The Harris Government

A Mid-term Review

by Marc T. Law, Howard I. Markowitz, and Fazil Mihlar

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Summary: Main Policy Recommendations

For more detailed explanations of the following policy proposals, please see the relevant sections in the main text.

Spending policy

- Legislate provincial government spending limits. We recommend an indefinite freeze on provincial government spending at the 1997/98 level of $54.3 billion.
- Develop a debt elimination strategy.

Taxation policy

- Continue to reduce the tax burden in tandem with the spending freeze.
- Reduce marginal income tax rates and, in particular, eliminate income tax surcharges.
- Reduce payroll taxes.

Social policy

- Continue to trim welfare benefit rates.
- Adopt the Sarlo poverty line as the benchmark for welfare benefit rates.
- Replace the current welfare system with a Negative Income Tax (NIT).

Labour policy

- Eliminate the minimum wage.
- Repeal the Labour Relations Act; enact Right-to-Work (RTW) legislation.
- Reform the Workers Compensation Board (WCB) to put it on a firmer financial footing.

Health policy

- Ignore the Canada Health Act and allow more private market forces to operate in the delivery of health care services.
- Allot government funds for health care directly to consumers through a system of Medical Premium Accounts (MPA).

Education policy

- Redirect all education spending directly to parents through a system of school vouchers (educational opportunity scholarships); or
- Pass charter-school legislation to allow for more choice in schools.
- End closed-shop union privileges currently enjoyed by the Ontario Teachers Federation (OTF).

Regulatory policy

- Impose a three-year moratorium on all new regulations (with exemptions for natural disasters and national emergencies).
- Introduce more market-driven responses and non-regulatory alternatives into current regulations.
- Prioritize all regulations using modern risk-assessment techniques.
- Provide "sunset review" of all regulations.

Privatization policy

- Privatize major public companies and crown corporations including Ontario Hydro, the Liquor Control Board of Ontario, the Ontario Film Development Corporation, the Ontario Loan Corporation, Ontario Place Corporation, and the Ontario Waste Management Corporation.
- Contract-out public sector services wherever possible through a process of competitive bids.

Municipal affairs

- Replace the current system of two-tiered local government in Toronto and elsewhere with a single-tier of competing local governments.
- Encourage municipalities to charge for consumption of municipal services on a user-fee basis.
- Use Unit Assessment (UA) techniques for all property tax assessments.

Introduction

The superficiality of current policy debates

It is an unfortunate fact that discussions about public policy are often clouded by politics and ideology. All too often, debate about public policy centres not on the actual impact of policies but on the identities and ideologies of those who support or oppose these policies. For example, it is often heard that Party A supports policy X because Party A is a right-wing party that is unconcerned with the plight of the working poor. Just as familiar is the claim that Party B, a left-wing party, is opposed to policy X because such a policy would advance the interests of the business community. Because the policy debate is framed in such a manner, meaningful discussion about what will actually occur if a policy is implemented seldom takes place. Instead, the discussion degenerates into name-calling and finger pointing, an exercise that is inevitably futile for there can be no reconciling such divisive points of view.

That policy debates are often framed in such terms should come as no surprise. Oscar Wilde noted long ago that "We live … in an age of surfaces" (1899/1986: 304). Too often, we believe that by assigning blame we can solve our problems. We are all too willing to buy into the quick and easy fixes sold to us by politicians and so-called experts. And so frequently our quick fixes get us nowhere and our witch-hunts leave us polarized. This is the triumph of superficiality over depth and of pseudo-intellectualism over considered rationality. Our failure to analyze the real consequences of our policy choices carefully and our willingness to take the easy route leaves us in a muddle that could and should have been avoided.

On the irrelevance of intentions

Discussions about public policy, if they are to be fruitful in any operative sense, must be about the actual consequences of particular policy choices. They must be discussions about how policies affect the well being of individuals and not simply about who is advancing a policy proposal and for what political reasons. Much of the current debate can neither inform nor guide policy choices as the preoccupation with intentions and ideology tells us nothing useful about whether or not particular policies should or should not be adopted. Indeed, the current obsession with ideology and partisan politics in the policy debate overlooks the fact that bad outcomes are more likely to be the product of bad ideas than bad intentions. This point was made explicitly two centuries ago in a remark by Pierre S. du Pont, a Deputy from Nemours, to the French National Assembly:

> Gentlemen, it is a disagreeable custom, to which one is too easily led by the harshness of the discussions, to assume evil intentions. It is necessary to be gracious as to intentions: one should only believe them good, and apparently they are; but we do not have to be gracious at all to inconsistent logic or absurd reasoning. Bad logicians have committed more involuntary crimes than bad men have done intentionally.[1]

Hence, if we are to go beyond the surface and actually engage in a meaningful discussion about public policy, it is necessary to abandon our prejudices and examine the real effects of various policies in a critical and disinterested manner. And if we are to examine the effects of policies and offer meaningful alternatives, we must have a base of good, solid, ideas that take into account both the seen and unseen consequences of human action.

1 Cited in Friedman 1977: 77. Apparently du Pont made the remark on September 25, 1790.

Economics as a guide to good public policy

Without doubt, the progress of economics as an empirical science has an important role to play in discussions about public policy. This is because economics, as an empirical discipline, is ideally suited to illuminate the consequences of human actions. Because the desirability of any policy proposal depends upon some prediction about the consequences of doing one thing rather than another, and since the tools of economics can be usefully employed to make such predictions, the application of economics in the policy arena goes a long way in advancing the public policy debate from one about intentions to one about outcomes.

In a seminal essay on economic methodology, Milton Friedman points out that the progress of economics as a science and its application in the realm of public policy can help enhance consensus about what policies should be adopted. Friedman writes:

> I venture the judgment, however, that currently in the Western world . . . differences [in opinion] about economic policy among disinterested citizens derive predominantly from different predictions about the economic consequences of taking action—differences that in principle can be eliminated by the progress of economics—rather than from fundamental differences in basic values, differences about which men can ultimately only fight. (1953: 5)

According to Friedman, there is probably a wide consensus among "disinterested citizens" over matters of fundamental values (1953: 5). And, indeed, among policy makers, politicians, and the public at large, there is probably broad agreement as to the goals of public policy. Everyone probably agrees that government should implement policies that encourage high employment, low inflation, strong economic growth, and a high and rising standard of living for all citizens. The desirability of these objectives is likely independent of one's political party. Thus, the policy debate is not about objectives but rather about instruments, and about what policies are best geared to achieve a certain set of goals. Economics, by outlining what can and cannot be achieved by the instruments of the state, and by detailing how best to achieve a given set of goals, can therefore contribute greatly to the public policy debate.

The Ontario government

In the spring of 1995, Premier Mike Harris and the Ontario Progressive Conservatives were swept into power on a mandate to "take a fresh look at government" and to "re-invent the way it works, to make it work for the people" (Progressive Conservative Party of Ontario [PCPO] 1994: 1). If asked, most observers would likely agree that government was not working particularly well in Ontario at that time. During the previous decade, taxes increased, spending mushroomed, the deficit grew, while the economy stagnated. Government intervention became a pervasive feature of economic life in Ontario with few tangible benefits. Campaigning on promises to cut taxes, reduce government spending, and eliminate barriers to economic growth and job creation, the Ontario Progressive Conservatives offered an alternative vision of government in Ontario—a vision of a smaller, more efficient government that would intervene less in economic affairs. It was hoped at the time that the implementation of this vision would pave the way to a more prosperous Ontario.

The Harris government has now been in power for nearly two-and-one-half years. The time seems ripe to evaluate their progress. The purpose of this report card is to shed light on the policy debate in Ontario by providing an economic analysis of the public policies adopted by the Ontario government since it was elected in 1995. We intend to highlight what the Ontario government has done in each of the major policy areas and to evaluate these actions within an economic framework. It is our hope that such an analysis will provoke a more rational debate about public policy in Ontario, a debate that deals directly with the real consequences of particular policy choices.

The structure of this report card

We divide the report into 9 sections, each dealing with a different area of public policy. Each section begins with a detailed discussion about what recent economic research has to say about the particular policy area. We then outline what the Ontario government has done in that policy area and evaluate the policy actions of the Ontario government in light of the recent economic research in this area. A letter grade is then assigned, reflecting how well the "student" (i.e. the Ontario government) has performed in that particular policy area.

Readers may note that much of the initial discussion in each policy area is of a very general nature and may not focus directly on the Ontario government. This is a very deliberate strategy on our part. Since the ultimate purpose of any report card is pedagogical, we believe it important to engage in a thorough discussion of what economic theory and the empirical evidence has to say about each policy area in order to describe what constitutes "good policy." Only then is it possible to evaluate critically the policy performance of the Ontario government.

Spending Policy

Intertemporal budget balance

Persistent government deficits have been a feature of the Canadian fiscal landscape for the last 20 years. Canada's federal government has not balanced its budget since the early 1970s. Provincial government deficits began to emerge as an issue during the 1980s. Following the lead of Alberta, most provincial governments in Canada have started to reverse this trend and are now on their way towards fiscal balance. The Government of Canada is expected to have a balanced budget by fiscal year 1999/2000 (Canada, Dep't of Finance 1997). Alberta balanced its budget in 1994/95 and is now enjoying the benefits of a budget surplus, estimated at approximately $2.5 billion (Alberta 1996). Fiscal retrenchment appears to be the order of the day.

Why governments have been forced to reverse the trend of persistent deficit finance is not difficult to understand. Intertemporally, all economic entities must balance their budgets. Over time, the present discounted value of expenditures must equal the present value of revenues; this is true for individuals, firms, and governments (Blanchard and Fischer 1993; Romer 1996; Good 1995). In the context of government finance, this principle can be restated as follows: a deficit today is a tax tomorrow. If the government runs a deficit in the current period, it must run surpluses at some future time to pay off the principal and interest accumulated on this period's deficit. Profligate governments in Canada ran deficits in the past; they must now work towards fiscal balance and run surpluses in the future to pay off those accumulated past deficits. There can be no "free rides or free lunches" when it comes to such matters.

Optimal public finance: intertemporal tax smoothing

Given that, as a matter of accounting, governments must balance their books intertemporally, the relevant policy question is: what is the optimal time path of government deficits and surpluses? In other words, what is the "best" (i.e. most efficient) way for a government to finance its spending over time, given that it has the option either to pay all its bills at once or to borrow now and defer payment?

Modern economic theory offers the following answer to this question. Governments should choose the sequence of deficits and surpluses that minimizes the "excess burden" of taxation (the seminal paper on this topic is Barro 1979). The logic behind this answer is that what makes government spending "costly" to the economy is that it must ultimately be financed by taxes, which are almost invariably a cause of some economic distortion. In a free market, prices work to allocate resources efficiently. However, in the presence of taxes, relative prices are distorted and economic incentives are altered since taxes drive a "wedge" between marginal costs and benefits (Aaron and Pechman 1981). Given that governments must eventually finance their expenditures through some sort of distortionary taxation, it follows that government imposes a deadweight loss (or "excess burden") on economic activity. Hence, pursuit of efficiency requires that the government seek to minimize the distortions it creates by having to (sooner or later) resort to taxation as a means of financing its expenditures (Aiyagari 1989: 22–32).

A fiscal rule requiring the government to balance its budget in each and every period would clearly not be optimal. Since tax collections and government spending often fluctuate according to cyclical patterns, such a fiscal rule would require tax rates also to fluctuate cyclically. The economic costs of tax collection would be very high under such a regime since tax rates would have to jump up and down depending on the cyclical behavior of output and government spending. Given that such fluctuations are often temporary (i.e. a product of economic cycles), a far better strategy would be to run deficits during economic downturns and pay these deficits later with surpluses when economic conditions improve. Such a strategy would enable the fiscal authority to smooth tax rates over time and minimize the inefficiencies caused by distortionary taxes (Aiyagari 1989).

However, if a change in economic circumstances is permanent, then optimal behaviour on the part of the fiscal authority requires that tax rates change permanently. Suppose, for instance, that the government decides to increase its expenditures permanently. Since spending is permanently higher, taxes must also be permanently higher. This is because all government finance must ultimately obey the intertemporal present-value budget constraint. It is impossible to finance a permanent increase in government spending by a deficit since, if spending is higher but taxes are the same, there will be no opportunity to run future surpluses to finance this permanently higher level of government spending. Hence, the optimal response to a permanent increase in government spending is a permanent increase in tax rates. Deficit finance is clearly not optimal (nor feasible) under such circumstances.

To summarize, optimal public finance requires the government to adopt the following policy rules:

- For temporary increases in spending (or temporary declines in output and tax revenues), the best strategy is to run a temporary deficit and pay it back later with future surpluses. This enables the fiscal authority to smooth tax rates over time and, in doing so, minimize the distortionary costs of taxation.

- For permanent increases in government spending, tax rates must also rise permanently (Conversely, a permanent reduction in government spending enables a permanent reduction in tax rates) (see Barro 1990). The government's intertemporal budget constraint precludes the opportunity for deficit finance in these cases.

While useful as a guide to understanding how taxes should be set, the analysis above is incomplete. It is incomplete because it takes government spending *as given* and then outlines the best way to finance a given path of government spending.[2] A more complete approach requires us to ask what is the optimal level of government spending.

On the optimal size of government

The fundamental issue at the heart of most debates on public finance is how much a government should spend. Although the analysis presented above is only geared to address the issue of how a government should finance its expenditures over time (and not how much it should actually spend), part of our previous discussion does provide some clues as to this issue. Recall that satisfaction of the government's intertemporal budget constraint requires it eventually to finance all its spending through taxes. Recall also that what makes government costly is that its expenditures must be ultimately financed through taxation, which imposes distortions on real economic activity (Browning 1976). Since permanently higher levels of government spending must be financed by permanently higher tax rates (which are distortionary), it follows that larger governments (i.e. governments that spend more) are more economically costly than smaller governments since the tax rates required to finance a larger government are necessarily higher than those needed to finance smaller governments.

