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Sketching Out a Plan for Inclusive Growth: The Case for Less Red Ink

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INTRODUCTION

This year's budget will be a critical moment for the Trudeau government. It should, for all intents and purposes, signal what we can expect from this government over the remainder of its mandate. Will it place a renewed emphasis on restoring a balanced budget? How will it make progress on the "inclusive growth" it has often promised? Budget 2017 should answer these questions.

Remember that the 2016 budget was tabled mere months after the federal election and was mostly focused on enacting the new government's key campaign commitments. There were few surprises and many placeholders for future policies. But Ottawa has had a year to orient itself and hold consultations on a range of budget-related issues, including innovation policy and rationalizing tax expenditures. The general rule about the inverse relationship between a budget's level of ambition and its proximity to the next election also applies. The upshot is the 2017 budget is shaping up to be the Trudeau government's most ambitious and agenda-shaping moment in its four-year mandate.

Much of the focus on budget day will be the government's fiscal plan and its agenda for "inclusive growth." These two key areas are the subject of this pre-budget commentary.

The purpose is to set out the parameters of a sound fiscal policy for the short- and long-term and put forward some practical ideas to create the conditions for economic and social mobility. At the core of these ideas is a genuine effort to be constructive and support the right set of policies to meet the government's objectives of economic growth and opportunity in the country.

Our principal advice is that the budget should be rooted in a clear, credible plan to fulfill the government's election commitment to balance the budget. This goal can only be achieved if Ottawa shows a greater focus on controlling spending than it has had to date. Just because the federal government's public finances are relatively strong does not mean that more spending and ongoing deficits is the right plan for Canada. A program for inclusive growth should *not* be written in red ink.

TRUST BUT VERIFY: THE NEED FOR A STRONG FISCAL ANCHOR

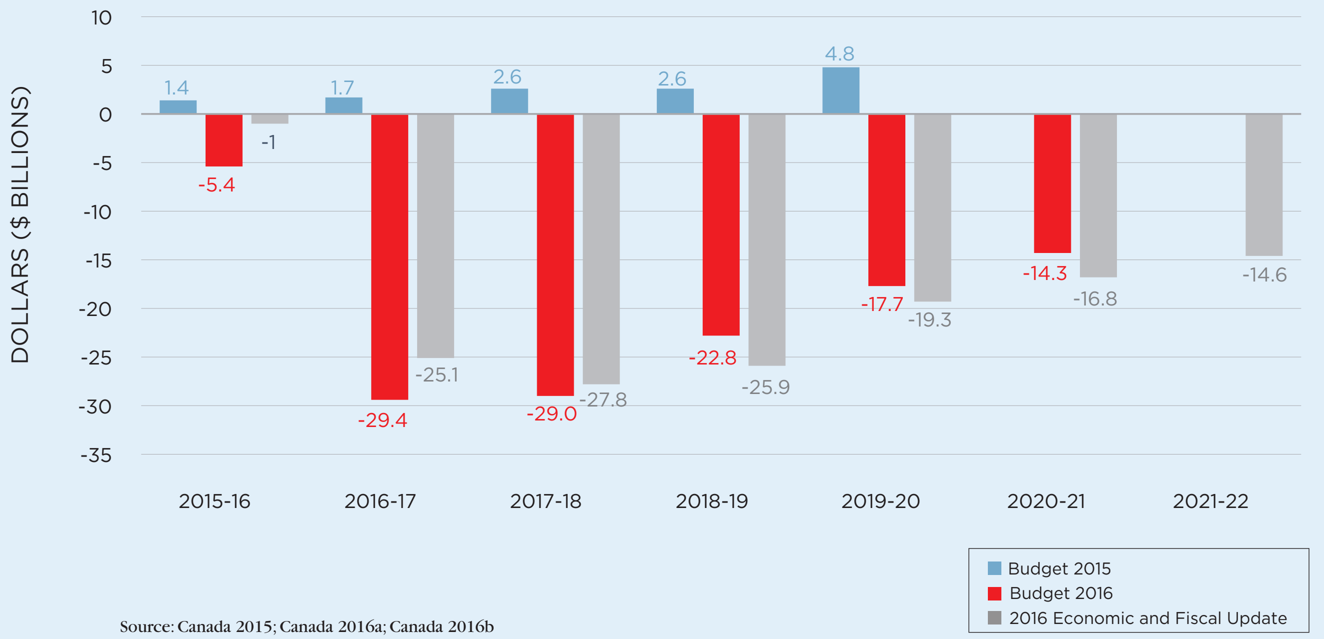
The government was elected on a platform of temporary deficit spending to "kick-start" short-term economic growth. There was some debate among economists about the utility of such a fiscal policy. But most generally agreed that, even if failed to stimulate economic activity, it was unharmful given the small magnitude and short-term nature.

