THE BUDGET THAT CHANGED CANADA

Essays on the 25th Anniversary of the 1995 Budget

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Executive Summary

February 28th, 2020, is the 25th anniversary of one of the most important federal budgets in Canada’s history. It took decisive steps to finally solve a problem of runaway deficits and debt that had begun in the late 1960s and grown worse, almost without pause, for over three decades. Not only did the 1995 budget address pressing fiscal issues but it fundamentally restored sound fiscal policies, changed the relationship for the better between Ottawa and the provinces, and created a foundation for fiscal reform and economic progress that continued for the better part of the next decade. The Fraser Institute invited noted economists and analysts to comment on different aspects of the 1995 budget. The following is a brief summary of each of the collected essays and their main insights.

The series begins with Lakehead University economist Livio Di Matteo exploring the origins of Canada’s federal fiscal difficulties. He discusses a number of factors that planted the seeds for the persistent and growing deficits of the 1970s and 80s, including the prevailing economic thinking of the time, which tolerated and even supported deficit-financed spending, as well as the OPEC oil crisis of 1973, whose impact on long-term growth rates western governments did not recognize or adjust to quickly enough. Di Matteo also discusses the high interest rates of the 1980s that were imposed by central banks in most industrial countries to curb inflation but also resulted in marked increases in interest costs by government. Perhaps most importantly, Di Matteo documents the dire state of federal finances circa 1993 when the Chrétien Liberals assumed office. Di Matteo’s insights regarding disciplined federal finances and concerns over public debt competing and even discouraging private investment are key to understanding the crisis in the mid-1990s as well as the risks associated with current federal fiscal policy.

University of Windsor Professor Lydia Miljan along with Fraser Institute economists Tegan Hill and Niels Veldhuis explore the importance of spending reductions—as opposed to tax increases—in the success of the 1995 budget. No fewer than 24 budget speeches in the previous three decades had claimed to introduce some sort of spending restraint. But the 1995 federal budget actually did: nominal program spending fell from $123.3 billion in 1994-95 to $111.3 billion in 1996-97.
author’s, a key reason for the budget’s success was its focus on spending. That focus was underpinned by a formal process of “Program Review” that set hard targets for spending reductions by department, approaching or even exceeding 50 percent in several cases. The process included a six-step analysis to assess and prioritize existing government spending: Does the program serve the public interest? Is it affordable? Is government intervention necessary? What is the appropriateness of the federal government’s involvement? Is there potential for private/public sector cooperation? Is it efficient? Miljan, Hill, and Veldhuis conclude that the spending reductions enacted in the 1995 budget and the process utilized vastly improved the state of federal finances and helped inaugurate a decade of balanced budgets and declining debts.

Several essays in the series explore specific aspects of the spending reductions summarized in the previous essay. Independent analyst Mark Milke, for instance, examines how the federal budgets of 1995 and 1996 made big cuts in what is variously known as subsidies to business, cor-
porate welfare, or crony capitalism. The Chrétien government undertook fundamental reform with an overall target of cutting subsidies to business by roughly 60 percent, or $2.3 billion, with cuts varying by sector from just over a third in cultural industries to more than 97 percent in transportation. Some programs were entirely eliminated, for example, grain transportation subsidies, while in other cases government enterprises were privatized—air traffic control, for example—or saw their privatizations completed, as with CNR, Petro-Canada and National Sea Products Limited. As Milke notes, these two budgets did not end corporate welfare at the federal level but for a time at least cuts in grants to business played an important role in re-establishing fiscal control.

University of Calgary economist Professor Ronald Kneebone and Fraser Institute economist Jake Fuss look at the 1995 budget’s role in reforming social assistance. The 1995 federal budget reduced spending in the Canada Assistance Plan (CAP), one of the key federal transfers to the provinces, but it also switched it to block funding. Specifically, as detailed in the essay, CAP was transitioned from a cost-sharing program in which the federal government had very limited control of the costs to a block grant that provided the provinces with a set amount of funding. Critic-
ally, the federal government also removed almost all the restrictions and guidelines attached to the funding with the sole remaining requirement that provinces not establish residency requirements for social assistance. Thus all three major federal social grants, which in 1996 became the “Canada Health and Social Transfer,” were now block grants with many fewer conditions imposed on the provinces outside of health care. As Kneebone and Fuss explain, less federal control over how federal transfer money was spent led to innovations and greater variety both in how much social assistance provinces delivered as well as in how, in what form (i.e., cash or non-cash benefits), and to whom they delivered it.

University of Calgary economist Professor Trevor Tombe takes up the related question of how the 1995 budget changed federal-provincial fiscal arrangements. In addition to switching the Canada Assistance Plan over to block funding the budget cut federal transfers to the provinces by an amount equal to three percent of provincial revenues, the largest single reduction in federal transfers to provincial governments in Canadian history. In theory at least, federal transfers consisted of cash payments but also of revenues the provinces raised using tax room Ottawa had ceded to them over the years. Under the rules of the day, the cash and tax-room transfers added up to the same per capita amount for all provinces. As part of achieving that, provinces whose tax room generated more revenue
received a smaller cash top-up. As the goal of the 1995 budget was to save Ottawa cash, the cash cuts hit better-off provinces disproportionately, effectively doubling the inequality of federal transfers. After Ottawa’s fiscal situation improved, however, the system was gradually re-jigged to make cash transfers equal per capita across provinces, leaving equalization to offset differences in provincial fiscal capacities. The new system that eventually emerged enhanced both the effectiveness and efficiency of federal transfers.

Canadian economist David Henderson (Professor Emeritus of economics at the Naval Postgraduate School in Monterey, California) examines how the concept of a “fiscal anchor” helped the Chrétien government achieve its broader fiscal goals. As Henderson explains, a fiscal anchor, or over-riding budget rule, guides a government in its decisions over allocating spending and raising revenues. The Chrétien government did not immediately adopt the anchor of a balanced budget but once it had achieved balance it then adopted the target of reducing the absolute value of the debt, which required running budget surpluses. Two techniques that allowed it to succeed were contingency buffers built into the budget and consistent underestimation of revenues. In three budget years (1997, 2000
and 2003) realized revenues exceeded budgeted revenues by more than $15 billion. The government’s strong fiscal discipline, made possible by its bringing on board a durable fiscal anchor, eventually enabled it to reduce the country’s real (i.e., inflation-adjusted) debt, its debt-to-GDP ratio, and its debt per person.

Fraser Institute economists Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill describe how the improvement in the federal government’s fiscal situation following the 1995 budget enabled it to gradually lower taxes in ways that improved Canada’s tax competitiveness and contributed to stronger economic performance in the first years of the new century. The government began to reduce personal income taxes in earnest in 1998, the year after the budget was balanced. Its first major tax cut, though, was the full indexation of the personal income tax in 2000, a reform that ensured taxpayers would thereafter only be taxed on real, rather than inflation-generated increases in their incomes. In 2001 the government removed a five percent surtax that had applied to upper-income taxpayers. It also reduced statutory personal income tax rates from 17 to 16 percent, from 25 to 22 percent, and from 29 to 26 percent. It introduced a
new top bracket with the previous rate of 29 percent for those with taxable incomes greater than $100,000. Finally, it materially reduced the capital gains tax by lowering the amount of capital gains included in income for tax purposes, known as the inclusion rate, from 75 percent to 50 percent. The authors conclude that the tax relief introduced by the Chrétien government helped improve incentives for Canadians to engage in productive economic activities, which improved the country’s economic performance and competitiveness.

In a companion piece, noted economist Jack Mintz (founding director of the University of Calgary’s School of Public Policy and former economics professor at the University of Toronto) summarizes the federal government’s reform of the business tax system following the report of the Technical Committee on Business Taxation, which he chaired. Canada’s main tax problem in the late 1990s was high and uncompetitive business tax rates that were tilted to favour primary and manufacturing businesses.
over services. The Technical Committee recommended a more neutral system with lower tax rates and fewer exceptions and exclusions. Successive federal governments largely complied with these recommendations, with the result that the “marginal effective tax rate” on capital for large and medium-sized businesses declined from more than 45 percent in 2000 to a low of about 17 percent in 2012. This change coincided, as would be expected, with an increase in investment spending as a share of GDP, relatively more economic activity in services, and no appreciable decline in revenues from corporate taxation. In sum, corporate tax reform from 2000-12 created a more neutral and competitive tax system.

Finally, Don Drummond, Associate Deputy Minister in the Department of Finance during the reforms, who went on to be Senior VP and Chief Economist for TD Bank, explains how the bold policy actions the federal government took in the mid-1990s put Canada’s public finances onto a virtuous circle that continues to control its fiscal fortunes today. Drummond explains how the determined actions of the Chrétien-Martin governments—coupled with some positive external factors such as a strong US economy—transformed a deficit of over $30 billion in 1995-96 into a surplus of $14.3 billion by 1999-00. The government’s electoral
success during this time showed that Canadians generally bought into the fiscal policies of the government—restrained and prioritized spending, balanced budgets, declining debt and tax relief. Importantly, Drummond explains how the fiscal policies of the decade preceding the crash of 2008 and the Great Recession that followed positioned Canada better than most G7 countries not only to weather the fiscal storm but then to return expeditiously to the productive policies of the Chrétien era. Drummond also warns, however, that the deficits of today that continue in excess of $20 billion despite the economy operating close to or even at capacity raise serious questions about the federal government’s commitment to the responsible path chosen in 1995.

As these essays show, the depth and breadth of the reforms enacted in the 1995 budget are impressive, indeed historic. They set the stage for more than a decade of fiscal responsibility and economic prosperity and provided a strong fiscal foundation that stood Canada in good stead during the turbulence of the 2008-09 financial crisis and recession. The hallmarks of fiscal responsibility established in 1995 and continued for at least ten years—restrained and prioritized spending, balanced budgets, declining debt, generalized tax relief, and greater federal-provincial decentralization—ultimately served the country very well. In view of the challenges and difficulties Canadians and their politicians faced in reversing 30 years of fiscal drift, it is surprising and disappointing on this 25th anniversary of such an important milestone in the country’s fiscal history that the current federal government has explicitly rejected budget balance, debt reduction, and universal tax relief as fiscal principles. It is our hope that helping Canadians understand the success of the 1995 budget—and the costs of the alternative approaches once again being favoured—will encourage a return to sounder and more productive fiscal policies.

—William Watson and Jason Clemens
INTRODUCTION

The 1995 Budget, 25 Years On

William Watson *

At a working dinner at Stornoway in February 1993, Liberal Party of Canada leader Jean Chrétien was asked by a quartet of policy experts he had convened what his strategic goals would be as prime minister should he prevail in the federal election that had to be held later that year. According to Edward Greenspon and Anthony Wilson-Smith in their 1996 book Double Vision: The Inside Story of the Liberals in Power, Chrétien said he had three priorities if he won the election: “To keep the country independent from the United States. To keep the International Monetary Fund out. And to maintain the unity of Canada” (Greenspon and Wilson-Smith, 1996: 25).

Canada-US relations and national unity have been permanent preoccupations of Canadian prime ministers since 1867 so it is not surprising Chrétien would be concerned about them, too. From the perspective of 2020, however, keeping out the International Monetary Fund (IMF) seems a strange anachronism. In the last quarter century Canadians have become accustomed to thinking of their country as a paragon of fiscal responsibility. The idea that the IMF might have to intervene in Canadian affairs seems as far-fetched as, say, the UN having to send peacekeepers to patrol the streets of our major cities.  

In 1993, however, that was not the case. For 24 straight years, since the first full year of Pierre Trudeau’s first government, the federal government had run deficits, sometimes large ones, and its debt had grown apace. By 1992-93, the last fiscal year of the Mulroney government, the deficit (the difference between current-year revenue and current-year expenditures) was $39.0 billion—$61.6 billion in 2019 dollars. The deficit was 5.4 percent of GDP (though it had been as high as 8.1 percent in 1984-5). The government’s accumulated deficit—its debt—was $449.0 billion,

* Endnotes, references, and the author biography can be found at the end of this document.
equivalent to $709.6 billion in 2019 dollars. The debt had risen from its post-war low of 18.4 percent of GDP in 1974-5 to 62.7 percent and rising. (It peaked at 66.8 percent of GDP in 1995-6.)

