ALTERNATIVE FEDERAL BUDGET 2005

TECHNICAL PAPER #1

WHAT SHOULD WE DO WITH THE FEDERAL BUDGET SURPLUS?

BY ELLEN RUSSELL

The allocation of forthcoming budget surpluses should be a matter for public debate. In the interest of promoting this debate, this paper considers the three distinct uses for future budget surpluses: 1) they can be used to pay down the debt, 2) cut taxes, or 3) spend on goods and services for Canadians.[1]

The Alternative Federal Budget has consistently argued that future budget surpluses should be allocated exclusively to restore existing social programs and to repair and extend Canada's deteriorating physical infrastructure. The first two sections of this paper deal with the case against using budget surpluses for either debt repayment or tax cuts. The final section provides an examination of the case for using budget surpluses to enhance spending.

THE CASE AGAINST USING THE SURPLUS FOR DEBT REPAYMENT

AN OVERVIEW OF CANADA'S DEBT

Canada's public debt currently stands at $501.5 billion, with debt-servicing costs at $35.8 billion in 2003/04.

Since the budget was balanced in 1997/98, the federal government has used its sizeable budget surpluses—$61 billion over seven years—to pay down the public debt. This debt repayment averages $8.7 billion dollars per year, far more than the government's yearly contingency reserve of $3 billion. (Since the budget went into surplus, contingency reserves have never been needed for unforeseen expenses—as the term "contingency" implies. Instead they have always formed part of the money the federal government has used for debt repayment.)

The trajectory of Canada's debt over the next six years is projected in Table 3.6 of the government's recent *Economic and Fiscal Update*. This table considers two scenarios: one in which no further debt is repaid, and one in which $3 billion in annual contingency reserves are used to pay down debt over the next six years.

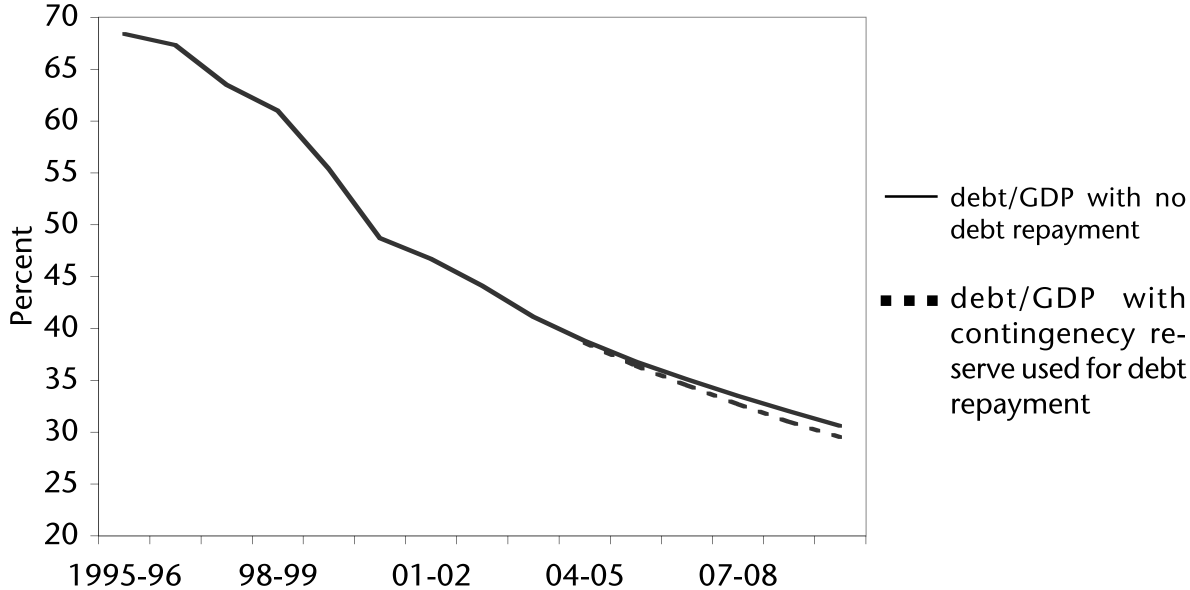
Economists assess a country's debt by comparing the size of the debt to the gross domestic product (GDP). Canada's debt/GDP ratio reached a high point of 68.4% in 1995/96, but it has declined rapidly to its current level of 41%. While debt repayment made some contribution towards decreasing this ratio, economic growth has made an even more powerful impact by increasing the denominator of the ratio.

SHOULD WE REPAY DEBT TO GET TO THE 25% DEBT/GDP TARGET?

The 2004 Federal Budget set a goal of achieving a 25% debt/GDP ratio by 2014. This is a self-imposed target; there is no domestic or international requirement that obliges Canada to achieve this particular ratio.

To what extent does debt repayment help the government reach this 25% debt/GDP

Figure 1: Debt/GDP 1995/96 – 2009/10 : Two Scenarios



Sources: Fiscal Reference Tables (actual) and *Economic and Fiscal Update* (projected)

target? Not much. As illustrated in Figure 1, using the $3 billion contingency reserve for debt repayment actually makes very little difference to how fast the debt/GDP ratio declines.

The real key to diminishing this ratio is economic growth. The government's own projections indicate that, even with absolutely no debt repayment, economic growth alone will enable us to reach this target by 2014/15. Using the contingency reserves for debt repayment will allow the government to reach its debt/GDP goal only about one year sooner.[2]

Should we repay debt to compare more favourably with other countries?

Canadians need not worry that our debt burden is excessive by international standards. Measured in terms of the general government net financial liabilities,[3] Canada has the lowest debt burden of all G-7 countries.

