Alternative Federal Budget 2003

A Funny Way of Sharing:

Revisiting the Liberal Government's "50:50" Promise

Alternative Federal Budget 2003 Technical Paper #3 February 12, 2003

Executive Summary

During the 1997 federal election campaign, Prime Minister Chrétien made an important promise that future "fiscal dividends" resulting from the elimination of the deficit would be allocated according to a "balanced approach." One half would be re-invested by the federal government in a range of important social priorities (such as more funding for health care, education, and poverty reduction), and the other half would be used to establish a more prudent and competitive fiscal climate, through the reduction of federal taxes and the repayment of federal debt. The government never promised to precisely divide the fiscal pie in half each and every year of its mandate, but the "50:50" approach was supposed to be a broad guide to its fiscal priorities. The Prime Minister reaffirmed this pledge during the 2000 federal election campaign, and both he and his successive Finance Ministers (Paul Martin and John Manley) have continued to assert that this "balanced approach" guides the government in its budgetary decisions.

Hard data on the federal government's actual budgetary performance since 1997, however, indicate that its allocation of the fiscal dividend has been anything but balanced. During the five fiscal years since the deficit was eliminated, fully 90 percent of newly-available resources have been dedicated to tax cuts and debt repayment, and just 10 percent to spending initiatives. Even if we consider the expanded value of the Canada Child Tax Benefit as a form of "spending" (rather than as a tax cut), the government's remaining tax cuts and debt repayment still claimed over 85 percent of the cumulative fiscal dividend.

Worse yet, the government's tax cuts alone presently consume over 60 percent of the new fiscal resources made available on a year-by-year basis. So, while the government's program spending is beginning to increase (a trend that will be reinforced by the federal-provincial health agreement and other upcoming initiatives), it will be impossible for the government to come anywhere near its stated 50:50 target, without either going into deficit or reversing some of its tax cuts. In short, by making deep and permanent tax cuts its top priority in the post-deficit fiscal environment, the government has tied its own hands. No matter how much it spends on new program initiatives in coming years, the 50:50 promise will remain just that: a promise that is politically convenient but fiscally unattainable.

Introduction: Remembering a Promise

The federal government has now enjoyed six straight years of budgetary surpluses, beginning with the elimination of the federal deficit in the 1997-98 fiscal year. Thanks to this much-improved fiscal situation, the Liberals have enjoyed the enviable task of allocating the subsequent "fiscal dividend" – that is, the resources freed up by ongoing economic growth and a shrinking debt burden – among competing end-uses. The three broad categories usually considered in this allocation are increases in federal program spending (mostly aimed at addressing perceived social needs), tax cuts, and the repayment of some of the federal government's outstanding debt (which currently stands at about $530 billion).

The Liberal Party is adept at appearing to straddle the political fence, and the government's announced approach to this issue is no exception. During the 1997 federal election campaign, when it was clear that the federal deficit was about to be extinguished (two years ahead of the government's own deficit-reduction timetable), Prime Minister Chrétien made an important promise that future fiscal dividends would be allocated according to a "balanced approach." One half would be reinvested by the federal government in a range of important social priorities (such as more funding for health care, education, and poverty reduction), and the other half would be used to establish a more prudent and competitive fiscal climate, through the reduction of federal taxes and the repayment of federal debt. The government never promised to precisely divide the fiscal pie in half each and every year of its mandate, but the "50:50" approach was supposed to be a broad guide to its fiscal priorities.

The Prime Minister reaffirmed this pledge during the 2000 federal election campaign, and both he and his successive Finance Ministers (Paul Martin and John Manley) have continued to assert that a "balanced approach" guides the government in its budgetary decisions. For example, in responding to questions following his *Fiscal and Economic Update* last October, Finance Minister Manley indicated again that the government uses the "50:50" rule as a broad milepost in its fiscal planning, and claimed that the government's fiscal approach has indeed been balanced. "So far, since we went into surplus for the first time in 1997, we're not that far off," Manley stated. "Really we're at about 55:45 – 55 percent debt reduction and tax reduction, and 45 percent in increased spending, so it's not hugely off."