What may be even worse than the absolute numbers, Ottawa’s inability to get its finances under control had given rise to a crisis of confidence in government itself. In successive budgets, the Mulroney government had printed a chart showing the federal deficit peaking two or three years out but then declining. Budget after budget, however, the projected decline stayed in the out years. Eventually, after it never did materialize, the government stopped printing the chart.

At the time of the 1993 election, interest payments on the debt were running at $41.3 billion a year, or $65.3 billion in 2019 dollars. That translated to fully 33.2 percent of federal revenues. In short, one of every three dollars of federal revenue was going to pay interest rather than for the goods and services or money transfers that Canadians regarded as the proper function of government. This shortfall led to another kind of crisis of confidence in government. Because few Canadians perceived any benefit from interest payments on the national debt, the cost of what public services were being delivered seemed one-third higher than it should have been.

In November 1993 the Liberals were elected on one of the most detailed platforms a Canadian political party had ever published, their famous “Red Book.” Its purpose was to persuade voters the party was ready for power, as had not been the case in 1988, when after a surge in support following the great free trade leaders’ debate of that year, it became clear the Liberals had no plan for government beyond tearing up the trade agreement. The Red Book’s other purpose was to establish consensus on difficult policy issues among the various factions of the Liberal party itself. On the contentious question of deficits and debts the compromise reached was to mimic the entry conditions of the European Union’s then year-old Maastricht Treaty and aim for a deficit of three percent of GDP.

The budget Finance Minister Paul Martin presented in February 1994, just 126 days after taking office, aimed to do just that. Initially it was well received. But a bump-up in interest rates over the next few months threw it badly off course. Short-term rates rose 400 basis points by the end of the year and forecast interest payments ballooned by an estimated $6 billion ($9.5 billion in 2019 dollars). A major lesson of Canada’s experience with high and rising debt in the 1970s and 1980s—one that may not be sufficiently appreciated by readers who have come to economic maturity during the last few years of very low interest rates—is precisely that when a government’s debt is high unforeseen spikes in interest rates can leave its budget in shreds. As motivation for Martin’s 1995 budget strategy, the importance of ending the debt’s ability to bushwhack government policy
cannot be underestimated. As the minister later put it: “Our goal in beating the deficit is not simply to make the bond market feel better. Our goal is to be in a position to tell the bond market to get lost” (Greenspon and Wilson-Smith, 1996: 293).

By mid-1994, the Chrétien government had become convinced that the 1995 budget would require extreme measures if it were to achieve the declared goal of meeting its budget targets and restoring Canadians' confidence in the federal government's ability to keep its budgetary promises. Starting in mid-summer, the department of finance began meeting with ministers to inform them how much cutting was to be required and to discuss ways in which they would do it. At the same time, cabinet member Marcel Massé, a former Clerk of the Privy Council, began “Program Review,” an exercise in zero-based budgeting. Ministerial consultations with Finance Minister Paul Martin and Massé became known around Ottawa as the “Star Chamber.” Some departments were put on what must have seemed like a fiscal rack. The requirement for Industry, for instance, was a 60 percent reduction in industrial subsidies.

The budget that resulted was sold as epoch-making. In his budget speech Finance Minister Martin declared:

Mr. Speaker, there are times in the progress of a people when fundamental challenges must be faced, fundamental choices made—a new course charted. For Canadians this is one of those times... We can take the path—too well trodden—of minimal change, of least resistance, of leadership lost. Or we can set out on a new road of fundamental reform, of renewal—of hope restored (Greenspon and Wilson-Smith, 1996: 273).

Similarly heroic language accompanies many budgets. But the 1995 budget really did take extreme measures. It cut government spending, not just in real terms, which is rare enough, but also in nominal terms, something that had not been seen since before World War II, and it did so for two years running. It re-made federal-provincial fiscal relations by completing the switch from tied to block grants that was begun in 1977 by the Trudeau government. It did away with the Crow Rate rail transportation subsidies that had stood since 1897. It cut the CBC to such an extent the corporation’s president resigned in protest the next day. It reduced Unemployment Insurance benefits and it promised, though it did not deliver, a reform of old age security, a decision that caused a last-minute dispute between Martin and Chrétien. And it set the stage both for the elimination of the federal deficit, which was achieved in 1997-98 and lasted for 10 years, as well as for reductions both in the absolute value of the debt and in the debt-to-GDP ratio—with the latter falling to under 30 percent.
of GDP, not as low as its post-war minimum but sufficient to establish the period of fiscal stability that has allowed most Canadians to forget about the possibility of the IMF intervening in our economic policy.

Did the 1995 budget change Canadian fiscal policy forever? No. After a difficult and impressive but also necessary step-down in both the level of federal spending and its share of GDP, spending eventually returned to trends that had been observed before the 1995 budget. But by then both were better proportioned to the economy’s ability to sustain them, which meant the vicious circle of interest payments leading to more debt leading to more interest payments finally was ended—or at least has been for two decades.

The question this generation of Canadians now faces is whether deliberately departing from the political consensus that held sway from 2000 to 2015 of favouring balanced federal budgets threatens a return to the potentially unstable debt dynamics of 1975 to 1995. The philosopher George Santayana famously said that those who cannot remember the past are condemned to repeat it. Though it does not strictly follow that those who do remember the past won’t be similarly condemned, a good understanding of what happened 25 and more years ago cannot hurt. To that end, the papers in this volume examine nine aspects of the 1995 budget, its precursors and consequences.
CHAPTER 1

The Path to Fiscal Crisis: Canada’s Federal Government, 1970 to 1995

By Livio Di Matteo*

Appreciating what brought Canada to the point of a fiscal crisis in the early 1990s is crucial to understanding the significance and impact of the 1995 federal budget. Just as Rome wasn’t built in a day, the sorry state of federal finances in the mid-1990s was the result, not of sudden misfortune, but of a long series of decisions—and non-decisions—often aggravated by economic conditions. Warnings through the 1980s about the dangers of the growing federal debt had sparked concerns, but efforts to address the problem proved insufficient until matters evolved into a crisis. In part, this was because in influential policy circles residual Keynesianism often held that debts and deficits, far from being inherently bad, were a way to deal with economic slowdowns.

As figures 1 and 2 show, in the two decades before 1995, federal finances underwent a dramatic transformation. From 1973-4 to 1995-6, revenues rose from $23.0 billion to $140.3 billion while expenditures grew from $25.2 billion to $170.3 billion. A large and persistent gap emerged between the two, a deficit that widened from $2.2 billion in 1973-4 to $39 billion at its peak in 1992-3, after which balance eventually returned. Though often at the time justified on Keynesian grounds, after 1975 federal deficits were primarily structural: in 13 of 16 years to 1990 the federal government’s cyclically adjusted budget—that is, after accounting for spending increases and revenue reductions brought about because GDP was short of its full-employment value—was in deficit (Canada, Department of Finance, 2010: table 46).

* Endnotes, references, and the author biography can be found at the end of this document.
Figure 1: Canadian Federal Government Revenues, Expenditures, and Deficits, 1969-70 to 2000-01 ($ billions)

![Diagram showing Canadian Federal Government Revenues, Expenditures, and Deficits, 1969-70 to 2000-01 ($ billions)](image)

Source: Canada, Department of Finance, 2019, *Fiscal Reference Tables 2019*.

Figure 2: Canadian Federal Government Net Debt ($ billions) and Net Debt to GDP (%), 1969-70 to 2000-01

![Diagram showing Canadian Federal Government Net Debt ($ billions) and Net Debt to GDP (%), 1969-70 to 2000-01](image)

The federal government ran an overall deficit every year from 1970-1 to 1996-7—at 27 years it was the longest string of deficits in the country’s history. Even the Great Depression and the demands of the war years had not extracted such a toll of continuous deficits. As a share of GDP, the deficit peaked following the recession of the early 1980s, hitting 8 percent in 1984-5. Meanwhile, from the early 1970s to 1995-6, the net federal debt rose from $20 billion to nearly $600 billion, while the federal debt’s ratio to GDP rose from 20 percent in 1973-4 to its peak of 72 percent in 1995-6.

The 1970s saw the beginning of a structural shift in Canadian and global economic performance that ended the post-war economic boom and “golden age” of economic growth. The first OPEC energy shock of 1973 quadrupled oil prices and triggered an international slowdown in growth. Canada experienced the slowdown in unique ways, given its intense reliance on natural resources and the regional tensions that were aggravated by political issues regarding resource wealth and Quebec sovereignty. Growth had been slowing prior to 1973, with the federal government recording several deficits in the run-up to the 1973-4 fiscal year. However, the supply-side shock from OPEC established a pattern of lower real GDP and productivity growth accompanied by rising inflation, rising unemployment, and ultimately, large deficits.

The initial policy response to these economic challenges embodied the view that interventionist government could address economic fluctuations with counter-cyclical fiscal and monetary policy. This view helped create rising deficits, the accumulation of a massive debt, and ultimately the fiscal crisis of the early 1990s. As for inflation, the federal government first responded with a regulatory approach that was largely ineffective. It included the Prices and Incomes Commission (1969-72), the Anti-Inflation Board (1975-78) and the “Six and Five Program” in 1982, voluntary wage restraint introduced by Ottawa and promoted with business and union groups (Perry, 1989: 6). In the end, however, only monetary restraint and the consequent steep rise in real interest rates could finally break the inflationary cycle of the 1980s, even as it worsened the fiscal crisis by causing debt service costs to soar.

As first nominal and then real interest rates had risen through the end of the 1970s and into the early 1980s, federal debt service costs grew dramatically, from just under $2 billion annually in the early 1970s to their eventual peak of nearly $50 billion a year in the mid-1990s. As a share of GDP, debt charges rose from 2 percent to just over 6 percent in the early 1990s. By the mid-1990s nearly one of every three dollars spent by the federal government went to interest payments. As Don Drummond points out in his contribution to this volume, such high interest payments created

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a vicious fiscal circle: revenues could only cover program spending, not total spending.

Through the 1970s, weaker economic growth caused weaker federal revenue growth, a trend reinforced by tax policy changes such as inflation indexation of the personal income tax and a proliferation of tax expenditures that narrowed the corporate and personal tax bases. The decade also saw deduction limits raised for contributions to registered pension plans and retirement savings plans, as well as increases in personal exemptions and the exemption for the elderly. The employment expense deduction was also introduced, as well as deductions for post-secondary students, for interest and dividend income, and for registered home ownership savings plans (Gillespie, 1991: 212-213).1

The years before 1995 were witness to various attempts to address the deficit and debt, and in its final years the Mulroney government did manage to turn the federal operating balance—i.e., the fiscal balance not counting interest payments—from deficit to surplus. Along the way, there were cost-restraining reforms to the federal transfer payment system. In 1977, Established Program Financing (EPF) replaced open-ended federal-provincial cost sharing on health with a block grant. In 1984, the Canada Health Act (CHA) tied the receipt of federal transfers to fulfillment of basic conditions for running a comprehensive and fully public health care system.

Conservative finance ministers Michael Wilson (1984-91) and Don Mazankowski (1991-93) repeatedly addressed the deficit but never seemed able to do enough, as rising debt service costs offset restraint. The Conservative tax reform of the late 1980s did recognize the importance of taxation in facilitating economic growth. Its first stage, in 1988, reduced the number of personal income-tax brackets from 11 to three and lowered marginal rates. The second stage, 1991’s consumption tax reform, replaced the federal Manufacturers’ Sales Tax with the broader-based and lower-rate Goods and Services Tax.

Until the actions of the Chrétien government in the mid-1990s, however, these efforts at deficit control proved insufficient. In the end, rising debt service costs and the wake-up call of the 1994 Mexican peso crisis finally led to decisive budgetary action in the form of 1994’s Program Review2 and Budget 1995,3 which together set the federal government on the path to a balanced budget and helped pave the way for the substantial economic progress made between the late 1990s and the 2008-09 global financial crisis and recession.

