



THE BUDGET THAT CHANGED CANADA

William Watson, editor
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25TH
ANNIVERSARY
1995 FEDERAL BUDGET



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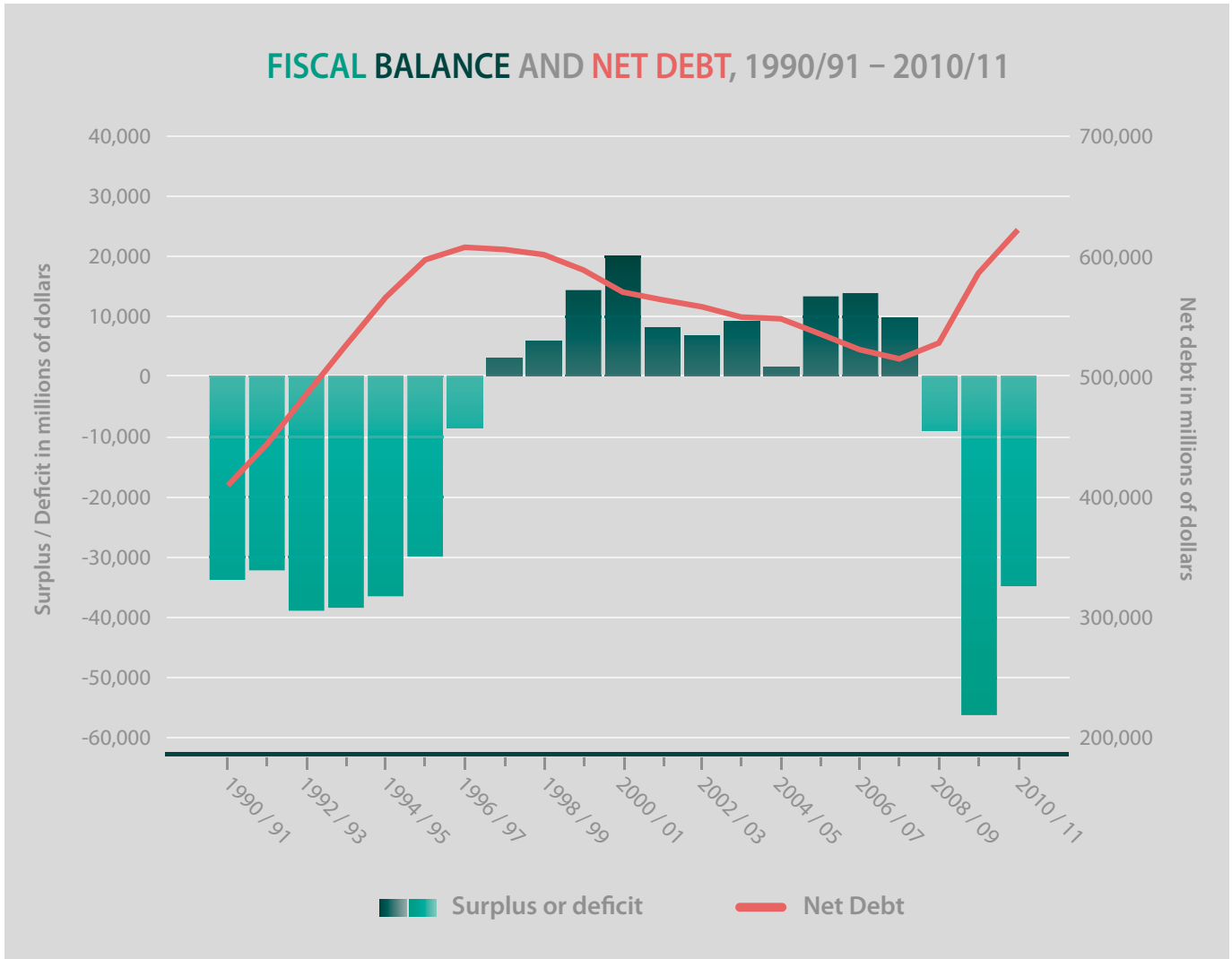
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February 28th, 2020, is the 25th anniversary of one of the most important federal budgets in Canada's history.