> "Now even supporters of the government's fiscal policy are beginning to express concerns, especially in light of new evidence that the restoration of a balanced budget could be decades away."

Then the size of the annual deficit and its duration quickly changed. The 2016 budget projected deficits as high as $30 billion per year and deferred decisions about the timelines for balancing the budget. The fiscal anchors in Finance Minister Bill Morneau's mandate letter were mostly abandoned (Trudeau 2015). Still the consensus was that this was not a problem, in large part due to Canada's relatively strong public finances.

Most recently, the *Fall Economic Statement* confirms that the government's fiscal position has further deteriorated. Spending was up by nearly $10-billion between 2015 and 2020 and the overall fiscal picture has worsened by $31.8-billion relative to the 2016 budget (Speer 2016b). The trend over the past 16 months has thus been in the direction of more spending, higher deficits, and rising debt (see figure 1). Now even supporters of the government's fiscal policy are beginning to express concerns, especially in light of new evidence that the restoration of a balanced budget could be decades away (Department of Finance 2016b).

FIGURE 1: CANADA'S DETERIORATING FISCAL PICTURE



Source: Canada 2015; Canada 2016a; Canada 2016b

A major reason for this growing concern is the absence of a clear plan or timeline for eliminating the budget deficit. The March budget at least said the government would "set a timeline for balancing the budget when growth is forecast to remain on a sustainably higher track" (Canada 2016a). The *Fall Economic Statement* was essentially silent on the subject. Observers are rightly beginning to question the reliability of the government's so-called "fiscal anchors."

And a closer look at the government's spending plans does little to instil confidence. Not only is the new spending not focused on productivity-enhancing projects, there is good reason to believe it is poised to rise rather than fall in the next few years. The risk then is that we spend more and more, and end up with little to show save for higher deficits and a greater debt burden.

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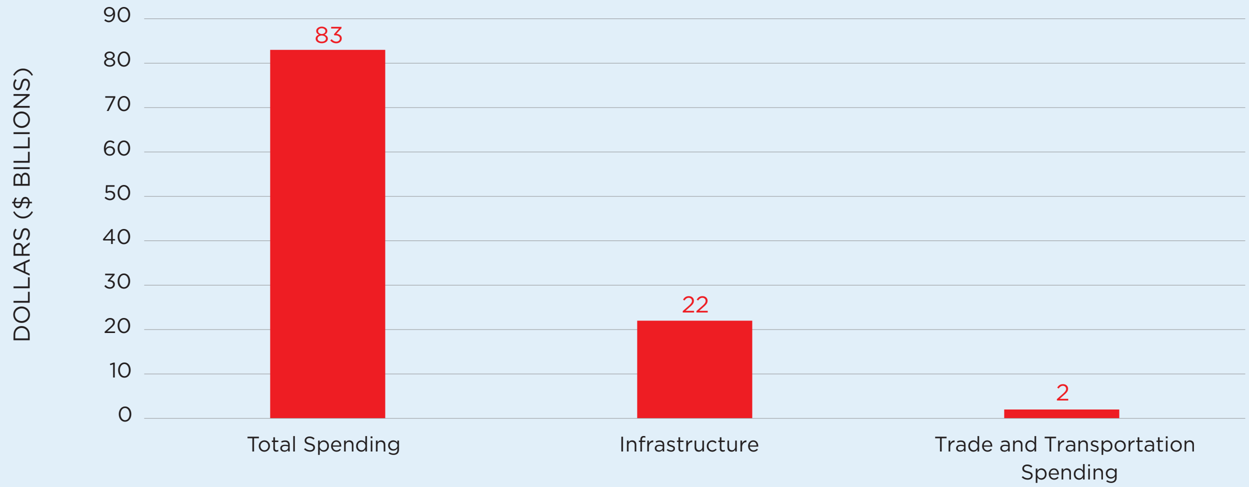
Remember budget deficits were justified as a means for increasing infrastructure spending in order to break out of the low-growth trap and create conditions for future economic growth. But the numbers tell a different story: Ottawa's deficit is primarily the result of discretionary spending and has little to do with infrastructure investments.

