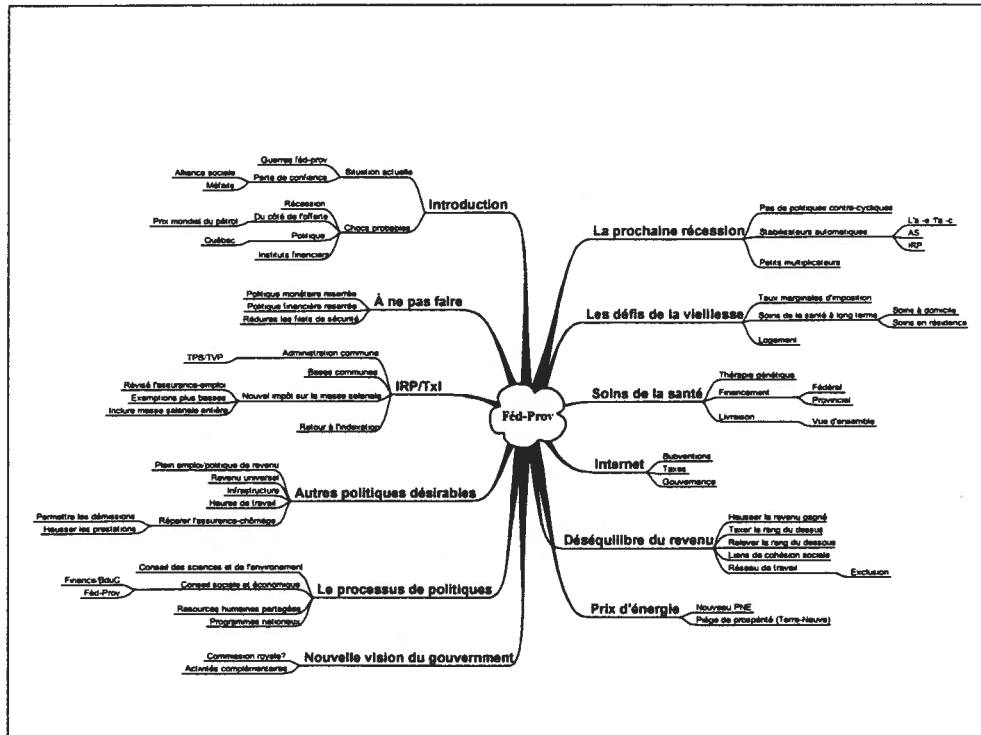
To change this world requires adopting a vision of "government", with federal, provincial, and municipal levels each complementing the others and all working together to deliver a better world for all citizens.

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On the right hand side are some problem areas. We will discuss those first.

On the left side are some possible solutions, including policy recommendations to improve the state of the economy.



Introduction

- Current State
 - Fed-prov “wars”
- High real interest rates
- High government debt ratios
- High personal debt ratios
- Large output gap
- High unemployment

Social exclusion - not part of the networks, particularly being employed for those not young or old - is a reality for too many parts of our society. Aboriginals, recent immigrants, the uneducated, the laid-off middle aged .

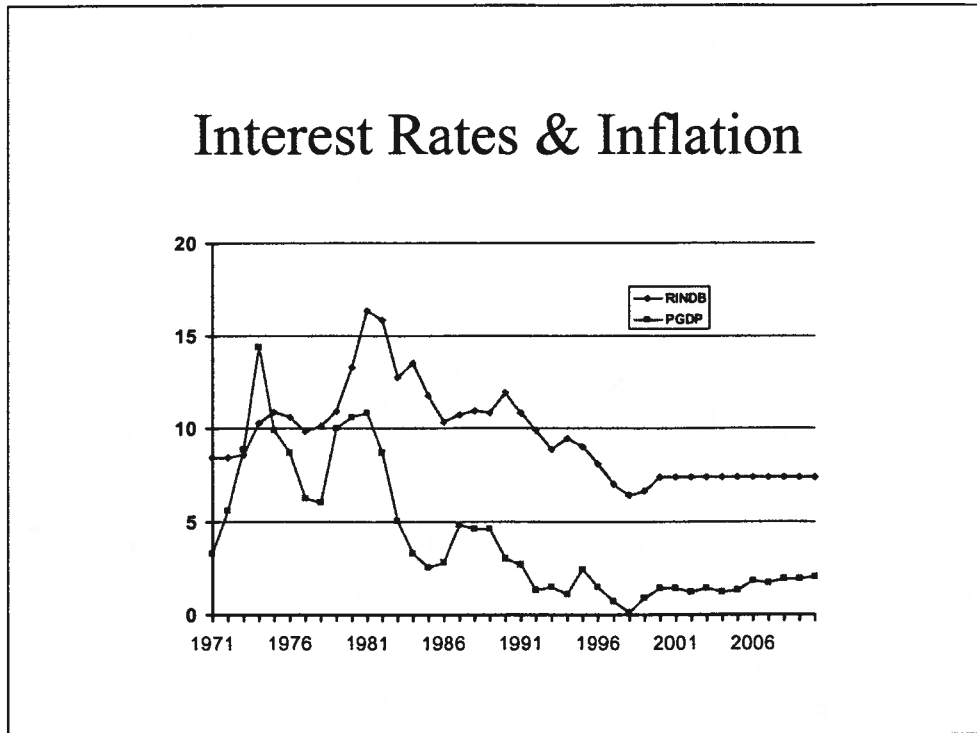
Double digit unemployment - youth, aboriginals