There are two key takeaways from the 20 years leading up to the fiscal reckoning of the mid-1990s: how important fiscal discipline is and how harmful the long-term effects of profligacy and delayed action can be. The unprecedented string of deficits leading up to what amounted to emer-
gency fiscal action by the Chrétien government was not the result of war or depression. In the end, there was little to show from the high deficits, debt, and debt service costs of this era, given that the extra spending they enabled had fueled current consumption rather than capital spending. In fact, the high interest rates the deficits helped cause reduced government capital spending by diverting resources to debt servicing and were also very likely a factor in weaker private capital investment. The result was a steep decline in public and private capital investment in Canada from a peak of 8 percent of GDP in the late 1960s to just 4 percent by the mid-1990s (Bazel and Mintz, 2015: 7). The resulting deterioration in Canada’s physical infrastructure would not begin to be remedied until the early 21st century.
Chapter 2

Spending Reductions and Reform: Bases for the Success of the 1995 Budget

By Lydia Miljan, Tegan Hill, and Niels Veldhuis

Introduction

As the introduction to this volume and several of the other essays point out, the 1995 federal budget was an historic achievement. It reversed more than three decades of growth in federal spending, mainly based on ever-larger deficits, which by the early 1990s had left federal finances in a near crisis. Thirty-plus budgets leading up to 1995 had all, to varying extents, paid lip service to the need to control spending and balance the budget. But the 1995 budget was the first to take concrete, purposeful, determined action to do so. More specifically, it reduced and reformed nominal spending over a short period to achieve a balanced budget. As Finance Minister Paul Martin stated in his Budget 1995 Speech: “We are acting on a new vision of the role of government in the economy. In many cases that means smaller government. In all cases it means smarter government” (Canada, 1995a: 6).

This essay touches on the historical significance of that approach, the success of focusing on spending reductions and reform, and the process by which the government achieved such large-scale changes in such a short time.

* References and the authors' biographies can be found at the end of this document.
A history of deficits

The 1995 budget came at a time when federal finances were facing considerable challenges. Between 1965 and 1995 Ottawa had incurred deficits in all but two years: 1965-66 and 1969-70. Nominal program spending had increased almost without exception during those three decades and public debt charges consumed an ever-growing share of government resources, squeezing out both spending on other programs and tax relief. By the early 1990s, the country was close to a debt and currency crisis.

Figure 1 shows the fiscal balance, i.e., the federal government surplus or deficit, over this period. Figure 2 shows the nominal value of federal program spending. As the figures demonstrate, nominal program spending increased throughout the three decades and was financed largely with deficits (i.e., borrowing). To be absolutely clear, successive governments chose to borrow in order to finance their increased spending.

Some governments—Liberal and Conservative, majority and minority—did recognize the problems caused by the persistent growth in spending. No fewer than 24 budget speeches in the three decades preceding 1995 explicitly declared a policy of expenditure restraint (Hill et al., 2019). Restraint was operationalized as a reduction in the growth of spending,
however, rather than in the actual amount of spending. Although the federal government claimed to recognize the problems posed by accumulating deficits and mounting debt it took few concrete actions to stem either.

**The 1995 budget**

In 1994, the newly elected Liberal government of Jean Chrétien took the first steps toward restoring stability to federal finances with the introduction of *Program Review*. Unlike previous initiatives, *Program Review* was a concerted, government-wide effort to review and assess federal spending with the twin objectives of eliminating the deficit and assessing government policies on the basis of “value for money.” Six specific questions guided the assessment of current spending:

- Does the program serve the public interest?
- Is it affordable?
- Is government intervention necessary?
- What is the appropriateness of the federal government’s involvement?
- Is there potential for private/public sector cooperation?
- Is it efficient?
Program Review was thus intended not only to reduce spending but also, and even more importantly, to determine the appropriate role of the federal government in delivering programs and services to Canadians. Its comprehensive review required ministers to evaluate all programs and services offered by their departments and to determine which could be reduced or eliminated based on the six questions. A critical feature of Program Review was that no department, agency, organization, or Crown corporation escaped review (Bourgon, 2009).

Budget 1995 was the first to be derived from Program Review. The government identified and introduced spending reductions across almost all federal departments and programs. Table 1 summarizes the planned reductions across departments between 1994-95 and 1997-98. Transport spending saw the deepest cut: 50.8 percent. Natural Resources was next, at 49.4 percent, while industrial and regional support programs were to be reduced by 46.0 percent. The smallest cuts, though still significant, were in heritage and cultural programs, social programs, foreign affairs and international assistance, and defence. All departments, excluding only social programs and justice, incurred reductions in spending in excess of 10 percent. Indian Affairs and Northern Development was one of the very few areas to experience an increase in spending.

In total, Program Review was expected to reduce federal spending by $16.9 billion over three years. The federal government projected that when Program Review was combined with other cost-reducing measures spending would fall by $25.3 billion from 1995-6 to 1997-8. In addition, the share of the economy consumed by government spending would decline markedly, from a peak of 17.1 percent in 1992-3, just before the Chrétien Liberals were elected, to a low of 11.8 percent in 1999-2000 and 2000-01 (Canada, DoF, 2019: table 2).

A significant reason for the government’s success in balancing the budget in relatively short order was its overwhelming reliance on spending reductions rather than tax increases. A significant body of research supports a policy of spending cuts over tax increases (see Alesina, 2017). One reason is simply that reducing and reforming spending is entirely within the control of the government. By contrast, relying on tax increases has proved less successful over time. Budgeted revenues often do not materialize, usually because taxpayers’ predictable behavioural responses to higher rates mean anticipated revenue increases simply do not occur (see Ferede, 2019 and Laurin, 2018). As it was, tax measures played only a supplementary role in the Chrétien government’s budget plan, accounting for just $3.7 billion of the total of $29 billion in direct savings. The most notable were a new tax on the investment income of private corporations, elimination
Table 1: Reductions in Program Spending After Program Review

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<th>Sector</th>
<th>Spending (billions)</th>
<th>Reductions</th>
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<td></td>
<td>1994-95</td>
<td>1997-98</td>
</tr>
<tr>
<td>Natural Resource Sector</td>
<td>4.8</td>
<td>3.3</td>
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<td>Agriculture</td>
<td>2.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Fisheries and Oceans</td>
<td>0.8</td>
<td>0.6</td>
</tr>
<tr>
<td>Natural Resources</td>
<td>1.3</td>
<td>0.6</td>
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<tr>
<td>Environment</td>
<td>0.7</td>
<td>0.5</td>
</tr>
<tr>
<td>Transport</td>
<td>2.9</td>
<td>1.4</td>
</tr>
<tr>
<td>Industrial, Regional and Scientific Programs</td>
<td>3.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Industry (and specified agencies)</td>
<td>1.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Science and Technology Agencies</td>
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</tr>
<tr>
<td>Regional Agencies</td>
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<td>0.6</td>
</tr>
<tr>
<td>Justice and Legal Programs</td>
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<td>3.1</td>
</tr>
<tr>
<td>Justice</td>
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<tr>
<td>Solicitor General</td>
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<td>2.4</td>
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<tr>
<td>Heritage and Cultural Programs</td>
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<td>2.2</td>
</tr>
<tr>
<td>Foreign Affairs and International Assistance</td>
<td>4.1</td>
<td>3.3</td>
</tr>
<tr>
<td>Foreign Affairs/International Trade</td>
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<td>1.2</td>
</tr>
<tr>
<td>International Assistance Envelope</td>
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<td>2.1</td>
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<td>Social Programs</td>
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<td>12.0</td>
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<td>Citizenship and Immigration</td>
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<td>0.6</td>
</tr>
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<td>Health</td>
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<td>1.7</td>
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<td>Human Resources Development</td>
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<td>Indian Affairs and Northern Development</td>
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<td>Canada Mortgage and Housing</td>
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<td>1.9</td>
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<td>Veterans Affairs</td>
<td>2.1</td>
<td>1.9</td>
</tr>
<tr>
<td>Defence/Emergency Preparedness</td>
<td>11.6</td>
<td>9.9</td>
</tr>
<tr>
<td>General Government Services</td>
<td>5.0</td>
<td>4.1</td>
</tr>
<tr>
<td>Parliament/Governor General</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Total</td>
<td>51.9</td>
<td>42.1</td>
</tr>
<tr>
<td>Percent of GDP</td>
<td>7</td>
<td>5</td>
</tr>
</tbody>
</table>

Notes: Numbers may not add due to rounding or the exclusion of other relatively minor line items
Source: Canada, Department of Finance, 1995b.
of the deferral of tax on business income, reduced contribution limits for RRSPs and money purchase plans, and rate increases for the large corporations’ tax, the corporate surtax, and gasoline and tobacco taxes.

Figure 3 shows the breakdown of spending cuts versus tax hikes in Budget 1995. According to the government, there would be only one dollar of revenue increase for every seven dollars (roughly) of spending reduction (Canada 1995b: 9). Specifically, in 1995-6, spending reductions would account for $4.1 billion in savings and tax measures only $0.9 billion. The equivalent numbers over the next two fiscal years were to be $9.3 billion vs. just $1.3 billion and $11.9 billion vs. just $1.4 billion. Over the entire three years the ratio of spending cuts to tax increases was to rise from 4.6 to 7.2 to 8.5. All this reflected the federal government’s conscious decision to focus on spending cuts rather than tax increases.

The results

As a result of Budget 1995 and the reforms it introduced, the federal government exceeded its deficit reduction targets. By 1997-98, only two years after the Budget 1995 spending cuts, the budget was in surplus for the first
time in a quarter century (at $3.0 billion). It would remain in surplus for the next decade (see figure 1).

It should be stressed just how unusual an event the reduction in nominal program spending introduced in the 1995-6 budget was. As figure 2 shows, nominal program spending declined from $123.2 billion in 1994-95 to $111.3 billion in 1996-97—nearly $12 billion—a 9.7 percent reduction in spending over two years. This reduction in nominal-dollar spending occurred at a time when both population and the price level were rising. It therefore represented a real cut in per capita federal spending, a rare occurrence in Canadian fiscal history.

In 1996-97, public debt charges also began to fall in nominal terms and by 1997-98 so, too, did the federal debt (Canada, 2019). Both these trends continued until the 2008-9 recession. As a result, by 2008-09, public debt charges only consumed 11.9 cents for each dollar in tax revenue, compared to 38.0 cents in 1990-91, while the federal debt was down to $468 billion, a reduction of $95 billion from its peak of $563 billion 1996-97.

Conclusion

From 1965 to the early 1990s the nominal program spending of Canada’s federal government grew routinely, year after year, and efforts to curtail it were, with few exceptions, insufficient, impermanent, or poorly implemented. The government’s habit of financing its spending by borrowing culminated in a near-crisis in 1995. The reforms implemented in Budget 1995 quickly restored fiscal balance and sustainability to federal finances. A critical component of these reforms was Program Review, which led to reduced and reformed government spending. No departments, organizations, or agencies were excluded from review and the cuts it led to constituted, for the most part, actual reductions in nominal spending, not simply reductions in the growth rate of spending. The expenditure reductions brought about by Program Review led to nearly a decade of budgetary surpluses, substantially reduced the federal debt, and vastly improved the state of federal finances.
CHAPTER 3

How the Chrétien-Martin Budgets Cut Corporate Welfare in the Mid-1990s

By Mark Milke*

As noted in several of the other essays in this collection, the Chrétien government introduced reductions in the nominal amount of federal spending in the 1995 and 1996 budgets. A key component of those reductions were cuts to subsidies to businesses.

One of the key reasons the fiscal crisis was averted in Canada in the mid-1990s was that Canadians had the impression—correctly—that businesses were sharing in the reductions in federal government spending.

Crises focus the mind—and priorities. In the 1995 and 1996 federal budgets, one overdue reduction was to the amount of tax revenue funneled to what is best described as “crony capitalism.” The practice can also be described colloquially as “corporate welfare,” and academically as “targeting” (i.e., subsidies are “targeted” to a particular business or sector), or as industrial policy, or “investment.” Whichever term is preferred, it is a multi-billion-dollar practice that this author has previously chronicled (see Milke 2007, 2008, 2009, 2012, 2013, and 2014).

Corporate welfare defined and an overview

Briefly defined, a government subsidy to business occurs when governments transfer tax dollars to business for reasons other than the receipt of goods or services. De facto subsidies can also occur where a preferential tax reduction, deduction, credit, or exemption is directed at one business

* Endnotes, references, and the author biography can be found at the end of this document.
or sector; such preferential tax treatment mimics direct subsidies even when no cheques are issued.