Empirically, this proposition receives a great deal of support. Cross-country growth regressions performed by Landau and Barro suggest that countries with smaller governments experience faster economic growth (Landau 1983; Barro 1991). Empirical tests by Marsden, Easterly, and Rebelo show that countries with lower marginal tax rates also experience faster growth than countries with higher tax rates (Marsden 1983; Easterly and Rebelo 1993). The intuition behind these results is straightforward. Smaller governments impose fewer distortions on economic activity. This is because smaller governments are able to levy much smaller and much less distortionary taxes. As a result, economies with smaller governments are likely to be more efficient and this is reflected in faster economic growth rates (Easterly 1993).

Hence, the central issue in the perennial debate about government budgets is not about the size of

2 It also assumes that the government can commit itself to a particular path of spending and will not deviate from it. The problem of commitment is sometimes called the "time-consistency problem." See Kydland and Prescott 1977.

the deficit *per se*. Whether or not a deficit in the current year is a good or bad thing really depends on the overall time-path of government spending and real output. As noted earlier, a deficit today may be a sensible way to finance a temporary increase in government spending but is obviously a foolish way to finance a permanent increase in spending. It is clearly not possible to judge the optimality of a government's finances by looking exclusively at the deficit. What really matters in these debates is not so much the size of the government's deficit as the size of its expenditures. Permanently lower levels of government expenditure are less damaging to the economy than permanently higher levels of spending because permanently lower levels of spending do not have to be financed by permanently high (and inefficient) tax rates. The real burden of government is therefore caused by how much it spends, rather than by the mix of debt and taxes it uses to finance its expenditures.[3]

The case of Ontario

The Ontario government's fiscal position has followed a historical pattern similar to that of other governments in Canada. Since the mid-1980s, Ontario has run persistent deficits. In fiscal year 1992/93, Ontario's deficit reached an all-time high of $12.4 billion, or approximately 4.4 percent of provincial GDP. Since then, the ratio of deficit to GDP has followed a downward trend. In 1996/97, it stood at roughly 2.3 percent of GDP and is projected to fall to 1.9 percent of GDP in 1997/98. The Ontario budget is expected to be balanced by 2000/01 (Ontario, Ministry of Finance 1997b). These overall trends are consistent with the arithmetic of intertemporal budget balance outlined earlier. Deficits in the past must eventually be paid back by surpluses in the future. There is no escaping this fact.

Given that the real cost of government lies not in how it finances its spending over time but rather in how much it actually spends over time, it is more revealing to look at the statistics on government spending. During the late 1980s and early 1990s, the ratio of Ontario public spending to provincial output followed an upward trend. In 1989/90, the ratio of provincial spending to output was 14.9 percent. By 1992/93, this ratio reached an all-time high of 19.2 percent, nearly one-fifth of the total economic output of the province. Since taking office, the Ontario Progressive Conservatives have succeeded in reducing this ratio somewhat. In 1996/97, the ratio of provincial expenditures to provincial GDP has fallen to 17.5 percent and is expected to fall by another 1.5 percent in the following fiscal year (Ontario, Ministry of Finance 1997b). These declines have been due to a combination of expenditure restraint and strong economic growth.[4]

The Harris government's efforts to reduce the size of the public sector in Ontario must be applauded. Without such fiscal restraint, large and inefficient government would have become a permanent reality in Ontario. Left unchecked, the tremendous increases in provincial government expenditure that occurred during the late 1980s and early 1990s would have required permanent increases in tax rates. This would have been disastrous for economic efficiency since the deadweight costs of taxation in Canada are very high.[5] The Harris government definitely deserves credit for having tilted fiscal policy in a more favourable direction.

However, much more still needs to be done. If the gains from smaller government are to be realized, the ratio of government spending to provincial output must continue to decline and, then, must remain at a lower level. Only a permanent reduction in government spending can result in a permanent reduction in taxes. The efficiency gains that result from lower taxes (fewer price distor-

3 Much public debate has centred around the subject of whether the Ontario government should cut taxes first or eliminate the deficit first. In light of the previous discussion, this debate is a red herring. The real issue is how much the government spends and not how government finances that spending.

4 Ontario, Ministry of Finance 1997. In particular, total Ontario government spending fell from $58.3 billion in 1995/96 to $56.6 billion in 1996/97 (a decline of 2.9 percent) and is projected to come down to $54.3 billion in 1997/98 (a decline of 4 percent). Meanwhile, provincial GDP rose from $313.3 billion in 1995/96 to $323.6 billion in 1996/97 (an increase of 3.3 percent) and is expected to rise to $339.8 billion in 1997/98 (an increase of 5 percent).

5 See Dahlby 1994. Dahlby estimates that each additional dollar of taxes collected through the personal income tax costs the economy $1.38 in lost output.

tions) can only arise if government spending is permanently decreased. Therefore, the Harris government must remain vigilant in its efforts to reduce the size of the Ontario public sector.

Some policy proposals

In order to consolidate the gains of smaller, more efficient government, the Ontario government must do the following:

- Legislate provincial spending limits. If government is to remain small, forces must be in place to check the constant political pressure for government hand-outs. One method of doing this is through legislated spending limits. We recommend that the Ontario government legislate an indefinite freeze on nominal provincial spending at the projected 1997/98 level of $54.3 billion (Ontario, Ministry of Finance 1997b). With such a provision, the ratio of government spending to GDP will fall sharply over time. This will enable a permanent reduction in tax rates and significant improvements in economic efficiency and growth.

- Introduce a debt-reduction plan. The ratio of total debt to GDP in Ontario is very high and has risen significantly over the past decade from 14.2 percent in 1989/90 to 31.4 percent in 1996/97 (Ontario, Ministry of Finance 1997b). Since debt must eventually be serviced by taxes, which impose economic inefficiencies, it is important that this ratio come down over time. We suggest that the Ontario government legislate a debt-retirement plan in which a fixed portion of future surpluses go directly towards debt reduction and the residual amount goes to permanent tax reductions.

Conclusions

The burden of government is best measured by the permanent component of its expenditures. A permanently large government must ultimately be financed by permanently high tax rates. There is significant evidence that suggests that taxes in Canada are distortionary and impose large deadweight costs on the economy. The Harris government must stay the course and ensure that its reductions in spending are permanent. For reducing the share of government spending to provincial GDP and reversing the trend of large and growing government, the Harris government deserves a **B+**.

Taxation Policy

Government as a redistributive agent

Broadly speaking, most of what government does is redistribute wealth. The large tax and transfer systems that have come to characterize most Western democratic states were put in place primarily for redistributive purposes. Programs that ostensibly serve other purposes also have a redistributive dimension.[6] Certainly the state does also play an allocative role. Enforcement of contracts, maintenance of law and order, provision of public goods—these are all allocative functions since they provide a stable framework within which markets can efficiently operate. However, expenditures devoted to these activities are a very small component of what government spends overall. Hence, it seems fair to conclude that government is largely a redistributive agent.

That this should be the case is not surprising. From an economic perspective, politicians are essentially "vote maximizers" (Tullock 1975; Buchanan and Tullock 1965): the main concern of a politician is to gain re-election. In a competitive democracy such as ours, politicians compete with other politicians for political support (i.e. votes and/or campaign contributions). In order to gain political support, politicians use the instruments of the state to redistribute wealth to various political constituencies. As a result, the central preoccupation of government becomes wealth redistribution (Matsusaka 1995a).

Redistribution in a static first-best world

If markets are perfectly competitive and the government is restricted to levying lump-sum taxes and transfers,[7] then the preoccupation of politicians with redistribution is of no concern to economists in a static world.[8] In such a "first-best" world, government—that agent responsible for levying taxes and transfers—will not impede economic efficiency. Redistribution will certainly make some better off and some worse off but it will not affect the allocative efficiency of the market. Hence, there are no economic arguments for or against redistribution in a static first-best world.

Why this should be the case is fairly easy to understand. If taxes and transfers are lump-sum and the world is static, then relative prices are not altered.[9] The unique feature of lump-sum taxes and transfers in the context of a static world is that they do not distort the incentives faced by economic actors.[10] Since lump-sum taxes (transfers) are levied (paid) to individuals on the basis of who they are, rather than what they do, relative prices are unaffected. As a result, resource allocation, which is guided by movements in relative prices, will continue to be efficient, in spite of changes in the distribution of wealth. Redistribution will therefore have no efficiency consequences in a static first-best world of perfect competition and lump-sum taxes.

6 For instance, the unemployment insurance system functions more as a redistributive instrument than as a true insurance system. See, for instance, Corak and Pyper 1995.

7 A lump-sum tax is a tax that is levied on individuals independent of what they do. According to *The New Palgrave Dictionary of Economics* a "lump sum tax is fixed in amount and of such a nature that no action by the victim (short of emigration or suicide) can alter his or her liability" (Graff 1987: 251). The classic example of a lump-sum tax is a poll tax.

8 This is simply a restatement of the Second Theorem of Welfare Economics: any Pareto optimal allocation can be achieved by lump sum taxes and transfers if markets are perfectly competitive. See Feldman 1980.

9 The assumption of a static, single-period world is important. In a dynamic, multi-period setting, however, individuals have the option to avoid an onerous lump-sum tax through migration.

10 This may not be the case if we allow for rent-seeking. Lump-sum transfers, by creating opportunities for wealth capture, may encourage individuals to devote resources simply for the purpose of extracting rents. Such rent-seeking is economically inefficient. See Tullock 1967; Buchanan, Tollison, and Tullock 1980.

Redistribution in a dynamic second-best world

Unfortunately, ours is not a first-best world. For practical and political reasons, few (if any) of the taxes and transfers employed by governments are of a lump-sum nature. Almost invariably, taxes (transfers) are levied (paid) to individuals on the basis of what they do rather than whom they are.[11] Furthermore, the fact that the real world is dynamic means that individuals can avoid paying even lump-sum taxes by migrating to other jurisdictions. Taxes and transfers in such a second-best world change the incentives faced by individuals. As a result, relative prices are altered and this has consequences for economic efficiency.[12]

This point requires some clarification. Maximization of economic welfare requires that the social marginal benefit of an activity equals the social marginal cost. In a perfectly competitive market, prices move to ensure that social marginal costs and benefits are equated. Hence, under perfect competition, social welfare is maximized. Suppose, however, that a distortionary per-unit tax is levied on the activity under consideration. This raises private cost of that activity above its social cost. Since the private cost of engaging in this activity is now higher than before, individuals will curtail the amount of resources they spend engaging in this activity. The result is that individuals engage in "too little" of this activity relative to what would be socially optimal (i.e. economically efficient). This economic misallocation is sometimes called the "deadweight loss" or "excess burden" of taxation (Aiyagari 1989). It is a measure of the reduction in economic welfare that results from using a distortionary tax to raise a given amount of tax revenue.

This same argument works in reverse for per-unit transfers. By raising the private benefit of an activity above its social benefit, a per-unit subsidy encourages individuals to engage in "too much" of this particular activity. As a result, economic resources are misallocated (too much goes to the subsidized activity, too little to other activities) and the economy experiences a deadweight loss. This reduces overall economic welfare.

Hence, because taxes and transfers in our second-best world are distortionary (because they affect economic incentives), redistribution is not costless from the perspective of economic efficiency.[13] How much and in what manner a government decides to tax and transfer through the machinery of the state has efficiency consequences. Politicians and governments, therefore, impose a burden on the economy when they must resort to distortionary taxes and transfers to effect their redistributive goals.

Empirical evidence on the effects of taxation

There is an enormous body of evidence showing the effects of distortionary taxation on economic behaviour. As noted earlier, by altering the private costs and benefits of an activity, taxation changes the incentive structure faced by individuals and can motivate outcomes that would not have occurred in the absence of taxation (Aaron and Fechman 1981). Below is a summary of some of the major findings on the effects of taxation on economic activity.

- High marginal tax rates on labour income reduce labour supply. By lowering the cost of leisure, high marginal income tax rates encourage people to substitute from work to leisure (Heckman 1993; Triest 1990).

- Payroll taxes increase the price of labour input relative to capital. As part of their cost-minimizing strategy, firms will change their mix of pro-

11 For instance, payroll taxes affect work effort and choice of labour input, labour income taxes affect work effort, sales taxes affect consumption, capital gains taxes affect the incentive to save and invest. Only poll taxes are neutral with respect to economic activity; however, poll taxes are seldom employed because they are regressive and politically unpalatable.

12 For a very readable explanation of how taxes cause economic misallocation, see the chapter Why taxes are bad: the logic of efficiency in Landsberg 1995.

13 This is not strictly true. In the presence of externalities, non-lump-sum taxes can improve efficiency if they force economic agents to internalize the external effects of their actions. This is known as a Pigouvian tax. As a practical matter, however, it is very difficult to estimate the correct Pigouvian tax. See Feldman 1980 for a discussion of Pigouvian taxation.

duction inputs away from labour and towards capital. Payroll taxes are therefore a tax on jobs. The empirical evidence suggests that payroll taxes have a negative impact on employment.[14]

- Taxation of capital gains and dividends reduces both savings rates and aggregate investment. What matters to investors is the rate of return net of taxes (Summers 1984; Ture and Sanden 1977). Taxes on capital gains and on investment income reduce the net rate of return and, thus, result in lower overall levels of investment. Since productivity improvements are often embodied in new capital investment, the impact of such taxes in the long run is to slow down the rate of capital accumulation and the rate of economic growth (Marsden 1983). Hence, taxation can reduce the dynamic efficiency of the economy.

- Punitive levels of taxation encourage the growth of an underground economy. When faced with very high tax rates, individuals will tend to engage in untaxed activities and avoid taxed activities (Feige 1989; Lippert and Walker 1997). The result is the blossoming of an underground economy. Empirical estimates suggest that the underground economy in Canada could be anywhere between 4.5 percent to 20 percent of GDP (Mirus, Smith, and Karoleff 1994; Drummond, Ethier, Fourgere, Girard, and Rudin 1994).

- The deadweight costs of taxation are very high in Canada. As noted earlier, the imposition of non-lump-sum taxes causes economic misallocation because such taxes distort economic incentives. It is estimated that each additional dollar of taxes collected through the Canadian federal personal income tax system reduces output by $1.38; a dollar increase in taxes collected through the provincial income tax reduces output by $1.66. Surtaxes in certain provinces impose extremely large deadweight losses and may even result in diminished tax collections (Dahlby 1994).

