Options on the Fiscal Dividend

JOHN MCCALLUM

Let me begin by saying what I think the federal Government will do. I think that it will target a never-ending string of balanced budgets. It will do so with extremely prudent assumptions and a sizable contingency reserve, so that if the economy grows normally, we will have surplus of significant size. This is what you might call surpluses by stealth. The political climate probably does not allow explicit targeting of surpluses but the government will end up with surpluses unless we have an economic down-turn. You might call also this policy sensible Keynesianism because it means you run surpluses in normal or good times and you have deficits—small deficits—if we have a down-turn. This is opposed to actual Keynesianism of the past where governments tended to forget about the surplus part.

At the Royal Bank, we have estimated the likely size of the fiscal dividend using the assumption that the federal Government will aim for this string of balanced budgets. We have assumed four percent annual growth of nominal GDP, an interest rate of seven percent and a contingency reserve of $3 billion. In addition, we assume that revenue grows at the same rate as GDP and program spending goes up with inflation and population. Under these assumptions, the fiscal dividend stars out small but then gets big. It will reach about $8 billion by the end of this government's mandate in 2001.

In considering spending and tax cuts, we have assumed that the government adheres to the Red Book formula and applies one-half of the fiscal dividend to spending increases. Under this assumption, the ratio of program spending relative to GDP remains more or less flat. The other point I would make is that the program spending projected for next year relative to GDP will be lower than it has been since 1948, about 50 years ago.

If we add interest payments to the federal government's program spending, spending becomes much larger. But, because of the projected growth in GDP and reduced interest payments on the falling debt, in 2006 the ratio of total spending to GDP will be the lowest since the mid-1960s. Program spending by all levels of government, federal, provincial and local—in spite of off-loading—is presently at about one-third of GDP, the lowest level since the late 1970s. Total spending by all levels of government is about 43 percent now, down from its peak of 50 percent just a couple of years ago.

Focusing on the federal Government alone, is this level of spending too high or too low? I would suggest that there is no answer to this question. There are arguments that, if government gets too large, there are large disincentive effects of higher taxes and so on upon the economy. But, for the federal Government today the principal answer to the question in a society such as ours comes at the ballot box. It is principally a political rather than an economic question. During the last election, one party, the NDP, wanted bigger government and higher taxes. If I interpret them correctly, the Conservatives and the Reform wanted lower taxes and smaller government. The Liberals were somewhere in between and they won. So, it seems to me as an economist that at least within reasonable bounds the question of bigger or smaller government is principally determined by voters on the basis of their political attitudes and ideology.

But, let us suppose that it has been determined politically that taxes should be cut. What taxes should be cut? Let me consider just two contenders: the first is the EI premium and the second is income tax. If we decide to cut income taxes, there is a question about the precise nature of these cuts.

The case for cuts in employment insurance premiums is quite powerful, given the large accumulated surplus in the account. Some regard it as immoral, others as illegal. It is also said to be a tax on jobs. That claim is possibly true but it is not a watertight argument. Its truth depends on the incidence of EI premiums. If it is primarily on the worker, it will not much affect the cost of labour to employers. My reading of the evidence suggests that the incidence is mainly, at least in the longer term, on workers. So it is not clear quite how much of this is a tax on jobs. However, a good argument can be made in that high EI premiums raise unemployment in the short run.

If we compare cuts in income taxes with reductions in EI premiums and social insurance contributions, it is possible to approach the subject in another way. Total social security taxes as a percent of GDP in Canada are the lowest among the G7 countries. On the other hand, personal income taxes as a percent of GDP in Canada are the highest of the G7 countries. These figures suggest that a cut in personal income taxes may be more appropriate than cuts in the EI and other payroll taxes.

Canada has lower payroll taxes but much higher personal income taxes than the United States. This difference may be a source of problems for the Canadian economy and adds a further argument in favour of cuts in income taxes over cuts to payroll taxes. I cannot offer here a resolution of the conflicting arguments about the merit of cuts in different types of taxes. My main purpose it to suggest that the issues are not as simple as they might appear at first glance.