Of the $83 billion in new spending between 2015 and 2020 in the 2016 budget, only one quarter is dedicated to infrastructure and only $1.6 billion is clearly focused on productivity-enhancing trade and transportation infrastructure (see figure 2). That means that more than 95 percent of new spending in this five-year period is not directed to the type of economic-oriented projects that many Canadians were led to believe (Speer and Crowley 2016b).

FIGURE 2: COMPOSITION OF NEW SPENDING, 2015-2020



Source: Canada 2016b

There are also reasons to be concerned that the government's fiscal trajectory understates its future spending level. Current spending projections anticipate average annual growth of 6.5 percent from 2015-16 to 2017-18 and then 2.4 percent between 2018-19 and 2021-22 with no explanation (see table 1). How the government intends to exercise such fiscal restraint – more than a 50-percent cut in year-over-year growth – after increasing spending by nearly 20 percent in three years is largely unexplained (Speer 2016b).

TABLE 1: YEAR-OVER-YEAR SPENDING GROWTH PROJECTIONS

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Total Program Spending ($ Billions)	253.8	270.8	291.3	306.5	313.2	317.2	326.0	336.5
Year-over-Year		6.7%	7.6%	5.2%	2.2%	1.3%	2.8%	3.2%

Source: Canada 2016b

It involves a pretty major leap of faith. And there is little reason to believe that the government is prepared to impose the type of sustained fiscal discipline to achieve this drop in spending growth. The reintroduction of the Labour-Sponsored Venture Capital Tax Credit (despite clear evidence it has subsidized poor investment decisions), reversal of the increase to the Old Age Security (OAS) eligibility age, and ending reforms to sick-leave benefits for public servants give reasons to doubt the government's willingness to make tough fiscal choices.

The greater likelihood is that spending rises faster than projected, especially with several big-ticket promises such as increasing health-care spending still outstanding (Crowley and Speer 2016a).

What can Ottawa do to improve its fiscal credibility and better control spending?

It should reconsider its aversion to codified fiscal rules such as balanced budget legislation. Such legislation could improve fiscal transparency, help to set clear markers for spendthrift departments and special interest groups, and help to reconcile trade-offs between spending priorities. It would serve as a legislative guidepost for fiscal policy decision-making and for parliamentary accountability and oversight.

Recall that the government repealed its predecessor's balanced budget legislation on the grounds that it was "inconsistent with the government's plan to return to balanced budgets responsibly, and in a manner that supports economic growth" (Canada 2016a). That the legislation did not preclude deficit spending but rather required that the government was transparent about its rationale for running deficits and had a clear plan to restore a balanced budget hardly seems restrictive. It strikes us as a basic and reasonable expectation.

But, nevertheless, if the government thought it was too limiting, there is nothing stopping it from introducing an alternative. The goal should be to restore the baseline assumption that the government should impose the taxes needed to pay for services it proposes to provide. Deviations from this baseline can be permitted where circumstances warrant but the onus should then be on the government to justify its decision and plan for returning to balance as soon as practical. The result would be to get at the "why" and "when" of deficit spending.

> "The lesson from Australia is that codified fiscal rules can be a useful tool for better and more controlled spending."

Such fiscal rules would not only help the government manage short- and long-term trade-offs, they can support the role of Parliament in scrutinizing fiscal policy in general and spending proposals in particular. The Trudeau government should be credited for restoring Parliament's responsibility for approving Ottawa's annual borrowing limits and providing a greater role for spending oversight by the legislative branch (Crowley and Speer 2016a). Codified fiscal rules would be consistent with these past steps.

New spending can be weighed against current spending and the relative merits can be judged. The budget process can thus become less transactional and more focused on big-picture questions about the long-term conditions for economic growth and rising living standards (Speer 2016a). The lesson from Australia is that codified fiscal rules can be a useful tool for better and more controlled spending (Kirchner et al. 2013).