To summarize, redistribution is costly because it must be effected by distortionary taxes and transfers that reduce economic efficiency. Greater amounts of redistribution must be financed by higher tax rates. Since the distortionary costs of taxation rise with the tax rate, redistribution is subject to diminishing returns; greater amounts of redistribution impose larger deadweight losses on the economy (i.e. the more a government chooses to redistribute, the more the economy will pay for it in terms of efficiency losses).[15] Operationally, this implies that governments should:

1 choose the *minimum* level of redistribution necessary to achieve its normative objectives; and

2 utilize the *least* distortionary taxes and transfers in effecting this level of redistribution.[16]

Given what is known about the excess burden of taxation in Canada, policy rule (1) implies that the total amount of redistribution (i.e. the total "tax take") should be reduced while policy rule (2) suggests a reduction in the most distortionary taxes (for instance, surtaxes on personal income).

Tax policy in Ontario

In the spring of 1995, the Progressive Conservatives were swept into power in Ontario on the promise of "redistributing wealth and decision-making power away from the politicians and the bureaucrats and returning it to the people themselves" (PCPO 1994: 5). This promise has been essentially met with action. Since 1995, the Ontario government has cut taxes by about 15.5 percent, largely by reducing personal income tax rates from 58 percent to 49 percent of the basic federal tax rate.[17] In the 1997 budget, Finance Minister Ernie Eves announced that the Ontario government would cut personal income tax rates twice more over the next two years—down to 45 percent in January 1998 and then leveling off to 40.5 percent

14 OECD 1994c. For some Canadian estimates on the extent to which payroll taxes have reduced employment, see De Matteo and Shannon 1995.

15 Alternatively stated, more progressive tax systems have higher efficiency costs. See Triest 1993.

16 This approach to optimal finance is sometimes known as "Ramsey taxation." See Ramsey 1927.

17 CIBC Wood Gundy 1997. In 1995, the top marginal personal income tax rate in Ontario (inclusive of surtaxes) was 53.19 percent. In 1997, this tax rate has fallen to 51.78 percent. See Alberta 1996 and 1997b.

of the basic federal rate sometime in 1999 (Ontario, Ministry of Finance 1997a).

In addition to cutting personal income taxes, the Ontario government has announced reductions in the Employer Health Tax. Introduced in 1989, the Employer Health Tax is a payroll tax that was implemented when Ontario Health Insurance Plan premiums were eliminated in that same year (Dominion Bond Rating Service 1996: 5). In the 1996 budget, the Ontario government promised to eliminate the Employer Health Tax on the first $400,000 of payroll over a three year period. By 1999, approximately 88 percent of private-sector employers will no longer have to pay the tax (Ontario, Ministry of Finance 1997a). This is a welcome development, since it is well known that payroll taxes eliminate jobs.[18]

However, to compensate for this loss of revenue, the Ontario government has incorporated a "Fair Share Health Care Levy" into the existing surtax on the Ontario personal income tax. Originally implemented for the 1996 taxation year, the Fair Share Health Care Levy amounts to 20 percent of Ontario income tax in excess of $5,310, plus 16 percent of Ontario income tax payable in excess of $7,270 (Ontario, Ministry of Finance 1996a). When fully phased in, the Fair Share Health Levy amounts to 0.2 cents per dollar of income at $50,000 and rises to a maximum of 2.0 cents per dollar on income at $150,000, taking back up to 40 percent of tax savings. Taking the Fair Share Health Care Levy into consideration, an average wage earner making $35,000 will gain $875 a year from a 30.2 percent provincial income tax cut, while a wage earner making $150,000 a year will only receive a 19.7 percent tax cut (Ontario, Ministry of Finance 1996a; *Globe and Mail* 1997d).

Policy analysis

The overall thrust of Ontario's tax policy is sound. The net effect of the tax cuts implemented so far is to reduce the average tax burden faced by Ontarians. If a government takes less in taxes from each person (and therefore redistributes less to its favoured constituencies), marginal tax rates can also come down. Since higher marginal tax rates cause larger distortions than lower marginal tax rates, reductions in these rates will result in efficiency gains. Thus, redistributing wealth and decision-making authority away from government and back to markets and individuals is a good idea from the perspective of economic efficiency because it enables a reduction in distortionary tax rates.

However, while the average tax burden of Ontarians has fallen, marginal tax rates remain high, particularly when compared with neighbouring jurisdictions.[19] Provincial surtaxes on individuals within the highest tax bracket are still in place in spite of the fact that surtaxes impose large deadweight losses. Furthermore, although the Ontario government has reduced the payroll taxes supporting the health care system, the Workers Compensation Board (WCB) payroll tax remains in place. Given that the WCB is severely underfunded, it seems likely that the WCB payroll tax will have to increase significantly in the near future unless the Ontario government embarks on significant reforms of the WCB. Since payroll taxes are known to be job-destroyers, the effects of such an increase on employment are likely to be disastrous, particularly for lower-wage earners.

Hence, while the direction of Ontario's tax policy is sound, much more attention must be paid to details. Not only must the average tax burden fall, but marginal tax rates must also decline if efficiency gains are to be realized. Furthermore, payroll taxes must be reduced if the Ontario economy is to become an engine for job creation. In light of the analysis presented above, we recommend that the Ontario government adopt the following policy proposals:

- Continue to reduce the overall tax burden faced by Ontarians. Since all spending must eventually be paid for by taxes, this means that spending should be kept under control and the amount of redistribution limited.

18 According to Finance Minister Paul Martin, "There is nothing more ludicrous than a tax on hiring. But that's what payroll taxes are." Quoted in Kesselman 1996.

19 The top marginal income tax rate in Ontario in 1997 is 51.78 percent, compared with a top marginal rate of 50.4 percent in Manitoba and 46.07 percent in Alberta. These tax rates include provincial surtaxes. Furthermore, small corporation income tax rates are 9.5 percent in Ontario, compared to 9 percent in Manitoba, 8 percent in Saskatchewan, 6 percent in Alberta, and 3.22 percent in Quebec. See Manitoba, Ministry of Finance (1997).

- Reduce marginal income tax rates. The efficiency costs of taxation are due to marginal tax rates, not average tax rates. Hence, if there are to be efficiency gains from less government, distortionary taxes must be reduced. In particular, personal income tax surcharges should be eliminated.

- Reduce payroll taxes. As noted earlier, payroll taxes are "job-destroyers." If the objective of the Ontario government is to create an environment conducive to job creation, then payroll taxes must come down.

Conclusion

Still, the Ontario government deserves credit for moving in the right direction with respect to its tax policy. Until the *Common Sense Revolution* took hold in Ontario, it seemed unlikely that the inefficiencies induced by excessive redistribution (and excessive taxation) would ever be curbed. Now that the overall "tax bite" has been reduced, the Ontario government has the leeway to reduce or eliminate those taxes that cause economic misallocation. Only then can efficiency gains be realized. For taking the first step towards this goal, the Ontario government deserves a **B+** for its tax policy.

Social Policy

The growth of the welfare state

The growth of government is perhaps one of the most salient features of twentieth-century history (Nutter 1978; Peltzman 1980; Meltzer and Richard 1981; Higgs 1988). Initially concerned with enforcing contracts, maintaining law and order, and protecting persons and their property, the state slowly started to assume responsibilities that were formerly considered to be the domain of families and private charity. Today, state intervention in both the economic and non-economic affairs of private citizens is pervasive. The modern welfare state is now expected to provide welfare for the poor, unemployment assistance and job training for those who cannot find work, pensions and old age benefits for the elderly, education for the young, and universal health care for everyone. No person, from cradle to grave, is left unaffected by the extensive social assistance of the modern welfare state.

Much of this growth in state activity was no doubt motivated by a genuine desire to help the materially disadvantaged members of society. Indeed, if asked, most people would likely agree that, if anyone is deserving of government assistance, it is those who are unable to help themselves. The good intentions of those social policy reformers who encouraged the growth of the welfare state are not in question. It has become clear, however, that good intentions alone are insufficient for good policy. In spite of extensive intervention, many of the problems that the welfare state set out to solve remain with us; high levels of unemployment, for instance, are still a major public policy concern in most Western industrialized nations (OECD 1994b). And, where the welfare state seems to have solved the problems, it is clear that success has been achieved only at considerable expense (Lermer 1984). The most enduring legacy of the welfare state is not the "elimination of want," as Lord Beveridge thought, but rather the massive public debt accumulated over the past two generations in order to finance the expansion of an increasingly expensive social legacy.

The welfare state is an effort to change the world without completely understanding it. An understanding of the world requires an appreciation of the effect of incentives on human behaviour. Economics is predicated on the view that people respond to incentives. The failure to account adequately for the effect of incentives on human action is perhaps one of the greatest errors of public policy.

Consider, for instance, the effect of welfare payments on the choices of the poor between labour and leisure. As currently practiced, welfare benefits are reduced practically one-for-one against earned income. In other words, welfare recipients face an implicit marginal tax rate of 100 percent. Given such a high marginal tax rate, a welfare recipient has little incentive to enter the labour market in search for work (Richards and Watson 1994). Thus, the very structure of the welfare system discourages poor individuals from seeking the best form of welfare available—gainful employment.

Social policy in Ontario

Since taking office in the spring of 1995, the Ontario government has embarked on a very ambitious welfare reform program. Indeed, cutting the rewards of welfare by 21 percent was one of the Harris government's first legislative acts (Ontario, Cabinet Office Communications 1995). Effective October 1, 1995, the Ontario government cut $500 million from welfare spending in its first year by lowering welfare benefits to a level 10 percent above the average of the nine other provinces (Harris 1997). These savings were achieved by cutting benefits per person and by imposing stricter limitations on eligibility. At a first pass, this strategy appears to be working. Within one month of cutting benefits, the number of Ontarians dependent on welfare declined by 24,000 (Sabatini 1996). Two years later, as many as 185,000 Ontarians had been removed from the welfare rolls (*Globe and Mail* 1997g).

Another dimension of the Harris government's welfare-reform package is the introduction of workfare. Under the *Ontario Works* program, able-bodied individuals receiving social assistance will have to earn their welfare payments by participating in community placement or retraining programs that will lead to an immediate job. Community placements require participants to contribute an average of 17 hours per week to projects organized by municipal and local community groups. The Community and Social Services Ministry's promise to assist welfare recipients in gaining employment is substantiated by the program's attempt to match participant's skills and interests with available placements. To this end, the Ontario government even allows individuals on social assistance to propose their own work projects that benefit Ontario communities (Ontario, Ministry of Social Services 1996). As of May 1997, business plans for *Ontario Works* programs in 21 municipalities have been approved, involving about 18,000 welfare recipients. In recent months, even those municipalities that initially opposed workfare, such as Ottawa-Carleton and Metro Toronto have hastened to submit their business plans after the province's offer to cover their costs of introducing it (*Globe and Mail* 1997e: A3).

Policy analysis

The Ontario government deserves credit for cutting welfare benefits. For too long, the size of welfare has been growing unchecked. Between 1981 and 1993, the real value of welfare benefits available to single individuals in Ontario rose by 72 percent, while benefits available to families increased by 51 percent. Not surprisingly, general social assistance caseloads in Ontario climbed from 52.3 per 1000 to 120.6 per 1000 during the same time (Brown 1994). While the recession of the early 1990s was in part responsible for this increase, greater availability and generosity of welfare benefits also played a significant role (Brown 1994). Cutting the rewards of welfare should reverse this trend.

Trimming welfare caseloads should also address another problem associated with social assistance—"duration dependence." One unfortunate dynamic economic consequence of welfare is that the longer one stays on social insurance, the less likely one is to find gainful employment (OECD 1994a). This happens because human capital tends to deteriorate when not in use. Another dynamic concern is "intergenerational dependence." Evidence from the United States suggests that children raised in families that receive welfare are three times more likely to be on welfare when they become adults than children whose parents do not receive welfare (Hill and O'Neil 1990). If the purpose of welfare is to help individuals lift themselves and their children from poverty to self sufficiency, intergenerational dependence is a sure signal that the welfare system is failing in its most important task. By getting people off the welfare rolls and into the work force, the Harris government's reforms will curb the problem of intergenerational dependence.

The other major component of welfare reform in Ontario is workfare. Whether or not workfare is an effective way to move individuals permanently into the labour force remains to be seen. On the one hand, to the extent that workfare programs help welfare recipients maintain some association with the labour market, it prevents deterioration of their human capital and may indeed facilitate the transition from welfare to work. On the other hand, the empirical evidence from the United States suggests that government-sponsored welfare-to-work programs do not generally succeed in achieving their objectives (Bloom 1997; Mihlar and Smith 1997). For instance, the Federal-State JOBS Program in California with 60,000 participants and an annual budget of $120 million succeeded in cutting welfare rolls by only 7 percent. Florida's more modest Project Independence (FPI) cut welfare rolls by only 5 percent in the areas where it was tried (*The Economist* 1993). Whether Ontario's workfare experiment will succeed in moving individuals off welfare and back into the labour force remains an open question.[20]

20 In a recent Fraser Institute study it was found that welfare-benefit rates in Ontario were the highest in Canada (even after the recent cuts); Ontario ranks fourteenth in terms of generosity among all American states and Canadian provinces. It is sometimes argued that high welfare-benefit rates are responsible for the general failure of government-sponsored welfare-to-work programs; if welfare benefits are too high, recipients have no incentive to join a welfare-to-work initiative. If welfare benefit rates remain high in Ontario, this could also be a problem for the *Ontario Works* initiative. See Walker and Emes 1996: 5-17 for data comparing welfare benefit rates across North American jurisdictions.

Policy proposals

In light of the previous discussion, we recommend that the Ontario government implement the following policy proposals:

- Continue to trim welfare benefits. Although the rewards of welfare have been cut significantly, Ontario's welfare benefit levels are still 10 percent higher than the average of the other nine provinces. Indeed, by any absolute standard, they are still extremely generous. Once taxes and benefits are accounted for, people on social assistance are paid an implied wage of $9.21 per hour, or $2.36 in excess of the provincial minimum wage (Walker and Emes 1996). If individuals—in particular young and unskilled workers—are to be induced to return to the labour market, welfare benefits must not be in excess of what these individuals could earn if they were to accept employment in the labour market.

