



HELI *and*
High Water:

**An Assessment
of Paul Martin's
Record and
Implications
for the Future**

Edited by Todd Scarth



Hell and High Water

An assessment of Paul Martin's record
and implications for the future

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Taxation: The Martin Record

by Hugh Mackenzie

On October 18, 2000, Paul Martin rose from his seat next to the Prime Minister in the House of Commons to deliver an election budget that cut federal taxes by \$100 billion over five years. In that political moment, the campaign of the newly-formed Canadian Alliance all but vanished, the core of their platform appearing plank after plank in the self-satisfied drone of the Minister of Finance.

But the Alliance Party's platform wasn't all that vanished on October 18, 2000.

So did the hopes of progressives within the Liberal party, and without, for a renewal any time soon of the federal government's role in Canadian social policy. One wonders if any of the Liberals who leaped to their feet to applaud this "political master-stroke" understood that their efforts to restore public services devastated by the fight against the deficit had just been dealt a body blow. One wonders if the Prime Minister sitting beaming up at his Minister of Finance appreciated that this budget would force him into an embarrassing last-minute struggle to rehabilitate his legacy and to distinguish it from that of his bitter internal rival.

Having decimated public services in his crusade against the deficit, Paul Martin had with one stroke wiped out the government's fiscal capacity to rebuild the services and transfers that were cut in the mid-1990s. His tax policy "coup" etched in stone his vision of a smaller, less influential federal government in a way that none of his actions in the previous five years could have done.

Reducing fiscal capacity was the main event, but, in any other political atmosphere, the side-effects would have been just as worthy of note. Martin's move to slash capital gains taxes – in effect conferring a substantial tax preference on unearned income – drove the final nail into the coffin of the 1960s Carter Commission notion that “a buck is a buck is a buck” that underpinned the goals of Canadian tax reform for thirty years. That move also put the finishing touches on a tax plan so disproportionate in its favouring of the highest-income taxpayers that it would have made Brian Mulroney's notoriously pro-business Finance Minister, Michael Wilson, blush.

And by embarking on a program of substantial corporate tax cuts, Martin abandoned Canada's resistance to pressure from tax cutters in the United States and vaulted to the head of the pack in the race to the bottom in the taxation of income from capital.

Cutting off the life support for public services renewal

Of course, the package of tax cuts announced by Martin in October 2000 was not the first tax change he made, nor was reducing federal fiscal capacity the only tax policy objective on his agenda. But to understand the significance of Martin's tax package, you have to go back five years to the beginning of his five-year quest to reduce and then control the size of the federal government – the one clear accomplishment of Martin's career as Finance Minister.

When Paul Martin officially unveiled his assault on the federal public economy in his 1995 budget speech, one of his many forecasts stood out from the others:

By 1996-97, we will have reduced program spending from \$120 billion in 1993-94 to under \$108 billion. Relative to the size of our economy, program spending will be lower in 1996-97 than at any time since 1951.¹ [emphasis added]

It was a forecast breathtaking in its simplicity and stunning in its implications. And, in true Paul Martin fashion, it was understated. Federal program spending for the 1996-7 fiscal year turned out to be 12.5% of GDP – lower than in any budget year since 1949-50. Even with the so-called “spending spree” with which Jean Chrétien ended his period as Prime Minister, the government's current forecasts have spending stabilizing at 11.6% of GDP.² We've only had two years since 1940 with a smaller federal government role in the economy: 1947-8 and 2000-1.

To find a point of comparison for Martin's vision of the role of the federal government in the economic lives of Canadians, he took Canadians back in our history to before Medicare, before the Canada Assistance Plan, before the Quiet Revolution in Quebec, before the era of co-operative federalism, before CBC Television first went on the air – in short, to an era before the beginnings of the development of the modern Canadian nation state.