More generally, the government will need to provide greater detail about its fiscal plan. Present deficit spending is not a crisis. The deficit as a share of gross domestic product (GDP) is low relative to historical experience and the federal debt-to-GDP ratio is steady. But virtually no one thinks that is a justification for unchecked spending increases or ongoing deficits, particularly since, as mentioned above, little of the new spending can be attributed to productivity-enhancing investments.

The Liberal Party (2015) platform set out a goal of realizing $3 billion in annual fiscal savings by 2019-20 through a review of tax expenditures and program spending. This is a smart idea. But the government should be ambitious about the review's scope and goals. It can draw from the lessons of the Program Review exercise that the former Liberal government under Jean Chrétien undertook to scrutinize federal spending and reform organizations and divest assets that were ineffective or outside of the federal scope. The objective should be to accrue significant fiscal savings and modernize the federal government (Speer and Lamman 2014a). It should ultimately be about more than simply cutting spending and instead focused on reforming government programming for the modern context.

There are plenty of options for structural reforms. One place to start is Canada Post. The Macdonald-Laurier Institute (MLI) has previously produced a series of recommendations to fundamentally reform the Crown corporation (Lee 2015). These reforms – including maintaining the transition to community mailboxes, reducing daily delivery to residential customers, and franchising all community post offices – may not improve the federal budget in the short-term, but would help the government fiscal position over the long-term, and, more importantly, improve Canada Post's operations and services.

Other areas ripe for review include:

- The Department of Health which performed below average in meeting spending reduction targets as part of the previous government's 2012 review exercise and delivers no front-line health services except for some reserve and Inuit communities (Canada 2012).

- Business subsidies across the government that produce an unlevel playing field in the market place and cost the federal government billions of dollars each year (Speer and Lamman 2014b).

- Employee sick-leave benefits that impose significant costs on taxpayers and fail federal workers with serious or chronic illnesses (Cross 2015).

There are doubtless dozens of others but these would be a good first step to signal to the market and Canadians that the government is serious about eliminating the budget deficit, maintaining Canada's strong public finances, and modernizing government programs and services.

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AN AGENDA OF INCLUSIVE GROWTH: SETTING THE RECORD STRAIGHT

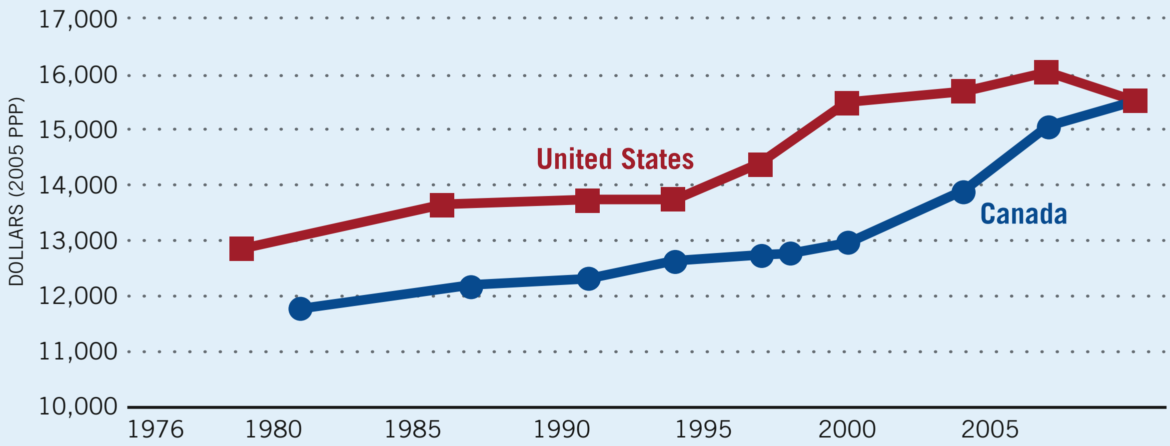
The government has consistently spoken about "inclusive growth" since it was first elected. This is arguably at the heart of what motivates its agenda - and for good reason. Creating the conditions for economic and social mobility ought to be among any government's overriding objectives.

