
Fixing BC's Structural Deficit: What, Why, When, How? And for Whom?

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PRÉCIS

Le nouveau gouvernement de la Colombie-Britannique, élu en mai 2001, veut rétablir rapidement la croissance économique de la province, et, à cette fin, concentre ses efforts à éliminer le déficit structurel. Bien que les prévisions d'une Commission de révision fiscale nommée par le gouvernement (publiées en juillet 2001) aient manifestement exagéré l'importance du déficit structurel auquel la province était confrontée, il est clair que les importantes réductions fiscales du nouveau gouvernement ont augmenté considérablement le déficit structurel hérité du gouvernement précédent. L'engagement officiel de rétablir l'équilibre budgétaire en 2004-2005 sans augmentation considérable des impôts donne lieu à des stratégies de compressions des dépenses importantes et radicales. Ces coupures entraînent des réductions substantielles dans les services publics et avantages accordés aux individus à faibles revenus et aux plus démunis. En supposant que des niveaux d'impôts nettement moins élevés sont nécessaires pour favoriser la croissance économique, la stratégie budgétaire de la Colombie-Britannique omet de considérer trois questions primordiales : Quelle devrait être la taille du gouvernement? Quels sont les effets de redistribution qu'entraîneraient les diverses politiques qui seront adoptées afin d'éliminer le déficit structurel? De quels moyens dispose-t-on pour accroître les revenus fiscaux tout en améliorant la performance économique de la province?

Cette étude examine en profondeur le concept du déficit structurel, l'applique à la situation particulière de la Colombie-Britannique et dresse des parallèles évidents pour d'autres gouvernements provinciaux. Selon l'auteur, un déficit structurel est un concept essentiellement dynamique, et il peut être résorbé à long terme par la croissance économique et les revenus gouvernementaux qui y sont associés à condition que la dette publique ne soit pas trop élevée et que la croissance des

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dépenses publiques soit sous contrôle. L'étude examine pourquoi un déficit structurel doit être éliminé, quand et dans quel délai il faut l'éliminer, et comment il faut procéder pour l'éliminer. La question des effets de redistribution — quels sont les gagnants et les perdants — est présente tout au cours de l'analyse. Même si le fait de ne pas s'attaquer au problème du déficit peut entraîner des coûts inacceptables pour les contribuables et les gouvernements futurs, il faut tout de même s'assurer de choisir des politiques qui causeront le moins de tort possible aux générations présentes de citoyens à faibles revenus et autres personnes démunies. Se donner plus de souplesse quant au délai pour éliminer le déficit structurel — prévoir, par exemple, une ou deux années de plus pour atteindre l'objectif — permettrait d'alléger considérablement le coût de tels ajustements. Trouver des sources additionnelles de revenus selon des méthodes judicieusement choisies pourrait alléger cet ajustement encore davantage, améliorer l'efficacité du régime fiscal et éviter les effets de redistribution les plus défavorables.

L'auteur s'intéresse particulièrement aux moyens fiscaux et non fiscaux d'accroître les revenus de la province afin de résoudre le problème du déficit structurel de la Colombie-Britannique. Le principe de base est que les revenus doivent être prélevés selon les méthodes les plus efficaces du point de vue économique et les plus favorables à la croissance économique. Parmi les sources possibles de revenus ne provenant pas des impôts, l'auteur cite les enchères pour les droits d'exploitation de terrains actuellement non développés et l'adoption des taux de marché pour le prix de l'énergie hydro-électrique de la province. L'auteur soutient que les fortes augmentations récentes des primes pour les soins de santé en Colombie-Britannique, bien qu'elles soient un exemple classique d'un impôt à taux forfaitaire, sont déficientes à plusieurs égards. Par ailleurs, si la forte mobilité interprovinciale de la main-d'œuvre qualifiée est un argument en faveur des réductions des taux d'impôt sur le revenu pour les tranches d'imposition les plus élevées, les pertes de revenus dues à de telles diminutions d'impôts non ciblées demeurent discutables quand il s'agit de s'attaquer au problème du déficit. L'auteur fait une comparaison entre la stratégie de diminution des impôts sur le revenu de la Colombie-Britannique et les stratégies mises de l'avant en Alberta, en Ontario et en Saskatchewan. L'auteur suggère qu'une taxe générale sur la masse salariale et une réforme en profondeur de l'impôt sur les sociétés seraient des méthodes plus intéressantes d'augmenter les revenus de la province. En réformant son système fiscal, la Colombie-Britannique pourrait à la fois augmenter ses revenus et stimuler la croissance des entreprises et des investissements.

Du côté des dépenses, l'auteur soutient qu'il y a plusieurs raisons de s'inquiéter des coupures qui transfèrent principalement les coûts aux ménages et aux entreprises. En Colombie-Britannique, un grand nombre de compressions budgétaires ont créé de fausses économies et des effets de redistribution défavorables. De plus, des politiques qui créent un climat négatif dans la société peuvent réduire la confiance des investisseurs en ce qui concerne la pérennité de ces politiques et, par conséquent, réduire les activités d'investissement. Les dépenses gouvernementales devraient être de nature à améliorer les compétences des individus et ainsi produire des rendements sociaux élevés qui s'étendraient au-delà du terme d'un seul gouvernement. La disponibilité d'une main-d'œuvre qualifiée, des systèmes de transport efficaces, des zones urbaines dynamiques et une société civile saine sont des éléments qui sont plus importants pour la plupart des entreprises que de bénéficier des niveaux d'impôts les plus faibles. Ces objectifs ne peuvent toutefois être atteints que par des gouvernements qui disposent de ressources financières adéquates. En somme, l'adoption d'un ensemble

de politiques fiscales diversifiées peut résoudre le problème du déficit structurel de la Colombie-Britannique et à la fois stimuler la croissance économique, protéger les programmes sociaux et favoriser l'inclusion sociale des membres les plus défavorisés de la société.

ABSTRACT

British Columbia's new government, elected in May 2001, is focused on fixing the province's structural deficit as part of an attempt to restore rapid growth to the bc economy. However, the government's broad tax cuts considerably enlarged the structural deficit inherited from the previous administration, and the magnitude of that deficit was evidently overstated in projections by a government-appointed Fiscal Review Panel. The official commitment to restoring budgetary balance by 2004-5 without major tax increases has generated plans for large and sweeping cuts to provincial spending. These cuts entail major reductions in public services and benefits affecting society's lower-income and vulnerable members. In assuming that much lower taxes are needed for economic growth, British Columbia's budgetary course has obscured three key issues: the choice between larger and smaller government, the distributional effects of alternative policy choices for fixing the structural deficit, and ways to augment revenue that would also improve the provincial economy's performance.

This study carefully reviews the structural deficit concept and applies it to the bc situation, with obvious parallels for other provincial governments. A structural deficit is found to be essentially a dynamic concept. Growth in an economy and its public revenues can resolve the problem over time if public debt is not too large and public expenditure growth is controlled. The study examines why a structural deficit should be fixed, when and how quickly to fix it, and how to fix it. The distributional issue—who gains and who loses—is interwoven throughout the analysis. Failing to address the deficit would lead to unacceptable burdens for future taxpayers and governments, but care needs to be exercised in the policies chosen to avoid adverse effects on current lower-income and vulnerable residents. Allowing more flexibility in how quickly to eliminate the structural deficit, adding perhaps one or two years to the target, would considerably ease the adjustment burden. Supplementing revenues through well-chosen means could further ease the adjustment, improve the efficiency of the tax regime, and avoid most adverse distributional impacts.

Particular attention is given to non-tax and tax revenue means of fixing British Columbia's structural deficit. The basic principle is that revenues should be collected in ways that are most economically efficient and favourable to growth. Potential non-tax revenue sources include auctions for rights to remove currently frozen lands for development and pricing of provincial hydroelectric energy at market rates. The recent sharp hikes in British Columbia's medicare premiums, while a classic example of a lump-sum tax, are found to be deficient on several grounds. High interprovincial mobility of skilled labour supports the province's cuts to upper-bracket personal income tax rates, but the revenue loss from the broader tax cuts is questionable in view of the deficit problem. British Columbia's personal-tax-cutting strategy is compared with those of Alberta, Ontario, and Saskatchewan. Other appealing ways of augmenting British Columbia's tax revenues are found in a general payroll tax or a major reform of corporate income taxes. By reshaping its tax system, British Columbia

could both generate more revenues and enhance its attractions for business expansion and investment.

On the expenditure side, there are reasons to be concerned about cuts that mainly shift costs to households and businesses. In British Columbia, many of these cuts have produced false economies and adverse distributional effects. Moreover, policies that create an adversarial climate in society can reduce investors' confidence about the durability of those policies and thereby diminish their stimulus to business investment. Expenditures should be targeted on the development of human skills and competencies, in ways that produce returns that are socially high but stretch beyond the term of a single government. Availability of skilled labour, effective transport systems, vital urban areas, and a safe, civil society are more important to most businesses than having the lowest taxes. Yet these goals can be achieved only by governments that have adequate financial resources. In summary, an alternative package of fiscal policies could fix British Columbia's structural deficit, while augmenting economic growth, protecting social programs, and offering inclusive treatment of society's disadvantaged members.

KEYWORDS: BRITISH COLUMBIA ■ BUDGETS ■ DEBT REDUCTION ■ DEFICITS ■ PROVINCIAL TAXES ■ TAX POLICY

INTRODUCTION

Since the election of a new government in May 2001, British Columbia has seen dramatic changes in taxation, public spending, and regulatory policies motivated by two key goals—restoring more rapid growth to the provincial economy and making the public sector sustainable.¹ The latter objective, sustainable public finances, can be gauged by a concept called “the structural deficit.” This concept quantifies the gap between public expenditures and revenues, abstracting from the effects of temporary economic slumps on these components. Any measure of the structural deficit must also take into account the long-run growth rate of the economy, since this affects the real value and relative burden of the accumulated public debt. Moreover, policy elements of the structural deficit (tax rates and program spending) can themselves influence the economy's long-run growth rate through various causal channels. For that reason, discretionary changes to taxation and expenditure policies can affect the structural deficit both directly and immediately, and indirectly over the longer term.

This article provides a non-technical overview of the structural deficit concept and an assessment of British Columbia's structural deficit. It then discusses considerations of why the structural deficit should be fixed, the appropriate timing of measures to fix it, and how policies should be chosen to fix it. Public finance and economic analysis do not provide an unequivocal prescription for addressing the structural deficit but rather a set of general principles by which actual or proposed policies can be judged. In the end, the choice of public policies will be preconditioned by personal values about the proper scale and scope of government. Often the policy alternatives are couched in ways that obscure this innate value choice between smaller and larger government. Also relevant are personal views about the appropriate distribution of the tax burden and of the benefits of public spending.

This distributional issue is typically stated in terms of reducing the burdens of public debt on future generations, but the distributional consequences of alternative policy choices for current residents at different income levels are equally vital.

The issues assessed in this article are also relevant for public finances of the other Canadian provinces, most of which have already confronted similar fiscal issues. Indeed, British Columbia's previous NDP administration struggled to restore budgetary balance after inheriting a large deficit (\$2.3 billion in 1991-92), most of it structural.² After initial years of tax rate hikes and restrained growth of public spending, the BC government met with reasonable success in fiscal sustainability, even allowing for modest tax rate cuts in its later years.³ The provincial debt-gross domestic product (GDP) ratio (a key measure of fiscal sustainability) barely budged from 19.5 percent in 1993-94 to 19.6 percent in 2000-1.⁴ The NDP's final budget of 2001-2, however, was able to forecast a surplus only by using a large one-time revenue gain from an accounting change, by projecting continued buoyant energy revenues, and by assuming a solid economic growth rate. The reversal of these factors in the following fiscal year plus large scheduled public sector wage increases pushed the BC budget into structural deficit. This deficit was greatly compounded by the new government's tax cuts of \$2.3 billion annually. Many other provincial budgets have also suffered the effects of a slowing economy, mounting health-care costs, and falling energy revenues over this period. However, while there is much commonality with the situation of other provinces, British Columbia's fiscal position appears more severe than elsewhere.

The fiscal situation in British Columbia offers a useful focus on central issues of provincial public finance. Sharp tax cuts for both individuals and business, when a structural deficit is already emerging, heighten the pressures to curtail public spending and services. Alternatively, they raise the question of how revenues can be restored in ways that are less inimical to economic growth than heavy taxes on higher earners and business investment. This study will consider methods by which British Columbia could replace revenues through non-tax measures, some of which may have relevance elsewhere. It will also assess the comparative strategies by which British Columbia, Alberta, Saskatchewan, and Ontario have chosen to reduce their personal income taxes. And it will consider ways of gathering additional taxes from business which are relatively favourable to investment. Public spending measures need to be equally focused on the economic growth and fiscal balance objectives, and some general observations are provided on this topic. Ultimately, it appears that British Columbia's recent policies will compromise the principles developed here unless the objective is simply to shrink government irrespective of fiscal sustainability.

THE STRUCTURAL DEFICIT CONCEPT

The concept of a structural deficit is often used in the analysis of public finance and macroeconomics.⁵ Although there is no universally agreed definition, the concept is generally taken to mean a persistent gap between a government's expenditures and revenues. Some analysts take this as the gap that arises when the economy is operating at full capacity,⁶ while others focus on the gap that arises on

average over the course of a business cycle. A somewhat more sophisticated rendition of the concept is related to the notion of fiscal sustainability—what the budgetary deficit can be over the course of a business cycle without raising the *relative* burden of the public debt on the economy. The latter is typically gauged by the ratio of public debt to GDP for the level of the economy (national or provincial) corresponding to the government of interest. An important aspect of all of these renditions is to obtain a measure of fiscal stringency or sustainability that is independent of the economy's actual state in the year of observation. These concepts are next considered in more detail with graphic aids.

Begin by assuming a static economy—one with zero inflation, zero population growth, and zero long-run real growth—but with real output displaying a cyclical pattern of alternating boom and bust years. Assume further that expenditures are constant in total (and also in real per capita terms) from year to year. With an unchanged tax structure and rates, cyclical variations in the economy will yield a cyclical pattern for tax revenues. Figure 1a shows this situation if revenues fall short of expenditures even in the boom years. In a year of recession, such as YD, the actual deficit will be a relatively large amount AD, and in a year of boom, such as YB, there will be a deficit of SD, which can provisionally be regarded as the structural deficit. In this scenario, the debt-GDP ratio will be seen to rise continuously over time, albeit at slower rates in boom years than in bust years. Hence, a more appropriate measure of the structural deficit would be SD^* , measured as the gap between expenditures (which are constant over time) and *average* revenues (taking the average of boom and bust years).

Continuing with the static economy assumption, alternative policies to eliminate the structural deficit are considered. Figure 1b shows that the structural deficit can be fully eliminated by raising tax rates so that the *average* level of revenues (taking both boom and bust years) is increased to equal the annual rate of expenditures. Then the debt-GDP ratio will rise in bust years and fall in boom years but follow a steady long-run path, so that public debt does not become an increasing burden on the economy. Alternatively, annual expenditures can be cut to a level that equals the average annual revenues. Either solution leaves the economy with a budgetary deficit in each bust year, but this is fully offset by an equal budgetary surplus in each boom year. The result will be fiscal sustainability over the indefinite long run. And either solution eliminates the structural deficit as defined previously by the average revenue level (SD^*).