At the time of Martin's 1995 budget, this unprecedented assault on Canadian public services was excused as a necessary response to an intractable federal budgetary deficit – as a *temporary* sacrifice on the part of all Canadians in order to secure our economic future. With the benefit of hindsight, we know that the deficit was largely a cyclical phenomenon – that, in the period of economic growth and reduced interest rates in the late 1990s, the budget would have been balanced ahead of Martin's original timetable without any program spending cuts. We also know, with the benefit of hindsight, that the sacrifice was neither temporary nor shared. Most of the essays in this book are devoted to an exploration of these facts.

By embarking on a program of substantial corporate tax cuts, Martin abandoned Canada's resistance to pressure from tax cutters in the U.S. and vaulted to the head of the pack in the race to the bottom in the taxation of income from capital.

We now know that the deficit justification was a fraud; that Paul Martin seized on Canadians' concern for their country's fiscal health as a smokescreen behind which he drove the Government of Canada towards a vision of a radically reduced role for public services in the lives of Canadians.

The crusade against the deficit served Martin's vision of smaller government well. But it could not last. The once-intractable deficit melted away so quickly that Martin had to resort to laughably blatant underestimates of revenue and overstatements of expenditures to dampen Canadians' expectations of an end to their "temporary" sacrifices. By 1997, the threat that the deficit might actually be beaten was so grave that Martin understated revenue by \$20 billion in an effort to keep resumed spending growth off the agenda for that year's federal election.

Revenue growth was accelerating rapidly, even as program cuts announced by Martin in the mid-1990s were still being implemented. Bur-

Table 1: Revenue and Program Spending, 2001-1 (actual) to 2008-9 (forecast) – millions of dollars

	2000-1	2001-2	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Personal income tax	82,300	83,790	81,707	83,440	86,025	91,105	96,200	102,375	109,530 ¹
Corporate income tax	28,200	24,013	22,222	23,450	24,755	26,095	26,855	26,990	26,860
Other income tax	4,300	3,035	3,291	3,315	3,455	3,585	3,710	3,825	3,895
Total income tax	114,800	110,838	107,220	110,205	114,235	120,785	126,765	133,191	140,285
Goods and services tax	25,000	24,909	28,248	29,260	31,170	32,865	34,585	36,425	38,475
Customs import duties	2,800	3,018	3,221	3,130	3,440	3,915	4,225	4,445	4,710
Energy taxes	4,758	2,496	2,525	2,585	2,650	2,700	2,735	2,775	2,775
Other excise taxes/duties	8,300	3,933	6,971	6,920	7,080	7,235	7,380	7,550	7,815
Air Travellers Security Charge	421	375	395	415	430	445	460	475	490
Total	36,100	36,638	41,357	42,210	44,670	47,080	49,320	51,600	54,235
Total tax revenues	151,000	147,476	148,577	152,415	158,905	167,865	176,085	184,790	194,520
El premium revenues	18,700	17,980	17,870	17,500	17,135	16,965	17,420	18,035	18,730
Other revenues	8,900	7,859	11,115	10,575	10,250	10,700	10,850	11,100	11,330
Total budgetary revenues	178,600	173,315	177,562	180,490	186,290	195,530	204,355	213,925	224,580
Personal income tax	7.8	7.7	7.1	6.9	6.8	6.8	6.9	7.0	7.1
Corporate income tax	2.7	2.2	1.9	1.9	1.9	2.0	1.9	1.8	1.7
Goods and services tax	2.4	2.3	2.4	2.4	2.5	2.5	2.5	2.5	2.5
Other excise	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.0	1.0
Tax revenues	14.3	13.5	12.9	12.5	12.5	12.6	12.5	12.6	12.6
El premium revenues	1.8	1.6	1.5	1.4	1.3	1.3	1.2	1.2	1.2
Non-tax revenues	0.8	0.7	1.0	0.9	0.8	0.8	0.8	0.8	0.7
Total	16.9	15.9	15.4	14.8	14.7	14.6	14.6	14.5	14.6
Personal income tax	6,200	12,700	15,600	18,300	22,300	22,975	24,104	25,308	26,386
Corporate income tax	-	600	1,900	3,200	4,400	4,400	4,400	4,400	4,400
Employment insurance	1,500	2,500	3,000	3,800	4,400	4,400	4,400	4,400	4,400
Total	7,700	15,900	20,500	25,300	31,100	34,205	35,749	39,157	39,287
Adjusted revenue as % of GDP	186,300	189,215	198,062	205,790	217,390	229,735	240,104	253,082	263,867
Tax cut losses as % of GDP	17.6%	17.4%	17.2%	16.9%	17.2%	17.2%	17.2%	17.2%	17.2%
Program spending as % of GDP	7,700	15,900	20,500	25,300	31,100	34,205	35,749	39,157	39,287
Program spending as % of GDP	0.7%	1.5%	1.8%	2.1%	2.5%	2.6%	2.6%	2.7%	2.6%
Program spending as % of GDP	119,300	126,700	133,323	142,050	147,064	155,310	162,575	170,361	177,890
Program spending as % of GDP	11.3%	11.6%	11.6%	11.6%	11.6%	11.6%	11.6%	11.5%	11.6%