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.

Livio Di Matteo



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

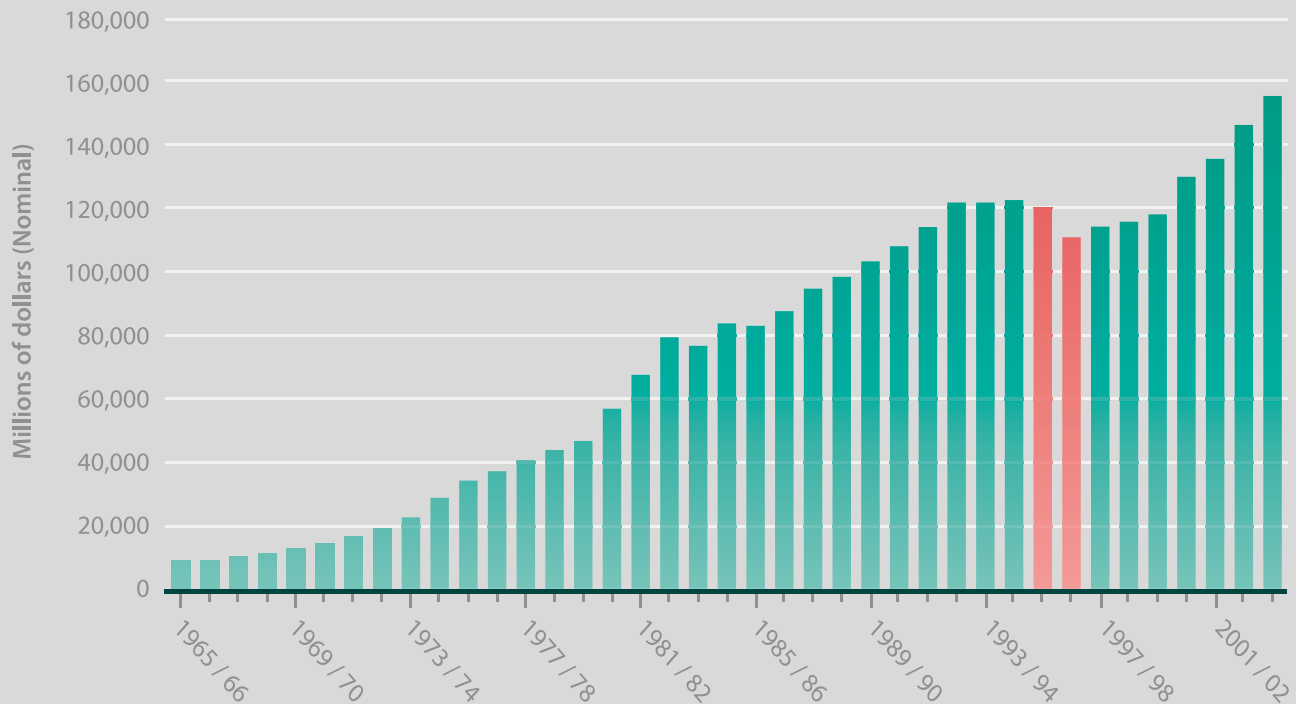
by central banks in most industrial countries to curb inflation but also resulted in marked increases in interest costs for government. Perhaps most importantly, Di Matteo documents the dire state of federal finances circa 1993 when the Chrétien Liberals assumed office. Di Matteo's insights regarding disciplined federal finances and concerns over public debt competing with 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.

Lydia **Miljan**, Tegan Hill, and Niels Veldhuis

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. According to the authors, a key reason for the budget’s success was its focus on spending. That focus was aided 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.