Important new aspects of the structural deficit and corrective policies arise when more realistic assumptions of a growing economy and a rising price level are considered. Real economic growth helps to reduce the burden of public debt in two ways. First, growth generates more revenue for the government, so that the actual deficit declines and the growth rate of public debt slows. Second, a growing economy—whether it reflects real output growth or a rising price level? or both—reduces the debt-GDP ratio, which reflects the relative financial burden of public debt. Even if it continues to grow, public debt becomes less of a burden if it is growing less rapidly than the economy. The federal government's declining debt-GDP ratio from over 70 percent in 1995-96 to less than 50 percent in 2001-2 is

FIGURE 1a Economy with Cycles but No Growth (with Structural Deficit)

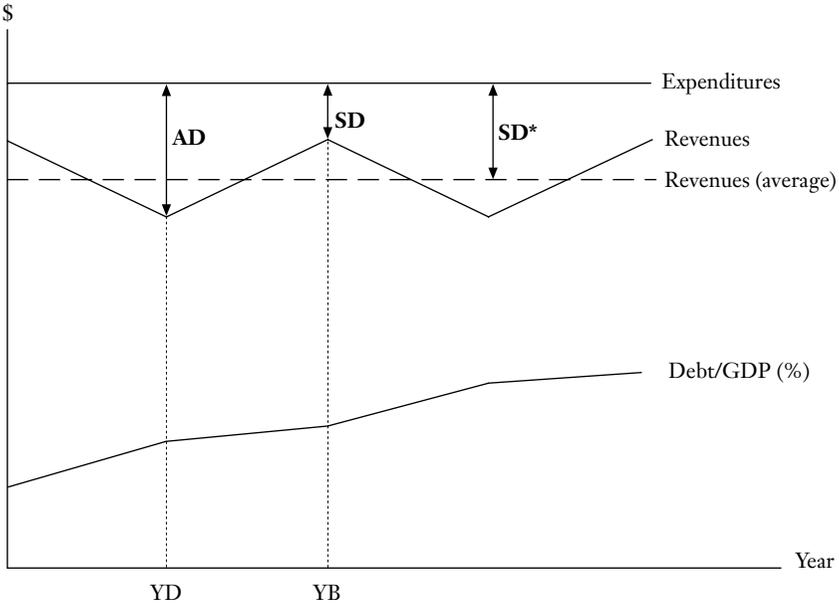


FIGURE 1b Economy with Cycles but No Growth (Structural Deficit Eliminated by Raising Tax Rates or by Cutting Expenditures)

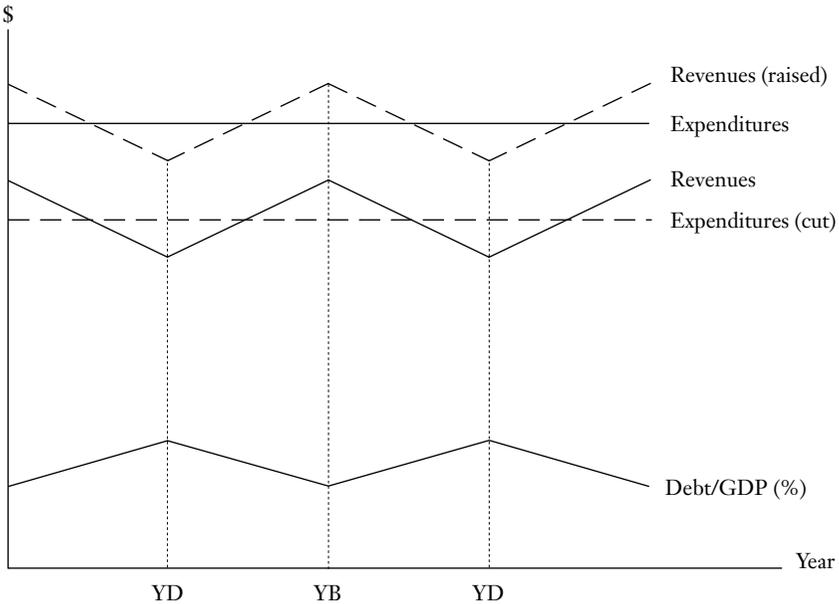


TABLE 1 Public Debt as a Percentage of Gross Domestic Product by Jurisdiction, 1994-95 to 2004-5^a

| Jurisdiction | 1994-95 | 2001-2 | 2004-5 |
|-------------------------------|-------------------|--------|--------|
| British Columbia | 19.0 | 21.3 | 27.4 |
| Alberta | 24.5 | 4.4 | 3.4 |
| Saskatchewan | 41.6 | 23.4 | 21.0 |
| Manitoba | 30.8 | 21.2 | 18.8 |
| Ontario | 29.4 | 24.5 | 22.2 |
| Quebec | 33.9 | 36.2 | 32.3 |
| New Brunswick | 38.6 | 32.5 | 28.6 |
| Nova Scotia | na | 46.5 | 41.2 |
| Prince Edward Island | 39.4 | 30.9 | 26.9 |
| Newfoundland | 54.4 | 44.1 | 38.9 |
| Canada (federal gov't.) | 70.7 ^b | 48.9 | 42.2 |

^a These figures are for net public debt in some jurisdictions and for taxpayer-supported debt in others (including British Columbia); figures for 2001-2 are estimates; for 2004-5, projections are based on various assumptions.

^b For 1995-96.

na Not available

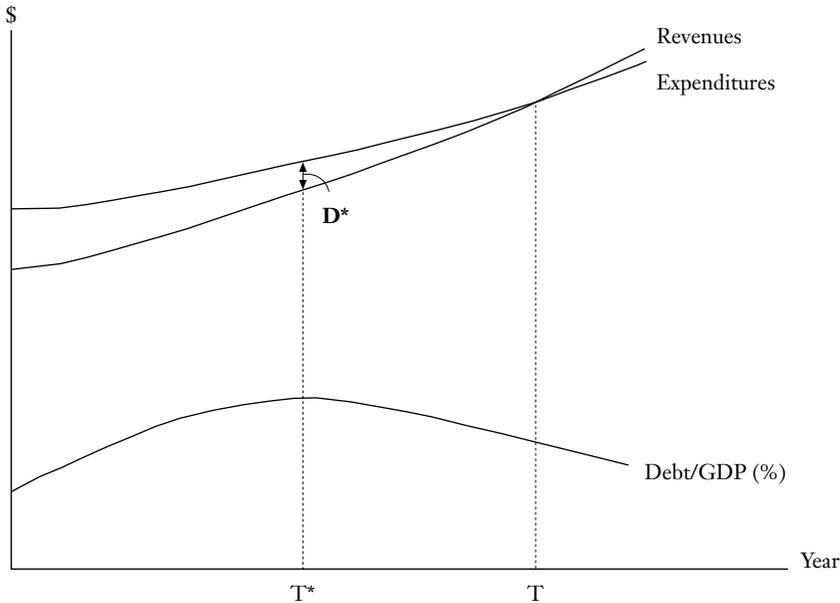
Source: TD Economics, *Report on Canadian Government Finances: Federal and Provincial Fiscal Outlook to 2005-06* (Toronto: TD Economics, October 12, 2001), available online at <http://www.td.com/economics>.

notable (see table 1). But it is of particular importance that growth of nominal GDP (the denominator in the ratio) has accounted for the great bulk of this decline. Even if the federal budget had been just balanced over this period, with no surpluses or debt repayment, economic growth would have dropped the debt-GDP ratio to 52 percent.

Next assume an economy that is growing but abstracted from the role of business cycles. Figure 2a shows the path of expenditures and revenues, assuming that revenues grow more quickly than expenditures. This case will arise if expenditures are maintained at real per capita levels over time or even if they grow at the same rate as nominal GDP; revenues will grow somewhat faster than nominal GDP because of the progressivity of the single largest tax, the personal income tax.⁸ With these assumptions, revenues will eventually overtake and exceed expenditures, so that the *actual* deficit will be eliminated at time T. Depending on the initial gap and relative growth rates, T could arise quickly or lie many years in the future. If debt charges are too large relative to the economy, and revenues do not grow fast enough relative to expenditures, a crossover point such as T will never arise, and the fiscal situation will prove unsustainable.⁹

With the dynamic economy assumptions, the debt-GDP ratio will reach a peak and stabilize before time T; this is shown as time T* in Figure 2a. Although there remains an actual deficit for additional years beyond T*, the debt-GDP ratio is actually declining. If the structural deficit concept is meant to imply an unsustainable rise in the financial burden of public debt on the economy, it would be wrong to say that there is a structural deficit from point T* onwards.¹⁰ Hence, for a

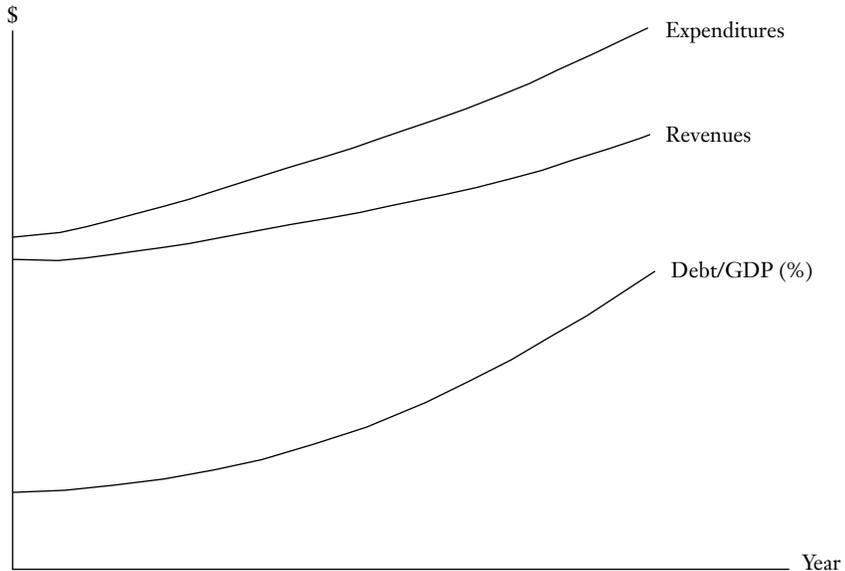
**FIGURE 2a Economy with Growth but No Cycles
(Expenditure Growth Rate Less Than Revenue Growth Rate)**



growing (or even simply a slowly inflating) economy, there is no structural deficit so long as the actual deficit (when revenues are measured at their average level over the business cycle) is less than this level. This “sustainable deficit” is one that holds constant the debt-GDP ratio. It arises when debt is growing at the same rate as nominal GDP, so that the sustainable deficit (D^*) equals the outstanding public debt multiplied by the long-run growth rate of nominal GDP. In the remainder of this study, “eliminating a structural deficit” will be regarded as including the possible choice to allow a “sustainable deficit” to continue indefinitely.

Although fiscal deficits will usually be self-eliminating by the growth process described above, this may take a long time and result in a much higher peak debt-GDP ratio. If expenditures are allowed to grow at a rate exceeding that of revenues, the debt-GDP ratio will rise without limit, and public debt will eventually overtake the economy (as shown in figure 2b). The point of peak debt-GDP ratio can be expedited, and the size of that peak ratio reduced, by corrective fiscal policies. One approach is to restrain the growth rate of expenditures; this can be done by holding constant the real per capita level of public outlays, which will reduce spending growth rates below that of nominal GDP and tax revenues (both of which reflect growth in real per capita incomes). The sustainable level can be reached more quickly by stronger spending restraint, such as freezing total expenditures (which means that real per capita services will decline over time), or by actual cuts in nominal expenditures. Alternatively, tax rates can be increased so as to raise the annual revenues in all periods; this will also expedite the point at which the peak debt-GDP ratio is reached and reduce its peak level.

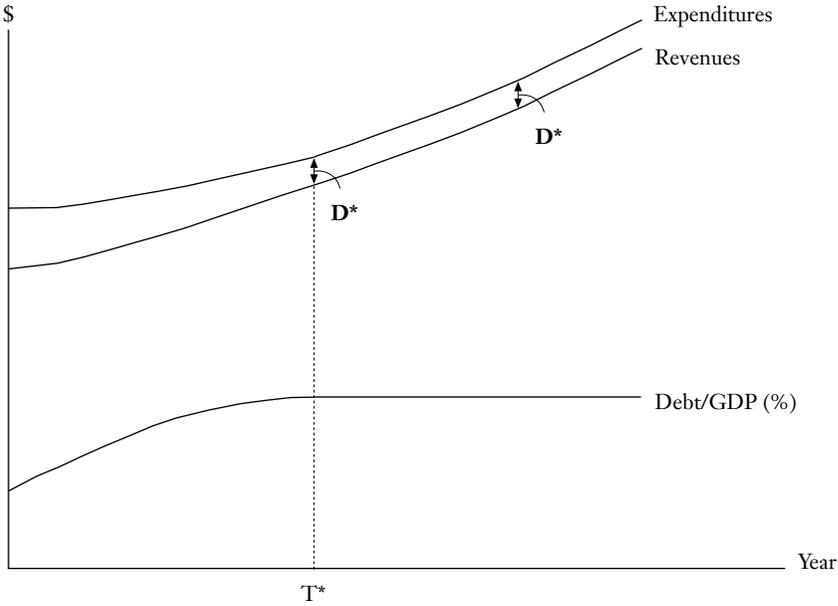
**FIGURE 2b Economy with Growth but No Cycles
(Expenditure Growth Rate Greater Than Revenue Growth Rate)**



The preceding insights suggest that, once the government's budget achieves its sustainable deficit (through corrective fiscal policies if required or if desired to expedite this point), it can accelerate the rate of spending growth to equal that of revenue growth. That is, the government can maintain an actual fiscal deficit indefinitely and still stabilize its debt-GDP ratio. Figure 2c shows this situation, with expenditure growth constrained until the point where the sustainable deficit (D^*) is achieved.¹¹ Thereafter, expenditure growth is raised to equal that of revenue growth; consequently, real per capita public outlays will be rising in an economy enjoying real economic gains. Of course, whether a society wishes to pursue this course is a matter of voters' valuation of public consumption versus private consumption. In most societies, as people become wealthier, they have displayed a preference for increasing both forms of consumption. For example, they want more and better roads to accompany their more and better cars, and they want the public transport system to deal with the increasing congestion from more cars on the roads.

The effects of common policies for correcting a structural deficit—or expediting its elimination—also can be illustrated graphically. Figure 2d shows an initial deficit situation that would eventually resolve itself, with revenues growing more rapidly than expenditures. If society wishes to accelerate the elimination of the deficit, and to keep the debt-GDP ratio from rising very high, it can reduce public expenditures. The figure shows expenditures that are cut both from their initial level and in their growth rate. This strategy expedites the attainment of the sustainable deficit from year T^* to year T^{**} , as well as the point at which the actual

FIGURE 2c Economy with Growth but No Cycles
(Before T^* Expenditures Growth Rate Less Than Revenues Growth Rate;
After T^* Growth Rates of Expenditures and Revenues Are Equal)

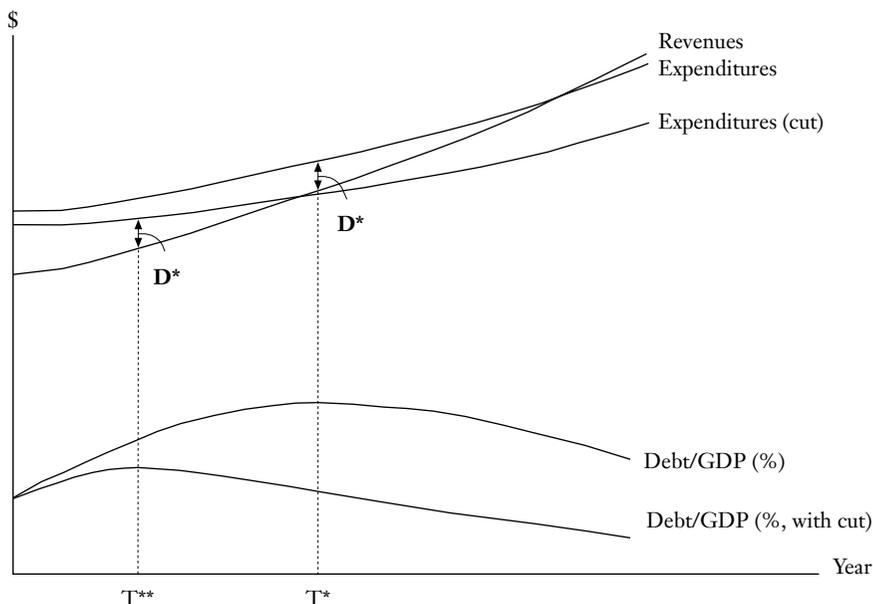


deficit is eliminated. It also causes the debt-GDP ratio to peak at a lower level than it would otherwise attain.

The conventional remedy for public deficits on the revenue side is to raise tax rates. Such tax hikes raise the revenue curve and hence expedite attainment of the sustainable deficit and elimination of the actual deficit; this process is similar to that depicted in figure 2d for expenditure cuts. However, increases in the rates of some taxes may reduce the economy’s long-run growth rate via disincentives for investment, business formation, and job creation. For this reason, some observers have advocated *cutting* tax rates as a way of addressing a fiscal deficit. Clearly, in the short to midterm, this policy will increase the size of the actual deficit, since less revenue is collected. If the tax rate cuts provide enough impetus to economic growth, after a sufficient period, revenues may be higher than they would have been absent the cuts. This favourable outcome is depicted in figure 2e. It is also possible that revenues will never overtake the levels they would have achieved if the higher initial tax rates had been maintained; in this case, tax rate cuts worsen the short-run *and* long-run structural deficit.

Even if tax rate cuts are eventually “self-financing,” they will leave the economy at a higher peak debt-GDP ratio than it would otherwise have attained. Moreover, in all likelihood the tax rate cuts will prolong the time until the economy achieves a sustainable deficit (D^*), as shown in figure 2e by the postponement of this point from T^* to T^{**} . Hence, if a government aims to restore fiscal sustainability (or achieve its sustainable deficit) by any given target year, tax rate cuts work against

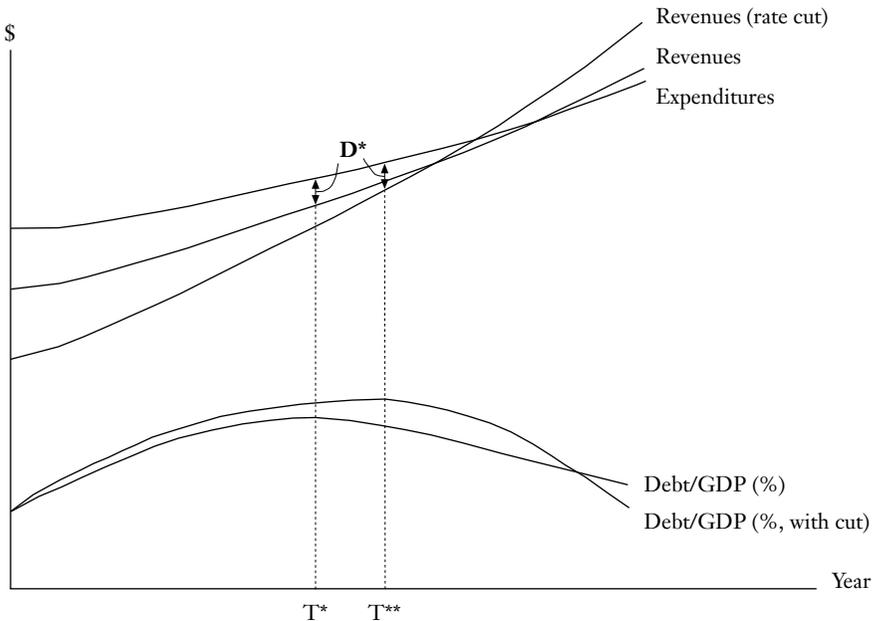
**FIGURE 2d Economy with Growth but No Cycles
(Expenditures Cut in Both Level and Growth Rate)**



this goal. They will require larger cuts to the level and/or growth rates of public expenditures than would otherwise be required. Cutting tax rates is thus the wrong direction for policy if the primary concern relates to fiscal sustainability. Nevertheless, if society consciously chooses to have a smaller public sector—that is, to consume less publicly and more privately—it may opt for a combination of tax rate cuts and large spending cuts. And if smaller government with lower tax rates does in fact imply faster long-run economic growth, society will obtain more private consumption than the public services it forgoes.¹² Yet it should be stressed that this outcome reflects choices about the size of government and public services and is not dictated by fiscal constraints.

