

The Economic and Social Consequences of Fiscal Retrenchment in Canada in the 1990s

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INTRODUCTION: WHAT DOES GOVERNMENT DO?

Contrary to the overheated rhetoric of certain conservative politicians, governments were not placed on this planet to waste money. Similarly, taxes are not some burden of mythical proportions which just appeared one day on the shoulders of citizens, who have since laboured to carry it. Rather, we pay taxes because we collectively *choose* to pay taxes, in order to finance the public provision of goods and, mostly, services which citizens believe to be useful and valuable. Over time, citizens have explicitly empowered their governments with mandates to collect taxes primarily in order to finance activities and services which are deemed to be inadequately supplied by private economic agents alone. This paper will consider the social and economic consequences of government taxing and spending activities, focusing particularly on the historic decline in that activity which has occurred coincident with the mid-1990s effort to reduce and eliminate government deficits.

The focus is on the general level of fiscal activity, not on imbalances between the taxing and spending sides of that activity. Most analysts would agree that in the long run the maintenance of some form of balanced budget — or at least the attainment of some measure of stability in public indebtedness — is a socially and economically beneficial goal.¹ A long-term secular rise in the ratio of public indebtedness is obviously not sustainable. So the issue is not *whether* budget imbalances will be eliminated, but *how*. In the Canadian experience of the mid-1990s, budget deficits at the federal level and in virtually every province were eliminated primarily by reducing program expenditure.² The decision to balance budgets in Canada, therefore, was coincident with the decision to significantly downsize government program activity. It is the social and economic consequences of this downsizing, not of the balancing per se, that is the focus of this paper. It is obviously conceivable that budgets could have been brought into balance without reducing program expenditures (by raising taxes, by lowering interest rates and/or by simply waiting for the beneficial

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impacts of economic growth on public finances), and so the decision to balance the budget and the decision to downsize the program activities of government should hardly be treated as synonymous.

The forms of government fiscal activity are many and varied, of course. But for the purposes of this paper, with its focus on the economic and social consequences of government taxation and spending, the following four categories can be considered.

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- **Discretionary Counter-Cyclical Fiscal Policy.** Many government fiscal activities have inherent counter-cyclical properties (so-called built-in stabilizers). At various times, discretionary fiscal policy has also been conducted to attempt to smooth out, more proactively, swings in private business activity. This discretionary activity has fallen out of favour, however, for various reasons such as information uncertainty and lags in the design and implementation of policies. There may be opportunity for careful experimentation in the future with discretionary counter-cyclical fiscal activities.³ For now, however, explicit counter-cyclical fiscal policy has largely been abandoned.
- **Provision of Pure Public Goods.** Even neoclassical economic theory admits a role for government fiscal activity, in relatively rare cases of true market failure. Some modern government functions roughly fit the description of true public goods (perhaps including policing and defence services), but most clearly do not. Most of the services which government provides (including highly valued health

and education services) could clearly be provided through private market structures, since the utility of their consumption can be “efficiently” transferred to the private purchaser of the service, and that utility can be denied to non-purchasers. The reason these services are provided through public channels is the widespread concern regarding the distributional consequences of private service provision (buttressed, in some cases, by concern over the administrative waste of private insurance schemes). Very little of current government activity can be justified using pure arguments regarding public goods and market failure.

- **Regulatory and Industrial Policy.** Canadian governments have traditionally invested considerable resources in efforts to reshape the structure and behaviour of the private-sector economy through various forms of regulation, subsidy and — more rarely — outright public ownership of businesses. Again, this category of government fiscal activity has diminished significantly in recent years, in the face of fiscal restraints and concern about the efficiency of some of these activities.⁴
- **Redistribution of Cash and Consumption.** I would argue that most modern government fiscal activity now fits into the broad category of efforts to redistribute both cash income and access to final consumption (including the consumption of non-cash public services), in the interests of greater equality, basic security and social inclusiveness. This is explicitly true for

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transfer payment programs, which redistribute cash income on the basis of concerns regarding equity and economic security for those (such as children, the elderly and the unemployed) whose market incomes may be inadequate to meet basic income standards.⁵ This is also clearly the case for the “big ticket” social programs such as health care and education. These services could be provided through private markets, but public concern over the immense personal consequences for those who might be unable to access those services through a private market system has led to public provision. In this case, again, the motive is clearly redistributive in nature: to provide Canadians (especially those of lower and moderate incomes) with more health, educational and other “human” services than they would be able to purchase through private market transactions. Even more mundane forms of government program activity — such as garbage collection, transportation infrastructure, recreational facilities and environmental protection — are aimed at providing Canadians of modest means with more of these particular forms of consumption than they would typically be able to access through private market transactions alone.

This redistributive motive for government fiscal activity carries various broader economic effects. For example, public provision of education may result in a better-educated population than would be possible with private education systems; alternatively, some of these programs (and/or the tax systems which are constructed to pay for them) may

have non-discretionary (or “automatic”) counter-cyclical effects. But the primary goal is one of redistribution and improved access: to provide lower- and middle-income Canadians with more of certain types of consumption than they would otherwise be able to afford, and to reassure better-off Canadians that they will receive those programs should their personal economic circumstances take a turn for the worse. The degree to which this general goal is fulfilled by government fiscal activity is likely to have suffered, therefore, with the overall reduction in government taxing and spending activities which occurred in the 1990s.