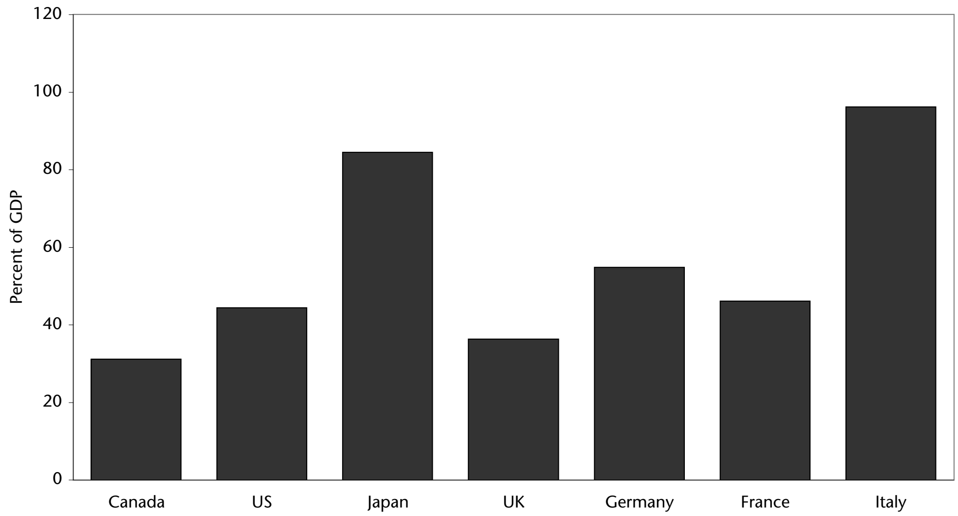
Should we repay debt to save on debt service charges?

Every dollar used to repay debt lowers future debt service charges. It is difficult to ascertain the expected savings produced by debt repayment because of a lack of transparency in the *Federal Budget* and the *Economic and Fiscal Update* on this issue.[4]

In response to an inquiry on this matter, a Department of Finance official indicated that the rate of return on debt repayment is about 5.5% per year. While this is a rough estimate, is will suffice for the comparisons made below.

When budget surpluses are used to pay down debt, it means that this money is not available to fund other priorities. Arguably, the benefits of the alternative uses of budget surplus dollars outweigh the savings in debt service charges produced by debt repayment. For example, government spending that enhances labour force skills contributes to economic growth, which has a host of benefits (including improving the debt/GDP ratio).

Figure 2 : Net Financial Liabilities Of G7 Countries (2004)



Source: OECD Economic Outlook (no. 76), December 2004.

When the government trumpets the savings produced by debt repayment, without taking into account the "opportunity cost" of paying down debt (i.e., the benefits of alternative uses of the budget surplus), it presents a misleading rationale for debt repayment.

The possible benefits of funding other priorities in lieu of debt repayment can be illustrated by a number of studies. A 2003 paper prepared for the Panel on the Role of Government in Ontario concluded that the social benefits of higher education provide a real rate of return to society in the range of 7% to 10 %.[5]

The Association of Colleges of Applied Arts and Technology of Ontario released a study in January 2004 finding that public investments in Ontario colleges repay the taxpayer at an annual rate of 12.7%, counting the additional earnings of college graduates as well as improved health, reduced welfare, unemployment and crime.[6]

The provision of high-quality child care provides a high social rate of return: using relatively cautious assumptions, a recent study found that every dollar spent on comprehensive public child care programs produces about $2 worth of benefits for children and their parents.[7]

The rates of return produced by education and child care encompass a variety of economic and social benefits, and are not strictly comparable with the 5.5% annual rate of return realized by the federal government from debt repayment. However, since the government is responsible for taking a comprehensive view of the implications of its decisions for Canadian society at large, it is imperative that all of these factors be weighed as we debate the allocation of forthcoming budget surpluses. It may well be that the savings produced by debt repayment are inferior to the benefits generated from spending budget surpluses in other ways.

Should we repay debt to prepare for an aging population?

Beginning in 2010, Canada will experience a wave of baby-boomer retirees. Recently the government has suggested that debt repayment is a prudent precaution to take against the future budgetary pressures of our aging population.[8]

The budgetary implications of our aging population are not necessarily as ominous as Canadians have been led to believe. As David Dodge, Governor of the Bank of Canada, reminds us, "[p]eople often forget how we treat savings for retirement. First, we allow the deduction of pension contributions, RSP contributions, and so on, at the time that they go in, but we tax them as they come out…The fiscal impact is not quite as severe as one might imagine simply because of the way we have treated contractual savings, be they pension, CPP [Canada Pension Plan], or RRSP".[9]

There is considerable evidence to suggest that deferred tax payments on the more that $1 trillion held in registered pension plans and RRSPs can nicely offset the health care costs, as well as the Old Age Security, Guaranteed Income Supplement, and Spousal Allowance costs associated with an aging population.[10] (Canada Pension Plan/ Quebec Pension Plan is not funded through tax revenues, but it too is in fine shape.[11])

Although we foresee no impending danger for the federal budget, we find it instructive to explore the government's case for debt repayment further. If we were to accept the government's premise that our aging population implies a future budgetary squeeze, how would debt repayment address this problem?

We consider two possible aspects of this argument:

1) **Debt repayment produces savings in interest costs which create additional spending room in the future.**

In the 2004 federal budget, the government argued that repaying debt now would generate future savings in debt-servicing costs that could be used to cope with the financial pressures of an aging population.[12]

Using an annual rate of return for debt repayment of 5.5%, applying contingency reserves to pay down debt will produce an annual savings of about $1 billion dollars in debt servicing costs by 2009/10—the time when baby-boom retirements accelerate. If we are anticipating serious budgetary strain, $1 billion per year of extra spending room in a budget with projected expenditures of about $187 billion by fiscal year 2009/10 does not constitute enough extra cash to make a meaningful dent in an impending budgetary crunch. Three times that amount could be absorbed just from the annual contingency reserve.

We also should consider the timing of any expenses associated with this demographic bulge. To prepare for aging Canadians' increased demands on infrastructure, such as hospitals, housing (particularly affordable housing), and various aspects of municipal infrastructure, investment must take place now so that these facilities will be in place by the time the number of retirees accelerates. For trained health care and social service providers to be ready in time to meet the needs of retirees, we must enhance post-secondary education spending *now.* Once the demographic bulge is upon us, it will be too late to establish infrastructure, personnel, and other programs. Money used for debt repayment would be better spent in enhancing our current capacity to meet these future needs.