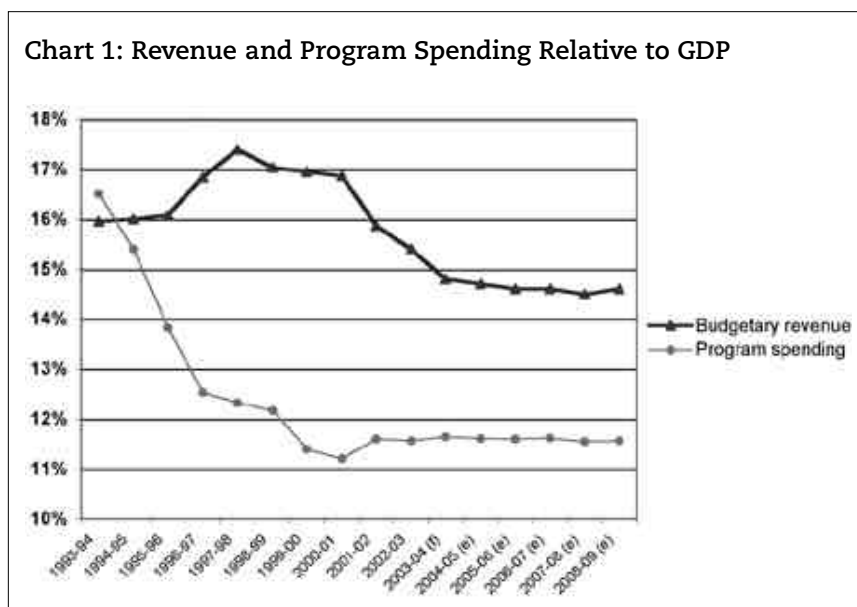
geoning surpluses not only destroyed the rationale for continuing with those cuts, but also confronted the government with two unpleasant facts: the Martin cuts hadn't been necessary in the first place; and the economy was generating more than enough additional revenue to make a substantial start on rebuilding.

At first, ultra-conservative economic assumptions, contingency reserves, and allowances for "prudence" kept the revenue growth off the political table until after the fiscal year-end, when it was too late to do anything with it except pay down the public debt.

So in the well-worn pattern of neo-conservative governments around the world, from Ronald Reagan and Margaret Thatcher forward, Martin set out to cut off the life-support for public services renewal by radically reducing taxes.

Seizing the opportunity presented by the demonstrated political salience of tax cuts in the province of Ontario and the imagined threat from the right in the form of the Canadian Alliance, on the eve of the 2000 election Martin pushed through a tax cut of \$100 billion over five years.

