

Government Involvement in the Economy

As Canada entered the 21st century, the issue of government involvement in the economy continued to attract controversy. While both federal and provincial governments in Canada reduced their spending and scaled back their involvement in the economy, critics lamented the systematic dismantling of the social welfare safety net that had distinguished Canada among industrialized nations. Today, many Canadians embrace a more "Americanized" model of government that features less government and reduced taxes. Through such government-reducing programs as privatization (which we explored in Chapter 6) and **deregulation** (a reduction of protective rules on certain industries), government becomes less involved in economic matters, and individuals and groups assume more economic freedom and responsibility.

However, fundamental questions continue. How can the common good prevail in an environment driven by individual self-interest? Can an economy correct itself sufficiently and quickly enough to eliminate the need for government involvement? What is the appropriate amount of government involvement? Should government involvement be limited to certain areas and methods of intervention? Currently, attitudes range from a strong advocacy of *laissez-faire* to unqualified support for substantial government involvement in order to ensure economic stability and a fair distribution of wealth. In this chapter, we shall look at the role of government in the Canadian economy to better understand its complexities.

The Great Depression

Among industrialized countries, few human tragedies parallel the pain and suffering inflicted by the Great Depression of the 1930s. Between 1929 and 1933, production in the United States dropped an estimated 42 per cent. Approximately 85 000 businesses failed, and some 5000 banks closed. Unemployment, which had been 3 per cent prior to the stock market crash of 29 October 1929, rose to an alarming 25 per cent.

In Canada, unemployment soared to a record level of 20 per cent as national production levels dropped an estimated 37 per cent. How could all this have happened? How long would it take the economy to recover? Could anything be done to speed up this recovery?

The frightening thing was that the "classical" answers were no longer valid. Prices had dramatically declined, but so too had national production and employment levels. This was not supposed to happen because falling prices, lower wages, and lower interest rates were all presumed to return the national economy to its normal state of full employment and capacity production. Glitches in the economy were supposed to be short-lived and self-correcting, but by 1933, the economy had yet to recover. It became apparent that something radically different had to be done before economic conditions deteriorated further.

Reconsidering *laissez-faire* capitalism

John Maynard Keynes was one of the first economists to propose that governments had to spend their way out of the Depression by hiring unemployed workers in major public works projects. He believed that this strategy would restore consumer spending and stimulate increased economic activity in the private sector. At first, Keynes's views were considered heretical, but as governments experimented with his new theory, economic activity eventually began to pick up. The government spending and the private investment that resulted from the Second World War returned the Canadian economy to full employment.

The Canadian welfare state

Since there was no formal welfare system and no Unemployment Insurance program, neither the federal nor the provincial government was obliged to provide financial help to those in need at the start of the Great Depression. It was usually left to local governments to help residents faced with unemployment and severe financial hardships. However, in provinces like Saskatchewan, where a lot of people needed assistance, the provincial governments had to provide organized relief services. As economic conditions worsened and millions of Canadians became unemployed, governments in Canada began to spend more on

relief programs, or *social assistance*, that consisted of government transfer payments to needy individuals and families.

From the 1930s to the 1970s, the role of government (especially the federal government) in attending to the socio-economic welfare of its citizens continued to expand. During the second half of the 20th century, Canada transformed itself into a welfare state. In a **welfare state**, the government plays a significant role in attempting to ensure the economic well-being of its residents. The welfare state represents a radical departure from the laissez-faire capitalism supported by the more traditional schools of economics. Figure 13.2 (page 291) outlines the principal components of Canada's **social welfare safety net**. By the end of the 20th century, government spending on income security, health, and education represented the three main pillars of the Canadian social welfare system.