A first step is ensuring any policy choices are rooted in the *actual* evidence of the Canadian experience. Much of the rhetoric about Canada's middle class in particular and social mobility in general is often times wrongly conflated with the wage stagflation and stalled mobility in the United States.

Canada has exhibited much higher levels of social mobility and middle-class wage growth in recent years. Yet there is still a tendency to draw conclusions based on the negative US experience. As one prominent think-tank scholar has put it: “the dismal U.S. headlines do not reflect Canadian reality” (Yakabuski 2013).

While Canada’s median household income lagged that of the US for most of the past 30 years, the trend has recently moved in a positive direction. The gap reached its peak in 1998, when median household income in the United States was 10 percent higher than in Canada. But since then, middle-class incomes have stagnated in the US, while a solid pace of growth has taken place here in Canada. As a result, not only has Canada erased the 20-year gap, it created a 9 percent income advantage by 2010 (see figure 3).

FIGURE 3: MEDIAN PER CAPITA INCOME IN CANADA AND THE UNITED STATES, 1979 TO 2010



Sources: New York Times/Luxembourg Income Study analysis, April 22, 2014; Reeves and Rodrigue 2014.

Canadians now enjoy more social mobility than Americans, too. Canadian boys born into the lowest income decile have a 38 percent chance of reaching the top half of the income distribution by adulthood, and only 16 percent of them will remain on the bottom rung as adults. The odds of a low-income American boy climbing to the top of income distribution are 29 percent, while 22 percent will remain stuck in place at the bottom (Crowley and Speer 2016b).

These divergent trends point to one clear conclusion: Economic opportunity is now less widely available in the United States than in Canada. As Canadian-born George Mason University scholar Frank Buckley has put it, the American dream seems to have migrated to Canada (Buckley 2016).

Yet, despite Canada’s divergent experience, political commentary from the United States has come to colour our policy debate and created a false – or at least incomplete – picture of the state of the Canadian middle-class experience in particular and the state of social mobility more generally.

It does not mean that the government should not be focused on sustaining and strengthening economic and social mobility. There are plenty of steps it can take to improve the conditions for middle-class growth and social mobility as we will outline momentarily. It is just essential that these decisions are informed by a proper understanding of the state of inclusive growth in Canada.

It is also important that a pro-opportunity agenda is rooted in a clear understanding of the limits of redistribution. This is not to say that redistribution should not be a feature of the modern state. But, clearly, the ultimate solution to inequality is not just reshuffling wealth. It neither addresses the root causes of unequal opportunity nor solves it.

New data from Statistics Canada finds that the vaunted "one percent" pay 20.5 percent of income taxes, the top 10-percent of income earners pay 54 percent, and the bottom 50 percent now pay 4.3 percent (Speer and Crowley 2016c). This modern tax distribution is more progressive than under Pierre Trudeau's vision of a "Just Society." At what point have we hit the limits of redistribution, especially in light of empirical evidence on the economic and social costs of high levels of taxation (Veldhuis et al. 2013)?

Of course, a critical role for government policy is to help create the conditions for economic and social mobility. The real solution involves pulling on the levers of federal, provincial, and municipal government – to say nothing of non-government institutions including families, communities, and philanthropists as we set out in the next section. But this commentary cautions that policy-making must start with a clear understanding of the state of Canada's middle class and the limits of wealth redistribution as a solution to unequal outcomes that stem from unequal opportunities.

A PRO-OPPORTUNITY AGENDA FOR CANADA

The government has made progress on its agenda for inclusive growth. Lowering the second-lowest personal tax rate, enacting the Canada Child Benefit, and reforming the Canada Student Grant are positive steps in the direction of strengthening the conditions for economic opportunity. But there is obviously more to be done to help low- and middle-income Canadians climb the economic and social ladder.

Here are three reforms the government ought to consider as part of a pro-opportunity agenda for the 2017 budget.

Affordable and responsible homeownership

Homeownership is associated with a raft of positive economic and social benefits, including better health and educational outcomes for children (Speer and Crowley 2016a). It is among the most effective means of sustaining and strengthening opportunity and middle-class aspirations. Yet rising house prices in major centres such as Toronto and Vancouver are increasingly making homeownership unattainable for low- and middle-income families.

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Notwithstanding anecdotal claims about the role of foreign investment in Canada's real estate market, MLI research shows how provincial and local policies that limit restrained housing supply are largely to blame.