How might a cut in income taxes be carried out? Marginal tax rates in Canada do not form a smoothly increasing function of income. Instead, the relationship has some peaks and valleys. Those who pay the highest marginal income tax rates in Canada (60 percent or more) are not the rich but the people whose incomes are between $25,000 and $35,000. Why is this so? As you know, we provide financial support to very low income earners through such methods as GST rebates and child subsidies. As incomes rise, these benefits are clawed back quite quickly, making for very high implicit marginal rates of taxation.

I would like to make a case, then, for cuts in marginal income tax rates, starting at the bottom and then going to higher rates. Such a policy can be defended on grounds of both efficiency and fairness. A lot of people would agree that high marginal tax rates, over 50 percent, have disincentive effects on the rich and the poor. People on welfare often have marginal tax rates above 80 percent or even 90 percent. These rates are a real disincentive to getting off welfare. Working, low-income people similarly face these high marginal tax rates.

The equity case for such cuts in marginal rates stems from the fact that in the last decade or so the rich have got richer and the poor have got poorer—inequality has increased. This divergence in income is due mostly to technological factors that resulted in a reduction in the demand for unskilled people across all industrial countries, including Canada. Some federal programs (like the child tax credit) directed to lower income people try to adjust for these developments. Other efforts should be made to lower the high marginal tax rates on the moderately low income groups.

On the other hand, a good case could also be made for attacking the high marginal tax rates for people with high incomes. This case would rest on concerns about the brain drain to the United States, a phenomenon that affects more high income than low income earners.

In conclusion, let me restate that it is absolutely critical that the balanced budget targets be met—come hell or high water. Given that we have reached this goal, there will be a rising fiscal dividend. I would argue that the proportions of this dividend that should go to social programs, tax cuts, or debt reductions definitely should be decided on the basis of some economic criteria. However, ultimately the choice of these proportions is at least as much a question for the electorate as for economists. I think that cuts to EI premiums and income tax rates are good targets and that a public debate should take place about the nature of the income tax cut, especially the relative merit of cutting marginal tax rates for those with low and high incomes.

View of the Canadian Chamber of Commerce

TIM REID

The views in this chapter are the 1997 policy positions of the Canadian Chamber of Commerce. On December 2, 1997, we held a meeting of the entire Board of Directors, where we discussed the resolutions we passed at annual meetings in Saskatoon the previous September. These resolutions related to the fiscal policy issues discussed at the Fraser Institute Conference, *How to Spend the Fiscal Dividend: What is the Optimal Size of Government*? and this chapter will give you an idea of the kind of advice that the Chamber would like to give the government.

The Canadian Chamber of Commerce believes that before any decisions are made on the allocation of anticipated surpluses, we must pause and reflect. The battle to balance the budget was not fought so that Canada could enjoy a fiscal surplus for a year or two, but rather to set Canada on a long-term course of increased growth and prosperity with enhanced opportunity and security for all. It is in this context that we must assess our options.

We need to develop a framework within which we can determine what combination of policy actions, spending increases, tax reductions, and debt reductions are most likely to enhance Canada's competitive position and future economic growth. Without such a framework, there is a danger that less desirable proposals will be implemented and it is in this context that we should have strong concerns with the government's announced target of 50 percent of any surplus being applied to spending. This runs the risk that spending will take place in areas that contribute little to our future prosperity at the expense of other more beneficial efforts. I suggest there are five elements to this framework: (1) anchoring the gains, (2) accountability targets, (3) prudent assumptions, (4) tax reduction, and (5) criteria for program spending.

Anchoring the gains

Before the government undertakes any significant spending measures, it should securely anchor our fiscal gains. This means, first and foremost, reducing that debt load, which will not only reinforce confidence in Canada but will serve to reduce our current massive debt servicing costs of $43 billion over the long run and increase fiscal flexibility. Even with low interest rates, in 1997 the Federal Government spending on interest payments alone was 32 cents of every revenue dollar that could be used for other purposes. Reducing that debt load has to be the long term issue.