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THE SOCIAL AND ECONOMIC EFFECTS OF TAXING AND SPENDING

Consumption of Public Services

The direct provision of public services consumed a total of \$205 billion in 1998, equal to just under one quarter of GDP.⁶ On average, then, each household in Canada received some \$16,320 worth of publicly provided non-cash services (defined here simply as the value of all non-transfer public program spending). The distribution of public service consumption across income brackets is difficult to estimate; no data on this subject are available.⁷ Some types of public services are targeted at lower-income Canadians (such as social services); other are used most intensively by higher-income Canadians (such as universities); many services would seem to be equally consumed by all Canadians, regardless of income (such as recreational or cultural facilities). In the analysis that follows, we will adopt the sim-

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TABLE 1
Public Consumption Per Household, 1998

Non-cash public services delivery per household: \$16,320		
Quintile	Average Household Disposable Income	Government Consumption as % Disposable Income
Lowest	\$10,017	163
Second	\$21,960	74
Third	\$33,374	49
Fourth	\$48,778	33
Highest	\$85,606	19

144 Source: Author's calculations from Statistics Canada, *Income in Canada, Canadian Economic Observer*.

plifying assumption that every Canadian income bracket consumes a roughly equal proportion of non-cash public services. To the extent that public services are consumed disproportionately by lower-income households, this assumption will understate the extent of redistribution that is occurring through government fiscal activity; the reverse is true if public services are accessed more intensively by higher-income Canadians.

Table 1 indicates that even an equal per capita consumption of public services still contributes disproportionately to the final consumption possibilities of lower- and middle-income Canadians. For the lowest quintile of Canadian households, their consumption of non-cash public services more than doubles their total household consumption possibilities (relative to the private consumption possibilities provided by their total disposable cash income, including government transfers). Even for the middle quintile of Canadians, their share of non-cash public services is equivalent to 50 percent of their total private (cash) consumption possibilities.

The obvious objection, of course, is that not all government consumption actually contributes to the quality of life of Canadian households. This is certainly the case — but it is also true of private consumption spending. Not all private consumption spending is useful; much is wasted (because of poor quality, incomplete information or inefficient pricing). The unique aspect of public or collective consumption is that it presupposes some kind of collective choice mechanism, and hence each individual does not have full control over the public consumption decisions which affect him or her; yet private consumption decisions are similarly constrained by the structure of individual decision-making power (such that access to benefits or efficiencies which might arise from collective forms of consumption are not available in a purely individualized consumption framework). So long as normal democratic processes are at work to ensure that a larger share of government spending is dedicated to concretely useful services, and a smaller share to boondoggles, it seems reasonable to conclude that citizens will collectively ensure that they get value for their money in non-cash public services, just as they continually strive to get value for their money in their personal cash spending. Moreover, to the extent that some services (such as health care) may be provided more efficiently through public delivery systems than private ones, then this analysis understates the improvement in living standards that results from the consumption of public non-cash services (since it would take an even larger amount of private cash purchases to attain the same consumption of services through private delivery means).

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TABLE 2
Taxes and Transfers Per Household, 1998

Quintile	Market Income	Government Transfers	Transfers As Share Total Income	Direct Taxes	Taxes As Share Total Income	Net Cash Effect of Taxes & Transfers
Lowest	\$3,993	\$6,696	63%	\$671	6%	+\$6,025
Second	\$16,211	\$8,367	34%	\$2,619	11%	+\$5,748
Third	\$32,979	\$6,801	17%	\$6,406	16%	+\$397
Fourth	\$55,417	\$5,176	9%	\$11,815	19%	-\$6,639
Highest	\$109,116	\$4,258	4%	\$27,768	24%	-\$23,510

Source: Author's calculations from Statistics Canada, *Income in Canada*, *Canadian Economic Observer*.

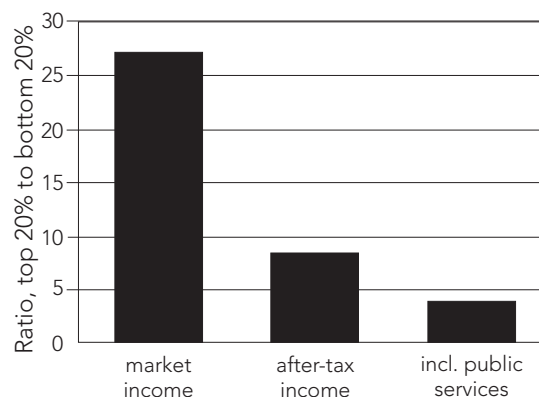
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The Redistribution of Income and Consumption

The most explicitly redistributive aspect of government fiscal activity is the system of personal taxes and transfer payments to individuals. Canada's personal income tax system is highly progressive; in 1997 (the most recent year for which final income tax data are available), almost 60 percent of total income taxes were paid by the highest-income 10 percent of the population, while the lowest-income 60 percent of Canadians paid only 10 percent of all income taxes.⁸ Other direct taxes in Canada are less progressive, or even regressive, in their burden. Meanwhile, transfer payments to households are also distributed on a progressive basis (due to the lower average incomes of the recipients of many transfer programs, such as Employment Insurance and the Guaranteed Income Supplement, and due also to the means-testing features of many transfer programs). The lowest-income quintile receives 50 percent more transfer income per household than the highest-income quintile — and that transfer income constitutes a much larger share of total household income for lower-income house-

holds (equalling two thirds of total income for the lowest quintile, versus less than 4 percent of total income for the highest quintile). The combined effect is a significant redistribution of cash income down the income ladder. As indicated in Table 2, the net effect of direct taxes and transfers increases the disposable cash income of the lowest quintile of Canadians by some \$6,000 per household (nearly tripling their pre-tax "market" income). On the other hand, it reduces the disposable income of the highest quintile of households by \$23,500 per household, or about 20 percent.

CHART 1
Government and Inequality



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TABLE 3
Tax and Benefit Balance Sheet, 1998

Quintile	Direct Taxes ¹	Estimated Consumption Taxes ²	Cash Transfers	Net Cash Gain or Loss	Non-Cash Public Services	Net Gain or Loss
Lowest	\$671	\$1,503	\$6,696	+\$4,522	\$16,320	+\$20,842
Second	\$2,619	\$3,294	\$8,367	+\$2,454	\$16,320	+\$18,774
Third	\$6,406	\$5,006	\$6,801	-\$4,611	\$16,320	+\$11,709
Fourth	\$11,815	\$7,317	\$5,176	-\$13,956	\$16,320	+\$2,364
Highest	\$27,768	\$12,841	\$4,258	-\$36,351	\$16,320	-\$20,031

¹ Direct taxes include income taxes and social insurance payroll deductions.