- Work by Chris Sarlo suggests that current measures of poverty—in particular, Statistics Canada's Low Income Cutoff (LICO)—are not indices of poverty but, rather, measures of inequality. Doubling the real income of all individuals in society would leave the number of poor people, as measured by the LICO, unchanged. Welfare should be targeted to those in need and not to those who merely have less than the Ontario average. We recommend that the Ontario government use the Sarlo poverty line as the basis for calculating welfare eligibility and benefit levels (Sarlo 1996).

- Replace the current welfare system with a Negative Income Tax (NIT). As noted earlier, the current welfare system implicitly taxes welfare recipients at a marginal tax rate of 100 percent because benefits are reduced almost one-for-one with each dollar of earned income. In order to eliminate this incentive problem, we recommend that the government replace the current welfare system with an NIT. First proposed by Milton Friedman, an NIT has many advantages over the present method of taxation (Friedman 1962). First, it reduces the implicit marginal tax rate faced by welfare recipients, increasing the incentive to find employment. In addition, it is easy to administer since it can be incorporated into the tax system. By encouraging individuals to join the work force, an NIT may help break the cycles of duration dependence and intergenerational dependence that seem to characterize the current welfare system.

Conclusion

Overall, the Harris government deserves credit for reversing the trend of ever-increasing welfare payments in Ontario. For making the first, bold effort to reform welfare in a generation, the Harris government deserves a **B** for its social policies.

Labour Policy

Unemployment and the productivity slowdown

If asked, most observers would likely agree that high and rising unemployment is the number one public-policy problem in Western, industrialized nations. Since the early 1970s, measured rates of unemployment have risen in most industrialized countries. During this period, most major industrial economies have also experienced slower rates of aggregate productivity growth (Romer 1996: ch. 1). While there are signs that productivity may be improving in at least some countries and in certain sectors,[21] unemployment remains a problem in nearly every Western jurisdiction with the notable exceptions of the United States of America, New Zealand, and the United Kingdom.

Undoubtedly there are many factors responsible for both the aggregate productivity slowdown and rising unemployment rates. Economists have devoted considerable effort trying to understand these phenomena (Romer 1987; Bailey and Gordon 1988; Griliches 1988; Grey 1987; Bruno 1984; Darby 1984). While no consensus has emerged, there is a growing body of evidence that suggests that structural factors are a major part of the story: labour market rigidities—institutional arrangements, laws, and conventions that prevent the labour market from clearing—may be partly to blame for both rising unemployment and stagnant productivity (Grubel 1988; Daly and MacCharles 1986; OECD 1994c).

Labour: supply and demand

At the heart of the structural explanation of unemployment is the standard supply-and-demand framework that is found in most introductory microeconomics courses (e.g. Gunderson and Riddell 1988). In this framework, labour demand is a decreasing function of the real wage. Optimal behaviour on the part of firms (which, of course, are the source of labour demand) requires that the value of the marginal product of labour equal the real wage. Since, for a given level of capital and other inputs, labour is subject to declining marginal product (i.e. diminishing returns), labour demand must vary negatively with the real wage. This is simply the law of demand applied to the labour market.

In contrast, labour supply is (at least to a point) an increasing function of the real wage. Other things being the same, a higher real wage raises the relative cost of leisure; as a result, workers will be induced to spend more time in the labour force (or perhaps, enter the labour force for the first time) and less time doing other things. This “substitution effect” of moving from leisure into work is simply a rational response on the part of optimizing workers to changing relative prices. Of course, this is not the end of the story. If real wages are sufficiently high, a rational worker might choose to enjoy both more leisure and a higher income. This “income effect” operates in the opposite direction of the “substitution effect” and works to reduce labour supply when the real wage rises (Gunderson and Riddell 1988).

If changes in the real wage induce both substitution and income effects, then why is it that we have argued that labour supply is indeed a positive function of the real wage? —because, for the vast majority of individuals who fall within the middle-income group, higher real wages do induce more labour supply. A “backward-bending” labour supply schedule (i.e. one in which the income effect dominates the substitution effect) is only likely to be the case for workers with very high incomes. In contrast, an upward sloping labour-supply curve

21 According to the McKinsey Global Institute, American productivity ranks first in the world and continues to grow rapidly. See *The Economist* 1996.

(one in which the substitution effect dominates the income effect) is true for most middle-income individuals and is particularly true for lower-income individuals, women, and minority groups (Heckman 1993). Hence, for aggregate purposes, it seems reasonable to assume that higher real wages raise labour supply.

The labour market is said to clear—or achieve equilibrium—at the real wage that equates labour demand and labour supply. Equilibrium in the labour market implies that all those workers who want to find work are able to do so at the given wage rate; it also implies that firms are able to hire all the workers they need at the wage rate. When the labour market is not in equilibrium, the real wage adjusts so as to equate demand and supply. As in all markets, prices—the wage rate in the current context—are the means through which the decentralized actions of individuals and firms are coordinated.

Structural causes of unemployment

Given this partial-equilibrium framework, it is possible to understand how structural rigidities may be responsible for rising unemployment rates. Minimum wage laws that artificially raise the real wage will induce firms to switch from relatively expensive labour to relatively cheap capital; such laws also increase labour supply by raising the price of leisure. Since the minimum wage is fixed by law, it cannot adjust to equate labour supply with labour demand. The result is an excess supply of workers and unemployment for those workers whose productivity is below the minimum wage (The literature on the effects of minimum wages on employment is enormous. For example, see Stigler 1946; Gramlich 1976; Rottemburg 1981; Linneman 1981; Neumark and Wascher 1992; Ernst and Young 1995).

Payroll taxes, employment equity laws, and laws that strengthen union power have a similar impact on the labour market. Payroll taxes and employment equity laws raise the relative price of labour as an input in the production process. (For the effects of payroll taxes on employment, see OECD 1994c; De Matteo and Shannon 1995; Parker 1995; for the effects of employment equity laws, see Block and Walker 1982). Laws that give unions an unfair advantage in the bargaining process will enable unions to bid wages to uncompetitive levels.[22] In an effort to minimize costs, firms will cut back on their labour demand and direct money into other, cheaper inputs. The result, of course, is a decreased demand for labour at any given real wage. Unemployment results.

There is a large body of empirical evidence that shows that labour-market rigidities of the sort outlined above have a detrimental impact on both employment and productivity growth. It is a well established fact that excessively high minimum wages are a cause of unemployment, particularly among young and unskilled workers (Stigler 1946; Gramlich 1976; Rottemburg 1981; Linneman 1981; Neumark and Wascher 1992; Ernst and Young 1995). For instance, economists Shannon and Beach found that the 1991 increase in Ontario's minimum wage reduced the number of jobs, and disproportionately hurt young and part-time workers in retail sales and hotel and food services (1995). In a recent survey article, labour economist Barry Hirsh reviews the empirical evidence on the effects of unionization on economic performance (1997). The general findings from this literature suggest that excessive union power erodes productivity and profits and reduces investment and employment growth. The literature on the effects of payroll taxes suggests a similar conclusion: payroll taxes "kill" jobs. Estimates using Canadian data suggest that payroll tax increases are a major cause of rising national unemployment rates.[23] Finally, employment equity laws do very little to reduce discrimination and introduce many job-destroying rigidities into the labour market (Block and Walker 1982). Indeed, the work of Nobel Laureate Gary Becker is most instructive in this regard: in a com-

22 Blanchflower and Freeman 1992. BlanchFlower and Freeman estimate that in the United States and Canada, compensation for unionized workers was between 18 to 20 percent higher than that for nonunionized workers, even after controlling for skilled workers. More findings to this effect are reported in OECD 1994d.

23 De Matteo and Shannon (1995) estimate that a 1 percent increase in payroll taxes raises real wage costs to employers by 0.56 percent and reduces employment by 0.32 percent. Parker (1995) estimates that increases in payroll taxes from 1991 to 1994 may have reduced employment by 1 percent.

petitive market, "arbitrary discrimination"[24] on the part of employers is unlikely to persist since it is costly for firms to practice such discrimination. In other words, the forces of the market work to penalize those employers who discriminate arbitrarily.[25] Employment equity laws may not only be harmful; they may also be unnecessary.

Hence, the overall lesson for labour policy to be drawn here is as follows. The optimal labour market policy—that most likely to be consistent with low unemployment and rising productivity growth—is that which introduces the fewest rigidities into the labour market. International comparisons are instructive in this regard. The United States of America, with the most flexible labour market of all major industrial economies, has among the lowest unemployment rates and highest productivity growth rates in the world.[26] In contrast, the European Union, which has one of the most highly regulated and rigid labour markets, stagnates with double digit unemployment rates and very sluggish rates of productivity growth.[27] While a flexible labour market policy alone may be insufficient to explain the gap between American and European unemployment rates, it is clear that a flexible labour market policy is a necessary condition for sustained job growth and productivity improvements.

Labour policy in Ontario

Since taking office in the spring of 1995, the Harris government has pursued a number of labour market reforms that will increase the flexibility of the Ontario labour market; these changes will, in turn, reduce the structural unemployment problem that is so pervasive among Western economies. Some of the major labour market reforms introduced by the Harris government are as follows:

- Repeal of the 1993 Employment Equity Act (*Globe and Mail* 1997h: A4B). As noted earlier, employment equity laws are not an effective means of reducing discrimination in the workplace. The natural forces of competition are the best way to induce employers to stop discriminating along arbitrary lines (Sowell 1981; Chiswick 1995). Imposition of legislated guidelines on the hiring decisions of employers can only serve to raise the costs of hiring and cause economic misallocation. Furthermore, such laws violate the fundamental freedom of employers to make their own decisions regarding the operation of their enterprises (Epstein 1992).

- Freeze of the minimum wage (Ontario, Ministry of Labour 1995). At $6.85 per hour, Ontario has one of the highest minimum wages in North America. The Harris government's decision to freeze the minimum wage indefinitely must be applauded since it is well known that minimum wage laws reduce employment growth and are detrimental to the job prospects of the most vulnerable members of the labour force.

- Curbing the excessive influence of unions. Through Bill 7, the Ontario government has amended the Labour Relations Act so that employers can now hire replacement workers in the event of a strike (Ontario, Ministry of Labour 1995). This is undoubtedly a positive development as it will give firms greater flexibility to continue operations in the event of a work stoppage. Since the Ontario economy operates within a global environment, work stoppages and other supply bottlenecks reduce the competitiveness of firms operating in Ontario. Furthermore, the amendments to the Labour Relations Act requiring a secret ballot for votes on strikes, ratification, certification, and decertification will reduce the coercive influence of union leaders over their constituents (Ontario, Ministry of Labour 1995). If unions are to be truly democratic institutions, union members must be free to express their preferences with-

24 Discrimination not based on differences in productivity (i.e. non-economic discrimination)

25 Becker 1957; for a very readable summary of Becker's work on discrimination, see Chiswick 1995

26 According to a study by the McKinsey Global Institute (1993), America's labour productivity exceeds Germany and Japan's in several industries.

27 OECD 1994c. Economist Charles Hanson captures the European experience quite succinctly: "What can we learn from the EU? That unduly high wages and work benefits coupled with an excess of regulation can severely damage the labour market and create mass unemployment." Hanson 1996: 16.

out being subject to undue influence from union bosses. The Ontario government deserves credit for taking measures to protect the right of unionized workers to express their interests in a less coercive environment.

Policy analysis

Both theory and evidence suggest that economies with less rigid labour markets produce more jobs and experience greater productivity gains than economies with more rigid labour markets. The Ontario government must be applauded for taking steps to reduce job-destroying labour-market rigidities. However, it still has a long way to go. Towards this end, we recommend that the Ontario government adopt the following proposals:

- Eliminate the minimum wage. Since it is a well established fact that minimum wages do more harm than good, why have one in the first place? If the labour market is to clear, there should be no impediments to the natural adjustment of real wages to changing conditions of demand and supply. If the young, less productive, and most vulnerable members of the labour force are to improve their lot, they must be able to find employment. We do no justice to these individuals by outpricing them in an already competitive labour market.

- Repeal the Labour Relations Act and pass Right-to-Work (RTW) legislation. If the Ontario government is truly to liberate the labour market from the shackles of excessive regulation, it must eliminate the monopoly power over labour supply that unions currently have in certain industries. Under a RTW law, all unions are forced to become voluntary organizations because such legislation allows employees to negotiate contracts with employers or seek other representation on an individual basis. This would introduce greater flexibility into the workplace and would force unions to become more responsive to the interests of their members. Furthermore, there is a large body of evidence which shows that jurisdictions with RTW laws experience faster economic growth and lower unemployment rates precisely because RTW laws increase the flexibility of the workplace (Mihlar 1997). If Ontario is to remain competitive on the world stage, it should implement a RTW law.

- Reform the Workers Compensation Board of Ontario (WCB). With unfunded liabilities totaling $10.9 billion, the WCB of Ontario is in serious financial trouble and is the most severely underfunded WCB in Canada (Business Council of British Columbia 1996). Efforts must be made to put the WCB of Ontario on a more secure financial basis. Furthermore, significant reforms must be introduced in order to improve the efficiency of the WCB. In particular, premiums (which are a tax on labour, and hence, on jobs) must be reduced, benefit levels must be cut, and provisions aiding workers to return to work must be strengthened. At the moment, the Ontario government is studying reform options for the WCB. Definitive action is required here.

Conclusion

Although much more work needs to be done, we must acknowledge that the Ontario government is heading in the right direction with respect to its labour-market policies.[28] The reforms implemented by the Ontario government to date will definitely help alleviate the structurally induced unemployment problem in Ontario. However, if these gains are to be maximized, the Ontario government must adopt the proposals outlined above. We award the Ontario government a **B+** for its labour-market policies.

28 The recent decision by the Ontario government not to impose a temporary ban on the right of public-sector employees to strike is commendable. The freedom to strike is an integral part of the right to collective bargaining. It is important, however, to note that the recent changes to the labour code allowing employers to hire replacement workers in the event of a strike or lock-out do not apply to the public sector. Given that the public sector has a monopoly over many of the services it supplies, the government should have the ability to hire replacement workers so that public services supplied to taxpayers will not be disrupted. Hence, we suggest that the option to have replacement workers be extended to public-sector employers as well.