Accountability targets

The Federal Government's first mandate accomplishment has been aided in a substantial measure by the publication of targets for a fixed annual-deficit-to-GDP rate. In adopting this approach, the government drew a line in the sand on which rested the credibility of our fiscal policy. Outcomes consistently exceeded expectations, the government's credibility soared, Canada's credibility soared, interest rates fell, and a virtuous circle took root, speeding the elimination of the deficit. It is precisely because that approach was so effective that one must voice concern over the apparent lack of definition in the government's present fiscal strategy.

The notional fiscal dividend is ill defined, and its prospective division among competing objectives has been arbitrarily decided. Canadians in the international marketplace are left without any clear milestones whereby to assess progress along our new fiscal path. Indeed, we have as yet no developed concept of what our desired destination should be.

The Canadian Chamber of Commerce believes that some form of accountability targets should be a part of the government's new fiscal framework designed for the era of budget surpluses. These new targets would replace the rolling two-year deficit targets that now work so well. The targets could take the form of debt-to-GDP ratios or—what I think personally is more interesting—targets set according to the ratio to GDP of interest payments on the federal debt.

Prudent assumptions

Projected surpluses are highly sensitive, as we all know, to many factors. We therefore urge the government to continue the practice of applying prudent assumptions in its budget projections. At the 1997 APEC meetings in Vancouver, I attended the CEO summit and listened to views of CEOs about the dramatic economic events in Asia. As a result, I suggest that it is important to adhere to very prudent assumptions about economic growth in the next budget.

Tax reduction

The new fiscal framework should be aimed at reducing the job-killing and incentive-crushing tax burden. Canadians now prefer the speedy reduction of the debt-to-GDP ratio, which is consistent with tax cuts in the longer run. For the longer term, the Chamber calls for a new vision of government's appropriate role with respect to all its activities, but with particular focus on tax and transfer policy issues.

The criteria for judging program spending

The last report but one of the Auditor General stated that many government programs have no clear objective and no means to measure success against any criteria. In this light, does it make any sense that the government would pre-commit to spend one-half of the expected surplus? If any of the spending is on new programs, will these programs also not have clear and measurable objectives? If they are existing programs without clear rationales, is it not possible to prioritize the list of new activities and perhaps fund the worthy ones through the elimination of those programs that cannot demonstrate greater relative utility. The Canadian Chamber believes that all government programs, new and existing, should be tested against clear criteria.

In the 1970s, I was the Assistant Secretary, Effectiveness Evaluation Division, Treasury Board of Canada and then I was promoted to be Deputy Secretary of the Treasury Board Responsible for Efficiency Evaluation. I am still waiting to see the results of the work I did in these positions.

The current transition to a surplus era provides Canadians with an historic opportunity to reconsider whether the past 20 to 30 years of growth in government spending and taxation has provided a sound payoff. In terms of Finance Minister Paul Martin's stated criteria, the question is whether it has created a strong society and an economy characterized by opportunity and security.

The simple emergence of a fiscal surplus does not imply that additional spending is desirable and that such spending would improve general economic and social welfare. In light of this fact, a 50/50 allocation is strictly arbitrary. The plan to spend one-half the projected surplus assumes that the federal Government is not currently spending enough. Enough to support employment growth? Enough to provide essential services that can be best provided by the Federal Government? Enough to foster long-term economic growth? There are many who would argue that, notwithstanding the recent cuts, government spending still accounts for far too high a proportion of Canadian gross domestic product. At the very least, the government should facilitate the public determination of what the appropriate level should be, rather than arbitrarily presuming the increase to be good.

The role of government

Any emerging budgetary surplus should primarily be allocated to the reduction of the national debt and to tax reductions in order to establish Canada as one of the most dynamic global economies. IMF statistics paint a stark picture of Canada's global position with respect to government spending and taxation. Government spending in Canada as a percentage of GDP was almost 45 percent in 1996, which is about the average of the 17 major industrialized countries. However, our spending is far in excess of that of our neighbour, the United States. There is no question that Canada has a very large government sector but there are real doubts whether the accomplishment of the government's missions requires it to be so large. For example, low government spending and low unemployment rates are perfectly compatible. It can be argued that low spending may actually be a cause of low unemployment.