Research on business subsidies does not support claims that corporate welfare increases economic growth or job creation, two of the most often-heard contentions. At best, a generous interpretation of the literature suggests that subsidies may, in very specific locations, produce some effect on local economic behaviour. But this impact is typically offset by losses elsewhere in the economy from having tax rates that are greater than would be the case without the business subsidies (see World Trade Organization 2006; OECD, 2015). A fair reading of the research suggests that subsidies to business are not the best means by which to encourage economic and employment growth.

The 1995 and 1996 budgets: Re-thinking the role of government

With that noted, Canada’s 1995 and 1996 federal budgets significantly cut back the practice of crony capitalism. The savings to be achieved by cutting corporate welfare were deliberate and were part of an early and well-defined strategy to re-think the role of government. The 1995 and 1996 budgets were derived in part from a Program Review initiated in the fall of 1994 by Prime Minister Jean Chrétien and characterized as “fundamentally different from those tried in the past.” Federal cabinet ministers were asked to review their own portfolios and provide their views on the federal government’s future roles and responsibilities.

The 1995 budget

The 1995 budget was clear that business subsidies would be reduced in line with the stated priority to “deliver a new vision of the federal government’s role in the economy that includes substantial reductions in business subsidies” and that reductions in subsidies to business were part of the overall plan to reduce spending by $7 for every $1 in new taxes imposed on Canadians. The initial aim in Budget 1995 was to reduce federal program spending by $29 billion between 1994/95 and 1996/97; reducing grants and contributions to business were part of that sought-after cost-savings (Canada, 1995: 31, 32).

As part of that reduction, the federal government aimed to reduce what it characterized as “major business subsidies” by more than 60 percent over three years, or nearly $2.3 billion, with reductions ranging from just under one third in sectors such as agriculture, to over 97 percent in
transportation, and 98 percent of grants and contributions then flowing to the energy sector (Canada, 1995: 42) (see table 1).

**The 1996 budget**

This message continued in 1996, with the federal government noting that the previous two budgets and the 1996 one all aimed to define “a more appropriate role for the federal government in the modern economy and federation” (Canada, 1996: 7). As part of its self-titled section “Getting Government Right”, *Budget 1996* referred to the reductions in business subsidies already cut and noted that “This budget announces further reductions in business subsidies, continuing privatization and commercialization in cases where a federal role is neither required nor efficient...” (Canada, 1996: 16).

*Budget 1996* trumpeted the “dramatic decline in business subsidies” along with privatization, commercialization measures, and a redefinition of core responsibilities across all departments as explanations for why federal government spending was down and the fiscal situation was improving. *Budget 1996* was clear that the government was going to focus on high-priority areas and business subsidies did not qualify as such (Canada, 1996: 36). Thus, the federal government signalled its intent to “further

---

**Table 1: Major Business Subsidies (Grants and Contributions), *Budget 1995***

<table>
<thead>
<tr>
<th></th>
<th>1994-95 (millions of dollars)</th>
<th>1997-98 (millions of dollars)</th>
<th>Percent reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>1,322</td>
<td>893</td>
<td>32.5</td>
</tr>
<tr>
<td>Transportation</td>
<td>696</td>
<td>19</td>
<td>97.3</td>
</tr>
<tr>
<td>Regional development</td>
<td>700</td>
<td>234</td>
<td>66.6</td>
</tr>
<tr>
<td>Industry, innovation and market development</td>
<td>525</td>
<td>264</td>
<td>49.7</td>
</tr>
<tr>
<td>Energy and resource sectors</td>
<td>410</td>
<td>8</td>
<td>98.0</td>
</tr>
<tr>
<td>Cultural industries</td>
<td>104</td>
<td>68</td>
<td>34.6</td>
</tr>
<tr>
<td><strong>Total grants and contributions</strong></td>
<td><strong>3,757</strong></td>
<td><strong>1,486</strong></td>
<td><strong>60.4</strong></td>
</tr>
</tbody>
</table>

Note: Numbers may not add up due to rounding.
Source: Canada, Department of Finance 1995: 42.
clarify the core program responsibilities of the federal government in the economy – through further reductions in business subsidies, privatization and commercialization…” (Canada, 1996: 35).

As per the 1995 goal of reducing major corporate welfare expenditures, and now with a three-year estimate in view, of the expenditures that fell into the major grants and contributions category, the mildest reduction was to occur to regional development. The sharpest cuts occurring and planned were in the energy/resource and transportation sectors with reductions already underway (of just under 93 percent) and planned (of over 99 percent) (Canada, 1996: 40). The goal was still a reduction in grants and contributions by 60 percent or more, or nearly $2.3 billion in annual savings by year four, with planned cuts to corporate welfare dropping from over $3.7 billion in 1994/95 to under $1.5 billion by 1998/98 (see table 2).

Specific examples from Budget 1995 and Budget 1996

The cuts to corporate welfare grants for transportation and energy were possible due to a focus on ending the transportation grants that subsidized freight shipments in Atlantic Canada, the Prairies, and also on Via Rail (Canada, 1995: 42-45). The reductions included the end of subsidies that dated back to 1897 for shipping grain, which were worth an annual $560 million in 1995 (Canada, 1995: 42). The energy sector saw reductions in

Table 2: Major Grants and Contributions to Businesses, Budget 1996

<table>
<thead>
<tr>
<th></th>
<th>1994-95 (millions of dollars)</th>
<th>1998-99 (millions of dollars)</th>
<th>Percent reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>1,231</td>
<td>648</td>
<td>47.4</td>
</tr>
<tr>
<td>Transportation</td>
<td>778</td>
<td>7</td>
<td>99.1</td>
</tr>
<tr>
<td>Regional development</td>
<td>512</td>
<td>380</td>
<td>25.8</td>
</tr>
<tr>
<td>Industry, innovation and market development</td>
<td>546</td>
<td>313</td>
<td>42.7</td>
</tr>
<tr>
<td>Energy and resource sectors</td>
<td>515</td>
<td>37</td>
<td>92.8</td>
</tr>
<tr>
<td>Cultural industries</td>
<td>167</td>
<td>97</td>
<td>41.9</td>
</tr>
<tr>
<td>Total grants and contributions</td>
<td>3,749</td>
<td>1,481</td>
<td>60.5</td>
</tr>
</tbody>
</table>

Note: Numbers may not add up due to rounding.

Source: Canada, Department of Finance, 1996: 40.
grants to energy companies but also in grants to Atomic Energy of Canada Limited (Canada, 1996: 45).

In addition, and on a parallel track, the government was determined no longer to own commercially viable entities, and thus partially or fully privatized some companies, including all of the government’s remaining shares in Canadian National Railways, a substantial portion of the government’s shares in Petro-Canada, and all its shares in National Sea Products Limited, a Nova Scotia-based fish and seafood products company. The federal government also transferred some government-run agencies to the private sector. For example, it transferred Transport Canada’s Air Navigation System to Nav Canada, a new private sector corporation controlled by the airport sector’s stakeholders that was to operate as a non-profit (Canada, 1996: 42).

A clear understanding and a clear focus

The dramatic reductions in corporate welfare were possible partly because the federal government clearly grasped that both market interference and corporate welfare were often failures and did not deliver the often-promised results. *Budget 1995* quoted a 1994 OECD study to this effect, noting that “Subsidies tend to operate in exactly the opposite way from what is needed: they slow rather than stimulate adjustment; they discourage rather than encourage innovation; and they tend to become permanent” (Canada, 1995: 42).

Critically, the 1995 and 1996 budgets did not end all federal corporate welfare. The federal government continued to subsidize some businesses, including small businesses; it also continued regional development programs; and it focused more, at least initially, on subsidizing businesses through loans and loan guarantees. Over time, the federal government would again more heavily fund corporate welfare through regional development agencies, federal departments, and via loans, loan guarantees, and “contributions” (grants by another name)—and the grants would again be substantial (Milke, 2014). Nevertheless, as part of the initial mid-1990s attempt to dramatically reduce federal spending, a drastic reduction in business subsidies was a key part of bringing Canada’s federal finances into balance.
Chapter 4

Budget 1995 and Welfare Reform

By Ron Kneebone and Jake Fuss*

From 1977 until the 1995 budget and subsequent reforms, federal government funding to assist provincial governments in providing income support and health care came via two programs: Established Programs Financing (EPF) and the Canada Assistance Plan (CAP). EPF was a block transfer meant to help finance post-secondary education and health care. CAP was a cost-sharing arrangement in which the federal government reimbursed provinces for half their social assistance costs so long as they met certain federally-imposed conditions, including a prohibition on work requirements for the receipt of benefits (Eisen et al., 2016). The CAP transfer meant provincial governments could design income support programs safe in the knowledge that they were only spending “50-cent dollars.” Open-ended cost-sharing through CAP meant the federal government would pay the other 50 cents.

The 1990-91 recession contributed to a dramatic increase in the number of people relying on social assistance benefits. Between 1990 and 1994 the number of social assistance beneficiaries in Canada increased by nearly 1.2 million. Sixty percent of this increase occurred in Ontario, which at the time had only 37 percent of Canada’s population. By 1994, nearly 11 percent of Canadians depended on social assistance, double the 5.5 percent that had in 1975 (Clemens, 2011).

At the same time as the number of people on social assistance was rising, the federal government came to realize it was in a fiscal crisis that would require large cuts in spending. In the end, much of the heavy lifting to resolve the crisis came via cuts in federal transfers to the provinces and a reform of how the transfers worked.

* Endnotes, references, and the authors’ biographies can be found at the end of this document.
Changes to federal transfers

In 1996 Ottawa ended cost-sharing by replacing ETF and CAP with the block-funded Canada Health and Social Transfer (CHST) (Clemens, 2011). As Boychuk (2006) notes, the introduction of the CHST ended any pretense that the federal government ensured uniform standards of social assistance across the country. The only funding requirement that remained was the prohibition on provincial residency requirements. The lack of cost-sharing meant provinces would no longer be spending 50-cent dollars. On the other hand, with the withdrawal of federal conditions a range of policy options opened up for them.

In addition to ending cost-sharing, the 1995 budget reduced the amount transferred to provinces. As figure 1 shows, combined spending on the EPF and CAP was projected to be $29.7 billion in 1995-96. The budget aimed to cut nearly $3 billion from the total grant by 1996-97 (see Canada, 1995: 51-54). The 1996 budget reduced CHST spending to $25.1 billion in 1997-98 and froze funding for three years until 2000-01. The CHST would then begin to increase in line with GDP growth (see Canada, 1996: 56-60).

Figure 1: Planned Spending through Established Programs Financing (EPF) and Canada Assistance Plan (CAP) vs. Spending through Canada Health and Social Transfer (CHST), 1993/94 to 2002/03

Sources: Canada, 1995; 1996.
Provincial social assistance reforms

The large cut in the federal transfer and the elimination of cost-sharing provided provincial governments with a strong incentive to innovate in the design and delivery of social assistance. As noted by Kneebone and White (2009), with cost-sharing gone provincial governments would now capture the whole of any savings they could produce. Two types of policy reform followed: one involved changing how eligibility for social assistance was determined while the other altered the manner in which benefits were provided.

Eligibility rules were tightened in many provinces and there was a renewed focus both on trying to integrate welfare recipients back into the workforce and in preventing them from accessing benefits in the first place. In Alberta, for example, benefit payments were reduced for people deemed employable who had quit their job. Some supplemental benefits were completely eliminated and timelines for social assistance eligibility were also reduced. Significant changes in British Columbia included limiting individuals to receiving social assistance for no more than 24 months within any 60-month period, while in Ontario recipients who failed to participate in employment programs were refused social assistance for three months (Clemens, 2011).

Provincial governments’ other main response to the new funding arrangements was to reconsider how and in what amounts benefits were provided. In 1997, for instance, approximately 85 percent of the social assistance benefit paid to a lone parent with one child was in the form of a cash payment. By 2018 this would fall to approximately 60 percent. The decline was the result of two things. First, Ottawa’s decision, made shortly after its cut to provincial transfers, to play a larger and more direct role in social assistance via the provision of federal child benefits. This allowed provincial governments to reduce their own contributions in virtual lockstep with the growth in federal child benefits and so see total benefits remain more or less constant in real terms even as provincial payments declined. The second reason for the fall in the relative importance of the provincial cash payment was the provinces introducing new ways of providing benefits.