Health Policy

Economics and health care

Economics is the science of how individuals make choices in the presence of scarce resources and unlimited wants. Choices about health care—how it should be delivered and financed—are necessarily economic choices since health care involves the use of resources that carry a positive opportunity cost. Unfortunately, in the Canadian context, economic principles—principles that, if applied, would improve the efficiency and effectiveness of our health-care system—have been ignored in the debate over health care. Instead, the focus of the debate has been ideologically driven, and issues relating to cost and efficiency have been little considered.

Markets versus government

Most economists would argue that, under certain conditions, the market is the "best" mechanism by which society can allocate resources (Gwartney and Stroup 1993). Markets produce a system of relative prices, and the price-system is an extremely efficient way of coordinating the actions of decentralized economic agents (Hayek 1945). Certainly the market does not always give us the first-best outcome from the perspective of economic efficiency. Sometimes, prices do not always completely convey costs and benefits.[29] On other occasions, uncertainty and incomplete information can cause inefficiencies.[30] The fact that markets are imperfect, however, does not constitute a sufficient argument for command and control methods of allocation. That the market does not always guarantee a first-best outcome does not mean that the government can.[31]

The provision and financing of health care in Canada is skewed away from markets and towards government command and control. If the extent to which the market guides the allocation of resources can be approximated by the presence of prices, it is clear that the determination of how resources are allocated in the Canadian health-care sector is largely in the hands of government, as there are very few prices charged for health care services. Under the Canada Health Act, health care in Canada is a single-payer, fee-per-service system. Since the single payer is the state, consumers are not charged for their consumption of most health care services. Suppliers of medical services—physicians, physiotherapists, optometrists, and so on—bill the government for each service rendered at a rate fixed by the government. Hence, market prices do not emerge as a mechanism for resource allocation.

Since consumers in Canada are not, in general, charged a price for their consumption of medical care, there is no incentive on the part of individuals to curtail their use of medical goods. However, since health-care budgets are finite and set by governments, it is obviously impossible to satisfy this demand for health care. As a result, governments have been forced gradually to de-list many medical procedures and long queues have emerged for many elective procedures.[32] Rationing by waiting

29 When prices do not fully convey costs and benefits, we say that there exists an "externality." This constitutes a "market failure." For a classic presentation of this argument, see Bator 1958.

30 Optimality also requires complete information on the part of all economic agents. Incomplete information is also a source of market failure (Bator 1958).

31 The inability of governments to correct market failures, or for that matter, to behave in a manner consistent with overall economic efficiency is known as "government failure." For a discussion of the problems of government failure, see Wolf 1993; Mitchell and Simmons 1994.

32 Ramsay and Walker 1997. Ramsay and Walker estimate that the average time that patients in Ontario waited for an appointment with a specialist (after having seen a GP) was 4.7 weeks in 1996. The average time waited for treatment after an appointment with a specialist was 5.6 weeks.

is now the unofficial, de facto allocative instrument in the Canadian system of universal health care.

Demand curves slope downwards

The emergence of waiting lists should not come as a surprise to anyone familiar with economic theory. A fundamental principle of economics is the "law of demand," which tells us that, all other things held constant, the quantity demanded of a particular good rises as the price of that good falls. This well established fact applies with equal force to the market for health care: as the relative price of health care falls, people consume more of it. Hence, if the price of health care is extremely small, we would expect the demand for health care to be extremely large.

That the "law of demand" should apply to health care is not only intuitively obvious; it also receives a great deal of empirical support. Perhaps the most decisive empirical test of this proposition was provided by the RAND Corporation in its famous Health Insurance Experiment (HIE) (Newhouse and the Health Insurance Group 1994). Researchers at RAND observed the behaviour of families who received varying degrees of health insurance over several years. Some families received complete insurance for routine medical expenses; these families paid essentially a zero price for health care. Other families received partial coverage for their health care expenses; these co-insured households paid a positive price for their health care expenses. What researchers at RAND found was that families that received more health insurance consumed more health care. In other words, as the price for routine medical expenses rises, people consume less health care. Moving households from full insurance to co-insurance has the effect of reducing consumption of health care services. In other words, the demand curve for health care slopes downwards.

That this should be the case is not, in itself, surprising. Incentives matter and it is not clear why the incentives that apply to every other market should not apply to health care. The more interesting finding of the RAND Health Insurance Experiment was that, with a few exceptions, individuals' consumption of routine medical expenses was unrelated to their health (Newhouse et al. 1994). In other words, individuals who were charged positive prices for health care did not experience significantly worse health than individuals who received "free" health care. Positive prices for routine medical expenses do not induce most individuals to "under-consume" health care services.[33] Charging prices for medical services is therefore not inconsistent with good health for the population at large.

Lessons for Canada

The RAND experiment and other health care studies from abroad suggest the following broad lessons for health care policy makers in Canada:

- Co-insurance for routine medical services is a viable way to improve the efficiency of health care demand without adverse effects on health (Newhouse et al. 1994).

- Competition among suppliers of health care tends to reduce costs and raise production efficiencies. In other words, government monopoly in health-care supply is likely to be inefficient; and competition between government suppliers of health care and private suppliers is likely to improve standards of care and reduce costs (Ramsay, McArthur, and Walker 1996). This lesson is true for virtually every other market; why should it not apply with equal force to health care? Indeed, liberalizing the supply of medical services would not only improve allocative efficiency but, over time, it would also enable the health-care sector to become an engine of economic growth.

Health policy in Ontario

Ontario's health care policy is not so much a health care policy as a "cost control" policy. In the 1996 budget, the Ontario government froze health care spending at $17.4 billion for 5 years, promising to improve the efficiency of each dollar spent on

33 Newhouse et al. 1994. The only groups that suffered adverse health as a result of co-insurance were the very poor, the mentally disabled, and the chronically ill. Combined, these groups make up a very small percentage of the total population. Clearly, co-insurance is a viable option for the vast majority of individuals.

health care by reducing overlap and duplication.[34] Under Bill 26, the Savings and Restructuring Act, the Ontario government set up a Health Services Restructuring Commission that has broad powers to restructure hospitals and root out inefficiencies in the health care system. Towards this end, the Commission has proposed the closure or merger of several hospitals and has redirected funds within the health budget towards community care, dialysis, breast cancer screening and other procedures.[35] It is hoped that these changes will enable the government of Ontario to provide better health care for less.

The Ontario government deserves some credit for pursuing this strategy. Clearly, there are inefficiencies within the health care system that can be eliminated by such restructuring. For instance, it has been estimated that as much as one-third of hospital capacity in Ontario is unused. Over the past decade, nearly 9,000 hospital beds were eliminated in Ontario but not a single hospital was shut down (Ontario, Ministry of Health 1995). Indeed, within Metro Toronto alone, there are 40 percent fewer acute-care beds today than 10 years ago but no fewer hospitals (*Globe and Mail* 1997c). By closing down and merging several hospitals, the Health Services Restructuring Commission is acting in the best interests of Ontario taxpayers. It makes no sense for the taxpayer to continue funding bricks and mortar that have no measurable impact on the health of the population.

Fundamental change is wanting

Unfortunately, cutting costs by reducing overlap and duplication is only window dressing and does little to solve the underlying problems inherent in our present medical system. Closing down a hospital and redirecting funds from less utilized services to more utilized services may result in some short-term savings. However, in the long run, it does not address the fundamental problem with the Canadian system of universal health care: the absence of prices and competition.

If prices are not allowed to signal how resources are to be allocated in the health care sector, then government fiat becomes the allocative instrument. Unfortunately, government fiat is an extremely inefficient way to determine the allocation of resources because government lacks the information necessary for "rational economic calculation" (Hayek 1945) and is subject to political forces that undermine its best efforts to spend wisely.[36] Because of demographic factors[37] and the absence of proper incentives, the natural tendency is for health costs to rise dramatically. In their efforts to contain these costs, governments will seek to impose further controls on the health care sector. Viewed from this perspective, the Hospital Services Restructuring Commission and the various proposals being floated in Ontario to control where new physicians can practice (*Globe and Mail* 1996a) are more a symptom of than a cure for the health care dilemma.

Policy proposals

It is only by liberating the health care market that the Ontario government will be able to achieve its real objective of improving the quality of health care at a reasonable price. Given the current situation, controls are necessary, but there is nothing inevitable or inescapable about the status quo. If the government of Ontario truly wishes to improve health care, it should allow prices to play a larger role in the allocation of health care resources. Furthermore, it should permit greater competition among health-care providers. The evidence suggests that the presence of prices and competition in the health-care sector will inject a much needed dosage of economic rationality into the allocative process without compromising standards of care or the health of the population. Indeed, the experience of the United Kingdom and New Zealand with respect to health-care reform is most instruc-

34 Ontario, Ministry of Finance 1996b. Note that the government of Ontario raised spending on health care in the 1997 budget to $17.8 billion.

35 Ontario, Ministry of Health 1995. The Ontario government plans to close down 24 hospitals in total (*Maclean's* 1997b).

36 This is the problem of "government failure." See Wolf 1993 and Mitchell and Simmons 1994.

37 As is well known, Canada's population is aging. Since consumption of health care generally rises with age, an increase in the average of the population will likely result in higher total health costs.

tive in this regard (Ramsey, McArthur and Walker 1996). Until quite recently, both countries had health-care systems very similar to Canada's.[38] Faced with escalating costs, long waiting lists, and declining service quality, both the United Kingdom and New Zealand liberalized their health-care sectors by allowing private market forces to play a greater role. Today, government and the private sector compete to provide health-care services in both countries.[39] Health-care budgets have become more manageable, service quality and choice have improved, and waiting lists have been shortened. Thus, there is empirical evidence that greater competition can only benefit the health care sector.

In light of the evidence presented above, we suggest that the Ontario government adopt the following policy proposals:

- Ignore the Canada Health Act. As a result of the Canada Health Act, the federal government is able to punish financially provinces that deviate from the federal vision of health care as a single-payer system controlled and operated by government. Ontario need not worry too much about such sanctions because (1) Ontario receives less per resident than most other provinces (with the exception of Alberta) in federal transfers for health care (Ontario, Ministry of Finance 1997a), and (2) the trend towards greater decentralization will result in greater reductions in federal spending (particularly for the wealthier provinces) on health care.[40] If the federal government is no longer paying for health care, why should it be able to determine how the health-care system should be run? Unthinking obedience to the principles of the Canada Health Act may be politically expedient in the short run but, in the long run, it compromises the best interests of Ontarians.

- Set up a system of Medical Premium Accounts (MPA).[41] The results from the RAND Corporation's Health Insurance Experiment suggest that co-insurance for basic medical procedures is the best way to improve the efficiency of health-care demand without compromising health. One way to implement a system of co-insurance is for the government to allot all funds for health care to the consumer directly through an MPA. Under such a system, each individual has an MPA that is divided into two parts. One part is used to fund a catastrophic insurance plan, the other is used to pay for routine medical expenses (i.e. trips to the general practitioner, chiropractor, pharmaceutical expenses, etc.) for which consumers will be charged prices. Under such a system, competitive forces can play a role in providing health care. Consumers will have the option to use the MPA wherever they like, improving service quality and efficiency since the presence of competition and prices will make the costs of health care more apparent to both producers and consumers. Finally, the provision of government-funded catastrophic insurance will ensure that no one is bankrupted by major illnesses.

Conclusion

The *ideology* of health care in Canada is this. Government can and must provide health care at a zero price to consumers. If market forces are allowed to determine the allocation of health-care resources in Canada, the poor and defenceless will be outpriced and will not be able to afford high quality health care. As a result, the health of many Canadians would be compromised.

The *reality* of health care is as follows. The individual's consumption of health care is sensitive to price; higher prices discourage demand. However, the empirical evidence does not suggest that lower demand will cause health to deteriorate. Most individuals do not "under-consume" health care when charged a price for it. Hence, the emergence of prices and market forces need not be inconsistent with good health for the public at large.

38 Indeed, it is worth noting that Canada's system of universal health care was fashioned after the UK's National Health Service.

39 In fact, according to Tim Evans of the Independent Healthcare Association in the United Kingdom, roughly 17 percent of the British population has some kind of private medical or health insurance. See Pollard and Evans 1996.

40 See Boessenkool 1996. Boessenkool estimates that by fiscal year 2002/03, Ontario will receive $43 *less* per capita below the equal transfers per-capita benchmark for a total cash *loss* of over $500 million.

41 For more details on how MPAs work, see Goodman. and Musgrave 1992.

If prices are not charged, rationing and government control become the allocative instrument. The evidence from around the world suggests that government control is not an efficient way to determine the allocation of real economic resources In the end, government control is self defeating—it begets more controls that, in turn, reduce efficiency and result in an even greater need for controls. "Restructuring commissions" with wide sweeping powers should be viewed as a symptom of rather than a cure for this deeper problem.

The Ontario government deserves some credit for trying to improve the efficiency of tax dollars devoted to health care. However, its overall approach to health care is misguided. For failing to address the real problems that plague the Canadian system of universal health care, the Harris government deserves a **C** for its health care policy.

Education Policy

Economics of education

Most economists would agree that government has a role to play in the market for education. Education—in particular, primary and secondary schooling—is an activity in which social benefits are likely to exceed private benefits. Certainly each of us benefits privately from being more educated; higher levels of education may improve one's skills and enable one to earn a higher income and enjoy a higher standard of living. A convincing case can be made, however, that society as a whole also benefits when each individual has a basic level of education. A more literate society may be a more law-abiding and civil society. We are all better off when our neighbours are "better citizens." Hence, because education confers benefits that accrue not only to the person being educated but also to society at large, society has an interest in ensuring that each person receives at least a basic level of education.[42]

Another way of stating this proposition is as follows: the social rates of return on basic schooling exceed the private rates of return (Easton 1988). In a free market, economic actors will undertake an activity until private marginal benefits equal private marginal costs. Efficiency, however, requires that social marginal benefits and social marginal costs be equated. Since the social benefits of basic schooling exceed the private benefits, a free market in basic education may result in too little schooling taking place (i.e. an under-investment in education). The existence of such "external benefits" may provide a (partial) rationale for government intervention in the market for basic education.[43]

The role of government in education

That government may have a role to play in the market for education, however, does not establish precisely what that role should be. In theory, there are many ways governments can intervene in the education market.[44] It can simply *finance* education, giving money or vouchers to parents with children and allow parents to choose among private-sector suppliers. Or, it can *finance* and *provide* education through a system of schools owned and operated by the government. Or, it can allow some mix of private and public provision and financing. In Ontario, the second approach to primary and secondary schooling has dominated educational policy. The Ontario government finances and provides schooling for the majority of students in Ontario. In other words, the public sector has a virtual monopoly in the provision of basic schooling.[45]

Unfortunately, this approach to schooling has proven to be both costly and ineffective. Ontario taxpayers pay more per student than the average of the 9 other provinces—$644 more per student—and, although the ratio of students to teacher are lower in Ontario than in any other Canadian province (Ontario, Office of the Premier 1996a), this ad-

42 This is not likely to be the case for higher levels of education as the returns to a university education are almost entirely captured as higher future income by the person being educated. Hence, the rationale for government intervention in the market for higher education is much weaker. See Constantos and West 1991.