Manley's response to the question was probably based on a Finance Canada analysis of the allocation of incremental fiscal resources, that was prepared over two years ago in the run-up to the 2000 federal election. This analysis was published as an appendix in Finance Minister Martin's pre-election *Economic Statement and Budget Update* (Annex 1, "Spending, Tax Relief and Debt Reduction Since the 1997 Budget," October 2000). The analysis was forward-looking, projecting spending, tax cut, and debt repayment patterns up to and including the current fiscal year (2002-03). Over the five years subsequent to the first budget balance, the analysis claimed that the federal government would have allocated 46.5 percent of newly available resources to spending initiatives (including but not limited to social programs), and 53.5 percent to tax cuts and debt reduction. That's within spitting distance of a 50:50 split, by anyone's definition. The report estimated the

cumulative fiscal dividend during those 5 years at some $170 billion.

There were many problems, however, with this 2000 Finance Canada analysis. Since it was forward-looking, most of its estimates were based on assumptions regarding economic conditions and budget balances that have proven to be notoriously conservative. In particular, thanks to the use of "contingency funds," allowances for "economic prudence," and other misleading accounting techniques, cumulative government surpluses during this period have been almost twice as large in reality as were estimated in this report. Similarly, the estimated value of future tax cuts was also heavily dependent on economic assumptions, not to mention important definitional issues. For example, the Finance Canada report includes the savings resulting from the indexation of the tax system as a form of tax "relief;" most observers, however, interpret indexation not as a form of tax relief, but rather as a measure which limits the extent to which taxes would otherwise *rise* automatically with inflation.

A particularly controversial aspect of the Finance Canada methodology was its inclusion of "targeted tax relief" as a form of social spending. The analysis counted some $14 billion worth of expanded tax credits and loopholes as a form of program spending, and hence lumped this value into the spending side of the 50:50 ledger. In some cases – most notably the expansion of the Canada Child Tax Benefit – it may be legitimate to consider a targeted, socially-motivated tax measure as being equivalent to a form of social spending. In most cases, however, this approach stretches the limits of credibility to the breaking point. For example, the Finance Canada analysis included the estimated value of the two major expansions of the capital gains exemption in 2000 (a tax measure which delivers almost all of its benefit to the richest segment of Canada's population) as equivalent to a spending initiative, and hence counts it on the "social programs" side of the estimated budgetary split. While some critics might jokingly suggest that capital gains exemptions are indeed a "social program for the rich," it is clearly not justifiable to consider this type of tax loophole as equivalent to a social reinvestment. If these "targeted" tax measures are counted as tax cuts rather than social programs, then the split between spending and tax cuts/debt repayment projected in the 2000 Finance Canada analysis changed significantly – to 38 percent for social spending, and 62 percent for tax cuts and debt repayment, over the five-year period ending in 2002-03.

> The Liberal government's actual allocation of the fiscal dividend which resulted from the historic elimination of the deficit, has been anything but balanced. Over the five years since the budget was balanced, fully 90 percent of newly-available resources have been dedicated to tax cuts and debt repayment, and only 10 percent to spending initiatives.

It is now possible to look back on the first five years of the federal government's new fiscal era, and calculate with actual data – rather than forward-looking assumptions and often

questionable definitions – how the Liberals in practice have allocated their much-anticipated "fiscal dividend." (Budget outcomes for the fifth year of this data, covering the 2002-03 fiscal year, must still be projected, but this can be done relatively accurately on the basis of mid-year economic data, government financial reports, and Finance Canada's own pre-budget estimates.) Has the government indeed followed a "balanced approach" in allocating the substantial fiscal resources which have been freed up by the combination of continuing economic growth and a falling debt burden? And is Finance Minister Manley justified in continuing to invoke the 50:50 rule as a broad description of his government's actual budgeting?