PROGRAM SPENDING, 1965/66 – 2003/04



Mark Milke

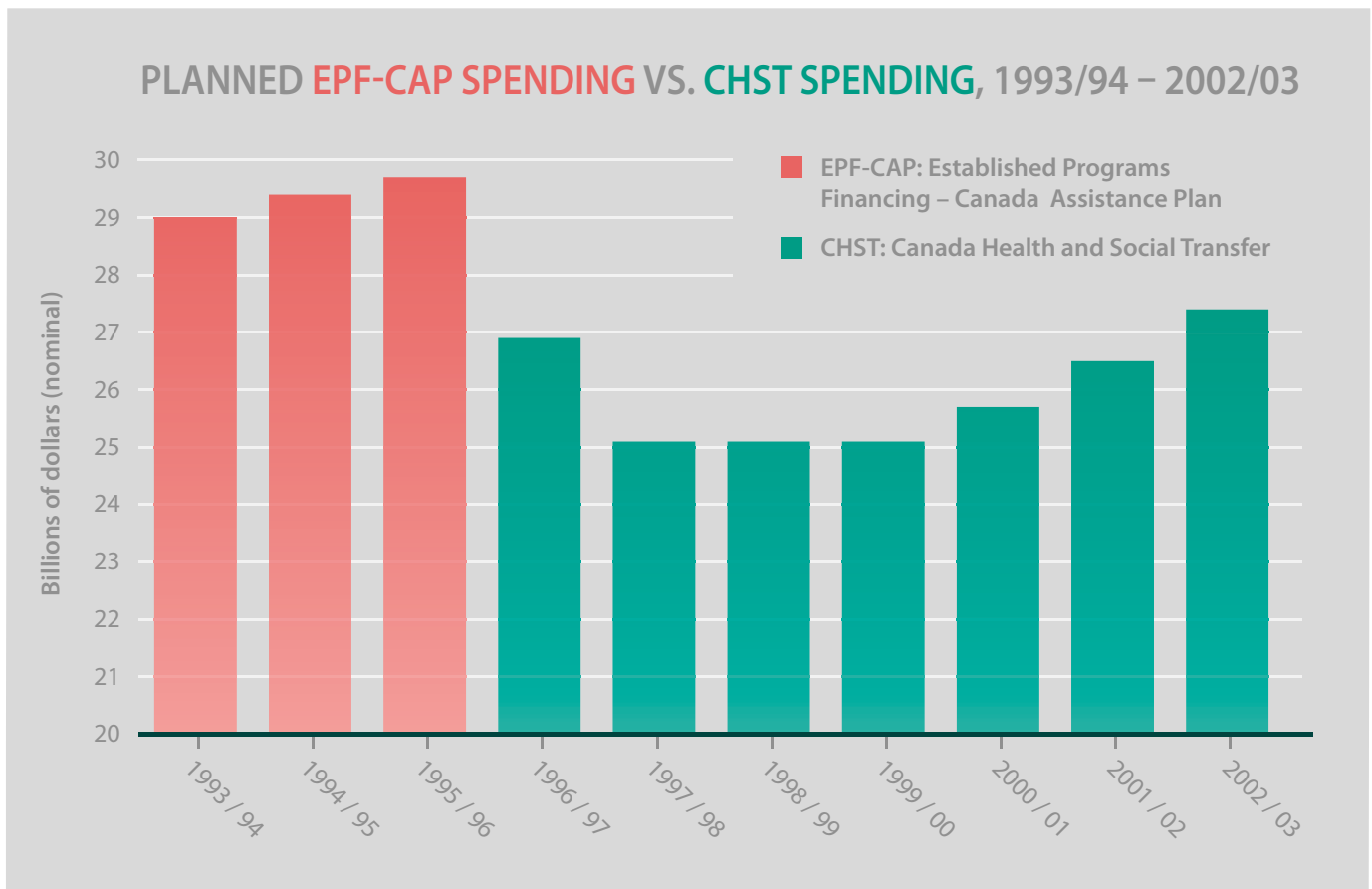
Several essays in the series explore specific aspects of the spending reductions summarized in the previous essay. Independent analyst Mark Milke, for instance, examines how the federal budgets of 1995 and 1996 made big cuts in what is variously known as subsidies to business, corporate welfare, or crony 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.



Ronald **Kneebone** and Jake Fuss

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, 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. Critically, 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.



