LET'S CUT PAUL MARTIN SOME SLACK

Paul Martin's pragmatic approach to budgeting is paying off big-time: Just about every fiscal indicator is moving in the right direction, and substantially so. People need to understand, however, that the last-minute booking of current spending to future years is a fundamental part of the strategy of prudence. Without it, too much of the fiscal dividend will end up going to debt reduction, rather than tax cuts or spending

L'approche pragmatique de Paul Martin en matière de budgétisation s'avère très payante : presque tous les indices financiers se déplacent dans la bonne direction et ce, de manière très appréciable. Toutefois, les gens doivent comprendre que le report de dernière minute de dépenses courantes aux années ultérieures est un aspect fondamental de la stratégie de prudence. Autrement, une part trop importante du dividende fiscal irait à la réduction de la dette, plutôt qu'aux réductions d'impôt ou aux dépenses.

Patrick Grady

Given the unmitigated string of unsuccessful deficit-fighting budgets brought down by his predecessors, it's hard to find fault with Paul Martin's most recent budget. The federal deficit has disappeared for an almost unprecedented second year in a row and shows no signs of reappearing. The debt-to-GDP ratio is on a steady downtrend. The fiscal dividend is being used in a balanced way to increase spending, cut personal income taxes, and pay down the debt. The spending increases are in the areas generally regarded as the highest priority by Canadians — health care, and knowledge, skills and innovation. The tax cuts and increases in the child tax benefit are fair and provide the largest proportionate benefits to low — and middle-income families.

The chart in *The Budget Plan 1999* that shows how Mr. Martin put a stop to the growing string of deficits that began in 1970-71 and peaked out at $42 billion in 1993-94 is nothing short of amazing (see next page). I'm sure that there weren't many around when he took over as finance minister who would have predicted such a dramatic turnaround in the nation's finances. None of the other G-7 countries has come anywhere close to matching Canada's recent fiscal performance. Under Mr. Martin's tenure, we have gone from the worst budgetary position in the G-7 to the best. Our fiscal credibility has been restored and we are already reaping the economic benefits of improved fiscal management with lower interest rates and higher growth in output and employment.

The debt-to-GDP ratio is already down from a high of 71.2 per cent in 1995-96 to 65.3 per cent in 1998-99. According to the budget plan, it will fall to 61.7 per cent in 2000-01, while if GDP growth averages 3.5 per cent and the budget remains balanced, it will reach as low as 57 per cent within five years. And if the contingency

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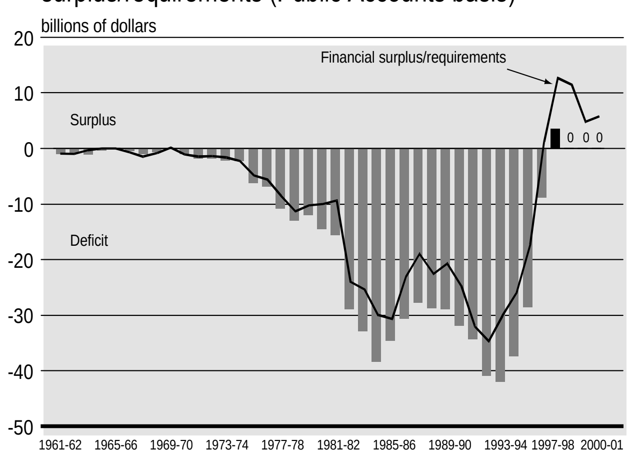
reserve is not required, it will hit 55 per cent. Economists can quibble about the speed of the decline, but few would deny that the projected decrease in the debt ratio is a substantial move in the right direction. Fiscal policy is — indisputably, finally and firmly — on the right track.

Last year's targeting of both the increase in the basic tax-free amount and relief from the three per cent surtax introduced an undesirable additional element of complexity in an already overly complex personal income tax system, so it is good that the tax cuts in this year's budget were delivered across-the-board, in a way that uncomplicates the tax system at least slightly. There are always good arguments for targeting measures on low- and middle-income earners and seldom a good time to remove such measures. As a result, the tax system tends to become increasingly complex over time — a kind of tax law of entropy in reverse. Mr. Martin's decision to buck this trend, even at the cost of some criticism from left-wing critics, is good public policy. Incidentally, the three per cent surtax, which was introduced in 1986 as a temporary deficit reducing measure, turns out to be one of the first temporary tax increases in history to turn out to be really temporary — even if, in this case, "temporary" lasted 13 years.