As Chart 1 and Table 1 show, the impact of the tax cuts on the fiscal capacity of the Government of Canada has been dramatic. By the fifth year – 2004-5 – federal government revenue-raising capacity will be down by \$31.1 billion a year, compared with where it was in 2000-1, a reduction of 17% in total federal government revenue compared with what it would



have been without the tax cuts. Measures not fully implemented by 2004-5, including the elimination of the capital tax on large corporations, will reduce revenue still further in subsequent years.

Rewarding Canadians for their sacrifices

Finance Minister Martin pitched his tax cuts as a “reward” to Canadians for the sacrifices they had made in the fight to eliminate the federal deficit. Fine-sounding rhetoric, except that the Canadians who were rewarded were not the Canadians who had suffered the sacrifices imposed on them through federal budget cuts. The burden of the cuts had fallen disproportionately on the poor and disabled (through the elimination of the Canada Assistance Plan); on the unemployed (as a result of substantial cuts in unemployment insurance benefits); on students (through the cuts in federal transfers to the provinces for higher education and as a result of changes

The burden of the cuts had fallen disproportionately on the poor and disabled, the unemployed, students, the under-housed and homeless, and Canadians who depend on our health care system.

to the Canada Student Loans Program); on the under-housed and homeless (as a result of the elimination of the co-operative and non-profit housing program); and on Canadians who depend on our health care system (as a consequence of a reduction of the federal share of provincial Medicare costs.

The benefits went disproportionately to the highest-income individuals in Canada. More than 30% of the benefit from the Martin tax package went to the highest-income 5.3% of taxpayers. The highest-income 30% of taxpayers received 70% of the benefit, and the middle 50% of taxpayers received 31% of the benefit.³

Chart 2 illustrates in dramatic fashion the nature of the Martin tax cut package. It organizes the tax savings from the lowest-income taxpayers with taxable incomes to the highest-income taxpayers with taxable incomes, showing average tax savings for taxpayers from the lowest-income to the highest-income. It shows, for example, that a taxpayer in the median income range (\$30-35,000) would receive an average saving of approximately \$800. A taxpayer in the top half of 1% of incomes would receive an average saving of just over \$19,000. For comparison purposes, an equal distribution of the savings would be a flat line at approximately \$1,100.

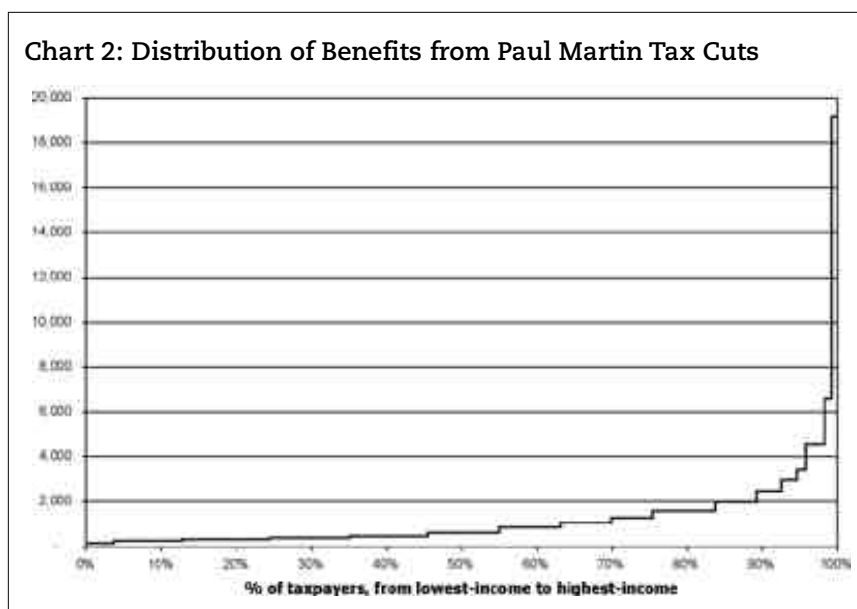
The area under the line on the chart measures the total value of the tax cut as we move up the income scale.