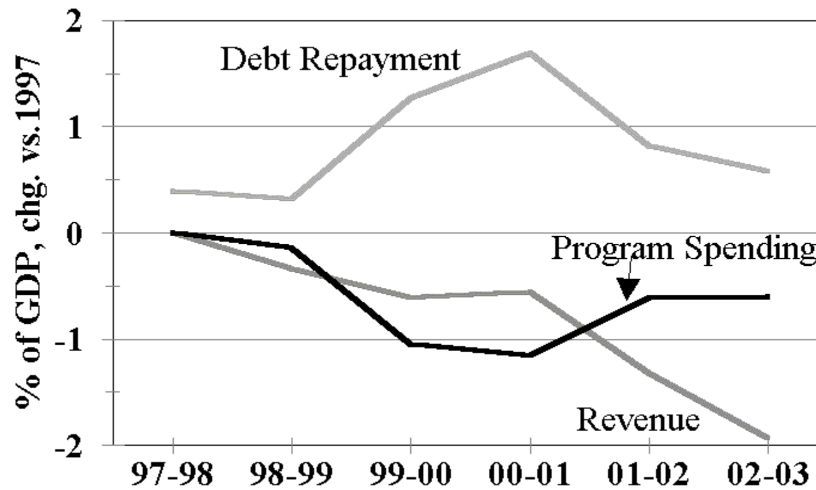
This report will indicate that the Liberal government's actual allocation of the fiscal dividend which resulted from the historic elimination of the deficit, has been anything but balanced. Over the five years since the budget was balanced, fully 90 percent of newly-available resources have been dedicated to tax cuts and debt repayment, and only 10 percent to spending initiatives. Even if we consider the expanded value of the Canada Child Tax Benefit – which has been the federal government's most important anti-poverty measure, delivered through the tax system rather than through outright spending programs – as a form of "spending," the government's remaining tax cuts and debt repayment still claimed over 85 percent of the cumulative fiscal dividend. Worse yet, the government's tax cuts alone now consume over 60 percent of the new resources being made available on a year-by-year basis. So, while the government's program spending is beginning to increase (a trend that will be reinforced by the federal-provincial health agreement and other upcoming initiatives), it will be impossible for the government to come anywhere near its stated 50:50 target, without either going into deficit or reversing some of its tax cuts. In short, by making deep and permanent tax cuts its top priority in the post-deficit fiscal environment, the government has tied its own hands. No matter how much it spends on new program initiatives in coming years, the 50:50 promise will remain just that: a promise, politically convenient but fiscally unattainable.

Overview of Federal Budget Parameters Since 1997-98

Since the budget was first balanced in 1997-98, the federal government has recorded six straight fiscal surpluses. On the expectation that the surplus for the current fiscal year will equal $6-7 billion (as most observers expect, barring any last-minute spending allocations[1]), cumulative debt repayment over this period will equal about $50 billion. Debt repayment reached a peak of $ 18.2 billion in fiscal 2000-01. In every single year since 1999-00, the surplus exceeded the official Budget Plan estimate (according to which the value of the "contingency reserve," usually $3 billion per year, is used to pay down the debt in the event that economic growth meets or exceeds forecast rates).

During the same time, federal tax revenues have declined steadily as a share of Canada's GDP: from 17.2 percent of GDP in 1997-98, to an estimated 15.2 percent in the current fiscal year. This decline reflects both the structural impact of repeated tax cuts announced by the government during this time (including the major personal and corporate income tax cuts announced in 2000, annual

Figure 1
The Fiscal Evolution
The Budget's Changing Make-Up



reductions in EI premiums, and other tax reductions and exemptions), as well as the more recent cyclical effects of the downturn in the stock market and other economic variables on particular revenue sources (especially capital gains tax payments and corporate income tax revenues). The value of annual debt repayment (measured as a share of GDP), and the ongoing decline in overall tax revenues as a share of GDP, are both illustrated in Figure 1. In the current fiscal year, the fact that federal tax revenues have declined by almost 2 full percentage points from its 1997-98 level, is equivalent to an aggregate tax saving for Canadians of some $22 billion.

In contrast, as indicated in Figure 1, the rebound in program spending since the deficit was eliminated has been modest, at best. In fact, federal program spending as a share of GDP is still significantly lower than it was when the budget was balanced (12.2 percent of GDP in 1997-98). This indicates that initial increases in program budgets did not even keep up with the ongoing growth of the economy, so that the relative economic importance of those programs continued to decline. Since 2000-01, however, when federal programs reached a post-war low of just 11.0 percent of GDP, more rapid increases in spending have powered a modest expansion in the share of program spending in overall GDP, to 11.6 percent last year (a level that is expected to be sustained in the current fiscal year).

This simple overview of the trends in federal budget components since 1997-98 indicates already that the federal government's support for new spending initiatives remains a distant third place behind its commitment to tax cuts and debt repayment. We will now measure more precisely the proportion of the overall fiscal dividend which has been dedicated to program spending, compared to the resources expended on debt reduction and tax cuts.

Methodology

Many different approaches have been employed to estimate the overall value of the federal government's fiscal dividend, and then describe its allocation to major competing end-uses: program spending, tax cuts, and debt repayment. The methodology adopted here is consistent with the approach that is most often used by private-sector economic forecasters in their projections of future fiscal balances. It does not add up the value of the government's explicit spending and tax initiatives and announcements (as did the Finance Canada analysis contained in the October 2000 *Economic Statement and Budget Update*). In those announcements, it is often difficult to distinguish genuine changes in tax and spending parameters from the normal expected evolution of those parameters over time. (Current debates regarding the true value of the new federal-provincial agreement on health care spending provide the latest example of that difficulty.) Instead, the analysis below considers actual trends in the government's spending, tax, and debt repayment parameters over time, measured relative to appropriate economic benchmarks defined at the point in time (fiscal 1997-98) when the budget was first balanced. In this case, for example, it's not enough that the government announced that taxes will be cut by $100 billion over five years; this tax cut must actually become visible in the government's budgetary data, before it is counted as part of the allocated fiscal dividend.