Real disposable income per household is below 1981 levels by 4%, below 1989 by 8%; per capita down 4% from 1989.

Falling federal program spending in real per capita terms.

High marginal rates, lack of indexing in the past, and cuts to transfers have worsened after-tax income distributions while imbalances in earned incomes worsen before-tax distributions.

Health care cutbacks, tuition increases, training problems, student debt problems.

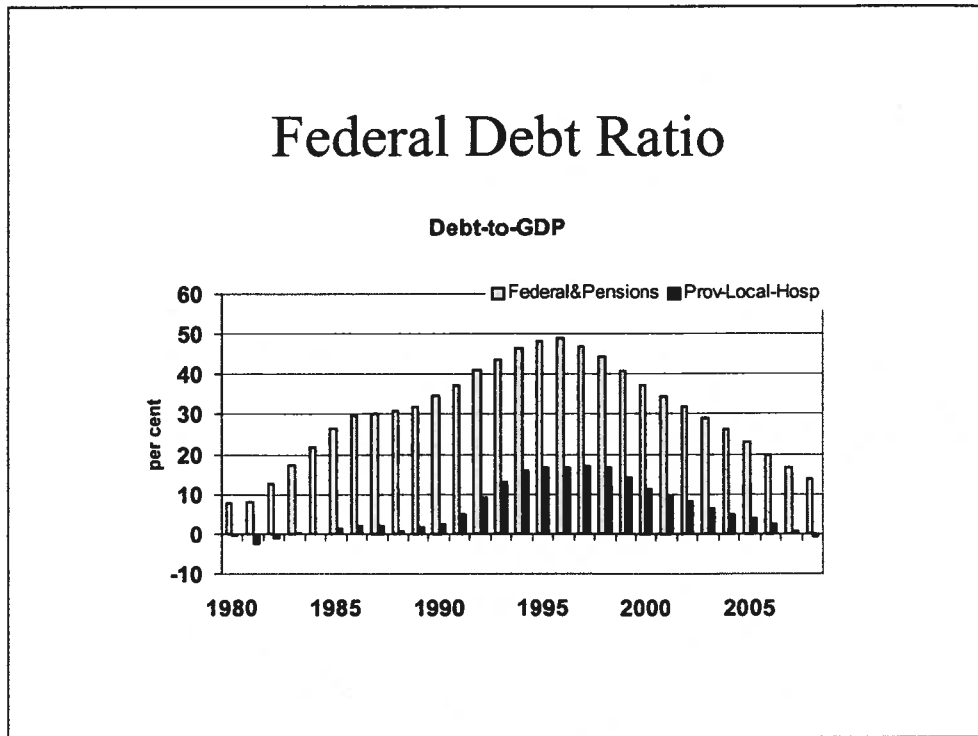


The difference between nominal interest rates (using the corporate bond rate) and the rate of inflation (here using the GDP deflator) is a measure of real interest rates.

The low real interest rates in the 1970s have moved to a world of 7% real rates or higher in the 1980s and early 1990s. The recent "improvement" has been to a lower rate of about 6%, with a forecast of about 5% from 2000 on.

With interest rates greater than real growth the instability problem persists.

Government borrowing rates may be below these rates by 50 to 100 basis points.



The Federal debt ratio continues to decline, reflecting the large primary surpluses in place over this period, even with slower growth.