2) **Debt repayment facilitates the ability of government to borrow in the future.**

Perhaps by paying down debt now, the government wishes to have greater ability to incur more debt in the future to pay for its obligations toward aging Canadians. In light of the current taboo against deficits, and the depiction of federal debt as a "mortgage on the future" *(see below),* it is not surprising that the federal government has left this possibility rather vague.

With Canadians enjoying longer life spans, the expenses implied by an aging population are not transitory. Borrowing to address these expenses would constitute a policy of running chronic deficits in the future.

If the government intends to handle the expenses of an aging population with future borrowing, then it should immediately dispense with any consideration of tax cuts. Why would a government diminish its fiscal capacity if it foresees a budgetary situation that would necessitate ongoing future borrowing?

Should we repay debt as a matter of fairness to future generations?

The federal government frequently justifies debt repayment as an issue of intergenerational fairness:

> *"Simple fairness also demands that future generations not be saddled with a debt they did not incur… Unless we continue to reduce the debt burden, the inheritance we leave to our children and grandchildren will be a heavy mortgage on their futures. (Annual Financial Report, p. 2)*

For years now, Canadian children have not been provided with the long-awaited national child care system. Nor has the government honoured the unanimous commitment of all parliamentarians to end child poverty by 2000. Meanwhile, $61 billion in budget surpluses have been used for debt repayment since 1997/98—money that could have funded the urgent needs of today's children. Using budget surpluses to repay debt is a highly dubious gesture of inter-generational fairness if today's children are neglected in order to lighten the load of future taxpayers.

The legacy we leave to future generations includes more than just the public debt. Infrastructure of all types, environmental protection, and a variety of social programs to safeguard the most vulnerable Canadians are part of the physical, social, and environmental assets that future generations will inherit. Younger people might well choose to forgo debt repayment now in favour of using budget surpluses to enhance educational opportunities, create better housing, safeguard the environment, and invest in other priorities that form part of their inheritance.

In terms of issues of equity, the case can be made that passing along public debt is less injurious than the consequences of bequeathing deteriorated social and physical assets. The expenses of shouldering the public debt fall on all taxpayers, but the burden of neglected education, public transportation, child care, and many types of social services arguably falls more severely on the young, especially the young of non-affluent families.

The case against using the surplus for tax reduction

An overview of Canada's taxation situation

Part of the government's budget surpluses have already been allocated to tax cuts. The multi-year $100 billion tax cut announced in 2000 was justified, in part, as a reward for the sacrifices Canadians had endured in balancing the budget. However, the Canadians who suffered the most from spending cuts during the deficit-fighting years received the least gain from this tax-cut package. The benefits of the 2000 tax cuts went disproportionately to the highest-income families in Canada: it is estimated that the highest-income 23% of census families received 51% of the benefit of that tax-cut package, while the lowest-income 20% received 4.7% of the benefit.[13]

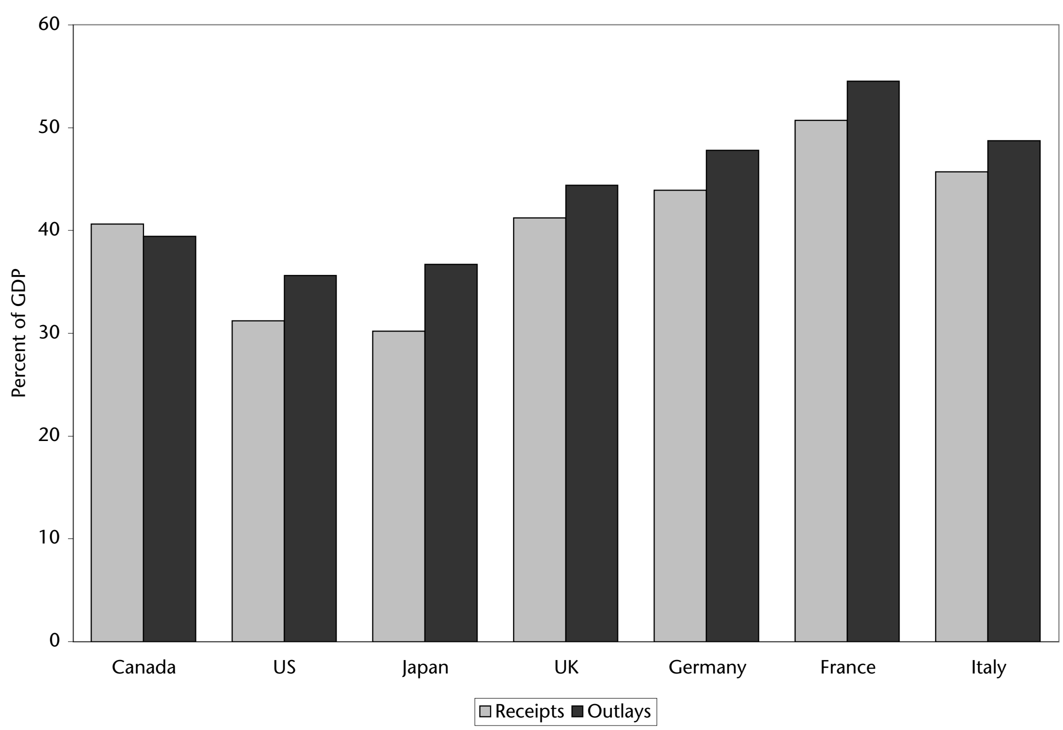
The AFB has long argued for changes in the tax system that would increase tax fairness and make Canada a more equitable society through a more progressive taxation system. This paper does not consider these more fine-tuned tax proposals. Instead, we examine the arguments against making untargeted tax cuts such as lowering marginal tax rates, adjusting tax brackets downward, or raising the basic personal exemption. Untargeted tax cuts are a very blunt means to achieve any policy goal. In addition, because untargeted tax cuts apply to all taxpayers, they are enormously expensive.

Should we cut taxes because Canadian taxes are too high?