In BC, provincial child benefits have come (in 1996) and gone (in 2005) and then reappeared (in 2015). A small provincial tax credit was significantly increased in 2008 but then was cut in half in 2014. Alberta discontinued certain additional benefits in 2004 and did not introduce a child benefit until 2016. Child benefits in Saskatchewan were introduced in 1998 but were discontinued in 2006, while a provincial tax credit introduced in 2000 has continued to this day. Manitoba has never offered a provincial child benefit. In 2014 it cut the cash benefit and replaced it with
what is now a very large housing benefit. In addition to its cash benefit, Ontario provided additional benefits from 1997 to 2007 but these were replaced in 2007 by a provincial child benefit. The government of Quebec has always provided a large child benefit and starting in 2005 traded a reduced cash benefit for additional non-cash benefits. The governments of New Brunswick and Nova Scotia have, like Quebec, always offered a provincial child benefit, though a much smaller one. Beginning in 2010 in Nova Scotia and 2011 in New Brunswick these governments introduced a new provincial tax credit as a way of providing additional support. Newfoundland & Labrador is unique among the provinces for having provided benefits in the form of child benefits, tax credits, and additional non-cash benefits every year since 1997. PEI is also unique but in the opposite direction: it relied solely on a cash benefit until very recently (2013) when it also began offering a modest tax credit.

As this brief description suggests, how provinces provide social assistance has changed a great deal since 1995. Over time provinces have become more similar in their reliance on tax credits but less similar in terms of the amount of the basic benefit they provide. Child benefits have waxed and waned in both size and frequency of use by provincial governments.

Implications for social assistance programs

The changes to intergovernmental transfers introduced in 1995 allowed provinces the autonomy over program design that would enable them to tailor social assistance to local needs and preferences. The impact that autonomy had on social assistance programs can be measured in at least two ways. The first is in how the changes have influenced the number of people reliant on social assistance (see figure 2). This is challenging to determine in part because immediately following the 1995 federal budget the economy experienced a prolonged period of strong economic growth. Any estimate of the influence of policy changes on the fall in the percentage of the population relying on social assistance—from 10.7 percent in 1994 to 4.9 percent in 2008—has to control for that influence. In a careful attempt to do so, Berg and Gabel (2015) found that in provinces where they were introduced, changes in eligibility requirements had very large effects on the number of people using social assistance. They also reported a significant influence from changes in the dollar amount of social assistance benefits.

A second influence of the 1995 adjustments to intergovernmental transfers might be found in describing changes to who is reliant on social assistance. Key developments include a decline in child poverty rates and
singles replacing lone parents as the largest demographic of social assistance recipients (see, for example, Pulkinson (2015)). These adjustments might be related to changes in how benefits are provided, whether via a cash benefit, a child benefit, a tax credit, subsidized childcare, or some other form of benefit delivery. Milligan (2016) has recently described the transformation in the way children are treated in the Canadian tax system, a transformation reflected in a myriad of changes to how transfers and benefits are delivered. He notes these changes likely have their roots in politics and changing preferences for income redistribution. As we have noted, there has been a great deal of variation since 1995, both across provinces and over time, in how provincial governments deliver social assistance benefits. These changes, like some of those Milligan described, have their origins in a political decision made in 1995 that provided provincial governments greater autonomy over the design of their social assistance programs and so enabled them to better align their programs with local preferences for redistribution.
Chapter 5

Effective, Flexible, and Affordable: Towards a New System of Federal-Provincial Transfers in *Budget 1995*

*By Trevor Tombe*

“With this budget,” said Finance Minister Paul Martin in his 1995 *Budget Speech*, “we are saying yes to the provinces’ desire to sit down for a bottom-up review of the financing of both levels of government... if there are ways to make this federation function better, then by all means let’s do it” (Martin, 1995: 19). Over the coming months and years, Ottawa and the provinces did just that.

The goal was to “modernize the federal-provincial fiscal regime, making it more effective, flexible and affordable” (Canada, 1995: 7) and to put transfers “on a basis that is more in line with the actual responsibilities of the two levels of government” (Martin, 1995: 7). The eventual changes were substantial.

*Budget 1995* significantly and fundamentally altered the size and structure of federal-provincial fiscal arrangements in Canada. Today’s transfers are less complex, more coherent, more sustainable, and more equitable than what had prevailed throughout most of Canada’s history. *Budget 1995* is why.

A new system of transfers to the provinces

First, *Budget 1995* merged two major transfer programs into one. The Established Programs Financing (EPF) and the Canada Assistance Plan

* References and the author biography can be found at the end of this document.
Figure 1: Federal Transfers to Provincial Governments, 1867 to 2018\(^1\)


(CAP) became what *Budget 1995* called a new Canada Social Transfer, later renamed the Canada Health and Social Transfer (CHST).

This was more than a simple consolidation. The previous programs evolved from explicit cost-sharing arrangements and featured many rules that provinces needed to follow. The new CHST was a block grant, with only minor restrictions on provinces imposed through the *Canada Health Act*. This flexibility allowed provinces to innovate in program delivery and disconnected federal spending from provincial decisions.

For provinces, though, this flexibility didn’t come cheap. *Budget 1995* reduced total transfers by over 15 percent or $4.5 billion in fiscal year 1997-98 relative to what EPF plus CAP would have been. Specifically, the CHST was projected to transfer $25.1 billion in 1997-98 but would have been a combined $29.6 billion had the EPF and CAP continued. This change alone was roughly three percent of total provincial revenues.

But this way of framing the change understates—dramatically—the hit the provinces took. At the time, federal transfers took two forms: tax-point transfers and cash transfers. The former reflected the value of federal income tax room given over to the provinces decades earlier. Because the provinces’ average incomes differ, these tax points had unequal value. The
cash transfer portion was a top-up to those tax points that raised all provinces to a common combined standard. In 1994-95, for example, the total nominal size of the EPF transfer was $735 per person, but the mix between tax points and cash varied. Provinces with higher-value tax points, such as Alberta, got less cash. This matters. Federal policy cannot affect the value of tax points (since they are actually provincial taxes), so the reductions in Budget 1995 came entirely through significantly smaller cash transfers. Budget 1995 estimated total non-equalization cash transfers to the provinces at $16.9 billion. By 1997-98, that was projected to fall 40 percent to $10.3 billion.

This represented the largest reduction in federal transfers to provincial governments in Canadian history. As figure 1 illustrates, there were large increases in transfers following the Second World War. They rose from roughly 1.3 percent of GDP in 1945 to over 4.0 percent by 1970, where they remained for a quarter century. That ended with Budget 1995, however. Within two years, transfers were down nearly 1.5 percent of GDP—equivalent to a $35 billion per year reduction today. And though they subsequently rose again, they remain today roughly 0.5 percent below their pre-Budget 1995 level.

To be sure, Budget 1995 did not cut all transfer payments. Equalization continued to increase, rising from $8.5 billion in 1994-95 to $9.7 billion in 1997-98. Equalization is designed to address horizontal differences between provinces in terms of their ability to raise revenue (their “fiscal capacity”). And while health and social transfers were not designed to address such differences, they featured significant implicit equalization as cash transfers were larger to provinces with weaker economies and therefore where tax-point transfers were worth less. Because of Budget 1995, as we’ll see, such differences in the value of cash transfers across provinces would eventually end.

**Greater equality between the provinces**

The tighter budget constraints of the mid-1990s made allocation rules for cash transfers critical. The federal government committed to “consult with provinces on the principles that should govern allocation of the [Canada Social Transfer] on a permanent basis thereafter” (Canada, 1995: 54. The effects of the resulting changes remain with us today.

Before Budget 1995, inequality in health and social transfers varied from year to year but, roughly speaking, approximately five percent of total transfers would have had to be reallocated in order to achieve perfect equality between the provinces. The funding reductions in Budget 1995...
dramatically increased disparities among provinces. When the cuts were fully phased in, the level of inequality was roughly double its pre-1995 level, as illustrated in figure 2 using a Schutz Index of inequality.

The cause of the large increase in inequality relates to the distinction between cash and tax-point transfers. As mentioned, only the former could be cut and their uneven distribution meant provinces with small per-capita cash transfers experienced a proportionally larger reduction. The drop in Alberta’s transfer by 1997-98, for example, was one-third larger than the national average.

Following consultations with the provinces, the federal government committed in Budget 1996 to a new five-year funding arrangement that, beginning in 1998-99, would gradually bring the allocation of health and social transfers closer to proportionality with provincial populations. By the government’s own measure, it planned to cut disparities in half by 2002-03. And it succeeded. But the process didn’t end there. In the government’s words, it remained “willing to examine with provinces further...
refinements to the allocation that may be appropriate beyond 2002-03” (Martin, 1996: 12).

Eventually, as fiscal pressures eased and federal transfers increased, equal per-capita allocations became the new benchmark for cash transfers. In Budget 1999, for example, an additional $11.5 billion in increased CHST funding over five years was announced and the government allocated the entire increase on an equal per-capita basis (Canada, 1999: 83-84). If a province accounted for 10 percent of the Canadian population, it would receive 10 percent of the increased funding. Subsequent budgets, especially the Harper government’s Budget 2007, provided for the completion of this process by 2014. Today, all major health and social transfers are equal per capita. Were it not for the changes in Budget 1995, these transfers would look very different today.

**Provincial revenue stabilization**

Finally, Budget 1995 introduced changes to a rarely used but important federal program: Provincial Revenue Stabilization. Begun in 1967, this program provides additional transfers to provinces that experience a sharp drop in their own revenues. Originally, if a province’s total revenues declined more than five percent, the federal government would cover the losses. This provided a kind of insurance that helped pool risks associated with severe economic downturns across all provinces. This deductible was removed in 1972, making it easier for provinces to qualify. Budget 1995, sensibly, put it back. After all, insurance arrangements must consider moral hazard and deductibles are an effective tool to mitigate this risk.

Much of the Budget 1995 language grounded this decision in the original principles of fiscal stabilization as designed in 1967. And it reiterated that “the federal government will continue to play a role in stabilizing revenues of provincial governments, but only in times of severe economic shocks, as was originally intended when the program was introduced” (Canada, 1995: 55). This job is not yet finished.

Specifically, there remains a $60 per person cap on payments that was originally imposed in 1987. There was no such cap in 1967, as it severely limits the program’s ability to provide meaningful insurance to provincial governments. In effect, provincial revenue declines in excess of five percent are insured—but only up to six percent. There is therefore no material revenue insurance in Canada today. This matters. When two oil-producing provinces (Alberta and Newfoundland & Labrador) qualified for stabilization payments in 2015-16, for example, they received only the small $60 per person amount. And a second payment to Alberta for
2016/17 was also constrained by the $60 per person cap. The sentiment expressed in *Budget 1995*—the commitment of the federal government to stabilize provincial revenues—may motivate further changes to the stabilization program today, such as easing the cap and moving yet closer to the original 1967 principles of stabilization policy design.

**More effective, efficient, and affordable transfers**

*Budget 1995* enhanced the effectiveness and efficiency of federal transfers. Provincial flexibility ensured health and social transfers supported provincial autonomy and decentralization. Greater equality (and eventually perfect equality) in the allocation of health and social transfers meant regional differences would be addressed only through a single program: equalization. This division of objectives between the major transfer programs is productive. It may even have helped facilitate reforms to equalization recommended by the Expert Panel on Equalization and Territorial Formula Financing in 2006 and implemented in *Budget 2007*, something no one in 1995 could have foreseen.

While federal-provincial fiscal arrangements are always evolving in response to competing economic, social, and political pressures, the transfer reforms in *Budget 1995* left an important legacy that remains with us to this day.
Chapter 6

Chrétien’s Fiscal Anchor: A Key to His Government’s Success

By David R. Henderson

As other essays in this series have explained, the government of Prime Minister Jean Chrétien and Finance Minister Paul Martin introduced far-reaching reforms in their 1995 budget that had positive, long-lasting effects. One often-ignored aspect of this period, however, is the explicit and implicit fiscal anchor that the Chrétien government used to achieve its goals.