The size of the overall fiscal dividend, and its allocation among competing uses, must be estimated relative to some assumed "status-quo" baseline – that is, relative to a budgetary position that is considered the starting point, from which subsequent improvements (new spending, reduced taxes, and repaid debt) are implemented. Like the 2000 Finance Canada analysis, we use the 1997-98 budget, the first one in the modern era to feature a surplus, as that starting point. Against that baseline, we analyze budgetary outcomes over the five subsequent fiscal years (from 1998-99 through the current year, 2002-03). Within each of the three broad budget categories (program spending, tax rates, and debt repayment), we must also define a baseline, as follows:

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Program Spending:

The federal government spent $108.8 billion on programs in 1997-98. That amount would be expected to increase normally in subsequent years, at least to reflect the ongoing growth in Canada's population and the increase in the general price level. As a proxy for a given level of real government program and service delivery, our "baseline" spending profile equals that level of spending required to maintain real per capita federal program spending at its 1997-98 level. This baseline level of spending is reported in Table 1 (on the basis of actual changes in Canada's popu-

lation and the consumer price index for each fiscal year); any additional program spending above that level should reflect a real enhancement in the programs provided to Canadians (as opposed to a purely nominal increase in program budgets to accompany population growth and inflation). For example, the federal government tends to count every dollar increase in its transfer payments to the provinces as a "social reinvestment," ignoring the fact that nominal transfers must increase just to keep pace with population growth and inflation (let alone to keep up with deeper structural trends, like the aging of Canada's population). Our approach, on the other hand, considers only increases in the real per capita value of program budgets, as representing the true value of incremental program investments.

Tax Levels:

The share of federal revenues in Canada's GDP can be interpreted as a broad indicator of the overall federal "tax rate." For each dol-

Table 1
Allocating the Fiscal Dividend
Federal Budgets, 1997-98 through 2002-03

	1997-98 *(Base)*	1998-99	1999-00	2000-01	2001-02	2002-03 *(Fcst.)*[1]	5-yr. Total
GDP ($billion)	892	924	1003	1080	1093	1158	
Fed. Budget Aggregates							
Revenue	153.2	155.7	166.1	179.6	173.3	176.6	
Program Spending	108.8	111.4	111.8	119.3	126.7	134.3	
Surplus	3.5	2.9	12.7	18.2	8.9	6.7	
Budget Shares (%GDP)							
Revenue	17.2	16.8	16.6	16.6	15.9	15.2	
Program Spending	12.2	12.1	11.2	11.0	11.6	11.6	
Surplus	0.4	0.3	1.3	1.7	0.8	0.6	
Program Spending							
Baseline[2]	108.8	110.8	114.2	118.3	122.2	126.8	
Above Baseline ($)		0.6	-2.4	1.0	4.5	7.5	**$11.2 b.**
Above Baseline (%GDP)		0.1	-0.2	0.1	0.4	0.6	**1.0%**
Tax Reductions							
Baseline[3]	153.2	158.8	172.2	185.6	187.8	198.9	
Below Baseline ($)		3.1	6.1	6.0	14.5	22.4	**$52.0 b.**
Below Baseline (%GDP)		0.3	0.6	0.6	1.3	1.9	**4.8%**
Debt Repayment							
Nominal ($)		2.9	12.7	18.2	8.9	6.7	**$49.4 b.**
Share (%GDP)		0.3	1.3	1.7	0.8	0.6	**4.7%**
Total Fiscal Dividend							
Nominal ($)		6.6	16.5	25.1	27.9	36.5	**$113 b.**
Share (%GDP)		0.7	1.6	2.3	2.6	3.1	**10.4%**
Annual Dividend Shares							
(% dividend)[4]							
Higher Spending		9.5	-14.4	3.8	16.3	20.4	**10.0%**
Lower Taxes		46.7	37.2	23.8	51.8	61.3	**46.2%**
Debt Repayment		43.8	77.2	72.4	31.9	18.3	**43.9%**
Sub-Total: Taxes+Debt		*90.5*	*114.4*	*96.2*	*83.7*	*79.6*	***90.0%***