² Estimated as 15 percent (the average combined federal and provincial sales tax rate in Canada) of after-tax-and-transfer disposable income; actual consumption taxes are lower for households, such as higher-income households, which save more of their disposable income.

Source: Author's calculations from Statistics Canada, *Income in Canada*, *Canadian Economic Observer*.

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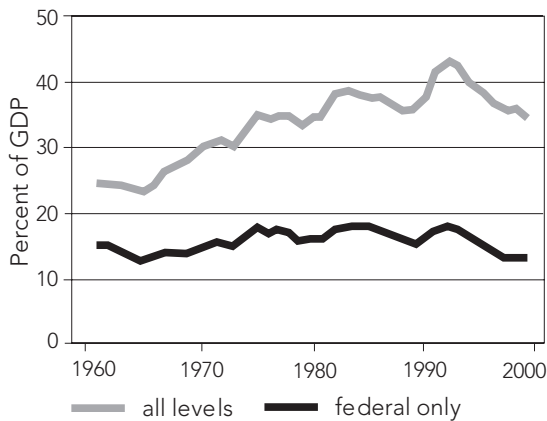
Together with the provision of non-cash public services, this tax-and-transfer system results in a very significant net redistribution of both cash income and final consumption possibilities. Chart 1 indicates that the top quintile received pre-tax or "market" income equal to some 27 times the pre-tax income of the lowest quintile. This inequality of pre-tax income has grown significantly over the past two decades. After taxes and transfers, however, the ratio of inequality falls to 8.5 to 1. This ratio of disposable income inequality stayed more or less constant, despite rising market inequality, until 1995, when it began to rise moderately. And when the per capita value of non-cash public services is added to the equation, the ratio of inequality in final consumption possibilities falls to less than 4-to-1. Total government fiscal activity, therefore — considering both cash taxes and transfers, and the provision of non-cash public services — has the combined effect of reducing this particular measure of inequality in Canadian society by about 85 percent.

Table 3 indicates that the bottom two quintiles of households receive, on average, more cash back from government in the form of transfers than they pay to government in income taxes, payroll deductions and consumption taxes.⁹ In this immediate sense, government "pays off" for the lower-income 40 percent of society. Even for the middle (third) and upper-middle (fourth) quintiles, once the value of non-cash public services is considered, households on average still get more back from government than they pay in income taxes, payroll deductions and consumption taxes (on the continued assumption, of course, that these households continue to view those non-cash government services as useful). Only the highest quintile of society pays more in income taxes, payroll deductions and consumption taxes than it receives back from government fiscal activity, making a net contribution of some \$20,000 per household.¹⁰

Even if the approximate tax costs per household were grossed up to reflect the burden of other taxes not considered here (such as property and corporate taxes), it is clear

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CHART 2
Government Program Spending



that the bottom 60 percent of Canadians are net beneficiaries of the taxing and spending activities of government, while the upper-middle quintile of Canadians roughly “break even.” This result reflects the highly progressive nature of the Canadian income tax system, and the targeted nature of many cash transfer programs.

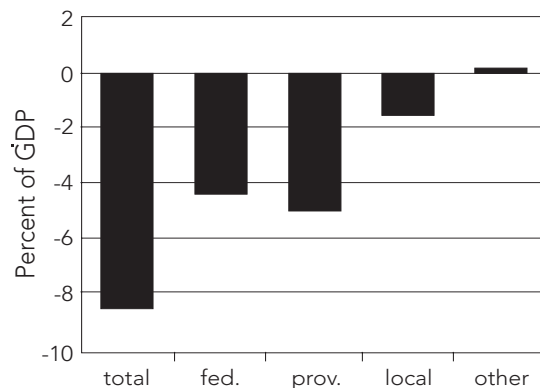
THE RETRENCHMENT OF TAXING AND SPENDING

Coincident with the effort to reduce government deficits at all levels during the mid-1990s, the program activity of Canadian governments experienced a historically unique reduction beginning in the mid-1990s. Ironically, this shrinkage in the relative and even absolute size of government program spending continued through the end of the decade, even after the attainment of fiscal balance and the generation of large surpluses. This immediately suggests that to some degree the downsizing of government programs was motivated by something other than solely concern with government deficits.

Since 1992, program spending by all levels of government in Canada (on a national accounts basis) has fallen by approximately one fifth, measured as a share of GDP — from an all-time peak of 43 percent of GDP in 1992 to 34 percent in 1999 (see Chart 2). The program spending share has fallen further since then. At the federal level alone, program spending has fallen somewhat more sharply, by about one quarter — from a peak of 17.9 percent of GDP in 1992 to some 13.5 percent of GDP in 1999. In either case this represents by far the most significant rollback of real government program activity in Canada since the end of the huge military effort in World War II.

The retrenchment in program activity was experienced broadly at the federal, provincial and municipal levels of government (see Chart 3). Some “other” government sector agencies, such as pension plans and hospital boards, maintained their program spending as a share of GDP. As a proportion of GDP, the provincial level of government experienced the largest reduction in program activity, shrinking by almost 5 points of GDP during this period. Local governments reduced their program activity by close to 2 points of GDP.