Tax policies

The positions of the Canadian Chamber of Commerce on taxation are determined at annual meetings of representatives from 500 Chambers of Commerce across the country through debates and votes on policy resolutions. So the Chamber positions are not thought up by myself nor a select committee of experts; they genuinely represent the views of businesses across Canada and are derived through intensive grassroots contacts as well as the input of an economic policy committee and a taxation committee made up of some of the best business economists in this country.

Positions we have taken have implications for the federal debt and they must be seen as a hierarchy of priorities. This hierarchy begins with the need to reduce our debt-to-GDP ratio substantially and quickly and, therefore, the expenditures of interest on that debt (which is the proper definition of a "fiscal dividend"). Then, there is the need for reductions on the job-killing EI premiums over the next two years. Chamber members, small businesses, and large businesses in all parts of the country believe that, if there was a significant reduction in EI over the next two years, more people would be hired because the cost of labour relative to the cost of other inputs would have been lowered. Moreover, reductions in employment insurance rates has the added advantage that it appeals to Canadians' sense of fairness. The EI premium is a fixed rate that applies only to the first $39,000 income. Therefore, by definition, it is a regressive tax whose burden falls disproportionately on those Canadians with low incomes and who are most vulnerable.

Beyond reductions in debt and EI premium rates, the Canadian Chamber proposes the lowering of the tax load on its citizens. Canadians have seen their tax load rise significantly over the years as a result of high EI premiums, hikes in CPP payments, higher effective tax rates through bracket creep and outright tax increases. As the federal Government gradually regains fiscal flexibility, it should consider the following specific changes in taxation: increases in the basic personal and spousal tax credits, restoration of full indexing of personal exemptions and brackets to inflation, restoration of the RRSP contribution limits to the level proposed many years ago, the elimination of the 3 percent surtax on high income earners. The latter tax was, in any event, intended as only as a temporary measure.

View of CIBC Wood Gundy

Jeffrey Rubin

I do not believe that massive surpluses will arise in the very distant future. I believe that we will see potentially massive surpluses in the very near term. While the Finance Minister has officially targeted a balanced budget for next year, it is pretty clear from the fiscal numbers to date that it will be achieved in the current 1997/1998 fiscal year. There may actually be a small surplus.

Revenues are about $10 billion ahead of plan, program spending is once again running below plan, and public-debt charges are right now tracking about $2 billion lower than the budget estimates. So, in fact, the most conservative assumptions would be that we would have a balanced budget this year and we may have a surplus of as much as $10 billion in the upcoming fiscal year, 1998/99.

I believe that under the guise of eliminating a phantom budget deficit, the Finance Minister will ward off calls for both tax cuts and government spending increases. He will effectively let the system crank out surpluses for this year and possibly 2 or 3 more years in the future. What the Finance Minister cannot achieve through political consensus at the Cabinet table, he will achieve through prudent budgetary assumptions.

As a result of such prudent assumptions, the deficit fell five times as much as was planned last year and produced a $15 billion overshoot of the deficit reduction target. In fact, a $10 billion surplus next year would not be even as large an overshoot as what he has achieved last year. Furthermore, the Finance Minister has already served notice in his Fall 1997 update that any future overshoots in deficit reduction would go directly to paying down the debt. So, in effect, the debate on how to utilize the surplus will begin only after the first $9 billion to $10 billion of that surplus is already used for debt reduction. This represents a *de facto* victory for debt reduction against competing uses of the fiscal dividend, be they government spending increases or tax cuts.

However, I do not believe that, beyond 1998/99, the government will make further debt reduction payments of that size without addressing those competing uses of the surplus. By that time, surpluses will already become apparent and it will be clear that they will grow exponentially. Even if growth of nominal GDP averaged 4 percent over the next four years, which is no greater than the lackluster performance of the last four years, the present fiscal system is primed to pump out very large surpluses. They would grow from roughly $9 billion or $10 billion next year to as much as $21 billion over the next four years, resulting in a cumulative surplus of $60 billion during the Liberal's second mandate.