To make sense of public deficits in the real world, one needs to combine insights from the cyclical and the economic growth factors. Actual fiscal deficits reported during periods of recession or slow growth will overstate the structural deficit and can lead to inappropriate policy responses. The restoration of fiscal sustainability may hinge on economic recovery and the resumption of solid growth rates as much as sharp policy responses. At the same time, projections of deficits must use realistic expectations for future growth of the economy, revenues, and expenditures. Small variations in these assumed growth rates can accumulate to large differences in the deficits projected over several years. Another hazard common to economic forecasters as well as finance departments and politicians is extrapolating recent experience into the longer-term future. In boom periods, few are brave or wise enough to predict the end of prosperity, and governments forecast

**FIGURE 2e Economy with Growth but No Cycles
(Tax Rate Cut Assumed To Raise Long-Run Growth Rates
of Economy and Revenues)**



budgets with great optimism that can lead to overspending or unsustainable tax cuts. In periods of economic slack, the tendency is to understate the odds of recovery and resumption of rapid economic growth, leading to excessive gloom, overstatement of structural deficits, and (for the fiscally staid) excessive spending cuts.

WHAT IS BRITISH COLUMBIA'S STRUCTURAL DEFICIT?

The BC government has initiated sharp cuts to public expenditures and imposed settlements and amended contracts to contain wage costs for public employees. Given that these actions have been justified on the basis of fiscal sustainability, it is useful to assess the province's structural deficit *in the absence of these changes*. The most detailed publicly accessible analysis estimating the size of British Columbia's structural deficit was provided in a mid-2001 report of the BC Fiscal Review Panel (FRP).¹³ This FRP had been appointed by the BC government, and its full report was appended to the Ministry of Finance's solicitation of input for the 2002 BC budget.¹⁴ It made specific assumptions about the course of the economy and of BC fiscal policies without any corrective actions (the so-called status quo forecast). In public pronouncements about the need for sharp spending cuts, the BC government has also cited the FRP's findings of large, growing, and unsustainable deficits that would arise unless actions were taken.

Table 2 reproduces the budgetary forecasts made by the FRP for 2001-2 through 2003-4, supplemented by the direct impact of the government's tax cuts. Before

counting the tax cut impact, the FRP projected “status quo” deficits of \$24 million in 2001-2, \$3.0 billion in 2002-3, and \$3.8 billion in 2003-4. After adding the direct impact of the personal and business tax cuts, these figures swell to \$1.4 billion, \$5.2 billion, and \$6.1 billion, respectively. Even if one accepts all the FRP's assumptions, the new BC government's choice to cut tax rates sharply increased the structural deficits by two-thirds from their projected levels. In the FRP's words,

[t]hese projected deficits indicate a structural fiscal imbalance that represents a serious threat to the financial health of the province. While we are not in an immediate financial crisis, government is operating in a fundamentally unsustainable manner.¹⁵

If the FRP's projected deficit figures became reality, they would constitute the largest deficits in British Columbia's history and cause the province's debt-GDP ratio to jump sharply (though still remaining well below that of the most indebted provinces). Clearly, the actual path of British Columbia's deficits will be deflected from the dire FRP forecasts by actions taken in the 2002-3 provincial budget.¹⁶ The sharp spending cuts and modest tax hikes in this budget reflect one government's choices for addressing the structural deficit.¹⁷

The following assessment will examine each of the major elements of the FRP's projections—revenue growth, expenditure growth, and the forecast allowance. For each of these items, the FRP made assumptions about the future course of fiscal policies if unchanged and the course of the economy. The present study will assess the realism and plausibility of each of these assumptions on the basis of the historical record. (In fact, it appears that all of the growth rates assumed in the report originated in the BC finance ministry rather than the FRP.)¹⁸ Additionally, this study will consider the future course of provincial finances that would emerge with alternative assumptions and relatively moderate policy changes compared with those being pursued currently. It will be seen that variations in assumptions that are not all that big can accumulate to large differences in the forecast deficit over several years.

The FRP forecast an increase in provincial revenues from \$24,012 million to \$24,788 million in the two years between 2001-2 and 2003-4—an annual growth rate of just 1.6 percent.¹⁹ This remarkably low projection for revenue growth is explained, in part, by the FRP's belief that revenues were inflated in 2001-2 on account of temporarily high energy prices in the earlier part of that fiscal year. If energy-related revenues were temporarily boosted by \$500 million in the base year, the adjusted revenue growth rate would be raised to 2.7 percent; and if the energy-revenue bulge were as large as \$1 billion, the adjusted revenue growth rate underlying the FRP revenue forecast would rise to 3.8 percent. Yet any of the cited rates, even the highest of them, would represent relatively slow revenue growth for the BC economy. This point is reinforced by the fact that the next two years should witness economic recovery from a period of near-recession and by the vaunted growth stimulus of British Columbia's new taxation and regulatory policies.

Surprisingly, the FRP allowed only for the direct impact of the BC tax cuts on revenues—the loss of revenues assuming no beneficial effects to the economy. This position is far more pessimistic than rejection of the government's early claim that

TABLE 2 BC Budgetary “Status Quo” Forecasts by Fiscal Review Panel

| | Fiscal year | | |
|---|--------------------|----------|----------|
| | 2001-2 | 2002-3 | 2003-4 |
| | <i>\$ millions</i> | | |
| Revenues | 24,012 | 23,920 | 24,788 |
| Expenditures | (24,457) | (25,755) | (27,281) |
| Consolidated revenue fund balance | (445) | (1,835) | (2,493) |
| Crown corporations and agencies | (239) | (105) | (27) |
| Summary accounts balance | (684) | (1,940) | (2,520) |
| Forecast allowance | (730) | (1,100) | (1,250) |
| Pension adjustment | 1,390 | 0 | 0 |
| Status quo summary accounts balance | (24) | (3,040) | (3,770) |
| Direct impact of personal tax cuts | (1,150) | (1,500) | (1,500) |
| Direct impact of business tax cuts | (228) | (633) | (790) |
| Budgetary balance after tax cuts | (1,402) | (5,173) | (6,060) |

Source: British Columbia, *Report of the British Columbia Fiscal Review Panel: British Columbia Fiscal Forecasts and Issues 2001/02 to 2003/04* (Victoria: Ministry of Finance and Corporate Relations, July 23, 2001), 17, supplemented by BC Ministry of Finance estimates of direct impact of business tax cuts; figures in parentheses are deficits or losses.

the tax cuts would “pay for themselves” through enhanced growth and offsetting revenues. At least some tangible benefit to the economy, and hence to revenues, should be anticipated within three years following the tax cuts, or else the very rationale for those cuts will become suspect. The FRP’s low rates of projected revenue growth should also be placed in historical context. British Columbia’s revenue growth rate under the previous administration was 5.0 percent from 1992-93 through 2000-1. Omitting the first two years, which reflected many large tax rate hikes, the revenue growth rate was 3.5 percent from 1994-95 through 2000-1. That period included several tax rate cuts in the later years;²⁰ without those cuts, the rate of revenue growth would have been over 4.0 percent, despite the BC economy’s relatively poor performance.

The FRP forecast an increase in public expenditures from \$24,457 million to \$27,281 million in the two years from 2001-2 to 2003-4, an annual growth rate of 5.6 percent. These figures presumably reflected pre-existing commitments and spending trends of the BC government. The FRP had been instructed to prepare its budgetary forecasts assuming a “status quo” path for public spending—what would result if the existing policy path were undisturbed. Yet a 5.6 percent growth rate during a period of very low inflation and relatively slow population growth for British Columbia implies that real per capita levels of public spending would be rising rapidly in the absence of altered policies. This assumed rate of growth departs sharply from the province’s recent historical record. In the last five years of the previous administration, ending with fiscal 2000-1, the average growth rate of public expenditures was a much lower 2.2 percent.²¹ After its earlier more free-spending habits, and despite some high-profile costly mega-projects, the NDP had turned to cost containment on public programs in its later years. The FRP’s high

forecast rate of spending growth for the next two years reflected, in part, some large impending wage hikes for public sector employees.

Next consider the FRP's assumed \$1.25 billion forecast allowance for 2003-4. This is an unprecedented size for a forecast allowance in British Columbia, more than four times the \$300 million allowance in the original 2001-2 budget. The forecast allowance is an arbitrarily set figure intended to allow leeway for future unanticipated events.²² Choosing a large figure for the forecast allowance, combined with a deficit elimination target and antipathy to tax rate increases,²³ tightly constrains public spending policies. Thus, conservatism in accounting also supports the familiar conservative outcome of smaller government; but those who pay for this practice are the groups most dependent on public programs and services. Unless there is some overarching reason to achieve a fiscal target, such as budgetary balance, in a particular year, using any forecast allowance seems questionable. It biases fiscal choices toward contractionary policies and increases the likelihood that the budget will be in surplus rather than balanced in the target year. If the underlying forecasts for growth of the economy and budgetary variables are based on the best estimates, it appears appropriate to dispense with the forecast allowance. Then the odds are equal that the budget will be in surplus or in deficit by the target year, with an expected value of being roughly in balance.

Since the FRP's forecasts assume that expenditures will be growing more rapidly than revenues, the report clearly paints the scenario of a large and uncontained structural deficit. This is similar to the non-convergent situation depicted earlier in figure 2b. The passage of more time only makes the deficit grow progressively larger. The discussion above and the historical figures cast doubt on whether British Columbia was truly facing such a dire fiscal outlook. At the same time, it is clear that the new government entered office with looming fiscal challenges. Although the official 2001-2 budget of the previous administration forecast a surplus, this balance was not sustainable on account of several factors:

1. the BC economy was slowing, and the full extent of this slowdown became more apparent as 2001 proceeded;
2. the original forecast budget balance relied on a one-time accounting adjustment to add \$1.4 billion on the positive side;
3. energy-related revenues showed an unusual bulge on account of temporarily high electricity prices; and
4. a series of generous public sector wage settlements made late in the previous administration and outstanding wage negotiations would create large incremental costs in future years.

All of the cited factors except the first reflect structural rather than cyclical forces, but the subsequent problems with the United States over softwood lumber may also make slower growth for the BC economy more persistent than transitory. Hence, British Columbia is undeniably facing a structural deficit, though it is smaller than the actual deficit reported during a period of very slow growth.

There is no unambiguous way to measure the size of British Columbia's structural deficit, since this depends on the time allowed for economic growth to replenish revenues and the assumed extent of spending restraint. As shown in the earlier qualitative analysis, if the growth rate of revenues exceeds that of spending, under most situations the structural deficit will be self-liquidating over time. This study undertakes some quantitative exercises to illustrate how British Columbia's actual and structural deficit could be eliminated, given sufficient time and a reasonable set of revenue assumptions and spending constraints. The figures provided are not intended to be a prescription for policy, but rather an illustration of the range of actions and events that would be consistent with fiscal sustainability for British Columbia.

Table 3 presents budgetary forecasts that begin with the FRP's 2001-2 forecast figures for revenues and expenditures and make alternative assumptions about the economy and policies. It is assumed that Crown corporations and agencies are fully in balance by 2004-5, following the FRP's projected trend toward balance over the preceding three years.²⁴ Also, following the earlier discussion, the forecast allowance is set at zero. If the economy and revenues perform better than assumed, the budget will simply be balanced more quickly; in the converse situation, more time will be needed for budgetary balance. Expenditures are assumed to be controlled in their nominal growth rate to 2.5 percent per year for the period following 2001-2. This rate approximates British Columbia's population growth rate plus the low inflation rates experienced in recent years and projected into the future.²⁵ Hence, it is assumed that provincial public expenditures are held roughly constant in real per capita terms. One example of how this restraint might be allocated is 4 percent annual growth in health-care outlays, 2.5 percent growth in education, and 1 percent growth in all the other program areas. As a result, spending outside the two "core" areas would still decline by 6 percent over four years in real per capita terms.

The effects on the forecast budgetary balance are explored using assumptions about revenue growth rates that are more in line with historical experience and the likely future outlook for British Columbia. First, the FRP forecast level of revenue for 2001-2 is reduced by \$500 million to reflect the temporary bulge from high energy prices.²⁶ Then the budgetary balance is calculated under two alternative annual revenue growth rates—4.5 percent (the first two columns of figures in table 3) and 4.0 percent annual growth (the last two columns of table 3). Given projected inflation of around 1.5 percent and the fact that revenues tend to grow at a slightly faster rate than the economy, the real economic growth rates underlying these two assumed revenue growth rates are just under 3.0 percent and 2.5 percent, respectively.²⁷ Economic growth will likely fall below these rates in 2002-3, given current forecasts and uncertainty about the precise timing and speed of the economic recovery. But for the succeeding years, these are very cautious real growth rates to project for the BC economy. If the government's taxation and regulatory policies succeed in revitalizing the economy, real growth rates averaging up to 4 percent are quite feasible over a period of several years. That outcome would bring budgetary balance more quickly than is projected in table 3 for the alternative policies.

TABLE 3 BC Budgetary Forecasts for Alternative Economic and Policy Assumptions

| | Fiscal year | | | |
|---|--------------------|----------|----------|----------|
| | 2004-5A | 2005-6A | 2005-6B | 2006-7B |
| | <i>\$ millions</i> | | | |
| Revenues | 26,831 | 28,038 | 27,506 | 28,605 |
| Expenditures | (26,338) | (26,995) | (26,995) | (27,671) |
| Consolidated revenue fund balance . . . | 493 | 1,043 | 511 | 934 |
| Crown corporations and agencies . . | 0 | 0 | 0 | 0 |
| Forecast allowance | 0 | 0 | 0 | 0 |
| Summary accounts balance | 493 | 1,043 | 511 | 934 |
| Direct impact of tax cuts | (2,290) | (2,290) | (2,290) | (2,290) |
| Impact of proposed payroll tax | 1,250 | 1,300 | 1,300 | 1,350 |
| Budgetary balance after tax changes . . . | (547) | 53 | (479) | (6) |

Notes:

A—forecasts assume base year 2001-2 figures from Fiscal Review Panel (see table 2); revenues decreased by \$500 million for unusually high energy prices in 2001-2; annual revenue growth at 4.5 percent annual rate; annual expenditure growth at 2.5 percent; zero balance for Crown corporations and agencies; zero forecast allowance; and general payroll tax at 2 percent rate on payrolls over \$400,000.

B—forecasts use same assumptions as in A, except revenue growth at 4.0 percent annual rate.

The other element in these alternative budgetary forecasts is the assumption that the province taps a new revenue source, illustrated by a 2 percent payroll tax. If this were structured similar to Ontario's "employer health tax," it would cover only the largest tenth of employers and generate about \$1.1 billion annually for British Columbia in 2001-2. The revenues generated for succeeding years would grow by about 4 percent annually, in line with the growth of aggregate payrolls—thus yielding the figures of \$1.25, \$1.3, and \$1.35 billion for fiscal years 2004-5 onward. A payroll tax is used for illustration; similar revenues would arise from a 2 percentage point hike in the rate of provincial sales tax. (More discussion of choices for revenue enhancement is deferred to the later section on "how" to fix the structural deficit.) In years following elimination of the deficit, this new revenue source could be phased out. Alternatively, the surpluses generated could be used to restore real per capita growth to public spending, to cut other taxes, and/or to pay down public debt accumulated over this adjustment period.