A critical look at the welfare state

Critics of the welfare state and of **transfer payments**—the transfer of monies from the state to disadvantaged individuals and households—generally point to three main problems, as outlined below:

- **Incentive to work.** One major criticism of Canada's social welfare programs is that they often reduce an individual's incentive to work and, therefore, to be self-supporting. For every dollar that a welfare recipient earns by working, welfare benefits are reduced. Although the purpose of this policy is to provide finite government assistance where it is most needed, it also has the unintended effect of discouraging some recipients from finding full- or part-time jobs. The **marginal tax rate**, or the tax rate paid on any increases in income, also acts as a disincentive. Since, as a general rule, welfare recipients are low-income

A Matter of Opinion | What Is Government's Role in the Economy?

Political Perspective	Right-wing View	Left-wing View
Orientation	• Conservative; traditionalist	• Progressive; liberal-minded
Market preference	• Laissez-faire free-enterprise capitalism	• Mixed market (capitalism with government enterprise and a social conscience)
Sample political affiliation in Canada	• Progressive Conservative; Canadian Alliance	• New Democratic Party
Fundamental economic beliefs	• Values the classical school of economics founded by Adam Smith. Self-interest and competition serve as an invisible hand that guides decision making in a free market toward a self-regulated balance; government intervention upsets this natural balance. • Free-enterprise capitalism can best satisfy human wants while making efficient use of available resources. • The free-enterprise system is most able to correct itself and promote prosperity.	• Challenges the classical school of economics and its contention that the free market is fair and self-correcting. • Uncontrolled capitalism has a tendency to be exploitative—acting out of self-interest, the powerful can and will exploit and oppress the weak. • Free markets are vulnerable to cyclical downturns, which tend to victimize the weak. During a recession, firms generally lay off workers to protect the profit levels of wealthy investors.

Continued

Political Perspective	Right-wing View	Left-wing View
Role of consumers	In a free-market economy, competition ensures that the consumer is sovereign. By generally choosing the best quality at the lowest price, consumers rule the market place by rewarding firms that efficiently produce what is demanded and by rejecting firms that do not.	In a free-market economy, big business can manipulate consumer choice through production, pricing, and marketing strategies that influence product demand and selection and that limit the entry and effectiveness of competing firms.
Distribution of wealth	- Driven by self-interest, the incentives of private ownership and profit promote efficiency and wealth. - Market forces facilitate a fair distribution of wealth—individuals get a share of national wealth based on merit and effort.	- Uncontrolled capitalism contributes to the maldistribution of wealth—as employers and investors receive the lion's share of wealth, workers receive a disproportionate share. - Market forces facilitate the concentrated accumulation of wealth and capital—the rich get richer as the poor become more desperate.
Role of government	- Government involvement in the free marketplace is an intrusion that is generally inefficient or ineffective. It should be kept to a minimum and focused on the areas of administration of law and justice, national defence, public works, and public institutions. - The more people expect from their government, the more dependent and, therefore, less self-sufficient they become.	- Beyond the areas identified by laissez-faire advocates, government involvement is necessary to address the excesses of the free-market system (that is, to provide goods and services that the private sector will not because of low profit margins); to regulate business practices and protect competition, especially in key industries; and to facilitate a more equitable distribution of wealth. - The government must look after the common good (especially when individual decisions act against it) and serve the needs of those least able to care for themselves.

Figure 13.1 Conflicting viewpoints about the government's role in the economy. The spectrum of political viewpoints was introduced in Chapter 2. The left and the right of the political spectrum in Canada have significantly different views regarding the rightful role of government in the economy. This comparison chart outlines some of the key differences in these viewpoints.

QUESTIONS

- For each of the following government strategies, write two statements of opinion—one reflecting the viewpoint of the political right, the other of the political left. Explain why each view is held by its respective group.
 - an increase in tuition fees for post-secondary education
 - raising taxes on investment income (interest, dividends, and capital gains) in order to reduce the cost of day care for low-income earners
 - increased government spending on public broadcasting
 - a decrease in corporate income tax rates
 - charging user fees for medical services and prescription drugs
 - borrowing in money markets in order to finance expanded social programs
- Which viewpoint best describes your position regarding the role of government in the economy? Explain where you agree and disagree with these views.
- Re-examine these opposing viewpoints at the end of this chapter to assess whether your position has changed or has been reinforced.

earners, they pay very little income tax. Many welfare recipients gain little from taking on work because they have to pay a relatively high marginal tax rate. As much as 80 per cent of their extra income can be lost to taxes. In comparison, the highest income earners in Canada pay a marginal tax rate of close to 50 per cent.