43 In the jargon of economists, basic levels of education generate positive "externalities." The presence of externalities constitutes a "market failure" and this has traditionally been used as a justification for government intervention. See Baumol 1965 and Bator 1958.

44 See Easton 1988 for an overview of the Canadian experience.

45 This is not, of course, strictly the case. There are private schools in Ontario, most of which charge tuition. Further, school taxes can be directed towards the Catholic public schools as well as the secular public schools. The public sector, however, has a near monopoly over schooling since public-sector schools do not charge tuition and have greater access to government funds than do private institutions. Parents who send their children to private schools must pay tuition *in addition* to school property taxes.

ditional spending has not been reflected in the education received by students. For instance, test results from the Third International Math and Science Study show that Ontario students are below the Canadian average in math and science skills (*Maclean's* 1997a). Clearly, Ontario's education dollars are not being well spent.

The failure of schooling financed and operated by the state is not unique to Ontario. State-controlled education dominates educational policies in most Canadian provinces and the results are usually the same: government-run schools are expensive and do not serve the interests of students and parents well. There is widespread dissatisfaction across Canada with the public-school system and provincial governments across the country are under pressure to change the *status quo*.

Monopoly: the cause of failure

The failure of the public-school system has its roots in its monopolistic position (Gardner 1996; Raham 1996). The monopoly enjoyed by the public-school system in Ontario makes it unresponsive to change. When educational policy is standardized by public-sector officials in Toronto, a one-size-fits-all approach to schooling tends to emerge since this approach is easier to administer from a bureaucratic perspective. Clearly, however, no single approach to education will be appropriate for all students, given the diversity in talents and endowments present in the population at large. The result, unfortunately, is that few students will receive the type of schooling they need and deserve. A one-size-fits-all approach to schooling stifles the experimentation and diversity that would make schooling more responsive to the needs of individual students. Choice and competition are compromised for the sake of bureaucratic ease.

Furthermore, when government has a monopoly over the provision of schools, the school system ceases to be accountable to its customers, the parents and students. In the absence of choice and competition, educational policy can be set without the approval of parents. Whole programs and pedagogies can appear or disappear at the whim of administrators without the consent of parents.[46] In addition, since there are no published statistics on how well students are taught in different schools, parents have no way of knowing which schools are better and which are worse, with the result that supply becomes detached from demand: the suppliers of education produce a product and the demanders of that product must buy whether they like it or not.

Ontario's education policy

Since taking office in 1995, the Ontario government's education policy has been a "cost control" policy. As noted earlier, Ontario spends more per student for primary and secondary schooling than most Canadian provinces with no appreciable improvement in the education of its students. During the decade from 1985 to 1995, school enrollment rose by 16 percent but the real value of school property taxes increased by over 80 percent (Harris 1997). While part of this increase can be accounted for by lower student-to teacher ratios, much of it is due to a large and inefficient educational bureaucracy of school board trustees, administrators, and so on.

In an effort to contain these costs, the Ontario government is taking aim at the educational bureaucracy. In particular, it is cutting the number of school boards from 166 to 66, capping school trustee salaries at $5,000, reducing the total number of school trustees by two-thirds, and pursuing a number of other measures to root out overlap, duplication, and other inefficiencies (Ontario, Ministry of Municipal Affairs and Housing 1997a). These are positive initiatives as they will ensure that more education dollars go to classrooms as opposed to bureaucrats and administrators. Furthermore, responsibility for funding the school system will be transferred from municipalities to the provincial government. This will curb the upward spiral in school property taxes.

The Harris government has also implemented a number of reforms that will improve the accountability of the school system. Every school will be required to have an advisory school council. Annual reports will be published by the Ministry of

46 Consider, for instance, British Columbia's experiment with "child-centered" learning.

Education, which will enable parents to monitor the performance of local school boards (Ontario, Ministry of Municipal Affairs and Housing 1997a). In addition, the Ontario government will be the first in Canada to introduce comprehensive testing of students (PCPO 1996). The move towards comprehensive testing is a welcome development since it will facilitate monitoring of basic educational standards.

Policy analysis

Cost control is necessary but, in itself, will not solve the problems inherent in the school system. If the Ontario government is truly interested in improving the quality and efficiency of the Ontario school system, it must liberate the market for education and end the virtual monopoly enjoyed by public schools. It is only through choice and competition that the diverse needs of different students can be met. And the only way to introduce competition and choice into the educational system is to enable other types of schools to enter into the educational market.

The "way ahead" is to end the monopoly of the public-school system. The state should stop providing universal primary and secondary schooling and restrict its role to that of a financier, letting parents, community groups, churches, teachers—in short, the private sector—provide the education. The state should certainly provide some minimum curriculum standards, and testing should be used where possible to ensure that these standards are met, particularly in core subjects such as math, science, and language instruction. Furthermore, performance statistics should be made readily available to parents so as to enhance accountability and, in doing so, enable parents to make informed choices as to which schools are best for their children. However, within this broad framework, there should be no limit as to what sort of schools could emerge. Competition and choice will act to ensure that the diverse needs and interests of individuals are better served.

A voucher system is perhaps the best way to liberate the market for schooling.[47] Under a voucher system, the government finances education by giving all parents a voucher for the education of their children. Parents are free to take this voucher to the educational institution of their choice. The provision of education is then left to the private sector, which will offer schooling in exchange for vouchers (which the school can then redeem for cash from the provincial government). Schools are free to charge fees greater or less than the voucher value. Parents must make up the difference if total fees exceed the value of the voucher. Competition for students among private suppliers of education—associations of like-minded teachers and parents, churches, community groups—will ensure that a wide variety of educational products is available. This will improve the match between supply and demand.

Charter schools provide another way to liberate the market for schooling (Raham 1996; Freedman 1996). Interested groups can apply for a government charter to establish their own schools. Such chartered schools receive from the province a subsidy per student roughly equal to that paid to public schools. Parents are free to send their children either to public schools or to charter schools. Since private-sector groups run these charter schools, a wider range of school types will emerge, and a degree of choice and competition is introduced into the market for education as the charter schools will have to innovate in order to attract students.

Evidence from around the world suggests that choice among schools—either through school vouchers or charter schools—is the most effective way to improve educational outcomes and reduce costs. Charter schools compete with public schools in both New Zealand and the United Kingdom. Test scores suggest that students in charter schools perform better in standardized exams than their cohorts in public schools. Furthermore, charter schools can often revitalize schooling in poor regions; charter schools in several American inner cities have much lower drop-out rates and boast higher academic achievement records than public inner city schools (Raham 1996: 13–14). Finally, the data also suggest that school choice reduces educational costs; data from various jurisdictions suggest that charter schools are more efficiently run than

47 The voucher system was first proposed by Friedman (1962). In the United States, vouchers are sometimes called "educational opportunity scholarships." For details on American experiments with school vouchers, see Hanks 1997.

public schools (Raham 1996; Freedman 1996). Clearly, the way to revitalize schooling is to end the public-school monopoly and give parents the right to choose where their children go to school.

Policy proposals

Given the benefits of choice in schools, we recommend that the Ontario government adopt the following policy proposals.

- Redirect all spending on education directly to parents through a system of vouchers as the best way to liberate the supply of education while at the same time ensuring that all students have access to education. Competition and choice among schools will raise educational achievements, improve student and parent satisfaction with the school system, and allow innovation and diversity to flourish.

- Alternatively, the Ontario government can pass charter-school legislation allowing interested groups to set up their own schools and receive funding from the government per student at levels equal to that received by public schools. The introduction of charter schools will stimulate innovation and diversity within the school system since charter schools must compete with public schools for students. Charter schools, however, do not offer the same flexibility as vouchers since, with a voucher system, schools can charge fees in excess of the value of the voucher. This allows for greater product diversity since not all types of programs will cost the same. In contrast, charter schools are not allowed to charge fees and hence, may be more restricted in terms of their ability to develop new programs. Still, the introduction of charter schools would be a vast improvement over the *status quo*, as it would enable parents a greater degree of choice than the current system.

- In order to maximize the benefits of either a voucher system or a charter school system, the closed-shop union privileges of the Ontario Teachers Federation (OTF) must be eliminated. All teachers in possession of a teaching certificate from an accredited institution should be eligible to teach; membership in the OTF must not be a barrier to entry into the teaching profession. Furthermore, the monopoly power of the OTF over the supply of teachers must be curbed in order to allow more flexible hiring and promotion—under the OTF, teachers are rewarded on the basis of seniority, not teaching performance. Allowing schools to experiment with different methods of determining salaries—for instance, performance-based pay—will introduce greater flexibility and efficiency into the system by improving the incentives faced by teachers.

Conclusion

The Ontario government deserves credit for trying to improve the effectiveness of tax dollars spent on education. School choice—either through a voucher system or the introduction of charter schools—is the next step. There is still much to be done. Nonetheless, for having the courage to take on the educational bureaucracy, reduce spiraling costs, and improve the accountability of the public school system, the Ontario government deserves a **C** for its educational policies.

Regulatory Policy

Regulation: hurting living standards?

Governments around the world, including Ontario's, are being forced by large budget deficits and debts to be more fiscally responsible. This might lead one to believe that politicians are on a short leash. They are not. Governments have two ways to spend: they can extract money through taxation and spend it directly, or they can order individuals and firms to spend their resources in order to achieve the government's goals. This latter route is called regulation. It is one of the most important challenges to Ontario's competitiveness.

Technological change and productivity growth have been major contributors to improvements in worldwide standards of living (Solow 1957; Jorgenson, Gollup and Fraumeni 1987; Mokyr 1990; Lipsey 1996). Productivity refers to the efficiency with which an industry combines capital, labour, and other factors to produce a given level of output. Canada, and Ontario in particular, experienced a substantial slowdown in productivity growth beginning in the 1970s (OECD 1994a), and this, in turn, has led to slower real income growth and sizable losses to the economy. Empirical studies suggest that as much as 25 percent of the productivity slowdown can be attributed to government regulation (Littman. and Nordhaus 1982; Grey 1987; Hazilla and Kopp 1990). Thus, regulation may have cost the Ontario economy billions of dollars in lost output.

A major source of improvement in labour productivity is new investment, which expands the amount of capital available to each worker. Reductions in new investment slow the growth rate of labour productivity and total factor productivity. How does this process work? Regulation reduces new investment for a number of reasons. Uncertainty about the future requirements of regulation (leading to uncertainty about future profits) reduces a firm's willingness to invest in new plant and equipment. Firms may postpone new investment until the uncertainty is removed. The need to invest in pollution abatement techniques or more safety equipment may also reduce investment in new productive machinery if the firm has limited resources. Regulation may also hinder new product development if firms are not sure what regulatory constraints the new product will face (Kazman 1990). Since technical change, innovation, and capital formation are central to the growth process, the long-run effect of regulation is to slow the rate at which economic welfare improves. Quite simply, by raising the cost of doing business, regulatory burdens introduce inefficiencies into the production process, reduce productivity and investment, and impede job creation.

The cost of regulation

In 1993/94 alone, the whole array of federal, provincial, and local regulation cost Canadians $85 billion (12 percent of GDP) in compliance costs, according to a recent Fraser Institute study. These regulatory compliance costs impose a burden of nearly $12,000 per family of four. In Ontario, government regulation has been a growth industry. Between 1977 and 1994, the government passed about 850 new regulations annually. To manage this run-away regulatory train, the province's regulatory design and enforcement expenditures rose by 164 percent in real terms between 1973/74 and 1993/94.[48]

Government regulations are ostensibly intended to protect the public. Supporters of more regulation argue that its purpose is to shield people from harmful air and water pollution, and to prevent injury from defective and dangerous products, unsafe workplaces, and other hazards. While these goals are laudable, policy makers often fail to ask whether regulation is the most cost-effective way of achieving a particular goal, or whether it will have costly and unintended side effects (Stanbury 1996). Past

48 For a detailed discussion on the costs of regulation in Canada, see Mihlar 1996.

experience suggests that policy makers overlook or ignore alternatives ways to achieve the results they seek, including market solutions that may cause fewer job-losses, impose fewer distortions, and serve taxpayers and consumers better. Indeed, there are many instances in which government intervention has impaired economic efficiency and resulted in even more inequitable outcomes than was created by the original "market failure" (Mitchell and Simmons 1994). The empirical evidence also suggests that in many instances the costs of regulation far outweigh the benefits (Hahn and Hird 1991).

Ontario's response

The Ontario Progressive Conservatives, in their election platform, promised to cut government-created barriers to economic growth, investment, and job creation. To this end, they stated that they would set up a commission to review current regulations affecting firms and to eliminate onerous regulations within 12 months of taking office (PCPO 1994).

To its credit, the Harris government set up a Red Tape Review Commission headed by Frank Sheehan, MPP. Its mandate was to review existing regulations as they relate to businesses, to make recommendations to the Cabinet on ways and means to eliminate any unnecessary regulations, and to design a regulatory impact assessment test and a review process for any new proposed regulatory undertakings (Carr-Gordon and Erin 1994).

To date, the Red Tape Commission has drafted several bills designed to amend or repeal about 200 pieces of legislation and about 1,500 regulations. More importantly, the Commission has also drafted a regulatory impact assessment test called the Less Paper/More Jobs Test. This test will ensure that (1) there is a clearly evident need for new government regulations; (2) non-regulatory alternatives are considered; (3) the benefits of new regulations outweigh the costs to business and government; (4) new regulations do not duplicate or overlap with existing rules; (5) there are proper consultations with all businesses affected.