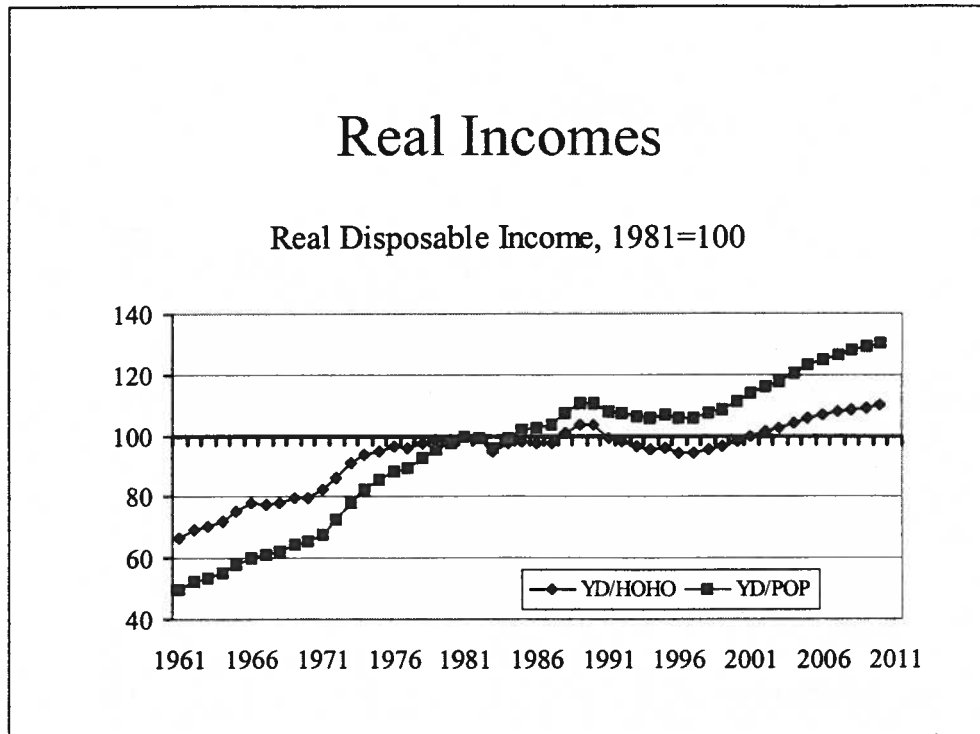
Indeed, it is assumed that the federal government will not budge off of its lower debt ratio objective.

The only issue is how quickly it will decline.

Similarly, P-L-H Debt is eliminated by 2008.

In the event of a major recession, then there will be a real problem for PLH given their sensitivity to weak growth.

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One of the sources of discontent in Canada has been the lack of progress in the growth in real disposable income per household.

Although there was some recovery in the 1980s after the recession, the more recent recession plunged the consumer back into a funk. Levels declined below those in 1982, and have so far failed to show any sustained progress. Indeed the incomes per household declined every year from 1989 through 1998..

The prospect, starting in 1999, is for some improvement to set in. It will be 2002, however, before levels are back to 1981 values. (This is based on a "current policies continued" case.)

In essence, over 20 years will have passed with no real income gains on average.

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Canada has not tracked with the US since the early 1980s, **choosing** to grow less rapidly to reduce inflation. With a deeper recession in 1982 and a longer recession in 1990-92, a substantial and persistent gap has developed between Canadian and US unemployment rates.