CHART 3
Change in Program Spending, 1992–99



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The total government sector and most components within it have experienced balanced budgets (on a national accounts basis) since 1997. This has meant that the worst of the program spending retrenchment which was experienced in the mid-1990s is now over. Nevertheless, the decline in program spending activity by Canadian governments, relative to the size of the overall economy, shows no sign of easing. Indeed, the federal government has explicitly *pledged* that its program spending will continue to decline as a share of GDP in the coming years.¹¹ At the federal level (despite campaign promises to the contrary) the clear majority of discretionary funds will be allocated to tax cuts, rather than enhancements in program activity;¹² this will ultimately reinforce the decline in the importance of program spending. There is no indication, in summary, that the declining trend in the total government program spending share has stopped, even though deficits have apparently been vanquished and the public debt burden (measured appropriately as a share of GDP) is declining rapidly.¹³

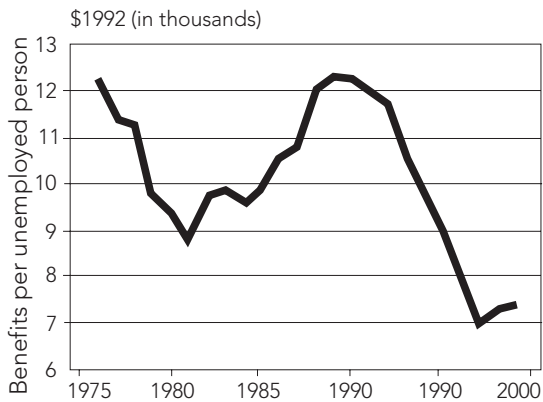
Some of the reduction in program spending (measured in both relative and absolute terms) is obviously attributable to the strong expansion in Canada's economy in the last couple of years. Broader economic growth has the effect of expanding GDP (the denominator of the program spending share) and reducing some cyclically sensitive program expenditures (such as transfer payments to unemployed persons). However, the cyclical component to the observed decline in the importance of program spending should not be overemphasized. Clearly a deep structural shift in the role of government programs in Canadian society has occurred. While the

program spending share is likely to rebound to some extent in the event of a future economic downturn (reflecting both contraction in the GDP denominator and normal cyclical increases in certain types of spending), it is unlikely that this would offset much of the one fifth decline in the program spending share which has been observed since 1992.

For example, employment insurance benefits are perhaps the most directly counter-cyclical form of government transfer payment (rising automatically in the event of a downturn, falling when unemployment abates with economic recovery). Regular EI benefits have fallen by more than 50 percent since peaking in 1993; in real per capita terms, they have fallen even further. This retrenchment in one of Canada's most expensive social programs has been an important source of the federal government's fiscal improvement (accounting for over 1 full point of the decline in program spending as a share of GDP since 1992, or one quarter of the federal government's bottom-line fiscal improvement during that time). Clearly the reduction in unemployment (by some 450,000 persons between 1993 and 1999) has been important in that decline. But even more important have been deep structural changes in the EI system itself, which have reduced eligibility and benefit levels. For example, real EI benefit payments were 40 percent lower in 1999 than in 1990 (mostly due to the declining coverage of the program, and only slightly due to declining real benefits for those who are covered) — even though the number of total unemployed was roughly equal in the two years. Chart 4 illustrates the stark decline in the level of real EI benefits paid out per unemployed person in Canada (a rough indicator

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CHART 4
Structural Change in EI Benefits



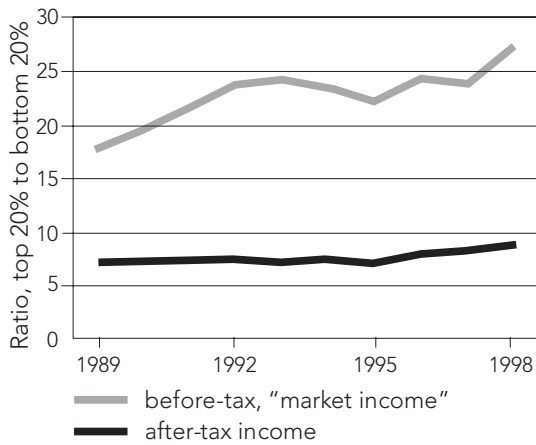
of the overall “generosity” of the EI program) since 1990, to levels not seen since well before the path-breaking UI reforms of 1971. Even in the event of a serious recession, therefore, the increase in program spending by this most cyclically sensitive of government programs will be modest by historical experience. Increasing unemployment by 50 percent (as occurred, for example, during the 1991-92 recession) and holding real average benefit levels constant would result in an increase in EI-related program spending of less than one half percent of GDP — offsetting barely one twentieth of the decline in the program spending share that has been observed at all levels of government since 1992. The trend indicated in Chart 2, therefore, can only be interpreted as primarily structural in nature.¹⁴

Regarding the direct provision of non-cash public services (rather than transfer payments), some analysts have argued that this provision has not declined to the same extent as real program budgets, due to downward flexibility in the effective real “costs” of those services (measured in terms of public expenditure per unit of real service delivery).¹⁵ Consider Canada’s education system,

for example, which has digested significant budget reductions during the 1990s: total public education spending per enrolled student, in real terms, declined by 5.7 percent between 1994 and 1997, and probably more since then.¹⁶ About 40 percent of this decline in public spending was offset by a 16 percent increase in private fees and other revenues, but bottom-line budgets for educational institutions in Canada still shrank by 3.4 percent in real per student terms. A good portion of that funding decline has been reflected in declining real wages for teachers and other educational workers. For example, the average real weekly earnings of teachers and others employed in elementary and secondary schools declined by over 13 percent between 1993 and 2000.¹⁷ At the same time, the ratio of elementary and secondary students per full-time teacher employed in the industry (which might be considered as a broad measure of average classroom sizes) hardly changed at all. This would imply that teachers and other education workers have “absorbed” much of the decline in public funding in the form of lower real incomes, thus insulating the level of real service provision — for a while, anyway. Some caution must be taken, however, before concluding that real public service provision has not been harmed by the funding cutbacks. In the first place, the sharp decline in real incomes for teachers and other public service workers has generated immediate losses among those workers, their families and their communities. Secondly, the decline in real incomes for those workers will certainly have a major impact on the quality of the work which they are performing; eventually, declining real incomes will make it increasingly difficult for schools to attract and retain qualified

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CHART 5
Measures of Inequality



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work effort of those teachers who remain employed.¹⁸ In this manner, the decline in financial support for education and other public services will ultimately be reflected in a deterioration in the quantity and quality of public service delivery, on top of their more immediate impact on the real incomes of public service providers.