The government has also managed to streamline certain services. For example, it eliminated the annual corporate filing fee; this will save Ontario firms about $14 million per year. The government has also managed to reduce the time required to register a new business from 4 to 6 weeks to 10 days by introducing electronic work stations throughout the province (Ontario 1996). All of these measures are certainly a step in the right direction.

Policy proposals

Apart from the measures already taken, the Harris government should implement the following proposals if it is to stop the runaway train of regulation and its adverse economic and social consequences.

- A moratorium on all new regulations for a three-year period. This step will stem the tide of regulations that has engulfed Ontario. This rule should, of course, have a few exemptions for extraordinary events such as earthquakes, floods, major epidemics, and other natural disasters.

- Reliance on market-driven responses. The provincial government should rely on mechanisms other than regulation whenever possible; alternatives could include economic incentives, performance standards, negotiated compliance, and information techniques (Mannnix 1994).

- Regulators should prioritize all regulations. All regulatory agencies should use risk assessment to help set priorities for achieving greater protection of health, safety, and the environment in the most cost-effective manner. Given that not all risks are of equal magnitude, the Ontario government should therefore focus on the most serious risks (Hahn 1996).

- A provision for "sunset review" of all regulations. Regulatory agencies should include in all regulations a sunset clause repealing the regulation on a three-year cycle.

Conclusion

The Harris government appears to recognize the adverse impacts of excessive regulation and is instituting several changes to the regulatory decision-making process. It has also made some progress in streamlining its business services. For moving swiftly to implement regulatory reforms, the government deserves a **B+**.

Privatization Policy

Reducing the size and scope of government

In the past two decades, governments of various political positions have been forced, largely by fiscal concerns, to reduce the size and scope of their activities. One approach to achieving this goal has been through privatization. Privatization has taken many forms and is often defined differently. Sometimes privatization involves the sale of enterprises owned and operated by the government to the private sector; on other occasions it implies the use of competitive contracting of particular public services (Adam Smith Institute 1986). Whatever the case, the broad thrust of privatization has been to replace state ownership and control of various industries and services with private ownership and control. This transfer of ownership and control has increased the influence of market forces (and, by extension, decreased the influence of political forces) over the allocation of economic resources.

The economics of privatization

From the economic point of view, the desirability of privatization must be justified on efficiency grounds. Privatization of a government enterprise or a public service is worthwhile if it results in efficiency gains. Broadly speaking, efficiency refers to the ability of producers to combine inputs to produce outputs. More efficient producers are able to use fewer inputs to provide a given level of output. Privatization passes the economic cost-benefit test if private suppliers are able to provide a given level of output using fewer resources than public suppliers.

There are many theoretical reasons to believe that private suppliers are more efficient that public suppliers. For one thing, the incentives faced by public sector managers are often very different than those faced by private entrepreneurs.[49] Private entrepreneurs are largely concerned about profit. In an effort to maximize profits, private organizations are forced to use the most efficient methods of production given relative factor prices. Further, in order to remain competitive and viable, private firms must continue to innovate and offer quality products at a reasonable price (Gwartney and Stroup 1993). In contrast, the objectives of public-sector enterprises are often more varied. Government organizations need not record a profit to ensure their existence, and often receive subsidies from the state when they do not record profits. As a result, they are not under the same pressure to keep costs down and maintain efficient production methods. Further, because public enterprises often face little competition, there is virtually no incentive to improve product quality and service. Producer rather than consumer interests tend to dominate when the public sector gets involved (Mitchell and Simmons 1994; Niskanen 1971).

The empirical evidence supports many of these theoretical observations. Generally, public sector enterprises tend to use more labour than their private-sector counterparts for the same service. Public-sector firms also tend to use capital much less efficiently than private-sector firms in the same industry (Pirie 1988). Inefficient use of input is costly to the economy because it reduces the quantity of labour and capital available for alternative endeavours. Because workplace rules are often more rigid in the public sector, the ability of public enterprises to innovate and experiment with new production techniques is often hindered (Pirie 1988). This retards technical progress and, over time, reduces the dynamic efficiency of the economy.

Case studies of enterprises before and after privatization provide considerable evidence in support of

49 The effect of different incentives on economic performance is outlined in the entry Privatization in the *New Palgrave Dictionary of Economics* (Hanke 1987: 976–77).

privatization. Contracting out for municipal garbage collection results in significant efficiency gains. Private garbage collectors use fewer employees per vehicle and use each vehicle more intensively than their public-sector counterparts; the result is a more efficient use of inputs and significant savings for taxpayers.[50] The privatization of prisons in the United States is also instructive. Privately run prisons generally utilize more sophisticated surveillance techniques than publicly run prisons. The result is each guard is able to supervise more prisoners (i.e. fewer guards are needed) with no deterioration in the quality of that supervision.[51] Another case study in privatization is the Alberta Liquor Control Board (ALCB). In the fall of 1993, the ALCB relinquished control over all its liquor retailing outlets to the private sector. Since privatization, Alberta liquor consumers have enjoyed better access to liquor retailing outlets, improved product choice, and better service quality (West 1997).

Internationally, privatization has become "big business." According to the National Centre for Policy Analysis (1997), governments world wide privatized \$86 billion of businesses in 1996 alone; since 1985, over \$600 billion worth of government businesses have been sold to the private sector. A recent study by the World Bank examined the performance of over 60 privatized companies in 18 different countries and found that after privatization, profitability increased by 45 percent, efficiency by 11 percent, output rose by 27 percent, and investment in new plant and equipment jumped by 44 percent (National Centre for Policy Analysis 1997). Among those enterprises privatized were airports, air-traffic control systems, telecommunications systems, mining companies, oil and gas companies, banks, and postal services.

Hence, there is reason to believe that many public services and industries now run by the public sector could be transferred over to private enterprise. As noted earlier, the presence of competition ensures that private suppliers will produce as efficiently as possible. A private garbage-collection service that does not produce efficiently can be replaced when its contract expires; public garbage-collection services cannot be so easily replaced. That this same logic can be applied to many other industries and services yields the following general policy conclusion: governments should privatize all businesses and services that can be more efficiently produced by the private sector. This will free scarce resources for more productive uses in other sectors.

Privatization in Ontario?

One of the stated objectives of the Harris government is to reduce the size and scope of the public sector in Ontario. As noted earlier, privatization is one method that has been used to achieve this objective. Towards this goal, the Ontario government recently launched a Privatization Review of its business operations under Rob Sampson, Minister without Portfolio. Currently, the Review is considering the privatization of the Province of Ontario Savings Office, the Metro Toronto Convention Centre, Ortech research facilities, and three government-operated tree nurseries (Ontario, Office of Privatization 1997).

Policy proposals

While these measures signal a shift in the right direction, there is still much to be done. Currently, the Ontario government owns and operates over 500 public enterprises, of which 46 are crown corporations (Ontario, Public Appointments Secretariat 1997). If the government is truly interested in maximizing the efficiency gains from greater private-sector involvement in the supply of public services,[52] it must pursue more privatization initiatives with greater vigilance. To begin, the government of

50 McDavid 1988. Professor McDavid estimates that, after privatization of garbage collection services in Richmond, British Columbia, tonnes of garbage collected per crew member per day rose from 6.2 to 10.25. Furthermore, costs per household fell from \$52.71 to \$31.72 per tonne.

51 Thomas 1996. For a brief overview of the evidence, see Easton (1997), who estimates that privatization of Canada's prison system could save taxpayers \$200 million per year.

52 Note that not all government-operated enterprises are involved in producing "public services." Consider, for instance, the tree nurseries and convention centre mentioned earlier. These are essentially private services produced by the public sector.

Ontario should consider privatizing the following crown corporations:

- Ontario Hydro
- Liquor Control Board of Ontario (LCBO)
- Niagara Parks Commission
- Ontario Energy Council
- Ontario Film Development Corporation
- Ontario Loan Corporation
- Ontario Place Corporation
- Ontario Waste Management Corporation
- Thunder Bay Ski Jumps Limited.

Of course, this is only the tip of a very large iceberg. Privatization of large and visible crown corporations is a start. However, there is a multitude of smaller, less visible, public sector services which could be contracted out to private suppliers. For instance, the chartered banks could take over responsibility for issuing welfare cheques. Provincial prisons could be run by private corporations. Government documents could be printed by private publishers. That certain services and functions have been traditionally performed by the state is not an argument against private sector involvement. The evidence from around the world suggests that the possibilities for greater private sector involvement in the provision of public services are virtually limitless (Pirie 1988).

Conclusion

There are theoretical and empirical reasons to believe that privatization of public enterprises results in gains in efficiency. Private entrepreneurs face a set of incentives different from those faced by their public-sector counterparts. Market forces and competition generally force private sector enterprises to behave efficiently. Public sector enterprises do not face these pressures since they do not have to record profits to remain in business. As a result, public sector enterprises tend to use labour and capital less efficiently than private sector firms performing the same task. This misallocation represents a deadweight loss to the economy as a whole.

Hence, privatization is often desirable on efficiency grounds. Unfortunately, the Harris government has been slow to learn this lesson and has only recently started a Privatization Review. For dragging its feet in an area of fundamental importance, the Ontario government deserves a **D** for its privatization policies.

Municipal Affairs

The Ontario Progressive Conservatives promised, on page three of *The Common Sense Revolution*, to "cut the size of government" and "provide the people of Ontario with better for less" (1994: 3). But, increased municipal user fees, the introduction of Actual Value Assessment (AVA) for property taxes, and recent legislation creating a Toronto mega-city mean less from local government for Ontario's taxpayers in exchange for more charges.

A mega-mistake

In a recent issue of *Forbes*, Toronto was rated the best place in the world to work and raise a family. With the passage of Bill 103, the city of Toronto will cease to exist on January 1, 1998 (*Globe and Mail* 1997a), replaced by a mega-city, one cozy neighbourhood of approximately 2.3 million people. Ignoring the results of 6 referenda (*Maclean's* 1997b) and defeating a court challenge based on the Charter of Rights and Freedoms (*Globe and Mail* 1997h), the Harris government will unify the area's 6 municipalities with the regional government of Metropolitan Toronto.

Unfortunately for the people of Ontario, Bill 103, which creates the mega-city, suffers from a fatal weakness that jeopardizes its mission to cut spending by $865 million by the year 2000, reduce the number of municipal councillors by 62, and eliminate 4,500 civil service jobs (*Maclean's* 1997b). The Ontario government has confused the desirability of smaller government with the totalitarian ideal of a smaller number of governments. Since the City of Toronto Act is just one move in the Ontario government's agenda to reduce the number of Ontario municipalities from 840 to fewer than 350 (Ontario Taxpayers Federation 1996), a deeper analysis of Bill 103 is of interest to all residents of Ontario.

Problems with the *status quo*

A major overhaul of Metro Toronto's municipal government system was definitely in order. Local government in Toronto simply makes no sense. As *Maclean's* magazine states, "almost nobody outside government, the media, and the land development business understands how it works" (*Maclean's* 1997c: 42). For over 43 years, Toronto has been operating on a pseudo-federal system with a metropolitan government providing certain broad services for everyone, plus 6 separate regional councils furnishing additional local services. Not only are residents represented by a local councillor, but each is also represented by a metro councillor as well. While some services, like police and ambulances, are under metro control, others, such as fire protection, are the responsibility of local government. Meanwhile, other facilities, such as libraries, are run by both local and metro government. Therefore, according to Patricia Peterson, director of Urban Studies at the University of Toronto, "People don't know what's going on, people get confused and angry and afraid, because it's complicated" (*Maclean's* 1997c: 42).

Local government in old Toronto may very well be inefficient. Nevertheless, there is reason to believe that the mega-city of Toronto will be even more inefficient. While there is a great deal of needless overlap and duplication under the current local government, there is at least some inter-governmental competition among Metro Toronto's 6 distinct municipalities. Under the mega-city, all governments will be amalgamated into one and intergovernmental competition will be replaced by monopolistic government. If monopolistic firms are considered to be inefficient, then surely the same analysis applies to government.

No market—no motive

When Municipal Affairs Minister Al Leach condemns the duplication of services among Ontario municipalities—"People know it's not common sense to have 7 different sets of rules, 7 sets of administrations, and 7 sets of local councils debating the issues *when one will do*" (Ontario, Ministry of Municipal Affairs and Housing 1996)—one begins to wonder if the government will soon pass legislation to eliminate the hugely wasteful choice of cars on the road, toothpastes in the drugstore, and movies in the theatre. Why let so many different car companies exist if one huge competition-free mega-corporation can supposedly operate more efficiently? One look at the East German manufactured Trabant—the car driven only by those with no alternative (Block and Walker 1989)—and the Ontario government would be reminded of the importance of those incentives towards maximum quality at minimum expense that only free market competition can provide.

This "no market, no motive" principle holds equally detrimental effects for the residents of a unified Toronto. Without competing municipalities, local politicians have no incentive to improve services and lower taxes. Further, under mega-city rule, Toronto's residents lose both the ability to judge one municipal government's performance against that of another, and the power to "vote with their feet" to express dissatisfaction (Tullock 1994).

Mega-city migration

Henry Ford—the industrialist who told consumers that they could buy his Model-T in any colour they wanted, so long as their choice was black—would make an appropriate mayor for Toronto's new mega-city. Ford nearly lost his entire market share to General Motor's Corporation and its consumer-friendly Chevrolet (Branden 1976). Since Bill 103 subjects all inhabitants of a unified Toronto to a uniform set of by-laws, uniform methods of property-tax assessment, and uniform levels of service, government operations cannot be customized to satisfy the distinct preferences of individual residents. For example, residents from the area formerly known as North York may prefer paying higher taxes in exchange for luxury services, such as daily snow removal, garbage collection three times a week, and gold-plated playgrounds in every park. On the other hand, residents of the area formerly known as Scarborough may miss their arrangement, by which they pay lower taxes for fewer services.