In order to escape this high rate of marginal tax, welfare recipients must move beyond the low-income levels. Unfortunately, it is quite difficult for untrained and inexperienced persons to get these well-paying jobs. The self-interest that drives most Canadians to improve their economic circumstances through hard work offers little motivation for the poorest sector of the population.

Canada's Employment Insurance (EI) program has been criticized for actually contributing to unemployment by allowing repeated claims for benefits, after a brief work period. This can reduce the incentive to find more permanent employment in a different industry or region of Canada. In addition, employers' EI contributions increase each time an additional worker is hired—a factor, critics argue, that may discourage employers from increasing their workforce.

- *Inequities, abuses, and inefficiencies.* The welfare system is designed to redistribute income from higher-income Canadians to lower-income Canadians. However, under the present system, some disadvantaged Canadians fail to receive enough assistance while billions of dollars of benefits are paid out, instead, to less disadvantaged people. This is a direct result of **universality**, a long-standing principle of the Canadian welfare system. It recognizes that some benefits, such as Employment Insurance, Old Age Security, and Medicare, should be available to all Canadians regardless of income. In recent years, in order to combat the escalating cost of social welfare programs, which contributed greatly to government deficits, there has been a move toward means testing. Under **means testing**, transfer payments vary according to each recipient's income. Examples of means-tested programs include the Guaranteed Income Supplement

for older people and the Child Tax Credit for parents.

Advocates for low-income people challenge the use of means testing because, by raising the requirements, many Canadians who need social assistance are disqualified from receiving full benefits. On the other hand, critics note abuses of programs such as Employment Insurance and Medicare. For example, the cost of Medicare is greatly increased by abuses of the system linked to the fraudulent use of health cards and the charging of unnecessary expenses and procedures.

It is generally agreed that Canada's social welfare system is too complex and inefficient; there are too many programs with too many levels of government administering them. Critics point to the uncertainty about the benefits to which individuals and households should be entitled, to program overlaps and costly duplication, and to the levels of expensive government **bureaucracy** (or administrative structure) as proof of systemic inefficiency.

- *Effectiveness and cost.* Despite the spending of billions of dollars annually on social welfare programs, the distribution of income in Canada has remained virtually unchanged even as the welfare system has been expanded over the past 40 years. Many Canadians still live in poverty, with the poorest segment (20 per cent) of the population continuing to receive about 4 per cent of all income. Critics conclude that the present system has been relatively ineffective as a tool to redistribute income. Pointing to such evidence as the increased number of homeless people since 1995, advocates suggest that lower income levels would drop even further if existing programs were scaled back.

After the 1970s, government spending in Canada increased much faster than tax revenues. This led to annual budget deficits and increased borrowing in order to support growing social welfare programs. By the 1990s, it was clear that neither the Canadian economy nor the Canadian government could continue to absorb these rising costs.