Trevor Tombe

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 prov-

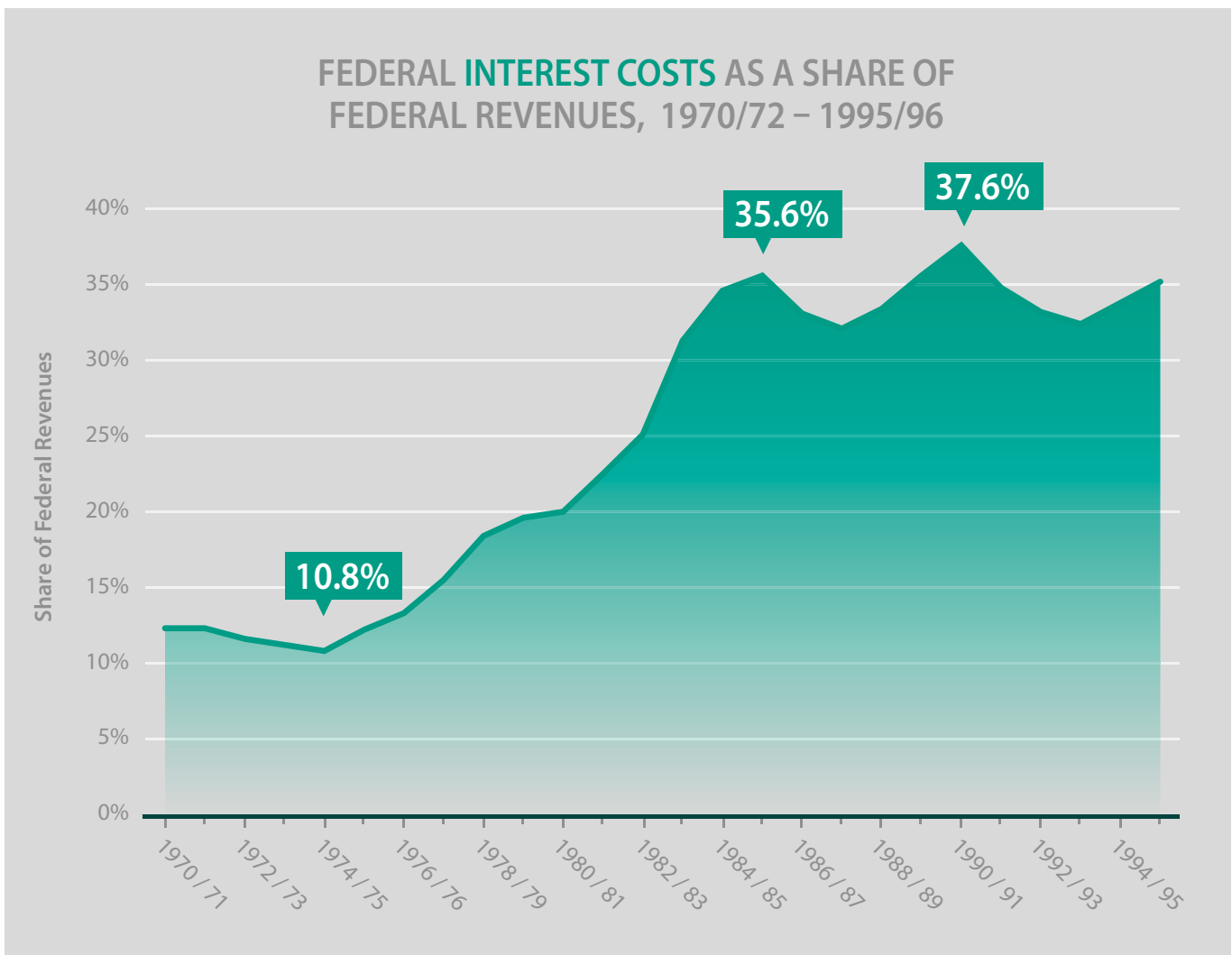
inces. As part of achieving that, provinces whose tax room generated more revenue received a smaller cash top-up. As the goal of the 1995 budget was to save Ottawa cash, the cash cuts hit better-off provinces disproportionately, effectively doubling the inequality of federal transfers. After Ottawa's 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.