It is a complex matter to evaluate the claim of the pro-tax-cut advocates that Canadian taxes are "too high." In comparing the aggregates taxes paid to all domestic levels of government in various countries, Canadian government revenues comprise about 41.1% of GDP, almost exactly the G-7 average (although higher than that of the United States).

However, a comparison of the revenue that governments receive doesn't really tell us if Canadian taxes are "too high." We must look at what taxpayers *get* for their taxes. (If you were asked if the price of a car was "too high," wouldn't you want to know what kind of car was being offered for that price?)

Figure 3: Government Receipts and Outlays for G7 countries (2004)



Source: *OECD Economic Outlook* (no. 76), December 2004.

When we compare government outlays as a percentage of GDP, it is evident that Canadian taxpayers get more in goods and services provided by government than do taxpayers in the United States. To further investigate whether taxes are "too high," we should also consider what goods and services taxpayers are getting for the taxes they pay. Canadians get publicly-funded health insurance paid for out of tax revenues, which may strike readers as a more compelling benefit than, say, the greater emphasis on military spending that taxpayers in the United States receive in return for their taxes.

Why does the impression that Canadian taxes are exorbitant persist? Often the tax-cut lobby promotes this perception by focusing on taxes that affect only affluent Canadians. For example, complaints about issues related to the taxation of capital gains or the top marginal tax bracket are only relevant for the most prosperous Canadians. Instances in which these forms of taxation are higher in Canada than in other countries are not troubling for those of us who believe that equity in Canada should be promoted via a progressive tax system. We think it is entirely appropriate that higher income earners and wealthy Canadians—who have the means to do so—should shoulder more of the tax burden.

Most Canadian workers do not bear an income tax burden that is out of line with that of Americans. According to the Organization for Economic Cooperation and Development's *Taxing Wages 2002-03*, a single Canadian worker earning the average gross manufacturing wage pays an effective income tax rate of 24.6%,[14] while a comparable U.S. worker would pay 24.1%. The evidence concerning families with children is mixed. Low-income single parents fare much better in the Canadian income tax system than do low-income single parents in the United States. Canadian two-parent, two-income families with children generally pay effective income tax rates that are 3-4 percentage points higher than American families (hence the AFB's support for more generous child tax benefit provisions). However, slightly higher effective tax rates for these families should be weighed against the many public services provided to children in Canada compared to children in the United States.

Should we cut taxes to improve our competitiveness?

The Department of Finance argues that Canada already has a significant business tax advantage *vis-à- vis* the United States.[15] With the changes introduced in 2000, Canada's average (federal-provincial) corporate tax rate, including capital taxes, is now 2.3 percentage points lower than the average U.S. (federal-state) rate. When the federal capital tax is phased out completely (by 2008), this advantage will grow to 3.4 percentage points.

Those who want further cuts to corporate income taxes challenge the government's claim concerning the Canadian tax advantage.[16] The tax-cut lobby cites any discrepancy between American and Canadian taxation as the potential provocation of an exodus of business to the United States in search of lower taxes. At times the advocates of business tax cuts assert that Canada should cut taxes below that of the U.S., or cut taxes in anticipation that the U.S. might cut taxes in the future, in order to pre-empt the possibility of Canadian corporations being at a tax disadvantage.

The argument that we must cut corporate taxes in order to prevent business flight from Canada is overly-simplistic. Firms base their location decision on many factors (including the availability of a skilled work-force, proximity to markets, transportation considerations, etc.). Many forms of government spending create competitive advantages that encourage businesses to locate in Canada.

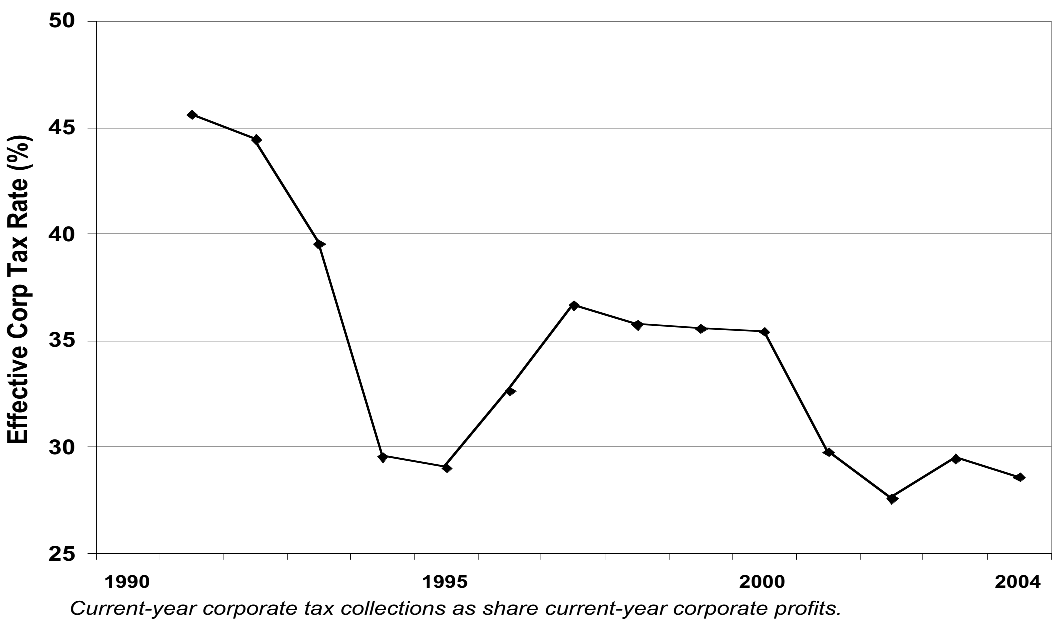
For example, the public provision of health insurance gives Canadian employers a competitive advantage because they do not have to provide costly private basic health insurance for their employees and retirees. The 2004 KPMG survey of international competitiveness found that the costs of doing business in Canada were approximately 9% below those in the United States.[17] A significant aspect of this advantage is Canada's lower labour costs resulting from lower employee-sponsored benefits, especially medical insurance.

Should we cut taxes to create jobs?