Component	Description
Unemployment Insurance (UI)	This federally run program was started in 1942. It provides assistance to Canadians who have paid benefits for at least one year and who now find themselves temporarily out of work because of job loss, illness, or the birth or adoption of a child. All working Canadians and their employers make compulsory contributions in order to build up the fund. Any shortfalls are made up by the federal government. In 1996, the program was updated and its name was changed to Employment Insurance (EI) in order to reflect a more positive outlook. Although premiums were increased, benefits were decreased; by 2000, the fund had developed a \$30-billion surplus, prompting renewed calls for a reduction in premiums, especially from employers who create jobs.
Family Allowance	Starting in 1945, all families received a standard amount of monetary support for each child under 18 years of age. Also known as the "baby bonus," this was a universal benefit paid to all families, regardless of family income. In 1978, the program was replaced by a Child Tax Credit , available only to low-income households.
Old Age Security (OAS)	This federal program, started in 1952, provides monthly benefits to all residents of Canada once they reach the age of 65. These benefits are considered taxable income. The Guaranteed Income Supplement (GIS) was introduced in 1966 to help boost the monthly income of older Canadians whose primary source of income is Old Age Security.
Canada Assistance Plan (CAP)	In 1965, the federal government initiated this cost-sharing program to help fund the welfare services provided by provincial, territorial, and local governments to individuals and households that cannot support themselves. As of 1997, the federal government significantly decreased its contributions to this plan in order to reduce spending.
Canada Pension Plan (CPP)	Along with the Quebec Pension Plan (QPP) , the CPP was started in 1966 to provide monthly payments to retired workers who made regular contributions to the plan during their working years. Employers and employees pay an equal share of Canada Pension premiums.
Medicare	In this program, launched in 1968, the cost of medical services for Canadians is shared by the federal and provincial governments, instead of being paid directly by the individuals receiving the service. Through Medicare, Canadians receive quality medical services without the burden of large, unexpected bills. Even though health care costs as a percentage of GDP doubled in Canada from the 1950s to the 1990s, many Canadians are still concerned about the quality of health care available. Reports of hospital emergency wards turning away patients because of a lack of beds and staff, as well as recent provincial initiatives to reintroduce private health care, remain matters of public concern, in spite of increased annual spending on socialized health care.
Publicly funded education	Primary and secondary education are financed entirely by tax revenues. Post-secondary education is still heavily subsidized by the both federal and provincial governments. Despite rising tuition fees during the late 1990s, governments continue to contribute the majority of the funds needed to sustain Canada's post-secondary institutions. Government support of post-secondary education is generally accepted on two grounds. First, this investment in "human capital" is necessary in an increasingly complex and competitive society. Second, public funding provides greater equality of opportunity for Canadians who might not otherwise be able to afford the costs of higher education. By the end of the 20th century, Canada was spending more on public education (as a percentage of GDP) than virtually any other nation.

Figure 13.2 Canada's social welfare safety net.

By restraining federal spending, increasing the use of means testing, and downloading more health and welfare costs to the provincial governments, the federal government was able to balance its annual budget. A budget surplus was achieved by the end of the 1990s. In turn, provincial governments reduced their spending on programs and downloaded some welfare costs to local governments in order to bring spending in line with revenues. While social advocates lament the adverse effect that this has had on the most needy of Canadians, advocates of free-enterprise capitalism continue to question the overall effectiveness of Canada's expensive social welfare safety net.

During the "nasty 90s," many Canadians began to fear the systematic dismantling of the social welfare safety net as a means of reducing the huge government deficits. As the federal government began to experience a budget surplus during the late 1990s, public debate focused on whether to use the extra money to pay down the accumulated national debt, to increase spending on social programs, or to cut taxes for Canadians. After the terrorist attacks of 11 September 2001, the need for additional spending on national security consumed a significant portion of this surplus.

Check Your

Understanding

1. How did government relief programs during the Great Depression set the foundation for the Canadian welfare state?
2. Identify and explain the three main pillars of the Canadian welfare system.
3. Compare the principles of universality and means testing.
4. What are the main problems identified with Canada's complex social welfare system? What reforms have been introduced to address these concerns?

Taxation and Government Spending

The main purpose of taxation is to

- finance state activity (such as national security and social welfare),
- promote income equity, and
- influence conditions in specific markets.

The taxes collected by all three levels of government in Canada have increased significantly over the past decades, relative to national production figures. While taxes represented close to 10 per cent of Gross National Production in 1926, by the end of the century, this ratio had increased to approximately 38 per cent.

The principles of benefits received (as applied to gasoline consumption taxes) and ability to pay (as applied to income taxes) are generally used to determine how the burden of tax is distributed to taxpayers.