A fiscal anchor, as it has come to be known, refers to a fiscal or budget rule that governs all other decisions. It is the primary measure by which a government tests its policies and it can, as it did in Canada in the Chrétien years, impose fiscal restraint on the government.

Taking action

Both Finance Minister Paul Martin’s 1995 speech presenting the government’s budget and, more important, the contents of the budget itself, made clear that balancing the budget was a top priority for the government. As Martin stated:

This government came into office because it believes that the nation’s priority must be jobs and growth. And it is because of that, not in spite of that, that we must act now to restore the nation’s finances to health. As the Prime Minister has said: “The time to reduce deficits is when the economy is growing. So now is the time.” Not to act now to put our fiscal house in order would be to abandon the purposes for which our Party

* References and the author biography can be found at the end of this document.
exists and this government stands—competence, compassion, reform and hope.

The debt and deficit are not inventions of ideology. They are facts of arithmetic. The quicksand of compound interest is real. The last thing Canadians need is another lecture on the dangers of the deficit. The only thing Canadians want is clear action (Canada 1995: 2).

The minister followed up his speech with real action. The budget proposed reductions in nominal program spending—all federal spending other than interest on the debt—from $120.0 billion in 1993-94 to a planned $107.9 billion in 1996-97, a decline of a little more than 10.0 percent over three years (Canada, 1995b: 5, table 1.1). The government almost achieved that ambitious goal: the actual reduction by 1996-97 was to $111.3 billion (Canada, 2019: table 1).

The anchor or budget rule guiding the government’s financial decisions during this initial period was clearly to balance the budget mainly through spending restraint. The underlying test applied to any financial decision during this period was whether or not it supported that goal. The finance minister himself repeatedly stressed the need to remain vigilant in balancing the budget.

This commitment to a balanced budget and the role the fiscal anchor played in helping maintain focus on that single goal resulted in a balanced budget in 1997-98, the first in three decades. Achieving a balanced budget did not, however, change the Chrétien government’s fiscal anchor. The government continued to emphasize the need for a balanced budget well after achieving that goal, and in fact planned for a balanced budget every year between 1998-9 and 2003-4 when Prime Minister Chrétien stepped down. In the 1998 budget speech, however, Finance Minister Martin did go one step beyond the balanced-budget goal to indicate that the government wanted to “bring down the absolute level of debt” (Canada, 1998: 8).

Reducing the absolute level of the debt required running a surplus. Two techniques helped the Chrétien government do so. The first was a “contingency reserve,” first introduced in the 1996 budget. The amounts were initially $2.5 billion (and later $3.0 billion) per year. From 2000 to 2003 the government also budgeted $1.0 billion a year in “economic prudence” to cushion against higher-than-anticipated interest rates or lower-than-forecast economic growth. If the government met its revenue and spending plans, which it invariably did, the monies in these reserves went to debt reduction.

The second method, which was not explicitly stated as policy, was a consistent underestimation of revenues. Figure 1 shows that except for 1995 itself, the government underestimated its revenues every year be-
between 1995 and 2003. In some cases, the gap between budgeted revenues and actual revenues was substantial. For instance, in 1997, actual revenues exceeded budgeted revenues by $15.4 billion while in both 2000 and 2003 they exceeded budgeted revenues by more than $16 billion.

The combination of higher-than-budgeted revenues and generous contingency reserves led to actual budget surpluses rather than simply a balanced budget. Figure 2 compares the expected and actual budget balances from 1995 to 2003. On average, the actual budgetary balance was $10.7 billion better than expected during this period. Running budget surpluses meant the government reduced the nominal debt.

### Declining debt

The string of surpluses began in 1997-98. Nominal debt declined by nearly $2.0 billion that year—to $607.2 billion. The government’s nominal net debt—the difference between its gross debt and its financial assets—then fell every year until 2008-09. In total, it declined by $92.7 billion, or 15.2 percent, from 1996-97 through 2007-08 (see figure 3).
Though inflation seldom exceeded the official mid-range target of 2.0 percent a year over this period, it was greater than zero so reductions in nominal debt meant even larger declines in real (i.e., inflation-adjusted) debt, per-person debt, and the debt-to-GDP ratio. Between 1996-97 and 2007-08, real federal debt fell by almost a third—32.4 percent, to be precise.

The combination of reductions in federal debt and a growing population meant that the debt burden per Canadian also declined. In 1996-97, real federal debt per person was $20,567 in 1995 dollars. Eleven years later, following the string of surpluses, real federal net debt per Canadian, still in 1995 dollars, had declined by $4,869, or 23.7 percent (see figure 3).

Finally, there was a marked decrease in the ratio of debt to the size of the economy (GDP). Over the 11 years, as federal net debt was declining, Canada’s economy was growing by a real annual average of 3.5 percent. The result was a reduction in the debt-to-GDP ratio from 70.8 percent in 1996-97 to just 32.7 percent in 2007-08 (see figure 3). In a relatively short time—much shorter than the time it had taken to accumulate—federal debt-to-GDP was cut in half.
To put this debt reduction in perspective, figure 3 illustrates the change in nominal debt, real debt, the debt-to-GDP ratio, and real debt per person, with each indexed to an initial value of 100. The chart makes clear that over the course of the following 12 years, all four measures of debt declined relative to 1995.

Because the federal government reduced its total nominal debt, the other three debt indicators decreased by an even greater percentage. By choosing a fiscal anchor of declining overall nominal debt and achieving that goal, the federal government also reduced real adjusted debt, the debt-to-GDP ratio, and both nominal and real debt per person.

The substantial reduction in debt during this period becomes even more impressive considering the large tax reductions the federal government enacted at the same time. Long overdue measures to reduce taxes on personal income, capital gains, and businesses were introduced while the government ran large surpluses (Clemens et al., 2017). The fiscal prudence demonstrated during the mid-1990s to the late-2000s is a remarkable achievement in Canadian fiscal history.
Conclusion

The Chrétien government’s strong fiscal discipline was made possible by its bringing on board a durable fiscal anchor that proved crucial in the restoration of sound public finances. The government ran annual surpluses to ensure that its nominal debt declined, partly by using a new “contingency reserve” and consistently underestimating federal revenues. The reduction in nominal debt in the 11 years following Budget 1995 brought down real debt, the debt-to-GDP ratio, and debt per person.
CHAPTER 7

Budget 1995 as the Foundation for Personal Income and Capital Gains Tax Relief

By Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill

Introduction

The 1995 federal budget, which worked to rein in spending and balance the budget two years later, set the stage for meaningful tax relief. The small surplus recorded in 1997-98 was the first in nearly three decades and began a process of reducing the nominal value of the federal government’s debt. Overall between 1996-97 and 2007-08, net debt (total debt minus financial assets) fell by almost $100 billion, or 15.2 percent (Clemens et al., 2017).

The decline in the nominal debt, coupled with generally declining interest rates, meant large-scale savings in federal government interest costs. Part of these savings was used to reduce taxes. Specifically, Ottawa went from spending more than one out of every three dollars of revenue on interest costs (35.2 percent) in 1995-96 to spending less than one in every seven (13.6 percent) by 2007-08 (see figure 1). In nominal dollar terms, annual interest payments declined from $49.4 billion to $33.3 billion over this period.

The reduction in interest payments and shift toward surpluses enabled the federal government to turn its attention to other policy priorities, such as tax relief. Finance Minister Paul Martin noted in his 1997 budget speech that his government was now able to address tax competitiveness only because of the “progress we have made in reducing the deficit and restoring responsible financial management” (Canada, 1997: 26).

* Endnotes, references and the authors’ biographies can be found at the end of this document.
Over the next decade, the federal government implemented a series of important tax relief measures that improved Canada’s economic competitiveness. These measures could not have been introduced without the foundation for a balanced budget that the government began to build in 1995.

### Personal income tax (PIT) reform

A key component of tax relief was a reduction in personal income taxes, including reduced income tax rates and full indexation of the personal income tax system. According to the government, these reforms represented almost $40 billion in personal income tax relief\(^1\) over the five years from 2000-01 to 2004-05 (Canada, 2000a: 84).\(^2\)

One of the government’s first tax-cutting actions, begun in *Budget 1998*, was the gradual elimination of the 3 percent surtax that applied to all taxpayers and which had effectively increased statutory tax rates. In 1998 it was eliminated for taxpayers with incomes up to $50,000 and then, in *Budget 1999*, for all remaining taxpayers.
The first major tax reform was the full indexation of personal income tax rates in 2000. By tying both the basic personal exemption and all bracket thresholds to the price level (i.e., adjusting for inflation), this policy ended automatic increases in the tax burden caused by inflation, a process known as bracket creep, in which taxpayers had faced higher income tax rates simply because their incomes had increased in nominal, though not necessarily in real terms. The introduction of a fully indexed system in which all thresholds are automatically increased each year to offset inflation eliminated bracket creep.

The federal government also implemented several personal income tax rate reductions in *Budget 2001* (see table 1 and figure 2). The rate reductions applied across all income levels. The bottom tax rate, for income below $30,755, was cut from 17 to 16 percent. The rate for those above $30,755 up to $61,509 fell from 25 to 22 percent. Between $61,510 and $100,000 the rate was reduced from 29 to 26 percent. Finally, a new threshold was added at $100,000, maintaining the top rate of 29 percent.

As mentioned, however, the top tax rate was effectively reduced by the elimination of two surtaxes. The 3 percent general surtax that applied

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Table 1: Personal Income Tax Rate Reductions

<table>
<thead>
<tr>
<th>Tax Bracket*</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>30,754 or less</td>
<td>17%</td>
<td>16%</td>
</tr>
<tr>
<td>30,755 to 61,509</td>
<td>25%</td>
<td>22%</td>
</tr>
<tr>
<td>61,510 to 100,000</td>
<td>29%</td>
<td>26%</td>
</tr>
<tr>
<td>Over 100,000</td>
<td>29%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Surtax (base amount)</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>15,500</td>
<td>5%</td>
<td>—</td>
</tr>
</tbody>
</table>

* Thresholds are for the 2001 tax year.
* The 3 percent surtax was eliminated in 1999 so is not included in this table.

Note: New tax bracket marked in grey.

to all taxpayers was eliminated in 1999, effectively reducing the rate by a little less than one percentage point. A second surtax of 5 percent, which applied to incomes above $65,000, was eliminated in 2001, effectively reducing the top tax rate on income by 1.45 percentage points.

There were other personal income tax reductions as well. For instance, in 2005 the bottom tax rate was reduced to 15 percent and the amount of money earned tax free, referred to as the “basic personal exemption,” was increased by more than the rate of inflation, meaning real tax-free income increased. Between 2004 and 2009 the basic personal exemption rose from $8,012 to $10,320, a 29 percent increase compared to inflation of just under 9 percent over those years, according to the Bank of Canada’s Inflation Calculator.

Personal income tax reform, including rate reductions and full indexation, was the first step toward improving Canada’s tax competitiveness and enhancing incentives for individuals to pursue productive
activity. In subsequent years, the federal government recognized personal income tax relief as a crucial factor in creating the conditions for strong economic growth and job creation, stating that “personal income tax changes have increased incentives for Canadians to learn, work, save and invest” (Canada, 2004: 159). Critically, though, the federal government acknowledged that more needed to be done in reducing personal income taxes to continue improving tax competitiveness and the incentives for work, investment in human capital, entrepreneurship, and investment.4

**Capital gains reform**

In addition to personal income tax relief, the federal government also reduced taxes on capital gains. Capital gains occur when an individual or business sells an asset for more than its purchase price. A portion of capital gains—determined by the “inclusion” rate—is taxed at a person’s (or business’s) top marginal personal income tax rate. Because capital gains are not indexed, inflationary gains in the asset’s value end up being taxed—even though such gains do not increase the taxpayer’s purchasing power, which is what in most theories of income taxation the income tax aims to tax.