Tax cuts only create jobs if firms use their tax savings to expand production—and thereby employment—domestically. There is no guarantee, however, that savings on corporate taxes will be spent on new domestic investment. A firm's tax savings can be deployed in any way the firm wishes, including, say, to increase executive salaries. In fact, despite substantial corporate tax cuts rolling in since the 2000 Martin tax-cut package, business investment in Canada has been sluggish. As Jim Stanford illustrates in a forthcoming paper,[18] since 2000 the declining effective corporate tax rate has not coincided with any upswing in business investment *(see Figures 4 and 5)*.

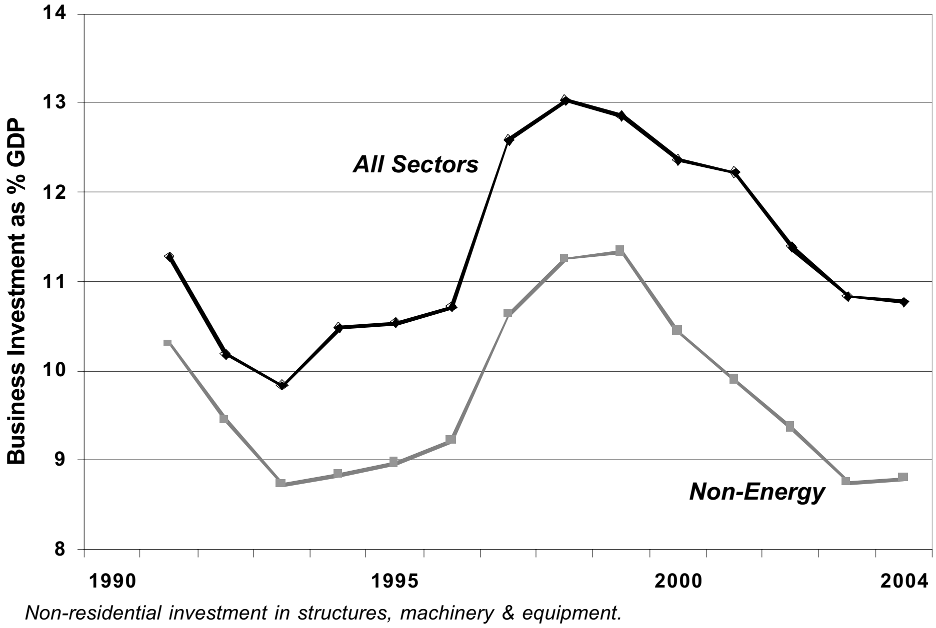
The link between tax savings and enhanced investment is particularly problematic when we consider the dismal record of investment during the recent period of high corporate profitability. High corporate profits (just like tax cuts) represent more money in corporations' hands that could be used for investment. Despite this recent period of high profitability, investment in new facilities and capital equipment has *declined.* Why should Ca-

Figure 4: Effective Corporate Tax rate



Source: Jim Stanford, forthcoming

Figure 5 : Business Investment as a percentage of GDP



Source: Jim Stanford, forthcoming

nadian taxpayers pile further tax breaks on top of an already high level of corporate profitability in hopes that this surfeit of resources will finally entice investment?

This dismal Canadian investment performance may point to problems that are not rooted in the tax system. In an era of high corporate profitability but low investment, one would suspect that demand conditions play a large role in lacklustre investment. If corporations anticipate that they may not be able to sell what they produce, they will not invest, regardless of new tax incentives. This analysis suggests the advisability of the domestic demand stimulus that can result from government spending. Particularly in an era in which a falling U.S. dollar makes exporting to the United States more problematic, the domestic demand stimulus generated by spending budget surpluses may prove an important stabilizer in the Canadian economy.

Should we cut taxes to improve corporate productivity?

Tax cut advocates claim that further corporate tax reductions will enable firms to invest in productivity-enhancing technology. As with the previous argument, this assumes that tax savings will be directed in a particular manner, in this case to new technology or research and development that will increase productivity.

Pro-tax cut advocates support this position by arguing that corporate income taxes are a disincentive to innovation. They argue that corporations would have a stronger incentive to innovate if the additional profits generated by their innovation were taxed more lightly.

This belief that our corporate tax system is inordinately punitive towards corporations often downplays the benefits accorded corporations under the current tax system. When businesses incur losses, they are tax-deductible. In addition, corporations receive generous tax incentives to support research and development, thus it is reasonable that the taxpayer should benefit if this research and development bears fruit.

Moreover, the argument that vigorous innovation is dependent upon further tax cuts does not hold if we believe that corporations exist in a competitive global market. While corporations might hope to increase productivity in order to earn unusually high profits, in practice firms in a competitive marketplace are obliged to innovate to survive. Even when one firm finds some way to increase productivity and thereby elevate its profit rate, it will be quickly imitated and those unusually high profits will be abated. To suggest that tax policy is the major determinant of corporate innovation neglects the motivations that are inherent in the competitive dynamics of a market economy.

Should we cut taxes to help low-income people?

It has become politically expedient for the tax-cut lobby to claim that its agenda for personal income tax cuts is intended to help low-income Canadians. After all, many Canadians struggling with disappointing real wage growth (or unemployment) and increasing levels of personal indebtedness desperately need help.

But the untargeted tax cuts touted by the tax cut lobby as a means to help poor Canadians actually deliver very little benefit to low-income people. A recent study done for the National Anti-Poverty Organization (NAPO) examined one of the untargeted tax cuts currently being promoted as a measure to provide support to low-income Canadians.[19]

It examined raising the basic personal exemption to $12,000, and determined that a poor family could expect to get about $111 from this plan. The lion's share of the benefits of this policy would go to higher-income taxpayers. For every dollar that would go to poor families under this proposal, the study found that $28 would go to families not defined as poor.

Untargeted tax cuts are an enormously expensive way to deliver very paltry help to low-income Canadians. The NAPO study found that raising the basic personal exemption to $12,000 would cost $9 billion annually. Because they take such a large bite out of government revenues, untargeted tax cuts reduce the government's ability to support the types of income support programs that really do provide meaningful help to low-income people.