Taxes are related to income in one of three possible ways, as shown in Figure 13.5. In each of the taxes outlined in Figure 13.5, the amount of tax paid by the person earning \$40 000 is greater than the tax paid by the person earning \$10 000, but the difference varies greatly between each tax. A progressive tax generally provides the greatest proportional difference between what high- and low-income earners will pay. Progressive taxes are politically popular because they are based on the principle of ability to pay.

When a government tax is imposed, the individual or firm for whom the tax is intended may actually assume the burden of payment. However, in some cases, the burden of payment can be passed on to others. When the burden of payment is considered, economists recognize two different forms of taxa-

Economic Concept	Progressive Tax		Regressive Tax		Proportional Tax	
Taxable income	\$10 000	\$40 000	\$10 000	\$40 000	\$10 000	\$40 000
Tax rate	10%	20%	10%	5%	10%	10%
Tax payable	\$1000	\$8000	\$1000	\$2000	\$1000	\$4000
Relationship between tax and income	Tax rate takes a proportionately higher percentage from higher income earners.		Tax rate takes a proportionately lower percentage from higher income earners.		Tax rate takes a constant percentage from all income earners.	

Figure 13.5 Taxes (progressive, regressive, and proportional) and income.

tion. With **direct taxes**, the real burden of payment falls directly on the individual or firm immediately responsible for payment and cannot be passed on to others. Taxes collected on the income earned by individuals and firms are an example of direct taxes. With **indirect taxes**, the real burden of payment is added to the selling price and is, therefore, passed on to the buyer. Taxes on goods and services are an example of indirect taxes. In this case, producers may prepay the tax and then recover all or part of this payment from their customers.

Types of Taxation

Canadian governments use five main types of taxes to generate revenues:

- **Personal income taxes** are payable to both federal and provincial governments on the income individuals earn from wages and salaries, interest (from savings certificates deposited in financial institutions), dividends (from profits earned by stock holdings), capital gains (from the difference between the purchase and selling prices of assets such as land, property, and stock), and transfer payments (from governments for social assistance). Generally speaking, Canadians earning higher incomes pay higher percentage rates of income tax. Income taxes are, therefore, said to be progressive taxes.
- **Corporate income taxes** are directly payable to federal and provincial governments as a percentage of a company's annual profits

after all available deductions have been applied. Corporations, as we learned in Chapter 6, are treated as distinct persons under Canadian law.

- **Sales taxes** are payable to both federal and provincial governments on the purchase and consumption of goods and services by the end user. **Provincial Sales Tax (PST)** is charged by provincial governments on a wide range of goods and services as a set percentage of the selling price. **Goods and Services Tax (GST)** is charged by the federal government on a wide range of goods and services as a set percentage of the selling price (harmonized into one in some provinces, including Newfoundland and Labrador).
- **Excise taxes** are payable to federal and provincial governments, as a set dollar amount per unit, on particular products such as gasoline, liquor, and tobacco. **Custom duties**, or **tariffs**, charged by the federal government on foreign goods entering Canada, are a special type of excise tax used to protect Canadian producers. (Tariffs will be explained more fully in Chapter 17.) Excise taxes are a good example of an indirect tax because they are ultimately added to the selling price and paid by consumers.
- **Property taxes** are payable to local governments on the value of buildings and land. First, these holdings are assessed to establish a set value, intended to approximate the market value at a specific time. Then, each year, the local government establishes a **mill rate** that represents the property tax rate as a fraction

of the assessed value. For example, if the mill rate is set at 0.0123, for every \$100 000 of assessed property value, the owner will be charged \$1230 ($0.0123 \times \$100\,000$) in property taxes. Property taxes are affected by changes in the assessed value as well as by changes in the mill rate. Toward the end of the 20th century, property taxes in many communities across Canada increased as the operating expenses of local government grew.

Taxation and the Marketplace

The imposition of an indirect tax will affect market conditions for that specific good or service. The graphs in Figure 13.8 (page 298) help to illustrate the specific effects of taxation on the market price and the quantity transacted for pork (representing goods with an elastic demand) and gasoline (representing goods with an inelastic demand). Review the concept of elasticity of demand, developed in Chapter 5, to help you understand the elasticity of demand for each sample commodity.