By far the most inequitable of the Martin tax moves was the reduction in the inclusion rate for capital gains from 75% to 50% – reducing the rate of tax on capital gains from 3/4 of the normal tax rate to 1/2. More than 45% of the benefit from the capital gains tax cut went to the highest income 0.6% of taxpayers. The highest-income 25% of taxpayers received nearly 90% of the benefit.

These data do not take into account tax and transfer changes based on family incomes. In particular, they do not account for improvements in the Child Tax Benefit, which provided substantial additional benefits to low-income families not dependent on social assistance, or for cuts to unemployment insurance.

However, a more complete calculation based on census families presents a similar picture. An analysis of the full package of tax-and-transfer changes based on year-2000 family incomes shows that the highest-income 23% of census families (incomes over \$75,000) derived 51% of the benefit. The lowest-income 20% received 4.7% of the benefit.⁴

While the decision to cut taxes on unearned capital gains income was the most blatant assault on the “buck is a buck” philosophy that had guided Canadian tax policy for more than a generation, it was not Martin’s first assault on those principles.



One of the guiding principles of Canadian tax policy had been the view that the granting of special deductions and credits in the personal income tax system undermined the equity of the tax system and destroyed its transparency. From the early 1970s on, successive federal governments had moved to limit or eliminate special categorical deductions that favoured certain types of income or expenditures over others. During Paul Martin's tenure as Finance Minister, the principle of horizontal equity – equal treatment of individuals with equal incomes – was turned on its head, as Martin moved to deliver financial assistance directly to individual Canadians through the tax system. Even during his deficit-fighter period, Martin's annual budgets were laced with narrowly-targeted tax-delivered preferences, many of them in the areas of public policy in which program spending was being most sharply curtailed.

Corporate taxes and the race to the bottom

The only significant tax-reform thinking undertaken during Paul Martin's tenure as Finance Minister was a sweeping analysis of Canadian corporate taxation conducted by then-University of Toronto Professor Jack Mintz.⁵ Asked to make revenue-neutral recommendations for reform of Canada's corporate income tax system, Professor Mintz's Task Force recommended that the government eliminate a wide range of special deductions, credits, and tax preferences in the corporate tax system and use the revenue generated from their elimination to fund a reduction in corporate tax rates. In addition, although he made no specific recommendations, Mintz expressed skepticism about the policy case for – and the economic efficacy of – special reduced tax rates for small businesses.

Mintz's tax preference recommendations were ignored. Instead, Martin implemented a package of corporate tax cuts that put Canada into the lead in the race to the bottom in North America in corporate tax rates, including reductions in rates of tax on small businesses.

The Ministry of Finance's own data demonstrate clearly that the schedule of Canadian corporate tax rate cuts currently being implemented will put corporate tax rates in Canada substantially below corporate tax rates in the United States.

By the time the schedule of cuts is complete in 2008, the general corporate tax rate will have been reduced from 28% to 21%.

Table 1 shows revenue from corporate taxes dropping from 2.7% of GDP before Martin began his orgy of corporate tax cuts to 1.7% by the

end of the federal government's current five-year planning horizon. Relative to the size of the economy, corporate taxes will have been cut by more than 35% by 2008-9.

For all the talk about having to respond to a competitive taxation environment, Canada is now a source of negative pressure on public revenue from corporations in other jurisdictions. We are well ahead in the race to the bottom. It's a race you join by reducing the contribution made by the owners of corporations to the support of public services. A race in which you move ahead by giving in more, and more quickly, to the demands of corporations for a free ride. A race in which your lead inevitably evaporates, as other jurisdictions are forced to bid corporate taxes even lower.