Should we cut taxes to deter government waste or corruption?

Advocates of tax cuts often depict so-called "big government" as both wasteful and corrupt. This perception is promoted by citing the recent sponsorship scandal and other instances of inefficient or dubious practices in government programs pointed out by the Auditor General.

"Small government" proponents often embrace tax cuts as a way of forcing government programs to downsize, implying that this shrinking of government will also address issues of waste and corruption. The precise causal relationship between diminishing government revenues and a resulting improvement in government efficiency and integrity is unspecified. Why should a poorer government be a more efficient and more honest government?

There is reason to suspect that chronic underfunding can actually create conditions that promote mismanagement. For example, prolonged and excessive budget cuts can deplete the resources and qualified staff required to ensure compliance with internal financial control systems. This can create opportunities for both waste and abuse. The Association of Public Service Financial Administrators called attention to this possibility in a report released in the wake of years of shrinking government spending (relative to the size of the economy).[20]

It that report, the association representing government financial officers warned:

> While the Government of Canada's Financial Control Framework has allowed public servants to achieve [prudent management] in the past, there are growing signs that the Framework is starting to break down. Left unchecked, this problem will only get worse, leeching scarce resources from deserving programs and services, enriching unscrupulous individuals at the expense of all of us, and most importantly undermining the confidence of Canadians in their federal government.

Should we cut taxes because the private sector can take over roles the government now plays?

Advocates of shrinking the size of government by reducing tax revenues often claim the private sector should assume responsibilities that have previously been fulfilled by the government. For example, infrastructure needs may be met by privately-owned companies, or a relationship may be formed between government and private sector firms via so-called public private partnerships (P3s).[21]

There are a variety of reasons that suggest the private sector may be less efficient than the government in providing public infrastructure and services. Large private projects must be financed, and private firms borrow funds on much less attractive terms than the government. Consequently, they must mark up their costs to compensate for these higher borrowing expenses. In addition to covering higher capital costs, private sector firms must include a profit mark-up. A recent study of Brampton's P3 hospital found that its price tag was increased by at least $175 million more than would have been the case if it had been built publicly.[22]

Someone must shoulder these costs. If it is a P3 arrangement, the government must pay these increased prices, either out of tax revenues or via user fees paid by consumers. If it is a private sector firm *in toto,* low-income Canadians may be deprived when they cannot afford the rising market price of these goods or services. Alternatively, private firms under pressure to hold their prices down while maintaining their profit margins may compromise service quality.[23]

Unlike federal government departments, private corporations are not under the scrutiny of the Auditor General, thus Canadians have much less disclosure about their activities. It is often very difficult to ascertain just what is contained in the complex long-term contracts P3s have with governments, which makes it hard to detect if the government is being overcharged. To add to the complexity, the enormous infrastructure and service needs across the country would require the government to engage in thousands of these P3 contracts, making oversight of these arrangements an herculean task.

The case for using the surplus to enhance spending

An overview of federal government spending

Canadians experienced an era of deep budget cuts in the mid-1990s. While on average the ratio of program spending to GDP has been 15.3% since 1946, by last fiscal year it dropped to 11.6% of GDP—well below the historical precedent in Canada.[24]

Despite recent well-publicized announcements of new spending for both health care and equalization payments, the government projects that its program spending for the 2005/06 fiscal year will only rise to 11.7% of GDP.

It is important to note that, even after the federal budget was already balanced, the program spending/GDP ratio continued to drop, from 12.1% in 1997/98 to a low point of 11% in 2000/01. Although it has since inched back up slightly to 11.6% of GDP in the last fiscal year, program spending is still very low by historical standards. To reach the equivalent of 12.1% of GDP—the level we were at when budgets were first balanced—we would have needed to spend an additional $5.7 billion in the last fiscal year.

The government should spend the surplus to enhance Canada's economic potential

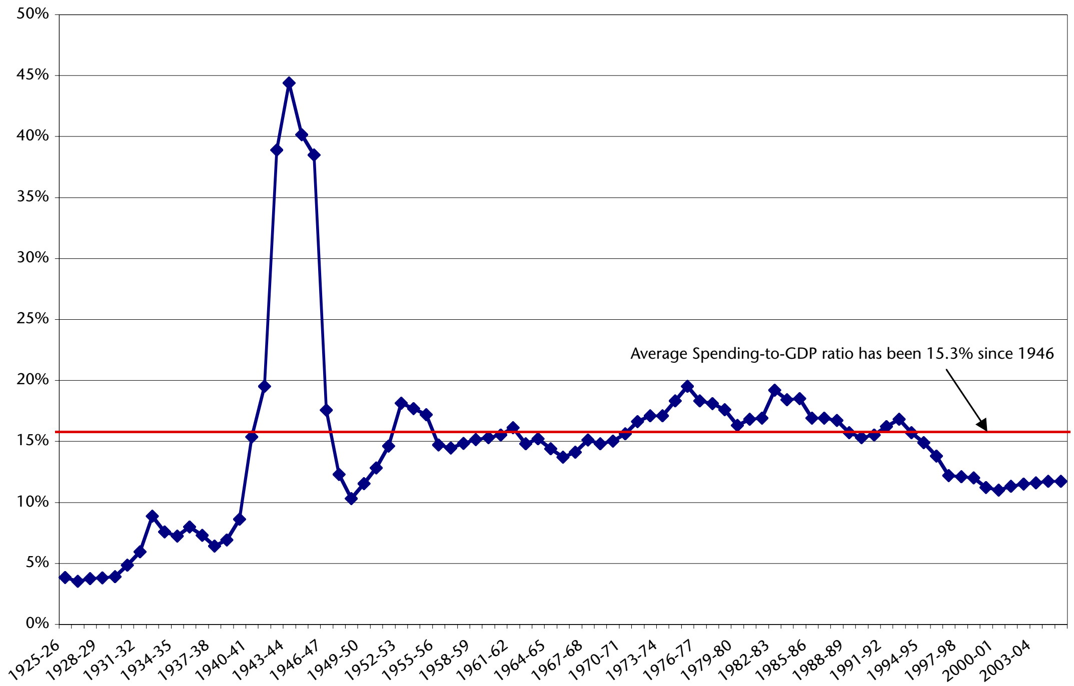
The cuts to government spending in the 1990s, and the failure to meaningfully rebuild spending since then, have had important economic consequences. As part of its commitment to facilitate Canada's economic growth in the future, the federal government must reverse the under-investment in several key areas.