Let's assume that the federal government imposes a special excise tax amounting to \$1.00 per kilogram on pork and \$0.50 per litre on gasoline. Figure 13.8 demonstrates that the effect of indirect taxes depends on the elasticity of demand for the good or service being taxed. In the case of the pork market, the new tax acts as a tax on production and may seriously affect the ability of some pork producers to stay in business. In the case of the gasoline market, the new tax acts as a tax on consumption and may affect both driving habits and the sale of more energy-efficient vehicles. Which of these two taxes is the Canadian government more likely to impose?

Anyone operating a motor vehicle today will quickly recognize that the excise taxes already imposed on gasoline account for close to half of the per-litre price paid by Canadian consumers at the pump. Governments prefer to impose these indirect taxes on goods such as tobacco, gasoline, and alcohol to generate steady revenue streams and to tax and regulate consumption. Some of the revenues generated from gasoline excise taxes can then be used by

governments to build and maintain the infrastructure of roads and bridges needed by both individuals and industry.

Tax Reform in Canada

Generally speaking, governments can generate revenues by taxing incomes, assets, and spending, but, in doing so, there are always economic costs. High income taxes can be a disincentive to work, save, and invest and can, therefore, have an adverse effect on national production levels. Personal income tax was introduced in Canada during the First World War as a temporary means of raising funds. By the 1990s, over half of federal government revenues came from personal income tax.

Property taxes discriminate against those who hold property assets instead of other assets. Since property taxes consume a larger portion of the income earned by lower-income residents, property taxes are recognized as a regressive tax. Sales taxes are also more burdensome on low-income households. Since both low- and high-income earners pay the same amount of tax on the goods and services they consume, sales taxes make up a higher percentage of the incomes of low-income households. For this reason, economists also consider sales taxes to be regressive taxes.

Taxes collected by all three levels of government in Canada increased steadily during the 20th century relative to the size of the national economy. Where total taxes represented approximately 12 per cent of the Gross Domestic Product in 1926, by the end of the 1990s, they represented closer to 40 per cent of the value of national production. This increase was needed to build and administer the social welfare safety net that Canadians wanted from their governments. Since the late 1980s, the federal government has attempted to address this concern about overtaxation by introducing a series of reforms intended to focus on three important aspects of taxation:

- Marginal tax rates on personal incomes were reduced so that if Canadians earned extra income, they could keep more of it to spend, save, or invest.