The retrenchment of public sector fiscal activity in Canada is significantly altering this country's standing in international comparisons of this subject. Program spending at the federal level is now significantly smaller, relative to GDP, than is the case in the United States, although lower-level program spending in Canada is still twice as great proportionately as in the US (reflecting both the relatively decentralized nature of government in Canada and the greater importance here of public services such as health care which are provided in Canada by lower levels of government). As recently as 1995, Canada ranked in the middle of all OECD countries in terms of program spending as a share of GDP; now we rank among the lower third of countries by this measure,

with a program spending ratio significantly lower than the OECD average.

THE SOCIAL EFFECTS OF PROGRAM RETRENCHMENT

Within another two or three years, program spending by government in Canada will likely have reached its lowest level (as a share of GDP) in three decades. Not since the 1960s will Canada have experienced such a low level of government fiscal activity, relative to the size and growth of the overall economy. Since it was in the 1960s and 1970s that welfare-oriented interventionism reached its peak in Canada, and we developed an international reputation as a "just society," the long-run social implications of this unprecedented rollback in government fiscal activity are likely to be significant.

Many data on key social indicators are published with a lag of two or more years, and the effects of government spending reductions on those indicators will generally not be felt for some time. As a result, the impact of the mid-1990s fiscal retrenchment on social variables is only just becoming visible. At the same time, the strong economic and labour performance that Canada has enjoyed since 1998 is helping to offset some of the negative social consequences of that retrenchment. Nevertheless, there are some worrisome signs of deteriorating underlying social conditions in Canada that will need to be monitored carefully in coming years.

Transfer payments to individuals have declined moderately in real terms since 1994, as summarized in Table 4. Canadian households, on average, lost some \$400 per year (in 1998 dollar terms) of government transfer

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income between 1994 and 1998, representing about 1 percent of their disposable income. This decline was felt most strongly among the bottom two quintiles of the income ladder, both of whom lost some 4 percent of their real 1998 disposable income to transfer payment reductions over the previous four years.

During the same period, Canada experienced the first notable increase in the inequality of after-tax disposable income in recent decades — despite the positive distributional effects resulting from the strengthening of labour markets. As noted above, the tax-and-transfer system has traditionally offset much of the growing inequality that has been visible in pre-tax, pre-transfer “market” incomes. In 1995, however, inequality started to grow markedly, even in disposable income terms (see Chart 5). The disposable income ratio between the top quintile and the bottom quintile increased by about 20 percent between 1995 and 1998 — almost as much as the corresponding 23 percent increase in the ratio of pre-tax-and-transfer market

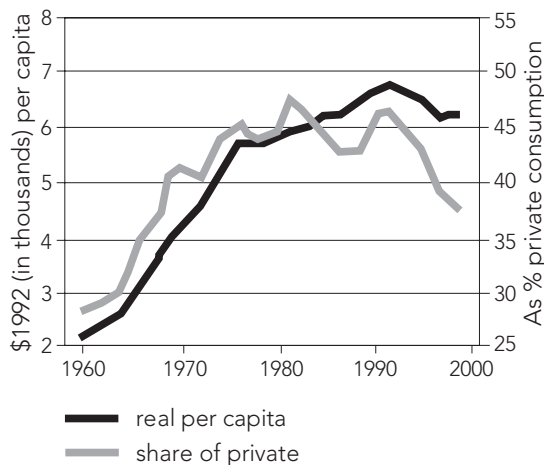
TABLE 4
Decline in Transfer Income Per Household, 1994–98

Quintile	Change Real Transfer Income, 1994–98 (\$1998)	Decline as Share 1998 Disposable Income (%)
Lowest	-\$391	3.9
Second	-\$902	4.1
Third	-\$210	0.6
Fourth	-\$381	0.8
Highest	-\$93	0.1
Average	-\$395	1.0

Source: Author’s calculations from Statistics Canada, *Income in Canada*.

incomes between the same two quintiles. In other words, with the downsizing of government transfer programs in the mid-1990s, followed by the implementation of growing income tax cuts (the largest of which are not yet reflected in this income distribution data), it seems that Canada’s tax-and-transfer system is failing to play its traditional role of offsetting the growing inequality of private market incomes.¹⁹ One quarter of the increase in the inequality of disposable incomes between the top and bottom quintiles in recent years is attributable to the absolute decline in real transfer payments to the poorest families. Most of the rest is attributable to the failure of those real transfer incomes to keep up with the increase in average real market incomes (or, in other words, attributable to the *relative* erosion of the importance of transfer payments). For those who have argued that the reduction of transfer payments to poor Canadians will somehow encourage them to go out and earn more in the private “market,” recent data are cold comfort: the real pre-tax market incomes of the bottom quintile actually declined by some 10 percent between 1995

CHART 6
Public Consumption



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and 1999 (despite an improving labour market), amplifying the decline in transfer income received by these same households.

But the importance of government to the distribution and quality of economic opportunity is not limited to the tax-and-transfer system. As described above, the provision of direct, non-cash public services is also an important component of the overall standard of living of most Canadians. If anything, this activity has declined even more dramatically in the wake of the program spending cutbacks by all levels of government. Chart 6 illustrates the decline since 1992 in the real per capita provision of public services in Canada. Since peaking in 1992 at close to \$7,000 (in 1992 dollars) per capita, the average consumption of public services has declined by 8 percent. At the same time, private consumption spending has increased (in real per capita terms) by 14 percent. This implies that public consumption has declined even more rapidly in relative terms — that is, as a share of the total bundle of consumption opportunities. Indeed, Chart 6 indicates the declining trend in per capita public consumption as a proportion of per capita private consumption. This ratio peaked in 1982 at close to 48 percent of private consumption; in other words, the total consumption basket at that time was allocated two-thirds to private consumption and one third to public consumption. This indicates that public service delivery reached its zenith at the end of the 1970s in terms of its relative importance. The ratio gradually declined over the next 15 years, reflecting the gradual erosion of the importance of government, and has contracted precipitously since 1995 to its lowest level since the 1960s. In terms of the

relative importance of public consumption, then, Canada is already a “leaner, meaner” and more privatized society than at any time in the past three decades — and the recent election promises of politicians at both the federal and provincial levels suggest that this trend will be accentuated in the coming years.