David Henderson

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 generous 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.

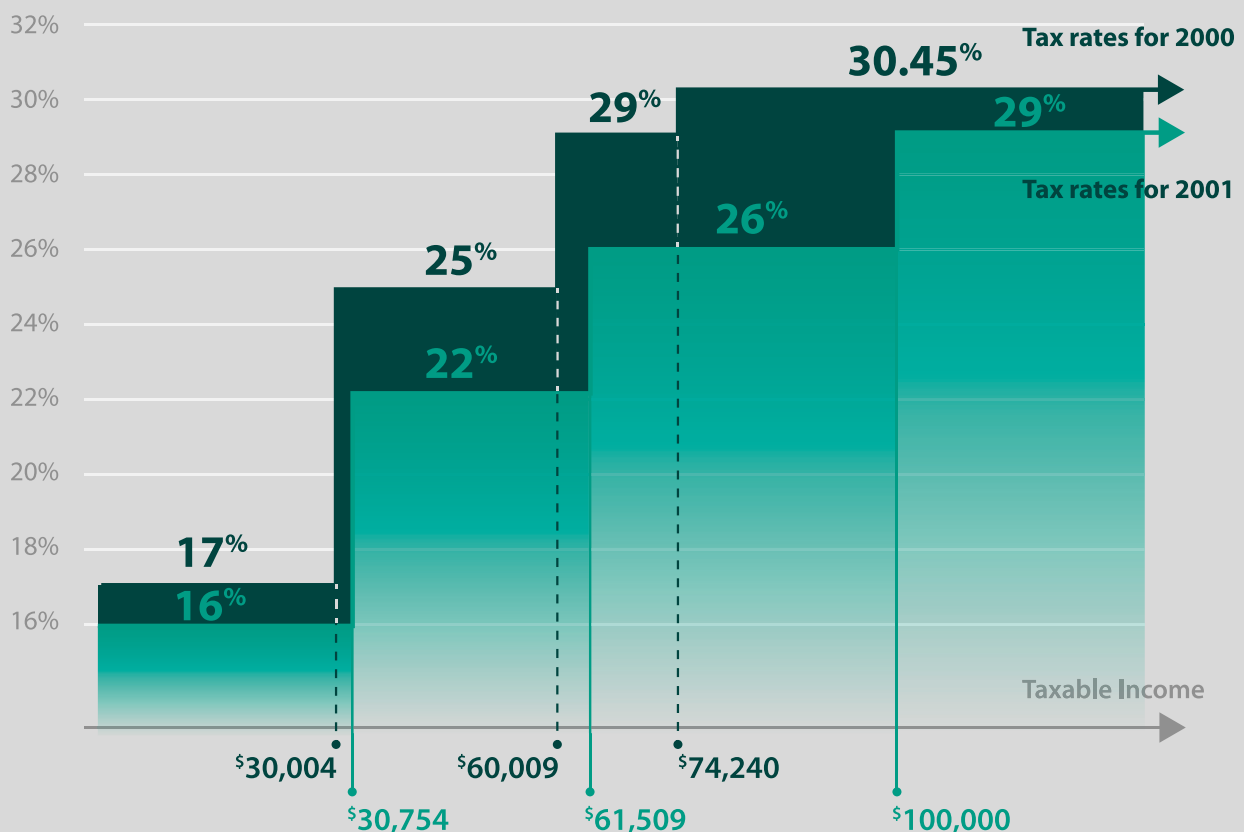


Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill

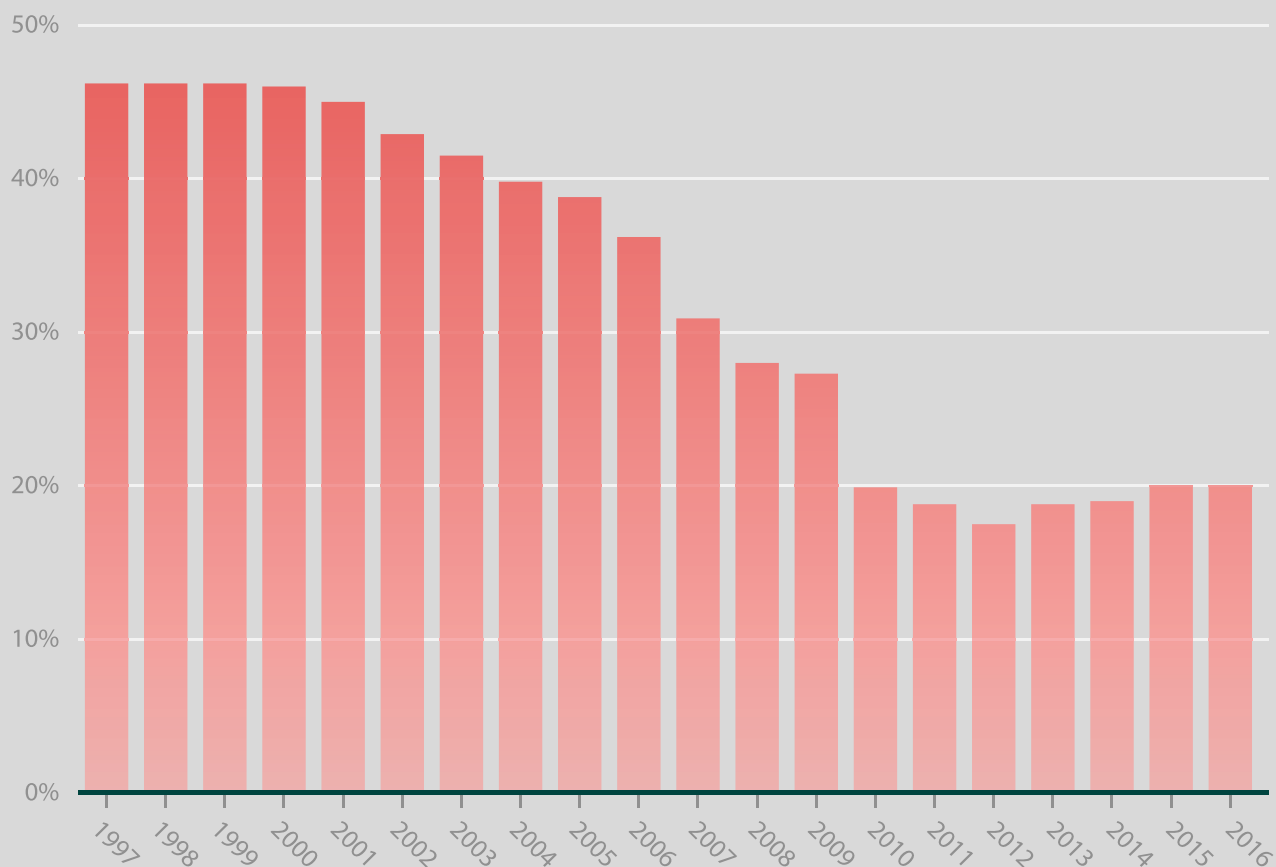
Fraser Institute economists Jason Clemens, Milagros Palacios, Jake Fuss, and Tegan Hill describe how the improvement in the federal government's fiscal situation following the 1995 budget enabled it to gradually lower taxes in ways that improved Canada's tax competitiveness and contributed to stronger economic performance. 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, for the three existing tax brackets and it introduced a new top rate of 29 percent for those with taxable incomes greater than \$100,000 a year. Finally, it 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.