As shown in table 3, with these assumptions the BC budget would be restored to balance in 2005-6 with 4.5 percent revenue growth and in 2006-7 with 4.0 percent revenue growth. These results are one and two years later, respectively, than British Columbia's official target of 2004-5 for budgetary balance. However, either of these alternatives would entail far less severe cuts to public spending and services than the government's current plan. The existing policies will freeze health-care and education spending for three years (resulting in a nearly 8 percent cut in real services per capita) and cut spending in all other programs by 25 percent over three years (reducing real per capita service levels by fully one-third).²⁸ The cost of

the alternative policy course would be the accumulation of additional public debt and a higher peak debt-GDP ratio before stabilizing.²⁹ This outcome does not appear to be fiscally hazardous for British Columbia, which is now tied with Manitoba for second-lowest debt-GDP ratio (see table 1) and which spends just 7 cents of each revenue dollar in interest payments on the public debt.³⁰

It appears clear that at the outset of 2002, British Columbia faced a structural deficit requiring corrective public policies, though the scale and nature of the needed measures are open to debate. The remaining questions to be addressed are why fix this structural deficit, when and how quickly to fix it, and how to fix it—through what choice of fiscal and other policies? Each question is considered in sequence, although there are obvious interrelations among the various issues. And the distributional aspect of fixing the structural deficit—for whom?—will be seen to be intricately interleaved with all the other questions.

WHY FIX THE STRUCTURAL DEFICIT?

Two reasons are commonly cited for taking policy actions to eliminate a structural deficit. The first reason is to preserve equity between the current and future generations in distributing the real burden of financing the public sector. If public debt rises substantially relative to the size of the economy, future interest payments needed to service that debt will consume a larger proportion of future tax revenues (thereby reducing the future public services that can be financed for given tax rates) or require higher tax rates (thereby reducing future private consumption levels). Yet future generations will, with ongoing real wage growth, be richer than current workers, so that some shifting of these costs to the future may be ethically acceptable. If the best policies can generate sufficient additional investment (including public education and health-care facilities) and higher real wages in the future, workers then will still be better off even with tax rates somewhat higher than otherwise. Moreover, reducing the structural deficit currently may involve policy choices that harm individuals at below-average lifetime income levels in the current generation. To the extent that these policies benefit disproportionately above-average earners in future generations, such redistribution may be deemed undesirable. Hence, larger deficits may be tolerated for a period and the structural deficit eliminated less quickly.

The other main reason cited for eliminating a structural deficit revolves around the mounting financial costs and sustainability of servicing the public debt.³¹ If a structural deficit is sufficiently large to cause the debt-GDP ratio to rise continuously, over many years this increase will create a burden for public finances that may become unsustainable. More and more of the net borrowing each year will be needed simply to pay the interest on the debt, and at some point a jurisdiction could face insolvency as lenders lose faith in the security of the debt. Of course, this is an extreme outcome, and there may also be concern that a rising debt-GDP ratio raises the rate of interest the jurisdiction must pay on incremental borrowing. If lenders believe that the jurisdiction is not pursuing a fiscally sustainable course, its interest rates may rise sharply even though it is still able to borrow. Mounting

interest costs—because both the debt level and the interest rate are rising rapidly—will force the government to raise taxes and/or cut spending. That, in part, was the experience of the federal government in the early to mid-1990s.

For jurisdictions with debt-GDP ratios that are not very high, however, empirical evidence finds only a small effect of debt-GDP ratios on the market interest rate.³² Table 4 presents recent figures on yields to maturity for Canadian provincial bonds with 5 and 10 years to maturity, with the provinces ranked by their recent debt-GDP ratios.³³ For British Columbia, allowing its debt-GDP ratio to rise from the recent 21 percent to a percentage in the upper 20s would affect the interest rate on incremental borrowings by around 15 basis points (hundredths of 1 percent).³⁴ But 15 basis points represents just about a 3 percent increase (0.15 divided by an initial interest rate of around 5.5 percent), so that the additional interest expense resulting from the worsened borrowing terms would be very small. For example, on incremental borrowing of \$5 billion, this added interest cost would be about \$8 million per year. Even if British Columbia's entire pre-existing debt eventually had to be refinanced at that higher interest rate, the associated extra annual debt service costs would be only \$40 million. Hence, if there are good policy reasons for fixing a structural deficit in a more extended manner, they will not be negated by any additional effect on annual debt service costs from a marginally higher interest rate.

Another essential point is not to confuse fixing a province's structural deficit with fixing its economy's growth prospects—both key goals of British Columbia's present government. The steps needed to restore fiscal sustainability are distinct from, and not always congruent with, the steps needed to augment long-run economic growth. For example, raising tax rates sufficiently will readily eliminate any structural deficit. Yet raising certain types of tax rates—in particular, those on investment and higher earners—may adversely affect the long-run economic growth rate by driving capital and skilled labour from the province. Cutting public outlays will also help to relieve the structural deficit, but cuts in particular areas (such as education, health care, and transportation) may reduce the economy's long-run growth potential. The challenge is to find revenue and spending measures that serve both goals simultaneously while also satisfying various social and environmental criteria.

WHEN TO FIX THE STRUCTURAL DEFICIT?

For a jurisdiction that faces a structural deficit, important policy issues arise with respect to *when and how quickly* it should be eliminated. Two aspects of the timing can be distinguished. First, is it better to move more aggressively when the economy is slack or when it is buoyant, and does the best policy mix of revenue and expenditure measures hinge upon the state of the business cycle? Second, independent of the economy's stage in the business cycle, over what period should a structural deficit be eliminated, and upon what economic variables does this choice hinge? The answers to these questions will be as important as those relating to the choice of specific policy measures in an overall strategy for fixing a government's structural deficit.

TABLE 4 Provincial Bond Yields for 5- and 10-Year Terms to Maturity

| Jurisdiction | Debt/GDP | 5-year yield | 10-year yield |
|-------------------------------|----------|----------------|---------------|
| | | <i>percent</i> | |
| Alberta | 4.4 | 4.97 | 5.45 |
| Manitoba | 21.2 | 5.24 | 5.94 |
| British Columbia | 21.3 | 5.24 | 6.14 |
| Saskatchewan | 23.4 | 5.25 | 6.23 |
| Ontario | 24.5 | 5.01 | 6.16 |
| Prince Edward Island | 30.9 | 5.47 | 6.37 |
| New Brunswick | 32.5 | 5.64 | 6.00 |
| Quebec | 36.2 | 5.24 | 6.31 |
| Newfoundland | 44.1 | 5.61 | 6.46 |
| Nova Scotia | 46.5 | 5.32 | 6.33 |
| Canada (federal gov't.) | 48.9 | 4.99 | 5.67 |

Sources: Debt/GDP ratios are from table 1 for 2001-2; yields from the Web site <http://www.bondcan.com> for February 8, 2002, taking for each province the bond maturity closest to 5 and 10 years, with no adjustments for discrepancies in actual duration or for differing coupon rates.

If an economy is in recession or a cyclical phase of slow growth, as the BC economy has been recently, should this factor temper the pursuit of policies to eliminate its structural deficit? Traditional principles of macroeconomic stabilization suggest that fiscal policies should be expansionary (tax cuts and/or spending hikes) during periods of recession and contractionary (tax hikes and/or spending cuts) during periods of boom. However, if the economy also faces a *structural* deficit, it requires fiscal policies that will have short-run contractionary effects. Should such an economy delay its attack on a structural deficit until it is well into the growth phase? For a provincial economy, the reasons to defer the long-run requisite policy response are less salient than for a national economy. The spending leakages from one provincial economy to other provinces and internationally are larger than for the national economy. Hence, much of the decreased demand from contractionary provincial fiscal policies will be borne by markets outside the province. Still, there remains some basis for moderating the fiscal contraction until the economy is well into the growth phase of its cycle.

The state of the economy may also tilt the choice between tax hikes and spending cuts needed to eliminate a structural deficit. During a period of economic slack, spending cuts will be more injurious to the local economy than tax hikes. The reason is that part of the increased taxes will come out of personal and business savings, whereas all of the spending cuts will reduce demand for output. In the case of provincial spending, where a high proportion of outlays flows directly into salaries of resident public employees, there is still stronger reason to prefer tax increases over spending cuts in a slack period.³⁵ Yet over the longer term, the relative mix of taxation and spending measures to deal with a structural deficit should be governed by society's fundamental choices about how much to consume publicly versus privately—in other words, the size of government in the economy. Departing from this mix for short-term purposes of stabilizing a provincial

economy will only complicate the overall strategy, since it may involve temporary tax hikes to be undone by tax cuts accompanied by larger spending cuts after economic recovery.

Abstracting from the state of the economy, are there any principled guideposts for how quickly a jurisdiction should eliminate its structural deficit? Choosing a slower path will leave the government with a permanently higher, albeit ultimately stable, debt-GDP ratio. Unfortunately, economic analysis has not reached definitive findings about the optimal ratio of public debt to GDP. There is not even firm evidence that increased public debt displaces private investment, thereby slowing long-run economic growth, when capital is highly mobile internationally and interprovincially.³⁶ Hence, it is a matter of political judgment how quickly to address a structural deficit and to stabilize the debt-GDP ratio. One might imagine that a minimum criterion for the speed of response would be a ratio rising at a rate that is declining in successive years, with due allowance for the actual state of the economy. If the ratio continued to rise but at an accelerating rate, this could undermine the confidence of financial markets that the problem will ever be solved.

For a government running a large deficit, targeting a short period for eliminating that deficit places severe constraints on public spending. If tax cuts are added to the policy mix and there is an aversion to any offsetting revenue measures, the pressures on public spending are further intensified. British Columbia's legislated target of fiscal 2004-5 for achieving budgetary balance faces additional strains on account of the predicted slow economy in the first of the three years. Provincial budgeting is based on a forecast of just 0.6 percent real growth for the BC economy in 2002.³⁷ That leaves just two years of faster (but short of stellar) forecast growth, at rates of 2.8 and 3.1 percent, in which to restore budgetary balance. Extending the target for balancing the budget by a year or two would greatly reduce the pressures for sharp cuts in public spending, since that period will likely have faster economic growth. Many of British Columbia's policy initiatives in the taxation and regulatory areas should by then begin to yield returns in the form of above-average economic growth. That would be a more appropriate period in which to conclude the province's budget-balancing exercise. With the current plan, at least the next two years will be needed to eliminate the cyclical part of the deficit, leaving at most one year for growth factors to work down the structural component of the provincial deficit.

A final consideration in the speed of addressing a structural deficit is that future economic performance is uncertain. Both the Canadian and BC economies have exhibited widely varying real growth and inflation rates over the past several decades. As shown earlier, computing the structural deficit hinges on knowledge of these rates. One significant risk is that governments, and their economic advisers, tend to underestimate future growth rates when the economy is in recession—just as they tend to project continued rapid growth when the economy is booming. The earlier analysis of the FRP's projections for British Columbia reveals this kind of pessimistic outlook. The danger here is that the implied fiscal policy responses will be unduly aggressive and likely to overshoot their goals. Public spending will

be sharply cut and/or revenues increased, to the point that sizable surpluses are likely to arise when the economy fully recovers. A structural deficit will be transformed into a structural surplus, and many of the earlier spending cuts may prove to have been unnecessary.³⁸ A more cautious, incremental strategy would be to attack the structural deficit less quickly and to adjust course over future years while observing the economy's actual growth experience.³⁹ The added uncertainties for the BC economy of whether, when, and how fully the softwood lumber dispute will be resolved increase the prudence of this strategy.

HOW TO FIX THE STRUCTURAL DEFICIT?

A government facing a structural deficit needs to select policy measures that will make its public finances sustainable. Raising tax rates and cutting public services are politically hazardous acts, ones that are typically resisted as long as possible.⁴⁰ There exist a wide range of policy options for cutting expenditures and boosting revenues, and the choices will have differing effects on various groups in society. Economists studying this problem have astutely observed:

[E]ven though it is agreed that stabilization requires a change in fiscal policy to eliminate budget deficits, there may be disagreement about how the burden of the policy change is to be shared. When socioeconomic groups perceive the possibility of shifting this burden elsewhere, each group may attempt to wait the others out. This war of attrition ends, and a stabilization is enacted, when certain groups "concede" and allow their political opponents to decide on the allocation of the burden of the fiscal adjustment. Concession may occur via legislative agreement, electoral outcomes, or ceding power of decree to policymakers.⁴¹

This section addresses the general issues involved in how to fix a structural deficit, with specific reference to the situation facing British Columbia. The intention is to illustrate the underlying principles rather than to prescribe a specific set of solutions.

Augmented growth allows the economy to outgrow the burden of its deficits and public debt—both by raising revenues that directly reduce the deficit and by reducing the size of public debt relative to the economy. Hence, the least painful, and politically most attractive, strategy involves policies that can boost economic growth *without* raising tax rates or cutting spending on public services. That explains why politicians resort to a variety of confidence-raising measures, including exhortation and optimistic forecasts, which sometimes can assist in cyclical recovery. But for raising an economy's long-run growth rate, more substantive measures are required. These can include loosening of regulatory constraints on business practices, labour practices, and particular industries. Reducing regulatory burdens has the benefit of improving the climate for business investment and job creation, while not costing the government any revenues or outlays. The obvious hazard is that some regulatory constraints will be relaxed even when their total benefits to society (via improved safety, health, and environmental outcomes)

exceed their total costs to the economy. While that will raise the measured growth rate of output and incomes, it can actually lower the real standard of living.

The discussion here focuses on *fiscal* measures that are designed to augment an economy's long-run growth rate; the budgetary implications of these policies also are considered. (An appendix considers evidence as to whether contractionary fiscal policies can be expansionary for an economy over the short to midterm.) In order to boost the rate of economic growth, including real wages and employment, British Columbia needs to attract more business investment, corporate head offices, knowledge-based businesses, value-added resource businesses, and all of the ancillary economic activity. On the spending side, this goal dictates well-designed public investments in infrastructure, health care, education and training, and social services. On the revenue side, the key priorities are

1. reducing total and marginal tax rates for higher earners;
2. reducing the effective tax rate on business investment in ways that raise productivity; and
3. tilting the revenue mix away from distorting taxes and relying more on efficient tax and non-tax revenue sources.

British Columbia's tax policies have targeted the first two of these goals but ignored the third goal and sharply undercut total revenues. The resulting fiscal pressures have created difficult conflicts between addressing the structural deficit and tending to public expenditure needs.

Non-Tax Revenue Policies⁴²

A basic proposition in the economics of public finance is that revenues should be raised with the least feasible distortion to economic efficiency and growth (with due regard to matters of equity and simplicity). This idea applies to both tax and non-tax revenues. An ideal revenue source is one that does not distort the allocation of economic resources in production or consumption. Most taxes in practice do distort economic choices, but "pure economic rents" such as those stemming from monopolies, natural resources, and land can, in concept, be taxed without distorting their uses. Like the other western provinces, British Columbia collects significant non-tax revenues from resource royalties and charges. However, British Columbia could consider policies that would generate more revenues from sources that entail relatively little cost to economic efficiency or growth. These revenues could be used to reduce the structural deficit, to allow lower rates of distorting taxes, and to alleviate the pressures on public services. Within the limits of its natural endowments, British Columbia could emulate Alberta's practice of using resource royalties to provide relatively high levels of public services at competitive tax rates. Two underexploited revenue sources for British Columbia are land values and hydroelectric power.⁴³

Following this principle, British Columbia might do well to consider the “single tax” proposal of the late-19th-century thinker Henry George.⁴⁴ He argued that taxes should be collected, as far as possible, from the increased value of land that arises with urbanization. While his proposal centred on equity arguments, it was also consistent with efficient public finance. Revenues collected from pure land value have no effect on economic activity; they simply diminish the landowner’s share of the total value.⁴⁵ British Columbia has an institutional framework that is well-suited to applying this principle—the Agricultural Land Reserve, which has frozen large areas adjoining urban regions. To the extent that the province wishes to release portions of those lands in particular areas for development, it could do so through an auction process. Owners of “frozen” land would bid on the right to have their land released for development. In that way, provincial revenues could capture most of the land value stemming from its upgraded use relative to agricultural use.⁴⁶ Releasing more land adjacent to urban areas would reduce the cost of housing, commercial, and industrial development. Thus, the scheme offers an attractive combination of increasing public revenues while also promoting economic growth. Of course, such decisions must also hinge on review of the environmental, transport, and other spillover effects on surrounding communities and local governments.

British Columbia has another domain where it could collect additional non-tax revenues in an economically efficient manner—higher rates for electricity sold within the province. Nearly 90 percent of British Columbia’s electricity is generated by hydro power, which has low production costs owing to the construction of dams years ago and the free flow of water into reservoirs. Incremental power generation requires much more costly construction of new thermal plant capacity and the high operating cost of natural gas. The prices charged to consumers within the province reflect a mix of mostly low-cost hydro power and some high-cost thermal power. Economic efficiency dictates that prices reflect the long-run marginal costs of incremental production, which is the higher cost of new thermal facilities.⁴⁷ Hence, by raising the prices charged for electricity sales within the province, British Columbia could both collect additional revenues (beyond those now collected for “water rental” fees and dividends from BC Hydro) and improve the efficiency of resource allocation. Moreover, higher prices would provide incentives for energy conservation in homes and industry, thereby reducing the environmental costs of additional thermal generation.

The potential additional revenues from pricing in-province electricity sales are sufficiently large to make this an attractive option. On the basis of comparative power prices in Seattle for residential and commercial/industrial users, BC Hydro could raise rates for in-province sales by 50 percent and still remain competitive.⁴⁸ (Comparisons with rates in many other cities in North America are still more favourable for British Columbia.) A hike of that magnitude would generate about \$1.2 billion more per year for the provincial treasury.⁴⁹ The positive aspect of this policy for households and businesses is that distorting taxes could be reduced and/or public services increased by a corresponding sum. For example, assume that a typical household paid an additional \$250 per year on its hydro bill with an equal

reduction in its total taxes. It would then choose to conserve on its electricity usage to purchase more of the goods and services that it valued more highly. Moreover, at lower tax rates, less distortion would arise for work effort and many other activities. This example illustrates the efficiency gains—and the gains to the well-being of society—arising from market-based pricing.