The erosion of public service consumption in Canada during the 1990s has been described here using relatively abstract composite indicators, such as program spending budgets as a share of GDP and public consumption as a share of total consumption. The historic decline in these aggregate measures, obviously, does not directly illustrate the more concrete manifestations of hardship and dislocation which have been associated with the retrenchment of government fiscal activity. The goal of public programs, obviously, is to concretely improve living conditions — not to boost the program spending share for its own sake. The task of documenting the deterioration of living standards in Canada associated with the shrinkage in public programs is necessarily undertaken through detailed, sector-specific investigations. Examples of studies which document this deterioration follow.

- Bezanson and McMurray (2000) document the longer-run effect of provincial welfare cutbacks on individual families in Ontario.
- The Ontario Health Coalition (2000) documents the growth of user fees and other private health costs during the 1990s in Ontario.
- Raphael (1999) finds linkages between growing income inequality and the deterioration of health outcomes among poor Canadians.

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- Doherty-Delorme and Shaker (2000) documents the decline in the quality of post-secondary education in Canada in the 1990s according to indicators such as faculty turnover and student-faculty ratios.
- Zelder and Wilson (2000) find a 51 percent increase in average waiting times for important medical treatments in Canada between 1993 and 1999.
- Osberg and Sharpe (1998) describe a sustained decline in economic well-being in Canada through the 1990s, largely attributable to rising economic insecurity among Canadians.
- Brown and Stanford (2000) provide similar evidence of a decline in economic well-being in Canada between 1990 and 1999, driven exclusively by a decline in social insurance and public consumption.

While each of these investigations typically describes only a small, specific slice of the overall erosion of public consumption and economic security in Canada, they collectively paint a picture of real decline in public services, and a corresponding erosion of economic security and well-being experienced in many segments of Canadian society. At the same time, however, other studies report continued public confidence in and support for the quality of important public services such as health care and education, and public opinion polls consistently suggest that Canadians view public financial support for these programs as representing the highest priority for future fiscal allocations.²⁰ Despite the apparent decline in the quality and effectiveness of many public programs, therefore, Canadians still express a strong view that they generally represent a worth-

while use of expendable public funds. The pressure to repair and rebuild many damaged programs, and to initiate new programs to address emerging social and economic needs (such as early childhood education or home care), is likely to persist, despite the current bias of Canadian federal and provincial governments in favour of tax cuts.

WAS THERE A CHOICE?

Supporters of the retrenchment in public expenditures which dominated Canada's fiscal landscape during the 1990s argue that the spending reductions were necessary in order to address chronic fiscal weakness and an accumulation of public debt which most analysts agree was unsustainable. The fact that program spending is still declining in relative terms, despite the vast improvement in the bottom-line fortunes of Canadian governments, inspires some scepticism regarding the claim that the retrenchment was motivated solely by fiscal necessity. And, indeed, the post-hoc evidence suggests that deficits could indeed have been eliminated without nearly the damage to the program spending activities of Canadian governments.

At the federal level, for example, Finance Minister Paul Martin famously set out a deficit-reduction timetable in his 1995 budget that he pledged to meet "come hell or high water." This timetable would see the federal public accounts deficit shrink from the nearly 5 percent of GDP booked in fiscal 1994 to 3 percent in fiscal 1996, 2 percent in fiscal 1997 and 1 percent in fiscal 1998. The budget could presumably then be balanced in fiscal 1999 (although this final step was not spelled out explicitly in the

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Finance Minister's initial timetable). This timetable represented an ambitious but not unreasonable pace of deficit reduction, especially in the context of global economic recovery.²¹ In reality, however, the federal government implemented what was clearly a much more dramatic plan for reducing and eliminating the deficit. The government's spending and tax decisions reflected a more rapid internal timetable for elimination of the deficit, but this more aggressive stance was "hidden" in official budget documents through measures such as deliberately pessimistic macroeconomic assumptions and the allocation of large "contingency" funds. In practice, the federal government outperformed its own deficit reduction timetable by two full years — reducing the deficit to just 1 percent of GDP in fiscal 1996 and then attaining a balanced budget a year later. This made Canada's federal government the first in the G7 to balance its budget — even though Canada's fiscal situation had ranked among the worst in the OECD just a few years earlier.

Was this dramatic and accelerated pace of deficit reduction necessary? Clearly there are some benefits from eliminating deficits sooner rather than later — a smaller accumulation of debt, and lower interest charges arising from that debt, chief among them. Yet the social and economic consequences of deficit reduction through program spending cuts are obviously heightened when that reduction occurs at such an accelerated pace. Indeed, it turns out that the initial 3-2-1 timetable so famously laid out by Mr. Martin could have been achieved *without any nominal program spending reductions at all*. Table 5 summarizes two deficit reduction scenarios: the actual experience of the federal government

since 1994 (top portion), and a counterfactual scenario which assumes the federal government had only frozen nominal program spending at its 1994 levels, rather than implementing the deep spending cuts that began with the 1995 budget. The counterfactual scenario also assumes that Canada's nominal GDP growth during the period of spending cutbacks would have been strengthened by the amount of the spending cutback.²² On the basis of other plausible assumptions (regarding average effective tax rates and average effective interest rates, which are assumed constant in the two scenarios), the federal government would still have outperformed its supposed "official" deficit reduction timetable, and balanced the budget by fiscal 1999 — with no cuts in nominal program spending and no additional increases in aggregate taxation (other than those which were in fact imposed by the federal government).²³

In this context, the claim that the only alternatives to deep program spending cuts would have been either the continuing indefinite accumulation of public debt or the imposition of dramatic tax increases is not credible. The fact that so many other countries also eliminated deficits during the latter 1990s, most of them more gradually than Canada and most without dramatic reductions in program expenditure, similarly supports the notion that real choices were available while still accepting the general goal of deficit reduction. And the decision by Canadian governments to impose dramatic program spending reductions to attain a uniquely fast improvement in bottom-line fiscal balances must therefore reflect priorities other than simply the desire to balance the budget.