I can guarantee one thing: someone will spend that money because there is no political support on either side of the political spectrum for governments running surpluses of such magnitude. The major cause of the projected surpluses is the growth in federal tax revenues in excess of economic growth.

Underlying this trend are built-in tax increases due to the absence of indexation of tax brackets and tax rates. Canadian taxpayers have been facing tax hikes since the mid-1980s when the indexation of personal exemptions and tax brackets was eliminated. They will do so in the future. Perversely, the reward for Canadian taxpayers for low inflation is a billion-dollar tax increase every year without any change in the schedule of rates. If average consumer-price inflation is 2 percent over the next four years, that means that there will be an effective tax hike of $4 billion at the federal level and, of course, a corresponding $2-billion tax hike for the provinces. If inflation were to rise to 3 percent, the automatic tax hike could be as large as $6 billion federally and $3.6 billion provincially.

It is important to note that the projected huge government surpluses require no further cuts in government spending. In our modeling exercise from which these projections are derived, we have allowed program spending beyond 1998/99 to grow by about 3.2 percent per year, reflecting inflation and population growth. In other words, we are allowing real per capita program spending to be preserved at the 1998/99 levels. This is a fairly generous assumption, given that over the last four years real per capita spending has fallen by about 20 percent. In addition, there is probably more flexibility for government spending than is implied by our assumptions. Payments of employment insurance claims are running between $2 billion and $3 billion less than budgeted in the fiscal plan. These funds will be available for reallocation to new spending initiatives without affecting the total level of program expenditures.

Lastly, the scale of debt reduction and the reduced borrowing needs insulate the federal government from the very large increases in debt servicing costs that plagued the federal Government in the late l980s and early 1990s. So, even with as much as a 200-basis-point rise in interest rates throughout the yield curve over the next four years, we will not see very much movement in debt servicing costs.

The federal Government has said that it will use 50 percent of the fiscal dividend to increase government spending. We have estimated that this policy would result in an unprecedented increase in government spending. It would result in a $9 billion increase in spending in 1998/99. Such an increase would wipe out all of the spending restraint of the last three budgets. Over the three-year period from 1999/2000 to 2001/02, spending would increase over $20 billion annually. Spending in the future would grow at 6 percent per year. It should be remembered that such spending increases could take place while budgets remain balanced and there are no explicit tax increases.

Alternatively, if 50 percent of the projected surpluses were allocated to tax cuts, these could equal a $3 billion a year in each of the next four years, commencing in the next budget. That would accumulate to a little over $13 billion annually at the end of the period. Even with these tax cuts, the government would still post modest surpluses of about $5 billion to $6 billion a year, which, in turn, would accumulate to a debt reduction of about $24 billion. The debt-to-GDP ratio would decline from near 73 percent in 1997 to about 53 percent, reversing all of the fiscal deterioration since the 1990s.

What about the notion that the projected surplus be allocated totally to debt reduction? The American experience suggests that this is not likely to take place for political reasons. Even during very prosperous times in 1997, with unemployment at a 25-year low, all prospective surpluses were quickly spent by Congress and the Administration. There was no political will to run a budgetary surplus.

In both the Republican and Democratic camp, budget surpluses ran a very distant second to alternative fiscal uses. In the Republican camp, tax cuts came first, with capital gain tax cuts on the top of the list. For the Democrats, government spending increases came first, with priority going to spending on education. I find it hard to believe that in Canada with 9.1 percent unemployment, the public will endorse debt reduction of a very aggressive scale.

I believe it is important to compare Canadian with foreign rates of taxation. Although we hear a lot about substantial increases in CPP premiums over the next four to five years, in fact Canada has the lowest indirect taxes as a percentage of GDP in the entire G7, including the United States. Alternatively, personal income taxes as a share of GDP in Canada are by far the highest.

Personal income taxes in Canada are also at an all-time high historically. Even a tax cut of $3 billion a year, or $13 billion over four years would just restore the ratio of personal income tax to GDP to its level in 1988. This level, in turn, is still much higher than it was at the beginning of the 1980s.