Looking forward

Paul Martin likes to use words of caution in describing his approach to politics: words like balance; responsibility; prudence. And during his period as Finance Minister, he structured his budgets, and his forecasts of their impact, so that they appeared to support that claim.

In fact, the Finance Minister was anything but cautious in delivering on the wish lists of the most conservative forces in Canadian society.

By his own proud admission, he reduced federal public service to its level in the late 1940s. And, through his tax policies, he made it next-to-impossible for any centrist government to recover the ground lost.

So don't expect to see any true initiatives on the tax side from Paul Martin. As Prime Minister, he will follow the pattern he set as Finance Minister, implementing tax cuts as they are needed to slow revenue growth down to the pace of expenditure growth in a constrained and still-shrinking federal government.

That doesn't mean we won't see more tax cuts from Paul Martin. He has made it clear repeatedly that he intends to continue to cut Canada's revenue potential to fit a (reduced) program spending level. That message is reinforced by his repeated declaration that his first step towards implementing any new agenda items will be to find space within the existing budget through program review.

For all the talk about having to respond to a competitive taxation environment, Canada is now a source of negative pressure on public revenue from corporations in other jurisdictions. We are well ahead in the race to the bottom.

That begs two questions: where might the potential cuts come from? And where will the political will come from to implement them?

Health care clearly cannot be on the agenda for future spending cuts. Indeed, it is already scheduled for increases into the future, and will likely increase still further as the federal government attempts to re-establish the position in national health care policy it lost under Mulroney and Martin as Finance Minister. Nor can defence, or public security. If anything, Martin is a critic of the Chrétien government from the other side of the debate on defence spending and spending on public security. Old Age Security can't be touched. Even Paul Martin would have to acknowledge that it would be difficult to cut Employment Insurance any further.

That leaves an array of much smaller programs on the chopping block. And here, what we should expect depends on which of two Paul Martins has become the Prime Minister. Paul Martin the business turn-around artist abandoned sailors in foreign ports when his ships were re-flagged

In the Martin-as-Finance-Minister era, he had Jean Chrétien the disarming salesman standing in front of him, convincing Canadians of the need to make tough choices and creating the political space within which Martin could work.

and single-handedly shut down the Great Lakes shipbuilding industry, laying off hundreds in the process. With that Paul Martin as Prime Minister, we might see entire activities of the federal government terminated. However, we have seen only occasional glimpses of that Paul Martin: when he gutted the Unemployment Insurance program; and when he tore up 25 years of federal-provincial financial arrangements with the Canada Health and Social Transfer.

Paul Martin the Finance Minister made most of his cuts by following the path of least resistance, cutting transfer payments – forcing others to do the dirty work; focusing on programs whose political constituencies didn't matter to him; and otherwise imposing small cuts across the whole federal public service. The problem is that we've been there, done that.

The question of political will is truly an unknown. In the Martin-as-Finance-Minister era, he had Jean Chrétien the disarming salesman standing in front of him, convincing Canadians of the need to make "tough choices" and creating the political space within which Martin could work. Chrétien had a reserve of public affection to draw on. There is no evidence that Martin has a similar reserve. And there is no evidence that

Martin has the communications skills to sell more cutbacks at a time when there is no perceived crisis that calls for them.

Notes

¹ Budget Speech, 1995.

² Fiscal and Economic Update, Annex 3, p. 103

³ Estimates of impact derived from a model of the Canadian tax system using the most current available personal income tax data (2001). In the model, detailed tax form data for income groups are used to simulate revenue raised under various rate-and-tax-credit structures. Source Data: Individual Income Tax Statistics, Interim Basic Table 2A, Taxable Returns by Total Income Class.

⁴ Analysis of the impact of Federal Government tax and transfer policy changes announced in the 2000 Budget and Mini-Budget, using the Social Policy Simulation Database and Model, Version 7.0.

⁵ Professor Mintz is currently on leave from the University of Toronto as President of the C.D. Howe Institute.