Prior to the reforms, the federal government included 75 percent of capital gains as taxable income. *Budget 2000* reduced the capital gains tax by reducing the inclusion rate to 66.7 percent. It was then further reduced that fall in the economic update to 50 percent. The adjusted inclusion rate effectively lowered the tax rate applied on capital gains. For many people, the change in the inclusion rate meant a reduction in the capital gains tax rate from 22.8 percent in early 2000 to 14.5 percent in 2001.5

This was an important tax cut. The capital gains tax imposes high economic costs on society because it distorts the behaviour of entrepreneurs and investors (Clemens et al., 2017). Specifically, capital gains taxes reduce the number of entrepreneurs and investors willing to finance businesses and take on risk because they reduce the expected return from engaging in such activities.

The Chrétien government evidently understood these consequences and reduced the tax on capital gains to ensure stronger competitiveness, improved economic incentives, and better integration with the rest of the tax code.6 Canada needed to compete in an increasingly globalized and knowledge-based economy and the government recognized that innovation would be critical in the years ahead. As it said in *Budget 2000*, the government reduced capital gains taxes in an effort to “encourage entrepreneurship and risk taking” (Canada, 2000b: 21).
The reduction in the capital gains inclusion rate, in conjunction with personal income tax relief, created an economic environment more supportive of investment and entrepreneurship and contributed to nearly a decade of economic prosperity prior to the downturn of 2008-09.

**Conclusion**

The spending reductions introduced in *Budget 1995* were crucial in eliminating deficits, lowering the federal debt, reducing interest costs, and ultimately paving the way for tax relief. In the years following that budget, the federal government was able to take the first steps toward improving Canada's tax competitiveness by reducing personal income tax rates, restoring full indexation of the personal income tax system, and lowering the effective tax rate for capital gains.

The tax relief introduced by the Chrétien government was an important step towards improving the economic incentive for individuals to work, save, invest, and engage in entrepreneurship. Ultimately, the personal income and capital gains tax relief enabled by the spending cuts made in *Budget 1995* contributed to economic prosperity and nearly a decade of robust economic growth in Canada.
Chapter 8

Corporate Tax Reform Since 2000 and its Aftermath

By Jack Mintz*

After the 1995 spending-restraint federal budget, the minister of finance, Paul Martin, looked to address the revenue side once the federal deficit was eliminated. He struck a Technical Committee on Business Taxation in January 1996 to provide recommendations to reform the business tax structure to encourage growth and job creation, keeping in mind that the budget was not yet in surplus. Recommendations therefore had to be revenue neutral.

What was the problem?

Historically, Canada had been reliant on capital inflows and the development of export markets to grow its economy. Its labour productivity record in the 1990s was fourth lowest among OECD countries (Fortin, 1999). Although free trade in North America provided access to the large US market for Canadian businesses, it was unclear whether Canada would be in a position to attract businesses to serve the North American market. Despite the federal government’s having replaced the manufacturers’ sales tax with the GST in 1991 (which relieved capital inputs from federal sales tax), businesses faced one of the highest tax burdens on capital investment among OECD countries, impairing both adoption of innovation and export competitiveness.¹

By the late 1990s, Canada had the highest federal-provincial corporate income tax rate in the world (43 percent), plus federal-provincial capital taxes, plus provincial retail sales taxes on capital purchases in most

* Endnotes, references and the author biography can be found at the end of this document.
provinces. Thus, the tax system impaired both competitiveness and investment. It also worked against federal and provincial public finances because Canada’s high corporate income tax resulted in substantial tax avoidance as companies shifted the corporate tax base out of Canada through financial and transfer pricing arrangements.

The tax system also favoured primary and manufacturing investments over service businesses that were increasingly being exposed to trade. Only 12 percent of tax-favoured small businesses grew into larger firms. Employment Insurance supported many resource and manufacturing businesses with EI benefits in excess of contributions while service companies paid more premiums than they received in benefits. The federal fuel excise tax narrowly applied to one type of energy source as the federal government was becoming increasingly focused on environmental issues, especially the December 1997 Kyoto agreement on climate change.

**What the report recommended**

Paul Martin’s technical committee argued that the best business tax structure to address growth and competitiveness would be to impose similar tax burdens on all business activities—i.e., create tax neutrality—by levying internationally competitive tax rates. The committee recommended that the federal general corporate income tax rate be reduced from 29.12 percent to 21.0 percent, the differential rate between manufacturing and other sectors be eliminated, and the small business tax rate left unchanged (thus reducing the differential between large and small business tax rates). Further, the committee recommended that the tax rate on resource profits should remain the same although the resource allowance in lieu of royalty deductibility would bring the statutory rate down to 21.0 percent. It made a number of recommendations to scale back various tax incentives.

The committee supported the integration of corporate and personal taxes but recommended a minimum tax on dividends paid by companies to ensure that the dividend tax credit was equal to corporate tax payments in the year. The committee frowned upon income trusts as a corporate structure because they not only enabled companies to avoid paying corporate taxes but also distorted capital market efficiency. It also noted that capital taxes placed a burden on a cyclically-based economy like Canada’s. It called for a review of capital cost allowances so that they better reflected economic asset depreciation. It made various recommendations regarding international taxes so as to encourage capital exports and imports and to tighten up deductions to protect the corporate tax base, especially with respect to withholding taxes and interest limitation rules.
The committee recommended experience-rating for Employment Insurance to better relate premiums to employer layoffs. While it could not talk about carbon taxes (which were not government policy at the time), the committee recommended broadening the federal fuel excise tax by lowering motor fuel tax rates and expanding the tax to include natural gas and coal to account for sulphur and other pollutants.

**What happened?**

The report was released in April 1998. In 2000 the government announced a package of corporate and personal income reforms that enabled tax reductions in the presence of fiscal surpluses. The general corporate income tax rate was reduced to 21.0 percent over four years. The differential between manufacturing and non-manufacturing federal tax rates was eliminated. Federal Finance Minister John Manley introduced reductions to capital taxes in 2003, keeping the capital tax on financial institutions as a minimum tax. He also eliminated the resource allowance and introduced deductibility of resource taxes, which I personally supported (Mintz, 2001). The Harper government also reduced the federal corporate income tax to 15.0 percent by 2012 although it re-introduced accelerated depreciation for manufacturing equipment in 2006, contrary to the report’s recommendations.

The federal report also influenced the provinces. Alberta was first to reduce its general corporate income tax rate from 15.5 percent to 10.0 percent and broaden its tax base. Other provinces followed suit with reform packages, including NDP governments in Manitoba and Saskatchewan. Most provinces also eliminated capital taxes though a few retained a financial institution tax.

As for other reforms, capital cost allowances were reviewed by 2004. It took time but the federal government phased out most income trusts beginning in 2006. Withholding taxes on interest payments were eliminated in 2007 and various measures were adopted to protect the international tax base. On the other hand, the minimum dividend tax, EI experience-rating, and the federal fuel excise tax reforms were not adopted.

**Economic impact**

The effect of corporate tax reform together with provincial sales tax harmonization in Ontario and Prince Edward Island after 2010, resulted in a dramatic reduction in the corporate marginal effective tax rate on capital
An increase in the METR squeezes out marginal projects and results in a loss of investment (the converse for a reduction in the METR).

As figure 1 shows, the METR fell dramatically, from about 46.0 percent in 1997 to 18.0 percent in 2012. (Since then, it rose to 20.9 percent by 2017, but dropped to 15.5 percent in 2019 with accelerated depreciation.) The decline in the tax burden on capital was steeper than the corporate income tax rate because federal and provincial governments also reduced other taxes on investment.

Did the METR change result in better investment performance? As figure 2 shows, private investment picked up after 2000 after performing poorly in the 1990s. As a share of GDP, private investment rose from 10.5 percent in 2003 to 13.0 percent by 2012. The better performance was partly related to the commodity boom but also to the improved fiscal climate for investment as shown by various economic studies. While mining and petroleum investment expanded as expected from the commodity price boom, services, which benefited the most from tax reform, rose from 5.5 percent in 2001 to 8.0 percent of GDP. The average growth rate for private investment in Canada rose from 2.1 percent in 1988 to 2000 to 4.5 percent in 2001 to 2011 (both periods had significant recessions: the former

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Figure 1: Marginal Effective Tax Rates and Corporate Income Tax Rates for Large and Medium-Sized Corporations, 1997 to 2016

Source: Bazel and Mintz, 2016.

After 2014, private investment declined, no doubt reflecting the commodity downturn. However, it is also the case the METR started rising after 2012, with other business tax hikes and regulations affecting cost competitiveness.

Did corporate tax reductions lower revenues? Canadian corporate tax revenues hardly budged between 2001 and 2012 during the rate reduction, ranging between 3.0 percent and 3.5 percent of GDP (see Chen and Mintz, 2012). Corporate taxes have held up for at least two reasons. First, multinational companies were willing to keep more profits in Canada when its corporate rate was lower than in many other large countries, especially the United States. Second, the lower rates also encouraged in-

Figure 2: Private Investment as a Share of GDP in Canada

Source: Statistics Canada, Table 36-10-0096-01. Excluded are educational services, health care, social assistance, and the government sector.
dividends to shift income into the corporate sector, although small business rates did not decline much during this period.

**Conclusion**

Corporate tax reform from 2000 to 2012 was a success in Canada. It led to more investment without a significant loss in revenues and it created a more neutral and competitive tax system.
Chapter 9

Replacing a Vicious Fiscal Circle with a Virtuous One

By Don Drummond

Much has been made of the fiscal correction engineered by Canada’s federal government beginning in 1995-96. Fast forward almost 25 years and much was made during the 2019 election of the lackadaisical attitude of all political parties toward persisting fiscal deficits. The two events are related. The bold policy action taken in the 1990s, aided by some luck, arrested a vicious fiscal circle and put the country’s finances onto a virtuous circle that largely continues today, despite having faced several challenges, and enables the current relaxed attitude toward deficits.

Breaking a vicious fiscal circle in the 1990s

In 1995-96, federal debt was 66.8 percent of gross domestic product (GDP), up from around 20 percent in the mid-1970s (see figure 1).1 Revenues had exceeded program spending, thus producing an operating surplus, since 1987-88. But the federal debt required such large interest payments that overall deficits remained high. By 1995-96, interest payments on the debt consumed 35.2 cents of every revenue dollar, compared to only 12 cents two decades earlier (figure 2). This met the conditions of a vicious fiscal circle. Interest was paid with new debt, which generated greater interest, and so on. Such large interest payments ensured that only bold action would reduce deficits and the debt burden.

The Liberal government of the day applied such bold action. It focused on driving down program spending (i.e., total spending less inter-

* The endnote, reference, and the author biography can be found at the end of this document.
est payments on public debt). In nominal dollars, the level of spending remained below the 1995-96 peak for four years—which is unprecedented in recent decades. To be sure, luck played a role in raising revenues and lowering interest payments. World economic growth was solid, especially in the United States, boosting Canadian growth and hence revenues. The Canadian exchange rate depreciated, boosting net exports. Though the government introduced few revenue-enhancing measures, revenues grew at a healthy annual pace of 5.9 percent over those four years. In addition, global interest rates declined, aiding the decline in Canadian rates and reducing interest payments on the public debt. With program spending cut and revenue growth firm, the operating surplus rose from $7.6 billion in 1994-95 to fully $57.6 billion in 1999-2000, or 5.7 percent of GDP. Interest payments started to fall and by 1999-2000 were down to 25.6 cents on the revenue dollar. An overall deficit of $30.0 billion in 1995-96 swung around to a surplus of $14.2 billion by 1999-2000. What had been ceaseless increases in the debt burden were arrested and the federal debt-to-GDP ratio fell from its peak of 66.8 percent to 53.7 percent.
The fiscal turnaround required tremendous sacrifice from Canadians

In 1999-00 and 2000-01, Canadians received only 67 cents of program spending for every revenue dollar they sent to Ottawa. Of $194.3 billion of revenue collected in 2000-01, the federal government spent only $130.6 billion on programs. The resulting operating surplus of $63.8 billion was used to pay $43.9 billion of interest payments on debt and to retire $19.9 billion of debt.