1. Forecasts assume same economic growth, budgeted program spending, and debt service charges as reported in the October 2002 *Fiscal and Economic Update;* revenues which fall to 15.2% of GDP (as in the *Update*); this produces an anticipated surplus (barring last-minute spending or tax announcements) of $6.7 billion.
2. Baseline program spending is the amount required to maintain real per capita program spending at its 1997-98 level.
3. Baseline tax revenue is the amount produced if aggregate tax rate (revenues as % of GDP) stayed at its 1997-98 level.
4. Totals may not add to 100 due to rounding.

lar in income generated in the economy, this ratio indicates the portion that is collected in taxes by the federal government. Federal tax revenues normally increase with the expansion of the economy; this, of course, is not because of "tax increases" (notwithstanding the claims of Canadian Alliance critics), but merely reflects government's share of a growing economic pie. To measure the impact of pro-active tax policy changes, therefore, we should focus not on changes in nominal revenues, but rather on changes in the relative importance of those revenues measured as a proportion of GDP.[2] For example, a sustained decline in tax revenues as a share of GDP can be safely interpreted as a decline in the general intensity of federal taxation. (This is especially true given the tendency of taxes, in the absence of tax policy changes, to rise as a share of GDP over time.) As a baseline level of federal taxation, then, Table 1 reports the amount of taxes that would have been collected had federal taxes remained at the same proportion of GDP (17.2 percent) as in 1997-98, when the budget was first balanced. The difference between actual tax collections and that 1997-98 baseline – a difference which has increased steadily each year – thus represents the composite value of reductions in the aggregate federal tax burden.

Debt Repayment:

Federal surpluses are used to reduce the outstanding stock of net federal debt (including both the government's market debt, owed to outside lenders, and its internal public accounts debt – that is, money it owes to itself to reflect future liabilities such as public service pension costs). Any positive surplus corresponds to a reduction in the accumulated net debt, and hence the cumulative reduction of debt equals simply the cumulative budgetary surplus since the budget was balanced. During the five consecutive years from 1998-99 through 2002-03, the nominal net debt was reduced by $50 billion, or about 9 percent, through consecutive budget surpluses.[3]

The Total "Fiscal Dividend":

Utilizing the preceding definitions of respective fiscal baselines, we can estimate the total value of the fiscal dividend that has been enjoyed since the 1997-98 budget as simply equaling the sum of the three sources to which the dividend has been allocated. The fiscal dividend is defined as the sum of program spending in excess of that which would maintain program spending at the same real per capita level as in 1997-98; the difference between actual tax revenues and those that would have been collected had the aggregate tax rate been maintained at its 1997-98 level (as a share of GDP); and the cumulative nominal repayment of federal debt (through budgetary surpluses). As indicated in Table 1, the annual value of this fiscal dividend increased steadily over the five-year period considered, from $6.6 billion in 1998-99, to $36.5 billion in the current fiscal year. The cumulative value of the fiscal dividend over the period as a whole was $113 billion.[4]

How Was the Dividend Spent?

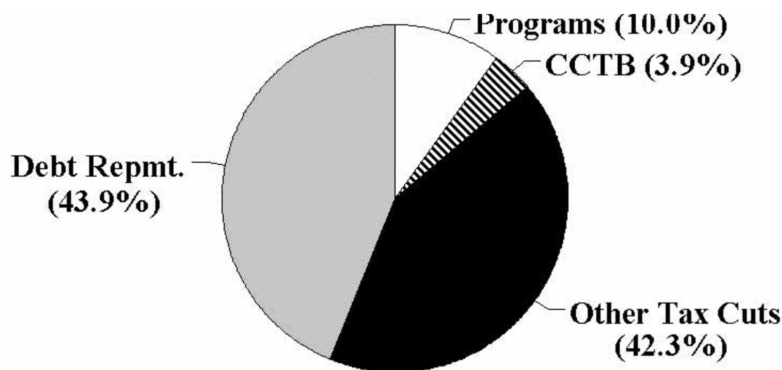
The bottom portion of Table 1 indicates how that substantial fiscal dividend was allocated across the three broad competing goals: new program spending, tax cuts, and debt repayment. As indicated above, consecutive budget surpluses reduced the outstanding nominal federal debt by almost $50 billion over this period. The decline in aggregate taxation lev-

els, by some 2 percent of GDP between 1997-98 and 2002-03, saved taxpayers almost an identical amount over the same period: some $52 billion in total over the five years (most of that in the last two fiscal years, in the wake of the major tax rate reductions announced in 2000).