According to Andrew Sancton, a political science professor at the University of Western Ontario, services in the mega-city will likely move to the very highest level because powerful public-sector unions will not agree to wages that are an average of those paid in their previous collective agreements (Canadian Taxpayers Federation 1997c). In the end, residents will have no way to avoid a tax hike for new luxury services other than by leaving the Toronto region altogether—removing their tax dollars and their contribution to the local economy.

Who gains from the mega-city?

Will those residents who are willing to pay higher taxes in exchange for luxury municipal services save money from the mega-city's new economies of scale? The most likely beneficiaries are likely to be not the residents but union monopolies. Union contracts covering large groups of workers leave taxpayers vulnerable to inefficient work rules, which, in turn, discourage customer-oriented services, reduce product quality, and lead to relatively high unit costs for municipal taxpayers. Since more than 60 percent of municipal expenses are related to employees (Cox 1997: 22), stronger (i.e. larger) trade unions translate into skyrocketing costs for Ontario's mega-city.

With respect to the Ontario government's plan for "real savings to taxpayers" (Ministry of Municipal Affairs and Housing 1996) the American experience should set off a piercing alarm for those predicting the real costs of municipal amalgamation. In the United States, per-capita expenditures of cities over one million are 10 percent higher than those in cities of 500,000 to one million. American counties with more than one million residents spend more than double the per-capita amount spent by smaller, amalgamated cities (Cox 1997). Amalgamated cities in the United States with a population greater than one million spend 152 percent more per capita than amalgamated cities with a population between 100,000 and 500,000 (Canadian Taxpayers Federation [CTF] 1997b). Explosive costs have forced London and Copenhagen to dismantle their regional governments (CTF 1996), and the amalgamated city of Chicago has lost one million residents since 1950 (CTF 1997a). While the experience in other jurisdictions may not be strictly comparable, the general lesson is applicable. It appears that there are significant diseconomies of scale associated with large municipal governments—i.e. they not only fail to achieve economies of scale but even find their efficiency decreasing.

Mending the mistake

How can the Ontario government mend its mega-mistake? It should replace two-tiered local governments in southern Ontario and the Sudbury region with a single tier of competing municipal governments. Since individuals are free to migrate from one municipality to another, municipal councils have every incentive to offer constituents the best services at the lowest possible price. Furthermore, individual municipalities breed community spirit and neighbourhood cohesion as like-minded Ontarians with similar preferences for particular service-tax combinations will choose to live in the same local communities (Tullock 1994).

Individual municipalities need not amalgamate in order to avoid duplication of services; economies of scale can be achieved through intergovernmental cooperation. In the business world, competing corporations often share technology and enter into joint-ventures to the mutual benefit of both firms. Just as General Motor's 1984 Chevy Nova shared engine components with its primary competitor, the Toyota Corolla (Hill 1992), North York and Scarborough could negotiate a more advantageous snow-removal contract by bidding as one cooperative unit. At the same time, however, both municipalities could retain their distinct character in other areas such as road construction, garbage collection, park services, and local city by-laws. Competition and cooperation among a single tier of local governments can therefore lead to a greater innovation and experimentation in the design and delivery of local services, innovation that would be stifled by a single, amalgamated government.

Leaner local government

The Ontario government has created an official "Fat-Finding" Commission to "find waste that can be cut, and ways of simplifying the government structure" (PCPO 1994). In 1994, Ontario's municipalities spent $21 billion on municipal services—police, fire protection, road maintenance, snow removal, transit service, sewers, garbage disposal, welfare, daycare, and park facilities (Pagnuelo 1996). Funding for these local government services comes from federal and provincial grants, property taxes, user-fees, and development charges. In other words, municipalities are fully funded by the Ontario taxpayer.

To curb this growth in spending by local governments, the Ontario government has cut $552 million (2.6 percent) in municipal transfer payments (*Globe and Mail* 1995a), while cutting residential education property taxes by 50 percent, and setting a provincial mill rate[53] on the remaining $2.5 billion. Further, $225 million in public health costs for local services as well as public transit operations, library funding, municipal airports, land ambulances, and water and sewer services will be assumed by municipalities (Ontario, Ministry of Municipal Affairs and Housing 1997b). Although municipalities will receive unconditional block transfers totaling $666 million in 1997/98, these grants will disappear in the following year, leaving local governments little choice but to grow smaller, leaner, and more efficient than before (Ontario, Ministry of Municipal Affairs and Housing 1997c).

To cope with such dramatic changes, the Ontario government amended the Municipal Act to allow municipalities to innovate through looser spending restrictions and new rights to charge user-fees in exchange for services to residents. Meanwhile, changes, introduced in omnibus Bill 26, to the Municipal Franchises Act and Ontario's Public Utilities Act allow local governments to privatize utilities without the former requirement of holding a public referendum; this paves the way for municipalities to sell off water and sewage plants, transit systems, and electric utilities (*Globe and Mail* 1996b).

The fairness of user-fees

If "fairness" entails paying for what you use, then what method of financing municipal services can be more fair than taxing residents in direct proportion to the amount of services they consume? Until recently, user-fees in Ontario had been restricted to a handful of municipal services such as water and public transit, generating only 18 percent of total municipal revenues (*Globe and Mail* 1995b). The remaining 82 percent of municipal revenues pay for services that many individual taxpayers may not use. For instance, a large family of 5 is charged the

53 Mill rate is used to calculate municipal taxes; owners pay $.001 per dollar of the assessed value of their properties.

same for garbage disposal as the bachelor across the street; an individual who never uses the local library must still pay to support library services used by his neighbour who borrows 20 books a week.

Not only do municipalities' flat-fee tax system coerce low-consumption taxpayers into subsidizing their high-consumption neighbours, it also encourages the placing of larger burdens on public services because it fails to hold individuals accountable for their share of municipal expense; American taxpayers who can vote to have their state charge a direct user-fee instead of hiding the cost of public services in general taxes tend to enjoy lower tax burdens.[54] Meanwhile, because the local governments do not provide residents with a fully itemized account of municipal purchases on their behalf, residents have no way of discovering how their tax dollars are being spent. Therefore, in the interests of those Ontarians who want to know where their property taxes are going, the government's encouragement of user-fees deserves applause.

Actual Value Assessment

Ontario's property taxes are the highest in Canada. Approximately 8.8 percent of the average Ontario family's tax bill takes the form of property taxes, compared with 7.5 percent in Quebec and 6.4 percent in Manitoba (Horry, Palda, and Walker 1997). Given the commitment of Ontario's Progressive Conservatives to smaller and more efficient government, one might expect the provincial government to ease homeowners' tax burden. Instead, the Ontario government's re-introduction of Actual Value Assessment (AVA) will punish those residents who improve their property and enrich the value of Ontario neighbourhoods.

Actual value was the standard for local tax assessment prior to 1970, when Queen's Park made an unsuccessful attempt to standardize all property assessments to a base of common market values. By 1978, Ontario had moved to a local-option approach in which municipalities decided for themselves whether to update their assessment base or retain the base evaluation-year already in use. In the mid-1980s, new provincial legislation empowered regional governments—with the exception of Metro Toronto—to initiate reassessments. With the recent introduction of Bill 106, market-based property tax assessment will become the norm. This could be a very costly mistake.

The Ontario government's rationale for introducing AVA is effectively captured by the comments of MPP Isabel Bassett, who praises AVA for getting "rid of a system that taxes mansions in Rosedale less than a small house in Scarborough" (*Globe and Mail* 1997f). Underlying this statement is the mistaken belief that property taxes should support services other than those directly consumed by the property itself and its residents. A beautiful four-bedroom house imposes no more burden on a city's snow-removal operations than an ugly house of less value. Owners of more valuable houses do not necessarily visit the local park any more than do owners of less valuable properties, and owners of properties worth more on paper do not necessarily have the cash flows on hand to pay for a large increase in the property tax and the provincial government's new AVA initiative will likely force some homeowners to sell their lands, since unrealized potential market value cannot pay taxes. Others will likely cease renovations and basic maintenance on their homes altogether in fear of higher property assessments in the future.

What are some alternatives to AVA? In California, Actual Price Acquisition ties assessments to the last purchase price of the property. In the United Kingdom, the British Council Tax assesses all properties at the same rate within eight bands of 1991 market value. Perhaps the fairest and most efficient property tax assessment of all, however, is the simple Unit Assessment (UA) as practiced by Israel (Canadian Taxpayers Federation [no date]: 9). Under the UA, property assessments are calculated with nothing more than a tape measure, so that local taxes are closely related to the actual level of services consumed by a particular property. In this sense, the UA is the least distortionary of all types of property taxes since it alters economic incentives the least. In contrast, the Ontario government's AVA averages property values over a three-year period,

54 Matsusaka 1995. Matsusaka estimates that in states where citizens can put initiatives to the popular vote, taxes are $100 lower per head. Taxes are lower in these jurisdictions because citizens vote to have government charge direct user fees for certain services, instead of having the costs hidden in general taxes.

requiring an annual reassessment bureaucracy. With 3.8 million assessments to be updated in Toronto alone—some of which have not been reviewed since 1940—this promises to be a very costly endeavour (*Globe and Mail* 1997f). With UA, on the other hand, your one-time assessment remains constant unless you build an extension to your house or demolish an unused garage, so that property taxes can be calculated in advance.

Policy proposals

In light of the analysis presented above, we recommend that the Ontario government adopt the following policy proposals for municipal affairs.

- Replace the current system of local government in Toronto and elsewhere with a single tier of competing local governments.
- Encourage municipalities to charge, wherever possible, for the consumption of municipal services on a user-fee basis.
- Use the Unit Assessment technique for property tax assessment.

Conclusions

Overall, the municipal-affairs policies pursued by the Ontario government are disappointing. While the encouragement of user-fees and downloading of hard services to the local level means superior government accountability and increased control by taxpayers over the taxes they pay, perverse policies in the area of municipal amalgamation and property-tax assessment overshadow these favourable initiatives. For these reasons, the government deserves a **D** for municipal affairs.

Final Thoughts

At the beginning of this report, we remarked that public discussion of policy issues seldom scratches beneath the surface to deal with the substantive issues that must be part of any meaningful debate about public policy. A meaningful debate about public policy requires that we analyze the actual outcomes of particular policies; this, in turn, requires an analytical framework that can highlight both the visible and invisible consequences of human action. Rarely, if ever, does public debate about policy issues ever extend beyond issues of partisan politics and ideology.

Public discourse about the economic and social policies being pursued by the Ontario government has, unfortunately, been subject to this same tendency. Ideological and political matters dominate over genuine concern about the actual impact of public policy in Ontario. Consider, for instance, the following statements about some of the policies that have been implemented by the Ontario government:

> Why in a civilized society is the political form of child abuse still legal? . . . The Harris government of Ontario has, with its cruel cuts to social welfare, deepened the poverty of poor children and literally thrown people onto the street (*Globe and Mail* 1996c).
>
> This is the cold-hearted face of Mike Harris' Ontario. The most vulnerable get trampled in order to find dollars to pay for a tax cut (McLeod 1995).
>
> The thread going through all of this is that they are attacking the most vulnerable and lowest-paid workers.[55]

At best, these statements reflect the fact that all changes in policy are likely to be controversial. When governments make changes to public policy, society's redistributive equilibrium is upset. Some win, others lose. And those who perceive themselves to be worse off will try to resist such changes. This is simply an illustration of a principle we discussed earlier: that all politics is redistributional.

But these statements hold little value otherwise for they fail to go beyond the surface. That is, they fail to provide a dispassionate analysis of all the consequences, both seen and unseen, of particular policy changes. And, indeed, many of these statements are based on mistaken facts. Have the Harris government's "cruel cuts to social welfare" truly deepened the plight of children and the poor? Welfare benefit rates in Ontario for the disabled and the unemployable are still 48 percent above the average of all other provinces while child-care spending in Ontario per capita is 50 percent higher than Quebec and three times more generous than Saskatchewan (Harris 1997). Are, in fact, the most vulnerable Ontarians getting "trampled" in order to pay for a tax cut? Welfare benefits for employable adults in Ontario are still 12 percent higher than in the rest of Canada; per-capita health-care spending in Ontario is higher than every other province except British Columbia even after cuts to taxes and government spending (Harris 1997). Do changes to the regulatory structure and the labour code really represent an attack on the "most vulnerable and lowest paid workers"? Both economic theory and the empirical evidence suggest that high minimum wages are perhaps the most effective way to threaten the employment prospects of the least qualified and most vulnerable members of the work force (Shannon and Beach 1995; Gramlich 1976). It seems that much of the current debate is not only uninformative; it is also severely misinformed.

Our purpose is not to defend the Harris government against its critics. All governments have their detractors—that is the nature of politics in a free

55 Gordon Wilson, president of the Ontario Federation of Labour, commenting on reforms to Ontario's regulatory and labour regime (*Globe and Mail* 1997b).

society—and our interests are not political. Instead, our intention is to provide a dispassionate analysis of the policy choices of the current Ontario government and to discuss how those choices will affect the economic welfare of Ontarians. Where possible, we outline alternative policies that we believe would improve the economic condition of Ontario. In all cases, our conclusions and analysis are grounded in economic theory and the attendant body of empirical evidence.

Overall, we conclude that the performance of the Ontario government has been satisfactory. Cuts to government spending will free up resources for more productive uses in the private sector. Reductions in tax rates will reduce some of the distortionary costs of taxation and improve allocative efficiency. Changes to the welfare system should discourage welfare dependence and encourage able-bodied individuals to return to the work force. Finally, the restructuring of health care and education will redirect dollars to where they are needed most. These are all very positive developments.

However, much work remains to be done. If the efficiencies arising from smaller government and lower taxes are to be completely realized, marginal tax rates must continue to fall and government spending must remain low permanently. If the Ontario government is truly to follow through in its promise to redirect resources away from the state and back to the private sector, a more vigorous privatization strategy must be adopted. And if the Harris government is really interested in ensuring that Ontarians have access to health care and education of the best quality at the lowest price, then choice and competition must be permitted to flourish in both sectors. There is still a long way to go.

Nonetheless, credit must be given to the Harris government for moving in the right direction. And, we must also recognize that, while much still has to be done, much time remains. For having the courage to take a first positive step towards improving the economic condition of Ontario, the Harris government deserves an overall grade of **C+**.

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