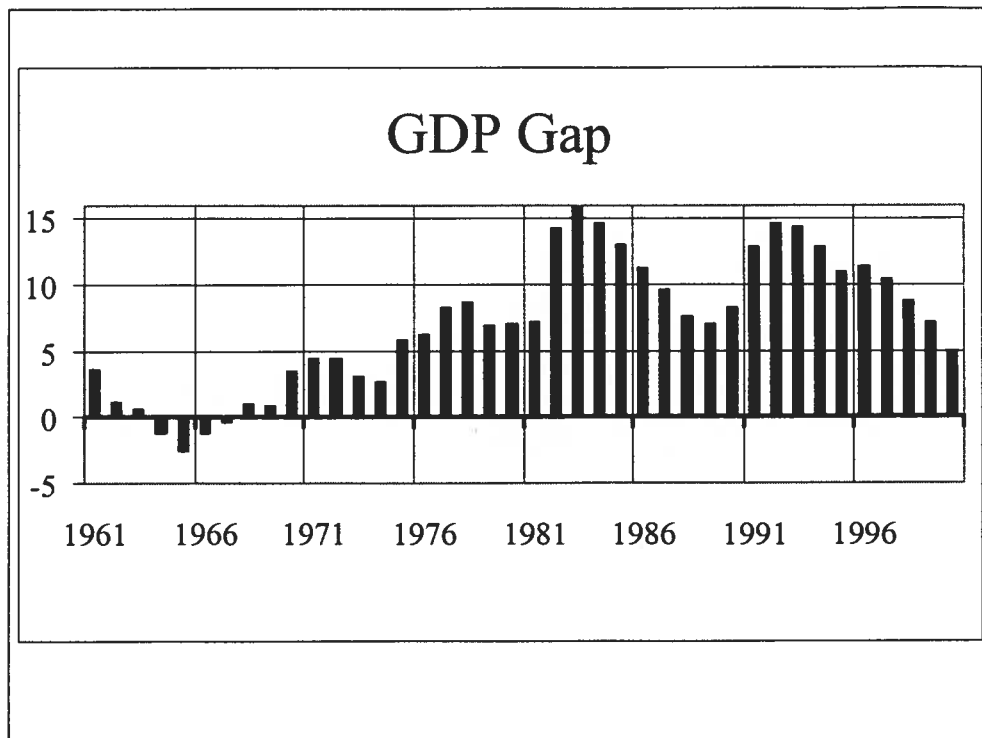
The “economic theory” of the neoclassical economists suggests the improved inflation performance should translate into above-average business investment and heightened productivity growth on a continuing basis, providing the long-term reward for the short-term pain.

We await the long run.

YOUTH UNEMPLOYMENT is about 7 percentage points above the total unemployment rate, or 1.8 times that level.

Aboriginal Unemployment is three times higher than the overall average.

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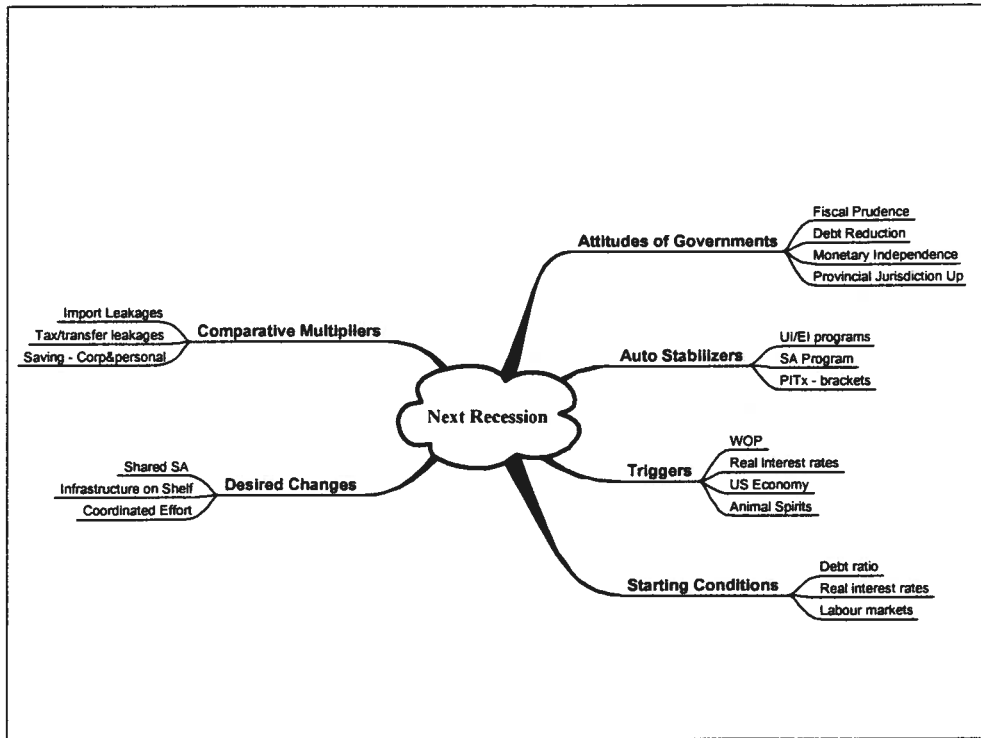
The output gap has been large in Canada since the late 1970s. In the recovery from the 1981-82 recession the gap was reduced only to the level of the late 1970s. In the 1990-92 recession, the gap rose to over 14%.