In contrast, genuine improvements in program spending, above and beyond the real per capita levels provided for in 1997-98, have been modest at best. During the first years of the post-deficit era, there were hardly any genuine enhancements to program spending at all; in fact, during 1999-00 program spending actually fell *below* the 1997-98 real per capita baseline. The last two fiscal years, beginning in 2001-02, have witnessed the first significant expansion of program budgets during the Liberals' entire decade in office, with real per capita program spending growing by about 5 percent over the two years (and with program spending growing as a share of GDP for the first time since the government came to power). Nevertheless, even this more recent spending has left the government far short of its promise to allocate 50 percent of the fiscal dividend to new spending initiatives. Program spending exceeded the 1997-98 baseline by a cumulative total of only $11 billion during the five years since the attainment of the balanced budget. These programs have obviously represented a far lower order of priority for this government than either debt reduction or tax cuts.

The overall allocation of the fiscal dividend during the past five years can therefore be summarized, as indicated at the bottom of Table 1 and illustrated in Figure 2. Of the $113 billion in new resources which were freed up by the combination of economic growth and a shrinking debt burden since 1997-98, just 10 percent was allocated to genuine enhancements in federal spending programs (above and beyond the level and quality of programming which was already being provided when the budget was balanced). The remaining 90 percent was divided roughly evenly between tax cuts and debt repayment. (Perhaps this is what the Liberals meant by a "balanced approach"?) Debt repayment was more important in the early post-deficit years, while tax cuts (especially the major rate reductions announced in 2000) have been eating up the lion's share of the fiscal dividend more recently.

Figure 2
5-Year Dividend Allocation



Allocations of resources to real improvements in federal programs were virtually nonexistent during the first three years after the budget was balanced. Spending increases have been more significant in the last two years, but even then do not come close to consuming half of the fiscal dividend. Figure 3 illustrates the changing pattern in the annual allocation of the fiscal dividend, on a year-by-year basis. By 2002-03, enhancements in federal program spending were consuming one-fifth of the underlying fiscal dividend – for the first time matching the resources allocated to debt reduction. Tax cuts, however, were clearly the government's top fiscal priority, accounting for over 60 percent of the dividend.

The Canada Child Tax Benefit

As discussed above, Finance Canada's 2000 analysis of the balance between spending, tax cuts, and debt repayment argued dubiously that any "targeted" tax cut should be considered as a form of program spending. Hence that report counted $14 billion worth of tax cuts on the "spending" side of the ledger, boosting the estimated post-deficit division of resources closer to the 50:50 benchmark promised by the Prime Minister. In most cases, this argument is not at all convincing. There is one important anti-poverty measure delivered through the tax system, however, that could be genuinely considered as a "social measure." The Canada Child Tax Benefit has been the most important new social initiative implemented by the Liberal government, and now refunds an estimated $8 billion per year to low- and middle-income families with children; it is refundable even to families with no taxable income, and in this sense is indistinguishable from other government income security programs. Studies indicate that the program has had a noticeable impact in reducing the incidence and depth of poverty among Canadian children.[5] The Liberals have expanded the CCTB significantly since the elimination of the deficit in 1997-98, and