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TABLE 5
Actual and Simulated Deficit Reduction, 1994–99

	1994	1995	1996	1997	1998	1999
Official Deficit Target (% GDP)			-3.0	-2.0	-1.0	0.0
Actual Experience						
Nominal GDP Growth (%)		5.6	3.1	4.3	3.2	7.6
Revenue (\$b)	123.3	130.3	140.9	153.2	155.7	160.0
Program Spending (\$b)	118.7	112.0	104.8	108.8	111.4	115.5
Debt Service (\$b)	42.0	46.9	45.0	40.9	41.4	41.5
Balance (% GDP)	-4.8	-3.5	-1.1	0.4	0.3	0.3
Counterfactual Simulation						
Nominal GDP Growth (%)		6.5	4.0	4.3	3.2	7.6
Revenue (\$b)	123.3	131.4	143.3	155.8	158.3	162.7
Program Spending (\$b)	118.7	118.7	118.7	118.7	118.7	118.7
Debt Service (\$b)	42.0	47.1	45.9	42.5	43.6	44.1
Balance (% GDP)	-4.8	-4.2	-2.5	-0.6	-0.4	0.0

Note: Counterfactual simulation assumes identical revenue/GDP ratio and average effective interest rate as in actual experience; program spending is frozen at 1994 nominal level; GDP growth adjusted by the amount of the foregone program spending cutbacks in 1995 and 1996; and debt accumulation and debt service charges adjusted accordingly.

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CONCLUSION

Analysts of virtually all political stripes agree that fiscal balance is something that governments should strive to maintain. But the maintenance of fiscal balance, and deep reductions in the absolute and relative importance of government fiscal activity, are two different and distinct concepts. For various reasons, Canadian governments in the mid-1990s elected to attain virtually all of its deficit reduction through deep reductions in program spending — and hence placed the burden of that reduction onto the backs of the lower- and middle-income Canadians for whom that program spending (in the forms of both cash transfers and non-cash public services) is most important. It is now four years since balanced budgets were attained in Canada, yet the historic decline

in program spending shows no sign of reversing itself. Taxes are now declining as a share of GDP, and that decline will accelerate in the wake of the tax-cut promises of current governments. As taxes decline, “catching up” to the earlier decline in program spending, the current downsized state of government programs will become cemented.

Continued government downsizing long after the attainment of balanced budgets suggests that factors other than deficit reduction were a motivating force for the historic retrenchment in the fiscal role of government that has been experienced in Canada. Most developed economies attained reduced government deficits over the past decade. However, the program spending reductions in Canada were uniquely deep; only three other OECD countries experienced a similarly large shrinkage in the relative impor-

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tance of government program spending during the 1990s, even though several experienced budget deficits that were equally large if not larger.

High-income Canadians pay more into government than they get back, they clearly would like to keep more of their pre-tax income (who wouldn't?) and they constitute a disproportionately important political influence. Businesses would prefer to see lower income and payroll taxes, and they also carry disproportionate political weight. Employers would prefer to deal with a labour force which is relatively less "entitled," in terms of the security and consumption opportunities which are provided through the state (rather than through private employment income). Legitimate public concern over unsustainable government deficits in the 1990s provided these constituencies with the opportunity to effect a structural change in Canadian society that goes far, far beyond simply balancing the government's books. It involves an unprecedented and lasting retrenchment in the overall role of government programs in the social and economic lives of Canadians. For those who enjoy high pre-tax market incomes, this restructuring may enhance their long-term prospects (although even they may experience some insecurity as a result of the erosion of social entitlements). But for most Canadians, who still get more back from government than they pay into it, the incidence of poverty, inequality and insecurity will almost certainly increase.

As government programs are cut back, and taxes eventually decline to keep up, then Canada will look increasingly like the lopsided 27-to-1 society that is already visible in the data on the distribution of market

incomes. The provision of both cash income supplements and non-cash public services is becoming markedly less important, in both absolute and relative terms. For the bottom and middle quintiles of the distribution ladder, this will inevitably translate into a reduction in long-term consumption possibilities. Canadian society will demonstrate more private consumption, less public consumption, great and growing inequality, and in the long run probably a decline in observed performance on a range of health and social indicators.

NOTES

- 1 For a left-wing vision that accepts the need for some form of "balanced budgets," see the various editions of the *Alternative Federal Budget* project, which has been produced annually since 1995 by the Canadian Centre for Policy Alternatives and CHOICES.
- 2 In his paper in this volume, Don Drummond estimates that over 75 percent of the discretionary fiscal change at the federal level between 1993 and 1997 took the form of program spending cutbacks. Similarly, in a previous paper, Stanford (2000) estimates that program spending cutbacks constituted 64 percent of the total improvement in the federal budget balance between 1994 and 1998. This estimate incorporates the fiscal savings resulting from lower interest rates (while Drummond considers only the effects of what he calls "discretionary" fiscal measures, not including interest rate changes); if interest savings are excluded from the Stanford analysis, then spending cutbacks similarly account for more than 75 percent of fiscal improvement over the same period. At the provincial level, the fiscal balance (on a national

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accounts basis) improved by 3.8 percentage points of GDP between 1992 and the attainment of balanced aggregate provincial budgets in 1997. More than 100 percent of this improvement (4.3 points of GDP) was attributable to reduced program spending (which was partly offset at the bottom line by rising debt service payments and falling provincial transfer revenue from the federal level).