What are the potential drawbacks of augmenting non-tax revenues through market-based hydro rates? Any concerns over the impact on lower-income households could be addressed through expanded refundable tax credits (as was done with the recent hike in the BC sales tax rate).⁵⁰ Any adverse impacts on heavy energy-consuming industries such as forestry and mining could be muted by phasing in the price hikes over several years. Moreover, the higher prices would open new opportunities for the co-generation of power in industry as well private production of power through small hydro projects. Selling a provincial resource at prices below its scarcity value is an inefficient way to stimulate business expansion in British Columbia; Alberta does not price its petroleum and gas resources lower for in-province users than for world markets. And the benefits of higher electricity prices in British Columbia would arise quite apart from any further efficiency gains that might arise from privatizing parts of BC Hydro's operations. The pros and cons of privatization should be assessed independently of the gains from moving to market-based rates, and privatization should not be used as a covert method of raising electricity rates.

Before the 2002 budget, the BC government chose to augment one form of non-tax revenue; it raised BC Medical Services Plan (MSP) premiums by 50 percent. (All other provinces except Alberta long ago abandoned such premiums.) This move sharply reduced or more than offset the benefits of the personal tax cut for many moderate earners.⁵¹ The premium hikes might be viewed as undoing income tax cuts for earners in ranges where British Columbia did not face competitive problems, an issue discussed later. For the lowest-income households, the government considerably enriched the premium assistance provisions to blunt the impact of the rate hikes.⁵² Since the premiums are a form of lump-sum or “head” tax, they appear to be a non-distorting and economically efficient way of gathering more revenues, somewhat like taxes on pure economic rents. The choice to augment revenues through MSP premiums might also have been influenced by the government's distaste for raising “taxes” and the ostensible linkage between this revenue source and rising health-care costs. However, with mounting health-care costs, the government felt compelled to raise the rates of overt taxes in its 2002 budget.

Despite the apparent attractions of health-care premiums as a revenue source, most arguments for their use do not hold up to scrutiny. First, like “premiums” for federal employment insurance and Canada Pension Plan, MSP premiums are simply a tax by another name. And since the \$900 million of annual MSP premiums before the hikes cover just one-tenth of British Columbia's total health-care expenditures, BC residents who have not paid their premiums are barred from getting services for which they have already paid most of the cost via other taxes. The premiums are a highly regressive head tax (except for the lowest-income households,

which get premium reductions). While a head tax appears to be efficient in that it is non-distorting, its use requires that other elements of the tax system be more progressive in their rate structure for any given view about the proper distribution of the overall tax burden. Hence, the economic inefficiencies are simply displaced to another part of the tax system, which requires rates that rise more steeply with incomes.⁵³ And since the premiums are a fixed amount independent of the quantity of public health-care services the individual actually uses, they do not offer any of the disciplining incentives of a true user charge. The BC government would do well to concede that MSP premiums are simply another tax, so that it can move on to find better forms of taxation to supplement revenues as needed.

Taxation Policies⁵⁴

Relatively high interprovincial mobility of labour—especially skilled, managerial, and professional workers—means that attempts by one province to redistribute income via the tax system will mostly be dissipated to the disadvantage of its economy.⁵⁵ Employers of skilled labour will bear most of the tax burden in the form of higher wages, which in effect will compensate the workers for their higher tax rates. As a consequence, there will be little improvement in the distribution of net incomes, but industry sectors that are intensive in their use of skilled labour will be deterred from expanding in that province. The provincial economy will thereby be deprived of investment in the high-productivity sectors, with all of the associated spinoffs for employment, wages, and productivity of low- and mid-skilled labour. The provincial treasury will be deprived of the large tax revenues that can be obtained from higher earners even at more moderate tax rates.⁵⁶ As a result, substantially progressive income tax rate structures are much more appropriate for the federal tax than for the provincial taxes. This point has been recognized by a handful of US states that have flat-rate income taxes and more recently by Alberta with its adoption of a flat-rate provincial income tax.⁵⁷

In its “dramatic” personal income tax cuts of 2001, the BC government did address the matter of high marginal tax rates on high earners.⁵⁸ It cut the top marginal tax rate (on taxable incomes above \$85,000) by 5 percentage points from 19.7 percent to 14.7 percent in 2002. However, in keeping with its electoral commitments, the government also granted large tax rate cuts at all income levels. Indeed, the tax cuts trumpeted in the election were those for all earners below \$60,000; little, if anything, had been said about cuts for higher earners. The government advertised its actual tax cuts as even-handed in that they reduced the taxes for all income levels by about 25 percent; but for bottom-bracket taxpayers (those with taxable incomes below \$30,500), the cut was 2.35 percentage points or less than half the cut for those in the top bracket. The result was top-end marginal rate cuts that are well justified in economic policy, but which the BC Liberal Party was afraid to promote in its campaign, and tax cuts for low and middle earners that the party was pleased to promote electorally, but for which there was less economic justification. Workers at low and middle incomes display less interprovincial mobility and are also less critical in promoting the growth of high-productivity industries

TABLE 5 Comparative Progressivity of Tax Rate Schedules by Jurisdiction

| Jurisdiction/year | Marginal tax rates by bracket | | |
|-------------------------|-------------------------------|---------|------------------|
| | Bottom (%) | Top (%) | Ratio top/bottom |
| Ontario 2002 | 6.05 | 17.41 | 2.88 |
| BC 2002 | 6.05 | 14.7 | 2.43 |
| BC 2001 pre-cuts | 8.4 | 19.7 | 2.35 |
| Federal 2002 | 16 | 29 | 1.81 |
| Saskatchewan 2003 | 11 | 15 | 1.36 |
| Alberta 2002 | 10 | 10 | 1.00 |

than are high-skilled workers. Consequently, this policy strategy cost the provincial treasury considerably more than—perhaps double—what was needed for the growth-augmenting goal.⁵⁹

British Columbia followed the footsteps of other provinces in pursuing personal tax cuts, and it is instructive to compare their strategies. Table 5 presents the resulting top- and bottom-bracket marginal tax rates for four provinces, as well as federal rates. Very different patterns for personal tax rate cuts have been chosen in British Columbia, Alberta, Saskatchewan, and Ontario. The Ontario tax rate cuts were heavily skewed to favour low and moderate earners; high earners (those above \$55,000 in 2002) were stuck with a “fair share health care levy” in the form of steep income surtaxes. Judged by the ratio of top to bottom marginal tax rates, Ontario has the steepest progression of tax rate schedules of the provinces tabulated. Its tax rates rise substantially more steeply than those of the federal income tax. On the basis of the earlier discussion of this issue, interprovincial mobility suggests that rate progressivity for provincial taxes should be *less* than that for the federal tax. While in purely economic terms Ontario’s strategy appears deficient, there still may be sound political reasons for this approach. In a climate where major spending cuts are hitting a wide range of groups, including those at lower incomes, at least there is not the image that the big gainers are those at the top of the income heap. This perception helps to maintain some degree of social cohesion through the transition period and to win public support for the fiscal adjustments. In British Columbia, the spending cuts affecting low-income groups contrast sharply with the large tax savings reaped by the highest income groups.

At the opposite pole in tax-cutting strategy was Alberta, which fully flattened its marginal tax rate schedule in 2001.⁶⁰ Now all taxpayers above the taxable threshold face a uniform marginal tax rate of 10 percent. While in principle this change implies a sharp reduction in tax progressivity, Alberta combined the rate cuts with extremely generous increases in the tax exemptions for filers, spouses, and single parents. For example, in 2001, Alberta’s basic exemption for a tax filer was \$12,900 or 50 percent higher than British Columbia’s \$8,600. Moreover, Alberta allowed this full exemption amount to be claimed for dependent spouses and for the first child of single parents. As a result, by far the largest proportionate tax cuts were

TABLE 6 Comparative Provincial Income Taxes, BC, Alberta, and Ontario, 2001

| Family type and annual income (all labour earnings) | BC tax ^a | Alberta tax | Ontario tax | Alberta below BC tax by | Ontario below BC tax by |
|--|---------------------|----------------|----------------|-------------------------------|-------------------------------|
| | | <i>dollars</i> | | <i>percent</i> | |
| Single, \$15,000 | 469 | 127 | 57 | 73 | 88 |
| Single parent, \$25,000 | 728 | 0 | 395 | 100 | 46 |
| Single, \$32,000 | 1,906 | 1,715 | 1,283 | 10 | 33 |
| One-earner couple, \$35,000 | 1,671 | 706 | 1,152 | 58 | 31 |
| One-earner couple, \$50,000 | 3,436 | 2,183 | 2,529 | 36 | 26 |
| Two-earner couple, \$50,000 (split equally) | 2,606 | 2,123 | 1,683 | 19 | 35 |
| Single, \$60,000 | 5,202 | 4,473 | 3,844 | 14 | 26 |
| Two-earner couple, \$75,000 (split \$20,000 and \$55,000) | 5,517 | 4,567 | 3,934 | 17 | 29 |

^a BC taxes are computed for the rates in effect in January 2001, before the rate cuts instituted by the new government.

Source: Jonathan R. Kesselman, "A Tax Strategy To Revitalize the BC Economy" (mimeograph, University of British Columbia, Department of Economics, May 9, 2001), available online at <http://www.policy.ca> and <http://www.arts.ubc.ca/cresp>.

reaped by low-income Albertans, and especially by single parents and one-earner couples. Table 6 compares the resulting actual tax burdens for some illustrative taxpayer types in Alberta, Ontario, and British Columbia for 2001, before the BC tax cuts. Since British Columbia's subsequent tax cuts amounted to about 25 percent (a few percentage points higher for the lowest tax bracket), the table shows that many types of low- and even middle-income taxpayers in Alberta and Ontario still have lower tax burdens than those in British Columbia. For example, a single earner with \$15,000 annual income and a single parent with \$25,000 both pay less tax in Alberta and Ontario than in British Columbia. A two-earner couple with \$50,000 equally split between the partners pays less tax in Ontario than in British Columbia. Alberta's approach is more consistent than that of either British Columbia or Ontario with the notion that provincial income tax rates should be less steep than the federal rate structure. However, there is no need for a province to fully abandon rate progressivity so long as its upper marginal rates are not excessive relative to those of competing provinces.

Saskatchewan's tax-cutting strategy illustrates the latter point.⁶¹ In 2003, the province will have fully implemented its personal tax cuts with a rate of 11 percent for taxable incomes up to \$35,000, 13 percent for incomes from \$35,000 to \$100,000, and 15 percent above \$100,000. In announcing these cuts, the government argued:

Saskatchewan also faces significant competitive pressures from outside the province as other jurisdictions introduce tax reduction strategies. If ignored, Alberta's introduction of an 11 percent [later revised to 10 percent] single-rate tax system and Ontario's significant reduction in personal income taxes could impair Saskatchewan's ability to attract and retain skilled workers and investment. . . .

[A] progressive tax system must be maintained, but it should not unduly impair the competitiveness of Saskatchewan's tax system. . . .

[There are also concerns] that tax reductions must not lead to a return to deficits and that tax reductions must not jeopardize valued public services such as health care and education.⁶²

Thus, Saskatchewan implemented a rate schedule that was considerably flatter than British Columbia's new schedule (a ratio of top to bottom marginal rates of 1.36 and 2.43, respectively—see table 5). Saskatchewan was also able to achieve virtually the same top marginal rate as British Columbia (15 percent and 14.7 percent, respectively), with a lower marginal rate for earners between \$70,000 and \$100,000 (13 percent as compared with 13.7 to 14.7 percent for British Columbia). And Saskatchewan was able to retain much more revenue by not cutting the rates for low and moderate earners nearly as sharply as did the BC government. This strategy could be sold by an NDP-led government via its commitment to maintaining spending on key public services and benefit programs. Even if British Columbia had simply mirrored the federal rate structure, setting the province's rates at half the corresponding federal tax rates, this approach would have yielded lower marginal tax rates for earners above \$70,000 than did its actual cuts, and the government would not have given up as much revenue (see table 7).

Has British Columbia gone sufficiently far in its personal tax cutting, or does it need to move further to be competitive with Alberta's tax regime? To the extent that these taxes are borne by workers rather than their employers, it should be recognized that individuals are motivated by many non-pecuniary aspects of their lives, as well as by their take-home income. For example, many individuals may prefer the weather, natural setting, and cosmopolitan qualities of Vancouver or Victoria to those of Calgary or Edmonton. This fact alone could allow British Columbia to sustain higher taxes than Alberta; clearly, the distinct linguistic and cultural attributes of Quebec allow it to maintain higher overall taxes than the rest of Canada. Yet there may be room for some further moderation in British Columbia's tax rates at upper-middle and higher incomes. In particular, the threshold for the top marginal tax rate could be raised from the current \$86,785 at least to match, if not surpass, that for the top federal rate, currently \$103,000. And British Columbia's marginal tax rate for upper-middle earners with incomes below this augmented threshold could be reduced below the current 13.7 percent. However, moves of this kind are not sufficiently compelling to be pursued until after the province has eliminated its structural deficit.

One promising source for revenues to help bridge British Columbia's structural deficit would be a general payroll tax similar to that used by four other Canadian provinces—Manitoba, Ontario, Quebec, and Newfoundland.⁶³ Those provinces

TABLE 7 Cutting BC Personal Tax Rates in Line with Federal Rates

| BC marginal tax rates (%) | | | Federal marginal tax rates (%) | | BC rate if 50% of federal rate |
|---------------------------|-----------------|--------------|--------------------------------|------|--------------------------------------|
| Income range | Pre-cut 2001 | 2002 rate | Income range | Rate | |
| \$0-30,484 | 8.4 | 6.05 | \$0-30,754 | 16 | 8.0 |
| \$30,484-60,969 | 11.9 | 9.15 | \$30,754-61,509 | 22 | 11.0 |
| \$60,969-70,000 | 16.7 | 11.7 | \$61,509-100,000 | 26 | 13.0 |
| \$70,000-85,000 | 18.7 | 13.7 | Over \$100,000 | 29 | 14.5 |
| Over \$85,000 | 19.7 | 14.7 | | | |

Note: Income ranges are given for 2001; these figures were indexed in 2002.

employ such taxes to help finance their health-care and/or post-secondary education costs; Ontario explicitly adopted its “employer health tax” in 1990 to replace health-care premiums like British Columbia’s current MSP premiums. Payroll taxes are large revenue generators—for example, about \$3.6 billion per year in Ontario and \$4.4 billion in Quebec. If British Columbia implemented a payroll tax at a 2 percent rate and restricted it to the largest one-tenth of employers (similar to Ontario’s approach), it would generate about \$1.1 billion in 2001-2, with revenues growing by about 4 percent per year. Advantages of this form of tax include simple administration and operation, low costs in economic efficiency,⁶⁴ and substantial revenues produced at low rates. An employer payroll tax tends over time to be shifted onto employees via lower wage rates, though this shift will be dampened when the tax is applied by one jurisdiction at a higher rate than that of its competitors.⁶⁵ While not progressive, such a payroll tax is at least far less regressive than the MSP premiums. To collect the same amount of additional revenues under the BC retail sales tax, it would be necessary to raise the tax rate by 2 percentage points. That approach would be more regressive than a payroll tax (since it would strike persons on low fixed incomes), and it would be hard to maintain in view of the much lower total sales tax rates in neighbouring Alberta and Washington state.

At the start of 2002, British Columbia cut its general corporate income tax rate by 3 percentage points to 13.5 percent. This cut was an attempt to remain competitive with other provinces. Ontario and Alberta have pledged to lower their general corporate tax rates over the next two to three years to just 8 percent; Quebec already has a corporate income tax rate of about 9 percent. In cutting its rate, the BC government committed to “strive to keep the rate competitive in the future.”⁶⁶ Hence, the next few years will likely see significant further loss of corporate income tax revenues for British Columbia. An innovative alternative would be to replace the province’s corporate income tax with a type of business transfer tax.⁶⁷ The base for this tax differs from the existing corporate tax base in that it includes all labour costs but allows full deductions for all capital purchases (which at present can only be depreciated over time). This form of tax is a combination of a general payroll tax and a cash flow tax; the latter tax is well known in the public finance literature to be more economically efficient and investment-friendly than a conventional tax on corporate income.⁶⁸ Even at a rate of 4 percent (half of the target

rate for corporate taxes in Alberta and Ontario), this tax could raise about \$1.4 billion more per year than British Columbia collects under the current tax.⁶⁹ And it could make British Columbia the most attractive Canadian province for new investment, which should be a central element of a growth-promoting strategy.⁷⁰

While tax policy is an important part of an overall strategy for stimulating the provincial economy, it does not warrant a fixation on tax cuts. To the extent that differential tax burdens in one province are borne by firms located there, they affect the attractions for business location and expansion.⁷¹ But employee compensation (wages, salaries, and fringe benefits) ranks far larger than taxes in total business costs. A well-crafted mix of taxes and public services can make the province more attractive for workers, thereby lowering salary levels and spurring business expansion. Better public services can also directly substitute for more costly employer-paid fringe benefits, such as extended health-care insurance. Improved quality of public education will attract employees to a province at moderated wages. For example, the cost of sending just one child to a private school can fully offset the tax differential between British Columbia and a low-tax US state for even a higher earner. Prudent public outlays and regulations that affect the quality of public transit and the cost of housing also can substitute for large amounts of compensation needed to attract workers. Through this channel, higher taxes, even if borne by business, can actually contribute to the competitiveness of a jurisdiction. This observation does not imply that the public sector should necessarily be larger, but rather that provincial government should operate in a manner that is both cost-effective and responsive to the desires of the tax-paying public.