Figure 3
Yearly Allocations
Annual Fiscal Dividend Shares

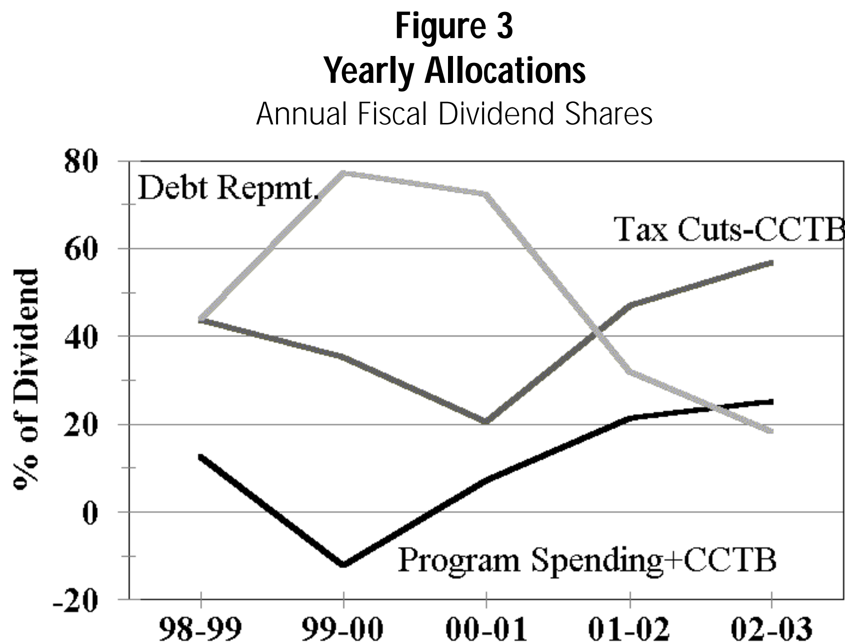


Table 2
Making Adjustment for Increases in the Canada Child Tax Benefit
1997-98 through 2002-03

	1997-98 *(Base)*	1998-99	1999-00	2000-01	2001-02	2002-03 *(Fcst.)*	5-yr. Total
CCTB							
Actual Value ($bil.)[1]	5.325	5.625	5.930	6.610	7.360	7.870	
Baseline ($bil.)[2]		5.422	5.588	5.792	5.979	6.208	
Above Baseline ($bil.)		0.203	0.342	0.818	1.381	1.662	**$4.4 b**
Above Baseline (%GDP)		0.02	0.03	0.08	0.13	0.14	**0.4%**
Program Spending (*Including* CCTB)							
Actual	114.1	117.0	117.7	125.9	134.1	142.2	
Baseline[2]		116.2	119.8	124.1	128.1	133.1	
Above Baseline ($)		0.8	-2.0	1.8	5.9	9.1	**$15.6 b.**
Above Baseline (%GDP)		0.1	-0.2	0.2	0.5	0.8	**1.4%**
Adjusted Dividend Shares (% dividend)[3]							
Higher Spending		12.6	-12.3	7.1	21.2	25.0	**13.9%**
Lower Taxes		43.6	35.1	46.9	46.9	56.7	**42.3%**
Debt Repayment		43.8	77.2	31.9	31.9	18.3	**43.9%**
Sub-Total: Taxes+Debt		*87.4*	*112.3*	*78.8*	*78.8*	*75.0*	***86.1%***

1. Department of Finance, *Tax Expenditures and Evaluations* (2002), Table 1.
2. Baseline is the level of benefits or spending required to maintain real per capita benefits or spending at their 1997-98 level.
3. Totals may not add to 100 due to rounding.

these new resources could more reasonably be considered to belong with the government's other spending initiatives.

Table 2 indicates, however, that considering the important new resources dedicated to the CCTB since 1997-98 does not alter the very lopsided apparent allocation of the overall federal fiscal dividend. CCTB payouts have increased by $2.5 billion since 1997-98. Close to $1 billion of this increase, however, would have been required to maintain CCTB levels constant in real per capita terms (the same baseline concept which we applied to other federal program spending). The extra CCTB increases, above and beyond that baseline, constitute about 4 percent of the total available fiscal dividend since 1997-98. Including those increases as a form of program spending, and deducting an equivalent amount from the cumulative value of aggregate tax reductions, does not significantly alter the division described above: program spending initiatives (including the CCTB) consumed 14 percent of the dividend, while tax cuts and debt reduction together consumed 86 percent (with this amount split approximately equally between tax cuts and debt reduction).

Conclusion: A Funny Way to Share

Any kindergarten student understands what it means to divide something in half. If they are sharing something with their neighbour, and are asked by their teacher to divide it in half, they may not split the item exactly along its midpoint, but they will come close – or else their neighbour will complain loudly and the teacher will intervene.

Unfortunately, the sophisticated and knowledgeable officials managing the federal

government's finances have not accomplished anything like this task, despite their promise to Canadians in two consecutive federal election campaigns. After six consecutive years of budgetary surpluses, with federal coffers swollen by the proceeds of strong economic growth and job creation, the federal government has enhanced its provision of programs and services for Canadians by just 5 percent (in real per capita terms). The resources embodied in these enhancements constitute a very thin slice – between 10 and 14 percent, depending on the treatment of the CCTB – of a large pie created by the combination of ongoing economic growth and a shrinking relative debt burden. Despite their promise to follow a "balanced approach" in allocating the proceeds of this happy development, the Liberals have placed an obvious and expensive priority on more conservative fiscal goals: first by booking annual surpluses far in excess of their official projections, and then by implementing deep reductions in taxes (the main benefits of which are being captured by the high-income earners who pay most taxes in Canada). No wonder this government retains the support of big business, the financial community, and a large segment of high-income households. The priorities which the government has emphasized in practice are much closer to long-standing conservative goals (cut taxes, pay off the debt), than to the supposedly liberal principles on which the government was elected.