Why has the issue of tax cuts attracted so little public attention in recent times? There are two fundamental reasons. First, until recently people very much believed Paul Martin's deficit numbers; I think many among my colleagues on Bay Street still do. This pessimistic view on deficits ruled out tax cuts. I think that this was a proper attitude then, but now that it is increasingly realized that the deficits are actually turning into surpluses, tax cuts are getting discussed more and more. I am convinced that the case for cuts will win.

Second, there has been a failure in the political arena to bring up the subject of tax cuts in the proper context. The very people who advocated tax cuts in the last election, specifically the Reform Party and the Progressive Conservatives, played Paul Martin's game by accepting his forecasts for continued deficits. As a result, they were forced to endorse large cuts in government spending in order to pay for tax cuts. Canadians quite rightly thought that they did not want to endure any further cuts in government spending and accompanying closures of hospitals and schools. These closures were not worth to them a small reduction in their personal income taxes.

The reality is that the public was offered a false choice. There was no need for spending reductions to finance tax cuts. The real issue was whether the pace of deficit reduction would be tripled or quadrupled or whether Canadian taxpayers would share in some of these fiscal benefits.

Looking forward, I believe that Canadians do not want ideological arguments about the optimum size of government. They fear that they might lead to more years of painful program spending cuts. I believe that Canadians now realize that the choice is between surpluses and tax cuts. Once faced with this choice, I have confidence that Canadians will choose to reform a tax system that penalizes efficiency, confiscates purchasing power, and undermines competitiveness.

Discussion of Views of Business Economists

Editor's Note: The following draws on a transcript of a round-table discussion that took place after the presentations by John McCallum, Tim Reid, and Jeffrey Rubin. I have edited all questions and answers heavily to make them brief and concise, and I apologize for the omission of much wit, repartee, and rhetoric that brightened the live proceedings. The participants have given their approval of the edited version of their remarks.

Question 1

Michael Walker I have some questions that link the presentations by the business economists with the papers by the economists in the first session. According to Ludger Schuknecht, the empirical evidence strongly suggests that there are no benefits from government expenditures beyond 30 percent of GDP. Spending above this level does not increase school enrolment, life expectancy, or even income distribution. Gerald Scully pointed out that economic growth is reduced by tax rates above what he refers to as the optimal level. David Giles noted that the underground economy begins to swell as tax rates rise above a certain level.

Therefore I wonder what makes John McCallum say that economists have nothing to say about what the size of government should be. Surely the choice of an optimal size of government is not just ideological; it is not one just to be decided at the ballot box. It is important that the people know about the consequences of increased spending, that beyond a certain level of spending there will be few improvements in health, education, and life expectancy, and that it is likely to reduce economic growth.

Response

John McCallum I do not think I said economists had nothing to say. I said I think that, within limits, it is principally a political issue when it comes to income distribution. Ludger Schuknecht notes that income distribution is more equal when transfers and subsidies are higher. Economists from Queen's University in Kingston compared the increase in inequality over the last several years in the United States and Canada. They found that the increase in inequality in terms of wage incomes was about the same, maybe slightly more in the United States than in Canada. However, once the Canadians tax and transfer system is taken into account, inequality in Canada had not increased significantly.

I accept that the tax and transfer system has had negative effects on incentives and economic growth in Canada. Therefore, Canada relative to the United States had a lower rate of economic growth but gained a greater equality of income. The trade-off between growth and equality is the kind of issue which I would suggest can only be settled through the political process.

Comment

Michael Walker I agree with your basic proposition that such a trade-off between growth and income equality involves ethical judgements. But, I would insist that they also have an empirical dimension. Consider that in 1965, 4.7 percent of income before tax went to the lowest quintile of income earners in Canada. In 1995, that quintile's share had risen to 5.4 percent. This improvement of one percentage point in the income going to the bottom quintile was achieved through an increase of spending from 30 percent to 45 percent of GDP. This is the kind of information economists can bring to the public decision making process, even if, at bottom, it involves ethical judgements that are resolved through the political process.