With only a modest pace of recovery in the 1990s, the output gap remains large. In essence, we are producing much less than feasible with the available resources, wasting \$50 to \$100 billion or more per year.

Some disagree with this view, estimating the gap at 2% or less. They argue that unemployment cannot be lowered to 4% without triggering accelerating inflation. An unemployment rate of 7% is considered appropriate, requiring only potential growth from this point forward.

The Bank of Canada would estimate the gap as not existing at this point in time. I disagree.

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Likely Shocks

- Major recession in US or ROW
- Interest rates up
- Higher WOP
- Financial institutions close
- Another referendum

In the next few years, there are many possible shocks that could trigger a recession in Canada.

We are more sensitive to external shocks than ever, and less willing to do anything about them.

The Next Recession

- Automatic Stabilizers Damaged
- No focus
- Smaller multipliers
- National versus regional stabilization
- Social compact is undone

Changes in UI coverage, qualification, and benefits has lessened its power to be a good automatic stabilizer.

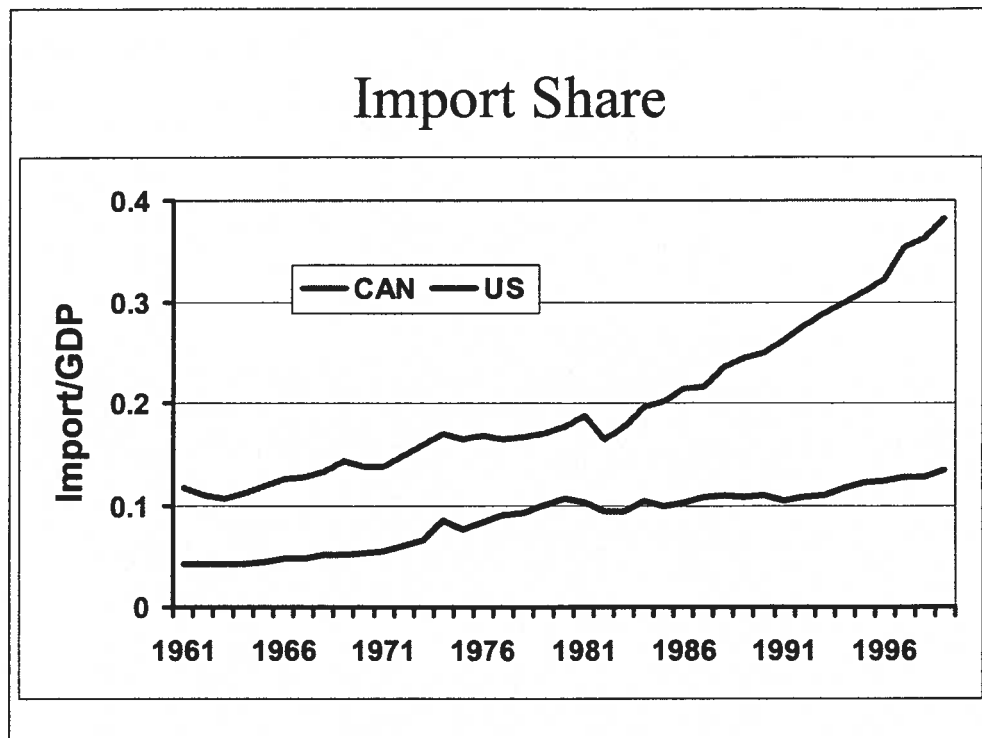
Cuts in SA, along with concentration of financing at provincial level ensure that it will not be as effective as an automatic stabilizer.

Fewer tax brackets provide less of an automatic stabilizer.

Governments no longer focus on stabilization.

Multipliers are smaller. This is a plus in terms of transmission impacts, but a negative in terms of doing anything about it. Large leakages into imports and government net revenues are the reason for lower multipliers..

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Imports of goods and services as a share of GDP has risen from about 15% in the 1960s to almost 40% at the close of the century.

The US remains relatively closed, not unlike Canada's situation in the 1960s.