The tax cuts in this and last year's budgets are a welcome start in getting personal income taxes more into line with those in the United States. Relatively high tax rates in Canada have undermined our growth and productivity and encouraged the emigration of some of the most productive members of our society. It is encouraging to hear Mr. Martin talk in terms of 20 more years of tax cuts. If all goes well in the economy, that is a perfectly reasonable expectation. It would, of course, have been premature and imprudent, not to mention out of character, for the minister to have heeded the advice of some business groups and delivered all those eagerly anticipated tax cuts up front in this year's budget, before the government actually receives the money to pay for them.

Federal budgetary balance and financial surplus/requirements (Public Accounts basis)



Source : The Fiscal Plan 1999.

In the immediate aftermath of the budget, the federal government came under harsh criticism from the Quebec government for phasing out the disparities in Canada Health and Social Transfer (CHST) funding to the provinces over the next three years. The widely divergent levels of per capita grants to the provinces to finance health and social programs resulted from *ad hoc* restraints imposed on the growth of transfers to the non-equalization receiving provinces by the previous government. It was never intended that such large gaps in transfers would open up and it is hard to justify a system that gives Quebec $939 per capita and Alberta only $800. The federal government already operates one program — equalization — that compensates for differences across provinces in revenue-generating capacity. It doesn't need another. But whatever pure logic might dictate, once a gap in per capita CHST funding was allowed to open up, it became politically very difficult to close. The luck of a large required increase in equalization, resulting mainly from the strength of the Ontario economy, provided the political cover for re-establishing the desirable principle of equal treatment for all provinces under the CHST. The federal government was wise to take advantage of this opportunity even if doing so did cause howling in some political circles in Quebec. In the long run, it was the only fair thing to do and it puts an end to an unnecessary and undesirable element of complexity in CHST financing.

Mr. Martin's pragmatic approach to budgeting may not appeal to those inclined to the more theoretical approach of a medium-term fiscal plan based on a best-guess forecast. In contrast, his approach rests on his now — famous triad of: two-year rolling fiscal plans based on prudent economic assumptions; an annual contingency reserve; and use of the contingency reserve when not needed to pay down the public debt. The use of prudent economic assumptions and a contingency reserve introduces a

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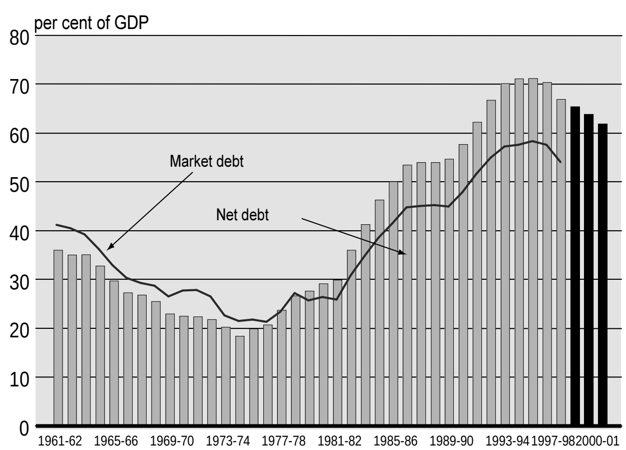
bias in the direction of surpluses that is a welcome change from the deficit bias that used to prevail in the bad old pre-Martin days. It has transformed the minister of finance's annual year-end problem from how to finance a deficit into how to spend a surplus. While this "problem" may be more fun to grapple with, it does cause some difficulties for a government committed to a balanced approach to dealing with the emerging fiscal dividend.

For the last several years, the government has found itself in the enviable position of having excess funds at the end of the year. Rather than hastily and imprudently spending the money on non-priority items, it has adopted the reasonable practice of booking large future non-recurring spending commitments as current expenditures. The most notable examples include: the Harmonized Sales Tax adjustment payments in 1995-96; the Canadian Foundation for Innovation in 1996-97; the Canadian Millennium Scholarship Foundation in 1996-97; and the CHST supplement in 1998-99.

Federal debt-to-GDP
(Public Accounts)



Source: The Fiscal Plan 1999.

This practice of booking future spending in the current year has come under fire from the Auditor General. While there is some justification for his objections on narrow accounting grounds, it needs to be recognized that the prudent approach to budgeting can only work if the government is given the flexibility to allocate money at year end to priority spending areas. If not, a disproportionate share of the fiscal dividend will always go automatically to debt repayment.

Let's cut Mr. Martin a little slack. He's earned it through his successful application of a prudent approach to budgeting.

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