Restrictive land-use regulations, burdensome building and construction codes, and "snob" zoning have led to housing supply being outstripped by demand, which in turn drives up prices. Just consider that detached home construction is at 36-year low in Toronto and has been flat for a quarter century in Vancouver (Speer and Crowley 2016a). People are being precluded from living in these dynamic, job-creating cities and missing out on the opportunities that exist there.

The consequence is that the Trudeau government's own goals for inclusive growth and middle-class opportunity are being undermined by a government-induced housing crisis. It is therefore incumbent on Ottawa to catalyse reforms to support affordable and responsible homeownership for Canada's middle class. It should make itself the spokesperson and agent for the middle class on the housing file and use its spending programs to spur provinces and municipalities to stop obstructing housing supply and the rise of the middle class.

To this end, the Trudeau government could announce in the 2017 budget that its new social housing and infrastructure funding to the provinces and cities will be conditional on liberalizing reforms to restrictive zoning and housing regulations that support more housing supply. It is counterproductive to reward provinces and municipalities with affordable housing and infrastructure funding if these same governments are impairing housing affordability and in turn middle-class opportunity. Ottawa can use its social housing dollars to drive positive reforms.

Making work pay

The design of many low-income benefits often put recipients in the difficult dilemma of choosing between paid work and losing public benefits. The trade-off can be steep. A dollar-for-dollar claw back, for instance, can make work unaffordable after accounting for payroll taxes and additional costs such as transportation and child-care. A basic test for good public policy is that it should not discourage or penalize work.

The Working Income Tax Benefit (WITB) is designed to help the working poor find, maintain, and expand employment without facing a decline in their living standards. It provides a basic income top-up, up to an income threshold, in order to offset reductions in other public benefits that result from accepting a job or assuming more hours.

> "The design of many low-income benefits often put recipients in the difficult dilemma of choosing between paid work and losing public benefits."

WITB is presently benefiting roughly 1.5 million Canadians and the evidence seems to show it is producing positive results (Department of Finance Canada 2016a). Most recipients see their employment income rise over time and only one in five recipients claimed the benefit for three consecutive years between 2009 and 2012 (Gillezeau and Speer 2016).

But the program remains limited in scope and scale especially when compared to the Earned Income Tax Credit in the United States, which is more generous and has higher income thresholds for eligibility. Increasing the WITB's maximum benefits and the income thresholds at which they apply could help the working poor, including those in low-paying yet full-time work. This change would increase the program's salience and also better enable successful transitions back to full-time work.

The government has recently committed to expanding the WITB by roughly $250 million per year. It should consider a larger-scale expansion to further remove the disincentives and penalties for the working poor. The result would be a fairer, more generous, and efficient social welfare policy.

Fairer access to private health insurance

Notwithstanding the Prime Minister's recent signal that the government does not intend to change the present tax treatment of employer-provided health and dental benefits from non-taxable to taxable, it is an idea that he and the finance minister should consider. The non-taxation of these benefits dates back decades and has produced an inherent unfairness, whereby those with such workplace benefits in effect receive a sizeable tax subsidy and those without a workplace plan must purchase insurance with after-tax dollars and minimal government support.

The result is that roughly four-in-ten Canadians do not have private health insurance and must pay for non-insured services with out-of-pocket spending (Speer and Lee 2016). This burden falls disproportionately on less affluent households, unattached individuals, and senior couples who spend a greater share of their disposable income on health care.

The solution is a "tax swap," whereby the government ceases treating workplace health and dental insurance as non-taxable and in turn uses the resulting revenues to establish a new refundable tax credit to help the defray the costs of buying private insurance. The new tax credit might involve a redesign of the existing Medical Expense Tax Credit and would be available to *all* Canadians irrespective of a person's employment circumstances, including coming in the form of a cash transfer for low-income citizens who do not pay income taxes.

One such proposal would provide an annual tax benefit of up to $750 for individuals with incomes less than $44,000 and up to $1,500 for families with incomes less than $89,000 (Canada 2015). Households with incomes below $100,000 would be better off and the growing costs of out-of-pocket spending on health care could be slowed.