Expenditure Policies

Some economic observations on the spending side of the budgetary ledger are also relevant to British Columbia's situation.⁷² Attracting business investment to the province is not solely or even principally a matter of producing the lowest tax regime; otherwise, the world's backwater undeveloped economies would be thriving. One critical resource for business is a well-educated, skilled, healthy, and motivated labour force. Particularly for knowledge-based sectors, workers with advanced levels of education and skills are essential. Hence, public investments in education can yield returns that greatly exceed costs for both the affected individuals and the government. At the post-secondary level, British Columbia along with most other Canadian provinces has sharply curtailed real per capita spending levels relative to those at US public institutions over the past decade. Even states with above-average tax levels, such as California, have been magnets for high-tech business because of their supply of well-educated workers. Allowing BC universities to raise more funds through higher tuition charges will help to bridge the gap, but it can only worsen the already low rates of participation by youth from disadvantaged groups and remote parts of the province. British Columbia's future economic prospects hinge on getting more of these youth into advanced education and training. This goal will likely require additional public funding along with innovative types of student loan schemes.⁷³

A government facing a substantial structural deficit faces pressure to find ways to reduce spending and to economize on the provision of public services. Unfortunately, it may pursue “false economies” that save budgetary funds but impose even larger costs on private parties than the public savings. For example, reduced highway maintenance can raise private costs in terms of slower travelling times for commercial transport and commuting, higher vehicle repair costs owing to rougher roadways, and greater risk of accidents. Drivers would prefer to pay the higher taxes needed to maintain roads better if those taxes are less than the incremental private costs incurred with poor roads. The planned closing of hospitals and courthouses in numerous BC communities may also involve false economies. Increased private travel and time costs may involve mortality risks as well as monetary costs, and these private costs are not fully reckoned by officials in the budget-balancing exercise.⁷⁴ These added costs could be reflected in higher wages that individuals will command to compensate them for living in towns and remote areas, adversely affecting economic development throughout the province.

The BC government is also seeking fiscal savings in the compensation costs of non-medical staff in hospitals (kitchen, laundry, housekeeping, and maintenance services) and home-care workers. Arguing that such workers are paid a large premium relative to comparable workers in private markets, the government has unilaterally revoked negotiated salary increases and allowed these services to be contracted out to private firms.⁷⁵ This approach appeals to the business sense of paying workers only “what they’re worth”⁷⁶ as reflected in competitive wages; it also reflects an antiquated view of the economics of wage determination in labour markets. More recent “efficiency wage” theory suggests that, in lines of work where the employer cares about the quality of work effort but cannot fully monitor it, wage rates will be set higher than a purely competitive level to discourage shirking by workers.⁷⁷ If workers are paid only the competitive wage that they could easily obtain in alternative work, they will not risk anything by shirking on the job even if they are detected and terminated. Thus, in the BC setting, if public policy is concerned with the quality of care for hospital patients and home-bound disabled and elderly persons, some wage premium should be maintained, but union strictures on firing for poor performance should be relaxed. The current policy course to eliminate the wage premium will likely succeed in cost savings but will sacrifice the quality of care. It will also inflict financial damage disproportionately on women and visible minority workers.

There are further hazards of false economies in the area of social spending, which result from a politically truncated time horizon for budget planning. Many types of social services are investments in the development of children and persons with mental, emotional, and physical disabilities. These investments pay off in both economic and personal terms through enhanced productivity, employability, independence, and dignity. When the individuals served are young or disabled, the payoffs may not be immediate, but they can be large and long-lasting. When a child at risk is provided the resources for healthy, sustained development, that can be the difference between a future adult who is a marginal worker, possibly even a

criminal, and a productive worker, taxpayer, and citizen. But an accounting that seeks these returns within a budget cycle, or even within one or two electoral cycles, will be biased against making investments whose long-run returns significantly outweigh the cost of added taxes. And even where there will never be fully compensating economic returns, many citizens are willing to pay higher taxes for public services that bring dignity, self-respect, and inclusion to the disadvantaged.

Discussion of the distributional impacts of British Columbia's fiscal policies has typically focused on the tax cuts of 2001 or the more recent hikes to sales tax and MSP premiums. While the personal and business tax cuts were heavily targeted on higher earners, the later BC policies sought to insulate the poorest households from their increased burdens. The sales tax hike of half a percentage point, to 7.5 percent, was offset for persons with incomes below \$18,000 by an increment to the province's refundable sales tax credit. And part of the additional MSP premium revenue was returned to individuals with incomes below \$24,000 and families below \$33,000 through enhanced premium relief. Nevertheless, the largest impact of the government's overall fiscal package on very low and moderate earners arises via the spending cuts. These include a sweeping set of program, service, and benefit cuts, many of which affect those groups that are most needy and vulnerable (see table 8). Examples include substantial cuts to legal aid services, social housing funds, day-care subsidies, services at school and in the community for children at risk, health-care services for the poor, pharmacare for the elderly, and home-care services for the disabled and elderly. For the lower-income population, it is much more critical that government have adequate financial resources than that they be sheltered from the entire tax burden.

CONCLUSIONS

British Columbia is facing a large budgetary deficit that reflects partly cyclical factors, partly structural factors, and sharp cuts in personal and business tax rates. If the revenues lost to the discretionary tax cuts are not at least partially recovered through other means, the province faces severe adjustments on the spending side of its budget. Even with some revenue offsets, British Columbia would face a significant structural deficit requiring actions to restrain public spending. The government is being driven in part by the dire budgetary forecasts of the FRP, which used extremely conservative assumptions, and also by its clear aversion to raising tax revenues broadly and its self-imposed target of fiscal 2004-5 for eliminating the deficit. Together, these constraints imply large spending cuts that will yield a substantially smaller provincial government relative to the BC economy. It is not clear whether the current policy course reflects an innate preference by political leaders for smaller government or a misconception that larger government and the requisite financing is an inescapable impediment to economic growth. Debate over the structural deficit often is conducted in a tone of urgency that obscures innate choices over smaller versus larger government and the distributional implications of various policies to address the deficit.

TABLE 8 Selected BC Public Service and Benefit Cutbacks, by Area, 2002

| Area | Brief description of selected changes |
|---------------------------|---|
| Justice | Closure of 24 out of 68 courthouses; sharp cut in funding for legal aid, especially for legal aid family law and poverty law programs; cuts to criminal injury compensation |
| Education | Large unfunded salary increases for teachers over three years to be borne in part through reduced provision of special education, ESL programs, counselling, programs for children at risk; freeze on capital spending at colleges and public schools |
| Training | Abolition of BC Industry Training and Apprenticeship Commission |
| Health care | Elimination of coverage for physiotherapy, massage therapy, eye exams, non-surgical podiatry, chiropractic, naturopathy (continued coverage to a total of 10 visits per year for those on MSP premium assistance); delisting of some drugs and increases in deductibles for pharmacare; closure of many hospitals or down-rating of their services |
| Housing | 1,000 social housing units to be converted to assisted living units for persons currently in residential care; reduced protection for tenants via staff reductions and office closures |
| Social services | Sharp reduction in staffing and provision of social services; reduced income level to qualify for day-care subsidies |
| Disabilities | Adults with developmental disabilities to be shifted to “congregate care” facilities; workers’ compensation benefits cut about 10 percent and appeal procedures restricted; home-care services reduced; audio-book program for visually impaired cut; abolition of BC Human Rights Commission; reduced campground passes for the disabled |
| Seniors | Bus pass subsidy eliminated and BC seniors supplement phased out for very low income OAS/GIS recipients; deductibles for pharmacare increased; diversion of more seniors from nursing homes to “assisted living” facilities; reduced provision of home-care services |
| Women | Reduced funding of women’s centres; reduced day-care subsidies for those at lower incomes; impact of cuts to homemakers and residential care services; sharply cut wages for hospital non-medical workers and community care workers; abolition of BC Human Rights Commission |
| Welfare | Reduced benefits for single parents and employable persons aged 55-64; hardship assistance eliminated for some; elimination of earnings exemptions (except for disabled clients); cuts to shelter portion of benefits for families of 3 or more, affecting mainly children; time limits for receipt of benefits; restricted appeal procedures; closure of offices |

Note: Some of these announced cutbacks were subsequently reversed in the face of public criticism; for example, the bus pass subsidies for low-income seniors were reinstated, and the funding cuts for legal aid and audio-book programs were partially restored.

Sources: British Columbia Government, Ministry Service Plans, announced as part of 2002 budget and stemming from the Core Services Review, at <http://www.gov.bc.ca/prem/popt/corereview>; miscellaneous news reports in the BC press; and the “Strategic Thoughts” Web site at <http://www.StrategicThoughts.com/navcuts.html>.

An alternative policy course for British Columbia would seek to devise a financing strategy—using both tax and non-tax revenues—that would be much more favourable to economic efficiency and growth than the current regime. Major elements could include non-tax revenues from land development auctions and market pricing of hydroelectric power; tax revenues from a flatter personal tax schedule with reduced rate cuts for the lower and middle tax brackets, where competitive pressures are less of a concern than with mobile skilled workers; and revenues from a general payroll tax or a reconfigured corporate tax based on payrolls plus cash flows rather than net incomes. This approach would enable prudent progress toward eliminating the structural deficit, but over a somewhat longer time frame than the official target. It would thereby greatly reduce the strain on provision of public services that is stemming from the current policy course. The proposed approach would avoid many of the “false economies” whereby public costs are being reduced while imposing offsetting cost increases on private actors, both individuals and businesses (such as pharmacare and medicare cutbacks and closing of courts and government offices). It would also allow for better-deliberated ways of finding cost savings in the public sector than the large-scale cuts that are disproportionately affecting lower-income and vulnerable BC residents.

In any strategy to eliminate the structural deficit, timing is a critical dimension. As the foregoing analysis has demonstrated, the structural deficit is essentially a dynamic rather than a static concept. Unless interest rates and debt levels are very high, or unless public spending is too far out of line with revenues, a structural deficit can be eliminated over the years through growth of the economy and associated revenues. At most, this may require constraining the growth rate of public spending so that real per capita levels do not rise; with a larger structural deficit, it may require some cuts to the initial real per capita spending levels. British Columbia's official target of eliminating not only the structural deficit but also the actual deficit by 2004-5 severely constrains policy choices. It provides just two years of growth to overcome the cyclical portion of the deficit and then just one year of further growth to vanquish the structural part. Extending the target by one or two years would greatly relieve matters by providing more time for growth to surmount the structural component of the deficit. British Columbia is pursuing a range of policies in the taxation, public service, and regulatory areas that could raise the economy's growth rate, and these policies must be given adequate time to work to raise provincial revenues.

It is important for British Columbia to avoid the “yo-yo” spending behaviour observed in other jurisdictions dealing with their deficit problems. Alberta, for example, sharply cut public spending in the early 1990s to deal with deficits from falling energy revenues; these were reversed in the last few years with large spending hikes and tax cuts financed by a resurgence of energy revenues; and with the more recent softening of energy revenues, the province has been forced to raise taxes and trim spending to avoid a return to deficits. The public is not well served by wide swings in the levels of health-care, education, justice, transport, and other

public services. It would be much better to smooth public spending and services over several years to see how the economy unfolds and what level of public services is affordable over the longer term. Cutting public services excessively now, to avoid a higher peak debt-GDP ratio for the province, in effect imposes the burden of adjustment on vulnerable and low-income people today to benefit higher-earning taxpayers in the future. It would also make sense to smooth tax rates and burdens over time rather than change them abruptly; a more gradual approach yields a lower total cost in economic efficiency than do sharp changes in tax rates.⁷⁸

This study's discussion of alternative tax, spending, and fiscal policy choices for British Columbia has, for the most part, ignored the political dimension. Proposals to recapture part of British Columbia's revenue losses through tax and non-tax measures might be opposed by businesses and some households, but the restoration of public funds to avoid severe public service cuts might prove to be broadly popular. Indeed, an Ipsos-Reid survey of BC residents taken in May 2002 to mark the first anniversary of the BC Liberal election victory appears to support this view.⁷⁹ Fully 70 percent of respondents felt that the state of health care in British Columbia was worse than at the election, and 61 percent felt that public education was in worse shape. Women and those at lower incomes expressed this dissatisfaction to a greater than average degree. And looking ahead three years, a plurality of respondents felt that these services would still be in worse shape at the time of the next election. More felt that provincial public finances had worsened than improved over the Liberals' first year, but a majority expected British Columbia's finances to improve over the next three years. An amazing 63 percent agreed with the statement that "the BC Liberals don't care about the people who are most affected by the changes they make" (with 44 percent "strongly agreeing"). Yet 59 percent held the view that "the actions taken by the BC Liberals may seem harsh, but they are necessary if BC is to prosper in the future." Apparently, the public has accepted the argument that the province's public finances are so distressed that the government had no choice other than to pursue its current policy course.

A final, broader dimension also needs to be recognized in choosing fiscal policies to address British Columbia's structural deficit. Businesses are attracted to jurisdictions with cost-effective government—not necessarily the lowest tax rates—and skilled labour. But they are additionally concerned with political stability and social polarization in making investments for the long term.⁸⁰ If they lack confidence that attractive public policies can be sustained for the long run, and if they have concern over labour-management strife and other risks that can arise from divisive policies, they will seek more tranquil places for their investment. Empirical studies find that increased inequality itself can be harmful to economic growth.⁸¹ The apparent channel for this effect is that distributional conflict leads to a greater risk of future taxes on investment and more resistance to growth-promoting policies with their inevitable dislocations. Hence, current fiscal policies would be wise to blunt such distributional conflict by being more sensitive to adverse impacts on lower-income groups when paring public spending to achieve fiscal sustainability.

From the evidence, this course of action may be as much a matter of promoting economic growth as promoting economic justice. And it will likely dictate less constriction of both taxes and expenditures in the fiscal balancing exercise.

APPENDIX: EXPANSIONARY FISCAL CONTRACTIONS?

The types of fiscal policies typically pursued to reduce deficits—tax increases and spending cuts—are predicted by conventional economic analysis to depress the economy in the short to midterm. This depressing effect makes the policies less effective in cutting the deficit because of the resultant impacts on tax revenues and public spending for income support and services for the unemployed. Also, the policy mix of tax cuts combined with even larger spending cuts (as pursued recently in British Columbia) is predicted to depress the economy over the near term. Yet, under certain circumstances, very different outcomes have been observed: fiscal contractions have proven to be expansionary.⁸² In the 1980s, Denmark and Ireland undertook severe fiscal policies to deal with large public deficits (5 to 10 percent of GDP). They combined large spending cuts with tax hikes and achieved greatly improved economic performance in the periods following their fiscal actions. Table A1 shows the performance of these two economies in their pre- and post-stabilization periods. However, such an outcome cannot be replicated by a subnational government, such as British Columbia, because those countries relied on stimulus by inducing sharp shifts in interest rates and exchange rates. A province cannot exploit these economic channels since it is constrained by the national interest and exchange rates.

The Irish fiscal policies of the 1990s are often cited as a particularly successful example of a growth-promotion strategy.⁸³ The government secured a series of national wage agreements with unions and employers; these produced moderation in wages in return for steady reductions in income tax rates. The Irish government also instituted extremely low preferential rates of corporate tax for profits from manufacturing and internationally traded services. Additionally, the comparatively low-wage Irish labour market was enhanced via public spending on advanced education and skill training. The result of these policies—plus large infusions of European Union funds—was a stream of foreign direct investment and remarkably high growth rates for GDP and real disposable incomes over the decade. As shown in table A2, Ireland was the world leader over this period for real per capita GDP growth rates. The table also shows the growth rates for other small open economies including Canada, and for the United States, and the associated national tax burdens. It is clear that there is no direct correlation between tax burdens per se and national economic performance.⁸⁴ Several countries with notably higher tax burdens than Canada's had much better-performing economies.

The tax-cutting policies of Alberta and Ontario in the mid- and late-1990s have been cited as models for other Canadian provinces to spur their economies. However,

TABLE A1 Fiscal Stabilization in Denmark and Ireland in the 1980s (Annual %)

| | Pre-stabilization period | Stabilization period |
|---|--------------------------|----------------------|
| <i>Denmark</i> | 1979-1982 | 1983-1986 |
| Net gov't. borrowing (% of GDP) | 5.3 | 2.5 |
| Average real consumption growth | -0.8 | 4.2 |
| Average real investment growth | -6.3 | 11.1 |
| Average real GDP growth | 1.3 | 3.7 |
| <i>Ireland</i> | 1983-1986 | 1987-1990 |
| Net gov't. borrowing (% of GDP) | 10.1 | 4.2 |
| Average real consumption growth | 2.6 | 3.8 |
| Average real investment growth | -4.9 | 5.3 |
| Average real GDP growth | 1.9 | 5.7 |

Source: Frank Berry and Michael B. Devereux, "Expansionary Fiscal Contraction: A Theoretical Exploration," *Journal of Macroeconomics*, forthcoming, table 2.