John McCallum My personal view is that we made a mistake raising the size of government as much as you indicated. We agree on that point. My main contention is that the present size of the federal Government is the lowest in 50 years and that we do not want it necessarily to be smaller than that.

Question 2

Audience I have seen the economic forecasts today and am reminded of my work at the Economic Council of Canada before it was dissolved. We made the same sort of simulations around 1990 and produced the same results. Very large surpluses would appear in just 3 or 4 years. We all know that these surpluses did not develop. There was this little matter of the 1991 recession that we had not put into our simulations. This experience leads me to suggest that it is risky to count the chickens before they are hatched—to plan tax reductions or spending or spending increases before the surplus is realized. The business cycle has not been repealed and we could have a recession before too long.

Answer

Jeffrey Rubin I think that it would be spurious to model a recession for a specific year in the future. All one can do in such modeling is to assume that the future four years will be much like the last four years in terms of economic growth and its effect on tax revenue and spending. Canada's nominal 4 percent average annual growth rate from 1990 to 1996 has not exactly been spectacular. So, forecasting an average 4 percent nominal GDP growth in the next four years could easily accommodate a recession as long there would be a recovery afterwards, which would be the normal case in any business cycle.

Let me note that the improvement in the fiscal balances, which in recent years has been two to three times faster than forecast by anyone—including the Department of Finance—was not driven by economic growth. It has mainly been driven by a combination of spending cutbacks and tax increases. Such tax increases will allow federal revenues to continue to grow faster than the 4 percent at which we expect nominal GDP to grow. This is due to the absence of indexation of the taxation system, which will generate an extra $6 billion in federal revenue over the next four years. More favourable fiscal outlooks could be obtained if, for example, we used the Bank of Canada's assumption that the economy would grow at 4 percent in real terms, a nominal growth closer to 6 percent.

Tim Reid I agree basically with Jeffrey Rubin's reply but I am concerned about the impact of the Asian flu, especially after I listened to government leaders at the recent APEC conference in Vancouver. In comparison, here in Canada we have some of our fundamentals right, but it is important to stay with conservative assumptions in making forecasts.

John McCallum My estimates are similar to Jefftey Rubin's, but there are some differences in the interpretation. I agree that the federal Government probably is in balance this year. My estimate of the fiscal dividends could afford a tax cut of $3 billion in each of the next four years, but I do not think we should embark on that road too soon. I was in Vancouver too, and it is scary. It is really scary. We do not know what will happen in Asia. Anything could happen. I personally think the impact on us will be limited but there is a risk that it could get out of hand. There is also the risk that the Quebec issue could get out of hand, especially with the election there coming up in 1998. Political events are much harder to predict than economic developments.

I do not want the Federal Government to commit itself in the next budget to a long string of substantial tax cuts when there will have been only one year at best of a balanced budget or a small surplus. If everything goes well and there are surpluses of $7 billion or $8 billion in 1998/99, it is not a catastrophe if these funds are used to reduce the debt.

Question 3

Audience I am concerned about the government's unfunded liabilities through the Canada Pension Plan and about the prospect of much higher medical expenses as the population ages. Is the government not in fact in a much worse situation than it looks on book? And, if that is the case, should paying down the debt not be given a very high priority?

Answer

John McCallum The biggest single reason for attaching a very high priority to getting the debt-to-GDP ratio down over the next 10 to 15 years is the large number of baby boomers reaching retirement age. Therefore the present grace period of 10, 12, or 15 years should be used to pay down the debt. On the CPP, I would say that it is in good shape now. Whether you like the way the government has dealt with it or not, it has been put on a solvent footing by those premium increases.

Jeffrey Rubin There is no doubt that we have to reduce the debt relative to the economy. But this will occur automatically when the budget is balanced and the economy grows. I have been advocating that we should get the debt-to-GDP ratio lowered to around 53 percent. Economists do not know what the optimal debt-to-GDP ratio is. Most would agree that it should not be 73 percent. I think it is better to use growth in GDP rather than absolute debt reductions to get to a lower debt-to-GDP ratio. The surpluses needed to pay down the debt are not going to be politically acceptable.