Infrastructure is one of the areas in which prolonged under-spending has taken its toll. As federal government cutbacks have ramified to all levels of government, physical infrastructure has deteriorated in all jurisdictions. The Canadian Federation of Municipalities estimates Canada's municipal infrastructure debt to be $60 billion, with another estimated $21 billion needed to improve urban transit.

Businesses are experiencing a wide range of consequences of this deterioration in infrastructure, including less effective transportation, municipal services, and energy transmission. A recent Statistics Canada study found that businesses benefit dramatically from reinvestment in infrastructure. This study found that, on average, a dollar spent enhancing public infrastructure yields 17 cents of cost saving to businesses.[25]

Repairing Canada's frayed social programs—and implementing new ones—helps contribute to a "high- road" economy with important competitive benefits. Increased spending on post-secondary education and training is critical to competing in an increasingly knowledge-based international economy. Providing high-quality public child care is a smart policy to enhance labour force participation and ensure that productivity does not suffer because of the stresses workers experience balancing workplace and child care demands. Generous social programs are consistent with highly competitive economies, as is underlined by the Global Competitiveness Report 2004-2005 published by the World Economic Forum. Finland is ranked as the most competitive economy (Denmark and Sweden also make it to the top 5), indicating that the existence of a solid

Figure 6: Program Spending/ GDP



Source: Armine Yalnizyan, *Canada's Commitment to Equality: A Gender Analysis of the Last Ten Federal Budgets (1995 – 2004)*, Ottawa: Canadian Feminist Alliance for International Action, February 2004

network of state-provided social programs supports a competitive economy.[26]

When government spending facilitates economic growth, it also helps to achieve a number of other stated government priorities. The government's target of 25% debt/GDP ratio will be automatically achieved, with no debt repayment, if the government engages in the spending required to put economic growth on a more certain long-term footing. In addition, if the government really is worried about the implications of an aging population, it should invest now to enhance the productivity of future workers. Using budget surpluses to invest in early childhood education and care, education and training will enhance our productivity, and thereby increase the workforce's ability to support retirees in the future.

The government should spend the surplus to reduce poverty in Canada

The federal spending cuts that helped to achieve Canada's string of federal budget surpluses were particularly painful to large groups of vulnerable Canadians. Cutbacks to unemployment insurance have forced the unemployed into much more desperate situations. The federal government presence in assuring the provision of affordable housing was also dramatically curtailed. Poor Canadians saw income support programs devastated as federal budget cuts reverberated to the provinces and municipalities. Cuts to Employment Insurance eligibility, for example, have denied benefits to more than half the workers who become unemployed.

Not surprisingly, these cutbacks have combined to intensify poverty in Canada. Four million Canadians live in poverty, including over 50% of female lone parents. Canada has one of the highest child poverty rates of the industrialized countries—in a country where all parliamentarians committed to ending child poverty by 2000. Poverty rates among Aboriginal peoples are three times the national average. Canada enters the new millennium with an increasingly unequal income distribution, beset with all the social problems that inevitably accompany such increasing social polarization.

The federal government should not consider using budget surplus for either debt reduction or untargeted tax cuts until we have made meaningful strides towards reducing poverty in Canada. This will require several reforms to the Canada Social Transfer *(see AFB for details).* This will also require rebuilding the wide range of social programs that play a role in combating poverty and promoting social equity. Issues related to Aboriginal peoples, child care, cities and communities, disabilities, education, employment insurance, housing, and retirement must also be addressed as part of a comprehensive attack on poverty.

The government should invest the surplus to address the unmet needs of Canadians

While the federal government has continued to post budget surpluses, many of the acknowledged needs of Canadians—cited in virtually any chapter of the AFB—have gone unmet. As long as these widely recognized priorities in our social, environmental, and physical infrastructure remain unfulfilled, it is imprudent for the federal government—or the broader Canadian society—to consider using surpluses for either debt repayment or tax cuts.

For example, the deplorable state of Canadian child care is a persistent disgrace. A recent OECD study states that Canada invests less that half of what European countries invest, on average, in early childhood education. Less than 20 % of Canadian children under 6 with working parents have regulated child care spaces, while 60% of children in U.K., and 78% of children in Denmark have access to regulated child care spaces.[27]

Our stewardship of the environment is another area in which acknowledged needs are going unaddressed. Canada is further from reaching its Kyoto Protocol target than any other G-8 country. The emission of pollutants into our air and water increased 49% between 1995 and 2002. The release of pollutants into the air rose by 21%, while releases into water increased by 137%.

The government should spend the surplus to fulfill its promises

When the federal budget was initially balanced in 1997/98, the government promised that benefits accruing from eliminating budget deficits would be split 50/50 (50% allocated to spending, and 50% allocated to a mixture of debt repayment and tax cuts). In practice, the government has not come anywhere close to meeting its 50/50 target. New research finds that the government devoted 73% of its surpluses to tax and debt cuts, and about 27% to new spending.[28]

In the 2004 election, the Liberal party ran on a platform that made a number of promises related to spending (for example: national child care and a new cities and communities agenda). The Liberals made no promises whatsoever concerning tax cuts, and only a very subdued nod to debt repayment. *The federal government must direct any future budget surpluses to delivering on these promises—be-*

fore any future tax reductions or debt repayment can even be considered.

THE GOVERNMENT SHOULD SPEND THE SURPLUS TO GIVE CANADIANS WHAT THEY CONSISTENTLY SAY THEY WANT

Canadians value rebuilding social programs more highly than they do either tax cuts or debt repayment. A January 2004 EKOS poll asked Canadians what priorities the federal government should have over the next five years. Respondents ranked the highest priorities as health care, education, child poverty, the environment, crime prevention, post-secondary education, crime and justice, unemployment, skills development, and affordable housing. When asked how they wished a government surplus to be used, 63% wanted it invested in social programs, while 20% wanted debt reduction and 17% wanted lower taxes.