TABLE A2 Comparative Economic Growth Rates and Tax Burdens, Selected Countries

| | Increase in real GDP per capita, 1988-1998 (%) | Total taxes as % of GDP, 1997 |
|--|---|----------------------------------|
| Ireland | 92.2 | 32.8 |
| Norway | 30.3 | 42.6 |
| Netherlands | 26.2 | 41.9 |
| Spain | 25.7 | 33.7 |
| Denmark | 21.8 | 49.5 |
| Australia | 20.4 | 29.8 |
| Belgium | 19.3 | 46.0 |
| United States | 18.5 | 29.7 |
| Sweden | 7.3 | 51.9 |
| New Zealand | 5.7 | 36.4 |
| Canada | 5.0 | 36.8 |
| 25 OECD country average ^a | 22.2 | 37.3 |

^a Excludes the four poorest OECD countries.

Sources: Pierre Fortin, *The Canadian Standard of Living: Is There a Way Up?* Benefactors Lecture (Toronto: C.D. Howe Institute, October 1999), table 1; Organisation for Economic Co-operation and Development, *Revenue Statistics, 1965/1998* (Paris: OECD, 1999).

both of those jurisdictions enjoyed strong external demand for their major industries—energy for Alberta and automobiles and manufacturing for Ontario. It is difficult to disentangle the demand stimulus from any supply shocks caused by tax reductions. Alberta pursued a strategy of first cutting public spending and then cutting taxes vigorously only after its public finances had improved. Ontario, in contrast, initiated its large tax cuts combined with public spending restraint while still running large deficits. British Columbia is also pursuing tax and spending cuts jointly, with the tax cuts front-loaded, but it is in an environment of depressed

external demand for and prices of some of its major sectors, including forest products, tourism, and base metals. There is little reason to believe that British Columbia can replicate Ontario's experience—within a few years, achieving rapid economic growth that raises total tax revenues above their real per capita levels before the tax rate cuts. Most of the revenue gains for Alberta and Ontario over those periods were attributable to externally generated demand growth rather than the tax rate cuts.

NOTES

- 1 The BC finance minister stated in his 2002 budget speech, “[W]e’re absolutely committed to getting our fiscal house in order. That means getting rid of the structural deficit, once and for all.” British Columbia, Ministry of Finance and Corporate Relations, 2002 Budget, Budget Speech, February 19, 2002, 6-7.
- 2 According to official estimates, \$1.8 billion of the 1991-92 deficit was structural (rather than cyclical). The structural deficit was reduced to between \$400 million and \$800 million in 1993-94. British Columbia, Ministry of Finance and Corporate Relations, 1993 Budget, March 30, 1993, 72. Moreover, the NDP's first budget cited its Independent Financial Review's projection of a \$2.8 billion deficit for 1992-93 without corrective policies and stated that British Columbia was “now burdened with a structural deficit.” British Columbia, Ministry of Finance and Corporate Relations, 1992 Budget, March 26, 1992, 5 and 69.
- 3 For comparative assessment of the deficit reduction experience of British Columbia, Alberta, and Saskatchewan, see the studies in Paul Boothe and Bradford Reid, eds., *Deficit Reduction in the Far West: The Great Experiment* (Edmonton: University of Alberta Press for the Institute of Public Economics, 2001).
- 4 See British Columbia, Ministry of Finance and Corporate Relations, budget reports of various years.
- 5 One representative textbook describes structural deficits “in the sense that they represented basic imbalances between federal revenues and spending. These deficits would have persisted even if the economy had been operating at acceptable levels of unemployment.” David N. Hyman and John C. Strick, *Public Finance in Canada: A Contemporary Application of Theory to Policy*, 2d ed. (Toronto: Harcourt Canada, 2001), 431. More advanced analyses of structural deficits and public policies to address the problem, framed for the national economy, can be found in William B.P. Robson and William M. Scarth, eds., *Deficit Reduction: What Pain, What Gain?* Policy Study no. 23 (Toronto: C.D. Howe Institute, 1994).
- 6 Another textbook states, “The deficit remaining [if income were at full employment] is referred to as structural, while the excess of the actual over the full-employment deficit is referred to as cyclical.” Richard A. Musgrave, Peggy B. Musgrave, and Richard M. Bird, *Public Finance in Theory and Practice*, 1st Canadian ed. (Toronto: McGraw-Hill Ryerson, 1987), 553.
- 7 However, if the growth reflects solely higher inflation, interest rates will begin to rise so that debt service charges also will rise. In turn, the cumulative debt level will increase, thus dampening any reduction in the debt-GDP ratio.
- 8 The restoration of full indexing to the rate schedules for federal and BC personal income taxes in the last couple of years reduces but does not eliminate the responsiveness of revenues to income growth. Note that corporate income tax revenues also can rise rapidly during the growth phase of the business cycle, but this increase is offset by sharp declines during recessions. According to BC's finance minister, each additional percentage point of GDP growth increases provincial revenues by between \$250 million and \$500 million, depending on

the sectors generating the most growth. Even the lower end of this range yields a revenue response that is slightly more than 1 percent for each 1 percent increase in real GDP growth. British Columbia Government, "Transcript of the Open Cabinet Meeting," February 7, 2002. Budget documents provide detailed figures on the sensitivity of each revenue component with respect to variations in relevant economic variables. See British Columbia, Ministry of Finance and Corporate Relations, 2001 Budget, Budget Reports, March 15, 2001, 56-58.

- 9 The present exposition is simplified by referring to expenditures as solely program spending. Interest costs on the public debt also need to be covered and are therefore part of total public expenditures. When public debt levels and/or real interest rates get very high, these interest costs can begin to overwhelm public finances and lead to an unsustainable situation.
- 10 For most of the seven-year period ending 2000-1, British Columbia ran either small surpluses or deficits that were sustainable in this sense. See the figures on debt-GDP ratios for British Columbia during this period cited in the introductory section.
- 11 And, by definition, the sustainable deficit itself will grow over time with growth of the economy.
- 12 Still, this begs the question of how society values the lost public services relative to the additional private consumption; the outputs of the two sectors are not fully substitutable, so that there may still be a higher value on the former at the margin.
- 13 British Columbia, *Report of the British Columbia Fiscal Review Panel: British Columbia Fiscal Forecasts and Issues 2001/02 to 2003/04* (Victoria: Ministry of Finance and Corporate Relations, July 23, 2001) (herein referred to as "the FRP report"), available online at <http://www.fin.gov.bc.ca/commbr/frpreport.pdf>.
- 14 British Columbia, Ministry of Finance and Corporate Relations, *Budget 2002 Consultation Paper* (Victoria: Ministry of Finance and Corporate Relations, September 2001), available online at http://www.fin.gov.bc.ca/CommBr/Prebudget_Consultation.pdf. The consultation paper retained the fiscal projections of the FRP but appended the revenue impacts of the personal and business tax cuts; those impacts were based on the assumption that there would be no offsetting revenues through induced higher rates of economic growth.
- 15 FRP report, *supra* note 13, at i.
- 16 The BC budget for 2002-3 forecast the following deficits after the effects of its policy changes: for fiscal 2002-3, \$4.4 billion including a \$750 million forecast allowance; for 2003-4, \$1.8 billion with no forecast allowance; and a balanced budget for 2004-5, also with no forecast allowance. British Columbia, Ministry of Finance and Corporate Relations, 2002 Budget, Budget and Fiscal Plan, 2002/03-2004/05, February 19, 2002, 2.
- 17 The budget's major departures from the forecasts of the FRP included slower economic growth, substantial increases in the salary budget for workers in the education and health-care sectors, and three revenue measures that covered most of those additional salary costs (a 50 percent hike in health-care premiums, a half-percentage hike in the BC sales tax rate, and higher tobacco taxes).
- 18 "The Panel has used status quo revenue and expenditure forecasts prepared for the Panel by the Ministry of Finance as the basis for its forecast." FRP report, *supra* note 13, at 17.
- 19 Note that the revenue impacts of the personal and business tax cuts (considered in the next paragraph) are shown separately in table 2.
- 20 The general rate of personal income tax was reduced; the surtax rate on high earners was reduced; the small business corporate tax rate was cut to 4.5 percent from 10 percent; the taxable threshold for corporate capital tax on non-financial corporations was more than tripled to \$5 million, so that 90 percent of businesses were exempt; and a 3 percent investment tax credit was introduced for the manufacturing and processing sectors as a partial offset against provincial sales tax.

- 21 This rate is computed from official budgetary figures for the consolidated revenue fund; it does not include transactions within the Crown corporations and other agencies that are added to produce the summary accounts figures. For discussion of this issue, see the FRP report, supra note 13, at 5-7. For an initial attempt to account for the province's finances on a broader basis, including both the enterprise sector (Crown corporations) and the "SUCH" sector (schools, universities, colleges, and hospitals), see Office of the Auditor General of British Columbia, *2001/2002 Report 4: Monitoring the Government's Finances* (Victoria: Office of the Auditor General of British Columbia, February 2002), available online at <http://www.bcauditor.com/AuditorGeneral.htm>.
- 22 For the official rationale for using a forecast allowance in BC budgeting, see 2001 Budget, Budget Reports, supra note 8, at 52.
- 23 The FRP members stated, "[T]ax increases are clearly not an option." FRP report, supra note 13, at ii.
- 24 Note that these figures abstract from payments by Crown corporations into the consolidated revenue fund, which are counted as part of revenues.
- 25 If inflation rates were to rise in future years, this increase would raise the requisite spending level but have an offsetting effect on revenues.
- 26 Considering recently depressed oil/gas and electricity prices, the annual revenue impact is probably larger. However, recent prices reflect the macroeconomic impact of a slow-growth North American, indeed world, economy, and prices should return to higher levels as the economic recovery proceeds. Additionally, British Columbia has a bright outlook for continued rapid expansion of oil/gas development with associated royalty and tax revenues.
- 27 The upper assumed rate of real growth for the BC economy is close to that achieved under the previous administration; from 1991 through 2000, the BC economy achieved an average annual real growth rate of 2.9 percent, half a percentage point below that for Canada as a whole. For discussion, see Lillian Hallin, "Bucking the Trend: BC's Economy During the 1990s," *Infoline* (Victoria: BC Stats, January 25, 2002), 3-10, available online at <http://www.bcstats.gov.bc.ca>.
- 28 Note that the BC government has already exceeded its original target of freezing nominal spending on health care, largely through salary increases for nurses, doctors, and medical technicians, but these costs have been offset by additional revenue measures. See supra note 17.
- 29 From the earlier discussion of the structural deficit concept, it is clear that a government has restored fiscal sustainability with an ongoing deficit so long as it does not exceed the "sustainable deficit"; the latter is equal to the rate of nominal GDP growth multiplied by the level of public debt. If the latter is restricted to "taxpayer-supported" debt in British Columbia, and 4.5 percent is taken as a cautious measure of long-run nominal GDP growth rates, the sustainable deficit currently is around \$1.3 billion (\$28 billion \times 0.045). The reason that this sum is not allowed for in the table 3 forecasts and associated discussion is that BC public accounts track separately the debts incurred through off-budget borrowing by various education, health, and transit authorities for capital projects; this figure must be added to the summary accounts deficit to obtain the total addition to public debt for the province in a year. In 2001-02, the off-budget borrowing was forecast at nearly \$1 billion, which consumes most of the apparent "sustainable deficit." British Columbia, Ministry of Finance and Corporate Relations, *Second Quarterly Report 2001/02* (Victoria: Ministry of Finance and Corporate Relations, November 22, 2001), 44.
- 30 This figure applies to both total provincial debt (including that of the Crowns) and taxpayer-supported debt. See the 2002 Budget, Budget and Fiscal Plan, 2002/03-2004/05, supra note 16, at 163. In 2000, British Columbia had the second-highest provincial debt credit rating (Aa2) from Moody's Investors Services. Office of the Auditor General of British Columbia, supra note 21, at 31.

- 31 Another reason sometimes cited is the real burden of public debt in displacing private investment, so that the economy grows less rapidly and leaves future generations with lower real living standards. There is a considerable economic literature assessing this phenomenon, but this effect should be muted for a small open economy such as Canada and particularly a subnational jurisdiction such as British Columbia. Savings from outside the country or province will be readily supplied to private business at interest rates determined on international markets and risk characteristics of the individual firm, not the risk associated with the public sector. A risk premium for private borrowers might rise in cases where the relevant government has become very highly indebted, if it is feared that rising tax rates will affect the solvency of private firms.
- 32 The only direct study of this issue for Canada is an unpublished paper by Gideon Rosenbluth, "The Influence of Government Deficits and Debt on Interest Rates: Canada 1970-1995," paper presented to the annual meetings of the Canadian Economics Association, Montreal, June 2, 1995. Canada is examined along with several other countries in an analysis of the linkage to deficits; see Jose Correia-Nunes and Loukas Stemitsiotis, "Budget Deficit and Interest Rates: Is There a Link? International Evidence" (1995) vol. 57, no. 4 *Oxford Bulletin of Economics and Statistics* 425-49. Also see Tamim Bayoumi, Morris Goldstein, and Geoffrey Woglom, "Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States" (1995) vol. 27, no. 4, part 1 *Journal of Money, Credit and Banking* 1046-59. The latter study finds that yield spreads grow at an increasing rate for jurisdictions with successively higher indebtedness. This relationship serves as a market disciplining device.
- 33 Note that the figures in this table are only a rough approximation, since for each province they are based on the bond with maturity closest to 5 and 10 years, without adjusting the yields for the actual maturities. The figures also do not adjust for effects of differing coupon rates on the yields that arise from the differential taxation of interest income and capital gains when the bonds mature.
- 34 This magnitude is somewhat larger than Rosenbluth's estimate for 1995 that a 10 percentage point difference in provincial debt-GDP ratios is associated with a 14 basis point difference in bond yields. Of course, bond-rating agencies and lenders also care about a province's future course of public finances, so that the interest rate impact could be considerably larger if the province did not have a credible plan for controlling its public finances within an acceptable period.
- 35 The proportion of BC public spending that goes to worker compensation is particularly high in the areas of health (68 percent), education for K-12 (85 percent), advanced education (64 percent), and community social services (80 percent). FRP report, supra note 13, at 8.
- 36 For an accessible review of the large literature on the effects of public debt and deficits on the economy, see Daniel N. Shaviro, *Do Deficits Matter?* (Chicago: University of Chicago Press, 1997).
- 37 These forecast growth rates for the BC economy were used in the 2002-3 budget: 2002 Budget, Budget and Fiscal Plan, 2002/03-2004/05, supra note 16, at 82.
- 38 This was precisely the experience of Alberta, which sharply cut public expenditures in 1994-1997 and turned a large structural deficit into a large structural surplus. Thus, a large portion of the cuts turned out to be unnecessary. In recent years, Alberta appears to have overshot once again, this time recreating a structural deficit by making unsustainably large tax cuts and spending increases. For analysis of the Alberta experience, see Ronald Kneebone, *Recent and Not So Recent Trends in Provincial Government Spending in Alberta*, Discussion Paper 2002-04 (Calgary: University of Calgary, Department of Economics, 2002), available online at <http://www.econ.ucalgary.ca/research/disc02.htm>.