INCOME TAX RATE CHANGES, 2000 – 2001



MARGINAL EFFECTIVE TAX RATES FOR LARGE AND MEDIUM-SIZED CORPORATIONS, 1997 – 2016



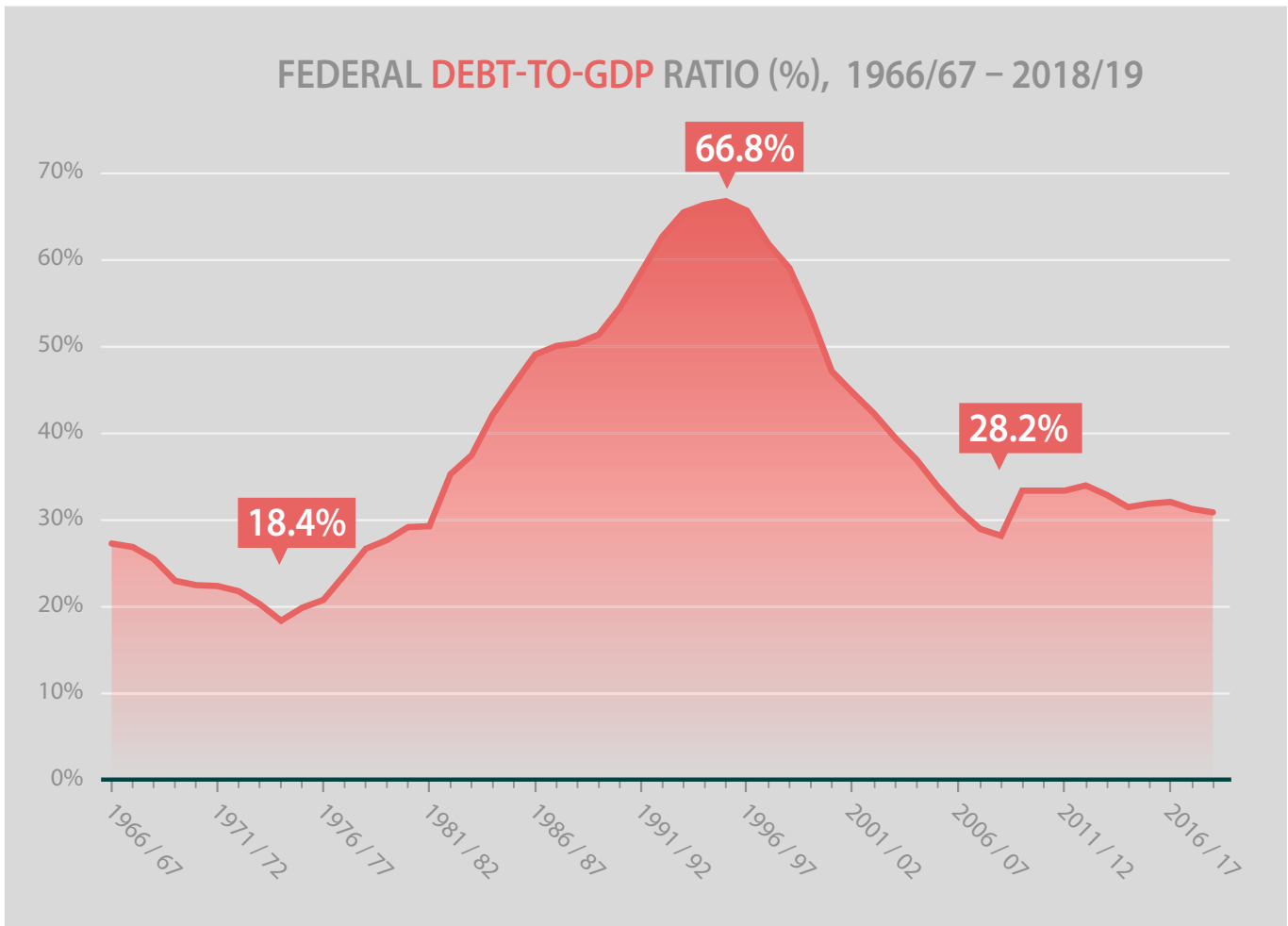
In a companion piece, noted economist Jack Mintz (founding director of the University of Calgary’s School of Public Policy and former economics professor at the University of Toronto) summarizes the federal government’s reform of the business tax system following the report of the Technical Committee 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.

Don Drummond

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 hoped that understanding the success of the 1995 budget and the costs of alternative approaches, as we are now beginning to experience again, will be the key to returning to sounder and more productive fiscal policies.

—William Watson and Jason Clemens