The government’s operating balance—the difference between its total revenues and its spending on programs—is a useful proxy for the fiscal sacrifice being asked of Canadians (see figure 3). Between 1975-76 and 1986-87, as the vicious fiscal circle was taking root and the federal debt-to-GDP ratio was rising from 19.9 to 49.1 percent, the federal government ran operating deficits for 12 consecutive years. It may have seemed Canadians were getting a good deal from the federal government, always receiving more back in programs than they were sending to Ottawa in taxes. But a large cost overhang was building. For the 12 years from 1996-97 to 2007-08, there was an average operating surplus of $47.1 billion or 4.1

Source: Canada, Department of Finance (2019), Fiscal Reference Tables; calculations by author.

Figure 2: The “Interest Bite”—Federal Interest Payments on the Public Debt per Dollar of Revenue, 1966-67 to 2018-19
percent of GDP. That is the amount by which federal revenues exceeded federal program spending.

With such a low perceived return on taxes in the form of government spending on programs, conditions would hardly seem favourable for the Liberal Party to get re-elected. But over the course of the fiscal correction the Liberals were re-elected—and with majorities—in both 1997 and 2000. Canadians clearly supported the fiscal correction and were prepared to accept the sacrifices it required—for a while at least.

**A virtuous fiscal circle was in place by the early 2000s**

The sharp fiscal turnaround engineered over the second half of the 1990s paid large dividends through much of the 2000s. Despite program spending growing at a very strong average annual pace of 6.9 percent from 1999-00 to 2007-08, the year before the financial crisis, the federal budget remained in surplus and the federal debt-to-GDP ratio continued to decline, falling to 29.0 percent just before the crisis. Key to the favourable fis-
The ongoing decline in interest payments on the debt, which was itself a key dividend from having established a virtuous fiscal circle.

**The virtuous fiscal circle withstands the financial crisis and recession**

Canadian finances suffered a major shock from the financial crisis and ensuing recession. Revenues fell by $24.9 billion from 2007-08 to 2009-10. Because of automatic stabilizers and discretionary fiscal stimulus, program spending rose $47.8 billion. The $9.6 billion surplus of 2007-08 turned into a $56.4 billion deficit just two years later. Yet the federal debt-to-GDP ratio did not soar. It rose from 29.0 to only 33.4 percent. Interest payments on debt actually fell—from 13.6 cents on a revenue dollar to 12.0 cents, reflecting the post-crash reduction in interest rates against only a relatively modest rise in the debt burden.

The relative stability of Canada’s finances, certainly as far as the debt burden goes, greatly facilitated the Conservative government’s efforts to reduce the deficit following the recession of 2009-10, as it had pledged to do. By 2014-15, the books were almost balanced.

**Spending increases in the late 2010s again threaten the virtuous fiscal circle**

Following the Harper government’s tight control on spending after its deliberate post-crash deficits, program spending started to increase strongly again in 2015-16, rising at an annual average pace of 6.0 percent through 2018-19. From coming close to being balanced in 2014-15, the budget was in deficit by $14.0 billion last year. Even so, we see relative stability in the federal debt-to-GDP ratio, which closed out 2018-19 at 30.9 percent.

**Deficit elimination was not a major theme during the 2019 election campaign**

During the 2019 election campaign, none of the major political parties emphasized quick elimination of the current federal fiscal deficit. The Liberal Party, which has now formed a minority government, put out a platform that foresaw the deficit declining only very gradually, from $27.4 billion in 2020-21 to $21.0 billion in 2023-24. The Bank of Canada estimates that the Canadian economy is operating around a normal rate of capacity utilization. In “Bank speak” the output gap is around zero—which means no
part of the deficit can be attributed to cyclical weakness in the economy. Indeed, of the $21.0 billion deficit quoted for 2023-24, $9.8 billion stems from initiatives in the Liberal platform, which involved new spending that is more than double new revenues.

In its relaxed attitude toward deficits, the Liberal platform, and indeed the platforms of all the parties, exploited the favourable mathematics of a virtuous fiscal circle. If nominal GDP increases 3.5 percent per annum (for example, 1.5 percent real GDP growth and 2.0 percent inflation), the federal debt-to-GDP ratio can stay constant even if the government is running deficits of around $24 billion per annum. Indeed, that is essentially the Liberal plan. Despite their projected deficits, the debt-to-GDP ratio remains between 30 and 31 percent.

**Fiscal sanguinity may not be well placed**

The failure of fiscally conservative critics of the parties’ fiscal plans to gain any traction during the election suggests there is considerable sanguinity these days about federal finances. This is largely based on the apparent stability of the debt burden at around 30 percent of GDP. That does keep the burden near where it was both just prior to the financial crisis and also way back in the late 1970s before the vicious fiscal circle took hold. And it remains the lowest ratio among the G7 countries. Yet there are vulnerabilities to the fiscal situation that should not be lost sight of.

The ageing of the population, combined with lacklustre productivity growth, are likely to shift the Canadian economy down to a longer-run growth path of only around 1.5 percent per annum. Given the current imbalances and instabilities in the world economy there could well be times when growth underperforms even that historically modest standard. Moreover, it seems inevitable that interest rates will eventually rise.

The bold fiscal action of the 1990s, reinforced by some good fortune in circumstances external to Canada, broke a vicious fiscal circle and put in place a much more favourable circle. That more virtuous circle has been paying dividends ever since. But this status quo should not be taken for granted. The gift bequeathed us by dint of real sacrifice in the mid-1990s could be lost if we do not take care. We need to take out additional policy insurance to keep the federal debt-to-GDP ratio from rising above 30 percent. That means lowering the deficits at a faster pace. Better still, we should drive the debt burden below 30 percent, restoring a level that prevailed in Canada until 40 years ago.
Notes to the Chapters

Introduction: The 1995 Budget, 25 Years On
by William Watson

1. Though the IMF had intervened in 1962 after a run on the Canadian dollar during the Diefenbaker years.
2. All budget numbers are from Canada (2019).

CHAPTER 1: The Path to Fiscal Crisis: Canada’s Federal Government, 1970 to 1995
by Livio Di Matteo

1. In addition to depleting them of revenues, these tax expenditures also greatly complicated the personal and corporate income tax systems (see Vaillancourt, Lammam, Ren and Roy, 2016).
2. Program Review (1994) required departments to evaluate their programs and led to significant structural change in some federal government programs (see Veldhuis, Clemens, and Palacios, 2011: 25).
3. In particular, Canada’s fiscal situation was highlighted in a January 12th editorial in the *Wall Street Journal* that argued that Canada had reached a “debt wall” and might need assistance from the International Monetary Fund (Veldhuis, Clemens, and Palacios, 2011: 19).

CHAPTER 2: Spending Reductions and Reform: Bases for the Success of the 1995 Budget
by Lydia Miljan, Tegan Hill, and Niels Veldhuis

1. Due to a break in the series following the introduction of full accrual accounting, data from 1983-84 onward are not directly comparable with earlier years.
CHAPTER 3: How the Chrétien-Martin Budgets Cut Corporate Welfare in the Mid-1990s

by Mark Milke

1. A full review of the literature on business subsidies is available in a past report (Milke, 2007: 27-36).

CHAPTER 4: Budget 1995 and Welfare Reform

by Ronald Kneebone and Jake Fuss

1. For more details on these and other policy changes affecting eligibility, see Kneebone and White (2009) and Berg and Gabel (2015).

2. These percentages varied slightly by province. The outlier is Quebec where the cash payment fell from 74 percent of the total benefit in 1997 to just over 42 percent in 2018. Data on social assistance benefits are from Maytree (Twedde and Aldridge, 2019).

CHAPTER 5: Effective, Flexible, and Affordable: Towards a New System of Federal-Provincial Transfers in Budget 1995

by Trevor Tombe

1. The federal government shared the provincial cost of unemployment relief and old age pensions until those became federal programs. This calculation includes support for the blind and youth training.

   Note: Displays total federal (cash) transfers to provincial governments as a share of national GDP. The shaded region marks the period from 1942 to 1946 when the Wartime Tax Agreement was in effect. Post-war transfers here include conditional grants.

2. Note: Displays the fraction of health and social transfers that would need to be reallocated to achieve equal per-capital allocations across provinces (known as a Schultz Index).

CHAPTER 6: Chrétien’s Fiscal Anchor: A Key to His Government’s Success

by David Henderson

1. Notes: (i) Actual Revenues come from the Public Accounts rather than Fiscal Reference Tables because of accounting changes made in 2003; (ii) Budgeted numbers in 2002 come from the 2002 Economic and Fiscal Update since there was no budget tabled that year.
2. Notes: (i) Actual Revenues come from the Public Accounts rather than Fiscal Reference Tables because of accounting changes made in 2003; (ii) Budgeted numbers in 2002 come from the 2002 Economic and Fiscal Update since there was no budget tabled that year.

CHAPTER 7: Budget 1995 as the Foundation for Personal Income and Capital Gains Tax Relief

*by Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill*

1. There is some debate about the total value of personal income tax relief included in *Budget 2000*. Some measures, such as the increase to the Canada Child Tax Benefit (CCTB), were counted as tax relief when some observers argued it should have been included as additional spending. The CCTB was a direct benefit provided to eligible families with children. The estimated cost of the increase in the CCTB for 2004-05 was $2.5 billion. See Section 4 of *Budget 2000*: https://www.budget.gc.ca/pdfarch/budget00/pdf/bpe.pdf.

2. Indeed, the breakdown on page 84 of *Budget 2000* indicated a total tax relief package of $58.3 billion over five years including personal income tax relief ($39.5 billion), business income tax reductions ($4.0 billion), and reductions in Employment Insurance ($14.8 billion). See https://www.budget.gc.ca/pdfarch/budget00/pdf/bpe.pdf.


4. For more on the relationship between taxes and economic growth see Murphy, Clemens, and Veldhuis (2013).

5. The federal surtax of 5 percent on high income earners was eliminated in 2001.

6. The Fraser Institute was particularly influential in the government’s decision to provide capital gains tax relief. A 2000 study by Herbert Grubel encouraged the Chrétien government to return the capital gains inclusion rate to its original level of 50 percent as one potential policy option (Grubel, 2000). Grubel emphasized that this reduction would provide greater incentives for entrepreneurship, risk-taking, investment, and job creation—all of which spur economic growth.
CHAPTER 8: Corporate Tax Reform Since 2000 and its Aftermath  
by Jack Mintz

1. Much of the discussion in this and the following section is based on conclusions in the report of the Technical Committee on Business Taxation (1998).

2. The METR is measured as the ratio of corporate income taxes, sales taxes on capital purchases, land transfer taxes, and asset-based taxes as a share of profits earned by marginal projects. Provincial and municipal property taxes as well as the resource and finance sectors are not included due to lack of data.

3. These results will be forthcoming in a new paper.

4. Taking into account the various economic and political factors that affect investment, a general result is a 10 percent increase in the cost of capital (adjusted for the METR, which adds to the cost of capital) causes a decline of 7 to 10 percent in capital stock (see Parsons, 2008).

5. Mintz and Smart (2004) estimate that a 1-point reduction in the provincial statutory tax rate increases the corporate tax base by 4.9 percent for large corporations that do not allocate income across provinces and 2.3 percent for those that do allocate corporate income.

CHAPTER 9: Replacing a Vicious Fiscal Circle with a Virtuous One  
by Don Drummond

1. Throughout this article federal debt refers to accumulated deficits. During the time of the 1990s fiscal correction the focus was on the net debt. Net debt is higher than the accumulated deficits, the difference being net non-financial assets, which are subtracted from net debt to produce accumulated deficits. The differences are $44.4 billion or eight per cent in 1995-96 and $86.6 billion or 12.6 per cent in 2018-19. Accumulated deficits are used here because due to an accounting change a consistent series for net debt is not available prior to 1983-84.

2. Notes: (i) The data shown are for “accumulated deficits” and are from Canada, Fiscal Reference Tables, various years; (ii) Due to a break in the series following the introduction of full accrual accounting, data from 1983/84 onward are not directly comparable with earlier years.
3. Note: Due to a break in the series following the introduction of full accrual accounting, data from 1983/84 onward are not directly comparable with earlier years.

4. Notes: (i) Operating balance is defined as revenues minus program spending (excludes debt charges); (ii) Due to a break in the series following the introduction of full accrual accounting, data from 1983/84 onward are not directly comparable with earlier years.
References

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