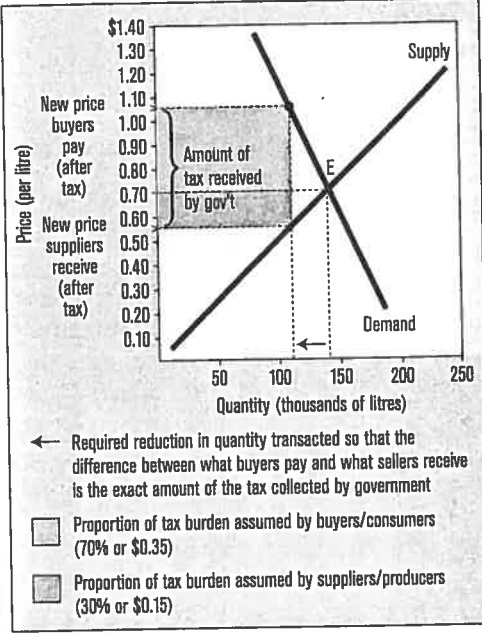
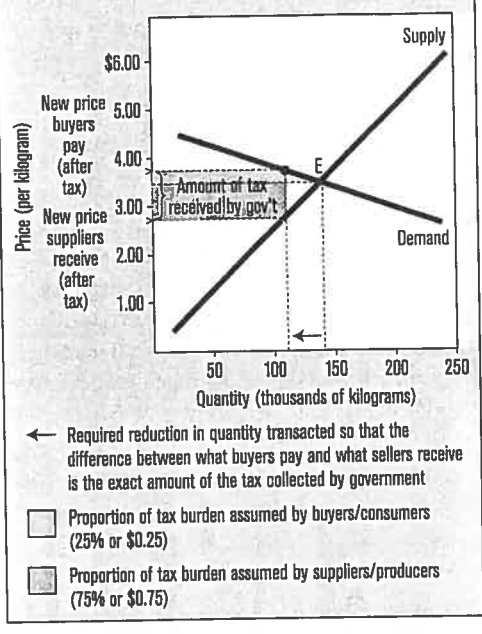
	Effect of a \$0.50 Tax on the Gasoline Market	Effect of a \$1.00 Tax on the Pork Market
Elasticity of demand	The demand for gasoline is relatively insensitive to price changes because gasoline is an essential source of fuel for automobiles, with very few substitutes readily available.	The demand for pork is sensitive to price changes because pork is a non-essential source of protein, with substitutes such as beef, fish, and poultry readily available.
	 ← Required reduction in quantity transacted so that the difference between what buyers pay and what sellers receive is the exact amount of the tax collected by government □ Proportion of tax burden assumed by buyers/consumers (70% or \$0.35) ■ Proportion of tax burden assumed by suppliers/producers (30% or \$0.15)	 ← Required reduction in quantity transacted so that the difference between what buyers pay and what sellers receive is the exact amount of the tax collected by government □ Proportion of tax burden assumed by buyers/consumers (25% or \$0.25) ■ Proportion of tax burden assumed by suppliers/producers (75% or \$0.75)
Pre-tax market conditions	The market is at equilibrium when 140 000 L of gasoline are being transacted at a price of \$0.70/L.	The market is at equilibrium when 140 000 kg of pork are being transacted at a price of \$3.50/kg.
Applying the new tax	With the tax in place, the price that buyers actually pay (\$1.05) and the price that suppliers actually receive (\$0.55) must differ by the exact amount of the tax (\$0.50) in order to keep the market in balance.	With the tax in place, the price that buyers actually pay (\$3.75) and the price that suppliers actually receive (\$2.75) must differ by the exact amount of the tax (\$1.00) in order to keep the market in balance.
Effect of tax	As a direct result of the tax, the price to consumers has increased by \$0.35, and the quantity transacted and consumed has decreased by 30 000 L.	As a direct result of the tax, the price to consumers has increased by \$0.25, and the quantity transacted and consumed has decreased by 30 000 kg.
Tax burden	Given the insensitivity of this commodity to changes in price, most of the tax burden (70 per cent) has been passed on to the buyers/consumers.	Given the sensitivity of this commodity to changes in price, most of the tax burden (75 per cent) has been assumed by the sellers.

Figure 13.8 Market comparison table for gasoline and pork.

- Tax credits were increased for lower-income earners to help offset the regressive effects of sales and property taxes and reduce the tax burden on low-income Canadians.
- The Goods and Services Tax (GST), a broadly based 7 per cent tax on consumption, was introduced in 1991 to replace the Federal Sales Tax (FST) on manufactured goods.

Revenue from the GST was intended to make up for the lost revenues incurred by the other tax reforms and also to help pay down the growing national debt. The GST is different and more complicated to administer than other sales taxes because producers do not have to pay GST on the materials needed for production. GST payments made on the purchase of production materials are refunded to manufacturers when they sell their final products. Therefore, unlike the old FST, there is no increase in production costs and no reduction in global competitiveness.

The GST is ultimately paid by the consumers of goods and services at the point of purchase. To help offset the regressive nature of this tax, a GST tax credit plan was introduced. Under this plan, low-income households receive GST rebates four times a year—in advance of actually paying the GST on their purchases.

During the late 1990s, provincial governments in Ontario and Alberta also attempted to stimulate their provincial economies by reducing income taxes in order to increase consumption. Increasing consumer spending was seen as one way to promote more employment and production. To fund these tax cuts, government spending on such programs as health care, education, welfare, and the environment was reduced.