- 3 For example, the NDP proposed in the most recent federal election a kind of infrastructure savings account, into which funds are invested during years of fiscal surplus and an inventory of plans is maintained for various infrastructure construction projects. When the economy slows, it is both fiscally and operationally possible for government to quickly organize counter-cyclical infrastructure construction activity in an efficient manner.
- 4 For example, total government subsidies to business in Canada have fallen by 60 percent since 1980 as a share of GDP, to just 1.1 percent in 1999. Similarly, the intensity of government regulation would seem to have been reduced (or at least streamlined) in recent years; a recent international study, for example, listed Canada as having the least burdensome regulations on business start-ups in the world (see Dixon, 2000).
- 5 In 1999, transfer payments to individuals by all levels of government totalled \$106 billion, accounting for about one third of total government program spending.
- 6 The year 1998 is chosen for this analysis to be consistent with the quintile household income distribution data utilized below; all public expenditure data are reported on a national accounts basis.
- 7 Irwin Gillespie conducted a landmark study to estimate the distributional impact of public spending in the 1960s and 1970s; see Gillespie (1966, 1978). He found, similarly, that public services are not consumed disproportionately by

lower-income categories, consistent with the simplifying assumption used here of equal per capita consumption of public services. Gillespie's studies would be worth repeating in the wake of the sea change in fiscal policy which has occurred in Canada since the publication of his work.

- 8 Author's calculations from Canada Customs and Revenue Agency (1997).
- 9 The analysis does not include other taxes, such as corporate taxes and property taxes, and hence understates the total cost of taxation and overstates the net benefits of government. Personal income taxes, social insurance payments and consumption taxes account for over two thirds of all government revenues. Consumption taxes are estimated as 15 percent (the weighted average combined federal and provincial sales tax rate in Canada) of disposable income for each quintile.
- 10 Jonathan Chevreau, the tax-bashing columnist for the *National Post*, once bemoaned this state of affairs as "the ruthless arithmetic of democracy" (Chevreau, 1999). Michael Walker, Executive Director of the Fraser Institute, agreed that most Canadians (those with annual incomes up to \$50,000 per year) get more out of government than they pay in, and held that this would limit efforts to reduce the size of government — because of continuing popular support for the redistributive function that government plays (see Walker 1999). In retrospect, Walker underestimated the ability of the top quintile to exercise disproportionate influence on Canada's political process; his pessimism was not fully justified (although continued support for government taxing and spending activities will limit the extent to which fiscal activity continues to shrink).
- 11 Finance Minister Paul Martin, in delivering his "Economic Statement and Budget Update" in October 2000, said: "Over the next five years, we will hold the rate of growth in pro-

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gram spending to less than the rate of growth in the economy.”

- 12 See Canadian Centre for Policy Alternatives (2000) for an analysis of the allocation of latent federal surpluses to the competing goals of program enhancement, tax cuts and debt reduction. Defining a “neutral” fiscal policy as one in which taxes are constant as a share of GDP and program spending per capita is held constant in real terms (Don Drummond utilizes a similar definition in his paper in this volume), the analysis finds that just 2 percent of available federal funds over the 1997-2001 period have been allocated to enhancements in program spending (and that includes the monies allocated under the September 2000 health accord between the federal and provincial governments).
- 13 The net federal government debt, in public accounts terms, declined from a peak of 71 percent in 1995 to an estimated 55 percent by the end of the current fiscal year. In national accounts terms (the reporting method used by most other industrialized countries), the net debt is some 15 percentage points lower (as a share of GDP), and falling faster. See Department of Finance Canada (2000), Table 3.1 and Annex 2.
- 14 In his paper in this volume, Don Drummond similarly estimates that 87 percent of the improvement in the federal fiscal balance between 1993 and 1997 resulted from discretionary policy changes, not from economic recovery.
- 15 The author is grateful to Jeremy Rudin for suggesting this line of argument.
- 16 Author’s calculations from Statistics Canada (2000b).
- 17 Author’s calculations from Statistics Canada (2000b).
- 18 Most Canadians seem to accept that the quality of public services will be correlated with the morale and working conditions of public service providers; see, for example, Ontario Secondary School Teachers’ Federation (2000), which reports the results of a public opinion poll regarding the likely effects on education quality of the intensification of work demands on teachers. For an overview of the negative trends in teacher recruitment and retention in Canada, see Canadian Teachers’ Federation (2000b).
- 19 For more detail and analysis of these trends, see the paper by Andrew Heisz, Andrew Jackson and Garnett Picot in this volume.
- 20 Despite evidence of the deteriorating quality of public health care, most Canadians view the public system as effective and valuable; see Rachlis, Evans, Barer and Lewis (2001). Support for the system is higher among those who have used it. Similarly, public opinions regarding public education are more positive (in terms both of desiring more public support and approving of the quality of public education) among those with children enrolled in public schools; see Canadian Teachers’ Federation (2000a). Public opinion polls conducted in 2000 and 2001 by EKOS Research Associates, Ipsos-Reid and the Canadian Broadcasting Corporation all indicated significantly more support for public spending on education, health care and other public services than for tax cuts.
- 21 Steadily improving fiscal balances were experienced very broadly among industrialized economies during the latter 1990s, whether or not they undertook to significantly reduce program expenditures.
- 22 In other words, it is assumed that each dollar of reduced program spending translated into a reduced dollar of GDP; no additional spin-off “multiplier effects” are assumed. This view is consistent with the estimates of analysts during 1995 and 1996 that government spending cuts, especially at the federal level, caused a significant fiscal “drag” effect which reduced Canadian GDP growth by as much as 1.0 percentage points in

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each of those years; see, for example, Rubin and Lester (1996).

- 23 The successive Alternative Federal Budgets produced by the Canadian Centre for Policy Alternatives and CHOICES in 1996 and 1997 accepted the official deficit reduction timetable outlined in 1995 by Mr. Martin, but attained those targets without program spending cuts (and without increasing the aggregate ratio of federal taxes to GDP). Of course, freezing the nominal program budget would still have implied a gradual erosion in the real per capita value of federal programs. Even simply by freezing nominal program spending at its 1994 level, federal program spending would still have declined by 1.8 points of GDP between 1994 and 1997 — smaller than the actual 3-point decline which occurred in this period but significant nonetheless.

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