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$$\text{Multiplier} = 1/(1-c+c*t+m)$$

<u>Year</u>	<u>c</u>	<u>t</u>	<u>m</u>	<u>Multiplier</u>
1973	0.85	0.37	0.16	1.63
1986	0.85	0.40	0.21	1.43
1999	0.85	0.44	0.38	1.11

If we use the standard textbook multiplier calculation, some sense of the fall in the multipliers is evident. As a result of rising leakages into taxes and imports, the multiplier has fallen from 1.6 to 1.1 today.

(The effect of marginal saving rates - personal and corporate - has been put aside for this analysis, although the 15% private saving rate is about right for 1999.

Do What?

- **Prepare to share Social Assistance burden**
- **Restore automatic stabilizers**
- **Develop project file**
- **Coordinate fed-prov thrusts**

At the present time, there is no public discussion of these issues, no sense that federal and provincial authorities are trying to develop a coordinated approach for the next recession.

Indeed, quite the opposite seems to be the case. There remains continuing attempts to offload responsibilities on others, while retaining the revenue.

The Aging Challenge

- High marginal tax rates
- Long-term Healthcare
- Housing

While poverty rates are low and transfer payments provide a base of income for all seniors, high marginal tax rates make it difficult for many to move above a low-income level.

The problem arises from high marginal tax rates at low levels of income.

For example, in a bracket of \$10,000 to \$15,000 of net income (includes OAS but not GIS), the average tax rate is 11% for under 65 and 7% for those 65+. As a result the elderly have higher disposable income. But marginal rates are 32-37% for the non-elderly, and 63-73% for the elderly.

These “stealth tax rates” have been examined in a CTJ article by Macnaughton et al in 1998.

There is a need for long-term care facilities. But asking elderly to pay room and board can be limited by the high marginal tax rates. How to finance? How to charge?

The transition of elderly from living in one form of housing to another remains a tricky area. The form and location of housing may interact with elder health care.

Healthcare

- Technological Impacts
- Financing
- Delivering

Gene technology offers much. But it also makes it more difficult for a private insurance system to operate as a provider of financing because of the information allowing discrimination across patients.

Financing health care out of general revenue seems the best approach - consistent with people while healthy providing for future health care. The federal government does a good job of collecting revenue and should be an integral part of health care financing.

Delivery of health care is a separable issue. Hospital and local health districts appear able to do a good job in delivery, if adequately funded. Provinces seem to be able to allocate budgets, set standards, and ensure mobility across these districts.

Internet

- Sales Taxation
- Bit Tax
- Governance

As retail sales through the internet grow, losses of retail sales tax revenues will grow.

Some of the rapid growth in the US appears to be fostered by the tax-free status of the internet sites. This is not technology but tax subsidization of one retailer at the expense of others.

What to do? A bit tax is possible, but this is probably better suited to providing a new revenue stream for a variety of purposes.

Transactions that are commercial on the Internet can be marked as "tax paid" and taxes remitted by sellers. Failure to mark them or other steps to evade taxes could result in firms being banned from net.

Governance as we know it is changing, with territory meaning less all of the time. Maintaining government capacities requires governments to adapt, to cooperate with each other, and to use these new technologies for improving their capacity to govern.

Income Inequality

- Earned Income
- Raising the Bottom
- Taxing the Top
- Why Bother?

Improvements in earned income can be accomplished through increased employment, longer hours for those working part-time, and higher wage rates.

For those at the bottom, transfer payments in some form can also help. Too rapid a clawback can make it difficult to get out of the hole.

Funds for redistribution need to come by higher taxation on those with higher incomes. This is an obvious point, consistent with Willie Sutton's principle of robbing banks because that is where the money is kept. But we seem to forget it when flat tax proposals arise.

Why do we seek a more equitable income distribution? There are several reasons, ranging from altruism to recognition of the uncertainty over the life cycle for all of us and our children.

But another reason is that there is growing evidence that a more equitable income distribution is likely to improve social cohesion, improve economic growth, and allow the society to operate better for all members. Thus even the selfish among you can support improving the income distribution, at least in principle.

Tax Changes

- New payroll tax
- Credits, surcharges, new brackets, slower clawbacks
- Re-indexing
- Catch-up

We should expect in the coming decade, a new federal payroll tax. Indeed, provinces are likely to join in to also “occupy” the room. The purpose will be to take over the EI premium system, to drop the management burden, while collecting significant revenue in the process. It would make sense to consider an exemption at the low end, no limit on the upper end, and taxation of all earned income including overtime, bonuses, etc. This might put some progressivity back into our tax and transfer system, after decades of removing it.