It is important to note that the debt-to-GDP ratio will be the same in the future whether 50 percent of the projected surplus is used for increased government spending at 6 percent to 7 percent a year, or for equivalent tax cuts. In this sense, the debt-to-GDP ratio is a red herring. The real issue is tax cuts or spending increases. I suggest we choose tax cuts.

Tim Reid I think that for Canada's international competitiveness it is important to consider the way the country is perceived abroad. Foreign investors act on their perception of Canada's fiscal toughness. They are difficult to persuade by complex arguments of the sort Jeffrey Rubin just made. I think that we need to send a clear and unambiguous message that Canada is serious about its fiscal order by a simple commitment to debt reduction—that we will reach a debt-to-GDP ratio of, say, 60 percent by the year 2,000 at the very, very latest and appropriate downward targets thereafter. I think that such a policy would help bring into Canada more of the foreign investment that now is going to the United States, in spite of the fact that we have many of our fundamentals right.

Comment

Michael Walker Regarding Tim Reid's comment, let me just remind you that in this morning's session it was noted that the rate of taxation for capital gains is 20 percent in the United States and 40 percent in Canada in some provinces. Investors in high-tech industries get most of their returns through capital gains. Therefore it should really not come as a surprise that Canada fails to attract the level of high-tech investment that all of us think we should have. While there is also a large gap in the personal income tax favouring the United States, I think that in the field of high-tech investment the government could achieve most by a lowering of the capital gains tax rate.

John McCallum I certainly think that it would help Canada if we had lower capital gains tax and lower income tax. But, I also think marketing is a crucial policy. Canada ranks very high in objective rankings of countries like those prepared by organizations like the World Economic Forum and the Economist's Intelligence Unit. Yet, on more subjective evaluations like those of the Chief Executive Officer in The World Economic Forum Canada ranks much lower. This problem should be addressed by appropriate marketing of Canada, conveying the message that we are open for business and that we have a lot of good things going for us.

On the point of capital gains, I agree that we need to narrow the gap between the Canadian and American rates. If we want to get lower unemployment and more jobs, we need to attract capital and small companies. They are the engines of job creation and they are discouraged from coming to Canada because of the high tax rates.

Question 4

Audience I wonder what the economic analysts foresee for monetary policy in Canada as the fiscal situation moves from deficits to potentially large surpluses and cuts in income taxes and as the economy closes the existing output gap.

Answer

Jeffrey Rubin I think we are a long way from closing the output gap in Canada by the fourth quarter of 1998. At a 9.1 percent unemployment rate, we are far from full employment. Inflationary pressures are much beyond short-term forecasting horizons. Wage inflation is unlikely to develop before the unemployment rate reaches 7 percent, which will not occur until we have created another 800,000 to 900,000 new jobs.

The Bank of Canada has now lost control of monetary policy because of concerns with the foreign exchange market. I think its forecast for 4 percent real economic growth is threatened by the developments in the money and foreign exchange markets. However, it is clear that if, against my expectation, Canada would have substantial fiscal surpluses, monetary policy would have to become easier.

John McCallum I agree with Jeffrey Rubin that Canada is a long way from an output gap of zero. The Asian crisis and the weaker world commodity prices make for lower future growth and even smaller prospects that the output gap will be closed soon.

On monetary policy, I would note that the monetary rule now followed by the Bank of Canada implies smaller fiscal multipliers in either direction than has been the case in the past. As the Bank of Canada targets a certain growth rate of the overall economy and has a certain view of how fast it wants the economy to grow, the impact of a tax cut or a tax increase on spending will be less than it was before.

Comment

Filip Palda John McCallum said that the optimal size of a government is probably a political question, and I think he was right. It should be the consumers of government services who decide in the end. The problem in Canada is that these consumers cannot express their views except in an elections once every four years. Maybe one way to get at the optimal size of government would be to give these consumers more ways of choosing their product: decentralization of government responsibilities, more use of referendums and greater use of user fees.