Critics still maintain that Canadians today are greatly overtaxed relative to their US neighbours and trading partners. The Canadian Alliance Party, for example, continues to claim that high taxation is one main reason for the *brain drain*, or exodus of highly educated and talented Canadians to job opportunities in the United States. Many Canadians are prepared to pay current tax levels to preserve their quality of life; however, according to recent public

opinion polls, most Canadians would like to see a reduction in what they perceive to be wasteful spending by government. Every year, for example, the federal Auditor General's report outlines examples of the inefficient or wasteful use of public funds.

A 1998 research study comparing tax rates in Ontario to those in New York State revealed that the difference in tax rates is relatively small. In fact, at lower income levels, tax rates are relatively lower in the Canadian welfare state than in the United States. For moderate income levels, the rates on both sides of the border seem comparable. Only at higher income levels do US households experience lower rates of taxation. Similar global comparisons indicate that taxation rates in Canada compare favourably to the rates found in most industrialized, or G7, nations.

Since 1995, the tax reform movement in Canada has focused its attention on

- reducing the tax burden of working- and middle-class Canadians,
- reducing government waste and inefficiency to make the best use of tax dollars, and
- further reducing marginal income tax rates to make it in the best interest of all Canadians to increase their own incomes.

Reducing tax rates is seen by some economists as a good way to stimulate consumption, production, investment, and employment.

How Tax Dollars Are Spent

Figure 13.9 (page 300) outlines how government spending patterns changed over the latter part of the 20th century. Clearly, almost half of all government spending in Canada is allocated to the "three pillars" of health, social services, and education.

Poverty in Canada

Every society in human history has had to deal with the issue of fair distribution of available wealth. In Canada, the economic goal of income equity is to reduce the number of people living in poverty. Social critics are quick to point out that additional structural

adjustments, government spending, and income redistribution will be necessary in order to reduce further the amount of poverty that now exists in Canada. In Chapter 15, we shall explore these issues of income distribution and poverty.

Deficit Reduction and the Accumulated Public Debt

With government spending levels generally exceeding revenues each year, governments in Canada had to borrow increasingly larger sums of money in order to finance their spending programs. This practice had an adverse effect on interest rates because, in order to secure the needed funds, governments had to offer attractive rates of interest. In addition, as annual deficits grew, the proportion of government spending required to make interest payments on the total accumulated debt continued to climb. Critics of deficit budgeting also linked inflation (general price increases) to unrealistic levels of

government spending. Advocates of deficit budgeting were quick to point out that, as the Canadian economy continued to grow, the accumulated public debt would remain manageable and slowly lose significance relative to the volume of national production. For many Canadians, this was seen as a reasonable price to pay for Canada's social welfare safety net.

By 1996, the accumulated public debt in Canada had once again become a significant portion of Gross National Production. The interest being paid to carry the public debt burden consumed close to one of every four dollars spent by government. Government spending was scaled back considerably in order to reduce deficits and begin the process of slowly repaying the accumulated public debt. Many Canadians remain convinced that increasing public debt in order to fund social programs, as was the case during the second half of the 20th century, may no longer be a viable option.

Check Your

Understanding

1. Which of the following principles of taxation is the most fair—ability to pay or benefits received? Explain. Which principle is the easiest to implement? Explain.
2. For each of the five types of taxes collected by governments in Canada, determine whether each is an example of direct or indirect taxation and whether each is a progressive or a regressive tax.
3. Use supply and demand graphs to explain how the elasticity of demand helps to determine the effect of an indirect tax on the market price and on consumption.
4. List the economic and political advantages and disadvantages of using each of the following methods to increase government revenues: personal income taxes, corporate income taxes, gasoline excise taxes, tobacco excise taxes, and consumption/sales taxes.
5. List and explain the tax reforms introduced since 1990. Explain the effect of the GST on the ability of Canadian firms to compete in global markets.