PIT -

Raise tax credit rate by 1% point, lower bracket down by 1% point. Detach these two items (as in Quebec already).

Drop surcharge, add new bracket at US levels.

Reduce clawback rate on OAS/GIS.

Re-index to CPI or FIF.

Other Sensible Policies

- Avoid permanent interest rate hikes
- Focus on gap & full employment
- Less fiscal drag and easier money
- Incomes policies
- Regulatory oversight up
- Basic Incomes
- Other Innovations

Other Innovations

- Push on infrastructure
- Look at Working time seriously
- Eliminate UI premiums for individuals
- Remove overtime incentives from UI and CPP premiums from employers
- Raise minimum wage for those with a high school diploma or equivalency.

Process of Policy Formulation

- One HR system
- National Institutions and Forums
 - Economic And Social Council
 - Science and Environmental Council

One HR system; all public servants - federal, provincial, and municipal - from at least the middle grades up, will be part of a single system. Mobility across the system, similar benefits, collective agreements, and common training are expected. Purpose is to create a single government system, with multiple political masters, but without public servants participating in the fed-prov-municipal battles.

Consensus-forming organizations

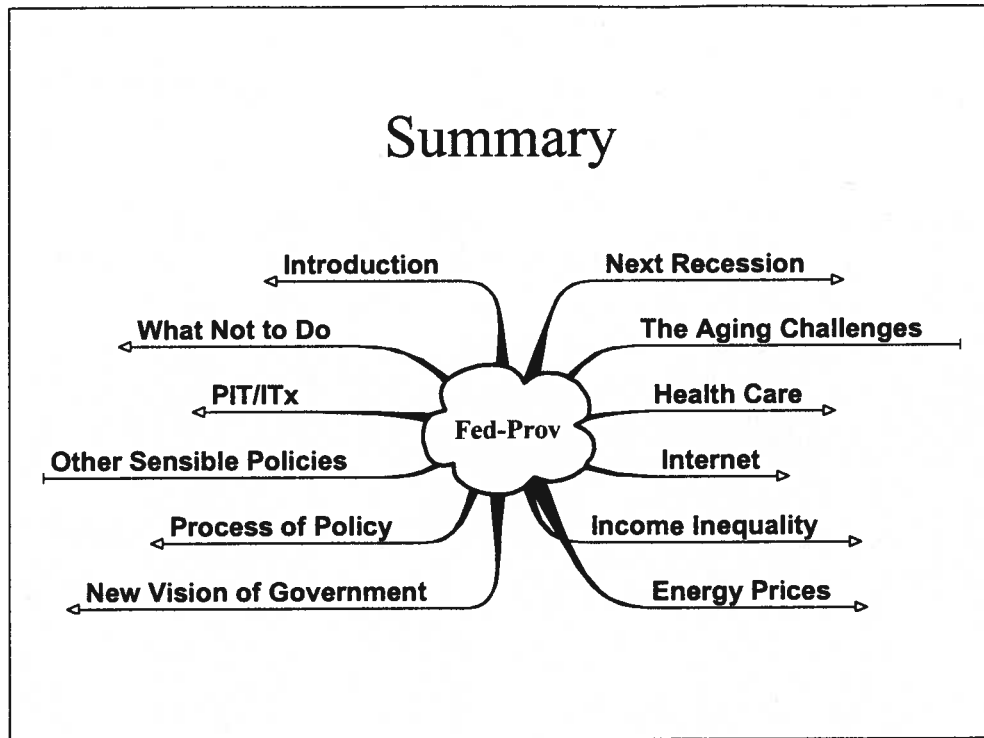
National - with federal and provincial governments, along with other stakeholders (labour, NGOs, big and small business)

Bank of Canada and Finance required by law to be present at all meetings.

Similar functions for Science and Environmental Council. Joint meetings with ESC from time to time.

A New Royal Commission on Government Roles -

Perhaps the time has come to focus on a review of the roles of the federal, provincial, and municipal governments, including financing, delivery, and coordination. Rowell-Sirois Commission was triggered by near collapse of provincial finances. Is there an easier way?



A number of different areas have been reviewed in which both the federal and provincial governments play important roles. The prospect with current institutions and attitudes is for continuing battles between levels of government, with growing distrust by citizens of government and politicians.

To change this world requires adopting a vision of "government", with federal, provincial, and municipal levels each complementing the others and all working together to deliver a better world for all citizens.