Even recent spending announcements (such as the federal-provincial health deal) will not dramatically alter this lopsided division. Since the cumulative forgone revenues resulting from successive tax cuts now consume over 60 percent of the total dividend (an amount that could grow in future years, since additional federal tax cuts – such as coming corporate income tax reductions – have yet to be fully implemented), it will be impossible for the government to reach its 50:50 target without reversing some of those tax cuts (or, even less likely, going into deficit). Even if the government stopped its debt repayment altogether, or at least became more honest in meeting its budget targets (paying down $3 billion per year, its official annual target, instead of many times that amount as it has done in practice), so much revenue has been given away through tax cuts that the 50:50 promise remains unattainable.

In sum, the Liberal government has missed its 50:50 pledge by a huge and ongoing margin. The government has not even approximately respected this broad guideline in its budgeting decisions. Finance Minister Manley has no credible basis on which to claim that his government is "not that far off" the 50:50 mark. And this pattern of underinvestment in public programs and services is so consistent that it can only reflect the government's true priorities. While the Liberals continue to speak the language of a fair-minded "balanced approach," their actions in practice – even with recent spending announcements – indicate clearly that they belong on the conservative side of the fence, not atop it.

Endnotes

1 Press coverage of the recent federal-provincial health agreement indicates that a portion (perhaps $2.5 billion) of future federal transfer payments to the provinces may be "booked" from the budget surplus which the government would otherwise experience in the current 2002-03 fiscal year. This money would be nominally set aside from the current surplus, but not actually spent until some future year. In this case, reported program spending for the current year may turn

out to be higher than projected, and the surplus lower. However, this rather artificial budgeting technique will have no impact on actual health expenditures this year.

[2] Even without pro-active adjustments in tax policies, revenues may change over time as a share of GDP. First, there are some forces which create a cyclical pattern in taxes as a share of GDP, matching the cyclical pattern of the economy: when the economy is strong, certain types of tax revenues (such as corporate income tax) grow at a faster pace than overall income, and vice versa when the economy is weak. Second, there is evidence that the long-run elasticity of federal tax revenues with respect to GDP is somewhat greater than one: in other words, over the long-run taxes will tend to grow slightly faster than GDP, even with no changes in tax rates, because of factors such as the impact of rising average incomes on tax payments in a progressive tax structure. (In previous years, the lack of indexation of the federal tax system also produced an ongoing increase in federal taxes as a share of GDP, but this effect has been largely eliminated by the indexation measures announced in 2000.) These two broad trends have worked in opposite directions in Canada in recent years: cyclical weakness in capital gains income and corporate profits has depressed the federal revenue share, while continuing strong economic growth and rising income levels should have increased it. Our adoption here of the federal tax share in 1997-98 as a "baseline" against which to measure tax policy changes is therefore quite appropriate – and certainly more valid than the Finance Canada approach of adding up the estimated value of announced tax cuts, including those (like indexation) which only serve to prevent an *increase* in taxes that would otherwise have occurred.

[3] Measured as a share of GDP, the net federal debt has declined much more quickly in the years since the attainment of a balanced budget. From a peak of 72 percent in 1995, the debt burden will have declined by over one-third by the end of the current fiscal year, to just 46 percent of GDP. Most of this decline, however, was due to the impact of ongoing economic growth on the *denominator* of the debt-to-GDP ratio, and not to actual repayment of debt. Even if the federal government had simply maintained balanced budgets during this period, with no surpluses whatsoever, the debt burden would still have declined to 50 percent by the end of this fiscal year – barely higher than its actual level, despite $50 billion worth of hard-earned debt repayment.

[4] This estimate of the overall size of the fiscal dividend is considerably smaller than the forward-looking estimate provided in the 2000 Finance Canada analysis, which suggested a cumulative fiscal dividend over those five years of some $170 billion. This difference mostly reflects definitional differences: the Finance Canada approach counted all new nominal program spending announcements as new allocations (whereas some of that new spending was required just to maintain real per capita program spending levels), and it also included the stated value of all tax reductions, even those (such as indexation of the tax system) which would not reduce aggregate tax levels below their 1997-98 levels.

[5] See the detailed analysis of the distributional outcomes of the CCTB in the 2002 edition of *Tax Expenditures and Evaluations* (Ottawa, Dept. of Finance).

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