CONCLUSION: SURPLUSES ARE ABOUT CHOICES

Canadians can expect economists to debate the intricacies and implications of the various options of how to use forthcoming budget surpluses. In all likelihood there will be a range of viewpoints points as the technicalities of all of the various options are discussed. But technicalities won't decide this issue- because ultimately this is a political debate about the sort of Canada we wish to create.

The AFB has always said that budgets are about choices—they are a reflection of our priorities as a society. Allocating budget surpluses is about choices as well. Recurring budget surpluses give us a historic opportunity to debate the sort of Canada we wish to create. Both debt repayment and untargeted tax cuts takes us further along the path hewn by 10 years of downsizing the role of government in Canadian society. This paper presents the case that using forthcoming budget surpluses for judicious government spending can bring substantial economic benefits while also promoting social equity.

ENDNOTES

1 Of course, after public debate some mixture of these three options could be chosen.

2 *Economic and Fiscal Update* page 19

3 This comparison is made using a national accounts framework, whereas the more familiar debt statistics cited above use a public accounts framework.

4 For example, the *Economic and Fiscal Update*'s Table 3.6 presents two scenarios, one in which the contingency reserve is used to repay debt, and a scenario in which no debt repayment occurs. One would expect that this same table would tell us the difference in public debt charges under the two different scenarios. Inexplicably, they provide only one estimate for public debt charges, and they do not disclose whether this public debt charge figure assumes that the contingency reserve has been applied to pay down debt or not. Thus Canadians are not able to compare the difference in debt service costs that results when surplus is allocated to debt repayment and when it is not.

5 Riddell, W.Craig. "The Role of Government in Post-Secondary Education in Ontario," Background Paper for the *Panel on the Role of Government in Ontario,* August 2003. www.law-lib.utoronto.ca/investing/reports/rp29.pdf

6 Christopherson, Kjell A. and M. Henry Hobison. *The Socioeconomic Benefits Generated by 24 Colleges of Applied Arts and Technology in Ontario* January 2004, www.acaato.on.ca/new/

7 Clevland, Gordon and Michael Krashinsky. *The Benefits and Costs of Good Child Care The Economic Rationale for Public Investment in Young Children* Department of Economics, University of Toronto at Scarborough, March 1998

8 See for example the *Economic and Fiscal Update 2004,* p. 18 and the *Federal Budget 2004* pp.10 and 48

9 David Dodge's appearance before the House of Commons Standing Committee on Banking Trade and Commerce on April 20,2004. www.parl.gc.ca/37/3/parlbus/commbus/senate/Com-e/bank-e/03eva-e.htm?Language=E&Parl=37&Ses=3&comm_id=3

[10] See Merette, Marcel. *The Bright Side: A Positive View on the Economics of Aging in* Choices (Institute for Research on Public Policy) Volume 8, #1. IRPP's March 2002

[11] See the Actuarial Report (21st) on the Canada Pension Plan As at 31 December 2003 www.osfi-bsif.gc.ca/eng/office/actuarialreports/index.asp#cpp

[12] *Federal Budget* 2004 , p. 48

[13] See Hugh Mackenzie, "Taxation: The Martin Record" In *Hell and High Water*, CCPA 2004.

[14] Including employee contributions less cash benefits

[15] *Federal Budget 2004, pp. 207-209*

[16] For example, a recent study claimed that effective taxes are actually higher in Canada than the US if provincial capital taxes, sales taxes on capital inputs and less favorable write-off regulations for depreciation and inventory are taken into account. See Duanjie Chen and Jack Mintz, *The 2004 Business Tax Outlook:Lowering Business Taxes Would Spur Investment* www.cdhowe.org/pdf/ebrief_1.pdf

[17] KPMG *The 2004 Competitive Alternatives Study: The CEO's Guide to International Business Costs*

[18] Stanford, Jim, "*Imagining a Progressive Industrial Strategy"* forthcoming from the Canadian Centre for Policy Alternatives.

[19] NAPO Discussion Paper: Federal Relief For Low Income People by Andrew Mitchell and Richard Shillington www.napo-onap.ca/en/issues/tax%20cuts.htm

[20] The Association of Public Service Financial Administrators *Checks and Balances,* December 2003. www.apsfa.ca/news/checksandbalances-e.pdf

[21] A Public Private Partnership is a private firm that contracts with the government to finance, design, build, operate or maintain facilities or services

[22] Hugh Mackenzie, "*Financing Canada's Hospitals: Public Alternatives to P3s*", www.web.net/~ohc/

[23] See Deber "*Cats and Categories: Public and Private in Canadian Healthcare*" www.longwoods.com/hp/4-4PublicPrivate/HP44Deber.html

[24] Yalnizyan, Armine *Canada's Commitment to Equality: A Gender Analysis of the Last Ten Federal Budgets (1995 – 2004)*, Ottawa: Canadian Feminist Alliance for International Action, February 2004

[25] Harchaoui, Tarek M. Faouzi Tarkhani and Paul Warren, *Public infrastructure in Canada: Where do we stand? Micro-economic Analysis Division, Statistics Canada,* November,2003.

[26] *Global Competitiveness Report 2004-2005* published by World Economic Forum, www.weforum.org/site/homepublic.nsf/Content/Global+Competitiveness+Programme%5CGlobal+Competitiveness+Report

[27] *Early Childhood Education and Care Policy: Canada,* OECD 2004.

[28] Yalnizyan, Armine. *Canada's Commitment to Equality: A Gender Analysis of the Last Ten Federal Budgets (1995 – 2004)*, Ottawa: Canadian Feminist Alliance for International Action, February 2004

Canadian Centre for Policy Alternatives
410-75 Albert Street, Ottawa, ON K1P 5E7
tel: 613-563-1341 fax: 613-233-1458
email: ccpa@policyalternatives.ca
http://www.policyalternatives.ca