The idea of replacing the current tax treatment with a new broad-based tax benefit is worth exploring. It would not only address the equity issues inherent in the current treatment, it would shift the insurance model from being tied to employment which is prudent in the face of changing labour force dynamics. Obviously any such policy change would need to consider options for pooling and low-cost, basic plans. But in theory it could be a positive step for expanding access to private health insurance.

CONCLUSION

The 2017 budget is shaping up to be the most important since the Harper government's first as a majority government in 2012 and the Chrétien government's budget-cutting efforts in 1995. Both budgets involved sweeping changes that played a dominant role in the remainder of each government's four-year mandate.

The Trudeau government now finds itself in similar circumstances. Its first year has been mostly focused on delivering on high-profile campaign commitments and consulting on its broader agenda. The 2017 budget will be a primary opportunity for a higher level of ambition, especially assuming the government becomes more cautious in the lead up to the 2019 federal election.

This short pre-budget commentary has sought to contribute to the government's thinking and planning about the budget with a particular focus on the need for a clear, credible fiscal plan. Inclusive growth must ultimately be rooted in a solid fiscal foundation.

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About the Macdonald-Laurier Institute

What Do We Do?

When you change how people think, you change what they want and how they act. That is why thought leadership is essential in every field. At MLI, we strip away the complexity that makes policy issues unintelligible and present them in a way that leads to action, to better quality policy decisions, to more effective government, and to a more focused pursuit of the national interest of all Canadians. MLI is the only non-partisan, independent national public policy think tank based in Ottawa that focuses on the full range of issues that fall under the jurisdiction of the federal government.

What Is in a Name?

The Macdonald-Laurier Institute exists not merely to burnish the splendid legacy of two towering figures in Canadian history – Sir John A. Macdonald and Sir Wilfrid Laurier – but to renew that legacy. A Tory and a Grit, an English speaker and a French speaker – these two men represent the very best of Canada's fine political tradition. As prime minister, each championed the values that led to Canada assuming her place as one of the world's leading democracies. We will continue to vigorously uphold these values, the cornerstones of our nation.


SIR JOHN A. MACDONALD


SIR WILFRID LAURIER

Working for a Better Canada

Good policy doesn't just happen; it requires good ideas, hard work, and being in the right place at the right time. In other words, it requires MLI. We pride ourselves on independence, and accept no funding from the government for our research. If you value our work and if you believe in the possibility of a better Canada, consider making a tax-deductible donation. The Macdonald-Laurier Institute is a registered charity.

Our Issues

The Institute undertakes an impressive programme of thought leadership on public policy. Some of the issues we have tackled recently include:

- Getting the most out of our petroleum resources;
- Ensuring students have the skills employers need;
- Aboriginal people and the management of our natural resources;
- Controlling government debt at all levels;
- The vulnerability of Canada's critical infrastructure;
- Ottawa's regulation of foreign investment; and
- How to fix Canadian health care.

True North in Canadian public policy

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What people are saying about the Macdonald-Laurier Institute

In five short years, the institute has established itself as a steady source of high-quality research and thoughtful policy analysis here in our nation's capital. Inspired by Canada's deep-rooted intellectual tradition of ordered liberty – as exemplified by Macdonald and Laurier – the institute is making unique contributions to federal public policy and discourse. Please accept my best wishes for a memorable anniversary celebration and continued success.

THE RIGHT HONOURABLE STEPHEN HARPER

The Macdonald-Laurier Institute is an important source of fact and opinion for so many, including me. Everything they tackle is accomplished in great depth and furthers the public policy debate in Canada. Happy Anniversary, this is but the beginning.

THE RIGHT HONOURABLE PAUL MARTIN

In its mere five years of existence, the Macdonald-Laurier Institute, under the erudite Brian Lee Crowley's vibrant leadership, has, through its various publications and public events, forged a reputation for brilliance and originality in areas of vital concern to Canadians: from all aspects of the economy to health care reform, aboriginal affairs, justice, and national security.

BARBARA KAY, NATIONAL POST COLUMNIST

Intelligent and informed debate contributes to a stronger, healthier and more competitive Canadian society. In five short years the Macdonald-Laurier Institute has emerged as a significant and respected voice in the shaping of public policy. On a wide range of issues important to our country's future, Brian Lee Crowley and his team are making a difference.

JOHN MANLEY, CEO COUNCIL