- 39 The federal government pursued this approach in attacking its deficit during the 1990s. There was no target year for achieving budgetary balance, but rather each budget committed to targets for the next two years. This approach provided greater flexibility for budgetary plans to respond to changes in the economy's performance.
- 40 Even the rhetoric of the BC Liberal Party in its 2001 campaign and the companion "New Era for British Columbia" platform demonstrated this political caution. The proposed tax rate cuts were represented as being fully self-financing, implying that they would not pose any risk to funding for public services, and there was no hint of the magnitude or sweep of the public spending cuts that would be pursued following the party's ascent to government.
- 41 Alberto Alesina and Allan Drazen, "Why Are Stabilizations Delayed?" (1991) vol. 81, no. 5 *The American Economic Review* 1170-88, at 1171.
- 42 Because of space limitations, this study does not examine the role of user charges or public-private partnerships (so-called P3s) in British Columbia's deficit elimination strategy. For an excellent review of the economic and policy aspects of user charges, see Richard M. Bird and Thomas Tsiopoulos, "User Charges for Public Services: Potentials and Problems" (1997) vol. 45, no. 1 *Canadian Tax Journal* 25-86. User charges can be useful in rationing the supply of goods and services by public agencies and the demand by households and businesses—thus increasing the economic efficiency of government—and further reducing the need for distorting taxes. However, increased reliance on user charges can carry adverse distributional effects relative to general revenue financing; these effects need to be offset by enhancements to targeted income supports. P3s can also be used to replace general revenue financing, and when the projects are financed by user charges (such as tolls on privately constructed roads and bridges), similar distributional issues arise. While British Columbia is pursuing both more user charges and P3s, it has actually been reducing rather than enhancing income support levels (for example, workers' compensation benefits, income assistance benefits, and BC seniors supplements).
- 43 British Columbia also enjoys the potential for increased efficient collection of non-tax revenues by enhancing access to exploration and development of offshore petroleum and natural gas resources. Yet another area illustrating economic rents, and a potential efficient revenue source, is British Columbia's softwood lumber industry, but this involves greater complexities than can be considered in the current study.
- 44 Henry George in his time became a famous economic/political philosopher with a cult-like following. For a Web site describing his work and its historical setting, see <http://www.progress.org/books/george.htm>. For more conventional economic analysis of this tradition, see Dick Netzer, ed., *Land Value Taxation: Can It and Will It Work Today?* (Cambridge, MA: Lincoln Institute of Land Policy, 1998); and Kenneth C. Wenzer, ed., *Land-Value Taxation: The Equitable and Efficient Source of Public Finance* (New York: M.E. Sharpe, 1999).
- 45 Note that the single tax would be applied solely to the land value and not to any structural improvements, thus avoiding any disincentives for investment on the land.
- 46 At present, this increased value is allowed to accrue to the landowner. The proposed process would also help to reduce the incentives for political pressures and payoffs to approve the release of land parcels from the reserve.
- 47 These efficiency gains stem from incentives for BC consumers to conserve on their use of electricity to the point where the marginal value equals the marginal cost of production; incentives for co-generation of electricity in industry; and the diversion of electricity sales to out-of-province customers where prices are higher. Note that there are some limited prospects for expansion of hydro generation capacity in British Columbia, but the construction costs today are far higher than the historical costs of earlier hydro facilities.
- 48 For large industrial users, the Seattle rates are actually just over 100 percent above BC Hydro's rates. Seattle's power rates are also significantly lower than those in most regions of the United

States. These comparative figures as of mid-2001 are provided in British Columbia, Ministry of Energy and Mines, *Strategic Considerations for a New British Columbia Energy Policy: Interim Report of the Task Force on Energy Policy* (Victoria: Ministry of Energy and Mines, November 30, 2001), 76, available online at <http://www.em.gov.bc.ca/EnergyPolicytaskforce/InterimReport.pdf>.

- 49 This figure is roughly in line with the \$1 billion estimate of the “dividend” from moving to market-based rates for the electricity generated from “endowment assets,” meaning the dams in the BC Hydro system, as estimated by an official BC task force. The task force also considered various “transitional arrangements” for moving to market-based rates. See British Columbia, Ministry of Energy and Mines, *supra* note 48, at 16 and 24-26.
- 50 Just over one-third of BC Hydro’s in-province sales, by revenue, are to residential customers. Hence, a 50 percent rate hike would involve less of a burden for households than a one-percentage-point rate hike in the BC sales tax (which is forecast to generate \$3.8 billion in 2002-3 at a rate of 7.5 percent, or just over \$500 million per percentage point of tax).
- 51 For example, it was estimated that the premium hikes were larger than the tax cuts for a married couple with two children and income of \$33,000, and also for a married couple on pensions with net income of \$40,000. Craig McInnes, “MSP Jump Eats Up Tax Cut,” *The Vancouver Sun*, February 6, 2002.
- 52 The government claimed that its premium assistance changes would result in lower MSP premiums for 230,000 people; specifically, they would affect single persons with net incomes below \$22,000 and couples and families with joint net incomes below \$31,000. British Columbia, Ministry of Finance and Ministry of Health Services, “Factsheet: Impact of Medical Service Plan Premium Changes,” accompanying *News Release*, no. JT/02, February 7, 2002.
- 53 Also, the associated provision of premium assistance adds to the effective marginal tax rates of lower-income households and thereby raises efficiency costs. And the collection of MSP premiums entails additional administrative and compliance costs. In a similar vein, it could be argued that British Columbia’s homeowner grants against property taxes are lump-sum transfers financed by distorting taxes. For that reason, much of the nearly \$500 million annual cost could be saved for deficit reduction by applying an income test to the grants. Perhaps better, scrapping the grants and replacing them with an enlarged BC refundable credit in the income tax would provide even-handed treatment to renters and homeowners.
- 54 For an economic assessment of the main elements of British Columbia’s tax system, see Jonathan R. Kesselman, “Provincial Tax Policies in the New Economy: The Case of British Columbia” (1995) vol. 4, no. 1 *Canadian Business Economics* 24-46. For an excellent analysis of the more generic tax policy issues at the subnational level, applied to the US states, see George R. Zodrow, *State Sales and Income Taxes: An Economic Analysis* (College Station, TX: Texas A&M University Press, 1999). Results similar to those of the present study were reported in an unpublished analysis of the BC economy completed in June 2001 just before the change of government; the authors were John de Wolf of CCG Consulting Group Ltd., Vancouver, and Ernie Stokes of the Centre for Spatial Economics, Waterdown, Ontario. They found that the package of tax policies yielding the largest payoff for provincial GDP included business tax cuts about twice the size of personal tax cuts (the opposite of the pattern pursued in British Columbia), with the business tax cuts fast-tracked and the personal tax cuts phased over several years, and with the personal cuts targeted on the upper rate brackets.
- 55 The most striking empirical study on this issue is based on experience in the United States; see Martin Feldstein and Marian Vaillant Wrobel, “Can State Taxes Redistribute Income?” (1998) vol. 68, no. 3 *Journal of Public Economics* 369-96. For an earlier review of Canadian evidence on this issue, see Kathleen M. Day and Stanley L. Winer, “Internal Migration and Public Policy:

- An Introduction to the Issues and a Review of Empirical Research on Canada,” in Allan M. Maslove, ed., *Issues in the Taxation of Individuals* (Toronto: University of Toronto Press in cooperation with the Ontario Fair Tax Commission, 1994), 3-61. A recent study based on Danish data found that variations in local income tax rates are partially borne by employers via higher gross wages; see Paul Bingley and Gauthier Lanot, “The Incidence of Income Tax on Wages and Labour Supply” (2002) vol. 83, no. 2 *Journal of Public Economics* 173-94.
- 56 For analysis of similar issues in the context of international labour migration, see Jonathan R. Kesselman, “Policies To Stem the Brain Drain—Without Americanizing Canada” (2001) vol. 27, no. 1 *Canadian Public Policy* 77-93.
- 57 For further analysis of the role of rate structures in Canadian tax policy, see Jonathan Kesselman, “Flat Taxes, Dual Taxes, Smart Taxes: Making the Best Choices” (2000) vol. 1, no. 7 *Policy Matters* 1-101, available online at <http://www.irpp.org>. The relative flatness of US state personal income taxes can also be seen for states leading in high-tech and financial industries. California’s top marginal tax rate (9.3 percent) begins at individual incomes of US\$37,725 (twice that figure for joint married returns); New York state’s top rate of 6.85 percent begins at US\$20,000 (double for joint returns); Massachusetts imposes a flat rate of 5.3 percent above US\$4,400 (or US\$8,800 for joint returns); and Texas has no state income tax. These rates are for the 2002 tax year and are from the Federation of Tax Administrators, online at http://www.taxadmin.org/fta/rate/ind_inc.pdf.
- 58 Even before these cuts, the NDP had begun trimming the high-income surtax rates it had imposed in the 1992 and 1993 budgets. In early 2001, British Columbia’s top marginal income tax rate of 19.7 percent was just 2.3 percentage points above Ontario’s top rate, albeit double Alberta’s.
- 59 An alternative electoral pledge could have been simply to remove the “growth-killing” high-income surtaxes implemented by the NDP in its first two budgets of the 1990s. That would have reduced the top marginal tax rate for British Columbia by even more than the rates chosen, while restricting the income tax cuts to higher earners and thereby greatly reducing the revenue costs. Note that in early 2001, the surtax rates affected taxable incomes down to about \$61,000.
- 60 For a critical analysis of Alberta’s flat tax, see Melville L. McMillan, “Alberta’s Single-Rate Tax: Some Implications and Alternatives” (2000) vol. 48, no. 4 *Canadian Tax Journal* 1019-52.
- 61 For the analysis behind the Saskatchewan changes, see Saskatchewan, *Final Report and Recommendations of the Saskatchewan Personal Income Tax Review Committee* (Regina: Department of Finance, November 1999), available online at <http://www.gov.sk.ca/finance/taxreform/pitrc>.
- 62 Saskatchewan, Department of Finance, *A Plan for Growth and Opportunity: Personal Tax Reform in Saskatchewan* (Regina: Department of Finance, Taxation and Intergovernmental Affairs Branch, March 29, 2000), 1-3, available online at <http://www.gov.sk.ca/finance/budget/budget00/brochure.pdf>.
- 63 Description and assessment of these provincial payroll taxes are provided in Jonathan R. Kesselman, *General Payroll Taxes: Economics, Politics, and Design*, Canadian Tax Paper no. 101 (Toronto: Canadian Tax Foundation, 1997), chapter 5, “General Payroll Taxes in Practice: The Canadian Provinces.”
- 64 For the evidence on the efficiency costs of payroll taxes vis-à-vis other taxes, and on the alleged “disemployment” effects of payroll taxes, see Kesselman, *ibid.*, at chapter 3, “Economic Issues of General Payroll Taxes.”
- 65 At a 2 percent rate, a payroll tax in British Columbia would be competitive with all the other provinces that apply such taxes and also all of the United States with its much higher rates of payroll taxes for social security. The provincial sales tax still imposes a major burden on businesses in British Columbia, even after the 2001 tax exemption for investment outlays in the manufacturing and resource industries.

- 66 British Columbia, Ministry of Finance and Corporate Relations, *Economic and Fiscal Update* (Victoria: Ministry of Finance and Corporate Relations, July 30, 2001), 66.
- 67 The BTT was proposed by the federal government in 1987 as a possible way to reform the then-existing manufacturers' sales tax. See Jonathan Kesselman, "Pros and Cons of a Business Transfer Tax in Canada," in Robin W. Boadway and Jack M. Mintz, eds., *Policy Forum on the Business Transfer Tax* (Kingston, ON: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1986), 24-30. For analysis of a similar proposal at the provincial level (but retaining depreciation rather than writeoff of capital expenses), called a "business value tax," see Richard M. Bird and Jack M. Mintz, "Tax Assignment in Canada: A Modest Proposal," in Harvey Lazar, ed., *Canada: The State of the Federation 1999/2000: Toward a New Mission Statement for Canadian Fiscal Federalism* (Kingston, ON: McGill-Queen's University Press for the Queen's University School of Policy Studies, 2000), 263-92; and Richard M. Bird and Kenneth J. McKenzie, *Taxing Business: A Provincial Affair?* C.D. Howe Institute Commentary no. 154 (Toronto: C.D. Howe Institute, November 2001). Note that the BTT would be an alternative to a provincial payroll tax. Moreover, it could be used to subsume the provincial sales tax, though this might pose complications for exports because it is an origin-based tax.
- 68 For example, see Robin Boadway, Neil Bruce, and Jack Mintz, "On the Neutrality of Flow-of-Funds Corporate Taxation" (1983) vol. 50, no. 197 *Economica* 49-61.
- 69 It was estimated that a fairly similar "business value tax" would have required a rate of just 2.5 percent in order to raise the same revenues as British Columbia's corporate income tax in 2000. See Bird and McKenzie, *supra* note 67, at 15.
- 70 Very low corporate tax rates were a pillar in Ireland's highly successful economic growth strategy of the 1990s (see the appendix).
- 71 Zodrow, *supra* note 54, at 29-38, provides a useful review of the large literature on determinants of business location; surveys have found that availability of skilled labour is a more important factor than state tax regimes. Recent empirical analysis supports the hypothesis that tax policies (for both capital and labour) affect the interprovincial location decisions of manufacturing firms in Canada. See Eugene Beaulieu, Kenneth J. McKenzie, and Jean-François Wen, "Do Taxes Matter for Firm Location?" (mimeograph, University of Calgary, Department of Economics, May 2002).
- 72 There are numerous studies documenting and assessing cost-reduction policies in other Canadian provinces as part of fiscal austerity. For example, see the contributions in Christopher J. Bruce, Ronald D. Kneebone, and Kenneth J. McKenzie, eds., *A Government Reinvented: A Study of Alberta's Deficit Elimination Program* (Toronto: Oxford University Press, 1997).
- 73 For example, see Jonathan R. Kesselman, "Squeezing Universities, Students, or Taxpayers? Issues in Designing a Canadian Income-Contingent Loan Program," in Stephen T. Easton, ed., *Ending the Squeeze on Universities* (Montreal: Institute for Research on Public Policy, 1993), 53-71.
- 74 False economies can also arise by imposing additional costs on other branches of government. For example, the planned closure of courthouses in many BC municipalities will "cost Burnaby dearly as police officers will incur increased travel costs given the amount of time they will need to make a round trip to give evidence, deliver prisoners, swear informations or apply for a judicial warrant." Ian Mulgrew, "Burnaby Will Pay Dearly for Court Changes," *Vancouver Sun*, May 28, 2002.
- 75 These provisions are embodied in British Columbia Bill 29 (2001, 37th Parliament, 2d session), Health and Social Services Delivery Improvement Act. The government argued that in the health sector, "[f]or support services staff, B.C.'s wage rates are up to 30 per cent higher than the rest of Canada." British Columbia, Ministry of Skills Development and Labour, "Health and Social Services Delivery Improvement Act," Background accompanying *News Release*, no.

- 2002-02, January 25, 2002. The differential between wages for hospital non-medical workers and those in the hospitality industry in British Columbia was first noted by Cynthia Ramsey, "Labour Costs in the Hospital Sector" [November 1995] *Fraser Forum* 16-18; this study was effectively critiqued in Marjorie Griffin Cohen, *Do Comparisons Between Hospital Support Workers and Hospitality Workers Make Sense?* (Vancouver: Hospital Employees' Union, October 2001). Still, neither study considered the superior benefit package of the public sector workers.
- 76 This phrase was widely used in publicity campaigns by BC nurses in 2001 to obtain large increases.
- 77 For an early analysis of this kind, see Carl Shapiro and Joseph E. Stiglitz, "Equilibrium Unemployment as a Worker Discipline Device" (1984) vol. 74, no. 3 *The American Economic Review* 433-44. Note that this argument does not necessarily justify all of the premium that such workers were formerly earning, and a fiscally pressed government concerned to reduce the "unit cost" of public services could be expected to review its options for the large budgetary costs of public employee compensation.
- 78 It is established in the economic theory of taxation that variations in tax rates over time can raise efficiency costs as much as the choice of an inefficient tax base. See Alan J. Auerbach, Laurence J. Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform" (1983) vol. 24, no. 1 *International Economic Review* 81-100.
- 79 Full details of the survey results and discussion of it can be found at the Ipsos-Reid Web site, <http://www.ipsos-reid.com/ca>. The survey did not ask questions relating to British Columbia's taxation policies or the 2001 tax cuts.
- 80 An empirical study of 70 countries found that increased income inequality depressed private business investment by fuelling social discontent and thereby increasing sociopolitical instability. See Alberto Alesina and Roberto Perotti, "Income Distribution, Political Instability, and Investment" (1996) vol. 40, no. 6 *European Economic Review* 1203-28.
- 81 A leading study was Torsten Persson and Guido Tabellini, "Is Inequality Harmful for Growth?" (1994) vol. 84, no. 3 *The American Economic Review* 600-21. For a partially contrasting analysis and findings, see Mark D. Partridge, "Is Inequality Harmful for Growth? Comment" (1997) vol. 87, no. 5 *The American Economic Review* 1019-32. For additional useful contributions on this topic, see the IRPP-CSLS Conference on the Linkages Between Economic Growth and Inequality, Ottawa, January 26-27, 2001, available at the Centre for the Study of Living Standards Web site at <http://www.csls.ca>.
- 82 A highly simplified account of the economic channels for expansionary fiscal contractions is that a sharp cut in the size of government causes consumers to anticipate lower future taxes and therefore expand their consumption, and the sharp decline in current and expected future deficits induces interest rates to plummet with a concomitant surge in private investment. The falling interest rates also cause depreciation of the exchange rate, thus stimulating net exports. For early analysis of this experience, see Francesco Giavazzi and Marco Pagano, "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries," in Olivier-Jean Blanchard and Stanley Fischer, eds., *NBER Macroeconomics Annual 1990* (Cambridge, MA: MIT Press, 1990), 75-111. Also see a related analysis for the Canadian economy by Tamim Bayoumi and Douglas Laxton, "Government Deficits, Debt, and the Business Cycle," in *Deficit Reduction: What Pain, What Gain?* supra note 5, 163-91. Later analysis can be found in Frank Berry and Michael B. Devereux, "Expansionary Fiscal Contraction: A Theoretical Exploration," *Journal of Macroeconomics*, forthcoming. Their model also relies in part on interest rate effects, which are not likely to operate at the provincial level of fiscal policy.
- 83 The Irish also undertook a failed stabilization attempt in the early 1980s that involved significant tax increases; the stabilization measures of the latter 1980s involved modest personal tax increases resulting from small cuts in marginal tax rates combined with base broadening.

See Giavazzi and Pagano, *supra* note 82. For an assessment of the 1990s fiscal policies, see Brendan Walsh, "The Role of Tax Policy in Ireland's Economic Renaissance" (2000) vol. 48, no. 3 *Canadian Tax Journal* 658-73.

- 84 However, there is considerable evidence that the mix and structure of taxes—rather than their overall level—does affect economic efficiency and growth. See sources cited in Kesselman, *supra* note 57.